REPORT ON THE MAIN LINES OF THE 2021 BUDGETS OF THE GENERAL GOVERNMENT

REPORT 29/20

Autoridad Independiente de Responsabilidad Fiscal

The mission of the Independent Authority for Fiscal Responsibility (AIReF) is to ensure strict compliance with the principles of budgetary stability and financial sustainability enshrined in Article 135 of the Spanish Constitution.

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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, but 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%.

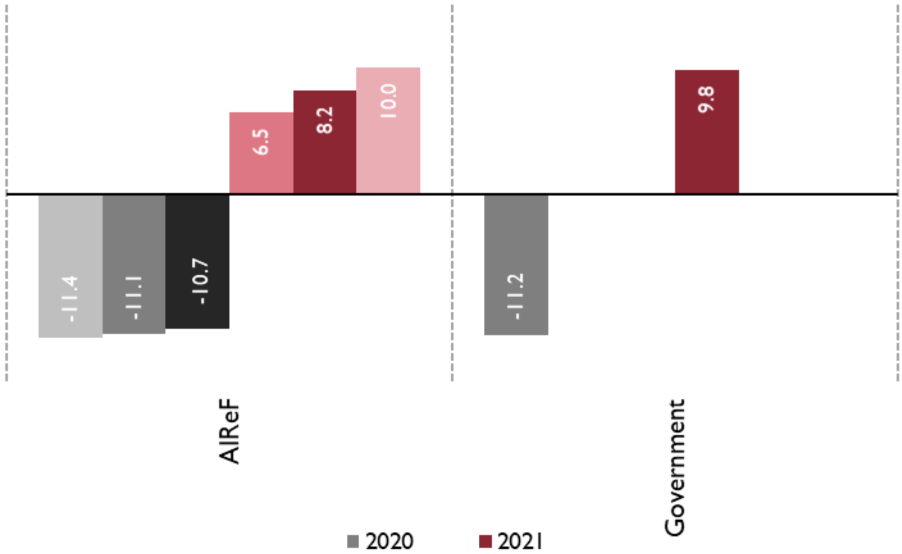
AIReF highlights the changing scenario surrounding the assessment of the GSB. In just a few weeks, the outlook for global growth has shifted towards more pessimistic scenarios as the severity and extent of the second wave of the coronavirus pandemic becomes apparent. In this context, in order to assess 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 based on AIReF's econometric model.

Based on 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 about 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 consider 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.

GDP GROWTH 2020 AND 2021



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 be expected, and the expenditure is carried out in a coordinated manner in a set of countries, as is the case with the RRF.

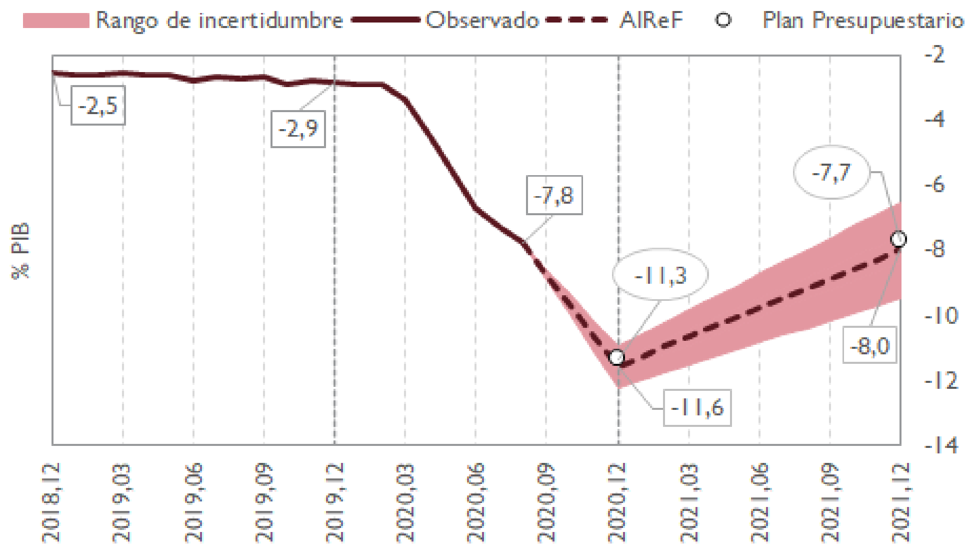
For this reason, AIReF agrees with the Government that the resources received could have a strong impact on growth if the projects meet the necessary requirements for boosting the modernisation and digitalisation of the Spanish economy. In fact, the estimates on the macroeconomic impact made by AIReF under the assumption of full implementation of the projects are very 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 AIReF'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, AIReF estimates a General Government deficit of 8% of GDP in 2021, after standing at 11.6% in 2020. Both 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, AIReF'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 THE GENERAL GOVERNMENT



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 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. Regarding 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

% GDP	2019	2020		2021	
		DBP	AIReF	DBP	AIReF
General Government	**-2.9**	**-11.3**	**-11.6**	**-7.7**	**-8.0**
CG	-1.3	-6.6	-7.2	-5.2	-5.6
SSFs	-1.3	-4.1	-3.8	-1.3	-1.5
Regions	-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, 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 considering 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.

The health crisis will need to be contained and economic activity normalised 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 AIReF, the sustainability of public finances remains essential for economic recovery and AIReF 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.

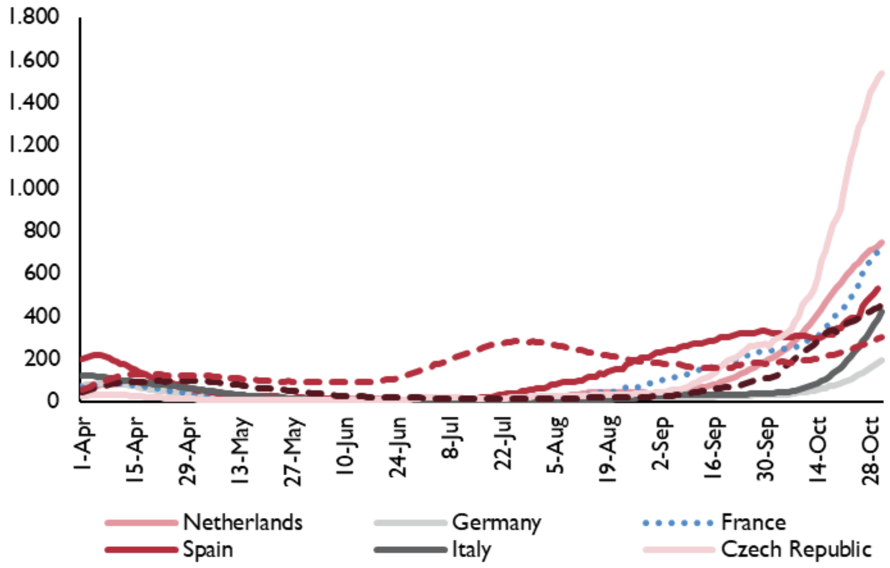
AIReF also makes a new recommendation aimed at managing the existing uncertainty. Since very different scenarios, both optimistic and pessimistic, from those set out in the Budgetary Plan, cannot be ruled out, the administrations should have the capacity to react both to implement further measures and 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.

1. INTRODUCTION

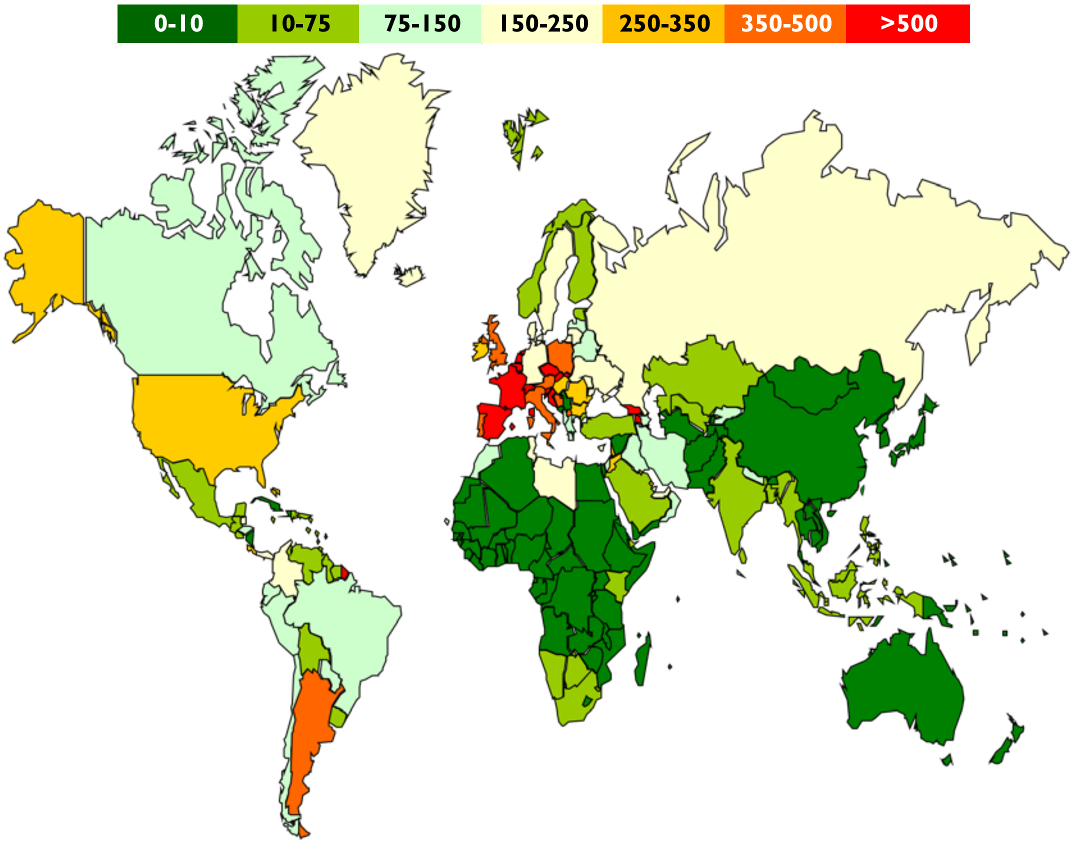
The COVID-19 crisis continues to pose a fundamental challenge to public health and growth prospects. The recent worsening of the pandemic and the continuing high level of uncertainty about its future development keeps the population immersed in an environment of extraordinary uncertainty that has a very severe impact on economic activity. In just a few weeks, the perception of most economies of how the crisis will develop has shifted towards more pessimistic scenarios as the severity of the second wave became apparent. Although this wave began with a certain delay regarding Spain, it is becoming particularly intense in the United States and Europe.

FIGURE 1. EVOLUTION OF COVID-19 CASES. 14-DAY CUMULATIVE NUMBER OF CASES PER 100,000 INHABITANTS



Source: European Centre for Disease Prevention and Control (31 October 2020).

FIGURE 2. GLOBAL, COVID-19 CASES. 14-DAY CUMULATIVE NUMBER OF CASES PER 100,000 INHABITANTS



Source: European Centre for Disease Prevention and Control (31 October 2020).

In the case of the Spanish economy, the presentation of the GSB coincided with the implementation of a new state of alarm that will last until May 2021. As of the report date, it is not known whether the gradual increase in cases recorded in July will eventually require lockdown and mobility restriction measures like those that have just been implemented in neighbouring countries.

Governments continue to implement measures to mitigate the effects of the crisis. In the area of monetary policy, the European Central Bank, after noting that the recovery in the euro area is losing momentum faster than expected, has just announced that in the coming months it will recalibrate and intensify the extraordinary measures to provide liquidity, grant credit and purchase assets that it has been implementing as a response to the crisis. International bodies such as the International Monetary Fund and the European Commission continue to highlight the need for Governments to maintain an expansive fiscal policy. European institutions have also made progress in implementing the mechanisms set up to deal with the crisis. In particular, the European Commission has provided a total of €6bn to Spain in the first tranche of the financial assistance provided through the SURE instrument (Support to Mitigate Unemployment Risks in an Emergency), which is aimed at mitigating the cost associated with unemployment and short-time work schemes in EU countries.

An essential element of this response is the Next Generation EU recovery fund (NGEU), which is highly influential for determining the macroeconomic and budgetary outlook. Progress has been made towards defining the NGEU, under which €750 billion will be allocated to mitigating the effects of the coronavirus crisis and to drive the structural transformation of European economies. However, it is still awaiting approval by the European Council and essential aspects remain to be defined, such as the macroeconomic conditions attached to receipt of the resources (which might imply, for example, that the funds will no longer be received if fiscal rules are not met) or the level of requirement for structural reforms linked to compliance with the recommendations of the European Semester.

In this changing context, AIReF has continued preparing forecast scenarios contingent on the pandemic's evolution in order to assess the level of realism of the Government's macroeconomic outlook. This maintains the approach previously used to assess the Stability Programme in May. All the scenarios incorporate the most recent information available on the development of the pandemic and on economic activity, including the figures of the quarterly accounts (QNA) published by the National Statistics Institute for the third quarter of the year[1].

AIReF's scenarios incorporate the impact associated with the Recovery, Transformation and Resilience Plan that the Government presented on 7 October. Since the GSB includes revenue and expenditure items associated with the RTRP, AIReF's scenarios also incorporate the associated impact under the assumption of full implementation of the measures set out in the General State Budget and in the Budgetary Plan. However, it is important to bear in mind that detailed information on the specific projects to which the resources will be allocated is not yet available and that the RTRP is pending approval by

[1] These figures were not available when the Government prepared its macroeconomic projections or when AIReF endorsed them (see https://www.airef.es/wp-content/uploads/2020/10/AVAL_MACRO/Informe-AIReF-Aval-Macro.pdf). However, the positive surprise provided by the figures of the third quarter national accounts is offset to a large degree by the negative effect associated with the worsening of the pandemic both in Spain and in other countries. The scenarios in this report are therefore marginally revised with regard to those used at the start of October to endorse the macroeconomic outlook of the Budgetary Plan presented by the Government to the European Commission.

the European Commission. The estimated macroeconomic effects are still therefore subject to a great deal of uncertainty[2].

On 15 October, the Government submitted the Budgetary Plan to the EU and, later, on 27 October, approved the draft 2021 GSB. The draft GSB is currently in its passage through Parliament, where it was presented on 28 October for parliamentary consideration.

AIReF issued a report on the macroeconomic projections underpinning the draft 2021 GSB. The law on the creation of AIReF establishes that the macroeconomic forecasts incorporated in the draft budgets of all sub-sectors of General Government must include a report from AIReF and indicate whether they have been endorsed by AIReF. For this purpose, on 6 October, AIReF issued its macroeconomic endorsement at the request of the Government, and this report completes AIReF's analysis.

AIReF also has the legal mandate to report on the draft GSB and the main lines of the budgets of the Autonomous Regions and Local Governments about whether they are in line with fiscal rules. The Organic Law on Budgetary Stability and Financial Stability and the Law on the Creation of AIReF and its implementing regulation set out AIReF's mandate to report on the draft GSB and the main budgetary lines with regard to whether they are in line with the expenditure rule and budgetary stability and public debt targets.

For 2021, as for 2020, there are, on an exceptional basis, no fiscal rules in force. Following AIReF's recommendation, on 6 October 2020, the Council of Ministers requested activation of the escape clause provided for in the Organic Law on Budgetary Stability and Financial Stability, which, following a report from AIReF, was approved by Parliament on 20 October. The activation of this escape clause on account of the extraordinary emergency caused by the pandemic renders without effect the fiscal rules of 2020 and 2021, which had been set in February of this year and ratified by Parliament in March.

Instead, a General Government reference deficit was set for 2021. On 6 October, the Council of Ministers set a reference deficit for the General Government and for each one of the sub-sectors for 2021. This reference is not a restriction on the deficit and therefore any failure to comply with it does not

[2] In fact, at the time of writing, there is considerable variability in how the different institutions and bodies making forecasts incorporate the effects of the RTRP. For example, the scenarios published on 5 November by the European Commission do not yet incorporate its effects, while other bodies incorporate extremely varied assumptions about the amount of the resources received and their macroeconomic impact.

lead to application of the corrective measures provided for in the Organic Law on Budgetary Stability and Financial Stability. No references have been set regarding the debt and expenditure, which are the other fiscal variables on which the debt target and expenditure rule, respectively, act.

TABLE 1. GENERAL GOVERNMENT REFERENCE DEFICIT FOR 2021 (%GDP)

(in % GDP)

	Deficit reference rate for 2021
Central Government (CG)	5.2
Regions	1.1
Local Government	0.1
Social Security Funds (SSFs)	1.3
General Government (GG)	**7.7**

The evaluation set out in this report is performed from a macroeconomic and budgetary perspective. For this purpose, the analysis is divided into six main blocks. Following this introduction, Heading 2 sets out the content and scope of the report. Heading 3, firstly, reviews the economic situation caused by the coronavirus crisis. Secondly, for greater clarity in the presentation, AIReF first evaluates the realism of the Government's macroeconomic scenario before incorporating the RTRP and, separately, the impact associated with this Plan. Lastly, the final scenarios, incorporating the RTRP, which are those that have been used as the basis for drawing up the budgetary forecasts, are compared and evaluated. Heading 4 analyses the budgetary forecasts, indicating the effect of the macroeconomic scenario and of the measures, including those of the RTRP. The evolution of revenue and expenditure in the General Government and each one of the sub-sectors is then analysed in detail. Heading 5 is devoted to analysing contingent liabilities and fiscal risks, and in Section 6 the challenges for the sustainability of public finances resulting from the macroeconomic and budgetary scenarios are assessed. Finally, Heading 6 presents the recommendations emerging from the analysis conducted.

2. PURPOSE AND SCOPE

The purpose of this report is to assess the main lines of the budgets of the sub-sectors of General Government for 2021 and, particularly, the draft 2021 GSB, from the perspective of whether they are in line with the expected or reference deficit. AIReF prepares this report primarily using the information set out in the Budgetary Plans for 2021 and that contained in the draft GSB, in addition to other available information. The budgetary plan provides fiscal information on the General Government in national accounts. The 2021 GSB is limited to the Central Government and the Social Security Funds in budgetary terms although the information contained plays a determining role over the other tiers of government both through their funding and through the setting of basic legislation on essential matters such as compensation of employees. Therefore, with the aim of having a comprehensive overview, AIReF assesses the General Government as well as each one of the sub-sectors with regard to the reference deficit.

At a regional level, updated information has only been received on the main lines of three Autonomous Regions and some Local Governments. In most regions, preparation of the specific lines and draft budget for 2021 has been launched in recent weeks due to the lack of knowledge until recently about fundamental elements for designing the regional budgets. The delay in drawing up the draft GSB has led to a delay in their budgetary process. As of the report date, only the draft 2021 budgets of the Autonomous Regions of Castile-La Mancha, the Canary Islands and Valencia have been approved. In the case of Local Governments, the information received about the main budgetary lines cannot be used as they were approved prior to the suspension of the fiscal rules for 2021 and approval of the draft GSB. They therefore do not include the financial effect that the use of surpluses from previous years, as well as application of the RRF, will have in 2021.

AIReF will later complete the analysis of the regional sub-sectors by issuing individual reports on the regions and a more extensive report on the Local Governments. The assessment of the sub-sectors of the regions and Local Governments included in this report will be completed, at a regional level, with the publication of the individual reports on the main lines of the Autonomous Regions for 2021. At a local level, a more extensive report will be published that will cover the individualised analysis of the 21 large Local Governments and the three Chartered Regime Councils of the Basque country, in addition to the Local Governments with significant sustainability risks according to AIReF's selection classification methodology.

As in previous years, the assessment of the draft 2021 GSB has been conditioned by the lack of an initial budget in terms of national accounts and national accounts adjustments. The draft 2021 GSB does not include information on the reconciliation of the budgetary balance with the reference deficits, which is measured in terms of national accounts. This information was published as from 2003 among the budgetary documentation but stopped being published as from the 2017 GSB. Furthermore, the Economic and Financial Report of the Social Security system published information in national accounts headings until 2017. This lack of information, contrary to EU legislation and the principle of transparency provided for in the Organic Law on Budgetary Stability and Financial Sustainability (Articles 6 and 27) significantly conditions AIReF's analysis. In addition to failing to publish the adjustments, an initial budget expressed in national accounts was not published either, which makes it extremely difficult to reconcile the two methodologies.

Furthermore, there is still a lack of greater transparency with regard to the obligations and potential risks of the CG. Although it may not be classified as a limitation on the scope, the GSB does not include information on possible liabilities faced by the CG resulting from contingent liabilities. This lack of information takes on greater importance in the GSB for 2021 as AIReF considers there are greater fiscal risks than in other years as the ordinary risks are compounded by those generated because of the pandemic. These include risks relating to the guarantees granted to SMEs and self-employed workers to preserve the quality of the productive fabric and the risks resulting from the materialisation of another, less favourable, macroeconomic scenario.

3. EVALUATION OF THE MACROECONOMIC SCENARIO

3.1. Recent economic developments

The severity of the second wave of the pandemic is triggering a rapid slowdown in economic activity worldwide, including in Spain, following the strong reactivation recorded over the summer months.

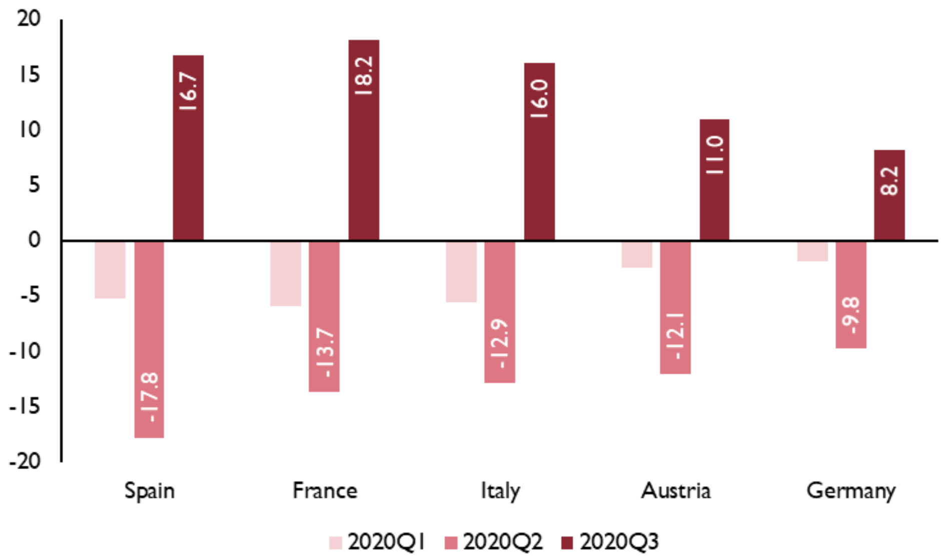
The Spanish economy recorded a historic contraction in gross domestic product in the second quarter of the year, higher than in other neighbouring countries. The reasons for this result can be explained, firstly, by the intensity with which the pandemic hit Spain, which required more stringent population lockdown measures than those implemented in other peer countries. This was compounded by the influence of some structural features of the economy: a high level of specialisation in activities that require greater social interaction – the fall in value added in the retail, transport and hospitality sector, which helps to explain 53% of the drop in economic activity recorded over the first three quarters of the year; the greater presence of micro-enterprises and SMEs, which are more vulnerable to the liquidity constraints caused by the halt in economic activity; the duality that still remains in the Spanish labour market, which resulted in almost 1 million temporary employees losing their jobs in the early days of the lockdown (according to the Labour Force Survey for the third quarter - the destruction of temporary employment explains 85% of the difference in the level of employment compared with the previous year) - and finally, the lower implementation or viability of teleworking.

The progressive easing of the measures restricting mobility allowed greater than expected economic dynamism over the summer months[3]. Quarterly accounts data for the third quarter of the year show that the gross domestic

[3] The consensus of forecasters in Spain puts the median value of the forecasts for the third quarter at around 12% to 13% at the end of October, significantly lower than the value observed.

product of the economy grew at a high rate in this period, by 16.7%, following a fall of 17.8% in the second quarter of the year. This dynamism was recorded across all the components of demand, with sharp growth in private consumption, gross fixed capital formation and exports of goods and services. This expansion occurred even though the restrictions on international mobility meant that the influx of tourists over the summer was very moderate. Other neighbouring economies also recorded significant quarter-on-quarter growth.

FIGURE 3. QUARTERLY GDP GROWTH IN SEVERAL EURO AREA COUNTRIES (PERCENTAGE)

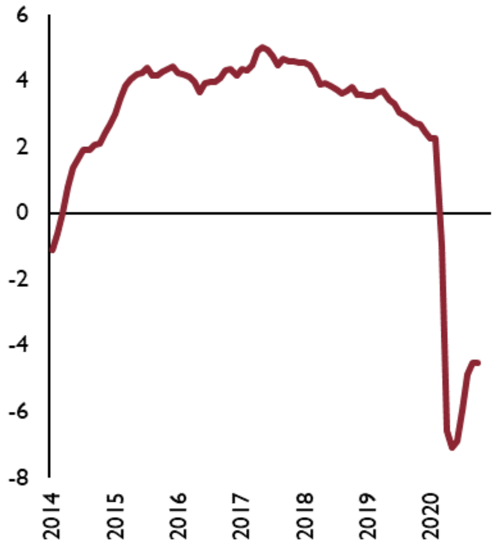


Source: Eurostat.

The employment figures for the summer months were also better than expected by the consensus of analysts. The Labour Force Survey showed an increase in employment of 569,700 people in the third quarter of 2020, bringing the fall in employment compared with the previous year to 3.5%. Effective hours worked also recovered, placing its year-on-year fall at 7.2% in the third quarter (-26.6% in the previous quarter). In addition, the number of workers under job-retention schemes (ERTEs) and benefits for cessation of activity - which in this crisis have acted as a powerful buffer against the fall in employment – fell to 887,00 in the third quarter, after reaching 4.6 million in the previous quarter (see Box 3 for further details on employment figures). For their part, the affiliations available up to October show that over recent months over 50% of the employment lost in March and April has been recovered, although the recovery in private employment has been weaker. In the case of self-employed workers, affiliation already exceeds the pre-crisis recorded figure. Finally, the number of workers under ERTEs due to *force majeure* has fallen up to October, although it should be noted that these figures do not include ERTEs due to impediment and limitation of activity approved by RDL

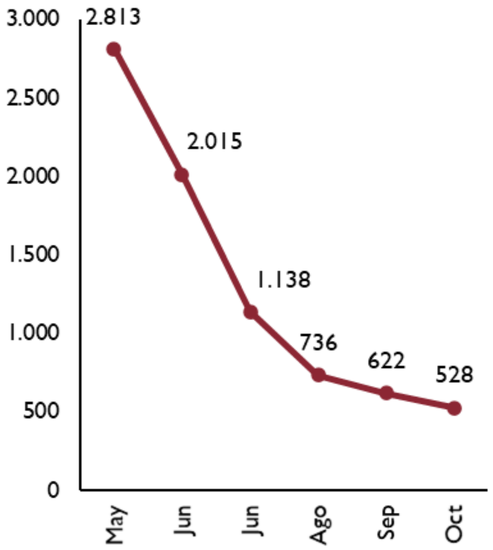
30/2020, which in regions that imposed restrictions earlier, such as Catalonia, seem to have increased.

FIGURE 4. EVOLUTION OF SOCIAL SECURITY AFFILIATIONS. PRIVATE SECTOR (YEAR-ON-YEAR RATE OF CHANGE)



Source: Ministry of Inclusion, Social Security and Migration. Excluding the branches of Administration, Education and Health.

FIGURE 5. NUMBER OF ERTES DUE TO *FORCE MAJEURE* (THOUSAND PEOPLE)



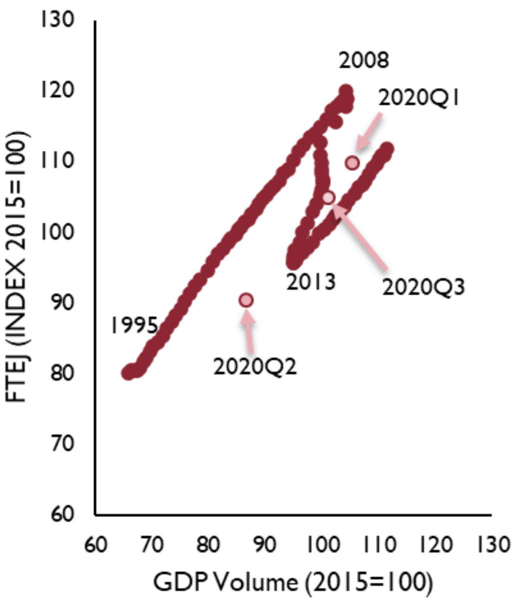
Source: Ministry of Inclusion, Social Security and Migration.

BOX 1.THE IMPACT OF THE CORONAVIRUS CRISIS ON THE LABOUR MARKET

The occupational and sectoral structure and the highly temporary nature that characterise the Spanish labour market, as well as the lower tendency to use teleworking compared with other European countries, have highlighted a high level of fragility, which has manifested itself in the strong impact of social distancing measures on the labour market.

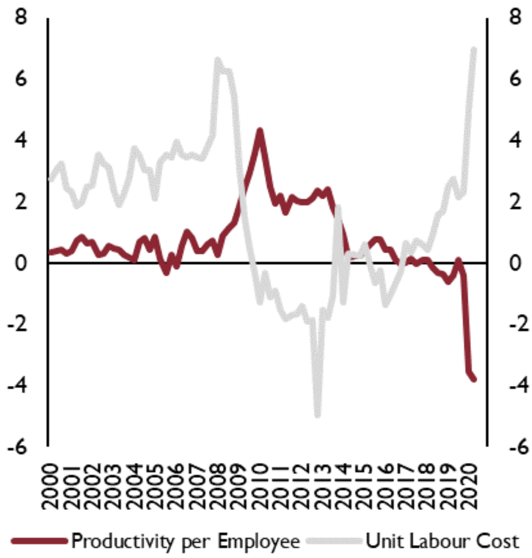
However, it is important to bear in mind that the measures to mitigate the spread of COVID-19 have influenced official labour market statistics in general, and, in particular, on employment, unemployment and activity rates. As a result, structural labour market relations have been altered, which has sometimes made it difficult to interpret the evolution of the statistical series.

EVOLUTION OF FULL-TIME EQUIVALENT EMPLOYMENT AND GDP



Source: INE.

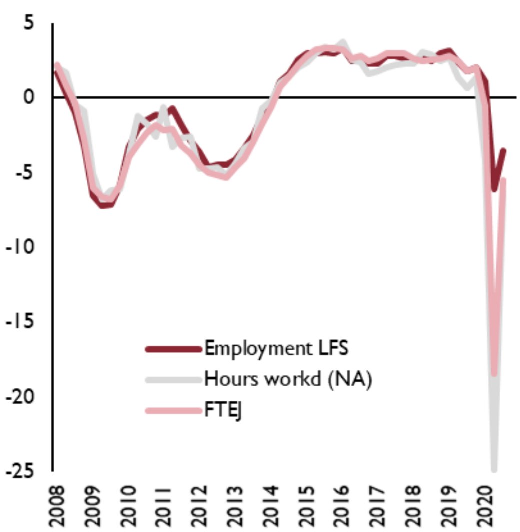
PRODUCTIVITY PER FULL-TIME EMPLOYEE AND UNIT LABOUR COSTS. YEAR-ON-YEAR RATE OF CHANGE



Source: INE.

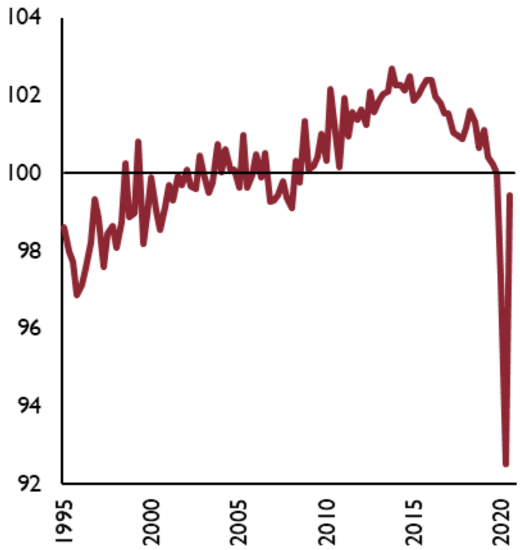
On the one hand, individuals affected by job suspensions - such as the job-retention schemes implemented during the COVID-19 crisis (hereinafter, ERTEs) - have no direct impact when calculating unemployment[4] or on the level of occupation of unemployment registers, social security affiliation or the major labour market surveys, even if those workers have not worked during the reference week. In contrast, the suspension of workers affected by ERTEs, together with other types of absences from work, have been reflected in the effective hours worked and in the average working week measured through the hours worked by each full-time employee. The figure below shows that as a result, the number of employees and the number of hours worked diverge in 2020.

EMPLOYMENT TREND ACCORDING TO VARIOUS CRITERIA (YEAR-ON-YEAR RATES OF CHANGE)



Source: INE.
*FTEJ: *Full-Time Equivalent Jobs, Total Employees.*

WORKING WEEK INDEX (AVERAGE FULL-TIME WORKING WEEK - HOURS/FULL-TIME JOB INDEX 2019Q4=100)

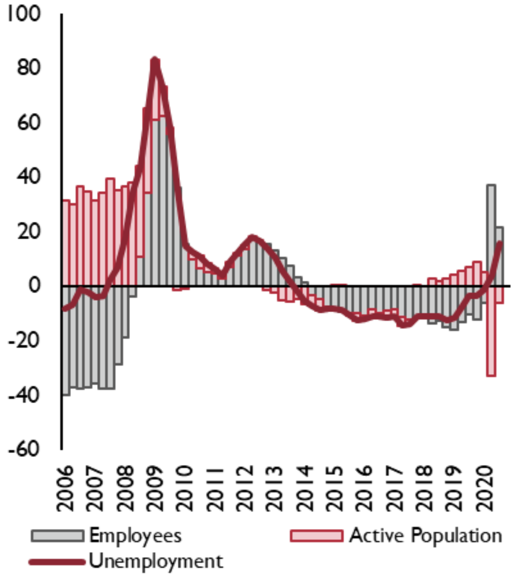


Source: INE

Social distancing measures have also had an impact on the unemployment and employment rates in surveys such as the LFS. Consequently, there was an increase in the population classified as inactive in the first two quarters of 2020 as the lockdown and forced closure of companies made it impossible for many people to look for a job, despite being available to work. Thus, these individuals were unable to meet all the conditions necessary to be classified as unemployed, and were therefore classified as inactive, with a particular impact on age groups up to 44. This has had a mitigating effect on the unemployment rate, which combines with the statistical effect linked to the ERTEs, which is expected to gradually fade away in the coming quarters, pushing up the unemployment rate for the rest of the year and 2021.

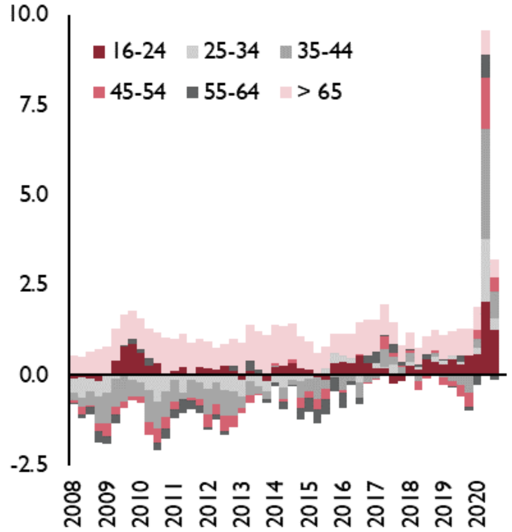
[4] See Order of 11 March 1985 establishing statistical criteria for measuring recorded unemployment.

BREAKDOWN OF THE YEAR-ON-YEAR RATE OF CHANGE IN THE UNEMPLOYMENT RATE.



Source: INE

CONTRIBUTION TO THE CHANGE IN THE INACTIVE POPULATION. ACCORDING TO AGE GROUP.



Source: INE

However, the recovery is still incomplete. In the third quarter of 2020, the GDP of the Spanish economy was still 8.7% lower than in the same period of the previous year, while in the euro area economies this gap stood at around 4%. Very high frequency indicators such as electricity consumption and mobility data also show levels lower than those recorded in comparable standard weeks.

FIGURE 6. INDEX OF MOBILITY TOWARDS TRANSPORT HUBS (REFERENCE DATE: 3 JANUARY TO 6 FEBRUARY 2020).

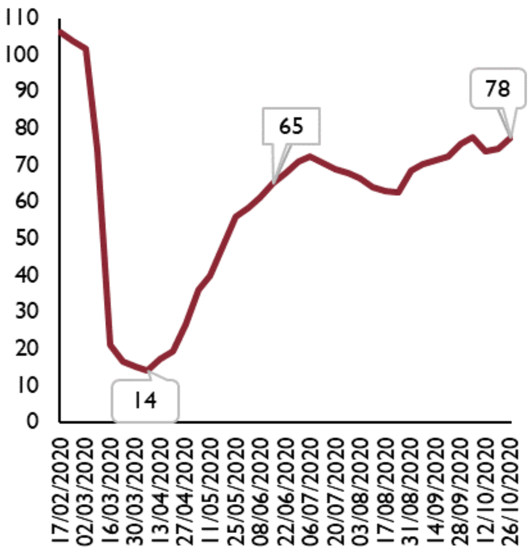
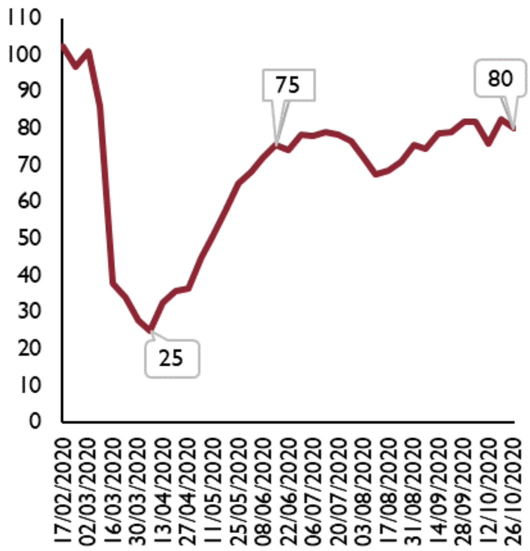


FIGURE 7. INDEX OF MOBILITY TOWARDS WORKPLACES (REFERENCE DATE: 3 JANUARY TO 6 FEBRUARY 2020).

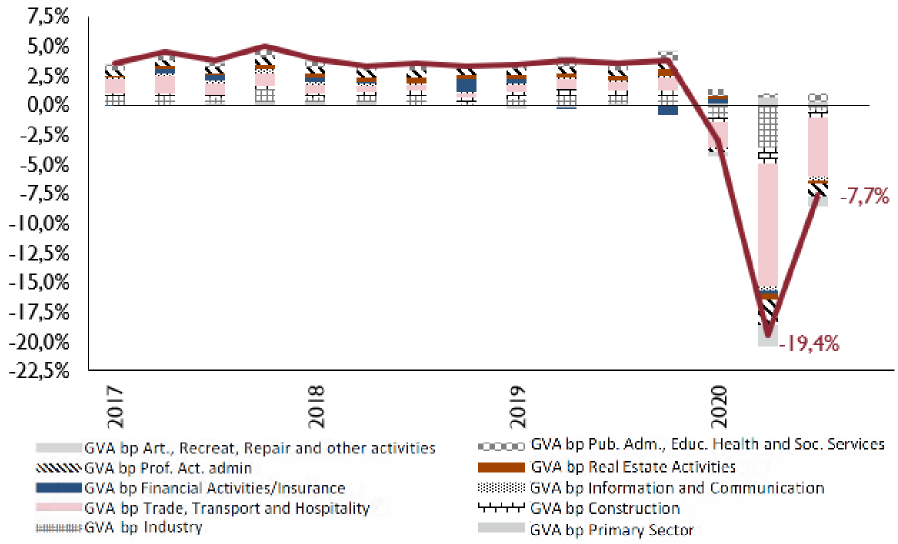


Source: Google Mobility Reports.

Source: Google Mobility Reports.

The recovery is also very uneven by sector and autonomous region. The recovery has been modest in activities requiring greater social interaction. There has been a particularly sharp fall in activity in the tourism sector over the summer months, affected by the continuous outbreaks and the imposition of international mobility restrictions by some countries: 8.1 million overnight stays were recorded in September, a fall of almost 80% compared with the previous year (-78% year-on-year). Hotel occupancy levels barely reached 40% in the summer months. This is reflected in sharp drops in activity in some regions such as the Balearic and Canary Islands - the regions most dependent on tourism.

FIGURE 8. CONTRIBUTIONS TO THE CHANGE IN GROSS VALUE ADDED. BY BRANCH OF ACTIVITY



Source: INE.

The crisis is also having a particularly strong impact on some sectors of the population that were already more vulnerable before the crisis. The impact of the crisis is also uneven at an individual level as a high proportion of the jobs affected by the crisis are done by young people and women, who largely work in service sectors that involve social interaction and where the possibility of teleworking is lower (Palomino *et al*, 2020[5]). It is also important to consider that these individuals also had greater financial vulnerability prior to the crisis

[5] Wage inequality and poverty effects of lockdown and social distancing in Europe. https://doi.org/10.1016/j.euroecorev.2020.103564. The authors analyse the effects of social distancing measures, concluding that these measures might generate *ex ante* an increase in inequality and poverty within and between regions. For this purpose, they establish a proxy for teleworking capacity in which, for Spain, high divergences are found particularly according to educational level, but also according to contract type and duration, and gender.

as shown in the *Household Finance and Consumption Survey* (HFCS) prepared by the European Central Bank (ECB), which indicates that almost 40% of Spanish households do not have enough savings to survive two months covering their basic expenses. The factors that increase the financial vulnerability of households according to this survey include being a woman, having a low level of education and being young, as well as being part of the group of workers on low incomes.

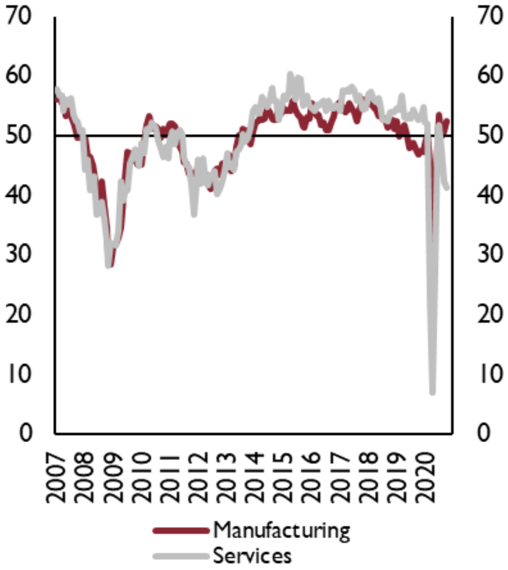
FIGURE 9. RISK OF JOB LOSS BASED ON SALARY LEVEL FOR THE SECOND QUARTER OF 2020. (PERCENTAGE)

Source: Eurostat's experimental statistics.

Note: The risk of job loss is used as a proxy for the probability of job loss. For further information, see https://ec.europa.eu/eurostat/statistics-explained/index.php?title=COVID-19_labour_effects_across_the_income_distribution.

In addition, over recent months there have been growing signs of a slowdown in activity as the pandemic worsens. The PMI indicator - based on the surveys carried out on company purchasing managers that is closely related to economic activity – worsened as from September, remaining below the value of 50, which suggests a fall in production. The deterioration was concentrated in services, which have now accumulated three consecutive months of decline, following the encouraging figure for July, while the manufacturing PMI recorded an improvement in October. Regarding the consumption of durable goods, car registrations fell again year-on-year. For its part, the improvement in affiliations in the private sector ground to a halt and the fall in workers affected by ERTEs has slowed and as indicated above, there may even be increases in some regions that have implemented restrictions on hotel and catering activities.

