

REPORT ON EXPECTED PUBLIC
ADMINISTRATION COMPLIANCE
WITH THE BUDGETARY STABILITY
TARGET, GOVERNMENT DEBT
TARGET AND EXPENDITURE RULE:
2018

REPORT 37/2018





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.

AIReF Contact:

C/José Abascal, 2, 2º planta. 28003 Madrid, Tel. +34 910 100 599

Email: Info@airef.es.

Web: www.airef.es

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EXECUTIVE SUMMARY

The purpose of this report is to assess the probability of compliance with the budgetary stability and government debt targets, as well as the expenditure rule of the different Public Administrations (PAs) in 2018. To do this, the macroeconomic and budgetary scenario for 2018 contained in the study that the Government entrusted to the Independent Authority for Fiscal Responsibility (AIReF) for 2018 and 2019, under a “no policy change” assumption and that was published on 13 July, was used as baseline.

AIReF considers it *unlikely* that the General Government sector (GG) will achieve the deficit target of 2.2% GDP in 2018, given that AIReF's estimated baseline scenario exceeds this target by 0.5%. The measures adopted during the processing of the General State Budgets (GSB) have decreased the likelihood of achieving the target with respect to the assessment made in AIReF's Report on the draft GSB for 2018.

This deviation from the approved target is mainly concentrated in the Central Administration (CA) and Social Security Funds (SSF), which will both end the year with a deficit of 1.5%. In the case of the CA, the deviation mainly occurs in expenditures due to the increase in payments made by the Deposit Guarantee Fund for the settlement of the Asset Protection Schemes (APS) of the Caja de Ahorros del Mediterráneo (CAM) and Unnim, the impact of the State's financial liability for toll roads and the measures contained in the GSB relating to the rise in public wages and the new transfer to finance Social Security. On the other hand, in the SSF the pension revaluation measures entail an acceleration in expenditure growth, which cannot be offset with the smooth running of contributions. These deviations cannot be absorbed by the margin produced in the Territorial Administrations (TAs), where the Autonomous Regions may end the year with a deficit of 0.3% GDP, 0.1% below target, although above that notified to the European Commission, and the

Local Governments (LGs) could maintain the previous years' surplus of 0.6% GDP.

The new Government has already publicly announced the impossibility of achieving the deficit target of 2.2% GDP in 2018, with its forecast for the GG standing at the figure of 2.7%, identified as AIReF's baseline scenario in the recently published study.

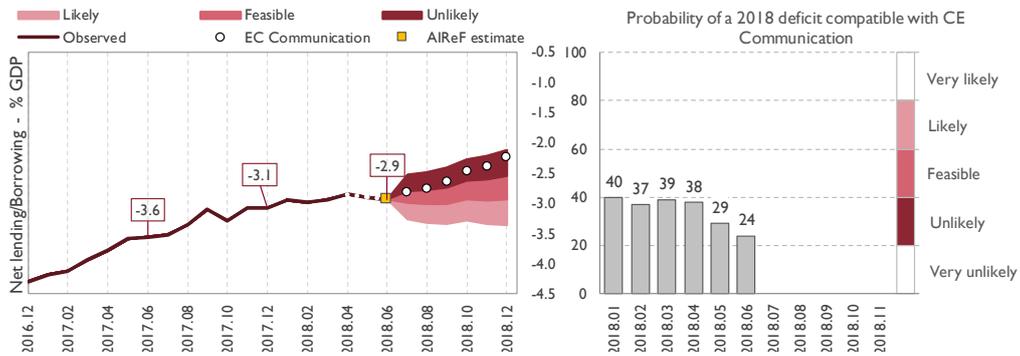
The Government is also promoting the amendment of the targets for the years 2019 to 2021 in order to set a more realistic deficit reduction path. At the same time it has stated its intention to implement various measures, the realisation and design of which will be unveiled in the coming months. It would therefore be difficult for the effects of said measures to be deployed in the current year. As a result, the budgetary scenario depicted in the Stability Programme Update (SPU) in April would be outdated.

Within its recommendations AIReF identifies the short-term need to correct the problems that can be observed in the definition, implementation and monitoring of the fiscal rules that particularly affect the LGs. In addition, AIReF also includes recommendations in its report that affect the current year and are addressed to the PAs in which there is risk of non-compliance with the fiscal rules.

