# Sustainable Future Fiscal and Debt Policies for Spain

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**Keywords:** fiscal policy, discretionary fiscal policy, fiscal sustainability, decentralization, Spain

**JEL Classification Codes:** E61, E62, E63, H77

**Abstract (250 words):** Opposite to mainstream economics, (Post) Keynesian economics has defended the need of a discretionary fiscal policy that helps to maintain the economic activity at a full employment level, offsetting the cyclical deviations of that level of output. In this sense, it is implicitly assumed that any discretionary management of public finances is, by definition, efficient. The Spanish case shows that public authorities can make an inefficient use of the discretionary room of the fiscal policy, leading to exacerbate the existing macroeconomic and fiscal imbalances, hence the need of rules that constrain the discretionary management of public finances.

Current fiscal policy in Spain is characterized by an intense process of fiscal consolidation. Between 2009 and 2013, using the data from the AMECO database, the primary structural balance (that is, the budget balance net of the cyclical component, one-off and other temporary measures and interest payments) has fallen from -6.7 % GDP to -0.6 % GDP. This fiscal adjustment is taking place during a deep economic crisis that has made that in 2013 the Spanish real GDP is 6 percent lower than in 2007.

This fiscal adjustment is the unavoidable consequence of an unsustainable public finances. Thus, in 2009 Spain's public finances registered a deficit amounting 11 % GDP. To a great extent, this hole is a consequence of the tremendous impact of the economic crisis. However, it is also true that fiscal problems in Spain are also the result of a wrong discretionary management of the public finances[1].

Keynesian economics has defended that a discretionary fiscal policy is an effective instrument to reach a full employment level of output and to avoid temporary deviation from that outcome, and their consequent cyclical imbalances. However, the case of Spain is illustrative of how a misguided use of this discretionary room can lead to huge fiscal and economic problems, hence the need to set limits to that discretionary management of fiscal public finances.

The paper structure as follows. First, we briefly analyze the role of the discretionary management of public finances in the (Post) Keynesian approach, emphasizing two potential sources of problems for the effectiveness of the fiscal policy: the possibility of a pro-cyclical discretionary fiscal policy, and the problems of co-ordination among different territorial levels of government. Next, we analyze the case of Spain's fiscal policy and the mistakes committed on the management of public finances. Final section summarizes and concludes.

## *Is a discretionary fiscal policy always efficient?*

Until the onset of the current crisis, for the mainstream economics the fiscal policy played a secondary role in the general strategy of economic policy. This role was clearly subordinated to the monetary policy and to its main (if not unique) objective of reaching and guaranteeing a low and stable inflation rate. To reach this objective the mainstream economists defended the need to avoid the generation of public budget deficits, or, at least, the need to set strict and precise limits to the size and the conditions to allow fiscal deficits. In parallel, they thought that excessive sizes (usually measured as percentages of the GDP) of the public expenditures and revenues were harmful for the economic activity and the economic growth (Wisman 2013). Consequently, the working of the fiscal policy should be guided by the joint objectives of reducing the size of the public sectors and of ensuring the budget stability, what implied that the required tax cuts should come with more intense cuts on the side of the public expenditures.

With the aim to fulfill these objectives, and in order to ensure the credibility of this strategy and the consequent necessary policies of fiscal consolidations, a number of economies, both developed and emerging, have developed and implemented different institutional reforms developing fiscal rules (Ayuso-i-Casals 2012, Bergman, Hutchinson and Jensen, 2013, Chortareas 2013, Mathieu and Sterdyniak 2012, Nerlich and Reuter 2013). The aim of these reforms is to restrain the discretionary room of the public authorities. This restrain would avoid that any administration, regardless its political orientation, could implement a fiscal policy opposite to the basic principles of fiscal austerity and sound public finances. As a result, a number of countries have approved budgetary laws, in many cases incorporating the fiscal norms at their Constitutions, that sanction the existence of balanced budget balances; fiscal councils have been created; or, like in the case of the Euro area, compulsory supranational rules have been designed and implemented, forcing the Euro economies to implement fiscal rules and guidelines that severely limit the discretionary management of the domestic fiscal policies (Creel, Hubert and Saraceno 2013, Hein and Truger 2013, Truger 2013).

