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Economic Watch

Spain

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Economic Analysis

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Challenges for the autonomous communities in 2011

- **Episodes of sovereign debt crises shape budget management by Spain's public administrations in 2010**
  Uncertainty last year sent public debt risk premiums soaring to near default levels in some countries, prompting the Spanish government to speed up fiscal consolidation and bring forward structural reforms in a bid to dispel doubts in financial markets regarding the ability of Spain's public administrations to repay their debts.

- **Autonomous communities showed uneven commitment to fiscal consolidation in 2010, registering a deficit of 3.4% of GDP, higher than the 3.1% target deficit agreed for the year**
  Adding this deficit, which includes the 2008 negative result of the financing system, autonomous community debt stood at 10.9% of GDP at year-end 2010, representing more than 18% of Spain's total public debt. As a result, fiscal adjustment and financial market pressures have concentrated on these administrations because, among other things, they have failed to meet the 2010 budget targets, and because of concerns regarding the central government's ability to prevent further deviations by some of them.

- **Sluggish economic growth heightens the pressure for the adjustment to fall on strong spending cuts and requires maximum rigor, austerity and discipline by the autonomous communities in the fiscal consolidation process**
  Public expenditure was reined in considerably in 2010 –a more than two percentage-point (pp) reduction from 2009- but not enough to make up for the nearly 3pp decline in autonomous community revenue in the year. What's more, with still-weak economic growth prospects for 2011, a rapid pick-up in revenue is unlikely, so fiscal adjustment this year will have to entail unprecedented cuts to autonomous community spending.

- **Current public debt risk premiums and market skittishness require greater commitment to the achievement of fiscal targets; the introduction of new medium- and long-term fiscal stability rules should help**
  In addition to rules aimed at achieving a balanced budget over the long term, other, transparent consolidation targets must be introduced in the medium term, such as a commitment to achieve a structurally balanced budget (i.e. a structural deficit of zero) by 2016. For these rules to be fully effective, they must be applied at all levels of public administration.

Autonomous community accounts have suffered markedly in recent years, casting these governments into the financial market spotlight

Market uncertainty stemming from the episodes of sovereign debt crises in 2010 prompted the government to speed up fiscal consolidation and bring forward structural reforms

Episodes of sovereign debt crises shaped budget management by Spain's public administrations throughout 2010. This was largely related to Greece's solvency woes at the beginning of the year and uncertainty surrounding the solvency of Ireland's banking system in October, two events which led to bailouts and spawned wariness in the markets towards the so-called European peripherals, including Spain.

Uncertainty sent public debt risk premiums soaring to levels implying high probabilities of partial public debt restructuring in some countries, prompting the Spanish government to speed up fiscal consolidation and bring forward structural reforms in a bid to dispel doubts in financial markets regarding the ability of Spain's public administrations to make their payments. In May 2010, the central government adopted a series of measures that reduced the deficit target by 0.5pp in 2010, 1.5pp in 2011 and 1.0pp in 2012, keeping the target 3% reduction in 2013. Curbing the deficit took up the bulk of the central government's fiscal consolidation efforts in 2010 and will take up most of the autonomous community government's efforts in 2011. The latter's commitment to fiscal discipline is crucial to meet the 2013 target.

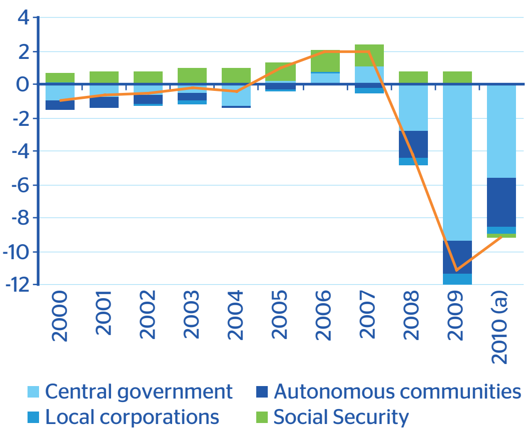
Moreover, once completed the process of fiscal decentralization from the State to the regions, autonomous community spending in 2009 represented slightly more than 17% of GDP (which in effect means the regional governments managed nearly 40% of total public sector expenditures in Spain), their fiscal consolidation becomes all the more vital to ensure any adjustment plan for the Spanish public sector is viable.

Fiscal adjustment pressure focused on the autonomous communities after they failed to meet the 2010 balanced budget target

Budget out-turn data for the autonomous communities in 2010 showed a disappointing and uneven commitment to the fiscal consolidation process, with a total regional deficit of 3.4%, higher than the 3.1% deficit target agreed for the year. With this deficit, autonomous community debt stood at 10.9% of GDP at year-end 2010, representing more than 18% of Spain's total public debt (charts 1 and 2).