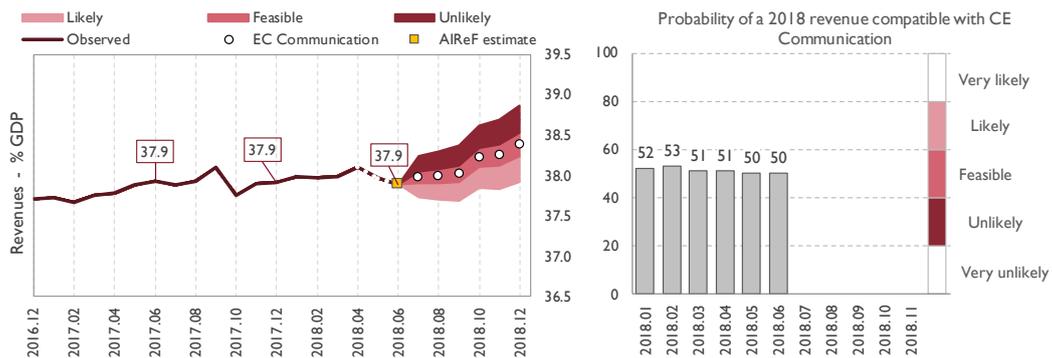
With a more medium term view, AIReF considers that the recommendations contained in its report on the SPU are especially relevant in the context of target redefinition and the budgetary plan in the medium term. In its report on the SPU, AIReF made recommendations aimed at reinforcing the fiscal framework in the medium term, understanding that beyond the formal restrictions of the regulatory framework, there was a need for consistent medium-term budgetary planning that took both the economic, social and budgetary feasibility of the path planned and the sustainability of public finances into account. In order to ensure the consistency and credibility of medium-term budgetary planning, AIReF noted that it would be desirable to forge a greater consensus, as greater debate and participation of the different administrations and actors in the processes for developing and making decisions on the various medium-term budgeting milestones is essential. Any move in this direction would strengthen the legitimacy and enforceability of the fiscal rules.

GENERAL GOVERNMENT

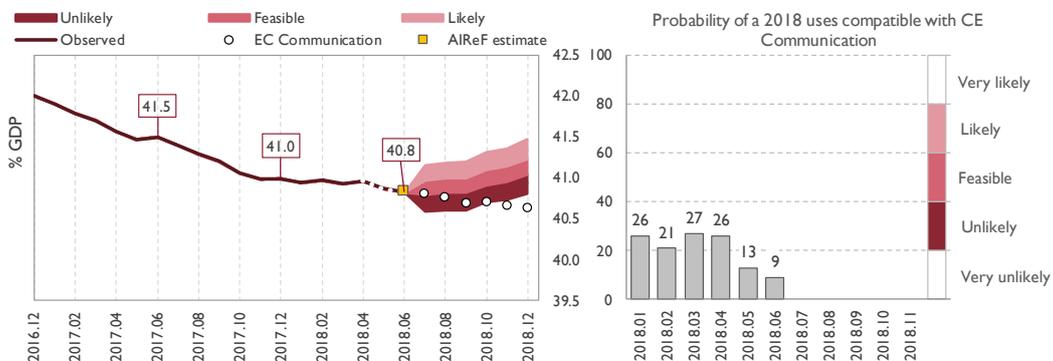
1 AIReF's baseline scenario places the deficit of the GG at 2.7%, making it *unlikely* to reach the target of 2.2%. On the one hand....



2 ... AIReF considers it *feasible* to achieve the level of revenues envisaged in the SPU...



3 ... while it is highly *unlikely* to reach the level of expenditure envisaged, thereby reversing the declining trend of previous years



Central Administration

AIReF considers it *unlikely* that the CA will reach the 2018 target notified to the European Commission of -1.2% GDP. In order to comply with this target, the CA would have to make an adjustment of 0.7% GDP with respect to the previous year.

AIReF considers it *feasible* that the CA will reach a revenue level in line with the forecasts contained in the GSB, while expenditure will maintain its weight in 2018, breaking the declining trend of previous years. AIReF's forecasts indicate that the growing path for revenues is maintained in 2018 despite the entry into force of the Personal Income Tax (PIT) reform, as the expected evolution of non-tax revenues is particularly significant due to the expected increase of funds from the European Union, among other factors. In the second half of 2018 the entry into force of the increase in public employees' wages and the transfer to Social Security, which will accompany the growth already recorded in investments and the payment of Asset Protection Schemes (APS) by the Deposit Guarantee Fund, will contribute to expenditure growth. This expenditure trend also entails non-compliance with the expenditure rule in the CA.

