

EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility (AIReF) is required to issue a report on the draft budgets and main budgetary lines of the general government for 2021. It is also required to issue a report on its endorsement of the macroeconomic forecast supporting the draft General State Budget for 2021 (2021 GSB). For this purpose, on 6 October, AIReF issued its endorsement of the macroeconomic forecasts at the request of the government, and this report completes the analysis of the 2021 GSB.

As a result of the COVID-19 crisis, the budgetary stability targets are on hold following activation of the escape clause provided for in Article 11.3 of Organic Law 2/2012 on Budgetary Stability and Financial Sustainability and approved by the Lower House of Parliament, following the report by AIReF dated 13 October on the existence of the exceptional circumstances referred to in OL 2/2012. However, although the budgetary stability targets have been put on hold, AIReF's fiscal oversight remains fully in force, becoming even more important as a guarantor of the sustainability of the public finances.

In this context, on 15 October, the government presented the Budgetary Plan for 2021 and, later, on 28 October, the draft GSB, which both form the subject matter of this report. While the former presents the fiscal situation of general government in national accounting, the latter is limited to the Central Government and the Social Security Funds in budgetary terms, which hinders analysis of the consistency between the two, which AIReF has warned about in successive reports. At any event, the GSB not only determines the fiscal development of the CG and the SSFs, it also has a determining role over the other tiers of government both through their funding and through the establishment of basic legislation on essential matters such as compensation of employees.

The macroeconomic scenario of the GSB for 2021

The macroeconomic scenario for the 2021 GSB incorporates a GDP contraction of 11.2% in 2020 as a result of the health crisis and the necessary

mobility restrictions for mitigating it. For 2021, the Government's scenario foresees a significant recovery in economic activity, with GDP growth of 9.8%.

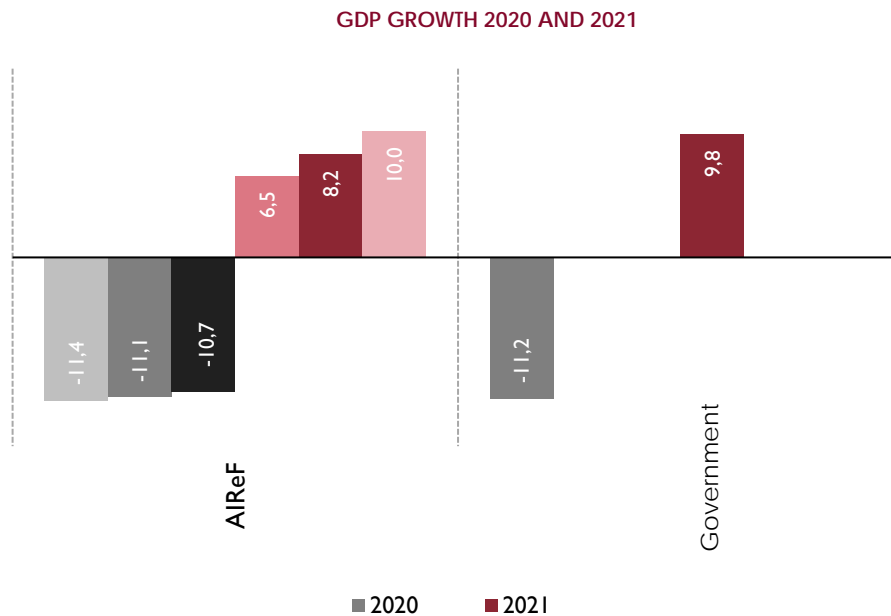
AIReF highlights the changing scenario surrounding the assessment of the GSB. In just a few weeks, the outlook for global growth has shifted towards more pessimistic scenarios as the severity and extent of the second wave of the coronavirus pandemic becomes apparent. In this context, in order to assess the macroeconomic framework of the 2021 GSB, AIReF has continued to prepare scenarios contingent on the development of the pandemic. These scenarios were reviewed with respect to expenditure 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 central 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, a figure which is very close to the government's, and that it will recover in 2021 to achieve GDP growth of 8.2%, almost two points lower than the figure forecast in the GSB. In contrast, in an optimistic scenario, in which it is assumed that the current outbreaks are controlled and that confidence and spending recover quickly, GDP might grow by 10% in 2021, after falling by 10.7% in 2020. Finally, if containment of the second wave is assumed to require more stringent measures to restrict mobility and economic activity, or if the pandemic is assumed to persist further over 2021, AIReF's GDP growth forecast for 2021 falls to 6.5%. These three scenarios incorporate an impact of the Recovery, Transformation and Resilience Plan (RTRP) and of the measures contained in the GSB of 2.7 percentage points (pp) in 2021 estimated on the basis of AIReF's econometric model.

