Independent Authority for Fiscal Responsibility

Report

17 July 2017

Report on compliance with the 2017 budget stability and debt targets and the expenditure rule 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.

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Executive Summary

The aim of this report is to assess the likelihood of compliance in 2017 with the budget stability and debt targets and with the expenditure rule by the different public administrations. Also, for the Autonomous Regions (ARs) that have submitted information on the Economic-Financial Plan (EFP, for the Spanish acronym) for AIReF's report prior to its presentation to the Fiscal and Financial Policy Council, this report includes an assessment of the 2017 and 2018 budget scenarios included in these plans, formulating the corresponding recommendations when assessing the risk of non-compliance with any of the fiscal rules.

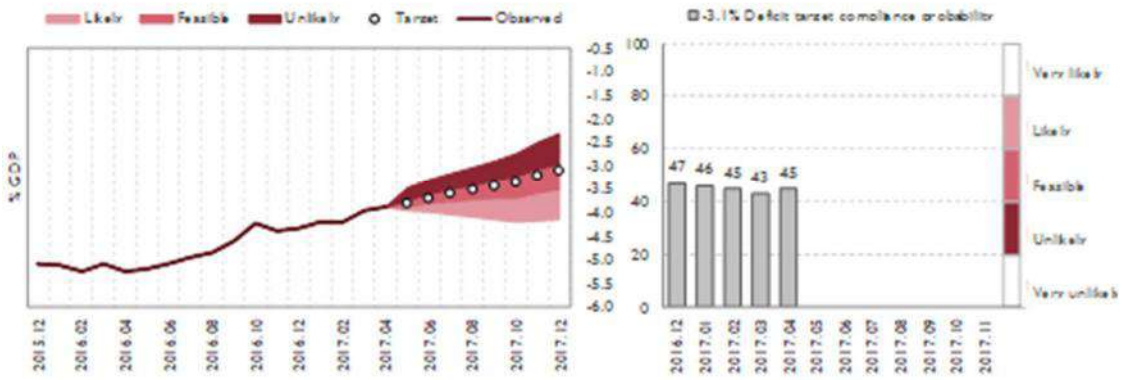
AIReF considers feasible for 2017, although demanding, the achievement of a 3.1% GDP deficit target[1]. The Government has provided new information, mostly related with the shift to 2018 of the projected 2017 impact of the state financial liability regarding toll roads. In relation to its last Report, the new information allows the AIReF to slightly improve the forecast of compliance with the stability target.

This feasibility consideration rests on the planned adjustment to non-financial expenditure which, with growth well below GDP, would be compatible with compliance with the expenditure rule, and on the shift to 2018 of the projected 2017 impact of the State's financial liability for toll roads on the Stability Programme Update (SPU 2017-2020). On the contrary, non-financial revenue maintains its weight on GDP, it being considered unlikely to reach the target. See Figure A1.

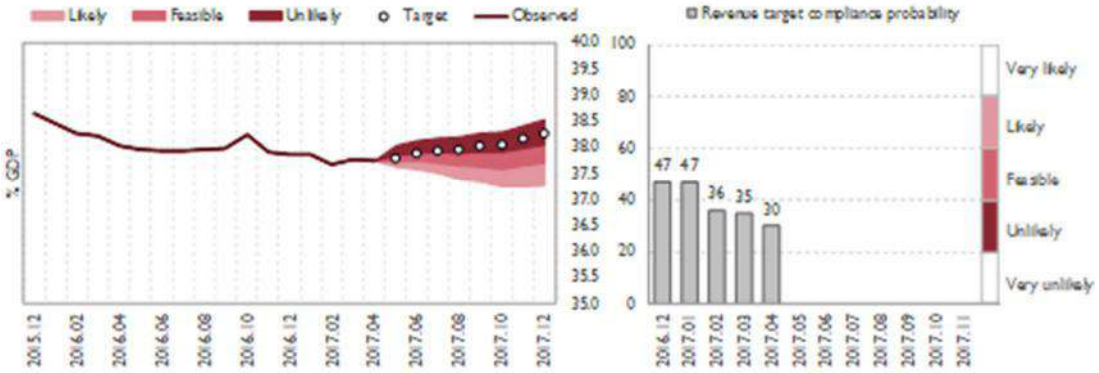
While the stability target is considered feasible for the General Government (GG), the subsectors show mixed results: The Local Governments (LGs) will meet the targets, while the Central Administration (CA) and, to a lesser extent, the Social Security Funds (SSF), present a high risk of deviation. The targets set on 2 December 2016 do not reflect the financial situation of the various subsectors or the limitation, in some cases, to implement the expenditure rule. The latter holds true despite the delay in the CA formation process, and therefore in the setting of the targets, allowed AIReF to have more information than in previous years on the 2016 year-end for each of the subsectors and the 2017 macroeconomic scenario.

[1] Excluding financial assistance to the banking sector.

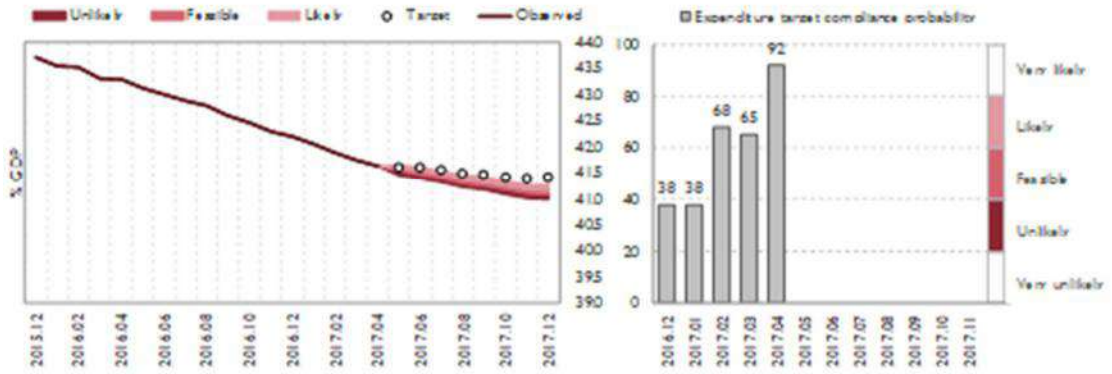
FIGURE A1. TOTAL GENERAL GOVERNMENT NET LENDING/BORROWING



REVENUE



EXPENDITURE



It was confirmed that the vertical targets approved in December were unrealistic just four months after approval, with the first notification from the Spanish Government to the European Commission (EC) under the Excessive Deficit Procedure framework. This communication confirmed AIReF's forecasts in its Report on the 2017 draft General State Budget (GSB) which projected the deviation of the CA and the SSF from the deficit target. This led to a paradox where, before the GSB was approved, the Government had already acknowledged that these were incompatible with the targets set just a few months before.

The sharing of a joint target, without a methodology to support it and its inconsistency with the individual targets, detracts from the proper implementation of the mechanisms provided in the LOEPSF. These mechanisms rest, first, on the individual responsibility of each administration to correct deviations that occur throughout the budget cycle and weaken fiscal rules effect. In this context, while compliance with the 2017 fiscal targets for the GG as a whole is feasible, sustained by a vigorous economic recovery, the implementation errors of the fiscal rules lead to problems in the medium term. This will be seen if the cyclical situation of the economy is less favourable and the individual discipline of aligning budgets to the fiscal targets becomes more necessary.

In the specific case of the ARs, the unsuitability of regional revenue to the needs and nature of expenditure means that the assessment of the fiscal situation can completely change from one year to the next without there being a change in the behaviour of the Region to justify, or not, the fiscal disciplinary measures.

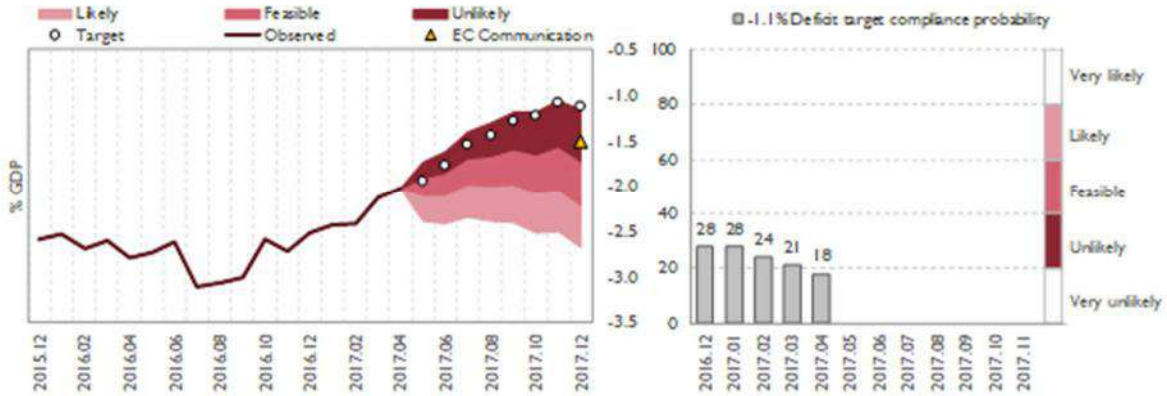
In this context, it is difficult for AIReF to carry out its work as a guarantor of the LOEPSF's application when its instrumentation is focused on procedures and disconnected from the targets and principles that inspired its creation.

Central Administration

AIReF deems highly unlikely that the CA will reach the approved 2017 target of -1.1% GDP. To meet this target, the CA would have to make an adjustment greater than 1.4% GDP compared to the previous year[2]. Although the Government's first notification to the EC under the Excessive Deficit Procedure framework projected a closure of 1.5% GDP, this forecast is still below AIReF's central scenario. See Figure A2.

FIGURE A2. CENTRAL ADMINISTRATION

NET LENDING/BORROWING



AIReF believes non-financial revenue will grow slightly below GDP, with the main uncertainties being found in Personal Income Tax. This is despite the robust growth of the Spanish economy in the first half of 2017 and its projected persistence through the rest of the year. Corporate Income Tax has shown a very high growth, influenced by the evolution of the first payment and the maintenance of the minimum rates. The growth in this tax, which AIReF considers feasible, will be conditioned by the impact of the tax measures adopted in Royal Decree-Law 3/2016. This impact will be seen with the payment of the 2016 instalment that will be made in July. With regard to indirect taxes, AIReF still considers feasible to achieve the recovery projected in budgeted VAT, although there is some risk of deviation in the Special Taxes.

On the other hand, besides possible deviations in tax revenue, CA´s total non-financial revenue is influenced by the increase in the 2015 final settlement in favour to the ARs and the agreement of the Mixed Commission on the Economic Arrangement with the Basque Country of 17 May, with a joint impact greater than two tenths of GDP.

With regard to non-financial expenditure, the downward trend in percentage of GDP initiated in prior years has continued, due to the drop in significant items such as public consumption, interest expenses and transfers between governments, which decrease due to the reduction of the transfer from the State to the Public State Employment Service (SEPE) and the growth of other transfers below GDP. In this sense, AIReF has slightly improved the forecast regarding non-financial expenditure by noting the information provided by MINHAFP on the impact derived from the Toll

[2] The 1.4% of GDP adjustment is estimated based on 2016 year-end figures excluding financial assisstance to the banking sector.

Road Asset Liability will almost entirely be transferred to 2018. However, there are other expenditure items, such as investment aid, which continue to grow considerably, as they are affected by other expenses arising from the bank restructuring process. In aggregate terms, the projected evolution of non-financial expenditure should allow compliance with the expenditure rule, although there is uncertainty about the forecasted tax impact of the tax measures as well as the new regulation of the Canary Region Competitiveness Fund.

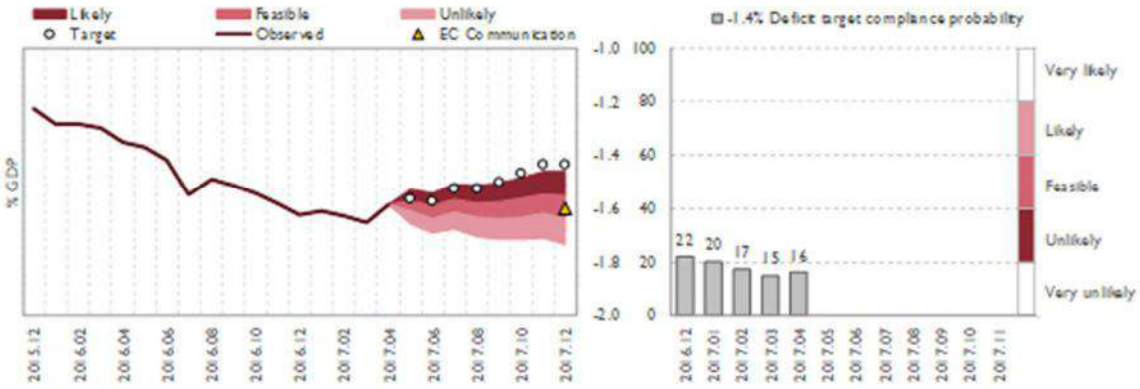
Regarding the debt target, AIReF's central forecast for 2017 is 71.8% GDP, slightly below the set target of 72% GDP.

Social Security Funds

Compliance with the 1.4% GDP deficit target for the SSF is considered highly unlikely. Although this year's target was substantially more realistic than previous years, it is still highly unlikely to reach the revenue level needed to meet the GSB forecasts and to make the adjustment of two tenths of GDP required for 2017. The 2017 stability targets approved in the Council of Minister's Agreement of 16 December 2016 established a deficit of 1.4% GDP for the SSF which was maintained in the SPU submitted in April 2017. However, the first notification sent to the EC on 31 March reported a deficit forecast of 1.6% GDP. See Figure A3.

FIGURE A3. SOCIAL SECURITY FUNDS

NET LENDING/BORROWING



AIReF forecasts are in line with the notification given that the lower revenue as a percentage of GDP projected for 2017 is offset by an equivalent expenditure adjustment, maintaining a similar deficit to the one observed the year before.

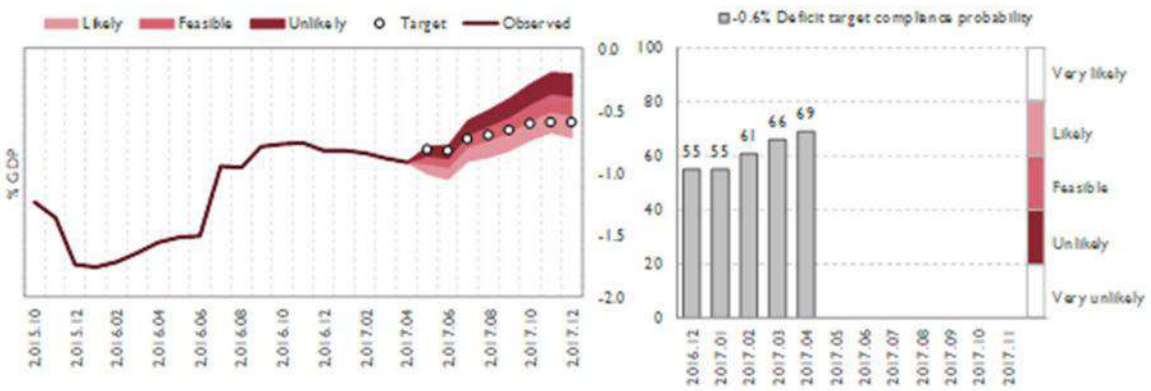
AIReF forecasts put non-financial expenditure at 14.2% GDP, three tenths less than in 2016. This reduction is due to pensions growing by about 3%, below GDP, and some unemployment benefits that continue to fall, especially non-contributory unemployment. This spending adjustment compensates for the lower revenue as a percentage of GDP, which in 2017 will reach 12.6%, three tenths less than in 2016, mainly due to the smaller transfer from CA to the SEPE and lower interest revenue of the Reserve Fund. During the period, contributions are projected to maintain their weight in GDP.

Autonomous Regions

AIReF projects that the ARs subsector is likely to meet the 2017 stability target (-0.6% GDP), making the two-tenths adjustment necessary starting from the closure recorded in 2016 (-0.8% GDP). Decisively contributing to this is the 6.6 billion-increase in revenue from the financing system, together with the good performance of other revenue and the possible fulfilment of the expenditure rule derived from the closure forecasts provided by the ARs and AIReF. See Figure A4.

FIGURE A4. REGIONS

NET LENDING/BORROWING

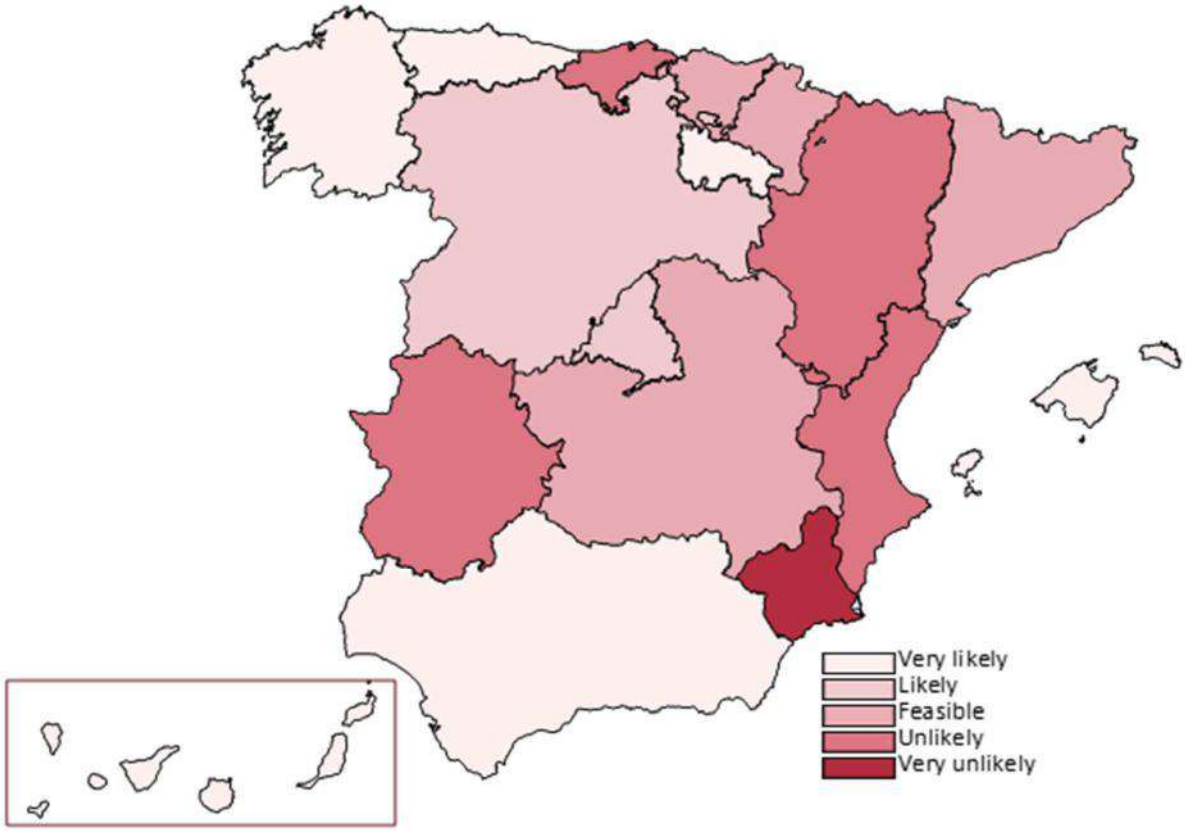


AIReF believes that 12 of the 17 ARs could achieve their stability targets, increasing the likelihood of compliance of all ARs compared to the last Report. The improvement is mainly due to the data from the recently reported final settlement of 2015 with the financing and the implementation data (see Figure A.5).

Regarding the expenditure rule, there is improvement in the amount of information provided by the ARs, although uncertainties persist on elements necessary for their calculation. Despite these limitations, AIReF analysed whether the projected evolution of the expenditure of each of the ARs could be compatible with compliance with the spending rule, with a risk of default being found in 4 ARs and very tight compliance being found in 4 other ARs.

Regarding the debt target, the ARs continue to fulfil their targets comfortably despite the risks of debt sustainability and the fact that the 13% GDP limit is projected to be reached on a date much later than 2020. A circumstance that increasingly contributes to its fulfilment and which abounds in the non-restrictive character of these targets is the fact that they include debt to finance the entire deficit target regardless of whether the Region finally incur lower deficits.

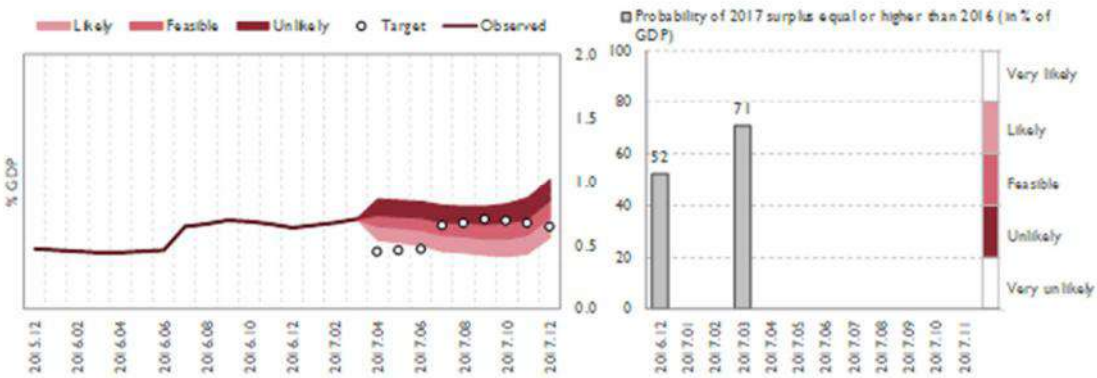
FIGURE A5. COMPLIANCE WITH THE 2017 STABILITY TARGET PROBABILITY FORECAST



Local Governments

AIReF considers highly likely that LGs subsector will meet the 2017 budgetary stability target, with a surplus likely to consolidate the results achieved in 2016, at a minimum. The Agreement of the Mixed Commission of the Economic Arrangement with the Basque Country of 17 May 2017 has recognized a debt of the State for settlements of the quote from previous years for 1.4 billion euros in favour of the Provincial Councils. This recognition, along with the delay in the approval of the GSB this year, which includes authorization for the LGs to make financial sustainable investments, could have a positive impact during the last quarter, favouring a financing capacity of the LGs somewhat higher than recorded last year. However, the 16 large cities with a population greater than 250,000 are expected to reduce their aggregate surplus by almost 40%, confirming the change in the trend started in 2016 and their different behaviour compared to other subsector entities. See Figure A5.

FIGURE A6. LOCAL GOVERNMENTS
NET LENDING/BORROWING



A surplus equal to the one recorded in 2016 would guarantee compliance with the expenditure rule in the LGs subsector.

As for debt, AIReF believes that, by 2017, the LGs could reach a debt-to-GDP level of around 2.6%. If the consolidation of the surplus in 2017 and later years is confirmed, the downward debt trend will continue and the debt-to-GDP ratio at the end of 2020 could be around 2% GDP.

In this Report, the sustainability analysis initiated in the December 2016 Report was deepened, gathering information from up to 32 municipalities. With a current debt to revenue ratio of more than 75%, and sustainability problems, we find negative results in the following financial and economic indicators: non-financial budget balance, cash surplus, average repayment period, and compliance with the obligations to supply information.

After the analysis, AIReF proposes the following recommendations:

1. Establish and public a clear methodology for the allocation of the vertical deficit target, considering the situations of the different subsectors.
2. Include the expenditure review processes into the budget planning, resulting in efficiency gains.
3. Close the gap between the LOEPSF and its application to the CA in cases of non-compliance risk, articulating an execution control through monthly monitoring carried out by the MINHAFP on how the tax measures are being implemented, signalling the risk of deviations that could occur at year-end.
4. Use the Toledo Pact to identify potential measures aimed at ensuring Social Security System financial balance and sustainability, whose evaluation and impact quantification could serve as a basis for future decisions.
5. Take measures for the correct implementation of the expenditure rule.
6. Coordinate the work of the supervisory bodies of the LGs, harmonizing, among other aspects, the application of article 25 of the LOEPSF regarding the adoption of credit non-availability agreements.

1. Introduction

AIReF has to prepare, prior to 15 July of each year, a report on budgetary execution, public debt and the expenditure rule. Organic Law 6/2013 of 14 November, on the creation of the AIReF, authorizing it to continuously evaluate the budget cycle and public indebtedness. AIReF can report, at any moment, on the advisability of activating the measures foreseen in the Organic Law on Budgetary Stability and Financial Sustainability (LOEPSF). In addition to this general authorization AIReF has to decide on the fulfilment of the budgetary stability and public debt targets, as well as the expenditure rule for the current year, prior to 15 July of each year[3].

Purpose of the report and limitations on scope

The purpose of this report is to assess the likelihood of compliance with the budgetary stability and public debt targets, as well as the government expenditure rule in 2017. In accordance with Article 17 of Organic Law 6/2013, this assessment will consider the budget execution and measures planned for the current year and in the previous year. It will identify potential risks of default for each of the agents that make up the Public Administrations sector.

Specifically, this report has analysed:

- ✓ The Central Administration subsector (CA).
- ✓ The Social Security Funds subsector (SSF)[4].
- ✓ The Regional subsector and each of the regions individually.
- ✓ The Local Governments subsector (LG). In this subsector, the 21 local entities analysed in the report on the main budget lines for 2017 have been subject to individual evaluation: the 16 municipalities with populations greater than 250,000, the Provincial Councils of Barcelona, Valencia and Seville, the Cabildo Island of Tenerife and the Insular Council of Mallorca. In addition, and continuing with the sustainability analysis of the LGs initiated in the report on the main budget lines, a primary assessment of 32 municipalities has been included, which, being in this group, present a negative situation in other variables, such as budget balance, balance sheet or the average payment period. The individualized analysis section includes these details, the criteria used for their selection, the type of information requested and the results of the assessment.
- ✓ The subsector risk analysis is complemented with an overview of the situation for the Public Administrations as a whole.

