Budgetary stability in the autonomous regions: Beyond constitutional reform

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Recent measures taken during the crisis in 2012 and 2013, aimed at fiscal consolidation, have helped rein in the regions' deficits. At the same time, however, they have also facilitated regional borrowing, resulting in higher debt levels and increased risks to future financial sustainability.

The approval of the Organic Law on Budgetary Stability and Financial Sustainability introduced a series of measures, which greatly strengthened the autonomous regions' budgetary stability framework and improved international perceptions of the overall sustainability of Spain's public accounts. The main measures as regards budgetary stability include: i) an increase in the central government's powers; ii) clarification of scope; iii) greater detail on key principles, such as the structural deficit and debt limits; iv) establishment of public expenditure limits; and, perhaps most importantly, enforcement mechanisms. While the new law appears to have been successful in reducing regional deficits, their levels of debt have increased. The excess of regulation and the new bail-out instruments created have facilitated regional borrowing and thus have now become a future cause for concern.

SEFO - Spanish Economic and Financial Outlook

The reform of Article 135 of the Spanish Constitution (CE) on September 27th, 2011, famously enshrined the principle of budgetary stability in the Constitution. This represents the culmination of a budgetary consolidation process that had begun back in the 1990s, and which made further progress with the passing of the first budgetary stability laws in 2001, and their reform in 2006. Organic Law 2/2012, April 27th, on Budgetary Stability and Financial Sustainability (LOEPSF in its Spanish initials) develops Article 135 CE, upholding the existing "internal stability pact". Before the Constitutional reform, the Constitutional Court had already confirmed the compatibility of the previous stability framework with the Constitution, [Opinion 134 - July 20th, 2011] (see Ruiz Almendral, 2013).

Organic Law on Budgetary Stability and Financial Sustainability

The measures included in the LOEPSF grant the status of organic law to a large portion of the agreements of the Fiscal and Financial Policy Council. These agreements, adopted in 2010, had been applied unevenly by the autonomous regions. The agreements did, however pave the way for a new model of regional budgetary stability coordination, which, in hindsight, probably

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failed to yield the desired results (see Cuenca, 2012). The LOEPSF's main characteristics and innovations with respect to the preceding legal framework were:

- Reinforcement of the State's powers in relation to budgetary stability. The LOEPSF comes directly under Art. 135 CE, without therefore alluding to the enabling provisions of Art. 149.1 CE that, according to Constitutional Court case law (STC 134/2011, July 20th, 2011, and STC 120/2012, June 5th, 2012, to cite just two recent examples) could support this authority. However, under this same doctrine, Art. 135 CE does not grant authority, but merely upholds the authority of the State on this matter (STC 157/2011, October 18th, 2011, FJ 1).

- Clarification of the scope of application of the rules, with reference to the European System of National and Regional Accounts approved by Regulation (EC) 2223/96 of the Council, June 25th, 1996.

- In terms of the principles, what is new is the greater degree of detail given in the LOEPSF. The new law defines the principle of budgetary stability in the same terms as before, but whereas the previous budgetary stability legislation (LEP) refers expressly to the European legislation, the new law mentions the principle of "structural deficit" (Art. 3). The LOEPSF adds a new principle referred to as the "Principle of financial sustainability" (Art. 4): which *"is understood to be the capacity to finance current and future expenditure commitments within the public debt and deficit limits, as established in this Law and in European legislation."*

  There is now a debt ceiling that, in line with the European legal framework, may not exceed 60% of GDP. This will be spread across the levels of government such that 44% will be available for the central government; 13% for the autonomous regions, both as a whole and individually; and 3% for local authorities. Nevertheless, although not expressly stated in Article 135 of the Constitution, the seventh final provision of the LOEPSF postpones the entry into force of the debt limits until January 1st, 2020.

