Spanish Regions

Emerging Challenges Cloud Short-Term Stability

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S&P Global Ratings

This report does not constitute a rating action

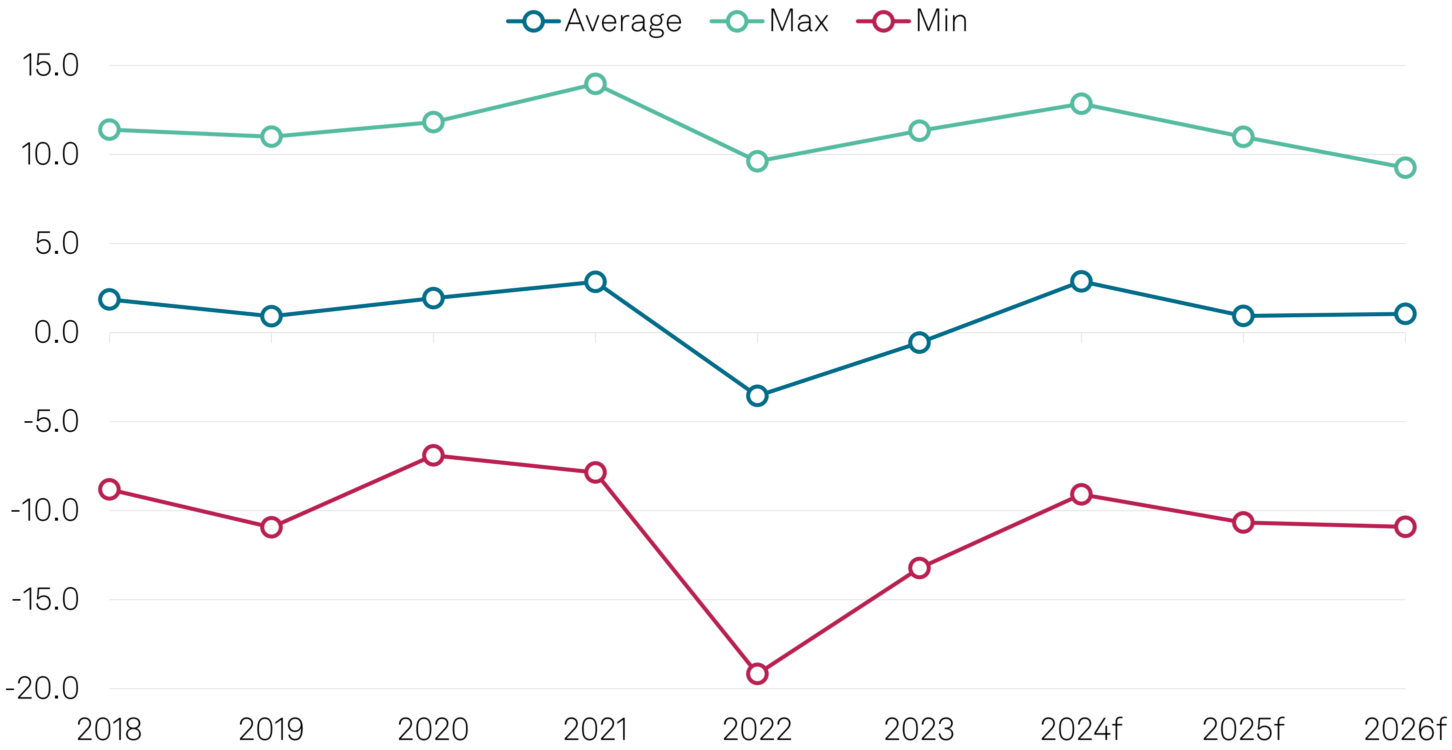
Key Takeaways

- We expect Spanish regions will improve their budgetary performance in 2024, supported by high revenues from the regional financing system and the return of fiscal rules. Difficulties will emerge from 2025 as revenue growth slows and high operating expenditures limit the flexibility of regional accounts.
- Recent revenue increases enabled the regions to reduce their debt ratios, although significant regional differences remain. Debt continues to rise in nominal terms.
- Spanish normal-status regions could benefit from the central government's debt write-off in 2025, although the precise timing and effect on individual regions remain uncertain.
- Mainly due to the political situation, Spanish regions face structural challenges and cyclical uncertainties. These are partly offset by mitigating factors, such as solid economic growth.

After Improving In 2024, Operating Balances Will Weaken From 2025

Budgetary execution will weaken, with persistent differences across regions

Operating balance as % of operating revenues



f--Forecast. Source: S&P Global Ratings.

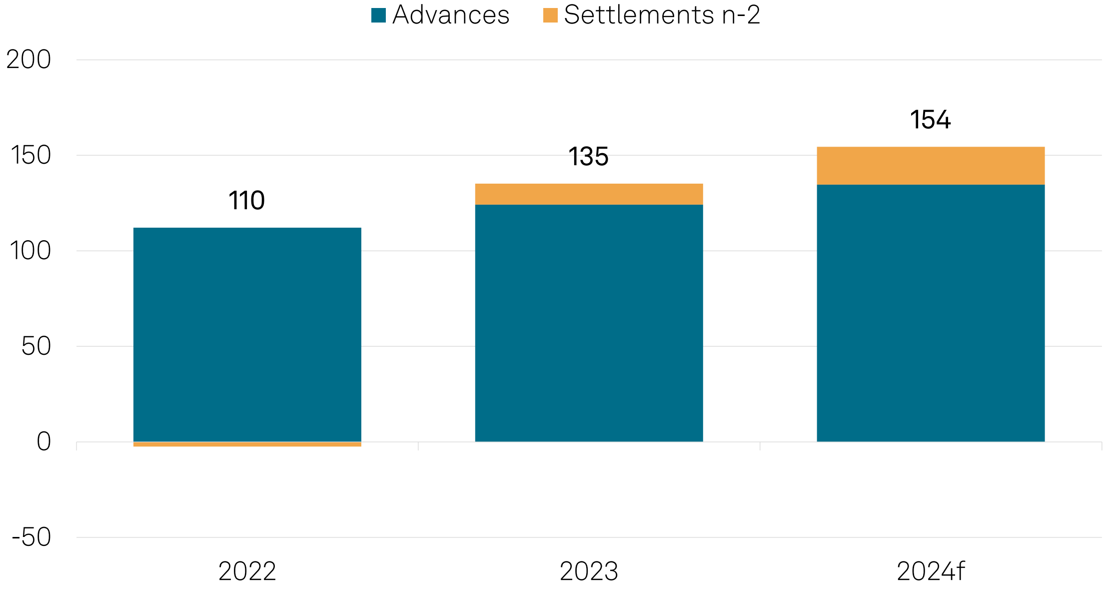
- Spanish regions' budgetary performance will improve in 2024 on the back of high revenue growth.
- The re-introduction of fiscal rules--including binding deficit, debt, and expenditure growth targets--could improve performance additionally, although we do not expect that the regions will fully comply with these rules.
- Regional performance disparities will continue because of structural funding differences.
- Regions that remain underfinanced struggle to balance their budgets.
- Some regions took advantage of the significant revenue increase in 2023, while limiting operating expenditure growth. This enabled them to post large operating surpluses.
- Spanish regions will post small operating surpluses, on average, over 2025-2026. Slower revenue growth means that these will fall short of operating surpluses in 2024.

