

REPORT ON THE MAIN BUDGETARY LINES OF THE REGIONS 2020

REPORT 69/2019





Autoridad Independiente
de Responsabilidad Fiscal

The Independent Authority for Fiscal Responsibility (AIReF by its Spanish acronym) was created with the mission of ensuring strict compliance with the principles of budgetary stability and financial sustainability set out in Article 135 of the Spanish Constitution.

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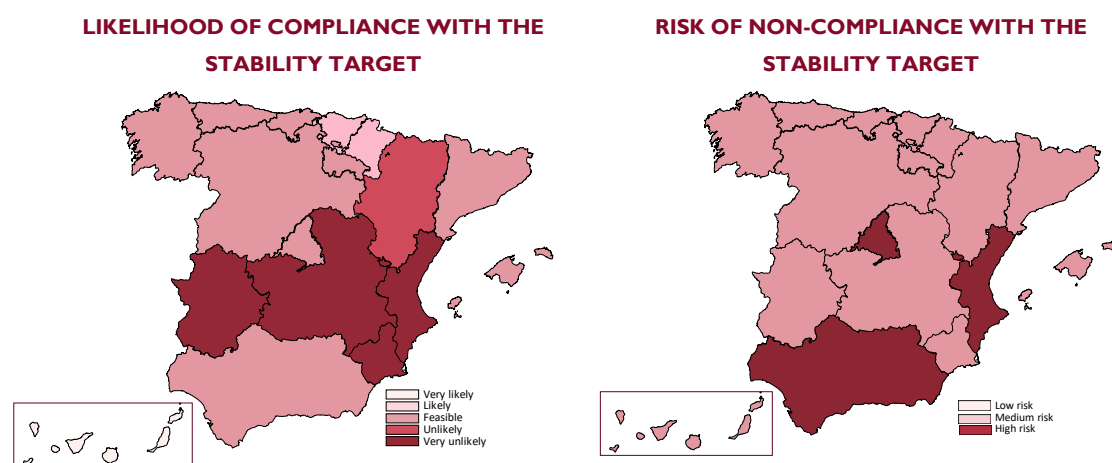
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EXECUTIVE SUMMARY

This report aims to analyse the main budgetary lines of Regions in 2020. Due to the uncertainties arising from the political environment, the regional Governments have delayed the submission of their budgetary lines, meaning that AIReF has had to delay its valuation.

AIReF considers it *feasible*, although difficult to achieve, that the Regions will reach the current stability target of 0.0% GDP in 2020. It is estimated that, at the close forecasted for 2019, revenue will increase 0.3% over GDP, while expenditure will maintain its weight, reaching the central point in AIReF's current forecast of -0.2% of GDP. At the individual level, there are difficulties in fulfilling this goal in Valencia, Murcia, Extremadura, Castile - La Mancha and Aragon. Regarding the expenditure rule, a *moderate risk* of non-compliance can be seen at the sub-sector level. This risk increases to *high* in the case of Andalusia, Madrid and Valencia.



AIReF estimates that the Regions' revenue in 2020 will increase by over 5% above the level estimated in 2019, boosted by the expected positive evolution in Regional Financial System resources. The overall growth of revenue includes tax measures that, in net terms, would result in a loss of collection of around 190 million euros.

Meanwhile, AIReF expects expenditure to grow, as a whole, by 4%, mainly due to the expected evolution of staff costs, which also includes staff measures generally agreed in the 2nd Agreement with the Trade Unions in March 2018,

additional measures foreseen by the Regions amounting to some 500 million euros.

AIREF'S ESTIMATE OF THE REGIONAL SUB-SECTOR OF THE 2020/2019 VARIATION

	Variation rate estimated by AIReF 2020/2019	
	% variation	%GDP
Total revenue	5%	0.3%
Regional Financial System	8%	0.3%
Other revenues	2%	0.0%
Total expenditure	4%	0.0%
Staff costs	4%	0.0%
Other expenditures	4%	0.0%

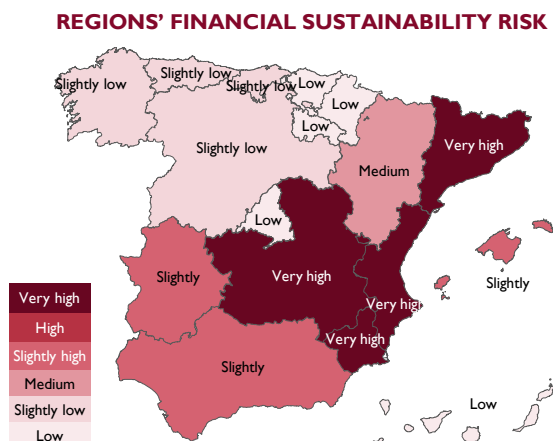
(*) System resources in Navarre are considered to be its net tax revenue from transfers to the State by agreement and to local corporations by its financing system. Transfers received from the Provincial Councils have been considered in the Basque Country.

AIReF expects debt to stand around 23.2% GDP in 2020, 1.2 percentage points of GDP less than in 2018, mainly due to the contribution of GDP. This expected level of indebtedness in 2020 would allow compliance with the debt target, as long as the current target system is maintained. These targets include the financing of the excess deficit recorded the previous year.

Following AIReF's recommendations, MINHAC has ceased to consider within the debt target the financing of the deficit permitted by the stability target when the deficit finally recorded is lower. This practice has generated a financing excess for the sub-sector of nearly 1,000 million that will now have to be compensated.

In AIReF's opinion, this significant advance in the measurement of debt targets should be supplemented with the incorporation of the application of the surplus provided for in article 32 of the Organic Law of Budgetary Stability and Financial Sustainability (LOEPySF for its Spanish acronym) to these targets, with the aim of further adjusting the debt limits to the Regions' true fiscal situation.

In addition, AIReF considers the sub-sector's sustainability risk to be *slightly high*, with a very diverse situation at the individual level.



In view of the above, AIRcF has created *new recommendations* for the following Regions:

- Aragon, which is considered unlikely to comply with the stability target, due to the starting deviation, made more difficult by tax reduction measures
- Castile - La Mancha, Extremadura, Murcia, which are considered very unlikely to comply with the stability target, mainly due to the starting deviation
- Valencia, which is considered very unlikely to comply with the stability target due to a significant starting deviation, combined with the negative effect of the expenditure increase measures forecast for 2020 that lead to a warning of a high risk of non-compliance with the expenditure rule.
- Andalusia, which is considered at high risk of not complying with the expenditure rule in 2020, exacerbated by the forecasted tax reduction measures
- Madrid, which is considered at high risk of not complying with the expenditure rule in 2020, arising from the estimated impact of the tax reduction measures and expenditure increase.

A new recommendation is also made regarding transparency for the Canary Islands and Basque Country, in relation to the implementation of the surplus pursuant to article 32 of the LOEPySF.

In turn, AIRcF directs three recommendations to the *Ministerio de Hacienda* (Ministry of Finance - MINHAC):

- Two new recommendations in relation to the Regions in which deviation from compliance with the rules is observed:
 - In the short-term, to monitor the proceedings that the Regions may carry out in the processing of their budgets.

