Independent Authority for Fiscal Responsibility

Report

28th September 2015

Report on the General Government draft budgets and main budgetary lines for 2016

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

Macroeconomic context

- Spain's public accounts continue to be immersed in an intense process of fiscal consolidation that was launched back in 2010. The budget stability targets for 2015 and 2016 are very demanding because of the size of the reduction required (the deficit has to be cut by 1.5% one year and 1.4% the following year) and because the Spanish economy is still performing significantly below its potential despite the cyclical economic upswing.

- The current macroeconomic context is having a mixed effect on public accounts. On the one hand, the cyclical recovery in economic activity is curbing the financing needs of the General Government sector by driving up tax revenue collection and bringing down unemployment benefit payments. On the other hand, the lengthy period of low prices and internal devaluation that has underpinned the improvement in the price-competitiveness of Spanish goods and services in the short term has acted as a brake on the nominal growth of revenue —especially Social Security revenue.

Central Government

- In line with the earlier than scheduled submission by the government of the Draft SGB for 2016, AIReF has brought forward its assessment of the Central Government and Social Security subsectors ahead of the scheduled timeframe of the report it has to publish on the drafts and main budgetary lines of the General Government. The statutory date of 15 October is still the scheduled date for publication of the report that will cover the territorial administrations in Spain (autonomous regions and local entities).

- The deficit target forecast for the Central Government in 2016 (2.2% of GDP) seems achievable and is supported by the buoyancy of taxation revenue, by the scaling down of the transfer made to the State Public Employment Service (SEPE) and by the lower debt servicing burden forecast. Compliance with the 2016 target should be aided by the good starting basis of the 2015 year-end result for which AIReF does not detect any significant risk of deviation.

- The growth in taxation revenue seems plausible overall. Nevertheless, there might be some downside risk in direct taxation —especially Corporation Tax— linked to the uncertainty stemming from the final impact of the tax reform, of the developments in economic activity and the final impact of the offsetting of tax loss carry forwards.

- No major tension, however, is viewed in the non-financial uses forecast for next year. A reduction in the debt servicing burden is forecast whilst the scaling down of the transfer to the State Public Employment Service to an amount that will allow it to balance its budget will be partially offset by the increased amount to be transferred out to the autonomous regions. Nevertheless, there is uncertainty about a hypothetical rise in interest rates given the current high level of debt.

Social Security Funds

- There is a high risk that the Social Security Funds will not meet the target set for 2016 at -0.3% of GDP. This risk exists primarily because of the confirmation of deviation from the 2015 deficit target that AIReF already highlighted in previous reports, as well as the difficulty of achieving the revenue forecasts in the 2016 budget.

- The financial position of the Social Security Funds has been deteriorating progressively since the onset of the crisis in 2008, building up a considerable deficit that the recent economic recovery has not been able to turn around. Since 2008, the development of revenue has always been below expenditure, even though expenditure has been curtailed because of the effect of the reform measures approved.

- In this context, the growth in non-financial uses in the social Security Funds budget for 2016 —essentially expenditure on pensions— seems well assessed. However, it is very likely that revenue will develop significantly below budget expectations. In fact revenues are not aligned with the trend in their macroeconomic underlying factors and there are no additional measures to justify this higher forecast for revenue collection by the Social Security System.

- Although revenue from social contributions has been recovering since 2014, largely because of the upturn in employment, the pace of increase is only moderate due to a combination of diverse factors: low inflation and the process of internal devaluation in Spain, the fall in the number of beneficiaries of the contributory unemployment benefit and the implementation of measures to incentivise employment. In addition, the yields on the Reserve Fund have been reduced since it has had to disburse part of its resources to cover the pension system deficits.

- Lastly, in 2016, the State Public Employment Service (SEPE) seems to have no margin now to offset even partially this deviation as it did in

2014 and as is likely to occur in 2015, because the transfer made by the Central Government has been adjusted to match the real needs of the institution. Consequently, the balance of the Social Security System (excluding SEPE and FOGASA) can be maintained in 2016 within a broader confidence interval but in line with the estimate for the 2015 deficit.

Government debt target and expenditure rule

- The SGB does not include any information on compliance with the debt target by subsectors or the expenditure rule.
- The government debt target is analysed from the standpoint of the sustainability of the General Government sector overall. The government debt-to-GDP ratio forecast in the draft budget both for 2016 and for the period 2017-2018 are in line with the estimates made by AIReF, although a gradual downward deviation is observed towards the end of the reference period.
- Compliance with the expenditure rule by Central Government in 2016 is more restrictive than the budget stability target. The need to absorb the deviations recorded in 2014 (the “health cent”) and the impact of the tax reform in 2015 and 2016 generate tensions for compliance with the expenditure rule.

Recommendations

AIReF makes a number of recommendations in its report including the following recommendations:

- The Social Security System has very few drivers available to it to boost revenue collection in the short term. Furthermore, although its expenditure is determined by legislation that has already been given a major overhaul, the full effects of the changes require a longer time frame to be appreciated. Following its recommendation made in July that an evaluation should be made of measures that could be adopted to ensure on a permanent basis the financing of the deficits of the Social Security System through the State General Budget or of any other decisions that could be taken to balance the system, AIReF is now recommending development of additional provision sixty-five in the draft Budget bill for 2016 and for the compatibility between the budgetary stability targets approved for the Social Security Funds and the funding of the benefits covered by the system to be guaranteed.
- AIReF recommends that all the necessary information required to determine the variation in the eligible expenditure in the Central Government should be included in the Draft State General Budget.

Furthermore, because of the difficulties in interpreting and appraising the components of the expenditure rule such as the impact and temporary nature of the normative changes that can trigger a rise or fall in revenue collection, there is need for implementing provisions to further develop the content of article 12 of the LOEPSF.

- Lastly, AIReF is of the view that some thought should be given to and discussions held on the design of the expenditure rule and its application to the different public administrations. AIReF is therefore recommending the setting up of working groups on the subject within the Fiscal and Financial Policy Council and the National Local Administration Commission.

1. Introduction

On 31st July this year Spain's Council of Ministers approved the State General Budget Draft for 2016, which was subsequently submitted as a bill to parliament on 4th August. This early submission —two months in advance of the usual schedule— of the draft State General Budget (SGB) for its passage through parliament to be enacted as legislation is linked to the fact that the government is reaching the end of its term in office and had publicly stated its intention of presenting the following year's budget before the general election in order to provide greater certainty and security to the different economic agents.

In line with the early submission of the 2016 draft SGB, the government also brought forward the date for sending the Kingdom of Spain's 2016 Budgetary Plan to the European Commission to 11th September. However, as the Budgetary Plan itself states, information on the main lines of the budgets of the Autonomous Regions (ARs) and Local Corporations (LC) was not available at the time of its publication because the statutory deadline for the information to be sent to the Ministry of Finance and Public Administrations (MINHAP) is 1st October. As a result the information contained in the Plan for the territorial administrations (TAs) —regional and local governments— is from the Stability Programme, updated with the personnel measures approved in the draft SGB that are of a basic nature and affect all subsectors. It also includes the increase in the financing system resources and the measures set out in the Economic-Financial Plans and Adjustment Plans prepared by those ARs under the obligation to submit such plans.

AIReF has deemed it appropriate to bring forward the publication of its own report on the draft budgets and main budgetary lines of the General Government sector mandated in article 17 of the Organic Law on Budgetary Stability and Financial Sustainability (the LOEPSF, as it is usually called using its Spanish acronym), for the Central Government (CG) and Social Security Funds (SSF) subsectors. The LOEPSF stipulates that before 15th October every year AIReF must prepare a report on the adequacy of the draft State General Budget and the budgets of the autonomous regions and local corporations for compliance with the stability, debt and expenditure rule targets. The 2016 SGB Draft is currently in its passage through the Spanish parliament as a bill to become legislation but, as the Budgetary Plan itself states, there is no information available on the main budgetary lines of the budgets prepared by the autonomous regions or local corporations. Nonetheless, AIReF has taken the view that to maintain consistency with the early submission of the draft SGB as a bill for parliament and the presentation of the Budgetary Plan, the independent fiscal institution should publish this first report analysing solely and exclusively the draft SGB and the information contained in the Budgetary Plan in relation to the Central Government and the Social Security system. By doing so it will be possible for the conclusions reached in the report to be taken into consideration prior to parliamentary approval of the SGB.

2. Object of the report and limitations on its scope

The object of this report is the appraisal of the draft SGB from the standpoint of compliance with the three fiscal rules defined in the LOEPSF: budgetary stability, government debt and expenditure rule. The earlier than scheduled passage through parliament of the draft 2016 SGB bill and the submission of the General Government sector Budgetary Plan have given rise to the publication of this report with the documentation available at the time, primarily concerning the CG and the SSF.

The scope of the report has been constrained by the lack of any reference to the government debt target by subsectors and to the Central Government expenditure rule in the draft SGB. Another constraint identified by AIReF has been the non-availability of budgetary data in national accounting terms that are necessary for the evaluation of the budgetary stability target. In the preparation of this report, as well as the published supporting documentation of the draft SGB itself, AIReF was able to use supplementary information made available by the Ministry of Finance and Public Administrations (MINHAP) and the Ministry of Employment and Social Security (MEYSS). Nevertheless, the scope of the report was limited by the following constraints:

1. Compliance with the debt target is mentioned at an aggregate level for the whole General Government sector but no reference to compliance with that target by the Central Government subsector is made.

2. No mention is made of the expenditure rule for the Central Government.

3. There is insufficient information on budgetary data in national accounting terms. In particular:

   a) Insufficient information contained in the Draft SGB

   ✓ *Equivalence between the Central Government budget balance and the national accounting balance:*

   - The level of disaggregation of the national accounting adjustments does not provide sufficient level of detail for the items they affect to be identified.

   - The surplus made by government agencies is included as a total balance figure and apparently does not include those agencies that are not really public agencies but are still consolidated for the purposes of ESA 2010 (for instance the Deposit Guarantee Fund, *Fondo de Garantía de Depósitos,* or the Electricity System Deficit

Securitisation Fund, *Fondo de Titulización del Déficit del Sistema Eléctrico*).

- ✓ *Social Security System initial budget in national accounting items.* The Social Security budget is presented in the format of national accounting items but only includes the Social Security System budget, not the State Public Employment Service (SEPE) or the Wage Guarantee Fund (FOGASA). Nor does it include the national accounting adjustments[1].

b) Lack of information in the Draft SGB:

- ✓ *Projected settlement for the 2015 Social Security Funds budget.* Article 37 of the General Budget Act (*Ley General Presupuestaria*) in Spain states that the budget bill sent to the Spanish parliament should be accompanied by a projection of the settlement of the budget for the current year. The draft Budget 2016 includes projections for the settlement in the case of Central Government but does not include the projection for the SSF.

  The budgetary plan has incorporated budget implementation data broken down by subsector up to May 2015 but it does not contain a projection for this year's settlement figures for each one of those subsectors.

- ✓ *Initial budget in national accounting terms for 2016 for the Central Government and Social Security Funds.* The lack of an initial budget in national accounting terms broken down by subsectors is a significant constraint when it comes to AIReF's analysis of the forecasts because it means they cannot be checked against the official figures at the level of resources and uses items.

  In the Budgetary Plan there is a presentation of the initial budget in national accounting terms for the whole General Government sector but it does not give details broken down by subsector.

