Independent Authority for Fiscal Responsibility

Report

17 April 2018

Report on the Main Budgetary Lines and Draft Budgets of the Public Administrations: 2018 Draft General State Budgets

(Article 17.1 of the Organic Law on Budgetary Stability and Financial Sustainability - LOEPySF)

The mission of AIReF, the Independent Authority for Fiscal Responsibility, is to ensure strict compliance with the principles of budgetary stability and financial sustainability contained in article 135 of the Spanish Constitution.

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Executive Summary

Once the Draft General State Budgets (GSB) have been submitted to Parliament, AIReF issues its report on the level of compliance with budgetary stability, government debt and expenditure rule targets of the Central Administration (CA) sub-sector and the Social Security Funds (SSF) and provides a provisional assessment of the probability of General Government (GG) achieving its budgetary stability target.

AIReF considers compliance with the target of -2.2% GDP to be feasible but hard to achieve, as it requires an adjustment of almost one percentage point of GDP by the CA and SSF, in accordance with the target distribution.

Similarly to previous years, the legally established target distribution does not acknowledge the real situation of each sub-sector, nor does it ensure coherence between the different fiscal rules. Strictly speaking, enforcing the different sub-sectors' targets would lead to the AC and SSF sub-sectors being required to make adjustments and implement measures, while the more or less well-off situation of the rest of the sub-sectors in relation to their targets would lead to over-compliance by the GG and a restrictive fiscal policy.

The Government acknowledged the real situation of the sub-sectors in its April 2017 notification to the European Union, in the context of the Excessive Deficit Procedure (EDP), estimating, as eventually happened, that the deviations in the CA and the SSF would be offset by the surplus of the Territorial Administrations (TAs).

AIReF has warned repeatedly in its reports that the lack of realism when setting sub-sector targets, mainly due to not recognising the recurrent surplus of Local Governments (LGs), greatly complicates the monitoring of budgetary execution and stability targets, and reduces the enforceability of an increasingly devalued fiscal framework. For this reason, AIReF has considered it more appropriate to recognise this situation in its assessment of the Draft GSB by comparing its revenue and expenditure forecasts and the resulting deficit with a "theoretical target" that would allow GG compliance, while assuming reasonable results for the remaining sub-sectors for which the uncertainty is lower.

Once the non-compliance of the CA and the SSF has been recognised, AIReF prefers to focus its analysis on the feasibility of a tentative deficit pathway compatible with GG compliance with the target. This is why, on the one hand, AIReF based its analysis on the recurrent surplus situation of the LGs, estimated to be 0.6% GDP, and, on the other hand, on the restriction of 0.2% GDP that compliance with the expenditure rule would entail for the Regions' stability targets. This would result in a margin of 0.8% GDP on the initial AC and SSF targets. Taking into account the limited discretion of SSF revenue and expenditure, it is reasonable to consider that this sub-sector would present a similar result, 1.5% GDP, at the end of 2017. Therefore the CA deficit compatible with compliance with the GG stability target would be 1.1% GDP.

This situation, similar to that experienced in 2017, should lead to a deeper reflection on the functioning of the existing fiscal framework. Target setting procedures should avoid becoming just a formal exercise, separated from necessary realistic budgetary planning that would take into account both the feasibility of achieving the target and the sustainability of public finances. Any progress in this direction would also strengthen the legitimacy and enforceability of the fiscal rules.

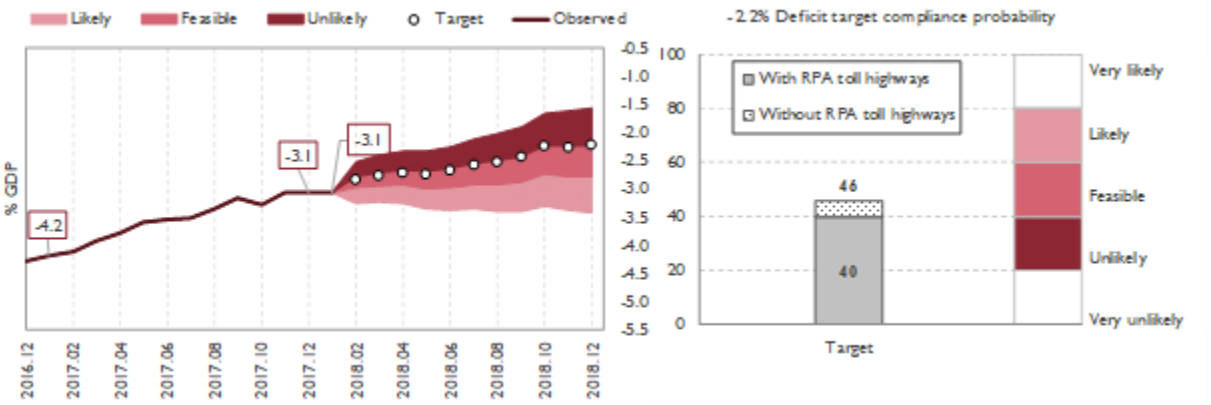
The measures contained in the Draft GSB and the changes in the macroeconomic scenario have altered the revenue and expenditure forecasts, under the assumption of no policy change, contained in the Budgetary Plan of October 2017. The 2018 macroeconomic scenario is more favourable, the result of the greater dynamism of the main trade partners, alongside a less intense materialisation of the institutional uncertainty shocks than expected. In turn, this improvement in the macroeconomic forecasts implies greater revenue than that estimated in October, as detailed in the report.

Moreover, the 2018 Draft GSB contains measures that alter the revenue and expenditure forecasts and assume a deterioration of the fiscal balance with respect to the "no policy change" scenario contained in the Budgetary Plan. In addition, it is necessary to take into account that the effects of these measures are not confined to the CA and the SSF, but also have a marked impact on the TAs. In this sense, for the most part, the budgets of the Regions and LGs were approved prior to the submission of these measures.

These measures notably include, due to their short and medium term impact, the application of the Agreement with trade unions on wage increases for civil servants, as well as the additional provisions that introduce exceptions to the application of the expenditure rule. It is also worth noting the possibility of incentivising the TAs to comply with the fiscal rules and their specific targets. This aim of this is to bring about a lower impact on the TAs' debt ratio from the reduced resources resulting from debt repayment to the CA.

Finally, the General Government's compliance with the stability target is effected in 2018 by the expected impact of the State's financial liability for bailing out toll roads. This specific and non-recurrent increase in expenditure, estimated at €2 billion, impairs the GG's probability of achieving the deficit target without a change in the assessment of its fiscal situation. On the other hand, the Government has announced its intent to tender for these concessions in the shortest possible time, which would result in revenues partially offsetting costs in that year.

GRAPH A1 GENERAL GOVERNMENT: NET LENDING/BORROWING



Central Administration

The CA expenditure and revenue forecasts contained in the Draft GSB are considered to be realistic overall. AIReF forecasts that the 1.1% deficit, compatible with achievement of the GG's stability target, is feasible.

AIReF's expenditure forecasts include the impact of State financial liability for toll roads, amounting to 0.2% GDP, although the Draft GSB does not include any budgetary appropriations to cover this item. The probability of compliance with the target improves if this non-recurrent item is excluded.

The 2018 Draft GSB revenue forecasts are considered plausible. The projected revenue from Personal Income Tax (PIT), Corporate Income Tax (CIT) and Value Added Tax (VAT) are considered feasible, while forecasts are only considered very unlikely in the case of Special Taxes (ST). The improvement in the 2018 macroeconomic scenario with respect to that envisaged in the Budgetary Plan enables the levels of revenue forecast in the GSB to be reached. On the other hand, tax measures adopted on PIT will begin to have an impact in 2018 (€899 M), shifting most of the impact of the reform, €1.309 billion, to 2019.

Non-financial expenditure will remain relatively stable as a percentage of GDP throughout 2018, against the decreasing trend recorded in previous years. The reduction in expenditure forecast due to a lower interest burden on 2017 and the reduced transfers from the CA to the State Public Employment Service (SEPE) are more than offset by the increases forecasted for other appropriations, essentially compensation of employees, civil servants' contributory pensions, investments and transfers to the Social Security System to fund the rise in pensions of a lesser amount. The result is a 5.1% increase in non-financial expenditure in budgetary terms with respect to the interim settlement of 2017.

The 2018 Draft GSB does not include any information relating to compliance with the expenditure rule. However, with the available information and AIReF's estimates there is risk of non-compliance with this rule, which limits eligible expenditure growth to 2.4% in 2018. In addition to the increase in eligible expenditure resulting from the Draft GSB, the permanent €899m reduction in earnings from PIT included will cause additional difficulties in compliance with the expenditure rule this year.

Social Security Funds

As in the case of the CA, the revenue and expenditure set out in the draft Social Security budgets are considered realistic. As a result, AIReF estimates that the deficit will be at a level similar to that of 2017 in terms of percentage GDP.

The Social Security revenue forecasted in the Draft GSB is more realistic than in previous years, although higher than the scenario considered most probable by AIReF in accordance with the trends observed last year and the data already available for 2018. The composition of growth is slightly different compared to 2017, with an increase in the component attributable to contribution bases and a reduction in that of employment.

On the other hand, the SSF expenditure forecasts in the draft budgets present aggregate figures in line with AIReF estimates. Pension expenditure is expected to grow by approximately €1 billion as a result of the increases for the lowest contributory pensions and non-contributory pensions and the increase from 52 to 54 in the percentage to be applied to the regulatory base in widows' pensions. It is estimated that approximately two thirds of this increase will be recovered through higher transfers from the CA, therefore the effect on the System's deficit will be lower than the increase in expenditure on these items.

Finally, it should be noted that the Draft GSB continues to omit forecasts for national accounting headings, which complicates the analysis of their adequacy in relation to fiscal rules. In addition, for the second year in a row, it also omits the information needed for the reconciliation of the budget balance of the Draft GSB with the budgetary stability target in national accounting terms.

As a result, this report makes the following recommendations, among others:

1. Set realistic targets.
2. Review the existing fiscal framework, ensuring the consistency and stability of the fiscal rules and compliance with their underlying principles.

In addition, AIReF reiterates the recommendations contained in previous reports regarding the review of the debt reduction path referred to in article 13 of the LOEPySF and regarding the transparency of the GSB.

Contents

1. Introduction

On 27 March the Council of Ministers approved the 2018 Draft General State Budgets (GSB), presented before the Parliament on 3 April. In accordance with the provisions of the Constitution and the General Budgetary Law, the 2017 GSB was automatically carried over for 2018 as the budgets corresponding to this year had not yet been approved. The budgetary carry-over will remain in force until the 2018 GSB is definitively approved by the Parliament.

The Organic Law on Budgetary Stability and Financial Sustainability (LOEPySF in its Spanish acronym) and the Law establishing and regulating AIReF require the Authority to draw up a report on the Draft GSB and the main budgetary lines of the Autonomous Regions and Local Governments (LGs). By October 15, AIReF must publish a report on the Draft GSB and the main budgetary lines of the territorial administrations (TAs) from the perspective of compliance with the expenditure rule and budgetary stability and government debt targets.

As the GSB was not presented to Parliament, it was necessary to postpone and break up the legally required report. The report on the main budgetary lines of the Regions[1] for 2018 was published on October 26, which included an initial assessment of the General Government (GG) on the basis of information contained in the Budgetary Plan. The report on the LGs was subsequently published on December 19. Once the 2018 Draft GSB has been presented to Parliament, AIReF completes the report on the Main Budgetary Lines and Draft Budgets of the Public Administrations (PAs) with its Report on the 2018 Draft GSB.

The report is divided into five sections, ending with recommendations for supervised entities, who must either comply or explain their non-compliance. Section 2 discusses the purpose and scope of the report, section 3 examines GG compliance with budgetary stability targets and provides greater detail on the CA and SSF sub-sectors, while section 4 and 5 discuss compliance with debt targets and the expenditure rule, respectively. The report ends with recommendations in section 6.

[1] Except for the report on the Region of Catalonia which was published on 3 November, 2017.

2. Purpose and scope

The purpose of this report is to assess the 2018 Draft GSB from the perspective of compliance with the three fiscal rules defined in the LOEPySF: budgetary stability, government debt and expenditure rule targets.

The scope of this report has been conditioned by the lack of information on the following areas:

1. **Initial budgets in national accounting terms and reconciliation of the budgetary balance of the Draft GSB with the budgetary stability target in national accounting terms.** The 2018 Draft GSB does not include information on national accounting adjustments nor on the fiscal balance of the Central Administration (CA) as a result of ESA 2010. This situation first occurred in the 2017 GSB, with this information having been published as part of budgetary documentation since 2003[2]. This lack of information is contrary to EU regulations and conflicts with implementation of the principle of transparency envisaged in article 17 of the LOEPySF. Furthermore, the lack of an initial budget in national accounting terms significantly affects AIReF's analysis. The forecasts cannot be compared with official figures at the level of revenue and expenditure headings, therefore certain items are sometimes considered in budgetary terms, integrating the estimate of the possible national accounting adjustments with information available on previous years.
2. **The 2018 Draft GSB does not include information on compliance with the expenditure rule or the debt target by sub-sector.** The 2018 Draft GSB does not mention the expenditure rule for the CA, therefore no information is available on expenditure rule components such as the impact of policy measures that entail a reduction or permanent increase in earnings. Additionally, the Draft GSB only refers to the government debt target for the GG, but no mention is made of the CA's compliance with the debt target.

