Spain´s autonomous regions in 2015: Budgetary stability and financial sustainability

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Expenditure cuts, together with improved economic conditions, have resulted in noteworthy fiscal consolidation at the regional level since 2010. In order to reach equilibrium in the medium-term, further measures affecting current income dynamics and budgetary compliance at the regional level will be needed.

This article examines the fiscal performance of the autonomous regions in 2014 and assesses the outlook for 2015 on the basis of available data. Overall, fiscal consolidation in Spain is still ongoing, although the pace has slackened somewhat in 2013 and 2014 relative to the rapid progress made in 2010-2012. As the second most relevant subsector in terms of public expenditure, surpassed only by the social security system, Spain's autonomous regions have also played their part - largely through expenditure cuts. The fiscal adjustment process at the regional level now appears to have stabilised at around 1.5% of GDP, with the effect of the measures taken having run its course. Correcting the outstanding imbalance will require additional economic growth to boost revenues, while containing expenditures. Additional measures should be taken on the income side, together with the implementation of more adequate control mechanisms to ensure regional commitment to fiscal/financial sustainability.

In order to explain changes in the public accounts, it is necessary to take a brief look at the prevailing economic climate. 2014 was characterised by economic growth at a rate of 2.7% in the fourth quarter (in annualised terms) supported by a strong recovery in domestic demand. This was driven by several factors, including falling oil prices, expansionary monetary policy, and improved credit conditions for households and businesses (Laborda and Fernández, 2015). Economic recovery has undoubtedly boosted the immediate outlook for public accounts at all levels of government. However, due to the characteristics of the financing system, autonomous regions in the common regime experience a slight lag in income fluctuations in response to changes in the economic cycle. The National Tax Administration Agency (AEAT) manages the financing of the autonomous regions in the common regime through a system of advance payments of assigned taxes, such that each year's forecast is independent of its tax revenues. The current economic recovery will therefore take time to show up in the regional accounts, except in the two "foral" regions (the Basque Country and Navarre), which manage all of their taxes directly.

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Autonomous regions' deficit

As Table 1 shows, since 2010, the autonomous regions have cut their borrowing requirement almost in half, which is an outstanding achievement considering that nominal GDP was 2.1% lower in 2014 than in 2010. What is more, this consolidation effort exceeds that of the general government as a whole, where the deficit has dropped by almost 40%. However, in 2014, the autonomous regions' borrowing requirement rose relative to the previous year for the first time since 2011, which could indicate that, on the current income and expenditure structure, the adjustment has run its course. All the autonomous regions made a substantial adjustment (a reduction of more than 70% in some cases) over the period as a whole, except Madrid, where the deficit is slightly worse than in 2010, and Extremadura, which ended 2014 with the same deficit as it began.

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Table 1

Regional Government Net Lending (+) / Net Borrowing (-)
(ESA* 2010. Base 2010)

Autonomous Regions	Excluding balance of final settlement		2012	2013	2014	Change 2013-2014 (% GDP)	Difference 2010-2014 (%)
	2010	2011					
Andalusia	-3.1	-3.4	-2.1	-1.5	-1.2	-0.36	-63.1
Aragon	-2.9	-2.6	-1.6	-2.2	-1.7	-0.52	-42.7
Asturias	-2.7	-3.6	-1.0	-1.1	-1.3	0.24	-51.9
Balearic Islands	-4.4	-4.3	-2.0	-1.2	-1.7	0.47	-61.1
Canary Islands	-2.4	-1.5	-1.1	-1.0	-0.9	-0.10	-62.0
Cantabria	-3.9	-3.7	-1.9	-1.2	-1.5	0.22	-62.5
Castile-La Mancha	-6.3	-7.6	-1.3	-2.0	-1.8	-0.26	-72.0
Castile and Leon	-2.6	-2.7	-1.5	-1.2	-1.1	-0.07	-56.8
Catalonia	-4.5	-4.1	-2.2	-2.0	-2.6	0.62	-42.4
Extremadura	-2.4	-4.6	-1.0	-0.9	-2.4	1.58	-0.1
Galicia	-2.3	-2.2	-1.3	-1.1	-1.0	-0.12	-55.9
Madrid region	-1.0	-1.8	-1.0	-0.9	-1.3	0.40	31.8
Murcia region	-4.9	-4.7	-3.2	-3.2	-2.8	-0.34	-42.1
Navarre	-3.8	-3.1	-1.7	-1.5	-0.7	-0.71	-80.4
La Rioja	-3.8	-1.5	-1.1	-1.0	-1.2	0.16	-68.4
Valencia region	-4.6	-4.9	-3.8	-2.2	-2.4	0.19	-48.0
Basque Country	-2.4	-2.7	-1.5	-1.2	-1.0	-0.16	-59.0
Regional government total	**-3.17**	**-3.34**	**-1.84**	**-1.52**	**-1.66**	**0.14**	**-47.8**
General government total	**-9.35**	**-8.94**	**-6.62**	**-6.33**	**-5.69**	**-0.64**	**-39.2**

