

Report on expected compliance with the 2016 budget stability, government debt and expenditure rule targets by the Public Administrations

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 objective of this report is to assess the likelihood of compliance in 2016 with the budget stability and debt targets and with the expenditure rule by the different public administrations. This assessment, which AIReF has to issue in July of each year, as mandated by its Organic Law, has been prepared in a particularly uncertain environment, given the provisional character of the fiscal objectives, the political circumstances of the moment, and the measures announced by the interim government in response to the European Council Decision of 12 July, stating that Spain has not taken effective action, in response to the ECOFIN Recommendation of 21 June 2013, to correct the excessive deficit in 2015.

In this report, AIReF notes that the current situation and outlook of public finances in Spain have experienced a sustained worsening since the assessment delivered last April when reporting on the Updated Stability Programme (USP) of the Kingdom of Spain 2016-2019. As a result, AIReF considers at present *unlikely* that the budget deficit of the general government in 2016 attains the objective of 3.6% of GDP proposed in the USP.

Last April, AIReF assessed this proposed target to be feasible, though demanding. This assessment was based on several considerations. First, the projected figure for the budget deficit was slightly below 4% of GDP in the central scenario of AIReF, a scenario characterized by a rate of real output growth close to 3% and some acceleration of prices leading to an average inflation rate of 1% in 2016. Second, it was assumed, in addition, that the temporary measures regulating pre-payments of the corporate income tax which were in place last year would be kept in 2016. Third, AIReF estimated that, even if difficult, there was, in principle, room in the State and, to a lower extent, in the Regional Governments budgets, for an effective implementation in the course of 2016 of the expenditure retrenchment measures which were announced in the USP and amounted to four tenths of a percent of GDP.

Nevertheless, the information gathered and analyzed since then entails a further divergence of AIReF central projection figure for the general government budget deficit from the proposed target of 3.6% of GDP, as well as a higher likelihood that more pessimistic scenarios materialize. Accordingly, AIReF has revised upwards its central projection for the general government deficit ratio 4.1% of GDP, due to several concurring factors:

- ✓ There is no acceleration of prices. The expected inflation rate in 2016 is now one percentage point below the figure projected three months ago. This developments are affecting negatively tax revenue, despite the dynamism of real output, which follows the expected path.
- ✓ The tax reform is having a higher than initially estimated impact on corporate income tax and, to a lesser extent, on personal income tax revenue, as shown by the data on tax collection and effective tax rates published up to May 2016. The measures announced by the government on 13 July would

go in the contrary direction, and concretely the pre-payment of the corporate tax on the recorded accounting profits at a rate that, according to the information facilitated by the government, could be raised to at least 20%.

- ✓ A uniform deficit target has been set for all Regional Governments, a target that lacks in ambition for the subsector as a whole. The implementation of the budgets adopted by several Regional Governments would have allowed them to reach a budget deficit below 0.7% of GDP, without expenditure cuts. However, the setting of the same target for all Regional Governments (0.7% of GDP) by the Ministry of Finance and Public Administration (MINHAP) has led them to foresee the full use of the room to spend made possible by this target, while the expenditure rule is not playing its limitative role. The loose interpretation by MINHAP of the proper implementation of the expenditure rule has contributed to its ineffectiveness by eliminating for many Regional Governments the potentially tighter constraint on spending imposed by the expenditure rule than by the deficit target.
- ✓ Non-availability agreements (AND) of approved budget appropriations have not been implemented by some Regional Governments. The information facilitated by Regional governments reveals that AND by the amount required to adjust the deficit as announced have not been adopted. In this respect, MINHAP has approved the adjustment plans of the Regional Governments joining in the Regional Liquidity Fund for 2016 (FLA 2016), without demanding from them the adoption of AND as one of the announced requirements entailed by their lack of compliance with their respective adjustment plans in 2015.
- ✓ The surplus recorded in past years by Local Governments is likely to decline in 2016. A trend of past surpluses to dwindle has been detected by AIReF in the data from 16 municipalities that are capital of provinces with more than 250000 residents. Determinants of this trend are the end of the period of increased rates in the real estate tax, the loose interpretation of the expenditure rule by MINHAP, and the lenient implementation of corrective measures by the overseeing entities of municipalities (either MINHAP or Regional Governments).

In addition to the net negative impact of these factors on the general government deficit, a further deterioration of the budget balance amounting to around six tenths of a percent of GDP can emerge, which would bring the deficit ratio up to 4.7% in 2016, depending on the precise way in which the Central Government finally implements certain measures. From a quantitative point of view, the highest risk for the deficit comes from not implementing in 2016 the measures increasing the pre-payments of the corporate income tax. The actual effect of implementing the AND approved by the Central Government in April is relevant as well. The uncertainty on the effectiveness of this AND stems from the fact that it has not been fully specified up to now (around 80% still pending), and from lack of identification of the concrete budget lines affected, although MINHAP announced that almost half of the 2 billion euros involved will correspond to

items in chapter VIII of the budget which impinge on the deficit. The non-availability of budget appropriations in this chapter, which mainly refer to capital transfers to enterprises and public entities, will reduce the general government deficit only in case the affected enterprises and entities are classified within the perimeter of the government sector in national accounts and effectively reduce their spending. Nevertheless, the decision to bring forward to July 2016 the deadline to commit expenditure approved in the budget for this year could also exercise a restraining effect on spending, whose amount has not been estimated.

Beyond the uncertainty about the impact on the deficit of all the elements mentioned above, and irrespective of the implications of the final figure for compliance with the commitments of Spain under the Excessive Deficit Procedure to which it is subject, there is a further cause for concern when looking forward to the medium term from the perspective of the sustainability of Spanish public finances. This concern for AIReF comes from the increasing leniency with which the new framework of fiscal discipline set up in the constitutional reform of 2011, the Organic Law of Budget Stability and Financial Sustainability of 2012, and later laws and regulations is being implemented. In view of these developments, AIReF urges the different public administrations to apply rigorously and with a medium-term perspective the existing rules of fiscal discipline, and to enhance accountability in the Central Government, the subsector where the main origin of lack of compliance with the targets is. With this aim, the present report includes, among other, the following recommendations:

1. To put in place a monthly control by MINHAP of the implementation of retrenchment measures adopted and their impact on the proposed budget stability target in order to detect eventual slippages well ahead of the end of the year. Monitoring should also be applied to tax collection so as to provide updated estimates of the tax reform impact on revenue from corporate and personal income taxes. This monitoring should be given as much transparency as possible, and reports should be sent to Parliament and to AIReF.
2. To adopt the necessary decisions to guarantee the financial balance of the Social Security System in the framework of the Pacto de Toledo Commission.
3. To monitor effectively by MINHAP the measures adopted by Regional Governments, demanding compliance with the strengthened conditionality compulsory under the rules of access to the FLA 2016
4. To revise in depth by the Regional Governments of Murcia, Valencia, Extremadura, Aragón, Catalonia and Castille-La Mancha, the Economic and Financial Plans they have presented, setting up jointly with MINHAP a feasible path for fiscal consolidation.
5. To establish and monitor by MINHAP a common framework for the exercise of the competencies on budget stability and the expenditure rule that are attributed to the overseeing entities of municipalities, so that the differences on interpretation and compliance that now seem to exist are eliminated

1. Introduction

AIReF is required to draw up, by 15 July each year, a Report on budget implementation, Government debt and the expenditure rule. Organic Law 6/2013, of 14 November, on the establishment of AIReF, assigns to this institution statutory powers to perform continuous assessment of the budget cycle and the Government's level of indebtedness and report, at any time, on the convenience of enacting the measures foreseen in the Organic Law on Budget Stability and Financial Sustainability (LOEPSF). In addition to this general duty, AIReF is also obliged to issue an opinion on the budget stability and Government debt targets, as well as on the expenditure rule, for the current year, before 15 July each year¹.

Object of the report and limitations to its scope

The object of this report is to assess the likelihood of compliance in 2016 with the budget stability and debt targets and with the expenditure rule by the General Government sector. In this assessment, that, in accordance with Article 17 of Organic Law 6/2013, will take into consideration the budget implementation and the measures envisaged for the current and the previous year, the potential risks of non-compliance are identified for each of the agents that make up the General Government sector.

In particular, the following will be analysed:

- ✓ The Central Government (CG) subsector.
- ✓ The Social Security Funds (FSS) subsector².
- ✓ The Autonomous Regions (AR) subsector and each of the regions.
- ✓ The Local Corporations (LC) subsector and the 16 City Councils with a population exceeding 250,000 inhabitants (Madrid, Barcelona, Valencia, Sevilla, Zaragoza, Málaga, Murcia, Palma de Mallorca, Las Palmas de Gran Canaria, Bilbao, Alicante, Córdoba, Valladolid, Vigo, Gijón and L'Hospitalet de Llobregat).

The risk analysis by subsectors is completed with a global vision of the situation for the General Government sector as a whole.

This report has been drawn up with the information published by the Ministry of Finance and Public Administrations (MINHAP), the Ministry of Economy and Competitiveness (MINECO) and the Bank of Spain. The most updated information available at the time of issuing this report has been used regarding non-financial and budget implementation operations published by the General Intervention Board of the State Administration (IGAE) and the General Secretariat of Regional and Local Coordination (SGCAL) in each subsector. The report has also used information published by the State Tax Administration Agency (AEAT), the Secretariat General for the Treasury and Financial Policy and the Bank of Spain.

¹ Article 17 of Law 6/2013 of 14 November, on the establishment of AIReF, and Article 19 of Royal Decree 215/2014 in which its Organic Statute is approved.

² In this case, only deficit target compliance is analyzed, as set forth in the Organic Law on Budget Stability and Financial Sustainability (LOEPSF).

Published information has been complemented with further data requested directly from the various Public Administrations. In order to issue this report, information was requested from the MINHAP Central Information office, from the Autonomous Regions and from the 16 City Councils with over 250,000 inhabitants, regarding budget implementation, budget outturn forecasts and measures enacted. The individual analyses of Autonomous Regions and City Councils have been performed with the information provided by these administrations, who have fulfilled their commitment to collaborate with AIReF in a timely manner, thus offsetting the failure on behalf of the Central Information office to provide most of the requested information on the regional bodies.

The scope of this report has been restricted by lack of information regarding:

1. **Initial budget and budget outturn forecast for 2016 in terms of domestic accounting by the CG, Social Security Funds (FSS), Autonomous Regions (AR) and Local Corporations (LC).** The aim of this report is to determine the existence of a potential risk of non-compliance with the budget stability, Government debt and expenditure rule targets, established as per ESA 2010. The lack of an initial budget and budget outturn forecast in terms of National Accounting significantly conditions the analysis of AIReF's outturn forecasts and any potential budget deviations, as these cannot be compared to official data at the level of the main headings of resources and uses.

This circumstance has led to some items being considered in administrative budgeting terms, with the incorporation of estimates for adjustments in national accounts terms, based on the available information from previous years. However, the Autonomous Regions and City Councils have provided a outturn forecast in budgetary terms including adjustments in national accounts terms to determine the borrowing requirement for the fiscal year.

The Central Government likewise lacks information on the components of the expenditure rule in the initial budget or in the budget outturn forecast. The Autonomous Regions and City Councils have submitted information on the expenditure rule with limitations deriving from their lack of information on certain items affecting their calculations

2. **Estimate of uncertain revenue collection adjustment by taxes and subsectors for 2016.** No published information is available either for the amount or for the methods employed to calculate this adjustment with the degree of detail required to assess the impact caused by uncertain revenue collection with regard to the risk of non-compliance with the stability target.
3. **Detailed information on the instrumentation of the Central Government's Non-Availability Agreement.** The CG has provided information on the instrumented amount of this Agreement to date (€1,625m) but has not given details of the items affected by this adjustment.



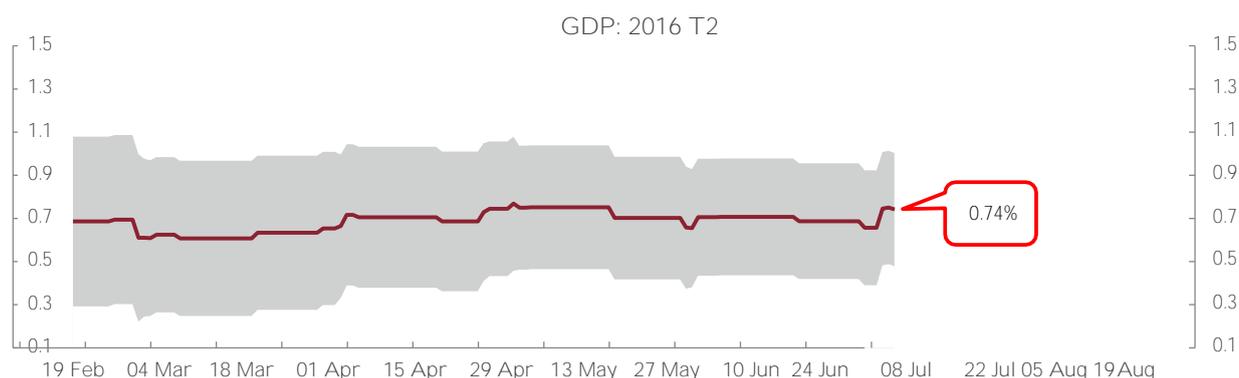
4. **Detailed information of the measures proposed in the pleadings submitted on 13 July to the European Commission, in the framework of a sanctioning procedure against Spain for failing to take effective action.** In the pleadings, reference is made to normative measures that will allow a €6,000m increase in corporate tax revenue and actions against fraud leading to a further gain of €1,000m, to be implemented by the new Government. These actions must be monitored in order to correctly assess their impact, once their nature and the manner in which they will be instrumented have been defined.

2. Analysis of the macroeconomic environment

The Spanish economy has maintained robust growth rates during the first half of 2016, pointing to an annual growth in GDP slightly above 3%. Having observed the data for growth in the first quarter (0.8%) and with indicators (see graph 1 for Mipred model forecasts)³ and expert opinions pointing to growth in the second quarter at around 0.7%, the carry over effect on the annual growth rate would appear to be sufficiently strong to ensure a growth in GDP for 2016 slightly above 3%, despite some slowing down in the economy over the second semester. This deceleration scenario, furthermore, seems unlikely given that the third quarter is also expected to show a positive behaviour, supported among other factors by a very favourable summer season campaign in the tourist sector.

GDP growth has managed to keep up its drive amid the political uncertainty that has reigned since late 2015. Real time forecasting models used by AIReF, fed with the latest short-term information for the Spanish economy, and with inputs including opinion indicators, likely to readily reflect this impact, do not appear to confirm for the present any significant repercussions arising from the uncertainty caused by the absence of Government and the recent Spanish Parliament re-elections (26 June). Indeed, as shown in graph 1, the Mipred model real-time forecast for second-quarter growth in 2016 has stayed at a value of around 0.7%, with no downward trend observed to date that may be ascribed to impact from political uncertainty in companies' and consumers' decisions. Nevertheless, caution is called for here as this situation, drawn out in time, could lead to distortions in economic agents' decision-making that could, in turn, affect activity levels.

GRAPH 1. REAL-TIME TREND IN THE 2016T2 GDP FORECAST (%)



Source: AIReF

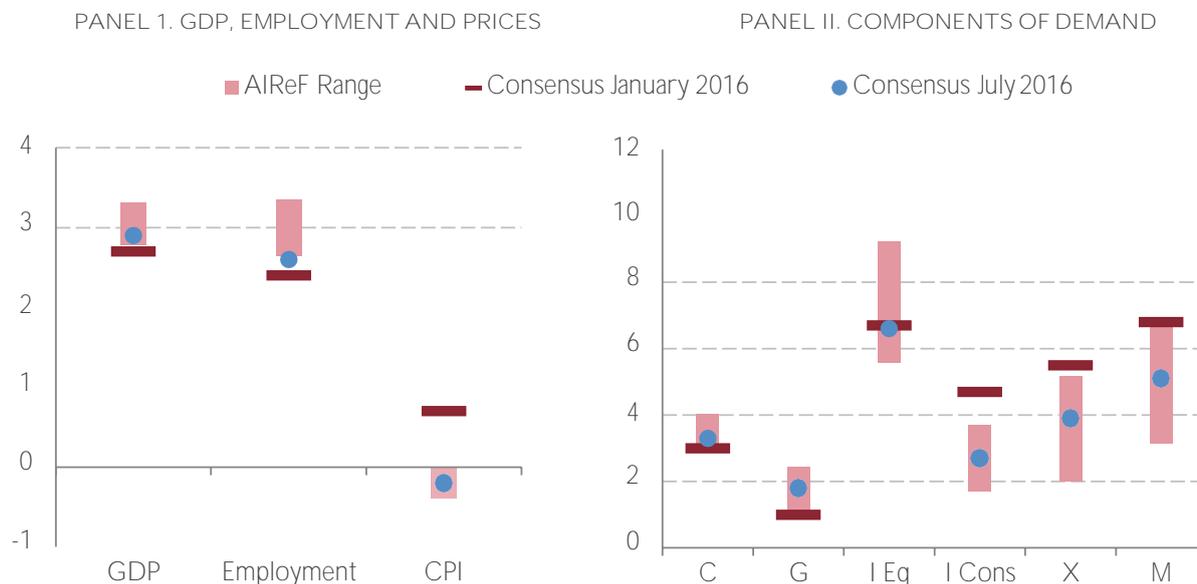
³ More details on the MIPred model can be found in the following working paper: Cuevas, A., Pérez-Quirós, G. and Quilis, E. (2015). "Integrated model for short-term forecasting of the Spanish economy (MIPred model)," Working Paper 4/2015, AIReF.

Expectations regarding the trend in GDP have remained stable from the turn of the year, with domestic demand as the main driver of the economy. Forecasts for GDP and employment by leading analysts (represented through the FUNCAS Forecasts Panel Consensus) have remained mostly stable since the beginning of the year, close to 2.7% and 2.4% respectively, slightly below AIReF's central forecasts, as shown on Panel I in graph 2. As for contributions to growth, Panel II shows that the driver is still domestic demand (although this has become more moderate), whereas external demand has maintained a negative contribution (though also smaller than forecast at the beginning of the year). Within the former, private consumption retains its relative strength based on intensive job creation and the improvement in the financial position of households thanks to the low interest rates and progressive debt reduction. These same determinants also seem to assist the recovery of investments in residential property, although this progresses at a moderate rate. Investment in equipment, for its part, will maintain for the remainder of the year its expansionary tone underpinned by reduced financial costs but at a slowing pace as final demand slacks off. Public investment is envisaged to drop in 2016, as a consequence of the possible setting in motion of the Non-Availability Agreements, and of the negative base effect deriving from the conclusion of the electoral period in 2015. This would lead to low levels of investment both from a historical perspective and in comparison with leading euro area countries, causing forecasts to be adjusted down. Lastly, forecasts made early in the year announcing a moderate trend in public expenditure have been revised up, confirming the risks pinpointed by AIReF in earlier reports. Concerning external demand, exports are expected to maintain their growth levels, albeit at a slightly slower pace in relation to the rather less expansionary trend in external markets and the expected appreciation of the euro, while vigorous imports may suffer from the deceleration in exports (with a high import content) and in public investment.

By contrast, prices have undergone a notable downward revision. Forecasts of inflation observed in the first semester have caused constant negative surprises (mean annual rate of -0.8% in the first six months of the year), chiefly hindered by slowing underlying inflation, as further drops in oil prices have not been registered. Forecasts for the second half of the year are a little more positive owing to two factors: (i) the recent stabilization and minimal recovery of oil prices (with rises of some 20\$/barrel over recent months); together with (ii) upward pressure exerted by the underlying component chiefly due to the reaction of wages to the labour market rebound and the moderate recovery in access to financing, mainly for companies and households.

This restrained price developments and the ensuing impact on salaries have had a negative impact on public accounts. To begin with, stagnant prices have impacted tax revenue collection, likewise largely hampering social contributions. The recovery in the economy and the labour market is not being reflected in a dynamic response in revenue, even after discounting the impact of reforms to the main income taxes, namely personal income tax (IRPF) and corporate tax (IS). It is therefore necessary to correct the initial central forecasts for revenue drafted on the basis of macro projections with information provided in the AEAT Monthly Tax Revenue Reports. Secondly, a low rate of inflation will eventually exert a moderating effect on the GDP deflator, with the ensuing denominator effect on all public accounts ratios in terms of nominal GDP.

Graph 2. MACROECONOMIC SCENARIO FOR 2016
 CONSENSUS FORECASTS BY THE FUNCAS PANEL and AIReF
 (% OF ANNUAL GROWTH)



Source: AIReF and FUNCAS. Intervals at 30%-70%

The risks involved in this outlook centred around 3% growth in GDP seem to be downward biased (weaker impulse). Although it is true that favourable financial conditions are still in place, thanks to the expansionary orientation in monetary policy, a certain slowdown is observed in some elements of a transitory nature that have fuelled recent activity, such as reductions in oil prices, depreciation of the euro or certain budgetary stimuli. Furthermore, the progressive normalisation of monetary policy in the United States, in conjunction with a deceleration in the Chinese economy and the weakness of some of the larger emerging economies, such as Russia and Brazil, have triggered growth perspectives in the major areas without the UEM to be cut back.⁴ The high level of uncertainty, both domestic and in Europe, is a further downward risk factor for growth in Spain. Uncertainty over future trends in budget policy (expected to be resolved after the next Government is formed) and uncertainty regarding the future of the EU and the costs to members stemming from the results of the referendum on the UK remaining in the European Union held on 23 June, in favour by a small margin of the leave option or *Brexit* (see Annex A for a sensitivity analysis on the potential impact of *Brexit* on growth in Spain in the short term).

⁴ See [ECB Euro system Staff Macroeconomic Projections for the euro area, June 2016](#).

3. Budget stability target and expenditure rule

The stability programme 2016-2019 altered the fiscal consolidation path with regard to the targets fixed by the Recommendation of the Council of the European Union dated 21 July 2013. The deficit reduction path agreed for Spain in the Recommendation of the Council of the European Union on 21 July 2013 established deficit targets for the General Government sector of 2.8% for 2016, 1.4% for 2017 and 0.3% for 2018. The new consolidation path incorporated to the Stability Programme Update (SPU) 2016-2019 envisages a deficit of 3.6% for 2016, 2.9% for 2017, 2.2% for 2018 and 1.6% in 2019. Subsequently, the European Commission, in its Recommendation of 18 May 2016, determined the convenience of adopting the necessary additional measures to guarantee a lasting correction of the excessive debt registered in 2016 and 2017, establishing the deficit for the General Government sector at 3.7 of GDP in 2016 and 2.5% of GDP in 2017.

On 12 July 2016, ECOFIN formally declared that Spain has not taken effective action to comply with its public deficit targets for 2016. Following this decision, the European Commission has 20 days to propose a recommendation to impose a fine on Spain. On 13 June 2016, Spain presented allegations in such a procedure. At the time of publishing this report, the Commission had not yet issued a proposal to impose a fine, nor expressed a view regarding a new deficit reduction path for Spain.

Table 1 shows the proposed official target for 2016 for each subsector included in the stability programme 2016-2019:

Table 1. PROPOSAL FOR THE OFFICIAL TARGET IN 2016 (% GDP)

		2016 Objective	Official SPU 2016-2019 proposal
Net Lending (+) / Borrowing (-) in % GDP	Central Administration	-2.2	-1.8
	Social Security	-0.3	-1.1
	Autonomous Communities	-0.3	-0.7
	Local Entities	0.0	0.0
	Total Public Administrations	-2.8	-3.6

Source: Stability programme 2016-2019 and MINHAP

To determine the risk of lack of compliance in each subsector with regard to the official target proposal included in the SPU 2016-2019, the following main items were taken into account:

- The updated macroeconomic data ⁵ analysed in paragraph 1,
- The available budget implementation data for the General Government sector and for each of its subsectors⁶,
- The measures with an economic impact adopted after the publication of the General Government sector's Initial Budget Report of which we have knowledge, paying special attention to the instrumentation and implementation of the Non-Availability Agreements signed in early 2016,
- Information on the final settlement of resources for the Autonomous Regions' financing system in 2014.
- The pleadings submitted on 13 July to the European Commission, in the framework of a sanctioning procedure against Spain for failing to take effective action.

In AIReF's assessment, based on newly available information, compliance with the target proposal for 2016 for the General Government sector of -3.6% of GDP is deemed unlikely. The estimations drawn up by AIReF in the Report on Initial Budgets placed the deficit for 2016, in the absence of significant additional measures to those envisaged in the initial budgets for the Public Administrations (AAPP), at around 4% of GDP. To reach the official deficit target of 3.6% of GDP proposed in the SPU, it was deemed necessary to make an extra consolidation effort of about 0.4% of GDP. To this end, additional measures were adopted such as the enactment of a Non-Availability Agreement (AND) by the Central Government (€2,000m), and ANDs and non-implementations were announced in several Autonomous Regions (€830m and €680m) that, in the event of fully deploying their effects, would enable the adjustment to be fulfilled to a large extent. AIReF, in its Report on the Stability Programme 2016-2019, deemed it feasible to reach the deficit proposed for 2016 of 3.6% of GDP provided that:

- ✓ The measures included in the SPU were strictly observed. In this sense, it was considered fundamental that the implementation of the Non-Availability Agreements over budget items that would indeed have an impact on the public deficit in each subsector be instrumented and guaranteed.
- ✓ A number of uncertainties did not materialise, despite having been identified in the reports on projects and initial budgets relating to the collection of direct taxes, especially corporate tax, situated at the top end of AIReF's confidence interval.
- ✓ The Central Government Bodies maintained the healthy performance of previous years producing a significantly higher surplus to that forecast in the General State Budget.

⁵ AIReF's forecasts referenced to GDP have been estimated using the GDP calculated by AIReF.

⁶ First quarter data for the General Government sector have been included, and data up to April for the Central Government, Social Security Funds and Autonomous Regions, complementing the Central Government's forecast with the data published for May for the State.

- ✓ Differentiated net lending/borrowing paths were established by Autonomous Regions in which the magnitude of the consolidation required in each region took into account aspects such as the trend in financing system resources, the incidence of non-recurrent operations registered in 2015 and the implied restraint in public expenditure.
- ✓ Local Corporations registered a surplus similar to that achieved in previous years.

Implementation data⁷ and monitoring of the measures announced by the Public Administrations have given rise to a revision of AIReF's deficit forecasts, situating the deficit at a higher level to that initially foreseen in the Stability Programme. The main reasons for this revision were:

- ✓ The AND announced in the SPU have not been fully instrumented. In the case of the CG, MINHAP has specified the amount (€1,625m) before the publication date of this report, but has not disseminated details of the budget items that will be affected, which generates uncertainty over the full effectiveness of the adjustment. Moreover, the information received from the Autonomous Regions highlights the non-instrumentation of the AND for the adjustment amount announced. In the SPU report it was clear that, given the nature and characteristics of the AND that the Autonomous Regions were planning to adopt, only €300m could be considered as measures exerting an additional impact on the deficit to those already envisaged in the Budget. Subsequently, the information provided by the Autonomous Regions has shown that, to date, ANDs with any impact on the deficit and on future years have only been adopted in the Autonomous Region of Extremadura, for €44m, while the Autonomous Region of Aragón has committed to adopting agreements of a similar nature for €33m.
- ✓ No differentiated targets have been announced for the various Autonomous Regions. In general, the Autonomous Regions have adjusted their outturn forecasts to the path proposed in the SPU, namely 0.7% deficit, including those in which the implementation of their budget would have allowed them to achieve a smaller deficit.
- ✓ Cash receipts data published up to May 2016 reveal considerable tensions in tax collection, with much uncertainty over the potential impact of the tax reform and the effects of consolidation measures taken in previous years on 2016 corporate tax revenue. The uncertainty over this tax and the foreseeably higher impact of normative changes on the Government's initial forecasts have led to a review of the estimates published in previous reports for direct taxes.

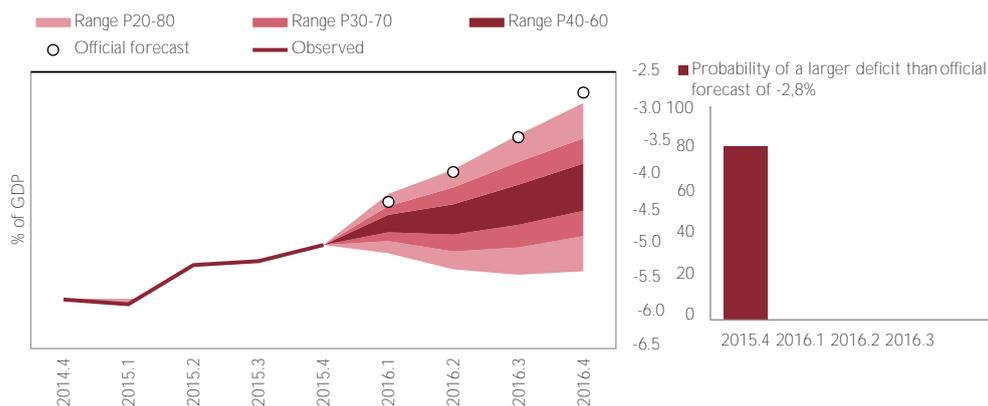
Graph 3 shows AIReF's estimates for net lending/borrowing for the General Government sector in 2016 published in several reports. As indicated above, in the Initial Budget Report AIReF's assessment was based on the approved target of -2.8% of GDP, and considered that compliance was highly unlikely. On approval of the 2016-2019 Stability Programme, AIReF's assessment was drawn up on the likelihood of compliance with the proposed target fixed

⁷ Implementation data in April for the CG, FSS and the ARs, and in the first quarter for the LCs. In the case of the CG, the assessment is complemented with the information published up to May for the State.

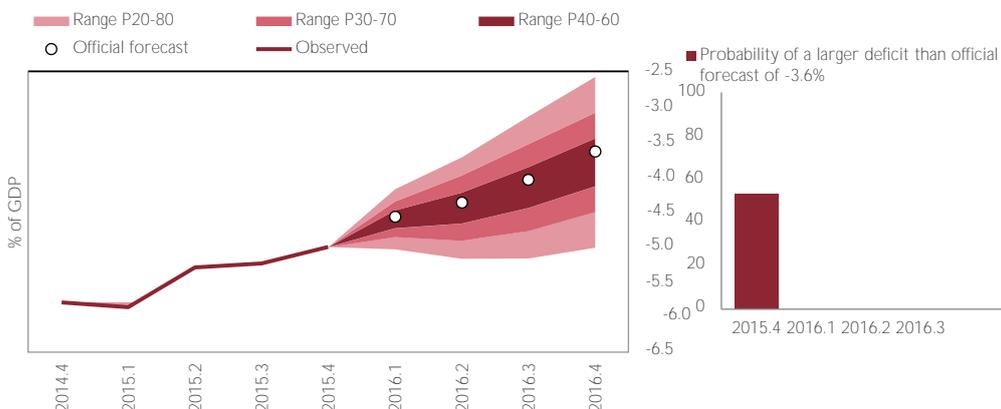
therein at 2016 of -3.6% of GDP. At that moment, compliance was deemed feasible but demanding, and required all the above conditions to be met. The current forecast, having analyzed the available information, raises the likelihood of reaching a deficit above the proposed target for 2016.

Graph 3: NET LENDING/BORROWING 2016. GENERAL GOVERNMENT SECTOR (% GDP).
AIREF ASSESSMENT REPORTS

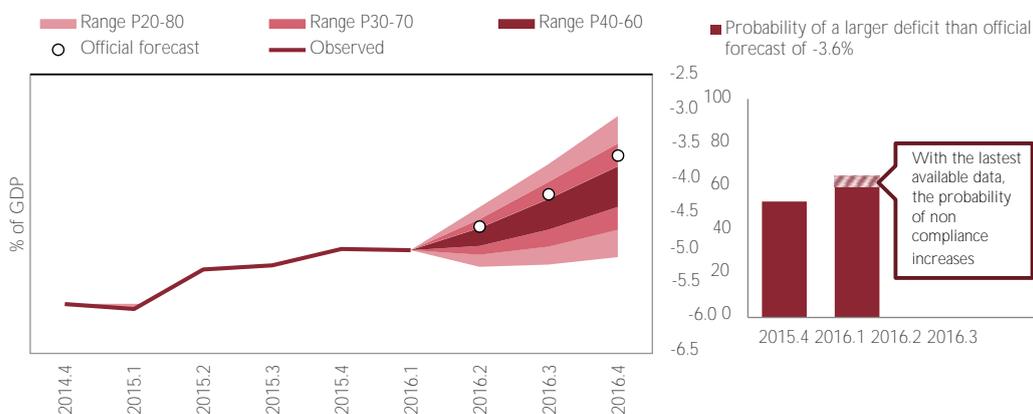
REPORT ON THE INITIAL BUDGET 2016



REPORT ON THE STABILITY PROGRAMME 2016-2019



CURRENT FORECAST

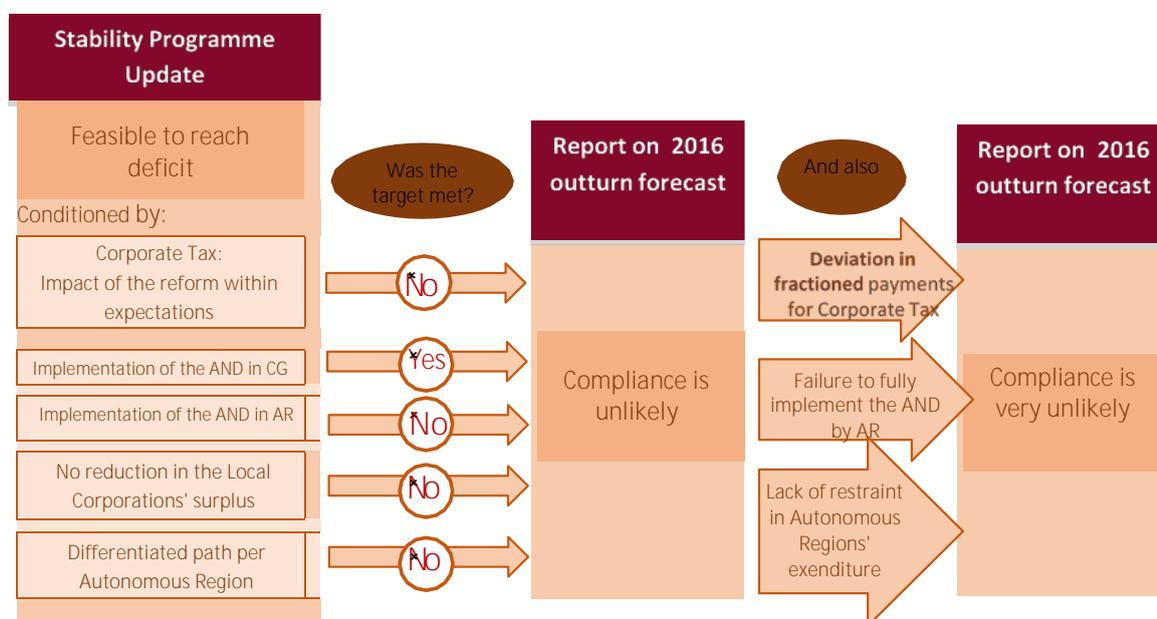


Compliance with the proposed target of -3.6% of GDP for the General Government sector is unlikely. The conclusion that may be drawn from analysing the available information, detailed in the following paragraphs for each subsector, is that to fulfil the proposed deficit target it is necessary that any possible slack in the Local Corporations subsector, together with a strict implementation of Autonomous Regions' expenditure, is sufficient to offset the deviation that will occur in the Social Security Funds and the foreseeable risks of deviation in the CG, a set of conditions which does not seem likely. By subsectors:

- ✓ **Non-compliance is confirmed as practically certain in the Social Security Funds with regard to the proposed official target of -1.1% of GDP.**
- ✓ **Central Government compliance is unlikely, as tensions are observed in non-financial resources.** Uncertainty over compliance may be attenuated when sufficient information becomes available on how the actions announced in the pleadings submitted to the Commission will be instrumented, the implementation of which, as noted in the document itself, will be the responsibility of the new Government.
- ✓ **In the Autonomous Regions, compliance with the proposed target is deemed feasible, but tight.**
- ✓ **The implementation data available for Local Corporations' financial trend point to a surplus in 2016 slightly smaller than in previous years'.**

Should the measures proposed by the Central Government fail to be fully effective, an additional deviation would occur and compliance with the proposed target would be classified as highly unlikely. As observed in table 2, if no changes are made in 2016 to the regulations for corporate tax regarding minimum fractioned pre-payments on the accounting outcome, and to a lesser extent, the Central Government's Non-Availability Agreement should fail to reach the expected levels of deficit adjustment, a further deviation may occur of about six tenths of a decimal point. However, the decision to bring forward to July 2016 the closure order may entail a further expenditure adjustment for an amount that is yet to be estimated. Additionally, this situation would be aggravated for the General Government sector if Autonomous Regions fail to apply a containment policy on public expenditure.

