Independent Authority for Fiscal Responsibility

Report

10th May 2016

Reports on the Kingdom of **Spain's** Stability Programme Update 2016-2019

(Articles 14 and 16 of the Organic Law 6/2013 creating the Independent Authority for Fiscal Responsibility)

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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Key conclusions from the analysis of the **Kingdom of Spain's Stability Programme** Update 2016-2019

Executive summary:

The legislation currently in force in Spain stipulates that the macroeconomic forecasts included in the Stability Programme Update (SPU) require a report to be issued on them by AIReF. The report has indicate whether AIReF endorses the forecasts or not (article 14, Organic Law 6/2013). Likewise, AIReF must report on the content of the draft SPU and especially assess the commitments guaranteeing compliance with the budget stability target, the government debt limit and the expenditure rule (article 16, Organic Law 6/2013).

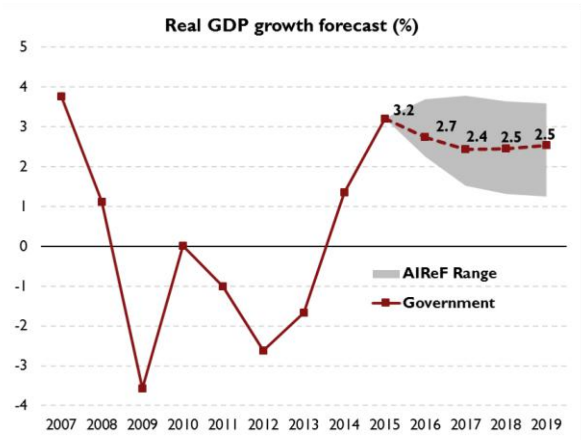
On 25th April AIReF published its assessment of the draft SPU 2016-2019 on the basis of the information available up to that date which was limited to quantitative information about the macroeconomic outlook and the fiscal scenario. That assessment was sent to the Government before the SPU was submitted to the EU institutions so as to allow the recommendations made to be evaluated and incorporated into the SPU as appropriate. Following the approval of the SPU by the Council of Ministers AIReF has been provided with the document that incorporates the commitments that have to be analysed by law as well as other aspects.

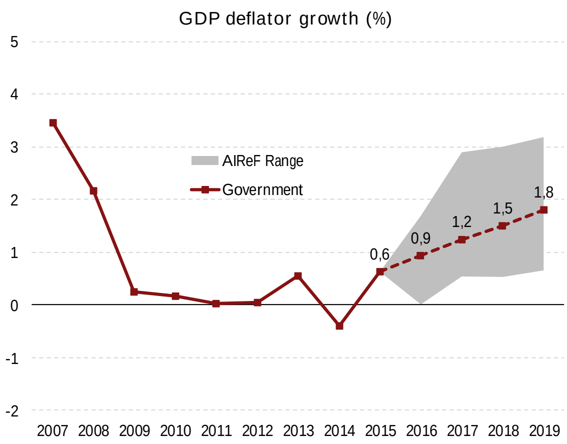
Following assessment of the SPU document AIReF is now publishing its full reports.

Macroeconomic forecasts:

AIReF endorses the macroeconomic forecasts in the SPU 2016-2019 on the basis of the exogenous assumptions underpinning them and the associated fiscal paths. The macroeconomic scenario and the growth forecasts for 2016 are deemed likely and seem compatible with the deficit forecast envisaged in the fiscal projections that are included in the SPU. As we move through the outlook timeframe towards 2019 an increasing number of risks are identified linked to the inconsistencies AIReF has detected between the macroeconomic context and the fiscal projections. From 2017 onwards through the years of the SPU timeframe the tax revenue projections included in it can be deemed conservative whereas the expenditure path in a scenario excluding additional measures seems too unwarranted.

GRAPH A1: GROWTH PROJECTIONS AND GDP DEFLATOR



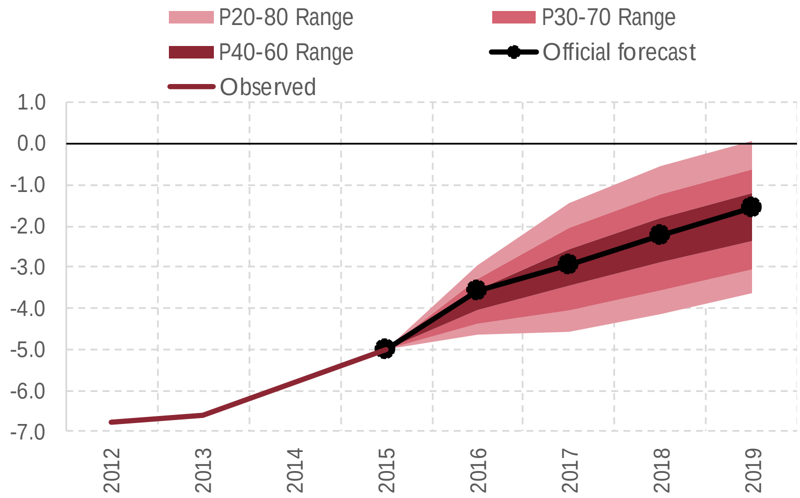


The SPU is forecasting a deficit reduction path for the whole General Government sector overall that is different from Spain's current target commitments with the EU institutions. The agreed deficit reduction path had set deficit targets of 2.8% of GDP for 2016, 1.4% for 2017 and 0.3% for 2018**.** The new consolidation path is more flexible in time as it establishes a deficit of 3.6% of GDP for 2016, 2.9% for 2017, 2.2% for 2018 and 1.6% in 2019. This new path means delaying by one year —to 2017— the deficit reduction down to below the 3% of GDP threshold set by European legislation to exit the Excessive Deficit Procedure.

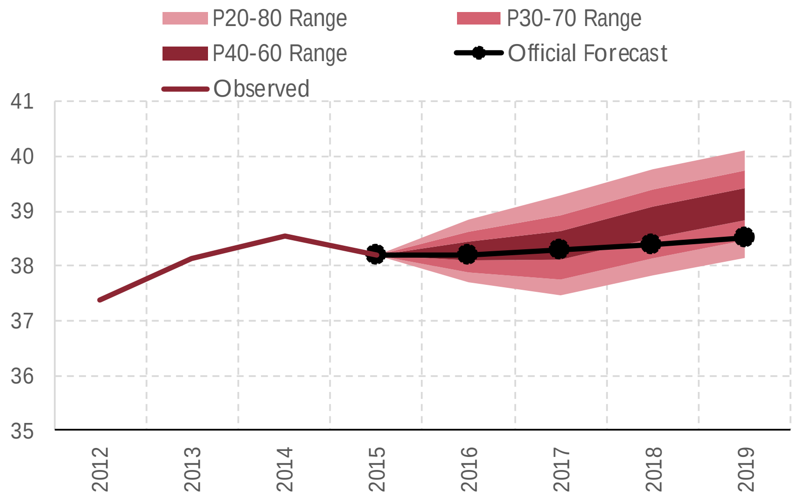
Stability target:

- In 2016 AIReF believes achievement of the government deficit target of 3.6% of GDP forecast in the SPU for ***the whole General Government (GG) sector overall*** to be demanding but feasible. AIReF's estimates placed the 2016 deficit at around 4% of GDP in the absence of any significant additional measures supplementing those already planned in the initial General Government sector budgets. Given that the tax revenue projection for 2016 given in the SPU is considered to be realistic, it would seem that a supplementary effort to consolidate expenditure of around 0.4% of GDP would be necessary this year to achieve the deficit forecast by the SPU. During the month of April a series of measures were adopted for the purpose of making that supplementary effort. Essentially the measures took the form of non-availability agreements (AND, *Acuerdos de No Disponibilidad*) that prevent disbursements of approved budget appropriations by the Central Government amounting to €2 billion. The SPU also includes an appraisal of the ANDs in the Autonomous Regions amounting to €830 million euros which are additional to forecasts on the non-implementation of expenditure measures amounting to €680 million. Provided that those measures are implemented with absolute rigour and there is a guarantee that every single Public Administration will apply the automatic prevention measures envisaged in the LOEPSF, AIReF is of the view that the path set for 2016 with a 3.6% of GDP deficit target is demanding but feasible.

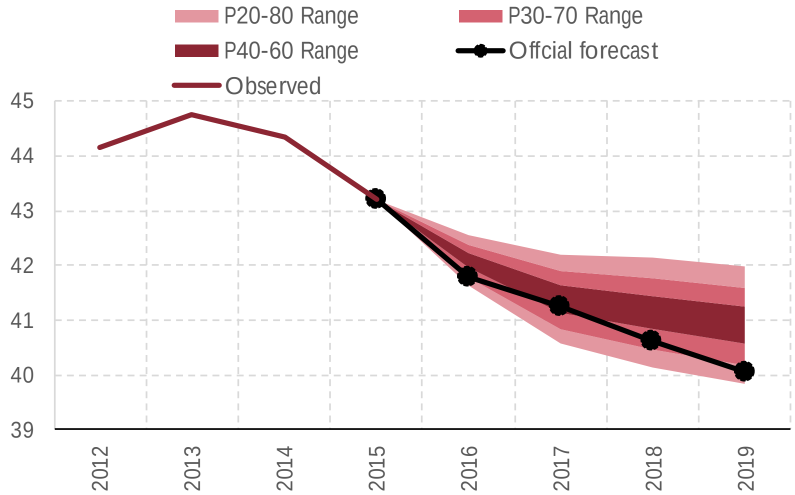
GRAPH B1. GG SECTOR. NET LENDING/BORROWING 2016-2019. % GDP



GRAPH B2. GG SECTOR. RESOURCES 2016-2019. % GDP



GRAPH B3. GG SECTOR. USES 2016-2019. % GDP



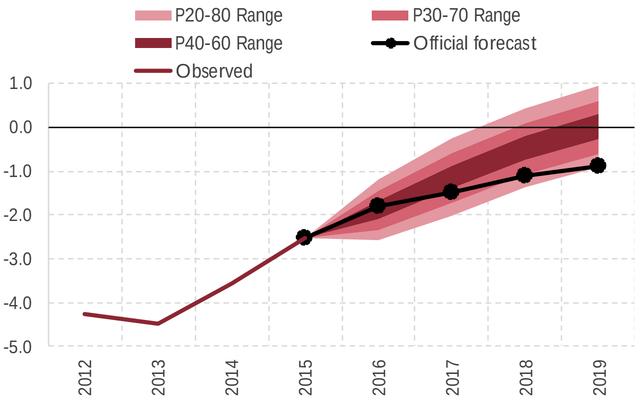
For the remainder of the period AIReF is also of the view that the deficit forecast in the SPU for the whole General Government sector overall is feasible. From 2017 onwards through the SPU time horizon the tax revenue projections incorporated into the SPU can be deemed conservative. In this regard, AIReF believes it is likely the favourable macroeconomic cycle will give rise to higher tax revenue. The SPU reflects an increase in the weight of direct taxes that would be feasible according to AIReF's estimates. Nevertheless, a certain downside bias is identified in the estimation of indirect taxes included in the SPU. The forecast for social contributions, however, entails a stable weight as a ratio of GDP throughout the period. This would be consistent in historical terms with the development of the labour market reflected in the SPU's macroeconomic scenario.

On the other hand, in the absence of significant restrictive measures from 2017 onwards, and given the historical development and hysteresis present in the key expenditure items, AIReF views the government expenditure dynamic put forward in the SPU for the 2017-2019 timeframe as too restrictive and unwarranted.

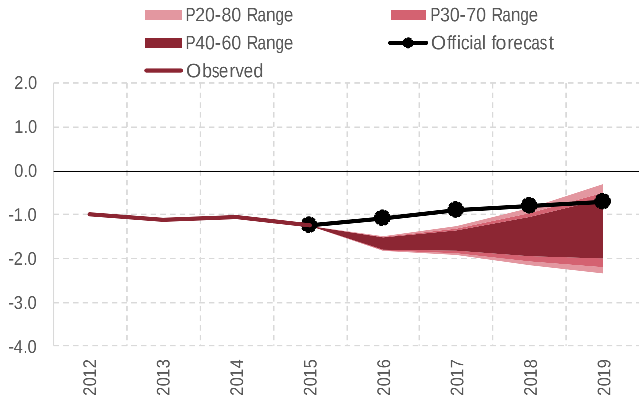
Additionally, the sustained reduction in government deficit over the next two years requires the adoption of measures that are intended to be permanent in nature. That permanence is not guaranteed in principle with the adoption of a non-availability agreement, which is effective for only a one-year term. Although it is true that the SPU takes for granted that the adjustment will be consolidated, no details have been given of any measures or actions that would guarantee the consolidation of that expenditure adjustment once the effective period of the 2016 budget to which the AND applies comes to an end. In order for the SPU forecasts to be met, it is necessary that the deficit reduction achieved in 2016 is maintained. According to those forecasts the deficit in 2017 would fall below 3% of GDP, which is the threshold set by EU legislation to exit the Excessive Deficit Procedure (EDP). To be able to determine the possibility of consolidating the adjustment in subsequent years, it is essential for AIReF to have available to it information on the expenditure lines the non-availability order in 2016 will apply to.

GRAPH C. NET LENDING/BORROWING 2016-2019 BY SUBSECTORS. % GDP

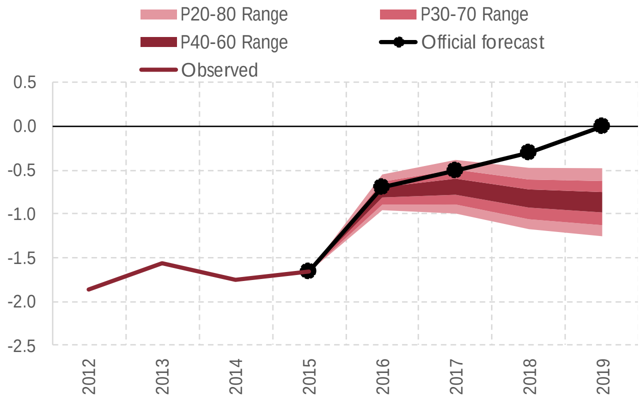
GRAPH C1. CENTRAL GOVERNMENT



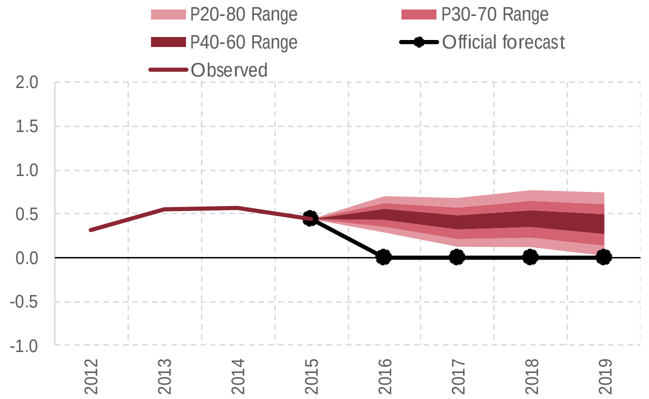
GRAPH C2. SOCIAL SECURITY



GRAPH C3. AUTONOMOUS REGIONS



GRAPH C4. LOCAL CORPORATIONS



- In the case of the ***Central Government*** (CG), with AIReF's estimates it is feasible to achieve the proposed deficit for 2016, which is 1.8% of GDP. To make the adjustment envisaged it is essential that the measures included in the SPU are strictly implemented, that the specific uncertainties affecting the forecasts for resources and uses do not materialise and that the CG autonomous entities continue to perform as well as in previous years by contributing a higher surplus than forecast in the SGB. For the remainder of the period, 2017-2019, AIReF is of the view that it is likely the deficit proposed in the SPU for the CG can be achieved. The materialisation of the macroeconomic scenario may entail higher tax revenue in the period, even though a large part of this increase may be transferred to the Autonomous Regions subsector. On the expenditure side, interest payments and transfers to the State Public Employment Service (SEPE) to cover its deficit is likely to exert less pressure than envisaged in the SPU. The CG measures are essentially focused on the AND approved for 2016, although there are other measures passed in previous years that have a residual impact in 2016 and 2017.

- The forecast path in the SPU for the ***Social Security Funds*** is highly unlikely for the overall time period of the programme. There is practical certainty that the proposed deficit figure (1.1% of GDP) will not be achieved in 2016. The revenue path for the period as a whole reflects sustained growth that AIReF deems realistic and a consequence of the higher employee compensation, growth in employment and the effect of the progressive exhaustion of the current reductions in social contributions for employees established as incentive measures for employers to hire workers on permanent contracts. Growth in expenditure —especially spending on pensions— becomes more moderate as a reflection of the reforms carried out. This trend, nonetheless, does not seem sufficient to reach the stability target set by the end of the period.

- For the ***Autonomous Regions*** (ARs) overall, the forecast path sets a 0.7% deficit for 2016 that might be feasible. To achieve this figure the measures planned in the SPU must be strictly complied with and implemented forcefully, and the setting of exactly the same reduction path for all of the Autonomous Regions should not lead to any relaxation of the effort on the part of some of the regions that would more than offset the consolidation effort it would prompt others to make. The SPU reflects expenditure measures totalling €1.51 billion stemming from non-availability agreements and non-implementation of budgets. Only €300 million of them can be considered additional to the forecasts made by AIReF in its report on the initial budgets in 2016. It would be advisable for clearly differentiated net lending or borrowing paths to be set Autonomous Region by Autonomous Region in which the size of the consolidation to be made by each one of them would take into account aspects such as the development of the regional financing system resources, the impact of the non-recurring operations recorded in 2015 and the implicit government expenditure restraint. Setting the same path for all the Autonomous Regions might lead to an easing of the commitments and forecasts already approved in the budgets in some regions. That would entail a risk for compliance with the overall budget stability target and the expenditure rule even though part of this effect might be offset through the incentive to make an additional effort in those other regions whose year-end forecast is close to the new path.

  For the remainder of the period up to 2019, AIReF's view is that it is highly unlikely that the Autonomous Regions subsector will achieve the reduction path forecast in the SPU. On the expenditure side, the expected development in AIReF's inertial scenario of primary government consumption components (mainly recording expenditure in health, education and social services) means higher growth than envisaged in the SPU and that would make achievement of the forecast adjustment very complicated. In particular, the forecast path in the SPU for spending on health and education in GDP terms shows a constant reduction in the period 2016-2019 which AIReF deems unlikely in accordance with the modelling it has done.

- AIReF considers it very likely that the ***Local Corporations*** (LC) subsector will consolidate within the SPU time horizon the surplus it has been achieving since 2013, although AIReF warns of the risk that the surplus be smaller. For 2016, there is practical certainty of compliance with the subsector's budget stability target. The possible reduction in the surplus recorded in previous years would be due amongst other aspects to the greater flexibility shown in the application of the expenditure rule and to the non-compliance with this rule recorded by this subsector in 2015. A consolidation effort that is sustained over time requires the correct application of the expenditure rule and the consequent revision of MINHAP's interpretation of this fiscal rule that has contributed to making its application more flexible and in a way has distorted the ultimate purpose of this fiscal rule These interpretations need to be revised and the methodological elements that are necessary for planning, monitoring and assessment of non-compliance with the expenditure rule should be clearly defined.

Government debt:

- The trend in government debt forecast in the SPU is downward and sustainable although it does not enable compliance with transitional provision one in the LOEPSF. The sustainability analysis carried out by AIReF highlights the importance for the sustainability of government debt both of maintaining a robust nominal growth scenario in the medium term and the improvement in the primary balance through compliance with the prevailing fiscal rules in Spain and the EU. In a stochastic analysis framework, the debt path underpinning the scenario included in the SPU is deemed likely, centred on the probability distribution towards the end of the period.

Transparency:

- The SPU should include sufficient information to evaluate its adequacy to comply with the fiscal rules. Nevertheless, it does not include budget projections that allow identification of the degree of compliance with the targets in an inertial scenario with no measures and in an alternative scenario including the measures forecast for each one of the subsectors. Likewise, the section on contingent liabilities only includes information on the guarantees granted by the public administrations. These shortcomings highlight the need to continue enhancing the transparency of government accounts and fundamental for that is to guarantee AIReF has access to the necessary information.

Recommendations:

On 25th April, with the publication of its assessment of the draft SPU 2016-2019, AIReF sent the Government several recommendations so that they could be taken into account in the version that was to be submitted to the EU institutions. Nonetheless, so far the Government has not expressed a view on them although it has already submitted the SPU to the EU institutions. As a result, AIReF's recommendation on the modification of the macroeconomic scenario in 2018 and 2019 has not been taken into account but the reason why the Government has departed from the recommendation has not been included in the SPU. Likewise, the Ministry of

Finance and Public Administrations has announced one single target for all of the Autonomous Regions. On the other hand, progress has also been made in implementing measures that had already been announced, such as the approval by the Government of the non-availability agreement. Consequently, the reports contain the recommendations to which the comply or explain principle applies, updated with the latest available information.

In line with the content of this assessment, AIReF makes the following recommendations on the macroeconomic forecasts:

- The GDP growth rate for 2018 and 2019 should be revised down slightly if the decision is to maintain the government consumption path in the draft SPU 2016-2019 in those years.
- The models used in the macroeconomic forecasts should be published, so satisfying the requirements established in Directive 2011/85 on budgetary frameworks.

With regard to the budget stability targets, AIReF recommends:

- Approval and implementation of the Non-Availability Agreements announced in the SPU in the terms envisaged in the LOEPSF in such a way that:
    - Those agreements give details of the expenditure reduction measures or identify the appropriations affected.
    - Those agreements cannot be revoked during the year in which they are approved or until measures are adopted that guarantee compliance with the target set, nor lead to any increase in expenditure recorded in the auxiliary accounts.
    - The implementation of the agreements is accompanied by stringent monitoring of the budget modifications and development of the auxiliary accounts, especially creditors for operations pending budget recording (409/413).
- Turning the decisions by regional governments on non-implementation of certain budget appropriations into non-availability agreements with the aim of giving them the effectiveness guarantees those agreements have.
- Reinforcement of the preventive nature of the LOEPSF by each one of the Public Administrations guaranteeing the application of automatic preventive measures, which entail an exhaustive monitoring of the implementation data and allow, if necessary, adjustments to be made, when there is still time for their effects to be felt within the same year the deviation risk is detected.
- Approving differentiated net lending or borrowing paths for the Autonomous Regions. Although it would be desirable for all the Autonomous Regions to achieve the stability target at the end of the period, one single identical target for all the Autonomous Regions might lead to a relaxation of the commitments and provisions in the budgets approved for eight Autonomous Regions (Andalusia, Asturias, Balearic Isles, Basque Country Canary Isles Galicia, Navarra and La Rioja). However, for the nine other regions this common target would require an effort that, even though it may be achievable by some of them, poses risks for its materialisation, just as seen in previous years.

- Details should be given of the measures adopted or the measures that might be adopted in order to guarantee the consolidation of this adjustment in subsequent years and to take the deficit as contained in the SPU forecasts down to below the 3% of GDP threshold in 2017.
- The necessary decisions should be taken to guarantee the financial equilibrium of the Social Security System within the framework of the Toledo Pact Commission.

As far as the expenditure rule is concerned, AIReF makes the following recommendation:

- MINHAP should revise its recent interpretation of the calculation of the expenditure rule in which any expenditure deviations generated each year are deferred for consolidation in the future. Likewise, the methodological elements that are necessary to plan and monitor the expenditure rule and to appraise compliance with it must be clearly defined.

With regard to improving the transparency in the way government accounts are managed AIReF makes the following recommendation:

- Include in the Stability Programme:
    - Budget projections in an inertial non-policy change scenario both for the whole General Government sector overall and for each one of its subsectors.
    - Budget projections that incorporate the measures and so would allow visibility on what part of the consolidation adjustment forecast would come from the adoption of measures.
    - Government debt targets distributed by subsectors.
    - Detailed information for the analysis of the expenditure rule for each one of the subsectors: eligible expenditure as well as the reference rates for the calculation of the expenditure rule for all the years covered in the Stability Programme Update.
    - More information on those risks, which if they materialise might affect the budget stability or debt targets.
- Take all the steps for coordination between MINHAP and AIReF aiming to guarantee access to the necessary information for AIReF to discharge the functions assigned to it by the LOEPSF and its implementing regulations.

Report on the Macroeconomic Forecasts for the Kingdom of Spain's Stability Programme Update (SPU) project 2016-2019

Contents

Introduction

The macroeconomic forecasts included in the Stability Programme Update (SPU) projects are required to incorporate a Report by the Independent Authority for Fiscal Responsibility, indicating whether they have been endorsed by this Authority as provided for in the Organic Law creating the AIReF. This report is submitted in response to the above mandate, providing an assessment of the Government's macroeconomic scenario as presented to the AIReF.

This report takes into account only the large figures in the macroeconomic and budget scenarios presented to AIReF by the Government. Although this information is insufficient for an in-depth analysis of these scenarios, it does allow for an overview of their internal consistency. This forecasts report is issued jointly with the Report on the Stability Programme Update project. In the former, AIReF provides a detailed analysis of the text and an assessment of the appropriateness of the measures specified in the budget scenario to the fiscal consolidation targets, in view of their consistency with the macroeconomic scenario adopted.

The Stability Programme Update (SPU) project is the key document in medium-term fiscal policy programming for EU member States and the coordination of their economic policies. Its content and form must meet the requirements of the Code of Conduct for implementing the Stability and Growth Pact.

The AIReF report on the macroeconomic forecasts for the SPU project is composed of three sections. Following this introduction to the report, section 1 contains an analysis ex post of the macroeconomic forecasts contained in previous Stability Programme updates. Section 2 presents an analysis of the macroeconomic scenario for SPU 2016-2019, with a reference to an AIReF inertial scenario, and a discussion on its exogenous circumstances, the cyclical position of the economy and its potential growth. It also examines, each in its own right, projections for the main variables in the macroeconomic outlook, the sensitivity analysis for this basic scenario and the principal risks inherent to the forecasts. Section 3 in the report gives a summary of the overall assessment of the official scenario and offers two recommendations and two suggestions for good practices.

The macroeconomic forecasts for previous years are examined to ascertain whether any errors committed have had a significant bias. To this end, a comparison is drawn between Government forecasts for the main macroeconomic variables, on the one hand, and those for other private and public independent institutions, on the other hand, yielding the results shown. The bias or difference in forecasts for the different macroeconomic variables with regard to the reference institutions is considered to be significant when of sufficient magnitude, i.e. when the figure forecast by governments falls without the interquartile range of independent forecasts being considered; when it has been systematic, that is, repeated for consecutive years; and when, in addition, it has not been justified by falling closer to the observed results.[1]

[1]Article 14.4 of the Organic Law creating the AIReF sets forth that this report should include an assessment of whether a significant bias in the macroeconomic forecasts over a period of four consecutive years, in accordance with COUNCIL DIRECTIVE 2011/85/EU of 8 November 2011, on requirements for budgetary frameworks of the member States.

The aim of the detailed analysis of Government forecasts for 2016-2019 is to determine whether they are realistic and whether they define the most probable macroeconomic scenario, or a more cautious scenario[2]. For this assessment, said forecasts for the main variables are checked for bias through a comparison against those of other institutions, following the procedure for previous years. Likewise, the methods, parameters and circumstances on which the forecasts were based on are reviewed, provided the information available allows it, and it is verified that the information used is fully updated.

[2]Article 14.3 of the Organic Law creating the AIReF sets forth that this report should examine the compliance of the forecasts with COUNCIL DIRECTIVE 2011/85/EU of 8 November 2011, on requirements for budgetary frameworks of the member States. The above directive in article 4.1 establishes that budget planning must be based on the most likely macro-budgeting scenario or a more cautious scenario.

1. Macroeconomic forecasts included in previous SPUs

1.1. Forecast comparison criteria

In comparing different forecasts it is essential to take into account the information available at the time of their drafting and the specific assumptions that were made in each case, as these two elements may greatly affect the differences observed among forecasts. Understanding the causes of these differences is necessary in determining the presence of bias in Government forecasts ex ante, that is, at the moment of their drafting. These comparisons of forecasts for the macroeconomic scenario in 2016-2019 are discussed in the next section.

The analysis ex post compares Government forecasts with those of other institutions, **both private** (grouped under the consensus forecast) **and public** (the European Commission, the Bank of Spain, the OECD and the IMF considered individually). The purpose of this comparison is to detect any significant bias in Government forecasts, with no analysis or justification of the possible causes for the differences observed.

Private institutions' consensus forecasts are published regularly but do not cover all relevant variables. The most recent forecasts published before tabling the SPU project may provide the most updated public information available, and all forecasts are published simultaneously. For the purposes of drawing a comparison, main or consensus forecasts by this diversified group of private forecasters provides a satisfactory reference in terms of independence and predictive results for the main macroeconomic variables.

Forecasts by the European Commission and the IMF are more comprehensive, but less directly comparable, which, being published less frequently, may be outdated at the time the Government is drafting its forecasts, and the specific assumptions may differ significantly. Therefore, the latest forecasts published by public institutions, despite being important to the body of information on which the Government forecasts are based, will be treated independently to those of private institutions. Forecasts by the IMF are particularly useful for assessing the Government forecasts included in the SPU project because only these cover the same outlook timeframe and their update is closer to the publication date of the Stability Programme Update.

Any Government forecast bias that is sufficiently pronounced, repeated several years in a row and not justified by falling closer to the observed results, will be considered as a significant bias. Bias in a variable is defined as the difference between the official forecast and the mean of the reference institutional forecasts. To gauge whether the bias in the Government's forecasts for the different variables that define the macroeconomic scenario for its budgets has been significant in recent years, a survey is conducted of the errors or departures from the forecasts with respect to the actual outcome. To sum up, the initial Government (G) forecasts are compared: (i) with the most recent previous forecasts by private institutions published in the consensus (C) forecast, revealing any bias; and (ii) with the result (R) observed, or with the Government's own most updated forecast if the result has not been estimated yet, representing the final forecast error. The bias is large if the Government forecast falls without the interquartile range[3] of the distribution among the panel of forecasts. Government forecasts' departures from the consensus forecasts will be considered unjustified if the absolute forecast error is greater than that of the consensus forecast; that is, if |G-R|>|C-R|.

1.2. Retrospective analysis of the forecasts for the years 2012 to 2015

1.2.1. SPU 2012-2015

The Spanish economy in 2012 was in an unsustainable fiscal situation, **characterised by severe financial and economic imbalances that reinforced each other in vicious circles**, generating negative dynamics that called for urgent redress: financial crisis, economic recession and sharp loss of jobs. In 2011 the public deficit hit 9.5% of GDP, surpassing the 6% target, which raised doubts over the capacity for budget consolidation. Government debt had grown in recent years, giving cause for concern. Moreover, private and external debt had reached high levels that increased the economy's exposure to a confidence crisis regarding its solvency, reflected in extremely high risk premiums.

The Government designed an economic policy strategy for the middle and long term to re-establish confidence in the Spanish economy and to lay the foundations for the recovery of production and employment, through a commitment to budget stability and structural reforms. Ambitious goals were set for reducing Government debt for the period 2012-2015: a deficit reduction path of 5.3% of GDP for 2012, 3% of GDP in 2013, 2.2% of GDP in 2014 and 1.1% of GDP in 2015, to reach budgetary equilibrium in 2016. This fiscal consolidation was to dampen the rising trend in the level of Government debt, which began to decrease after 2014.