Note: (*) European System of National and Regional Accounts.

Source: Intervención General de la Administración del Estado (IGAE), updated April 15th, 2015.

In 2014, only four autonomous regions met the 1% deficit target set by the government under Organic Law 2/2012 on Budgetary Stability and Financial Sustainability (LOEPSF). These were the two foral regions (the Basque Country and Navarre), the Canary Islands (which also have special financing arrangements), and finally Galicia, a region that traditionally meets its target. At the other end of the spectrum, the deficits of the Murcia region, Catalonia, Extremadura, and the Valencia region were in the 2.4% to 2.8% range. This apparently widespread non-compliance should be nuanced, as the problem is not just a lack of discipline, but that the targets set were somewhat unrealistic, being the same for all regions regardless of their starting point (Fernández Leiceaga and Lago Peñas, 2013). Examining the 2014 effort from a different perspective, nine autonomous regions have reduced their deficit with respect to 2013 (with the best performance in Navarre, Andalusia, and Aragon), while eight have increased it (with the greatest slippage in Extremadura, Catalonia, and the Balearic Islands).

On April 24th, 2015, the government approved the mandatory report on compliance with the stability objectives for 2014, which reflected the previous deficit figures. This report also confirmed compliance with the "expenditure rule" provided in the LOEPSF. Thus, the autonomous regions can be seen to have complied overall in 2014, but expenditure in the Basque Country, Catalonia, Extremadura and the Balearic Islands grew by more than 1.5%, thus breaking the rule at the individual level.

Table 2 shows how, over the period 2010-2014, the adjustment was largely on the expenditure side, which dropped by 2 points of GDP, while income grew very slightly (0.1% of GDP). Moreover, expenditure adjustment was largely achieved through a reduction in capital expenditure, which dropped by 1.4 points. As is well known, the autonomous regions manage health-care, education and social services expenditure, which tends to rise either as a result of technological change (in the case of health-care) or upward pressure from citizens. Therefore, any reduction in this expenditure, no matter how small (0.54% of GDP), represents a significant fiscal consolidation effort. The central government has also made a noteworthy effort by way of: a salary cut of 5% in 2010, which, due to the subsequent pay freeze, has not been recovered; low staff replacement rates; and measures in April 2012 affecting education (Royal Decree-Law 1472012) and health care (Royal Decree-law 16/2012).

Table 2 also shows that the difference between current resources and current expenditure has remained stable at around 1% of GDP since 2012. This means that –like the central

Table 2

Autonomous regions' non-financial operations
(ESA* 2010. % of GDP)

	2010	2011	2012	2013(P)	2014(P)
Non-Financial Resources	13.68	12.90	16.22	13.95	13.78
Current Resources	12.81	12.18	15.54	13.31	13.13
Capital Resources	0.88	0.72	0.68	0.64	0.65
Non-Financial Expenditure	17.40	18.00	18.07	15.46	15.43
Current Expenditure	14.70	15.80	16.53	14.15	14.16
Capital Expenditure	2.71	2.20	1.54	1.31	1.27

Notes (*) European System of National and Regional Accounts. (P) Provisional data.

