

Institutional Framework for Spanish Subnationals

Special Report

Increased Devolution: The basis of the Spanish institutional framework for subnationals was established in the 1978 constitution. Since then, many changes have affected all three main tiers of subnationals. Revenues are often more closely correlated with the economic base but the regional and provincial revenue base depends on taxes which are levied, collected and inspected by the state. Subnationals have a wider scope of responsibilities on expenditure, increasing their importance in the Spanish public sector.

Tight Control on Debt: The greater role of Spanish subnationals in the public sector has gone hand in hand with tighter control over their finances, particularly since the introduction of the budgetary stability law (BSL). Regional debt outstanding is monitored by the central government, which also knows the amount and timing of principals due the following year. Regional governments (LRGs)' authorization of debt is subject to a strict calendar, except for those who have complied with the deficit target.

Disclosure of Accounts: Tighter control has translated into much greater accounts transparency on the accounts and has made them more timely. The development of the BSL has meant that the regions' synthetic and standard statements are now disclosed on the Ministry of Finance's website. However, at the regional level, there have been hidden deficits from non-recognition of invoices and this has placed in question the reliability and effectiveness of the accounting inspection body.

Large Public Sector: This is particularly the case for regions that have developed in the last decade a complex network of participations in companies, which are, most of the time, public entities. This has made the comparison of their financial accounts complex and less accurate.

Limited Tax Flexibility: Even though Spanish LRGs have seen their revenue base increase in line with the local economic base, their involvement in tax management has not increased steeply. Therefore, the state makes estimates for a given year and settles later. This practice undermines the LRGs' ability to predict their own revenues. Cities are more involved in the collection of their own revenue and less dependent on state forecasts.

Improving Tax Equalisation: With the adoption of the new funding system, the solidarity across the regions to share tax has increased. As much as 75% of the tax collected by the central government is subject to redistribution according to some economic and demographic criteria. In the cities, the tax equalisation mechanism lacks transparency and is outdated so there is a substantial funding gap, even for those with a similar socio-economic profile.

Scope of Responsibilities: The central government can modify the scope of responsibilities of the subnationals. It passed in 2006 the care law, which required the autonomous communities and local entities to improve the social care for certain groups of citizen. As subnationals have gradually embraced important social welfare responsibilities, the state and the sub-nationals have to negotiate, in particular about funding. If a sub-national were to have difficulties in providing basic social services, the central government would probably help out.

Overall Neutral Framework: This stems from the stable regulatory regime, the debt restrictions that are currently in place with some financial liabilities that are still not fully integrated, adequate visibility of the accounts with sometimes a lack of transparency in part due to the complexity of the perimeter of the public sector. It also takes into account the lack of revenue flexibility.

Related Research

[Spanish Autonomous Communities' New Deficit Scenario \(August 2010\)](#)
[Spanish Autonomous Communities' New Funding System Greater Solidarity Makes Regional Revenue More Exposed to National Economy \(April 2010\)](#)

[Large Municipalities face New Element of Risk \(July 2003\)](#)

Analysts

Guilhem Costes
+34 93 323 8410
guilhem.costes@fitchratings.com

Clara Escrich
+34 93 32384 01
Clara.escrich@fitchratings.com

Fernando Mayorga
+34 93 32384 07
fernando.mayorga@fitchratings.com

Figure 1
Distribution of Provinces

Autonomous communities	Number of provinces
Andalusia	8
Asturias	1
Aragon	3
Balearic Islands ^a	4
Catalonia	4
Castile la Mancha	5
Castile Leon	8
Canary Islands ^a	7
Cantabria	1
Extremadura	2
Galicia	4
Madrid	1
Navarre	1
Basque Country	3
Murcia	1
Rioja	1
Valencia	3

^a Island councils
Source: Fitch

Local Administration and Finances

Legal Framework – Territorial Organisation

Subnationals in Spain are territorially divided into three main tiers of government: autonomous communities, provinces and municipalities and there is no subordination link between them.

- 57 provinces or island councils are grouped to form 17 autonomous communities. In the case of the two archipelagos (Balearic Islands and the Canary Islands), each island has its own government whose mission is similar to those of the provinces in continental Spain.
- Six autonomous communities out of the 17 consist of one single province and in these cases the autonomous community and province's funding and responsibilities are at the same tier (see Figure 1). Autonomous communities were initially divided into two main groups: those eligible for a fast-track decentralization process, and slow-track decentralization (under article 143 of the constitution). But since 2002, and after all autonomous communities took charge of the delivery of healthcare, the scope of responsibility was homogenized across the fast and slow-track communities. However, two autonomous communities have special regimes, allowing them more autonomy particularly on the fiscal side: Navarre and the Basque Country.
- 8,102 municipalities with similar scope of responsibility and only a slight differentiation (especially on the funding side) between those located under the common regime and those in Navarre and the Basque Country. Since 1988 (renewed in 2005-2006), Madrid and Barcelona have regimes different from other municipalities.

