AIReF Autoridad Independiente de Responsabilidad Fiscal

Reports on the Draft Spanish Stability Programme Update 2015-2018

(Articles 14 and 16 of Organic Law 6/2013 creating the Independent Authority for Fiscal Responsibility)

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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Preliminary note

Organic Law 6/2013 creating the Independent Authority for Fiscal Responsibility (AIReF) refers to the Draft Stability Programme Update (SPU for *Actualización del Programa de Estabilidad,* APE, as it is known in Spanish) in articles 14 and 16, which regulate the issuance of a report analysing the programme update from two different standpoints. On the one hand, AIReF must report on the macroeconomic forecasts included in the programme update (article 14) following a request for it to do so by the government. On the other hand, it must also assess the programme from the perspective of the likelihood of compliance with the targets set and of whether the commitments made to achieving these are sufficient (article 16).

The first report has no set publication date. Nevertheless, the fact that the draft SPU eventually submitted to the European Commission has to indicate whether the macroeconomic forecasts have been endorsed by AIReF or not sets in practice the deadline for the report as 30th April[1]. For the second report, on the contrary, there is a specific statutory deadline set by the law as 15th April.

The deadline for issuing the two reports is very tight with no leeway for an extension. This means that any possible delay in receiving the information necessary for AIReF to analyse the data and draft the report has to be absorbed within the process, which must necessarily come to an end before the draft SPU is submitted to the European Commission (30th April). The complexity and importance of the draft SPU, insofar as it is the medium-term national fiscal plan, together with the fact that this is the first year AIReF had to report on it, has undoubtedly made it more difficult for the Authority to receive the text of the draft and the supplementary information *with sufficient time in advance* — a requirement of article 15 of its Organic Statute.

AIReF became aware of a number of substantive elements of the SPU during its drafting process but the content and details of this information and the fact that the text of the draft SPU was not available, forced AIReF to publish an informative note[2] on 15th April, indicating that the publication of the report provided for in article 16 of the Organic Law was postponed to a later date.

Once the information necessary for issuing the two reports was received, they are published jointly here in a single document to facilitate a full understanding of the

[1]Article 4.1.of Regulation (EU) Nº 1175/2011 of the European Parliament and of the Council, amending Council Regulation (EC) Nº1466/97 of the Council on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, establishes that stability programmes shall be submitted annually in April, preferably by mid-April, and not later than 30th April. http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0012:0024:EN:PDF

[2]http://www.airef.es/system/assets/archives/000/000/582/original/Nota_informativa_relativa_al_Informe_sobre_el_proyecto_de_Programa_de_Estabilidad.pdf?1429101304

analysis conducted by AIReF on the draft Spanish SPU 2015-2018. The conclusions of both reports were submitted to the government before 30th April for appraisal and inclusion in the final text submitted to the European Commission, together with the recommendations put forward by AIReF during the process and the final endorsement of the macroeconomic forecasts, pursuant to the AIReF law and its statutes.

Key conclusions of the analysis of the Draft to the Spanish Stability Programme Update 2015-2018

AIReF endorses the macroeconomic forecasts of the draft Stability Programme Update 2015-2018 (SPU for Actualización del Programa de Estabilidad*, APE, as it is known in Spanish), based on the exogenous assumptions and defined policies and it considers the fiscal consolidation objectives of approaching a balanced budget by 2018 ambitious but achievable.*

The forecasts of the **government's** macroeconomic scenario assume a significant recovery in the economic cycle such that the output gap closes by 2018, the end of the projection period. This scenario is underpinned by highly favourable monetary and financial conditions against a backdrop of a dynamic external sector, with high world and EMU growth and a consolidation of the improvement in the Spanish economy's real terms of trade.

The budget scenario forecasts are partly prudent and partly normative. The limited favourable effects of the economic cycle on the primary balance of public sector accounts are prudent forecasts, tax revenue in particular, as are the moderate savings in interest payments. The forecasts of general government sector consumption and investment are normative given that they stem from the government's rigorous policy of containing discretional public spending.

Considerable risks of deviation have been identified, however, in the expansionary assumptions made and in the implementation of the restrictive spending policies designed. The first risk would be reflected in slightly less buoyant and stable growth, according to the historical experience shown by the analytical models used by AIReF. In contrast, a more relaxed spending policy would fuel growth in domestic demand and prices, widening the external trade imbalance of the Spanish economy and, more specifically, increasing private-sector financing needs. Effective containment of discretional public spending within the limits set in the programme would moderate the cyclical expansion in demand, prices and the financial imbalances of the Spanish economy and all its sectors. Although there would be less of a cyclical component in revenues and expenditure sensitive to economic developments, the reduction in the government structural deficit would be greater than in the previous case and would lend more credibility to the public debt reduction path.

These risks for the macroeconomic scenario would affect growth in real GDP and employment upwards in the short-term and downwards later on in the programme timeframe. A comparison of the government's macroeconomic scenario with the forecasts of private institutions and international bodies, and with the dynamics of the macroeconomic models used by AIReF, leads to the conclusion that the very strength of the current expansion in economic activity entails a risk of a sharper slowdown in the future. The risks affecting very short-term domestic demand seem to be upwards, tending to change its sign as we move forwards. Strong job growth and a marked fall in the employment rate are in sharp contrast to the persistent wage moderation and low inflationary pressure forecast in the macroeconomic scenario. There is a risk that both the unemployment and the inflation rate could be higher at the same time. With respect to external demand, there is a risk of lower exports and higher imports, resulting in a risk of the external sector deficit exceeding government forecasts.

Achieving the ambitious fiscal consolidation targets means rolling out a stringent budgetary policy that includes new expenditure containment measures against a backdrop of cyclical economic recovery. Indeed, the main risk inherent to the fiscal scenario in the draft SPU for the government sector as a whole stems from the forecast for public spending, estimated by the government to drop by a total of 5 percentage points of GDP by the end of 2018. This forecast entails restricting public sector consumption in aggregate terms. The margins for manoeuvre that seem to exist in the budget scenario regarding the possible favourable cyclical effects on the primary balance of public sector accounts and the foreseeable saving on debt servicing, should they materialise, would have to offset the tensions that will tend to emerge in certain expenditure components. At the same time, strict enforcement and close monitoring will have to be implemented on all levels of the PAs concerning the expenditure rule and the measures included in the SPU with the greatest economic impact (measures to rationalise public spending in the framework of the PA Reform Committee, system of direct settlement of social contributions, instruments to support the sustainability of health spending and local government reform).

There are risks stemming from a mismatch between the available resources and the level of provision of public goods and services corresponding to each subsector of the general government in accordance with the current distribution of competences. The persistent surpluses or deficits, driven by imbalances between the funding received by the different levels of the Public Administration and their spending requirements linked to competences, pose a risk to the sector as a whole that could prevent it from hitting budget stability targets, insofar as it could lead to a more lax attitude towards meeting the targets, which some see as unattainable and others as easy to achieve.

The SPU fiscal scenario shows that the Social Security Funds subsector is unlikely to meet the expected fiscal consolidation milestones. Although the SPU only includes a fiscal scenario for the general government sector as a whole, the specificity of revenues and expenditure in this particular subsector makes it possible to analyse the forecast development of its resources and uses without having to make any major assumptions about the distribution amongst subsectors. It is highly unlikely that the Social Security system will meet the deficit reduction targets set in the SPU, bearing in mind the legal framework in which both the level and the composition of its income and expenditure are defined. Thus, the trend in social security contributions will not allow meeting the -0.1% of GDP target set for the end of the period, even if the forecast scenario of a highly dynamic job market should materialise.

The Central Government is likely to meet the target set in 2018, although it may not have sufficient margin to offset the Social Security shortfall. The conservative tax revenue and interest expenditure forecasts of the SPU may give the Central Government the margin necessary to meet the targets set, although much of extra tax revenues will go to the Autonomous Regions as part of the funds paid out by the State in the funding system of interim instalments and final settlement. On the other hand, in line with article 11.5 of the Organic Law on Budgetary Stability and Financial Sustainability (*Ley Orgánica de Estabilidad Presupuestaria y Sostenibilidad Financiera,* LOEPySF), it seems reasonable to analyse the economic-financial situation of the Central Government and Social

Security jointly. From this standpoint, even if the margins indicated in tax revenues and interest rate expenditure were to materialise for the Central Government they are unlikely to be sufficient to offset the deviation in the Social Security Funds mentioned above.

There is a risk that the goal set for the Autonomous Region subsector of achieving a balanced budget may not be met in 2018 if the deficits that some of the ARs will probably record are not offset by the surpluses of other regions. Over the period, the Autonomous Regions will see an increase in their revenues from the funding system that reflects the economic recovery, albeit with a two-year time lag. However, this overall situation might be the result of compensating the deficit that the Autonomous Regions starting off in the worst initial situation will most likely record with the surplus that the Regions in a more comfortable financial situation will probably show. This offsetting requires a strict application of the expenditure rule that implies that the closer an administration is to achieving the budget balance or budget surplus, the more demanding the expenditure reduction policy is compared to the one resulting from meeting the nominal target of budget stability.

The Local Corporations subsector has sufficient margin available to meet the target of balancing the budget during the four years of the SPU. The healthy state of the local government subsector's finances means that the expenditure rule and the inertia of their revenues will take them beyond the budget target set. However the budget surpluses of the Local Corporations do not appear to be sustainable over a prolonged period against a backdrop of significant deficits among the other PAs.

AIReF makes the following recommendations:

1. The funding made available to the different levels of the PAs should be reviewed with a view to bringing their resources in line with the public goods and services provision responsibilities of each one pursuant to the current distribution of competences;

2. The situation of the Social Security Funds should be analysed given that the short and medium-term financial tensions in this subsector could pose a real and significant risk to the fiscal consolidation path;

3. The same importance should be placed on compliance with the expenditure rule as for budget stability and public debt targets, which requires enhanced transparency in its enforcement. In particular, AIReF recommends:

   - ✓ That the budgets of all the PAs for 2016 include a specific section in their Economic & Financial Report, or equivalent, identifying the components and calculations of the expenditure rule in sufficient detail to be able to reproduce it, and
   - ✓ That regular information be made available throughout the year on the extent of compliance with the expenditure rule at the different levels of general government;

4. The SPU should be supplemented with the minimum set of information to be provided in the forecasts and with the detailed specification and release of the methods, assumptions and data used to prepare them, pursuant to the requisites laid down in Directive 2011/85 on

budgetary frameworks and in article 29 of the LOEPySF, which defines the content of the medium-term budgetary plans of the PAs.

5. The macroeconomic forecasts published should include the pertinent methodologies, assumptions and parameters that underpin them, thus meeting the requisites established in Directive 2011/85 on budgetary frameworks.

6. The appropriate legal procedures should be applied in order to extend the transition period for compliance with the limit foreseen in Article 13 of the LOEPySF, adapting the requirements set up in transitional provision one of the aforesaid act and devising a reference path that is both credible and demanding, in order to achieve a sustained reduction in public debt ratio.

Report on the macroeconomic forecasts used in the Draft Spanish Stability Programme Update (SPU) 2015-2018

(Article 14 of Organic Law 6/2013 creating the Independent Authority for Fiscal Responsibility)

Introduction

The macroeconomic forecasts included in the draft Stability Programme Update (SPU) must be accompanied by a report from the Authority indicating whether it has endorsed them, in accordance with the Organic Law creating AIReF. This report fulfils that remit and provides an assessment of the government's macroeconomic scenario as it was submitted to AIReF.

This report only considers the key figures of the draft macroeconomic and budget scenario that has been provided to AIReF by the government. This information does not allow an exhaustive analysis of these scenarios to be made, but it does allow a general analysis of their internal consistency. This report on the forecasts is issued together with the report on the draft SPU. In the latter, AIReF makes a detailed analysis of the text and appraises the adequacy of the measures set out in the budget scenario with respect to fiscal consolidation targets, bearing in mind their consistency with the macroeconomic scenario adopted.

The Draft SPU is the key document for European Union Member States to programme their medium-term fiscal policy and coordinate their economic policies. The content and form must satisfy the requisites of the Code of Conduct for implementing the Stability and Growth Pact.

The AIReF report on the draft SPU macroeconomic forecasts comprises two central parts, which deal separately with the macroeconomic scenario and budget for 2015-2018 (section 2) and the analysis of the sensitivity of this baseline scenario to possible risks and alternative scenarios (section 3). After the introduction to the report, section 1 presents an ex post analysis of the macroeconomic forecasts contained in previous updates of the Draft SPU and finally, section 5 of the report presents a summary of the overall appraisal of the official scenario and offers some suggested best practices and recommendations.

The macroeconomic forecasts made in previous years are examined in order to assess whether there was any significant bias[3] in the mistakes made. To this end, the government's forecasts for the main macroeconomic variables are compared first with those of other independent private and public-sector institutions and then with the results observed. The bias or difference in the forecasts of the different macroeconomic variables against the average of the benchmark institutions is considered significant if it is large, that is, if the figure forecast by the government falls outside of the interquartile range of the distribution of the independent forecasts; if it is systematic, in other words, repeated in consecutive years; and if, furthermore, it has not been justified by being closer to the observed results.

[3] Article 14.4 of the Organic Law creating AIReF requires this report to include an assessment of whether there is a significant bias in the macroeconomic forecasts estimated for a period of four consecutive years, all of that in accordance with COUNCIL DIRECTIVE 2011/85/EU, of 8th November 2011, on the requirements applicable to the budgetary frameworks of Member States.

The objective **of the detailed analysis of the government's forecasts for 2015**-2018 is to assess whether they are realistic and whether they define the most likely macroeconomic scenarios, or a more prudent one[4]. To do this, first of all checks are made for bias in the forecasts for the key variables, by comparing them with the forecasts of other institutions, as in previous years. The methods, parameters and assumptions that underpin the forecasts are also reviewed —available information permitting— and AIReF also checks that the most updated information is used.

[4] Article 14.3 of the Organic Law creating AIReF requires the report to appraise the adequacy of the forecasts made to EU COUNCIL DIRECTIVE 2011/85/EU, of 8th November 2011, on the requirements applicable to the budgetary frameworks of Member States. Article 4.1 of the directive establishes that budgetary planning shall be based on the most likely macrofiscal scenario or on a more prudent scenario

1. Macroeconomic forecasts included in previous SPUs

1.1. Forecast comparison criteria

When comparing different forecasts, it is essential to bear in mind the information available at the time they were made and the specific assumptions that were used in them, as these two components can have a significant effect on the differences between them. The reasons for such differences need to be understood in order to assess whether there have been biases in the government forecasts ex ante, i.e. at the time they were made. The comparisons of forecasts for the macroeconomic scenario 2015-2018 are considered in the next section.

The ex post analysis compares government forecasts with the forecasts of other institutions, including both private institutions (grouped together in the consensus forecast) and public ones (European Commission, Banco de España, OECD and IMF, considered individually). The purpose of the comparison is to see if there are significant biases in the government forecasts, without analysing or justifying the reasons that could explain the differences observed.

The consensus forecasts of the private institutions are published regularly, but they do not cover all the variables of interest. The latest forecasts published before the draft SPU is submitted may include the latest information publicly available and all the forecasts are published at the same time. For comparison purposes, the average or consensus forecast of the diverse panel of private forecasters provides a satisfactory reference in terms of the independence and predictive results of the key macroeconomic variables.

The forecasts made by the European Commission, Banco de España, the OECD and the IMF are more complete but less directly comparable, because they are published less frequently. As a result they could be out-of date by the time the government is preparing its forecasts, and their specific assumptions may differ substantially. That is why, although the latest forecasts published by the public institutions are a highly relevant part of all the information on which government forecasts are based, they will be dealt with separately from those of the private institutions. IMF forecasts are particularly useful for assessing the forecasts of the government included in the draft SPU because they are the only ones that encompass the same time span.

If a bias in the government forecast is large, repeated in several consecutive years or is not justified by being closer to the result observed, it will be considered a significant bias. A bias in a variable is defined as the difference between the official forecast and the average of the forecasts made by the benchmark institutions. To assess whether the biases in the government forecasts for the different variables that define its budget macroeconomic scenario were significant in recent years, AIReF will take the approach of observing the deviation error of the forecasts against the data finally observed. In short, the government's initial forecasts (G) are compared: (i) with the most recent previous forecasts of the private institutions published in the consensus forecast (C) to reveal any bias there may be; and (ii) with the observed result (R), or the most up-to-date forecast made by the government itself is used if the result has not yet been estimated, which represents the final error of the forecast. A bias is large if the government forecast falls outside of the interquartile range[5] of distribution of the panel forecasts. The deviation of the government forecasts against the consensus forecasts will not be considered justified if its absolute forecast error is greater than that of the consensus forecast; in other words if |G-R|>|C-R|.

1.2. Retrospective analysis of the forecasts for 2011-2014

The macroeconomic scenario included in the draft SPU 2011-2014 projected a sustained recovery of the Spanish economy after the deep recession of previous year. According to the government forecasts, a 1.3% recovery in real GDP growth would be driven by external demand, with exports growing twice as fast as imports, while domestic demand remained flat.

Official forecasts showed an extremely optimistic bias, being the highest of all the forecasts (see tables and graphs in the Appendix). There was also a large bias in the composition of domestic demand, with government consumption holding back the growth of private-sector demand, and extreme optimism with respect to the fiscal consolidation target, with deficit targets of 6% and 4.4% of GDP in 2011 and 2012. No other panel forecaster believed those targets to be attainable.

The expected pattern of recovery was the same for both private and public forecasters, despite the apparent slowdown in economic activity seen since Q2 2010, which was to become negative growth from the beginning of 2011. The Spanish economy would continue to slip into ever-deeper recession for two more years, with the annualised rate of the fall bottoming out at almost 3% towards the end of 2012, and an average fall in real GDP of 0.6% in 2011 and 2.1% in 2012.The large initial biases and the optimism concerning the results of fiscal consolidation were not justified by being closer to the data observed ex post.

As the recession deepened, the government forecasts in the draft SPU 2012 - 2015 predicted a 1.7% fall in real GDP in 2012, which was in line with the consensus of all the forecasters. All components of domestic demand were predicted

[5] The interquartile range is a dispersion measure defined as the difference between the first and third quartile, thus including 50% of the observations found around the median.

to continue to shrink in 2012, against a backdrop of a worsening sovereign debt crisis across Europe and widespread fiscal consolidation measures. As a mirror image of the fall in domestic demand, net external demand was expected to substantially attenuate the fall in real output. The government forecast that exports would grow by 3.5% and imports would fall 5.1% in 2012. All the forecasters predicted that the recession would continue at a more moderate rate in 2013, although the government expected real positive growth (0.2%, which coincided with the upper limit of the interquartile range of the distribution of private forecasts), and a clear recovery over the next two years.

The Draft SPU 2012-2015 predicted a new drastic correction in the budget deficit of up to 5.3% of GDP in 2012, based in part on an 8% reduction in real government consumption, showing a large restrictive bias in both cases. This bias turned out to be unjustified ex post. Real GDP shrank 2.1%, somewhat more than expected, with a sharper than expected fall in private-sector consumption and a far less severe contraction in government consumption (2.9%), while the government-sector deficit grew instead of falling.

