



Independent Authority
for Fiscal Responsibility

Report

25 July 2017

Report on the setting of individual budget stability and regional government debt targets for the Autonomous Regions 2018-2020

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 Report

In this report, the AIRcF analyses the proposals submitted by the Ministry of Finance and Civil Service (MINHAFP) on the horizontal distribution of budgetary stability and public debt targets in the Autonomous Regions (ARs) for the period 2018-2020.

As in previous years, the AIRcF assessment focuses on the first year, 2018, taking 2016 as a starting point, being the last closed fiscal year. The lack of information on the revenue projected from the regional financing system, which affects the whole period, creates a degree of uncertainty that increases as we move forward in time. Reviews of the regional financing system and the expenditure rule are also expected to take place during the period covered by the proposal.

In terms of the stability target for 2018, set for the Regions as a whole at -0.4% of GDP, the AIRcF considers the proposal presented by the MINHAFP to be adequate. Under this proposal, the ARs would have an individual target equal to that established for the subsector. This assessment rests on the fact that this target is considered feasible for all Regions according to the analysed indicators.

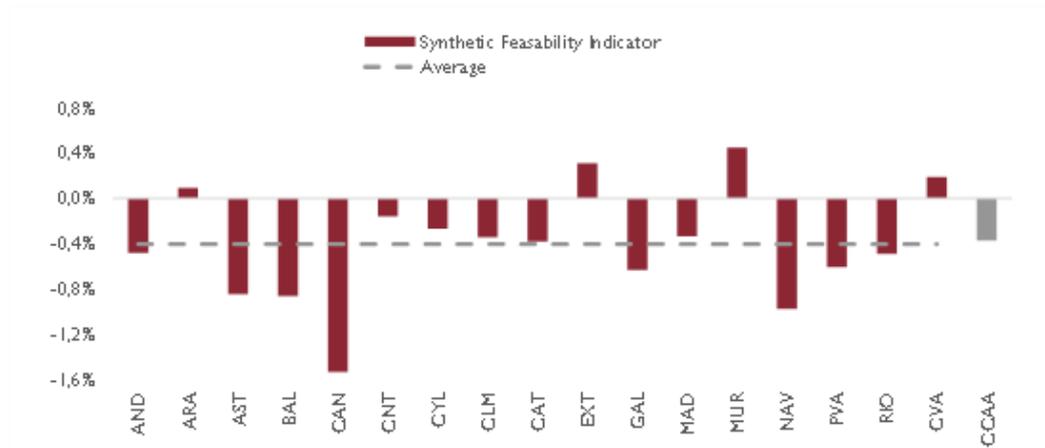
The main criterion followed by the MINHAFP for the homogeneous distribution of the stability target for the Regional subsector as a whole is that it is feasible. In order to verify the likelihood of each Region achieving their targets, the AIRcF has used the synthetic feasibility indicator¹, already applied in the previous report on setting targets for the ARs, which combines two indicators in line with the ECOFIN conclusions of 6 December of last year. The first of these indicators measures -as the European Commission's methodology establishes, the primary structural effort that the Autonomous Regions are required to make in 2018 to reach the proposed target of -1.4%. The second indicator measures (with some corrections) the non-financial expenditure's evolution needed to meet the target, assuming that all Autonomous Regions exercise a similar range of competences.

According to this indicator, the achievement of a target of -0.4 would only require the strengthening of four Regions: Extremadura, Region of Murcia, Comunitat Valenciana and Aragon, with some slack in joint compliance at the subsector level (see the following graph, numbered graph 3 of part 4).

Nevertheless, based on the effort made in previous years, the corrections required of these four regions can be considered feasible, although demanding in the case of the Region of Murcia.

¹ For more information, see the description of the calculations made and the indicators used in the Report on setting Regional targets of 22 December 2016.

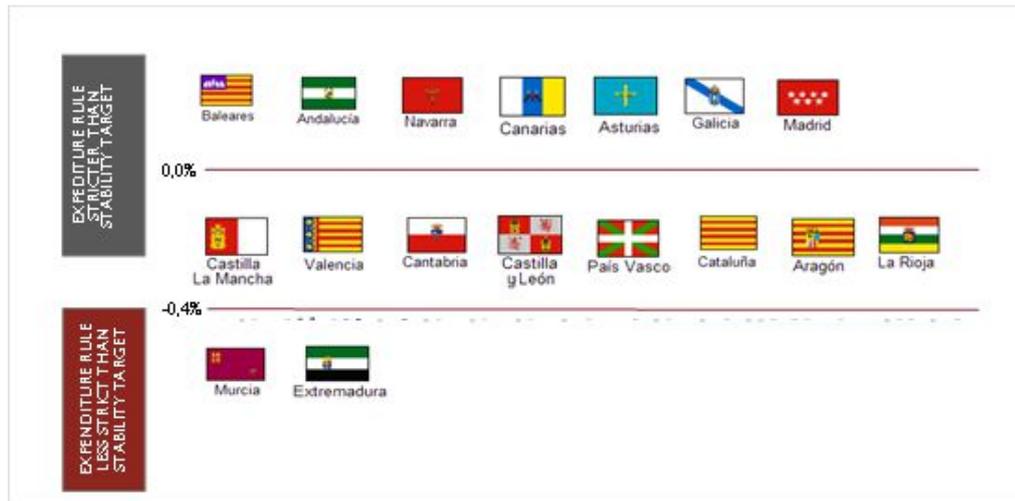
GRAPH. SYNTHETIC FEASIBILITY INDICATOR (% GDP)



The AIReF agrees on the feasibility of the Regional subsector achieving the stability target but despite this fact, in this report, the institution makes a series of considerations regarding the presented proposal.

On the one hand, it is contradictory to argue that the setting of equal stability targets for all regions contributes to transparency and monitoring of this target, while also making the assertion that the expenditure rule may be a greater restriction for some of them. If this is so, and it seems obvious that it is, the expenditure rule should be taken into account when setting the stability target, as stated in the Organic Law on Budget Stability and Financial Sustainability (LOEPSF). It should be clear that it is precisely for the sake of transparency that the stability target should allow compliance with an expenditure rule that, according to the AIReF forecasts, would restrict the deficit and could be achieved by all Regions, with the exception of Extremadura and the Region of Murcia (see the following graph, numbered graph 8 of part 4).

GRAPH. BALANCE REQUIRED IN 2018 THROUGH THE APPLICATION OF THE EXPENDITURE RULE WITH RESPECT TO THE STABILITY TARGET (% GDP)



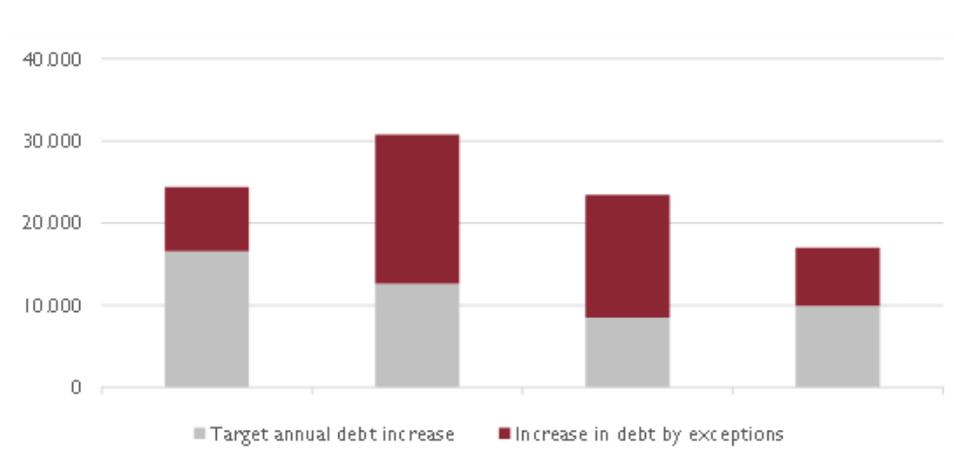
Accordingly, the contribution of the Regional subsector to the fulfilment of the Spain's commitments in the 2017-2020 Stability Programme Update (SPU) and in the framework of the Excessive Debt Procedure (EDP) is expected to exceed the one contemplated in the document, to the extent that compliance with the expenditure rule, coupled with the announced evolution of the revenue from the regional financing system in 2018, could lead the subsector to a situation close to budgetary equilibrium.

On the other hand, the proposal also introduces the argument that a homogeneous target for all Autonomous Regions avoids transferring the discussion on possible imbalances arising from the regional financing system to the sphere of budgetary targets. The AIReF considers it impossible to separate the two areas given the impact of regional financing system revenue on the Regional income and, consequently, on their deficits.

The stability in the evolution of an expense, limited by the expenditure rule and the variability of revenue determined by the regional financing system, greatly hinder the possibility of medium-term fiscal planning in accordance with the principle of financial stability. In this respect, and in this time-frame, an analysis of the debt stability should be included in the proposal, focused on the primary balance required to reach the reference level established by the LOEPSF at 13% of regional GDP.