Responsibilities

Autonomous Communities

Responsibilities can be divided into two groups. The first one relates to those over which autonomous communities have exclusive control, such as territorial and urban planning, culture, regional roads and social services. The second includes responsibilities where the autonomous community shares regulatory powers with central government, such as education, healthcare and the environment. The exact degree of involvement of each tier of authority in such responsibilities is difficult to determine, although the core legislation for all the autonomous communities is set by the central government, ensuring a basic level of service provision.

Conflict in the Level of Responsibilities

The 1978 constitution defined the level of responsibilities of autonomous communities leaving them the option to absorb other functions under certain conditions. Hence, autonomous communities approved their charters, which contained their scope of responsibilities; these and its modifications have to be approved by the regional and the central government. After several transfers of responsibilities and needing to integrate new demands and seek wider funding, some autonomous communities have recently modified their regional charters. The divergent wording of the regional charters and the constitution may cast doubts on the ownership of some responsibilities, especially when they are shared between the two tiers.

Provinces

Organic Law 7/1985 determines provincial governments' responsibilities. Rather than being specific, the framework is loosely defined, as the law states that provincial administrations are in charge of co-ordinating services among municipalities so that an adequate level of services is provided to citizens. The concept of adequacy of services remains vague and is subject to the province's own perceptions and will. This means that, generally, municipalities do not take legal action against provinces claiming that a service has not been adequately covered. The same Article 36 of the law that describes adequacy of services requires the province to provide any necessary technical, economic or legal assistance to municipalities, especially those of small size. However, the law neither specifies what is meant by small size nor the scope of assistance.

Related Criteria

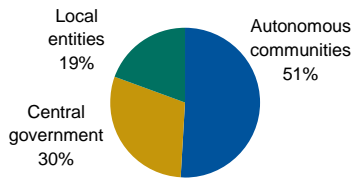
[Assessment of the Institutional Framework for Subnationals \(March 2011\)](#)

[Tax supported Rating Criteria \(August 2011\)](#)
[International Local and Regional Government Rating criteria \(April 2011\)](#)

Figure 2

Spanish Public Sector

Expenditure per tier of government



Source: Ministry of Economy and Finance and Fitch

As the main mission of a province is to assist its municipalities in providing an adequate level of service, it follows that the higher the proportion of smaller municipalities in its territory, the higher the pressure on its expenditure. For more on provinces see *Spanish Provinces Under Common Regime* published in February 2011.

Municipalities

Law 7/1985 (Ley de Bases de Régimen Local; LBRL) establishes the responsibilities of municipalities under the common regime according to their size. By law, cities of more than 50,000 inhabitants have exclusive responsibility for: lighting, cemeteries, waste collection and treatment, water provision, sewerage, street paving, food control, public gardens, markets, public libraries, civil protection, social services, fire brigades, sports infrastructure, public transport and environmental protection. However, the law does not set the level and quality of services to be provided, leaving some flexibility to the cities. In addition, as municipalities are the first institutional point of contact for citizens, they often have to provide services belonging to other tiers of government. Municipalities do not have legislative powers, as the state and autonomous communities do. However, municipalities can use by-laws (Ordenanzas Fiscales) to regulate taxes, fees and public charges.

Funding Arrangements**Autonomous Communities**

Alongside the decentralisation process and to guarantee the financial self-sufficiency stipulated in the constitution, autonomous communities' resources have gradually increased, particularly during reviews of their funding arrangements. The financial regime of the autonomous communities under the common regime is governed by the organic law 8/1980 (LOFCA). This law initially established that the financial model had a validity of five years. In consequent periodic reviews, the central government granted the autonomous communities a larger share of taxes.

The last review of the LOFCA in December 2009 (law 22/2009, 18 December) did not establish an expiry date but stipulated that the main elements of the model could be amended every five years. The basket of taxes in which the autonomous communities were entitled to a share was widened. In particular, autonomous communities are presently eligible to receive 50% of value-added tax (VAT), 50% of the personal income tax (PIT) and 58% of the special taxes. PIT and VAT are the two most important taxes in regional revenue; both are collected and inspected by central government and a share of both is then transferred to the autonomous communities.

VAT and special taxes are distributed according to consumption indexes calculated which are updated annually by the Spanish statistical office (INE) and in Fitch's view, autonomous communities would benefit from more transparency in the way those indexes are computed. PIT is distributed after taking into account the fiscal residence of the regional population and any regional-specific fiscal benefits. For more on regional funding please refer to *Spanish Autonomous Communities' New Funding System* published April 2010.