- Without prejudice to the foregoing, in line with recommendations of previous reports, to follow a medium-term approach when next setting the targets, in which the annual targets take into account the fiscal situation of each Region, and accompanied by specific conditions for each Region that ensures a firm commitment of the Regions to compliance with the fiscal rules.
- A reiterated recommendation, advising that next time debt targets are set account should be taken of differentiated stability targets and the surplus obtained in the previous year should be considered.

PURPOSE AND SCOPE

Before the 15th October each year, the Independent Authority for Fiscal Responsibility (AIReF) has to prepare a report on the main budgetary lines of the budgets of the Regions for the following year. Article 20 of Organic Law 6/2013 creating AIReF establishes that, before the 15th of October each year, AIReF must prepare a report on the draft budgets and main budgetary lines of the Public Administrations' budgets for the following year.

The uncertainties arising from the political context have delayed the presentation of the Regions' budgetary lines for 2020. The fact that many of the regional Governments have only recently formed and the uncertainties arising from the fact that a central government has still not been formed meant that, until recently, the Regions' budgetary lines for 2020 had not been defined and that, in many cases, these had been reflected directly in the draft budgets. As a result, AIReF has delayed the preparation of the reports on the Regions until the required information was available.

The present report updates the preliminary assessment of the regional sub-sector contained in AIReF's report of 25th October on the main budgetary lines of the Public Administrations' budgets for 2020¹. On the preliminary information available for the 2020 Budgetary Plan presented in October, AIReF issued the first statement on the forecasts for 2020 of the General Government, with an overall analysis of the regional sub-sector. This report updates the above statement, once the individual information of the majority of Regions became available. This information was obtained from the regional draft budgets published, the main budgetary lines of the budgets and, in the case of Murcia, the last provisional scenario provided in the context of the preparation of the Economic-Financial Plan. Thus, as of the date of preparing this report there are no budgetary estimates or measures provided for 2020 for the Region of Murcia, nor any details of the forecasts for 2019 and the measures considered in 2020 by the Region of Catalonia. In these cases AIReF has made its analysis based on a "no-policy-change" scenario and by considering the latest information provided by these Regions in relation to the 2019 and 2020 financial years.

To carry out the analysis, AIReF has defined its baseline scenario for 2020 under a series of assumptions that determines their evaluation. Given the existing uncertainties about the fundamental elements that influence the Regions'

¹ [Report on the main budgetary lines of the Public Administrations for 2020](#)

results, AIReF must define its baseline scenario and carry out the valuation of 2020 under a number of assumptions:

- In the absence of communication from the MINHAC on the forecasts of instalment payments to the Regions of financing system resources (RFS) in 2020, AIReF estimated the amount according to its current revenue estimates, and incorporates the expected settlement of 2018 that was notified. It is considered, given the experiences of previous years, that instalment payments corresponding to the year's revenue will be updated and paid, although this starts with carryover of the State budget.
- The central evaluation is performed with respect to the stability target of 0% GDP approved for the Regions In July 2017 and in force to date, under which practically all of the regional forecasts are being prepared. Only the Region of Galicia has taken the forecasts expressed in the April Stability Programme Update² as a reference, to which the recent Budgetary Plan³ made reference, preparing its draft with respect to a deficit target of 0.1% GDP.

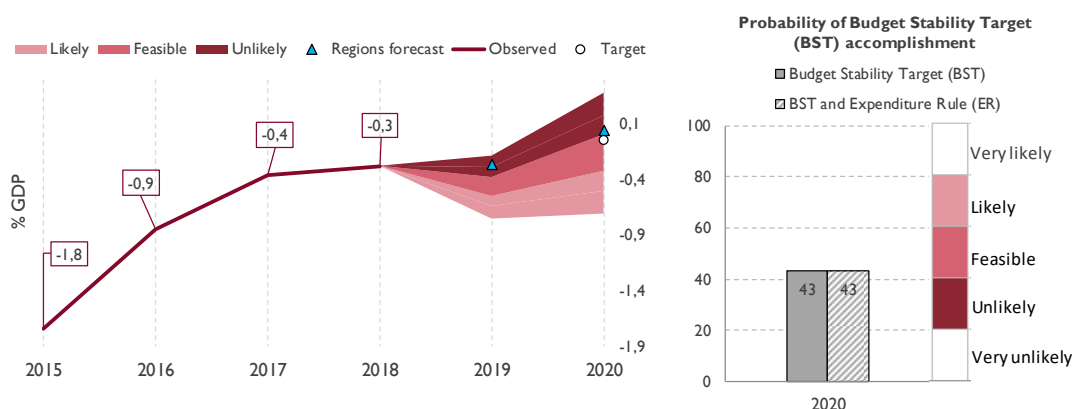
² [2019-2022 Stability Programme Update](#)

³ [Budgetary Plan 2020](#)

1. BUDGETARY STABILITY TARGET AND EXPENDITURE RULE

AIReF considers it *feasible*, although difficult to achieve, that the Regions could reach the current stability target of 0.0% GDP for 2020, with a moderate risk of non-compliance with the expenditure rule. Based on AIReF's closing forecast for 2019, achieving equilibrium would require an adjustment of almost 0.5% regional GDP. Achieving this adjustment is considered *feasible*, although close, given that revenue is expected to increase about 0.3% GDP in 2020 and the expenditure is expected to maintain its weight. Under the current revenue estimates, an evolution of expenditure that would allow compliance with the expenditure rule would require achieving a balance somewhat less demanding than the current stability target.

FIGURE I. LIKELIHOOD OF ACHIEVING A BALANCE OF 0% AND SIMULTANEOUSLY COMPLYING WITH THE EXPENDITURE RULE FOR THE WHOLE OF THE REGIONS IN 2020 (% GDP AND % PROBABILITY)



It would be difficult to achieve a balanced budget in 2020 in five Regions and risks of non-compliance with the rule in one of these, and in two others. Essentially due to the expected close of 2019, AIReF considers it unlikely that the Region of Aragon will reach a balance of 0% in 2020 and highly unlikely in Castile - La Mancha, Extremadura, Murcia and Valencia. On the other hand, in Andalusia and Madrid, in which the target of 0% GDP is attainable, the expenditure rule is more demanding, so that it is considered unlikely, under current revenue forecasts, that these Regions would achieve a balance that

would lead to a growth of expenditure that is compatible with compliance with the rule.