Source: Intervención General de la Administración del Estado (IGAE), Updated April 15th, 2015.

government– the autonomous regions finance a portion of their current expenditure with debt. This is unsustainable over the medium term and efforts to correct it have not yet succeeded. The economic recovery begun in 2014 should eliminate this structural imbalance, provided that the improvement in revenues is not accompanied by a corresponding rise in spending.

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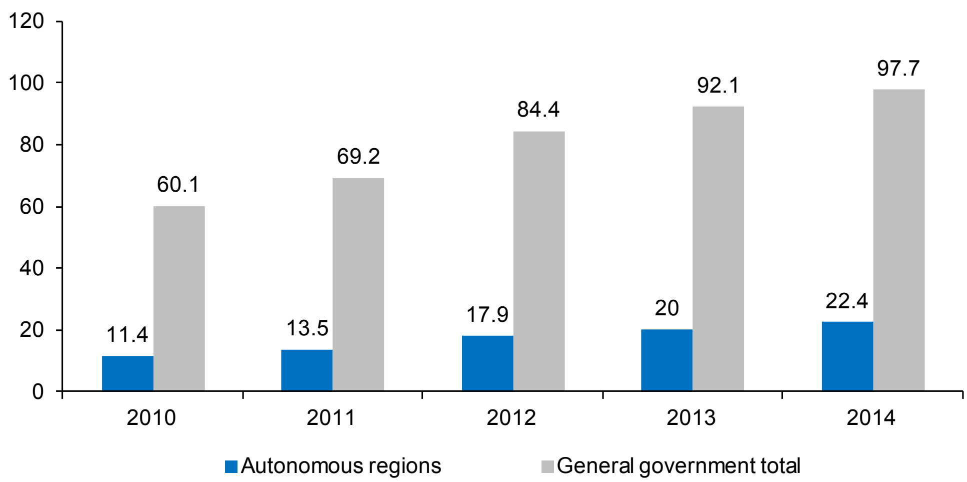
Autonomous regions' debt

Exhibit 1 shows the change in the autonomous regions' debt since 2010, in comparison with total general government debt in Spain based on data for the Excessive Deficit Procedure (EDP). Regional debt is a quarter of the total, although it is the fastest growing segment, having almost doubled, compared with a 62.6% increase in total debt over the period.

The main public debt figures need to be analysed at the level of the individual regions, given the wide divergences between them shown in Exhibit 2. There are five regions with a volume of debt exceeding the national average, revealing a continuous deficit path over the years, even before the crisis in some cases. These are the Valencia region, Castile-La Mancha, Catalonia, the Balearic Islands, and the Murcia region. Conversely, Madrid, the Basque country, and the Canary Islands have debt of less than 15% of GDP.

The sustainability of these debt levels cannot be assessed simply by comparing them with GDP. A more appropriate indicator is the region's ratio of debt to current revenues, as shown in Exhibit 3. The regions' debt comes to 170.4% of their current resources in national accounts terms. The five most indebted regions obviously have the

Exhibit 1
Regional and General Government debt
(% GDP)

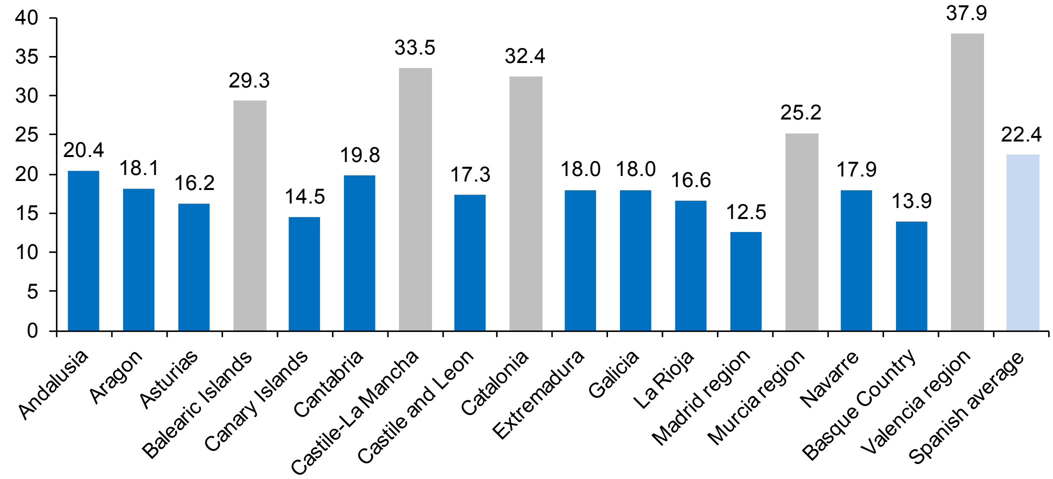


Source: Bank of Spain.