The budgetary adjustment had an adverse effect on economic activities in 2012 and the government anticipated a 1.7% decrease in GDP, in line with the consensus for private forecasts. A continuing slowdown of all components of domestic demand was expected in 2012, within a context of a heightening crisis in sovereign debt at European level and generalised fiscal consolidation measures. The net external demand, in a reversed image of the drop in domestic demand, was expected to substantially attenuate the drop in the actual GDP figure.

The results for 2012 were far worse than the Government's expectations and the deterioration of public accounts more acute, partly because the recession in the Spanish economy was more serious than initially estimated, with real GDP shrinking by 1% in 2011 instead of growing. In 2012 there was still strong, unjustified bias in forecasts for private consumption, which decreased two percentage points beyond the Governments' expectations, and public consumption, which decreased far less than planned in the expenditure policy. The net result of these forecasting errors of opposite sign was a deeper economic recession and public accounts imbalance: the real GDP fell

[3]The interquartile range is a dispersion measure defined as the difference between the first and third quartile, thus including 50% of the observations near the median.

2.6% and public deficit, far from regaining over three percentage points, increased by almost one percentage point. Nevertheless, in 2012 considerable progress was also made in correcting a fair number of internal and external imbalances, a necessary step toward launching economic recovery.

All forecasters pointed to a recession continuing at a slower rate in 2013, although for that year the Government was forecasting positive growth rates, based on the effective stabilisation of gross fixed capital formation, which would provoke a rise in imports fully offset by a rapid acceleration in exports. This pattern of recovery envisaged by the Government was shared by all existing forecasts, although the official figures were found to have large and unjustified biases across all three variables. These biases approximately offset each other in their impact on economic activity, and therefore a GDP growth of 0.2% coincided with the upper limits of the interquartile range in the distribution of private forecasts.

1.2.2. SPU 2013-2016

The macroeconomic scenario for the SPU 2013-2016 projected a gradual activity recovery path as of 2014, remaining moderate on the horizon and only topping the rate of 1% in 2016 (1.3%). The economic policy strategy strove to continue correcting the imbalance in the medium term, combining a strategy of structural reforms to the labour, capital and goods and services markets with restructuring and refloating the financial sector and an easing of fiscal adjustments.

In the SPU for 2013-2016, biases in prior updates pointing toward higher real GDP growth, with a stronger restriction on public consumption and a more buoyant private demand, were substantially corrected. This pattern of imbalance corrections based on competitive disinflation involved a growth composition in which the contribution of domestic demand was negative until 2015, inclusive, but decreasing in magnitude. By contrast, the contribution of external demand was forecast as being positive throughout the scenario, which was expected to cause the surplus in the goods and services balance to increase to reach the envisaged degree of external imbalance correction without precedent in the economic history of Spain. Salary moderation was key to the positive role prices would play on the path to correcting imbalances. Similarly, it was envisaged that the increased flexibility introduced by the 2012 labour reform would enable the creation of jobs as soon as a growth rate of 1% was surpassed, notably lower than the rates needed in earlier cycles.

The fiscal consolidation path led to an easing of the commitment to Government deficit reduction in the short term and a greater effort deferred to 2014 and 2015. The deferment of deficit correction was grounded on the need to adapt to a more severe cyclical environment than that forecast in 2012, for which reason the Government gave priority to exiting the recession by the end of 2013 or in early 2014. It was also envisaged, however, to continue refloating the public accounts, to reach in 2017 the Mid-Term Fiscal Objective after effectively balancing all the General government sector's structural deficit three years in advance of the deadline established in the Organic Law on Budgetary Stability and Financial Sustainability, which placed Government debt on a downward path set to reach 85% of GDP in 2019.

The results for 2013 were approximately as expected by the Government. GDP fell rather more than expected, while biases in other variables were not large: the contribution from external demand was less positive owing to imports remaining almost unchanged as the economy returned to growth in the second half of the year, coinciding with a fresh over-spill of the deficit ratio reaching 6.9% of GDP. The Spanish economy set out on an economic recovery path in the third quarter of 2013, putting an end to a deep and prolonged phase of recession, thanks to the progress made in correcting the principal imbalances in the Spanish economy. Prices and salaries had been substantially cut back, considerably enhancing competitiveness and reaching a current account surplus and a financing capability that reduced external debt, while both private debt and public deficit levels were dropping. Nonetheless, the decrease in deficit fell short of forecasts and the Government debt ratio continued to increase.

1.2.3. SPU 2014-2017

Macroeconomic forecasts for the SPU 2014-2017 were revised upward, following the rapid acceleration of the economy in the early months of 2014. The macroeconomic scenario for the SPU 2014-2017 envisaged balanced economic growth, sustained over time and generating jobs. For the entire forecast period, it was expected that both the domestic and the external demand would positively contribute to growth. The domestic demand was to have this effect in 2014, after six years of negative contributions. Improved consumer confidence, better perspectives for employment and the moderation in prices were expected to boost private consumption. In 2014 gross capital formation grew for the first time in seven years, thanks to the reactivation of investments in capital goods while investment in construction began to recover in 2015. Furthermore, the expected decrease in real interest rates, linked to a diminishing risk premium and the gradual return to normality for financial conditions, implied changes in the relative prices of present and future goods and, therefore, a stimulus for consumption and investment. The external demand continued to contribute positively to GDP variation, despite the quickening pace in imports, thanks to the sustained dynamism of exports deriving from the gain in competitiveness and the growth experienced in the main external markets.

It was postulated that the limiting effects on growth exercised by the fiscal consolidation strategy would be slight in the short term and, in the medium term, expansionary. This strategy aimed to increase the efficiency of the General Government sector's revenue and expenditure, favouring increased tax collection in the medium term and dismissing income tax increases on the grounds of their unfavourable effects on economic growth and the creation of jobs. In a cyclical context of robust recovery, the projected deficit ratio with regard to GDP was, likewise, revised down from the targeted 5.8% to 5.5%, a figure that was below all existing forecasts, but without altering the future fiscal consolidation path with the intention of abrogating the excessive deficit procedure in 2017. It was expected that Government debt would invert its upward trend as of 2016, having peaked in 2015. For 2017 the medium-term target was to attain the structural equilibrium established in the Organic Law on Financial Stability, well in advance of the 2020 deadline set therein.

In the year 2014 the Spanish economy recovery process initiated in mid-2013 was consolidated, becoming characterised by intense creation of jobs and rapidly decreasing unemployment, as well as the maintenance of a sound external balance and persistent disinflation, all surprising features in the light of past experience of our economy. Greater flexibility in the labour market as a result of the 2012 labour reform was a key factor in reducing the growth threshold required for creating jobs, bringing it below 1% of GDP while, at the same time, encouraging salary moderation. In addition to the positive effects of this and other structural reforms performed in previous years, came a succession of exogenous factors shared with other countries, such as reduced oil prices, the more relaxed European monetary policy and exchange rate depreciation.

The revised figure for real GDP growth for 2014 fell without the interquartile range of the distribution of private forecasts. This considerable upwards bias, however, was found to be justified ex post, with a real GDP growth of 1.4% for the whole year. By contrast, the forecast growth in public consumption for 2014, which had shown a considerable restrictive bias in budget forecasts that year, and which was revised upwards from -2.9% to -1.3%, resulted in merely maintaining its position.

However, the Government deficit target was not reached in 2014, but slid to 5.9% (5.7% with no financial aid), a slide attributed to an exceptional, non-recurrent factor (the devolution of the "healthcare cent"), while the public debt ratio continued to rise.

1.2.4. SPU 2015-2018

The macroeconomic scenario for the SPU 2015-2018 entailed a considerable upward revision of economic growth in comparison to the forecast in the previous update, with real GDP growth rates close to 3% throughout the projected period. The macroeconomic scenario of cyclical recovery has performed considerably better than expected in the budget forecasts for 2015. The downward risks identified in October failed to materialise, whereas additional growth-boosting factors appeared. The national and international environment had gained confidence, allowing for better performance of domestic demand, the external sector and the labour market, which was expected to enable compliance with the demanding budget revenue scenario.

The fiscal consolidation strategy remained focused on raising the efficiency of the General Government sector's revenue and expenditure. From the revenue point of view, 2015 was the first of the two years in which the fiscal reform, approved in late 2014, had been programmed. This fiscal reform aimed to contribute positively to recovering consumers' and companies' confidence and purchasing power. This reform sought to shift tax pressure from direct income tax burdens to indirect burdens on consumption, consistent with the orientation followed since 2012. Such fiscal burden re-balancing was also extended to Social Security contributions, with reduced contribution rates approved in February 2014 for new indefinite duration contracts (flat rate of 100 euros), that was replaced with the exemption from payment of contributions for common contingencies for the first 500 euros of the contribution rate, likewise for new indefinite duration contracts. From an expenditures viewpoint, the reforms launched in 2012 were aimed at structural aspects, as explained above. The SPU 2015-2018 envisaged compliance with the deficit commitments of 4.2% of GDP in 2015 and 2.8% in 2016 as established in the Recommendation of the Council of the European Union. A budget deficit reduction was foreseen that would lead to registering a primary surplus as of 2016 and reaching a balanced structural balance by the end of forecasting period. The debt/GDP ratio was expected to take a downward path from 2016, to reach 93.2% of GDP in 2018.

AIReF took into account in 2015, for the first time, the forecasts contained in a Stability Programme. The SPU 2015-2018 forecasts were considered to be partly prudent, due to the limited favourable cyclical effects on the primary balance of the public accounts and to the modest saving foreseen in interest payments, and partly normative, due to the stringent policy for containing discretionary public expenditure they included. In addition, considerable risks were identified regarding departure from the comprehensive assumptions adopted and the execution of the restrictive expenditure policies that were designed. The risks pointed out on the macroeconomic scenario turned into positive growth of real GDP and employment in the short-term, and negative in the longer-term programme horizon.

Fulfilment of the ambitious fiscal consolidation targets required the deployment of a strict budgetary policy able to contain public consumption in aggregate terms, although there appeared to be margins in the budget scenario with respect to the potential favourable cyclical effects on the primary balance of the public accounts and the envisaged saving in the payment of interest which, should they materialise, could offset pressures on certain components of the expenditure. Simultaneously, it was deemed necessary for the expenditure rule at different levels within the General Government sector to be applied rigorously and monitored closely, as well as the SPU measures wielding the greatest economic impact (public expenditure rationalisation measures within the framework of the Commission for Public Administration Reform, direct settlement system for social contributions, supporting instrument for the sustainability of healthcare expenditure and Local Reform). The Government brought forward to July 2015 the presentation of the 2016 budgets, whose economic forecasts were endorsed by AIReF. However, it stressed that these forecasts were subject to the risk of insufficient implementation of the strict policy for public consumption contention and the Government deficit targets were deemed difficult to meet. There existed, therefore, significant downward biases in the projection for public consumption, that have turned out to be unjustified ex post, on registering an increase in this variable of 2.7% in 2015, in contrast to the effective freeze planned by the Government.

Economic growth in 2015 exceeded SPU 2015-2018 forecasts but the fiscal consolidation target was not met. The downward deviation risks regarding the comprehensive assumptions adopted did not materialise, but the opposite trend was observed. By contrast, the risk of weaker restrictions on public expenditure did materialise. This trend has put greater pressure on domestic demand, with more public and less private consumption, while gross fixed capital formation and exports have increased as expected. The boom in domestic demand has stimulated imports beyond foreseen levels, but overall output growth has been slightly greater than forecast. Jobs and the unemployment rate, as well as inflation, have developed approximately as forecast by the Government, with a more favourable external balance owing to savings in energy costs and interest payments. The public accounts imbalance has continued to be corrected, although the public deficit ratio with respect to GDP has exceeded in eight percentage points the Government target for 2015, whereas the Government debt/GDP ratio has dropped slightly, for the first time since the beginning of the crisis in 2007, to 99.2%. The debit balance for the Nation has likewise decreased, both due to lower oil prices and to lower income balance deficit financing costs, this decrease being larger than that experienced by the General Government sector, which has allowed the private sector to make greater progress in its financial deleveraging process.

1.3. Forecast biases in the principal macroeconomic variables

Official forecasts have not shown significant or unjustified biases repeated in more than two of the four years studied. The analysis of bias in Government forecasts is limited to deviations from the consensus figures for the current year and the following year. A summary of bias assessment in these forecasts is shown in table 1. As can be seen, no systematic bias has persisted over all four years. Nevertheless, for nearly half of this four-year period, Government forecasts remained without the interquartile ranges for the consensus figures, showing significant biases that, in more than half the cases, were not justified ex post by falling closer to the results obtained.

Bias has gradually diminished with each new update. Table 1 shows that the forecasts for 2012 drafted by the Government in 2011 were somewhat misaligned with the consensus forecasts, with unjustified biases for most variables. These forecasts were reviewed in 2012 and were aligned more closely, except for private and public consumption and the deficit/GDP ratio, as stated above. Bias in subsequent updates has been less significant.

TABLE 1. FORECAST BIAS ASSESSMENT

		PREVIOUS YEAR FORECAST FOR				CURRENT YEAR FORECAST FOR			
		2012	2013	2014	2015	2012	2013	2014	2015
GDP	Large bias	YES	NO	NO	NO	NO	YES	YES	YES
	Unjustified	YES	-	-	-	-	YES	NO	NO
Pr. Cons	Large bias	YES	YES	NO	YES	YES	NO	YES	YES
	Unjustified	YES	NO	-	NO	YES	-	NO	NO
Pu.Con	Large bias	NO	NO	NO	YES	YES	NO	NO	YES
	Unjustified	-	-	-	YES	YES	-	NO	YES
Inv	Large bias	YES	YES	NO	YES	NO	NO	NO	YES
	Unjustified	YES	YES	-	NO	-	-	-	NO
Exp	Large bias	YES	YES	NO	NO	NO	NO	NO	NO
	Unjustified	YES	YES	-	-	-	-	-	-
Imp	Large bias	NO	YES	YES	NO	NO	NO	NO	NO
	Unjustified	-	YES	NO	-	-	-	-	-
Unemp	Large bias	YES	NO	NO	YES	NO	NO	YES	YES
	Unjustified	YES	-	-	NO	-	-	NO	NO
G. Bal	Large bias	YES	NO	YES	YES	YES	YES	YES	NO
	Unjustified	YES	-	NO	YES	YES	NO	YES	-

Forecasts for GDP and public deficit have shown biases over three years, but have not always been unjustified. GDP forecasts for the current year incorporated in the stability programme updates for the last three years have fallen narrowly without the interquartile range of the consensus forecasts, with an optimistic bias in 2013, when a more rapid economic recovery was expected, and a pessimistic bias in 2014 and 2015, when the strength of the recovery was underestimated. The above two deviations from the consensus toward a more cautious stance have proved to be justified. The public deficit ratio with regard to GDP has shown a bias toward optimism in three of the four years studied, but was not unjustified in 2013.

2. Macroeconomic scenario for the SPU 2016-2019 project

2.1. Introduction

The forecasts for the Government's macroeconomic scenario in the SPU 2016-2019 project are based on the most updated information available. The latest short-term indicators have been taken into account, as these have a strong effect on immediate perspectives and, therefore, influence the point of departure for the entire macroeconomic scenario 2016-2019.

The SPU 2016-2019 contains a brief description of the methods and parameters sustaining the Government's forecasts[4]. Despite the use of standard methodology in drafting the forecasts, with models and equations widely used by analysts, the specific instruments employed have not been published. To help understand the macroeconomic scenario, it would also be desirable for the body of information and forecasts to be integrated and published in simplified accounts for the nation, giving the forecasts internal unity and consistency.

2.2. Limitations to the scope and methods of analysis

The information provided by the Government does not allow for a detailed analysis of the consistency of its macroeconomic and budget forecasts. As pointed out in the first AIReF report on macroeconomic forecasts (see Report on the Macroeconomic Forecasts contained in the draft General Government Budget for 2015), it would have been necessary to integrate key elements in the forecasts in a simplified national accounts framework, in order to clarify the connections between economic activity, demand and employment, on the one hand, and on the other hand, income and borrowing requirement flows, and to recognise separately the impact of the policy measures adopted by the Government. AIReF has employed its own analytical tools to make up for this lack of information and assess the official forecasts as legally mandated. To examine the consistency of the macroeconomic and budget forecasts, the relationship between the magnitudes in the macroeconomic outlook and in the General Government sector accounts, and the remainder of institutional sectors, is established for accounting purposes in order to establish the national economy's accounts with the rest of the world. This is then analysed using several models to determine how families, companies and financial institutions would react to the fiscal policy decisions adopted to reach the targets in the programme, insofar as they can be quantified precisely.

The realism of these forecasts is analysed with a series of instruments for assessing the likelihood and risks associated with a specific scenario. The methodology employed by AIReF combines three types of instruments: macroeconomic

[4]Article 4.5 of Directive 2011/85/EU requires all member States to publish the relevant methods, assumptions and parameters sustaining their macroeconomic and budget forecasts.

models to analyse the interaction of macroeconomic and fiscal variables, satellite models for projections of public revenue and expenditure and debt dynamics, and accounting algorithms for preserving the consistency of independently projected figures[5].

The method for analysing the Government forecasts is initiated with the projection of an inertial macroeconomic scenario. In view of the information available at the closing date, the first two quarters are projected with dynamic factor models for GDP and its components of demand, employment and prices. The macroeconomic scenario then translates into a budget scenario, based on the projection obtained in the central BVAR for a synthetic variable that combines taxes and contributions net of unemployment benefits as percentages of GDP. This aggregate variable gives an approximate reflection of the influence of the economy's cyclical position over the fiscal variables most sensitive to the economic juncture. Finally, these macroeconomic and budgetary figures are incorporated to the simplified accounts of the remaining sectors in the national economy. The end state thus defined is used as a reference to assess the macroeconomic scenario prepared by the Government. By inserting in the inertial scenario the discretionary expenditure policy provided by the SPU 2016-2019 project, its effects on macroeconomic aggregates can be assessed, as well as its consequences on the remainder of variables.

2.3. A reference inertial scenario

With the models employed by AIReF, and under the exogenous assumptions adopted in the SPU 2016-2019, it is envisaged that real GDP growth will converge on a yearly rate close to 2.5% toward the end of the horizon. The pace of economic activity decelerated slightly in the second half of 2015, with weaker investment and public consumption growth, while private consumption continued to accelerate until the end of the summer, to some extent thanks to circumstantial factors such as the fall in oil prices, the payment of civil servants' annual bonus withheld in 2012 and the early implementation of the second phase in the personal income tax reform. Both exports and imports that, as in the case of private consumption, had maintained rapid growth until September decelerated sharply in the final quarter of 2015. The expansion in the Spanish economy's GDP has continued to decelerate during the first quarter this year to reach 0.7% and it is estimated that this trend will extend over the coming quarters. In the medium term, all the components of private domestic demand, as well as exports and imports, are following a decelerating trend toward more sustainable rates, in line with the long-term equilibrium in the models used. Public consumption, by contrast, which

[5]Macroeconometric models are used depending on the time horizon in the analysis. Within the short span of two or three quarters, projections for GDP, for the components of demand, employment, etc. are widely supported on dynamic factor models that exploit the latest information available (Model MIPRED). For a longer time horizon, the preferred model is the Bayesian vector autoregressive model (see the working paper by Ángel Cuevas and Enrique M. Quilis: BVARX modelling of the Spanish economy), which incorporates the dynamic interaction of the principal macroeconomic and fiscal variables (real GDP and GDP deflator, employment, credit and taxes plus contributions net of benefits), as well as equations with error-correction mechanisms for projecting adjustment paths for the main variables (see sample simulations programmed on a spreadsheet here. Satellite models are usually single-equation and autonomous, and are used to project separately tax revenues (on natural and legal persons, VAT, special taxes, etc.), Social Security contributions, Public Administrations' consumption and investments, pensions, interest payments and debt dynamics. Accounting algorithms allow the integration of information from diverse sources, exogenous variables, projections of models and expert assessments in a consistent set of accounts providing a synthesis of the macroeconomic and fiscal scenario.

registered steep growth in 2005, exceeding the long-term rate, and which is expected to settle in 2016 at just below this rate, will tend to accelerate in subsequent years in this inertial scenario of convergence at a sustainable equilibrium.

Private consumption has initiated a path of gentle deceleration leading toward the 2% mark. Both qualitative indicators (consumer confidence, PMI for consumer goods and services) and quantitative indicators (retail, industrial production of consumer goods) have shown some weakness in the most recent data available. For the whole of 2016 marginally slower growth is envisaged in private consumption than in the previous year. With regard to income and wealth, the situation for households has continued to improve. Employment is growing at a good pace, the ratio of financial burdens to income has fallen and net financial wealth is greater thanks to debt reduction and increasing value of assets, while the value of housing wealth is on the rise. These trends are projected as continuing inertially into the near future. Both the unemployment rate and the available income and the housing wealth of households, which still fall short of the maximum levels reached before the crisis, will gradually return to those levels, while households continue to accumulate net financial assets, that have surpassed the peak historical levels. Private consumption growth will foreseeably slow to rates in the region of 2% in the medium term, sustained mainly by an increase in available income and with positive, albeit decreasing, contributions from net financial and housing wealth.

Following the steady reactivation of gross fixed capital formation, its growth is projected to remain at rates exceeding 4%. Investment in capital goods, which had quickened during the two preceding years, has tended to stabilise at slower rates in 2016. As demand picked up again, financing costs eased and the conditions in financial markets recovered, the stock of productive capital has been gradually replenished, having suffered from the lack of investment during the recession years. Interest rates on bank credit to enterprises, the conditions governing the new loans and, in particular, the margins applied to ordinary loans, have remained on a favourable trend while the rate of decline for loans granted by resident institutions to the business sector, and the year-on-year decrease in loans received from the exterior tend to level off. Non-financial enterprises' capital positions are improving and debt and financial burden ratios with respect to GDP are declining. The accelerating effect on investment resulting from the reawakening of demand peaked in the second quarter of 2015 and has subsequently eased slightly to growth rates in excess of 4%, becoming more in line with the medium-term trends projected for the future, with smaller contributions from the use of productive capabilities, which tend to become stable at historical levels, and of user cost of capital, which remains well below its previous minimum levels. Investments in construction remain at steady rates of growth. In the wake of the notable recovery witnessed in 2015, driven by an upswing in the labour market and rising housing prices, residential investment has maintained high growth rates in early 2016, while non-residential construction shows a less dynamic outlook.

Public consumption on the inertial scenario is calculated by the mechanical projection of AIReF models, which point to a convergence from the high rates observed recently toward long-term values that are slightly lower than the rates for GDP and private consumption. Consequently, the trend projection for the public consumption to GDP ratio has experienced an average reduction of just over two tenths of a percentage point per year for the four years of the programme.

The negative contribution from net external demand to GDP growth will gradually decline. Whereas imports surged over the last two years, in line with the recovery in final demand in the Spanish economy, which is its key determinant, exports sustained their strong position bolstering the external trade balance, in contrast with the historical experience in other cyclical phases of growth in our economy. This suffocating effect by the external sector, whose traditional fragility had framed GDP growth, seems to have become far less restrictive at present. As growth in domestic demand has slowed over the last few quarters to approach rates that will be more sustainable in the long term, the negative contribution of net external demand has dropped. The mighty surge in exports that exceeded expectations in 2013 and 2014 has benefited in 2015 from an improvement in the real effective exchange rate. This beneficial effect is set to persist throughout 2016 and 2017, and its gradual exhaustion may be offset to a large extent by greater expansion of world trade in goods toward the end of the forecast horizon. The projection for imports, moreover, sees them growing on the strength of their final demand in our economy. In summary, trends for exports and imports for the coming years point to a steady rate of increase in the former in excess of 5% and a slowdown in the latter toward similar growth rates, causing the net combined contribution, which in 2015 caused the loss of half a percentage point from GDP growth, to dwindle almost to nothing.

This scenario of sustained growth at rates higher than the potential output induces an automatic cyclical correction of the imbalance in Government accounts. Said correction is estimated at approximately four or five tenths of a percentage point reduction in the GDP deficit ratio for each of the years in the programme, as a consequence of revenue elasticity slightly greater than one for public revenues with respect to nominal GDP and of reduced unemployment benefits. At the same time, the hypothesis of maintaining extraordinarily low interest rates throughout the whole period also contributed heavily to relieving the interest charges on Government debt, bringing an additional saving of just over a percentage point of GDP. The overall deficit in Government accounts is projected to be reduced by half, thanks to the effects of these two factors in the absence of additional measures on expenditure. This enhancement of Government accounts would lead to the gradual decrease in the Government debt ratio with respect to GDP by about five percentage points accompanied by the maintenance of the nation's financing capacity in the region of 2% of GDP, and a slight fall in household and enterprises savings ratios, as well as their financing capacity, as may be expected for a cyclical phase of growth.

2.4. Assumptions, cyclical position and potential growth

2.4.1. Assumptions

The baseline hypotheses sustaining the macroeconomic scenario for the period 2016-2019 seem probable and even prudent, compared with the most recent forecasts by international bodies and to recent developments in commodities and debt markets (see tables at annex). The Stability Programme Update for the period 2016-2019 postulates a balanced set of external hypotheses that have been revised in two dimensions with respect to the previous Update. On the one hand, the external environment has lost impulse, leaving a scenario of weaker growth for the economy and world trade, and a weaker knock-on effect on the main trading partners, the eurozone countries. On the other hand, the forward interest rates curve presents an upward shift for all maturities, with an especially prudent profile in the evolution of long-term Government bond yields, in line with the evolution of the forward curve. Lastly, it is worth noting that the trend in oil prices has led to a considerable reduction in comparison with last year, although it has stayed within the forecasts issued by the futures markets and leading international institutions.

The growth path in the eurozone coincides with the projections of the Central European Bank (CEB) and is consistent with a progressive slowdown in global growth and a slight appreciation of the euro's effective exchange rate. In its most recent projection, published in March this year, the ECB reduced its growth forecasts slightly for the euro area on the grounds of the slowdown in certain driving factors: (i) slower global growth (centred on emerging economies); (ii) strengthening of the single currency in the euro area; and (iii) greater volatility in financial markets. Despite such moderation, a positive profile is maintained on the basis of the solid domestic demand resting chiefly on the expansionary monetary policy that is supported by the monetary authority and the improvement in available revenue brought about by low oil prices. In line with these forecasts, the tabled hypotheses contemplate a slowing down of growth and world trade, and of growth in the eurozone, together with a slight appreciation of the euro's effective exchange rate at the beginning of the period studied.

The hypotheses regarding the yield of Government debt securities assume a curve shift both in the short and the long term, in line with market expectations. The trend in 10-year Government debt interest rate forecast in the SPU 2016-2019 is increased by 0.8 percentage points from a baseline of 1.7%. This evolution ties in with the market future forecasts observed in the evolving forward curve and implicitly maintains the differential or credibility gap with regard to the German bond of reference. This hypothesis is regarded as prudent as it assumes the progressive return to normality of the monetary conditions in the euro area, in line also with maintaining the bilateral dollar/euro exchange rate.

Oil prices have followed a path aligned with futures markets and leading international organisations' forecasts. The crude oil price hypothesis has been revised down with regard to the SPU 2016-2019, in line with the trend for crude oil prices per barrel (Brent) which has dropped around 35% since April 2015, reaching the lowest levels in the last decade. The forecasts are similar to those issued by the principal international institutions, albeit with some nuances toward the end of the period. Concretely, for 2016 and 2017 the figures in the SPU 2016-2019 are in line with the futures market, although they remain constant after 2017 while market expectations point to a mild upswing.

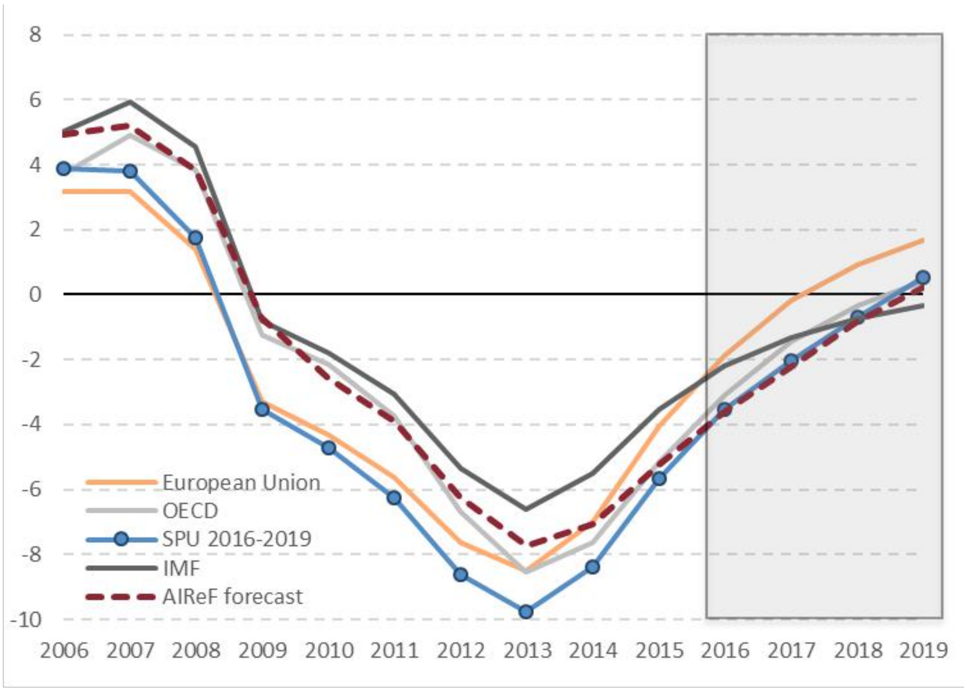
Despite the equilibrium displayed in the external scenario, it would be advisable to consider potential downward risks deriving from slower world growth, a quicker oil price recovery than envisaged or the consolidation of a slower potential growth for the euro zone economy as a consequence of a prolonged period of insufficient demand and very low inflation rates. Firstly, as made explicit in the spring forecasts report issued by the International Monetary Fund, the materialisation of certain contingencies could affect growth and world trade: among others, (i) the negative spill-over effects caused by a deceleration of the Chinese economy at a faster pace than envisaged: (ii) increasing geopolitical tension both in the Middle East and in relation to the possibility of Brexit; (iii) a negative wealth effect derived from household assets' progressive loss of value as a result of current turbulence in financial markets. Secondly, the escalation of tensions among the chief oil producing countries such as Russia or Middle Eastern countries, or the materialisation of ongoing talks among them to limit supply and thus put an end to the deflationary spiral, may lead to a rising trend in oil prices on the projection horizon. Finally, the incomplete transmission of monetary stimuli to the eurozone economy in association with a low energy price scenario could place a burden on domestic demand through two channels. To begin with, through the fragmentation of financing conditions for households and enterprises between the periphery and the nucleus. And secondly, through risks associated to deflation within an environment of constrained expectations for inflation and the postponement of decisions on consumption and investment. These effects are liable to be aggravated in the current high-leverage context, both private and public, in the Spanish economy.

In sum, the external assumptions in the SPU 2016-2019 imply a growth projection that falls slightly below the growth previously envisaged. This revision is the result of the negative impact on exports, an external market slowdown, and an appreciation in the euro exchange rate, not fully offset by the favourable effects of lower commodity prices, and especially oil prices, nor by the sustained improvement in the financing conditions for households and enterprises.

