

Report on the setting of individual budget stability and regional government debt targets for the Autonomous Regions

The mission of AIReF, the Independent Authority for Fiscal Responsibility, is to ensure strict compliance with the principles of budgetary stability and financial sustainability contained in article 135 of the Spanish Constitution.

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Executive Summary

AIReF issues this report with a double perspective: on the one hand, to assess the proposals for individual targets for deficit and public debt of the Autonomous Regions (ARs) in 2016 and for the period 2017-2019 submitted by the Ministry of Finance and Civil Service (MINHAFP), and on the other hand, to monitor compliance with the fiscal rules. In agreement with current regulations, AIReF is obliged to report on proposals for the horizontal distribution of budget stability and public debt targets in the Autonomous Regions (ARs) in 2016 and for the period 2017-2019 submitted by the Ministry of Finance and Civil Service (MINHAFP). The recommendations deriving from this assessment may, if required, serve to draft a new proposal by the Ministry following the 'comply or explain' principle. Neither the Organic Law creating the AIReF nor the Organic Law on Budget Stability and Financial Sustainability (LOEPSF), in any case, envisage the submission of an alternative proposal by this institution. This report is issued in the fulfilment of AIReF's supervisory duties, which according to the explanatory memorandum of Organic Law 6/2013 on the creation of AIReF, arise from the need for an independent fiscal institution able to effectively monitor compliance with the fiscal rules.

AIReF is not obliged to submit an alternative proposal for the individual distribution of targets, but to assess the proposal drafted by MINHAFP. In the report on the horizontal distribution of deficit and debt targets in the Autonomous Regions in 2015, AIReF selected a number of indicators that, in its opinion, should be included in the proposal drafted by MINHAFP, whose implementation seemed to suit the asymmetrical deficits resulting from the relative position of each autonomous region. This opinion led to a recommendation to which MINHAFP replied that AIReF had *"taken the opportunity to include in its report a proposal for setting both targets on the basis of the assumptions it deemed appropriate"*. In this regard, AIReF understands that its competences do not extend to taking alternative actions to those that are the responsibility of MINHAFP, but rather to assess those actions, within the scope and to the extent defined in the Organic Law on the creation of AIReF and the Organic Law on Budget Stability and Financial Sustainability.

AIReF is obliged to give warning of the risk of non-compliance with the fiscal rules throughout the budget cycle, wherein the first task is to set the deficit and debt targets. Monitoring fiscal rules requires the stability and debt targets to be set for the various Public Administration subsectors and for each of the Autonomous Regions. From this perspective, assessment of the risk of non-compliance commences on establishing these targets, and for this

reason AIReF analyses, in this report, the likelihood of compliance with these targets by the Autonomous Regions, giving warning, as appropriate, of any risk of non-compliance.

The assessment by AIReF of the proposal received is centred on the year 2017. The documentation received does not comprise a year-end forecast for public debt in 2016 that allows fixing a starting point for setting targets for the period 2017-2019, or an estimate of the expected trend in revenue over the coming years. Owing to the lack of the pertinent information and the uncertainty associated with revisions to the financing system and the expenditure rule which, foreseeably, will take place during the period envisaged in the proposal, AIReF offers a pronouncement only regarding the targets proposed for 2017 assuming a point of departure in 2015, the last year available.

AIReF formulates recommendations for establishing differentiated targets and for implicating the Autonomous Regions in the process of distributing the targets for the subsector. AIReF recommends that the horizontal distribution of targets should rest on indicators that permit differentiation per Autonomous Region according to their relative position in terms of feasibility, equity and the expenditure rule. Similarly, AIReF recommends the Autonomous Regions to become involved in the process of drafting the proposal for stability targets and improving the system for setting the debt targets.

- **Budgetary stability target**

MINHAFP has presented homogeneous targets for the autonomous regions, on the basis of their likelihood in each case. The proposals submitted by MINHAFP are based on the assumption that the deficit for 2016 and the adjustment path for 2017-2019 established for the subsector overall (-0.7%; -0.6%; -0.3% and 0% in terms of GDP for each of these years, respectively), is feasible for all the Autonomous Regions and, therefore, presents similar targets.

This feasibility is not grounded on any measurement methods and is based on the mere comparison of relative positions with respect to 2013. Setting homogeneous targets is justified on the grounds that the difference in borrowing requirements registered in recent years in Autonomous Regions with varying deficits is not great, and that, consequently, it is feasible to achieve a common target insofar as this requires greater effort on behalf of the Autonomous Regions furthest from the target in the previous year, but in any case not as great as the effort required in 2013, when differentiated targets were set. However, the proposal submitted by MINHAFP does not contain any

measurement method upholding its rating of feasibility and, therefore, cannot be assessed by AIReF.

Significant differences persist in the starting point for the Autonomous Regions, for which reason and from the perspective of feasibility, AIReF is of the opinion that, at present, setting similar targets for all Autonomous Regions involves a risk of deviation for those regions furthest from the target and probably also for the subsector overall, which comes at a cost in terms of credibility. The effort required in 2016 and 2017 to reach in the second of these years the target of -0.6%, measured in primary structural terms, presents a spread of around one decimal point between the regions with the best and worst positions, which for some Autonomous Regions will mean a substantial adjustment in two years. On these lines, AIReF warned in its report on the Stability Programme Update (SPU) of the risk implied by setting a single path for all the Autonomous Regions regarding compliance with the global budget stability target and the expenditure rule for the subsector in 2016, and recommended setting differentiated paths for the Autonomous Regions. MINHAFP replied that it was not the right time for such a recommendation, and that the right moment for AIReF to issue a pronouncement on the matter is at the time of submitting its proposal for the horizontal distribution of targets. However, in view of the date on which the proposal was submitted, the Autonomous Regions have adjusted their performance to the homogeneous proposal put forward by MINHAFP following submission of the SPU, so that the Autonomous Regions that, a priori, were able to achieve a deficit below the 0.7% target set for the subsector, seem to be exhausting the margin afforded by the trend in financing system revenue and the strict implementation of the expenditure rule.

Feasibility indicators exist, that should be incorporated to the proposals for the distribution of targets sufficiently in advance to be discussed at the Fiscal and Financial Policy Council. AIReF believes that the likelihood of compliance with the stability target can be measured through indicators that, with some variants, are commonly recognised nationally and internationally as instruments for the assessment of fiscal rules. AIReF proposes two feasibility indicators that are in line with the conclusions reached by ECOFIN on 6 December. The first of these measures, following European Commission methodology, is the primary structural effort that the Autonomous Regions are required to make over the period 2016-2017 to reach, in the second of these years, the proposed target of -0.6%. The second is the development in non-financial expenditure (with some corrections and for the same period) needed to comply with the target, assuming that all Autonomous Regions exercise a similar range of competences.

The combination of indicators for structural effort and evolution of expenditure, applied through a common factor procedure, has allowed five Autonomous Regions to be singled out that are clearly struggling to comply with the deficit target of 0.6% of GDP proposed for 2017. The Autonomous Regions of Aragón, Catalonia, Valencia and especially Extremadura and Murcia will need to make a fiscal consolidation effort in the period 2016-2017 well above the Autonomous Regions average. From this feasibility viewpoint, their deficit target should be higher, to a greater or lesser degree, than the target for the subsector overall.

Nevertheless, any future assessment of the distribution of deficit targets will necessarily incorporate the aspect of equity. For this reason, AIReF has conducted a joint feasibility and equity analysis by means of an intertemporal substitution relation between past and future effort. The assessment report includes a study of the indicators for structural adjustment and expenditure over the period from 2007 to 2015, which brings the consideration of equity into the analysis. Thus, of the five Autonomous Regions identified, only Valencia has performed an effort equal to the subsector average during this period. However, other equity factors need to be taken into account, such as the relative position of the regions in terms of financing system revenue or the use of normative competences in fiscal matters.

