

Spanish Constitutional Reform

What is seen and not seen

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On September 7th, five weeks after the European Central Bank (ECB) started buying Spanish bonds as part of its Securities Market Programme, and four weeks since Merkel and Sarkozy announced their proposal of writing debt limits into national laws, the Spanish Parliament has approved a constitutional reform that, by constraining the general government's spending and borrowing capacity, aims to mitigate concerns over public finances. This reform, the second since the current Constitution was enacted by referendum in 1978, has been made possible by an agreement between the ruling socialists (PSOE) and the main opposition party (conservative PP).

Undoubtedly, any effort aimed at introducing mechanisms that help limit the arbitrary nature of fiscal policy should be welcomed. At the same time, it is encouraging that Spain's two major parties (accounting for 92% of the seats in the Parliament's lower house) have reached such an historical agreement in such a short period of

time. Political unity will be a precondition for successfully tackling the challenges the Spanish economy currently faces.

The constitutional reform consists of two parts, each with different beneficiaries and effects over time. First, a debt limit has been introduced in the Constitution. Second, interest and principal payments have been given *explicit* priority over any other expenditure. In the former case, the beneficiaries are the Spanish citizens, who are now better protected against the whims and caprices of the ruling parties. In the latter case, beneficiaries are the creditors who, knowing that their claims will be the first to be paid out of the public coffers, will demand lower risk premiums on their loans to the Spanish state. In addition, the phasing of each of the two measures is different: While the first one will not come into effect until 2020, the second measure should have an immediate impact.

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Reform of the Spanish Constitution

*Old Article 135**

1. *The Government must be authorised by law in order to issue Public Debt bonds or to contract loans.*
2. *Loans to meet payment on the interest and capital of the State's Public Debt shall always be deemed to be included in budget expenditure and may not be subject to amendment or modification as long as they conform to the terms of issue.*

*New Article 135**

1. *All public administrations will conform to the principle of budgetary stability.*
2. *The State and the autonomous communities may not incur a structural deficit that exceeds the limits established by the European Union for their member states.*
An Organic Law shall determine the maximum structural deficit the state and the autonomous communities may have, in relation to its gross domestic product. Local authorities must submit a balanced budget.
3. *The State and the regions must be authorised by law in order to issue Public Debt bonds or to contract loans.*
Loans to meet payment on the interest and capital of the State's Public Debt shall always be deemed to be included in budget expenditure and their payment shall have absolute priority. These appropriations may not be subject to amendment or modification as long as they conform to the terms of issue.
The volume of public debt of all the public administrations in relation to the State's gross domestic product may not exceed the benchmark established by the Treaty on the Functioning of the European Union.
4. *The limits of the structural deficit and public debt volume may be exceeded only in case of natural disasters, economic recession or extraordinary emergency situations that are either beyond the control of the State or significantly impair the financial situation or the economic or social sustainability of the State, as appreciated by an absolute majority of the members of the Congress of Deputies.*
5. *An Organic Law shall develop the principles referred to in this article, as well as participation in the respective procedures of the organs of institutional coordination between government fiscal policy and financial support. In any case, the Organic Law shall address:*
 - a. *The distribution of the limits of deficit and debt among the different public administrations, the exceptional circumstances to overcome them and the manner and time in which to correct the deviations on each other.*
 - b. *The methodology and procedure for calculating the structural deficit.*
 - c. *The responsibility of each public administration in case of breach of budgetary stability objectives.*
6. *The autonomous communities in accordance with their respective laws and within the limits referred to in this article shall take the appropriate procedures for effective implementation of the principle of stability in their rules and budgetary decisions.*

New Additional Provisions (NAPs)

1. *The Organic Law, as provided for in Article 135 of the Spanish Constitution, must be approved before June 30, 2012.*
2. *Such law shall provide mechanisms for compliance with the debt limit referred to in Article 135.3.*
3. *Structural deficit limits set forth in Article 135.2 of the Spanish Constitution shall come into force in 2020.*

* While the *old* article's translation is official, the translation of the *new* one is ours, based on the text approved by the Senate (higher house) on 7 September 2011.