2.4.2. The cyclical position and potential growth

The cyclical position of the Spanish economy incorporated in the SPU 2016-2019 project appears to achieve its potential in the year 2019, thus closing a cycle that opened with the accession of Spain to the Economic and Monetary Union (EMU) in 1998. According to the update project, the output gap in 2015 stood at -5.7% and gradually catches up at an average annual rate close to 1.5 percentage points for the projected period, and is set to reach a positive figure (+0.6%) in 2019. This dynamic is in line with recent estimates by leading international institutions, and is associated to steeper potential growth envisaged at 1% in 2019 according to all existing estimates (see table and graph at annex).

Graph 1: Output gaps in the Spanish economy *(% of potential GDP)*



Source: SPU 2016-2019, OECD Economic Outlook November 2015, IMF WEO April 2016 and EC Winter Forecast 2016

In view of the dynamics presented for the output gap, the correction to the fiscal balance explained for the cycle represents an annual mean of 7 to 8 tenths of a percentage point of GDP during these 4 years. With a cyclical balance semielasticity at the output gap just over 0.5, it is envisaged that the cyclical component of the fiscal balance (the part explained by the cyclical position of the economy) will gradually decrease into the SPU horizon at a mean rate of approximately 8 tenths of a percentage point of GDP, and entering surplus status by 2019. Cumulative gain in terms of reduced deficit during the period studied is in line with the estimates by leading organisations taken into account, although the latter foresee a smaller initial output gap, especially in the case of the International Monetary Fund. The residual component of the deficit observed as of 2018 can, therefore, be considered structural and would require a credible commitment to budgetary equilibrium in the medium term to correct it, instrumented through measures designed to persist over time.

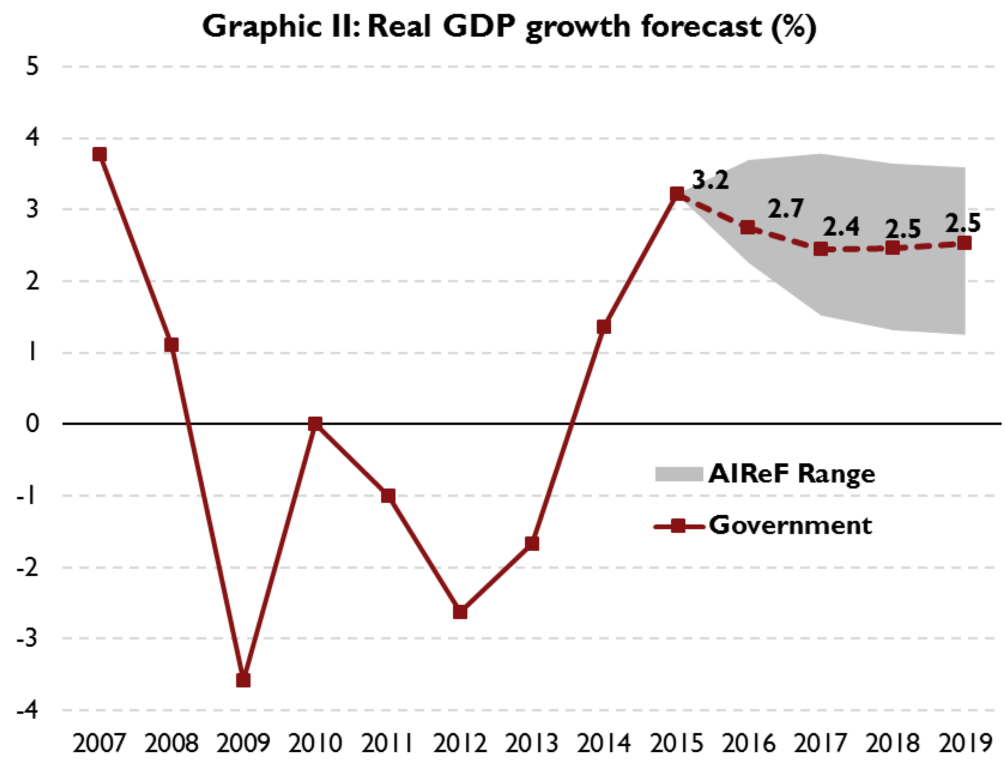
In sum, the output gap path incorporated in the SPU is feasible, despite its initial amplitude. It must be borne in mind, however, that there is considerable uncertainty over estimates for the output gap and for the potential output and its robustness, as these results need to be interpreted cautiously. The diversity of methods employed by international organisations to estimate potential output usually produce results on substantially different levels and which vary greatly with each addition of new information, particularly at turning points in the economy. This uncertainty may lead to frequent and major reviews, providing changing signals of economic slack.

2.5. Analysis of the macroeconomic scenario for the SPU 2016-2019 project

Forecasts for real GDP in the SPU 2016-2019 project indicate growth rates falling gently for the first two years in the programme, and levelling off at 2.5% in the final two years. This sustained growth in real output is prompted by the surge in domestic demand toward rates that exceed by between one and two percentage points the estimates for the increase in potential output. Net external demand, having slowed economic activity growth by one half of a percentage point in 2015, is expected to continue to contribute negatively to economic dynamics in 2016 and 2017, but gradually progress to a neutral position in 2018 and to having a positive effect by 2019. These forecasts are in agreement with the remainder of forecasts available, private and public, for the first two years of the programme, but for the final two years they stand at just over half a percentage point above the forecast by the IMF, the only body to forecast GDP growth for this four-year period.

The expansion of domestic demand displays the same profile as that of output. Both consumption and investments are expected to decelerate gradually, the former more in relation to the latter, as can be expected during a cyclical boom phase in which real output rises above its potential. These features are shared in other available forecasts. In the composition of domestic demand, Government forecasts envisage more vigorous private spending in consumption and investments and greater moderation in public consumption, which in 2016-2017 increased less than the average consensus.

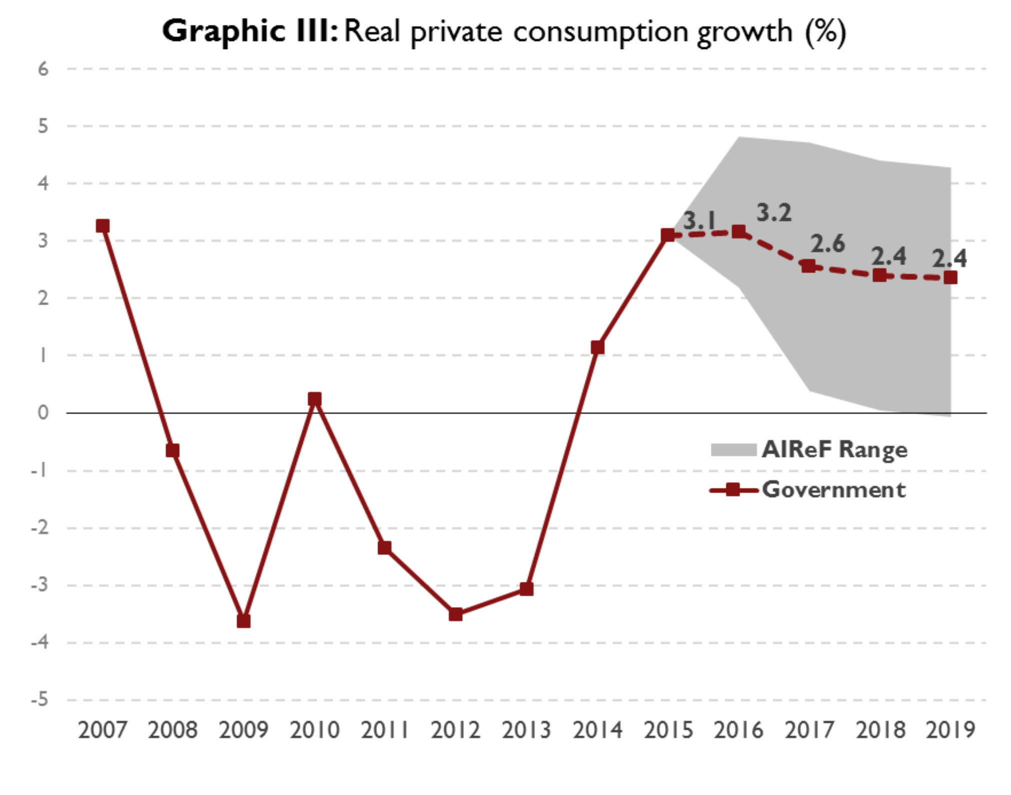
The strict implementation of this budget policy is not expected to lead to weaker real GDP growth than forecast for 2016-2017. It must be noted, however, that the implementation of this persistently restrictive public consumption policy is fraught with difficulties, judging from the results of previous years' experience, and from the first data on budget implementation available for this year. The broad contractionary bias revealed by comparison with independent institutions' forecasts entails a major risk to its materialisation, that is likewise detected through the statistical projection models employed by AIReF. Should these risks, which become more acute as we progress on the projection horizon, materialise, GDP growth during the two final years in the programme could be half a percentage point lower than expected by the Government.

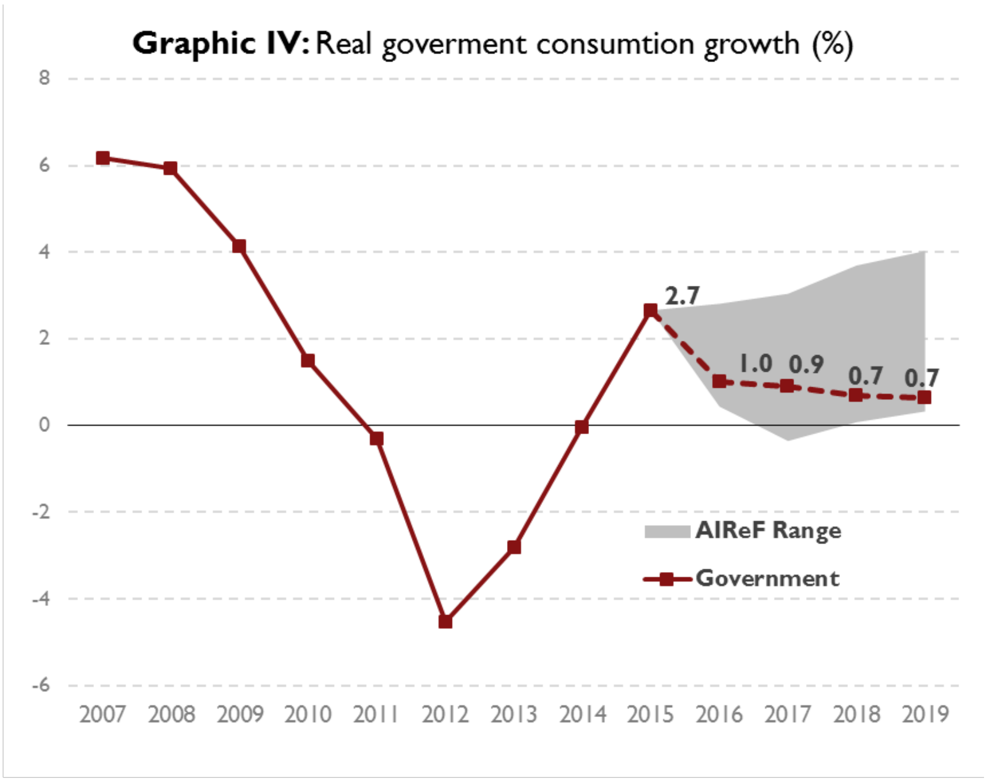


Source: Ministry of Economy and Competitiveness (dotted line) and AIReF estimates

The forecast for real private consumption growth shows a large upward bias with regard to private institutions' consensus forecast, in the two initial years of the programme, and is likewise higher than the forecasts issued by the Bank of Spain and international institutions. However, according to the uncertainty interval generated by the predictive models developed at AIReF, the figures forecast by the Government are not unlikely, but come close to the projection confidence interval with a slight downward bias in the short term, which becomes an upward bias as a more distant horizon is considered.

The public consumption forecast for the SPU 2016-2019 project scenario shows a large downward bias when compared against other forecasts, on the limits of the interquartile range for the distribution of private institutions' forecasts in 2016 and falling short in 2017. This is a key variable in the articulation of the macroeconomic scenario with the budgetary scenario, which on previous project updates was often projected with the ambitious aim of containing the upward pressures on public expenditure. In the SPU 2016-2019 project, this restrictive orientation is maintained for public consumption as a key component in the fiscal consolidation strategy.





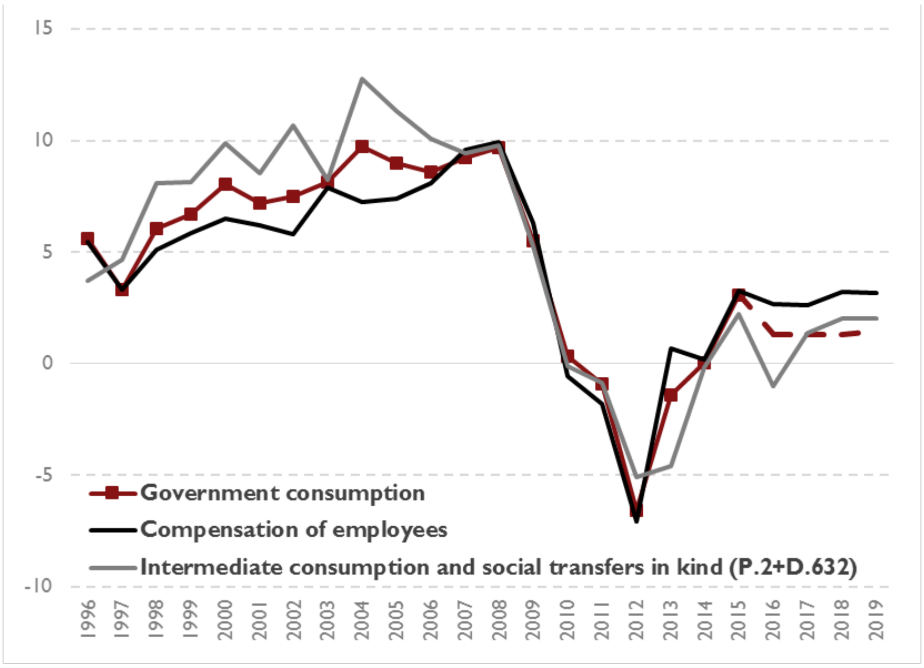
Source: Ministry of Economy and Competitiveness (dotted line) and AIReF estimates

No information has been available to assess the measures supporting the public consumption trend forecast by the Government, as no precise details have been given for said measures, and the appropriate national accounts headings have not been used. The trend for the public consumption deflator shows a smaller increase than that of the deflator implicit in the GDP and to the compensation per employee for the national economy as a whole, and therefore both employment and compensation per employee in the General Government sector are projected to grow well below the levels forecast for the rest of the economy. At the same time, the partial data provided on forecasts for rises in employee compensation and intermediate consumption as well as social transfers in kind purchased on the market by Public Administrations in the budget scenario suggest that the rise in public consumption could be greater than foreseen in the macroeconomic outlook for 2018 and 2019.

Government growth forecasts for real gross fixed capital formation show a large upward bias in 2016, which disappears for subsequent years. These discrepancies are found in capital goods investment, a variable for which the Government holds the most expansionary forecast of all those available, with the exception of the Bank of Spain. The short-term projections in AIReF models, however, point to a more pronounced fall in equipment investment throughout this year, although in the medium term this will tend to converge on a central path forecast by the Government with a growth rate close to 5.5%. Construction, by contrast, is expected to remain at sustained growth rates of approximately 4.5%, albeit with a wide uncertainty range.

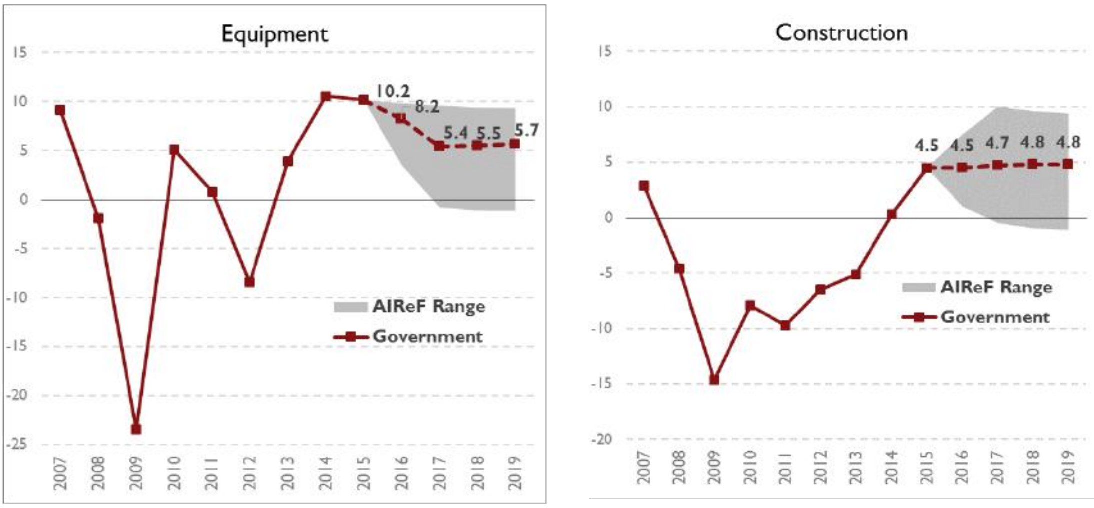
The high and stable growth path for exports is deemed likely but somewhat biased upward in the medium term. The more sluggish activity in Spanish export markets, and the perspectives for slower growth in the eurozone, coupled with the appreciation in the nominal effective exchange rate this year, and its envisaged subsequent stabilisation, signal risks in the Government's economic scenario forecast for 2017-2019.

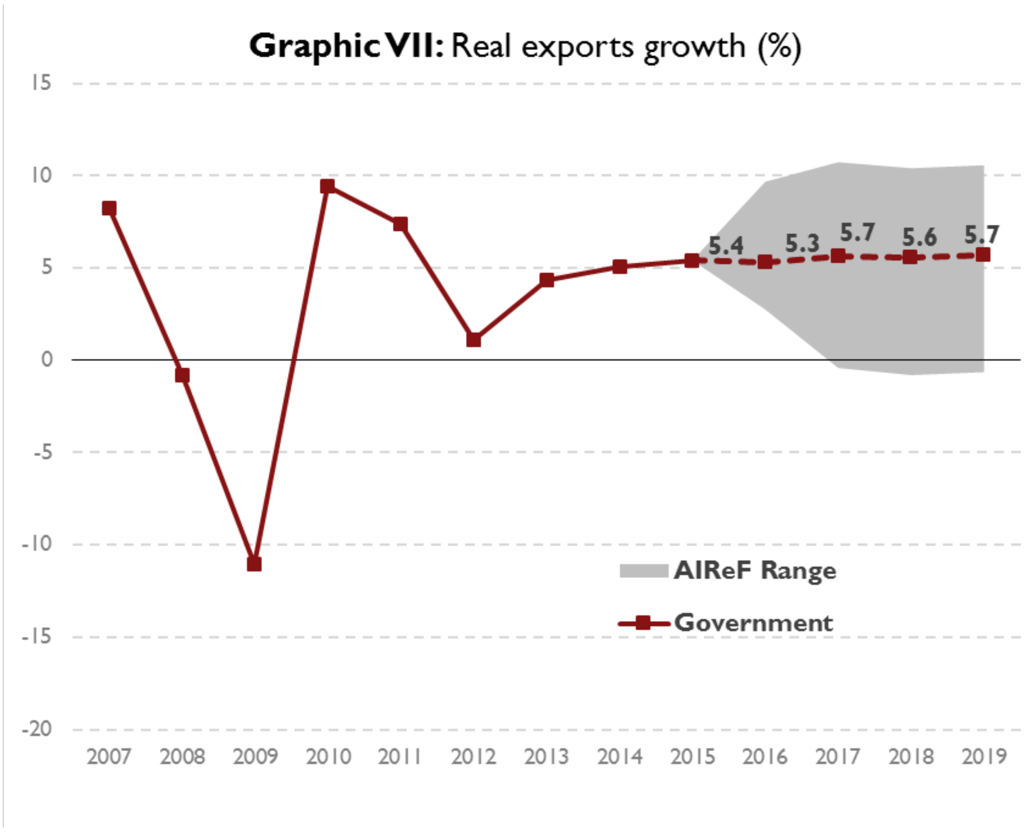
Graph V: Nominal growth of public consumption and its principal components (%)



Source: Ministry of Economy and Competitiveness (dotted line) and AIReF estimates

Graph VI: Growth of gross real capital formation (%)

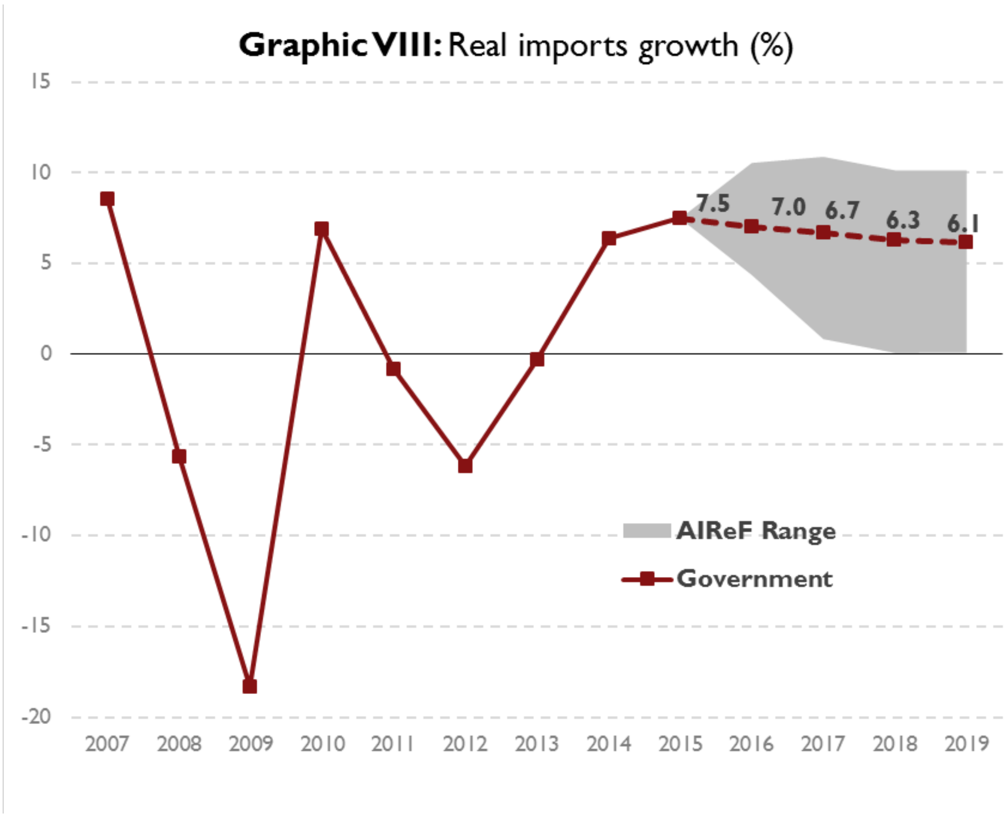




Source: Ministry of Economy and Competitiveness (dotted line) and AIReF estimates

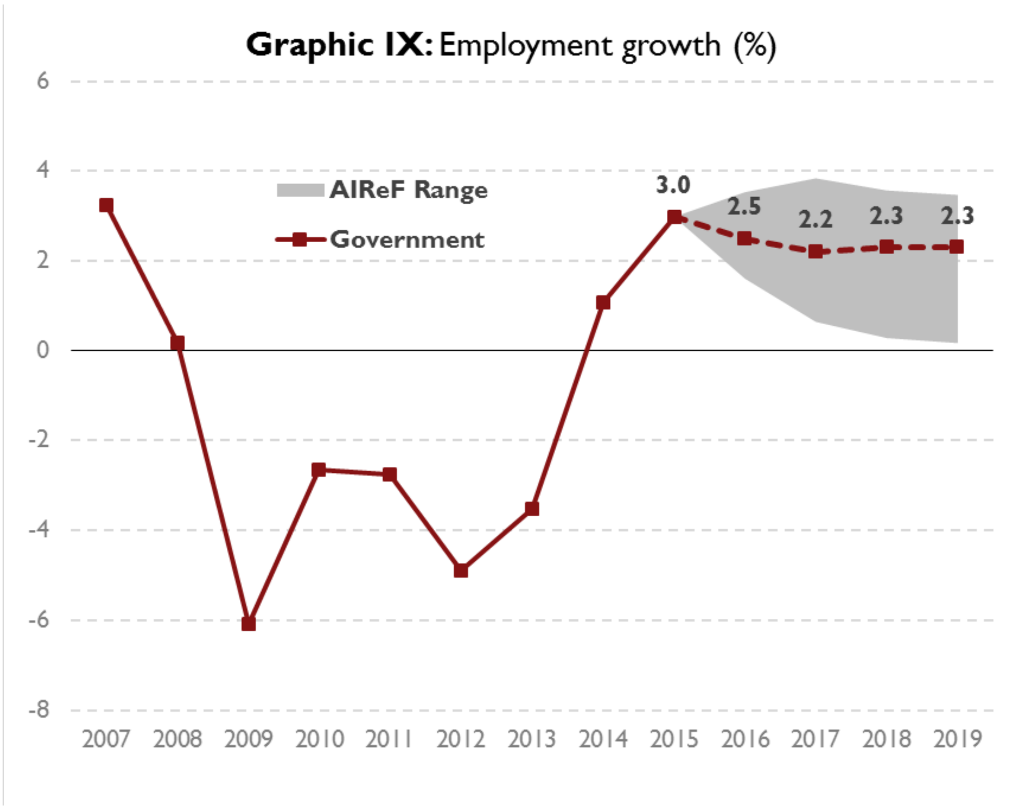
Although in the short term it is possible that the increase in exports may exceed expectations, the path they follow shows, for the period 2017-2019, average growth greater than the AIReF inertial scenario, and in 2017 exhibits a large upward bias with regard to the consensus forecasts on private institutions, and also exceeding the expectations of the Bank of Spain, the OECD and the IMF.

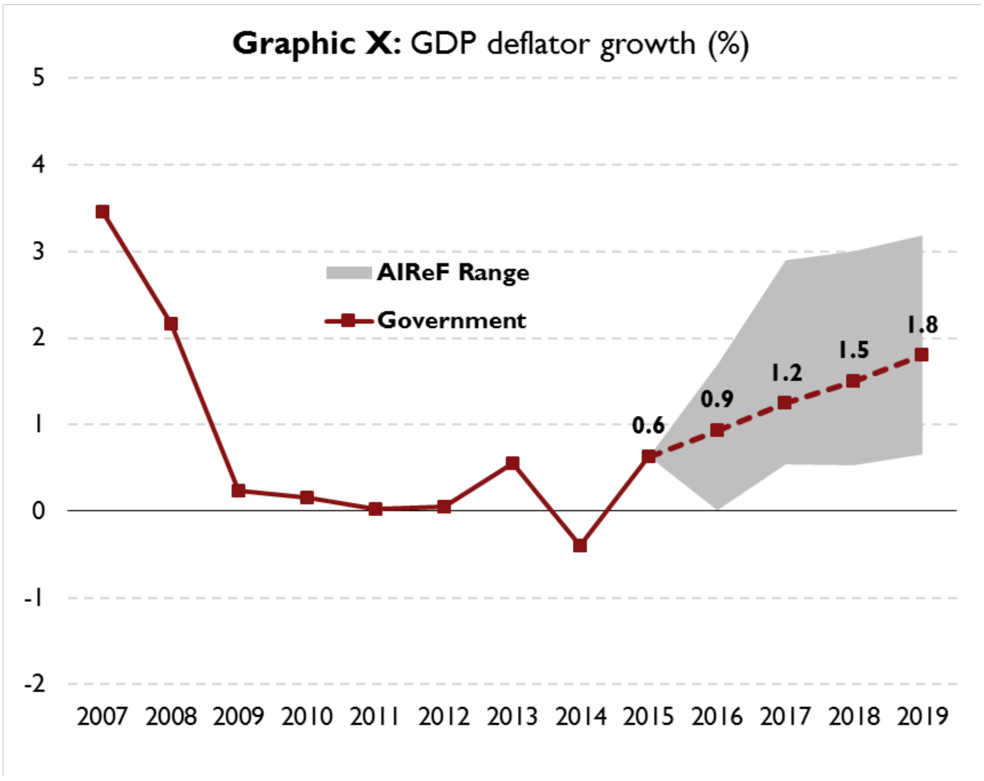
Likewise, the imports profile shows a large upward bias in its forecast growth rate. Bias is large in each of the years covered in the programme, as the imports growth figure forecast by the Government is the highest among all institutions in 2016, and hardly changes for 2017 and subsequent years. As in the case of exports, AIReF's short-term models confirm Government expectations for the short term, given the dynamic imports scenario in the first months of this year, although medium-term models predict a sharper deceleration rate into the forecast horizon, to converge at rates one percentage point below those forecast in the SPU 2016-2019.



Source: Ministry of Economy and Competitiveness (dotted line) and AIReF estimates

Total full-time equivalent employment is foreseen to increase in line with real GDP growth, at a rate of two tenths of a percentage point below GDP. These employment forecasts are in agreement with the remainder of forecasts available and imply a slight increase in apparent productivity, and for this reason unit labour costs are also expected to grow two tenths of a percentage point less than compensation per employee. The declining rate of unemployment projected by the Government, however, is more pronounced than in other forecasts, and shows a significant downward bias of approximately half a percentage point for 2016-2017.





Source: Ministry of Economy and Competitiveness (dotted line) and AIReF estimates

The macroeconomic scenario envisaged by the Government entails a gradual increase of inflationary pressure on the economy. Both the GDP deflator and the private consumption deflator are expected to gather pace during the period, to match the inflation target set by the European Central Bank, between 1.7% and 1.8%, in 2019. Forecasts for inflation are in agreement with the consensus forecasts and international organisations' forecasts, among which the Bank of Spain and the European Commission foresee more immediate acceleration, up to 1.6% by 2017, while the IMF and OECD do not foresee inflation above 1%. The rise in compensation per employee forecast for the macroeconomic scenario in the SPU 2016-2019 project is extremely moderate, but gathers pace in parallel with prices, at growth rates marginally greater than those of the private consumption deflator and in line with those of the GDP deflator.

To sum up, the macroeconomic scenario for the SPU 2016-2019 is feasible as a whole, though its consistency with the budget scenario raises some doubts, particularly over the final two years of the programme. On the one hand, in view of the projections for potential growth of the Spanish economy, a closing of the output gap is envisaged on the programme horizon, with a cyclical recovery amounting to some six percentage points, which would lead to a mechanical reduction of the deficit of more than three percentage points of GDP as a consequence of the working of the automatic stabilisers. This cyclical effect would operate mainly due to a growth in revenue, and to a lesser extent, to decreasing unemployment benefits. On the budget scenario, however, the ratio of revenue from taxes and contributions to GDP is foreseen to grow a mere three tenths of a percentage point until 2019, while the strategy for reducing the deficit is centred around decreasing the ratio of public expenditure to GDP. Moreover, the rise in employee compensation and the increase in intermediate consumption contemplated on the budget scenario imply nominal growth rates exceeding those included for public consumption in the macroeconomic outlook. In AIReF's inertial scenario described above, real GDP growth and the closure of the output gap are approximately equal to those incorporated in the macroeconomic scenario for the SPU 2016-2019. The cyclical gain furnished by the working of the automatic stabilisers is considerably greater than the figure put forward in the budget scenario. At the same time, the inertial public consumption dynamic is stronger than those described in the macroeconomic and budget scenarios. Therefore, a degree of inconsistency is appreciated between the projections for public consumption, GDP growth, cyclical revenue gain and reduction of public deficit in the SPU 2016-2019. As the differences with the AIReF inertial scenario, in which all these variables are forecast jointly, have not been substantiated, it may be concluded that there is room for some slack in the forecasts whose elimination may entail a combination of more expansionary public consumption or a smaller increase in GDP for the macroeconomic outlook, and greater revenue ratios and smaller public deficit ratios, in light of the expenditures projection, on the budget scenario.

