Report

4th April 2016

Report on the General Government sector initial budgets for 2016

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

This report makes an assessment of the General Government sector initial budgets with the inclusion of the new information that has been made available since the Independent Authority for Fiscal Responsibility (AIReF) prepared its earlier reports on the General Government sector 2016 draft budgets and main lines for the different subsectors. Those reports were published between September and November 2015 in a calendar that was conditioned by the timing of the elections held at different levels of government in Spain.

The information now available on the approved budgets confirms the conclusions of AIReF's reports on the draft budgets and main budget lines and the heightened risk there is now of non-compliance with the 2016 stability target as a consequence of the now confirmed deviation from the targets in 2015. Moreover, the data on Local Corporations (LCs) seem to point to a likely reduction in the surplus recorded in recent years. This lower surplus had already been detected in the assessment made of the main budgetary lines.

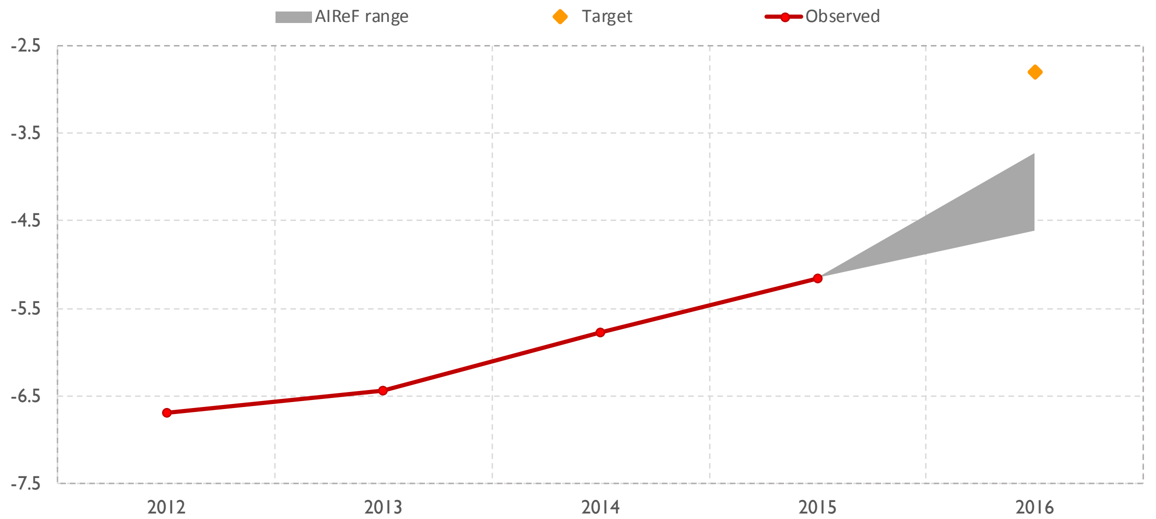
In this context, any margin that might be generated in the Local Corporations subsector and to a lesser extent in the Central Government subsector would still be clearly insufficient to offset the considerable deviation that will certainly be recorded in the Social Security Funds (SSF) and the highly likely —albeit more moderate— deviation expected in the Autonomous Regions (ARs).

Compliance in 2016 with the -2.8% of GDP stability target set for the General Government sector as a whole is very demanding. It will be difficult to achieve because as graph A1 below shows, compliance with the target would require a correction of 2.4 percentage points of GDP (around 2% if non recurring items are excluded) to be made. A reduction of this size is not supported either by the approved budgets or by the information on available measures to date.

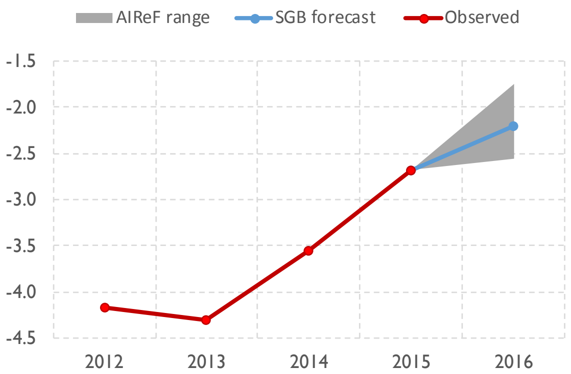
The correction of around one percentage point that AIReF is forecasting would stem almost entirely from the effects of the cyclical upswing in the economy and the impact of lower interest rates on government accounts. Almost the entire deficit of the General Government sector as a whole in 2016 —estimated at around 4 percentage points— is recorded in the Central Government and Social Security Funds subsectors. The aggregate deficit of the subnational subsectors (ARs and LCs) is very small.