[3] Article 17 of Law 6/2013 of 14 November, on the creation of the AIReF, and Article 19 of Royal Decree 215/2014 approving its Organic Statute.

[4] In this case, compliance with the deficit target will be analyzed exclusively, in accordance with the Organic Law on Budgetary Stability and Financial Sustainability (LOEPSF).

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As in previous reports, the purpose of this report has been conditioned by the lack of the following:

- ✓ Initial budget and settlement forecast for 2017 in terms of the national accounts of the CA, SSF and the ARs.
- ✓ Information needed to evaluate compliance with the expenditure rule in the CA and the Local Government subsector.
- ✓ Complete and updated information on the impact of the main contingent liabilities
- ✓ Information requested from an individual Local Entity. The Local Entities have generally sent the requested information, with the exception of the City Council of Palma de Mallorca out of the 21 LGs subject to detailed analysis. Information is also missing from the cities of Almadén, Ayamonte, Moratalla, Los Palacios and Villafranca and Valsequillo of Grand Canary Island, out of the 32 local governments subject to the first analysis. All of these entities have been given the duty of collaboration provided for in Article 4.3 of Organic Law 6/2013, creating the AIReF and its consequences. The Cities of Jaén and La Línea de la Concepción have submitted incomplete information or with unjustified incongruities that limit the AIReF's evaluation. The City of Maracena has sent incomplete information that makes the AIReF's pronouncement impossible.
- ✓ The limited period of time with which the information that affects the Local Government subsector has been received from the Central Information Centre, which, despite being requested on 13 June, end with a deadline of 28 June, was received in two batches on 6 July and 12 July, only 3 days prior to the issue date of this report. The City of Gandía has sent the requested information on the same day as the report's issuance, 15 days past the deadline.

2. Analysis of the macroeconomic environment

The Spanish economy has maintained robust economic growth in the first half of 2017, shown by an annual variation in real GDP in line with that recorded in 2016. The quarter-on-quarter growth observed in the first quarter (0.8%) and projected for the second quarter (0.9%) on the basis of the most recent economic information (see figure 7 for Mipred forecasts for the second quarter)[5] suggest a slight acceleration in the pace of growth compared to the end of 2016. The impact of the first half of the year on the annual data would indicate rates close to that observed in 2016 (3.2%) and even more if we consider that the push of the second quarter can be maintained through the third, as the available information suggest may be possible.[6]

As for the composition of the growth, the push is backed by a greater contribution of domestic demand, while the external contribution would maintain its positive contribution, although at a smaller magnitude than projected six months ago. The composition of the growth continues to reflect positive contributions from both domestic and external demand, in inter-annual terms (see Table 1). Within the former, private consumption continues to be sustained, supported by good employment performance, a healthy financial position of households and an increase in new loans, both factors that would also support the rebound observed in residential investment. As for the investment in equipment, this area continues its growth in 2017 when compared to 2016, supported by reduced financing costs and the good behaviour of the corporate margins. The evolution of public consumption also seems to rebound in the second quarter after a flat year in which its weight in GDP was reduced.

The expectations of the main analysts for 2017, as well as the Government forecasts, have undergone continuous positive revisions so far this year. The consensus growth forecasts have been revised upwards continuously in recent editions,[7] as have the updates of the Government's macroeconomic picture.[8] As can be seen in figure 8, the successive revisions have brought the GDP forecasts closer to the AIReF's central band, starting from the lower margins of the probability interval. In the case of prices, revisions have been slower and in the opposite direction after the acceleration signs at the beginning of the year from the energy component were interpreted as transitory. Inflation, as well as the evolution of employee compensation, is expected to remain in a moderate growth environment by the end of the year. In comparative terms, the Government's consumer price forecasts (0) are in line with the consensus, close to AIReF's central bands. In the case of the GDP deflator, the official forecasts are in line with AIReF estimates, with convergence in terms of nominal GDP due to the real component.

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[5] More details on the MIPred model can be found in the following working document: Cuevas, A., Pérez-Quirós, G. and Quilis, E. (2015). "Modelo integrado de predicción a corto plazo de la economía española (modelo MIPred)," Working Document 4/2015, AIReF. [Integrated short-term prediction model for the Spanish Economy (MIPred model)]]

[6] It is necessary to cautiously consider the forecasts referring to the third quarter due to the low observed proportion of the total indicators.

[7] Represented through the FUNCAS Forecast Panel of March, May and July.

[8] Corresponding to the State General Budget draft, the 2017-2020 Updated Stability Program and the approval of the State expenditure ceiling for 2018.

In this context, AIReF, based on exogenous assumptions and defined policies, provided the forecasts of the Government's macroeconomic scenario included in the 2017-2020 Stability Program Update (SPU). AIReF considered the Government's macroeconomic scenario accompanying the 2017-2020 USP to be likely as a whole. The basic assumptions concerning the external environment and the evolution of oil prices and interest rates, which underpin the official macroeconomic scenario for the 2017-2020 period, were considered feasible in relation to the most recent international agency forecasts and the latest information on commodities and debt markets. The growth composition was considered plausible, with consolidated domestic demand as the main source of growth, supported by a slightly positive contribution from the Foreign Sector for the whole horizon.

The USP report identified upside risks in the short term for official forecasting, which have been confirmed with the latest update of the Government's macroeconomic picture. High-frequency economic information and the review of analysts' forecasts were already pointing to strong growth rates in 2017 in April, with increases in the official figure presented by the Government in the 2017-2020 USP. With the approval of the spending ceiling for 2018, the Government's growth rate for 2017 has been revised upwards to reach 3%, confirming the materialization of previously identified upward risks.

As indicated in the 2017 SGB report, the projected dynamics for 2017 in terms of growth and employment, together with the return to moderate levels of inflation and wage developments, should positively affect revenue. A positive evolution of salaries would contribute to higher revenue for both personal income tax and for contributions. In addition, this effect would be reinforced in the case of IRPF due to fiscal drag due to the progressivity of the tax and, in the case of contributions, the measures adopted with minimum and maximum contribution bases. Indirect collection should be favoured by the evolution of prices and the corresponding rise in household expenditure in nominal terms and by the recovery of the housing market for both first and second-hand homes.

The assessment of the 2017 revenue forecasts is in line with the improvement in the fundamentals from the macroeconomic environment, which was already anticipated at the beginning of the year as mentioned above, and was therefore included in AIReF's central forecasts. Likewise, all the most recent information from the Monthly Tax Collection Reports from the AEAT was also incorporated, taking into account the persistent uncertainty regarding the effects of the different measures with impact in 2017.

Finally, an expenditure execution in accordance with the application of the expenditure rule, combined with higher nominal growth, would continue to affect the expenditure-to-GDP ratio. The forecast for the 2017 economy, with an accelerated growth in nominal terms, will be around 4.5%, above the projected reference rate for the expenditure rule in 2017 (2.1%). Therefore, increases in expenditure compatible with the reference rate will contribute to the achievement of the public deficit target by reducing the expenditure ratio in terms of GDP.

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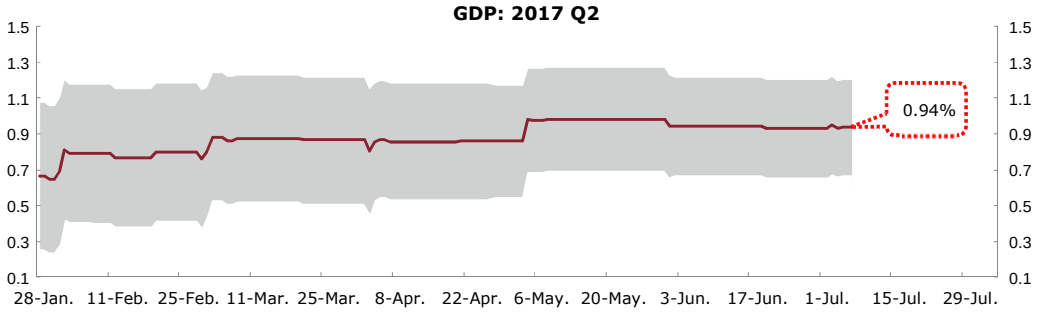
FIGURE 7. EVOLUTION OF 2017Q2 GDP FORECAST IN REAL TIME (INTER-QUARTER RATE IN %)



Source: AIReF

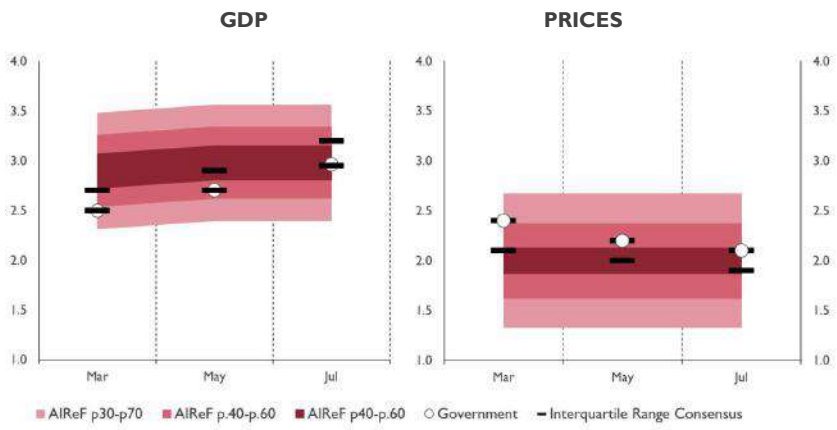
TABLE 1: EVOLUTION OF THE 2017Q2 FORECAST IN REAL TIME (INTER-QUARTER RATE IN %)

CVEC Volume data	Inter-quarter Rates			Inter-quarter Rates		
	2016Q4	2017Q1	2017Q2	2016Q4	2017Q1	2017Q2
GDP to market prices	0.7	0.8		3.0	3.0	
Private final consumption expenditure	0.8	0.4		3.0	2.5	
Final govt. consumption expenditure	-0.2	0.3		0.0	0.1	
FBCF. Equipment goods	0.0	3.0		2.6	4.9	
FBCF. Construction and other FBCF	0.9	1.4		2.0	3.2	
Variation of inventory	11.6	-10.8		13.0	-1.9	13.1
Export of goods and services	2.0	4.0		4.4	8.4	
Import of goods and services	1.8	3.8		2.3	6.4	
Domestic demand contribution				2.2	2.2	
Foreign demand contribution				0.8	0.8	
USP fully occupied	0.5	0.7		2.3	2.2	

Source: INE, AIReF

FIGURE 8. GDP SCENARIO AND CONSUMER PRICES FOR 2017 FORECASTS FROM FUNCAS PANEL, GOVERNMENT AND AIREF INTERVALS.

(% ANNUAL GROWTH)



Source: Government, AIReF and FUNCAS. Intervals at 30%-70%

3. Budgetary stability target and expenditure rule

To meet the targets set for 2017, the Public Administrations will have to make an adjustment of 1.2% GDP in relation to the end of 2016. The GG closed 2016 with -4.3% GDP, with the 2017 target being set at -3.1% GDP. The Agreement of the Council of Ministers of 2 December 2016 established the distribution of this target among the different subsectors. On 31 March 2017, the Government informed the EC of a 2017 closure forecast by subsector different than the targets approved by the Council of Ministers (see 2). In this notice, the deficit forecast for both the CA and the SSF is higher than the approved target, offsetting this deviation with the surplus forecast for the LGs, which, according to the approved targets, would be in balance.

TABLE 2. 2017 BUDGETARY STABILITY TARGETS (% GDP)

Lending (+) Borrowing (-) as % GDP	Close 2016	2017 target ACM 2/12/2016	1st Notification to Commission 31/03/2017
Central Administration	-2.5	-1.1	-1.5
Social Security	-1.6	-1.4	-1.6
ARs	-0.8	-0.6	-0.6
Local Entities	[redacted]	[redacted]	[redacted]
Total General Government	**-4.3**	**-3.1**	**-3.1**

Source: Council of Ministers Agreement and 1st notification to the EC

AIReF continuously monitors compliance with the budgetary stability target at different points in the budget cycle, starting with the Draft or budget lines. AIReF has at different times in 2017 assessed the probability of meeting the deficit target for the GG by updating it with the available information:

- The first assessment of compliance with the 2017 target was made on 25 April. At that time, the deficit target for the GG was considered feasible but demanding. This assessment was made taking into account the closure data for 2016, the information of the drafts and budgets from the different subsectors and the observed data from January and February 2017. The feasibility of achieving the target was based on the fact that the foreseeable deviation that could occur in the CA and SSF subsectors could be covered by the surplus from the LGs.
- This assessment was subsequently revised with the information contained in the 2017/2020 SPU, aggravating the AIReF forecast as a consequence of the inclusion of the possible impact of the Administration's Asset Liability (RPA) for the toll highways. The USP forecasts included about 0.2% GDP in gross capital formation as a result of the potential impact of the RPA in 2017. The inclusion of this new information meant that the assessment needed to be changed.
- The assessment of unlikely compliance was maintained in the assessment of the monthly execution data for March.

To determine the risk of incompliance in this report, the most up-to-date information available has been considered, mainly:

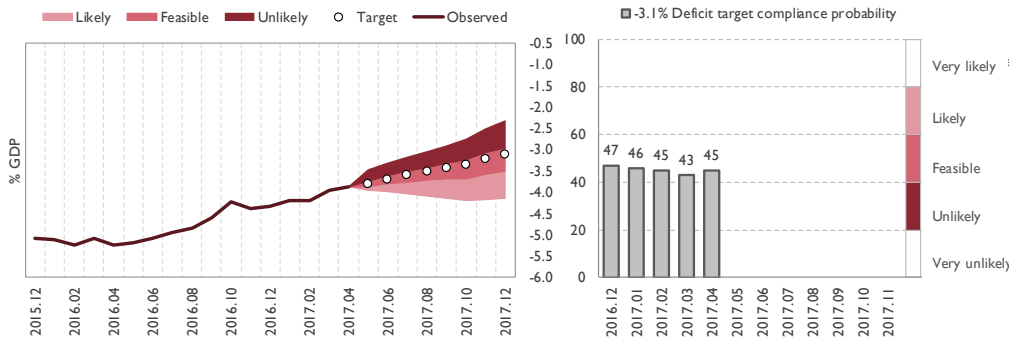
- Updated macroeconomic information analysed in section 1,
- MINHAFP updated information on possible "one offs" included in the 2017-2020 USP,
- Budget execution data available for the GG as a whole and for each of its subsectors[9],
- Information on the final settlement of the 2015 Regional financing system.

The new information available leads to a slight improvement in the assessment of compliance with the target for the GG as a whole. According to the information recently provided by MINHAFP, the impact of the contingency resulting from the "toll highways" could be almost entirely transferred to 2018, slightly improving the forecast for the achievement of the stability target for the GG, as can be seen in Figure 3. The likelihood of complying with the stability target is concentrated on the adjustment for non-financial expenditure, which maintains growth below GDP, reflecting the impact of new RPA information. Despite the strong growth of the Spanish economy, non-financial revenue does not reflect significant improvement, maintaining its weight in GDP at the close of 2017.

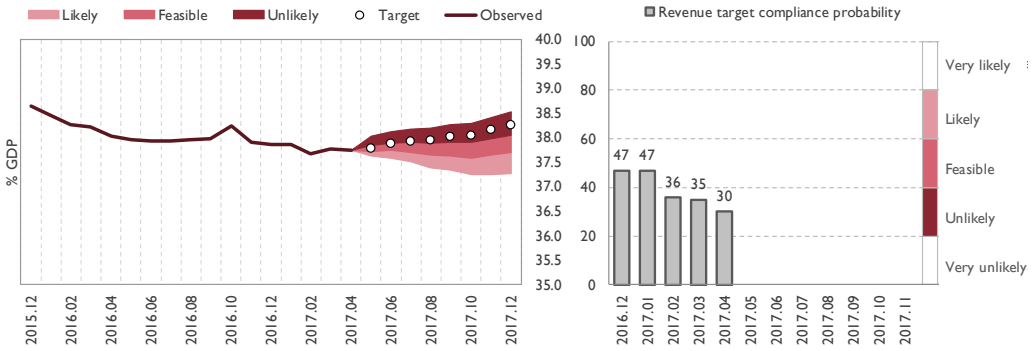
[9] First quarter data for the General Government and data up to April for the Regional, Social Security Fund and Central Administration subsectors has been included, completing the Regional Forecast with the data published for the State in May.

FIGURE 9. TOTAL PUBLIC ADMINISTRATIONS

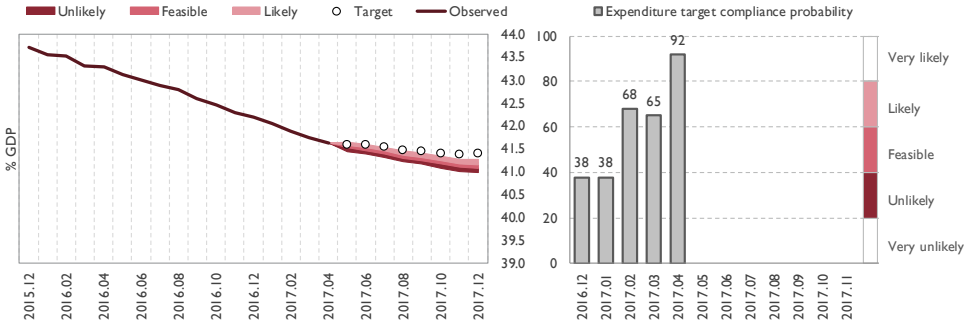
NET LENDING/BORROWING



REVENUE



EXPENDITURE



Despite the feasibility of reaching the target for the GG as a whole, the latest execution data show different situations for each of the subsectors. In can be concluded from the analysis of the available information, which is detailed in the following sections for each of the subsectors, that in order to meet the deficit target, the projected surplus of the Local Government subsector, accompanied by a strict execution of the ARs in accordance with the application of the expenditure rule, would be sufficient to compensate for the deviations that will occur in the SSF and CA. By subsector:

- ✓ **In the CA, despite the lower risk of the toll roads impacting 2017, it is highly unlikely that the target will be met with tensions in non-financial revenue**. The evolution of direct taxes, the impact of the Agreement of the Mixed Commission of the Economic Agreement with the Basque Country of 17 May, which implies lower revenue for this subsector, and the impact of the greater 2015 final settlement in favour of the ARs, make it highly unlikely to achieve the -1.1% GDP target.
- ✓ **It is confirmed that it is highly unlikely that the SSF will fall within the approved target of -1.4% GDP.**
- ✓ **In the ARs, it is considered feasible to comply with the target, and there may be a small margin, provided that expenditure is adjusted to the expenditure rule reference rate.**
- ✓ **The available data on the financial evolution of the LGs point to a surplus in 2017 which could be even slightly higher than the previous year.**

3.1. Central Administration

3.1.1. Stability Target

It is highly unlikely that the CA will reach the approved target for 2017 of -1.1% GDP. To meet the target set for 2017, the CA would have to adjust more than 1.4% GDP compared to the end of 2016. With the information contained in the Draft State General Budget, it was considered unlikely that the target set for this subsector would be met. The assessment of this sub-sector was aggravated in subsequent months due to the following:

- ✓ The impact of the Agreement of the Mixed Commission of the Economic Agreement with the Basque Country of 17 May, which recognizes a State debt for the settlement of the quota from 2011 to 2016 amounting to 1.4 billion euros.
- ✓ The increase in the amount of the final settlement of the 2015 Regional funding system has resulted in a decrease in Regional revenue of about 1.2 billion euros.
- ✓ The information included in the USP showed that in 2017, the administration's asset liability for the toll roads could materialized. Therefore, AIReF's assessment at that moment was worse. However, recent information provided by MINHAFP allows this effect to be reduced, as it will be transferred practically to 2018.

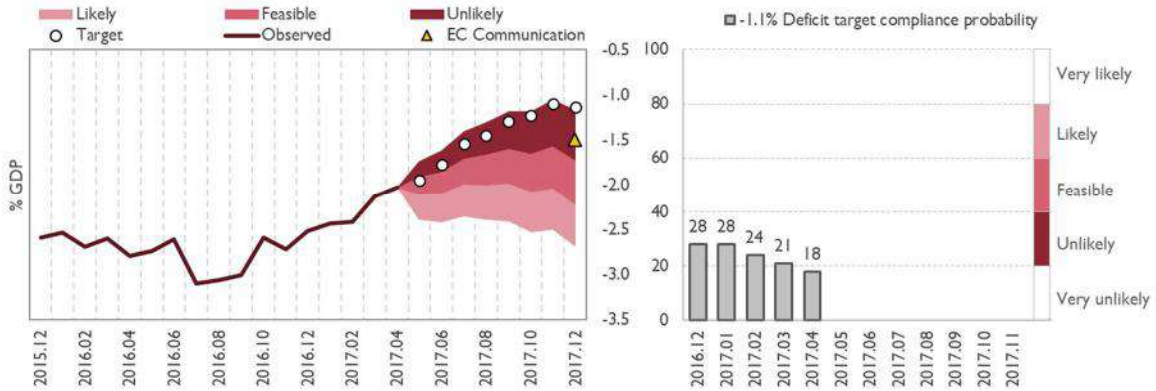
The Government informed the EC of a closure forecast for 2017 four tenths of a percent higher than the approved target but still below the AIReF forecast. In the first notification to the European Union under the Excessive Deficit Procedure, the Government reported a closure forecast for 2017 of -1.5% GDP, higher than the approved target, confirming the risk of deviation indicated in the draft State General Budget.

The projected deficit closure reported by the Government to the EC is lower than AIReF's central forecast. Figure 4 shows the evolution of the assessment made in the first months of 2017, both of the balance and non-financial revenue and expenditure. The AIReF forecast is shown to be more pessimistic than the Government's. As can be seen in the deficit Figure, the CA has made an adjustment in its balance of almost 1% GDP. This adjustment is explained by the following:

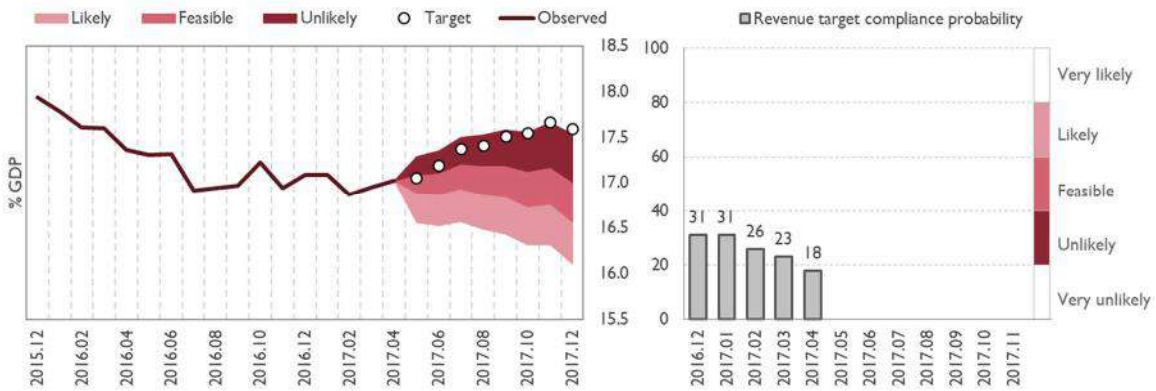
- ✓ The declining trend of non-financial expenditure. The adjustment of non-financial expenditure in the second half of 2016 is due to the impact of the early close Order and the Non-Availability Agreement. In the first months of 2017, non-financial expenditure maintained the declining trend due to the reduction of public consumption and significant items such as interest and transfers from the State to SEPE. This evolution, coupled with new information on the impact of toll roads, makes it feasible to reach a level of expenditure compatible with the target, with an expected adjustment for 2017 of almost one percentage point compared to the end of 2016.
- ✓ The evolution of non-financial revenue, which grew below GDP. The 2016 evolution of tax revenue was affected by the tax reform, whereas in the first months of 2017, the evolution of tax revenue and the loss of the contribution to the Single Resolution Fund have prevented contributions to the adjustment. The AIReF forecasts determine that over the months, revenue will foreseeably close 2017 about three tenths below 2016, mainly due to the possible risks arising from tax collection, which will be analysed in the following section, due to the impact the Agreement of the Mixed Commission of the Economic Agreement with the Basque Country of May 17, 2017 has on this subsector and the increase of the final settlement of 2015 to the ARs. This leads the consideration to pass from unlikely to very unlikely.

FIGURE 10. CENTRAL ADMINISTRATION.