The trade-off equity-feasibility and the weight given to each of these two criteria is a decision that calls for prior discussion, which is impossible in the time allowed between holding the preparatory session and the plenary session at the Fiscal and Financial Policy Council at which the proposal by MINHAFP is to be voted on. Committing to budget stability entails ensuring that all the Public Administrations are aware of the milestones in the budget cycle. From this perspective, AIReF recommends that the target proposal, together with the accompanying report, should be studied and discussed sufficiently in advance by the CPFF working groups that the Ministry may modify, as appropriate, the proposal with inputs from the Autonomous Regions and from AIReF before submission to the Council Plenary.

The proposal received does not take into account the expenditure rule, which, were it considered, could cause seven Autonomous Regions to face more demanding targets. In addition to the feasibility factor, the document refers to the coherence of the proposed stability targets with the expenditure rule for the Autonomous Regions overall, but does not take into consideration the different situation in each Autonomous Region, nor apply this as a differentiating factor, despite the expenditure rule being a limiting factor in the Autonomous Regions that are closest to compliance with the

targets. The implementation of the expenditure rule, therefore, may lead to a more demanding deficit than the stability target in the Autonomous Regions of Andalusia, Balearic Islands, Canary Islands, Galicia, Navarra, Basque Country and La Rioja.

The non-incorporation of the expenditure rule at the time of setting the budget stability targets, as required by the Organic Law on Budget Stability and Financial Sustainability (LOEPSF), detracts from the rule's effectiveness. The proposal for stability targets fails to take into account the relative position of each region with regard to the implementation of the expenditure rule, such that the adjustment of expenditure to the current reference rate is left until the subsequent implementation of the Budget. AIReF understands that this delay in incorporating the expenditure rule to the budgetary process contributes to its consideration as a second-order fiscal rule, despite the LOEPSF rating all three fiscal rules on an equal footing regarding their compliance. To this consideration we must add the problems of a methodological and practical nature, and probably also of definition, which must undoubtedly be analysed by the working group that MINHAFP has announced it will set up for this purpose.

- **Debt target**

AIReF finds that the current system for setting annual debt targets is ineffective, and until it is redesigned, the assessment is focused on certain aspects that leave room for improvement. AIReF is of the opinion that the debt target is a sustainability objective, and must therefore be viewed on a long-term horizon. Additionally, as pointed out in previous reports¹, the current design of debt targets does not guarantee debt sustainability in the middle and long term, given that compliance with the debt target is unrelated to the annual increase in debt or to the gap to be spanned to reach the reference value of 13% of GDP. Consequently, until the present system is redesigned, the assessment focuses on appraising certain formal aspects of the debt targets that can be improved on, such as transparency, the definition of debt limited by the target, or coherence with the stability targets.

It cannot be considered that there is coherence between the debt targets and the stability targets, when the debt targets are extended to cover unauthorised deficit increases from previous years. The debt target proposals for 2016 and for 2017-2019 are said to be coherent with the stability targets for the respective years. However, this coherence cannot be considered to exist when the debt targets can be extended to finance deficit overruns with respect to the stability target carried over from previous years.

¹ [Report on initial budgets for 2016](#); [Report on the main aspects for the Autonomous Regions in 2016](#)

I. Introduction

The Independent Authority for Fiscal Responsibility (AIReF) has a statutory duty to issue a report on the setting of the budget stability and government debt targets for each one of the Autonomous Regions (ARs). The Organic Law on Budget Stability and Financial Sustainability (LOEPSF) states that, once the budget stability and government debt targets have been set for the whole General Government sector and each one of its subsectors, the Ministry of Finance and Public Administrations (MINHAFP) must draw up a proposal of individual budget stability and government debt targets for each one of the Autonomous Regions. The Government then uses that proposal as a basis to set the budget stability and government debt targets for each one of the Autonomous Regions after receiving reports from the Fiscal and Financial Policy Council (CPFF) and AIReF.

The exceptional delay in setting the vertical targets, approved in Parliament on 20 December, has conditioned the publication date of this report. The presence of a caretaker Government until October and the announcement, on 2 August, by the European Council of a new fiscal consolidation path for 2016-2019, has delayed setting the target for the Autonomous Regions overall and, as a consequence, has delayed MINHAFP in drafting its proposal for horizontal distribution that is under assessment in this report.

II. Object of the report and limitations to its scope

The object of this report is the study of the proposals for setting of the budget stability and government debt targets for each one of the ARs for 2016 and the period 2016-2018, once the targets have been set for the subsector. In accordance with article 16 in AIReF's Statutes, once approval is given on the targets for the General Government sector, MINHAFP has to provide AIReF with the documentation and background data used, together with an individual analysis with the possible proposal for setting the individual targets for each of the ARs (horizontal allocation of targets). Therefore, in assessing said allocation, AIReF's report is constrained by the target set for the subsector overall.

The scope of this report is limited to 2017. The submission, in December, of the proposal renders ineffective any pronouncement by AIReF on the targets for 2016. Moreover, the documentation does not take into account key aspects such as a 2016 year-end forecast or an estimate of revenue during 2017-2019. To this circumstance must be added the uncertainty associated to a review of the financing system that will foreseeably be conducted in the period affected by the proposal. Owing to all the above limitations, AIReF's assessment of the proposal received is centred on the year 2017.

III. **Assessment of MINHAFP'S proposal**

MINHAFP's proposal for the 2016-2019 budget stability targets sets homogeneous targets for all Autonomous Regions that are the same as those set for the subsector for each of the years in this period. Expressed as a percentage of GDP, the proposed homogeneous targets are as follows: -0.7% in 2016; -0.6% in 2017; -0.3% in 2018; and 0% in 2019. MINHAFP grounds this proposal on arguments relating to the sector overall and to the individual situation within each AR.

✓ Arguments relating to the AR subsector

- The proposal allows compliance with the stability target, according to the established path for the AR subsector overall, and with the expenditure rule, under the terms established for both of these fiscal rules by Agreement at the Council of Ministers on 2 December 2016.
- The expenditure rule involves an additional restriction in the medium term, which would preclude higher discretionary expenditure.
- Setting homogeneous targets will sidestep the need to take the discussion on possible imbalances deriving from the current financing systems to the field of budget stability, and, through a simple shift to the shared target for the subsector, will bring transparency and visibility to its control.

AIReF finds that the arguments given are invalid to justify the adoption of homogeneous targets for all Autonomous Regions, because they do not take into account the situation within each Region, either regarding the ability to make the required effort to reach the adjustment path, or regarding the risk of easing fiscal policy in view of deficit targets that are perceived as easily achievable.

As for the expenditure rule, MINHAFP points out that this burdens the subsector with an additional restriction to that already implied in the stability target. However, if the expenditure rule is not incorporated at the time of setting the individual budget stability targets, as required by the LOEPSF, the rule loses effectiveness. The proposal fails to take into account the relative position of each region with regard to implementation of the expenditure rule, such that the adjustment of expenditure to the current reference rate is left until the subsequent implementation of the budget. AIReF understands that this delay in incorporating the expenditure rule to the budgetary process contributes to its consideration as a second-order fiscal rule, despite the LOEPSF rating all three fiscal rules on an equal footing regarding their compliance. To this consideration we must add the problems of a methodological and practical nature, and probably also of definition, which must undoubtedly be analysed by the working group that MINHAFP has announced it will set up for this purpose.

Moreover, MINHAFP argues that setting symmetrical criteria "will prevent taking the discussion on potential dysfunctions or imbalances in revenue yielded by the financing systems to the field of budget stability...". Although AIReF agrees that this is not the right field to discuss these situations, it nevertheless considers that these and other circumstances, that determine different positions among the Autonomous Regions with regard to feasible fiscal consolidation processes, independently of the origin of such differences, cannot be overlooked.

Lastly, AIReF shares the idea that simplicity in fiscal rules affords transparency and visibility to their control, but this simplicity cannot be a substitute for other equally important criteria, such as feasibility of compliance, for instance.

