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

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The Spanish authorities have implemented strongly restrictive fiscal policies with a negative impact on GDP and employment, especially during the recession of 2011–2013. This paper shows that the end of fiscal austerity is feasible for Spain. Adopting a 'functional finance' approach to fiscal policy and making a (partial) use of the idea of Balanced Budget Expansion, we present an alternative fiscal policy for the years 2016–2018 which is not focused on deficit reduction, but on employment creation and on the development of social and structural policies aimed at a real transformation of the Spanish economy. The two main components of this plan are a progressive fiscal reform to increase public revenue over GDP, and a simultaneous increase in the ratio of public expenditure over GDP. With the aid of a three-equation model, this paper proves that an alternative plan to austerity can be not only expansionary but also fully compatible with fiscal sustainability. The choice, then, lies between prioritising either the rate at which unemployment is reduced or at which public deficit is reduced.

*Key words*: Fiscal policy, Austerity, Functional finance, Balanced budget expansion, Spanish economy
*JEL classifications*: E62, E63, E65

## 1. Introduction and conceptual framework

The Spanish authorities have implemented strongly restrictive fiscal policies with a negative impact on GDP and employment, especially during the recession of 2011–2013. Nevertheless, Spain still had the second highest public deficit in the EU in 2014 (5.9% GDP). Once economic growth has recovered, the *Stability Programme 2015–2018* (SP henceforth) aims for a fast budgetary consolidation, with public deficit under 3% in 2016, and budgetary equilibrium in 2018 (Spanish Government, 2015).

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However, some important problems of the Spanish economy remain unsolved, in spite of current GDP growth. The unemployment rate is very high (22% in 2015) and the macroeconomic scenario included in the SP does not forecast a rapid reduction (15.6% in 2018). Inequality and poverty have grown fast during the last years as well. Finally, industrial policies and public investment are needed to change the sectorial specialization. At the same time, Spanish public revenue and expenditure ratios over GDP are well behind EU averages, and austerity policies have meant dramatic cuts in some areas, such as education, health and public investment.

This paper shows that the end of fiscal austerity is feasible for Spain in order to solve these problems. To do so, we present an alternative fiscal policy for the next three years (2016–2018) which aims to increase employment and reduce unemployment faster than expected. Specifically, we have set the objective of recovering the same number of jobs that the Spanish economy had before the onset of the Great Recession (about 20.6 million), which would mean an unemployment rate of 10.6% in 2018.

We adopt the 'functional finance' approach to fiscal policy, in contrast to the 'sound finances' approach that characterizes the current policies recommended by the European authorities and applied by the Spanish government, with the SP as an example. According to the sound finances approach, structural budget balances must be assured, and all the decisions regarding public revenue and expenditure are conditioned by this objective. On the contrary, the functional finance perspective implies that 'budget deficits are incurred where it is necessary to support aggregate demand, and in effect absorb the excess of private savings over private investment' (Sawyer, 2011).

We also make (partial) use of the notion of the Balanced Budget Multiplier. As is well known, a Balanced Budget Expansion involves a policy whereby the government increases public spending and, simultaneously, increases its tax revenues to keep the budget deficit unchanged. Provided that the public spending multiplier is larger than the revenue multiplier, this policy will lead to an increase in aggregate demand, and it is a possible alternative if debt is seen as a constraint (Wren-Lewis, 2011; IMF, 2012a; Ragan, 2013; Karagounis *et al.*, 2015; Mulheirn, 2012; Hungerford, 2015).

Considering that Spain has a lower than average ratio of public revenue over GDP, we think that it has considerable scope to improve tax collection. So, we propose a combination of discretional increases in both expenditure and revenue to achieve the targeted impulse in GDP and employment with the least possible effect on public debt. Nevertheless, our proposal is only a sort of 'imperfect' Balanced Budget Expansion, because the required increase in public revenue in order to maintain the public deficit unchanged (relative to the SP) and boost the targeted increase in employment seems unrealistic for a period of three years.

Frequently, austerity policies are presented as unavoidable, and the proposals for a more expansive fiscal policy focused on employment creation and other social and structural objectives are defined as 'wishful thinking'. With the aid of a three-equation model, this paper proves, on the contrary, that an alternative plan to austerity can be not only expansionary—with a faster reduction in unemployment—but also fully compatible with fiscal sustainability. This conclusion is relevant both from a strict theoretical perspective and also from a more practical standpoint, to the extent that at least one Spanish political party (Podemos) is promoting a U-turn in current fiscal policies very similar to the one we propose here.

The rest of our paper is organized as follows. We describe recent economic and fiscal development in Spain in Section 2, focusing on the effects of austerity on economic growth. We also explain here why Spain needs a change in its fiscal policy. Section 3 describes our alternative proposal, the methodology used to define it and to measure its effects, and summarizes the macroeconomic consequences derived from its implementation. Section 4 explores two possible constraints that could hinder our proposal: the balance of payment constraint and current EU fiscal rules. Finally, Section 5 concludes.

## 2. The recent economic development of the Spanish economy and the Stability Programme (2015–2018)

### *2.1 The years of austerity (2010–2013)*

Spain has been one of the European countries most strongly hit by the crisis. This is the result, first, of the burst of the real estate bubble, but also the consequence of a mistaken macroeconomic policy: 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.[1]

At the beginning of the Great Recession (2008–2009), Spain had a large fiscal space (public balance and public debt were 2% and 36% GDP in 2007, respectively), and the government implemented one of the most expansive fiscal stimulus in the world. 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% GDP in 2009). Then, the government curbed public spending in 2010, and the stance of Spanish budgetary policy became strongly restrictive and procyclical between 2010 and 2013. 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, but the increase in public revenue has been systematically lower than forecasted. The other side of the Spanish economic policy strategy has been the so-called 'internal devaluation' (the attempt to increase price-competitiveness by the means of wage repression).

