

EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility (AIReF) has to report on the content of the 2021-2024 Stability Programme Update (SPU), both in terms of the macroeconomic forecasts and its fiscal scenario, in compliance with the mandate of Articles 14 and 16 of Organic Law 6/2013 on the Establishment of AIReF. This report provides a comprehensive assessment of the SPU, which this year recovers its usual medium-term horizon.

The presentation of the SPU comes at a complex time. On the one hand, the pandemic continues to cast a high level of uncertainty over macroeconomic and fiscal projections. In addition, activation of the escape clause at least until 2022, both within the scope of national legislation and the Stability and Growth Pact, means that there are no regulatory benchmarks for comparing the evolution of the public balances forecast in the SPU. Furthermore, the European fiscal framework to be applied as from that time is subject to the outcome of the review process that was launched prior to the crisis and has, for the time being, been put on hold. In this changing context, the work performed by independent fiscal institutions supervising the public finances is even more relevant, but also more complex.

In addition, 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, this year's Stability Programme does not meet the objective of being an instrument for guiding fiscal policy in the medium term.

In its previous reports, AIReF has been recommending the need to design a realistic and credible medium-term fiscal strategy that guarantees the sustainability of the public finances. The SPU can merely be considered an incomplete approach to this strategy.

Firstly, in its budgetary aspect, the SPU is presented as an element that is isolated from the RTRP. It only incorporates the macroeconomic impact of the

investments planned in the RTRP and the consequent revenue impact associated with this higher growth. On the one hand, the SPU does not incorporate the reforms that are still pending legislative implementation and that affect core areas for the growth and sustainability of public finances, such as the pension system, the tax system and the labour market. In the same vein, 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 sets 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 3.5% of GDP). Another legacy of the crisis is the high levels of debt, which would stand at around 112% in 2024 according to the Government’s forecasts. These are a major factor in the vulnerability of the Spanish economy to any changes in financing conditions. It is therefore necessary to establish a rebalancing plan that will start to be implemented when the recovery is strong and that will allow sufficient room for manoeuvre to be generated so as to meet the challenges arising from the ageing population and future crises.

For all of these reasons, AIRcF reiterates its recommendation to design a medium-term fiscal strategy with a sufficiently long time horizon, which will need to be integrated with the RTRP.

2021-2024 macroeconomic scenario

On April 26th, AIRcF gave advance notice of its endorsement of the macroeconomic outlook, thus allowing it to be included in the SPU for it to be submitted by the Government to the EU institutions. However, it highlighted the high level of uncertainty surrounding the COVID-19 crisis and the design, implementation and macroeconomic impact of 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 only six months ago. At that time, AIRcF already warned of the risk of more adverse scenarios regarding the evolution of the pandemic and highlighted downside risks to the impact of the Plan estimated by the Government related both to the process of implementing the projects and their possible effects.

The uncertainty about both elements remains high. AIRcF therefore considers that the expected growth for 2021 is feasible if, and only if, progress is made in the control of the pandemic that will lift mobility restrictions throughout the

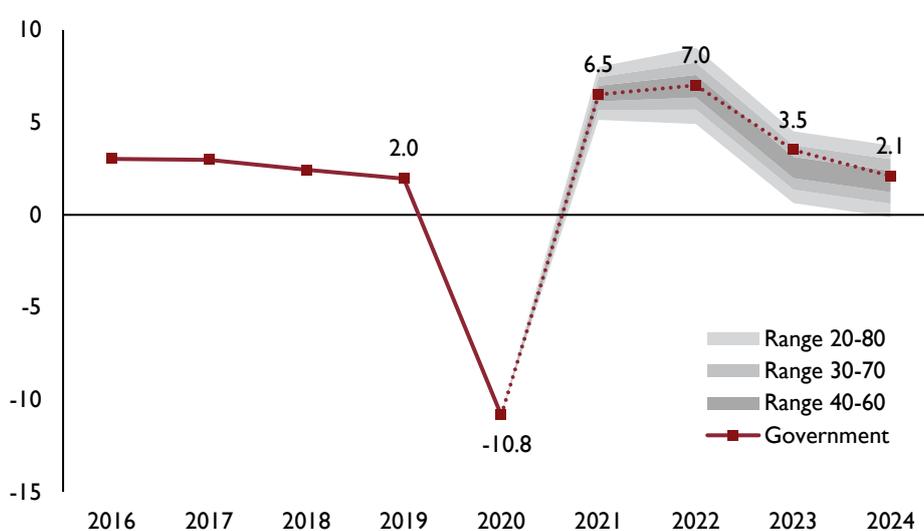
year and if the effects of the RTRP begin to materialise in the second half of the year.

