

Is the end of fiscal austerity feasible in Spain? An alternative plan to the current Stability Programme (2015-2018)¹

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Abstract:

Spanish authorities have implemented strongly restrictive fiscal policies with a negative impact in GDP and employment, especially during 2011-2013, but Spain still has the second highest public deficit in the EU. Once economic growth has recovered, the Stability Programme (2015-2018) aims to a fast budgetary consolidation, freezing public spending in nominal terms (and reducing it in terms of GDP by 5 p.p.) and allocating all the tax revenues coming from economic growth to reduce public deficits.

However, some important problems remain unsolved. Unemployment is very high and the Programme does not forecast a rapid reduction in this rate (16% in 2018). Inequality and poverty have sky rocketed. Industrial policies and public investments are needed to deal with structural problems. And austerity policies has meant dramatic cutbacks in some areas as education, health or public investment.

We present an alternative fiscal policy for the next four years, based in an “imperfect” balance budget multiplier. Instead of reducing public expenditures over GDP, it would maintain its current value, allowing an increase in social policies and public investment. And a progressive fiscal reform to increase public revenues over GDP in 3 p.p. would be undertaken. With sensible values of the parameters we find that the plan is expansionary, unemployment reduction occurs faster, and fiscal sustainability is assured.

1. Introduction.

Spanish authorities have implemented strongly restrictive fiscal policies with a negative impact in GDP and employment, especially during the recession of 2011-2013. Nevertheless, Spain still has the second highest public deficit in the EU (5.8% of GDP). Once economic growth has recovered, the Stability Programme (2015-2018) presented by the Spanish Government (SP henceforth) aims to a fast budgetary consolidation, freezing public spending in nominal terms (and reducing it in terms of GDP by 5 p.p.) and allocating all the tax revenues coming from economic growth to reduce public deficits. Specifically, the SP foresees that public deficit will be under 3% in 2016, and that Spain will register budgetary equilibrium in 2018.

However, some important problems of the Spanish economy remain unsolved, in spite of current GDP growth. Spain unemployment is very high (24% in 2014) and the macroeconomic scenario included in the SP does not forecast a rapid reduction in this rate (15% in 2018). Inequality and poverty have grown fast during the last years as well. Finally, industrial policies

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and public investments are needed to change the sectorial specialization. At the same time, Spanish public revenues and expenditure ratios over GDP are well behind EU averages, and austerity policies has meant dramatic cuts in some areas as education, health or public investment.

In order to fix these problems, we present an alternative fiscal policy for the next four years, aimed at a more fasted decreasing of unemployment. Specifically, we have set the objective of an unemployment rate of 10% in 2018 (instead of 15% forecast by the SP), which would require about 20.6 million people employed (the same number that in 2007). Then, we define an alternative fiscal policy able to reach this target, using a kind of partial of “imperfect” balanced budget multiplier.

The main components of this plan are: a) instead of reducing public expenditures over GDP, maintain its current value (44%), which would allow an increase in social policies and public investment; and b) a progressive fiscal reform to increase public revenues over GDP in 3-4%. And we underlines that the plan is completely compatible with public deficit and debt reduction, although the 3% threshold would be reached at the end of the four-years period and not at the beginning, as the SP proposes. With sensible values of the multipliers, we find that the plan is expansionary, unemployment reduction occurs faster, and fiscal sustainability is assured.

The rest of the papers is organized as follows. We explain the arguments for a change in the Spanish fiscal policy in section 2, and the main characteristics of the SP in section 3. Section 4 describes our alternative proposal, the methodology used to define it and to measure its effects, and summarize the macroeconomic consequences derived from its implementation. Section 5 and 6 explores two possible constraints that could hinder it: the balance of payment constraints and the current EU fiscal rules. Finally, section 7 concludes.

2. Why does Spain need a change in its fiscal policy?

The austerity measures implemented since 2010 to face the Great Recession had very different effects from those projected by the authorities and Spain, as well as other peripheral economies, experienced a second recession in 2010-2013. The drastic reduction in public spending was supposed to strengthen the financial solvency of the country and thereby restore growth and overcome the crisis. However, public sector cuts had a much more restrictive effect than expected by international organizations, and they reduced household income -together with internal wage devaluation- and private consumption. Neither took place the expected growth in private investment that should result from improved expectations and corporate profitability, due to lack of effective demand and excess of capacity installed. Finally, while exports grew at a high rate, similar to that recorded before the crisis, they could not offset declines in domestic demand.

However, since the last quarter of 2013 the Spanish economy has returned to positive GDP growth rates. In fact, growth has accelerated to currently achieve an annual rate of 3%. Does this mean that austerity policies have worked and have finally brought the expected recovery? Does it make sense to call for an alternative economic policy in Spain, and particularly the demand for a more expansionary fiscal policy?

From our point of view, four major reasons justify the need for a change in economic policy in Spain, and the implementation of an expansionary fiscal policy: 1) strengthen and underpin

economic recovery; 2) reverse the effects of austerity policies on essential public services; 3) reduce the strong inequalities; and 4) address the structural problems of the Spanish economy.

First, the determinants that explain the current recovery are not the result of austerity, but of other factors, which explains the fragility of the ongoing recovery and the need to reinforce it.

Various external factors have provided to the Spanish economy an important tailwind for a year and a half: the buying of government bonds by the ECB has continued to reduce the interest rates, which were higher in Spain than in the Eurozone, and contributed to credit recovery; the sharp drop in oil prices, with a corresponding expansionary effect on private consumption; and also the depreciation of the euro.

Domestic factors also matter. The gradual fall in the rate of household saving has a positive impact on private consumption and, in addition, the government has significantly relaxed the pace of austerity over the past year. The net primary expenditure (without financial aids to the banking system) rose 1.9 billion in 2014.

These determinants suggest that the current growth is fragile: external factors could well disappear over the next year; the increase in private consumption based on reduction of savings is not sustainable in a context where families still have high levels of indebtedness and nominal wages remain stagnant; and the absolute priority given in the Stability Program to achieve an structural budget balance and to reduce deficit below 3%, presage a return to austerity if current forecasts of a strong increase in tax revenues fail.

Fiscal austerity and wage cuts are not therefore the factors behind the incipient recovery. On the contrary, these policies have prevented the Spanish economy to emerge from the crisis before, and they have led to a lost decade. Spain still has a real GDP 4% lower than in 2007, and has recovered only 30% of the jobs lost during the crisis. After reaching a peak of 27% in 2013, the unemployment rate was still 22% in the second quarter of 2015 and the government's own forecasts included in the Stability Program are that it will remain above 15% in 2018.

It is therefore still needed an alternative strategy, putting an end definitely to the austerity, in order to consolidate a true recovery and favor a faster reduction of unemployment. As it has been evident throughout 2014 and 2015, fiscal multipliers remain positive and high, so a more expansionary fiscal policy would boost recovery and job creation.

Apart from this macroeconomic argument, there are other reasons to justify a proposal for recovery of public spending, thus very different from the one included in the Stability Program of the Spanish authorities (consisting in freezing spending in nominal terms, and therefore reducing the expenditure to GDP ratio).

Austerity policies substantially weakened these years some essential public services, increasing the gap between Spain and neighboring countries. Now it is therefore necessary to gradually regain lost ground. A post-austerity policy is not only to stop reducing public spending, but also to reverse the effects of this cuts. As we will see in more detail below, in 2013 public spending was reduced in total by 29 billion Euro compared to 2009. And if we deduct from public spending direct aid to financial institutions (50 billion in the period 2011-2013) and interest payments (which increased by 16 billion between 2009 and 2013), the total nominal reduction was 52 billion Euro. The expenditure/GDP ratio experienced a minor decline, from 45.8% to 44.3%, even though production fell in nominal terms 30 billion Euro. In cyclically adjusted terms,

the weight of public expenditure in GDP is 7.5 percentage points lower in Spain than the Eurozone average.

Ignoring pensions and unemployment spending, the rest of essential services have been reduced by 22 billion Euro. If we analyze these figures in terms of real per capita spending, we observe that expenditure in basic public services increased from 55% of the EU-14 average to 63% from 1999-2007. In 2013 real per capita spending in Spain, compared to the EU-14 average, has again reduced to 60%. Public investment has been reduced by 33,000 million between 2009 and 2013, which meant that its share in GDP has collapsed from 5.1% to 2.1%.

