Report

25 April 2017

Report on the Government draft Budgets and main Budgetary lines: Draft State Budget 2017

(Article 17.1 of the organic law on fiscal stability and financial sustainability)

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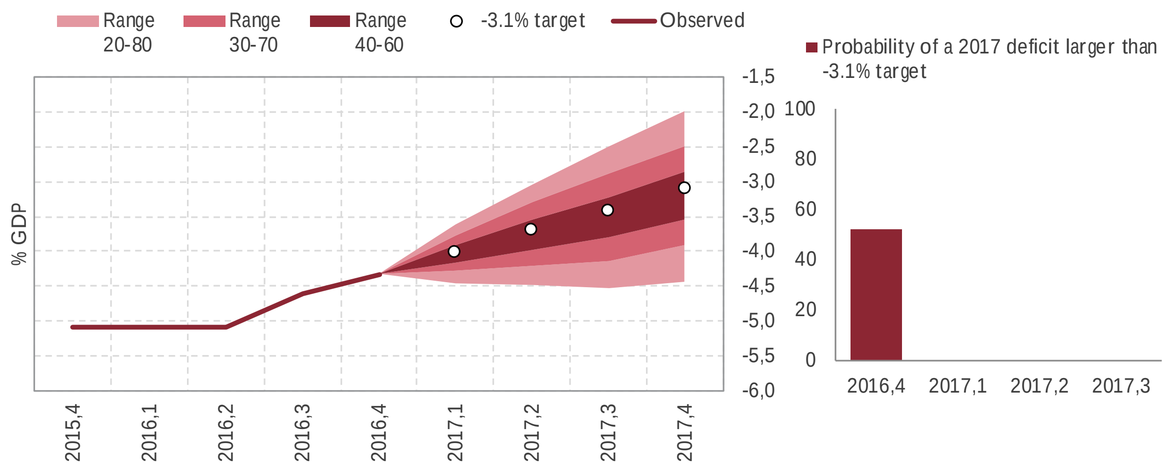
Executive summary

Once the Draft State Budget (PGE) has been presented to the Parliament, the AIReF issues its report on the level of compliance with the budget stability, Government debt and expenditure rule targets in the Central Government (CG) subsector and the Social Security Funds (SSF), providing the first assessment of compliance with the budget stability target throughout the General Government sector. As a consequence of the delay in presenting the PGE Draft, AIReF has not expressed a view before now on the likelihood the 2017 target, set at -3.1% of GDP, being met by the General Government sector. Having studied the information given in the PGE Draft 2017 for the Central Government and the Social Security Funds and having issued reports on the initial budgets in the Local Corporation (LC) and Autonomous Region (ARs) subsectors, AIReF deems it feasible for the budget stability target to be complied with throughout the General Government sector. Compliance with the target will be possible provided that the foreseeable consolidation of the surplus envisaged in the LC subsector is sufficient to offset deviations in the ARs and the SSF. In the case of ARs, AIReF observes no risk of deviation, mainly because the increase in financing system resources will enable an adjustment of the two tenths of a percentage point of GDP needed to reach the target set for 2017.

CHART A1. GENERAL GOVERNMENT SECTOR TOTAL: NET LENDING/BORROWING



Central Government

The assessment of the 2017 stability target was conditioned by the lack of information in the PGE Draft on cash-accrual adjustments, which allow the non-financial revenue and expenditure balance included therein to be reconciled with the deficit target defined in terms of the European System of National and Regional Accounts (ESA 2010). The organic law on Fiscal Stability and Financial Sustainability .establishes as mandatory that the various public administrations' budgets should include this information, which is essential for evaluating the budgets under the terms of ESA 2010. State non-financial revenue and expenditure, in budgetary terms, without cash-accrual adjustments, determine a deficit of -1.8% of GDP. Pending the determination of possible surpluses within the central government public entities, the cash-accrual adjustments that would render the state budget balance compatible with the target of -1.1% of GDP are around seven tenths of a percentage point of GDP, a considerably larger figure than those forecast in the PGE Drafts in previous years. The lack of information on cash-accrual adjustments, as well as entailing non-compliance with European regulations and with the organic law on Fiscal Stability and Financial Sustainability, significantly curtail the ability to express an opinion on the degree to which the PGE Draft is compliant with the deficit target set at 1.1% of GDP.

Despite the limited information on cash-accrual adjustments, AIReF has drawn up its own estimate of compliance with the -1.1% of GDP target, with which the CG is deemed unlikely to comply. Although the forecast for 2017, featuring a dynamic of growth and job creation, and the envisaged recovery in prices and salaries, ought to have a positive impact on tax revenue, this may be insufficient to guarantee the adjustment of 1.7[1] percentage points of GDP that is needed to comply with the target. Uncertainty is perceived once more over direct tax revenue. Revenue from Personal Income Tax will need to display a sustained recovery after a few years under the influence of numerous tax reforms. Moreover, Corporate Tax will be affected by the new measures, included in Royal Decree-Law 3/2016, which should deploy their full effects for the target foreseen in the PGE Draft to be achieved. Revenue from this tax will also be conditioned by larger returns associated to minimum instalments in 2016, that will have a negative impact this year. However, no uncertainty is observed over indirect tax revenues, and the growth in VAT foreseen in the PGE Draft is deemed feasible, owing to an upturn in private consumption and the property market, and to the effects of the normative measures taken.

Non-financial expenditure in 2017 will remain on a downward trend as a percentage of GDP, as a consequence of the reduction in financial expenses on debt and the moderate growth in some expenditure, considerably below the growth forecast by AIReF for nominal GDP (around 4.4%), which will make it possible for a large portion to be achieved of the adjustment needed to comply with the expenditure target. The Central Government will benefit from the reduced transfer to Employment Public Service (SEPE) (0.2% of GDP) that will offset the transfer by the same amount in terms of ESA 2010 to the Territorial Administrations. By contrast, it will be facing higher expenses such as pensions or its contribution to the European Union budget.

The PGE Draft does not include information on contingent liabilities or their possible effects in 2017, and therefore the trend in CG non-financial expenditure may turn out to be conditioned by the possible impact in 2017 of some of the financial liability procedures pending, such as the "health cent ruling" or that deriving from "toll roads". Should these or other risks materialise, linked to the bank restructuring process, the likelihood of meeting the stability target for 2017 will be further reduced.

Additionally, and regarding transparency, the PGE 2017 Draft should include information enabling the conduct of proper monitoring of the debt target and the expenditure rule for this subsector.

[1] Adjustment taking into account non-recurrent operations in 2016

No risk of non-compliance is observed for the expenditure rule or the debt target for 2017. However, in the debt analysis conducted by AIReF, Transitional Provision One of the organic law on Fiscal Stability and Financial Sustainability is not complied with, which determines that, in 2020, the level of public debt in the CG and the SSF will reach 44% of GDP, a limit that will not be reached until 2035 according to AIReF's estimates.

Social Security Funds

AIReF's forecasts for 2017 show a deficit similar to year-end 2016 (-1.6% of GDP), announcing risk of non-compliance with the budget stability target set at -1.4% of GDP. This deviation from the target will be caused mainly by growth in total revenue close to 2.5%, below the forecasts in the PGE 2017 Draft and below the nominal GDP growth forecast by AIReF. Despite vigorous growth in contributions, total revenue will be affected by smaller transfers received from the CG in order to balance the SEPE. The contributions included in the PGE Draft will grow, in national accounting terms, at a rate close to 6%, which is higher than the rate forecasted by AIReF. This growth is the result of an increase forecast in the number of affiliates, which may rise above 3%, an increase in the maximum contribution ceilings and floors, smaller reductions in the contributions by the unemployed and higher unemployment contribution rates in fix-term contracts than in other contract types. Regarding non-financial expenditure, these will continue to grow moderately in 2017, in line with forecasts in the PGE Draft. It is envisaged that pensions will grow at a rate in the region of 3% including a revaluation of 0.25%, while expenditure in unemployment benefits will continue to decrease, especially in the case of non-contributory benefits. This moderate growth in expenditure, jointly with growth in GDP, allows the downward trend to be maintained, in terms of GDP.

In these circumstances, AIReF deems it essential that the Central Government should guarantee compliance with the principle of transparency foreseen in the organic law on Fiscal Stability and Financial Sustainability and should rigorously apply this law to guarantee budgetary discipline. It is also necessary, both in the case of the Central Government and the Social Security Funds, that stronger monitoring mechanisms are established for budget implementation in order to anticipate any potential risk of non-compliance with the target. With this aim, the present report includes, among others, the following recommendations:

1. That the directives established in the organic law on Fiscal Stability and Financial Sustainability regarding transparency are complied with, and that the cash-accrual adjustments allowing the budgetary balance to be reconciled with net lending/borrowing in terms of ESA 2010 should be included in the 2017 Draft State Budget.

2. That control mechanisms should be set up for the CG by means of monthly monitoring conducted by the Ministry of Finance and Civil Service, to determine whether the trend in non-financial expenditure and the effect of the approved tax measures are sufficient to meet the target.

3. That an analysis should be made of the need to review the organic law on Fiscal Stability and Financial Sustainability in order to establish automatic corrective measures that are applicable to the Central Government in the event of non-compliance with its legal obligations.
4. That progress should be made in the actions already under way and the necessary decisions adopted to guarantee financial equilibrium in the Social Security System in the framework of the Toledo Pact Commission.
5. That the appropriate legal mechanisms should be used to extend the transitional period for complying with the limit established in article 13 of the organic law on Fiscal Stability and Financial Sustainability.
6. That information should be included in the PGE as necessary for evaluating the expenditure rule.

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1. Introduction

The Council of Ministers approved the General Draft State Budget on March 31st 2017, which was submitted to the Spanish Parliament on April 4th 2017. This six-month delay with regard to the normal calendar for presenting and processing the Draft State Budget (PGE Draft) has been linked to the process of Government formation. The current term commenced on July 19th 2016, when parliamentary chambers were constituted, but the Government was not formed until November 3rd 2016. This situation caused the 2016 Central Government and Social Security Fund budgets to be extended, and the process for the 2017 PGE Draft to be delayed.

Given the delay in processing the PGE 2017 Draft, the AIReF postponed issuing its Projects and Main Budgetary lines report and Public Administration budget on the General Government and Social Security Funds subsectors to the Central Government. The organic law on Budget Stability and Financial Sustainability establishes in article 17 that, by 15 October, AIReF will issue a Report on the stability, debt and expenditure rule targets in the project and General Government sector budget's main lines. The existence of a caretaker government up to the end of October 2016 and regional elections in Galicia and the Basque Country, have affected the process of drafting and submitting draft budgets in several administrations and, consequently, the AIReF schedule on issuing reports on the budget cycle. Thus, the report the main budgetary lines and draft budgets has been fragmented and issued exclusively to those administrations that presented their budget lines or drafts ARs[2] and LCs[3]. Concerning the Central Government and Social Security, AIReF deems it coherent to delay its report until the PGE 2017 Draft has been rolled out.

2. Aim and Scope

The aim of this report is to assess the PGE 2017 draft from the angle of compliance with the three fiscal rules defined in the organic law on Fiscal Stability and Financial Sustainability: budget stability, public debt and expenditure rule targets. The delay in processing the 2017 PGE Draft justifies issuing this report solely on the CG and the SSF.

The scope of this report is limited due to lacking information regarding:

1. **Information enabling the PGE Draft to be reconciled with the budget stability target in terms of national accounting.** The PGE 2017 Draft, unlike previous years' budgets, does not include information on cash-accrual adjustments, nor, therefore, on the CG's balance in terms of ESA 2010. This lack of information contravenes European regulations and article 27 of the organic law on Fiscal Stability and Financial

[2] On 14 February 2017 the Report on the main budgetary lines and projects for the ARs was published

[3] On 7 December 2016 the Report on the Projects and Main Budgetary Budgetary lines of LCs' budgets was published

Sustainability, causing considerable limitation in assessing the draft budget's likelihood of budget stability target compliance. The amount of cash-accrual adjustments allowing the State's non-financial revenue and expenditure to be compatible with the -1.1% expenditure target, without taking into account any potential surplus, would be 0.7% of GDP.

2. **Initial budget in national accounting terms of the CG and the SSF.** The aim of this report is to determine the existence of any potential risk of budget stability, Government debt, and expenditure rule target non-compliance, as per ESA 2010. The lack of an initial budget in terms of national accounting significantly affects the AIReF's year-end forecasts analysis of any potential budget deviations, as these cannot be compared to official data under revenue and expenditure.
   This circumstance has led to some lines being considered under budgeting terms, incorporating estimates for cash-accrual adjustments, based on the available information from foregoing years.
   The Central Government’s lack of budget information in terms of accounting is absolute whereas the SSF subsector and the Social Security Budget are presented with national accounting headings; however, these refer exclusively to the Social Security System’s Budget and do not include the SEPE or the Salary Guarantee Fund. National chart of accounts adjustments are also not included.
3. **The PGE 2017 Draft does not include information regarding adaptation to the expenditure rule, nor with the debt target by subsectors.** The PGE 2017 Draft makes no mention of the expenditure rule for the Central Government. No information is forthcoming on aspects of the expenditure rule in the initial budget or in the 2016 year-end accounting closure. Moreover, the PGE Draft solely mentions public debt target for the General Government sector is referred to, but no mention is made of compliance with the Central Government’s compliance with the debt target.