Revenue Growth Will Decrease Over 2025-2026

Revenues from the financing system will increase significantly in 2024, thanks to a large positive settlement from 2022 that affects 2024 figures. Tax revenue growth in 2022 exceeded the central government's initial estimates. Tax collection continued to grow in 2023, although at a slower pace than in 2022. This could result in a lower settlement in 2025, likely leading to an overall slowdown in revenue growth.

Financing system resources grow by 14% due to settlements

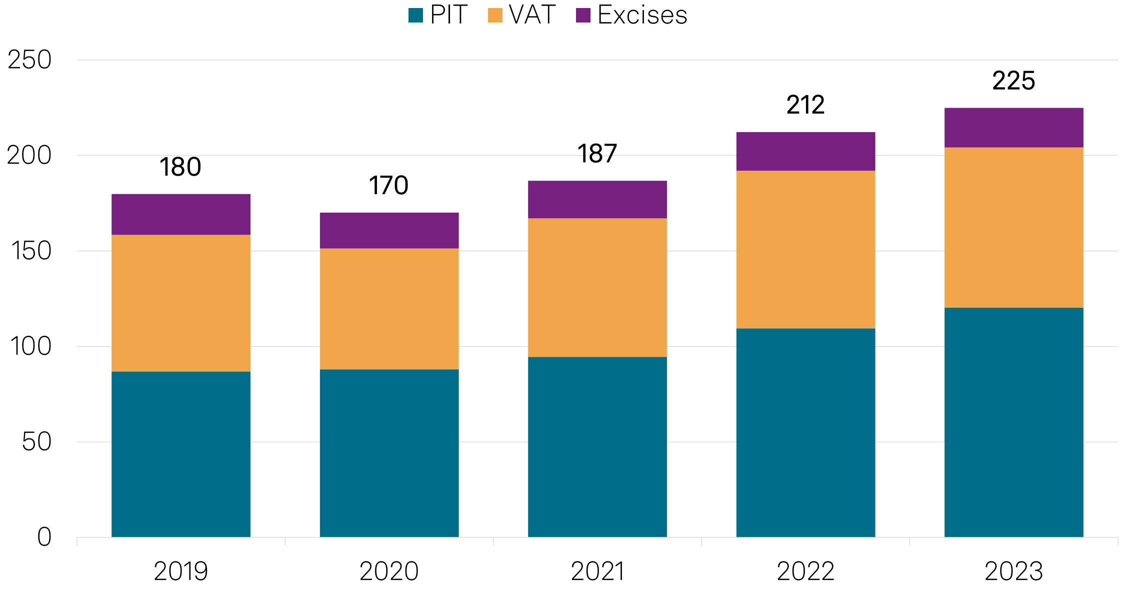
Resources from the regional financing system (bil. €)



f--Forecast. Source: S&P Global Ratings.

Tax revenues increased by 6% in 2023, versus 13% in 2022

Tax revenues (bil. €)



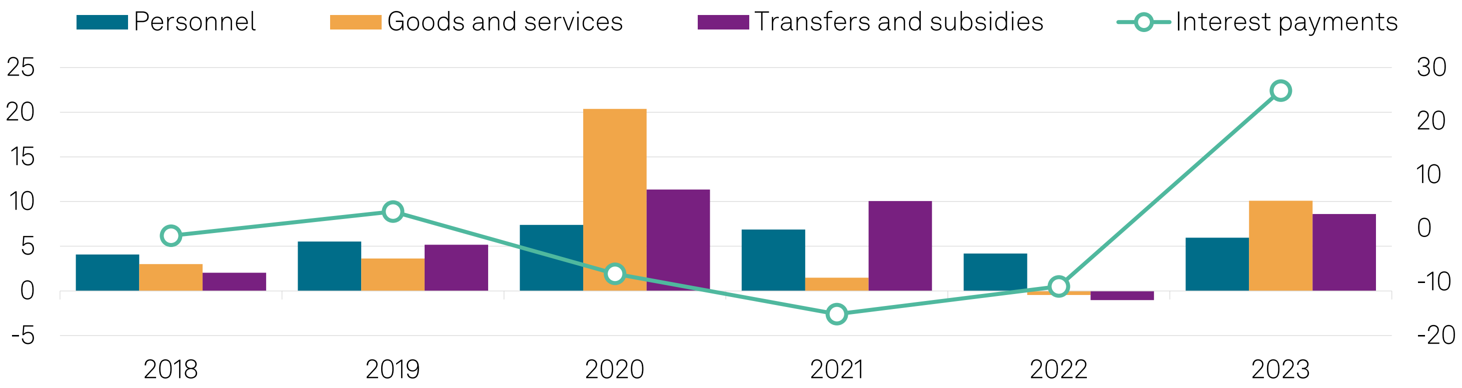
PIT--Personal income tax. VAT--Value-added tax. Sources: Spanish Tax Agency, S&P Global Ratings.