Moreover, the profile of the recovery is contributing to reinforce or exacerbate other problems of the Spanish economy, which will have adverse macroeconomic effects in the future. Among them we have the rapid growth of inequalities, reinforcing the lack of demand and the excessive use of credit by households. Spain is the European country where more has increased inequality since the start of the crisis, and more than 10 million people live below the poverty line. The AROPE indicator, which measures the risk of poverty plus social exclusion, has grown from 24.5% in 2008 to 29.2% in 2013 (over 13 million people).

In addition, the employment is being created is not only insufficient, but also of very poor quality: 90% of the contracts signed are temporary, more than 4 million workers are no longer covered by collective agreements and salary of new employees tends to be 10% lower. Employment is no longer a guarantee against poverty and to achieve sufficient welfare. In Spain, 12.2% of employed workers were poor in 2012.

In this context, more than 750,000 families receive no income and almost 4 million unemployed do not receive unemployment benefits. Inequality has increased in both the primary distribution of income and in the secondary (after taxes and benefits). This shows the redistributive weakness of the Spanish tax and social protection systems: according to the OECD, the poorest 20% of the population gets a much lower volume of public benefits compared to the 20% richer.

All this points to the need for an emergency plan to fight poverty and inequality, which requires both tax reform to strengthen the progressivity of the system and a more redistributive spending policy. This should include, for example, a guaranteed income scheme for low income households to address the situation of those most affected by the crisis. This emergency plan also requires changes in other aspects of the economic policy mix, such as a new labor reform to rebalance collective bargaining, to prevent excessive temporary employment and to end with wage devaluation.

Finally, transforming the pattern and structure of the actual growth is just as important as consolidating its rate. The nature of the actual growth is characterized again by major industrial and external imbalances, which the policies implemented during the crisis have not resolved.

The current growth has raised up a longstanding imbalance of the Spanish economy: the strong import propensity of our economy (especially in the field of fossil fuels), triggered a negative contribution of the external sector to GDP growth in recent quarters (despite a significant advance of exports).

Despite the dominant discourse, wage devaluation policy has not been useful to guarantee a current account balance, since the pattern of industrial specialization in sectors of medium value and low productivity remains unchanged. The consequence of this is that the Spanish

economy will have to rely, as in past decades, on external borrowing. If there are no changes in the industrial structure, the higher the growth, the greater the need for external financing.

If we want to promote a true recovery, it is necessary to put an end to austerity. But this does not suffice. A post-austerity policy must be accompanied by other structural measures: increase R&D funds to close the Spanish gap with the EU average, thereby facilitating the displacement of our production towards higher value-added segments; undertake a plan of energy saving and development of renewable sources that reduces our dependence on imports and rebalance the current account; a minimum wage increase, the discouragement of temporary hiring and promoting the reconciliation of work and family life; to endorse the restructuring of the mortgage debt of households.

In the absence of structural measures such as these, the actual growth will be difficult to sustain and will produce heavy economic and social imbalances. But to promote these structural measures financial funds are necessary and therefore a new fiscal policy is required. Expansionary fiscal policy and structural reforms to modernize the economy, and reduce external dependence, go hand in hand.

3. The years of austerity and the Stability Programme (2015-2018).

Spain has been one of the European countries more strongly hit by the crisis. Briefly, we hold that this is, first, the result of the burst of the real estate bubble, but also the consequence of a mistaken macroeconomic policy². Specifically, the combination of fiscal austerity and wage devaluation had strong restrictive effects on domestic demand between 2011 and 2013, triggering a second recession with severe effects on employment.

At the beginning of the Great Recession (2008-2009), the Spanish government implemented an economic policy aimed at the recovery of domestic demand, through an expansive fiscal programme. Actually, the Spanish package of fiscal stimulus was one of the most expansive in the world (2.3% of GDP in 2009), because Spain had a large fiscal space (public balance and public debt were 2% and 36% of GDP in 2007). Of course, one of the outcomes of the crisis itself and of this expansive policy was the increase in fiscal deficit and public debt (-11.1% and 53.1% of GDP in 2009). Then, the government curbed public spending in 2010, due to the sovereign debt markets crisis and pressure from other governments and the European Commission. Between 2010 and 2013, the stance of Spanish budgetary policy was strongly restrictive and procyclical.

Economic authorities argued initially that fiscal consolidation could be associated with an expansion in private domestic demand through some “non-Keynesian effects” such as expectations of future tax cuts, decreasing interest rates or more confidence from investors³. Quite to the contrary, fiscal austerity has been systematically associated with lower growth during the crisis, and the Spanish government has finally recognized that fiscal austerity is detrimental to domestic demand in the short run, arguing that its positive effect would come in the long run in the form of higher potential growth and job creation (for example, Spanish

² Febrero and Bermejo (2013) provide a non-orthodox interpretation of the causes that drove the Spanish economy to recession, and the limitations of the economic policies applied by the authorities.

³ Alesina (2010) summarises these arguments, while Romer (2012) provides an opposing point of view.

Government, 2013). Theoretically, this would be the outcome of the combination of the improvement in fiscal finances, leading to a reduction in interest rates, and the rebalancing of the external sector because of the recovered competitiveness derived from internal devaluation, with structural reforms accelerating the convergence towards a full employment position. Nevertheless, potential growth is not independent from real aggregate demand growth. Austerity measures not only depress output and employment in the short-run, but they have longer lasting consequences as well. Ball (2014) offers clear evidence about this long-term damage from the Great Recession in OECD countries, including Spain.

The Spanish experience shows crystal clear that while fiscal austerity and internal devaluation had a strong depressive effect on internal demand, they did not trigger an expansion in exports sufficient to offset it and to handle the recovery of growth and employment⁴. As a result, although the Spanish economy has recovered positive rates of growth since the last quarter of 2013, its real GDP was 4% lower than its pre-crisis level in the second quarter of 2015, and the rate of unemployment was 22%. This means that even with high real GDP growth, the elimination of this level of unemployment will take years.

Most of the fiscal adjustment in Spain has been due to reductions in public expenditure. The sum of public consumption and public investment was, in real terms, 16.5% lower in 2014 than in 2009. The Spanish authorities also raised some taxes (direct taxes on income, but above all indirect taxes such as VAT), but the increase in public revenue has been systematically lower than forecasted, precisely because of the strong negative impact on effective demand of these decisions. The negative contribution to growth of public demand explains 40% of the total drop in domestic demand in this period.

Despite the policy of cutbacks, Spain has failed to reduce public deficit in line with established targets, and still has the second largest deficit in the EU. This does not mean that even further cuts in spending should be implemented but should be seen as an indication that “austerity does not work”: the restrictive effects of austerity policy prevent the very objectives it pursues from being achieved.

The impact of wage restraint (internal devaluation) on domestic demand is reflected in the evolution of private consumption, which also registered negative growth rates in real terms during this period, especially in 2012 and 2013. At the end of 2013, household final consumption was 7% lower than in 2009 in real terms. In those two years, the average negative contribution to growth of private consumption was 1.7 percentage points.

Undoubtedly, this drop is the result of decreasing household disposable income, which is mainly derived from wages. During 2008 and 2009, household nominal disposable income increased despite the drop in GDP, mostly due to expansive fiscal policies. However, the saving rate also rose for precautionary reasons, and nominal consumer spending fell in 2009. From 2010, household income began to diminish because of job destruction, fiscal consolidation and decreasing wages, and both real and nominal consumption were falling from 2011 to 2013.

During that years there were a reduction in the saving rate, especially in households with lower incomes. However, this was not possible in the case of households with a high level of

⁴ Uxó, Febrero and Bermejo (2015).

debt, because they have to set aside a portion of their disposable income to repay it (“forced savings”). This reveals that economies which have got heavily indebted in a short period of time and which have experienced large current account imbalances, like Spain, face the risk of suffering a debt-deflation problem when trying to rebalance their external sector through wage devaluation. When outstanding debt is high, falling wages increases the burden of debt servicing, reducing private consumption, which in Spain is roughly 60% of GDP.

Theoretically, the reduction in consumption expenditure could be compensated by higher investment by firms whose profitability was increasing. Actually, falling labour costs and rising profit margins has led to an increase in the disposable income of Spanish corporations. However, private investment has made a negative contribution to growth during the whole of this period. This can be explained because of very low levels of capacity utilization due to stagnated demand, and because firms have devoted their increasing incomes to reduce debt more than to productive investment. Then, internal devaluation has had a negative effect on domestic demand, contributing to increasing unemployment.