3. Budget Stability Target

The budget stability target for the General Government sector, set at -3.1% of GDP for 2017, requires an adjustment of 1.4 percentage points of GDP compared to the 2016-year end accounting closure. As a consequence of the delay in presenting the PGE draft, the AIReF had not expressed a view until now on the 2017 target, set at -3.1% of GDP, for the General Government sector. The General Government sector deficit in 2016 reached -4.5% of GDP (See Table 1 and Table 2). Compliance with the 2017 target entails a consolidation adjustment of 1.4 percentage points of GDP, discounting one-off operations in relation to the 2016-year end accounting closure. The Central Government is the subsector that needs to make the greatest effort adjustment.

TABLE 1. BUDGETARY STABILITY TARGET 2017

Net lending (+) Net borrowing (-) as % of GDP	2016 target	Close of 2016	Close of 2016 without one-off measures	2017 target
Central Administration	-2.2	-2.7	-2.8	-1.1
Social Security	-1.7	-1.6	-1.6	-1.4
Autonomous Regions	-0.7	-0.8	-0.7	-0.6
Local Entities	0.0	0.6	0.6	0.0
Total Public Administrations	-4.6	-4.5	-4.5	-3.1

TABLE 2. NON-RECURRENT OPERATIONS BY SUBSECTORS

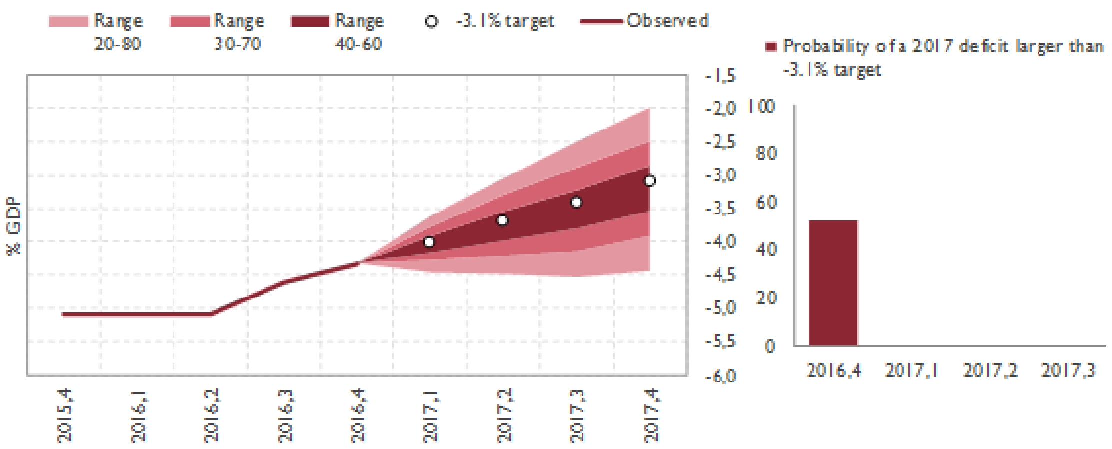
One-off operations	2016
Nominal balance	**-4.5**
Financial aid (AR)	-0.2
Payment in instalments (AR)	0.3
Non-recurring items (Regional Administrations)	-0.1
Balance adjusted for non-recurring operations	**-4.5**

The AIReF considers that compliance with the -3.1% of GDP target may be feasible, provided that the foreseeable deviation by the Central Government and, to a lesser extent, by the SSF, can be offset with the positive margin in Local Corporations. According to AIReF estimates, the main non-compliance risk with 2017 budget stability target concerns the Central Government, which needs to make an adjustment of 1.7 GDP percentage points in order to comply with the target. The SSF, will need to make a smaller adjustment of around 2 tenths of GDP, but there are some structural problems t which could affect deficit reduction. However, the foreseeable compliance by the Autonomous Region subsector and the consolidation of local corporation subsector surplus, may be enough to offset CG and SSF deviations. AIReF's forecast points to the possibility of maintaining the surplus reached in the LCs in 2016, mainly due to non-financial revenue in this subsector that appear to be stable and the continued downward trend of non-financial expenditure, resulting from the expenditure rule implementation which entails growth below the nominal GDP growth AIReF projection (hovering around 4.4%). AR subsector compliance is based on growth in non-financial revenue, stemming mainly from increase in financing system revenue (more than 5 billion), and the expected stability in non-financial expenditure as a percentage of GDP. In the following sections of this report, details are provided on the main risks linked to the Central Government's and SSF's deviation.

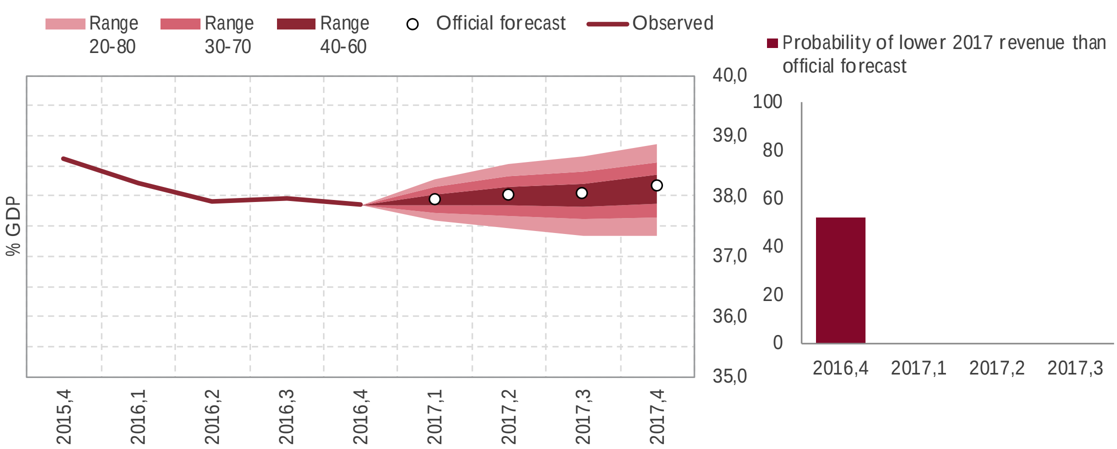
Growth in tax revenue, a decreasing financial burden on Government debt and a conservative expenditure policy will ease the adjustment, but this may not be enough to guarantee target compliance. The upturn in the economy and the adoption of tax measures, together with a reduction in non-financial expenditure deriving from a conservative public expenditure policy and compliance with the expenditure rule will allow part of the adjustment to be fulfilled. However, the CG's expected deviation, that will materialise with a greater impact should the adopted tax measures fail to deploy their full effect, may hinder the possibility of reaching the target in the entire General Government sector which, as shown in Chart 1, is set within the confidence range calculated by AIReF. The AIReF's forecasts assume that the tax measures adopted by the CG exert the foreseen impact and that significant deviations are not instigated by non-financial expenditure.

The comparison between expenditure and revenue foreseen in the 2017 Budgetary Plan Update for the General Government sector is neither uniform nor directly comparable with the budgets presented by the various subsectors. The official path for the General Government sector has been assumed to be the total expenditure and revenue foreseen in the 2017 Budgetary Plan Update submitted to the European Commission on December 2016.

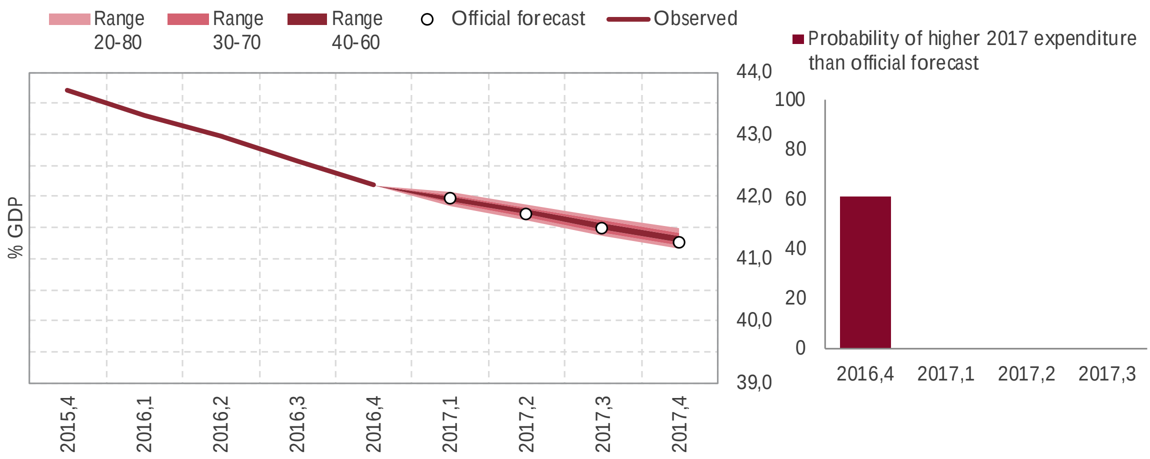
CHART 1. GENERAL GOVERNMENT SECTOR: NET LENDING/BORROWING



GENERAL GOVERNMENT SECTOR REVENUE



GENERAL GOVERNMENT SECTOR EXPENDITURE



In the following sections, an analysis of the macroeconomic environment and elements affecting CG and the SSF stability target compliance is provided.

3.1. Macroeconomic Setting

The rate of progress in the Spanish economy maintained its thrust in 2016 and is being consolidated in 2017. In 2016, the rate of growth was above 3% for the second consecutive year, reaching a GDP level close to the 2008 historic maximum level. The real 3.2% growth was supported by the positive contribution both of domestic demand (2.78 percentage points) and of the external demand (0.45 percentage points), unheard of since the beginning of the last economic cycle in 2000.

The positive data presented by short-term indicators so far this year point to maintaining a robust growth rate. The most recent short-term information, given in the real-time MIPred model forecast for the first quarter in 2017, signals quarterly growth at a rate of around 0.8% (See Chart 2).[4] The carry-over effect generated by the favourable data in the second semester of 2016 and the beginning of 2017 could be strong enough to support a real GDP growth of around 3% in 2017. Similarly, the degree of uncertainty over external demand appears to be limited, but may increase driven by the uncertain results of Great Britain's negotiations over Brexit and by the upcoming elections in several major economies in the European Union. Likewise, the manner in which the new US Administration's economic policies are designed adds certain risks related to a more restrictive monetary policy by the Federal Reserve, and protectionist policies that, if materialise, would be harmful to both the global and European economies.

[4] The MIPred model synthesises the most representative and recent short-term information on the Spanish economy (including judgement indicators, viewed as advanced). For further details of this model, see Cuevas, A., Pérez-Quirós, G. y Quilis, E. (2015). "Integrated model for short-term forecasting of the Spanish economy (MIPred model)," Working Paper 4/2015, AIReF.

Consensus expectations regarding developments in GDP and prices for 2017 have been revised in recent months (see Chart 2, Panel I).[5] Leading analysts' forecasts for GDP and employment (represented through FUNCAS consensus by the forecasting panel) have suffered upward revision, coming closer to AIReF's central forecasts (albeit remaining at the lower limit of the interval, as is the case for GDP), as shown in Panel I of Chart 2. As for contributions to growth, this continues to be driven by domestic demand, while external demand will continue to make a small positive contribution that will nevertheless be greater than estimated six months ago (See Chart 2, Panel II). Within the former, private consumption retains its relative strength based on intensive job generation and the improvement in the financial position of households thanks to the low interest rates and progressive debt reduction. These same factors are also expected to foster the recovery of investments in residential property, although a moderate growth rate, its envisaged growth having dropped over the last six months. The same is true for investment in equipment that, despite maintaining its expansionary tone for the remainder of the year, bolstered by low financing costs, has also revised its growth downward. Public consumption has been revised up slightly by the leading panelists, which would seem to reflect a mild impact of the favourable performance of the economy on the contribution by the General Government sector to GDP. Lastly, prices have undergone a significant upward revision. Inflation forecasts observed in the last quarter of last year have been a constant source of positive surprise, influenced mainly by the trend in forecasts for the energy component. Compensation per employee is developing within a context of moderate growth in labour costs.

In this context, the AIReF, on the basis of exogenous assumptions and defined policies, endorses the Government's macroeconomic forecast, underpinning the PGE 2017 Draft.[6] The AIReF deems the Government’s macroeconomic setting accompanying the 2017 Draft State Budget to be prudent overall. The hypotheses regarding growth among principal partners, the trend in oil prices, the cost of financing debt, and the exchange rate are deemed prudent, as these show a more unfavourable trend for these factors than assumed in more recent forecasts by international organisations and market assessments. In aggregate terms, upward risks are deemed to exist according to the official 2017 GDP growth forecast (2.5%), at the lower limit of the interval in the AIReF's forecasts and likewise showing a downward bias with respect to the latest experts' revisions.