- Introduction of the limit on the structural deficit. Although it is not due to come into effect until 2020, it is stated as follows (Art. 11.2): *"No public administration may incur a structural deficit, defined as a deficit adjusted over the cycle, net of exceptional and temporary measures. Nevertheless, in the case of structural reforms with long-term budgetary effects, in accordance with European legislation, a structural deficit of 0.4 percent of Gross Domestic Product expressed in nominal term, or that established in the European legislation, if lower, may be reached."*

- Limits on public expenditure. Binding rules applicable to all public bodies have been introduced limiting expenditure so as to contain its growth (Art. 12) and place a limit on non-financial expenditure in the budget (Art. 30).

Perhaps the most significant feature is that Chapter IV of LOEPSF sets out a prevention, correction and enforcement mechanism that is similar in form to the European system. This creates a genuine control framework, with potential penalties. However, as it has yet to be applied, it is too soon to assess its impact.

- Enforcement mechanisms. Perhaps the most significant feature is that Chapter IV of LOEPSF sets out a prevention, correction and enforcement mechanism that is similar in form to the European system. There is therefore a "preventive" phase, which implies a limit on borrowing (Art. 18), as an "automatic" preventive measure, and "warning" of the risk (Art. 19), which will be made public, requiring the administration concerned (regional or local) to adopt "the necessary measures to prevent

the risk" within one month. If it fails to do so, or if these measures are considered inadequate, the "corrective measures" [Arts. 20, 21, and 25(1) a] will come into effect. As in the case of the "preventive" phase, the "correction" phase also begins with the adoption of "automatic" corrective measures (Art. 20), which include the submission of "economic-financial" plans and "rebalancing." Finally, the "enforcement" and "obligatory" measures (Arts. 25 and 26) imply the imposition of penalties. This creates a genuine control framework, with potential penalties. However, as it has yet to be applied, it is too soon to assess its impact.

In addition to the LOEPSF, Art. 135 CE has been implemented by a second law, Organic Law 6/2013, November 14th, 2014, creating the Independent Fiscal Responsibility Authority (LOAIRF).

The connections between the LOEPSF and the European legal framework stand out, comprising on the one hand the Treaty on the Functioning of the European Union (TFEU), and on the other, seven Regulations and a Directive (the so-called "six pack" and "two pack"). However, beyond those mentioned in the preamble to the Organic Law on Stability, the technical articulation of the stability control procedures has little to do with the European legal framework, among other reasons because the latter hinges on a system of checks and balances, applied by the Commission and the Council. In other words, European budgetary discipline is applied by Member States to themselves (although not in all the phases). By contrast, the legal framework envisaged in LOEPSF largely depends on–and is applied by–the Ministry of Financial Affairs and Public Administration, with some participation of the Fiscal and Financial Policy Council (CPFF), and barely any intervention from Parliament[3] (see Fabbrini, 2013).

These reforms merely confirm a process that has been under way since 1992, whereby the economic constitution of the Member States is now the European economic constitution. From that perspective, Art. 135 CE is just the formal culmination of the process of constitutional transformation of Title VII of the Spanish Constitution.

The legal framework just described has had implications for the autonomous regions' deficit and debt. If we compare the situations in 2012 and 2013 with 2011, the year of the constitutional reform, the deficit has been reduced in all the regions. This is largely attributable to the regulatory framework. However, the debt has risen in all of them. As Table 1 shows, after two years of application of the new LOEPSF, only the Madrid region and the Basque Country are complying with the limit set in LOEPSF.

Table 1

Deficit and debt by autonomous region
(% Regional GDP)

		2011	2012	2013	2014 (QI)*
Andalusia	Deficit/Surplus	-3.49	-2.07	-1.55	-0.40
	Debt	10.0	14.8	17.3	18.5
Aragon	Deficit/Surplus	-2.67	-1.46	-2.06	-0.45
	Debt	10.0	14.2	16.6	18.8
Asturias	Deficit/Surplus	-3.66	-1.01	-1.06	0.01
	Debt	9.5	12.2	14.2	15.9

[3] As is the case in other EU countries.

