8. Spain facing the global financial crisis: cutting public spending and struggling with structural reforms

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The impact of the global financial crisis (GFC) in Spain was far stronger and more prolonged than ever anticipated. The risk of public debt default still imposes immense pressures for fiscal consolidation on the national budget and for the immediate adoption of structural reforms to Spain's economic, financial and fiscal systems. As with the reaction of most European Union (EU) countries to the crisis, the then Spanish Socialist government first applied an expansive fiscal intervention to avoid financial and economic collapse, and then undertook a series of medium-term fiscal consolidation plans to tackle the quick deterioration of public finances. By 2010 Spain had imposed one of the largest austerity packages in absolute terms of any Organisation for Economic Co-operation and Development (OECD) country. Yet, recovery remained slow and highly uncertain. Since 20 November 2011, the new Popular Party (PP) right-wing government has declared its full commitment to comply with EU fiscal stability targets. And indeed it has started to take further austerity measures and to prepare fiscal legislative reforms as required by the recently amended Article 135 of the Spanish Constitution.

The issues at stake here are: What types of fiscal measures were undertaken? Were they sufficient as a response to the GFC and, if not, why not? What were the longer-term effects? What relevant knowledge can be gained and recommended from Spanish mistakes and achievements? What adaptations have taken place in budget systems? This chapter first provides an overview of the main effects of the GFC on the Spanish economy and its public finances, and on the government reactions to these impacts. Then, particular attention is turned to the fiscal consequences and budgetary adaptations made as a result of the GFC. The final section presents an overall assessment of the impact of the GFC on Spain and offers some further suggestions for improvements. But before starting, it is important to review some relevant background and contextual information.

THE 'GOOD EUROPEAN': BOOM TIMES BEFORE THE CRISIS

Prior to the 1980s Spain had a relatively small public sector by international standards (around 25 percent of gross domestic product, GDP). Public budgeting was largely revenue-driven (Gunther 1980), but revenues were dependent on a weak tax system based on income sources rather than an integral tax on personal and company incomes. However, during the second half of the 1980s through to the beginning of the 1990s the volume of resources managed by the public sector almost doubled from 25 to 45 percent of GDP. These profound changes in public finances were brought about by exponential social and demographic demands, the consequences of political decentralization, and a particular sanction in the Spanish Constitution (1978). The combined effect of these forces created budgetary stress even before the GFC appeared.

The economic crisis of 1993 hit the Spanish public sector hard. Previous assumptions about the levels of economic growth prior to this crisis soon proved overly optimistic. Decentralized new regional governments faced problems in meeting the increasing community demands for public services in areas under their responsibility, such as education and health. The inevitable result was increasing deficits and a growing burden of public debt at both regional and local levels. After 1994, following pressures from the Economic and Monetary Union (EMU) setting clear conditions for membership, successive Spanish governments made serious efforts toward achieving and maintaining fiscal stability (Ballart and Zapico 2010).

Partially due to EU funds for structural development and to the economic policies that followed from the mid-1990s to 2007, the Spanish economy enjoyed a prolonged period of growth similar to many other EMU countries (Cuerpo and Kessler 2011). Hence, the domestic economic situation before the crisis was buoyant. The Spanish economy grew at an annual average of 3.6 percent of GDP between 1997 and 2007, creating more employment and producing a sound fiscal position. Up to 2007 Spain was considered to be a 'good European'. The integration into the eurozone (EMU) brought with it beneficial short to medium-term advantages for Spain (such as improved fiscal discipline), but it also had long-term undesired effects. A rapid increase in internal demand (especially with real estate, tourism, cars and noticeable consumption) was fuelled by an EMU low interest rate policy causing high levels of private sector indebtedness for apparently endless profitable undertakings. Extended greediness provoked market bubbles, particularly in the real estate sector. Moreover, revenue increases, along with disciplinary rules over expenditure, made it possible to achieve an almost balanced budget in the year 2000 and annual budgetary surpluses from 2005 to 2007. European pressure at the time reinforced a top-down discipline over the aggregate budget. Initially, the rightist government of the Popular Party under President José M. Aznar (1996–2004) and then the Socialist Party under José L. Rodriguez Zapatero (2004–2011) prepared tough fiscal legislation enshrining the main requirements of the European Stability and Growth Pact of 2005.

Both the Popular and Socialist governments became convinced that establishing fiscal rules in statutory law approved by the parliament was the best way of imposing budget discipline across the system and avoiding the tendency of present or future political authorities to resort to uncontrolled public spending. However, at the onset of the financial crisis in 2008 and its immediate impact, the efficacy of this tough and detailed fiscal legislation was rather limited. As with other countries, the Spanish government responded urgently to these external shocks with budgetary injections, discarding (temporarily) the previous policy of stringency budgeting. Most European countries applied expansionary measures followed by the implementation of fiscal consolidation plans. After the amendment of the Stability and Growth Pact in 2005, exceptional cases of a severe reduction in economic activity could be accepted as a justification for amassing public deficits beyond the limits established by the EU (Ballart and Zapico 2010). Hence, budgetary discipline was not guaranteed simply by reinforcing the strictness of legislative regulation over the budget, or by intentions to comply with EU limits on spending. Rules and norms can control budget figures but not necessarily socio-economic behavior.

POSTPONEMENT OF LONG-STANDING AND CONFLICTIVE STRUCTURAL REFORMS

The good times were not used for tackling and coping with ever-present structural problems. Solutions were postponed again and again by successive governments of different affiliations. Examples of these structural problems were: low competitiveness and productivity (labor market rigidity, high fiscal and social burdens); an external trade deficit; high dependence on external energy; huge private indebtedness of households and corporations; a real estate sector with a bubble of about 700000 unsold houses, most of them owned by banks; an informal economy estimated by experts as representing in 2008 between 20 and 23.7 percent of GDP and involving 2 million hidden jobs (Arrazola et al. 2011); weak and inefficient public services; a public sector structural deficit in 2007 of around 3 percent of GDP; ill-defined intergovernmental fiscal coordination; and low awareness or consciousness of co-responsibility among sub-central governments.

Most of these problems required sizeable structural reforms affecting powerful and privileged groups and, thus, requiring considerable political strength. Yet Spain's governments have been anything but strong. The GFC and its fiscal consequences further disclosed the political weaknesses of Spanish governments to manage conflict and change. The post-fascist democratic regime with a bicameral legislature has thus far produced a rotation of government between two parties: the Spanish Socialist Workers' Party (PSOE) and the right-wing Popular Party (PP). Both parties have ruled from a relatively weak de facto position, dependent on parliamentary agreements with Nationalist parties, leaving them unable to address complex and conflictive problems. After eight years in power, more than three of which have been under the GFC, the image and capacity of the then Socialist President Zapatero became greatly undermined. The political situation became bipolar and dysfunctional with a weak central government and a persistent non-collaborative attitude from the opposition (including over response to the economic crisis).

