

**REASONED REQUEST  
ADDRESSED TO  
THE EUROPEAN COMMISSION  
IN RESPONSE TO  
COUNCIL DECISION  
OF 12 JULY 2016**

**SPAIN**

13 July 2016

**THE KINGDOM OF SPAIN,**

Having regard to the decision of the Council of 12 of July 2016, establishing that no effective action has been taken by Spain in response to the Council recommendation of 21 June 2013,

**Hereby**, and by means of this document, **ADDRESSES** a **reasoned request** to the European Commission that the fine referred to in Article 6 of Regulation (EU) No 1173/2011 is cancelled.

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## 1. Executive summary

Spain was among the European countries hardest hit by the economic crisis. From 2008 to 2013 real GDP decreased by 9% and around 3.5 million jobs were lost. In a very challenging global economic context, Spain implemented a far-reaching policy agenda built on fiscal consolidation and structural reforms. Measures included a thorough reform and restructuring of the financial sector, an ambitious labour market reform to spur job creation, and increased liberalisation of key sectors of the economy, among many others. During this period, Spain has demonstrated full commitment with the Country Specific Recommendations (CSR) addressed under the European Semester. In fact, the European Commission has identified Spain among the top performers in terms of CSR compliance in the EU-28 (best performer in 2013 and among the top three in 2015).

This economic strategy has proven effective. The combination of structural reforms and fiscal consolidation has been optimal to correct accumulated imbalances and to foster sustainable economic growth and employment. In 2015 Spain grew twice as fast as the euro area and is expected to outperform its peers also in 2016 and 2017. The right policies to strengthen the recovery and job creation have been prioritized. This is especially crucial in a country like Spain, where reducing the high level of unemployment remains the biggest challenge.

A remarkable correction of the macroeconomic imbalances has been achieved in the last few years. The current account balance has gone from -10% of GDP in 2007 to three consecutive years of surplus with an annual average of 1.3% of GDP. Net International Invest Position has improved by almost 7 percentage points of GDP since the peak. Private debt has been reduced by 45 percentage points of GDP and this has been consistent with a reactivation in new credit to SMEs since 2013. The growth pattern of the Spanish economy has shifted from the construction sector to more high-value added industries, with a substantial increase in the weight of exports to GDP.

In the same way, Spain has demonstrated a firm commitment to fiscal sustainability and deficit reduction. The fiscal effort undertaken by Spain is undeniable. Public deficit ended 2011 at 9.6% of GDP and was practically halved by 2015, among the four largest fiscal consolidations in the Eurozone in this period. This sizeable headline deficit reduction of 4.5 percentage points of GDP has been achieved in a period of negligible economic growth in Spain, combined with an adverse global economic context. Furthermore, negative inflation since 2013 has made the fiscal adjustment even more difficult. The impact of the negative deviation of inflation on the 2015 public deficit has been quantified at 0.7 percentage points of GDP. Similar exceptional economic circumstances have been taken into account in the evaluation of effective action in other countries.

The importance of negative inflation cannot be underestimated in the case of Spain, and equal treatment with previous cases should apply. Negative inflation in Spain must be analysed in the context of exceptionally and persistently low

inflation across the euro area, which the European Central Bank is trying to tackle. Negative inflation has not only impacted on the evolution of public finances, it has also made the adjustment in Spain's real exchange rate more costly. Other channels have also been at play (for example, negative inflation has muted the benefits of monetary policy actions in Spain). The conclusion is that, on balance, negative inflation might have been detrimental to economic activity growth in Spain. Despite this drag, structural reforms have succeeded in restoring Spain's growth and they are the main drivers of its positive economic growth differential with respect to the euro area, as has been widely recognized by the main international economic institutions. In these circumstances, not giving due consideration to negative inflation on the basis that its adverse effects on public finances have been offset by higher-than-expected real GDP growth would be tantamount to penalizing countries most committed to the structural reforms requested by the EU governance framework.

Spain has made an outstanding fiscal structural effort in the last years. The improvement in the structural balance is estimated at 4.1 percentage points of GDP in the period 2012-2015, more than one point each year on average. If nominal output gaps were used to account for negative inflation, the resulting structural fiscal effort would be higher, amounting to 5 percentage points. Moreover, the true effort made is even bigger. As the European Commission has recognized, the structural effort in the case of Spain is underestimated due to methodological issues.

The year 2015 was particularly remarkable in terms of economic achievements. GDP grew by 3.2%, placing Spain among the largest advanced economies in terms of fastest growth. More than half million jobs were created, a third of the total employment generated in the euro area, and unemployment was reduced by almost 700,000. Fiscal consolidation further advanced. The deficit was reduced by almost 1 percentage point to 5% of GDP, above the 4.2% target. Public debt-to-GDP ratio fell for the first time since the beginning of the crisis and is projected to continue declining in the coming years. Moreover, the Treasury's net issuances have been halved, going from 96.6 billion euro in 2012 to 40 billion euro planned in the 2016 Funding Programme.

Lower-than-expected tax collection is a key factor to explain the deficit deviation in 2015. Although tax revenues increased in 2015, they have been affected both by lower-than-forecasted inflation and by a structural fiscal reform aimed at reducing the tax wedge and improving income distribution. Furthermore, social security incentives have been put in place to foster open-ended contracts and reduce temporary employment in the labour market. These measures, which may have a short-term negative impact on public finances, are essential to increase potential growth. They are therefore in line with the EU economic guidance. In addition, expenditures declined in 2015 by 1.2 percentage points of GDP, reflecting that expenditure restraint was maintained despite general elections and elections in most of the regions and all the municipalities.

Regardless of common factors that have benefited all euro area member States, such as tailwinds for growth or the reduction of financial fragmentation

in the region, the turnaround of the Spanish economy is clearly the result of supply-side reforms. In the last years, Spain restructured its banking sector, embarked on a significant labour market overhaul, increased efficiency in product and service markets, regained competitiveness and corrected macroeconomic imbalances. Aggregate demand policies are not a key factor to explain Spain's economic growth differential. In this sense, it should be highlighted that in economies with high degree of openness such as Spain, demand stimuli are likely to fade away fast through cross-border spill-over effects, resulting in deterioration in the external balance. This has not happened in Spain.

