



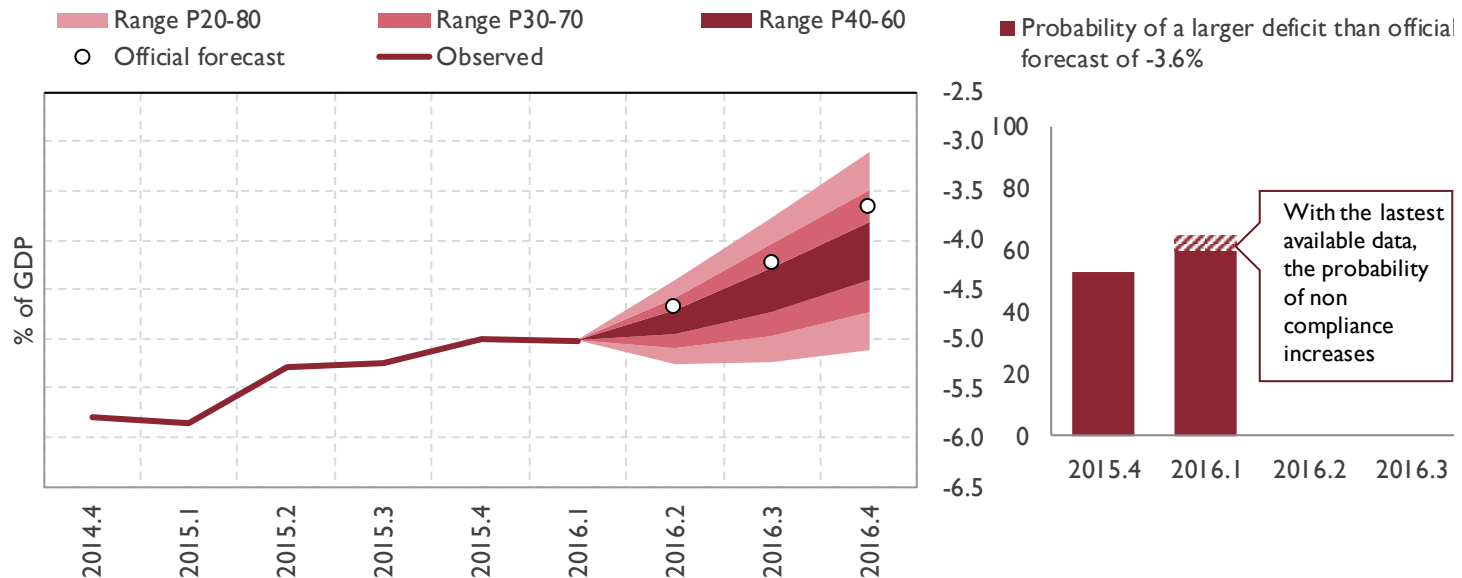
Independent Authority
for Fiscal Responsibility

Report on the expected compliance of Public Administrations with the 2016 targets for budget stability, public debt and the expenditure rule

Madrid, 20th of July, 2016

Worsening of the situation of public finances

AIReF considers that compliance with the stability target proposed in the Updated Stability Plan (set at 3.6% of GDP) is unlikely



With respect to AIReF's previous (April) central estimate of a deficit figure slightly below 4% of GDP, the worsening situation raises this figure up to between 4.1% and 4.7%, depending on the degree of implementation of the committed measures.