Furthermore, Spain has a quasi-federal system in which all levels of government contribute substantially to public spending. The central government accounts for 50 percent of total public spending (including social security), while regional governments commit a further 36 percent, and municipalities another 14 percent (Lopez-Laborda 2011). During the crisis the Socialist central government was forced to share power with many regional and local governments ruled by the right-wing party. After the local and regional elections of May 2011, almost all sub-central governments were governed by right-wing authorities. The general election of November 2011 evicted the Socialists and installed the right-wing PP under President Mariano Rajoy with sufficient overall majority in the legislature. Going forward, this might facilitate better intergovernmental coordination, and eventually fiscal discipline at the regional level. The budget for 2012 was presented by the new government by March. However, fiscal uncertainty still remains.

THE INITIAL IMPACT OF THE GFC AND EMERGENCY REACTIONS, 2008–09

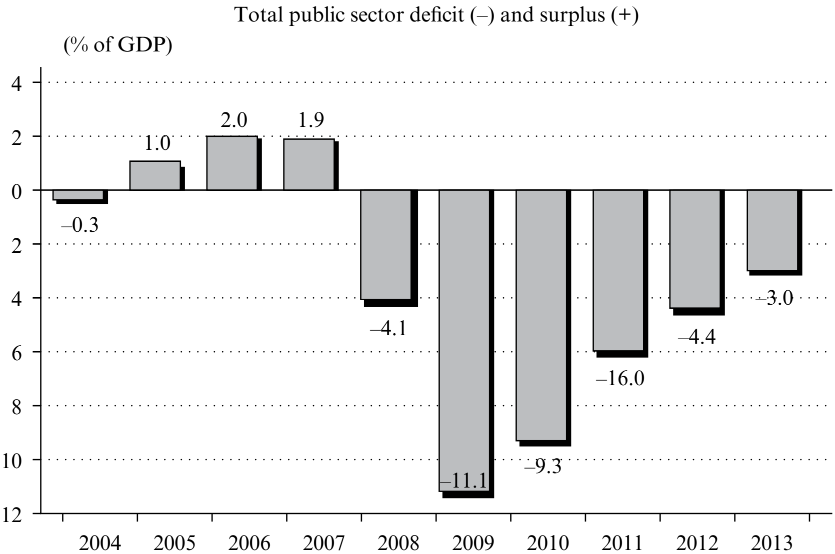
The immediate effects of the GFC created a credit freeze leading to serious difficulties for refinancing private debt. Following pressures on the banking sector, the Spanish government undertook rescue measures designed to avoid the collapse of the financial system, for example, bank guarantees for refinancing debt, raising the limit of individual accounts and deposit guarantees, the creation of a special fund, the Fondo de Restructuración y Ordenación Bancaria (Fund for Orderly Bank Restructuring, FROB) to assist banks with their restructuring processes such as internal restructuring, mergers, and so on. However, this was merely the start of a long road to recovery. Government financial support to the banking system did not flow towards businesses and families, since the measures adopted provided insufficient guarantees for banks to lend money. The problem was more than financial.

Uncertainty over the scope and dimensions of the GFC along with a collapse in confidence in the economy caused a sharp fall in demand (a drop of 5 percent of GDP in 2007–08) similar to the experience of other members of the EU (MEF 2011). In Spain the decline in economic activity was particularly drastic in the previously booming housing sector. Unemployment increased by an additional 2 million from 2007 to 2009, bringing the total jobless figure to 20 percent of the active population, the highest percentage in the EU. Moreover, one of the immediate consequences of the GFC was a sharp deterioration in public finances, leading to a fall of 13 points of GDP in the budget balance between 2007 and 2009.

Spain had appeared fiscally sound in 2007, with a nominal budget surplus of 1.9 percent of GDP (even though some estimates put the budget in structural deficit to the tune of 3 percent GDP) and a moderate public debt level of 37.5 percent of GDP. However, not surprisingly for experts in the field, these advantages quickly vanished as the crisis took hold and emergency measures were required. The deterioration of public sector finances was quick and sharp: the budget went from a nominal surplus of 1.9 percent in 2007 to a surprising 11.1 percent deficit in 2009. The level of public debt increased from about 37 percent in 2007 to 63 percent in 2010 and was further expected to reach 69 percent at the end of 2011 (MEF 2011) (see Figure 8.1).

The Government's First Reaction: Emergency Fiscal Expansion

Growing pressures from financial markets and suggestions from the G20 and international oversight organizations – the EU and International Monetary Fund (IMF) – were essential drivers influencing the timing, shape and composition of the government's reactions. An urgent series of top-down packages were undertaken sequentially and reactively. Spain responded, without much time for analysis, to the emergency EU coordinated Plan for Economic Recovery (2008). New measures were added or previous ones adjusted as these proved inadequate or were perceived as



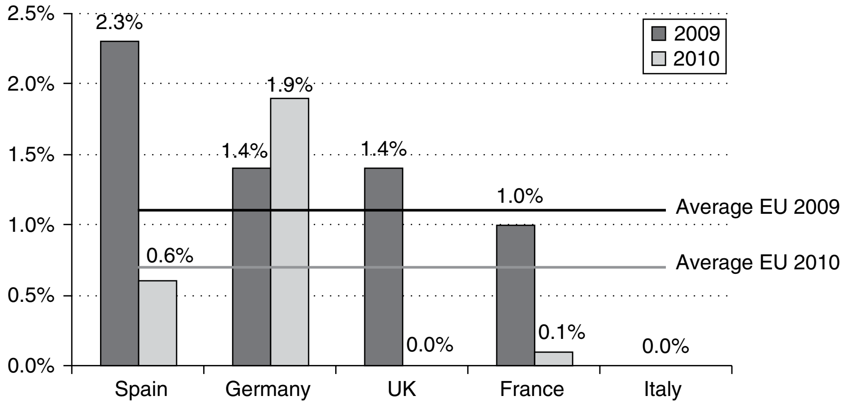
Source: MEF (2011).