Operating Expenditure Has Outpaced Inflation

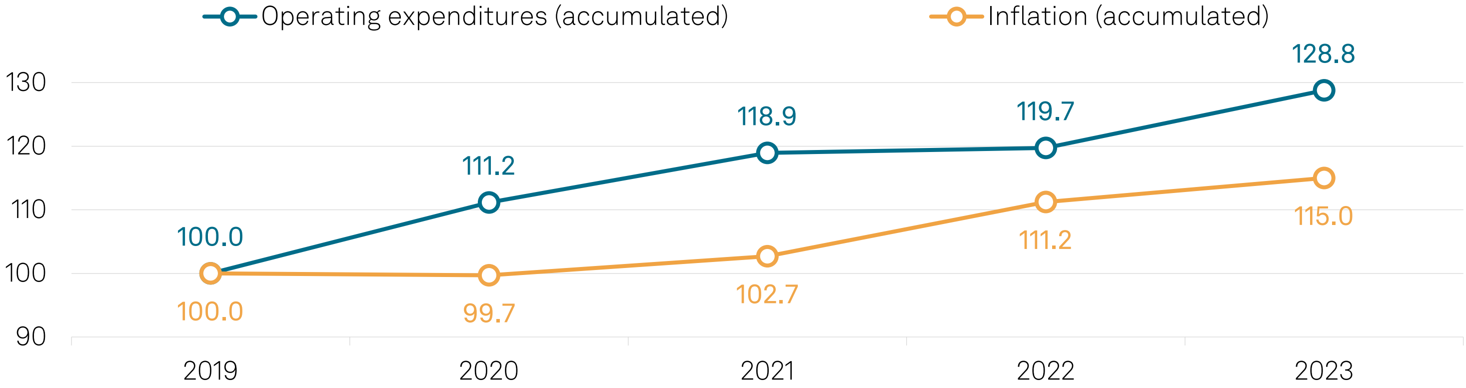
- Spanish regions' operating expenditures are relatively rigid as most of their spending is related to healthcare and education.
- The COVID-19 pandemic led to an expansion in personnel expenditure to reinforce public services, and increased purchases of goods and services. Most of these expenditures have now become structural in regional budgets.
- Inflation explains the growth in operating expenditures only partially. The cumulative increase in operating expenditures significantly outpaces price increases.
- Interest payments also put pressure on regional operating expenditures but remain manageable for now.
- We expect Spanish regions will moderate this expenditure growth over 2024-2026 as inflationary pressures ease. Some pandemic- and inflation-related transfers to support families and businesses are phased out.
- The return of fiscal rules will also limit expenditure expansion.

Expansion in operating expenditures due to the pandemic has become structural

Operating expenditure by type (% growth)



Index (2019=100)



Source: S&P Global Ratings.

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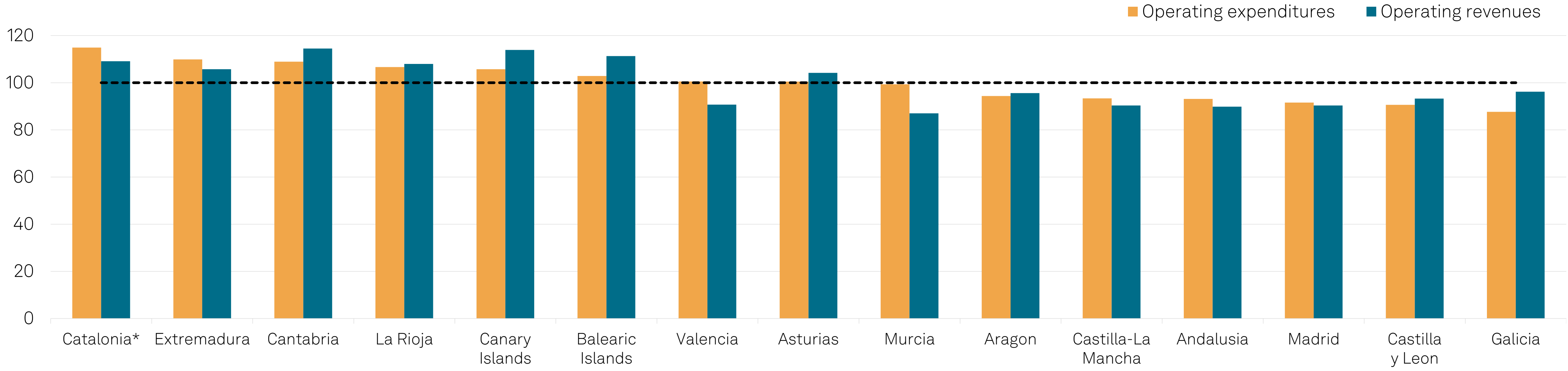
Per Capita Spending And Revenues Differ Across Regions

Regional differences in per capita financing remain significant, even after taking into account need-based adjusted population figures, and bear no clear relation to relative fiscal capacity or wealth levels.

Expenditures also differ considerably. The expenditures of underfunded regions, such as Valencia and Murcia, are in line with the regions' overall average, which leads to structural budgetary imbalances.

Operating revenues versus operating expenditures

Per capita, based on adjusted population figures versus the national average (%)



Adjusted population figures from 2021. Revenues and expenditure data from 2023. *Catalonia is not directly comparable with other regions as they have different responsibilities.
Sources: Ministry of Finance, S&P Global Ratings.

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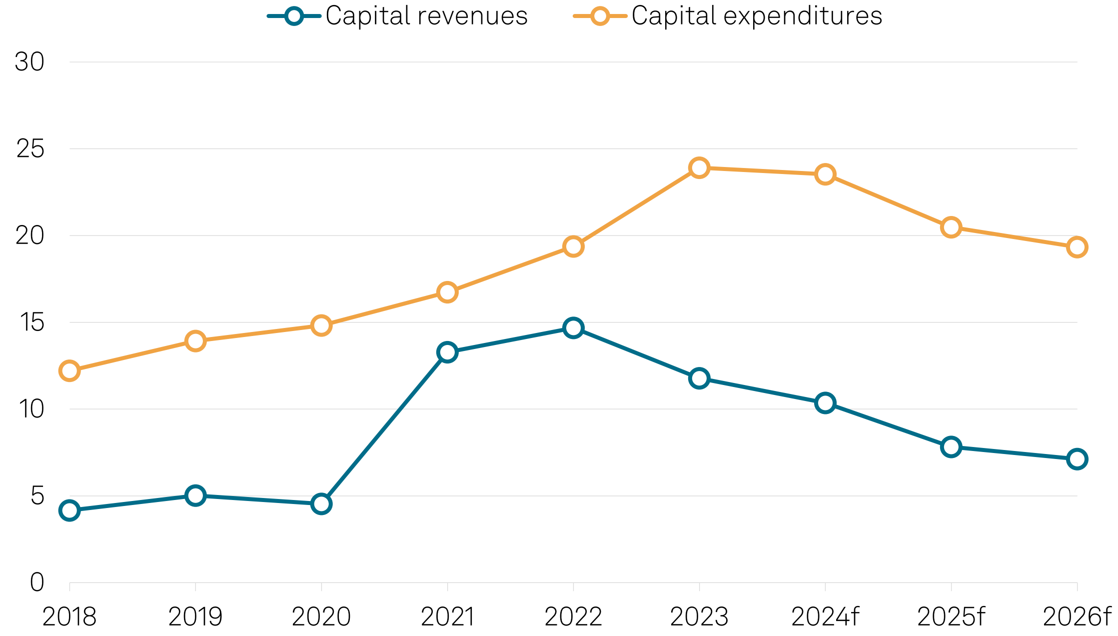
Capital Investments Will Remain High Over 2024-2026

Spanish regions continue to accelerate investments from the EU's Recovery and Resilience Facility (RRF). We estimate that they have spent an average of almost 40% of the funds allocated to them. Capital revenues will decline as most funds were already transferred to regions over 2021-2023.

