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Recommendation for a

COUNCIL IMPLEMENTING DECISION

imposing a fine on Spain for failure to take effective action to address an excessive deficit

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area, and in particular Article 6 thereof,

Whereas,

(1) The Council, by decision adopted on 12 July 2016 established that no effective action has been taken by Spain to correct the excessive deficit in response to the Council Recommendation of 21 June 2013 under Article 126(7) of the Treaty.

(2) Following the Council's decision under Article 126(8) of the Treaty that Spain has not taken effective action to correct the excessive deficit, the Commission should recommend the Council to impose a fine.

(3) The fine to be imposed on Spain should in principle amount to 0.2% of its GDP in the preceding year, but its amount may be reduced or cancelled on grounds of exceptional economic circumstances or following a reasoned request by the Member State concerned.

(4) The GDP of Spain in 2015 was EUR 1081.19 billion. 0.2% of that GDP corresponds to EUR 2162.38 million.

(5) In accordance with Article 2(3) of Regulation (EU) No 1173/2011, 'exceptional economic circumstances' means circumstances where an excess of a government deficit over the reference value is considered exceptional within the meaning of the second indent of point (a) of Article 126(2) TFEU, as specified in Regulation (EC) No 1467/97. According to the latter Regulation, such an excess is exceptional when it results (i) from an unusual event outside the control of the Member State concerned and with a major impact on the financial position of general government or (ii) from a severe economic downturn, meaning a negative annual GDP volume growth rate or an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential..

(6) An evaluation of the application of the above-mentioned conditions to Spain yields the following conclusions:

- Following ten consecutive quarters of negative real GDP growth, economic growth in Spain resumed in the third quarter of 2013. Real GDP growth reached 1.4% in 2014 and accelerated to 3.2% in 2015. According to the updated Commission 2016 spring forecast, real GDP growth is expected to reach 2.9% in 2016. This is an upwards revision of 0.3 pp. compared to the Commission 2016 spring forecast, driven by higher-than-expected public and private consumption in the first quarter of the year. Consequently, there has not been a severe economic downturn over the period covered by the 21 June 2013 Council Recommendation (i.e. 2013-2016).

- Moreover, no unusual events outside the control of the government, with major impact on public finances over 2013-2016, took place. Even though Spanish inflation surprised on the low side and was even negative in 2014, its impact on the public finances was not major as it was largely offset by higher-than-expected real GDP growth, with fast job creation and a tax-rich composition of growth benefitting the deficit reduction.

(7) Therefore, exceptional economic circumstances that would warrant a reduction of the amount of the fine do not exist.

(8) On 13 July 2016, Spain submitted a reasoned request to the Commission to recommend that the Council set the amount of the fine to zero. In support of its request, Spain gave the following reasons:

(9) Spain recalls its important achievements in implementing a far-reaching reform agenda, despite a very challenging economic context, that proved decisive in supporting the strong rebound of economic activity and job creation, as well as the correction of accumulated imbalances. It also highlights the significant fiscal effort implemented in the wake of the crisis and the negative impact of low and even negative inflation on the fiscal adjustment process and the economy as a whole. Methodological issues are also raised, concerning the alleged inability of the current methodology to assess SGP compliance to take account of negative inflation surprises or to accurately measure potential GDP growth in the case of Spain. Finally, it reports on measures and commitments taken to reduce the public deficit in 2016 and reaffirms the commitment to correct the excessive deficit by 2017.

(10) An assessment of the abovementioned arguments leads to the considerations below.

(11) The Spanish economy has experienced a significant turnaround in recent years, also thanks to reforms undertaken in a challenging economic environment that helped ease existing rigidities in labour and product markets. The successful completion of the financial assistance programme for the recapitalisation of financial institutions in Spain in early 2014 and the major structural reforms that have been carried out alongside created a sound basis for the economic recovery. Also after the completion of the programme, Spain continued to implement structural reforms, including a reform of the insolvency framework, the completion of the banking sector restructuring, the public administration reform and the creation of an independent fiscal council. Helped by monetary policy and a reinforced euro area governance framework, this paved the way for a return of capital inflows and improved financial conditions. As growth resumed in the second half of 2013, internal and external rebalancing advanced, also supported by reform-induced competitiveness gains. The recovery is accompanied by strong job creation, supported by continued wage moderation and the impact of labour market reforms. Notwithstanding the progress in rebalancing the economy, important challenges remain, as still high private and public debt reflected in the very high level of net external liabilities exposes the country to risks stemming from shifts in market sentiment, and still high unemployment hampers economic adjustment.