TABLE I. SUMMARY BY REGIONS OF AIREF'S CONCLUSIONS ON COMPLIANCE WITH THE STABILITY TARGET AND THE EXPENDITURE RULE IN 2020

Region	Probability of Stability target (0.0% GDP) accomplishment in 2020	Probability of simultaneous accomplishment of Stability target and expenditure rule in 2020	Risk of expenditure rule breach (2.9% maximum expenditure increase)
ANDALUCÍA	Feasible	Unlikely	High Risk
ARAGÓN	Unlikely	Unlikely	Medium Risk
ASTURIAS	Feasible	Feasible	Medium Risk
BALEARES	Feasible	Feasible	Medium Risk
CANARIAS	Very likely	Feasible	Medium Risk
CANTABRIA	Feasible	Feasible	Medium Risk
CASTILLA Y LEÓN	Feasible	Feasible	Medium Risk
CASTILLA - LA MANCHA	Very unlikely	Very unlikely	Medium Risk
CATALUÑA	Feasible	Feasible	Medium Risk
EXTREMADURA	Very unlikely	Very unlikely	Medium Risk
GALICIA	Feasible	Feasible	Medium Risk
COMUNIDAD DE MADRID	Feasible	Unlikely	High Risk
REGIÓN DE MURCIA	Very unlikely	Very unlikely	Medium Risk
CF DE NAVARRA	Likely	Feasible	Medium Risk
PAÍS VASCO	Likely	Feasible	Medium Risk
LA RIOJA	Feasible	Feasible	Medium Risk
COMUNITAT VALENCIANA	Very unlikely	Very unlikely	High Risk
REGIONS TOTAL	Feasible	Feasible	Medium Risk

It is estimated that the Regions' revenue in 2020 will rise by more than 5% over the level estimated in 2019, conditioned by the expected positive evolution in system resources. Under AIReF's baseline scenario, all of the revenue in the sub-sector would grow above 5%, increasing its weight over regional GDP by 0.3%. Within them, the financing system resources (RFS) subject to instalment payments in the Region would grow almost 8% above the 2019 figure, (affected by the impact on the settlement of 2017 of the Immediate Information System - IIS- of VAT⁴). This growth would offset a more moderate

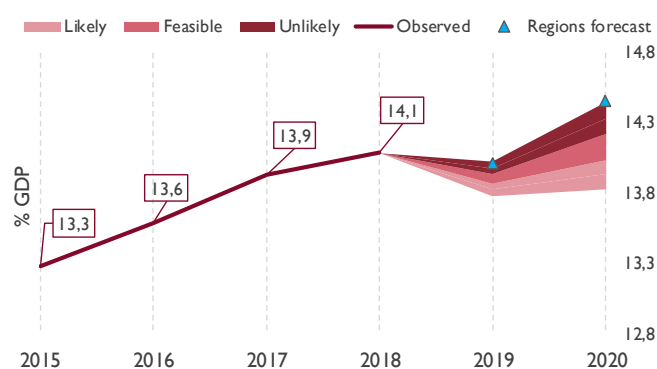
⁴ The implementation of the Immediate Information System (IIS), extending the deadline to enter VAT self-assessments, meant that in 2017 the *Agencia Estatal de Administración Tributaria* (AEAT - State Tax Agency)

evolution of the rest of resources, 2%, estimated from the available execution data, the evolution observed to date and the information provided by the Regions on revenue measures and other circumstances.

The Regions intend to adopt fiscal tax measures in 2020 that, in net terms, would mean a loss of collection close to 190 million euros. As the whole, the Regions have valued the lower collection expected in 2020 due to the tax reduction measures adopted or forecasted, which would primarily affect , from highest to lowest impact, Inheritance and Gift Tax (IGT), Personal Income Tax (PIT), Tax on Property Transfers and Documented Legal Acts (TPTDLA) and Wealth Tax (WT), at approximately 260 million. Specifically, Andalusia, Galicia, Madrid, Navarre and La Rioja expect tax reduction measures for 2020. In view of this, the Region of the Canary Islands is expected to reverse the tax reduction measures of previous years and increase collection of the General Indirect Canary Islands Tax (IGIC) by more than 70 million and, to a lesser extent, other taxes. Some Regions estimate increasing revenue from alienation of real investments or improvement measures against tax fraud; however, the available information has not allowed AIRcF to incorporate the expected total impact of these operations.

The Regions as a whole reflect more optimistic revenue forecasts than those estimated by AIRcF. The Regions' aggregate forecasts, in general, offer more optimistic revenue forecasts to achieve in 2020, starting from a higher expected level in 2019 than foreseen by AIRcF and envisaging better prospects for the funds to be received from the State and the EU.

FIGURE 2. EVOLUTION OF REGIONAL REVENUE (% GDP)



At the individual level, AIRcF records marked growth in the financing system resources of the Regions under common regime and a moderate evolution of the rest of revenue. By Regions, in those under the common regime there is

would collect only 11 monthly instalments. This lower total collection was not reflected in the RFS 2017 instalment payments paid to the Regions, but in the settlement of the year that occurred in 2019.

expected to be a substantial increase in financing system resources (between 6% and 11%) due to being affected by the impact of VAT-IIS in 2019⁵. AIReF estimates, in general, a moderate growth of the rest of revenue items, affected by tax reduction measures and a moderate trend of funds from the State and the EU.

TABLE 2. AIREF ESTIMATE BY REGION OF THE 2020/2019 VARIATION OF NON-FINANCIAL REVENUE (% VARIATION AND % GDP)

Regions	Estimated variation 2020/2019 of non-financial revenue					
	Total income		Regional Financial System (*)		Other incomes	
	% variation	% GDP	% variation	% GDP	% variation	% GDP
ANDALUCÍA	6%	0.3%	8%	0.4%	1%	-0.1%
ARAGÓN	6%	0.2%	8%	0.4%	-1%	-0.2%
ASTURIAS	5%	0.2%	6%	0.2%	3%	0.0%
BALEARES	8%	0.6%	11%	0.6%	4%	0.0%
CANARIAS	7%	0.7%	8%	0.5%	6%	0.2%
CANTABRIA	6%	0.4%	7%	0.4%	3%	0.0%
CASTILLA Y LEÓN	5%	0.2%	6%	0.3%	1%	-0.1%
CASTILLA - LA MANCHA	5%	0.3%	6%	0.3%	3%	0.0%
CATALUÑA	6%	0.3%	8%	0.3%	2%	-0.1%
EXTREMADURA	5%	0.3%	6%	0.4%	3%	-0.1%
GALICIA	5%	0.1%	6%	0.2%	2%	-0.1%
COMUNIDAD DE MADRID	5%	0.2%	9%	0.3%	-2%	-0.1%
REGIÓN DE MURCIA	6%	0.3%	7%	0.3%	5%	0.0%
CF DE NAVARRA (*)	3%	-0.1%	3%	0.0%	3%	-0.1%
PAÍS VASCO (*)	3%	-0.2%	3%	0.0%	-9%	-0.2%
LA RIOJA	5%	0.1%	6%	0.2%	3%	0.0%
COMUNITAT VALENCIANA	5%	0.2%	9%	0.4%	-1%	-0.2%
REGIONS TOTAL	5%	0.3%	8%	0.3%	2%	-0.1%

(*) System resources in Navarre are considered to be its net tax revenue from transfers to the State by agreement and to local corporations by its financing system. Transfers received from the Provincial Councils have been considered in the Basque Country.