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 high growth estimated in 2022 is conditioned by two key elements. The first is the return to normal of tourism activity, according to the SPU it will recover pre-pandemic levels in 2022. It will depend on the vaccination progress and the lifting of restrictions on international travel. The second is the impact of the RTRP, which is an essential element in the macroeconomic scenario over the projection horizon and with regard to which the stability programme provides little information beyond indicating the related increase in GDP on average over 2021-2023 and the accumulated job creation over the period (two additional points of growth and an additional 800,000 jobs). It also indicates an impact on potential growth of 0.4 pp.

In this regard, the Government has now published the details and timing of investments and projects for most of the components of the RTRP. Accordingly, AIRcF estimates that 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, it should be noted that they are subject to a high degree of uncertainty. Firstly, the pace at which projects are implemented and their final completion will be key to determining the impact on growth and employment. Secondly, there is little empirical evidence on the macroeconomic impact associated with any of the components of the Plan. Empirical evidence suggests that expenditure on investment in physical, technological and human capital is associated with a high impact on GDP and employment, particularly when it takes place in periods of recession and in a coordinated manner in a group of countries, as is the case with the Next Generation EU funds. Furthermore, the effects associated with technological and human capital tend to last over time, particularly if they are accompanied by structural reforms. However, there is little evidence on the macroeconomic effects of such new types of investment as the Artificial Intelligence Strategy or the Hydrogen Roadmap, for example, although it should be noted that these represent a small proportion of investments. 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 pandemic subsides globally and if the projects included in the RTRP are implemented within the deadlines and meet the requirements established at European level and have sufficient quality to achieve the expected multiplier effects. The Government's scenario is within the confidence intervals estimated by AIReF, although these intervals do not reflect the high uncertainty that persists in the economy.

GROSS DOMESTIC PRODUCT. TERMS OF VOLUME. (YEAR-ON-YEAR RATE OF CHANGE)

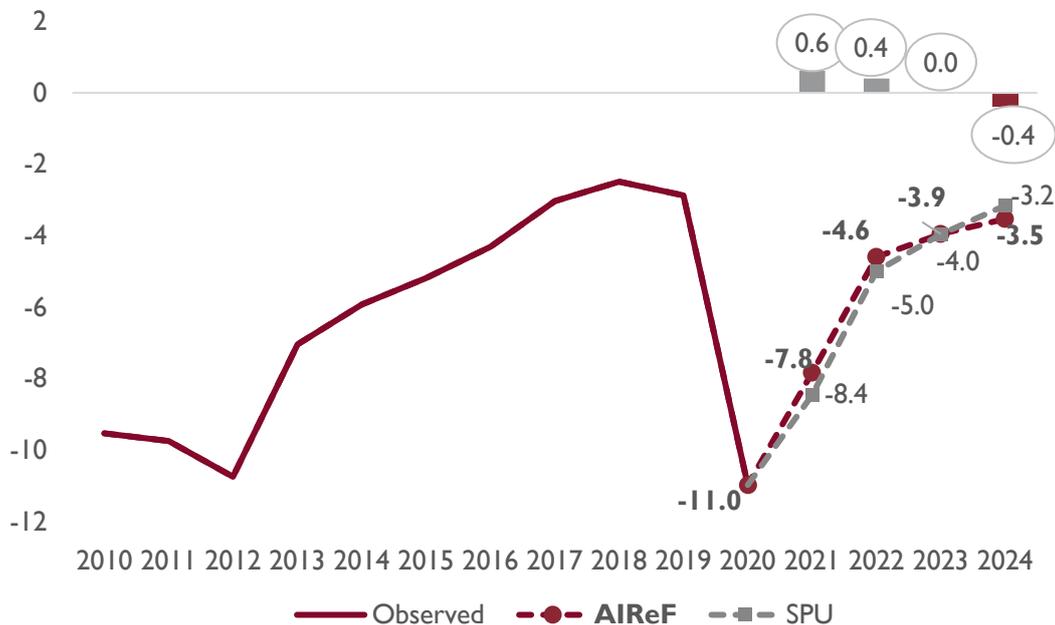


Source: AIReF and Ministry of Economic Affairs and Digital Transformation

2021 - 2024 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. This explains that, although in the early years AIReF expects a lower deficit than the SPU, the period ends with a greater deficit in the case of AIReF. 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.

EVOLUTION OF THE BALANCE OF THE GENERAL GOVERNMENT



Source: AIReF, Ministry of Economic Affairs and Digital Transformation and AIReF estimates

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. Taxes on production grow strongly with domestic demand in 2021 and 2022, with more moderate growth in the following years. For their part, taxes on income and social contributions record more moderate growth in 2021 and 2022, reflecting the smaller fall they suffered in 2020, with their rate of growth also slowing in 2023 and 2024. Compared with the SPU, AIReF forecasts higher revenue from taxes on production and lower social security contributions and taxes on income.