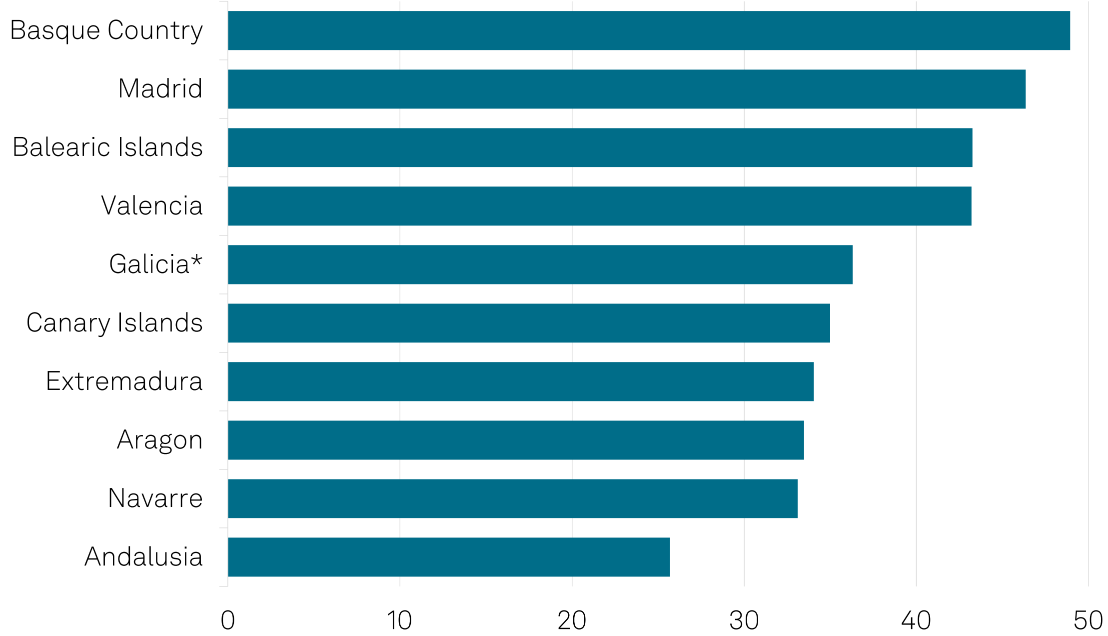
Capital revenues and expenditures will decrease (bil. €)



f--Forecast. Source: S&P Global Ratings.

Execution is progressing but at different speeds

European RRF execution as of 2023 (%)



Only considers regions we rate. *Data as of March 2024. Source: S&P Global Ratings.

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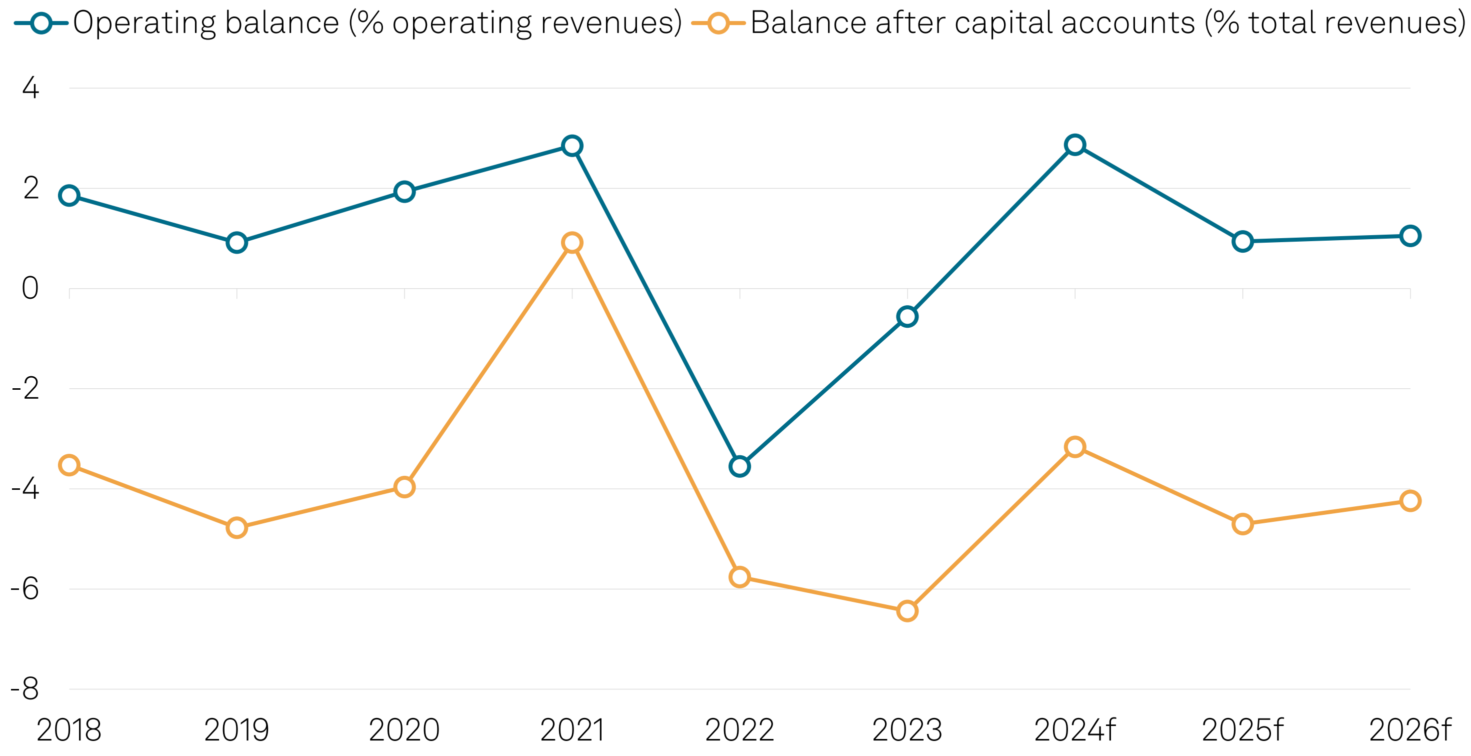
RRF Fund Execution Will Weigh On Balances After Capital Accounts

Spanish regions will continue to post moderate deficits after capital accounts



f--Forecast. Source: S&P Global Ratings.