The system in place since January 2009 (only fully integrated for the first time in 2011) has two main funds aimed at equalising revenue amongst autonomous communities:

Guarantee of Basic Public Services Fund (GBPSF) ensures that all autonomous communities receive the same resources per inhabitant, in terms of corrected population or unit of need, not just in the first year of application, but also in the future. The GBPSF is made up of 75% of most of the autonomous communities' tax revenues and EUR7.4bn added by the state and is distributed according to adjusted population criteria. Thus, an autonomous community will receive a positive or negative transfer depending on whether its own tax revenue covers its funding per unit of need.

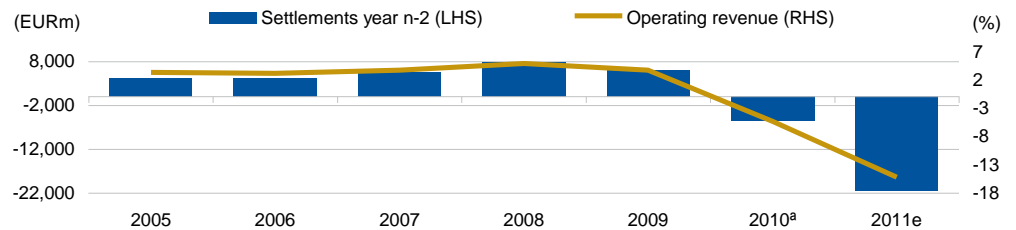
Global Sufficiency Fund: the overall financing needs of each autonomous community estimated by the central government in the base year are in theory covered with its tax capacity, the

transfer from the Guarantee Fund and the Global Sufficiency Fund (GSF). For more on the funding system please see *Greater Solidarity Makes Regional Revenues More Exposed to National Economy*.

Figure 3

Settlement From Past Years

Autonomous communities under the common regime



^a 2010 and 2011e: 2011 is unofficial estimation. These two negative settlements do not impact 2010 and 2011's accounts but from 2011 onwards

Source: Ministry of Economy and Finance and Fitch

In order for each autonomous community to prepare its annual budget, central government provides them (usually during the autumn of the previous year) with an estimate of the amount of tax, the balance of the GBPSF and the GSF to be received the following year. For each of these concepts, the autonomous community receives two amounts: the expected amount of the proceeds generated by a certain tax in a given year (also called interim), and the system settlement from two years before. The latter is the difference between the interim payments advanced two years before and the actual collection of each tax. In light of the great settlements (both credit and debit to autonomous communities) since 2002, this lack of involvement in forecasting undermines the autonomous communities' revenue planning ability. In 2009, the tax settlement was overestimated by as much as EUR18bn or about 13% of the operating revenue and had to be returned to the central government. Usually, it is returned in one year, but due to size of the deviations, it was agreed to be returned within five years.

Provinces

The financial resources of provincial administrations are derived from grants from central government. A new model was established in 1988 with an annual grant from the central government of EUR1,682m. The model has barely changed since then, except in 2002, when the central government decided that, from 2004, provinces would be entitled to receive a share of several taxes, but that their transfers from the central government would be reduced. Under the adjusted system the provinces receive:

- 0.9936% of their residents' personal income tax collected by central government, excluding the 33% share ceded to the regions.
- 1.538% of the value-added tax collected by central government, excluding the 35% share ceded to the regions.
- 1.2044% of the special taxes (duties on alcohol, beer, tobacco and wine) received by central government, excluding the share 40% ceded to the regions.

Provinces do not have any power to modify the rates of these taxes or apply deductions or reductions, which restricts their revenue autonomy and flexibility. For more on provinces see *Spanish provinces Under a Common Regime*, February 2011. Should the state introduce deductions in residents' tax income, provinces should receive some form of compensation.

The share of VAT and special taxes distributed by central government to each province will be based first on the regional consumption index (calculated by the national statistical institute) of the respective region where the province is located, and then adjusted in accordance with the province's population as a proportion of its region. Therefore, if there are migratory outflows,

the province could face a decline in revenue even though actual VAT and special tax collection may have increased. At the same time, migratory outflows imply a decline in the personal income tax base. The new system makes provincial revenues more dependent on the provincial economy.

Municipalities

The base of the municipalities' funding is described in its latest modification (Royal Decree 2/2004) – the initial law regulating local funding was approved in December 1988. This amendment simplified the funding system, dividing revenue into: taxes, fees, public prices and special contributions, and current transfers. Most of the current transfers come from the central government through participation in some nationally collected taxes. For more details on the funding on Spanish Municipalities, please see *Spanish Municipalities Face New Elements of Risks*.