Table 2. AIREF QUALIFICATION STABILITY TARGET



3.1 Central Government

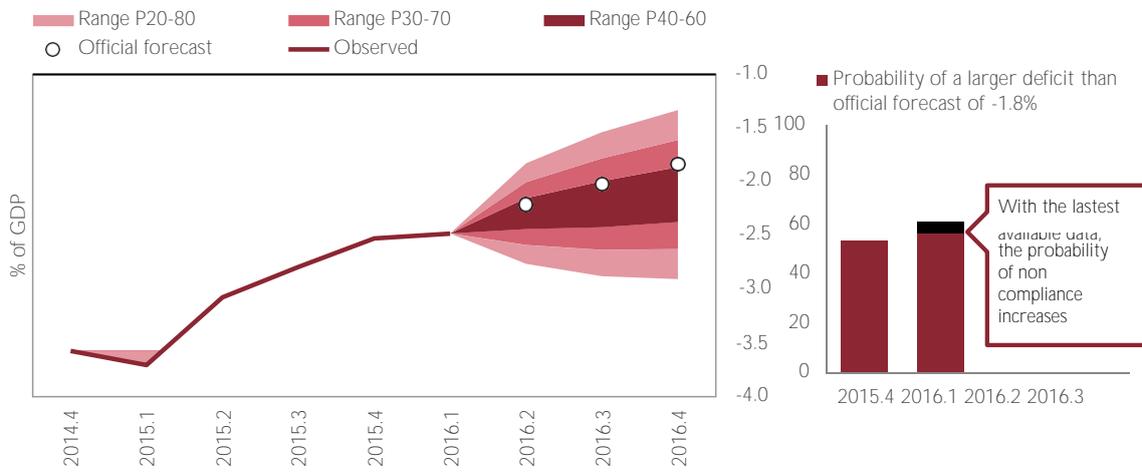
3.1.1 Stability target

In the period 2011-2015 the Central Government performed an adjustment⁸ of 2.9% of GDP, reducing the deficit from 5.4% in 2011 to 2.5% in 2015. The Central Government closed 2015 with a deficit of 2.5%, fulfilling the fixed stability target, having to perform a further consolidation adjustment for 2016 of 0.7% of GDP to reach the official target proposal of -1.8% expressed in the SPU for that year.

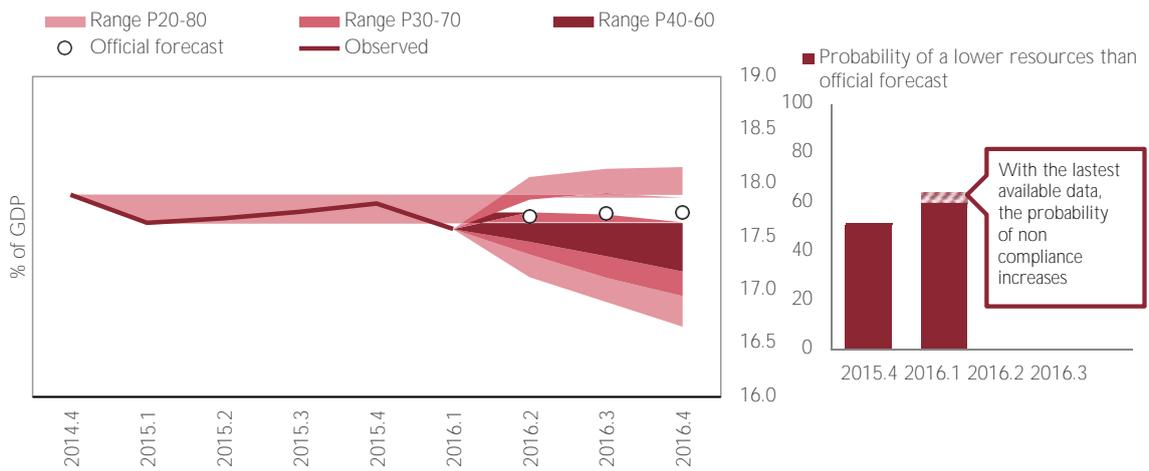
It is likely that the Central Government will deviate from the proposed target of -1.8% of GDP. The proposed target in the SPU presents a reduction of 0.4 GDP points on the initial deficit approved for the CG (-2.2% of GDP). The Government has justified this additional adjustment to that envisaged in the 2016 General State Budget with the approval of a Non-Availability Agreement for a value of €2,000m. Implementation data published up to the month of April for the CG, and the State data for May, highlight the difficulty involved in effecting the proposed adjustment for 2016.

⁸ Exclusive of final negative settlement balances for the financing system, and exclusive of financial support.

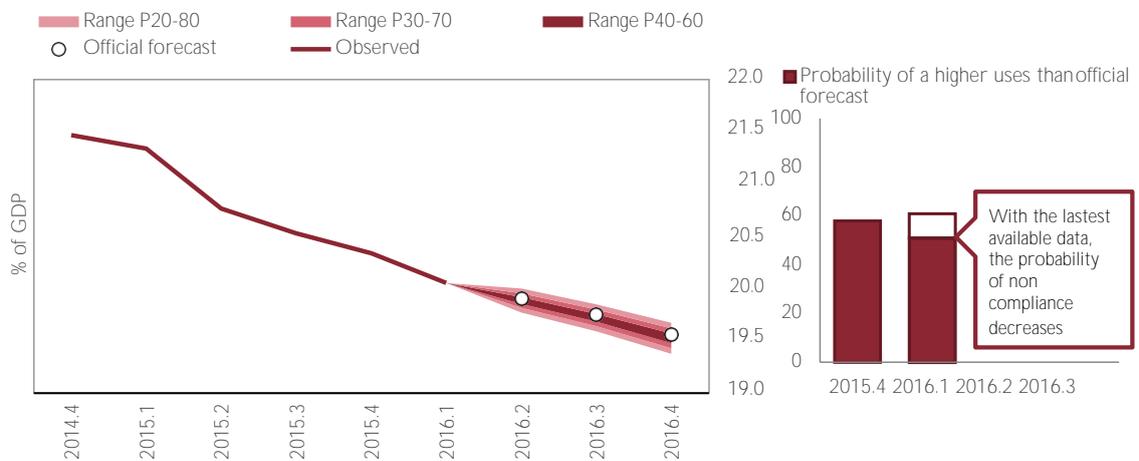
GRAPH 4: NET LENDING/BORROWING. CENTRAL GOVERNMENT



CG RESOURCES



CG USES



Non-financial resources

Non-financial resources as a percentage of GDP show a decreasing trend during the first few months of the year, mainly due to tax revenue developments. The variations in cash revenue that may occur as the year unfolds are transferred fully to the Central Government's resources (with some adjustments) since the portion assigned to the territorial entities remains substantially unchanged throughout the year. Implementation data published by AEAT show that tax revenue before assignment in the months of January and March has dropped 2.5% in comparison with the same period in the previous year. This rate is a long way from the growth rate of 6.3% forecast in the 2016 General State Budget.

The moderation in prices and the impact of the direct tax reform are negatively affecting tax collection. Despite the fact that tax revenue is driven by a favourable trend in the main macroeconomic variables (both consumption and employment increasing to rates close to 3%), taxes are growing at a slower pace to that initially envisaged in the Budget, as they depend on nominal variables that have suffered negative effects from a moderation in prices. In addition, the direct tax reform, together with the expiry of the consolidation measures adopted between 2012 and 2015, may have a negative impact on the higher than initially expected revenue and cause the forecasts in the Budget to be very hard to achieve. The measures announced in the pleadings will partly offset this trend.

The main risk lies in Corporate Tax, which has undergone numerous normative changes. AIReF had already pointed out in earlier reports that the revenue forecast in the 2016 General State Budget for Corporate Tax would be difficult to achieve, among other reasons owing to the cumulative deviation in said tax at 2015 year-end, which implied that the tax needed to grow 20.4% in order to comply with the Budget forecast. As well as the deviation registered the year before, the data for the first fractioned pre-payment in April 2016 (analysed in depth in Annex A, relative to this tax), are very negative (the payment in April registered a 48.7% drop with regard to the same period in the foregoing year) despite the growth in corporate profits and the improved credit conditions. The reasons for this negative evolution are fundamentally two: the entry into force of the second tranche of the fiscal reform (which implies that fractioned pre-payment rates have dropped in general from 20% to 17%, and an increase in deductibility of negative tax bases), and the disappearance of temporary measures that have not been extended, the most important of which in tax revenue terms are incremented rates for larger companies, partial integration in the tax base of dividend payments, and minimum payment on the basis of accounting results. Some of these measures are of a merely financial nature, implying a loss of tax revenue in 2016 and an increase in 2017. Nevertheless, in the Stability Programme it is mentioned that, in view of their effect on the National Accounts for 2016, and consequently on the deficit, new extensions could be enforced if deemed necessary during the year by the new Government. In this vein, the pleadings submitted on 13 July to the European Commission, in the framework of a sanctioning procedure against Spain for failing to take effective action, contain a provision for the new Government to enact a Royal Decree-Law adopting measures regarding fractioned pre-payments for an amount of €6,000m. AIReF has included in its estimates said measures for increasing Corporate Tax fractioned pre-payments that, according to the Government, could be at least 20% of the accounting result. However, AIReF considers that, in all probability, a

part of the Corporate Tax reform will not be recovered and, therefore, the figure foreseen in the Budget will be difficult to comply with.

Tax collection is not growing according to macroeconomic aggregates owing to the fiscal reform. As for IRPF, the positive trend in employment is reflected in salary income, undergoing a growth rate of 4% in the first semester. However, withholding tax has not followed the same trend, decreasing by 2.7% up to May. Therefore, although this effect will become weaker as the year progresses, in comparison to periods in 2015 and 2016 affected by lower withholding rates, there may be certain risks of a greater impact from the reform than initially foreseen. In addition, capital income in the early months of 2016 has taken an unfavourable trend as a consequence of financial markets' volatility. Thanks to these factors, compliance with the budget data, according to which this tax was expected to grow by 4.3%, involves certain risks.

Taking the above into account, and making the necessary adjustments, an estimate has been drawn up for direct taxes in National Accounting terms. As seen in graph 5, according to AIReF's forecasts and the data published in National Accounting, compliance is deemed unlikely. Similarly, once the data for the first quarter is published, the likelihood of non-compliance increases with respect to the previous quarter.

Indirect taxes, unaffected by the reform, demonstrate greater dynamism than direct taxes, particularly VAT, although this is not growing at such high rates as in 2015. The trend in private consumption and salaries prompts forecasts for VAT to tend toward rates that are compatible with the Budget forecasts, but less vigorous than those struck last year (7.4%). Nevertheless, the uncertainty affecting this tax also stems from a normative change relative to VAT on imports, that came into force in 2015 and had a negative impact on that year and a positive impact in the early months of 2016. In the second half of the year, once this effect has become mitigated, if the tax continues to match the macroeconomic forecasts the year may close in line with the budget. As shown in graph 5, according to AIReF's estimates, compliance with the Government's forecasts with regard to this tax is feasible. Similarly, once the data for the first quarter are published, the likelihood of compliance increases with respect to the previous quarter.

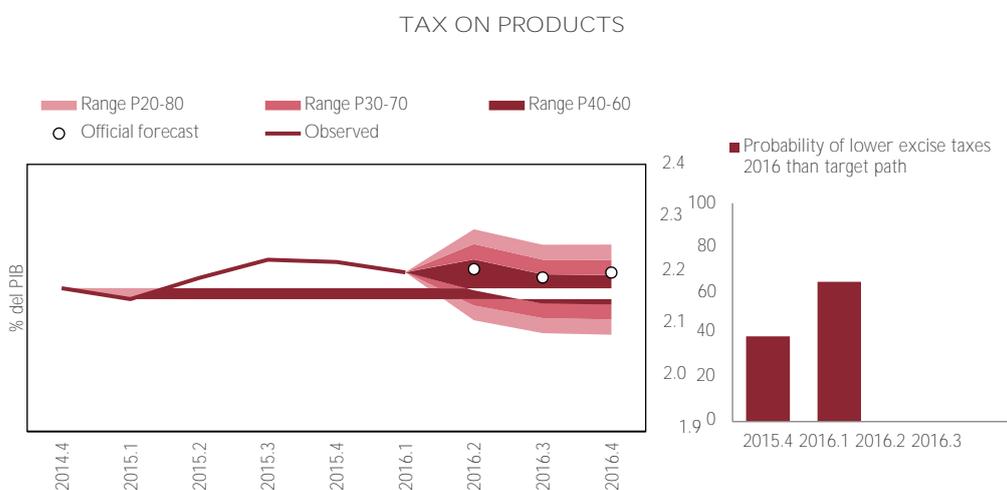
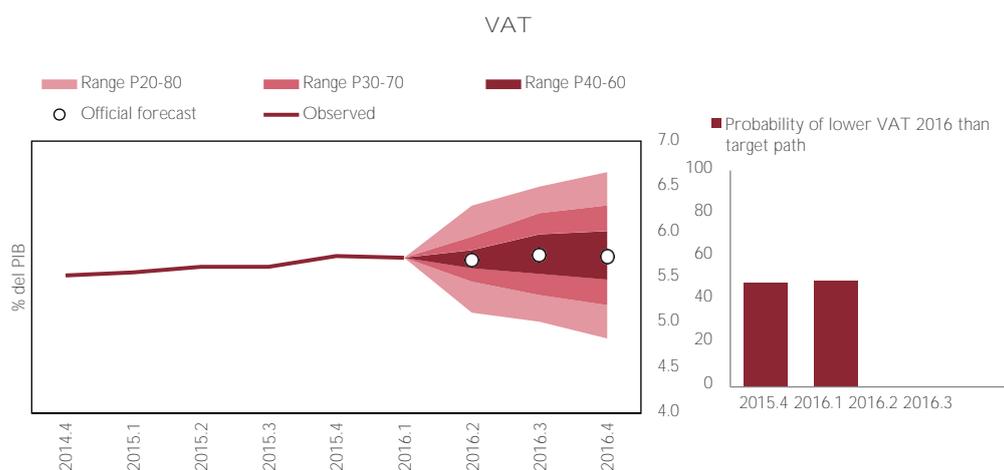
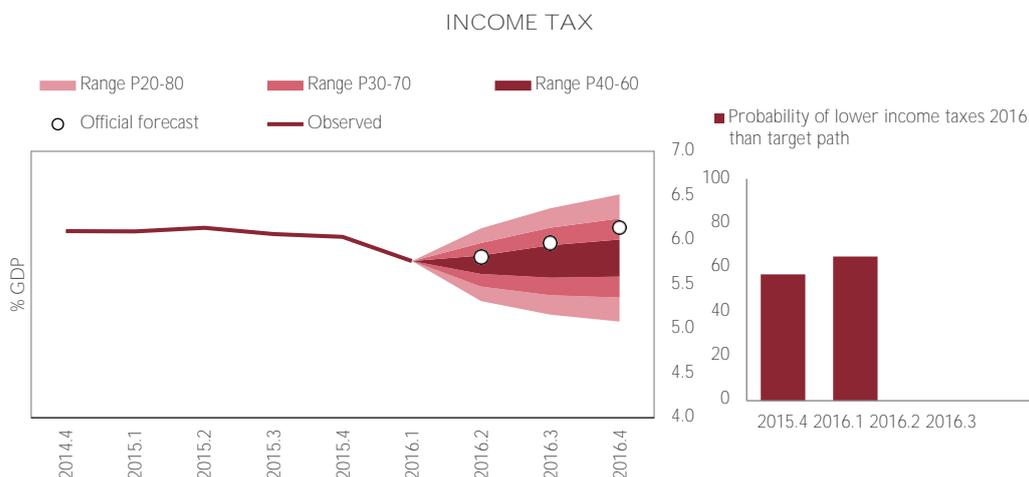
Excise Taxes are increasing at very moderate rates. Up to the month of May, excise taxes have grown with moderation chiefly due to the trends in taxes on electricity and tobacco, whereas the Tax on Hydrocarbons shows a more favourable trend due to increased consumption of gasoline and diesel, especially in the last two months. In addition, environmental taxes are also growing more slowly than expected.

These taxes form part of the taxes on products under National Accounting. As shown in the graph, although compliance with the forecast for taxes on products is feasible, the likelihood of compliance is smaller than in the previous quarter as seen in graph 5.

The final settlement in the financing system for 2014 represents an increase of €703m in favour of the Autonomous Regions with respect to the 2016 Budget forecast. Besides the measures relative to the tax reform, Central Government revenues have been negatively affected by the financing system settlement. In June a positive balance was reported for the Autonomous Regions, deriving from the 2014 System settlement for €703m. This balance is

composed of two fundamental parts: on the one hand, higher revenue from Personal Income Tax (IRPF) than envisaged, benefiting the Autonomous Regions by €838m, and on the other hand, the smaller amount in the Competitiveness fund with regard to the initial estimate of €135m for the State.

Graph 5: CENTRAL GOVERNMENT TAXES



Non-financial uses

In the early months of 2016, non-financial uses presented a general downward trend. Overall, non-financial uses diminished with the exception of the headings for aid to investment. The legal constraints on a caretaker Government during the first few months of the year may have contributed to a slightly greater restraint in public expenditure than initially envisaged which, together with the approval of the Non-Availability Agreement on 29 April 2016, allowed the downward trend to be consolidated.

MINHAP has announced that €1,625m have been implemented in this Non-Availability Agreement, while €375m are still pending as this is a complex process requiring re-programming of expenditure commitments. Details have not been forthcoming regarding the expenditure items affected by this adjustment. However, the Ministry of Finance and Public Administrations has announced that of the €2,000m, €950m affected expenditures in chapter VIII with an impact on deficit, and expenditure items in the Ministries of Economy and Competitiveness, of Industry, Energy and Tourism, and of Public Works. In this vein, it is necessary to point out that insofar as non-availability is applied to budget appropriations destined for contributions and transfers to companies or public entities within the consolidation perimeter of the General Government sector, the actual impact on deficit will only be effective if the latter reduce their own expenditure. In most cases, these entities' budgets are tentative rather than limitative, which calls for their careful monitoring through the supervising Ministries and the Ministry of Finance and Public Administrations in order to guarantee the effectiveness of the Non-Availability Agreement. Nevertheless, anticipating to July the order for the closure of accounts may cause an additional restraint to expenditure, for an amount that has not been estimated.

In any case, AIReF deems it essential to implement, as soon as possible, the remaining part of the Non-Availability Agreement and to exert effective control over all the budget items affected, in order to guarantee the expected deficit reduction.

Interest payments have dropped 5% and will foreseeably remain at this level for the rest of the year. The downward trend in interest payments remains steady and reflects the impact of the expansionary monetary policy and lighter pressure from the Spanish risk premium. AIReF's forecasts reveal less expenditure than the initial General State Budget forecast of 0.1% of GDP.

Aids to investment increased significantly in the first months in 2016 as a consequence of the transfer to the European Single Resolution Mechanism (SRM). This transfer complies with Act 11/2015, of 18 June, on the recovery and resolution of credit institutions and investment services companies, which establishes that from 1 January 2016 credit institutions are obliged to make their contributions to the European SRM. Contributions for 2015, funded with contributions from banking institutions in 2015, were made in early 2016 as a capital transfer under the remainder of uses in 2016. As expressed in the National Resolution Fund annual accounts, contributions for this year must be transferred before 30 June 2016, funded with the contributions for 2016. It may occur that in 2016, it being the first year, both quotas (2015 and 2016) are entered as financial uses.

Non-financial uses could be affected by the existence of obligations unforeseen in the General State Budget. For the purpose of following up on compliance with the budget stability and financial sustainability target it is necessary to analyse not only the obligations envisaged in the initial budgets but also other 'potential risks' that, should they materialise, may negatively affect compliance with the deficit or debt targets. In a number of reports, AIReF has mentioned the need to provide sufficient information on these risks. The most outstanding known risks liable to affect the 2016 deficit are the following:

- ✓ Possible impact deriving from the financial responsibility over toll road concessionaires that the CG may need to assume
- ✓ Impact deriving from the judgment handed down by the Supreme Court in January 2016, on the claim regarding the State's financial responsibility over the Tax on Retail Sales of Certain Hydrocarbons (the "healthcare cent").

In the 2016 Budget no budget allocation is foreseen for these obligations, nor is sufficient information published to enable the monitoring of such contingencies. A request has been submitted to MINHAP for information on the potential impact of these and other known contingencies regarding the deficit in 2016, indicating that to date there is no assessment available in which an estimate is given of the possibility of having to face these expenses in 2016.

To conduct proper monitoring of these risks, it is essential to give greater transparency to the potential obligations and risks the Central Government may have to face. The General State Budget does not include information on potential responsibilities the General Government sector may need to face deriving from judgments, information relating to Private-Public Partnerships or other types of risks that may affect Public Administrations' budget stability and financial sustainability targets arising, for example, from non-performing loans. This information is likewise not included in the monthly information on implementation data for the various Public Administrations.

3.1.2 Expenditure rule

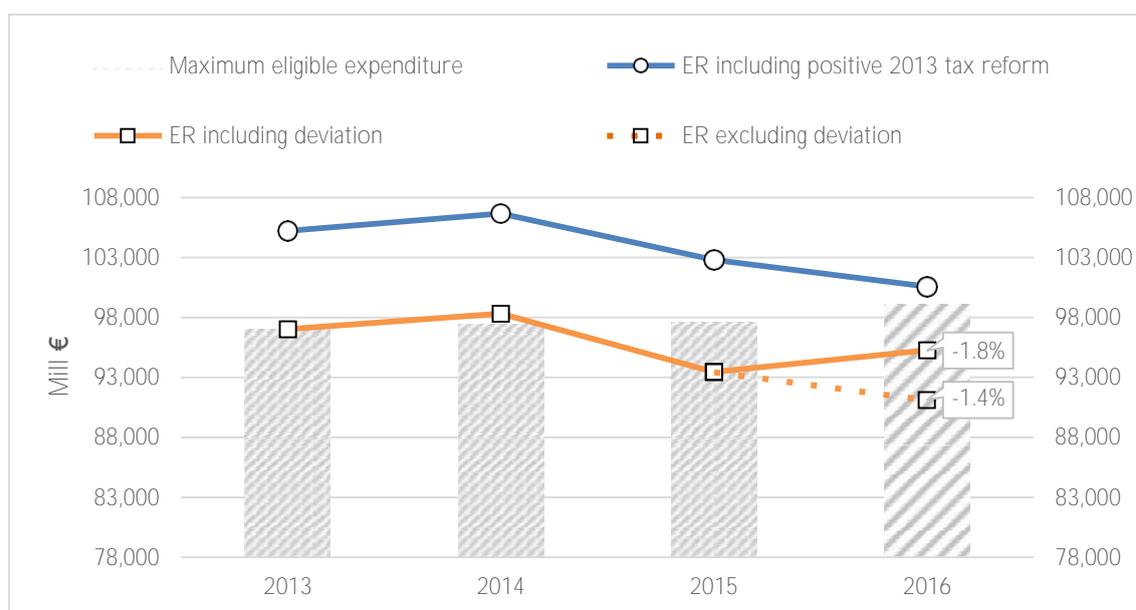
The Central Government may fail to comply with the expenditure rule again in 2016. The risk of the Central Government failing to comply with the expenditure rule derives fundamentally from the ultimate impact this year of the normative changes caused by a decrease in revenue stemming from the fiscal reform of IRPF and IS. Foreseeably, growth in eligible expenditure in 2016 will remain below the reference rate for the expenditure rule (1.8%). However, expenditure should be substantially reduced in addition to compensate for the impact of the fiscal reform.

Failure to comply with the expenditure rule in 2016 will be particularly significant if the deviation in 2015 is corrected. As can be observed in graph 6, applying the reference rate for the eligible expenditure in the last year in which the rule was fulfilled (*strict ER*) the CG needs to considerably reduce its eligible expenditure in 2016.

The above analysis has been completed with a simulation of the level of eligible expenditure the CG could have achieved by increasing it in 2013 to the limits permitted by the fiscal reform

instrumented in that year, which allowed for a €1000m increase in revenue (*ER absorbing the 2013 fiscal reform margin*). Implementation of the expenditure rule above this level would have compensated for the fiscal reform of 2015/2016 but would have entailed a deficit greater than -and incompatible with- the approved deficit target.

GRAPH 6. ELIGIBLE EXPENDITURE WITH EXPENDITURE RULE AND NET LENDING/BORROWING CENTRAL GOVERNMENT



Graph 7 shows that in 2016 eligible expenditure items intended to support the adjustment to comply with the expenditure rule, having excluded pensions for civil servants and the contribution to the European Union, which are more inflexible, have reached historic lows as a consequence of the consolidation process taking place over recent years.

GRAPH 7. TREND IN ELIGIBLE EXPENDITURE EXCLUDING PENSIONS FOR CIVIL SERVANTS AND EU CONTRIBUTIONS (% GDP) CENTRAL GOVERNMENT



3.2 Social Security Funds

It is practically certain that the FSS stability target, fixed initially at 0.3% of GDP and updated in the SPU to 1.1% of GDP, will not be met. The proposed target in the SPU is 0.8 percentage points higher than the initially approved FSS target of 0.3% of GDP. AIReF, however, maintains that lack of compliance is certain. The adjustment needed to reach this target, from a baseline deficit in 2015 of 1.3% of GDP, and taking into account that the CG has reduced by 0.5 percentage points its contribution to SEPE, is 0.7% of GDP. The trend observed in recent months and the absence of measures make this adjustment impossible to materialise.

Social contributions growth show more dynamism over recent months, but insufficient to meet the proposed deficit target. The increase in membership, which grew by 2.9% in June, together with the compensation per employee and the expiring of part of the reductions to incentive hiring, is clearing the way for an increase in revenue from social contributions that could level out at around 3.4% by the end of the year. This growth is in line with AIReF's forecasts in earlier reports. Compliance with the proposed deficit target would require an annual growth rate in contributions of more than 9%, which is very far from the growth estimated by AIReF.

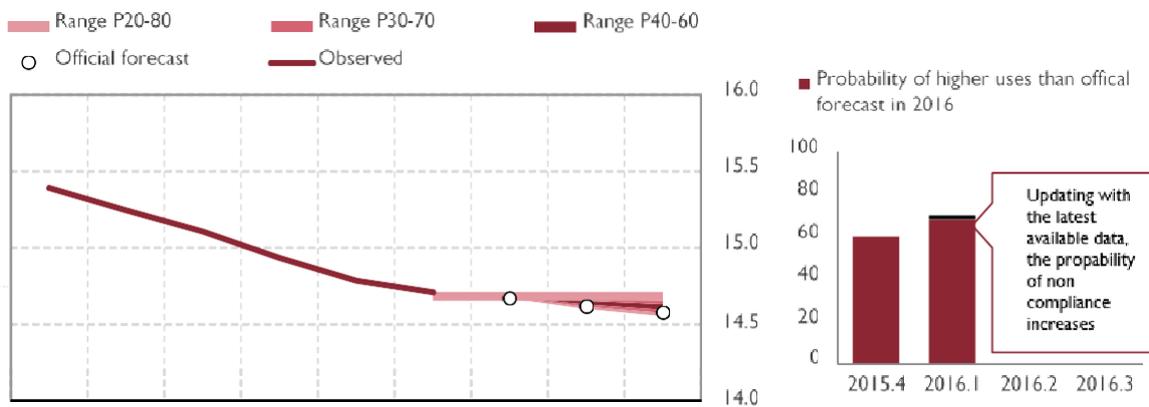
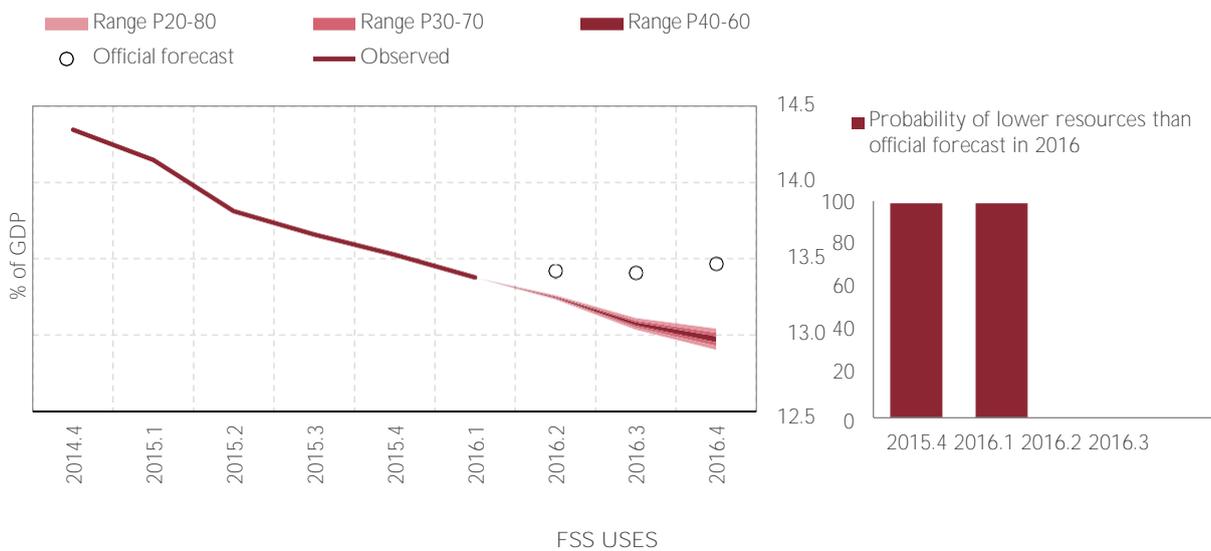
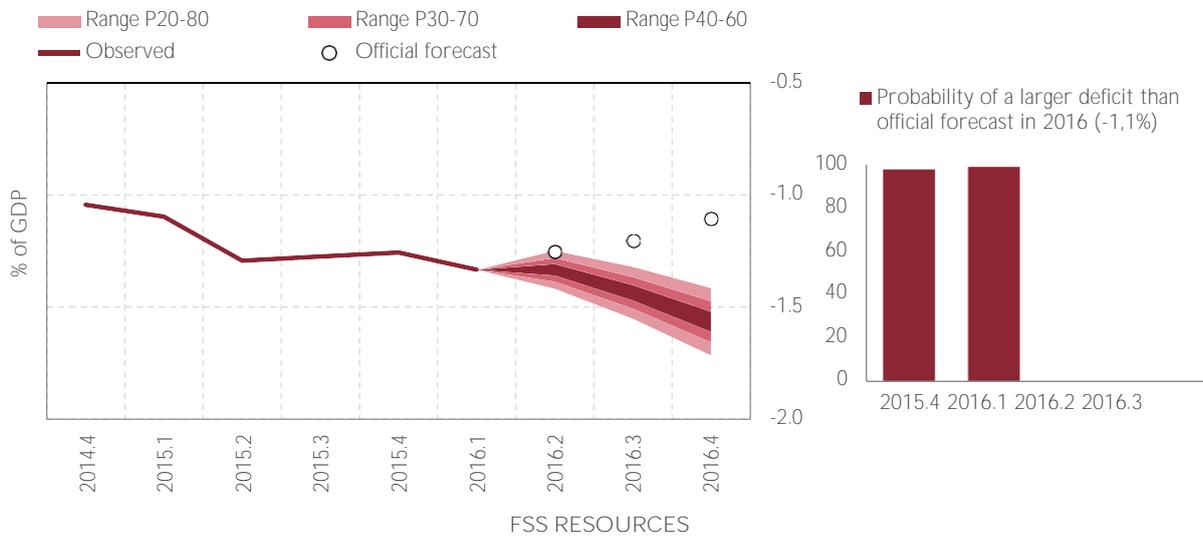
The foreseen increase in contributions from employed persons is greater than the growth in expenditure in contributory pensions. Expenditure in pensions is undergoing growth at around 3%, reflecting a slowdown in the rate of increase of the number of pensions, the effects of applying the Pension Revaluation Index⁹ (IRP), and the reduction in expenditure on complements to pensions below the minimum (-2% until May).

The reduction in expenditure on unemployment benefits continues, fundamentally in contributory benefits, though these are falling at a slowing rate. Expenditure in unemployment benefits continues to decrease, albeit at a slower rate than in 2015. This decrease is a consequence of both greater activity in the labour market and the expiring of entitlement periods to receive contributory benefits and long-term unemployment benefits. In this light, the coverage rate (number of beneficiaries/number of unemployed registered) continues to drop reaching 52.9% in May.

The CG's transfers to the FSS have decreased owing to smaller expenditure in SEPE unemployment benefits. In 2016, the State will transfer €3,922m to SEPE, as opposed to €10,090m in 2015, to balance the institution's budget. This reduction in the amount transferred means a reduction in overall financing for the Social Security Funds. In view of the fact that unemployment benefits are dropping at a higher rate than initially envisaged, the budgeted transfer to SEPE is foreseeably greater than actually required, leading to a surplus of around 0.1 percentage points of GDP for this institution.

⁹ [Opinion on the determination of the 2015 Pension Revaluation Index](#)

GRAPH 8: NET LENDING/BORROWING. SOCIAL SECURITY FUNDS



Analysis by agents

Social Security System

The Social Security System will maintain a deficit in 2016 slightly greater than that of 2015. Although contributions are growing at a quicker pace, reaching 2.4% in May¹⁰, the drop in revenue in interest accrued by the Reserve Fund and the growth in expenditure in social benefits will prevent a correction being made for the deficit in the System.

AIReF's forecasting model for contributions, updated with the budget implementation data for May, predicts that contributions will grow at a rate of approximately 3.3% in the year. The data available for May show a growth rate of 3.2% for contributions by employed persons and a reduction of 8% in contributions from workers receiving unemployment benefits and employment subsidies paid by SEPE into the Social Security System. For the full year, AIReF's estimates for revenue from contributions are still closer to the forecasts given in the SPU than those in the General State Budget for 2016. Growth in revenue from employed persons has surpassed membership for a second consecutive month, reflecting the improvement in contribution bases which is partly explained by the expiring of employment subsidies.

Reserve Fund returns are decreasing. Overall revenue also reflects a decrease in returns from the Reserve Fund, as a consequence of a reduction in the Fund's total assets owing to the need to finance the deficits incurred in recent years. In July 2016 a disbursement of €8,700m has been made from the Fund, coinciding with the payment of July pension bonuses and the corresponding IRPF payments. For 2016 it is estimated that interest from the Reserve Fund will provide over 0.1% of GDP to the system's resources.

Expenditure in pensions remains in line with AIREF's estimates. Contributory pensions maintain year-on-year growth at 3% fueled by the greater number of pensions (1.13%), the substitution effect caused by the new pensions being higher than those being cancelled (1.63%) and the updating of existing pensions (0.25%), which is the minimum rate possible according to the regulations governing the IRP.

Adding up a complementary maternity benefit on the pensions of women with two or more children will raise expenditure, but with little economic impact in 2016. Establishing a complement of 5% to 15% on pensions for mothers of two or more children, enacted in the General State Budget in 2016 and coming into force in January for newcomers to the pension scheme, entails greater expenditure and is expected to benefit 124,000 pensioners this year. According to AIReF's estimates, the cost in 2016 will be in the region of €48m, gradually increasing to reach €240m in 2019.

Insufficient funding has been observed for expenditure in temporary disability benefits. In the 2016 Budget €5,404m were earmarked for temporary disability benefits, 12% less than in 2015, despite which this expenditure continues to grow at a vigorous rate (14.5%), gradually

¹⁰ Monthly budget implementation data published by the Social Security General Intervention

recovering pre-crisis levels. For 2016, therefore, this item is identified as under-funded by up to €1,250m.

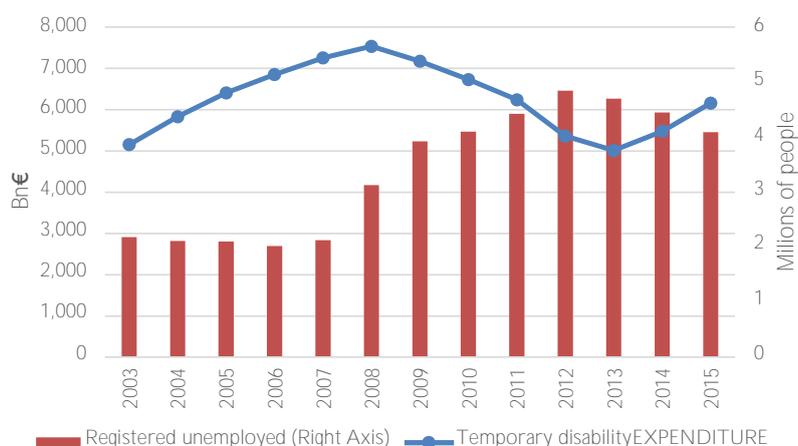
Table 2. Recent trend for expenditure in Temporary Disability (TD)

Economic benefits for Temporary Disability are intended to cover the loss of income produced when an employee, due to accident or illness, temporarily loses the capacity to work. This disability may be caused by a common illness or occupational hazards, or by accident, whether at the workplace or elsewhere. The amount of the benefit depends on the contribution base, the nature of the contingency and the duration of the disability.