GRAPH A. NET LENDING/BORROWING (% GDP)

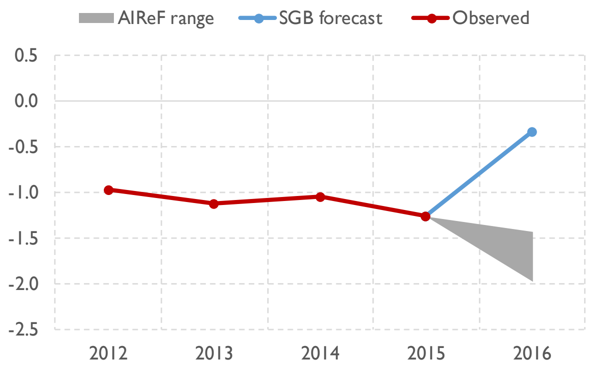
A.1 General Government



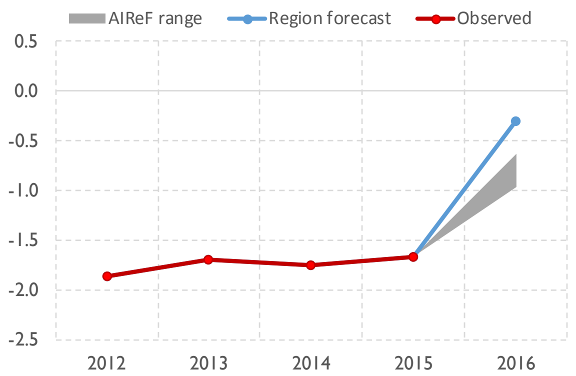
A.2 Central Government



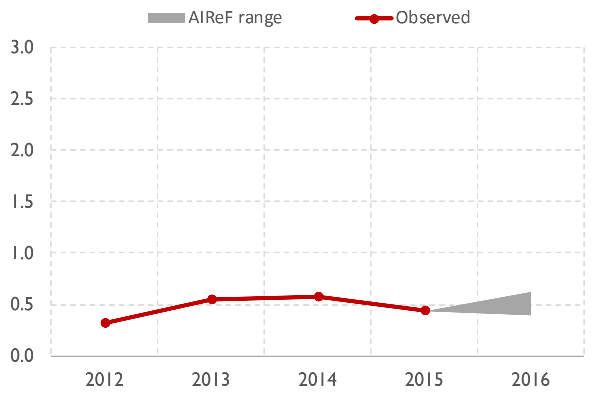
A.3 Social Security Funds



A.4 Autonomous Regions



A.5 Local governments



Source: INE, MINHAP, IGAE, SGB and AIReF forecast

More specifically, the situation broken down by subsectors in the General Government sector in Spain is as follows:

The Central Government has to reduce its deficit by 0.5% of GDP in order to reach the -2.2% target. AIReF is of the view that the Central Government budget will allow it to comply with the budget stability target (see graph A2) on the back of the positive development of tax revenue, lower expenditure on government debt servicing and the possible incorporation of the surplus recorded by autonomous entities in recent years. Nevertheless, compliance with the expenditure rule requires it to achieve a lower deficit than the target set. This requirement is essentially linked to the need to offset in 2015 and 2016 the substantial impact of loss of revenue because of the tax reform. The fact that even with this circumstance the Central Government is still managing to meet its stability targets reflects how undemanding the target is, together with the expenditure restraint policy it has been implementing.

The Social Security Funds have to reduce their deficit by 1% of GDP in order to be able to comply with the -0.3% deficit target set for 2016. With the confirmation of a substantial deviation in 2015 (seven tenths of a percentage point of GDP) and the unrealistic forecasts for revenues from social contributions in the 2016 budget, AIReF has reached the conclusion that the Social Security Funds will fail to comply with the budget stability target this year as shown in graph A3. It is highly likely that the deviation will be much larger than the deviation from target recorded the previous year as a consequence of the cutback in the transfer the State Public Employment Service (SEPE) receives from the State because of the reduction in actual expenditure on unemployment benefits and the lower yields generated by the Social Security Reserve Fund.