Although economic authorities argued initially that fiscal consolidation could be expansionary,[2] fiscal austerity and internal devaluation have had a strong depressionary effect on internal demand, without triggering an expansion in exports sufficient to offset it and to handle the recovery of growth and employment (Uxó *et al.*, 2016). Moreover, Spain has failed to reduce public deficit in line with established targets despite this policy of cutbacks, and at the European Commission (2015) has expressed its doubts that the 3% target can be reached in 2016. We interpret this as an indication that 'austerity does not work': the restrictive effects of austerity policy prevent the very objectives it pursues from being achieved.

### *2.2 Growth recovery (2014–2015)*

Various external factors have provided an important tailwind to the Spanish economy since the beginning of 2014, with positive growth rates since then: the ECB's QE programme, which has reduced the interest rates (higher in Spain than in the Eurozone)

[1] 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.

[2] See Muñoz de Bustillo (2014) for a criticism of the theoretical underpinnings of the concept of 'expansionary austerity'.

and contributed to credit recovery; the sharp drop in oil prices, with a corresponding expansionary effect on private consumption (Banco de España, 2015); and the depreciation of the euro. The interaction of these three phenomena has certainly played an expanding role for the Spanish economy, given the dependence of Spain on energy imports and on bank financing.

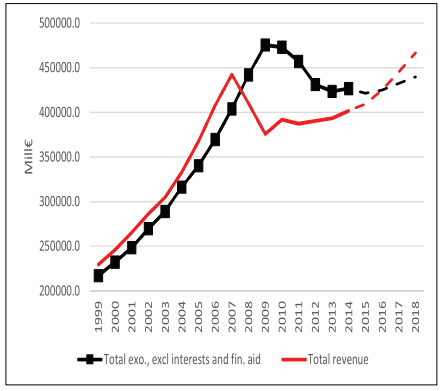
Domestic factors also matter. The gradual fall in the rate of household saving has had a positive impact on private consumption and, in addition, the government has significantly relaxed the pace of austerity, although without questioning its economic foundations or reversing past budget cutbacks. Net primary expenditure (without financial aid to the banking system) rose 1.9 billion in 2014, and public consumption grew by 2.5% in 2015. If public final consumption and investment were making a negative contribution to growth between mid-2010 and the end of 2013, they began to make a positive contribution in 2014. In 2016, once the electoral cycle ends, the government undertakes again new cuts in public spending.

Fiscal austerity and wage cuts are not, therefore, the factors behind Spain's incipient recovery (Rosnick and Weibstrot, 2015). On the contrary, these policies have prevented the Spanish economy from emerging from the crisis before, and they have led to a lost decade. Spain still has a real GDP 5% lower than in 2008, 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 21% in the fourth quarter of 2015.

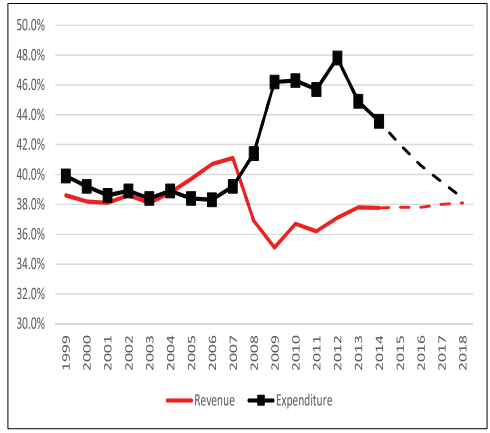
**Table 1.** *Main fiscal indicators for Spain and the Eurozone*

| 2014 | Spain | | Euroarea | |
|---|---|---|---|---|
| | Billion € | % GDP | Billion € | % GDP |
| Revenue | 399.7 | 37.8% | 4715.4 | 46.6% |
| Expenditure | 461.1 | 43.6% | 4961.3 | 49.0% |
| Balance | -61.4 | -5.8% | -245.9 | -2.4% |
| Debt | 1033.9 | 97.7% | 9292.6 | 91.9% |

*Source:* Eurostat




**Graph 1.** *Public expenditure and public revenue (Spain, Mill €)*
*Source:* Eurostat (for years 1999–2014) and Stability Programme (for years 2015–2018).




**Graph 2.** Public expenditure and public revenue (Spain, % GDP)
*Source:* Eurostat (for years 1999–2014) and Stability Programme (for years 2015–2018).

*2.3 The Stability Programme 2015–2018 and the need for a new fiscal policy*

Table 1 compares the main fiscal magnitudes in Spain and in the Eurozone in 2014, and the dotted lines of Graphs 1 and 2 represent, in turn, the evolution of fiscal magnitudes for the years 2015–2018 according to the SP.

Although the public expenditure/GDP ratio has risen since the start of the crisis, this has mainly been due to the reduction in nominal GDP, and the weight of public expenditure in GDP is systematically lower in Spain than the Eurozone average (7.5 p.p. in cyclically adjusted terms). Spain is also characterised by a lower capacity to collect sufficient revenue than the European average, and the weight of public revenue in relation to GDP is at around 9 p.p. below the Eurozone average. The graphs also show that the government has made two key fiscal policy decisions in the SP:

- From the standpoint of revenue, the government has not adopted measures to compensate the low revenue-raising capacity that characterises Spain compared to the European average. 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 revenue (72 billion) is almost exclusively the consequence of forecasted economic growth (3.2% in 2015 and 3% for 2016–2018).
- This additional revenue 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 balanced budget being achieved in 2018. Public expenditure will scarcely rise (14 billion in four years), which will in fact mean a reduction of five points in the expenditure/GDP ratio.

This leads us to think that austerity has not been abandoned, but merely softened, and we find at least four major arguments for the implementation of a more expansionary fiscal policy, in spite of current positive rates of growth: 1) to strengthen and underpin economic recovery, and assure a faster reduction in the unemployment rate; 2) to reverse the effects of austerity policies on essential public services; 3) to reduce the deep inequalities; and 4) to address the structural problems of the Spanish economy.