Finally, in relation to the debt targets, the lack of transparency and predictability noted in previous reports continues to be an issue. As the exception clause that allows for the rectification of targets at year-end is not limited, the amount of these exceptions is significant (see the following graph, shown in figure 10.0 of part 5).

GRAPH. INCREASE IN DEBT BY EXCEPTIONS IN RELATION TO TOTAL ANNUAL DEBT INCREASE. TOTAL REGIONAL SUBSECTOR (MILLIONS OF €)



In this context, the AIRcF recommends the presented proposal:

- Discuss the restrictions imposed by the application of the expenditure rule for many Regions.
- Include the projected revenue from the regional financing system for the proposal horizon, as well as its distribution by region.
- Include a 2017 year-end forecast.
- Include an explanation of the methodology and criteria that support the setting of a deficit target of 0.4% GDP for each and all of the Autonomous Regions, as well as the feasibility of this target.
- Be specific about the escape clause of the debt targets, limiting the exceptions that make it possible to rectify the initial targets at the end of the fiscal year.

Likewise, the AIRcF recommends that future proposals, in addition to the above, include a medium-term debt sustainability analysis.

1. Introduction

The AIRcF has to report the budgetary stability and public debt targets proposed by the MINHAFP for each of the Autonomous Regions. The LOEPSF notes that once the budgetary stability and public debt targets have been established for the General Government as a whole and its subsectors, the MINHAFP has to formulate a proposal for individual budget stability and public debt targets for each of the Autonomous Regions. Based on this proposal, and following the report from the AIRcF and the Fiscal and Financial Policy Council, the Central Government will establish the budgetary stability and public debt targets for each of them

This Report must be issued within 10 days since the Government's approval of the General Government targets, once the information demanded by the AIRcF statute is received. The targets for the General Government as a whole were established by the Government on July 7, but as this Report requires the submission of the documentation, the 10-day period began on July 19, the date the AIRcF received the proposal for the individual 2018-2020 budgetary stability and public debt targets. However, this Report will be issued before the 10-day deadline; it will be included in the file submitted to the CPFF on July 27.

2. Purpose of the Report and Limitations

The purpose of this Report is to study the proposals established for the 2018-2020 budgetary stability and public debt targets for each of the Autonomous Regions, once the targets for the whole subsector are set. In accordance with Article 16 of the AIReF Statute, once the targets for the General Government and each of the subsectors has been approved on July 7, the AIReF has to report on the MINHAFP proposal on the distribution among the Regions, submitted for its analysis. The Report will consider the background documentation and history, accompanied by an initial analysis with the possible proposal for individual targets for each of the Autonomous Regions (horizontal distribution of the targets). Therefore, this report from the AIReF is limited to the assessment of this distribution, with regard to the target set for the subsector as a whole.

The scope of the report has been limited to 2018, where there are uncertainties, although not as significant as those that may affect 2019 and 2020. The documents submitted by the MINHAFP does not include essential aspects such as a forecast of the projected evolution of revenue from the regional financing system for the 2018-2020 period or the 2017 year-end forecast. In addition, there is also uncertainty associated with the reviews of the regional financing system and the expenditure rule, which are expected to take place in the period covered by the proposal. Despite the fact that these uncertainties affect the whole period, as there is an approximation of the global revenue number for 2018 and since the uncertainties increase over time, the AIReF assessment of the proposal focuses on 2018, taking 2016 (the last closed fiscal year) as a starting point.

3. Assessment of the MINHAFP proposal

3.1. Stability Targets

The MINHAFP proposal sets homogeneous budget stability targets for each of the Autonomous Regions equal to the subsector targets. Expressed as a percentage of GDP, the proposed homogeneous targets for the 2018-2020 period are: -0.4% in 2018; -0.1% in 2019 and 0.0% in 2020.

The MINHAFP bases this proposed homogeneous distribution on arguments related to the subsector as a whole and the individual situation of each region:

- ✓ **Arguments relating to the Regional subsector as a whole:**
 - Enables compliance with the commitments assumed by Spain in the 2017-2020 (SPU) and in the framework of the Excessive Deficit Procedure (EDP).
 - Improves the cyclical component of the fiscal balance, which will greatly reduce the additional structural efforts to be made by the Autonomous Regions to achieve the nominal targets included in the SPU.
 - Avoids transferring the discussion on possible imbalances, arising from the current Regional Financing System, to the sphere of budgetary stability,
 - Involves a simple transfer of the joint target, which provides transparency and visibility to its control.
- ✓ **Arguments related to the individual situation of each Region:**
 - Feasibility: for the achievement of the individual 2017 targets, feasibility is favoured by the positive evolution of revenue from the Regional Financing System and the application of the LOEPSF measures to the Autonomous Regions. For successive years, feasibility improves due to the expansion of the 2018 and 2019 targets by one tenth, together with the favourable evolution of the economy.
 - Equity: greater structural effort will be required for those Regions that, to a large extent, have made less consolidation efforts compared to the average in previous years, according to the MINHAFP and in line with the equity indicators included in the AIRcF report on the individual targets of 22 December 2016. For other Regions, it is possible that the expenditure rule established for this period may eventually be more restrictive than the individual targets.

The AIRcF considers the submitted proposal to be adequate, based on the feasibility criteria, although it makes some considerations regarding the arguments indicated by the MINHAFP to justify the proposal. The AIRcF shares some specific aspects of the arguments raised by the MINHAFP, but generally considers that they should be further developed because they are not sufficiently substantiated. In particular, the following is indicated in relation to these arguments:

- The AIRcF agrees with the MINHAFP that the proposal contains feasible targets for all Autonomous Regions. The Ministry considers that one of the elements that favours feasibility in 2017 is the application of the LOEPSF measures to the regions, including the adoption of Non-Availability of Credit Agreements for non-compliance with the adjustment plans. This measure is considered to have been activated in 2017 for the six Autonomous Regions² that failed to comply with their 2016 stability targets. However, only Cantabria refers to this measure in their respective 2017-2018 draft Financial Economic Plan (PEF), which was the subject of the July AIRcF report. In addition, with respect to the application of these Non-Availability of Credit Agreements in 2016 for non-compliance with the 2015 stability targets, the AIRcF has repeatedly stated that, in general terms³, none of these agreements were adopted in the terms required by the LOEPSF, so it was not possible to consider the effectiveness of this measure. On the other hand, in relation to the 2017-2018 PEF, regardless of the specific measures in any single region, for the subsector as a whole, it is not possible to consider the existence of measures other than the smallest amount of the refund for excess payments made in 2012. Therefore, the AIRcF considers that the elements that will contribute most to feasibility are those related to the improved evolution of revenue and, in particular, the increase of revenue from the regional financing system, expansions of the stability targets⁴ and the containment of expenditure. All these factors make, in general terms, unnecessary the adoption of discretionary measures.
- The AIRcF also agrees with the MINHAFP's argument, which states that, in line with the equity indicator, some Regions that have made less effort in the past will have to make a greater effort than the average, although the proposal submitted does not contain the metrics that support either the feasibility or equity assessments.
- The MINHAFP notes that for some Regions, the expenditure rule may imply an additional restriction in excess of that set by the stability target, while also arguing that the proposal represents a simple transfer of the joint target, which

² Aragon, Cantabria, Catalunya, Extremadura, Murcia Region and Valencia.

³ Excepting Extremadura and Aragon, for the aggregate amount of 80 million euros.

⁴ In 2016, the target was extended from -0.3% GDP to -0.7% GDP and from 0,0% GDP to 0,1%GDP, respectively.

provides transparency and visibility to its control. However, the AIRcF considers that these two arguments are contradictory, since it is not possible to state that the proposed targets are simple, transparent and visible in their control while the MINHAFP also implicitly acknowledges that the established targets are not those that will effectively operate as a limit at year-end. If the expenditure rule supposes a greater restriction for some Autonomous Regions, it would require a balance lower than the stability target. The AIRcF also believes that the importance of the expenditure rule as a legal criterion to be taken into account in the setting of stability targets would require further development by the MINHAFP of this criterion. It would also need to include an individual study of how the expenditure rule affects each of the Regions.

- On the other hand, the AIRcF agrees with the argument that the area of budgetary stability is not the most appropriate sphere for the discussion on possible dysfunctions or imbalances in the revenue provided by the regional financing system. However, the AIRcF believes it is impossible to separate the two areas given the impact of the regional financing system revenue on the Autonomous Region income and, consequently, on the evolution of their deficits.
- In relation to the fact that the proposal allows compliance with the Spanish commitments arising from the Stability and Growth Pact, the AIRcF agrees that the submitted proposal is consistent with the joint targets and, in this sense, that the Regional subsector target would also be contributing to the achievement of the targets for the General Government as a whole and, consequently, to compliance with Spain's commitments with the European Union. It should be noted that the inclusion of the expenditure rule could lead to more demanding targets for most Regions and, consequently, a lower balance for the subsector.