The Autonomous Regions will have to cut their deficit by 1.4% of GDP in order to comply with the stability target. According to their budgets, half of this reduction would come from the increase compared to the previous year of the resources linked to the regional financing system (0.7% of GDP). Another two tenths of a percentage point of GDP would come from the non-recurrence in 2016 of the expenditure in 2015 on certain investments, legal rulings and part of the initial cost of the hepatitis C treatment. Compliance with the expenditure rule, nevertheless, would demand an additional reduction of around 0.3%, insofar as in some Autonomous Regions the deficit that would have to be attained for compliance with this rule is lower than the stability target that has been set. The approved revenue and expenditure budget scenario in general terms does not fully —or only partially— takes on board the deviation incurred in 2015. This fact, added to the absence of any significant measures except in Balearic Isles and Aragón, makes compliance in 2016 with the budget stability target unlikely in this subsector although the existing gap to the target could be closed significantly (see graph A4).

The 2015 year-end data and the new information furnished by the Autonomous Regions do not alter AIReF's risk appraisal made in its report on the draft budgets and main budget lines but it does affect how the risk is graded in each one of the regions. With the data available at present, there are only six regions (Andalusia, Canary Isles, Galicia, Asturias, La Rioja and Basque Country) for which AIReF assesses compliance with the budget stability target as likely. In two regions —Navarra and Balearic Isles— the risk of non-compliance is moderate. Cantabria, Castilla y León, Castilla-La Mancha and Madrid all show a high risk of not attaining the target. Lastly, AIReF deems there to be a very high risk of non-compliance in the following regions: Catalonia, Extremadura, Murcia, Valencia, and Aragón.

Nevertheless, it can be seen that almost without any new significant deficit correction measures, the 1% deviation from the 2015 stability target has been halved and fewer Autonomous Regions will miss the target. This highlights that the stability target set for the Autonomous Regions in 2015 was particularly demanding, when taking into account the resources from the financing system they could receive.

TABLE A: AUTONOMOUS REGIONS

COMPARATIVE TABLE OF THE ASSESSMENT OF RISK FOR COMPLIANCE WITH THE 2016 BUDGET STABILITY TARGET IN THE AUTONOMOUS REGIONS