In addition, the report highlights the need to strengthen the transparency of the obligations and potential risks that the CA might be required to undertake in order to correctly enforce said targets. Although it cannot be defined as a scope limitation, the GSB does not include information on possible responsibilities to be borne by the PAs as a result of rulings, information on public and private associations or other types of risks that could affect the budgetary stability and financial sustainability targets of the PAs, such as non-performing loans. The 2018 Draft GSB also does not include information on the possible impact in 2018 of the actions towards recovering and transforming the financial sector, which essentially affect the CA Agencies (through FROB or the Deposit Guarantee Fund).

[2] Both in the Economic-Financial Report and in the yellow paper of the Presentation of the GSB

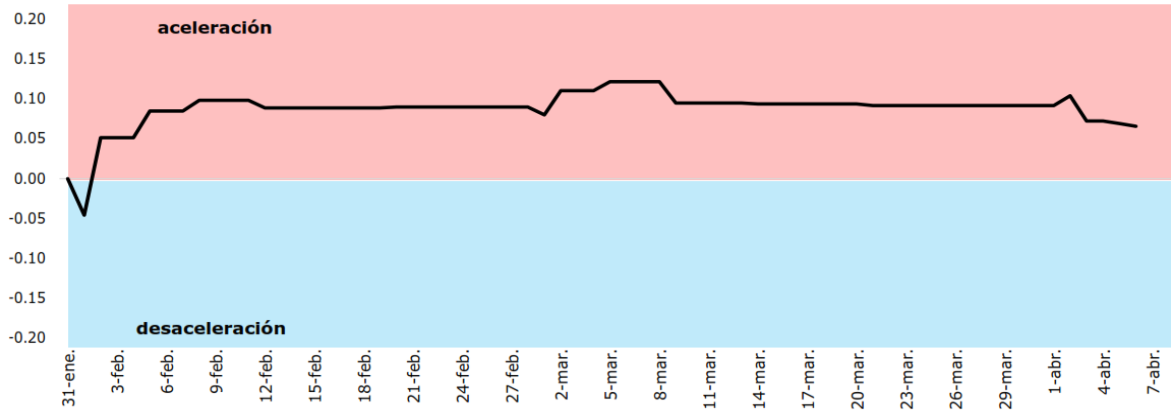
3. Budgetary stability target

3.1. Macroeconomic scenario

Spanish economic growth maintained its drive in 2017, supported by the contribution of domestic demand. The Spanish economy grew by over 3% in real terms in 2017 for the third year in a row. The observed growth of 3.1% was mainly based on the positive contribution of domestic demand (2.8%), 0.3% above that observed in 2016. In turn, an upturn was seen in external demand (0.3%), confirming the change in the growth pattern with respect to the previous cycle, although its contribution fell by 0.4% compared to one year ago.

The most recent short-term information upholds the signs of dynamism seen at the start of 2018. The latest high-frequency indicators observed for the first quarter of 2018 have shown that the economy's dynamism has strengthened at the start of the year, with an accumulated positive balance of surprises or changes, as reflected by the Spanish Economy Thermometer published by AIReF (see gráfico 1)[3]. The forecasted trends for the first half of 2018 contained in the latest real-time MIPred model forecast point to a quarterly growth of around 0.8%, both for the first and second quarter.[4] As in 2017, the carry-over effect caused by a dynamic start to the year would support growth of around 3% in 2018 as a whole.

GRÁFICO I. SPANISH ECONOMY THERMOMETER (% CHANGE COMPARED TO FINAL ESTIMATE)



Source: AIREF

In this context, the forecasts underlying the 2018 GSB contain a significant upward revision of the Government's 2018 growth forecast for. The official 2018 GDP growth forecast has been updated since the Draft Budgetary Plan (DBP), from 2.3% to 2.7%, in parallel to the forecasts of the main analysts and institutions following the Spanish economy. This forecast also lies within the confidence intervals of AIReF's models, at the bottom end.

[3] The Spanish Economy Thermometer, prepared based on real-time forecasts generated by the MIPred model, includes the surprises or changes that occur as a result of the comparison between observed data and the forecast implied by the model indicators.

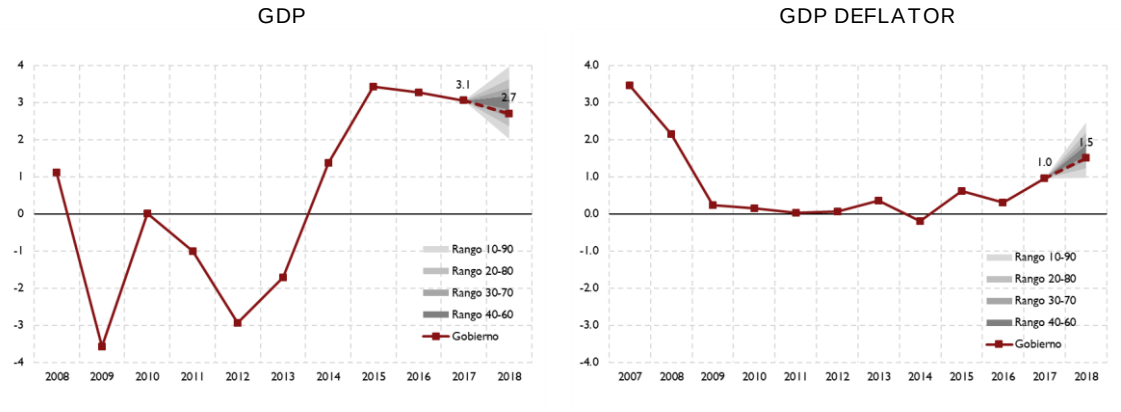
[4] The MIPred model summarises the most representative and recent short-term information on the Spanish economy (also including subjective indicators, considered as early). For more details on the model, see Cuevas, A., Pérez-Quirós, G. y Quilis, E. (2015). "Modelo integrado de predicción a corto plazo de la economía española (modelo MIPred)," Working Paper 4/2015, AIReF.

The upward correction at the aggregate level is supported by the greater dynamism of the main trade partners, along with a less intense institutional uncertainty shock than expected, the impact of which was limited to October. In addition to these factors, there is the potential impact of the expansive fiscal policy measures envisaged in the 2018 GSB, which could result in greater household disposable income and, therefore, in greater consumer demand.

On the basis of exogenous assumptions and defined policies, AIReF has endorsed the macroeconomic scenario forecasts underlying the 2018 GSB, considering them to be prudent and their composition plausible. The macroeconomic scenario presented by the Government points to a nominal growth slightly above 4% for 2018, in line with that observed in 2017, although with a greater relative contribution of the price component. Given the latest high-frequency information available and the expected evolution of the main drivers of growth in the medium term, AIReF's analysis considers these forecasts to be prudent, standing at the bottom of the forecasting interval, both in real terms and in terms of prices (see gráfico 2). In terms of composition, as in 2017, the Government's macroeconomic scenario projected that domestic demand would continue to be the main driver of growth. In this sense, it is worth noting the dynamism forecasted for investment, both productive and in construction, and the contained evolution of consumption. The Government's private consumption forecast lies outside the interquartile range of the panellists and at the lower end of AIReF's internal models, thereby exhibiting the possibility of performing above the 2018 forecast, in particular an improvement in the financial position of households and the robust behaviour of the labour market, taking into account the budgetary measures contained in the GSB. In the case of the public consumption forecast, although it lies near the mid-point of the confidence interval of AIReF's models, the evolution of compensation per employee is considered likely, while the evolution of the consumption deflator is contained with respect to AIReF's estimates. Finally, the external sector is consolidating its moderate positive contribution, in line with private analysts and AIReF's estimates, confirming the changing growth pattern of the Spanish economy with respect to the previous cycle.

The greater dynamism in nominal growth expected for 2018 translates into a positive impact on earnings. The 2018 forecast maintains the dynamism in terms of activity and job creation, alongside continued recovery of prices and wages. Dynamic tax bases will further drive nominal growth, with a positive impact on earnings, as occurred in 2017. On the one hand, the recovery of prices, both for consumption and housing, consolidates the cyclical gain stemming from indirect taxes, through Value Added Tax (VAT) and earnings from Property Transfer Tax (PTT). On the other hand, intensive growth in employment accompanied by positive trends in compensation of employees would support growth in revenues from social security contributions and the bases for Personal Income Tax (PIT). As concerns earnings from Corporate Income Tax (CIT), the good economic performance and the expected improvement in business revenues would contribute positively to the earnings forecast in 2018.

GRÁFICO 2. 2017 MACROECONOMIC FORECAST
AIREF'S CONFIDENCE INTERVALS AND GOVERNMENT FORECASTS *(% ANNUAL VARIATION)*



Source: Government and AIReF

3.2. Provisional assessment of the General Government

The 2018 GG budgetary stability target of -2.2% GDP requires an adjustment of 0.9% GDP with respect to the end of 2017. Achieving the 2018 target entails an adjustment of almost 1% GDP, with the CA needing to make most of the adjustment.

CUADRO 1. 2018 BUDGETARY STABILITY TARGET

Capacidad (+) Necesidad (-) financiación en % PIB	2017 Acuerdo CM Dic 2016	2017 1ª Notif Marzo 2017	2017 Cierre	2018 Acuerdo CM Julio 2017	2018 Senda tentativa AIReF*
Administración Central	-1,1	-1,5	-1,9	-0,7	-1,1
Seguridad Social	-1,4	-1,6	-1,5	-1,1	-1,5
Comunidades Autónomas	-0,6	-0,6	-0,3	-0,4	-0,2
Entidades Locales	0,0	0,6	0,6	0,0	0,6
Total AAPP	-3,1	-3,1	-3,1	-2,2	-2,2

*Senda tentativa, realista y coherente con el conjunto de las reglas fiscales estimada por AIReF

AIReF deems compliance with the target of -2.2% GDP to be feasible, but very hard to achieve. This would require the expected deviation of the CA and the SSF to be offset with the margin available to the TAs. The adjustment needed to comply with the budgetary stability target falls to the CA and the SSF (1.6% GDP with respect to the end of 2017), while the Regions may incur a deficit greater than that recorded in 2017 by 0.1% GDP. The recurrent surplus of the LGs and regional compliance with the expenditure rule would lessen the adjustment amount by 0.8% GDP.

The lack of realism in setting targets complicates the implementation of the existing fiscal framework. Similarly to 2017, the legally established target distribution does not recognise the real situation of each sub-sector, nor does it ensure coherence between the different fiscal rules. Strictly speaking, enforcing the sub-sectors' targets would lead to the AC and SSF being required to make adjustments and implement measures, which, in any case, would lead to over-compliance by the GG and a restrictive fiscal policy. The Government recognised the real situation of the sub-sectors in its April 2017 deficit notification to the European Commission, estimating, as eventually happened, that the deviations in the CA and the SSF would be offset by the surplus of the TAs.

For 2018, AIReF examines the feasibility of a tentative and realistic path, consistent with the fiscal rules. This is why, on the one hand, AIReF based its analysis on the recurrent surplus situation of the LGs, valued at 0.6% GDP, and, on the other hand, the restriction of 0.2% GDP that compliance with the expenditure rule would entail for the Regions' stability targets. This would result in a margin of 0.8% GDP on the initial CA and SSF targets. Taking into account that the SSF estimate is similar to that of the end of 2017, 1.5% GDP, the SSF would absorb a 0.4% margin. Finally, the remaining margin of 0.4% would be assigned to the CA, which could have a deficit of 1.1% compatible with achievement of the GG stability target.

An adjustment of 0.8% GDP with respect to the end of 2017 would be needed for the CA to achieve this tentative deficit level. This entails an adjustment of 0.4% less than that required by strict enforcement of the targets in force. In turn, the TAs, and specifically the Regions, would only need to reduce their deficit by 0.1% with respect to the end of 2017 as a result of the application of the expenditure rule.

Presentation of the Draft GSB before Parliament involves the review of the Budgetary Plan. This Budgetary Plan was drawn up in October under the assumption of a "no policy change" economic scenario. The Draft GSB reviews the forecasts of the Budgetary Plan that will be incorporated into the 2018-2021 Stability Programme Update. The Stability Programme Update must be submitted by the Government prior to the 30th of April and AIReF will also prepare a report on it.

The measures contained in the Draft GSB and the changes in the macroeconomic scenario alter the revenue and expenditure forecasts contained in the Plan. On the one hand, as detailed in the previous section, the 2018 macroeconomic scenario is more favourable than in October, as a result of the greater dynamism of the main trade partners, alongside a less intense materialisation of the institutional uncertainty shock than expected. This improvement in the macroeconomic forecasts implies greater revenue than that estimated in October, as detailed later in the report. Moreover, the 2018 Draft GSB includes new

measures that assume a deterioration of the fiscal balance with regard to the "no policy change" scenario contained in the Budgetary Plan.