First, the ongoing recovery is not the result of austerity but of other factors, which explains its fragility and the need to reinforce it. External factors could well disappear over the next year. The increase in private consumption based on a reduction in savings is not sustainable because families still have high levels of indebtedness and nominal wages remain stagnant. And the absolute priority given in the SP to achieve a structural budget balance, and to reduce the deficit below 3%, presage a return to austerity if current forecasts of a strong increase in tax revenues fail. Therefore, an alternative strategy is still needed, to consolidate a true recovery and a faster reduction of unemployment.

On the other hand, austerity policies substantially weakened some essential public services during these years, increasing the gap between Spain and neighbouring countries. Now it is essential to gradually regain lost ground. A post-austerity policy is not only to stop reducing public spending, but also to reverse the effects of these cuts. In 2013 public spending was reduced in total by 29 billion euros compared to 2009, the amount devoted to education and healthcare has been reduced by 18 billion euros, and public investment by 33 billion euros (from 5.1% to 2.1% GDP).

Moreover, the profile of the recovery is contributing to exacerbate other problems of the Spanish economy, which will have adverse macroeconomic effects in the future. Among them we have the rapid growth of inequality: Spain is one of the European countries where inequality has grown faster since the start of the crisis, and more than 10 million people live below the poverty line. The AROPE indicator has grown from 24.5% in 2008 to 29.2% in 2013. All this points to the need for an emergency plan to fight poverty and inequality.

Finally, transforming the pattern and structure of current growth is just as important as consolidating its rate. Current growth has raised up a long-standing imbalance of the Spanish economy: the strong import propensity of our economy (especially in the field of fossil fuels) has triggered a negative contribution of the external sector to GDP growth in recent quarters (despite a significant advance of exports). 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. To promote changes in the industrial structure and reduce external dependence—for example, fostering investment in renewable energies, funds are necessary—expansionary fiscal policy and structural reforms to modernize the economy go hand in hand.

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

We present in this section an alternative fiscal policy that it is not focused on deficit reduction, but on employment creation and on the development of social and structural policies. These policies require increased public expenditure, but we also show that they are compatible with sustainable public finances.

According to the macroeconomic scenario included in the SP, the unemployment rate would be 15.6% of the 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 we try to define an alternative course of discretional public expenditure and revenue aimed at

creating employment at a faster pace between 2016 and 2018. Specifically, we have set the objective of recovering the same number of jobs that the Spanish economy had before the onset of the Great Recession (about 20.6 million), which would mean an unemployment rate of 10.6% in 2018.

There are multiple combinations of revenue and expenditure by which the required stimulus in aggregate demand might be achieved. Each of them, however, also has different implications on public deficit and debt, because the multipliers associated to each instrument are not equal. Given that the expenditure multiplier is clearly higher than the revenue one, there exists a combination of discretional increases in both expenditure and revenue that would simultaneously permit the achievement of the targeted impulse in GDP and employment and keep the public budget balance constant (at the level corresponding to the SP). However, the required increase in public revenue seems unrealistic for a period of three years. Then, our proposal could be considered as a 'partial' or an imperfect application of the balance budget multiplier:

1. We calculate the required increase in GDP to meet the target in terms of employment.
2. We propose an increase in this ratio that could realistically be attained in 2018.
3. Then, we calculate, with the aid of the equations that will be explained later, the required discretional increase in public expenditure.
4. Finally, we evaluate the consequences of this combination of higher revenue and higher expenditure on the public deficit and debt during the whole period, verifying that this fiscal policy is compatible with the medium-term sustainability of public finances.

Following the same methodology as 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. 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 a change in fiscal policy, maintaining the same assumptions about the rest of the variables affecting the economy.

We are aware that the macroeconomic forecasts of the SP can be a baseline scenario slightly biased, since it is usually over-optimistic. This over-optimism of official scenarios is typically associated with the hypothetical expansionary effects assigned to 'structural reforms', rarely fulfilled. Nevertheless, taking the SP as the baseline scenario allows us to focus our attention on the effects that an expansionary fiscal policy would have, regardless of the realism of the SP.

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, it will permit us to show that our proposal would mean higher growth and less unemployment and the possibility of funding social and structural policies in Spain, without compromising the medium-term sustainability of public finances at all.

Furthermore, in the event that SP forecasts finally result in being over-optimistic, an expansionary fiscal policy such as the one proposed here will be even more justified.

*3.1 Equations*

We can carry out most of our calculations with a very simple model of only three equations. First, we set an employment target for 2018 (N⋆), and calculate the GDP level that should be reached to make it possible (Y⋆), supposing that the behaviour of labour productivity does not change as a result of the new fiscal policy. If N and Y are the levels of employment and GDP forecasted in the current SP, we can write:

$$Y^{\star} = N^{\star}\frac{Y}{N} \tag{1}$$

Second, the influence of fiscal policy on income (ΔY)[3] will depend on the change in total public expenditure (ΔG) and revenue (ΔT), and on the multipliers. We call the expenditure multiplier $\alpha_G$ and the tax multiplier $\alpha_T$:

$$\Delta Y = \alpha_G \Delta G - \alpha_T \Delta T$$

We distinguish now between changes in public revenue or expenditure coming from voluntary decisions adopted by the authorities ('discretional', 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). Where $\gamma_T>0$ and $\gamma_G<0$ are parameters which measure the effect of a change in GDP on public revenue and expenditure:

$$\Delta Y = \alpha_G \left(\Delta G^D + \Delta G^C\right) - \alpha_T \left(\Delta T^D + \Delta T^C\right)$$

$$\Delta Y = \alpha_G \left(\Delta G^D + \gamma_G \Delta \mathrm{Y}\right) - \alpha_T \left(\Delta T^D + \gamma_T \Delta Y\right)$$

Reorganising the terms:

$$\Delta Y = \frac{\alpha_G}{1 - \alpha_G\gamma_G + \alpha_T\gamma_T}\Delta G^D - \frac{\alpha_T}{1 - \alpha_G\gamma_G + \alpha_T\gamma_T}\Delta T^D$$

Simplified:

$$\Delta Y = \Omega_G \Delta G^D - \Omega_T \Delta T^D \tag{2}$$

where $\Omega_G$ and $\Omega_T$ are the multipliers that link this *discretional* change in expenditure and revenue to national income, taking into account the effect of automatic stabilisers. Equation (2) tells us how much GDP changes when there is a discretional change in expenditure and revenue.