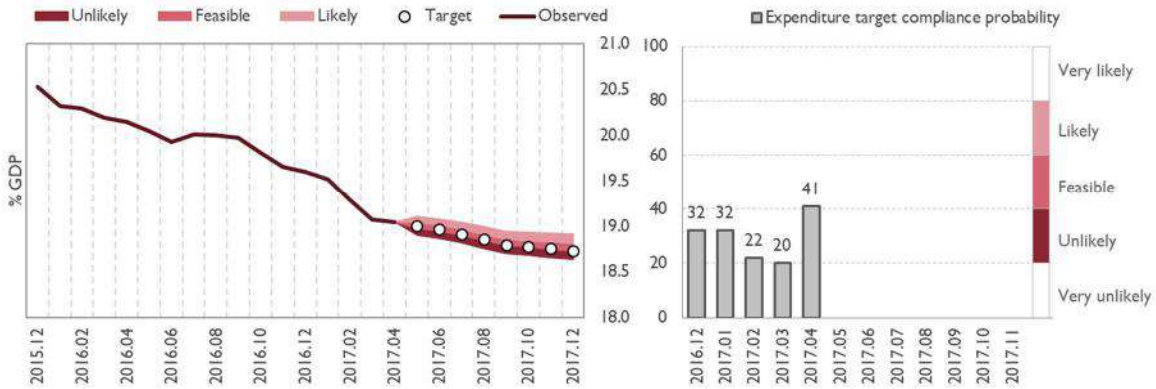
NET LENDING/BORROWING (*)



REVENUE



EXPENDITURE



(*) The 31 March debt and deficit notification sent to the EC included a 2017 closure forecast reflecting a deficit of 1.5% GDP.

Non-financial revenue

It is highly unlikely that the CA will reach the level of revenue that is compatible with its stability target. The AIReF forecasts show a possible risk of deviation from tax collection, mainly in direct taxation which, coupled with the expected evolution of non-tax revenue, makes it very unlikely to achieve a level of revenue compatible with the -1.1% target. See 0).

The analysis of the CA's tax revenue is directly influenced by the evolution of the tax revenues before assignment. The participation of the Territorial Administrations in the tax revenue is established in the Law of Budgets, the transfer occurring during that fiscal year for the forecasted amount regardless of the final result of the evolution of the tax revenue. This means that any upward or downward deviations that may exist during the year in tax revenues subject to assignment[10], are fully transferred to the CA (with some adjustments), since the part transferred to the territorial entities will not be affected until the calculation of the final settlement in subsequent years. Taking this detail into account, the following sections will analyse the main taxes before assignment.

The principle uncertainty of taxes occurs in direct taxation and especially in personal income tax, which grows slightly below nominal GDP, a trend that will continue until the end of the year, at around 6.5% GDP. To date, personal income tax has grown 3.2% in terms of cumulative 12 months[11], driven by the improvement of employment and nominal wages, and the end of the effects of the tax reforms of 2015 and 2016. However, the tax is growing below nominal GDP (which would increase by around 4%), thus slightly decreasing its weight on GDP, at levels of 6.5%. In addition, the growth recorded to date is far from that forecasted in the Budget (which envisages an increase of 7.7% at the end of the year). Therefore, according to the AIReF forecast shown in Figure 5, the Budget target is highly unlikely and, in addition, this likelihood has been reduced as the months have advanced.

Corporate Income Tax revenues are growing at a very high rate and are expected to close by 2.1% GDP in 2017, a gain of two tenths of GDP compared to 2016, but are subject to uncertainties arising from the new tax reforms. Corporate Income Tax has grown 33.5% in terms of cumulative 12 months to date, as it includes a period in which two instalment payments (October 2016 and April 2017) have been made that were much larger than usual with a new minimum payment established (RDL 2/2016). In this manner, the tax at May is 2.2% GDP, increasing by five tenths compared to the same month of the previous year. Although this increase will be qualified when the tax returns are filed, as shown in Figure 5, it will still be feasible to reach the Budget target. However, there are uncertainties associated with the final impact of the measures adopted in RDL 3/2016[12], initially valued at 0.4% GDP (about €4.7 billion) which have not yet materialized. Specifically, according to official estimates, $3.05 billion would be paid in

[10] The taxes subject to assignment are Personal Income Tax, VAT and Special Taxes.

[11] The rates of change that refer to "cumulative terms" and that explain the evolution of revenue, expenditure, balances, taxes and contributions in % GDP are calculated in terms of accumulated twelve months. This is updated using the latest available data: April/May. Nominal GDP used follows the same methodology.

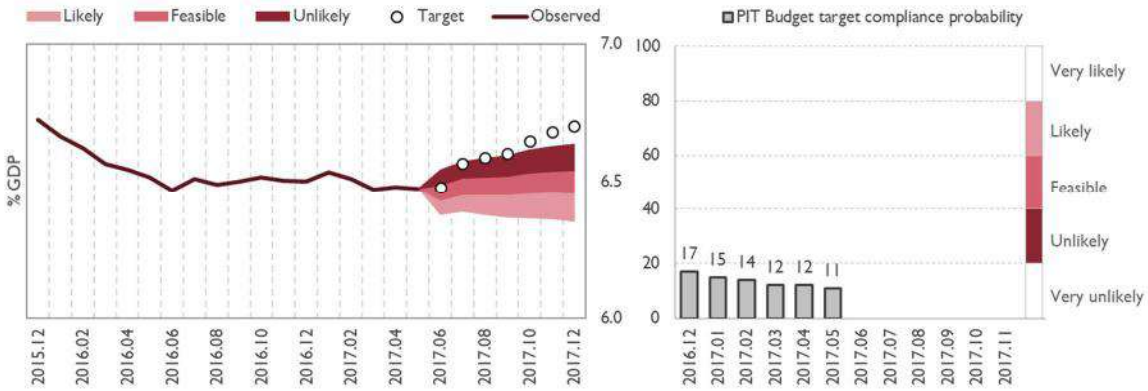
[12] Royal Decree 3/2016, in relation to Corporate Income Tax, includes measures such as the limitation of Negative Taxes and the double tax deduction, the reversal of impairment losses and the limitation of the deductibility of losses arising from the transmission of own funds. For more information on this, consult the AIReF 2017 Draft SGB report.

instalments and the rest, €1.605 billion would be paid in instalments paid in 2017. To date, only €230 million has been paid in the April instalment, so it will be necessary to wait for July's tax quota to know if the measure finally has the forecasted effects.

VAT has grown more than 6% to date, driven by private consumption, with a two-tenths profit expected at the end of the year, which is expected to reach 5.8% GDP. AIReF forecasts the tax to grow at the end of the year in line with the budget target, above 7%, driven by the higher nominal growth of private consumption, given the increase in employment and improvement in the construction sector. However, the likelihood of meeting the target has declined as the months have passed since the AIReF has corrected its forecast of the impact of the VAT tax deferral measure. Initially, the official forecast of the measure was €1.5 billion; as of May, 627 million has been collected[13]. AIReF's new forecast takes into account what will be taken in during the last months of the year through the deferrals that were not granted at the beginning of the year, therefore the net effect would be below €800 million. This correction made the likelihood of complying with the VAT collection in the budget slightly lower although it is expected to remain feasible to achieve the target, gaining two tenths GDP at the end of the year, as shown in Figure 5.

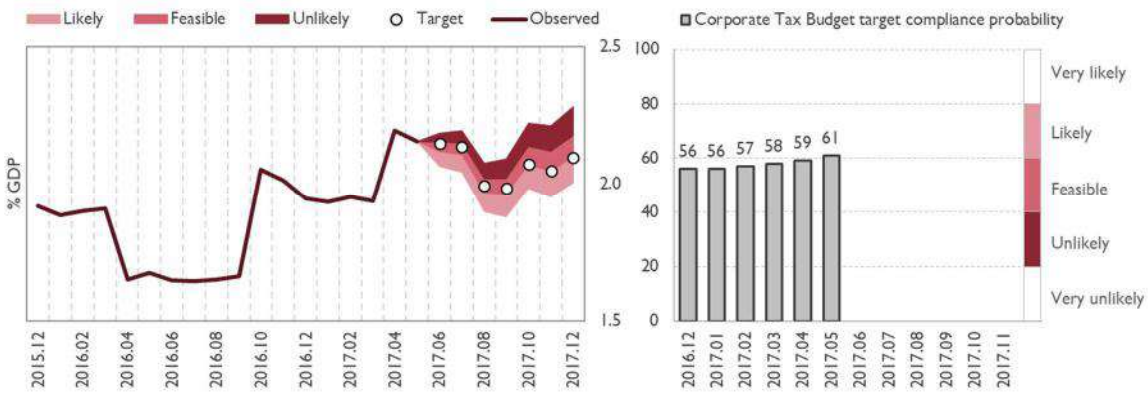
Special taxes have grown below GDP, mainly weighted by tobacco and electricity taxes, which have not shown significant growth, with a close slightly below the previous year. AIReF projects that excise taxes will grow at the end of the year even slightly below this figure, given that consumption will not evolve at very dynamic rates, therefore growth will be below nominal GDP, with collection decreasing as a percentage of GDP, despite the pull of hydrocarbons and alcohol. The projected evolution of excise duties leads to the consideration that the SGB forecast of a 4.5% increase is unlikely

FIGURE 5. TAXES PAID – PERSONAL INCOME TAX

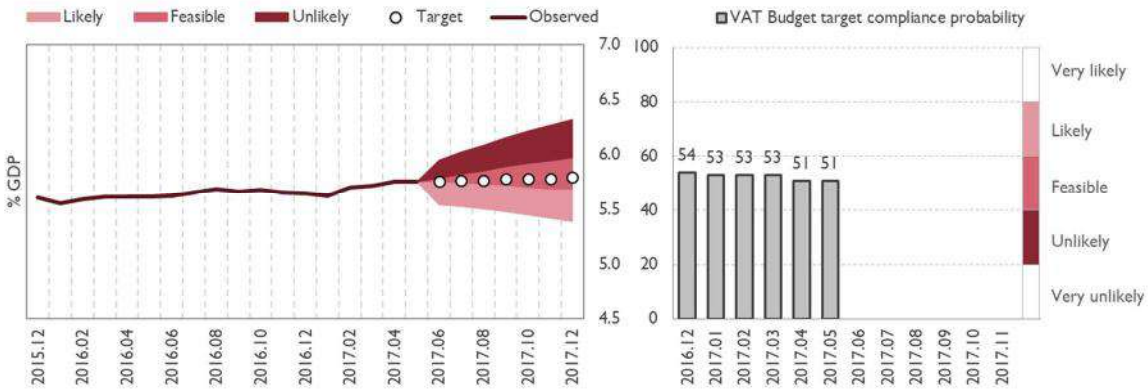


[13] According to the information contained in the May Monthly Tax Collection Report from the AEAT.

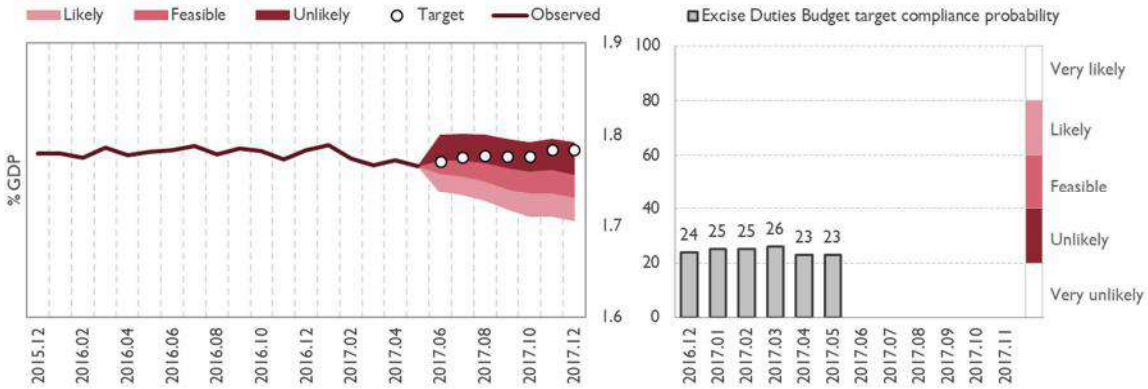
CORPORATE INCOME TAX



VALUE ADDED TAX



EXCISES DUTIES



BOX 1. EFFECT OF REVENUE POLICY CHANGES

In Spain, since 2000, there have been numerous regulatory changes in the principle direct and indirect taxes. These changes, both in types and bases, have affected the current collection level so it is necessary to refine these series of regulatory changes to see the effect of macroeconomics on public revenues.

An exercise has been carried out to correct the principle tax series of these regulatory measures to see it, in their absence, tax collection in terms of GDP would be above or below current levels. It should be noted that the series of regulatory changes have been obtained from the tax collection reports published by the AEAT on a monthly and annual basis. The comparison is made since the year 2000, leading to an output gap this year close to zero and until the most recent available year, 2016. The methodology assumes that that in the baseline year, 2000, the observed revenue (T_0) and the adjusted revenue (T_0') are equal. In the following year, 2001, adjusted revenues (T_1') are obtained by subtracting the discretionary measures of that year (DM_1) from observed revenues (T_1):

$$T_1' = T_1 - DM_1$$

For the following years, the series have been corrected using three approaches:

- ✓ Proportional approach: (according to the Barrios and Fargnoli method, 2010): this method has been used for measures affecting bases and/or rates and/or deductions:

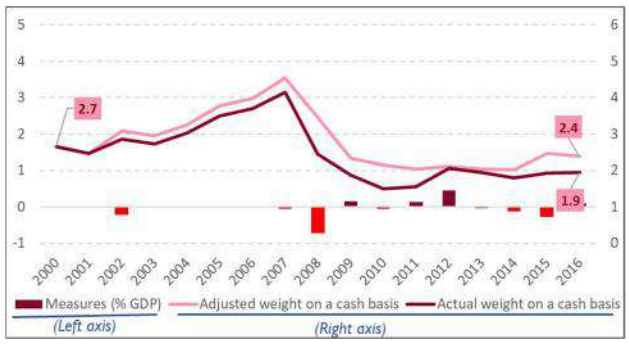
$$T'_j = T'_1 \prod_{i=2}^{j} \frac{T_i - DM_i}{T_{i-1}} \ \forall \ j = 2, \dots, n$$

- ✓ Non-proportional approach: Used for those measures that do not impact any of the above elements, therefore, for measures that do not affect the tax structure.
- ✓ Financial approach: used for the measures that do not have an effect on collection, but a purely financial effect.

Using these methodologies, the following conclusions can be drawn on the series of direct and indirect taxes paid in terms of GDP.

PAID PERSONAL INCOME TAX (% GDP)

PAID CORPORATE TAX (% GDP)

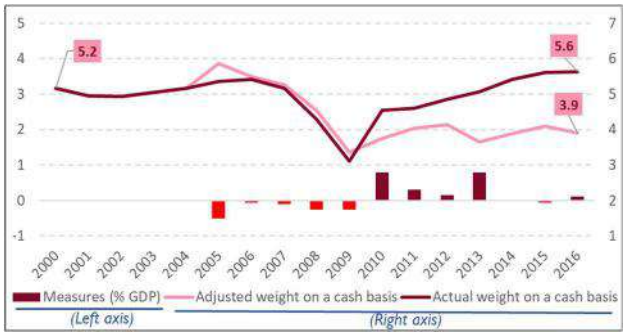


In relation to direct taxes, Personal Income tax shows significant differences between the adjusted and unadjusted series. Until 2009, all reforms had a negative impact on collections, the most significant being the reduction of rates and the modification of the 2003 scales and the deduction of 400€ for workers in 2008, which led the series to diverge. On the other hand, reforms undertaken during the crisis period, including consolidation measures such as the abolition of the €400 deduction and the 2012 rate surcharge, led to the rapprochement between the series. Finally, the effect of the last fiscal reform of 2015 and 2016 is seen in

the Figure. As a result of the measures, Personal Income Tax stood at around 6.5% GDP in 2016 whereas, in the absence of the measures, it would have reached 8%.

Under Corporate Income Tax, up to the cyclical maximum reached in 2007, the series are similar. The first measure of great impact is the drop in rates from 35% to 30% applied in 2008, which produced a gap between the series. In the crisis stage, consolidation measures were adopted, focused on split payments, financial expenditure and amortizations, which made the series coincide in 2012. However, the aforementioned fiscal reform of 2015 and 2016 led to Corporate Tax collection at a level of 1.9% GDP, while in the absence of the reform, the level would have been 2.4%. Therefore, for both taxes, the absence of measures would have led tax collection as a % of GDP to be higher.

VAT PAID (% GDP)



SPECIAL TAXES PAID (% GDP)

In indirect taxes, there has been the opposite trend. In both VAT and Special taxes, revenue as a % of GDP in 2016 would have been lower in the absence of the measures. In the case of VAT, measures until 2009 are purely financial in nature. In 2010, financial measures were combined with impact measures on the structure of the tax, with the raising of rates from 16% to 18% and from 8% to 10% in the case of reduced rates. In 2012, there was a second increase in rates from 18% to 21% in the general rate and a reclassification of products from the reduced to the general rate. In the absence of the measures, revenue would have reached 3.9% GDP while with the measures, it has reached 5.6% GDP. In the case of Special Taxes, all measures have been consolidation measures with rate increases in tobacco, alcohol and hydrocarbons and the reform of environmental taxation. If the measures had not been implemented, collections would have been 1.3% compared to 1.8% in 2016.

By taking jointly the measures of direct and indirect taxes, the net effect is practically null because they compensate for each other. Therefore, in the absence of measures, tax revenues would have been similar to the current collections although with a different composition.

AIReF has not included any measures to combat fraud in its measures. In July, the new system for the Immediate Provision of VAT Information (SII) came into force, which establishes for large companies the obligation to forward, within a period of four days the details on invoices that must be recorded in the VAT Invoice Record Book. The official projection for this measure was 350M€. However, AIReF ha not included this amount into its forecast since there is no data on the measure's effectiveness.

On the other hand, taxpayers receiving the SII will increase the term of their monthly declarations by ten days, with their maturities changing from the 20th of the following month to the 30th. As a result of this measure, there will be a temporary displacement of cash receipts as the VAT declarations corresponding to November will be paid until December 30 and will be considered cash for the month of January of the following year. However, in terms of national accounts, the measure has no effect as the time the payment is made is not important but the period in which the accrual occurs.

Finally, the announced measure of the modification of the regulation on the publication of debtors' listings to the Treasury for debts or tax penalties, provided for in article 95 bis of the LGT, to encourage payment of the amounts owed, has not been approved. The impact of these measures was estimated at 150M€, which have not been included in the AIReF forecasts since there was no legislative change.

The foreseeable deviation in pre-assignment revenue poses a clear risk for CA revenue. The risk is particularly pronounced in the case of direct taxes for the forecasted deviation in Personal Income Tax. The CA Income Taxes in National Accounts include the Income Tax payment data, after the deduction of the assignments to the territorial entities, together with the Corporate Income Tax and Non-Resident Income Tax. Also, the National Account adjustments projected by AIReF are considered.

The CA taxes in National Accounts have grown 5% until April. Income taxes in National accounts have increased 10%, included the April Corporate Income tax instalment payment which was larger than usual. However, once this effect is diluted, AIReF projects much more moderate growth in direct taxes. On the other hand, taxes on production and imports have grown only 1.4%, despite the good performance of VAT, mainly because they no longer include the credit entity contributions to the FUR. These contributions were channelled in 2016 through the FROB and in 2017, they were made directly by the entities[14].

Although tax growth has been dynamic, revenue has grown much more moderately. Until April, revenue has grown by 1.9% since many of the components of non-tax revenue, such as dividends, sales and transfers have dropped.

Revenue is projected to grow at the end of the year by about 2.5%, reducing its weight in GDP by three tenths compared to 2016, as there are additional elements that negatively affect its evolution. In addition to the risks derived from the possible deviation in tax collection and the evolution of non-tax revenue, other elements are produced that will make it difficult to achieve the stability target**:**

[14] This element has no effect on the public deficit, since the provision of that Fund was recorded in the same year as an expense on other capital transfers, included in other expenditure.

- The impact of the increase of the final 2015 settlement of the financing system to the Territorial Administrations amounting to 1.2 billion euros. The AIReF forecasts have considered that this settlement will fundamentally reduce Income Tax collection corresponding to the CA.
- The agreements with the Basque Country Region, which have resulted in a reduction in CA revenue (current transfers received) of about 1.4 billion euros.

Non-financial expenditure

The trend of consolidation of non-financial expenditure has maintained, which is projected to register an adjustment of almost one percentage point of GDP compared to 2016. As shown in Figure 4, non-financial expenditure continues its downward trend due to the drop in significant items such as public consumption, interest expenses and transfers between Public Administrations, which drop due to the reduction of the transfer from the State to the SEPE and a growth below GDP of the other transfers. Nevertheless, there are items such as investment aid that continues a strong growth trend, conditioned, inter alia, by the impact of the costs of the bank restructuring process, or non-in-kind transfers, which have also increased slightly above GDP.

Employee compensation shows an accumulated drop of 0.4% until April without reflecting the impact of the 1% update of staff compensation. After the approval of the GSB, public employee compensation will be updated. However, this growth will be nullified by the repayment of the 50% extra pay from 2012 that was paid in May 2016, so it is projected that, despite the update, the updated compensation for 2017 will be lower than that of 2016, decreasing one tenth of a percentage point of GDP.

The downward trend in interest expenses during recent months continues and are projected to decrease two tenths of a percentage point of GDP with respect to 2016. The evolution of interest expenses continues to reflect the impact of the expansionary monetary policy and the lower pressure of the Spanish risk premium, decreasing by 7% in cumulative terms up to April. AIReF forecasts lead to a reduction in the interest burden compared to 2016 of two tenths of a percentage point of GDP, and there may be some margin over the forecasts included in the 2017 GSB, as anticipated in the Draft GSB Report.

Non-in-kind transfers maintain accumulated growth until April higher than GDP growth. This is conditioned by the evolution of the passive classes, which grew until May to 3.9%[15], in line with AIReF forecasts, and by the evolution of other benefits such as deductions for maternity, large families and disability benefits.

Gross capital formation is strongly conditioned by the impact that will finally be felt from the administration's asset liability for toll highways. In the first months of 2017, gross capital formation begins to show a slight increase. The information provided by MINHAFP regarding the Administration's asset liability for toll highways indicates that it will have residual or almost zero impact in 2017, being transferred to 2018. By including this information, as shown in Figure 4, the likelihood of the previous assessments is considerably improved, with 2017 non-financial expenditure being considered compatible with the target.

[15] Cash flow data for passive classes.

Investment aid and other capital transfers[16] increased by 24% compared to April 2016, mainly due to the impact of transfers to public companies and the Deposit Guarantee Fund. Despite the fact that the contribution to the FUR in 2017 is no longer expenditure or revenue when carried out directly and not through the FROB, investment aid is growing significantly compared to 2016. This increase is mainly due to the impact of the payment made by the Deposit Guarantee Fund in 2017 to cover the Asset Protection Plan granted to Banco CAM, S.A. Certain transfers to public companies that were not affected by the Non-Availability Agreement in 2016 also impact this item if they are projected in the 2017 SGB.

In order to properly monitor non-financial expenditure, it would be essential to provide greater transparency to the potential obligations and risks that the CA may have to assume in the short-term. As previously mentioned, the SGB does not include information on possible responsibilities that must be faced by Public Administrations arising from judgments, information on private public partnerships or other risks that may affect the Public Administration's budgetary stability targets and financial sustainability targets that could be derived, for example, from delinquent loans. This information is also not included in the monthly information on execution data from the different Public Administrations, which makes it difficult to monitor. See Box 2.

[16] Excluding those expenses that qualify as financial aid.

BOX2. TRANSPARENCY AND CONTINGENT LIABILITIES

The Public Administrations accounts may be affected by “potential” tax obligations whose impact depends on the occurrence of specific and independent facts that are known as “contingent liabilities”. Contingent liabilities may have a different economic nature, with examples such as the guarantees granted, delinquent loans or indemnities derived from judgments or other liability procedures faced by the Public Administrations. Contingent liabilities are characterized in that, in most cases, the conditions that determine their value are not known, since they depend on the occurrence of future or uncertain events. The level of uncertainty in their amount and the concurrence of the specific conditions for payment is the main difficulty these operations present for the accounting and statistical systems.

Directive 2011/85/EU, on Transparency in Public Finance and the overall scope of budgetary frameworks, stipulates that Member States should publish information on the following categories of contingent liabilities: guarantees, delinquent loans and liabilities from public corporations. Although the publication of this information complies with the requirements laid down by Community Legislation, with the aggregate nature of the information by subsector, the failure to identify the main operations included in each of the categories, together with the absence of an assessment of the probability and the year in which the risks could materialize, this information remains ineffective as a useful instrument to assess the possible impact of the risks on public accounts. Contingent liabilities may evolve in a way that was not initially anticipated and continuous assessment is necessary to determine the likelihood of an impact on public accounts.

In recent years, Public Administration accounts have borne the economic impact of the materialization of certain contingent liabilities, such as the judgment of the so-called "sanitary cent" on the CA or the reclassifications of various Public Private Associations in Regional governments or in some cities. Of particular relevance are the guarantees granted in the banking restructuring processes and the financial economic situation of entities such as SAREB. An example of these guarantees that currently impacts on the accounts of the CA are the transfers made by the Deposit Guarantee Fund within the framework of the Asset Protection Scheme coverage granted to the CAM.

In a scenario such as the current one, with some demanding deficit targets for the different subsectors, the materialization of a contingent liability in a given year may lead to non-compliance with the stability targets and affect public debt. It is therefore important to improve transparency of public accounts and include information on existing contingent liabilities in the various Administration Budgets with an assessment of the likelihood of their realization and their economic impact. This information should be duly updated in the event that situations occur that modify the probability of its realization.

3.1.2. Expenditure Rule

The 2017 GSB does not include any information regarding compliance with the expenditure rule. As noted in the 2017 Draft SGB Report, no information was included on the components that affect the expenditure rule or its possible compliance in 2017. AIReF recommended in its Draft SGB Report the inclusion of the information on non-financial expenditure in terms of SEC 2010 as well as the projection of the regulatory impacts that affect computable expenditure for the purposes of compliance with the expenditure rule detailed for adopted measures. This information has not been included in the 2017 SGB approved on 28 June.