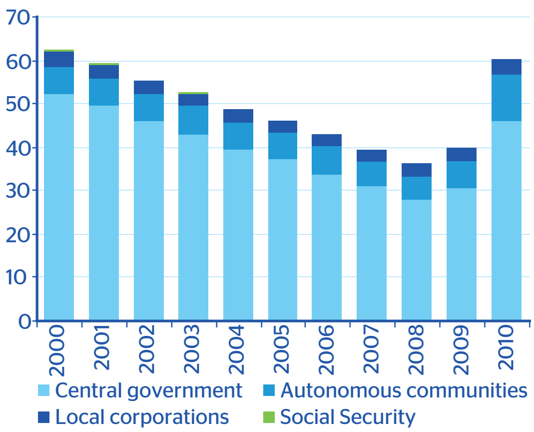
As a result, fiscal adjustment and financial market pressures have concentrated on these administrations, as seen in the recent downgrades of both sovereign and certain autonomous community debt ratings by Moody's due, among other things, to the widespread failure to meet the 2010 balanced budget target by the autonomous governments and the central government's scant ability to control them..

Chart 1
Autonomous communities: non-financial balance in 2010 (% of regional GDP)



Source: BBVA Research based on Ministry of Economy and Finance data

Chart 2
Autonomous communities: revenue and expenditure (% of GDP)



Source: BBVA Research based on Ministry of Economy and Finance data

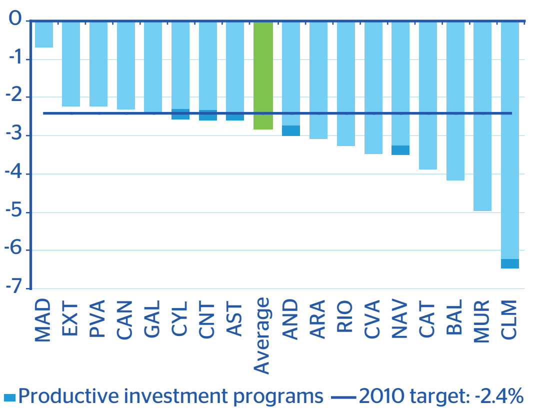
The performances by autonomous communities in 2010 were mixed, but overall they failed to meet the balanced budget target

Expenditure by the autonomous communities was reined in considerably in 2010, but not enough to offset the decline in revenue, with a generalised failure to meet the balanced budget target

The total deficit in 2010 of the autonomous communities was 3.39% (1.4pp higher than in 2009), of which more than half a point related to the negative result of the financing system for 2008. Stripping out the latter, the performance across regions was more uneven (see chart 3), with just five regions meeting the 2.4% deficit target. In addition to the marked shortfalls by Murcia and Castilla-La Mancha highlighted in the budget out-turn for 3Q10, Valencia, Navarra, Cataluña and Baleares were more than 1pp off the target.

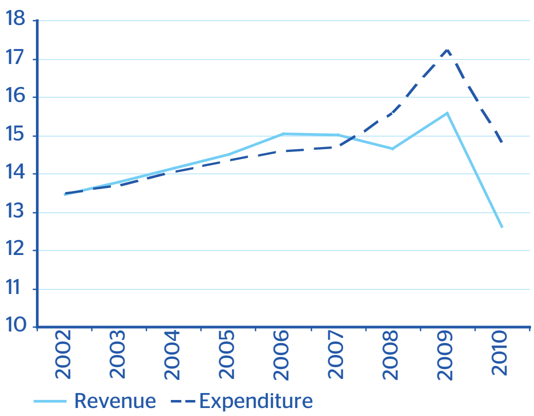
Nonetheless, budget out-turn data at year-end 2010 show major efforts to contain expenditure; expenditure as a percentage of GDP decreased by more than 2pp compared to recognised expenditure in 2009. However, this was not enough to make up for the nearly 3pp decline in autonomous community revenue in 2010 (see chart 4). What's more, still-weak economic prospects for 2011 –this will affect tax bases and, therefore, autonomous community revenue- an no tax hikes in the cards would indicate that fiscal adjustment this year must entail unprecedented cuts to autonomous community expenditure. Therefore, to ensure that the 1.3% deficit target for 2011 is met maximum rigor, austerity and discipline in the fiscal consolidation process are required.