Changes compared to the last Report

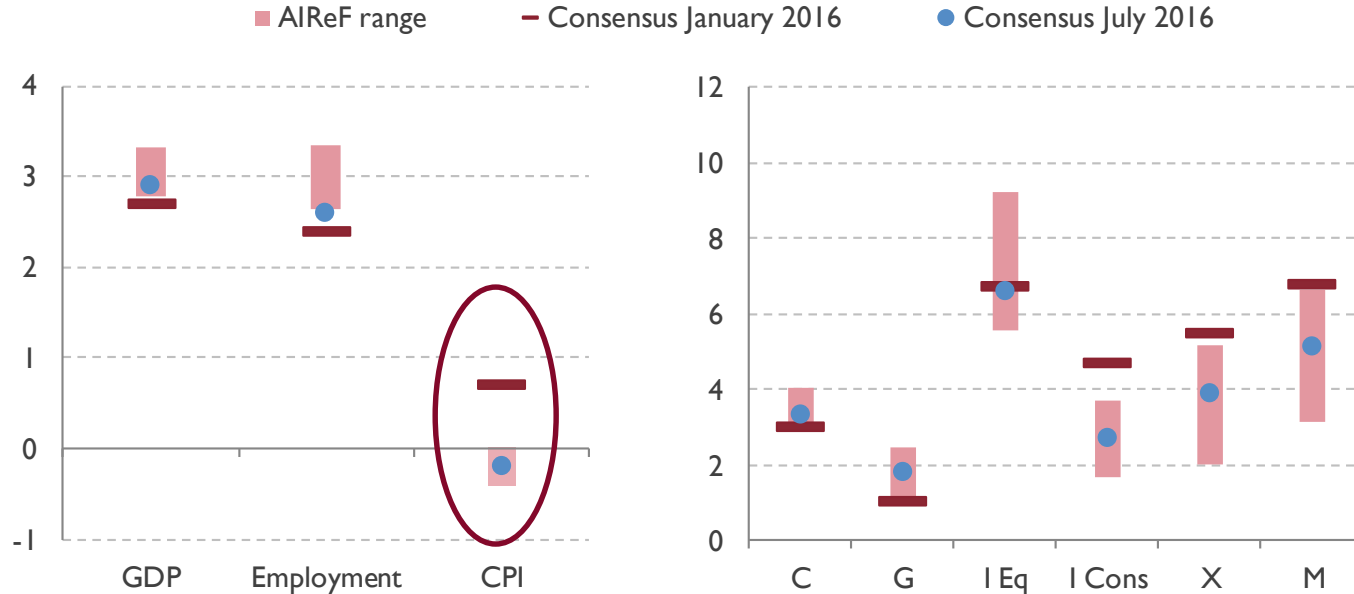
Reasons for the net deterioration of 3 tenths, up to 4.1% of GDP:

- 1. Lower inflation:** negative effect on tax revenues
- 2. Fiscal reform (Corporate Income and Personal Income Taxes):** the impact has been higher than expected. The increase in the pre-payment of the CT operates in the opposite sense.
- 3. Setting symmetric targets for the Regions:** not ambitious enough for the subsector as a whole
- 4. Non-availability Agreements for the Regions:** The adjustment plans have been approved without their implementation
- 5. Reduction of the municipalities' surpluses:** flexibility in the expenditure rule and end to the temporary increase of the Real State Tax.

1. Lower inflation: negative impact on tax revenues

There is a downward revision of prices, although...