The 2018 Draft GSB includes measures that affect the TAs, alongside the CA and the SSF. In addition to transfers between the PAs, the 2018 Draft GSB Law contains various provisions that directly affect the finances of all PAs. In terms of staff, the possibility of reducing working hours is established, as well as pay rises arising from the multi-year agreement with the trade unions and the replacement rates that limit the supply of public employment of the various administrations, setting different levels depending on compliance with fiscal rules.

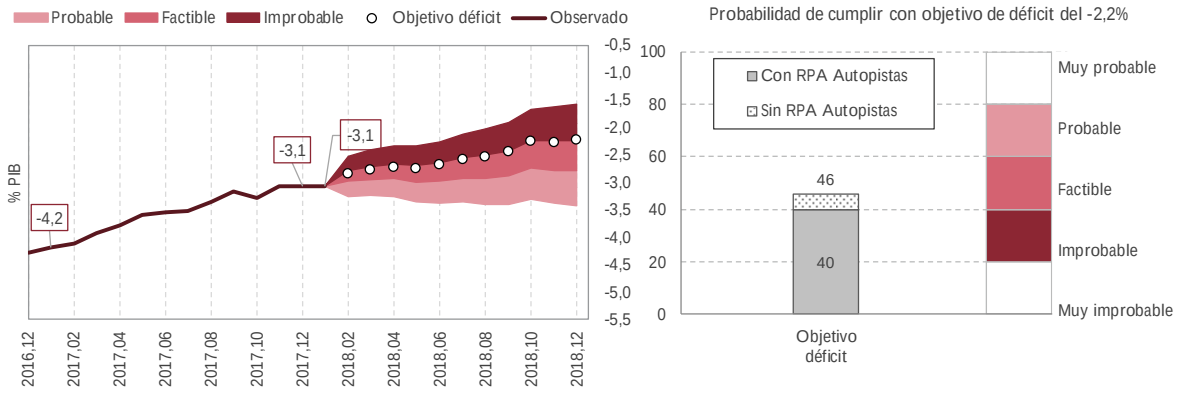
It also includes provisions on the application of the fiscal rules to the TAs. On the one hand, it introduces the possibility of incentivising the TAs to comply with the fiscal rules and their specific targets. The aim of this is to bring about a lower impact on the TAs' debt ratio from the reduced resources resulting from debt repayment to the CA. On the other hand, it excludes investments that are financially sustainable due to the application of the expenditure rule by the Regions that have complied with fiscal rules. Finally, the definition of the financially sustainable investments that LGs can make has been expanded by Royal Decree-Law.

The GG revenue announced by the Government for 2018 is in line with AIReF's estimates. AIReF considers achieving revenue of 38.3% GDP, similar to the figure contained in the 2018 Budgetary Plan, to be feasible. This assessment takes into account both the improvement in the macroeconomic scenario and the new taxation measures announced by the Government.

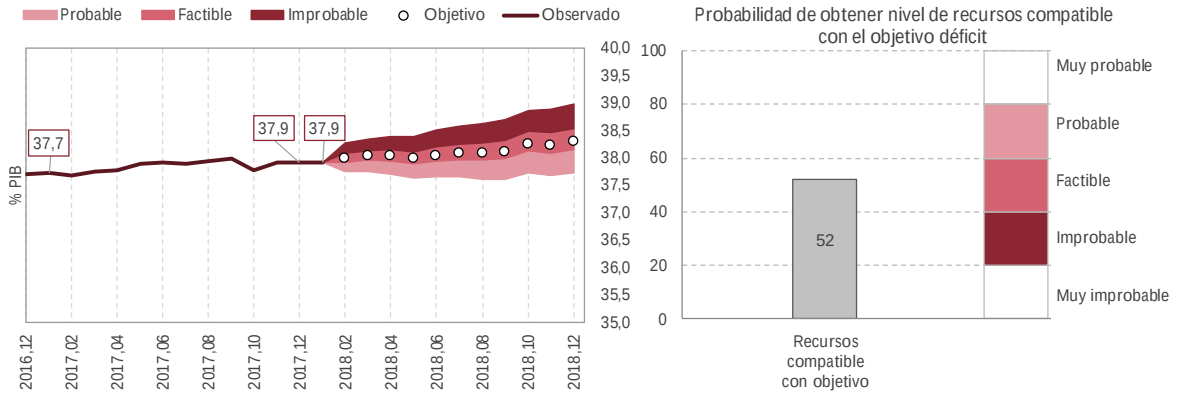
AIReF considers achieving the public expenditure level of 40.5% GDP announced by the Government for 2018 to be unlikely. According to AIReF's estimates, the downward trend in the contribution of public expenditure to GDP will be mitigated, although expenditure will continue to grow below nominal GDP. If we exclude the non-recurrent effect of the State's financial liability for toll roads, the probability of achieving the level of expenditure announced by the Government increases, although the rating of unlikely remains.

A more detailed analysis of the expenditure and revenue trends for the GG will be contained in the Report on the 2018-2021 Stability Programme Update. Both the new macroeconomic scenario and the measures contained in the Draft GSB entail modification of the expenditure and revenue trends contained in the Budgetary Plan, therefore its review will enable proper comparison of said trends with AIReF's own estimates. The level of GG revenue and expenditure announced by the Government in the presentation of the 2018 Draft GSB were provisionally taken as a reference.

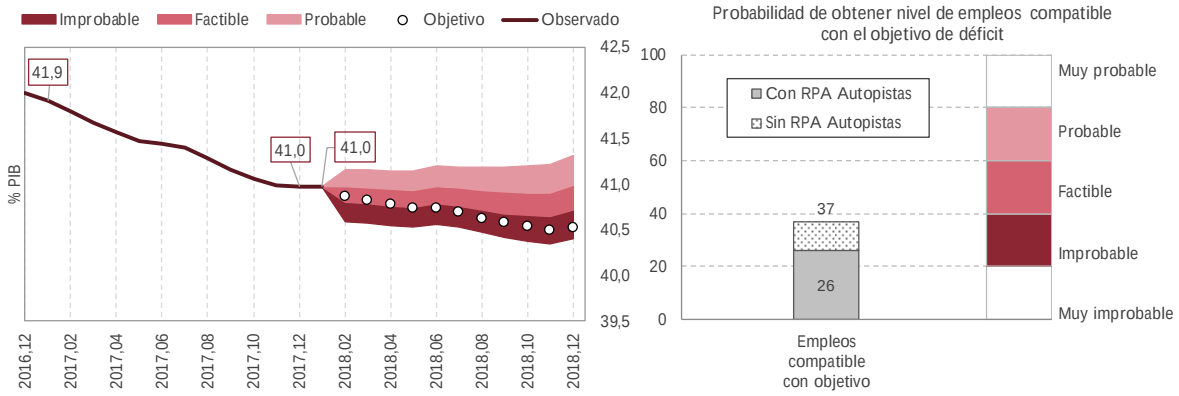
GRÁFICO 3. GENERAL GOVERNMENT: NET LENDING/BORROWING



TOTAL NON-FINANCIAL REVENUE



TOTAL NON-FINANCIAL EXPENDITURE



3.3. Central Administration

AIReF considers achievement of the deficit of 1.1% GDP to be feasible, estimated to be compatible with the GG stability target. To achieve the deficit of 1.1%, the CA must make an adjustment of 0.8% GDP with respect to the end of 2017. In addition, the probability of achieving 1.1% GDP improves if we exclude the non-recurrent effect of the State's financial liability for toll roads.

It is considered unlikely that the CA will comply with the target of 0.7% GDP for 2018. Achieving the legally approved target would require the CA to make an adjustment of 1.2% GDP on the -1.9% GDP achieved in 2017. As can be observed in gráfico 4, achievement of this adjustment is considered unlikely given AIReF's forecasts based on the revenue and expenditure contained in the Draft GSB. The CA is the sub-sector that most reduced its deficit in 2017; however, it is also the sub-sector with the most deviation from the target approved for that year, a deviation that is expected to be repeated in 2018. cuadro 2 shows the reconciliation of the CA's budgetary balance with that of the national accounts included in the Draft GSBs for 2013 to 2016 and estimates the national accounting adjustments necessary to achieve the 2017 and 2018 deficit targets, years for which these adjustments are not available. As can be observed in the table below, as these adjustments do not integrate the possible surplus/deficit of the Agencies, they would be much greater than those envisaged in previous years' Draft GSB, also taking into account that the adjustment arising from deferment of the settlements of the Regions and LGs (0.4% GDP) expires in 2017.

CUADRO 2. EQUIVALENCE BETWEEN STATE BUDGETARY BALANCE AND NATIONAL ACCOUNTING BALANCE OF THE CA IN %GDP 2013/2018

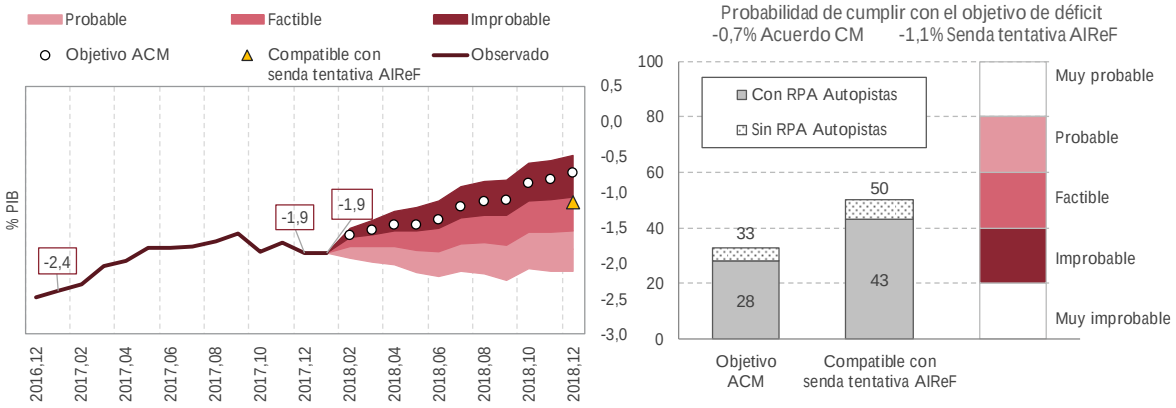
	2013	2014	2015	2016	2017	2018
Ingresos no financieros	11,7	12,2	12,2	11,8	11,5	11,6
Gastos no financieros	15,3	15,7	14,8	13,8	13,3	12,9
Superavit (+)/déficit (-) no financiero del Presupuesto	-3,6	-3,5	-2,6	-2,0	-1,8	-1,3
Ajustes Contabilidad Nacional	-0,2	-0,2	-0,3	-0,2	0,7	0,6
Ajustes Contabilidad Nacional netos de liquidaciones	0,3	0,3	0,2	0,2	0,7	0,6
Capacidad (+) Necesidad (-) de financiación OBJETIVO	-3,8	-3,7	-2,9	-2,2	-1,1	-0,7

Fuente: Informe Economico-Financiero de los PGE

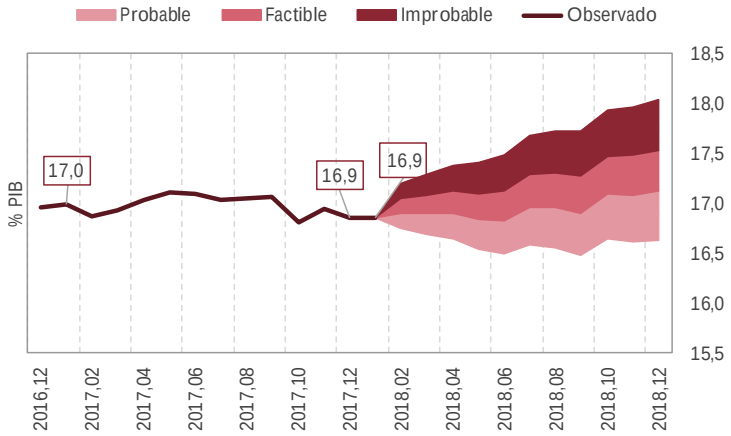
Both the revenue and expenditure forecasts of the 2018 Draft GSB are considered to be realistic. Unlike in previous years, the revenue forecasts contained in the Draft GSB are considered to be realistic, as examined in the following section, and AIReF's expenditure forecasts based on budgetary data are considered prudent, as they do not include the expenditure stemming from the State's financial liability for re-granting of concessions for toll roads.

AIReF's expenditure forecasts include the impact of the State's financial liability for toll roads, amounting to 0.2% GDP. The Draft GSB does not include any budgetary appropriations to cover this item. However, AIReF's forecasts do include €2 billion under the heading of Gross Fixed Capital Formation for the State's financial liability, stemming from the judicial procedures of toll roads that have entered into arrangements with creditors, as included in the Budgetary Plan submitted to the European Commission in October 2017.