Last, our third equation represents the final effect of the change in the fiscal policy on the public budget balance (B), taking into account the full operation of automatic stabilisers:

[3] The symbol Δ represents the variation experimented by a variable resulting from the change in fiscal policy compared to the baseline scenario.

$$\Delta B = \left(\Delta T^D - \Delta G^D\right) + \left(\Delta T^C - \Delta G^C\right)$$

$$\Delta B = \left(\Delta T^D - \Delta G^D\right) + \left(\gamma_T - \gamma_G\right)\Delta Y$$

Replacing ΔY by equation (2) and operating:

$$\Delta B = \left[1 - \left(\gamma_T - \gamma_G\right)\Omega_T\right]\Delta T^D - \left[1 - \left(\gamma_T - \gamma_G\right)\Omega_G\right]\Delta G^D \quad (3)$$

### *3.2 Multipliers and cyclical sensitivity of public revenue and expenditure*

According to equations (2) and (3), the impact of a change in fiscal policy on income and public balance actually depends on the expenditure and revenue multipliers ($\alpha_G$ and $\alpha_T$) and on the cyclical sensitivity of expenditure and revenue ($\gamma_G$ and $\gamma_T$).

The empirical literature on fiscal multipliers has increased significantly since the onset of the Great Recession, with the recognition by the IMF (2012b) that it had underestimated the value of fiscal multipliers—and, then, the negative impact on the real economy of cuts in public expenditure that had been advising—as an important milestone. 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, and it has also become clear that the specific value of the multipliers depends on some factors such as the economic situation (fiscal policy is more effective when it 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) show a very useful attempt to systematize all this research. 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 the 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 expenditure rises during bad times, mainly because accommodative monetary policies are more likely during economic downturns, when risks are more on the side of deflation than on inflation acceleration, and central banks do not increase interest rates. And this argument is reinforced if the zero lower bound of nominal interest rates has been reached. Specifically, the multiplier of unspecified government expenditure rises by 0.7 approximately, reaching a value of 1.3. But another 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. In strong contrast with normal times, public transfers turn out to be the most effective

expenditure type when the economy is in a downturn, with a multiplier of 2.3. This might be explained by an increase in the number of liquidity or credit-constrained households when the economy is stagnated.

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 expenditure multipliers are considerably larger in recessions than in expansions, and they find that changes in taxes always have a lower impact on GDP than changes in expenditure. 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, 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—we can take as given that the expenditure multiplier is higher than 1 and higher than the revenue multiplier, which in turn is lower than 1. Its precise value will depend on different factors, such 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 $\alpha_G = 1.25$ and $\alpha_T = 0.6$.

Regarding cyclical sensitivity, the European Commission estimates a one-to-one cyclical reaction of revenue with respect to GDP, such that the public revenue/GDP ratio remains approximately constant along the cycle. In contrast, most public expenditure does not exhibit a cyclical pattern. As a consequence, the ratio between public expenditure and GDP tends to vary anti-cyclically, mostly driven by the cyclical effect on the denominator. Specifically, the European Commission calculates for Spain a revenue cyclical sensitivity ($\gamma_T$) of 0.38 and an expenditure cyclical sensitivity ($\gamma_G$) 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.

Using these values for $\alpha_G$, $\alpha_T$, $\gamma_G$ and $\gamma_T$, equations (2) and (3) become:

$$\Delta Y = 0.97\Delta G^D - 0.46\Delta T^D \tag{2}$$

$$\Delta B = 0.80\,\Delta T^D - 0.58\Delta G^D \tag{3}$$

### *3.3 Our alternative fiscal policy proposal*

According to equation (1), fiscal policy should provoke an increase in nominal GDP ($\Delta Y^\star$) equivalent to 71.4 billion euros (relative to the figure forecasted in the SP for 2018) to reach the employment target ($N^\star$) of 20.6 million jobs. To attain this goal, we propose to increase public revenue and public expenditure simultaneously.

Spanish public revenue in relation to GDP stands at around 9 p.p. below the Eurozone average, provoking a chronic lack of resources to properly finance the development of

**Table 2.** *Comparative macroeconomic scenarios of the government's Stability Programme and our alternative fiscal policy proposal, 2018*

| | 2015 | | 2018 | | | | Difference between Alternative fiscal policy and: | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Stability Programme | | Alternative fiscal policy | | 2015 | | Stability Programme | |
| | Billion€ | %GDP | Billion€ | %GDP | Billion€ | %GDP | Billion€ | %GDP | Billion€ | %GDP |
| Revenue | 409.3 | 37.8% | 466.7 | 38.1% | 531.5 | 41.0% | 122.2 | 3.2% | 64.8 | 2.9% |
| Expenditure | 454.8 | 42.0% | 470.4 | 38.4% | 558.6 | 43.1% | 103.8 | 1.1% | 88.2 | 4.7% |
| Balance | -45.5 | -4.2% | -3.7 | -0.3% | -27.1 | -2.1% | 18.4 | 2.1% | -23.4 | -1.8% |
| Debt | 1070.9 | 98.9% | 1141.7 | 93.2% | 1191.8 | 91.9% | 120.9 | -7.0% | 50.1 | -1.3% |
| Av. GDP growth (2016–2018) | 3.2% | | 3.0% | | 5.0% | | 1.8% | | 2.0% | |
| Unemployment Rate | 22.1% | | 15.6% | | 10.6% | | -11.4% | | -5.0% | |
| Employment (Million) | 17866.1 | | 19466.0 | | 20614.6 | | 2748.5 | | 1148.7 | |

*Source:* Authors' calculations and Stability Programme (2015–2018).

the welfare state and to address policies of structural change. Moreover, public revenue is 3 p.p. of GDP lower than in 2007, when this ratio registered its highest value of the past two decades (41% GDP). Therefore, Spain has a considerable scope to improve tax collection, and we consider that this increase in the percentage of public revenue to GDP by 3% GDP is an achievable—but ambitious—objective.