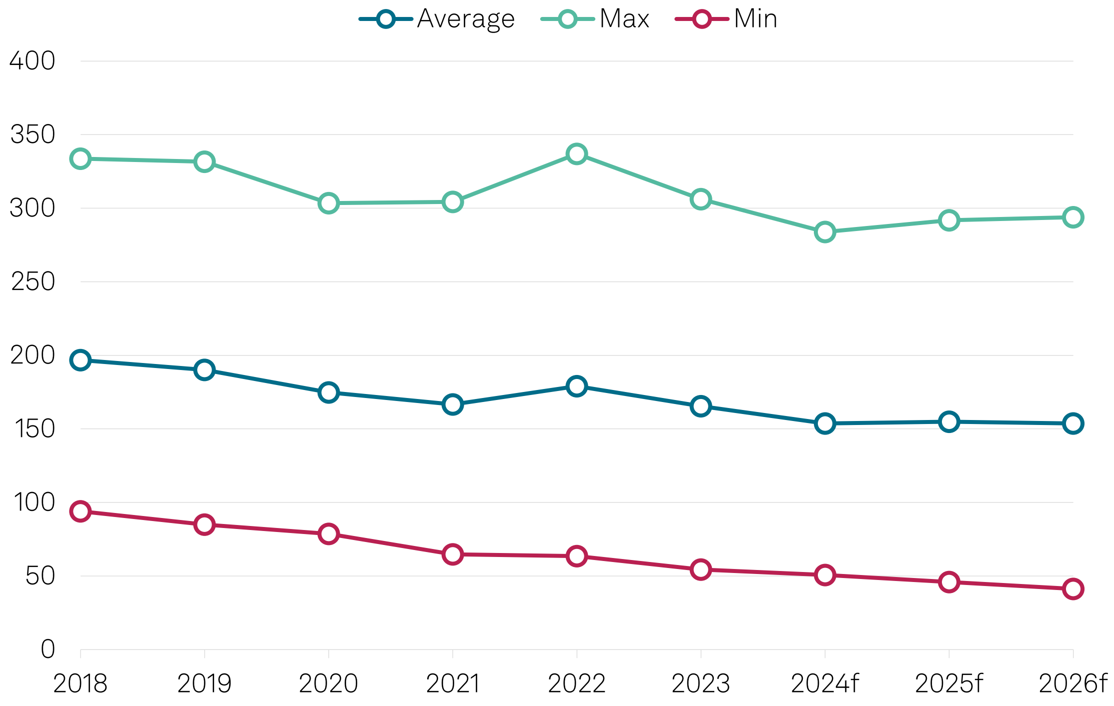
- We forecast Spanish regions will post modest deficits after capital accounts over 2024-2026, mostly due to the execution of the RRF.
- Nevertheless, we acknowledge that, in national accounting terms, the effect of RRF funds is neutral and adjusted when calculating official deficits.
- The transfer of RRF funds over 2021-2022 distorted regional deficits in budgetary accounting terms by narrowing the gap between operating balances and balances after capital accounts. This is because Spanish regions received high capital revenues from the RRF that they did not spend immediately.
- This gap has expanded since 2023 as investments accelerated and Spanish regions received fewer RRF funds.

Increasing Revenues Reduced Debt Ratios

However, debt continues to increase in nominal terms and structural differences in debt levels across regions persist.

Debt ratios have decreased since 2022

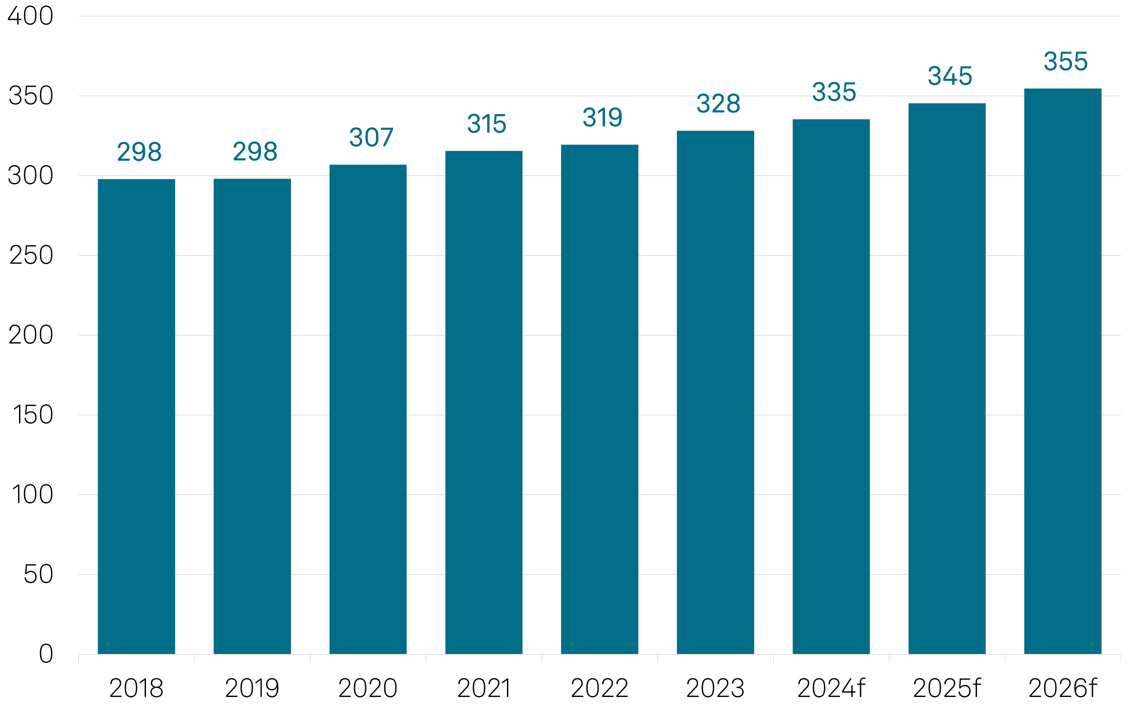
Tax-supported debt (% of consolidated operating revenues)



f--Forecast. Source: S&P Global Ratings.

Debt in nominal terms continues to rise steadily

Tax-supported debt (bil. €)



f--Forecast. Source: S&P Global Ratings.