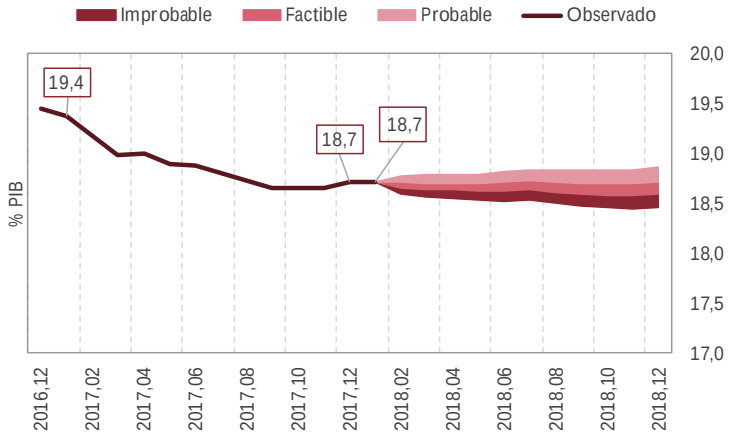
GRÁFICO 4. CENTRAL ADMINISTRATION NET LENDING/BORROWING



CENTRAL ADMINISTRATION REVENUE



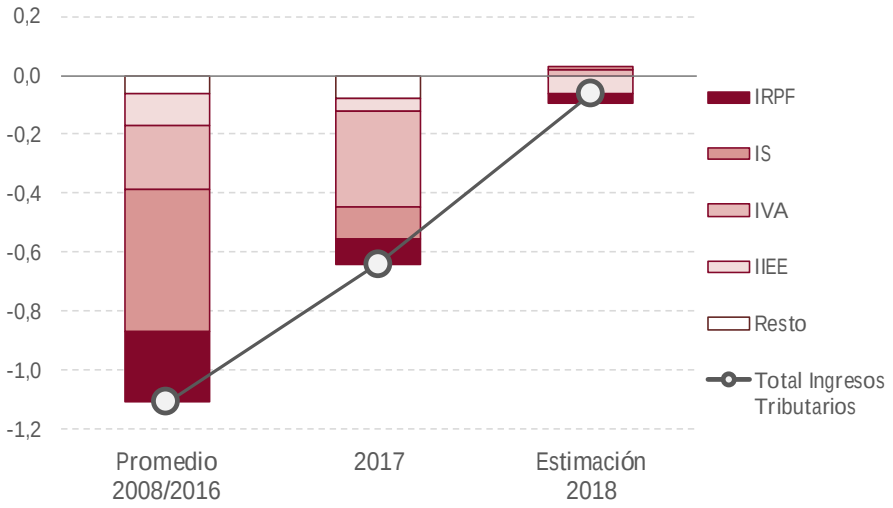
CENTRAL ADMINISTRATION EXPENDITURE



Non-financial revenue forecast

In 2017 tax revenues recorded an amount €7.5 billion below what was budgeted. If we take into account all taxes plus Social Security contributions, the deviation stands at € -10 billion. However, this deviation observed in 2017 is lower than the average observed in the 2008-2016 period, which stood above €17 billion. gráfico 5 shows the deviation or budgeting error, which is calculated by comparing the revenue estimates included in the budgets with the tax collection actually carried out, once the positive or negative impact on earnings resulting from the regulatory measures adopted following the approval of the GSB of each year has been deducted.

GRÁFICO 5. DEVIATION ENTERED WITH RESPECT TO THE APPROVED BUDGET (*)



(*) Ingresado (sin impacto de medidas aprobadas con posterioridad a los PGE) - Presupuestado
Positiva: Presupuestado < Ingresado
Negativa: Presupuestado > Ingresado

The behaviour of the tax bases was not translated into an equivalent increase in earnings. The tax bases of the main taxes grew by 5.6%, slightly exceeding the 5.5% envisaged in the budgets. This increase is mainly a result of the good evolution of wages (revenue base) and prices (expenditure base). However, the positive behaviour seen in the tax bases did not translate into equivalent earnings increases, as the growth of tax revenue was 3.8%.

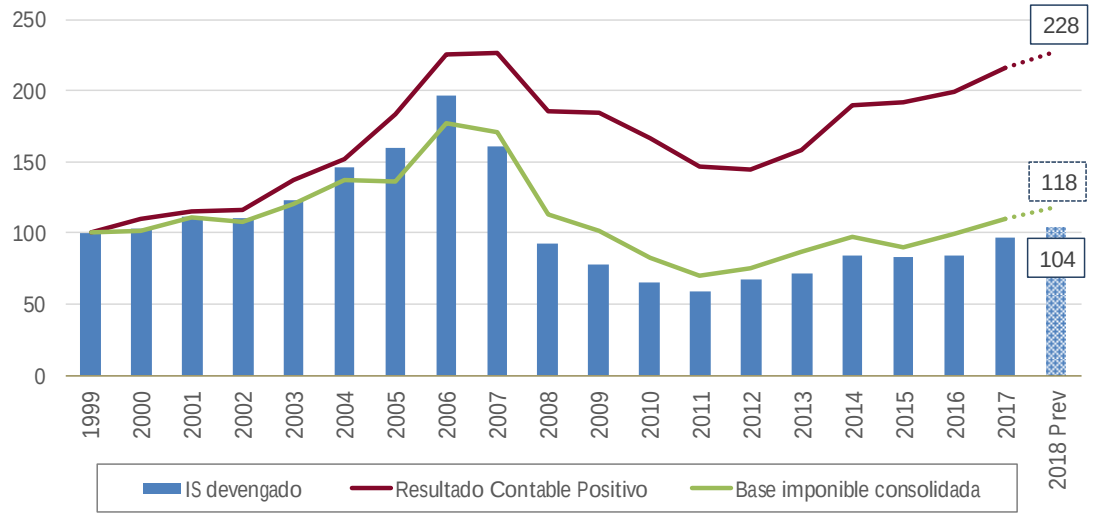
The main deviation was seen in VAT mainly as a result of the entry into force of the new Immediate Information System (IIS) in July 2017. With this new system participating entities have seen the deadline for submitting monthly statements extended from the 20th to the 30th of the following month. In order to account for cash revenues, the income taken from the 21st of the previous month to the 20th of the current month is calculated. Therefore the application of the IIS in practice means that the revenue for each month is accounted for one month later than what was done previously. In this case, VAT revenue payable for November 2017, which would have been realised until 20th December, was realised until the 30th of December, and therefore the income was moved to the January 2018 accounts. The impact of the entry into

force of the IIS is estimated at €4.15 billion, which could more than account for the budgeting error in VAT which stood at € -3.816 billion. However, it must be taken into account that this new system was approved prior to the preparation of the 2017 GSB and therefore its impact had to be considered when making the estimate for income from VAT. Special Taxes grew at a rate of 2.2%, in line with the consumption of products subject to these taxes and far from the 6.4% envisaged in the budgets.

In 2017 PIT revenues grew by 6.4%. This growth is explained, on the one hand, by the evolution of PIT withholdings, arising from the good behaviour of employment (wages and the actual rate of withholdings remained virtually unchanged, except later in the year) and, on the other hand, by the excellent result of the 2016 annual statement presented in June 2017, as a result of the better behaviour than expected of personal income not subject to withholding. However, as can be observed in gráfico 5, the budgeting deviation in PIT was close to €-1 billion, much lower than the deviation recorded in previous years, which may be explained by a wage increase lower than that included in the macroeconomic outlook forecasts.

CIT growth was far from the 12.6% forecasted in the budgets, with a deviation of € -1.256 billion. The main cause of this deviation was the fact that the impact of the measures of Royal Decree-Law 3/2016 was much lower than estimated. The budgets included an impact of €4.655 billion from these measures, while the latest estimates indicate an impact of €1.283 billion. CIT revenue grew by 6.8%, in line with the evolution of payments by instalments, which were the most important item and make up almost 100% of earnings in recent years. In terms of accrual, and while still awaiting the annual statement which will be presented in July 2018, it is estimated that 2017 growth was 15%, similar to the evolution of tax base (which improved by around 12%) and the positive accounting result of large companies and groups (around 14%). The behaviour of these three variables is in contrast with trends in recent years where, as shown in gráfico 6, a gap has been developing between the positive accounting result, on the one hand, and the tax base and the tax due on the other. On average, in the 1999-2016 period the growth recorded by the positive accounting result doubled that of the tax base and the tax due.

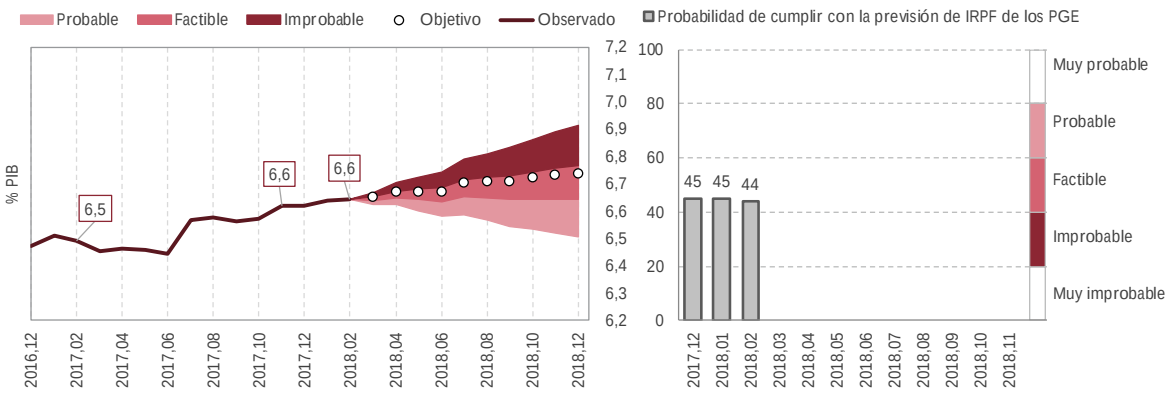
GRÁFICO 6. POSITIVE ACCOUNTING RESULT, TAX BASE AND CORPORATE INCOME TAX DUE
Index 1999=100 and constant prices



The 2018 Draft GSB forecasted an increase in total tax revenue prior to transfer of 6% compared to the end of 2017, excluding the effect of the IIS (8.3% if the effect of the IIS is included). This increase is mainly based on the forecasted evolution of the tax base as a result of an expected upturn in the GDP deflator and compensation of employees, partially offset by the effects of the regulatory measures contained in the budgets. The increase in tax revenue forecasted for the CA is greater, reaching 11.6% as a result of the impact of the system for funding the TAs.

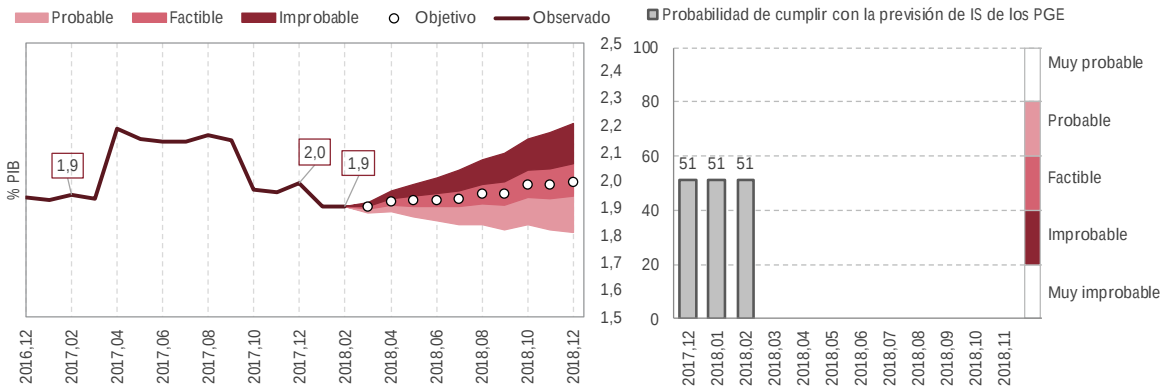
The Draft GSB contains a 6.5% growth in PIT prior to transfer. AIReF considers this forecast to be feasible although growth may be more moderate, in line with the expected increase in tax base and taking into account the deduction for the regulatory measures envisaged (€-900M).

