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Budgetary stability and reforms: lessons from the crisis and challenges pending

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All the signs are that in the next few days Congress will give its definitive approval to the General State Budget for 2017 following intense debate. The pace and make-up of fiscal consolidation and the fiscal policy options have again been subjected to multiple amendments. Ten years after the onset of the international financial crisis it is well to remember that the recession and the expansive fiscal policies applied increased the public deficit to 11.2% of GDP in 2009 and that 27 of every 100 euros of public spending were financed by debt. If the forecasts of the Budgets are met, public debt will be 98.8% of GDP in 2017 and the deficit will be 3.1%. A reduction of eight percentage points in as many years.

This pace of reduction has been fairly gradual, and at the same time as slow as the financial markets have allowed. Thus the conclusions of a recent study of BBVA Research are fulfilled. The aim has been to strike the difficult balance between harming employment and economic growth as little as possible in the short term and maintaining the credibility of the objective of budgetary stability. Reducing the deficit by means of reductions in public spending and increases in taxes has costs in terms of activity. But the cost of not reducing it would have been much greater. In fact, between 2009 and 2011 the public accounts were on the very brink of becoming unsustainable, with growing risk premiums which accelerated the dynamic of a self-fulfilling prophesy. Moreover, the interaction of sovereign and bank risks led to a vicious circle from which it was impossible to escape without applying fiscal consolidation. While the process of private sector deleveraging was in full swing, not reducing risk premiums from the second half of 2012 to their present levels (thanks also to the ECB's measures) would have been fatal to Spanish businesses and households. And it would also have impeded the intense recovery that we have been experiencing since the end of 2013.

Contrary to the opinion of those who mistakenly describe this slow fiscal adjustment as "austericide", the fact is that the fiscal adjustment has basically been a partial reversal of the fiscal stimulus measures applied in 2008 and 2009. In fact, real per capita public spending in 2016 was 6% more than its pre-crisis level, while public revenues remained 10% lower than the 2007 level. As a result of this slow process of fiscal consolidation there has also been an increase in public debt, which has not come without cost. According to our estimates, the long-term costs of stabilising debt at much higher levels than before the crisis (more than 65 percentage points of GDP) are considerable. On average, they equate to 5.5 pp less GDP, 6.7 pp less private investment and 3.1 pp less employment.

To reduce these costs in terms of growth and activity, lighten the burden on the younger generations and gain the necessary fiscal space with which to confront futures crises, we need to reduce public debt. So what is the best way of doing so? Undoubtedly with reforms that increase growth and boost the income from which to collect taxes. According to our estimates, a permanent reduction of 8 pp in the unemployment rate would lead to an equally permanent improvement in the budget balance of 6 pp of GDP. Obviously, reducing the unemployment rate is no easy task. Quite apart from economic policy restrictions, unemployment cannot be slashed overnight but only gradually by means of a wide range of measures. But the benefits are worth the effort. A permanent reduction in unemployment of that magnitude, as well as especially benefiting the least favoured segments of the labour market and reducing inequality, would boost GDP and per capita public spending by more than 20%, while the tax pressure could fall by five percentage points.

In short, Spain needs to continue widening its fiscal margin, ensuring a primary budget surplus (which is not foreseen before 2018) and gradually reducing public debt. The best way to attain these objectives is through reforms that improve the tax structure (for example, a fiscal devaluation), reduce structural employment and temporary employment and increase aggregate productivity. These increases in productivity must also be contributed to by more efficient public services, which should take advantage of the opportunities deriving from the process of technological and digital transformation that is under way to close the gap with countries at the forefront of public sector efficiency. More than a fiscal policy option, this represents a necessity, if we wish to see the Spanish economy return to the path of a convergence toward the levels of prosperity and well-being experienced in the most advanced societies.

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