Regarding the external sector, Spain went from a net borrowing of over 10% in 2008 to net lending in 2013, mainly because of the improvement in its balance of goods and services. This change made the foreign sector go from making a negative contribution to growth before the crisis, to a positive contribution from 2010 to 2014. However, the change in the behaviour of the foreign sector is better explained by the collapse of domestic demand and of imports than by changes in relative prices (real depreciation). So it can hardly be attributed to the “positive” effects of a “successful” internal devaluation.

Graphs 1 and 2 represent the evolution of public revenues and expenditures in Spain, and Table 1 compares their situation in Spain and in the Euroarea in 2014.

During the 1999-2007 period public spending experienced strong growth in Spain, 22.9 billion Euro per year on average. This spending growth is more significant considering that payment of interest on debt was reduced to an average of 428 million Euro per year (from 3.4% of GDP to 1.6%). Real spending per capita went from 8,100 Euro in 1999 to 9,500 Euro in 2007. In that last year, total public expenditure in Spain was 38.9% of GDP, figure very similar to that achieved when the monetary union was created. Nevertheless, this ratio was 7 percentage points below the average of the EU-14. And if we make the comparison in terms of per capita spending, public spending in Spain was only 65% of the EU-14 mean.

The biggest gap in public spending was recorded on social spending (5.1% of GDP less in Spain). This gap was concentrated in pension expenditure (2.5% of GDP less), in health (1.1%) and education (1%). That is, in 2007 Spain spent on essential public services (education, health and social protection) 7.1% of GDP less than other EU-14 economies. This gap was virtually the same that existed in 1999. The gap also remains during this period if we look to the figure of real total spending per capita (moving from 63% of the EU-14 average to 65%). In addition, this period is characterized by a major effort of public investment, accounting in Spain for 10.5% of total spending between 1999 and 2007 (6.2% in the EU-14), and 4% of GDP (2.9% in the EU-14).

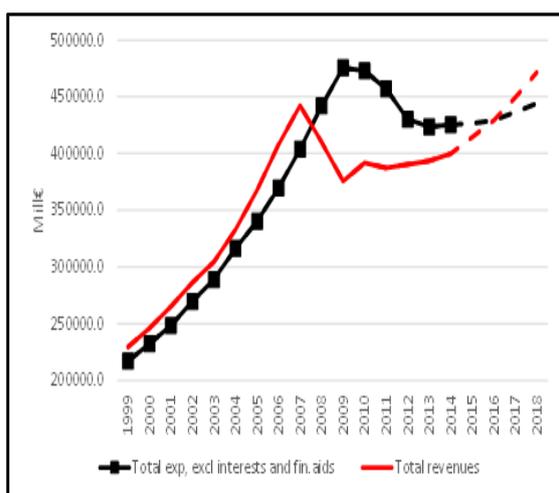
The discretionary fiscal stimulus applied by the Spanish authorities in 2008 and 2009, and the effect of the automatic stabilizers, provoked that public spending growth accelerated in these two years (39,000 and 34,000 million € respectively). This was an increase of the expenditure/GDP ratio of 6.8 percentage points, to reach 45.8%. In the EU-14 fiscal policy was

far less expansive, and although the increase in the expenditure/GDP ratio was very similar (from 45.8% to 51.3%), this was explained by a sharp drop in GDP⁵. In terms of GDP, we observe an increase in all type of expenses, except defense, but the largest increases in spending are concentrated in unemployment (1.5% of GDP), pension expenditure (1.1%) and health care (1, 1%). The weight of public investment in GDP also grew 0.5 point.

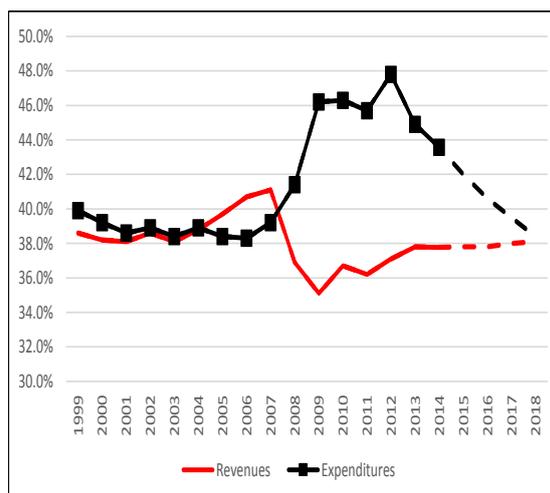
Since 2010, fiscal adjustment primarily focused on cutbacks in spending, which amounted to 29 billion Euros less in 2013 than in 2009, with huge effects on the main public services, as we have mentioned before. In 2014, fiscal policy turned to a more neutral stance in 2014, when primary expenditure increased in 1.9 billion euro if we exclude aids to the financial institutions.

The public expenditure/GDP ratio has risen since the start of the crisis, but this has mainly been due to the reduction in nominal GDP. Actually, the weight of public expenditure in GDP is systematically lower in Spain than the Eurozone average. Spain is also characterised by a lower capacity to collect sufficient revenues than the European average, and the weight of public revenues in relation to GDP is at around nine percentage points below the Eurozone average.

Graph 1: Public expenditures and public revenues (Spain, Mill €)



Graph 2: Public expenditures and public revenues (Spain, % GDP)



Source: Eurostat (for years 1999-2014) and Stability Programme (for years 2015-2018).

⁵ This means that in cyclically-adjusted terms, the gap was shortened compared to the European average.

Table 1: Main fiscal indicators for Spain and the Eurozone

2014	Spain		Euroarea	
	Billion€	%GDP	Billion€	%GDP
Revenues	399.7	37.8%	4715.4	46.6%
Expenditures	461.1	43.6%	4961.3	49.0%
Balance	-61.4	-5.8%	-245.9	-2.4%
Debt	1033.857	97.7%	9292.618	91.9%

Source: Eurostat

The dotted part of the lines in these graphs represents the evolution of public expenditures, public revenues and public balance derived from the SP for the years 2015-2018 sent by the government of the Popular Party to the European Commission (Spanish Government, 2015).

For the coming four years, the SP forecasts strong economic growth (3%), which will be reflected in an increase of 72 billion in tax revenue (see Table 2)⁶. In this context, the government has taken two key fiscal policy decisions:

- From the standpoint of revenues, the government has not adopted measures to compensate the low revenue raising capacity that characterises Spain compared to the European average. Indeed, the tax reform currently in place reduces collection of revenue without improving equality. The percentage of revenue to GDP will remain virtually constant at its present value (moving from 37.8% to 38.1%) and the increase in revenues is almost exclusively the consequence of strong economic growth.
- These additional revenues will not be used to reverse earlier cutbacks nor to attend to social and investment needs, but will mainly be used to reduce public deficit, with budget balance being achieved in 2018. Public expenditures will scarcely rise (14 billion in four years), which will in fact mean a reduction of five points in the expenditure/GDP ratio.

In our opinion, then, it can be said that austerity will not be abandoned but merely softened. And we think that the social and economic effectiveness of the public revenues coming from the recovery in GDP growth would be greater if they were devoted to create employment, implement social policies and transform the economy, instead of employed to reduce public deficit so rapidly, particularly given extremely low interest rates. Because of this, the rest of this paper is devoted to analyse the feasibility of an alternative fiscal policy in Spain during the period 2015-2018.

⁶ The Spanish government has modified some of these forecasts in the budget project for 2016. However, the main characteristics of the macroeconomic scenario and fiscal policy remain the same.

Table 2: Macroeconomic and fiscal variables, Spain

Concept	Units	Actual	SP Forecasts			
		2014	2015	2016	2017	2018
GDP (% real growth)	% real growth	1.4%	2.9%	2.9%	3.0%	3.0%
Total Employment (thousand)	Thousand	17344.2	17864.5	18382.6	18915.7	19464.2
Unemployment rate (% active)	% active population	24.4%	22.1%	19.8%	17.7%	15.6%
Ct ^o deflact	% growth	-0.5%	0.7%	0.9%	1.2%	1.6%
Goods and services Balance	% GDP	2.4%	2.9%	2.9%	2.8%	2.7%
Net Borrowing/Net lending	% GDP	1.0%	1.7%	1.8%	1.6%	1.4%
- Private	% GDP	6.8%	5.9%	4.6%	3.0%	1.7%
- Public Sector	% GDP	-5.8%	-4.2%	-2.8%	-1.4%	-0.3%
Public revenues	Billion Euro	399.7	414.5	429.0	449.4	471.3
Public expenditures	Billion Euro	461.1	460.6	460.8	467.1	475.0
Public balance	Billion Euro	-61.4	-46.1	-31.8	-17.7	-3.7
Public debt	Billion Euro	1033.9	1084.5	1117.9	1141.2	1152.9
Public revenues	% GDP	37.8%	37.8%	37.8%	38.0%	38.1%
Public expenditures	% GDP	43.6%	42.0%	40.6%	39.5%	38.4%
Public balance	% GDP	-5.8%	-4.2%	-2.8%	-1.5%	-0.3%
Public debt	% GDP	97.7%	98.9%	98.5%	96.5%	93.2%

Source: Stability Programme (2015-2018).