FIGURE 10. MARKIT PURCHASING MANAGERS INDEX (> 50 DENOTES MONTH-ON-MONTH EXPANSION // <50 MONTH-ON-MONTH CONTRACTION)



Source: Markit.

FIGURE 11. CAR REGISTRATIONS. (THOUSAND UNITS)

Source: Red Eléctrica de España.

In the financial field, implementation of the ECB's asset purchase programmes has allowed the economy's borrowing conditions to remain favourable. European sovereign bond yields stood at levels lower than before the crisis. In particular, the yield on the 10-year Spanish bond stood at 0.13% at the end of October, only 10 basis points (bp) above the historical low recorded in August 2019. Risk premiums remain stable at levels close to those of February. Specifically, Spanish and Italian risk premiums have remained practically at their pre-crisis level since mid-July, at 76 and 136 bp respectively (below the average for last year).

FIGURE 12. CENTRAL BANK BALANCE SHEET, TRILLIONS

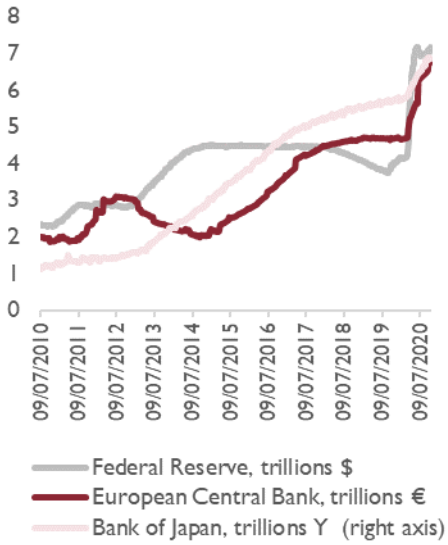
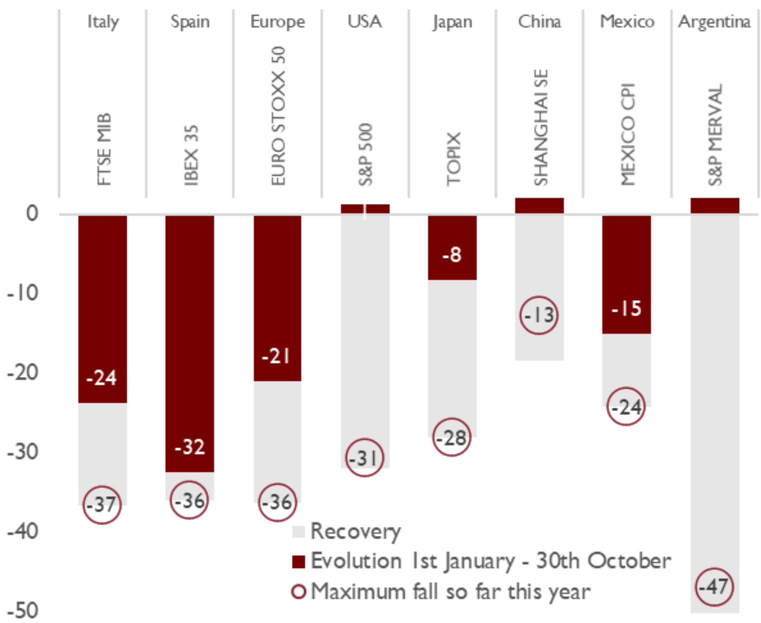


FIGURE 13. RISK PREMIUMS (BP)

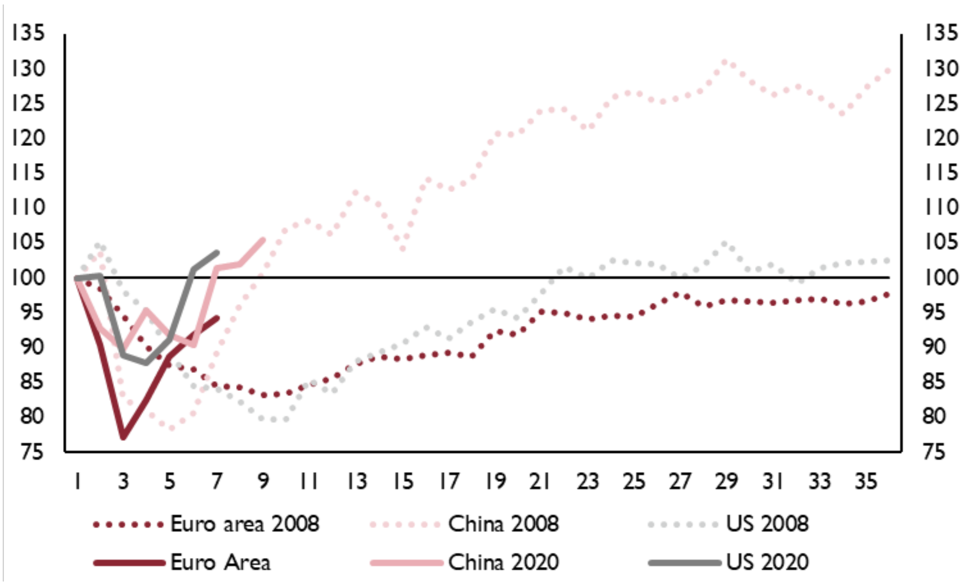
The recent worsening of the pandemic triggered a sharp decline in stock markets in the last sessions of October and a rise in volatility indices. The IBEX-35 is among the worst performing indices during the crisis, trading very close to the March lows. Oil closed the month of October breaking through the $40/barrel barrier following several months of stability trading in the $40-45 range. This is compounded by the correction of inflation expectations in recent weeks, partly caused by the significant appreciation of the euro against the US dollar.

FIGURE 14. STOCK MARKETS, CUMULATIVE RETURN IN 2020. (%)



Another noteworthy aspect is the recent strength of world trade after a contraction at the start of the COVID-19 crisis. The contraction of world trade in goods up to July - the month in which the data relating to May were observed – seem to reflect a similar pattern to that seen at the start of the financial crisis. However, the most recent data show a quick recovery in goods imports, albeit unevenly across geographical areas. In the case of the euro area, the recovery seems to be slower than in the case of China and the USA.

FIGURE 15. IMPORTS OF GOODS. (VOLUME INDICES BASE 100 ACCORDING TO MONTHS PRIOR TO REDUCTION IN IMPORTS). HORIZONTAL AXIS REFLECTS THE MONTHS SINCE THE MONTH PRIOR TO THAT IN WHICH THE CONTRACT TAKES PLACE



Source: CPB Netherlands, Prepared by AIReF

NB: 2008 Base 100 placed in September 2008.
For 2020, Base 100 placed in February 2020, except in China where the base has been taken in December 2019.

3.2. Assessment of the assumptions about the pandemic and other technical assumptions in the GSB scenario

The main assumption conditioning the Government's macroeconomic scenario is the evolution of the pandemic. As explained in the draft Budgetary Plan, the forecasts of the GSB are based on the hypothesis that a generalised lockdown of the population will not be necessary for the rest of the year and over 2021 progress will be made on a vaccine and treatments for coronavirus that will allow a gradual return to normality. In AIReF's opinion, the worsening of the pandemic reduces the likelihood of this scenario. AIReF considers that the other technical assumptions of the Government's scenario are reasonable.

In order to assess the sensitivity of the macroeconomic scenario of the GSB to the assumptions on the severity of the pandemic, AIReF has developed different scenarios contingent on the development of the COVID-19 crisis. Specifically, it prepared three scenarios.

In the central scenario, it is considered that the severity of the spread of the disease and the necessary measures to contain the pandemic generate significant uncertainty that hampers economic growth in the very short term. Although it is assumed that there will be no need for a widespread lockdown of the population, it should not be forgotten that the measures to contain the pandemic in Spain focus on reducing mobility in large cities, where a significant part of GDP takes place, and in sectors where social proximity is necessary, which account for a large proportion of the Spanish productive structure. In addition, the persistence of the continuous outbreaks generates ongoing uncertainty about the possible imposition of measures to reduce mobility, which has a negative impact on expectations, hampering private consumption and investment. Furthermore, the worsening of the pandemic on a global level and the measures being introduced by other countries hold back the recovery in world trade and the influx of tourists.

However, in the medium term, this central scenario assumes a gradual normalisation of activity. It is assumed that the development of vaccines and treatments for the disease will reduce infections, allow a return of confidence and activities that involve greater social interaction in the second half of 2021. Despite the persistence of the pandemic, there is assumed to be no structural damage to the productive fabric in that time.

For its part, in the pessimistic scenario, it is assumed that the spread of the pandemic will require strict measures to restrict the mobility of the Spanish population in the final months of 2020 and that structural damage will be caused to the productive fabric that will hamper the subsequent recovery. In line with what has been seen in numerous European economies, the mobility restrictions incorporated in this scenario are not as stringent as those implemented in the months of March and April, which for a time entailed a ban on non-essential activities. The impact on economic activity is therefore not as severe. Infections would be more controlled over 2021, which would allow a gradual rekindling of activity. However, the greater persistence of the pandemic and reduced confidence would lead to the inevitable appearance of structural damage in the form of business bankruptcies and job losses that hinder the intensity of the recovery.

Finally, the optimistic scenario assumes that the pandemic will be brought under control over 2021, either through the emergence of an effective treatment, a vaccine or improvements in managing the spread of the disease.

In this scenario, it is considered that the severity of the current outbreaks of COVID-19 will diminish in the final months of 2020 and the measures to reduce mobility in and between cities, as well as capacity restrictions in public and private establishments, can be progressively phased out. In addition, as in the central scenario, progress is made over 2021 in obtaining a vaccine or treatment that is effective enough to allow a return to normal social interaction and economic activity without causing structural damage.

This last scenario is the one that is closest to the narrative underlining the scenario of the macroeconomic forecasts on which the draft 2021 Budget is based. The recent worsening of the pandemic reduces the likelihood of this scenario.

Beyond the assumptions about the pandemic, AIReF considers that the other technical assumptions of the Government's scenario are reasonable. AIReF's macroeconomic scenarios are based on the technical assumptions that are included in Annex 1. AIReF considers that the assumptions are reasonable as they incorporate the most recent forecasts of global growth and trade made by the ECB and other international bodies. They also incorporate the most recent trends in the euro exchange rate and oil prices. However, the recent worsening of the pandemic in neighbouring countries poses downside risks to the assumption of a recovery in export markets on which the Government's scenario is based.

3.3. Assessment of the baseline scenario of the GSB (before incorporating the European Plan).

The Government's baseline scenario (calculated before incorporating the impact of the RTRP and other economic policy measures) might be achievable if the pandemic can be brought under control more effectively than it is at present. The scenario of the 2021 GSB is close to AIReF's optimistic scenario.

The Government expects a contraction in GDP, in terms of volume, of 11.2% in 2020, followed by an expansion of 7.2% in 2021, before incorporating the macroeconomic effects associated with the Recovery, Transformation and Resilience Plan (RTRP). While the contraction for 2020 forecast by the Government matches AIReF's central scenario, the rate for 2021 stands at around the figure for AIReF's optimistic scenario. The recent worsening of the pandemic and its persistence mean that less favourable scenarios than those considered in the GSB cannot be ruled out. Reduced household and business confidence and uncertainty about the duration of the pandemic would lead to increased caution in consumption and investment decisions. This would make it difficult for such an intense recovery as that incorporated in the macroeconomic scenario accompanying the 2021 GSB to take place (see figure below). AIReF's central scenario projects baseline GDP growth of 5.5% for 2021, almost two points lower than the Government's, while expected growth in the adverse scenario would be 3.8%, almost four points lower than that of the Government.

TABLE 2. BASELINE MACROECONOMIC OUTLOOK. COMPARISON

Year-on-Year Rates of Change		2020				2021			
	2019	Opt.	Central	Pess.	Gov.	Opt.	Central	Pess.	Gov.
Private domestic final consumption exp.	0.9	-13.0	-13.5	-13.8	-12.6	8.3	7.0	5.3	8.3
General Government final consumption exp.	2.3	6.0	6.0	6.0	6.3	-0.8	-0.8	-0.8	0.5
GFCF Equipment and cultivated assets	4.3	-15.4	-16.5	-17.6	-21.2	10.9	5.4	3.7	8.7
GFCF Construction and intellectual property	1.9	-13.5	-14.0	-14.5	-16.9	7.8	4.0	3.3	6.6
Domestic Demand*	*1.4*	*-9.1*	*-9.6*	*-9.9*	-10.0	*6.1*	*4.5*	3.4	6.2
Exports of goods and services	2.3	-19.8	-20.0	-20.1	-22.7	11.7	9.5	5.8	11.7
Imports of goods and services	0.7	-16.6	-16.9	-17.2	-20.0	8.5	7.0	4.9	8.6
External balance*	*0.6*	*-1.6*	*-1.6*	-1.5	-1.5	*1.1*	*0.9*	0.4	1.1
Gross Domestic Product	**2.0**	**-10.8**	**-11.2**	**-11.4**	**-11.2**	**7.3**	**5.5**	**3.8**	**7.2**
Nominal GDP	**3.4**	**-10.1**	**-10.5**	**-10.8**	**-11.2**	**8.5**	**6.5**	**4.6**	**8.1**
Gross Domestic Product Deflator	**1.4**	**0.8**	**0.8**	**0.8**	**0.0**	**1.1**	**1.0**	**0.8**	**0.9**
Full-Time Equivalent Employment	2.3	-8.4	-8.7	-9.0	-8.4	6.2	3.9	1.9	5.6

* Contribution to GDP growth

Sources: Ministry of Economic Affairs and Digital Transformation, INE and AIReF estimates.

The recovery in private consumption 2021 is also feasible, although in AIReF's optimistic range. It is important to note that the Government's scenarios forecast strong growth in private consumption as early as the last months of 2020, which conditions the expected growth for 2021. AIReF considers that the worsening of the second wave will lead households to have a more cautious attitude and therefore the recovery in this aggregate will be lower than that set out in the baseline scenario of the draft GSB (8.3% compared with 7% in AIReF's central scenario). This caution is already evident in the continuing contraction of purchases of durable goods and the increase in savings rates up to historically high levels, partly for precautionary reasons.

Regarding investment, in 2021 both investment in equipment and investment in construction and intellectual property will be close, but a little below that expected in AIReF's optimistic scenario. The Government's figures for 2020 do not include the data corresponding to the third quarter, which showed strong growth. For 2021, the path projected by the Government for investment in capital equipment, cultivated assets, construction and intellectual property is very similar to that expected in AIReF's optimistic scenario. In a context of uncertainty about the evolution of COVID-19 transmission and other elements such as the outcome of Brexit, the evolution of both aggregates is very uncertain, with the possibility of scenarios that are less favourable than those projected by the Government. The recent contraction in lending to households for house purchases and to companies points to moderate growth in this aggregate.

The Government forecasts that the contribution of external demand to growth will be negative in 2020 but will become positive in 2021, in line with AIReF's forecasts, although with greater dynamism. The forecast evolution of exports and imports is also like that set out in AIReF's optimistic scenario. In the Government's scenario, exports show a pattern of recovery in line with the recent recovery in international demand. However, the worsening of the pandemic in the Spanish economy's main trade partners may lead to less benign scenarios, particularly in the case of tourism services, where the tightening of mobility restrictions may have a crucial impact. In the case of imports, the greater dynamism projected in the baseline scenario underpinning the draft GSB is in line with the higher expected growth in domestic demand.

In the case of total full-time equivalent employment, the forecast behaviour in the 2021 GSB is once again at the optimistic end of the evolution forecast by AIReF. Specifically, in line with production, the growth in full-time equivalent employment forecast by the Government is close to AIReF's optimistic scenario.

As regards inflation, the Government's baseline macroeconomic scenario foresees zero GDP deflator growth in 2020, followed by an increase of close to 0.9% for 2021. The private consumption deflator and the GDP deflator follow the same direction, with stagnation in 2020 and moderate progress in 2021. Although the path followed is like that of the two scenarios established by AIReF, the low level of the GDP deflator in 2020 in the GSB is noteworthy. This fact explains the difference in the evolution of nominal GDP under the two scenarios.

3.4. Impact of the Recovery, Transformation and Resilience Plan.

According to the Government's estimates, the funds channelled through the Recovery, Transformation and Resilience Plan will have an impact on GDP growth of 2.6 pp in 2021. This estimate is in line with AIReF's, although the risk of delays in implementation of the projects is high. The simulations performed by AIReF confirm that the RTRP represents an historic opportunity, with the possibility of deploying particularly significant effects on growth over the

medium term if the increase in investment is accompanied by reforms aimed at increasing the economy's productivity and the skills of human capital.

The European Council meeting of July 2020 reached an historic agreement for the creation of a Recovery Fund called Next Generation EU (NGEU). The purpose of this fund is to mitigate the effects of the coronavirus crisis on the most affected economies and drive the structural transformation of those most in need of reform.

The agreement is a milestone in the history of the EU. This is the case not only on account of the amount of the NGEU (over 5% of the EU's GDP), but also because this is the first time the EU offers a joint response that is resounding and redistributive in order to address a severe exogenous crisis that is having asymmetric effects on the different countries. Furthermore, EU debt issues will be made for the first time to finance this joint capacity.

NGEU has 750 billion (bn) euros, more than two thirds of which are channelled in the form of transfers. These transfers are allocated with a strong redistributive nature towards the States with higher levels of unemployment and/or those most affected by the pandemic (see figure below). The most important component is the Recovery and Resilience Facility (RRF) (€672.5bn at 2018 prices, of which €312.5bn consist of transfers and the rest loans) whose main aim is to finance digitisation and environmental transformation projects and structural reforms that increase the economies' resilience.

	(million 2018 euros)
Recovery and Resilience Facility, of which	672,500
Loans	*360,000*
Transfers	*312,500*
ReactEU (similar to the traditional structural funds, but without national co-financing and with direct distribution to the Central Government)	47,500
Horizon Europe (research programme)	5,000
InvestEU (business development)	5,600
Rural development	7,500
Just Transition Fund	10,000
RescEU (civil protection and humanitarian aid)	1,900
Total	750,000

Source: Conclusions of the July 2020 European Council meeting

FIGURE 16. TRANSFERS PLANNED FOR 2021-2023 UNDER THE RECOVERY AND RESILIENCE FACILITY

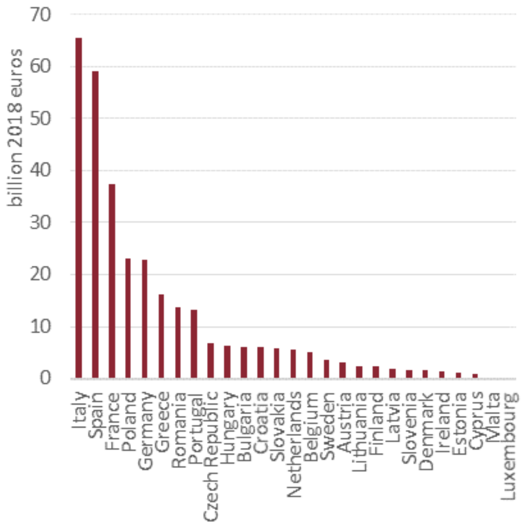
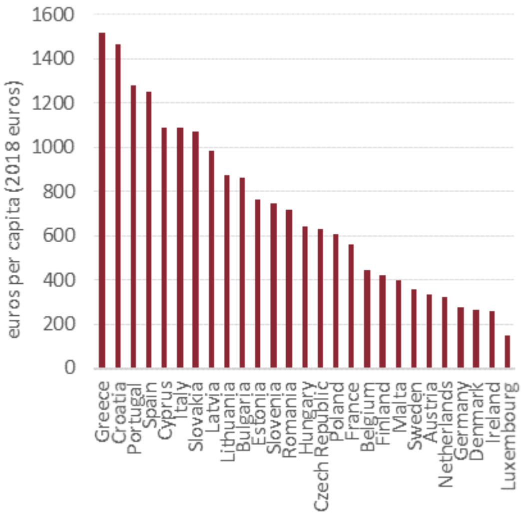


FIGURE 17. PER CAPITA TRANSFERS PLANNED IN 2021-23 UNDER THE RECOVERY AND RESILIENCE FACILITY



Source: Conclusions of the July 2020 European Council meeting and AIReF

Each Member State must agree its Recovery and Resilience Plan with the European Commission. In this plan, each country must specify the reforms and investments which it intends will form the basis for driving the recovery and generating solid foundations for long-term growth. The resources will be mobilised based on a timetable setting out the main milestones and targets of the measures contained in the Plan. The Commission will disburse the resources as these milestones and targets are met. Although Governments must concentrate their investment efforts over the first three years (2021-2023), effective disbursement of the funds may be delayed until 2026 and therefore each Government may, if it wishes, borrow in the markets in order to bring forward execution of the spending associated with the Plan.

The Government estimates that the transfers received by the Spanish economy might amount to €72bn between 2021 and 2023 (7% of GDP). Requesting loans depending on the borrowing needs and conditions is not ruled out.

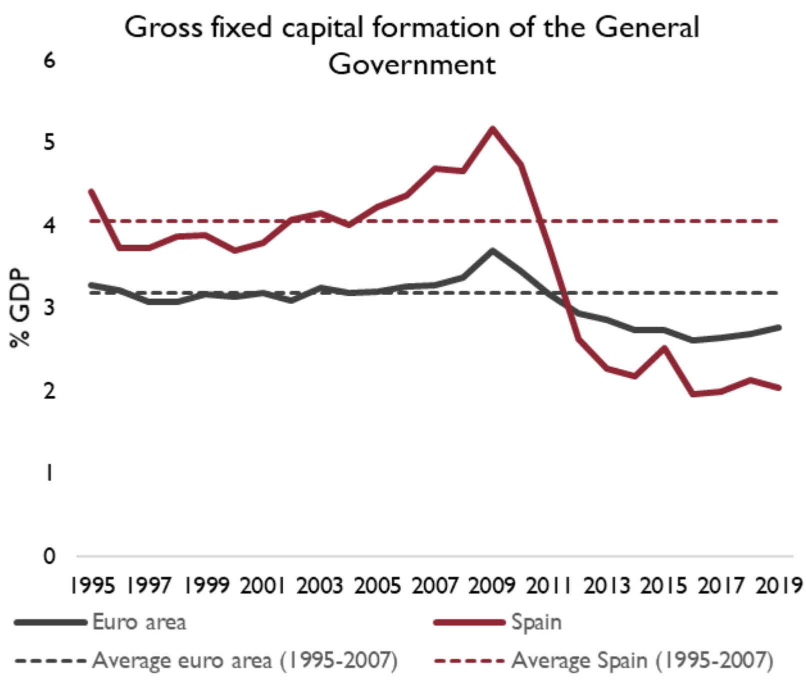
On 7 October, the Government announced the strategic lines of the Recovery, Transformation and Resilience Plan that it will present to the European institutions. For 2021, the RTRP assumes the mobilisation of €25bn of the RRF and €2.4bn of the REACT-EU instrument, which are incorporated into the expenditure ceiling of the GSB for that year - another significant amount is earmarked for financing actions by the autonomous regions. A high percentage of these resources will be allocated to industry and energy (21.1%), followed by R&D&I and digitisation (17.8%) and resilient infrastructures and ecosystems (17.6%). Another set of funds will be allocated to entrepreneurship, improving education and lifelong learning and strengthening inclusion policies, among other items.

As for the macroeconomic impact, the Government expects the Plan to have a positive impact of 2.6 pp on annual GDP growth over the period 2021-2023. As set out in the Presentation of the 2021 GSB, this impact has been evaluated using general equilibrium models with a bottom-up approach, considering the specific plans that make up the Plan. The average multiplier stands at 1.2, although it is heterogeneous by project, particularly that associated with the increase in spending on innovation and digitisation (close to 2%). In the Government's simulations, the different projects will be transmitted to the economy through different channels, such as improving total factor productivity, boosting private investment and export capacity, improving skills and digital capabilities and enhancing labour market efficiency. Consequently, according to Government estimates, the long-term potential growth of the economy (2030) might stand at between 0.4 and 0.5 percentage points above the figure forecast in the absence of this Plan.

BOX 2. **THE DOUBLE DIVIDEND OF PUBLIC INVESTMENT**

It is essential to maintain appropriate levels of investment in order to achieve balanced economic growth. Firstly, because as a component of aggregate demand, an increase in capital expenditure contributes towards boosting economic growth in the short term, which can have a stabilising effect depending on the cyclical position. At the same time, unlike other elements of aggregate demand, an increase in effective investment can increase the economy's productive capacity and long-term growth prospects. The literature often refers to this situation as the "double dividend" of investment, as it may deploy potentially beneficial effects both in the short and in the long term.

Nevertheless, episodes of fiscal consolidation are often accompanied by significant cuts in public investment. The budgetary adjustments that followed the financial crisis were no exception in this regard. Consequently, in the case of Spain, public investment recorded a cumulative fall of almost three points of GDP compared with the level prior to the crisis. In fact, at the end of 2019, public investment in Spain remains two points of GDP lower than the average for the period before the Great Recession. This trend, although sharper in the case of Spain, can also be seen in the euro area as a whole and in other similar advanced economies, such as Japan and the US.



The rationale for public sector involvement in investment activities is often associated with its complementary nature in relation to private inputs: by providing the necessary critical infrastructure and inputs, the public sector underpins and catalyses future private investment, thus contributing towards driving long-term potential growth[6].

Moreover, in the short term, the extensive literature on fiscal multipliers finds that the multipliers for public investment are higher than for other types of Government expenditure[7]. In the case of Spain, empirical literature finds that the cumulative multiplier of public investment takes values of 1.1 and 1.9 after four and eight quarters respectively[8]. This expansionary impact is particularly important in periods of economic crisis, when increased investment by the public sector can partially offset the fall in private demand. Furthermore, public investment has an even greater expansionary effect when no increase in interest rates can be expected from monetary authorities. Both circumstances are in place currently.

Therefore, from a fiscal policy perspective, public investment strategies have to be designed taking into account both short and long-term horizons.

When the main objective of public investment strategies is to promote economic recovery, it is essential that they are designed to maximise their short-term expansionary impact without compromising their long-term positive effect.

It is no surprise that the investment plans approved in past periods of economic crisis reveal an inherent tension between these two-time dimensions: counter-cyclical investment strategies need to be applied quickly, which often means that the decision on allocating funds between some projects and others is highly influenced by the speed of commitment and implementation of the expenditure. Accordingly, past evidence shows that certain infrastructure projects tend to be rejected because the corresponding lengthy authorisation procedures invalidate them as effective short-term stimulus instruments, irrespective of their potential to enhance the economy's long-term performance.

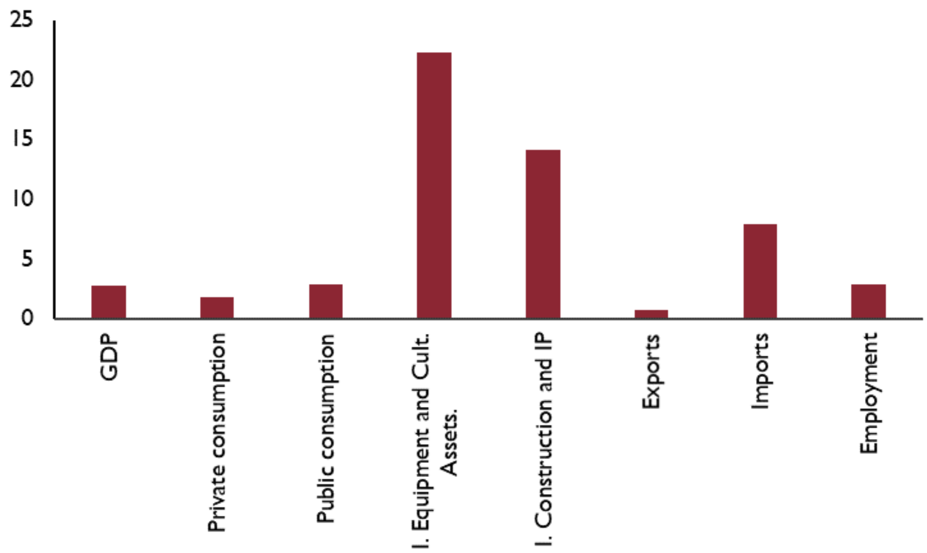
Easing this potential tension makes it necessary to choose the right combination of investment projects, which is often linked to good tax

[6] Bom and Ligthart, 2013.
[7] See for example Coenen *et al*, 2012; Leeper *et al*, 2011, and Roeger and in't Veld, 2010.
[8] De Castro and Hernandez de Cos (2006)

governance: good budget management and tax governance processes usually lead to better designed investment strategies[9]

AIReF has conducted several simulations to assess the macroeconomic impact estimated by the Government both in the short and medium term. AIReF's quarterly model (see Annex I) estimated from error correction mechanism models is used to assess the short-term impact. In the absence of details on the sectoral plans and projects, as well as the reforms contained in the Government's Plan, the simulations have been performed on the assumption that the resources of the Recovery and Resilience Facility (around €25bn) are primarily allocated to increasing public investment (78.3% of the funds, based on the information available and that provided by the Government, which would increase spending on infrastructures, intangible assets and construction) and, to a lesser extent, public consumption (for the part corresponding to expenditure on education and improving healthcare, 21.7%).

FIGURE 18. SIMULATION OF THE IMPACT OF THE RECOVERY, TRANSFORMATION AND RESILIENCE PLAN. AS %



Source: prepared by AIReF.

The Plan's impact estimated by AIReF stands at 2.7 pp of GDP, very similar to the value that the Government includes in the GSB. According to the simulations performed, the greatest impact would be seen in investment, which would drag along the various components of demand, particularly imports. This will contribute towards the contribution of the external balance

[9] OECD, 2011.

remaining negative for the second consecutive year. The increase in employment associated with the investment drive also has a positive effect on private consumption.

Based on these simulations, 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 digitisation of the Spanish economy. Accordingly, if reforms are introduced that lead to an improvement in productivity, competitiveness or training, the effects might be extended and prolonged over time (see Box 2).

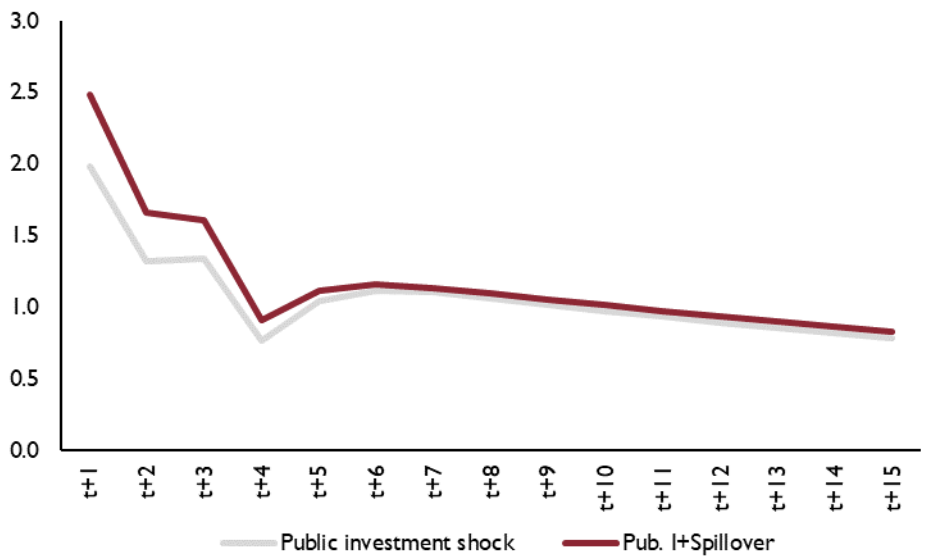
However, the risks of delays in the implementation of these projects are high. It is not appropriate to extrapolate the experience in the absorption of structural funds as the European Plan does not require co-financing of projects and comes at a unique time at which the political will to implement these projects could be significant. However, the magnitude of the resources allocated may lead to delays in project implementation. This is compounded by the possibility that some resources might not have the desired impact if the selection of specific projects is not optimal, thereby reducing the multiplier effect associated with spending. In addition, the Government's simulations incorporate some supply channels (which are reflected in the boost to exports resulting from the Plan) that are likely to take longer to be deployed. On the other hand, the Government’s estimates do not incorporate possible spillover effects associated with implementation of the Plan in other countries.

BOX 3. THE IMPACT OF THE RECOVERY, TRANSFORMATION AND RESILIENCE PLAN IN A GENERAL EQUILIBRIUM MODEL (QUEST III)

In order to verify the results obtained using AIReF's quarterly model, the QUEST model estimated by the European Commission has also been used to simulate the impact of the Recovery, Transformation and Resilience Plan (RTRP).[10] This is a Dynamic Stochastic General Equilibrium (DSGE) model developed by the Directorate-General for Economic and Financial Affairs at the European Commission that makes it possible to take into account the various channels through which the impact of the resources received and associated reforms flow, in addition to the spillover effects associated with implementation of the Plan in other European Union countries. AIReF has considered the distribution of the transfers by country presented in the figure below. No country has been considered to make use of the loans and no other items of lower volume of the July European Council agreement are included. For the purposes of the simulation, a public investment shock equivalent to that outlined by the Government in the Budgetary Plan is introduced (€25bn in 2021, €20bn in 2022 and €15bn in 2023, corresponding to the Recovery and Resilience Facility (RRF)).

The impact of the increase in public investment on GDP using this tool is estimated at 2 pp. This value would rise to 2.5 pp when spillover effects associated with the implementation of the Plan in other countries are considered. It is important to highlight that the model considers an elasticity of public investment of 0.12. Bearing in mind that the public investment of this plan is focused on projects related to mobility, digitisation, R&D expenditure, among others, which might be expected to have a higher elasticity in GDP than that of the current public capital stock, this impact should be considered as a lower limit. In addition, the simulations carried out with the QUEST model suggest some persistence of the effects of RTRP on GDP growth.

ESTIMATED IMPACT OF THE PUBLIC INVESTMENT SHOCK. IN PP



[10] Roeger W., J. Varga and J. in't Veld (2008), "Structural reforms in the EU: a simulation-based analysis using the QUEST model with endogenous growth", European Economy Economic Paper 351.

Source: (AIReF)

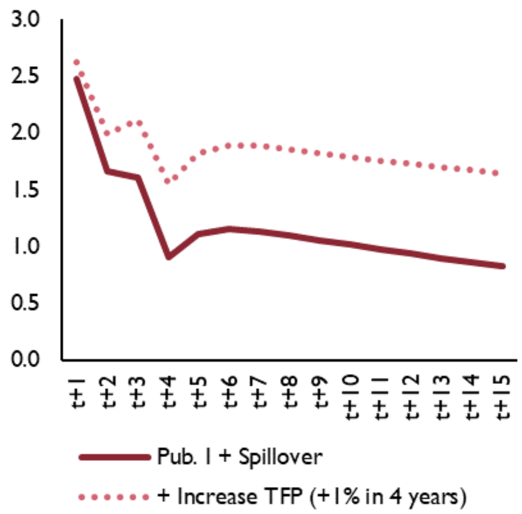
The QUEST model allows the impact of the Plan to be simulated by assuming that the investment is accompanied by structural reforms aimed at increasing economic efficiency and the skills of human capital. The limited information available so far on the measures through which the Recovery, Transformation and Resistance Plan will be implemented has led to the QUEST simulation being limited to an increased public investment shock over the next three years. However, with the aim of highlighting the historic opportunity that we are facing, several exercises have been performed aimed at showing the impact this increase in public investment would have if it is carried out in such a way that it leads to greater productivity of the economy, improved competitiveness or an increase in the skills of human capital.

- The first exercise combines the public investment shocks in Spain and in the euro area, detailed above, over three years with an improvement of 1% in total factor productivity (TFP) that would take place progressively over four years. As can be seen, the increase in TFP would heighten the impact on GDP, bringing the level of GDP, even after 10 years, to 1.8% above its steady-state level.

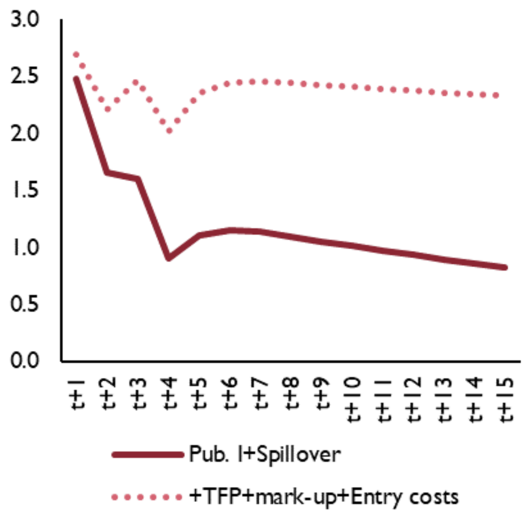
- If, in addition to the increase in the TFP, the measures adopted lead to an improvement in competitiveness and a decrease in administrative barriers, simulated in QUEST through a 1% decrease in mark-ups and a 10% reduction in the costs of entering the final goods market, both progressively over four years, which would lead GDP after 10 years to be 2.4% higher than its steady-state level.

SIMULATION OF THE PUBLIC INVESTMENT SHOCK ACCOMPANIED BY REFORMS

1% IMPROVEMENT IN FACTOR PRODUCTIVITY (TFP)



1% DECREASE IN MARKUPS AND 10% REDUCTION IN THE COSTS OF ENTERING THE FINAL GOODS MARKET,



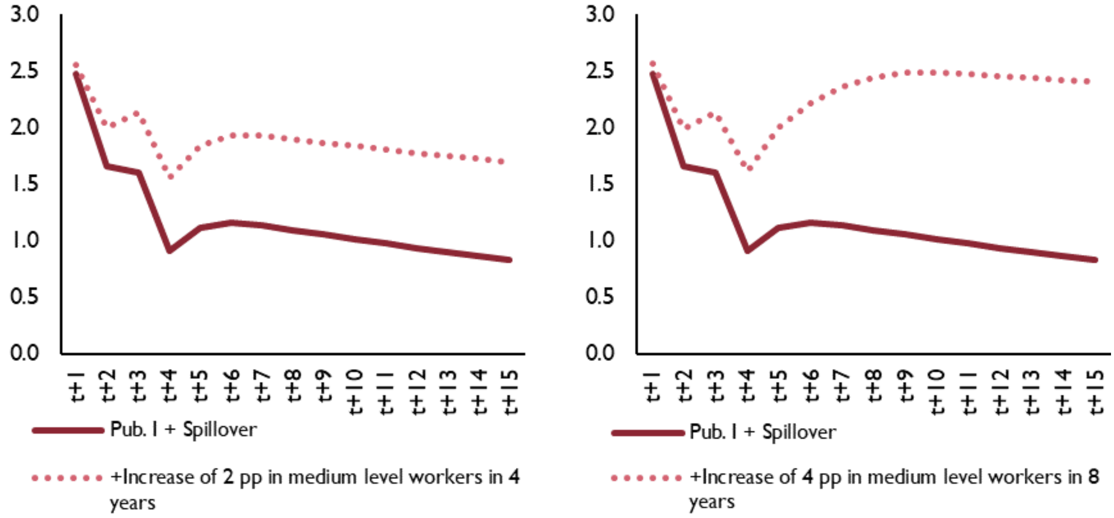
Source: AIReF

Finally, if the funds succeed in increasing the skills of workers so as to achieve, in the terms of the QUEST model, that 2 pp of the proportion of workers considered to have low skill levels would become workers with a medium skill level within four years, the impact in 10 years would be 1.8%. This impact would rise to 2.5% if the increase in the percentage of workers with a medium skill level reached 4 pp over eight years.

SIMULATION OF PUBLIC INVESTMENT SHOCK ACCOMPANIED BY REFORMS

INCREASE IN THE PROPORTION OF WORKERS WITH MEDIUM SKILL LEVEL BY 2 PP OVER A PERIOD OF FOUR YEARS

INCREASE IN PROPORTION OF WORKERS WITH MEDIUM SKILL LEVEL BY 4 PP OVER A PERIOD OF EIGHT YEARS



Source: AIReF

All these simulations confirm that the Plan represents an historic opportunity that should not be missed. The effects on medium-term growth may be particularly significant if the increase in investment is accompanied by reforms aimed at increasing the economy's productivity and the skills of human capital.

3.5. Assessment of the final scenario

Compared with AIReF's central scenario, the Government's forecasts envisage a significantly stronger recovery in economic activity in 2021. The differences are due not so much to the estimated impact of the funds channelled through the Recovery, Transformation and Resilience Plan – although there are absorption and implementation risks – but to the baseline recovery underpinning the two macroeconomic outlooks. This, in turn, is strongly linked to the assumptions about the development of the pandemic, which the Government views with greater optimism than AIReF.

TABLE 3. FINAL MACROECONOMIC OUTLOOK. COMPARISON.

Year-on-Year Rates of Change	2019	2020 Optimistic	2020 Central	2020 Pessimistic	2020 Government	2021 Optimistic	2021 Central	2021 Pessimistic	2021 Government
Private domestic final consumption exp.	0.9	-12.9	-13.5	-13.8	-12.6	10.1	8.8	7.1	10.7
General Government final consumption exp.	2.3	6.2	6.2	6.2	6.3	2.1	2.1	2.1	2.6
GFCF Equipment and cultivated assets	4.3	-15.4	-16.5	-17.6	-21.2	33.2	27.7	26.0	20.7
GFCF Construction and intellectual property	1.9	-13.5	-14.0	-14.5	-16.9	21.9	18.1	17.4	12.4
Domestic Demand*	*1.4*	*-9.0*	*-9.5*	*-9.8*	-10.0	*10.9*	*9.4*	*8.2*	9.5
Exports of goods and services	2.3	-19.8	-20.0	-20.1	-22.7	12.3	10.2	6.5	18.0
Imports of goods and services	0.7	-16.4	-16.8	-17.1	-20.0	16.4	14.8	12.8	17.1
External balance*	*0.6*	*-1.7*	*-1.6*	*-1.6*	-1.5	*-0.9*	*-1.1*	*-1.7*	0.5
Gross Domestic Product	**2.0**	**-10.7**	**-11.1**	**-11.4**	**-11.2**	**10.0**	**8.2**	**6.5**	**9.8**
Nominal GDP	**3.4**	**-10.0**	**-10.5**	**-10.7**	**-11.2**	**11.6**	**9.6**	**7.7**	**10.8**
Gross Domestic Product Deflator	**1.4**	**0.8**	**0.8**	**0.8**	**0.0**	**1.5**	**1.3**	**1.1**	**0.9**
Full-Time Equivalent Employment	2.3	-8.3	-8.6	-8.9	-8.4	9.1	6.8	4.8	7.2

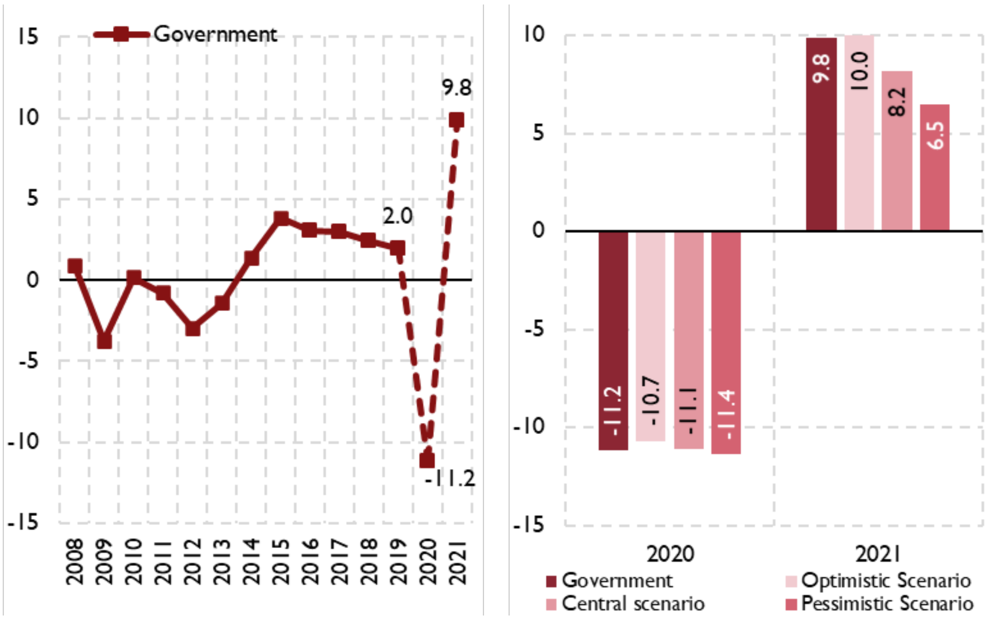
* Contribution to GDP growth

Sources: Ministry of Economic Affairs and Digital Transformation, INE and AIReF estimates.