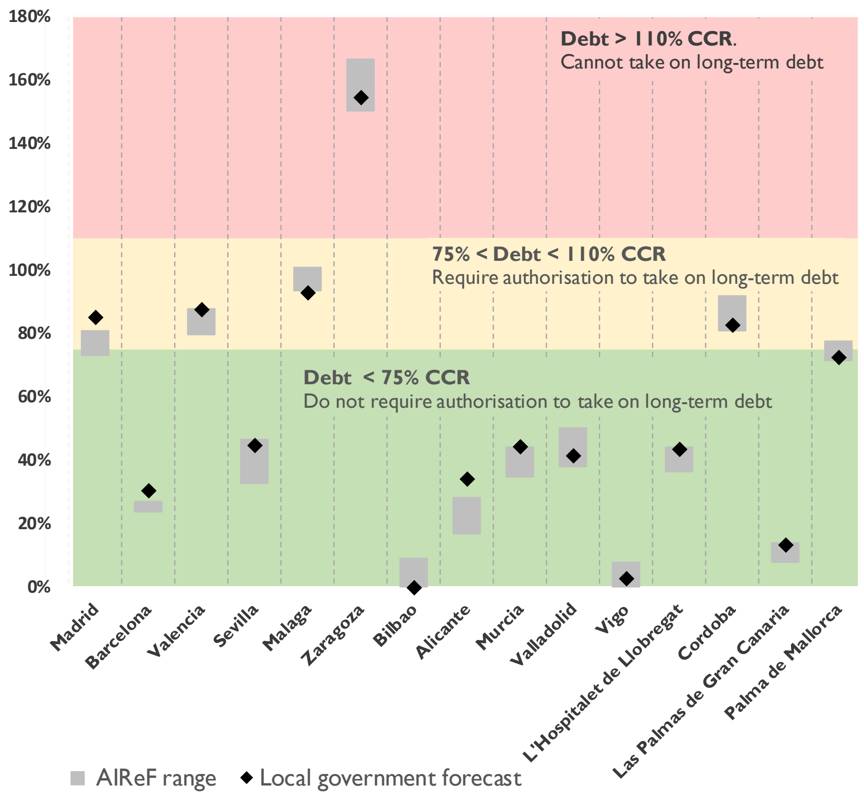
Autonomous Regions	AIReF 2016 year-end forecasts		
	Assessment of compliance with stability target (-0.3%GDP)	Net lending/borrowing	
		Lower	Higher
Andalusia	Likely compliance	-0.6%	-0.2%
Aragón	Very high risk	-1.2%	-0.8%
Asturias	Likely compliance	-0.5%	-0.2%
Balearic Isles	Moderate risk	-0.7%	-0.4%
Canary Isles	Likely compliance	-0.1%	0.2%
Cantabria	High risk	-0.8%	-0.5%
Castilla y León	High risk	-0.9%	-0.6%
Castilla-La Mancha	High risk	-1.1%	-0.7%
Catalonia	Very high risk	-1.5%	-1.0%
Extremadura	Very high risk	-1.5%	-1.0%
Galicia	Likely compliance	-0.4%	0.0%
Madrid	High risk	-0.9%	-0.7%
Murcia	Very high risk	-1.5%	-1.2%
Navarra	Moderate risk	-0.7%	-0.4%
Basque Country	Likely compliance	-0.5%	-0.2%
La Rioja	Likely compliance	-0.6%	-0.2%
Valencia	Likely compliance	-1.7%	-1.3%
Total Autonomous Regions	**Unlikely**	**-1.0%**	**-0.6%**

The Local Corporations will comfortably achieve the balanced budget target given that compliance with the expenditure rule means that the subsector as a whole will have to achieve a surplus similar to the figure recorded in the last three years. The information sent by the Central Information Bureau in the Ministry of Finance and Public Administrations (MINHAP) does not allow this margin to be quantified. Nevertheless, AIReF flags the risk of a reduction in the surplus the subsector due to a number of reasons, including the greater flexibility MINHAP has been allowing in the application of the expenditure rule at the level of each corporation as far as the information requirements and determination of the level of initial expenditure are concerned.

The individual analysis of the 16 largest local governments confirms the trend observed in the subsector of compliance with the stability target in 2016 although the margin by which they will outperform the target tends to be lower than before. As far as compliance with the expenditure rule is concerned, it was not possible for AIReF to make its assessment on the following local governments: Alicante, Córdoba, Gijón, Murcia, Palma de Mallorca and Las Palmas de Gran Canaria, as not all the information requested by AIReF was supplied. There is evidence of a risk of non-compliance with this rule in Bilbao, Madrid, Valencia, Valladolid and Zaragoza local governments. As far as the debt ceiling is concerned, only Zaragoza city council will not be able to arrange any new borrowing in 2016 because its debt to consolidated current revenue ratio is higher than 110%.

For this subsector, which in general terms has a balanced budget or budget surplus, the most relevant analysis is the analysis of its debt level.

GRAPH B. 2016 FORECAST OF OUTSTANDING DEBT TO CONSOLIDATED CURRENT REVENUE RATIO (CCR)



Source: Data supplied by the local governments, Banco de España, SGCAL and AIReF estimates

When appraising these conclusions, it is important to bear in mind that this asymmetrical situation of the different subsectors in the General Government sector is the consequence of many factors, among which the efficient and responsible government management, as well as the commitment to budget stability, are key but not the only ones. The feasibility of attaining the set targets, the sensitivity of revenue and expenditure to the economic cycle and the sufficiency and adequacy of the financing systems in relation to the competences over expenditure of the different General Government subsectors have are also factors that undoubtedly have to be taken into account. Focusing the debate solely on the confirmation of their compliance or non-compliance with the stability targets would be a simplification when attempting to identify solutions. It would be a way of treating the symptoms instead of the underlying causes of the problem.