4. Abandoning austerity: an alternative fiscal policy and its impact on the economy and on the sustainability of public finances.

Frequently, it has been argued that there were no alternative to austerity policies, because they were the only way to correct some macroeconomic imbalances that the Spanish economy was suffering (competitiveness losses, current account deficit and growing indebtedness). And the Spanish authorities are currently using the same argument to present the fiscal policy that we have just described as the only possibility to reach the “needed” reduction in public deficit. On the contrary, we present in this section an alternative proposal that it is not focused on deficit reduction, but on employment creation and on social and structural policies related to a real transformation of the Spanish economy. That policies require increased public expenditures, but we also show that they are compatible with sustainable public finances. The main idea behind this proposal is a kind of “imperfect” balanced budget multiplier.

4.1. Methodology and equations:

We are interested in the comparison between the outcomes of the fiscal policy proposed in the SP (in terms of economic growth, unemployment and public deficit and debt) and the results of an alternative strategy aimed at the economic policy objectives that we have defined above. Following the same approach than Rosnick and Weibstrot (2013) we take the macroeconomic forecasts of the SP as the baseline scenario, and then we analyse how it would alter as a result of the changes in fiscal policy we advocate.⁷

⁷ Rosnick and Weibstrot (2013) compare different alternative changes in public expenditures and revenues with the IMF’s forecasts of the Spanish economy published in the WEO, October 2013.

This baseline scenario reflects, then, the evolution of the Spanish economy that the current government considers most likely, given the economic policy it will implement and as a result of other external factors. We do not intend either to validate or refute the likelihood of such a scenario actually materialising. Rather, our aim is to isolate the changes in the evolution of the Spanish economy that could be attributed exclusively to the change in fiscal policy, maintaining the same assumptions than the Spanish government about the rest of variables affecting the economy.

In other words, we first determine the GDP and employment targets that fiscal policy should pursue in the years 2015-2018. Then, taking the SP forecasts and current government's fiscal policy as the baseline scenario, we estimate the *discretionary change* in public revenues and expenditures necessary to reach the targets. Thirdly, we calculate the effect that this change would have on public deficit and public debt once automatic stabilisers have been taken account of and, finally, we add these effects to the figures forecast by the SP, and compare with the baseline scenario.

In our opinion, this methodology makes it easier to compare the consequences of alternative fiscal policies, and its conclusions are only conditioned by two pairs of parameters, the multipliers and the cyclical sensitivity of public revenues and public expenditures. In spite of its simplicity, however, it will permit us to show that –given the same forecasts about those variables not affected by changes in the fiscal stance- our proposal would mean higher growth, less unemployment and the possibility of funding much needed social and structural policies in Spain, without compromising the medium-term sustainability of public finances at all.

We can carry out most of our calculations with a very simple model of only two equations. We use the symbol Δ to represent the variation experimented by a variable resulting from the change in fiscal policy compared to the baseline scenario (Stability Programme).

The influence of fiscal policy on income (Y) will depend on the change in total public expenditures (G) and revenues (R), and on the multipliers. We call the expenditure multiplier α_G and the tax multiplier α_R , such that we have:

$$\Delta Y = \alpha_G \Delta G - \alpha_R \Delta R$$

We distinguish now between changes in public revenues or expenditures coming from voluntary decisions adopted by the authorities (“discretionary”, identified by the superscript D) and due to a variation in the cyclical conditions of the economy and the working of automatic stabilisers (“cyclical”, identified by the superscript C). Being $\gamma_R > 0$ a parameter which measures the effect of a change in GDP on public revenues, and $\gamma_G < 0$ the parameter which represents the same effect but on public expenditures, we write:

$$\Delta Y = \alpha_G (\Delta G^D + \Delta G^C) - \alpha_R (\Delta R^D + \Delta R^C)$$

$$\Delta Y = \alpha_G (\Delta G^D + \gamma_G \Delta Y) - \alpha_R (\Delta R^D + \gamma_R \Delta Y)$$

Reorganising the terms:

$$\Delta Y = \frac{\alpha_G}{1 - \alpha_G \gamma_G + \alpha_R \gamma_R} \Delta G^D - \frac{\alpha_R}{1 - \alpha_G \gamma_G + \alpha_R \gamma_R} \Delta R^D$$

Simplified:

$$\Delta Y = \Omega_G \Delta G^D - \Omega_R \Delta R \quad (1)$$

This equation tells us how much GDP changes -compared to the SP forecast- when there is a discretionary change in expenditures and revenues. Ω_E and Ω_R are the multipliers that link this *discretionary* change in expenditures and revenues to national income, taking into account the effect of automatic stabilisers. Obviously, they are lower than the *total* multipliers. If, for example, the government performs an increase in public investment to stimulate the economy, there will be reductions in other kind of expenditures –such as unemployment benefits- and increases in tax collection as a consequence of the first-round expansive effects.

Our second equation represents in turn the final effect of the change in the fiscal policy on the public budget balance (B), taking into account again the operation of automatic stabilisers:

$$\Delta B = (\Delta R^D - \Delta G^D) + (\Delta R^C - \Delta G^C)$$

$$\Delta B = (\Delta R^D - \Delta G^D) + (\gamma_R - \gamma_G) \Delta Y$$

Finally, replacing ΔY by equation (1) and operating:

$$\Delta B = [1 - (\gamma_R - \gamma_G) \alpha_R] \Delta R^D - [1 - (\gamma_R - \gamma_G) \alpha_G] \Delta G^D \quad (2)$$

We can use this equation to see the final impact of a discretionary change in fiscal policy on public budget balance in absolute terms. Under sensible assumptions on the values of multipliers and cyclical sensitivity of public revenues and expenditures, this effect is less than proportional.

4.2. Multipliers and cyclical sensitivity of public revenues and expenditures:

According to equations (1) and (2), the impact of a change in fiscal policy on income and public balance actually depend to a great extent on two kinds of parameter: on the one hand, the expenditures and revenues multipliers (α_G and α_R) and, on the other, the cyclical sensitivity of expenditures and revenues (γ_G and γ_R).

The empirical literature on fiscal multipliers has increased significantly since the onset of the Great Recession. Initially, this was due to the application by a number of governments of some kind of fiscal stimulus aimed at the recovery of domestic demand. As a consequence of the sovereign debt crisis in the Eurozone, however, the main interest has turned to be the contractive effects of fiscal consolidation programmes put in practice by many European countries since 2010, especially in the periphery.

The recognition by the IMF (2012) that it had underestimated the value of fiscal multipliers –and, then, the negative impact on the real economy of cuts in public expenditures that that institution had been advising- can be considered an important milestone in this regard. Using international evidence for 28 economies, its main conclusion is that actual multipliers of public deficit could be in the range of 0.9 to 1.7, while multipliers implicitly used to forecast the effects of fiscal consolidations had been about 0.5.

Nevertheless, this literature has also shown a great variation in the results of the estimations. Although it can be partially explained by the differences in the implicit economic

model or in the econometric methodology used in each case, it has also become clear that the specific value of the multipliers depends on some factors such as the economic situation (fiscal policy seems to be more effective when is applied in depressed economies with idle resources and a deflationary bias) or the kind of instrument put in practice (public investment, public consumption, transfers to the private sector or taxes).

Gechert and Rannenberg (2014) is a very useful attempt to systematize all this literature. They conduct a meta-regression analysis of 98 empirical studies, controlling for the economic regime (if the economy is in normal, bad or good times) and also for the kind of fiscal impulse applied.

Regarding normal times, they find that public investment is clearly the category of expenditure with a higher impact on the economy, with an estimated multiplier of 1.4, while the multiplier takes a value of 0.5 in the case of public consumption, and 0.3 when the public sector increases its transfers to the private sector. The multiplier associated to tax reductions is 0.3 as well. In those studies in which the kind of expenditure is unspecified, the estimated multiplier is 0.6.

The multiplier of public expenditures rises during bad times, mainly because accommodative monetary policies are more likely during economic downturns. In turn, this is due to the zero lower bound of nominal interest rates and to a smaller response to inflation by part of central banks. Specifically, the multiplier of unspecified government expenditure rises by 0.7 approximately, reaching a value of 1.3. But other important conclusion of their study is that the size of this increase depends on the specific instrument applied in each case.