4. Subsequent to the publication by the government of the draft SGB for 2016 the National Statistics Institute (INE) recently revised down the GDP series. This annual national accounting revision in nominal terms amounts to a loss of €17.3 billion in 2014 because of the worsening of the crisis between 2011 and 2013.

[1] The Social Security Funds (SSF) subsector is made up of the Social Security System, the State Public Employment Service (SEPE) and the Wage Guarantee Fund (FOGASA).

3. Budget stability target

The budget stability target set for the general Government sector as a whole in 2016 is -2.8% of GDP in line with the EU's excessive deficit recommendation made to Spain in June 2013.[2] Over the last few years, the public administrations in Spain have implemented a fiscal consolidation policy designed to put them back on track on a government deficit path consistent with the requirement under EU legislation to bring the deficit down by 2016 to under the 3% threshold in order for Spain to exit the Excessive Deficit Procedure (EDP).[3]

Central Government	Social Security	Autonomous Regions	Local Corporations	General Government
-2,2	-0,3	-0,3	0	-2,8

Source: MINHAP

The budget stability target set for 2016, which entails a cut in the deficit of 1.4% of GDP, is demanding and all the subsectors will have to contribute to its achievement. The deficit target for the General Government sector set for 2016 means reducing the deficit from 4.2% to 2.8% of GDP. As part of this global target for the General Government accounts, the Central Government has to bring down its own deficit from 2.9% to 2.2% and the Social Security Funds must reduce its deficit from 0.6% to 0.3% of GDP.

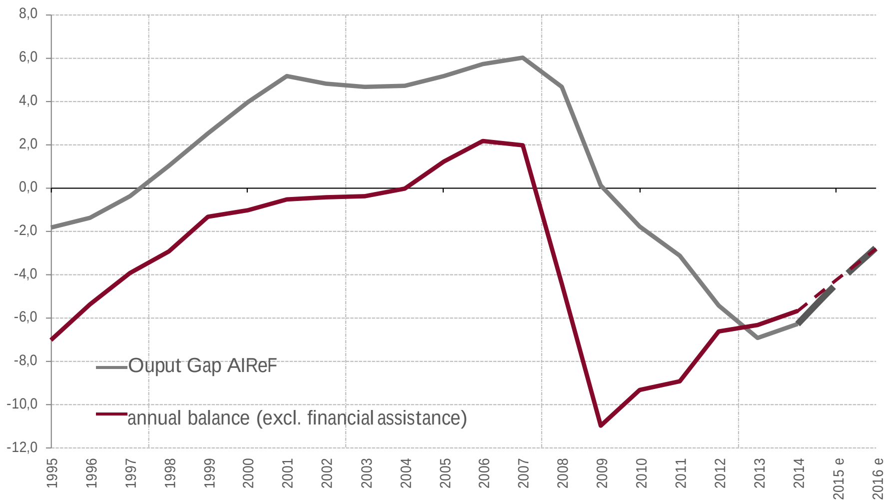
These demanding budget stability targets are set against a backdrop of buoyant economic activity in the Spanish economy and a moderate pace of development of prices. As can be observed in Graph 1, given the pro-cyclical nature of the development of the fiscal balance, the economic recovery that started in 2014 should give substantial momentum to the fiscal consolidation process insofar as it has a knock-on effect on the breadth of tax bases and is accompanied by a similar upturn in the employment rate. In its report on the macroeconomic forecasts published on 31st July,[4] AIReF endorsed the macroeconomic scenario supporting the 2016 SGB although its view was that the composition of growth may be different from the forecast, with more consumption and less investment, and that job creation may be somewhat lower than expected.

[2] The Agreement of the Council of Ministers (ACM) of 10th July set the budget stability and government debt targets for the whole General Government sector.

[3] For the European Council to decide to lift the EDP for Spain, the recorded figure for the government deficit achieved in 2016 must be no more than 3% of GDP. In addition, the European Commission forecast must indicate that the 2017 deficit will not overshoot that target either. In line with usual practice to date and the calendars for reporting fiscal information to the Commission, that decision might be taken around June 2017.

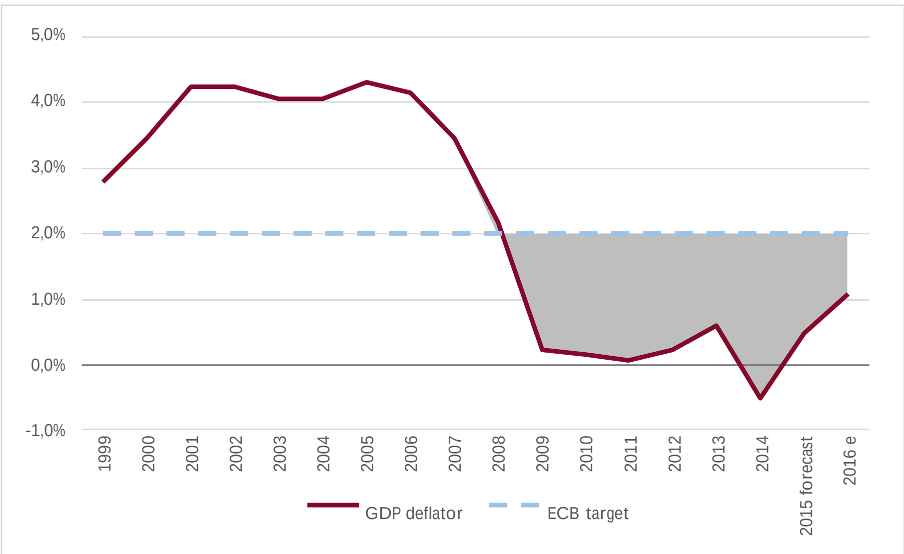
[4] Report on the macroeconomic forecast in the 2016 Draft State General Budget

Graph 1. Spanish economy output gap and annual balance for General Government sector (excl. financial assistance to banks)



Source: IGAE and AIReF

Graph 2. Annual trend for GDP deflator Spain and ECB pricing target



Source: INE, AIReF and FUNCAS

However, the intense process of a more moderate inflation rate that is very likely to continue throughout 2016 is slowing down fiscal consolidation by limiting the growth of revenue and the nominal GDP. As shown in Graph 2, the rise in prices in Spain since the outset of the crisis measured with the GDP deflator (an indicator that is closer to the development of final prices in the economy) has been much lower than the European Central Bank target. From a fiscal standpoint, this process of price containment together with the internal devaluation process in Spain is having a short-term effect of slowing the pace of increase of fiscal revenues insofar as they are linked to nominal variables. These considerations are especially relevant in the case of the Social Security System because although the recovery is fairly strong in employment, resources have been directly affected by wage dynamics that ultimately determine the calculation base underpinning the revenue collected of social contributions.

Central Government

AIReF's estimates do not show evidence of any risk that the Central Government will fail to comply with the deficit target for 2015 provided that the deviations in taxation revenue collection are no higher than those already included in the 2015 projection and there are no extraordinary expense increases in the last few months of the year. The draft SGB for 2016 is accompanied by a projection of the settlement of the 2015 Central Government Budget in national accounting terms in which the year-end figures show a GDP deficit of -2.9%.

The 2015 year-end projection is forecasting a deficit of 3.2% for the State, which is offset by a surplus in the Central Government Agencies totalling 0.3% of GDP, which will allow it to hit the target for 2015. As AIReF pointed out in its report published on 15th July, the CG might comply with the 2.9% GDP deficit figure set for 2015. The 2015 settlement projection for tax revenue in the draft SGB is estimating a negative deviation of tax revenues adding up to 0.35 % of GDP with regard to the initial budget. This deviation is due primarily to the earlier than scheduled effect in 2015 of the reform of personal income tax, *Impuesto sobre la Renta de las Personas Físicas* (IRPF) forecast for 2016 (-0.14 % of GDP), to the adjustment for special taxes, *Impuestos Especiales* (IIEE) arising from the refund of the so-called health cent (-0.7% of GDP) and an adjustment of the forecast for corporation tax, *Impuesto sobre Sociedades* (IS) (-0.09% of GDP) as a consequence of the deviation in the 2014 settlement.[5] This lower revenue is offset by lower than expected expenditure on interest payments and a possible surplus in government agencies. Nonetheless, this compliance with the budget stability target is subject to the trend in implementation of expenditure remaining consistent with the implementation data available to date, and on the consolidation of the surplus forecast for the agencies (Box 1).

On the basis of the assumption that it will first comply with its 2015 target the Central Government has to make an adjustment equivalent to 0.7% of GDP in 2016. The SGB draft does not contain any additional expenditure reduction measures or taxation measures designed to increase tax revenue collection. According to the SGB, the fiscal adjustment required to comply with the 2016 target in this subsector will come mainly from the higher tax revenue collected as a

[5] This uncertainty in the estimate of corporation tax revenue was already highlighted in AIReF's Report on the initial budgets published on 30th April.

consequence of the economic environment, the reduction in the transfer made by the CG to the SEPE and the reduction in the interest burden of government debt.

BOX 1. Institutions within the scope of the Central Government

The Central Government subsector is made up of the State and dependent government agencies, non-market producer public corporations, funds with no legal personality and other entities that are not really public entities but are still classified under the ESA 2010 as falling within the scope of the Central Government subsector such as the Deposit Guarantee Fund (*Fondo de Garantía de Depósitos*, FGD). The SGB does not include any budget information for these units that are not public entities despite the fact that they are subsequently integrated into the budget implementation data presented in national accounting terms. Over the last three years the balance of the Central Government agencies has made a positive contribution to the stability target, with major differences observed between the balance initially budgeted and final implementation figures. The cause of this difference lies in the contribution made by the FGD that does not appear to be included in the initial balance of the agencies as no mention at all is made of it in the SGB.

LENDING (+) / BORROWING (-) CG AGENCIES (*millions of euros*)

	2012	2013	2014	2015
Initial Budget	-669	-514	338	435
Nat. accounting Impl.	569	1028	2600	3133

Source: SGB, IGAE. 2015 Implementation settlement projection SGB 2016.

The current *Fondo de Garantía de Depósitos de Entidades de Crédito* (FGD) is an entity with its own legal personality and with full capacity to carry out its own mandate under private law arrangements. The Deposit Guarantee Fund was created by Royal Decree-Law 16/2011, of 14 October, through the merger of the three guarantee funds that existed at the time for banks, savings bank and credit cooperatives. The normative changes brought about by this merger and the subsequent regulation that broadened the functions of the FGD, granting it the power to implement support measures in the resolution of lending institutions, led to its reclassification from the financial institutions sector to the General Government sector. It has therefore been classified as within the Central Government subsector since 1st January 2012.

The FGD's function is to guarantee deposits and reinforce the solvency and functioning of the lending institutions that have signed up to it. The impact that the FGD or other entities like it that are classified for the purposes of ESA 2010 as Central Government agencies may have on the borrowing/lending of the Central Government is unknown as there is no information on them included in the SGB draft.

Non-financial revenue forecast for 2016

The draft SGB is forecasting a 6.2% increase in total pre-ceded tax revenue compared to the initial year-end figures forecasted for 2015. This increase is primarily supported by the buoyancy of the key macroeconomic variables. Although tax revenue rises by 6.2%, the amount corresponding to the State in the end is up by 4.7%. This is the result of the effect of the regional financing system whose impact is described in greater detail in Box 2 below.