The CA may comply with the Expenditure Rule in 2017. According to the AIReF forecasts, the CA could comply with the expenditure rule in 2017, as shown in Figure 6. The expenditure forecasted in the SGB presents increases compatible with the projected 2017 reference rate. In

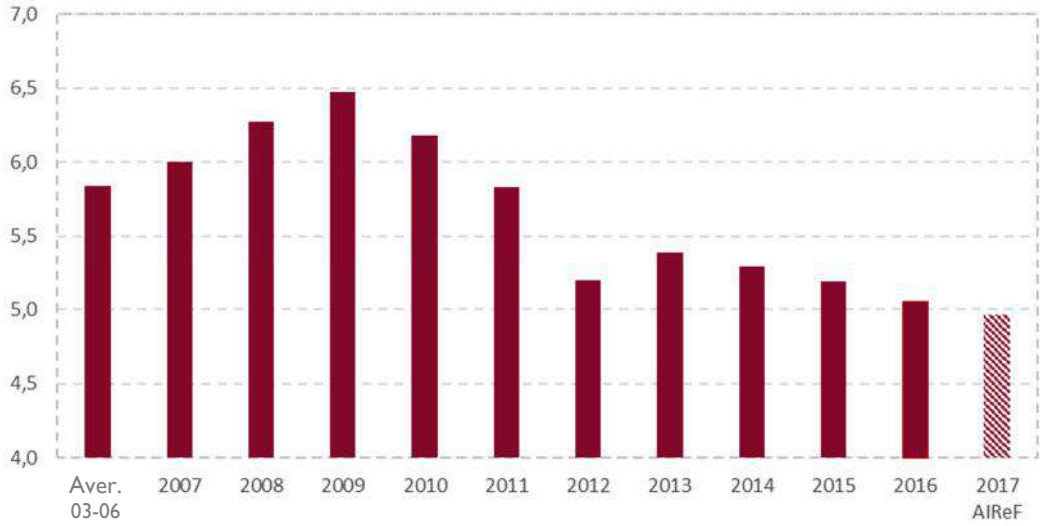
addition, in 2017, the CA adopted regulatory measures that could lead to a permanent increase in collections, contributing to the expectation of compliance with the expenditure rule. However, there may be tensions in compliance with the expenditure rule in the event that the tax regulatory changes do not have the expected tax effect and from the impact that the new regulation of the Competitiveness Fund of the Canary Island Region may have for the CA, for the purposes of the expenditure rule.

FIGURE 6. CENTRAL ADMINISTRATION COMPUTABLE EXPENDITURE WITH EXPENDITURE RULE AND NET LENDING/BORROWING

Source: 2013-2016 IGAE target compliance report and AIReF 2017 forecast

Figure 7 shows that in 2017, the computable expenditure items that should support the adjustment to comply with the expenditure rule, once the passive classes and contributions to the European Community that present greater rigidity are excluded, have reached historic lows as a result of the consolidation process in recent years.

FIGURE 7. EVOLUTION OF CENTRAL ADMINISTRATION EXPENDITURE EXCLUDING PUBLIC ADMINISTRATIONS TRANSFERS, INTEREST, PASSIVE CLASSES AND EU CONTRIBUTIONS (%GDP)



Source: IGAE and AIReF forecast

3.2. Social Security Funds

Compliance with the 1.4% GDP deficit target for the SSF is considered highly unlikely. Although this year's target was set substantially more realistically, it is still highly unlikely the SSF will reach the level of revenue needed to meet the SGB forecasts and to make the adjustment of two tenths of a percentage point GDP required for 2017, as shown in Figure 8. The stability targets approved for 2017 in the Council of Ministers Agreement of 16 December 2016 established a deficit target for the SSF of 1.4% GDP which was maintained in the SPU presented in April 2017. However, the first notification sent to the EC on 31 March reported a deficit forecast of -1.6% GDP, in line with AIReF forecasts.

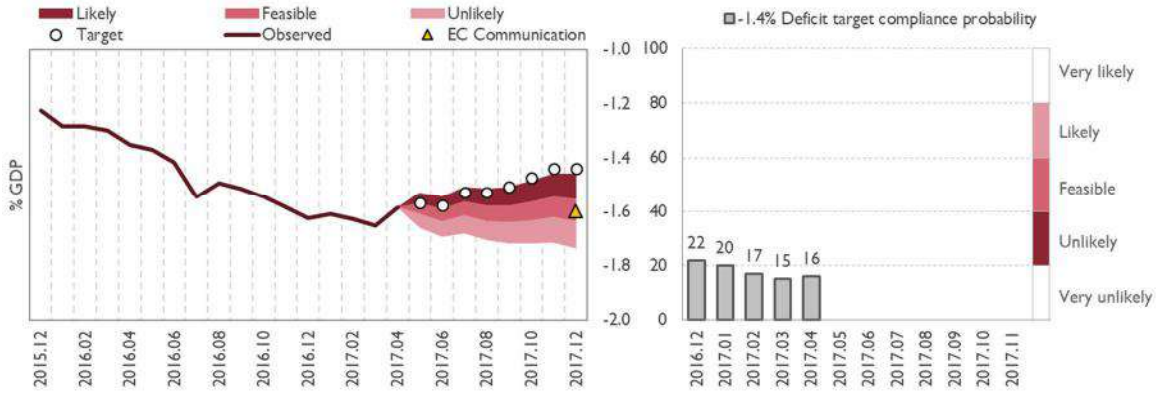
Social Security affiliation reaches inter-annual growth rates not registered since before the crisis. The number of Social Security affiliates increased at a year-over-year rate of 3.8% in June, which is 672,800 more workers and is slightly above AIReF's annual forecast. This rate is five tenths higher than the average for the last 12 months and the highest rate recorded in June since 2006.

AIReF forecasts for the end of 2017 put revenue at 12.6% GDP, three tenths below the end of 2016. SSF revenue in accumulated 12-month terms until April reached 12.8% GDP, six tenths less than in April 2016. This reduction is explained by the lower transfer from the CA to the SEPE and by the lower Fixed Deposit interest rates. In terms of variation, Social Security Revenue in accumulated 12-month terms reduced 0.5% until April, a reduction that will moderate during the year thanks to the positive evolution shown by contributions. The AIReF forecast projects that SSF revenue at the end of the period will grow at a rate slightly above 2%. In this sense, the contributions in accumulated terms grow in April to 3.8% and it is projected that they will end the year at a rate close to the growth of nominal GDP, recovering its historical elasticity close to one.

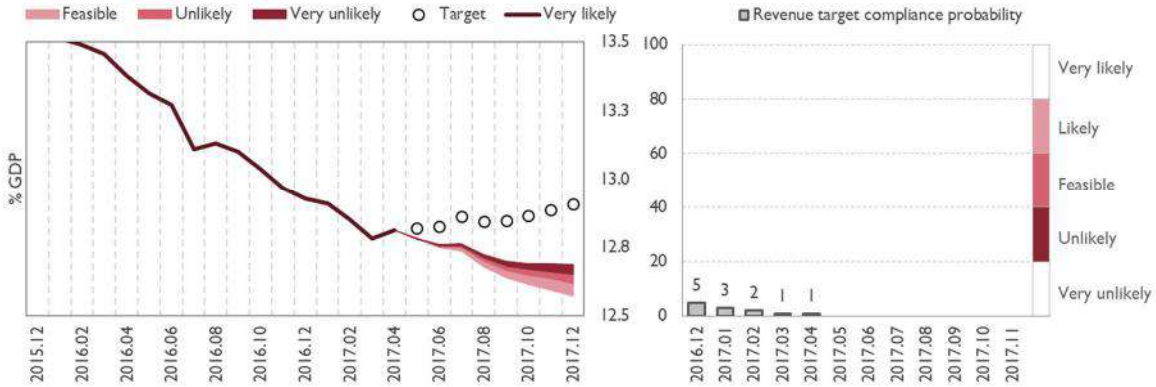
The AIReF forecast for the end of the year places expenditure at 14.2% GDP. Non-financial expenditure in accumulated 12-month terms in April represent 14.4% GDP, three tenths less than in April 2016. In rates variation, expenditure increases 1.5% until April, well below accumulated GDP growth. AIReF projects that this dynamic will accelerate throughout the year, moderating the drop in the ratio of expenditure to GDP. This effect would be due to the growth in pension expenditure, which will remain at 3%, in line with the SGB forecast and recent trends. It is also due to the evolution of unemployment benefits, especially non-contributory benefits, which will moderate its drop, reflecting the greater dynamism of the labour market and the depletion of benefits.

During 2017, both revenue and expenditure reduce their weight in GDP, keeping the deficit forecast in line with the close of 2016. The recovery of inflation and wages coupled with robust growth in real terms will allow GDP to accelerate in nominal terms by 2017 above the projected growth of SSF revenue and expenditure. The reduction in expenditure offsets the reduction in revenue as a percentage of GDP by keeping the SSF deficit at 2016 levels.

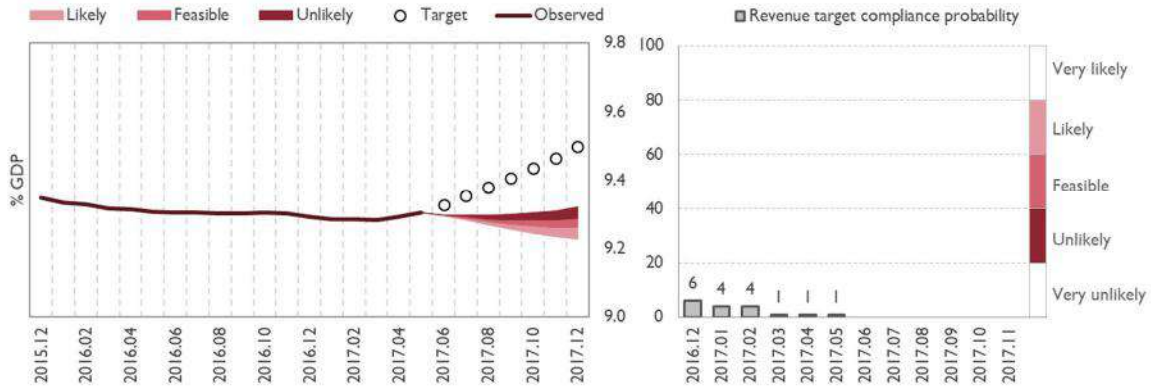
FIGURE 8. SOCIAL SECURITY FUND – NET LENDING/BORROWING

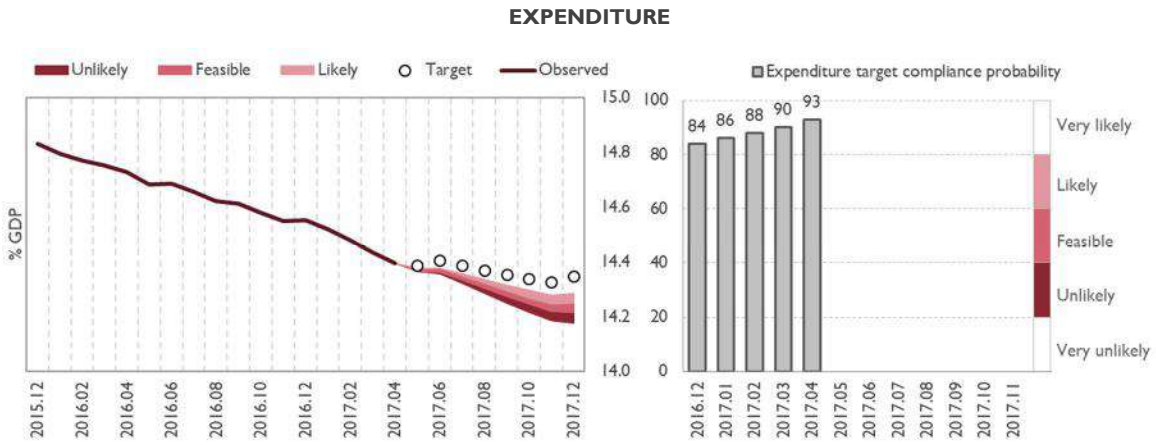


REVENUE



CONTRIBUTIONS





Analysis by agent

Social Security System

According to AIReF forecasts, in 2017, the Social Security System will maintain a deficit similar to that of 2016. The improvement in contributions, although important, will be partially offset by the drop in interest revenue from the Reserve Fund, resulting in total revenue increasing less than expenditure. The expenditure increase is mainly due to the pensions and temporary disability benefits.

The evolution of the labour market and the measures adopted to increase the contributory basis will allow growth in contributions of about 4.5%. This growth is higher than in 2016, but still far from the 6.8% projected in the 2017 SGB. The AIReF forecast models updated with the latest macroeconomic forecasts, which include the 3% increase in the maximum contributory bases, weighted by the data on budgetary execution available until May allows us to anticipate growth in employment contributions of about 5.5%. The 8% increase in the minimum contribution bases, although relevant, does not have a significant impact on collections. The budgetary execution data in May reflect a growth of 5.3% in employment and a -4.9% reduction in unemployment.

The yields from the Reserve Fund continue to decline even though the State loan will not allow it to be depleted in 2017. After reaching a maximum level of 66.815 billion euros in 2011, the Reserve Fund has been using its resources until the end of 2016 with an amount of 15.02 billion euros (1.4% GDP). The Social Security Mutual partners have contributed the surplus from the Temporary Disability benefits for common contingencies during the entire crisis period, although in 2016 the contribution was very small, a trend that is expected to continue. In July 2017, 3.514 billion euros have been used from the maturities and coupons from the fund of the total of 7.3 billion euros projected in the 2017 SGB. After this forecast, the Reserve Fund accumulated 11.602 billion euros.

Part of the loan granted by the State to the Social Security System is available. In July, 5.986 billion euros were made available out of the 10.192 billion euros provided in the 2017 SGB from the State loan. This loan is included in the ninth additional Provision of the 2017 State General

Budget and is granted without interest and with a maximum cancellation period of 10 years starting in 2018. There is uncertainty about the consideration of this loan in national accounts, since it could be considered a transfer of capital by the subsidized part of interest or by the totality of the loan in case the non-accrual of interest and/or uncertainty of repayment prevented its consideration as a financial transaction in accordance with this methodology. Information has been requested from MINHAP, but as of yet, no reply has been received. This operation could lead to a larger CA deficit and a lower SSF deficit.

Despite the 0.25% revaluation, pension expenditure will grow in 2017 at a rate of 3% that is maintained for the fourth consecutive year. The expenditure forecasts included in the 2017 SGB are in line with the AIReF forecasts, with an 1.2% increase in the number of pensions and a replacement rate of 1.6%. This year, for the first time, detailed information on the calculation of the PRI formula parameters was published, with the information published by the Ministry of Employment & Social Security. It is worth noting that a 3% reduction would have to be applied to pensions to balance the system if there was no minimum revaluation of 0.25%. AIReF recently published its opinion on the PRI confirming the 0.25% increase and making several observations on the medium-term forecasts provided by the Ministry of Education & Social Security.[17]

Again in 2017, there is a slight insufficiency in the allocation of expenditure for temporary disability benefits. The 2017 Budget provided for an increase in spending to cover the 2.1% Temporary Disability Benefit, while data on budget execution in May show a growth of 8%. This growth shows the progressive recovery of the levels prior to the crisis of this service. If the rhythm of execution of other years is maintained, an insufficiency will be generated in this item, which could reach 500 million euros.

Since the start of the current legislature, the Toledo Pact Commission is studying possible proposals to present to the Government on the pension system. Experts on pensions, employment and demography have appeared before this Commission. The AIReF President offered an analysis of the medium and long term vision of the pension system. The Commission's work must conclude with recommendations, but an agreement is still pending between the different political groups.

State Public Employment Service (SEPE) and Wage Guarantee Fund (FOGASA)

The State Public Employment Service will forecast a surplus similar to that from 2016, compared to the balance projected by the 2017 draft SGB. The surplus is mainly a result of contributions that grow above the 2017 SGB forecast, but also because of a much lower than expected unemployment benefit expenditure. The reduction in unemployment benefit expenditure will be around -9%, higher in non-contributory benefits than in contributory benefits. According to AIReF forecasts, this expenditure's weight in GDP will reach pre-crisis levels by 2017.

AIReF's forecast for SEPE contributions for 2017 is close to 5.5%, above the 3.5% forecast by the SGB. Although budgetary execution data still do not show the projected growth in

[17] 2017 PRI Opinion

contributions (in May, contributions grew 3.4%), the national accounts data show significant growth rates, above 6%. This difference is not explained in the publications, which makes it particularly difficult to monitor this agency.

Unemployment benefits continue to drop, mainly non-contributory benefits. Contributory benefit expenditure, which represents 63% of the total benefit expenditure, has dropped to 2006 levels while non-contributory benefit expenditure almost doubled the 2006 figure.

Transfers from the CA to the SEPE fell 0.2% GDP. The improvement in contributions and the reduction in benefits expenditure are reflected in the lower contributions from the CA to the SEPE. As was also the case in 2016, SEPE contributory revenue will be higher than the unemployment benefit expenditure.

Regarding the FOGASA, the 2017 deficit is forecasted to be less than in 2016. The latest published budgetary execution data shows a non-financial expenditure for FOGASA which is substantially reduced compared to May 2016, while prices are growing at around 2%. Despite the smaller CA transfer, the 2017 deficit will be in line with the 2016 deficit.

3.3. Autonomous Regions

3.3.1. Stability target

The final settlement of the 2015 financing system and the new available information increase the likelihood of the ARs as a whole meeting the target at closing and, in the cases of Andalusia, the Principality of Asturias, Cantabria, Castilla y León, Extremadura, Galicia and Navarra, represent an improvement over the last rating assigned. AIReF has elevated the probability of the Regional subsector complying with the target at the end of the year, mainly due to the final settlement of 2015 that will be received in 2017, which has meant an increase of 1.2 billion euros with respect to the data available when the 2017 budgets were drawn. In the case of Navarra, the improvement was mainly due to the favourable evolution of the execution data. Finally, for the ARs of Navarra, Cantabria and Extremadura, which had problems meeting the 2017 stability target, the improvement has meant a change in the rating of the likelihood of compliance, but only in Navarra has this change helped the Regional group be able to reach its target.

The analysis now allows us to differentiate between to Regional groups (see 0 and 0):

- 12 ARs where it is forecasted that the target could be met with various degrees of likelihood:
  - ✓ Very likely: Andalusia, Asturias, Illes Balears, Canary Islands, Galicia and La Rioja.
  - ✓ Likely: Castilla León and Madrid.
  - ✓ Feasible: Catalonia, Castilla-La Mancha, Navarra and the Basque Country[18].
- 5 ARs where it is forecasted that the target will not be met, with various degrees of likelihood:
  - ✓ Unlikely: Extremadura, Cantabria, Aragón and Valencia.
  - ✓ Highly Unlikely: Region of Murcia.

For the ARs with a 2017-2018 EFP, the likelihood of compliance with the 2017 target has, where appropriate, resulted in AIReF issuing recommendations to report these EFPs. The 10 ARs that are required to submit a 2017-2018 EFP for failing to meet the stability target and/or the expenditure rule for 2016 have sent the EFP for a previous AIReF report. However, while the reports from three regions (Extremadura, Murcia and the Basque Country) have already been published, later changes regarding the final settlement data from 2015 to be received in 2017 and the 2018 stability target have meant that the EFP scenarios have to be redone, leading to delay in the Reports to be issued with respect to those that have not yet been reported. Once this information has been included in the EFP scenarios, the reports from the remaining 7 regions (Catalonia, Cantabria, Valencia, Aragon, Galicia, Andalusia and the Canary Islands) and the updates from the previous reports will be published at the same time as the Reports on forecasted

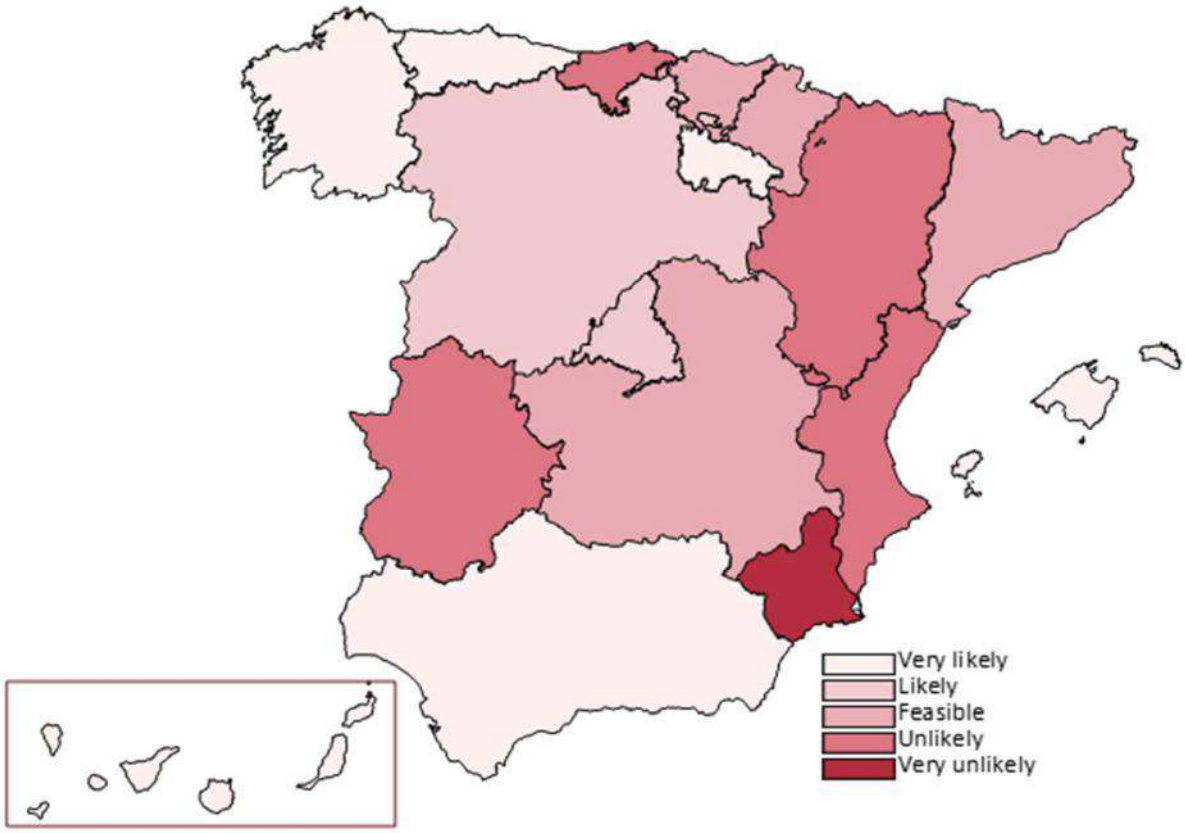
[18] For the basque Country, the likelihood of compliance could be feasible to highly likely, depending on the internal agreement reached with the Provincial Councils to distribute the positive effect derived from the regularization of the overdue quota amounts.

compliance at the end of 2017 to expedite the approval process and the implementation of the plans. The consideration of the likelihood of compliance with the 2017 targets have resulted in EFP Reports including recommendations aimed at credit retention and/or exploring tax margins in relation to some taxes.

TABLE 3. COMPARISON OF THE LIKELIHOOD OF COMPLIANCE WITH THE -0.6% GDP TARGET IN 2017

REGIONS	Probability of compliance with target -0.6% GDP	
	Rating in the previous report published	Current rating
Andalusia	Likely	Highly Likely
Aragón	Unlikely	Unlikely
Asturias	Likely	Highly Likely
Illes Balears	Highly Likely	Highly Likely
Canary Islands	Highly Likely	Highly Likely
Cantabria	Highly unlikely	Unlikely
Castilla y León	Feasible	Likely
Castilla-La Mancha	Feasible	Feasible
Catalonia	Feasible	Feasible
Extremadura	Highly unlikely	Unlikely
Galicia	Likely	Highly Likely
Comunity of Madrid	Likely	Likely
Region of Murcia	Highly unlikely	Highly unlikely
CF de Navarra	Unlikely	Feasible
Basque Country	Feasible	Feasible
La Rioja	Highly Likely	Highly Likely
Comunitat Valenciana	Unlikely	Unlikely

FIGURE 9: ESTIMATES PROBABILITIES OF COMPLIANCE WITH THE 2017 STABILITY TARGET



AIReF considers compliance with the 2017 stability target at the end of the year to be likely for the ARs as a whole. AIReF improves the likelihood of compliance assigned by reporting baselines and initial budgets. In the above reports, compliance with the target was considered feasible given the increase of 5.4 billion in funding revenue in 2017 compared to 2016 and the adjustment of two tenths from the 2016 settlement from -0.8% GDP to the 2017 target of -0.6% GDP. However, with the additional increase of 1.2 billion in the final 2015 settlement data, together with other available information, compliance is considered likely for the whole subsector, with the AIReF central forecast below the -0.6% GDP deficit target (see figure 10).