The biases in previous updates towards greater growth in real GDP, with stronger contraction of government consumption and more buoyant private-sector demand, were substantially corrected in the draft SPU 2013-2016. The government predicted that real GDP would fall 1.3% in 2013 and grow 0.5% in 2014, only slightly more positive figures than those implicit in the private consensus forecasters and in line with the outlook of the Commission and the IMF. However, a slight degree of optimism remained in the expected correction of the budget deficit, for which a target of 6.3% of GDP was set for 2013. This optimism, however, was less notable than even the most positive view adopted by private forecasters, as they all expected a more pronounced fall in the budget imbalance, in contrast to the more pessimistic expectations of the Commission and the IMF, which predicted an additional increase in the deficit/GDP ratio.

The 2013 results were approximately what the government expected. GDP and domestic demand contracted less than expected, while the contribution made by external demand was less positive, because imports remained almost constant as the economy picked up in the second half of the year, while the deficit ratio overran and reached 6.8% of GDP.

The macroeconomic forecasts of the draft SPU 2014-2017 were revised upwards, after the sharp acceleration in economic activity in the first months of 2014, from 0.7% in real GDP growth in September 2013, to 1.2% in the spring of 2014. Although this figure fell outside of the interquartile range of the distribution of private forecasts when these were made, this large upward bias tuned out to be justified ex post, with real GDP growing 1.4% in the year as a whole. The forecasted growth in government consumption in 2014, however, which had shown a large restrictive bias on the budget forecasts for the year, and which was also revised up from -2.9% to -1.3%, ended up merely remaining flat.

In a cyclical context of strong recovery, the forecasted deficit-to-GDP ratio was also revised down from the 5.8% target to 5.5%, a figure that was below all existing forecasts, albeit without altering the future path of fiscal consolidation with the intention of abrogating the excess deficit procedure in 2017. Although the deficit for the general government sector as a whole in 2014 was 5.8% (5.7% without financial aid), the slippage was explained by a one-off, non-recurring factor (the refund of the "health cent"). The macroeconomic situation, which has continued to improve, together with the current fiscal position, offer a firm foundation for hitting the 2015 deficit target of 4.2% of GDP.

The macroeconomic scenario of cyclical recovery is developing significantly better than expected in the budget forecasts for 2015. The downside risks identified in October have not materialised, whereas additional factors giving momentum to growth have appeared since then. There is greater confidence both in the domestic and international environment. All of these factors are making it possible for domestic demand, the external sector and the labour market to develop better than expected, thus facilitating compliance with the demanding revenue scenario envisaged in the budget.

In summary, stability programme updates in 2011 and 2012 showed large upside biases in growth and fiscal consolidation. These biases were corrected in later years so they cannot be classed as systematic. However, although the comparison with other forecasts has not shown significant biases in any of the key variables, the degree of approximation to the observed data, in other words, the quality of the government's forecasts has been very different for these key variables. The government forecasts made in the 2011 and 2012 updates were generally less accurate than in subsequent ones.

In the appraisal of forecasting errors, consideration has to be given to the effect of the statistical revisions of the baseline of the previous year. In some cases, the differences observed ex post between the forecast and the observed variable are affected significantly by revisions of the provisional estimates of the year before. There have been fewer revisions for the debt/GDP ratio than for real GDP growth, and less revision was made of this variable than for the growth in the demand components. The element that was revised least was equivalent full-time employment. This component of the error in forecasting has a different qualitative meaning than the component of errors in the profile and magnitude of the expected performance of a variable. In terms of the profile, the peculiarity of the forecasts for government consumption in three of these four years is notable. With the exception of the draft SPU 2012-2015, which predicted a slowdown in government consumption of almost six percentage points, but turned out to be approximately half of that, all the other years predicted a relatively constant rate of contraction for the four years of the programme (around 0.8% for 2011-2014, 3.7% for 2013-2016 and 1.6% for 2014-2017). Ex post deviations of this variable against the initial forecasts have been significant because the persistence of the recessive economic environment buffered the pro-cyclical contractive adjustment the fiscal policy had been programmed with.

2. Macroeconomic scenario of the draft SPU 2015-2018

2.1. Introduction

The forecasts of the government's macroeconomic scenario in the draft SPU 2015-2018 use the latest information available. They have taken into account the latest short-term indicators, which have a significant influence on the immediate outlook and which therefore influence the starting point of any macroeconomic scenario for 2015-2018.

There is very little public information on the methods and parameters that underpin the G**overnment's forecasts**[6]. Although the methodology used to draw up the forecasts appears to be standard, with models and equations widely used by analysts, the specific instruments used have not been published. Furthermore, the information set and forecasts that should be included in an accounting framework to give it unity and internal consistency are not published along with the forecasts either. This makes it difficult to understand the connection between the key variables in the macroeconomic scenario.

The basic hypotheses of the g**overnment's macroeconomic scenario are** examined in this section and the government forecasts are compared with those of other insti**tutions and with AIReF's own projections** of an inertial scenario. As in the previous section, although now from an ex ante point of view, a check is run to see if there is a bias in the government's forecasts for 2015 by comparing them with those of other institutions. The official forecasts are also analysed against an inertial scenario drawn up by AIReF as a reference, following the routine described in section 2.4.

2.2. Limitations to the scope of this report

The information provided by the government does not allow for a detailed analysis of the consistency of its macroeconomic and budget forecasts. As AIReF recommended last September (see Report on the Macroeconomic forecasts contained in the draft general budget for 2015), it would have been necessary to include the key elements of the forecasts in a simplified framework of national accounts to be able to understand the connections between economic activity, demand and employment, on the one hand, and income flows and borrowing on the other, thus identifying the impact of the policy measures taken by the government.

[6] Article 4.5 of Directive 2011/85/EU, requires Member States to make public the methodologies, assumptions and relevant parameters underpinning their macroeconomic and budget forecasts.

This data set is hardly enough to make an aggregate macroeconomic analysis of the main lines of the draft SPU. AIReF has used its own analytical tools to fill this information gap and appraise the official forecasts, as its legal remit requires it to do. To examine the consistency of the macroeconomic and budgetary forecasts, the accounting relationship of the figures included in the macroeconomic table and in the general government sector accounts with the other institutional sectors is established, in order to get to the national economy's accounts with the rest of the world. Different models are then used to analyse the behaviour of families, enterprises and financial institutions in reaction to the fiscal policy decisions adopted to attain the programme targets, insofar as they are quantified exactly.

The realism of the forecasts is analysed with a set of instruments for assessing the likelihood and risks associated with a specific scenario. The methodology used by AIReF combines three kinds of instruments: macroeconomic models to analyse the interaction of the macroeconomic and fiscal variables, satellite models to project public revenues and expenditure and debt movements, and accounting algorithms to maintain the consistency of the figures projected independently.

Different macroeconometric models are used depending on the horizon of the analysis. In the short-term —two or three quarters—, GDP forecasts, demand components, employment, etc., are strongly relying on dynamic factor models that incorporate the latest available information. For a timeline of six to eight quarters, the preferred model is a Bayesian vector auto regression model (BVAR), which includes the dynamic interaction of the key macroeconomic and fiscal variables (real GDP and deflator, employment, credit, and taxes plus social security contributions net of social benefits). For longer time spans, a model with error correction mechanisms is used in order to project the adjustment paths of the most important variables.

Satellite models are normally single equation and independent, and they are used to forecast tax revenues separately (on personal income and corporate income, VAT, excise duties, etc.), social security contributions, government sector consumption and investment, pensions, interest payments and the dynamics of debt.

Accounting algorithms allow information from different sources to be integrated —exogenous variables, forecasts from models, expert judgements— in a consistent set of accounts that presents the synthesis of the macroeconomic and fiscal scenario.

2.3. Assumptions, cyclical position and potential growth

2.3.1. Assumptions

The basic hypotheses of the draft SPU macroeconomic scenario are just slightly more optimistic in 2015 and 2016 than the forecasts of the international bodies and market expectations, although this divergence is greater in 2017 and 2018 (see tables in the Appendix). Until 2016, the initial assumptions based on the hypotheses of the European Commission present a likely albeit fairly benign international environment, as the driving forces of recovery in the advanced economies gain traction, especially in the European Union, and none of the downside risks materialise. This scenario rests on two assumptions. Firstly, oil prices remain substantially lower than in the past, driving real disposable income in oil-importing countries. Secondly, the ECB maintains an openly expansionary monetary policy and its asset purchase programme generates a sharply favourable impact on the interest rate curve, the exchange rate of the euro and equities, and reduces financial fragmentation. Furthermore, all this is accompanied by a more moderate fiscal adjustment. It also considers that financing conditions will continue to improve in Spain. Finally, it also implicitly assumes that there will be no escalation in geopolitical tensions. The environment becomes even more optimistic in 2017 and 2018, given that on top of the favourable backdrop above, there is an acceleration of the world economy in general and in the European Union particularly, despite the expectations of lower potential medium-term growth and the risks of a slowdown in the advanced economies.

The basic hypotheses assume that the long-term interest rates on Spanish government debt will remain historically low against a backdrop of improving financing conditions for business and families. In the macroeconomic scenario for the draft SPU 2015-2018, the 10-year interest rate on Spanish government debt remains very low on average until 2016 and will fall in 2017 and 2018. This hypothesis implies a certain normalisation of financing conditions for firms and households, as the ECB maintains its asset purchase policy beyond 2016, and after the bank restructuring effort made in the Spanish economy. In terms of the spread of Spanish sovereign bonds against German bonds, the draft SPU assumes it will be reduced, although it does climb above pre-crisis levels after 2017. The interest rate path does not coincide with market expectations, which predict an increase in long-term rates in the next few years. That is why the materialisation of this interest rate assumption requires additional credibility with respect to Spain’s financial sustainability and it presents upside risk arising from the expected normalisation of monetary policy in the United States and the uncertain situation in Greece.

The trend taken by oil prices is in line with the futures markets, although there is a risk of oil prices rising faster than expected. A reduction in supply in response to prices could be more significant than expected. Furthermore, any escalation in the tensions with Russia or in the Middle East could strangle supply. The increase in implicit volatility in the future markets would indicate a greater divergence in the underlying perspectives. A scenario of gains in real income triggered by falling oil prices having a greater-than-expected impact on economic activity should not be ruled out either. In the opposite direction, a bigger impact of real income gains from the fall in oil prices on economic activity cannot be ruled out either. The euro exchange rate assumption involves an upside risk in overseas demand as a lack of synchrony in the monetary policies of advanced countries could trigger a stronger real depreciation of the euro.

The EU growth path i**n 2015 and 2016 is similar to the European Commission's** winter macroeconomic outlook exercise, which is conditional on favourable assumptions: (i) an accommodating fiscal policy, (ii) the effectiveness of the ECB monetary policy to drive credit and a reduction in financial fragmentation, (iii) that structural reforms will sustain domestic demand and (iv), the positive impact of the EU investment plan in 2016. The draft SPU considers that growth will pick up in the EU in 2017 and 2018, opening a gap with IMF forecasts, the only ones available for the time span.

2.3.2. Cyclical position and potential growth

The cyclical position of the Spanish economy factored into the draft SPU 2015-2018 shows that the economy will not reach its potential output in the time span of the programme, despite the high growth forecast. This performance is in contrast to the potential output estimations of the European Commission, the OECD and the IMF, all of which are public sources. The assessment of the underlying cyclical situation in the draft Stability Programme and its repercussion on the fiscal balance is made from an analysis of the output gap; in other words, the percentage difference between real observed GDP and potential GDP. The respective output gaps for these approaches are inferred by comparing the expected development of real GDP in the draft SPU macroeconomic scenario with the estimates of the potential output of the Spanish economy made by these international agencies.

According to the draft SPU, the output gap will close in 2018, which is plausible considering the cyclical patterns of recovery of the economy. The development of the output gap considered in the draft SPU starts at -8.2% in 2014 (-6.1% for the EC with a similar methodological approach) and potential growth will accelerate from 0.4% to 1.2% over the horizon, which implies not closing the gap fully until 2018. That is why the cyclical component of the fiscal balance (the part explained by the cyclical position of the economy) will decrease over the timeline of the draft SPU, which will imply a greater importance of the targets in structural terms with respect to the balances observed. Given the growth expected in the draft SPU, the starting point for the methodological approaches of the international agencies is a smaller initial output gap and their estimates for potential growth are slightly lower for 2015-18, which leads to an accelerated closing of the output gap, possibly in 2017 (see table 3). In any event, these latter approaches have historically offered pro-cyclical potential growths (e.g. estimated potential growth usually increases in times of high GDP growth and vice versa), so these are expected to be revised up in the recovery phase, which would delay the closing of the output gap. On the other hand, the cyclical patterns of the Spanish economy have been characterised by slower expansions (increase in the gap) than recessions (reduction in the gap), as indicated in graph 1. For all these reasons, once the pro-cyclical nature of potential growth and the cyclical pattern of the economy are taken into consideration, the output gap path considered in the draft SPU tends to be plausible, despite its large initial size.

There is great uncertainty around the estimates of the output gap and potential output and its robustness; consequently these results should be interpreted with caution. The variants used by the international agencies (EC, OECD and IMF) for estimating potential output usually provide substantially different results and they vary to a large extent if new information is factored in, especially at the turning points of the economy. This uncertainty leads to frequent and significant revisions, putting out unreliable signals about the state of the economy. In the case of Spain, there have been notable revisions of potential growth, using both the European Commission approach and the OECD approach, and, as already mentioned, estimates of potential growth have tended to be pro-cyclical. The importance of output gaps in appraising the fiscal adjustment aggravates the problem, as this is key for assessing target compliance in terms of structural fiscal balances.

The method for estimating potential output should bear in mind a broad set of indicators of economic imbalances and provide more stable potential growth estimates that are less subject to revisions. One of the reasons for the limitations of the standard potential growth estimate methodologies is that they consider a single indicator to summarise all the imbalances in the economy: the inflation rate. However, partly thanks to the success of central banks in controlling inflation and to the globalisation process, inflation no longer seems to be sufficient indicator of the macroeconomic imbalances in many economies. Estimates of potential growth should factor in a broader idea of balance than wages and prices not accelerating; it should also consider the sustainability of other, both internal and external, macroeconomic imbalances.

2.4. An inertial baseline scenario

The government forecast analysis routine starts by projecting an inertial macroeconomic scenario. Given the information available up to the cut-off date, the first two quarters are projected with dynamic factor models for GDP and its components of demand —employment and prices. These independent projections are made mutually consistent by applying an account-balancing algorithm. For a longer time span, and with exogenous assumptions about real GDP growth in the EU, interest and exchange rates and oil prices, the key macroeconomic variables (real GDP growth, employment, credit to the private sector, and taxes and social security contributions net of social benefits in cash and kind) are projected with a BVAR model. The components of GDP, from the standpoint of demand, at both current prices and their volume indexes, are projected separately, also using BVAR models and behaviour equations with error correction mechanisms. The forecasts of the central BVAR and of the other models for the demand components are once again made consistent with an accounting algorithm, in which the greater the uncertainty with which a variable is projected, the greater the adjustment accepted, and it also revises the positively-correlated variables in the same direction, and the negatively-correlated ones in the opposite direction.

The macroeconomic scenario is then translated into a budgetary scenario, based on the projection obtained in the central BVAR of a synthetic variable that combines taxes and contributions net of benefits as percentages of GDP. This aggregate variable approximately reflects the influence of the cyclical position of the economy on the fiscal variables most sensitive to economic developments. Its response to an impulse in real GDP growth is close to the semi-elasticity of the budgetary balance with respect to the growth in real GDP used by the government to estimate the cyclical component of the government deficit (0.54). This variable is broken down into its different components using satellite models for each one of the taxes, contributions and benefits that appear in public-sector accounts. For the other lines of the accounts, mainly on the expenditure side, the projections take into account the measures already adopted by the government or, if there is no reliable quantitative information, they keep their ratios constant with respect to projected GDP. This inertial policy of discretionary spending on goods and services (government sector consumption and investment), along with the aforementioned cyclical effects, produces a primary deficit path that, along with the interest rate assumptions, allows the inertial baseline budget scenario to be completed.

These macroeconomic and budgetary figures are then entered in the simplified accounts of the other sectors of the national economy, in order to have a full and consistent set of figures in national accounting terms, once again, using a combination of equations with error correction mechanisms for the variables that represent the behaviour of the economic agents and inertial assumptions regarding the less important items that are entered in the accounting algorithms. The final scenario defined in this fashion is used as a reference for assessing the macroeconomic scenario prepared by the government. By entering the discretionary spending policy of the draft SPU 2015-2018 in the inertial scenario, the effects on the macroeconomic aggregates and their consequences on the other variables can be assessed. This analysis does not set out to compare the figures of the two forecasts; its intention is to apply an objective procedure to quantify the uncertainty of the forecasts and the risks that the key figures of the official scenario may pose for meeting the budget stability targets.

Using AIReF models and under the exogenous assumptions of the draft SPU, the acceleration of real GDP in 2015 to an annual rate above 3% in 2015 scarcely slows down in the following years. The GDP deflator records a marginally positive growth rate in 2015 and accelerates in a sustained fashion up to 2% in 2018. Employment increases in line with real GDP, albeit at slightly lower rates, while loans to firms and families, which are still expected to decrease in 2015, expand rapidly in the following years, to reach rates of over 11% in real terms by the end of the period. This inertial scenario predicts that growth in domestic demand will accelerate to almost 4% in 2015 although this rate will moderate to around 3% subsequently. Private consumption and gross fixed capital formation show the same time profile, far more pronounced in the latter than in the former, and investment in both capital goods and in construction slow down from the peak in 2015, reducing their growth rate to half towards the end of the period. Nominal government consumption continues to grow at the pace of GDP at current prices, by hypothesis, implying a gradual acceleration in its real growth over the four years of the programme. Exports grow in this inertial scenario at a rate of close to six percentage points in 2015, before falling off in the next two years to around 4.5%, and they spike again in 2018. With these rates of expansion of domestic demand and exports, imports are expected to grow fast in 2015, close to 10%, before slowing down afterward, although they will continue to grow at a higher rate than exports throughout the period. As a result, the net foreign trade balance shows an acute deterioration this year, taking almost one percentage point off GDP growth, although it moderates its negative contribution in the following years.

This scenario of sustained economic expansion with high growth rates goes hand in hand with a major cyclical improvement effect on the budget balance, as a consequence of the automatic stabilisers. The size of the cyclical correction of the primary government deficit in the four years of the programme is projected to be about four percentage points of GDP, maintaining current policies in force and without taking into account the effects of the recent tax reform, estimated as just over one percentage point. The increase in fiscal pressure of taxes and contributions accounts for around half of the approximately three remaining percentage points, principally personal income tax, and the fall in the relative weight of social benefits in GDP, basically the reduction in unemployment benefit, provides the rest. On top of this, there is a reduction in debt servicing that would provide an additional saving of almost one percentage point of GDP. Consequently, the total government accounting deficit would be over 3% of GDP in 2016 and 2% of GDP in 2018. Therefore, compared to the last SPU 2014-2017 and with a substantially more expansionary macroeconomic scenario than forecast, a discretionary public spending policy that merely keeps its weight of GDP constant would not achieve the intended fiscal consolidation. Other additional measures would have to be adopted to meet the government deficit targets, set for 4.2% of GDP for 2015, 2.8% for 2016 and 1.1% for 2017.