✓ **Arguments relating to the individual situation of each AR**

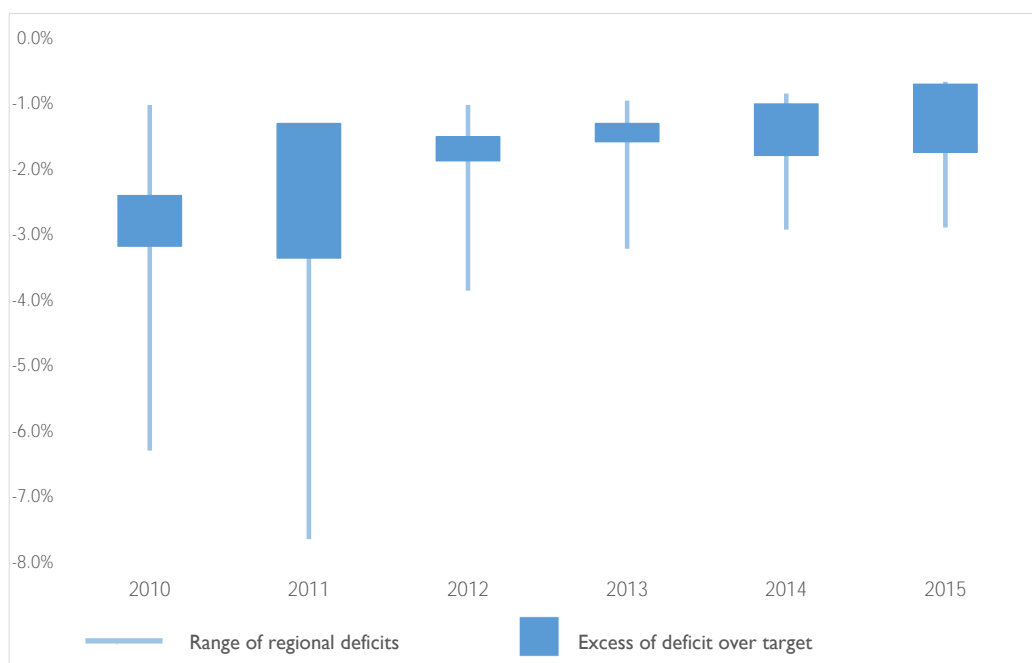
- Achieving these homogeneous targets is feasible since, unlike in 2013 when individual targets were set, there has been convergence in the ARs' deficit data that, according to fiscal projections, would lead to nominal equilibrium 2019.
- Setting homogeneous targets will require a greater effort by the ARs furthest from the starting point.

This appreciation of feasibility is not grounded on any methodology and is based on the mere comparison of relative positions with respect to 2013. Apart from this comparison of relative positions, the proposal submitted by MINHAFP does not contain any measurement method upholding its feasibility rating and, therefore, cannot be assessed by AIReF.

Significant differences persist in the starting point for the Autonomous Regions, for which reason and from the perspective of feasibility, AIReF is of the opinion that, at present, setting homogeneous targets for all ARs involves a risk of deviation for those furthest from the target and probably also for the subsector overall, which comes at a cost in terms of credibility. The effort required in 2016 and 2017 to reach, in the second of these years, the target of -0.6%, measured in primary structural terms, presents a spread of around one percentage point between the regions with the best and worst positions which, for some ARs, will mean a substantial adjustment in two years. On these lines, AIReF warned in its report on the Stability Programme Update (SPU) of the risk implied by setting a single path for all the Autonomous Regions regarding compliance with the global budget stability target and the expenditure rule for the subsector in 2016, and recommended setting differentiated paths for the Autonomous Regions. MINHAFP replied that, at the time, such a recommendation was no more than an opinion, since the proper time for AIReF to issue a pronouncement on the matter is at the time of submitting its proposal for the horizontal allocation of targets. However, in view of the date on which the proposal was submitted, the ARs have gradually adjusted their performance to the homogeneous proposal put forward by MINHAFP following submission of the SPU, so that the ARs that, a priori, were able to achieve a deficit below the 0.7% target set for the subsector seem to be exhausting the margin afforded by the trend in revenue from the financing system and the strict implementation of the expenditure rule.

As shown in chart 1, the convergence referred to in the proposal corresponds fundamentally to the fiscal cutback conducted prior to 2013. By contrast, the difference between the target and overall achievement in the subsector (represented in the chart by a rectangle) has shown significant variations that have gradually increased from 2013 to 2015. It is also observed that the line representing the range of values for the ARs' deficit tends to decrease noticeably in the area of target compliance (above the rectangle), particularly in the years 2014 and 2015. This asymmetry relates to the trend among the ARs to adapt to an easily achievable target, as the regions, lacking an individual target suited to their situation, may exercise a degree of looseness in their fiscal policy.

CHART 1: MAXIMUM AND MINIMUM DEFICITS REGISTERED BY THE AUTONOMOUS REGIONS AND DISTANCE TO THE TARGET WITHIN THE SUBSECTOR OVERALL (% OF GDP)



Source: The authors, from data provided by MINHAFP.

Note: The line represents the range of results, in terms of net lending/borrowing as a percentage of regional GDP, for the Autonomous Regions. The box represents the gap between the target and the subsector results as % of GDP.

There are two further legal aspects that are not considered in the proposal for setting targets. The first, related to setting the targets, derives from article 15 of the LOEPSF which states that when setting stability targets for the Public Administrations, the expenditure rule and the structural balance reached in the fiscal year immediately before that year have to be taken into account. It goes on to state that the government debt targets shall be set in a manner consistent with the budget stability targets. The second is that no reference is made in the documentation received to aspects that AIReF, as per its statute, is obliged to take into account in drafting its report, such as - among others- the particular circumstances of each Administration with regard to the implementation of the LOEPSF and especially the existence of a plan to balance the budget or an economic-financial plan, as well as that Administration's initial level of debt.

AIReF deems it necessary to incorporate to the agreement on setting targets a feasibility analysis of said targets that takes into account each AR's starting point, and that highlights the coherence of the budget stability target and the expenditure rule. For this purpose, and in view of

the limitations and uncertainty described in the section "Object of the report and limitations to its scope", AIReF provides the following indicators for differentiating the individual targets for the ARs, in line with the conclusions issued by ECOFIN on 6 December and the European Commission methodology for measuring structural deficit.

Feasibility analysis

AIReF has developed indicators that permit measuring the feasibility of achieving 2017 targets, combining the structural effort with the trend in expenditure. AIReF finds that the fundamental criterion for setting the targets for the period 2017-2019 is the feasibility of their compliance. Only by setting feasible targets can there be any confidence in their compliance and in the effectiveness of the corrective mechanisms envisaged in the LOEPSF. Likewise, AIReF believes that this feasibility is measurable, and has developed two feasibility indicators, and one synthetic indicator combining the two, that are commonly used internationally.

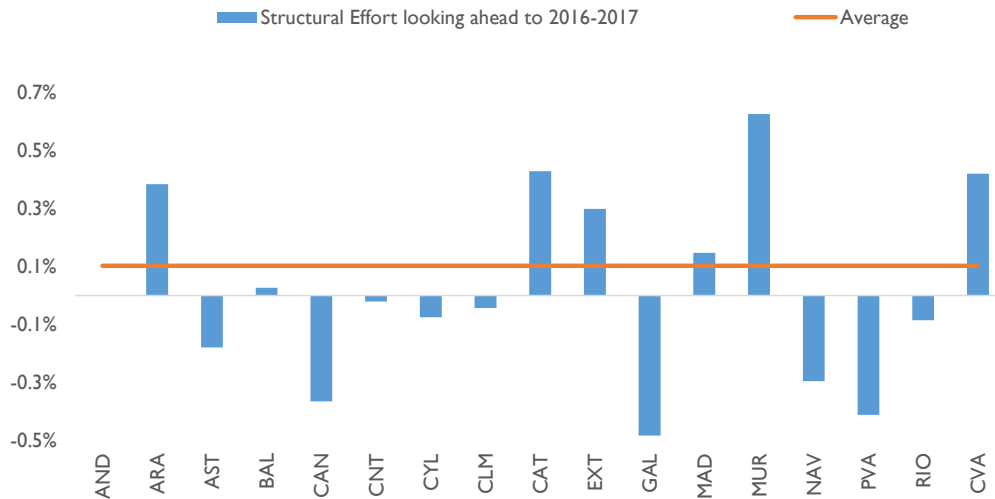
FEASIBILITY INDICATORS

1. Structural effort looking ahead to 2016-2017 (% regional GDP)

This indicator is the internationally applied standard, taking an indirect approach to fiscal adjustment because it is based on estimating the impact of the economic cycle on public accounts, according to the methodology given in Order ECC/1556/2016. Interest expenses are excluded from the analysis because the Autonomous Regions have very little decision-making capacity over those expenses and circumstances vary for each region depending on whether or not they have adhered to the extraordinary financing mechanisms set up by MINHAFP.

