EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility (AIReF) must prepare a report on the content of the 2019 - 2022 Stability Programme Update (SPU). AIReF’s assessment must encompass the macroeconomic forecasts underlying the 2019-2022 SPU and its budgetary scenario, with a special focus on the commitments that ensure compliance with the budgetary stability target, the government debt limit and the expenditure rule, in response to the mandate of articles 14 and 16 of the Organic Law 6/2013 creating AIReF.

AIReF received preliminary information from the Government on the 2019 - 2022 SPU, before 15 April, which included the macroeconomic and fiscal scenario for the entire period.

Based on these data, on 25 April AIReF endorsed the macroeconomic scenario underlying the 2019 - 2022 SPU and carried out an initial evaluation of the budgetary scenario that was sent to the Government, including some recommendations to ensure compliance with the envisaged fiscal path and coherence between the macroeconomic scenario and fiscal forecasts, with the aim of these being taken into account in the final document, as far as possible.

The SPU presented has incorporated many of the recommendations, which has allowed a readjustment of the fiscal scenario compared to that initially received, which AIReF considered to be feasible to achieve over the whole period, with a drop in this probability in the last two years.

Is the Government’s macroeconomic scenario plausible?

The profile of real GDP growth shown in the 2019-2022 SPU is considered prudent overall. The Government estimates that the growth of aggregate activity will gradually reduce by 2.6% in 2018 to 1.8% in 2022. These forecasts are in the central part of the interval estimated by AIReF and are in line with
other available forecasts, both in the private and public sectors, which generally only cover the years 2019 and 2020.

\[ \text{REAL GDP GROWTH (\%)} \]

In terms of cyclical evolution, the SPU also poses a prudent scenario, with an economic cycle considered to be ahead and expected to mature earlier. The evolution of the output gap expected in the SPU is ahead compared to the cycle estimated by AIReF, with a gap that becomes positive as early as 2018. The cycle presented by the Government reaches its point of maturity in the middle of the forecasting period, earlier than AIReF’s estimates. In addition, this characteristic implies a lower average potential GDP growth. As can be seen in the following figure, there are notable differences in the potential growth underlying the Government’s estimation of the cycle with respect to AIReF’s estimate. The SPU presents a potential GDP growth forecast that increases gradually until it converges to values close to those estimated by AIReF at the end of the period.
The composition of growth is prudent due to the contribution of domestic demand, offset by an optimistic view of the external sector. The progressive moderation of GDP expected in the SPU is characterised by a contribution of domestic demand that matures in the next 4 years. For its part, the contribution to growth of external demand becomes neutral from 2020 until the end of the forecasting horizon. While both the growth profile and growth level are considered to be credible overall, this composition is biased downward in domestic demand, according to AIReF’s analysis and the existence of levers or supports to the growth of the main components of domestic demand, alongside income policies that support the evolution of household...
consumption. In turn, the expected contribution of the external sector is considered optimistic, considering recent developments in world trade and the prospects of Spain’s main trading partners, as well as the latent risks relating to the major economies of the euro area, the definitive departure of the United Kingdom from the European Union or the evolution of oil prices.

**How does the macroeconomic scenario translate to the fiscal forecasts?**

This macroeconomic scenario mainly translates to the fiscal scenario through tax revenues, including social contributions, which represent about 90% of the General Government (GG) revenue. AIReF considers the revenue forecast of the 2019 - 2022 SPU to be feasible in most of the period, although with a different composition and a decrease in probability in the last years. According to the SPU, in 2022 revenue will have gained 1.8 points in relation to GDP, with its weight increasing from 38.9 to 40.7% GDP, 0.3% above AIReF’s forecast. This difference, which fundamentally affects the tax forecasts, is because AIReF estimates a lower impact of the revenue measures approved and announced by the Government. In addition, AIReF’s fiscal scenario is somewhat more balanced in the distribution of the cyclical gain by type of tax, allocating more growth to indirect taxes and less to direct taxes with respect to the SPU estimates.

However, AIReF identifies a risk associated with the lack of consistency between a prudent macroeconomic and the Government’s revenue estimates, which would be optimistic compared to the macroeconomic forecasts theoretically underlying them. AIReF’s consistency analysis reveals that collection would be around 0.2% GDP lower for the 2020 - 2022 period if the Government’s macroeconomic forecasts were to materialise.

On the expenditure side, the items most linked to macroeconomic developments would be unemployment benefits, which according to the SPU will reduce their weight over GDP by 0.1%, in line with AIReF’s estimates.

