2017: smaller public deficit, revenues and spending both up

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Next year the public accounts will once again present an imbalance, and public sector debt will remain stuck at around 100% of GDP. Looking ahead to 2017, the expected increase in corporate taxation will help to reduce the public deficit, but it will have short- and medium-term costs.

In 2016 the public sector deficit is estimated to have fallen by about 0.5% of GDP, despite GDP growth of more than 3%. Analysts' consensus for next year points to lower GDP growth of around 2.5%, and yet the government's objective is to reduce the public deficit from around 4.5% to 3.1% of GDP. In other words it aims to reduce the imbalance in the public accounts by three times as much as it did in 2016, with lower GDP growth. Is this possible?

In principle, the increased dynamism of economic activity should be enough to achieve the target set. For example, nominal GDP is expected to increase by around 4.5%. Public spending for 2016 is expected to come in at around 42.5% of GDP. Freezing this numerator would reduce the ratio by 1.8 percentage points of GDP. In other words next year's objective would be achieved just by freezing public spending. What is more, the improvement in activity is expected to reduce unemployment benefits and low interest rates should bring down public sector financial costs. These last two factors, plus the growth in nominal GDP would give a margin of more than two percentage points of GDP. And all this without taking account of the possible effect of measures to improve public spending efficiency.

However it is equally true that some other obligations will continue to increase. In particular, pensions and healthcare costs show increasing trends, so it will be difficult to freeze these items. Moreover, spending would ideally be maintained in real terms so as to avoid any deterioration in the quality of public services. Although inflation will probably be close to 2% in 2017, this increase will be largely due to the expected increase in the price of fuels. A better guide to the possible change in the cost of public services would be the changes in core inflation or in the trend (excluding volatile components), which will continue at around 1%. If instead of a freeze on public spending in nominal terms we assume an increase of this magnitude (1%), the reduction in the deficit (of around 1.5 pp of GDP) would still be enough to achieve the target.

Therefore, the tax increase recently announced by the government is aimed at financing greater growth in public spending, rather than at reducing the deficit by more. This decision may reflect the preferences of a society that perceives the need to increase the resources dedicated to public services following a period of cuts. However account must be taken of the costs that this entails.

In the first place, public debt remains very high. Neither the all-time low interest rates nor the high rate of growth that we are currently seeing will continue in the next few years. Therefore failure to take advantage of this particularly positive time to reduce indebtedness might make future adjustment slower and more difficult.

Secondly, the tax increase will have negative effects in the medium and long term. In the short term, the impact will probably be limited, since it will be concentrated in the major corporates, those with easier access to financial markets, and in an environment of low interest rates. However, the increased tax uncertainty perceived by businesses in the past few months will reduce investment and medium-term growth.

Lastly, it is not currently possible to assess the positive effect that increased spending might have. What is clear is that the big winners will be the governments of the autonomous regions, which will barely have to reduce their deficits in terms of GDP, in an environment in which revenue will increase in line with activity, so that spending will increase by considerably more than the inflation rate. How they will distribute these increased resources, how efficiently they will be used and their effect on growth are all open questions at the moment.

Going forward, it is important that there be general understanding and acceptance of the fact that reduction of public debt is necessary in order to reduce the vulnerability of the Spanish economy. In this regard we should like to see the implementation of multi-annual plans, preferably based on the design of reforms that increase the growth capacity of the economy.