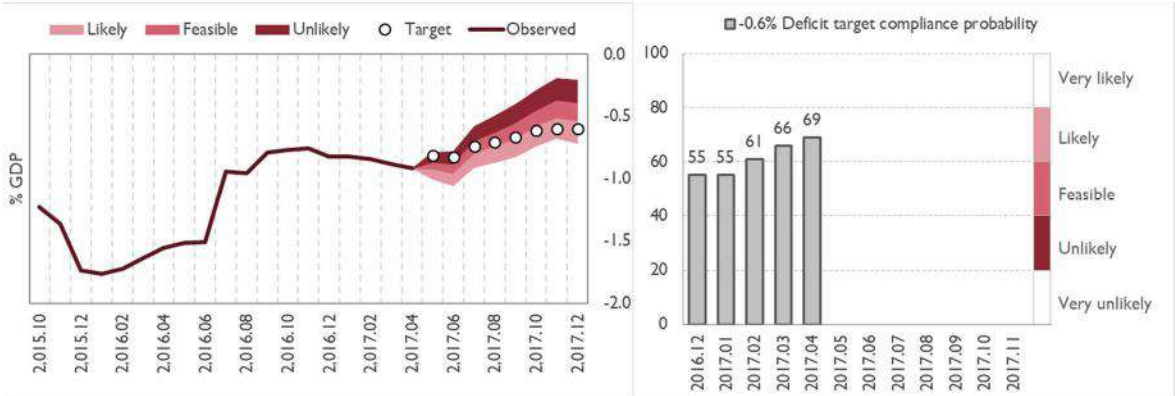
With respect to the evolution of revenue, once the information on the final 2015 revenue settlement with the 2017 financing system has been included, it is projected that the Regional subsector as a whole will see an increased growth of two tenths of its weight over GDP. With the new published data on the final 2015 settlement of the autonomous financing system that corresponds to the ARs for 2017, the growth of this revenue for the whole of the ARs represents an increase of two tenths in its weight over GDP compared to the previous year. Likewise, starting at the end of 2016, AIReF considers that the remaining revenue could register an increase but maintaining its weight in GDP, mainly due to the better-than-forecasted evolution in revenue from the European Union with respect to 2016, which was affected by the delay in the implementation

of the current Operational Program. The autonomic regional forecasts are in line with the AIReF forecasts (see figure 10).

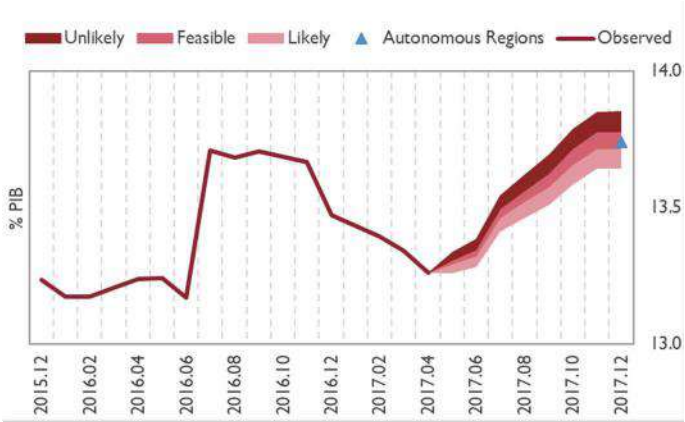
In the case of expenditure, the available information points to a growth that represents a drop of one tenth in terms of GDP. Current expenditure growth projections represent a decrease of two tenths in terms of GDP compared to the 2016 level. Meanwhile, there is a projected increase in capital expenditures of one tenth of GDP over the previous year, linked to greater than expected performance in some communities of expenditure co-financed with EU funds in 2017 coupled with the drop recorded in 2016. The autonomic forecasts for the subsector as a whole are in line with the AIReF forecasts, although with some difference in the composition of the expenditure (see 0).

FIGURE 10. REGIONAL SUBSECTOR

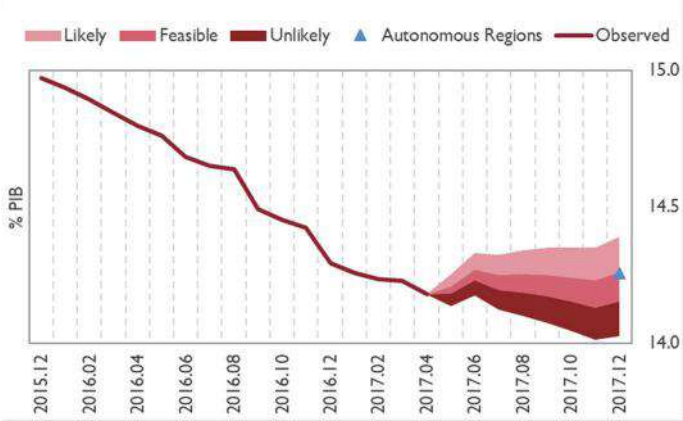
NET LENDING/BORROWING



NON-FINANCIAL REVENUE



NON-FINANCIAL EXPENDITURE



On the other hand, there are some uncertainties that affect the 2017 deficit derived both from the regularization of the arrears in the Basque Country quotas and from the offsetting of part of the 2016 excess deficit for the Autonomous ARs affiliated to the 2016 FLA. There are two circumstances that may have an impact on the 2017 deficit, but as of the issue date of this report, their effects are unknown:

- **The regularization of the arrears in the Basque Country quotas.** Depending on the final impact in 2017 derived from the internal agreement reached between the Provincial Councils and the Region to distribute the positive effect derived from the regularization of the arrears as a quota, the probability of compliance with the Basque Country's target could range from "feasible" to "highly likely", so long as the possible improvement in regional revenue is not transferred to expenditure. Although the community has not incorporated this effect into the 2017-2018 EFP scenario reported by AIReF, this expanded range of probability reflects uncertainties about both the amount and the year of the impact.
- **Compensation for part of the excess 2016 deficit for the ARs affiliated to the 2016 FLA.** As a result of the strengthened fiscal conditionality of the 2016 FLA, the regions were required to adhere to this mechanism and deviate from their 2016 stability target, to compensate for part of that excess for subsequent years. This measure affects the ARs of Aragon, Catalonia, Extremadura, Comunitat Valenciana, Cantabria and Murcia. The effect that it may have on the 2017 deficit will depend on what percentage of deviation must be offset with higher revenue or with lower expenditure and the year it will be implemented. This measure is foreseen in the 2017-2020 SPU, therefore, the AIReF report on it already recommended the publication of the percentage that should be compensated and the years in which that compensation must be made, precisely to reduce this uncertainty. However, the MINHAFP did not provide any answers to these questions in its response.

3.3.2. Expenditure Rule

In general, there is improvement in the information provided by the ARs for the calculation of the expenditure rule, although uncertainties remain on the elements necessary for its calculation. Unlike the information submitted by the ARs for the preparation of the previous

reports, there is improvement in the calculations made for the expenditure rule, mainly due to the use of 2016 data coincident with the published data on computable expenditure for that year. The coincidence in the starting data has it possible to consider, in most cases, the data on 2017 exclusions provided by the community, instead of needing to rely on AIReF forecasts. With regard to the increase in the amount of information provided, it should be noted that the 2017-2018 EFP questionnaire on the Canary Islands expenditure rule included a new concept called "*Transfers of expenditure capacity from other general government*", to include the effect of the larger transfer from the Competitiveness Fund, which the Region has indicated is a modification of its spending capacity, in accordance with the IGAE. Not provided for in the LOEPSF, this new concept has an effect similar to the legislative changes for increases in permanent collections, but is treated differently, since it is included in the questionnaire as a new category. In any case, there is uncertainty regarding the breakdown of exclusions for the calculation of computable expenditure and the revenue measures used to correct it, which are not published by the MINHAFP. The MINHAFP has repeatedly requested the publication of this data, however, neither the MINHAFP Report on the degree of compliance with the 2016 fiscal rules nor the monthly execution reports disaggregate this information, which limits the monitoring and calculation of this fiscal rule.

Despite these limitations, AIReF analysed whether the expected evolution of expenditure for each of the ARs could be compatible with compliance with the expenditure rule. Risk of default was found in 4 ARs and very tight compliance in another 4. According to AIReF forecasts, the ARs can be split into two groups:

- 13 ARs whose evolution of expenditure could be compatible with compliance with the expenditure rule: Extremadura, Comunitat Valenciana, Aragon, Asturias, Castilla-La Mancha, Castilla y León, the Basque Country, Galicia, the Canary Islands, Catalonia, Madrid, Navarre and La Rioja. Although compliance is very tight in Catalonia, Madrid, Murcia and the Basque Country.
- 4 ARs whose expenditure could compromise compliance with the expenditure rule: Andalusia, Illes Balears, Cantabria and Murcia.

At the subsector level, the expected evolution of expenditure could be compatible with compliance with the expenditure rule. According to AIReF forecasts, once the information from the latest report on the degree of compliance with the fiscal rules was taken into account, the evolution of expenditure around 4% could be compatible with the spending rule that allows variation of computable 2017 expenditure of 2.1% compared to 2016.

FIGURE 11. FAVOURABLE/UNFAVOURABLE STATUS OF THE REGIONS IN TERMS OF COMPLIANCE WITH THE 2017 STABILITY TARGET AND EXPENDITURE RULE

3.4. Local Governments

3.4.1. Local Government Subsector

3.4.1.1 Stability target

AIReF forecasts that it is highly likely that the Local Government Subsector will comply with the 2017 budgetary stability target, with a surplus likely to replicate the results achieved in 2016, at a minimum. The MINHAFP, using information sent by the local interventions,[19] has elevated the Local Government subsector to the national total, providing AIReF with this information. Based on this information, and taking into account the national accounts of the first quarter 2017 and the latest publications of the Bank of Spain on changes in financial assets and liabilities, AIReF forecasts that in 2017 the Local Government subsector is likely to replicate the 2016 surplus results.

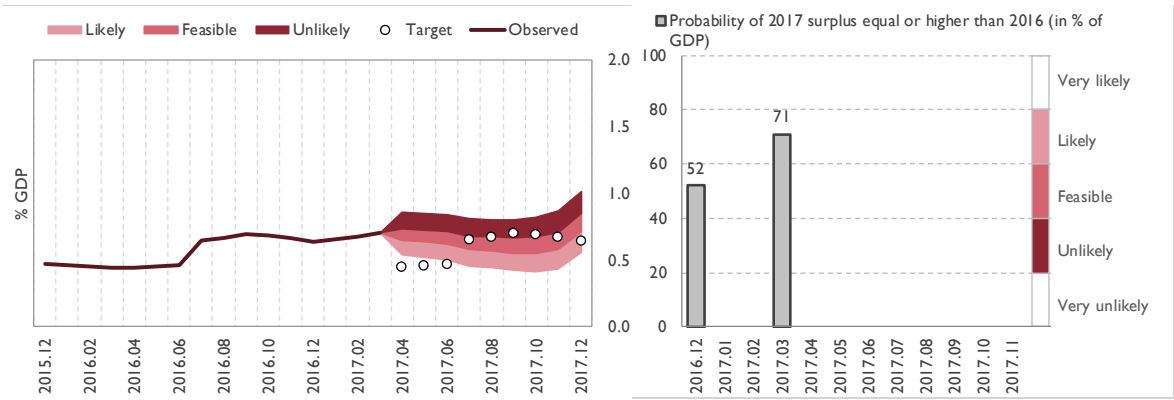
The Agreement of the Mixed Commission of the Economic Agreement with the Basque Country of 17 May 2017, and the delay in the approval of this year's State General Budgets could have a positive impact on the magnitude of the 2017 local surplus. The Agreement of

[19] The local interventions of the municipalities of more than 5,000 inhabitants transmit quarterly information on non-financial budget operations, revenue/expenditure of local businesses classified as public administraitons and CN adjustments.

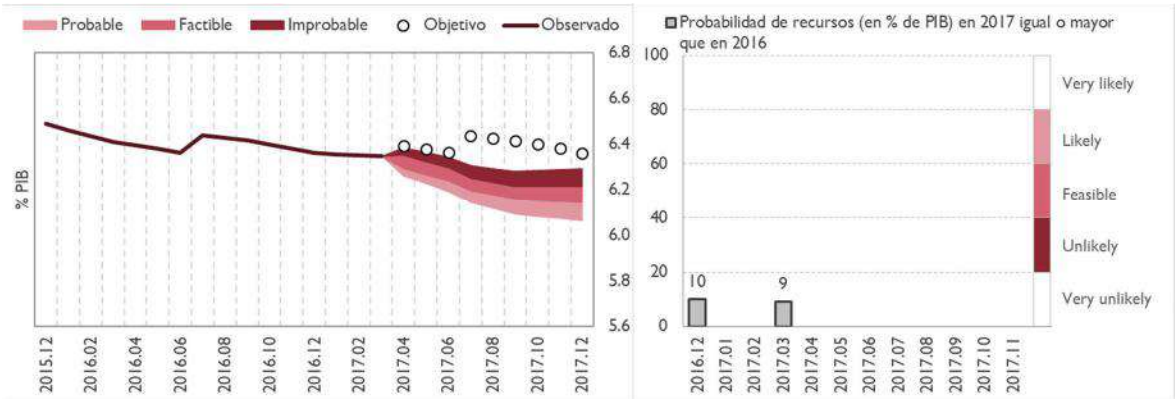
the Mixed Commission of the Economic Agreement with the Basque Country of 17 May 2017 has recognized a debt for settlements of the quota from past years for 1.4 billion euros in favour of the Provincial Councils. Although this settlement may be allocated to the Basque Country Region, at this time its distribution is not known and the EFP submitted by the Region does not include it. Therefore, it has been allocated in full to the Provincial Councils, in terms of the payment of the quota to the state, which implies a net positive effect on non-financial uses of the subsector for the same amount. In addition, the delays in approving this year's LPGE, which includes authorization for the LGs to make financially sustainable investments, could lead to a decrease in gross fixed capital formation in 2017. These positive effects on the surplus lead the AIReF to consider it likely that by the end of the year, the Local Government financing capacity will be somewhat higher than previous years.

Figure 12 shows the monthly financing capacity of the Local Government subsector in 2015 and 2016, and the range of AIReF forecasts for the end of 2017, as well as the probability at the end of each quarter (periodicity of published information) that the surplus at the end of this year will be greater than that obtained in 2016 (0.6% GDP). According to these forecasts, the likelihood of reaching a surplus of more than 0.6% in 2017 is around 70%. In addition, the same graph includes the revenue and non-financial expenditure with the same structure. Note that, despite the increase in the absolute value of the revenue, this increase does not compensate for the increase in GDP, which is why it is considered highly unlikely that the 2016 results will be replicated. On the other hand, in terms of expenditure, the double effect of the expected decrease in absolute terms and the increase in GDP lead AIReF to consider it highly unlikely that the end of 2017 will reach the 2016 level. Due to the lack of information at this time on the allocation of the commitments derived from the Agreement of the Mixed Commission of the Agreement with the Basque Country, the forecasts have allocated this effect to December, which is why the profile for that month has a positive effect under non-financial expenditure. This means, in net terms, expenditure lowered by about 1.4 billion euros.

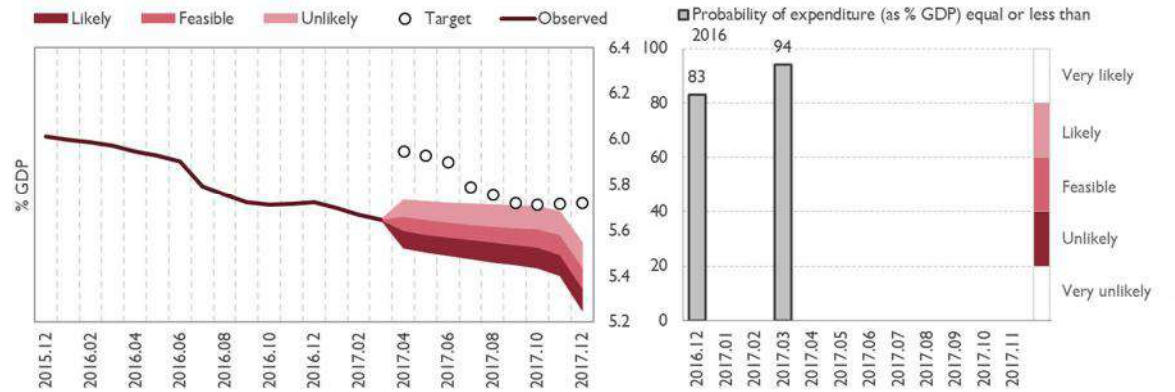
FIGURE 12. NET LENDING/BORROWING FOR LOCAL GOVERNMENT SUBSECTOR AS % OF GDP



NON-FINANCIAL REVENUE IN LOCAL GOVERNMENT SUBSECTOR AS % GDP



NON-FINANCIAL EXPENDITURE IN LOCAL GOVERNMENT SUBSECTOR AS % GDP



Source: MINHAFP and AIReF forecasts.

The 16 large cities with populations greater than 250,000 are expected to reduce their aggregate surplus by almost 40% by 2017. The data submitted to AIReF for the report on the initial 2017 budgets by the 16 large municipalities subject to individual assessment confirmed a change in the 2016 trend in its behaviour with respect to the other entities in the subsector. In 2016, while the subsector as a whole increased its surplus by almost 40% compared to 2015, these large cities reduced their aggregate surplus by around 1%, implying that the rest of the subsector increased their financing capacity by more than 60%. In 2017, this trend is consolidated. All available data shows a probable upward trend in the surplus to be obtained at the end of the year by the subsector. The end of year forecasts submitted to AIReF by these large cities, as shown in Table 4, are projecting to close the year with an additional reduction of their aggregate surplus of 40%.

TABLE 4. IMPORTANCE OF THE LARGE CITIES ON THE LOCAL GOVT. SUBSECTOR SURPLUS

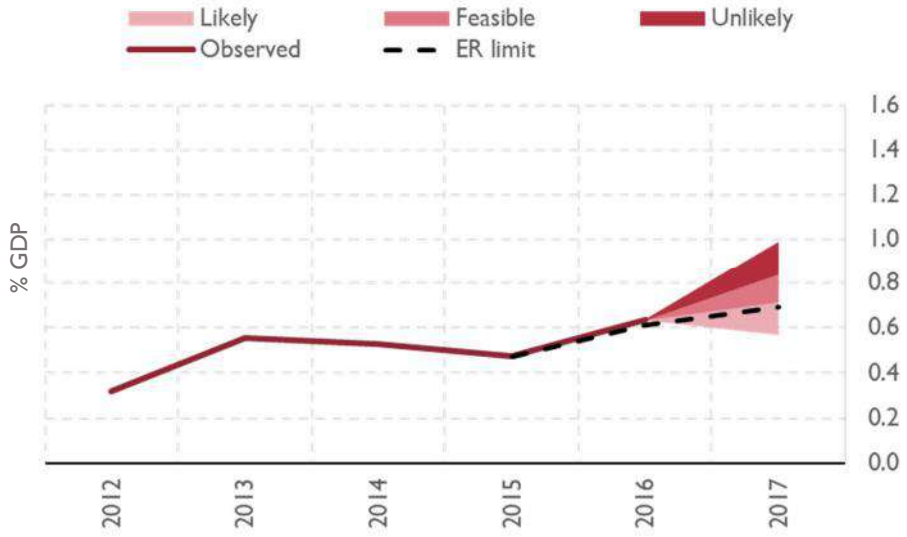
Cities with populations greater than 250,000							
Lending (+) or borrowing (-) for financing							
	Amounts (millions €)				% over non-financial revenue		
[redacted]	Interannual variation 2016-2015(%)	2016 Ctas 4T [redacted]	2017(P)	interannual variation 2017-2016(%)	[redacted]	[redacted]	Variation 2017 - 2016
Alicante/Alacant	108,9%	[redacted]	[redacted]	-43,6%	19,6%	12,0%	-7,6%
Barcelona	-32,7%	113	26	-77,1%	4,0%	0,9%	-3,1%
Bilbao	-59,3%	11	-29	-360,2%	2,0%	-5,3%	-7,3%
Córdoba	76,2%	73	15	-79,6%	23,2%	4,8%	-18,4%
Gijón/Xixón	-49,5%	16	6	-62,2%	7,0%	2,6%	-4,4%
Hospitalet de Llobregat (L')	322,8%	37	29	-22,8%	15,0%	11,9%	-3,1%
Madrid	-19,1%	1.115	622	-44,3%	23,0%	12,7%	-10,3%
Málaga	137,9%	69	93	34,6%	10,7%	13,8%	3,0%
Murcia	-406,3%	-147	5	-	-38,8%	1,4%	40,2%
Palma	869,8%	48	22	-54,1%	11,6%	5,3%	-6,2%
Palmas de Gran Canaria (Las)	-7,2%	54	39	-27,8%	15,5%	10,8%	-4,7%
Sevilla	63,9%	59	86	45,1%	7,2%	10,1%	2,9%
València	-3,8%	126	75	-40,9%	14,9%	9,3%	-5,6%
Valladolid	44,7%	28	8	-71,5%	10,3%	2,9%	-7,5%
Vigo	-21,4%	19	7	-64,3%	8,1%	2,9%	-5,2%
Zaragoza	-147,8%	[redacted]	[redacted]	-60,7%	15,2%	6,0%	-9,3%
Aggregate of 16 large cities	**-1,1%**	**1.784**	**1.075**	**-39,7%**	**12,7%**	**7,7%**	**-5,0%**
Other cities	**61,0%**	**5.299**					
Total Subsector CCLL	**39,0%**	**7.083**					

Source: Data provided by the municipalities and MINHAFP.

3.4.1.2 Expenditure rule

AIReF believes that a surplus of at least 0.6% is likely to be achieved in 2017, which would allow the Local Government subsector to comply with the expenditure rule. The MINHAFP has not provided information to analyse compliance with the expenditure rule at the subsector level. However, AIReF has made an approximation to compliance with this fiscal rule using its own estimates. Based on data published during the first quarter of 2017 on the main components of the expenditure rule, AIReF has forecasted the minimum financing capacity that would enable compliance with both fiscal rules in the hypothesis of weight constancy of expenditure excluded from the Expenditure rule for the first quarter of 2016 over annual data, except for the exclusions lined to the financing system, interest expense and payments to the State and to the Basque Country Region by the Provincial Councils. According to these projections, if in 2017, the subsector financing capacity is more than 0.6% GDP, this surplus would guarantee compliance with the expenditure rule. This percentage is within the range of AIReF forecasts (Figure 13).

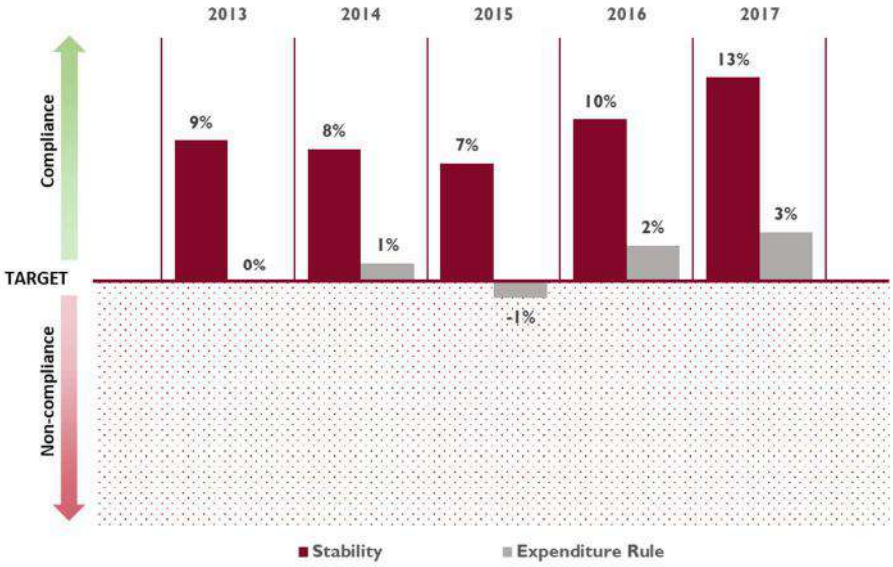
FIGURE 13. NET LENDING/BORROWING FOR LOCAL GOVT. SUBSECTOR THAT ALLOWS IT TO COMPLY WITH EXPENDITURE RULE



Source: MINHAFP and AIReF forecasts.

In the Local Government subsector, joint compliance with the stability target and the expenditure rule requires annual surpluses. In 2017, it is expected that the LGs as a whole will comply with both rules and obtain surpluses at least equal to 2016. Figure 14 shows the evolution from 2013 to 2016 in the joint compliance with these fiscal rules and the positive margin (compliance) or negative (non-compliance) with each rule over the annual target, as well as the AIReF forecasts for 2017. According to this graph, the margin on compliance with the stability target for the subsector since 2013 has also allowed the subsector to comply with the expenditure rule, with the exception of 2015, where the subsector did not comply with this rule by a small margin. AIReF forecasts the 2017 over-compliance with the stability target and the expenditure rule could exceed the surpluses achieved in 2016.

FIGURE 14. COMPLIANCE WITH STABILITY TARGET AND EXPENDITURE RULE 2013-2016 AND 2017 FORECAST



Source: MINHAFP and AIReF forecasts

3.4.2. Individual Analysis of the Local Governments

3.4.2.1 Cities with populations greater than 250,000 and 5 large councils or similar entities

This report includes the individual assessment of the 16 cities with populations greater than 250,000 as well as the 5 Councils or similar entities with the largest non-financial budgets. This report is subject to the legal obligation to assess the likelihood of compliance with the fiscal rules at the end of 2017, based on the analysis of the budgetary execution data. These 21 LGs have been analysed by AIReF since the beginning of the 2017 budget cycle.

The individual evaluation was mainly based on the information sent by the selected Local entities, along with information later received from the MINHAFP information centre. Only the City of Palma de Mallorca has not submitted information. All the entities complied with the duty to collaborate, in both time and form, with the exception of the city of Palma de Mallorca. After the initial request, once the deadline had passed, AIReF reiterated the request for information, stating that failure to comply with the duty to collaborate could lead to the warning provided for in Article 4.3 of Organic Law 6/2013, and still no response was received. This lead to the publication on the AIReF website of a warning for breach of the duty of collaboration, under the procedure set forth in Article 4.3.

