Report

15 October 2014

Report on the Draft budgets and Main Budgetary Lines of General Government

2015 Draft for the State Budget and Main Budgetary Lines of Regional Governments and Local Governments.

Executive Summary

The AIReF has analyzed the Draft State Budget (PGE, according to Spanish acronym) and main budgetary lines regarding Regional Governments and Local Governments from the viewpoint of their adequacy to achieve the stability and debt objectives and compliance with the expenditure rule established for 2015.

The main conclusions of this analysis are:

1. The stability objective for 2015, a General Government deficit amounting to 4.2% of GDP, is very demanding. Attaining such objective requires a strict execution of the budgets, which should lead to realize savings in those sub-sectors that apparently have leeway, in order to offset the shortfalls found in other sub-sectors. In particular, meeting the objective requires the contribution of a series of factors:

- the execution of the 2014 budget guarantees that the stability objective for this year, a General Government deficit amounting to 5.5% of GDP, is met and, therefore, provides a

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sound starting point for the implementation of budgetary plans in 2015;

- the macroeconomic scenario of cyclical recovery of the economy materializes, and its main downside risks are not realized. If so, the revenue scenario, even though it is still ambitious, may be achieved;

- the collection of social security contributions, bolstered by the new direct settlement system and the widening of bases to include compensation in kind, fulfills the expectations reflected in the Social Security Funds budget. Likewise, unemployment benefits keep its current downward trend;

- the margin for retrenchment which apparently exist in the State's budget, mainly related to interest payments, generates actual savings in budgeted expenditure. In addition, new measures to control expenditure growth should limit the upward deviations with respect to the stability objective of 2015 which the sub-sector of the Regional Governments is likely to experience.

2. On the basis of the information currently available, it is very likely that the budget outcome in 2014 estimated for Regional Governments exceeds by a wide margin the stability objective established for them, and that they reach a deficit similar to the one registered in 2013. This negative deviation must be offset by better than targeted results in the State and Local Governments sub-sectors, which seem to have some leeway. The budgetary objective for 2014 as regards Social Security Funds seems to be within reach, although not without effort, as a consequence of offsetting a significant surplus in the Public State Employment Service (SEPE according to the Spanish acronym) and a shortfall in the Social Security.

3. The main non-compliance risk with the stability objectives for 2015 is focused on the Regional Governments subsector, the deficit of which must reach 0.7% of GDP from 1% established for 2014. However, as mentioned in the previous paragraph, as a consequence of the likely non-attainment of this year's stability objective, the efforts to deliver on the budgetary consolidation foreseen for 2015 will be more demanding. Besides, unlike other sub-sectors, in 2015, Regional Governments will benefit only partially from the effects of the cyclical recovery of the economy, since most of their expenditure is not affected by the economic cycle, while their revenue is lagging the recovery, due to the structure of the regional financing system. Finally, expenditure consolidation measures foreseen for 2015 in relation to this sub-sector are currently insufficiently defined.

4. The AIReF recommends the following measures:

- Application of those mechanisms foreseen by Organic Law 2/2012, of 27 April, on Budget Stability and Financial Sustainability (LOEPySF, according to the Spanish acronym) for the early detection of possible deviations and their correction;
- Integration of the budgetary process within a medium-term horizon;
- Improvement of transparency so as to extend the scope of the analysis and to examine the annual budget within the framework of the Stability Programme and the Budgetary Plan.
- Coordination of the timeline for the presentation of the budget projects of the different levels of General Government.
- Initiation of the works aimed at reviewing the debt reduction path so that such path may be seen as a credible and demanding reference allowing General Government to guarantee financial sustainability.

- Publication of the list of entities included in the General Government sector and within each one of the sub-sectors, in accordance with the current System of National and Regional Accounts (ESA 2012).

Introduction

The AIReF, by virtue of the provisions of the LOEPSF and the Law governing its creation (Organic Law 6/2013), must publish, before the 15 of October, a report on the adequacy of the Draft State Budget and Main Budgetary Lines of the Regional Governments and Local Governments to the stability and debt objectives and to the expenditure rule. This report is aimed at complying with such provisions. The analysis and conclusions are structured in accordance with the classification by sub-sectors of the General Government in national accounts: Central Government, Social Security Funds, Regional Governments and Local Governments.

A detailed analysis is carried out for each sub-sector separately, since the information available and the limitations entailed by the existence of different budgetary structures and coverage make it impossible to offer an integrated analysis of the General Government as a whole. However, a global assessment of the General Government sector is included, as well as general recommendations in addition to the specific recommendations on each one of the sub-sectors.

The report contains, for each sub-sector, an analysis of the revenue and expenditure forecasts encompassing the expected outcome for 2014, the projections for 2015, and the national accounts adjustments and measures envisaged for both fiscal years. The report also identifies items for which there exist risks of deviation in their implementation, generating some uncertainty on the probability of attainment of the objectives set for the forthcoming year.

