Curbing the Deficit in Spain and its Autonomous Communities: a Constitutional Conundrum

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1. Introduction

On September 27th 2012 the Spanish Constitution was amended in order to introduce debt and deficit limitations, according to the European legal framework. Thus, the new article 135.1 of the Constitution establishes that ‘All public administrations will conform to the principle of budgetary stability’, and it also refers to future ‘organic law’ to fully implement the new measures. On April 2012, Organic Law 2/2012 (Organic Law 2/2012, 27 April, on Budgetary Stability and Financial Sustainability) came into force developing the new Constitutional provision.

Before the Constitutional reform, a ‘internal stability pact’, consisting of a set of laws approved in 2001 and reformed in 2006, had already been put in place in Spain. Despite the old and the new laws regulating budgetary stability, the current debt and deficit indicators do reveal a growing debt and deficit, which will make it very hard to comply with EU limits. As I write these lines, Spain’s banks have already been ‘bailed out’, but as the recession deepens, the odds are growingly in favor of a full-fledged rescue of Spain. At the same time, the measures undertaken in order to curb public deficit are also deepening it, as tax revenues plummet and it becomes increasingly harder to meet the debt and deficit targets. On July 19th, 2012, the Spanish Government approved a group of measures that intended to lower the debt and deficit figures by, among other, increasing taxes (for example, the top rate of VAT, which in 2010 went up to 18 per cent, has again been increased, this time to 21 percent) and substantially decreasing the salaries of public servants. Also, a system to facilitate the financing of Autonomous Communities with a special ‘liquidity fund’ (Fondo de Liquidez Autonómica) has been put in place. Many more measures may need to be implemented, should Spain finally be bailed-out.

In this context, and with economic indicators and debt and deficit projections changing by the week¹, it is certainly hard to find the necessary...
peace of mind to analyze the still recent Constitutional reform enshrining the debt and deficit limitations. After the Constitutional reform, the larger fundamental question is of course whether and how the existing legal framework failed, and whether it should be expected that the new one will be more successful. The problem is that the debt and deficit exploded in Spain as a consequence of the 2007 crisis, so that it was only in 2009 that an excessive deficit procedure was opened for the first time. Experts agree that it was not the lack of a credible legal framework that caused or failed to correct the increase of the debt and deficit, but rather a gravely ill economy (low productivity, insufficient exports and so negative current account balance, or high unemployment).4

But the purpose of this paper is more modest and limited. I will briefly explain the Spanish legal framework to curb the debt and deficit introduced after the Constitutional reform of September 2011, before the ‘Six Pack’5, or the ‘Fiscal Compact’ (Treaty on Stability, Coordination and Governance or TSCG) made it mandatory, and in so doing, address two questions: to what extent does the reform actually change the previous Spanish legal environment of debt and deficit limitation and what consequences may it have on the Spanish ‘quasi-federal’ model of Autonomous Communities.

2. The new legal framework on debt and deficit

Both the (new) article 135 of the Constitution and in particular the Organic Law 2/2012 closely follow the Fiscal Compact. But the new rules also build on the existing Spanish legal framework to curb excessive debt and deficit. In 2001, Spain introduced what has been informally labeled an ‘internal stability pact’ by establishing strict deficit limitations in budgetary policy. In practice, the 2001 laws radically changed how the Central Government’s budget was designed and carried out, and the question of in-debtment slowly began to creep into financing agreements with Autonomous Communities, even if no mandatory rules were imposed. It can in fact be argued that the economic growth that ensued after the 2001 internal Stability pact did not provide sufficient incentives to strictly enforce the rules, which to some extent, had no teeth, so that no real sanctions were imposed upon Autonomous Communities that failed to meet the deficit targets.6 Also, those rules only addressed the deficit, but not the debt, so that Communities were also able to increase their debt burden with relative freedom. After all, in the period 1997-2007

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4 I have dealt extensively with these issues in the following book and recent papers, where some of the conclusions, and recent economic data, can be found: Ruiz Almendral 2008; Ruiz Almendral 2012a; Ruiz Almendral 2012b; Ruiz Almendral 2012c. Available at ssrn.com.
5 The ‘Six Pack’ is the set of 5 Rulings and 1 Directive that modify the legal framework of the Stability and Growth Pack. See: ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm
6 In fact, some Communities lowered their tax pressure as they were building larger deficits; see Ruiz Almendral 2012c, p. 95 et seq.
The deficit and in-debtment were low and there was not much debate, political or academic, on the subject.

