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SPAIN: TOWARDS A PROTRACTED INCREASE IN THE PUBLIC DEFICIT?

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Strong fiscal support is currently key to limit the impact of the coronavirus shock on growth and employment. But in the long term, the question of public finances control will be asked.

In its November forecast, the European Commission predicts that Spain's structural public deficit will widen to 7.2% of GDP in 2022. This would be the biggest deficit since 2010 – 2009 being a record high – and the largest within the Eurozone[1].

Spain will not stabilise its primary structural deficit, which could surpass 5% of GDP by 2022. Nevertheless, the impact on public expenditures will be softened by low sovereign rates.

Three major obstacles – some of which will be amplified by the Covid-19 crisis – will limit any decline in the public deficit ratio: rising unemployment and poverty, the impact of the ageing population on pension financing, and the sluggish level of potential growth.

THE STRUCTURAL DEFICIT CONTINUES TO WIDEN

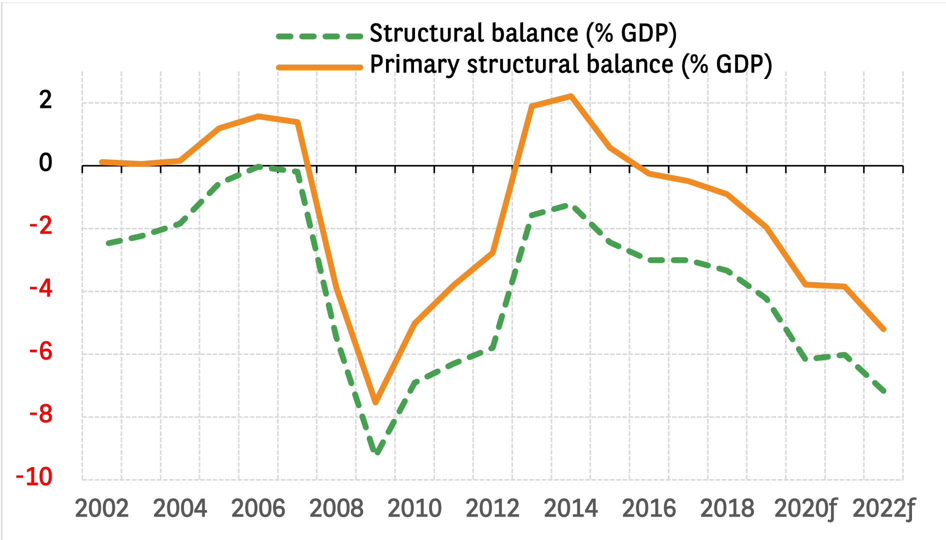

CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

Fiscal policy in Spain will remain very expansionary in 2021. According to the Ministry of Finance, the public deficit is forecast to reach 7.7% of GDP this year[1], after a shortfall of 11.3% in 2020. Given the uncertainty over the pandemic's evolution over time and the prolongation of any lockdown measures or restrictions, these figures may have to be revised in the months ahead.

Although the deficit has surged since the first lockdown last March, the underlying trajectory of Spanish public finances was already on a downward slope well before the epidemic outbreak. Indeed, the structural fiscal balance, which excludes cyclical fluctuations in revenues and spending, has swung back into deficit from 2016 onwards (*see chart 1*). This followed several years of improvement, resulting largely from the impact of austerity measures implemented by the Mariano Rajoy administration (mainly cutbacks in investment spending and wages)[2].

1 See the 2021 budget proposal https://www.sepg.pap.hacienda.gob.es/sitios/sepg/es-ES/Presupuestos/PGE/PGE2021/Documents/LIBROAMARILLO2021.pdf

2 Between 2009 and 2016, primary structural spending by the general government dropped from 42.5% of GDP to 38.4% of GDP. Over the same period, structural revenue as a share of GDP increased from 35.0% to 38.1% (Source: European Commission).

As things currently stand, efforts to combat the health crisis should keep the public deficit at a high level in the years ahead, due to a protracted increase in public spending.

According to the European Commission, structural public expenditure as a share of GDP will remain, by 2022, nearly 6.5 points higher than the pre-Covid 2019 level (*see chart 2*)[3]. The expenditure categories that are expected to increase the most, as a share of GDP, are social transfers, wage compensations and intermediate consumption.

1ST OBSTACLE: A JUMP IN POST-COVID SOCIAL WELFARE SPENDING?

Although job retention mechanisms (ERTE temporary unemployment scheme, tighter corporate bankruptcy conditions…) have helped limit the economic shock on the labour market so far, Spanish unemployment has already jumped by 725,000 (+22%) over the course of 2020[4]. A large proportion of the newly unemployed workers should be able to find jobs again once the pandemic has receded and lockdown restrictions have been lifted. Yet according to the Bank of Spain's latest forecasts, the current crisis will leave its mark on the labour market: the unemployment rate is not expected to return to pre-crisis levels before the end of 2023[5].