The reduction in the government deficit in this inertial scenario is accompanied by **a fall in the country's borrowing** capacity, implying a significant reduction in the borrowing capacity of the private sector. This is due to a strong expansion in consumer demand and investment from families and businesses that is accompanied by greater inflationary pressure on prices and an income distribution in which employee compensation gains weight at the expense of gross operating surplus. The latter has a negative effect on company savings, whereas the increase in taxes and contributions and the fall in social benefits erode family disposable income at the same time, entailing a fall in the rate of saving.

A government consumption and investment expenditure containment policy has a negative effect on GDP and employment growth. If the inertial scenario is simulated, the degree to which demand would be restricted by a policy such as the one considered in the SPU 2015-2018 can be seen. The effects would not be significant in the first two years, but GDP growth could be just over half a percentage point less in the last two years of the scenario. Moreover, if the government sector consumption and investment paths of the draft SPU 2015-2018 are taken as a given, the growth in GDP in the AIReF inertial scenario would be unlikely, leading to more severe private savings and investment imbalances than those already mentioned by automatically transferring their implications to the accounts of families and business.

2.5. Analysis of the draft SPU 2015-2018 macroeconomic scenario

The real GDP and employment forecasts contained in the draft SPU 2015-2018 show growth rates of around 3% for the four years of the programme in contrast to the scenario of more acceleration in 2015 followed by a slowdown in both in the AIReF inertial scenario. The momentum gained in activity in the Spanish economy during the last two years is expected to continue to fuel growth of real GDP and employment over the coming quarters. All the short-term forecasts confirm that growth in real GDP and employment in 2015 will be well above the 2% and 1.4% respectively forecasted by the budget for this year. The forecasts made by the different institutions have been revised up repeatedly and the current consensus, which is taken as a reference for assessing possible biases in the official forecasts, could be underestimated due to the fact that many institutions have not yet updated their forecasts.

When compared with other forecasts, expected real GDP growth in the draft SPU 2015-2018 shows a large bias towards expansion because it is at the top end of the range of all existing forecasts for 2015 at this time, and above all of them in 2016. It is also more than one percentage point above the IMF's recently published forecasts for 2017 and 2018. This bias comes from equally large upward biases to be found in the forecasts for job creation and increase in domestic demand, private consumption (but not government consumption) and gross capital formation. On the other hand, forecasts for exports and imports fall within the interquartile range of the other forecasts and their bias is small against the median. The fiscal consolidation targets set in the draft SPU 2014-2017 are as ambitious for 2015 and 2016 as the closest private forecasts, and a lot more demanding for 2017 and 2018 than the IMF expects.

After hitting a growth ceiling in 2015, the domestic demand forecast by the government flattens off at around 2.9% in 2016-2018. This profile is in contrast to the AIReF inertial scenario, where domestic demand slows down in the last three years of the outlook period. Furthermore, there is a difference between the levels of growth of the two scenarios of more than one percentage point in 2015. This difference is gradually reduced until it disappears in 2018. This is due to the fact that the government includes a far more restrictive fiscal consolidation policy for government consumption and, to a lesser extent, for government sector investment, especially intense in 2015-2016, in comparison with this inertial scenario. The effect of this discrepancy is offset with a similar difference in magnitude, but with the opposite sign, in the contribution of net external demand to growth in real GDP, which is negative in the AIReF scenario and approximately zero in the government scenario.

The forecast for growth in real private consumption shows a large upside bias against the private institution consensus in the first two years of the programme, and it is also higher than the projections made by the Banco de España and the international institutions. But, according to the confidence interval generated by the prediction models developed in AIReF, the government's figures are not unlikely; they are close to the centre of the forecast's confidence interval, with a small, short-term downside bias, which disappears as the time horizon is lengthened.

The materialisation of the scenario of high and stable growth forecast by the government rests on a favourable combination of conditions in the labour market, disposable income and household assets. An analysis of the main determinants of private consumption allows for an examination of the implicit assumptions that would have to be satisfied for the growth path envisaged in the draft SPU 2015-2018 to materialise. The key assumptions are a strong recovery of the labour and housing markets, which entails rapid job creation and significant growth in household assets (particularly real estate assets), generating highly positive real disposable income dynamics. In the AIReF inertial scenario, this variable does not develop very differently from the government forecast, but its composition and dynamics do. What is notable is that the increase in employment is slightly less pronounced in the AIReF forecast, but wages accelerate more, particularly in the last two years of the horizon. As a result, compensation per employee would grow half a point more than in the government scenario, a difference that would grow to 1.3 percentage points over the horizon of the programme. At the same time, the taxes paid by families, net of the social benefits received, grow more in the AIReF scenario due to the more intense cyclical effects of the automatic stabilisers, while consumer prices also increase faster in the inertial baseline scenario, leading to real disposable income that is not very different from the one underpinning the government forecast.

The risks for the predicted growth path of private consumption depend critically on the performance of the labour market, which has a crucial effect on the draft SPU 2015-2018 macroeconomic scenario as a whole. In the government forecasts, the labour market generates a larger increase in employment and less growth in wages than the models used for the analysis in the AIReF inertial scenario. The effects of labour reform, which are probably not yet reflected in the models, could produce these developments in the labour market expected by the government, with a practically inexistent increase in the apparent productivity of labour and a very small increase in compensation per employee in 2015-2018. The lower economic growth rate required to generate jobs in the Spanish economy and the wage moderation that prevails to date, are indications in the course of this recovery that sustain the hypothesis of greater efficiency and flexibility in the Spanish labour market. The high unemployment rate reached in the recession, the composition of the employment generated and the average wages paid, along with the beneficial effects of deflation and low oil prices, are factors that have determined this recent performance, in addition to the intended effects due to labour market reforms.

The government consumption forecast in the draft SPU 2015-2018 scenario has a large bias towards restriction when compared with other forecasts, putting it below the interquartile range of distribution of the forecasts of the private institutions. This is a key variable in connecting up the macroeconomic scenario with the budget scenario, which was projected in previous SPUs with an ambitious objective of reducing public spending, an objective that was relaxed ex post, as analysed in a previous report (see Report on the Macroeconomic Forecasts contained in the Draft general budget for 2015). This restrictive orientation of government consumption is maintained in the draft SPU 2015-2018 as one of the cornerstones of the fiscal consolidation strategy implicit in the budget scenario, which takes the form of negligible growth in wages and falls in intermediate consumption and social benefits in kind acquired in the market in the course of these years. Little information has been made available for appraising the measures that underpin the government consumption performance forecast, as they are not defined in precise detail, nor are they related directly to the corresponding items in national accounting terms. The government consumption deflator is projected to grow less than the implicit GDP deflator or the private consumption deflator, so presumably it will be public sector employee compensation that will experience a sustained reduction against compensation per employee in the rest of the economy. The restrictions on government consumption spending are substantially relaxed in the last two years of the programme, with its components growing 1.4% in 2017 and 1.7% in 2018 in nominal terms, albeit maintaining low deflator growth.

A strict implementation of this budgetary policy would mean slightly less growth in GDP than the figures forecast in the draft SPU 2015-2018 macroeconomic scenario. Over and above the implementation difficulties posed by this restrictive government consumption policy, to judge by the results of recent experience, including the first budget implementation data made available this year, and the large contractive bias revealed by comparing it with the forecasts of independent institutions, it is worth pointing out the downside risk it entails for real GDP growth forecasts in the government's macroeconomic scenario, which could be somewhat less —although not substantially— during the first years of the programme, but certainly lower in the last two years. This countercyclical policy of stringently contained expenditure at a time of rapid recovery of private demand would have a moderating effect on the financial imbalances that this expansion generates and would help make real GDP growth more sustainable.

The government forecasts of growth in real gross fixed capital formation seem likely on average for the period in light of the assumptions made, although they also imply a large upside bias in comparison with the consensus forecasts of the private institutions both for capital goods and, above all, for construction. The path marked for 2015-2018 is within the confidence intervals estimated with the error correction models that AIReF uses. However, the time profile is one of less acceleration than the AIReF inertial scenario in the first two years, and very little slowdown afterwards, thus approaching the upper limit at the end of the forecast period.

The gross fixed capital formation in construction forecast in the draft SPU has major downside risks in 2017 and 2018, taking it close to the upper limit of the confidence interval associated with the performance model in those years. Internal AIReF forecasts suggest a return to high growth rates in the forecast time span 2015-2018, after the profound dip experienced between 2008 and 2014, when it recorded an accumulated fall of almost 50%. The main drivers to investment in construction are the favourable perspectives for household wealth in both financial and real estate assets. This improvement requires a normalisation of the financial situation, which would then reactivate lending flows for house buying, against a backdrop of low interest rates. Furthermore, it is important to maintain the pace of improvement observed in the labour market in early 2015, recovering lost ground in terms of unemployment and disposable income for households.

The draft SPU forecasts for gross fixed capital formation in capital goods and cultivated assets are in line with internal AIReF forecasts. They both follow an expansionary path too, with a higher growth profile in the immediate future and a more moderate pace towards the end of the forecast time line, but this profile is far sharper in the AIReF inertial scenario. The robustness of the expansion in final demand and the improvement in the financial environment of the Spanish economy will be a powerful driver for investment by non-financial enterprises. However, despite the sharp reduction in interest rates so far this year, especially in relation to the performance of the cost of labour, it is unlikely to continue at the same pace in the coming years.

The path of high and stable export growth can be considered as likely, albeit with an upward bias on average. The increase in Spanish export markets and the prospects of greater growth for the euro area, together with the depreciation of the effective nominal exchange rate this year and its expected stabilisation afterwards, support this forecast made in the government economic scenario. This path does however show greater growth than the AIReF inertial scenario as an average for 2015-2018, and there is a large upward bias for 2015 and 2016 in comparison with the consensus forecasts made by private institutions, putting it in a position that is also above the expectations of the Banco de España and the Commission. All this suggests there are some downside risks in the official figures for expected export growth, which have always turned out to be optimistic in Stability Programme updates.

Imports, on the other hand, show a downward bias in their expected growth. The strength of domestic demand suggests that the acceleration in imports observed over recent quarters will only moderate slightly in the immediate future, as the effect of the depreciating euro making imports from outside of the euro area more expensive fades away. The normalisation of growth in domestic demand and an assumed stabilisation in the ratio of import prices and domestic prices will give rise to more contained growth of imports in this horizon, a conclusion that is compatible with the government's expected path. Growth in imports however, which has no significant bias in 2015-2016 in comparison with the private institution consensus, has been greater than the government expected in the two previous years and it is possible that it will outstrip the forecasts made in the initial budget for 2015 too. Moreover, compared with the AIReF inertial scenario, the government import forecasts show a profile of a slight slow-down and lower average growth for 2015-2018. This difference is substantial, bearing in mind that import dynamics are explained to a large extent by the performance of investment in capital goods and exports, variables that are far more dynamic in the government scenario than in the AIReF inertial scenario. These considerations therefore lead to the conclusion that there are certain upside risks in the official forecast.

The government macroeconomic forecast expects very little inflationary pressure in the economy. This view does not seem to be very much in line with the sharp expansion in output and employment and with the fall in the unemployment rate, in light of the results of the models based on historical experience. There is little information about the government expectations for the labour market and prices and it does not allow for a detailed analysis. The growth in compensation per employee forecast in the draft SPU 2015-2018 macroeconomic scenario is very moderate, although it does gradually pick up in parallel with the GDP deflator, whose growth remains below 2%. There are obvious upside risks to this forecast against a backdrop of significant expansion in demand and employment, which the government expects to grow in line with real GDP. Employment growth rates contain a large positive bias against private forecasts for 2015 and 2016, leaving them above the top end of the distribution, and they are also greater than the forecasts made by the international institutions. The AIReF inertial scenario, however, does not allow these projections of increased employment to be considered unlikely, as output expands in a similar fashion. What is noticeable, finally, is that the fall in the unemployment rate forecast by the government is more pronounced than the fall predicted by the AIReF inertial scenario, which does however show a slightly greater acceleration in the GDP deflator and much larger acceleration in wages. These growth differentials suggest there could be leeway for upside inflation and unemployment risks to materialise at the same time in the government's macroeconomic scenario.

The effect of the cyclical correction of the government deficit is similar in both the government macroeconomic scenario and the AIReF inertial scenario, although the methodologies are very different. The output gap in the Spanish economy closes within the programme horizon according to the draft SPU 2015-2018, with a cyclical recovery of 8 percentage points. With the estimated semi-elasticity of the budget balance compared with the output gap (0.54), the correction of the cyclical deficit is 4.4 percentage points and the cyclically adjusted balance, just over 1.1 percentage points, practically meeting the budget stability target by the end of the period. These results are associated with relative stability in the revenue to GDP ratio and a cyclical fluctuation in the budget balance as a percentage of observed GDP that operates fundamentally on the expenditure side when this grows in line with potential GDP, as the expenditure rule adopted in Spain implies. During upswings in the cycle, the spending ratio as a percentage of nominal GDP tends to decrease, not only because of the effect of savings in social benefits, but also due to the "denominator effect" produced mechanically by observed nominal GDP growth outstripping potential GDP growth.

In substance, the so-**called "denominator effect" requires a strict** application of the expenditure rule contained in our Organic Law on Budgetary Stability and Financial Sustainability. The expenditure rule anchors the stabilising fiscal policy programmed by the government. This rule limits the nominal growth of discretionary spending (or "eligible" expenditure, which excludes mainly financial expenses and expenditure on unemployment benefits from aggregate expenditure for the general government sector as a whole) to a sustainable reference rate[7], which is between two and two and a half points below the expected rate of nominal GDP growth, so a substantial reduction in the ratio of this discretionary expenditure is expected against GDP each year. In the AIReF inertial scenario, the cyclical effect on taxes and contributions net of benefits implies a saving in benefits in line with the forecast of the draft SPU 2015-2018, but the rest would operate through an increase in fiscal pressure instead of a decrease in the discretionary spending to GDP ratio. Comparing the results of these two approaches leads to the conclusion that the government fiscal strategy is prudent on the revenue side and demanding on the discretionary expenditure side.

[7] This rate is calculated for each year by averaging the rates of the 5 previous years, the current year and of the next 4 years. For GDP growth in real terms, the data on potential GDP growth for the same years is taken. The lower of the two following values is taken each year for growth of the deflator: either 2% or the growth rate of the GDP deflator actually recorded according to the National Accounts or expected by the government.

3. Sensitivity analysis

The information about the draft SPU 2015-2018 includes a sensitivity analysis that meets the requirements that the macroeconomic scenario must satisfy according to EU rules. As a robustness contrast with the sensitivity analysis presented in the draft SPU 2015-2018, conducted from a different methodological approach, this section explores the sensitivity of the AIReF inertial scenario to changes in the key assumptions. It should be noted, however, that unlike the programme analysis, based on a dynamic general equilibrium model, the more limited approach taken by AIReF is an analysis of the "impact" of changes on each variable separately, rather than a succession of complete scenarios. The impact only includes the initial effect of an alternative hypothesis. In other words, the first step in constructing a complete scenario that reflects the detailed consequences of this hypothesis within all the information included in the integrated accounts, following the process described above in section 2.4 of this report. Consideration is first given to the sensitivity of economic growth, employment, prices, credit to firms and families, plus the cyclical effects on the budget balance if there are variations to the external assumptions on the growth of the EU economy, interest rates, exchange rates and oil prices. These are the variables that the AIReF BVAR takes as exogenous assumptions. After the analysis, there is a discussion of the main risks involved in the key figures of the government macroeconomic and budgetary scenario in the information submitted to AIReF.

3.1. Alternative assumptions

The external assumptions present risks, as seen already. It would therefore appear necessary to analyse how the inertial macroeconomic and budget scenario that AIReF has used as a reference for appraising the sensitivity analysis of the draft SPU 2015-208 would be affected by modifications to these assumptions.

Variations in the assumptions about oil prices and exchange rates do not have any notable effects per se on the AIReF inertial scenario. It is clearly artificial to consider a major variation in crude oil prices or the euro exchange rate in isolation, while keeping all the other exogenous variables constant. If assumptions about oil prices change, and they are increased by 10%, or about exchange rates, down by 10%, the dynamic impacts on the path of the GDP deflator (positive), real GDP and employment (negative) are very weak in both hypotheses. The cyclical impact on public accounts is also of the expected sign in both cases, albeit equally negligible. The sensitivity analysis presented by the draft SPU 2015-2018 is more general and produces qualitatively similar albeit more marked results.

Modifying the hypotheses on interest rates has a significant effect on macroeconomic and budget scenarios. The results of the simulations on AIReF models are generally consistent with those presented in the draft SPU 2015-2018, although there are some differences in the dynamic adjustment of the variables. If a one percentage point increase is considered from 2Q15 to 4Q18, the average annual inflation rate, measured by the variation in the GDP deflator, is practically not affected in 2015 and 2016, but it falls three tenths of a percentage point in 2017 and six tenths in 2018. Credit to families and firms would be greatly affected, with growth falling somewhat in 2015 and more sharply in the following years: by two, four and six percentage points in 2016, 2017 and 2018 respectively. The effects on real GDP are more gradual, but still large, as its growth rate would be corrected downwards by two tenths in 2016, half a percentage point in 2017 and eight tenths in 2018. The same thing happens with the increase in employment, which would fall by three and seven tenths in 2016 and 2017 and by one percentage point in 2018. Finally, the cyclical effect on taxes and contributions net of benefits would also be progressive and increasingly negative each year. It would not be appreciable in 2015, but it would reach three and seven tenths in 2016 and 2017, rising to 1.2 percentage points in 2018.

The **growth assumed for the EU also has significant effects on Spain's eco**nomic and budgetary perspectives. If the hypothesis is that growth in the EU will be one percentage point lower than expected per year for the three years 2016-2018, the trend in prices would hardly change, although it would do so in the direction expected of lower inflation. Lending to families and businesses would also grow somewhat less (six tenths of a percentage point in 2017 and 1.2% in 2018), but economic activity and employment would be affected slightly. Real GDP growth would correct down by four tenths in 2016, eight in 2017 and another eight in 2018, as it would also weaken the expansion of employment by six tenths of a percentage point in 2016 and by 1.3% in 2017 and 2018. In line with this dynamic impact, the path of taxes and contributions net of benefits as a percentage of GDP would have a lower profile by two, six and nine tenths of a percentage point in the three years 2016-2018. This analysis is not easily comparable with the analysis of the draft SPU 2015-2018 and although the results point in the same direction, they are a lot more negative in the AIReF inertial scenario. These differences are not negligible and reconciliation requires publication of the details of the models, data and assumptions made in the two methodological approaches. AIReF will make public the technical documents used in its analysis shortly and suggests the government do the same.

3.2. Key risks of the forecasts

With respect to the risk analysis, it should be emphasised that the hypotheses about the external environment are expansionary and overall present downside risks. These downside risks arise from lower growth in the EU, a less benign financial environment, if price rises in the euro zone were to threaten the European Central Bank's inflation target, or from greater geopolitical tensions or, with less impact, from a significant rise in oil prices. There are also upside risks, albeit more limited in the short term, such as the risk arising from a greater depreciation of the euro.