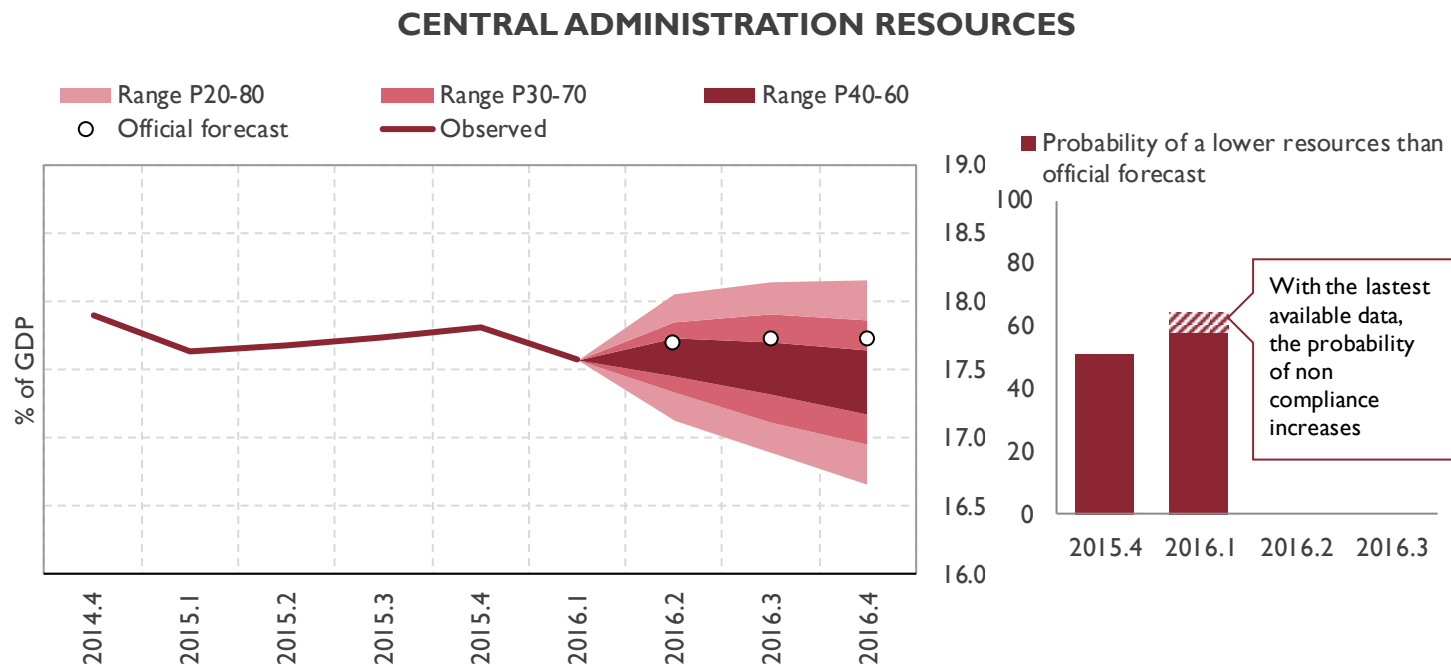
FUNCAS CONSENSUS AND AIReF FORECASTS



...expected growth for real GDP is slightly above 3%

2. Fiscal reform (Corporate and Income Taxes)

The tax reform is having a net negative impact above the initial estimates for the Corporate Income Tax, and to a lesser extent, for the Personal Income Tax (as shown by data on effective rates and tax revenues).



The measures announced by the Government on 13 July would operate in the opposite sense, specifically the increase of the minimum payment on accounting profits.