2.6. Sensitivity analysis and main forecast risks

The information in the SPU 2016-2019 project includes a brief sensitivity analysis. This fulfils the European Commission code of conduct recommendation regarding stability programme content. The sensitivity analysis for the principal variables' response to changes in their determinant factors covered in the models allows the impact of alternative modelling hypotheses on said variables to be quantified, and the uncertainty affecting both in terms of risk to be determined. The SPU 2016-2019 presents results for three simulation exercises (higher interest rates, slower growth in Spanish export markets, and rising oil prices) using a dynamic general equilibrium model (REMS). In this section, these risks are examined and the implications of their potential materialisation are assessed.

Variations in the assumptions regarding oil prices have no substantial effects on output growth. In the event of oil prices being ten per cent above the assumed path, the impact on the GDP deflator path (positive), and on the real GDP, employment and public deficit paths (negative) is a deviation of between one and three tenths of a percentage point, according to the SPU 2016-2019 simulations, and slightly less in the AIReF inertial scenario sensitivity analysis. The cumulative effect on the Government debt to GDP ratio would amount to some eight tenths of a percentage point at the end of the horizon.

Sensitivity in the macroeconomic and budget scenario to changing hypotheses for interest rates is greater. In the simulation presented in the SPU 2016-2019, an interest rate path one percentage point above the path assumed in the baseline scenario would entail a real GDP of almost one percentage point lower at the end of the forecast horizon. Collateral effects on public accounts would also be significant, with deficit and debt ratios with respect to GDP half a percentage point and two percentage points higher, respectively. The simulations performed by AIReF yield similar results for the budget scenario, but with a smaller impact on economic activity and employment.

The effects of weaker growth in exports on economic activity and employment simulated in the SPU 2016-2019 seem underestimated. Assuming a growth rate in Spanish exports four percentage points below the assumption for 2016, maintaining the baseline scenario growth rates in successive years, the impact simulated in the SPU 2016-2019 is a drop of approximately six tenths of a percentage point in GDP growth for this year, whereas in the baseline scenario simulations performed by AIReF this effect is greater. In subsequent years, the GDP path would remain at between three and four tenths of a percentage point below the baseline scenario path in the SPU 2016-2019, while in the AIReF simulation this discrepancy is foreseen as greater than one percentage point, implying similarly significant differences in the remainder of principal variables in the macroeconomic and budget scenarios.

External assumptions, as a whole, present downward risks to the Spanish economy's growth forecast, as mentioned above. The chief downward risks consist of slower growth in the EU, which would have a substantial impact on the Spanish economy, and a sharper upturn in oil prices, with minor consequences. Certain upward risks are also present, particularly in the short term, such as a more rapid levelling-off in financial conditions stimulating a rise in credit and private demand. In addition to the uncertainty affecting assumptions on exogenous variables that are difficult to predict or quantify (such as effects on confidence deriving from geopolitical tensions), there are other risks deriving from difficulties in implementing decisions or economic policy measures, and from the internal consistencies of macroeconomic and budget forecasts.

Risks from implementing the rigorous expenditure containment policy affecting public consumption forecasts are considerable. These risks, which are analysed in greater detail in the Stability Programme Report and arise through the deficient implementation of control mechanisms (temporary or imprecise non-availability agreements, perverse incentives that undermine the Autonomous Regions' budgetary discipline, obscure or insufficient implementation, monitoring and assessment of the expenditure rule), affect the macroeconomic scenario in that a restrictive policy such as that programmed for public expenditure on consumption and investment negatively affects growth of GDP and employment. By simulating in the inertial scenario the degree of restriction on the demand exercised by the implementation of a policy such as that envisaged in the SPU 2016-2019 project, little effect would be felt for the first two years but the GDP growth path for the final two years in the period would settle at approximately half a percentage point below the projection in the programme. By contrast, the risk of insufficiently containing growth in public expenditure, which in the past has materialised repeatedly, contributes to temporarily exacerbate the rise in domestic demand that is already rising at a much faster pace than the economy's potential growth. This risk, furthermore, implies insufficient correction of public deficit, thus perpetuating the fragility of the Spanish economy in the face of changes in the extraordinarily favourable juncture it enjoys at present. A comparison of this Stability Programme Update against the previous update confirms (section 5.1 of the SPU 2016-2019) that these risks, as AIReF had warned, materialised in 2015. AIReF underlines that these same risks are still present in the latest update.

Risks deriving from the macroeconomic and budget scenarios in the SPU 2016-2019 project are greater in the second two-year period. These risks are reflected in the interdependence among public consumption forecasts, GDP, the cyclical revenue impulse and public deficit. As explained above, forecasts for these variables in the SPU 2016-2019 do not appear to be fully consistent on examination through the models employed by AIReF. Accepting the fiscal consolidation strategy that reveals the budget scenario and combines a strict limitation to public expenditure growth with cautious assumptions regarding the inertial increase or margins for slack in reducing the ratio of public revenue to GDP, the consistency of the macroeconomic scenario with the budget scenario would require a lower projection, in the region of half a percentage point per year, for GDP growth over the years 2018-2019.

In summary, the risks facing growth in real GDP and employment seem to be of opposite signs in the short term (slightly upwards) and in the medium term (downwards). In the short term, the dynamism displayed both by domestic demand and private and public consumption and by exports may be maintained throughout 2016, implying economic activity growth a little above the Government's forecasts. In the medium term, however, downward risks prevail deriving chiefly from the possibility of a less favourable trend than forecast in the external environment. These risks are aggravated as the forecast horizon increases and affect not only the robustness of exports demand but also domestic demand, especially private consumption and gross fixed capital formation, and despite the presence of upward risks that affect public consumption and involve greater budget imbalances, these fail to offset, in quantitative terms, those overshadowing demand in the private sector.

3. Endorsement of the forecasts and specific suggestions

AIReF endorses, on the basis of the exogenous assumptions and the policies defined, the forecasts for economic growth in the macroeconomic scenario issued by the Government for the Stability Programme Update to cover the period 2016-2019. AIReF finds, however, that the exogenous assumptions adopted, which as a whole are favourable to growth and to correcting the imbalances in our economy, pose downward risks that are exacerbated in the medium term. These risks suggest that the macroeconomic scenario foreseen by the Government may not reach the growth rates forecast for the last two years in the programme, according to the historical experience incorporated in the analytical models employed by the AIReF. Moreover, there are certain upward risks for domestic demand that derive from the insufficient implementation of the restrictive expenditure policies drawn up.

AIReF proposes two recommendations:

1. **To revise the GDP growth rate for 2018 and 2019** down slightly, if the decision is to maintain the government consumption path in the SPU 2016-2019 project for those years.

2. **To publish the models used in the macroeconomic forecasts,** thus satisfying the requirements established in Directive 2011/85 on budgetary frameworks.

AIReF submits to the Government two suggestions for good practices:

1. **To accompany the macroeconomic scenario with a separate quantitative study of the impact of the measures adopted or foreseen on the macroeconomic aggregates**, in order to facilitate comprehension of the forecasts.

2. **To integrate the key elements in the forecasts in a simplified national accounting framework**, in order to analyse the links between economic activity, demand and employment, on the one hand, and flows in income and borrowing requirements, on the other.

4. Appendix with tables and graphs

Tables

Basic Hypotheses for the Stability Programme Update 2016-2019 Scenario

Annual variation as % unless otherwise indicated

	2015	2016 (F)	2017 (F)	2018 (F)	2019 (F)
Short-term interest rates (Euribor 3 months)	0.0	-0.3	-0.3	-0.2	0.0
Long-term interest rates (10 year Government debt, Spain)	1.7	1.7	1.9	2.2	2.5
Exchange rate (US dollar/euro)	1.11	1.09	1.09	1.09	1.09
Effective nominal euro zone exchange rate (% variation)	-6.8	1.2	-0.2	0.0	0.0
Global GDP growth, excluding the EU	3.2	3.4	3.7	3.8	3.9
GDP growth in the euro zone	1.6	1.4	1.7	1.8	1.9
Volume of imports worldwide excluding the EU	0.8	2.2	3.5	4.0	4.5
Spanish export markets	3.7	4.1	4.9	5.0	5.1
Oil prices (Brent, dollars/barrel)	52.2	39.7	45.3	45.3	45.3
(F) Forecast					
Sources: European Commission, IMF, ECB and Ministry of Economy and Competitiveness					

International Organisations' forecasts and market expectations

(% variation over the previous year, unless otherwise stated)

		2015	2016	2017	2018	2019
ECB (March 2016)	Global GDP (ex euro area)	3.1	3.2	3.8	3.9	
	GDP in the euro area	1.5	1.4	1.7	1.8	
	Imports of goods and services (ex euro area)	0.7	2.2	3.8	4.1	
	Oil prices for Brent (USD per barrel)	52.4	34.9	41.2	44.9	
	Euribor 3 months (%)	0.0	-0.3	-0.3	-0.2	
	10 year interest rates on Government debt in the euro area (%)	1.2	1.2	1.4	1.7	
	USD/EUR exchange rate (level)	1.11	1.11	1.12	1.12	
	Effective euro exchange rate	-7.1	4.8	0.2	0.0	
IMF (WEO April 2016)	Global GDP	3.1	3.2	3.5	3.6	3.8
	GDP in the euro area	1.6	1.5	1.6	1.6	1.6
	GDP in the EU	2.0	1.8	1.9	1.9	1.9
	Trade in goods and services	2.8	3.1	3.8	4.1	4.3
	Oil prices for Brent (USD per barrel)	52.4	36.1	42.2	45.4	47.8
	Libor 3 months (%)	0.0	-0.3	-0.4		
European Commission (February 2016)	Global GDP	3.0	3.3	3.5		
	GDP in the euro area	1.6	1.7	1.9		
	GDP in the EU	1.9	1.9	2.0		
	World imports in goods and services	2.4	3.6	4.3		
OECD (November 2015)	OECD GDP	2.0	2.2	2.3		
	GDP in the euro area	1.5	1.8	1.9		
	Trade in goods and services	2.0	3.6	4.8		
Market expectations (April 2016)	Long-term interest rates (10 year Government debt, Spain)	1.2	1.6	1.9	2.2	2.4
	Oil prices for Brent (USD per barrel)	52.4	44.5	46.8	48.8	50.2

Cyclical evolution %GDP (unless otherwise stated)					
	2015	**2016**	**2017**	**2018**	**2019**
Real GDP growth *(% change)*					
SPU 2016-2019	*3.2*	*2.7*	*2.4*	*2.5*	*2.5*
Potential output growth *(% change) (ii)*					
EC	0.0	0.5	0.7	0.8	1.1
OECD	0.5	0.6	0.8	0.9	1.2
IMF	1.1	1.3	1.3	1.3	1.3
SPU 2016-2019	*0.2*	*0.5*	*0.8*	*1.1*	*1.3*
Output Gap *(% GDP) (i) (ii)*					
EC	-4.1	-1.9	-0.2	0.9	1.7
OECD	-5.1	-3.1	-1.4	-0.2	0.7
IMF	-3.5	-2.2	-1.3	-0.7	-0.2
SPU 2016-2019	*-5.7*	*-3.5*	*-2.0*	*-0.7*	*0.5*

Source: SPU 2016-2019, OECD Economic Outlook November 2015, IMF WEO April 2016, EC Winter Forecast 2016

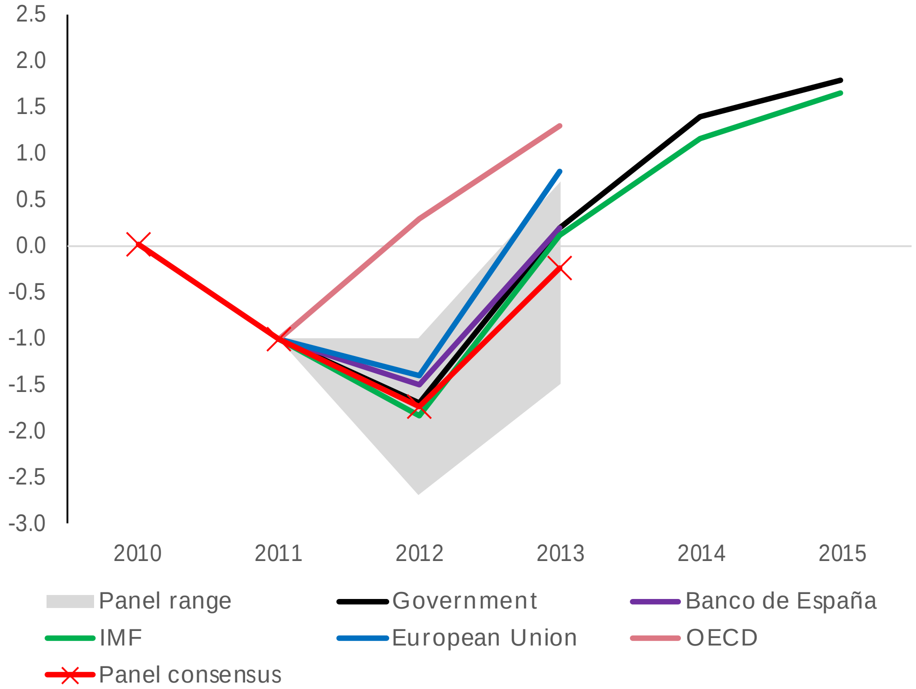
Notes:

(i) Shaded areas signal additional assumptions regarding potential output and output growth forecasts.

(ii) Actual GDP growth is assumed not to affect potential GDP growth.

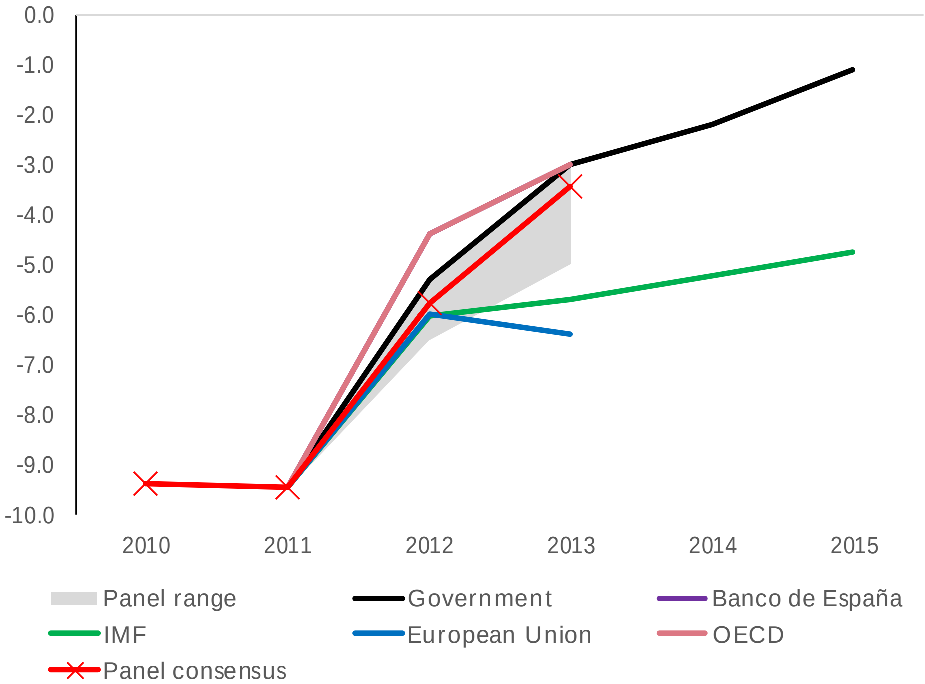
2012

GDP forecast 2012



Source: INE, MINECO and AIReF estimates.

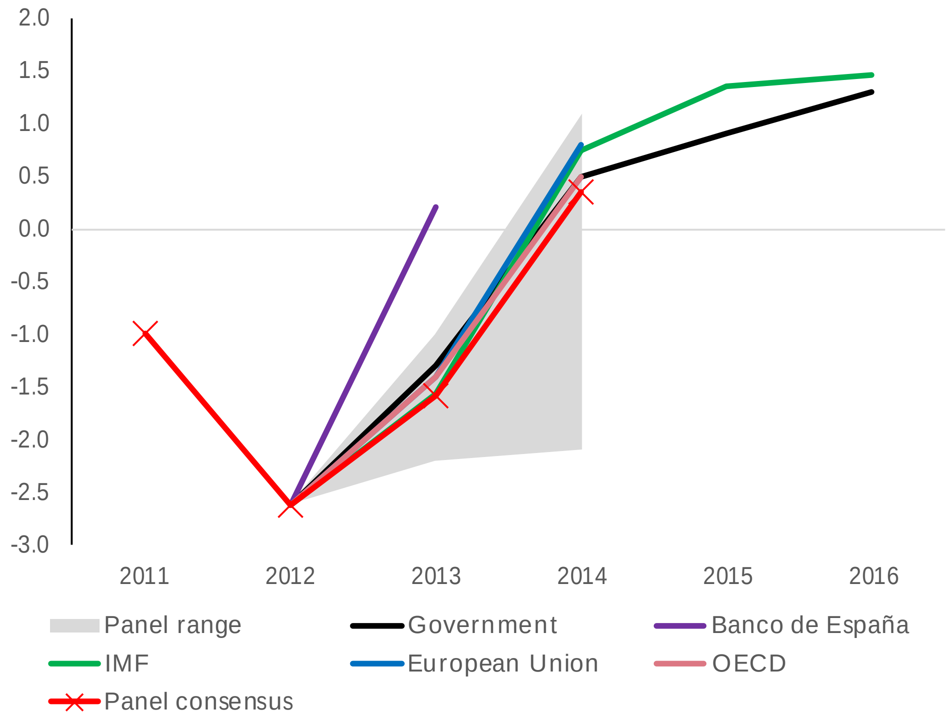
Government Balance forecast 2012



Source: INE, MINECO and AIReF estimates.

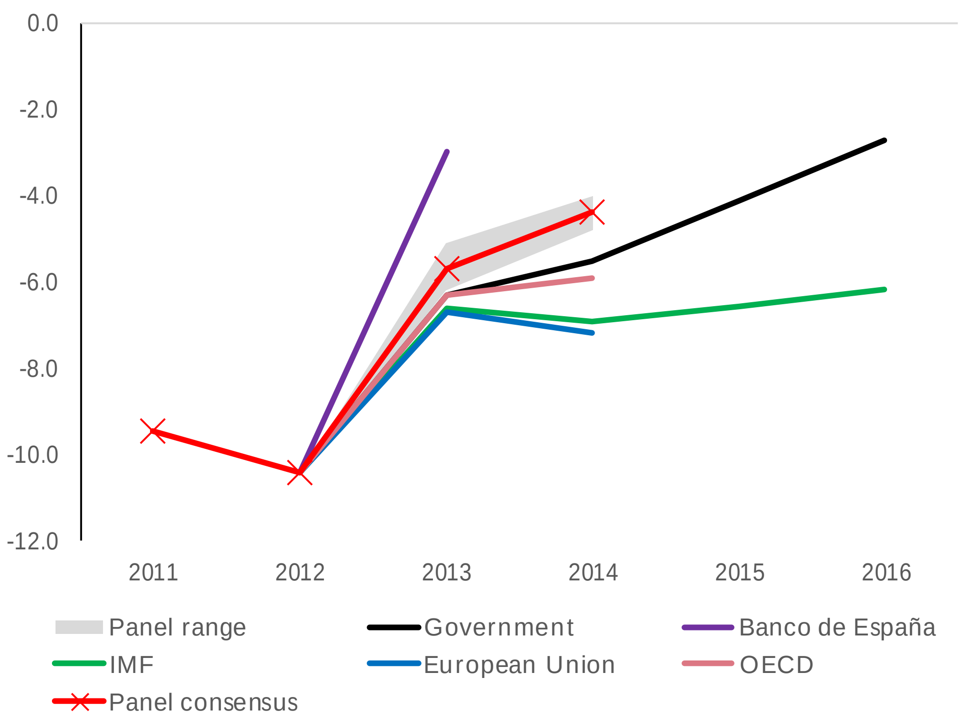
2013

GDP forecast 2013



Source: INE, MINECO and AIReF estimates.

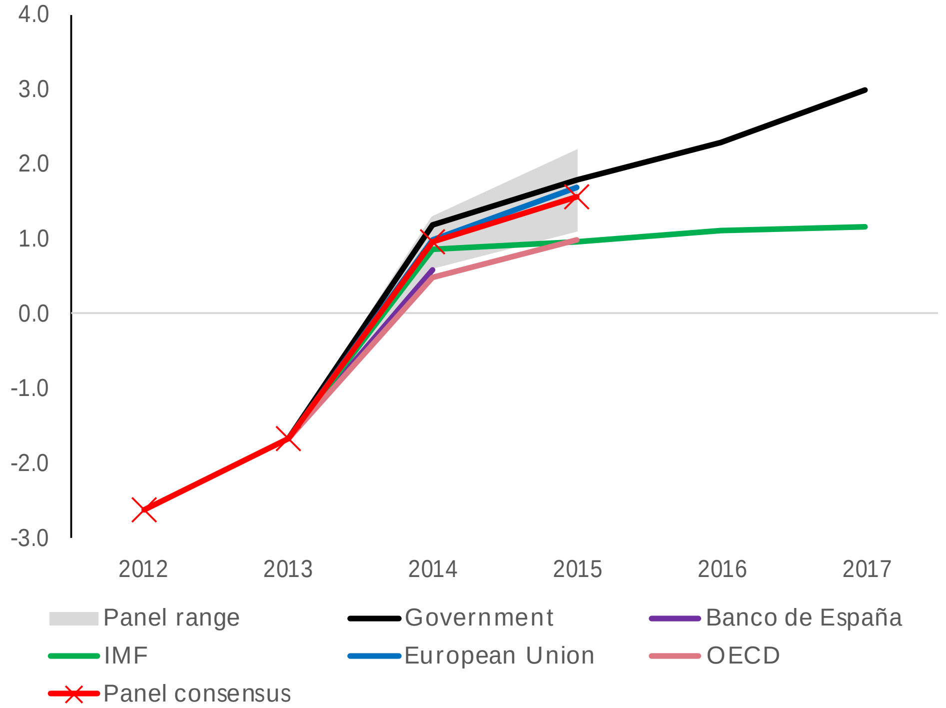
Government Balance forecast 2013



Source: INE, MINECO and AIReF estimates.

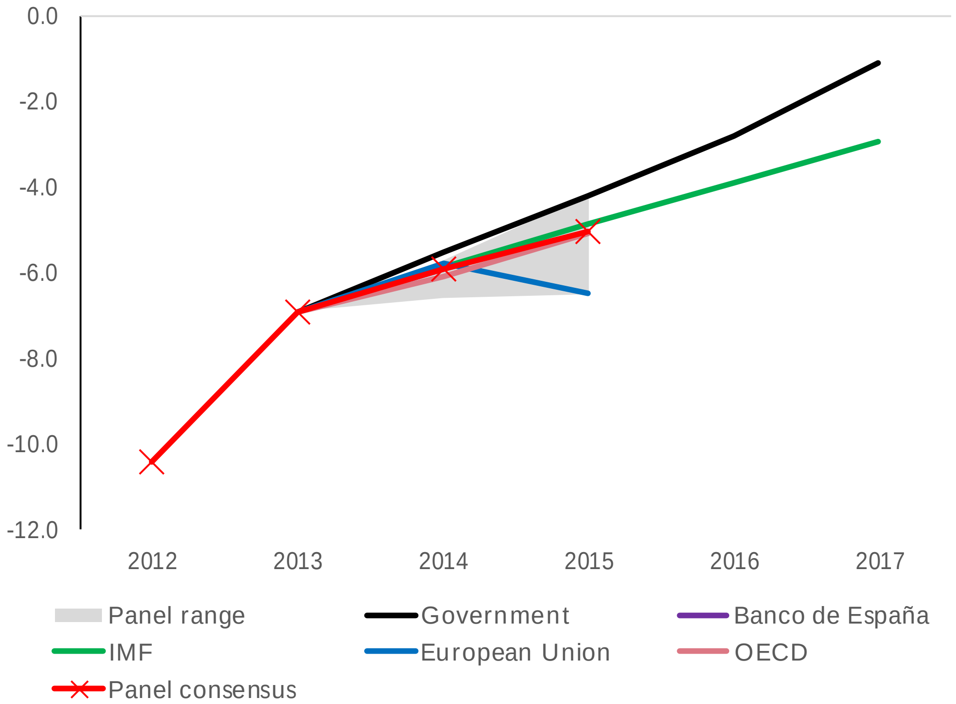
2014

GDP forecast 2014



Source: INE, MINECO and AIReF estimates.

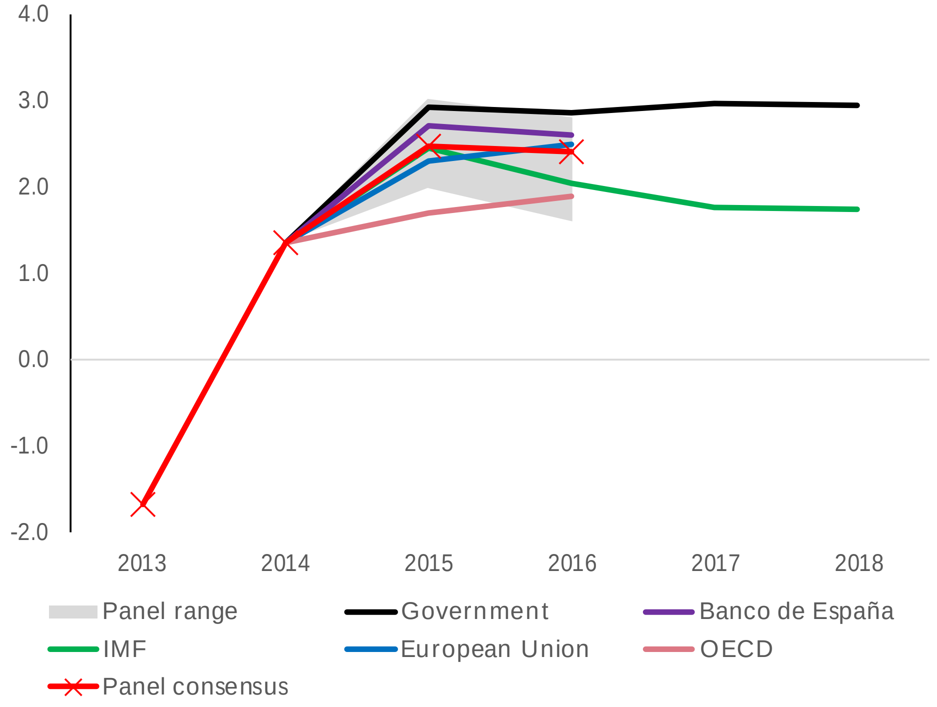
Government Balance forecast 2014



Source: INE, MINECO and AIReF estimates.

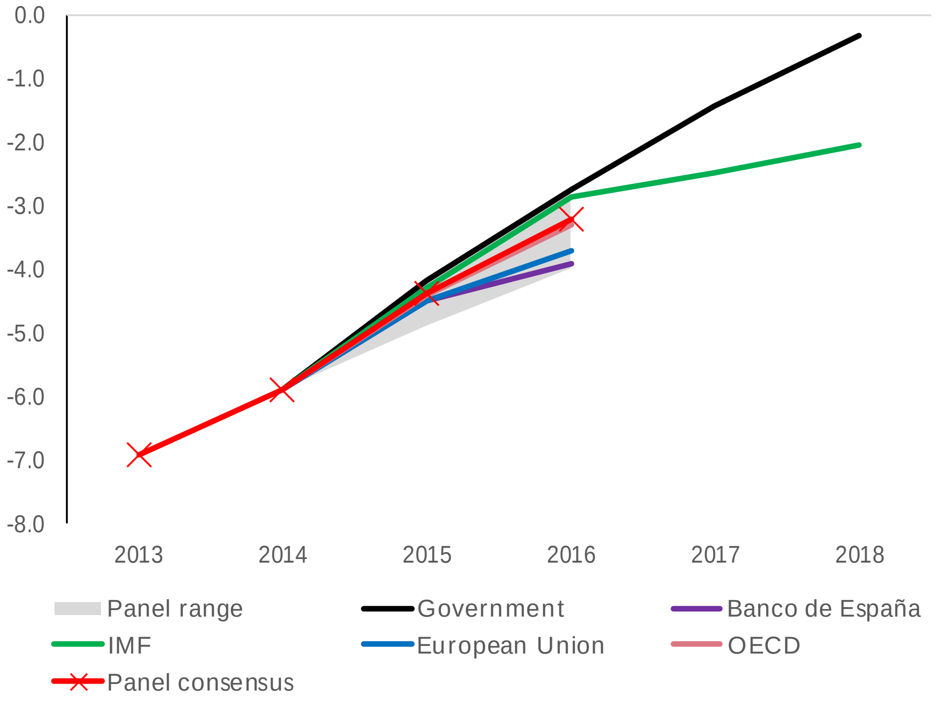
2015

GDP forecast 2015



Source: INE, MINECO and AIReF estimates.

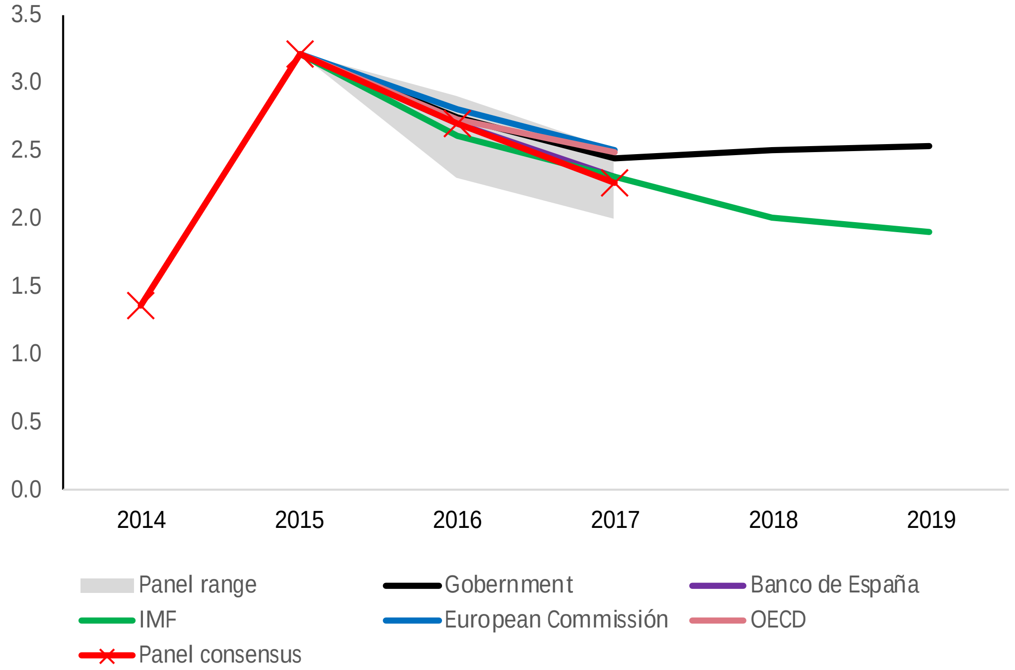
Government Balance forecast 2015



Source: INE, MINECO and AIReF estimates.