Debt limit

The debt limit is twofold. First of all, the Spanish Constitution's new amendment imposes a *direct* limit on the absolute level of the general government's debt (Art. 135.3.3^o). Such a limit will be determined by the "reference value established by the Treaty on the Functioning of the European Union" - currently at 60% of GDP. *Indirectly*, debt dynamics will also be constrained by a limit on the general government's structural budget deficit (Art. 135.2). While the details of the Organic Law

needed to develop this constitutional provision (to be passed before the end of June 2012) still have to be worked out, socialists and conservatives have already agreed on a maximum structural deficit of 0.4% of GDP. In any case, deficits will also be tied to the "margins established by the European Union" - currently at 3% of GDP for the non-cyclically-adjusted balance.¹

¹ EU limits on both debt and non-structural deficits are established in Art. 126 of the Treaty on the Functioning of

The rules are given some flexibility by introducing a number of circumstances in which the limits may be breached (Art. 135.4): i) natural disasters, ii) economic recession and iii) situations that “significantly impair” financial stability or the “economic or social sustainability of the State”. In our view:

- This opt-out clause should have been excluded from the reform since it is broad enough so as to erode the rules’ credibility. Also, despite the fact that Art. 135.4 requires support from an “absolute majority of the members of the Congress of Deputies”, we think this is just a mere formality; at the end of the day, any Government will always have, *de facto*, the support of an absolute majority of the Congress.²
- The first circumstance (“*natural disasters*”) is redundant. Art. 116 of the Constitution on the ‘states of emergency’ already grants the Government the power to temporarily restrict (and even suspend³) individual liberties and fundamental rights in exceptional cases such as, for example, natural disasters.⁴ Therefore, an *argumentum a fortiori* holds since “he who can do more, can do less”.
- The reference to “economic recession” as an exceptional circumstance should, at the minimum, be removed. Since the limit set by Art. 135.2 is on the ‘structural’ (rather than on

the non-cyclically-adjusted) budget deficit, then this value already embeds an adjustment for any potential cyclical deviations. In other words, a recession should be no excuse for increasing structural spending. Note that, otherwise, the Constitution would be explicitly allowing the Government to repeat in the future exactly the kind of behaviour that this reform aimed at preventing in the first place!

- Structural budget balances are, by their nature, fraught with uncertainty since they are not observable and have to be estimated. Consequentially, unless a consistent methodology is specified for the estimation (and conducted by an independent entity such as Eurostat), governments will have the incentive during cyclical booms to ‘cheat’ with the adjustment and make extra spending appear the least structural as possible.
- Finally, the last circumstance (“*extraordinary emergency situations that are either beyond the control of the State or significantly impair the financial situation or the economic or social sustainability of the State*”) is, admittedly, a black-box in which almost anything can fit. In our opinion, the Organic Law should narrow this circumstance’s meaning down to ‘financial instability’, while clearly defining the conditions (and procedures) for public interventions in the financial sector. Ideally, this should be done in parallel with the development of alternative ways (e.g. bank resolution regimes⁵) to cope with the orderly restructuring of banks in case of crises.

At the same time, one of the greatest achievements of the reform has been to extend both the debt and deficit limits to the regions (Art. 135.6) as well as to impose a balanced budget on the local authorities (Art. 135.2.2). That said, we think the limits should have also been extended to all public corporations. In other words, limits should apply to the ‘public sector’ as a whole and not just to the ‘general government’.⁶ In the absence of transparent and

the European Union (TFEU) and in Art. 1 of the Treaty’s Protocol No. 12.

² Generally, either a Government has an absolute majority *de jure* (i.e. the ruling party’s MPs account for, at least, 50% + 1 of the seats in the Congress) or has to ‘trade’ for support with other minor regional parties. A minority Government that, on a regular basis, was unable to reach agreements with other parties would be likely forced to call early elections.

