

Executive Report on the main budgetary lines of the Autonomous Regions for 2018

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

The AIReF has evaluated the main budgetary lines of the Autonomous Regions (ARs), postponing its opinion on the other General Government (GG) subsectors, whose reports will be published separately as the data becomes available. Every year before October 15, the AIReF has to report on the Draft State Budget and the main budgetary lines of the subnational governments for the following year. However, the situation of each administration with regard to budgetary procedures and the availability of information is very different. Therefore, the AIReF will publish its reports as the data becomes available.

This report does contain a provisional assessment of the Draft Budgetary Plan forecasts in order to provide an overview of the General Government, which would otherwise be delayed until they present their main budgetary lines and budget drafts. The forecasts included in the Draft Budgetary Plan have been analysed, comparing them with the AIReF forecasts, assuming the renewal of the Draft General State Budget and considering the information available at this time concerning the main budgetary lines of the Autonomous Regions and the Local Governments.

From this provisional assessment, it is concluded that it would be feasible to reach the deficit of 2.3% of GDP forecasted in the 2018 Draft Budgetary Plan, despite the economic growth revision included in the government's macroeconomic scenario. The AIReF believes it is feasible that the Draft Budgetary Plan deficit forecasts will be met for the General Government as a whole, provided that the macroeconomic scenario for real GDP growth is also met. This assessment includes the possible uncertainty shock associated with the temporary political instability in Catalonia which would, according to AIReF forecasts, result in a deterioration of the budget balance of around 2 tenths with regard to the 2.2% of GDP target. However, if the uncertainty continues throughout the next year, economic growth could be significant lower than projected, which would place the public deficit at around 2.7% of GDP, in the most pessimistic scenario.

Despite the feasibility of achieving the forecasted fiscal balance, the AIReF believes it is unlikely that the Draft Budgetary Plan revenue forecast will be met. The Draft Budgetary Plan has greater revenue and expenditure scenarios than those projected by the AIReF. The main differences in revenue are focused on the projected current taxes on income trends that are about two tenths of GDP above the AIReF forecasts. The AIReF believes that part of this difference could be offset by the margin that appears to exist on the expenditure side in certain headings, such as interest.

By subsectors, the main risk of non-compliance with the budgetary stability target for 2018 is centred on the Central Administration (CA) and the Social Security Funds (SSF), insofar as these subsectors must make almost all adjustments required after the projected 2017 closure. The CA and the SSF would have to make a joint adjustment of more than 1% of GDP. In addition to this

adjustment, for the General Government as a whole to meet the target, the Local Governments would have to consolidate a surplus similar to that of recent years and the AR subsector would have to adjust its expenditure trend to the economy reference rate, which would generate some margin in the fulfillment of the target.

Report on the main lines of the Autonomous Regions 2018 Budgets

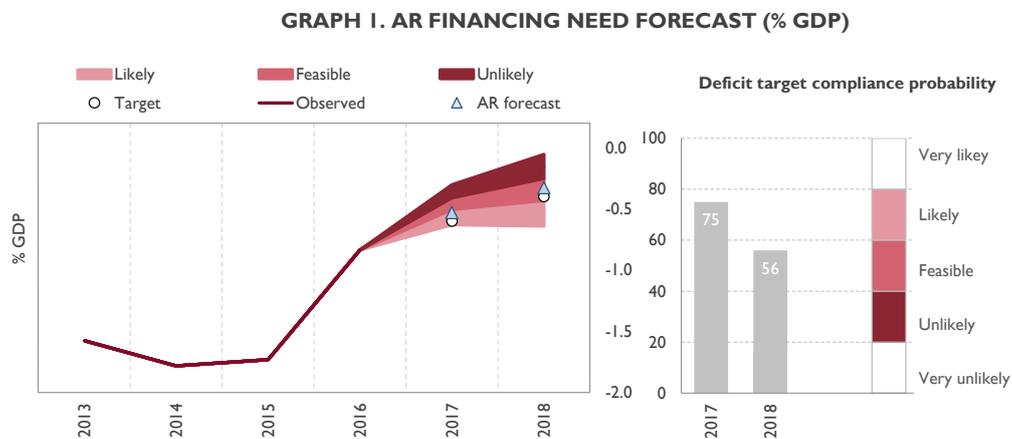
The purpose of this Report is to assess the main lines of the 2018 Regional Budgets from the perspective of compliance with the three fiscal rules defined in the Organic Law on Budgetary Stability & Financial Sustainability. However, as in previous years, there have been limitations on the scope of the assessment of the debt target and the expenditure rule. When assessing the main lines of the 2018 regional budgets, the AIRcF has included additional information provided by the Regions, and with this data, it has been able to provide an opinion on their ability to comply with the budgetary stability targets. However, there are deficiencies in the available information on the debt target and the expenditure rule that have limited the scope of the assessment.

