REPORT ON EXPECTED COMPLIANCE WITH THE BUDGETARY STABILITY AND GOVERNMENT DEBT TARGETS AND THE EXPENDITURE RULE FOR 2019

REPORT 33/19

AIReF

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EXECUTIVE SUMMARY

The purpose of this report is to assess the probability of compliance with the budgetary stability and government debt targets, as well as the expenditure rule of the different Public Administrations (PAs) in 2019. AIReF has previously issued its opinion on this probability in the Report on the initial budgets of the Public Administrations and in the Report on the Stability Programme Update (SPU) 2019-2022, published in April and May, respectively.

This time, AIReF has updated the forecasts, considering the budgetary execution of almost the entire first half of the year, the information provided by each administration regarding their closing forecasts, and the data that was sent by the Ministry of Finance with impact not only on the result of the *Central Government* (CG) but also on the rest of sub-sectors.

In light of the new information analysed, AIReF places the General Government (GG) for 2019 at around 2% GDP, slightly below the figure in its opinions from April and May, maintaining the feasibility of reaching the forecast notified to the European Commission on March 31st, 2019. If this estimate is confirmed, the PAs would reduce their deficit by 0.5% GDP compared to the figure recorded in 2018. However, it has to be considered that this figure includes non-recurrent operations with an estimated amount of 0.4% GDP in 2019. After adjusting for these operations, the adjustment made would be 0.6% GDP and the starting point to consider when setting the deficit targets for the next three years would be -1.6% GDP, which is the deficit underlying the expected closure of -2%.

GENERAL GOVERNMENT NET LENDING/BORROWING (% GDP)
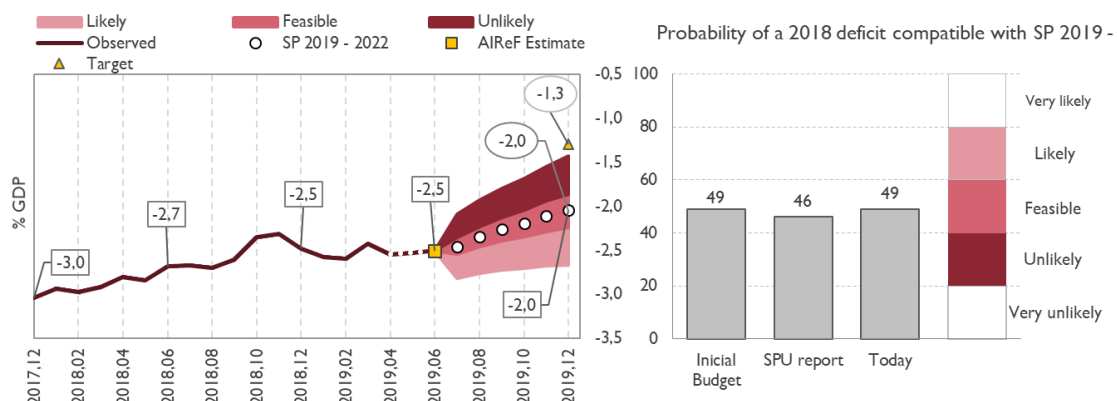
The improvement in the forecasts of AIReF's baseline scenario is boosted by the positive data of the 2018 income campaign; the good pace in social contributions, with expected growth of around 7.5%; and the downward revision of the interest expenditure, according to the cost reduction on the last Treasury debt issues and the more favourable development of the yield curves.

The overall effect from these items has an impact of almost 0.3% GDP. This allows the absorption, with a reduced positive net margin, of the downward revision to the forecast for the other taxes and EU funds, as well as the rise in the expected evolution of expenditure, which mainly affects the Territorial Administrations.

The lowering tax revenue forecasts has an effect of 0.1% GDP, mainly affecting VAT, Corporate Income Tax (CIT), and taxes on products, including Special Taxes and Taxes on Capital Transfers and Documented Legal Acts. The increased VAT returns, the shift from 2018 to 2019 of a ruling that negatively affects the CIT forecast, and the execution data to date, are the main factors conditioning this revision. With less quantitative importance in the GG sector, the negative influence of the application of the Ruling of the Constitutional Court dated 11th May 2017, on revenue from the Tax on Value Increase of Urban Land, has also been revised. Regarding the decrease in the forecasts of EU funds, the greater breakdown of EU funds obtained by the Autonomous Regions in 2018 as a consequence of the final settlement of the 2007-2013 Operational Programmes, allowed the accurate identification of the exceptional funds that will not be repeated in 2019.

Regarding expenditure, the upward revision mainly affects current expenditure (staff, agreements and operating costs) of the Autonomous Regions and investment expenditure of the Local Governments (LGs). The

expenditure on social transfers has also been revised upwards, in line with the evolution recorded in the number of pensions in the first half of the year.

Although the updating of these closing estimations has only a slight impact on the GG, it has affected the various sub-sectors unevenly, generally registering an improvement in the forecasts of the CG and of the *Social Security Funds* (SSF), and a worsening in the Autonomous Regions and in the LGs. Moreover, the distribution by sub-sectors of AIReF's baseline scenario has been amended according to the data provided by the Ministry of Finance–(MINHAC), regarding leaving the time limits of the VAT Immediate Information System (VAT-IIS) unchanged. As a result, AIReF's assessment and analysis were carried out by considering a scenario of financing flows updated with AIReF's revenue forecast, not including any additional revenue due to the neutralisation of the VAT-IIS adopted in 2017 in the settlement of these resources.

REVISION OF CLOSING SCENARIO (% GDP)

% GDP	Closing 2018	2019 AIReF Initial Budgeting	2019 AIReF Expected Compliance (with IIS modification)	2019 AIReF Expected Compliance (without IIS modification)
CA	-1,4	-1,0	-0,8	-0,6
SSF	-1,4	-1,4	-1,3	-1,3
AR	-0,2	-0,2	-0,3	-0,5
LG	+0,5	+0,5	+0,4	+0,4
GG	-2,5	-2,1	-2,0	-2,0

AIReF sets the debt level at the end of 2019 0.3% above the forecasts in the SPU 2019-2020. In this context, AIReF continues to claim that the current system for setting annual targets suffers from a number of shortcomings and does not provide an adequate view of the medium-term sustainability of the debt path.

DEBT TARGETS AND FORECASTS (EDP AS % GDP)

EDP Debt Targets (% GDP)	2018		2019		
	CMA July 2017	Observed	CMA July 2017	Observed	AIReF
Central Government and Social Security Funds	70,8	70,7	69,5	..	70,6
Autonomous Communities	24,1	24,3	23,3	..	23,7
Local Government	2,7	2,1	2,6	..	1,9
General Government	97,6	97,1	95,4	95,8	96,1

Regarding the expenditure rule, AIReF considers that only the CG will comply. At the local level, the highest risk is noted in the Autonomous Regions, with an increase in computable expenditure above the 3.8% growth of nominal GDP. However, the correction of non-recurrent operations would also lead to non-compliance in the CG whose reference rate, corrected for the regulatory measures to reduce taxes, stands at 1.6%.

EXPENDITURE RULE (VARIATION CHANGE)
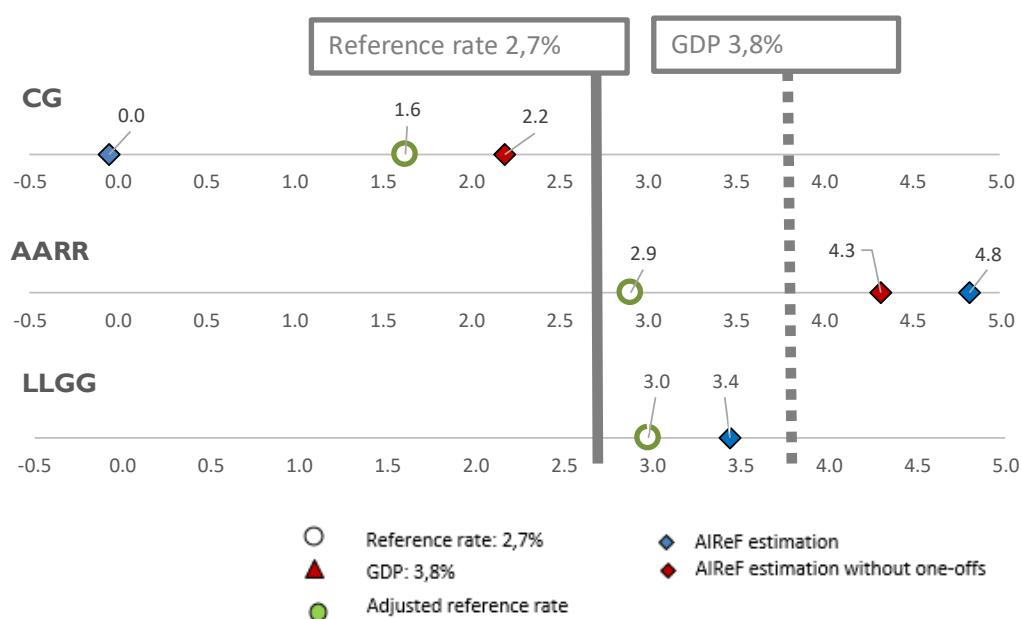
Additionally, regarding this rule, AIReF has noted that the criteria for allocating EU funds significantly distort the evolution of regional computable expenditure, despite the fact that in theory its effect should be neutral if the stream of revenue and expenditure was steady. Therefore, the rate of change of computable expenditure could vary by up to 5 points in the case of the Autonomous Regions where most of these funds are received.

Lastly, AIReF makes recommendations to the Ministry of Finance aimed at strengthening the fiscal framework and the enforceability of compliance with the targets, avoiding uncertainty in the assumptions and criteria applicable in their measurement, and correcting the distortions noted in the estimation of the expenditure rule. Likewise, it recommends, in general, to adjust the budgetary execution to the new revenue scenario affected, in the distribution by sub-sectors, by the non-settlement of the VAT-IIS.

In particular, AIReF has made specific recommendations to those administrations at risk of non-compliance with the targets.

Specifically, it recalls a recommendation already made in previous reports, regarding the need to implement a monitoring and early warning system in theCG, as the Organic Law on Budgetary Stability and Financial Sustainability (LOEPySF for its Spanish acronym) only considers a specific procedure for the Territorial Administrations.

Likewise, the evolution registered and expected for local and regional expenditure, causes the AIReF to recommend that certain territorial administrations adopt measures, as well as the activation by the MINHAC of the preventive mechanisms of the LOEPySF according to Article 19:

- Autonomous Regions:
    - Due to the deviations envisaged, both in the deficit target and in expenditure growth: Murcia, Valencia and Balearic Islands. These Autonomous Regions are in the process of drafting/approving an Economic Financial Plan (2019-2020 EFP) so the application of preventive measures is not appropriate, but rather the fiscal scenario would need to be adjusted within the framework of the EFP.
    - Due to the high expenditure growth, ranging between 5% and 8%, having deducted non-recurrent operations and the distortion of EU funds: Canary Islands, Madrid and Navarre.
- Local Governments:
    - Due to the strong increase recorded and forecasted in expenditure, with variation rates of around 10%: City Councils of Córdoba, Las Palmas de Gran Canaria, and Madrid, and Island Council of Tenerife.
    - Due to high risk of non-compliance with the fiscal rules in 2019 (recurrent deficits), as a consequence of the expenditure growing above 8% despite being city councils with structural sustainability issues: Almonte, Jaén, Jerez de la Frontera, Parla and Navalcarnero.

1 INTRODUCTION

AIReF must prepare a report on budgetary execution, government debt and the expenditure rule by 15 July of each year. The Organic Law 6/2013, of 14 November, creating AIReF, entrusts this institution with the continuous evaluation of the budgetary cycle and public indebtedness with the ability to prepare a report, at any time, on the desirability of activating the measures provided for in the Organic Law on Budgetary Stability and Financial Sustainability (LOEPySF for its Spanish acronym). In addition to these general powers, AIReF is obliged to issue an opinion on the compliance with the budgetary stability and government targets, as well as on the expenditure rule, for the current year, before 15 July of each year[1].

After the report on the initial budgets for 2019, published in April, this report updates the statement regarding compliance with the fiscal rules by the Public Administrations (PAs). Subsequently in May, AIReF published a report on the Stability Programme Update, which contained a medium-term evaluation focused on the General Government (GG). Since the publication of the previous report, all the new information provided by the PAs regarding their budgetary execution this year and closing forecasts, as well as the evolution the macroeconomic environment, have been included in the analysis. Although there have been elections at all levels of administration, the new governments are still forming at different paces. Consequently, there have not been significant changes regarding the fiscal stance since the last report.

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[1] Law 6/2013 of 14 November, Article 17, creating AIReF, and Royal Decree 215/2014, Article 19 approving its Organic Statute.

2 PURPOSE AND SCOPE

The purpose of this report is to assess the probability of compliance with the budgetary stability and government debt targets, as well as the expenditure rule of the PAs in 2019. In accordance with article 17 of Organic Law 6/2013, this evaluation, which will consider budgetary execution and the measures envisaged in the current and previous year, will identify the possible risks of non-compliance for each of the agents that make up the GG sector.

In particular, the following were analysed:

- ✓ The Central Government (CG) sub-sector.
- ✓ The Social Security Funds –(SSF) sub-sector[2].
- ✓ The regional sub-sector and each Autonomous Region (AR).
- ✓ The Local Government (LG) sub-sector.
- ✓ Apart from the LG sub-sector, 24 large local corporations (LCs) have been assessed individually, which have been assessed in previous reports: the 16 largest city councils with over 250,000 inhabitants, the Provincial Councils of Barcelona, Valencia, Sevilla, the Island Councils of Tenerife and Mallorca, and the Provincial Councils of Guipúzcoa, Vizcaya and Álava. Moreover, during the assessment of local sustainability, 24 city councils with medium-term sustainability risk were analysed following the procedure used in previous reports.
- ✓ The risk analysis by sub-sector is completed with an overview of the situation for the GG sector.

As in previous reports, the subject of the report has been conditioned by a lack of:

- ✓ Initial budget and settlement forecast for 2019 in national accounting terms for the PAs.
- ✓ Information needed to assess compliance with the expenditure rule in all sub-sectors.

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[2] In this case only compliance with the deficit target will be analysed, in accordance with the Organic Law on Budgetary Stability and Financial Sustainability (LOEPySF).

✓ Completed and updated information about the impact of the main contingent liabilities, mainly rulings that could have affected the 2019 deficit.

3 BUDGETARY STABILITY TARGET

3.1 Macroeconomic scenario

3.1.1 Recent evolution of the Spanish economy

During the first half of 2019 the Spanish economy has continued to show strong growth rates, almost in line with that recorded at the end of 2018. Quarterly national accounting data showed a quarter-on-quarter increase in Gross Domestic Product (GDP) of 0.7%, one tenth higher than the record for the previous quarter. This, together with the signal provided by the most recent short-term information (see graph 1 for the forecasts of the MIPred model for the second quarter), points to essentially steady growth in the first quarters of the year, translating into year-on-year rates of 2.4% and 2.5% for the first and second quarter, respectively.

GRAPH 1.   EVOLUTION OF GDP IN TERMS OF VOLUME. (QUARTER-ON-QUARTER RATES)
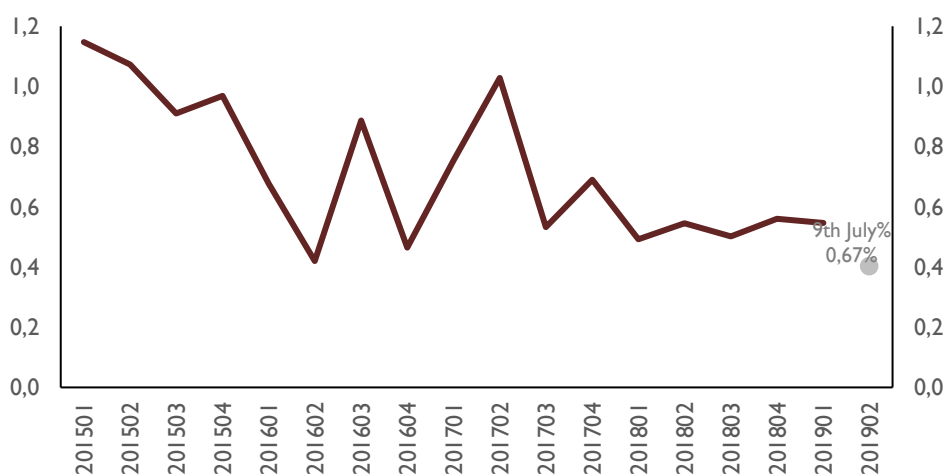
Source: AIReF.

The growth during the first half of the year has mainly been supported by national demand, together with slightly positive contribution, though slowing, of external demand. The growth noted during the first quarter, as well as the

growth expected for the second and third quarters[3], has been characterised by the upswing in private consumption expenditure, which would mainly be supported by families' sound financial situation and position, as well as by job creation. Public consumption is expected to maintain a steady year-to-year evolution with growth below that of GDP. After the positive surprise of the first quarter, the growth of productive capital formation is expected to slow slightly in the second quarter, returning to a stronger pace in the third quarter. Regarding external demand, growth of both exports and imports of goods and services has been weakened, but AIReF expects that they will return to a more solid growth path, in line with that observed in 2018, unless the persistent uncertainty of international trade flows and the weakness in demand from the main trade partners taint these expectations. Still, external demand will continue to positively contribute to aggregate growth, weakening its contribution as the cycle progresses.

TABLE 1.   REAL TIME EVOLUTION OF THE GDP FORECAST FOR 2019 Q1 AND 2019 Q2 (QUARTER-ON-QUARTER AND YEAR-ON-YEAR RATE AS %)

	Quarter-on-quarter growth				Year-on-year growth			
	2018T4	2019T1	2019T2	2019T3	2018T4	2019T1	2019T2	2019T3
GDP at market prices	0,6	0,7	0,7	0,6	2,3	2,4	2,4	2,5
Private Consumption	0,4	0,4	0,8	0,6	1,9	1,5	2,2	2,3
Public Consumption	0,4	0,4	0,6	0,6	2,2	2,0	2,2	2,0
Productive investment	-2,7	4,3	0,7	2,8	2,8	7,2	1,8	5,0
Construction investment	1,1	-0,1	1,2	0,7	5,3	3,3	2,8	3,0
Exports	0,7	0,0	0,6	0,3	1,0	0,0	0,6	1,7
Imports	0,0	-0,3	1,1	0,9	1,7	-0,5	-0,2	1,6
Contribution to GDP growth								
Domestic Demand					2,5	2,2	2,2	2,4
External Demand					-0,2	0,2	0,2	0,1
Employment (Labour Force Survey)	0,9	0,8	0,6	0,5	2,9	3,1	2,8	2,7

Source: AIReF.

3.1.2 Forecast for 2019

For the whole of 2019, AIReF[4] maintains a growth forecast of 2.3%. This figure is in line with the most recent estimations from the panel of major analysts, especially with the most recent revisions made by the Bank of Spain, and it is based in the strength of the main components of domestic demand, alongside the economic policy measures that have positively affected household disposable income. From the perspective of the economic cycle, AIReF's macroeconomic scenario forecasts the start of an expansive cycle with early maturity, supported by a sounder financial position of non-financial

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[3] The publication is available on AIReF's website Integrated forecasts of the macroeconomic scenario

[4] Report on the 2019 - 2022 Stability Programme Update of the Kingdom of Spain. May 9, 2019.

corporations and families, than the one noted in the previous expansive phase.

In the absence of significant changes with respect to the previous report, the progressive recovery of the nominal component still implies that the economic cycle will maintain its contribution to reducing the deficit of the PAs. Considering the evolution of the labour market, employment shows a solid growth, although it is expected to start slowing in line with the forecasts. On the one hand, due to the progressive reduction of the unemployment rate (plus an increase in the labour force), the wage bill is growing above the figures recorded in recent years. On the other hand, the development of these factors is also marked with a wage growth, both in the private and the public sector, so that, in the absence of a substantial increase in labour productivity, a growth of the unit labour costs over the GDP deflator is expected. Regarding the minimum wage increase, in force since January, in the data available there is still no significant impact on job creation. It is necessary to wait until Autumn to obtain individual data which allows a detailed evaluation of the effect of this measure on job creation. All these items together are boosting the collection from PIT and social contributions. All in all, the growth pattern described favours a higher collection of public revenue, making it easier to reduce the deficit in its cyclical component.

The risks of the macroeconomic scenario set in AIReF's report on the SPU 2019-2022 are still valid, most notably those that come from the deterioration of the external environment. Of the main risks the most relevant are those related to an intensification of tariff disputes among the main actors in global trade, their possible spread to other areas, and their consequences on economic growth in the Euro zone. Likewise, the risks linked to the uncertainty of economic policy in Italy prevail, which, although particularly susceptible to generating a contagion effect towards the Spanish economy through the financial channel, seems to have subsided in recent weeks. Finally, the UK's withdrawal from the European Union is still an uncertain element that could influence the evolution of trade, direct investment and migratory flows in the EU in the coming quarters.

3.2 General Government sector

**AIReF estimates a deficit of around 2.0% GDP for the PAs, slightly below the April forecast.** Both in the report on the initial budgets and in the report about SPU, AIReF's baseline scenario envisaged a deficit of around 2.1%, which has changed slightly, although the changes in its composition are more significant. Also considering the revision of the closing figures for 2018, the PAs will reduce their deficit by 0.5% GDP in 2019.