The composition of growth in the Government's macroeconomic outlook is deemed likely, with domestic demand driving the economy jointly with a positive contribution from the external sector. As shown in Chart 2, among the components of the domestic demand, the private consumption envisaged by the Government maintains a high growth rate (above 3%), in line with a strong recovery in Employment and favourable monetary conditions. In turn, the trend in public consumption is viewed as feasible despite upward risks. In terms of capital creation, investment in construction has growth rates with a downward bias, both in comparison with the consensus forecasts and in relation to AIReF's

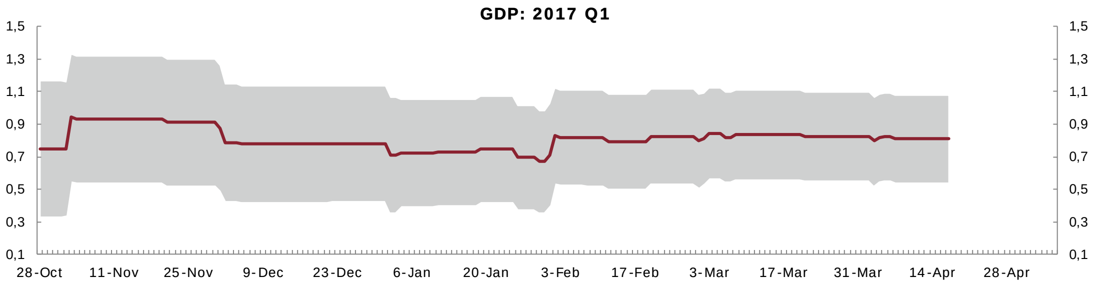
[5] The FUNCAS panel of forecasts for September 2016 is compared against that of March 2017.
[6] See the Report on the Macroeconomic Forecasts in the PGE 2017 Draft

models. The External Sector contribution is also considered to be likely, as it stands on moderately positive ground and is in line with AIReF's internal forecasts.

The dynamism forecast for 2017 in terms of growth and job creation, as well as the envisaged recovery in prices and salaries, ought to have a positive impact on tax revenue. As for Personal Income Tax and social contributions, a positive turn in salaries is expected to lead to larger bases, which the case for the Personal Income Tax that would be reinforced by fiscal drag given the progressiveness of this tax. The foreseeable improvement in corporate revenue would also contribute to higher corporate tax revenue. With regard to indirect taxes, it is envisaged that a rise in nominal household expenditure will affect VAT revenue, and that the recovery in the housing market will contribute to increased revenue from the tax on property transfers.

The assessment of the revenue forecasts in the PGE Draft is done taking into account the improvement in base levels, deriving from the macroeconomic scenario, and likewise taking into consideration the uncertainty that persists over the effects of the range of measures taken in the last two years and those impacts that will be felt in 2017.

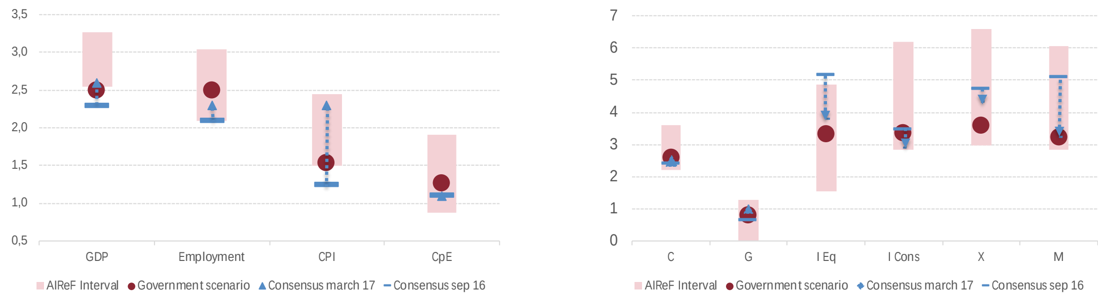
CHART 2. REAL-TIME TREND IN THE 2017 Q1 GDP FORECAST (QUARTERLY RATE AS %)



Source: AIReF

CHART 3 MACROECONOMIC SCENARIO FOR 2017
CONSENSUS FORECASTS BY THE FUNCAS PANEL, GOVERNMENT AND AND AIREF INTERVALS (% OF ANNUAL GROWTH)

PANEL 1. GDP, EMPLOYMENT AND PRICES **PANEL II. COMPONENTS OF DEMAND**



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

3.2. Central Government

The PGE 2017 Draft does not include information enabling the budget balance to be reconciled with the national accounting target. European regulations establish the obligation for budgets to include sufficient information to enable the budget data with the balance in terms of ESA 2010. In the same vein, article 27 of the organic law on Fiscal Stability and Financial Sustainability sets forth that each Public Administration's budget should be accompanied by the necessary information to match the balance of budget income and expenditure with the lending or borrowing requirement calculated according to the rules of the European System of Domestic and Regional Accounts. In previous years, this information was submitted in the Economic and Financial Report in the yellow series of the State Budget.

The absence of information that allows the budget balance to be reconciled with the target in terms of national accounting makes it impossible ascertain whether the PGE 2017 Draft submitted complies the -1.1% of GDP target. The information included in the 2017 PGE Draft refers solely to the -3.1% of GDP target for the General Government sector, but makes no mention of the Central Government's target. This lack of information hinders target compliance analysis in terms of the ESA 2010. Table 3 shows the reconciliation of the budget balance of the State with the national accounting included in the PGE drafts from 2013 to 2016. Likewise, on the basis of the non-financial revenue and expenditure forecast in the PGE 2017 Draft, the cash-accrual adjustments are estimated that would be compatible with reaching the target of -1.1% of GDP, pending the incorporation of possible surpluses. As shown in Table 3, the cash-accrual adjustments that would allow the budget balance to be compatible with the target in terms of national accounting, are greater than envisaged in the PGE Drafts of previous years. This difference may be partially due to the fact that, this year, the negative adjustment, deriving from deferring the settlements for the ARs and LCs has created a small effect (0.4% of GDP). No information is available to determine which operations correspond to the adjustments in national accounting that guarantee target compliance.

TABLE 3. EQUIVALENCE BETWEEN THE BUDGET BALANCE OF THE STATE AND THE NATIONAL ACCOUNTING BALANCE AS PERCENTAGE OF GDP IN 2013/2017

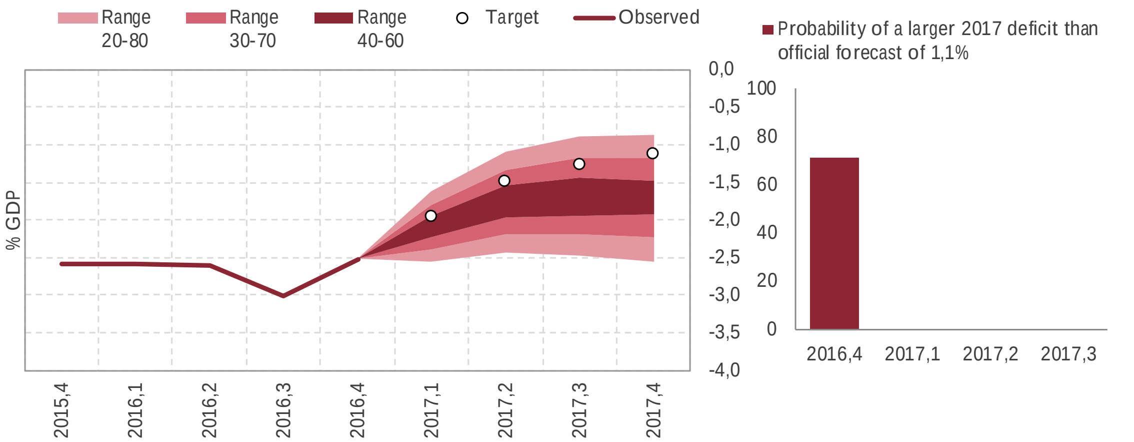
	2013	2014	2015	2016	2017
Non-financial revenue	11.7	12.2	12.2	11.8	11.5
Non-financial expenditure	15.3	15.7	14.8	13.8	13.3
Budget's non-financial surplus (+) or deficit (-)	-3.6	-3.5	-2.6	-2.0	-1.8
Cash-Accrual Adjustments	-0.2	-0.2	-0.3	-0.2	0.7
Net borrowing (+) Net lending (-)	**-3.8**	**-3.7**	**-2.9**	**-2.2**	**-1.1**

The PGE Draft does not include net lending/borrowing for the CG Bodies. In addition to the lack of information on cash-accrual adjustments, the PGE Draft likewise provides no information on the CG public entities that do not have public entity status, such as the Deposit Guarantee Fund, but which are classed as per ESA 2010 within the CG subsector.

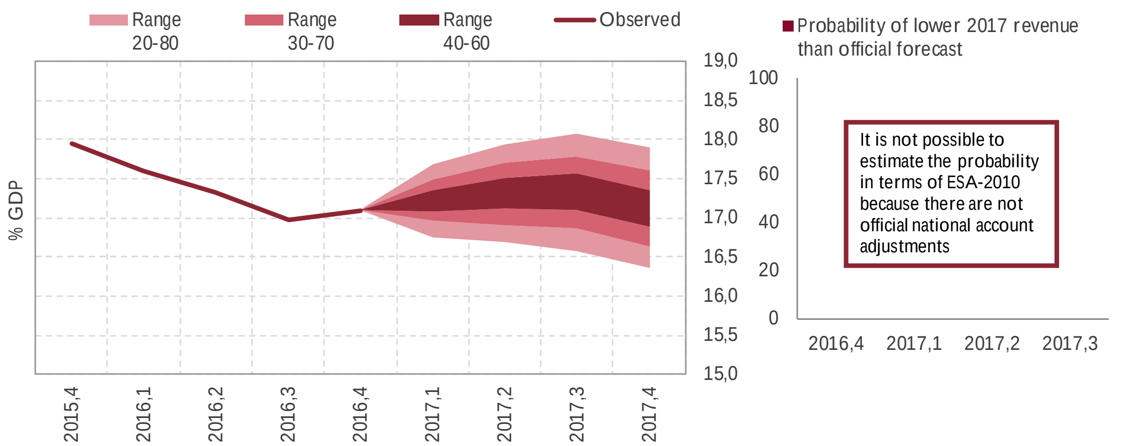
To meet the 2017 target of -1.1% of GDP, the CG needs to make an adjustment of 1.7 percentage points of GDP. The deviation produced at 2016-year end accounting closure, mainly as a consequence of developments in tax revenue, makes necessary to adjust the deficit in 1.7 percentage points in order to comply with the target. This adjustment has been calculated discounting non-recurrent operations (mainly financial aid and higher revenue from increased corporate tax payments) (See Table 2).

With the information available, AIReF deems compliance with the 2017 target of -1.1% of GDP difficult to achieve, mainly due to the uncertainty over revenue from direct taxes and an adjustment in expenditure that may turn out to be insufficient to guarantee compliance. Despite the shortcomings to the information with regard to national accounting, the AIReF has estimated the likelihood of compliance with the target in terms of ESA- 2010, finding risk of non-compliance. As described in the next section, the main uncertainties are associated with revenue in 2017 from direct taxes, that may be aggravated should the tax measures adopted fail to deploy their full effects. Similarly, some pressure may be felt in non-financial expenditure deriving from the real consolidation of the measures adopted in 2016, which have led to the need to re-programme expenditure initially foreseen for 2016 to 2017 or later, which may generate some tension over the capacity to address new commitments this year. As shown in Chart 4, target compliance is unlikely for the CG, with risk centred on possible deviations in revenue and in the decreasing trend in non-lending expenditure being insufficient to guarantee adjustment.

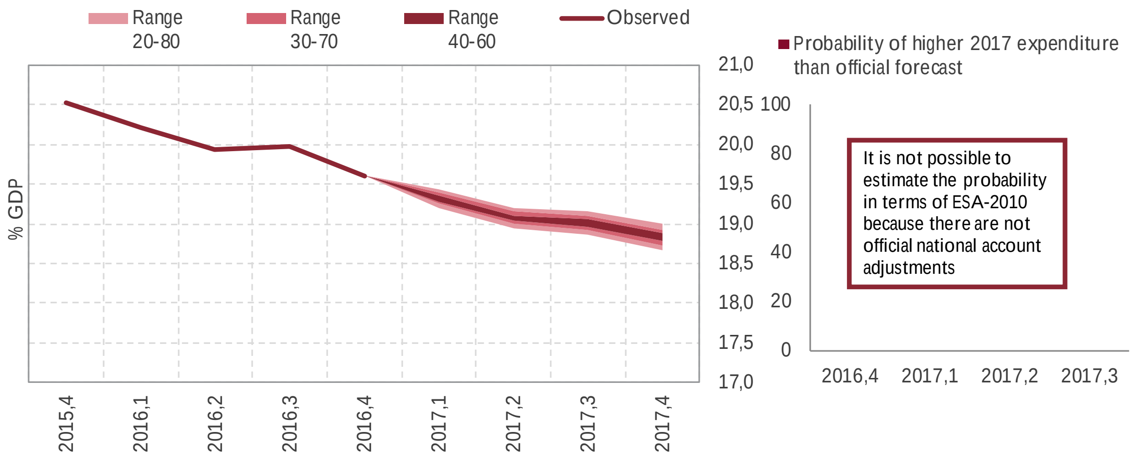
CHART 4 FINANCING NEED/CAPACITY OF THE CENTRAL GOVERNMENT



CENTRAL ADMINISTRATION REVENUE



CENTRAL GOVERNMENT EXPENDITURE



Non-Financial Revenue Forecast

The 2016 total tax revenue collected registered a significant deviation from the initial budget due to smaller direct tax revenue. Personal Income Tax showed a deviation of 3 tenths of a percentage point with respect to the budget, as a consequence of a fiscal reform impact greater than initially envisaged (the 2017 draft budget forecasts an impact of 1.5 tenths of a percentage point which, was eventually set at 4.5 tenths of a percentage point of GDP). In the case of corporate tax, a similar deviation was produced for multiple reasons: on the one hand, the 2015- year end accounting closure corporate tax rate was below forecast levels causing the budget figure for 2016 to be hard to reach. Other elements in this tax such as amortisations, negative tax basis and other fiscal credits prevented revenue from increasing as envisaged. If the fact that for this tax normative measures increasing revenue by 3 tenths of a percentage point were to be taken into account, the deviation would be much more significant.