BOX 2. Effects of the autonomous regional financing system on the Central Government budget in 2016

The resources of the autonomous regions in the common regime under the current financing system (Law 22/2009, of 18th December) can be classified in three groups depending on the channel through which the funds are paid to the regions:

1. **Resources collected by the ARs** stemming from the taxes that are fully ceded to the regions (e.g. the tax on inheritance and donations).
2. **Resources collected by the national tax agency (AEAT)** that are transferred on a monthly basis according to the amount that has been collected (e.g. tax on certain modes of transport).
3. **Resources subject to interim payments** (IRPF, VAT, IIEE, Global Sufficiency Fund and Guarantee Fund Transfer, paid by the State (AGE) on the basis of an estimate of the final amount due. When that final amount to be paid is worked out (two years later) the relevant payment settlement is made and paid out by the AGE to the ARS or by the ARs to the State depending on whether it is positive or negative. In the year when the final settlement is made, the AGE also pays the Convergence Funds amount. All of these resources represent more than 80% of the system total.

Of the resources included in point 3 above only the Global Sufficiency Fund, the Guarantee Fund and the Convergence Funds are reflected in the SGB:

- In the State expenditure budget: the Global Sufficiency Fund payable to the ARs, the contribution of the State to the Guarantee Fund and the Convergence Funds.
- In the State revenue budget: the Global Sufficiency Fund payable to the State and the settlement of the contribution to the Guarantee Fund.

The interim payments and settlements of personal income tax (IRPF), VAT and special taxes (IIEE), on the contrary, are not shown in the State budget. Nor are the non-budgetary advance payments made by the State to the ARs to pay the deferrals of the negative settlements in 2008 and 2009 included in the budget.

The table below shows the increase recorded by the resources of the common regime autonomous regions in 2016 through the regional financing system:

	Mn€
EXPENDITURE BUDGET. Transfers from AGE to ARs	315
REVENUE BUDGET. Transfers to AGE from ARs	2.269
NOT REFLECTED IN THE SGB:	4.871
- IRPF, VAT & IIEE ceded	*5.974*
- Non-budget advance payments	*-1.103*
TOTAL INCREASE IN FUNDING ARS FINANCING SYSTEM	7.455

AIReF's estimates for the development of the resources of the Central Government in the SGB seem plausible. As can be seen in Graph 3, this is the case provided the deviations in taxation collection are no higher than the deviations included in the 2015 projection and the downside risks in the macroeconomic scenario do not materialise.[6]

The personal income tax (IRPF) collection will rise thanks to higher employment income (mainly wages) stemming from the recovery in the job market. However, in line with the estimates made by AIReF, the IRPF collection for 2016 forecast in the SGB might have some upward bias should the risk of lower job creation than in the SGB[7] as identified in AIReF's Report on the macroeconomic forecasts (published on 31st July 2015) materialise.

In line with the SGB draft, corporation tax will record growth of around 10% in 2016, despite the fact that it is subject to a tax reform that will have a negative impact on the revenue collection equivalent to 0.2% of GDP.[8] The development of corporation tax forecast in the SGB is determined by several factors:

- ✓ Higher company profits tied to economic growth and the likely loss of effect of some measures that had triggered lower tax collection in previous years, such as the offsetting of tax loss carry forwards and of the deduction balances pending payment[9].
- ✓ The uncertainty derived from the impact of the tax reform and of the possible effect of measures like the offsetting of tax loss carry forwards in 2016.
- ✓ As shown in Box 3, the considerable margin for upside shown by the still large gap between the corporation tax collection to GDP ratio and the average ratio recorded in the past when the Spanish economy was close to its growth potential (2.1% compared to 2.7%) for this tax that is tightly bound to the economic cycle.

Taking into account the uncertainties highlighted for IRPF and corporation tax, the estimates made by AIReF determine that the forecasts in the SGB draft have a slight upward bias in the income taxes that fall within the upper part of the confidence interval calculated following the methodology described in Box 4.

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[6] IRPF personal income tax has been estimated using the model published in AIReF's Working Paper 2/2015 *Modelización y proyección de ingresos por el Impuesto sobre la Renta de las Personas Físicas* (available in Spanish) and for the estimate of confidence intervals. Corporation tax, VAT and IIEE have been estimated using the model described in Annex I of the Report on the General Government drafts and main budgetary lines.
[7] The development of employment forecast in the macroeconomic table accompanying the draft SGB would be above the consensus forecast.
[8] Estimated impact of the 2016 General Government Budgetary Plan.
[9] No additional details are given in the SGB either on the quantification of these balances or on the effect forecast for 2016 and AIReF has been unable to obtain that information.

The growth forecast in indirect taxes based on the improvement in consumption and in the housing market is in line with the estimates made by AIReF. For VAT, the forecast is for it to grow more than in 2015 driven by higher prices. Revenue from special taxes, IIEE, will be higher because of the lower figure for refunds of the “health cent” which affect the hydrocarbons tax. These refunds are not taken into account in national accounting terms in 2016 as they were already booked in previous years.

In national accounting terms the forecasts for tax collection using the accrual basis are included. Graph 4 contains AIReF’s estimates for each one of the key items in national accounting terms.

Non-taxation revenue figures overall do not undergo any major change. The most significant variations are listed below:

- ✓ An increase in interest received is forecast because interest is no longer charged at 0% on financing granted to the regional and local governments through the regional Financing Funds (0.1% of GDP).
- ✓ New income amounts have been included in the budget for dividends from ENAIRE (0.04% of GDP).
- ✓ The transfers received from the ARs are significantly lower as a consequence of the reduction in the transfers stemming from the Sufficiency Fund and others (0.2% of GDP).

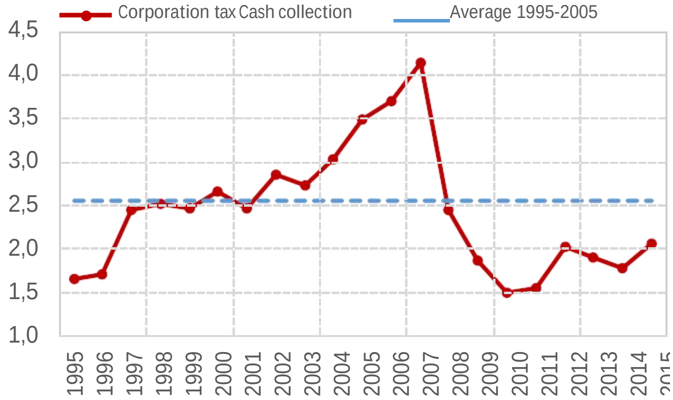
BOX 3. Uncertainty in the estimate for corporation tax

The revenues collected through corporation tax as a ratio of GDP have fluctuated considerably over recent decades because they are highly influenced by the intensity of the economic cycle. Revenues from corporation tax recorded continuous growth during the long expansionary phase up to the all-time high point reached in 2007 (4.1% of GDP) as a consequence of the huge financial and real estate bubble in the Spanish economy. The crisis that commenced in 2008 caused a slump in corporation tax revenue that fell to its lowest point in 2010 (1.5% of GDP). Average corporation tax revenues as a percentage of GDP collected during the period 1997-2005 —years in which GDP growth rates were close to its equilibrium potential (output gap not far off 0)— were 2.7% of GDP.

The assumption that in 2018 corporation tax revenue collection would equal the average figure above would mean a cumulative annual growth rate over the next three years three times higher than GDP (13.1% compared to 4%).

A large number of legislative amendments have been made to corporation tax since 2012 with the goal of boosting revenue collection by restricting deductions and broadening the tax base. The implementation of measures such as limits on the offsetting of tax loss carry forwards (TLCF), more tax bill payments paid in partial instalments, the elimination of the freedom to amortise or the limitation on the deductibility of financial expenses had an immediate effect in 2012, raising corporation tax collected despite the fall in GDP, as can be seen in the graph below:

GRAPH. CORPORATION TAX (%GDP)



Source: AEAT. Note: the 2015 figure is the forecast in the advance settlement data accompanying the draft SGB

However, despite the fact that there was further consolidation in 2013 and 2014 with measures such as the cancellation of the deductibility of losses, the amount collected fell again. The primary explanation for this fall was the offsetting of tax loss carry forwards that had been accumulated to that date and the application of the balance of pending deductions originating in the years of the economic crisis. The corporation tax base is generated from company accounting profits after applying a series of extraccounting adjustments. In the years of the economic crisis, large tax losses were built up as tax credits to be carried forward and offset in subsequent years. Although during the years 2012 to 2014, the offsetting of these tax loss carry forwards changed from having no limit set on the amount to having limits over time of 25% and 50% (according to the net turnover figure of the company) of the taxable profit for each financial year, the huge amount of TLCFs that had been accumulated up to that date prevented corporation tax collection revenues from growing in 2014, despite the economic upturn. An additional factor to take into account is that the tax reform has now placed a permanent cap on the amount that can be offset that is currently being phased in. The cap will be 60% in 2015 and 70% in 2016 and the time limit for them to be offset (18 years previously) has been removed. Furthermore, another element of uncertainty is the fact that in 2016 the second phase of the tax reform will come into effect, bringing down the 28% corporation tax rate in force in 2015 to 25% in 2016.

Forecast of non-financial uses in 2016

On the expenditure side, the adjustment forecast by the government is concentrated in the reduction of the financial burden of the debt and the transfer to the national Public Employment Service, *Servicio Público de Empleo Estatal*, SEPE. The draft SGB 2016 does not include any new measures that entail expenditure reductions as the adjustment is essentially centred on the significant scaling down of the transfer from Central Government to the SEPE (0.53 % of GDP) and on the expected lower financial expenses (0.16 % of GDP).

AIReF does not see any tensions in the non-financial uses forecast in the draft SGB. As can be deduced from Graph 3, the estimates AIReF has made for total uses and for the key expense items would be in line with the forecasts of the draft SGB 2016. The points in its analysis to highlight are as follows:

✓ **The transfers to other subsectors of General Government (ARs, LCs, and SSF) account for around 50% of the total of the non-financial uses of the Central Government.** The Central Government budget allocates a fundamental part of its uses to finance competences exercised by the regional and local governments (the so-called Territorial Administrations, TAs) and the Social Security Funds. In 2016, the transfer to the SEPE is significantly reduced (0.5 % of GDP). Nevertheless, this reduction is partly offset by the increased funds received by the TAs.

✓ **In all the other non-financial uses the key expenditure areas are interest payments, pensioners, employee compensation and other investment expenditure.** These expenditure items will develop as follows**:**

- **Financial expenses (interest payments) fall 5.9% compared to the 2015 settlement projection.** The draft reflects a 5.9% decrease on the 2015 settlement projection due to cheaper financing costs. This forecast is in line with AIReF's estimates. Nonetheless, there is uncertainty about a hypothetical rise in interest rates given the high level of existing debt.