The benefit is managed through the mutual insurance companies collaborating with the Social Security System, the National Social Security Institute (INSS), and the Social Institute of the Navy (ISM) for workers under the Special Maritime Regime. Workers affiliated to the Special Self-Employed Regime are under the obligation to contribute to TD since 2008 for common contingencies, while cover for professional contingencies is voluntary. In 2014, a number of aspects regarding the management of TD were regulated: (i) workers' occupation and age were added to the theoretical tables for estimating duration of TD; (ii) monitoring was established for TD leave in terms of expected duration rather than on a weekly basis; and (iii) collaboration was encouraged among the mutual insurance companies, Managing Agents and regional healthcare services.

Expenditure in TD is of a procyclical nature, that is, it decreases in times of recession (represented by an increase in unemployment) and increases in times of economic growth (periods of lower unemployment). This pattern occurs not only thanks to the smaller volume of workers given protection in times of recession, but also because workers who are employed take less TD leave during times of high unemployment levels. The highest expenditure in TD was reached in 2008, at €7,540m. In the 2016 General State Budget, expenditure destined to paying benefits was €5,398m, to which a further €357m must be added for the signing of agreements with ordinary regime Autonomous Regions for controlling benefits.

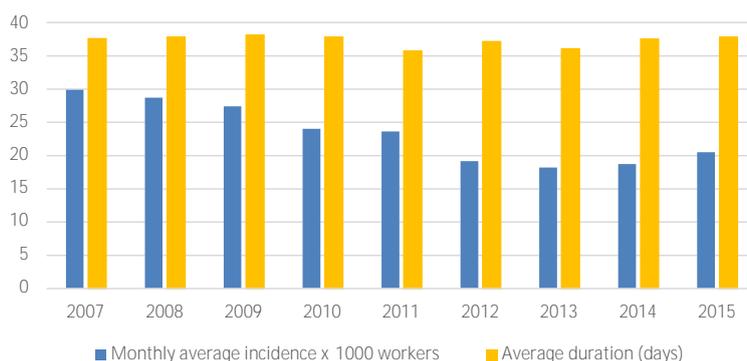
GRAPH 1. TRENDS IN EXPENDITURE IN TD AND UNEMPLOYMENT



Source: MEYSS

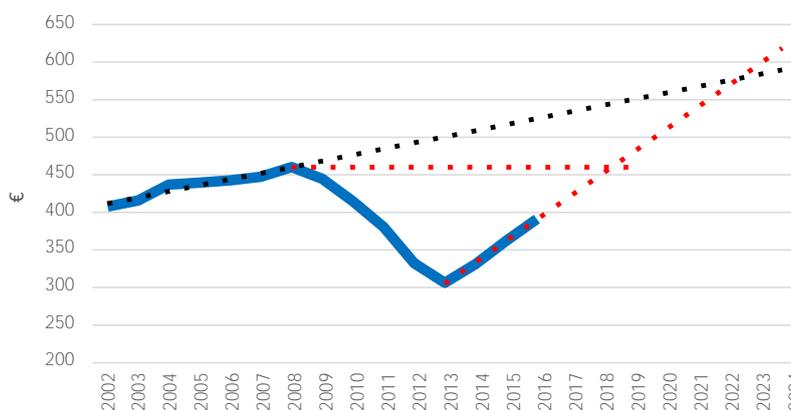
As mentioned above, expenditure in TD is determined both by the collective receiving protection and the duration and number of processes launched during the period. These indicators demonstrate how the average duration remains relatively stable in aggregate terms for the System, despite considerable dispersion at a regional level. Moreover, the mean monthly incidence defined as the number of processes launched per 1,000 protected workers, shows a procyclical pattern: it drops during periods of high unemployment and increases when jobs are created; it also presents marked differences from one province to another.

GRAPH 3. EVOLUTION OF INCIDENCE AND DURATION OF TD PROCESSES



Analysing expenditure exclusively for the employed workers collective (the aggregate of all regimes except the self-employment regime under which Temporary Disability processes differ mainly in being less frequent and of longer duration) the average annual expenditure per affiliated member, at constant prices for 2016 (deflated by the general IPC) reached a maximum in 2008, was reduced drastically in 2013 and has increased regularly since then. On the one hand, projecting the trend in the above mentioned expenditure from the end of the previous expansionary period, and on the other hand the trend experienced in the current recovery phase, it can be observed that the high reached in 2008 will be reached in 2019, and the pre-crisis trend will not be recovered until 2023.

GRAPH 3. MEAN EXPENDITURE IN TD PER AFFILIATED MEMBER EMPLOYED BY OTHERS



Source: The authors, from data provided by MEYSS

The deficit level foreseen for the Social Security System in 2016, and the gradual depletion of the Reserve Fund, require measures to be adopted to guarantee short-term financing for the system. The Social Security System presents financial tensions in the short and medium term, financed to date by the Reserve Fund, but as the deficit trend points to depletion within the next few years it is essential to take the necessary measures in advance. In this vein, the 2016 General State Budget includes an additional provision establishing that the Government will take steps toward compatibility among budget stability and financial sustainability targets, and those of fully financing non-contributory and universal benefits at the expense of Public Administrations' budgets, for which purpose the nature of the benefits included in the system deemed suitable will be assessed.¹¹

The report submitted by the Ministry of Employment and Social Security in April 2016 to the Toledo Pact Commission, in which an analysis is given of the measures adopted in recent years to develop the recommendations in the Report on Assessment and Reform of the Toledo Pact, approved at a plenary session in Congress in 2011, could be the starting point for this analysis.

Public State Employment Service (SEPE) and Salary Guarantee Fund (FOGASA)

The drop in expenditure in unemployment benefits, greater than foreseen in the 2016 General State Budget, will allow SEPE to reach a modest surplus. Despite the decrease in the State transfer to SEPE to balance the institution's needs (which have dropped from 0.9% to 0.4% of GDP), the steady decrease in unemployment benefits (-10.6%) at a higher rate than forecast (-7.3%) may generate a surplus greater than 0.1% of GDP for surplus.

Expenditure in contributory unemployment benefits is decreasing, albeit at a slower pace than in 2015. Job creation and expiration of the period of entitlement to the benefit explain the reduction in expenditure, albeit at rates well below those of 2015. In June 2015 they were dropping at an annual rate of 23.3% and in June 2016 –at 12.5%.

Expenditure in non-contributory benefits and subsidies is decreasing at a faster pace despite the extension to April 2017 of the Employment Activation Programme and the extension of the "Plan Prepara"¹². The provisional Employment Activation Programme, designed for the long-term unemployed in a situation of special need, who have lost other unemployment protection entitlements, represent a much smaller cost than expected (€161m in 2015 in contrast to €850m budgeted). The forecast for 2016 in the SPU is a similar expenditure, approximately €160m. The data for June reflect expenditure in the region of €65m, well below the figure in the 2016 General State Budget (€350m). An extension has also been applied to the "Plan Prepara", a professional qualification programme with active policies

¹¹ Eighty-fifth additional provision of the General State Budget. Separation of the sources of funding for Social Security benefits.

¹² Provisional Employment Activation Programme regulated in Royal Decree-Law 16/2014 of December, and Royal Decree-Law 1/2016, of 15 April, extending the Employment Activation Programme and modifying the second additional provision to Royal Decree Law 1/2013 of 25 January.



and subsidies for persons losing their unemployment compensation entitlements , introduced in principle as a temporary measure until the unemployment rate reaches 18% (20% in April 2016).

Contributions grow faster than forecast in the 2016 General State Budget. Revenue from contributions to SEPE have maintained their dynamic behaviour with respect to outturn data for 2015, with a growth rate exceeding 5% as opposed to 2.8% envisaged in the initial budget.

The Salary Guarantee Fund may represent a deficit of 0.02% of GDP, slightly above the forecast figure. Expenditure in benefits is growing more than expected, so that the institution's deficit may exceed the €96m foreseen in the 2016 General State Budget.

3.3 Autonomous Regions

3.3.1 Stability target

For 2016, the Autonomous Regions must make adjustments equivalent to 1% of GDP in order to meet the deficit target of 0.7% of GDP stated in the SPU.¹³ In the period 2011-2015 the Autonomous Regions undertook an adjustment of 1.7% of GDP, reducing the deficit from 3.4% in 2011 to 1.7% in 2015. This subsector failed to comply with the budget stability target stipulated for 2015 (-0.7% of GDP), reaching an outturn of -1.7% of GDP that, not counting the effect of non-recurrent operations, was -1.4%. This means that the consolidation adjustment, having discounted the effect of non-recurrent operations, to be made by the subsector for 2016, is 0.7% of GDP, in order to achieve the official proposed target of -0.7% stated in the APE for this year.

TABLE 3: NECESSARY ADJUSTMENT AND AIREF ASSESSMENT OF OUTTURN IN 2016 BY AUTONOMOUS REGIONS

Autonomous Regions	AIReF assessment of 2016 outturn (%GDP)						
	Year-end 2015 (1)	One-off operations in 2016 (2)	System resources trend (a) (b) (3)	AIReF's assessment of other factors			AIReF 2016 Central Forecast (7)=(1)+(2)+(3) +(4)+(5)+(6)
				Non Availability Agreement (4)	Supported by measures (5)	Other factors (6)	
Andalusia	-1.1%	0.0%	1.1%	0.0%	0.0%	-0.6%	-0.6%
Aragón	-2.1%	0.1%	0.5%	0.1%	0.2%	0.1%	-1.1%
Asturias	-1.5%	0.7%	0.5%	0.0%	0.0%	-0.3%	-0.6%
Balearic Isles	-1.5%	0.5%	0.4%	0.0%	0.2%	-0.2%	-0.6%
Canary Isles	-0.5%	0.0%	0.4%	0.0%	-0.1%	-0.1%	-0.3%
Cantabria	-1.4%	0.6%	0.4%	0.0%	0.0%	-0.3%	-0.7%
Castilla y León	-1.3%	0.2%	0.6%	0.0%	0.0%	-0.2%	-0.7%
Castilla-La Mancha	-1.7%	0.3%	0.5%	0.0%	0.1%	-0.2%	-0.8%
Catalonia	-2.7%	0.8%	0.9%	0.0%	0.1%	0.0%	-0.9%
Extremadura	-2.7%	0.5%	1.1%	0.2%	0.0%	-0.3%	-1.2%
Galicia	-0.6%	0.1%	0.7%	0.0%	-0.1%	-0.4%	-0.6%
Madrid	-1.4%	0.1%	0.4%	0.0%	0.0%	0.3%	-0.6%
Murcia	-2.5%	0.1%	0.9%	0.0%	-0.3%	0.4%	-1.4%
Navarra	-1.3%	0.2%	0.7%	0.0%	-0.1%	-0.2%	-0.7%
Basque Country	-0.7%	0.0%	0.9%	0.0%	0.0%	-0.9%	-0.7%
La Rioja	-1.1%	0.0%	0.8%	0.0%	-0.1%	0.0%	-0.4%
Valencia	-2.5%	0.3%	0.9%	0.0%	-0.1%	0.1%	-1.3%
Autonomous Regions Total	-1.7%	0.3%	0.7%	0.0%	0.0%	-0.1%	-0.8%

Autonomous Regions' compliance with the proposed target of -0.7% in 2016 is deemed feasible, but tight. The proposal in the SPU is 0.4 percentage points higher than the deficit originally approved for the Autonomous Regions (-0.3% of GDP) and attributes a similar path for all the regions, incorporating the effect of Non-Availability Agreements and similar measures valued at 0.14% of GDP. However, AIReF concluded that, of these measures, only

¹³ Before negative settlements in the financing system for 2008 and 2009.

those amounting to 0.03% of GDP could be considered as additional corrections to the initial budget scenarios, for which AIReF estimated a slightly higher deficit for the subsector. Information obtained subsequently, basically through the EFPs and updates to the Autonomous Regions' outturn forecasts, as well as the most recently published implementation data (April), in general seem to confirm the estimated outcome for the subsector, although they modify the Autonomous Regions' outturn forecasts and highlight that:

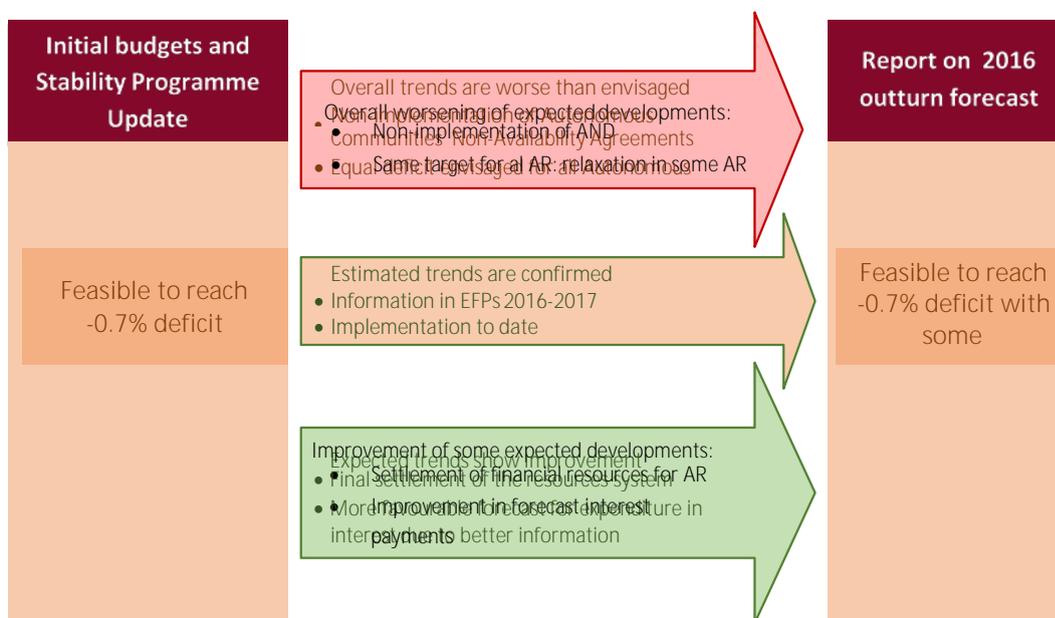
- To date, only in the Autonomous Region of Extremadura have ANDs been adopted with the characteristics and guarantees required by the LOEPSF, while the Autonomous Region of Aragón is committed to adopting a similar agreement. In the remaining Autonomous Regions that have adopted similar measures, these have no additional impact on the deficit.
- Generally speaking, the Autonomous Regions have adapted their scenarios and forecasts to the new path set forth in the SPU or, at all events, to a path less strict than initially proposed in the Budget. This has led to some easing of the commitments by Autonomous Regions in which the implementation of their initial budget would have allowed them to incur a smaller deficit, such as in the case of Andalusia, Asturias, Balearic Islands, Galicia, Navarra and Basque Country. By contrast, however, it may have implied an incentive for making further cutbacks in addition to those deriving from the initial scenarios in regions such as Cantabria, Castilla y León, Catalonia, Extremadura and Madrid, although the overall effect causes the worsening of outturn forecasts. Only the Autonomous Region of La Rioja has maintained an outturn scenario similar to its initial budget, according to which it foresaw a deficit below -0.3% of GDP, and the Autonomous Region of Canary Islands has updated its forecast to -0.3% of GDP.

Other circumstances concur in this scenario, that favour achieving the deficit established for the subsector:

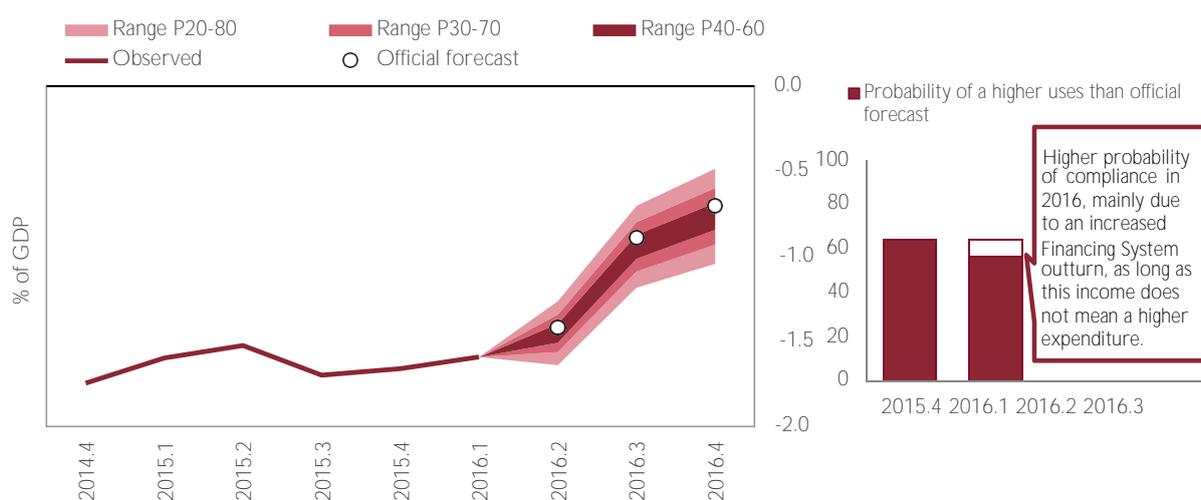
- Improvement in the 2014 settlement for financing system resources subject to interim payments, for €703m.
- The improvement in forecasts for expenditure in interest deriving from current information on additional financing mechanisms.

The mentioned factors taken as a whole (see table 4) determines that, for the Autonomous Regions subsector it is seen as feasible, but tight, to reach the target stated in the SPU (see graph 9).

TABLE 4: FACTORS CONSIDERED IN THE ASSESSMENT OF THE AUTONOMOUS REGIONS AND THE EFFECT ON THE OUTTURN FORECASTS IN THE SUBSECTOR



GRAPH 9: AUTONOMOUS REGIONS. NET LENDING/BORROWING IN THE AUTONOMOUS REGIONS SUBSECTOR



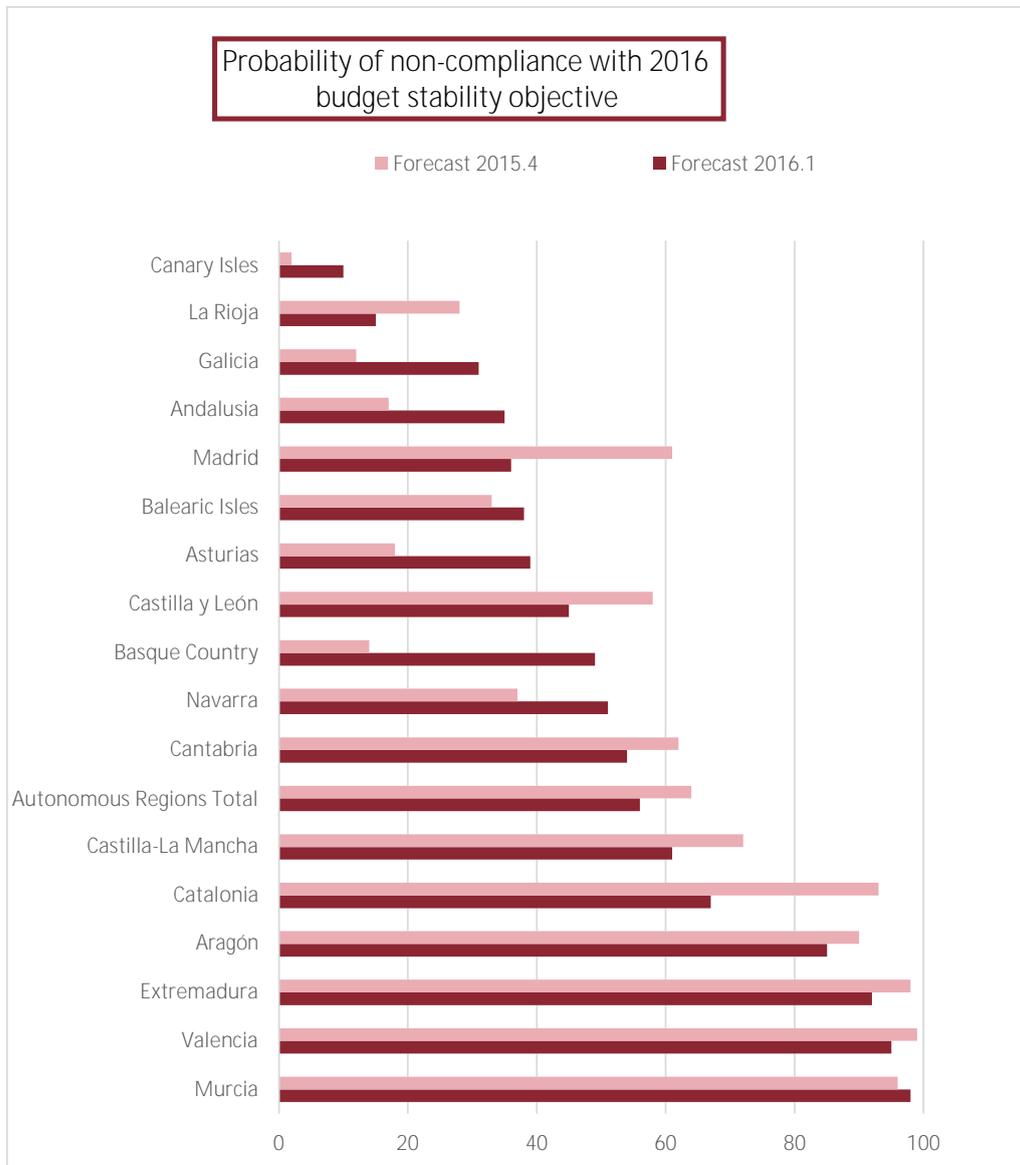
Several groups of Autonomous Regions can be distinguished, according to their likelihood of reaching a deficit target of 0.7% of GDP (see Autonomous Regions Annexes and graph 10). The information provided in the EFPs or in the outturn forecasts submitted recently by the Autonomous Regions, the implementation data to date and the information regarding the final settlement for 2014 of sources subject to interim payments, determine that compliance with the target stated in the SPU be considered:

- **Very likely for Canary Islands and La Rioja,**
- **Probable for Galicia, Andalusia, Madrid, Balearic Islands and Asturias,**
- **Feasible for Castilla y León, Basque Country, Navarra and Cantabria,**
- **Unlikely for Castilla-La Mancha and Catalonia,**
- **Very unlikely for Aragón, Extremadura, Valencia and Murcia.**

It must be noted that the information on final distribution per Autonomous Region for the increased financing settlement in 2014 has improved the outturn forecast with regard to those studied in the recent assessment published in the Autonomous Regions' EFPs¹⁴. In some of these, this circumstance has improved AIReF's assessment of the likelihood of compliance with the target proposed in the SPU, although its effect will depend on not increasing expenditure beyond current forecasts in the wake of this higher revenue. Additionally, in the Autonomous Regions whose EFPs were assessed before the data for April were published, the implementation declared to date may also have led to an update in their forecasts by AIReF.

¹⁴ [Assessment of the Autonomous Regions' Economic and Financial Plans for 2016-2017](#)

GRAPH 10: AUTONOMOUS REGIONS. LIKELIHOOD OF AUTONOMOUS REGIONS' COMPLIANCE WITH THE TARGETS FOR 2016



3.3.2 Expenditure rule

In the individual analysis per Autonomous Region of the expenditure rule, risk of non-compliance with the rule in 2016 is only detected in Andalusia, Galicia, La Rioja and Basque Country, though the risk in Andalusia is greatest. In general, it can be appreciated that the Autonomous Regions will be able to comply with the expenditure rule in 2016, with some tension in the Autonomous Regions of Canary Islands and Cantabria. Risk of non-compliance is appreciated only in the Autonomous Regions of Andalusia, Galicia, La Rioja and Basque Country, most outstandingly in Andalusia.

This forecast for general compliance is supported by the criterion applied by MINHAP to calculating the rule, taking the level of expenditure for an Autonomous Region in the previous year as a basis and consolidating non-compliance incurred in foregoing years. This circumstance is more visible in the Autonomous Regions in which eligible expenditure in 2015 comprises one-off operations for a significant amount which will foreseeably not be repeated in the current year.

Moreover, it must be borne in mind that the easing of the target put forward in the SPU with respect to the target set initially has encouraged an increase in the expenditure level with respect to the levels initially forecast for the Autonomous Regions. This has been confirmed in the trend in expenditure demonstrated in the data available to date.

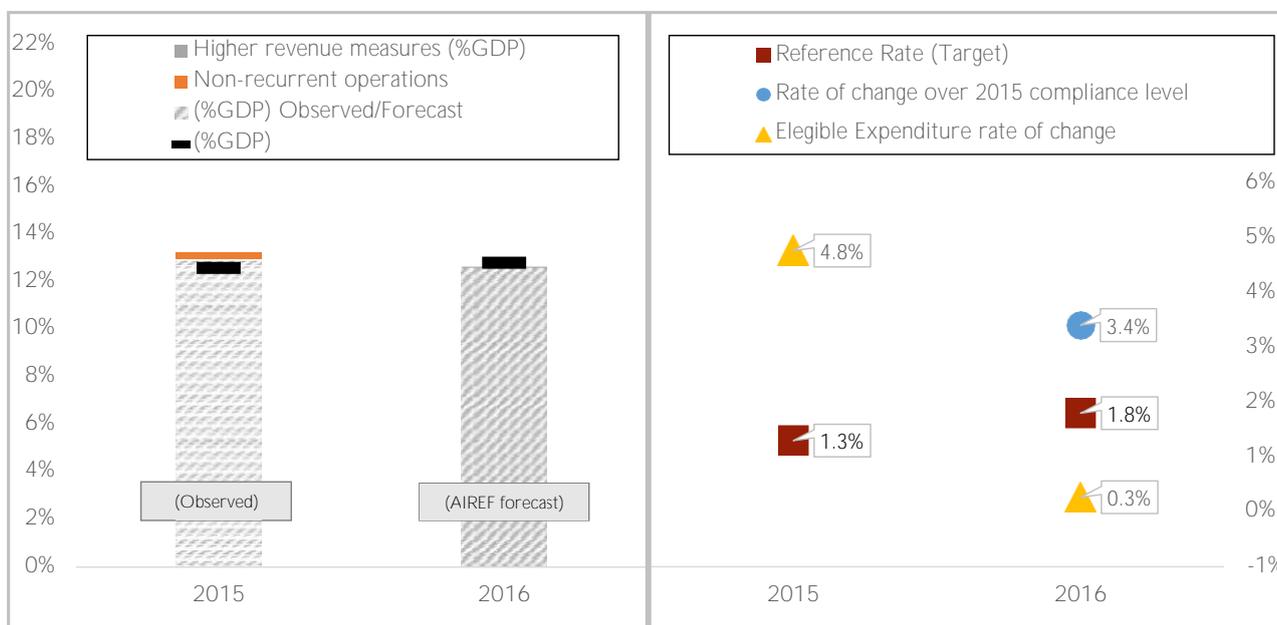
The variation in eligible expenditure in each Autonomous Region has been estimated from AIReF's baseline estimates for uses in 2016 and taking into consideration the information submitted by the Autonomous Regions relative to excluded expenditure and the revenue measures liable to correct eligible expenditure in 2016. In view of the shortage of information on the revenue taken into account by MINHAP for each Autonomous Region to correct the eligible expenditure in 2015 (for a net total of €46m for the entire subsector), no measure has been considered for calculating the baseline eligible expenditure.

Therefore, under the mentioned limitations and on the basis of the information submitted by the Autonomous Regions, a variation rate has been estimated for eligible expenditure in each Autonomous Region and has been compared against the reference rate set for 2016 at 1.8%. The result is an estimate for eligible expenditure variation rate that is:

- Higher than the reference rate (1.8%): Galicia, La Rioja, Basque Country and Andalusia, with a considerable distance to the reference rate in the case of the latter;
- Slightly higher than the reference rate (1.8%): Canary Islands and Cantabria;
- Similar or lower than the reference rate (1.8%), and in some cases negative: Murcia, Castilla y León, Navarra, Madrid, Castilla-La Mancha, Balearic Islands, Valencia, Aragón, Asturias and Catalonia.

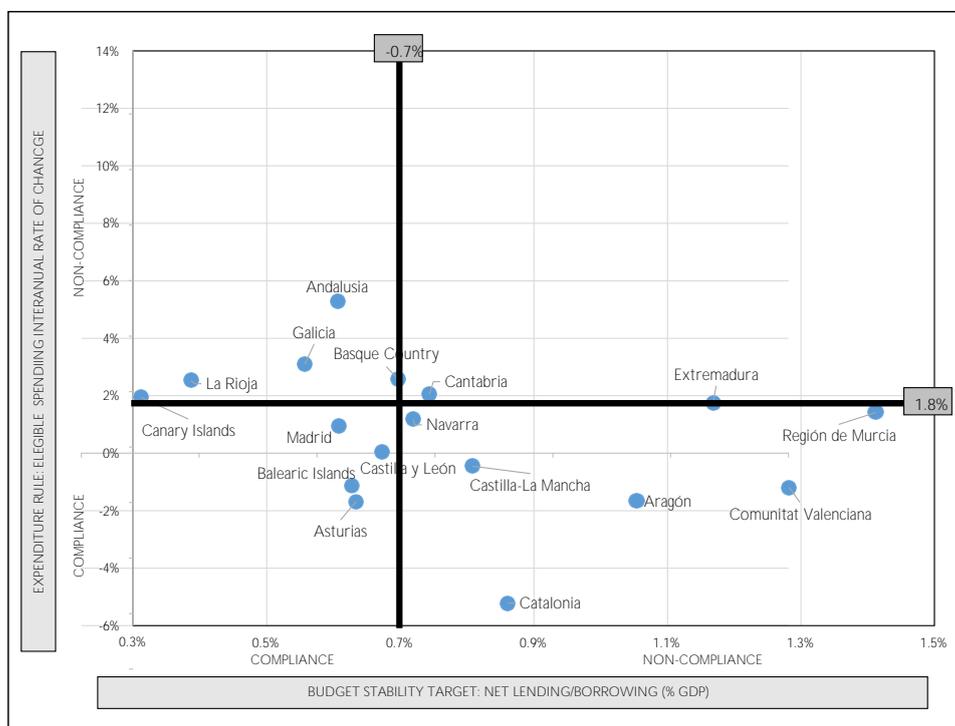
The estimate for the Autonomous Regions subsector overall determines that there is no risk of non-compliance with the expenditure rule for 2016, as the variation rate (0.3%) is lower than the reference rate fixed at 1.8% (see graph 11). The eligible expenditure thus estimated for 2016 is 3.4% larger than the level of compliance in 2015.

GRAPH 11: ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. AUTONOMOUS REGIONS SUBSECTOR

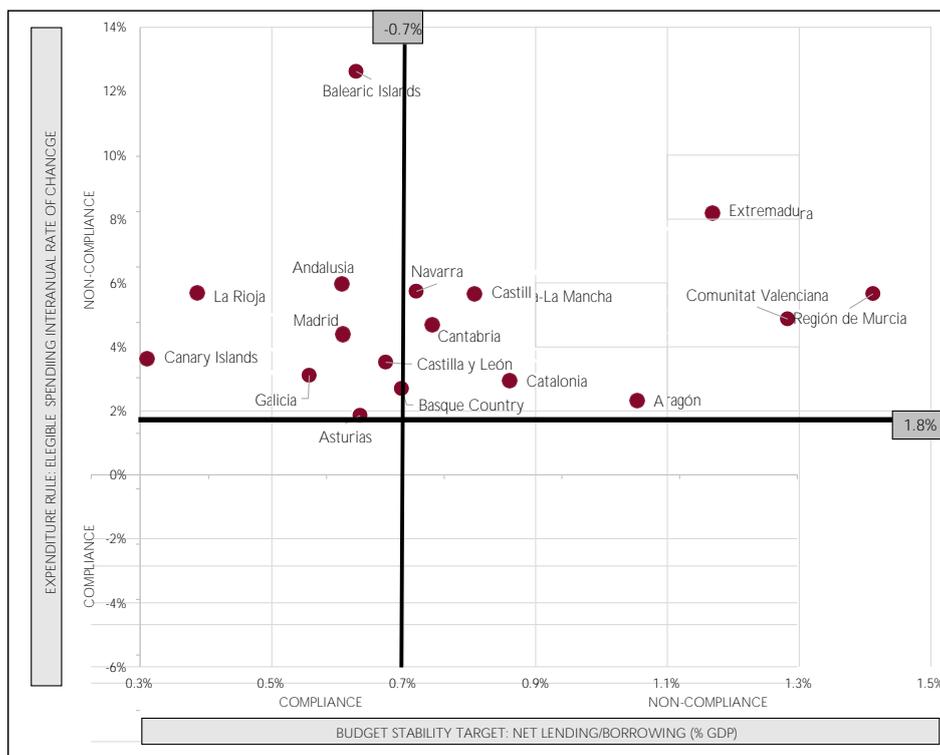


Additionally, if compliance with the expenditure rule is analysed jointly with the budget stability target, it can be seen (graph 12) that in the Autonomous Regions considered likely to meet the proposed stability target (La Rioja, Canary Islands, Galicia, Basque Country, Andalusia, Madrid, Navarra, Balearic Islands, Asturias, Cantabria and Castilla y León), the expenditure rule does not clearly imply a higher restriction to that deriving from the foreseen deficit, except in the case of Andalusia and, to a lesser extent, La Rioja, Basque Country and Galicia. By contrast, should the variation in eligible expenditure be estimated on the level of compliance resulting from non-consolidation of deviations incurred in previous years, as shown in graph 13, the variation would be considerably higher than the reference rate. In such a situation, compliance with the rule would demand a lower level of expenditure, and consequently a smaller deficit than that deriving from the forecasts for 2016 in nearly all the Autonomous Regions (maintaining a constant level of resources).

GRAPH 12: FORECASTS FOR COMPLIANCE WITH THE STABILITY TARGET AND EXPENDITURE RULE IN 2016



GRAPH 13: FORECASTS FOR COMPLIANCE WITH THE STABILITY TARGET AND EXPENDITURE RULE IN 2016 EXCLUDING CONSOLIDATION OF NON-COMPLIANCE IN PREVIOUS YEARS



AIReF has pointed out in previous reports the problems arising at present from the expenditure rule, and the need to redefine it, open it to debate and review of the interpretation criteria applied in calculating the rule. This need is becoming increasingly pressing as the effects and demands deriving from this rule are becoming evident.

3.4 Local Corporations

3.4.1 Local Corporations subsector

3.4.1.1 Stability target

It is highly probable that the Local Corporations subsector will comply with the budget stability target in 2016, although the surplus achieved in recent years may be reduced slightly. According to the data for the first quarter in 2016, Local Corporations have achieved a surplus 33% smaller than in the same period in 2013, which proves that although there is no risk of missing the legal target of equilibrium in this subsector, the margins of previous years may decrease.

In the first quarter 2016, Local Corporations have achieved a surplus of 0.06% of GDP, which is more than 30% smaller than the surplus registered for the same period in 2015 (0.09% of GDP). This smaller surplus is due to the combined effect of non-financial resources decreasing by almost 2% and an increase in non-financial expenditure by 0.3%.

Budget estimates for the outturn in 2016 submitted by MINHAP based on the information provided by the Local Corporations are inconclusive. MINHAP has not provided information on outturn forecasts for 2016 in terms of National Accounting, but from the budget information provided (which does not include municipalities with less than 5,000 inhabitants, as these are not obliged to submit quarterly data) it can be deduced that the non-financial budget balance will be in the region of 30% less than in 2015. AIReF has doubts over the suitability of these data, in light of the fact that the first quarter has little effect on the final implementation for the year. In addition, at the date of issuing this report the requested clarifications have not been forthcoming from MINHAP, and therefore AIReF is unable to make an overall pronouncement on the basis of this information.