Figure 4

Taxes collected by Municipalities and Maximum Tax Rates

(%)	2009 amount (EURm)	City	Cities with a status of capital of province
Property tax (IBI)	9,937	1.23 ^a	1.3 ^a
Tax on economic activities (IAE) (1st category)	1,548	3.8	3.8
Tax on vehicles (IVTM)	2,436		Depends on horse power
Tax on construction and building permits (ICIO)	1,187	4	4
Tax on land value increase (IIVT)	1,533	30	30

^a For cities that provide urban transport and services not compulsory to provide according to the law 7/1985. Source: Ministry of Economy and Finance, advanced data (December 2010).

The main local taxes are: the property tax, the tax on economic activities, the tax on land value increase (IIVT), the tax on construction and building permits (ICIO), and tax on vehicles (IVTM). These taxes, and especially the property tax, are resilient to the economic cycle.

The legal framework of these taxes is defined by the Royal Decree 2/2004 (consolidated law regulating local entities), but municipalities set the rates with thresholds established by the state. Municipalities are responsible for managing, collecting and inspecting their own taxes. In practice, a large number of cities transfer this task to the autonomous community, province or other local entity. Municipalities can also specify certain deductions and exemptions from these taxes.

In 2002, the central government passed law 51/2002, establishing that companies with a turnover of less than EUR1m did not have to pay the tax on economic activities. With the objective of preserving the municipalities' financial sufficiency, the state agreed to compensate them for this loss.

Law 39/1988 created the possibility for municipalities to participate in the state's revenue. The law has not seen any major changes. Nevertheless, since 2004 for municipalities (local authorities with more than 75,000 inhabitants and provincial capitals) the non-earmarked transfers from central government were replaced by a set percentage of certain national taxes, without these municipalities having any tax-setting powers or ability to change the bases:

- 1.6875% of the income tax of their residents after deducting the 33% share transferred to the autonomous communities. The central government collects the entire amount and then redistributes it to the municipalities.
- 1.7897% of VAT collected after deducting the 35% share transferred to the autonomous communities. The distribution is carried out according to consumption indexes calculated by the INE for each autonomous community and then adjusted by population.
- 2.0454% of the special taxes collected by the central government after deducting the 40% share transferred to the autonomous communities. The distribution is the same as for VAT.

The main disadvantage is the reduction of the highly predictable transfers from central government and the introduction of an element of revenue volatility, as economic performance has a greater effect on revenue growth.

The Foral Regime

Administrative and Political Framework

The first additional provision contained in the 1978 Constitution explicitly recognizes the existence of the foral regime. This regime applies to four provinces: Alava, Bizkaia, Gipuzkoa and Navarre. These are organised into two autonomous communities, the Basque Country (grouping Alava, Bizkaia and Gipuzkoa), and Navarre (uniprovincial region).

The special regime is attributed to the foral provinces and not to the autonomous communities, as it is based on historical rights exercised by these provinces. The main feature of the foral regime is its special tax arrangement whereby by which foral territories enjoy wide fiscal powers. This means that foral territories are entitled to levy, collect and inspect the main taxes generated within its boundaries, including PIT, VAT, special taxes and CIT. Foral territories then have to transfer part of these revenues (agreed taxes) to other tiers of government.

Fiscal Autonomy Is Often Threatened

Foral territories levy, rule and collect CIT, a freedom that is often questioned by other neighbouring sub-nationals and institutions. For instance, as historical territories have applied rates below those of the state, autonomous communities such as La Rioja and Castile Leon had appealed to consider this as state aid. In 1993 the Basque historical territories applied a fiscal exemption to newly created companies setting up in their territory, but that was considered in 2007 by the EU as state aid.

The point of these two appeals is whether historical territories can or cannot establish a different fiscal norm from the state without being considered as state aid. The EU decision was based on the legal precedent of Azores tax exemptions, in which the European Court of Justice established three conditions that need to be fulfilled to consider a territory as truly autonomous and with the right to have a different tax system:

- Institutional autonomy: the subnational (Historical Territories, Azores) has to have a different political and administrative statute.
- Procedural autonomy: the rule establishing differences in taxes must be approved without the interference of the central government.
- Economic autonomy: the loss of fiscal proceeds should not be compensated by the central government.

Historical territories fulfil these three conditions and that is why EU favoured their tax autonomy in its judgement in September 2008.

Transfers to the State: The Cupo Payment

The Statute of Autonomy of the Basque Country and the Law on the Reintegration and Improvement of the Foral System of Navarre stipulate that the financial relationship between these two autonomous communities and the state is to be drafted in the Economic Agreement in the case of the Basque Country and in the Convention System for Navarre.

These two agreements decide on the amount (the Cupo payment) that the two autonomous communities must transfer to the state for the responsibilities that have not been devolved. The latest update on the calculation of the Cupo payment corresponds to law 12/2002 in the case of the Basque Country and the latest update on the convention for Navarre is dated 2011. These two agreements stipulate an amount for the base year, which is then updated at the same rate as the growth of the state's revenues.