Exhibit 2

Regional debt

(% of GDP)



Source: Bank of Spain.

highest levels on Exhibit 3, although the relative positions of some of them change. For instance, the Madrid region is no longer in the best position, although it remains below the average. Two regions stand out: Catalonia and the Valencia

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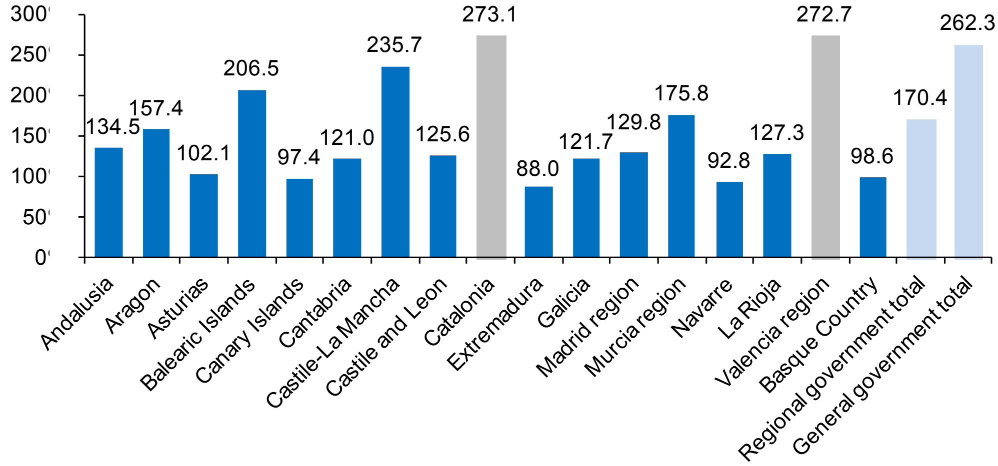
region, which exceed even the ratio of public debt to current resources of Spain as a whole (262.3%). Now that international financial markets are not suffering the stresses of 2010 and 2012, it will be possible to roll over these high levels of debt without serious difficulty and at low interest rates. Moreover, the institutionalisation of State liquidity mechanisms insulates the regions from market tensions. As discussed below, in late 2014 the exceptional funding mechanism introduced in 2012 was made permanent.

Under LOEPSF, the Fiscal and Financial Policy Council (CPFF) and the government set the overall and individual debt targets the autonomous regions are to meet in the following year. Although this target was corrected in July 2014, being set at 21.1% of GDP, the regions have only been able to meet it thanks to a series of exceptions the Council of Ministers applied to the calculations. Thus, the report on compliance with the LOEPSF (Ministry of Finance and Public Administration, 2015) states that the target with exceptions was 22.5%, such that it would be met with a debt of 22.4%. Nevertheless, the regions of Aragon, Castile-Leon, Catalonia, and La Rioja have a regional debt-to-GDP ratio that exceeds their target. Given the peculiarity of this result it is worth quoting the report of the Independent Fiscal Responsibility Authority (AIReF, 2015) on this point: “The AIReF cannot assess the autonomous regions’ compliance with the target as there

Exhibit 3

Debt as percentage of current resources



Sources: Intervención General de la Administración del Estado (IGAE), (National Audit Office) current resource data (2015) and Bank of Spain EDP debt data (2015).

are uncertainties as to the operations that are ultimately to be included in the calculation, given the possibility that the Ministry of Finance and Public Administration determines the existence of circumstances that need to be taken into account in the achievement of the target." This being the case, the debt target is proving irrelevant and needs to be improved in the future. However, on a positive note, it is now different for each region, depending on its initial level.