Indirect taxes, unaffected by normative changes, have yielded revenues in 2016 that are more in line with the budget targets and economic development. VAT displayed dynamic behaviour as a consequence of the growth in household consumption expenditure and closed off with slightly above forecast levels. Excise taxes, however, maintained a certain apathy but did not suffer significant deviation.

The PGE 2017 Draft forecasts an increase in total tax revenue before transfers of 7.9% with respect to 2016-year end accounting closure. This increase is based mainly on the dynamism shown in the main macroeconomic variables, as well as on the effects of the normative measures approved by Royal Decree-Law 3/2016 (these measures are described in Box 1 below. Tax revenues that ultimately correspond to the State increased by 7.2%, as a result of lending system effects.

Uncertainty in 2017 is once again associated to direct taxes revenue. In 2017, the effects of the fiscal reform applied over the last two years will be exhausted, but both income tax and corporate tax will continue to be subject to considerable uncertainty, especially corporate tax. On the one hand, revenue from Personal Income Tax will need to display a sustained recovery after a few years under the influence of numerous tax reforms. On the other hand, corporate tax will continue under the effect of numerous normative changes: greater returns associated to minimum instalments will negatively impact revenue, the new measures included in RDL 3/2016 will increase revenue.

BOX 1. Normative measures with impact in 2017

In December the government announced, in the 2017 budgetary plan update, revenue measures with a foreseen impact of 6.5 tenths of a percentage point of GDP (around €7,500m) for this year. Most of these measures, estimated at around 5.5 tenths of a percentage point of GDP (about €6,300m), were approved in December 2016 by RDL 3/2016 and are currently in force. Among the aforementioned measures figure the following:

1) **Measures relative to Corporate Tax**. The package for Corporate Tax, with a foreseen impact of around 4 tenths of GDP, (around €4700m), includes three measures:

a) Limits to Negative Tax Bases and to Deductions for Double Taxation. Compensation for negative tax bases is limited to 25% and 50%, depending on corporate turnover, for periods beginning on January 1st 2016. This measure had formerly been in force until 2015. In addition, a new limit is set for the applicability of deductions for double taxation generated or pending compensation, set at 50% of the total liability. The Government has provided information on the impact of this measure, estimated at €2,220m.

b) Reversal of Impairment Losses. Up until 2012, impairment losses were tax deductible from participation in Shareholders' Equity. As of 2013, these are no longer tax deductible, but impairment endowed up to that year remained (law 16/2013). Effective as of 2016, it is mandatory to revert, within a 5-year time limit, the stock of allowances endowed until 2012. The Government has quantified this measure at €2000m for 2017.

c) Restrictions on Tax Deductibility of Losses Deriving from Shareholders' Equity Transfers. The law on corporate tax envisaged, provided that certain requirements were met and with the aim of avoiding double taxation, tax exemption of both dividends and positive income deriving from the transfer of securities representative of Shareholders' Equity of resident and non-resident institutions. Given this regulation modification, exemption is extended to encompass losses deriving from the transfer of said securities. This measure was established for tax periods commencing in 2017.

Most of the Corporate Tax measures foreseen for 2017 will affect the tax liability for 2016, to be settled in July 2017. Therefore, this element generates some uncertainty over the final scope of the measures.

2) **Measures Regarding Excise Taxes on Alcohol and Tobacco**. These measures aim to modify the tax rates with a rather limited impact on revenue (€150m). Their quantification is similar to that calculated by the AIReF.

3) **Deferral Measures.** These are estimated at almost 1.5 tenths of a percentage point of GDP (€1500m). These limit the deferral granted for certain taxes, especially outstanding VAT debts. This measure came into force on January 1st 2017 and has had an impact of €445m in the first two months of this year.

Moreover, the AIReF has not taken into account part of the measures envisaged in the package announced in the Budgetary Plan as they have not yet been approved. The impact of these measures is around 1 tenth of a percentage point of GDP (€1200m). Among the most noteworthy are the publication of a list of debtors, amounting to some €150m; the new system for immediate provision of information on VAT (around €350m); the new tax on carbonated beverages (some €200m); and the package of environmental measures, the latter not specified by the Government and amount to €500m.

According to the General Draft State Budget, revenue from Personal Income Tax before transfers will grow by 7.7% in 2017, whereas AIREF believes that growth may be more moderate, in agreement with the forecast growth in income tax bases. The AIReF foresees an increase in Personal Income Tax revenue in 2017, after several years of sluggish growth, favoured by higher labour income and the end of fiscal reform impact. According to AIReF, however, macroeconomic variables in both wages and employment, are not expected to generate such vigorous growth as that envisaged in the Budget. As shown in Chart 5, monthly Personal Income Tax revenue up to the month of February, as cumulative percentage of GDP, follows a similar trend to the preceding months. This flat trend is expected to continue to year-end, situating the target[7] out of the confidence ranges and making compliance very unlikely.

According to the draft budget, corporate tax will grow by 12.6% in 2017 driven by the increase in business income and by the new measures included in the Royal Decree-Law 3/2016. Meanwhile, the AIReF forecasts that revenue may grow at a slightly higher rate if the normative measures deploy their full effects. According to AIReF's forecasts, Corporate Tax will follow a dynamic trend owing to greater corporate benefits, possibly reaching figures slightly higher than those given in the PGE draft, provided that the normative measures in RDL 3/2016 and the returns associated to minimum payment in relation to Corporate Tax follow the envisaged pattern. Therefore, one should bear in mind that the normative elements reintroduce uncertainty to this tax. Should the measures deploy their full effects, the AIReF deems that it is feasible that the figure foreseen in the Budget will be met. Corporate tax, in the first few months of the year, is performing at rates similar to those of late 2016 but no instalments have yet been received, the first being due in April. An upward trend is expected for the coming months, with a slight drop during the months of August and September associated with the smaller quota for 2017 that will be affected by returns on minimum instalments. At year end, with the October and December instalments, this trend is expected to fall in the central range of the confidence interval, as shown in Chart 5.

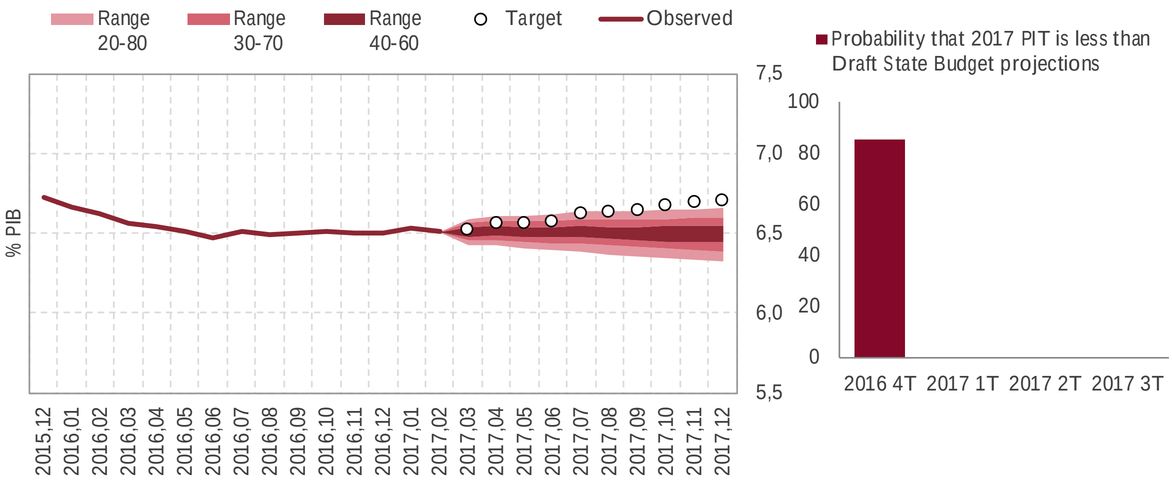
According to the PGE Draft, better conditions in private consumption and the housing market as well as the effects of normative measures will generate growth of 7.3% in VAT, which is similar to the rate forecast by AIReF. AIReF foresees greater growth in VAT than in 2016, driven by higher nominal growth in private consumption and the upturn in the construction sector, that may even surpass the Government forecasts. However, this tax poses some uncertainty with respect to the certain normative measures for deferrals. To date, VAT revenue, according to the revenue report by AEAT on February 4th 2017, amounted to €445m, which makes reaching the estimated impact of €1300m feasible. Therefore, AIReF forecasts a continuing upward trend for this tax for the remainder of the year. Also, that the Government target will be set on the central path of the confidence range interval, and that reaching the PGE 2017 Draft forecasts will be feasible, as shown in Chart 5.

[7] Since there is no target in terms of National Accounts, AIReF has used its own estimate starting from Budgetary Accounting figures.

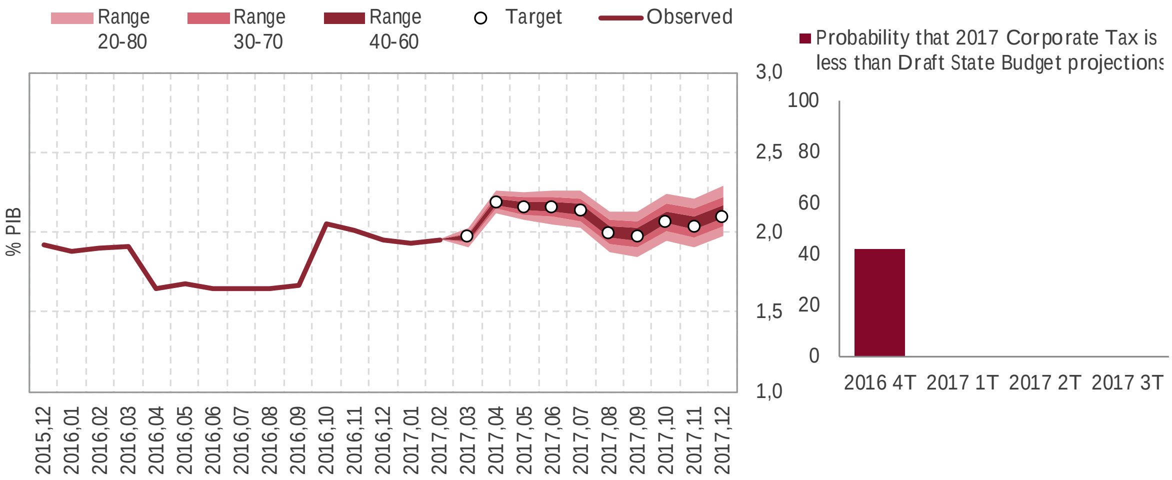
Regarding Excise Taxes, the PGE 2017 Draft forecasts 4.6% growth, which is higher than that of previous years, due to an upturn in the Tax on Hydrocarbons and Tobacco; the AIReF's estimates, however, envisage more moderate growth as consumption is expected to be slightly lower. The AIReF forecasts higher growth in Excise Taxes this year than in 2016 but lower than the level forecast in the Budget, as consumption in the main taxes, namely, hydrocarbons and tobacco products are expected to be lower. Therein, the AIReF deems Budget forecasts to be unlikely.