The state and these two autonomous communities have joint committees to solve potential discrepancies between them. Comisión Mixta is that of the Basque Country and made up of 12 members, six belonging to the state, three to the Basque Country and one for each foral province. The Junta de Cooperación is that of Navarre and has an equal number of members from the state and Navarre. These organs are in charge, amongst others, of coordinating the stability principles and arbitrate conflicts between both parties.

Transfers Within Institutions in the Basque Country

Foral provinces in the Basque Country are in charge of funding the autonomous community and the municipalities located in its territory. Law 27/1983 establishes the financial relationship amongst the institutions in the Basque Country and says that the Basque Council of Public Finance (BCPF) is in charge of determining the methodology of distribution of the agreed taxes with the Leyes de Aportaciones for minimum periods of three years. This methodology then has to be approved by the Basque parliament. These tax arrangements have been approved every five years, covering the same period as the revision of the methodology calculation for the cupo.

Basque Municipalities

The Law 27/1983 establishes that Basque municipalities cannot have lower funding than municipalities belonging to the common regime. On the other hand, the foral norms of each historical territory establish the municipal financial resources. Basque municipalities have the same set of revenues as those located under the common territory, except for transfers which are paid by the historical territories and those located under the common regime are paid by the state (Participación en los tributos del Estado).

In this regard, the historical territories are in charge of financing their municipalities. After transfers to the autonomous community and to the state are deducted from the agreed taxes, historical territories transfer some of the remaining funds to their municipalities. The BCPF recommends that at least 54.7% of the provincial resources after institutional transfers are distributed amongst municipalities. In practice, the three historical territories have followed this recommendation and have even exceeded it. However, there are differences amongst the three, illustrating that the municipality funding relies ultimately on the historical territories.

Navarre's Municipalities

Navarre is also in charge of funding its municipalities. Navarre's government informs the executive of the amount of funding destined for the municipalities and its distribution for a four-year period. With this funding model, municipalities benefit from predictability in their revenue base but lack power to modulate the scope and size of their funding.

Municipalities in Navarre have two main sources of funding from the autonomous community. The first is the participation fund of the local entities. Navarre sets an amount for the base year (2009 was the latest), and then annually updates it at the same rate as Navarre's Consumer Price Index (CPI) plus 2pp. The participation of the municipalities in this fund is mainly determined by population. The second source is capital funding, which is pre-established for a four-year period. The latest was approved in 2009 and covered 2009-2012. The agreement describes every single intervention and even quantifies its cost. Therefore distribution amongst municipalities is dependent upon infrastructures deemed to be needed.

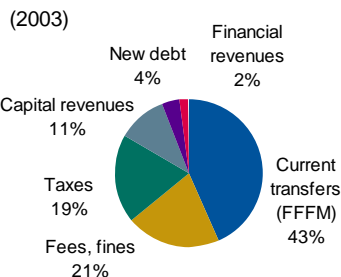
As with the rest of the Spanish municipalities, Navarre's municipalities are entitled to levy and collect some taxes generated in their territory, the main one being the property tax.

Accounting and Budgeting

Accounts of Spanish LRGs are on an accruals basis but also include statements in cash. Depreciation, provision and amortization are not included in their expenditures and few regional governments publish a balance sheet.

Figure 5

Basque Municipalities' Source of Revenues



Source: Basque Statistics Office

Spanish subnationals are free to take stakes in the capital of public and private companies without needing central government authorisation. Fitch has noted positively that the central government has since 2007 increased its monitoring of the LRGs' participation. Many of the austerity measures taken since the economic slowdown refer to the concentration and reduction in the number of dependent satellites.

LRG budgets are prepared by the executive and a draft is presented to the assembly at a time around October of the previous year. The budget must be approved by the assembly; if no majority is obtained to pass the budget, then the previous year's budget is automatically rolled-over. The budget is made up of the accounts of the general administration, autonomous bodies, and dependent public sector entities (PSEs) but autonomous communities have a wide degree of autonomy to present the budgets.

Unlike in other European countries, Spanish LRGs are not legally required to present multi-year budgeting or financial forecasting. Although, as LRGs, autonomous communities have been more involved in the presentation of economic and financial plans, they usually provide forward-looking statements, which are not necessarily disclosed.

Autonomous Communities Accounting Particularities

National law grants autonomous communities in Spain a significant degree of independence in the way they compile their accounts. Each autonomous community has its own finance law (ley de hacienda), which details the preparation and execution of annual budgets and the rules for recognising expenditure. Central government does not interfere in this process, and this contributes to the development of individual accounting procedures, while reflecting the autonomous communities' exclusive responsibility for the preparation and approval of budgets.

Debt, Liquidity and Contingent Liabilities

Borrowing Restrictions for Autonomous Communities

The financial law does not define the nature of all the financial operations that constitute financial debt. However, the BSL states that the outstanding real debt of an autonomous community is as defined under European System of Accounts 95 (ESA95) criteria.