According to this indicator, as shown in chart 2, the regions of Aragón, Catalonia, Extremadura, Murcia, Valencia and, to a lesser extent, Madrid would have to make a greater primary structural effort than the ARs' average effort for 2016 and 2017 to reach the common target of -0.6% of GDP for the subsector.

CHART 2. STRUCTURAL EFFORT LOOKING AHEAD TO 2016-2017 (% REGIONAL GDP)



Source: MINHAFP, MINEICO and AIReF estimates.

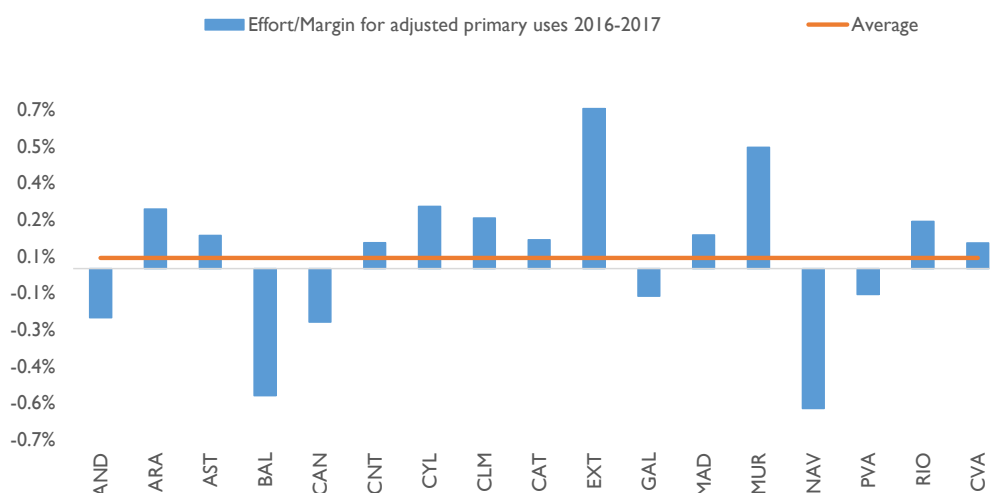
Note: Mean annual variation of the primary structural balance, estimated as per the methodology given in Order ECC/1556/2016 to be applied in the period 2016-2017 in order to reach the 2017 target of -0.6% of GDP.

2. EFFORT/MARGIN FOR ADJUSTED PRIMARY USES 2016-2017 IN TERMS OF HOMOGENEOUS COMPETENCES (% OF REGIONAL GDP)

This indicator analyses the average reduction effort or the scope for increase in primary expenditure, in the period 2016-2017, required to meet the -0.6% target in 2017, with a given level of revenue estimated by AIReF as described in the Annex on methodology.

Chart 3 shows the annual mean effort required in each AR for the period 2016-2017 to reach the target of -0.6% of GDP. The ARs of Extremadura and Murcia stand out for having to make a far greater effort than the average for the subsector.

CHART 3. EFFORT/MARGIN FOR ADJUSTED PRIMARY USES 2016-2017 IN TERMS OF HOMOGENEOUS COMPETENCES (% OF REGIONAL GDP)



Source: MINHAFP, ARs and AIReF estimates.

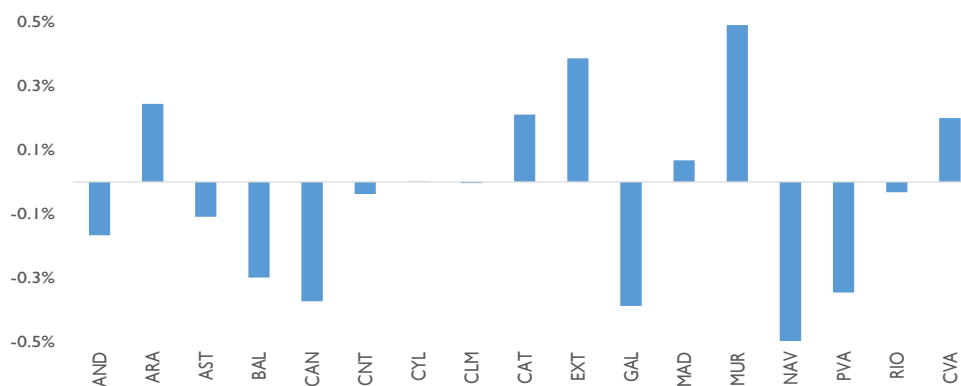
Note: Average effort/margin measured from annual variations, as percentage of GDP, in non-financial uses with comparable competences in expenditure, excluding expenditure in interest and having factored out expenditure in 2015 that is non-recurrent in 2017, payments for financing system resources and aids to investment, that are required for compliance with the -0.6% target, with the revenue for 2017 estimated by AIReF.

3. Synthetic feasibility indicator (deviation from the average as % of regional GDP)

This measures, in terms of deviation from the mean as % of regional GDP, the effort required of ARs during 2016-2017 to reach the target of -0.6% of regional GDP in 2017, weighting the information gathered from previous feasibility indicators with weights of 54% and 46%, respectively, as described in the methodology.

Through the use of this synthetic indicator that combines the feasibility indicators in terms of structural effort and non-financial uses, as shown in chart 4, the Autonomous Regions of Murcia and Extremadura, and to a lesser degree Aragón, Catalonia and Valencia, will need to make a considerably greater effort in 2016-2017 than the average to reach the target for the subsector in 2017.

CHART 4. SYNTHETIC FEASIBILITY INDICATOR (DEVIATION FROM THE AVERAGE AS % OF REGIONAL GDP)



Source: MINHAFF, ARs and AIReF estimates.

Note: Weighted indicator that measures the effort required to reach the target of -0.6% of regional GDP in 2017, as deviation from the AR average. This indicator combines the information provided by the two equity indicators, with weightings of 54% and 46%, respectively, allocated through a statistical procedure.

Equity analysis

AIReF has likewise designed equity indicators to measure the effort made by the ARs in the past. To the feasibility of complying with the stability targets for the period, AIReF has added further equity indicators that show the efforts made by the Autonomous Regions over the period 2008-2015. This period has been selected for study as its extension is sufficient to span different phases in the economic cycle, in which competences over expenditure are very similar and in which final data for past years is available.

EQUITY INDICATORS

Equity indicators have been split into main and supplementary indicators.

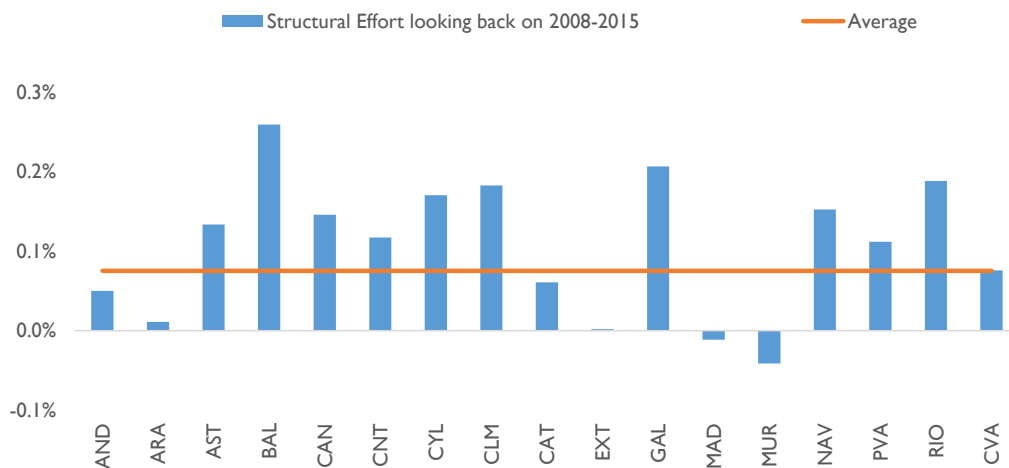
Main indicators:

1. Structural effort looking back on 2008-2015 (% regional GDP)

This indicator measures the mean annual variation in the primary structural balance, calculated with the methodology given in Order ECC/1556/2016, between 2008 and 2015.