GRÁFICO 7. PERSONAL INCOME TAX



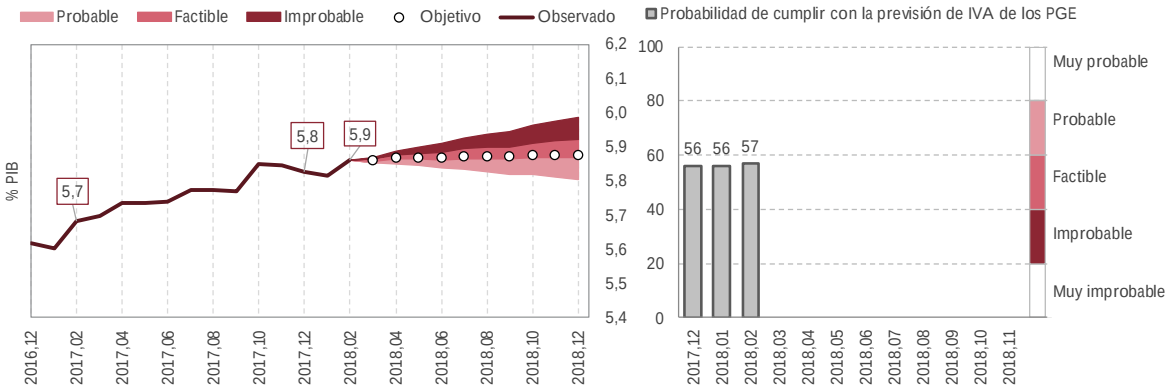
The 2018 Draft GSB forecasts for earnings from CIT are considered feasible. The 2018 budgets forecast a 4.8% growth in CIT, lower than the 12.6% envisaged in the 2017 budgets and in line with AIReF's forecast. The continued evolution of the tax base in a similar line to that of 2017 and the absence of new regulatory measures means that a smoother evolution than in previous budgets can be expected.

GRÁFICO 8. CORPORATE INCOME TAX



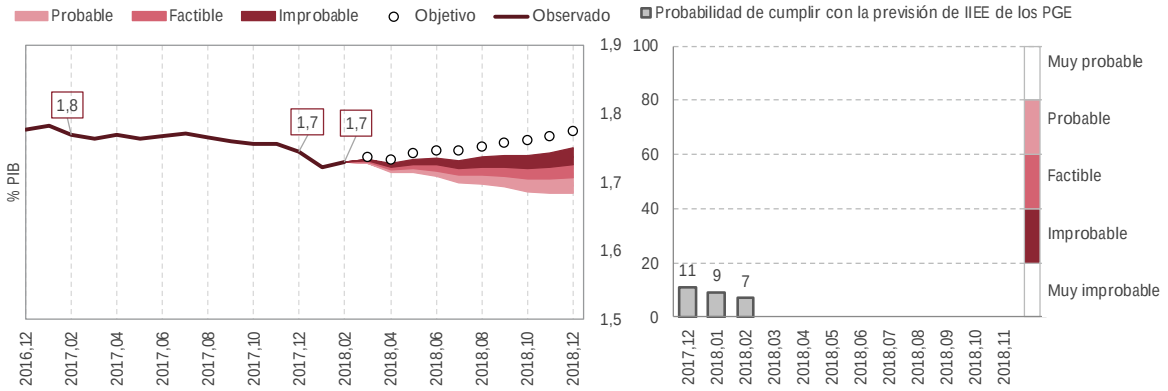
The forecasted earnings from VAT are also considered feasible. In the budgets VAT grew by 12.5% (19.7% if only CA income, once the financing system has been deducted, is considered). These rates fall if the effect of the VAT IIS is excluded, standing at 5.6% and 4.8% respectively. With no significant regulatory changes, the evolution of the VAT due will be determined by the behaviour of its tax base, Final Expenditure Subject to VAT, for which AIReF estimates a growth of around 7% in 2018.

GRÁFICO 9. VALUE ADDED TAX



AIReF considers it very unlikely that the budgetary forecast for Special Taxes will be reached. The 2018 Draft GSB forecasted a growth of 6.4% (15.1% for the CA), much greater than the 2.2% observed in these taxes in 2017. AIReF's rating of very unlikely for these taxes is mainly based on Mineral Oil Tax, where, with no regulatory changes, and with a 2018 growth estimate for consumption of these products below 3%, it seems that it will be difficult to reach the rate of 6.3% envisaged in the budgets. AIReF estimates a growth of 3% for these taxes, around €700 million below what was budgeted.

GRÁFICO 10. SPECIAL TAXES



Growth of non-financial revenue in national accounting terms reflects the expected increase in taxes. CA taxes in national accounting terms will show a growth of around 8%, notably the increase in income and property taxes which now includes the expected income from the financial provision for conversion of deferred tax assets. This provision has been required since 2016 to maintain the right to conversion and is equivalent to 1.5% of the total balance of said assets outstanding as of the last day of the tax period of the CIT statement. It is also worth noting the expected increase in other taxes on production corresponding to CA agencies estimated by AIReF due to the new railway levy scheme, which includes the payment that Renfe-Operadora will make to ADIF.

Income dynamism can also be observed in the rest of non-financial revenues. The non-tax revenues estimated by AIReF based on the forecasts included in the Draft GSB notably include the growth in transfers between PAs, with a rate of change of 16.8%, mainly due to the increase in revenue from the territorial financing system. An increase in revenue from the European Union is also expected. Regarding other revenues, forecasts for Effective Social Security Contributions have been increased and those for Imputed Contributions have been reduced, a result of the gradual integration of civil servants into the General Social Security Scheme. Sales, dividends and other income from property forecasts remain relatively stable.

BOX 1. Regulatory measures with 2018 impact

The 2018 budgets include a set of measures relating to tax revenue (PIT and VAT) with an expected impact of 0.18% GDP, around € 2.2 billion (900 in 2018 and the rest in 2019).

The most important measures relate to **PIT:**

1) **Increase in the reduction for income from work**. The measure was implemented through the amendment to article 20 of the PIT Law in two respects:

- Increase of the maximum reduction for income from work from the current €3,700 to €5,575. The purpose of this measure is to increase the minimum taxation threshold to €14,000.
- Modification of the progressive reduction for income from work until income of €18,000 is reached.

2) **Family aid.** There are three deductions in family and disability support:

- Childcare expenses deduction, complements the current deduction for working mothers through a new deduction of up to €1,000 per year (€83 a month) for expenses incurred on childcare or children's education centres for each child under three.
- Deduction for spouse with disabilities, establishing a deduction of €1,200 per year when the spouse, not legally separated, has disabilities and is economically dependent on the declarant (income below €8,000).
- Increase in the deduction for large families. The amount per child that exceeds the number legally established to be considered as a large family has been increased to €600.

	CUADRO RESUMEN DE MEDIDAS		Impacto previsto 2018	2019	Total
IRPF	Rendimientos del trabajo	Elevación de la reducción por rendimientos del trabajo: - Incremento de la reducción máxima desde los 3.700 € a los 5.575€ - Modificación de la reducción progresiva hasta alcanzar a las rentas del trabajo de 18.000€	700	845	1.545
	Ayudas a las familias	Deducción gastos de guardería hasta 1.000€		265	265
		Deducción por cónyuge con discapacidad 1.200€	187,5	187,5	375
		Deducción familia numerosa por cada hijo que exceda el número establecido 600€	11,5	11,5	23
			899	**1.309**	**2.208**
IVA	Aplicación del tipo reducido de IVA (10%) a las entradas de salas cinematográficas		**25**	**25**	**50**

AIReF has estimated the impact on earnings from these measures, resulting in an assessment in line with the forecasts included in the budget.

Non-financial expenditure forecast

The 2018 Draft GSB includes a 5.1% increase in non-financial expenditure in budgetary terms with respect to the interim settlement published in 2017. The CA's non-financial expenditure envisaged in the 2018 Draft GSB increases by 1.8% with respect to the 2017 GSB, but 5.1% with respect to the provisional closing data for 2017. In budgetary terms this growth entails €7.6 billion more CA non-financial expenditure than in 2017. The increases notably include staff costs with a growth of 4.5%, which entails €700 million more expenditure, an increase in interest on a cash basis of €1.2 billion and an increase in current transfers of €2.617 billion, mainly to fund civil servants' contributory pensions, the TAs, the contribution to the European Union and the payments towards the State's financial liability for the tax on sales of certain hydrocarbons. The 15.4% growth in real investment should also be noted, reflecting an increase in investments in Special Defence Modernisation Programmes and in peace-keeping operations.

The appropriations for investments in the Draft GSB now include the costs arising from participation of the Armed Forces in peace-keeping operations, which are traditionally funded with the Contingency Fund. The difficulty in knowing the expenditure on unforeseen peace-keeping operations in advance of preparing the GSB justifies the consideration that the appropriations for this type of operations may be increased. However, this expense has become recurrent, serving both unforeseen operations and ongoing operations, partially losing the eligibility towards being funded with the Contingency Fund (budgetary item equivalent to 2% of non-financial expenditure, excluding expenditure intended for TA financing systems, intended to fund unforeseen and non-discretionary needs that may arise during the year). The 2018 Draft GSB allocates € 278 million for these investments. Although this does not alter the impact on the public deficit, it entails an improvement in transparency and in the eligibility towards funding the expenses with the Contingency Fund.

AIReF estimates that non-financial expenditure in national accounting terms will remain relatively stable as a percentage of GDP throughout 2018, against the decreasing trend recorded in previous years. CA expenditure (non-financial expenditure in national accounting terms) maintained negative rates of change throughout the 2013-2017 period, which generated a reduction of close to 4% GDP in this period. Once AIReF had analysed the information included in the Draft GSB, it forecasted a growth rate slightly above 4% for 2018, which would mean maintaining the level of non-financial expenditure as a percentage of GDP relatively stable, as shown in gráfico 4. The reduction in expenditure forecasted due to a lower interest burden on 2017 and the reduced transfers from the CA to the State Public Employment Service (SEPE) do not offset the increases forecasted for other appropriations, essentially compensation of employees, civil servants' contributory pensions and gross capital formation.

CUADRO 3. AIReF FORECASTING CRITERIA

Previsiones AIReF (Empleos AC)	% Var
Remuneración de asalariados	3,1%
Actualización monetaria del 1,75% y equiparación CCFF Seguridad Estado	
Nivel de empleo: moderada reducción	
Intereses	-2,6%
Reducción de 0,2% del PIB	
Estimación conservadora del PGE	
Prestaciones sociales distintas de transferencias en especies	5,9%
Prestaciones de clases pasivas incremento en línea con PGE	
Incremento de los impuestos negativos	
Resto de Empleos corrientes	10,4%
Incremento de Subvenciones y aportación UE	
Transferencias entre AAPP	1,3%
Se reduce la transferencia al SEPE, aumenta la de SS y las de AATT	
Las transferencias a AATT crecen por debajo del PIB nominal	
Formación Bruta Capital Fijo	43,2%
Incluye 2.000M€ de RPA de autopistas e Δ inversion PGE	

Compensation of employees includes the agreement between the Government and trade unions on public employment, with a pay rise of 1.75%. According to AIReF's estimates, compensation of employees will grow above 3%, incorporating both the wage increase of 1.75% and the equalisation of the State law enforcement agencies' wage to that of autonomous police forces, allocating €310 million for this purpose. Regarding the size of the workforce, the expected moderate reduction resulting from a lower number of people entering public sector employment than the number of retiring civil servants is maintained, in contrast to that forecasted in the Draft GSB, which projected a stabilisation in the workforce.

The reduction of the debt burden for 2018 continues, although this reduction is slowing down. AIReF estimates a reduction in interest expenditure of 0.2% GDP. This forecast cannot be compared with the 2018 Draft GSB as it does not include the estimate of interest in national accounting terms that is traditionally included in budgetary documentation. The forecast in budgetary terms or on a cash basis is considered to be conservative, with an increase in CA interest expenditure of €1.2 billion compared to the end of 2017, an item where there may be some flexibility.

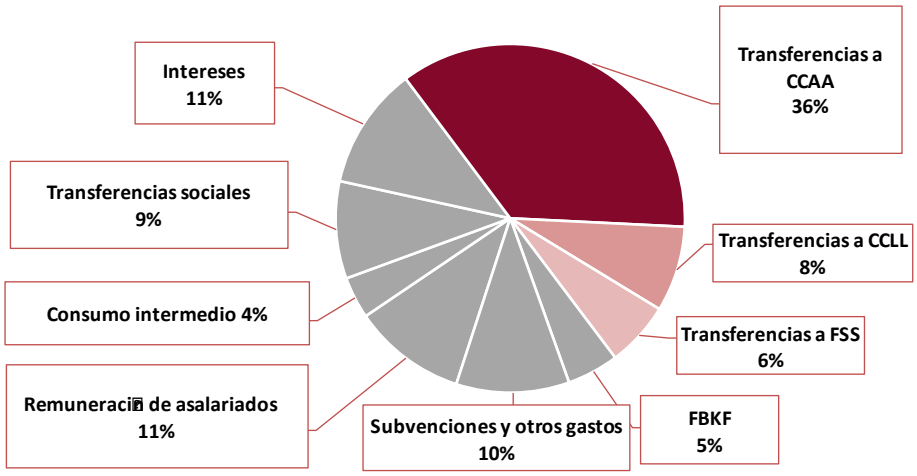
AIReF estimates that civil servants' benefits will experience growth of 5.7% in line with the budgetary estimates. The strong increase in expenditure on civil servants reflects both the measures taken to improve minimum pensions and the expected increase in the number of pensioners. In addition to civil servants' benefits the heading "Social benefits other than transfers in kind" incorporates the negative taxes for deductions made for maternity, large

families or dependent family members with disabilities, which are expected to increase as a result of the measures adopted on PIT.