Spain has always been firmly committed to its compliance with the EU fiscal and economic rules. This has been proven in the last years, even in exceptionally difficult economic and social circumstances. This determination is also evident in the response of the caretaker government to the Autonomous Commission Recommendation addressed to Spain in March 2016. To ensure full compliance with this recommendation, a package of measures was adopted in April 2016. On the one hand, measures were taken to narrow regional government deficits, including the stepping-up of the preventive and corrective mechanisms of fiscal discipline envisaged in the Spanish Organic Law on Budget Stability. On the other hand, efforts were intensified to rein in public expenditure at the Central government level, with the adoption of budget appropriation cuts amounting to 2 billion euros.

Those measures are starting to bear fruit, as shown in the latest budget execution data. The regional deficit has declined until April by almost 30% year-on-year, while total non-financial expenditure excluding Local Governments increased only by 1% in this period.

Spain reiterates its firm and unambiguous commitment to put an end to the excessive deficit situation, bringing its public deficit below 3% of GDP in 2017. In this sense, and in line with its strong commitment to comply with the obligations under the Stability and Growth Pact, Spain stands prepared to make additional commitments. In particular, Spain will be ready to adopt a reform of the instalment payments of the Corporate Income Tax as soon as the new government takes office. This measure is estimated to have a budgetary impact of 6 billion euro in 2016. In addition, new measures will be adopted to step up the fight against tax fraud (impact estimated at 1 billion euro) and the 2016 budget closure will be advanced to further rein in public spending.

Clear and compelling reasons exist for not imposing a fine on Spain. It would seem paradoxical to impose a fine, based on a single year deviation, on a country that has always been fully committed to the rules of the Economic and Monetary Union. This is even more apparent when account is taken of the methodological inconsistencies for assessing effective action that emerge in the case of Spain. The ongoing revision of this methodology further reinforces the need for a prudent approach.

Spain is no threat to the financial stability of the euro area. A decision to impose a fine on Spain would be not only incoherent but counter-productive. It should be recalled that the Stability and Growth Pact is based on *“the objective of*

*sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation".*

A fine on Spain would be a step in the opposite direction of what is needed in Europe, disregarding the main economic policy priorities currently being sought at the EU level. In a moment of heightened uncertainty and risks in the global economy and European financial markets, protecting the credibility of EU and euro area governance framework should be crucial in the economic policy making.

## **2. Macroeconomic performance: reforms and outcomes**

The Spanish economy was one of the hardest hit by the crisis. From 2008 to 2013 real GDP decreased by 9%, four times more the euro area average. More than 3.5 million employments were lost in this period, around half of the jobs destroyed in the Eurozone. This situation entailed a serious threat not only to the sustainability of the Spanish welfare state but also to the stability of the Eurozone and the world economy. Against this background, Spain undertook from 2012 a series of ambitious structural reforms and a programme of fiscal consolidation which are paving the way for sustainable growth and for the correction of the main macroeconomic imbalances. This programme of reforms has been essential for ensuring the viability and effectiveness of social welfare policies.

Spain is currently growing at more than 3% of GDP, twice the rate of the Eurozone, with more than half a million employments created annually. After more than eleven quarters of consecutive growth, Spain has managed to recover around half of the GDP lost and the unemployment rate has fallen by 6 percentage points.

As recognized by the European Commission and the main economic international organizations, this turnaround in the Spanish economic performance has been possible due to an optimal policy-mix based on structural reforms and fiscal consolidation.

### **2.1. Reforms**

During the period 2012-2015, Spain implemented a reformist agenda based on fiscal consolidation, a reform of the financial system and structural reforms for competitiveness, productivity and job creation. This shows the firm commitment of Spain with structural reforms, as evidenced in the implementation of Country Specific Recommendation (CSR). In fact, in 2015 Spain was ranked by the European Commission among the top three EU countries in terms of CSR implementation, while in 2013 it was ranked first.

#### **Job creation as a priority**

A comprehensive labour market reform was adopted in 2012 to ease the main obstacles to job creation and to increase flexibility at the firm level as an alternative to layoffs in the presence of adverse company shocks. The reform tackled key historical problems in Spain's labour market. Several measures were

aimed at improving the efficacy of wage bargaining, particularly by making it more sensible to the underlying economic situation of the labour market and the specific conditions at each firm. Measures were also taken to increase the utilization of intra-firm flexibility (such as temporary reductions in working hours or wages) as a substitute of collective redundancies. Other aspects were also improved, such as the regulation of training contracts.

Significant efforts have been also made to improve the effectiveness of active labour market policies, particularly for the most vulnerable groups, such as long-term unemployed and young people. The Youth Guarantee Programme, the Employment Activation Programme for long-term unemployed and the Programme of Guidance for the long-term unemployed are among the main measures approved.

### **A sounder, deeper and more transparent financial system**

A far-reaching financial reform strategy was implemented, based on 4 pillars:

- First, an unprecedented transparency on banks' balance sheets, with three different exercises conducted by the IMF and two independent external evaluators;
- Second, the clean-up of the banks' balance sheets, through a substantial increase of bank provisioning requirements and the transfer of troubled real estate assets to SAREB, the Asset Management Company;
- Third, the recapitalization and restructuring of financial institutions, supported by an ESM loan under the banking sector financial program that disbursed 41 billion euro for capital injections; and
- Finally, steadfast efforts to improve good corporate governance and enhance the professionalization and independence of financial institutions.

Measures were also adopted to promote alternative sources of funding for the economy, with improvements in the legal framework for disintermediation and promotion of capital markets for SMEs. Among other measures, the legislation of securitizations was improved, crowdfunding was regulated for the first time and alternative markets for debt and equity for mid-cap companies were promoted.

### **More efficient product, energy and services markets**

Ambitious reforms in product and services markets were implemented to foster long-term growth and competitiveness. Measures sought to enhance competition, increase productivity, improve the business environment and remove barriers to the growth of firms.

The 2013 law on entrepreneurship and internationalisation promoted a favourable environment for entrepreneurs and improved access to financing. It included measures to reduce the cost and time of creation of companies

support their growth and internationalisation and simplify administrative burdens.

In the retail sector, regulations were adopted to increase flexibility in commercial opening hours and to eliminate restrictions on sale activities. The use of the “express licensing” was also extended and other measures were taken to facilitate business licensing.

The Law on Market Unity of 2013 was a major effort to improve the business environment and reduce administrative burdens, with important efficiency and productivity gains. The reform tackled the fragmentation of the domestic market arising from different layers of regulation and created an open-ended process to address possible regulatory barriers that could emerge going forward.