- **Pensions are up 3.5%.**

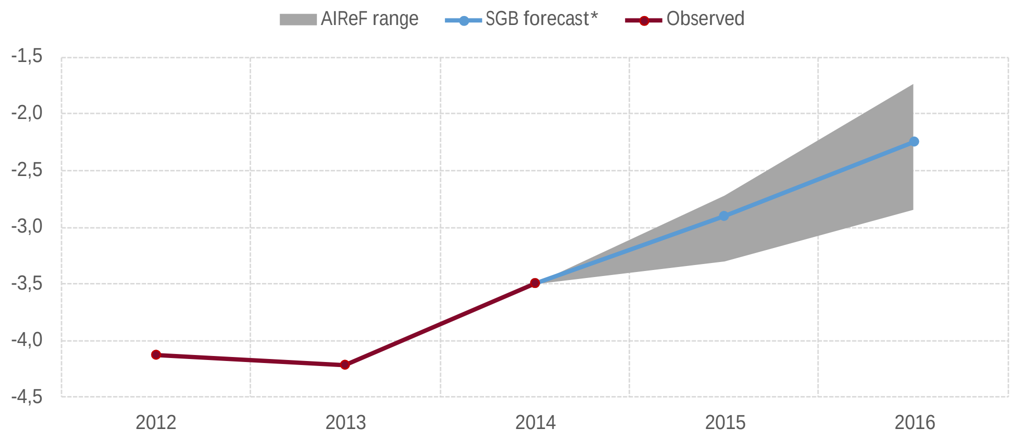
- **Central Government consumption might increase in 2016 primarily due to the increased compensation paid to employees.** The largest government consumption component for Central Government is compensation to employees. This employee compensation is up as a result of the 1% pay rise for public employees and the reinstatement of 50% of the 2012 extraordinary wage payment. The replacement rate is up to 50% generally and will be 100% in the sectors classified as priority sectors.

On the other hand, intermediate consumption items are down slightly due to the non-continuation of the expenses incurred in holding the general and regional elections in 2015 and possible savings from the Cora Plan.

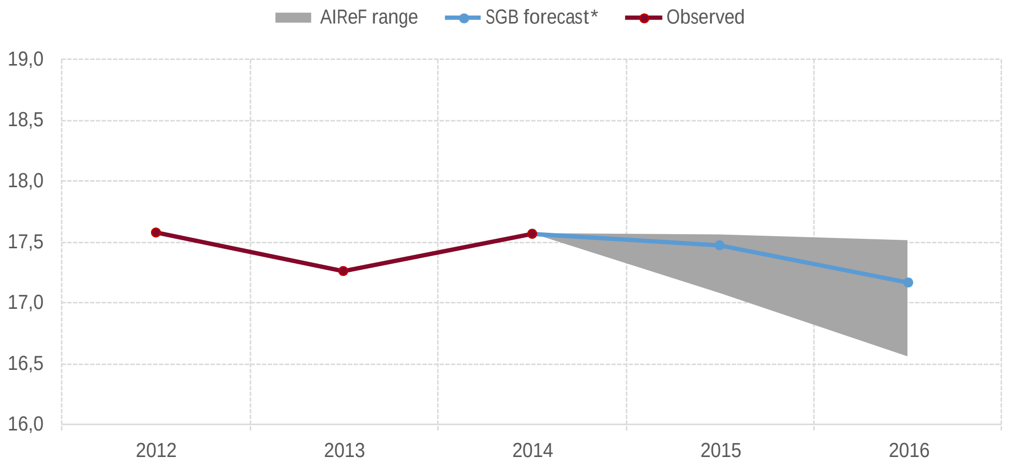
- **In 2016 investment (gross capital formation) is up 4.6% and some expenditure items are down as a consequence of the non-continuation of measures forecast in 2015.** In 2016 investment is up 4.6%, with actions such as the CRECE Plan continuing. Conversely, the transfer allocated to financing the subsidies for readjustment of antennae due to the TDT frequency change (0.02% of GDP) and the transfer allocated to financing the costs of the electricity system is down (by 0.03% of GDP).

GRAPH 3. CENTRAL GOVERNMENT.
DEVELOPMENT OF BALANCE, NON-FINANCIAL RESOURCES AND USES (% GDP)

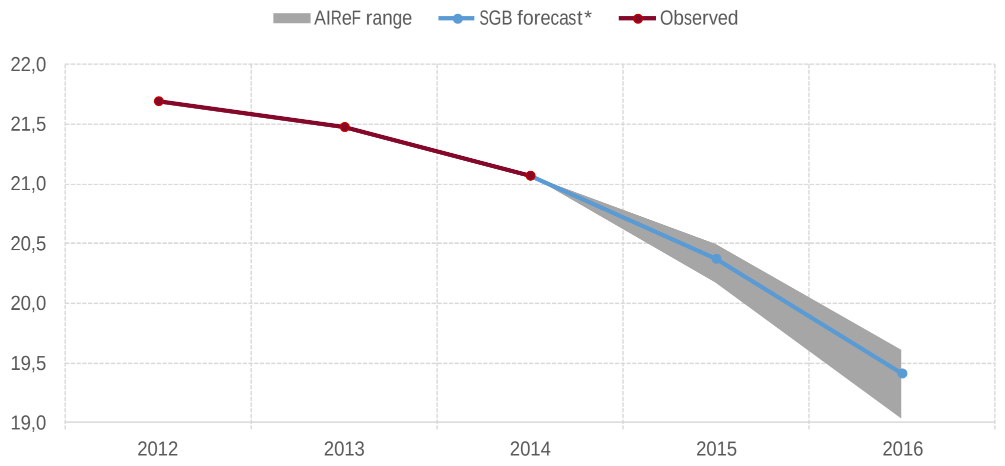
Annual balance



Non-financial resources



Non-financial uses

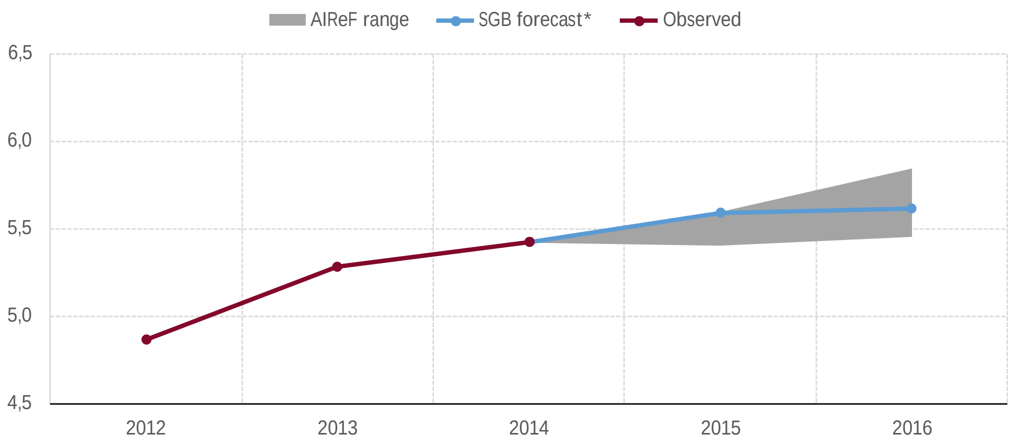


Source: State General Budget (SGB), IGAE and AIReF

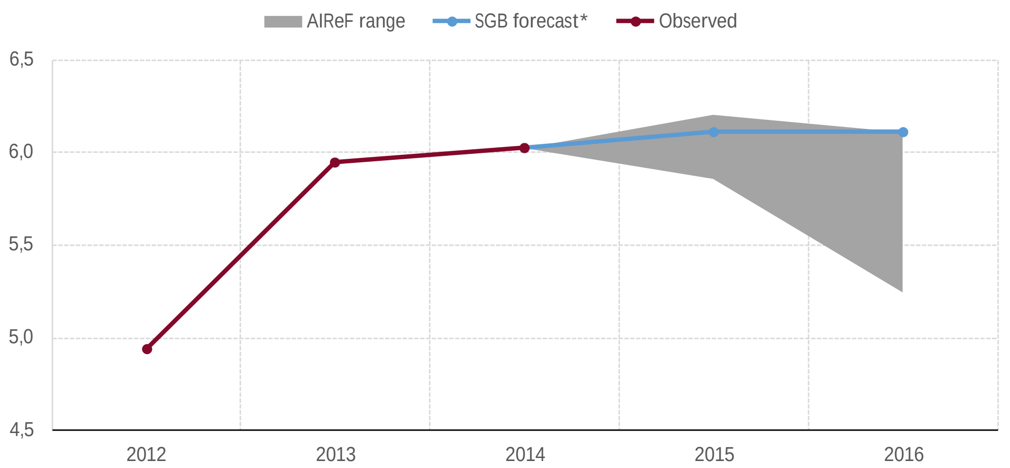
Notes: 1) The figure for the 2015 SGB forecast refers to the advance settlement data in National Accounts included in the Draft SGB for 2016 2) The 2016 Draft 2016 forecasts have been estimated in ESA-2010 national accounting terms due as no official forecast exists.

GRAPH 4. CENTRAL GOVERNMENT.
DEVELOPMENT OF MAIN TAXES (% GDP)

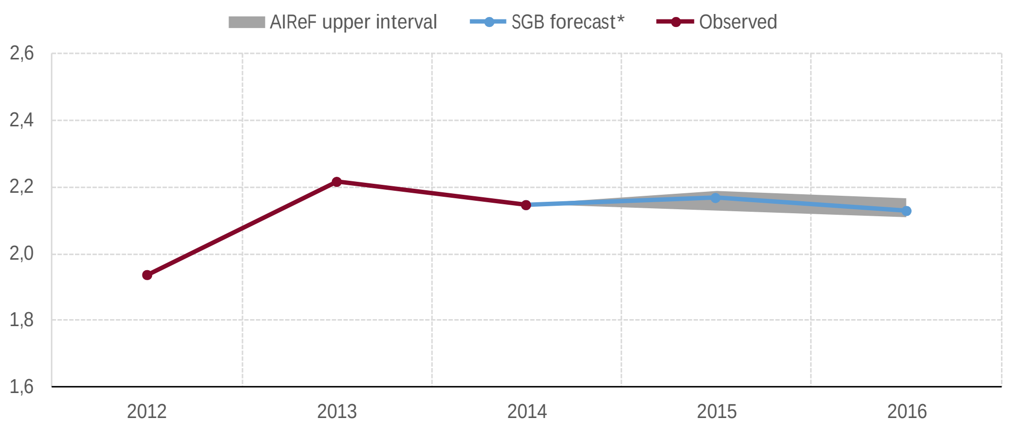
Value Added Tax



Income taxes



Special taxes



Sources: SGB, IGAE and AIReF estimates.

Notes: 1) The figure for the 2015 SGB forecast refers to the advance settlement data in National Accounts included in the Draft SGB for 2016 2) The 2016 Draft 2016 forecasts have been estimated in ESA-2010 national accounting terms as no official forecast exists.

BOX 4. Calculation of the confidence interval for the different aggregates

This box contains a description of how a measurement of uncertainty has been constructed around the future materialisation of the different aggregate data covered in the report. The measurement will take as a general rule one standard deviation that is deduced using the different forecasting models. The general definition of variance of a sum of random variables is understood as (if it is a subtraction, the covariance term would be negative):

$$Var\left(\sum_{i=1}^{n} Z_i\right) = \sum_{i=1}^{n} Var(Z_i) + 2\sum_{i \neq j} Cov(Z_i, Z_j)$$

From which it is derived that the standard deviation of that sum will be given by the expression:

$$\sqrt{Var\left(\sum_{i=1}^{n} Z_i\right)} = \sqrt{\sum_{i=1}^{n} Var(Z_i) + 2\sum_{i \neq j} Cov(Z_i, Z_j)}$$

Thus, when constructing confidence intervals of aggregates of the components or of given balances, apart from taking into account the variance derived from their predictive models, the terms of the cross-covariances between the forecasting errors of the headings involved have also had to be calculated. To do that, error series of the different models have been calculated as a basis for obtaining their empirical covariance. However, it should be pointed out that because of the specific nature of certain items, it has been assumed that they are orthogonal to the other components and so their corresponding covariance with all the other headings is nil.