The Law 8/1980, of autonomous communities' financing, sets some limits on indebtedness:

- Autonomous communities can take out short-term debt only to fund transitory liquidity needs;
- Long-term debt can only be used to fund investments, or for debt servicing (amortisations and interest), and cannot exceed 25% of current revenue. This limit was exceptionally softened in 2010, when autonomous communities were authorized to fund current expenses with long-term debt as long as the maturity did not exceed five years;
- Maximum debt level: the limit on 31 December each year must equal the stock of debt of the previous year plus net debt allowed to finance the agreed maximum deficit in the current year.

Debt Authorization

All autonomous communities shall require authorization from the state for debt issuance and foreign currency operations. Since the introduction of the BSL, autonomous communities need explicit authorization from the state under certain circumstances. (See Figure 6).

Figure 6

Debt Operations Needing Authorization by the State

Circumstances	Debt Issues and foreign currency	LT operations	ST operations
Compliance with the stability goal	Yes	No	No
Regions having filed for an Economic and Financial Plan (EFP) and compliant with it	Yes	Yes	No
Noncompliant with stability goal and/or goal in its EFP, which has not presented an EFP or amended its existing EFP	Yes	Yes	Yes

Source: Ministry of Economy and Finance.

Since the second half of 2010 the authorizations extended by the state to borrow (loans or issuances) are given in three stages, and follow the terms in Figure 7. If autonomous communities fail or are likely to fail their stability goal (see Deficit Restrictions Imposed by the BSL below), then the state will not authorise any borrowing. However, there are a number of financial products that still can be agreed by autonomous communities and escape the central government's control, such as factoring contracts, amongst others.

Figure 7

Authorization Schedule (As a % regional GDP)

When?	Contingent upon...	2010	2011
1st half of the year	With the presentation of the annual debt programme	0.75	0.65
2nd half of the year	the region is likely to comply with deficit target	1.2	0.4
1st half of the next year	The region has actually complied with deficit target	0.45	0.25
Total		2.4	1.3

Source: Ministry of Economy and Finance.

Deficit Restrictions Imposed by the BSL on Autonomous Communities

The BSL was passed in 2001, but it has been amended several times. The latest amendment establishes that sub-nationals in Spain must present balanced accounts through the business cycle. The Ministry of Economy and Finance will forecast in September of a single year the expected economic growth for the following year. Thus it will authorize a deficit (initially at a maximum of 0.05% of regional GDP), a surplus or balanced accounts depending on the expected growth of GDP (See Figure 8). These are identified as stability goals and must then be agreed by the Council of Fiscal and Financial Policy (CFFP), which is composed of members of the central governments and the regions (except the Basque Country and Navarre).

Figure 9

Change in Deficit Allowances for Autonomous Communities

As a % regional GDP	2009	2010	2011	2012	2013	2014
October 2008	-0.75					
June 2009		-2.5	-1.7	-1.3		
June 2010 ^a		-2.4	-1.3	-1.3	-1.1	
June 2011				-1.3	-1.1	-1.0

^a Does not take into account deficit derived from settlements.

Source: Ministry of Economy and Finance

If an autonomous community fails to comply with the stability goal agreed, then it must submit an Economic and Financial Plan (EFP) ensuring that the entity is to achieve balanced accounts within the following three years. On July 2010, the state established that autonomous communities with an economic and financial plan in place may exceptionally post a maximum deficit of 2.4% of the regional GDP in 2010, 1.3% in 2011, 1.3% for 2012 and 1.1% for 2013 (see Figure 9). Failure or potential failure of compliance with these targets could mean that the state does not authorize its debt operations.

Figure 8
Stability Goals for Autonomous Communities

Expected economic cycle (real GDP growth) (%)	Surplus (deficit) goal ^a (as a % of the regional GDP)
More than 3	0.25
2-3	0.00
Less than 2	-0.75

^a As defined by (ESA95) criteria
Source: Law 15/2006, 26th of May

Borrowing Restrictions for Municipalities

The local funding laws do not define extensively the scope of financial debt. However, the BSL considers that the overall outstanding debt of a municipality must include the debt of the entire public sector as defined by ESA95.

Although there is no specific protection for lenders, the original financial law sets some debt limits: long-term debt should be used only to fund capital expenditure; and short-term debt cannot be more than 30% of the current revenue of the previous year.