Above all, there are three risk elements arising from the interaction between the draft SPU 2015-2018 macroeconomic and budgetary scenarios, which become more severe for the last years of the macroeconomic forecasts. The interaction of risks is important, first of all, between government consumption, deficit and GDP forecasts; secondly, between forecasts for output and employment growth and prices and wages, given the forecasts for potential output; and finally, between the forecast of a robust upsurge in private sector demand, maintaining the nation's lending capacity and a sharp reduction in the government deficit, which leads to a substantial worsening of the financial situation of the private sector.

The implementation risks of the rigorous policy of expenditure restraint reflected in the government consumption forecasts are significant. If this implementation risk does not materialise and the programmed policy is strictly implemented, the growth in real GDP in the macroeconomic scenario could be lower in 2017 and 2018. If, on the other hand, this risk does materialise, as seems likely, the less restrictive fiscal policy on the expenditure side would reinforce the expansive dynamics of domestic demand, driving inflationary tensions and aggravating the financial imbalances of the national economy and those of households and corporations. The reduction in the government deficit predicted in the budgetary scenario would not be so pronounced in nominal terms, because the second-order effects of the greater expansion of economic activity and prices on cyclically-sensitive revenues and expenditure would not be enough to offset the higher government spending on goods and services. In structural terms, there would undoubtedly be less fiscal consolidation.

Another risk arises from the interaction of a strong expansion in demand and employment with weak inflationary pressure on prices and wages, against a backdrop of low potential growth that induces a rapid closing of the output gap. Although this nominal moderation result would indeed be highly favourable for correcting the imbalances of the Spanish economy, it seems unlikely that a substantial and sustained reduction of the unemployment rate would not accelerate wages more than expected, and that the buoyant expansion of domestic demand at much higher rates than the most optimistic forecasts for potential output growth in the Spanish economy would not accelerate prices more than expected in the macroeconomic scenario set out in the draft SPU 2015-2018. This risk is linked to a strict implementation of government spending policy, which already entails an ever-widening gap between the growth rate of private sector wages and public sector employee compensation.

A third source of risk **concerns the correction of Spain's** financial imbalances and its distribution by sectors. The profile of exports continuing to outgrow imports throughout the programme in a context of acute pressure from domestic demand and exports on the productive potential of the economy seems unlikely. The same could be said for maintaining a positive and stable financing capacity for Spain as a whole as a percentage of GDP compared to the rest of the world. In the AIReF inertial scenario, there is a reduction in the economy's lending capacity and a notable fall in the lending capacity of households and corporations, when their debt level has still not been sufficiently reduced, so that they remain vulnerable overall to possible spikes in interest rates or market turmoil. Furthermore, this reduction occurs despite the fact that the cyclical inertial reduction in the borrowing requirements of the government sector is not enough to meet the targets of the last SPU 2014-2017. Meeting these targets would consequently worsen the financial position of households and corporations. This financial impairment would endanger the longevity of such expansionary consumer demand and residential and non-residential investment expected in the draft SPU 2015-2017 macroeconomic scenario.

In summary, the risks for growth in real GDP and employment seem to be to the downside, arising basically from the possibility of less favourable results than those assumed in the external environment. The risks that affect domestic demand seem slightly downside in private consumption and gross fixed capital formation, and upside in government consumption. External demand faces downside risks in exports and upside risks in imports, resulting in a risk of a greater foreign trade deficit than expected by the government. The risk of inflationary pressure on the other hand, is upside and particularly uncertain and important because it would affect the sustainability of the expected cyclical upswing. All these risks are aggravated over time and could make the macroeconomic scenario less expansionary than expected by the government, particularly in 2017-2018. The intensity of the upswing the Spanish economy is currently experiencing, which could be stronger than the government expects in 2015, entails risks that cast doubts on whether the high and stable growth in the 2018 forecast horizon could be maintained as it appears in the draft SPU 2015-2018.

4. Endorsement of the forecasts and specific suggestions

Based on the exogenous assumptions and the policies defined, AIReF endorses the forecasts for economic growth in the government's projected scenario for the draft Stability Programme Update 2015-2018. However, AIReF considers that there are risks in the exogenous assumptions adopted, which are highly expansionary, and in the implementation of the spending policies designed, which are clearly restrictive. These risks suggest that the government's macroeconomic scenario may not be as buoyant as the programme predicts, according to the historical experience built into the analytical models used by AIReF. On the other hand, a more relaxed spending policy could accentuate the risks arising from accelerated growth in inflation and more severe financial imbalances.

As a whole, the scenario assumptions are expansionary. In particular, the acceleration in the growth of real EU GDP way above its potential for the time line to 2018, along with the persistence of an exceptionally benign financial environment and interest rates at an all-time low seems a highly expansionary combination with clear downside risk for the GDP, employment and fiscal consolidation forecasts contained in the draft SPU 2015-2018.

AIReF suggests a number of best practices to the government, listed below:

1. Prepare supplementary macroeconomic and budgetary scenarios that factor in the possible materialisation of the key risks identified in this report.

2. In order to improve the forecasting process in the future, it would be advisable for the government to make its forecasts on the assumption of keeping current policies unchanged. They should be accompanied by a separate quantification of the impact of the new measures planned and how they would affect the macroeconomic aggregates.

3. With respect to the minimum information to be provided in the forecasts, AIReF reiterates its recommendation to include the key elements in the forecasts in a simplified national accounting framework. This would make it possible to understand the connections between economic activity, demand and employment on the one hand, and income flows and borrowing requirements on the other, and so identify the impact of the policy measures adopted by the government.

AIReF recommends that the published macroeconomic forecasts include all the relevant methodologies, assumptions and parameters underpinning them, so making them compliant with Directive 2011/85 on budget frameworks.

5. Appendix: tables and graphs

Tables

Key assumptions in the scenario in the Stability Programme Update 2015-2018

Annual percentage change, unless otherwise stated

	2014	2015 (F)	2016 (F)	2017 (F)	2018 (F)
Short-term interest rates (3-month Euribor)	0.2	0.0	0.0	0.1	0.2
Long-term interest rates (10-year government debt, Spain)	2.7	1.3	1.4	1.1	1.1
Exchange rate (USD/euro)	1.3	1.1	1.1	1.1	1.1
Nominal actual exchange rate euro area (% variation)	2.1	-6.2	-0.5	0.0	0.0
World GDP growth, excl. EU	3.7	4.0	4.4	4.5	4.6
EU GDP growth	1.3	1.7	2.1	2.3	2.4
World import volume excl. EU	2.1	3.9	5.2	5.5	6.0
Spanish export markets growth	2.4	3.8	4.9	5.2	5.4
Brent crude oil price (Brent, USD/barrel)	99.4	61.5	68.8	68.8	68.8

(F) Forecast.

Sources: European Commission and Ministry of Economy and Competitiveness.

Forecasts by international organisations

(annual percentage change, unless otherwise stated)

		2014	2015	2016	2017	2018
ECB (March 2015)	World GDP (ex euro area)	3.6	3.8	4.2	4.1	
	Euro area GDP	0.9	1.5	1.9	2.1	
	Imports of goods and services (ex euro area)	2.9	3.9	5.1	5.4	
	Brent type oil prices (USD per barrel)	99.3	58.5	66.8	70.7	
	Euribor, three months (%)	0.2	0.1	0.1	0.2	
	10y Spanish government bond yield (%)	2.0	1.2	1.4	1.6	
	Exchange rate USD/EUR (level)	1.33	1.14	1.13	1.13	
	Effective exchange rate	0.6	-7.9	-0.2	0.0	
IMF (WEO April 2015)	World GDP	3.4	3.5	3.8	3.8	3.9
	Euro area GDP	0.9	1.5	1.6	1.6	1.6
	EU GDP	1.4	1.8	1.9	1.9	1.9
	Trade in goods and services	3.4	3.7	4.7	5.1	5.1
	Brent oil prices (USD per barrel)	98.9	61.5	68.9	72.0	74.5
	Libor, three months (%)	0.21	0.02	0.02		
European Commission (Feb 2015)	World GDP	3.3	3.6	4.0		
	Euro area GDP	0.8	1.3	1.9		
	EU GDP	1.3	1.7	2.1		
	Imports of goods and services	2.6	4.3	5.3		
OECD (Nov 2014)	OECD GDP	1.8	2.3	2.6		
	Euro area GDP	0.8	1.1	2.7		
	Trade in goods and services	3.0	4.5	5.5		

Cyclical development *annual percentage change, unless otherwise indicated*	2014	2015	2016	2017	2018
Real GDP growth					
SPU 2015-2018	*1.39*	*2.92*	*2.92*	*2.96*	*2.96*
Potential GDP growth					
EC	-0.24	-0.06	0.39	0.58	0.74
OECD	0.55	0.73	0.94	1.04	1.10
IMF	0.56	0.87	0.95	1.05	1.10
SPU 2015-2018	*0.11*	*0.38*	*0.70*	*0.98*	*1.20*
Output gap *(% potential GDP)*					
EC	-6.1	-3.3	-0.9	1.5	3.7
OECD	-6.0	-3.9	-2.1	-0.2	1.6
IMF	-5.0	-3.1	-1.2	0.7	2.5
SPU 2015-2018	*-8.2*	*-5.9*	*-3.8*	*-1.9*	*-0.2*

Sources: SPU 2015-2018, OECD Economic Outlook November 2014, IMF WEO April 2015, EC Winter Forecast 2015

Notes:

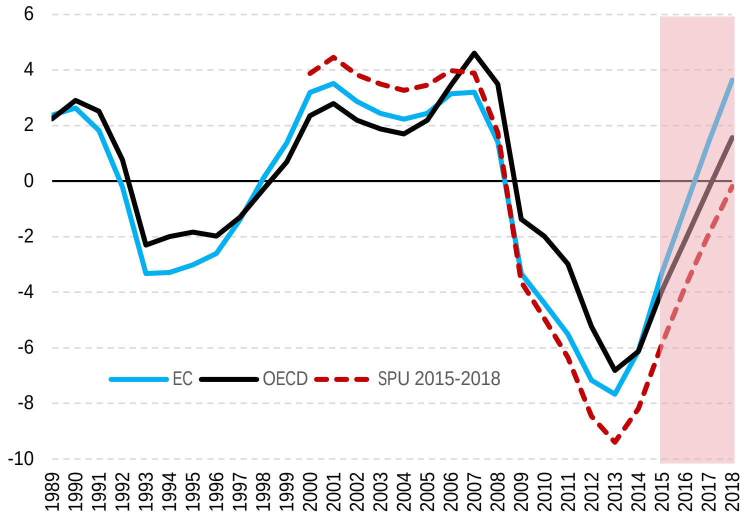
(i) The shaded areas indicate additional assumptions about growth in potential output.

(ii) It is assumed that the forecast growth observed does not affect potential growth within the forecast horizon.

Graphs

Output gaps

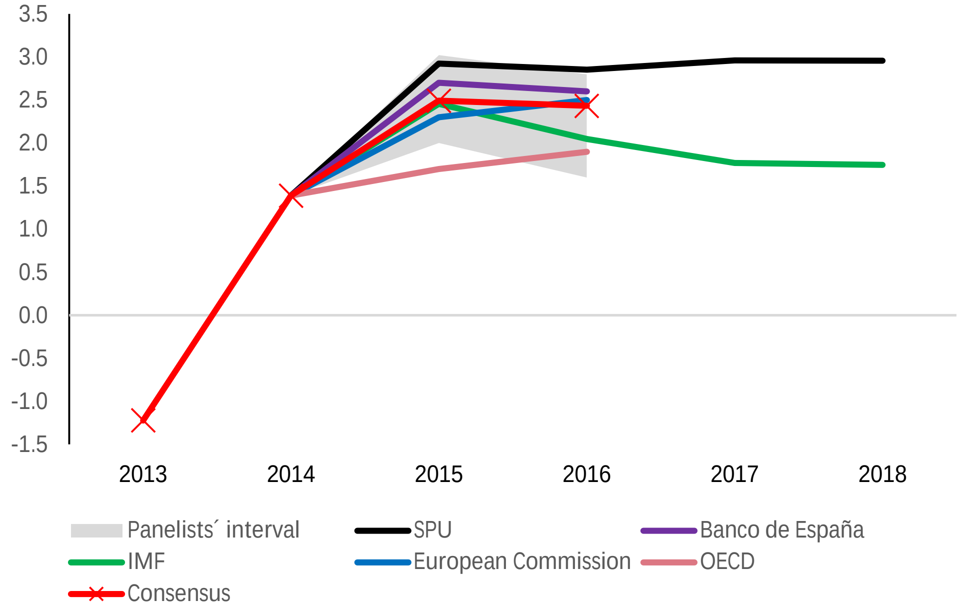
according to the methodologies of the EC, the OECD and the SPU



Sources: SPU, OECD Economic Outlook November 2014 and EC Winter Forecast 2015

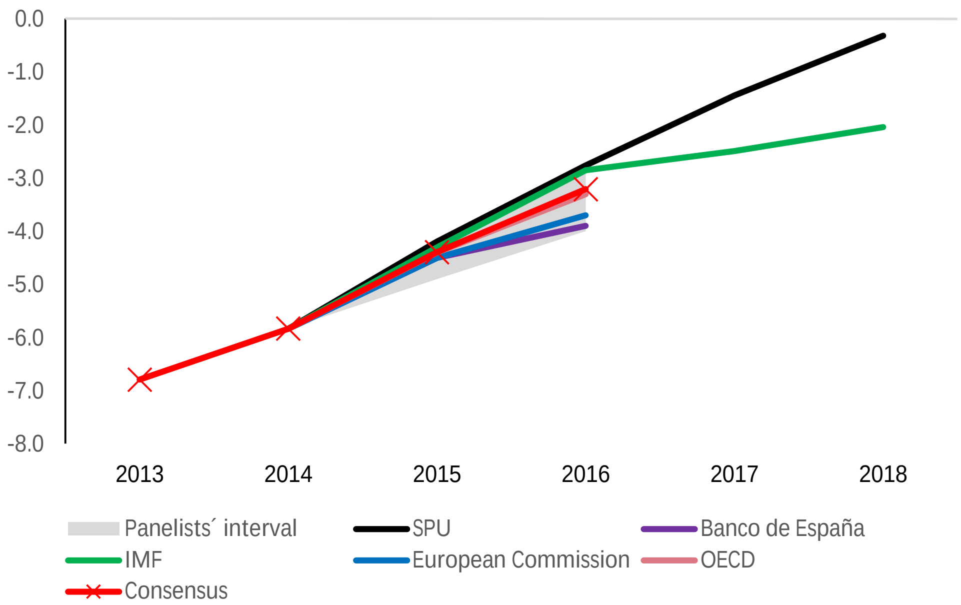
2015

GDP forecasts : 2015



Source: INE, MINECO and AIReF estimates.

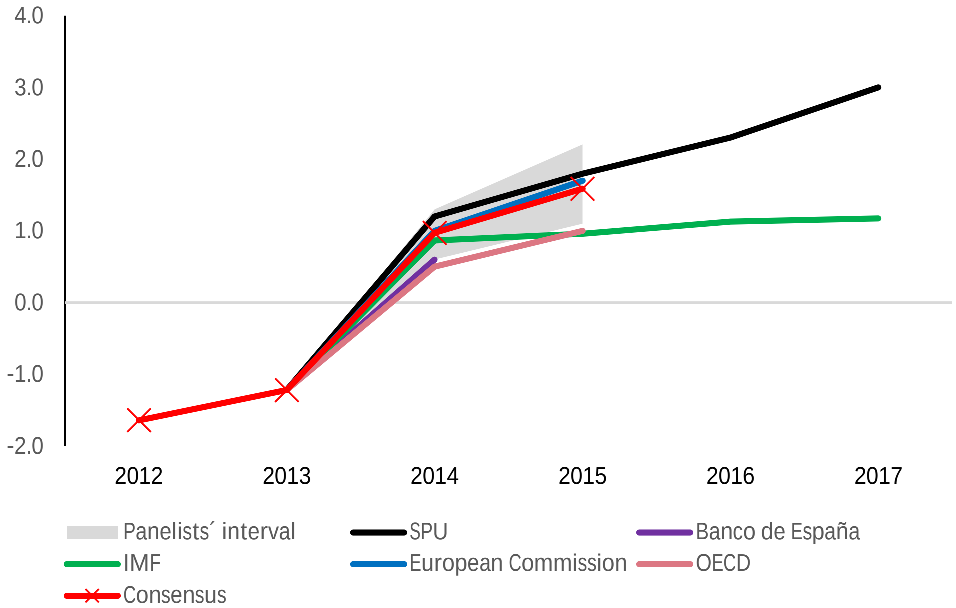
Forecasts of government lending/borrowing : 2015



Source: INE, MINECO and AIReF estimates.

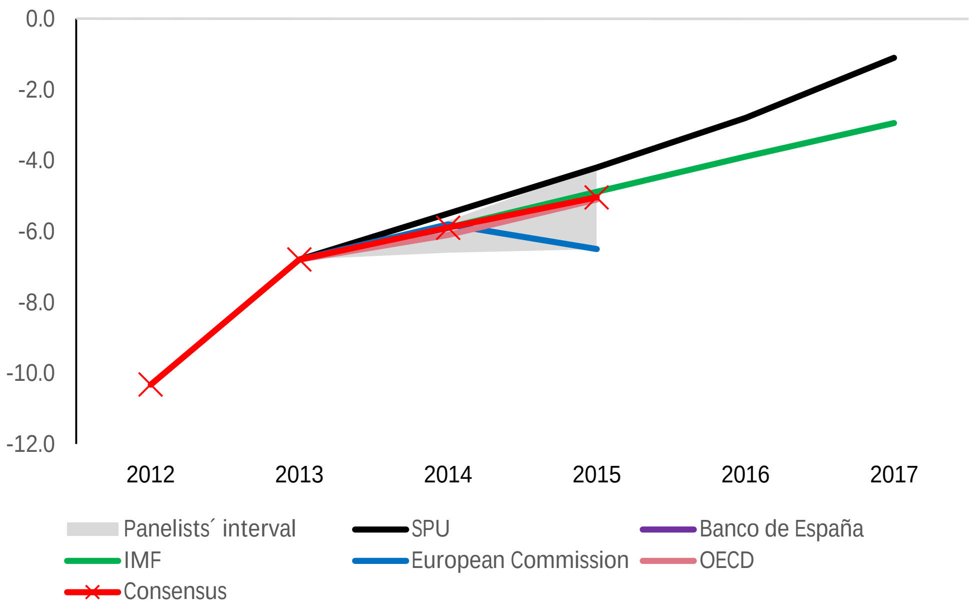
2014

GDP forecasts : 2014



Source: INE, MINECO and AIReF estimates.