For example, the effect of transfers on the real economy changes much more dramatically than the public investment multiplier. Public transfers is the second least effective expenditure type during normal times, but it turns to be the most effective one –with a multiplier of 2.3– when the economy is in a downturn. This might be explained by an increase in the number of liquidity or credit-constrained households when the economy is stagnated. On the contrary, the multiplier associated to public investment increases only moderately in the lower regime.

It also should be underlined that the cumulative multiplier of all kind of government expenditure exceeds one in the lower regime, which means that there is an overall crowding-in effect, not a crowding-out one.

Regarding tax multipliers, they are rather small in all regimes (their mean is around half of the mean of public expenditure multipliers) and appear to be almost unaffected by the economic situation.

Martínez and Zubiri (2014) summarize some estimations on the fiscal multiplier in Spain and offer their own calculations of the expenditure and revenue multipliers. They also conclude that that expenditure multipliers are considerably larger in expansions than in recessions, and in all cases they find that changes in taxes have a lower impact on GDP than changes in expenditures. Specifically, their estimated value for the expenditure multiplier is between 1.3 and 1.7.

Finally, Rosnick and Weibstrot (2013) give a value of 1.5 to the multiplier related to direct public spending (consumption and investment) and a value of 0.5 to the multiplier related to transfers from the public sector to the private sector and to the tax multiplier.

Concluding, we can take as given that in the current economic situation of Spain –high unemployment, low utilization of productive capacity, very low or negative rates of inflation, and an accommodative monetary policy with near zero interest rates- expenditure multiplier is higher than 1 and higher than the revenues multiplier, which in turn is lower than 1. Its precise value will depend on different factors, as the composition of the fiscal impulse. To deliver our analysis, then, we have considered that the expenditure multiplier is within the interval [1, 1.5], and that the tax multiplier belongs to the interval [0.45, 0.75]. In this paper, we present the results obtained with the pair of values 1.25-0.6.

With regard to cyclical sensitivity, we use the European Commission’s own estimations (Mourre et al., 2013). They report a one-to-one cyclical reaction of revenues with respect to GDP, such that the public revenues/GDP ratio remains approximately constant along the cycle. In contrast, most public expenditure does not exhibit a cyclical pattern (the average elasticity of expenditures in the Euroarea is -0.15). As a consequence, the ratio between public expenditures and GDP tends to vary anti-cyclically (it increases during a recession and falls when the economy expands, assuming there are no discretionary changes in expenditures) mostly driven by the cyclical effect on the denominator. Specifically, the European Commission calculates for Spain a revenue cyclical sensitivity (γ_R) of 0.38 and an expenditure cyclical sensitivity (γ_E) of -0.05, giving a total cyclical sensitivity of 0.43 (Mourre et al., 2013, Table 2.4). This means that for each 100 Euro increase in GDP, public deficit is automatically reduced by 43 Euros.

4.3. Our alternative fiscal policy proposal:

According to the macroeconomic scenario included in the SP, the percentage of unemployed workers would be 15% of active population in 2018 if the fiscal policy currently proposed was applied, and there would be 19.5 million people employed that year (1.1 million less than at the end of 2007). We find these figures disappointing, so that we try to define an alternative course of discretionary public expenditures and revenues aimed at creating (decent) jobs at a faster pace between 2015 and 2018. Specifically, we have set the objective of an unemployment rate of 10% in 2018, which would require about 20.6 million people employed (the same number that in 2007) if active population grows the same as in the SP.

There are multiple combinations of revenues and expenditures by which this goal may be achieved. For example, the government might stimulate aggregate demand only by means of an increase in expenditures, only by tax reductions, by a combination of more expenditure and less taxes, or by an increase in both expenditures and taxes, taking advantage of the “balance budget multiplier”. Each of them, however, has also different implications on public deficit and debt, because the multipliers associated to each instrument are not the same. Given that the expenditure multiplier is clearly higher than the revenues one, trying to increase aggregate demand only through tax cuts is the less effective alternative, and it would provoke the higher increase in public deficits. On the contrary, there exist a combination of discretionary increases in both expenditures and revenues that would permit simultaneously to reach the targeted

impulse in GDP and employment and to let constant the public budget balance (at the level corresponding to the SP). However, the required increase in public revenues seems to be unrealistic for a period of four years. Then, our proposal could be considered as a “partial” or imperfect application of the balance budget multiplier:

1. Taking into account that the ratio of public revenues on GDP is substantially lower in Spain than in the average of European countries, we propose an increase in this ratio that could realistically be attained during a period of four years.
2. Given the values of the multipliers and the cyclical sensitivity of public revenues and expenditures, we calculate, with the aid of equations (1) and (2), the required discretionary increase in public expenditures to reach the targets previously defined in terms of employment.
3. Finally, we evaluate the consequences of this combination of higher revenues and higher expenditures on public deficits and debt during the whole period, verifying that this fiscal policy is compatible with medium-term sustainability.

Regarding tax revenues, our starting point is that, as we have previously mentioned, public revenues in relation to GDP stand at around nine percentage points below the Eurozone average, provoking a chronic lack of resources to properly finance the development of the welfare state and to address policies of structural change. Therefore, Spain has a considerable scope to improving tax collection.

One of the reasons explaining this low percentage of public revenues over national income is the high size of the informal sector, and a resolute effort to fight tax fraud should be made. According to Conde-Ruiz et al. (2015), the informal sector represents 5 percentage points of GDP more in Spain than in other countries such as Sweden and Germany, and they conclude that closing this gap could rise additional public revenues by an amount equivalent to 2%-2.5% of GDP.

Nevertheless, as they also underline, this would not completely eliminate the difference with the European average, which is also due to some chronic problems related to the design and equity of the tax system. Then, the fight against tax avoidance should be accompanied by a progressive tax reform⁸.

Indeed, public revenues in 2014 were 3.3 percentage points of GDP lower than in 2007, when Spain registered public surplus and the higher percentage of public revenues over GDP in

⁸ Godar, Paetz and Truger (2014a, 2014b) provide a critical assessment of the standard arguments against progressive tax reform –basically, that higher taxes on top personal incomes, corporate income and wealth are detrimental to growth and employment-. According to them, even within the mainstream theoretical framework there is substantial leeway for redistributive taxation. From a Keynesian macroeconomic perspective, redistribution may even be systematically conducive to growth and employment. They also argue that, at the international level, some opportunities for this progressive reform of the tax system have developed recently, as a widespread consensus concerning the need to combat tax evasion, limit tax avoidance and to introduce a financial transaction tax. Moreover, they consider that there are also scope for redistributive tax policies at the national level. Making use of it, governments would create extra revenue and increase the fiscal space, which could be used for essential public purposes and for decreasing inequality.

the last two decades. However, this was the consequence of the expansion of real estate activities. Even more, although the increase in tax revenues derived from the housing bubble should have been considered temporary, the government implemented at the same time permanent reductions in taxation on capital revenues, companies' incomes and wealth, provoking an important loss of tax collection capacity. Once the Great Recession began and the bubble burst, public revenues dropped sharply, and their ratio over GDP diminished by more than 6 percentage points. This reduction is much more intense in Spain than in the rest of the European countries, and it constitutes a new proof of the problems of our tax system and the need of its reform.

Then, the first part of our fiscal policy proposal is to undertake a progressive tax reform and to make a resolute effort to fight tax fraud⁹, which should allow the percentage of public revenues to GDP to increase over the four years by at least 3% (reaching a value of 41%, the same than in 2007, the peak since 1995). We have considered that this would occur gradually: the first year, the amount collected would increase by 15 billion, the second by 10 billion, and the following two years a further 5 billion each year. In total, 35 billion Euros more in 2018 in relation to the tax collection forecast in the SP, to which increased revenue arising directly from the growth in GDP would be added.

At the same time, to attain the aimed expansive effect on GDP and employment, the authorities should apply discretionary expenditure programmes, raising this amount by 30 billion in 2015 and in 2016 (compared to the figures forecast in the SP), and by a further 20 billion in each of the two remaining years. In total, 100 billion, or an average increase of 25 billion during each of the four years. In the macroeconomic scenario on which the SP is based and with the values of the multipliers and the cyclical sensitivity that we are considering, the development of such plan would mean maintaining the percentage of public expenditures over GDP rather than reducing it by five percentage points, as we will show below.