With regard to the models used, in general and as far as possible, an attempt has been made to model the different components in the most disaggregated form possible through econometric models with error correction mechanisms. Alternatively, for those items where this type of model has not been suitable, a univariate ARIMA model has been estimated from which the corresponding variances of the prediction errors have likewise been obtained.

Specifically, and for the variables illustrated in the report, in the case of the Central Government the confidence bands of the different taxes have been obtained using error correction models adapted to each one. All the other resources have been modelled directly through a univariate model although the current and capital transfers between the subsectors have been previously deducted for the calculation of the variance as they are considered not to be a stochastic element and additionally they are assumed to be orthogonal to the main taxes. In the bands for the total resources, the orthogonality of corporation tax to the rest of the taxes has likewise been assumed. In the case of uses, an univariate ARIMA model has been specified from which the current and capital transfers between the subsectors have been deducted because of their deterministic nature. Lastly, to calculate the uncertainty associated with the deficit orthogonality between resources and uses has been assumed. For the Social Security funds, the confidence bands for contributions, expenditure on pensions and expenditure on unemployment have been deduced directly from their corresponding models with an error correction mechanism, whereas the bands associated with the deficit have ben derived by considering the aggregation of the previous items, assuming orthogonality in pensions compared to the others. Just as in the case of the Central Government, current and capital transfers between the subsectors have been judged to be deterministic.

Social Security Funds

In spite of the improvement in the numbers registered with the system, the application of the Pension Revaluation Index (PRI) and the slowdown in expenditure on unemployment benefits, the Social Security Funds (SSF) show a clear risk of deviation from the deficit targets set for 2015 and 2016. The severe crisis experienced by the Spanish economy has gone hand in hand with massive job destruction (2.9 million workers lost their jobs), which has had a negative impact on the revenue from social security contributions, the primary revenue stream for the SSF. On the expenditure side, pensions continue to grow at a rate close to 3% despite the curb on growth imposed through the PRI and the fact that the expenditure on unemployment benefits has fallen both because of a lower number of beneficiaries and because of the exhaustion of entitlements to unemployment benefit. The recent trend and the range forecast by AIReF can be seen in Graphs 5 and 6.

Since the start of the crisis in 2008, the financial position of the Social Security Funds — closely linked to employment, wages paid to workers and demographics— has been deteriorating progressively to the point now where it has built up a considerable deficit because revenue is less buoyant than expenditure. The Funds have grown as the State has taken on the full cost of the supplements to minimum benefits in pensions but they have been negatively affected by the intense destruction of jobs that has seriously impaired income from contributions, its main source of financing. In addition, the low inflation environment since the start of the crisis and the internal devaluation that has affected wages since 2010 have worked together to improve the price-competitiveness of the Spanish economy but have also acted as a brake on the nominal growth of social contributions. On the other hand, the growth trend in expenditure has been curbed through reforms approved in recent years, fundamentally in the pensions system (parametric reforms and the annual Pension Revaluation Index), but the effects are still limited because insufficient time has gone by for its full effects to be felt.

The upturn in economic activity that commenced last year and which has almost wholly been transferred through into job creation, has boosted revenues but the intensity of the improvement is limited by several factors:

- The implementation of employment stimulus measures offering employers a reduction in contributions in 2014 and 2015 (flat rate and an exemption from contributions on the first €500) has also limited the growth in revenue from contributions.

- The decrease in the number of beneficiaries of a contributory unemployment benefit has been eroding the revenues from contributions over the last few years in the same way as it contributed at the start of the crisis to limiting the fall in contribution collection by performing a countercyclical function.

- In addition, the yields on the Reserve Fund are falling as some of the resources of the Fund have been used to cover the deficits in the pensions system.

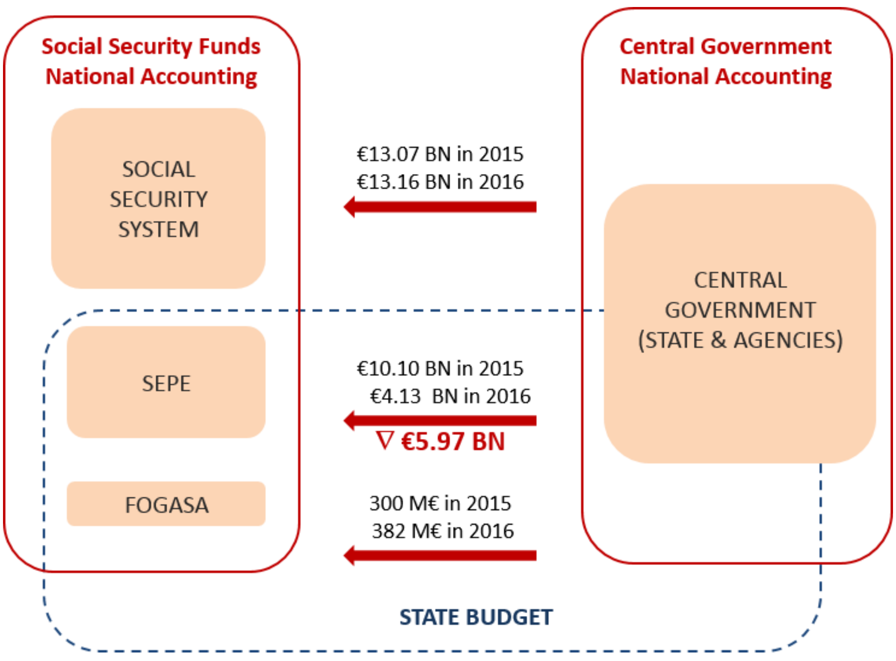
On the other hand, as explained below in Box 5, the transfer flows between the Central Government and the Social Security Funds included in the SGB are lower in 2016 compared to the figures recorded in 2015 due to the scaling down of the transfer from the State to the SEPE. Unlike the practice in previous years, in 2016 the transfer is adjusted to match the amount required by the institution to reach equilibrium.

BOX 5. Institutional framework of the Social Security Funds (SSF)

In ESA 2010 terms, the Social Security Funds in Spain are made up of the aggregate total of consolidated revenue and expenditure in the Social Security System, the State Public Employment service (SEPE) and the Wage Guarantee Fund (FOGASA).

The three components of the Social Security Funds received transfers for different reasons from the Central Government in order for them to perform their functions: SEPE and FOGASA receive transfers when their own revenue is insufficient to meet their expenditure obligations and the Social Security receives transfers to pay the non-contributory benefits in compliance with the principle of separation of financing sources. In 2016, the amount transferred from Central Government to SEPE is substantially lower, as shown in the diagram below:

Financial flows between the CG and the SSF



Analysis of each agency in the SSF

Social Security System

In 2016, the Social Security System's deficit might remain above 1% of GDP in a context in which it has very few drivers available to it to improve its financial position on the revenue side and where its expenditure is determined by legislation that needs a longer timeframe for proper evaluation of the effects of the changes made to it.

The risk of deviation from the target set for 2015 means an even greater adjustment will be needed in 2016. Although there is no 2015 settlement projection for the SSF budget in the draft SGB, the data available confirm that the greater pace of growth in expenditure compared to revenue in 2015 is enlarging the Social Security System's deficit so that it would end the year above 1% of GDP.

The deviation in 2015 is largely due to the negligible growth in revenue collection. Despite the favourable data for employment and registrations with the system, the revenue from contributions in 2015 will be lower than the forecasts included in the initial budget. The budgetary implementation data available to July reflect much lower annual revenue collection growth than forecast in the SGB 2015 (0.75% compared to 10.8%), although the registration of new contributors to the system is growing at a 3.2% year-on-year rate to August, with a slight reduction in the weight of part-time contracts in the general Regime.[10] In this regard, AIReF's estimates for 2015 indicate a maximum growth in social contribution collection of 2.7%.[11]

This slow growth in revenue inflows can be explained by several factors:

- A significant reduction in the collection of contributions paid by the beneficiaries of unemployment benefits.
- The implementation of measures for the partial exemption of payment of the social security contribution.
- The contribution base of employed workers is developing only very moderately.
- The reduced impact on actual revenue collection of the collection management improvement measures taken.

The SGB draft for 2016 includes a very ambitious contributions revenue forecast. The SGB estimates 6.7% growth compared to the initial 2015 budget and more than 15% up compared to the forecast settlement made by AIReF for that year. This growth is not in line with the growth of contributions forecast in the

[10] Down from 22.8% in December 2014 to 22% in August 2015.
[11] Upper end of the range of the contributions estimate model,

Budgetary Plan submitted for 2015-2016 that is estimating growth of 1.8% in 2015 and 3.9% in 2016.

The estimates included in the draft SGB 2016 to support the expected development in social contributions do not explain such a large increase. The forecasts for contributions are based on:

- An increase in people registered with the system in line with the growth in workers in employment (3% of employment).
- An updating of the contribution base in line with the development of employee compensation (1.4%).
- A 1% increase in the maximum contribution bases and the minimum bases in the Special Regime for Self-Employed Workers, *Régimen Especial de Trabajadores Autónomos* (RETA).

The growth in revenue is further lowered by the effect of the reduction in the contributions in force. The information included in the draft SGB indicates a greater impact of the reductions applied to the contributions (0.19% of GDP in 2016 compared to 0.14% in 2015). This is the consequence of the effect of the flat rates and the exemption from paying contributions for the first 500 euros in the new indefinite duration job contracts.[12]

AIReF's estimates for contributions are substantially different from the forecasts included in the draft SGB 2016 but they are in line with the forecasts in the Budgetary Plan. The forecast for employment, employee compensation, and the increase in the contribution base support a 3-3.3% range increase in the contributions range for 2016. This forecast incorporates a reduction in the contributions of unemployed workers as a result of the lower number of beneficiaries of the contributory unemployment benefit.

Box 6 provides details of AIReF's modelling of the revenues from contributions and a simulation exercise of the impact that an inflation shock would have had on the collection of contributions revenue.

Lastly, with regard to total revenues, the yields on the Reserve Fund are falling. In addition, the total revenues in the system will be limited by the lower returns earned by Reserve Fund as it has reduced its total assets because of the need to fund the deficits of the last few years.

[12] The contribution reductions are different from the discounts on contributions that are paid by the SEPE to the Social Security (0.14% of GDP in 2016 and almost 0.13% of GDP in 2015).

BOX 6. Price and wage moderation and Social Security System balance

The correction of the severe macroeconomic imbalances built up by the Spanish economy in the decade prior to the outbreak of the global financial crisis has hinged on a significant episode of internal devaluation, with real and nominal effects. This process was initially supported by a strong downturn in demand and the competitive gains stemming from a significant curbing of the productive factors, especially labour costs. It was likewise driven by an external environment of highly contained prices, which was primarily the result of the growing process of globalisation of the supply of goods and services and the prices of commodities.