For the purposes of this assessment, we must consider the possible existence of a EFP where the Local Entity may establish targets other than those generally established under the LOEPSF. Failure to comply with any of the tax rules requires that the Plenary of each entity prepare a EFP, which, in the case of the 21 entities analysed, must be approved by the agency that supervises them financially. In accordance with the provisions of the stability regulations, the approved EFP has to permit compliance with the stability target and the expenditure rule in both the year in progress and the following year. According to the provisions established in Article 21 of the LOEPSF and the MINHAFP manual published in February 2017 on the EFP model, in each of the years of the plan, all fiscal rules must be complied with in order for the document to be valid.

Of the 21 LGs evaluated, 7 have Financial Economic Plans approved by their supervisory bodies and in force for 2017. 1 is in the approval process and another has exceeded the deadlines to have their EFP approved. The cities of Alicante, Barcelona, Bilbao, Malaga, Palma de Mallorca, Zaragoza and the Council of Valencia all have Financial Economic Plans effective in 2017. The city of Murcia is in the process of getting its EFP approved. To date, the City of Madrid, which did not comply with the expenditure rule in 2015, does not have a Financial Economic Plan for 2017.

Two LGs evaluated, the Cities of Barcelona and Bilbao, have situations that are not adjusted to the current legislation. The city of Barcelona has a EFP in force approved by the Region that is not adjusted to the current regulations, even after successive modifications to prevent noncompliance. Neither the city nor its supervisory agency have responded to the recommendations made in this regard by AIReF in its report on the initial budgets of 2017. For its part, the city of Bilbao approved its 2017 budget without complying with the stability target. It has a

EFP approved by the Provincial Council of Vizcaya which does not comply with the LOEPSF provisions. In response to the AIReF recommendations, this supervisory body replied that the EFP complies with its charter. This divergence has been transferred to the Ministry of Finance and Public Function for the appropriate purposes.

Of the 21 LGs analysed, only the cities of Alicante, Las Palmas de Gran Canaria, Vigo and Sevilla show no risk of non-compliance with the fiscal rules in 2017. Table 5 and Table 6 show the situation of each Local Government with respect to compliance in 2017, as well as AIReF's main conclusions for each of them and, where appropriate, the recommendations that are derived. Table 5 summarizes the situation of each Local Government regarding compliance with the stability target and the expenditure rule in the 2016 settlement and the 2017 closure forecast, highlighting the changes with respect to the report on the initial budgets for 2017[20]. Table 6 summarizes the principle AIReF conclusions regarding each Local Entity's 2017 closure and each fiscal rule, as well as the recommendations made. In this table, the risk of non-compliance with one or several fiscal rules is graded into five possible categories, ranging from no appreciable risk to very high risk of non-compliance. According to this grading, and for the reasons given in the summary table:

- **The cities of Alicante, Las Palmas de Gran Canaria, Vigo and Seville show no risk of non-compliance.**
- **The cities of L'Hospitalet de Llobregat and Valladolid show low risks that require monitoring.**
- **There are moderate risks of non-compliance with the fiscal rules that require the adoption of measures in the cities of Bilbao, Cordoba, Gijon, Malaga, Murcia, Valencia and Zaragoza, the Councils of Barcelona and Sevilla and the Cabildo of Tenerife and the Island Council of Mallorca.**
- **In the city of Barcelona and the Council of Valencia, there is a high risk of non-compliance with a fiscal rule that requires the adoption of the measures listed in Article 25 of the LOEPSF.**
- **In the cities of Madrid and Palma de Mallorca, there is a very high risk of non-compliance with a fiscal rule and/or its reiterative character, which requires the adoption of the measures listed in Article 25 of the LOEPSF[21].**

Figures 15, 16 and 17 present a comparative view of compliance with the 3 fiscal rules from 2012 to 2016 and the 2017 closure forecasts of these Local Entities as well as the average performance of the group as whole that is highly influenced by the weight of the City of Madrid:

- For each local entity and in terms of the stability target, Figure 15 shows the margin in percentage of non-financial revenue over the target (the legal balance or the one established in the EFP) for 2012 through 2016, showing the year with the best and worst results, as well as the results of the latest settlement (2016). As can be seen in the graph, in the reference

[20] Report on the 2017 Local Government initial budgets

[21] The City of Palma de Mallorca has not submitted the requested information on the 2017 closure forecast, although with the data provided by the city for the April report and the partial data submitted, AIReF considers its risk situation to be very high, in the absence of other information.

period, the group as a whole has always been in compliance with the stability target, with very little oscillation (with a positive margin between 9% and 13% over the average target). in 2016, the group average was around 12%.

- Graph 16 shows the 2017 closure forecasts in relation to compliance with the stability target and the expenditure rule, as the margin over the target for both fiscal rules. This situation of compliance or not with the stability target and the expenditure rule is shown as a percentage margin (excess or deficit) over the target (the legal target or that established in the approved EFP) for each of them. In terms of the stability target, this margin is calculated as a percentage of non-financial revenue. In terms of the expenditure rule, this margin is calculated as a percentage of the spending limit that allows compliance. This graph shows that in 2017, the group as a whole is projected to close the year in compliance with the stability target with a margin of 6% over the average target, much lower than the results of 2016, and not enough to ensure compliance with the group expenditure rule, which is expected to exceed the average spending limit by 3%.
- Figure 17 shows the debt limit, the evolution from 2012 to 2016 and the 2017 forecasts for the ratio of outstanding debt to consolidated current income. The group as a whole shows a strong reduction in indebtedness from 2012 to 2016 (from 100% of the average current income to 61%). This trend is projected to continue this year, with the group's average debt ratio ending at about 50%.

TABLE 5. COMPARATIVE LOOK AT COMPLIANCE WITH THE STABILITY TARGET AND THE EXPENDITURE RULE

LOCAL GOVT.	EFP APPROVED AND IN PLACE		Stability Target (ST)		Expenditure rule (ER)	
	CAUSE FOR EFP	CURRENT	Close 2016	Forecast 2017	Close 2016	Forecast 2017
MADRID	Non-compliance with ER15	EFP'S 16-17 for 15, non-compliance not approved	✓	✓	✗	✗
BARCELONA	Non-compliance with ER15	EFP approved 15-16, revised for after 2016 breach. New 16-17 EFP	✓	✗	✓	✓
VALENCIA			✓	✓	✓	✗
SEVILLA			✓	✓	✓	✓
ZARAGOZA	Non-compliance with ER15	EFP approved 16-17	✓	✗	✓	✓
MÁLAGA	Non-compliance with ER15	EFP approved 16-17	✓	✓	✓	✓
MURCIA	Non-compliance with rules	Pending approval	✗	pte.EFP	✗	pte.EFP
PALMA DE MALLORCA	Non-compliance with ER15	EFP approved 16-17	✓	no data	✓	no data
LAS PALMAS DE GRAN CANARIA			✓	✓	✓	✓
BILBAO	Non-comlpliace with 2017	EFP aprobado 17-18	✓	(*)	✓	✗
ALICANTE	Non-compliance with ER15	EFP approved 16-17	✓	✓	✓	✓
CÓRDOBA		2016 debt refinancing plan	✓	✓	✓	✗
VALLADOLID			✓	✓	✓	✓
VIGO			✓	✓	✓	✓
GIJÓN			✓	✓	✓	✗
L'HOSPITALET DE LLOBREGAT			✓	✓	✓	✓
DIP. BARCELONA	Non-compliance with ST & ER15	EFP approved 16	✓	✓	✓	✗
DIP. VALENCIA	Non-compliance with ER15	EFP approved 16-17	✗	✗	✓	✓
DIP. SEVILLA			✓	✓	✓	✗
CABILDO INSULAR DE TENERIFE			✓	✓	✓	✗
CONSEJO INSULAR DE MALLORCA			✓	✓	✓	✗

✓ Compliance

✗ Non-compliance

(*) Compliance with EFP not adjusted to LOEPSF

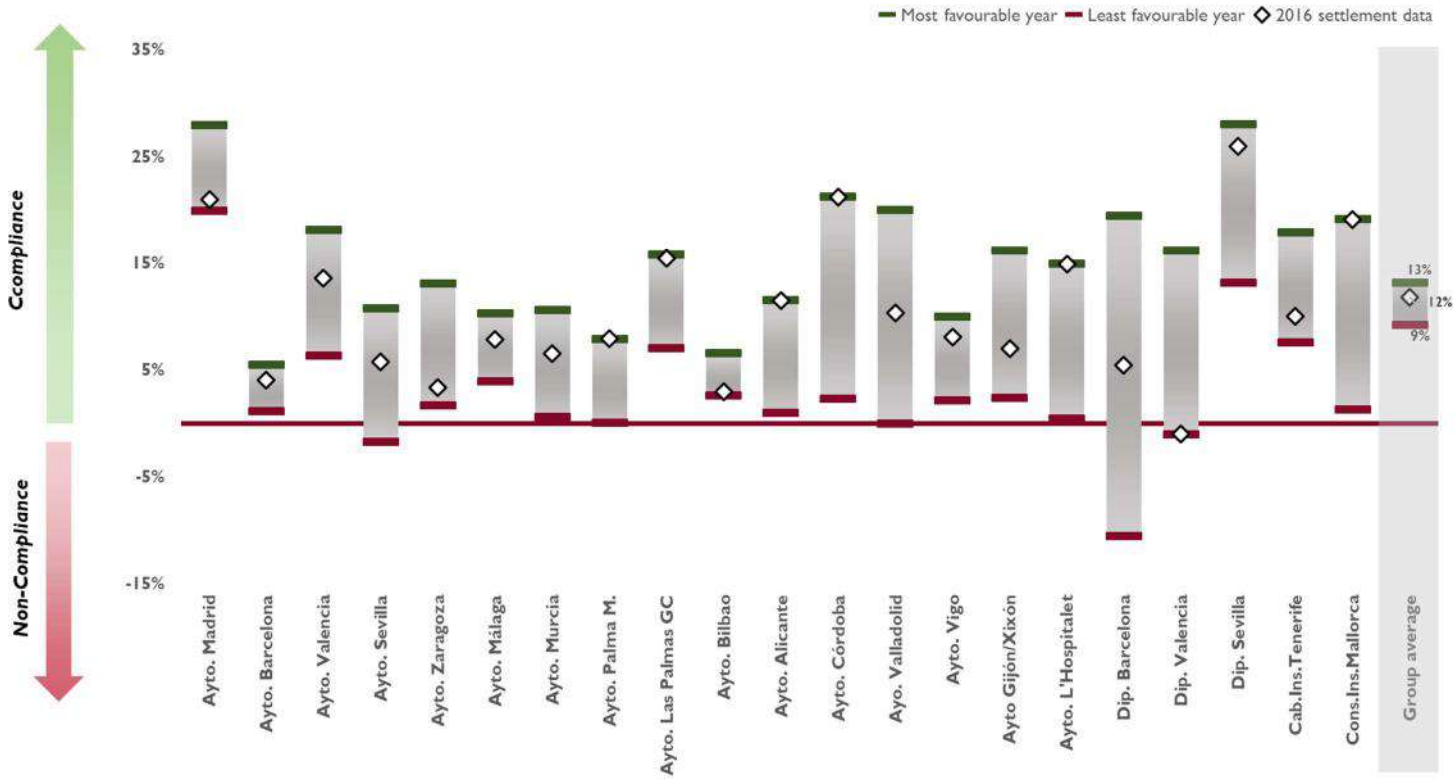
With changes compared to April information

TABLE 6. THE AIREF MAIN CONCLUSIONS ON RISK OF NON-COMPLIANCE WITH THE 2017 FISCAL RULES AND RECOMMENDATIONS

LOCAL GOVT.	AIREF CONCLUSIONS ON COMPLIANCE WITH 2017 FISCAL RULES	RECOMMENDATIONS
MADRID	**ST:** The city projects compliance at end of 2017 with a surplus less than 3% of that projected in April information, with a reduction of more than 50% from 2015 number, decreasing in 2016 by 400 M€ **ER:** Projected non-compliance with expenditure rule provided in budget, as in 2016, with excess over the limit of more than 440M€ **DR:** Projected to lower debt at end of year, ending at less than 75% of current revenue, but operations are subject to authorization	Adopt measures of article 25 of the LOEPSF as there is no EFP in place after repeated non-compliances. With projected non-compliance with ER in 2017 by 440M, without coverage of EFP pending approval since 2016, recommend the application of the cited article to avoid non-compliance at year-end
BARCELONA	**ST:** Projected non-compliance with 2017 EFP with financing capacity less than 80% of demand and 78% of 2016. AIReF also forecasts said non-compliance but with lesser amount **ER:** Projected compliance in 2017 EFP although very demanding **DR:** Maintains a debt ratio about 30%	Adopt measures of article 25 of LOEPSF for non-compliance with current EFP
VALENCIA	**ST:** Projected compliance with 2017 target **ER:** Projected non-compliance with 2017 ER for increase in expenses of about 18% (April information projected compliance) **DR:** Has improved, but still over 75%	Adopt measures to comply with ER at close of 2017
SEVILLE	The city failed to comply with ER in 2015 and instituted a EFP for 2016-2017 which was not approved by the supervisory agency because the city had already approved the 2017 budget not adjusted to the EFP. However, as the city indicates, both the 2016 and 2017 budgets include reductions in credit to reach compliance at end of year. CA, in line with AIReF recommendation, demanded application of Article 25 LOEPSF, approving the budgets with reductions **ST & ER:** Projected compliance with both rules at close of 2017. **DR:** Since 2009, maintained a ratio under 75%	
ZARAGOZA	**ST:** Projected non-compliance with EFP at close of 2017, for amount greater than projected in April **ER:** Compliance with rule in EFP projected for close of 2017 **DR:** Maintain a ration greater than 110%, at least since 2012, a ratio which increased since 2015 for loans for tram construction	Adopt measures to comply with EFP ST at close of year
MALAGA	**ST:** Projected non-compliance with EFP at close of 2017, increasing margin communicated in April **ER:** Also projected compliance with limit provided in EFP **DR:** Maintain a ratio greater than 75% and less than 110%	Adopt measures to reduce debt to not surpass 75% limit
MURCIA	**ST:** Projected compliance with demanding target at end of 2017. However, measurement of said compliance is made in accordance with EFP that is pending approval due to investment in city tram (173M€). **ER:** Projected compliance at end of 2017, although with EFP described above. **DR:** Prior to 2016, had ratio less than 75%. Since then, due to the above loan, ration surpassed 100%	Get approval of EFP to establish limits of compliance with fiscal rules
PALMA DE MALLORCA	The city has failed to comply with the AIReF duty to collaborate without providing any information. The MINHAFP has provided only partial information for evaluation of ST. **ST:** According to information provided by MINHAFP, which does not include companies that compute the target, non-compliance with EFP ST. **ER:** Lacking new information, April information projects non-compliance in 2017 **DR:** In 2016, Debt was under 75% limit. No data for end of 2017	Non-compliance with duty to collaborate. AIReF provisional pronouncement: Adopt measures for 2017 to comply with EFP targets, if conclusions are corroborated with completed information
LAS PALMAS DE GRAN CANARIA	**ST:** Projected compliance **ER:** Projected compliance in 2017 **DR:** Maintain a rate less than 75%, projected to be reduced considerably from 20% in 2016 to 6% at year-end	
BILBAO	**ST:** The city projects non-compliance with authorized deficit by approved EFP **ER:** Projected non-compliance with EFP rule, worsening situation with respect to information provided in April where it projected compliance with the EFP limit. **DR:** Maintain a debt ratio very close to zero	Adopt measure to comply with fiscal rules at end of year
	No risk of non-compliance with any fiscal rule Low risk that requires monitoring Moderate risk of non-compliance with any fiscal rule High risk and/or repeated non-compliance with any fiscal rule Very high risk of non-compliance with any fiscal rule	**ST:** Stability target ER: Expenditure Rule DR: Debt ratio over current revenue

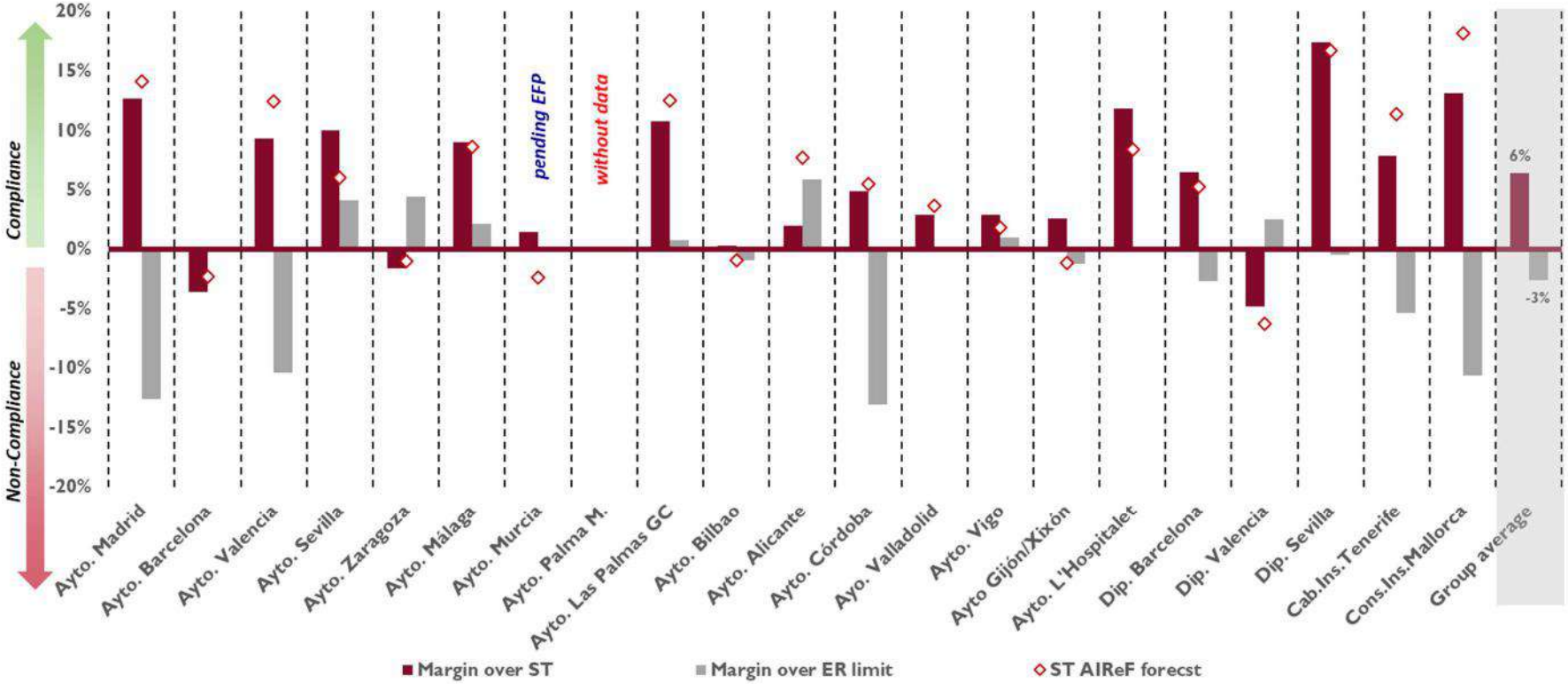
LOCAL GOVT.	AIREF CONCLUSIONS ON COMPLIANCE WITH 2017 FISCAL RULES	RECOMMENDATIONS
ALICANTE	**ST:** Compliance with ST projected at close of 2017 in EFP **ER:** Compliance with Expenditure rule limit also projected for end of 2017 in EFP **DR:** Maintains a DR less than 75%. Projected to be about 32% at end of 2017	
CORDOBA	**ST:** Compliance with ST projected for close of 2017, although with a drop in 2016 financing capacity of about 80% **ER:** Maintains a projected non-compliance with the ER at close based on information supplied in April **DR:** The City projects a debt reduction of 81% in 2016 to 72%	Maintain the monitoring of compliance with the fiscal rules, as the city indicates in the response to the recommendation made by the AIReF in the report on the initial budget, adopt measures necessary if there is risk of non-compliance.
VALLADOLID	**ST:** Compliance with ST projected at close of 2017, although with a drop of 72% from 2016 surplus **ER:** Compliance projected at close of 2017, although very demanding. In information sent in April, projected non-compliance. Current modification is a result of the inclusion of some sustainable financial investments **DR:** Maintain a debt ratio less than 75%	Monitor 2017 execution of investments which could affect compliance with the Expenditure rule
VIGO	**ST:** Projected compliance with ST at close of 2017, although with a drop of 64% from 2016 surplus **ER:** Projected compliance at end of 2017 **DR:** Ended 2016 with 0 debt and same expected for 2017	
GIJON	**ST:** Projected compliance at end of 2017, although with a drop of 62% from 2016 surplus **ER:** Projected non-compliance at close of 2017 more than projected in April information **DR:** Maintain a debt ratio less than 75%	Adopt measures to comply with expenditure rule at close of 2017.
L'HOSPITALET DE LLOBREGAT	**ST:** Projected compliance at close of 2017 **ER:** Projected compliance at close of 2017 with very demanding margin **DR:** Maintain a debt ratio less than 75%	Monitor 2017 execution to ensure compliance with ER at close
Council of BARCELONA	**ST:** Projected compliance at close of 2017. **ER:** Projected non-compliance at close of 2017 with estimated expenditure similar to the limit for 2016 in the EFP that is current for only that year. As real expenditure is less than this amount, expenditure limit for 2017 has been reduced. **DR:** Maintain a DR less than 75% projecting a rate of 17% at close of 2017	Adopt measures to comply with ER at close of 2017
Council of VALENCIA	**ST:** Projected non-compliance with ST established in EFP at close of 2017, with capacity near 50% of demand, increasing non-compliance projected in April **ER:** Projected compliance at end of 2017 **DR:** Maintain a DR less than 75%, expected to be 36% at close of 2017	Adopt measures of Article 25 of LOEPSF for non-compliance with current EFP
Council of SEVILLE	**ST:** Projected compliance **ER:** Projected non-compliance at end of 2017, although for amount less than projected in April **DR:** Maintain a rate less than 75%, estimated to be 20% at close of 2017	Adopt measures to comply with ER at close of 2017.
ISLAND COUNCIL OF TENERIFE	**ST:** Projected compliance at end of 2017 **ER:** Projected non-compliance at end of 2017. **DR:** Maintain ratio less than 75%, projected to be 34% at close of 2017	Adopt measures to comply with ER at close of 2017
ISLAND COUNCIL OF MALLORCA	**ST:** Projected compliance at end of 2017 **ER:** Projected non-compliance at end of 2017, with excess of 11% **DR:** Maintain a ratio less than 75%, projected to substantially reduce 2016 debt past 36% to 7% at close of 2017	Adopt measures to comply with ER at close of 2017
	No risk of non-compliance with any fiscal rule	**ST:** Stability target
	Low risk that requires monitoring	ER: Expenditure Rule
	Moderate risk of non-compliance with any fiscal rule	DR: Debt ratio over current revenue
	High risk and/or repeated non-compliance with any fiscal rule	
	Very high risk of non-compliance with any fiscal rule	

FIGURE 15. DEGREE OF COMPLIANCE WITH THE STABILITY TARGET, 2012-2016. (DIFFERENCE BETWEEN OBSERVED NET LENDING/BORROWING AND THE NON-FINANCIAL REVENUE TARGET PERCENTAGE)



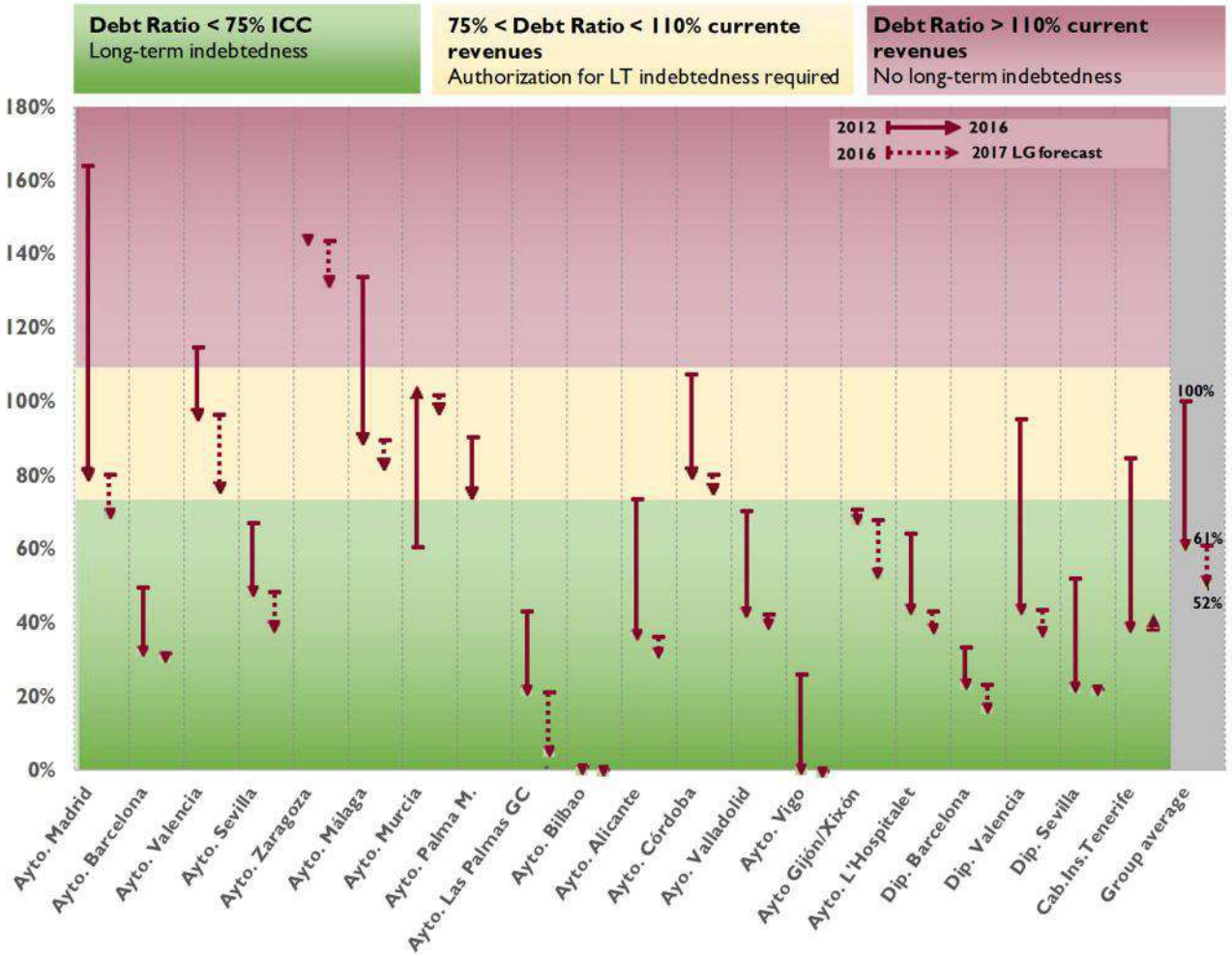
Note:
The 2016 settlement data is that provided by the corresponding local entity on the finally approved settlement or an advance thereof.
In the cities of Zaragoza and Murcia, the effect on the financing capacity of each of the tramway construction operations through PPPs has not been included in the graph because they are considered to be non-recurring operations that only affected 2015 and 2016, respectively.