One good example of this could be the existing antagonism between the situation of the Local Corporations and the Social Security Funds subsectors. The LCs overall are a very financially healthy subsector. The role assigned to each local government internal audit service by stability legislation has made a key contribution to that financial health. However, from the standpoint of feasibility of achievement of the targets, an important point the LCs have in their favour is their substantial capacity for raising taxation revenue through local taxes that are very stable over time. Some of them even have considerable revenue collection potential like the local property tax *Impuesto sobre Bienes Inmuebles* (IBI). In addition to this tax revenue and other sources of revenue such as municipal rates and public prices, the Local Corporations also receive transfers from the State for their participation in State taxes amounting to just over 20% of their non-financial revenue (€17 billion). In recent years the Local Corporations have been recording a surplus of around 0.5% of GDP, a substantial part of which is earmarked for the acquisition of financial assets given the reduced level of debt in this subsector. Evidence of this practice can be seen in the latest 2015 year-end information from Banco de España, according to which the deposits set up by the LCs during 2015 increased by an amount equivalent to almost 32% of the surplus obtained.

The position of the Social Security Funds is quite different when it comes to the feasibility of it attaining its targets because Social Security expenditure by its very nature depends to a great extent on demographic factors and changing their impact would require consensus and a time lag for their full implementation. Current revenue is highly conditional on the levels of employment and wages but in addition to that, the majority of social contributions impinge upon the labour costs of companies. These characteristics in both cases make it difficult for the subsector to adopt any short-term fixes.

AIReF, moreover, believes that in a context like the present one, with deficit targets that are still very demanding in some subsectors, the consolidation of surpluses is not sustainable and may generate perverse effects in the composition of government expenditure. In this regard, what AIReF has been recommending in several of its previous reports is the preparation of a comprehensive analysis of the funding system of the different subsectors in the General Government sector so that the system can be aligned with the level of expenditure in each subsector, as evaluated in terms of efficiency and in accordance with the powers over expenditure actually exercised by the subsectors. AIReF has also highlighted two further points to be incorporated into this analysis: how much capacity each subsector has to take actions that can impact their own revenue, and their compliance with the expenditure rule regulated in the LOEPSF.

Notwithstanding the above, AIReF believes that there is an urgent need for fiscal consolidation measures to be adopted that will allow further progress to be made with the government deficit reduction path. The ultimate aim is to guarantee the financial sustainability of public sector provision of goods and services. A key role in this process is played by the strict application of the expenditure rule, which should be taken into account when setting the budget stability target in accordance with the LOEPSF.

AIReF makes a number of recommendations in this framework, some of which were already put forward in previous reports. They include the following actions:

1. Conduct a joint review of the financing systems of the different subsectors in the General Government sector by analysing in depth their expenditure needs and avoiding the incremental bias or bias towards keeping the status quo as an initial approach that has been a feature of the previous reforms of the funding systems for territorial administrations in Spain. The special situation the Social Security Funds are in requires priority to be given to an analysis of its short and medium term position in the framework of the Toledo Pact Commission.
2. Clarify and simplify the applicable fiscal framework insofar as the monitoring and control mechanisms that have been developed over time linked to the extraordinary financing mechanisms may overlap with the correction measures envisaged in the LOEPSF.
3. Develop normatively the application of the expenditure rule, setting criteria, procedures for information exchanges and a common estimation methodology that can be used by the different subsectors.

Furthermore, AIReF advocates the use of the mechanisms envisaged in the LOEPSF to prevent and correct cases of non-compliance with the fiscal rules, given that these are the mechanisms with the transparency guarantees provided for in the law itself. Nevertheless, with the aim of anticipating the presentation of measures by the Autonomous Regions and even though they may be subsequently included in the EFPs to be submitted to the Fiscal and Financial Policy Council (*Consejo de Política Fiscal y Financiera*) AIReF believes that the content of the adjustment plans associated with the FLA 2016 should be made explicitly known as soon as possible. That would mean, as an exception for this year, that the adjustment plans could be considered to be an anticipation of the EFPs. For that to be the case, the adjustment plans would have to satisfy all the guarantees of the EFPs as regards how they are dealt with in procedural terms, monitored and made public.