On the basis of these scenarios, AIReF continues to consider that the macroeconomic scenario of the 2021 GSB might be achievable if a variety of favourable circumstances come into place, both with regard to evolution of the pandemic and implementation and impact of funds received through the Recovery and Resilience Facility (RRF) and other Next Generation EU (NGEU) funds, which in the government's scenario are the lever on which the economic recovery is based.

However, AIReF notes the risk of less benign scenarios associated with lower growth rates. In fact, the government's growth forecasts for 2021 are in the upper range of the scenarios prepared by AIReF, as reflected in the following figure. Therefore, the endorsement of the Draft Budgetary Plan recommended that when the budgets were to be drawn up, the forecasts should be made with the necessary caution to take into account the possibility that more adverse scenarios than those forecast by the government might materialise.

This has not been done. The budget is based on a forecast of significant economic growth, which has a very favourable impact on budget revenue projections.



Source: Ministry of Economic Affairs and Digital Transformation and AIReF.

Main downside risks surrounding the government’s forecasts

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. This assumption is essential for sustaining the high growth in household spending on which the government supports its forecasts in the baseline scenario as early as the end of 2020 (before incorporating the effects of the RTRP).

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.

If the more adverse evolution of the pandemic seen over recent weeks persists and more stringent measures limiting mobility than those currently in place are introduced, as is the case in neighbouring economies, this will lead to a contention of spending and later recovery of the sectors that involve greater social interaction. This would delay the recovery in employment and spending and would increase the likelihood of structural damage to the business sector.

Assessment of the macroeconomic impact of the Recovery, Transformation and Resilience Plan

The macroeconomic impact associated with the RTRP incorporated in the government's scenario amounts to 2.6 pp of GDP growth in 2021, with a multiplier effect of around 1.2%, which would close the gap in economic activity opened by the coronavirus crisis in 2022.

According to the information available, this boost comes from transfers received through the Recovery and Resilience Facility (RRF), which in the simulations performed by the government are assumed to amount to €25bn in 2021. No macroeconomic effect from the Recovery Assistance for Cohesion and the Territories of Europe (React-EU) is incorporated, but it is included in the non-financial expenditure limit of the 2021 GSB (for an amount of €2bn).

In accordance with the 2021 GSB, the resources received through the RRF will mostly be allocated to public investment in infrastructures and intangible assets associated with innovation and digitalisation. Another set of funds will be allocated to increasing energy efficiency and the technological transformation, encouraging entrepreneurship, improving education and lifelong learning and strengthening inclusion policies, among other items.

Empirical evidence suggests that expenditure on investment, in its broadest sense (human, intellectual and physical capital), is associated with a high impact on GDP and employment, particularly in periods of recession, where interest rates are close to their zero lower bound, so that a monetary policy response to the fiscal expansion is not expected, and the expenditure is carried out in a coordinated manner in a set of countries, as is the case with the RRF.

For this reason, AIReF agrees with the government that the resources received could have a strong impact on growth if the projects meet the necessary requirements for boosting the modernisation and digitalisation of the Spanish economy. In fact, the estimates on the macroeconomic impact made by AIReF under the assumption of full implementation of the projects are very

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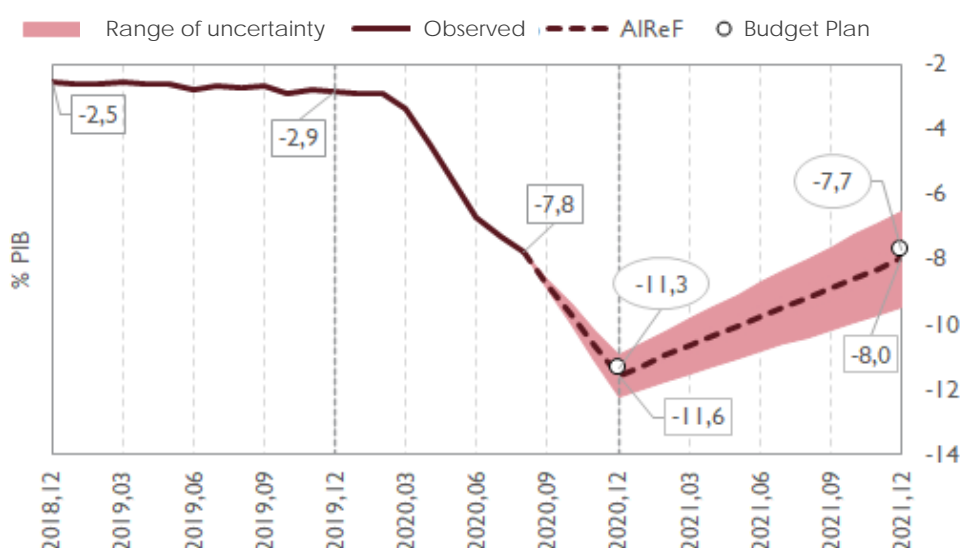
similar to those of the government (2.7 pp vs. 2.6 pp in the case of the government).