The Laws regulating the ‘internal pact’ are: *Ley Orgánica 5/2001, de 13 de diciembre, complementaria a la Ley de Estabilidad Presupuestaria* and *Real Decreto Legislativo 2/2007, de 28 de diciembre, por el que se aprueba el texto refundido de la Ley General de Estabilidad Presupuestaria*. The Stability laws were highly contested and were thus challenged before the Constitutional Court on the grounds that they may reduce the equal distribution of public funds and curb the Autonomous Communities’ financial autonomy. The Court decided on these issues in its Opinion of 20 July (STC 134/2011), declaring the laws constitutional. The Constitutional reform took place only 2 months after that Ruling. After the enactment of the new art. 135, there have been ten Constitutional Court rulings, all deciding on the 2001 laws, but applying the new art. 135 to the reasoning (Rulings: 157/2011, 18 October; Rulings 187, 188 and 189, 23 November; 195, 196, 197, 198 and 199, 13 December; and 203/2011, 14 December).

In fact, it is not an overstatement to say that until 2010, there were almost no academic seminars on the subject of the Stability pact. Discussions on the financing system of Autonomous Communities typically ignored the debt and deficit figures. In this context, the hasty approval of Article 135 of the Spanish Constitution was not carried out in the context of informed debate or opinion.

The new article 135 of the Spanish Constitution, does the following things:

- Section 1 enshrines the principle of stability as regulated in the Treaty for the Functioning of the European Union (TFUE), to which the article specifically refers, thus ‘*all public administrations will follow the principle of budget stability*’. The inclusion of the principle of stability is not a radical change or an innovation of the Spanish legal system, at least to the extent that it was already mentioned in the TFUE, which is part of Spanish law. But it does facilitate the coordination between Spanish budgetary principles and European ones, and it probably makes it easier to impose these limits to sub-national entities without the constant claim that it may limit their financial autonomy (enshrined in article 156 of the Constitution).

- The reform limits debt (section 135.3), not just the deficit. This is new as, to date, the internal stability pact only dealt with deficit limits.

- The reform includes several elements of flexibility: a first element is that the specific deficit limitations will be established in an Organic Law, which is easier to change than the Constitution. A second element of flexibility is that the deficit and debt limits may be infringed in cases of ‘natural catastrophes, economic recession or situations of...’
extraordinary emergency that are beyond the central Governments control’. Such circumstances will need to be assessed by an absolute majority of Congress.

– The new section 135.5 refers the fundamental changes to an organic law. Such a law develops the principle of stability as well as establishes how Autonomous Communities and Municipalities may participate in the process of distributing the deficit and debt threshold among the different entities.

– The new section 135.6 is directed to Autonomous Communities that must adopt the pertinent legislation, or modify the existing legislation if that is the case, in order to comply with the new article 135.

Art. 135 refers to the ‘organic law’ the determination of the main elements of the regime, such as what the actual targets and how these shall be distributed between the Centre, the Autonomous Communities and the Municipalities. The new Organic Law 2/2012, which entered into force in April 2012, further implements the rule and does so in a way that fundamentally mimics the Fiscal Compact. This blatant ‘transplant’ of the Fiscal Compact sometimes implies treating Autonomous Communities as Member States (they may thus be ‘bailed-out’ and their Budgets closely monitored by the Central Government –as if assuming the role of the Commission–), and the Spanish Constitutional Court as the European Court of Justice.

The new Law changes the existing legal framework in different ways. The main change is the substantial limitations of Autonomous Communities’ leeway for indebtedment and deficit. After decades of legal reforms increasing both the taxing powers and financial autonomy of the Communities, this may be the beginning of reconsidering the distribution of authority in a much larger scale.

The main changes to the existing budgetary stability legal framework can be summarized as follows:

1. Increased powers of the Central Government

Law 2/2012 draws its authority directly from art. 135 of the Constitution, without mentioning other articles of the Constitution (arts. 149.1, paras. 11, 13 and 14, and art. 157.3), which had until then been employed to guarantee the central government’s power to curb the deficit and the debt. Art. 10.3 of the Law stresses those powers and empowers the central government to establish any measure that may be needed to ensure full coordination among the budgetary policies of the Autonomous Communities, the Municipalities and the central government.
2. Defining who the public sector is
The law stresses the need to include public enterprises or agencies in order to avoid fiscal gimmickry practices. This is not strictly new, but it is a clarification of the previous rules on this. This is relevant because some Communities had ‘hidden’ part of their debt by creating other entities (mainly public enterprises). [art. 2].

3. (More) Principles
Articles 3 to 10 fully enunciate a set of principles (stability, fiscal sustainability, multi-annual budget planning, transparency, efficiency, responsibility, and coordination) that should now direct all public spending rules or regulations, but also the relations among different tiers of power. The stability principle, already present in the previous legal framework, is now defined as ‘equilibrium’ (art. 3.2) or zero structural deficit.