The information on Regional and Local Governments provided to the AIReF by the Ministry of Finance and Public Administrations (MINHAP, according to the Spanish acronym) limits the scope of the report, as the adequacy of the main budgetary lines to the stability objective can only be analysed at the aggregate level of each subsector. The documentation provided has different contents and levels of quality. As regards the Central Government and the Social Security, the AIReF was provided the PGE Draft submitted to the Parliament as well as different complementary information. In the case of the Regional Governments and the Local Governments, information refers to the Main Budgetary Lines, whose contents are not yet final as per today[1]**.** As disposed by Directive 2011/85/EU of the Council, of 8 November 2011, on the requirements for budgetary frameworks of the Member States, this information is the most updated one (art. 4.1), but it does not include the methodologies, assumptions and parameters underpinning those forecasts (art. 4.5).

This report will be supplemented by a subsequent report in which the scope for Regional Governments and Local Governments will be extended, including an analysis of the Draft Budget of each Region Government, as well as an assessment of the macroeconomic forecasts they incorporate.

[1] Resolution 5/2014: Resolución 5/2014 Información necesaria para la emisión del Informe de los proyectos y líneas fundamentales de presupuestos 2015 de las Administraciones Públicas

General Government

The 2015 stability objective established for the General Government as a whole is a deficit of 4.2% of GDP. In this moment of the budget cycle, the two key elements for assessing the likelihood of attainment of this objective are: the 2014 outcome forecast and the analysis of the draft budgets and main budgetary lines for 2015 submitted by the General Government.

According to the information currently available, it is likely that the 2014 stability objective of a deficit amounting to 5.5% of GDP is attained by the General Government sector as a whole. However, this global compliance depends on whether the likely negative deviation of the Regional Governments can be offset in the proper amount by positive deviations existing in other sub-sectors. Right now, there seems to be certain leeway in some of the other sub-sectors, but uncertainty lies in whether the amount of such leeway will be enough.

The 2015 stability objective of a deficit of 5.5% of GDP for the General Government as a whole is a very demanding one. Based on the analysis of the draft budgets and main budgetary lines, we may conclude that compliance will depend on the ability of each administration to adjust expenditure and revenue when some of the risks materialize, not only within each sub-sector, but also from the wider perspective of compliance by the General Government sector.

According to the information currently available, **it is likely that Regional Governments do not attain the stability objective established for 2014** and reach instead a deficit similar to the one registered in 2013. That is why, in the report section devoted to this sub-sector a detailed analysis of the situation in 2014 will be carried out. This analysis will not be carried out in such a degree of detail in the other sub-sectors since, as of today, no major problems of compliance with the objectives established for that year have been detected.

From the viewpoint of their adequacy to achieve the stability and debt objectives and compliance with the expenditure rule, the analysis of the draft budgets and main budgetary lines submitted by the General Government corresponds to an analysis of those "weaknesses" and "strengths" that must be monitored and controlled during their

implementation. The budget includes the foreseen revenue and the maximum expenses the General Government is allowed to incur during the fiscal year. In this regard, the report on the adequacy of the draft budgets and main budgetary lines as regards stability, debt and expenditure rule objectives may only identify those "weaknesses" and "strengths", to be confirmed or not throughout the implementation of the budget. In this context, it can be construed as an exercise aimed at focusing attention on certain revenue and expenditure items which should be more carefully monitored.

This report anticipates the follow-up timeline provided by article 18 of the LOEPySF, which improves efficiency of those preventive measures foreseen. [2]

As regards the debt objective, in accordance with the information provided by the MINHAP, the debt ratio of the General Government in relation to GDP is foreseen to reach 97.6% in 2014 and around 100.3% in 2015. Since the objectives established for 2014 and 2015 were targeted at 99.5 % and 101.7% of GDP, respective, **it is foreseeable that both objectives will be complied with, with a positive deviation amounting to 1.9% and 1.4%, respectively.**

In view of the foreseen public debt levels, which will reach 100% of GDP in 2015, **it does not seem likely that in 2020 such debt level will be reduced up to 60% and that debt limits established for the different sub-sectors in article 13 of the LOEPySF will be met, as required by Transitional Provision One of said law.**

Therefore, in line with the ***Opinion on the Attainment of Deficit and Debt Targets*** issued by the AIReF the last 30 July, it is advisable to review in 2015 the debt reduction path and to use the appropriate legal mechanisms in order to extend the transitional period for the compliance with those limits established in article 13, adapting those requirements set forth in Transitional Provision One and defining a credible and demanding reference path for the sustainable

[2] Art. 18.1 of the LOEPySF: *The General Government shall perform a follow-up of budgetary execution data and it shall adjust public expenditure so as to guarantee that, at the end of the fiscal year, the budgetary stability objective is complied with.*

reduction of the debt ratio which allows the General Government to guarantee the proper financial sustainability.

It was not possible to analyse the adequacy of budget documents as regards expenditure rule, except in relation to the Central Government and with the restrictions established in the report.