On the contrary, non-mainstream economics, like the Post Keynesian economics, have firmly defended the validity and effectiveness of the fiscal policy as an instrument of macroeconomic management (Philip Arestis 2011, Eckhard Hein and Achim Truger 2012-2013, Yiannis Kitromilides 2011, Seccareccia 2013). From the Post Keynesian approach, the fiscal policy is a useful policy to change the long-term rate of economic growth, ensuring a full employment level of economic activity. Fiscal policy would also be an effective instrument to offset the short-term cyclical fluctuations and the consequent cyclical imbalances. Moreover, the management of the different kind of expenditures and the use of the different taxes could also redistribute the income in a more egalitarian way, generating a positive impact on the aggregate demand.

From this perspective, it is essential not only that fiscal policy operates through the built-in stabilizers, but also that the public authorities can manage in a discretionary way the different items of public expenditures and revenues with the objective of generating in every moment the necessary structural non-cyclical public budget balance to stabilize the economic activity around the long-term objective, in principle, the economic activity needed to maintain the full employment.

The main weakness of this view is that it assumes that the economic authorities will always be guided by the principle of counter-cyclical macroeconomic policy, with fiscal policy adopting an expansionary stance during recessions and a restrictive stance in expansions. In this sense, it is not relevant that such a counter-cyclical stance be exclusively generated by the working of the automatic built-in stabilizers (implying a balanced structural or cyclically adjusted budget balance) or by a joint action of the built-in stabilizers and by a negative (deficit) discretionary balance in recessions and a positive (surplus) discretionary balance in expansions.

On the other hand, that view about the working of the fiscal policy, also assumes the existence of a single economic authority in charge of the management of the whole public finances. That is, is assumes than only one public authority will make the decisions related to the management of the public expenditures and revenues, what in terms of the structure of the public sector implies the existence of a centralized state. In this sense, the problems arise when there are different territorial levels of the government, with each level having different competences about certain items of revenues and expenditures. In this case, it cannot be excluded the possibility that certain level of government adopts in their public finances an stance opposite to that adopted by other government, offsetting, partially or totally, the stance of other government (or governments).

As far as the responsibility of the management of the (macroeconomic) fiscal policy falls in the hands of the central government, the stance of the global fiscal policy, that is, that defined by the total public expenditures and revenues of the whole set of public administrations (and the consequent public budget balance), would be determined by the public finances of the central government. In these circumstances, the management of the revenues and expenditures of the sub-national (local and regional) governments should adopt a neutral stance. This means a balanced budget of these governments, or a balance in line with that adopted by the central government. This coordination of the public finances of the different levels of government implies that, for the sub-national governments, only imbalances generated by the built-in stabilizers of their budgets is allowed, or that the sign and the size of their fiscal imbalances be compatible and coordinated with the discretionary budget balance of the central government.

Therefore, the effective discretionary management of the fiscal policy must ensure, first, that public finances behave according to the objective of the counter-cyclical macroeconomic stabilization, and, second, that all the different levels of the government coordinate the stance of their public finances, something that is especially relevant during the processes of fiscal consolidation (European Commission 2013).

This strategy implies that, though it may sound paradoxical, the discretionary management of the fiscal policy must be constrained and limited to rules and institutions that ensure that at any time the behavior of the public authorities on these matters be in accordance to the principles of macroeconomic stabilization, avoiding measures that lead to a pro-cyclical stance of the fiscal policy.

## *Lessons from Spain*

In this sense, the case of Spain is illustrative of how a discretionary management of the fiscal policy, and an uncoordinated management of the public finances of the different territorial levels of administration can lead not only to a loss of effectiveness of the fiscal policy, understood as an instrument of macroeconomic stabilization but also to the generation of huge fiscal imbalances. Thus, for the year 2013, it is estimated that the public deficit will be 6.8 percent of the GDP, with the outstanding public debt registering unparalleled records of 94.8 percent GDP (see table 1). The existence of these fiscal imbalances, and the consequent situation of unsustainability of the public finances, makes that the only possible objective of the fiscal policy be the reduction in the size of the fiscal deficits and the outstanding public debt. This objective must be pursued regardless the economic situation, what, in the case of a recession (or an abrupt slowdown of the economic growth) makes that the fiscal policy adopts a pro-cyclical stance.