As shown in chart 5, this indicator reveals that all ARs, with the exception of Andalusia, Aragón, Catalonia, Extremadura, Madrid and Murcia, have made a greater primary structural effort than the Autonomous Regions' average from 2008 to 2015.

CHART 5. STRUCTURAL EFFORT LOOKING BACK ON 2008-2015 (% REGIONAL GDP)



Source: INE, MINHAFP, MINEICO and AIReF estimates.

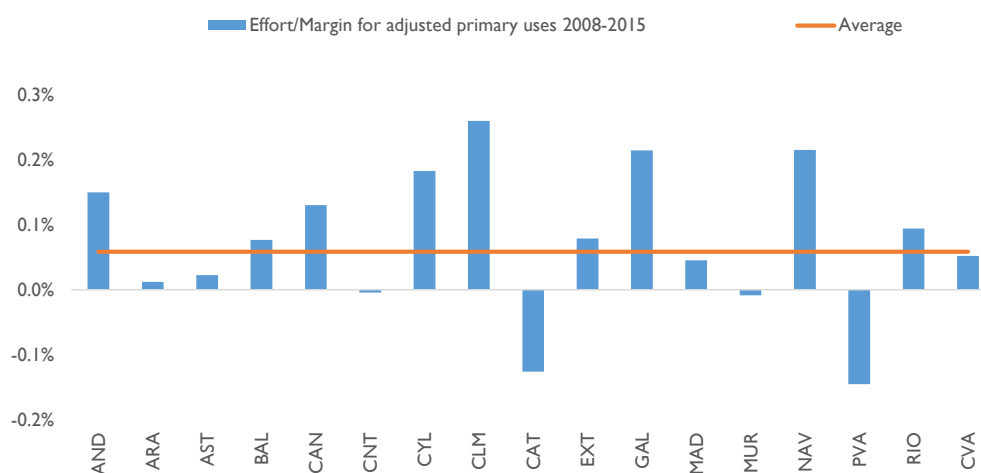
Note: Mean annual variation of the primary structural balance calculated with the methodology given in Order ECC/1556/2016 between 2008 and 2015.

2. EFFORT/MARGIN FOR ADJUSTED PRIMARY USES 2008-2015 IN TERMS OF HOMOGENEOUS COMPETENCES (% OF REGIONAL GDP)

This indicator measures the effort that, in terms of mean annual variation, ARs have made in the period 2008-2015, as a percentage of regional GDP, in non-financial uses excluding interest payments, payments to the State for the financing system and revenue for aid to investment.

Chart 6 shows how the ARs of Aragón, Asturias, Cantabria, Catalonia, Madrid, Murcia and Basque Country have made a smaller effort than the average across the Autonomous Regions, taking the annual mean for the period 2008-2015.

CHART 6. EFFORT/MARGIN FOR ADJUSTED PRIMARY USES 2008-2015 IN TERMS OF HOMOGENEOUS COMPETENCES (% OF REGIONAL GDP)



Source: INE, MINHAFP and AIReF estimates.

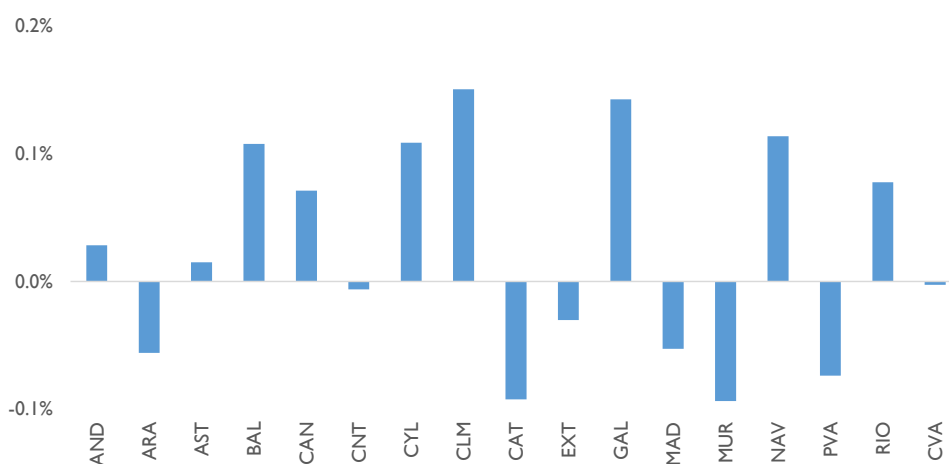
Note: Effort/margin made in the period 2008-2015 in terms of mean annual variation, as a percentage of GDP, of non-financial uses with comparable competences in expenditure, excluding expenditure in interest, payments for financing system resources and aid to investment.

3. Synthetic equity indicator (deviation from the average as % of regional GDP)

Of the weighted combination of the above two equity indicators, a synthetic indicator has been obtained, expressed as the deviation with regard to the mean as a percentage of regional GDP. This indicator measures the deviation with respect to the average effort made in the period 2008-2015. The two indicators have been weighted with weights of 54% and 46%, respectively, following the statistical procedure described in the Annex on methodology.

Chart 7 shows that the Autonomous Regions making a smaller than average effort over 2008-2015 were Aragón, Catalonia, Madrid, Murcia and Basque Country, and to a lesser degree, Extremadura.

CHART 7. SYNTHETIC EQUITY INDICATOR (DEVIATION FROM THE AVERAGE AS % OF REGIONAL GDP)



Source: INE, MINHAFP and AIReF estimates.

Note: Weighted indicator measuring the effort made in the period 2008-2015, as a deviation from the Autonomous Regions' average. This indicator combines the information provided by the two equity indicators, with weightings of 54% and 46%, respectively, allocated through a statistical procedure.

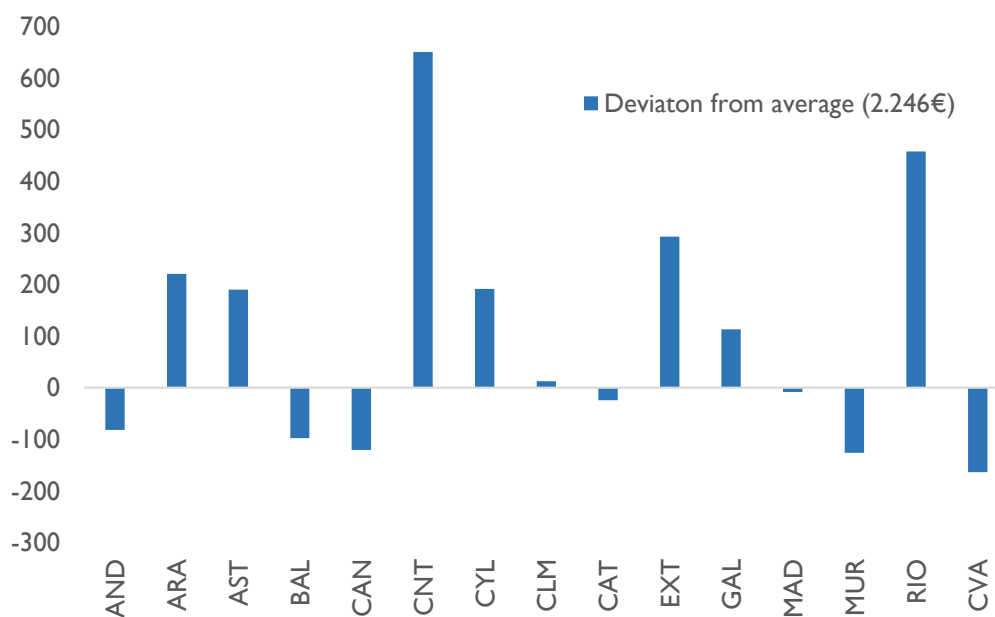
Supplementary indicators:

4. Financing system resources (euros adjusted per inhabitant)

In view of the impact of financing obtained from the ordinary-regime Autonomous Regions financing system (Act 22/2009) on the resources received, an indicator has been devised to determine the relative position of each region in relation to the mean, in terms of like-for-like normative resources adjusted per inhabitant for the 2012-2016 average, as per the methodology described at annex.