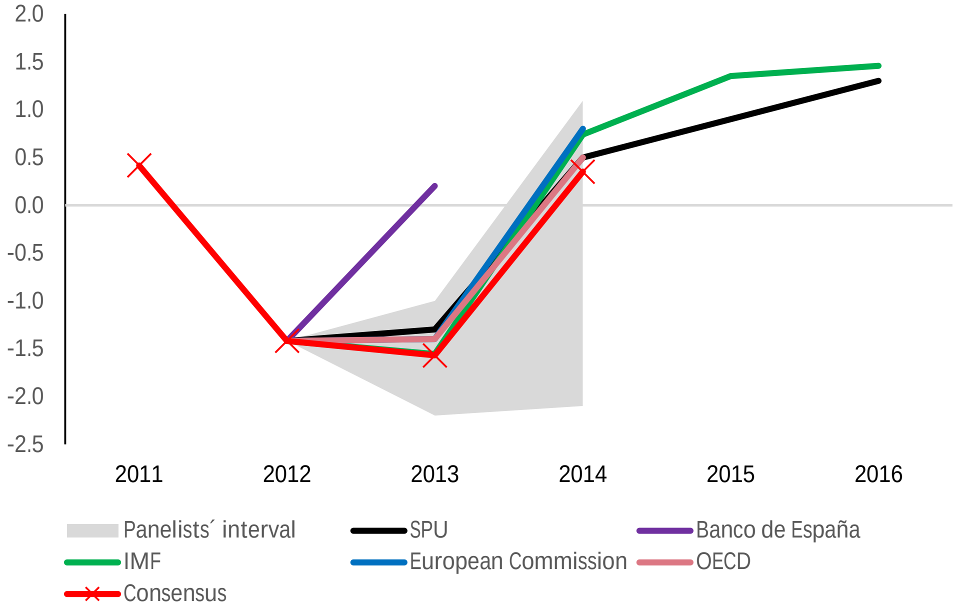
Forecasts of government lending/borrowing : 2014



Source: INE, MINECO and AIReF estimates.

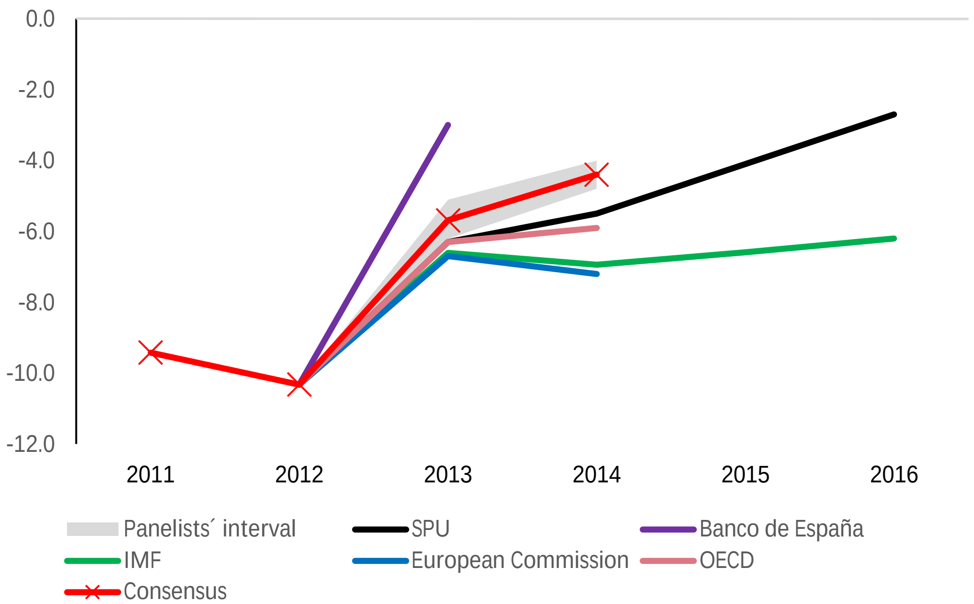
2013

GDP forecasts : 2013



Source: INE, MINECO and AIReF estimates.

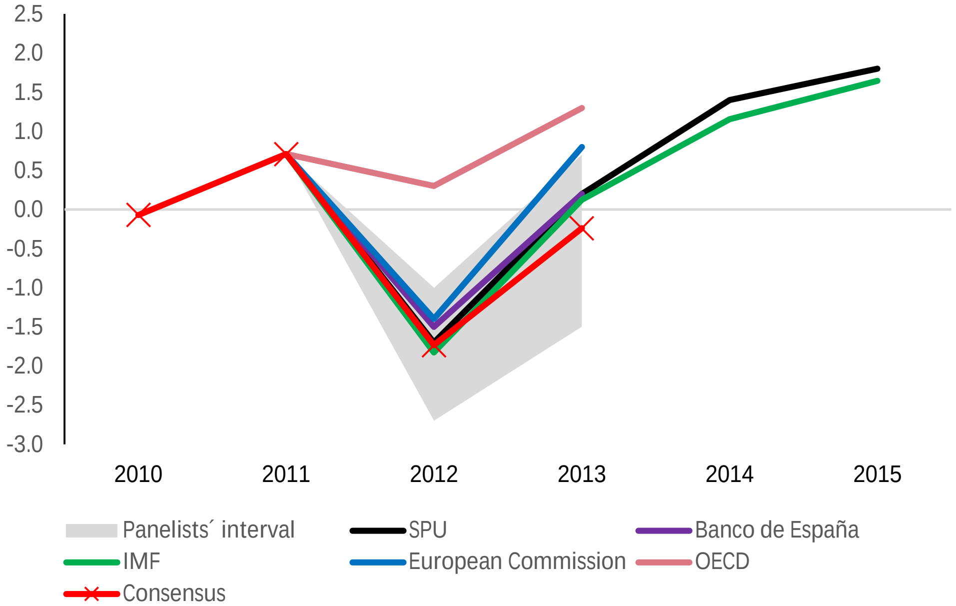
Forecasts of government lending/borrowing : 2013



Source: INE, MINECO and AIReF estimates.

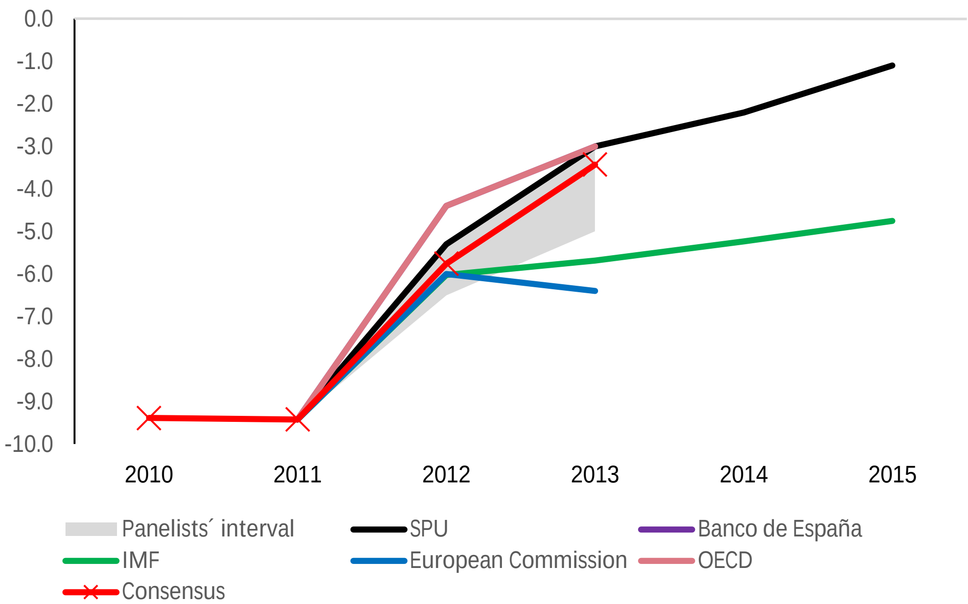
2012

GDP forecasts : 2012



Source: INE, MINECO and AIReF estimates.

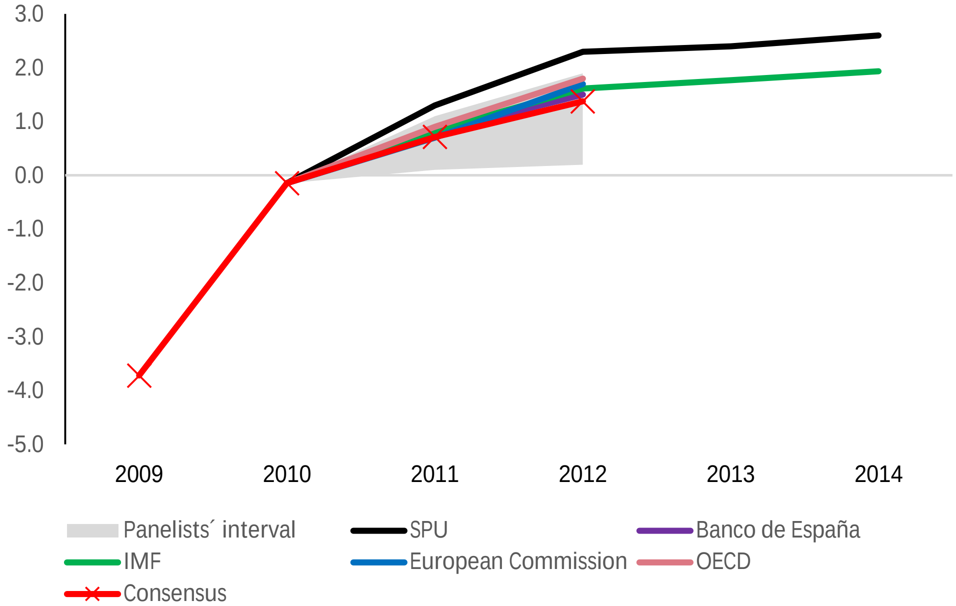
Forecasts of government lending/borrowing : 2012



Source: INE, MINECO and AIReF estimates.

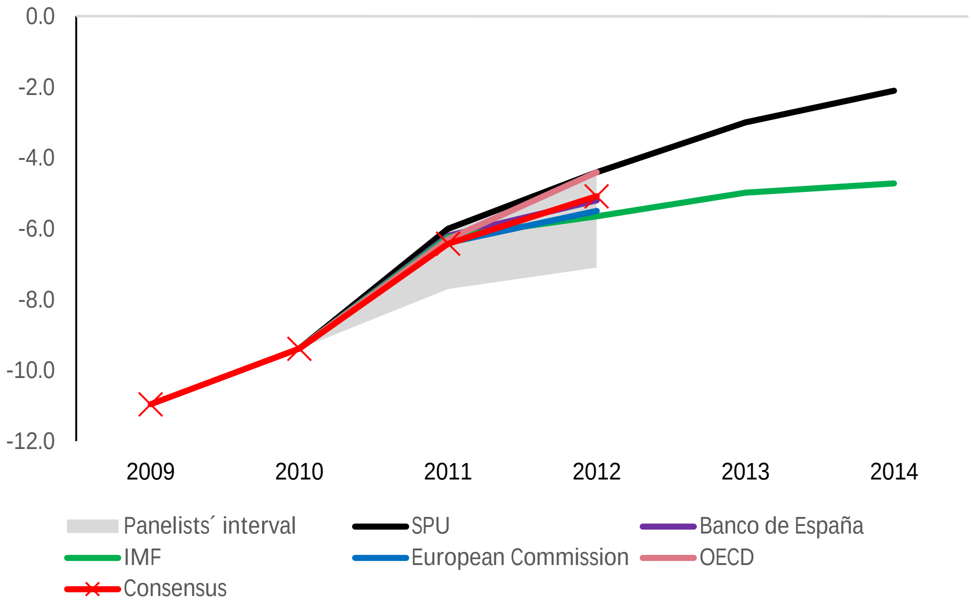
2011

GDP forecasts : 2011



Source: INE, MINECO and AIReF estimates.

Forecasts of government lending/borrowing : 2011



Source: INE, MINECO and AIReF estimates.

Report on the Draft Stability Programme Update 2015-2018
(Article 16 of Organic Law 6/2013 creating the Independent Authority for Fiscal Responsibility)

Introduction

AIReF has to report on the Stability Programme Update (SPU for *Actualización del Programa de Estabilidad,* APE, as it is known in Spanish) and in doing so assess especially whether the measures contained in it guarantee compliance with the budget stability targets, the debt limit and the expenditure rule set. AIReF is required to do this by article 16 of Organic Law 6/2013 creating the Independent Authority for Fiscal Responsibility (AIReF) and article 15 of Royal Decree 215/2014, 28th March, approving its Organic Statute. In order to issue the report, AIReF should receive the text of the draft Stability Programme, accompanied by the corresponding medium-term budget forecasts and any other information or documentation supporting the forecasts and data contained in it, with sufficient time in advance.

The information available at the time did not allow the report to be published by the statutory annual deadline of 15th April. On 15th April, AIReF had available to it quantitative information on projections and measures, but the nature and detail of this information made it impossible to prepare the report. Consequently, an informative note was released indicating that publication of the report would be postponed until the full information required was available.

This report has been sent to the government before the submission of the draft SPU to the European Commission. This allows the government to appraise the recommendations put forward and to incorporate them as appropriate.

Object of the report and limitations to its scope

The object of this report is to analyse the draft Stability Programme 2015-2018 and any other information provided that supports the data and forecasts contained in it. This report appraises the plausibility of the adjustment path presented in the draft Stability Programme. To this end, the sufficiency of the commitments envisaged to guarantee compliance with the budget stability, public debt limit and expenditure rule targets are analysed over the Stability Programme outlook period, on the one hand, and on the other, the analysis focuses on the likelihood of certain factors having a positive or negative impact on the attainment of the targets.

The Stability Programme is deemed to be a medium-term national fiscal plan and an assessment of it has to bear in mind the fiscal rules established by both the domestic and the European legislative framework. (See box 1). The SPU is a key document in designing fiscal policy in the medium term and for coordinating economic policies in the European Union. It describes the path to be followed for deficit reduction, public debt and the expenditure rule, along with the measures considered necessary to meet the targets, including indications on how the reforms and measures proposed are expected to help meet national targets and commitments. It is important to understand the European and national legislative framework within which this appraisal is made. The SPU has to be in line with Regulation (EU) 473/2013 of the European Parliament and the Council, of 21st of May 2013, on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area. Directive 2011/85 on requirements for budgetary frameworks and article 29 of Organic Law on Budgetary Stability and Financial Sustainability (LOEPySF[8] and [9], as it is known in Spanish), detailing the parameters that the medium-term budgetary plan included in the SPU must contain, are also applicable.

The preparation of the annual budget is encompassed in the SPU. From this perspective, the conclusions and recommendations made about the draft SPU must be evaluated with a view to including them in programming the 2016 budget, which will detail and specify the scenario contemplated in the Draft Stability Programme.

The budgetary projections included in the draft SPU for 2015-2018 are given in detail for the general government sector as a whole (PAs), without disaggregating them into subsectors. Furthermore, there is not sufficient information to assess the economic impact of some of the measures included in the SPU. Both these factors act as constraints on the analysis conducted by AIReF.

[8] http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0011:0023:EN:PDF
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0041:0047:EN:PDF

[9] Organic Law 2/2010 of 27 April 2012 Fiscal Stability and Financial Sustainability

Box 1. Fiscal legislative framework for the draft SPU 2015-2018 outlook

In the European Union, Spain is currently subject to the corrective arm of the Stability and Growth Pact (SGP) and therefore must comply with the Council recommendation aimed at bringing the situation of excessive deficit to an end in 2016. Spain will move to the preventive arm of the SGP one year after correcting its excessive deficit, and must ensure adequate progress towards structural budgetary balance. Moreover, for 3 years after correcting the excessive deficit, Spain will be subject to the transitional arrangements to comply with the debt criterion. During this time sufficient progress towards compliance must be ensured.

Nationally, the reference legislation is the LOEPySF, which establishes the principles of budgetary stability, financial sustainability and the expenditure rule. More specifically, transitional provision one of that law is applicable during the outlook period of the SPU, which establishes the necessary reduction paths to attain the objectives of structural balance and a public debt to GDP ratio of 60% by 2020.

The details of both legislations applicable to Spain are presented in the Appendix: Legislative Framework. In conclusion, European legislation focuses on deficit reduction during the phase of correcting excessive deficit, and the debt and expenditure rules will only be assessed as of 2017. National legislation on the other hand, does require compliance of not only the budgetary stability targets, but also the debt and public expenditure rules during the entire outlook period of the draft SPU. However, as long as the EDP remains open, national legislation defers to the fiscal targets in the Council’s recommendation.

1. Assessment of the fiscal scenario 2015-2018

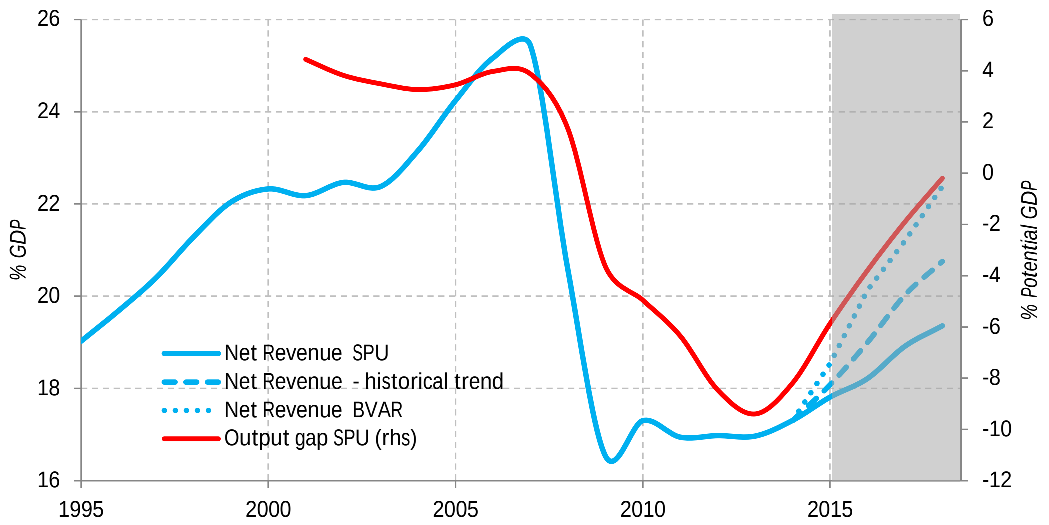
1.1. Analysis of the fiscal path 2015-2018 of the draft Stability Programme Update

In the section on Budgetary Forecasts, the Draft SPU includes the fiscal consolidation path for the general government sector as a whole for 2015-2018, broken down into subsectors. The revenue and expenditure fiscal scenario however, is only defined for the government sector as a whole.

The path envisaged in the draft SPU for the government sector as a whole includes a major consolidation adjustment of 5,4% of GDP[10] in 2015-2018. AIReF is of the opinion that this adjustment is ambitious but attainable. This adjustment is attained to a large extent by a reduction in expenditure of about 5 percentage points of GDP (from 43.6% to 38.4%) and a slight increase in revenues against GDP (from 37.8% in 2014 to 38.1% in 2018).

The draft SPU revenue forecast for 2015-2018 is conservative. The cyclical upswing included in the macroeconomic picture is expected to generate higher tax revenues than those provided for in the SPU budgetary forecasts.

Net Revenue and output gap



[10] From a target in 2014 of -5.7% of GDP without financial aid to 0.3% of GDP in 2018.

It seems plausible to keep current taxes on income and wealth at around 10% of GDP in 2018. This stability is influenced by the tax reform, which has a negative impact on revenues from the two main taxes on income (Personal Income Tax – IRPF, as it is known in Spanish - and Corporate Income Tax – IS, in its Spanish acronym), offsetting the positive performance of the economic upswing.