However, the risks of delays in the absorption of these resources and in the implementation of these projects are high. Furthermore, some resources might not have the desired impact if the projects are not properly selected. In contrast, neither the government's nor AIRcF's estimates incorporate possible spillover effects associated with the implementation of the NGEU in other countries.

Budgetary scenario of general government

For its central scenario, AIRcF estimates a general government deficit of 8% of GDP in 2021, after standing at 11.6% in 2020. Both of these figures are higher than those included in the Budgetary Plan, 11.3% for 2020 and 7.7% for 2021. The economic recovery, the progressive withdrawal of the measures implemented to mitigate the effects of the COVID-19 crisis and the tax changes included in the draft GSB will drive this deficit reduction. In the opposite direction, the new spending measures contained in the draft GSB imply a smaller reduction in the deficit. With a neutral effect on the deficit, AIRcF's estimates assume the Recovery and Resilience Plan will be implemented in 2021 in accordance with the government's forecasts in the draft GSB, which will mean an increase in revenue and expenditure of 2.8 point of GDP.

EVOLUTION OF THE BALANCE OF GENERAL GOVERNMENT



Following a 6.4% fall in 2020, AIRcF forecasts that revenue will grow by 6.2% in 2021, to stand at 39.7% of GDP, 42.5 % if the revenue of the Recovery Plan 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 assume quick and effective implementation of the Recovery, Transformation and Resilience Plan (RTRP) and approval of the General State Budget (GSB) with the proposed tax modifications (VAT, Personal Income Tax, Corporate Income Tax, Special Taxes and Taxes on Insurance Premiums), as well as the new approved taxes (Financial Transactions Tax and Tax on Certain Digital Services), and the announced Tax on Single-use Waste and Plastic. AIReF estimates lower tax growth, around one point of GDP, as a result of a lesser impact of the tax measures, a less favourable macroeconomic scenario and the greater optimism incorporated into the government's forecasting models. The differences in the impact of the tax measures are concentrated in the new taxes, mainly 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 draft GSB and consolidation of part of the health expenditure. In nominal terms, spending would fall by 0.6% according to AIReF's estimates, while the Budgetary Plan envisages a rise of 0.4%, assuming 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 central 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 revenue forecast of around €18.4bn lower than that of the government, while it would remain at around the forecasts of the Budgetary Plan in the case of the optimistic scenario. Furthermore, as indicated above, the risks in the implementation of the RTRP might lead to lower economic growth, which would result in a greater deficit for the general government.

By sub-sector, the CG 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 tiers of government. With regard to the reference rates included in the Budgetary Plan, AIReF estimates deviations in the case of the Central Government and Social Security Funds, partially offset by a lower deficit of the regions.

GENERAL GOVERNMENT DEFICIT BY SUB-SECTOR IN % GDP

%PIB	2019	2020		2021	
		DBP	AIReF	DBP	AIReF
GG	-2.9	-11.3	-11.6	-7.7	-8.0
CG	-1.3	-6.6	-7.2	-5.2	-5.6
FSS	-1.3	-4.1	-3.8	-1.3	-1.5
AR	-0.6	-0.6	-0.6	-1.1	-0.8
LG	0.3	0.0	0.0	-0.1	-0.1

Central Government

After analysing the GSB, AIReF estimates a deficit of 5.6% of GDP for the CG in 2021, after reaching 7.2% in 2020. In both cases these are higher than the figures in the Budgetary Plan. In both years, AIReF has a lower revenue forecast than the government. Since payments from the regional and local financing systems are set in the GSB, the differences in tax collection forecasts only have an impact on the CG. AIReF estimates non-financial revenue 1% of GDP lower than that set out in the GSB. For 2021, the CG continues to bear a similar amount to 2020 for transfers to the Autonomous Regions and Social Security Funds to offset the effects of COVID-19. Finally, it should be pointed out that the CG will manage the funds of the Recovery and Resilience Facility and a part of the REACT-EU funds, channelling a significant part of these funds to the other sub-sectors through transfers.