Chart 8 shows that, regarding the mean for 2012-2016, the Autonomous Regions that received adjusted per inhabitant financial resources above the mean were Cantabria, Rioja and Extremadura, and to a lesser extent, Aragón, Asturias, Castile y León and Galicia.

CHART 8. FINANCING SYSTEM (DEVIATION FROM THE MEAN IN EUROS ADJUSTED PER INHABITANT)



Source: MINHAFP and estimates by AIReF

Note: Relative position of the ordinary-regime Autonomous Regions, measured as the deviation from the mean in like-for-like resources adjusted per inhabitant received from the financing system for the 2012-2016 average.

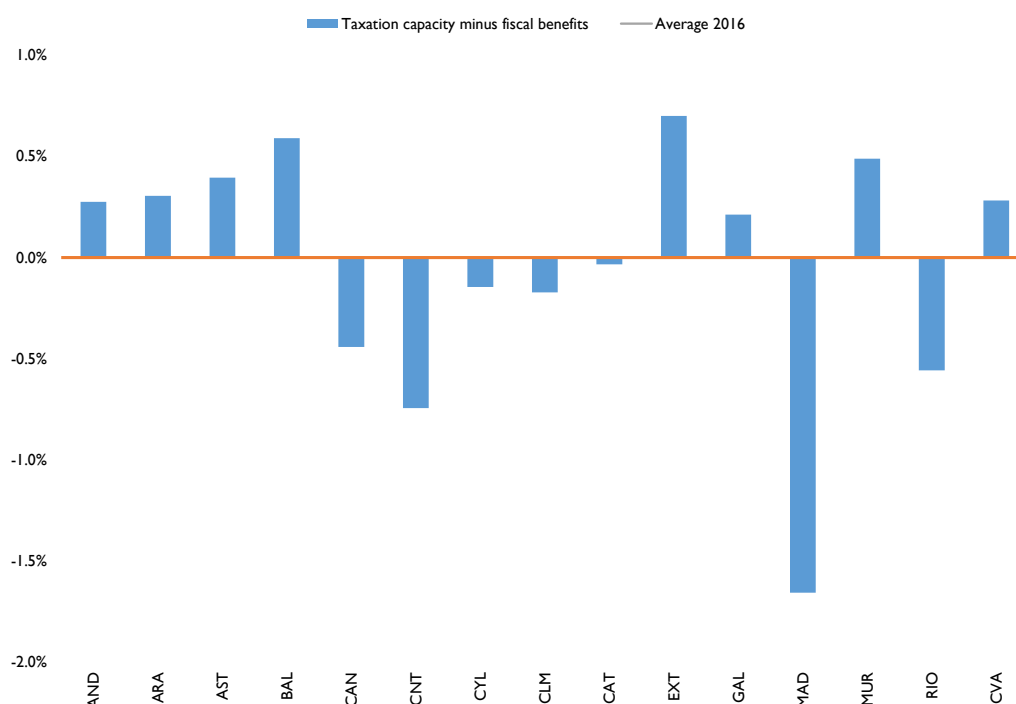
5. Exercise of normative tax powers (% regional GDP)

AIReF has estimated the increase or decrease in normative capacity exercised by the Autonomous Regions according to the sources and methodology described at Annex.

Chart 9 shows a quantification of the normative capacity over taxation exercised by the ordinary-regime Autonomous Regions both for ceded taxes and own regional taxes. This indicator is the result of aggregating the capacity exercised to raise both ceded and own taxes, minus the amount estimated by the ARs for the effect in 2016 of the fiscal benefits approved for the ceded taxes.

The ARs exercising the lowest normative capacity below the mean was Madrid, and to a lesser extent, Canary Islands, Cantabria, Rioja, Castilla y León and Castilla-La Mancha.

CHART 9. EXERCISE OF NORMATIVE POWERS OVER TAXATION BY THE ORDINARY-REGIME AUTONOMOUS REGIONS (% OF REGIONAL GDP)



Source: INE, MINHAFP, ARs and AIReF estimates.

Note: Quantification of the Autonomous Regions' exercise of normative capacity over taxation, both for ceded taxes and their own approved taxes. Sum of AIReF's estimates for normative capacity exercised to raise taxation (ceded and own taxes) minus the amount estimated by the ARs resulting from the effect in 2016 of the fiscal benefits approved to date.

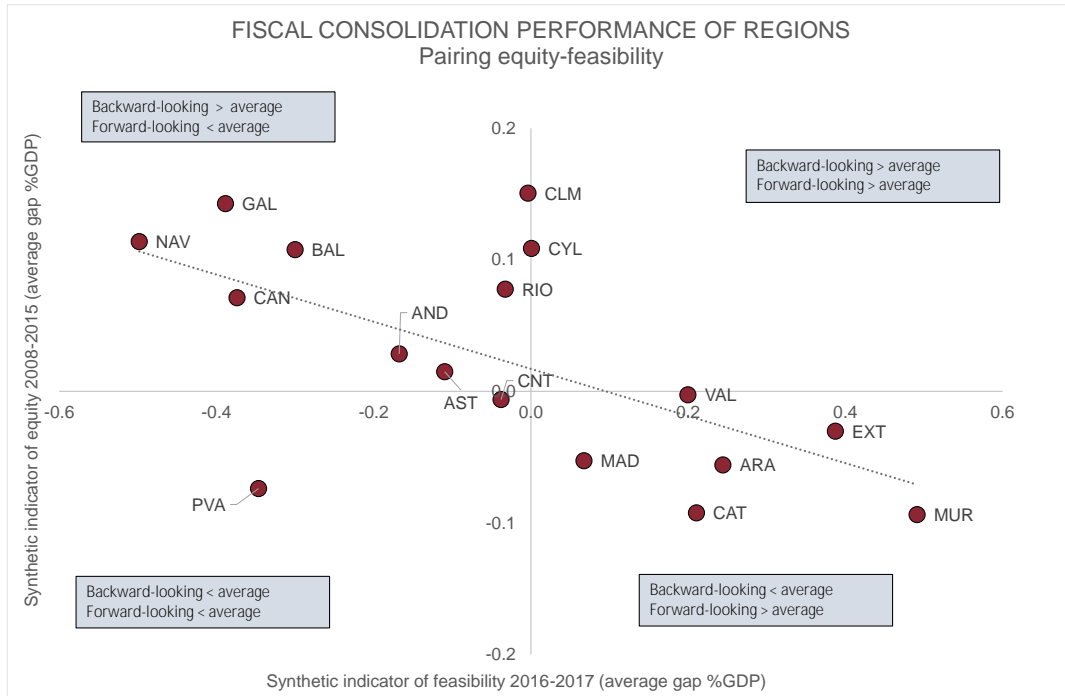
Combined feasibility and equity analysis

The combined analysis of feasibility and equity allows the comparison of efforts made by Autonomous Regions in the past against the efforts they should make to meet the stability target in 2017. This analysis should not be understood as an absolute measure of two terms, feasibility and -particularly- equity, both of which have many connotations within the Autonomous Regions. To the contrary, its scope is constrained to examining the horizontal allocation of targets, with respect to which the relative position of each region, with regard to compliance with said targets, dependent on their feasibility, as well as the efforts limiting future effort margins, should be taken into account when setting differentiated targets for the ARs.