4. Deficit target
The structural zero deficit target is enshrined in art. 11.2, but it may be increased to a maximum of -0.4 percent should structural reforms with long term effects be undertaken. The wording mimics the Fiscal Compact (art. 3.3.b).

5. Control of Spending growth and Expenditure ceiling (arts. 12 and 30)
Art. 12 rules that growth rate of public spending by all entities (the Centre and subnational) may not surpass the mid-term GDP growth. Art. 30 requires all budgets to start off with a Expenditure ceiling that will need to be met.

6. Debt limits
Art. 13 establishes debt limitations for the first time in the domestic rules on Budgetary Stability. But there is a caveat: together with the zero deficit target set by art. 11.2, these limitations shall not be applicable until 2020. This of course means that until then at least, the Fiscal Compact limits, which are more flexible, in practice apply.

7. The teeth of the reform and the internal distribution of the deficit and debt targets
Chapter IV of the law sets up a complicated system of sanctions, directed at Municipalities and Autonomous Communities, of incremental nature, clearly following the European system: there is a ‘prevention’ phase where measures may be proposed to subnational entities, a ‘correction’ phase and the possibility of monetary sanctions too.
Together with the expenditure ceiling, the possibility of imposing sanctions substantially alters the previous legal framework. It is too early, and the crisis too deep, to conclude what effects the new framework may have on the deficit and debt limits, but it is already clear that the budgetary processes and even the nature of the Spanish fiscal federalism system will be transformed.

3. The end of the ‘national’ Budget powers and a re-centralization of the Spanish State of Autonomies

Spain might not be a federal country by name, but the level of decentralization of public expenditures and, to a lesser extent, of taxation powers, equals that of many formal or traditional federations. Unlike other European constitutions, such as the German, the Spanish Constitution of 1978 omits any reference to the form of the state. That is, it does not describe it as centralized, unitary, federal, or regional. After almost forty years of Franco’s highly centralized government, consensus on this matter was understandably hard to obtain. The decentralization process in Spain has been remarkably swift, (see Table below), and considering its novelty (before 1978, Spain was a very centralized country) this new tier of government had, until before the crisis, been well accepted by citizens.

Table 1: Decentralization of Public Spending in Spain (% share of spending)

<table>
<thead>
<tr>
<th>Administration</th>
<th>1982</th>
<th>1996</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government</td>
<td>53</td>
<td>37.5</td>
<td>20.9</td>
</tr>
<tr>
<td>Social Security(^8)</td>
<td>32.5</td>
<td>29.2</td>
<td>29.9</td>
</tr>
<tr>
<td>Autonomous Communities</td>
<td>3.6</td>
<td>22.3</td>
<td>35.6</td>
</tr>
<tr>
<td>Municipalities</td>
<td>10.6</td>
<td>11.6</td>
<td>13.6</td>
</tr>
</tbody>
</table>

1. A consequence of the new rules is that they may facilitate a re-centralization of the Communities’ powers, which is coherent with the ongoing centralization that the Fiscal Compact implies, and generally, the European Union’s Economic Constitution, that already implied a centralization of powers and the transformation of the Member States’ economic Constitutions. Also, it has been suggested that the Spanish State of Autonomies was already in a changing course of re-centralization, so this may only

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\(^8\) Social Security is a central government responsibility, but it has its own Budget so it is usually disaggregated when presenting the debt and deficit projections.
accelerate the process. One example lies in how the process of sharing the deficit and debt ‘pie’ among different tiers of Government has been designed. The system of intergovernmental relations between the Centre and the Communities has been reshaped, as the deficit and debt ‘pie’ is divided by the Centre among Communities that have virtually no leeway to propose their own limits. Formal meetings in the ‘Consejo de Política Fiscal y Financiera’, an intergovernmental Council where the Minister of the Treasury meets with the corresponding officials of the Autonomous Communities, is increasingly just a forum where the Centre tells Communities how much their deficit/debt targets may amount to, and (increasingly) what they must do to meet them. Communities’ control over their spending has substantially decreased.

The level of conflict between Communities and the Centre is growing and will most certainly increase substantially. The Court has already played a fundamental role in shaping the Spanish State of Autonomies, in particular by interpreting the boundaries of the respective level of authorities, which in most cases are shared by the Centre and the Communities. The new Organic law (additional provision n. 3) states that any provision that contravenes art. 135 of the Constitution may be challenged before the Court. Such a provision seems unnecessary, since the Constitution already states that role of the Court (section 161), unless of course its intention is to boost the traditional Court’s role of umpire of the system.