TABLE 2.   BUDGETARY STABILITY TARGET

Lending (+) Borrowing (-) as % GDP	2016	2017		2018		2019		
	Year-end	CM Agreement Dec 2016	Year-end	CM Agreement July 2017	Year-end	CM Agreement July 2017	Notific. EC	AIReF
Administración Central	-2.6	-1.1	-1.9	-0.7	-1.4	-0.3	-1.0	-0.6
Fondos Seguridad Social	-1.6	-1.4	-1.5	-1.1	-1.4	-0.9	-1.4	-1.3
Regions and LGs	-0.3	-0.6	0.3	-0.4	0.3	-0.1	0.4	-0.1
Regions	*-0.9*	*-0.6*	*-0.3*	*-0.4*	*-0.2*	*-0.1*	*-0.1*	*-0.5*
Local Governments	*0.6*	*0.0*	*0.6*	*0.0*	*0.5*	*0.0*	*0.5*	*0.4*
General Government	**-4.5**	**-3.1**	**-3.1**	**-2.2**	**-2.5**	**-1.3**	**-2.0**	**-2.0**

AIReF considers it very unlikely to comply with the stability target set at -1.3% GDP for 2019 and considers it feasible that the -2% notified to the European Commission and contained in the SPU could still be achieved. As indicated in previous reports, the budgetary stability target is unlikely to be achieved. This target entails an adjustment of 1.2% GDP, compared to the end of 2018. If we consider the targets approved by the Council of Ministers, the weight of the adjustment would be borne by the CG and the SSF, 1.6% GDP, while the TAs would have a margin of 0.4% GDP. In this sense, on 31 March 2019 the Government sent the European Commission a closing forecast for 2019 by sub-sectors, different from the targets approved by the Council of Ministers. In this report, the expected deficit, both for the PAs and for the CG and SSF sub-sectors, is above the target approved, not compensating this deviation with the surplus expected for the LGs. According to this report, the Government forecasts an adjustment of 0.4% GDP in the AC and of the 0.1% in the Autonomous Regions in 2019.

GRAPH 2.   GENERAL GOVERNMENT SECTOR

GRAPH 2.A.   NET LENDING/BORROWING (% GDP)
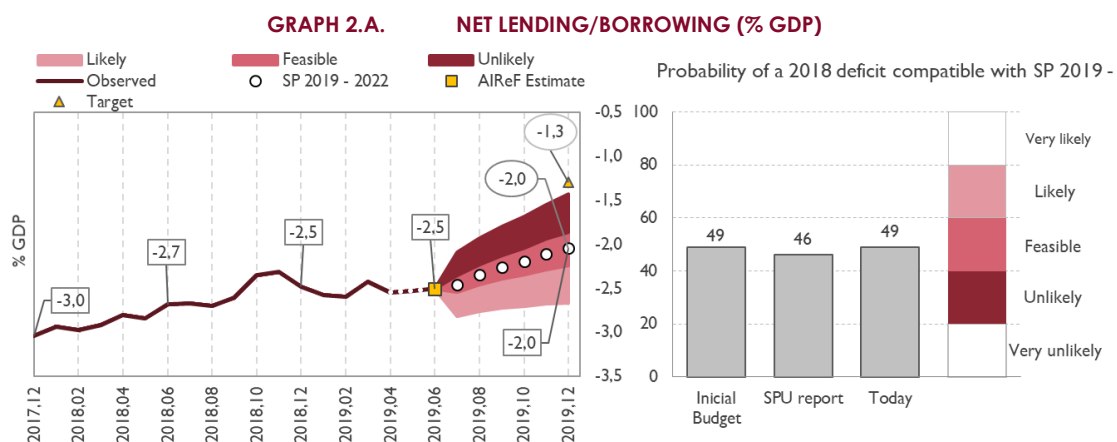
GRAPH 2.B.   REVENUE (% GDP)
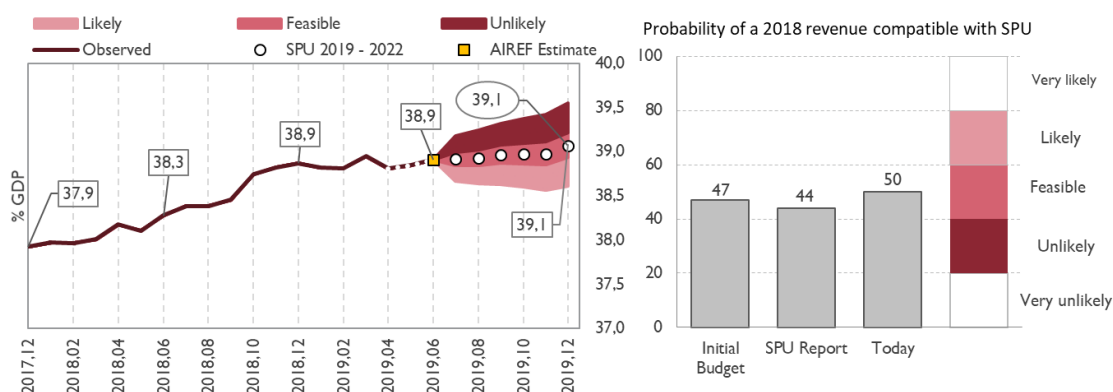
GRAPH 2.C.   EXPENDITURE (% GDP)
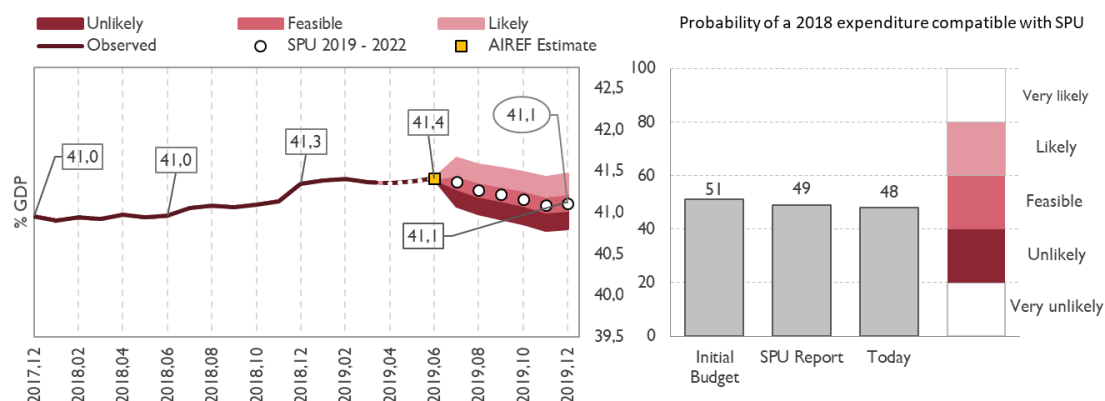
The changes in AIReF's estimation compared to the report on the initial budgets mainly stem from new budgetary execution data and the closing forecasts of the PAs, as well as from the revision of the end of 2018. After the publication of the report on the initial budgets, the General Intervention Board of the State Administration (IGAE) published new closing figures for 2018, which decreased the deficit for the GG sector from 2.6% to 2.5% GDP. Furthermore, the addition to the analysis of new budgetary execution data, as well as the information provided by the different PAs, has led to variations in the revenue and expenditure estimates, thus slightly reducing the deficit forecast in aggregate form. Lastly, it should be noted that new information about the macroeconomic environment has had a limited impact on revenue forecasts.

The revision of the end of 2018 mainly affected the temporary imputation of some non-recurrent elements. AIReF also received information that allowed a better quantification of these elements. Consequently, AIReF estimates that the amount of these elements would be higher in 2019 compared to 2018,

0.4% GDP compared to 0.3%, while the estimate in the report on the initial budgets was 0.5% in 2018 and 0.2% in 2019. In general, the lower amount in 2019 due to the State's Financial Liability (SFL) for toll motorways and due to tax credits payable to the Administration are offset by the absence or reversion of non-recurrent revenue items. Moreover, the effect of the ruling on Corporate Income Tax has been postponed from 2018 to 2019, resulting in a higher deficit for the CG in 2019.

TABLE 3.   NON-RECURRENT ITEMS WITH IMPACT ON THE DEFICIT

GENERAL GOVERNMENT SECTOR	2017	2018	2019
Deficit (%GDP)	**-3.1**	**-2.5**	**-2.0**
Non-recurrent items*			
Toll motorways		1,800	
Tax credits payable	512	1,073	500
APS Payments	797	1,849	1,793
Financial aid	508	78	
Ruling on Corporate Income Tax			702
Maternity rebate		622	741
Estimated expenditure of interest on non-recurrent items			240
Non-recurrent revenues from Corporate Income Tax		-1,600	1,600
Non-recurring expenditure in Regions (various rulings; 2018 and 2019: AND, CVA, BAL, MAD)	629	860	288
Non-recurrent revenues in Regions (2018: settlement of EU Funds PO 07-13; 2019: extraordinary rev AST and CVA)		-1,147	-408
Non-recurring expenditure LGs (reclassification app and other)	108	84	
Non-recurrent items	**2,554**	**3,619**	**5,455**
Non-recurrent items (% of GDP)	**0.2**	**0.3**	**0.4**
PA deficit without non-recurrent items (% GDP)	**-2.9**	**-2.2**	**-1.6**

* When positive, greater deficit; when negative, lower deficit

Source: AIReF estimate based on information published by IGAE and *Agencia Estatal de Administración Tributaria* (Spanish Tax Agency - AEAT)

AIReF has revised its revenue estimate upwards, mainly due to a higher figure than expected in PIT and the improved collection of social contributions. The revenue level contained in the SPU is considered feasible, although the possibility of reaching it improves compared to the report on the initial budgets. This revision of the estimates is mainly due to the incorporation of new collection data into the analysis. This way, revenue will increase to 39.1% GDP, 0.2% above the estimate for the first quarter and that achieved in 2018. The main changes led to an upward revision of the expected collection from PIT

due to the results of the 2018 declarations and social security contributions, and a downward revision of collection from VAT, special taxes, and Corporate Income Tax.

The expenditure estimate has been slightly revised upwards, though the SPU's forecast is still feasible. Although the first half of the year is expected to end with a higher expenditure level than the end of 2018 in twelve-months accumulated terms, in the second half its weight over GDP will be reduced until it reaches 41.1%. This expenditure execution profile is strongly conditioned by the entry into force of increases in pensions and public wages (January 2019 against August 2018), as well as the impact throughout the year of certain non-recurrent elements, such as the PIT return for parental benefits that occurred in the second half of 2018 and the first half of 2019. The latest information analysed has entailed, among other things, an increase in the estimated expenditure on social transfers and the expenditure of the Autonomous Regions and LGs, partly offset by the reduction in interest expenditures and subsidies to cover the electricity tariff deficit.

3.3 Central Government

The deficit estimated by AIReF for the CG, excluding the effect of no changes to the IIS, improves compared to the report on the initial budgets. The better-than-expected result of annual PIT declarations is partially offset by downward revisions in other items. The budgetary execution data known to date reflect a lower increase in VAT, ST and CIT than expected, essentially due to the greater number of VAT returns requested and the effect of the court ruling on CIT. In turn, aggregate expenditure reduced when compared to the forecasts in the previous report, with changes in opposing directions depending on the headings: less expenditure on interests and subsidies, and more intermediate consumption and social transfers in cash. In AIReF's baseline scenario, revenues have risen to 17.7% GDP and expenditure fell slightly, although the absence of changes to the IIS reduces its weight by an additional 0.2%, to 18.3% GDP. This way, AIReF estimates a deficit around 0.6% GDP, which would rise to 0.8% if the IIS was modified.

AIReF considers it unlikely to achieve the budgetary stability target of -0.3% GDP for 2019 but considers it likely to achieve the -1% deficit reported to the European Commission. To achieve this target, the CG would have to reduce the deficit by 1.1 % GDP compared to the end of 2018. The CG is the sub-sector that most reduced its deficit in 2017 and 2018, and the one that is expected to reduce it the most in 2019. On the contrary, in the first notification to the European Commission in April 2019, the Government recognises a

closing forecast with a deficit of 1% for the CG. The overall effect of the extension of the GSB, the measures adopted by the Government early in the year, and the lower impact of non-recurrent elements compared to 2018, will allow a reduction in the deficit of 0.8% GDP in this sub-sector, higher than that recorded in 2018. This reduction is mainly concentrated in expenditure, specifically capital expenditure on non-recurrent elements, on interest, and on the transfers to the PAs, due to the negative settlement of the Territorial Administrations as a result of the IIS in 2017.

The revision of the closure of 2018 also conditions the result for 2019. This revision, made after AIReF's April report on the initial budgets, has led to a more positive year-end for the CG in 2018 than the one initially published. This way, the CG went from closing 2018 with 1.5% GDP to 1.4% GDP. However, part of this lower deficit entails a higher deficit in 2019 due to the shift of the impact of the court ruling on CIT from 2018 to 2019. Consequently, the amount of the non-recurrent elements becomes higher in 2019 than in 2018, and a different timeline throughout the year.

GRAPH 3.   **CENTRAL GOVERNMENT**

GRAPH 3.A.   **NET LENDING/BORROWING (% GDP)**
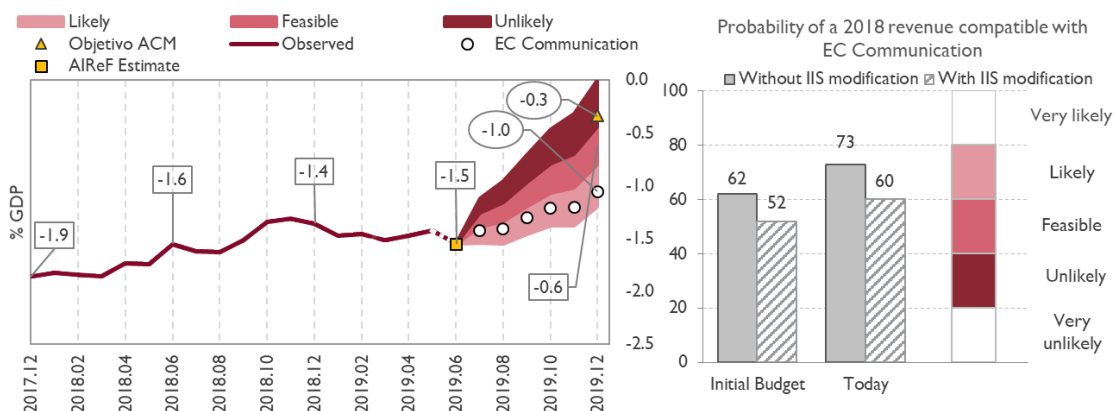
GRAPH 3.B.   **REVENUE (% GDP)**
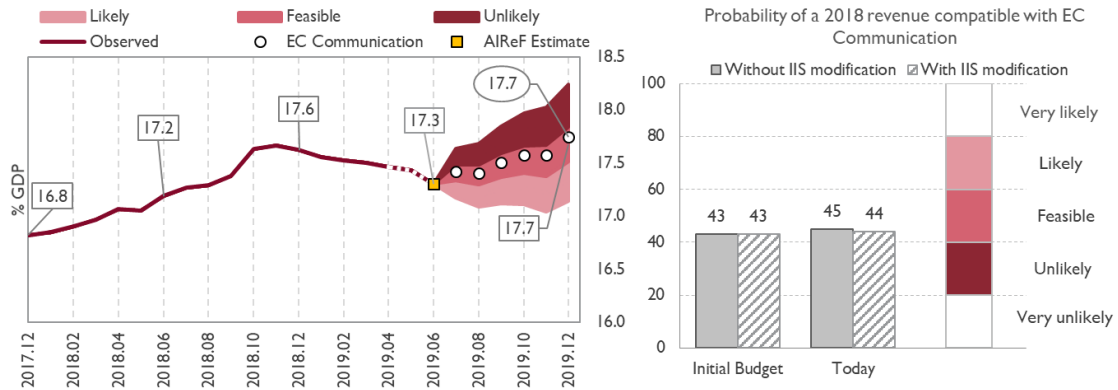
GRAPH 3.C.   **EXPENDITURE (% GDP)**
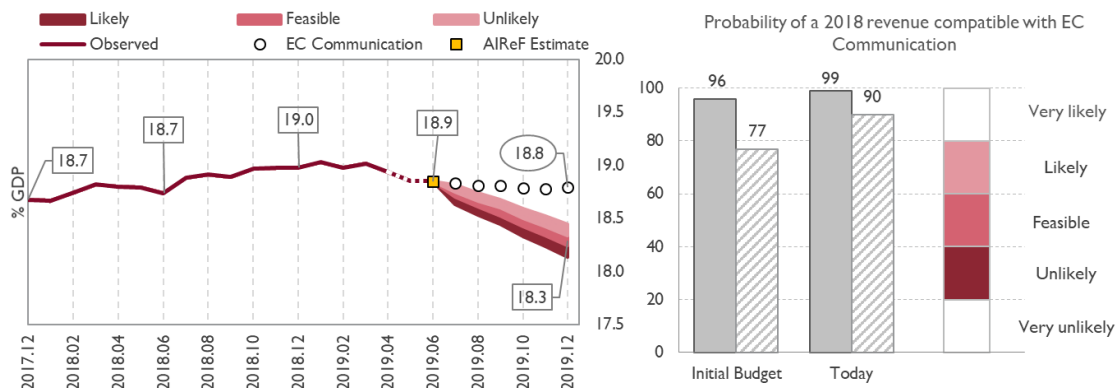

3.3.1 Non-financial revenue forecast

Regarding the report on the initial budgets, the new information added led to an upward revision of the revenue forecasts of 0.1% over GDP. Since the report on the initial budgets, the AEAT has published the first quarter in terms of accrual of the main tax figures, May in cash terms and a press release about the development of the 2018 PIT campaign. Find below the main revisions to tax collection resulting from information added prior to the report on the initial budgets[5]. The changes were concentrated in tax revenue, while non-tax revenue remain almost the same.

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[5] Although the Report on the 2019-2022 SPU is the latest report published in relation to the targets, it did not individually explain the tax evolution in cash terms, firstly because it had a multi-year purpose, and secondly because it was framed within an European commitment, thus having

In national accounts the CG's revenue increased its weight over GDP to 17.7% compared to 2018. In 2019, most of the headings maintain an increase with respect to 2018, in line with nominal GDP. However, there are two counteracting effects. On the one hand, the effect of the advance CIT payment in 2018 for some big companies and the shift of the imputation of a court ruling from 2018 to 2019, deducting 0.2% from the weight of revenue over GDP compared to 2018. On the other hand, the positive development of PIT after publishing the results of the 2018 income campaign, settled in 2019, as well as the higher collection of the Tax on Hydrocarbons, due to the integration of the regional tariff, improving the weight over GDP of 2018 by a further 0.1%. Moreover, there was an improvement of the revenue for transfers between PAs compared to 2018.

TABLE 4.   EVOLUTION OF TAX REVENUE BEFORE TRANSFER TO THE TAS IN NATIONAL ACCOUNTING TERMS

Growth in % var. 2019/2018	AIReF estimate Initial budgets	Revision	Updated AIReF estimate
PIT	3.9	3.4	7.3
VAT	4.4	-0.5	3.9
CIT	-0.2	-5.4	-5.6
ST	10.7	-2.3	8.4
NRIT	0.6	-4.9	-4.3
Others	7.1	0.0	7.1
TOTAL	**4.3**	**0.2**	**4.5**

3.3.2 Taxes in cash before transfer to the Territorial Administrations.

The forecast in settlement terms of the main tax figures was amended upwards compared to that envisaged in the report on the initial budgets. This revision is largely due to the incorporation of the information from the 2018 income campaign with higher revenue than expected, partially due to an increase in the income derived from capital gains. This upward revision would have been greater had it not considered a gentle downward revision in taxes on production (VAT and ST), which include the contained evolution of the first

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been analysed as national accounts, and was focused on the GG sector and not on each sub-sector.

months of the year, in addition to the incorporation of the receivables due to the administration for CIT.

Despite the fact that the gross revenue is growing at 3.8% so far this year, the collection until May only increased by 0.4%, due to the 16% growth in returns so far this year. The growth of gross revenue is similar to AIReF's nominal GDP growth forecast. In 2019 the returns inherent to the collection mechanism of each tax figure, are joined by the returns stemming from two rulings; on the one hand, the rebate of maternity/paternity leave in PIT, which in cash terms would result in a lower collection of the tax by about 1,600 M€, and, on the other hand, a return of about 700M€ in CIT. Moreover, this is in addition to the payment of receivables to the administration in CIT for about 120 M€, not incorporated in the report on the initial budgets. In the absence of this set of extraordinary returns, the evolution of the collection so far this year, without taking into account the positive surprise of the end of the 2018 income campaign, would have reached a growth of 3.6% compared to 2018. Following the approach of the report on the initial budgets, the breakdown of tax growth, in cash terms, has been updated into two components, on the one hand, the "normative", and, on the other hand, the component derived from the cycle and the mechanics of each tax (effect without policy changes)[6].

AIReF improves its PIT collection forecast, increasing from 3.6% to 5.7%. As a result, the evolution of PIT deducted from the Draft Budgets for 2019 is now considered likely. The main difference with respect to the previous estimate is in the positive surprise of the end of the 2018 income campaign that would imply an improvement of over 3 points. In addition, by incorporating the collection data known until May, the growth has been revised upwards slightly by 0.1% compared to the previous estimate. On the other hand, less collection is expected due to the court ruling on maternity/paternity leave and a greater effect of the measures approved in the General State Budgets (GSB) for 2018[7].

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[6] The effect, with no policy changes, is broken down into three parts: (1) the evolution of the bases, explained by macroeconomic changes, (2) the evolution of rates, justified by the progressivity of each tax, and (3) the evolution of the collection mechanism, motivated by a change in the rate of return, application of postponements, changes in the tax difference, etc...this is the last component in which imputation differences may occur between the settlement and national accounting criteria.