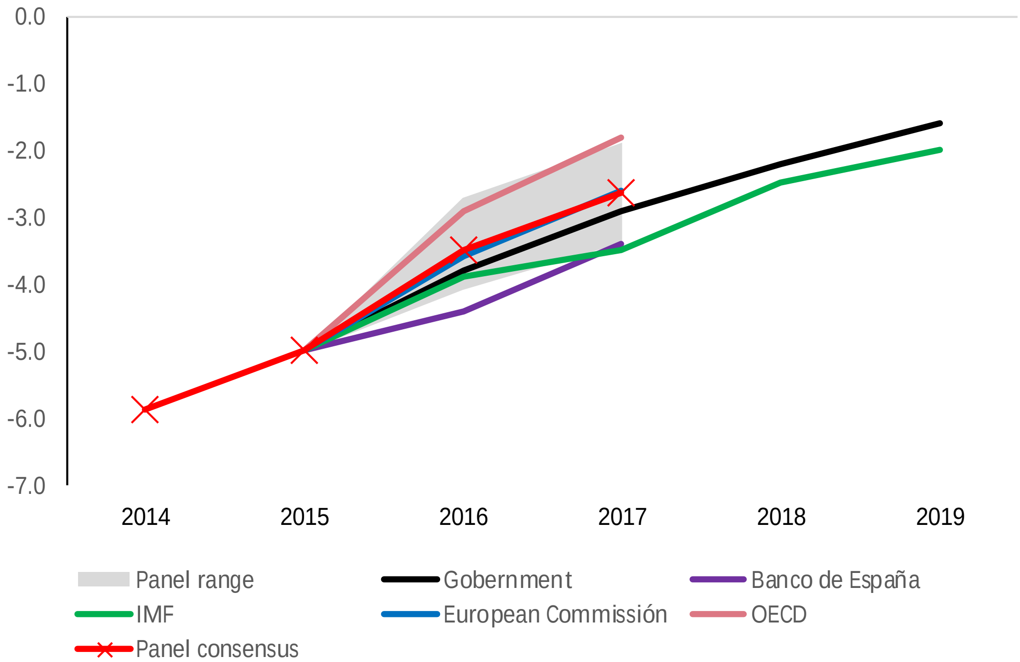
2016

GDP forecast 2016



Source: INE, MINECO and AIReF estimates.

Government Balance forecast 2016



Source: INE, MINECO and AIReF estimates.

Report on the Stability Programme Update 2016-2019

(Article 16 of the Organic Law 6/2013 creating the Independent Authority for Fiscal Responsibility)

Introduction

AIReF is obliged to report on the Stability Programme Update (SPU) project, assessing in particular whether the measures envisaged guarantee compliance with the stated budget stability, limitation of liability and expenditure rule targets. To issue the report, AIReF needs to receive, sufficiently in advance, the text of the Stability Programme accompanied by the corresponding budget forecasts for the medium term, as well as any other information or documentation supporting the forecasts and the data incorporated therein.[6]

AIReF published, on 25 April 2016, an assessment of the macroeconomic outlook and fiscal scenario in the Stability Programme Update 2016-2019 project. This assessment, limited to the macroeconomic outlook and fiscal assumptions, was forwarded to the Government before submitting the SPU to the European Commission, to allow any recommendations to be studied and incorporated, if applicable, to the document. Access to the document in full was not provided before its publication, for which reason AIReF was unable to report on the adequacy of the measures included in the SPU in its draft phase.

Purpose of the report

The purpose of this report is to provide an analysis the Stability Programme 2016-2019 and of any other supporting information regarding the data and forecasts incorporated thereto. This report contains an assessment of the feasibility of the consolidation path presented in the Stability Programme. The assessment comprises, on the one hand, an analysis of the adequacy of the envisaged commitments to guarantee compliance with the budget stability, limitation of Government debt and expenditure rule targets, within the period covered by the SPU, and on the other hand, of the likelihood that the evolution of certain factors will have positive or negative effects on the fulfilment of the stated targets.

Similarly, it must be borne in mind that the Stability Programme 2016-2019 is the medium-term budgetary plan that serves as the framework for drafting the annual State budgets. From this perspective, the conclusions and recommendations put forward must be studied with a view to their inclusion for the financial year 2017, for which budget planning is now commencing and will provide details and concrete data on the scenario forecast in the Stability Programme.

The content and timeline for the Stability Programme must also comply with the requirements established in European and Spanish legislation. The SPU must be compliant with the provisions of EU Regulation 473/2013, of 21 May 2013, on common provisions for monitoring and assessing budgetary planning projects, Directive 2011/85 on budgetary frameworks and Article 29 of the Organic Law on Budget Stability and Financial Sustainability (LOEPSF).

[6] This is a requirement set forth in Art. 16 of Organic Law 6/2013 creating the Independent Authority for Fiscal Responsibility (AIReF) and Art. 15 of Royal Decree 215/2014, of 28 March, approving AIReF's Statutes.

1. Assessment of the fiscal scenario 2016-2019

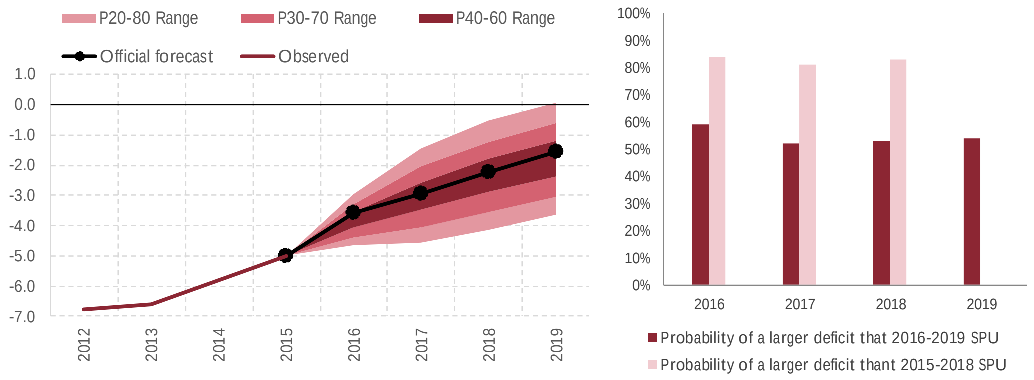
1.1. Analysis of the fiscal path for 2016-2019 in the Stability Programme Update

The section on budget projections in the SPU includes the fiscal consolidation path for the General Government sector in the period 2016-2019. The fiscal revenue and expenditure scenario contained in the SPU is defined exclusively for the General Government sector as a whole. AIReF has already pointed out in previous reports the need for more in-depth detail for the main headings 'uses' and 'resources', and the need for disaggregation by subsectors.

The SPU modifies the fiscal consolidation path with respect to the targets set according to the Recommendation of the Council of the European Union dated 21 July 2013. The agreed deficit reduction path for Spain had set deficit targets of 2.8% of GDP for 2016, 1.4% for 2017 and 0.3% for 2018**.** The new consolidation path envisages a deficit of 3.6% for 2016, 2.9% for 2017, 2.2% for 2018 and 1.6% in 2019. This new path means delaying by one year, to 2017, the deficit reduction down to below the 3% of GDP threshold set by European legislation to exit the Excessive Deficit Procedure. In this sense, it is worth recalling that the budget stability target for 2016, set at 2.8% of GDP, was assessed by AIReF in earlier reports as extraordinarily demanding, as it required an annual deficit correction of 2.2 percentage points of GDP that was not guaranteed in the approved budgets or in the information provided on measures available.

The path forecast in the SPU for the General Government sector as a whole involves a consolidation adjustment of 3.4% of GDP for the period 2016-2019. Graph 1 shows the deficit reduction path foreseen in the SPU for the General Government sector (table 4.3.1.1 in the SPU) and the projections calculated by AIReF in an inertial scenario without additional measures as of 2017. From the information contained in the SPU it emerges that the 3.4% adjustment to GDP is reached largely through reducing expenditure by 3.1% of GDP (from 43.2% to 40.1%) and a slight rise in revenue by 0.3% of GDP (from 38.2 to 38.5).

GRAPH 1: NET LENDING/BORROWING PATH FOR 2016-2019. TOTAL FOR THE GENERAL GOVERNMENT SECTOR AS % GDP.



To reach the public deficit of 3.6% of GDP forecast in the SPU in 2016, strict compliance with all the measures and Non-Availability Agreements envisaged for this year would be necessary. AIReF's own estimates placed 2016 deficit at around 4% of GDP in the absence of any significant additional measures supplementing those already planned in the initial General Government sector budgets. To reach the deficit foreseen in the SPU of 3.6% of GDP in the current year, a supplementary effort was required to consolidate expenditure with regard to the potential expenditure of around 0.4% of GDP deriving from implementing the budget. The measures adopted after approval of the budget, which are analysed in the following section of this report, relative to the approval of a Non-Availability Agreement on behalf of the Central Government (€2,000m) and a number of Autonomous Regions (€830m), should they come into force, will allow the bulk of the adjustment to be performed. However, as shown in graph 1, the -3.6% target falls within the confidence intervals set by AIReF with a probability rate of 60% for a deficit greater than the path reflected in the SPU (right-hand panel on the graph).[7] For the General Government sector to close 2016 with a deficit of -3.6%, it is therefore paramount that:

(i) The implementation of Non-Availability Agreements under the terms set forth in the Organic Law on Budget Stability and Financial Sustainability be instrumented and guaranteed. Thus, the Non-Availability Agreements:

- ✓ Shall give details of the expenditure reduction measures and identify the appropriations affected.

[7] The confidence intervals used in the fan charts of the graphs referred to the General Government sector and the various subsectors are calculated in two stages. Firstly, a VAR model estimation is produced for the following variables: (i) variables specific to the sector in question, such as public employment in goods and services; public resources and the public debt to GDP ratio; and (ii) common variables referred to the national aggregate: real GDP, GDP deflator and the yield on Government 10-year bonds. Secondly, taking the projected paths for the different variables and the estimation for the joint distribution of VAR shocks, 1500 probabilistic scenarios are constructed for Spanish Government debt. The intervals displayed on the graphs refer to the percentiles 20-80, 30-70 and 40-60. These probabilistic intervals allow conclusions to be drawn regarding the feasibility of the path expressed in SPU 2016-2019 and of the target path, officially set at the ECOFIN Council in July 2013 in the framework of the Excessive Deficit Recommendation for Spain, included in the SPU 2016-2019.

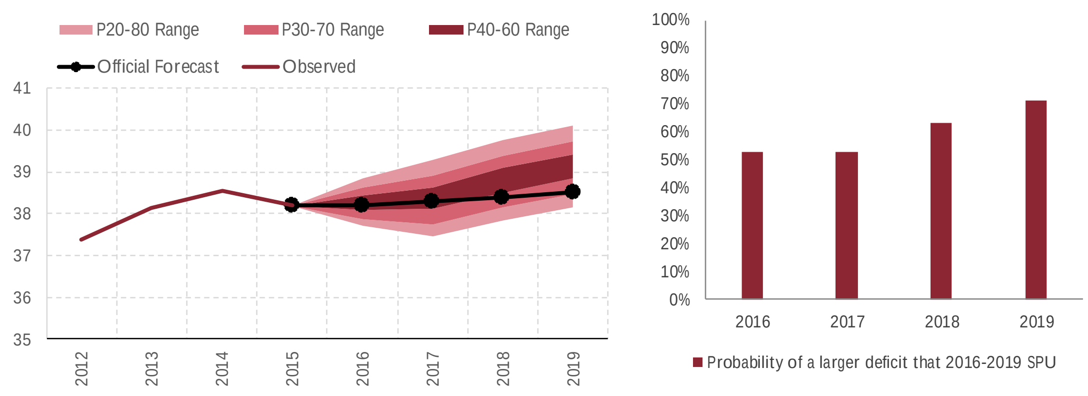
- ✓ May not be revoked during the year in which they are approved or until measures are adopted that guarantee compliance with the target set, nor lead to any increase in expenditure recorded in the auxiliary accounts.
- ✓ Shall be implemented accompanied by stringent monitoring of the budget modifications and the development of the auxiliary accounts, especially Creditors for non-budgetary operations (409/413).

(ii) No deviations occur in the collection of tax revenue or contributions. It should be remembered that AIReF pointed out in its report on the project and initial budgets for 2016 the uncertainty regarding direct taxes, and especially Corporate Tax, that were forecast this year at the top end of the AIReF confidence interval. In this sense, it would seem that the path for direct taxes forecast in the SPU already includes a possible downward correction under this heading. It cannot be asserted with absolute certainty that this is due to Corporate Tax, as a break-down is not given, but in view of the uncertainties associated with collection of this tax expressed in the Stability Programme itself, this is possibly the case.

From 2017 onwards, through the years of the SPU horizon the tax revenue projections included therein can be deemed conservative, whereas the expenditure path, in a scenario excluding additional measures, seems too unwarranted. Despite the global probability of the macroeconomic and fiscal scenario contained in the SPU, as the projection horizon advances toward 2019 certain risks can be identified, increasing over time, associated with inconsistencies detected between the macroeconomic context and the fiscal projections.

The revenue forecast in the SPU for the period 2017-2019 is conservative. Revenue forecasts envisaged in the SPU may suffer a downward bias with regard to AIReF estimations. It is considered likely that the favourable macroeconomic cycle and the trend in the labour market will lead to higher revenue than the SPU budget projections, as shown in graph 2.

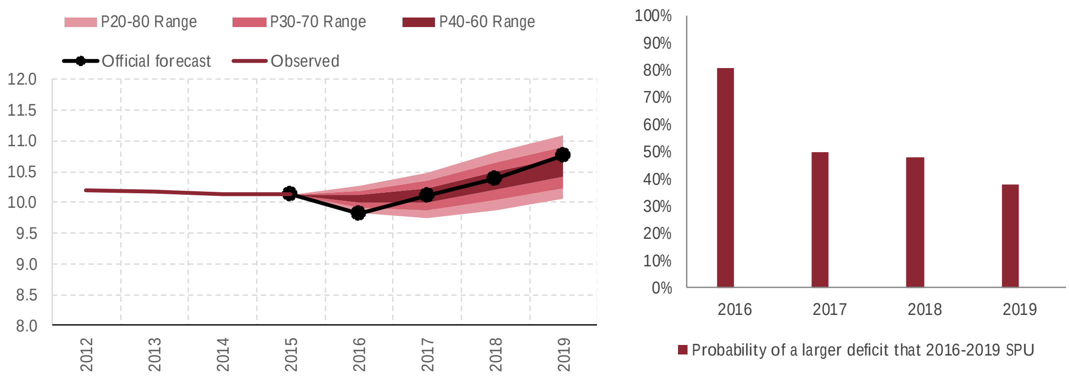
GRAPH 2: PATH FOR NON-FINANCIAL RESOURCES 2016-2019. TOTAL FOR THE GENERAL GOVERNMENT SECTOR AS % GDP.



Source: Stability Programme, IGAE and AIReF estimates

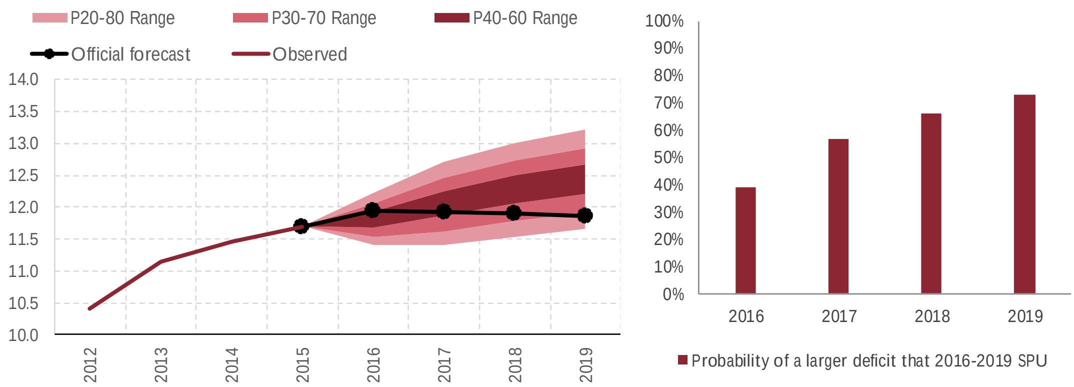
Direct taxes forecast in the SPU are expected to rise by 0.7 percentage points of GDP between 2015 and 2019 to hit 10.8% of GDP. From 2017, as shown in graph 3, a recovery is envisaged in revenue from the two main income taxes (IRPF and IS) which reflects the cyclical improvement in the economy after overcoming the effects of the fiscal reform that had a negative impact in 2015 and 2016. In 2016, as mentioned earlier, the SPU foreseeably includes a possible downward correction under the heading for direct taxes, placing this item in the lower part of the band of the AIReF projection.

GRAPH 3: PATH OF DIRECT TAXES 2016-2019. TOTAL FOR the General Government sector AS % GDP.



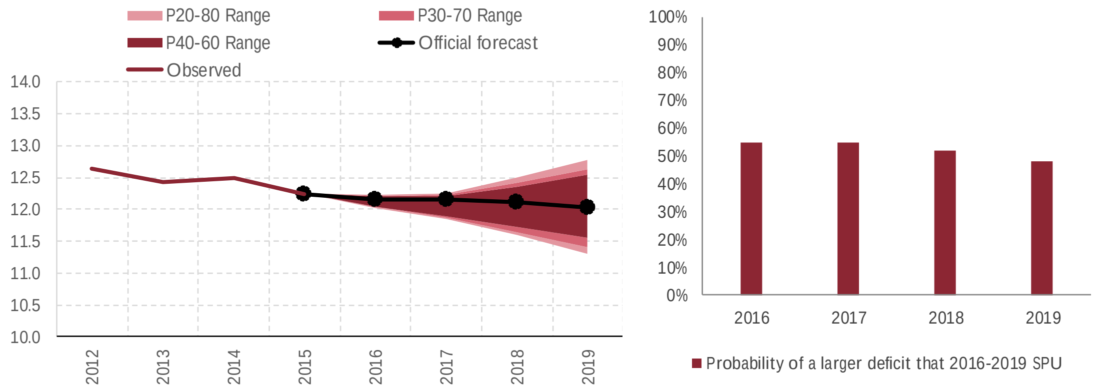
The indirect taxes estimation expressed in the SPU may present a degree of downward bias. These tax figures harbour the greatest slack deriving from the positive trend in macroeconomic variables, chiefly private consumption and the housing market. For these reasons, there may be an upward margin in the estimation included in the projected path for the programme, chiefly for the years 2018 and 2019 (see graph 4).

GRAPH 4: PATH OF INDIRECT TAXES 2016-2019. TOTAL FOR the General Government sector AS % GDP.



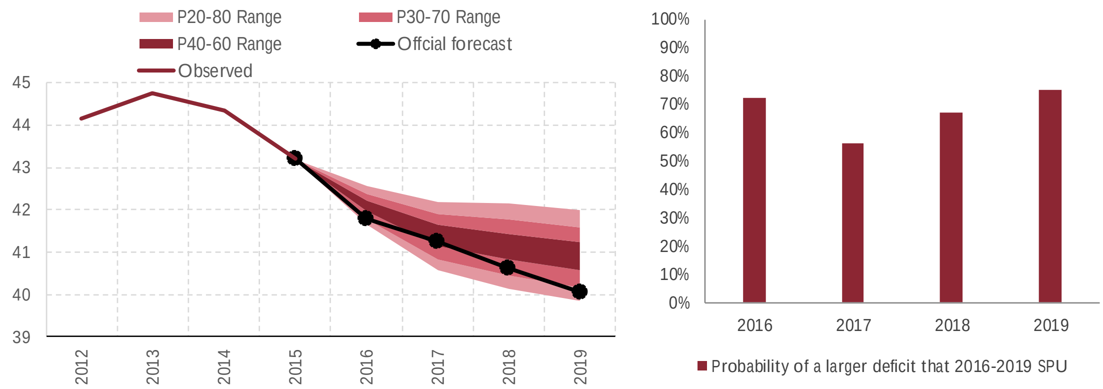
The forecast for social contributions presents a stable proportion of GDP, at around 12% throughout the period. This is deemed coherent in historical terms with the labour market trend shown in the framework outlook for the SPU, as can be observed in graph 5.

GRAPH 5: CONTRIBUTIONS 2016-2019. TOTAL FOR THE GENERAL GOVERNMENT SECTOR AS % OF GDP.



The trend in expenditure lines is subject to an upward risk. In the absence of significant restrictive measures from 2017 onwards, and given the historical development and hysteresis present in the key expenditure lines, AIReF views the government expenditure dynamic put forward in the SPU for the 2017-2019 timeframe as too unwarranted (see graph 6). Although no significant measures for expenditure adjustment are provided in the SPU, further to those presented in the Budget Plan, it is pointed out that during the period 2016-2019 expenditure is expected to grow below the nominal growth rate for the economy, with the aim of ensuring the General Government sector complies with the expenditure rule. The materialisation of this restrictive path for expenditure implies, *ceteris paribus*, a short-term cost in terms of slower growth in productive activity, therefore giving rise to a downward risk in GDP growth.

GRAPH 6: PATH FOR NON-FINANCIAL JOBS 2016-2019. TOTAL FOR THE GENERAL GOVERNMENT SECTOR AS % GDP.



Source: Stability Programme, IGAE and AIReF estimates

The SPU expenditures path foresees a net adjustment of 3.1 percentage points of GDP. This adjustment is chiefly due to:

- ✓ **An adjustment of 1.9 GDP points deriving from the trend in interest rates and social transfers in cash.** The evolution of interest rates is deemed coherent within a context of decreasing deficit and consolidation of economic recovery. With regard to social transfers in cash (fundamentally expenditures in pensions and social benefits), these present a path showing a reasonable trend.

- ✓ **The path forecast for public consumption may be too restrictive.** The key expenditure lines making up public consumption (employee compensation, intermediate consumption and social benefits in kind) will undergo an expected adjustment of 1.2% of GDP, although most of the Non-Availability Agreements do not affect these items. The materialisation of this restrictive path for expenditure implies, *ceteris paribus*, a short-term cost in terms of slower growth in productive activity, therefore giving rise to a downward risk in GDP growth.
- ✓ **Gross capital formation lightens its weight in GDP slightly over the full period**. The trends for these items may generate uncertainty deriving from the deep re-programming of forward investments implemented in foregoing years as a consequence of the sharp adjustment to fiscal consolidation and which may entail certain tensions on the scenario forecast in the SPU.

1.2. Analysis of the cyclical orientation of fiscal policy

The impact of economic recovery on the General Government sector balance is expected at around 3 GDP points in cumulative terms between 2016 and 2019, as stated in the report on the macroeconomic forecasts proposed in the SPU 2016-2019**.** The output gap dynamic in the SPU 2016-2019 is expected to narrow progressively until early in 2019. Implicit in this trend is a cyclical gain in the General Government sector balance of some 7 to 8 tenths of a GDP point on average on a yearly basis for the studied period, in line with the estimations by leading international organisations and AIReF.

In structural terms, the General Government sector's borrowing requirement is consolidated at close to 2.3% of GDP, taking into account that much uncertainty still remains over the estimation of the component associated to the cycle. Given the starting point in 2015, namely a borrowing requirement of 5% of GDP, the measures adopted for 2016 together with the trend for the cycle discussed above, would involve a structural balance remaining in excess of 2 GDP points in 2019. In the current situation described in the SPU as "no policy change" or the absence of measures from 2017, there is a lack of compliance with the obligation stipulated in the first Transitory Provision of the LOEPSF according to which structural deficit should be reduced by, at least, an annual average of 8 tenths of a GDP point until 2020.

Having discounted the trend for the cycle and the interest burden, the fiscal policy orientation would be rendered essentially neutral within a context of normalising economic activity. As shown in graph 7, the fiscal policy tone or orientation defined as the variation in primary structural balance (discounting from the deficit the effects of the cycle and interest payments) has been highly restrictive during the period 2010-2014, following two years of booming expansion in 2008 and 2009. In 2015, due in great measure to the tax reform that took place, the primary structural balance took a new downturn (expansionary orientation). Neutral values are maintained for the projection horizon, as during the first years after joining the Economic and monetary Union. [8]

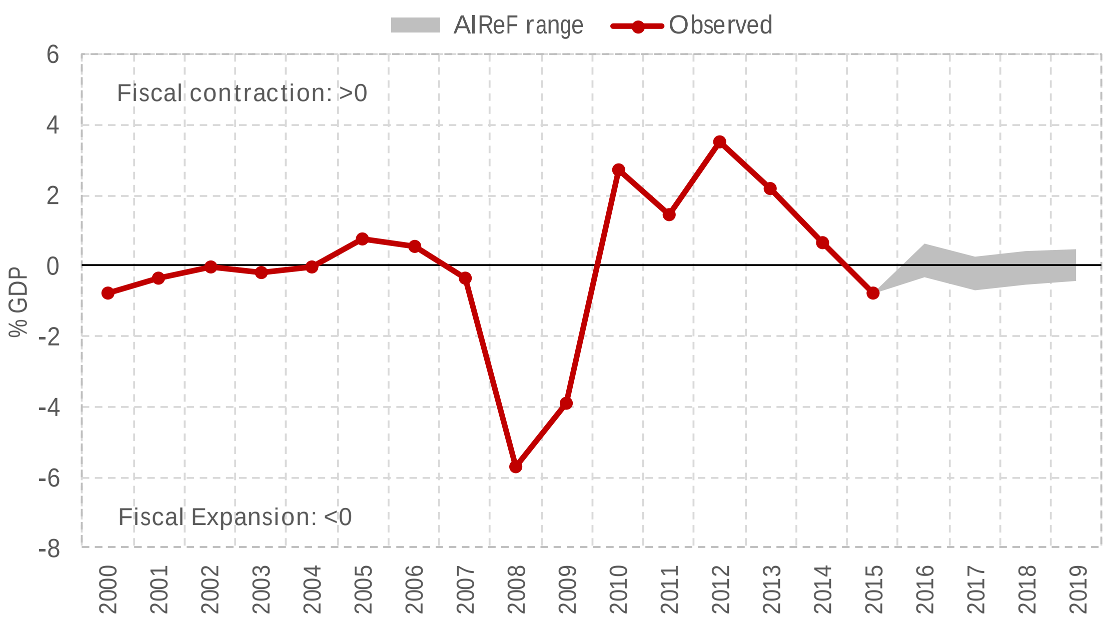
Fiscal policy ceases to be pro-cyclical and restrictive as of 2015. Placed within the context of the economic cycle trend (graph 8), fiscal policy orientation for 2016-2019 may be qualified as neutral. Indeed, the existence of a negative output gap identifies this somewhat expansionary policy for 2015 as counter-cyclical, contributing to the slowdown in economic activity. This qualification is maintained until the end of the period, while the output gap narrows to a close.

The elevated debt level represents a de facto restriction to the existing fiscal space. Debt dynamics since the beginning of the crisis (increases of more than 60 percentage points) placed the Spanish economy at considerably higher levels than those existing at the onset of the current economic cycle, as seen in graph 8 (bottom panel). In addition, the process for reducing the Government debt ratio with regard to GDP,

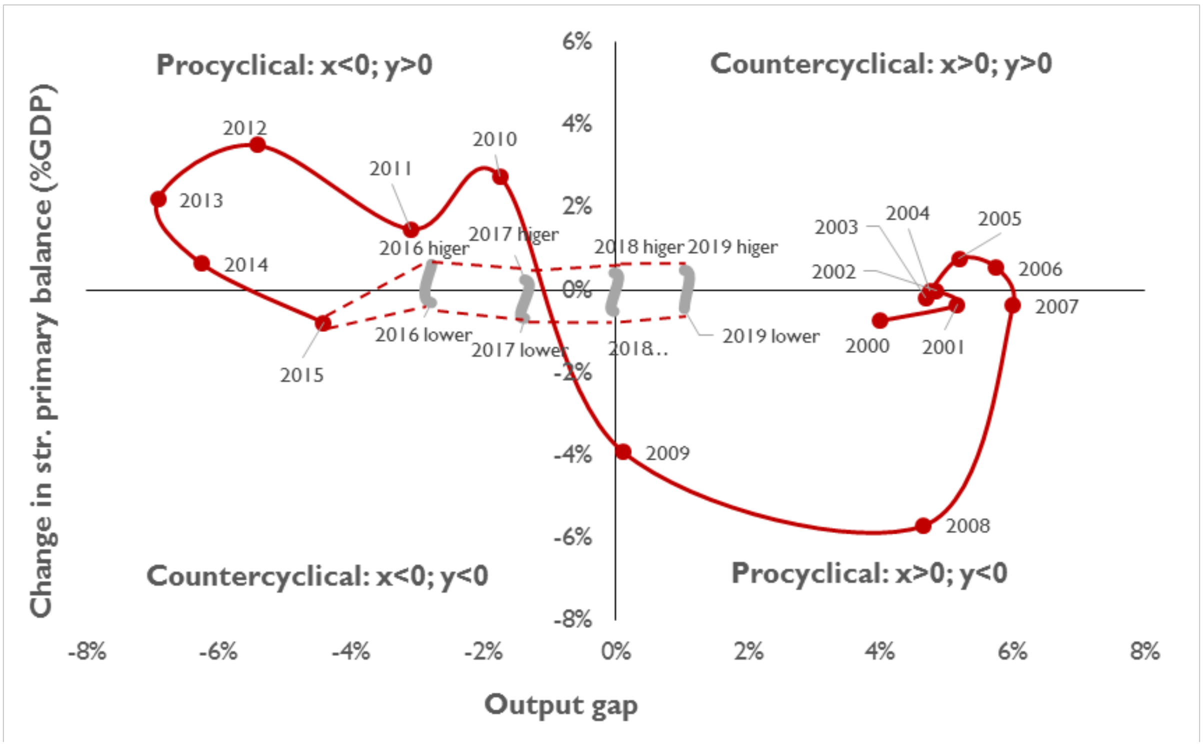
[8] The confidence interval for the years 2016-2019 reflects the current uncertainty regarding estimations for the output gap. In particular, one of the main methodological critiques of this type of tools is taken into account, namely, the degree to which estimations have been revised ex-post with respect to concurrent estimations.