It is realistic because, as we have mentioned, this percentage of public revenue over GDP was effectively reached in 2007. However, this was the consequence of the expansion of real estate activities and not the result of an efficient tax system. Moreover, the government implemented at the same time permanent reductions in taxation on capital revenue, companies' incomes and wealth, provoking an important loss of tax collection capacity. Once the Great Recession began and the bubble burst, public revenue dropped sharply, and its ratio over GDP diminished by more than 6 p.p., a much higher decrease than in the rest of the European countries.

Then, a main component of an alternative fiscal policy for Spain should be a progressive tax reform, to address the chronic problems related to the design and equity of its tax system. A detailed description of those measures is beyond the scope of this paper, but we would recommend, for example: establishing the same general tax rate structure for all kinds of incomes (labour and capital); restoring and increasing the wealth tax; a deep-rooted reform of corporate tax, eliminating tax breaks and deductions; creating a minimum temporary tax for large businesses, aimed at reintroducing corporate tax collection; and reinforcing environmental taxes. (Godar *et al.*, 2014, provide theoretical and empirical arguments for progressive tax reforms in the current context.)

Another reason explaining the low percentage of Spanish public revenue over national income is the high size of the informal sector (20% GDP, according to Schneider [2012]). This provokes a loss of public revenue near 6% GDP (Consejo Económico y Social, 2013) and a resolute effort to fight tax fraud should be made as well. If the weight of the informal sector were reduced to a level similar to other countries such as Sweden and Germany, public revenue could increase by 1.5 p.p. of GDP.

If $T^{\star}$ refers to public revenue in 2018 corresponding to our proposal, T refers to public revenues derived from the SP that same year (466.7 billion €), and these measures are adopted and T/GDP increases to 41%, we can write:

$$T^{\star} = 0.41Y^{\star}$$

$$\Delta T^{\star} = 0.41Y^{\star} - T$$

$$\Delta T^{\star} = \gamma_T \Delta Y^{\star} + \Delta T^{D}$$

Provided that $Y^{\star}$=1296.4 is effectively reached ($\Delta Y^{\star}$=71.4), the result would be a discretional increase in public revenue ($\Delta T^{D}$) by 37.7 billion euros in 2018. The total increase in public revenue would be higher, as we will show later, as a consequence of rising GDP.

The second component of our proposal is a discretional increase in public expenditure, whose amount can be calculated using equation (2):

$$\Delta Y = \Omega_G \Delta G^{D} - \Omega_T \Delta T^{D} \tag{2}$$

$$\Delta G^D = \frac{\Delta Y^{\star} + \Omega_T \Delta T^D}{\Omega_G}$$

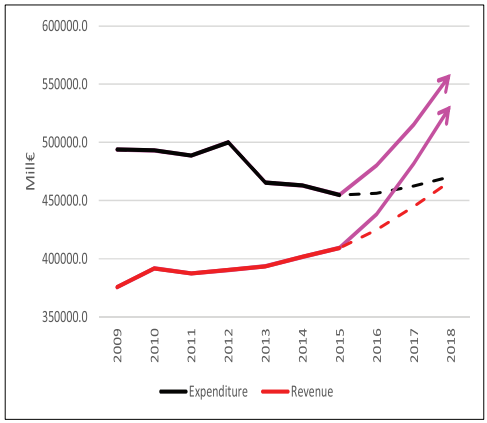
Given this realistic increase in discretional revenue, the authorities should apply, to attain the aimed expansive effect on GDP and employment, discretional expansive programmes which would mean an increase in public expenditure by a total amount of 91.8 billion € in 2018, or an average increase of 30.6 billion during each of the three 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 ratio of public expenditure over GDP would be 1 p.p. higher in 2018 than in 2015, rather than being 3.6 p.p. lower as the current SP implies. It is worth remembering that this ratio is currently lower in Spain than the European average, not higher.

We remember here that one of the arguments for a change in Spanish fiscal policy was the need to fund public policies to address some social problems and to foster some structural changes in the Spanish economy. Therefore, just as important as the actual amount involved is ensuring the right distribution: it should prioritise spending that would have a high multiplier effect, a strong social impact and which would evidence a greater ability to stimulate the necessary changes in the Spanish economy.

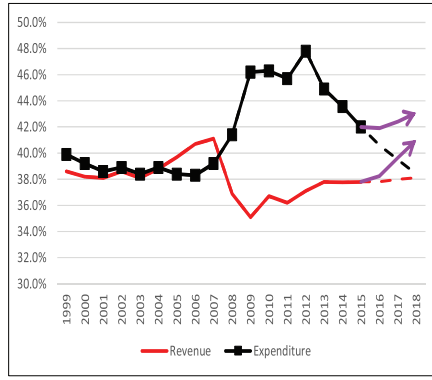
In this regard, we believe that the key items to be increased by an expansionary fiscal program are four: a guaranteed income scheme to ensure social cohesion and to address the problem of poverty of millions of households in Spain; spending on education and health services, until they reach previous levels before the crisis; public investment to develop a Plan of Energy Transition, focused on retrofitting existing buildings and developing the use of renewable energy; and boost spending on R&D, still far from European standards.