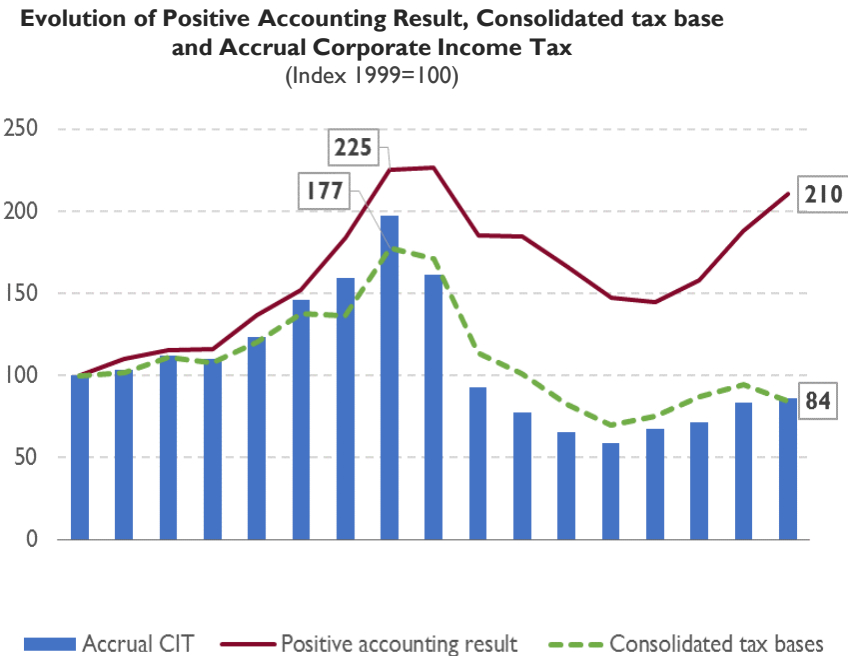
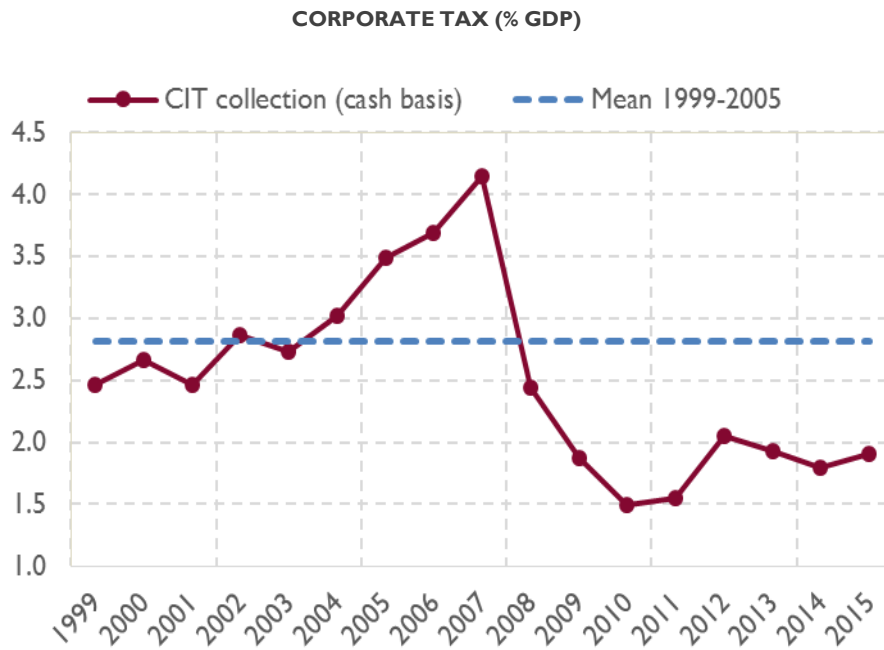
2. Fiscal reform (CT)

In 2015:

- ❖ 1st phase of the fiscal reform (from a 30% to a 28% rate)
- ❖ Many consolidation measures from previous years were still in forced

In 2016:

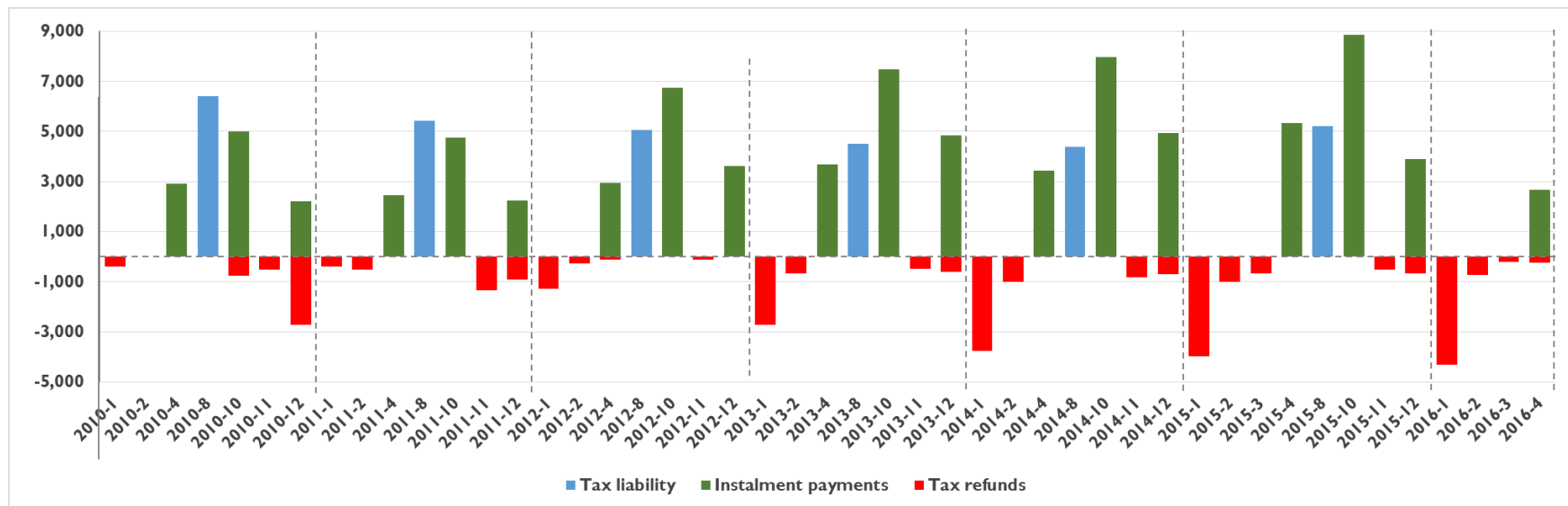
- ❖ 2nd phase of the reform (from 28% to 25% rates)
- ❖ Almost all temporary measures expired, included the minimum pre-payment.



2. Increase of CT pre-payments

- ❖ According to the allegations document sent to the European Commission on the 13th of July, the new Government will approve measures related to pre-payments amounting to € 6,000 million.