Insofar as the GSB still do not include a breakdown of the adjustments that would make it possible to reconcile the budgetary balance with the reference rate of the Budgetary Planning under national accounting, AIReF has made its own estimates. These national accounting adjustments are particularly relevant in 2021 as they include the neutrality of the RTRP, increasing the amount to 2% of GDP compared with the 1.4% that may be deduced from the GSB. In both cases this is much higher than the historical average of -0.1% of GDP. This would imply a positive deviation from the reference deficit of 0.6 points, which partially offsets the sharp difference in the estimate of non-financial revenue of the State, which is 1% of GDP less. As regards the evolution of expenditure, AIReF notes that the sharp increase is mainly based on the implementation of the RTRP.

Social Security Funds

After reaching a peak of 3.8% of GDP in 2020, the deficit of the Social Security Funds will fall to 1.5% of GDP according to AIReF's estimates. The Budgetary Plan foresees a high deficit in 2020 and a lower deficit in 2021. The reduction in the deficit is explained by the gradual withdrawal of measures such as the job retention schemes and the cessation of activity of self-employed people, the recovery in employment and the maintenance of the transfers of the

Autonomous Regions. However, it is important to highlight that part of these transfers would finance on a structural basis the expenses considered “improper” by the recently approved Toledo Pact report. Pension expenditure will grow by 3.3%, including the revaluation of 0.9%, while expenditure on unemployment will fall significantly, even taking into account an extension of the job-retention schemes during the first half of the year.

Regions

The deficit of the regions will grow in 2021 to 0.8% from 0.6% at year-end 2020. This evolution is more positive than the one foreseen by the Budgetary Plan, which places the regional deficit at 1.1%. The difference in the estimates is mainly due to the assumptions on the level of consolidation of the expenditure associated with the pandemic, as AIReF considers that a part of the increase in 2020 will be temporary. In addition to implementing the Recovery and Resilience Facility projects financed through conditional transfers from the CG, the regions must implement the REACT-EU programmes for an amount of €8bn in 2021, which will allow them to significantly increase their expenditure in parallel with their revenue. Insofar as most of the regions are this year at an early stage in their budgetary process, and insufficient information is available, AIREF will later issue an individual report on their draft budgets.

Local Governments

Local governments will incur a deficit of 0.1% of GDP in 2021, after closing 2020 with a balanced budget. This sub-sector will also play a role in implementing the RTRP, albeit quantitatively less than that of other sub-sectors. As is the case with the Autonomous Regions, AIReF will later issue a report in the Main Lines of the budgets of local governments, which it analyses individually.

Challenges that can be noted from the point of view of the sustainability of public finances

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 100 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. This estimate is in line with the draft GSB projection, which puts the debt ratio at 118.7% of GDP in 2020 and 117.4% in 2021.

Summary

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 (either those relating to the RTRP or other types of measures contained in the Budget). 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, designing an appropriate consolidation plan will be necessary for reducing the debt ratio to more prudent levels. A gradual and sustained reduction in the public deficit towards the target of structural equilibrium, as set out in our fiscal framework, would bring the public debt ratio below pre-pandemic levels over the next decade.

The risks and challenges for the medium- and long-term sustainability of the public accounts are high. In this regard, one of the major risks of the current situation is that the recession mutates into a depression, meaning 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 State-backed loans. Another notable risk, in a context of high debt levels, 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

Although the government has activated the escape clause provided for in the national fiscal framework, as recommended by AIRcF, the sustainability of public finances remains essential for economic recovery and AIRcF reiterates the recommendation to establish a national medium-term fiscal strategy that will act as fiscal guidance and will realistically and credibly ensure the financial sustainability of general government. This requires the support of all tiers of government, considering their fiscal realities in terms of revenues and powers, in order to ensure appropriate coordination and co-responsibility. It is also necessary to consider public debt levels and fiscal risks, particularly those borne from managing the COVID-19 crisis. This strategy should establish a tentative timetable in order to achieve the milestones and to act as a

framework for the rebalancing plans of general government and promote coordination of the strategy with the Recovery and Resilience Plan.

Furthermore, 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.

AIReF also makes a new recommendation aimed at managing the existing uncertainty. Since very different scenarios, both optimistic and pessimistic, from those set out in the Budgetary Plan, cannot be ruled out, the administrations should have the capacity to react both to implement further measures and to prevent consolidation of expenditure that was initially devised as a temporary solution to mitigate the effects of the crisis.

Finally, in response to the challenge of effectively monitoring the effects of the pandemic, AIReF makes another recommendation aimed at improving high-frequency reporting as progress needs to be made in preparing such reporting and making it available to the public and, especially, to institutions with oversight powers.

