Autoridad Independiente de Responsabilidad Fiscal

**Opinion**

30 July 2014

# Compliance with Deficit and Debt Targets

## Executive Summary




The Independent Authority for Fiscal Responsibility (AIReF) has been created with the mission of ensuring full compliance with the principles of budgetary stability and sustainability enshrined in Article 135 of the Spanish Constitution.

**AIReF Contact Details**:

C/José Abascal, 2, 2º planta. 28003 Madrid. Phone +34 917 017 990

E-mail: Info@airef.es.

Website: www.airef.es



This document may be used and reproduced, whether in full or in part, provided that the original source of the document is stated (AIReF).

The purpose of the Independent Authority for Fiscal Responsibility is to ensure effective compliance by the General Government with the budgetary stability and sustainability principles enshrined in Article 135 of the Spanish Constitution. This Article was implemented by virtue of the Organic Law on Budgetary Stability and Financial Sustainability (hereinafter referred to as LOEPySF), through a continuous monitoring of the budgetary cycle and public indebtedness and the analysis of economic forecasts.

This opinion herein is issued in accordance with the provisions set forth in articles 5 and 23 of OL 6/2013 on the establishment of the Independent Authority for Fiscal Responsibility (AIReF) by virtue of which this Institution is authorised to issue opinions as a means to guaranteeing sustainability of public finances in the long run.

First of all, it should be taken into consideration that there are two regulatory frameworks governing the scope of financial sustainability and budgetary stability –i.e. Community/National frameworks– which are concurrent but not mutually exclusive. An effective implementation of both regulatory frameworks must be ensured in all cases. For this purpose, both frameworks should be integrated, guaranteeing full compliance with the substantive aspects thereof. In particular, it is important to preserve those elements from the national framework that have proven to be more demanding than European regulations as for certain aspects related to compliance and monitoring of budgetary stability and financial sustainability targets.

In this context, a thorough examination has been performed on the document “Report on the degree of compliance with budgetary stability/public debt targets and the debt-ceiling rule for financial year 2013” (hereinafter referred to as ICOEP) in line with the national regulatory framework[1], dated 11 April 2014, which was prepared by the Ministry of Finance and General Government (MINHAP) and addressed to the Central Government, all of that pursuant to the provisions set forth in Article 17(3) of the LOEPySF, as well as on the report "Update of

1 As defined in the LOEPySF

the 2014-2017 Stability Programme of the Kingdom of Spain" (hereinafter referred to as SP), in line with the European regulations[2].

As a result of this analysis, the AIReF has drawn the following conclusions:

**1.-There are risks of non-compliance with the public debt threshold established for 2020.**

Sustainability of public finances requires maximum credibility regarding the reduction in public debt ratios. Therefore, the target path of such ratio shall allow to perform a predictable reduction thereof up to the 60% limit foreseen in Article 13 of the LOESPySF.

The Public Debt/GDP ratio calculated in accordance with the Protocol on the Excessive Deficit Procedure (PEDP) reached 96.8% in the first quarter of 2014, following a period of strong growth from the minimum value of 35.5%, recorded during the early part of 2008.

In the analysis of the causes of such an increase in debt, there are some circumstances related to the financial crisis in the euro area that should be taken into consideration, a crisis that has especially affected the Spanish economy. The primary consequences of the financial crisis in the Spanish economy were the lack of liquidity and a high risk premium, which had a direct impact on public debt. Financial support was required to ensure stability of the banking system and to provide liquidity to territorial administrations so as to regularise payments to suppliers. All those circumstances had not been foreseen at the time when the LOEPySF was drafted. In fact, the 2012-2015 SP submitted after the above mentioned organic law was passed, foresaw a maximum public debt ratio of 82.3% in 2013. However, the estimated value of the debt ratio was 93.9% at the end of 2013. Such a remarkable increase is entirely due to the funding provided to the financial system, the Autonomous Communities

[2] The provisions set forth in the SP are established pursuant to Article 126 of the Treaty on the Functioning of the European Union and Council Regulation 1466/1997 on the strengthening of the surveillance of budgetary positions and coordination of economic policies

(CCAA) and Local Corporations (CCLL) –in connection with extraordinary financing mechanisms for payment to suppliers–, the European Financial Stability Fund and the European Financial Stability Facility.

Transitional provision one of the above mentioned LOEPySF sets up a transitional period until 2020 to meet this 60% limit, as well as some other requirements to be complied with each year for such purpose. The SP forecasts a non-compliance with the requirement demanding reduction of the public debt ratio in 2016[3], whereas it is expected to achieve a GDP/Public Debt ratio of 98.5% in 2017.

Therefore, the AIReF considers that there is a very high risk of non-compliance with the 60% debt ratio limit in 2020. Bringing this ratio down in more than 38 percentage points from the current level not only entails an unprecedented fiscal effort but it would also have massive effects on the economy[4].