Table 1. Public finances in Spain 2006 - 2013

| | Public budget balance (% GDP) | Cyclically adjusted public budget balance (% GDP) | Public debt (% GDP) | Output gap (% potential GDP) | GDP rate of growth (%) |
|---|---|---|---|---|---|
| 2006 | 2.4 | 1.5 | 39.7 | 1.8 | 4.1 |
| 2007 | 2.0 | 1.0 | 36.3 | 2.0 | 3.5 |
| 2008 | -4.5 | -4.7 | 40.2 | 0.5 | 0.9 |
| 2009 | -11.1 | -9.1 | 54.0 | -4.2 | -3.8 |
| 2010 | -9.6 | -7.4 | 61.7 | -4.7 | -0.2 |
| 2011 | -9.6 | -7.5 | 70.5 | -4.4 | 0.1 |
| 2012 | -10.6 | -8.2 | 86.0 | -5.1 | -1.6 |
| 2013 | -6.8 | -4.3 | 94.8 | -5.2 | -1.3 |

Source: AMECO Database (December 2013)

However, before the crisis, the situation of the public finances was really sound. In 2006, the public budget balanced was +2.4 percent GDP, with a cyclically adjusted budget balance estimated at +1.5 % GDP and the consolidated general government amounted 39.7 percent GDP.

This sound situation of the public finances in Spain started to change in the year 2006. Two years later, Spain registered a public deficit equivalent to 4.5 percentage points of the GDP, and the cyclically adjusted public budget balances had fallen from +1.5 % GDP to -4.7 percent GDP. In other words, the Spanish economy registered a fiscal impulse amounting 6.2 percentage points of the GDP. This discretionary expansionary fiscal policy took place in a context of expansion, as the two last columns of table 1 show: the output gap was positive and the Spanish economy was still growing at positive rates in the year 2008 (indeed, negative rates of growth were only registered in the last quarter of

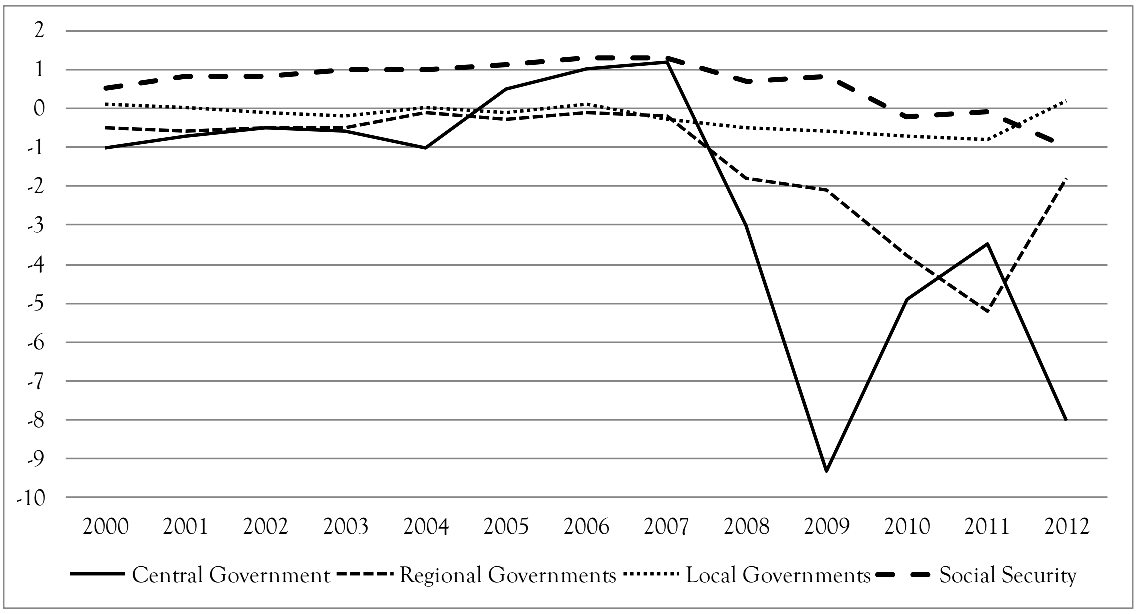
2008). Indeed, the estimations for the cyclical budget balance were 0.9 % GDP, 1 % GDP, and 0.2 % GDP, for the years 2006, 2007, and 2008, respectively[2].