Intermediate consumption and social transfers in kind are maintaining a moderate growth, therefore maintaining their contribution to GDP, while subsidies and other current expenses are increasing. The new structure of railway levies involves greater contributions from the CA to Renfe-Operadora, a public business entity, due to greater costs for the universal public service, which entails greater expenditure on subsidies. The contribution to the EU budget from own revenue also increases, with a cash growth of 1.9% with respect to the provisional closing data for 2017. It is necessary to take into account the adjustments of each year in national accounting terms and AIReF has no information to determine the growth of the contribution to the EU budget on a like-for-like basis. However, according to the EU budget, the Spanish contribution will be 0.14% GDP greater than in 2017. This increase is explained by the low implementation of the Community budget in 2017, which reduced the contributions of the Member States below what was initially envisaged.

In national accounting terms transfers between PAs are declining, allowing an adjustment of 0.3% GDP. The heading of transfers between PAs includes the transfers made by the CA to other public administrations and represents 50% of their non-financial expenditure. The 2018 GSB presents an important adjustment resulting from the decrease in transfers made by the CA to the SEPE and the Wage Guarantee Fund (FOGASA) (0.2% GDP) and a growth in transfers to the Regions and LGs lower than nominal GDP growth. However, transfers to the Social Security System are increasing, both due to the increase in minimum pensions and due to the improvement in lower pensions, which entails an expenditure increase on the minimum supplement funded by the CA.

GRÁFICO 11. DISTRIBUTION OF CA NON-FINANCIAL EXPENDITURE



AIReF's Gross Fixed Capital Formation forecast increases substantially due to the imputation of the State's financial liability for toll roads and the rest of the investment envisaged in the 2018 Draft GSB. Excluding the State's financial liability for toll roads, there

is still an increase in investments made in the Ministries of Development, Environment and ADIF forecasts.

The budgets allocate € 500 million to cover the State's financial liability for the Tax on Retail Sales of Certain Hydrocarbons resulting from the Supreme Court Judgement of 2016. In its report on the 2017 Draft GSB, AIReF previously noted the risk of having to cover these payments during the year. This budgetary appropriation will have an additional impact on national accounts in relation to that recorded in previous years.

3.4. Social Security Funds

AIReF considers the SSF reaching a deficit level similar to that reached in 2017 to be the most probable scenario. It is considered unlikely that the SSF will comply with the target of -1.1% GDP set for 2018. Achieving the legally approved target would require the SSF to make an adjustment of 0.4% GDP on the -1.5% GDP achieved in 2017. As can be observed in gráfico 12, achievement of this adjustment is considered unlikely given AIReF's forecasts based on the Draft GSB revenue and expenditure.

The revenue and expenditure set out in the draft Social Security budgets are considered realistic overall. CUADRO 4 Shows the reconciliation of the SSF budgetary balance with the national accounting balance achieved in the years 2014 to 2017 and estimates the national accounting adjustments using the lowest of the last 5 years, which would result in a deficit similar to that of 2017, as in AIReF's most likely scenario.

CUADRO 4. EQUIVALENCE BETWEEN BUDGETARY BALANCE AND NATIONAL ACCOUNTING BALANCE OF THE SSF IN %GDP 2014/2018

Ejecución presupuestaria	2014	2015	2016	2017	2018*
Ingresos no financieros (DR)	14,9	14,4	13,4	13,2	13,0
Gastos no financieros (OR)	15,9	15,4	14,9	14,6	14,4
Superavit (+)/déficit (-) no financiero	-1,0	-1,1	-1,5	-1,4	-1,5
Ajustes Contabilidad Nacional	0,0	-0,1	-0,1	-0,1	0,0
Capacidad (+) Necesidad (-) de financiación	-1,0	-1,2	-1,6	-1,5	-1,5

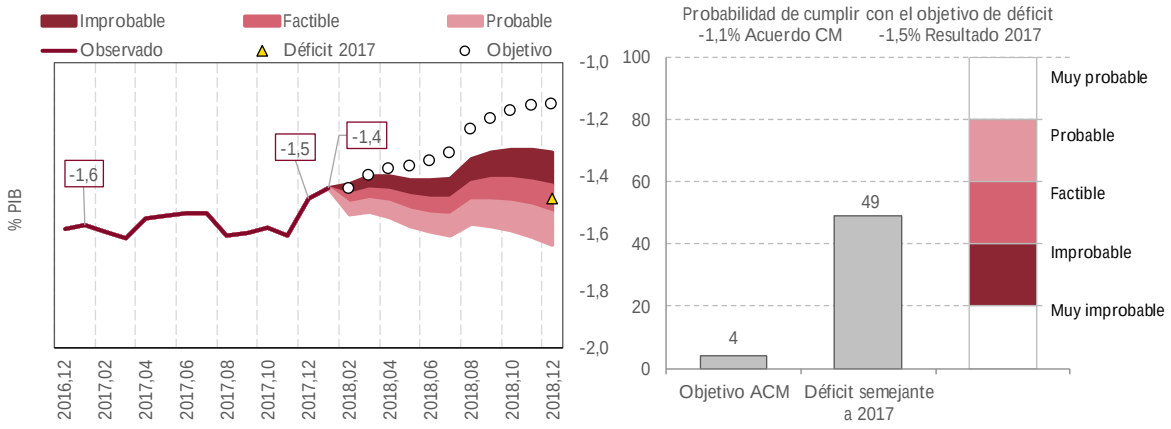
* Proyecto de presupuestos y objetivo de déficit. Menor ajuste de los últimos 4 años

The Social Security revenue forecasted in the Draft GSB is more realistic than in previous years, although lower than the scenario considered most probable by AIReF. Revenues from transfers between PAs have fallen by over one billion euros. This decline is mainly a result of the decrease in transfers to the SEPE and the FOGASA once these entities are out of their deficit. Conversely, CA transfers to the Social Security System increase as a result of the increase in minimum and non-contributory pensions funded by the State.

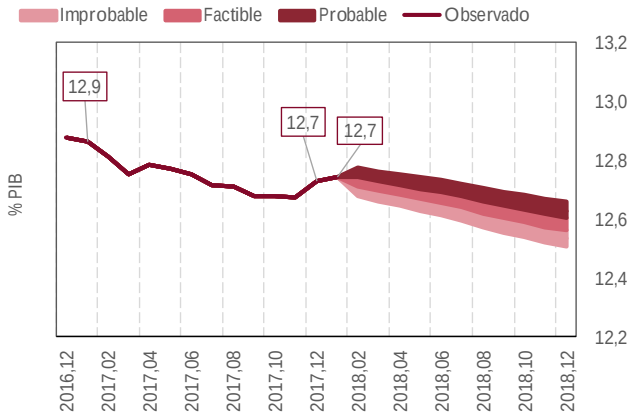
SSF employment forecasts in the Draft GSB present aggregate figures in line with AIReF's estimates. In AIReF's most probable scenario, social benefits other than transfers in kind increase above that recorded in 2017, although below nominal GDP. In turn, it is considered that after several years of sharp decline in expenditure on unemployment benefits

this will stabilise. In contrast, the Draft GSB considers that it will continue to decline although at a more moderate rate than in 2017.

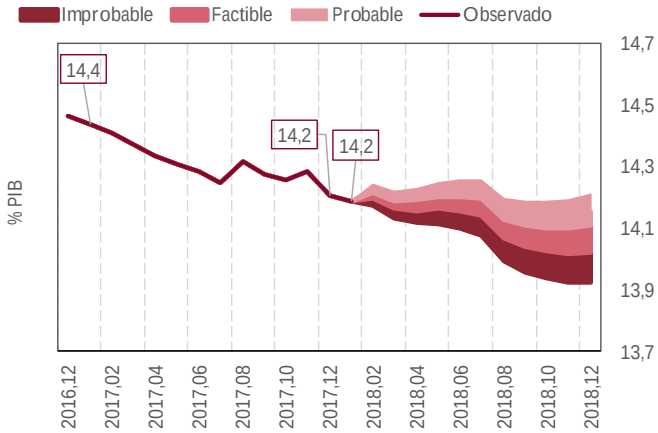
GRÁFICO 12. SOCIAL SECURITY FUNDS NET LENDING/BORROWING



SSF REVENUE



SSF EXPENDITURE



Analysis by stakeholders

Social Security System

The Social Security System deficit will be at levels similar to 2017. The Draft GSB forecasted that revenues from contributions would grow by 5.4%, above expected nominal GDP growth. According to AIReF's estimates, which incorporate the latest data published, it is considered unlikely to reach the level of contributions provided for in the Draft GSB. However, it should be noted that the difference between the contributions provided for in the Draft GSB and AIReF's estimates is much lower than deviations observed in previous years, standing at around € 500 million, as can be observed in gráfico 14.

AIReF's estimates include a growth in social security contributions slightly above nominal GDP growth, but below that contained in the Draft GSB. This growth is in line with that observed last year and with the data available for 2018. The composition of growth is slightly different compared to 2017, with an increase in the component attributable to contribution bases and a reduction in that of employment. Regarding the discretionary measures with an effect on contributions, in 2018 these notably include the increase in what is known as the "flat rate" and the reduction in contributions from members of the Special Regime for Self-Employed Workers, introduced by Law 6/2017, of 24 October, on Urgent Reforms of Self-Employed Work. In 2018 the effect of this is considered to be limited, estimating that the greatest intensity of its effects will be produced in 2019 when acting upon new registrations to the regime. The maximum contribution base of the Social Security System increased by 1.4% according to the Draft GSB against the 3% increase in 2017. Despite affecting a limited percentage of contributors, the evolution of this variable has a significant importance on the total amount collected and an increase in this base below that of the previous year has a negative impact on the contribution growth rate.

GRÁFICO 13. SOCIAL SECURITY CONTRIBUTIONS

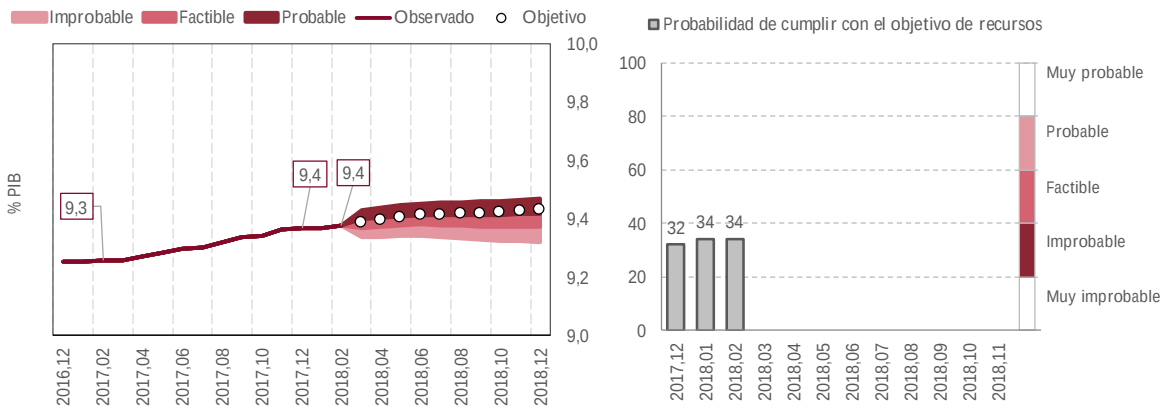
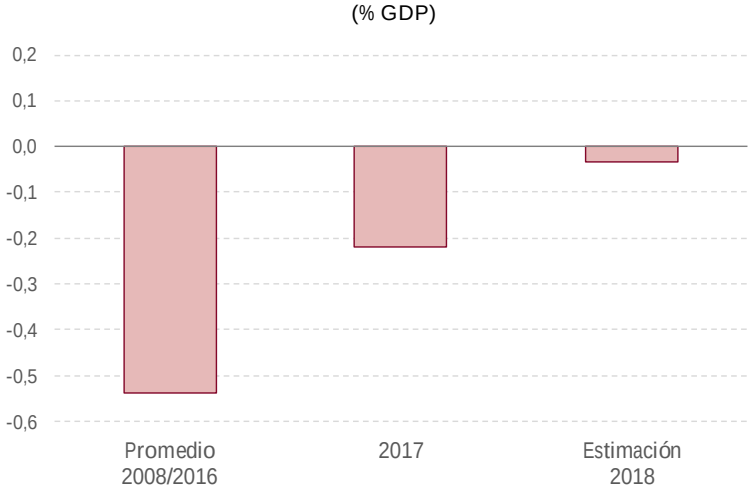
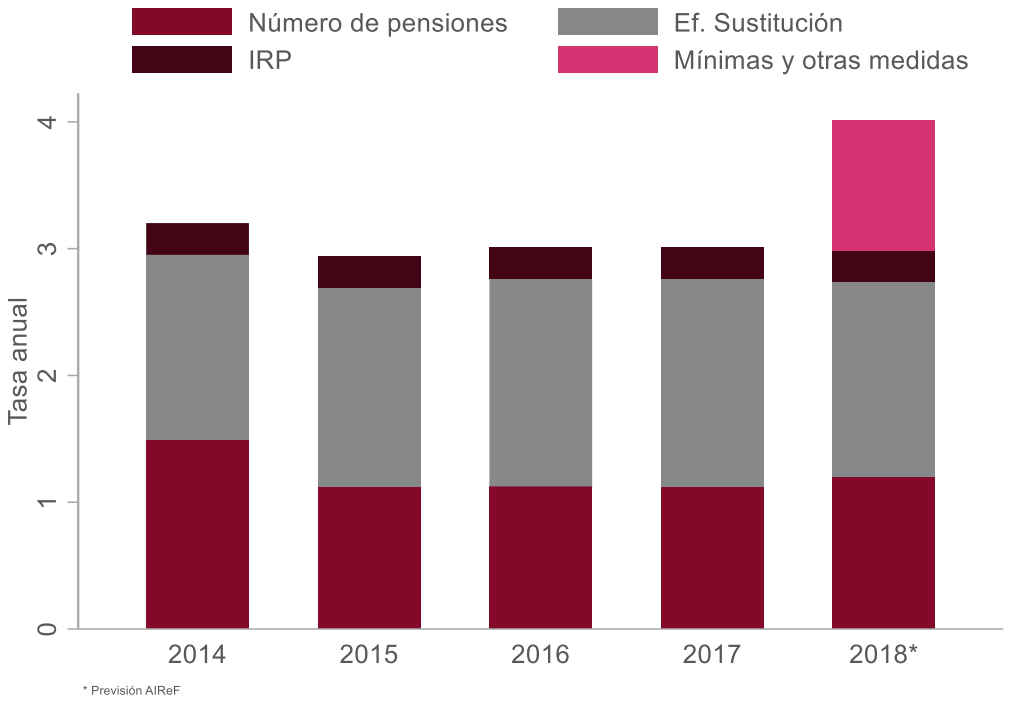