³ According to Art. 55.1 of the Constitution, “*The rights enshrined in Articles 17, 18, paragraphs 2 and 3; Articles 19, 20, paragraphs 1, a) and d), and 5, Articles 21 and 28, paragraph 2, and Article 37, paragraph 2, may be suspended when the states of emergency or siege are declared under the terms established in the Constitution. Paragraph 3 of Article 17 is exempted from the foregoing in the event of declaration of state of emergency.*”

⁴ According to Art. 4.a) of the Organic Law 4/1981, ‘natural disasters’ (“*Catastrofes, public calamities or disasters such as earthquakes, floods, forest fires or urban large-scale accidents*”) is one of the circumstances that would justify the declaration of the ‘state of alarm’ by the government.

⁵ See, e.g. Alexander et al. (2009).

⁶ According to the standard methodology used for government finance statistics, while the ‘general government’ (the usual measure against which consolidation targets are set and fiscal performance is evaluated) involves all levels of government (state, social

effective limits on the general government's capacity to increase its off-balance sheet activities, this reform might well lead to an uncontrolled rise in contingent liabilities.

Overall, while certainly positive from an institutional perspective, the fact that none of the two limits will be binding before 2020 (NAP no. 3) makes this part of the reform relatively innocuous. It is, therefore, surprising that the spotlight is on this part of the constitutional reform rather on the "absolute priority" given to public debt service.

Absolute priority to debt service

In our view, the inclusion of an *explicit* reference to the "absolute priority" of debt service payments (Art. 135.3.2^o) represents the most interesting change coming out of the recent reform. By *de facto* eliminating the possibility of a default by any of the public administrations, it is – we think – the part of the reform with the biggest potential to both mitigate investors' concerns over the Spanish government's ability to service its debt and also to minimise contagion effects. Fiscal problems would become sovereign political problems and not threats to the stability of the monetary union (Cooley & Marimón, 2011). We believe that explaining and publicising this measure, with the same emphasis with which the fiscal rules have been announced, would result in investors lowering their expectations of default risk. We think prioritising debt service payments (and doing so in a credible way) has the potential to stabilise government bond yields at current levels and relieve the ECB of the need to intervene in secondary markets through its Securities Market Programme. A lower cost of capital for the State should result in better financing conditions for the private sector as well.

In fairness, it should be said that the old Art. 135.2 (new Art. 135.3.1^o and 2^o) of the Spanish Constitution already gave, *implicitly*, absolute priority to debt service over other expenditures. According to its standard interpretation (see Jiménez Díaz, 2003), this article established the presumption that the funds required to meet

security, regions and local authorities), it excludes public corporations. The 'public sector' measure would fill this gap by adding public corporations' balance sheets to the general government's balance sheets (see IMF, 2001).

public debt's interest and principal payments would always be included in the State's budget. Furthermore, the article also contained an absolute prohibition on the modification or amendment of the appropriations needed to meet these payments, provided they complied with the terms of issue.

That said, the old Art. 135.2 had – in our view – two major flaws: First of all, the "absolute priority" *could* be inferred from the text but was not explicitly stated in it;⁷ and second, the mechanisms for making such "absolute priority" credible were lacking. While the current reform has solved the former, we urge policy-makers to address the latter. The Organic Law that, according to Art. 135.5, will regulate the details of the reform, could also be used to incorporate enforcement mechanisms into the institutional framework. In our view, making credible the "absolute priority" given to debt service requires two conditions:

- *Ex ante*, the obligation to include contingency plans in the budget of each year. Each administration should take into account (as well as publicly report) the measures to be taken, in case deviations of macroeconomic variables from the assumptions under which the budget was built undermine that administration's ability (or willingness) to repay its debt.
- *Ex post*, in the case that the (central, regional or local) government does not follow its contingency plan, it would be necessary to devise an extremely brief procedure that allowed a minority of the Congress (regional parliament or local council) to enforce its implementation.

Mitigating tail-risks

As we have tried to highlight, we do think Spain's recent constitutional reform (specially the part on which neither politicians nor the media are putting the spotlight) has the potential to stop the bleeding observed in funding markets. However, we cannot stress enough the importance of designing and implementing

⁷ The fact that, to our knowledge, there has been no judgement from the Constitutional Court on this article's implications, creates some uncertainty with regard to how fiscal authorities would actually interpret it.

enforcement mechanisms that make the reform credible. In the absence of such mechanisms, not only Spain might be losing a unique opportunity for fundamental reform, but it might also be running the risk of further undermining the credibility of its institutions. Moreover, we think the recent reform could help address two of the major tail-risks investors are concerned with.