Figure 8.1 The direct fiscal impact on the budget balance and public debt of the GFC

insufficient for tackling the successive waves of disturbing news, such as further deteriorations in the economy, financial market pressure across Europe, geopolitical conflicts and energy crises. Participation from domestic stakeholders in these packages took place through formal channels – for example, parliament, the Council of Fiscal and Financial Policy (Consejo de Politica Fiscal y Financiera, CFFP), the Spanish Federation of Municipalities and Provinces, and other social partners – and via informal meetings with the government, for example, special meetings between the President and bankers, the largest entrepreneurs and leaders of the trade unions.

The initial effort of government was relatively large compared to other EU initiatives. In 2009, the stimulus measures amounted to 2.3 percent of GDP, more than double the EU average of 1.1 percent (Vallés-Liberal and Monzó-Torrecillas 2011). The estimated stimulus spending for 2010 was expected to fall back to 0.6 percent of GDP but these estimates were made before important additional measures were announced subsequently by government (see Figure 8.2).

As with other countries in the region, Spain's initial response was to implement some quick expansionary fiscal measures amounting to



Source: Vallés-Liberal and Monzó-Torrecillas (2011: 21).

Figure 8.2 The magnitude of the fiscal stimulus in the main European Union member states (% GDP)

€25 billion. On the expenditure side, the Plan Español para el Estímulo de la Economía y el Empleo (Spanish Plan for Stimulating the Economy and Employment or 'Plan E') was launched and financed by the central government, but implemented through local governments. It included a long list of small or medium-sized investment projects, easy to initiate and manage, and oriented toward the employment of the jobless rather than large investments and equipment acquisition. The initiatives were essentially a long list of low-productivity projects with high overall cost.

On the revenue side, the main response measures saw the introduction of a €400 deduction in personal income tax delivered in conjunction with several other small bonuses and subsidies (for example, the 'baby check', a car renovation plan). These measures were small and generally oriented to all citizens, but not necessarily to those prone to consuming or groups especially affected by the crisis, meaning that the multiplier effect of the initiatives was not optimized (Uxó et al. 2010).

INITIATING A LONG AND PAINFUL PROCESS TOWARD FISCAL CONSOLIDATION FROM 2010

Following recommendations from the Council of the EU given on 30 November 2009, the Spanish government approved in January 2010 a strict Stability and Growth Program 2009–13 aimed at achieving fiscal consolidation by the end of the period projected. However, later in the year, after the first Greek crisis of May 2010, further extraordinary austerity measures were taken to respond to financial market pressures. Additional economic recovery overall measures contained in the Economic Stability Strategy (ESS) were designed in 2010, and legislated in March 2011 in the Sustainable Economic Law (see below). This section provides an overview of these three initiatives and related instruments.

Updating the Stability and Growth Program 2009–13

The announced targets of the Stability and Growth Program 2009–13 included reducing the public deficit from 9.2 percent of GDP in 2010 to 3 percent in 2013, and containing the size of public debt to below 70 percent of GDP, thereby anticipating an increase of about 15 percent in debt from 53.4 percent of GDP in 2010 to 69 percent in 2013. The consolidation effort from the spending side (reductions) was estimated to total some €65 billion and from the revenue side (increases) around €6 billion. This program was presented along with national plans for reforms which provide information on sector policy initiatives envisaged as necessary to achieve the objectives (see Table 8.1).

The main instruments supporting figures of the Stability and Growth Program were the Plan of Immediate Action, the Austerity Plan for Central Government Spending 2010–13 and the Framework Agreements between Central and Regional Governments.

The Immediate Action Plan imposed budgetary cuts of €5 billion. It cut the operating costs of ministries (totaling €3.5 billion) and reduced the Budget Contingency Fund by €1.5 billion. Furthermore, this plan included the elimination or postponement (without further date) of a selected number of non-priority capital investment projects. It also proposed to reduce the level of public employment by imposing a replacement rate of only 10 percent of staff retiring and preventing any recruitment of

Table 8.1 Stability and Growth Program 2010–13

% GDP	2009	2010	2011	2012	2013
Estimated GDP growth	−3.7	−0.1	1.3	2.3	2.4
Public deficit (excluding interest)	−11.1	−9.2	−6.6	−4.4	−3.0
Public debt	53.3	60.1	67.3	68.5	69.3
Public debt % change on previous year	13.4	6.9	7.1	1.2	0.8

Source: MEF (2010).

'interim' personnel (temporary personnel who are neither civil servants nor labor contract staff).

The Austerity Plan for Central Government Spending 2010–13 proposed a further general cut of €50 billion over four years. Annual austerity cuts were to be specified in each of the forthcoming budgets to 2013. The implementation of the first round of this austerity plan resulted in a tough spending review and severe cuts to all budget items amounting to €23 billion, with only selected priorities exempted. The plan included new budget rules for achieving fiscal consolidation, including that new spending initiatives would only be financed if targets were already achieved (that is, applying the 'pay-as-you-go' rule), any unexpected revenue gains had to be allocated to deficit reduction, and if necessary further cuts would be applied to achieve the objectives. The effort on the revenue side was more limited. The fiscal stimulus measures adopted in 2008 and worth collectively around €4.1 billion were withdrawn (that is, the €400 fixed personal income tax concession, €2500 'baby check' and house acquisition financial aid); tax increases were imposed on high-income taxpayers and on the saving tax rate raising €400 million; a cut of five points in the corporate tax rate was made for small and medium-sized enterprises meeting certain minimum criteria; an increase of two points in the VAT tax rate was made, and one point for basic goods, raising an estimated €1.9 billion; and an increase in oil and tobacco taxes was announced.

The Framework Agreements between Central and Regional Governments were used to implement the principle of co-responsibility vis-à-vis public sector fiscal discipline. These agreements were discussed and approved by the CFFP, which stipulated both regional government financial arrangements and budget discipline scenarios. Framework Agreements were aimed at achieving budget consolidation at the regional level consistent with the projections presented in the Spanish Stability and Growth Pact presented to the EU. The deficits and debt levels of regional and local governments had already been worrying in 2008–09. Yet, the fiscal scenarios for budget discipline approved by the council were not, as a rule, very credible. This was due to several reasons: the lack of effective monitoring systems, the lack of rewards or sanctions, and little control over debt burdens (Arellano et al. 2011). In June 2010, the main Framework Agreement was strengthened with additional deficit and debt reductions for regional governments and new budget procedures (see below).

Extraordinary Cutting Measures

A further deterioration in the economic situation in the first half of 2010 (alongside the first Greek crisis) saw reinforced pressures emerge from the EU on member states, especially the Southern peripheral countries. Continued uncertainty in the financial markets and volatility in the cost of servicing Spanish public debt forced the Spanish government to propose additional austerity measures. A new wave of extraordinary budget cuts totaling €15 billion were imposed across all levels of government: civil servants' wages were reduced by 5 percent, pensions were frozen for the year 2011, and pharmaceutical spending was reduced. Many of these subsequent measures affected social rights, but some compensatory fiscal supports were allowed to preserve or improve the rights of specific groups (for example, the long-term unemployed).