From a fiscal standpoint, however, this process of macro rebalancing and contained prices has meant a drag in the short-term both through falls in revenues stemming from less economic activity and by higher expenditure associated essentially with the deterioration of the labour market. These considerations are especially relevant in the case of the Social Security System whose resources and uses have been directly affected by the numbers (development of employment) and by prices (wage dynamics).

With the aim of estimating the impact of the stagnant wage environment existing in Spain over the last four years (2012-2015) on the forecast for contributions to the Social Security System and unemployment costs, therefore, a counterfactual simulation has been run of higher wage rises through error correction models estimated for the period 1995-2014. It is worth remembering that the exercise carried out is merely illustrative in nature and allows conclusions to be drawn only from the standpoint of partial balance, without taking into account the impact of the rest of the economy (and possible feedbacks) of wage shocks.

<u>Estimated models</u>
The favourable development of the labour market in the last seven quarters has entailed different reactions in the components of the contributions to the Social Security system: the contributions of employed workers have risen whereas the contributions of unemployed workers have been reduced (with a reduced weight in the total remaining under 9% in 2014). Therefore, in order to reflect more accurately the dynamics of revenues from contributions, they have been modelled by disaggregating the contributions of employed workers from those of unemployed workers. In this way, any possible bias in the development of the contributions is eliminated and the development of contributions for unemployment is not camouflaged within the positive overall picture stemming from the improvement in employment.
As far as the specific modelling is concerned, the following features are considered: (i) the existence of a stable long-term relationship means the contributions of employed workers can be modelled in the form of an error correction model, with the employees, compensation per employee and the development of the maximum base as the main determinants and (ii) the contributions of the unemployed workers are modelled in differences, in relation to the expenditure on unemployment, with which they are highly correlated even though there is no evidence of cointegration. This relationship underwent a change as of 2009 due to the increased spending on social benefits that pay a lower contribution compared to the contributory benefits and is reflected in the existence of a significant dummy. In turn the expenditure on unemployment depends on the compensation of employees in the previous period and on the unemployment rate. They are modelled in the form of error correction, as evidence of cointegration is detected. The modification of behaviour introduced into the labour market by the last reform is also shown by a binary variable. The coefficients and significance of the different variables (in logarithms except the unemployment rate) are reflected in Table I.

Simulation exercise: impact of a rise in compensation per employee

The result of the forecast is compared in two simulated scenarios for the 2012-2015 period: (i) the base case scenario, defined by the growths observed in compensation per employee (rpa) and (ii) and the alternative scenario, in which the rpa is subject to a disruption equal to the existing gap between the observed growth of the GDP deflator and a reference rate of 2%, reflected in Figure I (i.e. implicitly assuming a degree of pass-through or complete transmission from prices to wages).

The results in cumulative terms in the period 2012-2015 are shown in Figure II. It can be observed how the weak development of prices and wages has implied in this context of partial equilibrium a decrease in revenue close to €15 billion, together with higher expenditure for unemployment benefits of around €5 billion, that cushion the impact in terms of the Social Security Funds deficit.

Figure I: Gap between the development of the GDP deflator and a reference rate, %

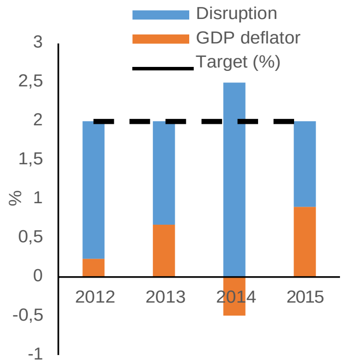
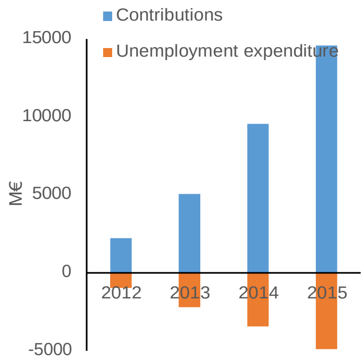


Figure II: Cumulative impact of the alternative scenario in revenue and expenditure terms



Source: AIReF

Notes: (i) the figures for expenditure on unemployment are represented as negative because of their impact on the total balance; (ii) the estimate of the impact on contributions may be considered a lower limit given that the estimated model only projects those referring to the Social Security System (that account for close to 85% of the total).

Table I. Models estimated for the development of contributions

Modelo de Ingresos por Ocupados					
Largo plazo			Corto plazo		
Variable	Coeficiente	t-valor	Variable	Coeficiente	t-valor
Constante	-3.91	-12.03	Δ(Asalariados)	1.02	18.03
Asalariados	1.07	51.02	Δ(Rem. Por Asal.)	0.70	5.49
Rem. Por Asal.	0.60	7.12	Δ(Base máx)	0.35	2.84
Base máx	0.37	4.60	Correc. Error	-0.94	-7.97
			Bondad del ajuste	R2=0,96	DW=1,49
Modelo de Ingresos de desempleados					
Ecuación en diferencias					
Variable	Coeficiente	t-valor			
Constante	0.06	3.24			
Δ(gastos x desemp.)	0.48	4.95			
Dummy	-0.10	-2.81			
Bondad del ajuste	R2=0,71	DW=1,46			
Modelo de Gastos por Desempleo					
Largo plazo			Corto plazo		
Variable	Coeficiente	t-valor	Variable	Coeficiente	t-valor
Constante	-7.40	-7.59	Δ(Remuneración (-1))	1.32	4.60
Remuneración (-1)	1.27	16.75	Δ(Desempleados)	0.06	8.06
Desempleados	0.05	10.40	Correc. Error	-0.55	-3.36
Dummy	-0.31	-3.32			
			Bondad del ajuste	R2=0,82	DW=1,65

Within the Social Security expenditure-side no risk is observed of any deviations in the pension forecast. Contributory pensions are budgeted with an annual growth rate of 2.8% as a consequence of the increased number of pensions (1%), from the replacement effect caused by the higher number of new pensions compared to pensions taken out of the system (1.6%), and the updating of the amount paid for pensions currently in force (0.25%) by the minimum possible rate under the regulations on the Pension Revaluation Index. The draft SGB 2016 does not include information on the parameters used to estimate it.

One aspect worth mentioning is the submission of an amendment to legislation that would establish a supplement for the demographic contribution to the Social Security system for women with two or more children. If the amendment were passed it would mean higher expenditure than the figure included in the SGB. This modification would not have any significant financial impact in this financial year although it might generate expenditure costs to be taken into account the following year.

On the contrary, a possible insufficient provisioning of the expenditure allocated for the temporary incapacity for work benefit is observed. During 2015, the average monthly rate for this benefit and the number of applications received and being processed is higher than recorded in 2014. For 2016 this item is also seen to be possibly insufficient although to a lesser extent than the shortfall detected for 2015.

The draft SGB incorporates the possibility of expanding the number of pensions classified as non-contributory and financing them with a transfer from the Central Government. The Draft SGB includes an additional provision in the bill sent to parliament which states that the government will endeavour to achieve compatibility of the budget stability and financial sustainability targets with the full financing of the non-contributory and universal benefits through the General Government budgets, for which it will assess the conditions of the benefits included in the system that might be considered to be non-contributory and universal.[13]

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

The State Public Employment Service will end 2015 with a significant surplus in the range of 0.4%- 0.5% of GDP. This favourable trend is due to the following factors:

- ✓ The expenditure on unemployment benefits is falling faster than forecast in the budget as a consequence of the improved employment rate and the exhaustion of benefit entitlements (-15% compared to -4.3%).

[13] Additional provision sixty-five of the draft SGB bill. Separation of sources of financing of Social Security benefits.

- ✓ The financial assistance included in the Employment Activation Programme for long-term unemployed with family dependents is generating less expense than forecast initially.
- ✓ Revenues from contributions are likely to end the year very close to the initial forecast.
- ✓ The transfer included in the initial budget to be received from the CG is higher than the amount necessary to balance the budget.

For 2016, the SEPE might end the year with a balanced budget or with a much lower surplus than in previous years despite the lower expenditure on unemployment benefits given the big reduction in transfers from the State. The SEPE receives a transfer from the State to balance its budget when it does not obtain sufficient revenue to meet its payment obligations. The transfer received from the State in the budget is substantially scaled down compared to 2015 (from 0.9% to 0.4% of GDP) to match the precise funding needs of the agency to achieve a balanced budget and so reduce its overfinancing. This corrects the situation of preceding years when the transfer had been excessive to requirements and had generated large surpluses in the agency.

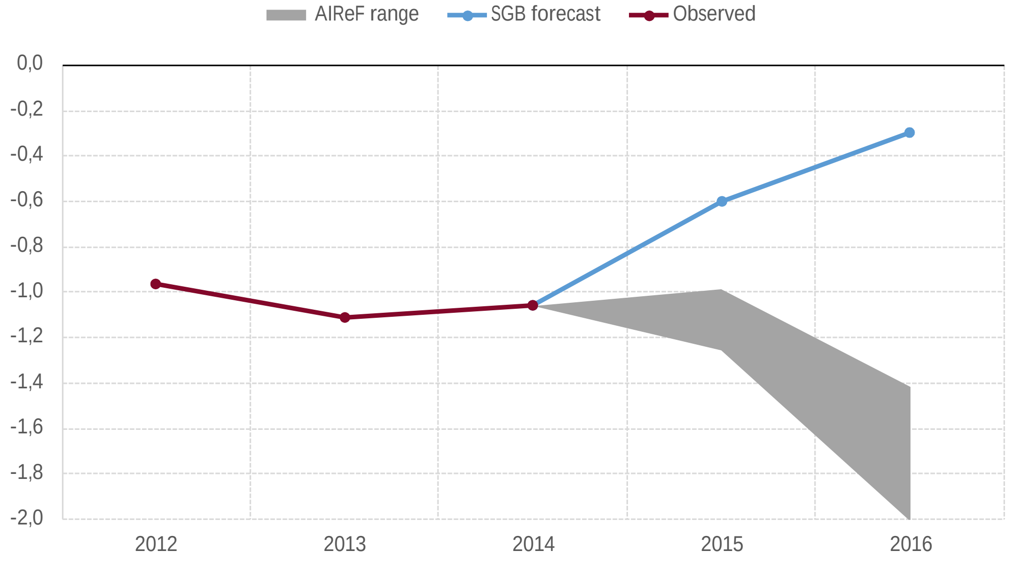
Unemployment benefits and the forecasts of revenue through contributions (unemployment and training) included in the draft SGB 2016 are deemed realistic. The figure for unemployment benefits included in the SGB is in line with AIReF's estimates, within the upper part of the band, and so may generate a tiny margin, although much lower than the margin recorded in previous years. The allocation for unemployment benefits is much lower than in the initial budget 2015 (-23%) although this reduction would be lower with regard to the forecast settlement estimated by AIReF for 2015. The growth in contributions budgeted is 4% compared to the forecast for 2015 settlement made by AIReF, higher but in line with the growth expected in the inflows from contributions from employed workers.

There is no change in the deficit forecast for the Wage Guarantee Fund (FOGASA) included in the SGB for 2015 at around 0.02% of GDP.