Chart 3
Autonomous communities: non-financial balance in 2010 (% of regional GDP)



Source: BBVA Research based on Ministry of Economy and Finance data

Chart 4
Autonomous communities: revenue and expenditure (% of GDP)



Source: BBVA Research based on Ministry of Economy and Finance data

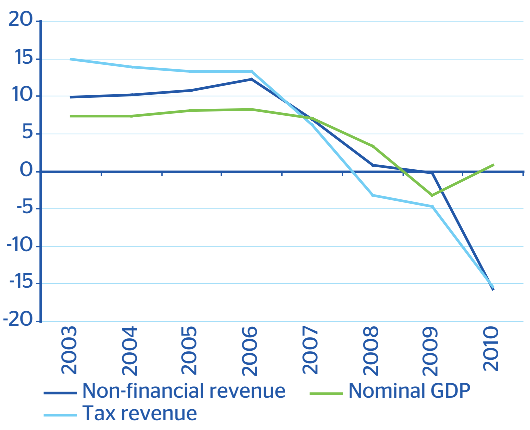
The crisis has undermined autonomous community revenue, leading to the first contraction since the end of the 1980s

The property market crisis, coupled with the weak economic environment, reduced autonomous community revenue to levels seen at the beginning of the last decade

Autonomous community revenue has suffered since 2007 from the weak economic environment, leading to an average contraction -for the first time since the end of the 1980s- of 5.5% in the last three years, far above the average nominal GDP contraction (see chart 5). There were two different phases in the decline in regional revenue, and mainly in tax receipts. The first, in 2008 and 2009, derived mostly from the property market slump, which during boom years provided the regions with additional revenue that they will be hard-pressed to recoup in future. The second, throughout 2010, autonomous community revenue was hit by the cut to tax bases caused mainly by the falls in gross income and consumption. In this phase, part of the decline was tempered by the impact of the VAT hikes in July 2010.

Chart 5

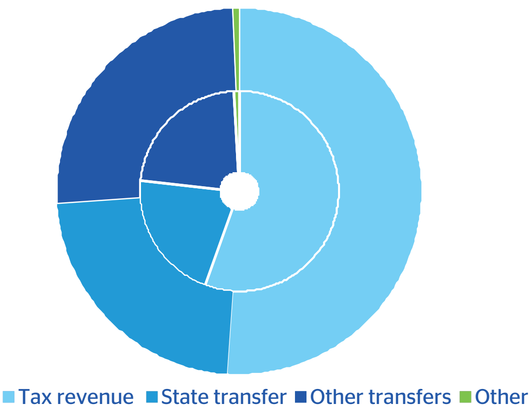
Autonomous communities: y-o-y growth in revenue (%). According to recognised rights



Source: BBVA Research based on Ministry of Economy and Finance and INE data

Chart 6

Autonomous communities: Structure of non-financial income. According to recognised rights*



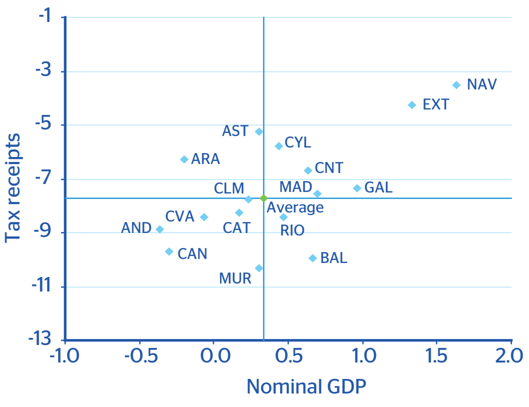
* Note: 2007 internal circular, 2010 external circular
Source: BBVA Research based on Ministry of Economy and Finance data

The fall in tax receipts affected the autonomous communities along the Mediterranean and Canarias most

The autonomous governments' tax capacity, understood as share of tax receipts over total revenue, has eroded, from 56% in 2007 to 51% in 2010 (see chart 6). Amid a generalised decline in tax revenue, the economic downturn in general and the decline in income from the construction industry in particular have hit the regions along the Mediterranean, especially Murcia and Baleares, and Canarias, the hardest. Meanwhile, Castilla y León, Asturias and Extremadura are less vulnerable to the business cycle; sustaining smaller declines in tax revenue (see charts 7 and 8).

Chart 7

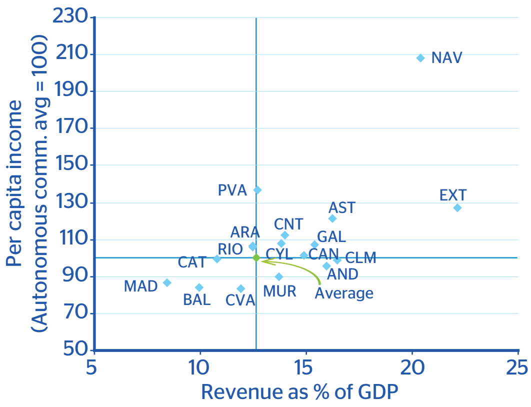
Autonomous communities: growth in tax receipts. Average: 2008-2010



Source: BBVA Research based on Ministry of Economy and Finance and INE data

Chart 8

Autonomous communities: Non-financial income. According to recognised rights in 2010



Source: BBVA Research based on Ministry of Economy and Finance and INE data

Virtually all autonomous community revenue items declined

With tax receipts dwindling, the autonomous governments relied more heavily on central government transfers ("Sufficiency fund" and "Inter-territorial Compensation Fund" mainly); which represented nearly 23% of autonomous government revenue in 2010, up from 21% in 2007. State transfers make up for the sharper falls in revenue in regions where economic growth is below the national average.

