Regional Government Deficit during the Crisis: Falling revenues and delayed fiscal consolidation

FUNCAS

In 2011, Autonomous Communities missed deficit targets agreed in the context of the EU Stability Pact. The explanation can be found not only in delayed consolidation but also from the negative impact of the crisis on revenues

Regional government fiscal slippage primarily explains Spain's deviation from its 2011 deficit target. Delays in the regional governments' fiscal consolidation process, together with the negative impact of the crisis on their revenues, have resulted in most of the autonomous communities missing their deficit targets for 2011. However, fiscal performance differs across the regions, suggesting underlying economic conditions and policies also vary substantially.

Spain has faced considerable fiscal pressure at all levels of government since the onset of the crisis in 2008. In Spain, the central government accounts for 20.9% of expenditure, the Social Security system for 29.9%, the regional governments for 35.6% with the rest accounted for by the local entities. Given that a large part of public expenditure is in the hands of the regions, analysts and the media have focused on regional governments' fiscal performance since the beginning of the crisis.

The regional government deficit, stood at 0.2% of GDP in 2007. As the crisis unfolded, the deficit rose to 1.6% of GDP in 2008, to 2.0% in 2009, and to 2.9% in 2010 and 2011. Last year, the Total Public Sector deficit reached 8.5% of GDP. The central government deficit was 5.1% of GDP, the Social Security deficit was 0.1% of GDP, and the local entities recorded a deficit of 0.4% of GDP. Therefore, the regional governments are responsible for approximately one third of the Spanish deficit, similar to their share in total public expenditure[1].

Revenues declined by one fifth since the onset of the crisis and investment was reduced by 30%, but labour costs and other operating expenditures continued to rise.

The crisis has had a very considerable impact on regional government revenue (Table 1). Non-financial revenue of the regional governments fell by 20.3% over the period from 2007 (pre-crisis) through 2011. Most of this decline in revenue can be attributed to a decline in tax receipts, which in 2011 accounted for 95.5% of total revenue.

On the expenditure side, the regional governments responded by reducing investment expenditure, but between 2007 and 2011, current expenditure continued to grow. Non-financial expenditure rose by 6.4%[2] (Table 2). The trend in regional

[1] Ministry of Finance and Public Administration budget figures have been used to analyze regional government fiscal performance during the crisis. The budget data differ from the ESA data, but reflect most significant activity. See: http://www.minhap.gob.es/esES/Estadistica%20e%20Informes/Estadisticas%20territoriales/ Paginas/Estadisticas%20Territoriales.aspx

[2] This increase includes 0.5% due to transfers of power to the regional governments made between 2008 and 2011 amounting to €774.87mn in 2007 values. See: http://www.seap.minhap.gob.es/es/areas/politica_autonomica/traspasos/datos_basicos.html

Table 1: Non-financial revenue of the regional governments

Revenue	Rights recognised 2007	Rights recognised 2011	Rate of change 2007-2011
1 . Direct taxes	30,445,309.09	39,872,567.56	30.96%
2 . Indirect taxes	53,014,046.21	46,882,070.25	-11.57%
3 . Levies, public prices and other revenue	4,549,294.92	4,768,888.94	4.83%
4 . Current transfers	62,283,527.06	28,228,258.22	-54.68%
5 . Financial revenue	966,308.75	705,324.26	-27.01%
Current income	**151,258,486.03**	**120,457,109.23**	**-20.36%**
6 . Disposal of investments	347,202.64	177,704.83	-48.82%
7 . Capital transfers	6,665,444.92	5,475,455.39	-17.85%
Capital income	**7,012,647.56**	**5,653,160.22**	**-19.39%**
Non-financial income	**158,271,133.59**	**126,110,269.44**	-20.32%

Source: Ministry of Finance and Public Administrations. Data in € thsd. and percentages.

government expenditure can largely be attributed to the evolution of current expenses, which have risen by 14.4% since 2007. By contrast, over the four years of budgetary outcomes during the crisis period, expenditure relating to capital .expenses fell by 30.0%.

Table 2: Non-financial expenditure of the regional governments

Expenditure	Obligations recognised 2007	Obligations recognised 2011	Rate of change 2007-2011
1 . Staff costs	48,956,613.82	57,377,013.53	17.20%
2 . Current expenditure on goods & services	25,210,027.03	27,344,473.64	8.47%
3 . Interest expenses	2,167,356.77	4,555,498.43	110.19%
4 . Current transfers	39,460,692.17	43,212,962.13	9.51%
Current expenses	**115,794,689.79**	**132,489,947.73**	**14.42%**
6 . Investment	12,421,316.04	7,660,765.67	-38.33%
7 . Capital transfers	13,666,855.92	10,060,134.79	-26.39%
Capital expenses	**25,327,931.93**	**17,720,900.47**	**-30.03%**
Non-financial expenses	**141,122,621.72**	**150,210,848.20**	**6.44%**

Source: Ministry of Finance and Public Administrations. Data in € thsd. and percentages. For 2007, certain adjustments have been made to local financial intermediaries and EAGF funds for standardisation purposes.