The preparation of this report has been marked by the uncertainty arising from the failure to present the Draft GIP in the 2018 installments and by the impact of the political situation in Catalonia on economic growth. According to the information received, the ARs are preparing their draft budgets according to the interim instalments forecasts provided by the MINHAFP last July. However, since the Draft General State Budget has not been submitted to the Parliament, it is feasible that they will be updated with the new macroeconomic scenario or even that the 2017 budgets will be renewed in the event that the new budget for 2018 is not approved. Moreover, the effects of lower economic growth on the 2018 AR balances will depend on the shock size, the cyclical sensitivity to their tax revenues and on the moment when this lower growth is included in the calculation of the instalments of the financing system. These factors shall determine the size of the impact and its duration, insofar as it could be transferred, in whole or in part, to 2020 via the settlement of 2018 revenues.

Additionally, the assessment of the budgetary forecasts submitted by the Region of Catalonia requires an assessment of the idiosyncratic shock that delays the AIRcF's judgment on this region. The uncertainty associated with the Catalanian political situation has specific effects in this region, which will particularly affect the regional GDP and tax revenue forecasts, especially those related to the real estate sector, which represents about 10% of the regional revenue. This methodologically complex assessment has led the AIRcF to postpone the individual report for Catalonia, although a regional estimate has been included in the subsector assessment in a scenario defined by the projected general shock.

With the Draft Budgetary Plan growth forecasts, the AIRcF considers it feasible for the AR subsector as a whole to meet the deficit target of 0.4% of GDP under the scenario that the revenue from the Autonomous Financing System would be the ones communicated last July. The adjustment forecasted in the targets set

for the ARs for 2017 and 2018 is two tenths of GDP, although, after analysing the data provided by the Regions, the AIReF estimates that the 2017 closure could be more favourable for the ARs. (See Graph 1).



In this scenario, the AIReF forecasts that revenue will maintain its weight in GDP for 2018 while expenditure would decrease by one tenth, facilitating compliance with the stability target. AIReF forecasts put revenue at about 13.7% of GDP and expenditure at around 14%, although these forecasts have been corrected by the projected effect on revenue of the shock associated with the political uncertainty in Catalonia. Regarding expenditure, the AIReF projects a trend of current expenses of 2.5%, five tenths less than the Regional estimates. This difference is mainly due to the personnel costs that are higher in the Regional projections than in the AIReF forecasts, which take into account the failure to submit the GIPs. Likewise, the AIReF projects a much more moderate trend in capital expenditures than expected by the Autonomous Regions, which expect growth of more than 10%, with no available information or history seemingly able to support this growth.

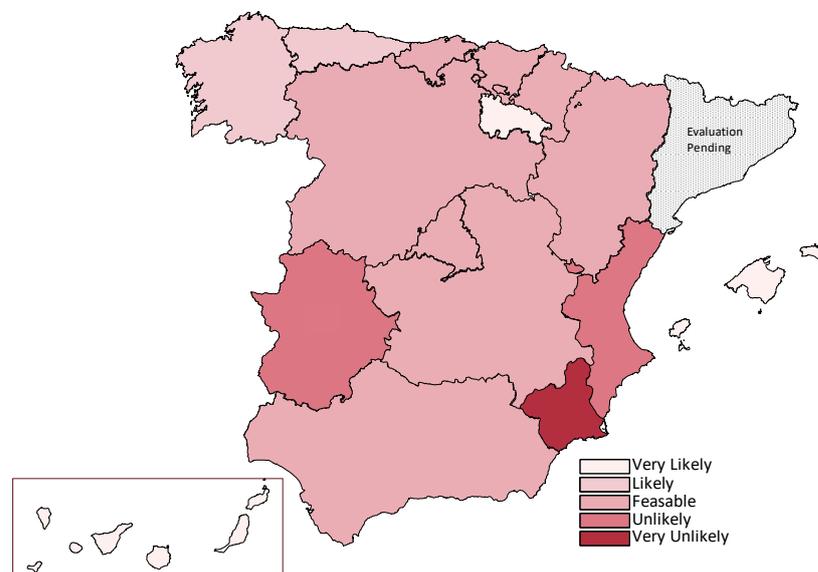
However, the decline of one tenth of GDP in the level of expenditure would not be sufficient to comply with the expenditure rule. The AIReF believes that, with the personnel costs not updated due to the failure to submit the Draft General State Budget, the computable expenditure for the Regional subsector as a whole could be, in an adjusted manner, compatible with the compliance of the expenditure rule. This would leave no margin if the salary increases were to be updated with the approval of the Draft General State Budget.