FIGURE 16. ESTIMATED DEGREE OF COMPLIANCE WITH THE STABILITY TARGET AND THE EXPENDITURE RULE IN 2017



Note:
Margin over Stability Target (ST): Difference between observed financing capacity/need and the target as a percentage of non-financial revenue.
Margin over Expenditure Rule (ER) limit: Difference between the computable expenditure forecasted in 2017 and the spending limit as a percentage over the indicated limit.
Stability Target AIReF forecast: AIReF forecast of the margin over the Stability Target, based on the information submitted and the available historical data.

FIGURE 17. EVOLUTION OF THE INDEBTEDNESS OF THE LOCAL GOVERNMENTS 2012-2016 AND 2017 FORECAST (PERCENTAGE OF DEBT OVER CONSOLIDATED CURRENT REVENUE)



3.4.2.2 Cities analysed with sustainability risks

Taking a closer look at the analysis of local financial sustainability initiated in the report of December 2016, this report includes, for the first time, a synthetic evaluation of 32 cities with more than 5,000 inhabitants that present sustainability risks and negative results in some relevant economic and financial indicators. In the individual analyses of the LGs, AIReF has expanded the subjective scope of the entities in its successive reports. In this analysis, AIReF began by evaluating the most representative Local entities, by both budget and population, including the 6 municipalities with populations greater than 500,000 (Madrid, Barcelona, Valencia, Seville, Zaragoza, Malaga), the 16 municipalities with populations greater than 250,000 (in addition to the previous, Murcia, Las Palmas de Gran Canaria, Bilbao, Alicante, Cordoba, Valladolid, Vigo, Gijon and L'Hospitalet de Llobregat) and later including other local entities due to their specific competences and funding (the Provincial Councils of Barcelona, Valencia and Sevilla, the Consell of Mallorca and the City of Tenerife).

The December 2016 report was the first assessment of the criticality of the Local Entity situation in matters of debt, identifying 90 Local Entities with medium term sustainability risks and rating their situations.

This report has expanded this Local Entity sustainability analysis. Starting with the city councils that are required to report quarterly information and, as such, report on their settlement forecasts (cities with populations greater than 5,000) and considering the latest available final settlement information (2015), the cities to be analysed have been selected from among the previous if they present negative financial results in one of the main financial-economic indicators analysed. The indicators, in addition to the ratio of current debt to current revenue (the preferred indicator since AIReF's first local sustainability analysis), include the following:

- ✓ Non-financial budget balance,
- ✓ Cash surplus,
- ✓ Average period of payment, and
- ✓ compliance with obligations to provide information.

Those city councils that had 3 or more negative warning indicators (or 2 indicators if one of them was debt) during the past year, according to a confidence threshold established by AIReF as determinants of possible risk of non-compliance with fiscal rules in future years. These thresholds were the following:

- ✓ Present a negative non-financial balance greater than 20% of the non-financial revenue in the final 2015 settlement, or 10% if in the year prior if the balance was also negative.
- ✓ Have a negative cash balance in more than 20% of their current revenues in the cited settlement.

- ✓ Present a ratio of current debt to consolidated current revenue greater than 75%, requiring more than 20 years to fall below this percentage, assuming the entire positive non-financial balance is applied to the amortization of the debt.
- ✓ Having a supplier payment period over 60 days over the legal period.
- ✓ Failure to disclose the 2015 settlement information on 31 December 2016.

The selected town councils are listed in the following table:

REGIONS	Cities from whom information was requested				
	between 100,001 and 500,000 inhab.	between 50,001 and 100,000 inhab.	between 20,001 and 50,000 inhab.	between 10,001 and 20,000 inhab.	between 5,001 and 10,000 inhab.
Andalusia	• Algeciras • Cádiz • Jerez de la Frontera • Granada • Jaen	• La Línea de la Concepción	• Los Barrios • Macarena • Almonte • Ayamonte • Los Palacios y Villafranca	• Albox • Villamartín	• Macael • Dúrcal • Villa de Otura • Nerva
Community of Madrid	• Parla	• Aranjuez	• Algete • Navalcarnero		• El Álamo • Torrejón de la Calzada
Castilla-La Mancha		• Cuenca			• Almadén
Comunitat Valenciana		• Gandía			
Castilla y León			• San Andrés de Rabanedo		
Galicia				• Vilanova de Arousa	
Region of Murcia				• Ceutí	• Moratalla
Canary Islands					• Valsequillo de Gran Canaria
Principado de Asturias					• Salas

A summary form was sent to these 32 cities requesting a synthetic assessment based on large indicators.

The cities of Almaden, Ayamonte, Moratalla, los Palacios and Villafranca y Valsequillo de Gran Canaria have not complied with the duty to collaborate with AIReF. All of the above entities have been given the duty of collaboration provided in Article 4.3 of Organic Law 6/2013, on the creation of AIReF and its consequences. Of the 32 cities selected, 27 have submitted the requested information. AIReF has been able to classify the risk of non-compliance with the fiscal rules for 26 of them based on the information they have submitted or published. Of these, the cities of Jaen and La Linea de la Concepcion have submitted incomplete information and/or there are incongruities that are not justified, although they have been classified, using historical information and the information provided. This was not the case with the City of Maracena, where the information submitted suffers from such deficiencies that it was not possible to classify its risk.

Table 7 presents the risk of non-compliance with one or several fiscal rules, ranging from low/moderate risk to very high risk of non-compliance. These LGs that have been classified as low/moderate risk have had a surplus in recent years, project a surplus for 2017, and the AIReF considers it feasible for them to make their expected debt payments. Those LGs whose financing capacity is not projected to be reached until 2016 or 2017, or if it has been reached, do not appear to be stable and/or sufficient to guarantee the sustainability of the debt have been classified as high risk. The LGs who have not reached financing capacity in the analysed period and are not expected to reach it in 2017 have been classified as very high risk.

TABLE 7. AIREF RATING OF THE RISK OF NON-COMPLIANCE WITH THE FISCAL RULES FOR EACH CITY

Criticality Rating			No rating	
Low/moderate risk	**High Risk**	**Very High Risk**	**No information submitted**	**With incomplete information or inconsistencies making a rating impossible**
· Algete · Dúrcal · Macael · Vilanova de Arousa · Nerva · Salas · Villamartín · Albox · Ceutí · Cuenca · El Álamo . Cádiz · Los Barrios	· Algeciras · Almonte · Aranjuez · Granada · Navalcarnero · San Andrés del Rabanedo · Torrejón de la Calzada · Villa de Otura	· Gandía · Jaén (*) · Jeréz de la Frontera · La Línea de la Concepción (*) · Parla	· Almadén · Ayamonte · Moratalla · Los Palacios y Villafranca · Valsequillo de Gran Canaria	· Maracena

(*) With incomplete and/or inconsistent information but with a criticality rating

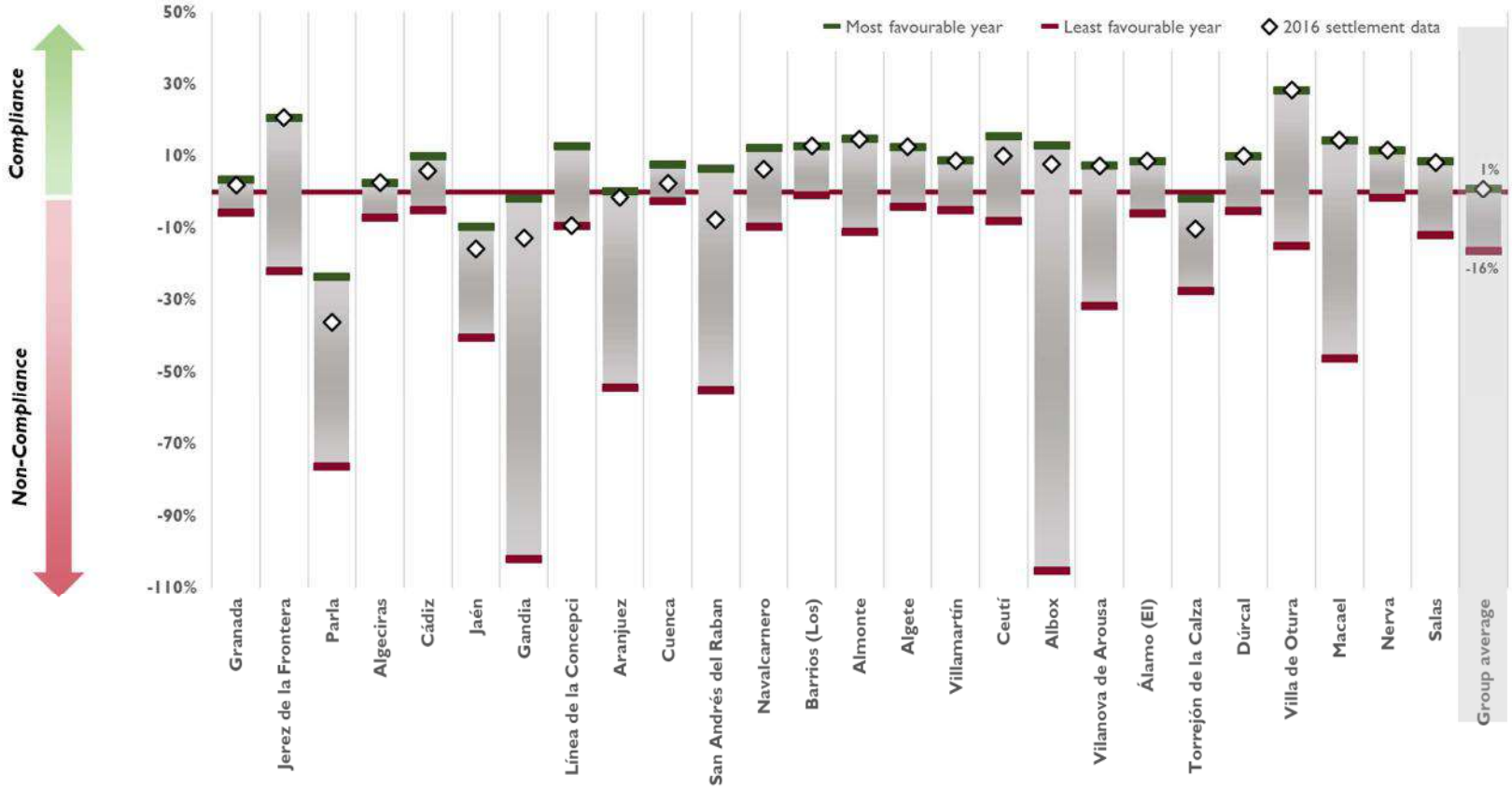
Likewise, Figures 18, 19 and 20 summarize, with the same structure and content as shown for the 21 large LGs, a comparative view of these LGs with respect to compliance with the stability target, expenditure rule and the debt limit from 2012 to 2016, as well as projected compliance or non-compliance with the 3 fiscal rules at the end of 2017.

The graphs also include the behaviour of the group as a whole, influenced by the weight and status of the cities with populations greater than 100,000 (Algeciras, Cadiz, Jerez de la Frontera, Granada, Jaén and Parla). This leads to the following conclusions:

- In terms of compliance with the stability target for the 2012-2016 period, the group as a whole has been in default, moving from the most unfavourable position of 16% margin of default to the most favourable position, which coincides with the last settlement year and is slightly above achievement of the average target.
- In the 2017 forecasts on the stability target and the expenditure rule, the group average was non-compliant with the stability target, albeit by a small margin, and compliant with the expenditure rule, also by a very tight margin.

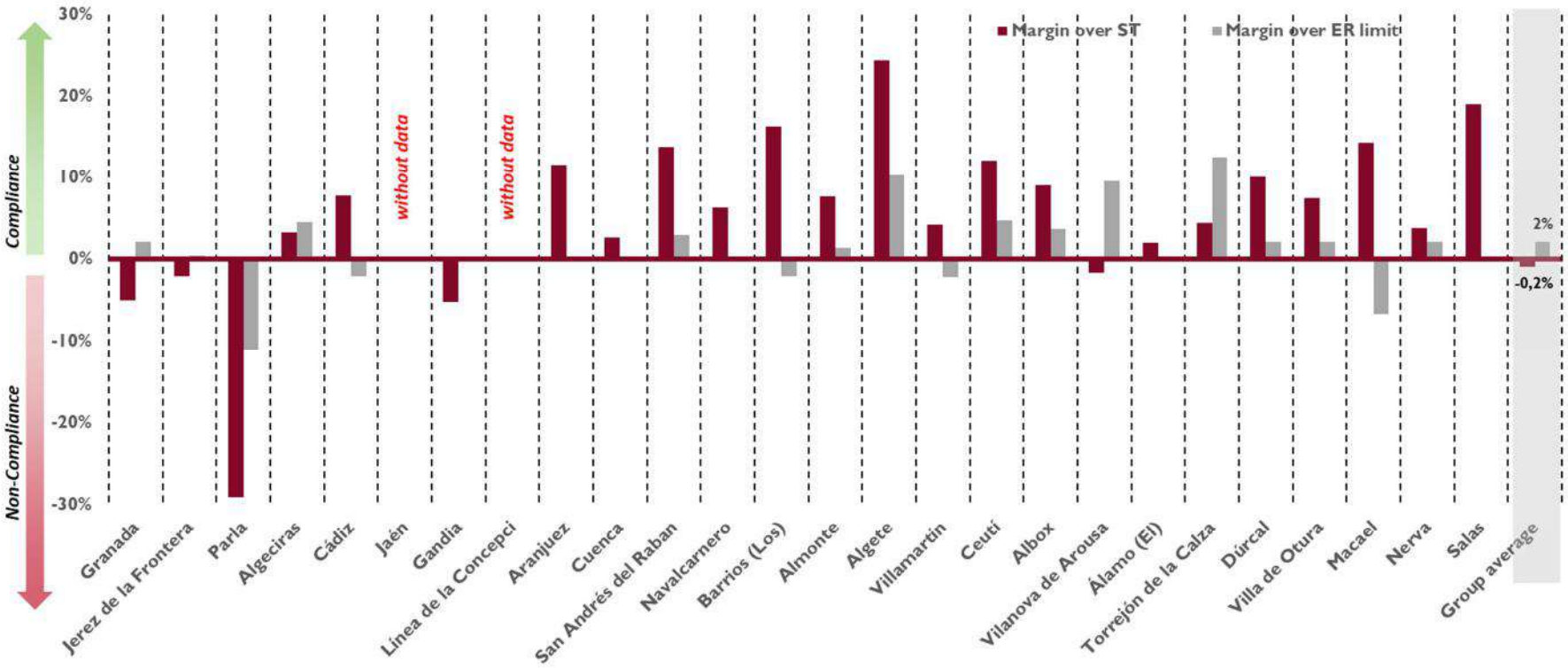
- Finally, in the case of average debt, the graph shows an increase from 2012 to 2016 of about 75% over the average current revenue, rising to 240% in 2016. In 2017, a slight reduction is projected.

FIGURE 18: DEGREE OF COMPLIANCE WITH THE STABILITY TARGET – 2012-2016 PERIOD (DIFFERENCE BETWEEN OBSERVED NET LENDING/BORROWING AND THE TARGET AS PERCENTAGE OF NON-FINANCIAL REVENUE)



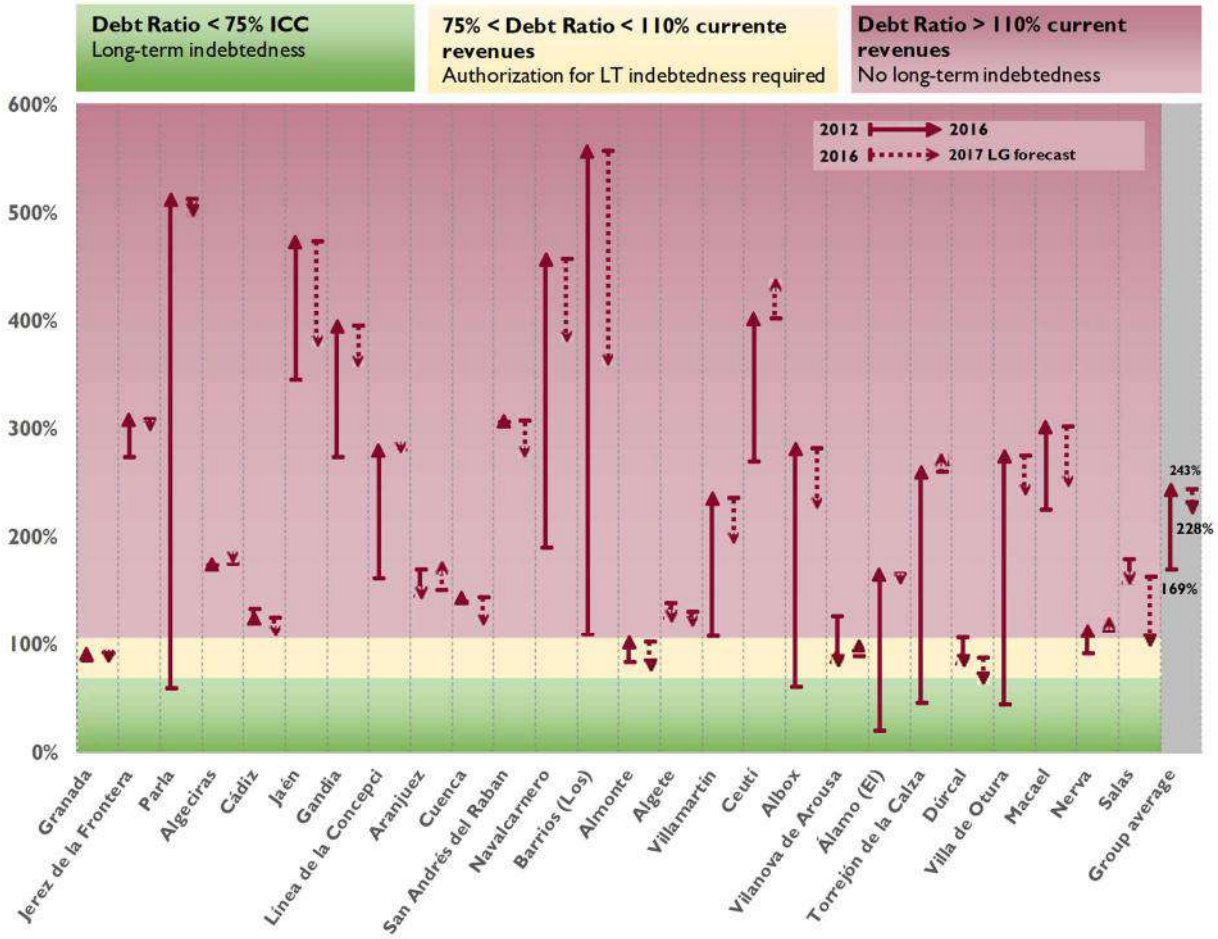
Note: The 2016 settlement date is that provided by the corresponding local government, either the final approved settlement or an advance thereof.

FIGURE 19. ESTIMATED DEGREE OF COMPLIANCE WITH THE 2017 STABILITY TARGET AND THE EXPENDITURE RULE



Note:
Margin over Stability Target: Difference between observed lending/borrowing and target as a percentage of non-financial revenue.
Margin over Expenditure Rule limit: Difference between the computable expense foreseen in 2017 and the Expenditure Rule spending limit as a percentage over the indicated limit.

FIGURE 20. EVOLUTION OF THE INDEBTEDNESS OF THE LOCAL GOVERNMENTS 2012-2016 AND THE 2017 FORECAST (PERCENTAGE OF DEBT OVER CONSOLIDATED CURRENT REVENUE)



4. Public Debt

The 2017 debt targets were set by the Council of Ministers Agreement (CMA) of 2 December 2016 for both the Public Administrations as a whole and for each of the subsectors, as shown in table 8.

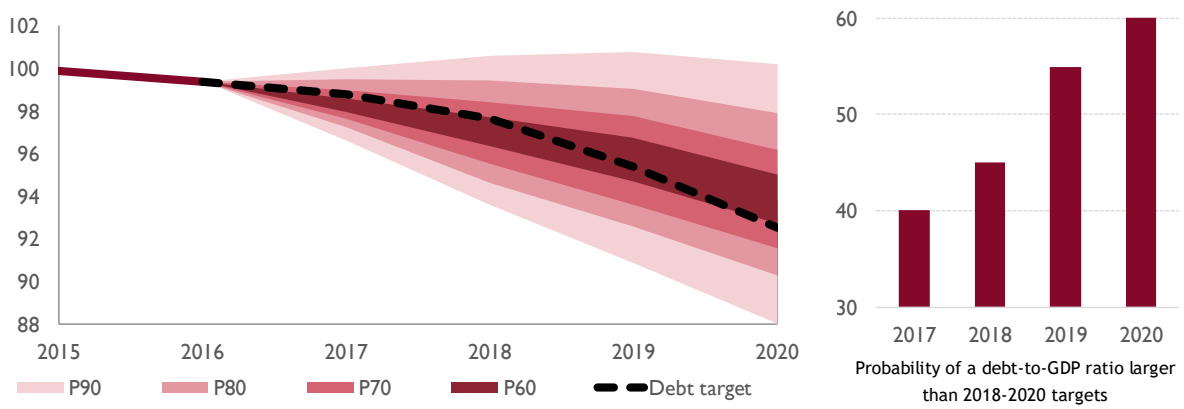
TABLE 8. DEBT TARGETS (DEBT AS % OF GDP)[22]

EDP Debt	2017	2018	2019	2020
Central Administration and Social Security	72.0	70.8	69.5	67.6
ARs	24.1	24.1	23.3	22.4
LGs	2.9	2.7	2.6	2.5
Total General Government	**99.0**	**97.6**	**95.4**	**92.5**

AIReF debt-to-GDP ratio forecasts for all Public Administrations as a whole is in line with the target of 99%. With respect to the 2016 closing debt ratio, which reached 99.4% GDP, a slight reduction is projected in 2017 to bring the debt ratio to about 99% GDP. Although the figure for the first quarter of 2017 published by the Bank of Spain puts the debt-to-GDP ratio for all Public Administrations at 100.4% (€1.12872 billion), AIReF forecasts maintain the debt level slightly below 99%, mainly supported by the denominator effect due to the higher-than-expected growth of nominal GDP.

In the medium term, the targets set for the GG as a whole begin to deviate from the central AIReF scenario, which considers a slightly lower reduction. The likelihood of reaching the targets, consistent with the official medium-term forecasts included in the 2017-2020 SPU, decrease as the forecast horizon increases, taking into account AIReF's projected neutral path and its associated uncertainty, represented by the confidence intervals in Figure 21.

FIGURE 21. DEBT DYNAMICS: CONFIDENCE INTERVALS (% GDP)

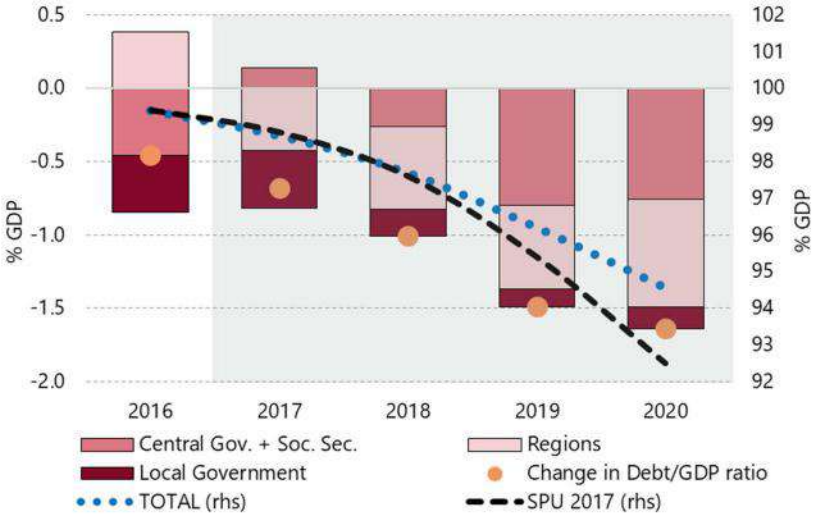


[22] The debt targets for the 2018-2020 period are those established by the Council of Ministers Agreement of 7 July 2017.