By cutting taxes and rising public expenditures (between 2006 and 2008, cyclically adjusted total revenues fell 3.8 percentage points of the GDP, whilst cyclically adjusted total expenditure increased 2.4 percentage points of the GDP), Spain implemented a discretionary pro-cyclical fiscal policy that overheated the economy (the trade deficit peaked 10.4 percent GDP in 2007) and paved the wave to the huge fiscal deficit that peaked 11.1 % GDP in 2009, fuelled now by the cyclical component of public finances and the expansionary fiscal measures adopted at the beginning of the crisis.

This unsustainable fiscal deficit was aggravated by the sovereign debt crisis unleashed with the Greek crisis in 2010 that led to a surge in the spread of the Spanish bonds with the German bund that made that in July 2012 the yield of the 10-years Spanish treasury bond peaked 7.5%, with the spread with the German bond reaching 636 basic points. Moreover, the late restructuring of the financial institutions most damaged by the financial crisis implied that in 2012 the impact on the public budget balance of the activities to support financial institutions amounted 3.7 percent GDP. All in all, nowadays fiscal adjustment is unavoidable and the only matter of discussion is the speed of that consolidation.

The absence of appropriate mechanisms of coordination between the different levels of public administration has been another source of problems for a correct management of public finances and fiscal policy. Figure 1 shows the evolution of the public budget balances of the different levels of administration. Until the onset of the crisis, the sub-national governments maintained a neutral position, being the public finances of the central government the most influenced by cyclical fluctuations. The crisis worsened the the budget balance of all administrations. However, whilst in 2009 the central government started an intense consolidation process, the budget balance of the social security system, the local governments and, mainly, the regional governments kept worsening. Thus, in 2010 the public balance of the central government improved 4.4 percentage points of the GDP, but the balances of the local governments, the social security system and the regional governments deteriorated in 0.1% GDP, 1% GDP and 1.7% GDP, respectively.

Figure 1. Public budget balance by administration (% GDP)




Source: Bank of Spain

The approval in 2011 of the reform of the Spanish Constitution that introduced a fiscal rule limiting the size of the structural public deficit and of the public debt and the subsequent approval in 2012 of the Law of Budgetary Stability and Financial Sustainability implied a significant improvement in the public finances of local and regional governments. The setting of strict limits (and sanctions) to the maximum allowed size of public deficits in these levels of governments led these governments to implement deep austerity programmes, in line with the austerity measures adopted by the central government, and thus making that all the national and sub-national administrations follow the same path of fiscal adjustment.

## *Conclusions*

The case of Spain illustrates how the discretionary management of the fiscal policy and the public finances, joined to the lack of a appropriate coordination between the different levels of territorial governments can prevent the implementation of a correct counter-cyclical fiscal policy. In this sense, it would be convenient the existence of norms, rules or institutions that ensure that at any time the fiscal policy adopts the necessary counter-cyclical stance through the working of the automatic built-in stabilizers and/or the adoption of discretionary measures

This does not mean, however, that any fiscal rule or institutions limiting the discretionary management of the fiscal policy be valid. In Spain, like in other European economies, the national fiscal framework has been reformulated with the objective of achieving a sound situation of public finances, what actually means to maintain a situation of equilibrium in the public budget or to avoid the existence of structural-cyclically adjusted deficits. This framework of fiscal governance is incompatible with a strategy of fiscal policy inspired in the Keynesian principles of generating the needed fiscal balances to offset the cyclical fluctuations of economic activity, and, even with the objective of generating a structural fiscal deficit in the presence of extraordinary, like the current one, declines in the economic activity.

## *Footnotes*

1. For a deeper analysis of the fiscal policy implemented in Spain in the recent years, see Ferreiro, Gómez and Serrano (2013), Ferreiro and Serrano (2012a and 2012b) and Serrano (2013)
2. It must be mentioned that that expansionary fiscal policy also happened in other European countries. This, between 2006 and 2008, 20 European union countries registered a worsening in their cyclically adjusted public balances. However, the size of these fiscal impulses was much lower: in the case of the Euro area, the fiscal impulse in that period was equivalent to 0.9 percentage points of the Euro area GDP (the cyclically adjusted public balances fell from -2.1% GGP to -3% GDP)

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