This additional public expenditure could be implement through a Social Welfare and Economic Modernisation Plan, which would target social policies, strengthening the welfare state and public investment, and would have a positive impact on job creation. As important as the actual amount involved is ensuring the right distribution: it should prioritise spending that would have a high multiplying effect, a strong social impact and which would evidence a greater ability to stimulate the necessary change in the Spanish economy. Another criterion that could be used is to pinpoint areas of spending which have been the focus of the cutbacks applied since 2010, or those in which Spain lags significantly behind compared to the European average.

The Social Welfare and Economic Modernisation Plan means a significant increase in public expenditure devoted to priority goals in our economic policy, which would furthermore prove to be perfectly viable in financial terms. Firstly, through increased revenues stemming from fiscal

⁹ A detailed description of those measures is beyond the scope of this paper. However, we would recommend, for example: to establish the same general tax rate structure for all kinds of incomes (labour and capital); to restore and increase wealth tax; a deep-rooted reform of corporate tax, eliminating tax breaks and deductions, paying special attention to transfer prices, or to financial expenditure deductions; to create a minimum temporary tax for large businesses, aimed at reintroducing corporate tax collection; the Introduction of different tax rates according to the destination of a firm's profits (distributed amongst shareholders and productively reinvested in the firm); and to reinforce environmental taxes.

reform and the fight against fraud. Secondly, actual economic growth itself would also translate into higher public revenues. Indeed, we calculate that for each 25 billion in additional expenditure, revenue would increase by around 10.4 billion, or 42% of increased expenditure, because of its expansive impact on GDP. Finally, some fiscal space could be gained from postponing the goal of reducing public deficit to 3%. In this regard, our proposal also considers a reduction in deficit and debt, albeit at a slower rate than in the SP, as it can be seen in the next section.

4.4. *Effects:*

With the help of equation (1), we calculate the change in GDP when applying this fiscal policy, and –provided that the increase in productivity and in the labour force are equal to those forecast in the SP- we obtain the changes in the employment and unemployment figures. Having done this, by using equation (2) we estimate what would happen with total public revenues and expenditures and with public deficit. We can also see the effect this would have on debt, both in nominal terms and in relation to GDP. Table 3 and Graphs 3, 4, 5 and 6 summarize our main findings and compare with the SP.

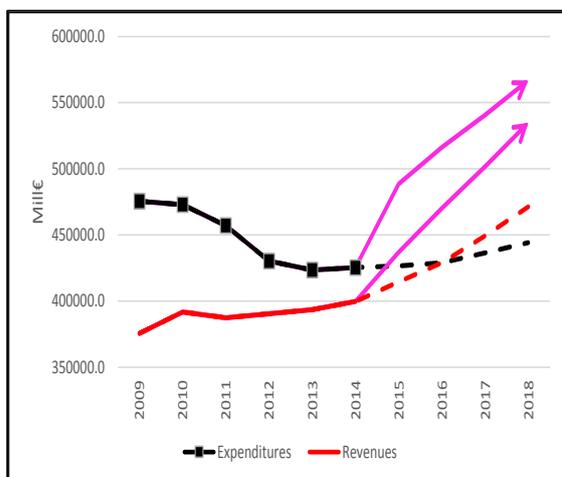
The effect on GDP growth will be positive since expenditure multipliers are greater than revenue multipliers. Specifically, according to our estimations, this fiscal policy might lead to an accumulated increase in real GDP of 6% in 2018 compared to the SP. The unemployment rate would fall to 10.3% in 2018, five percentage points below the government forecast, and the number of jobs would be 20.7 million, the same as in 2007, before the onset of the crisis. This is over 1.2 million more than the figure envisaged by the SP.

Table 3: Comparative macroeconomic scenarios of the government’s Stability Programme and our alternative fiscal policy proposal, 2018

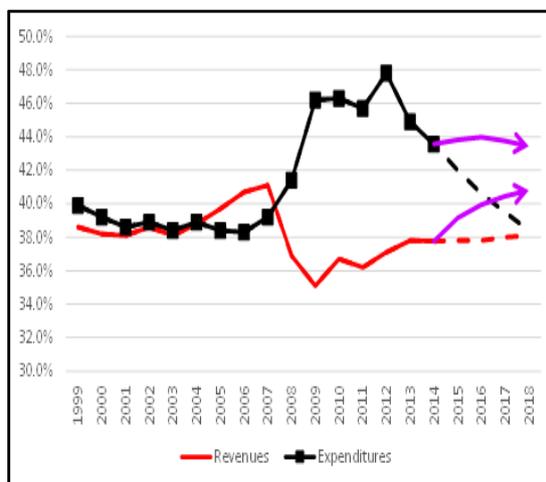
	2014		2018				Difference between Alternative fiscal policy and:			
	Billion€	%GDP	Stability Programme		Alternative fiscal policy		2014		Stability Programme	
			Billion€	%GDP	Billion€	%GDP	Billion€	%GDP	Billion€	%GDP
Revenues	399.7	37.8%	471.3	38.1%	536.9	40.8%	137.2	3.0%	65.6	2.7%
Expenditures	461.1	43.6%	475.0	38.4%	571.0	43.3%	109.9	-0.2%	96.0	4.9%
Balance	-61.4	-5.8%	-3.7	-0.3%	-34.1	-2.6%	27.3	3.2%	-30.3	-2.3%
Debt	1033.9	97.7%	1152.9	93.2%	1226.4	93.1%	192.6	-4.6%	73.5	-0.1%
Av. GDP growth (2015-2018)	1.4%		3.0%		4.5%		3.1%		1.5%	
Unempl. Rate	24.4%		15.6%		10.3%		-14.1%		-5.3%	
Employment (Million)	17344.2		19464.2		20684.7		3340.5		1220.4	

Source: Authors’ calculations and Stability Programme (2015-2018).

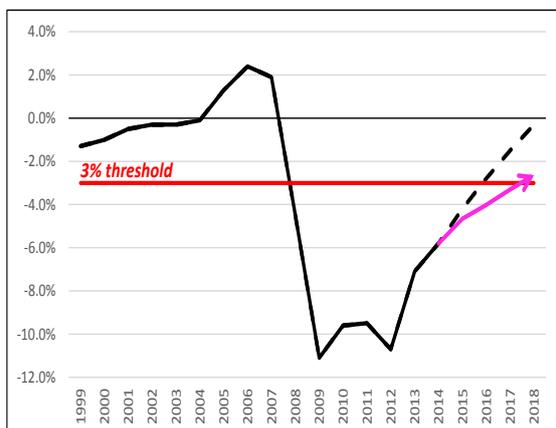
Graph 3: Public expenditures and revenues (SP and alternative fiscal policy, Mill €)



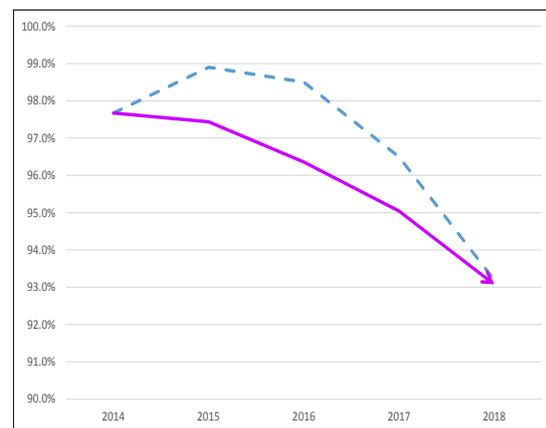
Graph 4: Public expenditures and revenues (SP and alternative fiscal policy, % GDP)



Graph 5: Public balance (SP and alternative fiscal policy, % GDP)



Graph 6: Public debt (SP and alternative fiscal policy, % GDP)



Source: Eurostat, authors' calculations and Stability Programme (2015-2018). Dotted lines represent the SP and the arrows our alternative proposal.