- ❖ According to the Government, the increase in pre-payments could be above 20% of the accounting profits.
- ❖ With high probability, part of the losses entailed by the tax reform will not be recovered. The figure included in the Budget is difficult to attain.

CORPORATE TAX - CASH (ONLY RELEVANT MONTHS)



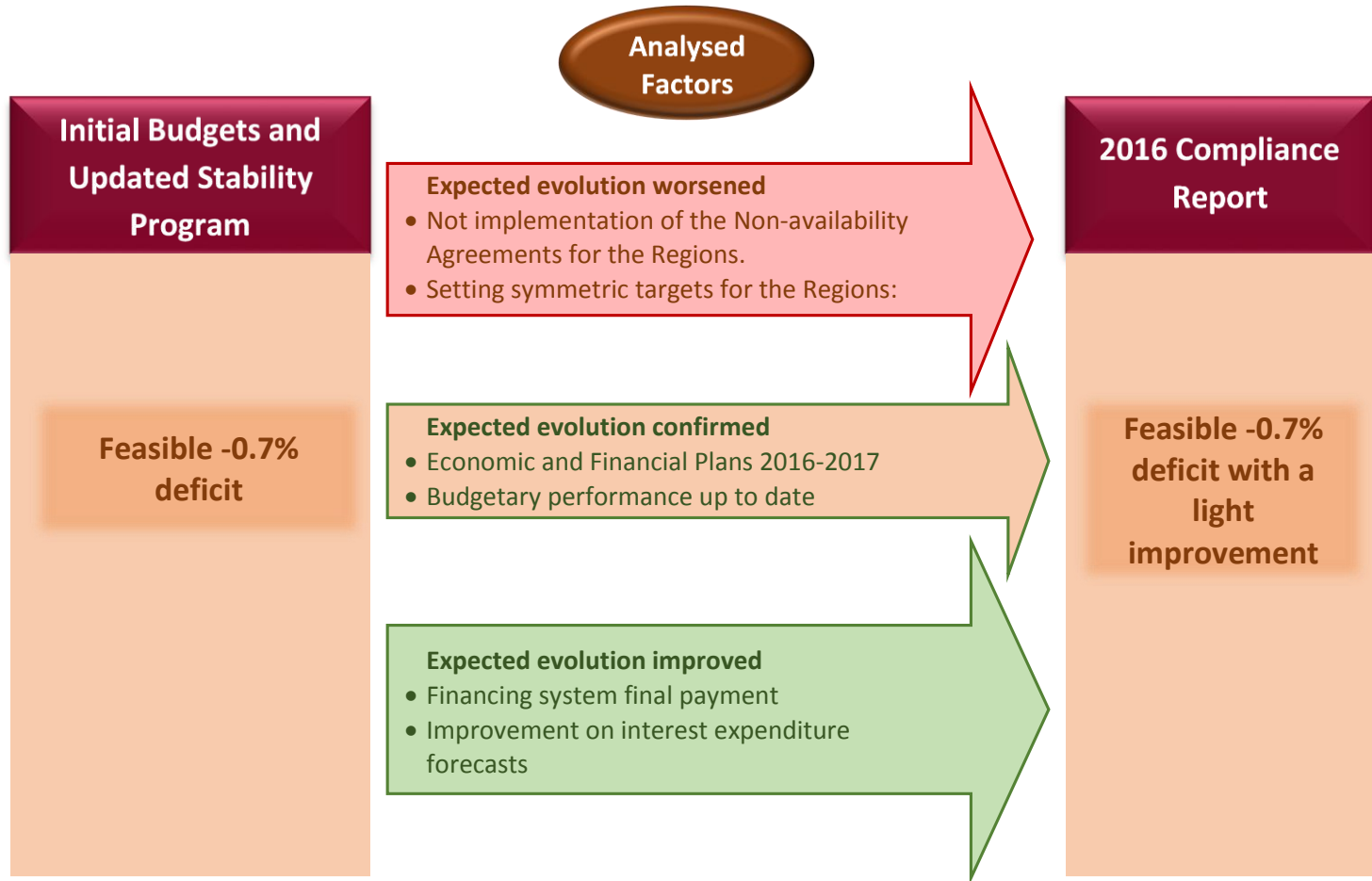
3. Setting symmetric targets for the Autonomous Regions