### *3.4 Effects*

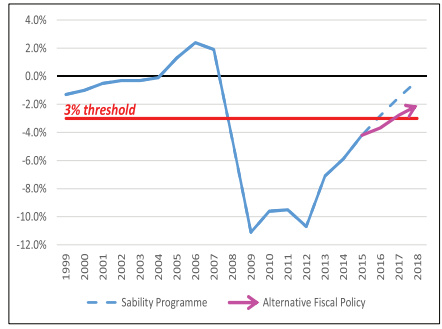
With the help of equation (2), we calculate the change in GDP when applying this fiscal policy, and—provided that the increase in productivity and in the labour force are



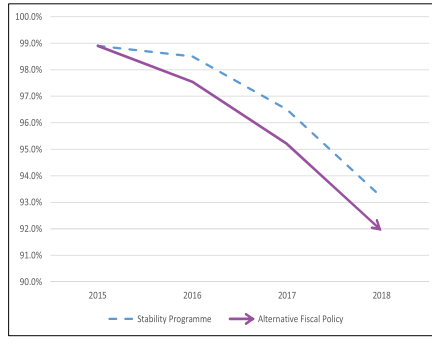

**Graph 3.** Public expenditure and revenue (Mill €)
*Source:* Eurostat, authors' calculations and Stability Programme (2015–2018). Bold lines represent actual data, dotted lines the SP and the arrows our alternative proposal.




**Graph 4.** Public expenditure and revenue (% GDP)
*Source:* Eurostat, authors' calculations and Stability Programme (2015–2018). Bold lines represent actual data, dotted lines the SP and the arrows our alternative proposal.




**Graph 5.** Public balance (% GDP)
*Source:* Eurostat, authors' calculations and Stability Programme (2015–2018). Bold lines represent actual data, dotted lines the SP and the arrows our alternative proposal.




**Graph 6.** Public debt (% GDP)
*Source:* Eurostat, authors' calculations and Stability Programme (2015–2018). Bold lines represent actual data, dotted lines the SP and the arrows our alternative proposal.

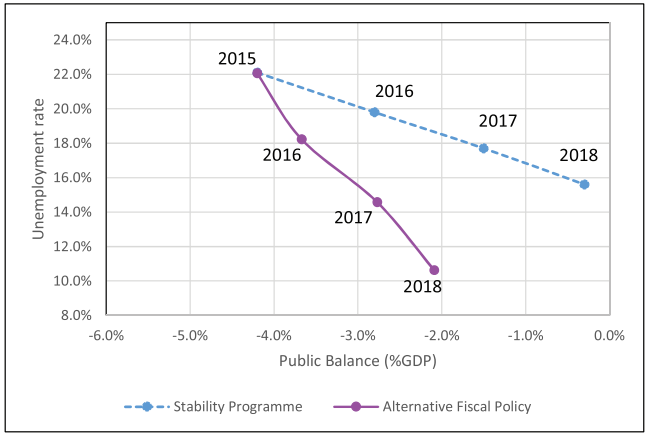
equal to those forecast in the SP—we also obtain the corresponding employment and unemployment figures. Having done this, by using equation (3) we estimate the evolution of total public revenue and expenditure and of public deficit. We can also see the effect this would have on debt, both in nominal terms and in relation to GDP. Table 2 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, with an average growth rate of 5% instead of 3%. The unemployment rate would fall to 10.6% in 2018, 5 p.p. below the government forecast, and the number of jobs would be 20.6 million, the same as in 2007, which was our target.

Due to these expansive effects, the operation of automatic stabilisers would mean new revenue from taxes coupled with a proportionally lower increase in public expenditure. Specifically, if we compare with 2015, revenue would increase by 122.2 billion euros, and public expenditure by 103.8 billion. If we now compare with the figures envisaged in the SP, revenue would be 64.8 billion higher in our proposal (37.7 billion through tax reform and 27.1 billion thanks to the expansive nature of fiscal policy) and public expenditure 88.2 billion higher.

This means that public deficit would continue to fall, albeit at a slower rate. In 2018, the reduction in deficit would be 18.4 billion (the SP anticipates a reduction of 41.8 billion). As a result, public deficit would be 2.1% GDP in 2018, while the SP forecasts budget balance. However, there are no economic reasons to support the idea that budget equilibrium and 15.6% unemployment is necessarily better than a public deficit of 2.1% and 10.6% unemployment. Regarding public debt, although the total debt figure is higher, this would also be divided by a bigger nominal GDP, and the public debt burden in GDP would even be a little lower in our scenario than in the SP (92% versus 93% in 2018).

All of this means that, although our proposal involves a significant increase in public expenditure, it would be perfectly viable in financial terms. First, through increased revenue stemming from fiscal reform and the fight against fraud. Second, because economic growth itself would translate into higher public revenue and lower cyclical




**Graph 7.** Unemployment rate (%) vs. public deficit (% GDP), Spain 2014–2018
*Source:* Authors' calculations and Stability Programme (2015–2018).

expenditure. We calculate that 42% of the discretional expansion in public expenditure is self-financed. Finally, some fiscal space could be gained from postponing the year in which public deficit reaches the 3% threshold. The choice, then, lies between prioritising either the rate at which unemployment is reduced or at which public deficit is reduced, as Graph 7 clearly shows.

## 4. Could other constraints prevent the application of this alternative?

Besides the effects on public finances sustainability, we have also considered two other constraints that could prevent the application of this change in fiscal policy: the balance of payment and the fiscal rules of the European Monetary Union.

### *4.1 The balance of payment constraint*

A higher economic growth in Spain than the European average is the most likely scenario for the next few years, especially if an expansive fiscal policy is implemented, as we recommend. This higher growth is necessary for reducing the Spanish unemployment rate as fast as possible, but it will probably be translated into a deterioration in the current account balance as well.