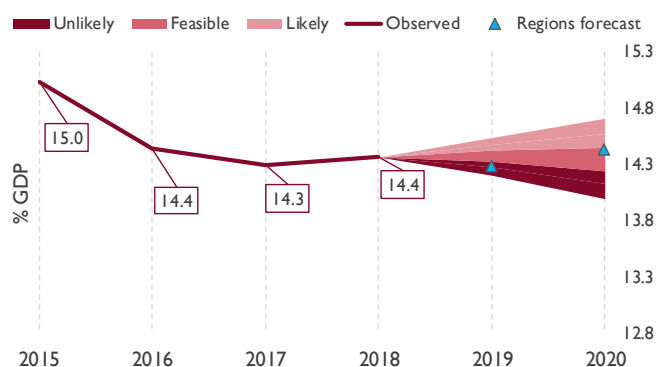
⁵ In the absence of the impact of the VAT-IIS in 2019, increases in the resources of the RFS would be between 3% and 9% by Regions, and they would have been 5% for the whole of the sub-sector.

AIRcF foresees that the sub-sector's expenditure will grow by 4% overall. This growth is conditioned by:

- The expected average increase in staff costs of 4%, which includes:
 - The estimated impact in 2020 of the staff measures generally agreed in the 2nd Agreement with the Trade Unions in March 2018.
 - In turn, the greater expenditure derived from the additional measures foreseen by the Regions According to the information provided by these, the greater expenditure expected due to staff measures adopted in previous years with impact in 2010 could exceed 500 million euros.
 - Other factors, such as rulings or the impact in the educational field of some of the measures of Royal Decree-Law 14/2012 and the greater expenditure derived from the replacement of retired staff subject to MUFACE (General Spanish Civil Service Mutual Insurance Company) with new staff subject to the general Social Security regime.
- An increase slightly below 4% in the rest of expenditure items. The impact recorded in the Regions of expenditure measures is null in net terms, and only has relevance in two Regions, in opposite directions: Catalonia records potential savings in 2020 from the efficiency plan initiated in previous years, and Valencia envisages higher expenditure for various measures in the social and educational fields expected to be offset in part by savings from centralised purchasing in healthcare.

The Regions as a whole expect to reach an expenditure level similar to that considered by AIRcF, although with more pronounced variations due to a lower starting point in 2019. The Regions' aggregate forecasts depart from the more optimistic estimates of 2019, and expect a more pronounced growth for 2020 than considered by AIRcF due, in general, to the expected evolution in capital expenditure.

FIGURE 3. EVOLUTION OF THE EXPENDITURE OF THE REGIONS AS A WHOLE (% GDP)



At the individual level by Regions AIReF incorporates the information on expenditure measures provided by each Region, which primarily focus on staff. AIReF estimates that the variation in staff expenditure would range between 3% and 4% in most Regions. Lower growth is expected in the Regions affected by significant ruling in 2019, as in the case of the Basque Country and Navarre; and higher growth is expected in Regions with reported measures of higher expenditure in 2020 (Asturias, Canary Islands, Cantabria, Castile - La Mancha, Catalonia, Galicia, Madrid, Navarre and the Valencia). AIReF expects that the rest of the expenditure items will vary at similar rates.

TABLE 3. AIREF ESTIMATE BY REGION OF THE 2020/2019 VARIATION OF NON-FINANCIAL EXPENDITURE (% VARIATION AND % GDP)

Regions	Estimated variation 2020/2019 of non-financial expenditure					
	Total expenditure		Staff costs		Other expenditures	
	% variation	% GDP	% variation	% GDP	% variation	% GDP
ANDALUCÍA	4%	0.0%	4%	0.0%	4%	0.0%
ARAGÓN	3%	-0.1%	3%	0.0%	3%	-0.1%
ASTURIAS	3%	-0.1%	4%	0.0%	3%	-0.1%
BALEARES	4%	0.0%	4%	0.1%	4%	0.0%
CANARIAS	6%	0.4%	5%	0.1%	-4%	0.3%
CANTABRIA	3%	-0.1%	4%	0.0%	3%	-0.1%
CASTILLA Y LEÓN	3%	-0.1%	3%	0.0%	3%	-0.1%
CASTILLA - LA MANCHA	3%	0.0%	4%	0.0%	3%	-0.1%
CATALUÑA	4%	0.0%	7%	0.1%	4%	-0.2%
EXTREMADURA	3%	-0.2%	3%	-0.1%	3%	-0.1%
GALICIA	3%	-0.2%	3%	-0.1%	3%	-0.1%
COMUNIDAD DE MADRID	4%	0.0%	4%	0.0%	4%	0.0%
REGIÓN DE MURCIA	5%	0.0%	4%	-0.1%	5%	0.1%
CF DE NAVARRA	3%	-0.1%	2%	-0.1%	3%	0.0%
PAÍS VASCO	2%	-0.2%	1%	-0.2%	2%	0.0%
LA RIOJA	3%	-0.1%	3%	-0.1%	3%	-0.1%
COMUNITAT VALENCIANA	4%	0.0%	6%	0.1%	4%	-0.1%
REGIONS TOTAL	4%	0.0%	4%	0.0%	4%	-0.1%

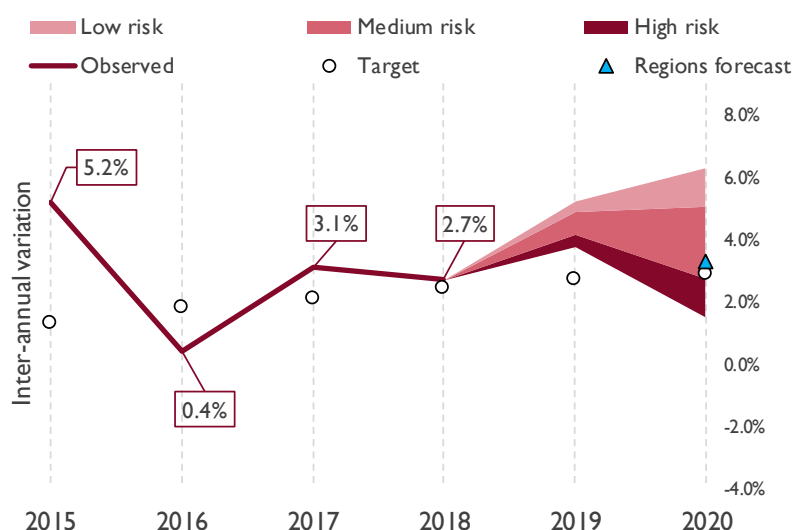
The analysis of the expenditure variation should take into account the effect of certain revenue items when assessing risks in the expenditure rule. For the purposes of the expenditure rule, a joint analysis of the composition must be carried out of expenditure and revenue in order to assess the risks of the rule. In this sense, Regions such as Murcia or the Canary Islands record observed increases in expenditure, higher than the other Regions, which are mitigated in the computable expenditure for the purposes of the expenditure rule by certain revenue items. In the first case, the increase in the estimated expenditure to meet the damage caused by storms is accompanied by an expected increase in revenue received from the State to co-finance such expenditure, under Royal Decree-Law 11/2019, of 20 September⁶. In the case of the Canary Islands, the risk derived from the expected variation in

⁶ [Royal Decree-Law 11/2019](#)

expenditure is mitigated by the favourable effect of fiscal measures to increase collection.

In the sub-sector and at the individual level AIReF observes a moderate risk of non-compliance with the expenditure rule in 2020. The growth of 4% expected in expenditure, the estimated evolution of expenditure excluded from the calculation of the rule, and the net effect of the negative impact of the envisaged tax measures in several Regions could lead to a growth of computable expenditure in 2020 in excess of the 2.9% set as the reference rate for this year.