Recommendations

In accordance to the foregoing information, the following recommendations are made:

1. In order to improve the follow-up of stability objectives, it would be advisable that draft budgets would include a presentation thereof in national accounts headings, detailing the necessary adjustments for establishing the correlation between budgetary revenue and expenses and national accounts resources and allocations.

2. It is necessary to schedule the annual budget within a medium-term horizon under the terms provided by article 29 of the LOEPySF by virtue of which *"a medium-term budgetary plan to be included within the Stability Programme shall be prepared; such plan shall contain the preparation of annual budgets and it shall guarantee a proper budget forecast which must be consistent with the budgetary stability and public debt objectives and be compliant with the expenditure rule".* Along these lines, the 2014 Budgetary Plan says that *"the starting point for the preparation process of draft budgets of the Spanish General Government can be found in the latest version of the Stability Programme for the period 2013-2013, which contains the medium-term tax strategy"*.
   In view of the foregoing, it would be necessary to be provided with the information included in the latest version of the 2014-2017 Stability Programme broken down by sub-sectors so as to adapt accordingly those budgetary documents subject to analysis.

3. On the other hand, in furtherance of accountability, it would be advisable that all sub-sectors of the General Government would submit their Draft Budgets including an expected outcome of the previous fiscal year both under budgetary terms and under the terms of the European System of National and Regional Accounts with sufficient information so as to match both balances.

4. It would also be advisable to coordinate those budget processing timelines of the General Government so as to allow the preparation of those reports foreseen by the LOEPySF within the established terms and including the necessary information to do so.

5. Likewise, it would be advisable to review the timeline for the issuing of reports on the part of the AIReF so the Report on Draft Budgets and Main Budgetary Lines may extend its analysis to cover the Draft Budgetary Plan[3].

6. Likewise, as stated in the Opinion on the budget cycle issued by the AIReF on the 22 July, it is essential that the General Government harmonises budgetary structures so that a budget analysis of the sector can be conducted.

Scope Limits

The scope of this report was limited due to the fact that it was not possible to analyse certain aspects related to the stability and expenditure rule objectives since sufficient information was not available.

Notwithstanding the foregoing, this report constitutes the first analysis carried out by the AIReF on the attainment of the stability and debt objectives and compliance with the expenditure rule, so it must be taken into consideration that

[3] The Regulation 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the Euro area, establishes that Member States are required to submit to the Commission and to the Eurogroup, no later than 15 October, a draft budget for the forthcoming year. This draft budget must include the PGE Draft and the Main Budgetary Lines of the Regional Governments and Local Governments.

the different Governments may implement the relevant actions aimed at improving and completing the necessary information for the proper implementation of the report.

I. Draft State Budgets.

I.1. Stability Objective

I.1.1. Sub-sector: Central Government

The Central Government has established in the 2015 Draft State Budget (PGE Draft) a deficit amounting to 2.9% of GDP, in line with the stability objective approved by virtue of the Resolution of the Council of Ministers of 27 June 2014.

The revenue and expenditure forecast included in **the 2015 Draft State Budget (2015 PGE Draft)** is the one shown in the table below:

Financing Need/Capacity of the Central Government

Million Euros

Items	2015
1. Non-financial revenue	133,711.7
2. Non-financial expenditure	161,992.3
3. Non-financial Surplus (+) or deficit (-) of the Budget (1-2)	**-28,280.6**
expressed as a percentage of the GDP	**-2.9**
4. Adjustments	-3,409.6
5. Net lending (+) or borrowing (-) of the State	-31,690.2
6. Net lending (+) or borrowing (-) of the Central Government Organisms	435.2
7. Net lending (+) or borrowing (-) of the Central Government (5+6)	**-31,255.0**
expressed as a percentage of GDP	**-2.9**

Source*: Economic and Financial Report of the 2015 PGE Draft*

In **Annex I. Report on the 2015 Draft State Budget,** attached to this report, detailed information on the process carried out by the AIReF in order to assess those data contained in the previous table is included.

The 2015 Draft State Budget establishes that the steady improvement shown in the macroeconomic scenario included in the 2015 PGE Draft will positively affect the evolution of the tax bases and, as a consequence, it will also boost revenue.

In order to analyse this assumption, the AIReF has assessed through quantitative tools the validity of revenue forecasts related to the main taxes in 2015. The methodology applied to this analysis is included in the Methodology for the Forecast of Total Tax Revenue included in Annex I.

In accordance to this assessment, it can be concluded that tax objectives may be met as long as forecasts regarding the macroeconomic scenario included in the 2015 Draft State Budget occur. However, there is some uncertainty associated to tax refunds arising from the main taxes.