In 2020, the government has already implemented long-term measures to respond to the deteriorating social situation. The Minimum Vital Income, Spain's universal minimum income, was created last June. Intended to help a total of nearly 850,000 households, the programme will grow in importance in 2021, with its budget increasing to EUR 3 bn from EUR 1 bn in 2020. Moreover, the IPREM index, which is the metric used to calculate most of the country's social welfare benefits, will be adjusted upwards by 5% this year. This has been the biggest annual increase since the index creation in 2004.

The government plans to create new sources of income to offset these new expenditures. These include the creation of a "green" tax on waste and plastics, a digital tax, a "Tobin" tax on financial transactions and a reinforcement of its efforts to reduce tax fraud[6]. According to the government, these new sources of revenue would bring in an additional total of EUR 6.1 bn in 2021, which would only very partially close the gap between the State's primary structural income and expenses, which was estimated at about EUR 42 bn in 2020 (European Commission)[7].

Other factors are also expected to continue driving up social welfare spending in the medium term. These include ongoing efforts to raise the minimum wage towards a target of 60% of the median wage (one of the current government's campaign promises).

2ND OBSTACLE: THE SHARE OF PENSION EXPENSES CONTINUES TO RISE

The second major spending vector comprises retirement pension funding, the cost of which will continue to rise steadily in the years ahead, as the population ages. As a share of GDP, retirement pension spending will rise by 0.4% of GDP to reach 9.4% of GDP by 2030[8].

PUBLIC SPENDING: A BEFORE AND AFTER COVID?

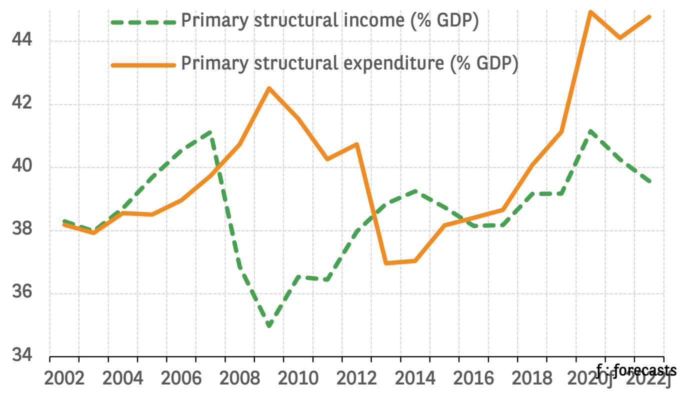

CHART 2 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

As in most western countries, the population dependency ratio, i.e., the ratio between the over-65 age group and the working-age population (20-64 age group), is rising steadily. Currently (2020), Spain's dependency ratio is close to the European average. Yet the aging of its population will accelerate in the years ahead, more rapidly than the OECD average[9]. Eventually, Spain will have the highest dependency ratio in Europe and the second highest in the OECD after Japan. Since 2013, Spain has gradually raised the legal retirement age, which will limit somewhat the imbalance between contributors and beneficiaries: the retirement age has risen from 65 in 2013 to 66 in 2021 and will reach 67 by 2027.

However, the deficit of the retirement system is not only due to an imbalance between contributors and beneficiaries. The calculation of retirement pensions in Spain is indeed "generous" if we compare it to other OECD countries: in particular, the replacement rate (i.e. the percentage of the last salary received at the time of retirement) is over 80%, one of the highest levels in developed countries.

One of the main sticking points in the coming years will be the way of calculating pension adjustments. In 2017, the government decided to suspend the calculation method introduced in 2013. To simplify, with this method, the adjustment in pensions was made so that pension expenditures rose in line with social-security revenues. This allowed for a better fiscal balance in the long term, but at the expense of a low adjustment rate on pensions. Instead, since 2018, changes in pensions have been aligned with the consumer price index, resulting in much bigger annual increases (1.6% in 2018 and 2019, compared to 0.25% under the method established in 2013)[10].

3 European Commission calculations exclude temporary and one-off measures implemented by governments to counter the Covid-19 crisis.
4 Source: SEPE, the Spanish employment agency.
5 Specifically, in its central scenario, the Bank of Spain is projecting an unemployment rate of 14.3% in 2023, compared to 14.1% in 2019.
6 For the full document detailing the 2021 budget, see https://www.sepg.pap.hacienda.gob.es/Presup/PGE2021Proyecto/MaestroDocumentos/PGE-ROM/doc/3/1/N_21_A_A_1_1.PDF
7The structural primary deficit is estimated at 3.6% of potential GDP in 2020. With potential GDP estimated at EUR 1,164.4 bn, this brings the structural primary deficit to EUR 41.9 bn (1164.4 x 0.036 = 41.9).
8The 2018 Ageing Report: Economic and Budgetary Projections for the EU Member States (2016-2070), European Commission paper, May 2018.
9 https://www.oecd.org/spain/PAG2019-ESP.pdf
10 See *Pensions at a Glance 2019: How does Spain compare*? OECD, November 2019.