(12) While Spain did not take effective action to address the excessive deficit in compliance with the Council's recommendation of 21 June 2013, it should be acknowledged that Spain had already delivered sizeable fiscal efforts to correct its excessive in the budgets for 2012 and to a lesser extent 2013. The consolidation fatigue highlighted by the Council decision of 12 July 2016 followed this substantial fiscal structural effort and occurred after difficult economic conditions that impinged on social cohesion. Indeed, notwithstanding the strong rebound of the economy since

the third quarter of 2013, Spain kept experiencing unfavourable economic conditions during the period covered by the last Council recommendation. The output gap reached −8.5% of potential GDP in 2013 and, while improving fast, it was still largely negative, at −4.0%, in 2015. The unemployment rate peaked at 26.1% in 2013 and social exclusion and inequality worsened in the wake of the crisis, bringing the overall share of people at risk of poverty or social exclusion to 29.2 % in 2014, one of the highest rates in the EU.

(13) In this context, while some of the measures taken in recent years had a negative direct impact on the public finances, they may contribute to growth and employment in the medium to long term, and in turn to the sustainability of public finances. Social security contributions exemptions and rebates contributed to the persistent general government deficit, but to some extent supported social cohesion by targeting lower income earners, less qualified workers and new permanent contracts. The tax reforms adopted in late 2014, while being under-funded, are aimed at making the tax structure more growth-friendly as well as improving tax governance and equity.

(14) For 2016, the Spanish government, in its caretaker position, has taken deficit-reducing measures following the Commission Recommendation of 9 March 2016 regarding measures to be taken by Spain in order to ensure a timely correction of its excessive deficit, which is welcome. In particular, with a view to implementing provisions in domestic legislation to enforce fiscal discipline on regional governments, on 6 April, the government required 12 regional governments to approve cuts in budget appropriations to ensure compliance with their deficit targets for 2016. While the expenditure cuts for 2016 adopted to date by those governments are considerably below the expected amount reported in the 2016 Stability Programme, Spain's central government has approved around 0.2% of GDP cuts to budgetary appropriations. On 13 July, the Spanish caretaker government announced its commitment to put in place further welcome deficit-reducing measures. On the revenue side, amendments to the corporate income tax law, to be adopted as soon as a new government is formed, have been envisaged to make up for the loss in revenues of around 0.5% of GDP expected for 2016 following the changes made to the regulation of instalment payments (*pagos fraccionados*) of the corporate income tax, so as to ensure that corporate income tax revenues reach the level expected in the 2016 Stability Programme. On the expenditure side, the advancing of the date of closure of the central government's fiscal year, adopted on 14 July, can help contain expenditure developments in the second half of 2016. Nevertheless, these measures are still subject to considerable implementation risks, in particular with respect to the timely adoption by Parliament of required changes to the corporate income tax law and whether they will be sufficient to offset the expected shortfall in corporate income tax revenues. The government has also committed to take further measures against tax fraud.

(15) Spain's reasoned request to the Commission also highlights the negative impact of low and even negative inflation on the fiscal adjustment process and the economy as a whole. As also argued in the Council Decision of 12 July 2016, over 2013-2015, Spanish inflation (as measured by the GDP deflator) was indeed well below that in the baseline macroeconomic scenario underpinning the recommendation (it was even negative in 2014, at −0.4%). However, the negative impact of low or even negative inflation on Spain's fiscal outcomes was largely offset by higher-than-expected real GDP growth.

(16) Spain also puts forward methodological issues concerning the alleged inability of the current effective action methodology to take account of negative inflation surprises or to accurately measure potential GDP growth in the case of Spain. Concerning the

possible underestimation of the structural effort carried out in Spain, it must be borne in mind that, in estimating potential growth, the Commission applies the commonly agreed production function methodology, endorsed by the Council. As regards the impact the impact of negative inflation, the Commission acknowledges in its analytical work that the methodology agreed for fiscal surveillance – and based on the correction of headline balance figures by means of potential output estimates – can, in the presence of a negative inflation shock, lead to the underestimation of the structural effort. However, this approach is complemented by a so-called bottom-up measure of the fiscal effort, which assesses whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented. Contrary to the change in the structural balance, this bottom-up measure will likely be over-estimating the fiscal effort following a disinflation shock. In the case of Spain, also the use of such bottom-up methodology shows that no cumulated effort was delivered over 2013-2015, against the recommended cumulative structural effort of 3.0% of GDP.

(17) In view of Spain's reasoned request and having regard of the previous points, notably the deep structural reforms undertaken by the Spanish government since 2012 and still in place, the challenging economic environment during the period covered by the June 2013 Council recommendation, the deficit-reducing commitments announced by the Spanish caretaker government in its reasoned request, along with the consolidation measures put in place following the Commission Recommendation of 9 March 2016 regarding measures to be taken by Spain in order to ensure a timely correction of its excessive deficit, a cancellation of the fine of 0.2% of GDP is considered warranted.

HAS ADOPTED THIS DECISION:

Article 1

The fine of 0.2% of GDP to be imposed on Spain for failure to take effective action in response to the Council recommendation of 21 June 2013 is cancelled.

Article 2

This decision is addressed to the Kingdom of Spain.

Done at Brussels,

For the Council
The President