On the other hand, it must be pointed out that 2015 will be affected by the effects of the Tax Reform, which is based on the amendment of the main taxes of the Spanish Tax System which mainly affects the Personal Income Tax (IRPF) and the Corporate Tax (IS). The effects of this reform are distributed between fiscal years 2015 and 2016, according to the information included in the 2015 PGE Draft and in the economic dossiers attached to the Bills enacting such reform. The total ex-ante impact for both fiscal years amounts to € -9,059 million (0.9% of GDP) which, once the second-round effects that imply higher revenues are taken into account, will have an estimated ex-post cost amounting to € -6,900 Million (0.6% of GDP). These dossiers include a detailed and consistent analysis of the economic effects which will arise during fiscal years 2015 and 2016.

The ex-post impact of the tax reform foreseen in the 2015 PGE Draft matches, as regards its total amount, the forecast included in the Stability Programme for the IRPF Tax and the IS Tax.

Non-tax revenue of the Central Government for 2015 will not be affected by those support measures for the Regional Governments aimed at improving the financial conditions of the Regional Governments included in the Regional Liquidity Fund (FLA, according to the Spanish acronym). This measure, which means lower income for the Central Government, was not foreseen in the Stability Programme since it was approved later.

The Non-Financial Expenditure Budget of the Central Government for 2015 amounts to € 161,992 million, 0.1% higher than the outcome forecast included in the PGE Drafts for 2014.

According to the analysis carried out on the different revenue items, there are no significant risks. Along these lines, the credit estimated for covering interest-related expenditure may present a leeway considering the implementation foreseen for 2014 and the recent evolution of interest rates.

Within the expenditure budget of the Central Government, the transfers the Central Government allocates to the Social Security Administrations amount to 14.5% of its non-financial budget, coming up to € 23,483 million, a decrease by 15% as regards the amount included in the 2014 Budget, which is basically a consequence of the lower transfer to the SEPE.

The amount the Central Government transfers to the SEPE (€ 10,098 million) in order to balance its budget is one of the items which, according to the historical analysis of the implementation of the State Budget, presented significant deviations during the last fiscal years as a result of the progressive worsening of the unemployment rate. However, in 2014, it is expected that the transfer exceeds by 0.3% of GDP the needs of the entity, which is consistent with the change in the cycle of the labour market.

The 2015 PGE Draft includes information which allows to match the resulting balance from income and revenue of the Budget with the net lending or borrowing requirement, calculated in accordance with the standards of the European System of National and Regional Accounts.

Finally, it is important to highlight that this analysis has been exclusively carried out for the Central Government. For the purposes of establishing the surplus/deficit of the Central Government, it is necessary to know the impact of the other entities which, according to the criteria of the European System of National and Regional Accounts, must be considered part of Central Government and which are included in the 2015 PGE Draft in an aggregated manner by means of the net lending or borrowing requirement of the Central Government Organisms.

The 2015 PGE Draft does not include a detailed list of those entities which, in accordance to the aforementioned criteria of the European System of National and Regional Accounts, must be considered entities within the Central Government sector.

This situation is particularly significant for fiscal year 2015, in which Regulation No. 549/2013 of the European Parliament and of the Council, on the establishment of a new European system of national and regional accounts (ESA 2010) enters into force.

One of the impacts of the new ESA-2010 on the accounts of the General Government involves a strengthening of the public control as a criterion to include an entity within the sector. This regulation provides that a series of entities are integrated within the General Government sector; therefore, their revenue and expenditure, as well as their debt, are also integrated within this sector.

Revenue and expenditure from all these entities, which must be estimated following the criteria of the ESA 2010, present a surplus of € 435.2 million, according to the Economic and Financial Report.

This figure, together with its impact on the deficit of the Central Government, cannot be analysed in sufficient depth as a consequence of the aforementioned uncertainties and due to the insufficient information provided by the 2015 PGE Draft as regards the list of entities comprising those Organisms within the Central Government sub-sector.

Recommendations

The Central Government does not prepare a budget based on national accounts headings that would enable to automatically determine the stability objective. However, it is true that article 27 of the LOEPySF only requires to provide accurate supporting information in order to be able to relate the resulting balance of the Budget revenue and expenditure to the net lending or borrowing. Given that budgetary stability regulations are defined in terms of the European System of National and Regional Accounts, it would be necessary to accompany the Budget with a presentation in these terms. Furthermore, the expected outcome that accompanies the Budget should offer additional data on the national accounts adjustments.

The PGE Draft for 2015 does not contain information on the organisms and other public entities that according to the ESA 2010 are part of the Central Government sub-sector, so it would be advisable to add a list of all entities included under this Sub-sector.

The PGE Draft does not include data on contingent liabilities. The 2014-2017 Stability Programme contains exclusively information on the guarantees granted by the Central Government as at 31 March 2014.

Pursuant to the accountability principle, it is essential for draft budgets to include not only information on the guarantees granted by the Central Government, but also on any other situation deemed a contingent liability that affects the State or any of the entities in which it takes part.

I.1.2. Sub-Sector of Social Security Funds

The budgetary stability objective set out in the Resolution of the Council of Ministers of July 2014 for Social Security Administrations corresponds to a deficit of 0.6% of GDP. Assessing the achievement of this objective would require a comprehensive analysis of the budget for 2015 of the Social Security system, the Public State Employment Service (SEPE according to the Spanish acronym) and the Wage Guarantee Fund (FOGASA according to the Spanish acronym), these being entities included under the sub-sector of Social Security Funds according to the National and Regional Accounts System.