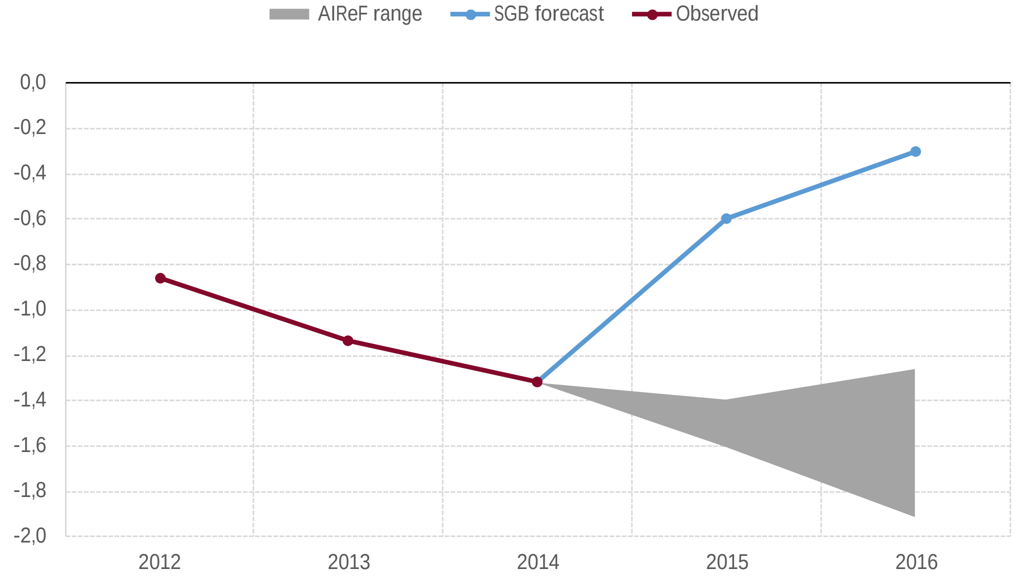
For 2016, the FOGASA Budget is shown as generating a deficit (€94 million). This is the result of revenue collection from the FOGASA contribution and a financial allocation from the State in line with 2015 and slightly lower expenditure on benefits (€1.05 billion).

GRAPH 5. SOCIAL SECURITY FUNDS (% GDP)

Social Security Funds (SSF) balance



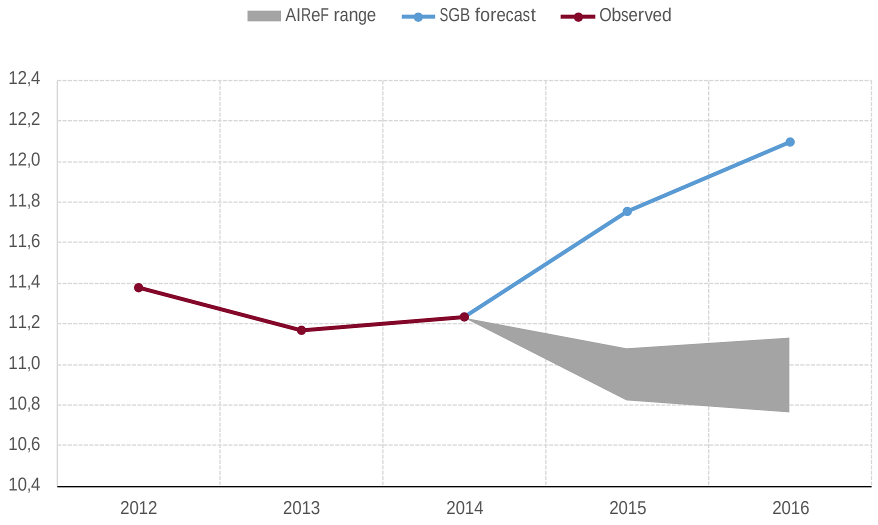
Social Security Funds (SSF) balance



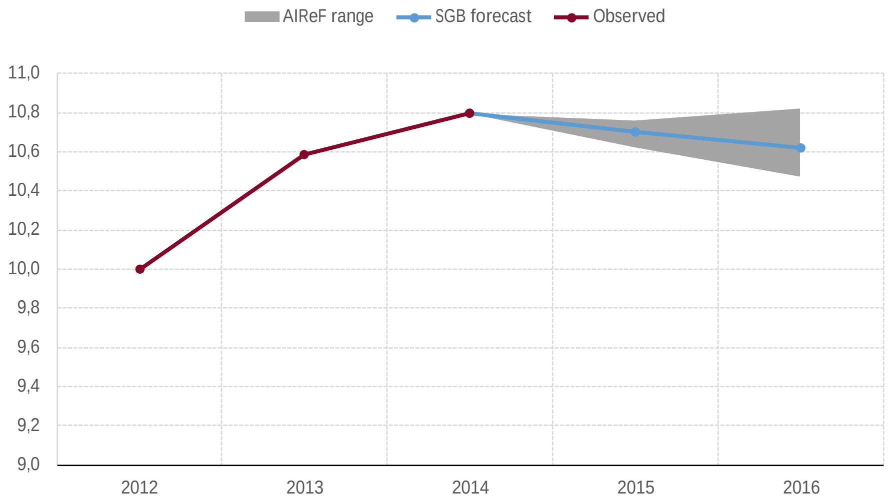
Source: State General Budget (SGB), IGAE and AIReF estimates

GRAPH 6. SOCIAL SECURITY FUNDS (%GDP)

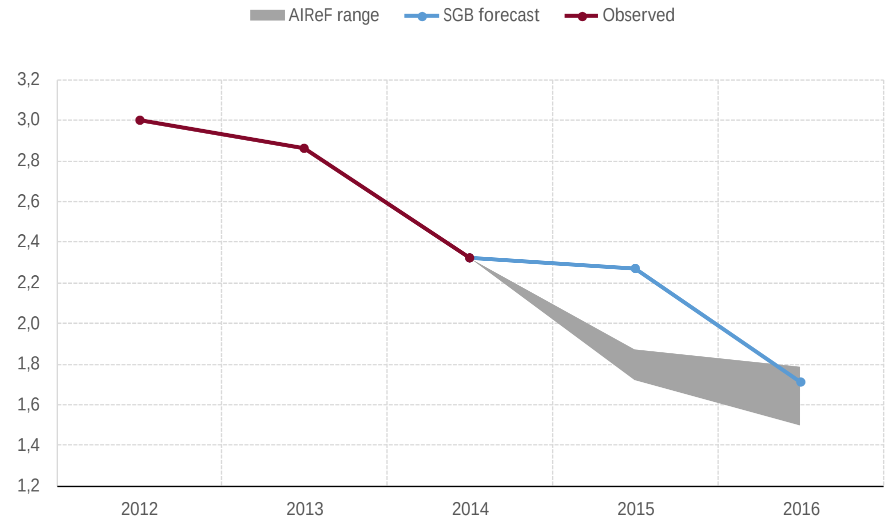
Social Security contributions



Expenditure on pensions



Expenditure on unemployment



Source: State General Budget (SGB), IGAE and AIReF estimates

4. Government debt

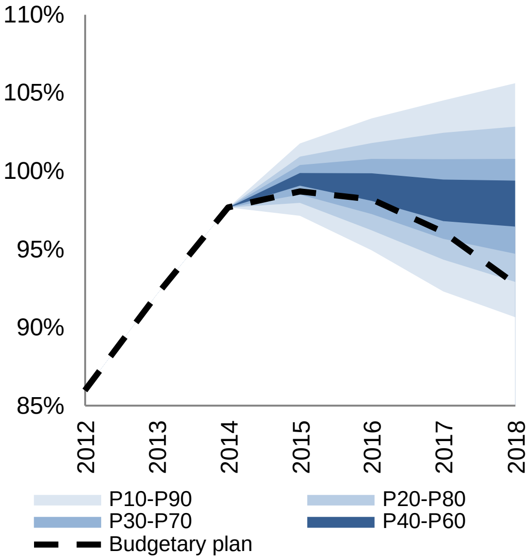
The 2016 draft SGB bill does not include any specific mention of the Central Government's debt target. The draft SGB, like the Stability Programme and the Budgetary Plan, only provides information on the General Government sector as a whole but makes no reference to the forecast for the target of the CG and the SSF.

The debt target for 2016 for the whole General Government sector is 98.5% of GDP[14]. The draft SGB states that it forecasts that the debt-to-GDP ratio for the General Government sector will end the year 2015 at 98.7% and that it will fall in 2016 to 98.2%. 2016 will be the first year since the start of the crisis that a reduction in debt will be recorded and this will therefore mean compliance with the target set for that year[15]. The Budgetary Plan 2016 includes the development of the General Government Sector debt up to 2018.

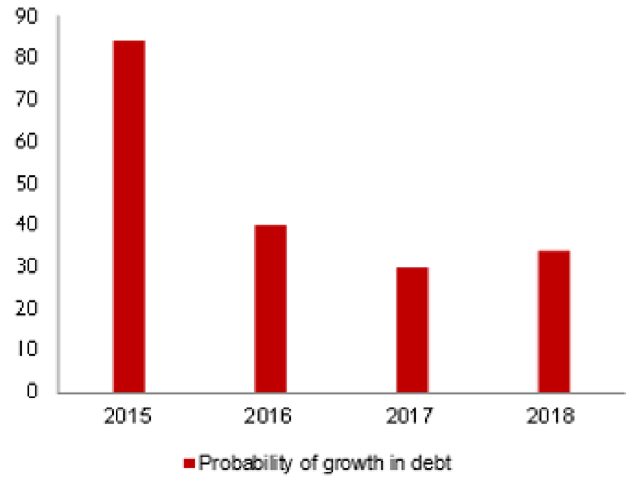
Both the medium-term debt reduction path and the level for 2016 forecast for the whole General Government sector seem to be in line with the estimates made, although a gradual deviation should be noted towards the end of the period. As AIReF stated in its Report on the Draft Stability Programme Update 2015-2018, the official reduction path for government debt can be assessed in a probabilistic environment. In fact, the estimation of a multivariate model for debt enables the construction of stochastic projections through bootstrapping techniques, as shown in Graphs 7 and 8[16.] According to this analysis, the government debt path included in the Budgetary Plan enters into reasonable probabilistic intervals for the reference period 2015-2016 and deviates slightly downwards at the end of the period. In addition, as Graph 7 shows, the probability of reaching the debt ceiling during 2016 is more than 50%.

[14] The Council of Ministers' Agreement of 10th July 2015 approving the budget stability, debt and expenditure ceiling for the State for 2016 set a debt target for the whole General Government sector of 98.5% of GDP, broken down into 72.6% for Central Government, 22.5% for the Autonomous Regions and 3.4% for the Local Corporations.
[15] The Stability Programme was forecasting a debt/GDP ratio of 98.9% of GDP. The latest figures published by the Banco de España for the second quarter in 2015 put the figure at 97.7%
[16] See Cuerpo, C. (2014) for more details of the methodology.