Failing to consider feasibility in the efforts exacted of the worst-situated ARs, in conjunction with the risks deriving from slacker fiscal policy in the ARs closest to budgetary equilibrium, poses serious risks to fiscal consolidation.

The consolidation effort among the Autonomous Regions, analysed by means of the equity-feasibility trade-off as shown in chart 10, allows a relationship of exchange between the efforts made in previous years and the effort required to meet the 2017 targets to be determined from the trendline. In this manner it is observed that, in general, the ARs having made the greatest efforts regarding the average for the period 2008-2015, according to the indicators used in the analysis, could meet the 2017 targets with an annual effort close to or well below the mean. Contrariwise, the ARs that in the past made smaller efforts than the average, still according to the indicators employed, would need to make an effort greater than the average for the period 2016-2017.

CHART 10. SYNTHETIC EQUITY-FEASIBILITY INDICATOR (DEVIATION FROM THE AVERAGE AS % OF REGIONAL GDP)



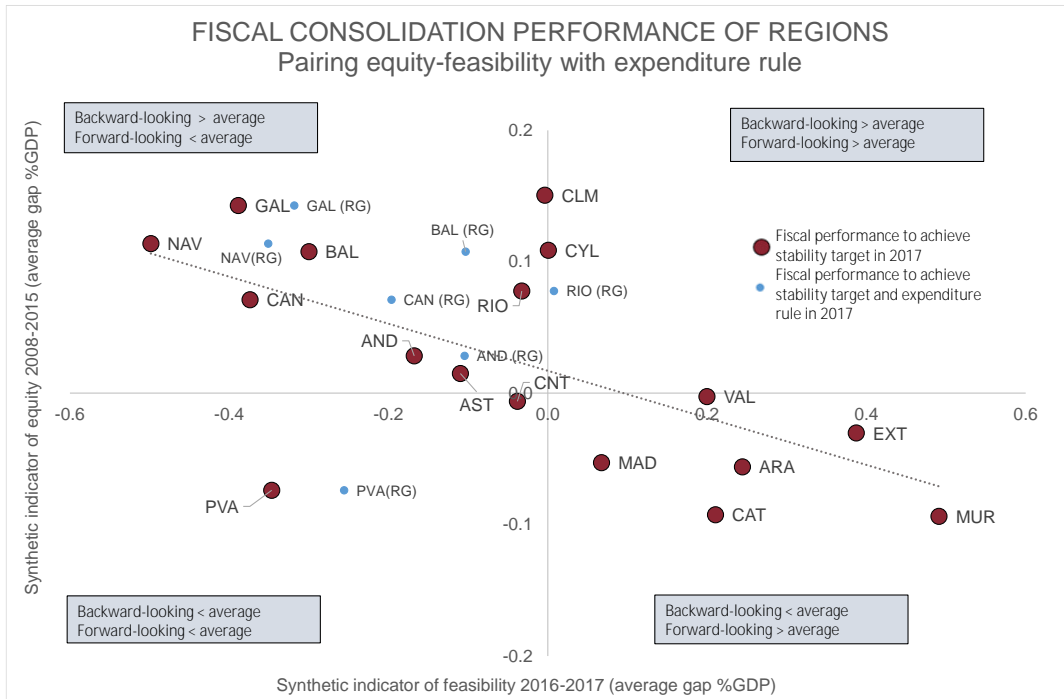
Source: INE, MINHAFP, MINEICO, ARs and AIReF estimates.

Note: Joint display of the synthetic feasibility and equity indicators comparing the effort made by the ARs against the effort required to meet the stability target of -0.6% of GDP in 2017.

In view of the fact that the selected periods for the analysis of past variations and demands for future efforts, 2008-2015 and 2016-2017, respectively, are different in size, the mean annual variation in effort for the entire period has been taken for the analysis as per the methodology provided.

Likewise, the relative position of each AR with respect to the implementation of the expenditure rule must be considered. As shown in chart 11, for certain ARs and particularly in Andalusia, Balearic Islands, Canary Islands, Galicia, Navarra, Basque Country and La Rioja, compliance with this fiscal rule may lead to additional effort beyond that of compliance with the stability target. For these ARs, compliance with the expenditure rule would represent a deficit below 0.6%.

CHART 11. SYNTHETIC EQUITY-FEASIBILITY INDICATOR WITH RESTRAINT ON THE EXPENDITURE RULE (DEVIATION FROM THE AVERAGE AS % OF REGIONAL GDP)



Source: INE, MINHAFP, MINEICO, ARs and AIReF estimates.

Note: Joint display of the synthetic feasibility and equity indicators comparing the effort made by the ARs against the effort required to meet the stability target and the expenditure rule in 2017.

Debt sustainability analysis

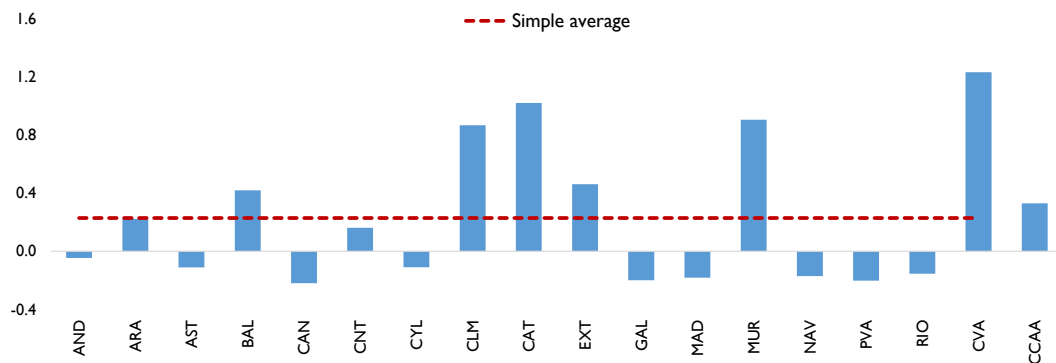
Together with the above mentioned feasibility indicators, a supplementary longer-term view of potential convergence at the debt reference level of 13% of regional GDP can be provided for each AR.

For this perspective, a sustainability indicator is suggested to quantify the magnitude of the additional fiscal effort to be delivered in terms of primary balance over GDP in order to achieve the level of public debt in each AR, set as the target in the LOEPSF (13% of regional GDP) in 2013, the reference year for the medium-long term.

The positive values of this indicator shown in chart 12 reflect, therefore, the additional fiscal consolidation adjustments in terms of primary balance with a view to a long-term scenario of sustained budget stability. Given that the LOEPSF stipulates that the public debt target for each AR is 13% of regional GDP, sustainability has been analysed by quantifying the additional adjustment effort necessary in terms of primary balance in order to reach that target in 2030. The baseline scenario, therefore, draws on AIReF estimates for each AR for GDP, primary balance and interest burden, taking as starting point the 2016-2019 Stability Programme Update.

Thus, a positive indicator signals that given the expected developments in the interest burden, budgetary equilibrium would not be sufficient to converge on the 13% target in 2030 and additional adjustments in the primary balance would be needed.

CHART 12. ADDITIONAL FISCAL EFFORT TO GUARANTEE SUSTAINABILITY IN 2030 (ANNUAL, % GDP)



Source: INE, MINHAFP and AIReF estimates.

Note: The indicator is defined as the average additional primary fiscal balance necessary to reach the reference regional debt level of 13% of GDP in 2030.

Concerning the proposal on government debt targets for 2016-2018

AIReF finds that the current system for setting annual debt targets is ineffective and, until it is redesigned, the assessment is focused on certain aspects that leave room for improvement. AIReF believes that the debt target should not be annual, but analysed from a long-term perspective in terms of sustainability. Additionally, as pointed out in previous reports², the current design of debt targets does not guarantee debt sustainability in the middle and long term, given that debt target compliance is unrelated to the annual increase in debt or to the gap to be spanned to reach the reference value of 13% of GDP. Consequently, until the present system is redesigned, the assessment focuses on appraising certain formal aspects of the debt targets that can be improved on, such as transparency, the definition of debt limited by the target, or coherence with the stability targets.

