

Report on the 2021-2024 Stability Programme Update.

AIReF FORCASTS A REDUCTION IN THE GENERAL GOVERNMENT DEFICIT TO 3.5% OF GDP BY 2024

- The Independent Authority for Fiscal Responsibility (AIReF) considers the Stability Programme to be an incomplete approximation to the medium-term fiscal strategy it has recommended in previous reports
- AIReF considers that the Recovery, Transformation and Resilience Plan (RTRP) needs to be better integrated into the Stability Programme, which does not include the effects of the reforms on growth and sustainability of the General Government.
- It considers that the macroeconomic scenario is achievable in the short and medium term, provided that the global pandemic subsides worldwide and the RTRP is implemented in a timely manner and with sufficient quality.
- It estimates that the investment and expenditure associated with the RTRP could have an impact on growth of 1.5% in 2021, 2.5% in 2022 and 1.6% in 2023
- It forecasts a reduction in the General Government deficit over the period to 3.5% of GDP in 2024, 0.3 points higher than that set out in the SPU, with a lower deficit for the Central Government and a higher deficit for the Social Security Funds (SSF) and the Autonomous Regions (ARs)
- It estimates that debt will remain at highly vulnerable levels, at around 112.4% of GDP in 2024
- It insists on the need to design a medium-term fiscal strategy with a sufficiently long time horizon which will need to be integrated within the RTRP

The Independent Authority for Fiscal Responsibility (AIReF) today published on its website the Report on the 2021-2024 Stability Programme Update (SPU), in which it analyses the Government's macroeconomic scenario and fiscal strategy for the period 2021-2024. AIReF estimates a reduction in the General Government deficit over the period to 3.5% of GDP in 2024, 0.3 points higher than the figure included in the SPU, and highlights that at the end of the period, debt will stand at around 112% of GDP, which is a major factor of vulnerability for the Spanish economy. In its report, it concludes that the Stability Programme does not meet the objective of being an instrument for guiding fiscal policy over the medium term. It therefore recommends completing a fiscal strategy that will allow a deficit to be reached that is sufficient to steer the debt towards more sustainable paths that will reduce the vulnerability of the Spanish economy. This implies

extending the time horizon of the strategy and integrating into it the macroeconomic and fiscal implications of the implementation of the investments and reforms set out in the RTRP.

In the report, AIReF highlights that the presentation of the SPU takes place at a complex time, given the high level of uncertainty about macroeconomic and fiscal forecasts and activation of the escape clause at least until 2022. This means that there are no regulatory benchmarks for comparing the evolution of the public balances forecast in the SPU. In addition, the revision of the European tax framework to be applied as from that time has been put on hold. In this context, the supervisory work performed by independent fiscal institutions is even more relevant, but also more complex.

Furthermore, the progress in the design of the Recovery, Transformation and Resilience Plan (RTRP) allows us to foresee major changes in Spain's economic and budgetary policy that are still pending budgetary and legislative implementation, and which might have a fundamental impact on the fiscal scenario over the medium and long term. In this regard, AIReF states that this year's Stability Programme does not meet the objective of being an instrument for guiding fiscal policy in the medium term.

In fact, AIReF believes that the Stability Programme can only be considered an incomplete approach to this strategy since, firstly, in its budgetary aspect, it is presented as an element that is isolated from the RTRP. It only incorporates the macroeconomic impact of the RTRP investments and the consequent revenue impact, but not the reforms that are still pending legislative implementation and that affect core areas for the growth and the sustainability of public finances (pensions, the tax system and the job market). In addition, from 2021 onwards, it draws a “no-policy-change” fiscal scenario, which does not include any target path for the fiscal policy or even any tax measures that the RTRP set out as entering into force in 2022. In addition, the SPU does not consider which part of the investments will lead to structural expenditure increases that may persist after the end of the plan.