In terms of the contributions of the different subsectors, AIReF's neutral scenario envisages a positive contribution in the medium term for all of them, jointly contributing to the reduction of the debt ratio. In the AIReF neutral risk scenario for the next 4 years, all subsectors contribute to the reduction of the ratio. In cumulative terms, most of the decline in the debt-to-GDP ratio is projected to come in equal parts from the CA and SSF, taken together, and the ARs, as shown in Figure 22.

The sustainability analysis of the public debt path of the GG as a whole, despite showing a medium-long term downward trend, implies non-compliance with the first Transitional Provision of the LOEPSF. The first Transitional Provision of the LOEPSF establishes a transitional period until 2020 to reach the debt limit of 60% GDP, requiring a reduction of at least two percentage points in the debt-to-GDP ratio, if the real growth of the economy or expenditure grows above 2%. Both the official forecasts and the AIReF projections foresee non-compliance with these two conditions. Given AIReF's neutral scenario, which projects a downward path of the debt-to-GDP ratio, albeit with a moderate correction, the achievement of the 60% GDP reference value for the Government as a whole is not reached until 2035. As has already been noted in a number of AIReF reports, the factual impossibility of the first Transitional Provision calls for its review to provide demanding but realistic convergence paths at the reference levels.

FIGURE 22. CENTRAL DEBT PROJECTION AND CONTRIBUTION BY SUBSECTOR (% GDP)



Source: Bank of Spain & AIReF

4.1. Central Administration Subsector and Social Security Funds

AIReF's central forecast for 2017 debt in the CA and SSF subsectors is 71.8% GDP, slightly below the target set at 72% GDP. The debt target for this subsector continues in 2017 at 72% GDP. In 2016, the consolidated group formed by the CA and the SSF reached a debt ratio of 71.6% GDP, five tenths below 2015 and below target. For 2017, the projected increase in borrowing needs takes into account the forecasted CA deficit, the part corresponding to the additional tax

administration financing mechanisms, other stock-flow adjustment operations and the SSF deficit which will be financed in part with the Reserve Fund and through a treasury loan amounting to 10.192 billion euros to be repaid over a 10-year period from 2018 without any accrual of interest.

4.2. Autonomous Regions

At the subsector level, the risks associated with debt sustainability have declined slightly relative to the April report, but are still high. Improvement in the revenue forecasts derived from the autonomous financing system and the inclusion of the new fiscal measures by some ARs have contributed to improve the projected dynamics of debt-over-GDP in the long-term. There is an improvement in the risk classification in 10 ARs (Aragon, Asturias, Illes Balears, Canary Islands, Castile y León, Extremadura, Galicia, Madrid, the Basque Country and La Rioja), although in the case of Extremadura, the risk is considered high. In addition, only in the Canary Islands, the Basque Country and Madrid regions is the reference value of debt-to-GDP of 13% expected to be reached before 2020. Of the 7 remaining regions where the ratings remain unchanged, Castilla-La Mancha, Catalonia, Comunitat Valenciana and Murcia continue to stand out, where there is a very high risk of debt sustainability, especially if there is no possibility of recourse to State funding mechanisms.

The ARs continue to loosely comply with the debt targets despite the risks to sustainability and the fact that 13% GDP is expected to be reached much later than 2020. As AIReF notes in its Report, as in previous Reports, there are high risks for the sustainability of the Regional debt and it is projected that the legal limit of 13% GDP will not be reached until a date much later than 2020. In spite of this situation, there is still widespread compliance with the debt targets by the ARs. In particular, in 2016, the 17 regions complied with the debt targets and the great majority even fell below the established target.

A circumstance that increasingly contributes to its compliance and which abounds in the non-restricted character of these targets is the fact that financing debt is included in the totality of the deficit target, regardless of whether the ARs finally incur a lower deficit. The targets include debt to finance the total deficit authorized by the stability target, which is why the ARs incur a deficit below the allowable deficit at year end, with the difference being an additional margin within the target**.** This situation is becoming increasingly present. In 2016, half of the ARs incurred a deficit below the deficit target of 0.7% GDP. For 2017, it is projected that at least 7 will comply with the deficit target (the ARs whose likelihood has been rated as likely or highly likely).

At year end, the ARs as a whole project a debt of 24.7% GDP which, although exceeding the target of 24.1% GDP for 2017, could be compatible with compliance with this target once it is recalculated in order to verify compliance. The projected debt increase for the Regional subsector at the end of the year represents 24.7% GDP. This amount exceeds the target initially set for 2017 at 24.1% of GDP, but this does not necessarily lead to noncompliance, since the initial targets do not represent the limit that will be used to measure compliance at year-end. Despite the limitations in calculating this limit the net increase in the debt forecast for the ARs corresponds to concepts that would be included for this subsector[23]. However, the subsector's debt level is

[23] The amounts listed by Region correspond to: (i) the deficit target of 0.6% GDP; (ii) the annual amount of 2008/2009 negative settlement deferrals, and (iii) the amounts received in 2017 from the FFCCAA 2016 or authorized in 2016 to finance a deficit from prior years.

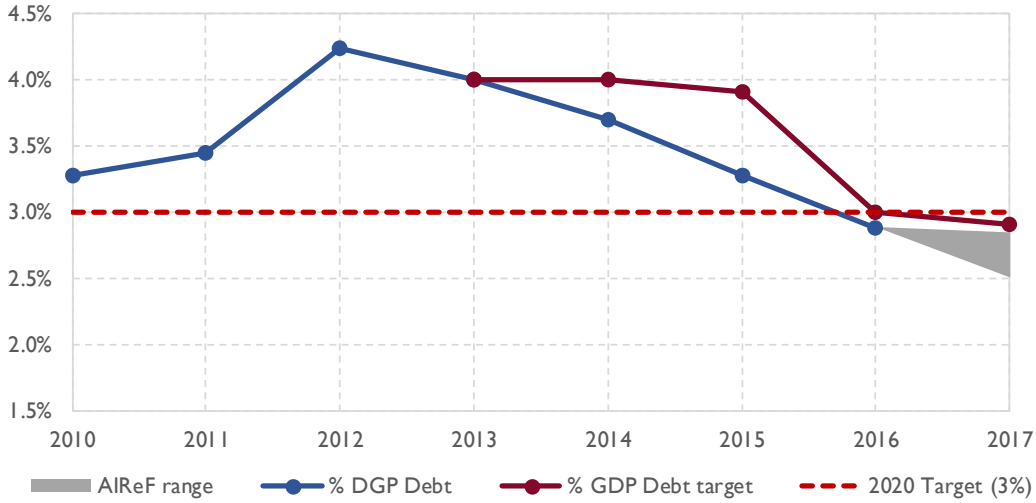
expected to increase at year-end, since, with some exceptions, this amount does not reflect the projected increases in the extra FLA 2017. These increases will not jeopardize compliance as they can be included in the target limit at the close of the year.

4.3. Local Governments

According to AIReF forecasts, in 2017 the Local Government subsector could reach a debt-to-GDP level of around 2.6%. As shown in the initial budget report, this subsector closed 2016 with a debt volume of 32.094 billion euros, 2.9% of GDP, which meant a decrease of almost 9% compared to the 2015 level and compliance with the 2017 target already in 2016. If the consolidation of the local surplus in 2017 and later years is confirmed, AIReF projects that the debt reduction path will continue and the debt-to-GDP ratio at the end of 2020 could be around 2% GDP.

Figure 23 shows the evolution of the observed data on current debt (as % GDP), as well as AIReF's forecast for the close of 2017 in the most favourable scenario, that is, that the surplus obtained each year is fully allocated to debt repayment. It also includes the relative position with respect to the agreed target for 2013 through 2017.

FIGURE 23. LOCAL GOVERNMENT SUBSECTOR DEBT (% GDP)



2013-2017 targets don't incluide the indebtedness from extraordinary mechanisms of payment to suppliers

Source: Banco de España and AIReF forecast

This situation for the subsector as a whole masks the individual situations of medium-term debt sustainability risk. Going deeper into the Local Government sustainability analysis, the report on the fundamental lines of the 2017 budget included a study of the composition and concentration of the local indebtedness and the individual situations with a higher level of criticality. Moving forward in this analysis, the April budget report this year identified those Local Entities with a population greater than 75,000, provincial or regional capitals, with medium-term sustainability risks (their current debt to current revenue ratios exceeded 75%). The results obtained showed more than 30% of these entities presented sustainability risks and of these, almost 20% were above 110%, which meant the impossibility of concluding new operations.

This report goes one step further in the analysis of local sustainability, including the evaluation of 32 municipalities whose debt ratio exceeds 75% and, in addition, presented settlements in previous years greater than a negative financial-economic indicator. The results of this analysis, as a first approximation of the sustainability of these local governments, are presented in the corresponding section on individual assessment. The criteria followed for their selection and the type of information requested is detailed.

5. Recommendations and best practice guidelines

5.1. Recommendations

- **Public Administrations**

To comply with the projected 2017 target of -3.1% GDP, the GG must make an adjustment of 1.2% GDP which AIReF considers feasible in the event that the impact of the asset liability derived from the toll highways is moved mainly to 2018. Although this compliance with the stability target is feasible for the Government as a whole, the situation by subsector is mixed, with subsectors such as LGs, which could close with a surplus even higher than 2016, and others, such as the CA, and to a lesser extent, the SSF, which presents a high risk of deviation. AIReF has insisted in previous reports on the need to provide greater transparency to the joint target vertical distribution process and to establish public methodologies to ensure that this distribution is carried out according to known criteria that take into account the financial situation of the subsectors and provide rigor, realism and enforceability to the fixing and subsequent compliance with the targets.

The repeated lack of recognition in the target vertical distribution process of the Local Government surplus entails setting unrealistic targets for the other subsectors, which undermines the purpose of the budget as a guiding document of the activity of the Public Administrations submitted to the approval of the national and regional parliaments. In addition, this lack of realistic targets detracts credibility from the application of the preventive and corrective mechanisms provided for in the LOEPSF. AIReF must guarantee their application.

To ensure the proper application of the LOEPSF, **AIReF once again recommends**:

1. ***Establish and publish a clear methodology for the vertical distribution of the deficit target that considers the financial situation of the different subsectors and endows rigor, realism and enforceability with the establishment of and subsequent compliance with the stability targets.***

The EU Council's specific recommendation to Spain as part of the 2017 European Semester urges our country to review expenditure in order to identify possible areas for improving the efficiency of public expenditure.

Improving efficiency is one of the general principles that inspire the LOEPSF and, in this sense, public expenditure reviews should be carried out as an instrument of efficiency in the allocation and use of public resources, generating fiscal spaces and guiding the budget towards achieving results. In the context of the expenditure review included in the SPU (USP 2017-2020), AIReF will request information on the particular review processes planned or under development by the various Public Administrations to have a joint vision to facilitate its monitoring.

In this area, ***AIReF recommends:***

2. ***The expenditure review processes put in place by the various Public Administrations, jointly or individually, result in effective efficiency gains and are permanently put into budgetary practice.***

- **Central Administration**

AIReF observes risk of non-compliance with the CA's deficit target of 1.1% GDP. In the 2017 Draft State General Budget of 26 April, AIReF already warned that, with the information available at that time, and without knowing the impact on the budgetary balance of the national account adjustments, there was a risk of non-compliance. Therefore, AIReF recommended that the Government should coordinate a budget implementation check to identify the impact of the tax measures adopted and warn of the potential risk of deviation from the target. Subsequently, the publication of the first notification made by the Government to the EC under the Excessive Deficit Procedure confirmed the deviation, setting a closure forecast for the CA of -1.5% GDP, a forecast still below AIReF's central scenario.

Since the issuance of the 2017 Draft SGB which considered compliance with the target unlikely, there have been a number of circumstances that have reinforced AIReF's assessment and which mainly focus on the impact derived from the new Basque quota regulation and the 2015 settlement of the Regional financing system.

For the CA subsector, the LOEPSF does not regulate a preventive procedure similar to the one existing for the Territorial Administrations in the event of deviation risks, a fact that is especially relevant in 2017 as it is in that subsector where there is the greatest risk of deviation.

AIReF, when evaluating the 2017 draft Budget, has already made recommendations in this regard, and the Government has not replied in this regard. It can be argued that the CA's responsibilities to the European authorities in relation to all the reliable targets for all Public Administrations generate sufficient incentives to compensate for possible deviations from the rest of the subsectors with its own revenue and expenditure. This line of argument has two weaknesses. First, the perception of a lower "accountability" level for the CA can erode the degree of commitment of the other Public Administrations with regard to compliance with its fiscal targets. And secondly, once Spain abandons the Excessive Deficit Procedure, probably in 2018, the degree of European supervision over Spain's public accounts is considerably reduced and, on the contrary, national legislation (mainly the LOEPSF and the AIReF Organic Law) acquires pre-eminence.

Therefore, ***AIReF again recommends***:

3. ***Provide coverage for the current gap in the LOEPSF regarding its application to the CA in cases of risk of noncompliance with the established targets. In particular, monitoring of the CA's execution by the MINHAFP on how the tax measures adopted are being implemented and their effect on the stability target should be articulated, alerting the risk of deviations that could occur at year-end. This monitoring should be carried out with the greatest possible transparency, with reports sent to the Cortes Generales and AIReF.***

- **Social Security Funds**

The projected 2017 deficit level for the Social Security System and the significant reduction of the Reserve Fund in recent years has made it necessary for the CA to make a loan to the SSF, as AIReF has repeatedly recommended in various reports the adoption of measures to ensure financing of the SSF in the medium term.

Therefore, ***AIReF recommends:***

4. ***That the Toledo Pact Commission identify potential measures aimed at ensuring the financial balance and sustainability of the Social Security System, whose impact assessment and quantification serve as a basis for future decisions.***

- **Autonomous Regions**

The probability of compliance with the stability target for a given fiscal year depends to a large extent on the revenue of the financing system, thus the assessment of the fiscal situation of a region can vary significantly from year to year without it having changed its behaviour from a fiscal point of view. From this perspective, the development and monitoring of fiscal consolidation scenarios and autonomic finances in the medium term is practically impossible. There is significant bias toward the adoption of short-term measures that seek to meet the deficit targets in hopes that the financing system revenue will improve. The dissociation that can occur in a given year between the financing system revenue and the expenditure scenario, in one way or another, tends to be corrected by adapting the latter to available revenue. This situation is not in line with the nature of the services provided by the ARs, and it is essential to have a stable financing system that takes into account the nature of autonomous expenditure and the application of well-defined, medium-term expenditure rule whose method of calculation is known and replicable.

Therefore, ***AIReF again recommends:***

4. ***Speed up the necessary work for the constitution of the announced working groups to analyse the expenditure rule and identify the problems that impede its effective application.***

Regarding the current application of the expenditure rule, the Canary Islands 2017-2018 draft EFP questionnaire on the Canary Islands expenditure rule included a new concept called "*Transfers of expenditure capacity from other General Government*", to include the effect of the larger transfer from the Competitiveness Fund, which the Region has indicated is a modification of its spending capacity, in accordance with the IGAE. This new concept has an effect similar to the legislative changes for increases in permanent collections, but is treated differently, since it is included in the questionnaire as a new category. This category, which is confusing, is not provided for in article 12 of the LOEPSF, where the only thing that can correct the computable expenditure are the regulatory changes that imply permanent increases/decreases in collection. If the breakdown is justified as a separate category, it would be necessary to change the "*Guide for the determination of the Regional Expenditure Rule"* published by the IGAE to assist the ARs with the calculation of the expenditure rule.

To ensure transparency and the predictability of the fiscal rules, ***AIReF recommends that:***

5. ***The MINHAFP eliminates this new heading or, if justified by the particular nature of any operation and compatible with the LOEPSF, it should be included, for general knowledge, in the "Guide for the determination of the Regional Expenditure Rule".***

AIReF has reiterated on numerous occasions the need to revise the system for establishing the Regional debt targets, insofar as they are not contributing to medium- and long-term debt sustainability. Among the recommendations made, it should be noted that the goal was to ensure consistency between the debt target and the stability target[24]. The point was to make it clear that the excess deficit in relation to the stability target should not be included in the debt target for the following year without any consequences. We need to avoid morally risky situations. With regard to this recommendation, MINHAFP has merely stated that the debt targets are established as provided in the LOEPSF. However, the law only regulates formal but not substantive aspects, which does not prevent the content of the limit imposed by the debt targets.

This report refers to the opposite case, that is, when the region incurs a deficit below the fixed stability target. In this case, which includes more and more ARs, AIReF understands that the whole of the stability target should not be included in the debt limit, but rather the deficit actually achieved.

Therefore***, AIReF recommends:***

6. ***When the ARs incur a deficit below the established stability target, the debt target does not include the whole stability target, but is adjusted to the financing needs at the end of the year.***

- **Local Governments**

AIReF has noted in previous reports that, at the local level, there are non-compliances with some fiscal rules that are not covered by an approved EFP. In this context, AIReF recommended that the MINHAFP promote the establishment of a legal procedure to overcome the blockage that sometimes occurs in the processing of a EFP and that, as long as such a procedure does not exist, the application of corrective and coercive measures of the LOEPSF. The MINHAFP, in response to the recommendation, reported that on a yearly basis, settlement data is checked against those effectively approved EFP's to detect non-compliances that are not covered by a plan, formulating (either the MINHAFP or the Regional agency) the requirements for approval of the EFP or the application of Article 25 of the above Law (Agreement of Non-Availability of Credit- AND-).

In some of the LGs that are individually assessed, AIReF has been able to observe that the application of Article 25 of the LOEPSF for the different financial supervisory bodies is not homogenous. Thus, some of them emphasize that the AND is a coercive measure against an

[24] Report on

established non-compliance with a fiscal rule, so that its issuance signifies a non-compliance. On the contrary, other supervisory bodies grant the AND as a preventive and sanctioning measure, intended to avoid non-compliance in the current year, establishing the non-availability of credit in the amount necessary for it. This second interpretation is the one that seems more in line with the LOEPSF, in that it is noted that the AND must guarantee compliance in the same fiscal year.

In any case, AIReF continues to insist on the need to standardize the actions of the supervisory bodies and ***recommends***:

7. ***The MINHAFP promotes the application and homogenous interpretation of article 25 of the LOEPSF by all the Local Government financial supervisory bodies as a coercive measure that also avoids repeated non-compliances.***

In this coordination of the supervisory bodies, AIReF has recommended in previous reports that the MINHAFP establish a common framework for the exercise of the duties of the different local government supervisory bodies in terms of the fiscal rules, where the criteria for action are clearly defined and the meetings and commitments are publicized. The MINHAFP responded to the recommendation that this common framework has already existed since 2014, with annual technical meetings. AIReF will be invited starting in 2017. In these meetings, the general coordination criteria and practical implementation of the LOEPSF is established, which are documented in the minutes whose content is not binding since it would require the consideration of the contents by the policy makers.

Taking this response into consideration, ***AIReF recommends:***

8. ***That the MINHAFP publish the firm commitments adopted at the meetings of the Local Government supervisory bodies on the common criteria for the application of the fiscal rules, as well as actions not related to those criteria. To this end, this Ministry should promote the necessary procedures to ensure the assumption of such agreements by the policy-makers.***

Regarding the application of the transparency principle, AIReF has already recommended to the MINHAFP in previous reports that it promote the publication of all the data required to verify local government compliance with the stability target and the expenditure rule. These publications should include individualized information by local entity in terms of national accounts. The MINHAFP responded to the recommendation, reporting that the SGFAL already publishes data that permits verification of compliance with the fiscal rules and that, as of March 2017, the IGAE has published individualized data in terms of national accounting for compliance with the stability target for ten local governments. Regarding the individual publication of the expenditure rule, the MINHAFP had previously reported that, since verification of the requirement demands data for two consecutive years, provided that all necessary information is available, the IGAE will publish individualized information on all the previous Local Entities in 2018. In this sense, AIReF reiterates the recommendation, since the individual publications of the SGFAL only refer to compliance with the stability target, not to other fiscal rules, without specifying the amount of non-compliance/compliance, which substantially limits its assessment.

Therefore***, AIReF reiterates the recommendation:***

9. The MINHAFP promote the publication of the data necessary to verify compliance with all the fiscal rules at the level of the local government subsector and, at the individual level, and announce the main components that are involved in its calculations.

As already recommended by AIReF in its report on the initial 2017 budgets, in the event that a local government has an Adjustment Plan to access the extraordinary financing mechanisms and a EFP for non-compliance with a fiscal rule, both plans should be coherent and include the same limits for compliance with these rules for the same terms, since they are documents approved by different agencies and with different time horizons, but concerned with the financial-economic activity of a single entity. The MINHAFP responded to this recommendation stating that this situation occurs precisely because these instruments have different time horizons, and the committed limits must be the same for the same years. For this reason, AIReF recommends that the MINHAFP arbitrate the necessary procedures to ensure that such limits are consistent, so that when one of these documents must be approved with the other, the competent body for approval takes into account the already approved plan to ensure consistency.

Therefore, ***AIReF recommends:***

10. The MINHAFP arbitrates the necessary procedures to ensure consistency of limits in compliance with the fiscal rules between the Adjustment Plan and the Financial-Economic Plans for the same years, so that when one of these documents has to be approved with another, the Competent body takes the already approved plan into account to ensure consistency.

The detailed individual assessment of the 21 large local entities subject to analysis has been carried out since the beginning of the budget cycle, based on the perceived risks of non-compliance with any fiscal rules. ***AIReF recommends***:

11. The cities of Madrid, Barcelona and Palma de Mallorca and the Council of Valencia adopt the measures of Article 25 of the LOEPSF in the absence of a EFP in force for 2017, in the case of Madrid, or present a risk of non-compliance with the EFP targets, in the rest.

12. The cities of Valencia, Zaragoza, Bilbao and Gijón, the Council of Barcelona and the Council of Seville, the Island Council of Tenerife and the Consell de Mallorca, adopt execution measures to ensure compliance at the end of the year.

13. The city of Murcia expedite the procedures to approve the corresponding EFP that establishes limits to comply with the 2017 fiscal rules.

14. The city of Malaga adopt debt reduction measures to place the debt-to-income ratio below the limit of 75%.

15. The cities of L'Hospitalet de Llobregat and Valladolid monitor their execution this year to ensure compliance with the fiscal rules at the end of the year.

5.2. Good Practices in Transparency

In recent years, the Public Administration accounts have borne the economic impact of the materialization of certain contingent liabilities, such as the judgment of the so-called “sanitary cent” or the reclassifications of various Public Private Associations in any Region or city. Currently, there are still a number of possible contingencies that could significantly impact our public finances in a short period of time, such as the toll roads. Also of special relevance are the guarantees granted in the bank restructuring processes. The information requirements laid down by the Community legislation for contingent liabilities are insufficient to carry out a detailed analysis of this type of risk as the legislation includes the different subsectors in an aggregate way and does not allow the identification of risks such as the one derived from the asset liabilities arising from judicial procedures that have been relevant in recent times.

Therefore***, AIReF recommends as a good practice:***

1. ***That information be published on contingent liabilities that may affect public accounts with a breakdown greater than that required for the purposes of the Stability Program or the Budgetary Framework Directive in order to provide updated information on the potential risks which may affect public accounts.***

ANNEX I. Monthly Monitoring Chart Methodology

The AIReF projections for the balances, revenue and expenditure for the different subsectors (CA, SSF, ARs and LGs) as well as for the GG as a whole, are updated using the results of the models themselves and the known national accounting data.

The 2017 stability targets are those set by the Council of Ministers on 2 December 2016. The notification of the deficit and debt of 31 March sent to the EC included a closure forecast for 2017 which reflects that the CA deficit is above the approved -1.1% target, standing at -1.5% GDP (¬¬-1.4% GDP without financial aid) and that the SSF is above the approved -1.4% target, standing at -1.6% GDP.

The AIReF forecasts and the official balance, revenue and expenditure trends are updated monthly, using the same weights as assigned by the ARIMA projections each month, for each of these components, collecting the effect of both seasonality and the trend of the series.

The observed data for the month of April for the GG as a whole reflected in the graphs have been estimated from the consolidated data published by IGAE, which includes the CA, SSF and Regional subsectors, adding the AIReF's monthly forecasts for the local entities. Given that the information on the LGs' 2017 Q2 execution is not published until the end of September, the data for the month of April 2017, as well as for the rest of the months of the year reflected in the graph, have been projected taking into account the Monthly payment of transfers from the state to the local governments from the financing system and payments from the provincial councils to the AGE for the quota and to the Basque Country, the rest of the revenue and expenditure has been estimated based on their historical behaviour.

The confidence intervals are obtained in two stages. First, a VAR model is projected for the following variables: (i) subsector specific variables, such as expenditure, revenue and the ratio of public debt to GDP; and (ii) common variables referring to the national aggregate: real GDP, GDP deflator and ten-year government bond yields. Second, using projected trajectories for different variables and the projected joint distribution of VAR shocks, 1500 probabilistic scenarios are constructed. The intervals shown in the graphs refer to the 20-80, 30-70 and 40-60 percentiles. These probabilistic intervals provide conclusions about the likelihood of the official forecast:

Very likely	80-99%: compliance highly likely
Likely	60-79%: compliance likely.
Feasible	40-59%: compliance feasible.
Unlikely	20-39%: compliance unlikely.
Very unlikely	0-19%: compliance highly unlikely.