The simplification of the system for setting public debt targets since 2016 has not prevented its lack of transparency and predictability to persist, as it fails to establish clearly the debt increase permitted while complying with the target. Despite the fact that MINHAFP considers the ARs to possess the necessary elements to establish the volume of indebtedness in their budgets, the current system still does not allow proper planning as a consequence of the following factors:

- **Relaxation in 2016 of the initially agreed assumptions to change the debt targets.** MINHAFP, at the recommendation of AIReF, reduced the possible scenarios in which changes to the Autonomous Regions' debt targets as of 2016 would be possible to just two (the amounts from financing mechanisms not used to pay debt incurred or the year's deficit, and the debt increases deriving from reclassification of bodies in the General Government sector that do not finance the current year's deficit). In 2016, nevertheless, a waiver was permitted for debt not derived from financing mechanisms to finance debt overruns from previous years and, in the case of chartered regime ARs, the expenditure in 2015 on hepatitis C³. As a result, on the one hand, exceptions have been admitted that were

² [Report on initial budgets for 2016](#); [Report on the main aspects for the Autonomous Regions in 2016](#)

³ For the common-regime ARs that are members of the Autonomous Regions financing fund, the amount expended on hepatitis C has been excluded from the measure of compliance with the 2015 debt target (Council of Ministers of 11 December 2015), as foreseen in the debt waiver clauses established for 2015 (open clause)

not initially envisaged in the agreed joint target approved in Parliament; and on the other hand, an increase in the Autonomous Regions subsector target of this amount (around 0.1% of GDP) that will not be offset by a smaller increase in Central Government debt, thus affecting General Government sector debt. This practice in 2016 may be repeated in the period 2017-2019, should the same exception scenarios for debt limits recur.

- **Uncertainty over the date and the amounts to be received by the Autonomous Regions from the Regional Liquidity Fund (FLA) to finance debt outstanding from previous years.** MINHAFP reports on the extract from the CDGAE Agreements in which decisions are adopted on the amounts assigned to the ARs from additional liquidity mechanisms, as well as publishing regularly updated information on these mechanisms. AIReF greatly appreciates this drive for transparency undertaken by MINHAFP, but nonetheless considers that, for the ARs to conduct proper planning and monitoring of their debt targets, the envisaged schedule for each year with the dates and amounts to be assigned by the CDGAE Agreements should be made available sufficiently in advance, in view of the weight of this debt in the annual debt increase for a majority of the ARs.
- **Additionally, for 2017, there is some uncertainty regarding the debt increase that will allow the 2017 debt target to be changed to finance 2016 debt overruns.** Both the 2016-2019 SPU and, subsequently, the strengthened conditionality of the FLA approved by the Government's Delegated Committee on Economic Affairs (CDGAE) on 31 March 2016 (Official State Gazette 13 May 2016), establish limits to the deficit overruns in 2016 that may be financed in 2017⁴. This measure casts uncertainty on the debt increase that will be permitted for the purpose of compliance with the debt target in 2017, an issue that is not clarified in the proposal on targets.

It cannot be considered that there is coherence between the debt targets and the stability targets, when the debt targets are extended to cover unauthorised deficit increases from previous years. The debt target proposals for 2016 and for 2017-2019 are said to be coherent with the stability targets for the respective years. However, this coherence is not preserved

⁴ Deficit deviations potentially incurred by the ARs regarding the 2016 targets will be partially offset by their budgets for subsequent years, compensating for said deviations with smaller expenditure or higher revenue, therefore preventing FLA financing for these deviations from reaching the total amount or exceeding the percentage decided by the CDGAE. To determine this percentage, the CDGAE will study the nature and reasons for the deviation.

when the debt targets can be extended to finance deficit overruns with respect to the stability target carried over from previous years, or in the specific case of the targets proposed for 2016, that include upfront a portion of the debt earmarked for financing unauthorised deficit from previous years. In short, the debt targets end up incorporating the debt overruns deriving from having to finance deficit that is not authorised by the stability target.

Owing to this disconnectedness between the stability and debt targets, cases of systematic deficit non-compliance by some ARs do not necessarily translate into instances of non-compliance with debt targets. At present, some ARs systematically fail to meet their deficit targets, whereas financing such overruns at the expense of greater indebtedness does not lead to non-compliance with their debt targets. These debt overruns, as they are incorporated to the debt target, are not visible at the time of checking debt target compliance, which among the ARs is the general pattern, but is actually contributing to further distance the level of regional debt from compliance with the debt limits of 13% of GDP demanded in the medium term.

Recommendations

With respect to the proposal for stability targets:

The proposal tabled by MINHAFP envisages homogeneous targets for all of the Autonomous Regions on the grounds of compliance feasibility and coherence with the expenditure rule throughout the AR subsector. However, it does not contain any measurement method upholding its feasibility assessment, nor does it provide individual analyses of ARs' positions on how demanding compliance with the expenditure rule is. This uniform proposal poses a risk of deviation for the ARs furthest from the target and, by extension, for the subsector as a whole, at a cost in terms of credibility regarding target compliance and the implementation, in the event of deviations, of the correction mechanisms envisaged in the LOEPSF. Therefore, **AIReF recommends the following:**

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- 1. Differentiated stability targets should be set for 2017, so that the targets take into account each AR's particular situation in terms of feasibility and equity, while at the same time guaranteeing their coherence in complying with the expenditure rule.***
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Similarly, in view of the conceptual and methodological problems undermining rigour and thoroughness in applying the expenditure rule **AIReF recommends:**

2. That MINHAFP establishes without delay the working group for conducting a revision of the expenditure rule.

Moreover, AIReF believes that the target proposals should incorporate indicators that -with some variants- are commonly recognised internationally as instruments for the assessment of fiscal rules in terms of compliance feasibility. These indicators must be complemented with equity criteria that bring into the assessment a retrospective vision of previous efforts and an indicator for each AR's relative position regarding revenue.

Likewise, AIReF is of the understanding that the active participation in the process of setting the targets of the administrations that have to take the necessary fiscal policy decisions for their attainment would strengthen their commitment to budget stability. In this regard, **AIReF recommends:**

3. That MINHAFP should submit the proposal for individual targets, together with AIReF's report, to be studied and discussed sufficiently in advance by the Fiscal and Financial Policy Council (CPFF) working groups, to allow MINHAFP to modify, as appropriate, the proposal with inputs from the Autonomous Regions and from AIReF before its submission to the Council Plenary.

AIReF finds that the proposal for setting the targets for 2017-2019 does not contain the necessary elements for its assessment. In this regard, article 16 of AIReF's Statute states "*MINHAFP will deliver the basic documentation and other material used, accompanied by a preliminary analysis and draft proposal...*". **AIReF recommends:**

4. That the proposal put forward by MINHAFP should contain the necessary background data and the methodology supporting the allocation of targets, such that AIReF may assess and analyse any risk of non-compliance within the framework of its competences for monitoring fiscal rules.

With respect to the proposal for debt targets:

With the aim of improving transparency and allowing proper planning within the Autonomous Regions for compliance with the debt target, **AIReF recommends:**

5. That the debt targets should be defined perfectly from the moment they are set. In particular, that clear specifications are given for the cases that will permit a change in the debt targets, that a calendar is published with the amounts to be allocated by the CDGAE for the subsequent year, and that the effect of the measure announced by

the Government regarding funding for the debt overrun in 2016 on the 2017 debt increase is quantified.

The fiscal rules should be consistent with each other. In particular, the debt target should be coherent with the stability target, as required in article 15 of the LOEPSF. Therefore, **AIReF recommends:**

- 6. That net debt increases produced to finance debt overruns should affect the assessment of debt target compliance. In particular, that these should give rise to a non-compliance with the debt target assessment, or at least to make the assessment of compliance conditional upon correcting the financing overrun on an agreed time horizon.***
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