CHART 5. CASH TAXES BEFORE TRANSFERS

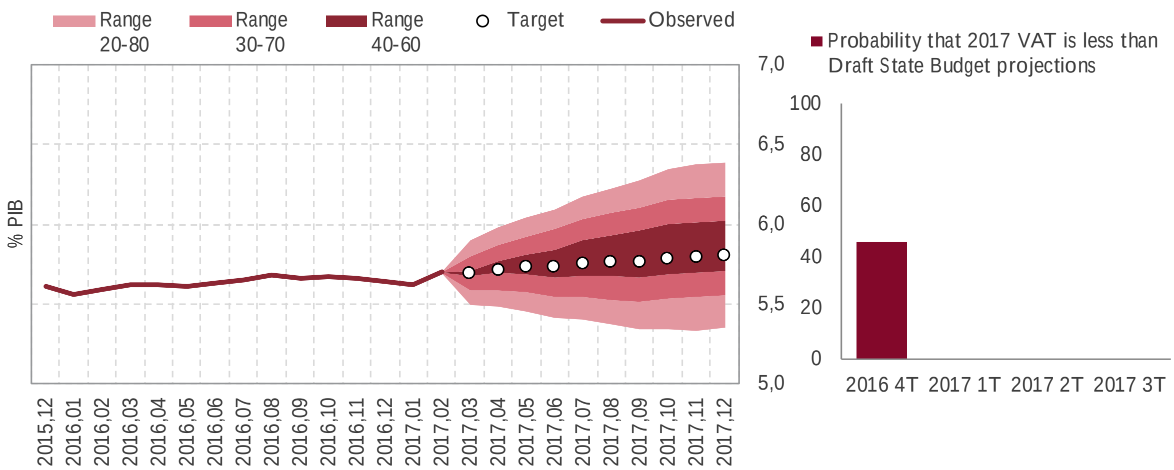
PERSONAL INCOME TAX



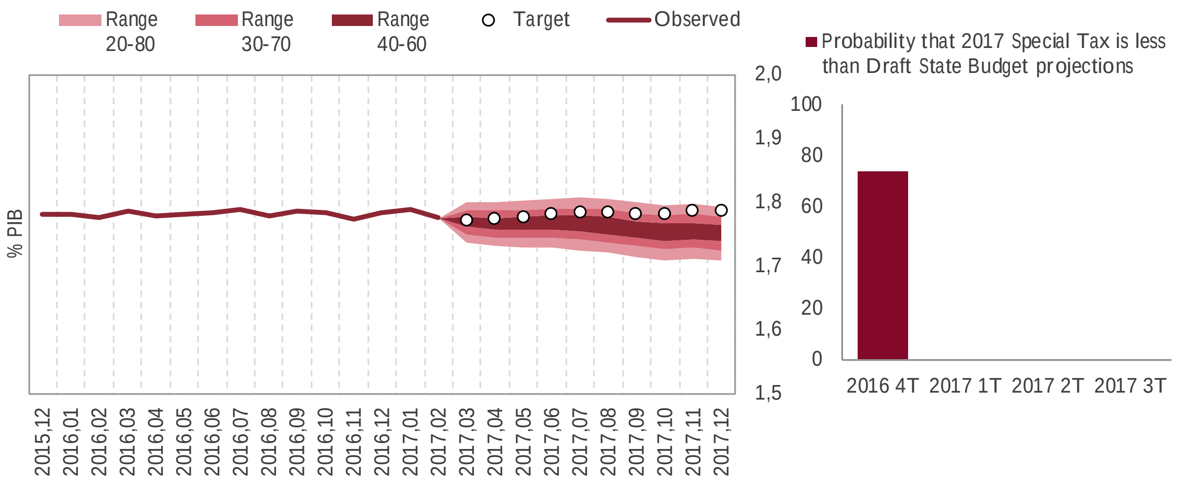
CORPORATE TAX



VALUE ADDED TAX



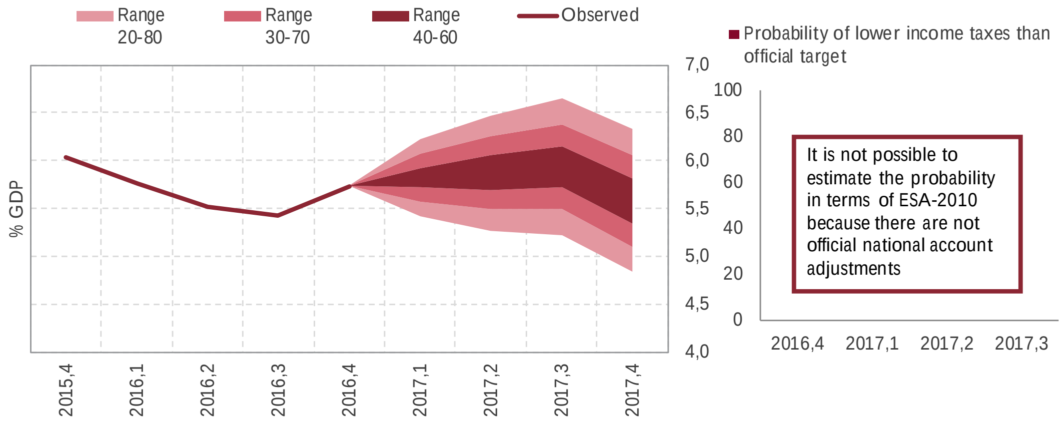
EXCISE DUTIES



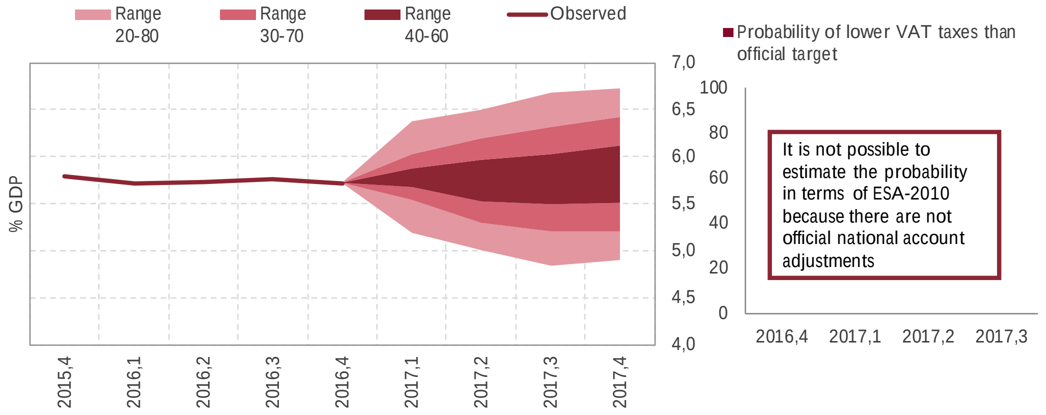
In terms of national accounting and the Central Government, the AIReF has drafted its forecast taking into account the adjustments made in previous years as the Budget does not include information enabling budget data to be reconciled with national accounting data. National accounting, the Central Government personal income tax, corporate tax and non-resident income tax are comprised under a single income tax heading. The forecast revenue from these taxes comply with the accrual principle taking the adjustments made in previous years and discounting the corresponding Personal Income Tax transfers to territorial entities. In this manner the confidence ranges for AIReF's central forecast are achieved. Similarly, both VAT and taxes placed on products have also been adapted to the national accounting criteria to build the confidence range intervals shown in Chart 6.

CHART 6. TAXES IN TERMS OF NATIONAL ACCOUNTING

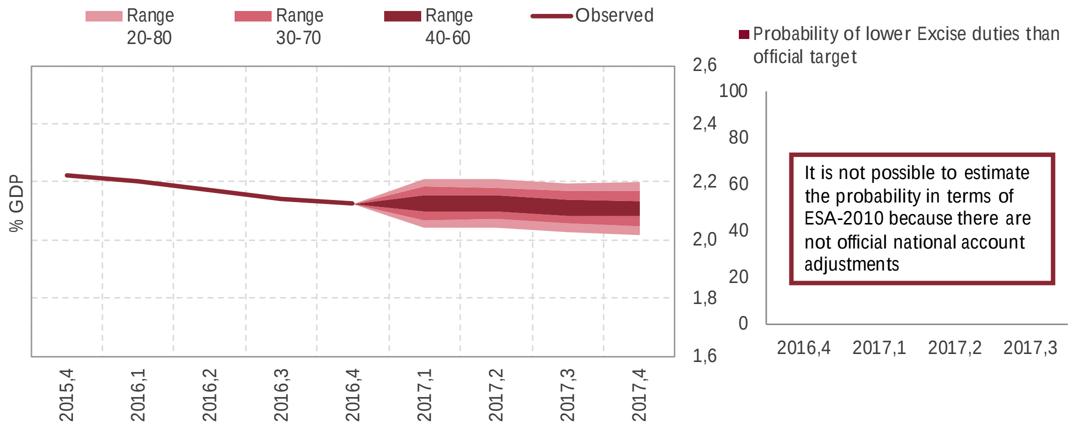
INCOME TAX



VAT



TAX ON PRODUCTS



The most significant variations in non-tax revenue foreseen by AIReF are:

- ✓ An increase is envisaged in interest received as a consequence of the new lending conditions for the Funds delivered to the Territorial Administrations through the Autonomous Regions.
- ✓ Revenue from Bank of Spain and ENAIRE dividends is expected to drop slightly.
- ✓ Transfers received from the Autonomous Regions will not suffer significant variation.
- ✓ Other capital revenue will increase considerably for two reasons. Firstly, a slight reduction is expected in uncertain collection, associated with the new measure limiting tax deferrals. Secondly, an increase is envisaged under the heading for aid to investment, as increased revenue is foreseen from the EU, which at the 2016-year end accounting closure was lower than expected.

Non-Financial Expenditure Forecasts

Non-financial expenditure in 2016 was affected by the adjustment measures adopted in 2016, whose impact was close to 0.3% of GDP. In 2016, in order to guarantee budget stability target compliance, the CG adopted a Non-Availability Agreement and approved bringing forward a closure order to the month of July. These two measures mainly affected intermediate consumption, subsidies, gross capital formation and investment aid. The overall impact of these measures on the mentioned items amounted to around 0.3% of GDP.

To meet the target set in the PGE 2017 Draft an adjustment of over one and a half percentage points of GDP is required. This adjustment, according to the Budget Draft, is based on:

- ✓ A favourable trend in tax revenue, partly motivated by the effects of the tax measures regulated in the Royal Decree Law 3/2016.
- ✓ A reduction in the interest burden on the initial budget for 2016.
- ✓ A smaller transfer from the CG to the SEPE.
- ✓ An adjustment in the appropriations in the PGE implemented in 2016.

According to the AIReF's forecasts, non-financial expenditure for 2017 follow the downward trend as a percentage of GDP initiated in previous years, thus contributing significantly toward achieving the necessary adjustment to reach the target. Due to the shortage of information on cash-accrual adjustments, non-financial expenditure have been analysed by adapting expenditure in the PGE Draft to the national accounting headings, based on the budget information and the estimates drafted by AIReF. State non-financial expenditure forecast in the PGE 2017 Draft, without taking into account special programmes for defence, increased by 1.1% with respect to year-end 2016 in budgetary terms. This growth in State non-financial expenditure, despite being moderate, entails reaching a slightly higher level of real implementation in 2016. This increase is due to the fact that, despite the Ministries' available appropriations reflecting the consolidation of savings produced in 2016, other budget lines (mainly the contribution to the EU budget and pensioners) grow in 2017. Nevertheless, as shown in Chart 4, the moderation in expenditure with variations below the growth forecast by AIReF at around 4.4% of nominal GDP, implies that non-financial expenditure will maintain the downward trend of recent years, contributing significantly to the required adjustment.

Appropriations for investment in the PGE Draft incorporate, for the first time, appropriations to meet the payments for the special defence programs that have already caused an impact on deficit in previous years. The PGE 2017 Draft includes among its initial appropriations of €1,818m to meet commitments to pay for special armament programs with no impact on deficit in the present year as these are deliveries made in previous years. For the purposes of public deficit, their impact is not felt at the time of payment, but rather at the time of transferring ownership of the goods (delivery). To date, the PGE did not include appropriations for special defence programmes in the initial budget, any extraordinary appropriation was processed during the year with no impact on deficit.

The AIReF, in its first report on the PGE 2015 Draft, gave warning of this situation pointing to the convenience of "the aim of enhancing transparency and offering a true image of the investments made by the Ministry of Defence, to incorporate the appropriations for special programs in the PGE". The PGE 2017 Draft includes the recommendations made and incorporates these appropriations in the initial budget. The limitation to non-financial expenditure approved on December 2nd 2016 for €118,337m did not envisage their incorporation.

Pensioners will experience a growth of 3.5% in line with AIReF's estimates. Pensioners and the contribution to the European Union are two of the expenditure items expected to grow in 2017. The estimated growth in expenditure on pensioners in the PGE 2017 Draft (3.5%) is in line with the AIReF's estimates. The contribution to the EU budget presents growth on a cash accounting basis of 16%, as the appropriation for 2016 is affected by the refunds due this year. The AIReF avails of no information on which to determine growth in the contribution to the EU budget in homogeneous terms.

Employee compensation includes a 1% increment in the salary of public employees. Despite public employees' retribution having been increased by 1%, the employee compensation heading will decrease with respect to the 2016-year end accounting closure as a result of the impact in 2016 due to the return of 50% of the 2012 extra month's salary. This return will not affect 2017.

The smaller financial burden on debt will contribute to reducing the deficit in 2017. The AIReF's estimates forecast a reduction in interest expenditure of about 0.2% of GDP that will contribute to making the necessary adjustment to comply with the target in 2017. However, State interest included in the PGE Draft, in terms of ESA 2010 and on a cash accounting basis, involves a smaller adjustment, in the region of 0.1% of GDP.

Transfers between Public Administrations in terms of ESA 2010 remain at practically 2016 levels allowing an adjustment of around 0.4% of GDP to be made. Under the heading for transfers among public administrations are the transfers by the CG to other subsectors: SSF, ARs and LCs. The 2017 PGE presents a significant adjustment deriving from smaller transfers made by the CG to SEPE (0.2% of GDP) and the virtual freezing in budgetary terms of the transfers from the ARs and the LCs. However, in ESA 2010 terms, transfers among public administrations remain practically at 2016 levels as a consequence of including a 0.2% of GDP increase in the system of financing that is not reflected in the budget. This circumstance, together with the forecast growth in GDP, allows an adjustment of 0.4% of GDP to be made.

In the report on the PGE 2016 Draft, a table was included showing the impact of the ARs' lending system on the Central Government Administration Budget. In Table 4, according to the same methodology, shows the impact on the budget and in terms of national accounting of ARs' revenue increase of 0.5% of GDP.

