

PRESS RELEASE
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Appearance of Cristina Herrero before the Budget Committee

**AIReF ESTIMATES A DEFICIT OF 8% OF GDP IN 2021,
AFTER REACHING 11.6% IN 2020**

- In the baseline scenario, the Independent Authority for Fiscal Responsibility estimates that GDP could fall by 11.1% in 2020 and recover in 2021 to record 8.2% growth
- The differences between scenarios of AIReF and the Government are mainly due to the expected speed of recovery, which is closely linked to the assumptions on the evolution of the pandemic
- In the baseline scenario, revenue will stand at 42.5% in 2021, which is 0.6 percentage points below the figure forecast by the Government as AIReF expects lower tax collection
- Materialisation of AIReF's pessimistic macroeconomic scenario would lead to an expected shortfall of revenue of €18.4bn compared with the Government's scenario, while in the optimistic scenario, the forecast of the Budgetary Plan would be achieved.
- AIReF projects a rise in the debt-to-GDP ratio of around 23 points in 2020, and a reduction of up to 2.4 points in 2021. This would bring the debt-to-GDP ratio to 118.4% and 116% of GDP in 2020 and 2021, respectively
- The institution reiterates its recommendation to design a national medium-term fiscal strategy and it makes two new recommendations aimed at managing uncertainty and improving high-frequency reporting

The president of the Independent Authority for Fiscal Responsibility (AIReF), Cristina Herrero, appeared today before the Budget Committee of the lower house of the Parliament, where she presented the Report on the Main Lines of the 2021 Budgets of the Public Administrations, in which the institution analyses the Government's Budgetary Plan and the Draft State Budget for 2021. In the report, AIReF estimates a government deficit of 11.6% of GDP in 2020, which will fall to 8% in 2021.

Cristina Herrero began her participation by stressing the changing scenario surrounding the assessment of the Budgets. In just a few weeks, the outlook for global growth has shifted towards more pessimistic scenarios as the severity and extent of the second wave of the coronavirus pandemic becomes apparent. In this context, in order to assess the macroeconomic framework of the Budgets, AIReF has continued to prepare scenarios contingent on the development of the pandemic. These scenarios



were reviewed with respect to employees at the start of October in the endorsement of the Budgetary Plan in order to collect the most recent information on the evolution of economic activity and the worsening of the pandemic.

In a baseline scenario in which the pandemic is assumed to persist, but a general lockdown is not necessary, AIReF estimates that GDP might fall by 11.1% in 2020 and would recover in 2021 with growth of 8.2%. In an optimistic scenario, with current outbreaks being controlled and confidence and spending recovering rapidly, GDP could rise by up to 10% in 2021, after falling by 10.7% in 2020. Finally, if the containment of the second wave requires more severe measures to restrict mobility and economic activity, or if the pandemic is assumed to persist further, GDP growth forecasts for 2021 drop to 6.5%, after recording a fall of 11.4% in 2020. These three scenarios incorporate an impact of the Recovery, Transformation and Resilience Plan (RTRP) of 2.7 points in 2021, estimated on the basis of AIReF's econometric model.

Based on these scenarios, AIReF still believes that the macroeconomic scenario of the 2021 Budget could be achievable if favourable circumstances converge, both in terms of the development of the pandemic and the implementation and impact of the funds received, through the Recovery and Resilience Facility (RRF) and the other Next Generation EU funds, which constitute the lever supporting the economic recovery in the Government's scenario. However, AIReF notes the risk of less benign scenarios associated with lower growth rates. The Government's growth forecasts for 2021 are, in fact, in the upper range of the scenarios developed by AIReF.

The differences between AIReF's and the Government's scenarios are not so much due to the estimated impact of the RTRP as to the speed of the expected recovery, which is closely linked to the assumptions about the development of the pandemic. The recent worsening of the pandemic makes it less likely that the assumptions on which the Government's macroeconomic forecasts are based will materialise. The Government assumes that the outbreaks will remain controlled and concentrated, without leading to strict lockdown measures. In addition, the Government's forecasts assume that significant progress will be made in the fight against the pandemic over 2021, allowing for a gradual return to normality. For its part, AIReF believes that, despite the progress in the development of a vaccine and treatments against COVID-19, it is still very uncertain when these might become available for mass use among the population and the level of coverage they might achieve so that they can effectively solve the health crisis and thus remove the pandemic containment measures that are hindering economic growth.

With regard to the RTRP, AIReF stresses the need for the projects and reforms to be selected with the strictest requirements so that they will have the desired multiplier effects on economic activity over the short and medium term.



Budgetary scenario

In the baseline scenario, AIReF estimates a general government deficit of 8% of GDP in 2021, after 11.6% in 2020. Both figures are higher than those set out in the Budgetary Plan (11.3% in 2020 and 7.7% in 2021). The economic recovery, the progressive withdrawal of the measures implemented as a result of the COVID-19 crisis and the tax changes included in the draft Budget will drive this deficit reduction. In the opposite direction, the new spending measures imply a smaller reduction in the deficit. With a neutral effect on the deficit, AIReF's estimates assume the RTRP will be implemented according to the Government's forecast, which indicates an increase in revenue and spending of 2.8 points of GDP.