The estimated revenue from contributions to the Social Security system for 2015 amounts to €109,833 million, 6.8% above the initial budget of 2014, which entails an increase of €7,000 million. In view of the evolution of revenue until August, the annual increase on the final outcome for this year needed to reach the figure expected in 2015 might be higher.

The analysis of the evolution of macroeconomic variables that affect the revenue from contributions, particularly full-time employment and compensation per employee, does not support the revenue from contributions expected in the Social Security budget. This perception was confirmed by modelling the time series of social contributions collected from 1995 to 2013, taking into account the relevant explanatory variables, which showed that the contributions expected in the 2015 Budget are out of the confidence intervals of the model. On the other hand, this model was completed with the revenue forecast estimated in the Draft State Budget for the personal income tax or IRPF [4] (including also social contributions as an

[4] Analysis based on the revenue forecast of the Central Government

explanatory variable), and an inconsistency was identified between the forecast for contributions and the IRPF forecast.

Nevertheless, there are certain additional structural elements that might significantly affect the revenue from contributions for 2015, which could not be included in the model due to a lack of absolute certainty regarding their collection potential:

- The implementation of the new direct settlement system (CRETA), that is currently in trial stage but will soon be fully operational in May according to Social Security sources, could significantly improve collection thanks to a better control on the use of individual bases of employees, bonuses on contracts and on the application of deductions for temporary incapacity.
- The widening of bases to include compensation in kind during fiscal year 2015.

  Lastly, there is a certain inconsistency between the growth forecast for contributions included in the Draft Budgets of the Social Security system and of the Public State Employment Service for 2015, as the latter estimates a growth in contributions of 3.6% compared with the initial budget of 2014.

As for the forecast of non-financial expenditure, no significant risks were identified.

Pension payment expenditure is growing as expected, with an estimated increase of 1.23% in the number of pensions, an increase of 1.6% in the average pension of new pensioners compared with the expired pensions, and an annual update of 0.25% of current pensions. These percentages are reasonable and maybe slightly optimistic regarding the evolution of the number of pensions, considering that the data until August show an increase of 1.44% in the number of pensions and an increase of 1.67% in the average pension, both compared to the same month of 2013, although it must be acknowledged that these variations were slightly smaller during the last few months.

The draft budget does not include information on the estimates of the Pension Update Index (IRP according to the Spanish acronym), which will be the subject of a specific analysis by the AIReF soon.

The 2015 draft budget of the SEPE is in balance.

The budget foresees a reduction in unemployment benefits expenditure compared to the initial budget for 2014, mainly focused on contributory benefits and, to a lesser extent, on subsidies, while the expenditure allocated to Active Inclution Income is significantly increased.

If compared to the 2014 outcome estimate performed by the AIReF, the unemployment allowances foreseen for 2015 are reduced by 3%. Compared to that estimate, the allocation for 2015 seems too cautions, based on current legislation. Considering the macroeconomic employment forecasts and an eventual termination of contributory benefits, there might be some leeway in the Budget of the SEPE to achieve a significant surplus next year, provided the initial transfer of the State is kept.

Recommendations

The analysis performed by the AIReF concludes that the new management measures and the widening of bases to include compensation in kind will determine the capacity to achieve the demanding revenue objectives set out in the Social Security budget for 2015.

The potential margins generated in unemployment benefits expenditure, as a result of the employment market dynamics and of the exhaustion of contributory benefits, might generate a surplus in the accounts of the SEPE, which would compensate a hypothetical shortfall in Social Security revenue.

Considering the risks and uncertainties outlined in this report as regards the revenue estimates, it will be necessary, pursuant to article 18.1 of the LOEPSF, to perform a **monitoring of the revenue data as the budget is implemented** so that, if needed, the relevant measures may be adopted in 2015 to guarantee the attainment of the stability objective.

On the other hand, the Draft Budget of the Social Security System does not include the expected outcome of the Budget for the previous fiscal year and does not incorporate the necessary adjustments to link the resulting balance of Budget revenue and expenditure with the net lending or borrowing.

Lastly and from a formal standpoint, given that the Draft Budget of the SEPE for expenditure shows indistinctly credits to satisfy obligations of this and previous fiscal years, it would be advisable, in furtherance of accountability, to duly identify the obligations from previous fiscal years under the relevant specific credits.

I.2. Expenditure Rule

Pursuant to articles 17.1 of the LOEPySF and 16.1 of the Organic Law of the AIReF, this report must inform on whether the 2015 PGE Draft was prepared in compliance with the expenditure rule.