As for other funds, noteworthy for their volume were EU transfers. Their role as a funding source for the autonomous communities is also diminishing since, under the new programming framework, only six regions (Galicia, Andalucía, Extremadura and Castilla-La Mancha, directly, and Asturias and Murcia as part of the temporary phasing out) receive aid as part of the convergence objective[1].

In short, virtually all autonomous community revenue items in 2010 fell, especially tax-related revenue and current transfers.

1: Previous Objective 1 in the previous programming period.

Autonomous government spending cuts affected investments most, although there were moderate declines in nearly all expense items

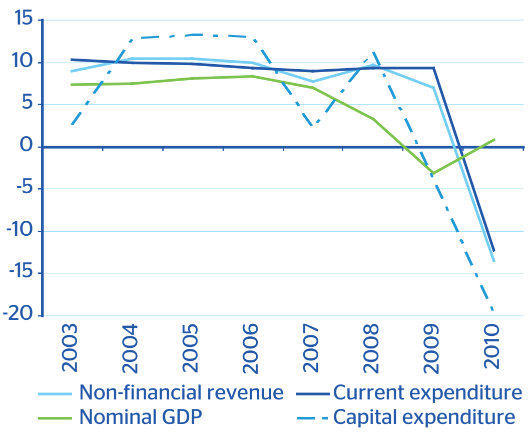
Autonomous communities slashed expenditure in 2010, mainly taking the scissors to investment

The crisis has also affected spending, above all in 2010. As with revenue, there have been two different phases in the last three years. The first, during the initial crisis years; i.e. 2008 and 2009, saw autonomous communities continue to increase spending at similar rates as before the crisis although the economy was clearly contracting. The second, 2010, saw one of the tightest grips over expenditure by the autonomous communities ever. However, as we said above, this was still not enough.

To illustrate, non-financial expenditure in 2010 was 13.4% lower than in 2009. Of total non-financial expenditure by the autonomous communities in 2010, 85.8% was current expenditure –that entailing recurring items and, therefore the most stubborn- with a 12.3% fall from 2009 (see chart 9). Meanwhile, capital expenditure, through which the regions implement their investment plans, represented the remaining 14.2% of non-financial spending in 2010, falling nearly 20% from the year before.

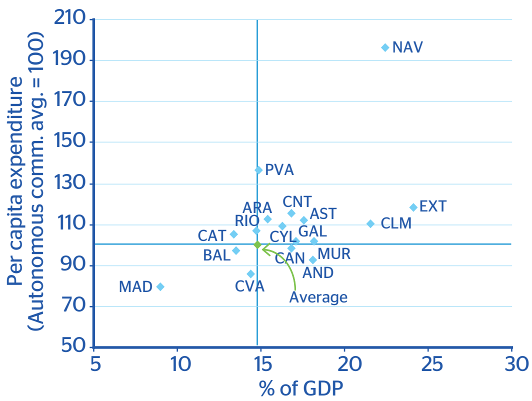
The performances across regions were again uneven, especially with respect to current expenditure. In three regions –Baleares, Murcia and Castilla y León- current expenditure continued to rise, albeit moderately. Meanwhile, Aragón and Canarias sustained the sharpest declines, followed by Cataluña and Valencia, with somewhat more moderate drops. Elsewhere, the falls in current expenditure were around the average. As for capital expenditure, the bulk of the autonomous communities' fiscal adjustment efforts targeted investment, except for Valencia and, to a lesser extent the País Vasco, with both increasing investment outlays in 2010 compared to 2009.

