



Country focus — Spain

KPMG INTERNATIONAL

Spain's fiscal position has come under intense scrutiny over recent months as a result of the sovereign debt crisis in the Eurozone. With investors concerned about the medium-term solvency of Greece and several other Eurozone countries with weaker public finances, bond yields in Spain have been pushed upwards, increasing the pressure on the country's budget.

Spain's deficit problem has emerged relatively recently. The budget deficit averaged only 1.3 percent of GDP from 1995–2007 and the budget was actually in surplus from 2005–2007. As a result, Spain also ended 2007 with a rather modest level of public sector debt, amounting to just 43 percent of GDP.¹

Chart 1 – Spain: Budget deficit

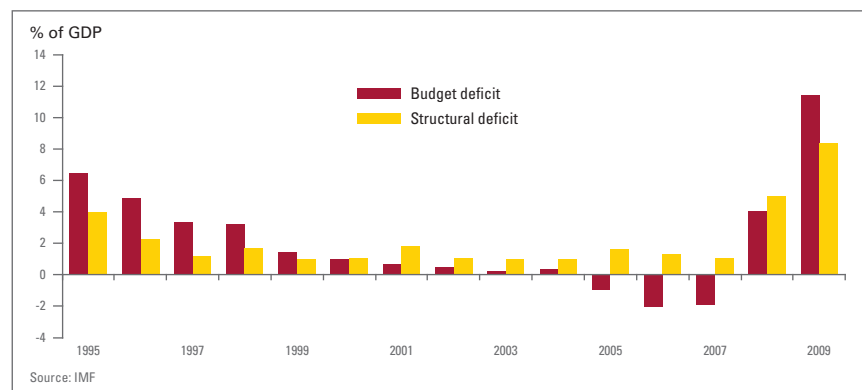
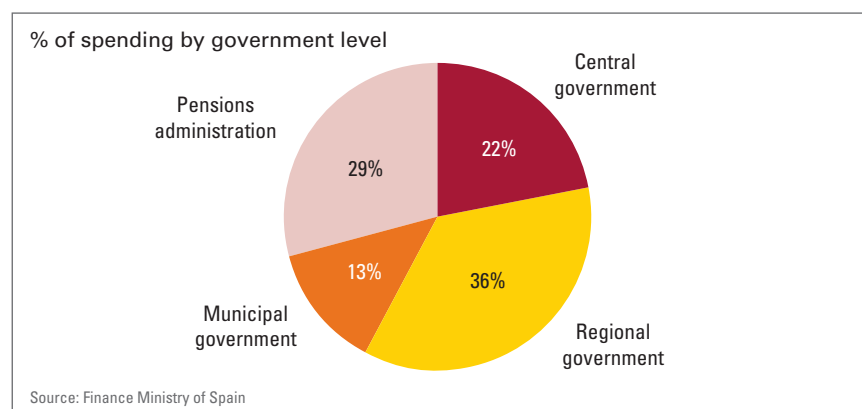


Chart 2 – Spain: Breakdown of government spending



In the wake of the financial crisis and the global recession, however, Spain's budgetary position deteriorated rapidly, with the deficit topping 11 percent of GDP in 2009. As a result, public debt began to mount rapidly and is expected by the European Commission to exceed 70 percent of GDP by 2011, even assuming significant corrective action in the meantime.²

The sudden deterioration of Spain's public finances from a position of apparent strength in 2007 appears to be the result of a number of factors. Firstly, the authorities responded to the economic downturn with a large-scale fiscal stimulus package which increased the structural budget deficit by an estimated three percent of GDP in 2008.³

In addition, the initial fiscal position was not as strong as it appeared. Much of the decline in the deficit in the late 1990s was the result of a shrinking bill for interest payments brought about by the sharp decline in bond yields that preceded Spain joining the European Monetary Union (EMU) – essentially a one-off boost to the budgetary position. The fiscal position was also boosted prior to the recession by 'boom-time' revenues generated as a consequence of the rapid growth of consumer spending and the surging real estate market. IMF estimates suggest that the boom in the Spanish housing sector increased tax revenues by 2.5–3 percent of GDP from 1995–2007, more than half the increase in tax revenues as a percent of GDP in this period.⁴

These favorable revenue streams were thought permanent at the time but are now declining and seem unlikely to revive in the near future. House prices in Spain look likely to fall further and the market overall to remain weak in the face of a large inventory of unsold properties. Meanwhile households are likely to pay down debt accumulated over the boom years during the years ahead, dampening consumer spending and the revenues associated with this such as from VAT. A *senior regional government official* notes, "The decade of rapid growth led to a cyclical increase in revenues, which translated into a structural hike in spending which now has to be trimmed."