Again, these additional austerity measures in 2010 were top-down urgent decisions presented sequentially and reacting to a range of market pressures, emergency EU agreements and recovery plans. Little time was available for systematic analysis of the expected results. Measures were augmented as they proved or were perceived to be insufficient for tackling successive disturbing news in the deteriorating economy.

Experts considered that the Stability and Growth Pact 2010–13 was based on optimistic economic growth estimations for this period. One assumption was that the deficit would be reduced to just 6.6 percent of GDP in 2011. Furthermore, the announced cuts or tax increases were not based on substantial reforms to reduce the structural deficit. Fiscal adjustments were mainly based on the spending side of the budget with a generic proposal of €50 billion in reduced spending. Tools and methods were not sufficiently explained. Some measures were contrary to the left-wing government's ideology and electoral program, although specific measures were taken to compensate specially affected groups.

It was not easy to quantify the specific impacts of the austerity measures announced in 2010. The diversity of measures and the annual cumulative effects made precise calculations difficult. But overall the achievement of the 2010 fiscal objective (reducing the deficit to 9.4 percent GDP or just 0.2 percent higher than the declared target) was a positive signal and tended to validate the government's strategy. However, approximately 7.8 points of the deficit remained structural (Valle 2010). The Socialist government had reduced the speculative pressure on financial markets and announced its fiscal commitments through to 2014, with annual spending increases of 6 percent in 2011, 4.4 percent in 2012, 3 percent in 2013, and 2.3 percent in 2014.

Efforts Toward Fiscal Consolidation

During 2011 the government continued its fiscal consolidation efforts. A new Stability and Growth Program 2011–14 was approved, extending and

Table 8.2 Budget balance as percentage of GDP (excluded debt interest)

Budget entity	2010	2011	2012	2013	2014
Central government	−5.7	−4.8	−3.2	−2.1	−1.5
Regional governments	−2.8	−1.3	−1.3	−1.1	−1.0
Local governments	−0.5	−0.3	−0.3	−0.2	0.0
Social security	−0.2	+0.4	+0.4	+0.4	+0.4
Total	−9.2	−6.0	−4.4	−3.0	−2.1

Source: Council of Ministers Agreement of 24 June 2011.

adapting fiscal discipline figures of the previous plan. To date, this is one of the most ambitious consolidation plans in the eurozone. In June 2011 the public sector deficit target for 2011 was 6 percent of GDP falling to 2.1 percent by 2014. The country aimed to get its deficit below the EMU three percent level by 2013, meaning it would begin debt reduction in earnest from 2014, gradually reducing debt from estimated 69 percent GDP in that year (see Table 8.2). Hence, the main effect of the fiscal measures undertaken in 2010 was expected to cumulate during the period 2011–14. Further spending cuts introduced in the central government budget for 2011 and the projected cyclical effect were expected to allow the achievement of public deficit targets set up to 2014. Following the 2011 elections, the Minister of Economy and Competitiveness of the new Spanish government has recently ratified the government's commitment to reduce the deficit to 4.4 percent in 2012 (*El Pais* 24 January 2012).

In the second year of the Austerity Plan for Central Government Spending 2010–13, the government imposed cuts that were selected so as not to damage productivity and social welfare. It cut administrative personnel costs by 2.1 percent; introduced efficiency measures saving 6.7 percent, including reduced orders for goods and services; cut current transfers by 8 percent; reduced investment capital transfers by 38 percent; and reduced infrastructure investment by 22.4 percent. Nevertheless, the budget share of education, and research and development, were maintained.

This revised plan was based on two optimistic assumptions: that increases in economic growth rates would occur, and that regional governments would comply in achieving their fiscal targets. Official projections of GDP were based on an average annual rate increase of 2.4 percent, which was overestimated by about 0.6 percent compared with other international and domestic calculations, putting GDP at 1.8 percent. The IMF predicted a deficit for 2014 of nearly 4 percent of GDP, which implied that to achieve the desired fiscal targets further cuts to wages and investments, and increases in the VAT and excise rates, would be necessary (IMF 2011).

More austerity measures could still be necessary if financial costs, running at around 20 percent of GDP, keep growing due to financial market pressures or if the economic situation further deteriorated. Both the President and the Ministry of Economy and Finance (MEF) agreed that the government would take such steps if these risks materialized. But the solution of further austerity remains complex in the current situation. Speculative pressures from financial markets in Spain, Italy and Greece threatened a much worse scenario for the eurozone. Serious concerns about a second recession have also risen. And in Spain some experts started arguing that future economic growth would be inhibited if the economy was further burdened by excessive, overly concentrated and short-term austerity measures (Ontiveros 2011; Casais 2011). Spain's troubles during 2011 were not helped by the long duration of the pre-electoral political blockages, in which a weakened Socialist government led by a 'lame duck' president was incapable of taking drastic actions to address the structural problems of the economy.

Furthermore, fiscal indiscipline by the regional governments became apparent after the May 2011 local elections. The MEF warned regional governments falling into fiscal difficulties that there would be no further approvals of increased debt levels until they presented a credible fiscal recovery plan to reduce their own deficits from 2.8 percent in 2010 to 1.3 percent in 2011. Most regional governments have recovery plans approved by the CFFP. Yet, in 2011, total regional government spending increased by 5.4 percent while revenues decreased by 2.23 percent over the year. The most recent Framework Agreements introduced new debt authorization procedures requiring improved information and reposting systems. Transfers of revenues to regional and local governments were now conditional on proper budget reporting. Moreover, due to the change of regional governments at the May 2011 elections, there was serious pressure from incoming right-wing governments for full accounting disclosures.

BEYOND FISCAL CONSOLIDATION: SEARCHING FOR ECONOMIC SUSTAINABILITY

The related Economic Stability Strategy (ESS) of 2010 identified an ambitious, long-term set of structural reforms prepared in the context of the Europe 2020 Strategy. Many of them had been claimed for years. The ESS included a long list of legal and administrative measures oriented towards counter-cyclical economic recovery and structural reforms to produce a more sustainable economic future. It prescribed reforms needed in order to advance towards a more productive and competitive economy. The main reform agenda included: restructuring the financial system; fighting the informal economy; the promotion of innovation and competitiveness; devising a sustainable energy model; reform of the labor market and pensions; and the modernization of administration. These objectives were supported by declared targets and selected performance indicators through to 2020; and as the ESS evolves its ambitions can be updated and enhanced as the situation becomes clearer or the context changes. Its objectives and indicators coincided with the EU's overall Stability and Growth Pact (committing to deficits of less than 3 percent of GDP) and were able to be updated in Spain's Stability and Growth Programmes. It also established the overarching aim of reducing the relative size of regional government debt to that of the central government (MEF 2009).