Secondly, the analysis carried out in this report shows how the health crisis has led to an increase in the structural deficit of the Spanish economy, which was already starting from high levels (close to 2.5% of GDP). Another legacy of the crisis is the high level of debt, which is a major factor in the vulnerability of the Spanish economy to any changes in financing conditions. AIReF therefore deems it necessary to establish a rebalancing plan that will start to be implemented when the recovery is strong and that will allow sufficient room to manoeuvre so as to meet the challenges arising from the ageing population and future crises.

Macroeconomic scenario 2021-2024

On April 26th, AIReF gave notice of its endorsement of the macroeconomic outlook, although it highlighted the high level of uncertainty surrounding the health crisis and the RTRP. The macroeconomic scenario of the Stability Programme assumes GDP growth of 6.5% in 2021, almost three percentage points lower than the growth of 9.8% with which the General State Budget for 2021 was prepared. AIReF believes that this growth is feasible if progress is made in controlling the pandemic so that mobility restrictions can be lifted over the year and if the effects of the RTRP begin to materialise in the second half of the year.

PRESS RELEASE

11/05/2021

More in the medium term, the Government's forecasts assume that GDP will record high growth, of 7% in 2022, to return at the end of the forecast horizon to rates of 3.5% in 2023 and 2.1% in 2024, higher than the pre-crisis estimates of potential growth. The estimated growth in 2022 reflects the revival of international tourism and the impact of the RTRP, an aspect on which the Stability Programme provides little information. Specifically, it only indicates the increase that it entails on GDP in the average of 2021-2023 (2 points), the effect on cumulative job creation in that period (800,000 jobs) and an impact on potential growth of 0.4 points.

The Government has now published the details and timing of investments and projects for most of the components of the RTRP. According to this information, AIReF estimates that the investments and expenditure associated with the RTRP might have an impact of 1.5% in 2021, 2.5% in 2022 and 1.6% in 2023, mainly resulting from the boost to demand. Although these estimates are similar to those envisaged by the Government, they are subject to a high degree of uncertainty. Firstly, the pace at which the projects are implemented and their final completion will be key to determining the impact. Secondly, there is little empirical evidence on the macroeconomic impact associated with any of the components of the Plan. In addition, there is still no specific legislation for the structural reforms of the job market and the pension and tax systems that are crucial for determining the possible impact of the Plan on productivity, medium-term growth and the sustainability of public accounts.

Therefore, AIReF considers that the macroeconomic scenario in the short and medium term is achievable if the global pandemic subsides globally and if the projects included in the RTRP are implemented by the established deadlines and meet the requirements set at a European level, and are of sufficient quality to achieve the expected multiplier effects. The Government's scenario falls within the confidence intervals estimated by AIReF, although these intervals do not reflect the high degree of uncertainty that persists in the economy.

Fiscal strategy

For its central scenario, AIReF estimates a reduction in the General Government deficit over the period to 3.5% of GDP in 2024, 0.3 points higher than the figure included in the SPU. In both cases, the path is characterised by a sharp reduction in the deficit between 2020 and 2022 as a result of the progressive withdrawal of the measures implemented to mitigate the effects of the health crisis and the strong economic recovery, which subsequently slows down as both factors run out. This slowdown in deficit reduction is larger in AIReF's central scenario, which expects a deficit lower than the SPU in the first years, but a greater lag at the end of the period. Both AIReF and the SPU assume that implementation of the investments provided for in the RTRP will have a neutral effect on the deficit throughout the period.

AIReF forecasts that the weight of revenue over GDP, excluding the RTRP, will gradually fall to 39.1% in 2024, slightly less than 0.2 points below the path of the SPU. In 2021 and 2022, revenue grows strongly, on average by 6%, due to the dynamism of the economic recovery, albeit at a slower pace than nominal GDP. This growth moderates in the last two years of the period to an average of 3.5%, which is closer, although still slightly below nominal GDP.

The weight of expenditure as a proportion of GDP, excluding the RTRP, also falls in AIReF's central scenario, to 42.7% in 2024, 0.2 points above the figure included in the SPU. As in the case of revenue, there are two distinct periods with a more notable fall

PRESS RELEASE**11/05/2021**

in 2021 and 2022. As a consequence of the gradual withdrawal of the measures, AIReF forecasts, in nominal terms, a fall in total expenditure excluding the RTRP of the measures following their practical stabilisation in 2021. Subsequently, expenditure would grow by around 2.3% following its baseline evolution.

