



Independent Authority
for Fiscal Responsibility

Report

19th July 2016

Report on compliance with the Budget Stability and debt targets and with the expenditure rule 2016 by the different public administrations

The mission of AIReF, the Independent Authority for Fiscal Responsibility, is to ensure strict compliance with the principles of budgetary stability and financial sustainability contained in article 135 of the Spanish Constitution.

AIReF:

José Abascal, 2, 2nd floor. 28003 Madrid. Tel. +34 910 100 599

E-mail: Info@airef.es

Website: www.airef.es

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Executive summary

The objective of this report is to assess the likelihood of compliance in 2016 with the budget stability and debt targets and with the expenditure rule by the different public administrations. This assessment, which AIReF has to issue in July of each year, as mandated by its Organic Law, has been prepared in a particularly uncertain environment, given the provisional character of the fiscal objectives, the political circumstances of the moment, and the measures announced by the interim government in response to the European Council Decision of 12 July, stating that Spain has not taken effective action, in response to the ECOFIN Recommendation of 21 June 2013, to correct the excessive deficit in 2015.

In this report, AIReF notes that the current situation and outlook of public finances in Spain have experienced a sustained worsening since the assessment delivered last April when reporting on the Updated Stability Programme (USP) of the Kingdom of Spain 2016-2019. As a result, AIReF considers at present *unlikely* that the budget deficit of the general government in 2016 attains the objective of 3.6% of GDP proposed in the USP.

Last April, AIReF assessed this proposed target to be feasible, though demanding. This assessment was based on several considerations. First, the projected figure for the budget deficit was slightly below 4% of GDP in the central scenario of AIReF, a scenario characterized by a rate of real output growth close to 3% and some acceleration of prices leading to an average inflation rate of 1% in 2016. Second, it was assumed, in addition, that the temporary measures regulating pre-payments of the corporate income tax which were in place last year would be kept in 2016. Third, AIReF

estimated that, even if difficult, there was, in principle, room in the State and, to a lower extent, in the Regional Governments budgets, for an effective implementation in the course of 2016 of the expenditure retrenchment measures which were announced in the USP and amounted to four tenths of a percent of GDP.

Nevertheless, the information gathered and analyzed since then entails a further divergence of AIReF central projection figure for the general government budget deficit from the proposed target of 3.6% of GDP, as well as a higher likelihood that more pessimistic scenarios materialize. Accordingly, AIReF has revised upwards its central projection for the general government deficit ratio 4.1% of GDP, due to several concurring factors:

- ✓ There is no acceleration of prices. The expected inflation rate in 2016 is now one percentage point below the figure projected three months ago. This developments are affecting negatively tax revenue, despite the dynamism of real output, which follows the expected path.
- ✓ The tax reform is having a higher than initially estimated impact on corporate income tax and, to a lesser extent, on personal income tax revenue, as shown by the data on tax collection and effective tax rates published up to May 2016. The measures announced by the government on 13 July would go in the contrary direction, and concretely the pre-payment of the corporate tax on the recorded accounting profits at a rate that, according to the information facilitated by the government, could be raised to at least 20%.
- ✓ A uniform deficit target has been set for all Regional Governments, a target that lacks in ambition for the subsector as a whole. The implementation of the budgets adopted by several Regional Governments would have allowed them to reach a budget deficit below 0.7% of GDP, without expenditure cuts. However, the setting of the same target for all Regional Governments (0.7% of GDP) by

the Ministry of Finance and Public Administration (MINHAP) has led them to foresee the full use of the room to spend made possible by this target, while the expenditure rule is not playing its limitative role. The loose interpretation by MINHAP of the proper implementation of the expenditure rule has contributed to its ineffectiveness by eliminating for many Regional Governments the potentially tighter constraint on spending imposed by the expenditure rule than by the deficit target.