Table 1 (continued)

Deficit and debt by autonomous region
(% Regional GDP)

		2011	2012	2013	2014 (QI)*
Balearic Islands	Deficit/Surplus	-4.26	-1.84	-1.28	0.08
	Debt	16.6	22.3	25.3	27
Canary Islands	Deficit/Surplus	-1.53	-1.11	-1.00	0.10
	Debt	8.9	11.7	13.1	13.9
Cantabria	Deficit/Surplus	-3.66	-1.52	-1.00	-0.12
	Debt	9.9	16.2	17.6	18.5
Castile-Leon	Deficit/Surplus	-2.60	-1.39	-1.10	-0.19
	Debt	9.8	14.0	15.3	17.5
Castile-La Mancha	Deficit/Surplus	-8.11	-1.54	-2.13	-0.44
	Debt	18.5	28.2	31.5	33.5
Catalonia	Deficit/Surplus	-4.12	-2.23	-1.96	-0.37
	Debt	21.7	26.7	29.7	31
Valencia	Deficit/Surplus	-5.12	-3.94	-2.33	0.13
	Debt	21.0	30.2	32.8	34.8
Extremadura	Deficit/Surplus	-4.81	-1.03	-0.99	-0.69
	Debt	11.8	14.9	16.2	18
Galicia	Deficit/Surplus	-2.22	-1.28	-1.10	-0.26
	Debt	12.4	14.9	16.5	18.2
Madrid	Deficit/Surplus	-1.94	-1.06	-1.01	-0.37
	Debt	8.1	10.9	12.1	13.1
Murcia	Deficit/Surplus	-4.68	-3.18	-3.17	-0.36
	Debt	10.1	17.4	21.0	23.1
Navarre	Deficit/Surplus	-2.58	-1.73	-1.55	-0.24
	Debt	13.1	15.8	17.7	20.2
Basque Country	Deficit/Surplus	-2.72	-1.46	-1.08	0.13
	Debt	8.4	11.3	13.1	14.5
Rioja	Deficit/Surplus	-1.46	-1.16	-1.04	-0.24
	Debt	11.2	13.3	14.7	16
Total Autonomous Regions	Deficit/Surplus	-3.41	-1.86	-1.54	-0.25
	Debt	13.6	18	20.2	21.7

*Note: *The deficit data in Table 1 for 2014 refer to the first quarter only, and so are not comparable with the annual data for 2011, 2012, and 2013.*

Source: Ministry of Finance and Public Administration and Bank of Spain.

The above framework changed in 2012 and 2013, as the LOEPSF was amended on three occasions, by the following laws:

- Organic Law 4/2012, September 28th, 2012, amending Organic Law 2/2012, April 27th, 2012, on Budgetary Stability and Financial Sustainability (referred to here as LO 4/2012).
- Organic Law 6/2013, November 14th, 2013, creating the Independent Fiscal Responsibility Authority (referred to here as LO 6/2013).
- Organic Law 9/2013, December 20th, 2013, controlling public sector commercial debt (referred to here as LO 9/2013).

These amendments have substantially altered some of the aspects of the LOEPSF, making it worth briefly describing them here.

The aim of LO 4/2012 was to incorporate the financial support measures for the autonomous regions and local authorities that had been enacted (described in the next section of this article). Amendments were introduced to apply stricter fiscal discipline, together with mechanisms that imposed enhanced disclosure obligations for autonomous regions that decide to take part in what Law 4/2012 defines as "extraordinary liquidity mechanisms." These regions must submit monthly information on their accounts (rather than quarterly information as initially established in the LOEPSF). These mechanisms are only relatively "extraordinary", as the Law states, considering how the fourth transitional provision of the LOEPSF has been amended to allow the extraordinary liquidity mechanisms to be extended beyond 2012. They will, very likely, become permanent.

As a result of Organic Law 4/2012, the penalty system has also been made stricter. Thus, a mere risk of default on the payment of financial debt may be considered as seriously harming the public interest for the purposes of Art. 26 of LOEPSF, which in turn refers to the mechanism established by Art. 155 CE; an option by which the central government may in practice suspend autonomy. It has never been employed.

When the autonomous regions request access to the extraordinary support and liquidity measures from the State, they will have to accept an adjustment plan with the Ministry of Finance and Public Administration to ensure compliance with the budgetary stability and public debt targets. A genuine global bail-out mechanism has been put into place for the autonomous regions, in exchange for this control.