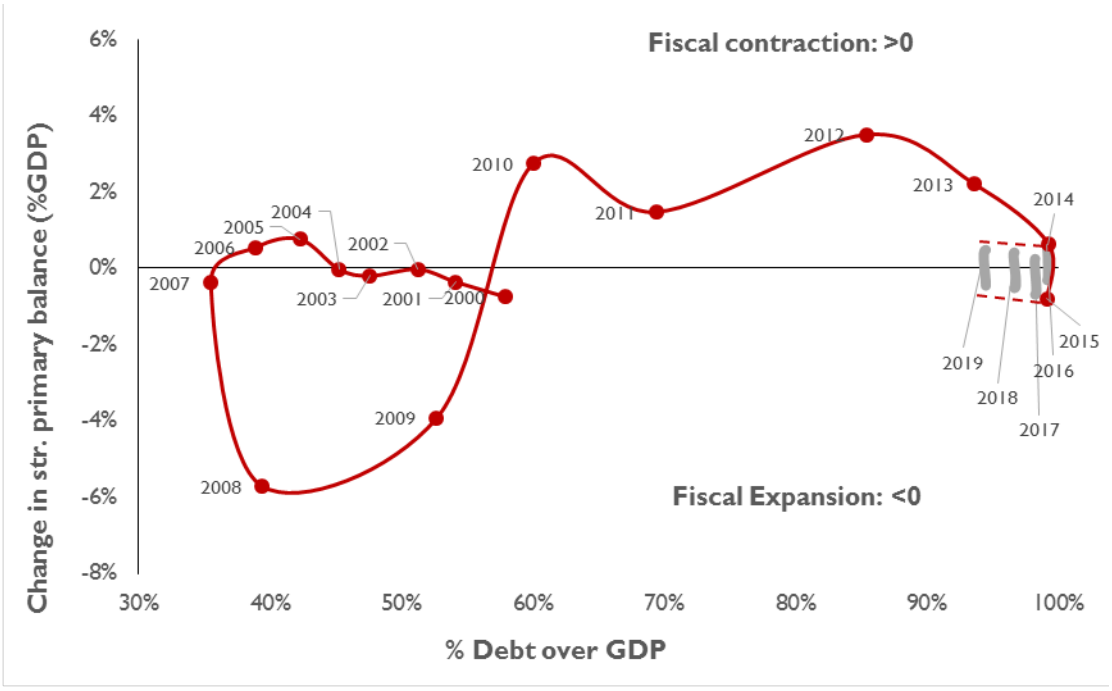
though expected to commence now on the SPU projection horizon, will be a slow process and depend heavily on both a robust nominal growth and the maintenance of responsible fiscal policies. The existing fiscal space will suffer limitations, therefore, from the need to maintain a medium-term orientation that will generate credibility regarding the sustainability of public finance.

GRAPH 7: SPU 2016-2019 FISCAL POLICY ORIENTATION, CHANGES IN THE PRIMARY STRUCTURAL BALANCE



GRAPH 8: SPU 2016-2019 FISCAL POLICY ORIENTATION AND SPACE





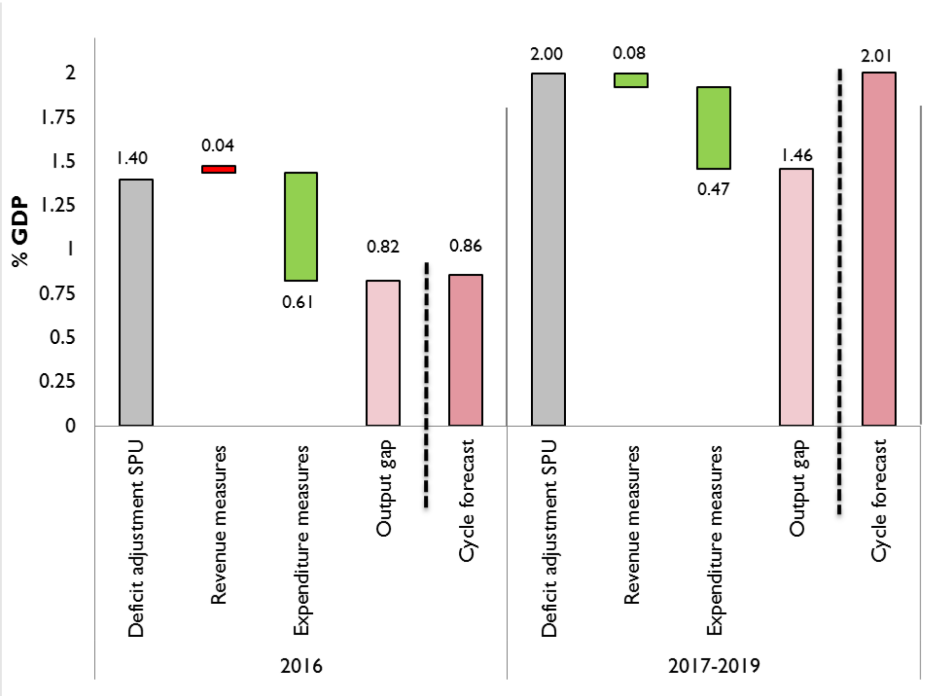
Source: Stability Programme, IGAE and AIReF estimates

1.3. Analysis of the commitments made in the Stability Programme to comply with the stability targets

The likelihood analysis of the fiscal consolidation path presented in the SPU for the period 2016-2019 calls for a study to ascertain the adequacy of the measures foreseen to guarantee compliance with the budget stability targets. The SPU 2016-2019 has been drawn up by a caretaker Government, which circumstance explains the inclusion of hardly any measures for the years 2017 to 2019 and that those included are similar to those incorporated in the Budget Plan for 2016, with the exception of those affecting the Autonomous Regions and the inclusion of a Non-Availability Agreement (AND) by the Central Government for 2016 for the amount of €2,000m approved by the Council of Ministers on 29 April 2016.

Graph 9 shows the consolidation adjustment to be performed by the General Government sector as a whole in the period 2016-2019 and the impact the revenue and expenditure measures forecast in the SPU will have on the overall balance trend. The difference, or gap, between the two will determine the magnitude of the adjustment linked to the economic cycle (shown in detail in the graph) and to decisions on budget policy. This graph also features the AND affecting both the Central Government and the Autonomous Regions, without taking into account one-off measures affecting these two subsectors in 2015.

GRAPH 9: ADJUSTMENT FOR THE GENERAL GOVERNMENT SECTOR OVERALL IN THE STABILITY PROGRAMME
DISTRIBUTION OF REVENUE AND EXPENDITURE



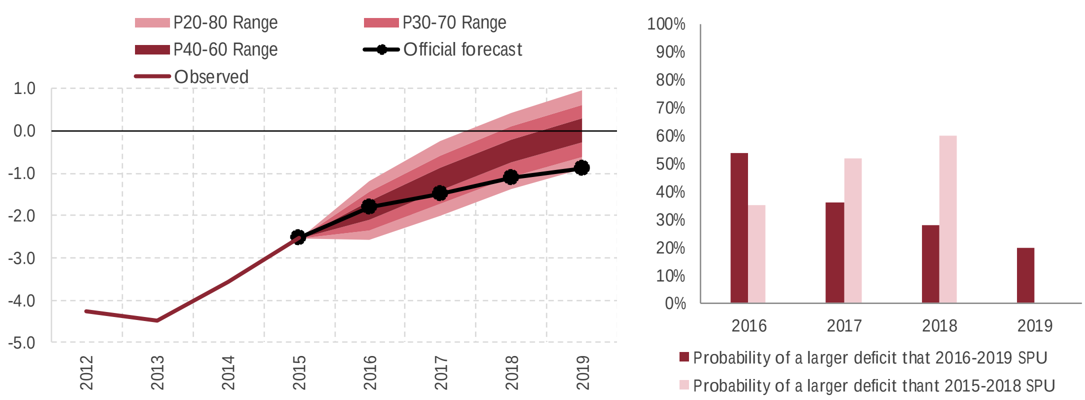
These measures and their adequacy to guarantee compliance with the path forecast in the SPU are analysed for each of the subsectors, on the basis of the information on measures given for each of them.

1.3.1. Assessment of the measures foreseen by the Central Government

The path forecast for the Central Government involves a consolidation adjustment of 1.8% of GDP in the period 2016-2019, which is viewed as feasible. This adjustment has not taken into consideration revenue from usage of the radioelectric space that, following Eurostat criteria, were imputed as lower expenses in 2015 amounting to 0.15% of GDP. This revenue should be considered as non-recurrent operations pertaining to 2015 and will not be taken into account for the purposes of the consolidation adjustment to be applied in this period.

The -1.8% target for 2016 falls within the main confidence interval set by AIReF, as shown in graph 10, with a 54% probability of a higher deficit than the SPU forecast for this year (right-hand panel on the graph). For the remainder of the period, the deficit is expected to be lower than the SPU projection and, therefore, the probability of non-fulfilment decreases progressively during the period 2016-2019.

GRAPH 10: FINANCING CAPACITY/NEED PATH FOR 2016-2019. CENTRAL GOVERNMENT IN % GDP.

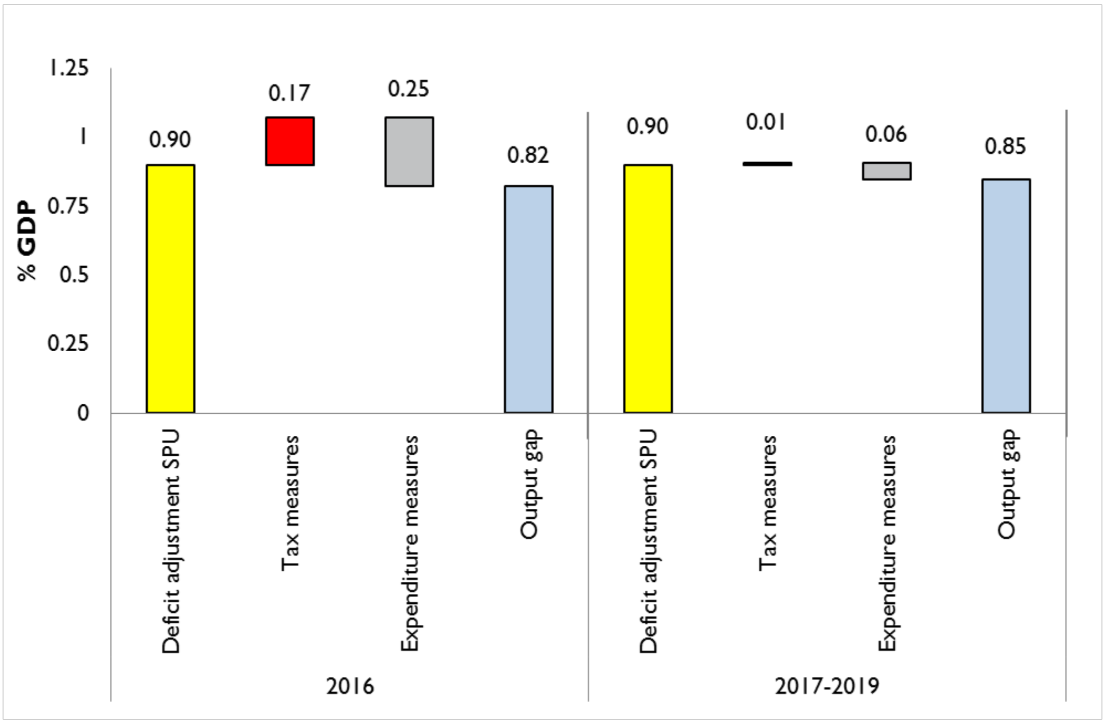


Source: Stability Programme, IGAE and AIReF estimates

The consolidation adjustment to be performed by the CG is based fundamentally on an improving macroeconomic scenario. From 2016, practically no measures are contemplated for adjusting expenditure or increasing revenue, whereas the bulk of adjustments were focused on improving the macroeconomic situation.

Graph 11 shows the necessary consolidation adjustment and the contribution thereto by the expenditure and revenue measures for the period 2016-2019. The measures envisaged by the CG refer chiefly to 2016, with no significant measures included for subsequent years.

GRAPH 11: CENTRAL GOVERNMENT ADJUSTMENT IN THE STABILITY PROGRAMME. DISTRIBUTION OF REVENUE AND EXPENDITURE



The foreseen path establishes a 1.8% deficit for the CG in 2016 that may be feasible provided that the measures included in the SPU are strictly complied with, and certain uncertainties regarding forecasts for resources and jobs do not materialise. The path envisaged for the CG entails an adjustment of 0.9% of GDP on the year-end closure for 2015 excluding the mentioned revenue from the use of radioelectric space. The State General Budget (PGE) for 2016 was approved with a deficit target of 2.2% of GDP; consequently, this new path represents an additional adjustment to the target approved in the 2016 PGE of 0.4% of GDP. The additional adjustment is based fundamentally on the approval of an AND of 0.18% of GDP that is not enough to reach the deficit target of 1.8%. Reaching this path will depend on (i) that no deviations occur in tax revenue collection, (ii) that no unforeseen risks arise in the budgets, (iii) the CG bodies maintain a similar pattern of behaviour as in previous years and (iv) the correct implementation of the approved AND is guaranteed. In this sense, it should be underscored that the uncertainty with regard to corporate tax collection, the final impact of the fiscal reform and the materialisation of potential liabilities unforeseen in the 2016 PGE, such as for instance the obligation deriving from an action for financial liability against the State involving the Tax on Retail Sales of Certain Hydrocarbons, known as *the "healthcare cent"*[9].

The CG expenditure measures are essentially focused on the AND approved for 2016, and on the effects of other measures passed in previous years that have a residual impact in 2016 and 2017:

[9] The 2016 PGE contains no budget allocation for the above obligation. A request for information on the impact the above mentioned sentence may have in 2016 has been submitted to MINHAP, which has not been forthcoming.

- ✓ The first measure in order of importance consists in the AND, that is instrumented for the amount of 0.18% of GDP. The information provided does not allow, at this point in time, the budget lines on which the adjustment approved by the Council of Ministers will eventually be applied to be determined. Therefore, it will be necessary to monitor the Central Government implementation data to ensure its correct application. Furthermore, it can be deduced from the information provided in the SPU that the expenditure adjustment of 0.18% of GDP, deriving from the AND approved 2016, will be consolidated in subsequent years. No details have been given of any measures or actions that would guarantee the consolidation of this expenditure adjustment once the effective period of the 2016 budget to which the Non-Availability Agreement applies comes to an end. To determine the possibility of consolidating the adjustment in subsequent years, it is essential for AIReF to have access to information on the expenditure lines that the non-availability order in 2016 will apply to.
- ✓ Measures affecting public employment. Some impact remains from non-replacement of personnel taking retirement, which accounts for a saving of 344M€ in the period 2016-2019. Contrariwise, in 2016 an updated measure has been included of 1% of civil servants' compensation (€257m). In the SPU, this measure is assessed jointly for the Central Government and Social Security Funds, and appears to become consolidated in subsequent years.
- ✓ Savings deriving from rationalisation measures for public expenditure are foreseen in 2016 deriving from the CORA (General Government Review Committee). These measures will affect several headings already foreseen in the Budget Plan for 2016 (€729m). However, no savings of any significance are observed to derive from the study of the 2016 Central Government budgets. The information provided by the SPU does not include data enabling an estimation of the savings envisaged within the CORA framework.

TABLE 1: IMPACT OF THE PRINCIPAL NORMATIVE CHANGES ON THE DEFICIT. CG SUBSECTOR. EXPENDITURE DIFFERENTIAL IMPACT ON THE PREVIOUS YEAR (% GDP)

	2016	2017	2018
Central Government Expenditure	*0.25*	*0.06*	*0.01*
Non-availability	*0.18*	*0.00*	*0.00*
Refund of 13th month's salary for 2012 and 1% salary increase	*-0.02*	*0.05*	*0.00*
Public Employment (general personnel measures)	*0.02*	*0.01*	*0.01*
CORA	*0.07*	*0.00*	*0.00*
Force majeure	*0.01*	*0.00*	*0.00*

The expenditure in interest and transfers to SEPE (Spanish Public State Employment Service) to cover its deficit will foreseeably put a lighter pressure on expenditures. Interest rate trends and the foreseen reduction in expenditure in unemployment benefits will entail a decrease in non-financial jobs that will enable the implementation of part of the fiscal cutback required of the CG. Interest payments are expected to drop by 0.6 GDP points in the period 2015-2019.

Improvements in the macroeconomic scenario will lead to higher tax revenues in the period 2016-2019. Despite the fact that the macroeconomic scenario will bring about these improvements in the General Government sector's tax revenue, the current Regional Governments' funding system requires that a major portion of this increase in resources is transferred to the Autonomous Regions subsector throughout the period.

The measures affecting revenue refer exclusively to taxes and exert a negative differential impact of -0.18% of GDP for the period 2016-2018.

TABLE 2: IMPACT OF THE PRINCIPAL NORMATIVE CHANGES ON THE DEFICIT. REVENUE CG SUBSECTOR. DIFFERENTIAL IMPACT ON THE PREVIOUS YEAR (% GDP)

	2016	2017	2018
Central Government Revenue	*-0.17*	*-0.01*	*0.00*
Personal income tax (IRPF) and non-resident tax	*-0.22*	*-0.10*	*0.00*
Corporate tax (IS)	*-0.14*	*0.01*	*0.00*
Anti-fraud measures	*0.09*	*0.09*	*0.00*
Special taxes and environmental tax	*0.00*	*0.01*	*0.00*
VAT	*0.11*	*0.00*	*0.00*
Fees and other revenue	*-0.02*	*0.00*	*0.00*

Source: SPU.

In 2016, the overall impact of revenue measures is expected to be negative as a consequence of the fiscal reform, affecting Personal Income Tax (IRPF), Non-Resident Taxes and Corporate Tax. The SPU does not individually detail the economic impact of each of the measures affecting these three taxes. Bearing in mind the weight of this reform, and the modifications to its implementation timeline (part of the IRPF reform envisaged for 2016 was brought forward to July 2015), it would be advisable to give details of each economic impact caused by the reform for the purposes of its assessment.

The impact of the fiscal reform described in the SPU in ex post terms (after appraisal of second-round effects) for the years 2015, 2016 and 2017 has increased with respect to the scenario forecast in the Budget Plan for 2016. Since the presentation of the Budget Plan the estimation for total impact of the IRPF reform, which has grown from an impact during the period 2015-2017 from -0.51% of GDP to -0.64% of GDP, has risen by 0.13% as reflected in table 3. Besides, the impact of Corporate Tax has also fluctuated, rising in 2015 and dropping in 2016 by a similar proportion, 0.07% of GDP, leaving the impact over the total period 2015-2017 unaltered. Therefore, taking both taxes into account, the impact caused by the reform is seen to increase by 0.13% of GDP. As mentioned on several occasions, there is still uncertainty regarding the overall impact of this reform, both relating to Personal Income Tax and –especially– to Corporate Tax, which has been subjected to a number of normative changes in recent years. Furthermore, it is envisaged that this tax may exert an effect on tax revenue on a settlement basis in 2016 linked to the regulation on fractioned payments.

TABLE 3: IMPACT OF THE FISCAL REFORM. BUDGET PLAN AND STABILITY PROGRAMME

	Budget Plan 2016				Stability Programme 2016-2019			
Impact of the reform (% GD	2015	2016	2017	Total	2015	2016	2017	Total
Reform of IRPF	-0.36	-0.14	-0.01	-0.51	-0.36	-0.23	-0.05	-0.64
Initial reform	-0.22	-0.23	-0.05	-0.50	-0.22	-0.23	-0.05	-0.50
Anticipation of the reform	-0.14	0.09	0.04	-0.01	-0.14	0.00	0.00	-0.14
IS reform	-0.01	-0.21	0.01	-0.21	-0.08	-0.14	0.01	-0.21
Total reform	-0.37	-0.35	-0.01	-0.72	-0.44	-0.36	-0.05	-0.85

Source: SPU and Budget Plan 2016

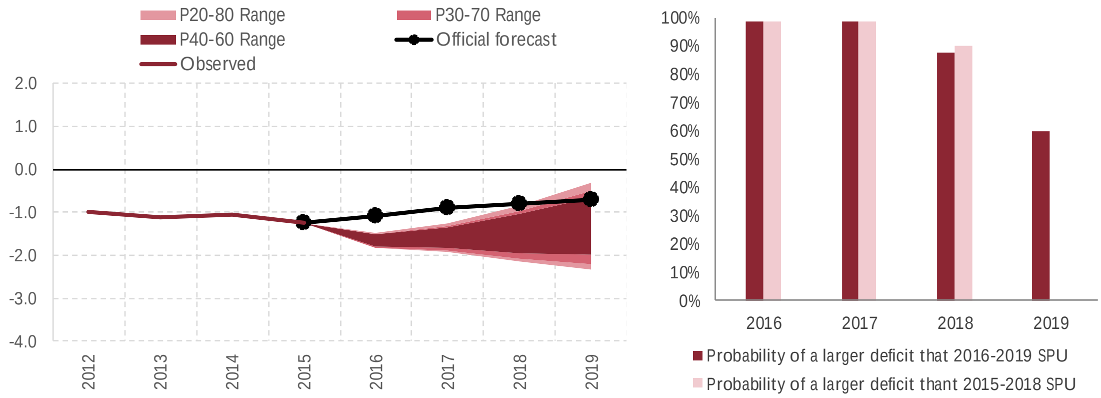
The State General Budget for 2016 has also incorporated, thanks to the amendment, a measure that will positively impact on revenue, namely, the financial obligation on Deferred Tax Assets, whose impact is not reflected in the stability programme.

The impact of revenue measures in 2017 are foreseen to have a positive impact, mainly due to the fact that the measures taken to counter fraud offset the negative impact visible in the remainder of tax measures. From 2018, no further measures with an impact on revenue are listed.

1.3.1. Assessment of the measures foreseen for Social Security Funds

The deficit targets for Social Security Funds during the period 2016-2019 call for a cumulative adjustment of 0.6% of GDP that appears to be out of reach unless additional measures are adopted. As shown in graph 12, the path forecast in the SPU for Social Security Funds is highly demanding and difficult to achieve. In the first years of the projection horizon the probability of non-compliance is very high (99%) but, by the end of the period, drops to 60%. See the right-hand panel in the illustration.

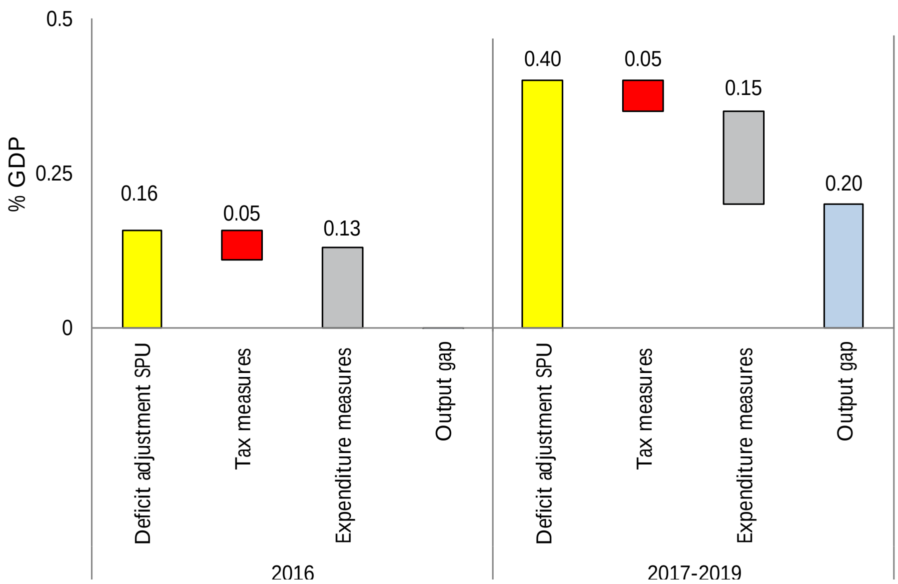
GRAPH 12: NET LENDING/BORROWING PATH FOR 2016-2019. SOCIAL SECURITY FUNDS IN % OF GDP



Source: Stability Programme, IGAE and AIReF estimates

Graph 13 shows the necessary consolidation adjustment and the contribution thereto by the expenditure and revenue measures contained in the SPU:

GRAPH 13: SOCIAL SECURITY FUNDS ADJUSTMENT IN THE STABILITY PROGRAMME. DISTRIBUTION OF REVENUE AND EXPENDITURE



The measures foreseen in the SPU are insufficient to reach the forecast balances. The closure of the economic cycle will contribute to reducing the deficit by means of eliminating its cyclical component. However, there remains a gap between revenue and expenditure in structural terms that reflects increasing expenditure in pensions and the gradual reduction of the Central Government transfer to SEPE, as the expenditure in unemployment benefits drops.

Revenue from contributions foreseen in the SPU lightens their weight in GDP. The estimation for contributions is viewed as reasonable and prudent, in contrast to the forecast included in the State General Budget for 2016. The revenue path for the period as a whole reflects sustained growth that AIReF deems realistic and a consequence of higher employee compensation, growth in employment and the effect of the progressive exhaustion of the current reductions in social contributions for employees established as incentive measures for employers to hire workers on permanent contracts[10]**.**

The expenditure in pensions slows down, reflecting the impact of the reforms implemented. The cause for this deceleration is twofold: the containment of growth in the number of pensions, and slower growth of the average benefit. Expenditure growth already matches that of contributions by employed people in 2016, so it is anticipated that the system's deficit will cease to increase.

Expenditure in unemployment benefits continues to decrease, albeit more slowly, especially contributory benefits[11]. In principle, this improvement in unemployment benefits expenditure should not impact the deficit observed in Social Security Funds, as the Central Government transfer of funds to SEPE will simultaneously be reduced.

The SPU includes revenue and expenditure measures for Social Security Funds amounting to 0.38% of GDP for the period 2016-2019, which respond to measures already implemented (tables 4 and 5).

TABLE 4: SOCIAL SECURITY FUNDS SUBSECTOR. IMPACT OF THE PRINCIPAL NORMATIVE CHANGES ON DEFICIT.
EXPENDITURE DIFFERENTIAL IMPACT ON THE PREVIOUS YEAR (% GDP)

	2016	2017	2018
Social Security Expenditures	0.13	0.08	0.07
Pensions	*0.10*	*0.10*	*0.08*
Labour market policies	*0.03*	*-0.02*	*-0.01*

Source: SPU.

[10] The reduced flat rate for contributions for new indefinite duration contracts signed between February 2014 and March 2015, when net employment was maintained for at least three years (created in Royal Decree Law 3/2014 on 26 February and extended in Royal Decree Law 17/2014), and the establishment of an exemption minimum for corporate contributions for common contingencies to the Social Security for indefinite-duration contracts between March 2015 and August 2016 (Royal Decree Law 1/2015 of 27 February)

[11] In March 2016 the expenditure in contributory benefits dropped to 12.1%, compared to 22.9% in the same month in 2015. The expenditure in non-contributory benefits has remained on a downward trend close to 6%, despite the strong increase in contributions in the Employment Promotion Programme.

Expenditure measures are assessed in the SPU at 0.28 GDP points for the period 2016-2018. The bulk of these are lower expenditures from previous reforms, mainly reforms to the pension system in 2011 and 2012 that account for approximately one tenth of a GDP point per year.

In 2019 the Sustainability Factor will begin to apply to new pensions[12]. This factor will cause a reduction in the initial pension amount for new retirees, depending on the increase in the life expectancy at 67 years between 2012 and 2019. The impact on the overall expenditure in 2019 is envisaged as being negligible at first (causing a reduction of 1% of the initial pension amount). However, this will be a noteworthy new development automatically linking the Social Security system retirement pension amount to the trend in pensioners' life expectancy, adjusting the amounts to be received by future pensioners retiring in similar conditions at different points in time.

The measures listed do not consider the impact on expenditure by the complementary maternity benefit to which retired mothers with two or more children are eligible. The implementation of this complementary benefit of between 5% and 15% for mothers of two or more children, approved in the 2016 State General Budget and in force since January for new retirees, represents an increase in expenditure that is expected to benefit 124,000 pensioners this year. The impact from this complementary benefit is not listed under expenditure measures in the SPU. According to AIReF estimations, the cost in 2016 could rise to approximately €48m, progressively increasing to reach €240m in 2019.

The remainder of expenditure measures are focused on the labour market. Of these, quantitatively speaking, the most outstanding is the conclusion of the tax allowance programme and the reinstatement of measures regulating lay-offs[13] that will lead to a reduced deficit of €300m in 2016, according to the SPU, and to the extension of the Extraordinary Employment Promotion Programme.

The Employment Promotion Programme (Royal Decree Law 16/2014 of December), of a temporary nature, is extended to 15 April 2017. This programme, aimed at long-term unemployed workers in a situation of special hardship and who have exhausted other unemployment protection means, has had in 2015 a much lower cost than expected (€161m instead of the forecast €850m). The forecast for 2016 expressed in the SPU refers to a similar expense, in the region of €160m, one half of the State General Budget allocation for 2016 (€350m). The extension of the "Plan Prepara" could be included in the list of expenditure measures, as it entails a reduction in the unemployment rate from 20% to 18%. This benefit will be extinguished at the conclusion of the extension.

[12] Governed by Art. 211 in the Codified Text of the General Law on Social Security. In accordance with AIReF estimations, this represents a reduction of less than 1% of the initial pension.
[13] Royal Decree Law 1/2013, of 25 January, extending the programme for professional re-qualification in the PER and Law 3/2012

TABLE 5 SOCIAL SECURITY FUNDS SUBSECTOR. IMPACT OF THE PRINCIPAL NORMATIVE CHANGES ON DEFICIT.
DIFFERENTIAL IMPACT ON THE PREVIOUS YEAR (% GDP)

	2016	2017	2018
Social Security Revenue	*0.05*	*0.03*	*0.02*
Flat rate and minimum exemption	*0.04*	*0.02*	*0.02*
Direct contribution settlement system	*0.01*	*0.01*	*0.00*

Source: SPU.

Revenue measures are valued in the SPU as an increase of 0.1 GDP points for the period 2016-2018.

The impact on tax revenue of the direct contribution settlement system, envisaged by the SPU to provide 0.01 GDP points in 2016 (€114m), is revised downward. This amount is close to the forecast included in the economic report accompanying the draft bill, which estimated that setting the plan in motion would represent a revenue increase of some €180m.

The remainder of revenue measures will cause higher tax revenues, whose overall impact is valued in the SPU at €900m for the period 2016-2018. In concrete terms, the progressive exhaustion of reduced social contributions for indefinite-duration labour contracts, which were applied from February 2014 for a period of 24 months extendable to a further 10 months in some cases, and the replacement of this measure with the establishment of a minimum exemption threshold for the first €500 which is the more progressive the lower the salaries it is focused on.

The available information advises an analysis of the short- and medium-term financial situation of the Social Security Funds to be conducted in order to anticipate the exhaustion of the Reserve Fund. The Social Security System presents financial tensions in the short and medium term that, up to the present, have been financed from the Reserve Fund. The deficit trend is expected to lead it to exhaustion in the next few years making it advisable to take action in time by analysing the financial situation in the system in the medium term and adopting the necessary measures.

The State General Budget for 2016 features the possibility of redefining pensions considered as non-contributive, funding these with Autonomous Region transfers. The State General Budget for 2016 includes an additional provision that establishes that the Government will endeavour to progress toward obtaining compatibility between the budget stability and financial sustainability targets, and those of full funding for non-contributive and universal benefits borne by the General Government sector budgets, for which purpose it will assess the benefits included in the system whose conditions make them eligible for this consideration. [14]

The report submitted in April 2016 by the Ministry of Employment and Social Security to the Toledo Pact Commission on the development of the recommendations issued by the Toledo Pact is a starting point. This report presents

[14] Eighty-fifth Additional Provision to the State General Budget (PGE). Separation of the sources of funding for Social Security benefits

the measures taken during the period 2011-2015, and analyses the fulfilment of the various recommendations given in the Report on the Assessment and Review of the Toledo Pact, approved in Parliament in 2011. This report can be considered as a starting point for the necessary agreement to resolve the medium-term financial tensions in the system.