Incorporating the information contained in the GSB and the expected effects of the European Plan, the Government estimates that GDP will expand, in terms of volume, by 9.8% in 2021, after contracting by 11.2% in 2020[11]. These rates are like those projected in AIReF's optimistic scenario, after incorporating the impact (2.7 pp) of the RTRP and the measures set out in the GSB. However, in AIReF's central scenario, growth for 2021 would be almost two points lower than that forecast by the Government, reaching almost four points less should the most adverse scenarios foreseen by AIReF materialise. There are also important differences by component.

[11] The macroeconomic outlook under the central scenario, once the measures have been incorporated, is available in Annex II.

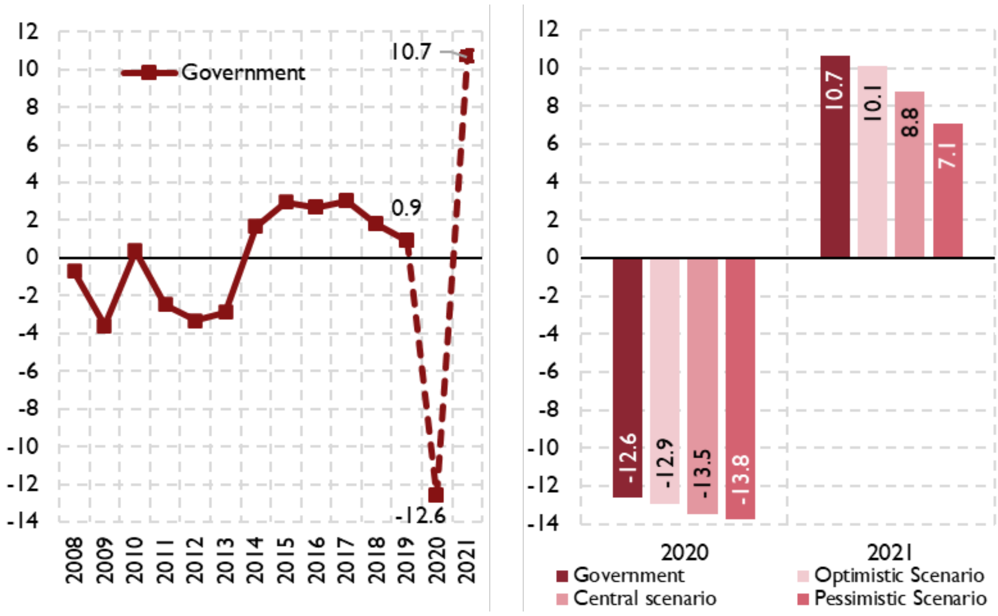
FIGURE 19. GDP GROWTH IN TERMS OF VOLUME (%)



Source: Ministry of Economic Affairs and Digital Transformation (dashed line) and AIReF.

The growth in private consumption estimated by the Government for 2021 stands above that forecast by AIReF in its most optimistic scenario. The recovery in private consumption in the GSB scenario is optimistic in comparison with AIReF's scenarios. This result does not stem from estimates of employment growth, but rather seems to reflect a higher propensity for consumer spending in Government estimates. In this regard, AIReF considers that the existing uncertainty, as well as the impact that the coronavirus crisis has had on some segments of the population with greater financial vulnerability, might lead to greater caution even if the development of the pandemic allows for a progressive return to normality.

FIGURE 20. GROWTH OF PRIVATE CONSUMPTION IN TERMS OF VOLUME (%)



Source: Ministry of Economic Affairs and Digital Transformation (dashed line) and AIReF.

As for investment, in 2021 both expenditure on equipment and on construction and intellectual property would be significantly lower than expected even in AIReF's pessimistic scenario. It is important to highlight that this large gap appears fundamentally when incorporating the impact of the RTRP and the measures contained in the GSB, since the forecast for both aggregates in the baseline scenarios stood between AIReF's optimistic and central scenarios. The impacts on investment estimated by AIReF are a result of incorporating 78.3% of the almost €25bn of the RTRP that the Government expects to execute in 2021 and which are spread between the two types of investment.

FIGURE 21. GROWTH IN GFCF IN CONSTRUCTION AND INTELLECTUAL PROPERTY IN TERMS OF VOLUME (%)

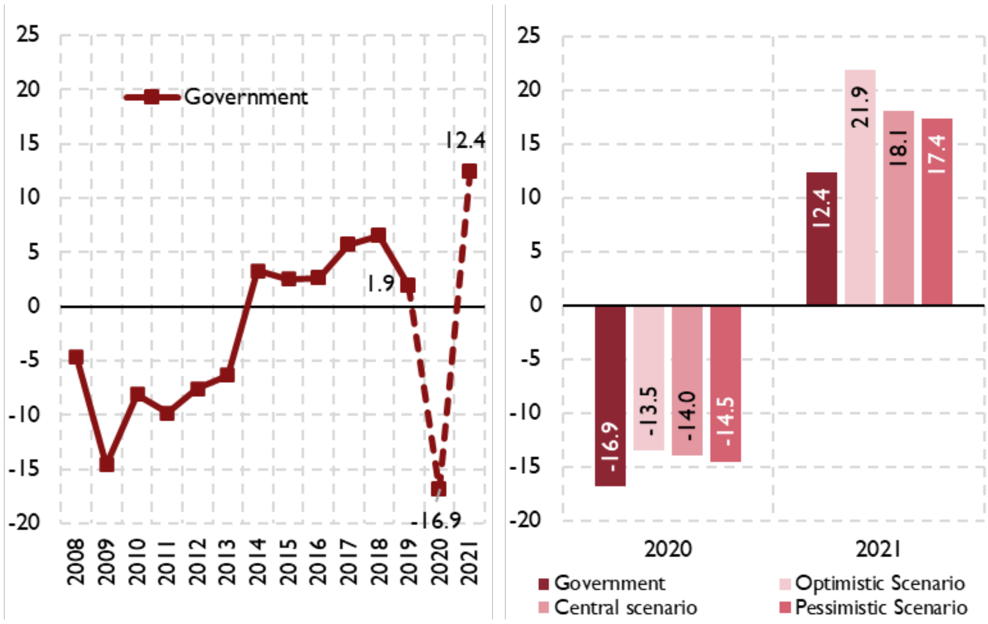
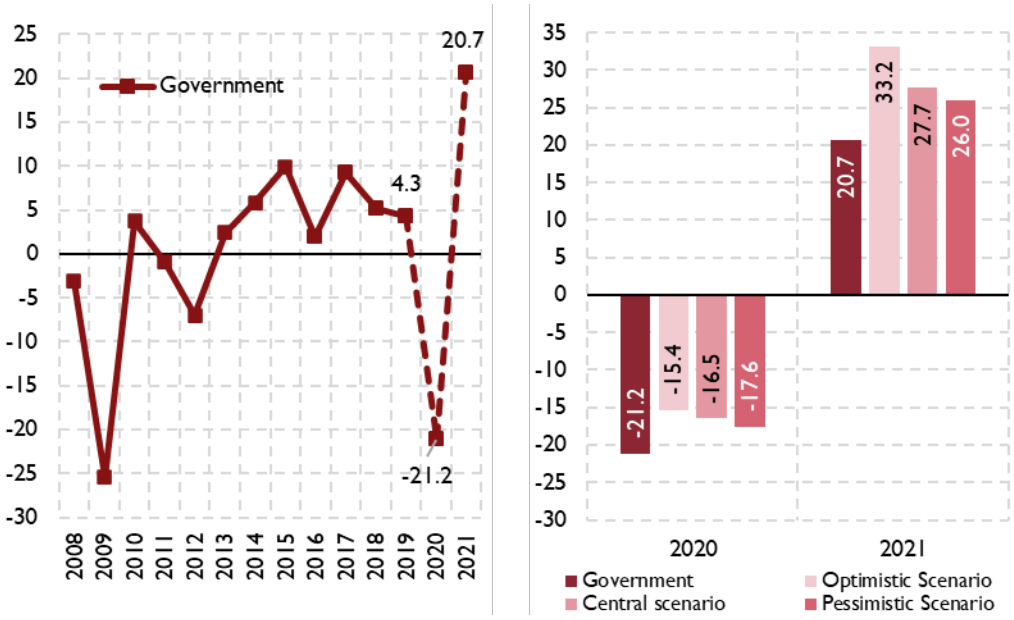


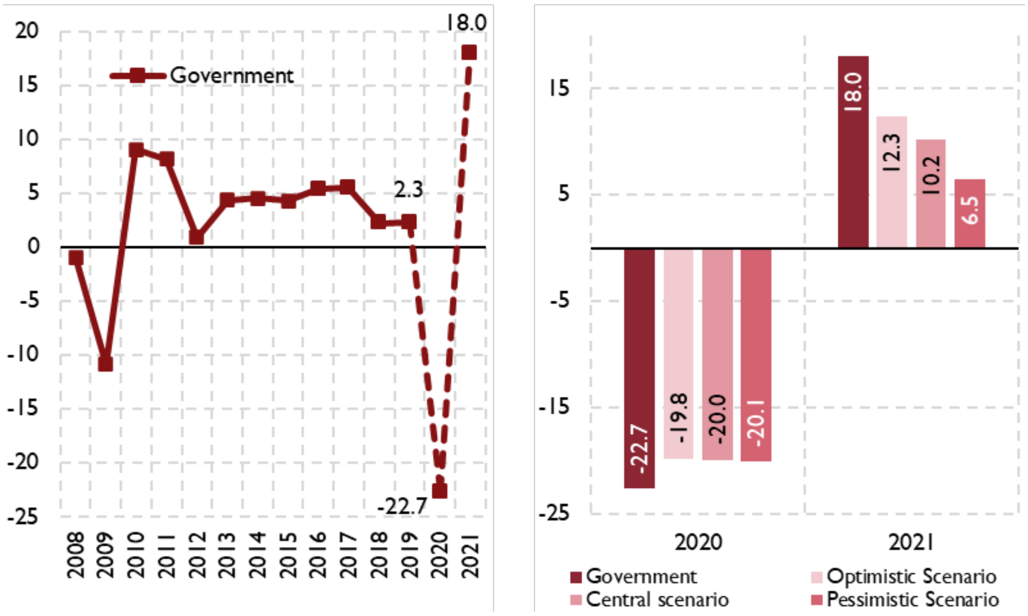
FIGURE 22. GROWTH IN GFCF IN EQUIPMENT AND CULTIVATED ASSETS IN TERMS OF VOLUME (%)



Source: Ministry of Economic Affairs and Digital Transformation (dashed line) and AIReF.

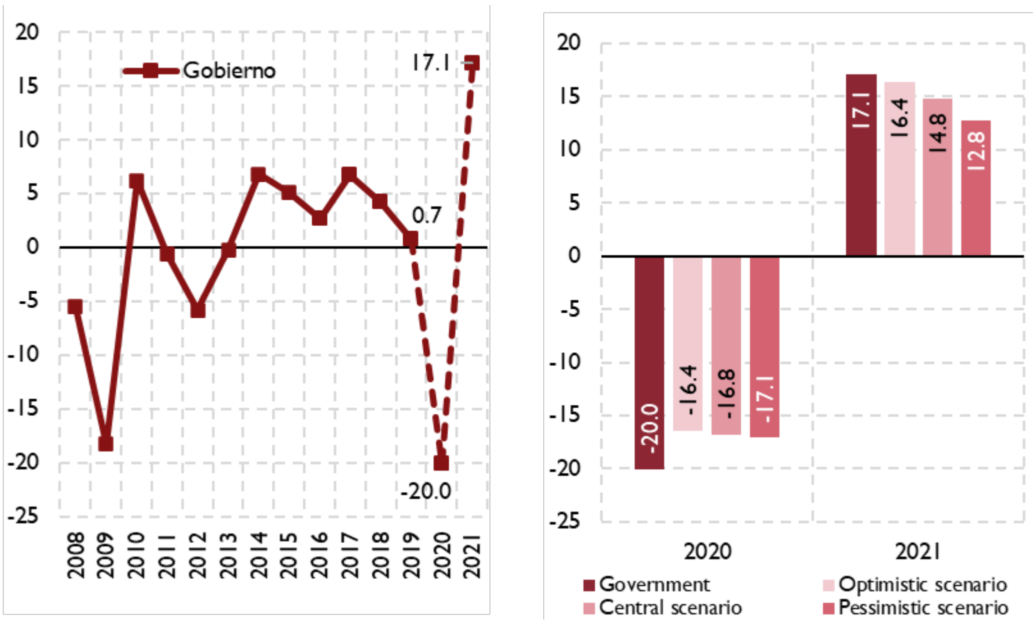
The contribution of external demand to growth is positive in the Government's scenario and negative in AIReF's. In the case of AIReF's scenarios, the contribution of external demand was positive in the baseline scenarios but became negative in the final scenarios as incorporation of the RTRP has a significant impact on imports, in response to the increase in domestic demand, while exports are hardly affected by the RTRP in the short term. In contrast, in the Government's scenarios, it is surprising that the RTRP has such a major impact on exports as early as 2021.

FIGURE 23. EXPORT GROWTH IN TERMS OF VOLUME (%)



Source: Ministry of Economic Affairs and Digital Transformation (dashed line) and AIReF.

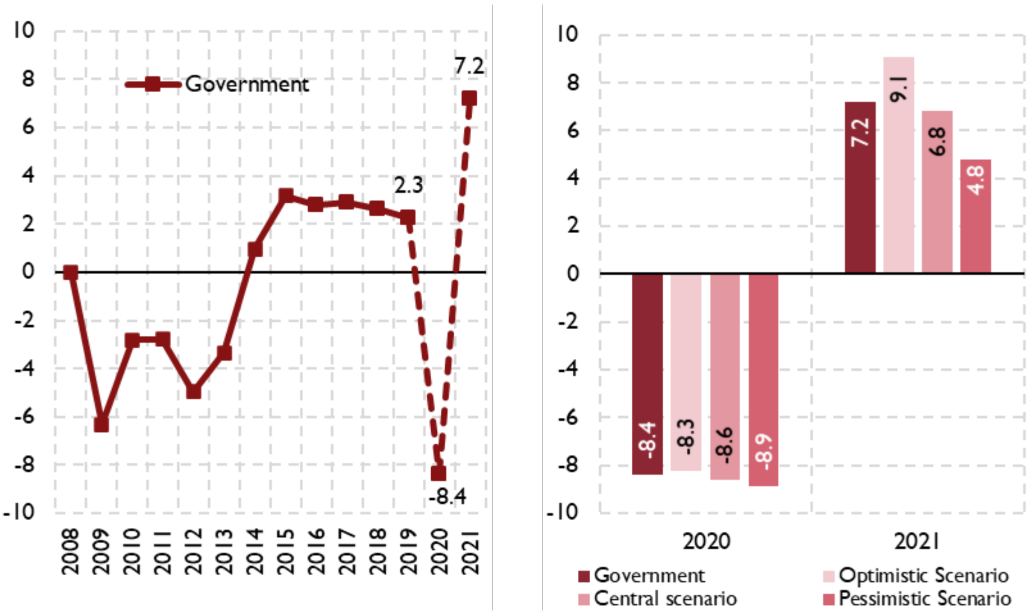
FIGURE 24. IMPORT GROWTH IN TERMS OF VOLUME (%)



Source: Ministry of Economic Affairs and Digital Transformation (dashed line) and AIReF.

In the case of total full-time equivalent employment, as the Government estimates a lower impact of the measures in 2021 (1.6 pp), it would bring its forecast close to AIReF's central scenario. Specifically, AIReF estimates full-time equivalent employment growth of 6.8% in its central scenario, 2.9 pp higher than forecast in the baseline scenario. This leads to an increase in apparent productivity of the labour factor of 1.4%, 0.1 points lower than forecast in both AIReF's and the Government's baseline scenario, and more than one point lower than that estimated by the Government in its final scenario, which amounts to 2.5% in 2021.

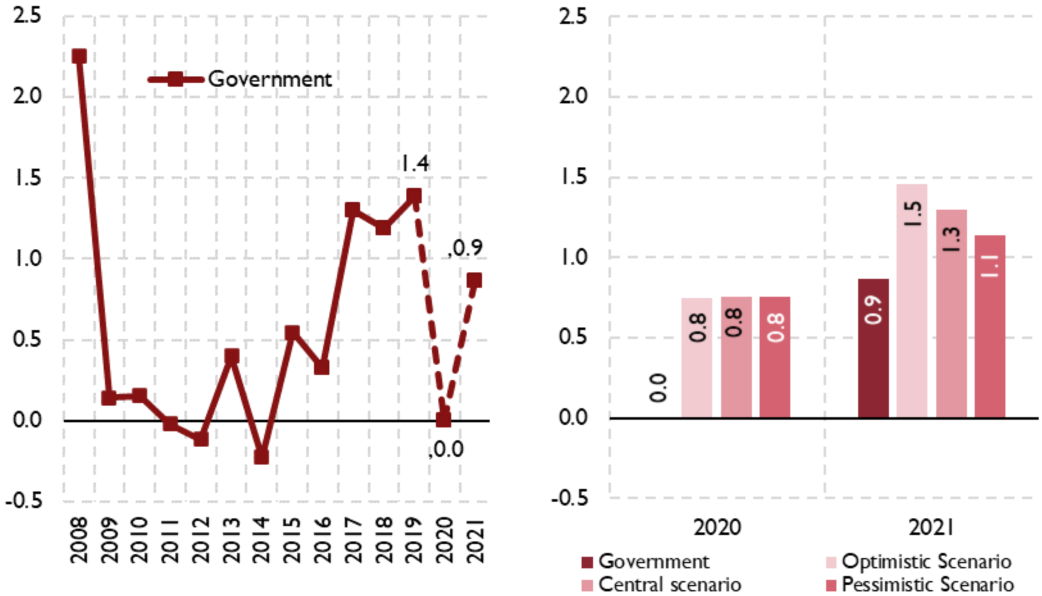
FIGURE 25. GROWTH IN EMPLOYMENT (%)



Source: Ministry of Economic Affairs and Digital Transformation (dashed line) and AIReF estimates

About prices, the Government forecasts growth in the GDP deflator of 0.9% in 2021, both in its baseline scenario and in the final scenario, which is below the figure for AIReF's pessimistic scenario. Incorporating the measures of the GSB and the European Fund in AIReF's scenario raises the forecast for growth of the GDP deflator in 2021 by 0.3 pp to stand at 1.3% in its central scenario. The Government does not consider any impact on the deflator. Therefore, if its forecast under the baseline scenario was between AIReF's central and pessimistic scenarios, it now stands outside of them.

FIGURE 26. GDP DEFLATOR GROWTH (%)



Source: Ministry of Economic Affairs and Digital Transformation (dashed line) and AIReF estimates

BOX 4. ANALYSIS OF ERRORS AND BIASES IN THE GOVERNMENT'S MACROECONOMIC FORECASTS

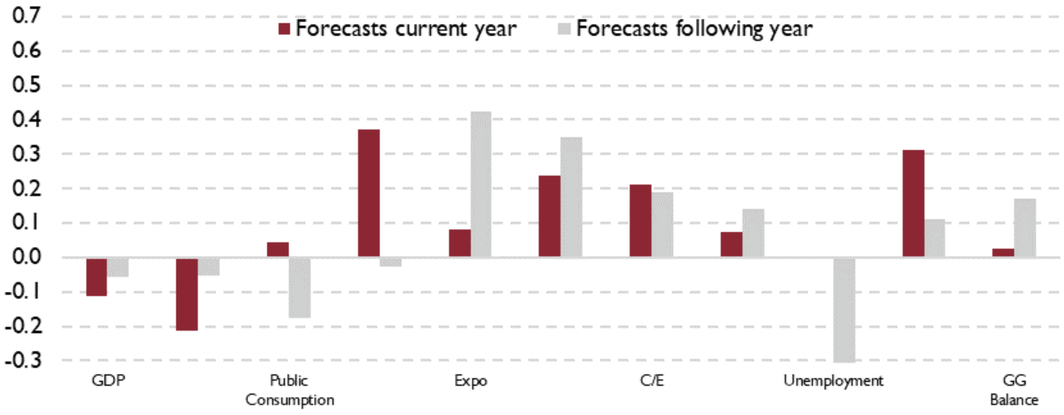
Organic Law 6/2013, of 14 November, on the creation of the Independent Authority for Fiscal Responsibility (Article 14.4) requires that an evaluation be included as regards to whether there is a “significant bias” in the macroeconomic forecasts, according to Article 4.6 of Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States. If the report concludes that the bias exists, the State shall take the necessary action to correct it and make it public.

A significant bias is defined if the forecast error, calculated as the difference between the forecast and the realised value is large (outside the interquartile range of the error of the FUNCAS panel of professional analysts) and unjustified (its direction does not improve the forecast, but worsens it) for four consecutive years.

Having analysed the forecasts that the Government has made in the various draft GSBs, no significant biases have been found in the forecasts made by the Government in the last four years. However, there are major errors in the forecast for GDP and imports for the current year in 2016, 2018 and 2019 and in the forecast for the following year for imports and the unemployment rate in 2016, 2017 and 2018. In addition, there are no unjustified errors in the forecasts for the current year or for the following year in the last four years.

The direction of the Government’s bias has been uneven in the last four years compared with that of the consensus of professional analysts. In particular, the Government is more pessimistic in its forecasts for GDP, private consumption and the unemployment rate and more optimistic in its forecasts for gross fixed capital formation, exports, imports, compensation of employees and employment, current account balance and the General Government balance. In the case of public consumption, the Government is more optimistic for the current year and more pessimistic for the following year.

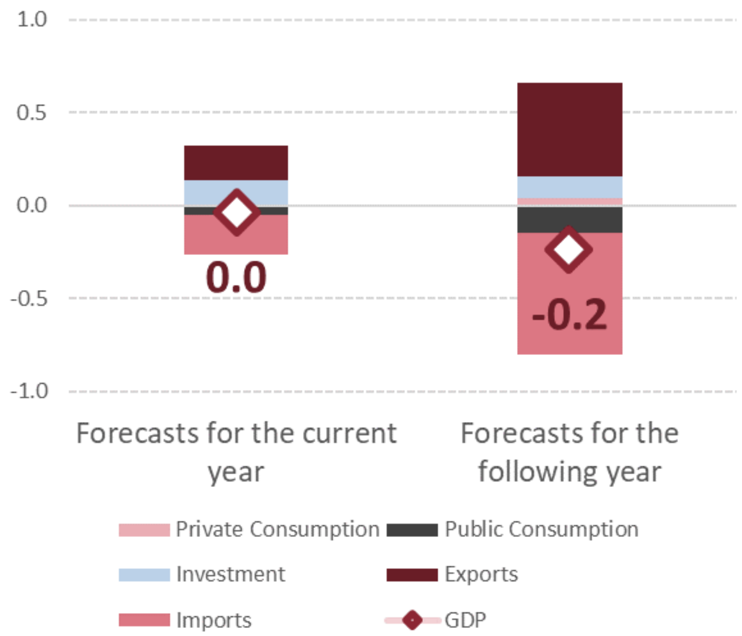
FIGURE 27. GOVERNMENT FORECAST ERRORS COMPARED WITH THE CONSENSUS (AVERAGE LAST FOUR YEARS)



Source: Prepared by AIReF NB: The variables are expressed in percentage growth rates, except unemployment, current account balance and GG, which are ratios expressed as a percentage.

The apparent absence of bias in the GDP forecasts masks the bias identified in its components due to the composition effect. The optimistic bias found in exports has been offset by the optimistic bias of imports.

FIGURE 28. BREAKDOWN OF GDP FORECASTING ERRORS (AVERAGE LAST FOUR YEARS)



Source: Prepared by AIReF

3.6. Risk analysis

The macroeconomic projections incorporated in the Budget face clear downside risks that include a more adverse health scenario, delays in implementation of the Recovery, Transformation and Resilience Plan, the possibility of structural damage to the business fabric and the labour market, financial difficulties in the banking system and a no-deal Brexit.

The main risk is linked to the recent worsening of the pandemic. The Government's scenarios assume that any outbreaks that may emerge can be contained with partial restrictions on mobility and that there will be progress in the availability of the vaccine or effective treatment over 2021 that will allow a return to normality. AIReF considers that these assumptions may be benign. In the short term, the recent worsening of the pandemic, which is leading many countries to impose more stringent and widespread lockdowns, suggests that the economic momentum from abroad will be lower. The impact that these restrictions might have on the tourism sector over the coming months is particularly significant as some islands have their high season at Christmas. More in the medium term, AIReF highlights the uncertainty surrounding the time when effective treatment will become available and allow a return to normality.

The high levels of savings noted in household financial accounts show the fragility of the recovery in a scenario where the pandemic persists. In the second quarter of 2020, households increased their savings rate by more than 12 pp to 22.5% of disposable income in seasonally adjusted terms, the all-time high of this series. Although much of this is forced savings associated with the lockdown period, the worsening of confidence and the outlook for employment suggest that there may also be precautionary savings, which may be hampering the recovery of household spending[12].

The second risk element is linked to implementation of the Recovery, Transformation and Resilience Plan. As indicated above, 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, the simulations performed

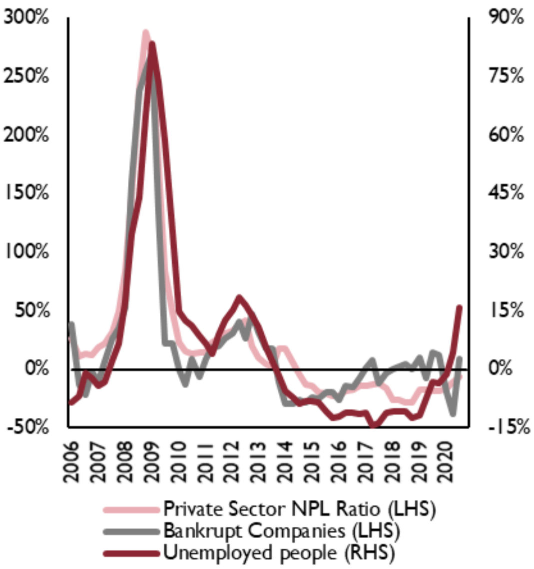
[12] See European Central Bank 2020 "*COVID-19 and the increase in household savings: precautionary or forced?*" https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202006_05~d36f12a192.en.html.

by AIReF suggest that if the increase in spending on investment is accompanied by structural reforms aimed at increasing the economy's efficiency, the Plan's impact may be greater, although probably not in 2021, and more long-lasting.

The persistence of the pandemic raises the risk of structural damage to the business fabric and the labour market. Despite the measures aimed at preserving liquidity and corporate solvency, the duration of the pandemic raises the likelihood of permanent damage to companies, especially in those sectors where restrictions on mobility have a greater impact, which are particularly important in Spain. Studies carried out by the Bank of Spain suggest that although Spanish companies have faced the crisis with a stronger financial position, the figures of the Central Balance Sheet Data Office show a sharp drop in profits and corporate profitability. In fact, the Bank of Spain has performed simulations which suggest that in an adverse scenario in which the disease persists, the percentage of companies with liquidity needs will rise to 70% in the last quarter of the year and only 50% of these liquidity needs could be covered with liquid assets and lines of credit.

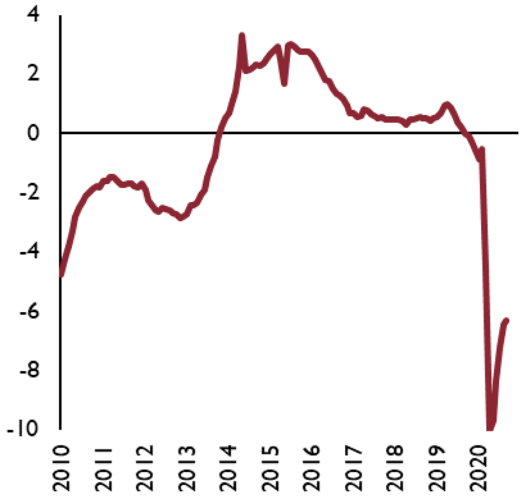
The measures to preserve corporate liquidity and solvency are key to curbing the deterioration in credit risk indicators. The relationship between the rate of non-performing loans and bankrupt companies shown in the figure is currently affected by the statistical effects, but also by the protection measures for debtors – mortgage and non-mortgage – and the lines of public guarantees. As shown in the figure, the increase in moratoriums, as in the case of ERTEs, is mainly concentrated around activities of retail and wholesale trade, hospitality, professional and technical activities and market services linked to recreational services. The persistence of the pandemic means that these measures need to be maintained to ensure their liquidity (and solvency) in the coming months. The number of companies contributing to social security has recovered but is still at levels much lower than prior to the crisis.

FIGURE 29. UNEMPLOYED, PRIVATE SECTOR NPLS AND BANKRUPT COMPANIES (YEAR-ON-YEAR RATES OF CHANGE)



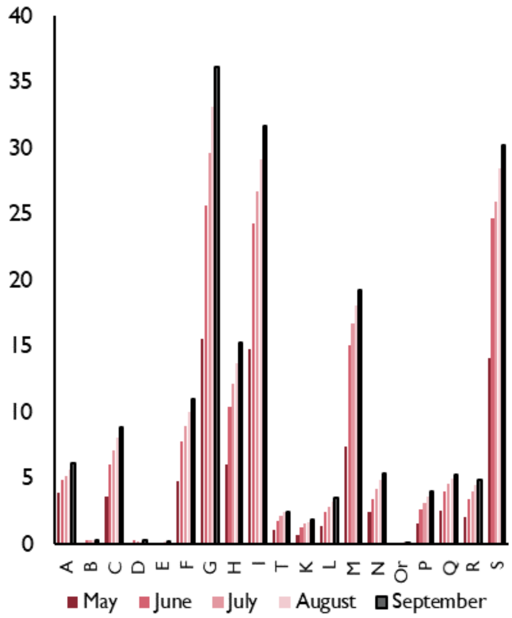
Source: INE and Bank of Spain.

FIGURE 30. SOCIAL SECURITY AFFILIATION ACCOUNT CODES (YEAR-ON-YEAR RATES OF CHANGE)



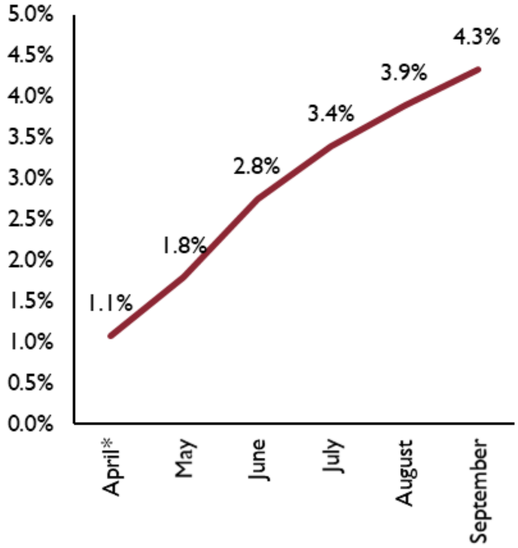
Source: Ministry of Inclusion, Social Security and Migration

FIGURE 31. SECTORAL MORATORIUMS. SYSTEM TOTAL. BREAKDOWN OF SELF-EMPLOYED DEBTORS ACCORDING TO CNAE (NATIONAL CLASSIFICATION OF ECONOMIC ACTIVITIES). CODE NUMBER OF SELF-EMPLOYED PERSONS SUBJECT TO MORATORIUM (THOUSANDS OF MORATORIUMS, ACCUMULATED)



Source: Bank of Spain.

FIGURE 32. OUTSTANDING BALANCE PENDING REPAYMENT OVER BALANCE OF LOANS (PERCENTAGE OVER TOTAL SYSTEM LOANS)



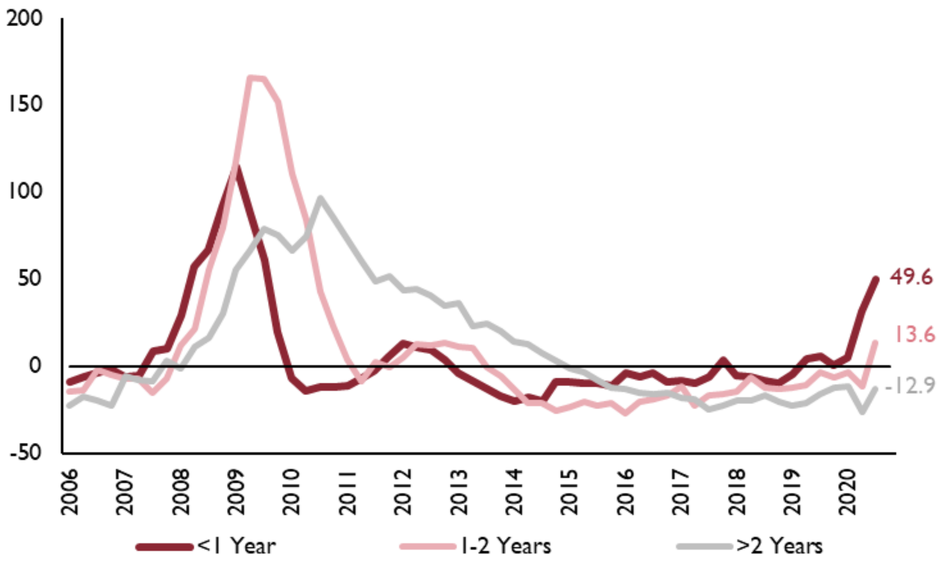
Source: Bank of Spain.

* Approximate Value

There is an increased risk that the persistence of the pandemic could trigger financial difficulties globally and in the banking system. In its recent financial stability report, the Bank of Spain has warned of the risk of the intensity of the second wave of infections and that the spread of the crisis might end up having a negative impact on the solvency of the banking system, leading to a reduction in lending that might trigger a financial crisis that would delay the recovery. In fact, the results of the Bank Lending Survey show that there was a widespread contraction of the credit supply both in Spain and in the euro area, which would be linked to the increase in perceived risks. At an international level, many institutions are warning about the possibility that the duration of the crisis may end up generating financial difficulties in some countries, especially in vulnerable economies such as Latin American countries that have significant financial links with Spain.

In the labour market, it is still too early to perceive permanent damage, but this is a significant risk for the coming year. However, reviewing unemployment according to the time spent looking for a job although the increase is concentrated particularly among unemployed people who have been out of work less for than a year, the percentage of people who have been looking for a job for over one year is also increasing significantly. This is even though the ERTEs are providing an important unemployment buffer during the current crisis. Another element to consider is that the crisis has had a greater impact on households and people with greater financial fragility and lower wages, whose jobs are performed in the services sectors most affected by social distancing.

FIGURE 33. RATE OF CHANGE OF UNEMPLOYED PEOPLE ACCORDING TO TIME SPENT LOOKING FOR WORK



Source: INE.

Added to this is the possibility that a no-deal Brexit will have a negative impact on the Spanish economy and the EMU. Although Spain's trade and financial exposure to the United Kingdom is lower than the average for the euro area, it is important to bear in mind that this economy accounts for 20% of the flows of inbound tourists. The Bank of Spain estimates that the cumulative impact of a no-deal Brexit could be -0.7 pp of GDP growth after five years[13].

[13] Juan Luis Vega (ed). 2019. Brexit: current situation and outlook https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/PublicacionesSeriadas/DocumentosOcasionales/19/Files/do1905e.pdf

4. ANALYSIS OF 2020-2021 BUDGETARY SCENARIO

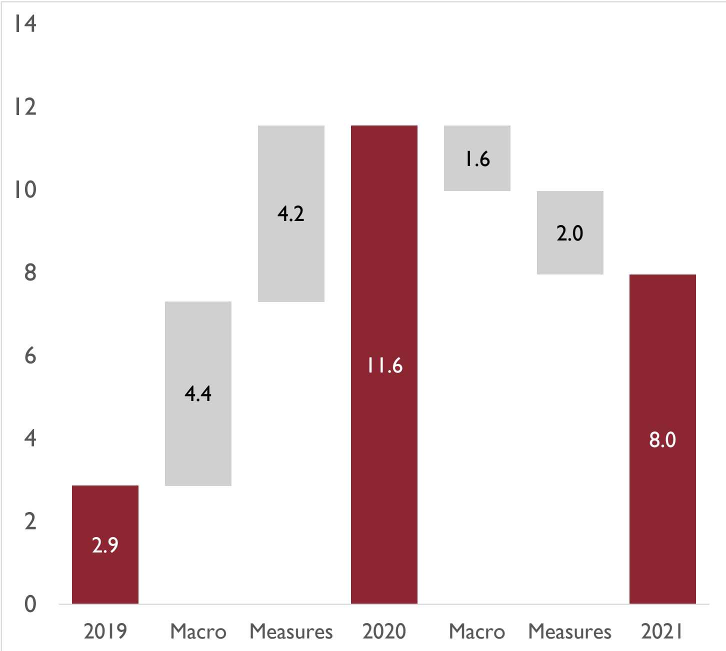
For its central scenario, AIReF estimates a deficit of 8% of GDP for the GG in 2021, after reaching 11.6% in 2020. In both cases these are higher than the figures in the Budgetary Plan. The Government expects to close 2020 with a deficit of 11.3%, which would narrow by 3.6 points in 2021 to 7.7% of GDP. For its part, AIReF considers that the deficit will be higher in 2020, although it expects a similar reduction in 2021, with both years remaining within the confidence bands of AIReF. 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 Budgetary Plan will drive this significant deficit reduction. In the opposite direction, the new spending measures contained in the draft GSB imply a smaller reduction in the deficit. Finally, both the Budgetary Plan and AIReF's estimates assume that the Recovery, Transformation and Resilience Plan (RTRP) will have a neutral effect on the 2021 deficit. Although there may in practice be time lags between revenue and expenditure, the impact will be neutral in the medium term and assuming this hypothesis for 2021 allows a better analysis of the evolution of the deficit.

TABLE 4. GENERAL GOVERNMENT DEFICIT (% GDP)

		2020		2021	
% GDP	2019	DBP	AIReF	DBP	AIReF
General Government	**-2.9**	**-11.3**	**-11.6**	**-7.7**	**-8.0**
CG	-1.3	-6.6	-7.2	-5.2	-5.6
SSFs	-1.3	-4.1	-3.8	-1.3	-1.5
Regions	-0.6	-0.6	-0.6	-1.1	-0.8
LG	0.3	0.0	0.0	-0.1	-0.1

The improvement in the macroeconomic environment in 2021 explains 1.6 points of GDP of the deficit reduction, while the gradual withdrawal of measures will result in a reduction of 2 points. The weight of the deficit over GDP rises by 8.7 points in 2020 from 2.9% in 2019 to 11.6% according to AIReF's forecasts. The fall in economic activity explains 4.4 points of this change, while the measures implemented to mitigate the effects of the crisis on households explain 4.2 points. A recovery in economic activity is expected in 2021 as the effects of the pandemic fade, leading to an improvement in the public accounts that will help to reduce the deficit by 1.6 points. This includes the increase in revenue from the economic recovery, the baseline evolution of expenditure and the denominator effect of nominal GDP growth. In addition to this, there is a further 2-point reduction due to the progressive withdrawal of the measures approved in 2020 to mitigate the effects of the pandemic. The two effects will place the 2021 deficit at 8% of GDP.

FIGURE 34. EVOLUTION OF DEFICIT BY COMPONENT, AIREF (% GDP)



In 2020, AIReF's estimates put revenue at 41% of GDP, below the figure included in the Budgetary Plan, while expenditure amounts to 52.5% of GDP, 0.5 points below the Budgetary Plan. In nominal terms, revenue would fall by 6.4% compared with 2019, below nominal GDP, which explains the increase in its weight over GDP. In contrast, expenditure will rise by 11.8%, which, together with the fall in nominal GDP, will increase its weight over GDP by 10.5 points. The fall in revenue comes essentially as a result of the decline in economic activity due to the COVID-19 crisis, while the growth in expenditure is mainly the result of the healthcare, economic and social measures implemented to mitigate the effects of the crisis.

TABLE 5. REVENUE AND EXPENDITURE OF THE GENERAL GOVERNMENT WITHOUT RTRP (% GDP)

% GDP		Without RRF and REACT			
		2020		2021	
	2019	DBP	AIReF	DBP	AIReF
REVENUE	39.2	41.7	41.0	40.3	39.7
EXPENDITURE	42.0	53.0	52.5	48.0	47.6
NET LENDING/BORROWING	**-2.9**	**-11.3**	**-11.6**	**-7.7**	**-8.0**

TABLE 6. REVENUE AND EXPENDITURE OF THE GENERAL GOVERNMENT WITH RTRP (% GDP)

% GDP		With RRF and REACT			
		2020		2021	
		DBP	AIReF	DBP	AIReF
REVENUE	39.2	41.7	41.0	43.2	42.5
EXPENDITURE	42.0	53.0	52.5	50.8	50.5
NET LENDING/BORROWING	**-2.9**	**-11.3**	**-11.6**	**-7.7**	**-8.0**

AIReF forecasts that revenue, excluding the RTRP, will be 39.7% of GDP in 2021, below the forecast included in the Budgetary Plan. The recovery of revenue as a result of the economic growth is strengthened by the introduction of new tax categories and the modification of certain taxes in the draft GSB. In nominal terms, AIReF expects revenue growth of 6.2% compared with the higher forecast in the Budgetary Plan of 7.3%. However, the difference that also exists in the nominal GDP estimates mean that in terms of percentage of GDP the difference is only 0.6 points. In both cases, the revenue forecast is based on macroeconomic scenarios that assume quick and effective implementation of the RTRP and approval of the GSB with the proposed tax modifications as well as the new tax categories announced. According to the pace of execution of the RTRP (RRM and RRF) forecast by the Government, revenue would increase by an additional 2.8 points of GDP to stand of 42.5% in the case of AIReF's central scenario and 43.2% in the case of the Budgetary Plan.

According to AIReF's estimates, expenditure in 2021 will be 47.6%, excluding the RTRP, compared with 48% in the Budgetary Plan. 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 healthcare expenditure. In nominal terms, expenditure will fall by 0.6%, while it grows by 0.4% in the Budgetary Plan. Implementation of the RTRP in the terms envisaged by the Government would increase the expenditure forecast by 2.8 points of GDP to reach 50.5% in the case of AIReF's central scenario and 50.8% in the case of the Budgetary Plan.