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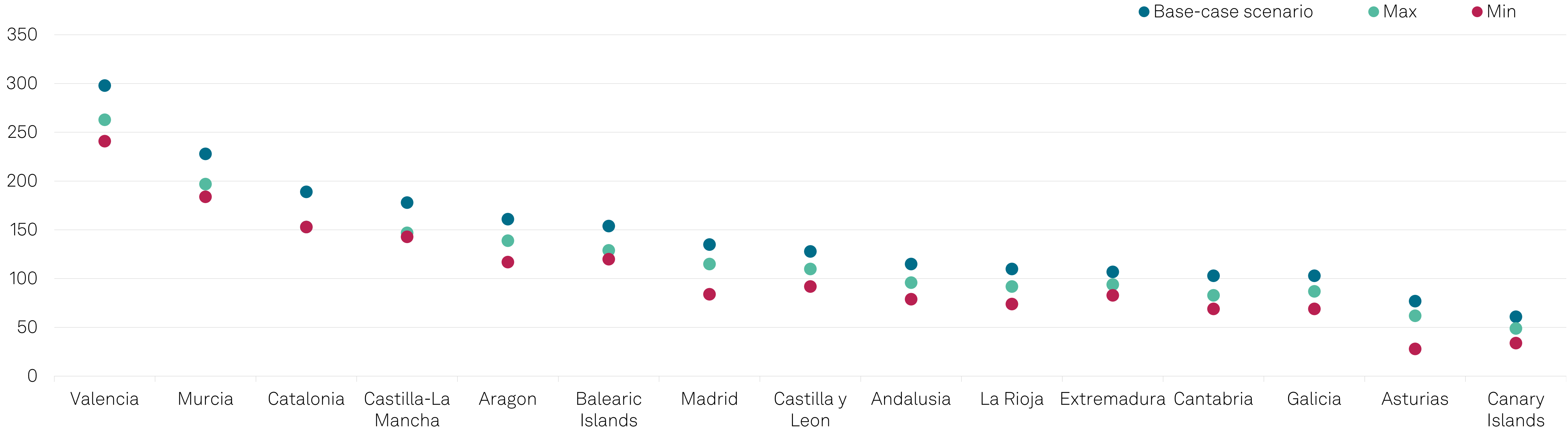
A Debt Write-Off By The Government Would Only Have Short-Term Benefits

A potential debt write-off, whose precise effects on Spanish regions remain uncertain, would leave the structural problems that led to debt increases unaddressed.

Potential effect of different debt write-off scenarios on regional debt ratios (March 2024 estimate)

Change in tax-supported debt as a percentage of consolidated operating revenues (%)



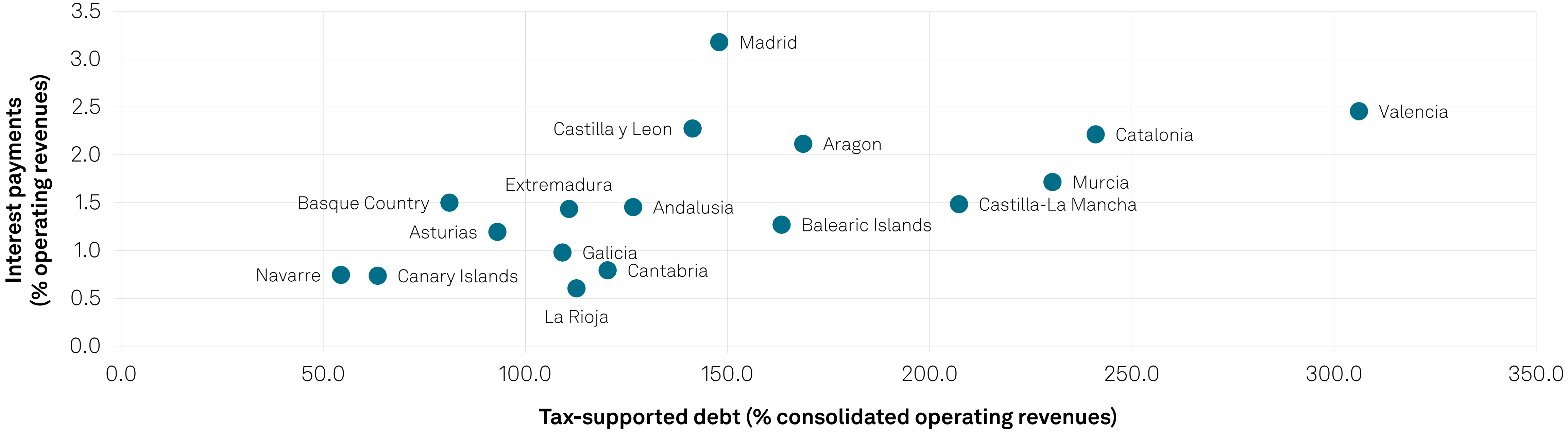
Source: S&P Global Ratings.

Asymmetries In Debt Levels And Interest Payments Remain

Regions that finance their needs through long-dated bonds, such as Madrid, pay higher interest rates but have flattened their maturity profiles. Regions that fund their needs mainly with central government liquidity have a lower interest burden than their debt stock would suggest.

Differences in interest burdens are narrower than debt ratios would suggest

Tax-supported debt versus interest payments in 2023



Source: S&P Global Ratings.

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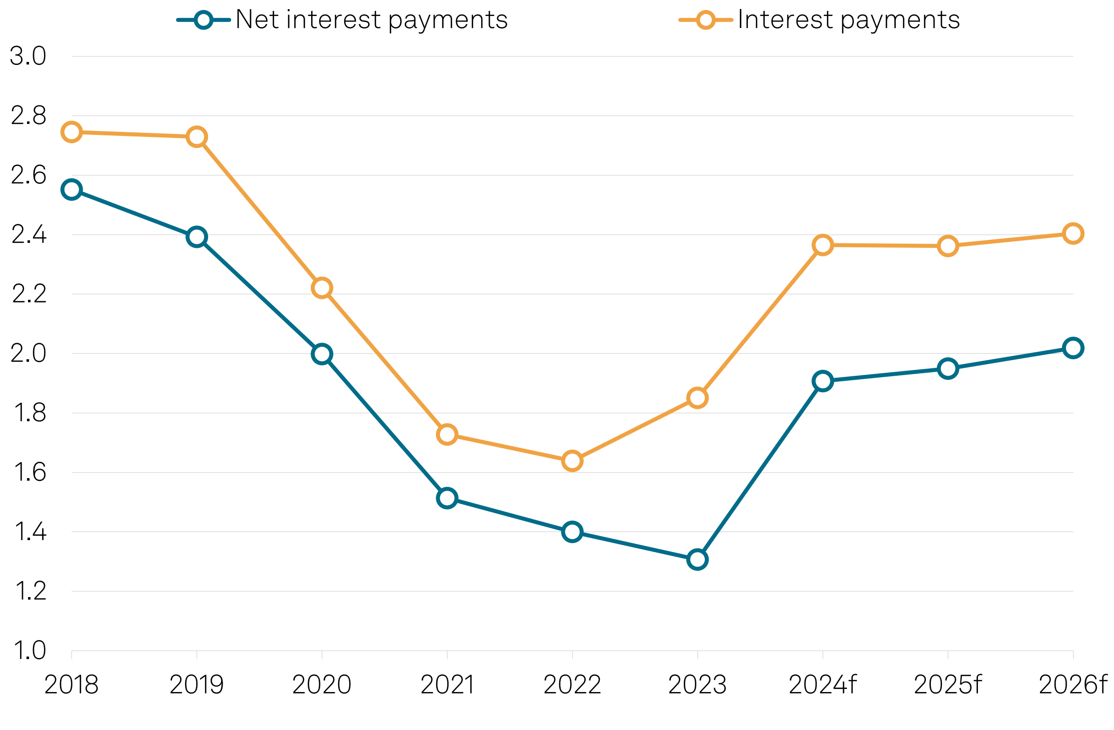
Revenues From Bank Deposits Temporarily Mitigated The Increase In Interest Payments