Most of the ESS initiatives were reflected in the Sustainable Economy Law, drafted in 2010 and approved after some delay in March 2011. The law was equally ambitious, covering multiple domains: the need for better regulation and transparency; for better evaluation and greater independence of regulators; financial sector reform; and new rules, measures and incentives for fiscal sustainability and austerity plans at all levels of government. The law also mandated follow-up and reporting conditions, and participatory and evaluation arrangements of the implementation of the ESS.

Some initial negative opinions criticized the Sustainable Economic Law for being an incomplete disarray of casuistic measures (Valle 2010). However, a macroeconomic analysis (the Rational Expectation Models for Spain using a dynamic general equilibrium approach) claimed that the main measures of the law had potential impact in terms of their influence on productivity factors. These authors argued:

> The orientation of the set of policy changes . . . (envisaged by the Sustainable Economic Law), creates the right incentives to move towards a more intensive knowledge and innovation economy, to raise potential GDP of the economy through mainly increases in productivity . . . The impulses of productivity related to the fulfillment of the objectives are relevant and would be compatible with progress, although moderate in employment. (Cuerpo and Kessler 2011)

However, they also added that this estimated impact would only materialize if the law's objectives were attained expeditiously. Supporting legislation and reform agreements were supposed to be ready before the dissolution of parliament in late 2011, but several of these reforms were not produced. Progress was also delayed by the change of government at the general elections of November 2011. Hence, parts of the reform agenda have been initiated, but advances in the difficult structural reform areas (for example, labor market reform or financial reform) have so far produced only limited and diffused results (Pimentel 2011). One reason for this is that some of the law's objectives affect some highly conflictive policy arenas and the prerogatives of powerful vested interests in society; many of these structural issues appeared to be characterized by lasting unresolved conflicts.

ADAPTATION OF BUDGET NORMS, INSTITUTIONS AND PROCEDURES

The Budget Normative Framework

There was no substantial change in the central government's budget norms and procedures as a result of its response to the crisis. The current legal-budgetary framework was configured early in the previous decade, through the General Stability Budget Law (2001) and its complementary Organic Budget Law (2001). National fiscal legislation already enshrined the main conditions required under EU agreements such as the preparation of fiscal scenarios, setting stability targets and non-financial spending limits for government. However, at the end of the previous parliament (September 2011), the Socialist government and the opposition agreed to reform the Spanish Constitution to incorporate explicit reference to budget discipline measures (see below).

Following the EU's Stability and Growth Pact (2005), Spain's legal framework was adapted in 2006 and 2007, seeking more flexibility in the application of the EU's deficit rule, considering that the original definition of 'stability' was excessively rigid and framed on the year rather than the economic cycle. New stability legislation stipulated the obligation for governments to budget for a surplus when economic circumstances were favorable, while allowing the possibility of incurring a deficit during the low points of the economic cycle with the aim of achieving an average position of equilibrium (Gil-Ruiz and Iglesias 2007). Moreover, it was also felt necessary that regional governments had to participate in the discussion of the general budget framework as they were also responsible for the final budgetary results of the whole country. The conformation of this legal framework of fiscal legislation was followed by a period of fiscal discipline between 2001 and 2007, although this was mainly due to the economic expansion during the same period (Fernández and Monasterio 2010).

After the GFC there were no changes to this legal framework. Instead, internal efforts were made to enhance the application of fiscal discipline and reinforce the application of budget norms and principles. For instance, government plans and declarations have insisted on the need for evaluation of all new spending proposals and apply a 'pay-as-you-go' condition (that is, any proposal that implies increased ongoing spending or decreased tax collection must be compensated through offsetting spending or tax measures). Furthermore, the latest Stability and Growth Program 2011–14 announced acceptance of new spending rules as requested by the EU. So, throughout the crisis, Spain's legal-budgetary framework was considered to be appropriate for central government, even though it proved to be less effective for fiscal discipline in the regions.

New Budget Rules for Regional Governments

New norms and conditions have been introduced to encourage sub-central governments to discipline their fiscal policy. These have been debated and approved jointly by central and regional governments in the CFFP. Various reasons might be given for the cause of the fiscal difficulties of regional governments. An important one is the vicious circle initiated with the GFC, leading to the deterioration of their revenues, forcing them to search for financial credit and escalating their financial costs. A good illustration of this is Catalonia, where the Regional Government of Catalonia issued two 'patriotic' bonds (similar to war bonds) in 2010, at 4.75 percent rate (plus 3 percent bank commission). Thus, although the government managed a 10 percent spending cut in 2011 its debt service became 35 percent more expensive.

For more than three decades regional governments have required central authorization for their debt levels, further debt issuance and any financial dealings abroad (LOFCA 1980). With the crisis, debt procedures became tougher and a new authorization system was established. Regional government information systems were improved through increased publicity and frequency of reporting on budget execution and debt issuing. They were compelled to use standardized accounting and budgetary formats covering execution, scope and reporting, with budget data presented to the CFFP not later than 60 days after each trimester. Furthermore, the central government required that if regional governments did not comply with their stability targets, they had to produce rationalization plans for budgetary correction (structural reorganization, efficiency, spending reduction, and so on) and get central approval for long-term budgetary operations. If a region did not achieve its targets and did not present a recovery plan of sufficient quality accepted by the CFFP, then all short-term debt required central authorization. Debt limits would gradually be applied, together with additional conditions and risk assessments (for example, an approved recovery plan, first-semester budget execution, recovery accomplishment). Furthermore, policy sector agreements for transfers from central to regional governments would be adjusted to comply with fiscal targets. Finally, the principle of co-responsibility in the event of any EU sanctions was also applied. Fiscal misbehavior by regional governments was also addressed on a 'name and shame' basis (IMF 2011).

Generally, these containment measures did not work, and even stricter measures were being considered over spending and deficit rules. A constitutional reform was considered necessary. The new content of Article 135 of the Spanish Constitution of 1978 was approved in September 2011, incorporating the principle of fiscal stability in the constitution and requiring government to present a new organic budget law with concrete references to a deficit limit for each level of government, before 30 June 2012 (see below).