By sub-sector, since the Central Government assumed most of the increase in the deficit in 2020, AIReF also expects it to record most of its reduction. In the absence of extraordinary transfers in 2022, the ARs and LGs would see their balance worsen due to the impact of the negative settlements of the 2019 financing system in order to normalise their situation in 2023 and 2024, i.e., without extraordinary transfers or settlements. In the case of the ARs, this means ending 2024 with a deficit of 0.9% of GDP, which is higher than that recorded in 2019 mainly because a part of the increase in health expenditure is considered structural. In contrast, the LGs would recover their structural surplus at around 0.3% of GDP. For their part, the Social Security Funds would stabilise their deficit at around 1% of GDP as from 2022. In general terms, the SPU foresees a higher deficit for the CG and a lower deficit for the SSFs and the ARs, which may be due to the implicit assumption of higher transfers between these sub-sectors.

These forecasts are subject to the usual uncertainty associated with the evolution of the macroeconomic scenario and the discretionary action of each administration, which are factors that are amplified by COVID-19. Although AIReF deems it reasonable to assume as a central assumption that the pandemic will be resolved in the short term, it is still uncertain to what extent and for how long its effects on the economy, society and the General Government might last. This also depends on the policies implemented by the public sector. The implementation of the RTRP also adds uncertainty. Its implementation has implications for the fiscal strategy that have not been assessed in the SPU and which AIReF has been unable to evaluate. These might, as the case may be, lead to increases or reductions in the structural deficit beyond those envisaged in the SPU.

AIReF's estimates of the fiscal policy stance suggest that, after the fiscal expansion that took place in 2020, national fiscal policy takes a neutral tone that would extend to the end of the projection horizon. The Government, in contrast, estimates that, after maintaining a neutral tone in 2020, the national fiscal policy will maintain an expansive tone in 2021 (without considering the boost provided by the RTRP). Both agree on indicating a neutral tone in 2022 and 2023. However, according to the Government, in 2024 there would then be a structural adjustment of €8bn that AIReF does not consider to be supported by measures, and which may be unrealistic in view of the usual optimism presented by the Stability Programmes. In addition, AIReF estimates that the medium-term structural cost of the pandemic for public finances is around 1% to 2% of GDP.

Sustainability

Under the macro-fiscal forecasts, AIReF projects a reduction in the debt-to-GDP ratio of 7.6 points by 2024, to 112.4%. The expected upturn in economic activity driven by the RTRP, the improvement in the cyclical component of the public balance and the gradual disappearance of the pandemic-related emergency measures, make it possible to project this reduction in the debt ratio, which is in line with that presented by the Government.

According to the institution, the significant increase in the stock of public debt resulting from the crisis, on top of the previous high level, places the sustainability of public finances in a position of greater vulnerability. In the short term, one of the first challenges will be to tackle a higher structural deficit through a consolidation strategy that allows a gradual return to a balanced budget that does not adversely affect growth. In the medium and long term, contingent liabilities arising from the ageing of the population together with a possible tightening of financing conditions are seen as the main risks.

Recommendations

In this context, AIReF once again recommends, in line with other comparable countries, the design of a credible and realistic medium-term fiscal strategy that guarantees the sustainability of public finances. In its view, the SPU is a starting point, but it falls short. In addition, the SPU still does not have sufficient content to be the main instrument for medium-term budgetary planning of the General Government in the terms provided for by both European and national legislation. AIReF therefore recommends that the Government complete the medium-term fiscal strategy for achieving a level of deficit that is sufficient to steer the debt towards more sustainable paths that will reduce the vulnerability of the Spanish economy. This implies extending the time horizon of the strategy and integrating into it the macroeconomic and fiscal implications of the implementation of the investments and reforms of the RTRP. AIReF also maintains its recommendation on the need to expand the content of the SPU.