There also appears to be a certain downside bias in the estimates of indirect taxes contained in the SPU. It is in these tax figures where the greatest leeway is to be found, due the positive development of the macroeconomic variables, basically in private consumption and the housing market. For these reasons, there could be ample leeway in the estimate included in the programme path for 2015-2018.

The forecast for social contributions keeps a stable weight in GDP of around 12% throughout the outlook period. This is considered a reasonable performance and more in line with the one resulting from the labour market presented in the SPU macroeconomic scenario that expects strong performance.

With respect to the spending path, there is a net adjustment of 5.1% of GDP. This is mainly due to:

- ✓ Cyclical adjustment of 2.4% of GDP arising from the development of interest rates and social transfers in cash. The performance of interest rates, although consistent with the macroeconomic picture, could be considered prudent. As far as social transfers in cash are concerned, they show a reasonable adjustment path, which could, however, generate some upside tension. These tensions could be caused by the uncertainty surrounding the labour market in the medium term and the rigidity of pension expenditure that represents a highly significant volume in this heading.
- ✓ The rest of the expenditure adjustment will come from adopting budgetary policy measures and decisions.

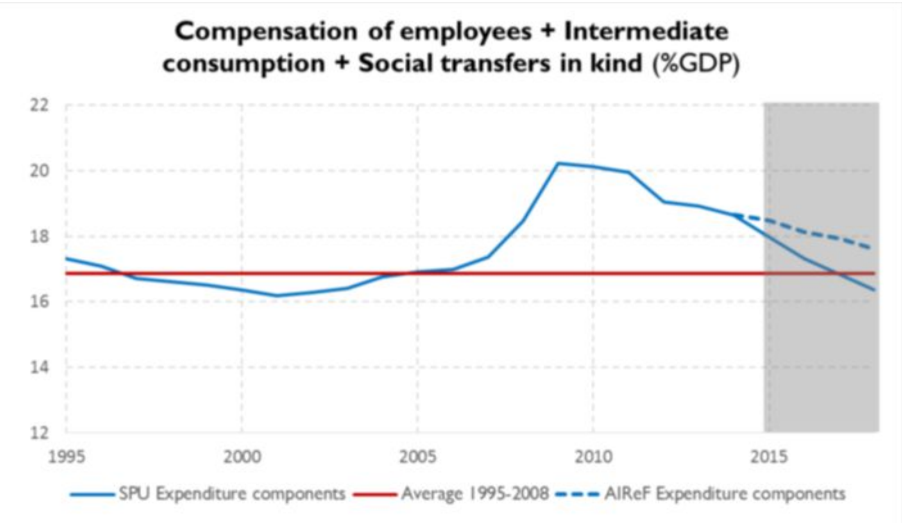
In the analysis of expenditure items, special attention should be paid to the analysis of government consumption and gross capital formation:

- ✓ Government consumption remains restrictive in aggregate terms until it reaches the average of the pre-crisis years. Public consumption falls 2.2 percentage points of GDP in 2014-2018, until it reaches the average level of the decade prior to the crisis with respect to GDP. The breakdown of expenditure included in this heading is as follows:

  - Employee compensation falls 1.3% of GDP over the 2014-2018 outlook period, reaching a similar average to that of the last decade of the last expansionary stage (9.5 points 2018). The measures in the draft SPU include one on an incomplete replacement of workers as they retire, quantified at €1bn in differential terms each year of the period 2014-2018. This measure might not be enough to justify the forecast path for employee compensation, and there is uncertainty around the estimate made for the medium term too.

- Intermediate consumption falls 0.7% of GDP over the period 2014-2018 to a weight of 4.5% of GDP. This adjustment could be justified in part by the expenditure rationalisation measures adopted by the Public Administration Reform Committee (CORA, as it is known in Spanish) and by the new health expenditure rationalisation instrument. Although the adjustment scenario is possible, there are doubts regarding the materialisation of these savings in the medium term without having enough available information to fully evaluate this.

- Expenditure on social transfers in kind, including expenditure on education and health agreements and non-hospital pharmacy falls over the period 0.3% of GDP to 2.3% of GDP. This could be explained in part by the measures concerning the creation of a new rationalisation instrument for health spending. Uncertainty about the scope and application of the measure, not yet approved, makes it impossible to make an adequate appraisal



:

The graph shows the trend in the expenditure items that comprise government consumption.

✓ The path foreseen for gross capital formation could be excessively conservative, remaining at an all-time low of 2% of GDP since 1995. This could be affected in the 2015-2018 outlook by a major forward rescheduling of investments carried out in the past as a consequence of the significant fiscal consolidation adjustment, generating uncertainty about how this item will behave.

Box 2. Comparison of the 1995–1999 and 2014–2018 adjustments

FISCAL ADJUSTMENT (% GDP)			
	Item	1995-1999	2014-2018
1	**Public deficit adjustment (1=2+5+6+7)**	**-5.7**	**-5.4**
2	**Cyclical component of revenue and expenditure (2=3+4)**	**-2.6**	**-1.9**
3	Revenue	-1.3	-0.4
4	Expenditure on social benefits	-1.3	-1.6
5	Debt servicing	-1.5	-0.8
6	Investmenl expenditure	-1.2	-0.3
7	**Government consumption and other expenditure (7=8+9+10+11)**	**-0.3**	**-2.5**
8	Compensation per employee	-0.7	-1.3
9	Intermediate consumption	-0.3	-0.7
10	Social benefit payments in kind	0.2	-0.3
11	Other expenditure	0.5	-0.3
	Memorandum item:		
	Real GDP growth *(Annual average)*	3.7	3.0
	Nominal GDP growth *(Annual average)*	6.7	4.0
	Change in output gap (cumulative)	4.4	8.0

The fiscal adjustment path presented in the draft Stability Programme Update 2015 – 2018 implies reducing government deficit by 5.4 points of GDP between 2014 and 2018. One has to go back to 1995-1999 to find a historic precedent against a similar backdrop of economic recovery, when a fiscal adjustment of 5.7 points of GDP was made in the same time span. But consideration must also be given to the fact that nominal growth was greater from 1995 to 1999 than the growth forecast for 2014 – 2018.

The table shows major differences between the two fiscal adjustment paths. First, the contribution of the cyclical component is 2.6 points in the period 1995 – 1999, against just 1.9 points in 2014-2018. This is due mainly to a lower increase in revenues, which only accounts for 0.4 points of the adjustment in 2014 – 2018.

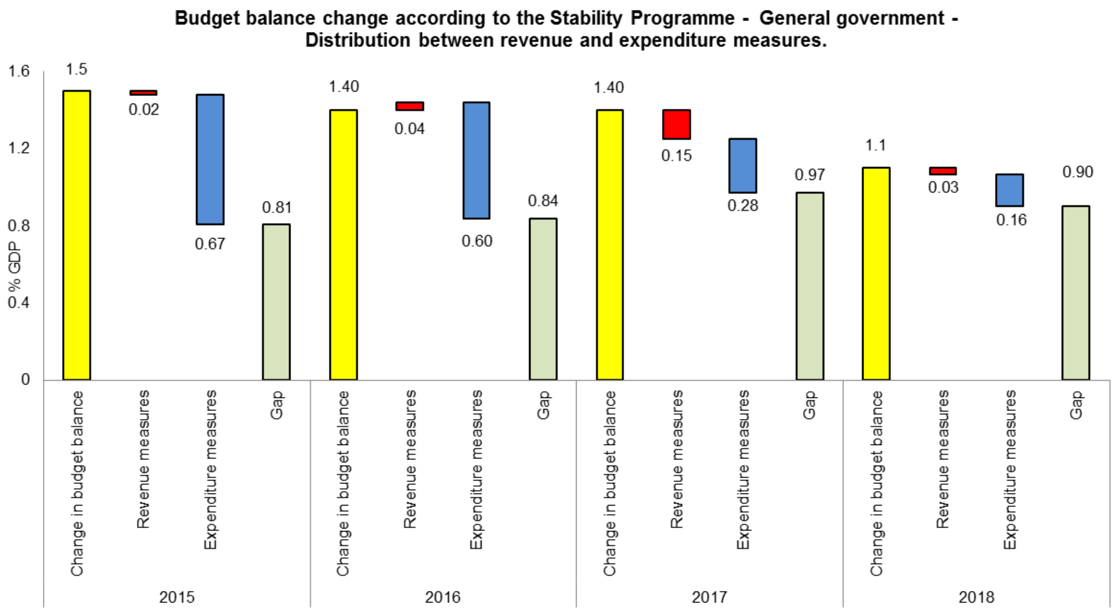
The reduction in debt servicing costs on the other hand is also less than in 2014 – 2018, because the starting point is a lower interest rate and the margin is therefore smaller too. Similarly, investment spending, which would include both gross fixed capital formation and capital transfers, started from much higher levels, 6.5% of GDP in 1995 against 2.8% in 2014, so there is little margin for reduction.

Consequently, government consumption and other expenses would account for 47% of the adjustment in 2014-2018, 2.5 points of GDP, against 6% that it accounted for in the fiscal adjustment between 1995 and 1999, 0.3 of a point of GDP. So this is a highly ambitious target that would require strict control of personnel expenditure by means of both wages and by means of the number of public-sector employees, by containing intermediate consumption with a nominal 1% increase over the period and a reduction of other expenses. Although the revenue estimates contained in the draft SPU 2015-2018 are prudent, the expenditure reduction target is very demanding, so a strict enforcement of the expenditure rule is essential.

1.2 Analysis of the commitments made in the Draft Stability Programme Update to comply with the stability targets

An analysis of the plausibility of the fiscal consolidation path as presented in the draft SPU for 2015-2018 requires an appraisal of whether the measures proposed are enough to guarantee compliance with the budgetary stability targets, under article 16 of Organic Law 6/2012 creating AIReF.

The graph below shows the consolidation adjustment to be made by the government sector as a whole in 2015-2018 and the impact of the revenue and expenditure measures of the draft SPU on the total adjustment. The difference between the two (gap) determines the magnitude of the adjustment tied to the economic cycle and to budgetary policy decisions.

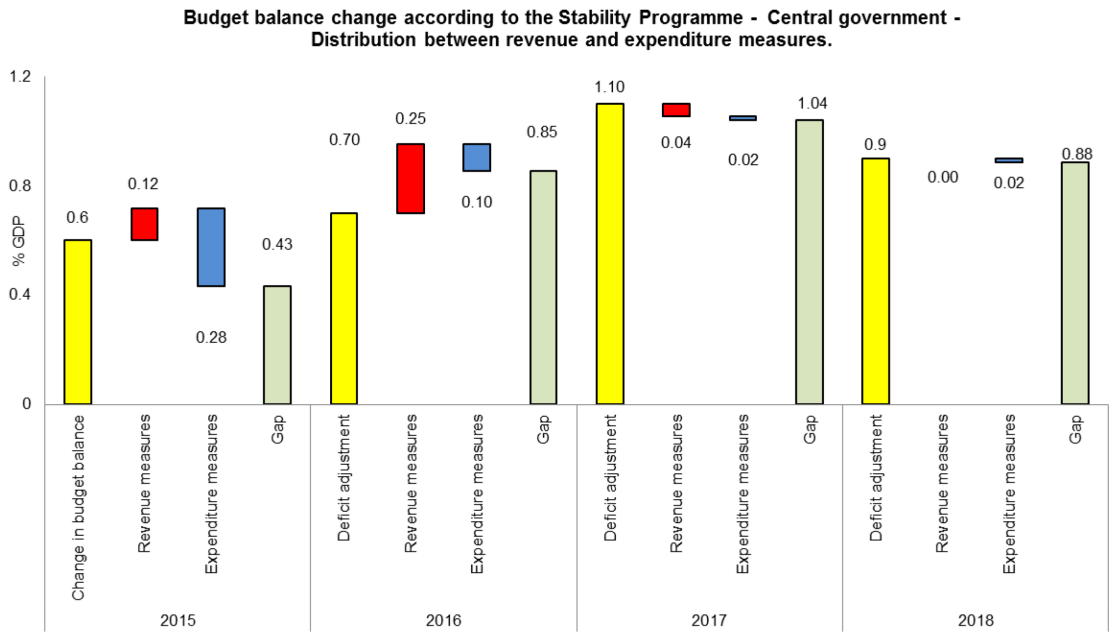


An analysis of these measures and their adequacy for guaranteeing compliance with the objectives is carried out for each of the subsectors in the respective section, based on the information contained in the draft SPU.

1.3. Appraisal of the measures proposed for the central government subsector

The path proposed for the central government (CG) subsector means making a major consolidation adjustment of 3.3% of GDP between 2015 and 2018, which is seen as achievable, provided that the margins that seem to exist according to the medium-term macroeconomic forecasts actually materialise.

The next graph shows the consolidation adjustment necessary and the contribution made to it by the revenue and expenditure measures:



The adjustment is propitiated essentially by an improvement in the macroeconomic scenario that will entail a significant increase in tax revenues in 2015-2018. Although it is true that the macroeconomic scenario will propitiate this improvement in the general government sector tax resources, the Funding System of the Territorial Administrations currently in effect means that a large part of this increase in resources will be transferred to the Autonomous Regions subsector from 2016.

On the other hand, expenditure on debt servicing and transfers to the State Public Employment Service (SEPE, as it is known in Spanish) to cover the deficit are likely to mean less pressure on the expenditure side as a consequence of interest rate developments and the likely fall in spending on unemployment benefits.

The risks observed in this scenario, as highlighted in the Report on the Macroeconomic Forecasts, could affect the consolidation adjustment. If these risks materialise, the measures established in the draft SPU for the central government subsector might not be sufficient, especially in 2015 and 2016, when revenue measures have a negative impact as a consequence of the tax reform and arising from Royal Legislative Decree 17/2014, of 26th December. Moreover, the expenditure measures do not have a very significant financial impact.

The expenditure measures falling within the scope of the central government subsector are articulated through actions aimed at rationalising public expenditure stemming from Public Administration Reform Committee (CORA, as it is known in Spanish) and from savings arising from not fully replacing manpower in 2015-2018.

CG subsector: Impact of the main legislative changes on the deficit. Expenditure
Year-on-year impact (% GDP)

	2015	2016	2017	2018
Expenditure CG	0.28	0.10	0.02	0.02
Extra salary payment public employees 2012	-0.02	0.02	0.00	0.00
Public employment (general personnel measures)	0.02	0.02	0.02	0.02
CORA	0.10	0.06	0.00	0.00
Refund under EUCJ ruling	0.18	0.00	0.00	0.00

Source: SPU.

There are two measures that affect employee compensation: the recovery of 25% of the extra monthly salary payment from 2012 and the incomplete replacement of staff that retire. These amount to a saving of 0.8% of GDP in 2015-2018. These measures are evaluated jointly in the draft SPU for both the central government and for the Social Security Funds subsectors.

With respect to measures aimed at rationalising public spending formulated in the framework of the Public Administration Reform Committee (CORA), these are expected to make total savings of 0.16% of GDP over the outlook period 2015-2017. These measures affect several headings and were already included in the Budget Plan for 2015. The information provided in the draft SPU does not include enough details to allow the estimate of expected savings in the CORA framework to be assessed, and an examination of the central government 2015 budget has not yet revealed any especially significant savings.

The revenue measures refer exclusively to taxes and they have a differential impact as a percentage of GDP of -0.12 in 2015, -0.25 in 2016 and 0.04 in 2017. The impact of the revenue measures for the whole period 2015-2018 is -0.33% of GDP.

The effect of lower revenues in 2015 due to the implementation of Royal Legislative Decree 17/2014, of 26th December, concerning the financial conditions of the Territorial Administrations’ funding mechanisms is not included.

CG subsector: Impact of the main legislative changes on the deficit. Revenues
Year-on-year impact (% GDP)

	2015	2016	2017	2018
Revenue CG	-0.12	-0.25	0.04	0.00
Total taxation	-0.12	-0.25	0.04	0.00
IRPF and taxation on non-residents	-0.22	-0.18	-0.05	0.00
Corporation tax	-0.05	-0.21	0.01	0.00
Anti-fraud measures	0.09	0.09	0.08	0.00
Special duties and environmental taxes	0.04	0.00	0.00	0.00
VAT	0.03	0.00	0.00	0.00
Fees and financial transaction tax	-0.01	0.05	0.00	0.00

Source: SPU. There are no revenue measures in 2018

Most of the revenue measures were already included in the 2015 Budgetary Programme published in October 2014. Two new measures have been identified[11]: the water fee, enacted by Royal Decree 198/2015, 23rd March, with an impact of €305m in 2015 and -€96m in 2016 in differential terms, and the anti-fraud measures, that have an annual impact in GDP terms of 0.09 in 2015 and 2016 and 0.08 in 2017 in year-on-year terms. These measures appear to be justified in the draft SPU as a consequence of the amendment to be made to the General Tax Act (*Ley General Tributaria*) this year.

The total impact of the revenue measures in 2015 and 2016 is negative, as a consequence of what is known as the Fiscal Reform that affects IRPF, IRNR and IS (personal income tax, non-resident income tax and corporate income tax). The draft SPU does not individually detail the financial impact of the measures that affect these three taxes. Bearing in mind the weight of this reform, and as indicated in the report published by AIReF on 31st March 2015[12], it would be advisable to itemise the financial impact of this reform in order to be able to better evaluate it.

The Draft SPU does include the impact of the fiscal reform in ex post terms (after factoring in second round effects) for 2015, 2016 and 2017, without any variations with respect to the estimates included in the 2015 Budget Plan, and despite the fact that the measures with a negative impact were approved subsequently. Since the Budget Plan was presented, two measures have been passed that will have a negative impact on revenues: the amendment concerning capital gains reduction coefficients approved during the parliamentary reading of the 2015 Budget Act (which entails lower revenues than expected) and the measure broadening the scope

[11] Furthermore, the one-off health cent measure, which was booked on the revenue side of the accounts, is now booked on the expenditure side

[12] Report on the initial Budgets of the Public Administrations for 2015.

of application of IRPF deductions for large families or families with disabled dependents included in Royal Legislative Decree 1/2015, 27th of February, on second opportunity mechanisms, reduction of the financial burden and other social measures (the cost of collecting the revenues from this measure is quoted in the financial report as €410m a year and calculated on an accruals basis).

