



Independent Authority
for Fiscal Responsibility

Report

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Report on the setting of individual budget stability and regional government debt targets for the Autonomous Regions

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.

AIREF contact details:

C/ José Abascal, 2, 2ª planta. 28003 Madrid, Tel. +34 910 100 895

E-mail: Info@airef.es

Website: www.airef.es

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Executive Summary

AIReF issues this report with a double perspective: on the one hand, to assess the proposals for individual deficit and public debt targets for the Autonomous Regions (ARs) in 2016 and for the period 2017-2019 submitted by the Ministry of Finance and Civil Service (MINHAFP), and on the other hand, to monitor compliance with the fiscal rules. In agreement with current regulations, AIReF is obliged to report on proposals for the horizontal distribution of budget stability and public debt targets in the Autonomous Regions (ARs) in 2016 and for the period 2017-2019 submitted by the Ministry of Finance and Civil Service (MINHAFP). The recommendations deriving from this assessment may, if required, serve to draft a new proposal by the Ministry following the 'comply or explain' principle. Neither the Organic Law creating the AIReF nor the Organic Law on Budget Stability and Financial Sustainability (LOEPSF), in any case, envisage the submission of an alternative proposal by this institution. This report is issued in the fulfilment of AIReF's supervisory duties, which according to the explanatory memorandum of Organic Law 6/2013 on the creation of AIReF, arise from the need for an independent fiscal institution able to effectively monitor compliance with the fiscal rules.

AIReF is not obliged to submit an alternative proposal for the individual distribution of targets, but an assessment of such a proposal drafted by MINHAFP. In the report on the horizontal distribution of deficit and debt targets in the Autonomous Regions in 2015, AIReF selected a number of indicators that, in its opinion, should be included in the proposal drafted by MINHAFP, whose implementation seemed to suit the asymmetrical deficits resulting from the relative position of each autonomous region. This opinion led to a recommendation to which MINHAFP replied that AIReF had *"taken the opportunity to include in its report a proposal for setting both targets on the basis of the assumptions it deemed appropriate"*. In this regard, AIReF understands that its competences do not extend to taking alternative actions to those that are the responsibility of MINHAFP, but rather to assess those actions, within the scope and to the extent defined in the Organic Law on the creation of AIReF and the Organic Law on Budget Stability and Financial Sustainability.

AIReF is obliged to give warning of the risk of non-compliance with the fiscal rules throughout the budget cycle, wherein the first task is to set the deficit and debt targets. Monitoring fiscal rules requires the stability and debt targets to be set for the various Public Administration subsectors and for each of the Autonomous Regions. From this perspective, assessment of the risk of non-compliance commences on establishing these targets, and for this

reason AIReF analyses, in this report, the likelihood of compliance with these targets by the Autonomous Regions, giving warning, as appropriate, of any risk of non-compliance.

The assessment by AIReF of the proposal received is centred on the year 2017. The documentation received does not comprise a year-end forecast for public debt in 2016 that allows fixing a starting point for setting targets for the period 2017-2019, or an estimate of the expected trend in revenue over the coming years. Owing to the lack of the pertinent information and the uncertainty associated with revisions to the financing system and the expenditure rule which, foreseeably, will take place during the period envisaged in the proposal, AIReF offers a pronouncement only regarding the targets proposed for 2017 assuming a point of departure in 2015, the last year available.

AIReF formulates recommendations for establishing differentiated targets and for implicating the Autonomous Regions in the process of distributing the targets for the subsector. AIReF recommends that the horizontal distribution of targets should rest on indicators that permit differentiation per Autonomous Region according to their relative position in terms of feasibility, equity and the expenditure rule. Similarly, AIReF recommends the Autonomous Regions to become involved in the process of drafting the proposal for stability targets and improving the system for setting the debt targets.

- **Budgetary stability target**

MINHAFP has presented homogeneous targets for the autonomous regions, on the basis of their likelihood in each case. The proposals submitted by MINHAFP are based on the assumption that the deficit for 2016 and the adjustment path for 2017-2019 established for the subsector overall (-0.7%; -0.6%; -0.3% and 0% in terms of GDP for each of these years, respectively), is feasible for all the Autonomous Regions and, therefore, presents similar targets.

This feasibility is not grounded on any measurement methods and is based on the mere comparison of relative positions with respect to 2013. Setting homogeneous targets is justified on the grounds that the difference in borrowing requirements registered in recent years in Autonomous Regions with varying deficits is not great, and that, consequently, it is feasible to achieve a common target insofar as this requires greater effort on behalf of the Autonomous Regions furthest from the target in the previous year, but in any case not as great as the effort required in 2013, when differentiated targets were set. However, the proposal submitted by MINHAFP does not contain any

measurement method upholding its rating of feasibility and, therefore, cannot be assessed by AIReF.

Significant differences persist in the starting point for the Autonomous Regions, for which reason and from the perspective of feasibility, AIReF is of the opinion that, at present, setting similar targets for all Autonomous Regions involves a risk of deviation for those regions furthest from the target and probably also for the subsector overall, which comes at a cost in terms of credibility. The effort required in 2016 and 2017 to reach in the second of these years the target of -0.6%, measured in primary structural terms, presents a spread of around one decimal point between the regions with the best and worst positions, which for some Autonomous Regions will mean a substantial adjustment in two years. On these lines, AIReF warned in its report on the Stability Programme Update (SPU) of the risk implied by setting a single path for all the Autonomous Regions regarding compliance with the global budget stability target and the expenditure rule for the subsector in 2016, and recommended setting differentiated paths for the Autonomous Regions. MINHAFP replied that it was not the right time for such a recommendation, and that the right moment for AIReF to issue a pronouncement on the matter is at the time of submitting its proposal for the horizontal distribution of targets. However, in view of the date on which the proposal was submitted, the Autonomous Regions have adjusted their performance to the homogeneous proposal put forward by MINHAFP following submission of the SPU, so that the Autonomous Regions that, a priori, were able to achieve a deficit below the 0.7% target set for the subsector, seem to be exhausting the margin afforded by the trend in financing system revenue and the strict implementation of the expenditure rule.