Regarding the individual situations of the ARs (except Catalonia), in the analysis of the information received, the regions can be split into two groups in terms of the probability of meeting the 2018 deficit target. (See Graph 2).

- 13 ARs where budgetary execution in accordance with the main lines submitted would allow the achievement of the objective with a different degree of probability:
 - Highly Likely: Balearic Islands, Canary Islands and La Rioja.

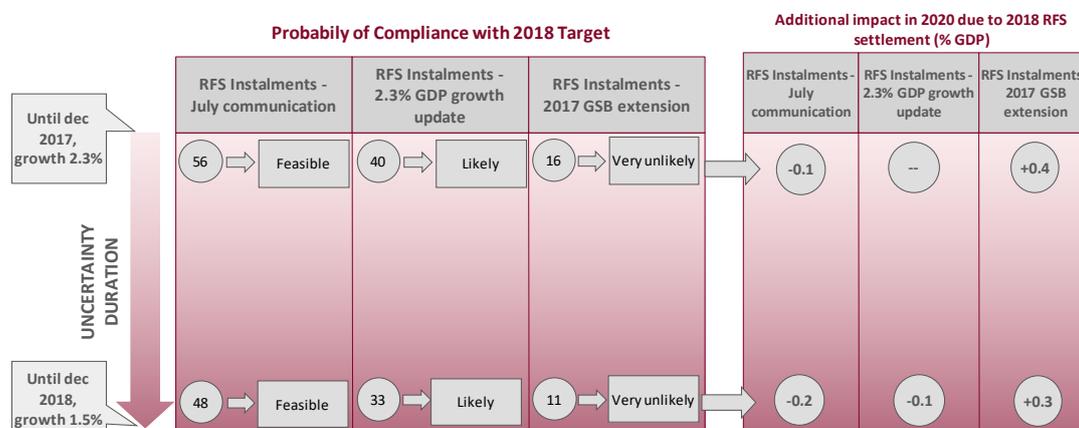
- Likely: Asturias, Galicia.
 - Feasible: Andalusia, Aragon, Cantabria, Castilla y Leon, Castilla-La Mancha, Madrid, Navarra and the Basque Country.
- 3 ARs where budgetary execution would not permit the target to be reached, with different degrees of probability:
- Unlikely: Extremadura and the Valencian Community.
 - Highly Unlikely: Region of Murcia.

**GRAPH 2. PROBABILITY OF COMPLIANCE WITH
2018 STABILITY TARGET, BY REGION**



In addition to the previous analysis, the AIRcF has assessed several scenarios in relation to the regional financing system revenue that the ARs will received in 2018, as well as the impact of a hypothetical elongation of the crisis in Catalonia on the probability of meeting the stability target in each region. If regional financing system revenue is updated to the 2.3% growth forecasts of the Draft Budgetary Plan, then the probability would be feasible, although at the lower end of the feasibility range. However, both probabilities of compliance could be reduced by the worsening GDP growth associated with a prolongation of the uncertainty and political instability in Catalonia, up to 10 p.p. if this situation lasts until December 2018. Finally, if the regional financing system revenue for 2018 is limited because of the renewal of the Draft General State Budget, without being updated, compliance with the 2018 target would be considered very unlikely. On the other hand, the final settlement in 2020 that results from the regional financing system revenue being delivered in 2018, will have a greater or lesser impact depending on the prolongation of the crisis. (See Table 1)

TABLE I. RANGE OF PROBABILITY OF 2018 COMPLIANCE IN DIFFERENT SCENARIOS. IMPACT OF FINAL SETTLEMENT IN 2020.



The AIReF makes general recommendations to the MINHAFFP to adapt the regional financing system revenue to the GDP growth forecast in the 2018 Draft Budgetary Plan and to address the pending methodological, practical and design issues concerning the expenditure rule. It also recommends that the evaluation criteria for the debt targets be adjusted.

The AIReF makes specific recommendations aimed at compliance with the 2018 deficit target and the expenditure rule, as well as the inclusion of information related to compliance with the debt target in the 2018 budgets.

- **Deficit target:** Extremadura, Valencian Community and Murcia
- **Expenditure Rule:** Andalusia, Asturias, Balearic Islands, Castilla y Leon, Galicia, Madrid, Murcia, Basque Country and Valencian Community.
- **Inclusion of information related to compliance with the debt target in the budgets:** All ARs except Andalusia, Canary Islands and Galicia.

Finally, the report includes guidance on best practices for prudence in expenditure in a context of uncertainty and for the consideration of the budget document as a realistic and reliable reference framework for the activity carried out by the PSAs.