The Law on Deindexation tackled the issue of excessive use of indexation clauses, which linked public prices to overall inflation, creating unwarranted second round effects of inflationary shocks. The electricity sector was reformed and the tariff deficit (a contingent liability amounting to around 26 billion euros) was tackled and eliminated.

### **Insolvency reform**

Ambitious reforms on the corporate and personal insolvency regimes were implemented to accelerate private deleveraging. New tools have been introduced to foster debt restructuring processes, facilitate out-of-court insolvency agreements and to promote a second chance. All this was accompanied with measures to protect more vulnerable mortgage debtors.

### **Reinforcement of the Budgetary Framework**

The Law on Budgetary Stability and Financial Sustainability of 2012 strengthened fiscal discipline and monitoring of public finances at all layers of government. The Independent Fiscal Authority (AIReF) was established in 2013, in line with the Two-Pack provisions.

In addition, a set of liquidity measures (the Supplier Payment Fund and the Regional Liquidity Fund) were created to provide liquidity and financing to regional and local governments, under conditionality criteria. Commercial arrears to public sector suppliers have been addressed, with a substantial impact on the real economy.

A comprehensive reform affecting all Public Administrations was adopted to contain and streamline public expenditure and increase the efficiency of the public sector. Measures sought to reduce burdens and duplicities and to improve the provision of common services and resource management. The savings of these measures between 2012 and 2015 reached 30.5 billion euros. According to the Labour Force Survey, the number of public employees has been reduced to 3 million people in 2016 (the same level of 2004), compared to 3.250 million in 2010.

This has been complemented with significant reforms in public administration, healthcare, education and local administration, all resulting in significant structural savings.

### **Tax reform**

A comprehensive and growth-friendly tax reform was adopted in 2014, tackling the personal and corporate income tax and VAT. The reform aimed at improving potential growth through a reduction in the tax-wedge and at increasing the efficiency of the tax system.

### **Sustainability of the pension system**

A major reform of the pension system was approved to promote long-term fiscal sustainability, focused on two main elements: a new index for pension revaluation and a sustainability factor to link the level of new retirement pensions with the evolution of life expectancy.

## **2.2. Correction of macroeconomic imbalances**

Thanks to the reform efforts, a significant correction of the macroeconomic imbalances accumulated in the pre-crisis years has taken place. Commercial, financial and employment flows regained a sustainable trend allowing the stocks to decrease rapidly.

### **A job-rich recovery**

The labour reform was key to foster job creation and reverse the severe employment destruction.

In February 2012, at the time of the reform, employment was falling at a rate above 3% and cumulated employment losses totaled 3 million people. Three years later, job creation is growing at above 3%, a pace three times faster than the euro area average and any of its main economies. More than one million new jobs have been created in the period 2014-2015 and the unemployment rate has dropped by almost 6 percentage points from its peak. It is also significant that the reduction of young and long-term unemployment, two vulnerable groups, is now more intense than that of total unemployment. According to the latest Labour Force Survey figures, in the first quarter of 2016 young unemployment fell by 14.3% year-on-year and long-term unemployment by 17%, well above the 12% reduction of total unemployment. In particular, young unemployment rate has been reduced by more than 10 percentage points since the first quarter of 2013, despite it remains too high.

The reform has also improved labour market dynamics and increased the competitiveness of the economy. The GDP growth threshold needed to create employment was lowered from above 2% prior to its adoption to below 0.7%. Different analyses have highlighted the positive impact of the labour market reform. According to the Commission, in the absence of this reform, about 400,000 more jobs would have been lost, employment creation would have

started months later in Q2-2014 and the recovery in employment would have been milder.

Employment creation is still the most crucial challenge the Spanish economy is confronted to. The labour market will continue improving in the coming years, with half million new net jobs per year expected in the period 2016-2019.

### **Strong recovery with external surplus**

For the first time in 30 years Spain is recording current account surpluses in a context of solid economic growth based on domestic demand dynamism.

In 2015 the current account balance registered a surplus for the third consecutive year, equivalent to 1.4% of GDP, yielding a net lending position to the rest of the world of 2.1% of GDP.

The current account surpluses have contributed to reducing the debtor position of the international investment position (IIP), which has dropped by 3.4 percentage points down to 90.2% of GDP between 2009 and 2015.

### **Rebalancing through tradable sectors**

In 2007, as now, the Spanish economy was growing at rates above 3%. However, it was an economic growth model fuelled by a credit and real estate bubble. Currently, Spain is growing at 3.4%, with construction accounting for 10.3% of GDP, half the 21.1% weight it had in 2007.

The reliance of Spain's economic growth on the construction sector has been replaced to a great extent by exports, which today account for 32.4% of GDP, compared with 25.7% in 2007.

Econometric models indicate that the increasing exporting pattern of the Spanish economy is predominantly structural in nature, as it reflects persistent competitiveness gains. In this regard, the real effective exchange rate against developed countries measured with manufacturing unit labour costs depreciated by 12.5% between 2008 and 2015, both due to the depreciation of the nominal exchange rate (3.7%) and, more importantly, to the decline in unit labour costs (9.1%).

The transition to a growth pattern more oriented to the rest of the world has been also favoured by greater geographical diversification, a widening of the export base (with the number of regularly exporting SME almost doubling between 2012 and 2014), the higher dynamism of high value added subsectors (such as motor vehicles and pharmaceutical products), productivity-enhancing FDI inflows, the normalization of financing conditions, the progressive improvement of firm's financial health and the continuing containment of labour costs.

## **Private sector deleveraging compatible with new credit growth**

The deleveraging process of the private sector has continued on the back of the recovery. Private debt has decreased by 46 percentage points of GDP from its peak reached in mid-2010. The non-consolidated debt of the non-financial private sector stood at 172.1% of GDP in the fourth quarter of 2015 (153.5% of GDP on a consolidated basis) the same levels of early 2006 and close to the EU average. The deleveraging of companies (of 28.4 percentage points to 104.6% of GDP) and of households (of 17.3 percentage points to 67.5% of GDP) has been compatible with credit reactivation since 2013. New credit operations registered an annual increase of 12.2% in 2015, which brought about stronger economic growth.

## **Fiscal sustainability strengthened**

On the fiscal front, Spain has followed an ambitious consolidation path. From its peak in 2012, the headline deficit has declined by 5.3 percentage points of GDP and public debt-to-GDP ratio started to decline in 2015.

The S2 sustainability indicator has improved significantly during the last years, mostly due to the 2013 pension reform. According to this indicator, the upfront adjustment to the current structural primary balance required to stabilize the debt-to-GDP ratio over an infinite horizon was estimated at 0.8% of GDP in 2015, compared to 4.8% in 2012.