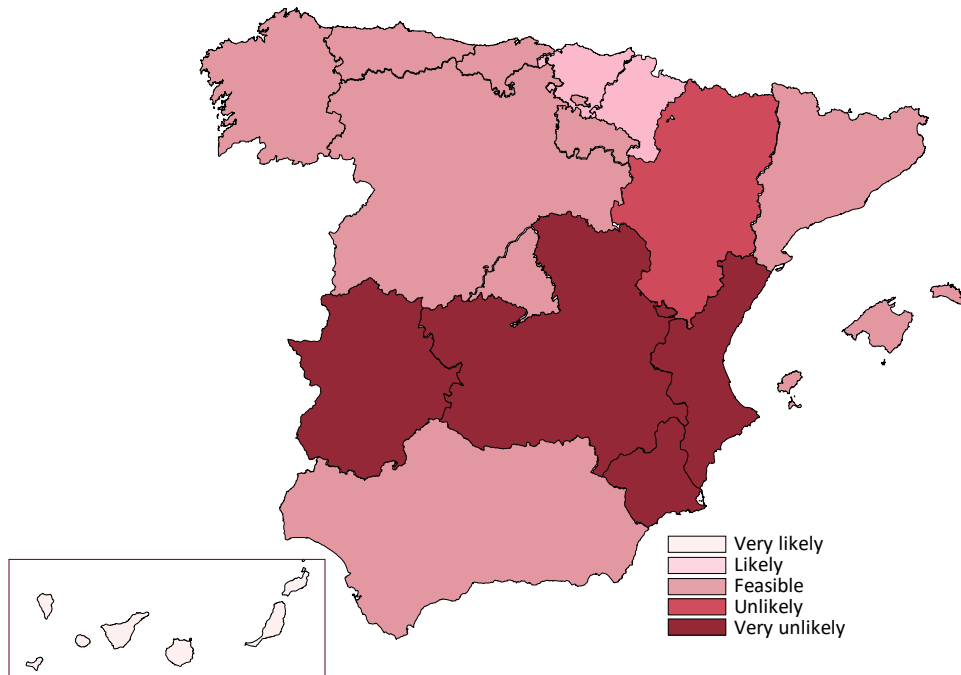
FIGURE 4. EVOLUTION OF COMPUTABLE EXPENDITURE FOR THE PURPOSES OF THE EXPENDITURE RULE IN THE REGIONS AS A WHOLE (% VARIATION)



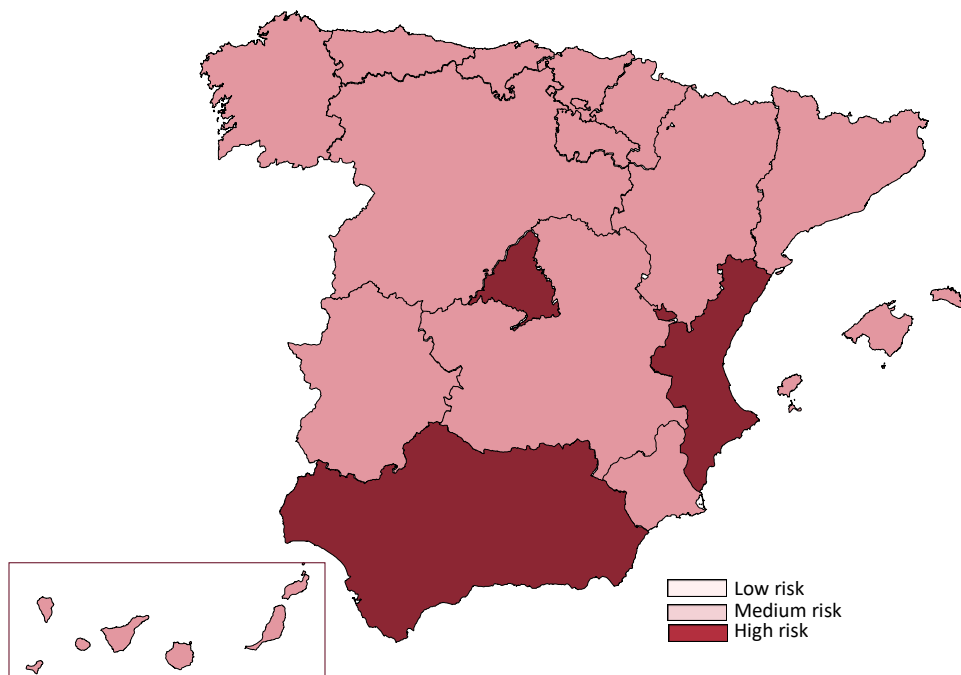
There are risks, more or less intense, non-compliance with the expenditure rule in all Regions. The minimum expected growth of 3% in current expenditure, which accounted for 90% of regional expenditure, point to risks of non-compliance with the expenditure rule in all Regions, particularly marked in Andalusia and Madrid due to the impact of regulatory tax reduction measures, and Valencia due to the expected growth in expenditure. In these Regions the forecast for growth of primary expenditure net of payments to the State presents far higher rates than the growth of the economy.

FIGURE 5 MAPS OF REGIONS FOR 2020: PROBABILITY OF COMPLIANCE WITH THE STABILITY TARGET AND RISK OF NON-COMPLIANCE WITH THE EXPENDITURE RULE