[7] With the information deduced to date AIReF has revised the impact in 2019 of the measures adopted by the GSB 2018 to reach approximately 1,200 M€ (620 due to a reduction in work performance, 265 M € due to the childcare vouchers, and 280 for family deductions)

TABLE 5.   BREAKDOWN OF THE CHANGE IN PIT

| PIT	2018 year-end	GSB 2019	AIReF 2019 estimate Initial budgets	AIReF 2019 estimate current
Total (% var.)	**7.6**	**4.9**	**3.6**	**5.7**
Breakdown of growth:				
(1) Regulatory effect	-0.5	-1.9	-1.9	-3.3
(2) Effect without regulatory changes (a)+(b)+(c)	8.1	6.2	5.5	9.0
Evolution of bases (a)	5.2		3.6	3.7
Evolution of rates (b)	1.0		1.9	1.9
Effect of collection mechanism (c)	1.8		0.1	3.4

GRAPH 4.   PERSONAL INCOME TAX
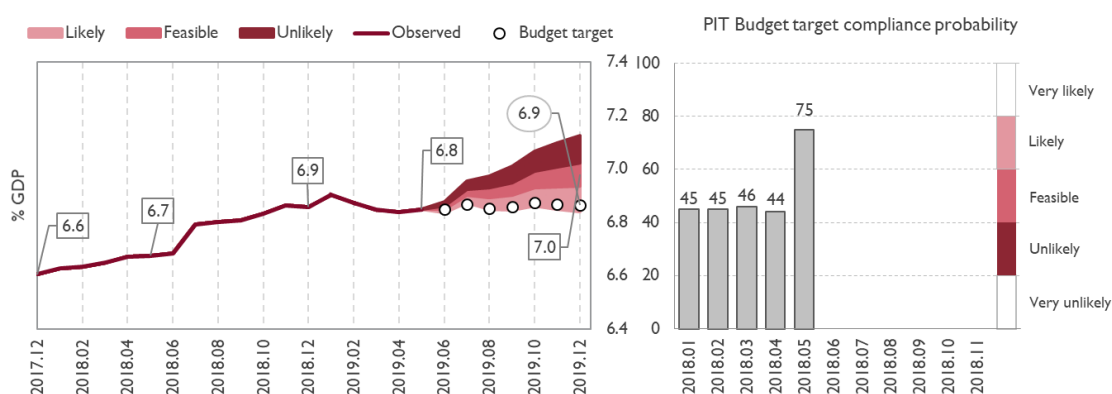
Furthermore, the expected CIT collection is revised downwards compared with the previous report, maintaining the rating of unlikely in relation to the figure deduced in the 2019 GSB. In the case of this tax, the collection so far this year does not provide relevant information about the evolution of the entire year as two of the larger instalment payments were recorded in the last two months of the year and the settlement did not occur until the end of July. The main difference between AIReF's forecast and the budgetary data has already been explained in previous reports and in this report there is a slight update stemming from the registration of a payable tax credit that involves a reduction in collection of 120 M€[8], which implies an update of 0.5% to the evolution of the tax. Furthermore, with the incorporation of the information published until May the previous forecast of the macro evolution is revised slightly, although the base continues to evolve at a faster rate than the forecast for nominal GDP.

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[8] The effect of the incorporation of the DTA results in a smaller collection of CIT without affecting the tax in national accounting terms.

TABLE 6.   BREAKDOWN OF THE CHANGE IN CIT

| Corporate Income Tax	2018 year-end	GSB 2019	AIReF estimate 2019 Initial budgets	AIReF 2019 estimate current
Total (% var.)	**7.3**	**14.1**	**-1.1**	**-1.8**
Breakdown of growth:				
(1) Regulatory effect	0.0	7.5	-2.8	-3.3
(2) Effect without regulatory changes (a)+(b)+(c)	7.3	3.5	1.7	1.5
Evolution of bases (a)	12.8		8.1	8.0
Evolution of rates (b)	2.0		1.2	1.2
Effect of collection mechanism (c)	-7.5		-7.6	-7.7

GRAPH 5.   CORPORATE INCOME TAX
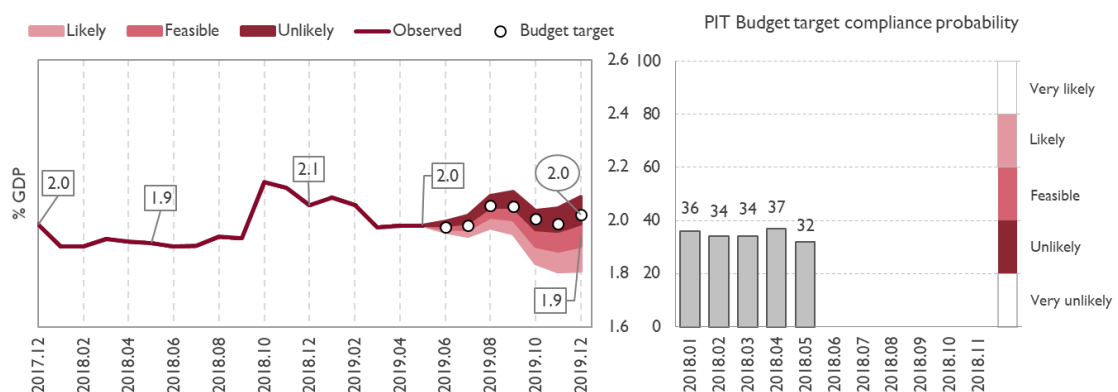
AIReF considers it very unlikely to reach the VAT collection expected in the 2019 GSB. The largest discrepancy between AIReF's estimate, with a projected growth for 2019 of 3.5%, and the budget, of 5%, was previously explained in the report on the initial budgets by the increase in expected returns in relation to 2018. In addition, with the information available to May, AIReF revises this effect by 0.2%. It also made a slight downward revision to the base of just 0.1% due to the more contained evolution of accrued tax published in the first quarter of the year and linked to a lower household final consumption expenditure, both volume and prices, than expected.

However, the greater revision compared to AIReF's previous forecast in cash terms is due to considering the non-reversal in the VAT-IIS as the baseline scenario. This change, however, has not been translated in national accounting terms to the evolution of the tax but rather to the evolution of transfers granted by the State and received by the Autonomous Regions, explained in their respective sections.

TABLE 7.   BREAKDOWN OF THE CHANGE IN VAT

VAT	2018 year-end	GSB 2019	AIReF estimate 2019 Initial budgets	AIReF 2019 estimate current
Total (% var.)	**10.3**	**5.0**	**10.5**	**3.5**
Breakdown of growth:				
(1) Regulatory effect	5.8	-0.1	6.5	-0.1
(2) Effect without regulatory changes (a)+(b)+(c)	4.5	5.1	3.9	3.6
Evolution of bases (a)	5.6		4.5	4.4
Evolution of rates (b)	-0.1		0.0	0.0
Effect of collection mechanism (c)	-1.1		-0.6	-0.8

GRAPH 6.   VALUE ADDED TAX
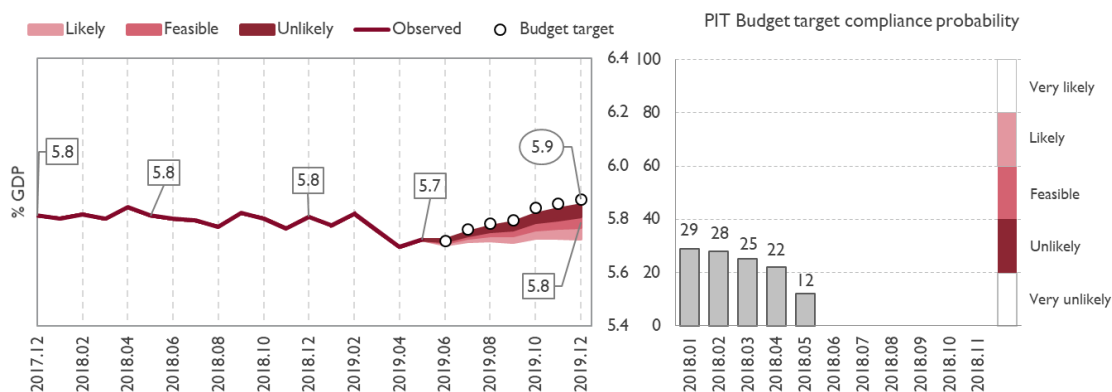
AIReF revised the forecast for collection of Special Taxes (ST) downwards, considering the closure expected in the 2019 GSB to be unlikely. There are several factors that explain the lower collection. On the one hand, so far this year there has been lower collection than initially expected for the tax on tobacco products, which implies more than one point less in the expected growth. On the other hand, the moderate behaviour of hydrocarbons and tobacco consumption affects the growth of its collection with respect to 2018 by 0.3%. In addition, the normative impact at the end of the year has been updated due to the incorporation of the regional rate of the tax on hydrocarbons. In any case, it is necessary to put this variation in the growth rate of this type of taxes into perspective, as this change only represents 0.04% GDP.

TABLE 8.   BREAKDOWN OF THE CHANGE IN ST

ST	2018 year-end	GSB 2019	AIReF estimate 2019 Initial budgets	AIReF 2019 estimate current
Total (% var.)	**1.1**	**12.3**	**10.8**	**8.1**
Breakdown of growth:				
(1) Regulatory effect	0.0	6.6	6.6	5.7
(2) Effect without regulatory changes (a)+(b)+(c)	1.1	5.7	4.2	2.4
Evolution of bases (a)	6.8		2.3	2.0
Evolution of rates (b)	-4.6		0.3	0.3
Effect of collection mechanism (c)	-1.1		1.6	0.1

GRAPH 7.   SPECIAL TAXES
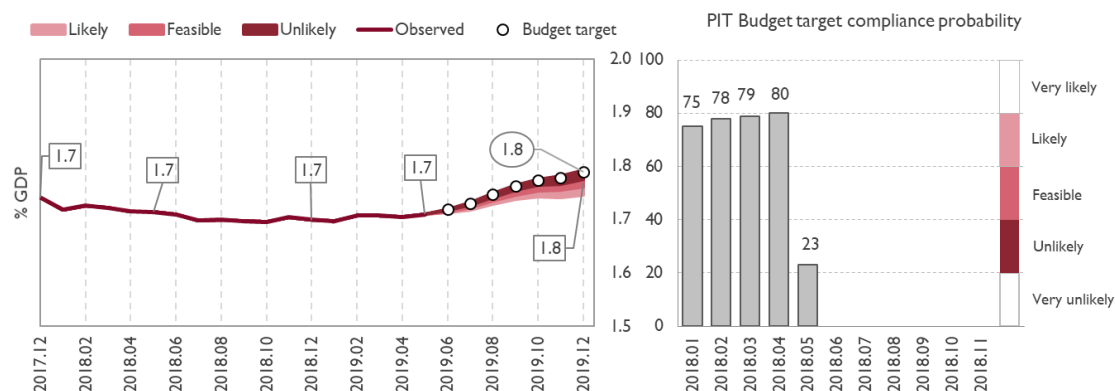
3.3.3 Expenditure forecast

During the first half of the year non-financial expenditure maintained a declining trend that will accelerate until the end of the year. Expenditure growth rates of have remained high but declining during the first half of the year due to the fact that the GSB for 2018 were approved in July, therefore the entry into force of the wage increase for public employees and revaluation of civil servants' pensions did not occur until August 2018. During the second half of the year the variation rates are expected to moderate, closing the year with an increase in the CG's expenditure of 0.2%.

GRAPH 8.   **CONTRIBUTION TO GROWTH OF EXPENDITURE ITEMS (%)**

Expenditure Growth 0,2%
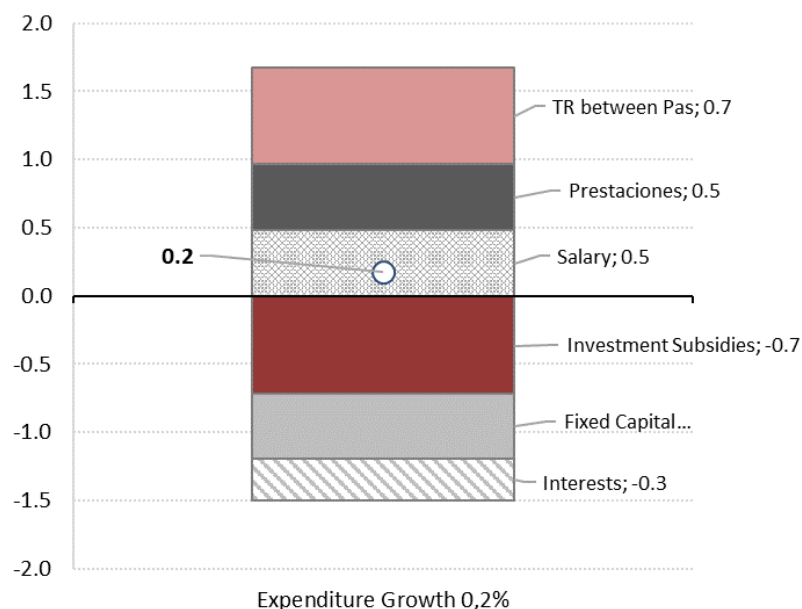
Non-financial expenditure is expected to fall by 0.7% GDP in 2019, with the adjustment being concentrated in transfers between PAs, interest and capital expenditure. As a percentage of GDP current expenditure will drop by 0.3% due to the lower weight of interest and transfers to other PAs, and capital expenditure will drop by the same amount, essentially due to the one-off operations in 2018 that will not be replicated in 2019. In nominal terms the higher expenditure on compensation of employees, civil servants' benefits and current transfers to the PAs are partially offset by lower capital expenditure both in investments and investment aid as well as in capital transfers between PAs.

This adjustment is essentially explained by the fact that in 2018 there were one-off operations that will not be repeated or will not do so in the same magnitude in 2019. The non-recurring items are concentrated in the impact of the reversion to the State of certain bankrupt toll motorways and the SFL generated and the deferred tax assets converted into tax credits payable to the Tax Administration, that are higher in 2018 than the forecast made for 2019. In homogeneous terms, without considering the effect of these non-recurrent items, 2019 growth would be close to 1.4%.

AIReF expects a lower expenditure for 2019 than the forecast in its report on the initial budgets. The most significant variations are concentrated in interests and subsidies that decreased due to the lesser compensation to the electricity sector not provided for in the previous report, a consequence of the

temporary suspension of the tax on electricity. To the contrary, there was an increase in electoral expenditure and the impact of assuming non-professional caregiver fees in social benefits other than in-kind transfers is incorporated.

In addition, the lack of change to the VAT-IIS reduces the expenditure estimate by 0.2%. As noted above, until the current report AIReF's baseline scenario considered that changes would be made to the IIS to offset the effect in the territorial administrations. However, AIReF's current scenario no longer considers the adoption of these measures, therefore transfers to the Autonomous Regions and LGs are reduced by 0.2% GDP.

Public consumption is revised upwards due to a higher than expected expenditure on elections. Public consumption is expected to increase by 4.1%, driven by the growth of expenditure on compensation of employees and on elections. Excluding expenditure on elections, public consumption is expected to grow by around 3% according to AIReF's estimates, in line with the forecasts of the report on the initial budgets.

The main component of public consumption is compensation of employees which is expected to grow by 4.6%, slightly above AIReF's forecast of previous reports. The increase in compensation of employees was approved by Royal Decree in December 2018, therefore it has applied to 2019 since the beginning of the year while, in 2018, the update was incorporated into the GSB which was adopted in July, therefore its impact is not observed until August 2018, including the retroactive effects since January. For this reason, the greater growth rates for compensation recorded until July are expected to moderate in the rest of the year.

The rest of public consumption items, with the exception of election expenditure, are kept in line with AIReF's forecasts. Intermediate consumption has been revised upwards slightly in AIReF's forecasts, incorporating 312M€ versus the 177M€ originally expected for election expenditure. In turn, social transfers in kind are maintained with respect to the forecast, presenting a slight reduction compared to 2018 due to the lower discounts on transport prices.

RECUADRO 1. PUBLIC EMPLOYMENT OFFER

The Public Employment Offer (PEO) for the incorporation of new personnel to the CG is approved through Royal Decree, including the internal promotion vacancies and those corresponding to employment on a group contract basis. This publication is the beginning of the process in order to be able to fill the jobs that need to be filled within a maximum period of 3 years. After years of decline, in 2016 the replacement rate increased (percentage of employment terminations that are covered with new staff) to 50% overall and to 100% for certain sectors and the public employment offer substantially increased, especially concentrated in vacancies with free access for new admissions.

Public Employment Offer and replacement rate 2015 - 2019
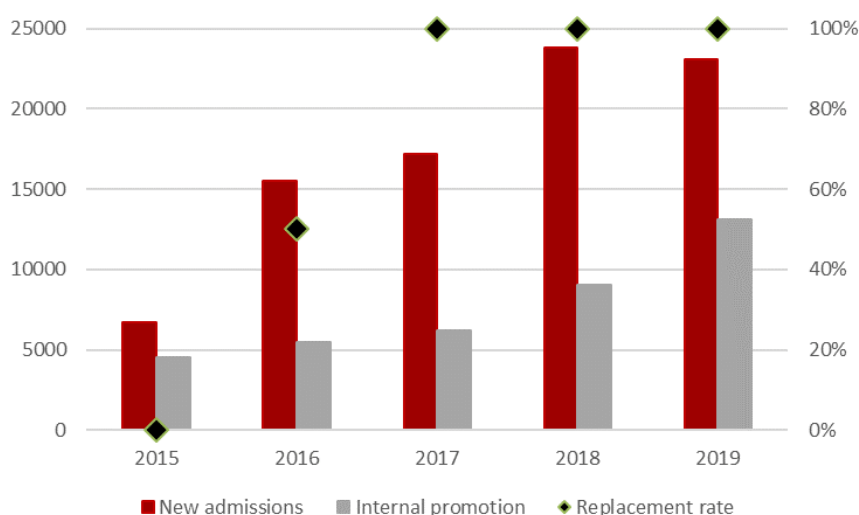
The different PEOs have presented a substantial increase in vacancies for new admissions from 2016, especially significant in 2018 and 2019. On the other hand, the internal promotion vacancies experienced a notable increase in 2019. The impact of this increase in PEO vacancies is not immediate in expenditure on compensation of employees due to the selection and recruitment process itself and due to the effects of retirements in the total number of staff in the CG.

The CG's expenditure on compensation of employees grows above the increase in wages, due to the evolution of the workforces and the sliding effect that occurs because of vacancies, promotions, etc. There are several sources of information on public administration staff and they present important institutional differences. The following table shows the variations included in the Report on staff at the service of the State Public Sector

published by IGAE and the Statistical Bulletin of staff at the service of the PAs published by the Ministry of Land Policy and Public Service.

Evolution of wages and the workforce in the CG 2015 - 2019

	AC Compensation of employees		Wage update	Staff of AGE and its autonomous bodies (IGAE)	Central Personnel Registry (CPR)
	Million €	% Var			
2015	23,721	2.2	0.00%	-0.84%	-1.64%
2016	23,489	-1.0	0.00%	-1.74%	-1.21%
2017	23,200	-1.2	1.00%	-0.97%	-2.01%
2018	23,937	3.2	1.83%	0.35%	-1.03%
2019*	25,037	4.6	2.75%	0.92%	-

* AIReF forecasts

Sources: Personnel at the Service of the State Public Sector (IGAE) and Statistical Bulletin of the personnel at the service of the Public Administrations

For 2019, AIReF has revised its estimate of expenditure on interest downwards compared to its report on the initial budgets. Compared to the report on the initial budgets, the forecast for interests has decreased in line with the execution data to date, the reduction of the costs of the latest Treasury debt issue and the more favourable evolution of the yield curves than initially envisaged. As a result, interests reduce their weight over GDP by 0.2% compared to 2018, standing at around 2% GDP.

Social benefits other than transfers in kind are expected to grow by 5.8%. Civil servants' benefits evolve according to AIReF's estimates and in line with the forecasts included in the GSB given that the revaluation was approved by Royal Decree-Law in December 2018 without being affected by the extension. This heading contains the non-professional caregiver fees that the State assumes and that entail a revenue from contributions to the SSF. In previous reports AIReF considered these fees as a transfer between PAs. The rest of the heading includes negative taxes for deductions for maternity and paternity, large families and dependant family member with disabilities in PIT.

The rest of current expenditure items are revised downwards, essentially due to the lower expenditure on subsidies due to the temporary suspension of the tax on electricity. Expenditure on subsidies includes compensation of costs to the electrical system, a form of compensation that depends on collection of the tax on electricity generation which was suspended for 6 months. The forecast for contributions to the EU is kept in line with the report on the initial

budgets, according to information published on financial flows with the EU, and for the rest of current expenditure.

Capital expenditure is maintained in line with AIReF's forecast in its report on the initial budgets. Investments decreased by 0.2% GDP due to the incidence of non-recurrent items in 2018 that are not repeated in 2019. Investment expenditure excluding these items decreased by 0.9%, remaining far below the level envisaged in the draft GSB that ended up being rejected in the Spanish parliament. In 2018 the State's Financial Liability (SFL) for bailing out toll motorways entailed an increase in Gross Capital Formation of 686 million Euros, in addition to 1,114 million Euros as capital transfer. In addition, 342 million were included for the reversion of the A1 motorway, which is also recorded as a revenue for the same amount. None of these elements are repeated in 2019. Other non-recurrent operations that are repeated in 2019 but with less of an impact are tax credits payable which will change from 1,073 million euros in 2018 to approximately 500 million in 2019. In addition, payments for the Asset Protection Schemes rise slightly compared to the previous report, although still below their impact in 2018. To the contrary, the amount of PIT rebates for maternity rises compared to 2018 and very slightly compared to the previous forecast according to data published in May.

According to the statement by the Ministry of Finance, there is uncertainty about the update of the transfers between PAs linked to the financing system of the Territorial Administrations. In its baseline scenario AIReF has considered that before the end of the year the changes necessary will be implemented so that the transfers provided for in the extension will be updated with regard to the instalment payments to the Autonomous Regions and LGs, and that the rules on the VAT-IIS will not change. With respect to transfers to the SSF, AIReF has considered the transfers included in the extension.

There is no information on contingent liabilities that could have an impact on the expenditure forecasts of the CG. It is common to find extraordinary expenditure items with a significant impact on public accounts, on which there was no prior information, in the information published at the end of the year. As has been pointed out in previous reports, information on fiscal risks, including contingent liabilities, is very limited, despite complying with the requirements of the budgetary frameworks. Thus, other countries regularly publish information on fiscal risks, including details on judicial processes, managed risks in the area of public-private partnerships, guarantees granted, loans provided and non-performing loan rate, etc.