TABLE 4 EQUIVALENCE BUDGET-NATIONAL ACCOUNTING

Increase in Financing for Autonomous Regions from Financing System	Variation 2016-2017 (Millions €)
EXPENDITURE BUDGET. Transfers from Central State Administration to Autonomous Regions	296
REVENUE BUDGET. Transfers to Central State Administration from Autonomous Regions	1,771
NOT REFLECTED IN GENERAL STATE BUDGET	3,319
- transfer of income tax, VAT and special taxes	6,992
- non-budgetary advances	-3,673
Total increase in financing	**5,386**

Non-financial expenditure could be affected by the existence of obligations unforeseen in the General State Budget. Previous reports issued by the AIReF already mentioned the risk deriving from having to address the financial responsibility of the State over the Special tax on retail sales of certain fuels (IVMDH), known as the "healthcare cent", deriving from the 2016 Supreme Court ruling. In the PGE 2017 Draft no budgetary endowment is foreseen for this obligation which may give rise to some additional tension should this payment be necessary this year. Similarly, information should be provided on the possible impact deriving from the financial responsibility over toll road concessionaires that the CG may need to assume during 2017. Information on the above and other possible contingencies has been requested from the Ministry of Finance and Civil Service but at the time of writing this report was not forthcoming.

To conduct proper monitoring of risks, it is essential to render greater transparency on the potential obligations and risks the Central Government may have to overcome. The General State Budget does not include information on potential responsibilities the General Government sector may need to face deriving from rulings, information relating to Private-Public Associations, or other types of risks that may affect Public Administrations' budget stability and financial sustainability targets arising, for instance, from non-performing loans. This information is likewise not included in the monthly information on implementation data for the various Public Administrations.

The PGE 2017 Draft includes no information regarding the possible impact in 2017 of operations relative to the recovery and transformation of the financial sector. In the economic and financial report, no detailed information is included on the possible impact in 2017 of the actions taken in the framework of the realignment operations in the banking system, which affect mainly the central government entities (through the FROB or the Deposit Guarantee Fund).

3.3. Social Security Funds

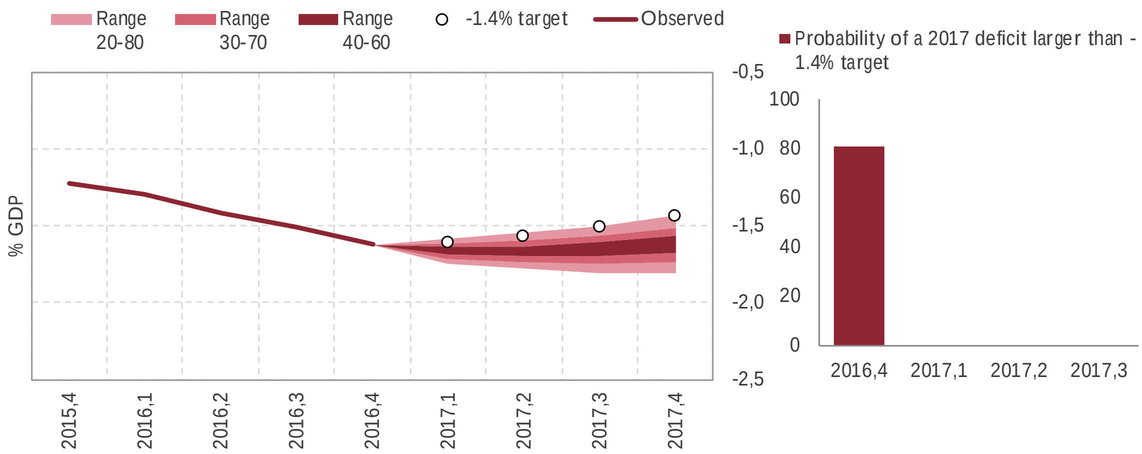
The PGE 2017 Draft forecasts a deficit of 1.4% of GDP for the Social Security Funds (SSF) and AIReF deems unlikely to comply with it if additional measures are not adopted. The AIReF's forecasts for 2017 show a deficit similar to that of 2016 (see Chart 7). The SSF reached year-end 2016 with a deficit of 1.6% of GDP, thus complying with the 1.7% target established in the Council of Minsters' Agreement of December 2016, rather than the target in the PGE 2016, the latter envisaging a deficit of 0.3%.

Total revenue will register a growth of 2.5% according to AIReF's forecasts, below nominal GDP growth and below forecasts in the PGE 2017[8]. Despite strong growth in contributions, the smaller transfers received by SEPE from the CG explain the growth in SSF revenue. The 2017 PGE envisages contributions growing at 6.8% in the Social Security System and at 3.5% in SEPE. However, AIReF's estimates forecast Social Security contributions with the growth rate of 4.5% and those for the Public State Employment Service (SEPE) at 5%. This increase is explained by the increasing number of affiliates, which may be greater than 3%, the increase in the maximum and minimum contributions and the smaller reduction in contributions by unemployed workers. Higher growth in contributions to the SEPE than in those to the Social Security is due, in part, to reductions that affect the latter and to the higher unemployment contribution rate stated in fixed-term contracts than in other contract types.

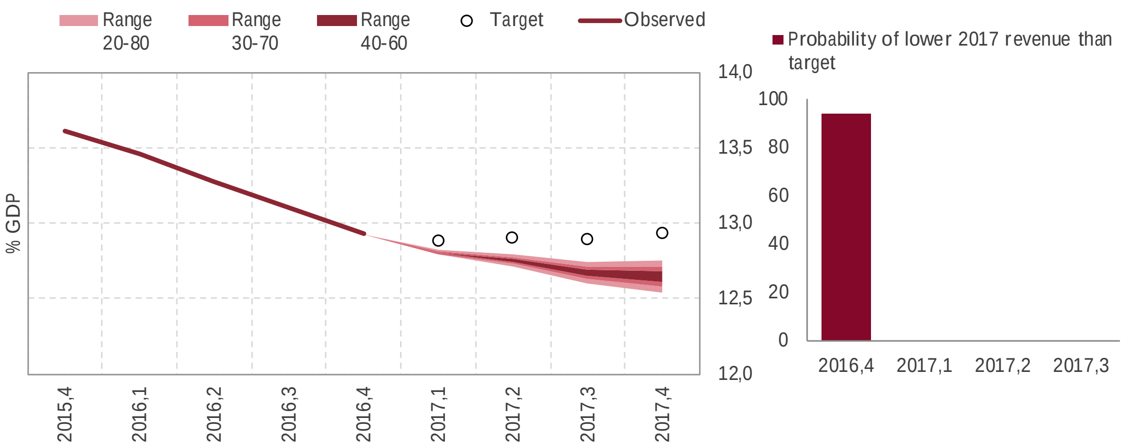
Non-financial expenditure will continue to grow moderately in 2017, in line with forecasts in the PGE Draft. It is envisaged that pensions will grow at a rate around 3% including a revaluation of 0.25%, while expenditure in unemployment benefits will continue to decrease, especially in the case of non-contributory benefits. A progressive recovery is expected in the coverage rate that in March 2017 stood above the 2016 rate. This moderate growth in expenditure, jointly with growth in GDP, allows the downward trend to be maintained, in terms of GDP, as shown in Chart 7.

[8] In terms of national accounting, the PGE for the FSS consists of an estimate conducted by AIReF from budget data provided by the Social Security System, the Public State Employment Service and the Salary Guarantee Fund. The Social Security IEF (Financial and Economical Report) provides a budget for the System in national accounting terms but does not apply the criteria that are appropriate for this accounting system.

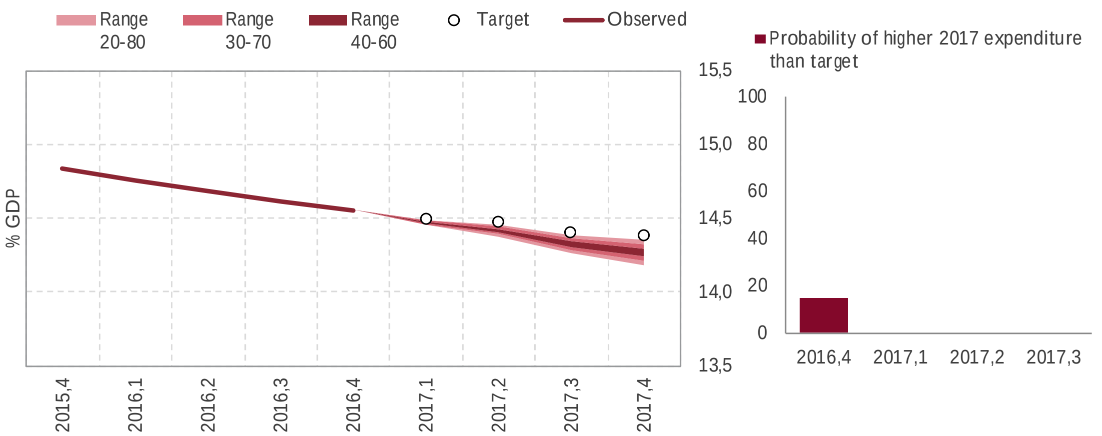
CHART 7 SOCIAL SECURITY FUNDS NET LENDING/BORROWING



SSF REVENUE



SSF EXPENDITURE



Analysis performed by Agents

Social Security System

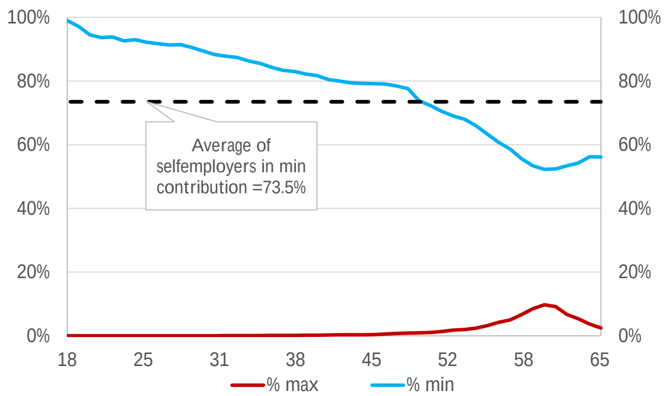
The Social Security System will reach a deficit in 2017 similar to that of 2016. Growth in employment; the increase in the contribution basis; the small impact in 2017 of the implementation of reductions approved in the form of a flat rate for new open-ended contracts; and a minimum exemption from contribution of the initial €500 of the contribution base, will affect revenue from contributions in 2017. The AIReF forecasts that growth will reach approximately 4.5% rather than the 6.8% envisaged in the PGE 2017. Expenditure in pensions will continue to grow by 3% in 2017, owing to the 1% growth in the number of pensions, a substitution effect of 1.8% and a revaluation of 0.25% of GDP.

Employee contributions will grow slightly above while contributions by unemployed workers will decrease more moderately. In contrast with the 2.9% growth in employment registered in 2016, moderate growth is forecasted for 2017, reaching approximately 2.6%. This effect will partly be offset by the measures adopted to increase the maximum contribution base (3%) and the minimum base (8%, except in the Social Security Scheme for self-employed workers which will increase by 3%). Cumulative contributions by employed workers from January to February 2017 have grown by 4.6%, compared to 3% in the same period in 2016. Contributions by unemployed workers have decreased at a more moderate rate, dropping by 4.8% in February in contrast to 9.7% in the same period in 2016.

BOX 2. Increase in the Minimum Contribution Base under the RETA

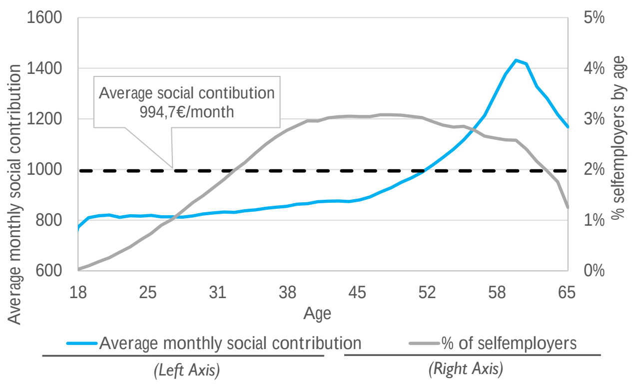
Affiliates and other special regime for self-employed workers (RETA) may choose their contribution base from the maximum and minimum basis established each year up to 47 years of age. From the age of 48, a maximum ceiling is established for contributions, depending on the worker's previous contribution base. In the PGE 2017 Draft the maximum and minimum contribution bases are increased by 3%. This table shows the distribution of workers on the minimum RETA base.

Using the MCVL (Continuous Professional Life Sample) for 2015 the contribution percentage by self-employed workers is estimated to fall between the maximum and minimum bases. To this end, the monthly contributions by each affiliate to RETA during the period 2013-2015 were calculated, raising the observed value of the contribution given in the MCVL as a function of the number of days per month of affiliation. With this exercise, for the period analysed, it was identified that 73.5% of self-employed workers contribute on the minimum base, while only 1.9% do so on the maximum base. The figure below displays the development in the percentage of self-employed workers contributing on maximum or minimum bases depending on their age (2013-2015):



The results show that during the period 2013-2015, the majority of affiliates to RETA contributes at the minimum base while at a young age, and that as they become older this percentage diminishes and reaches its lowest point at the age of 60 years, when more than 50% of self-employed workers reach this minimum value. As of the age of 48, the number of self-employed workers on the minimum contribution base is clearly seen to decrease at a steeper rate. As for the maximum bases, hardly any workers under the age of 48 contribute at this rate; over this age, the percentage at the maximum base increases peaking at 60 years and falling off after this age.

