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## **AIReF RECOMMENDS ACTIVATING THE ESCAPE CLAUSE, ESTABLISHING A MEDIUM-TERM FISCAL STRATEGY AND IMPLEMENTING THE SPENDING REVIEW'S PROPOSALS**

- The Independent Authority for Fiscal Responsibility continues to use an analysis framework based on two alternative scenarios, which differ in their estimated drop in GDP in 2020, ranging from -10.1% to -12.4% in 2020 depending on the duration of the pandemic
- In budgetary matters, AIReF estimates a general government deficit of 11.9% in 2020, which could reach 14.4% if the most adverse scenario occurs
- The increase in deficit compared to the previous report, 1% of GDP in scenario 1 and 0.6% in scenario 2, is mainly explained by the new approved measures
- The Public Administrations' (PAs) revenue will be 40.3% of GDP in 2020 in either scenario, while expenditure will reach 52.2% of GDP in scenario 1 and 54.8% in scenario 2
- The distribution of the impact of the crisis by sub-sector has changed substantially due to the additional transfers to Social Security and the Non-Reimbursable Fund for the Regions
- AIReF continues to project an increase in the debt-to-GDP ratio of between 22.1% and 27.7% in 2020, placing debt in a range between 117.6% and 123.2% of GDP in 2020

Today, the Independent Authority for Fiscal Responsibility (AIReF) published the Report on the 2020 Budgetary Execution, Public Debt and Expenditure Rule, in which it updates its macroeconomic and fiscal forecasts and issues a series of recommendations. These recommendations include activating the exceptionality clause provided for in the Organic Law on Budgetary Stability and Financial Sustainability, establishing a medium-term national fiscal strategy that guarantees the sustainability of the Public Administrations and implementing the proposals made by AIReF in the Spending Review.

AIReF is mandated to report on compliance with the stability and debt targets and the expenditure rule for the current year, before 15 July. However, the 2020 targets have been eclipsed by the crisis, which has made it impossible for AIReF to report on compliance, shifting the analysis' focus from calculating the probability of compliance towards evaluating deficit and debt forecasts.

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The forecasts are updated in a context of continued high uncertainty that prevents AIReF from taking the traditional approach. The institution therefore continues to use two alternative scenarios for its analyses. The PAs' deficit for 2020 is estimated to be 11.9% in the first scenario, and could reach 14.4% if the most adverse scenario occurs, compared to the 10.9–13.8% predicted in May. Meanwhile, the decrease in economic activity will be between -10.1% and -12.4%, depending on the duration of the pandemic and the resilience of the Spanish economy. This was previously estimated to be between -8.9 and -11.7%.

The revision of the macroeconomic estimates is in line with other national and international institutions and organisations and is mainly due to the greater contraction in GDP estimated for the second quarter of 2020. This greater contraction is marked by the adverse evolution of some highly significant activities in Spain's productive structure, which continue to be very negatively affected by the necessary social distancing and the contraction of international tourism flows.

In 2021, AIReF expects an incomplete and moderate recovery due to the persistence of social distancing measures, high participation in the productive structure of activities with increased social interaction, temporary employment contracts and a business demography with increased participation of small- and medium-sized companies that are more vulnerable to financing difficulties.

In budgetary matters, AIReF estimates a public deficit of 11.9% in 2020, which could reach 14.4% if the most adverse scenario occurs. Compared to the previous report, AIReF has increased its deficit estimate by 1% in scenario 1 due to the new measures approved and, to a lesser extent, due to the revision of the macroeconomic forecasts. For the most adverse scenario, this revision was lower, at 0.6% of GDP, and is essentially due to the new measures.

More specifically, new measures or the extension of existing measures represent an increase in the deficit of 0.8% or 0.6% of GDP, depending on the scenario. These measures include the approval of the Minimum Living Income, the extension of Temporary Redundancy Plans (ERTEs) and the extension and reformulation of benefits for the self-employed. In addition, the territorial administrations have approved new measures and the estimated impact of the crisis on health expenditure has been updated. Meanwhile, the revision of the macroeconomic scenario implicates a further deterioration in the deficit of 0.2% of GDP in scenario 1, due to the increase in the weight of the deficit on a lower GDP (denominator effect), the revision of the revenue forecasts and the upward revision of unemployment expenditure. In scenario 2, the downward revision of GDP presents a composition with different effects on fiscal variables, so that there is no increase in the deficit despite the lower growth forecast.

The PAs' revenue will stand at 40.3% of GDP in 2020 in both scenarios. This entails an upward revision due to the fact that the exemptions from social contributions through the ERTes and for the self-employed are not considered to be lower revenue in the National Accounts, but rather higher expenditure on subsidies. Excluding this effect, revenue has

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been revised downward in scenario 1 by 0.2% of GDP, while it remains the same in scenario 2. Personal Income Tax collection is performing better than expected, but does not offset the downward revision in VAT, Corporate Income Tax and Special Taxes.

On the other hand, public expenditure will reach 52.2% of GDP in scenario 1, increasing to 54.8% in scenario 2. As well as the effect of accounting for social security exemptions as subsidy expenditure, the new measures have increased expenditure forecasts, along with an increase in the estimated impact of COVID-19 on the Regions' health expenditure.

### Changes in distribution by sub-sector

The distribution of the impact of the crisis by sub-sector has changed substantially since the previous report, with the *Administración Central* (Central Administration - AC) assuming part of the deterioration of other sub-sectors through transfers. On the one hand, the Government has approved additional transfers to the *Fondos de la Seguridad Social* (Social Security Funds - FSS) for an amount of 15.7 billion. On the other hand, it has approved the Non-Reimbursable Fund for Regions for the amount of 16 billion.

In this way, AIReF estimates that the AC's deficit will increase by between 3.2% and 2.7%, reaching 7.7% in scenario 1 and 8.3% in scenario 2. Meanwhile, the FSS deficit will be between -3.9% and 5.1% of GDP, also reflecting the impact of the new approved measures. The Regions' deficit estimate is also reduced, although to a lesser extent than the new transfers due to higher health expenditure and new measures.

### Debt

Updating the forecasts does not substantially change the conclusions of the previous report on the sustainability of public finances. AIReF predicts an increase in the debt-to-GDP ratio of between 22.1% and 27.7% in 2020, placing the debt-to-GDP ratio in a range between 117.6% and 123.2% of GDP in 2020

Even assuming an annual reduction in the public deficit of 0.5% of GDP from the projected 2021 level until a primary surplus of 2% is reached, AIReF simulations indicate that it will take at least two decades to return to the debt level of 95.5% recorded at the end of 2019. Simulations also indicate that 60% will no longer be reached before 2050, in contrast to the scenarios predicted by AIReF before the crisis that predicted that 60% level would be reached around 2035.

### Recommendations

To tackle the current lack of definition in the fiscal framework, AIReF recommends that the Government clarify, as soon as possible, the fiscal framework applicable to each of the Public Administrations. This is particularly important for preparing each administration's Budgetary Plan and budget, which means activating the exceptionality clause provided for in the Organic Law on Budgetary Stability and Financial Sustainability, clarifying the consequences of non-compliance with the fiscal rules and setting new stability and debt targets.

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Furthermore, it recommends establishing a national medium-term fiscal strategy that serves as a fiscal guide and guarantees the Public Administrations' financial sustainability in a realistic and credible way. The implementation of the proposals made by AIReF in the Spending Reviews, both those already carried out and those that will be presented soon, should be explored within the framework of this fiscal strategy.