3.4 Social Security Funds

AIReF reduces the estimated deficit of the SSF in 2019 by 1.4% to 1.3% GDP, driven by the improvement in the forecast for social contributions. The growth of affiliation and the contribution bases allow revenue to grow above expenditure. Affiliation to Social Security is maintaining the good tone with which it ended 2018, although in recent months it is showing signs of slowing, which is offset with the positive evolution of the contribution bases. On the one hand, average affiliation increased year-on-year in June by 2.7% against 2.9% in January. The slowdown in the General Tax Regime, which most influences the system's collection, is less pronounced with a year-on-year rate that goes from a 3.3% in January to 3.2% in June, while in the Autonomous Regions the rate falls from 1.3% in January to 0.4% in June. This slowdown is more than offset by the evolution of the contribution bases driven by wage growth and the measures adopted.

AIReF continues to consider it very unlikely that the target of 0.9% GDP will be achieved, although it is feasible for the SSF to reach the deficit notified for 2019 of 1.4% GDP. Compliance with the legally approved target would require the SSF to make an adjustment of 0.5% GDP on the -1.4% GDP reached in 2018, an adjustment that is considered to be very unlikely. To finance the sub-sector's deficit, close to 17,000 M€, a transfer of 1,334 M€ has been created, intended to support the system's budgetary balance. The remaining amount will be covered with a new loan of 13,830 M€ and with the provision of part of the Reserve Fund, which had assets worth approximately 5,000 M€ at the end of 2018.
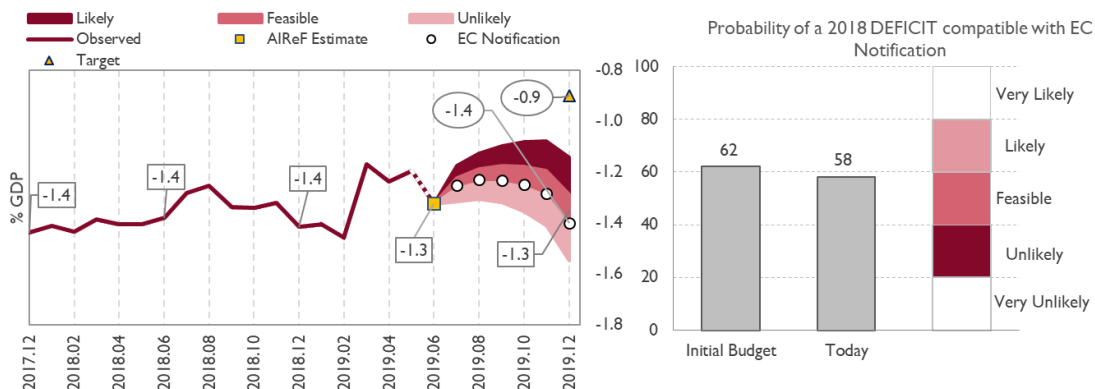
With respect to its report on the initial budgets, AIReF raises the SSF revenue forecast to 13.2% GDP for 2019. In variation rates, it is estimated that the SSF revenue in 12-month accumulated terms will increase in the first half the year by 7% year-on-year, thanks to the transfers received from the State and the good behaviour of contributions, which grew in cash terms by 6.3%, with their growth expected to accelerate to 7.5% in the remaining part of the year. In this way, the SSF revenue in 12-month accumulated terms until June reaches 13.1% GDP , 0.3% more than one year prior, which is partly explained by the important transfers from the State to the Social Security System in March, including 666 M€ intended to support the system's equilibrium, while last year the transfers received were concentrated in July.

AIReF's forecast for the end of the year places expenditure at 14.5% GDP, a level similar to that estimated in the previous report. In 12-month accumulated terms, non-financial expenditure accounted for 14.5% GDP in June, 0.4% more than in June 2018. In terms of variation rates expenditure grew by 6% in the last 12 months. AIReF expects that this growth will be maintained for the rest of the
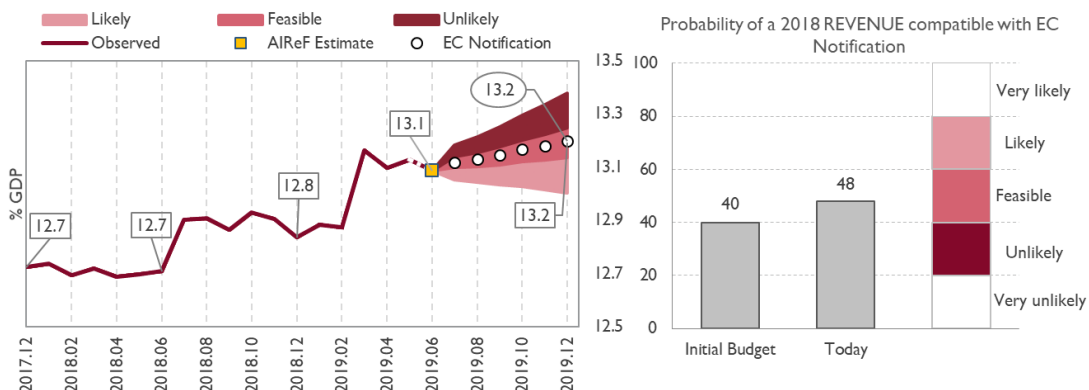
year, influenced by the evolution of its main components, pension expenditure and unemployment. It is therefore expected that pension expenditure at the end of 2019 will grow to 5.9%, slightly above the figure forecasted in the previous report due to an increase in the number of pensions slightly higher than initially estimated. On the other hand, unemployment expenditure is expected to increase by 3.7%, after the stagnation of 2018. Overall expenditure, with inertial growth above 4%, is driven by the measures adopted on pensions and unemployment and, to a lesser extent, on paternity and family benefits.

GRAPH 9.   SOCIAL SECURITY FUNDS

GRAPH 9.A.   NET LENDING/BORROWING (% GDP)

Probability of a 2018 DEFICIT compatible with EC Notification

GRAPH 9.B.   FSS REVENUE (%GDP)

Probability of a 2018 REVENUE compatible with EC Notification

GRAPH 9.C.   CONTRIBUTIONS ON CASH (%GDP)

CONTRIBUTIONS Budget target compliance probability
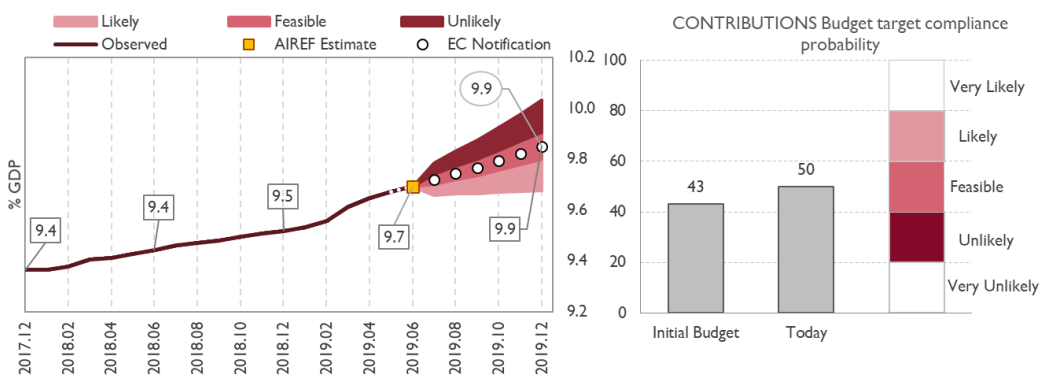
GRAPH 9.D.   FSS EXPENDITURE (%GDP)
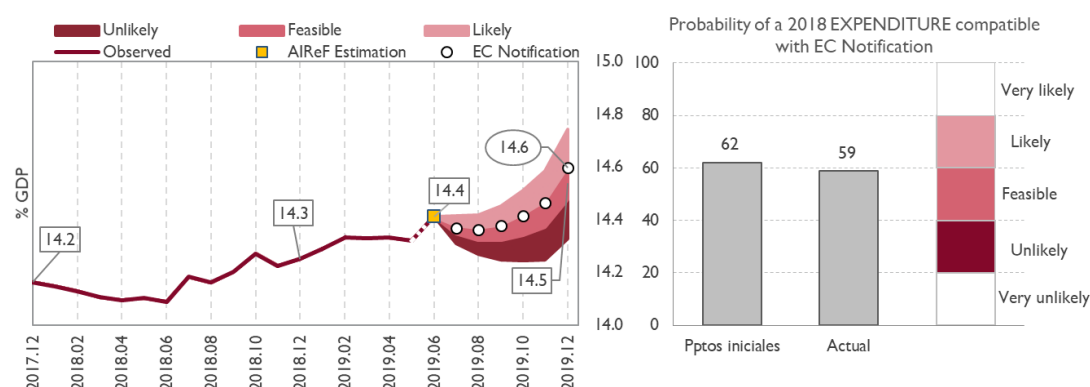
Analysis by agents

Social Security System

According to AIReF's forecasts, in 2019 the Social Security System will maintain a deficit similar to that of 2018. Social security contributions will grow strongly, above 7%. The transfers received from the State remain at the level of last year, after years of decline due to the drop-in weight of pension supplementation benefits. Revenues from returns of the Reserve Fund confirm their token weight, with just 200 M€.

The evolution of the labour market and the gradual increase in the contribution bases will allow a growth of contributions around 7.5%, above the estimate of the report on the initial budgets. This growth is significantly higher than in 2018 (5.4%). The growth of the contribution bases continues to gradually increase in line with inflation, with a significant contribution of the legal maximum and minimum bases, which increased by 7% and 22%, respectively, due to the measures adopted, well above the increase in 2018 of 1.4% and 0%, respectively. The budgetary execution data until May reflects a growth of contributions of the employed of 7.8% and of the unemployed of 9.7%, higher than that initially forecasted.

Returns of the Reserve Fund continue their declining path in 2019. After reaching its highest level in 2011 with an amount of 66,815M€, the Social Security Reserve Fund has been disposing of its resources until closing 2018 with an amount of around 5,000M€. This, alongside the reduced profitability of government debt in which the Reserve Fund invests, leads to the forecast that the income from its returns will only just reach 200M€ in 2019.

Pension expenditure will grow by almost 6%, higher than expected in the previous report due to a larger increase in the number of pensions than initially

estimated. In December[9] the Government approved a general revaluation of 1.6% and 3% for minimum and non-contributory pensions, as implemented in August 2018. In addition, the Government established[10] two increases for most widowhood pensions of approximately 7.5% each: the first in August 2018 and the second in January 2019. In sum, pension expenditure grew by 4.7%, explained by the growth in the number of pensions (1.3%), the general revaluation (1.6%) and the substitution effect (1.6%). With the remaining measures adopted, pension expenditure accelerates to 5.9%, more than 1% above last year's rate. For its part, the monthly profile of expenditure on contributory pensions in budgetary terms is consistent with the time of adoption of the measures indicated. The acceleration from August 2018 onwards is due to the revaluation of that year and the first increase in widowhood pensions, while measures of January 2019 generate a further acceleration. In this way, the year-on-year rate of the first half of 2019, 7%, records the cumulative effect of the measures of both years. In the last months of the year, in which there are only additional 2019 measures, the rate should fall to around 5%, so that for the entire year the rate is consistent with the 5.9% estimated for pension expenditure in National Accounting terms.

[9] Royal Decree-Law 28/2018, of 28 December, for the revaluation of public pensions and other urgent measures in social, labour and employment matters.

[10] Royal Decree 900/2018, of 20 July, for the implementation of the 30th additional provision of Law 27/2011, of 1 August, on the update, adequacy and modernisation of the Social Security system, regarding the widowhood pension.

GRAPH 10.   BREAKDOWN OF PENSION EXPENDITURE AND MONTHLY PROFILE
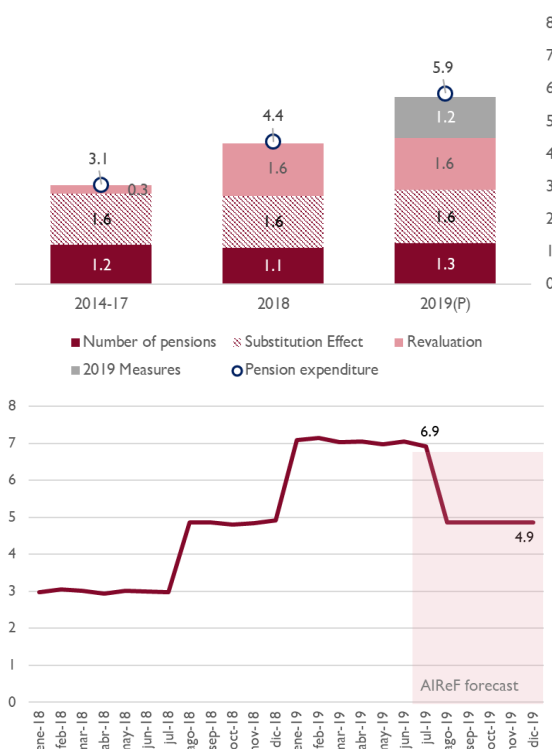
For the rest of the items AIReF expects an evolution similar to that of the last report. The IGAE does not present a breakdown of benefits other than those in kind, therefore the evolution of each item, which are estimated with budgetary execution data, is not known, considering that in 2018 there was a slight insufficiency in the expenditure appropriation for the temporary disability benefit. The recovery of employment and affiliation has led to average growth rates close to 10% between 2015 and 2018. Accordingly, it is estimated that temporary disability will grow to around 8% in 2019. On the other hand, the evaluation of previous reports on the extension of paternity leave to three weeks [11] and the increase in the child allowance[12] is maintained.

Recourse to State loans to finance the Social Security deficit will continue. In June 7,500M€ of the 13,830 M€ of the loan from the State for 2019 was made available. This loan, like those granted in 2017 and 2018, will not accrue interest and has a maximum settlement deadline of 10 years. Together with the debt owed to the State in the early '90s, accrued liabilities of Social Security are expected to exceed 55,000 M€ by the end of this year.

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[11] Royal Decree-law 6/2019, of 1 March, on urgent measures to guarantee equal treatment and equal opportunities between women and men in employment and occupation.
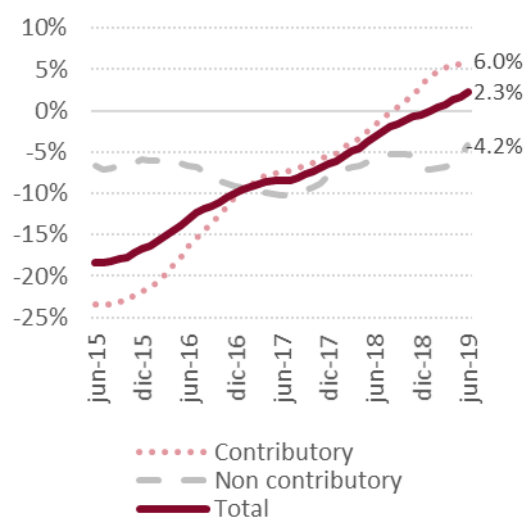
[12] Royal Decree-law 8/2019, of 8 March, on urgent measures for social protection and the fight against job insecurity in the working day

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

In 2019 the State Public Employment Service will present a surplus of 0.2% GDP, higher than that of 2018. As was the case last year, there is no recourse to transfers from the State. The greater surplus is explained by a growth in contributions above 7% and a growth in benefits around 4%, following six years of negative rates, due to the standardisation of the labor market and the measures adopted. The main measure in this area is the reinstatement of the subsidy for people aged over 52 years[1], with an estimated impact of 225 M€. In addition, it is estimated that the impact of the Minimum Wage on Social Security contributions, which are part of unemployment benefits, will be about 400 M€.

In 12-month cumulative terms, expenditure on unemployment benefits accelerated to 2.3%, versus the decline of 0.5% in 2018. Expenditure on contributory benefits has accelerated to 6%, against 3.1% in 2018. In turn, non-contributory benefits have moderated their downturn to 4.2%, below the 6.9% of the previous year. It is especially worth noting the growth of 16.3% in the quota of beneficiaries of the unemployment subsidy, probably linked to the increase in the amount from 100% to 125% of the minimum contribution base for persons aged over 52. In this sense, it is also worth noting how, in the first three months since this subsidy was reformed, around 30,000 beneficiaries have signed up to it, in line with the 114,000 expected by the end of the year.

GRAPH 11.   EVOLUTION OF UNEMPLOYMENT EXPENDITURE: 12-MONTH CUMULATIVE RATE OF CHANGE AND CONTRIBUTIONS TO GROWTH

[1] Royal Decree-law 8/2019, of 8 March, on urgent measures for social protection and the fight against job insecurity in the working day
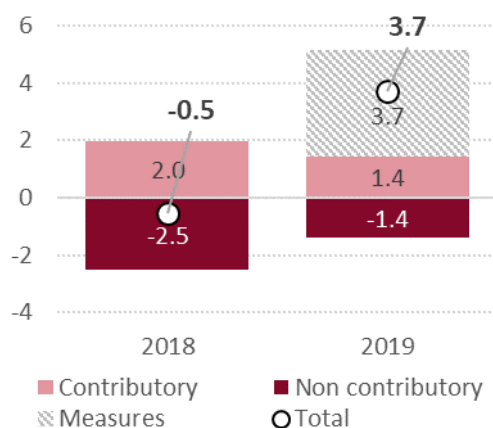
With regard to the FOGASA the surplus in 2019 is expected to be similar to 2018. The latest budgetary execution data point to a surplus at year-end of approximately 200M€.

3.5 Autonomous Regions

3.5.1 Stability Target

AIReF has dropped its assessment compared to the report on the initial budgets, from feasible to unlikely to comply with the budgetary stability target. The analysis of the new information received and the execution data to date, has resulted in a deterioration of the assessment of compliance with the target made in the report on the initial budgets, which is no longer feasible but rather considered unlikely. This change in the assessment is due, on the one hand, to the lower estimate of income from funds received from the European Union (EU) and collection of traditional taxes ceded and, on the other hand, the increase in the expenditure forecast driven by staff expenditure.

In addition, the absence of a change to the VAT-IIS reduces this assessment to very unlikely[13]. According to information communicated by the MINHAC the measure aimed at changing the time limits for input into the VAT-IIS are not expected to be adopted. This would mean that the Autonomous Regions under the common tax regime would not offset the negative impact of this rule on the settlement of the Regional Financing System's (RFS) resources of 2017, which will be received in 2019. As a result, the Autonomous Regions would no longer input this compensation in 2019, with a collection loss of close

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[13] See Box 1 of the Report on the main budgetary lines and draft budgets of the PAs: draft GSB for 2019

to 2,500 million euros (0.2% GDP), which leads to the consideration that, in this scenario, it is very unlikely that the sub-sector will comply with the stability target.

With the current information, the estimate of revenue from EU funds for 2019 and traditional ceded taxes has been revised downward. According to the new information received, it has been possible to obtain further breakdown of EU funds that the Autonomous Regions obtained in 2018 as a result of the final settlement of the Operational Programmes 2007-2013, more accurately identifying those that were exceptional and will not be repeated in 2019. The amount of these extraordinary funds was higher than estimated in the report on the initial budgets, which has entailed a downward correction of the sub-sector's revenue forecasts for 2019. In addition, budgetary execution data shows some slowdown in the growth of traditional ceded taxes, especially the Tax on Property Transfers and Documented Legal Acts (TPTDLA).

On the other hand, the forecast for current expenditure has been revised upwards, notably with an increase in staff expenditure. With the current information provided by the Autonomous Regions and execution data to date, the estimate of regional current expenditure has been corrected upwards. Therefore, the forecasted growth of intermediate consumption and, above all, staff expenditure increased, and at the end of 2019 there is expected to be an increase close to 5%, although with differences between Autonomous Regions ranging from growth below 3% to increases of 7%.
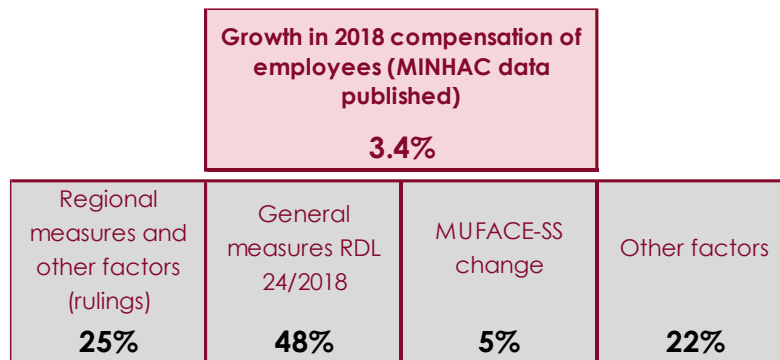
In line with the above considerations, AIReF revised the growth of the Autonomous Regions' revenue downwards, forecasting a decline of around 0.3% of its weight over GDP compared to the end of 2018. The current forecast is that the Autonomous Regions' overall revenue will grow below 2%, appreciating a decline in its weight over GDP of around 0.3%, of which 0.2% stem from the consideration of the current revenue scenario of the financing system. In particular, the RFS' resources are expected to grow by 3.5%, while there is expected to be a decrease in the rest of revenue items primarily because significant revenue items recorded as one-offs in 2018, such as the Ruling of the Supreme Court in favour of the Canary Islands for road investment agreements and the settlement of EU funds from the Operational Programmes 2007-2013, will not be replicated.