To better understand these figures, some further disaggregation is required. Exhibit 1 breaks regional government revenue down into two sub-groups: i) Regional taxes and levies revenue, and ii) Autonomous Regions´ Financing System. The revenue in the first group is managed and regulated by the regional governments and is directly linked to regional economic activity. The second group includes a share of national taxes collected in the region - 50% of personal income tax (IRPF), 50% of value added tax (VAT) and 58% of excise duties (II.EE.)- plus transfers to regions from the central government.

Exhibit 1: Current revenue

(€ million)

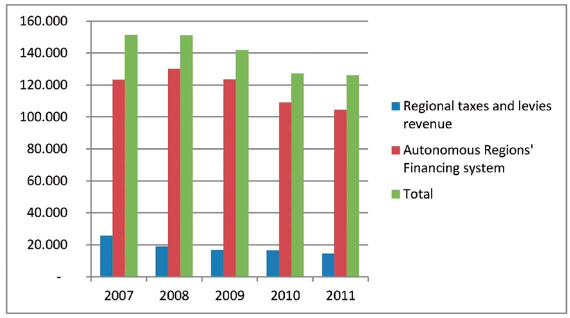
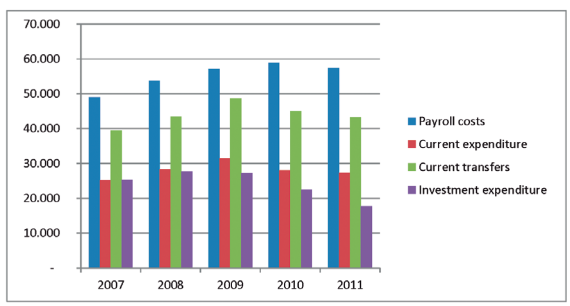


Exhibit 1 shows that of the €32.1bn that the regional governments have "lost" in total revenue since 2007, €11.3bn was regional taxes and levies revenue, which has declined by 44.1% during the crisis. The remaining €20.8bn was comprised of reductions related to the Autonomous Regions' Financing system (€18.6bn), which fell by 15.1% and other revenues (€2.2bn), which include capital income.

Exhibit 2 tracks annual expenditure performance in the period 2007-2011. Despite the crisis, payroll costs continued to rise through 2010, declining only in 2011 as a result of the measures adopted by the central government [3].

Exhibit 2: Expenditure

(€ million)



Expenditure on purchases of goods and services began to decelerate in 2010 and declined further in 2011. Current transfers followed a similar trend, beginning their slowdown in 2010 and

[3] Royal Decree Law 8/2010 of 20 May 2010, adopting extraordinary measures to reduce the public deficit, and 2011 General State Budget Law 39/2010.

continuing to decline in 2011. Lastly, investment expenditure peaked in 2008 at €27.6bn and has fallen by almost €10bn since then. In short, regional government expenditure cuts were long overdue and expenditure remained above 2007 levels.

There are significant differences in fiscal performance across the regions.

Table 3 displays the balance of financial activity of the regional governments in terms of Net Lending (+) or Borrowing (-) Requirement as a percentage of regional GDP, broken down by region.

In terms of the national total, the regional government deficit in 2011 was a repeat of the 2010 figure (2.94% in both years). Non-financial expenditure declined by 4.5%, but to a lesser degree than the decline in non-financial revenue, down 6.1%. Overall, almost all of the regional governments missed the established official deficit target of 1.3%.

Table 3: Net Lending/Borrowing Requirement as a percentage of regional GDP

Region	2007	2008	2009	2010	2011
ANDALUSIA	0.38	-1.01	-1.62	-3.12	-3.22
ARAGON	-0.16	-0.99	-1.71	-2.94	-2.88
ASTURIAS	0.03	-0.79	-1.56	-2.73	-3.64
BALEARIC ISLANDS	-1.95	-3.32	-3.29	-4.09	-4.00
BASQUE COUNTRY	1.09	-1.22	-4.02	-2.49	-2.56
CANARY ISLANDS	0.14	-0.82	-1.09	-2.35	-1.78
CANTABRIA	-0.03	-1.15	-3.40	-3.01	-4.04
CASTILE-LA MANCHA	-0.37	-2.64	-4.53	-6.07	-7.30
CASTILE-LEON	-0.20	-0.99	-1.69	-2.32	-2.35
CATALONIA	-0.62	-2.62	-2.43	-4.28	-3.72
EXTREMADURA	0.49	-1.22	-1.96	-2.51	-4.59
GALICIA	0.18	-0.36	-0.98	-2.34	-1.61
LA RIOJA	-1.00	-1.28	-0.91	-3.01	-1.97
MADRID	0.00	-0.75	-0.43	-0.73	-1.13
MURCIA	-0.11	-2.76	-2.57	-4.83	-4.33
NAVARRA	1.06	-4.80	-2.97	-3.11	-1.89
VALENCIA	-1.22	-2.08	-3.11	-3.60	-3.68
NATIONAL TOTAL	**-0.16**	**-1.56**	**-2.00**	**-2.94**	**-2.94**

Source: Ministry of Finance and Public Administrations. Base 2000 for 2007 regional GDP; base 2008 thereafter.