3.2. Public Debt Targets

The MINHAFP proposal includes the starting position of the Regional subsector debt that is applicable for the establishment of the 2018-2020 targets, but does not use it to establish the distribution among the Regions. The proposal indicates the level of debt that has been taken as the starting point for establishing the 2018-2020 debt targets and the exceptions that may later rectify the targets set during that period, but does not specify the elements considered to carry out the annual distribution of the targets. However, as in previous years, the proposed individual targets are obtained by taking the stability targets and the postponements for the negative settlements corresponding to each of the years of the period as an annual increase.

4. Analysis of the proposed stability target

Feasibility analysis

The AIReF has analysed the feasibility of achieving the 2018 stability targets, assessing the structural effort and the evolution of expenditure for the entire subsector and for each region. As noted in previous reports, considering the feasibility of the 2018-2020, it is essential to establish these targets to rely upon their achievement and the effectiveness of the correction mechanisms provided for in the LOEPSF. Setting unfeasible targets involves a risk of deviation and a cost in terms of credibility.

Under this analysis, the AIReF concludes that it would be feasible for all Autonomous Regions to reach a deficit of 0.4% GDP, with different degrees of effort, which is why the MINHAFP proposal is considered adequate. In order to analyse the feasibility of reaching the deficit of 0.4% GDP proposed by the MINHAFP for all Autonomous Regions in 2018, the AIReF has used a series of feasibility indicators, already listed and described in the Report on 2017-2019 Targets of December 2016⁵. The feasibility indicator's updated methodology is included in the annex on calculations, whose results show that for the majority of the Regions, and the subsector as a whole, the balance of -0.4% GDP does not require much effort. According to these indicators, only four Regions (Aragon, Valencia, Extremadura and the Region of Murcia) need to make an effort to reach this deficit level. In relation to these regions, it is concluded that in all of them, although it will be more demanding for the Region of Murcia, it is viable to make the effort to reach the 2018 deficit of 0.4% GDP, taking the previous periods into account.

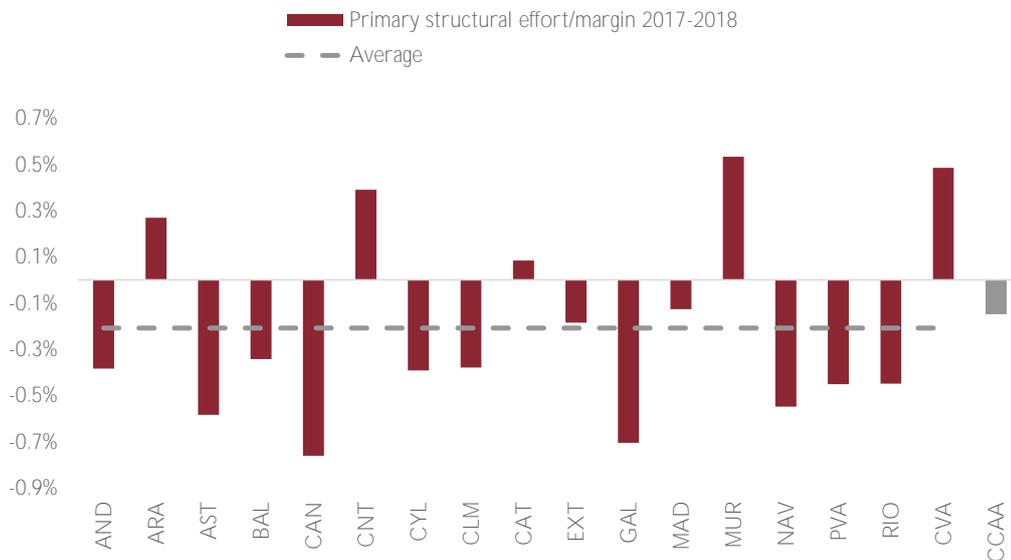
1. 2017-2018 Structural Effort (%GDP).

This indicator is an approximation to the fiscal effort, based on the projected impact of the economic cycle on public accounts, according to the content of Order ECC/1556/2016 on the methodology of the European Commission, excluding the interest analysis.

According to this indicator, as shown in figure 1, only five regions (Aragon, Cantabria, Catalonia, the Region of Murcia and Valencia) have to make a structural effort to achieve the established target of -0.4% GDP. The indicator shows that, for the subsector as a whole, it is not necessary to make a structural effort to reach the established deficit level.

⁵ [Report on the setting of individual budget stability and regional government debt targets for the Autonomous Regions of 22 December 2016](#)

FIGURE 1. 2017-2018 STRUCTURAL EFFORT BY REGION (% GDP)



Source: MINHAFP, MINEICO and AIRcF forecasts

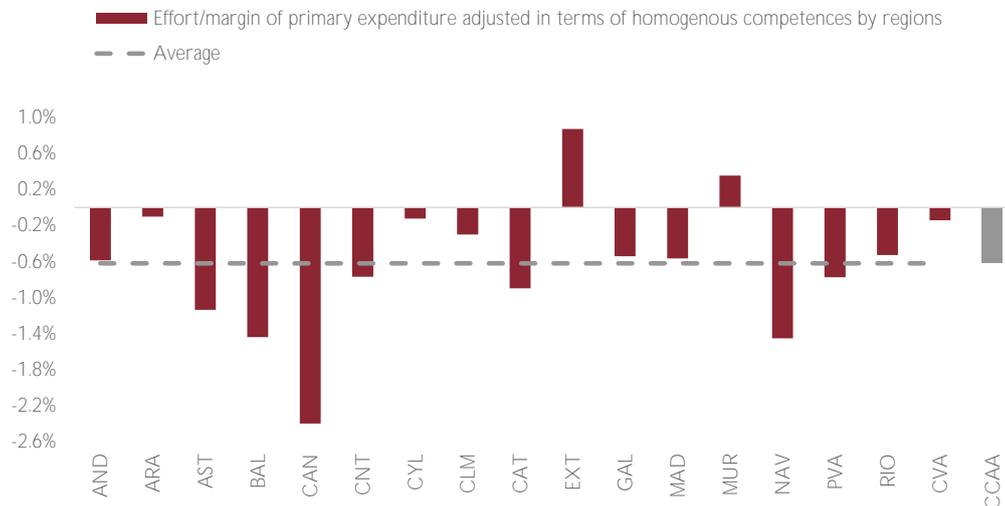
Note: Variation in the 2017-2018 period, as a percentage of GDP, of the primary structural balance, projected according to the methodology of Order ECC/1556/2016, to reach -0.4% GDP in 2018.

2. 2017-2018 Effort/margin of primary expenditure, adjusted for homogeneous competences and refined investment aid for the subsector as a whole (% regional GDP).

This indicator analyses the reduction effort or the margin of increase of the primary expenditure that would be required to comply with the 2018 -0.4% deficit target, given a certain level of revenue projected by the AIRcF. This revenue projection is based, among other factors, on the latest public information on the evolution of the system's revenue in 2018 for the Regional subsector as a whole, of which there are no details available on its composition and distribution.

Figure 2 shows that only Extremadura and the Region of Murcia would have to make an effort in terms of reducing primary expenditure to reach a target of -0.4% GDP. For the subsector, it is observed that the achievement of the 2018 target allows a margin of increase of primary expenditure adjusted in terms of homogeneous competences.

FIGURE 2. 2017-2018 EFFORT/MARGIN OF PRIMARY EXPENDITURE ADJUSTED IN TERMS OF HOMOGENEOUS COMPETENCES BY REGION (% GDP)



Source: : MINHAFP, CCAA and AIRcF forecasts

Note: Variation in the 2017-2018 period, as a percentage of GDP, of primary non-financial expenditure with homogeneity in expenditure, debugged from 2016 expenditure non-recurrent in 2018, payments to the State for the regional financing system, and investment aid, to reach the target of -0.4% GDP in 2018.

3. Synthetic feasibility indicator (absolute values in % regional GDP)

The synthetic feasibility indicator measures the effort to be made by the Autonomous Regions in the analysed period, weighting the information contained in the previous indicators. The weights used for each of the two indicators, the structural balance and the evolution of expenditure, from 53% and 47% respectively, have been calculated according to a statistical procedure⁶. The AIRcF's feasibility analysis in the last report on the setting of Regional targets, which identified those regions that needed to make a very different effort than the subsector average, was based on this indicator.

Given the slackness of the subsector in meeting the 2018 target, as shown by the indicators, the measurement of the synthetic indicator by region, based on the deviation from the mean, does not provide significant information regarding the effort to be made by the different regions. For this reason, the synthetic indicator has been defined in absolute values, instead of a distance to the average, being used to identify those regions that must make an effort during the 2017-2018 period to reach the 2018 budgetary stability target.