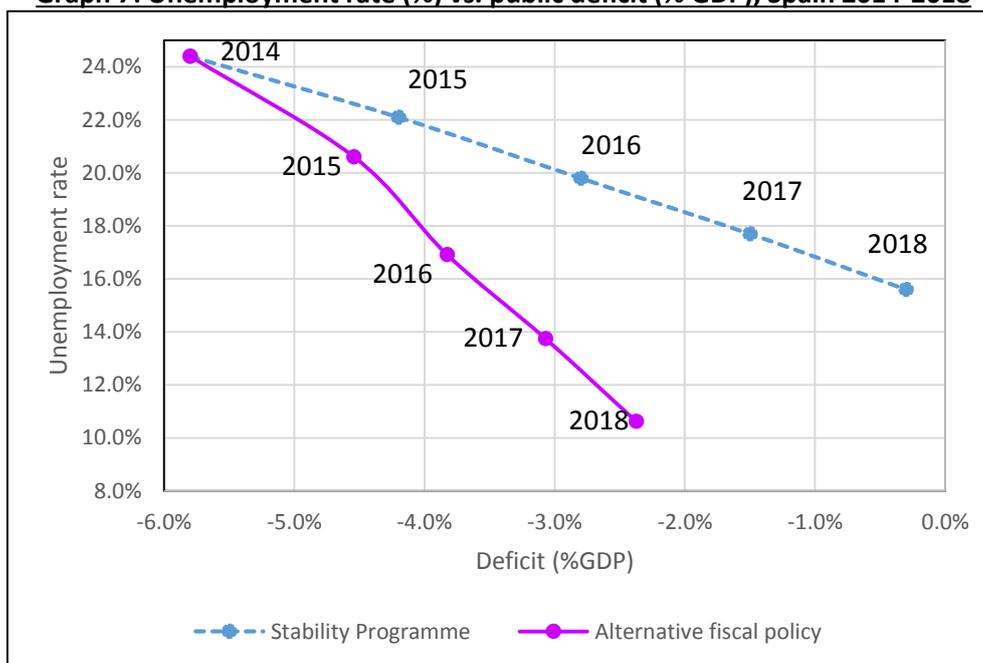
Due to these expansive effects, the operation of automatic stabilisers would mean new revenues from taxes coupled with less public expenditure. Specifically, if we compare with 2014, revenues would increase by 137 billion Euros, and public expenditure by 110 billion. If we compare now with the figures envisaged in the SP, revenues would be 66 billion higher in our proposal (35 billion through tax reform and 31 billion thanks to the expansive nature of fiscal policy) and public expenditure 96 billion higher.

This means that public deficit would continue to fall, albeit at a slower rate. In 2018, the reduction in deficit would be 27 billion (the SP anticipates a reduction of 58 billion). As a result, a public deficit equal to 3% of GDP would not be reached in 2016, but in 2018. That year, public deficit would be 2.6%, while the SP forecasts budget balance.

In 2018, the public debt burden in GDP would be the same in our scenario as forecast in the SP (93%). Although the total debt figure is higher, this would also be divided by a higher nominal GDP.

As a conclusion, we emphasize that this alternative policy –which is clearly better in terms of economic growth and employment, and that would also allow to implement other social and structural policies completely necessary to assure the sustainability of the Spanish economy– may be implemented without compromising fiscal stability. Both deficit and debt would be reduced. The choice, then, lies between prioritising either the rate at which unemployment is reduced or at which public deficit is reduced, as Graphs 7 clearly shows.

Graph 7: Unemployment rate (%) vs. public deficit (% GDP), Spain 2014-2018



Source: Authors' calculations and 2015-2018 Stability Programme.

5. The balance of payments constraint.

Spanish economy will grow above European average for the next few years, according to most of the forecasts. Our proposal would even deepen further this gap, if we want to reduce unemployment as fast as possible and tackle those social and structural needs that have been neglected during the “austerity” years. So there is a reason to project a deteriorating current account balance, and one could if this would confront our proposal with the limits of “one country Keynesianism”. Indeed, we think we should think about this possibility carefully. Between 2000 and 2007, persistent differences in the rates of growth within the Euroarea gave rise to unsustainable current account imbalances, which can be considered as one of the main causes of the current crisis and its severity. From a more long-term perspective, balance of payment crisis after a period of rapid economic growth have been frequent in the Spanish history.

Nevertheless, the Spanish economy registered in 2014 a net lending position (1% of GDP), mainly due to a goods and services surplus (2.4%). The income and current transfers balance had a negative sign (-1.8%), and the capital balance a small surplus (0.4%). This current account surplus provides some space to apply more expansive fiscal policy without being constrained by the balance of payments. Furthermore, the trade balance is positive (1.5%) if we exclude energy (the deficit in this sub-balance is equal to 3.5% of GDP). From an economic policy point of view,

then, measures oriented to reduce this dependence of the Spanish economy on energy imports are very relevant.

The current account balance has radically changed during the last years, as in 2007 registered a strong deficit. This adjustment stems mainly from a much lower deficit in the trade balance of goods. It is the consequence of several causes: some increase in price-competitiveness, the collapse of domestic demand until 2013, the decrease in energy prices or the diversification of the geographical distribution of the Spanish exports, with a notable increase in some dynamic areas outside the EU¹⁰.

The Stability Programme forecasts net lending positions between 2015 and 2018, explained mainly by positive (although decreasing) net savings of the private sector and a decreasing deficit of the public sector. As a consequence, the Net International Investment Position (net external debt) should be dropping, both in nominal terms and as a percentage of GDP. In terms of the different sub-balances, the Stability Programme forecasts a trade balance surplus in 2018 (2.7%), while the rest of balances would have a total deficit (-1.3%). With these forecasts as a starting point, we have estimated the impact of our proposal on the Spanish current account balance and the evolution of net external debt (measured by the Net International Investment Position). Our main conclusions are the following.

A proper functioning of a Monetary Union is incompatible with persisting unsustainable current account imbalances. We should avoid to repeat the experience of EMU early years, characterized by the coexistence of two different growth models (export-led countries and debt-led countries) and the creation of two country blocks (center/surplus countries and peripheral/deficit countries). However, the existence of growth differentials may be inevitable, and thus, some current account imbalances may also appear mainly due to: a) countries with higher unemployment rate (such as Spain) need to grow more to reduce unemployment at a social acceptable rate; and b) convergence of lower income countries.

As a result of both processes, and taking into account the expansive effects of our proposal, Spain might experience indeed a deterioration of its current account balance which would imply a mild deficit in 2018 of about -2.0% of GDP. According to our estimations, nevertheless, this figure is behind the threshold compatible with a constant relationship between (net) external debt and GDP, given the expected GDP growth.

On the other hand, Hein and Detzer (2015) state that when a country grows “too fast” and have current account deficits, two different situations might appear: a “bad case”, which is characterized by a bubble, or a credit expansion that fuels debt financed consumption (this was the case of Spain between 2000-2007); and a “good case”, related with convergence processes associated with massive productive investments. Our economic proposal is not just about increasing public spending, but to foster a social and structural transformation of the economy. We thus think that our proposal is more related with “the good situation” rather than with the “bad situation”.

Be that as it may, this analysis shows that the Spanish authorities should take some measures for securing external sustainability in a context of high growth:

¹⁰ Even so, more than half of Spanish exports are destined to the euro area, with exports to France, Italy, and Portugal combined accounting for almost 30 % of total exports.

- Spanish economy has a historically high dependency of imports and the income elasticity of imports is clearly above the Eurozone average. Then, transforming the productive structure is necessary to avoid the “balance of payments restriction”: bending it towards high value added sectors, increasing exports and thus reducing this imports dependency.
- In this regard, the Social Welfare and Economic Modernisation Plan we have proposed should include, for example, measures to foster a new energy model, focused on renewable energies and improving energy efficiency in buildings and constructions.
- Macro and micro prudential measures should also be implemented to avoid new financial and real estate bubbles.
- Above all, mercantilist and wage competition strategies are not the solution to reduce current account imbalances within the euro area.

6. Is our proposal compatible with the European Union fiscal rules?

Fiscal policy applied by the Member States of the European Union is constrained by the Stability and Growth Pact, and the so-called Six-Pack and Two-Pack have strengthened the surveillance exerted over national governments. They have “institutionalized” austerity policies in the EU and enabled the Commission to achieve more effective *ex ante* control of the economic policy in different countries. In addition, the Fiscal Compact (formally, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union), signed on March 2012, largely reinforces the agreements contained in the Six-Pack: along with the obligation not to exceed a general budget deficit of 3% of the GDP, Member States are due to maintain a structural deficit lower than 0.5%. The Fiscal Compact also defines a “debt brake” benchmark criterion: the pace of debt reduction should be one-twentieth per year of the difference between the actual debt-to-GDP ratio and the aforementioned 60% limit. Finally, the powers of control and punishment of the European Commission are significantly strengthened.

Spain is currently in the excessive deficit procedure, according to which it should reduce deficit (5.8% in 2014) below 3% in 2016. And if Spain would strictly stick to these fiscal rules, it should continue to reduce deficit until structural balance is reached (according to European Commission Spain had a 2% structural deficit in 2014). Since debt/GDP ratio is above the 60% threshold, EC forecast for 2017 1.5% of output gap, and growth rate above its potential rate, current European fiscal rules would imply structural deficit reduction above 0.5% of GDP. Strict application of the EU fiscal rules substantially would reduce the Spanish government’s room for manoeuvre, at most allowing austerity measures to be softened.