The calculations performed by AIReF, using the methodology described in Annex I of the Expenditure Rule section, show that **the expenditure rule was duly observed in the State draft budget for 2015, both in terms of the initial 2014 budget and in terms of the expected outcome**, although the margin of compliance in both cases was considerably smaller than the one achieved with the provisional outcome of 2013 compared to 2012, according to the data contained in the report of the Ministry of Finance and Public Administrations. That is mainly due to the fact that in 2013 certain regulatory changes occurred that entailed significant permanent revenue increases, which raised the eligible expenditure level thus enabling the aforementioned wide margin of compliance, while for 2015 the tax reform foresees a negative net impact.

Recommendations

In furtherance of accountability, it would be necessary to publish the data of **non-financial expenditure in the initial budget**.

Likewise, the **methodology used to calculate the expenditure rule and the information on the compliance thereof should also be made public.**

Given the obligation of the Government to comply with the expenditure rule of the Central Government, the Economic and Financial Report of the PGE should contain information on said compliance, both in the draft budget and in the approved budget. In this sense, **it is recommended to include this information in the following Economic and Financial Report for the approved 2015 General State Budget.**

II. Main Budgetary Lines of Regional Governments and Local Governments. Budget Stability Objective.

II.1. Sub-Sector of Regional Governments

According to the information provided and made available as at the date of drafting of this report, the **achievement of the budget stability objective for 2015 in the sub-sector of Regional Governments is considered unlikely.**

The budgetary scenario for 2015 provided by the MINHAP for the whole sub-sector **shows a potential overvaluation of the revenue foreseen:**

1. The data provided regarding the **resources of the financing system show an excess of 950 million Euros** compared to the Government-estimated resources. This constitutes an **increase of 0.09% of GDP in the net borrowing of the Regional Governments sub-sector**.

2. A potential **deviation of the revenue forecast is observed as a result of the Tax on Asset Transactions and Documented Legal Acts (ITPyAJD),** the projection of which for 2014-2015 does not seem to be endorsed by actual revenue developments so far and the measures foreseen for the period. The expected revenue is overblown, even taking into account the improvement of tax collection forecasts for 2015, based on the evolution of the prices of unsubsidised housing and transactions of second-hand housing, according to the study carried out by the AIReF.

3. The **uncertainty related to the execution of the foreseen privatizations of assets** was confirmed, although the risk might be somewhat mitigated to the extent that some of the transactions foreseen for 2014 that could not be executed during this year might be transferred to 2015.

As for the expenditure, the information provided does not show any deviation risks other than the ones already mentioned. It is worth stating that regional expenditure is made up, to a large extent, of very rigid budgetary items, such as public health, education or social expenses, which stand for around 70% of the total expenditure of Regional Governments, which means that their expenditure levels are barely affected by changes in the economic cycle.

Nevertheless, the main non-compliance risk for 2015 is a consequence of the fact that it **is likely for Regional Governments to close fiscal year 2014 with deviations from the objective set out, which would entail keeping the deficit of this sub-sector at a level similar to that of 2013.** The revenue scenario included under the outcome forecasts for 2014 for the main budgetary lines do not seem to match the implementation recorded during the first semester of the current year and with the impact of the measures foreseen and implemented.

1. In terms of **revenue**, the **main risks** of the scenario communicated for 2014 are:

- Overvaluation of the resources from the financing system to be provided by the Central Government in 2014 amounting to more than 400 million Euros, **which would entail an increase of 0.04% of GDP in the net borrowing for 2014.**
- **The forecast outcome for 2014 shows an estimated increase of the ITPyAJD that is not supported by the tax collected during the first semester or by the measures adopted.** Revenue forecasts based on market variables, pursuant to the study carried out by the AIReF that is mentioned in Annex II, seem to endorse this conclusion.
- **Most forecasts on revenue from administrative concessions and assets disposal do not seen likely to be forthcoming**. The revenue in the 2014 foreseen outcome for administrative concessions and disposal of assets exceeds 3,900 million, having realized during the first semester of the year approximately 8% of the aforementioned amount.

2. **Other risk factors for 2014** are the result of:

- **An eventual effect on Regional Governments of the ruling of the European Union Court of Justice** of 27 February 2014, which **declared that the tax on retail sales of certain hydrocarbons is contrary to EU law**.

- **Regional Governments that did not attain the deficit/debt objective for 2013, except for Aragón, do not currently have an Economic and Financial Plan establishing the roadmap to be followed in 2014 and 2015 in order to redirect the deviation suffered.** Up to date, only the Economic and Financial Plan of the Regional Government of Aragón has been approved and published, including an express reference to the compliance with the recommendations issued in the report of the AIReF, particularly focused on the need to specify the budget items affected by the decisions on non-availability of funds. No updates of the Economic and Financial Plans that were the object of the AIReF report have been received, so the conclusions issued in that report on the non-compliance risks identified for 2014 are remain valid. This is still the case even taking into account the improvement of the financial conditions of the extraordinary financing mechanisms, which might entail for said regions an additional saving of 409 million Euros in 2014, compared to the scenario described in their relevant plans.