Since 2015, easing in the implementation of the expenditure rule and discontinuing some of the measures regarding revenue imposed by the State to safeguard compliance with the overall target may lead to a slightly smaller surplus than in previous years. In this subsector, with a consolidated surplus, implementation of the expenditure rule is more restrictive than compliance with the stability target, although both rules guarantee long-term stability for the subsector. MINHAP's easing, since September 2015¹⁵, of the implementation

¹⁵Easing in the implementation of the expenditure rule, as envisaged in the handbook published by MINHAP on 28 September 2015 as a guide to Local Corporations for communicating their economic and financial plans (PEFEL2), allows the initial data for these calculations to be those of a non-compliance year rather than those of the last year in which the expenditure rule was met as previously stipulated. This new interpretation either reduces the potential surplus or increases the deficit, insofar as all expenditure, including the excess over the permitted limits, follows the trend set by the reference rate for the economy in the medium term.

of the expenditure rule, which in that year and for the first time caused non-compliance with the rule, may lead to a reduction in the potential surplus, insofar as all expenditures, including the excess over the permitted limits, follows the trend set by the reference rate for the economy in the medium term. To this we must add the fact that some of the consolidation measures to guarantee the level of revenue, such as the measure regarding the incremented land value tax rate, are not operational in 2016.¹⁶

The forecasts submitted by the 16 large City Councils regarding the stability target in this year corroborate this downward trend in the expected surplus. For these 16 municipalities as a whole, as shown in table 5, from 2013 and on average, over 30% of the financing capacity for the subsector overall, the surplus for 2016 is envisaged at 10% of the consolidated non-financial revenues, i.e., almost 30% smaller than in 2015. Should the performance for the entire subsector resemble that of this group of municipalities, we can estimate a smaller surplus in 2016 than was achieved in 2015.

TABLE 5: REPRESENTATIVENESS OF THE 16 MAJOR CITY COUNCILS IN THE FINANCING CAPACITY FOR THE LOCAL CORPORATIONS SUBSECTOR OVERALL

(€m)

Accounting Year	Financing Capacity		% Representativity of 16 Councils in total subsector
	LC Subsector (1)	16 Major City Councils (2)	
2013	5,689	1,637	28.8%
2014	5,938	1,866	31.4%
2015	4,765	1,780	37.4%
2016 (estimate)		1,293	
AVERAGE PERCENTAGE			32.5%

(1) Source: IGAE publication "ONF de Administración Local" (S.1313)

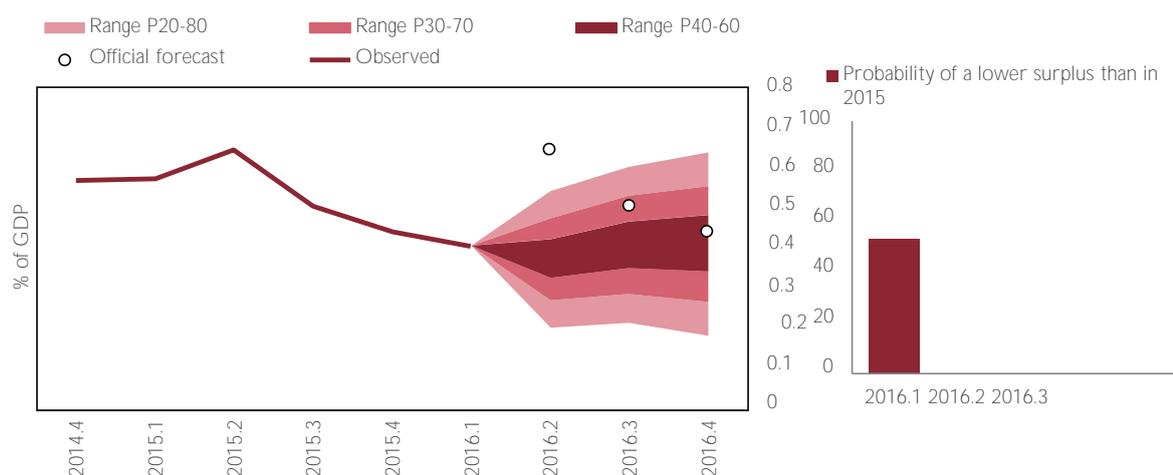
(2) Aggregated Data from year-end estimates in terms of National Accounting reported by the municipalities

The latest implementation data published have entailed the revision of AIReF's forecasts for the Local Corporations subsector, with the surplus envisaged for 2016 slightly lower than estimated in the Reports on the Initial Budgets for 2016 by the General Government sector and the SPU. Graph 14 includes AIReF's estimates for the Local Corporations subsector's net lending/borrowing in 2016 as a percentage of GDP. These estimates are complemented with a comparison against the same headings in 2015 for each quarter, in order to visualise whether its behaviour throughout the year is similar and to determine the likelihood of the previous years' results being consolidated in 2016. According

¹⁶ For 2012 and 2013, in accordance with Article 8 in Royal Decree Law 20/2011, of 30 December, on urgent budgeting tax and financial deficit correction measures, land value tax rates rose by 4%, 6% or 10% depending on the year in which the value assessments were approved. For 2014 and 2015, Article 8 of Law 16/2013, of 29 October, establishing certain measures regarding environmental tax issues and enacting other fiscal and financial tax measures, extended the incremented tax rates set forth in Royal Decree-Law 20/2011.

to the current forecast, having analysed the available information, the likelihood of reaching a smaller surplus to that achieved in 2015 is close to 50%. AIReF's central forecast in this assessment has been drawn up with the most recent published data on budget implementation and in terms of National Accounting for the first semester 2016.

GRAPH 14: LOCAL CORPORATIONS SUBSECTOR
NET LENDING/BORROWING (AS % OF GDP)



3.4.1.2 Expenditure rule

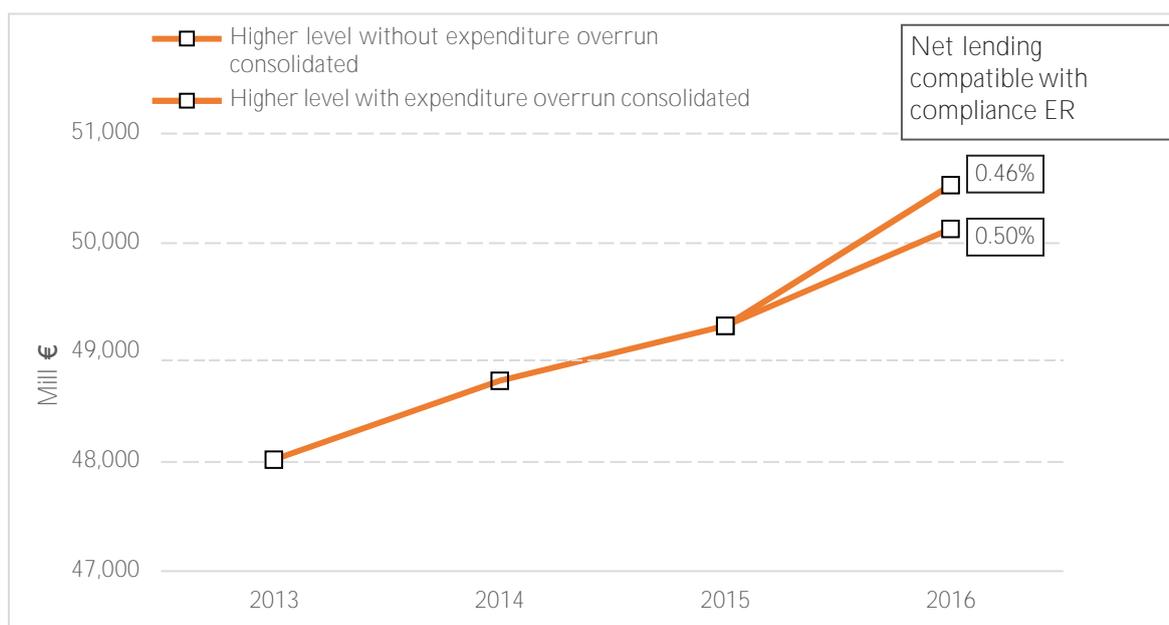
MINHAP has provided no information on the necessary components for calculating the expenditure rule. As pointed out in the section on limitations to scope, non-availability of changes in the national chart of accounts and other components to bear in mind for calculating this fiscal rule makes it impossible for AIReF to assess compliance or non-compliance in this subsector.

In 2016 there is a degree of likelihood that the Local Corporations subsector will fail to comply with the expenditure rule. This likelihood would increase if the deviation in 2015 were corrected. As MINHAP has not provided the necessary information to determine the expenditure rule, AIReF has estimated non-financial uses and other components of the rule for the purpose of issuing a draft assessment of their compliance. AIReF's forecasts for 2016 follow the criterion applied in 2015 by MINHAP, according to which the baseline data to determine compliance are those of the previous year's outturn, independently of whether they met the expenditure rule or not and consolidating previous years' overruns. According to this criterion for easing the expenditure rule held by MINHAP, it is likely that the Local Corporations subsector will comply with this fiscal rule.

AIReF has also drawn up an estimate for compliance with said rule in the event of non-consolidation of the expenditure overruns, always applying the expenditure rule to the last compliant year. In such cases, it is highly probable that the subsector will fail to comply with the expenditure rule.

As shown in graph 15, if strict implementation of the expenditure rule is understood to entail applying the reference rate to the eligible expenditure in the last compliant year, the Local Corporations should reduce their eligible expenditure in 2016 in order to meet this fiscal rule.

GRAPH 15. LOCAL CORPORATIONS SUBSECTOR
ELIGIBLE EXPENDITURE FOR THE PURPOSES OF EXPENDITURE RULE (€m)
 AND ASSOCIATED FINANCING CAPACITY (% GDP)



3.4.2 Individual analysis of the 16 City Councils with a population exceeding 250,000 inhabitants

3.4.2.1 Stability target

This report comprises individual analyses of the 16 City Councils with a population exceeding 250,000 inhabitants. This report, as in the initial budget for 2016, comprises individual analyses for the City Councils of Madrid, Barcelona, Valencia, Sevilla, Zaragoza, Málaga, Murcia, Palma de Mallorca, Las Palmas de Gran Canaria, Bilbao, Alicante, Córdoba, Valladolid, Vigo, Gijón and L'Hospitalet de Llobregat. To guarantee homogeneity in the assessment of the 16 Corporations analysed, AIReF has prepared a standard form for implementation in the first quarter of 2016 and outturn estimates. All the City Councils analysed have complied with their duty to collaborate and have submitted all the requested information.

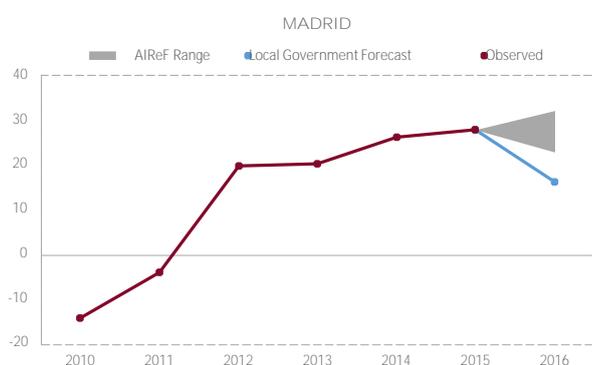
No risk of non-compliance with the 2016 stability target has been appreciated at any of the 16 City Councils examined, provided that the tendency shown in the last few years remains unaltered; in general, however, the margin over the target may diminish with regard to previous years' margins. AIReF has made forecasts for 2016 according to an econometric model that takes into account the historical behaviour for quarterly implementation of revenue and expenditure. According to this model, all the City Councils analysed will meet the stability target in 2016.

Outturn estimates submitted by Local Corporations, comprising the information on budgetary decisions and measures for the year, show that solely in the case of the City Council of Barcelona can a risk of failure to comply with the stability target be appreciated, owing to the scant margin to the equilibrium forecast by the Corporation. All the Corporations analysed have submitted financing capacity forecasts with sufficient margins to absorb any reasonable mismatch with the targeted equilibrium, with the exception of the City Council of Barcelona where the slightest lag in forecasts for revenue and expenditure could lead to non-compliance with the target. The above notwithstanding, it must be said that these forecasts have been drafted with information from the first quarter of the year which, generally speaking, is inconclusive.

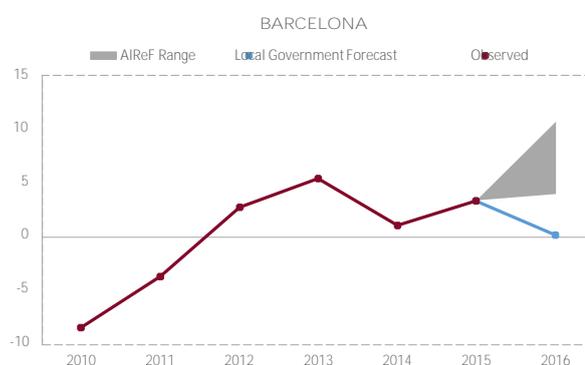
The following graphs show historical data from 2010 for the major municipalities regarding net lending/borrowing (corrected in 2010 and 2011 as a result of the negative settlements from participation in State taxes in 2008 and 2009), the outturn forecast by each City Council in 2016 and AIReF's ranges for the trend forecasts of the current year outturn.

The City Councils of Barcelona, Gijón and Madrid forecast a surplus for 2016 below the minimum level estimated by AIReF.

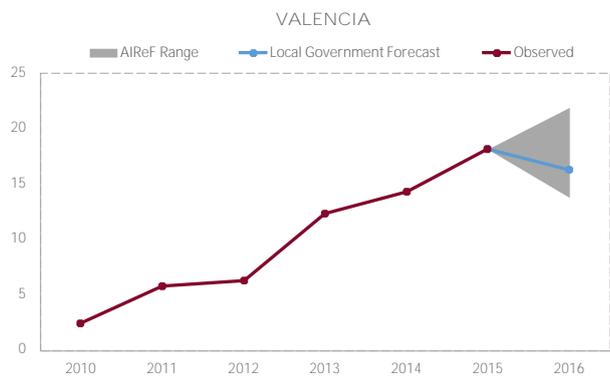
GRAPH 16. THE 16 MAJOR CITY COUNCILS
FINANCING CAPACITY (% NON-FINANCIAL REVENUES)



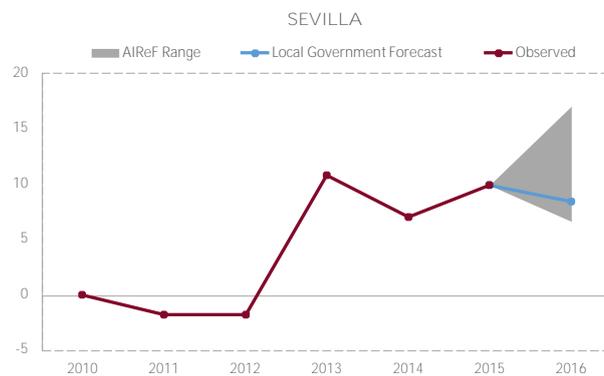
Source: MINHAP, Local Government & AIReF forecast



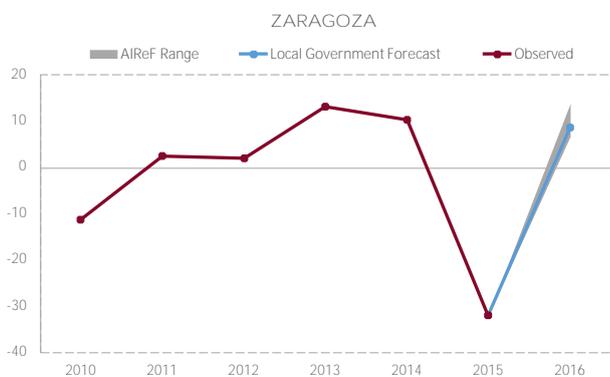
Source: MINHAP, Local Government & AIReF forecast



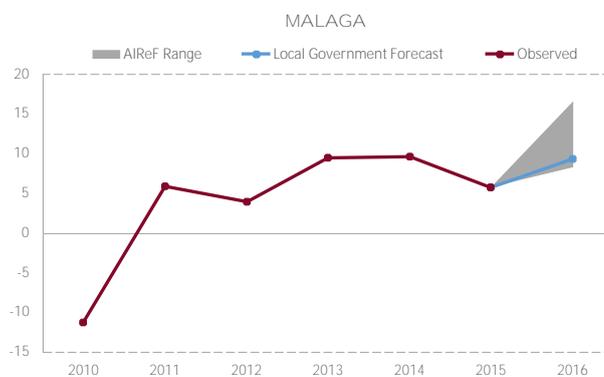
Source: MINHAP, Local Government & AIReF forecast



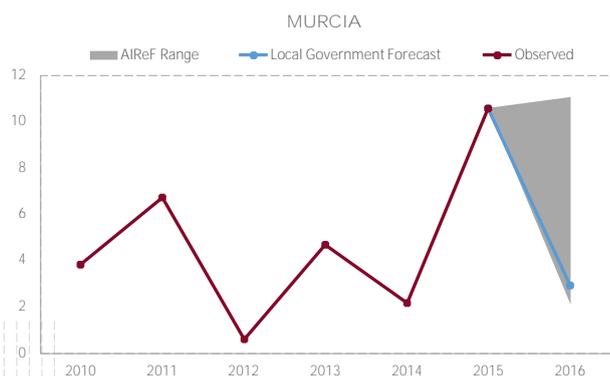
Source: MINHAP, Local Government & AIReF forecast



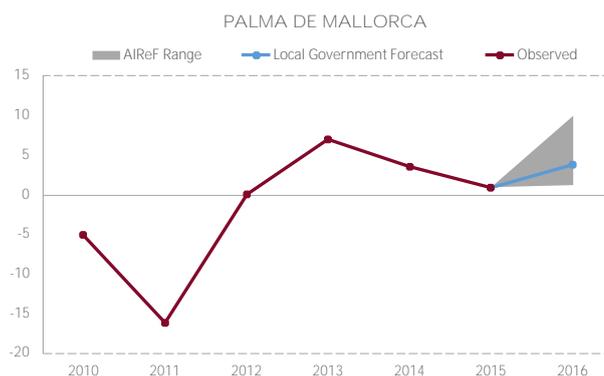
Source: MINHAP, Local Government & AIReF forecast



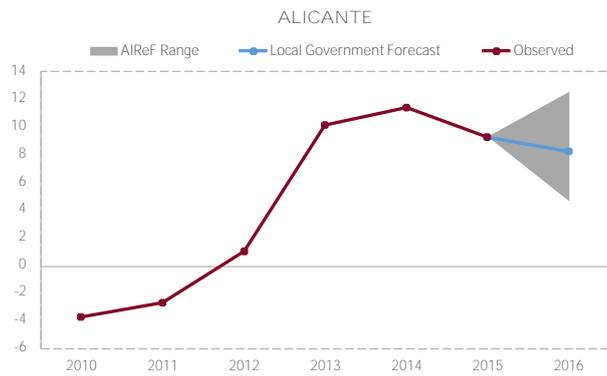
Source: MINHAP, Local Government & AIReF forecast



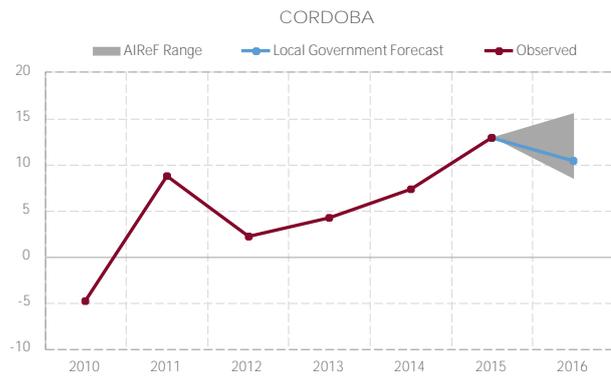
Source: MINHAP, Local Government & AIReF forecast



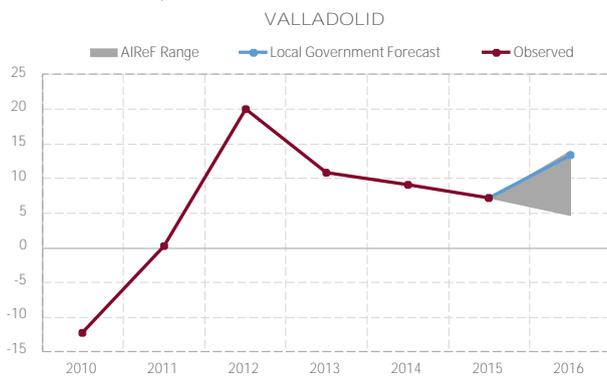
Source: MINHAP, Local Government & AIReF forecast



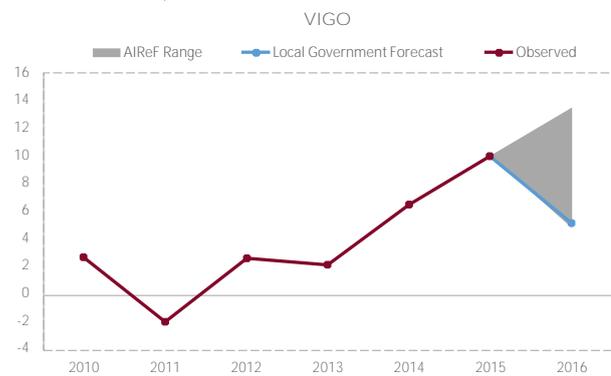
Source: MINHAP, Local Government & AIReF forecast



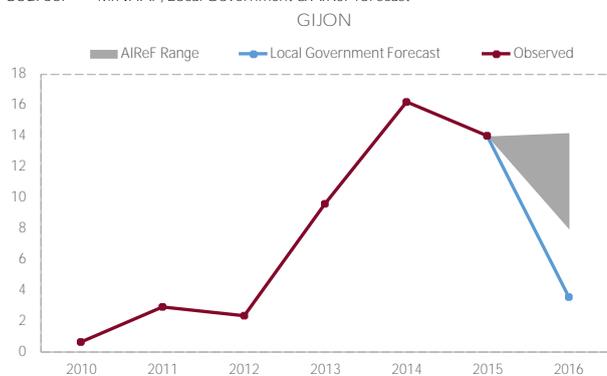
Source: MINHAP, Local Government & AIReF forecast



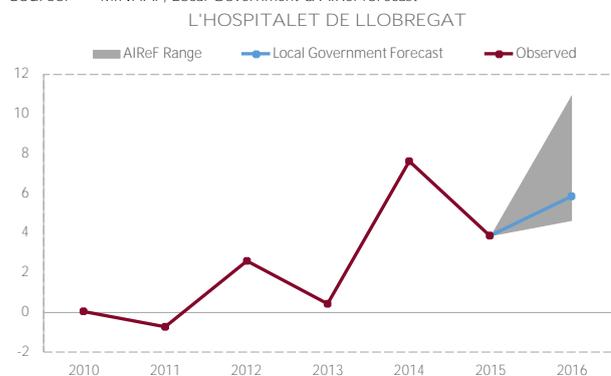
Source: MINHAP, Local Government & AIReF forecast



Source: MINHAP, Local Government & AIReF forecast



Source: MINHAP, Local Government & AIReF forecast



Source: MINHAP, Local Government & AIReF forecast

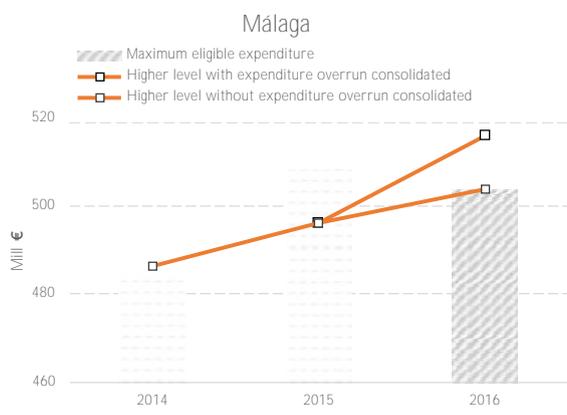
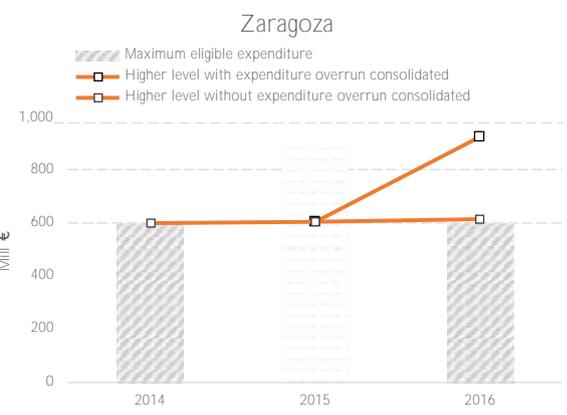
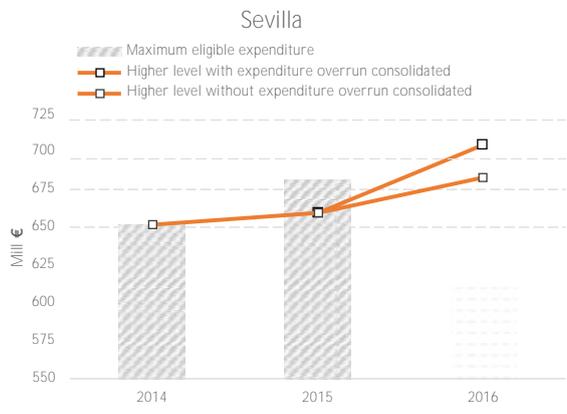
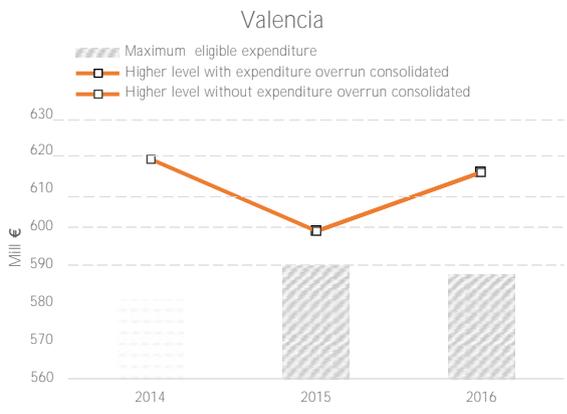
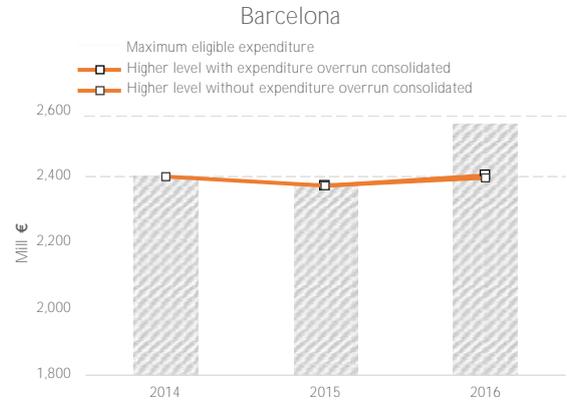
3.4.2.2 Expenditure rule

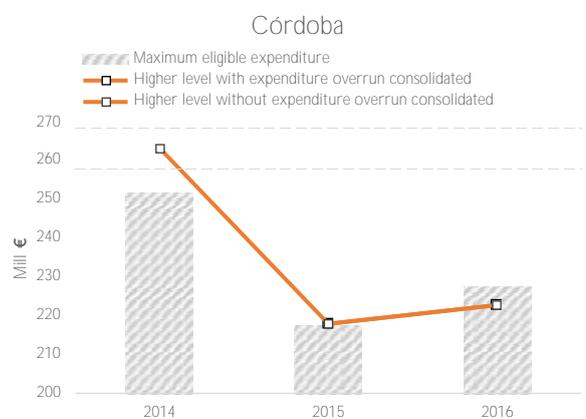
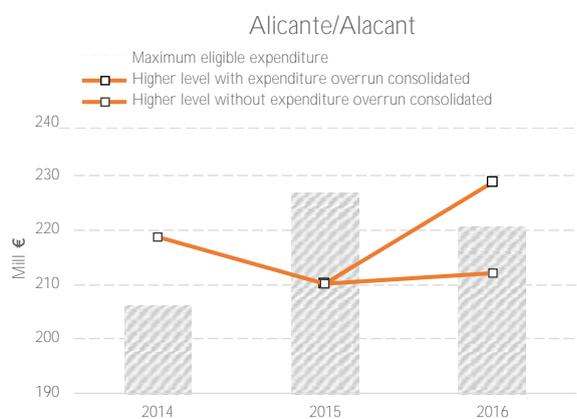
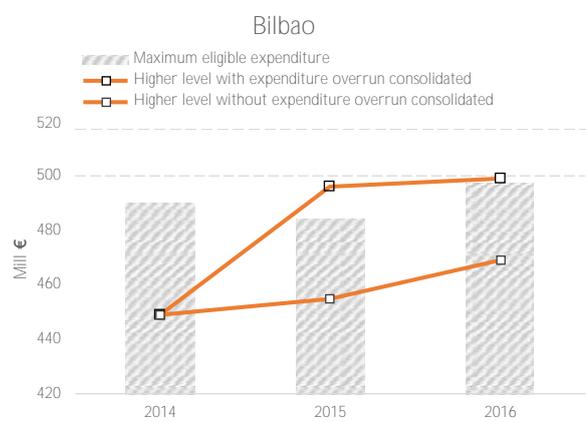
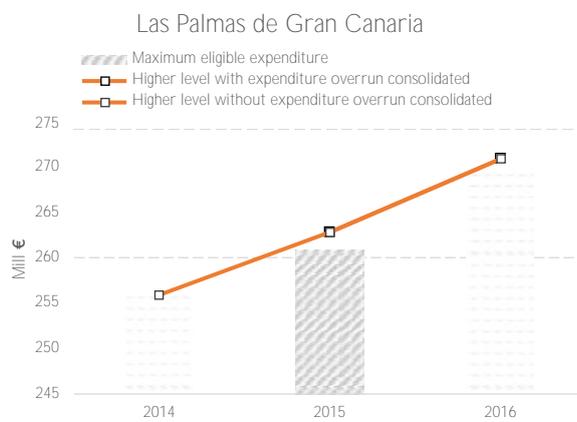
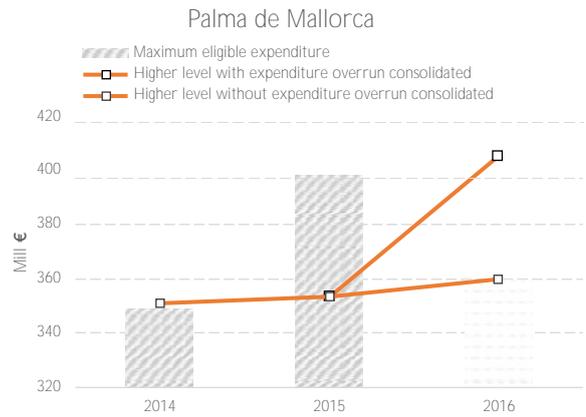
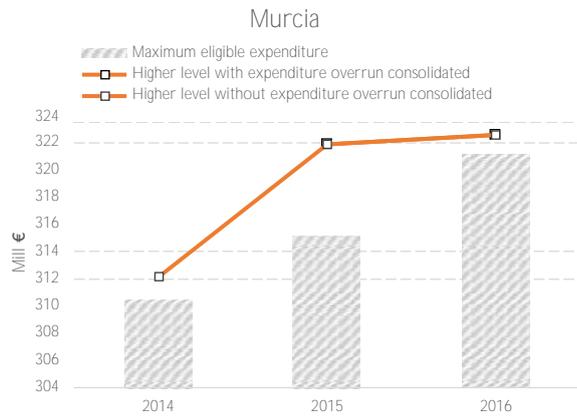
The City Councils of Barcelona, Córdoba, Gijón and Madrid estimate for 2016 a level of eligible expenditure regarding the expenditure rule that exceeds the limit that can be deduced from the implementation of the rule. However, in the case of Barcelona this will not lead to non-compliance provided it remains within the limits expressed in its economic and financial plan (EFP).

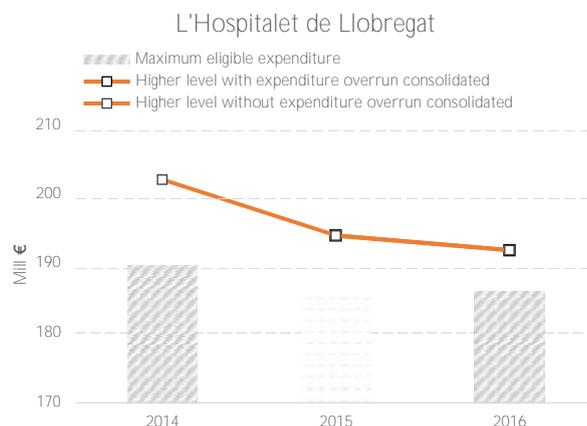
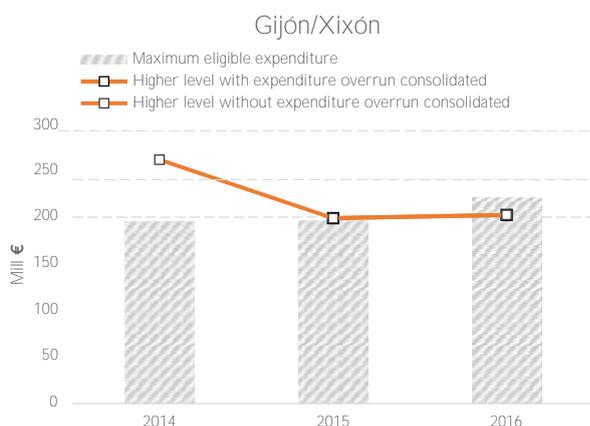
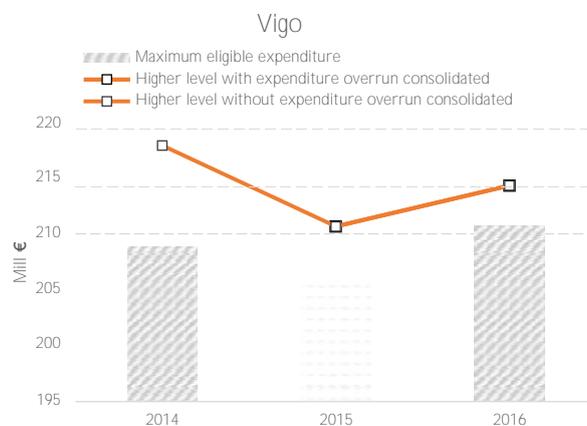
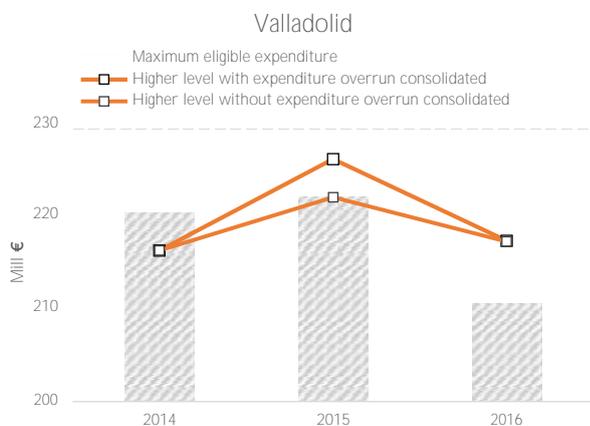
The graphs below show the degree of eligible expenditure for the 16 major City Councils since 2014, as well as the expenditure limit for the purpose of the expenditure rule. For 2016, this limit has been calculated according to MINHAP's consolidation criterion for expenditure overruns and strict implementation of the rule under which these overruns are not consolidated. In strict implementation of this rule, **should the published outturn estimates be confirmed, Alicante -as well as the mentioned City Councils- would incur in non-compliance in 2016. Bilbao also presents overruns exceeding the limit after strict implementation of the rule; however, this will not lead to non-compliance while remaining within the limits expressed in the EFP.**

GRAPH 17. THE 16 MAJOR CITY COUNCILS

ELIGIBLE EXPENDITURE AND LIMIT TO THE EXPENDITURE RULE (€M)







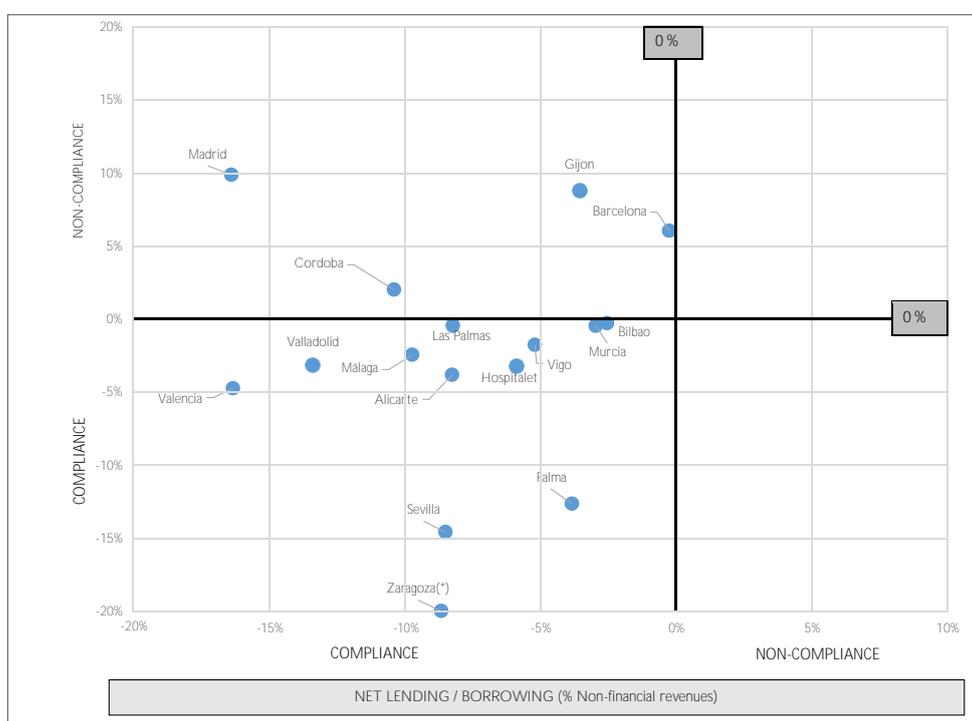
As provided for in the LOEPSF, the City Councils of Alicante, Barcelona, Madrid, Málaga, Palma de Mallorca, Sevilla and Zaragoza should have enacted, through the corresponding entity for financial guardianship, an economic and financial plan (EFP) after non-compliance of the expenditure rule in 2015, establishing the limits applicable to said rule for the two years it was in force.