The cited additional financing mechanisms have a number of consequences. Firstly, they have increased net debt, as they will be included in the debt limit calculation. Secondly, they come with a lot of conditions attached, established in the new first additional provision of the LOEPSF. Thus, when the autonomous regions request access to the extraordinary support and liquidity measures from the central government (or if they did in 2012), they will have to accept an adjustment plan with the Ministry of Finance and Public Administration to ensure compliance with the budgetary stability and public debt targets.

A genuine global bail-out mechanism has been put into place for the autonomous regions, in exchange for enhanced control from the central government. All elements of this bail-out plan are to be made public, along with the timetable for its application, notwithstanding the autonomous regions' obligation to send information to the Ministry of Finance and Public Administration.

Failure to provide this information, an unfavourable opinion on it (presumably by the Minister of the Treasury) or the breach of the adjustment plan "will trigger the application of the enforcement

measures under Articles 25 and 26 envisaged in cases of breach of the Economic and Financial Plan." These penalty measures have been questioned by some critics, as well as by the Council of State, which in its opinion 164/2012, March 1st, 2012, on the draft bill for LOEPSF, has even questioned its compatibility with the Constitution.

LO 6/2013, has slightly modified the budgetary discipline control process, introducing checks at the various stages. This has meant an amendment to three articles of the Law (16, 17 and 23). Thus, the Independent Fiscal Responsibility Authority takes part in setting individual targets for autonomous regions (Art. 16), once approved by parliament in accordance with the procedure in Art. 15. It will also take part in preparing reports on the fulfilment of the budgetary stability, public debt and expenditure rule objectives referred to in Art. 17 of LOEPSF, and the approval and monitoring of economic and financial plans and rebalancing plans as referred to in Art. 23, which must now be presented "following a report by the Independent Fiscal Responsibility Authority."

LO 9/2013 substantially widens the scope of the application of the control and discipline framework. This law broadens the concept of sustainability, as stated by its preamble: "financial sustainability is not just the control over public financial debt, but control over commercial debt," focusing on public sector creditor protection, such that, it continues, "this reform expands the concept of public debt to enhance the protection of all creditors."

The main consequence is that a large part of LOEPSF's control and discipline framework will now also apply when the average time taken to pay autonomous regions' suppliers exceeds the maximum period in default regulations by more than 30 days, which may also trigger the application of the penalty framework in Arts. 25 and 26 of LOEPSF.

New financing mechanisms for the autonomous regions

As mentioned, in its first additional provision the LOEPSF envisages the creation of extraordinary financing mechanisms for regional and local administrations. When an autonomous region resorts to the extraordinary financing mechanism, it will be subjected to an adjustment plan to ensure the stability and public debt targets are met. Failure to comply with this plan will trigger the enforcement measures envisaged in Art. 25 of LOEPSF. Specifically, two extraordinary financing mechanisms have been created:

- First, the supplier payment finance fund (FFPP), established in Royal Decree-Law 7/2012, created as a public legal body, with its own legal personality and capacity to tap the capital markets with a government guarantee.

  This Royal Decree-Law extends the mechanism to the autonomous regions and, as envisaged, Royal Decree-Law 7/2012 establishes a financing mechanism to pay local authorities' suppliers.

  RDL 7/2012 sets a term of 10 years, with a two-year grace period, for loans to subnational governments. Moreover, direct payments to suppliers by the central government are provided for in the case of all pending debts that are matured, liquidated and due and were submitted before January 1st, 2012.[4] Finally, in the case of local entities, the loans are guaranteed by the possibility of withholding the local authority's share of State taxes.

- The second extraordinary financing measure is the regional liquidity fund (FLA), which was created by Royal Decree-Law 21/2012 on liquidity measures for public administrations and in the financial area. This involves a fund without its own legal personality, financed from

[4] On renewing the supplier payment plan, this limit was subsequently extended.

State debt and implemented through the Official Credit Institute (ICO in its Spanish initials).