Analysing the average contributions to RETA for the period 2013-2015, the basis is seen to stagnate at a value close to €850 per month up to the age of 45, with a considerable increase over the subsequent years peaking at 60 years with average monthly contributions of €1,430. The figure below shows the revolution in monthly contribution bases according to age and the percentage of affiliates to RETA by age (2013-2015):



To finance the deficit in the Social Security System the PGE 2017 Draft envisages using part of the Reserve Fund (€7300m) and the granting of a loan[9] by the CG (€10,192m) free from interest and with a cancellation date within a maximum of 10 years from 2018. The Reserve Fund had accumulated €15,020m by December 2016. Similarly, the PGE 2017 Draft raises the 3% again on the disposal of assets for 2017 and 2018[10].

Revenue from Reserve Fund returns will be smaller than those in 2016 and CG transfers will increase slightly. The progressive exhaustion of the reserve fund assets is reflected in smaller revenue from interest on the SSF, which explain the contraction in equity income. Regarding transfers received from the CG, the PGE 2017 forecasts assume an increase of 1.1% which entails a reduction in the weight of GDP for this budget line.

Expenditure in pensions will continue to grow at close to 3%, below the envisaged growth in GDP. Pensions continue to grow at around 3%, with growth in contributory pensions forecast by AIReF to reach 2.9% whereas non-contributory pensions will remain practically stable with growth forecast at 0.3%. The average age for new pensioners has been 64 years in 2016, very similar to the average in 2015 and below the legal age[11]. In the period 2013-2016 the percentage of early pensioners increased with regard to the total number of new pensions, mainly due to an increase in partial retirement pensions. The maternity compliment recognised from 1 January 2016 for new pensions for women with two or more children is estimated to cost approximately €150m in 2017.

The Social Security System Budget include, for the first time, information on the calculation of the Pension Revaluation Index (IRP). The Social Security's Economic and Financial Report comprises a new section on pension revaluation in which detailed data is given for income, trends in the number of pensions, the effect of substitution for each of the years during the period of 2011 to 2017, and forecasts for average growth in these variables for the period of 2017 to 2022. Noteworthy in this data is the forecast for a slowdown in revenue (from 5.7% in 2017 to 3.6% in the period 2017-2022) and in expenditure (envisaged to drop from 3.4% in 2017 to 2.5% in 2017-22). In this section, the MEYSS uses the consolidated and non-aggregate revenue and expenditure data as established in the General Social Security Act.

At all events, the AIReF will issue an Opinion on the values calculated by MEYSS to determine the IRP applicable to 2017. The AIReF included in its recommendations the advantages of publishing the necessary data series for calculating the IRP, integrating the latter in the PGE, and assessing revenue and expenditure in consolidated, on non-aggregate terms, in order to avoid undervaluing the last component in the formula. The mentioned section complies with Additional Provision One of Act 23/2013 with a large part of the recommendations made by the AIReF.

The results of applying the formula as per the data provided by MEYSS is -2.96% which falls within the 0.25% limit. It should be highlighted that the greater transparency

[9] Ninth Additional Provision in the PGE 2017. State loans to the General Treasury for Social Security.
[10] 107th Additional Provision in the PGE. Exceptional regime for using Social Security Reserve Fund assets.
[11] In 2016, 65 years and four months for working lifetimes of less than 36 years, and 65 years of age for working lifetimes of more than 36 years.

gained by publishing the results of the formula before applying the limitations, as this measures the effort that would be required to balance the system and contribute to raising the general awareness of the magnitude of the challenge of financing the pension system within the context of an ageing population.

Temporary incapacity benefits are expected to maintain a growth rate similar to that of employment. A levelling-out in temporary incapacity benefit expenditure is forecasted, with moderate the strong growth registered in 2014, 2015 and 2016 during which expenditure has grown by about 10%. The forecasts in the PGE are in line with AIReF's forecasts.

As of 2017, the paternity benefit extension will come into force, allowing up to 4 weeks. The paternity leave extension was approved in 2007 with a transitional period for its implementation until 2013. However, putting it into force was postponed year after year until it coming into force in 2017. An expenditure increase is foreseen to reach about €200m.

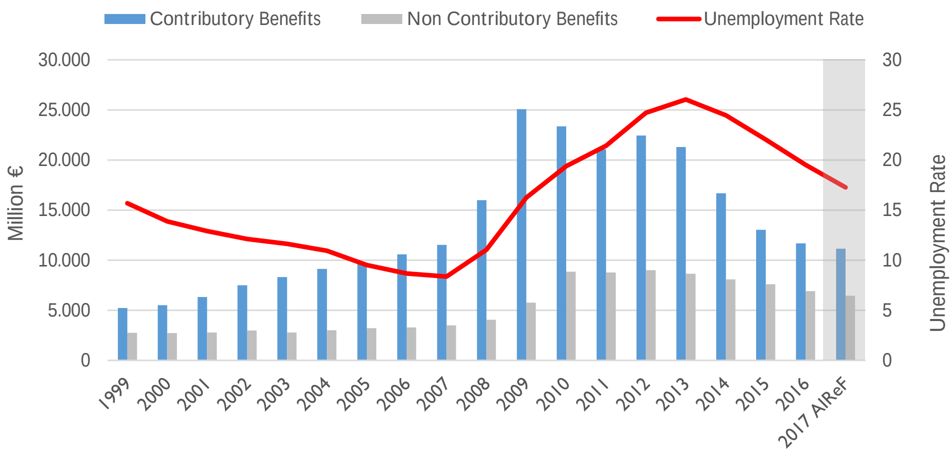
Public State Employment Service (SEPE) and Salary Guarantee Fund (FOGASA)

The state public employment service could present a slight surplus in 2017 compared to the balance foreseen in the PGE 2017 Draft. The envisaged surplus is the consequence of greater contributions and smaller expenditure in benefits than foreseen in the PGE 2017. Expenditure continues to decrease in unemployment benefits and envisaged reduction for 2017 of more than 5%, more pronounced in non-contributory benefits than in contributory benefits. According to the AIReF's forecasts, the weight of GDP in the above expenditure will reach pre-crisis levels in 2017.

AIReF's forecast for SEPE social contributions in 2017 hovers around 5%, which is above the 3.5%. PGE forecast. Unemployment contributions collected by SEPE are expected to grow at a higher rate than those collected by the Social Security System, mainly due to the impact on the latter of the reductions ensuing from the flat rates and the minimum exempt contribution base and also by the contract type applied to the new employment, the unemployment contribution rate being higher in fixed-term contracts than in open-ended contracts.

Unemployment benefits continue to be reduced albeit at a lower pace than in recent years. Expenditure in contributory benefits is diminishing, reaching 2007 levels, while expenditure in non-contributory benefits has almost doubled the 2007 figure.

CHART 8 UNEMPLOYMENT BENEFITS



Transfers from the CG to SEPE reduced by 0.2 percentage points of GDP. Improved contributions and reduced expenditure in benefits are reflected in the smaller contributions by the CG to SEPE. Likewise, as in 2016, revenue from contributions to SEPE will be greater than expenditure in unemployment benefits.

Regarding FOGASA, the deficit in 2017 will be smaller than that of 2016. Expenditure in benefits will remain at present levels while contributions will grow at a faster rate than in 2016, maintaining by the end of 2017, which represents a smaller deficit than in 2016.

4. Government Debt

Debt targets for 2017 were fixed by Agreement of the Cabinet of Ministers (ACM) on December 2nd 2016, both for the General Government sector (99% of GDP) and for the various subsectors, as shown in Table 4.

TABLE 5. DEBT TARGETS (Excessive Debt Protocol as % of GDP)

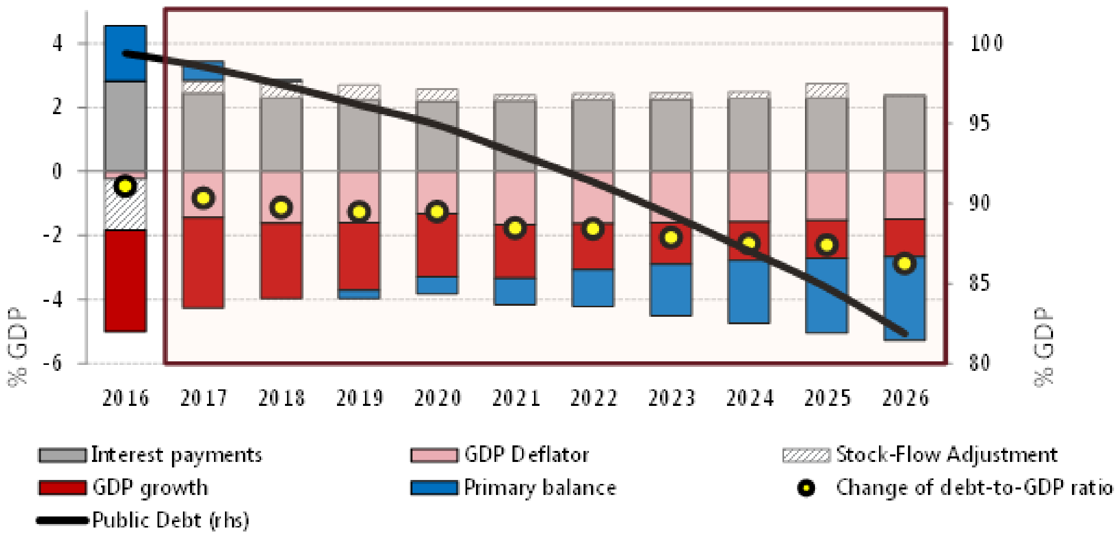
	2017	2018	2019
Central Administration & Social Security	72	71.3	70
Autonomous Regions	24.1	23.6	22.7
Local Entities	2.9	2.8	2.7
Total Public Administrations	**99**	**97.7**	**95.4**

The debt-to-GDP ratio for the General Government sector dropped four tenths of a percentage point in 2016 to reach the 99.4% target, although in nominal terms, public indebtedness has reached a new historic annual peak and, as both employment and the growth rate of real GDP exceeded 2%, the legal requirement of a reduction of at least 2 percentage points of the debt-to-GDP ratio has not been met.

As pointed out by the AIReF in previous reports, Government debt analysis should not be limited to the risk of debt target non-compliance for the year in progress, but should have a medium-term horizon. Regarding Government debt, looking beyond the situation in 2017, it is essential to conduct a sustainability analysis within the convergence framework with the limits established in Article 13 and Transitional Provision One of the organic law on Fiscal Stability and Financial Sustainability.

The sustainability analysis of the Government debt path for the General Government sector, despite showing a sustainable profile in the medium and long term, implies Transitional Provision One non-compliance of the organic law on Fiscal Stability and Financial Sustainability. Transitional Provision one of the organic law on Fiscal Stability and Financial Sustainability sets a tr ansitional period until 2020 to achieve the debt limit of 60% of GDP, demanding a debt reduction of at least two percentage points, if real GDP or employment grow in excess of 2%. Chart 9 shows the trend in the data observed for qualifying outstanding debt as a percentage of GDP for the General Government sector, as well as the AIReF's forecast for 2017 and its outlook on a central scenario until 2027 and the main determinants thereof. According to the dynamic observed in this trend, the limit envisaged in Article 13 of the organic law on Fiscal Stability and Financial Sustainability would not be reached until the year 2036.

CHART 9 CENTRAL PROJECTION OF DEBT AND CONTRIBUTIONS IN THE GENERAL GOVERNMENT SECTOR (% GDP)



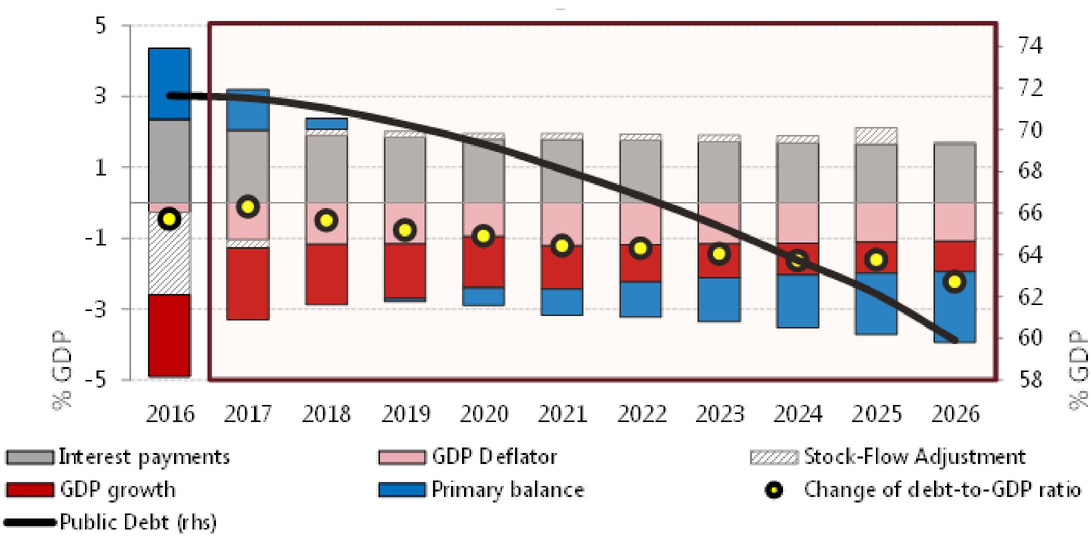
Source: Bank of Spain and AIReF

The AIReF's 2017 central forecast regarding the CG and the SSF is 71.5% of GDP, short of the target set at 72% of GDP. The debt target for this subsector has remained stable throughout 2016 and 2017 at 72% of GDP. In 2016, the consolidated sum of the CG and the SSF reached a debt ratio of 71.6% of GDP, four tenths of a percentage point below the figure for 2015 and falling short of the 72% target.