To date, Alicante, Madrid, Málaga, Palma de Mallorca, Sevilla and Zaragoza do not have an EFP approved by their financial guardianship entity and in force. The City Council of Barcelona has stated that, due to having approved a modification to the budget raising expenditure above the limit approved in the 2015 EFP, it has been obliged to adopt a new EFP after modifying said limit.

In conclusion, the graphs below show, for 2016, the relative position of these 16 major City Councils with regard to their compliance with the stability target and of the expenditure rule, both following MINHAP's criterion, allowing the consolidation of expenditure overruns in the previous year, and according to the strict implementation of this rule, under which the

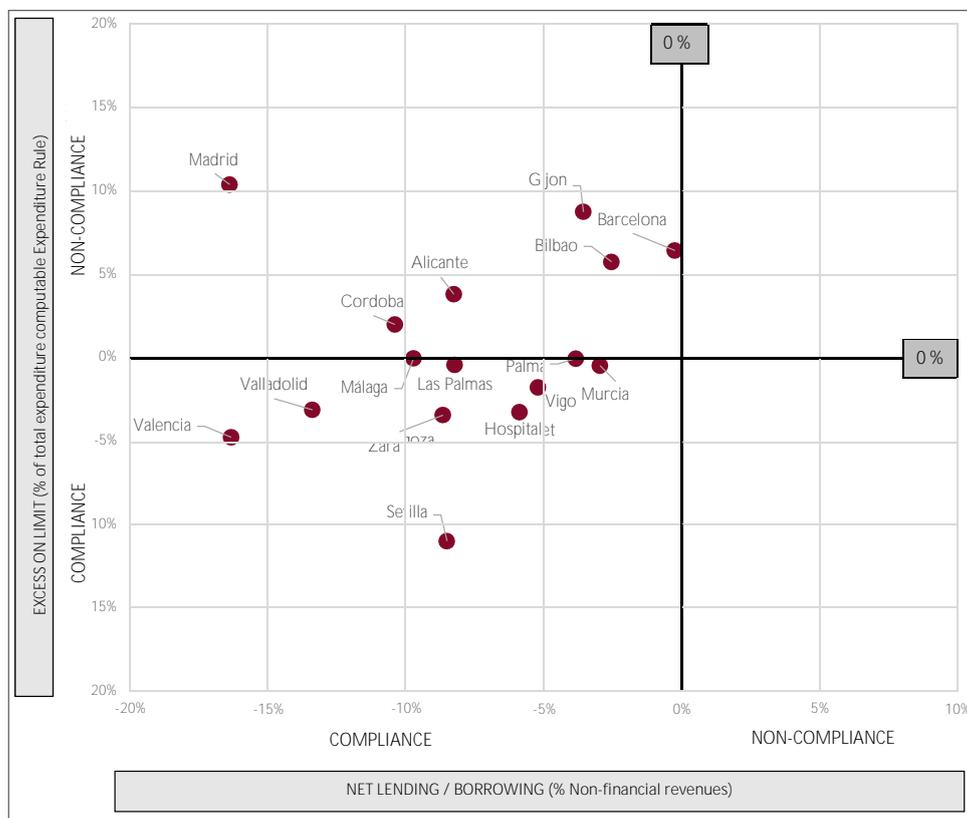
expenditure overruns in non-compliant fiscal years are not consolidated. In view of the relative importance to the local authorities of the normative changes affecting revenue, owing to their greater financial autonomy, and of their financially sustainable investments, both of which elements raise the expenditure limit above the reference rate (1.8% in 2016), the expenditure rule was implemented in these graphs calculating the overruns exceeding this limit and determining the weight of the overruns on the total eligible expenditure.

GRAPH 18: FORECASTS FOR COMPLIANCE WITH THE STABILITY TARGET AND EXPENDITURE RULE IN 2016



(*) In the case of Zaragoza, consolidation of expenditure overruns on account of exploiting the tram service the Corporation to meet the expenditure rule with a margin over the limit of 54%. However, for the purpose of presentation on this graph, the data have been adjusted to the highest value shown.

GRAPH 19: FORECASTS FOR COMPLIANCE WITH THE STABILITY TARGET AND EXPENDITURE RULE IN 2016 EXCLUDING CONSOLIDATION OF NON-COMPLIANCE IN PREVIOUS YEARS



4. Government debt

Debt targets for the period comprising 2016 were fixed by Agreement of the Cabinet of Ministers (ACM) on 10 July de 2015, both for the General Government sector (98.5% of GDP) and for the various subsectors, as shown in table 6.

TABLE 6: DEBT TARGETS (EXCESSIVE DEBT PROTOCOL AS % OF GDP)

Debt (EDP, % GDP)	2015	AIREF forecasts	ACM 2015 Target	SPU Target	Mechanisms (% stock total debt)
		2016	2016	2016	2016-I
Public Administrations	99.2	99.5	98.5	99.1	-
CG + FSS	71.7	71.8	72.6	71.7	-
Local Corporations	3.3	3.0	3.4	3.2	20.6
TOTAL Communities*	24.2	24.7	22.5	24.2	48.3

* In the case of the Autonomous Regions, targets may be rectified by the effective amount of implementation of additional financing mechanisms for the Autonomous Regions adopted during the corresponding years (provided that those funds are not used to pay debt incurred or finance deficit from the financial year in which the funds are allocated) and by any increase in debt deriving from reclassifying public entities and bodies in the General Government sector (provided that these are not used to finance the year's deficit).

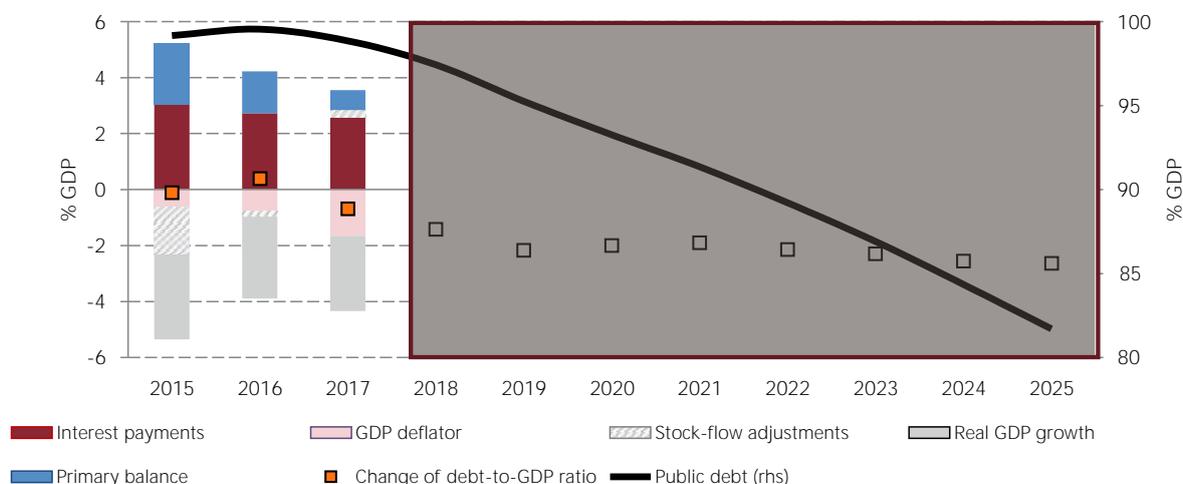
The debt forecast updated in the SPU 2016-2019 assumes non-compliance of the target fixed for the General Government sector in the ACM. The Stability Programme Update presented in April 2016 projects a level of Excessive Deficit Protocol debt for 2016 that exceeds the target set by the ACM in 2015 (99.1% rather than 98.5% of GDP). Broken down into subsectors, the outturn forecast in the SPU assumes non-compliance by more than 1.5 percentage points, in the case of the Autonomous Regions, and compliance in the case of the Local Corporations and consolidated CG+FSS.

AIReF's estimates for debt in 2016 for the General Government sector (99.5% of GDP) stand above both the original target set at the ACM in 2015, and the update provided in the SPU 2016-2019. AIReF's central projection for 2016 remains close to 100% of GDP and would represent, on the one hand, an increase with regard to 2015 and, on the other hand, non-compliance with the targets set at the 2015 ACM and the updated forecast given in SPU 2016-2019. As for the various subsectors, they are all expected to comply with the target set in 2015, with the exception of the Autonomous Regions, whose indebtedness is expected to be very close to 25% of GDP. Similarly, AIReF's forecasts are higher than the figures given in the SPU 2016-2019 for the Autonomous Regions and practically in line with the case of CG+FSS.

As pointed out by AIReF in previous reports, Government debt analysis should not be limited to the risk of non-compliance of the debt target for the year in progress, but should have a medium-term horizon. Regarding Government debt, looking beyond the situation in 2016, it is essential to conduct a sustainability analysis within the framework of convergence with the limits established in Article 13 and transitional provision one of the LOEPSF.

The sustainability analysis of the Government debt path for the General Government sector, despite showing a sustainable profile in the medium and long term, implies non-compliance of Transitional Provision One of the LOEPSF. Transitional Provision One of the LOEPSF establishes a transitional period until 2020 to reach the debt limit of 60% of GDP, demanding a debt reduction of at least two percentage points, if real GDP grows in excess of 2%. Graph 18 shows the trend in the data observed for qualifying outstanding debt as a percentage of GDP, as well as AIReF's forecast for 2016¹⁷ and its evolution of a central scenario until 2025 and the main determinants thereof. According to the dynamics observed in this trend, the limit envisaged in Article 13 of the LOEPSF would not be reached until the year 2035.

GRAPH 20. CENTRAL PROJECTION OF DEBT AND CONTRIBUTIONS (% GDP)



Source: Banco de España and AIReF

¹⁷The debt has been projected on the basis of AIReF's fiscal balance estimates for 2016-2019. In addition, standard assumptions regarding the trend in GDP have been used (expected to converge at its potential in 2018 following which nominal growth will stabilise at around 3.3%, with long-term inflation at 1.8%); the fiscal balance (the primary balance as of 2020 will evolve gradually, to reach the debt target and subsequently remain near budgetary equilibrium) and, as far as interest rates are concerned, the real interest rate will ultimately equal the potential output variation rate in the long term.

4.1 Central Government Subsector and Social Security Funds

For 2016 AIReF envisages compliance with the debt target approved at the ACM on 10 July 2015 in the CG and the FSS, practically in line with the forecasts in the SPU. The increment in indebtedness needs is estimated taking into account the CG deficit foreseen for 2016, the portion corresponding to additional financing mechanisms for the Territorial Administrations (TA), other stock-flow adjustment operations and the deficit in the FSS that will be funded from the Reserve Fund. In this estimation, revenue from differences between redemption and issue values registered until June for the amount of €4,141m, exceeding the €3,300m forecast in the General State Budget. The greater the revenue collected for this reason, the smaller the need for indebtedness.

The sustainability analysis of the Government debt path likewise shows a sustainable profile in the middle and long term, but again failing to comply with Transitional Provision One of the LOEPSF. The reference level established in the Transitional Provision One of the LOEPSF to be reached in 2020 for the consolidated CG and FSS subsector is situated at around 44% of GDP. Focusing on the trend in debt as a percentage of GDP estimated by AIReF on a central scenario (defined above), the limit foreseen in Article 13 of the LOEPSF would not be attained until the year 2035.

4.2 Autonomous Regions

Certain circumstances affect 2016, in addition to those deriving from the system for determining the debt target for Autonomous Regions, causing the 2016 targets fixed at the July 2015 ACM to set debt limits well below those applied at year-end to verify their compliance. The debt target for 2016 in the Autonomous Regions subsector was fixed on 10 July 2015 at 22.5% of GDP. Subsequently, individual targets were set in accordance with the legally established procedure.¹⁸ Nevertheless, these targets cannot be used to verify compliance with this fiscal rule because they do not accommodate for certain debt increments that allow the *de facto* extension to this target at year-end,¹⁹ and in addition to this, in 2016 further circumstances concur:

- Larger debt increments permitted in 2015: the 2015 target was allowed to be extended to finance the hepatitis C campaign (as an additional financing measure to the deficit target) and to include debt overruns with respect to the 2014 target²⁰ (as opposed to the 2014 debt target in which corrections were made for overruns regarding the target for 2013).²¹ Given that the level of debt in 2015 was taken as the baseline for 2016, both of these debt increments will raise the targets for 2016.²²

¹⁸ On 11 September 2015, debt for ordinary regime Autonomous Regions and 12 February for chartered Regions.

¹⁹ Debt increments for the effective amount from financing mechanisms or reclassifications, provided that these are not used to finance the year's deficit.

²⁰ [The compliance report issued on 15 April 2016 on the degree of compliance with fiscal rules in 2015](#) (in Spanish)

²¹ [Report of 24 October 2015 on the degree of compliance registered in 2014](#) (in Spanish)

²² The debt target is defined as stock variable rather than as a flow variable, and is therefore affected by the level of debt reached in the previous year.

- A greater debt increment in 2016 to finance a deficit exceeding 0.3% of GDP: the debt targets for 2016 were initially fixed with a view to finance the 0.3% of GDP deficit target for the year. However, subsequently and in line with the path outlined by the Government in the SPU, MINHAP announced to the Autonomous Regions and published on its website a deficit path for 2016 of 0.7% of GDP for the subsector, applicable equally to each one of the Regions. In the event that this deficit is legally fixed as the 2016 stability target for the Autonomous Regions, the debt increment arising from the difference (0.4% of GDP) will be included in the debt target.

MINHAP has forecast a debt level at 2016 year-end for the Autonomous Regions subsector of 24.2% of GDP, in line with the debt forecast in the SPU 2016-2019 at 99.1% of GDP for the General Government sector. However, MINHAP has not established the allocation of this level of debt among the Autonomous Regions. The Government debt path approved on 30 April forecast General Government sector debt to reach 99.1% of GDP at 2016 year-end. Subsequently, MINHAP has published the allocation of this level of Government debt by subsectors, in which the Autonomous Regions subsector is assigned a level of Government debt for 2016 of 24.2% of GDP. However, the debt targets fixed according to the legally established procedure are maintained (22.5% of GDP), which have no connection with the subsector's new debt level (24.2% of GDP).

The debt increase permitted in the 2016 target would lead to an update of the debt target in the Autonomous Regions subsector of approximately 24.8% of GDP, higher than the rate envisaged by the Government in the debt trend expressed in the SPU. Assuming that MINHAP's criteria remained constant in fixing the targets (exceptions) and in their verification (non-correction of deviations), the debt increment permitted in the targets for the Autonomous Regions subsector would entail a level of debt in the region of 24.8% of GDP, which, following the distribution expressed in the SPU, is higher than the Government's most recent forecast.²³ This level of debt would increase in the event that, for the remainder of the year, new financing methods should arise, different to those assigned at present by mechanisms or changes in the limits of the government sector, or other reclassifications.

AIReF values very highly the information published by MINHAP on its website regarding Autonomous Regions' financing mechanisms and their adjustment plans, which is a significant step forward in increasing transparency in Government accounts.

Updating the debt target in the subsector to 24.8% includes the overrun on the 2015 debt target. In line with MINHAP's interpretation of not correcting debt deviations with regard to the target, and consolidating the level of debt reached including overruns, with a view to verifying compliance with the debt target for the following year, the updated target is comprehensive of said overruns. In accordance with MINHAP's interpretation, in 2016 debt deviations arising from failure to comply with the 2015 target should not be corrected (this is case in Catalonia and Asturias) and debt levels should be consolidated in order to verify compliance with the debt target in 2016.

²³ To update the targeted level (24.8% of GDP), the 2015 level is taken as the baseline (24.2%) and contributions from three factors are taken into account: (i) the denominator effect (-0.7% of GDP); (ii) the increment caused by the deficit target (0.7%); and (iii) a positive deficit-debt adjustment of 0.6% of GDP.

This interpretation by MINHAP of the debt target is identical to that of the expenditure rule. In both cases, higher levels of debt and expenditure are consolidated as their correction is deemed unnecessary in order to respect the limits imposed by these fiscal rules, which, in addition to being an incentive to non-compliance, detracts from their effectiveness. In the specific case of the debt target, the result is nothing short of an aggravation of the already contested effectiveness of this target owing to its current design, as AIReF has claimed in previous reports.

Given the upward target update to 24.8% of GDP, AIReF's forecast mentioned above (24.7%) no longer implies non-compliance in the subsector. As demonstrated in table 6, non-compliance with the Autonomous Regions' debt targets is detected in the comparison between AIReF's forecasts for both the target stated in the 2015 ACM and the figure expressed in SPU 2016-2019. However, having given consideration to the exceptions mentioned above, AIReF's forecasts fall into line with the updated target (24.8% of GDP).

The sustainability analysis of the Government debt path likewise shows a sustainable profile in the middle and long term, but again failing to comply with Transitional Provision One of the LOEPSF. The stipulated reference level for the Autonomous Regions subsector is 13% of GDP. Focusing on the trend in debt as a percentage of GDP estimated by AIReF on a central scenario (defined according to the assumptions given above), the limit foreseen in Article 13 of the LOEPSF would not be attained until the year 2038.

4.3 Local Corporations

In 2016, given AIReF's central estimate at 3% of GDP, the Local Corporations subsector will comply with the provisions of Article 13 of the LOEPSF. The 2016 debt target for the Local Corporations, in coherence with the target of 99.1% fixed for the General Government sector in the SPU 2016-2019, is 3.2%, thus repeating the 2015 debt level.

According to AIReF's estimates, it is highly likely that the level of debt over GDP in this subsector, by the end of 2016, will meet the proposed target for the year within the region of 3%. These estimates, based on the trend in the subsector's surplus and the stock-flow adjustment allow us to conclude that in this year it is likely that the debt limit will be reached as established in Transitional Provision One of the LOEPSF for the year 2020. This implies a slight upward revision of the path forecast by AIReF in the Report on the General Government sector Initial Budget for 2016, confirming some slowing in the pace of debt reduction.

As pointed out by AIReF in the Report on the Initial Budget, of the City Councils analysed only Zaragoza will present, at 2016 year-end, an outstanding debt to consolidated current revenues ratio exceeding 110%, and therefore cannot conduct new long-term credit operations this year.

The analyses performed on each of the 16 City Councils include both the stated 2015 outturn and the City Councils' and AIReF's 2016 forecasts, the latter taking the most favourable scenario in which the surplus generated is dedicated entirely to writing off the debt. According to this analysis, only Zaragoza will generate a debt ratio in excess of 110%, and therefore

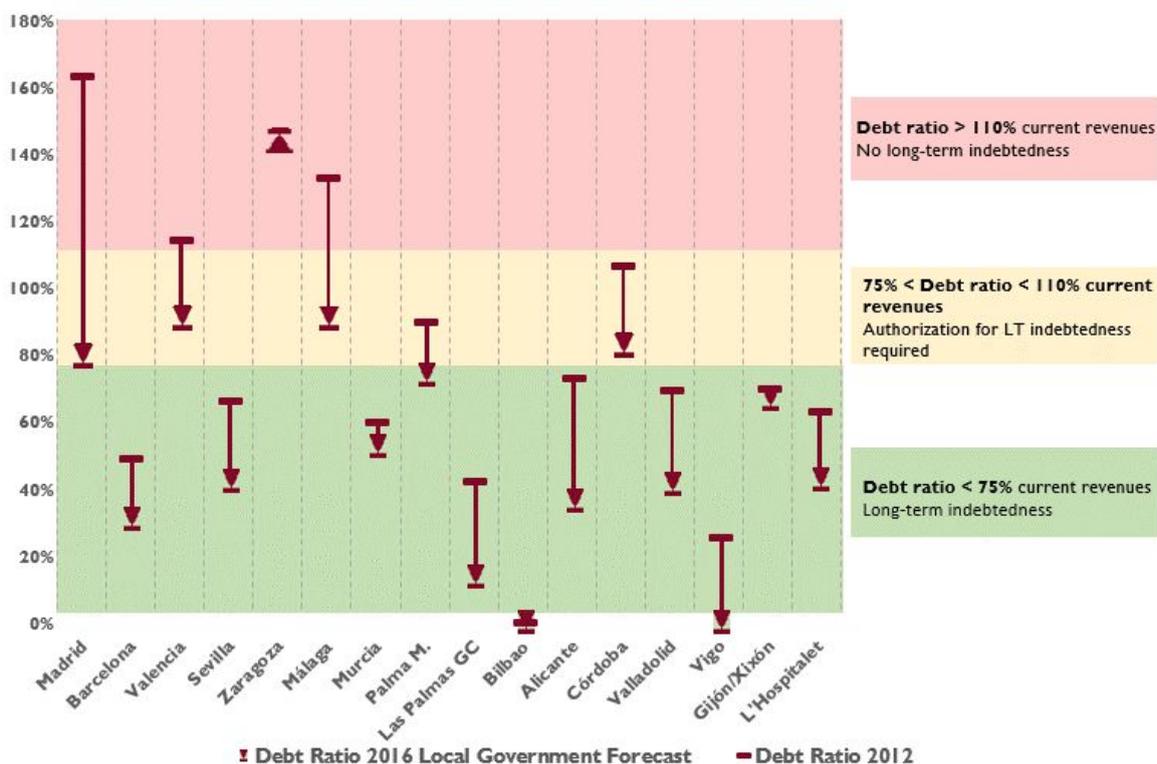
compliant with the applicable regulation²⁴ it cannot conduct new long-term credit operations. This ratio is affected by the City Council's indebtedness on account of the loan for the investment in the city's tram system, which is estimated to raise the Council's outstanding debt ratio at 2016 year-end from 112% to above 140%.

The assessment comprises an analysis of the debt reduction effort made by these Corporations since 2012, the year in which the LOEPSF came into force. These Corporations have reduced their levels of outstanding debt on the time horizon analysed. However, **the greatest effort to reduce indebtedness has been made in Madrid, at over 80% of its level of outstanding debt in 2012.**

Graph 19 includes a comparison showing the relative positions of these 16 City Councils with regard to their level of outstanding debt over current revenues, in the year 2012 and estimated by the councils at year-end 2016, depending on the different tranches determining different positions from which to conduct new debt operations.

Graph 21. THE 16 CITY COUNCILS.

DEBT RATIO AT YEAR-END IN 2012 AND 2016 OVER CURRENT REVENUES



Source: Local Government, Banco de España and SGCAL

²⁴ Final Provision Thirty-one of Law 17/2012, on the General State Budget for 2013, in force for an indefinite duration.

5. Recommendations and guidelines on good practices

5.1 Budget stability

- Central Government

AIReF observes risk of non-compliance of the proposed deficit for the Central Government, fixed in the APE, of 1.8% of GDP. The CG's non-financial revenues have suffered a considerable downturn during the first months of 2016, with the greatest uncertainties focused on Corporate Tax. This drop in revenue seems to reveal that the fiscal reform and the elimination of the consolidation measures applied in previous years are producing a greater impact than initially envisaged by the Government.

From the point of view of measures announced by the Government, it must be pointed out that the Non-Availability Agreement approved on 29 April 2016 is still in the process of instrumentation, for the amount of €2,000m, of which €375m are still to be decided on according to MINHAP. Moreover, in the pleadings submitted on 13 July to the European Commission, in the framework of the prosecution procedure against Spain for failing to take effective action, it is stated that the new Government will adopt measures to improve collection of Corporate Tax by €6,000m and obtain a further €1,000m from actions against fraud. The lack of definition for these measures and the fact that they are to be adopted by the new Government is generating some uncertainty over their implementation and effects.

AIReF deems it indispensable to monitor the full instrumentation and effectiveness of the Non-Availability Agreement and of the impact of the new measures, given their importance in the year's performance. In this light, the LOEPSF, in the section on prevention, is geared toward the Territorial Administrations rather than the Central Government, which can only count on the self-discipline foreseen, in general terms, in Article 18 for the whole of the General Government sector. Thus, Article 19 of the LOEPSF only envisages the *risk of non-compliance warning* as an instrument for use in the event that this risk is identified in any Autonomous Region or Local Corporation.

The non-compliance risk situation described in the report calls for this legal loophole to be covered and the urgent establishment of an internal monitoring procedure that will allow deviations in the Central Government to be corrected.

To achieve this, *AIReF recommends the following:*

-
1. ***MINHAP should put in place a CG control mechanism through monthly MINHAP monitoring of the instrumentation of measures adopted and their impact on the proposed budget stability target, in order to detect eventual slippages well ahead of the end of the year. Monitoring should also be applied to trends in tax revenue, so as to provide updated estimates of the tax reform impact on revenue from corporate and personal income taxes. This monitoring should be given as much transparency as possible, and reports should be sent to Parliament and to AIReF.***
-

□ Social Security Funds

The deficit level foreseen for the Social Security System in 2016 and the gradual depletion of the Reserve Fund, require measures to be adopted to guarantee short-term financing for the system, as AIReF has recommended in previous reports.

The Eighty-fifth Additional Provision to the 2016 General State Budget and the report submitted by the Ministry of Employment and Social Security in April 2016 to the Toledo Pact Commission provide a suitable starting point for developing them, which is why *AIReF once again recommends that:*

-
2. ***Progress is made without delay in the actions already under way and the necessary decisions are adopted to guarantee the financial balance of the Social Security System in the framework of the Toledo Pact Commission.***
-

□ Autonomous Regions

AIReF has repeatedly insisted on the importance of early detection of potential slippages to avoid delays liable to hamper their corrections. For this reason, AIReF has recommended on many occasions that the Autonomous Regions should apply the automatic mechanisms foreseen in Article 18 of the LOEPSF, giving a leading role to monitoring and assessment of budget implementation data by the acting Autonomous Region, in a procedure that a majority of Regions are already implementing.

Likewise, to strengthen the preventive arm of the law, in the report on the main lines of the Autonomous Regions 2016 budgets²⁵, AIReF warned of the risk of non-compliance with the deficit target for this year in several Regions, urging MINHAP to set in motion the preventive measures in Article 19 of the LOEPSF, that finally were not activated.

In April this year, after it was established that the majority of the Autonomous Regions failed to comply with the 2015 budget stability target, MINHAP required the affected Regions among

²⁵ [Report on the main lines of the budgets of the Autonomous Regions for 2016](#)

other conditions such as adhesion to the pharmaceutical industry protocol and the healthcare expenditure rule, to adopt a Non-Availability Agreement (AND). This requirement was made according to article 25 of the LOEPSF, as a result of non-compliance with the adjustment plan in force in 2015 deriving from accession to the additional financing mechanisms for that year²⁶. This measure was reflected in the SPU 2016-2019, where non-implementation of the expenditure budget was valued at 0.2% of GDP, and which included a Non-Availability Agreement for some €800m.

Despite having enacted adjustment plans in connection with FLA 2016, no Non-Availability Agreements have been adopted with an impact on deficit equivalent to the announced adjustment and with the guarantees and features required by the LOEPSF, except in the case of Extremadura.

Finally, the EFPs for 2016-2017 are pending approval.

All the above circumstances clearly indicate a lack of rigour in the implementation of preventive and corrective measures and instruments, hindering the capacity to address any possible deviations in compliance with fiscal rules in an efficient and timely manner.

For this reason, **AIReF recommends that:**

-
3. ***MINHAP performs effective monitoring of the measures adopted by the Autonomous Regions, demanding compliance with the compulsory strengthened conditionality approved by the Government's Delegated Committee on Economic Affairs (CDGAE) to receive funds from the FLA. These measures must be incorporated to the EFPs which, after the AIReF's report, must be re-drafted by the Autonomous Regions for submission to the Fiscal and Financial Policy Council, particularly in the case of Regions such as Andalusia where, while the stability target is likely to be met, a clear risk of non-compliance with the expenditure rule can be seen.***

 4. ***In addition to this, in the Autonomous Regions of Murcia, Valencia, Extremadura, Aragón, Catalonia and Castilla-La Mancha, an in-depth revision of the EFPs submitted to AIReF is required, to incorporate budget scenarios comprehensive of the necessary measures to guarantee compliance with the targets, from a multiyear perspective that contemplates a feasible consolidation path fixed jointly with MINHAP. The duration and intensity of adjustments must take into account aspects such as the relative situation within the Region regarding expenditure level and structure, usage of the normative capacity on taxes, and indebtedness.***
-

Re-drafting and submission of the EFPs in the stated multiyear framework requires the stability targets to be defined in for the period in question. In this sense, AIReF has pointed out in previous reports²⁷ that to fix targets, a number of indicators must be taken into account to

²⁶ Excluded from this condition were Castilla y León, Navarra and La Rioja, which though having failed to meet the 2015 target had an adjustment plan in force.

²⁷ 27 July 2015 Report on the setting of the stability and Government debt targets for the ARs

enable both the feasibility of the budget stability target and their coherence with the budget stability to be evaluated, under the terms demanded by the LOEPSF. In turn, fixing targets in this manner should be agreed in the framework of medium-term planning and given concrete form in a yearly programme forming part of the budget, thus contributing to attaining a path converging with budgetary equilibrium by 2019.

AIReF recommends once more that:

5. *Asymmetric deficit targets are set for 2017-2019. To achieve this, the following could be taken into account:*

- ✓ ***The relative position of the autonomous region as regards the feasibility of its compliance with the target measured in terms of the relative adjustment required.***
 - ✓ ***The consistency of the budget stability target with compliance with the expenditure rule.***
 - ✓ ***The trend toward convergence with budgetary equilibrium for 2019***
-

- **Local Corporations**

The estimates submitted by the 16 major City Councils highlight that a surplus reduction is foreseen for 2016 with respect to that deriving from previous years' outturns. This is particularly representative of the Councils of Madrid and Barcelona. Despite this reduction, from the outturn forecasts for the City Council of Madrid the risk of non-compliance with the stability target cannot be deduced owing to the surplus amount foreseen. However, in the case of Barcelona there is greater uncertainty over compliance with the target, as the estimated amount for the Corporation is close to budgetary equilibrium, which requires strict implementation of the budget for the remainder of the year.

In general terms, this surplus reduction has been largely driven by the increase in expenditures that form part of the expenditure rule, leading to non-compliance of said rule in 2015 in both City Councils, where it is very likely that this situation will recur in 2016. The City Council of Barcelona²⁸ has implemented the corrective measures stated in the LOEPSF, which require an economic and financial plan to be enacted. By contrast, the Madrid City Council, to date, does not have an EFP approved by its overseeing entities.

From the analysis of the 16 large City Councils, it can be inferred that in addition to the two Councils mentioned, Alicante, Málaga, Palma de Mallorca, Sevilla and Zaragoza should have enacted, through the corresponding entity for financial guardianship, an economic and financial plan (EFP) after non-compliance of the expenditure rule, establishing the limits applicable to said rule for the two years it was in force.

²⁸ The City Council of Barcelona has stated that, due to having approved a modification to the budget raising expenditure above the limit approved in the 2015 EFP, it has been obliged to adopt a new EFP after modifying said limit.

At present, none of these has an EFP approved by the financial guardianship entity (Autonomous Region or MINHAP in the case of Palma de Mallorca), although the City Councils of Zaragoza and Palma have been approved at a plenary session of the City Council.

For this reason, **AIReF recommends that:**

6. The Autonomous Regions of Valencia, Andalusia and Aragón, as well as MINHAP, in their capacity as financial guardianship entities for the City Councils of Alicante; Málaga and Sevilla; Zaragoza; and Madrid and Palma de Mallorca, respectively, take the necessary steps to guarantee approval of the EFPs, to enable the appropriate planning for correcting situations arising from non-compliance.

AIReF re-states the recommendation made in the Report on the Public Administrations' Initial Budget for 2016 regarding the need for coordination among the various financial guardianship entities for the Local Corporations, with the aim of establishing a common working framework and of uniting criteria for the implementation and interpretation of the LOEPSF.

7. That MINHAP sets up and monitors a common framework for the exercise of the powers attributed to the municipalities' overseeing entities over budget stability and the expenditure rule, so that the differences in interpretation and compliance that now seem to exist are eliminated.

5.2 Expenditure rule

AIReF has highlighted in several reports the increasing importance of the expenditure rule, which in the short term requires a deeper knowledge of the conditions and criteria for calculating and implementing, and probably, in the medium term, a review of its design. AIReF has made a series of recommendations to which MINHAP has replied stating that it does not consider it necessary to follow them. Nevertheless, AIReF restates the following recommendations:

Interpretation of the expenditure rule

AIReF has repeatedly recommended that MINHAP's interpretation of implementing the expenditure rule, according to which non-compliance of the rule in a given year does not entail the need to correct the deviation in the following year, needs to be revised as it distorts the objective of any international rule of discipline in public expenditure and departs from the interpretation criteria for the European expenditure rule.

MINHAP has replied stating that the percentage of variation in eligible expenditure is as fixed by the Ministry of Economy and Competitiveness (MINECO), except when a different target is established in an EFP.

In this regard, AIReF reiterates its recommendation, insofar as it does not relate to the reference rate but to the baseline level of expenditure upon which the rate is applied.

Transparency

AIReF greatly appreciates that the IGAE should publish the monthly developments in eligible expenditure for the purpose of calculating the expenditure rule for the year in progress for the Central Government and the Autonomous Regions, but deems it necessary to strive for greater transparency, incorporating to the budgets the necessary information to determine compliance with the expenditure rule and regulating, by ministerial order, both methodological issues and the procedure, timeline and content of information exchanged among Public Administrations.

MINHAP's understanding is that the published guidelines are sufficient for calculating the expenditure rule in the Local Corporations and the Autonomous Regions.

AIReF reiterates its recommendation, as it considers that these procedural and information exchange issues are not addressed in the guidelines and that there are many unanswered questions regarding methodology, as can be gathered from the information received from the Territorial Administrations.

The creation of working groups for the implementation, analysis and debate of the expenditure rule

To all the above short-term recommendations, AIReF adds a further, more ambitious recommendation involving a potential revision of the expenditure rule as it is currently defined. Verification of compliance with the expenditure rule is performed since 2013, and therefore its implementation has had some running-in time allowing a number of hitches in its definition and practical application to be identified, which must be examined and discussed by the various Public Administrations. With this aim, AIReF has recommended that maximum benefit is taken from the experience gained over the years in which the expenditure rule has been applied, setting up working groups with participants from all the Administrations involved in order to forge ahead in the analysis and implementation of an expenditure rule that will not generate asymmetry or distortions among the different subjects applying it.

In this case, MINHAP has considered these working groups to be unnecessary, as the above mentioned guidelines have already been published.

AIReF reiterates its recommendation, in view of the fact that the proposed working groups cover more ground than the mentioned guidelines.

5.3 Debt

- General Government sector

The debt trend forecast in the SPU will not allow for compliance with the Transitional Provision One of the LOEPSF. In accordance with this provision, by 2020 the level of Government debt should stand at 60%. To achieve this, the public debt ratio should be reduced at a yearly rate of at least 2% of GDP, as soon as the Spanish economy reaches a real annual growth rate of at least 2%. However, it is foreseen that the debt to GDP ratio will register a cumulative reduction for the entire period of around five percentage points of GDP, with the debt level in 2020 levelling out at close to 94% of GDP. This path will not allow, on the one hand, said target to be met by the fixed term (2020) owing to the distance to the target of 60% (34 GDP points still at year-end 2020).

AIReF recommends once more that:

8. The appropriate legal mechanisms are employed to extend the transitional period for compliance with the limit established in Article 13 of the LOEPSF, adapting the requirements specified in Transitional Provision One of the above law and defining a credible but demanding reference path for the sustained reduction of the debt ratio.