### **3. Significant fiscal consolidation in exceptional economic circumstances**

#### **3.1. The public deficit in 2015**

##### **Fiscal consolidation in 2015**

Public deficit excluding financial assistance reached in 2015 5.0% of GDP, 0.8 percentage points higher than the 2013 EDP Recommendation (4.2% of GDP) and 0.8 percentage points lower than the deficit recorded in 2014 (5.8% of GDP). The public debt-to-GDP ratio fell in 2015 for the first time since the start of the crisis to 99.2%. The Spanish Treasury's net issuances have been halved, going from 90.6 billion euro in 2012 to the 40 billion euro planned in the 2016 Funding Strategy.

By subsectors, the deficit deviation can be attributed mostly to regions, which generated a 0.96% of GDP deviation from the target.

In terms of nominal GDP, expenditure has continued its reduction path (1.2 percentage points of GDP in 2015) and revenues experienced a minor reduction (0.4 percentage points of GDP).

Most of the deviation from the deficit target derived from lower-than-expected non tax revenues and also from extraordinary spending. In this regard, a large part of the deficit deviation could be attributed to exceptional circumstances outside the control of the government.

## **Exceptional circumstances outside the control of the Government in 2015**

### Tax revenues affected by negative inflation

Tax revenues in ESA terms have increased at a rate close to 3% for the period 2012-2014 and by more than 5% in 2015, first year of the implementation of the tax reform.

The increase in tax collection has taken place despite lower-than-forecasted inflation. The adverse impact on the 2015 public deficit from the negative deviation of inflation has been quantified at 0.7 percentage points of GDP, as detailed in the Annex.

### Extraordinary spending (one-offs)

In 2015, the Spanish public deficit includes several one-off extraordinary expenditure transactions:

- Reclassifications of Public Private Partnerships (PPPs) that increased capital expenditure by more than 2.0 billion euro. These reclassifications have affected the regions of Cataluña, Asturias, Baleares and the municipality of Zaragoza. Other capital expenses, in regions like Valencia, Madrid, Extremadura and Castilla La Mancha have had an additional impact of 0.4 billion euro.
- An extraordinary expenditure of almost 1.1 billion euros was recorded to finance Hepatitis C treatments. The cost in 2016 of these treatments is limited to 0.7 billion euro, as a result of the decline in the target population.
- Partial repayment of the foregone 2012 Christmas bonus had an additional budgetary impact of 2.1 billion euro in 2015, partially offset by extraordinary revenue related to the reclassification of UMTS frequency auction.

## **Supply-side fiscal measures to reduce the tax wedge**

Revenues in 2015 were affected by structural reforms aimed at increasing Spain's potential growth through a reduction in the tax wedge and increased efficiency, in line with Commission guidance.

Social Security budget has been negatively affected by the 500 euros minimum exemption in the Social Security contributions. This tax benefit was reformed in 2015, targeting lower income earners, less qualified workers and new permanent contracts. Although the incentive has a direct short-term cost in terms of less revenue for the Social Security, it has played a key role in reducing temporality. This temporality is still high compared to the EU average. Similarly, this measure has also allowed a substantial reduction of the tax wedge.

In addition, the growth-friendly tax reform adopted in 2015 was aimed at increasing the efficiency and the income distribution capacity of the fiscal system.

- The PIT and Social Security Contributions (SSC) reform has allowed reducing the tax wedge by more than 5 percentage points of GDP (from 40.62% of GDP in 2012 to 35.56% in 2015).
- The PIT reform has also enhanced tax efficiency through the suppression of tax benefits (€1,500 dividend tax exemption, elimination of tax benefits for the landlord renting and elimination of the exemption for severance payments and corrective coefficients for taxing capital gains).
- Increased policy ownership and improved income distribution. The PIT reform increases policy ownership and the reform is focused on improving conditions for low income taxpayers; those under 24,000 euro of yearly income will reduce their tax payment by 23.47% and those below 18,000 euro by 31.06%, while the average overall reduction is 14.6%. The 2015 PIT reform suppressed the so-called temporary surcharge in PIT, which raised revenue mainly from the high end of the income distribution. It also lowered tax rates and reduced tax brackets to improve tax efficiency. New tax rates have been designed to benefit low income earners the most, so as to improve the policy ownership of fiscal consolidation.
- The CIT reform contributed to broaden tax bases (setting limits on tax deductibility of financial expenses, mainstreaming the fiscal amortization schemes and removing the deductibility of impairment losses) and to enhance tax efficiency (reducing marginal tax rates and suppressing special SME regimes).
- In order to encourage deleveraging, CIT reform eliminated previous tax biases and included new incentives for firms to raise equity via targeted tax deductions (business capitalization reserve and business equalization reserve). New incentives to invest in R&D were introduced, in line with the recommendations addressed to Spain.

These tax and social security reforms have a significant positive impact on long term growth and employment (a time horizon of 10 years), estimated at 1.22 and 0.63 percentage points respectively. More details can be found in the 2016 Spanish National Reform Program. As a final element, the General Tax Law was reformed. This reform aims to generate a fairer and nimbler tax system as a whole. Inspection procedures and tax compliance obligations have been simplified to be more effective. Revenues from the fight against tax fraud have constantly improved by an average of 1,000 million euro every year since 2011, to reach 15 billion euro in 2015. Recent reforms to fight against tax fraud include new mandatory declaration of foreign assets, a list of major debtors to the Tax Agency, and the incorporation of Spain as a front runner in BEPS initiative.

### **3.2. Strong fiscal consolidation in 2012-2015**

A remarkable fiscal consolidation effort has been made between 2011 and 2015, with a reduction in the public deficit of 4.5 percentage points (from 9.6% of GDP in 2011 to 5.1% of GDP in 2015). Moreover, the ratio of public debt to GDP has started to decrease already in 2015, one year ahead of what the

government expected and two years ahead of what the Commission forecasted. Against this backdrop, Spain ranks among the top four countries of the Eurozone in terms of fiscal consolidation in 2012-2015. In addition, fiscal consolidation has been supported by the above mentioned budgetary structural reforms implemented at all levels of Government.

This consolidation effort is especially significant taking into account the deep recession suffered by the Spanish economy during the first two years of the period, with almost no real GDP growth on average in 2012-2015, and given the negative impact that much lower inflation rates than initially expected had on public deficit. In fact, the Commission acknowledged that Spain made *effective action* in 2013 and 2014 in response to the Council Recommendation of 21 June 2013.