Regarding expenditure, AIReF maintains the forecast for 2019 that their weight over GDP will fall slightly. Expenditure is expected to grow above 3%, compared to the level of 2018, reducing its weight over GDP by around 0.1%, in line with the report on the initial budgets. In terms of its composition, it is expected that current expenditure will increase by 4% compared to 2018 and, conversely, investment will drop which will lead to a decline in overall capital
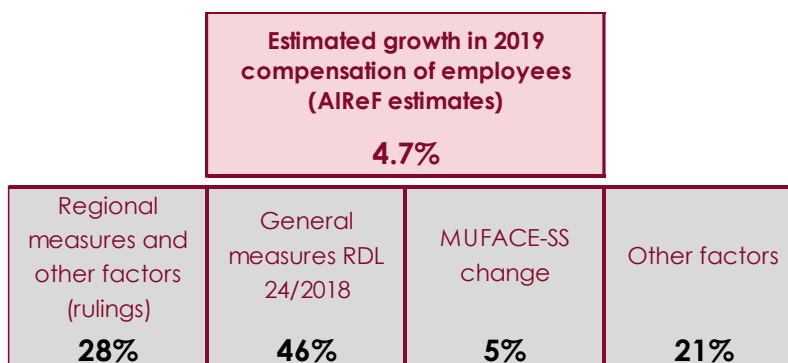
expenditure as the level of non-recurrent operations recorded in 2018 in this category will not be replicated.

RECUADRO 2.   GROWTH FACTORS IN COMPENSATION OF EMPLOYEES IN THE AUTONOMOUS REGIONS.

The Autonomous Regions have provided updated information on the measures adopted in the field of staff, in addition to those arising from Royal Decree-Law 24/2018, of 21 December, as well as on other factors that have influenced the variation of these expenditure items in the previous year and that may have an impact throughout the year. This is the case of the higher expenditure resulting from the change in the contributions of General Spanish Civil Service Mutual Insurance Company (MUFACE) to Social Security in the replacement of employees that seems to have a significant impact in some Autonomous Regions, or from the rulings on staff from agreements adopted in previous years.

Growth in 2018 compensation of employees (MINHAC data published) 3.4%			
Regional measures and other factors (rulings) 25%	General measures RDL 24/2018 48%	MUFACE-SS change 5%	Other factors 22%

Based on this information and the observed execution data to date, AIReF's forecasts on compensation of employees in 2019 have been revised, incorporating the impact of the measures envisaged and the estimate of the effect of other factors.

Estimated growth in 2019 compensation of employees (AIReF estimates) 4.7%			
Regional measures and other factors (rulings) 28%	General measures RDL 24/2018 46%	MUFACE-SS change 5%	Other factors 21%

GRAPH 12.   AUTONOMOUS REGIONS (% GDP)

GRAPH 12.A.   REGIONAL NET LENDING/BORROWING (% GDP)
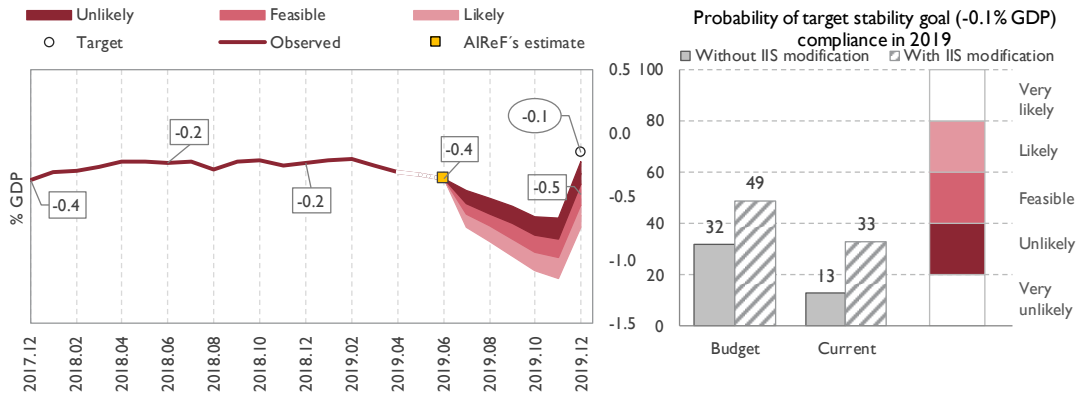
GRAPH 12.B.   REGIONAL REVENUE (% GDP)

GRAPH 12.C.   EXPENDITURE (% GDP)

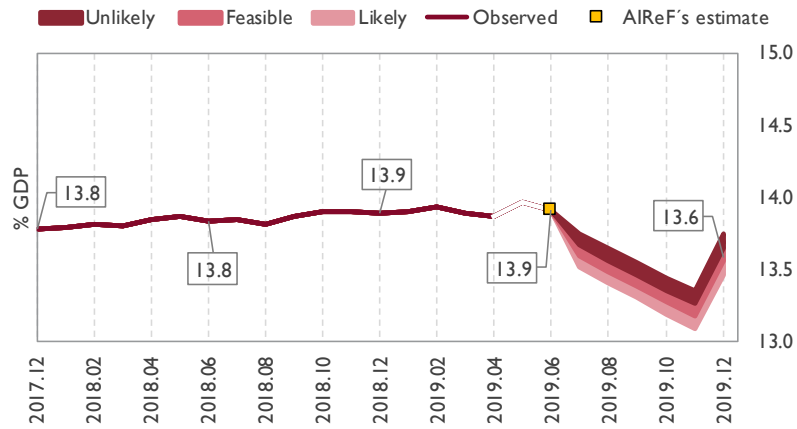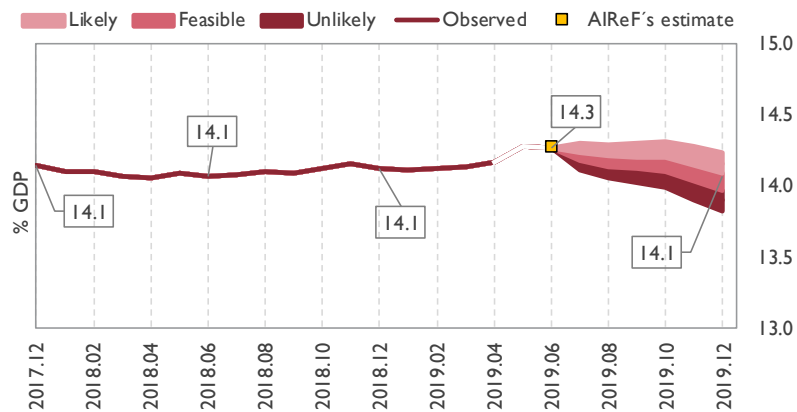Regarding the individual analysis, the probability of complying with the stability target has generally worsened.[14] AIReF only maintains the same assessment for 5 Autonomous Regions: on the one hand, for Navarre and Basque Country, which are not affected substantially by the modification of the VAT-IIS, and the Canary Islands, which is kept at very likely despite the revision of revenue; and on the other hand, for Murcia and Valencia for which compliance was already considered very unlikely. However, for the remaining 12 Autonomous Regions the changes in the probability rating may either come from the revision of revenue and expenditure resulting from the new information available (Asturias, Balearic Islands, Castile-La Mancha, Catalonia, Extremadura and Madrid) and, as the case may be, later worsen due to the new scenario that does not provide for the settlement of the VAT-IIS (Asturias, Balearic Islands, Madrid and Catalonia), or mainly stem from the latter new scenario (Andalusia, Aragon, Cantabria, Castile and Leon, Galicia and La Rioja).

TABLE 9.   INDIVIDUAL ESTIMATE OF COMPLIANCE WITH THE STABILITY TARGET FOR 2019. COMPARISON WITH THE PREVIOUS REPORT

Regions	Initial budgets 2019		Expected compliance 2019 (Compensation of VAT-IIS)		Expected compliance 2019 (Non-compensation of VAT-IIS)	
	Rating	Probability	Rating	Probability	Rating	Probability
Andalusia	Feasible	57	Feasible	49	Unlikely	20
Aragon	Unlikely	34	Unlikely	26	Very unlikely	12
Asturias	Likely	67	Feasible	49	Unlikely	20
Balearic Islands	Feasible	54	Unlikely	21	Very unlikely	10
Canary Islands	Very Likely	99	Very likely	99	Very likely	97
Cantabria	Feasible	52	Feasible	41	Very unlikely	16
Castile and Leon	Feasible	41	Feasible	40	Unlikely	20
Castile La Mancha	Unlikely	30	Very unlikely	16	Very unlikely	3
Catalonia	Feasible	45	Unlikely	31	Very unlikely	13
Extremadura	Unlikely	26	Very unlikely	1	Very unlikely	1
Galicia	Likely	69	Likely	69	Feasible	43
Madrid	Likely	61	Feasible	47	Unlikely	31
Murcia	Very unlikely	1	Very unlikely	1	Very unlikely	1
Navarre	Very Likely	86	Very likely	93	Very likely	93
Basque Country	Very Likely	82	Very likely	81	Very likely	81
Rioja	Feasible	53	Feasible	48	Unlikely	27
Valencia	Very unlikely	1	Very unlikely	1	Very unlikely	1
Total Regions	**Feasible**	**49**	**Unlikely**	**33**	**Very unlikely**	**13**

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[14] For the individual situation of each Region, the individual reports on the closing estimates of the Autonomous Regions for 2019 contain a detailed analysis by Region, published on AIReF's website.

In conclusion, AIReF expects that 7 Autonomous Regions will not comply with the stability target with the new information available, increasing to 13 Autonomous Regions if the new forecasted revenue scenario is considered. As a result of the revision of revenue and expenditure, the Autonomous Regions as in the previous report (Aragon, Castile-La Mancha, Extremadura, Murcia and Valencia) are not expected to comply, now with the addition of Balearic Islands and Catalonia. Of these, 3 would be unlikely and 4 would be very unlikely. In addition, if we consider the new scenario that does not envisage the settlement of the VAT-IIS, these 7 Autonomous Regions would be joined by a further 6 Autonomous Regions that are not expected to comply with the stability target (Andalusia, Asturias, Cantabria, Castile and Leon, Madrid and La Rioja) amounting to a total of 13 Autonomous Regions, of which 5 would be unlikely and 8 very unlikely.

In general, the Autonomous Regions included the revenue from settlement of the IIS in their budgets, with an impact ranging between 0.15% GDP and almost 0.4% GDP. Most of the Autonomous Regions counted this revenue when preparing their budgets. Only Aragon, the Canary Islands, Extremadura and Madrid, had not initially incorporated it in their initial budgets or forecasts. In the case of Murcia, La Rioja, the Balearic Islands and Valencia, although they did include this revenue, they removed it from their current closing forecast scenarios. The impact estimated by AIReF of what this revenue could entail for each Region individually ranges from 0.15% GDP in Madrid to close to 0.4% GDP in Extremadura, (see TABLE 10).

TABLE 10. INDIVIDUAL ESTIMATE OF THE IMPACT OF THE VAT-IIS

Regions	Impact of IIS (% GDP)
Andalusia	0.29%
Aragon	0.22%
Asturias	0.28%
Balearic Islands	0.15%
Canary Islands	0.23%
Cantabria	0.32%
Castile and Leon	0.27%
Castile La Mancha	0.29%
Catalonia	0.19%
Extremadura	0.39%
Galicia	0.29%
Madrid	0.15%
Murcia	0.24%
Rioja	0.28%
Valencia	0.20%
Total Regions	**0.21%**

3.6 Local Governments

AIReF reduces its assessment of the local surplus compared to its estimate in the April report on the budgets for 2019, placing it around 0.4% GDP. Both in the reports of October 2018 and January and April 2019, AIReF considered it feasible that the LG sub-sector would reach a surplus of around 0.5% GDP this year, although slightly below the result for 2018 of 0.52%. The information on the end of 2018, published in March 2019, as well as the data reported by the LGs to MINHAC on the initial budgets, confirmed these estimates.

AIReF expects a reduction in the surplus of the 24 large LCs individually analysed in 2019. To date, the execution data of the first quarter and the closing estimate for 2019 provided to AIReF by the 24 large LCs individually analysed, representing around 35% of the overall surplus on average over the last 5 years, show a reduction of the expected result for the group of 7 percentage points. This reduction in the surplus projected by the large LCs is particularly significant in the City Council of Madrid, which reduces its forecasts by over 75% compared to that settled in 2018, with an effect that AIReF estimates will be lower than communicated, but still significant in the total group and in the sub-sector as a whole. In the same sense, the sub-sector information published by the IGAE on execution in the first quarter of the year

shows a significant reduction in the net lending of the local sub-sector, 77 %, although at the start of each year this information tends not to be particularly representative of the result to be obtained at year-end as the trend is corrected throughout the year. Similarly, the financial side shows a slight deterioration in the net liability position of the LGs due to an increase in financial debt. All this appears to suggest that the net lending of the local sub-sector could worsen by around 0.05% compared to AIReF's estimate in the report of April of this year, placing the surplus to be obtained at around 0.4% GDP (see graph 13.a).

AIReF's baseline scenario is also reduced due to the non-neutralisation of the impact of the VAT-IIS on the financing system's resources. In addition, the closing estimates for 2019 are negatively affected by around 0.05% GDP due to the non-approval of the standard that amends the deadline for input into the VAT-IIS, as has been indicated in previous points in the report. This affects the estimated surplus for 2019, which is expected to drop by 0.1%.

GRAPH 13.   LOCAL GOVERNMENTS (% OF GDP)

GRAPH 13.A.   NET LENDING/BORROWING (% GDP)
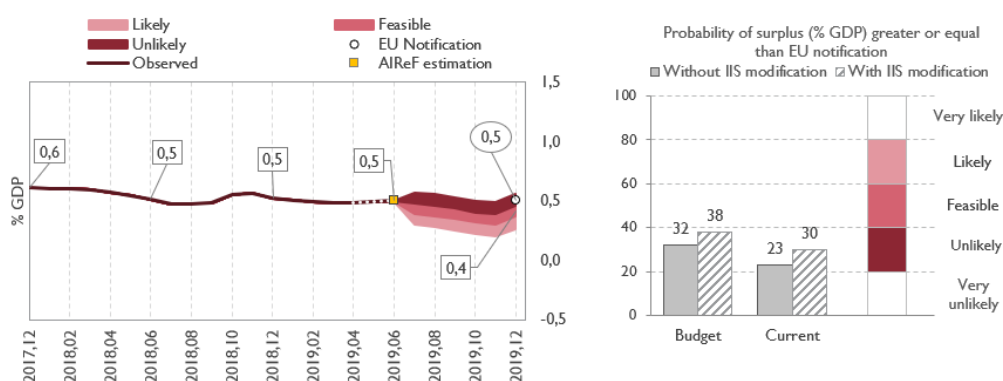
GRAPH 13.B.   NON-FINANCIAL REVENUE (% OF GDP)
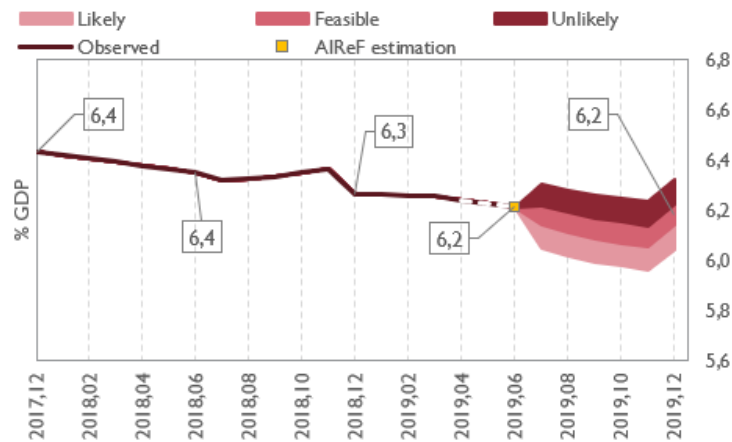
GRAPH 13.C.   NON-FINANCIAL EXPENDITURE (% GDP)
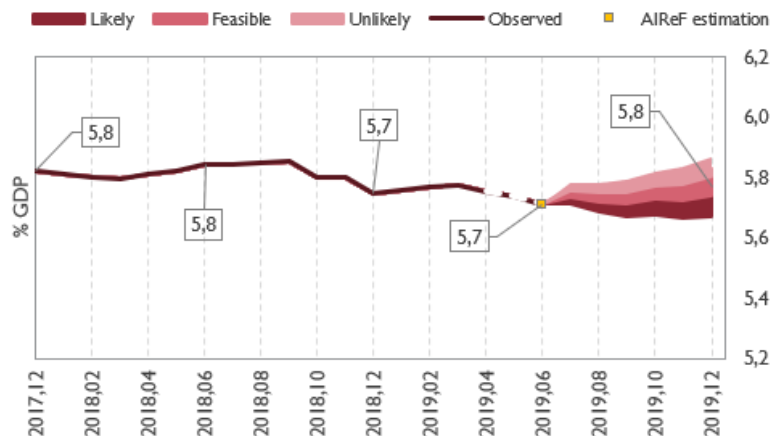
AIReF has revised its revenue forecasts for 2019, mainly due to the negative effect of the revenue returns on the municipal tax on capital gains, arising from the implementation of the Ruling of the Constitutional Court of May 2017. The data provided to AIReF by the 16 large City Councils individually analysed have shown an attenuation in the growth of their tax revenue, due to the negative effect on collection of the tax on the increase in value of urban land of the implementation of the Ruling of the Constitutional Court dated 11 May 2017. Collection of this tax represents almost 90% of that corresponding to the capital taxes of the LGs and, that of the 16 large City Councils represents almost 50% of the national total. Considering the possible increased incidence of this lower collection on the large LGs compared to the small ones, and considering their impact on the LGs as a whole, AIReF has estimated that the sub-sector's revenue from capital taxes could drop by around 300M€, which

has led to AIReF's downward revision of the revenue stream estimated at the end of this year.

The worsening of AIReF's estimates of the local surplus for 2019 is mainly due to the upward revision of expenditure growth forecasts. The closing information for 2019 estimated by the large LGs shows a growth in staff expenditure, other current expenditure and investment expenditure much higher than the rate that allows compliance with the expenditure rule. In the same sense, the latest quarterly information published for the sector as a whole reflects a growth of this expenditure of over 6%. Both pieces of information have led to the upward revision of the expenditure growth estimated by AIReF for 2019 (see graph 13.c).

AIReF estimates that staff expenditure in 2019 will maintain an average increase of around 3.5%. The information provided by the large LCs on the estimate for the end of the year shows an average growth of staff expenditure above 5%. This information is particularly affected by the increase, of almost 10%, communicated by the City Council of Madrid.

According to AIReF's estimates staff expenditure is expected to grow by around 3.5% in 2019. AIReF has carried out a simulation to estimate the amount expected in 2019 for this heading, which represents almost 20% of non-financial expenditure, on the basis of average affiliation data published by the Treasury General of Social Security (TGSS) and the wage increases and staff replacement approved in Royal Decree-Law 24/2018, of 21 December. According to this simulation, staff expenditure will grow by around 3.5% in 2019 compared to 2018, 0.8% above the approved rate for calculating the expenditure rule. This growth forecast is consistent with the sub-sector's quarterly accounts for the first quarter of the year, published by the IGAE, where the year-on-year growth of this expenditure exceeds 3%, expected to be replicated throughout the year as these are recurrent expenditure items without major fluctuations throughout the year.

AIReF expects that current expenditure on goods and services will grow slightly above the expenditure growth rate approved for calculating the expenditure rule. The data provided by the large LCs show estimated average growth of current expenditure for this year of over 9%. However, the result obtained at year-end will depend on the degree of execution achieved. AIReF estimates that, given the execution realised, its growth will be above that permitted by the growth rate of the expenditure rule.

AIReF has revised its forecasts for investment expenditure upwards, mainly due to the incorporation in 2019 of the execution of financially sustainable investments in 2018. The closing information for 2019 provided by the large LGs shows an average growth of investment expenditure around 6%. This increase

is mainly due to the possibility contained in Royal Decree-Law 1/2018 of committing to and recognising financially sustainable investment projects in 2019 that could not be fully implemented in 2018, provided that the LG does not incur a deficit at year-end. This possibility has led the total sub-sector's investment expenditure in the first quarter to grow 30% over the same period last year, due to the completion of the 2018 investments, a growth that is expected to attenuate throughout the year.

The supplementary report that accompanies this report analyses the 24 large LGs. None show risk of non-compliance with their stability targets (0% GDP) in 2019, as detailed in TABLE 11.

TABLE 11. COMPARATIVE VIEW OF COMPLIANCE WITH THE STABILITY TARGET FOR 2018 AND 2019 OF THE 24 LARGE LOCAL GOVERNMENTS

LOCAL GOVERNMENTS	STABILITY TARGET (ST)	
	2018 year-end	2019 Forecast
MADRID	✓	✓
BARCELONA	✓	✓
VALENCIA	✓	✓
SEVILLE	✓	✓
ZARAGOZA	✓	✓
MALAGA	✓	✓
MURCIA	✓	✓
PALMA	✓	✓
LAS PALMAS DE GRAN CANARIA	✓	✓
BILBAO	✓	✓
ALICANTE	✓	✓
CORDOBA	✓	✓

| LOCAL GOVERNMENTS	STABILITY TARGET (ST)	
	2018 year-end	2019 Forecast
VALLADOLID	✓	✓
VIGO	✗	✓
GIJÓN	✓	✓
L'HOSPITALET DE LLOBREGAT	✓	✓
Council of BARCELONA	✓	✓
Council of VALENCIA	✓	✓
Council of SEVILLE	✓	✓
ISLAND COUNCIL OF TENERIFE	✓	✓
ISLAND COUNCIL OF MALLORCA	✓	✓
PROVINCIAL COUNCIL OF ARABA/ÁLAVA	✓	✓
PROVINCIAL COUNCIL OF GIPUZKOA	✓	✓
PROVINCIAL COUNCIL OF BIZKAIA	✓	✓

| ✓ | Compliance | ✗ | Non-compliance |

The supplementary report also details the individual analysis of the 24 LGs with medium-term sustainability risk according to the methodology followed in previous reports. Regarding their compliance with the stability target for 2019 (0% GDP), those for which recommendations were made in the previous report due to risk of non-compliance with the target, such as the City Councils of Parla, Jaén, Los Barrios, Navalcarnero and Almonte, were analysed in greater detail. Except for the City Council of Los Barrios, for which a surplus is expected,

in the rest of these City Councils there is risk of non-compliance with the stability target. The same happens in the case of the City Council of Jerez de la Frontera for which the previous report estimated a surplus.