Social Security Funds

In 2018 the Social Security Funds will maintain a deficit similar to that of 2017, supported by the strong growth of contributions, a lower reduction in unemployment expenditure and a significant increase in expenditure on pensions due to a revaluation above that implemented in previous years. These budgets also envisage a new transfer from the CA "to support its budgetary balance" and that, for the first time, does not fund the System's non-contributory or universal expenditure.

Autonomous Regions

AIReF considers it *likely* that the regional sub-sector will comply with the stability target set at -0.4% GDP for 2018, the achievement of which does not require an additional adjustment with respect to the end of 2017. However, the high risk of non-compliance with the expenditure rule means that it is deemed *unlikely* to achieve the balance of -0.2% notified to the Commission, which would allow simultaneous compliance with the two fiscal rules.

With regard to the evolution of revenues, it is expected that the entire regional sub-sector will experience a year-on-year growth of around 4%, favoured by the evolution of the financing system's resources and the good performance of the Tax on Asset Transfers and Documented Legal Acts (TATDLA) and funds

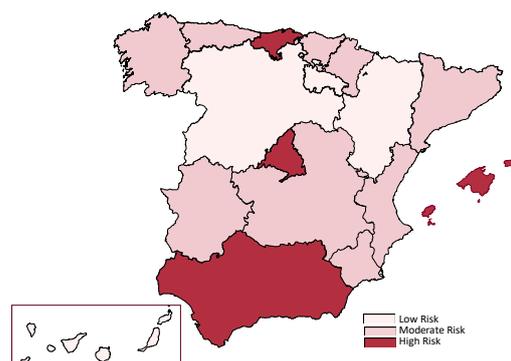
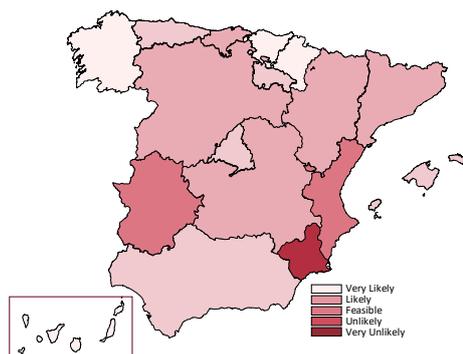
from the European Union. In the case of expenditure, available information points to a year-on-year growth rate higher than that estimated in previous reports and documents, close to 4%, which raises the risk of non-compliance with the expenditure rule.

In the individual analysis, it was only considered *unlikely* for three Regions to achieve the stability target (Extremadura, Valencia and Murcia), observing high or moderate risk of non-compliance with the expenditure rule in thirteen Regions.

INDIVIDUAL ANALYSIS BY REGION

❶ Difficulties in achieving the stability target of -0.4% are only observed in three Regions, however

❷ ... there are moderate or high risks of non-compliance with the expenditure rule in thirteen Regions.



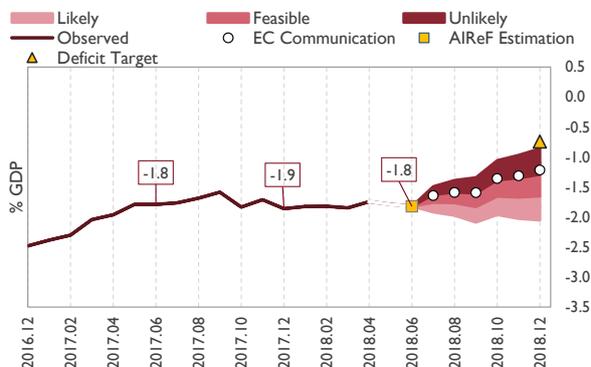
Local Governments

AIReF considers it *very likely* that the LG sub-sector will comply with the stability target in 2018, as it is *feasible* to obtain a surplus, slightly lower than that recorded in 2017 in terms of GDP, which, however, would still represent 0.6% GDP.

LG revenues will grow, on a like-for-like basis, by around 2%, replicating the trend of previous years. In the case of expenditure, AIReF estimates a growth slightly above 3%, which reflects the impact of the agreement on compensation of employees and an estimate on the amount to be invested by each local corporation in the budgetary programmes permitted for the realisation of financially sustainable investments (SFI).