⁶ [For more information, see the description of the calculations made and the indicators used in the Report on the setting of individual budget stability and regional government debt targets for the Autonomous Regions of 22 December 2016.](#)

From the results shown in Figure 3 for each region, it can be observed that achievement of a -0.4% target would only require an effort for four autonomous regions: Extremadura, Region of Murcia, Valencia and Aragon.

FIGURE 3. SYNTHETIC FEASIBILITY INDICATOR (% GDP)



Source: MINHAFP, MINEICO, Regions and AIRcF forecast

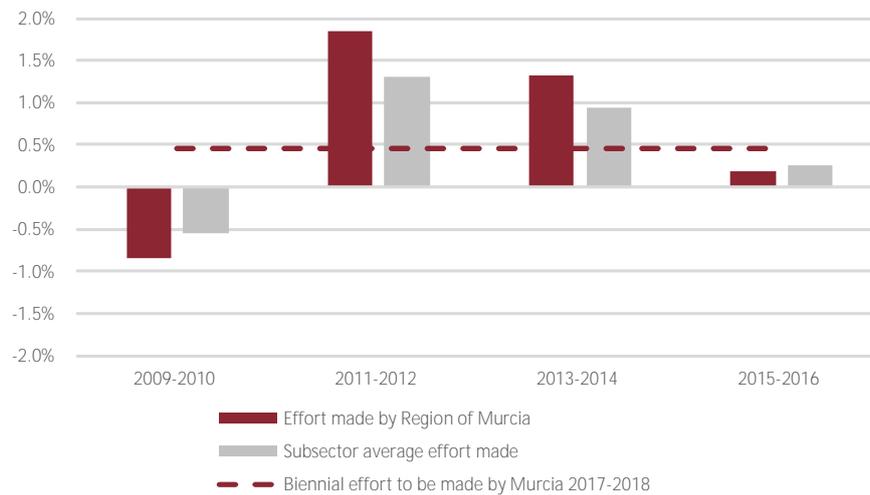
Note: Weighted indicator that measures the effort to be made in the 2017-2018 period to reach the -0.4% GDP target in 2018. It includes information from two feasibility indicators, combined with weights of 53% and 47%, respectively.

In order to effectively analyse the individual feasibility in an environment where the projected revenue increases for the Regional subsector in 2017 and 2018 seem to indicate a negative net effort for most, it is necessary to do an individualized study of those regions that must make a positive effort in absolute terms. In order to do so, the efforts of each of these four regions (Region of Murcia, Extremadura, Valencia and Aragon) that must be made in the 2017-2018 period is compared with the efforts made in the four previous biennial periods (2009-2010, 2011-2012, 2013-2014 and 2015-2016) and with the subsector average for those periods.

In this manner, we verify whether there is empirical evidence that this region and/or the subsector average have been able to carry out an effort similar to that demanded in the 2017-2018 period to reach -0.4% GDP in 2018. This evidence provides a measure of the feasibility of carrying out the required effort.

Applying the analysis described above to the Autonomous Region of the Region of Murcia, which presents the greatest effort to be made in the 2017-2018 period, it is observed that in two of the four biennial periods (2011-2012 and 2013-2014), the Region made a greater effort than the required to reach the 2018 target of -0.4% GDP.

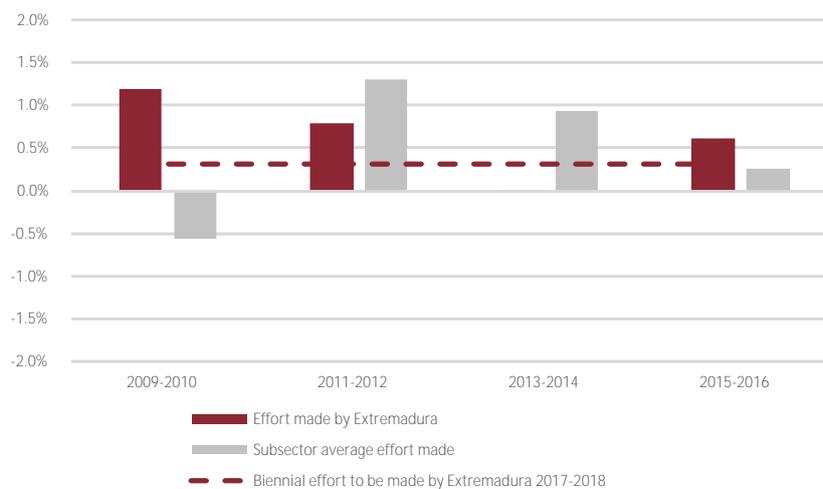
FIGURE 4. BIENNIAL EFFORTS MADE BY REGION OF MURCIA IN PAST (2008-2016) AND FUTURE (2017-2018), ACCORDING TO SYNTHETIC INDICATOR (% GDP)



Source: MINHAFP, MINEICO, Regions and AIRcF forecasts

The Autonomous Regions of Extremadura, the second in terms of effort to be made in the 2017-2018 period, has made a greater effort than the currently needed to reach a deficit of 0.4% GDP in 2018 in three of the previous four biennial periods.

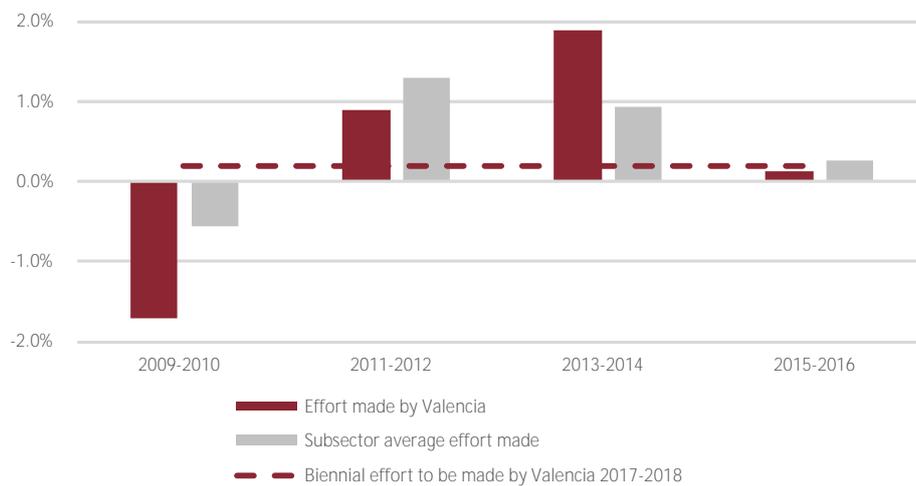
FIGURE 5. BIENNIAL EFFORTS MADE BY EXTREMADURA IN PAST (2008-2016) AND FUTURE (2017-2018), ACCORDING TO SYNTHETIC INDICATOR (% GDP)



Source: MINHAFP, MINEICO, Regions and AIRcF forecasts

Valencia also presents a positive net effort to be made in the 2017-2018 period, although less than the previous two regions discussed. The effort made in two of the four previous biennial periods is significantly greater than the effort needed to reach -0.4% GDP in the current period.

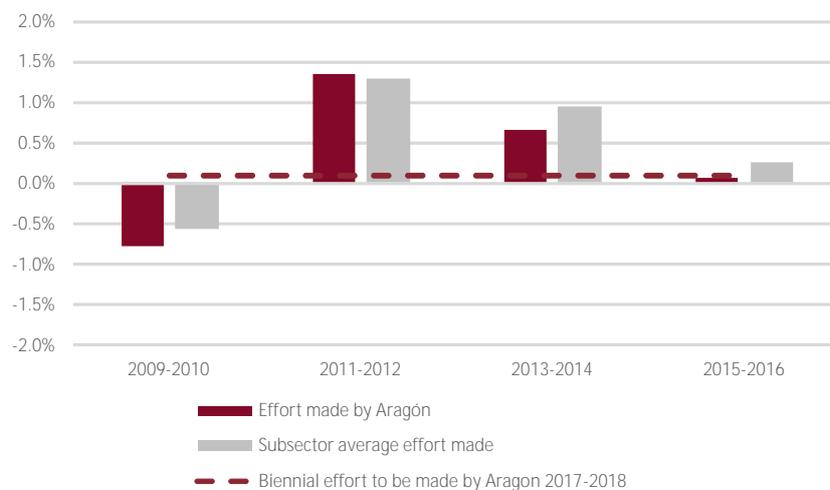
FIGURE 6. BIENNIAL EFFORTS MADE BY VALENCIA IN PAST (2008-2016) AND FUTURE (2017-2018) (% GDP)



Source: MINHAFP, MINEICO, Regions and AIRcF forecasts

Finally, in the case of the Autonomous Region of Aragón, which, according to the feasibility indicator, should make a positive (but small) effort to reach the 2018 deficit target of 0.4%, the efforts made in two of the four previous biennial periods are greater than needed for the current period to reach the stated deficit target.