Spain's consolidated structural fiscal effort in 2012-2015 reached 4.1 percentage points, according to Stability Programme data, equivalent to more than 1 point per year. Therefore, in terms of structural fiscal effort, Spain ranks among the top countries of the Eurozone in this period. This consolidation effort has been based on a front-loading strategy tailored to the optimal policy-mix required by the Spanish economy.

Moreover, the actual structural effort carried out by Spain in 2012-2015 is even higher. In fact, the true fiscal effort is underestimated due to the impact of negative inflation and methodological inconsistencies.

### **3.3. The impact of negative inflation on public finances**

Spain has maintained an inflation differential favourable against our main trade partners, contributing to regain competitiveness and to correct the appreciation of Spain's real effective exchange rate. However, in a context of exceptionally and persistently low inflation in the euro area, this negative differential has required Spain to maintain negative inflation rates in the period under consideration.

As far as public finances are concerned, the lower than forecasted inflation rate has hampered the fiscal consolidation process. The Spanish inflation accumulated in the 2013-2015 period was lower than that projected by the Commission at the time of the Recommendation in 2013. This deviation can be estimated at around 3 percentage points, depending on the inflation measure used. This inflation trend is having a negative impact on tax bases and leads to downward revisions in tax revenues, while expenditures are less sensitive to inflation revisions. Moreover, structural reforms (pensions and de-indexation) have made expenditures even less responsive to inflation than before.

As outlined in Spain's 2016 Stability Programme, the impact of the negative deviation of inflation on the Spanish 2015 public deficit is quantified at 0.7 percentage points of GDP. If the comparison is made with regards to a more normalized scenario of 2% inflation in the euro area, the detrimental impact increases to 1% of GDP. For additional details, see Annex.

The effects of negative inflation in Spain are not limited to fiscal variables. In fact, in order to account for the full impact of negative inflation on public finances it is necessary to adopt a general equilibrium perspective which allows better understanding of the effects of negative inflation on real economic growth.

Prior to this exercise, a relevant clarification is warranted: although a negative price differential with respect to the Eurozone is positive in terms of competitiveness and export performance, this positive effect is derived from the adjustment in the real exchange rate and depends on the inflation differential, not on the negative inflation rate per se. In other words, the positive effects of the adjustment in the real exchange rate could have been achieved without Spain entering into negative inflation territory, if price dynamics in the euro area as a whole had been closer to the 2% inflation benchmark. An analysis of the effects of low inflation in real variables, therefore, must abstract from the effects derived from the real exchange rate.

In this context, a negative inflation rate such as the one registered in Spain during the last years, has had negative effects on growth. The main channels through which persistently low inflation takes a toll on economic activity have all been observed in Spain.

- Downward nominal rigidities make it more difficult to achieve required relative price adjustment in goods, services and factor markets. When inflation is moderate but positive, relative prices can be adapted to market conditions without resorting to downward revisions in nominal prices. However, as inflation gets lower, the number of products that would require a nominal downward adjustment to realign its relative price increases. When this realignment is costly, then, the fraction of products that is unable to adjust fully increases as well. As full adjustment of relative prices becomes impossible, real economic distortions appear.
- Second, low inflation slows the deleveraging process of economic agents. When inflation is negative, this effect may even result in an increase in the real debt of private agents, since debts are fixed in nominal terms. This is the well-known Fisher debt deflation theory.
- Spain has not been able to fully benefit from the relaxation of financial conditions of the ECB's monetary policy, as the policy transmission mechanism has been impaired during most of the period under consideration. Spain's borrowing costs in real terms for new credit flows have been historically high during 2012-2014, when the cyclical conditions of the Spanish economy would have demanded low real interest rates. As such, Spain has not been able to fully benefit from the operation of standard monetary policy mechanisms that are implicit in neo-keynesian models used in policy simulations.
- Moreover, given the fall in inflation expectations occurring throughout this period, a limited relaxation of real borrowing costs has only been observed starting in 2015. However, this relaxation has been insufficient to drive real interest rates to historically low levels. Recent studies by Banca de Italia and other institutions show that the reaction of monetary policy is the key element

to avoid a negative impact of low or negative inflation, and that in the presence of a zero lower bound on interest rates; these negative effects cannot be fully compensated without extraordinary measures. It can be argued, then, that Spain has been faced with a situation where the lower bound of interest rates was hit at levels above 0%, because of the persistence of very high risk premia in bank lending. In these conditions, the negative impact of negative inflation on growth is expected to be larger than what standard economic models imply.

Thus, the Spanish fiscal adjustment has been hindered by negative inflation. Under these unfavourable economic circumstances, Spain has made a great effort trying to meet two key objectives, fiscal consolidation and sustainable growth. Fortunately, the positive effect of structural reforms has allowed overcoming the headwinds coming from price dynamics, but ignoring these headwinds when judging Spain's policy efforts would be very misleading.

### **3.4. Methodological aspects regarding effective action assessment**

Apart from the negative impact of negative inflation on public finances, there are methodological aspects to be considered in the assessment of the action taken by Spain in response to the 2013 EDP Recommendation.

Spain has become a paradigmatic case that shows the deficiencies of the methodology for calculating the output gap and potential GDP growth. This has important consequences, both when assessing the Spanish fiscal policy stance and for the credibility of the structural budget balance as a leading instrument to guide fiscal policy decisions. Notably, the 2013 fiscal Recommendation for Spain has proven to be inconsistent since the structural effort requested has been more ambitious than the nominal target.

#### **Potential output estimations**

One of the main implications of the methodological inconsistencies is the underestimation of the structural effort carried out in the Spanish economy in recent years. This is recognized by the European Commission itself in its Opinion dated 28th November 2014 on the Draft Budgetary Plan of Spain: "*[...] specifically at the turning point of the cycle, developments in the structural balance for Spain may tend to underestimate the true fiscal effort*". The Commission repeated this argument in several technical notes distributed in 2015.

A limitation of the current methodology is the high uncertainty and the significant revisions of growth potential figures and, therefore, of the output gap. In the Spanish case, the methodology used does not capture the full impact of the structural reforms implemented over the past years. In particular, the structural unemployment rate (NAWRU) is overestimated, which reduces the potential GDP and therefore, the structural balance.

Furthermore, the NAWRU responds very slowly to relevant structural changes, as is the case of the labour reform of 2012, due to the time horizon used and the methodology for calculating it.