3RD OBSTACLE: SLUGGISH POTENTIAL GROWTH LIMITS THE DECLINE IN THE PUBLIC DEFICIT-TO-GDP RATIO

The expected increase in public spending takes place in the context of sluggish underlying GDP growth. Spain's potential growth rate had already been reduced by the successive crises of 2008 and 2011, and could be impacted negatively again by the coronavirus shock. The contraction in 2020 GDP was unprecedented, and certainly exceeded 11%. A recent study by the European Central Bank highlights the negative impact of Covid-19 on long-term growth[11]. This is explained mainly by the sharp decline in the number of working hours, as a large share of workers have been placed in temporary unemployment. According to European Commission estimates, between 2019 and 2022, Spain's potential GDP level will increase by 1.4%, one of the slowest growth rates in the Eurozone, and lower than the increase in structural public spending. Spain's potential growth trajectory could hold well below that of the Eurozone as a whole (*see chart 3*).

Spain's low potential growth rate reflects in part the country's ageing population, which undermines the labour force's contribution to economic growth. But this is not the only obstacle. Spain is not investing enough. Investment (gross fixed capital formation) as a share of GDP remains lower than the European Union average[12]. Positively, the EUR 140 bn national recovery plan (Recovery, Resilience and Transformation Plan) will stimulate investment and boost potential growth in the years ahead. None of this will have a major impact on Spain's public finances, since virtually all of the package will be financed through sums received from the European recovery fund. Even so, the persistent low trend in growth reduces manoeuvring room for the authorities to significantly lower the public deficit ratio in the medium to long term.

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With the health crisis extending into 2021, strong support from fiscal policy is necessary. Thanks to the ECB's ongoing monetary measures and the low trend in inflation, Spain's sovereign rates remain at historically low levels[13]. However, in the long term, worries about the rapid build-up in debt could resurface once the health crisis is over and the economic recovery durably on track. In response to the increase in the structural deficit, at the end of last year the European Commission stated that, among other measures, it might condition part of the allocation of the European Recovery Fund on measures designed to help sustainably balance the social security fund[14]. By year-end 2022, the Spanish debt ratio could approach 125% of GDP, an increase of more than 25 points of GDP above pre-Covid levels (*see chart 4*).

Guillaume Derrien

POTENTIAL GDP: SPAIN & EUROZONE

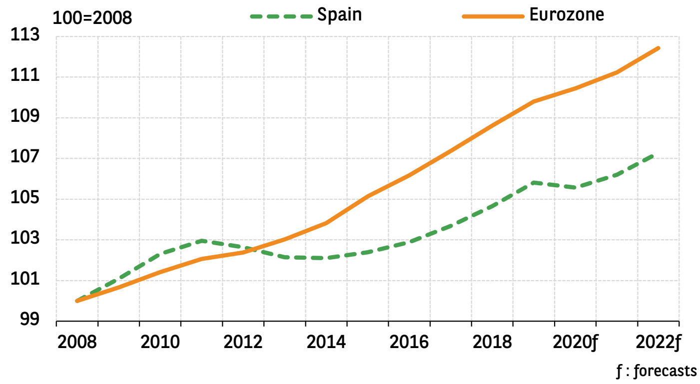

CHART 3 — SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

SPAIN: CONSOLIDATED PUBLIC SECTOR DEBT (% OF GDP)

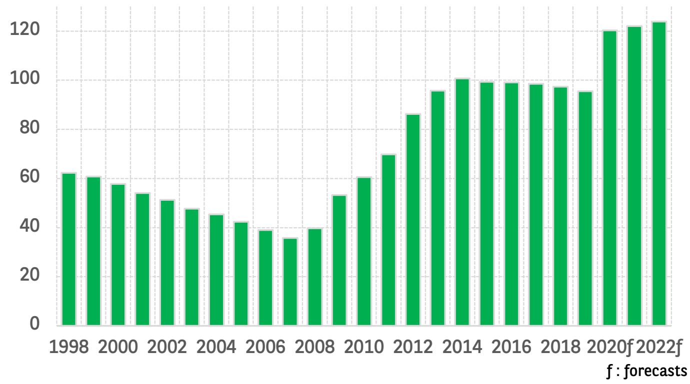

CHART 4 — SOURCE: AMECO, BNP PARIBAS

11 Bodnar et al. (November 2020), *The impact of COVID-19 on potential output in the euro area*, ECB Economic Bulletin
12 See BNP Paribas EcoConjoncture, *Southern Europe: why is potential growth so low?*, November 2020
13 Spain draws more than EUR 130 bn of orders in record sale of 10-year debt, Financial Times, 13 January 2021.
14 "Brussels urges Spain to reform pensions and jobs in return for EU funds", El Pais, 8 December 2020.

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