Net interest payments start to climb only in 2024

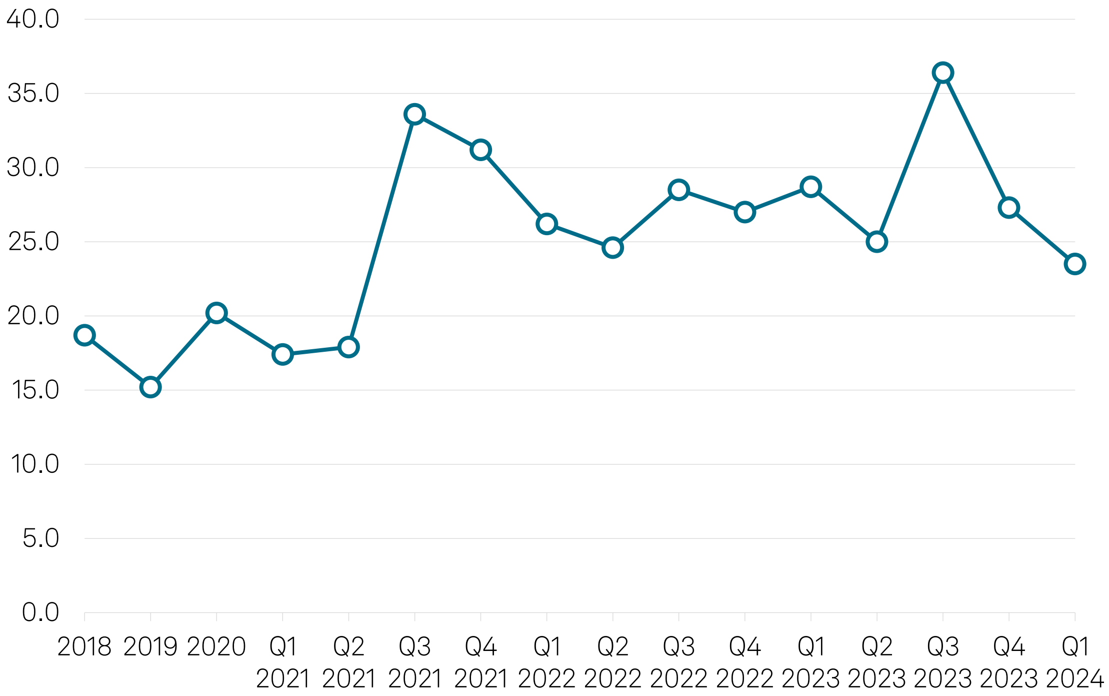
Percentage of operating revenues (%)



Net interest payments are interest payments minus interest income. f--Forecast. Source: S&P Global Ratings.

Cash balances are set to decline over the coming years

Regional bank deposits (bil. €)

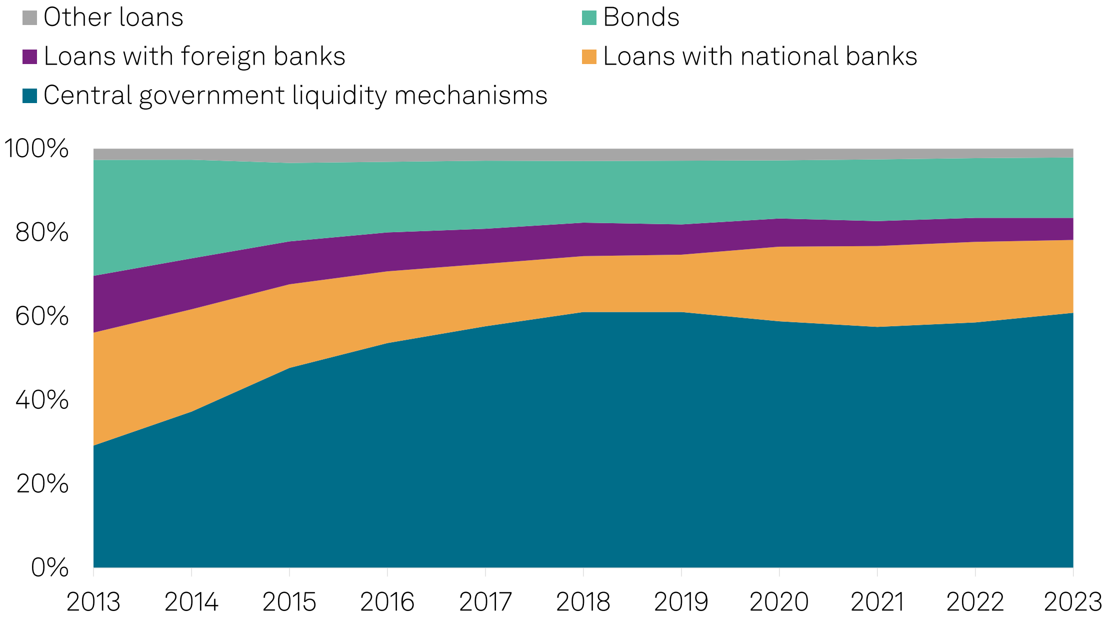


Q--Quarter. Sources: Bank of Spain, S&P Global Ratings.

The Appetite For Market-Based Financing Increases

Spanish regions' bond issuances until June 2024 already exceeded those in full-year 2023. Yet liquidity mechanisms remain the main financing source.