1. The 'Irish scenario'

Despite the proven resiliency of Spanish banks throughout the crisis,⁸ concerns over their potential losses and capital needs still linger. On the back of such concerns, some commentators have even suggested the possibility that Spain might suffer the same destiny as Ireland where the government has been forced to assume the liabilities of the banking system. We do think such claims are exaggerated⁹ and believe the

⁸ According to De Nederlandsche Bank (2011), government support (i.e. capital injections as well as asset relief and debt guarantee measures) to financial institutions in Spain were – by far – the lowest out of a sample of nine countries, including the Netherlands, Belgium, Germany, France, Ireland, Spain, the UK, the US and Switzerland. Data were as of 1 August 2010.

⁹ Explaining why – we think – the Spanish banking system is, fundamentally, far more robust than the Irish one, would exceed the purpose of the present note. It should nevertheless suffice to enumerate five key differences between the two:

- (i) *Size*. While bank assets of Irish banks accounted for 800% of GDP at the end of 2009, Spanish banks' assets accounted for just around 300% of GDP, in line with other euro area countries like Germany or France.
- (ii) *Concentration*. In Ireland, problems were concentrated in just a few banks (i.e. in the six main Irish banks whose liabilities were fully guaranteed by the Irish State in 2008). In contrast, the problem of the Spanish banking sector is one of over-capacity – troubled assets are much more widely spread out.
- (iii) *Clean-up*. Apart from the counter-cyclical provisions built-up during the years prior to the crisis, Spanish banks have undergone a process of catch-up provisioning since its start (for details, see Roldán, 2011). Since early 2008, Spanish banks have increased provisions by €100 billion and equity by €50 billion, and it is expected that these figures will also rise to €70 billion and €20 billion, respectively, over the course of 2011-12 (Recarte, 2011). At the end of 2012, total clean-up would amount to around €250 billion or 25% of the Spanish GDP.
- (iv) *Regulations* by the Banco de España are, in general, stricter than those of other European regulators. In

recent constitutional reform – if credibly implemented – should help mitigate such concerns.

Art. 135.4 of the Constitution includes 'financial stability' ("*extraordinary emergency situations which (...) significantly impair the financial situation*") as one of the exceptions in which the government is allowed to deviate from the debt limit imposed by Art. 135.3.3°. That is, should the Spanish government judge that a bank (or a group of banks) poses a threat to the country's financial stability, the Constitution would grant it permission to raise debt levels beyond the limit in order to finance a particular government support programme. The question is, therefore, whether the Constitution provides any guidance with regard to the maximum extent of any such intervention. We think it does. According to Art. 135.3.2° (absolute priority to debt service payments), the government may default on its debt only after it has already foregone other spending commitments (pensions, public servants' wage bill, education, healthcare, etc.). If credible – for which the adequate enforcement mechanisms are still lacking – this article should create the incentives for fiscal authorities to devise, as we suggested above, alternative ways (such as bank resolution regimes) to cope with the orderly restructuring of banks in case of crises.

The 'hard limit' set by debt service's absolute priority should be the key *rule* constraining any time-inconsistency in fiscal policy. The Spanish government might raise as much debt as it wished to, provided it i) complied with the enforcement mechanisms in place, and ii) was willing to internalise voters' attitudes towards

fact, even though the same terms are normally used to make cross-country comparisons, they actually refer to different concepts (reflecting cross-country differences in financial regulation). In short, for the same core tier 1 capital ratio, a Spanish bank will generally be better capitalised than a non-Spanish bank.