- ❖ The execution of the approved budget would have allowed for a deficit below 0.7% of GDP.
- ❖ The new target, not ambitious enough, has caused most of the Regions to foresee the exhaustion of the margins given by the added flexibility.
- ❖ The expenditure rule has not operated as a constraint because of the loose interpretation given by the Ministry of Finance.

4. Non-availability Agreements for the Regions

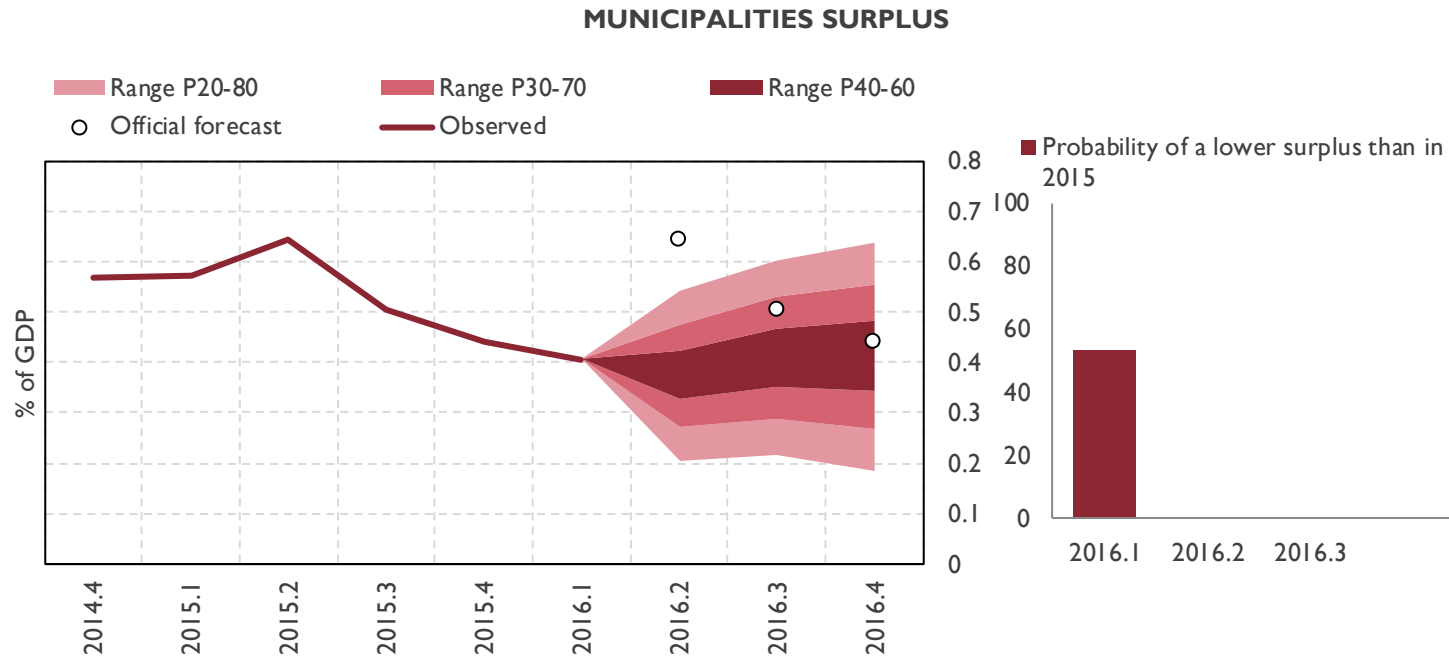
- ❖ The information gathered from the Regions proves that the NAA has not been put to use.
- ❖ The Ministry of Finance has approved the adjustment plans of regions joining the Regional Liquidity Fund in 2016, without demanding the implementation of the NAA.

3-4. Aggregate situation of the Regions



5. Decrease in the municipalities' surpluses

There is practical certainty on the compliance with the 2016 target, although the surplus could be smaller than in previous years.



Flexibility in 2015 in the implementation of the expenditure rule, and the end of the period for the application of the increased rate in the Real State Tax have contributed to this decrease.

Changes compared to the last Report

Reasons for the net deterioration of 3 tenths, up to 4.1% of GDP:

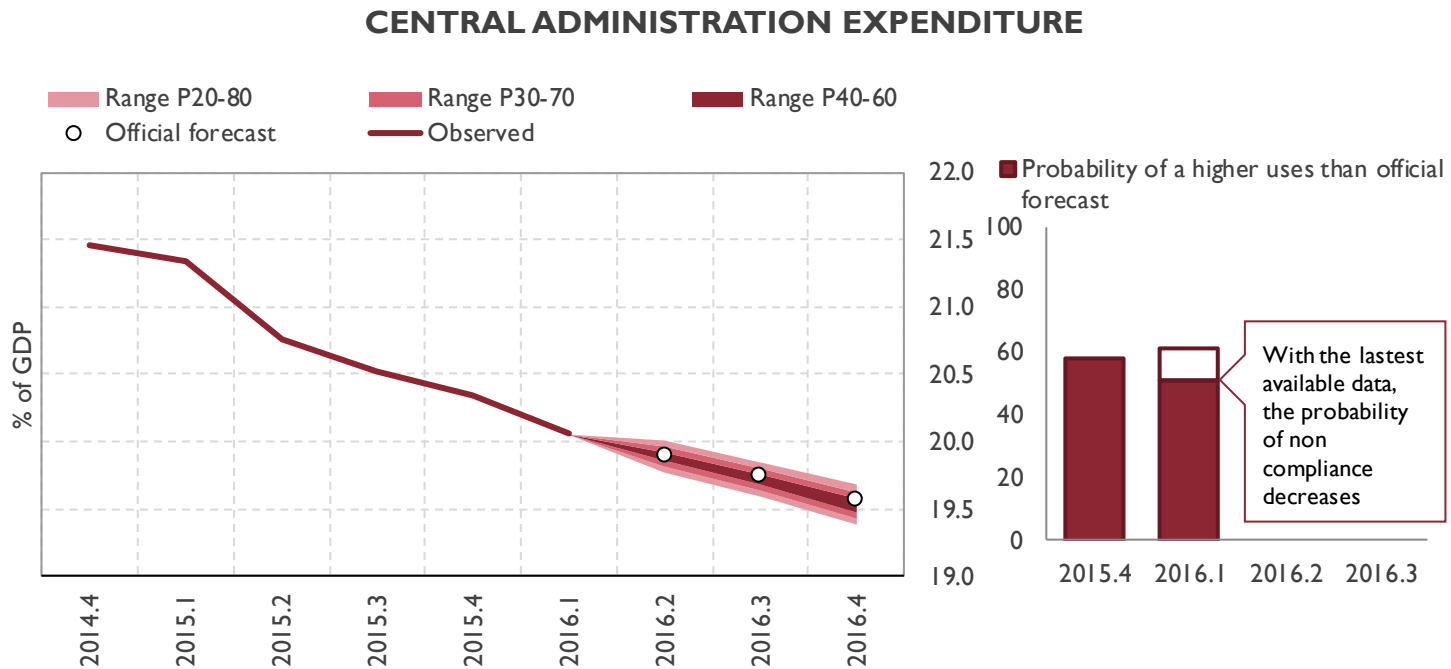
1. **Lower inflation:** negative effect on tax revenues
2. **Fiscal reform (Corporate Income and Personal Income Taxes):** the impact has been higher than expected. The increase in the fractionated payment of the CT operates in the opposite sense.
3. **Setting symmetric targets for the Regions:** not ambitious enough for the subsector as a whole
4. **Non-availability Agreements for the Regions:** The adjustment plans have been approved without their implementation
5. **Reduction of the municipalities' surpluses:** flexibility in the expenditure rule and end to the temporary increase of the Real State Tax.

There is an additional risk of 6 tenths, up to 4.7% of GDP, depending on how and when the **increase in the pre-payment of the CT** is enforced.

Furthermore, there is uncertainty about the expenditure retrenchment in the Central Administration.

Expenditure retrenchment in the Central Administration

Public employment keeps its decreasing trend, which could be buttressed through the implementation of the NAA.



There is uncertainty about the effectiveness of the NAA, as it has not been completely specified and the concrete budget items affected are unknown.

However, bringing forward to July the deadline to commit budget appropriations could lead to additional (not quantified) spending restraint.

Conclusions

- ❖ The ongoing situation and outlook for public finances have experienced a sustained worsening since the report on the USP was issued in April.
- ❖ AIReF considers that compliance with the stability target proposed in the USP (set at 3.6% of GDP) is **unlikely**.
- ❖ With respect to AIReF's previous (April) central estimate of a deficit figure slightly below 4% of GDP, the worsening situation raises this figure up to between 4.1% and 4.7%, depending on the degree of implementation of the committed measures.

Conclusions

According with available data, AIReF assessment of the targets for budget stability proposed by the Government in the 2016 Updated Stability Program is:

	2016
Public Administrations	Unlikely compliance
Central Administration	Unlikely compliance
Social Security Funds	Non-compliance is practically certain
Autonomous Regions	Feasible compliance
Municipalities	Compliance is practically certain

Main recommendations

AIReF recommends to consolidate the national framework for fiscal discipline. Key elements:

- ❖ Monthly control of the implementation of retrenchment measures by the Central Administration, with an early warning by the Ministry of Finance on deviations risks.
- ❖ Guarantee the financial balance of the Social Security System within the framework of the Toledo's Pact.
- ❖ Effective follow-up of the measures implemented in the Regions, demanding compliance with the compulsory reinforced conditionality required to access the 2016 Regional Liquidity Fund.
- ❖ Revision of the Economic and Financial Plans of Murcia, Valencia, Extremadura, Aragón, Cataluña and Castilla-La Mancha
- ❖ Common framework for the fiscal surveillance of the municipalities



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