It must be stressed that its creation was described as being "temporary and voluntary" (Art. 1). In parallel, the financial instruments the regions can use for their borrowing outside the FLA have been limited, and such borrowing requires the submission of an adjustment plan. A new feature of this plan is that it includes a liquidity plan enabling the liquidity situation in the autonomous regions to be monitored at all times.

In short, the promulgation and application of the LOEPSF coincides with the implementation of the supplier payment fund, of which there have been three phases, as well as with the regional liquidity fund (FLA), which has been extended at least until 2014.[5]

Moreover, the ICO opened a series of credit lines for autonomous regions and local governments that function as extraordinary financing mechanisms for local governments.[6] Legally, putting into place the Suppliers Fund and the FLA has required the introduction of an exception to the no bail-out clause stated in Art. 8.2, according to which: *"The State shall not assume or answer for the commitments of the autonomous regions, local authorities, and bodies envisaged in Article 2.2 of this Law linked or dependent on them, without prejudice to the mutual financial guarantees for the joint realisation of specific projects."* This confirms that the described mechanisms represent an exception to the no bail-out clause.

Impact of new State financing measures on public debt

A the end of 2011, Spain's total public debt reached 70.5% of GDP, which means that fulfilling the 60% limit in 2020, which is only eight years away, would require considerable discipline. Moreover, at the end of 2013 the public debt had reached 93.9% of GDP, due to the autonomous regions' debt, as will be explained below. Table 2 shows the change in the autonomous regions' debt since the second quarter of 2011.

Table 2
Regional debt
(% GDP and millons of euros)

	% GDP	Total debt	FFPP	FLA
II-2011	13.0	136,587	-	-
III-2011	13.2	138,488	-	-
IV-2011	13.6	142,342	-	-
I-2012	14.1	147,358	-	-
II-2012	16.3	169,218	17,692	-
III-2012	16.3	168,407	17,692	-
IV-2012	18.0	185,456	17,689	16,641
I-2013	18.6	190,525	17,689	19,884
II-2013	19.0	194,088	17,689	27,535
III-2013	19.2	196,687	18,627	30,739
IV-2013	20.2	206,768	22,428	39,063
I-2014	21.7	221,997	30,410	43,947

Source: Bank of Spain.

The autonomous regions' debt has risen by 8.7 percentage points of GDP since 2011. At the end of the first quarter of 2014, the supplier payment fund (FFPP) had already accumulated 30,410 million euros, 13.7% of the regions' debt. For its part, FLA came to 43,947 million euros, 19.8% of the debt. Thus, the total increase in regional debt amounts to 74,639 million euros since the LOEPSF was enacted (in the second quarter of 2012), and can be attributed, almost exclusively, to the new extraordinary financing mechanisms, which provided a total of 73,357 million euros.

[5] Law 13/2014, July 15th has integrated the Suppliers' Payment Fund into the central government's treasury, without altering its economic consequences. Thus, the Fund will no longer be an independent Fund, but be directly managed by the central government.

[6] In 2012, the ICO granted loans for the sum of 5,397 million euros to six autonomous regions: Andalusia (597); Balearic islands (71); Castile-La Mancha (469); Catalonia (1,304); Murcia (175); and the Valencia region (2,781).

It should be noted that part of this increase in regional debt in 2012 originated in expenditures undertaken in previous fiscal years. Although it is difficult to be precise, by definition, at least the 17,692 million euros of the supplier fund in 2012 derived from bills presented before January 1st, 2012. That is to say, commercial debt predating December 31st, 2011, and not reflected as such in the EDP, was brought to light and, consequently, turned into public debt.

The total increase in regional debt of 74,639 million euros since the LOEPSF was passed (in the second quarter of 2012) was possible almost exclusively due to the new State financing mechanisms, which provided a total of 73,357 million euros.