Changes made to the National Accounts series had also a relevant impact that should be considered. With the new series based on ESA-2010, an important part of the structural effort that in the previous base was allocated to 2013 has been moved to 2012. Thus, such effort remains outside the reference period of the EDP Recommendation.

Finally, the Commission is currently estimating potential output using the projection horizon of the most recent forecast exercise, which is two years (2017 in the case of the most recent Commission's Forecasts), while Member States use a range of four years (2019). As a result, relevant discrepancies in structural balances emerge. This generates uncertainty in the evaluation of key public finance variables, particularly in the assessment of compliance under the Stability and Growth Pact.

### **The assessment of effective action under negative inflation**

Another relevant problem of the current methodology is directly related to the calculation of the structural fiscal effort based on real output gap estimates. This approach does not take into account price effects on structural public deficit. This is especially relevant for countries with negative inflation rates, such as Spain.

The resulting structural fiscal effort for Spain would have been higher if a nominal output gap had been used for assessing effective action in the past years. To quantify this effect, an exercise has been conducted to estimate the structural fiscal effort based on nominal output gap. First, a price gap is calculated as a ratio between the GDP deflator and its trend, the latter being obtained using a Hodrick-Prescott filter. Then, this price gap is added to the real output gap figures based on the Commission's methodology. Finally, a nominal output gap is obtained. In the case of Spain, the addition of the price gap implies a lower nominal output gap. This leads to a structural effort of about 5 percentage points in 2012-2015, much higher than that obtained with real output gap (4.1 percentage points).

The Commission has already included the existence of negative price surprises and the environment of low inflation as a mitigating factor in some other recent assessments of compliance with the SGP. In particular, when the Commission proposed a revised EDP recommendation for France in March 2015, it took into account that *"inflation in 2013 and 2014 turned out to be markedly lower than projected"*. As stated by the Commission staff working document in their evaluation of France's budgetary situation for the year 2014, negative inflation surprises distort the evaluation of measures of effective fiscal effort<sup>1</sup>.

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<sup>1</sup> Negative inflation surprises strongly impact the assessment of the change in the adjusted structural balance (the so-called "top-down approach"). To quote literally from the aforementioned report: *"[...] the top-down assessment is strongly impacted by the inflation shock, unlike the bottom-up assessment. The deterioration in the headline deficit leads to a worsening of the structural balance, thus leading to an estimated lower effort according to the top-down assessment. This is because the output gap, which is used to estimate the cyclical part of the deficit, is computed in volume terms and is hence not impacted by inflation. In turn, the cyclical part of the headline deficit is not affected by the downward revision in inflation, and hence all the inflation-related deterioration in the headline deficit results in a similar deterioration of the structural balance."*

As regards the observed budget impact of the new measures implemented ("bottom-up approach"), a negative inflation rate may render ineffective some actions that were designed to work under a positive inflation environment. Spain has adopted several expenditure freezing measures that have been economically and politically costly, but whose effects are not computed in the assessment of the bottom-up effort. Three relevant cases stand out: 1) the freezing of public employees' wages; 2) the limitation of pension revaluations to 0.25% per year, starting in 2013; 3) the de-indexation of public procurement contracts. All these measures would have resulted in substantial real savings in government expenditure under a more normalized inflation scenario. However, they are not considered in the bottom-up evaluation of effort. This effect of low inflation was also considered in the evaluation of France's budgetary position in 2014<sup>2</sup>.

The methodology for assessing effective action has already been applied with some flexibility. In particular, the Commission draft recommendation and the revised Council recommendation for France in March 2015 were based on the assessment by the Commission services that "*the available evidence does not allow to conclude on no effective action*". This implies that the Commission de facto interpreted that effective action had taken place as it proposed an extension to the deadline for the correction of the excessive deficit by two years. However, this was the first time the Commission based its recommendation on the assumption that the methodology is inconclusive, thus establishing a precedent for future assessments of effective action.

Since the Commission has included the negative price surprise and the environment of low inflation as a mitigating factor in recent assessments of compliance with the Pact of some other member States<sup>3</sup>, not acknowledging the impact of this event in the case of Spain would raise issues of equal

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<sup>2</sup> The European Commission's evaluation of France's budgetary position in 2014: "*In addition, a number of expenditures, notably public wages and social transfers related to pensions and housing, were frozen in nominal terms in 2014, making the achievement of further savings more difficult.*" The nominal freeze on these expenditure items has also made it impossible to take advantage of the fall in oil prices (which acts as an autonomous injection of purchasing power for public employees). Under a more normalized inflation scenario, the downward pressure on inflation derived from an oil shock would have made it possible to moderate wage increases for public employees, helping in the reduction of the public sector deficit, and still allow them some real gains in their purchasing power. However, when public sector wages are frozen, as has been the case in Spain until 2016, the fall in oil prices is fully captured by public employees, without a corresponding improvement in the fiscal deficit.

<sup>3</sup> The Commission has not only taken into account the negative effects of low inflation on the fiscal outcome in the case of France, but also in the cases of Italy and Belgium. In the so-called 126(3) reports for Italy and Belgium, both in February 2015 and May 2016, the Commission considered "*the occurrence of extraordinary economic conditions*", specifically "*the current environment of low inflation*", as one of the three relevant factors that were taken into account to conclude that "*the debt criterion should be considered as [currently] complied with*". In its report for Italy in May 2016, the Commission clearly states that "*low inflation can hamper the reduction of the debt-to-GDP ratio and make compliance with the Stability and Growth Pact provisions particularly demanding, and thus needs to be taken into account*", and it adds: "*in the current economic circumstances, the required additional structural effort could be expected to have negative implications for growth and further aggravate the current low-inflation environment, thereby not contributing towards bringing debt on an appropriate downward path*". Therefore, it might be advisable to modulate the required fiscal effort if it can be detrimental to growth and price stability, which ultimately are the factors underpinning fiscal sustainability.

treatment in the application of the rules. This is especially relevant in view of the total magnitude of the downward revision of inflation in Spain since the EDP recommendation was issued in 2013, which is more significant than in the case of other Member States where this factor was taken into account.

The fact that real GDP growth in Spain has been higher than forecasted (as opposed to France's) cannot be used against Spain's fiscal compliance in 2015. It would be paradoxical to penalize Spain for its fastest economic growth. Spain's growth differential is not the result of lower prices or fiscal impulse, but the consequence of the deep structural reforms undertaken, which have allowed to leverage on the tailwinds.