FIGURE 7. BIENNIAL EFFORTS MADE BY ARAGON IN PAST (2008-2016) AND FUTURE (2017-2018) (% GDP)



Source: MINHAFP, MINEICO, Regions and AIRcF forecasts

From the individual analyses carried out previously for those Regions that, according to the synthetic feasibility indicator, required a net positive effort to reach the -0.4% GDP target in 2018, it follows that, given the efforts made in the past by these Regions (and others), the efforts to be made in the 2017-2018 period could be accomplished by all of them.

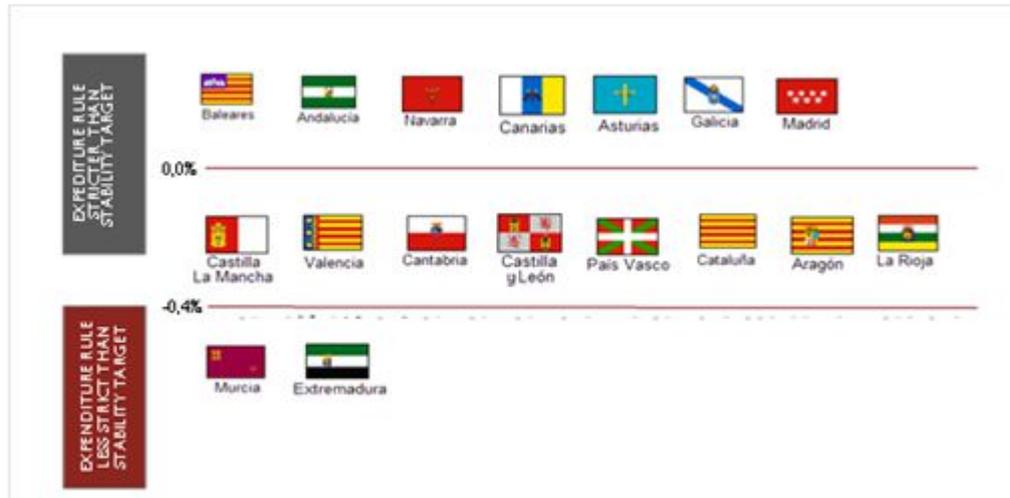
From the perspective of equity, the Autonomous Regions that must make an effort in the 2017-2018 period to reach a deficit level of 0.4% made an effort under the subsector average in the past. The AIReF has also designed equity indicators that measure the efforts made by the Regions in the past. These indicators were described and defined in the previous report on targets for the 2008-2015 period, and updated in subsequent reports to include 2016 data⁷. According to these indicators, as established in the above reports, the term of equity in those regions that require a net positive effort to reach the -0.4% GDP target derives from the fact that the four regions are below average in past efforts made in the 2008-2016 period.

Expenditure Rule

Together with the above criteria, the establishment of the targets should consider the relative position of each Autonomous Region regarding the application of the expenditure rule, according to the LOEPSF. The MINHAFP proposal suffers from a certain contradiction that affects its transparency because it sets an identical target for all Autonomous Regions, and then recognizes that the application of the expenditure rule will generate differences in execution. Without neglecting the methodological difficulties currently presented in the calculation and forecasting of the expenditure rule, its consideration should be made clear in the setting of the targets, and, precisely because of the above, the pending issues should be resolved as soon as possible. According to the AIReF projections shown in Figure 8, the application of the expenditure rule could require stricter balances than the one proposed in 2018, which would lead to a real deficit for the subsector of less than 0.4%.

⁷ [Report on the initial budgets of the Autonomous Regions for 2017 \(April\)](#)

FIGURE 8. BALANCE REQUIRED IN 2018 BY THE APPLICATION OF THE EXPENDITURE RULE REGARDING THE STABILITY TARGETS (%GDP)



Source: AIReF forecasts

Reflecting this situation for 2018, there is a certain inconsistency in setting and meeting targets in the medium-term. The evolution of system revenue, decoupled from the evolution of expenditure, without significant changes in the management structure of the Autonomous Regions, leads to a significant variability in their deficit situation. In fact, the evolution of the system revenue is conditioned by the evolution of the economic cycle, whereas the evolution of expenditure, in general, presents less variability, some dissociation from the cycle, and it is subjected to a controlled path under the expenditure rule. Fundamental as a countercyclical instrument, it could contribute to decrease in the Regional indebtedness levels. This circumstance can lead to periods where there are gaps for the achievement of the targets, with periods where compliance is not feasible, which cannot be anticipated sufficiently in advance, which greatly hinders the possibility of fiscal planning in the medium term in line with the principle of financial sustainability.

In addition to the expenditure rule, the indebtedness level of each of the Autonomous Regions should be taken into account to set the stability targets. Another factor that must be considered when setting the stability targets is each region's public debt level. As can be seen from the debt sustainability analysis carried out in the following section, the debt levels for all the Autonomous Regions exceed the limits of 13% GDP and, in some cases, exceeds it considerably. Therefore, the distance to meet this limit should be a factor to consider in demanding greater fiscal effort. In times like the present, where the economy is experiencing remarkable growth, this would allow the regions to not increase, or if necessary, reduce the stock of debt accumulated in previous years, which is a drag on the recovery of the regional economy.

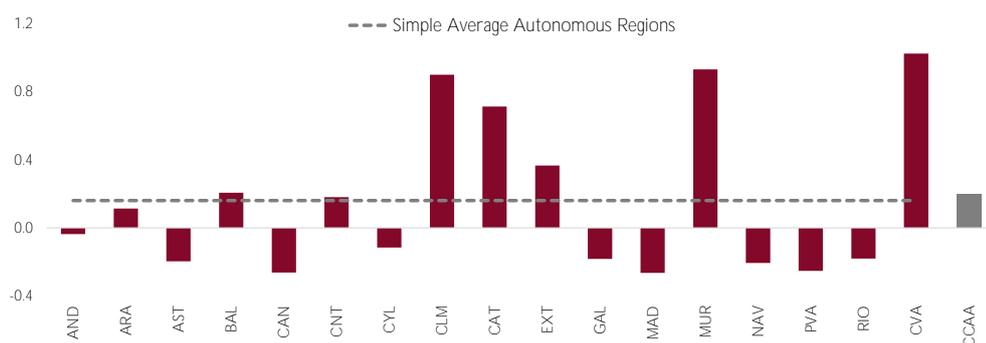
Debt sustainability analysis

Together with the feasibility indicators, the debt sustainability analysis provides a complementary, medium-long view. Specifically, and in line with the indicators established as an international reference level, a sustainability indicator is proposed to quantify the magnitude of the average additional fiscal effort to be made, in terms of the primary balance over GDP, to achieve the level of public debt for each Region established as a reference level in the LOEPSF (13% of regional GDP) in the year 2030, as a framework year in the medium-long term.

Positive values of this indicator (see Figure 9) reflect additional fiscal consolidation efforts, in terms of the primary balance, relative to a baseline scenario, to reach the 13% GDP level in 2030.

The baseline scenario is based on the AIReF forecasts for each Region in relation to GDP, primary balance and interest burden, starting from the horizon of the 2017-2020 Stability Programme Update. From 2020 onwards, the evolution of the primary balance of each region is gradually and consistently assumed with the achievement of the corresponding long-term debt target, albeit with an upper limit reflected by its historical evolution (0.75% GDP). With regard to GDP, it is assumed that from 2020 onward, it gradually converges to a nominal growth trend in the environment of 3.3% (with long-term inflation of 1.8%). Finally, financing conditions are supposed to converge gradually from the current levels to the Treasury levels, with the exception of the regions of Asturias, Castilla y Leon, Madrid, Navarra, the Basque Country, and La Rioja, where it is assumed that they will have made substantial use of the market since 2017⁸.

FIGURE 9. ADDITIONAL FISCAL EFFORT TO ENSURE SUSTAINABILITY IN 2030
(ANNUAL, % GDP)



Source: INE, MINHAFP and AIReF forecasts.

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

⁸ For more details on the definition of the assumptions and the calculation of the paths, see the [methodological annex](#) to the Debt Monitor published by AIReF.

5. Reference to the proposed debt targets

The debt targets proposed by the MINHAFP establish limits that are initially not very restrictive for most of the Autonomous Regions. The LOEPSF requires that the fixing of the debt targets is consistent with the established stability targets. Although the MINHAFP proposal does not specify how the debt targets have been calculated, as stated in part 3.2 of this Report, it is possible to verify that the proposed stability targets for each financial year have been taken into account. Therefore, the debt targets include the financing of some homogeneous stability targets for all the Regions and, insofar as the stability targets do not include the restrictions that would derive from the consideration of the expenditure rule and the level of indebtedness, these clearances are transferred to the debt targets, derived from a somewhat restrictive starting point, without the additional flexibility resulting from the exceptions permitted at the end of the fiscal year.