Stability target 2020



Expenditure rule 2020

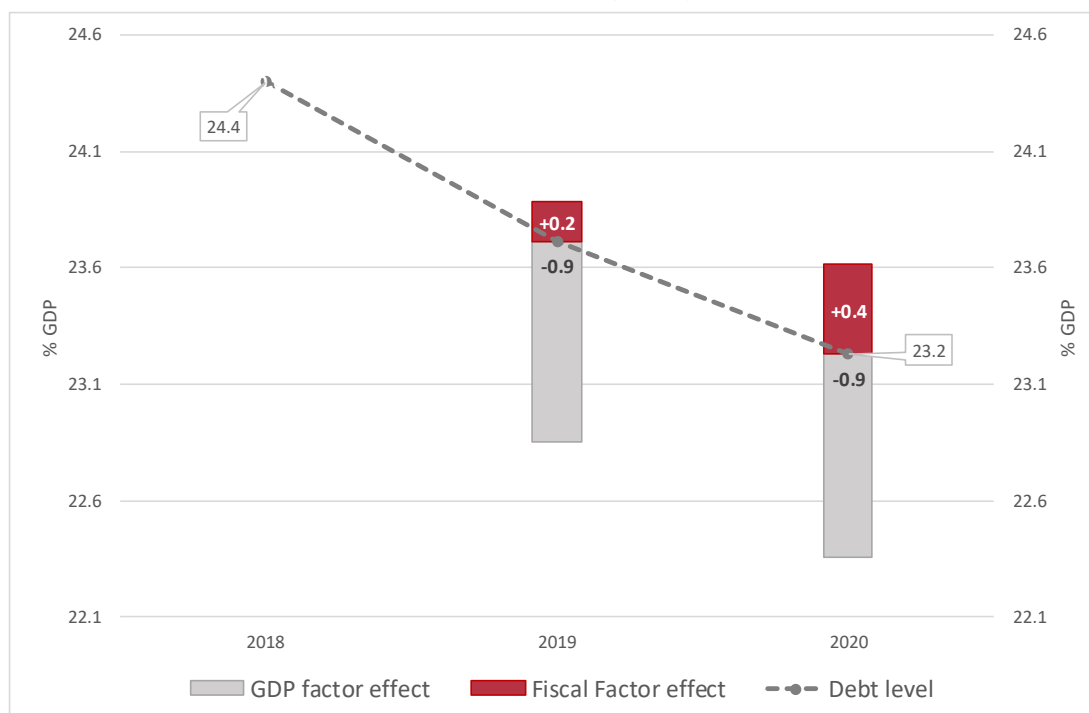


2. GOVERNMENT DEBT

2.1.1. Debt target

AIReF expects that the Regions will reduce their debt to around 23.2% GDP for 2020, mainly due to the contribution of GDP growth. AIReF estimates that regional debt will drop 1.2 percentage points of GDP from the 24.4% recorded in 2018, which would bring the debt level to around 23.2% GDP (see Figure 6). It is expected that this reduction will mainly occur due to the effect of the expected growth of GDP in 2019 and 2020, which according to AIReF's forecasts could make a contribution close to one percentage point of GDP in each of these years. However, it is expected that this positive contribution will be partially offset by an increase in debt derived from fiscal factors (mainly, the financing in 2020 of the excess deficit expected above the target of -0.1% GDP in 2019 for all Regions, except for Navarre, Basque Country and the Canary Islands for which a surplus is estimated). However, it is considered that this increase will be more contained due to the application of the surpluses of 2018 and those envisaged for 2019, not intended for the financing of financially sustainable investments, as well as due to the compensation of the over-financing generated in 2017 and 2018, referred to later.

FIGURE 6. EXPECTED EVOLUTION OF THE INDEBTEDNESS OF THE REGIONS: CONTRIBUTION OF FACTORS (% GDP)



This expected level of indebtedness in 2020 would allow the compliance with the debt target, as long as the current system of targets is maintained. AIReF expects compliance with the Regions' debt target for 2020 given that the variation expected since 2018, as the last year ended, until 2020 is estimated to be compatible with the current target setting system. Therefore, the increase in the volume of debt of this period would correspond mainly to the financing of: (i) the annual amounts of the postponed negative settlements 2008/2009; (ii) the maximum deficit permitted by the deficit target of 0.1% GDP in 2019⁷ except for the 3 Regions for which AIReF expects a surplus in that year (Canary Islands, the Basque Country and Navarre) for which no increase is expected; and (iii) for the 14 remaining Regions, the excess deficit estimated exceeds that target. This increase would be limited by the above-mentioned compensation of the excess financing from previous years.

The MINHAC, following AIReF's recommendations, has ceased to consider the financing of the deficit ceiling of the stability target when the deficit is lower within the debt target. AIReF has recommended on several occasions to MINHAC to not include in the limit authorised by the debt target the increases in indebtedness to finance the entire deficit target when the Region finally records a lower deficit. The purpose of this recommendation was that the Regions adjust their debt to the real borrowing needs, avoiding excess

⁷ To date no deficit is expected to be financed in 2020, as a balanced target has been set for this year.

indebtedness. For this reason, AIRcF greatly appreciates the MINHAC's compliance with this recommendation, which leads to a more strict control of regional debt.

Prior to this change of criterion, the majority of Regions accumulated financing excesses for a total of close to 1,000 million euros that are still to be offset. The MINHAC's second report on compliance with the stability target, debt target and expenditure rule of 2018, published on 15 November, shows that, in recent years, the debt target was allowing debt increases above the Regions' real borrowing needs, as AIRcF has been pointing out in its reports. For these purposes, 11 Regions will have to offset the financing excesses that they have been generating in 2017 and 2018, for a total amount of approximately 1,000 million euros, which represents nearly 0.1% GDP (see table 4). AIRcF will monitor the repayment of debt or the lower increases that will result from the offsetting of this over-financing.

TABLE 4. EXCESS FINANCING STILL TO BE OFFSET AT THE END OF 2018

Regions	2017	2018
ANDALUCÍA	26	143
ARAGÓN		20
ASTURIAS	23	94
BALEARES		
CANARIAS		
CANTABRIA		11
CASTILLA Y LEÓN		11
CASTILLA - LA MANCHA		86
CATALUÑA		
EXTREMADURA		25
GALICIA		191
COMUNIDAD DE MADRID		
REGIÓN DE MURCIA		130
CF DE NAVARRA		
PAÍS VASCO	38	
LA RIOJA	191	
COMUNITAT VALENCIANA		
REGIONS TOTAL	278	711

In AIRcF's opinion this significant progress in the measurement of the debt targets should be supplemented with the incorporation into the limit of the debt target from the application of the surplus provided for in article 32 of the LOEPySF. AIRcF considers that the setting of fiscal rules should take into account the fiscal position of each Region. In this sense, considering only the debt actually recorded, when it is less than the target set, as a debt increase has meant a significant step forward. In order to continue to adjust the debt

limits to the true fiscal situation of those Regions that are generating surpluses, it is desirable that the debt repayment resulting from the application of the surplus will be deducted from the annual limit established by the debt target. Otherwise, restrictive debt targets would not be set for these Regions, while these could interpret that they are reducing their debt as they are not exhausting the margin of indebtedness permitted by the debt target.

2.1.2. Government debt sustainability

At the regional sub-sector level, the sustainability risk is *slightly high*. According to the methodology⁸ used by AIReF, the composite indicator points to a *slightly high* risk for the financial sustainability of the sub-sector, with its main determinants being the high levels of indebtedness and dependence on extraordinary financing mechanisms (Regional funds). At the individual level, the situation is very diverse, with four Regions (Catalonia, Valencia, Castile - La Mancha and Murcia) at *very high* risk for financial sustainability and a *speculative* credit rating in long-term debt.

FIGURE 7. FINANCIAL SUSTAINABILITY RISK OF THE REGIONS

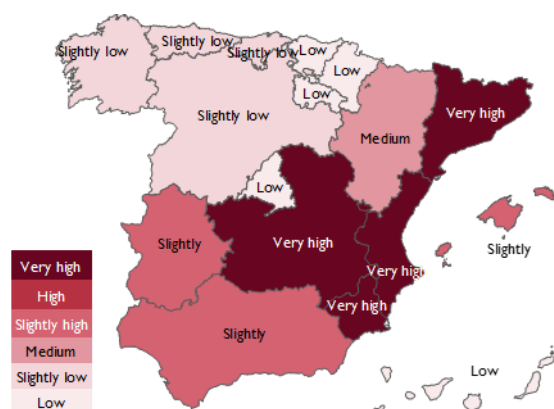
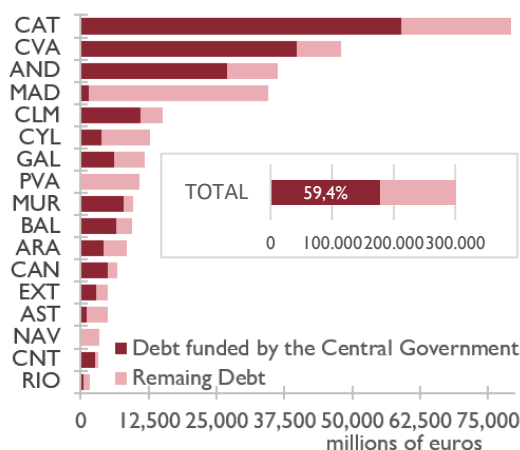