Feasibility indicators exist, that should be incorporated to the proposals for the distribution of targets sufficiently in advance to be discussed at the Fiscal and Financial Policy Council. AIReF believes that the likelihood of compliance with the stability target can be measured through indicators that, with some variants, are commonly recognised nationally and internationally as instruments for the assessment of fiscal rules. AIReF proposes two feasibility indicators that are in line with the conclusions reached by ECOFIN on 6 December. The first of these measures, following European Commission methodology, is the primary structural effort that the Autonomous Regions are required to make over the period 2016-2017 to reach, in the second of these years, the proposed target of -0.6%. The second is the development in non-financial expenditure (with some corrections and for the same period) needed to comply with the target, assuming that all Autonomous Regions exercise a similar range of competences.

The combination of indicators for structural effort and evolution of expenditure, applied through a common factor procedure, has allowed five Autonomous Regions to be singled out that are clearly struggling to comply with the deficit target of 0.6% of GDP proposed for 2017. The Autonomous Regions of Aragón, Catalonia, Valencia and especially Extremadura and Murcia will need to make a fiscal consolidation effort in the period 2016-2017 well above the Autonomous Regions average. From this feasibility viewpoint, their deficit target should be higher, to a greater or lesser degree, than the target for the subsector overall.

Nevertheless, any future assessment of the distribution of deficit targets will necessarily incorporate the aspect of equity. For this reason, AIReF has conducted a joint feasibility and equity analysis by means of an intertemporal substitution relation between past and future effort. The assessment report includes a study of the indicators for structural adjustment and expenditure over the period from 2007 to 2015, which brings the consideration of equity into the analysis. Thus, of the five Autonomous Regions identified, only Valencia has performed an effort equal to the subsector average during this period. However, other equity factors need to be taken into account, such as the relative position of the regions in terms of financing system revenue or the use of normative competences in fiscal matters.

The dyad equity-feasibility and the weight given to the scope within each of these is a decision that calls for prior discussion, which is impossible in the time allowed between holding the preparatory session and the plenary session at the Fiscal and Financial Policy Council at which the proposal by MINHAFP is to be voted on. Committing to budget stability entails ensuring that all the Public Administrations are aware of the milestones in the budget cycle. From this perspective, AIReF recommends that the target proposal, together with the accompanying report, should be studied and discussed sufficiently in advance by the CPFF working groups that the Ministry may modify, as appropriate, the proposal with inputs from the Autonomous Regions and from AIReF before submission to the Council Plenary.

The proposal received does not take into account the expenditure rule, which, were it considered, could cause seven Autonomous Regions to face more demanding targets. In addition to the feasibility factor, the document refers to the coherence of the proposed stability targets with the expenditure rule for the Autonomous Regions overall, but does not take into consideration the different situation in each Autonomous Region, nor apply this as a differentiating factor, despite the expenditure rule being a limiting factor in the Autonomous Regions that are closest to compliance with the

targets. The implementation of the expenditure rule, therefore, may lead to a more demanding deficit than the stability target in the Autonomous Regions of Andalusia, Balearic Islands, Canary Islands, Galicia, Navarra, Basque Country and La Rioja.

The non-incorporation of the expenditure rule at the time of setting the budget stability targets, as required by the Organic Law on Budget Stability and Financial Sustainability (LOEPSF), detracts from the rule's effectiveness. The proposal for stability targets fails to take into account the relative position of each region with regard to the implementation of the expenditure rule, such that the adjustment of expenditure to the current reference rate is left until the subsequent implementation of the Budget. AIReF understands that this delay in incorporating the expenditure rule to the budgetary process contributes to its consideration as a second-order fiscal rule, despite the LOEPSF rating all three fiscal rules on an equal footing regarding their compliance. To this consideration we must add the problems of a methodological and practical nature, and probably also of definition, which must undoubtedly be analysed by the working group that MINHAFP has announced it will set up for this purpose.

- **Debt target**

AIReF finds that the current system for setting annual debt targets is inefficient, and until it is redesigned, the assessment is focused on certain aspects that leave room for improvement. AIReF is of the opinion that the debt target is a sustainability objective, and must therefore be viewed on a long-term horizon. Additionally, as pointed out in previous reports¹, the current design of debt targets does not guarantee debt sustainability in the middle and long term, given that compliance with the debt target is unrelated to the annual increase in debt or to the gap to be spanned to reach the reference value of 13% of GDP. Consequently, until the present system is redesigned, the assessment focuses on appraising certain formal aspects of the debt targets that can be improved on, such as transparency, the definition of debt limited by the target, or coherence with the stability targets.

It cannot be considered that there is coherence between the debt targets and the stability targets, when the debt targets are extended to cover unauthorised deficit increases from previous years. The debt target proposals for 2016 and for 2017-2019 are said to be coherent with the stability targets for the respective years. However, this coherence cannot be considered to exist when the debt targets can be extended to finance deficit overruns with respect to the stability target carried over from previous years.

¹[Report on initial budgets for 2016](#); [Report on the main aspects for the Autonomous Regions in 2016](#)