No Major Changes in Budget Institutions and Processes, but Reinforced Top-Down Decision-Making

From a formal perspective, the preparation of the annual draft budget is a well-regulated inter-institutional political process, involving the legislative and executive branches of government, and technical interactions between the MEF, sector ministries and their counterparts in regional governments. In fact, multiple informal interactions normally take place throughout the budget process. The government maintains direct contact with other political parties and negotiates to build a coalition of support to guarantee final budget approval in parliament. Continuous lobbying pressures are exercised by relevant stakeholders (for example, regions, trade unions, entrepreneurs associations, non-governmental organizations – NGOs, and so on) during the preparation of the draft budget and throughout the parliamentary debates. Prior to the change of government on 20 November 2011, relations between the government and opposition were highly contentious, so that the former needed support from some regional Nationalist parties at the price of compensating benefits.

At the beginning of the fiscal year, according to the Stability and Growth Pact, the MEF would prepare an economic and fiscal outlook based on a one-plus-three-year scenario. This projected scenario did not really create a fully fledged medium-term economic framework (see IMF 2011). Although the outlook presented economic growth forecasts and fiscal targets for the central, regional and local governments, the regional targets remained to be debated and agreed in the CFFP, while local government targets were set in consultation with the Spanish Federation of Municipalities and Provinces. Prior to the crisis, the process of setting fiscal objectives for each region was mainly bilateral, between each region and the central government (Ruiz-Almendral, quoted in Fernández and Monasterio 2010). Since the crisis, the process has become more multilateral.

In 2011 at the central government level, the Secretary-General for Budget and Public Spending drafted budget estimates and ceilings for the following year (to include in the economic and fiscal outlook) in line with stability targets and government priorities. Once approved by the parliament, the budget scenario was presented by the MEF to spending ministries in the Spending Policy Analysis Commission. Then, ministries prepared their budget requests within the scenario. The preliminary draft budget is normally discussed and approved by the Council of Ministers in September and a draft budget is then submitted to the parliament by 1 October for debate and approval. However, preparation of the draft budget for 2012 was stopped in September 2011 and postponed until after the general elections in late November 2011. The new central government began by functioning on the basis of a prorogated 2011 budget, although it announced that it intended to present its draft budget by March 2012.

After the crisis, no major changes have been taken to adapt or improve the institutional capacity of the budget system. The creation of the Parliamentary Budget Office took place but so far its effective functioning has been delayed. Fiscal and expenditure management control institutions (for example, Court of Auditors, internal control and evaluation organizations) have not been specifically or sufficiently adapted and used to combat the fiscal consequences of the crisis. In general, the level of budget management and control transparency is low (OECD 2009), but the preparation of transparency legislation has been delayed for several years. The strengthening of the budget system is a pending issue.

However, additional emphasis was placed on top-down decision-making, ensuring that budget requests were within the limits set in the Stability and Growth Pacts, applying the so-called ‘pay-as-you-go’ criteria and checking that cutting decisions taken by government were applied. As in previous years, several specialist executive commissions continued to play a key role as forums for communicating government fiscal priorities, imposing aggregate budget ceilings and distributing the main spending aggregates among ministries. These commissions are: the Spending Policies Analysis Commission, which analyzes and debates spending programs; the bilateral Program Analysis Commissions and Ministerial Budget Commissions; and the Revenue Commission, which presents revenue forecasts according to the MEF’s GDP growth assumptions (Ballart and Zapico 2010). The MEF’s current assumptions about growth running at 1.4 percent of GDP for 2011 were considered too optimistic compared to other forecasts of around 0.8 percent, but nevertheless its estimates for 2010 proved to be more accurate than others. In the aftermath of the crisis, the authority of both the Finance Minister and the President has been enhanced for imposing fiscal priorities and budget cuts. Budget commissions have restrained portfolio budgets to fit within strict restrictions from the MEF, while Program Analysis Commissions at the program level have ensured that reduction decisions respect spending limits and government priorities (education, research and innovation, and the social welfare guarantee for citizens suffering the worst effects of the crisis).

In short, throughout the crisis, the MEF has adopted a pragmatic and flexible role. Budget adjustments were prepared either within or outside the formal budget procedure. Budget preparation became a much more top-down, restrictive exercise. Once the crisis was recognized, the MEF has enjoyed the full support of the President to impose with the strictest discipline the priority of consolidating public finances as committed in the sequential Stability and Growth Programs. The power of the MEF has been reinforced to consolidate fiscal stability at the central government level, but it has been less successful with regional spending, and insufficient efforts have been made to improve the institutional capacity of the overall budget system.

Postponement of Efficiency Initiatives in the Face of Cutbacks

Prior to the crisis, new legislation was passed aimed at improving 'budgeting for results' (General Budget Law 2003) and initiating a decentralized public management model (Agencies Law 2006), including the creation of the State Agency of Evaluation. Both were aimed at achieving greater efficiencies. 'Budgeting for results' had been used for some decades for presentational purposes, but the actual use of performance information for budgeting remained rather low (OECD 2009). The Agencies Law enabled the government to create new public entities (called Agencias Estatales) with greater autonomy in the management of personnel and spending resources. However, the crisis together with bureaucratic politics appears to have frozen this initiative. As Valero (2010) argued, a 'lack of concordance between the Ministry of Public Administration and the Ministry of Economy and Finance, ended up limiting the . . . degree of autonomy' of agencies, while 'the creation of new agencies in standby has been paralyzed as a result of the measures taken to reduce the public deficit'. Accordingly, the impact of these reforms on public spending management performance has so far not matched expectations. With the crisis there seems to be an indeterminate postponement of these efficiency-related initiatives. Spain's stability plans and austerity measures do not include relevant efforts to improve public management efficiency (Valle 2010). Yet, once recovery commences, perhaps some ongoing initiatives may have positive implications for promoting efficiency gains by enhancing evaluation, auditing for performance, and through strategic-analytic advisory units in sector ministries (Feinstein and Zapico 2010). Recent measures including the creation of the Parliamentary Budget Office may lead to a qualitative jump in the budgetary transparency but so far there have been delays in its functioning.