4 EXPENDITURE RULE

The aggregate computable expenditure of the CG, Autonomous Regions and LGs is not expected to comply with the expenditure rule. The decrease in the CG's computable expenditure does not offset the growth of the rest of the sub-sectors, meaning the aggregate of the CG, Autonomous Regions and LGs is not expected to comply with the expenditure rule. There is different behaviour between sub-sectors, with computable expenditure remaining stable in the CG against expenditure growth in the rest of the sub-sectors, although this evolution is due to the impact of non-recurrent operations. Conversely, the policy measures that entail lower collection in the CG are much higher than those adopted by the rest of the sub-sectors, which entail permanent collection increases.

GRAPH 14.   COMPLIANCE WITH THE EXPENDITURE RULE BY SUB-SECTORS
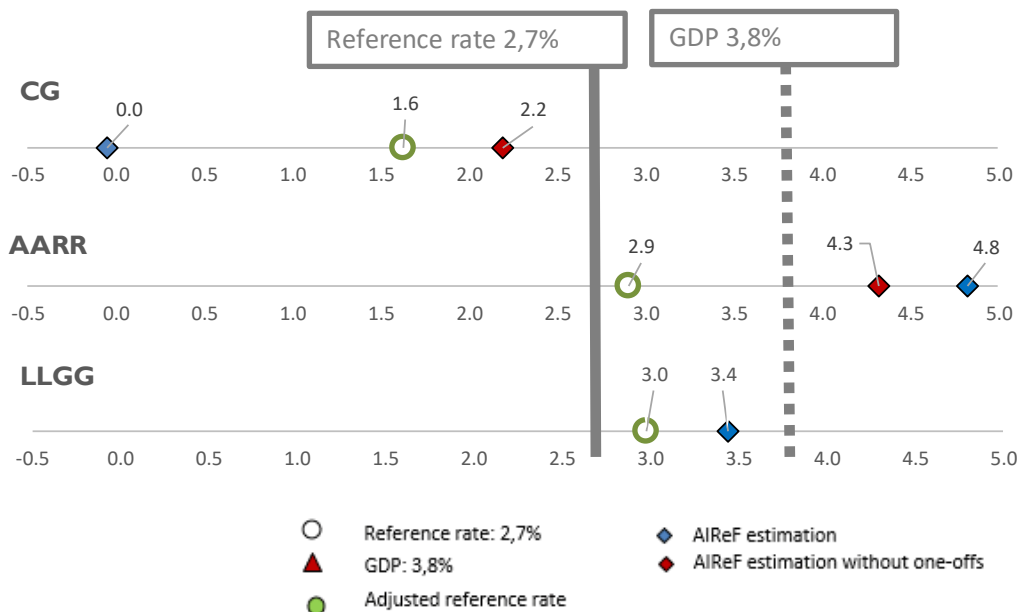
In an exercise of approximation to the EU expenditure rule that incorporates the expenditure of the SSF, the GG is expected to grow well above the reference rate adjusted for revenue measures. Although the expenditure rule does not apply to the SSF, an approximation to the rule envisaged in the EU legislation would achieve a growth computable expenditure of 4.8%, above the reference rate adjusted for measures and below nominal GDP growth. In

past reports the approximation to the EU expenditure rule was less exact as it fully eliminated expenditure on unemployment benefits and did not exclude non-recurrent operations. On this occasion, only the non-discretionary component of unemployment benefits calculated according to the EU methodology is removed from the SSF expenditure and the exercise is performed with and without non-recurrent operations.

GRAPH 15.   PA COMPLIANCE WITH THE EXPENDITURE RULE

4.1 Central Government

The computable expenditure is kept constant compared with the end of 2018, therefore complying with the expenditure rule. AIReF's forecasts made with the available information allow it to estimate that computable expenditure will remain at the level of the previous year, with zero growth and below the 2.7% set for the reference rate approved for 2019. The growth of compensation of employees and expenditure on civil servants' benefits is offset by the lower investments and investment aid, due to the non-repetition in 2019 of the SFL and the lower impact of DTAs compared to 2018.

GRAPH 16.   AC COMPUTABLE EXPENDITURE AND COMPLIANCE WITH THE EXPENDITURE RULE
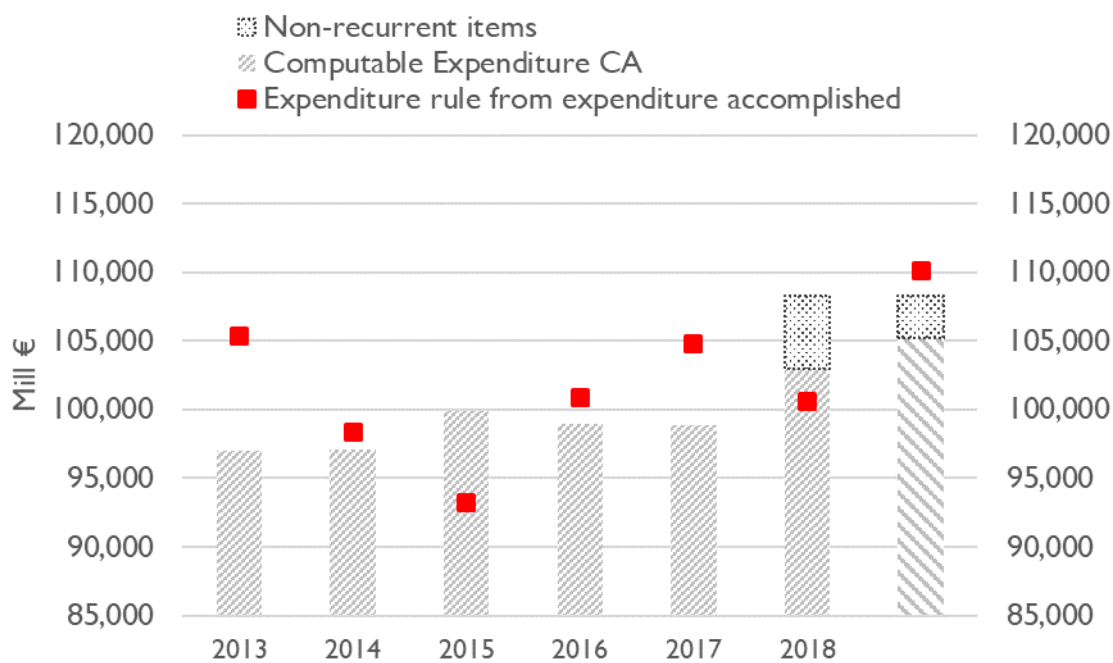
The policy measures adopted to lower collection reduce the adjusted reference rate to 1.6%. In 2019 the impact of the permanent policy measures considered by AIReF involve lower PIT collection of 1,167 million euros. Considering the impact of these measures, computable expenditure could have grown up to 1.6% and complied with the expenditure rule.

However, this compliance is the result of certain non-recurrent operations and not an effort to restrain expenditure. Excluding the effect of the non-recurrent items, the CG's computable expenditure is expected to grow by 2.2% and not comply with the expenditure rule adjusted for the measures taken.

In any case, the scope for discretionary expenditure in the CG is reduced, with over 51% of expenditure to make transfers to other PAs. This discretionary expenditure has recorded significant reductions over the years of fiscal consolidation while remaining relatively stable since 2016, with a slight upturn in 2018 primarily due to the improvement in remuneration and an increase in investments, even without taking into account the SFL of toll motorways. In 2019 the discretionary expenditure reduced as a result of the extension of the GSB and lesser impact of certain non-recurrent measures such as the materialisation of the tax credits due.

GRAPH 17. EVOLUTION OF THE AC'S EXPENDITURE WITHOUT TRANSFERS TO THE PAS, INTEREST, CIVIL SERVANTS AND EU CONTRIBUTIONS (%GDP) WITHOUT SFL
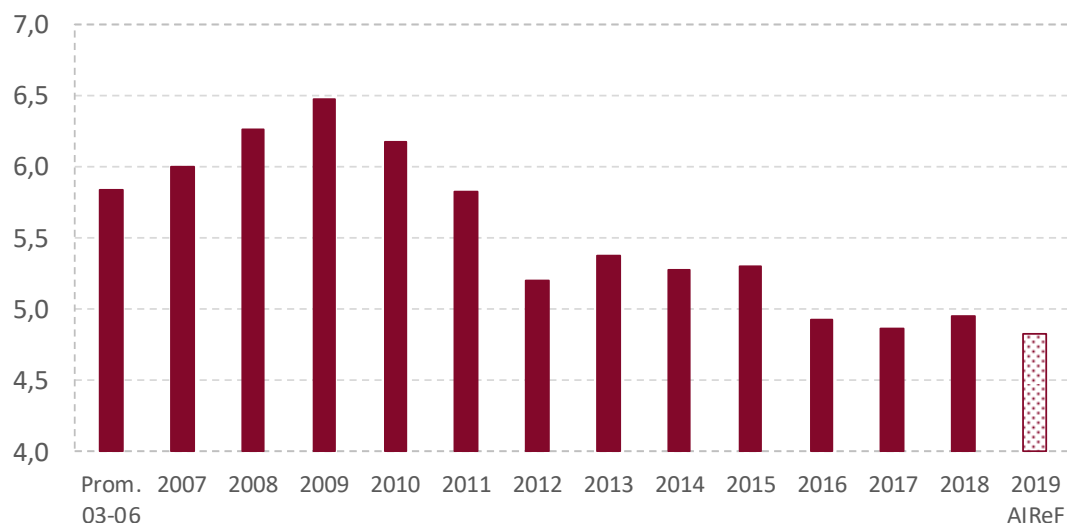
4.2 Autonomous Regions

The risk of non-compliance with the expenditure rule is accentuated in 2019 compared to the report on the initial budgets, passing from moderate to high. The expenditure growth above 3% reveals a moderate risk that computable expenditure will grow above the reference rate of 2.7% in 2019. However, incorporating the new information available on EU funds expected for 2019, the risk of non-compliance with the expenditure rule is increased compared to the previous report, which is now considered high for the sub-sector.

GRAPH 18.   EXPENDITURE RULE - AUTONOMOUS REGIONS
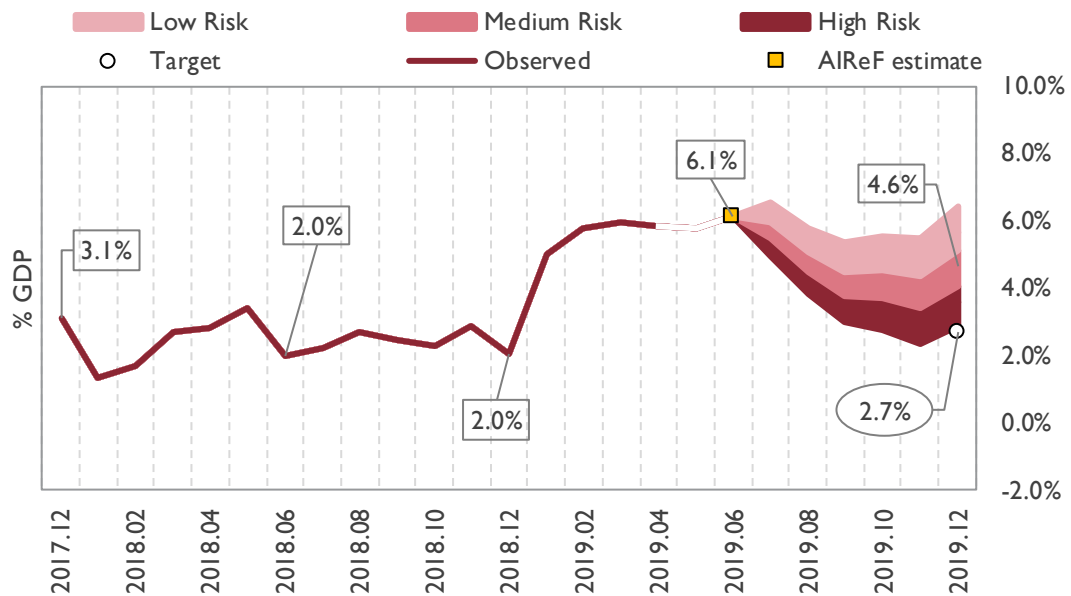
The lower forecast of EU funds for 2019 is the main factor that aggravates the risk of non-compliance. Although the part of expenditure financed by EU funds is not part of computable expenditure and, therefore, should have a neutral effect on compliance with the rule, the calculation method used to exclude this expenditure from computable expenditure conditions compliance with the rule, sometimes positively and sometimes negatively. In 2019 it is expected to have a negative impact, since the amount of EU funds excluded from computable expenditure will be much lower than in 2018, which makes compliance difficult (see recuadro 3).

RECUADRO 3.   EFFECT OF EXPENDITURE FINANCED WITH FUNDS PROVIDED BY THE EUROPEAN UNION ON COMPLIANCE WITH THE EXPENDITURE RULE.

In theory, the expenditure financed with funds from the European Union (EU) should not affect compliance with the expenditure rule. The purpose of this rule is for the growth of the public administrations' expenditure to be limited by the capacity to finance it with revenue that is stable and sustained over time.

For this reason, the design of this rule, both in the national regulations (article 12 of the LOEPySF) and in the European regulations, excludes the share of expenditure financed with EU funds from its scope of application, since the legislator does not intend to limit the growth of this expenditure that already has earmarked funding.

However, in practice, the method used to calculate the exclusion of this expenditure produces a major distortion in the calculation of the rule, affecting its compliance. Expenditure made in each year that is certified in the same should be excluded, for meeting the requirements to recognise the revenue from the funds that finance it. In practice, however, the revenue from the funds is excluded for the expenditure certified in the year (regardless of whether the expenditure was made in this or in previous years), or sometimes for certifications made in previous years (settlement of operational programmes).

This approximate calculation method would not cause any distortion if the revenue from the funds for each year always corresponded to the expenditure made in the same year (Case A), with which an amount included therein would be excluded from the computable expenditure of each year. But this equivalence does not always occur because the funds recognised in one year may correspond to expenditure made in previous years (Case B).

Case A: Equivalence between the funds received and expenditure made in the year
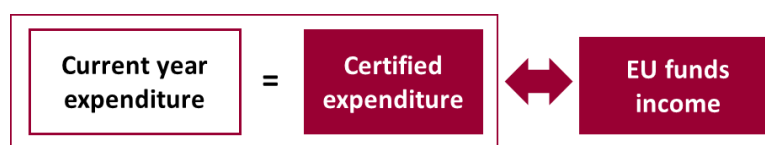
Case B: Non-equivalence between the funds received and expenditure made in the year
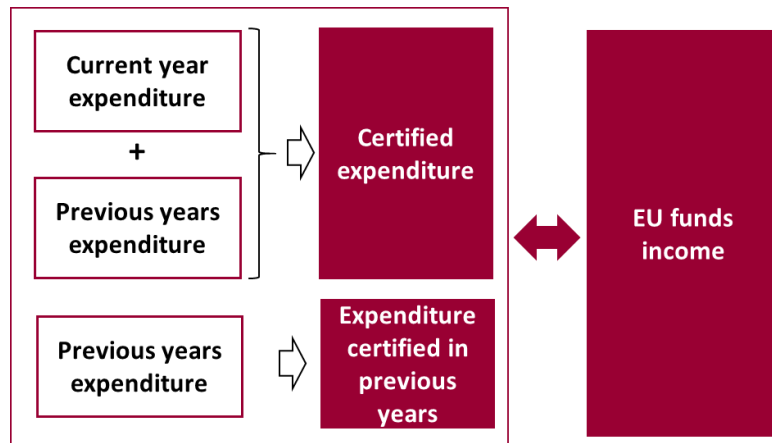
In the years that is recognised revenue from funds corresponding to expenditure made in previous years, an expenditure that is not recorded in the year is excluded from the expenditure rule, therefore a greater amount than recorded will be excluded, favouring compliance with the rule in this year. On the contrary, there will be years in which an expenditure is made that is not certified and, therefore, does not give rise to revenue recognition. In this case an amount lower than that recorded will be excluded, which will make compliance with the rule more difficult.

Therefore, the EU funds received each year will make it easier or more difficult to comply with the expenditure rule. This goes against the intention of the legislature because, on the one hand, compliance with the expenditure rule becomes dependent on a circumstance that is not always equivalent with the expenditure made in the year, on the other, because the alleged neutrality of the expenditure that is already financed with EU funds is not achieved in the calculation of the expenditure rule.

This is precisely the situation that occurred in 2018, when the Autonomous Regions received a significant increase in EU funds for the final settlement of the Operational Programme 2007-2013. This has facilitated or allowed, depending on the amount, compliance with the expenditure rule. On the contrary, in 2019, the Autonomous Regions will receive less funding in comparison with 2018, which, in some cases, will make it more significantly more difficult to comply with the expenditure rule this year.

At the individual level, the risk of non-compliance with the expenditure rule worsens in most of the Autonomous Regions. It is estimated that the risk will especially worsen in those Autonomous Regions that received more extraordinary funds from the EU in 2018 for the settlement of the Operational Programme 2007-2013. In other Autonomous Regions the higher risk of non-compliance stems from the growth of current expenditure, largely due to the impact of non-recurrent operations -non-repetition of the lower expenditure

charged in 2018 or higher expenditure expected in 2019 (Madrid and Basque Country)- or, due to the higher expected impact of the tax cuts adopted (Canary Islands).

With the current information, the risk is now considered high in 11 Autonomous Regions AIReF appreciates a high risk of non-compliance with the expenditure rule in the Autonomous Regions of Asturias, Balearic Islands, Canary Islands, Castile-La Mancha, Catalonia, Extremadura, Madrid, Navarre, Basque Country and Murcia, in addition to Valencia for which a high risk was appreciated in the previous report. For all of them in 2019 there is expected to be an increase in computable expenditure above the 3.8% nominal GDP growth expected by AIReF. However, recommendations have only been made related to the correction of these deviations for those Autonomous Regions (Balearic Islands, Canary Islands, Madrid, Murcia, Navarre and the Valencia) whose computable expenditure growth remains above 3.8%, even after excluding non-recurrent operations and having removed the distorting effect of EU funds in the calculation of the expenditure rule.

TABLE 12. INDIVIDUAL ESTIMATE OF COMPLIANCE WITH THE EXPENDITURE RULE 2019. COMPARISON WITH PREVIOUS REPORT. COMPUTABLE EXPENDITURE GROWTH FORECAST

Regions	Risk of non-compliance with the 2019 expenditure rule of 2.7%			Growth range of computable expenditure Underlying value (*)
	Reports on 2019 Budgets	Reports on expected compliance at end of 2019		
		Assessment	Growth range (computable expenditure according to art. 12 LOEPySF)	
Andalusia	Moderate risk	Moderate risk	(2.3 - 3.5)	(2.6 - 3.7)
Aragon	Moderate risk	Moderate risk	(1.8 - 3.0)	(0.7 - 1.9)
Asturias	Moderate risk	High risk	(4.8 - 5.9)	(2.3 - 3.4)
Balearic Islands	Moderate risk	High risk	(4.7 - 5.9)	(7.0 - 8.1)
Canary Islands	Moderate risk	High risk	(6.8 - 8.0)	(5.6 - 6.8)
Cantabria	Moderate risk	Moderate risk	(3.0 - 4.2)	(1.2 - 2.4)
Castile and Leon	Moderate risk	Moderate risk	(2.0 - 3.2)	(1.4 - 2.5)
Castile La Mancha	Moderate risk	High risk	(4.8 - 6.0)	(3.0 - 4.1)
Catalonia	Moderate risk	High risk	(3.8 - 4.9)	(3.3 - 4.4)
Extremadura	Moderate risk	High risk	(6.7 - 7.9)	(1.7 - 2.9)
Galicia	Moderate risk	Moderate risk	(1.7 - 2.8)	(1.0 - 2.2)
Madrid	Moderate risk	High risk	(5.4 - 6.6)	(4.0 - 5.1)
Murcia	Moderate risk	High risk	(4.8 - 5.9)	(4.2 - 5.3)
Navarre	Moderate risk	High risk	(3.8 - 4.9)	(3.9 - 5.1)
Basque Country	Moderate risk	High risk	(4.6 - 5.8)	(2.6 - 3.7)
Rioja	Moderate risk	Moderate risk	(1.9 - 3.1)	(1.7 - 2.9)
Valencia	High risk	High risk	(5.6 - 6.7)	(5.7 - 6.8)
Total Regions	**Moderate risk**	**High risk**	**(4.0 - 5.2)**	**(3.8 - 5.0)**

(*) The range of computable expenditure growth has been calculated by removing non-recurrent operations and extraordinary revenue derived from EU Funds.

It indicates those Regions whose range of computable expenditure growth values exceeds nominal GDP growth (3.8%).

AIReF considers it desirable to minimise the impact of the functioning of EU funds on compliance with the expenditure rule. In order to prevent compliance with the expenditure rule being affected by the functioning of EU funds, it would be advisable to seek out formulas that, at least, contribute to minimising this effect. Some proposals could involve charging a constant percentage of revenue over the total funds corresponding to each Operational Programme each year, or averaging the amount of EU funds excluded each year for a period of four years (similar to what is done in the EU to soften the impact of investments on the expenditure rule).

4.3 Local Governments

AIReF estimates that a surplus slightly higher than 0.4% GDP would enable the LG sub-sector to comply with the expenditure rule in 2019. According to AIReF's estimates, the minimum net lending that would enable compliance with both fiscal rules should be slightly above 0.4% GDP. However, there are risks of non-compliance with the expenditure rule in 2019 stemming from the amount of expenditure excluded this year, particularly in financially sustainable investments (FSI). AIReF has estimated that, if the rest of the exclusions remain constant, expenditure on FSI should be at least 15% more than in 2018 in order to comply with the expenditure rule. If the FSI estimates communicated by the large LCs were to be confirmed for the entire sub-sector, compliance with this rule could be achieved, although difficult.