Chart 9
Autonomous communities: y-o-y growth in expenditure (%). According to recognised obligations



Source: BBVA Research based on Ministry of Economy and Finance and INE data

Chart 10
Autonomous communities: Non-financial expenditure. According to recognised obligations in 2010



Source: BBVA Research based on Ministry of Economy and Finance and INE data

55% of total autonomous community non-financial expenditure relates to operating expenditure given the large volume of spending on education and healthcare services

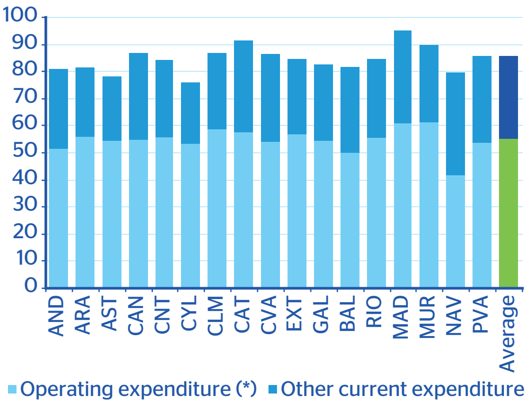
By concentrating cut-backs on capital expenditure, the share of operating expenditure (personnel costs plus current expenditure on goods and services) increased to 55% of total non-financial expenditure in 2010 (see chart 11), although the total declined compared to 2009 due mainly to lower current expenditure on goods and services[2]. The large weight and scant variation in personnel costs is due precisely to healthcare and education services, two highly personnel-intensive areas, managed by the autonomous communities. Of the total 1,346,826 civil servants in autonomous governments at end-July 2010, 76.9% corresponded to personnel in non-university education (40.3%) and healthcare institutions (36.6%). In all, spending on education and healthcare services represented over half of total autonomous community expenditure (see chart 12).

2: Current expenditure on goods and services includes government spending on current consumables: supplies, rents, technical assistance and advertising, in addition to spending on pharmaceuticals, one of the main areas of debate in the expense budget.

After investment, current transfers suffered the largest cutback. Part of the decline was due to the smaller contribution by local corporations to State revenues, transfers for specific projects that some regions channel through their budget. However, current transfers also include, in addition to EU funds for the Common Agricultural Policy (CAP), also transfers for specific projects, amounts for pension benefits[3] managed by the regions, transfers to universities and other public sector institutions and the related spending on healthcare, above all hospital pharmacies. As no breakdown of this item is provided, we cannot verify the cuts to some of these discretionary amounts, which in some cases could be very high.

Chart 11

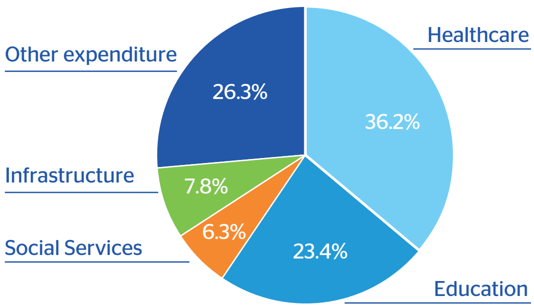
Autonomous communities: current expenditures as % of total. According to recognised obligations in 2010



* Personnel costs plus current expenditure on goods and services
Source: BBVA Research based on Ministry of Economy and Finance and INE data

Chart 12

Autonomous communities: Non-financial expenditure by purpose. According to recognised obligations in 2008



Source: BBVA Research based on Ministry of Economy and Finance data

Because of the crisis, autonomous community accounts deteriorated increasingly, leading to an all-time high deficit in 2010

The fall in current revenue led to negative gross saving in 2010 in virtually all autonomous communities

As indicated previously, the cuts to autonomous community spending in 2010 were not enough to make up for the drop in revenue, seriously undermining the autonomous community accounts. Throughout the crisis, gross government savings by the regions fell gradually, turning negative in 2010 (see chart 1); current revenue generated in the year by the autonomous communities was insufficient to meet current expenditure. Savings fell in all regions, led by Murcia, Castilla-La Mancha, Cataluña and Baleares, which at the end of 2010 was negative by more than 15% of current revenue. Meanwhile, average total autonomous community saving was a negative 6% of current revenues in the year. In contrast, Asturias, Castilla y León, Andalucia, Galicia and, above all Navarra, however, maintained a certain ability to generate positive savings.

3: Related mainly to obligations stipulated in the Dependency Law.

Table 1

Autonomous communities: main budget ratios. According to recognised rights and obligations.

Millions of euros and %	2005	2006	2007	2008	2009	2010 (a)
Gross saving	16,528	22,835	22,672	10.,14	1,960	-7,678
% GS/CR (1)	13.3	16.2	15.0	6.9	1.3	-6.0
Capital balance	-15,220	-18,385	-19,076	-20,406	-19,154	-15,187
% CB/NFE (2)	-11.7	-12.8	-12.3	-12.0	-10.6	-9.7
Non-financial balance	1,308	4,449	3,597	-9,992	-17,194	-22,866
% NFB/CR (3)	1.1	3.2	2.4	-6.6	-11.0	-18.0
Net borrowing requirement	-126	2,370	602	-12,655	-20,060	-25,106
% Financial burden (4)	4.9	4.0	4.1	3.8	4.6	7.1