Spain, however, faces upward pressures on spending in both the short and long-run. In the short-run, high unemployment – hovering around 20 percent – will keep welfare spending up in the next few years. In the long-run, Spain is subject to significant spending pressures related to demographic factors. The IMF estimates age-related spending in areas like health and pensions could push up total government spending by around four percent of GDP by 2030 and as much as nine percent of GDP by 2050.⁵

Against this background of a large deficit, looming long-run fiscal challenges and weak market confidence, the Spanish authorities have moved over recent months to enact packages aimed at bringing the public finances back under control. The challenge they face to restore fiscal sustainability is significant, with the IMF estimating that to bring the debt/GDP ratio back to 60 percent of GDP by 2030 the structural primary budget balance needs to improve by over nine percent of GDP over the next decade and this improvement then be sustained for a further decade.⁶

² European Commission, Communication from the Commission to the Council, June 2010

³ IMF, op. cit. (2009)

⁴ IMF, op. cit. (2009)

⁵ IMF – 'From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies' 2010

⁶ IMF op. cit. (2010)

In the absence of strong action, there could be serious negative consequences for growth. *KPMG partner in Spain, Candido Perez Serrano* suggests that heavy government borrowing already risks crowding out the private sector from the credit market, and further argues that spending cuts are needed to give a positive jolt to private sector expectations – “not expecting a future increase in taxation would help the private sector to invest.”

Spain's current fiscal plans aim to bring the deficit down from over 11 percent of GDP in 2009 to three percent of GDP by 2013, with three-fifths of the adjustment to take place in 2010 and 2011 alone. In order to achieve this, both revenue raising and spending reduction measures are planned, in roughly equal proportion. These include a five percent cut in government wages, a freeze on pensions, reduced state investment, reduced tax allowances for children and cuts in transfers to regions and local governments.⁷

This program is very ambitious but is subject to a number of risk factors. The first is the possible effects on growth. The authorities assume GDP will contract 0.3 percent in 2010 then grow 1.3 percent in 2011, 2.5 percent in 2012 and 2.7 percent in 2013. These are quite upbeat forecasts compared to many private sector estimates, and the European Commission has suggested that the negative impact on growth might yet require additional measures worth about 0.75 percent of GDP to be implemented.⁸

More generally, if Spain remains stuck in a period of recession or low growth for a long period, there is a risk that the authorities may prove unwilling to continue with such stern austerity measures – the May 2010 fiscal package passed the Spanish parliament by only a single vote (with the help of small regional parties) and there have also been a series of strikes and protests. This risk is higher for Spain than some adjusting countries in the recent past given membership of EMU which leaves the country unable to offset tight fiscal policy with loose monetary and/or exchange rate policy.

Another area of concern relates to the banking sector. As a result of the collapse of the property bubble, Spanish financial institutions face heavy losses on loans to the construction sector and on mortgages. This is especially the case for the so-called Cajas or regional savings banks. S&P raised their estimates for loan losses in June 2010 to around €100 billion, close to the amount already set aside by government for bank restructuring. Any overshoot, for example connected with weak economic growth, could add to the budgetary burden.⁹

There are also structural and longer-term challenges to deficit recovery in Spain. One of these is Spain's highly decentralized fiscal structure. Regional and municipal governments account for around half of total public spending¹⁰ so any fiscal strategy needs these tiers of government to contribute in order to be successful.

⁷ European Commission, op. cit. (2010)

⁸ Spanish Treasury 'Accelerating fiscal adjustment and structural rebalancing in Spain', European Commission op. cit. (2010)

⁹ Standard & Poors 'Updated assumptions for loan losses of financial institutions in Spain under our credit stress testing methodology' June 2010

¹⁰ Spanish Treasury, op. cit. (2010)

Under current plans regional and municipal governments are expected to contribute only just over one percent of GDP to the eight percent of GDP adjustment due by 2013, but even this contribution is subject to risks. One problem is that the regions are responsible for much of health and social spending, areas with a long-term tendency to increase. *A senior regional government official* argues that at the regional level, healthcare expenditure is the only area in which improvement is actually being attempted. However, the decisions that would lead to more convincing progress in cutting this expenditure are the responsibility of central government, which determines the services to be provided to citizens.

The regions also face major financial pressures. Taxes linked to property sales accounted for up to 20 percent of revenues in the boom period and revenue from this source has now slumped – as a result, S&P estimates regional debt could reach 110 percent of operating revenues in 2010 (up from 40 percent in 2007).¹¹ Many regions are also facing elections in 2010 and 2011, an additional risk factor.

Spain's recent experience also suggests major tax reform also needs to be part of a package aimed at long-term fiscal sustainability. As *KPMG's Candido Perez Serrano* notes, "A worrying feature of the Spanish system is the high elasticity of revenues with respect to GDP ... reorganizing the system of taxation should aim at stabilizing revenues over the economic cycle."

As in other countries, Spain may also need to look at approaches that transcend the standard spending cut and revenue raising options available to governments.

Improving public sector efficiency via greater private sector involvement is one such approach, and there are already some positive examples of this – *a senior regional government official* notes, "we think outsourcing and public/private partnerships are effective means of controlling spending ... the Madrid Region has had a good experience in several areas, such as new hospitals or the regional train service."

These positive examples need to be expanded on, with *KPMG's Candido Perez Serrano* arguing that "the public administration can implement the best management practice." He notes that outsourcing to the private sector "is not only a way to cut costs, but also, more importantly a way to improve efficiency." Embedding a culture of cost control in the public sector can help Spain avoid a rerun of its recent experience of a rapidly rising deficit, and help meet its serious long-term fiscal challenges.

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¹¹ Standard & Poors Report Card May 17 2010

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