A comparison of how the regional governments have performed during the crisis reflects significant differences. In 2007, pre-crisis, eight regional governments were running a balanced budget or surplus. By 2011, all 17 of Spain's regional governments recorded a deficit, ranging from 1.13% in the case of Madrid to 7.30% in the case of Castile-La Mancha. Nevertheless, in 2011, various autonomous regions reduced their deficit by a considerable amount (Canary Islands, Catalonia, Galicia, La Rioja and Murcia) initiating the necessary fiscal consolidation effort. Madrid, for its part, although increasing its deficit with respect to 2010, is the region with the lowest deficit, below the target established for the regions for 2011.

Taking into account the entire period (2007-2011), regions may be divided into three groups according to their fiscal performance: (i) those whose deficit was below the national average for all five years: Aragon, Canary Islands, Galicia and Madrid, representing 30.1% of national GDP, (ii) those whose deficit was above the national average for at least four years: Balearic Islands, Castile-La Mancha, Catalonia, Valencia and Murcia[4] , representing 36.9% of national GDP; and, (iii) those whose deficits remained around the national average throughout the period: Andalusia, Asturias, Cantabria, Castile-Leon, Extremadura, Navarra, Basque Country and La Rioja, representing 33% of national GDP.

For 2012, the government has established a deficit target for Spain as a whole of 5.3% of GDP and, pending the final decision, the deficit target for the regions will be 1.5% of GDP. This implies a significant correction of the deficit, which will have to be reduced by 3.2% of which 1.4% corresponds to the regions.

[4] All of the Autonomous regions in this group recorded a deficit above the national average for 5 years with the exception of Murcia, which exceeded the national average for 4 years.

BOX: BILL FOR BUDGETARY STABILITY AND FINANCIAL SUSTAINABILITY

The government has presented a Budget Stability and Financial Sustainability Bill implementing the reform of the Spanish Constitution from September 2011, which introduced a ceiling on the level of public deficit and debt. The main objective of this bill is to increase international confidence in the stability of the Spanish economy and to strengthen Spain's commitments to the European Union.

The new legislation is a reform of the existing Spanish legislation in effect since 2001. It introduces the following main new features:

a) The structural deficit will be prohibited as of 2020. Under the constitutional pact, the deficit ceiling was to be established at each point in time by the European Union. The new rule is, therefore, even more demanding than the Constitution itself. Nevertheless, there is an exception that would permit a structural deficit of up to 0.4% of GDP.

b) The volume of public debt is capped in accordance with the terms of the Constitution, which in turn were linked to the provisions established in the Treaty of the European Union.

c) The new Law includes an "expenditure rule" which was already applicable at the national (State) level and is now extended to all other levels of government (regional and local).

d) Neither the structural deficit nor the public debt ceiling will apply until 2020. Accordingly, until then, the deficit target will be set in line with the consolidation path agreed upon between the European Commission and Spain.

e) With a view to enhancing fiscal policy coordination with the regional and local governments, the control mechanisms are strengthened, similar to the system established in recent European legislation. A number of improvements are included at the preventive stage which will help increase fiscal discipline at the regional and local government levels.

f) At the corrective stage, the existing mechanisms are maintained (rebalancing plans, authorisation of long-term debt by tranche, limits on pacts and subsidies). The most notable new feature is that any form of non compliance with the rebalancing plan will automatically prompt the creation of a deposit in the amount of 0.2% of regional GDP. This deposit will be cancelled if and when correction measures are adopted; failing this, it will be converted into a fine.

g) Moreover, the central government is authorised to monitor the activities of any regional government that fails to comply. Until now, only the State auditors held this power, which is now extended to the Executive.

h) The new legislation includes considerable improvements in transparency; many of these measures were already being applied in practice, but they will now acquire legal status.

i) Lastly, the establishment of an expenditure ceiling and creation of a budget contingency fund to enhance management at all three levels of government becomes mandatory.

In short, although other improvements that had been considered have been put on hold for the time being, such as, for example, strengthening the role of coordination mechanisms with the regional governments, the new legislation (in the process of parliamentary approval) provides the Government with an appropriate tool to coordinate and meet fiscal policy targets similar to those being adopted in other EU countries.