- (v) *House prices*. Growth in house prices in Spain evidenced a lower over-valuation component than in other countries. According to the IMF (2008), while the percentage increase that is not attributable to fundamentals was over 32% in Ireland, it was just around 17% in Spain (in line with other countries such as Sweden and Belgium).

spending cuts going forward.¹⁰ In this sense, we believe Art. 135.3.2^o will prove more effective in setting the right incentives than relying on how policy-makers *decide to* interpret the exceptions included in Art. 135.4 of the Constitution. Identifying such exceptions is a difficult task even for trained economists, so leaving the judgement to politicians would introduce even more arbitrariness and special interests into the process. We should not forget that PM Zapatero and his cabinet explicitly denied the existence of the crisis itself until July 2008... and even labelled those MPs, businessmen and economists urging them to take measures and reforms as “anti-patriots”!

2. The ‘Hungarian risk’

Some may argue that, even with adequate enforcement mechanisms in place, the constitutional reform would not exclude the risk that the government could decide – as we have recently seen in Hungary – to nationalise all private pension assets in order to pay down the debt while giving people pay-as-you-go promises instead. In our view, however, it would precisely be the presence of “adequate enforcement mechanisms” – like the ones outlined above – that would rule such a risk out.

First and foremost, given the prominent role played by pension funds in financial markets, dismantling the private pension system would adversely affect liquidity in both bond and equity markets. Lower demand for public bonds at a time of higher funding needs would necessarily result in much higher (likely unaffordable) interest rates. As a result, Art. 135.3.2^o of the Constitution (debt service priority) would force every level of the general government to implement cuts in order to meet debt service payments. The mere thought of having to explain to voters why the expropriation of their savings also led to a higher cost of capital that is forcing them to cut a number of social expenditures should discourage fiscal authorities from taking such a measure in the first place. Furthermore,

¹⁰ At the end of the day, it is unlikely that politicians will acknowledge to their voters that today’s spending cuts are the result of yesterday’s irresponsible spending decisions. That said, it is not very difficult to think of government officials blaming the previous administrations!

given that the pay-as-you-go promises would have a lower level of security than the general government debt, people should prefer government bonds held in pension schemes to government pension promises and therefore would feel defrauded in case the nationalisation did actually happen.¹¹

Second, even if the higher fiscal revenues derived from such nationalisation temporarily offset the deterioration of access to wholesale funding markets, two consequences would be unavoidable: Firstly, the additional *cyclical* revenues would encourage increased spending and deteriorate the general government’s structural deficit, undermining the credibility of the limit set by Art. 135.2 of the Constitution;¹² and secondly, the cost of capital to the private sector – via equity and private bond markets – would remain unaffordable.

Overall, given the relatively low level of general government debt in Spain (63.6% of GDP as of the 1st quarter of 2011¹³), it is not at all clear that the benefits of a lower *stock* of debt would outweigh the negative impact of this measure on the State’s fiscal position (*flow*), and on its cost of capital in particular, through any of – or all – the channels we have just discussed. The most likely result would be a multi-notch downgrade of the Spanish Government’s credit rating.¹⁴

Conclusion

Finally, note that, although with the potential to stop the bleeding, even the credible implementation of these measures would not be

¹¹ In Hungary, assets of equal value and priority were swapped with the only loser being the next generation being saddled with opaque debt.

¹² To avoid this, fiscal authorities in Brussels and Madrid should put as much emphasis on structural targets as they seem to be putting on non-structural ones. An example of what should have been avoided is the rescheduling of corporate tax payments recently announced by the Spanish government. *Ceteris paribus*, this one-off measure will increase this year’s revenues by an amount equal to how much they will decrease in the next one. It might help meet this year’s target (a non-cyclically-adjusted general government deficit of 6% of GDP), but *at the cost of* forcing the government coming out of the November general elections to implement an even tougher consolidation programme in 2012.

¹³ Data from the Banco de España.

¹⁴ For Hungary’s case, see Hornung et al. (2011).

sufficient to reactivate the patient's vital signs. It is imperative that the constitutional reform, which undoubtedly represents in itself a major step forward and sends a very positive signal to the outside, is integrated within a more ambitious programme of structural reforms, with special emphasis on areas such as the labour market and the tax system. The ultimate goal should be to reduce the rigidities inherent in the Spanish economy, improve the country's competitiveness and mitigate the legal and institutional uncertainty that currently surrounds Spain.

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