□ Autonomous Regions

AIReF believes that the failure to correct deviations from the debt target, far from contributing to the discipline and sustainability of regional public debt, deepens the inefficiency of this fiscal rule owing to its current design. As pointed out by AIReF in earlier reports, the system for setting debt targets does not guarantee medium or long-term sustainability of the debt because compliance with the debt targets that have been set has no connection with either the increase in the region's debt or with the gap to the long-term reference target ratio of 13% of regional GDP.

AIReF recommends once more that:

9. MINHAP revises its interpretation regarding initial level of debt, according to which debt deviations arising in each year are deferred for consolidation in the future.

Additionally, it is deemed necessary for MINHAP to regulate and publish the criteria to be applied in measuring compliance with the debt target, so that the Autonomous Regions may be aware, a priori, both of the operations that will be considered as exceptions to the debt target and of the criterion to be applied for verifying compliance, in order to allow them to conduct proper monitoring and control of this target.

For this reason, **AIReF once more recommends that:**

10. MINHAP regulates and publishes the criteria envisaged to measure compliance with the debt target.

5.4 Transparency

To fulfil its functions, AIReF needs to have access to the economic and financial information affecting the entities included in the subjective area of implementation of the LOEPSF. To issue this report, a request was made initially to MINHAP's Information Centre for data relative to the subsectors Central Government, Autonomous Regions and Local Corporations, but in most cases the requested information has not been provided. Some requests have not received a formal reply before the date of issuing this report, while others have been answered either partially or referring to previously published information.

For the Autonomous Regions and Local Corporations subsectors, this lack of information is partly compensated for by AIReF directly addressing the 17 Autonomous Regions and the 16 City Councils being examined, which places a double burden on these administrations who are obliged to submit the same information to MINHAP and AIReF.

In many cases the reason given by MINHAP for denying the information is that the requested information is ancillary or unavailable, or that AIReF is not competent to handle such information. In this line, AIReF finds that, in line with the duty to collaborate regulated in the General Budget Act and with the interpretation criterion of the Council for Transparency and Good Governance, any relevant information for AIReF to form a criterion within the framework of this institution's analyses, monitoring and assessments functions cannot be considered as ancillary or supporting data.

This shortage of information hinders and constrains AIReF's analysis and prevents access to aggregate data for the regional and local subsectors as well as official data to compare against the estimates drawn up within the Central Government.

Article 4 of Organic Law 6/2014 and Article 6 in Royal Decree 215/2014, of 28 March, in which AIReF's Organic Statute is approved, regulate the scope and consequences arising from the failure to provide documentation requested in a timely manner and in due form, that may qualify as in default of the duty to collaborate. In view of the obstacles AIReF continues to face to gain access to information, **AIReF urges MINHAP to:**

11. Give AIReF access, in a timely and appropriate manner, to the information necessary for the fulfilment of the statutory powers assigned to this institution by the LOEPSF.

ANNEX A. Potential Impact on the growth of the Spanish economy of United Kingdom leaving the European Union, sensitivity analysis.

Early 2013 the UK government committed to negotiate a new agreement with the European Union (EU) more aligned to its interests and to subsequently hold a referendum on UK's membership of the EU. The referendum finally took place on 23 June 2016 with the Brexit, or leave option, winning. The referendum finally took place on 23 June 2016 with the Brexit, or leave option, winning.

This result opens several uncertainties on the future framework of understanding between the UK and the EU, even affecting the common European project itself. In quantifying the impact of this process in the short to medium term most studies focus on two main mechanisms: (i) the financial channel, with an immediate impact of uncertainty on agents' confidence in their investment and purchasing decisions, also potentially reflected in increased volatility in financial markets and higher risk premiums on public debt in the more vulnerable countries (which could lead to higher financing costs in the private sector); and (ii) the commercial channel, which would come into play when the exit is formalised, with a negative impact on trade and labour mobility.

Pending negotiations between UK and the other member states regarding the new framework of relations between Britain and the EU, this report focuses on evaluating the potential impact in the very short term on the Spanish economy, with special attention to possible spillover effects of financial turmoil in 2016.

Model

For the purpose of modelling the sensitivity of disturbance associated with UK leaving the EU, or *Brexit*, an econometric time series tool called Bayesian Vector of Autoregressions (BVAR)²⁹ with external variables has been used. In this type of model the level of any variable at a given moment is expressed by the linear combination of four parameters: lagged values of the variable itself (dynamic), offset of the remaining variables involved in the model (crossed dynamic), contemporary values of exogenous variables and a purely random factor that captures any other variables not taken into account in the model. The weight of each component is determined empirically by finding the best sampling fit, and the Bayesian elements offset the effects of over-rating that may exist due to the high number of parameters being estimated.

Projecting the aforementioned BVAR model forwards gives both specific prediction values and associated confidence forecasts. In particular, the confidence intervals quantify the degree of uncertainty attributable to the predictions of different variables for different horizons. The endogenous variables included in this model are: the GDP deflator, the GDP volume index,

²⁹ More details on the BVARX model can be found in the following working paper: Cuevas, A. and Quilis, E. (2015). "BVARX model for forecasting the Spanish economy in the medium term" Working Paper 1/2016, AIR^eF.

the full-time employment equivalent, real credit (financing to business and households deflated by the core CPI) and net incomes with cyclical sensitivity (defined as the sum of taxes on production and imports, current taxes on income and wealth, and social contributions, from which unemployment benefits are deducted) as a percentage of GDP. The exogenous variables considered are: the exchange rate of the euro, the dollar price of oil, the EU GDP, interest rates (loans requested by companies of up to 1 million euros) and a constant term.

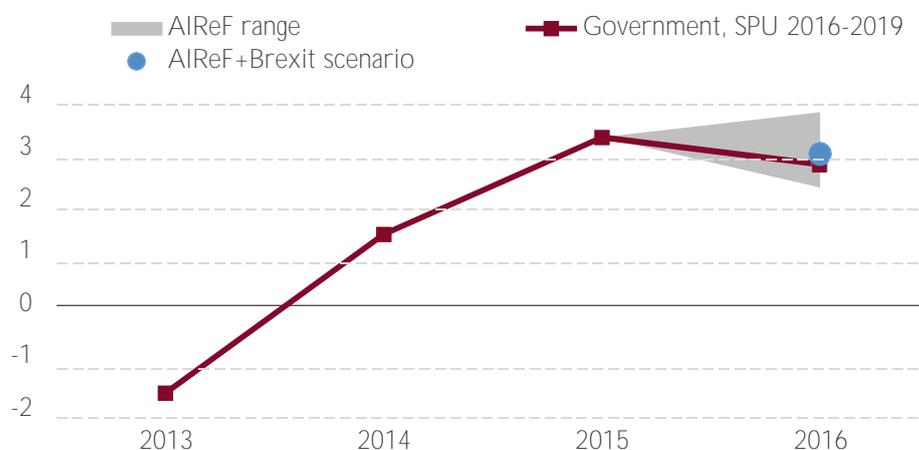
Shock

To gauge the shock that Brexit would cause for Spain in the very short term, the study "The Economic Consequences of Brexit: a Taxing Decision", OECD Economic Policy Paper, 04/2016 by Kierzenkowski, R., Pain, N., Rusticelli, E. and Zwart, S. (2015) has been used. "The Economic Consequences of Brexit: a Taxing Decision", OECD Economic Policy Paper, 04/2016). Using an equation linking spreads on corporate bonds with a factor of uncertainty and an index of stock market volatility, the authors estimate that Brexit would imply an increase in funding costs for British companies of 100 base points in the second half of 2016. When assessing the possible spillover effect for the rest of the EU it is reckoned that the impact will be 33% of the original size. To simulate the impact, therefore, a rise of 33 base points in corporate bonds transferred to the cost of corporate financing is reckoned. This shock is implemented by an equivalent increase in the exogenous variable corresponding to interest rates for companies in the BVAR, taking into account possible differences in the cost of access to finance between British and Spanish companies, due to the depth of the British corporate bond market compared to the supply of bank financing for Spanish companies.

Results

The estimated model reflects a 0.24 elasticity of GDP to interest rates on loans to companies. That is, on a rise of 100 base points, GDP would fall by 0.24%. Regarding the shock calibrated in the preceding paragraph, the impact on GDP would be only a tenth in 2016. As graph R1-I shows, the correction of the central path expected by AIReF for the potential impact of Brexit would be close to predictions included in the Stability Programme Update, 2016-2019.

GRAPH A.I. PROJECTIONS OF REAL GDP GROWTH (%), SIMULATION OF BREXIT SCENARIO



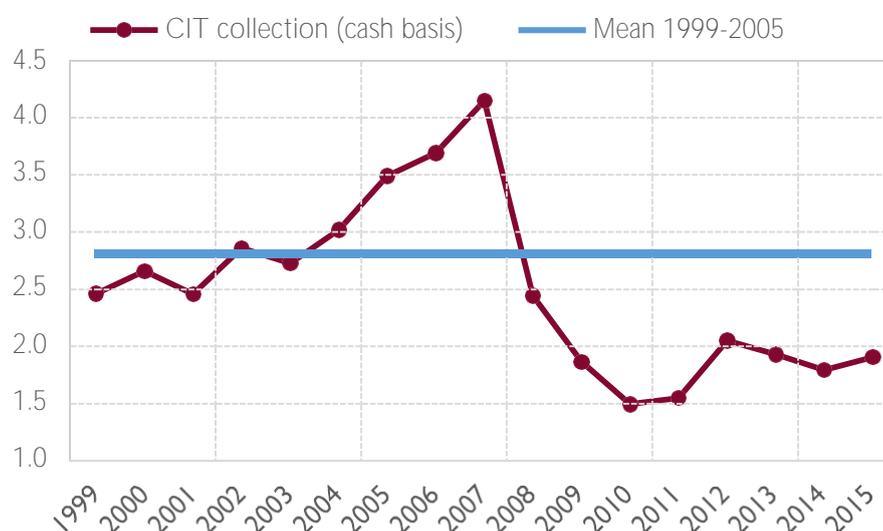


As discussed above, these results should be seen as very short term, and do not include possible spillover effects through commercial channels or worker mobility, which would only begin to take effect after a de facto UK exit, and whose size would depend on the final agreement that the UK reached with the European Union. Several studies have evaluated these effects for both the UK and Spain. For example, the International Monetary Fund gave a medium to long term estimate in its latest article IV report on the United Kingdom, taking into consideration other studies evaluating the impact of Brexit both domestically and on other EU countries.

ANNEX B. Uncertainty associated with Corporate Tax

The collection of corporate tax has seen large fluctuations throughout its history, caused both by the economic cycle and by the numerous regulatory changes that have affected the tax. The maximum returns during the period 1999-2015 occurred in 2007, when revenues reached 4.1% of GDP, and the minimum in 2010, after the crisis had begun, when it stood at 1.5%. In 2015 it reached 1.9%, still far below the average before the economic crisis.

GRAPH B1. CORPORATE TAX REVENUES (% GDP)



To understand how we arrived at the current position on corporate income tax it is necessary to analyze the relationship between net income and taxable income, the collection mechanism and policy measures taken in recent years.

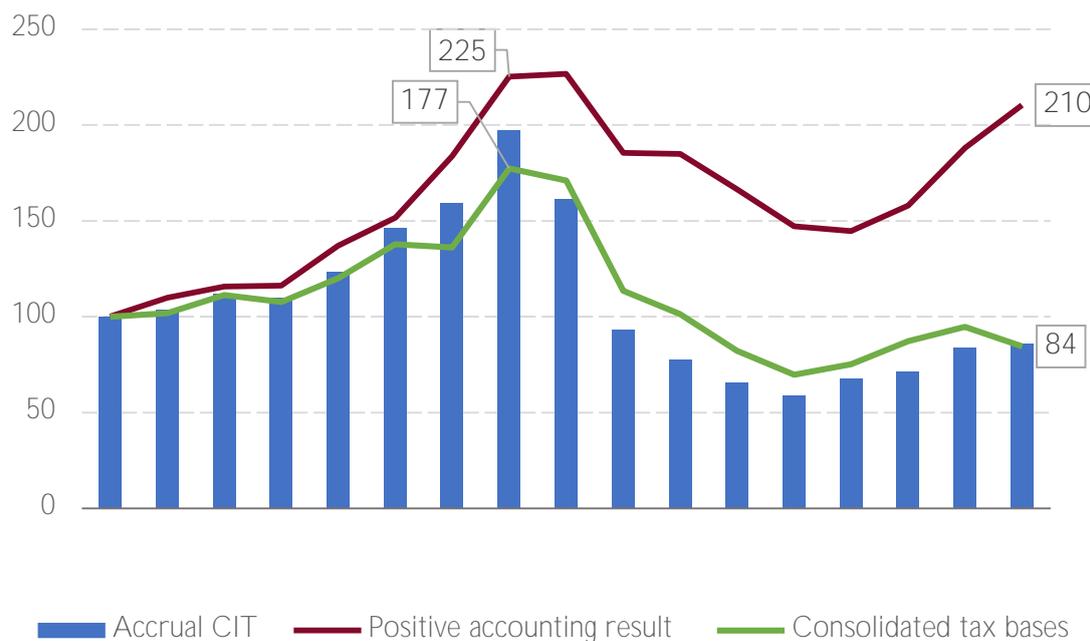
Regarding the first question, tax is not calculated directly on profits, but after a series of adjustments are made to progress from the accounting result to the taxable amount.

$$\begin{array}{c}
 \text{Positive Accounting Result} \\
 \pm \text{Tax Adjustments} \\
 - \text{Negative Tax Bases} \\
 \hline
 \text{Taxable amount for the period}
 \end{array}$$

This relationship seems to have been changing over time. As shown in Figure B2, taking 1999 as the base value and in deflated terms, to enable comparisons in constant terms, both variables evolved in a similar manner until 2006, but from 2007 the differences have been increasing. In 2015 the largest discrepancy is observed as the net income is at 2006-2007

levels while the taxable profit has fallen to the lowest point of the series standing at 84% compared to 1999. The correlation between net income and taxable profit has been shrinking from 84% in 2000-2008 to 74% in 2000-2015.

GRAPH B2. TREND IN POSITIVE ACCOUNTING RESULT, TAXABLE INCOME AND CORPORATE TAX ACCRUED IN DEFLATED TERMS (BASE 1999 = 100)



Source: Historical series of bases, rates and accrued tax. AEAT

Regarding the tax revenue collection mechanism, Figure B3 (below) shows a payment scheme over time. Tax is levied coinciding with the company’s financial year, usually the calendar year. However, cash flows, income and returns, occur on a different and irregular basis. Basic income derives from partial receipts and instalments. The first accrue in the third, ninth and eleventh months of each year and are settled within 20 days, discounting earlier receipts and deductions allowed at each instalment, which are usually insignificant. Therefore, in cash terms, partial receipts occur in the months of April, October and December.³⁰

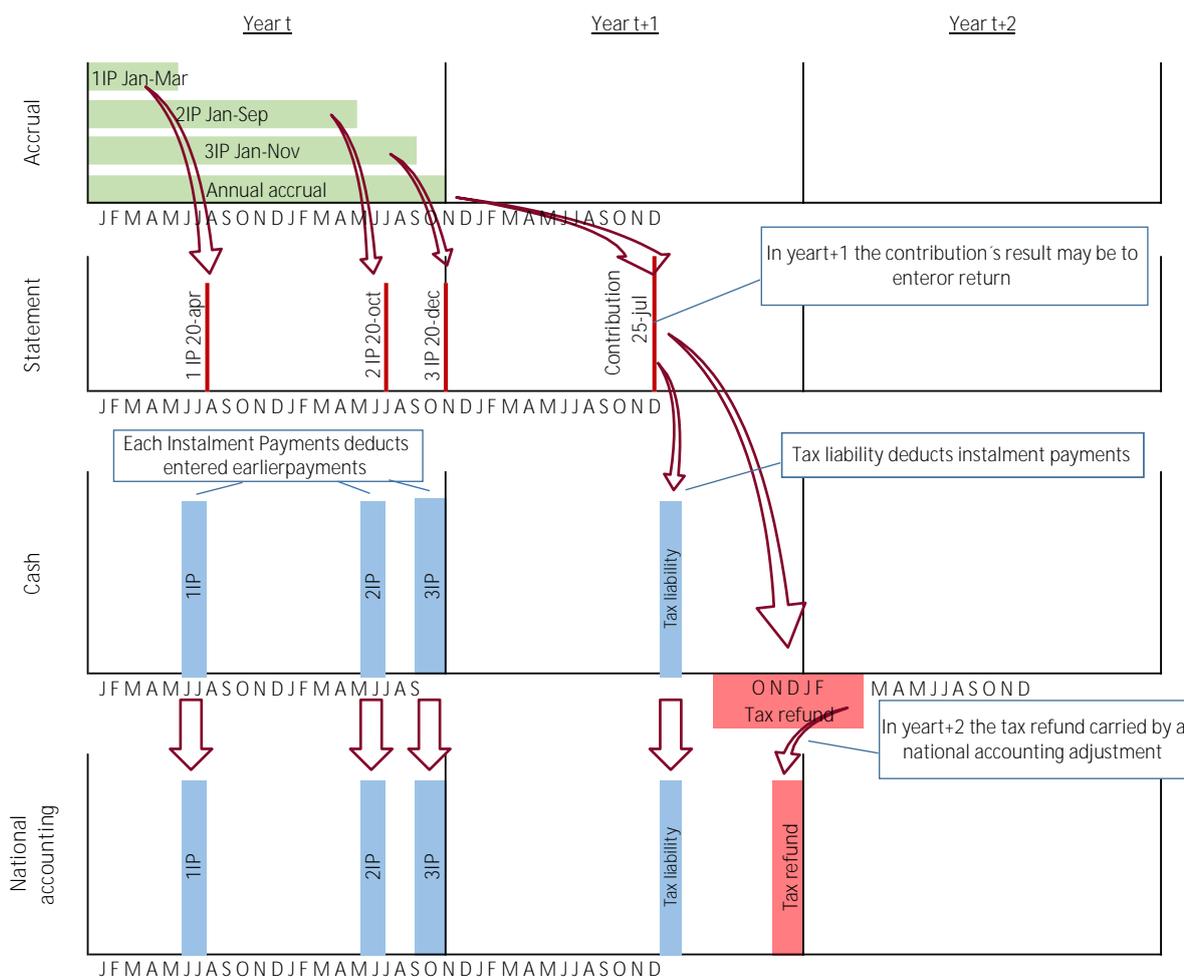
The annual payment ‘t’ accrues on the last day of the financial year but is not paid until 7 months later, usually in the first 25 days of July the following year, ‘t+1’. Partial payments already made plus any deductions are accounted for, so the result can be a positive or negative amount. In the former case collection occurs in July or August. But if the result is negative -a tax rebate- the administration has a period of six months in which to settle the rebate without

³⁰ There are two methods for calculating instalment payments. Large companies and those which choose this method calculate it as a function of the taxable base, whilst other companies do so by applying a percentage of the final tax due. This annex only analyzes the former case, which represents the largest revenue.

incurring any interest, until 25 January the following year, which means that a portion of the rebates are made in year 't+1' (until 31 December) and the remainder in year 't+2'.

However, in terms of National Accounts, rebates should be assigned to the year in which they are claimed, so those made by the tax administration in 't+2' are adjusted to 't+1'.

GRAPH B3. TIMELINE OF CORPORATE TAX RECEIPTS



Having dealt with these two issues, it is necessary to analyse policy measures taken in order to explain the evolution of income tax following the low amount collected in 2010.

During the years 2011 to 2014, with the aim of contributing to fiscal consolidation, a number of regulatory changes were approved. Amongst these the most noteworthy were a limit on the possibility of offsetting losses carried forward, higher fractioned pre-payments, restricting freedom of amortization, suppression of deductible losses in participated corporations or limiting deductible financial expenditure.

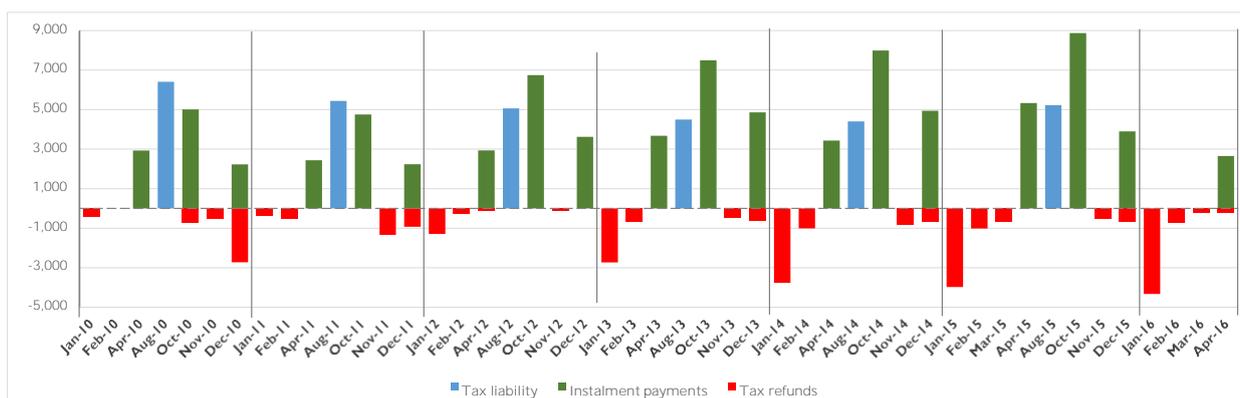
The effect of these measures on revenues collected in the period 2011-2014 is uncertain. As shown in graph B1, revenues recovered in 2012, despite worsening corporate profits driven by the aforementioned consolidation measures. However, in 2013 and 2014 that trend did not continue even though economic activity improved, probably because some of the measures had a purely financial effect, advancing some of 2012's takings and reducing those in 2013, and because the tax rebate schedule was altered.

Since 2015 regulatory changes were geared towards a reduction in the tax burden with a new tax reform in two phases:

- In 2015 the tax rate was reduced to 28% and the cost of payment by instalments were lowered, whilst at the same time preserving many temporary consolidation measures from previous years (although other temporary measures such as deduction of depreciation costs were not to be extended). In terms of revenues, a slight improvement in taxes was observed compared to the previous year, probably due to the effect of the improvement in economic activity on interest rates.
- In 2016 the reforms yield more significant results. On the one hand new measures such as the new 25% tax rate, the new limit on offsetting losses carried forward (60% in 2016 and 70% in 2017) and the coming into force of the capital reserve, and on the other hand most of the afore-mentioned consolidation measures phased out, such as the minimum instalment payment. Taken together, these measures led to the first receipts of 2016 being much lower than in previous years.

These effects can be seen in graph B4, which shows tax periods, instalment payments and rebates from 2010 to the present.

GRAPH B4. CORPORATE TAX RECEIPTS (RELEVANT MONTHS ONLY)



Tax returns, which until 2011 were presented in November & December, were moved into the first months of the following year. In addition, as instalment payments increased due to policy measures affecting them, an increase in refunded amounts and a decrease in tax payments occurs, probably because, as already mentioned, some of the measures had a financial effect.

In 2015 a slightly different picture emerges, since tax receipts are higher than previous years, owing to improved corporate profits, but 2015 third instalment receipts breaks the upward trend of 2012, 2013 & 2014. Taking 2015 as a whole, tax revenues were better than 2014 but lower than expected given the improvements in employment and corporate profits.

Similar to the third payment period in 2015, the first period in 2016 was lower than anticipated, which could be as a result of a change in the tax behaviour pattern. Figure B5 shows in more detail the change in the relationship between taxable income and instalment payments.

GRAPH B5. EVOLUTION OF TAXABLE INCOME AND THE ACCRUAL OF INSTALMENT PAYMENTS (€m AND VARIABLE YEARLY TAX RATES)



In accrual terms, the changes in taxable income and instalment payments show a similar pattern, i.e. variations in the tax base trigger similar fluctuations in payments received. However, the last two payments diverge from the pattern followed since 2009. The third instalment of 2015 saw in a significant reduction in the taxable base, -44.8%, probably due of the implementation of the reform measures and the expiry of the transitional measures relating to depreciation expenses. The transitional measures of minimum payments on accounting profits mitigated this fall but payments by instalment fell -30.3%.

During the first payment period in 2016 the tax base fell by -32.5% whilst instalment payments fell by almost twice that amount, around -57.9%. As pointed out in the April Monthly Revenue Report by AEAT, the main reasons that explain this negative trend could be the following:

- The introduction of the second part of the tax reform. Instalment costs have fallen more than in the previous year, from 20% to 17%. Moreover, deductibility of offsetting losses is increased (from 25% to 50%, according to turnover, while in 2016 it is 60%)
- Short-term measures which have not been extended: partial integration in taxable dividend payments and minimum payment on the income, among others.



- The extraordinary income from the AENA stock market launch in the first quarter of 2015.

According to the cited report, April 2016 payments, in cash terms, amounted to €2,768m, a fall of -€2,625m over the same period of 2015. Of these -€2,625m, the first two factors would be €1,725m (€291m and €1,434m respectively). The remaining decline could be due, among other reasons, to the effect of the new 60% limits on tax losses operating since 2016 (in the years 2012 to 2016 the limits were 25% and 50%) and other factors which affected the last payment in 2015, such as the new regulation regarding amortization expenses (which was already operating in 2015).

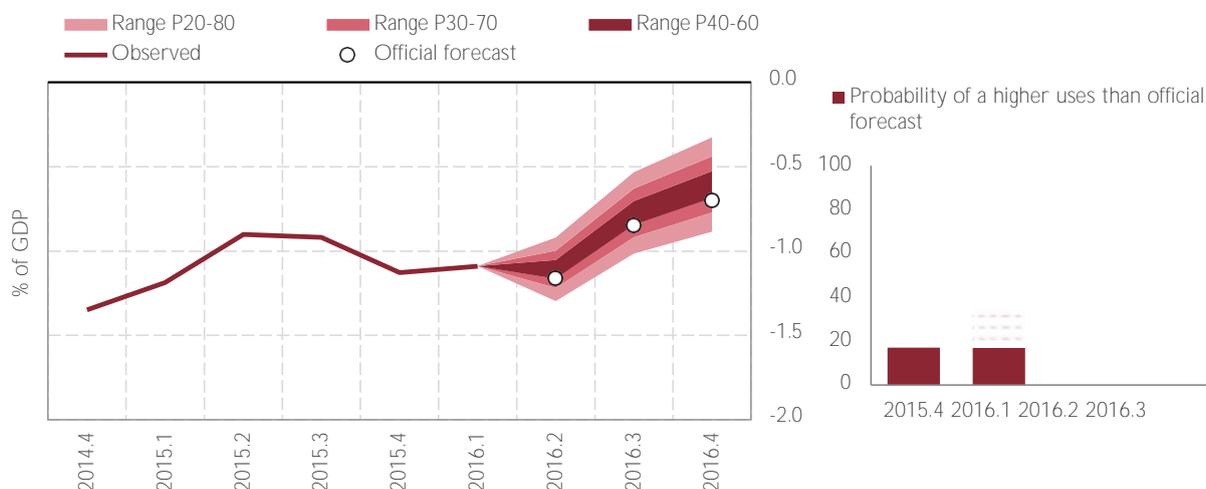
Therefore, all these factors cause a lot of uncertainty regarding the collection of income tax in 2016. On the one hand, if measures to increase the minimum instalment payment under the terms announced by the Government on allegations addressed by the Spanish Government to the European Commission, a portion of the proceeds could be recovered. On the other hand, part of the loss comes from the reform itself, which would be difficult to recover. For that reason, the report considers that meeting the budgeted figure for this tax would be difficult.



ANNEX C. Individual analyses by Autonomous Communities

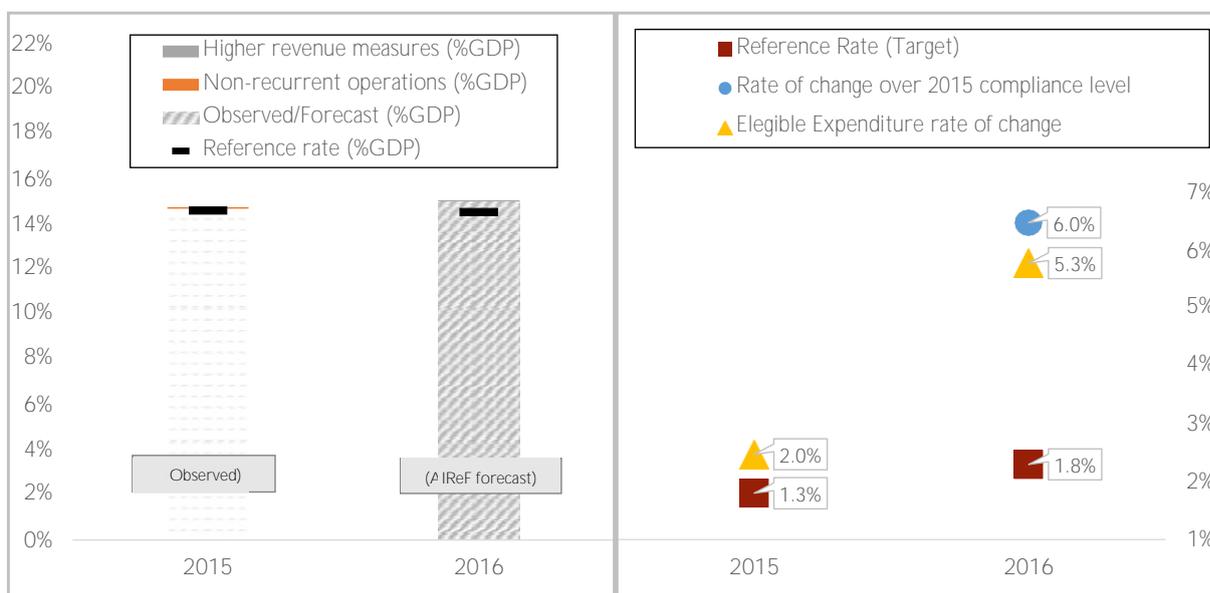
Andalusia

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). ANDALUSIA



AIReF considered Andalusia's compliance with objectives for 2016 proposed in the Stability Programme Update (SPU) likely. This probability of compliance is less than that derived from analysis of the initial budget, mainly due to the region's increased expenditure foreseen to adjust to the SPU objective, which is more flexible than forecast in the approved budget. On the other hand, the AIReF assessment indicated in the EFP assessment remains valid, since the increase of final settlement in the financing system corresponding to 2014 is offset by the change in expenditure up to April.

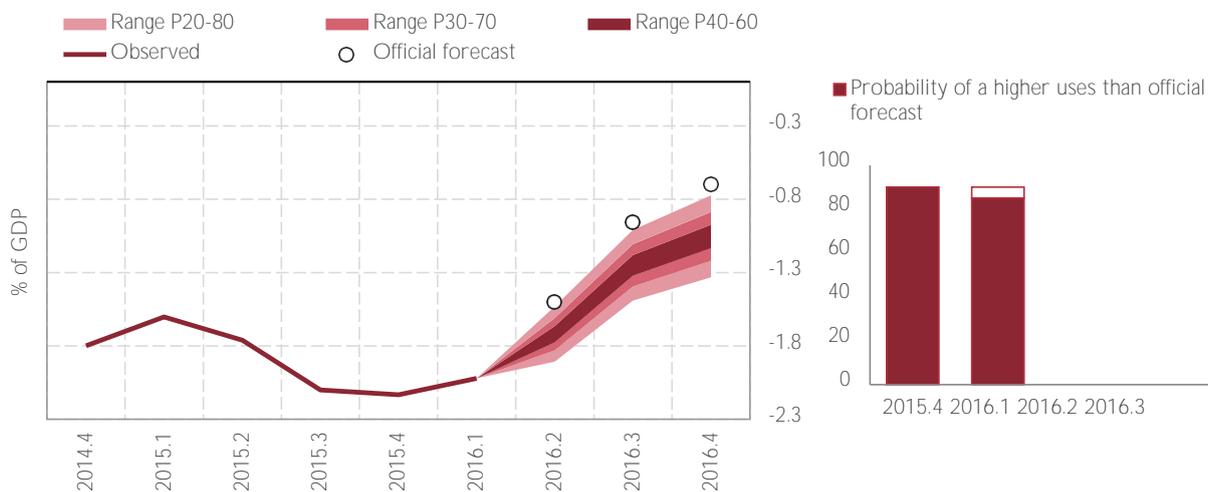
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. ANDALUSIA



AIReF estimates that there is a clear risk of default for Andalusia's expenditure rule in 2016 due to the envisaged trend in spending, confirming the data so far. The risk already considered in the initial budget analysis is compounded by the region's upward revision of the regional expenditure reflected in their execution to date. The estimated eligible expenditure for 2016 grew 6% from the 2015 level of compliance.

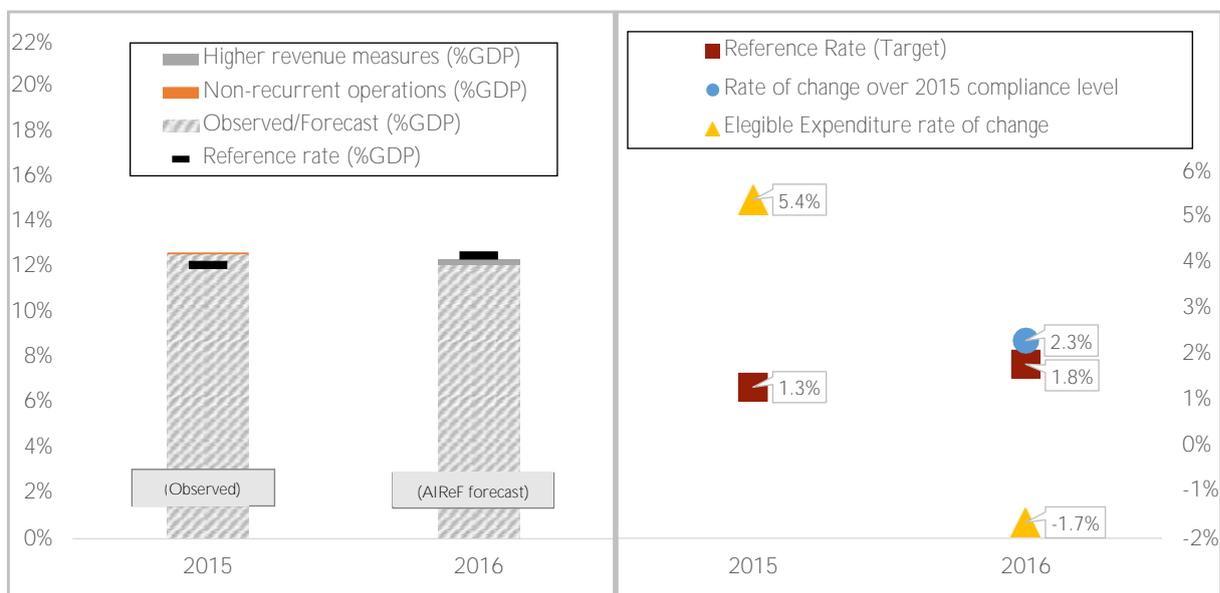
Aragón

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). ARAGÓN



AIReF estimated as highly unlikely that Aragón will comply with the proposed SPU 2016 target, as pointed out in the EFP assessment, but analyses of the initial budget and EFP have slightly improved the likelihood of compliance, suggested mainly by an increase in the final settlement of the 2014 funding system.

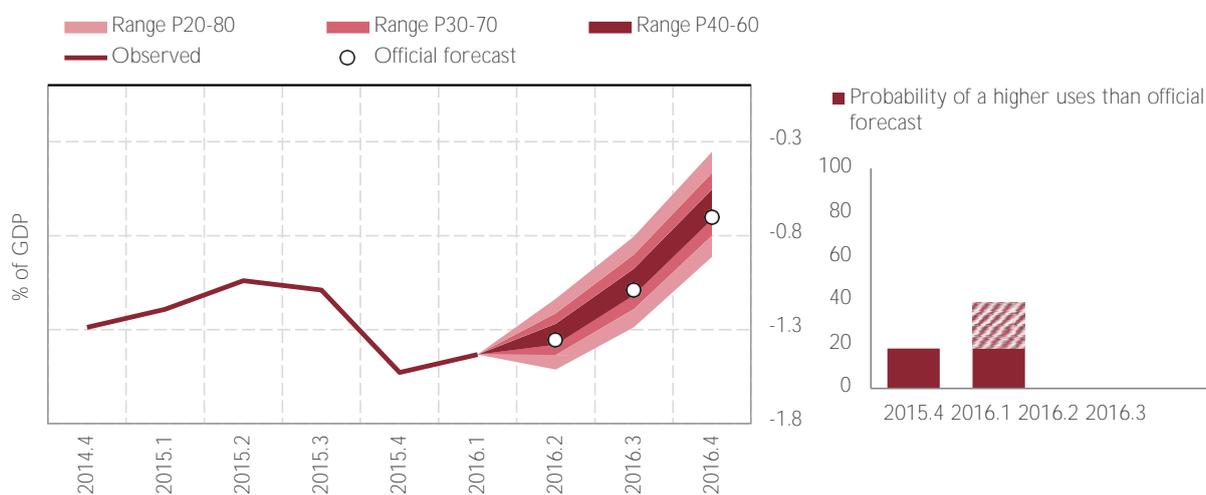
GRAPH C2. ELIGIBLE EXPENDITURE FOR THE PURPOSE OF THE EXPENDITURE RULE (% GDP) AND VARIATION RATES. ARAGÓN



AIReF does not anticipate any risk of lack of compliance with the expenditure rule in 2016 for Aragón, which is supported by the 2016 forecast of permanent normative measures for revenue increase. The estimated eligible expenditure for 2016 grows by 2.3% compared with the 2015 level of compliance.