The proposal for setting the debt targets is not very transparent and predictable, since the escape clauses that allow the targets to be rectified at the end of the year are not included. The current proposal involves the return to the previous system of setting targets. For circumstances that did not derive from discretionary decisions of the Regions and, in accordance with the MINHAFP, in this previous system there was an open clause that allowed exceptions in compliance with the targets at year-end. In order to fulfill the AIRcF recommendations, a simplification was introduced into the system for the setting of these targets in 2016 and 2017, limiting the possible exceptions to two specific assumptions⁹. However, as the AIRcF stated in the Report on the setting of targets of 22 December 2016¹⁰, in practice, this change did not prevent the broadening of the initially agreed assumptions to rectify the debt targets. In the current proposal, instead of clearly specifying the assumptions that will allow the targets to be rectified, the MINHAFP has returned to the general escape clause. Consequently, since the exceptions are not effectively limited, there is uncertainty as to what the final limit will be for the purpose of verifying compliance and, therefore, the increase in debt that allows to meet the target, making it difficult to adequately plan the budget and monitor the debt target, which is contrary to the concepts of transparency and predictability that should characterize any fiscal rule.

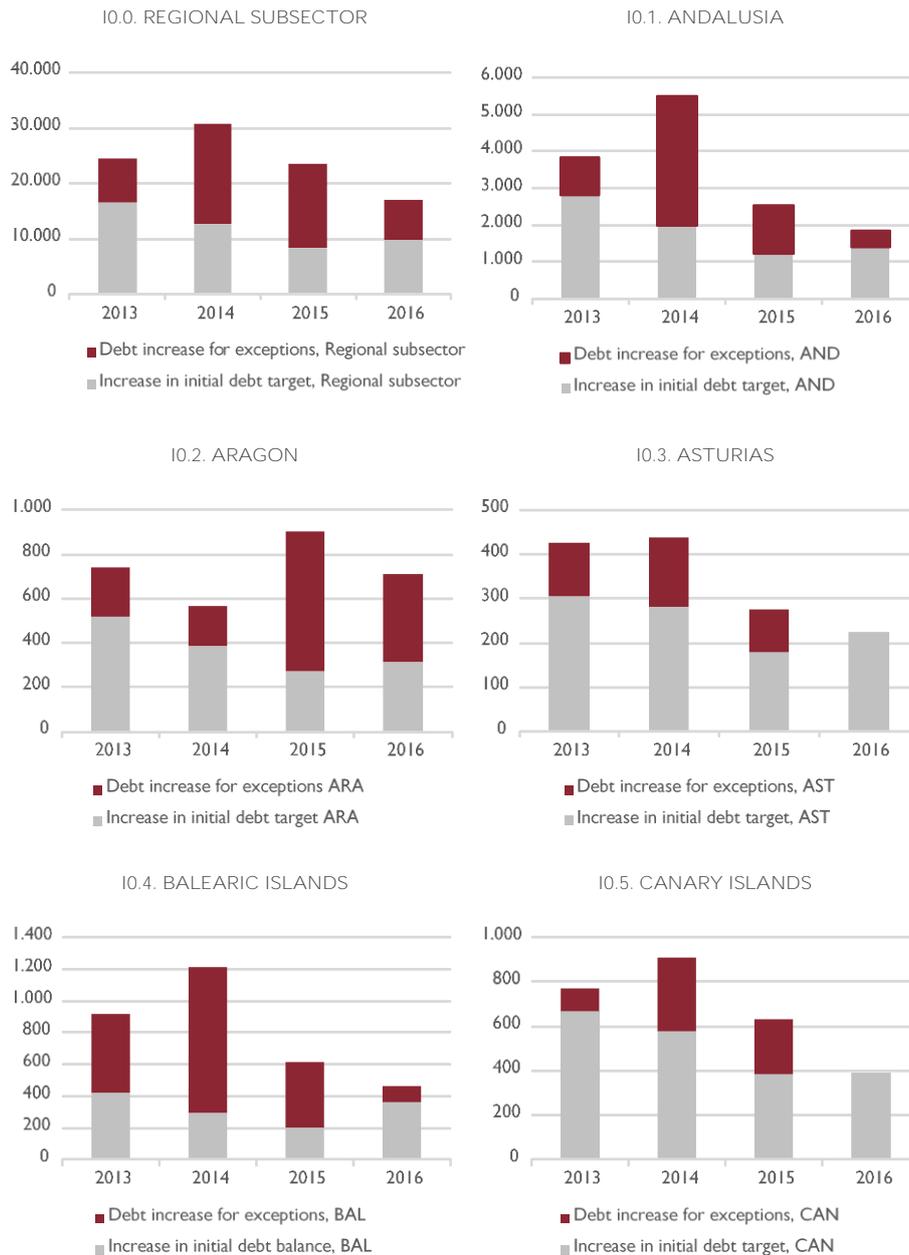
These escape clauses cover a very important part of the increase in regional debt, which increases the need for them to be bounded and defined from the moment the targets are set. Contrary to what might seem to be exceptional, these clauses do not correspond to infrequent or insignificant debt increases, but since 2013, the first year of the debt targets, until 2016, they have accounted for 50% of the total debt increase for the regions. During this period, the debt increased by about

⁹ (i) the amount of the financing mechanisms that are not intended to finance debt maturities and the yearly deficit, and (ii) the increases in debt derived from the reclassifications of entities in the General Government sector that do not finance deficit for the year.

¹⁰ [Report on the setting of individual budget stability and regional government debt targets for the Autonomous Regions](#) of 22 December 2016

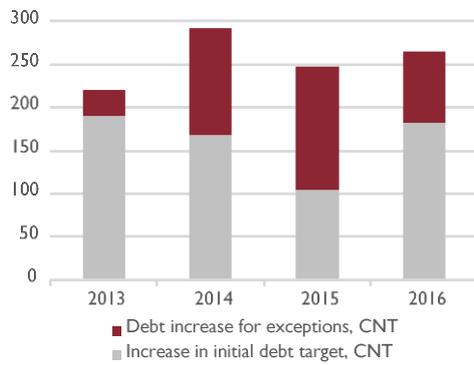
47.5 billion euros according to what was permitted by the initial target and by 48 billion euros by way of exceptions. At the individual level, this proportion has been able to represent more than 60% of the total debt increase in some of the Regions over the 2013-2016 period. For example, this proportion amounted to 70% in Valencia and 65% in the Region of Murcia (see Figure 10).

FIGURE 10. INCREASE IN DEBT THROUGH EXCEPTIONS IN RELATION TO TOTAL ANNUAL DEBT INCREASE (MILLIONS OF €)

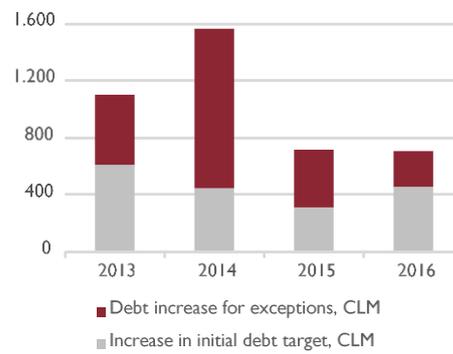


Source: MINHAFP.

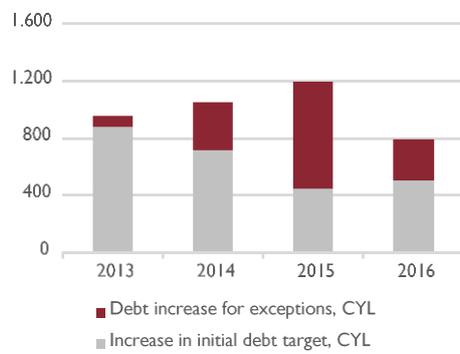
10.6. CANTABRIA



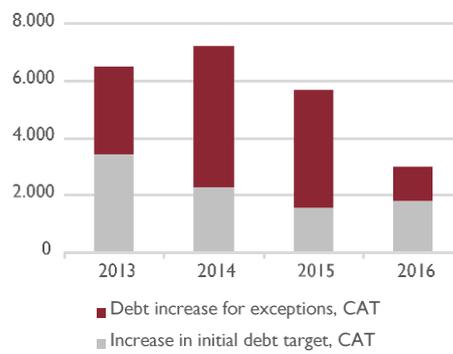
10.7. CASTILLA – LA MANCHA



10.8. CASTILLA Y LEÓN



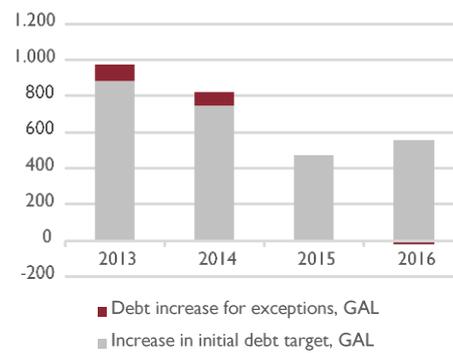
10.9. CATALONIA



10.10. EXTREMADURA

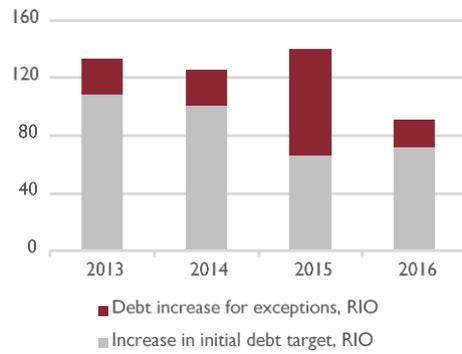


10.11. GALICIA

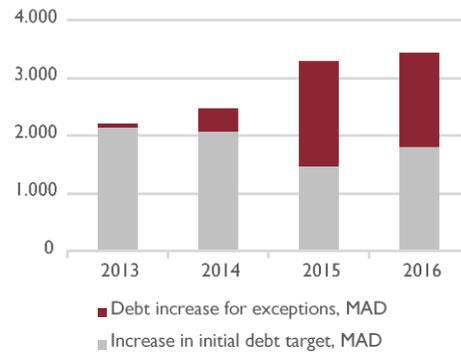


Source: MINHAFP.