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 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 following its practical stabilisation in 2021. Subsequently, expenditure would grow by around 2.3% following its baseline evolution. In terms of its composition, AIReF estimates that the components of

public consumption and investment would return to levels in line with or slightly above their pre-crisis weight of GDP, while interest rates would continue to reduce their weight. For their part, social transfers in cash would reduce their weight compared with 2020, but without returning to 2019 levels. This is mainly due to the evolution of pensions independent of the economic cycle. Compared with the SPU, AIReF expects higher expenditure in public consumption, especially at the end of the period, and in other expenditure and lower spending on social benefits and interest.

By sub-sector, since the Central Government (CG) 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 Autonomous Regions (ARs) and Local Governments (LGs) would see their balance worsen due to the impact of the negative settlements of the 2020 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 (SSFs) would stabilise their deficit at around 1% of GDP as from 2022. In general terms, the SPU forecasts 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.

EVOLUTION OF THE BALANCE BY SUB-SECTOR

	2020	AIReF				SPU			
		2021	2022	2023	2024	2021	2022	2023	2024
GG	-11.0	-7.8	-4.6	-3.9	-3.5	-8.4	-5.0	-4.0	-3.2
CG	-8.4	-6.1	-2.0	-2.2	-2.0	-6.3	-3.5	-3.1	-2.5
SSFs	-2.6	-1.8	-1.0	-1.0	-1.0	-1.5	-0.8	-0.7	-0.7
Ars	-0.2	-0.4	-1.7	-1.1	-0.9	-0.7	-0.6	-0.4	-0.2
LGs	0.3	0.3	0.1	0.3	0.3	0.0	0.0	0.3	0.3

These medium-term forecasts are subject to the usual uncertainty associated with the evolution of the macroeconomic scenario and the discretionary action of each public authority. These factors are amplified as a result of the COVID-19 health crisis. Although it seems reasonable to assume as a central assumption that the health crisis 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. In this regard, the implementation of the RTRP, both in terms of investments and reforms, also adds uncertainty. Its implementation has implications for the fiscal strategy that have not been assessed in the SPU and which AIReF has not been able to evaluate. These

might, as the case may be, lead to increases or reductions in the structural deficit beyond those envisaged in the SPU.

Fiscal policy stance

The fiscal policy stance over the projection horizon is crucially dependent on the RTRP. AIReF therefore considers it relevant on this occasion to offer a separate diagnosis of the national fiscal policy stance, excluding the expansionary fiscal boost associated with the RTRP, which, in accordance with the guidelines of the European Commission, will have a neutral impact on the deficit.

In this regard, AIReF's estimates of the fiscal policy stance over the horizon of the stability programme – under alternative methodologies that attempt to bypass the high level of uncertainty associated with estimating the output gap and the structural balances at times of major fluctuations in activity – suggest that, after the fiscal expansion that took place in 2020, the national fiscal policy takes a neutral tone that would extend to the end of the projection horizon.

These estimates show some discrepancies with the contents of the SPU. Specifically, the Government estimates that, after maintaining a neutral tone in 2020, the national fiscal policy will remain expansionary in 2021 (without considering the boost provided by the RTRP). 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 shown in the stability programmes in that projection horizon.

In addition, according to AIReF's estimates, the medium-term structural cost of the pandemic for Spanish public finances is around 1% to 2% of GDP, depending on the different methodologies used.

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

The COVID-19 pandemic triggered a global economic crisis in 2020 that has resulted in a deterioration in the public accounts and an unprecedented increase in government debt ratios. The Spanish economy is among those that have been hit hardest by this crisis and it has recorded the largest government deficit and largest contraction in GDP in the European Union. This has led to an increase in the debt ratio of 24.5 points, placing it at 120% of GDP, its highest level for the last 100 years.

Under its 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.

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. This is essential for generating the fiscal space that will allow future risks to be addressed.

Higher public expenditure resulting from the ageing of the population, together with a possible tightening of financing conditions, are seen as the main risks for the sustainability of public finances in a medium and long-term horizon. This is due both to the likelihood of occurrence and to their high impact.

Recommendations

In this context, AIReF once again insists on the need for a credible and realistic medium-term fiscal strategy that guarantees the sustainability of public finances. The SPU is a starting point, but is insufficient as shown by the sustainability analysis of the government debt and the limitations for analysing the macroeconomic and fiscal implications of the RTRP. In addition, as AIReF has repeatedly pointed out in previous reports, the SPU still does not have sufficient content to be the main instrument for the medium-term budgetary planning of the General Government in the terms provided for by both European and national legislation. For these reasons, AIReF recommends that:

- The Government should complete the medium-term fiscal strategy to achieve 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 set out in the RTRP.
- AIReF also maintains its recommendation on the need to expand the content of the SPU.