This raises some concerns on the possible limits of 'one country Keynesianism', whose potential relevance is highlighted by the current account imbalances registered within the European Monetary Union between 2000 and 2007. Those (unsustainable) imbalances were mostly related to persistent differences in the growth rates of its members, and they can be considered as one of the main causes of the current crisis and its severity (Uxó *et al.*, 2011). Will Spain suffer similar current account deficits as a consequence of our proposal, accumulating again unsustainable levels of external debt, and provoking the need for new adjustments sooner or later? We do not think so.

Hein and Detzer (2015) offer an appropriate framework to address this topic, applying the model of the 'balance-of-payments-constrained growth rate' (BPCGR) to the case of a monetary union. The BPCGR of a country depends on the growth rate of the rest of the Eurozone; the difference between domestic and average inflation; and price and income elasticities of exports and imports. If actual growth is higher (lower) than the BPCGR, the current account balance decreases (rises). They propose a new set of economic policies aimed not only at generating high-demand growth, but also at assuring internal balance within the Eurozone, which requires the adjustment of actual growth rates for each country and its respective BPCGR.

Nevertheless, the existence of growth differentials might be inevitable, due to: a) countries with higher unemployment rates (such as Spain) need to grow more to reduce unemployment to a socially acceptable rate; and b) the convergence of lower-income countries. These growth differentials would probably imply differences between actual growth and BPCRG as well, and some current account imbalances might appear. Regarding this, Hein and Detzer (2015) offer three interesting considerations that can be applied to the Spanish case:

1. *Due to the high growth rates that characterize deficit countries, the stabilisation of the net foreign debt-GDP ratio can be compatible with a trade deficit, if it does not exceed a certain threshold.*

   The Spanish current account balance has radically changed during the past years, from a strong deficit in 2007 (–9.6% GDP) to a surplus equivalent to 1.5% GDP in

2015. This adjustment stems mainly from a much lower deficit in the trade balance of goods, and it is the consequence of several causes: some increases in price-competitiveness, the collapse of domestic demand until 2013, the fall in energy prices or the diversification of the geographical distribution of Spanish exports. Including the surplus of the capital balance, the Spanish economy presented a net lending position equivalent to 2.0% GDP in 2015.

The SP forecasts that the Spanish economy will register net lending between 2016 and 2018 (1.4% GDP last year), with a positive sign of the goods and services balance (2.7%). As a consequence, the Net International Investment Position (NIIP, –91% GDP in 2015) should be dropping, both in nominal terms and as a percentage of GDP.[4]

In our opinion, this provides some space to apply a more expansive fiscal policy without being constrained by the balance of payments. Specifically, we have estimated the impact of our proposal on the Spanish current account balance and the evolution of net external debt (measured by the NIIP), and we have found that, although the Spanish economy would register a current account deficit in 2018, it would fall behind the threshold compatible with a constant NIIP/GDP ratio, given the expected GDP growth.

The evolution of the NIIP/GDP ratio (with a negative sign) depends on the joint current plus capital account deficit (D, expressed as a % GDP) and the nominal rate of growth (g):

$$\left(\frac{-NIIP}{GDP}\right)_t = \frac{\left(\frac{-NIIP}{GDP}\right)_{t-1}}{(1+g)} + D \tag{4}$$

Calling D' the external deficit compatible with a constant NIIP/GDP ratio (a higher deficit than D' means an increasing ratio), we can write:

$$D' = \left(\frac{-NIIP}{GDP}\right)_{t-1} \frac{g}{(1+g)} \tag{5}$$

For example, the SP forecasts an average nominal growth rate of 4.2% for the period 2016–2018. With a (negative) NIIP/GDP ratio equal to 91% in 2015, the threshold would be D'=3.7%. As the external balance forecast is not a deficit, but a surplus, the net external debt would be decreasing in the next years, reaching a value of –76% GDP in 2018.

The application of our proposed fiscal policy would mean a higher average nominal growth (6.2%). Therefore, the maximum deficit compatible with a constant –NIIP/GDP would also increase, so that D' would be 5.3%.

Simultaneously, higher growth implies more imports and a worsening of the balance of payments. The change that a more expansive fiscal policy provokes in the goods and services balance (ΔGSB) depends on the past value of imports (M), the acceleration in GDP growth, and the income elasticity of imports (ε):

[4] As we are mainly interested in the change in the NIIP derived from our expansive fiscal policy proposal, we do not take into account possible valuation effects.

$$\Delta GSB = \Delta M = M_{t-1}\varepsilon\Delta g \quad (6)$$

The Spanish economy is characterized by high income elasticity, mainly because of its dependence on imported energy, its structural specialization, and the high import content of its exports. The estimated value of this elasticity is between 1.5 and 2.0 (Orsini, 2015; BBVA Research, 2013; IMF, 2015). Using a value of 1.75, a more expansive fiscal policy would provoke a deficit of about –2.0% GDP in 2018. Although this is a significant change in the external balance, it is clearly behind the threshold compatible with a constant NIIP/GDP ratio, which would actually be decreasing. In 2018, the net external debt (–78% GDP) would present a very similar percentage to the SP forecast (–76%).

2. *Two different situations should be distinguished when a country grows 'too fast' relative to its BPCRG and current account deficits appear: a 'bad case', which is characterized by a bubble or by a credit expansion that fuels debt financed consumption, and that should be avoided (this was the case of Spain between 2000–2007); and a 'good case', associated to convergence processes and massive productive investments, which should be welcomed.*

Our economic proposal is not just about increasing public spending, but to foster a social and structural transformation of the economy. Because of this, we have said that the government should select carefully the elements of the discretional expenditure package. And it should also implement macro and micro prudential measures to avoid new financial and real estate bubbles. Hence, we think that our proposal is related to the 'good case' rather than to the 'bad case'.

3. *We can conclude that 'the BPCGR is too low' and that some measures should be applied to increase it. Specifically,* Hein and Detzer (2015) *recommend improving non-price competitiveness, which would imply a higher income elasticity of exports, or a lower income elasticity of imports. On the contrary, they discourage redistributive policies at the expense of the labour income to gain price-competitiveness, because of their deflationary and demand depressing effects.*

The authorities should take some measures for securing external sustainability in a context of high growth, especially considering that the Spanish economy has a historically high dependency on imports and that the income elasticity of imports is clearly above the Eurozone average. Transforming the productive structure is necessary to lift up the BPCGR and to avoid the 'balance of payments constraint'.