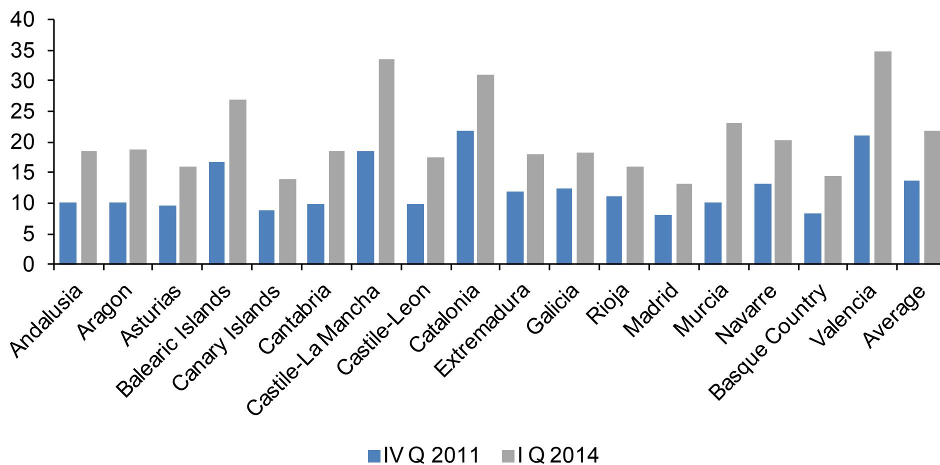
Furthermore, the performance of the autonomous regions should not be looked at in the aggregate, as there are considerable differences among them. Exhibit 1 shows how borrowing grew, asymmetrically, between 2012 and 2013.

Four autonomous regions –Balearic Islands, Castile-La Mancha, Catalonia and Valencia– had an above-average debt-to-GDP ratio at the end of 2011. At the end of the first quarter of 2014, the same autonomous regions remained above the average, with the Murcia region joining the group of the most heavily indebted regions. It is worth highlighting that although average regional debt has grown by 8.7 points of GDP, in five regions this growth has been faster than average: Balearic Islands (10.4 pp), Castile-La Mancha (15 pp), Catalonia (9.3 pp), Valencia (13.8 pp) and Murcia region (13 pp). This pattern suggests that these regions' debt could continue to grow significantly and become unsustainable. However, not all the autonomous regions have received money from the suppliers' fund and the FLA. In particular, the regions of Galicia, La Rioja, Navarre, and the Basque Country have no debts with the State.

Exhibit 2 shows the differences in the degree of dependence on State financing. The most heavily indebted regions also have the highest degree of dependence, with the exception of Andalusia, which has 50.5% of its debt in the hands of the State without belonging to the most indebted

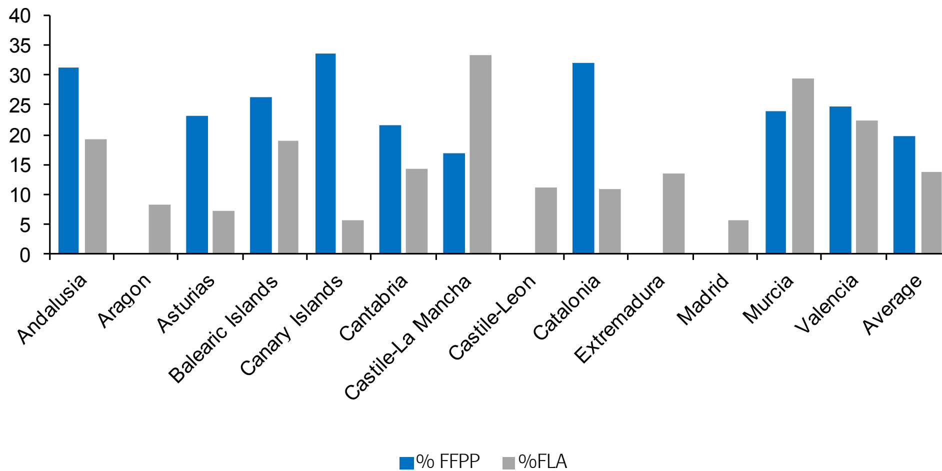
Exhibit 1

Regional debt
(% Regional GDP)



Source: Bank of Spain.

Exhibit 2
Regional debt
(% Regional GDP)



Source: Bank of Spain.

group. Aragon (8.4%), Castile-Leon (11.2%), Extremadura (13.5%), and Madrid (5.6%), have a low degree of dependence.