The evolution of the rest of the expenditure items is marked by population variables and established policies or budgetary decisions taken by the various administrations. AIReF considers it feasible to achieve the SPU’s downward path of non-financial expenditure throughout the entire period, although it would be considered unlikely in 2021 and 2022 should the Government’s GDP forecast materialise. The SPU’s expenditure path foresees an adjustment of 0.6% GDP from 41.3% to 40.7% GDP that is concentrated between 2019 and 2021 to then stabilise in 2022, compared to AIReF’s estimates that maintain a relatively stable path at around 41% GDP, with an adjustment of 0.4% GDP.
AIReF’s envisage higher expenditure in nominal terms than those reflected in the SPU by 0.5% GDP. These differences are concentrated in gross capital formation and, to a lesser extent, in compensation of employees and social transfers in kind.

**Is the Stability Programme Update’s fiscal scenario plausible?**

As a result of the evolution described above, the path foreseen in the SPU envisages a reduction of public deficit of 2.5% GDP in 4 years, which is considered feasible until 2021 and unlikely, by a narrow margin, in 2022.

This reduction is mainly explained by the entry into force of several measures to increase revenue, some incorporated in the Budgetary Plan for 2019, but not processed due to the rejection of the draft GSB and the elections. These new revenue measures represent an increase in collection of 0.5% GDP, although according to AIReF’s estimates the impact would be 0.4%. The differences in the assessment of the new tax revenue measures are maintained with respect to the Budgetary Plan. These measures are in addition to those already in force that form part of the baseline scenario, with an assessment of 0.2% GDP, 0.1% less according to AIReF’s estimates.

It also includes measures that would be the result of the implementation of the proposals of the spending review carried out by AIReF with a progressive effect toward the end of the period. These savings materialise increasingly as higher contributions throughout the period due to the reduction of hiring incentives and reduced expenditure on subsidies and social transfers in kind, a heading that contains non-hospital pharmaceutical expenditure, with an overall amount of 0.2% GDP.

The rest of the SPU’s measures, such as the revaluation of pensions, the rise in public salaries and social measures taken following the rejection of the budgets, have been incorporated into AIReF’s baseline scenario in previous reports, although there is an approximation of the SPU to AIReF’s estimates in the evolution of these headings.
Informe sobre la actualización del programa de estabilidad 2019-2022

17 de mayo de 2019

Once again, the target distribution by sub-sector established in the SPU does not reflect the real situation of each of them. On the one hand, the Local Governments (LGs) have been recording a surplus above 0.5% GDP. In addition, the deficit estimated for the Regions in 2019 set in the SPU at 0.3% GDP differs from the 0.1% included in the “Deficit and debt notification to the European Union (EDP)”. Finally, the SPU expects a reduction in the deficit of the Social Security Funds (SSF) to reach an equilibrium that is not plausible without additional measures.

On the other hand, the SPU does not have enough information on the fiscal risks that may affect the sustainability of the GG. Beyond the contingent liabilities such as those resulting from judgements or of the State’s Financial Liability, AIReF identifies a series of fiscal risks that could hamper the reduction of the structural deficit. On the one hand, there are certain expenditure headings subject to upward pressure such as compensation of employees, investment or reform of the minimum income system. On the other hand, the weaknesses already identified by AIReF in the design of the Spanish fiscal framework could lead to additional strains on the structural deficit due to the progressive depletion of the LGs’ surplus or due to the upward pressure on healthcare and education expenditure that, as noted by the SPU, may arise from the reform of the regional financing system. Finally, a worse than expected macroeconomic evolution as a baseline scenario also entails a fiscal risk as noted above.

What are the implications from the point of view of the sustainability of public finances?

AIReF considers the debt projections included in the 2019-2022 SPU to be at the limit of feasibility. The path of public debt over GDP included in the SPU presents a downward trend throughout the period, with a cumulative adjustment of 8.4 points, above AIReF’s baseline scenario (at current policies).
According to AIReF’s sustainability analysis, in its baseline scenario (at current policies) the debt-to-GDP ratio would stabilise at around 70%. This implies a fiscal policy aimed to put the debt-to-GDP ratio back to its reference level while keeping the purchasing power of pensions. However, additional fiscal space is necessary to deal with the vulnerability arising from contingent liabilities, geopolitical risks, financial crises or macroeconomic shocks.

The fiscal strategy set forth in the SPU does not envisage additional fiscal effort in 2019 and distributes the required effort uniformly over the 2020-2022 period. As noted above, the deficit path foreseen in the SPU makes a correction of 2.5 p.p. in the next 4 years. The bulk of the correction (1.7 p.p.) is due to new measures that are distributed uniformly over the 2020-2022 period, with an annual average of 0.6% GDP.