In 2017, the increase in indebtedness needs is estimated taking into account the foreseen CG deficit; the proportion corresponding to additional financing mechanisms for the Territorial Administrations (TA); other stock-flow adjustment operations; and the SSF deficit that will be partly funded from the Reserve Fund by means of a loan from the Treasury of €10,192m, free of interest and refundable over a period of 10 years from 2018 onward.

The sustainability analysis of the CG and SSF Government debt path also shows a sustainable profile in the mid-term and long-term but, once again, non-compliance with Transitional Provision One of the organic law on Fiscal Stability and Financial Sustainability. The reference level established in the Transitional Provision One of the organic law on Fiscal Stability and Financial Sustainability to be reached in 2020 for the consolidated CG and SSF subsector is situated at around 44% of GDP. Focussing debt trend as a percentage of GDP estimated by the AIReF on a central scenario, the limit foreseen in article 13 of the organic law on Fiscal Stability and Financial Sustainability would not be attained until 2035.

CHART 10. CENTRAL PROJECTION OF DEBT AND CONTRIBUTIONS CG AND SSF (% GDP)



5. The Central Government's Expenditure Rule

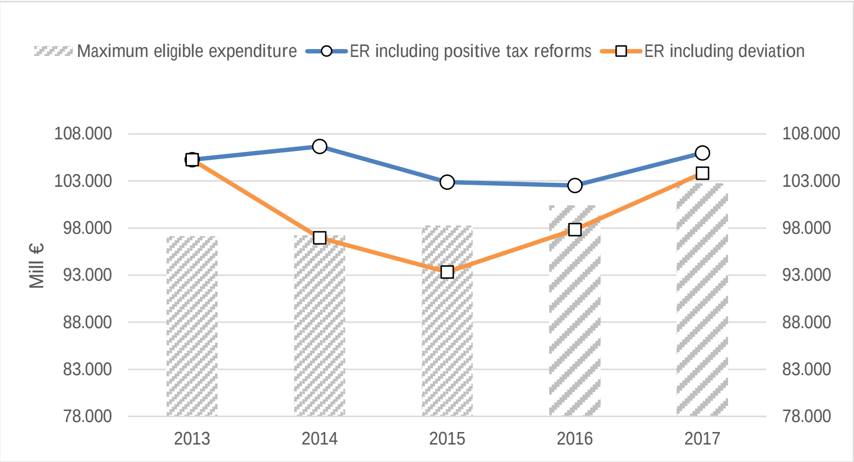
The PGE 2017 Draft includes no information relative to compliance with the expenditure rule. The PGE 2017 Draft does not include information relative to the components that affect the expenditure rule, nor does it refer to its possible compliance in 2017. The difficulty involved in the analysis to be conducted by AIReF is aggravated this year by the lack of the cash-accrual adjustments that allow non-financial expenses to be reconciled with expenditure in terms of ESA 2010. Additionally, the eligible expenditure for the purpose of the eligible expenditure is affected by the impact of normative changes on revenue. The CG is the subsector in which normative changes are producing the greatest impact on compliance with the expenditure rule. It is necessary for the PGE to include, in addition to the information on non-financial expenditure in terms of ESA 2010, an estimation of the normative impacts on the eligible expenditure for the purpose of compliance with the expenditure rule with details of the measures adopted.

The AIReF estimates have determined that, despite the positive impact of the and the early closure order, the CG failed to comply with the expenditure rule in 2016. Estimates by AIReF for the components of eligible expenditure that have not been published to date (impact of normative changes and other excluded expenditure lines) suggest CG non-compliance with the expenditure rule in 2016. The main causes of non-compliance are:

- ✓ The impact in 2016 from the normative changes causing a permanent decrease in revenue and that are the result of the fiscal reform on Personal Income Tax and corporate tax. According to data provided by AEAT, this impact amounts to 0.6% of GDP in 2016 on a cash accounting basis. In addition, the increased revenue linked to instalment payments is taken into account, although these could be transitory in nature if they finally remain in force until the deficit falls below 3% of GDP.
- ✓ The significant reduction in EU co-financing of investment in 2016 (close to 0.1% of GDP).
- ✓ The level of eligible expenditure in 2015 had benefited from this reduction of 0.1% of GDP as a consequence of charging revenue deriving from the "radio-electric spectrum" as a lesser non-financial use in this financial year.

No risk of CG expenditure rule is perceived, set at 2.1% growth in eligible expenditure for 2017. The CG has adopted normative measures that could lead to a permanent increase in revenue, and that may foreseeably contribute to compliance with the expenditure rule for this year. Additionally, the expenditure forecast in the PGE presents increases that are compatible with the reference rate envisaged for 2017. There may be some tension, however, in compliance with the expenditure rule in the event that the normative changes were not to have the envisaged impact on revenue, or in the event that some of the risks mentioned in the section of non-financial expenditure were to arise.

CHART 11. ELIGIBLE EXPENDITURE AND COMPLIANCE WITH THE EXPENDITURE RULE ARs



Source: 2013-2015 Report on compliance with the IGAE targets and 2017 estimates by AIReF

6. Recommendations

6.1. Budget Stability

Central Government

AIReF's remit includes alerting of possible risks of non-compliance with budget stability, public debt and expenditure rule targets set in terms of the European System of national and regional Accounting (ESA 2010). To fulfil this duty, and owing to the lack of initial budgets drafted as per national accounting headings, it is necessary to reconcile the balance resulting from revenue and expenditure in the Budget with net lending and borrowing calculated as per ESA 2010.

Until this year, the General State Budget included in the Economic and Financial Report on the cash-accrual adjustments that facilitated the above mentioned conciliation, compliant with the guidelines established in the European Regulation and the organic law on Budget Stability and Financial Sustainability (organic law on Fiscal Stability and Financial Sustainability). Nevertheless, the PGE 2017 Draft does not include any information relative to the cash-accrual adjustments. Neither does it provide net lending/borrowing by Central Government Bodies, a circumstance that is aggravated by the fact that the PGE includes no information on those bodies that are not public but are considered to be Central Government Bodies for the purposes of ESA 2010[12]. This lacking information the PGE 2017 Draft makes it impossible to determine whether the budget is submitted in compliance with the -1.1% of GDP target, as the balance of revenue and non-financial expenditure in the State Budget assumes a -1.8% of GDP deficit, pending incorporating the net lending/borrowing for these Bodies.

The Ministry of Finance and Public Administrations has not provided information to assess the cash-accrual adjustments, and it is therefore deemed essential to incorporate to the PGE 2017 Draft, urgently, information regarding the mentioned changes and the net lending/borrowing balance of the public entities, especially in view of the magnitude of the adjustment allowing compliance with the budget stability target to be guaranteed.

Despite the limitations deriving from the lack of information mentioned above, the estimates drafted by AIReF determine the risk of non-compliance with the budget stability target by the Central Government. From the information currently available, it is observed that despite the improvement in revenue and the consolidation of non-financial expenditure, risk of non-compliance with the stability target persists, even in the case that the measures adopted by Royal Decree Law 3/2016 should reach the envisaged results in revenue. It is, therefore, urgently necessary to complete the information included in the PGE 2017 Draft, in order to determine whether such information can mitigate the need to adopt measures to guarantee target compliance. Additionally, by applying article 18 of the organic law on Fiscal Stability and Financial Sustainability , the Central Government should conduct special monitoring of the budget implementation data and its compliance with the target, so that, should the risk

[12] For instance the Deposit Guarantee Fund or the FADE

observed by AIReF materialise, the necessary measures can be adopted to guarantee target compliance. In any case, this article should be applied with sufficient exactitude, as in 2016 the CG, faced with the risk budget stability target non-compliance, adopted a Non-Availability Agreement and brought forward the closure order to July, and likewise the measures affecting the increased corporate tax instalments, that were nevertheless insufficient to guarantee compliance. In order to conduct a full assessment of the stability target and achieve that, should the risk of non-compliance be confirmed, the CG is able to adopt the necessary measures.

The AIReF recommends:

1. ***That information on the cash-accrual adjustments allowing the budgetary balance to be reconciled with net lending/borrowing in terms of ESA 2010 should be included in the 2017 Draft General Government Budget.***
2. ***That the General State Budget should include information on those public entities that, though not public in nature, are included for the purpose of the ESA 2010 in the CG subsector and the resulting balance from the net lending/borrowing within CG bodies.***
3. ***That an initial budget be drafted in terms of national accounting for the Central Government and the Social Security Funds.***
4. ***For the Ministry of Finance and Civil Service to put in place a CG control mechanism through monthly Ministry monitoring of the instrumentation of measures adopted and their impact on the proposed budget stability target, in order to detect eventual slippages well ahead of the year-end accounting closure. This monitoring should be given as much transparency as possible, and reports should be sent to Parliament and to the AIReF.***

Social Security Funds

The level of deficit that will foreseeably be reached again by the Social Security System in 2017, and the significant reduction of the Reserve Fund over recent years, which have made it necessary to instrument the concession of a loan by the CG to the SSF, require measure to be adopted to guarantee SSF funding, as repeatedly recommended by the AIReF in a number of previous reports.

Since the publication of the last report in July 2016, actions have been launched in the framework of the Toledo Pact Commission, with participation by the AIReF, in which it is deemed indispensable to continue with analysis of system sustainability in this context, for which reasons AIReF recommends, once again:

5. **That progress should be made in the actions already under way and the necessary decisions adopted to guarantee financial equilibrium in the Social Security System in the framework of the Toledo Pact Commission.**

6.2. Government Debt

The PGE Draft incorporates information on the debt target for all the Public Administrations but no specific information on the Central Government. Article 6 of the organic law on Fiscal Stability and Financial Sustainability establishes that the budgets of the various Public Administrations "should contain sufficient and appropriate information to verify their financial situation, and compliance with the budget stability and financial stability targets".

In the debt analysis conducted by the AIReF, Transitional Provision One of the organic law on Fiscal Stability and Financial Sustainability is not complied with. This determines that, in 2020, the level of public debt in the CG and the SSF will reach 44% of GDP, a limit that will not be reached until 2035 according to AIReF's estimates.

The PGE Draft includes no information relative to the Central Government's compliance with the debt target in 2017, and therefore **AIReF recommends:**

6. ***That the information contained in the draft State General Budget should be completed, such that it will allow the specific assessment of compliance with the debt target by the Central Government.***
7. ***The appropriate legal mechanisms are employed to extend the transitional period for compliance with the limit established in Article 13 of the organic law on Fiscal Stability and Financial Sustainability, adapting the requirements specified in Transitional Provision One of the above law and defining a credible but demanding reference path for the sustained reduction of the debt ratio.***

6.3. Expenditure Rule

The PGE Draft 2017 includes no information on the expenditure rule components or its potential compliance in 2017**.** This year, as in the case of assessing the budget stability target, verification of compliance with the expenditure rule is aggravated by the shortage of information on the cash-accrual adjustments cash-accrual adjustments that allow non-financial expenditure to be reconciled with non-financial expenditure. It is also necessary to avail of information on the impact of normative changes on revenue. The CG is the subsector in which normative changes are producing the greatest impact on compliance with the expenditure rule. It is necessary for the PGE to include, in addition to the information on non-financial expenditure in terms of ESA 2010, an estimation of the normative impacts on the eligible expenditure for the purpose of compliance with the expenditure rule with details of the measures adopted.

AIReF recommends once again *that*:

8. ***Information should be included in the General State Budget as necessary for assessing the expenditure rule. Within the CG, information that will determine the impact of the main normative changes and their classification as "permanent or non permanent" for the purposes of the expenditure rule is required.***

6.4. Transparency

To fulfil its functions, the AIReF needs to have access to the economic and financial information affecting the entities included in the subjective area of implementation of the organic law on Fiscal Stability and Financial Sustainability. It is essential for the various Public Administrations to continue improving transparency, improving the quality of the non-compliance they publish and avoiding actions such as those described in this report involving clear non-compliance with article 27.1 of the organic law on Fiscal Stability and Financial Sustainability instrumenting the principle of transparency. The importance of complying with the principle of transparency lies in the immediate implementation of the measures envisaged in article 20 of the organic law on Fiscal Stability and Financial Sustainability, applied exclusively by the Territorial Administrations. As the Central Government is the administration failing to comply with the transparency principle, the organic law on Fiscal Stability and Financial Sustainability's shortcomings in regulating preventive and corrective mechanisms applied to the Central Government are once again manifest. The immediate measures legally provided for in the event of non-compliance with the duty to transparency are, again, aimed at the Territorial Administrations, leaving a legal loophole for instances in which the non-compliant entity with the obligation to transparency is the Central Government itself.

However, by contrast, it should be pointed out that the Economic and Financial Report on the Social Security incorporates, for the first time, a new section on pension revaluation that gives detailed information on revenue, developments in the number of pensions and the substitution effect required to estimate IRP.

Given this, ***the AIReF recommends that:***

9. ***The transparency principle should be complied with as provided for in article 27 of the organic law on Fiscal Stability and Financial Sustainability, through the publication of the cash-accrual adjustments. Also, an analysis should be made of the need to review the organic aw on Fiscal Stability and Financial Sustainability in order to establish automatic corrective measures that are applicable to the Central Government in the event of non-compliance with its legal obligations.***