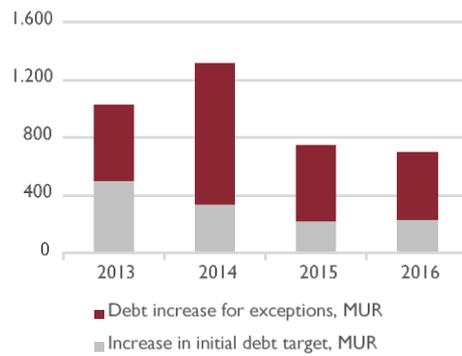
I0.12. LA RIOJA



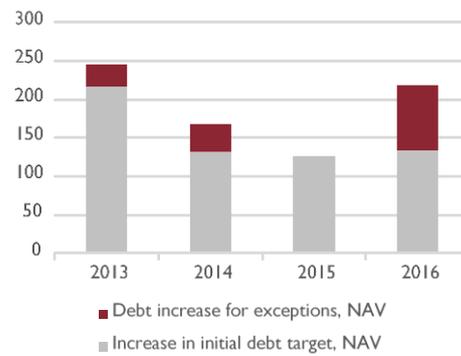
I0.13. COMMUNITY OF MADRID



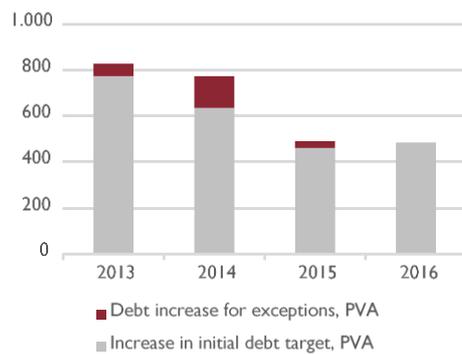
I0.14. REGION OF MURCIA



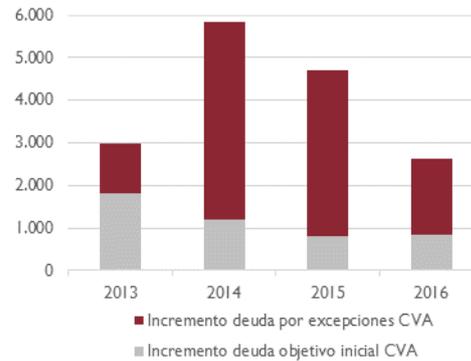
I0.15. NAVARRA



I0.16. BASQUE COUNTRY



I0.17. VALENCIA



Source: MINHAFP.

6. Recommendations

The proposal received from the MINHAFP responds to some of the considerations made by the AIRcF in the previous report on targets. In particular, the AIRcF noted that the previous proposal did not reflect the particular situation of each Administration regarding the LOEPSF, as well as the starting situation of their indebtedness. In response, the current proposal contains two tables with the above information.

However, the AIRcF believes that the proposal submitted for the horizontal distribution of the budgetary stability and public debt targets lacks some substantive information, such as the expected evolution and distribution of the regional financing system revenue or the restriction in terms of deficit that will be expected from the application of the expenditure rule, as stated in the document itself. Without ignoring the conceptual and methodological problems that remain with regard to the application and calculation of the expenditure rule, which in previous reports have led the AIRcF to recommend implementation of necessary measures for the correct application of this rule, for the sake of transparency, the AIRcF believes that the necessary effort in terms of the deficit required to the regions to comply with any of the established fiscal rules must be made explicit.

Moreover, the proposal does not include the methodology that supports it.

Therefore, *the AIRcF recommends that the MINHAFP:*

-
- 1. Shows the restriction imposed by the application of the expenditure rule for many Autonomous Regions.***
 - 2. Includes the revenue projections from the regional financing system for the horizon included in the proposal, as well as its distribution by Region.***
 - 3. Includes a 2017 year-end forecast.***
 - 4. Includes an explanation of the methodology and criteria that support the setting of a deficit target of 0.4% GDP for each and every Region, as well as the feasibility of this target.***
-

On the other hand, the MINHAFP proposal for the setting of the targets lacks a medium-term analysis according to the principle of financial sustainability, which takes into account each region's level of indebtedness and the need to generate primary revenue to achieve the debt reference level of 13% GDP established by the LOEPSF. Although the complexity of this analysis and the limited time available may prevent its inclusion in the current proposal, it would at least be desirable to take into account for future proposals.

Therefore, ***the AIRcF recommends that the MINHAFP:***

5. Includes a medium-term debt sustainability analysis in future proposals when setting the horizontal distribution of the stability targets.

The AIRcF has noted in previous reports that the debt targets must be clearly defined from the moment they are set and be transparent and predictable. It is therefore necessary that the escape clauses that allow the initial targets to be rectified at year-end are limited, especially considering that the debt authorized by these exceptions represents half the total increase in debt that has occurred in the Autonomous Regions since there were debt targets. Since the MINHAFP, following the AIRcF recommendations, had already limited the exceptions in 2016 and 2017 to two specific assumptions, the AIRcF believes that it should continue in that direction, clearly delimiting and defining those exceptions instead of returning to the previous system of general and open clauses which generate uncertainty, preventing adequate budgetary planning and the monitoring of this target, and which, in addition, could give way to discretion.

Therefore, for the sake of the transparency and predictability of the debt targets, ***the AIRcF again recommends that the MINHAFP:***

6. Moves forward in the direction initiated in 2016 and 2017 to limit the exceptions that make it possible to rectify the initial targets at year-end, clearly defining these exceptions and adjusting during the year to the initially established assumptions.

Annex: Description of calculations and indicators

A. Feasibility indicators

I. Primary structural effort 2017-2018

Effort in terms of primary structural balance (excluding interest), which would have to be achieved by the Autonomous Regions in the 2017-2018 period if the stability target was set at -0.4% GDP in 2018 (% regional GDP).

This represents the variation between 2016 and 2018 of the structural balance for each community, excluding the interest burden, assuming that the 2018 target for each Region is -0.4% of regional GDP.

The structural balance is associated with the budgetary situation that would prevail if an economy was using all its productive revenue without friction (i.e. at its potential level) and no temporary exceptional measures were taken (non-recurring operations). That is, the fiscal balance that would be recorded after discounting the effect of the economic cycle and these exceptional measures.

As it is known, the primary structural balance, does not include the interest burden. Given the changes in the financing mechanisms chosen by the Regions and understanding that the interest burden is largely outside the scope of the regional policies, it is considered to be a better measure of discretionary capacity. Therefore, the change in the primary structural balance is an indicator of the discretionary fiscal action to be carried out in 2017 and 2018 to reach the target.

The calculation of the cyclical sensitivities of each region and the production gap is described in the methodology annex of the Report on 2017-2019 targets published on 22 December 2016¹¹.

SEE FIGURE 1 OF THE REPORT AND TABLE A.1.

II. Effort/margin of 2017-2018 adjusted primary expenditure in terms of homogeneous competences

Effort or margin, in terms of non-financial homogeneous primary public expenditure (excluding interest, non-recurrent operations, regional financing system payments and investment aid), which the Regions would have if the

¹¹ [Report on the 2017-2019 individual Regional targets](#)

stability target for the subsector was set for all of them individually (% regional GDP).

It represents the variation between 2016 and 2018, by weight over GDP, of homogeneous primary non-financial expenditure deducted from payments to the State by the regional financing system, from the investment aid received and the operations carried out in 2016 which were not repeated in 2018, which each region would have in the period if the 2018 stability target of -0.4% GDP was established.

Therefore, it is possible to represent the different efforts that each region would need to make in the event that the criterion presented in the proposal to set the same target for each individual region in 2018 should be followed, without making any asymmetric distribution.