Exceptional funding mechanisms

Since 2012, various mechanisms have been put in place by the central government to help finance

With the creation of various State run regional financing and liquidity mechanisms, the structure of regional debt has changed and the Treasury is playing an increasingly important role as the "regions´ bank."

the regions and provide liquidity. Three editions of the Fund for Financing Payments to Suppliers (FFPP in its Spanish initials) were created and a Regional Liquidity Mechanism (FLA in its Spanish initials) was set up, changing the structure of regional debt. Table 3 shows how at year-end 2014, 37.5% of regional debt was now in the hands of the Spanish treasury. This debt totalled 88,724.9 million euros, 8.4% of GDP.

These exceptional mechanisms were made available in exchange for severe adjustment plans. The regions making most use of the mechanisms have been Murcia, Castile-La Mancha, Andalusia, Valencia, and Catalonia, three of which had a deficit exceeding 2% in 2014. It cannot be argued that the stricter control to which the regions drawing on these mechanisms have been subject has led to stronger budgetary discipline. Conversely, the two foral regions, Galicia, Castile-Leon, and La Rioja, have not resorted to any of the mechanisms and their deficit in 2014 was very small (see Table 1).

In each of the three years of application, State funding has increased its relative share, such that the Treasury is playing an increasingly important role as the "regions' bank". These measures finally

Table 3

Percentage State financing (FFPP + FLA)

Autonomous Regions	2012	2013	2014
Andalusia	26.1	43.6	55.7
Aragon	9.2	8.1%	1.2
Asturias	18.9	28.5	29.1
Balearic Islands	21.4	36.5	48.4
Canary Islands	24.3	34.8	43.2
Cantabria	22.8	32.1	42.6
Castile-La Mancha	38.8	45.3	56.9
Castile and Leon	13.3	12.3	0.0
Catalonia	16.6	37.3	49.3
Extremadura	9.4	8.9	10.4
Galicia	0.0	0.0	0.0
Madrid region	6.2	6.1	0.4
Murcia region	34.0	48.2	61.4
Navarre	0.0	0.0	0.0
La Rioja	6.8	0.0	0.0
Valencia region	27.2	37.9	54.3
Basque Country	0.0	0.0	0.0
Total	**18.2**	**29.3**	**37.5**

Source: Bank of Spain.

lost their exceptional character with the passing of Royal Decree Law 17/2014, which implemented new mechanisms and recast the existing ones. Although in December 2014, the financial markets were no longer closed to the autonomous regions, which had been the initial justification, it was decided that this liquidity system be consolidated, confirming a structural change in the Spanish regional financing model.

Thus, in 2015, an Autonomous Regions Financing Fund was created, comprising four sub-funds:

- Financial facility: aimed at regions meeting their budgetary stability, public debt, and commercial debt payment period objectives. Access to this sub-fund does not require the adoption of an adjustment plan.

- Regional liquidity fund: in principle, made available to regions already belonging to the liquidity fund (FLA), and to those not meeting the average supplier payment period target. The requirement for an adjustment plan and strict control by the Ministry of Finance and Public Administration has been maintained.

- Social fund: finances the regions' commitments to local government bodies through agreements for the provision of social services. Only applicable in 2015.[2]

[2] It has been endowed with 683.4 million euros so that the eight regions accessing it can pay the outstanding sums to local authorities. These are ten-year loans with a two year grace period and a zero interest rate in 2015. See http://www.minhap.gob.es/Documentacion/Publico/GabineteMinistro/Notas%20Prensa/2015/S.E.%20ADMINISTRACIONES%20P%C3%9ABLICAS/28-04-15%20NP%20FLA%20SOCIAL.pdf

- Liquidation fund for the financing of supplier payments, which holds the assets the Treasury has acquired from the autonomous regions from the three previous supplier funds, but it will not grant new loans.

Technically, membership of the various sub-funds is voluntary, but in the case of a region's not choosing to join the social fund, the State may withhold the financing system's payments so as to credit the corresponding amounts to the local government bodies. Also, if the budgetary stability or debt objectives are not met in the terms established in the LOEPSF, the Ministry of Finance and Public Administration (MINHAP) may require the region sign up to the FLA. A significant feature of the new Fund is that, at least in 2015, the interest rate will be 0% and the operations entered into in previous years have an additional year's grace period, such that no principal has yet been repaid on any of them (Seventh and eighth additional provisions of RDL 17/2014).