NET LENDING/BORROWING BY SUB-SECTORS

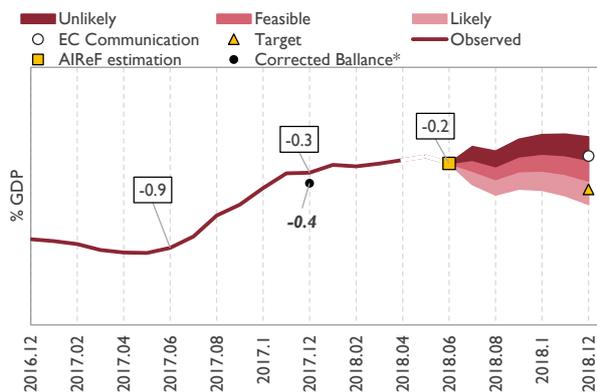
1 AIReF considers it *unlikely* that the CA will reach the target of -1.2%...



2 ... also deeming it *unlikely* that Social Security will comply with its target ...

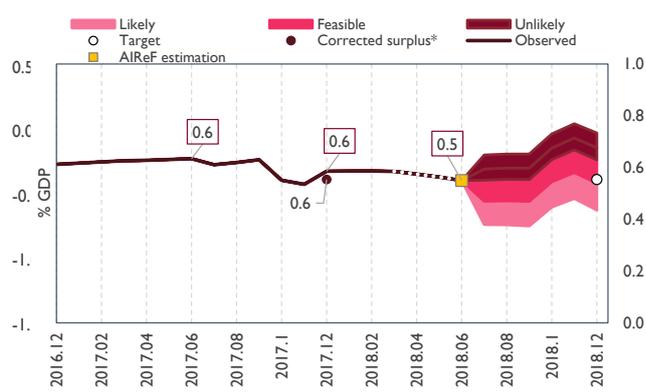


3 ... and, although it is considered *likely* that the Regions will comply with the target of -0.4%, it is deemed *unlikely* to reach the -0.2% notified ...



(*) Having removed the effect of the regularisations of previous years in the Basque Country and Navarre.

4 ... while in the LGs it is considered *feasible* to maintain a surplus similar to the previous year.



(*) Having removed the effect of the regularisations of previous years in the Provincial Councils.

As a supplement to this Report, we have included another report on the individual assessment of the LGs, which includes the analysis of the 21 large LCs (16 city councils with over 250,000 inhabitants and the 5 Provincial Councils or similar with larger non-financial budgets), and of the 18 LGs of over 20,000 inhabitants with serious sustainability problems in the medium term, the assessment of which has been conducted throughout this budgetary cycle.

- Given the comfortable fiscal situation of the LGs that make up the first group, the main problem is the specification of certain aspects of the regulatory framework that determine the measurement of compliance with the fiscal rules. In particular, the lack of regulatory precision on which targets must be complied with by the LGs with an EFP or AP containing

commitments for the current year, whether these are the limits agreed in these documents or the general limits of the Organic Law on Budgetary Stability and Financial Sustainability, means that there are differences in interpretation on the application of the corrective mechanisms, resulting in unequal treatment between the LGs of the national territory. Therefore, a promotion of the regulatory amendment has been recommended to MINHAC. This promotion is needed in order to specify the nature and scope of the targets agreed in the Economic-Financial Plans and Adjustment Plans of the LGs, so that the verification of their compliance and the application of the graduality of the Law in the event of non-compliance is uniform in all LGs, avoiding situations of unequal treatment between them.

- In turn, within the group of corporations with structural sustainability problems, AIRcF, based on the latest information available, confirms the ratings of their risk situation contained in its Report of May, in which a critical situation is observed in the City Councils of Jerez de la Frontera, Parla and Jaén, a situation of high risk in Algeciras, Gandia, La Linea de la Concepcion, Aranjuez, Totana, Navalcarnero, Isla Cristina and Ayamonte, moderate risk in Alcorcón, Valdemoro, Sanlúcar de Barrameda, San Andrés del Rabanedo and Almonte and a situation of low risk in Granada and Cuenca. With the current data, the combined analysis shows that all the city councils maintain their risk position in their group, although the City Councils of La Línea de la Concepción, Totana, Ayamonte, Alcorcon and Cuenca, due to at least implementing and consolidating the policies envisaged in their 2018 scenarios, would take longer to return to a sustainable situation, with respect to the estimate of the Report on the Main Budgetary Lines.