Despite the strong decrease in oil prices, the trade deficit registered by the Spanish economy during 2015 (–2.3% GDP) is completely explained by the energy deficit. Between 2010 and 2015, the average trade balance is positive (0.5%) if we exclude energy, while the average deficit in this sub-balance is equal to –3.6% 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. These measures should foster a new energy model, focused on renewable energies and improving energy efficiency in buildings and constructions.

Actually, one of the main objectives of this fiscal expansion programme is to fund public investments devoted to modernize the economic structure of the Spanish economy and obtain sound gains in competitiveness. These measures should offset potential negative effects on price-competitiveness derived from higher taxes.

*4.2 Is our proposal compatible with the European Union fiscal rules?*

Spain is currently in the Excessive Deficit Procedure, and a strict application of the EU fiscal rules would substantially reduce the Spanish government's room for manoeuvre. Nevertheless, our proposal is by no means incompatible with the economic principle of fiscal stability in the medium term, although the 3% deficit threshold would be reached later. Consequently, we put forward some economic arguments which could facilitate its implementation within the current fiscal rules:[5]

1. Although current European legislation defines bad, very bad or exceptionally bad economic circumstances in terms of growth rates and the output gap, the extraordinarily high Spanish unemployment rate is a better indicator of an 'exceptional situation', and this would justify some flexibility. Under normal circumstances, with low unemployment, the growth rate may provide a good indicator to detect economic situations that require more expansive fiscal policies. However, returning to normal rates of unemployment will imply exceptionally high growth rates over a number of years. On the other hand, the *output gap* is not an observable variable, and nowadays there is major uncertainty surrounding its value, precisely due to the effect of the Great Recession. 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 *et al.*, 2015).
2. Related to the problem of the estimation of potential output is the determination of 'structural' budgets and the 'structural effort' that national governments should implement to observe fiscal rules. Truger (2015) shows that the Spanish output gap has been underestimated and, consequently, the structural budget deficits have been overestimated. Then, more expansionary policies should be allowed, using this technical and interpretational leeway. Sawyer (2012) analyses the same problem in the UK, and the Italian government (2014) uses a similar argument: either the drop in the Italian potential output has been overestimated, or Italy is suffering a huge hysteresis effect. In both cases, a more expansive fiscal policy is recommended.
3. The fiscal rules also allow the exclusion of some expenditure from deficit accounts if they are allocated to structural reforms which contribute towards medium-term growth, as well as certain investments. Precisely, we propose to focus the increase in public expenditure on economic transformation goals and social needs. In this vein, a less strict application of these two exceptions should be requested, although this would require a significant extension of the current 'structural reform clause' and 'investment clause'.

## 5. Conclusions

Especially during the recession of 2011–2013, Spanish fiscal policy has been strongly restrictive and procyclical, with a negative impact on GDP and employment. And the Stability Programme (2015–2018) shows that 'austerity' has been softened, but

[5] In any case, we agree with Sawyer (2013) when he says that the Fiscal Compact, and specifically the structural balance budget objective, should be abandoned, in coherence with the functional finance approach to fiscal policy.

not fully abandoned. Its main objective continues to be a fast reduction in public deficit, freezing public expenditure in nominal terms, and reducing it as a percentage of GDP.

Spain has recovered positive growth since 2014. Nevertheless, deep-rooted changes in economic policy are still needed, and specifically the implementation of an expansionary fiscal policy: current growth is not the result of austerity measures and may prove temporary and fragile; the unemployment rate is very high and a rapid reduction of it is not foreseen; it is necessary to reverse the effects of austerity policies on essential public services; and some social and structural policies, as well as public investment, should be financed to address important problems of the Spanish economy that remain unsolved.

Adopting a 'functional finance' approach to fiscal policy and making a (partial) use of the idea of Balanced Budget Expansion, we present an alternative fiscal policy for the years 2016–2018 which is not focused on deficit reduction, but on employment creation and on the development of social and structural policies aimed at a real transformation of the Spanish economy. The two main components of this plan are a progressive fiscal reform to increase public revenue over GDP, and a simultaneous increase in the ratio of public expenditure over GDP.

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 our alternative strategy. We carry out this exercise with a very simple model whose results are only conditioned by two pairs of parameters, the multipliers and the cyclical sensitivity of public revenue and public expenditure. The main conclusions are:

1. The effect on GDP growth would be positive since expenditure multipliers are greater than revenue multipliers. Consequently, the targeted number of jobs would be reached, and the unemployment rate would fall to 10.6% in 2018, 5 p.p. below the SP forecast.
2. Although our proposal involves a significant increase in public expenditure, it would be perfectly viable in financial terms, through: increased revenues stemming from fiscal reform and the fight against fraud; higher public revenue and lower cyclical expenditure coming from the expansive effect of the discretional increase in public expenditure (42% of it is self-financed); and fiscal space gained from postponing the goal of reducing public deficit to 3%.
3. Public deficit would continue to fall, albeit at a slower rate than forecast by the SP. And the public debt burden in GDP would be nearly the same in our scenario as in the SP (92% versus 93% in 2018).

It has been argued frequently that there was no alternative to austerity policies, because they were the only way to correct some macroeconomic imbalances that the Spanish economy was suffering (losses in competitiveness, a current account deficit and growing indebtedness). And the Spanish authorities are currently using the same argument to present their fiscal policy as the only possibility to attain the 'needed' reduction in public deficit. On the contrary, this paper proves that an alternative plan to austerity can not only be expansionary, but also fully compatible with fiscal sustainability. The choice, then, lies between prioritising either the rate at which unemployment is reduced or at which public deficit is reduced.

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