Our proposal involves questioning in political terms this “application at any price” of the rules of budget adjustment, although it is by no means incompatible with the economic principle of fiscal stability in the medium term. We have demonstrated that a faster reduction in the unemployment rate is possible by slowing the pace at which public deficit is reduced, without any increase in the public debt over GDP ratio.

Then, allowing this delay by the European authorities is much more, in our opinion, a political than an economic decision. And Feigl and Truger (2015) argue that the communication recently published by the European Commission (2015) shows that a more expansive interpretation of the current fiscal framework is indeed possible. In that communication, some

minor changes were introduced in the interpretation of the fiscal rules (investment clause, structural clause, clarification of the meaning of “bad times”). Certainly, these changes will not have a meaningful impact on the fiscal space allowed by the rules, but its political importance is that they show that the application of the Stability and Growth Pact can (quickly) be changed if there exist political will. Consequently, even although we are aware that the current political climate in Europe is not favourable to an alternative fiscal policy as the one we have presented in this paper, we put forward some political and economic arguments which could facilitate its implementation within the current fiscal rules¹¹:

- Spain is in an “exceptional situation”, as it is shown by the staggering unemployment rate, which would require a too long a period to be reduced if austerity is not completely reversed. Spain is also the European country to experience the sharpest increase in inequality since 2007. More fiscal space is needed while these problems are tackled.

It is true that current European legislation defines bad, very bad or exceptionally bad economic circumstances in terms of growth rates and the output gap, and not in terms of unemployment, as we do. Nevertheless, there are sound reasons to question such an approach:

- Under normal circumstances, with low unemployment, the growth rate may provide a good indicator to detect economic situations that require more expansive fiscal policies. Currently, however, this proves insufficient, because after such a prolonged and harsh period of recession, returning to normal rates of unemployment will imply exceptionally high growth rates over a number of years. The gravity of the current situation is better measured by the *level* of certain variables, and in particular by the unemployment rate, not by *growth rates*.
 - It is true that the *output gap* provides us with this measure in terms of levels and not growth rates. Yet, this only works under normal circumstances, but not in the current situation because the *output gap* is not an observable variable, but depends on the estimation of potential GDP. At this moment in time, there is major uncertainty surrounding its value, precisely due to the effect of the Great Recession. By contrast, the unemployment rate does prove directly observable. Indeed, official estimations of the current *output gap* for the Spanish economy imply an extraordinarily high NAIRU (around 17%), which cannot be used as a reference to define a “normal” situation. Gechert, Rietzler and Tober (2015) provide a detailed analysis of this problem in the case of Spain.
- Related to the problem of the estimation of potential output is the determination of “structural” budgets (a highly debatable concept in theoretical terms, in any case) and the

¹¹ This “pragmatic” approach to current fiscal rules in order to facilitate the implementation of our proposal is compatible with a completely critic position regarding the main concepts lying behind the Stability and Growth Pact and the Fiscal Compact, which should be abandoned (Sawyer, 2013). Budgetary policy is a crucial tool for achieving full employment and other important economic policy goals (such as distribution, or structural economic transformation), so that its utility goes further than short term management of aggregate demand. That is why we don’t agree neither with long term structural balance budget objective, nor with short term nominal deficit objectives above any other goal. All of which would lead us to propose major changes in the present European fiscal policy framework.

“structural effort” that national governments should implement to observe fiscal rules. Truger (2015) argues that the ambiguity of these central concepts of the current European fiscal framework introduces a technical and interpretational leeway that could be used by the European Commission to allow more expansionary policies. Specifically, he states that as a consequence of the two recessions suffered by the European economy, the estimate of potential output has been pro-cyclically decreased, and that this has provoked an underestimation of the output gap and an overestimation of the structural budget deficits. In the case of Spain, for example, he calculates that if the potential output estimations published in the Spring 2010 Forecasts were used, the structural primary budget balance in 2014 would register a surplus of 2.7% of GDP. By contrast, the European Commission reports a surplus of only 1.1% of GDP, because of the downward revision of potential GDP. Then, the required consolidation effort asked to Spain by the European Commission would be clearly excessive. Actually, the Italian Government (2014) used a similar argument to discuss its fiscal targets. Its argument was that if the drop in the Italian potential output had been overestimated, most probably as the result of the statistical techniques the Commission uses, then the (negative) output gap was also higher. If, on the contrary, the estimated drop was correct, Italy was suffering a huge hysteresis effect as a consequence of stagnated demand. In both cases, the conclusion is that a more expansive fiscal policy should be allowed.

- Our proposed Social Welfare and Economic Modernisation Plan is focused on economic transformation goals and social needs. We propose public investment in a broad sense (R&D, energy transition, education, industrial policies) that would contribute to solve some structural problems of the Spanish economy that have not been tackled effectively by the economic policy strategy developed after the Great Recession. And, additionally to exceptional difficult economic circumstances, the fiscal rules allows excluding some expenditures from deficit accounts if they are allocated to structural reforms with budget effects but which contribute towards medium-term growth, as well as certain investments. European legislation also, such as those envisaged in the Juncker Plan. In this vein, a less strict application of these two exceptions should be requested, although this would require a significant extension of current “structural reform clause” and “investment clause”.
- Extending the period to reduce the deficit is nothing new (and has already occurred in Spain three times within the framework of the current Excessive Deficit Procedure, and indeed has recently been applied in France and Italy). Although these extensions tend to be applied when economic circumstances are worse than initially anticipated, in the present case the argument would be based on the exceptional nature of our situation and within the framework of a medium term fiscal stability plan.

7. Conclusions.

Although Spain is currently back on the road to economic growth, deep-rooted changes in economic policy are still needed. Firstly, because current growth is not the result of austerity measures but is due to the impact of certain external factors whose effect may prove temporary (the shift in ECB monetary policy, the depreciation of the Euro, lower energy costs) and, paradoxically, a softening of the cutbacks implemented in public expenditure which grew in 2014 (excluding aid given to financial institutions). Secondly, because the scale of the social and

labour consequences caused by the crisis and the cutbacks has been such that measures aimed specifically at dealing with them must be carried out. The type of employment being created (precarious, badly paid jobs with fewer rights and with low productivity) means that the social divide has not been overcome; quite the opposite, it is growing and is consigning whole sections of the population to the category of “poor workers”. Nor do we share the view that current growth, by itself, will solve social problems. Rather, we defend the need for major redistribution, driven by the public sector. Thirdly, Spain’s model of production continues to be plagued by serious structural problems which render it unsustainable. Productive specialisation in areas of low added value and low productivity growth has scarcely changed. Nor has it changed in terms of energy dependency. To a large extent this also accounts for Spain’s weak external sector, such that once again we run the risk of experiencing a substantial current account deficit as internal demand gradually picks up. Furthermore, not only is the model of growth unsustainable from the economic and social standpoint but also from the ecological perspective. Yet, current economic policy lacks any environmental agenda.

Abandoning once and for all the policy of austerity implemented since 2010 is a necessary condition if these priorities are to succeed. This basically entails breaking with “fiscal dogmatism”, which involves subordinating all budgetary decisions to one specific public deficit target that, in addition, must be met by a given deadline. The goals we set out to accomplish cannot be achieved without deep-rooted changes in budget policy that would enable us to: reverse the cutbacks implemented in recent years in the Welfare State; adopt decisive policies aimed at fighting poverty, such as an income guarantee scheme; or engage in a strong public investment programme (R&D, energy renewal, education) designed to modernise our productive structure.

Such an approach neither overlooks nor is incompatible with budgetary stability. Quite the opposite, as we have shown, it is fully compatible with a reduction in public deficit and public debt. What we are advocating is that the political priority should be to fight unemployment, repair the social damage inflicted by the crisis and adopt a new policy of public investment, albeit at the expense of delaying—not abandoning—the goal of reducing deficit.

Our proposal for budget policy for the coming four years, then, differs markedly from that of the governing Popular Party, because it inverts the order of priorities. We put correcting the employment deficit, social deficit and the structural deficit of the Spanish economy before correcting budget deficit. The social and economic effectiveness of the public revenues to come from the recovery in growth will be greater if put to the uses stated above rather than being employed solely to reduce public deficit more rapidly, particularly given the current climate of extremely low interest rates.

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