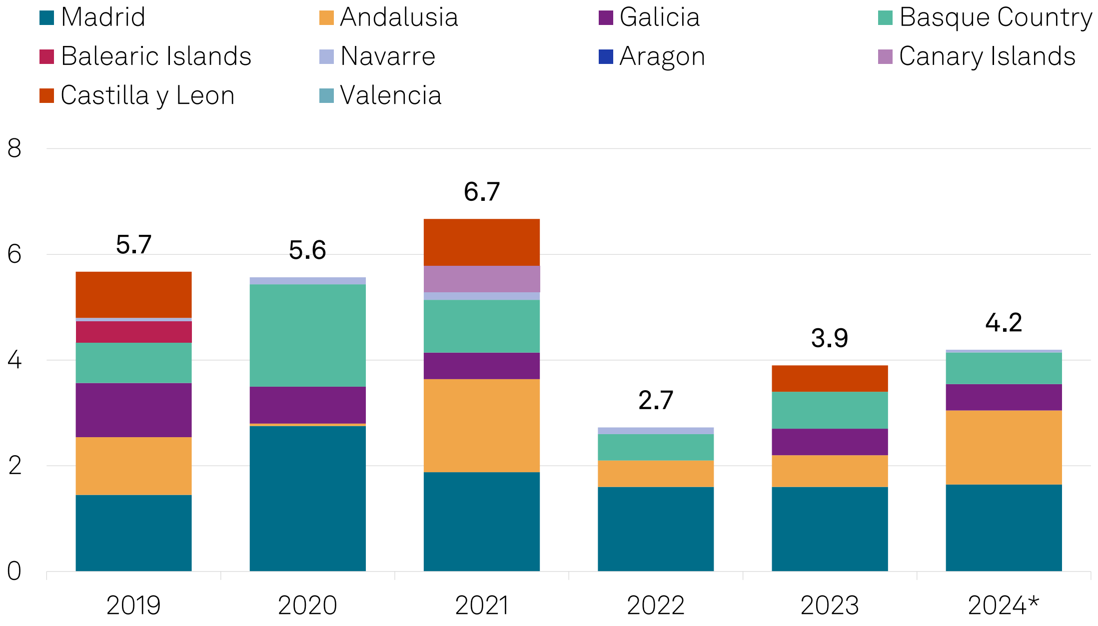
Liquidity mechanisms represent over half of total outstanding regional debt



Sources: Bank of Spain, S&P Global Ratings .

Madrid, Andalusia, Galicia, and the Basque Country are the most recurrent bond issuers

Bond issuances (bil. €)



*Data as of June 2024. Sources: CNMV, S&P Global Ratings.

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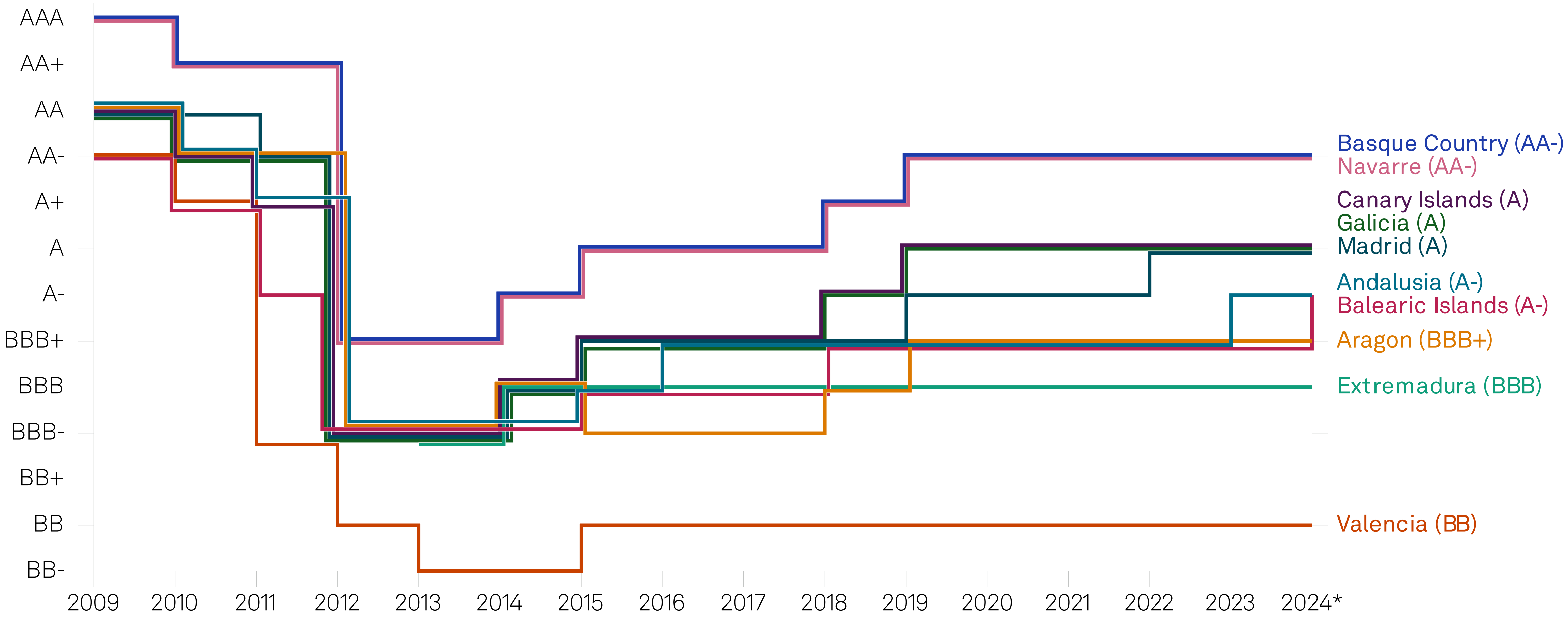
Spanish Regions Face Structural Challenges And Cyclical Uncertainties

Structural challenges	Short- and medium-term uncertainties	Mitigating factors
Reform of the regional financing system	Relations between regions and the central government are becoming harder to predict and less institutionalized	Strong economic growth compared with other eurozone countries, with tourism at record levels
Divergence in deficits and debt	Lack of clarity on the enforcement of new fiscal rules	Expected inflation moderation and interest rate cuts, which could ease pressure on budgets
Spending pressure due to the effect of the aging population on healthcare spending	Uncertainty about 2025 resources from the regional financing system	Investment capacity and economic growth, thanks to the RRF and other European funds
Normalizing access to market-based financing	Details about the debt write-off remain uncertain	Good access to diversified financing sources, including bonds and bank loans

Source: S&P Global Ratings.

Ratings History Of Spanish Regions



*Data as of June 19, 2024. Source: S&P Global Ratings.

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