GRÁFICO 14. DEVIATION IN SOCIAL SECURITY CONTRIBUTIONS WITH RESPECT TO THE BUDGET



Social Security Pensions of the Draft GSB are growing in line with AIReF's estimate, including the effect of the measures. The expected expenditure on pensions has grown by approximately €1 billion as a result of the 3% increase in minimum pensions and the 1.5% and 1% increase in pensions below €700 and €860, respectively, against a 0.25% rise in the rest of pensions as a result of the application of the Pension Revaluation Index (PRI). In turn, the percentage to be applied to the regulatory base to calculate widows' pensions has increased from 52% to 54%. It is estimated that approximately two thirds of this increase will be recovered through higher transfers from the CA due to the effect on non-contributory pensions or pensions that incorporate minimum supplements, therefore the effect on the System's deficit will be lower than the increase in total expenditure. Due to the above, the deficit resulting from non-financial operations envisaged in the Draft GSB for the Social Security System is very similar to that which AIReF considers the most likely scenario.

GRÁFICO 15. PENSION GROWTH (% CHANGE)



The information needed to calculate the Pension Revaluation Index is not included in the Social Security Economic-Financial Report. Unlike the 2017 GSB, the 2018 Draft GSB does not include the information needed to calculate the PRI. The Opinion on the PRI published in July 2017 provided a very positive assessment of the improvement in transparency that would entail including the information needed to calculate the PRI in the 2017 Social Security Economic-Financial Report.

The 2018 Draft GSB forecasted a provision of € 3.826 billion from the Reserve Fund and the granting of a loan of €15.164 billion by the CA. The loan is larger than that granted in 2017, €10.192 billion. These operations are of a financial nature, therefore they do not affect the national accounting balance. In December 2017, the Reserve Fund accumulated approximately €8 billion against the more than €15 billion of one year earlier. This is why a significant reduction in revenue from Reserve Fund yields is expected.

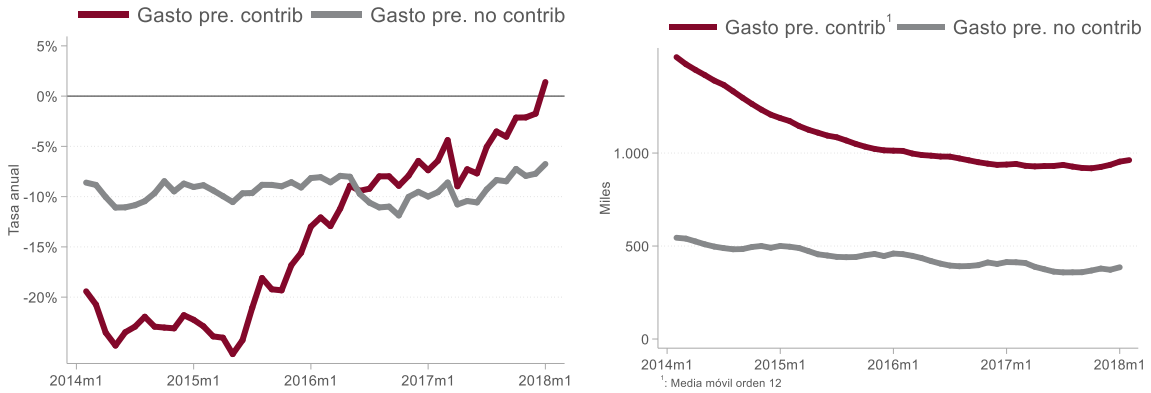
The budget in national accounting headings, which was incorporated into the Economic-Financial Report, has been eliminated from the draft budgets. The draft budgets of the Social Security System included the budget in national accounting headings until 2017. Although the criteria of this accounting system were not applied, at the least the national accounts headings to which the revenue and expenditure items were imputed were identified.

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

The SEPE and the FOGASA may be able to fund themselves with their own resources. Once they have reached a surplus, both agencies will cease to receive the transfers from the State that they have been receiving in recent years. This means no longer receiving €1.8 billion which, until this year, contributed to reducing the total deficit of the SSF.

Expenditure on unemployment benefits contained in the Draft GSB is below that considered most likely by AIReF. This is due to the fact that an increase in expenditure on contributory benefits is expected, offsetting the reduction in expenditure on non-contributory benefits which will continue to decline from historic highs. The greatest uncertainty in this area lies in the extent to which it is possible to execute the provision of €500 million in support of young people included in the National Youth Guarantee System. This is the same amount that was included in the 2017 budget, which was not executed.

GRÁFICO 16. EVOLUTION OF EXPENDITURE ON UNEMPLOYMENT



Conversely, regarding unemployment contributions AIReF considers the growth contained in the Draft GSB to be too low. The 3.5% growth forecasted in the Draft GSB would be too inconsistent with the forecast of Social Security System contributions. In any case, AIReF considers that unemployment contributions will continue to grow above Social Security System contributions to the extent to which temporary contracts, which provide contributions at a higher rate, continue to recover their weight on the total.

4. Government debt

The 2018 debt targets were set by the Agreement of the Council of Ministers (ACM) of 7 July 2017, both for the GG (97.6% GDP) and for the sub-sectors, as shown in Cuadro 5.

CUADRO 5. DEBT TARGETS (EDP IN % GDP)

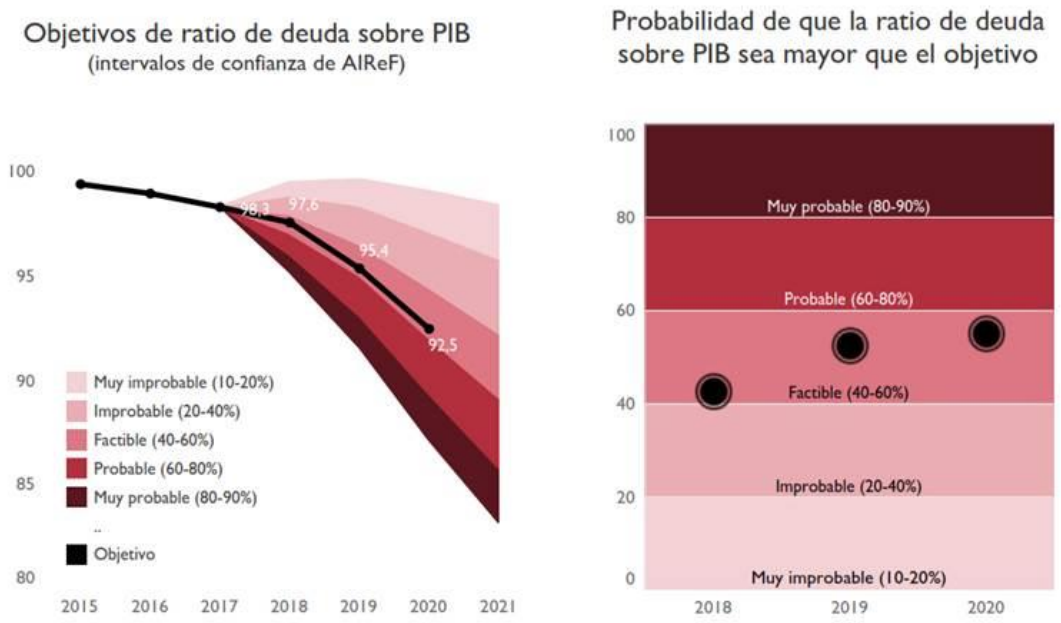
Deuda PDE	2017	2018	2019	2020
Administración Central y Seguridad Social	72,0	70,8	69,5	67,6
Comunidades Autónomas	24,1	24,1	23,3	22,4
Entidades Locales	2,9	2,7	2,6	2,5
Total AAPP	99,0	97,6	95,4	92,5

The GG debt-to-GDP ratio decreased to 98.3% GDP at the end of 2017, in compliance with the target set, but below that required by the LOEPySF for the third consecutive year. In nominal terms, government debt increased by €37.078 billion, reaching a new historic annual high. However, as in 2015 and 2016, the 0.7% reduction in the debt-to-GDP ratio is insufficient for compliance with the legal reduction required in the First Transitional Provision (1st TP) of the LOEPySF in 2017.

The Draft GSB forecasted compliance with the debt target in 2018, but the reduction in the debt-to-GDP ratio would also be lower than that required by the LOEPySF. AIReF considers compliance with the debt target to be feasible, as can be seen in gráfico 17. By projecting a GG debt-to-GDP ratio of 97% in 2018, the Draft GSB exceeds the reduction required by the debt target by 0.6%. For the fourth consecutive year, the reduction in the government debt-to-GDP ratio will be below the 2% required by the regulations in force in a context where real GDP and expenditure growth is expected to be greater than 2%.

GG debt shows a declining trend in the medium-long term in AIReF's baseline scenario, although this involves non-compliance with the 1st TP of the LOEPySF in 2020, calling for its review. The 1st TP of the LOEPySF provides for a transitional period until 2020 for reaching the debt limit of 60% GDP, also requiring a reduction of at least 2% of the debt-to-GDP ratio if real GDP or expenditure grow by more than 2%. According to AIReF's baseline scenario, the limit laid down in article 13 of the LOEPySF would be reached around the year 2035. Beyond the situation in 2018, the Draft GSB does not contain a sustainability analysis in the context of convergence with the limits set in article 13 and the 1st TP of the LOEPySF. AIReF reiterates that the analysis of government debt should consider a medium-term horizon and not be limited to the risk of non-compliance with the debt target for the current year.