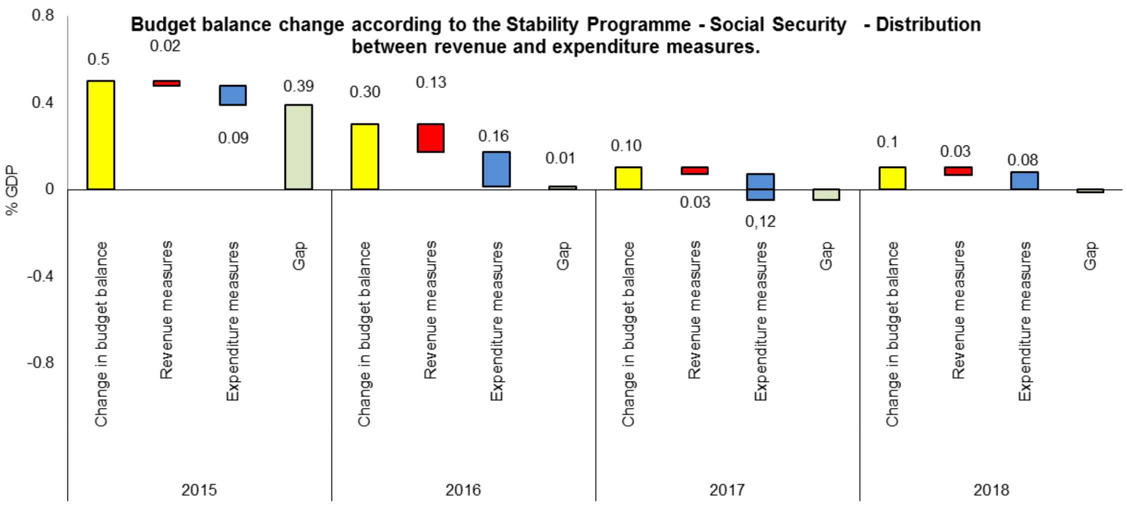
A priori, the impact of the tax reform in 2016 should have been affected by the approval of these measures and the expected impact of the Budget Plan would be modified. However, other elements of this ex post appraisal may have been taken into account, which are not reflected in the draft SPU.

The impact of the revenue measures is positive in 2017, basically due to the fact that the anti-fraud measures offset the negative impact on the other tax measures.

1.4. Appraisal of the measures set out for the Social Security subsector

The path set out for the Social Security Funds (SSF) subsector requires a consolidation adjustment of 1% of GDP between 2015 and 2018, which is unlikely to be achieved.

The graph below shows the consolidation adjustment necessary and the contribution made to it by the expenditure and revenue measures:



As in other subsectors, the consolidation adjustment is based fundamentally on the improved macroeconomic scenario, which will mean a significant increase in contribution revenues over the period 2015-2018.

The positive development of revenues is not enough, however, to meet the stability target set for the outlook 2015-2018 and the measures set out in the draft SPU do not manage to complete the retrenchment required. It must be remembered that the increase in pension expenditure that is going to occur during the period means that the real adjustment to be made is greater than indicated in the outlook. On the other hand, the improvement arising from lower unemployment benefits will basically affect the central government subsector by reducing the transfers destined to finance the SEPE deficit.

The draft SPU includes measures for the subsector of Social Security Funds that amount to 0.67% of GDP for the 2015-2018 timeline, much of which comes from measures adopted in previous programmes.

SSF subsector. Impact of key legislative changes on the deficit Expenditure
Year-on-year impact (% GDP)

	2015	2016	2017	2018
Expenditure SS	0.08	0.16	0.12	0.10
Social Security expenditure	0.09	0.10	0.10	0.10
Labour market policies	-0.01	0.06	0.02	0.00

Source: SPU.

The expenditure measures in the draft SPU are valued at 0.46% of GDP over the period 2015-2018. Most of these consist of lower expenditure because of previous reforms, mainly the reforms to the pension systems of 2011 and 2012, which account for almost one tenth of a percentage point of GDP per year. The other expenditure measures focus on the labour market and mean increased expenditure. More specifically, the approval of a new temporary Job Activation Programme (Royal Legislative Decree 16/2014, 26th December), for the long-term unemployed with family responsibilities that have exhausted their unemployment benefits. The financial report estimates this measure at €850m and €182m in 2015 and 2016 respectively. Finally, there is the new Mutual Insurance Company Act as a measure to reduce expenditure, which brings in changes to the way temporary sickness benefits are managed. The draft SPU appraises the impact of this modification at €511m saving in the system's expenses in 2015, but AIReF does not have sufficient information to make an appraisal of the possible impact of this measure.

SSF subsector. Impact of the key legislative changes on the deficit. Revenues
Year-on-year impact (% GDP)

	2015	2016	2017	2018
Revenue SS	0.02	0.13	0.03	0.03
Social Security contributions revenue	0.02	0.13	0.03	0.03

Source: SPU.

The revenue measures are valued in the SPU as an increase of 0.21% of GDP over the period 2015-2018. The most important of these measures is the new instalment payment system that the SPU expects to contribute 0.14% between **2015 and 2016 (€1.538bn).** Not enough information is made available to appraise this sum, except for the financial report that accompanied the draft bill, which estimated that rolling out the plan would increase revenues by almost €180, mainly from collecting unemployment contributions properly.

The Mutual Insurance Company act, according to the Stability Programme, will also bring in an extra €345m in revenues from the provision of health services by third parties and from contracting out the prevention service. Not enough information is available to appraise the estimated impact in the draft Stability Programme.

The other measures mean lower revenue collection. The draft SPU values the **overall impact of this at €2.457bn over the period 2015**-2018. More specifically, approving a three-month extension of the flat rate of €100 for hiring employees on indefinite contracts (Royal Legislative Decree 17/2014 26th December) and the second opportunity mechanism, reduction of the financial burden and other social measures (Royal Legislative Decree 1/2015, 27th February), which include two measures that affect the scope of Social Security:

- The exemption from paying contributions on the first €500 for indefinite contracts from March means a reduction in the employer contribution in the coming years.
- A 100% rebate on the Social Security contribution for common contingencies of the self-employed who shorten their working day to look after children under 7 or elderly dependents.

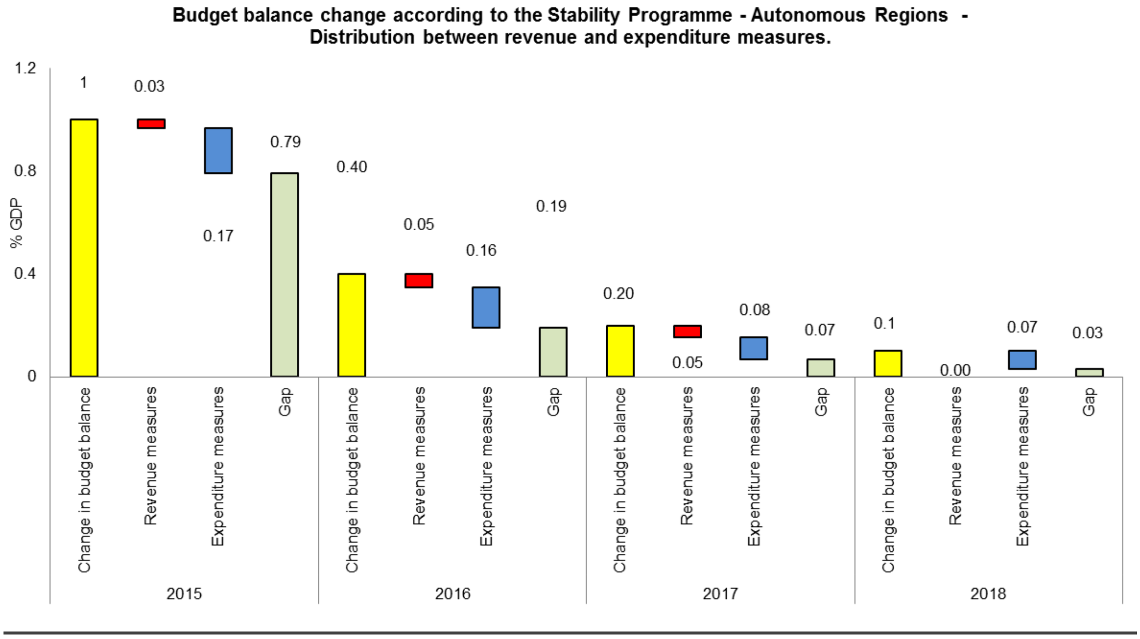
The central government subsector does not appear to have enough leeway to offset this shortfall over the period. On the other hand, in line with article 11.5 of the LOEPySF, it seems reasonable to analyse the economic-financial situation of the central government and Social Security Funds subsectors jointly. From this perspective, the conclusion drawn is that the central government subsector is unlikely to have enough leeway to offset the shortfall in the Social Security Funds subsector.

The available information advises to undertake an analysis of the short- and medium-term financial situation of the Social Security Funds subsector to anticipate the possibility of the Reserve Fund running out before it occurs. The Social Security system shows financial tensions in the short and medium term that represent a clear risk to meeting fiscal consolidation milestones. Given that the Reserve Fund is reducing its resources, it would be advisable to anticipate possible problems and analyse the medium term financial situation of the system.

1.5. Evaluation of the measures set out for the autonomous region (AR) subsector

The fiscal retrenchment to be made by the AR subsector over the period 2015-2018 is 1.6% of GDP and whether it achieves it will depend on offsetting the different relative positions of the ARs. The AR subsector closed 2014 with a deficit of €17.529bn and it has to balance its budget in 2018. This means fiscal retrenchment amounting to 1.6% of GDP is required.

The next graph shows the consolidation adjustment necessary and the contribution made to it by the expenditure and revenue measures:



The discretionary measures set out in the draft SPU would allow approximately half of the necessary fiscal consolidation adjustment to be achieved. The set of measures for the AR subsector or arising from discretionary State actions are valued at €8.295bn, or 0.7% of GDP, for the whole period.

On the expenditure side, the key savings affect government consumption and debt servicing costs (see table below):

- ✓ Personnel measures, basically, not replacing employees who retire, with an annual incremental effect of €589m and producing a cumulative impact of 0.2% of GDP at the end of the year.

- ✓ Pharmaceutical spending-related measures, as a result of the instrument for health expenditure sustainability, valued at €1.421bn over the period, 0.2% of GDP. This instrument will be rolled out with the amendment of the General Health System Act (*Ley General de Sanidad*), which is currently going through parliament and will introduce specific controls on the growth of pharmaceutical spending and the adoption of a battery of measures by the ARs in this area, but these measures have not yet been specified in detail.
- ✓ Application of Royal Legislative Decree 17/2014, on financial sustainability measures for autonomous regions and local entities and other economic measures, which expects to save €3.019bn in debt servicing costs in 2015 and €1.246bn over the whole period, 0.1% of GDP.

AR subsector. Impact of key legislative changes on the deficit Expenditure (*)
Year-on-year impact (% GDP)

	2015	2016	2017	2018
General expenditure measures in ARs	-0.04	0.10	0.05	0.00
Extra wage payment public employees 2012	-0.09	0.05	0.00	0.00
Public employment (general personnel measures)	0.05	0.05	0.05	0.00
Specific expenditure measures ARs	0.39	-0.02	0.03	0.06
Personnel measures other than general measures	-0.02	-0.01	0.00	0.05
Pharmaceutical spending	0.06	0.05	0.02	0.02
Interest	0.28	-0.14	0.00	-0.01
Other current expenditure measures	0.07	0.07	0.01	0.00
Capital expenditure measures	0.00	0.01	0.00	0.00

Source: SPU.

(*) The real estate disposal measures, presented in the general table of the draft SPU as lower expenses, are detailed in the revenue table

The tax measures are the most important revenue measures detailed in the table below. They are **valued at €1.808bn over the whole period (0.2% of GDP),** accounting for 83% of the total. The largest increases are expected from the measures affecting Tax on Inheritance and Donations (ISD, as it is known in Spanish) and Tax on Asset Transactions and Documented Legal Acts (ITPAJD, as it is known in Spanish), Tax on Hydrocarbons, and from the creation of new environmental taxes. Non-tax measures, basically asset disposals and administrative concessions have a greater weight in the early years of the period, although they are expected to be maintained throughout the outlook.

AR subsector. Impact of key legislative changes on the deficit Revenues (*)
Year-on-year impact (% GDP)

	2015	2016	2017	2018
Revenue measures ARs	0.13	-0.02	0.06	0.00
ITPAJD	0.00	0.01	0.02	0.00
ISD	0.00	0.01	0.01	0.00
Environmental taxes and hydrocarbons tax	0.00	0.02	0.02	0.00
Other taxes	0.03	0.01	0.01	0.00
Other measures, not taxation related	0.10	-0.07	0.00	0.00

Source: SPU.

(*) The real estate disposal measures, included in the general table of the draft SPU as lower expenditure, are detailed in this table.

These measures vary significantly from those included in the 2015 Budget Plan. The greatest differences against the figures in the 2015 Budget Plan come from the valuation of the effect of Royal Legislative Decree 17/2014, 26th December, from incorporating the forecasts contained in the Economic and Financial Plans approved at year-end 2014 and from updating the measures envisaged for 2015.

Meeting the demanding fiscal consolidation path requires that:

- The planned measures achieve the estimated economic effects, which raises doubts with respect to non-tax revenues, personnel measures, and those arising from the new health expenditure rationalisation instrument, which is still pending approval and concrete definition. Furthermore, the draft SPU points out the possibility that the ARs may raise higher revenues by exercising their legislative capacity but it does not provide any information for this to be evaluated.
- The macroeconomic scenario provides for an improvement in tax revenues, a significant part of which would be transferred to the ARs from 2016 onwards under the Funding System provisions. Under this assumption:
    - The resources in the system could increase significantly from 2016, which would make it possible to substantially reduce the current gap in the subsector's deficit.
    - ITPAJD and other tax revenues could improve considerably.

The circumstances described above would necessarily have to be accompanied by keeping expenditure in line with the expenditure rule. In this regard, it is essential that any margin generated in the ARs that are in a more comfortable financial position should be used to offset the deviations that will be recorded almost certainly by the ARs in a worse initial position. This offsetting requires the expenditure rule to be strictly applied.

1.6. Evaluation of the measures set out for the local corporation (LC) subsector[13]

It is highly likely that the LC subsector maintains the surplus of around 0.5% of GDP attained in 2013 and 2014 over the horizon of the Draft Stability Programme. Bearing in mind that this subsector achieved a surplus of 0.52% and 0.53% of GDP in 2013 and 2014 respectively, and having analysed the information available in the draft Stability Programme to date, it seems highly likely that it will make a similar surplus to the figure recorded in 2013 and 2014 in each of the years encompassed by the programme, even if some of the discretionary measures were not taken.

The consolidation of the surplus in this subsector is due to the joint implementation of the expenditure rule and the budgetary stability target. Implementing both fiscal rules at the same time guarantees that expenditure will be contained in times of budget surplus, with the expenditure rule operating as a preventive measure once the legal target of a balanced budget is achieved. This control and rationalisation of expenditure, together with the increase in revenues, allow the target of a balanced budget to be overshot and for this result to be consolidated going forward.

LC subsector. Impact of key legislative changes on the deficit Expenditure
Year-on-year impact (% GDP)

	2015	2016	2017	2018
Expenditure measures in LCs	0.13	0.18	0.06	0.00
Personnel expenditure reduction and non-replacement of staff	0.00	0.04	0.02	0.00
Reduction in current expenditure	0.04	0.02	0.01	0.00
Public sector businesses. Winding-up of companies	0.04	0.04	0.03	0.00
Elimination of services not a local competence and disappearance of minor local entities	0.05	0.01	0.00	0.00
Transfer of competences in health, education and social services	0.00	0.04	0.01	0.00
Integrated management of public services and mergers of municipali	0.01	0.02	0.01	0.00

Source: SPU. The appendices do not include measures for 2018.

LC subsector Impact of key legislative changes on the deficit Revenues
Year-on-year impact (% GDP)

	2015	2016	2017	2018
Revenue measures in LCs	0.08	0.04	0.03	0.00
Tax rises, elimination of exemptions and voluntary discounts	0.08	0.04	0.03	0.00
Public fees and prices	0.00	0.00	0.00	0.00

Source: SPU. The appendices do not include measures for 2018.

[13] There is no need to include the consolidation adjustment table given the surplus in the LC subsector

The measures proposed for the period 2015-2017 focus mainly on the expenditure side and will stem essentially from local government reform. Expenditure measures entail savings of some €4.211bn (0.37% of GDP), while revenue measures entail an increase of €1.7bn (0.15% of GDP), mainly from the discretionary measures adopted with respect to local taxes.

With regard to the 2015 Budget Plan, there is a reduction of €3.084bn (0.28% of GDP) in planned expenditure savings, **and a €536m** cut (0.05% of GDP) in planned increased revenues. The decrease in the amount of the measures planned on the expenditure side comes from updating the expected financial impact of local government reform. Back in 2014 —the first year that local reform was implemented— the impact of the expenditure measures was €459m, €609m less than estimated, i.e. 57% lower than forecast.

On the revenue side, the additional increases expected in 2015 and onwards, have been reduced. The measures on "public prices and fees", "reinforcing the effectiveness of executive collection" and "other revenue-side measures" totalling €635m (0.07% of GDP) have been eliminated from the draft SPU for the period 2015-2017 without any justification. Moreover, the measure concerning "tax increases" shows an increase of €100m in 2016 (0.01% of GDP) against the last published figure, once again, without any known justification.

Implementation of the expenditure rule in this subsector guarantees that the surplus will be maintained. Hence, in 2014 the proposed measures amounted to €1.995bn (0.19% of GDP), but according to the information from the draft SPU, these measures had a financial impact of €1.121bn (0.11% of GDP), i.e. 0.08% of GDP less than estimated. Despite these circumstances, the surplus reached 0.53% of GDP, a similar figure to the previous year.

2. Expenditure rule

Article 12 of the LOEPySF sets a ceiling on the growth of government expenditure at subsector level. More specifically, the variation in the "eligible expenditure" of the Central Government, Autonomous Regions and Local Corporations subsectors cannot exceed the medium-term reference GDP growth rate of the Spanish economy.

"Eligible expenditure" is defined as non-financial uses, excluding debt servicing, non-discretionary expenditure on unemployment benefits, the part of the expenditure that is financed by funds for a specific purpose from the European Union or other public administrations and the transfers to the autonomous regions and local corporations linked to the funding systems. Furthermore, legislative changes that entail changes in revenue collected are taken into account, such that, if the change brings about a permanent increase in revenues, for example, an equivalent increase in spending would be allowed. The "reference rate" is the average rate calculated by the Ministry of Economy and Competitiveness following the methodology used by the European Commission in compliance with European regulations.

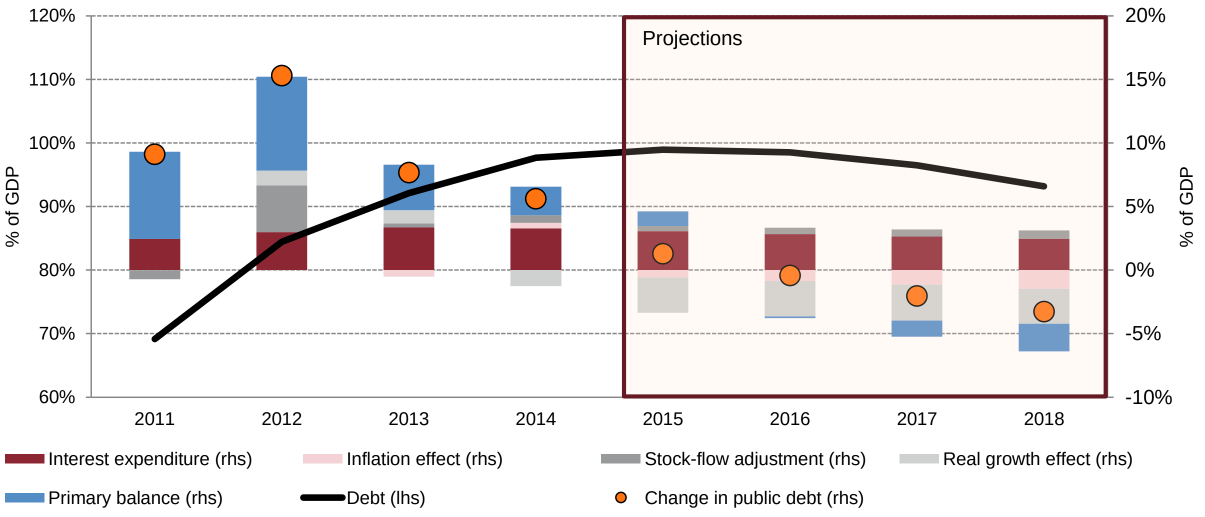
The information provided in the Stability Programme does not allow compliance of the expenditure rule to be adequately evaluated because it does not go into sufficient detail at subsector level. The GDP reference rate has not been published either, although it has been provided to AIReF. With these constraints, AIReF can only make an approximate assessment of the compliance of the government sector as a whole with the expenditure rule, concluding that there is compliance up to year-end 2016. In 2017 and 2018 however, there would be slight deviations from the target.