Municipalities shall require an explicit authorization from the Ministry of Economy and Finance and/or from the autonomous community in charge of tutelage under the following circumstances:

- In case total financial debt, including the real risk related to debt guaranteed to third parties by a municipality, exceeds 110% of its current revenue of the previous year, the municipality is required to ask for authorisation before contracting new long-term borrowing. Exceptionally for 2010 this ratio was lifted to 120% and in 2011 was reduced to 75%;
- Local entities cannot borrow long-term if they report a negative net current balance (current revenue minus current expenditure minus the estimated amount of debt servicing with guarantees) without an explicit authorization from the Ministry of Economy and Finance. Furthermore the plenum of the local entity must approve a recovery plan indicating measures that would enable it to post a balanced budget within three years. This plan has to be sent to the Ministry of Economy and Finance together with the long-term debt request;
- The issuance of bonds and debt denominated in foreign currency must be approved by the Ministry of Economy and Finance;
- In the case that a municipality has filed for an EFP, it is also required to ask for authorisation from the Ministry of Economy and Finance (or autonomous community competent in financial tutelage) before contracting long-term borrowings. If the local entity has not presented the EFP, then it needs explicit authorization for long and short-term borrowings.

Special Borrowing Restrictions for Local Entities for 2010 and 2011

The RD 8/2010, 20 May, aimed at reducing the deficit of the public sector, modified debt authorizations for local entities along 2010 and 2011 in the following terms:

- Long-term debt operations are postponed until 2012;
- From May 2010 and until December 2011, local entities are not allowed to contract debt to fund investments or substitute previous debt operations. The latter is allowed only if the substitution improves conditions for the local entity;
- Short-term debt operations (including disposal of revolving lines) should be cancelled at year-end.

In Fitch's view, achieving and controlling these strict measures seems difficult and some doubts arise on whether they will contain or not the deficits. Besides, Fitch has observed in the 2009-2011 period quite frequent changes in the conditions imposed by the central government.

Other Budgetary Restrictions Applicable to Local Entities

The law on local finance established that if a municipality posts a negative fund balance (receivables plus cash minus payables) it would have to correct this, preferably by cutting the next year's expenditure or through debt with some restrictions. In the last resort it would have to produce a surplus covering at least the magnitude of the accumulated deficit.

Municipalities also have to comply with the BSL. In 2006 the central government modified the BSL to adapt the deficit rule to the business cycle. This means that if the economy were forecast to grow at less than 2%, municipalities could post altogether a deficit up to 0.05% of national GDP, and if it were above 2% the budget should be balanced. As with other tiers of government, and due to the recession in the Spanish economy, the state has authorized higher maximum deficit allowances to local governments (see Figure 10).

Figure 10

Maximum Deficit Allowance at the Local Level

As a % GDP		2009	2010	2011	2012	2013	2014
Deficit (national accounting)		-0.2	-0.4	-0.3	-0.3	-0.2	0.0

^a Does not take into account deficit derived from settlements.
Source: Ministry of Economy and Finance; April 2011

The way that this maximum global deficit allowance is individualized is done the next year, once all variables are known (GDP and aggregate non-financial revenues). It was in April 2011 when the maximum deficit allowance under which local entities did not need to file an economic and financial plan (see Figure 11) was announced.

If a municipality does not comply with the BSL, it would have to file an EFP to the Ministry of Economy and Finance (to the general directorate of local entities coordination) or to the competent organ if it is under the financial tutelage of an autonomous community.

The plan will aim to correct the financial imbalance in the coming three years. Its results are annually monitored by the DG de Coordinación de las Entidades Locales or by the competent body if it is under the financial tutelage of an autonomous community. This plan should be presented within three months after the infringement of the BSL. Although the rules defining how to draw it up improved in 2007, it still lacks practical guidelines but the plan should contain corrective measures to balance the accounts and a debt plan.

The RD8/2011 amended the RD2/2007 by introducing a restriction in the growth of expenditure for central government and local entities. This set out that public administration's expenditure cannot increase its rate of growth faster than the average increase achieved by the Spanish economy in nominal terms. The latter is defined as the average nominal GDP growth for nine years, calculated as: real GDP growth in the current year and expected in the forthcoming three years throughout the stability programme; and real GDP growth registered in the previous five years. All those numbers are increased by 1.75% to take into account inflation. Local entities are not allowed to increase expenditure beyond the 3.23% in the 2012 budget.

The Basque Country and Historical Territories Have Stricter Debt Limits

Law 27/1983 establishes in its article 27 that the autonomous communities and the historical territories can take on debt with a maturity of over one year with two limitations: in the case of the historical territories, the debt service cannot exceed 12.5% of gross current revenue; and in the case of the autonomous community, debt service cannot exceed 12.5% of the gross current revenues of the three historical territories or 25% of own revenues. At the same time, the law specifies that the Basque Council of Financial Policy could eventually propose to the government the modification of this principle to maximise the ability of the entire Basque public sector to take on debt.

All three tiers of government have to respect the deficit limits set at the national level.

The law establishes that the BCPF will harmonise and co-ordinate the debt policy of the three foral territories. The territories will annually report their debt programmes to the BCPF and their implementation will have to follow the conditions set out each year. The historical territories require authorisation from the regional government to agree credit operations abroad.