FIGURE 8. DEBT OF THE REGIONS AND EXTRAORDINARY FINANCING MECHANISMS



The dependence on extraordinary regional liquidity mechanisms is very high, although with the gradual return to financing in the capital markets, this has begun to be reduced slightly. In the second quarter of 2019 the debt owed to

⁸ AIReF's analysis rates the level of aggregate risk for sustainability according to 6 levels (from low to very high), affected by 5 main factors or dimensions: (i) level of indebtedness; (ii) borrowing flows, associated with the evolution of the budget balance; (iii) capacity to repay, which represents the importance of current incomes; (iv) tax space available and (v) general economic conditions, including the labour market situation.

the AC represented 59.4% of the total external debt of the regional sub-sector, slightly below the 61.1% at the end of 2018. In 2018 and 2019 some of the Regions that are being financed through the Financial Facility mechanism have begun the process of gradual return to capital markets, what has begun to mean a gradual decline of the use of these funds.

In the last 4 years the debt-to-GDP ratio has stabilised at values slightly higher than 24%, despite the fact that the accumulated growth has contributed to reducing the ratio by over 3% GDP. From the minimum level reached in 2007, the debt-to-GDP has increased by more than 19 points until the peak reached in 2016. In the last 4 years, with the start of the economic recovery, the debt-to-GDP ratio has stabilised at values slightly higher than 24%, despite the fact that the accumulated growth in this period has contributed to reducing debt by over 3% GDP. For 2019, AIRcF's models project a debt-to-GDP ratio at around 24% GDP.

FIGURE 9. EVOLUTION AND DEBT PROJECTIONS (% GDP)

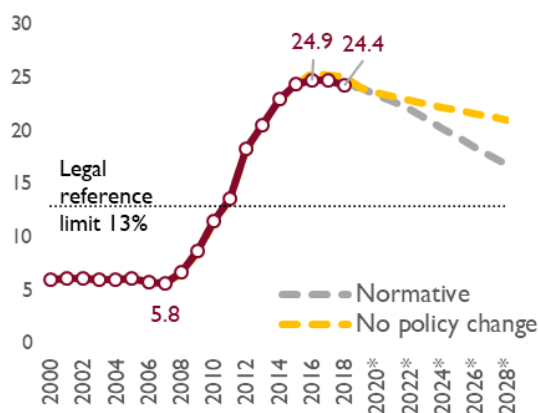
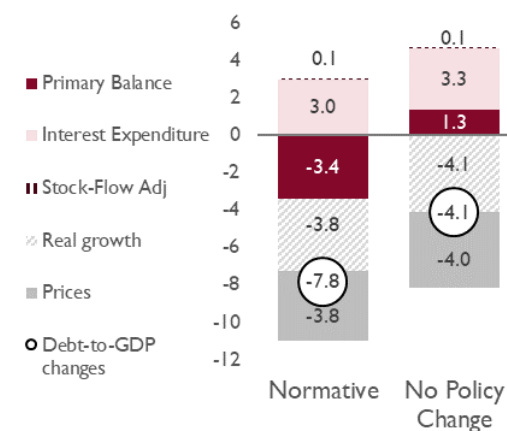


FIGURE 10. CONTRIBUTION TO THE VARIATION OF THE DEBT-TO-GDP RATIO (% GDP) 2019-2028



In its regulatory scenario⁹ AIRcF projects that the debt-to-GDP ratio will stand at 16.6% GDP over a horizon of 10 years. However, in the event of maintaining the primary balance estimated for 2019 constant (hypothesis of a “no-policy-change” scenario), the debt-to-GDP ratio would be 21.1% at the end of 2028. The reduction of 7.8 points under a regulatory scenario is mainly explained by the denominator effect (growth and inflation, contributing 7.5 points), while the accumulation of primary surpluses (3.4 points) is practically offsetting the interest burden (which subtracts 3 points). This scenario involves an implicit

⁹ An annual correction of the primary balance of 0.25 points of GDP (with a ceiling of 0.75%) until the debt reaches the reference limit of 13%.

average primary surplus of +0.34% GDP, a hypothesis far removed from the average primary balance of -0.9% in the last cycle (2000-2018). In the “no-policy-change” scenario, the debt ratio is reduced by about half (4.1 points), mainly as a result of maintaining a slight primary deficit (0.13% GDP).

AIReF projects that in the regulatory scenario the regional sub-sector will reach the legal reference limit (which assumes having a debt-to-GDO ratio of less than 13% GDP) within 15 years, with thirteen of the seventeen Regions succeeding before that date. However, in the event of maintain the primary balance estimated for 2019 constant (hypothesis of a “no-policy-change” scenario), only six Regions would reach a debt-to-GDP ratio of less than 13% GDP over the next 30 years.

FIGURE 11. YEAR OF ARRIVAL AT THE REFERENCE DEBT LEVEL (13% GDP) OF THE REGULATORY SCENARIO

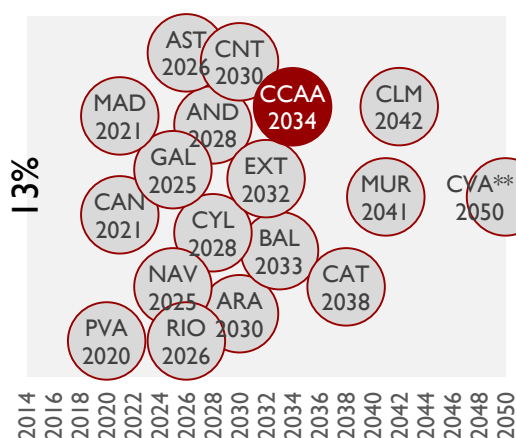
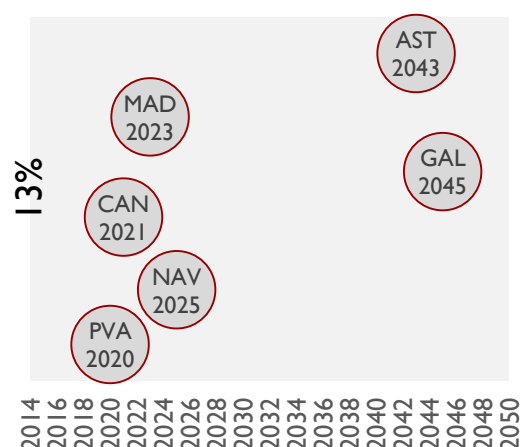


FIGURE 12. YEAR OF ARRIVAL AT THE REFERENCE DEBT LEVEL WHILE MAINTAINING THE PRIMARY BALANCE CONSTANT FROM 2019 ONWARDS



3. RECOMMENDATIONS

3.1. New recommendations

3.1.1. Stability Target

Difficulties in compliance with the stability target have been detected in five Regions in which the trend followed, since 2013 and to date, by their revenue and expenditure and the deficit once the impact of non-recurring operations has been removed and the impact of lower revenue derived from the VAT-IIS launched in that year have been transferred to 2017, has been analysed.