The following figure shows the lending capacity necessary for the LG sub-sector to comply with both fiscal rules at the end of 2019, estimating it to be feasible if the surplus were slightly above 0.4% GDP.

GRAPH 19.　　LENDING CAPACITY OF THE LG SUB-SECTOR THAT ENABLES COMPLIANCE WITH THE EXPENDITURE RULE AT THE END OF 2019 (%GDP)
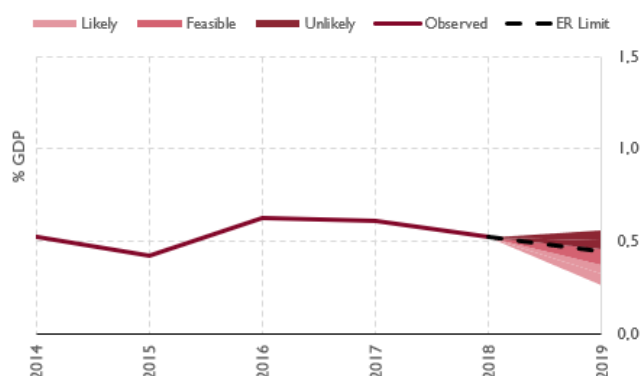
Moreover, the following figure shows the evolution of the joint compliance with these fiscal rules and the positive margin (compliance) or negative (non-compliance) of each of them over the annual target.

GRAPH 20.　　　LG SUB-SECTOR JOINT COMPLIANCE WITH THE STABILITY TARGET AND EXPENDITURE RULE 2013-2018 AND AIREF'S ESTIMATES FOR 2019 (MARGIN OVER TARGET AND % OVER NON-FINANCIAL REVENUE AND NON-FINANCIAL EXPENDITURE FOR EXPENDITURE RULE)
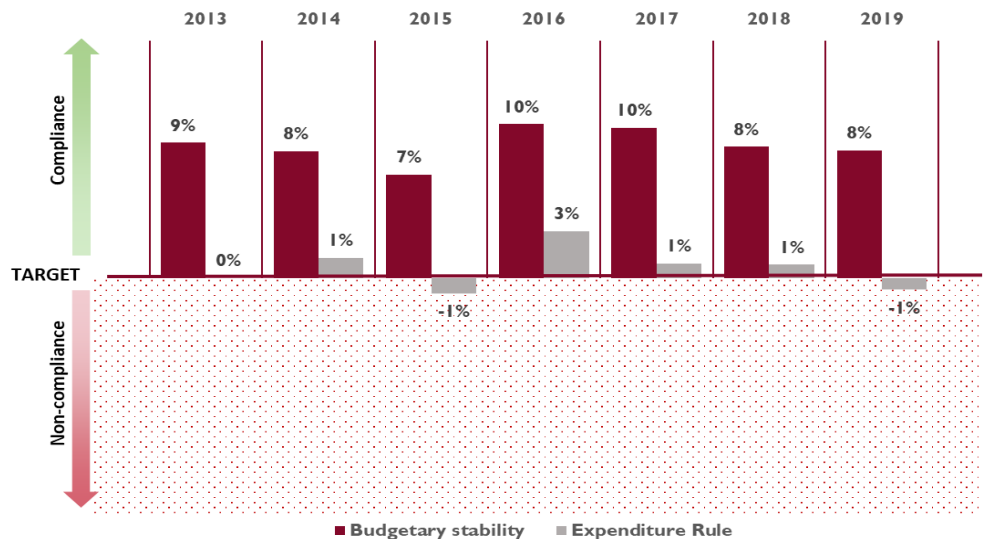
Regarding the LGs individually analysed, there are risks of non-compliance with the expenditure rule in 2019 in the City Councils of Madrid, Valencia, Las Palmas de Gran Canaria and Cordoba, as well as in the Island Council of Tenerife. In the case of Barcelona and Seville, which failed to comply with the expenditure rule in 2018, compliance with this rule was not evaluated as they do not have approved Economic-Financial Plans (EFP).

TABLE 13.   COMPARATIVE VIEW OF COMPLIANCE WITH THE EXPENDITURE RULE FOR 2018 AND 2019 OF THE 24 LARGE LOCAL GOVERNMENTS

LOCAL GOVERNMENTS	EXPENDITURE RULE (ER)		LOCAL GOVERNMENTS	EXPENDITURE RULE (ER)	
	2018 year-end	2019 Forecast		2018 year-end	2019 Forecast
MADRID	✓	✗	VALLADOLID	✓	✓
BARCELONA	✗	**Without EFP**	VIGO	✗	✓
VALENCIA	(*)	✗	GIJÓN	✗	✓
SEVILLE	✗	**Without EFP**	L'HOSPITALET DE LLOBREGAT	✗	✓
ZARAGOZA	✓	✓	Council of BARCELONA	✓	✓
MALAGA	✓	✓	Council of VALENCIA	✓	✓
MURCIA	✓	✓	Council of SEVILLE	✓	✓
PALMA	✓	✓	ISLAND COUNCIL OF TENERIFE	✓	✗
LAS PALMAS DE GRAN CANARIA	✓	✗	ISLAND COUNCIL OF MALLORCA	✓	✓
BILBAO	✓	✓	PROVINCIAL COUNCIL OF ARABA/ÁLAVA	✓	✓
ALICANTE	✓	✓	PROVINCIAL COUNCIL OF GIPUZKOA	✓	✓
CORDOBA	✓	✗	PROVINCIAL COUNCIL OF BIZKAIA	✓	✓

✓	Compliance	✗	Non-compliance

(*)   **As it does not have an EFP approved for non-compliance with the expenditure rule in 2017 (according to application of the homogeneous criteria of the IGAE and applied to the rest of the LGs), it complies with the expenditure rule in 2018.**

Regarding the city councils with sustainability issues for which AIReF has deepened its analysis, there are risks of non-compliance with the expenditure rule in Jerez de la Frontera, Almonte and Jaén.

5 GOVERNMENT DEBT

5.1 General Government sector

5.1.1 Recent evolution and medium-term vision

Despite the strong economic growth experienced in the last five years, the debt-to-GDP ratio has barely been corrected, staying close to 100%. Between the first quarter of 2014 and 2019 nominal GDP has accumulated an increase of 15%. However, the debt-to-GDP ratio corresponding to the first quarter of 2019 stood at 98.7%, the same level as one year earlier and even higher than the 98.1% in the first quarter of 2014. Given the level of growth of the Spanish economy in recent years, the government debt ratio of the PAs is among those that have reduced the least in Europe.

GRAPH 21.   INCREASE IN DEBT (% GDP) AND ACCUMULATED GROWTH (% VAR)
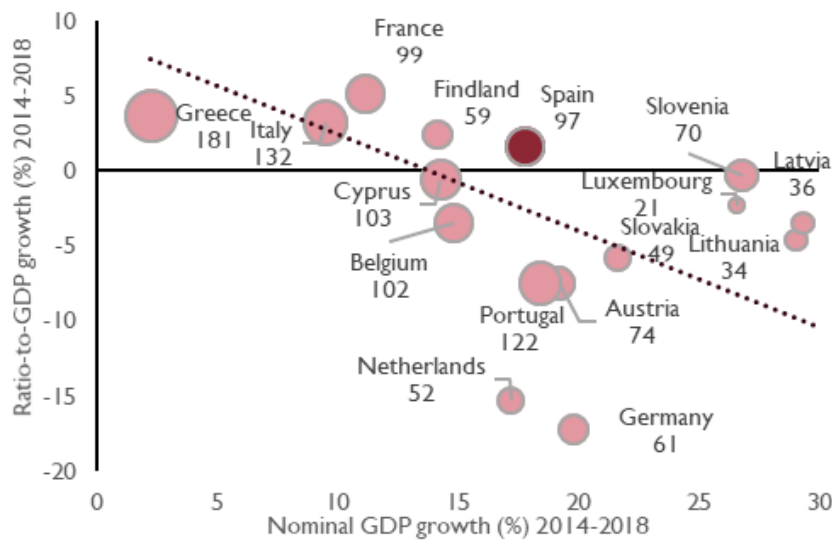
Note: The size of the circumference corresponds to the debt-to-GDP ratio in the third quarter of 2018.
Source: AIReF

In the medium-term, the achievement of primary surpluses along with a growth of around 2% will allow a more pronounced correction, to reach around 89% GDP in 2022. For the 2019-2022 period in its normative scenario AIReF expects a gradual reduction compared to the end of 2018 (97.1%) of around 2 percentage points on average per year, ending the period with a level slightly below 90%. This correction is supported by strong nominal growth

at the beginning of the period and a gradual improvement of the primary balances as the forecasting horizon progresses.

GRAPH 22.   CONTRIBUTION TO THE CHANGE IN DEBT (%GDP)
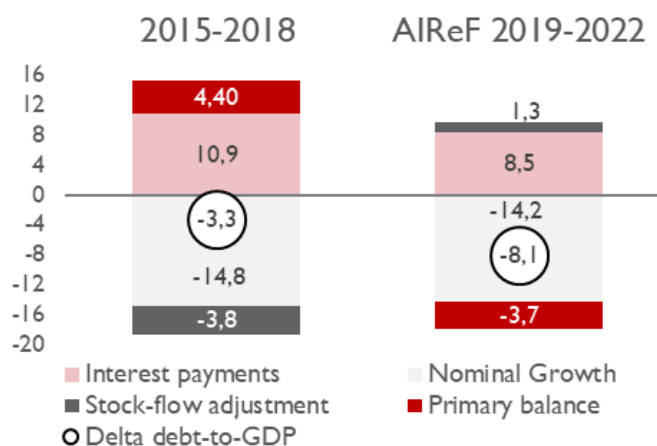
Source: AIReF

5.1.2 Compliance with the debt target

Despite having complied with the debt target in 2018, AIReF estimates that compliance will be unlikely at the level of the PAs in 2019. The public debt targets for the 2018-2020 period were laid down by the Agreement of the Council of Ministers (ACM) of 7 July 2017, both for the GG sector and for each of the sub-sectors. At the end of 2018 the debt-to-GDP ratio stood at 97.1% GDP, which implies compliance with the debt target for the GG sector with a margin of 0.5%. At the sub-sector level, the sum of the CG and SSF has been in line with their target (with a margin of compliance of 0.1% GDP), the LCs complied comfortably (0.6 points of margin), which has served to offset the divergence from the initial target (0.2 points) of the Autonomous Regions. [15] For the end of 2019 AIReF projects a debt-to-GDP ratio of 96.1% for the GG sector. This figure is 0.7% above the debt target set for that year and its compliance is estimated as unlikely according to AIReF's projection models. In the case of the joint debt of the CG and the SSF, AIReF projects that they will not reach the target set in 2019.

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[15] At the individual level, the initial debt target of each Region can be rectified in accordance with a series of exceptions approved in the aforementioned ACM. Therefore, this implies a rectification to the regional sub-sector. Historically, the target finally recalculated has been greater than the target initially set.

TABLE 14. INITIAL DEBT TARGETS AND FORECASTS (EDP AS % GDP).

| EDP Debt Targets (% GDP)	2018		2019		
	CMA July 2017	Observed	CMA July 2017	Observed	AIReF
Central Government and Social Security Funds	70,8	70,7	69,5	..	70,6
Autonomous Communities	24,1	24,3	23,3	..	23,7
Local Government	2,7	2,1	2,6	..	1,9
General Government	97,6	97,1	95,4	95,8	96,1

The current system for setting annual targets suffers several shortcomings and does not provide an adequate view of the medium-term sustainability of the debt path. As AIReF has pointed out in previous reports, an unrestrictive system for setting debt targets means that, in general, they lack economic rationale. In addition, the current system does not consider the relationship between stock and flow variables nor a medium-term view. To ensure financial sustainability, the debt targets must be set in relation to a medium-term anchor that ensures that the debt reduces to safe levels, making the different rules consistent with one another.[16]

5.1.3 Sustainability analysis

The Stability Programme Update, presented by the Government at the end of April, projected a medium-term path in line with AIReF's projections and foresaw non-compliance with the debt target for 2019 and 2020. The Stability Programme Update 2019-2022 contains a declining debt-to-GDP ratio for the PAs throughout the entire period, with a cumulative adjustment of 8.4 throughout the projection horizon. For the 2018-2020 period, the cumulative reduction in the debt-to-GDP ratio of the 2019-2022 SPU is slightly higher than projected by AIReF (4 tenths of a percentage point), but less than that required to comply with the debt target (2 percentage points). This is in part due to the time lag implicit in the current debt targets, which have not been updated since 2017 nor do they take into account the latest closing data for 2018. As can be seen in graph 23, the path of the SPU is within the area considered feasible based on AIReF's forecasts.

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[16] Cuerpo, C. and Rodríguez, L, *Some elements for a revamped fiscal framework for Spain*, WP 03/2018, AIReF

GRAPH 23.   **PTOBABILITY OF COMPLIANCE WITH ACM AND SPU** debt target**S**
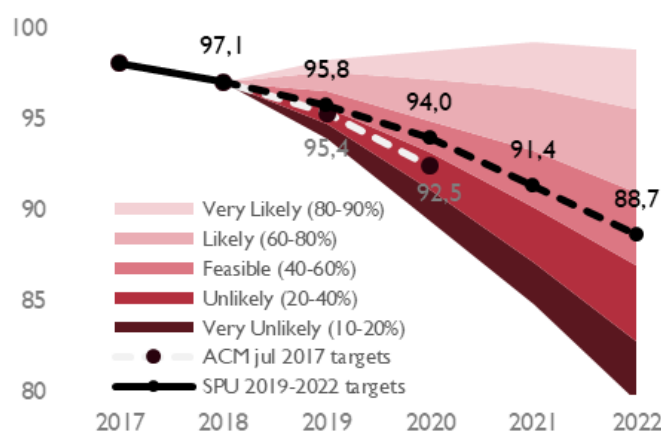
Source: Banco de España, MINECO (Ministry of Economy), AIReF

As in the past four years, it is projected that in 2019 the reduction in the debt-to-GDP ratio will remain consistent with what is required by the LOEPySF. As has been noted previously, the 1st Transitional Provision of the LOEPySF requires that the debt-to-GDP ratio should be reduced by at least 2% GDP per year when real GDP or expenditure growth are above 2%. 2018 was the fourth consecutive year where economic and expenditure growth rates above 2% were observed. However, the debt-to-GDP ratio of the PAs did not reduce by more than 2% GDP in any of these years, with the mean reduction for the years from 2015 to 2018 being approximately 0.8 percentage points per year. As in previous reports AIReF projects that, once again, this regulation will not be complied with in 2019.

5.2 Autonomous Regions

The Autonomous Regions are expected to comply with the debt target for 2019, while maintaining the current system for setting these targets. According to the information provided by the Autonomous Regions, the net increase in indebtedness that these forecast for 2019 is envisaged by the current system for setting debt targets, which would allow their compliance if this system is maintained. In general, as AIReF has reiterated in previous reports[17], the broad

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[17] Report on the PAs' expected compliance with the stability and debt targets and with the expenditure rule for 2019

definition of the debt target means that, except for specific exceptions[18], the Autonomous Regions have always complied with the debt target and it is foreseeable that they will also comply in 2019.

The target is higher than the annual borrowing requirement of most Autonomous Regions, despite the fact that the MINHAC notes having reduced its scope for 2018. The MINHAC has argued that the debt targets are set as a maximum limit. However, it has notified AIReF[19] actions taken[20] in 2018 intended to ensure that the Autonomous Regions adjust the debt to the deficit actually incurred in line with AIReF's recommendations and, therefore, the debt data at the end of 2018 reflect this adjustment. This Institution welcomes moving the debt target closer to the real borrowing requirements of the Autonomous Regions, making the target more restrictive and realistic. However, despite the adjustment indicated by the MINHAC, most of the Autonomous Regions don't even exhaust the limit set by the target, which remains far from their annual borrowing requirements (see graph 24).

GRAPH 24. **BORROWING MARGINS NOT EXHAUSTED BY THE AUTONOMOUS REGIONS IN RELATION TO THE DEBT TARGET (% OF GDP). 2018 DATA**
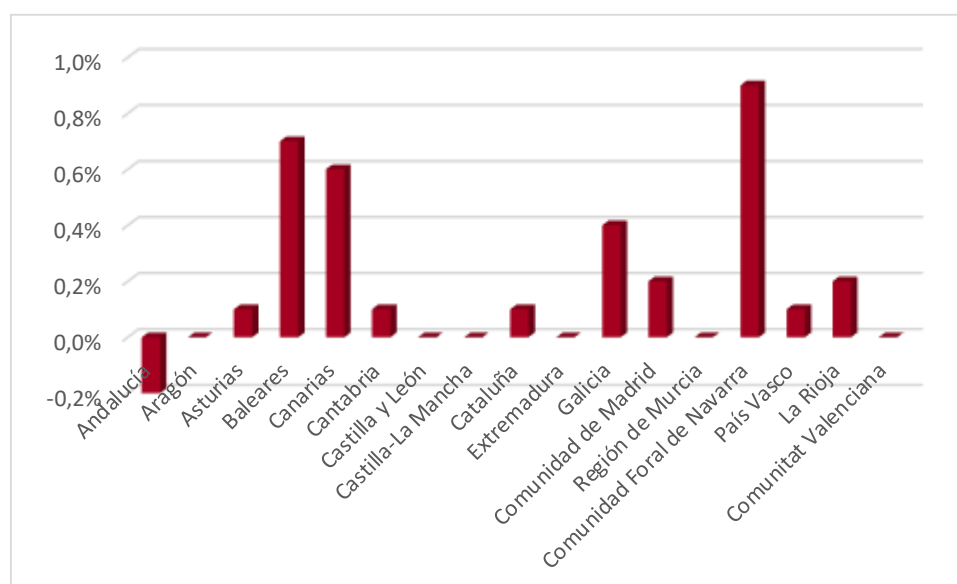
Note: Andalusia did not comply with the debt target in 2018 due the reclassification of the PPA of the Seville Metro.

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[18] In the past three years there were two cases of non-compliance: Extremadura, in 2017, due to a time lag in the receipt of additional liquidity mechanisms and Andalusia, in 2018, due to reclassification of the public-private association (PPA) of the Seville Metro.

[19] In MINHAC's response to AIReF's recommendations made in the Report on the initial budgets of the PAs for 2019.

[20] In this sense, AIReF has learned of the existence of questionnaires for the destination of the surplus from the information provided by the Autonomous Regions

The breadth of the debt target carries the risk that the Autonomous Regions will consider that they are reducing their debt by not exhausting the borrowing margin permitted. Some Autonomous Regions have interpreted that they have reduced their debt by the amount of the margin not used with respect to the debt limit permitted by the target. As mentioned above, these targets are very loose as they are higher than the annual borrowing requirements of the Autonomous Regions and mainly for those that have a healthier fiscal position and begin to generate a surplus.

Therefore, the debt target should consider the surplus obtained in the previous year as well as the sustainability criteria, with an assessment of the debt dynamics in the medium-term. The debt target should incorporate the surplus obtained in the previous year, as this entails lending capacity for the following year. In addition, it should consider sustainability and convergence toward the reference levels in the medium-term. The consistency between the debt target and the fiscal situation of the Autonomous Regions allows more realistic debt targets to be set and, in addition, the correct and transparent application of the destination of the surplus in compliance with article 32 of the LOEPySF.

The criteria for verification of compliance with the debt target should be known at the time of setting the targets. The MINHAC report of 10 May on the degree of compliance with the 2018 targets revealed the treatment given to the surplus of 2017 as well as the new approach to the debt permitted to the Autonomous Regions that have made FSI in 2018. At the time of setting the targets, the Autonomous Regions should know which criteria will be used to measure compliance. This way, the need to wait for the report on the degree of compliance, which is published at the following year, to know these criteria, is prevented.

At the end of 2018, the Autonomous Regions' debt accounted for 24.3% GDP and 207% of current revenue for 2017, and since 2014 the debt-to-GDP ratio has increased by 1.3% despite the contribution of GDP of around 3.6%. The Autonomous Regions' debt level is over 10 percentage points above the legal limit of 13% GDP. At the same time, in an exercise similar to the one that takes place in the LGs[21], the Autonomous Regions' debt volume for 2018 represented 207% of the current revenue for the sub-sector in 2017. By Autonomous Regions, it is worth noting the case of Catalonia and Valencia, which greatly exceed 300%, as well as Balearic Islands, Castile La Mancha and Murcia that exceed 200% and with virtually no Autonomous Regions falling

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[21] The LGs have to request authorisation to issue debt on the basis that the debt-to-current revenue ratio of the previous year exceeds 75% and from 110% onwards they cannot borrow. The calculation of this ratio not only includes the EDP debt but also guarantees and other risks.

below 100%. In addition, since the start of the recovery from the crisis in 2014, the debt-to-GDP ratio of the sub-sector has increased by 1.3%, despite the fact that the accumulated growth has contributed to reducing the ratio by 3.6 points of GDP (see TABLE 15).