  Therefore, the following **recommendations** are issued regarding the main budgetary lines for Regional Governments in 2015:

1. **Recommendations aimed at the adoption of measures:**

- **Adoption of measures** that enable to modify the budget scenario submitted and **achieve the stability objective set out for 2015**. These measures must be supported by regulations with the necessary legal status to ensure their effective implementation.

- Full implementation of royal decree laws adopting emergency measures for the rationalisation of public expenditure in education (RDLey 14/2012) and emergency measures to ensure the sustainability of the National Public Health System and to improve the quality and security of its benefits (RDLey

16/2012), as well as the development by the Central Government of the basic regulations needed to that end.

- To accelerate the actions of the working group established in the Fiscal and Financial Policy Council (CPFF according to the Spanish acronym) for the rationalisation and efficiency of public expenditure, so as to present its conclusions in the following Council meeting.

- Presentation, in the following CPFF meeting, of the Economic and Financial Plans pending approval due to the non-attainment of the 2013 deficit and/or debt objectives.

2. **General recommendations related to the enhancement of accountability and of the budget cycle.** Throughout the process of the works carried out for the preparation of this report, a series of circumstances were found out that affect the information provided so far and limit the scope of the analysis performed:

- Article 27.2 of Organic Law 2/2012 and its relevant regulations set out in article 13.3 of Order HAP/2105/2012 establish the obligation of Regional Governments to submit the data on the main budgetary lines before 1 October. However, on that date, most Regional Governments were still in the process of preparing their Draft Budgets, which have not yet been submitted to the competent regional legislative authority to be duly processed. According to budget regulations, the deadline for the submission of draft budgets of various Regional Governments ends in November. This circumstance prevents the availability of comprehensive and consistent information about the main lines of regional budgets in an individualised manner for each Region, and therefore limits the scope of the report issued to the whole vision of the sub-sector. Thus, pursuant to and as a complement of recommendation number 2 issued in the Opinion on the budget cycle issued by the AIReF on 22 July 2014[5], the harmonisation suggested for budget bases of the General Government should comprise **the harmonisation of the budget cycle so that homogeneous and comprehensive information is available on every Regional Government** for the preparation of this report.

[5] Document available at Opinions - Changes in Budget Cycle Procedures

- The analysis of effective expenditure performed and foreseen for each fiscal year requires knowing the obligations accrued in the current year that are pending allocation to the current budget, and of obligations accrued in previous fiscal years that have been allocated to the current budget. In other words, it is necessary to know all the movements occurred in each fiscal year under **accounts 413/409** and other similar ones in which the aforementioned obligations are booked. This information is not provided in a clear, comprehensive and detailed manner, which hinders the analysis of the evolution and forecast of regional expenditure. Therefore, in line with recommendation number 3 included in the Opinion on the budget cycle issued by the AIReF of 22 July 2014, it must be emphasized that there is a need to achieve **greater accountability and detail in the information submitted on the operations booked in the accounts** mentioned above, in order to perform a comprehensive analysis and monitoring of the various budget expenditure items to which accrued obligations are allocated.
- As for the revenue from regional taxes, the monthly data currently published on collections has limitations that affect the possibilities of analysis. In addition to the fact that the specific information published on taxes collected by each sub-sector has a delay of 6 months (in October the last available data were those referred to March), the information is not detailed by Regional Government. In turn, the data on the monthly budget implementation, which is more updated and detailed by regions, is not broken down as regards certain taxes with a significant weight in the aggregate non-financial regional revenue resulting from the financing system (tax on wealth, tax on hydrocarbons, tax on certain means of transport, tax and fees on gambling, etc.). Therefore, **it is recommended to update and improve the information published on the collection of regional taxes**.
- Lastly, the reference to the stability objective, which is measured in terms of national accounts, requires to complement the budget analysis with the analysis of the adjustments to national accounts, which would make it possible to correlate the figures in the budget with the net lending or borrowing. However, the information currently published on national accounts adjustments does not offer details about the aforementioned adjustments or about the methodology needed to link them with specific expenditure and revenue items. As a result, this analysis is basically limited to budgetary information and the information on regional budgetary lines does not include detailed, reasoned and comprehensive information on the adjustments to

national accounts foreseen. Thus, we reiterate the recommendations included in the Opinion on the budget cycle issued by the AIReF on 22 July 2014 regarding the **improvement of the accountability aspect of the information on calculation methods and details of national accounts adjustments**.