Fiscal projections remain subject to a high degree of uncertainty due to the development of the pandemic. The health crisis is still far from being deemed resolved and its duration and effects on society and the economy remain unknown. The Budgetary Plan assumes that the health crisis will be resolved fully and in a relatively short period of time, which, in view of the more recent evolution of the pandemic, may be among the more optimistic possible assumptions. Although AIReF makes somewhat more cautious assumptions about the impact of the pandemic on the economy, its central scenario would also be subject to significant downward risks. More pessimistic scenarios regarding the pandemic such as those raised by the World Health Organization, which delays control of the pandemic until 2022, can in no way be ruled out and they would lead to more adverse macroeconomic scenarios and the need to maintain the measures started in 2020 for a longer period, with the consequent worsening of public finances. In contrast, the materialisation of more optimistic scenarios, such as the one put forward by the Government, would allow a quicker economic recovery and faster withdrawal of the measures, which should be used for greater reduction of the public deficit.

The implementation of the RTRP also adds uncertainty to both the macroeconomic and the fiscal scenarios. Both AIReF and the Budgetary Plan assume implementation of the RTRP in the terms forecast by the Government for 2021, both in time periods and in beneficial effects on our economy. This poses a major challenge for all the public authorities involved, both nationally and the EU. Slower implementation would not therefore be unlikely, which would also imply lower economic growth in 2021. However, the implementation of the RTRP being less efficient than expected poses a greater challenge to medium-term growth. This would reduce the short and medium-term fiscal multipliers and their effect on the economy's potential growth, thus wasting opportunities to modernise our economy. Finally, the somewhat likely risk of a time lag between expenditure execution and revenue materialisation might raise the deficit in 2021, but would imply a further reduction for 2022, which should not divert attention from the underlying path of the deficit excluding this effect.

FIGURE 35. EVOLUTION OF THE BALANCE OF THE GENERAL GOVERNMENT

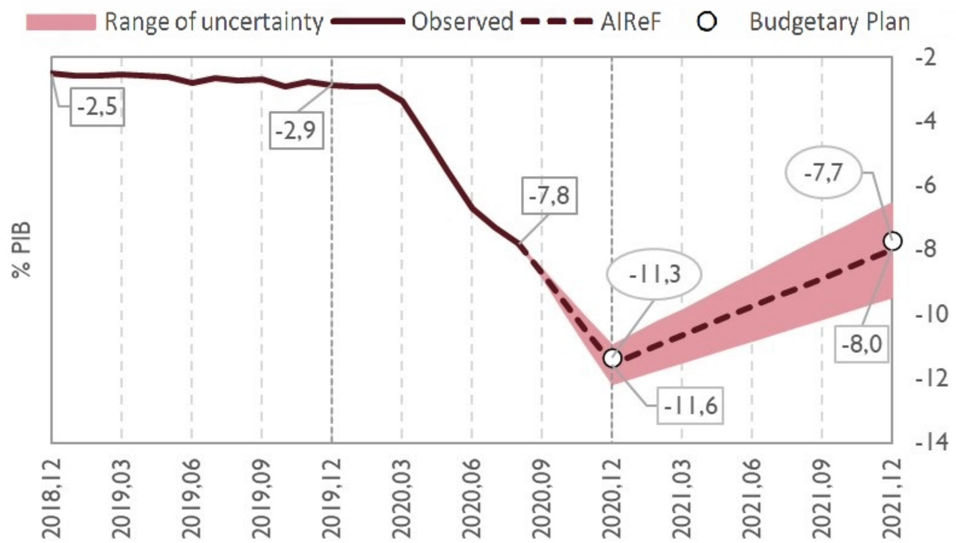


FIGURE 36. EVOLUTION OF GG REVENUE

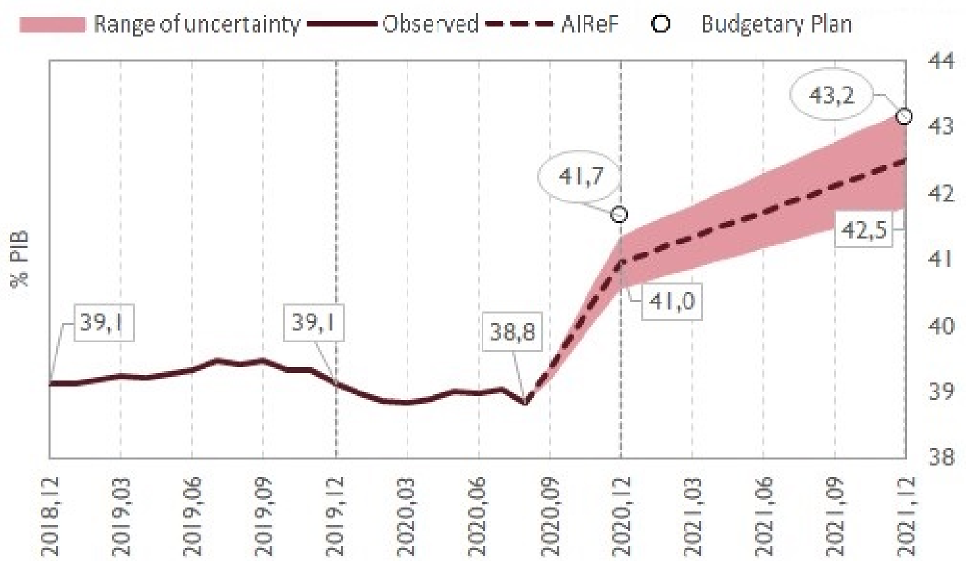
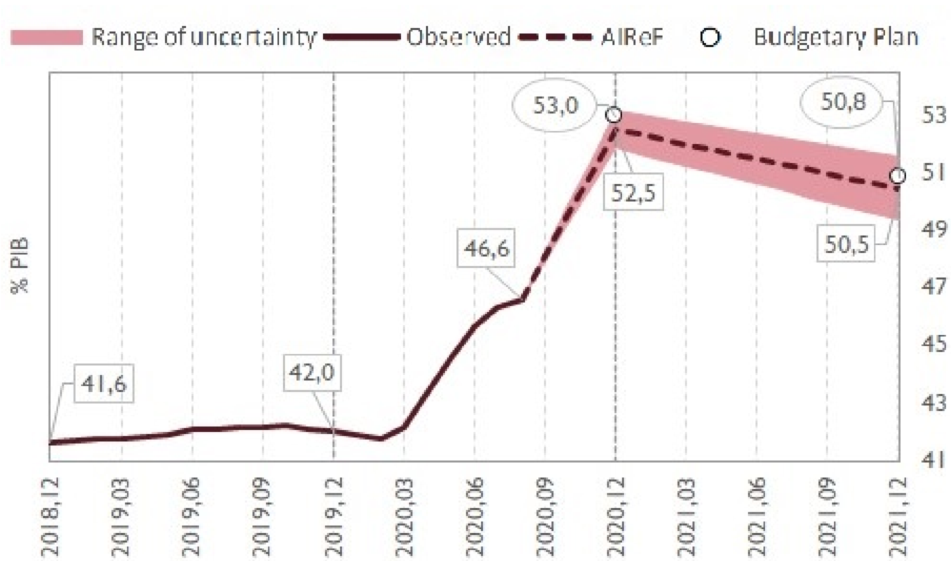


FIGURE 37. EVOLUTION OF GG EXPENDITURE



4.1. Effects of the macroeconomic scenario

GDP growth in 2021 leads to a deficit reduction of one point of GDP only as a result of the denominator effect, due to the reduction in the weight of expenditure in GDP of 4.7 points, offset by that of revenue of 3.8 points. The reduction in the deficit in 2021 has been broken down into three factors: the denominator effect resulting from the recovery of GDP; the effect of the measures taken by Governments; and the macroeconomic and baseline effect. As indicated above, in the central scenario, the recovery would lead to GDP growth of 9.6% in nominal terms. Given the size of the rise, the evolution of the ratio of fiscal data to GDP, which is usually used to express and oversee tax rules, would be somewhat distorted. Contrary to what has happened in 2020, the rise in GDP offsets the increase in revenue in nominal terms, while accentuating the fall in expenditure in nominal terms. As a result, this denominator effect also helps to reduce the deficit, in the same way that it accentuated its increase in 2020.

TABLE 7. BREAKDOWN OF CHANGE IN THE DEFICIT (% GDP)

			2020				2021		
			Breakdown of effects in % GDP				Breakdown of effects in % GDP		
	2019	2020	Denominator effect	Effect of measures	Macro / baseline effect	2021	Denominator effect	Effect of differential measures	Macro / baseline effect
REVENUE	39.2	41.0	4.3	-0.2	-2.3	42.5	-3.8	3.3	2.1
EXPENDITURE	42.0	52.5	5.1	4.1	1.3	50.5	-4.7	1.2	1.5
NET LEND./BORR.	**-2.9**	**-11.6**	**-0.8**	**-4.24**	**-3.7**	**-8.0**	**1.0**	**2.0**	**0.6**

In its central scenario, AIReF estimates that the economic recovery will result in a correction of the deficit of 0.6 points of GDP in 2021. On the one hand, the growth in revenue, excluding tax measures and RTRP revenue, would lead to a deficit reduction of 2.1 points of GDP in the central scenario, driven mainly by a recovery in private consumption and compensation of employees, which would grow by 10.1% and 7.3% in nominal terms in 2021. However, the baseline growth in expenditure, which also excludes the impact of the measures, offsets that reduction by 1.5 points of GDP. This baseline growth in expenditure includes the evolution of spending excluding the measures set out in the Budgetary Plan and in the draft GSB, which are analysed in the following sections.

Should the optimistic scenario developed by AIReF materialise, revenue for 2021 would be around €9.3bn higher than its central scenario and in line with the revenue included in the draft GSB. In the optimistic scenario, nominal GDP growth would be two points higher, to stand at 11.6%, which would translate into higher revenue. Mainly, the growth in employment and compensation of employees, of 9% and 9.4%, respectively, would drive the recovery in social contributions and the growth in the collection of Personal Income Tax. To a lesser extent, more dynamic private consumption, with nominal growth of 11.7%, would also translate into a greater recovery in indirect taxes. For its part, expenditure would remain virtually unchanged, allowing a greater reduction in the deficit.

FIGURE 38. DIFFERENCE BETWEEN AIREF AND GOVERNMENT REVENUE (€M).

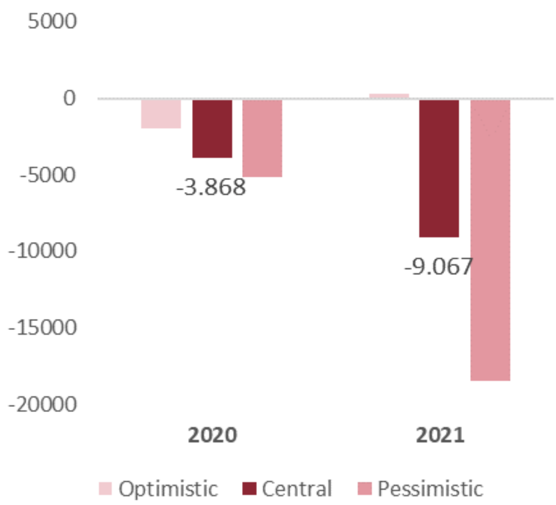


FIGURE 39. DIFFERENCE BETWEEN AIREF AND GOVERNMENT EXPENDITURE (€M).

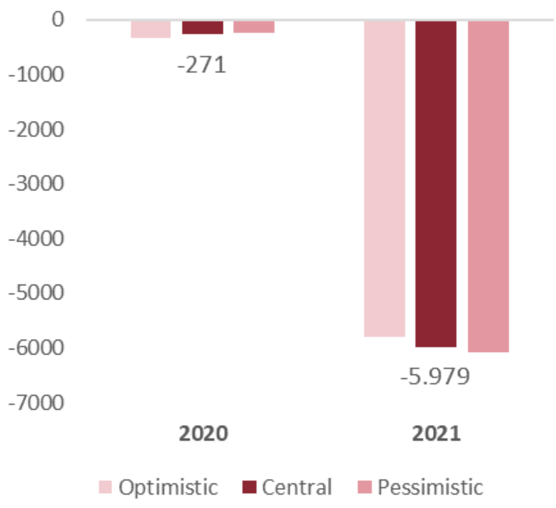
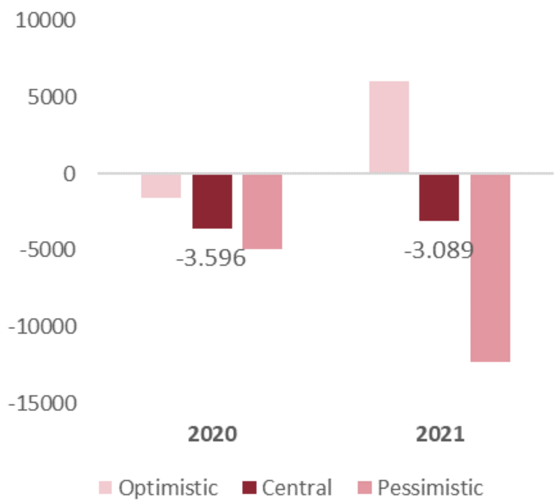


FIGURE 40. DIFFERENCE BETWEEN AIREF AND GOVERNMENT BALANCE (€M).



In contrast, AIReF's pessimistic scenario forecasts lower revenue for 2021, around €9.4bn less than in its central scenario and €18.4bn lower than the figure in the draft GSB. AIReF's pessimistic scenario assumes GDP growth in 2021 of 7.7% after a larger fall in 2020, reducing General Government revenue. In this case, the remuneration of employees would only grow by 5.3%, limiting the recovery of social contributions and Personal Income Tax. In addition, private consumption would grow by around 8.1%, limiting the recovery of revenue from VAT and other indirect taxes. Consequently, assuming a similar evolution of expenditure, the deficit would narrow by a smaller amount.

Taking the Government's macroeconomic outlook as the basis for AIReF's prediction models, revenue would be 0.1 points above the forecasts in AIReF's central scenario. This means that the differences between the AIReF and Government estimates is not the result of the macroeconomic outlook underpinning them but is also the product of the different prediction methodologies used by AIReF and the Government. Furthermore, this also leads to the conclusion that according to AIReF's estimates, revenue would not reach the figure forecast in the Budgetary Plan, even if the Government's macroeconomic outlook materialised.

4.1.1. Impact of measures to combat the COVID-19 crisis.

The measures to combat COVID-19 will still account for 1.7% of GDP in 2021 after accounting for 4.2% of GDP in 2020. The Central Government and regional Governments took a wide variety of measures to mitigate the effects of the crisis in 2020. Most of the measures taken, around 95%, are temporary and automatically reversed. All measures classified as temporary would result in a reduction in the deficit when they cease to be in force, which is linked to the duration of the pandemic. They will therefore still have a significant impact on the deficit in 2021, albeit smaller than in 2020.

The COVID-19 health crisis will still maintain a significant part of the increase in healthcare spending in 2021, estimated at 0.4 points of GDP. The increase in healthcare spending in 2020, 0.8 points of GDP, is mainly being recorded by the autonomous regions, 0.7 points, although it has been financed through the CG using the COVID-19 Fund. Part of this higher spending incurred in 2020 on employees, intermediate consumption, social transfers in kind and investment in equipment will be maintained in the regions in 2021 depending on the evolution of the pandemic. It is still difficult to predict what proportion of this increase in spending will be structural to strengthen the healthcare system. In addition, the RTRP will also bear part of the healthcare expenditure associated with the pandemic, such as buying the future vaccine.

Income replacement measures will continue to be very significant in 2021, although their impact on the deficit will fall to 0.9 points. The Government is attempting to mitigate the loss of household income by strengthening existing tools such as the Job-Retention Schemes (ERTEs) and the Temporary Incapacity for Work or the creation of new tools, such as the extraordinary benefits for self-employed workers.

TABLE 8. IMPACT OF MEASURES

Impact of the measures (sign + = greater deficit)		Government 2020		Government 2021		AIReF ESTIMATE 2020		AIReF ESTIMATE 2021		Government-AIReF differences 2020	Government-AIReF differences 2021
		Millions	% GDP	Millions	% GDP	Millions	% GDP	Millions	% GDP	Millions	Millions
Central Government		2,346	0.2	437	0.0	2,307	0.2	421	0.0	39	16
Expenditure measures		**2,083**	**0.2**	**437**	**0.0**	**2,083**	**0.2**	**437**	**0.0**	**0**	**0**
Healthcare expenditure		1,317	0.1	77.0	0.0	1,317	0.1	77.0	0.0	0	0.0
Social expenditure measures		147	0.0	0.0	0.0	147	0.0	0.0	0.0	0	0.0
Other expenditure measures		619	0.1	360.0	0.0	619	0.1	360.0	0.0	0	0.0
Tax measures		**263**	**0.0**	**0**	**0.0**	**224**	**0.0**	**-16**	**0.0**	**39**	**16**
VAT reduction in rates for COVID-19 medical supplies and e-books						72	0.0	52	0.0		
Corporate Income Tax Instalment payments SMEs						72	0.0	-72	0.0		
Waiver of the Personal Income Tax Objective Estimation Regime and the Simplified and Special		263	0.0	0	0.0	6	0.0	4	0.0	39	16
Proportional reduction in Objective Estimation for the days in the State of Alarm						74	0.0	0	0.0		
SSF		35,973	3.3	4,721	0.4	30,536	2.7	10,881	0.9	5,437	-6,160
Job-retention Scheme (ERTE)	Contributory unemployment benefit	17,840	1.6	718	0.1	14,738	1.3	4,171	0.3	3,102	-3,453
	Exemption from contribution	6,349	0.6	435	0.0	6,018	0.5	2,271	0.2	331	-1,836
Self-employed persons	Termination benefit	5,339	0.5	400	0.0	4,726	0.4	157	0.0	613	243
	Exemption from contribution	2,708	0.2	168	0.0	2,388	0.2	63	0.0	320	105
Temporary incapacity for work		1,355	0.1		0.0	2,108	0.2	1,263	0.1	-753	-1,263
Other measures		882	0.1		0.0	66	0.0	0	0.0	816	0
Minimum Living Income		1,500	0.1	3,000	0.2	492	0.0	2,956	0.2	1,008	44
Autonomous Regions		2,300	0.2		0.0	11,502	1.0	8,566	0.7	-9,202	-8,566
Revenue measures AR		490	0.0		0.0	537	0.0	367	0.0	-47	-367
Non-healthcare expenditure measures AR *(without transfers to LG)*		1,810	0.2		0.0	3,615	0.3	3,756	0.3	-1,805	-3,756
Healthcare expenditure measures AR			0.0		0.0	7,349	0.7	4,443	0.4	-7,349	-4,443
LG		388	0.0	490	0.0	2,959	0.3	1,326	0.1	-2,571	-836
Revenue measures LG *(without transfers from CSA and AR)*		0	0.0	102	0.0	1,255	0.1	474	0.0	-1,255	-372
Expenditure measures LG		388	0.0	388	0.0	1,705	0.2	852	0.1	-1,317	-464
TOTAL MEASURES		41,007	3.7	5,648	0.5	47,304	4.2	21,195	1.7	-6,297	-15,547

AIReF estimates a cost associated with the ERTEs due to *force majeure* of €20.757bn in 2020 and €6.442bn in 2021, if they last at least until the summer. This estimate includes the exemption from social contributions and would be comparable to the €24.189bn and €1.152bn set out in the Budgetary Plan for 2020 and 2021, respectively. The Government's estimate for 2020 is about €3.5 billion higher than that of AIReF, which, given the evolution of the number of ERTEs until the end of October, is difficult to explain without including assumptions of further closures of the economy. For 2021, AIReF’s higher estimate is due to assuming that the ERTEs will continue until June, instead of until January, which is what was approved in Royal Decree Law 30/2020. The evolution of the number of people affected until the end of September is based on data published by the Social Security system, which shows that of the 3.4m people affected in April, only 720,000 people remained in that situation at the end of September. Given the current uncertainty, with possible new closures, AIReF considers that there will be no improvement until March 2021, in line with the macroeconomic assumptions about the shedding of jobs set out in this report.

The benefit for cessation of activity of self-employed people and the exemption from the payment of contributions is valued at €7.114bn for 2020 and €220m for 2021, compared with €8.047bn for 2020 and €568m for 2021 forecast by the Budgetary Plan. The differences in the estimate are due to the assumptions that have been made about the evolution of expenditure in the last three months of the year. While AIReF considers that the expenditure will be moderately increased by the measures set out in Article 13 of RDL 20/2020, the Government considers that expenditure will increase by almost €350m per month. The number of people receiving the benefit since July has been obtained from the data published by the Social Security system. AIReF considers that this number will not change until January.

Incorporating leave for sickness or isolation due to COVID-19 as Temporary Incapacity for Work is valued at a cost of €2.108bn in 2020 and €1.263bn in 2021, compared with the €1.355bn estimated for 2020 in the Budgetary Plan. AIReF has based its estimate on data published by the Social Security system up to September. From September to March, it considers that the cost will rise by 15% per month. From then on, there will be a 35% monthly improvement up to June. The cost included in the Budgetary Plan is almost identical to that published by the Social Security system until September and does not include any cost for 2021, which is inconsistent with the most likely evolution of the pandemic.

AIReF's estimates of the cost of the Minimum Living Income, approved in June, are in line with those of the Government. This measure is permanent, implying an increase in the structural deficit. The Government has valued the cost of this benefit at €2.890bn[14] for a full year (€1.5bn and 850,000 beneficiaries in 2020). To estimate the cost of this measure, AIReF has used data from the 2018 Living Conditions Survey (LCS). Based on the result, it applied data provided by the Social Security system on the percentage of people who are excluded for reasons of wealth, and based on error correction and rate regression models, it estimates that the number of beneficiaries and the cost are in line with those estimated by the Social Security system. In addition, AIReF assumes the Social Security estimates on the cost of the employment incentive (€100

[14] Page 22 of the MAIN of RDL 20/2020, not prorated for the months the measure is in force in 2020.

million for one quarter of 2020, €400 million in 2021). The reduction in the cost of assimilation of the childcare allowance is obtained from the Social Security estimate for 2020 and the reduction in the cost of family benefits published in the 2021 GSB for 2021 (€108m in 2020, €436m in 2021). Based on Social Security data, AIReF considers that the approved applications for the Minimum Living Income (MLI) in 2020 have been lower than expected. Therefore, the cost for the first year will only be €492m. For 2021, AIReF considers a cost similar to that of the Government (€3bn) in addition to the cost of increasing the benefit by 1.8% included in the 2021 GSB. Furthermore, implementation of the MLI will lead to savings for the regions resulting from the overlap with regional benefits.

4.1.2. New measures included in the Budgetary Plan and the General State Budget

The main revenue measures affect the CG and involve creating new taxes and modifying the legislation on Personal Income Tax, VAT, Corporate Income Tax, the Tax on Hydrocarbons and the Tax on Insurance Premiums. Noteworthy among the new taxes are those recently approved by Parliament on Certain Digital Services and the Financial Transaction Tax, although others are also included that have not yet been considered by Parliament, such as the Taxes on Single-Use Plastics and on Waste. Most of these measures affect the Central Government. The following table summarises the main measures and the range valued by AIReF for incorporation into its forecasts.

TABLE 9. IMPACT OF REVENUE MEASURES: GOVERNMENT AND AIREF ESTIMATES

Impact of the REVENUE measures 2021	Government		AIReF		Differences	
	€ million	% GDP	€ million	% GDP	€ million	% GDP
Financial Transaction Tax (new tax)	**850**	**0.1**	**593**	**0.0**	**-257**	**0.0**
Tax on Certain Digital Services (new tax)	**968**	**0.1**	**542**	**0.0**	**-426**	**0.0**
Environmental taxation:	**1,802**	**0.1**	**1,124**	**0.1**	**-678**	**-0.1**
Reduction of the diesel allowance	450	0.0	571	0.0	121	0.0
Tax on Plastics (new tax)	491	0.0	123	0.0	-368	0.0
Tax on Waste (new tax)	861	0.1	431	0.0	-431	0.0
Direct taxation measures	**617**	**0.1**	**592**	**0.0**	**-25**	**0.0**
Personal Income Tax: Increase in higher income	144	0.0	119	0.0	-25	0.0
bases Corporate Income Tax: Limitation on exemption dividends and capital gains	473	0.0	473	0.0	0	0.0
Indirect taxation measures	**795**	**0.1**	**660**	**0.1**	**-135**	**0.0**
Change in VAT rate for sugary amd sweetened drinks	340	0.0	208	0.0	-132	0.0
Insurance premium rate increase	455	0.0	452	0.0	-3	0.0
Fight against tax fraud	**828**	**0.1**	**491**	**0.0**	**-337**	**0.0**
Other measures	**225**	**0.0**	**0**	**0.0**	**-225**	**0.0**
Total revenue measures	**6,085**	**0.5**	**4,002**	**0.3**	**-2,083**	**-0.2**

Estimates of the Financial Transaction Tax are highly uncertain. AIReF's estimates range from €430m to €864m, compared with the €850m estimated by the Government. An average of the two approximations gives a value of €647m. Of this sum, given the monthly nature of each return, €593m would accrue in 2021, while the rest would be carried over to 2022. These figures have been obtained by using data on financial transactions of the companies affected by the measure, Spanish companies with a capitalisation of over €1bn, and the experience of other comparable countries with similar taxes, mainly Italy and France. The first approximation makes it possible to obtain the upper part of the range. The reference used for the second approximation, which leads to a lower estimate, is France, which has a configuration of the tax that is similar to that approved in Spain. In 2017, France collected €1.451bn, corrected for the lower tax rate in Spain (0.2% compared with 0.3%) and the lower number of companies affected (64 compared with 144).

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In terms of environmental taxation, AIReF considers a greater impact than the Government because of the reduction in the diesel tax rebate and less impact for the new Taxes on Plastics and Waste. According to the Budgetary Plan, the change in the Tax on Hydrocarbons will lead to an increase in 2021 revenue of €450m, whereas AIReF values it at €571m. This estimate is based on the Tax Agency's diesel consumption data and its estimated evolution for 2021, deducting the share corresponding to professionals in the transport sector. The stipulated increase is applied to these figures, reduced by a factor that incorporates the fall in consumption as a result of the rate rise. In the case of Taxes on Plastics and on Waste, the Government forecasts revenue for 2021 of €491m and €861m, respectively, while AIReF estimates €123m and €431m because their passage through Parliament has not yet begun and it seems unlikely that they will enter into force in the first half of the year.

The impact of the direct taxation measures assessed by AIReF for 2021 is in line with that of the Government. The Budgetary Plan sets out an impact of €144m for 2021 due to the increase in the bases of Personal Income Tax for high incomes, while AIReF obtains an impact of €119m. The result is calculated based on the Tax Agency’s 2018 Personal Income Tax sample, to which the estimated evolution of the bases for 2021 is applied. The other changes in Personal Income Tax would have an effect on tax collection in 2022. AIReF’s quantification of the limitation of the exemption of dividends and gains from Corporate Income Tax matches the €473m included in the Budgetary Plan, with most of its impact transferred to 2022.

AIReF's estimate of the impact of eliminating the reduced VAT rate on sugary and sweetened drinks is lower than that of the Government. AIReF estimates that the impact will be €227m, of which €208m will be collected in 2021 and the rest in 2022. For its part, the Budgetary Plan estimates an impact of €400m, of which €340m would be paid in 2021. AIReF’s estimate is made on the basis of the increase in rates from 10% to 21% applied to household consumption of these types of drink, which is obtained from the 2019 Household Budget Survey.

AIReF's valuation of the increase in revenue as a result of the rise in Tax on Insurance Premiums is also in line with that set out in the Budgetary Plan. AIReF estimates a total impact of €452m compared with the €455m specified in the

Budgetary Plan. The estimate is made on the basis of the Insurance Premiums data contained in the Tax Agency's Annual Collection Report. The changes to these figures for 2021 are estimated and the established rise applied.

AIReF has incorporated a lower impact on tax collection of the measures against tax fraud. In this regard, it estimates a total impact of €491m, which is more limited than the €828m estimated by the Government. The breakdown of these measures includes restricting the use of cash between employers and professionals, strengthening the list of defaulters, and adopting regulatory, organisational and operational measures in line with best international practices. In order to estimate the restriction on the use of cash, information is used on the transactions affected from the information collected through the Immediate Supply of Information on VAT, the Spanish tax burden according to the World Bank, the percentage of fraud recovered by oversight actions and the percentage of improvement in the efficiency of oversight actions provided by the Tax Agency. To estimate the impact of the strengthening of the list of defaulters, AIReF uses information on the number of debtors that make payments following publication and the average payments of debtors, provided by the State Secretariat for Finance. Finally, for estimating the measures adapting legislation to best international practices, AIReF only assesses measures against the production, marketing and use of dual-new software. Due to insufficient information to make minimally accurate estimates, AIReF has not assessed the creation of a Central Coordination Unit for Control of Significant Assets and it has not quantified measures aimed at taxpayers beginning economic activities, optimisation of big data tools and analysis of the Tax Agency’s information.

The draft GSB also includes expenditure measures that increase the deficit by an amount estimated at 0.5 points of GDP. Although much of the increase in GSB expenditure is associated with the implementation of the RTRP and transfers to the SSFs and the regional Governments, it also includes measures that involve a structural increase in spending on various policies. A significant part of these policies is also implemented through transfers from the CG to the SSFs and the regions, as is the case of the increase in dependency expenditure. Other measures, such as the increase in scholarships, are implemented directly by the CG.

4.1.3. Recovery, Transformation and Resilience Plan

Spain will have €71bn over the next three years thanks to the new funds agreed by the EU, of which €59.168bn correspond to the Reconstruction and Resilience Facility, and €12.436bn will come from the REACT-EU programme. The health and economic crisis caused by COVID-19 led to the agreement in July between the EU Member States to make available a total of €750bn, of which €390bn will be transfers, with the rest in the form of loans, in order to mitigate the effects of the crisis. The so-called “Next Generation EU Package” mainly consists of two instruments - the Reconstruction and Resilience Facility (RRF), for a total of €672.5bn and the REACT-EU programme, with an amount of €312bn. The two instruments are designed to help tackle the socio-economic crisis and boost the digital and ecological transformation.

In order to channel these new funds, Spain will have to draw up the Recovery, Transformation and Resilience Plan (RTRP), whose funds for 2021 are reflected in the recently submitted 2021 GSB. The Recovery, Transformation and Resilience Plan is a multi-year reform agenda, for which the GSB allocates a total of €26.634bn in 2021, of which €24.198bn will come from the RRF, while the rest, a total of €2.436bn will come from the REACT-EU programme. The regions will also execute €10bn of this latter instrument, €8bn in 2021 and the rest in 2022. However, the funds have not yet been distributed among the regions, which must, in turn, incorporate them in the regional operational programmes (ERDF and ESF) following negotiations with the European Commission. EU regulation of these instruments is still pending approval. In parallel, the RTRP will be the subject of negotiations between the Government and the European Commission, with its final submission expected by 30 April 2021. AIReF has made its estimates based on the information included in the draft GSB although the composition of the RTRP may change substantially before its final approval.

The CG will receive the entire RRF and part of the REACT-EU programme, partially distributing these funds among the other sub-sectors. Part of the European funds received by the State are transformed into transfers to the regional administrations and the SSFs, which will be responsible for carrying out a major part of the final expenditure. Specifically, of the total €26.634bn of funds managed by the State, €10.793bn will be channelled to the regions, €1.483bn will be transferred to local Governments, and €1.143bn to the SSFs.

TABLE 10. DISTRIBUTION OF THE RECONSTRUCTION AND RESILIENCE FUND AND REACT-EU 2021 (% GDP)

Distribution of the Recovery and Resilience Fund and REACT-EU (% GDP)	Total Public Administrations	Regions	SSFs	Autonomous Regions	LG
NON-FINANCIAL REVENUE	**2.8**	**2.2**	**0.1**	**1.5**	**0.1**
CURRENT RESOURCES	**0.7**	**0.5**	**0.1**	**0.5**	**0.0**
Current transfers between public administrations			0.1	0.3	0.0
Current international cooperation	0.7	0.5		0.2	
CAPITAL REVENUE	**2.2**	**1.7**	**0.0**	**1.1**	**0.1**
Capital transfers between public administrations			0.0	0.6	0.1
Investment aid	2.2	1.7		0.5	0.0
NON- FINANCIAL EXPENDITURE	**2.8**	**2.2**	**0.1**	**1.5**	**0.1**
CURRENT EXPENSES	**0.6**	**0.4**	**0.1**	**0.5**	**0.0**
Compensation of employees	0.0	0.0			0.0
Intermediate Consumption	0.3	0.1		0.2	0.0
Social benefits other than social transfers in kind	0.1		0.0	0.1	
Social transfers in kind: purchased market production	0.1			0.1	
Current transfers between public administrations		0.3	0.1		
Other current transfers	0.1			0.1	
CAPITAL EXPENDITURE	**2.2**	**1.8**	**0.0**	**1.1**	**0.1**
Gross fixed capital formation	1.4	0.5		0.8	0.1
Capital transfers between public administrations		0.7	0.0		
Investment aid	0.9	0.6		0.3	

Out of the total funds received, the CG will directly execute close to €14bn, which would mainly increase gross capital formation and investment aid. According to AIReF's estimates with data from the GSB, the CG's gross capital formation would rise by almost €6bn and investment aid by 6.8 billion euros. The rest of the expenditure will be allocated to intermediate consumption, around €1.17bn, which will mainly be used for healthcare. Particularly important among the CG measures financed with these European funds are investments in industry and energy, with a total of €5.623bn (over 20% of the total funds), channelled through the Energy Diversification and Saving Institute (Spanish acronym: IDAE), investment in resilient infrastructure and ecosystems, and research, development, innovation and digitisation (the two policies will each receive around €5bn.

The regional and local Governments receive a total of €20.276bn in conditional transfers. These transfers will be used in projects to strengthen policies, particularly in education, health and social expenditure, and will significantly increase gross capital formation and investment aid and to a lesser extent intermediate consumption and social transfers in kind. The regions will receive over €3.7bn for environmental policy projects. Noteworthy among the educational policies, due to its amount, are the funds received by the *Educa Digital* [Digital Education] initiative, with close to €1bn in 2021, which aims to reduce the digital gap in the education sector. For its part, the Vocational Training Action Plan will also be undertaken by the regions and will have an impact on expenditure of €370m next year. A little over €1.65bn is allocated to the new measures in the area of housing, which are also the responsibility of the regions. With regard to healthcare expenditure, the regions will allocate funds from the RRF and/or from REACT EU, both from the part managed by the CG and the part that reaches them directly from the EU.

For their part, the SSFs will receive an amount of €1.143bn, which in turn will be distributed largely to the regions. The SSFs will receive funds that will mainly be allocated to employment promotion measures, implemented through the regional public employment services.

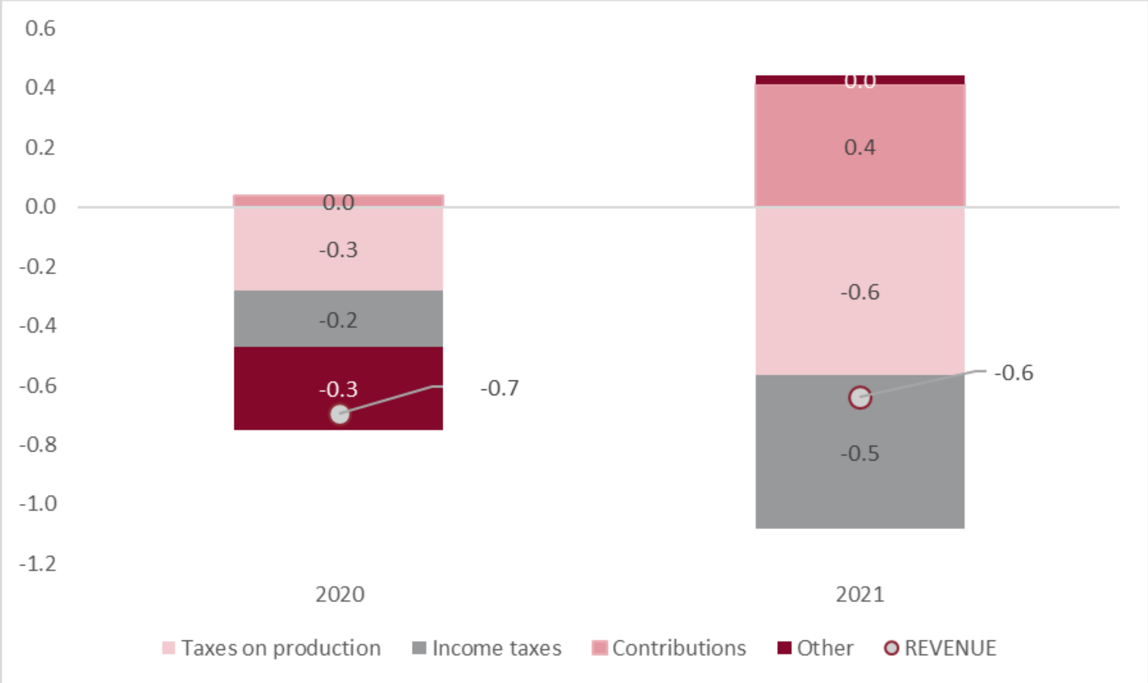
4.2. Evolution of General Government revenue

AIReF estimates that the GDP weight of revenue will be 0.7 points lower in 2020 and 0.6 points lower in 2021 compared with the figures presented in the Budgetary Plan. In 2021, there are both positive and negative deviations that result in the negative tax difference being mitigated by the positive deviations in contributions. At the end of the period, AIReF expects a weight of tax revenue in GDP of approximately one point less than the figure published in the Budgetary Plan. In addition, the Budgetary Plan expects growth in the weight of social contributions in GDP that is 0.5 points more moderate than that expected by AIReF. The uncertainty characterising the current situation will continue in 2021, which makes forecasting more difficult. It will be revenue that is most affected by the new economic reality following the pandemic as the main bases that support it become weaker: employment, wages, consumption, investment and business profits, which will lead to a sharp reduction in tax collection, revenue from contributions and other revenue.

TABLE 11. REVENUE IN % GDP BUDGETARY PLAN (+ EU FUNDS) VS AIREF

	2020			2021		
	DBP	**AIReF**	*Difference*	**DBP**	**AIReF**	*Difference*
REVENUE	**41.7**	**41.0**	**-0.7**	**43.2**	**42.5**	**-0.6**
TAXES	23.3	22.8	-0.5	23.6	22.5	-1.1
On production	11.5	11.2	-0.3	12.0	11.4	-0.6
On income	11.3	11.1	-0.2	11.2	10.7	-0.5
Capital	0.5	0.4	-0.1	0.5	0.4	0.0
CONTRIBUTIONS:	14.2	14.2	0.0	13.0	13.4	0.4
Property income	0.7	0.6	-0.1	0.6	0.6	0.0
Other Revenue	3.5	3.4	-0.1	6.0	6.1	0.1

FIGURE 41. DIFFERENCE IN REVENUE BETWEEN THE AIREF AND BUDGETARY PLAN SCENARIOS (% GDP)



AIReF's central scenario estimates a 6.4% fall in revenue 2020 and a recovery of 13.8% in 2021. In both cases, this is less optimistic than the Budgetary Plan. While in 2020 there were no significant legislative changes, in 2021, a little over half of the expected 13.8% growth is due to legislative changes or the effect of the RTRP funds, while 5.5 points are the result of the positive evolution of economic activity. The fiscal scenario presented in the Budgetary Plan expects a softer fall in revenue in 2020, of 5.6% compared with 6.4% in percentage change, and a faster recovery in 2021, of one point of change, compared with that presented by AIReF in its central scenario, which represents a difference of about €9bn. Part of the differences are explained by the different macroeconomic scenarios that underpin it, while another cause of the difference is due to the different estimates with regard to the impact of the legislative measures that have been approved and which are expected to have an impact on the economy in 2021. The remaining difference would be explained by the more optimistic forecasting modelling used by the Government.

FIGURE 42. CONTRIBUTIONS TO THE CHANGE IN REVENUE (%) AIREF

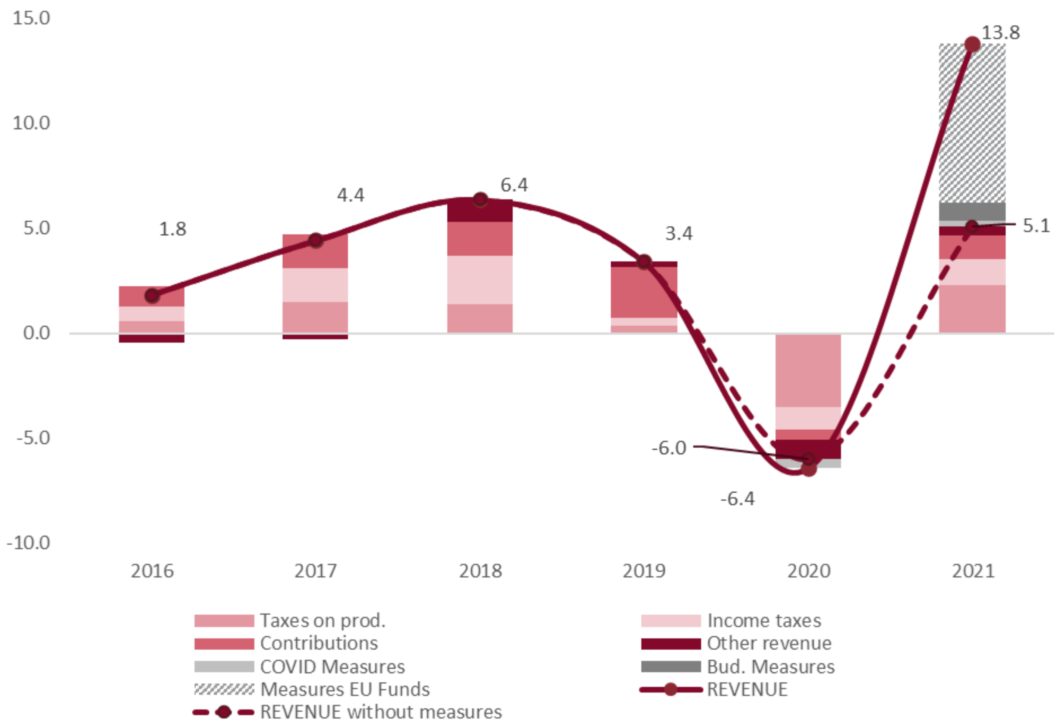


TABLE 12. RATE OF CHANGE (%) OF MAIN TAXES AND SOCIAL CONTRIBUTIONS IN NATIONAL ACCOUNTS TERMS

	2020		2021	
Rate change %	DBP	AIReF	DBP	AIReF
Taxes on products	-12.8	-14.0	17.7	12.7
Other taxes on production	0.5	-2.1	1.5	2.6
Household Income Tax	-1.1	-0.2	9.6	5.0
Corporate Income Tax	-13.5	-21.4	13.9	10.7
Social contributions	-2.5	-1.4	1.4	3.2

With regard to the tax revenue, AIReF estimates a fall of 8.9% in 2020 with a recovery of 7.9% in 2021 compared with the 7.6% fall and 13% recovery forecast in the draft GSB. This type of revenue accounts for approximately 60% of total revenue and its evolution will therefore set the tone for the evolution of revenue as a whole. The loss of tax collection is spread unevenly across the different taxes. The macroeconomic behaviour of the different agents following the crisis greatly affects the evolution of tax revenues. Thus, on the one hand, employment income has been maintained as a result of the measures taken by the Government, which have had a favourable impact on the collection of taxes paid directly by households. On the other hand, the lack of mobility during the lockdown, as well as the major uncertainty that still exists leads to more cautious behaviour in consumption and investment and therefore a contraction of the bases for VAT and special taxes.