(1) Gross saving over current revenue; (2) capital balance over non-financial expenditure; (3) non-financial balance over current revenue; (4) Autonomous community financing law limit: Financial burden–finance charges plus redemptions-over current revenue below 25%.
Source: BBVA Research based on Ministry of Economy and Finance data

The deterioration of autonomous community accounts led to an all-time high deficit in 2010, led by Baleares, Castilla-La Mancha and Cataluña

Fiscal consolidation efforts have mainly targeted capital expenditure, causing the negative capital balance to decrease gradually, from 12.3% of total non-financial expenditure in 2007 to 9.7% at the end of 2010. As a result, the regional non-financial budget balance has turned negative over the last three years, reaching an all-time high deficit of EUR 22.87 billion euros in 2010, equivalent to 18% of current revenue. While the deficit was previously concentrated in just a handful of regions[4], because of the crisis, the 17 autonomous communities have registered increasing deficits in the last three years, led by the Balearic Islands, Castile-La Mancha and Catalonia, precisely the regions whose deficits accounted for the largest percentage of current revenue at the end of 2010.

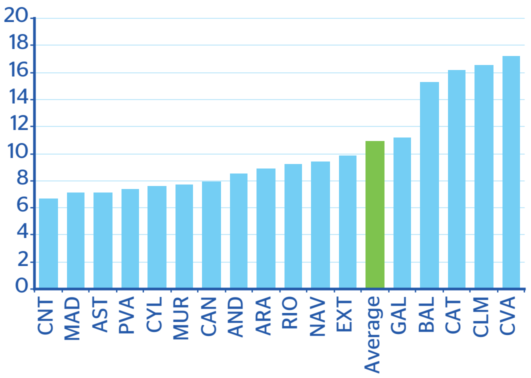
Meanwhile, the autonomous governments overall show increases in borrowing requirements due of the sharp deterioration in their finances and broadly stable spending on financial assets. The behaviour of this expense item could be explained by the shift of budget resources towards public companies or other dependent institutions, intensifying alternative schemes for funding investments.

This took autonomous community debt to 10.9% of GDP by year-end 2010

This caused total autonomous community debt to increase in 2010 by 2.6pp to 10.9% of GDP. The performances across regions were mixed. Baleares, Cataluña, Castilla-La Mancha and Valencia showed the highest debt and the worse budget performances in 2010. Murcia, seemingly in better shape than in previous years, showed a high level of unfunded deficit -with a deficit of nearly 5% of GDP, it increased debt by just 2.7pp-. Madrid still stood out on the positive side for its low debt and deficit in 2010.

Chart 13

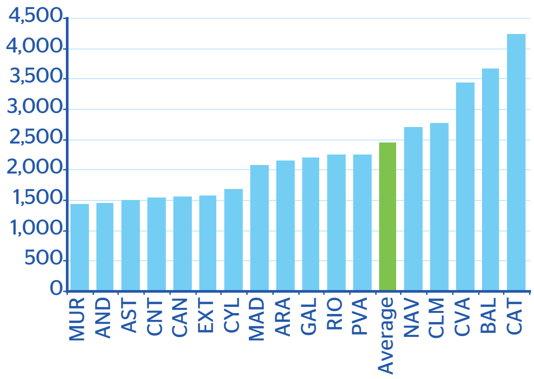
Autonomous communities: debt in 2010 (% of GDP)



Source: BBVA Research based on Bank of Spain data

Chart 14

Autonomous communities: debt per capita in 2010 (%)

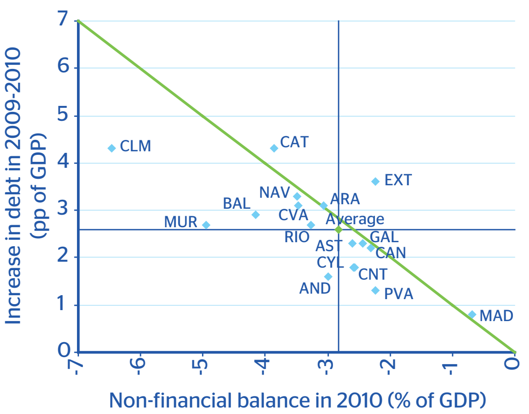


Source: BBVA Research based on Bank of Spain and INE data

4: See Pou, 2004, for more details on long-term trends in regional finances.