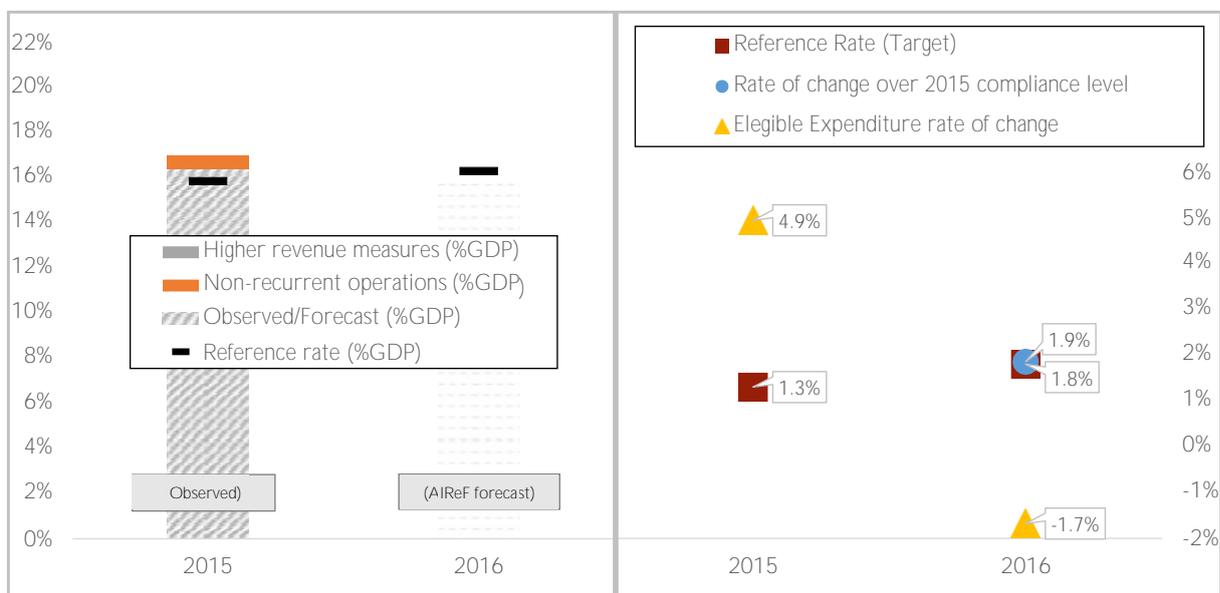
Asturias

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). ASTURIAS



AIReF reckons as **probable** for Asturias to be within the target for 2016 proposed in the SPU. However, the likelihood of compliance has worsened according to analysis of the initial budget mainly due to the growth of current expenditure estimated to meet the SPU objective (going from -0.3% to -0.7 %). On the other hand, the increase in final settlement of the funding system has improved the assessment made on the Region's EPF.

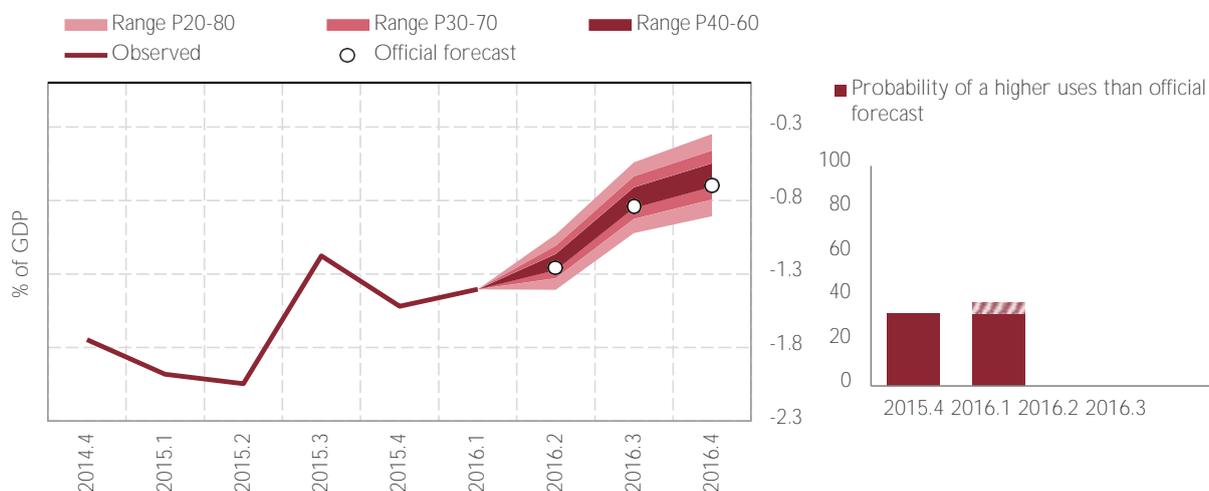
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE ASTURIAS



AIReF does not foresee a risk of default on the expenditure rule in 2016 for Asturias, mainly due to 2015 operating margins which will not occur in 2016. The estimated eligible expenditure for 2016 grew by 1.9% over the 2015 level of compliance.

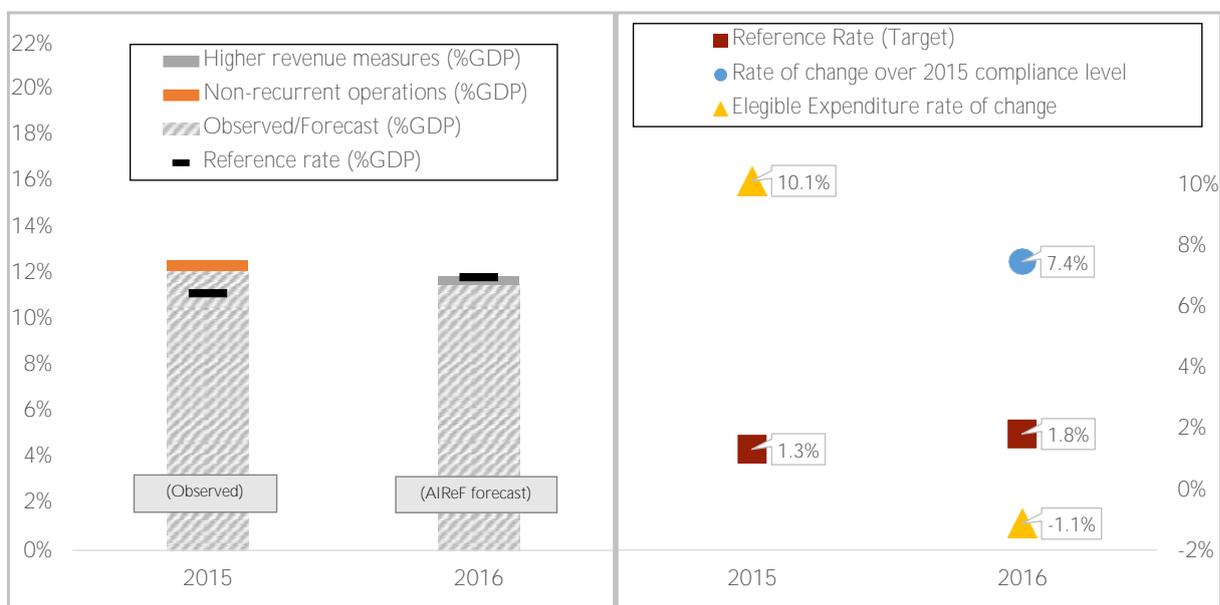
Balearic Islands

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). BALEARIC ISLANDS



AIReF estimates **probable** compliance for the Balearic Isles with the target proposed by the SPU for 2016. The chance of meeting a target of -0.7% of GDP is downgraded in the initial budget analysis due to the adjustment made to the SPU objective, which is more flexible than foreseen in the official budget, correcting upwards the estimates of expenditure over income increases. On the other hand, it improves AIReF's evaluation indicated in the EFP assessment the (feasible) due to the effect of the increase in the funding system final settlement for 2014.

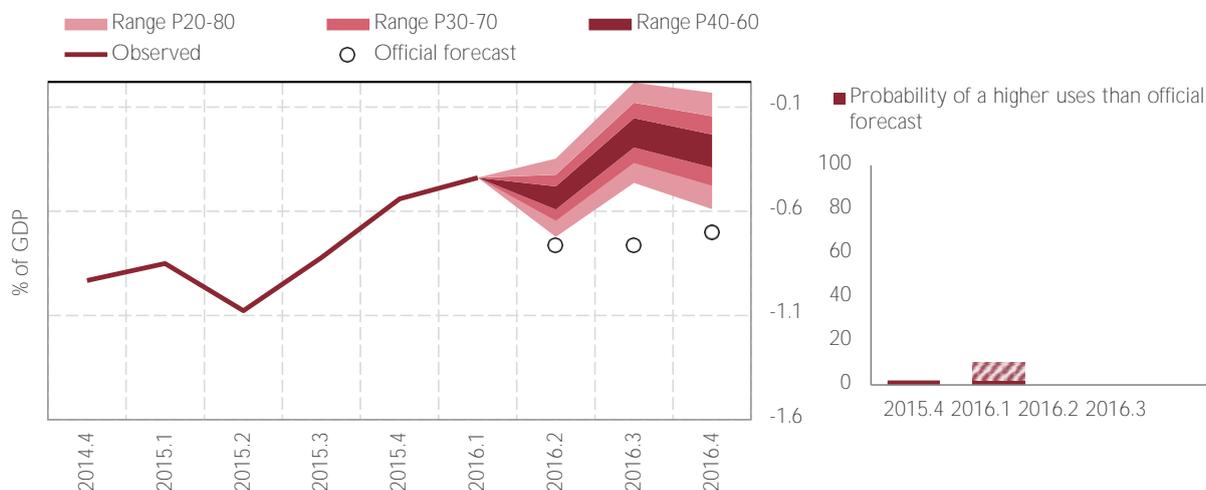
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. BALEARIC ISLANDS



AIReF does not foresee any risk of lack of compliance with the expenditure rule during this year for the Balearic Islands, mainly due to the favourable effect of two factors: the margin provided by 2015 operations will probably not be repeated in 2016 and permanent revenue increase policy measures in 2016. The eligible expenditure estimate for 2016 increased by 7.4% over the 2015 level of compliance.

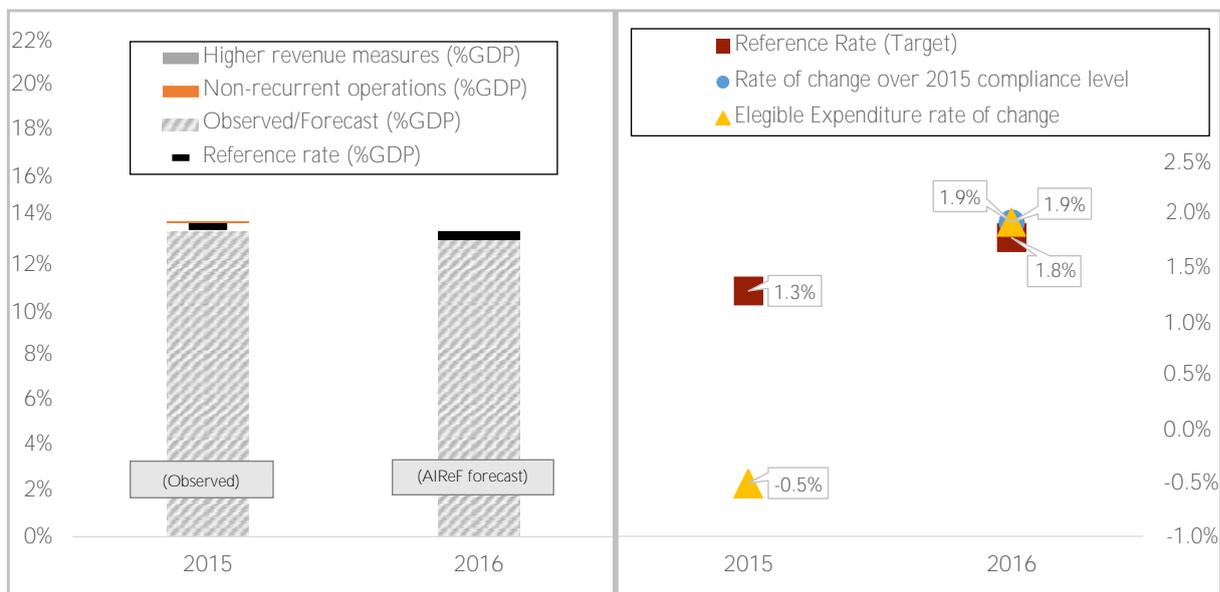
Canary Islands

GRAPH C1. NET LENDING/BORROWING 2016 (as % of GDP). CANARY ISLANDS



AIReF estimates as **very likely** for Canary Islands to comply with the Stability Programme Update 2016 target. However, the likelihood of compliance is less than that deriving from the analysis of the Autonomous Region's initial budget, mainly due to the increase in expenditure forecast carried out to review the closure scenario at a higher deficit than forecast in the initial budget, estimated to close below -0.3%. This effect, however, is mitigated in part by the increase in the final settlement of the funding system.

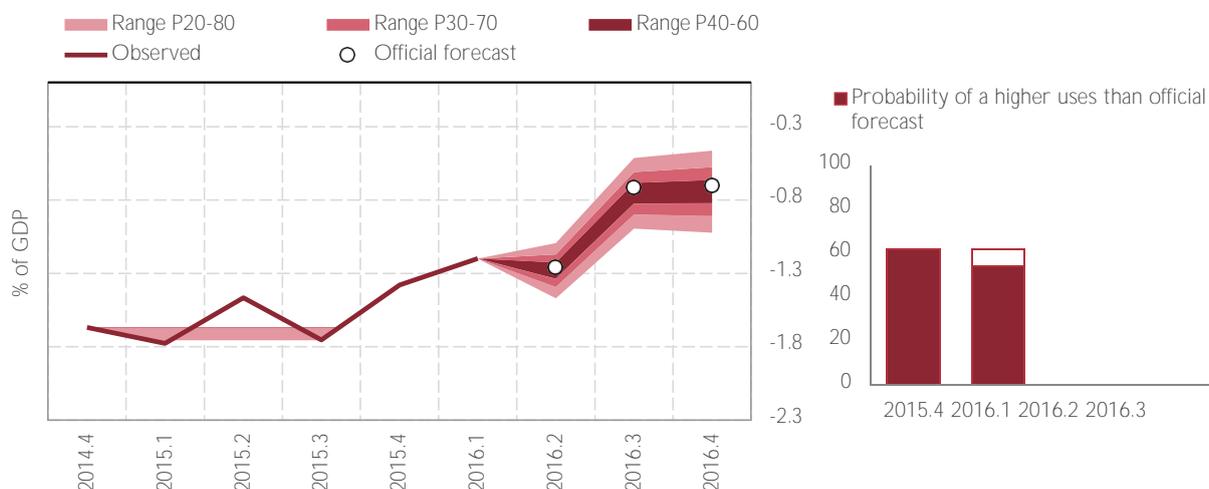
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. CANARY ISLANDS



The review of Canary Islands expenditure and its evolution until April could jeopardize compliance with the expenditure rule in 2016. The estimated eligible expenditure in 2016 has grown by 1.9% over the 2015 level, when that rule was fulfilled.

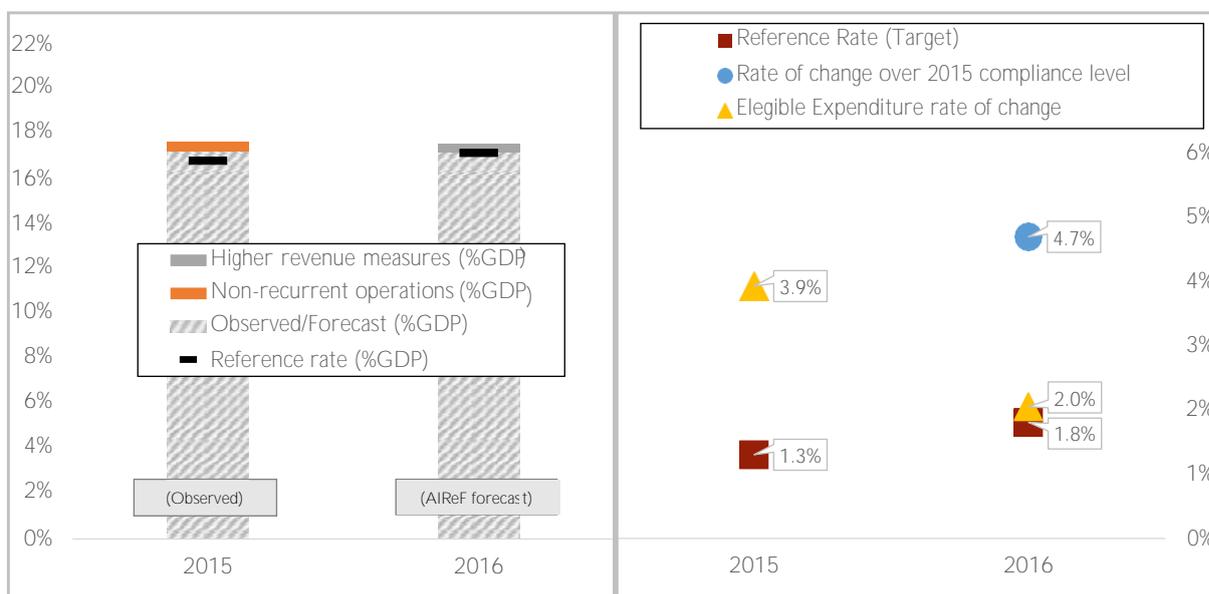
Cantabria

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). CANTABRIA



AIReF considers **feasible**, but **tight**, for Cantabria to comply with the target proposed in the 2016 SPU. The likelihood of compliance has improved following the analysis of the initial budget, mainly due to the information provided in the EFP, and to a lesser extent by the increase of the final settlement of the funding system.

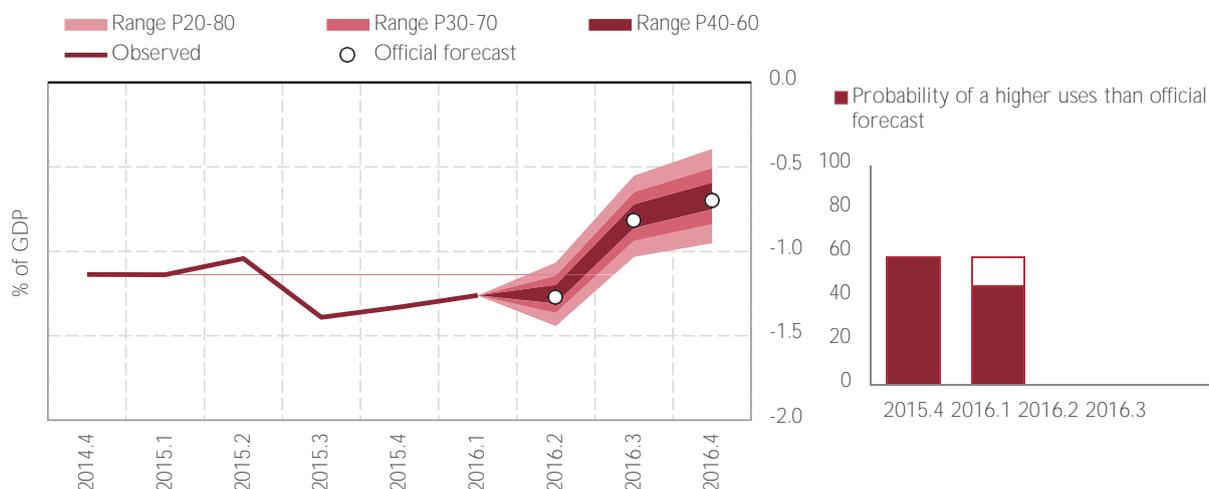
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. CANTABRIA



The evolution of expenditures observed until April for Cantabria seems to indicate spending growth that could jeopardize compliance with the expenditure rule in 16, in which two opposing factors are at play: a margin from 2015 operations will probably not be repeated in 2016, which is nullified by the effect of planned policy measures to reduce income for 2016. The estimated eligible expenditure for 2016 grew 4.7% over the 2015 level of compliance.

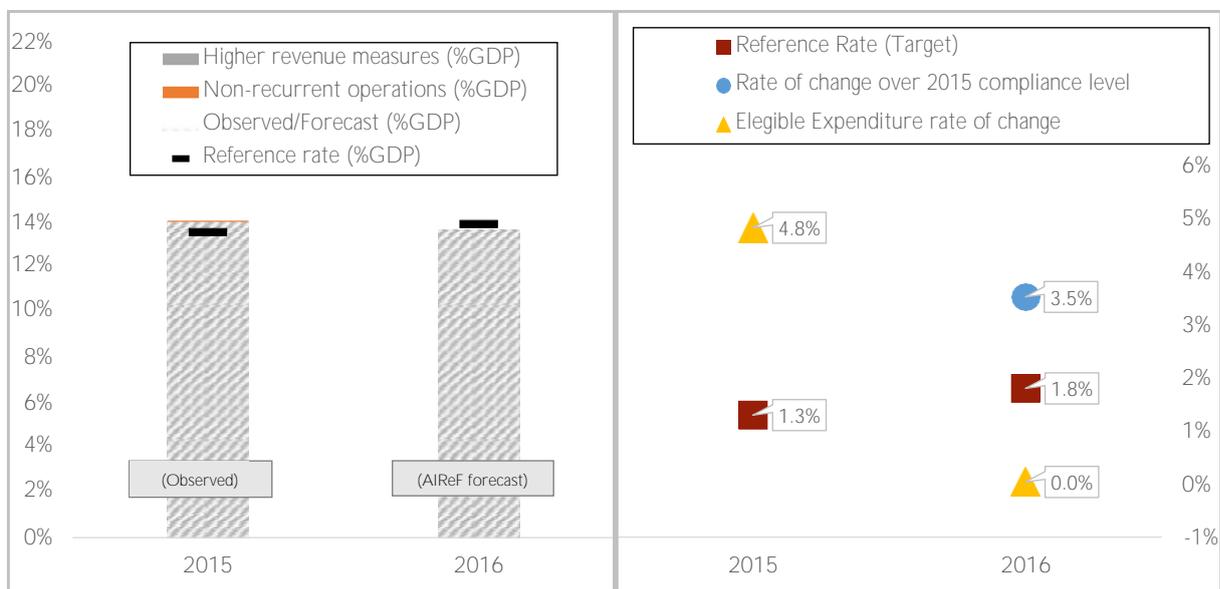
Castilla y León

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). CASTILLA Y LEÓN



AIReF considers the achievement of the 2016 objective proposed in the SPU and included in the EFP as **feasible** for the Community of Castilla and Leon. It has upgraded the likelihood of achieving the target of -0.7% of GDP from the analysis of the initial budget due to increased final settlement of the 2014 funding system.

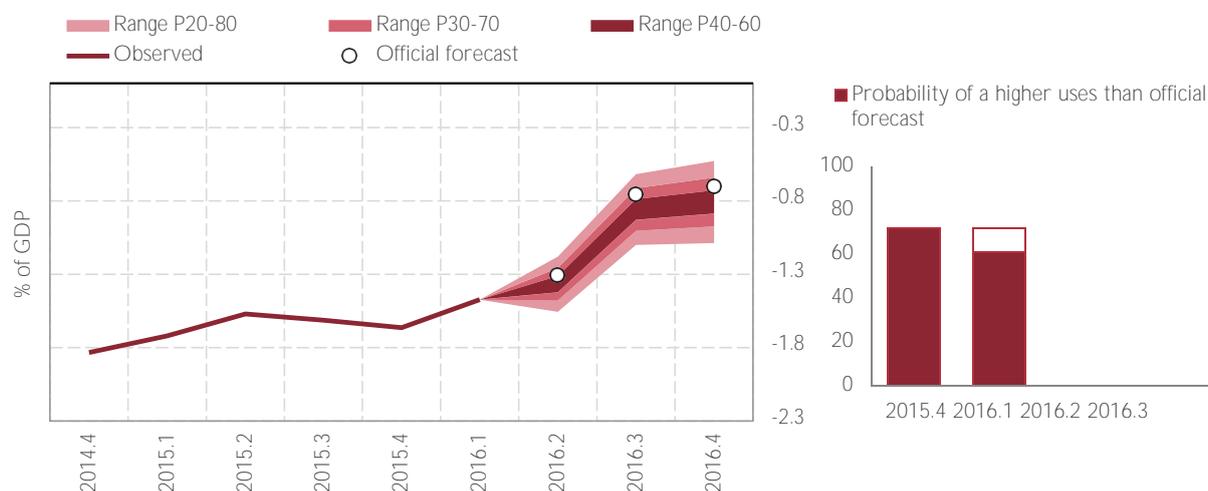
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. CASTILLA Y LEÓN



AIReF considers that there is no risk that the Autonomous Region of Castilla y León will breach the expenditure rule for the year 2016 as the expected evolution of their spending, confirmed by the data so far, seems on track for compliance with the reference rate. The computable spending estimate for 2016 grows by 3.5% compared to the 2015 level of compliance.

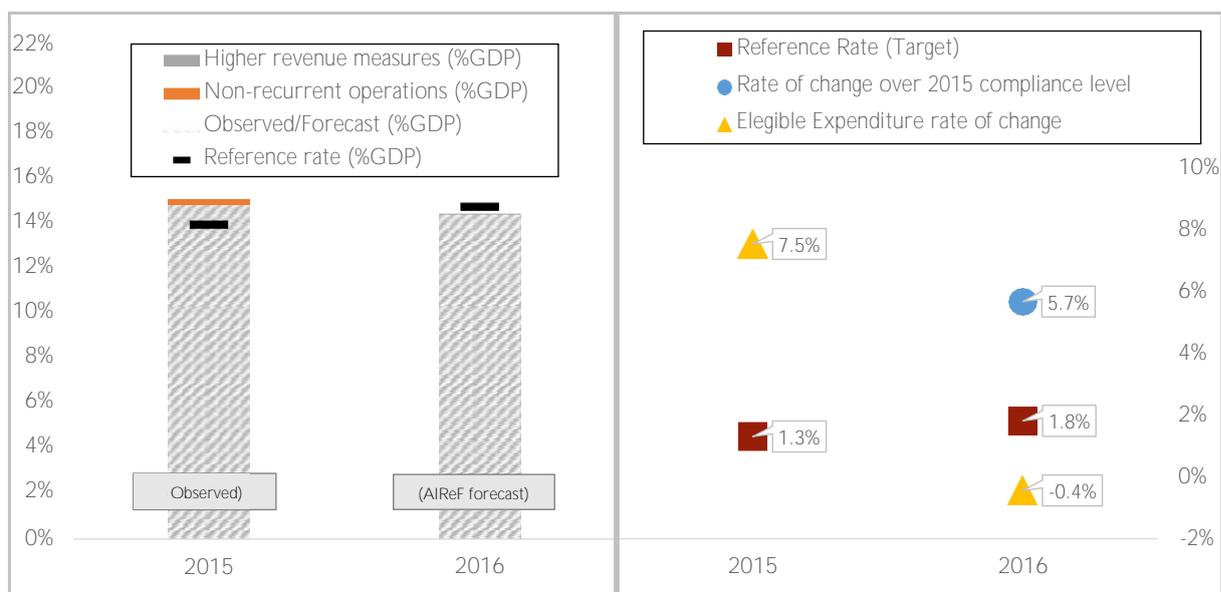
Castilla La Mancha

GRAPH C1. NET LENDING/BORROWING 2016 (AS % OF GDP). CASTILLA-LA MANCHA



AIReF estimates that Castilla - La Mancha is **unlikely** to comply with SPU targets proposed for 2016. On the other hand, the likelihood of compliance has improved from the analysis of the initial budget mainly because with the easing of the target after the approved budget, the region has slightly increased expenditure and eliminated some uncertainties in its income scenario, and thanks to the increase resulting from the final settlement of the funding system in 2014, although the assessment has not changed. Similarly, the evaluation indicated recently by AIReF in its assessment of the Autonomous Region's EFP stands.

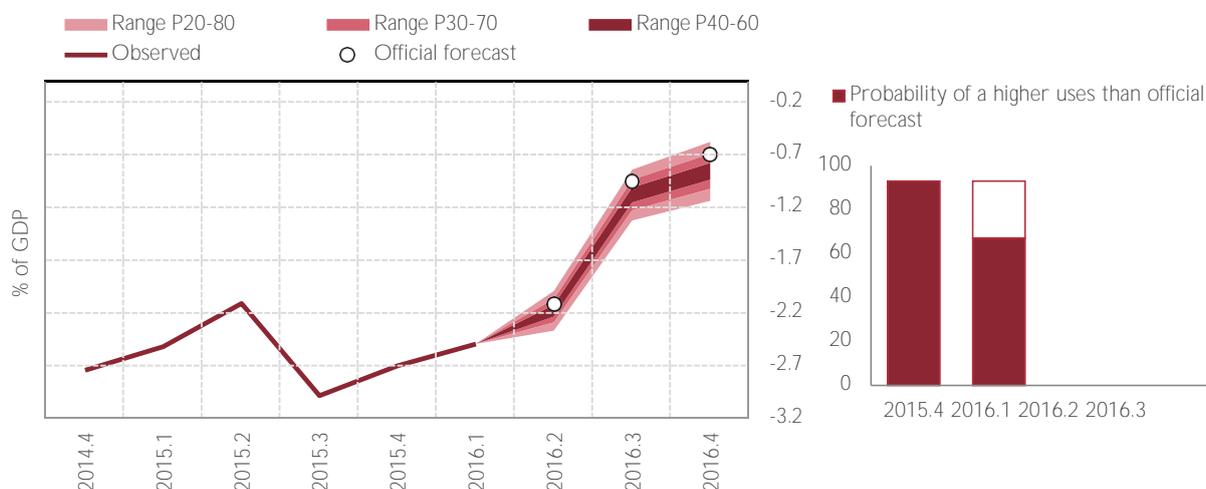
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. CASTILLA-LA MANCHA



AIReF does not foresee any risk of lack of compliance with the expenditure rule for Castilla - La Mancha for the year 2016, mainly due to the favourable impact of 2015 non-recurring operations. The estimated eligible expenditure for 2016 grew 5.7% over the 2015 level of compliance.

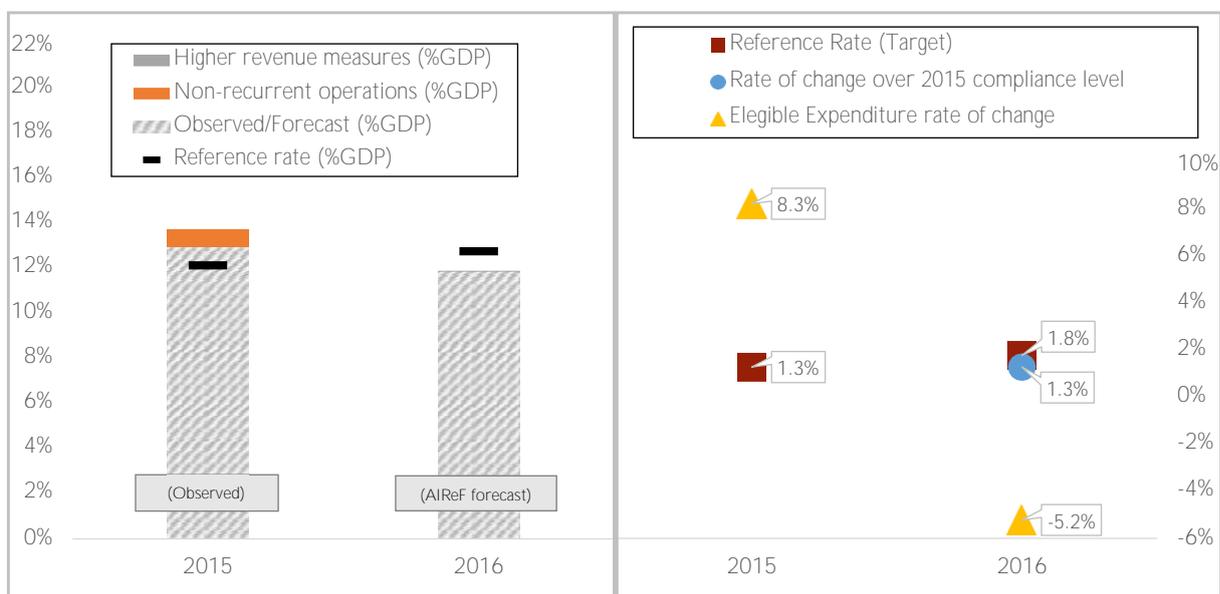
Catalonia

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). CATALONIA



AIReF considers **unlikely** that Catalonia will meet the SPU 2016 target. On the other hand, the likelihood of compliance from an analysis of the initial budget has improved on two counts which were not previously known: the final amount of non-recurring transaction (APP investments) was higher than initially expected and the final settlement of the 2014 funding system increased. However, the AIReF EFP assessment holds good, since the effect of non-recurring operations were taken into account.

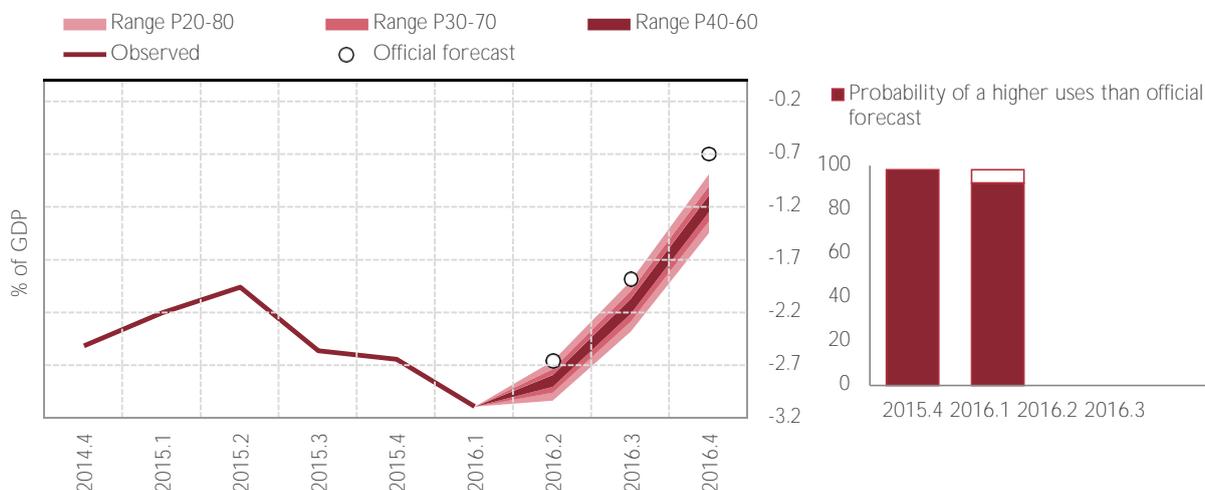
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. CATALONIA



AIReF does not foresee risk of lack of compliance with the expenditure rule for Catalonia for the year 2016, mainly due to the favourable effect of non-recurring 2015 operations. The estimated eligible expenditure for 2016 grew 1.3% over the 2015 level of compliance.