AIREF presents a fiscal scenario in which 2021 tax collection accounts for one point less of GDP than the scenario presented in the draft GSB. Close to 0.1 points of the difference is the result of greater optimism in the Government's outlook and 0.2 points as a result of a different estimate of the legislative measures that will take effect in 2021 for which AIReF estimates a lower impact on tax collection. The rest of the difference is due to different estimation methodologies used by AIReF and the Government. By tax category, the greatest deviations are seen in VAT, in the other taxes for which there are new tax categories and in Corporate Income Tax. A detailed analysis of the forecast evolution of the main tax categories of the ordinary regime, before their transfer to the regional and local Governments in terms of collection and their subsequent transfer to national accounts is presented below[15]. The forecasts for 2020 have been made incorporating the tax collection known up to September.

TABLE 13. CASH TAX REVENUE IN 2021 BETWEEN AIREF AND DRAFT 2021 GSB (% GDP)

	21 DGSB	AIReF	Difference
Tax Revenue	**18.1**	**17.1**	**-1.0**
Personal Income Tax	7.7	7.6	-0.1
Corporate Income Tax	1.8	1.6	-0.2
VAT	5.9	5.6	-0.3
Special Taxes	1.8	1.7	-0.1
Other	1.0	0.7	-0.3

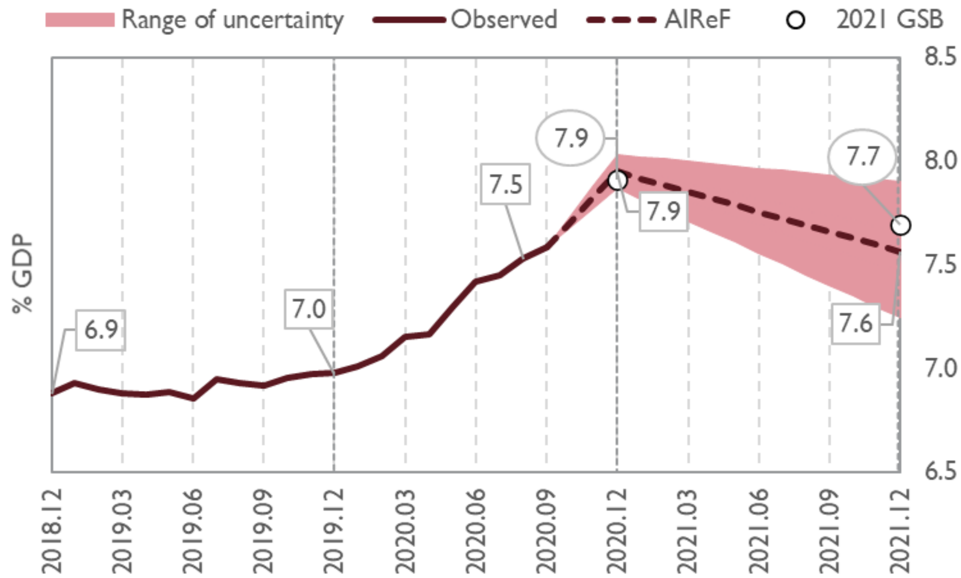
4.2.1. Personal Income Tax

AIReF forecasts an increase in the collection of IRPF of 2% and 4.3% in 2020 and 2021, respectively, compared with 0.6% and 7.8% in the draft GSB, with it being the tax category that stands up best to the negative effects of the crisis.

[15] For the forecast of the main tax categories, each of the components of their bases has been modelled aligning them with the most significant macroeconomic variables. The tax rates have then been applied to the estimate of the bases incorporating their corresponding progressive nature and then the accrued amount has been adapted to the collection mechanics specific to each tax, whether by calculating refunds or the settlement of the tax. Finally, the cash forecast is translated into national accounts terms following the criteria of the European System of Accounts ESA 2010 and the methodological notes published by the Intervention Board of the State Administration (IGAE).

The positive rate in 2020 is partly the results of the payment of the judgment relating to the refund of maternity and paternity benefits, which led to lower collection in 2019. Therefore, without this effect, the collection of Personal Income Tax would have remained at levels like those of 2019. Given that it is late in the year and no substantial changes are expected in the last quarter of the year, AIReF's forecast for 2020 is in line with the content of the draft 2021 GSB. There is a deviation between AIReF's and the Government's forecasts for 2021 of 0.1 points in the proportion of GDP. As explained in previous reports, AIReF expects total wages to be maintained in 2020, with a negative contribution from the private sector compared with a positive contribution from the public sector. In this regard, and given the progressive nature of the tax, a greater impact of the crisis on activities that concentrate lower employee remuneration has a smaller impact on tax collection.

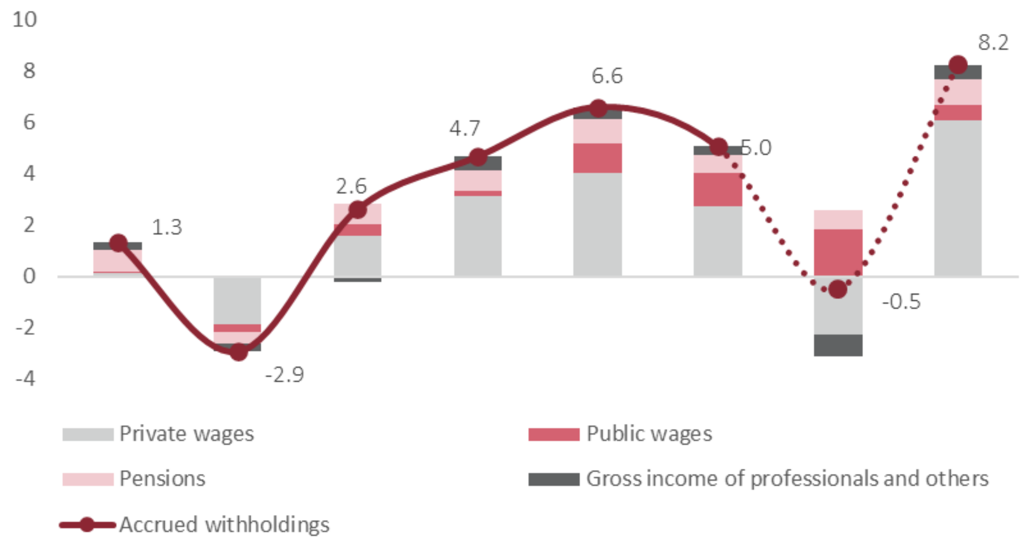
FIGURE 43. EVOLUCIÓN DE LOS INGRESOS POR IRPF (%PIB)



AIReF expects a smoother performance for Personal Income Tax during the period under analysis in contrast to the evolution of other taxes. AIReF estimates growth of around 4.3% for 2021. Its evolution will depend on two opposing elements. On the one hand, the most important part, that of withholdings, which will depend largely on the evolution of the wage bill made up of employment and wages, and, on the other hand, on the evolution of the net tax amount.

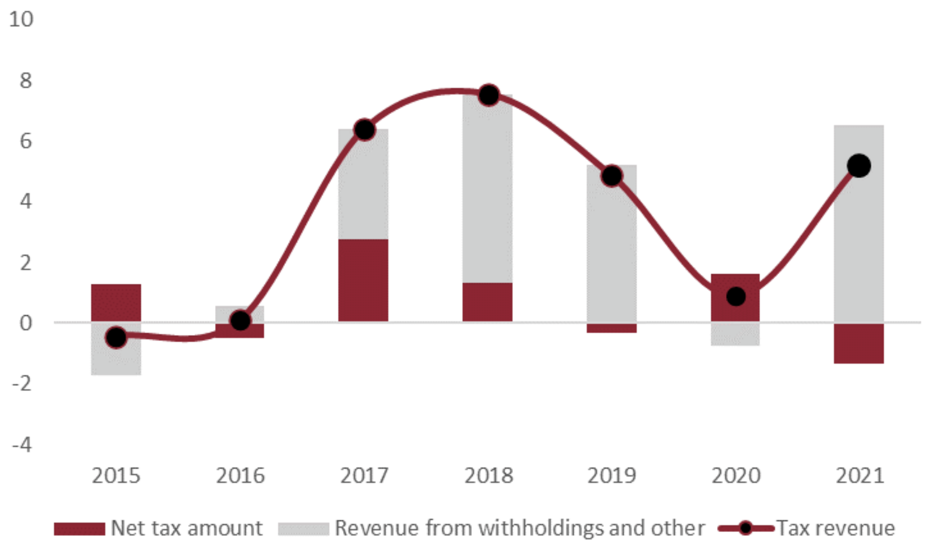
Withholdings, the main component of which is wages, will in turn perform differently in the public and the private sectors. Thus, for 2020, growth is expected where paid by the Government and significant falls where paid by the private sector. Withholdings resulting from public employees, with a known increase in their wages, have grown in 2020 even above the forecast prior to the pandemic due to the increase in health and education staff. Pensions also show a 0.9% increase in both 2020 and 2021. In contrast, there is a sharp contraction in withholdings from private wages in line with the forecast fall in private employment and wages in 2020 and a recovery in line with the growth of their base – employee remuneration. Consequently, although the stoppage of the economy has led to a major adjustment in both private employment and wages, its fall in 2020 is partially offset by the positive performance of the component where the Government is the payer, which accounts for 30% of the total of this type of income and which has even been strengthened in 2020 because of the pandemic. For 2021, the bases supporting these withholdings are expected to improve with growth of 8.2% on the previous year. However, in contrast with the previous year, the private wage component will be the main driver of growth. The contribution to growth of public income is lower than in 2020 as it will not grow as much as in the preceding year.

FIGURE 44. CHANGE (%) IN ACCRUED PERSONAL INCOME TAX WITHHOLDINGS



The net tax amount component will cause the percentages both fall in 2020 and the rise in 2021 to be smoothed out. The net tax amount relates to the previous year's campaign, with the good 2019 income tax campaign reflected in 2020 and a less positive one expected for 2021 as a fall is expected in income not subject to withholding linked to income from investment capital and capital gains, with the effect of the drop-in activity between the two years being diluted in the case of income tax.

FIGURE 45. CONTRIBUTION TO GROWTH BY COMPONENT IN PERSONAL INCOME TAX (% CHANGE)

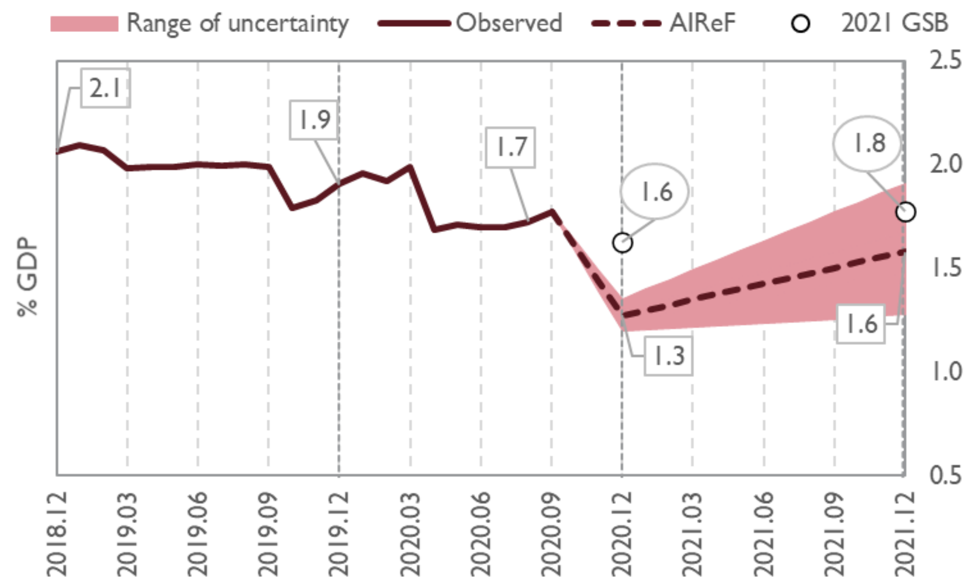


Personal Income Tax will grow by 0.9% to 5.2% in national accounts terms in 2020 and 2021. A lower cash adjustment to national accounts is expected in 2020 compared with 2019 largely as a result of the absence of the adjustment for the refund of maternity benefits and a lower adjustment for the time lag between the cash and the accrual of the first few months. The opposite would be the case with this time lag adjustment in 2021, which is expected to increase compared with 2020. The set of national accounts adjustments will result in a lower rate of change compared with the collection in 2020 and a higher rate for 2021.

4.2.2. Corporate Income Tax

AIReF estimates a fall in Corporate Income Tax in 2020 of 40.3% and a rebound in 2021 of 36.2%. The evolution of the tax in 2020 is affected not only by the base but also by various circumstances with opposing effects that cancel each other out. Firstly, there was an increase in collection as a result of the refund of approximately €1bn as following appeals against inspection reports from previous years. In addition, in 2019 there were reductions in collection due to the payment of a judgment for an amount of around €900m and DTAs for an amount of around €600m that are not repeated in 2020. In the opposite direction, there are higher returns as a result of the extraordinary instalment payment collected in 2018, settled in 2019, and largely paid in 2020. Although with a very limited effect, the COVID-19 measures cause a fall in revenue in 2020. Leaving aside these effects, the evolution of the tax has been linked to the macroeconomic variable that best reflects how this tax category behaves: the gross operating surplus. However, the mechanics of the tax and the definition of its taxable event mean that its tax base has different elasticities in the case of growth or contraction in economic activity, with the elasticities for recession estimated to be much higher.

FIGURE 46. CHANGE IN REVENUE FROM CORPORATE INCOME TAX (% OF GDP)



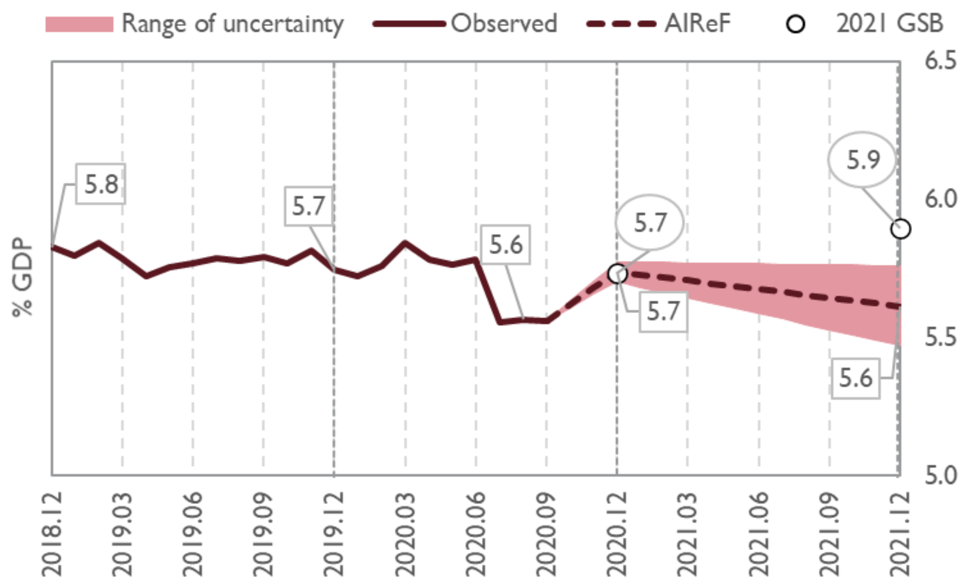
AIReF forecasts lower Corporate Income Tax revenue than the draft GSB, which incorporates a fall of 24.2% in 2020 and an improvement of 20.7% in 2021. At the end of 2021, AIReF forecasts about 0.2 points less in weight of GDP than that forecast by the Government in the GSB. AIReF estimates a sharper fall but also a faster recovery than that presented in the draft GSB. Therefore, the lower collection of Corporate Income Tax in 2020 with regard to that presented in the draft GSB is not amplified in 2021.

As with Personal Income Tax, the settlement of the tax will smooth out its evolution between 2020 and 2021. The mechanics of collecting the tax follow a similar pattern to that for Personal Income Tax, i.e., through withholdings paid over the year, specifically for this tax capital withholdings and three instalment payments, and a settlement with regard to what was paid the previous year. It is important to bear in mind the effect of higher cash refunds, which entail lower collection, but not lower revenue in national accounts terms, as these were recorded in 2019, in addition to the effect of DTAs. Both these circumstances will affect a higher adjustment in 2020 and a lower adjustment in 2021. This will transform the 40.3% fall in cash for 2022 to a more moderate fall in national accounts terms of 22%, while the opposite will happen in 2021, with the growth in tax revenue tempered to 13.7%.

4.2.3. VAT

AIReF estimates that VAT for 2021 will grow more moderately than forecast in the draft GSB, by 7.2% compared with 13.9%, after a drop of 10.6% in 2020 in line with the 11.4% contraction in the GSB. This difference is carried over to 2021 at 0.3 points of GDP weight. The alignment of the 2020 forecast between AIReF and the Government is partly because the first nine months of the year are known both in cash and in national accounts and no differential assumption is forecast for the fourth quarter with regard to the evolution of the cash figure. So far this year, VAT has fallen by 13.2% compared with last year, with a fall of 2.4% expected for the last quarter. The collection of the tax reflects with a certain time lag the evolution of the accrual as it reflects revenue from months not affected by the pandemic up to May. This means that the cash evolution of the forecasts shows a smoother behaviour in the fall and in the recovery compared with the accrual or in terms of national accounts. Thus, a fall of 13.3% and a recovery in 2021 of 11.8% is expected in national accounts, in line with the evolution of private consumption and investment in housing.

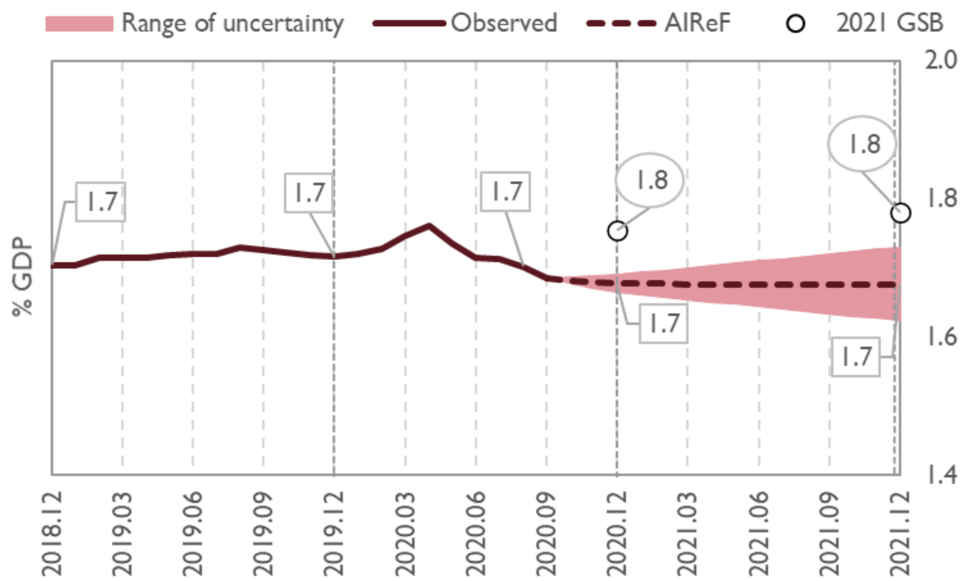
FIGURE 47. EVOLUTION OF VAT REVENUE (%GDP)



4.2.4. Special Taxes

AIReF forecasts a 12.6% fall in Special Taxes in 2020 and a 9.5% improvement in 2021 compared with a 9.3% fall and a 12.4% rebound in the draft 2021 GSB. Their evolution will depend on the consumption of each good subject to the tax. The tax for which the largest fall is forecast in 2020 is the Tax on Hydrocarbons for which the absence of mobility severely restricts the amount of the tax that can be collected. The taxes on tobacco products and beer are those for which a better performance is forecast than for other taxes. A noteworthy aspect in the evolution of these taxes is, as with VAT, the effect of the collection in cash in the first few months of 2020, for which the taxable event accrues in 2019, which is expected to be higher than the corresponding amount collected in 2021 and accrued in 2020. This could act as a buffer for part of the fall in 2020 and the rise in 2021. Unlike VAT, this effect is reproduced in terms of national accounts as there are no differences between these two accounting concepts in these taxes.

FIGURE 48. EVOLUTION OF REVENUE FROM SPECIAL TAXES (% GDP)



4.2.5. Other tax revenue

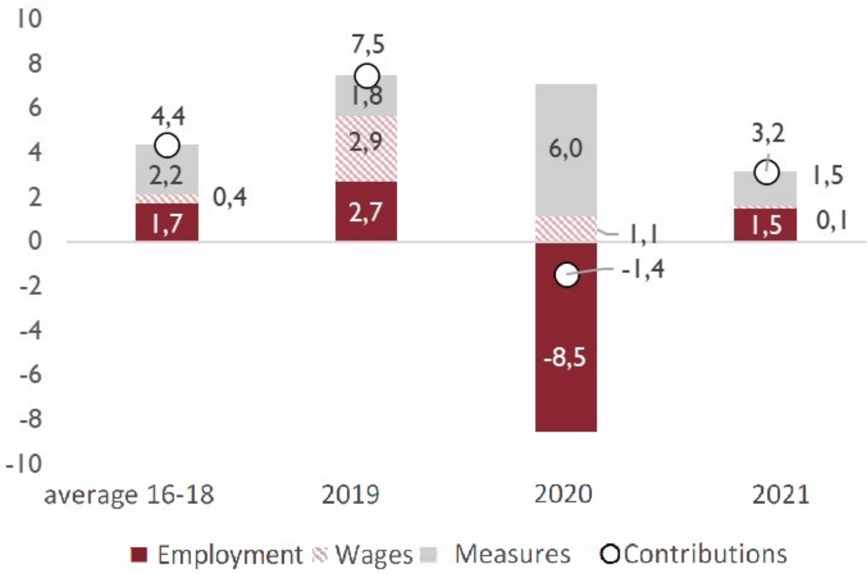
According to AIReF's forecast, other tax revenues fall by 6.9% in 2020 and are expected to rise by 25% in 2021. The sharp increase is due to the introduction of new tax measures. Regarding the evolution of the remaining tax revenue, 2020 is helped by the recovery of the Tax on Electricity Production, which was suspended for two quarters in 2019. Consequently, in this group of taxes, the fall is lower than that of GDP, with a decrease of 6.9% expected even though Non-resident Income Tax, one of the most significant taxes under this heading, is expected to fall by 28%. In 2021, an increase of 25% is expected due to the imposition of new tax categories for which a lower collection impact than that forecast by the Government is expected, as explained in the section on measures.

4.2.6. Social contributions

AIReF estimates that social contributions will amount to 14.2% of GDP in 2020 and 13.4% in 2021, while the Budgetary Plan estimates 14.2% for 2020 and 13% for 2020. Regarding the July estimate, AIReF has made an upward estimate of the contribution exemptions and incorporated a more positive macroeconomic outlook. With respect to 2021, the difference between the AIReF estimate and the Budgetary Plan estimate lies in both the starting point and in the valuation of the measures (0.2 pp), since AIReF considers that the ERTEs will continue until June, while the Budgetary Plan considers that they will end in January. AIReF considers a fall in 2020 of 1.4%, which is more positive than the 2.5% drop estimated in the Budgetary Plan. For 2021, AIReF considers a growth rate of 3.2%, with the 2019 level exceeded in 2021.

The determining factors of the contribution bases, wages and employment, together with the effect of the measures, explain the evolution both for 2020 and for 2021. The influence of employment is key to the fall, which is softened by the measures and, to a lesser extent, by rising wages. Both measures already adopted prior to the crisis and those focused on mitigating its effects are included both for 2020 and for 2021. The former, which mainly affect 2020, includes the increase in the contributions for non-professional caregivers (also includes the increase indicated for 2021 in the 2021 GSB), for recipients of the over-52 benefit (which will also affect 2021), a reduction in the flat-rate allowances and an increase in the minimum wage approved for 2020. Among the measures approved to tackle the crisis, which affect both years, the exemption from the payment of contributions for companies that make use of the ERTEs (in different percentages according to the period, the worker's situation and the company's size) and the self-employed people affected by the fall in activity are calculated as an increase in subsidies that are aimed at increasing the contributions for the exempt amounts.

FIGURE 49. BREAKDOWN OF GROWTH IN SOCIAL CONTRIBUTIONS



4.2.7. Other revenue

For the other revenue, AIReF expects a weight of 4% compared with the 4.2% of the Budgetary Plan in 2020 and high growth in 2021 due to revenue from the RRF, raising the weight of this revenue over GDP to 6.6% in both the AIReF and Government forecasts. In 2021, this revenue includes the Funds from the Recovery and Resilience Facility and REACT-EU quantified in national accounts terms at €34.634bn, although this amount corresponds to cash revenue of €6.788bn according to the draft GSB.

4.3. Evolution of General Government expenditure

AIReF's expenditure estimates stand at 52.5% of GDP in 2020 and at 50.5% in 2021, both lower than the path included in the Budgetary Plan. The path in the Budgetary Plan sets out an expenditure adjustment from 53% of GDP in 2020 to 50.8% in 2021, including the RTRP. This reduction is mainly due to expected GDP growth in 2021 (denominator effect), as an increase of millions of euros is expected compared with 2020. This growth is mainly driven by the implementation of RTRP projects and reforms, which will mainly affect investment aid and other capital transfers, gross capital formation and, to a lesser extent, intermediate consumption. AIReF has assumed as a working hypothesis that the RTRP will be executed as set out in the draft GSB, which differs in the breakdown by headings from the Budgetary Plan. In nominal terms, the expenditure estimates of AIReF and the Budgetary Plan are aligned.

The difference is due to AIReF expecting a lower GDP fall in nominal terms. In contrast, in 2021 it is due to the different evolution expected in nominal terms.

TABLE 14. DIFFERENCE IN EXPENDITURE BETWEEN AIREF AND BUDGETARY PLAN (% GDP)

	2020			2021		
	DBP	**AIReF**	*Difference*	**DBP**	**AIReF**	*Difference*
EXPENDITURE	**53.0**	**52.5**	**-0.5**	**50.8**	**50.5**	**-0.4**
Compensation of employees	12.9	12.7	-0.1	12.0	12.0	0.0
Intermediate Consumption	6.4	6.4	-0.1	6.4	6.1	-0.3
Social transfers	24.2	23.6	-0.6	21.7	21.1	-0.5
Interest	2.3	2.3	0.0	2.2	2.1	-0.1
Subsidies	2.0	2.0	0.0	1.4	1.5	0.1
Gross capital formation	2.5	2.7	0.1	3.6	3.8	0.2
Capital transfers	0.7	0.8	0.1	1.6	1.6	0.1
Other	1.9	2.0	0.1	2.0	2.2	0.1
NET LENDING OR BORROWING	**-11.3**	**-11.6**	**-0.2**	**-7.7**	**-8.0**	**-0.3**

FIGURE 50. DIFFERENCE IN EXPENDITURE BETWEEN AIREF'S SCENARIOS AND THE BUDGETARY PLAN

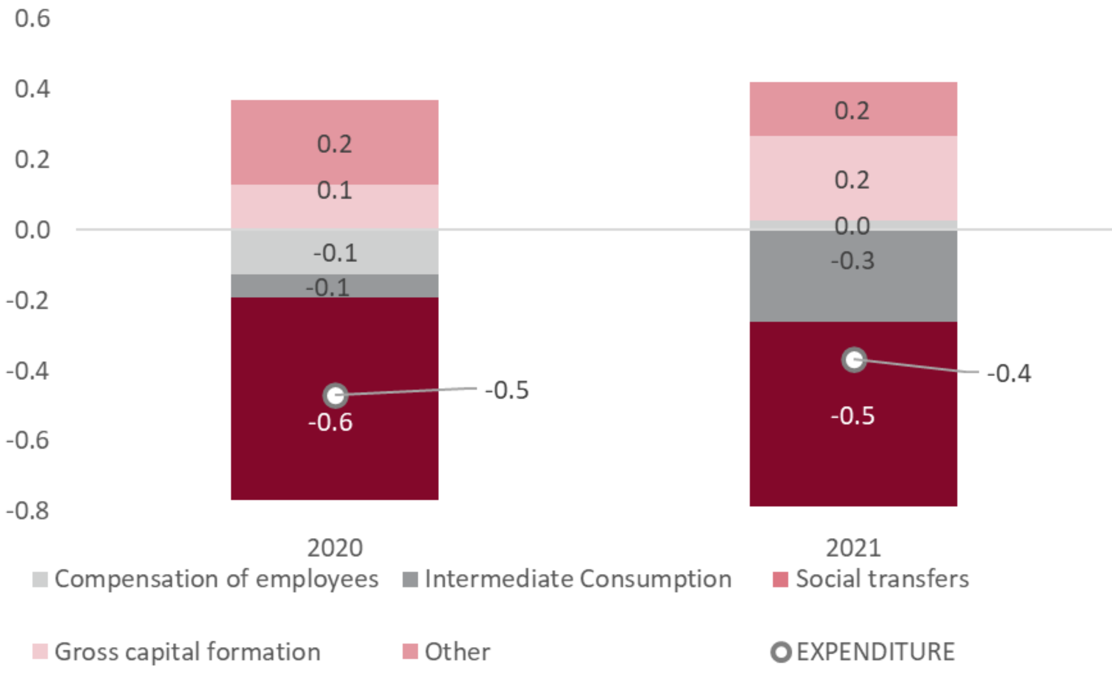
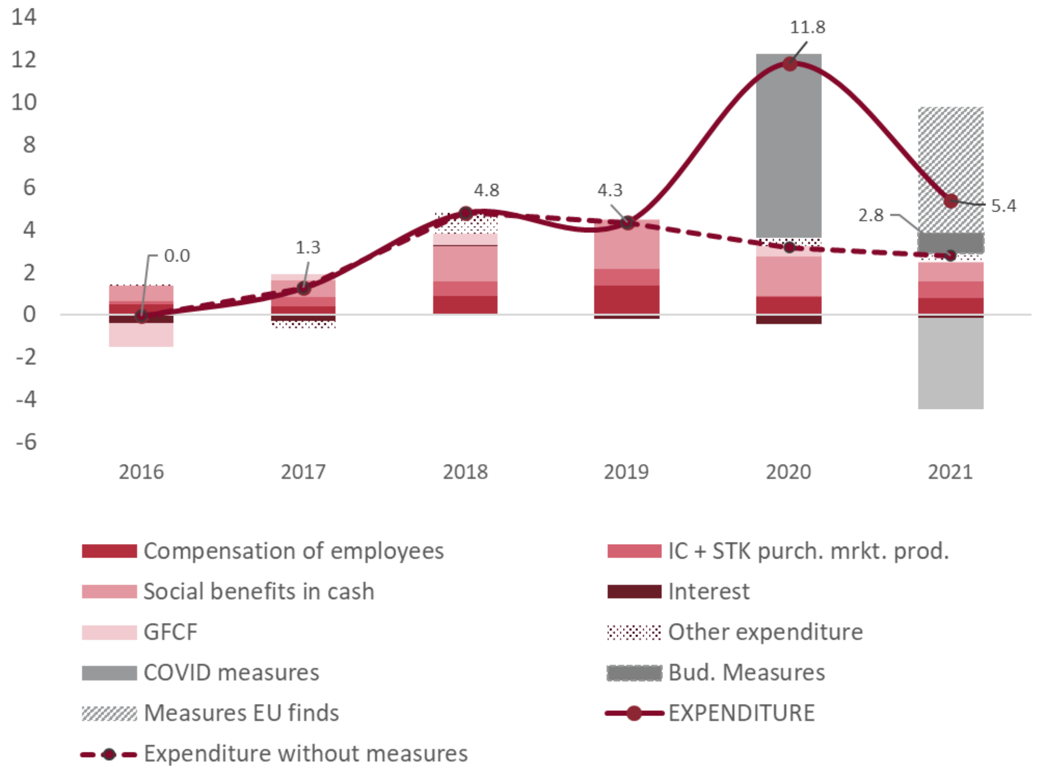
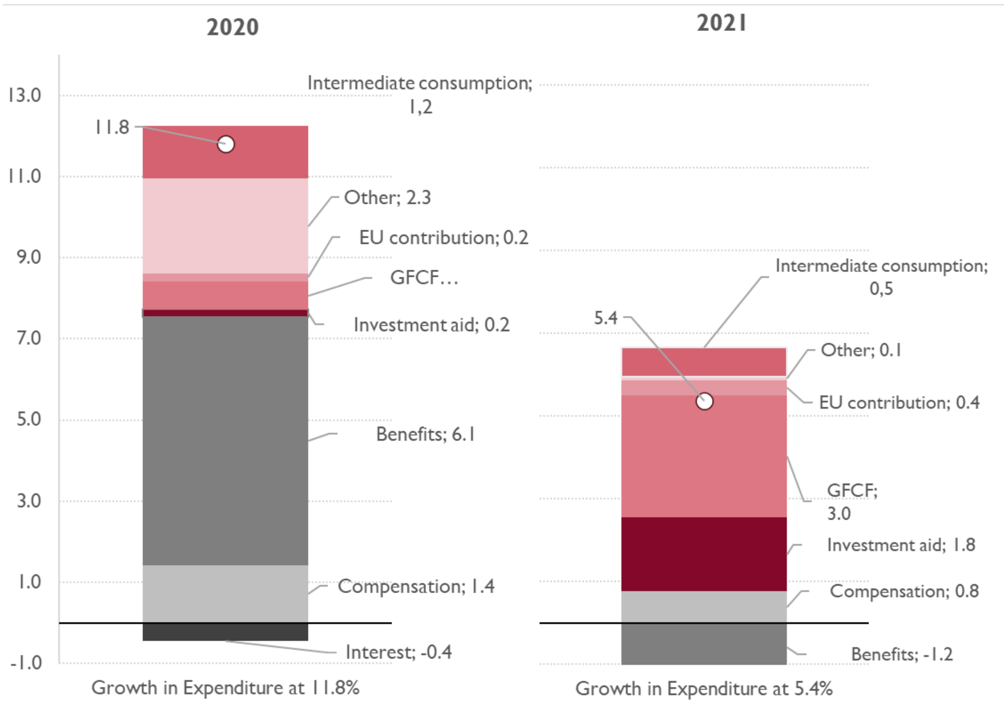


FIGURE 51. CONTRIBUTIONS TO THE CHANGE IN EXPENDITURE (%) AIREF



Following the sharp expected increase in expenditure in 2020, AIReF estimates a slight reduction in expenditure in 2021 of 0.6% excluding the RTRP. Compared with the 11.8% growth expected in 2020, AIReF estimates growth of 5.4% for 2021 with the RTRP and of -0.6% without the RTRP. This is mainly explained by the fall in expenditure linked to the pandemic in cash social benefits, such as unemployment benefits associated with the ERTEs and other extraordinary subsidies resulting from the state of alarm, together with expenditure on temporary incapacity for work. There is also expected to be a fall in the item of other expenditure, which includes the reduction in 2021 of the spending on subsidies as a result of the cost of the 2020 measure of exemptions from social contributions. In 2021, growth is moderated and mainly concentrated on the items of capital expenditure (gross capital formation, as well as investment aid and other capital transfers) driven by the expenditure on investment projects and reforms associated with the RTRP.

FIGURE 52. CONTRIBUTION TO THE GROWTH IN EXPENDITURE 2020-2021. GENERAL GOVERNMENT IN % GDP.



4.3.1. Main components of public consumption expenditure

Regarding the compensation of employees, AIReF's forecasts are in line with those of the Budgetary Plan, both for 2020 and 2021. For 2020, AIReF forecasts a lower weight for this heading, 12.7% of GDP, than that forecast in the Budgetary Plan as a result of the higher estimated nominal GDP. For 2021, AIReF's estimates would mean a reduction of 0.7 points of GDP with respect to 2020, to stand at 12% of GDP, with nominal growth of around 3%. This lower expected increase for 2021 is explained, on the one hand, by expiry of the Government-Trade Union Agreement for the improvement of public employment (2018-2020), which means a wage increase in line with the expected CPI (0.9%) in contrast with the 2% agreed for 2020. In addition, a further increase in recruitment is not expected, although the recruitment carried out in 2020 in health and education in order to deal with the pandemic is expected to be maintained in the first half of 2021 and then gradually reduced, which will have a particular impact in the area of the autonomous regions.

AIReF forecasts lower expenditure on intermediate consumption than that included in the Budgetary Plan for 2021, but in line with that forecast for 2020. For 2020, AIReF forecasts that intermediate consumption will stand at 6.4% of

GDP, the same figure as the Budgetary Plan. For 2021, AIReF forecasts that expenditure will fall to 6.1% of GDP, 0.3 points of GDP lower than the figure estimated by the Government. AIReF's forecasts reflect expenditure associated with purchases of medical supplies to continue fighting COVID-19, although to a lesser extent than in 2020. Added to that will be the expense of mass distribution of the vaccine. It is also important to highlight that part of this healthcare expenditure will be financed by REACT-EU and the RRF. Furthermore, as a result of the suspension of fiscal rules in 2021, local Governments can apply their savings from previous years to strengthen the provision of services, mainly social services including dependency care in order to mitigate situations of special needs resulting from COVID-19. This is particularly significant under the heading of intermediate consumption.

AIReF expects social transfers in kind to amount to 3% of GDP for 2021, slightly above the 2.9% forecast by the Government. AIReF's forecast is that the benefit will grow in 2021 slightly below GDP, thus reducing its weight by 0.1 points, compared with the fall of 0.3 points forecast in the Budgetary Plan. The increases in this item are mainly expected at a territorial level. In the regions, it will mainly be driven by strong expenditure on education, maintenance of the healthcare expenditure on pharmaceuticals and healthcare agreements in the first half of the year and the impact of the REACT-EU and RRF funds.

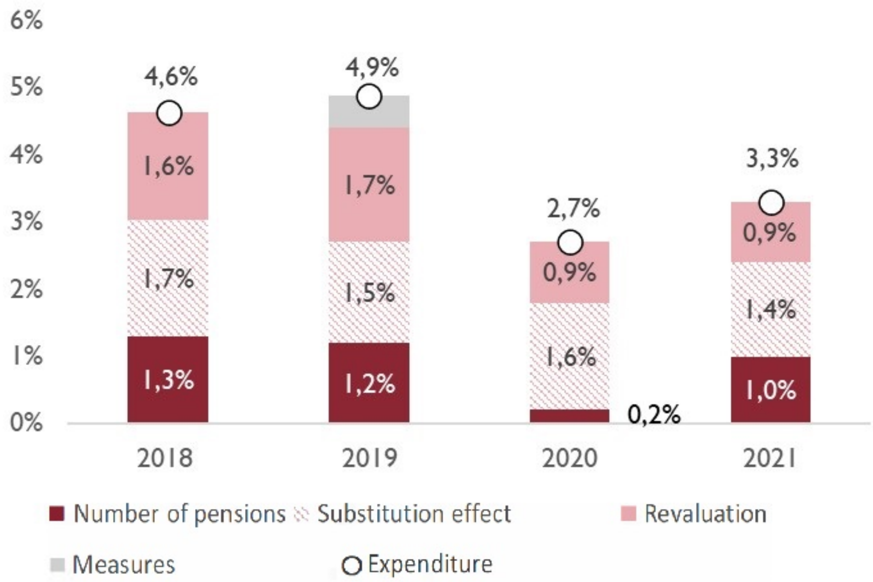
4.3.2. Social Transfers in Cash

AIReF forecasts that social transfers in cash will increase to stand at 20.5% of GDP in 2020, falling to 18.2% in 2021, compared with the 21% and 18.5%, respectively, forecast in the Budgetary Plan. This heading accumulates three effects: firstly, the impact of the measures taken in 2020 as a result of COVID-19 that will affect both 2020 and 2021; secondly, that of other expenditure measures approved in 2019 but which extend their effects to 2020 and even 2021, and finally, the measures included in the 2021 GSB. The first of these effects include unemployment benefits linked to the ERTEs and other extraordinary subsidiaries resulting from the state of alarm, together with spending on temporary incapacity for work, which are the COVID-19 crisis measures that account for the highest expenditure. With regard to the 2019 measures, the effect of increased pension expenditure, extended paternity leave, improved dependency care and unemployment benefits for people over 52 years of age is expected. The effect of lower GDP must also be added to this. With regard to the measures included in the 2021 GSB, the 5% increase in the IPREM (Public Multiple-Effect Income Indicator) and the 1.8% rise in the MLI and non-contributory pensions are included. In 2021, the weight of this heading would fall to 18.2%. For 2020, the difference with the Budgetary Plan is almost entirely due to the higher estimated cost for the COVID-19 measures by the Government with regard to 2021. The weight of this heading is 0.3 points higher than AIReF's. However, AIReF estimates a higher cost of the COVID-19 measures and pension growth than the Government, expenditure on unemployment that is similar (GSB) or higher (Budgetary Plan) than that of the Government and similar expenditure on the MLI.

Social transfers in cash increase by 4.7 points of GDP in 2020 from 15.8, and fall by 2.4 points in 2021. Of the differences existing with the Budgetary Plan for 2020, 0.4 points are due to the higher cost estimated for the ERTEs, self-employed workers, temporary incapacity for work and minimum living income measures in the Budgetary Plan (€26bn compared with €21.8bn in AIReF's estimate). For 2021, the estimate of the weight over GDP of the heading is lower for AIReF, even though AIReF's estimate of the measures is higher (€8.5bn compared with €4.1bn in the Budgetary Plan). This implies that the Government has considered an excess of around €5bn with regard to AIReF's estimate in some of the components. Only the weight of unemployment is specifically mentioned, which is 1.5% of GDP for the Budgetary Plan compared with the 2% estimated by AIReF. However, the 2021 GSB indicates that the expenditure on unemployment forecast for 2021 will be €25bn (2.1% of its GDP), which is in line with the expenditure estimated by AIReF.

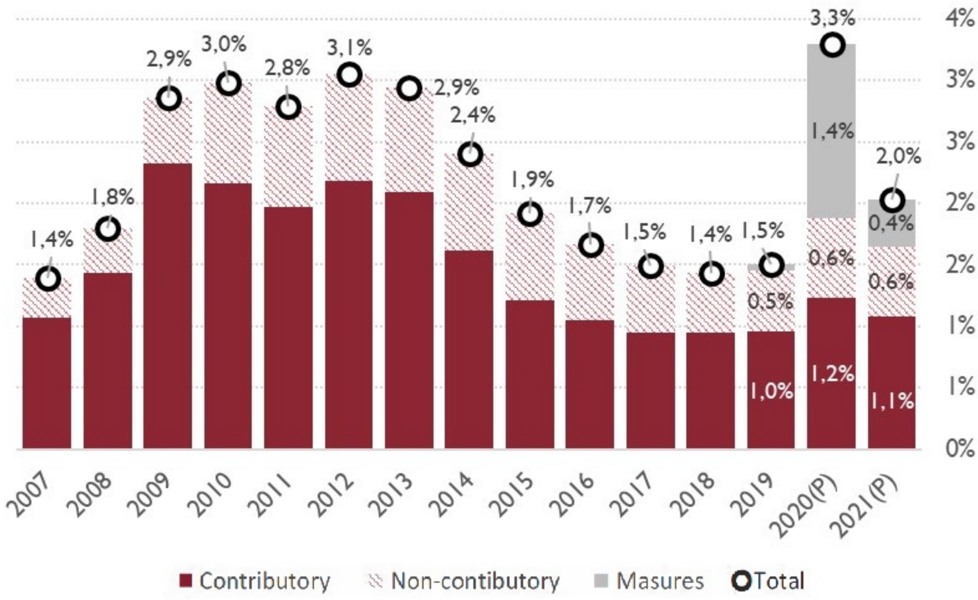
AIReF estimates a 2.7% increase in pension expenditure for 2020, in line with that indicated in the 2021 GSB, and of 3.3% in 2021, 0.3% more than that estimated by the Government. This lower growth for 2020 is because the COVID-19 crisis has affected the growth in the number of pensions, reducing it from the 1% originally estimated to 0.2%. It is expected that the growth in the number of pensions will once again be 1% in 2021. For both years, a revaluation of 0.9% is considered. The cost of revaluing non-contributory pensions at 1.8% in 2021, as set out in the 2021 GSB, is included. Regarding the substitution effect, the data for 2020 indicate a reduction mainly due to the measures in 2019. Therefore, although we maintain a substitution effect of 1.6% for 2020, we reduce it to 1.4% for 2021.