Finally, at the time this article was written, a draft law is being debated by parliament to reform Organic Law 22/1980 on Financing of the autonomous regions (LOFCA) to incorporate some of the instruments necessary for the operation of the financing fund. In particular, this consolidates the withholding of resources from the regional financing system to guarantee collection by the State of sums it has lent to the regions. This draft law also creates a new fund, termed the "Instrument to support the sustainability of pharmaceutical and health-care spending," which is expected to come into force in 2015, unless the Government Delegate Commission for Economic Affairs decides to extend it.[3] The amounts and conditions for the financing of pharmaceutical and health-care spending loans are pending implementation.

All the regions except the two foral regions and the Madrid region, which have maintained their ability to tap the markets, have joined the regional financing fund. The regions included in the liquidity fund (FLA) to date have had the option of joining the financial facility sub-fund if they meet the conditions. In 2015, the only regions remaining in the FLA are: Cantabria, Castile-La Mancha, Catalonia, Murcia and Valencia. The regions of Andalusia, Aragon, Asturias, the Canary Islands, Castile-Leon, Extremadura, Galicia, the Balearic Islands, and La Rioja are in the "financial facility" sub-fund,[4] which does not require an adjustment plan.

The passing of RDL 17/2014 was presented as generating savings for the regions it covered, thanks to the zero interest rates they would benefit from. However, it is not possible to quantify the savings exactly, as the Ministry of Finance has given varying figures. The latest figures published situate the savings in 2015 at 3,019 million euros for the 14 regions in the FLA.[5] It should be noted that the savings for the regions will be a cost for the State, which pays less interest on its debt, but will forgo the income it previously received from the regions. In effect, it represents a transfer of resources between levels of government.

RDL 17/2014 and the financial bail-out policy targeting the regions since 2012 have important consequences:[6]

- Firstly, it is worth asking whether the exceptional financing mechanisms have not led to an increase in the deficit and the debt. The total increase in regional debt over the three years (2012-14) was 91,661 million euros, of which 88,725 million euros were from the Treasury. In 2012, with the financial markets closed, State intervention was perhaps inevitable to avoid one or more regional defaults on international debt, but putting the mechanism on institutional

[3] Given that the FLA was created in 2012 with an identical formula, it is expected that the instrument will remain in place.

[4] In view of non-compliance in the 2014 financial year, some of these regions may pass to the FLA.

[5] Update to the 2015-2018 stability programme approved by the government on April 30th, 2015 (page 58).

[6] Without prejudice to the macroeconomic effects, which are not considered here. On this point, see Delgado *et al.* (2015).

footing could be encouraging the regions to take on debt.

- Moreover, the various sub-funds within the Financing Fund address debt maturities of past debt and financing of the deficit incurred in each year, without fulfilment of the established deficit target being an operational restriction. This was underlined by the AIReF: “With this Royal Decree-Law, a norm with the status of law envisages, on a permanent basis, the financing by the State of the deficit deviations of past financial years at a low rate of interest (in the short term the interest rate is zero).” This has softened the budgetary constraints on the autonomous regions considerably.

- The reference of market discipline controlling the behaviour of most autonomous regions has been lost. From now on, both financial institutions and suppliers know that no autonomous region will stop paying, as the State has committed itself to paying if necessary. This commitment comes at the price of a degree of loss of independence, but regional governments in non-compliance are not at risk of being denied access. Thus, financial markets no longer exert pressure on the autonomous regions to dissuade irresponsible conduct.

Institutionalising the Treasury’s position as the autonomous regions’ financier poses significant risks to future budgetary stability and financial sustainability, not just of the autonomous regions but the Kingdom of Spain as a whole.

In short, institutionalising the Treasury’s position as the autonomous regions’ financier poses significant risks to future budgetary stability and financial sustainability, not just of the autonomous regions but the Kingdom of Spain as a whole. Bear in mind that when an autonomous region owes large sums to the central government, the risk of default rises to the extent that it is only a political question. This risk is formally covered by the withholdings of payments from the funding system, but this lacks credibility as there is little likelihood that this withholding will be made in practice if a region were to allege that it was unable to meet its statutory expenditures if it repaid its debts to the State.