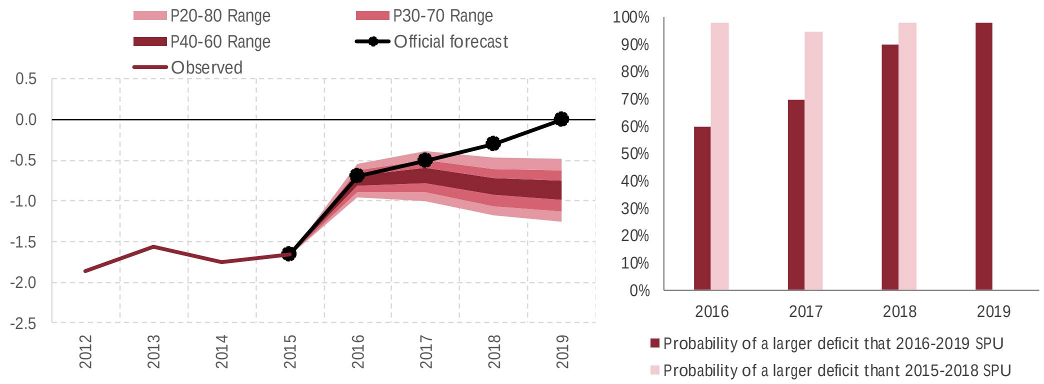
1.3.2. Assessment of the measures envisaged in the Autonomous Regions

The fiscal consolidation effort to be implemented in the period 2016-2019 by the Autonomous Regions subsector equals 1.5% of GDP. It is deemed highly unlikely that this path will be reached, especially in view of the trend expected for the period in the main components of public expenditure. In this adjustment, the expenditure registered in 2015 as a consequence of the reclassification of public-private associations, and other operations that may be considered as non-recurrent, have not been allowed for and, therefore, will not be taken into account for the purposes of consolidation during this period. The Autonomous Regions closed the year 2015 with a deficit of 1.7% of GDP, two tenths of a GDP point less after factoring out previous operations, and with the target for 2019 set at budget balance. This entails a fiscal adjustment of 1.5% of GDP for the period, the fulfilment of which is seen as unlikely, as shown in graph 14, chiefly because the trend foreseen in the inertial scenario forecast by AIReF for the main components of public consumption (in which the bulk of expenditure pertains to healthcare, education and social services) represents a higher rate of growth than that envisaged in the SPU.

The inertial scenario considered by AIReF, though it envisages for the period 2017-2019 an increase in resources surpassing the figure for 2016 conditioned by the evolution of resources within the financing system in line with the expected growth in the economy, it also estimates a slightly higher growth rate in uses, and therefore does not envisage fiscal cutbacks during this period for the subsector as a whole. This trend envisaged for uses incorporates the projections by AIReF models for expenditure in healthcare and education described in boxes 1 and 2, respectively, thus determining that the chief components in public consumption, accounting for 80% of non-financial uses (having factored out payments to the State deriving from the Autonomous Regions financing system), maintain for the period a greater growth rate than forecast in the SPU.

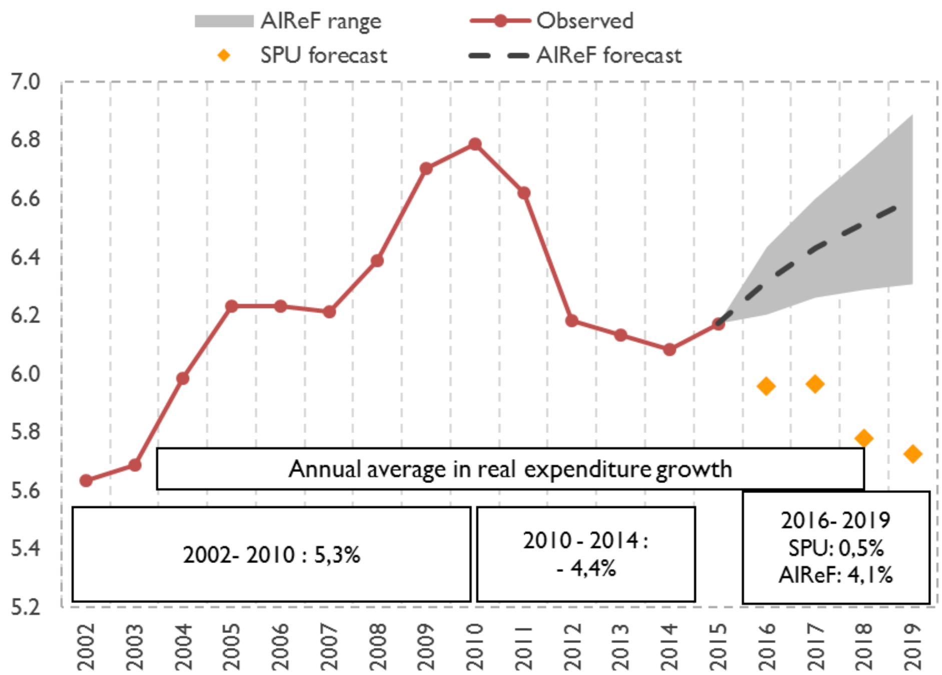
As shown in graph 14, it is highly unlikely that the path forecast in the SPU for the Autonomous Regions will be reached. Despite the fact that for 2016 the target of -0.7% lies centred within the confidence interval proposed by AIReF, the targets for the following two years increase their distance from the intervals (left-hand panel). As the path progresses, the likelihood of noncompliance increases and, from 60% in 2016, reaches 99% by the end of the period. See the right-hand panel in the illustration.

GRAPH 14: FINANCING CAPACITY/NEED PATH FOR 2016-2019. AUTONOMOUS REGIONS IN % OF GDP.



In particular, the path forecast in the SPU for spending on health in GDP terms shows a constant reduction in the period 2016-2019 which AIReF deems unlikely according to its own estimates. Graph 15 shows the expenditure path in healthcare forecast by AIReF, and the estimations given in the SPU (Table A.9b. Changes in the expenditure structure by functions). It is observed that during the period 2002-2010 average year-on-year growth in real healthcare expenditure was 5.3%; subsequently, during the period 2011-2014, said expenditure fell by a year-on-year average of 4.4%. The AIReF model for the projection of expenditure in healthcare described in box 1 envisages that the trend for this expenditure until 2019 will represent an average year-on-year growth of 4.1%, while the SPU forecasts for the same period indicate an average growth in real healthcare expenditure of 0.5%.

GRAPH 15: EVOLUTION OF HEALTH EXPENDITURE IN % OF GDP

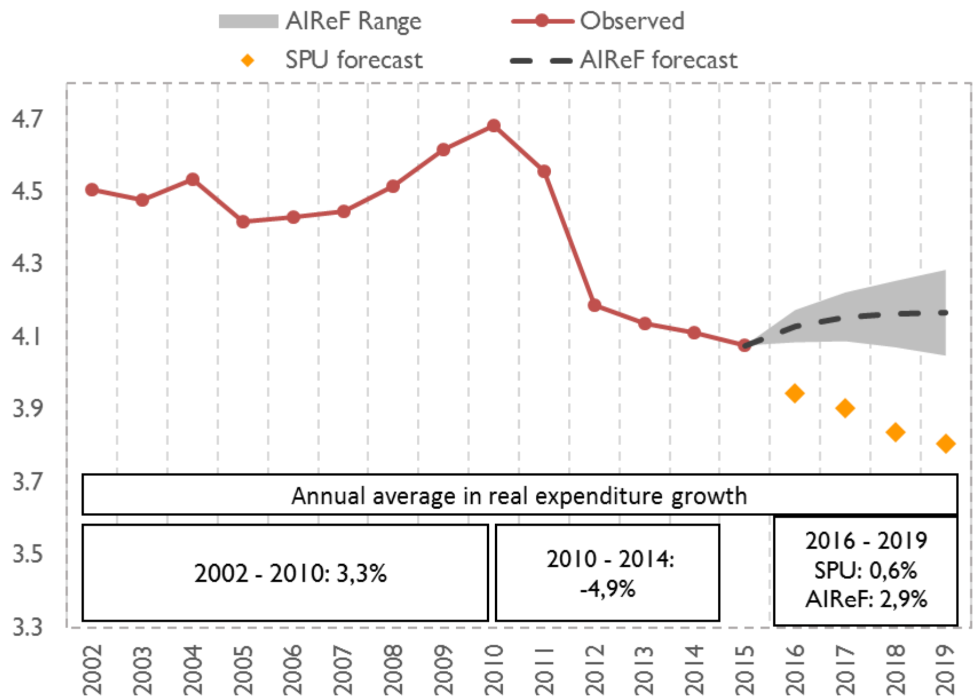


Source: SPU, IGAE and AIReF estimates

Note: Both the AIReF model projections and those of the SPU are based on the GDP estimated by AIReF, in order to eliminate from the analysis any discrepancies deriving from different forecasts for GDP.

Similarly, regarding expenditure in education, the trend foreseen in the SPU implies a constant reduction in proportion to GDP until 2019, which, as in the foregoing case, AIReF deems unlikely. Graph 16 shows the expenditure path observed in education and the projections for said path for the period 2016-2019, both by the SPU and by AIReF. It can be seen that in the period 2002-2010 the average year-on-year growth in real expenditure in education was 3.3%, with an average year-on-year drop of 4.9% from 2011 until 2014. The AIReF model for the projection of expenditure in education described in box 2 envisages that the trend for this expenditure until 2019 will represent an average year-on-year growth of 2.9%, while the SPU forecasts for the same period indicate an average growth in real healthcare expenditure of 0.6%.

GRAPH 16: EVOLUTION OF EXPENDITURE IN EDUCATION AS % OF GDP



Source: Stability Programme, IGAE and AIReF estimates

Note: Both the AIReF model projections and those of the SPU are based on the GDP estimated by AIReF, in order to eliminate from the analysis any discrepancies deriving from different forecasts for GDP.

BOX 1: ESTIMATION OF EXPENDITURE IN HEALTHCARE IN THE AUTONOMOUS REGIONS

To project expenditure in healthcare until 2019, a method in several stages has been developed combining the "structural" expenditure associated with population ageing along with a number of conjunctural variables.

"Structural" expenditure with a demographic focus is estimated as follows:

1. The Spanish National Health Survey of 2012 yielded a healthcare usage profile for four types of healthcare services (primary care appointments, specialist appointments, number of medicines consumed and nights stayed in hospital) by age and sex.
2. With these data and the information collected in the national accounting healthcare expenditure satellite accounts the unit expenditure is generated for each of the four types of healthcare service indicated above.
3. Data provided by the INE on the Census and Demographic movements and Autonomous Regions' projections for the population until 2019, and with previous estimates for healthcare usage profiles and unit costs, the overall annual healthcare expenditure associated to population ageing is calculated for each region.

The overall expenditure for a region "i" for the year "t" is obtained as the sum of the four services mentioned above plus a remainder in which all other items not included in the study are considered, such as public health services, collective health services or capital expenditure, among others, labelled $Gresto_{it}$. Thus:

$$Gastoestruc_{it} = Gprimaria_{it} + (Gespecialista + Ghospital)_{it} + Gfarmacia_{it} + Gresto_{it}$$

Having generated the "structural" healthcare expenditure, the annual expenditure is obtained by looking at the evolution of three factors:

- Healthcare expenditure due to demographic dynamics in the Autonomous Regions, calculated in stage 3.
- The percentage of healthcare expenditure that is dependent on the economic cycle, with a procyclical nature, with the variable GDP t-1.
- A trend variable that captured information regarding the evolution of other variables that influence healthcare expenditure such as technological progress.

Taking these specifications into account, the following regression is calculated:

$$\frac{\log(gastoobser_{it})}{\log(gastoestruc_{it})} = \beta_0 + \beta_1 \log(PIB_{i,t-1}) + \beta_2 trend_t + \varepsilon_{it}$$

i=1,…,17 t=2002,..,2014

Where the "$gastoobser_{it}$" is the expenditure observed in the region "i" in the year "t" obtained from the healthcare expenditure accounts in accordance with the COFOG classification, "$gastoestruc_{it}$" is the estimation obtained in phase 3 associated to population ageing, $GDP_{i,t-1}$ is the Gross Domestic Product for the region "i" in the previous year, "t-1", and lastly the variable "$trend_t$" takes the values 1, 2,... capturing the influence of the time trend.

The results obtained for "overall healthcare expenditure" at the national level are as follows:

	coefficient	*stand. Error*	*t-stat*	*p-value*
constan	0.7378	0.0364	20.2613	0.0000
PIB $_{t-1}$	0.0822	0.0119	6.8989	0.0000
trend	0.0063	0.0008	7.3955	0.0000

summary statistics	
correlation coef.	0.97096458
ajusted R-squared	0.93236718
standard error	0.0021314

A high explanatory capacity is displayed, with an adjusted R2 higher than 0.93, and statistically significant parameters associated to explanatory variables.

The values shown in this box refer to the overall nationwide trend in healthcare expenditure. However, by means of this estimation method, expenditure estimates can be made individually for each of the Autonomous Regions and for each of the healthcare service types, namely, expenditure in primary care, specialist and hospital care, pharmacy and total expenditure.

BOX 2: ESTIMATION OF EXPENDITURE IN EDUCATION IN THE AUTONOMOUS REGIONS

To make a projection for expenditure in education over the period 2016-2019, a method has been developed that is similar to that employed in the projection of healthcare expenditure, in several stages, combining "structural" expenditure associated to population ageing in the Autonomous Regions with other conjunctural variables.

"Structural" expenditure with a demographic focus is estimated as follows:

1. With the statistics provided by the Ministry of Education, Culture and Sports (Educabase) for 2012, an education usage profile for four types of educational services (primary and infant, secondary and training cycles, special education and university) by age and sex.
2. With these data and the information provided in the Statistics for public expenditure in Education provided by the Ministry of Education, Culture and Sports, each region's unit expenditure is generated for each of the four types of educational service indicated above.
3. With data provided by the INE on the Municipal Register and demographic movements and Autonomous Regions' projections for the population until 2019, and with previous estimates for educational usage profiles and unit costs, the overall annual educational expenditure associated to population ageing is calculated for each Region.

Lastly, overall expenditure in education in the region "i" during the year "t", taking into account demographic trends, is obtained as the sum of the four services mentioned above plus a remainder in which all other items not included in the study are considered, such as school meals and boarding facilities, education abroad, research or general administration, among others, labelled $Gresto_{it}$. Thus:

$$Gastoeduestruc_{it} = Gprimaria_{it} + Gsecundaria_{it} + Gregespe_{it} + Guniversidad_{it} + Gresto_{it}$$

Having generated the "structural" expenditure in education, the annual expenditure for the Autonomous Regions is obtained as the result of three components:

- The expenditure in education due to demographic dynamics in the region, calculated in stage 3.
- The percentage of educational expenditure that is dependent on the economic cycle, with a procyclical nature, with the variable GDP_{t-1}.
- A trend variable that captures information regarding the evolution of other variables that influence expenditure in education of a region.

The following regression is estimated:

$$\frac{\log(gastoedu.obser_{it})}{\log(gastoedu.estruc_{it})} = \beta_0 + \beta_1 \log(PIB_{i,t-1}) + \beta_2 trend_t + \varepsilon_{it}$$ i=1,…,17 t=2002,..,2014

Where the "gastoedu.obserit" is the expenditure observed in the region "i" in the year "t" obtained from the Statistics for Public Expenditure, "gastoedu.estrucit" is the estimated expenditure in education obtained in phase 3 associated to population ageing, GDPi,t-1 is the Gross Domestic Product for the region "i" in the previous year, "t-1", and lastly the variable "trendt" takes the values 1, 2,... capturing the influence of the time trend.

The estimates resulting from the above equation for the variable "overall expenditure in education" at the national level are as follows:

	coefficient	*stand. Error*	*t-stat*	*p-value*
constant	0.7158	0.0245	29.1796	0.0000
PIB $_{t-1}$	0.0904	0.0080	11.2580	0.0000
trend	0.0068	0.0006	11.8626	0.0000

summary statistics	
correlation coef.	0.98857438
ajusted R-squared	0.97314826
standard error	0.00143724

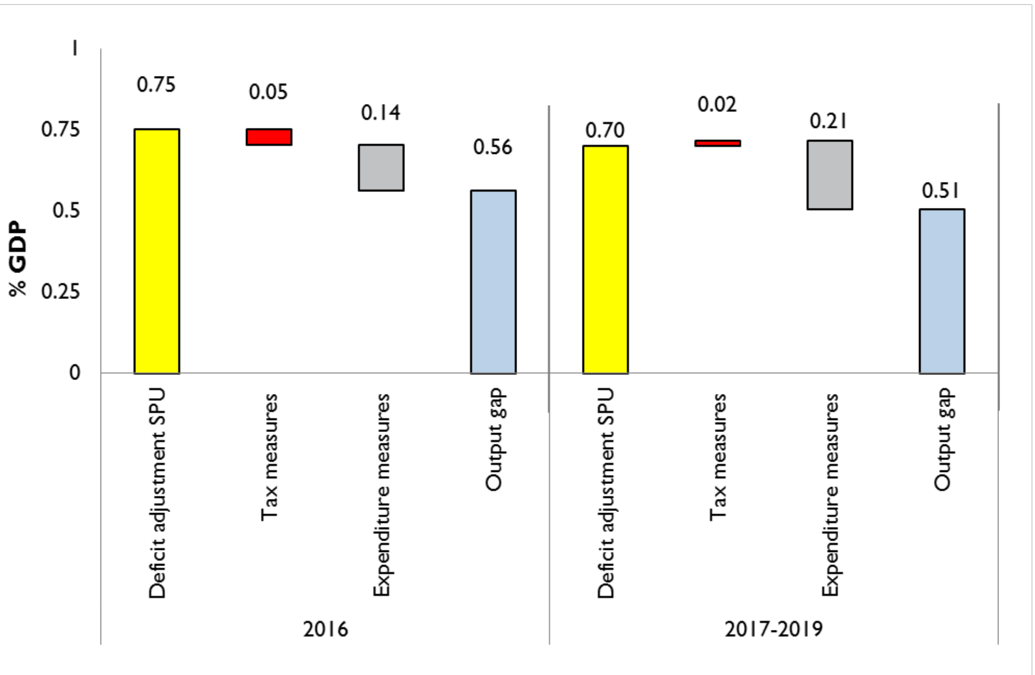
These estimates display high goodness of fit in the regression, with an adjusted R^2greater than 0.97, and high statistical significance of the estimates for the parameters studied in the regression.

Finally, it must be noted that the values shown in this box refer to the expenditure in education nationwide but that, using this method, it is possible to obtain individual estimates for each Autonomous Region and for each type of educational service looked at: expenditure in primary and infant school, secondary and training cycles, special education, university and total education.

The SPU foresees expenditure and revenue measures for the period 2016-2019 for the amount of €4,437m, mainly affecting expenditure. The consolidation adjustment to be performed by the Autonomous Regions is based fundamentally on the evolution of the regional financing system resources and on a moderate expenditure trend supported by maintaining the impact of the principal measure taken in 2016 (non-availability agreements and non-implementations of the expenditure budget), and on the additional impact deriving chiefly from reversing the effect of refunding the 13th month's salary for 2012 and the economy measures in pharmaceutical expenditures.

Graph 17 shows the necessary consolidation adjustment and the contribution thereto by the expenditure and revenue measures for the period 2016 - 2019.

GRAPH 17: AUTONOMOUS REGIONS ADJUSTMENTS IN THE STABILITY PROGRAMME DISTRIBUTION OF REVENUE AND EXPENDITURE



The impact of the chief expenditure measure taken in 2016, consisting in non-availability agreements and non-implementations, valued at €1,510m, is consolidated in subsequent years. Of this amount, €830m correspond to the AND adopted by the Autonomous Regions that failed to comply with the agreed adjustment plan by overshooting the stability target for 2015, and the remaining €630m are due to non-implementations foreseen in their budgets. As well as this, it is envisaged that the measures to reduce pharmaceutical expenditure will have an additional impact every year until 2018, with a similar impact in 2016 and 2017, and a smaller one in the final year. As far as expenditure in personnel is concerned, the reversal effect as of 2017 for the refunded 13th month's salary for 2012 is taken into account in the preceding years, and the additional annual impact from personnel non-replacement policies is maintained.

TABLE 6: SUBSECTOR AUTONOMOUS REGIONS. IMPACT OF THE PRINCIPAL NORMATIVE CHANGES ON DEFICIT. EXPENDITURE DIFFERENTIAL IMPACT ON THE PREVIOUS YEAR (% GDP)

	2016	2017	2018	2019
Autonomous Region expenditure	*0.14*	*0.12*	*0.04*	*0.05*
General Autonomous Region expenditure measure	*0.03*	*0.07*	*0.03*	*0.05*
Civil servants' 13th month's salary 2012	*0.00*	*0.04*	*0.01*	*0.02*
Public Employment (general personnel measures)	*0.03*	*0.03*	*0.02*	*0.02*
Specific Autonomous Region expenditure measure	*0.11*	*0.05*	*0.01*	*0.00*
Non-availability agreement	*0.13*	*0.00*	*0.00*	*0.00*
Pharmaceutical expenditure	*0.05*	*0.05*	*0.02*	*0.00*
Interest	*–0.07*	*0.00*	*–0.01*	*0.00*
Other current expenditure measures	*0.00*	*0.01*	*0.00*	*0.00*

Regarding revenue, a net increase in tax revenue is envisaged for 2016, driven by the tax measures adopted in certain regions and revenue deriving from disposition of investments. As of 2016, the forecast revenue measures will have negative effects.

TABLE 7: SUBSECTOR AUTONOMOUS REGIONS. IMPACT OF THE PRINCIPAL NORMATIVE CHANGES ON THE DEFICIT. REVENUE DIFFERENTIAL IMPACT ON THE PREVIOUS YEAR (% GDP)

	2016	2017	2018	2019
Autonomous Region revenue measures	*0.05*	***–0.01***	***–0.01***	*0.00*
Taxes	*0.01*	*0.00*	*0.00*	*0.00*
Fees	*0.00*	*0.00*	*0.00*	*0.00*
Other taxes	*0.01*	*0.00*	*0.00*	*0.00*
Nontax	*0.02*	*–0.01*	*–0.01*	*0.00*

For the Autonomous Regions overall, the forecast path sets a 0.7% deficit for 2016 that might be feasible, but demanding. To achieve this figure the measures planned in the SPU must be strictly complied with and implemented with guarantees, and the setting of exactly the same reduction path for all of the Autonomous Regions should not lead to any relaxation in any of the regions that would more than offset the consolidation effort this path would prompt others to make.

Among the Autonomous Regions' expenditure measures included in the SPU for 2016, the most notable are the savings deriving from the AND and from the non-implementations envisaged in their initial budgets for a total amount of €1,510m, of which, according to further information provided, only €300m can be considered as additional to the forecasts drawn up by AIReF in the report on the initial budgets in 2016. The Autonomous Regions' initial budgets for 2016 already allowed for non-implementations for an amount exceeding €1,000m, some of which, according to information provided by the Autonomous Regions, have been formalised as Non-Availability Agreements. In most cases, these amounts were considered in the AIReF year-end forecast for the whole of the sector given in the Report on the initial budgets. The only foreseen non-implementations that were not taken into account are those in which, due to the nature of the budget lines affected or to the small margins in the budget, the non-implementation of the appropriations did not seem plausible.

Therefore, of the expenditure measures registered in the SPU for 2016, only just over €500m in the AND can be considered as additional actions that will correct the year-end forecast for the subsector. However, according to the supplementary data provided, certain non-availability agreements, due to their nature, fail to constitute real expenditure contention measures, and therefore the final amount considered stands at around €300m:

- The credit non-availability convened in Cataluña, for €225m, affects appropriations carried over under chapter III, interest. The issue here, therefore, is the reduction in appropriations carried over from the previous year which allows them to be adapted to the execution of real expenditure for the fiscal year, already taken into consideration in the year-end forecasts. At all events, the expenditure in interest is not dependent on discretionary decisions and is determined in terms of national accounting (accrual), independently of the budget allocation (maturity), and therefore the non-availability of this item does not represent any real saving in expenditure. Non-availability of these appropriations prevents over-budgeting from being transferred to other items, thus contributing to limiting expenditure increases without causing expenditure reductions.
- In the case of Cantabria, the non-availability convened for certain appropriations, €19m, aims to enable other credits not initially foreseen in the budget for the refund of a part of the 2012 13th moth's salary and likewise, therefore, it does not constitute an expenditure reduction measure.

The effectiveness of the adjustment deriving from the AND and the likelihood that their impact will be maintained over subsequent years will require the implementation of the guarantees envisaged in the LOEPSF. To guarantee the effectiveness of the adjustments to the AND, these (i) must detail the expenditure reduction measures and identify the appropriations affected, and (ii) may not be revoked during the year in which they were approved or before measures are adopted to guarantee the fulfilment of the set target, nor give rise to any increase in the expenditure registered in the auxiliary accounts. The above will require monitoring of each budget line affected and of the movements in account number 413 to prevent expenditure from being diverted to non-budgetary accounts, and exercising control over budgetary modifications to increase expenditure that may compensate the effects deriving from non-availability.

Finally, though AIReF finds plausible that most of the forecast non-implementations will be fulfilled, their effectiveness is subject to risks:

- These measures are not backed by the guarantees required by the stability regulation governing non-availability agreements, and therefore, to confirm their validity they should be formalised as AND.
- Strict monitoring of the expenditure registered in extrabudgetary accounts must be implemented, to prevent the higher expenditure registered there from reducing the effect of budgetary non-implementations.

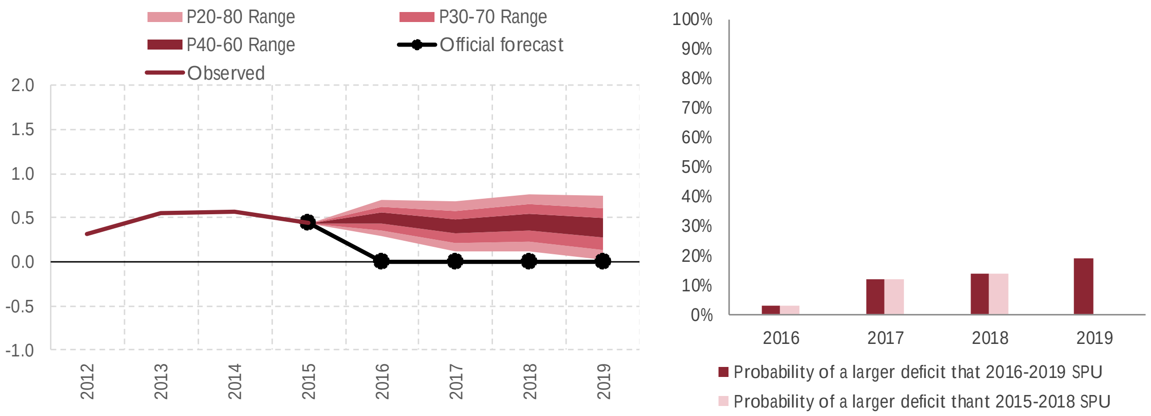
1.3.3. Assessment of the measures envisaged in the Local Corporations[15]

It is highly probable that the Local Corporations subsector, on the SPU temporal horizon, will consolidate the surplus result reached since 2012, despite AIReF alerting of the risk of a reduction in this surplus owing, among other aspects, to greater flexibility in applying the expenditure rule and to the subsector's non-compliance of this rule observed in 2015. According to the latest report published by MINHAP on 15 April 2016, on the degree of compliance with the budget stability and Government debt targets, and to the expenditure rule for the year 2015, the Local Corporations subsector achieved a surplus in that year of 0.44% of GDP, 0.13 points lower to that reached in 2014 and, for the first time, failed to comply with the expenditure rule, as the growth rate for eligible expenditure was 1.7%, four tenths of a point higher than the rate approved for that year which was 1.3%. As indicated in the Report on the Initial Budgets for 2016, easing the application of the expenditure rule as proposed in the handbook, published by MINHAP in September 2015, for Local Corporations to communicate their economic-financial plans (PEFEL2), in which the data from which to calculate this rule are those derived from the previous year's settlement and not those of the last year in which the rule was met, as previously established, allows the consolidation in future years of expenditure overruns through non-compliance. This determines a tendency toward a reduction in the potential surplus. The publication of the report on the degree of compliance with the budget stability and Government debt targets, and on the expenditure rule for 2015, revalidates this criterion.

The SPU 2016-2019 grounds the reduction of the surplus in this subsector in 2015, fundamentally, on the drop in resources stemming from the negative settlements in 2013 in the financing system, although the most recent data published reveal an increase in overall non-financial expenditure for that year well above the spending deriving from said settlements. The MINHAP publication in March 2016 on Local Corporations' non-financial operations, including year-end data for 2015, shows that overall Local Corporations' non-financial resources increased by 0.5% in 2015 with regard to 2014, despite the fall in revenue in the financing system, while non-financial jobs increased by 2.5% in the same period.

[15] Inclusion of the consolidation adjustments table is not applicable given the surplus situation in the Local corporations subsector.

GRAPH 18: NET LENDING/BORROWING PATH FOR 2016-2019. LOCAL CORPORATIONS IN % OF GDP



Source: Stability Programme, IGAE and AIReF estimates

The SPU includes measures for expenditure and revenue for the period 2016-2018 for a total amount of €2,239m and €1,056m, respectively. With regard to the Budget Plan for 2016, the SPU maintains, for 2016 and 2017, measures for increasing revenue, and makes a 20% cut in savings deriving through expenditure measures that had reached, for those years, €2,642m, justifying the reduction with the non-achievement of the estimated savings in local reforms after devolution of education, healthcare and social services to the Autonomous Regions, as a result of Constitutional Court ruling of 3 March 2016 in which the provisions on which such devolution was based were declared unconstitutional.

TABLE 8: LOCAL CORPORATIONS SUBSECTOR. IMPACT OF THE PRINCIPAL MEASURES ON THE TARGET. DIFFERENTIAL IMPACT ON THE PREVIOUS YEAR (% GDP)

	2016	2017	2018
Local Corporation expenditure measures	*0.10*	*0.04*	*0.01*
Reduced expenditure in personnel and non-replacen	*0.00*	*0.05*	*0.01*
Reduced current expenditure	*0.02*	*0.01*	*0.01*
Public Enterprise Sector	*0.05*	*0.03*	*0.00*
Suppression of services that are not a local competence and disappearance of minor local bodies	*0.01*	*0.00*	*0.00*
Integrated management of public services and municipality mergers	*0.02*	*0.01*	*0.00*

	2016	2017	2018
Local Corporation revenue measures	*0.04*	*0.03*	*0.02*
Tax increases, suppression of exemptions and voluntary allowances	*0.04*	*0.03*	*0.02*
Public fees and prices	*0.00*	*0.00*	*0.00*

2. Expenditure rule

The references given in the SPU regarding the expenditure rule are unclear and insufficient. The text mentions the expenditure rule on several occasions but it is not clear whether these instances refer to the European expenditure rule or that designed on a national level in Article 12 of the LOEPSF. Moreover, the data relating to the expenditure rule are on some occasions inconsistent internally with the data given in other tables in the document. In addition, the information contained in the SPU is insufficient to assess compliance with the expenditure rule during the entire period covered in the SPU 2016-2019, as it fails to provide the applicable reference rate for 2019 or any other data relative to that year[16].[17]

AIReF cannot issue an opinion on the fulfilment of the expenditure rule in the SPU 2016-2019. Clarification and additional information is needed on the expenditure rule contained in the SPU for the reference period 2016-2019, as well as a clear definition of the methodological elements required for its planning, monitoring and compliance assessment.