#### **4. Measures adopted to reduce the public deficit in 2016**

Spain is committed to continue reducing the public deficit and to adopt the necessary measures to comply with the deficit targets set by the Council.

During 2016, and in compliance with the Autonomous Recommendation from the European Commission, Spain adopted different measures that show this commitment.

The Central Government adopted on April 29th several cuts in budget appropriations (agreement of non-availability) amounting to 2 billion euro, equivalent to a reduction of 3% of the Ministries budget. This expenditure was designed to have no direct impact on social protection. It affects other current and capital expenditure with direct impact on the public deficit. Moreover, this spending cut is expected to have an automatic carry-over effect on future budgets, since it will reduce the base level of public expenditures and no incremental cost in subsequent years is envisaged.

In addition, the corrective and coercive measures contained in the Organic Law on Budgetary Stability have been enforced. On the expenditure-control side, on 6th April 2016 the Central Government required the Regional Governments that had failed to fulfil the agreed adjustment plan and exceeded the deficit target, to adopt budget appropriations cuts (an agreement of non-availability) for a sufficient amount to ensure compliance with the deficit objective in the year 2016. This measure had an estimated impact of 1.5 billion euro.

Furthermore, in March the Government decided to impose additional conditions (fiscal conditionality and structural reforms) to be fulfilled by the regions that benefit from the 2016 Regional Liquidity Fund. Regions may only have access to the funds corresponding to 2016, provided they meet the following conditions:

- Adherence to the instrument for the sustainability of pharmaceutical and healthcare spending of the Regional Governments.
- Signature of the collaboration Protocol signed between the General State Administration and "Farmaindustria", to control pharmaceutical expenditure.

- Connection of the accounting records with the electronic billing platform for the public sector.
- Prohibition to approve budget changes involving net increase in non-financial expenditure regarding the one budgeted for 2016.
- Signing of the agreement for the mutual provision of basic electronic administration solutions to gain efficiencies and reduce costs.
- Assessment report of the general comptroller of the regional government. Monthly, before the 30th, the general comptroller is required to send a report on the degree of compliance with budgetary stability objectives, spending rule and public debt targets, as well as on the risks and circumstances that might result in a breach of any of these objectives. This report will also include information on the implementation of the agreement of non-availability.
- Implementation of corrective measures for regions with excessive commercial debt, as measured through the Supplier Payment Period.

Measures in response to the March 2016 Autonomous Commission Recommendation are starting to bear fruit.

The latest budget execution data evidences the effort made to contain the deficit:

- At the Central Level, expenditures decreased up to May by 2.9% in annual terms, with a significant reduction in current expenditure of 4.3%, as a direct result of budget control and the implementation of the cut in budgetary appropriations. Similarly, tax bases are on a robust growth path (3.7% 2016 compared to 2% in 2015).
- The Regional deficit declined until April by 29.5% year-on-year while regional and computable spending is growing at 0.8% in this period, which suggests that the 1.8% benchmark for the regions related to the spending rule can be comfortably met. This trend will be strengthened as the effects of the measures in response to the Autonomous Commission Recommendation fully materialize. In addition, the revenue of the regions is also improving, in part due to increasing revenue from the financing system<sup>4</sup> (advance payments and settlement of fiscal year 2014). Increasing revenue will also help the regions meet their 2016 deficit targets.

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<sup>4</sup> In 2016, non-financial transfers from the Central Government to the regions will increase with respect to 2015 by 7.4 billion euro. Non-financial revenues will hence increase substantially for the first time since the crisis, incorporating the tax revenue increase from 2014 (the regional financing system incorporates the tax revenue path with a two year lag).

- The recovery of Social Security revenues is remarkable. Social contributions have increased up to April by 3.7% year-on-year, while they grew only 0.4% in the same period last year.

In line with Spain's strong commitment to the Stability and Growth Pact, and as further sign of the determination to correct the excessive deficit situation, the new Government will apply regulatory reforms to the CIP installment payment, with an estimated impact on 2016 tax collection of 6 billion euro. Additionally, new instruments to fight against fiscal fraud will be put in place to underpin tax revenue growth, whose estimated impact will sum up to 1 billion euro. A Royal-Decree Law could be adopted to introduce these measures once the new Government is in place.

Furthermore, the new Government will advance to the month of July the closure of the 2016 budget. This is a budget- management strategy that will help to rein in expenditure.

## **5. Considerations regarding the Stability and Growth Pact**

The Stability and Growth Pact seeks two main objectives: Sound finances and sustainable growth. When assessing SGP compliance, it is essential to consider globally the achievement of these goals, rather than focus on a single year fiscal deviation. The fact that this deviation has taken place under very unfavourable economic conditions and that the assessment methodology is currently being subject to revision makes this consideration even more compelling.

In this respect, the Commission has recently pointed out in its review of the Six-Pack and Two-Pack regulations, the need for *"improvement, concerning transparency and complexity of policy making"*.

In order to assess progress towards the achievement of fiscal targets, Member States have long argued for using indicators that are more observable, predictable, under the control of the government and easy to communicate to the public. Indeed, the use of indicators based on estimations of potential growth may point to misleading results and lead to undesirable policy implications.

For example, at the informal ECOFIN meeting in April 2016, *"Ministers stated that the current framework has become complex and hard to predict due to the use of multiple and sometimes unobservable and volatile indicators"* (i.e. indicators based on potential output and output gap estimations). Along that same line of reasoning, other international institutions, such as the IMF<sup>5</sup>, are currently arguing for fiscal frameworks based on an expenditure growth rule, so as to reduce the uncertainty and volatility of unobservable indicators.

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<sup>5</sup> See IMF "Euro Area Policies 2015" and "Euro Area: Staff Concluding Statement of the 2016 Article IV Mission".

This key issue is currently being addressed through two main pathways:

- First, following the Communication of 21 October 2015 “on Steps towards Completing Economic and Monetary Union”, the Commission has proposed to review the “effective action methodology” in the corrective arm of the Pact by replacing the adjusted change in the structural balance (i.e. the current alpha and beta corrections) and the bottom-up approach by an expenditure-based rule.
- Secondly, also at the informal ECOFIN, Ministers gave a mandate to the EFC to re-examine the methodology for estimating the output gap. In particular, the Output Gap Working Group (OGWG) will “accelerate its work to study the implications of the possible extension of the time horizon used for estimating potential growth, underpinned by rigorous technical analysis”.