Outlook for 2015

The starting point for an assessment of the outlook for the regional accounts in 2015 is a deficit of 1.7% of GDP in 2014. The target set by the Fiscal and Financial Policy Council (CPFF) and the government for 2015 is 0.7%. The current year therefore represents a significant consolidation challenge for the subsector as a whole, with the aim of cutting the borrowing requirement by at least half. Again, the analysis should distinguish between regions, as they are starting out from different positions and face different conditions. Firstly, the foral regions receive the totality of the tax revenues collected in their territories, such that the improvement in the economic situation should be clearly reflected in their revenues. The Canary Islands also obtain a larger share of tax revenue linked to economic activity, such as the Canary Islands general indirect tax (IGIC) and other taxes of their own. Moreover, in 2014, these three regions, along with Galicia, started with a deficit of 1% or less.

In the case of autonomous regions in the common system, advances under the financing system grew by 2.9% compared to 2014. Other income, accounting for approximately a quarter of non-financial resources, can be expected to improve as the economy picks up. However, the revenues from duty on transfers of assets and documented legal transactions (ITP and AJD), inheritance and gift tax (ISD), and income from property divestments, seem to be overestimated, as the AIReF points out (AIReF, 2015). Income from the financing system, paid by the Ministry of Finance and Public Administration, is also reported at above its real value, as recognised in the update to the 2015-2018 stability programme. Overall, budgeted income is 8.8% higher than the recognised obligations in 2014.[7] An over-optimistic income forecast makes it possible to budget for more spending in the deficit target framework, unless the spending rule is applied to initial budgets.[8] If real income is significantly less than budgeted, the deficit will overshoot that budgeted unless non-availability agreements or similar measures are adopted.

One factor to take into account in 2015 is that elections are under way in fifteen regions. This situation makes it impossible to adopt unpopular measures before the election, but may also mean more non-execution of spending than usual, as a change of government tends to slow activity. Nevertheless, the post-election political instability foreseeable in some parliaments and the incentives for new governments to frontload as much spending as possible in their first year in office could act in the opposite direction. Similarly, if further backlogs of invoices have built up, pending recognition on the accounts, as happened in the previous legislative period (2007-2011), these could emerge in late 2015 in an attempt to lay the blame on the outgoing government. This strategic behaviour can be seen in Table 1 in the case of Castile-La Mancha, Extremadura, Asturias, or even Madrid in 2011.

Nevertheless, the regional budgets for the current year did not take into account the savings in interest obtained from the passing of Royal Decree-Law 17/2014 of December 26th 2014, or the aid that the creation of the new “instrument” for financing pharmaceutical spending might imply. Moreover, almost all the autonomous regions will need to present or update financial/economic plans, having failed to meet their deficit, debt or spending rule targets in 2014, and this will be a good time to adopt containment measures to bring the deficit close to meeting the goal of 0.7%.

Reaching the budgetary stability and debt targets overall does not look possible in 2015, although a slight reduction from the 2014 deficit could be achieved.

In essence, reaching the budgetary stability and debt targets overall does not look possible, although a slight reduction from the 2014 deficit could be achieved. The AIReF (AIReF, 2015) does not believe the overall objective will be met because “a high risk of non-compliance with the 2015 stability objective is apparent in Andalusia, Aragon, the Balearic Islands, Cantabria, Castile-La Mancha, Catalonia, Extremadura, Murcia and the Valencia region.”

Concluding remarks

In the context of the current economic recovery, this article concludes with a look at the medium-term trends in regional budgets in the aftermath of the crisis. The stability programme update envisages the autonomous regions reaching budgetary equilibrium in 2018, which means achieving an adjustment of 1.7% of GDP over the next four years. Moreover, as we have seen in Table 2, there is still a negative gross saving pending correction. The consolidation of the public accounts therefore has to continue, on both the income and expenditure sides.