Graph 7: EDP debt projections and the Budgetary Plan scenario



Graph 8: Probability associated with growth of government debt compared to its level the previous year



Source: Ministry of Finance & Public Administrations and AIReF

5. Central Government expenditure rule

For 2016 there is clearly a risk of non-compliance by Central Government of the expenditure rule set at a growth rate of 1.8% for eligible expenditure under the rule. If the reference growth rate were applied the increase allowed in eligible expenditure in 2016 would be around 0.15% of GDP. When evaluating the degree of compliance with the expenditure rule several prior aspects have to be taken into account:

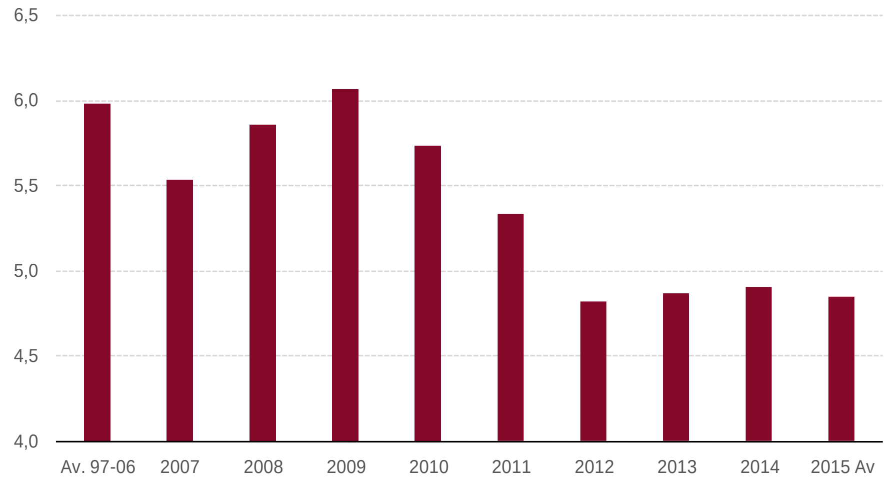
- The starting point or basis for the assessment is the maximum expenditure that would have been allowed in each year in the event of compliance with the expenditure rule. That means any excess spending in one year has to be absorbed the following year.
- This situation is especially significant in 2016 as the basis is non-compliance with the expenditure rule in 2014 as a consequence of the extraordinary expenditure the Central Government had to record because of the “one-off” payment made under the “health cent” ruling (0.18% of GDP). This has to be added to the likely non-compliance with the expenditure rule that will be the case in 2015 (0.3% of GDP) —essentially stemming from the tax reform. In accordance with the provisions in the LOEPSF, the increase in the eligible expenditure must offset any drop in

revenue collection because of normative changes and be increased if those changes will lead to permanently higher revenue collection. The tax reform in 2015 will entail a reduction in revenue collection of around 0.36% of GDP.

- In 2016 once again there is a negative impact produced by the tax reform amounting to 0.34% of GDP in 2016 that will have to be offset with spending cuts.
- Additionally, the eligible expenditure for the purposes of the expenditure rule represents less than 50% of the total non-financial uses of the Central Government. The eligible expenditure in 2014 used to assess compliance with the expenditure rule according to the compliance report published by IGAE accounted for 44% of the non-financial uses. The main components of this expenditure are employee compensation (23%), intermediate consumption (8%), gross capital formation (9%) and items for which there is no margin for adjustment like pensioners (15%), supplements to minimum benefits and other benefits (13%) or the contribution to the European Union budget (10%).

The graph below shows the development of non-financial uses of the CG without taking into account the transfers between subsectors, interest payments, pensioners and the contribution to the EU. It is currently at one of the lowest points since 1997.

GRAPH 9. Development of Central Government expenditure excl. General Government transfers, interest payments, pensions and EU contribution



Source: IGAE national accounting data

For all of these reasons, compliance with the expenditure rule by the Central Government in 2016 is more restrictive than compliance with the stability target. As was the case in 2014 and is likely to be the case in 2015, the CG in 2016 does not show any risk of failing to comply with the stability target but there is a risk it will fail to comply with the expenditure rule. According to AIReF's estimate compliance with the expenditure rule target would require an additional reduction on top of the deficit target set of around 0.3% of GDP every year. The impact would be similar to the loss of taxation revenue from the tax reform.

6. Recommendations

On the basis of its assessment of compliance with the budget stability and government debt targets as well as the expenditure rule by the Central Government and the Social Security Funds in 2016, AIReF makes a number of recommendations in this report relating to each one of the fiscal discipline targets. It also recapitulates the recommendations made already on the same subject in previous reports published.

Budget stability

The impact of the economic crisis on employment and on the revenues from social contributions, together with the trend in expenditure on pensions has caused the SSF to build up a deficit of around 1% of GDP since 2012. The linkage between the Social Security Funds' revenue and expenditure and the macroeconomic environment and demographic developments limits any margin for action in the short-term. This circumstance should be taken into account when setting stability targets.

AIReF has been recommending a revision of the financing of the different levels of the General Government sector in Spain with the aim of bringing their resources into line with the responsibilities they have for the provision of goods and services. In particular, in its report on the update of the Stability Programme 2015-2018 AIReF recommended an evaluation of the situation of the Social Security Funds given the short-term financial tensions seen in this subsector.

More specifically, in the report it published on 15th July on expected compliance by the General Government sector with the fiscal targets in 2015, AIReF said that budget implementation in the first half of the year made practically certain *non-compliance by a considerable margin, with the deficit target of 0.6% of GDP set for the Social Security Funds.* In the same report, AIReF said that the initiatives taken by the Social Security system to boost its revenue were only having a limited effect when it came to offsetting the negative impact employment stimulus measures and the moderate development of prices are having on revenue collection. For these reasons, AIReF recommended that insofar as this situation may continue for the next few years that an evaluation should be made of *measures that could be adopted to ensure on a permanent basis the financing of Social Security deficits through the State General Budget, or for other decisions to be adopted to balance the Social Security system.*

In line with this recommendation, the State Budget bill includes an additional provision that says that "*the Government will endeavour to achieve compatibility of the budget stability and financial sustainability targets with the targets of full funding of non-contributory and universal benefits paid for through the General Government budgets for which it will assess the conditions of the benefits included* *in this system that may be classified as such"* [17]. In this context, **AIReF recommends that:**

1. **Actions should be taken with the aim of developing Additional Provision Sixty-five in the 2016 Budget Bill and guaranteeing the compatibility between the budget stability targets approved for the Social Security Funds and the funding of the benefits included in the System.**

Expenditure rule

Unlike the budget stability and government debt targets that are mentioned, the State General Budget draft does not say anything about compliance with the expenditure rule in 2016. [18]

AIReF has already made recommendations about this fiscal rule in several of its reports and has highlighted the increasing importance of the expenditure rule as we approach budget stability.

Given that the expenditure rule was only introduced when the LOEPSF was passed in 2012, there has been a lack of experience in implementing it and serious shortcomings in the information flows that have now been more or less overcome certainly for the budget stability and government debt targets. That is why AIReF has been recommending that the economic and financial reports of the budgets produced by the different public administrations in Spain should include the figure for non-financial uses with the necessary breakdown for the calculation of the expenditure rule, that MINHAP should publish a template that can be filled in and that the Economic-Financial Plans (EFPs) should contain sufficient information for the assessment of the expenditure rule both at the time of their approval and in the quarterly monitoring by MINHAP.

In the work AIReF has been doing to fulfil its remit and from queries received from the autonomous regions about compliance with the recommendations highlighted above, AIReF has identified the need for the normative development of article 12 of the LOEPSF. That would mean the procedures, deadlines and criteria that can guarantee that the calculation of the expenditure rule by all the public administrations is homogeneous and correct would be regulated. In view of that need, in its Report on expected compliance with the 2015 fiscal targets by the public administrations in Spain, AIReF recommended that *MINHAP should approve through a ministerial order a methodology to calculate the expenditure rule and develop the content and procedure for the information required to be sent*

[17] Additional provision sixty-five. Separation of financing sources of the Social Security benefits.
[18] No mention is made of compliance with the debt target of the Central Government, only of the target for the whole General Government Sector.

so that each administration can make its own a priori calculation and monitor the expenditure rule which limits its spending.

With regard to these recommendations AIReF has been informed by MINHAP that it is finalising the methodological guide for the calculation of the expenditure rule but that it is of the view that there is no obligation for it to include information on the expenditure rule in the draft State Budget bill. Although it is true that there is nothing explicitly stated in legislation that says that information on the expenditure rule has to be included in the budget, any analysis of compliance with the expenditure rule during the different phases of preparation and implementation of budgets requires detailed information to be available on the components that make up eligible expenditure.

Moreover, non-compliance with the expenditure rule in 2014 and the risks identified by AIReF for 2015 and 2016 associated with the impact of the tax reform require more information to be provided about the different components affecting the rule both in the initial budget and in its implementation. **AIReF recommends:**

2. **Inclusion in the State General Budget draft of all the necessary information required to determine the variation in the eligible expenditure in the Central Government. Likewise, the difficulties arising in the interpretation and appraisal of the components of the expenditure rule, such as the impact and time frame of the normative changes that lead to higher or lower revenue collection, make it necessary for normative development of the content of article 12 of the LOEPSF.**

Furthermore, notwithstanding the specific recommendation made on that point, AIReF believes there should be thought given to and discussion about the design of the expenditure rule and how it is applied to the different General Government subsectors. In several different reports already AIReF has been asking for the same importance to be attached to the expenditure rule as to the deficit and debt targets exactly as the LOEPSF does. This is why it also draws attention to the existence of gaps in the definition and application of the expenditure rule that make a revision of the rule advisable. The revision should take into account the end purpose of this rule and the distortions that can be seen when it cascades down from the total General Government level to the lower levels of government given their vastly different revenue and expenditure positions including both their nature and composition. That is why **AIReF recommends:**

3. **The creation of working groups within the Fiscal and Financial Policy Council (CPFF) and the National Commission on Local Administration (CNAL) to think about and discuss in depth the expenditure rule and then produce a paper on the research carried out and its conclusions as well**

as concrete proposals to be debated in their respective plenary sessions.

Government debt

The draft SGB incorporates information on the debt target for the General Government Sector overall but does not include any specific information on the Central Government. Article 6 of the LOEPSF states that the budgets of the different public administrations "*must contain enough relevant information to allow verification of their financial situation, compliance with fiscal stability and financial sustainability targets".*

The draft SGB does not include information on the adequacy of the Central Government figures to meet the debt target in 2016 so **AIReF recommends:**

4. **More complete information should be given in the Draft State General Budget so that an assessment can be made specifically of compliance with the debt target by the Central Government.**

Other Recommendations

AIReF has already highlighted in different reports that is essential to have a budget presented in national accounting criteria when it comes to determining the existence of any possible risk of non-compliance with the budget stability, government debt and expenditure rule targets calculated in ESA 2010 terms. On the other hand, as AIReF has indicated in the report, the SGB does not contain information on those entities that are not really public entities but that are still considered for the purposes of ESA 2010 as central government agencies. This information is necessary to be able to evaluate compliance with the budget stability target. **That is why AIReF once again recommends that**:

5. **An initial budget should be drawn up in national accounting terms for the Central Government and the Social Security Funds and forecasts of settlements for the current year for the Social Security Funds.**

6. **The State General Budget should include information on the entities that are not public entities but that are still included for the purposes of ESA 2010 in the Central Government subsector.**

Additionally, in its Opinion on the Pension Revaluation Index (PRI) AIReF recommended the need to improve transparency. It suggested that the necessary information required to make the PRI calculations should be included in the documentation supporting the Draft State General Budget. The Draft SGB for 2016 does not include this information. **That is why AIReF once again makes the following recommendation**:

7. **The State General Budget should include sufficient information required to make the PRI calculation.**