FIGURE 53. GROWTH IN PENSION EXPENDITURE. AIREF PROJECTIONS



Unemployment benefits rise from 1.5% of GDP to a weight of 3.3% of GDP in 2020 and 2% in 2021, 0.5 points above the 1.5% published in the Budgetary Plan, but in line with the gross cost of €25bn (2.1% of its GDP) published in the 2021 GSB. This heading includes the cost of the ERTEs, the payment of unemployment benefits to temporary workers who were not entitled to it and the cost of the benefits for domestic workers. The increase mainly results from the measures taken by Central Government to tackle the COVID-19 crisis, which could amount to about €15bn in 2020 and about €4bn in 2021. In addition, it also includes non-extraordinary measures approved prior to the crisis, such as the subsidy for people aged over 52 and the increase in the national minimum wage. Finally, the cost of the measures included in the 2021 GSB has been included, specifically the impact of raising the IPREM (Public Multiple-Effect Income Indicator) by 5% on the cost of unemployment benefits.

FIGURE 54. EVOLUTION OF UNEMPLOYMENT EXPENDITURE % OF GDP. AIREF'S FORECASTS



The other items under the heading are also affected by the extraordinary measures, with their weight over GDP rising by 0.9 points over 2019 to stand at 2.1% in 2020, falling to 1.8% in 2021. Expenditure for Temporary Incapacity for Work includes the cost of sick leave due to infection and quarantine resulting from the COVID-19 virus and is expected to be maintained until June 2021. Other benefits include the cost of the benefit for cessation of activity for self-employed workers, which is estimated to remain in force until January 2021. The MLI and its revaluation of 1.8% for 2021, set out in the 2021 GSB, is also included.

4.3.3. Other expenditure

Subsidies

Subsidies rise by 1 point to 2% of GDP in 2020, falling by 0.5 points in 2021, mainly as a result of contribution exemption measures. In 2020, contribution exemption measures raise the weight of subsidies by 0.8 point of GDB. The reduction in 2021 is also due to the contribution exemptions, the weight of which falls to 0.2 points of GDP. In addition, the granting of aid as a result of the measures taken due to COVID-19 has led to an increase in subsidies in the CG and regional sub-sectors.

Interest

AIReF forecasts a slightly larger reduction in interest expenditure for 2021 than that set out in the Budgetary Plan. While for 2020, the estimates of AIReF and the Budgetary Plan are aligned at about 2.3% of GDP, for 2021 AIReF forecasts lower expenditure, with this heading standing at 2.1% of GDP compared with 2.2% for the Government. Despite the increase in debt linked to the worsening of the deficit due to the COVID-19 economic crisis, interest expenditure is forecast to decrease as a result of savings from ongoing very low interest rates, in a context in which the risks of monetary policy changes that might raise rates have faded.

Gross capital formation

The increase in gross capital formation forecast by AIReF for 2020 and 2021 is higher than that of the Budgetary Plan. For both years, AIReF expects expenditure under this heading to be at least around 0.2 points of GDP above the Budgetary Plan. In 2021, AIReF expects this heading to rise to 3.8% of GDP from the 2.7% of GDP forecast for 2020. The increase is mainly due to expenditure on investment projects and reforms that are expected to be financed from EU funds, both REACT and the RRF, in the area of the CG and of the regions and local Governments. These funds may involve over €16bn for the General Government in 2021, which mainly affects the Central Government and regional sub-sectors.

Other expenditure

With regard to the other expenditure items, AIReF's estimates are in line with those of the Budgetary Plan, except for other current expenditure, for which AIReF's forecast for 2021 is 0.2 points of GDP higher. The expected evolution for other expenditure is, in general, very similar to that considered by the Government. Of note is the expected increase in the investment aid and other capital expenditure headings due to the effect of the start-up of RTRP projects. However, there is some difference compared with other current expenditure, where AIReF expects greater growth in the heading of other current transfers, mainly as a result of the increase in scholarships planned in the 2021 GSB for that year and the application of European funds at a regional level.

4.4. Analysis by sub-sector

AIReF forecasts a larger deficit than the Budgetary Plan for the CG and the SSFs and a smaller deficit for the regions in 2021. By sub-sector, the CG will continue to take on part of the deficit of the other sub-sectors, Social Security Funds and regional Governments 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. For 2020, AIReF estimates a greater deficit of the CG compared with the reference rate of the Budgetary Plan, partially offset by the SSFs, while there are no significant differences in the regional Governments. For 2021, however, both the CG and the SSFs would have a higher-than-estimated deficit, while the regions would have a deficit lower than the reference of the Budgetary Plan, with local Governments standing at around the reference rate of said Plan.

4.4.1. Central Government

AIReF estimates that the CG deficit could reach 7.2% in 2020, falling to 5.6% in 2021. The sharp deterioration of the deficit in 2020 is the result, firstly, of the fall in revenue as a consequence of the drop-in activity, which is estimated at 11.5%, coupled with maintenance of the financing system instalment payments paid to regional and local Governments at 2019 levels. Secondly, there is a rise in expenditure that is largely the result of the increase in transfers made by the State to the SSFs and to the regions. In 2021, the balance is expected to improve by 1.6 points of GDP as a result of the recovery in activity and the new legislative measures. Coupled with the impact of the RTRP, this will lead to revenue growth of 24.6%, which, without the effect of the PRTR, would be 10.7%, and without the effect of legislative measures and the RTRP, 8.8%. On the expenditure side, an increase of 13% is expected in 2021, with 8.7% of total expenditure financed by the RTRP. In addition, extraordinary financing to other sub-sectors continues in 2021, as the transfer to the sub-sectors of the SSFs and the regions is consolidated and even increased in 2021. This expenditure accounts for close to 12% of the CG's total expenditure. However, part of the transfers to the SSFs becomes permanent when financing expenses considered as "improper" according to the conclusions and recommendations of the Toledo Pact.

AIReF forecasts that the CG's revenue will amount to 19.5% of GDP in 2021, boosted by the RTRP, after ending 2020 at 17.2% of GDP. The fall in the weight of GDP is small as the fall in revenue remains in line with the fall in GDP. The same effect also occurs in 2021. The evolution of revenue follows the upward path of GDP although in a more limited way. This would explain a fall in the weight of revenue in GDP, excluding the RTRP, of 0.2 points. The RTRP funds explain growth in revenue of 2.2 points and, to a lesser extent, the tax changes contained in the Budget and the new tax categories would contribute 0.3 points.

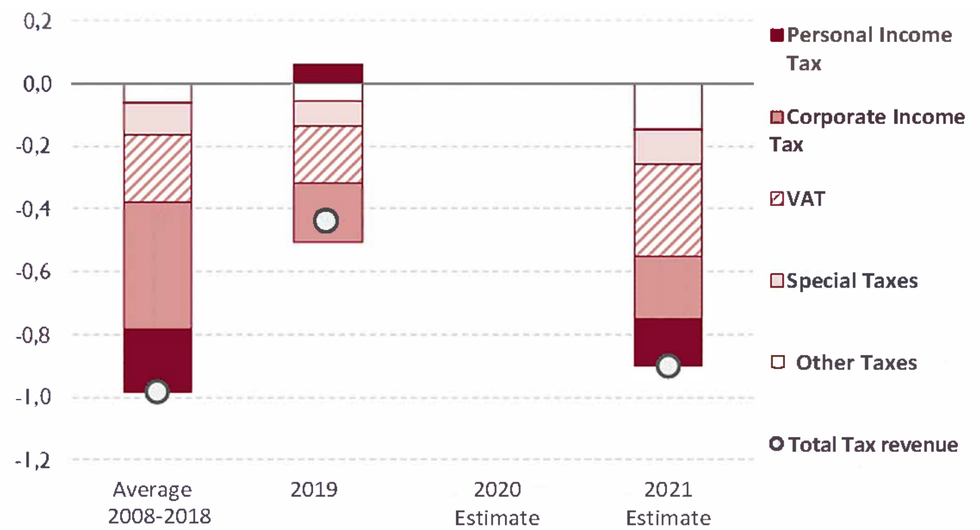
The larger fall in tax revenue relative to GDP in 2020 and greater containment when GDP grows in 2021 is partly explained by the system of regional and local financing. The CG absorbs the fall in revenue in its entirety in 2020 as the instalment payments are not updated with the real revenue forecasts. In 2021, it would receive the lower collection forecast by AIReF compared with the forecasts contained in the Budgetary Plan, which has been used to calculate the instalment payments. In addition, there are also certain measures included in the Budgetary Plan that in the end did not appear in the draft 2021 GSB.

Regarding non-tax revenue, AIReF forecasts growth of 0.2 points of GDP in 2020 and 1.9 points in 2021 to reach a weight of 5.7%. The growth of 0.2 points in 2020 is largely due to reversal to the State of a motorway, which is also recorded as an investment. This would consequently explain a loss of 0.2 points in the weight of this revenue in 2021. In 2021, in national accounts terms, revenue linked to the RTRP amounts to 2.2% of GDP, although of these 2.2 points, 1 point will be for financing the CG's own expenditure, while the rest is for financing the actions of other sub-sectors.

Deviations in the budgetary estimate

Tax revenue will be about €10bn below budget, about 0.9 points of GDP. This deviation forecast for 2021 is higher than that recorded in 2019 (the last complete year), but is in line with the average of the period between 2008 and 2018, which stands at over €15bn. Figure 55 shows the deviation or budgeting error, which is calculated by comparing the revenue forecasts included in the Budget with the actual collection after deducting the positive or negative impact on collection of any legislative measures approved subsequent to approval of the GSB for each year.

FIGURE 55. DEVIATION OF REVENUE WITH REGARD TO APPROVED BUDGET (*)



(*) *Deviation = Revenue without impact of measures approved subsequent to the GSB - Budgeted*
Positive: Revenue collected > Budgeted
Negative: Revenue collected < Budgeted

The deviation will occur in practically all taxes, with the greatest differences mainly recorded in VAT and Corporate Income Tax. VAT collection is expected to be approximately €3.6bn lower than budgeted. The possible cause of this deviation would be lower bases than those forecast by the Government as a result of lower domestic demand. In the case of Corporate Income Tax, the deviation would be the result of a lower recovery in companies' expected profit.

Non-financial expenditure limit

The non-financial expenditure limit for 2021 was set by the Government at €196.097bn but was incorporated into the draft 2021 GSB at the lower amount of €194.457bn. Through the resolution of 6 October, the Council of Ministers set the non-financial expenditure limit for 2021 at an amount of €196.097bn. However, after defining the tax measures eventually adopted and the final impact of the Funds of the Recovery Plan for Europe ("Next Generation EU"), this amount stands at €194.457bn, lower than the expenditure limit set by the Government. This figure does not include special defence modernisation programmes.

The non-financial expenditure limit incorporated in the draft 2021 GSB entails an increase of 21.8% over the expenditure limit, calculated with final appropriations, for 2020. The non-financial expenditure limit incorporated in the draft 2021 GSB amounts to €194.457bn, 21.8% higher than the 2020 expenditure limit calculated with the final appropriations and 52.4% above the approved limit, calculated with the initial appropriations. The exceptional situation caused by the pandemic means that the expenditure limit for 2021 will be much higher than the average annual increase in previous years. Most of this exceptional increase is due to an increase in expenditure on items without equivalence in previous years. Firstly, extraordinary expenditure transfers to absorb part of the deficit of other sub-sectors and, secondly, expenditure on investment projects and reforms that are expected to be financed with the funds of the Recovery Plan for Europe ("Next Generation EU").

The non-financial expenditure limit should be compatible with the deficit of 5.2% of GDP set as a reference for the CG for 2021. On an exceptional basis, there are no stability targets, and no expenditure rule has been approved for 2021. Only reference deficit amounts have been set for General Government, which for the CG stands at 5.2% of GDP. In this regard, the non-financial expenditure limit for 2021 calculated by the Ministry of Finance should allow, with the revenue forecast for that year, the approved 2021 GSB to be consistent with reaching a deficit of 5.2% of GDP in national accounts terms.

Since 2016, in the draft 2017 GSB, the Government has not published details on the national accounts adjustments necessary to reproduce the calculation of the non-financial expenditure limit. To calculate the non-financial expenditure limit, it is necessary to estimate non-financial revenue and the adjustments to national accounts, which allows the equivalence between the budgetary balance and the balance expressed in national accounts to be shown. The estimate of these adjustments must be published in the GSB (Articles 6 and 27 of the Organic Law on Budgetary Stability and Financial Stability). Despite this legal obligation and AIReF's repeated recommendations in the same regard, the Ministry of Finance has not published the details of these adjustments since the 2017 GSB. The better the estimate of these two variables, the greater the possibility that the calculated non-financial expenditure limit will allow the target deficit to be met. In contrast, an overly optimistic estimate, or one that is too unrealistic, would make this possibility less likely.

According to AIReF's non-financial revenue forecasts, the expenditure allowed by the non-financial expenditure limit would lead to a deficit excess of 1.2% of GDP over and above the reference deficit of 5.2% of GDP. The Ministry of Finance estimates non-financial revenue of 12.7% of GDP for 2021, while AIReF's forecast is lower, at 11.5% of GDP. Both figures include the expected revenues from extraordinary funds from the EU for 2021 amounting to €6.887bn (0.6% of GDP). Apart from these funds, AIReF's forecast of non-financial revenue is less optimistic than that of the Ministry of Finance. From the point of view of calculating the non-financial expenditure limit, if this is calculated with AIReF's revenue forecasts and keeping the other variables constant, it would be 1.2% of GDP lower than that set by the Ministry of Finance (see table).

AIReF has estimated the national accounts adjustments at 2% of GDP, which would mean a positive deviation of 0.6% of GDP from the CG reference deficit. In view of the lack of transparency in relation to these adjustments, AIReF has made its own estimate of the adjustments with the information available. In addition, the total of the Ministry of Finance adjustments can be calculated as the difference between the non-financial expenditure limit incorporated in the 2021 GSB and the other elements involved in its calculation, since all are known except for the adjustments. These adjustments calculated by difference amount to 1.4% of GDP, much higher than the last published amounts of the adjustments (-0.1% of GDP on average in the period 2013-2016). This higher amount is due to the large adjustment expected in 2021 to reconcile the estimated budgetary revenue to be collected from the Recovery Plan funds (€6.887bn) and that which would correspond in national accounts terms according to the expenditure to be carried out financed with these funds (€26.5bn). According to AIReF 's national accounts adjustments and keeping the other variables constant, the non-financial expenditure limit could be 0.6 point of GDP higher than that included in the 2021 GSB to achieve the deficit of 5.2%. Finally, if all the variables were those estimated by AIReF, the non-financial expenditure limit would be 0.2% of GDP lower than that included in the 2021 GSB (see table).

TABLE 15. TABLE. NON-FINANCIAL EXPENDITURE LIMIT CALCULATED BY THE MINISTRY OF FINANCE AND EXERCISE FOR APPROXIMATING THE CALCULATION OF THE NON-FINANCIAL EXPENDITURE LIMIT (% GDP)

(in % GDP)

	Ministry of Finance Forecast	Ministry of Finance Forecast, except AIReF revenue forecast	Ministry of Finance Forecast, except AIReF NA adjustments forecast	AIReF Forecast
1. 2021 deficit	5.2	5.2	5.2	5.6
2. Revenue forecast	12.7	11.5	12.7	11.5
3. National Accounts adjustments	1.4	1.4	2.0	2.0
4. Expenditure FS TAs	3.2	3.2	3.2	3.2
5. Special defence programmes	0.2	0.2	0.2	0.2
6. Non-Fin. Exp. Lim. (6)=(1)+(2)+	15.9	14.7	16.5	15.7

Note: all percentages are calculated on the GDP forecast by AIReF for 2021

BOX 5. NON-FINANCIAL EXPENDITURE LIMIT OR EXPENDITURE CEILING

What is it?

It is the maximum non-financial expenditure that can be included in the GSB so that, considering the forecast non-financial revenue, the deficit target and expenditure rule set for the financial year are met.

What is it for?

It is a budgetary management tool which seeks to ensure that the GSBs to be approved are consistent with the targets set. By setting a maximum for non-financial expenditure that can be considered when drafting the GSB, it is a very useful tool for curbing the pressures to raise expenditure that may emerge both from internal negotiation (expenditure requests by ministerial departments) and external negotiation (from political parties in the process of parliamentary approval of the GSB).

Who approves it?

It is approved by the Government by means of a resolution of the Council of Ministers, without the need for subsequent approval by Parliament. For 2021, it was set by a resolution of the Council of Ministers of 6 October 2020.

How does it differ from the expenditure rule?

Although both are expenditure limitations, they are different instruments each with its own purpose:

Purpose: The expenditure ceiling is used to set a maximum expenditure in budgetary terms that allows a Budget to be approved that is consistent with meeting a given deficit expressed in national accounts terms. While the expenditure rule limits the maximum annual increase in expenditure in national accounts terms compared with the previous year, with the aim of serving as an instrument for fiscal control and discipline.

Calculation: The expenditure ceiling covers budgetary non-financial expenditure less expenditure from the regional and local financing system. Unlike the above limit, the expenditure rule also excludes interest, expenditure funded by the EU and other public administrations. It also considers the adjustments for converting the budgetary expenditure into national accounts terms.

How is it calculated?

Its calculation can be summarised in three steps (see graph):

Firstly, a theoretical non-financial expenditure is obtained by summing the deficit allowed by the target plus the expected revenue. While the deficit target or, in this case, the deficit reference rate, is expressed in national accounts terms, the revenue forecast is in budgetary terms.

Secondly, the theoretical expenditure obtained is converted into budgetary expenditure by applying the expected adjustments in the period for the different criteria used to calculate certain operations in the Budget and in national accounts.

Thirdly, expenditure in budgetary terms is reduced by the State expenditure under the regional and local financing systems.

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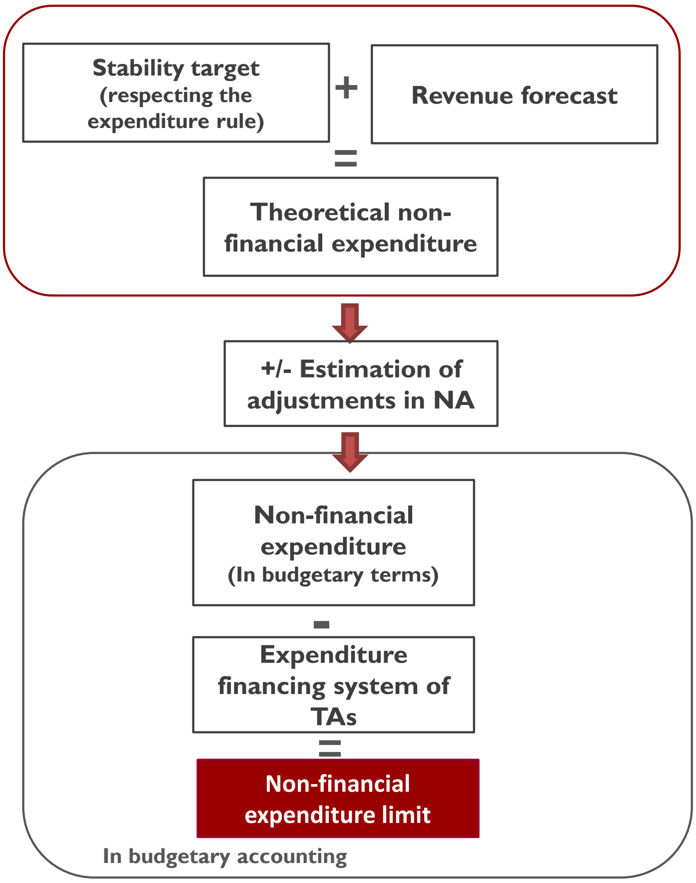


BOX 6. NATIONAL ACCOUNTS ADJUSTMENTS

What are they?

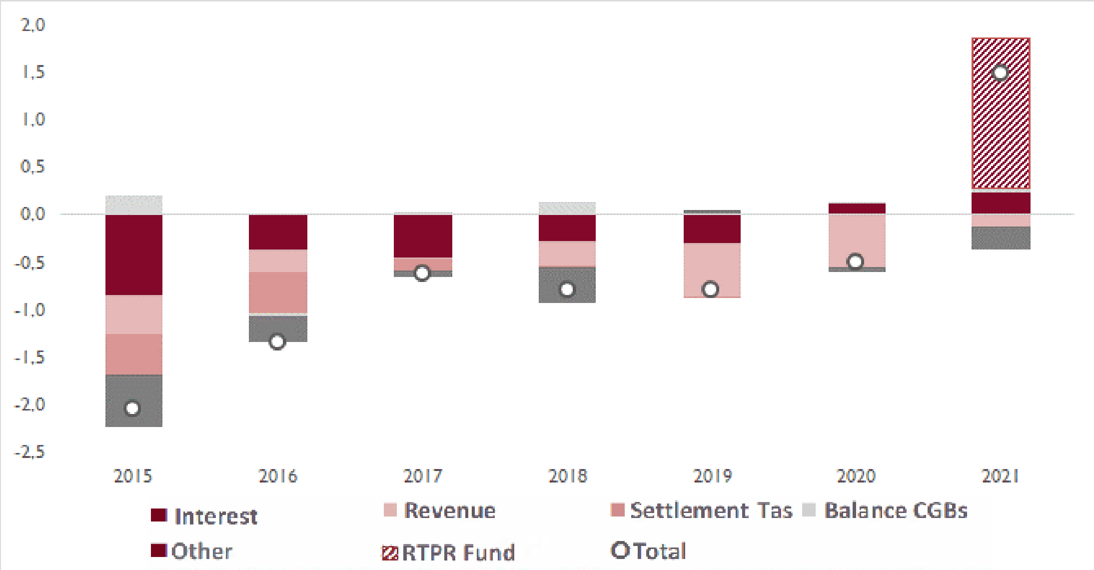
These are the differences in the valuation of non-financial revenue and expenditure between budgetary accounting and national accounting. Therefore, their calculation makes it possible to convert the State's budgetary balance into the CG's net lending/borrowing in national accounts terms.

National accounts criteria differ from the budgetary methodology in various aspects. The main difference is in the criterion for recording expenditure and revenue such that while in national accounts a general accrual criterion is applied, the cash criterion applies in the Budget. Furthermore, there are financial operations in the Budget that are considered non-financial by national accounts and *vice versa*. Therefore, in the Budget these operations do not have an impact on the public deficit, but they do have an impact for national accounts purposes and *vice versa*.

In the last four years, the main national accounts adjustments were made in relation to interest, revenue, negative settlements of the regional Governments resulting from the financing system[16] and the balances of Central Government bodies.

[16] This adjustment has been of major quantitative importance in previous years due to the negative settlements for 2008 and 2009, resulting from the Great Recession. It is likely to become important once again in 2022 as a result of the expected negative settlement corresponding to 2020, this time caused by the pandemic, if the State's collection is in instalments.

MAIN NATIONAL ACCOUNTS ADJUSTMENTS, PERIOD 2015-2021. (% GDP)



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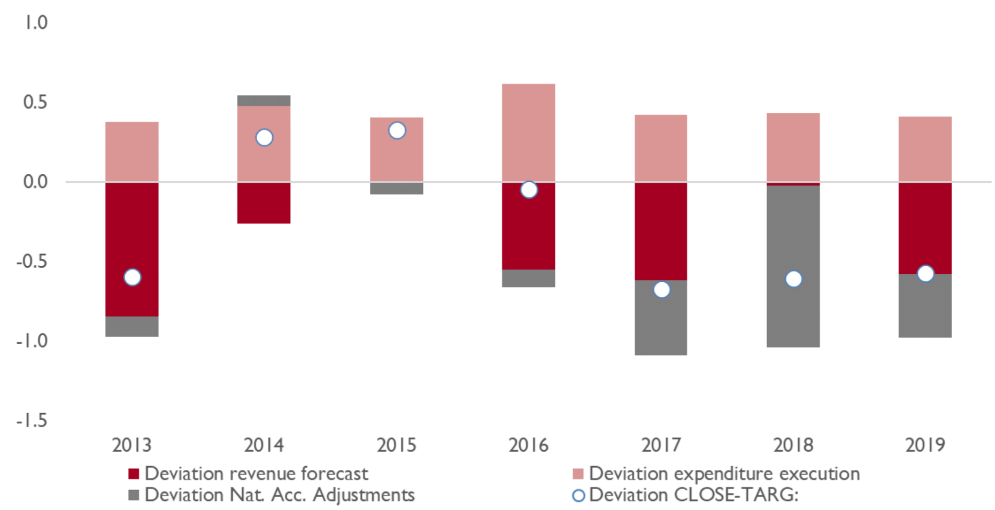
Source: EDP notification, September 2020

Why are they important?

Accounting adjustments are important insofar as they are a factor of possible deviation from the deficit target. The execution of the GSB may lead to a deviation in revenue and/or non-financial expenditure from what is initially budgeted, which will result in a deviation from the target deficit. However, this deviation may also come from national accounts adjustments other than those initially expected.

Since the 2017 GSB, the accounting adjustments that might allow reconciliation of the budgetary balance with the deficit in national accounts terms are not published. From that point on, national accounts adjustments went from having little impact on the deviation from the deficit target to having a significant impact.

BREAKDOWN OF THE DEVIATION FROM THE DEFICIT TARGET. PERIOD 2013-2019. (% GDP)



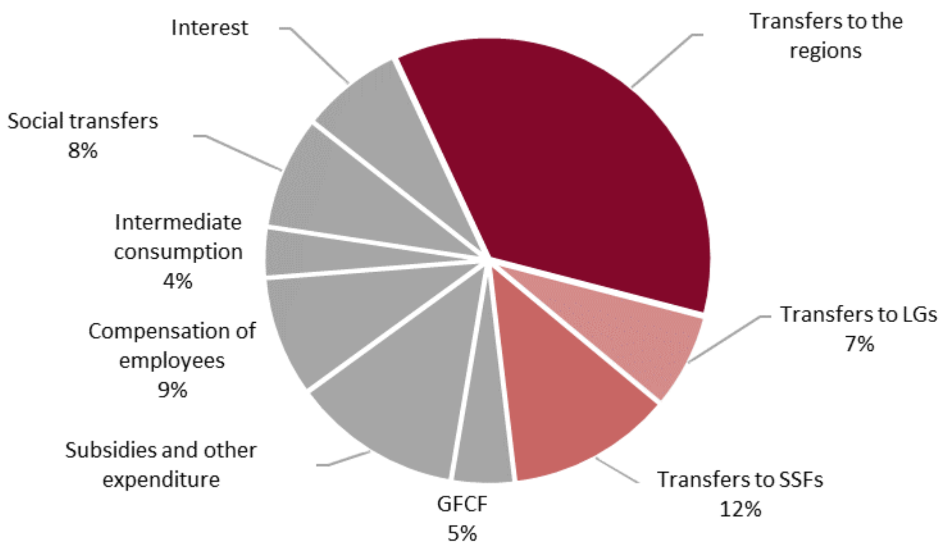
In order to prevent deviations in the achievement of the deficit target through national accounts adjustments, it is essential for them to be published in the GSB to provide transparency to these adjustments and allow appropriate oversight of their implementation.

Central Government Expenditure

AIReF forecasts an increase in the weight of expenditure over GDP of 0.7 points to 25.1% in 2021. This represents growth of 13% with respect to 2021, with the main factor behind the increase being implementation of the RTRP, €26.5bn (2.2% of GDP). Excluding this expenditure, the growth would be more moderate, around 3.2% and would be mainly due to the incorporation of new measures in the 2021 GSB. The transfers to the regions and the SSFs to offset the effects of COVID-19 remain at a similar amount to that of 2020.

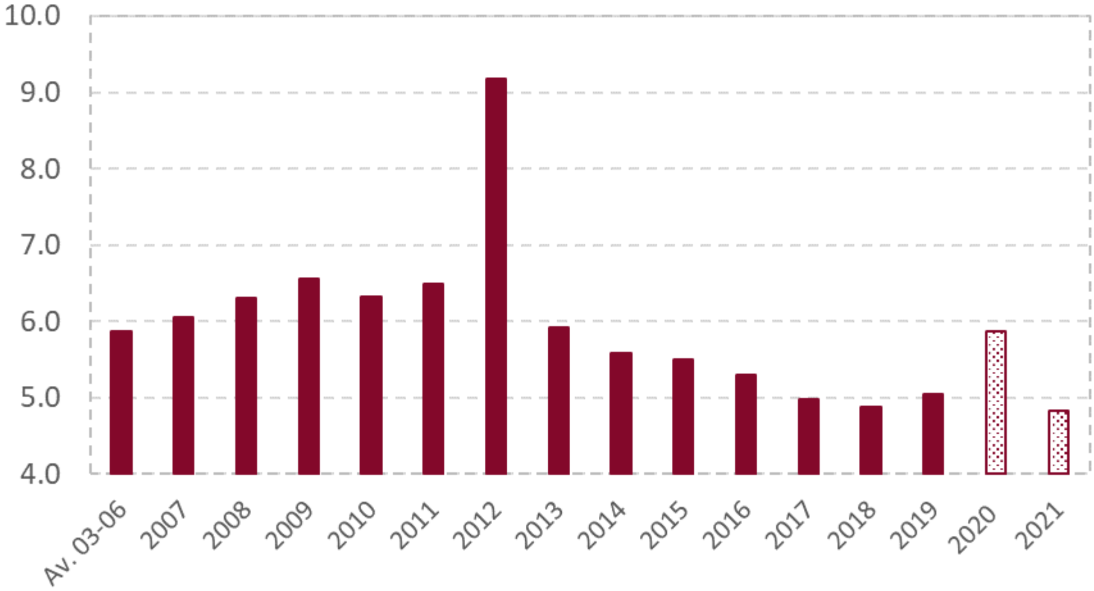
The transfers to other public administrations account for 55% of the CG's expenditure for 2021 as the State takes on part of the deficit of other sub-sectors and management of the extraordinary EU funds. The role of the State in managing the pandemic has led to more than half the CG's spending in 2021 going to fund spending by other sub-sectors, with the regional sub-sector receiving most transfers. Firstly, extraordinary transfers to the regions and to the SSFs are planned for 2021 for amounts like those received in 2020 in order to deal with the pandemic. Secondly, a large part of the expenditure measures set out in the 2021 GSB involve transfers to the regions or to the SSFs as they refer to matters that fall under their jurisdiction. Accordingly, there are noteworthy transfers planned for the regions to promote vocational training and the equality plan (development of the Co-Responsibility Plan) and the transfer to the SSFs to finance the strengthening of dependency care. Finally, the CG will centrally manage the RRF and a part of the REACT-EU funds, channelling a significant part of these funds to the other sub-sectors through transfers.

FIGURE 56. DISTRIBUTION OF NON-FINANCIAL EXPENDITURE OF THE CG 2021



Given that over 55% of CG expenditure in 2021 is earmarked for transfers to other public administrations, the margin for discretionary expenditure is small. There have been significant reductions in discretionary expenditure over recent years. In 2019, this expenditure stood at 5% of GDP. In 2020, a very significant rise in expenditure is expected as a result of the measures taken by the Central Government to combat the pandemic, which would explain the forecast that discretionary expenditure will amount to almost 6% of GDP. However, in 2021, after deducting the expenditure associated with the RRF and REACT-EU, discretionary expenditure is estimated to return to the levels of under 5% of GDP recorded in 2019, partly as a result of the increase in transfers between public administrations expected for that year.

FIGURE 57. EVOLUTION OF CG EXPENDITURE WITHOUT TRANSFERS TO PUBLIC ADMINISTRATIONS, INTEREST, CIVIL SERVANTS AND EU CONTRIBUTION (% GDP)



NB: Does not include: (2019) RPAS; (2020) Reversal of AP-4 and AP-7 and (2021) RRF and REACT-EU.

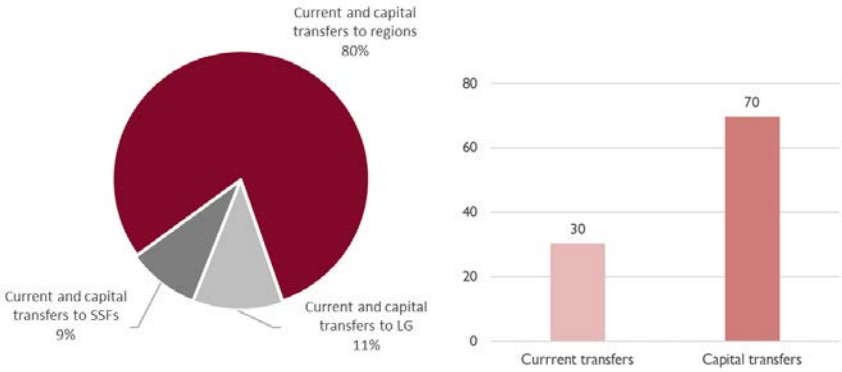
According to AIReF's estimates, employee remuneration will grow by 4.3% of GDP, in line with the increases of Chapter I on personnel costs in the GSB. This growth is due to the wage increase in line with the expected CPI (0.9%) compared with 2% in 2020, a moderately increasing workforce and, finally, a wage drift due to factors unrelated to the previous two. In addition, the impact of the equalisation of salaries for State law enforcement agencies, which was completed in 2020, no longer has an impact. Finally, there are hardly any increases in this item associated with the RTRP as it has been planned to essentially make use of the existing administrative structures to manage these extraordinary EU funds.

AIReF estimates that intermediate consumption will remain at 0.9% of GDP, while social transfers in kind will rise to 0.2% of GDP. Expenditure on medical supplies is expected to continue as a result of the continuation of the pandemic in the coming year, in addition to the expenditure associated with the mass distribution of the vaccine. These would be financed from REACT-EU funds for €1.17bn. In contrast, expenditure on transfers in kind is expected to grow due to the recovery in transport subsidies.

Transfers between public administrations will grow by 10%, remaining at 13.8% of GDP for 2021. The growth is largely the result of the advance payment made to the other sub-sectors of 48% of the revenue corresponding to the extraordinary EU funds for 2021. Although the State is responsible for centralising and managing the funds from the RRF and part of the funds from

REACT-EU, it will transfer almost half of them to the other sub-sectors. 70% will be capital transfers, while the remaining 30% will be current transfers. The regional sub-sector will be the main recipient of the transfers, with 80% of the total transferred amount, although if the CG funds going to said sub-sector indirectly through the SSFs are added, the final total rises to 85%. At a financial level, the State is going to grant a loan for the corresponding €8bn from REACT-EU as an advance on the funds that the regions will receive directly from the EU under this programme.

FIGURE 58. BREAKDOWN OF TRANSFERS FROM THE CG OF RRF AND REACT EU FUNDS BY RECIPIENT AND NATURE



As regards capital expenditure, there is a noteworthy sharp increase expected in both gross capital formation and investment aid and other capital transfers as a result of the RTRP. Capital expenditure will be significantly boosted by the investment projects and reforms of the national recovery and resilience plan, with a rise of 138% expected in 2021. Gross capital formation is expected to rise by 0.3 points of GDP to 1.1% of GDP in 2021. If it were not partially offset by the non-recurrence of the expenditure for €1.745bn that took place in 2020 for the reversal of the AP-7 and AP-4 motorways, this increase would have been even greater.

Within the CG, a State deficit of 5.6% of GDP is estimated. This would be slightly offset by the 0.1% surplus forecast for CG bodies. The impact of the pandemic is expected to fall primarily on State revenue and expenditure, and less so on CG bodies. For the State, which receives approximately 80% of the revenue of the sub-sector, revenue in national accounts terms is expected to fall by 12% in 2020 and rebound by 10% in 2021, which will rise to 25% with the effect of the revenue from the RRF and REACT-EU. While for CG bodies, which are less affected by the crisis, revenue is expected to fall by 2.5% in 2020 and grow by 5.6% in 2021. Regarding expenditure, an increase of 13% is expected for the State in 2021 compared with 17.6% forecast for 2020, above all driven by the expenditure associated with the RRF and REACT-EU. For their part, the expected increase in expenditure for CG Bodies is 2.7% with respect to 2020.

FIGURE 59. EVOLUTION OF CENTRAL GOVERNMENT BALANCE

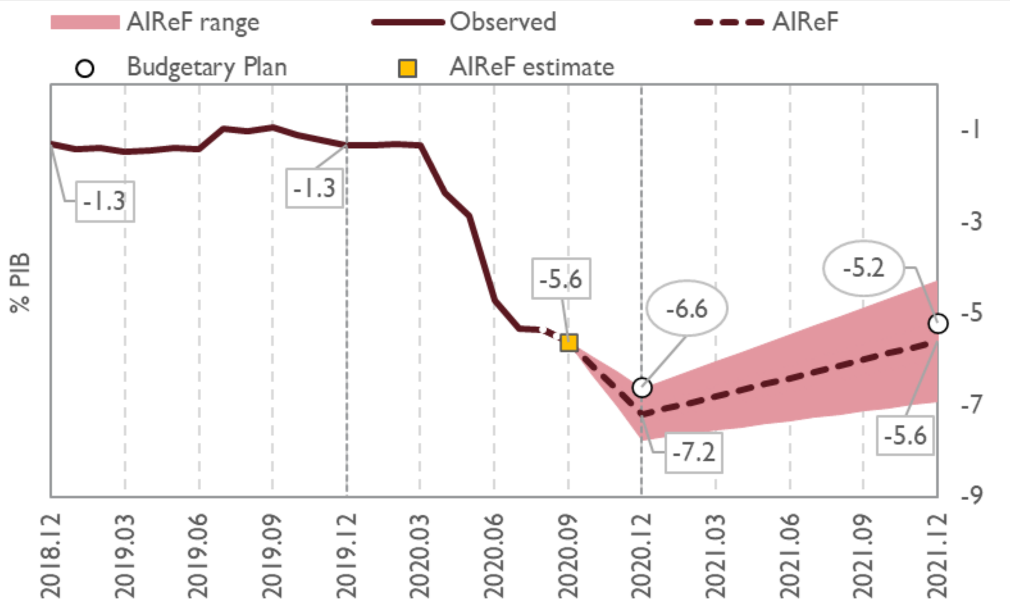


FIGURE 60. EVOLUTION OF CENTRAL GOVERNMENT REVENUE

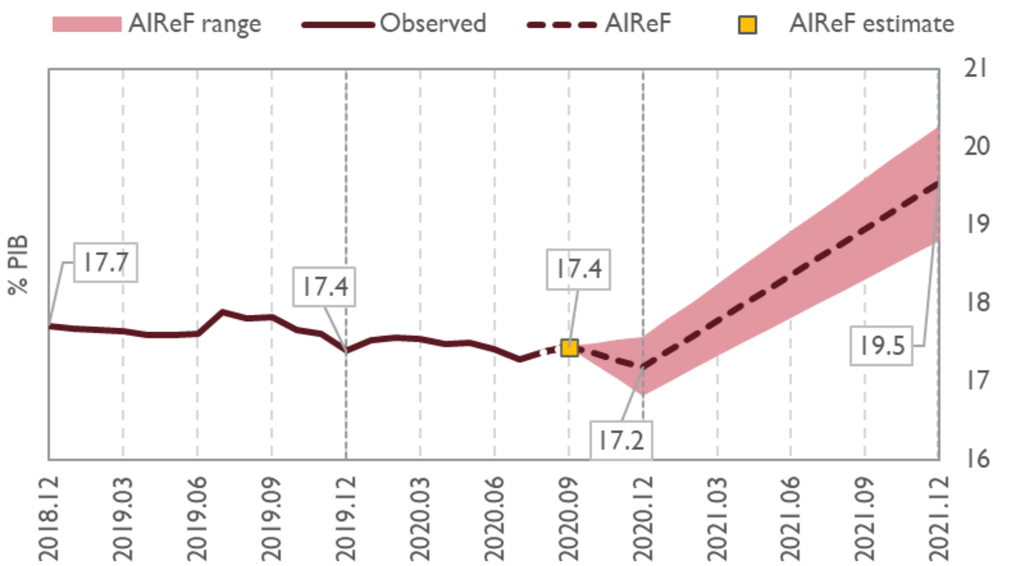
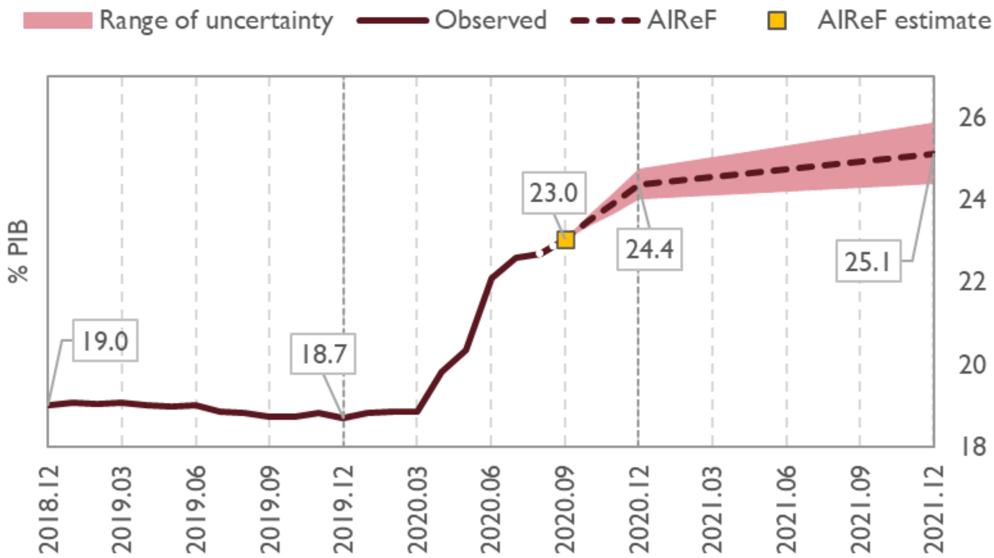


FIGURE 61. EVOLUTION OF CENTRAL GOVERNMENT EXPENDITURE



4.4.2. Social Security Funds

AIReF forecasts that the Social Security Funds (SSFs) will increase their deficit to 3.8% of GDP in 2020, falling to 1.5% in 2021, compared with a deficit of 4.1% in 2020 and 1.3% in 2021 in the Budgetary Plan. The COVID-19 crisis has had a two-fold impact on the SSFs. On the one hand, the measures taken to mitigate the crisis and, on the other hand, the worsening macroeconomic situation, and more specifically, employment, triggers a rise in expenditure for cash benefits and subsidies for exemptions from contributions, which is being partially alleviated by the transfers received from the State. The situation improves in 2021, returning to deficit levels like those that we have stabilised over recent years.

Revenue increases its weight over GDP from 13.4% to 16.1% in 2020, reducing its weight in 2021 to 15.6%, as a result of both current transfers and the denominator effect. Of the 2.7-point increase in 2020, 1.2 points are due to contributions, mainly as a result of the denominator effect, and 1.5 points are due to current transfers from the State. In 2021, the weight of contributions will fall by 0.8 points, mainly due to the recovery of GDP. This reduction in the weight of revenue is offset by the current transfers, which are expected to rise by 0.3 points.

