FOCUS · The balancing of the public finances, at the mercy of economic improvement

The public finances in Spain are improving year after year. The general government deficit stood at 3.1% of GDP in 2017, which represents a reduction of 1.2 pp compared to the deficit recorded in 2016 and allows the stability target agreed with the European Commission to be met. This notable decrease has been possible, above all, thanks to expenditure cutbacks of 1 pp of GDP. In particular, expenditure on debt interest, employee salaries and social benefits saw the biggest reductions (as a percentage of GDP). On the other hand, the improvement of revenues, particularly tax revenues and social security contributions which increased by 6.4% and 4.9%, respectively, contributed to the reduction by 0.2 pp of GDP.

While the reduction of the general government deficit is positive in itself, how this reduction is being achieved is also very significant. Judging by the areas in which the bulk of the reduction was focused, the positive performance of the economy was the main factor responsible for the improvement. In other words, a large part of the reduction was cyclical, not structural.

However, measuring the structural reduction of a country's budget deficit is not something trivial, since it is not a variable that can be observed directly.

So how is it possible to assess what part of the reduction of the budget deficit is structural?

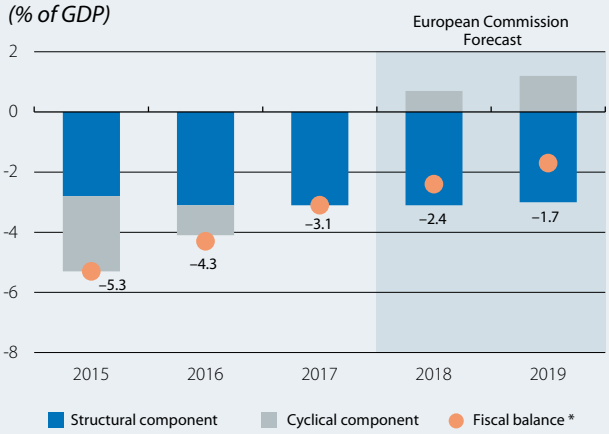
Usually, the benchmark measurement is the change in the structural balance, which is the general government fiscal balance we would observe when the economy is at its full capacity, i.e. when the observed GDP is equal to potential GDP. This measurement cannot, of course, be observed directly, so it has to be estimated using relatively sophisticated statistical techniques. This is what the European Commission does, in order to then take into account changes in this measurement when assessing whether or not the targets set in the excessive deficit procedure have been met. According to this procedure and following the deterioration of the structural balance experienced in 2016, in 2017 Spain was required to improve its structural deficit by 0.5 pp of GDP,[1] something which has not happened (see chart).

Looking forward to 2018, the positive economic outlook suggests that the public finances in Spain will continue their gradual improvement and that the public deficit will come close to the target of 2.2% of GDP. This improvement will be possible thanks to the containment of non-financial expenditure, which is limited to 1.3% in accordance with the expenditure limit approved in July 2017, as well as to the increase in tax revenues, which are expected to grow by almost 6%. Nevertheless, the absence of structural cost-reduction measures for this year suggests that, as in 2017, the reduction of the public deficit will only occur thanks to the improvement of the cyclical balance, while the reduction of the structural balance of 0.5 pp of GDP agreed with the European Commission will not be achieved. In a context of economic expansion such as the current one, and with a level of public debt hovering around 100% of GDP, it might be advisable to accompany the cyclic reduction of the deficit with measures that will help to reduce the structural deficit.

Finally, it is worth mentioning the problems associated with estimating the structural balance. These problems stem from the fact that the calculation of the structural balance is based on an estimate of potential GDP, and this estimate is subject to significant measurement problems. Conscious of this limitation, many governments supplement their structural balance reduction estimates with bottom-up analyses, which are based on estimating the fiscal impact of the main budgetary measures. In fact, the proposal for the 2018 General State Budgets estimates the impact of some expansionary measures, such as the tax breaks for lower incomes and large families, at 2,000 million euros. Although these analyses also present certain difficulties in their calculation, they provide a good supplement to the structural balance estimates.

Spain: fiscal balance

(% of GDP)



Note: ** Excludes losses for assistance provided to financial institutions.*
Source: *CaixaBank Research, based on data from the European Commission (11/2017).*

1. Council of the European Commission (2016), «Council Decision: giving notice to Spain to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit», Ecofin 742, UEM 282.