Each year, interest has been eliminated from non-financial expenditure, specified in terms of homogeneous responsibility, as a result of the great heterogeneity of the Regional subsector in relation to the interest paid for the debt and the few possibilities for action that the regions have on its evolution. Also, in the case of the regional subsector, the payments that must be made to the State in accordance with the regional financing system have been eliminated, along with, in the case of Navarra, the payments that must be made to the State for the Contribution, all according to the AIRcF forecasts. In both cases, the elimination has taken place as a consequence of the fact that the Regions do not have the capacity to change their evolution. Likewise, the amount of investment aid received in terms of national accounting, also projected by the AIRcF, has been eliminated. The purpose of this calculation is to determine the non-financial expenditure that can be assimilated into computable expenditure in order to calculate the expenditure rule.

The difference between the forecast of total non-financial revenue for 2018 (see methodology annex to the Report on 2017-2019 targets published 22 December 2016)¹² derived from the SFA payment forecast, the interest projected by the AIRcF for 2018, the assessment of non-homogeneous competences and investment aid, and the amount of the shortfall that would result for each Region if the target was set at -0.4%, would be the maximum amount of primary net expenditure payments that each region could reach in 2018.

The weight of the projected expenditure for 2018, in terms of regional GDP, is calculated and, in light of the difference between the weight in regional GDP in 2016, used to determine the margin or theoretical effort in terms of expenditure that the Regions would have to make to achieve the target of -0.4% GDP.

SEE FIGURE 2 OF THE REPORT AND TABLE A.1.

¹²Methodology annex to the [Report on the setting of individual budget stability and regional government debt targets for the Autonomous Regions](#), 22 December 2016.

III. Synthetic feasibility

Synthetic feasibility indicator (biennial variation in % regional GDP).

This indicator is calculated as a weighted average of the two indicators: (i) Effort in terms of primary structural balance; and (ii) Effort or margin, in terms of primary public non-financial expenditure. Like the indicators that make it up, it measures the effort to be made to reach the target of -0.4% regional GDP in 2018.

This indicator combines the information contained in the two effort indicators by means of weights, obtained through a statistical procedure. Specifically, the weight or weights are projected in three phases: (i) extraction of common factors by principal component analysis; (ii) rotation of the matrices of weight of the different factors according to VARIMAX techniques that maximize the correlation between the original variables and common factors; and (iii) aggregation of the weights corresponding to the different factors for each of the indicators.¹³

SEE FIGURE 3 OF THE REPORT AND TABLE A.1.

B. Equity Indicators

I. Biennial primary structural effort: 2009-2010, 2011-2012, 2013-2014 and 2015-2016.

For the individualized analysis of those communities that must make efforts in the 2017-2018 period to reach the 2018 stability target, it is necessary to compare the efforts made in previous biennial periods (2009-2010, 2011-2012, 2013-2014 and 2015-2016) by the Region and by the weighted average of the subsector with the effort to be made by the Region in the 2017-2018 period. Past efforts, in addition to introducing the equity perspective, provide an empirical measure of the possibility of achieving a given level of effort, expressed as % GDP, in a biennial period.

The primary structural effort represents the absolute biennial variation in the structural balance of each region, excluding the interest burden, measured for the four periods prior to the reference period (2017-2018). It is calculated similarly to the primary structural effort feasibility indicator, but referring to biennial periods that exclusively include closed fiscal years.

¹³ For more details, see OECD (2008), "Handbook on Constructing Composite Indicators: Methodology and User Guide," OECD publications.

The methodology annex of the Report on the 2017-2019 targets published 22 December 2016¹⁴ shows how to calculate the cyclical sensitivities of each region and the production gap.

SEE FIGURES 4-7 OF THE REPORT AND TABLE B.I.

II. Biennial effort/margin of primary expenditure adjusted in terms of homogeneous competences. 2009-2010, 2011-2012, 2013-2014, 2015-2016

The effort or margin, in terms of non-financial homogeneous primary public expenditure (excluding interest, regional financing system payments, non-recurring operations and investment aid) represents the absolute biennial variation measured for the four periods prior to the reference period (2017-2018) of the primary expenditure indicator. It is calculated similarly to the primary homogeneous expenditure effort feasibility indicator, but referring to biennial periods that exclusively include closed fiscal years.

SEE FIGURES 4-7 OF THE REPORT AND TABLE B.II.

III. Synthetic equity indicator (biennial variation in % regional GDP).

This indicator is calculated in the same manner as the synthetic feasibility indicator, with the only difference being that the biennial reference periods refer to closed fiscal years. The indicators that serve as the basis for the calculation of the synthetic or weighted indicator (effort in terms of primary structural balance and effort or margin, in terms of non-financial primary public expenditure) are defined for the 2009-2010, 2011-2012, 2013-2014 and 2015-2016 periods and reflect the efforts made in the respective periods.

SEE FIGURES 4-7 OF THE REPORT AND TABLE B.III.

¹⁴ [Report on the setting of individual budget stability and regional government debt targets for the Autonomous Regions.](#)

Annex: Data tables

TABLE A. I. 2017-2018 SYNTHETIC FEASIBILITY INDICATOR (%GDP)

Autonomous Regions	Biennial variation 2017/2018		Synthetic Feasibility Indicator 2017/2018
	Primary Structural Effort	Primary expenditure effort with homogeneous competences	
Andalusia	-0.4%	-0.6%	-0.5%
Aragon	0.3%	-0.1%	0.1%
Principality of Asturias	-0.6%	-1.1%	-0.8%
Balearic Islands	-0.3%	-1.4%	-0.9%
Canary Islands	-0.8%	-2.4%	-1.5%
Cantabria	0.4%	-0.8%	-0.2%
Castilla y León	-0.4%	-0.1%	-0.3%
Castilla - La Mancha	-0.4%	-0.3%	-0.3%
Catalonia	0.1%	-0.9%	-0.4%
Extremadura	-0.2%	0.9%	0.3%
Galicia	-0.7%	-0.5%	-0.6%
Community of Madrid	-0.1%	-0.6%	-0.3%
Region of Murcia	0.5%	0.4%	0.4%
C. Foral de Navarra	-0.5%	-1.5%	-1.0%
Basque Country	-0.5%	-0.8%	-0.6%
La Rioja	-0.4%	-0.5%	-0.5%
Valencian Region	0.5%	-0.1%	0.2%
Weighted Average	-0.2%	-0.6%	-0.2%

Source: MINHAFP, MINEICO and AIRcF forecasts.

TABLE B.I. PRIMARY STRUCTURAL EFFORT BY PERIOD FOR REGIONS THAT MUST MAKE EFFORTS IN 2017-2018 PERIOD (% REGIONAL GDP)

Autonomous Regions	Biennial Variation of the Primary Structural Balance				
	2009-2010	2011-2012	2013-2014	2015-2016	2017-2018 to reach target of -0.4%
Aragon	-0.8%	1.6%	0.5%	0.0%	0.3%
Extremadura	0.6%	1.0%	0.2%	0.5%	-0.2%
Region of Murcia	-0.8%	2.1%	1.3%	0.2%	0.5%
Valencian Region	-1.5%	1.2%	1.8%	0.0%	0.5%
Weighted Average	-0.4%	1.4%	0.9%	0.2%	-0.2%

Source: INE, MINHAFP, MINEICO and AIRcF forecasts.

TABLE B.II. EFFORT/MARGIN OF PRIMARY EXPENDITURE ADJUSTED BY PERIOD FOR REGIONS THAT MUST MAKE AN EFFORT IN 2017-2018 PERIOD (% REGIONAL GDP)

Autonomous Regions	Biennial variation of primary expenditure adjusted in terms of homogeneous competences				
	2009-2010	2011-2012	2013-2014	2015-2016	2017-2018 to reach target of -0.4%
Aragon	-0.8%	1.1%	0.8%	0.1%	-0.1%
Extremadura	1.9%	0.6%	-0.2%	0.8%	0.9%
Region of Murcia	-0.9%	1.6%	1.4%	0.1%	0.4%
Valencian Community	-2.0%	0.5%	2.0%	0.3%	-0.1%
Weighted Average	-0.7%	1.1%	1.0%	0.4%	-0.6%

Source: INE, MINHAFP and AIRcF forecasts.

TABLE B.III. SYNTHETIC INDICATORS OF EQUITY AND FEASIBILITY FOR BIENNIAL PERIODS BY REGION THAT MUST MAKE EFFORTS IN 2017-2018 (% REGIONAL GDP)

Autonomous Regions	Synthetic indicators of equity and feasibility per biennium				
	Effort made 2009-2010	Effort made 2011-2012	Effort made 2013-2014	Effort made 2015-2016	Effort needed in 2017-2018 to reach target of -0.4%
Aragon	-0.8%	1.4%	0.7%	0.1%	0.1%
Extremadura	1.2%	0.8%	0.0%	0.6%	0.3%
Region of Murcia	-0.9%	1.8%	1.3%	0.2%	0.4%
Valencian Region	-1.7%	0.9%	1.9%	0.1%	0.2%
Weighted Average	-0.6%	1.3%	0.9%	0.3%	-0.4%

Source: INE, MINHAFP, MINEICO and AIRcF forecasts.