Figure 11
Individualization of 2010 Deficit

(EURm)	
GDP 2010	1,062,591
Max deficit (%)	0.40
(In EURm)	4,250
Total non financial Revenues	76,866
Deficit allowance in terms of non-financial revenues (%)	5.53

Source: Comisión Nacional de la Administración Local

Oversight, Control and Prudential Regulations

Reporting

Law 2/2004 establishes that local governments must publish their annual budgets in the local or provincial official bulletins, although the magnitudes of publication vary across local entities. The detail of the regional budgets is specified in its autonomous community law on finance, which also specifies that budgets have to be published in the regional bulletins. Some of them go even further. For instance, Cantabria's finance law explicitly states that the internal auditor must publish the general accounts and budget execution and treasury operations.

Most of the LRGs have no legal requirement to publish their general accounts or any other accounting statements once budgets are settled. Notwithstanding, the Ministry of Economy and Finance specified in the BSL which accounting statements the LRGs need to send and with what frequency. It later discloses some of this information on its website (see Figure 12). Fitch notes that the Ministry does not perform an audit of this information. Since October 2011, the Ministry has penalized those local entities that have not sent the settlement of their 2010 budget, by freezing the transfers to municipalities corresponding to October 2011. This freeze does not mean that the local entity has lost the resources but they will be contingent upon receipt of the requested information.

In the case of the autonomous communities, since mid-2010, as the state authorizes debt operations contingent upon the likelihood of compliance of deficit targets, they have had to submit the financial information quarterly to the state. The information is mainly co-ordinated by the national audit department (Intervención General del Estado), which can review and revise it and is also entitled to adjust the result under ESA95 criteria. It can then send it to the Council of Fiscal and Financial Policy (CFFP) so that it can assess the autonomous community's annual compliance with the BSL.

Despite there is no legal requirement to publish the annual accounts, most of the autonomous communities and an increasing number of local governments publish their annual accounts on their websites. Presentation and the level of financial reporting provided by the different sub-nationals varies widely, as illustrated by the differences in their reporting of budget out-turns: some only report figures for general administration, some also include their autonomous bodies, some are consolidated and others include financial statements of its dependent public sector.

Data on debt is disclosed by the Bank of Spain on a quarterly basis. The Bank of Spain publishes data of each autonomous community classified as either administrative public sector or public sector companies. It also provides an aggregate for the local sub-nationals with a breakdown amongst the six main cities. This is useful information and Fitch would welcome more disclosure on the list of Public Sector Entities that fit into administrative classification. Regarding autonomous communities, differences between the Bank of Spain data and that of the autonomous communities have been observed that could stem from differences in consolidation.

Internal Control

Internal control of Spanish LRGs is carried out by an internal auditor, called interventor, who in the case of a local government is a national civil servant and in the case of a regional government is a public civil servant who is appointed by the regional parliament. The interventor draws up and signs the LRGs' annual accounts and reports back to the assembly during the presentation of the annual budget. He or she is responsible for ensuring the legality of transactions. Fitch considers that a more active rotation of internal auditors, a closer relationship with IGAE could improve accounting practices.

There have been some instances that invoices have not been fully reflected in the accounts of LRGs, particularly related to healthcare expenditure. With the decline of current revenues, some LRGs have delayed the payments to suppliers, and sometimes these expenses are not

Figure 12

Information Available on the Ministry of Economy and Finance Website (as of August 2011)

Autonomous communities	
Draft budget	2011
Budgets	2011
Settlement	2009
Quarterly outturns	Q211
Local governments	
Budget	2010
Outturns	2008

Source: Ministry of Economy and Finance

immediately reflected in the accounts, weighing on the accuracy of the accounts. While in other countries, suppliers tend to go to court, is not yet part of the culture to do so in Spain. Fitch has noted that when there is a political change in the management, the new executive often tends to audit the accounts, with the likely outcome of finding hidden deficit or expenses not recognised or accounted for.

External Control

The accounts of Spanish LRGs are generally, but not always systemically, audited ex-post by the regional court of accounts (only La Rioja and Murcia have not established any) or the national court of accounts. The regional court of accounts reports directly to the regional parliament, which usually sets the annual programme of the court of accounts. As one regional court of accounts is in charge of controlling a vast number of authorities, their reports are often outdated, and not all municipalities and/or annual accounts are audited. Regional courts of accounts follow different procedures, and thus are not shown in a standardized form, making difficult comparisons amongst them.

The courts lack coercive powers and can only make recommendations, which the sub-national may or may not adopt. The president of the regional court of accounts is appointed by the regional parliament.

Bankruptcy and Reparatory Proceedings

The 2006 amendment of the BSL stated that the state will not bail it out in case of an LRG default.

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](http://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE.

Copyright © 2012 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.