The government envisages that total public resources will rise from 37.8% of GDP in 2014 to 38.1% in 2018. If this is so, the regions’ current gap between resources and uses can only be closed on the income side through an increase in the autonomous regions´ share of total resources.

[7] Update to the Kingdom of Spain’s Stability Plan 2015-2018, page 53.

[8] To date, the spending rule has been confirmed only at the time of settlement.

This is difficult to predict, but if the central government has substantially reduced its portion of income tax and corporation tax, it is feasible that as the economy grows, the weight of indirect tax (of which the regions receive slightly more than half) and the regional portion of income tax would account for a larger share of the tax burden. Nevertheless, some regions have followed the State's lead on cutting income tax, which will have an impact on their revenues in 2016 onwards. Moreover, in its stability programme update, the government envisages that the regions will raise the rates of ITP, AJD and ISD. However, these taxes are regional competences, making it hard to be sure whether this will happen, unless the national parliament adopts far-reaching reform, such as setting a common floor for these taxes nationwide. The only conclusion we can draw is that the increase in income looks unlikely to allow the autonomous regions to achieve budgetary equilibrium on its own.

On the spending side, almost half of current expenditure goes to compensation of employees. The regions' payroll accounted for 7% of GDP in 2010 and now stands at 6.5% of GDP. In the years 2004-2006, this spending was 5.8% of GDP, which means that if the intention is to return to these levels, we are still only half way through the adjustment. Admittedly, if the limitation on replacement rates and pay freezes continues, rising GDP will reduce salaries' relative share by itself. The doubt that arises is whether, with the economy growing at a rate in real terms close to 3%, the national government –which has competence for public sector pay– will be able to resist the pressure to expand the workforce and restore purchasing power. As in 2010, the remainder of the autonomous regions' current expenditures was 7.7%. This reveals this component's considerable resistance to downward pressure. These expenditures include debt interest (rising to 0.7% in 2014 from 0.3% in 2010), health and education agreements, current transfers funding service delivery and other levels of government. Current expenditure other than staff costs came to 6% of GDP in the period 2004-2006. The positive outlook in this area is that debt interest is falling and the government has announced fresh controls on pharmaceutical spending, which have yet to be defined. Nevertheless, total debt continues to grow, making interest expenditure highly sensitive to possible future rate rises.

Finally, as already mentioned, capital expenditure has dropped from 2.7% to 1.3% of GDP. In the 2015-2018 stability programme update, the government forecasts public investment of around 2% of GDP at the end of the period. Additionally, it should be noted that tenders for public works at all levels of government started to grow as economic activity began to recover in 2014 (Laborda and Fernández (2015). This suggests that it will not be easy to keep down the regions' capital expenditure levels.

The autonomous regions were unable to turn a surplus in the previous growth cycle. Therefore, taking into consideration the trends just described, it remains to be seen whether or not the central government has the right mechanisms to ensure that the increase in regional income from the upturn in the economic cycle translates into surpluses earmarked for debt reduction rather than more expenditure. Following the numerous reforms undertaken since 2012, the LOEPSF is the right tool, but, as the AIReF reports (AIReF, 2015), its prevention, correction and coercion measures are not being applied. Perhaps the time has come to set different stability targets for each region. And applying the spending rule to initial budgets seems indispensable.

It remains to be seen whether or not the central government has the right mechanisms to ensure that the increase in regional income from the upturn in the economic cycle translates into surpluses earmarked for debt reduction rather than more expenditure.

In more general terms, the government also has the opportunity to reform the financing system for the regions in the common system, and link this reform to long-term commitments to budgetary stability and fiscal sustainability. The next few months could be a good time to renew the territorial agreement in three major directions: first, a solid commitment to the fiscal rule on budgetary stability and debt; second, a new regional financing system aimed at joint fiscal responsibility; and finally, an automatic penalty mechanism for breaches, with a stronger market focus. This agreement should be based on a cooperative approach reflecting the will of the parties involved, as happens at the European Union level between nation states, and not imposed top-down, which creates incentives for subsequent non-compliance (Ruiz Almendral and Cuenca, 2014). In short, in order to reach equilibrium in 2018, measures need to be taken affecting the regions. The current dynamics of income and control mechanisms could prove inadequate.

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