INITIATIVES AND MEASURES TAKEN BY THE NEW POPULAR PARTY GOVERNMENT

Faced with increased international concerns about a second global recession, the new PP government approved additional measures to correct the deficit. Its first fiscal-related decision on 30 December 2011 was to announce a further deficit reduction of about €15 billion net. This included an estimated amount of €6 billion on the revenue side including a temporary and progressive increase in the rates of several direct taxes (for example, personal income tax, savings income tax), combined with other revenue concessions to stimulate growth (for example, 4 percent reduction of VAT on home acquisition, extra tax benefits for home acquisition). From the expenditure side, an amount of about €9 billion included some spending reductions similar to the previous government (for example, current and capital spending cuts, reducing transfers to political parties and social partners, cutting the budget of public corporations, freezing personnel costs, reduction in the number of top public managers, zero personnel replacement in agencies except in education, health and police which maintained a 10 percent replacement limit), plus some spending increases (for example, a 1 percent increase to the pension, and the discontinuance of a special benefit for long-term jobless people while ending the time limits of the benefit).

Between January and March 2012 other measures were announced such as combating fraud by limiting cash payments, and reinforcing inspections in high-risk sectors such as labor and social security, expected to raise an amount of €8 billion; reducing or disinvesting of public corporations at all levels of government; and a new transparency law. On 30 March 2012, the Council of Ministers approved the Budget Bill of Central Government for the year with more than €27 300 million total estimated adjustment both on the expenditure side (including an average cut of 16.9 percent in the accounts of the ministries) and on the revenue side (for example, eliminating income tax allowances to big corporations, and a tax amnesty whereby undeclared incomes will be regularized by paying of a tax rate of 10 percent). The effects of several measures were not sufficiently explained. Overall, these measures did not create much credibility in the financial markets or the international press. A few days after the approval of the Budget for 2012, the Spanish government prepared the Stability Programme for 2012–15 and the corresponding National Reform Programme, including a savings plan to reduce spending in health and education policies. This plan focused on service reduction, rationalization and efficiency savings aiming for a reduction of €10 billion (in addition to the cuts already made in the budget for 2012).

In the legal domain, one of the priorities of the PP government was the implementation of the new Article 135 of the Constitution that obliges central government to prepare an Organic Law. The new Organic Law of Budget Stability and Financial Sustainability (April 2012) reinforced budget principles already considered in current legislation (fiscal stability, multi-annual projections, transparency and efficiency) and incorporated new principles (financial sustainability, responsibility and institutional loyalty). All levels of government are now obliged to present and achieve a surplus or budget balance. No structural deficit will be accepted from 2020. However, when undertaking structural reforms with long-term budgetary effects, a structural deficit of 0.4 percent of GDP will be accepted. The maximum rate of debt for the public sector will be 60 percent of GDP. These limits will gradually be implemented until full compliance is reached in 2020. During the transitional period, the public sector structural deficit should be annually reduced by an average of 0.8 percent. Public debt will be reduced if the economy is growing in real terms. The public debt has to be reduced by at least 2 percent of GDP when the GDP growth rate is 2 percent or above, or when there is an annual net increase in employment. Fiscal targets will be reviewed in 2015 and 2018. Fiscal objectives have to be fixed, taking into consideration EU recommendations on the Spanish Stability Programme. In general, the methodology for setting the limits and arrangements for ensuring compliance are similar to and coherent with EU budget stability framework and deficit deviation procedures. All levels of government (central, regional and local) have to approve a spending level that cannot be higher than the rate of GDP growth.

Deviations oblige the responsible government to present an annual correction plan. If this plan is not accomplished the responsible government will see automatically blocked budget estimates for an amount sufficient to guarantee the achievement of fiscal targets. This penalty is not applied if the deviation is due to exceptional circumstances (structural reforms and cases of hardship). EU penalties under the framework of budget stability will be paid by the government (central, regional or local) responsible for the deviation. According to the principle of transparency, regional governments are obliged to: provide main budget figures before approval; provide national accounting information corresponding to budget information; and provide information on extra-budgetary data every three months. The law also establishes incentives to encourage compliance. For instance, debt issue, policy grant concessions and intergovernmental agreements will be conditional upon achieving fiscal objectives. Furthermore, it guarantees the continuous and automatic adaptation of Spanish norms to future changes in the European economic governance. The extraordinary market pressures focused on Spain and other EU southern member states is accelerating the implementation of this legislation.

Furthermore the new government restructured the MEF, splitting the economic and finance sections of the portfolio (with the former now the Ministry of Economy and Competitiveness, and the latter the Ministry of Finance and Public Administration), thus providing an opportunity for better understanding and coherence between the budgetary and civil service functions.

PRELIMINARY ASSESSMENTS AND EMERGING CHALLENGES

It is still too soon and too difficult to evaluate the actual effects of the fiscal measures Spain undertook throughout the GFC. Achievements to date can only be estimated with reference to the first of the four years of the SGP 2011–14. It is obvious that the first year's stability efforts were not successful at all. There was a public deficit of 8.3 percent of GDP; a 2.3 percent deviation from the 6 percent planned. The Spanish economy was entering a new recession period (−1.7 percent of GDP) and new stability targets were reduced, in agreement with the EU, for next three years. However external factors, such as the Greek crisis, the increased international market pressures and the slow economic recovery in the US and Europe influenced and diluted the intended results of any measure or plan. Furthermore, the economic and fiscal effects of some measures will not be visible and relevant for several budgetary years. Important structural reforms (for example, labor markets, financial system, public finances) were approved and are slowly being implemented, but others, at the time of writing this chapter in 2012, remain on standby or have been neglected (for example, the electoral system and public management).

On the other hand, there is evidence of some positive international recognition for Spain's initiatives. A comprehensive pension reform plan has been agreed with social partners (IMF 2011). At mid-2011, economic growth rates remained positive, and there were signs of 'green shoots' in economic recovery. Although GDP growth was below that of other EU countries, it was approaching a 1 percent increase. Higher increases were expected if crucial sectors continued improving (a 10 percent increase in exports, 8 percent in tourism, and so on). However, at the beginning of 2012 the debt crisis was worsening and economic projections for 2012 were lowered. The IMF and the EU predicted a fall in the Spanish GDP of between 1.5 and 1.7 percent in 2012.

Up to 2012, budget cuts had been substantial, and are still ongoing, but were insufficient in dimension or inadequate to calm financial market pressures. The budget for 2012, approved in March 2012, was based on optimistic assumptions on the evolution of revenues (direct and indirect taxes) and of spending (for example, pensions and unemployment). The budget behavior has followed a sort of 'repetitive budget' pattern (Wildavsky 1975), in which taxes and spending adjustments are announced as soon as new information (macroeconomic data, market pressures, and so on) appears. For instance, just a week after the approval of the Central Government Budget for 2012, and as a reaction to a specific attack by financial markets on Spain and Italy, the Spanish government announced further adjustments, cuts and reforms to health and education amounting to €10000 million (without giving much information on concrete measures), on this occasion affecting regional governments.