The discussion on an expenditure-based indicator for the corrective arm and the work on the output gap methodology are not yet completed. Nevertheless, according to the work plan recently endorsed by the EFC, if brought to a successful conclusion, the outcome of those discussions “*could conceivably be included in an updated Code of Conduct by the end of the year*”. Since this process could potentially change the effective action methodology in the near future, a prudent approach should avoid taking any action based on the current methodology.

All in all, the Stability and Growth Pact should be applied in a predictable, transparent and consistent manner, including the assessment of all relevant factors. Instead of losing perspective when dealing with particular indicators, we should bear in mind that the Pact is based on “*the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation*”. Spain's economic policies since 2012 have precisely pursued these objectives and the results, in terms of both more sustainable growth and employment creation, have already materialized. This will in turn contribute to improving the sustainability of its public finances.

## **ANNEX: ANALYSIS OF THE IMPACT OF LOW INFLATION ON THE SPANISH PUBLIC DEFICIT**

In its 2015 Report on Public Finances, the EC acknowledged the negative impact that a lower-than-expected inflation has on the public accounts of the European economies. The purpose of this annex is to provide a quantitative estimate of the impact on the Spanish budget balance in 2015 of the negative deviation of the Spanish inflation versus the EC 2013 estimate, when it set the Spanish budgetary targets in the Recommendation. To this end, the methodology used by the community institution, which has an essentially qualitative nature, has been analysed in detail.

In the last three years, inflation in the Eurozone was persistently below the ECB's price stability target. This anomalous situation was expressly acknowledged by the ECB, which launched monetary expansionary measures, including the use of unconventional instruments to ensure the return of inflation to levels close to the medium-term objective. The inflation dynamics in the Eurozone also influenced the prices evolution in Spain. It should be noted that, in order to end the external deficits registered in the past, and the continued external borrowing necessary to finance them, it was necessary to maintain an inflation differential favourable to our country against the Eurozone, in order to regain competitiveness and to correct the appreciation of Spain's real effective exchange rate. Since the European inflation recorded very low levels, this negative differential was only possible to the extent that Spain was able to record negative price variation rates: the average of the Spanish harmonised CPI in the last three years up to 2015, corrected from indirect taxes and other tax measures recorded a 0.2% yearly fall.

The Spanish inflation accumulated in the 2013-2015 period was slightly lower than that projected by the EC at the time of the Recommendation. This deviation ranged between 2.2 and 3.1 percentage points, depending on the inflation measure used. The magnitude of these forecasting errors more than offsets the positive surprises of the real GDP, resulting in a nominal GDP in 2015 1% lower than the figure estimated by the EC in 2013.

This dynamics of the Spanish inflation had a negative impact on public finances through various transmission channels. On the one hand, the negative inflation dilutes a significant part of the positive effects on the tax revenues often associated with the recovery of economic activity and employment. On the other hand, a lower inflation does not necessarily imply a lower nominal spending, since the main items on the expenditure side are not indexed with the inflation as a result of the structural reforms implemented in recent years. However, the lower inflation does have an upward impact on the public spending/GDP ratio due to its effect on the denominator. As a result, the budget balance, both in levels and in percentage of GDP, worsens in a context of low inflation, especially if inflation is negative.

In this quantitative estimation, we use and consider in detail the methodology used by the EC in its Report on Public Finance. Firstly, the time horizon is extended from one to three years in order to include the negative inflation surprises recorded between 2013 and 2015. Thus, instead of analysing the effect

of a negative inflation shock of one percentage point in 2014, as the EC does in its report, the impact on the fiscal variables is estimated assuming the inflation forecasts for Spain in the 2013-2015 period published by the EC in 2013 are met. Secondly, OECD elasticities are used and complemented with other estimates that consider more accurately the specificities of the Spanish tax system. Thirdly the shock on inflation is defined in greater detail, considering that it affects wages and corporate profits, which allows using more precise elasticities for each fiscal variable. Finally, several alternative approaches are presented to estimate elasticities, thus ensuring that the results obtained are robust. The aggregated elasticities obtained with these three methodologies are consistent and are in line with those used by the EC for countries with tax systems similar to the Spanish one, as is the case of France and Italy.

### Tax revenues elasticities

	Method 1. Regression	Method 2. OECD elasticities <sup>(1)</sup>	Method 3. Tax parameters <sup>(2)</sup>	Average of alternative methods	Weight over GDP <sup>(3)</sup>
Income tax	1.12	1.04	1.31	1.16	8.1
Corporate tax	1.16	1.32	1.00	1.16	2.1
Indirect taxes	1.17	1.00	0.97	1.05	8.8
Social Security contributions	1.00	0.59	1.00	0.86	12.4
Non-tax revenue	0.00	0.00	0.00	0.00	6.8
<b>Aggregate elasticity</b>	0.90	0.71	0.88	0.83	
Total weight of revenue over GDP					38.2

<sup>(1)</sup> Methodology based on OECD estimates of tax to base elasticities and ad-hoc calibrations of base to inflation elasticities.

<sup>(2)</sup> Methodology based on the calibration employed by Spain's tax agency.

<sup>(3)</sup> Weights are based on year 2013 figures.

### Expenditure items elasticities

	Calibrated elasticity	Weight over GDP
Compensation of employees	0.00	11.1
Intermediate consumption	1.00	5.3
Social transfers in kind	0.00	2.7
Social transfers other than in kind	0.15	16.5
Interest payments	2.00	3.3
Subsidies	0.00	1.1
Transfers to EU	1.00	1.0
Gross fixed capital formation	1.00	2.2
Other capital expenditure	1.00	1.0
Other expenditure	0.00	0.8
<b>Aggregate elasticity</b>	0.41	
Total weight of expenditure over GDP	45.1	

Based on this detailed analysis of public revenues and public expenditure and their elasticities to inflation, it is estimated that the General Government net borrowing as a percentage of the GDP would have been approximately 0.7 percentage points lower in 2015 if the inflation observed would have coincided with the EC triennial forecasts published in 2013 (the year in which the EU Council set the target of 4.2% of GDP for 2015). This analysis was completed with

a second scenario that assumed an observed inflation of 2% in the Eurozone and 1.5% in Spain. In this case it is estimated that the Spanish General Government deficit as a percentage of GDP would have been approximately one percentage point lower than the figure registered in 2015. Therefore, these estimates as a whole are in line with those obtained by the Commission for other European economies, such as France and Italy, and they confirm that the low inflation dynamics were a significant impediment to achieve the fiscal consolidation objectives in Spain in recent years.