On the other hand, as shown in the appendix on the regulatory framework, the EU expenditure rule is more demanding than the Spanish rule. Real eligible expenditure must grow less than medium-term real GDP until such time as the medium-term budget objective (MTO) is reached, i.e. structural equilibrium in the case of Spain. This rule, however, will not be applicable to Spain until 2017, when Spain moves to the preventive arm of the Stability and Growth Pact.

3. Debt target

The Draft SPU includes the public debt path for the 2015-2018 outlook and, although there is a reduction over the period, it is not sufficient for compliance with transitional provision one of the LOEPySF. This provision establishes conditions to guarantee that public debt is not higher than 60% of GDP by 2020. To achieve that, when the domestic economy reaches a real growth rate of at least 2% per year, the debt-to-GDP ratio should fall by at least 2 percentage points of GDP each year. The forecasts however are for the debt-to-GDP ratio to achieve a cumulative reduction over the whole period of 4.4 percentage points of GDP, down to a debt ratio standing at 93.2% of GDP in 2018. This path does not allow the target to be met within the time frame set (2020) given the gap with the 60% target (still 33 percentage points of GDP at year-end 2018). Also, the pace of adjustment is lower than required because, as the draft SPU forecasts that real GDP will grow by nearly 3% from 2015, the reduction should have been at least 8 percentage points of GDP.

Debt-to-GDP ratio 2015-2018



An alternative way of evaluating the public debt path included in the draft SPU is on the basis of a debt projection obtained with an econometric model as shown in box 3. According to this model, the debt would peak around 2017, with an increasing possibility of reducing it as we move towards the end of the period.

Figure 1: EDP debt forecasts and Draft Stability Programme scenario

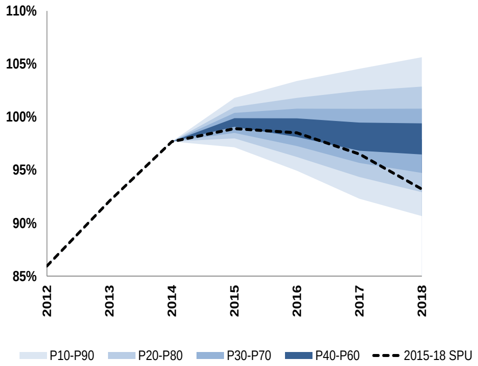
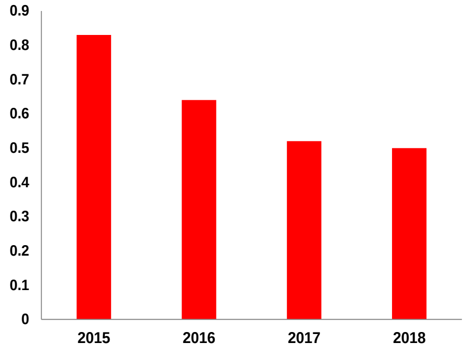


Figure 2: Probability of growth in public debt compared to its 2014 level, 97.68% of GDP



Source: Banco de España and AIReF estimates.

The debt path underpinning the draft SPU scenario gradually deviates from the path estimated by this model. In fact the draft SPU forecasts for debt fall within the central, or more likely intervals for 2015 and 2016, but its progressive fall to around 93.2% of GDP in 2018 are not corroborated by the model forecasts. In probability terms, it could be said that the probability of public debt as a percentage of GDP being higher than the figure forecast by the government in 2018 is 78%.

Box 3: Public debt sustainability exercise

The fiscal VAR model used is estimated with quarterly data and includes macroeconomic and fiscal variables (*). More specifically, the endogenous variables vector includes:

i. Real government expenditure on goods and services (defined as the sum total of government consumption and government investment);
ii. Real net revenues (total revenues, net of social expenditure and interest payments);
iii. Debt/GDP ratio;
iv. Real GDP;
v. GDP deflator;
vi. Ten-year government bond yields;

The fiscal data are taken from the quarterly database developed by Castro *et al*. (2014)(**). The GDP and GDP deflator series are taken from the National Statistics Institute (INE, as it is known in Spanish), while interest rates are taken from Banco de España data. The series are adjusted for seasonality and taken in logarithms, except for interest rates and the debt/GDP ratio, which are taken on levels. Finally, government spending on goods and services, net revenues and GDP are expressed in real terms, deflated by the GDP deflator.

The exercise itself is conducted in 3 stages;

1. Estimation of FVAR for the period 1986Q3-2015Q1:
   i. Up until 2014Q4, the sample comes from the data update provided by the Banco de España, having passed SEC2010.
   ii. Two steps are followed for 2015Q1. First, internal estimates of debt, GDP and its deflator from the factorial models are used as observed data. Second, the other variables for 2015Q1 are filled in by predicting them, conditional on the imposed data of debt, GDP and its deflator.
2. Projection by bootstrapping the public debt paths.
   1500 probability scenarios for Spanish public debt are constructed from the projected trajectories for the macroeconomic and fiscal variables and the estimated overall distribution of the VAR shocks.
3. Comparing FVAR projections with the path presented in the Draft Stability Programme

(*)The model was developed in Cuerpo y Ramos (2014): Working Paper 2/2014, AIReF

(**) de Castro, F., F. Martí, A. Montesinos, J.J. Pérez y A.J. Sánchez-Fuentes. 2014. "Fiscal Policies in Spain: Main Stylized Facts Revisited" Banco de España Working Paper Series, 1408

4. Recommendations and best practice guidelines

4.1. Recommendations

AIReF recommends:

1. That the funding for the different subsectors of the government sector be revised in order to bring resources in line with the responsibilities for providing goods and service established for each subsector under the distribution of competences in force;
2. That the situation of the Social Security System be analysed as the short- and medium-term financial tensions in this subsector represent a clear and significant risk for the fiscal consolidation path;
3. That compliance with the expenditure rule is given the same importance as budgetary stability and public debt targets, which would mean making a considerable improvement in the transparency with which it is implemented. In particular, AIReF recommends:
   - ✓ That the 2016 budgets of the entire government sector include a specific section in their Economic & Financial Report or equivalent, identifying the components and calculations of the expenditure rule in sufficient detail to allow it to be reproduced, and
   - ✓ That regular information be made available during the year on the extent to which the different government subsectors comply with the expenditure rule.
4. That the draft SPU be brought into line with Directive 2011/85 on budgetary frameworks and article 29 of the Organic Law on Budgetary Stability and Financial Sustainability (LOEPySF) containing details of parameters that must be included in the medium-term budgetary plan included in the draft SPU. Particularly it should:
   - ✓ make budget projections by subsectors and increase the level of detail of certain budgetary lines;
   - ✓ include, with a breakdown by subsectors, public debt targets and information on eligible expenses and the reference rate for calculating the expenditure rule for each year encompassed by the update.
5. Using the proper legal mechanisms to extend the transition period for complying with the limit established in article 13 of the LOEPySF by adapting the requisites specified in transitional provision one of the law and defining a credible and demanding path for a sustained reduction of the debt ratio.

4.2. Best practice guidelines

AIReF makes the following proposals:

1. Enhance the information on fiscal policy measures. The draft SPU does not detail the financial impact of fiscal reform individually for each tax and taxation measure. Bearing in mind the weight of this reform, and as highlighted in AIReF's report of 31st March 2015, it would be advisable to itemise individually the financial impact of the reform in greater detail in order to be able to appraise it. Moreover, the most significant variations in the information on measures compared with the information contained in the previous SPU or the current Budget Plan need to be justified.

2. Increase the information concerning contingent liabilities to guarantee the possibility of analysis. It would be a good idea to include more detailed information that would allow a proper analysis of the guarantees provided by the different Public Administration and existing contingent liabilities.

5. Appendix: Legislative Framework

Fiscal legislative framework for the timeline of the draft SPU 2015-2018

The appraisal of the draft Stability Programme Update (SPU) 2015-2018 must be made in the context of the fiscal legislative framework established in both Europe and Spain.

European legislative framework

At the European level, as is well known, Spain is currently subject to the corrective arm of the Stability and Growth Pact (SGP). This means that Spain is subject to a special procedure, called the Excessive Deficit Procedure (EDP), in order to bring its deficit down to below 3% of GDP. The Council opened the procedure for Spain in April 2009 when it set 2012 as the initial deadline for correcting this situation. After three revisions, the current recommendation - adopted by the Council in June 2013 - establishes that an end must be put to this situation by 2016. Apart from the deadline for correcting the excessive deficit, the recommendation also establishes a fiscal consolidation path in nominal terms and the structural effort required to achieve it. More specifically, for 2015 and 2016, these values are:

- Meeting targets of -4.2% of GDP for 2015 and -2.8% of GDP for 2016, in nominal terms.
- An improvement in the structural balance in GDP terms of 0.8% for 2015 and 1.2% for 2016. It must be remembered that this effort was consistent with the nominal path based on the European Commission's spring 2013 forecasts. That means that when the Commission appraises compliance with this criterion, it takes into account any possible deviations from those forecasts.

Complying with the draft SPU forecasts implies a very significant change of the backdrop for Spanish public finances from 2017 onwards. Achieving a government deficit of 2.8% of GDP for the government sector as a whole certainly would allow the EDP to be corrected[14]. At that time, Spain will move under the preventive arm of the SGP and, therefore must have met what is known as the medium-term objective (MTO[15]) or at least ensure sufficient

[14] For the Council to be able to close an EDP – abrogation in EU terminology – two conditions must occur: 1) Base such a decision on official data and, therefore on the deficit notification for 2016 that Spain must send to the EU institutions in April 2017; and 2) the European Commission forecasts at that time – spring 2017 - must indicate the Treaty's deficit and debt criteria will continue to be met over the timeline of the outlook.

[15] The MTO is a budgetary target that adjusts the impact of the cycle on public accounts and discounts one-off and temporary measures. Each country is free to determine how, within European room for manoeuvre, as the aim is for this objective to meet two conditions: provide enough leeway to respect the deficit threshold of 3% of GDP at times of economic weakness and ensure adequate progress towards sustainability.

progress towards it. As Spain's MTO is structural balance or a surplus, the draft SPU proposes a fiscal strategy that would not achieve the MTO in the timeline of the programme, as for 2018, the draft SPU predicts that there will still be a structural deficit of 0.2% of GDP.

As the forecast is for this MTO not to be attained in 2017 and 2018, what must be assessed is whether the convergence path towards that objective is the right one. Convergence towards this MTO requires a general annual structural adjustment of 0.5% or more of GDP when debt exceeds 60% of GDP. So Spain has to make a larger adjustment than 0.5% of GDP as its debt is over 60% of GDP. But after the European Commission's January 2015[16] communication about flexible interpretation, the corresponding adjustment for 2017 would be 0.5% of GDP. Compliance with the expenditure rule is also required, such that annual spending grows less than the reference average potential GDP medium-term growth rate, unless the excess is offset with discretionary revenue measures.

Finally, it must be remembered that once Spain leaves the EDP, it will be subject to an additional rule that provides for a 3-year transition period to meet the public debt criterion at the end of that period. In practice, this means that the European Commission will determine the necessary structural adjustment to be made between 2017 and 2019 to comply with this rule.

Spanish legislative framework

Nationally, the appraisal of the draft SPU must be made in the context of the LOEPySF. This law generally regulates the requisites that the government sector is required to meet when the MTO is reached. Structural balance or surplus is supposedly the fiscal position in which the public administrations would normally remain and, therefore, the regulations contained in the law refer fundamentally to this situation. But, the law also provides for transitional arrangements, in transitional provision 1 (TP 1), which will be applicable until the MTO is reached and public debt falls below 60% of GDP (deadline 2020) and which will include several demands with respect to structural adjustment, depending on whether or not Spain is subject to an EDP.

According to the data contained in the draft SPU, structural balance or surplus (MTO) will not be reached in the period 2015-2018, nor will the debt level. As a result, apart from the provisions generally required, the transitional arrangements of TP 1 of the LOEPySF will also be applicable during this period.

In this context, compliance with the deficit and public debt targets in nominal terms will be required (article 15 of the LOEPySF) during the period 2015-2018. These are set by an Agreement of the Council of Ministers approved by

Moreover, as a signatory to the Treaty for Stability, Coordination and Governance of the EMU (TSCG), Spain's MTO cannot exceed -0.5% of GDP. Spain however, set its objective as being structural balance or surplus. So it is a more demanding MTO than is permitted by EU regulations.

[16] This general rule has been recently made more explicit by the EC in its January 2015 communication on the flexible interpretation of the EDP to modulate the adjustment in accordance with the economic situation and public debt, and it permits adjustments of less than 0.5% of GDP under certain conditions.

parliament, in line with the consolidation path established in the Stability Programme. The targets for 2016-2018 will be set in June 2015, bringing them in line with the targets proposed in the 2015-2018 Stability Programme. At the same time, compliance with the expenditure rule (article 12 of the LOEPySF) will be required, such that the annual expenditure of the central government, AR and LC subsectors may not exceed the potential GDP medium-term reference rate, unless the excess is offset by revenue measures.

As indicated before, the transitional arrangements of TP 1 of the LOEPySP are also applicable in 2015-2018. These arrangements entail:

- On the one hand, an improvement in the structural balance, which will be at least 0.8% of GDP as an annual average during the transition period, except for 2015 and 2016, when, as Spain is subject to an EDP, TP 1 of the LOEPSF mandates that the structural effort be the same as required in accordance with the EDP (0.8% of GDP for 2015 and 1.2% of GDP for 2016, in the terms indicated above).

- On the other hand, the debt-to-GDP ratio is required to be reduced at the necessary rate as an annual average so as not to exceed 60% in 2020. Furthermore, the following requirements must be met:

    1. The variation in non-financial uses of each government subsector may not exceed the real GDP growth rate.

    2. As soon as the domestic economy reaches a real growth rate of at least 2% per year, or generates an annual growth in net employment of at least 2% per year, the public debt ratio will be reduced each year by at least 2 percentage points of GDP.

Comparison

In light of the demands arising from European and Spanish legislation, in general the conclusion to be drawn is that while the EDP remains open, European regulations focus their attention on reducing the deficit, both in nominal terms by meeting the fiscal consolidation path milestones, and in structural terms, by improving the structural balance. Spanish legislation however, requires compliance with the three fiscal rules during the period: deficit, debt and expenditure rule. So compliance with the requirements of both legislative frameworks must be analysed in the appraisal of the draft SPU.

European regulations make a distinction between whether or not there is an EDP

2015 and 2016	2017 and 2018[17]
Corrective arm (EDP)	Preventive arm
• Compliance with fiscal consolidation path in nominal terms. Spain's requirements: ○ 2015:-4.2% of GDP ○ 2016:-2.8% of GDP • Improved structural balance (structural fiscal retrenchment). Spain's requirements: ○ 2015: 0.8% of GDP ○ 2016: 1.2% of GDP *(the targets for structural fiscal retrenchment were set based on the European Commission's spring 2013 forecasts, so when it evaluates compliance with the targets the Commission looks at possible deviations from those forecasts)*	• Appraisal of the structural balance against the medium-term objective (MTO). The MTO (2) for Spain is structural balance or surplus, so the analysis will have to assess whether the structural balance is zero or positive. A. If the MTO is achieved: ○ Spain must stay within the MTO. ○ Comply with the expenditure rule: annual spending may grow at the same rate as the medium-term average potential GDP reference rate, unless the excess is offset by discretionary measures. B. Until the MTO is achieved: (this seems to be the case of Spain according to the data presented in the Stability Programme) ○ Everything has to be adjusted to that MTO: the annual structural adjustment required in general is 0.5% of GDP, or more than that figure if the debt exceeds 60% of GDP. So Spain has to make a greater adjustment than 0.5% of GDP because its debt is more than 60% of GDP. However, the adjustment allocated to 2017 is 0.5% of GDP according to the EC communiqué on flexible interpretation in January 2015. ○ Comply with the expenditure rule: annual spending can grow less than the medium term potential GDP reference rate, unless the excess is offset by discretionary measures. • 3-year transitional arrangements for countries with a debt of over 60% of GDP when the EDP is repealed (this will be applicable to Spain): respect a minimum straight-line structural adjustment to be calculated by the European Commission, which could be more demanding than the

[17] If Spain's EDP were to be abrogated in 2017

	adjustment required to converge with the MTO.

In general terms, the LOEPySF does not make a distinction on the basis of whether or not there is an EDP

2015 – 2018

- Compliance with deficit and public debt targets in nominal terms (article 15 of the LOEPySF): these are set by an Agreement of the Council of Ministers approved by parliament, in line with the consolidation path set in the Stability Programme.
  (targets for the period 2016-2018 are set in June 2015)

- Compliance with the expenditure rule (article 12 of the LOEPySF): annual spending of the Central Government, AR and LC subsectors may grow only at the same rate as the medium-term potential GDP reference rate, unless the excess is offset by discretionary measures.

- Transitional arrangements (TP 1 LOEPySF). Applicable until the MTO and public debt < 60% of GDP is reached (deadline 2020):
  - Reduction of the public debt-to-GDP ratio: This will be reduced at the necessary rate as an annual average so as not to exceed the 60% limit in 2020. Moreover:
    1. The variation in non-financial uses of each government subsector may not exceed the real GDP growth rate.
    2. As soon as the domestic economy reaches a real growth rate of at least 2% per year or generates a growth in net employment of at least 2% per year, the public debt ratio will be reduced by at least 2 percentage points of GDP each year.

2015 and 2016	2017 and 2018[18]
EDP	NO EDP
• Transitional arrangements (TP 1 LOEPySF). Applicable until the MTO and public debt < 60% of GDP target is reached (deadline 2020): ○ Improvement in structural balance. It will be the same as required by the EDP: ➢ 2015: 0.8% of GDP ➢ 2016: 1.2% of GDP *(the values for structural fiscal retrenchment were set based on the European Commission's spring 2013 forecasts, so when the Commission assesses compliance with them it looks at possible variations from those forecasts)*	• Transitional arrangements (TP 1 LOEPSF). Applicable until the MTO and < 60% of GDP (deadline 2020): ○ Improvement in the structural balance: at least 0.8% of GDP as an annual average for the transition period.

[18] If Spain's EDP were to be abrogated in 2017