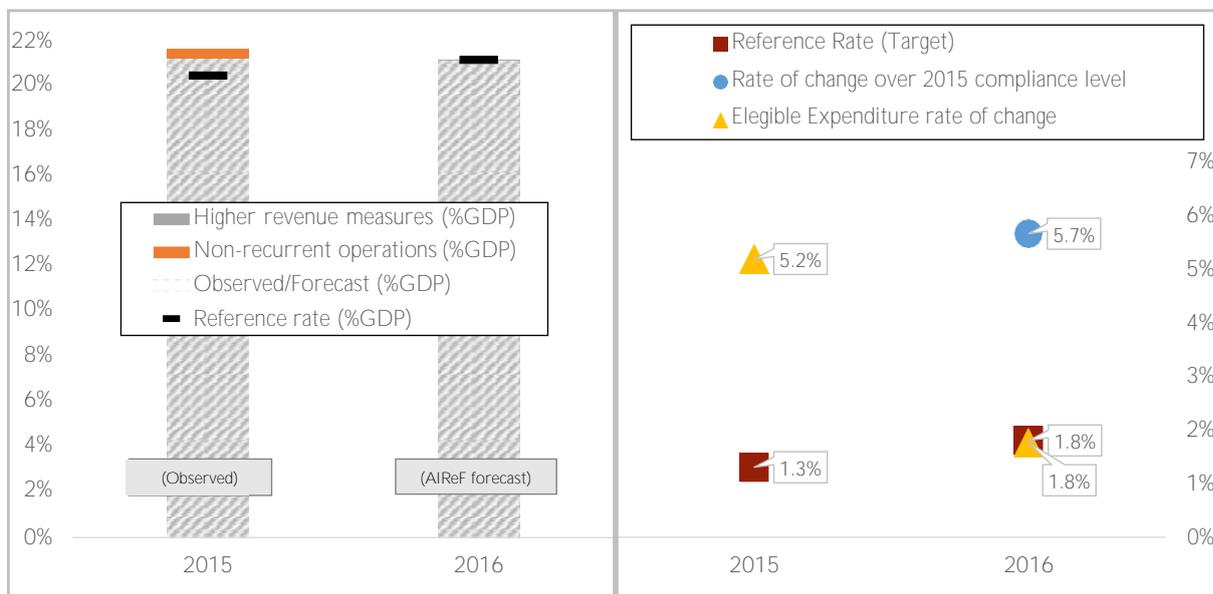
Extremadura

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). EXTREMADURA



AIReF considers **very unlikely** for the Autonomous Community of Extremadura to meet the SPU 2016 target. Analysis of the initial budget improves the likelihood of compliance due to a 2% of GDP Non-availability agreement and an increase in the final settlement of the 2014 funding system. On the other hand, the April data point to uncertainties reflected in the realization of anticipated revenues from the EU, which have worsened AIReF's forecast manifested in the Autonomous Region's EFP assessment.

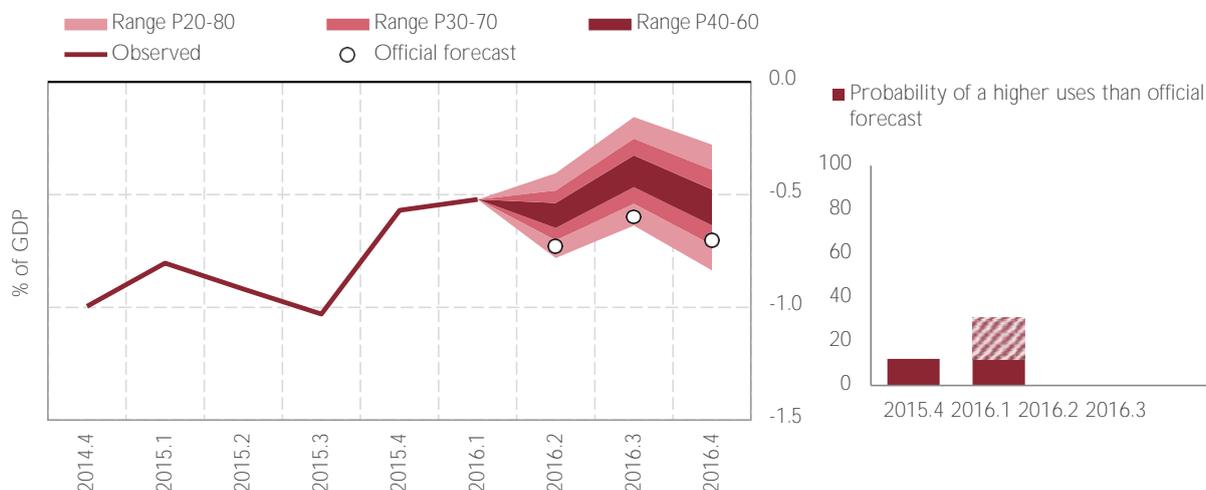
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. EXTREMADURA



AIReF does not foresee any risk of lack of compliance with the expenditure rule for Extremadura for the year 2016, mainly due to the favourable impact of 2015 non-recurring operations. The estimated eligible expenditure for 2016 grew 5.7% over the 2015 level of compliance.

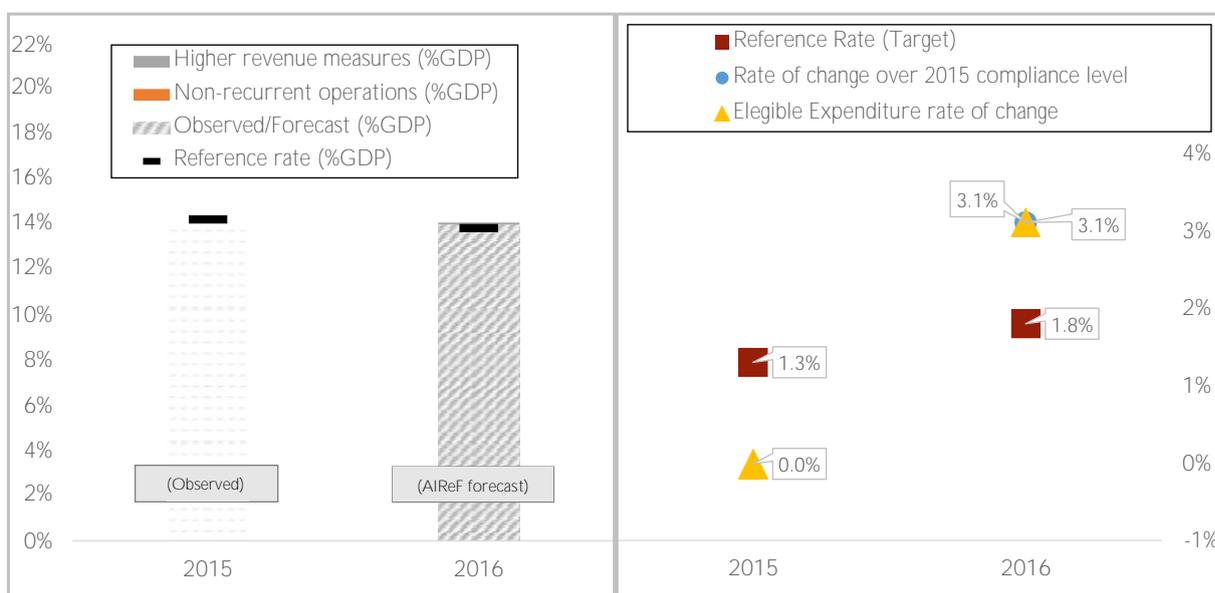
Galicia

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). GALICIA



AIReF considers as **probable** that Galicia will comply with the proposed 2016 SPU target. The probability of meeting a target of -0.7% with respect to the initial budget has deteriorated. This change rests on updating the region's year-end forecasts, which are close to the path proposed by the SPU, mainly by increasing their spending scenario, confirming the trend seen in recent data releases.

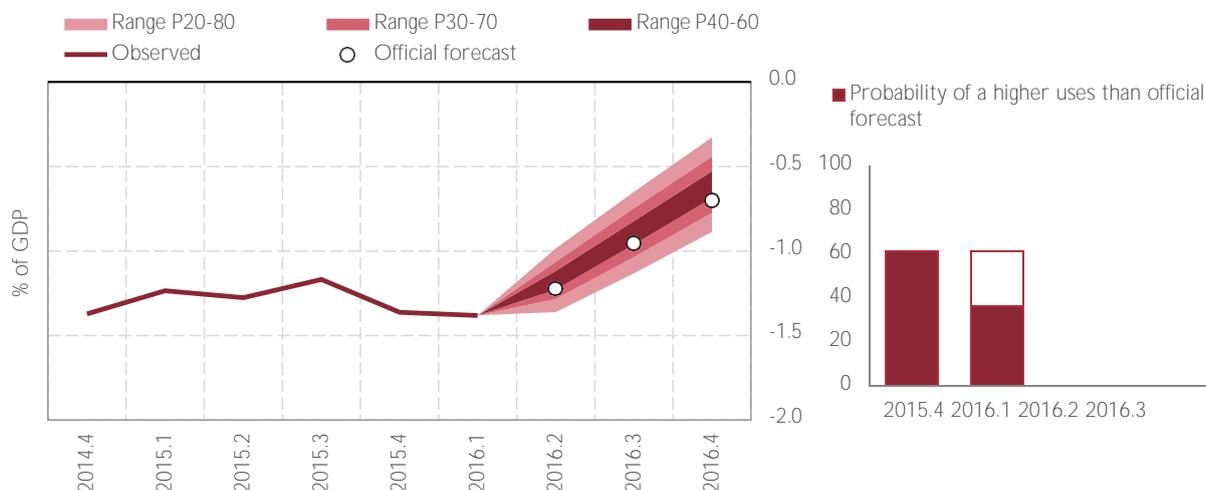
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. GALICIA



AIReF predicts a risk of lack of compliance with the 2016 expenditure rule for Galicia, derived from the expected trend in expenditure, compounded by regulatory measures to reduce the region's income for 2016. The estimated eligible expenditure for 2016 grew by 3.1% over the level of 2015, when the rule was fulfilled.

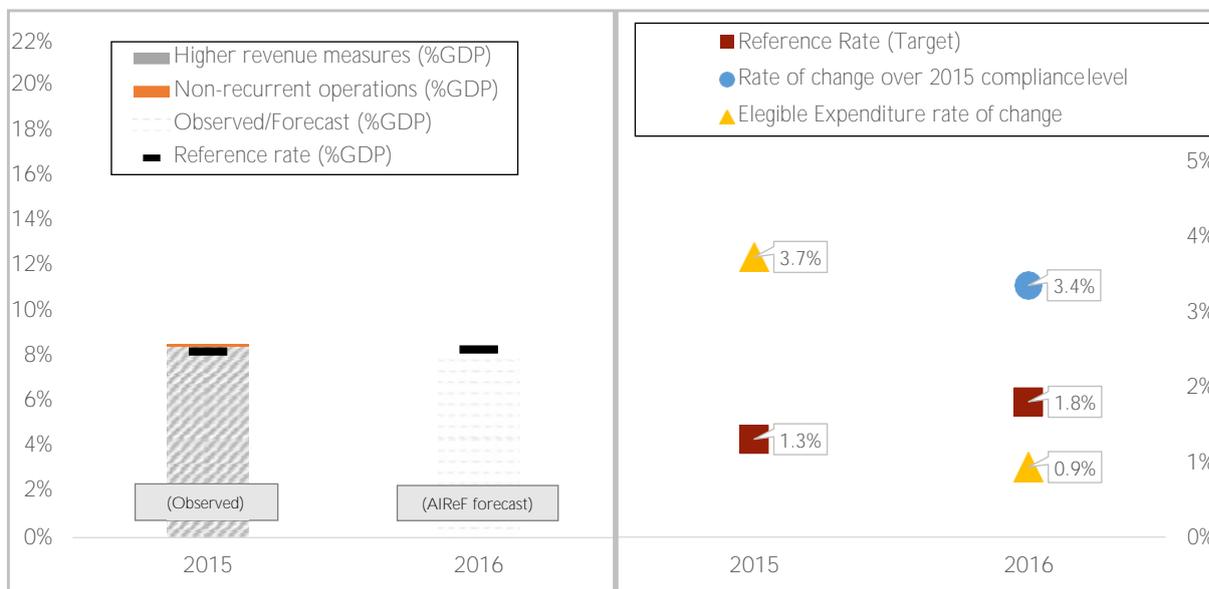
Madrid

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). MADRID



AIReF estimates as **probable** that Madrid will meet the 2016 SPU target. The likelihood of achieving this target (-0.7% of GDP) is greatly improved compared to the approved budget by: the downward revision of estimates of revenue and expenditure, provision of updated information on measures in the EFP and the increase arising from the final settlement of the 2014 funding system. Regarding the evaluation expressed by AIReF in the assessment of the EFP, an improvement occurs mainly due to the increase of the final settlement of the 2014 funding system.

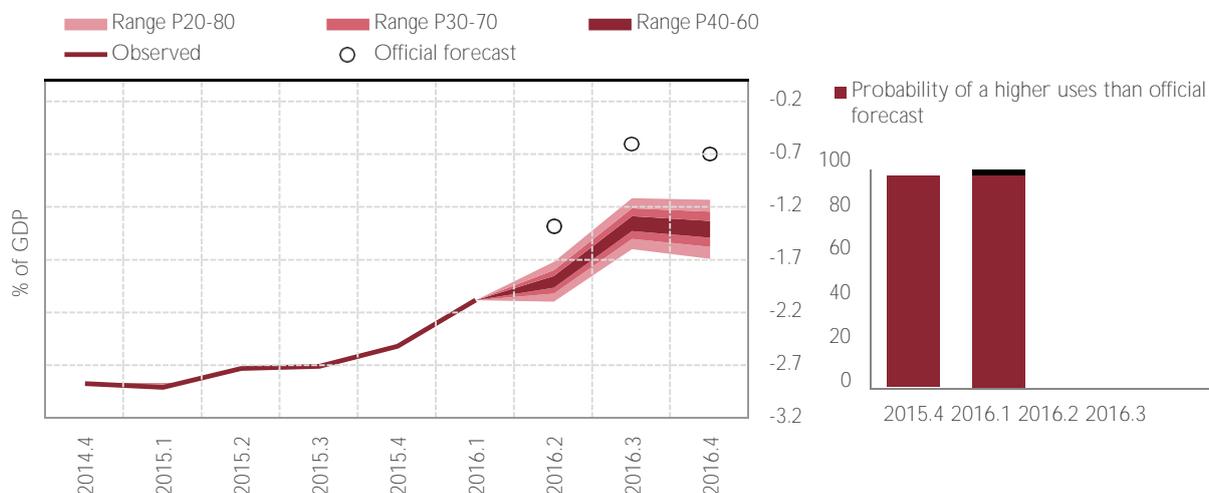
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. MADRID



AIReF does not anticipate risk of lack of compliance with this year's spending rule for the Community of Madrid. The 2016 estimate of computable spending grows 3.4% over the 2015 level of compliance.

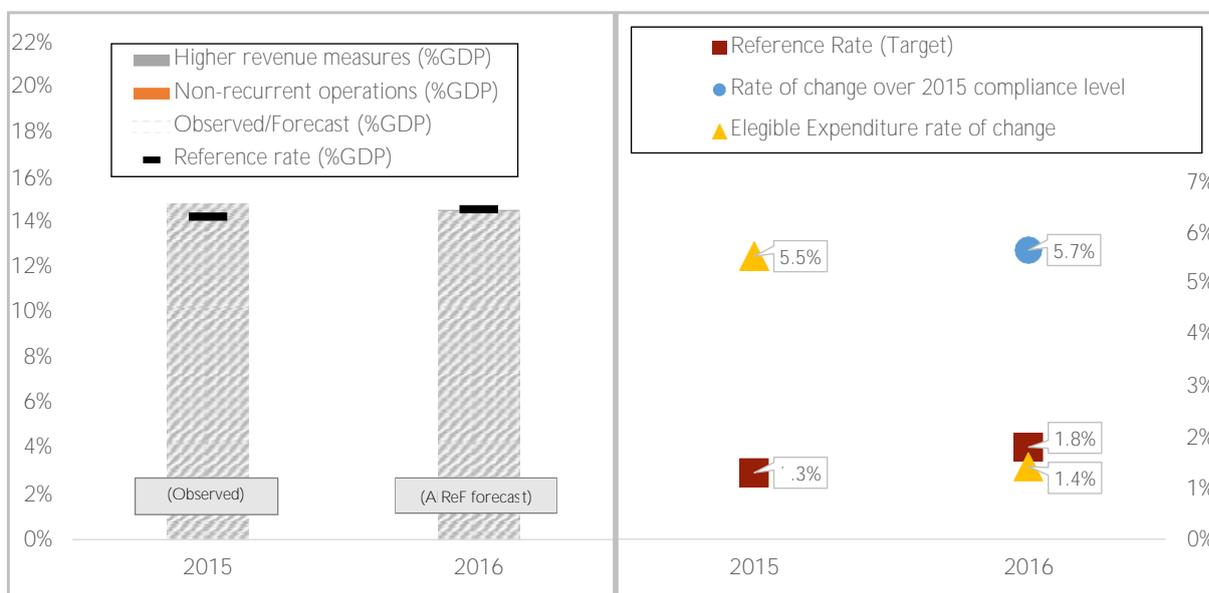
Murcia

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). MURCIA



AIReF considers **very unlikely** that the region of Murcia will meet the deficit target set by the SPU for 2016. The likelihood of achieving this objective (-0.7% of GDP) has fallen slightly since the analysis of the approved budget, mainly because the development of expenditure to April shows a higher increase than initially expected by AIReF, worsening the forecast closure. This situation, of which warning was already given in AIReF's assessment of the EFPs 2016-2017, has however improved slightly by the increase in the final settlement of 2014.

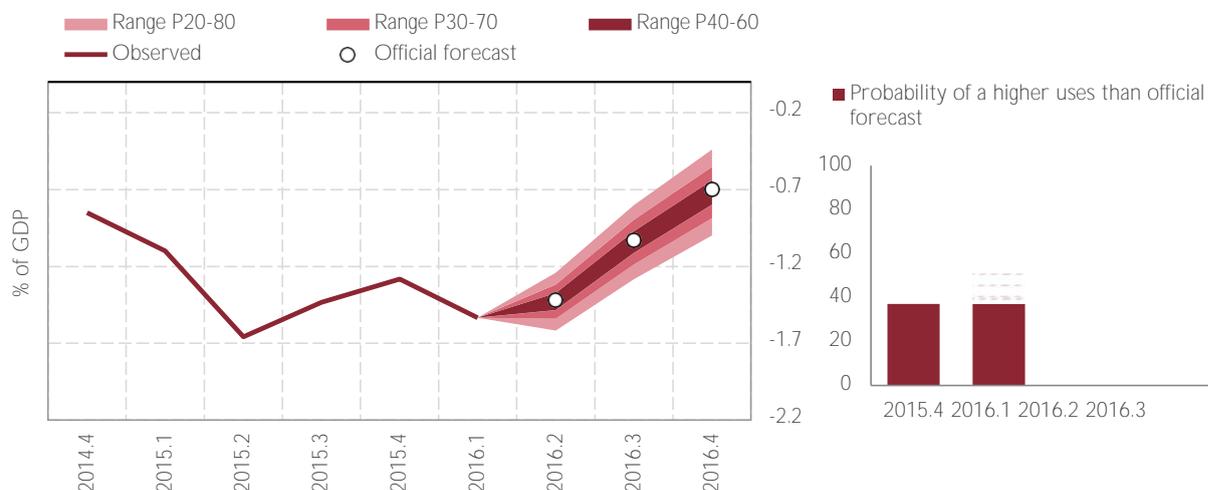
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. MURCIA



AIReF considers that there is no risk for the Autonomous Community of the Region of Murcia to breach the spending rule for the year 2016. The 2016 estimated computable spending grew 5.7% over the 2015 level of compliance.

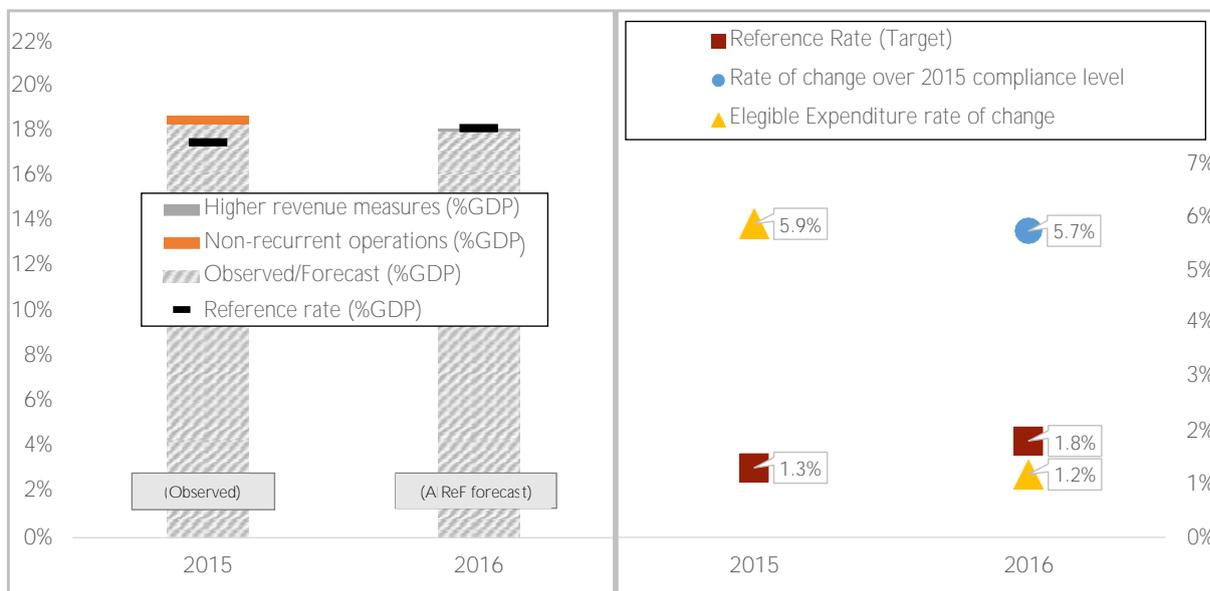
Navarra

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). NAVARRA



AIReF considers as **feasible** that Navarra will meet the deficit compliance forecasts for 2016, thereby maintaining the assessment made in the EFP 2016-2017 evaluation. However, the probability of meeting the target has fallen slightly with respect to the initial budget estimate, which contained a target of 0.3% of GDP. This easing was due to both the downward revision of revenue forecast as well as a rising trend in expenditure.

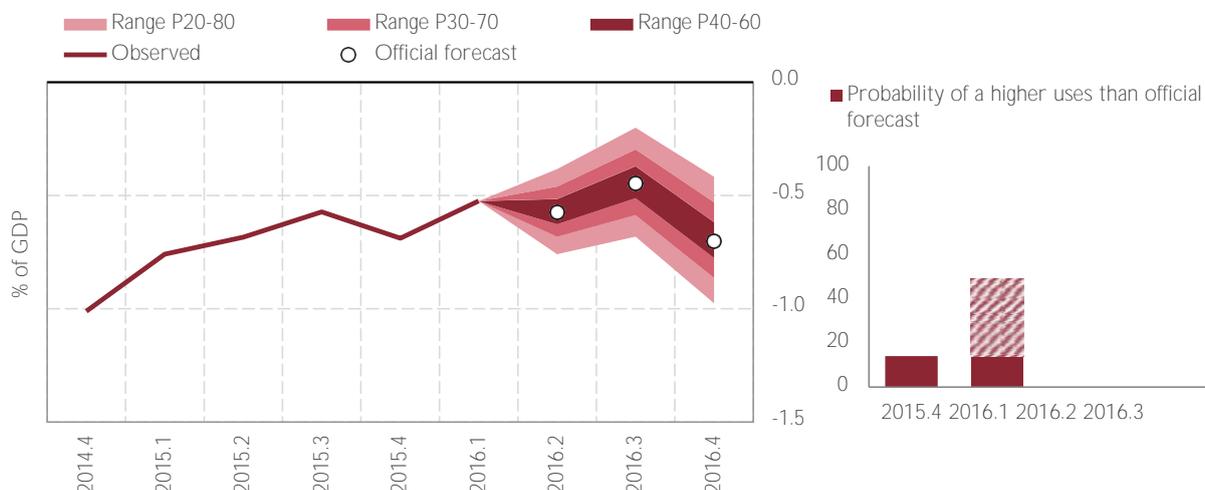
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. NAVARRA



AIReF does not appreciate a risk of lack of compliance with the Expenditure Rule in 2016 by Navarra, although the trend in expenditure with the data observed to date, if consolidated, could compromise the objective. The estimated eligible expenditure for 2016 grew 5.7% over the 2015 level of compliance.

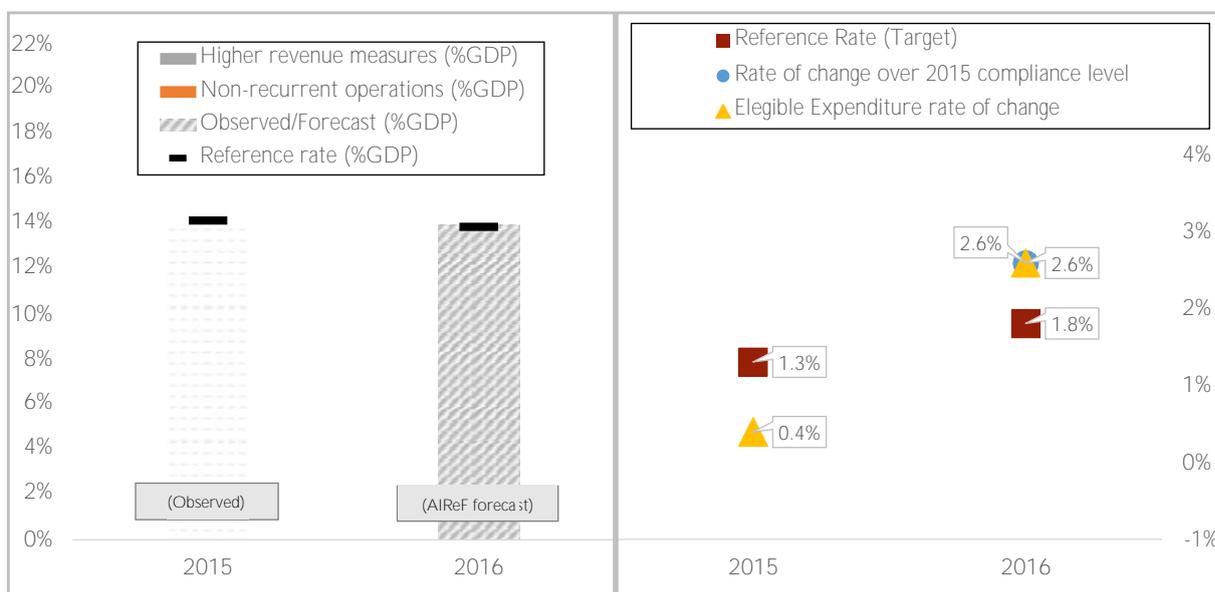
Basque Country

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). BASQUE COUNTRY



AIReF considers as **probable** that Basque Country will comply with the proposed 2016 SPU target of -0.7% of GDP. The probability of meeting this objective deteriorates notably from the analysis of the approved budget, drawn up under a scenario of -0.3% of GDP, mainly due to the significant downward revision in revenues to be received by the Provincial Councils.

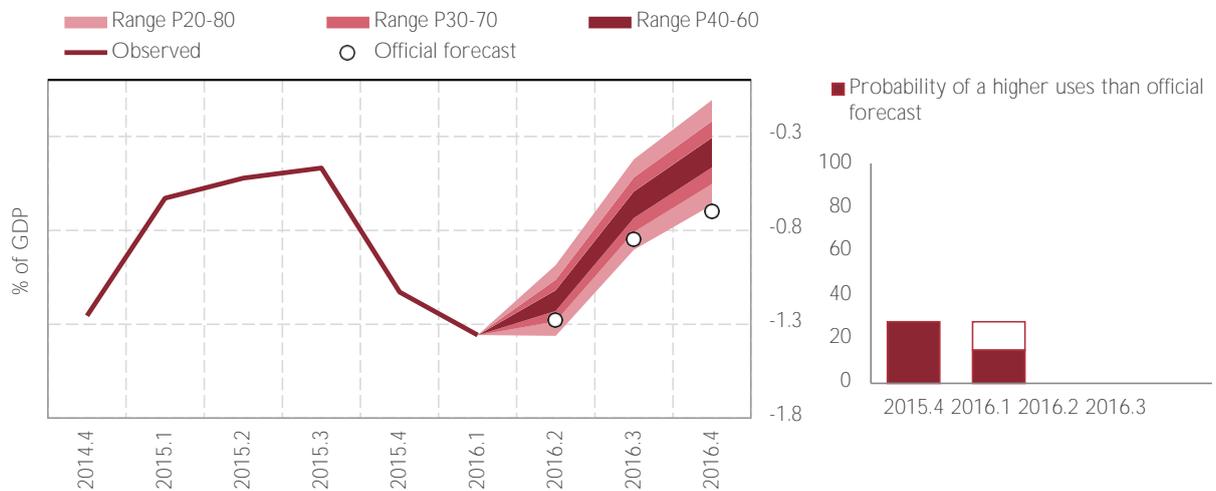
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. BASQUE COUNTRY



AIReF foresees a risk of lack of compliance with the Expenditure Rule in 2016 for the Basque Country, mainly due to the evolution of expenditure data revealed in April. The estimated 2016 eligible expenditure grew 2.6% over the 2015 level, when the rule was fulfilled.

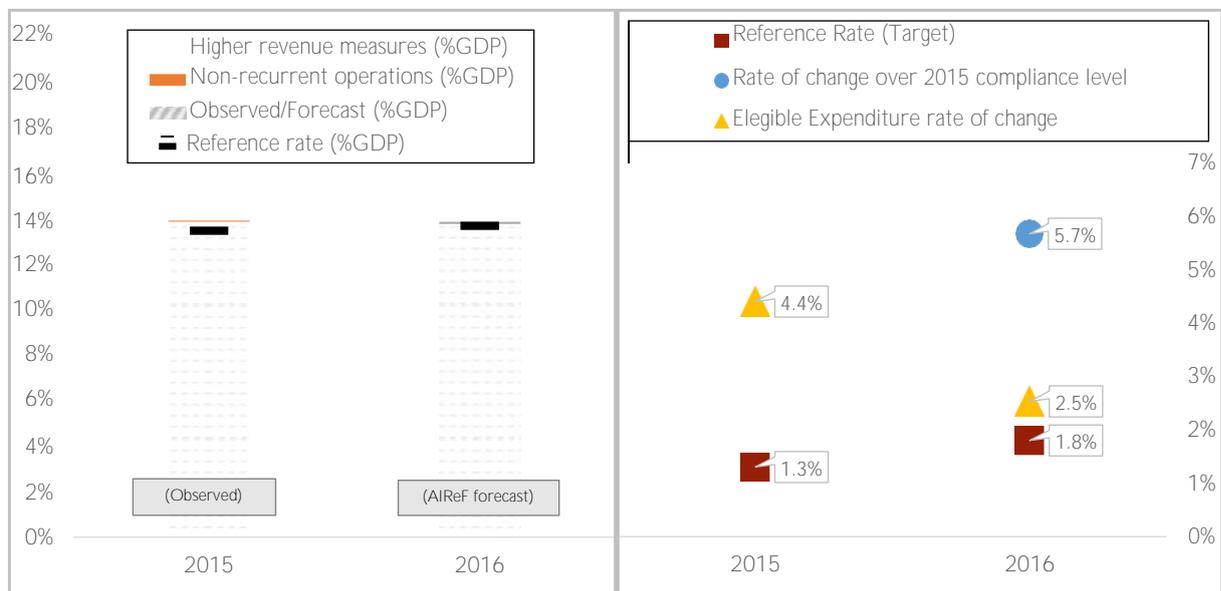
La Rioja

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). LA RIOJA



AIReF considers **very likely** that La Rioja in 2016 will achieve a lower level of debt than that proposed in the SPU. The probability of achieving the target has increased with regard to the initial budget estimate, despite changes that the new proposed target involves compared to those considered in the approved budget, since spending growth forecasts are prudent. The assessment made in the evaluation of the 2016-2017 EFP stands.

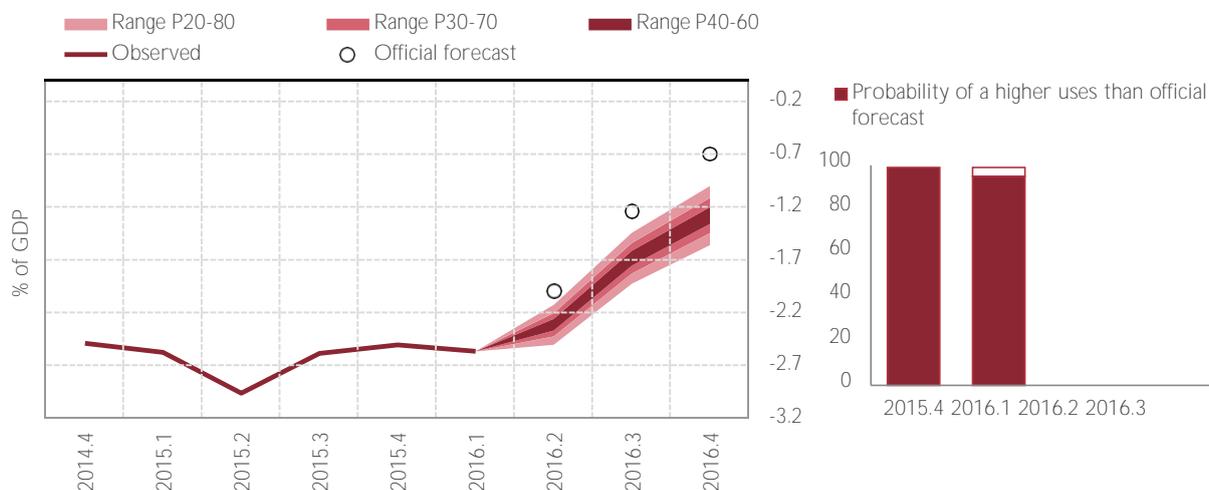
GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. LA RIOJA



The latest implementation data published show that the evolution of expenditure for La Rioja jeopardizes compliance with the Expenditure Rule for this year, compounded by regulatory measures to reduce the region's income in 2016. The estimated eligible expenditure for 2016 grew 5.7% over the 2015 level of compliance.

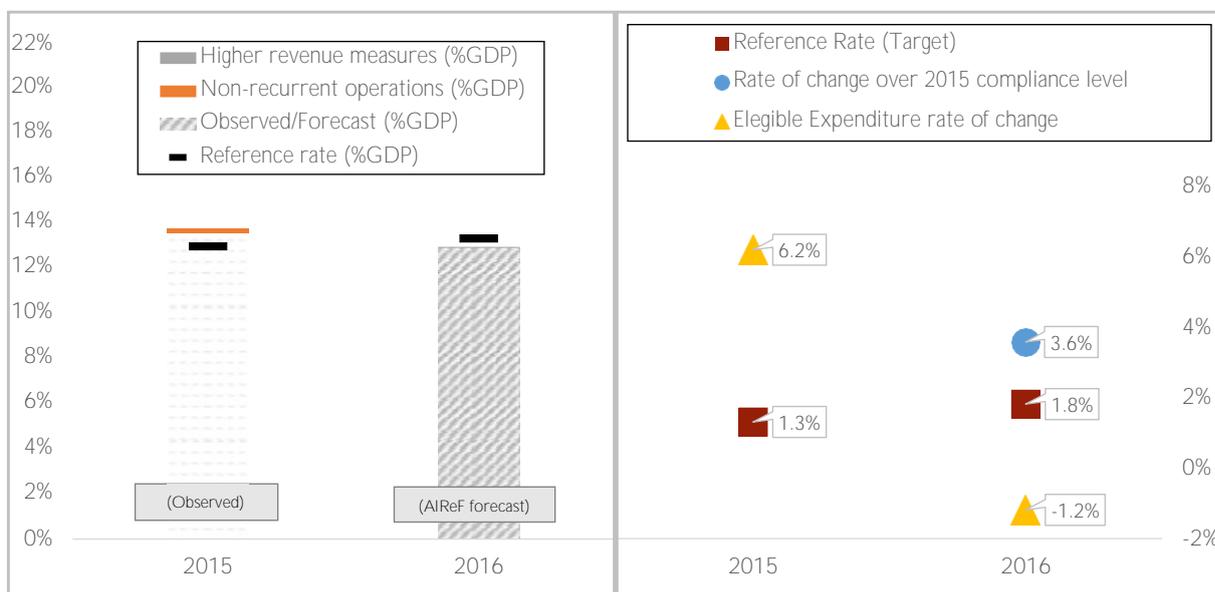
Valencia

GRAPH C1. NET LENDING/BORROWING 2016 (% GDP). VALENCIA



AIReF considers **very unlikely** that the region of Valencia will meet the deficit target set by the SPU for 2016. The high probability of default is down slightly from the initial budget analysis. This reduction is mainly due to the increase of the final settlement for 2014. The 2016-2017 EFP assessment holds for 2016.

GRAPH C2. ELIGIBLE EXPENDITURE WITH REGARD TO THE EXPENDITURE RULE (% GDP) AND VARIATION RATE. VALENCIA



AIReF does not foresee risk of lack of compliance with the Expenditure Rule in 2016 for Valencia, mainly due to 2015 operational margins not expected to occur in 2016. The estimated eligible expenditure for 2016 increased by 3.6% over the compliance level of 2015.