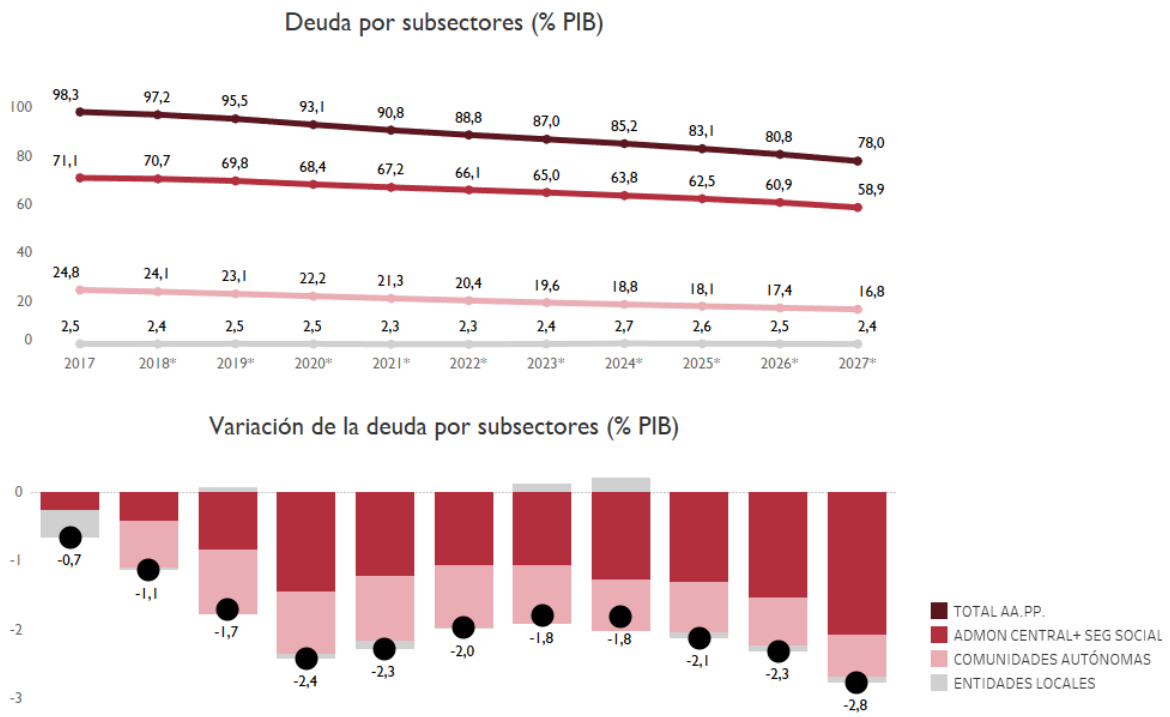
GRÁFICO 17. GOVERNMENT DEBT FORECAST (% GDP)



Source: Bank of Spain and AIReF

Although CA and SSF compliance with the debt target is considered likely, long term forecasts project non-compliance with the 1st TP of the LOEPySF. AIReF's 2018 central debt forecast for the CA and SSF is in line with the target set of 70.8% GDP, therefore compliance is considered likely. For 2018 the estimated increase in borrowing requirements takes into account the deficit envisaged for the CA, the part corresponding to additional mechanisms for financing the TAs, other stock-flow adjustments and the SSF deficit which will be partially financed with the Reserve Fund and by a loan from the Treasury. The reference level set in the 1st TP of the LOEPySF to be reached in 2020 for the consolidated CA and SSF sub-sector stands at 44% GDP. However, taking into account the evolution of the debt-to-GDP ratio estimated by AIReF in its baseline scenario, this limit laid down in article 13 of the LOEPySF will not be achieved before the year 2037.

GRÁFICO 18. BASELINE DEBT FORECAST BY SUB-SECTORS (% GDP)



Source: Bank of Spain and AIReF

5. Central Administration expenditure rule

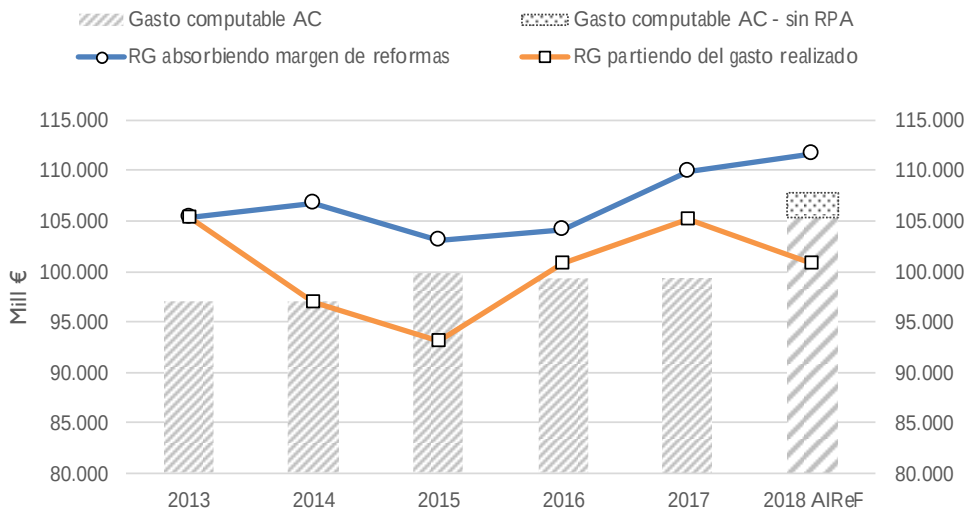
The CA complied with the expenditure rule in 2017, as included in the Report on the degree of compliance with the budgetary stability target, debt target and expenditure rule for 2017 published by the General Intervention Board of the State Administration (IGAE). Both the reduction in computable expenditure and the impact of the regulatory measures increasing earnings considered to be permanent by the IGAE enable compliance with the expenditure rule in 2017 as can be observed in Figure 19.

The 2018 Draft GSB does not include any information relating to compliance with the expenditure rule. As in previous years, the 2018 Draft GSB does not refer to compliance with the expenditure rule. In its response to AIReF's recommendations on the 2017 Draft GSB, the Ministry of Finance and Public Function (MINHAFP) reported that the information relating to the expenditure rule was included in the annual compliance reports prepared in April and October[5] and that, in addition, it was included in the monthly IGAE publication on budgetary execution. In previous reports AIReF has indicated that compliance with the rule should not only be observed throughout execution and at the end of the year, but that it is essential that the draft budgets are in line with the reference rate approved for that year. This means that the Draft GSB need to include all the necessary information: non-financial expenditure in terms of ESA 2010, estimate of the expenditure components excluded and of the permanent regulatory impacts on earnings.

There is risk of non-compliance with the expenditure rule for 2018, set at a growth of 2.4% of computable expenditure. With the information available and AIReF's estimates the risk of the computable expenditure for 2018 growing above the reference rate approved can be observed. Part of this risk is due to the increase in expenditure on compensation of employees, stemming from the agreement between the Government and the trade unions included in the Draft GSB, and to the fact that in 2018 the toll roads will be bailed out with an impact of 0.2% GDP, a bailout that will be part of the computable expenditure. In the analysis of the expenditure envisaged in the GSB there are no significant decreases that would enable this increase in expenditure to be absorbed in order to become compatible with the reference rate envisaged for 2018. On the other hand, the permanent regulatory measures included in the Draft GSB, estimated at a €899M reduction in earnings from PIT, generate additional strain on compliance with the expenditure rule this year. Despite the predicted non-compliance, the computable expenditure of the expenditure rule, excluding expenditure on benefits paid to civil servants, contributions to the EU and the State financial liability for toll roads, which will have an impact this year, increases by 4.2%.

[5] Reports prepared pursuant to Article 17, paragraphs 3 and 4 of the LOEPySF.

GRÁFICO 19. CA COMPUTABLE EXPENDITURE AND COMPLIANCE WITH EXPENDITURE RULE



Source: 2013-2016 IGAE Report on target compliance and 2017-2018 AIReF estimate

Given that 50% of the CA's expenditure is intended to make transfers between PAs the margin of discretionary expenditure is reduced. Significant reductions have been recorded for discretionary expenditure throughout the years of fiscal consolidation. However, as can be seen in gráfico 20 the 2018 forecasts increase this expenditure, essentially due to the improvement in wages and the increase in investments, although without taking the State's financial liability for toll roads into account.

GRÁFICO 20. EVOLUTION OF CA EXPENDITURE WITHOUT TRANSFERS BETWEEN PAS, INTEREST, CIVIL SERVANT BENEFITS AND EU CONTRIBUTIONS (% GDP)

6. Recommendations

6.1. New recommendations

AIReF reflects on the current fiscal framework in the context of the three fiscal rules.

Regarding the budgetary stability target, AIReF considers that the Government's presentation of a Draft GSB without reference to the stability targets approved by the Council of Ministers' Agreement and subsequently approved in the Parliament shows the weakness of the current target setting system and of the mechanisms that enable their enforcement.

The lack of realism when setting sub-sector targets, mainly due to not recognising the recurrent surplus of LGs, greatly complicates the monitoring of budgetary execution and stability targets, and reduces the enforceability of an increasingly devalued fiscal framework. From its analysis of the GSB, AIReF concludes that non-compliance with the targets by the CA and SSF is probable, despite the fact that achievement of the overall target is deemed feasible. In addition, although it would be necessary to take measures in the CA and SSF, the LOEPySF does not extend all of the preventive measures envisaged for the TAs to these sub-sectors.

AIReF recommends:

1. ***Setting targets for the different sub-sectors should take into account their fiscal situations, which would facilitate the monitoring and enforcement of said targets, thereby providing greater credibility to the current fiscal framework.***

Regarding the expenditure rule, AIReF continues to observe a mismatch between the distribution of the target by sub-sector and the restriction imposed for some administrations by the expenditure rule, whose regulation is in a provisional situation that fits poorly with the necessary stability of the "ground rules" that must be known in advance in the budgetary planning process.

Finally, **regarding the debt target**, AIReF recalls that the fiscal targets need to be in service of compliance with the principles referred to in the LOEPySF. In particular, AIReF has repeatedly stated in its reports that the setting and evaluation of the debt target is unconnected to the principle of financial sustainability, which requires the establishment of a debt reduction path whose definition is credible and its compliance enforceable.

AIReF recommends:

2. ***To revise the existing fiscal framework established by the LOEPySF in order to:***

a) guarantee consistency and stability of the fiscal rules and compliance with their underlying principles[6],

[6] In the context of the principle of financial sustainability, AIReF reiterates recommendation 4

b) incorporate the aspects considered to be urgent and the subject of transitional regulation in legal provisions other than the LOEPySF.

6.2. Reiterated recommendations

6.2.1. Budgetary stability

AIReF reiterates the following recommendations:

3. ***To prepare an initial budget in national accounting terms for the Central Administration and Social Security Funds***

Background

Until 2016 the General State Budgets included information on national accounting adjustments in the Economic-Financial Report, which enabled reconciliation between the revenue and expenditure balance of the Budget with the net lending/borrowing calculated in accordance with ESA 2010, thereby complying with the guidelines laid down by the Community regulations and by the LOEPySF. However, for 2018, the Draft GSB does not include information concerning national accounting adjustments for the second consecutive year. Nor does it include the net lending/borrowing of CA Agencies, a circumstance that is compounded by the fact that that the GSB does not include information on non-public entities that are considered CA Agencies for the purposes of ESA 2010.

Reasons for reiteration: non-compliance

The 2018 Draft GSB continues to omit information for reconciling the budgetary balance with the net lending/borrowing. This deficiency would be overcome if the budget is presented in national accounting terms, in addition to what is done currently. This would facilitate its analysis and monitoring and would enable it to be anchored to the medium-term fiscal scenario reflected in the Stability Programme Update (SPU).

6.2.2. Government debt

AIReF reiterates the following recommendation:

4. ***To use appropriate legal mechanisms to extend the transitional period for compliance with the limit laid down in article 13 of the LOEPySF, adapting the requirements specified in the first transitional provision of this law and defining a credible and demanding reference path for the sustainable reduction of the debt-to-GDP ratio.***

Background

The Draft GSB includes information on the debt target for all PAs, but it does not include information specific to the CA. Article 6 of the LOEPySF establishes that the budgets of the various PAs "must contain sufficient and adequate information in order to verify their financial situation, compliance with budgetary stability targets and financial sustainability targets".

Reasons for reiteration: non-compliance

The Draft GSB does not include information on the CA's compliance with the debt target in 2018. On the other hand, AIReF's analysis on the evolution of debt concludes that, according to the estimates of AIReF's baseline scenario, the 1st TP of the LOEPySF (which determines that the level of government debt of the CA and SSF must be 44% GDP in 2020) will not be complied with until 2037.

6.2.3. Transparency

AIReF reiterates the following recommendations:

5. ***To include information on the non-public entities that are included in the CA sub-sector for the purposes of the ESA 2010 in the GSB.***
6. ***To complete the information contained in the Draft GSB so as to enable specific assessment of CA compliance with the debt target.***
7. ***To include the information necessary for evaluation of the expenditure rule in the GSB. In particular, the impact of the main regulatory changes and their definition as "permanent or non-permanent" for the purposes of the expenditure rule.***
8. ***To include the necessary information for calculating the PRI in the GSB.***

Background

The lack of a Draft GSB in national accounting terms complicates the assessment of compliance and the enforcement of fiscal rules defined in national accounting terms. In this sense it is essential that the GSB includes information on the economic and financial activity of entities in the CA sub-sector, which includes information that enables identification of the

computable expenditure of the expenditure rule, alongside the regulatory changes that affect their compliance or the detailed analysis of the Government's forecasts on the evolution of the CA's debt.

It is essential that the various PAs continue to progress in terms of transparency, by improving the quality of the information published and in any case avoiding non-compliance with article 27.1 of the LOEPySF establishing the principle of transparency.

On the other hand, it is important to remember the weakness of the current LOEPySF in regulating the preventive and corrective mechanisms applied to the CA. The immediate measures envisaged by the law for cases of non-compliance with transparency obligations are directed towards the TAs, as there is a legal gap for cases in which the entity not complying with the transparency obligation is the CA itself.

Reasons for reiteration: non-compliance

The GSB continues to omit relevant information for verifying the calculation of the fiscal rules.

In addition, the 2018 Draft GSB does not include the information necessary to calculate the PRI, information that was included in the 2017 GSB. The Opinion on the PRI published in July 2017 provided a very positive assessment of the improvement in transparency that would entail including the information needed to calculate the PRI in the 2017 Social Security Economic-Financial Report. Omission of the information mentioned above from this Draft GSB justifies the reiteration of the recommendation.