II.2 Sub-Sector of Local Governments

The information submitted on the main budgetary lines of Local Governments for 2015 and on the scenario of measures supporting said lines suggests **that the attainment of the budget stability objective of this sub-sector for 2015 seems likely.**

Likewise, according to the data available on the measures implemented and foreseen and the trend resulting from the budget implementation of the first semester**, the revenue and expenditure scenario included under the forecast outcome of Local Governments for 2014 makes it possible for Local Governments to attain the budget stability objective.**

Notwithstanding the above, **the following risks were identified in connection with the margin to attain the stability objective of Local Governments, both in the outcome forecasts for 2014 and in the main budgetary lines for 2015**:

1. **There are several circumstances that might limit the positive impact expected from the local reform on the financial sustainability of Local Governments**, **such as for example the passing of certain regional regulations on the implementation of Act 27/2013 of 27 December on the Rationalisation and Sustainability of Local Governments, and the issuing by the Council of State of Opinion 338/2014 of 22 May regarding the conflict in favour of the local autonomy in connection with Act 27/2013.**
   These circumstances might jeopardise the achievement of the savings foreseen as a result of the local reform, both in terms of amounts and timeline. If such savings could not eventually be achieved, in full or in part, or if they had to be delayed to subsequent fiscal years, the margin to attain the stability objective of this sub-sector for the years 2014 and 2015, would be significantly affected.
   More specifically, the likelihood of meeting the revenue and expenditure forecasts included under the main budgetary lines of Local Governments for 2015 depends, at least to a certain extent, on the achievement of the savings foreseen as a result of the local reform, that is 3,523.5 million Euros, according to the schedule set out in the Update of the 2014-2017 Stability Programme.

These savings amount to 0.3% of GDP, and given that the non-financial budget balance resulting from the forecasts provided for 2015 amounts to 0.57% of GDP, any increase or decrease in the savings achieved compared to those foreseen would significantly affect the margin to attain the stability objective.

2. Besides the above, **the trend shown by investment expenditure in pre-election years and the exhaustion of fiscal pressure measures**, along with the **greater flexibility of the expenditure ceiling requested by Local Governments** in order to use the surplus obtained to stimulate their local economy, without endangering the achievement of the balance objective, make it possible to foresee that the years 2014 and 2015 might be liquidated with the achievement of the objective set out, but reducing their contribution to the achievement of the overall objective. Nevertheless, up to date, the aforementioned flexibility was not authorised by the State.

In view of the above, the following **recommendations** are issued:

1. **Recommendations regarding the implementation and monitoring of the local reform.** Given the relative importance of the savings expected as a result of the implementation of the local reform for the margin of attainment of the stability objective of Local Governments, **it is recommended to**:

- Specify the methodology used and calculations made for the quantification and allocation, under each fiscal year of the schedule, of the economic impact expected as a result of revenue and expenditure measures contained in such reform. Likewise, a comprehensive analysis of the reform should be carried out to the extent the reform affects the financing received, via transfers, by Local and Regional Governments, which amounts to 14,000 and 5,500 million Euros respectively, according to the last data settlement in 2012.

- To perform a quarterly monitoring of compliance with the economic forecasts of the reform, including information about deviations between the savings expected and achieved, as well as about the reasons for the revisions that, as applicable, might be made to the initial forecasts for each of the measures included therein.

2. General recommendations on accountability:

- Article 27.2 of Organic Law 2/2012 on Budget Stability and Financial Sustainability and article 15.1 of Order HAP/2105/2012 establish the obligation of the Local Governments to submit the data on their main budgetary lines before 1 October. On this date, most of these authorities are in the process of preparing their draft Budgets, so the information available is not still complete and this limits the scope of the report submitted to the sub-sector as a whole.

  Thus, **according to recommendation number 2 of the Opinion on the budget cycle issued by the AIReF on 22 July 2014, the harmonisation suggested for the budget bases of the General Government must comprise the harmonisation of the budget cycle**, so that homogeneous and comprehensive information is available on the date of submission thereof and for the preparation of this report.

- **The assessment of the stability objective requires to complement the budget analysis with the analysis of the national accounts adjustments, which enable to correlate budgetary figures with the net lending (+) or borrowing (-).** The information currently available on national accounts adjustments does not include data on the aforementioned adjustments, which limits the analysis exclusively to budgetary information.

  Therefore, **we reiterate the recommendations issued in the Opinion of the AIReF of 22 July 2014 regarding the improvement in the accountability of the information on said adjustments**. In particular, the assessment of the effective expenditure incurred and expected in each fiscal year requires know the accrued obligations pending to be allocated to the current budget in each fiscal year, and of obligations accrued in previous fiscal years that have been included in the current budget. The lack of this information results in a limitation of the analysis of the evolution and forecasts of expenses incurred and expectted.

- **Pursuant to the recommendations of the AIReF, last September the MINHAP published the individual compliance/non-compliance status of the stability objective** of Town Halls, Provincial Authorities, Island Councils and Authorities subject to the Common Regime (excluding town halls of the

Basque Country and Navarra and the provincial authorities of those two regions).

The information published contains a conclusion regarding the "compliance" or "non-compliance" of the stability objective of each local authority, according to the information submitted and signed, without giving details on the quantification of the net lending or borrowing. Only the amounts of the balance of non-financial operations are detailed according to budget criteria, but no information is provided on the national accounts adjustments, so **it is recommended to complete the information published by adding the local authorities that have not been included** and, in line with the above comment, **by providing data on national accounts adjustments and on the quantification of the individual objective of each authority.**