***The AIReF holds that it is not realistic to expect a reduction of more than 30 percentage points in public debt ratio from the current level until 2020 and therefore, it is recommended to apply the appropriate legal frameworks in order to extend the transitional period for compliance with the limit foreseen in Article 13 of the LOEPySF, adapting the requirements set up in transitional provision one of the aforesaid act and devising a reference scenario that is both credible and demanding, in order to achieve a sustained reduction in public debt ratio that allows the General Government to secure financial sustainability.***

**2.- The assessment of non-compliance with the appropriate public debt targets by the relevant Autonomous Communities must be performed comparing the initially set target and the actual data observed.**

[3] As showed in Table 4.5.2. of the SP, the requirement established in Transitional Provision One of the above referred LOEPySF, which demands reduction of the public debt ratio (of at least 2 percentage points of the Gross Domestic Product) when the domestic economy reaches a real level of growth of, at least, 2% per year or if it manages to create employment with a growth rate of at least 2% per year, will not be fulfilled in 2016, since a real GDP growth rate of 2.3% is expected and the reduction of public debt only accounts for 0.2% that year.

4 In Working Paper No. 1 prepared by the AIReF, some illustrative cases have been included on the evolution of public indebtedness in the medium run.

From the analysis conducted on the ICOEP and the SP several conclusions have been drawn that should lead to certain amendments allowing for an effective appraisal of the risks of non-compliance with the deficit, public indebtedness and expenditure-ceiling targets.

In particular, the ICOEP refers to a resolution of the Council of Ministers dated 12 July 2013 which establishes the budgetary stability and public debt targets for the various levels of the General Government and subsectors thereof. However, after that, it is stated that *“For the purpose of compliance with these targets, it is possible to take into consideration those circumstances that may affect debt limits, while not impairing either compliance with deficit targets or the expenditure-ceiling rule and provided that neither of them arise from discretionary decisions taken by the Autonomous Communities, with the approval of the Ministry of Finance and Public Administrations”.* By virtue of the aforesaid resolution agreed by the Council of Ministers, the ICOEP outlines a number of adjustments to the debt target, so that the aggregated GDP/EDP Ratio for the Autonomous Communities in 2013, calculated for the purpose of verifying the public debt targets reaches 20.5 (compared to the initially set objective of 19.1%).

The AIReF believes that the establishment of the public debt target for each of the subsectors integrating the General Government should not be subject to criteria other than those set forth in the LOEPySPF, which refers to the EDP for target measuring purposes. In this way, the public debt target set for the Kingdom of Spain is consistently applied at national level and at the different disaggregated levels of government. Consequently, the circumstances referred to in the appropriate resolution of the Council of Ministers –which serve as an argument to change this target– may explain why there is a slippage from the public debt target, but shall not be regarded as an exemption from compliance therewith.

Likewise, in the above mentioned resolution, reference has been made to the fact that implementing new extraordinary financing mechanisms could lead to changes in public debt targets, provided that those funds are not used to pay debt incurred or finance public deficit from the financial year in which the funds are allocated. Should this change in debt targets happen, a decoupling from deficit and public debt targets would occur, which ignores the fact that any borrowing transactions conducted by the General Government have an impact on its financial sustainability.

On the other hand, changes on the subjective and objective definition of the entities and transactions included therein pursuant to the national accounts method –the National Statistics Institute (INE) the General State Comptroller's Office (IGAE) and the Bank of Spain have the competence to make those changes– should not interfere with the establishment and measurement of the relevant targets according to a certain schedule, the initial conditions of which should remain the same over its entire execution.

In the definition and assessment of public debt targets, there should be as little room for discretion as possible, in order to strengthen the credibility of those rules.

***The AIReF believes that the assessment of non-compliance with the public debt target must be conducted on each subsector of the General Government, based on a comparison between the public debt target set by the Government for the current year with the stock of government debt observed at the end of the year, both assessed in line with the EDP method. From the comparison of these two pieces of information and the appropriate justification of the relevant deviations, certain conclusions will be drawn that will help to assess the magnitude of the potential non-compliance with the public debt target and to map the way towards target compliance.***

**3.- Proper mechanisms should be implemented in order to perform a quarterly monitoring of the corrective measures applied by the Central Government whenever it has failed to meet any deficit or public debt targets.**

Pursuant to the statements of the ICOEP, the Central Government, six Autonomous Communities and, presumably, a number of Local Corporations have failed to meet their deficit targets in 2013 as required by the LOEPySF, although thanks to the significant effort made both by the Social Security as well as by all Local Corporations, overall non-compliance accounted only for one-tenth in the entire General Government Sector.

The Central Government takes the view that, through the preparation of the SP, it has met the appropriate corrective measures foreseen in the LOEPySF on non-compliance with the deficit target. Notwithstanding this interpretation, it seems appropriate to extend the information contained in the SP, including the details on scope and minimum contents provided for in Article 21 of the LOEPySF. It is also appropriate to prepare quarterly monitoring reports[5] with that minimum contents, and the quarterly implementation plans thereof, thus allowing the AIReF to conduct surveillance pursuant to the LOEPySF and to perform an assessment on the effectiveness of the measures adopted in order to meet the appropriate fiscal targets. It would be convenient that the Ministry of Finance and General Government submitted its monitoring reports along with the quarterly information it provides on budget implementation.

***The AIReF considers that it would be appropriate to expand the SP in line with the scope details and the minimum contents established in the LOPEySF, and to prepare quarterly monitoring reports, thus allowing the AIReF to perform an analysis on the effectiveness of the measures adopted in order to meet the relevant fiscal targets.***

[5] The European Governance Framework and the SP will only guarantee a single six-monthly check.