Chart 15

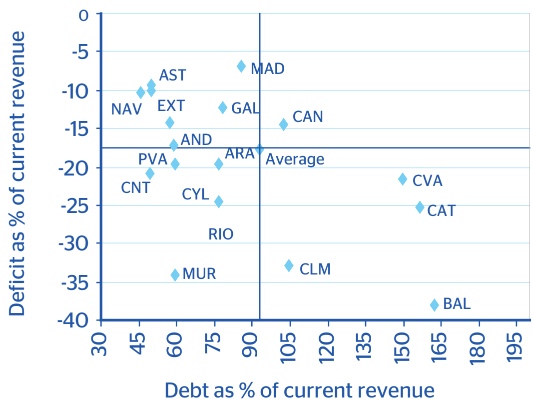
Autonomous communities: non-financial balance in 2010 vs. increase in debt (% of GDP)



Source: BBVA Research based on ECB and Ministry of Economy and Finance data

Chart 16

Autonomous communities: Relative position in 2010. According to recognised rights and obligations



Source: BBVA Research based on Bank of Spain and Ministry of Economy and Finance data

Weak economic growth heightens fiscal consolidation pressure for further spending cuts to meet the 2011 balanced budget target

With a sluggish economic growth, the fiscal adjustment effort in 2011 will concentrate on an unprecedented regional spending cuts

2011 poses a challenge for the autonomous communities, as they must reverse budget trends and reduce their deficit by 1.5pp to reach the 1.3% deficit target for 2011.

The approved regional budgets for 2011 show an 11% average increase in non-financial revenue on recognised rights in 2010, mostly because, for the first time, they will reflect all the resources earmarked under the new Autonomous Financing System, while initial expenditures look set to increase by 5% from the expense in 2009.

All this gears fiscal consolidation towards expenditure since with the economy still struggling, revenue is unlikely to rebound sharply. Meanwhile, the May 2011 elections in most autonomous communities will hardly provide the most propitious backdrop for approving spending cuts beforehand, especially in the areas of education and healthcare. With neither financial nor personnel costs expected to decline sharply, fiscal adjustment is likely to once again entail cuts to investments and, to a lesser extent, current transfers and current expenditure on goods and services.

The cost of public debt and market wariness require a firmer commitment to a balanced budget; the introduction of new medium term fiscal stability rules should help

Financial market wariness has caused the cost of Spanish public debt to soar

The expansive fiscal policies adopted by Spanish public administrations in general and the autonomous communities in particular, along with the sovereign debt crises mentioned previously, have caused the cost of Spanish public and therefore autonomous communities' debt to soar. In 2010, the risk premium paid by the Treasury topped 200bp at one point, while the autonomous communities, once considered virtually risk-free issuers, had to pay a spread equivalent to the sum of country risk and sub-sovereign risk, determined as the spread between the German länder and the bund (Goikoetxea and Cantalapiedra, 2011).

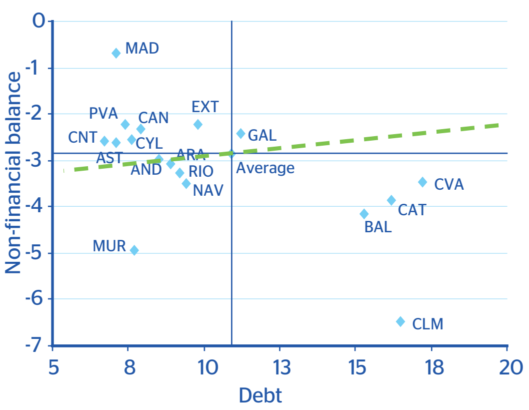
Debt of the autonomous communities increased 2.6pp of GDP in 2010, while the deficit for the year amounted to 2.8% of GDP, indicating that part of the deficit was unfunded, especially that of Murcia, Castilla-La Mancha, Andalucía and Baleares (see chart 15). On the contrary, País Vasco and Extremadura have taken on debt exceeding their deficits, indicating that they could be shifting expenditure/investments towards entities outside the public administrations.

This has led to an uneven combination of deficit and public debt across the autonomous communities (see chart 17). Taking the total autonomous public sector average for both variables as a percentage of GDP (-2.8% and 10.9%, respectively), Aragón and Andalucia would be in line with the average, while Castilla-La Mancha, Baleares, Cataluña, Valencia and Murcia would have a comparatively worse mix. Madrid would once again stand out for one of the best deficit-public debt mixes, closer to the source of the coordinates[5].

To bring the deficit and public debt back under control, a firm commitment to achieving a balanced budget by the autonomous communities is required

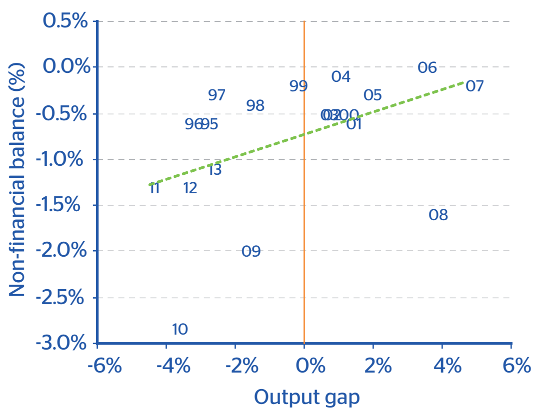
At any rate, to bring the deficit and public debt back under control, a firm commitment to achieving a balanced budget is required, above all by the autonomous communities which, as indicated, are key to the success of any fiscal adjustment[6]. Even meeting the 2011-2013 balanced budget targets, the autonomous communities would still have a structural deficit of around 0.7% of GDP (see chart 18), similar to 2007 and roughly half the total public administration structural deficit in 2013[7].