Expenditure increases its weight over GDP by 5.2 point of GDP in 2020, up to 19.9%, with its weight falling in 2021 to 17.1%. This increase is due both to the macro effect and the denominator effect and, mainly, to the measures adopted due to COVID-19, which explain almost 3 points of difference. The weight falls in 2021 as a result of the macro effect, the denominator effect and the lower cost of the measures.

FIGURE 62. EVOLUTION OF THE BALANCE OF THE SOCIAL SECURITY FUNDS

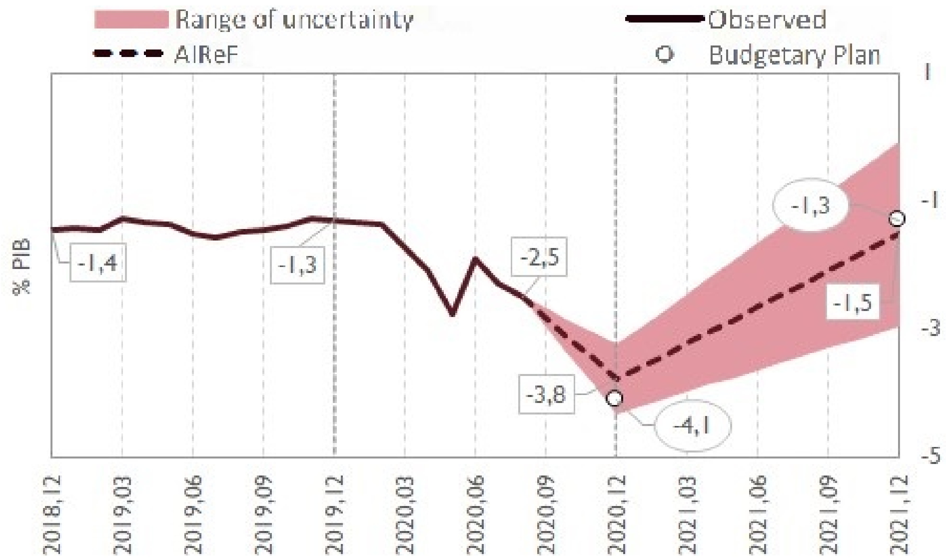


FIGURE 63. EVOLUTION OF THE REVENUE OF THE SOCIAL SECURITY FUNDS

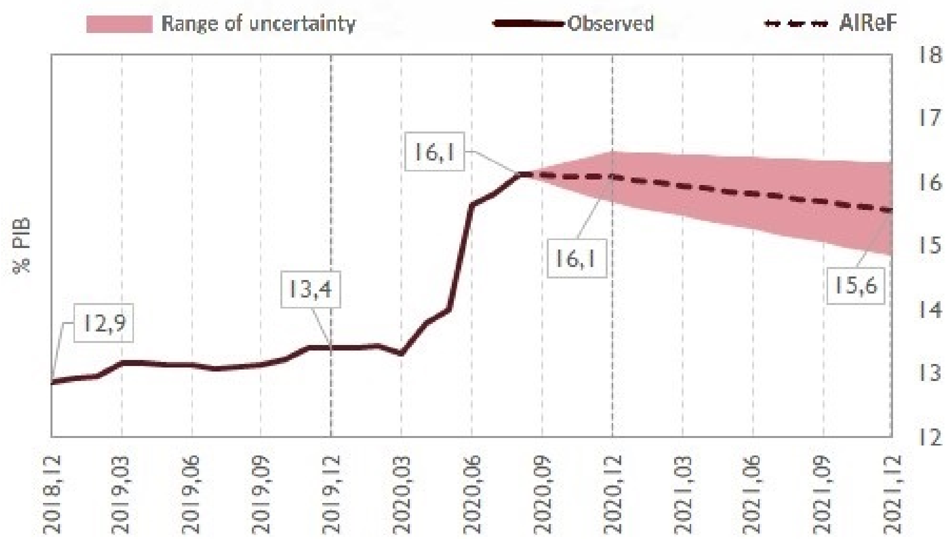


FIGURE 64. EVOLUTION OF THE EXPENDITURE OF THE SOCIAL SECURITY FUNDS

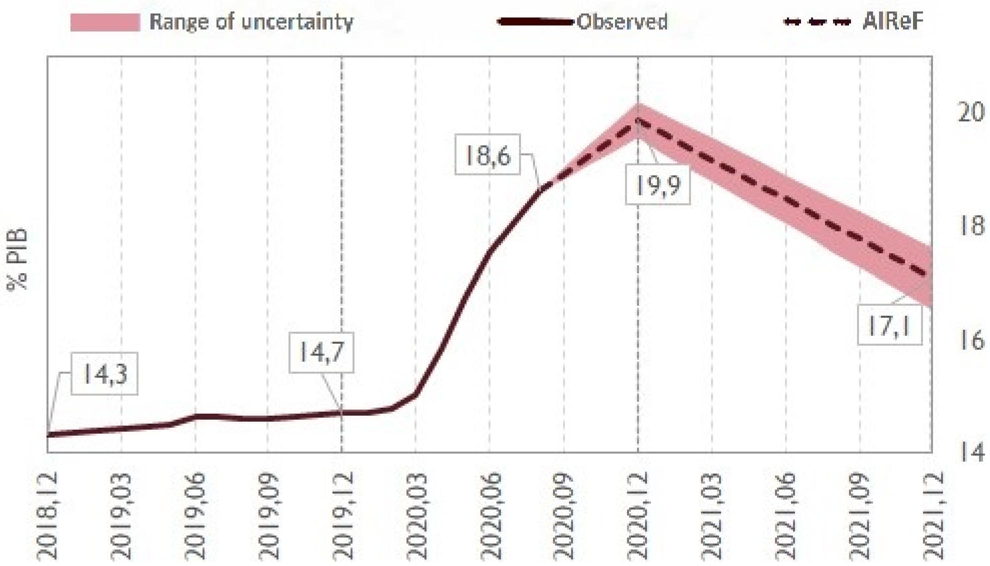
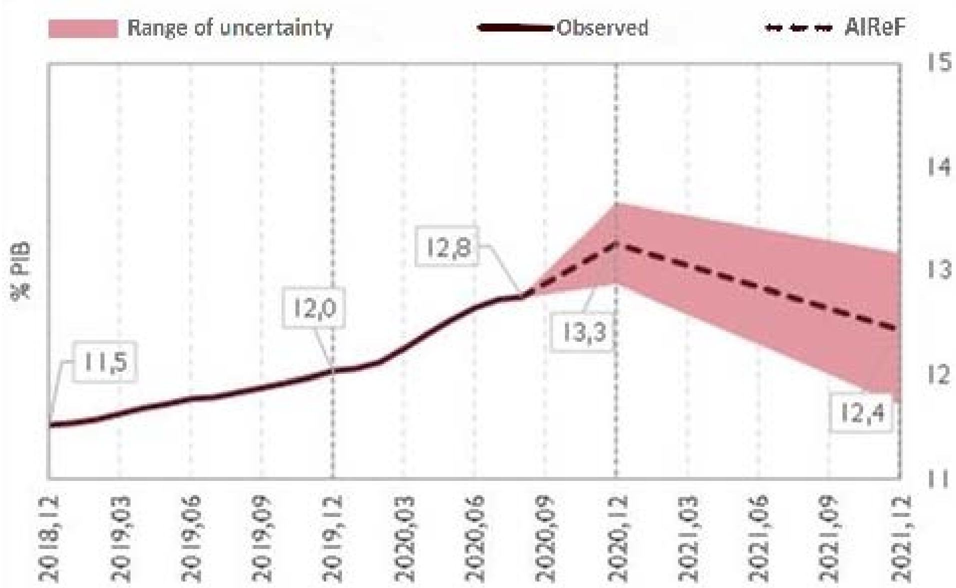


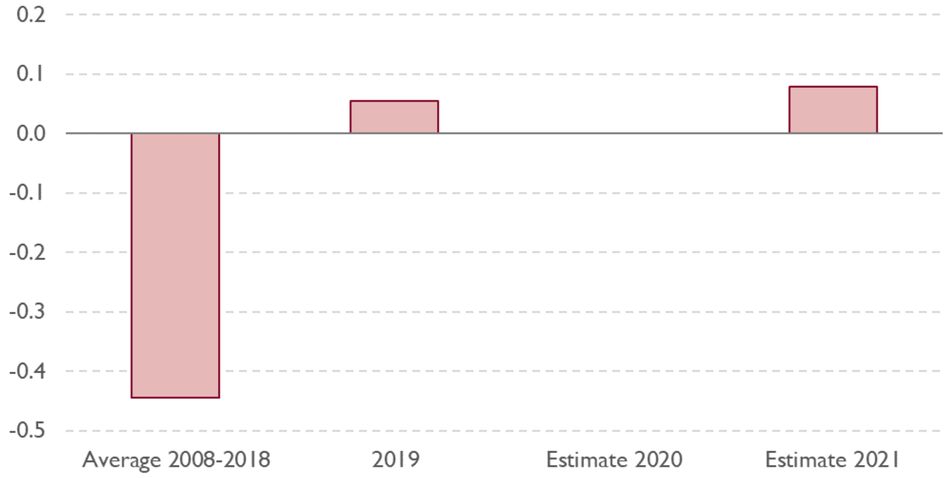
FIGURE 65. EVOLUTION OF THE CONTRIBUTIONS OF THE SOCIAL SECURITY FUNDS



Deviations in Social Contributions from the Budget

The social contributions of the SSS are estimated to record a higher amount in 2021 than forecast in the draft GSB by around €1bn. This positive deviation forecast for 2021 is slightly higher than that seen in 2019 (last completed year), and both represent behaviour that is contrary to what happened in previous years, in which the budgeting error was negative. Figure 66 shows the deviation or budgeting error, which is calculated by comparing the revenue forecasts included in the Budget with the actual collection after deducting the positive or negative impact on collection of any legislative measures approved after the approval of the GSB for each year.

FIGURE 66. DEVIATION: RECEIVED WITH RESPECT TO THE APPROVED BUDGET (*)



(*) Deviation = Revenue collected without the impact of measures approved subsequent to the GSB - Budgeted
Positive: Revenue collected > Budgeted
Negative: *Revenue collected < Budgeted*

During the state of alarm caused by the COVID-19 crisis, the Government has approved measures to mitigate the effects of the crisis amounting to 2.8 points of GDP. These measures, whose impact has been detailed above, will have a very significant effect in 2020, but will mostly reverse automatically when the state of alarm ends. AIReF considers that the COVID-19 crisis will continue until the middle of 2021, with the cost of the measures for the year estimated at 0.9% of GDP.

These measures do not affect the various agents of the Social Security Funds equally. By performing a simplified analysis, based on the pre-COVID situation of each agent, the impacts are broken down into a denominator effect, an effect of the measures and a macro effect. Regarding the macro effect, within the SSFs, the reduction in cyclical revenue is almost entirely from the social security system (SSS), while the increase in cyclical expenditure is almost entirely from the SEPE. Of the projected increase in the SSF deficit (2.5 points of GDP), only one third pertains to the SSS, due to the increase in current transfers, which according to the 2021 GSB are entirely for the SSS. Of the 2.3-point improvement forecast for 2021, the SEPE is responsible for just over half, due to both the planned transfers and the reduction in the cost of the expenditure measures.

TABLE 16. BALANCE BY AGENT OF THE SOCIAL SECURITY FUNDS (%GDP)

	2019	2020 COVID effect: Denominator effect (a)	2020 COVID effect: Effect of measures (b)	2020 COVID effect: Macro effect (c)	2020 COVID total impact (2)=(a)+(b)+(c)	2020 Current forecast (3)=(1)-(2)
SSFs	**-1.3**	**-0.3**	**-1.3**	**-0.9**	**-2.5**	**-3.8**
SSS	-1.4	-0.3	0.0	-0.5	-0.7	-2.2
SEPE	0.1	0.0	-1.3	-0.4	-1.7	-1.6

	2020	2021 Descomposición: Denominator effect (a)	2021 Descomposición: Effect of measures (COVID and non COVID) (b)	2021 Descomposición: Macro effect (c)	2021 Total Impact (2)=(a)+(b)+(c)	2021 Current forecast (3)=(1)-(2)
SSFs	**-3.8**	**0.2**	**0.9**	**1.2**	**2.3**	**-1.5**
SSS	-2.2	0.2	0.8	0.0	1.0	-1.2
SEPE	-1.6	0.0	0.1	1.2	1.3	-0.3

Transfers from the CG to the SSFs rise by 93% in 2020. In 2020, the CG is expected to transfer around €30bn to the SSFs, mainly due to the extraordinary transfer of €14bn to tackle COVID-19. This almost doubles the transfer made in 2019 for €15.6bn. In addition, Spain is expected to receive from the European Support to mitigate Unemployment Risks in Emergency (SURE) Fund a loan in 2020 to finance unemployment expenditure mainly associated with the ERTEs for an amount of €21.325bn. This allows the use of debt to finance the deficit of the SSFs in 2020 in relation to the part that is not financed with the loan of €30.33bn granted by the State for 2020 (compared with €13.83bn in 2019) and the application of the €2.15bn remaining in the SS Reserve Fund. According to AIReF's deficit forecast for the SSFs, this could raise the EDP (Excessive Deficit Protocol) debt of the SSFs by approximately €10bn.

For 2021, a smaller increase in transfers from the CG to the SSFs is expected, of 23%, which falls to 20% if those financed by the RRF are deducted. This increase, amounting to some €6bn, is expected to be concentrated in transfers to the SEPE, while transfers to the Social Security System (SSS) remain virtually constant. The extraordinary transfer of €14bn in 2020 rises to €18.4bn in 2021. Of this amount, €14bn is equivalent to the transfer of the previous year, while the rest is for SEPE. Unlike in 2020, this transfer will no longer be extraordinary but will become structural, with the aim of financing the so-called “improper” expenditure, in compliance with the conclusions and recommendations of the Toledo Pact. Consequently, while expenditure on transfers to the SSS remains practically constant, it grows with respect to the SEPE, rising by around €6bn, of which €1.1bn will be funded from the RTRP.

4.4.3. Regions

4.4.3.1 AIReF forecasts for 2021

AIReF forecasts that the regional sub-sector will record a deficit of 0.8% of GDP in 2021, lower than the 1.1% reference level. Given that most regions have not yet drawn up and submitted their budgetary lines for 2021, AIReF's forecasts about the sub-sector for this year are prepared with the information available in the draft 2021 GSB, under the estimates of the central scenario that assume the end of the health crisis in the middle of 2021, and considering, among other assumptions, a neutral impact of the EU funds. Under these premises, it is estimated that the regional sub-sector may record a deficit in 2021 of around 0.8% of GDP, lower than the reference level set for 2021 of -1.1%, although higher than that for 2020. Therefore, a similar balance is expected for the sub-sector to that forecast in the Budgetary Plan (-0.6%).

Regional revenue would grow by over 10%, gaining 0.1 points of weight of GDP, mainly as a result of EU funds and other assigned transfers. The resources of the regional financing system of the common regime would fall by 1.6% on 2020, while the extraordinary funds received from the State to address COVID expenditure fall by 15% (dropping from €16bn in 2020 to €13.486bn in 2021). These non-assigned funds, which account for more than 60% of total net revenues in 2021, fall by 3% overall. In the opposite direction, the remaining direct revenue of the regions, other than transfers from the State and from the EU, which account for 15% of total revenue, is expected to grow by 9% as result of improved economic activity and the reduced impact of the pandemic. Similarly, the assigned revenue from the remaining transfers from the State and EU funds, which together account for approximately 25% of regional revenue in 2021, will rise by over 50%.

At the same time, non-financial expenditure by the regions will rise by over 11%, increasing their weight in GDP by 0.2 points. The increase in expenditure associated with the new EU funds to be received by the regions leads to a significant increase in both current and capital expenditure. It is estimated that current expenditure, which accounts for 86% of total expenditure, could grow by close to 5%, with a particular impact in the area of education. For its part, capital expenditure could increase by more than 70%. Without incorporating the effect of EU funds, both current expenditure and investments and capital transfers would remain at a level slightly higher than that of 2020.

4.4.3.2 Information and assumptions considered.

No specific information is currently available from the regions on their budgetary lines for 2021. In most regions, preparation of the lines and draft budgets was up to now at a preliminary stage due to a lack of knowledge until recently, which in some aspects continues to be the case, about fundamental aspects for designing the regional budgets, such as the funding they will receive from the State, which will cover over 60% of their revenue, the situation relating to fiscal rules or targets and financing from EU funds.

At today's date, the distribution of the extraordinary transfer set out in the draft GSB to deal with the impact of the COVID crisis remains unknown. This allocation will be determined by a Government Royal Decree, as indicated in Article 118 of the draft GSB. Uncertainty remains about the total specific amounts that each region may receive from the European funds, as well as about their implementation, impact over time, nature of the projects to be funded and recording of the associated expenditure and revenue. Overall, with the information in the draft GSB, there are estimated to be €8bn euros from the REACT-EU funds, which will be recorded directly in the regional accounts, and €10.793bn that will be incorporated in the draft GSB to be allocated to the regions (€1.421bn REACT-EU and €9.372bn RRF - of the latter, €4.253bn distributed to the regions).

AIReF's forecasts for the regions assume that the health crisis will end in 2021 and that the effect of the RTRP will be neutral. AIReF has prepared its forecasts for 2021, collecting the information available in the draft GSB that affects regional revenue and expenditure, in addition to that reported by the regions with regard to the measures adopted or planned in previous years with an expected impact in 2021. The projection of the remaining revenue and expenditure has been made under two basic assumptions:

- The central scenario for 2021 envisages the end of the health crisis and the start of the economic recovery from the second half of 2021.
- Without further information on the implementation of the new EU funds - REACT-EU and RFR - it has been assumed that they will have a neutral impact on the regional deficit. They will therefore fund new expenditure projects and the expenditure made and associated revenue will be recorded at the same time for the same amount.

The assumptions of the central scenario condition the estimates of a great deal of the regional expenditure for 2021 and a part of the revenue. Under the assumption of the duration of the crisis indicated for the central scenario:

- The health expenditure model and the impact of the measures taken in 2020 as a result of the pandemic have been projected.

Consequently, a more limited impact is estimated in 2021 than that expected in the previous year, except in the field of education, in which the effect from 2020 of the measures adopted for the 2020/2021 academic year will generally be doubled.

- A greater baseline growth in non-COVID-19 expenditure than that recorded in 2020 has been assumed, except for personnel costs.
- The improvement in the direct regional revenue associated with the recovery in the macroeconomic scenario has been recorded.

The draft GSB for 2021 determines most of the sub-sector's revenue and a large part of its expenditure over 2021. The revenue side includes the revenue received by the regions in the common regime for the regional financing system (RFS). In addition to this revenue, there are the transfers to the regions set out in the draft GSB, both direct and those from EU funds: REACT-EU and RRF. In addition to the revenue, AIReF's forecasts for the sub-sector consider the regional expenditure associated with the measures in the draft GSB that finance regional actions and that resulting from application of the EU funds.

TABLE 17. MAIN REGIONAL REVENUE IN THE DRAFT 2021 GSB (€M)

Main revenue of regions in draft GSB	
Non-assigned revenue included in the draft GSB in favour of regions	**128,537**
RFS revenue (transfers from the State expenditure and revenue budget)	115,051
Additional revenue (COVID-19)	13,486
Assigned revenue in the draft GSB in favour of regions	**13,804**
REACT Funds	1,421
RRF funds	9,372
Promoting vocational training	792
Co-responsibility Plan	190
Dependency Care	2,029
Revenue in the regional budgets	**8,000**
REACT FUNDS	8,000

In addition, based on the information provided in the draft GSB for 2021, AIReF's estimates for the sub-sector include:

- The announced revenue of €8bn from the REACT-EU funds, as well as the equivalent expenditure associated with those funds.

- The growth in the wage bill set out in the draft GSB (0.9%), in addition to the average regional wage drift, the impact associated with COVID-19 on personnel cost in the areas of healthcare and education and the measures reported by the regions in this area compatible with basic legislation.

Finally, **AIReF considers other measures adopted or planned by the regions in the past, for which a limited impact is expected in 2021.** The forecasts for the sub-sector incorporate other actions taken in previous years by the regions which are expected to have an impact in 2021, particularly in the area of taxation, although the overall amount is not significant. AIReF has therefore assessed the expected collection in Catalonia resulting from the fiscal measures approved in 2020 (modification of the Waste Charge, of the Tax on Sugar-sweetened Drinks and of the Inheritance and Gift Tax and creation of new environmental taxes); the expected increase in the Wealth Tax in Rioja due to the abolition of allowances; and the fall in revenues in Andalusia due to the tax reduction in Inheritance and Gift Tax and the loss of force of the medicine auction system, which were measures initiated in previous years. On the expenditure side, an assessment is made of the healthcare savings resulting from the centralised purchasing of medicines and, in the opposite direction, reversal of the non-availability agreements and similar measures adopted in 2020.

FIGURE 67. EVOLUTION OF REGIONAL BALANCE (% GDP)

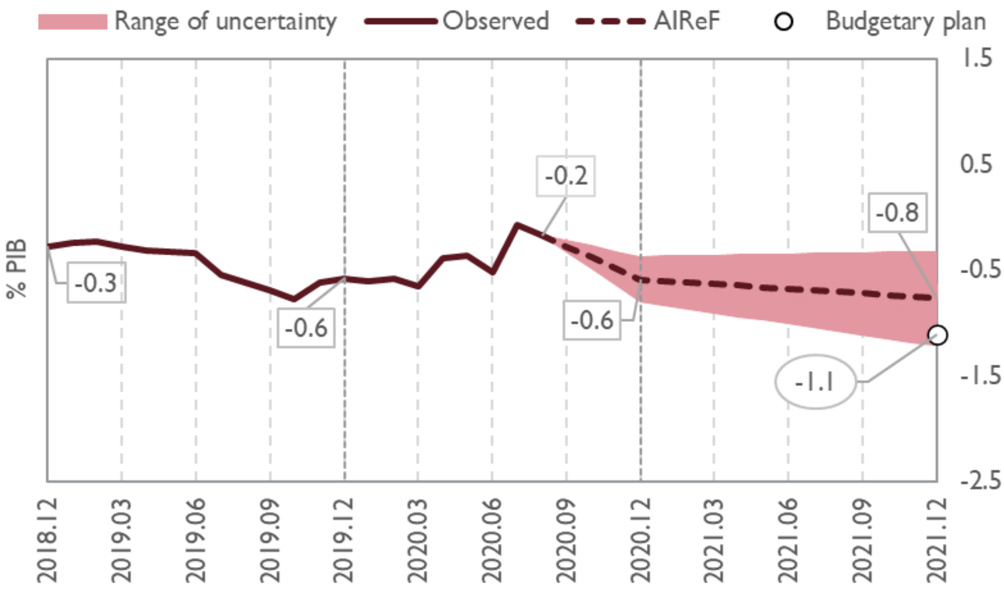


FIGURE 68. EVOLUTION OF REGIONAL REVENUE (% GDP)

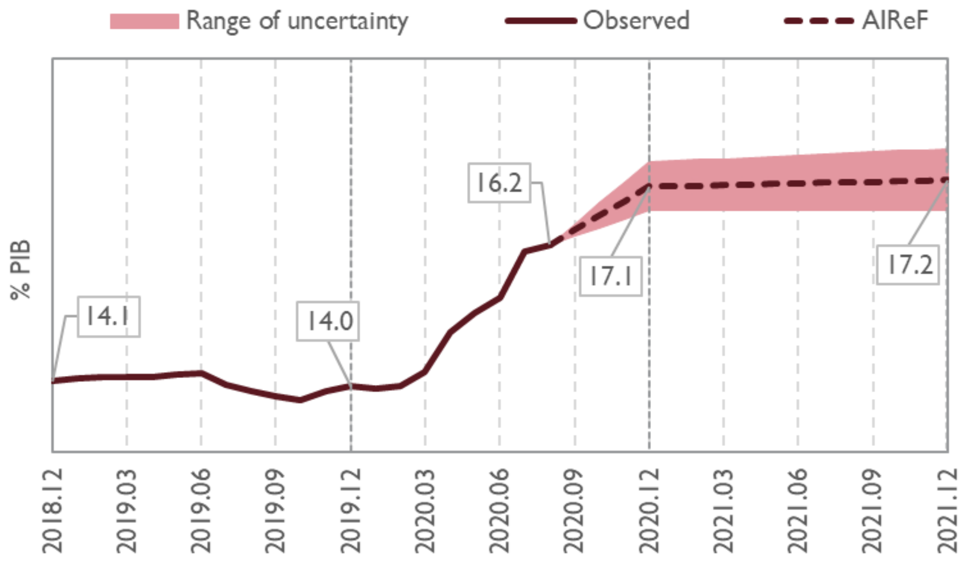
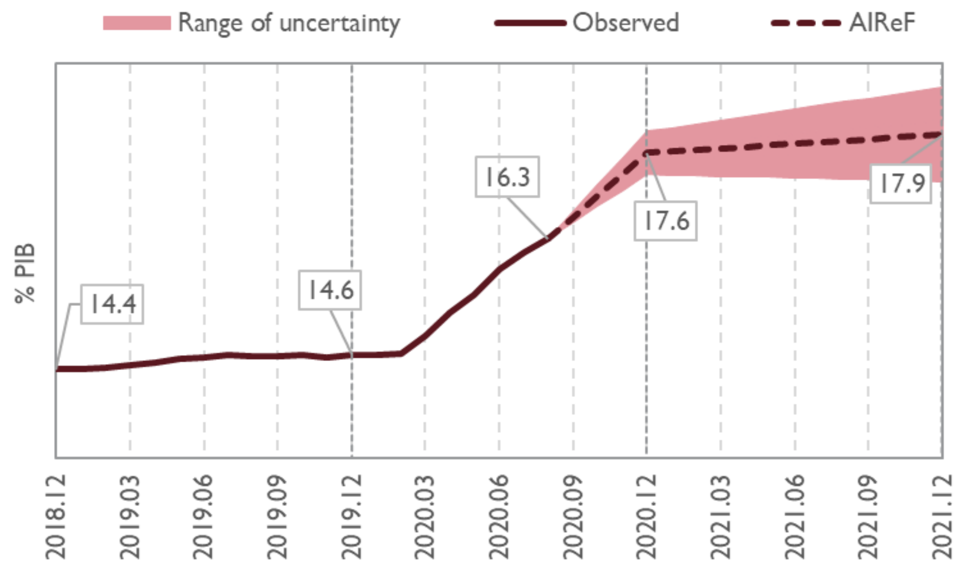


FIGURE 69. EVOLUTION OF REGIONAL EXPENDITURE (% GDP)



4.4.3.3 Medium-term outlook

The impact of the crisis is once again postponed in the regional sub-sector through the resources of the regional financing system and the extraordinary non-assigned transfers received from the State. As was the case in 2020, through the extraordinary fund planned for 2021, the State assumes this year the extraordinary expenditure and the impact on revenue that might yet be recorded in the regional accounts because of the pandemic.

In 2022, while regional expenditure may fall by 8%, revenue could fall by around 18%, including the estimated fall in revenue from the common regime system and the non-repetition of additional non-assigned transfers from the State. Excluding estimates of expenditure and revenue associated with EU funds, which are estimated to have a neutral effect, baseline expenditure growth in 2022 will be offset by the disappearance of most of the expenditure incurred in previous years due to COVID-19. Therefore, non-financial expenditure not financed by funds could remain at similar levels to those of the previous year. Nevertheless, there is likely to be a significant worsening in the sub-sector's balance in this year, over one and a half points of GDP, as a result of the expected fall in revenue. Given that the instalment payments of the regional financing system that regions under the common regime have received in 2020 did not incorporate the negative impact of tax revenue, in 2022 they will have to address the final settlement made in accordance with the tax revenue collected by the State in 2020. This may result in a 10% reduction in the overall revenue of the regional financing system compared with 2021. Coupled with this would be the non-repetition of the extraordinary transfers received in 2020 and 2021 to deal with the consequences of the pandemic and mitigate the regional deficit.

4.4.4. Local Governments

AIReF estimates that in 2020 the local Government sub-sector will reach a result close to fiscal equilibrium, with this forecast worsening in 2021 to a deficit of 0.1%, given the continuation of the pandemic. Using the latest published data, AIReF has updated the forecast results for the end of 2020 for local Governments under the assumption, in its central scenario, that the economic impacts and measures adopted to mitigate the negative effects of the pandemic will continue throughout 2020 and at least through the first half of 2021. AIReF has analysed the latest available data, corresponding to the budget execution of the second quarter of 2020, the level of local debt and deposits as of June of this year, and the data reported to AIReF by the large local Governments subject to individual monitoring on the updated estimate of figures for year-end 2020 and the impact of the revenue and expenditure measures adopted and estimated up to the end of the year to mitigate the effects of COVID-19. As a result of this analysis, AIReF maintains its forecast for 2020 that the local Government sub-sector will achieve a result close to fiscal equilibrium, although it downgrades slightly its previous estimates as a result of the extension until the end of the year of the extraordinary expenditure necessary to mitigate the negative impact of the pandemic, as well as the revenue reduction measures implemented to limit the effects of the pandemic on economic activity, such as allowances in the major local taxes for the most affected activities and households.

AIReF's forecasts for 2020 are in line with the budgetary scenario for the local Government sub-sector set out in the 2021 Budgetary Plan. AIReF's estimates for year-end 2020 are in line with the budgetary balance forecasts included in the 2021 Budgetary Plan, where the local Government result expected at the end of the year is one of equilibrium, three points of GDP below the balance obtained in 2019. AIReF estimates that the temporary suspension of compliance with fiscal rules in 2020 and 2021, given its approval only two months before the end of the year, will have very limited effects in 2020 on the growth in expenditure, while it will be a determining factor for the expected result in 2021.

For 2021, AIReF estimates a local Government deficit of over 0.1% of GDP, which is the result of expenditure growing by more than the expected increase in revenue. AIReF forecasts 4% growth in revenue despite the continuation of the measures adopted by local Governments to mitigate the negative effects of the pandemic, which will also extend into 2021. However, expenditure is expected to grow by around 6%. The increase in expenditure above the increase in revenue means that the expected local Government balance is negative, at around -0.1% of GDP.

In 2021, local Government resources will grow by over 4%, mainly conditioned by the improvement in the revenue of Provincial Councils and the larger funds to be received from the EU. According to AIReF's estimates, despite the continuation of the revenue reduction measures adopted or to be adopted by local Governments to mitigate the negative effects of the pandemic on the most affected economic sectors and households, the injection of the revenue from the EU's economic recovery mechanisms, of almost €1.5bn, and the growth in tax revenues in the Provincial Councils due to the improvement in economic activity, standing at close to €1bn, will lead to an increase in local revenue of over 4% in 2021. Excluding the effect of both sources of revenue, the expected growth in local revenue would not reach 2%.

At the same time, local Government expenditure would increase by almost 6% as a result of the application of the surpluses from previous years, the consolidation of the ordinary expenditure relating to COVID-19, greater expenditure funded by EU mechanisms and higher provincial council expenditure. AIReF estimates that expenditure might grow by 6% in 2021 as a result of the increase in current expenditure, mainly social expenditure, given the continuation of the COVID-19 crisis, the application of savings from previous years to this type of expenditure, the use of the RRF and the increase in transfers from the Provincial Councils to the Regional Government of the

Basque Country so that it may share in the higher tax revenue received. Excluding the effect of the expenditure resulting from EU revenue, the forecast growth in local revenue would not exceed 4%.

AIReF has estimated that applying the savings from previous years to expenditure may amount to 0.1 points of GDP in 2021. According to AIReF's forecasts, the economic impact of applying the savings accumulated in years of surplus to expenditure will not exhaust that obtained in 2019, close to €4,000, given that the capacity for expenditure is limited by compliance with the legal guarantees required by the procurement legislation in force, which delays expenditure execution processes. The most optimistic estimates suggest that half of said sum may be achieved.

Extension of the state of alarm, with the consequent possible consolidation in the first half of the year of the expenditure measures and revenue reduction relating to the health crisis, might amount to over 0.1 points of GDP. Extension of the state of alarm until May 2021 as a result of continuation of the health crisis resulting from the pandemic has forced AIReF to include in its forecast the estimated effect, at least for the first half of the year, of the reduction in revenue and increase in expenditure directly related to the economic and social crisis accompanying the health crisis. According to these estimates, the negative effect on the balance to be obtained at the end of the year could exceed €1bn, which is higher than the figure included in the Budgetary Plan (€490m).

Implementation of the RTRP will have no effect on the local result. Finally, the local Governments receiving funds from the EU's economic recovery mechanisms, close to €1.5bn, as set out in the draft GSB, will have no effect on the result to be achieved as it is estimated that the higher revenue will be offset by application to expenditure of said funds in the year.

There are uncertainties about the impact on the 2021 deficit of any COVID measures that may be adopted and their duration, as well as about the surpluses that may be applied to expenditure and the amount of the expenditure for applying the RRF. AIReF's central scenario may be shifted upwards or downwards by limitations on the scope arising from the quantification in 2021 of the expenditure that may be made by local Governments in application of the surpluses from previous years, as well as the measures taken or to be taken to mitigate the effects of the pandemic and the expenditure to be applied arising from the RRF. In addition, AIReF has analysed the information provided by the Ministry of Finance Information Centre and the large local Governments evaluated individually on the main lines of the local Governments' draft budgets for 2021, which include the main revenue and expenditure measures that will govern the budgets for the coming year, and which are aggregated in the Budgetary Plan for 2021. Given that these lines were prepared prior to activation of the suspension of the fiscal rules, AIReF believes that the revenue and expenditure policies reflected therein are not representative of the result to be obtained at the end of the year as they might be modified in the draft to be presented for approval by the plenary sessions or modulated during implementation. For this reason, local Governments have been asked to individually analyse information on the possibility of modifying the policies in order to adapt them to the new scenario or, otherwise, if the adaptation will take place in the draft budgets, or in implementation, with an indication of the impact of such changes.

FIGURE 70. EVOLUTION OF THE BALANCE IN THE LOCAL GOVERNMENTS (% GDP)

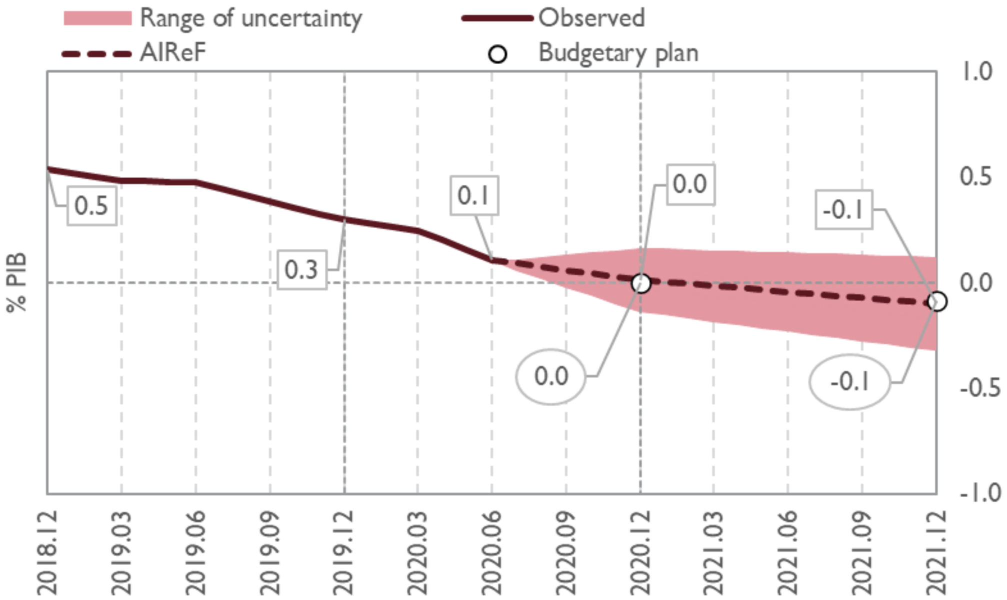


FIGURE 71. EVOLUTION OF REVENUE IN LOCAL GOVERNMENTS (% GDP)

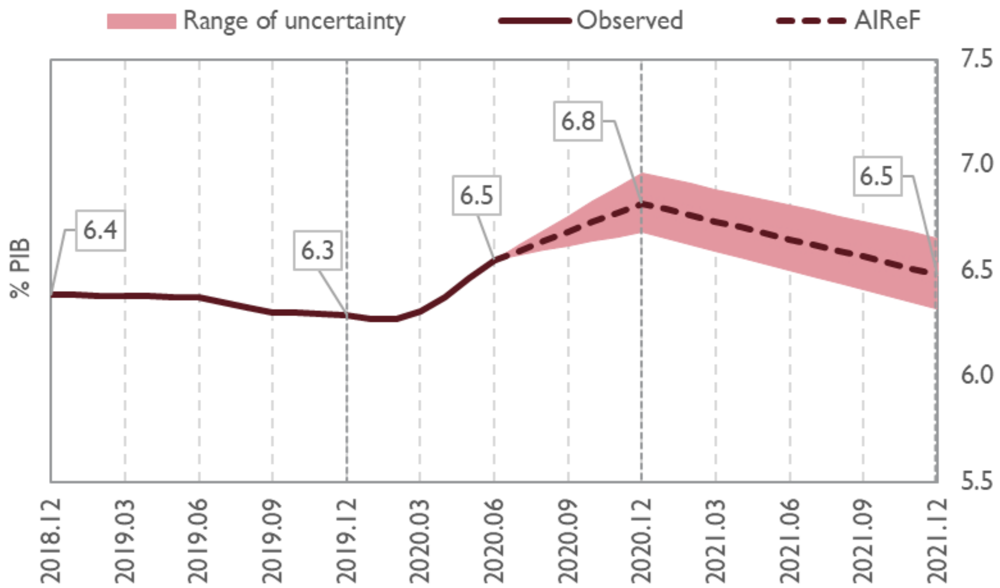
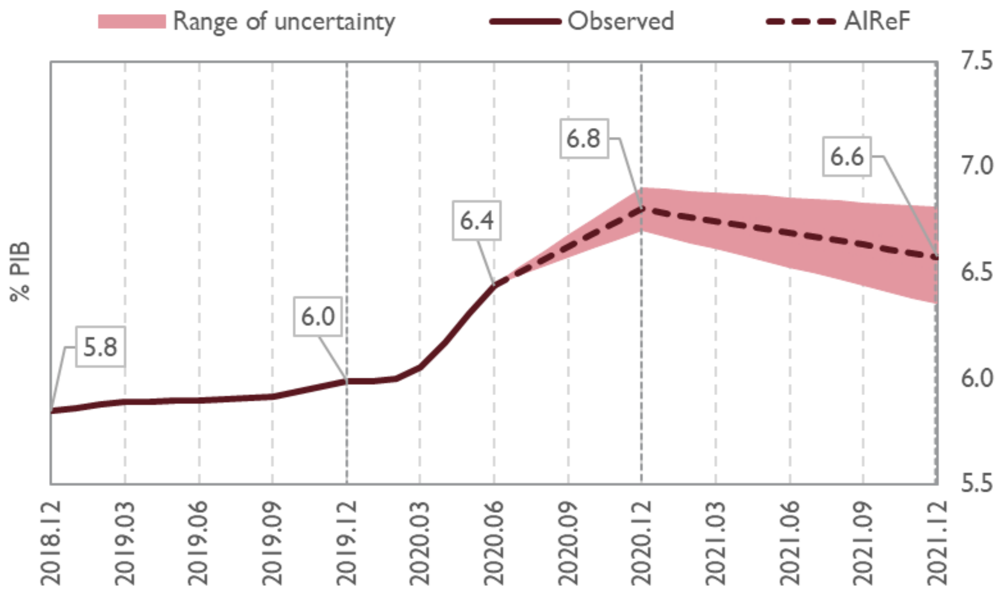


FIGURE 72. EVOLUTION OF EXPENDITURE IN LOCAL GOVERNMENTS (% GDP)



4.5. Contingent liabilities and fiscal risks

AIReF considers the existence of significant fiscal risks that could affect 2021, mainly resulting from the pandemic. In this section, AIReF identifies a series of fiscal risks that it considers to be greater than in other years because the usual risks are on top of risks generated as a result of the pandemic. These include risks relating to the guarantees granted to SMEs and self-employed workers to maintain the liquidity of the productive fabric; the risks resulting from the materialisation of another less favourable macroeconomic scenario; the risks resulting from the execution of the RTRP; the risks resulting from an excessively optimistic revenue forecast or the risk of expenditure associated with the pandemic becoming structural.

4.5.1. Fiscal risks arising from the pandemic.

Uncertainty about the evolution and duration of the health crisis persists and may continue during 2021. AIReF's central scenario, like that of most institutions, assumes a satisfactory resolution of the crisis in the first half of the year. However, there is a risk of other less benign scenarios materialising that would have a strong impact on economic activity and General Government, as AIReF has attempted to show by designing a pessimistic scenario. This risk, which has already been analysed in previous sections, remains the main risk facing the Spanish and the global economy.

In addition, there is a risk that expenditure linked to the pandemic becomes structural after the pandemic has disappeared. Substantial spending measures have been taken to address the health, economic and social crisis resulting from the pandemic. These measures are of a temporary nature, since their origin is linked to the extraordinary and exceptional situation of the pandemic. The risk is that, once the extraordinary needs that gave rise to it disappear, this expenditure will remain and become structural. Consolidation of this extraordinary spending over time would put undue upward pressure on expenditure, jeopardising the future fiscal consolidation of General Government. This risk rises with the materialisation of the optimistic scenario, as an early resolution of the crisis might render unnecessary certain expenditure increases for which funding has already been planned.

Both the Budgetary Plan and the draft GSB for 2021 refer to the liquidity measures adopted by the State in 2020 to address the pandemic. As a result of the COVID-19 crisis, the Government took numerous liquidity measures to ensure the sustainability of the productive fabric. Particularly noteworthy in terms of their amount were the measures to strengthen and create lines of financing and guarantees by the State, approval of the deferral of debts and moratoriums and implementation of various tax measures aimed at maintaining the liquidity of companies and self-employed workers. This whole package of measures amounts to around €160bn (13% of GDP). All this funding has so far made it possible to mobilise over €102bn, mainly for SMEs and self-employed workers.

According to the 2021 Budgetary Plan, these measures are not expected to lead to a greater deficit in 2020, although no mention is made of the impact in 2021. In theory, if the respective guarantees and/or collateral are not enforced, these measures will not lead to a greater deficit for the State. In this regard, the Budgetary Plan does not estimate that any of these guarantees will be enforced in 2020 and does not therefore forecast any budgetary impact for this year. This estimate is based, firstly, on the fact that the most important guarantee measures are usually associated with a one-year grace period. Secondly, it is based on the fact that these liquidity measures normally set the requirement of a situation of solvency on 31 December 2019, and they have therefore been allocated to companies that only have liquidity (and not solvency) problems. In contrast, no information is collected on how these fiscal risks are estimated to affect public accounts in 2021.

However, AIReF considers that there are important factors that raise the risk of enforcement of these guarantees. On the one hand, the high number of guarantees and collateral granted, which amount to 13% of GDP. On the other hand, the uncertainty that remains about the evolution and duration of the pandemic. In this regard, the development of recent events in which restrictions on mobility and authorised capacities are becoming widespread poses a serious obstacle to many businesses, in which SMEs and the self-employed are particularly vulnerable. There are therefore objective circumstances that raise the likelihood of the enforcement of these guarantees and, therefore, an impact on the deficit of 2021 and/or future years.