- ✓ Non-availability agreements (AND) of approved budget appropriations have not been implemented by some Regional Governments. The information facilitated by Regional governments reveals that AND by the amount required to adjust the deficit as announced have not been adopted. In this respect, MINAHP has approved the adjustment plans of the Regional Governments joining in the Regional Liquidity Fund for 2016 (FLA 2016), without demanding from them the adoption of AND as one of the announced requirements entailed by their lack of compliance with their respective adjustment plans in 2015.
- ✓ The surplus recorded in past years by Local Governments is likely to decline in 2016. A trend of past surpluses to dwindle has been detected by AIReF in the data from 16 municipalities that are capital of provinces with more than 250000 residents. Determinants of this trend are the end of the period of increased rates in the real estate tax, the loose interpretation of the expenditure rule by MINHAP, and the lenient implementation of corrective measures by the overseeing entities of municipalities (either MINHAP or Regional Governments).

In addition to the net negative impact of these factors on the general government deficit, a further deterioration of the budget balance amounting to around six tenths of a percent of GDP can emerge, which would bring the deficit ratio up to 4.7% in 2016, depending on the precise way in which the Central Government finally implements certain measures. From a quantitative

point of view, the highest risk for the deficit comes from not implementing in 2016 the measures increasing the pre-payments of the corporate income tax. The actual effect of implementing the AND approved by the Central Government in April is relevant as well. The uncertainty on the effectiveness of this AND stems from the fact that it has not been fully specified up to now (around 80% still pending), and from lack of identification of the concrete budget lines affected, although MINHAP announced that almost half of the 2 billion euros involved will correspond to items in chapter VIII of the budget which impinge on the deficit. The non-availability of budget appropriations in this chapter, which mainly refer to capital transfers to enterprises and public entities, will reduce the general government deficit only in case the affected enterprises and entities are classified within the perimeter of the government sector in national accounts and effectively reduce their spending. Nevertheless, the decision to bring forward to July 2016 the deadline to commit expenditure approved in the budget for this year could also exercise a restraining effect on spending, whose amount has not been estimated.

Beyond the uncertainty about the impact on the deficit of all the elements mentioned above, and irrespective of the implications of the final figure for compliance with the commitments of Spain under the Excessive Deficit Procedure to which it is subject, there is a further cause for concern when looking forward to the medium term from the perspective of the sustainability of Spanish public finances. This concern for AIReF comes from the increasing leniency with which the new framework of fiscal discipline set up in the constitutional reform of 2011, the Organic Law of Budget Stability and Financial Sustainability of 2012, and later laws and regulations is being implemented. In view of these developments, AIReF urges the different public administrations to apply rigorously and with a medium-term perspective the existing rules of fiscal discipline, and to enhance accountability in the Central Government, the subsector where the main origin of lack of compliance with the targets is. With this aim, the present report includes, among other, the following recommendations:

1. To put in place a monthly control by MINHAP of the implementation of retrenchment measures adopted and their impact on the proposed budget stability target in order to detect eventual slippages well ahead of the end of the year. Monitoring should also be applied to tax collection so as to provide updated estimates of the tax reform impact on revenue from corporate and personal income taxes. This monitoring should be given as much transparency as possible, and reports should be sent to Parliament and to AIReF.
2. To adopt the necessary decisions to guarantee the financial balance of the Social Security System in the framework of the Pacto de Toledo Commission.
3. To monitor effectively by MINHAP the measures adopted by Regional Governments, demanding compliance with the strengthened conditionality compulsory under the rules of access to the FLA 2016
4. To revise in depth by the Regional Governments of Murcia, Valencia, Extremadura, Aragón, Catalonia and Castille-La Mancha, the Economic and Financial Plans they have presented, setting up jointly with MINHAP a feasible path for fiscal consolidation.
5. To establish and monitor by MINHAP a common framework for the exercise of the competencies on budget stability and the expenditure rule that are attributed to the overseeing entities of municipalities, so that the differences on interpretation and compliance that now seem to exist are eliminated