Chart 17
Autonomous communities: non-financial balance and public debt in 2010 (% of regional GDP)



Source: BBVA Research based on Ministry of Economy and Finance data

Chart 18
Autonomous communities: non-financial balance vs. output gap



Source: BBVA Research based on Bank of Spain and Ministry of Economy and Finance data

At the European Council meeting of 24 and 25 March, the Spanish government said it was adopting a rule limiting the growth of expenditure in accordance with the country's potential economic growth, a proposal similar to that of Cuerpo, González-Calbet and Sanmartín (2011). This limit would be mandatory initially for central government spending, with the hopes that the autonomous communities would end up adopting it after debate and approval by the Fiscal and Financial Policy Council (FFPC). This rule would reinforce the long-term balanced budget target and make fiscal policy more credible. However, we would make two comments in this respect. First, any rule limiting public expenditure would have to be applied to all autonomous communities, which must ensure they move towards a cyclically balanced budget in the medium and term long. To achieve, this, the autonomous governments must achieve budget surpluses during fiscal expansion (see Beynet et al., 2011), something that has not happened since the fiscal decentralisation in Spain. Second, to prevent increases in fiscal pressure, the medium-term balanced budget objective requires a decrease in public expenditure as a percentage of GDP over the coming years, so growth in public spending in the short term must be lower than potential GDP.

5: : The line with the positive slope in Chart 17 represents the combinations of deficit and debt at present that give rise in the medium term to equivalent levels of debt as a percentage of GDP (calculated as the average of current debt and stationary debt), assuming potential nominal GDP growth of 4%. The parallel shifts of this line towards the source of the coordinates means better combinations of debt and deficit.
6: See Fernández y Monsterio, 2010, for an analysis of the budget co-ordination mechanisms and the effectiveness of the balanced budget regulations in Spain.
7: The line with the positive slope in Chart 18 represents the sensitivity of the budget balance to economic growth, determined by the impact of the automatic stabilizers in public accounts (see Corrales, Doménech y Varela, 2002). The output gap is defined as the percentage difference between actual GDP and long-term trend growth. The intersection with the vertical line for a zero output gap (i.e. a neutral economic cycle) provides an estimate of a structural deficit or surplus. Therefore, parallel upwards shifts can be interpreted as an improvement in the structural budget balance. According to our findings, a cyclical change of 6pp (e.g. from an output gap of 3% to one of -3%) could lead to a 1pp deterioration in the cyclical component of GDP, a sensitivity that is five times lower than that estimate for the entire public administrations (slightly below 5pp of GDP), in line with the estimates of Sebastián, González-Calbet and Pérez-Quirós (2004).

For the latter to happen, it would be opportune (if not completely necessary given the uncertainties existing in financial markets) to strengthen the principle of stability in Spain by undertaking a transparent and specific commitment beyond those to 2013 to reinforce the balanced budget in the medium term: reach a structurally balanced budget (i.e. zero structure deficit), for instance, by 2016. As indicated previously, to become fully effective this target requires firm cooperation and commitment at all echelons of public administration, and particularly of the autonomous communities. For this, the head of the FFPC, as the body in charge of liaising between the State and the autonomous communities on fiscal and financial matters, should be put in charge of assessing compliance by the communities with the fiscal rule and estimating the structural budget balance and the stage in the business cycle.

This rule, which would allow the automatic stabilizers to work -running deficits during recessions and surpluses during growth phases- would be compatible with the balanced budget regulations. It is also more restrictive than prevailing regulations, as it requires a structural deficit of zero year to year, whereas at present the deficit must be zero throughout the cycle. This commitment by the autonomous communities would require an upward shift by the line representing the sensitivity of the budget balance to the business cycle between 2014 and 2016 (see chart 12), until it intersects with the vertical line for a zero output gap at the point where the structural balance was zero.

Moreover, these rules should be bolstered by the implementation of measures to increase the transparency of public administration; e.g. drafting and present multi-year budgets, expanding the amount of information available to compare initial budgets with out-turn data for the given and previous year. The start of the "European semester" could provide a window of opportunity to improve the budget drafting process, fiscal consolidation at the autonomous community level, and the development of the necessary structural reforms.

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