Specific recommendations are made to all of them in the individual reports, which are expressed as follows:

- There is a distinct situation for the Region of **Aragon**, in which the deviation is much smaller and has followed a gradual convergence process, based in part on the adoption of specific measures and actions. The recommendation to this Region aims to encourage it to continue the trend that it has maintained so far and not relax its performance, therefore it is recommended, ***in the short term, to plan actions that favour compliance with the fiscal rules and the consolidation process, offsetting the impact of the tax measures taken.*** Regardless of this, there is a certain exhaustion and ineffectiveness of the expenditure containment measures over the short term, and room for improvement in some areas, so that, in the medium term, it is recommended that the Region ***carry out a comprehensive study to identify the possibilities for improvement in regional expenditure and/or in the revenue structure, in such a way that, based on the results of the previous study, it can design and plan specific actions that can be implemented over a medium term, to continue the path of deficit reduction and convergence to the targets.***

- In the Region of **Castile-La Mancha, Extremadura and Murcia** there are structural difficulties in convergence to the targets, and high or very high sustainability risks, so the recommendation made to these Regions is aimed at implementing medium-term structural actions. As in the previous case, the short-term measures aimed at correcting specific deviations of the year are seen to be inefficient. It is desirable to identify areas in which there are inefficiencies or the largest deviations from the initial forecasts are concentrated in order to design and implement specific actions aimed at correction and improvement over the medium term. Furthermore, AIReF also recommends that they **conduct a comprehensive study to identify the possibilities for improvement in regional expenditure and/or in the revenue structure, in such a way that, based on the results of the previous study, they can design and plan specific actions that can be implemented over a medium term, to continue the path of deficit reduction and convergence to the targets.**
- In **Valencia**, although factors similar to those identified in the previous Regions are identified, an additional differentiating element has been detected: measures to increase expenditure launched in the past two years, which continue their impact in 2020, mean that it has been the only Region that since 2018 has reversed the process of convergence, expanding the gap towards the target over the last two years. This situation means that high risks of non-compliance with the expenditure rule have also been detected. Consequently, an additional recommendation is added to the above: **to plan, in the budget being processed, actions in favour of compliance with the expenditure rule, offsetting the impact of increased expenditure of the measures taken; and, additionally to conduct a comprehensive study to identify the possibilities for improvement in regional expenditure and/or in the revenue structure, in such a way that, based on the results of the previous study, it can design and plan specific actions that can be implemented over a medium term.**

3.1.2. Expenditure rule

There have been high risks of non-compliance with the expenditure rule, in addition to in Valencia, in **Andalusia and Madrid**, due to the expected growth in expenditure and the negative impact of the tax reduction measures taken or planned, with impact in 2020. In the report on the Economic-Financial Plan of the Region of Andalusia, AIReF already warned of the risk in 2020 and made recommendations. The Regions has not followed the recommendations in the design of its draft budget, so AIReF, which deems the risks to have worsened,

maintains what was proposed and, as in Madrid, recommends **to postpone the implementation of the new measures envisaged to increase expenditure or plan actions to encourage compliance with the expenditure rule, offsetting the impact of the loss of revenue measures already adopted and of the current growth expected in expenditure.**

3.1.3. Stability target and expenditure rule

It would be desirable if, in the short term, the MINHAC conducted specific monitoring of the actions that the Regions could take, in order to correct deviations observed, in the process of preparing their budget. Without prejudice to the foregoing, it is considered that, for the Regions that present significant deviations from the general stability targets, a medium-term approach for convergence must be established so that the regional actions planned and implemented are in line with a more progressive deficit reduction path. In this sense, in its report on expected compliance with the fiscal rules in 2019¹⁰ in July AIRcF recommended to the Ministry that the Regions' stability targets for 2020-2022 should be set in a differentiated manner, in response to the fiscal position of each of them. The above recommendation must be based on medium-term planning and and be accompanied by a firm commitment on the part of the Regions to compliance with the fiscal rules.

As a result, **AIRcF recommends that the MINHAC:**

- 1. Monitor the actions that the Regions with risks of deviation could carry out in the processing of their budgets.**
- 2. Design the next setting of stability targets within a medium-term planning framework, in which the annual targets take into account the fiscal situation of each Region, and accompanied by specific conditions for each Region that ensures firm commitment of the Regions to compliance with the fiscal rules.**

3.1.4. Debt

The Regions of the Basque Country and the Canary Islands obtained significant surpluses in 2017 and 2018, respectively. Article 32 of the LOEPySF, which regulates the allocation of the budgetary surplus, establishes that this is allocated to reduce the level of net indebtedness whenever the volume limit

¹⁰ [Report on expected compliance with the stability target, government debt target and expenditure rule 2019](#)

of indebtedness is less than the amount of the surplus to allocate to debt reduction. In this sense, AIReF has recommended to the MINHAC the desirability of keeping the repayment of debt in line with application of the surplus in accordance with this article.

Once you the liquidity corresponding to the surpluses indicated has been obtained, which the Regions should allocate to debt repayment, it would be desirable to make this transparent by communicating how and when the amount mentioned will be applied. For this reason, AIReF has recommended to the Regions of the **Basque Country and the Canary Islands to communicate to AIReF the plans for debt repayment using the surpluses generated in previous years, and not used to finance financially sustainable investments, which has still to be carried out, specifying the criteria, amounts and deadlines, in which it is intended to be made effective.**

3.2. Reiterated recommendations

3.2.1. Debt target

Failure to recognise the lending capacity for a year derived from the surplus generated in previous fiscal years contributes to the breadth of the debt targets for the Regions that have a more sound fiscal position as well as their ability to interpret that, in compliance with article 32 of the LOEPySF, they are reducing their debt by not exhausting the allowable debt margin.

For that reason, in its report on expected compliance with the targets and the expenditure rule of 2019, published on 18 July, AIReF recommended that the debt targets for 2020-2022 should be set taking into account differentiated stability targets and should consider the surplus obtained in the previous year. The response of the MINHAC is that the Regions are obliged to reduce the net indebtedness in the event of a surplus due to application of article 32 of the LOEPySF and can adjust the programming of their cash and debt with enough time to bring it in line with the necessary liquidity.

However, AIReF considers that, regardless of whether the debt repayment by application of the surplus can be produced under article 32 of the LOEPSF, setting and measuring the debt target should assume a real restriction on indebtedness, which makes it necessary to take into account the lending capacity generated by the Regions in previous years and in the current year.

In order not to set higher debt targets than the real borrowing requirements of the Regions and set a single clear limit for restriction of indebtedness that

incorporates the obligation of Article 32 thus avoiding erroneous interpretations, **AIRcF reiterates to the MINHAC that:**

1. The setting of the debt targets for the next period should take into account differentiated stability targets and consider the surplus obtained in the preceding year.