The European expenditure rule is not applicable in Spain while an Excessive Deficit Procedure (EDP) is ongoing. The European expenditure rule is implemented at the General Government sector level and cannot be applied to countries subjected to an EDP (compliant with the path established in the SPU, it cannot be applied to Spain until 2018). After exiting the EDP and until the country has reached its medium-term objective (MTO) it is obliged to maintain eligible expenditure growth below the reference rate.

The current expenditure rule in force at the national level has been applied since 2013 and establishes limitations to public expenditure growth at the subsector level. In 2015, according to the Report by the Ministry of Finance and Public Administrations, issued on 15 April 2016, on the degree of compliance with the budget stability, Government debt and expenditure rule target in 2015, none of the subsectors has met the expenditure rule stipulated in Article 12 of the LOEPSF, increasing their eligible expenditure in excess of the reference rate of 1.3% fixed for that year (Central Government: 5.5%; Autonomous Regions: 4.4%; Local Corporations: 1.7%).

The Spanish expenditure rule is inspired on the European model and, despite some differences in its definition and implementation, both are configured as an instrument of budgetary discipline to guarantee the sustainability of Government accounts. As pointed out in the AIReF Report of 29 April 2015 on the SPU 2015-2018[18] and in AIReF's Informative Document on the expenditure rule issued on 20 November 2015[19], there are certain differences between the two fiscal rules. Nevertheless, the aim of both rules is to achieve that, on a medium-term horizon, growth in General Government sector expenditure is limited by the capacity to

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[16] Table A.2 “Amounts to exclude from the expenditure ceiling”.
[17] Table A.2 “Amounts to exclude from the expenditure ceiling” does not include information of the revenue measures given in table A.1 “Impact of the principal normative changes on deficit”.
[18] Reports on the SPU Project 2015-2018.
[19] Informative document on the expenditure rule

fund it with stable and sustainable revenues. Furthermore, the expenditure rule likewise serves the economic stabilisation objective from a two-fold perspective. Firstly, this rule does not operate on revenues and excludes expenditures most closely linked to the economic cycle (known as automatic stabilisers), allowing these to fluctuate freely to compensate for the effects of the cycle on the economy. Secondly, it generates a larger surplus in good times that can be used in times of deficit, contributing to dampen the oscillations in the economic cycle.

MINHAP's interpretation of the application of the expenditure rule distorts the objective pursued by said rule and deviates from the implementation criteria for the European expenditure rule. As mentioned above, a number of interpretations have arisen recently of the expenditure rule on behalf of the MINHAP[20] that have made its implementation more flexible and, to some extent, distort the intended purpose of this fiscal rule. MINHAP considers that non-compliance with the expenditure rule does not entail the obligation to correct the deviation produced, but rather that it allows consolidation of the expenditure overrun above the reference rate, from a greater baseline expenditure for the subsequent year. This criterion has a particularly distorting effect in the case of non-recurrent operations as it allows expenditure to be increased by the amounts of these operations when such amounts are automatically corrected in the following year, thus causing a duplicate effect. By contrast, European legislation demands that in the event of significant deviations from the reference rate, such deviations must be corrected within a maximum timeframe of five months, which is reduced to three months if the situation is deemed especially serious and requires urgent action[21].

[20] Update of the Handbook for the Local Corporations to communicate their economic-financial plans (September 2015) and Report on the degree of compliance with the deficit, debt and expenditure rule targets for 2015 (April 2016)
[21] Council Regulation (EC) No. 1466/97

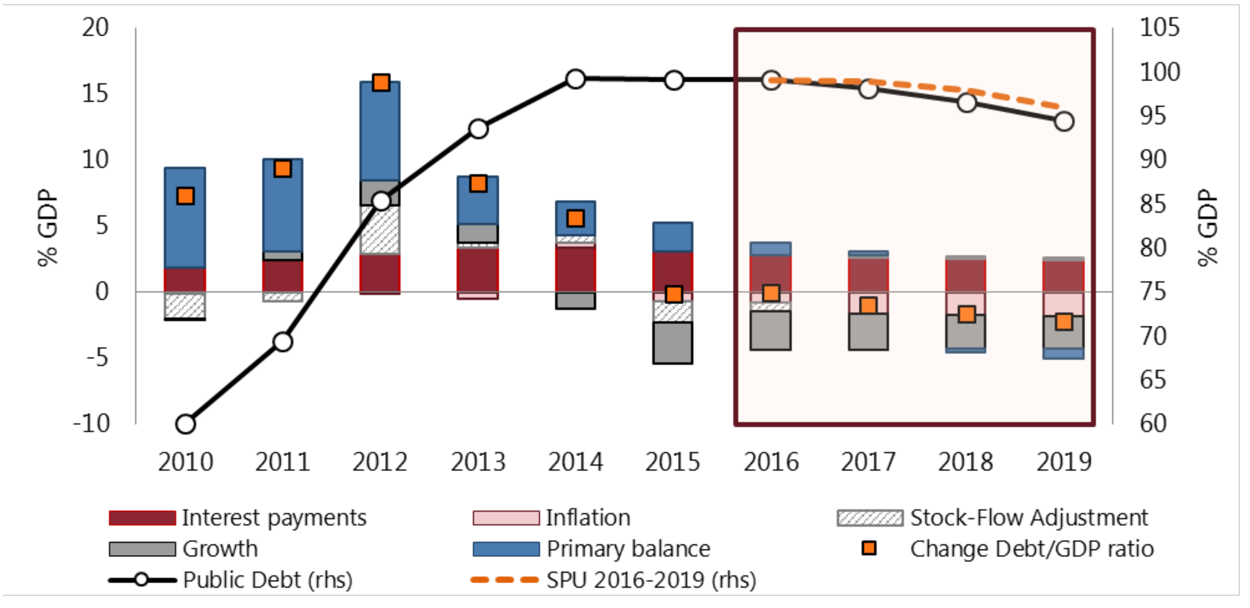
3. Government debt target

3.1. Assessment of the SPU scenario

The SPU 2016-2019 presents a Government debt to GDP path that is stable for 2016 and 2017, after which it is expected to decline, in line with the central projections by AIReF. The forecasts included in SPU 2016-2019 foresee the stabilisation of the debt/GDP ratio at around 99% during 2016 and 2017. From that time, the path follows a downward slope, though still experiencing timid corrections, to reach 96% of GDP in 2019. This trend may be seen as consistent with the macroeconomic scenario in the SPU, and is also in line with the trend forecast by AIReF in its main scenario.

Despite its decreasing and sustainable profile, the SPU debt trend forecast does not allow compliance with Transitional Provision One of the LOEPSF. In accordance with this provision, in 2020, the level of Government debt should drop to 60% of GDP and, for this to occur, as the domestic economy reaches a real growth rate of at least 2% per year, the Government debt ratio should be reduced annually by at least 2% of GDP. However, it is forecast that the debt ratio over GDP will register a cumulative reduction for the entire period of 3.2 percentage points of GDP, to stand at a debt level of 96% of GDP in 2019. This path will not allow, on the one hand, the mentioned objective to be reached in the given timeframe (2020) owing to the distance to the target of 60% (36 GDP points still remaining at the close of 2019) and, on the other hand, the rate of adjustment is smaller than the required rate since, as the SPU forecasts a real GDP growth of 2.5% on average for the period 2016-2019, a reduction of at least 8% of GDP would have been necessary.

GRAPH 19: EVOLUTION OF THE DEBT: GDP RATIO FOR THE PERIOD 2016 - 2019

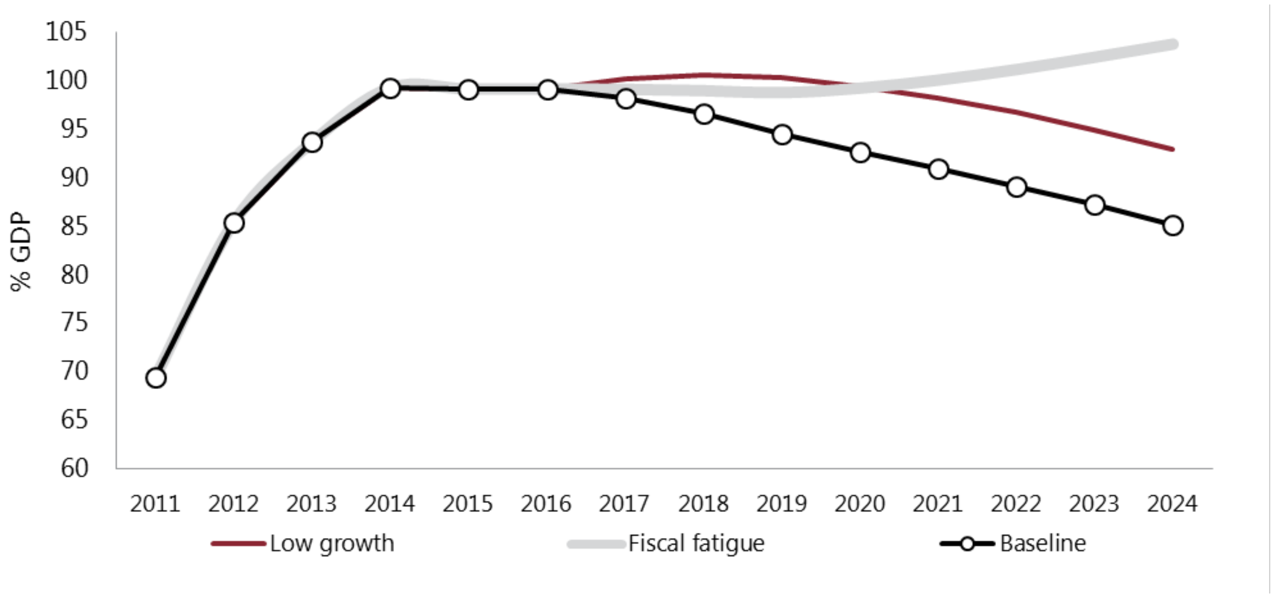


Source: SPU 2016-2019 and AIReF

3.2. Sensitivity analysis

The sensitivity analysis carried out by AIReF highlights the importance both of maintaining a robust nominal growth scenario in the medium term and the improvement of the primary balance through compliance with the prevailing fiscal rules in Spain and the EU. As shown in graph 19, the projection by AIReF points to a nominal improvement in the economy (GDP and inflation recovery) and the progressive correction in the primary balance as the key determinants of the downward trend in debt. Making these assumptions has major implications in debt sustainability. Firstly, if a temporary deviation for three years is assumed in economy growth (1 percentage point decrease in real growth and 0.5 percentage points lower inflation than projected in the baseline scenario, consistent with the central AIReF projections), an upturn can be observed in medium-term debt, with the peak delayed until the end of the period; however, this would not cause any qualitative change in the considerations regarding sustainability, nor alter the downward debt profile. Secondly, implicit in the "fiscal fatigue" scenario shown in graph 20 is the maintenance of a primary balance as a percentage of GDP from the level forecast for 2019. In this scenario, changes in sustainability concerns are qualitative, given that they disrupt the downward profile of the debt/GDP ratio. In view of the high level of Government debt, therefore, it is vital to have binding fiscal rules in place to offset the burden from debt interest payments, and more importantly still in a hypothetical environment of low nominal growth rates.

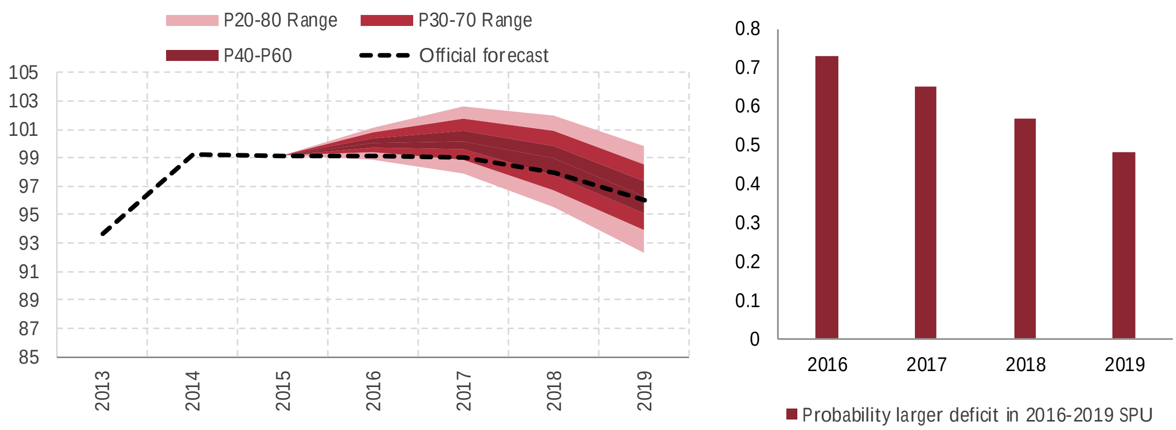
GRAPH 20: EVOLUTION OF THE DEBT: GDP RATIO FOR THE PERIOD 2016 - 2019, SENSITIVITY ANALYSIS



Source: SPU 2016-2019 and AIReF

In a stochastic analysis framework, the debt trend supporting the scenario included in the SPU falls within the estimated probability intervals (growing more prudent toward the end of the period). The deterministic nature of the sensitivity exercises described above fails to capture the air of uncertainty surrounding the forecasts for the future conditions of the economy. Therefore, to complete the analysis a stochastic modelling approach is needed, covering a constellation of shocks jointly affecting the nominal growth in GDP, debt interest and the primary balance (assessing whether fiscal reaction functions are in line with historical experience).[22] According to this stochastic analysis the probability of the debt/GDP ratio exceeding the level forecast in the SPU for the period 2016-2019 is greater than 70 per cent at the outset but, as the projection horizon progresses, this probability decreases to 50%, as shown in graph 21.

GRAPH 21: PROJECTIONS FOR DEBT EDP AND STABILITY PROGRAMME PROJECT SCENARIO AS % OF GDP AND ASSOCIATED PROBABILITIES



Source: AIReF and MINHAP

[22] Details of the model are available in Cuerpo, C. (2014). "Sustainability Analysis of Spanish Government Debt". Series of Working Documents, DT/2014/2, AIReF.

4. Transparency

The Stability Programme does not include budget projections that allow identification of the degree of compliance with the targets in an inertial scenario with no measures and in an alternative scenario including the measures forecast for each one of the subsectors. In the interest of improving transparency and to ensure that the commitments and measures foreseen in the SPU are analysed appropriately and deemed sufficient to guarantee compliance with the budget stability, Government debt limits and expenditure rule targets, in the period covered by the SPU, it is essential to include the following:

- ✓ Budget projections in an inertial scenario excluding measures both for the General Government sector overall and for each one of its subsectors.
- ✓ Budget projections that incorporate the measures, thus allowing visibility on what part of the consolidation adjustment forecast would come from the adoption of measures.
- ✓ Government debt targets distributed by subsectors.
- ✓ Detailed information for the analysis of the expenditure rule for each one of the subsectors: eligible expenditure as well as the reference rates to calculate the expenditure rule for all the years covered in the Stability Programme Update.

AIReF has repeatedly stated in previous reports the need to include budget projections, in terms of ESA 2010, for each one of the subsectors, and increase the level of detail under certain headings.

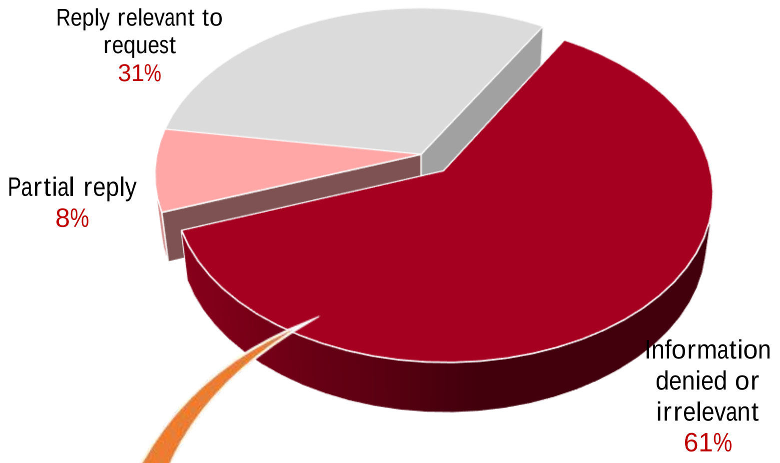
The stability programme, in the contingent liabilities section, includes exclusively the guarantees granted by the General Government sector as bonds. Despite the ‘contingent liabilities’ title given to this heading, it only includes data relevant to bonds. No information is given on the General Government sector's potential accountability regarding court rulings, information on public/private associations or other risks threatening the General Government sector's budget stability and financial sustainability targets that may derive, for instance, from non-performing loans. It is important to highlight, in this respect, that in recent years both the Central Government and the Autonomous Regions subsector, and even some Local Corporations, have seen a significant deficit increase as a consequence of implementing rulings (the ruling known as the *"healthcare cent"* in 2014) or the reclassification of contracts deriving from Private-Public Associations. The information provided on contingent liabilities should be enlarged upon, and not limited to the guarantees granted.

Further improvement is needed in Government accounts transparency and in guaranteeing AIReF's access to all necessary information to analyse compliance with the budget stability, Government debt and expenditure rule targets. The SPU notes that MINHAP publishes the replies to AIReF's recommendations to the "comply or explain" principle and AIReF's requests for information channelled through the Information Centre (CI). It is also pointed out in the SPU that 80% of AIReF’s requests for information were answered with information that needed to be compiled, and 20% with published information.

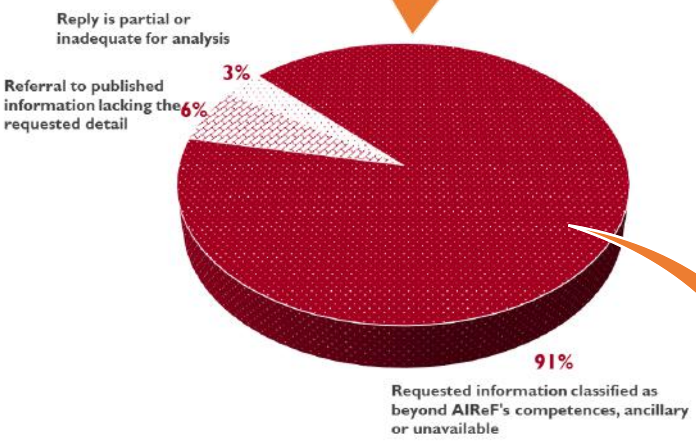
AIReF does not agree with MINHAP’s classification of the requests for information submitted. Graph 22 displays the classification drawn up by AIReF for the answers received from the CI, showing that in 61% of cases MINHAP responded to AIReF's requests either with information that was not relevant to the request or refusing the request. The grounds given for the refusals or irrelevant answers are listed in graph 23, where, according to MINHAP, in 91% of cases the cause was AIReF's lack of competencies and/or the information requested was ancillary or not available. However, as shown in graph 24, the content of these requests was fully in line with AIReF's powers for the assessment of the three fiscal rules.

AIReF will commence publishing on its website the status of its requests for information submitted to the CI, as well as the classification given to the answers received depending on their content and their relevance to the request.

GRAPH 22: AIREF CLASSIFICATION OF ANSWERS RECEIVED FROM THE INFORMATION CENTRE



GRAPH 23: MINHAP CLASSIFICATION OF REQUESTS THAT ARE REFUSED OR ANSWERED WITH IRRELEVANT INFORMATION

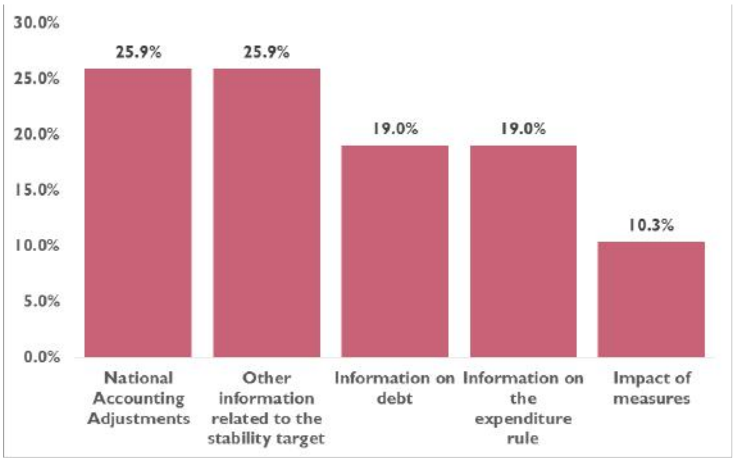


(*)

The requests qualified by MINHAP as surpassing the competences of AIReF are grounded on this institution's mandate to draft and issue the reports set forth in the provisions of the Organic Law on its creation and/or its Organic Statute.

The requests qualified by MINHAP as ancillary or unavailable information refer to data that, in general, are submitted by the various Public Administrations to MINHAP in compliance with their obligation to provide information, and are, therefore, available information and not ancillary data.

GRAPH 24: CONTENT OF REQUESTS CLASSIFIED BY MINHAP AS AIReF's lack of competencies and/or the information requested was ancillary or not available.



5. Recommendations

Stability target:

The stability programme features a new consolidation path for the General Government sector with regard to the objectives approved by the European Commission on 21 July 2013. The agreed deficit reduction path for Spain had set deficit targets of 2.8% of GDP for 2016, 1.4% for 2017 and 0.3% for 2018**.** The new consolidation path envisages a deficit of 3.6% for 2016, 2.9% for 2017, 2.2% for 2018 and 1.6% in 2019.

To reach the public deficit of 3.6% of GDP forecast in the SPU in 2016, a number of measures were implemented in April consisting, fundamentally, in adopting a non-availability agreement for Central Government credits totalling €2,000m and the announcement of non-availability agreements in several Autonomous Regions for €830m, together with non-implementations in the budget for 680 million euros. Nevertheless, in the case of the Autonomous Regions, these can only be considered measures whose impact is additional to that envisaged in the approved budgets totalling around €300m. AIReF finds the path fixed for 2016 demanding but feasible, with a deficit of 3.6% of GDP, provided that maximum rigour is exercised in the implementation of the accompanying measures, and it is guaranteed that each of the Public Administrations shall strictly apply the automatic prevention measures foreseen in the LOEPSF.

Additionally, the sustained reduction in Government deficit over the next two years requires the adoption of measures of a permanent nature that, a priori, are not guaranteed by adopting a non-availability agreement or yearly forecasts for non-implementation of expenditure. Supporting fiscal consolidation in this manner is necessary to comply with the SPU forecasts, according to which this deficit in 2017 would fall below 3% of GDP, which is the threshold set by EU legislation to exit the Excessive Deficit Procedure (EDP). In the Annexes to the SPU providing details of the impact of the principal measures on deficit, the expenditure adjustment stemming from the AND and non-implementations in subsequent years are consolidated. No details have been given of any measures or actions that would guarantee the consolidation of this expenditure adjustment once the effective period of the 2016 budget to which the AND or the non-implementation apply comes to an end. To be able to determine the possibility of consolidating the adjustment in subsequent years, it is essential for AIReF to have access to information on the expenditure lines the non-availability order in 2016 will apply to.

In this sense, AIReF will monitor the instrumentation of the AND and envisaged budget non-implementations and attach this data to the Report on the expected compliance with the 2016 General Government sector budget stability, Government debt and expenditure rule targets to be drawn up in July.

Similarly, ***AIReF recommends***:

1. Approval and implementation of the Non-Availability Agreements announced in the SPU in the terms envisaged in the LOEPSF in such a way that said Agreements:

- ✓ ***Provide details of the expenditure reduction measures and identify the appropriations affected.***
- ✓ ***Cannot be revoked during the year in which they were approved or until measures are adopted that guarantee compliance with the target set, nor lead to any increase in expenditure recorded in the auxiliary accounts.***
- ✓ ***Shall be implemented accompanied by strict monitoring of the budget modifications and development of the auxiliary accounts, especially Creditors for non-budgetary operations (409/413).***

2. Turning the non-implementations of regional government budget appropriations into non-availability agreements with the aim of giving them the effectiveness guarantees afforded by these agreements.

3. Reinforcing the preventive nature of the LOEPSF, each Public Administration guaranteeing the implementation of the automatic preventive measures provided for therein, which involve exhaustive monitoring of the implementation data and, if applicable, allow for expenditure adjustments to be performed to guarantee compliance with the stability target.

4. Details should be given of the measures adopted or that might be adopted to guarantee the consolidation of this adjustment in subsequent years and to take the deficit, as stated in the SPU forecasts, down to below the 3% of GDP threshold in 2017.

In any case, the magnitude of the consolidation to be implemented by the Autonomous Regions must take into account such aspects as the trend in Financing System resources, the incidence of non-recurrent operations registered in 2015 and the implicit containment in public expenditure to achieve the envisaged path. In this light, the establishment of a single path for all the Autonomous Regions poses a risk to compliance with the overall budget stability target, and an even greater risk to the expenditure rule, allowing in some of the Autonomous Regions the easing of the commitments and forecasts in their approved budgets; however, part of this effect may be offset through the incentive to make further cutbacks in Autonomous Regions whose year-end forecast is close to the new path.

Accordingly, ***AIReF recommends that:***

5. Paths be established for net lending or net borrowing, clearly differentiated by Autonomous Regions. A single, more flexible target for all Autonomous Regions might lead to easing of the commitments and forecasts in the budgets approved for eight Autonomous Regions (Andalusia, Asturias, Balearic Isles, Canary Isles, Galicia, Navarra, Basque Country and La Rioja). However, for the nine other regions this common target would require an effort that may be achievable for some but, to others, its materialisation poses risks, as seen in previous years.

The Social Security System presents financial tensions in the short and medium term that, up to the present, have been financed from the Reserve Fund. The deficit trend envisaged for this subsector makes the exhaustion of the Reserve Fund foreseeable in the next few years, and it is therefore deemed advisable, as AIReF has recommended repeatedly in previous reports, to anticipate events and analyse the financial situation of the system in the medium term and to adopt the necessary measures. The State General Budget for 2016 includes an additional provision that establishes that the Government will endeavour to progress toward obtaining compatibility between the budget stability and financial sustainability targets, and those of full funding for non-contributive and universal benefits borne by the General Government sector budgets, for which purpose it will assess the benefits included in the system whose conditions make them eligible for this consideration.[23] The report submitted in April 2016 by the Ministry of Employment and Social Security to the Toledo pact Commission on the development of the recommendations issued by the Toledo Pact may be taken as a starting point. This report presents the measures taken during the period 2011-2015, and analyses the fulfilment of the various recommendations given in the Report on the Assessment and Review of the Pact of Toledo, approved in Parliament in 2011.

AIReF recommends *once again* ***that:***

6. The necessary decisions be taken to guarantee the financial equilibrium of the Social Security System within the framework of the Toledo Pact Commission.

[23]Eighty-fifth Additional Provision to the State General Budget. Separation of the sources of funding for Social Security benefits.

Expenditure rule:

A consolidation effort sustained over time requires the correct implementation of the expenditure rule. For subsequent years, 2018 and 2019, and from a medium- and long-term perspective, it is fundamental that the expenditure rule is given the correct instrumentation, a circumstance that entails the need to express its implementation in concrete and clear terms. A number of interpretations of the expenditure rule have been issued recently by MINHAP that have made its implementation more flexible and, to some extent, distorted the intended purpose of this fiscal rule. These interpretations need to be revised and the methodological elements that are necessary for their planning, monitoring and compliance assessment should be clearly defined. Their proper implementation in subsequent years will allow for a consolidation effort sustained over time compatible with moderate growth in public consumption which would, nevertheless, entail smaller growth in economic activity.

AIReF recommends that:

> ***7. MINHAP revises its recent interpretation of the calculation of the expenditure rule in which any expenditure deviations generated each year are deferred for consolidation in the future. Likewise, the methodological elements that are necessary to plan and monitor the expenditure rule and to appraise compliance with it must be clearly defined***.

Government debt:

The debt trend forecast in the SPU does not allow compliance with Transitional Provision One of the LOEPSF. In accordance with this provision, in 2020, the level of Government debt is expected to reach 60% of GDP and, for this to occur, as the domestic economy reaches a real growth rate of at least 2% per year, the Government debt ratio should be reduced annually by at least 2% of GDP. However, it is forecast that the debt to GDP ratio will register a cumulative reduction for the entire period of 3.2 percentage points of GDP, to stand at a debt level of 96% of GDP in 2019. This path will not allow, on the one hand, the mentioned objective to be reached in the given timeframe (2020) owing to the distance to the target of 60% (36 GDP points still remaining at the close of 2019) and, on the other hand, the rate of adjustment is smaller than the required rate since, as the SPU forecasts a real GDP growth of 2.5% on average for the period 2016-2019, a reduction of at least 8% of GDP would have been necessary.

Accordingly, ***AIReF recommends once more that:***

> ***8. The appropriate legal mechanisms are used to extend the transitional period to comply with the limit established in Article 13 of the LOEPSF, adapting the requirements specified in the Transitional Provision One of said law, and defining a credible and demanding reference path for the sustained reduction of the debt ratio.***

Transparency: Information required for assessing fiscal regulations

With regard to transparency, the same recommendations are given as in previous reports on the need for the Stability Programme and the various Public Administrations' Budgets to include all the information required to assess compliance with the budget stability, debt and expenditure rule targets, in the terms set forth in ESA 2010, for proper assessment of compliance with fiscal regulations, as well as the adequacy of the commitments adopted by each of the Public Administrations.

Regarding transparency ***AIReF recommends that:***

9. The Stability Programme include:

- ✓ ***Budget projections in an inertial scenario excluding measures both for the General Government sector overall and for each one of its subsectors.***
- ✓ ***Budget projections that incorporate the measures to allow visibility on which part of the consolidation adjustment forecast would come from the adoption of measures.***
- ✓ ***Government debt targets distributed by subsectors.***
- ✓ ***Detailed information for the analysis of the expenditure rule for each one of the subsectors: eligible expenditure as well as the reference rates for the calculation of the expenditure rule for all the years covered in the Stability Programme Update.***
- ✓ ***More information on those risks, which if they were to materialise might affect budget stability or debt targets.***

To fulfil its functions according to the legislation governing budget stability and financial sustainability, AIReF needs to request economic-financial and budgetary information from the various Public Administrations. This exchange of information is carried out preferentially through the Information Centre dependent on MINHAP. It is stated in the SPU that 80% of AIReF’s requests for information were duly answered with information that needed to be compiled, and 20% with published information. However, AIReF upholds that only 30% of its requests were answered correctly, as on numerous occasions the information was not forthcoming on the grounds that it was *"ancillary information”* or that it *“exceeded the competencies of AIReF"*. In the interest of improving transparency, AIReF will commence publishing on its website the status of its requests for information submitted to the CI, as well as the classification given to the answers received depending on their content and their relevance to the request. It is paramount to make progress toward improving access to information and to provide AIReF with all the necessary information to assess, in terms of ESA 2010, the budget stability, Government debt and expenditure rule targets. In view of the above ***AIReF recommends that:***

10. ***All coordination efforts on behalf of MINHAP and AIReF are made to guarantee access to the necessary information for AIReF to fulfil its remit assigned by the LOEPSF and its implementing regulations.***