On the one hand, by constituting a source of finance for certain autonomous regions, the central government obtains effective control over the level of expenditure and even over the political spending priorities of the regions it supports. On the other, a region's outstanding debt with the FLA gives it a degree of bargaining power if it is unlikely to be able to meet its debt.

This situation raises two questions: first, how transitional or permanent these financing mechanisms are. Officially, the suppliers financing fund ends this year (2014), so it should, in fact, be transitional, as is consistent with itsorigins and purpose.[7] From this point of view, the system's credibility entails restoring the effectiveness of Art. 8 of LOEPSF. To that end, it is necessary to create a "no bail-out" reputation. And in order to do that, it is essential not to repeat bail-outs of this kind.

Second, in the plausible hypothesis that the FLA turns into a permanent mechanism, it is worth reflecting on the effect this new state of affairs might have on the regions' financial autonomy. Here, two contrary effects emerge. On the one hand, by constituting a source of finance for certain autonomous regions, the central government obtains effective control over the level of expenditure and even over the political spending priorities of the regions it supports. On the other, a region's outstanding debt with the FLA gives it a higher degree of bargaining power if it is unlikely to be able to meet its debt. This hypothetical situation would have a political impact in terms of the relationship between the

[7] On April 24th, 2014, the conditions of loans through the supplier fund for local government bodies were modified, extending the repayment period or grace period (see Resolution of the Secretary General for Regional and Local Coordination, published in the BOE on May 14th, 2014). It is foreseeable that something similar will apply to the autonomous regions.

two levels of government, in contrast to a default on debt in international bond markets.

There should be a thorough assessment of exactly what the medium-to-long-term impact of the State's assuming a portion of the regions' debt may be. Moral hazard cannot be ruled out, and it may encourage greater indebtedness.

Conclusions

The budgetary stability framework of the autonomous regions in 2012 and 2013 has been significantly strengthened, yielding positive results in terms of deficit reduction. This has undoubtedly improved the international perception of the sustainability of Spain's public accounts.

However, there is a certain excess of regulation. Despite the strict corrective mechanisms, bail-out instruments have been created that have facilitated regional debt. This could pose a future risk to financial sustainability, at least until the annual deficits are eliminated.

In a recent paper, Charles Wyplosz (2013) criticises the budgetary discipline supervision system adopted by the European Union, pointing out the inconsistency the over-centralisation of this budgetary discipline represents. In the case of Spain, the data reflect that the supervision of the regions' budgetary discipline was not credible until 2011, so that a reform (even a constitutional reform) was indeed necessary. It would nevertheless be desirable, notwithstanding the framework described, for the autonomous regions to comply with the mandate stated in article 135.6 CE and design their budgetary discipline frameworks in coordination with those of the State. That way, they would consider budgetary discipline as part of their "own" rules, and not something purely external, imposed by the central government. This would also increase their fiscal responsibility.

In any event, high debt levels preclude financial autonomy, whether at the regional or State level. In short, an indebted State is not free. German's Federal Constitutional Court has expressed this clearly most recently in its judgment of March 18th, 2014 [BVerfG, 2 BvR 1390/12],[8] in which it gave its endorsement to the EU's bail-out mechanisms and the Six Pack in the following terms (par. 169): "A constitutional commitment on the part of the parliaments and thus a palpable restriction of their budgetary power to act may be necessary precisely in order to preserve the democratic power to shape affairs in the long term. Even if such a commitment restricts democratic legislative discretion in the present, it guarantees it for the future. Admittedly, even a worrisome long-term development of the level of debt is not a constitutionally relevant impairment of the legislature's power to decide on fiscal policy at its discretion, and dependent on the situation. Nevertheless, this results in a *de facto* constriction of discretion. To avoid such a constriction is a legitimate aim of the (constitutional) legislature." Therefore, the autonomous regions' new financing mechanisms, and in particular the regional liquidity fund will perhaps require an overall rethinking as part of an institutional reform that consolidates the progress made by the "State of Autonomies" and its financing system.

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