2. But it would be overly simplistic to dismiss the reform as a mere re-centralization instrument or as a copy of EU rules (former and current). True, as pointed out earlier on, the rather hasty reform of article 135 took place before the Fiscal Compact and was triggered by the worsening of the economic crisis (the high bond yields in the summer of 2011 and the danger that Spain may end up losing access to financial markets). One year on after the reform, the situation is much worse, with bond yields close to 7 per cent (for 10 year bonds), so it could be argued that the reform clearly did not have a cure-all effect at all. Nevertheless, Spain clearly needed to have a credible system to both coordinate and limit the debt and deficit of municipalities and Autonomous Communities, an issue that had been almost completely out of the political agenda until the crisis began, despite the existing Stability laws. There was a legal system in place, but probably insufficient incentives.

In 2002 the devolution process was mostly culminated, with Health and Education –by far the most expensive areas of authority- transferred to all Autonomous Communities. I submit that the Financing systems of Autonomous Communities approved in 2001 and 2009, established in Central Governments Laws, failed to ensure that Communities would
spend the necessary resources on these areas. Add to this the economic deceleration and subsequent recession in 2009 and the result is a perfect storm where Communities revenues plummeted as their needs soared. This is related to a fundamental structural problem, which is a certain deficit of fiscal responsibility shown by Autonomous Communities that have generally been reluctant to use their taxing powers to raise revenue, and so have decided to rely on Government transfers or Public Debt instead, therefore avoiding the political cost of increasing the tax pressure. This is an old debate in Spain. In a book published in 1988 Antoni Castells already argued for a higher level of fiscal responsibility that would be coherent with the devolution of authority. In 1997 and 2001 a system of ‘shared taxes’ was implemented. But most Communities did in fact use their newly enlarged taxing powers to establish tax deductions and thus lower the tax pressure in their territories. This is a problem for debt and deficit because when subnational governments receive financing almost exclusively in the form of transfers, an incentive to overspend those moneys is created.

Furthermore, until 2011, the financing system of the Autonomous Communities did not sufficiently take into account the EU Stability Pact constraints. Therefore, although as pointed out earlier in this paper, Spain had indeed adopted an ‘internal stability pact’, the sanctions were not credible enough and Communities were in practice able to run large deficits while reducing the tax pressure for their citizens. It seems as if the financing of Communities was designed (still) without fully taking into account the European context.

The current article 135 of the Constitution may serve to change that. If a crisis can be viewed as an opportunity, the current one may bring about two theoretically opposite results: a larger decentralization of revenues, in the form of greater fiscal responsibility and a re-centralization of services, as a result of severe spending cuts by Autonomous Communities.

The new legal framework has also substantially altered the budgetary process. The first batch of stability laws in Spain (2001) had already brought about substantial changes in all aspects of the Budget. In particular, it had transformed the budget procedure as defined in article 134 of the Constitution. According to this article, the old process was purely domestic, starting (first phase) with the Government preparing a Budget project, which would then be examined by the Parliament, executed by the Government and, finally, controlled by the internal organs of the Government (IGAE) and, eventually, the Court of Auditors (dependent from Parliament).
After the reforms, there is a phase ‘zero’, whereby the Government presents the ‘stability objective’ or indicators of deficit and spending, which have been previously been examined by the Commission and must be approved by Parliament. This objective is then the basis for the elaboration of the budget project.

A blunt conclusion is that there is no longer a budget controlled by Parliament and the Government alone. The current semi-bail out, or ‘bail-out pending’ situation, together with the Excessive Deficit Procedure already in place, implies a total supervision of the different phases of the budget outside the Parliament (or the Government).

Furthermore, the whole process depends on projections of economic output, which are notorious for being often volatile and thus difficult to trust. Already after the implementation of the above mentioned austerity measures, predictions are grimmer than the official figures that serve to prepare the 2012 and 2013 budget projects. On July 10th 2012, the Council of the European Union gave Spain an extra year to meet the deficit targets, so that these are now 6.3 for 2012, 4.5 of GDP for 2013 and 2.8 of GDP for 2014. In the same document, it is revealed that the 2009 recommendations assumed growth rates that have then not occurred (a growth rate of 1 per cent had been initially assumed for 2012 and 2013, compared with the current -1.9 and -0.3 rates currently estimated).

The weak link of the system, both the Spanish internal stability system and the EU rules (Fiscal Compact/Six Pack system), is that it is largely based on measuring economic output and the attached variables. As the changing data demonstrates, the economic environment cannot be as predictable as the Rule of Law needs it to be. Designing a macro legal framework that may trigger such harsh consequences (requiring austerity measures, or imposing sanctions, and that is fundamentally based on contingent data, which increasingly also depends on volatile markets, is a dangerous situation and should be the subject of a deeper debate. Just like the military drones, the budget rules are in peril of becoming a kind of ‘Armed Unmanned Budgetary Vehicles’, well designed but whose consequences are as hard as ever to control or predict, going much beyond what Rawls may have anticipated in his famous ‘veil of ignorance’ analogy.

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