Notes on the 2017 State budget

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The State budget includes conservative macroeconomic forecasts. In scenarios with greater growth and inflation than forecast, expenditure as a percentage of GDP could fall by more than expected. As always, the uncertainty is around tax revenues. The measures taken in previous years hide the fact that corporation tax is historically volatile and pro-cyclical, so although the State's forecasts seem somewhat optimistic, they are not improbable.

In the forecasts for the General State Budget, the Government has an advantage, since the budget includes very conservative forecasts for both growth and inflation. This week's figures for social security sign-ons make it more likely that the real change in GDP will end up being 3.0% in 2017, half a point more than forecast in the State budget. Also, prices of domestic products will probably increase by half a point more than announced. In other words the accounts presented have been drawn up on the basis of nominal GDP growth one point lower than what we shall probably see. This factor will make it easier to attain the spending target as a percentage of GDP. To put it another way, if all the government bodies comply with the budget, a 1 pp excess in the denominator over the forecast figure will mean that spending as a percentage of GDP will be 0.4 pp less than forecast at the end of 2017. This gives room for manoeuvre in case revenues do not perform as expected. Unlike spending, most of which is independent of the economic cycle, there is greater uncertainty inherent in tax revenue. In any case, here too there are a few things to take into account. For example, this year the measures implemented should boost public revenue, not reduce it as they did in 2015 and 2016. In particular, we estimate that the policies put in place in the past two years will have structurally reduced revenue from direct taxation (personal income tax and corporation tax) by 2.5 pp of GDP. In fact, had it not been for these policies, we calculate that direct taxation revenue would have increased by 1.5 pp of GDP over the two-year period, which together with the efforts made to curb spending would have been enough to attain the deficit target in 2016. This year two factors will cause revenue to increase. On the one hand, the elimination of deductions from corporation tax announced at the end of last year. On the other, the economic recovery and, again, the conservative macroeconomic forecasts. Historically, the reaction of tax revenue has been more than proportional to the increase in nominal GDP. For the forecast corporation tax revenue to be achieved, in the first place the scenario of greater growth and inflation described above would have to materialise. In the second place, for each pint of growth in nominal GDP, tax revenue would have to increase by 2.5%. Although rather optimistic, this seems credible, given the high degree of volatility and pro-cyclicality shown by this item of public revenue.

The remainder of the forecasts, on revenue from other taxes such as VAT and personal income tax require less sensitivity to the economic cycle: for every 1% increase in nominal GDP, and again assuming that he likely scenario is that of greater growth and inflation, public revenues should increase by between 1.5% and 2.0%. Once again these values are in the optimistic part of the range of available estimates made by bodies such as the OECD and the European Commission, but they are credible.

As we have seen in the past, tax revenue can produce surprises, and it is not advisable to over-rely on it for attaining deficit targets. This implies that in order to ensure the necessary reduction in the imbalance of the public accounts it will be necessary one again to strictly monitor spending targets. If the forecasts for growth and inflation some true, this would already provide a margin to cover possible shortfalls in the revenue forecasts. Looking ahead, there is a need for tax reform to promote greater efficiency and a change in the productive model. Beyond that, the best way to reduce the deficit would be by means of an ambitious programme of reforms that would reduce the structural unemployment rate.