Following a 6.4% fall in 2020, AIReF forecasts that revenue will grow by 6.2% in 2021, to stand at 39.7% of GDP, 42.5% if RTRP revenue is included. This level will be 0.6 points lower than that assumed in the Budgetary Plan. In both cases, the revenue forecast is based on macroeconomic scenarios that envisage quick and effective implementation of the RTRP and approval of the Budget with the proposed tax changes and with the new announced categories. AIReF estimates lower tax growth, around one point of GDP. The differences in the impact of the tax measures are concentrated in the new taxes due to the likely delay in their approval. In contrast, AIReF expects a more positive evolution of social contributions and other current revenue.

Expenditure will stand at 47.6% in 2021, excluding the RTRP, according to AIReF's estimates, compared with 48% in the Budgetary Plan, following a peak of 52.5% of GDP in 2020. The progressive withdrawal of the measures implemented in 2020 will be partially offset by the measures provided for in the 2021 Budget and consolidation of part of the health expenditure. In nominal terms, jobs would fall by 0.6%, while the Budgetary Plan envisages a rise of 0.4%, assuming a greater consolidation of the expenditure linked to the pandemic. Nevertheless, implementation of the RTRP will boost the growth in spending, by 5.4% according to AIReF, to stand at 50.5% of GDP.

The estimates of AIReF's baseline scenario remain subject to a high level of uncertainty in relation to the development of the COVID-19 health crisis and its effects on economic activity, in addition to the risks of implementation of the RTRP. Materialisation of the pessimistic macroeconomic scenario outlined by AIReF would imply a lower revenue forecast of around €18.4bn, while it would remain at around the forecasts of the Budgetary Plan in the case of the optimistic scenario. In addition, the risks in the implementation of the RTRP might lead to lower growth, which would result in a greater deficit for the general government.

By sub-sector, the Central Government will continue to take on part of the deficit of the other sub-sectors, Social Security Funds and Autonomous Regions, through direct transfers. Furthermore, the implementation of the RTRP will affect all sub-sectors, even though it is also neutral for each of the administrations. With regard to the reference rates included in the Budgetary Plan, AIReF estimates deviations for 2021 in the case of the central government and Social Security Funds, partially offset by a lower deficit of the regions.

Sustainability



The halt in economic activity and the increase in borrowing needs resulting from the COVID-19 crisis will lead to a sharp, and in theory temporary, rise in the public deficit which in turn will bring about a permanent increase in the level of public debt over GDP, bringing it to its highest value of the last one hundred years. AIReF projects that the debt-to-GDP ratio will rise by around 23 points in 2020, and fall by up to 2.4 points in 2021, under the scenario of full implementation of the Recovery, Transformation and Resilience Plan budgeted for that year. This would place the debt-to-GDP ratio at 118.4% and 116% of GDP in 2020 and 2021, respectively.

AIReF maintains that the health crisis will need to be contained and economic activity normalised in order for the debt-to-GDP ratio to stabilise in the coming years. Above-trend growth for several years, as the world economy emerges from the recession caused by COVID-19, will allow the debt ratio to stabilise at around 120% of GDP in the absence of measures. The launch of *the Next Generation EU* European Plan will have a positive impact on economic activity in the short term, as well as on productivity and potential growth in the long term. This will lead to an improved fiscal position, with a reduction in the debt-to-GDP ratio of between 4 and 10 points. Once the crisis has been overcome, a pathway towards reducing the debt ratio that will place it below pre-pandemic levels over the coming decade will require an appropriate consolidation plan to be designed with a gradual and sustained reduction in the public deficit towards structural balance.

According to the institution, the risks and challenges for the medium- and long-term sustainability of the public accounts are high. One of the leading risks is that the recession will result in structural damages. This will mean that in the future it will be necessary to address not only a higher public debt ratio, but also a higher and more persistent structural deficit and a higher level of materialisation of the contingent liabilities of the State-backed loans. Another notable risk is the greater reliance on favourable borrowing conditions such as the current ones, as a rise in interest rates might quickly generate an upward trend in the public debt ratio. The above is compounded by the well-known challenge of an ageing population and higher pension expenditure, which, if not financed with additional revenue, will lead to a very significant increase in debt from levels that are already historically very high.

Recommendations

AIReF reiterates its recommendation to design a national medium-term fiscal strategy that will act as fiscal guidance and will realistically and credibly ensure the financial sustainability of the public administrations. This requires having the support of all levels of government, considering public debt levels and fiscal risks, establishing a tentative calendar for compliance with milestones to act as a framework for the rebalancing plans of the Public Administrations and promoting its coordination with the Recovery, Transformation and Resilience Plan.

Furthermore, AIReF adds two new recommendations. One of them aimed at managing uncertainty, since very different scenarios from those set out in the Budgetary Plan cannot be ruled out. This makes it recommendable to have the capacity to react both to implement further measures and to prevent consolidation of measures that were initially devised as temporary solutions to mitigate the effects of the crisis. As well as another aimed at improving high-frequency reporting, given the delay in the usual



statistics and the challenge this poses with regard to monitoring the effects of the pandemic.

Finally, as in previous reports, AIReF highlights the importance of raising transparency in the budgetary process and it therefore maintains the recommendations to include information in terms of national accounting in the General State Budget.