TABLE 15.   DEBT-TO-CURRENT REVENUE RATIO OF YEAR ENDED 2017 AND OVER % GDP. CHANGE IN DEBT 2014-2018. RATING

CCAA	Deuda PDE 2018		Período 2014-2018		Calificación de agencias de rating		
	% PIB	% ingresos corrientes 2017 (*)	Variación de deuda PDE	Contribución del PIB a la reducción de la deuda	Moody's	S&P	Fitch
Andalucía	22,0%	153%	0,9%	3,1%	Baa2	BBB+	BBB-
Aragón	21,9%	197%	3,6%	2,9%	-	BBB+	-
Asturias	18,4%	128%	1,5%	2,5%	Baa1	-	-
Illes Balears	27,6%	241%	-1,9%	5,1%	-	BBB+	-
Canarias	14,8%	100%	-0,4%	2,2%	-	A-	BBB
Cantabria	22,9%	154%	2,7%	3,1%	-	-	BBB
Castilla y León	21,0%	168%	3,0%	2,4%	Baa1	-	-
Castilla-La Mancha	35,1%	258%	-0,8%	5,5%	Ba1	-	BBB-
Cataluña	34,0%	329%	1,3%	5,5%	Ba3	-	BB
Extremadura	23,8%	126%	5,3%	3,1%	Baa2	BBB	-
Galicia	18,0%	135%	-0,4%	2,8%	Baa1	A-	-
Comunidad de Madrid	14,5%	192%	1,4%	2,3%	-	A-	BBB
Región de Murcia	29,5%	231%	3,9%	4,2%	Ba1	-	BBB-
Navarra	16,8%	108%	-1,2%	2,5%	-	A+	-
País Vasco	13,6%	99%	-0,3%	2,0%	A3	A+	A-
La Rioja	19,0%	148%	2,0%	1,7%	-	-	BBB
Comunitat Valenciana	42,0%	361%	3,6%	5,7%	Ba2	BB	BBB
TOTAL CCAA	**24,3%**	**207%**	**1,3%**	**3,6%**			

Source: Banco de España and MINHAC

Note: Current revenue for 2017 having removed Common Agricultural Policy and Local Financial Intermediation In the case of Navarre revenue is net of payments to the State and the contribution to the LGs

Grado medio superior
Grado medio inferior
Grado de no inversión especulativo

Finally, in terms of debt sustainability, AIReF continues to appreciate slightly high risks at the sub-sector level. At the regional sub-sector level, the composite indicator of sustainability risks developed by AIReF is at a slightly high level. With respect to previous analyses, the incorporation of new information has not caused great changes nor have substantial changes

been observed in the rating of specialised agencies. This is largely due to the fact that the economic and financial developments of the Autonomous Regions have been in line with expectations and there are no significant variations in the medium to long term.

At the same time, it is noted that great heterogeneity is maintained in the sustainability risk between Autonomous Regions. The difference in sustainability risk between Autonomous Regions is maintained, with no expectation of convergence in the medium term. At the individual level, Valencia, Catalonia, Castile-La Mancha and Murcia continue to have very high sustainability risks. Given their current high debt and fiscal position, it is not projected that those Autonomous Regions will reach the reference level of debt of 13% GDP within the next 20 years. On the other hand, in the case of the Basque Country, Canary Islands, Madrid and Navarre, it is projected that this situation will materialise in the medium term. In this group of Autonomous Regions, adding La Rioja, the sustainability risks identified by AIReF are very low. Finally, slightly low risks are identified in Asturias, Cantabria, Castile and Leon and Galicia, medium risks in Aragon and Extremadura and slightly high in Andalusia and the Balearic Islands.

As at the aggregate level, the sustainability risk in the long term does not necessarily fall due to compliance with the debt targets. Similarly to what happens at the level of the sub-sectors, there is no relationship between compliance with the annual debt targets and long-term financial sustainability. These targets are not formulated on the basis of a long-term anchor but rather residually, based on deficit targets that do not consider the specificities of each Region. (e.g. flows and stocks). This lack of economic rationale can also be inferred from the credit rating given by specialised agencies, which do not take into account compliance with the debt targets when giving their rating.

5.3 Local Governments

AIReF expects that at the end of 2019 the local debt-to-GDP ratio will stand slightly below 2%, broadly complying with the target set of 2.3%. The local debt data for the end of 2018, published by theBank of Spain, reported a reduction of more than 3,000 M€ last year, placing the debt-to-GDP ratio at 2.1% (target set for 2021). However, the data for the first quarter of this year show a slight worsening of the local debt, as it has increased by almost 200 M€ compared to the previous quarter, standing around 26,000M€. AIReF estimates that in 2019 the reduction in local debt will attenuate slightly, consistent with the decline of the surplus, standing at around 2% GDP at year-end. The following figure shows the evolution of the observed debt data of the LGs (as % GDP)

from 2010 to 2018 as well as AIReF's closing forecast for 2019 in its baseline scenario. The figure also includes the relative position with respect to the agreed targets for the years 2013 to 2019.

GRAPH 25.   **LG SUB-SECTOR DEBT EVOLUTION IN 2010-2018 PERIOD (% GDP) AND AIREF ESTIMATES FOR 2019**
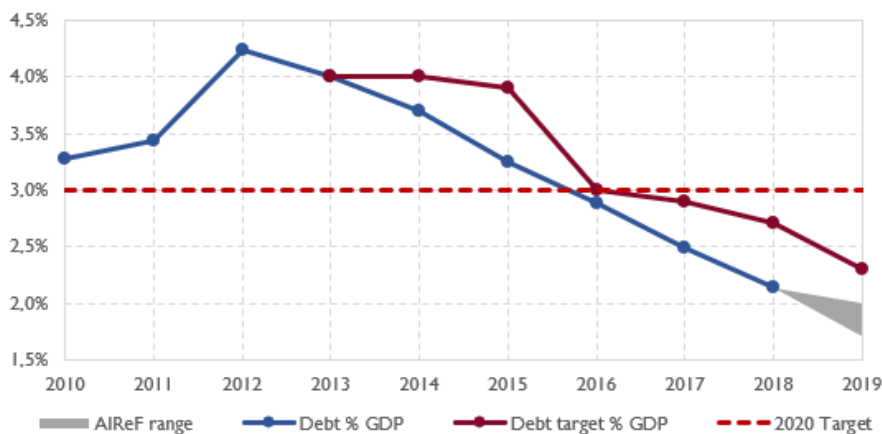
A large part of the local surplus remains immobilised in bank deposits. As previously highlighted in several of AIReF's reports, since the end of 2012 the primary balances of the LGs are being immobilised, to a large extent, in bank deposits, having stood above 27,000 M€ at the end of 2018. With this, the net debt of liquid financial assets of the LGs was negative for the first time at the end of 2018, a trend that is expected to continue in 2019 despite the fact that in the first quarter of the year the deposits have been reduced by over 1,000M€ linked to the cancellation of commercial debt outstanding at the end of the previous financial year. (See graph 26).

GRAPH 26.   EVOLUTION OF THE LG SUB-SECTOR DEBT AND LIQUID ASSETS IN THE 2012-2018 PERIOD (% GDP) AND AIREF ESTIMATES FOR 2019
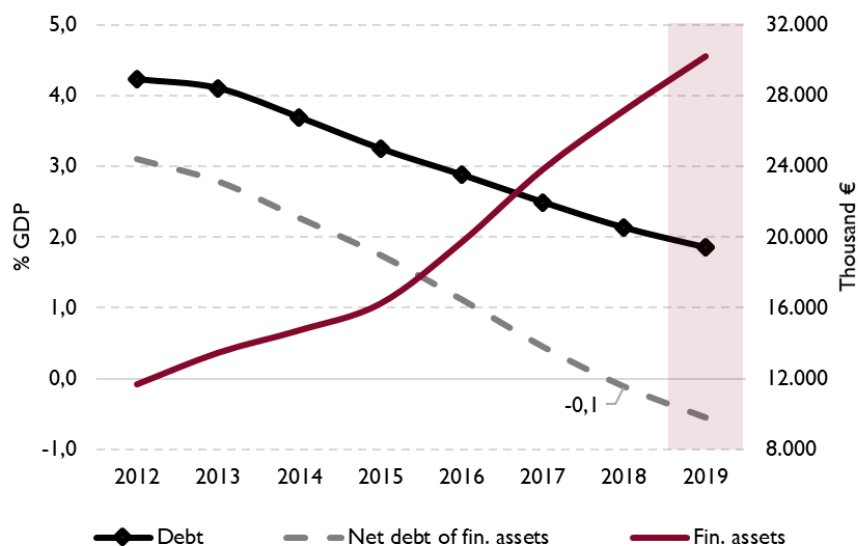
6 RECOMMENDATIONS

6.1 Central Administration

6.1.1 New recommendations

In previous reports, AIReF noted the high improbability of achieving the budgetary stability target assigned to the CG of 0.3% GDP. In this sense, the Government estimated a closing forecast with a deficit of 1% GDP for the CG in the notification sent to the European Commission, which was in line with the AIReF's forecasts in its report on the initial budgets published in April 2019.

However, with respect to the report on the initial budgets, AIReF's forecasts on the CG deficit have been reduced by 0.3% mainly as a result of two factors: the improvement of the forecasted collection of PIT due to the outcome of the annual declarations and the lower transfers to other PAs due to the non-modification of the VAT-IIS.

As has also been noted in previous reports, the lack of realism in the targets undermines the fiscal discipline as an unfeasible target discourages efforts to achieve it. In this sense, the improvement of the CG's situation is not sufficient to consider compliance with the target feasible. For this reason, it is essential that the new situation does not lead to a relaxation of fiscal discipline, and that the improvement is consolidated and contributes to minimising the deviation from the stability target by following the principles of article 12.5 of the LOEPySF that specifies that revenue above forecasts shall be destined for debt reduction.

This recommendation takes on greater relevance in the case of the savings resulting from the absence of modifications to the IIS, which implies less transfers to the TAs, since a large number of Autonomous Regions already had this revenue in their budgets and are making expenditure as if they were going to receive it, causing a deviation from their budgetary stability targets. Consequently, if the CG does not allocate these savings to reducing the deficit, there would be a double deviation.

For this reason, *AIReF recommends that*:

1.   The CG should allocate the revenue received above what is forecasted, as well as the savings from the non-modification of the VAT-IIS to reduce the deviation from their budgetary stability target.

6.1.2   Live recommendations

The LOEPySF does not provide for a preventive procedure for the CG similar to that existing for the TAs in the event of observing risks of deviation. AIReF has recommended to the MINHAC on numerous occasions that it should establish a procedure for monitoring the CG and SSF in order to detect risks and to be able to adopt measures for the early correction of deviations. In particular, it was recommended that it should establish a procedure that specifically includes the degree of implementation of the measures and the completion of budgetary management decisions aimed at the containment of budgetary execution. In addition, this monitoring must be carried out with the greatest possible transparency, sending the reports prepared to Parliament and AIReF.

MINHAC considers that it is already complying with this recommendation, therefore no additional actions are required to the extent that it regularly publishes the execution of the accounts of the various administrations and the State Tax Administration Agency values the impacts associated with changes in traditional tax figures and those newly created.

However, AIReF considers that it is not sufficient and that it is necessary to carry out a specific procedure beyond the automatic prevention measurements set out in article 18.1 of the LOEPySF. In addition, AIReF warns that the perception of a lower level of "accountability" by the CG could erode the degree of commitment of other PAs with regard to compliance with their fiscal targets.

For this reason, AIReF considers that this recommendation must be kept in place and be reflected as such on its web page.

6.2 Autonomous Regions

6.2.1   New recommendations

A robust and effective fiscal framework necessarily entails an adequate target setting system, so that each of the PAs is obliged to adjust their revenue and expenditure to deficit and debt limits that are consistent with their fiscal situation. In relation to the Autonomous Regions, this means that the

distribution of the sub-sector's target between each of them will give rise to differentiated stability target setting.

However, the same stability target is set for each and every one of the Autonomous Regions[22] (-0.1% of GDP for 2019), without acknowledging important differences in their fiscal position. In 2019, some Autonomous Regions are expected to obtain a surplus, making compliance with the target very likely, while others are still far from reaching it, considering their compliance to be very unlikely. This situation means that the deficit target is comfortable for some Autonomous Regions and unachievable for others.

The setting of debt targets is conditioned by these deficit targets, allowing the debt to be increased by the amount of the deficit target set for each year. Therefore, to the extent that the stability targets are comfortable, this breadth will also be transferred to the debt targets and, therefore, allowing more deficit and debt, in some cases, than would correspond according to the fiscal position of each Region.

On the other hand, the debt target does not consider the surplus generated in the previous year. Not recognising the lending capacity for one year stemming from the surplus generated in previous years not only contributes to the breadth of the debt targets but also to the fact that the Autonomous Regions could interpret that, in compliance with article 32 of the LOEPSF, they are reducing their debt by not exhausting the borrowing margin permitted.

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

1. ***The setting of the Autonomous Regions' stability targets for 2020-2022 should be carried out in a differentiated manner, considering the fiscal position of each of them.***
2. ***The setting of debt targets for 2020-2022 should take into account the differentiated stability targets and consider the surplus obtained in the previous year.***

The part of expenditure financed with EU founds should be a neutral expenditure in relation to compliance with the expenditure rule. However, as has been highlighted in this report, the method used to calculate the exclusion of this expenditure produces a major distortion in the calculation of the rule, affecting its compliance.

AIReF considers it essential that compliance with the expenditure rule is not influenced by anything other than the growth of computable expenditure, that is to say, the expenditure that is subject to the restriction of the reference

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[22] Except in 2013, when differentiated targets were set.

rate and, much less, by the variation experienced in a type of expenditure which, in theory, should be excluded from the rule.

In order to avoid compliance with the expenditure rule being affected by the functioning of EU funds, it would be desirable to find ways to try to minimise this effect as far as possible. Some proposals could involve charging a constant percentage of revenue over the total funds corresponding to each Operational Programme each year, or averaging the amount of EU funds excluded each year for a period of four years (similar to what is done in the EU to soften the impact of investments on the expenditure rule).

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

3. *The MINHAC should seek out a formula to calculate the exclusion of the part of expenditure financed by EU funds from the expenditure rule to minimise, as much as possible, its effect on compliance with the expenditure rule.*

In the face of adequate fiscal planning and, hence, compliance with the fiscal rules, the Autonomous Regions must know sufficiently in advance the scenario of the Regional Financing System (RFS) resources that they will have that year, as well as the criteria that will be used to measure compliance with the fiscal rules.

In 2019, the RFS resources have been substantially affected by the expectation of reversing the modification of the VAT-IIS this year. In this sense, almost all Autonomous Regions included the resources that they would receive from the envisaged modification in their budgets. However, when over half a year has passed, the MINHAC does not envisage carrying out the modification of the VAT-IIS, in which case the Autonomous Regions would cease to receive revenue whose amount fluctuates, as a percentage of regional GDP, between 0.15% and almost 0.4%, depending on the Autonomous Regions and around 0.2% for the Autonomous Regions overall.

On the other hand, the criteria for verification of compliance with the debt target must be known at the time of setting the targets. If it were so, it would not have been necessary to wait until the MINHAC report of 10 May on the degree of compliance with the 2018 targets to know the debt permitted to the Autonomous Regions that had made FSI in 2018 or the MINHAC's treatment of the 2017 surplus in relation to the debt target for 2018.

The fact that all these elements are not clearly defined sufficiently in advance hinders the fiscal planning necessary to comply with the fiscal rules and represents a weakening of the fiscal framework. All of this results in a lack of enforceability in the event of non-compliance with the rules.

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

4. *The MINHAC should set the basic assumptions of the scenario of the RFS resources that the Autonomous Regions will have in the following year sufficiently in advance and, at the time of setting the debt targets, the criteria that will be used to measure compliance.*
5. *In particular, for 2019, the MINHAC shall formally communicate and as soon as possible whether the Autonomous Regions will be compensated for the VAT-IIS.*

6.2.2 New recommendations contained in the individual reports on the Autonomous Regions

Risks of non-compliance with the stability target have been detected in 13 Autonomous Regions and non-compliance with the expenditure rule in 11 Autonomous Regions. To formulate the recommendations to correct those deviations, AIReF has taken into account, on the one hand, the Autonomous Regions that are currently involved in the preparation or approval of an EFP 2019-2020 for failure to comply with the fiscal rules for 2018 and, on the other hand, the reasons that lead to the expected deviations. In this sense, in the case of stability target it was considered whether the deviation arose from the execution data realised and forecasted or from the non-modification of the VAT-IIS. Likewise, in the case of the expenditure rule, AIReF has taken into consideration whether the risk of non-compliance originates in the growth of computable expenditure or whether it is affected by the distortion of EU funds on the calculation of the rule and/or non-recurrent operations.

As a result, AIReF has recommended that the Autonomous Regions of Andalusia, Asturias, Cantabria, Castile and Leon and La Rioja, for which non-compliance with the stability target would result from the non-modification of the VAT-IIS, should adjust the execution of their expenditure to the lower revenues forecasted in this new scenario. In the case of Andalusia, as it is in the process of approving the EFP 2019-202, this recommendation will be reflected in AIReF's report on the EFP, which will be published shortly. At the same time, it has been recommended that the Basque Country, for which there is a high risk of non-compliance with the expenditure rule, should monitor and, where appropriate, adjust its budgetary execution.

On the other hand, AIReF has requested that the MINHAC activates preventive measures in application of article 21 of the Organic Law creating AIReF, for Aragon, Extremadura, Castile La Mancha and Catalonia, in so far as non-compliance with the stability target is expected even in the case of modification of the VAT-IIS. However, given that they maintain a contained

expenditure growth and the growth of computable expenditure, having removed non-recurrent operations and the distortion of EU funds, is below the expected growth of nominal GDP of 3.8%, AIReF considers that it is not necessary to activate the measures and recommends that these Autonomous Regions adjust their expenditure to the lower revenue forecast from the non-modification of the VAT-IIS.

Finally, AIReF has requested that MINHAC activate preventive measures in application of the above-mentioned article 21, for the Autonomous Regions of Murcia, the Balearic Islands, Canary Islands, Madrid, Navarre, and Valencia. The reason for requesting this activation is that in all these Autonomous Regions there is a high risk of non-compliance with the expenditure rule due to the forecast of a computable expenditure growth well above the reference rate and even, once non-recurring operations and the distortion of EU funds have been removed, above the projected growth of nominal GDP. In addition, in the case of the Balearic Islands, Murcia and Valencia, it is considered that they will not comply with the stability target with or without modification of the VAT-IIS. However, the situation is different for these three Autonomous Regions, which must prepare an EFP for non-compliance with the fiscal rules in 2018. The adoption of specific measures and their assessment and follow-up must be framed within the scope of the plan.

6.3 Local Governments

6.3.1 Live recommendations

AIReF maintains several recommendations made to the MINHAC, that this ministry has welcomed, stating its willingness to put the necessary actions in place. These recommendations have been made in the following areas:

- In the framework of the competencies of the MINHAC, to accelerate the adoption and publication of a document reflecting the interpretation to be followed in the implementation of each fiscal rule, ensuring consistency between them, and the unity of the interpretative approach.
- In the area of transparency, to amend the Ministerial Order on the provision of information within the framework of the LOEPySF and incorporate the calculation of the expenditure rule in the information communicated by the LGs In the initial stages of the budgetary cycle so that the data that the MINHAC periodically publishes on the LGs are up to date.
- In the area of medium-term sustainability of the LGs with the greatest structural problems, the city councils of Jerez de la Frontera, Parla and Jaén, convene a committee of experts to analyse the causes of their critical sustainability level and propose solutions.

6.3.2   Recommendations contained in the individual evaluation report

6.3.2.1   New recommendations

As evidenced in paragraphs 1 and 2 of the supplementary report on the individual evaluation of the LGs there is risk of non-compliance with the expenditure rule in 2019 in the City Councils of Cordoba, Las Palmas de Gran Canaria and Madrid and the Island Council of Tenerife. For all of them, AIReF requests the MINHAC to activate the preventive measures pursuant to article 21 of the Organic Law creating AIReF, as a growth of its computable expenditure around 10% is estimated in 2019, which triples the reference rate adopted for this purpose.

It also requests the activation of measures in the case of the city councils with structural sustainability problems of Almonte, Jaén, Jerez de la Frontera, Parla and Navalcarnero, which also present high risks of non-compliance with the fiscal rules in 2019, a consequence of the growth of their expenditure above 8% year-on-year, corporations for which the AIReF has already made recommendations to monitor execution in the report issued in April on the initial budgets for 2019 (except the City Council of Jerez de la Frontera). Similarly, regarding follow-up of the measures to be agreed, the recommendation is made to the financial guardianship bodies of these City Councils, the MINHAC and the Region of Andalusia.

Furthermore, all the LCs for which the MINHAC has been requested to activate the measures pursuant to article 21 of the Organic Law creating AIReF, are recommended to implement the preventive measures referred to in Article 18 of the LOEPySF to prevent the estimated non-compliance, measures that should be taken into account in the content and scope of the planning to be agreed with the MINHAC in the proceedings of the hearing following detection of risk.

On the other hand, the City Councils of Barcelona and Seville, to which the AIReF had recommended in its April report that, should non-compliance with the expenditure rule occur at the settlement for 2018, they should approve an EFP within the legal deadlines, detected this non-compliance at settlement without having the required EFP to date, with the legal deadline having passed. Given the constitution of the new local governments, the delay is reasonable as the EFP must contain the measures that the new governments decide to put in place. To date, with the new government teams having been constituted, it is recommended that these city councils establish a timetable for the preparation and adoption of the EFP, in order to have the required

framework to guarantee compliance in the shortest possible time. At the same time, it is recommended that its financial guardianship bodies, the Autonomous Regions of Catalonia and Andalusia, should take the necessary actions to ensure that such EFP are approved in the shortest possible time.

Finally, in the case of the City Council of Valencia, which expects non-compliance with the expenditure rule in 2019, despite the consolidation of excess expenditure of 2017 for which it had not approved an EFP according to MINHAC's criteria, it is recommended that it should adopt the measures necessary to ensure compliance with this rule at the end of 2019. In addition, it is recommended that the Region of Valencia, as a financial guardianship body of this city council, should take the necessary actions to ensure that the non-compliance does not occur.

6.3.2.2   Live recommendations

The recommendations made to the City Council of Gijón, as well as its financial guardianship body (Asturias) are kept live, so that they comply with current legislation and implement the graduality provided for in the LOEPySF in the case of non-approval of an EFP within the deadlines set. This city council had to have submitted a PEF for non-compliance with the expenditure rule in 2017, having greatly exceeded the legal limits for approval. To date, the lack of the required fiscal framework is maintained, without knowing whether said LG has applied the corrective measures established by articles 25 and following of the LOEPySF, the reason for which AIReF reiterates the recommendation made.

El Presidente de la AIReF

José Luis Escrivá