Up to 2012, central government stringency efforts were more than offset by lower fiscal performance by the regional governments. Although transparency and prompt disclosure of fiscal data at the regional level have been enhanced, some important regions have missed their fiscal targets (for example, Andalucía, Catalonia and Valencia). Most regional governments have presented fiscal recovery plans and are enforcing austerity measures. But so far there is still uncertainty as to whether this will be sufficient to achieve the fiscal targets.

Formal limits on deficits and budget cutbacks, while being highly necessary to calm market pressures, might not be sufficient to guarantee economic growth. There are still high risks and challenges floating on the Spanish horizon. From a range of perspectives (fiscal, economic and political) the following challenges affect the capacity for budget resilience.

One of the main challenges in Spain has been the questioned credibility of budget projections, normally based on optimistic projections of GDP growth (IMF 2011) and quick budget cuts. Actual fiscal sustainability requires institutional measures such as the creation and effective functioning of an independent body or council of experts or similar mechanism that would enhance the credibility of growth estimates. Another challenge is to avoid poorly targeted public spending cuts in order to reduce the public deficit without postponing the recovery, or even provoking another recession. The way to diminish fiscal uncertainty is by reducing the high budget structural deficit that has been estimated at more than 60 percent of the total deficit (Valle 2010). Time and effort expended on budget program analysis and evaluation have been much reduced. These mechanisms need to be embedded into robust and systematic public expenditure reviews, so far neglected in Spanish government.

In principle, the new Organic Law of Budget Stability and Financial Sustainability (2012) enforced the reduction of the size of debt. But actual results will take some time to be effective, due to the long period allowed for full application of the new deficit limit (up to 2020). So far, public debt in Spain is quickly rising towards 100 percent of GDP.

High fiscal risk continues at the regional level. This level of government is constitutionally autonomous for decision-making in two high and growing spending areas: health and education. In fact, this autonomy is being restrained by new constitutional reform. Traditionally, regions have a low commitment to co-responsibility, having suffered for several decades an asymmetry between their spending responsibilities versus insufficient taxation ability. This asymmetry was officially balanced with the 2009 Agreement between Central and Regional Governments. The latter have made substantial use of their tax autonomy. But the former is still interested in enhancing the use of tax autonomy in order to promote accountability and budgetary discipline (Utande 2012). Up to 2011, there was little clear evidence that public deficits or debt levels were greater than officially recognized by regional or local governments, but there remain many suspicions (for example, creation of foundations with unclear public/private identities, retention of invoices and/or spending information, and so on). Measures announced in 2012 by the government were properly oriented to solve these problems (for example, reduction of the number of regional public corporations, financial aid conditional upon the presentation of recovery plans, obligation to report monthly on budget execution, and disciplinary measures in cases of deviation from approved fiscal targets).

There is also room for much-needed structural fiscal reforms for solving problems, for example: local government finances are not consolidated and suffer chronic shortages of resources; the tax system is highly sensitive to the economic cycle; the hidden economy is widespread with serious implications for fraud and tax evasion; there is feeble capacity for customary review of spending programs, tax expenditures and deductions, and program evaluation including selective in-depth analysis and evaluation of selected strategic policy initiatives; in general, the institutional capacity of the budget and control system is weak.

From an economic point of view the challenge is huge and urgent. In 2012, unemployment was about 22 percent and increasing. Despite uncompleted financial reform, the financial system is still in trouble and does not provide a funding or credit for the normal functioning of the economy. There is high dependence on the evolution of external demand, oil prices and comparable cost pressures. Structural economic reforms remain fragile. An ageing population places a huge burden on public spending policies (for example, over healthcare, social services and dependence care). The changes to the pension system have been consolidated but their effects will materialize only over the long term. Most of these reforms have lain dormant for years and are now being confronted within an urgent and uncertain framework.

From a political point of view, structural reforms need a strong government with the capacity to manage a series of conflicts and build support from society precisely when the country is under high social distress. The inclination of the PP is in line with neo-liberal ideas, preferring less government and more business (for example, downsizing the public sector and cutting public spending, externalizing activities, and searching for private capital for public investment). However, it is arguable whether this strategy will prove sufficient to sustain recovery without paying attention to growing demands for greater openness in policy-making and strengthened governance. A new law on transparency is close to being approved, including measures to penalize undisciplined budget behavior. But there seems to be insufficient awareness of the relevance of this law for open and participatory policy-making, effective learning-oriented control systems and long-term fiscal sustainability.

The political alignment of most regional governments with central government has created a clear opportunity for ameliorating the situation from all perspectives. As the new President Rajoy said in 2011, still from the opposition: 'never before has a political party had in its hands the possibility of coordinating territorial governments for an ambitious reform, and never before has it been so urgent and necessary' (PP 2011). But the materialization of this advantage depends on many ongoing political factors, such as cooperation from the regions governed by nationalists and other regions in which left-wing government can still be formed; the traditional lack of a consensus decision-making style in majority governments; and a growing distance between politics and society.

CONCLUSION

Fiscal consolidation efforts made by Spain have already been considerable, but there remain severe fiscal cautions ahead. A sequence of top-down decisions and measures has been taken in response to the evolving effects of the GFC and financial market pressures, and these were still growing in 2012. Public spending has been reduced and taxes increased, but further fiscal measures are necessary to comply with targets. Budget austerity has been imposed with increasing determination, and regional spending has been put under focus with tighter monitoring and increased transparency. Yet, they seem to be insufficient or perhaps contradictory to initiate recovery. New rules about the limit of the deficit and debt have been incorporated into the Constitution and Organic legislation. However, the strengthening of the institutional capacity of the public expenditure and control system is a pending issue.

Consolidating fiscal sustainability in the longer term and paving the way for a return to higher growth will require serious economic reform efforts that have proved too difficult to achieve in the past. So, four years after the beginning of the GFC in 2008, the Spanish situation was still highly uncertain and risky. Recovery was being postponed more than expected and, considering an emerging second recession, even recovery remained under question. A stronger right-wing government declared its full commitment to comply with the EU's fiscal targets, firmly corrected central government finances and was given a historic opportunity to convince regional government (most of them fellow party members) to discipline their finances. This is precisely the current challenge, the solution to which is being strongly requested by financial markets and the EU.

At the moment of editing these lines, some signals show initial improvements in the Spanish economy and fiscal situation (for example, expected GDP growth and public deficit curbing). There is emerging evidence of public spending discipline and deficit control. But these signals are shadowed by other data (for example, soaring public debt, and huge segments of the population without employment or on low salary schemes). The debate over the austerity model keeps growing.

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