While AIReF’s assessment coincides with the one included in the SPU in the years 2019 and 2020, it differs in the efforts envisaged in 2021 and 2022. However, this aggregate approach to estimating the effort suffers from important methodological limitations, so it is necessary to complement it with a more granular approach, considering the evolution of expenditure and exploiting existing information on discretionary measures. In this sense, the evolution of the GG’s modified expenditure aggregate, expanding the coverage of the national expenditure, confirms a neutral fiscal policy in 2019 and a contractionary fiscal policy in 2020. On the other hand, based on the European Commission’s more restrictive methodology, the evolution of modified expenditure aggregate stands above the requirements provided for in the recommendation of the ECOFIN Council in June 2018 and goes beyond the requirement of the debt rule, as set out in the SPU.
What recommendations does AIReF make?

Follow-up to the recommendations made previously in the process of preparing the SPU

AIReF has already made recommendations to the Government in its preliminary assessment of the SPU that have been partially considered in the final version of the SPU and in the fiscal scenario that underlies it. In this sense, the SPU includes the effect of the implementation of some of the proposals put forward by AIReF within the process of comprehensive expenditure review committed by Spain, as well as the savings that could be obtained with some of the projects of the second phase of the process. As a result, AIReF considers it relevant to reformulate the recommendation made in this area as follows:

- Specify the measures to be taken in the framework of the comprehensive expenditure review agreed with the Community institutions and whose performance, at various stages and in specific areas of expenditure, was commissioned to AIReF by agreement of the Council of Ministers.
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Regarding the coherence between the macroeconomic scenario and fiscal forecasts, the Government has not followed this recommendation. However, AIReF stresses the importance that this coherence is ensured, considering the risks and difficulties of evaluation that, from the perspective of the compliance with the fiscal targets, are associated to this lack of connection.

For this reason, AIReF maintains the following recommendation:

Coherence between the macroeconomic scenario and fiscal forecasts should be ensured at various milestones of the budgetary cycle.

Finally, the recommendation to expedite the processing of planned tax measures so that they can come into effect at the beginning of 2020 remains in force.
Other Recommendations

New

For the first time the SPU publishes the forecasts of the Ministry of Labour, which represents an important step forward in transparency in line with the suggestions for best practice contained in AIReF’s Opinion on the Sustainability of the Social Security System. However, contrary to what happens with the forecasts of the Ageing Report and AIReF also contained in the SPU, the underlying assumptions or the methodology followed are not explained. For this reason, AIReF recommends that:

- The Ministry of Labour, Migration and Social Security should publish and make accessible the results, data, assumptions and methodology that underpin its forecasts for expenditure on pensions, so that it will be possible to replicate its estimates.

Reiterated recommendations

AIReF also continues to identify the need to regulate the flow of information, procedures and the calendar related to the process of endorsement of the macroeconomic scenario. For this reason, AIReF reiterates that:

- The flow and timing of information exchange should be regulated through an agreement or “memorandum of understanding”, in line with the usual practices of surrounding countries.

Live recommendations

On the other hand, AIReF has recommended on several occasions that there is a need to devise a strategy that envisages a medium-term vision anchored in a credible debt reduction path, which allows future pressures on expenditure to be anticipated, thus enhancing financial sustainability. In this regard, the feasibility of the fiscal path envisaged in the SPU, the start of a new mandate and Spain’s departure from the Excessive Deficit Procedure, moving on to develop its fiscal policy within the framework of the preventive arm of the Stability and Growth Pact, are an opportunity to define a credible fiscal strategy for the medium term 2019-2022.

For this reason, AIReF keeps the following recommendations live:

1. The setting of budgetary stability targets for the 2020-2022 period should be underpinned by a government debt reduction pathway, which translates into a detailed fiscal strategy that includes an analysis of the evolution of the structural balance in the medium term.
2. The analysis and information that serves as a basis for determining the path of the stability targets and debt for the GG and for each of the sub-sectors should be published.

3. The fiscal strategy should consider the European framework and provide relevant information on compliance.

4. The following information should be included in the SPU
   - Budgetary forecasts for the general government sector and for each of the sub-sectors that incorporate the measures, displaying their contribution to the planned deficit reduction.
   - Government debt targets distributed by sub-sectors.
   - Detailed information for the analysis of the expenditure rule for each of the sub-sectors (computable expenditure and reference rates for all the years covered by the SPU).
   - More information on the risks that, if they materialise, may affect the budgetary stability or debt targets

5. An initial budget should be prepared in national accounting terms for the Central Administration and SSF.