4.5.2. Implementation risks of the extraordinary EU funds (RRF and REACT-EU)

The process of implementing the extraordinary EU funds (RRF and REACT-EU) also carries several fiscal risks. AIReF's central baseline scenario for making its estimates has been built by accepting a set of assumptions included in the draft 2021 GSB on implementation of the European funds, which, if not carried out, might lead to the materialisation of a less favourable macroeconomic and fiscal scenario. These risks may be manifested in various aspects, including those relating to the selection of projects; the pace of their implementation; maintenance of expenditure once European funding is exhausted; non-compliance with the milestones set for receiving payments and the possible timing impact on the public deficit in view of possible time lags between the funds received and the expenditure made.

One of the risks is that the projects selected will not be suitable for achieving the desired effects on the economy. The RRF and REACT-EU funds are provided with the aim of boosting economic activity in EU countries that have been severely affected by the pandemic crisis. The ultimate aim of these European Funds is not to temporarily finance the economic stoppage or slowdown during the months that the pandemic lasts, but rather to undertake the necessary structural reforms in each country to improve their potential growth. The aim is to prevent the COVID-19 crisis from eventually causing a drop in potential output at a structural level. In this context, it is essential that the projects selected are suitable for achieving the intended aims. Otherwise, the desired effect on potential GDP would not be achieved and the scenario that would materialise would be less favourable than that forecast by AIReF.

Another risk would be related to an insufficient pace of project implementation in 2021. The draft 2021 GSB forecasts a high level of execution of the Funds in 2021. In that year alone, spending projects worth around €26.6bn, around 2.2% of GDP, are expected to be carried out. This assumption is the ideal scenario because the sooner the funds are implemented, the sooner the positive effects on a country's economic activity start to be observed. However, if this scenario does not materialise and not all the projects planned for 2021 are implemented, there is a risk that the economy’s recovery will be slower and, in turn, the impact on revenue will be delayed. In short, this would make it difficult to reach the reference deficit levels.

Similarly, the design of the RTRP might lead to an increase in the structural deficit once its implementation is completed. The projects making up the RTRP will have a duration that goes beyond the implementation period of the RTRP itself and, therefore, of the funding that the Plan provides. There is therefore the risk that part of the expenditure of the RTRP will become structural and no permanent funding of the RTRP will have been provided for.

4.5.3. Other fiscal risks

Apart from the guarantees granted due to the pandemic, the Budgetary Plan only includes the amount of the guarantees for 2019. This information is also not routinely included in the GSB and can only be found scattered and partially in the accounts of General Government. The Budgetary Plan only includes the total value of the guarantees granted for 2019. Details are provided in relation to the guarantees granted by General Government and each sub-sector only to units that are not part of General Government. It does not therefore include, for example, the guarantees of FROB (Fund for Orderly Banking Restructuring) or the Securitisation Fund of the electricity system deficit or the guaranteed debt of the European Financial Stability Fund. The total value for the General Government amounted to 4.9% of 2019 GDP, with 99% corresponding to the CG. Detailed information is available in other reports, such as the annual accounts of the General State Administration (AGE) and public sector businesses and foundations, but in a scattered and incomplete manner.

The Budgetary Plan does not therefore include information on other possible contingent liabilities that may affect 2019 and 2020. This information is also not routinely included in the GSB and can only be found scattered and in partial form in the accounts of General Government. In particular, the 2019 General Account of the CSA includes a list of contingent liabilities of close to €14bn related, mainly, to the Administration's Financial Liability with regard to companies awarded ACESA toll motorway concession contracts (€2.376bn), the equity loans granted to companies awarded motorway concession contracts in a delicate financial situation (€257m), the partnership agreements concluded with the Regional Government of the Balearic Islands on roads, the international energy arbitrations for renewable energy support schemes (€9.632bn), the appeals filed by the regions and local Governments in relation to the definitive settlement of 2017 due to the new VAT management system (€1.298bn), the financial liability private copy compensation (€135m) and for sundry issues (€30m).

The Supreme Court has just recognised the right to collect from the State the compensation of €1.35bn paid for the closure of the Castor gas storage facility. The closure of the platform in 2013 was accompanied by a decree for compensation processed urgently to the promoter for an amount of €1.35bn. This compensation was made by ENAGAS financed by CaixaBank (€450m), Bankia (€200m) and Banco Santander (€700m) in exchange for the right to collect that would be passed on to the gas bill over a period of 30 years. This decree for compensation was declared null and void by the Constitutional Court in 2017 due to its urgent processing, leaving this right to recovery without effect. The banks claim from the Government the €1.35bn paid out in advance and the Supreme Court, on 29 October this year, recognised the rights of the three banks to collect that amount. Therefore, unless regulated again, the State may have to assume the financial responsibility for €1.35bn.

There are other operations that may pose a medium-term risk to the projected deficit path, such as military investments, and for which no information is provided. Investments in defence modernisation programmes are already in progress, involve a significant volume of expenditure each year and will have a major impact on the deficit in the coming years. However, no information is published on the planning of these military deliveries and their impact on the public deficit. There is also no information on the possible impact of the risks assumed by public-private partnership contracts or loans granted by General Government that might prove to be doubtful receivables.

5. EVOLUTION AND SUSTAINABILITY OF THE PUBLIC DEBT

5.1. Recent evolution and short-term projections

The high starting level of debt of the Spanish economy, with a debt-to-GDP ratio of 95.5% at the end of 2019 is an added difficulty in addressing the challenges that will arise from the economic crisis caused by the pandemic. One of the main legacies of economic crises is that public debt rises quickly but requires a much longer period to fall. This has been the case of the *Great Recession*. The 2008 crisis led to a 65-point increase in the debt-to-GDP ratio in just seven years, of which only five points have been reduced in the last five years. Had the annual debt reduction requirements of the Organic Law on Budgetary Stability and Financial Sustainability been met, the debt-to-GDP ratio in 2019 would have stood at around 90% instead of the value. The slow reduction of the debt ratio despite favourable growth conditions and historically low interest rates has limited the fiscal space to tackle a new crisis.

The stoppage of economic activity that took place in the first half of 2020 and the increase in borrowing needs resulting from the COVID-19 crisis have placed the debt-to-GDP ratio at around 110%, its highest level of the last 100 years. In the first six months of the year, over 100 billion euros were added to the public debt, bringing it to €1.3 trillion, raising the debt-to-GDP ratio to 110.2%, an increase of 14.7 points compared with the end of last year.

FIGURE 73. DEBT (% GDP), QUARTER-ON-QUARTER EVOLUTION

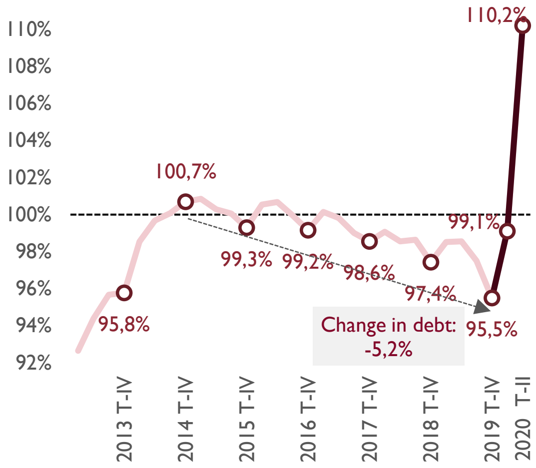
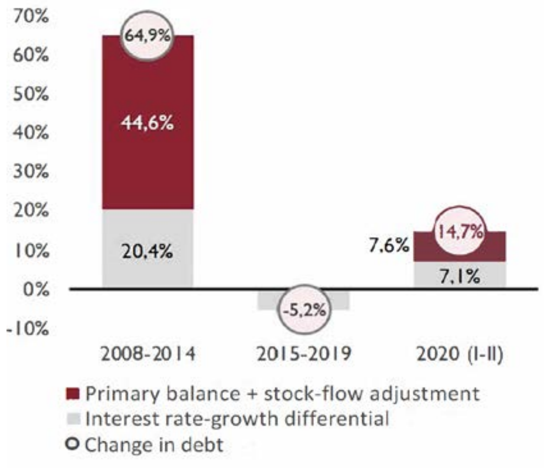


FIGURE 74. CONTRIBUTION TO THE CUMULATIVE CHANGE IN DEBT-TO-GDP RATIO



AIReF estimates an increase of close to 23 points in the debt-to-GDP ratio in 2020, and a fall of 2.4 points in 2021 under the assumption that all the projects included in the GSB[17] for that year are implemented. The projected widening of the Government deficit and fall in growth in 2020 will raise the debt ratio by 22.8 points, bringing it to 118.4% of GDP. The rebound in economic growth driven by the Recovery Plan in 2021, coupled with an environment of interest rates at historic lows, will result in a 2.4-point reduction in the ratio, to 116%. Both forecasts are in line with those presented previously by the Government in the 2021 GSB.

[17] The 2021 GSB estimates at €27.463bn the public expenditure that may be financed by transfers that the Kingdom of Spain will request from the European Commission in accordance with the RTRP.

FIGURE 75. DEBT FORECAST BY AIREF AND DRAFT 2021 BUDGET

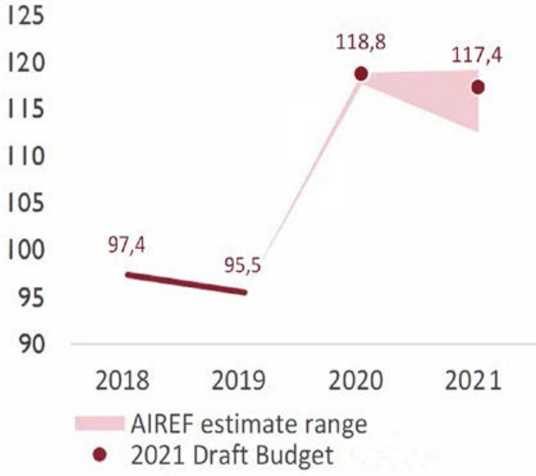
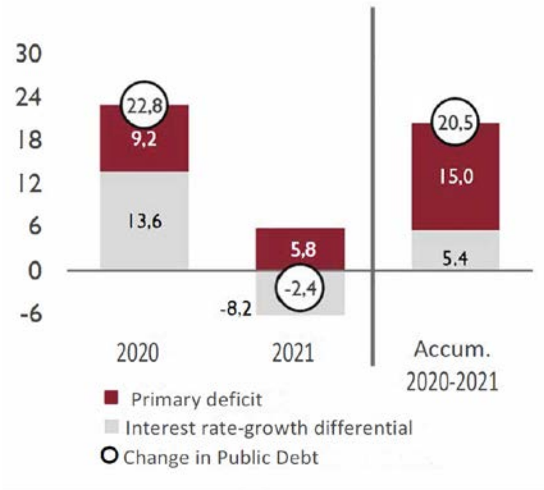


FIGURE 76. CONTRIBUTION TO CHANGE IN DEBT-TO-GDP RATIO



The fall in interest rates recorded in recent years has allowed a considerable reduction in the debt burden, bringing the interest expense to 2.3% of GDP at the end of 2019 from a peak of 3.5% in 2013. Since mid-2012, the effective cost of financing the General Government debt has fallen systematically by a total of 180 basis points (4.2% in 2012 vs. 2.4% in 2019), which has made it possible to reduce the interest expense, even in its absolute value, from €35,442bn in 2014 to €28,349bn in 2019.

FIGURE 77. INTEREST EXPENSE (%GDP) AND IMPLICIT INTEREST RATE ON DEBT (%)

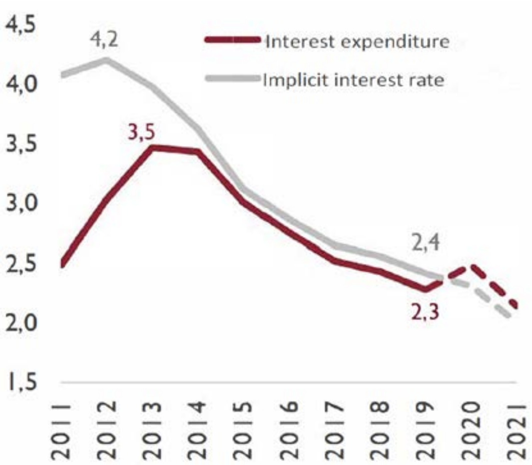
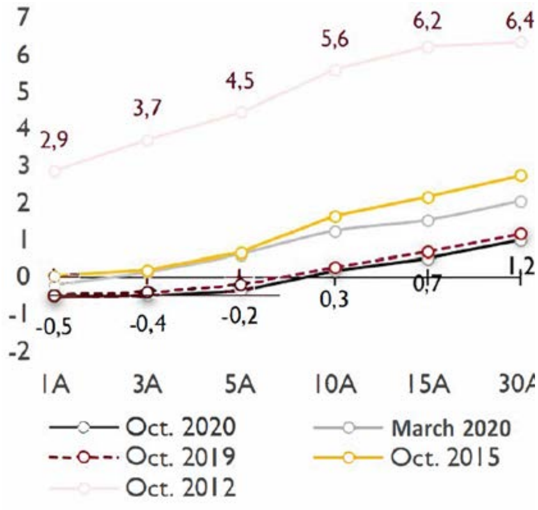


FIGURE 78. YIELD CURVE OF SOVEREIGN BONDS



Following a brief but significant rebound in sovereign debt yields and risk premiums of southern European countries at the beginning of the crisis, the

intensification of asset purchases by the ECB has brought spreads back to previous levels. Following a significant rebound in sovereign debt yields and risk premiums of southern European countries, where the yield on the Spanish 10-year bond rose to 100 bp, the ECB's commitment to ensure the smooth transmission of monetary policy by avoiding fragmentation in public debt markets through its Pandemic Emergency Purchase Programme has brought spreads close to pre-crisis levels and the Spanish interest rate curve to the level recorded in February, close to historic lows.

Despite the expected increase in the level of debt, under current borrowing conditions, the financial burden does not represent a worrying expenditure pressure in the short term. The favourable borrowing conditions for sovereign debt (the average rate of new Treasury issues stood at 0.23% in 2019 and 0.21% until October 2020, with a negative rate curve for terms of over five years) restrict an increase in the financial burden as low average borrowing rates offset the higher debt stock. However, this increase in debt generates a significant level of dependence on an environment of low interest rates, as explained below.

5.2. Sustainability analysis

The baseline scenario before including the Recovery Plan

The health crisis will need to be contained and economic activity normalised for the debt-to-GDP ratio to stabilise in the coming years. As noted above, the exceptional increase in the public debt ratio over 2020 has been caused by the COVID-19 crisis, and as long as uncertainty about the factors that have contributed to this increase (higher public expenditure, lower tax collection, fall in GDP) persist over time, additional rises in the debt ratio over the short-term cannot be ruled out.

Under the assumptions of AIReF's baseline scenario, in which above-trend growth is recorded for several years, in the absence of any measures (whether contractionary or expansionary linked to the RTRP), the debt-to-GDP ratio would stabilise at around 120%. A scenario of sustained growth that closes the negative output gap of 2020 over the next five years will cause, beyond the denominator effect, the cyclical component of the Government balance to improve, thus helping to stabilise the debt-to-GDP ratio at the level of 120%.

FIGURE 79. DEBT (% GDP), WITHOUT NGEU RECOVERY PLAN

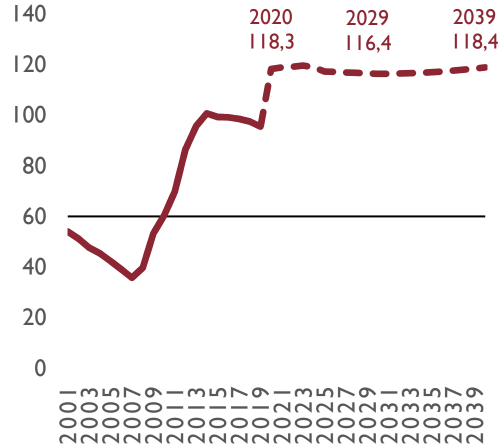
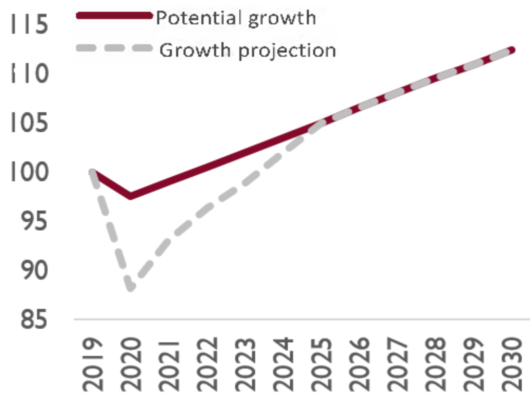


FIGURE 80. REAL GROWTH, CLOSING THE OUTPUT GAP IN FIVE YEARS



Impact of the Recovery Plan

The implementation of the European Next Generation EU Plan[18] will have a positive effect on economic activity in the short term. At the same time, it might lead to an improvement in productivity and long-term potential growth, which will result in an improved evolution of the fiscal position. The European NGEU Plan will provide a strong boost to public investment over the coming years without leading to a deterioration in public finances. There is major uncertainty about the impact of the plan and its economic effects will depend, among other factors, on the ability to execute the public Budget quickly, on how and on what the funds are invested and on the reforms that are made in order to increase potential growth.

Under a scenario of implementation of all the projects financed under transfers from the European NGEU Plan in the next three years, and assuming different fiscal multipliers, an impact on the reduction of the debt-to-GDP ratio of between 4 and 10 points is estimated. The Plan's impact on improving the debt ratio will be determined both by the denominator effect, given greater GDP growth, and by an improvement in the public balance thanks to higher tax collection, without a balancing entry of an increase in debt issuance, since new investments will be financed through transfers. This effect will be greater depending on the type of project and the associated multiplier effect. Under a simulation of the impact on short-term growth with different fiscal multipliers (between 0.5 and 1.5), and an increase in long-term potential growth of 0.15

[18] Over the next three years, the Kingdom of Spain will apply to the European Commission for direct transfers under the Next Generation EU programme in an amount of approximately €72bn. Of this sum, €27.463bn will be allocated in 2021, while the rest will be spread over the remaining two years.

points, the Recovery Plan will lead to a reduction in the debt-to-GDP ratio of between 4 and 10 points in 2030.

FIGURE 81. DEBT (% GDP)

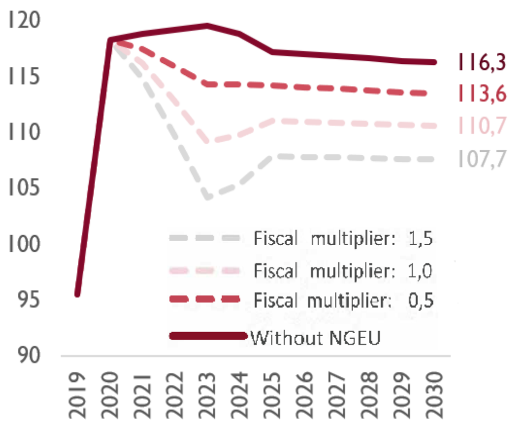
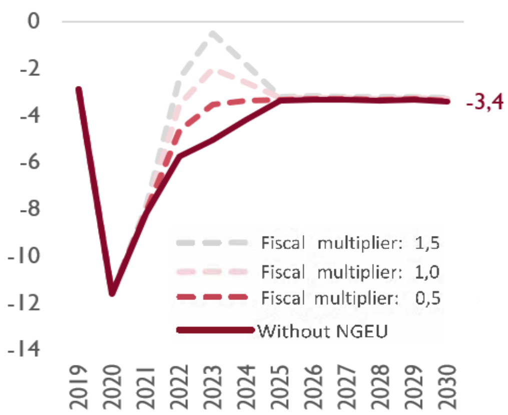


FIGURE 82. DEFICIT (% GDP)



Budgetary balance and sustainability over the medium term

As shown by the simulations performed by AIReF, the high levels of public debt mean that, when the crisis is over, consolidation plans must be designed to generate a sustained reduction in the debt ratio to more prudent levels. Beyond containing and stabilising the level of debt generated by the pandemic, the financial sustainability of the public accounts will require a path for reducing the debt ratio towards a much more stable position. The tailwind of a likely scenario with economic growth higher than the implicit interest-rate on debt will be a necessary, but not sufficient, condition for generating a downward path in the debt ratio, which at any rate will require the correction of the structural imbalances in the public accounts. Accordingly, maintaining a structural deficit like that recorded in 2019 over the long term will stabilise the debt at levels significantly above 100% of GDP. A gradual and sustained reduction of the public deficit towards structural equilibrium, as indicated by our fiscal framework, will generate a more marked path for reducing the debt ratio, placing it at the level prior to the pandemic over the coming decade.

FIGURE 83. DEBT (% GDP)

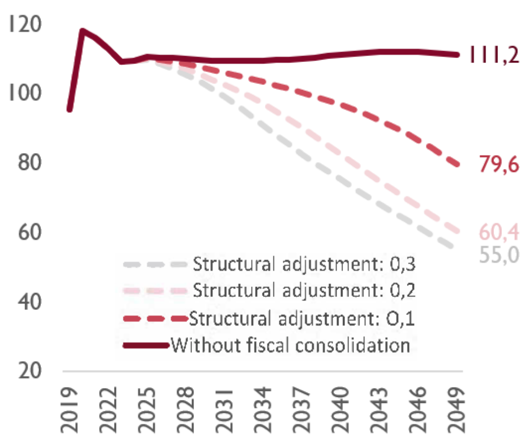
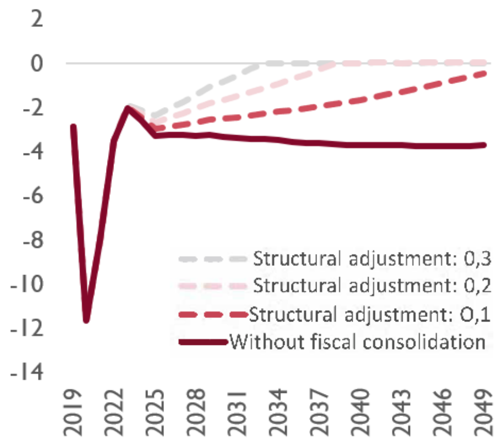


FIGURE 84. DEFICIT (% GDP)



Medium and long-term risks

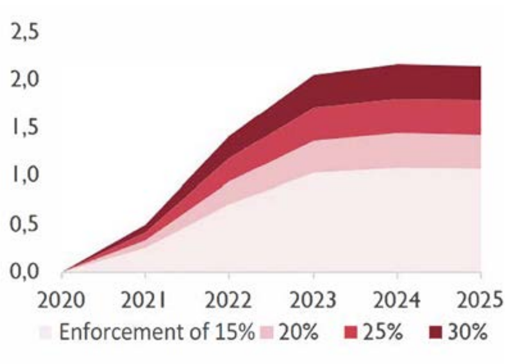
One of the major risks of the current situation is that the recession might mutate into a depression. This would mean that it will be necessary in the future to address not only a higher public debt ratio, but also a higher and more persistent structural deficit. The longer the economic crisis lasts, the more likely it will be that company bankruptcies, cancelled investments, worsening capital stock and long-term unemployment will eventually erode the capacity for growth in the medium term (i.e., potential growth). This would hinder the reversal of part of the current increase in the public deficit, the relief of which has a direct impact on the intensity of the subsequent recovery.

The materialisation of this risk would translate the contingent liabilities that the State is assuming with the umbrella guarantee programme[19] into losses, which would be reflected in an increase in the level of public debt.

[19] Royal Decree-Law 8/2020 of 17 March approved a Line of State Guarantees of up to €100bn to help maintain employment and mitigate the economic effects of the health crisis.

For the purpose of quantifying the order of magnitude of the risk, it is estimated that a level of enforcement of between 15% and 30% of the guarantees granted by the State over the next five years in which the line of guarantees is valid would lead to an additional increase in the debt ratio of between 1 and 2 points of GDP.

IMPACT ON DEBT (%GDP) OF THE ENFORCEMENT OF GOVERNMENT GUARANTEES



The reliance on an environment of low interest rates over a long-time horizon has become one of the most prominent aspects of the dynamics of debt sustainability. The current level of interest rates at historic lows favours debt sustainability, even allowing the stabilisation of the debt ratio under a given primary deficit. However, given the high debt level, an upturn in interest rates might quickly generate an upward trend in the ratio, which would need to be offset by additional fiscal adjustments for it not to become unsustainable. Accordingly, a rise of 100 bp in interest rate expectations over 2021 would lead to an increase in the financial burden of 1 point of GDP in 2030 and 1.4 in 2040, placing the heading of interest expenditure at 2.8% and at 3.6% of GDP, respectively. This would result in a 6-point increase in the debt ratio in 2030 and a 15-point increase in 2040.

FIGURE 85. INTEREST EXPENDITURE (% GDP)

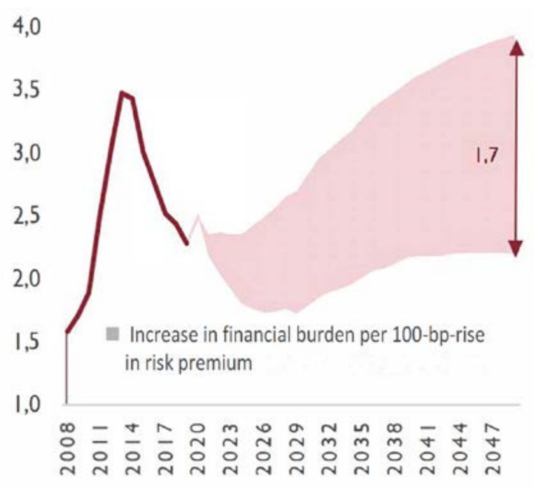
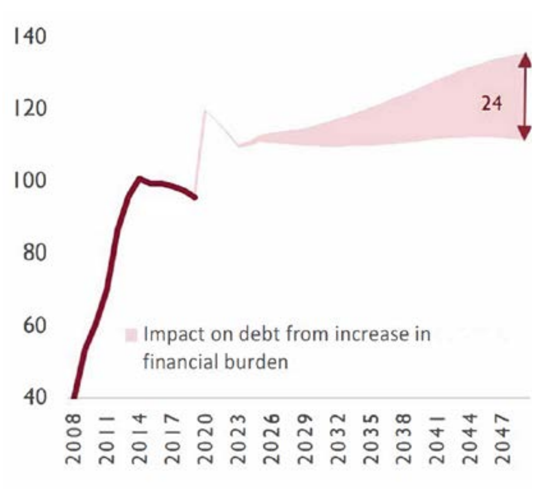


FIGURE 86. DEBT (% GDP)



In addition, the increase in pension expenditure linked to the ageing of the population is one of the major challenges for the sustainability of public

finances in the medium term. The "[Update of demographic and pension expenditure forecasts](#)" recently presented by AIReF estimates an increase in pension expenditure of 3.3 points of GDP over the 2019 level, bringing it to 14.2% by 2050. This increase in expenditure will be determined by the ageing process of the population and might be significantly raised should any of the risk scenarios simulated by AIReF materialise, such as lower net migration flows, stagnation of the labour market or the COVID-19 crisis having structural effects.

FIGURE 87. PENSION EXPENDITURE (% GDP)

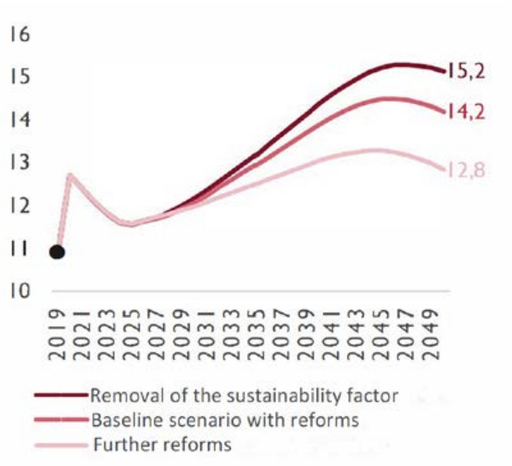
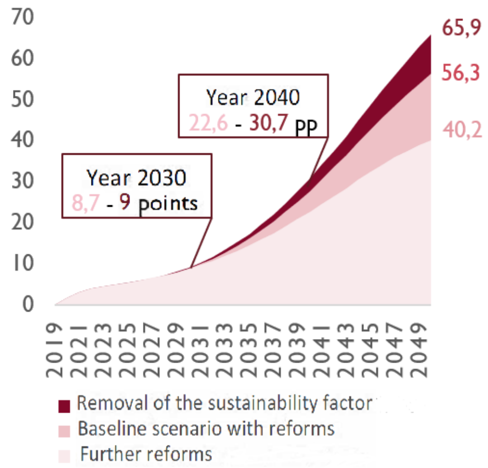


FIGURE 88. ADDITIONAL INCREASE IN DEBT (% GDP)



Higher structural expenditure on the pension system that is not covered by additional revenue will lead to a very significant rise in debt from historically very high levels. Accumulation of debts resulting from funding-increased pension expenditure poses a risk factor for medium-term sustainability. AIReF estimates a rise in the debt-to-GDP ratio of around 9 points at the end of this decade and between 22 and 30 points by 2040.

TABLE 18. PROJECTED PENSION EXPENDITURE SCENARIOS

Scenarios	Pension expenditure (% GDP)	Coverage rate	Debt increase (% GDP)
a. Baseline scenario with reforms: ➢ 2011 parametric reforms ➢ Application of the sustainability factor	14,2% GDP	53,3%	+56,3 pp GDP
b. Removal of the sustainability factor	Increase in expenditure of 0.9 points of GDP	56,9%	+65,9 pp GDP
c. Further reforms: ➢ Increase in the effective retirement age from 64.1 to 66. ➢ Increase in contribution career from 25 to 35 years	Saving of 1.4 points of GDP	52,7%	+40,2 pp GDP

6. RECOMMENDATIONS

6.1. New Recommendations:

There is still a high level of uncertainty about the evolution of the COVID-19 health crisis. As AIReF has been pointing out in the reports issued since the start of the pandemic, short-term measures need to be taken to cushion the impact of the crisis, without losing sight of a more medium-term perspective.

On the one hand, this means implementing flexibility mechanisms such as those planned and already activated in national and regional legislation. However, in both cases, emphasis is placed on the idea of maintaining fiscal responsibility by maintaining fiscal oversight mechanisms in force, such as AIReF reports.

The future evolution of the pandemic may lead us to different situations that AIReF has attempted to set out in the report by means of the central, optimistic and pessimistic scenarios. They all come with different risks for the sustainability of the public accounts and their materialisation will require General Government to have a significant capacity to adapt to reality.

Materialisation of more pessimistic scenarios will undoubtedly lead to a lower reduction in the deficit in the short term due to lower collection and the greater need for mitigating measures against the crisis. In this regard, the 2021 GSB guarantees stability of revenue for the regions to address the situations and therefore the bulk of the deviation would fall to the CG in the event of more adverse situations.

However, the materialisation of more optimistic scenarios also entails risks to sustainability, although they will boost deficit reduction in the short term through higher revenue. Accordingly, with the provision of resources for more adverse situations and in the absence of fiscal risks, there is a risk of maintaining a high growth in expenditure, no longer on a temporary basis and only to mitigate the effects of the crisis, but on a permanent basis, thus hindering the future reduction of the structural deficit.

For this reason, AIReF recommends that all administrations:

1. ***Adapt their actions in 2021 according to how the pandemic develops and the scenario that eventually materialises, aiming to avoid structural***

increases in expenditure that are not accompanied by the corresponding structural financing.

2. ***In response to the challenge of effectively monitoring the effects of the pandemic, AIReF makes a 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.***

6.2. Repeated recommendations

In successive reports that AIReF has issued over the year (firstly, in May, in the report on the Stability Programme Update, then in July, in the report on Budgetary Execution and, finally, in October, in the report on the Escape Clause), it has recommended that a medium-term national fiscal plan be drawn up.

There are several factors that make this plan particularly necessary over the medium term. Firstly, the Organic Law on Budgetary Stability and Financial Stability requires that the administrations carry out medium-term planning despite the seriousness and exceptional nature underlying activation of the escape clause. Secondly, the General Government Budget for 2021 includes the impact resulting from the Recovery for Europe Plan or “Generation EU” for an amount of close to €27.5bn to undertake investments in reforms which, due to their nature, have a multi-year effect and therefore go beyond the scope of the annual budgets. Thirdly, a context of uncertainty resulting from the pandemic persists, which strengthens the importance of having a medium-term perspective to be able to take decisions anticipating the consequences and in accordance with any circumstances that materialise.

The Ministry of Finance considers that it is already complying with this recommendation, as it is preparing the National Recovery and Resilience Plan 2021-2023, which it sets as the strategic framework for the policies to be implemented by General Government.

However, AIReF considers that the presentation of the 2021 GSB should already be accompanied by such a medium-term fiscal strategy. They should form the framework for these annual budgets in order to visualise the effects of the revenue and expenditure policies, the deficit path and expected debt and also to provide the necessary continuity to the revenue and expenditure linked to the recovery and resilience funds.

In addition, as already indicated in the AIReF report on the escape clause, it is important to bear in mind that the National Recovery and Resilience Plan is a medium-term plan for strategic investments and reforms of the General Government and, as such, will form part of the National Reform Programme, whether as an annex or as part of its content. However, it may only be deemed a medium-term fiscal plan to the extent that it reflects the forecasts of the main fiscal aggregates, so that it may serve as an instrument of budgetary policy beyond the annual budgetary calendar, including the setting of medium-term strategic priorities and budgetary targets.

For this reason, AIReF reiterates to the Government its recommendation that it should prepare such a national fiscal plan, whether this is part of the National Recovery and Resilience Plan, meeting certain fundamental requirements.

Therefore, ***AIReF reiterates to the Ministry of Finance***:

3. ***That it should 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.***
    - ***Considering the public debt levels and fiscal risks, particularly those assumed as a result of managing the COVID-19 crisis.***
    - ***Establishing a tentative timetable for achieving milestones.***
    - ***Acting as a framework for the rebalancing plans of General Government and promoting coordination of the strategy with the Recovery and Resilience Plan.***

6.3. Live recommendations[20]

In its report on the draft GSB for 2017, AIReF first alerted that no information had been included relating to national accounts adjustments, which made it impossible to determine whether the Budget was presented in line with the target set and it was recommended that the Ministry of Finance should urgently include information relating to said adjustments. This

[20] This section sets out recommendations made in previous reports which, even though the Ministry of Finance has explained the reasons why it deviates from compliance with the recommendations, AIReF considers them important for achieving the effectiveness and credibility of fiscal rules and a robust fiscal framework, which it believes is not guaranteed by the usual system and practices. It therefore considers that these recommendations remain in force, they are “live recommendations” and it urges the Ministry of Finance to comply with them. Should this not be the case, it is not necessary to explain once again the reasons for deviating from them, unless they are no longer the same.

recommendation was subsequently repeated in the respective reports on the draft GSBs for 2018 and 2019, which were presented in the same terms.

In its reply, the Ministry of Finance argued that the adjustments will be reflected and published, in accordance with EU regulations, in the EDP (Excessive Deficit Protocol) notification to be made.

AIReF considers that it is not sufficient for national accounts adjustments to be published in EDP notifications, as these reflect adjustments in the implementation of revenue and expenditure, but not the adjustments forecast in the initial Budget, which is when the GSB is drawn up and approved. These adjustments during execution do not allow for the reconciliation of the approved Budget with the stability target. Nor do they make it possible to know from the start the forecasts of the adjustments to allow them to be properly overseen, bearing in mind that the national accounts adjustments are a factor of possible deviation with regard to the deficit target.

As indicated in this report (see section XXX), since the GSB does not include the accounting adjustments that would allow reconciliation of the budgetary balance with the deficit in national accounts terms, these adjustments have gone from having an insignificant impact to having a notable impact on the deviation from the deficit target. Furthermore, the amount of these adjustments for 2021 is estimated to be much higher than that of previous years, at around 2% of GDP.

Therefore, as the draft 2021 GSB once again fails to include national accounts adjustments, AIReF insists that these adjustments be made transparent and included in the GSB. In addition to being a legal obligation (Articles 6 and 27 of the Organic Law on Budgetary Stability and Financial Sustainability); this is essential for determining whether the Budget is in line with the deficit target (or a reference as is the case of the 2021 GSB) and to prevent deviations from the target through the route of national accounts adjustments.

For this reason, ***AIReF recommends:***

4. That the following be included in the draft GSB:

a. information on national accounts adjustments to reconcile the budget balance with net borrowing or lending in terms of ESA 2010.

b. information on those entities which, although not of a public nature, are included for the purposes of ESA 2010 in the Central Government sub-sector and on the balance resulting from the net lending or borrowing of Central Government Bodies.

5. That the draft GSB for next year should include an initial Budget in national accounts terms for the Central Government and the Social Security Funds.

The president of AIReF

Cristina Herrero Sánchez

ANEXO I. MODELS USED IN AIREF'S MACROECONOMIC SCENARIOS

ERROR CORRECTION MODELS

LONG-TERM EQUATION		SHORT-TERM EQUATION	
PRIVATE CONSUMPTION			
Gross disposable income of households and NPISHs (vol.) (log)	0.634	Gross disposable income of households and NPISHs (vol.) (dlog)	0.146
Household financial wealth. Volume (log)	0.113	Total household credit. Volume (dlog)	0.119
Household wealth. Volume (log)	0.054	Employment rate (difference)	0.006
Total household credit. Volume (log)	0.044	Long-term error	-0.233
Type of credit to households. Real (levels)	-0.002	Constant	0.002
Constant	0.745		
INVESTMENT IN EQUIPMENT			
GDP Volume (log)	0.858	GDP Volume (dlog)	2.724
Relative unit labour costs (log)	-0.413	Capacity utilisation (differences)	0.006
Lending to resident companies. Balance Real (log)	0.180	Long-term interest rates Real (differences)	-0.008
Capacity utilisation (levels)	0.028	Long-term error	-0.177
Effective Corporate Income Tax rate * Dummy before 2008q1	-0.127	Dummy from 2013q1 to 2013q4	0.037
Effective Corporate Income Tax rate * Dummy after 2008q1	-0.142	Constant	-0.009
INVESTMENT IN CONSTRUCTION			
Price of Square Metre Housing INE Real (log)	0.154	Price of Square Metre Housing INE. Real (dlog)	0.135
Unemployment rate (levels)	-0.022	Unemployment rate (differences)	-0.018
Lending to households Housing. Volume (log)	0.195	Lending to households Housing. Volume (dlog)	0.228
Household financial wealth. Volume (log)	-0.172	Dummy 2014q1	0.049
Construction Climate Index (levels)	0.001	Long-term error	-0.278
Constant	4.289		
EXPORTS			
World Trade in Goods. Volume (log)	0.975	World Trade in Goods. Volume (dlog)	0.750
Euro-dollar exchange rate (log)	-0.232	Long-term error	-0.247
Relative unit labour costs (log)	-0.425	Constant	0.003
Constant	2.020		
IMPORTS			
Investment in equipment and cultured acts. Volume (log)	0.502	Investment in equipment and cultured acts. Volume (dlog)	0.279
Private consumption Volume (log)	0.818	Private consumption Volume (dlog)	1.024
Exports of goods and services. Volume (log)	0.249	Exports of goods and services. Volume (dlog)	0.633
Dummy from 2015q2	-0.052	Euro-dollar exchange rate (dlog)	0.089
Constant	-2.594	Long-term error	-0.182
PRIVATE EMPLOYEES			
GDP Volume (log)	2.035	GDP Volume (dlog)	1.170
Working age population. Total (log)	1.573	Nominal compensation per employee (dlog)	-0.111
Private capital stock (log)	-1.299	Dummy (2008Q2 2012Q4)	-0.009
Constant	3.136	Long-term error	-0.227
COMPENSATION PER EMPLOYEE. PRIVATE			
CPI Genral (log)	1.036	General CPI (dlog)	0.535
Productivity per employee (log)	0.381	Productivity per employee (dlog)	0.605
Compensation per employee. Public (log)	0.044	Compensation per employee. Public (dlog)	0.199
Effective rate of social contributions (levels)	-0.027	Effective rate of social contributions (differences)	-0.018
Dummy 2008q1 2012q4	0.017	Long-term error	-0.250
GROSS DISPOSABLE INCOME OF HOUSEHOLDS AND NPISHs			
Compensation of employees Total: Nominal (log)	0.513	Compensation of employees Total: Nominal (dlog)	0.465
Gross Operating Surplus Households and NPISHs Nominal (log)	0.273	Gross Operating Surplus Households and NPISHs Nominal (dlog)	0.344
PIT proxy rate (levels)	-0.006	PIT proxy rate (differences)	-0.007
Different Social Benefits STK. Nominal (log)	0.174	Different Social Benefits STK. Nominal (dlog)	0.160
Constant	1.339	Long-term error	-0.343
CORE CPI			
		GDP Volume (dlog)	0.134
		Unemployment rate (differences)	0.000
		Effective VAT rate (differences)	0.002
		Dummy 2012q4	-0.004
		Constant	0.007
GENERAL CPI			
		Core CPI (dlog)	1.030
		Brent in EUR = Brent* exchange rate EUR/$ (dlog)	0.016
GDP DEFLATOR			
		General CPI (dlog)	0.233
		Housing Price INE. Nominal (dlog)	0.074
		Unit labour costs (dlog)	0.316
		Dummy 97q4	0.014
		Constant	0.002

Sample 1995Q1 - 2018Q4 (except for private consumption and imports due to anomalous data at the beginning of the sample, 2000Q1 - 2018Q4 is taken

ANEXO II. MACROECONOMIC OUTLOOK. BASELINE SCENARIO

MACROECONOMIC SCENARIO		Central scenario	
VOLUME	**2019**	**2020**	**2021**
GDP (% actual change, unless otherwise indicated)	2.0	-11.1	8.2
Total consumption (contribution to GDP growth)	**1.0**	**-6.6**	**5.3**
Private consumption	0.9	-13.5	8.8
Public consumption	2.3	6.2	2.1
GFCF Equipment and cultivated assets	4.3	-16.5	27.7
GFCF Construction and intellectual property	1.9	-14.0	18.1
Domestic demand (contribution to GDP growth)	**1.4**	**-9.5**	**9.4**
Exports	2.3	-20.0	10.2
Imports	0.7	-16.8	14.8
PRICES	**2019**	**2020**	**2021**
GDP	1.4	0.8	1.3
Private consumption	1.0	-0.2	1.2
NOMINAL	**2019**	**2020**	**2021**
GDP	3.4	-10.5	9.6
GDP at current prices (billion euros)	1,244.8	1,114.7	1,221.8
Income	**2019**	**2020**	**2021**
GDP	1,244.8	1,114.7	1,221.8
Compensation of employees	4.8	-7.5	7.4
Gross Operating Surplus	2.5	-10.9	10.2
Net taxes on production & M	0.9	-21.9	18.1
Household saving rate (%)	6.8	16.1	12.7
EXTERNAL ASSUMPTIONS			
EU area growth (g)	1.5	-8.0	5.0
Nominal effective exchange rate (ESP/OECD)	-0.9	0.4	0.0
Interest rates for company loans up to 1 million euros (%)	2.6	2.4	2.9
Euribor 12m (level)	-0.2	-0.2	0.1
Oil price (US$/barrel)	64.4	42.3	43.9
EMPLOYMENT			
Employment (% change. Unless otherwise indicated)	**2019**	**2020**	**2021**
Total FTE employment	**2.3**	**-7.6**	**6.5**
Compensation per FTE employee (thousand euros)	**2.1**	**1.5**	**0.5**
Productivity per employed person	-0.3	-3.9	1.6
Nominal unit labour cost (ULC)	2.4	5.6	-1.1
Unemployment rate (% of active population).	14.1	16.7	16.3