EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility, AAI (AIReF) is required to issue a report on the main lines of the draft budgets of the General Government (GG) sub-sectors for 2022. Previously, AIReF issued on September 21st its endorsement of the macroeconomic forecasts at the request of the Government. This report analyses the draft General State Budget (GSB) for 2022, presented on October 13th, the Budgetary Plan submitted to the European Commission on October 15th, the main lines of the GG budget and updates the macroeconomic forecasts used in the issuance of the endorsement of the GSB forecasts. This report will subsequently be supplemented by the individual reports of the Autonomous Regions (ARs) and the sub-sector of the Local Governments (LGs).

As a result of the COVID-19 crisis, the budgetary stability targets remain on hold following the new 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 the Parliament, following the report by AIReF. In this context, AIReF's fiscal oversight remains fully in force, becoming even more important as a guarantor of the sustainability of the public finances.

The macroeconomic scenario of the GSB for 2022

On September 21st, AIReF endorsed the Government's macroeconomic scenario that accompanies the GSB. This scenario forecasts GDP growth of 6.5% and 7% in 2021 and 2022, with employment growth rates of 4% and 2.7%, respectively, and a reduction in the unemployment rate to 14.1% of the active population. AIReF endorsed this scenario, considering that both the expected path of GDP and the assumptions on which it is based were feasible. In fact, AIRef's forecasts at that time provided for GDP growth similar to the Government's estimates – 6.4% in 2021 and 6.8% in 2022. However, it warned of downside risks in 2022 related to the evolution of the pandemic, the emergence of disruptions and supply problems in productive processes at a global level and the macroeconomic impact of the RTRP.

As mentioned in the endorsement of the Government's estimates, after receiving relevant statistical and economic information, the scenario serving as the basis for judging the degree of realism of the budget forecasts has been revised.

Therefore, in this report AIReF presents a new scenario that includes a downward revision of its GDP growth forecasts for 2021 and 2022, to 5.5% and 6.3%,

respectively. This revision is made mainly as result of two facts. Firstly, the quarterly accounting figures published by the National Statistics Institute (Spanish acronym: INE) at the end of September after issuance of the endorsement are incorporated; these figures have led to a notable downward revision of estimated growth for the second quarter of the year with implications for the expected growth path. Secondly, AIReF's scenario now incorporates the materialisation of some of the risks that were foreseen in September. These include the rise in energy prices, which has become significantly more pronounced in September and the shortage of industrial supplies that has led to production disruptions in some specific sectors. This scenario envisages an impact of the RTRP of 0.7 percentage points in 2021 and 2.5 percentage points in 2022. These contributions remain unchanged with respect to the September forecasts due to a lack of additional information.

According to AIReF, the government scenario underpinning the budget is still achievable as it falls within the confidence bands drawn from the probabilistic analysis, but downside risks predominate. A further aggravation of the pandemic cannot be ruled out given the uneven vaccination rates in the world, the possibility of new variants or loss of vaccine effectiveness. Developments in the energy and raw material markets may delay the recovery in investment and create inflationary tensions in addition to those observed thus far. Finally, an incomplete, delayed, or inefficient implementation of the RTRP would drain the stimulus necessary for ensuring the return to pre-crisis GDP levels.

GDP IN VOLUME TERMS. RATE OF CHANGE (%)   NOMINAL GDP. RATE OF CHANGE (%)
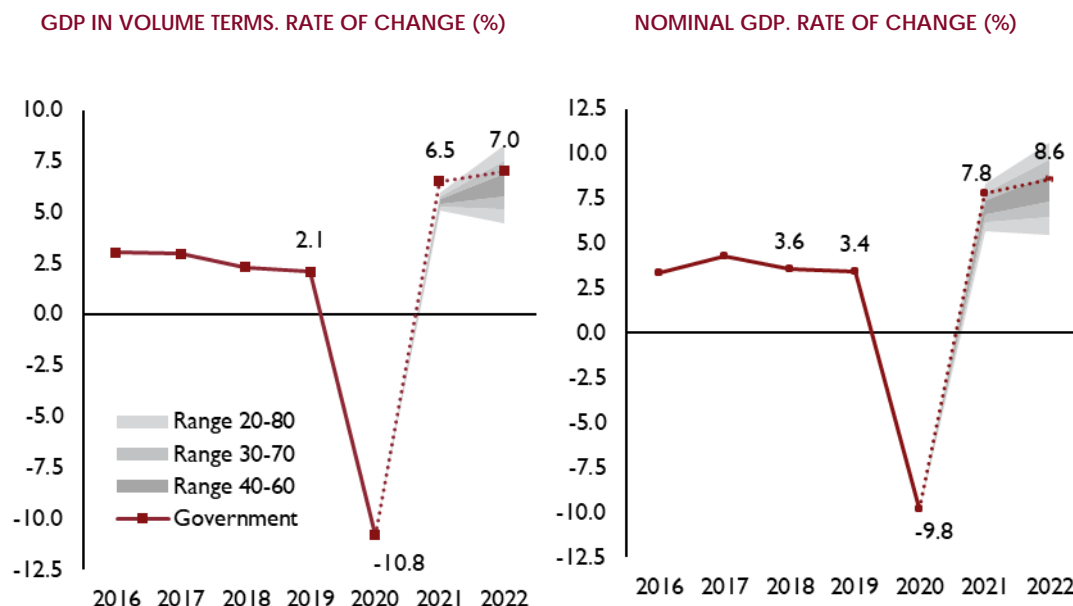
Source: INE and Ministry of Economic Affairs and Digital Transformation.

Budgetary scenario of GG

For its central scenario in the report published today, AIReF estimates a General Government deficit of 4.8% of GDP in 2022, after standing at 7.9% in 2021. Both figures are lower than those included in the Budgetary Plan, 8.4% for 2021 and

5% for 2022. The Budgetary Plan does not include the impact of the REACT-EU funds on General Government revenue and expenditure and assumes a neutral impact on the deficit. However, AIReF, in line with the case of other structural funds, considers that the timing difference between execution of the expenditure and allocation of its revenue, when the corresponding certification is sent to the Commission, implies a higher deficit in 2021 and a lower deficit in 2022, maintaining the neutrality over the years during which the funds apply. Therefore, excluding this effect, the deficit would be 7.7% of GDP in 2021 and 5% in 2022, which more faithfully reflects the underlying fiscal position of the General Government. In addition, the Recovery, Transformation and Resilience Plan (RTRP) has a neutral impact on the deficit, irrespective of the pace of execution of the associated revenue and expenditure.

AIReF estimates a reduction in the deficit of 2.7 points in 2022, excluding the impact of the REACT-EU funds, which is lower than the 3.4-point reduction included in the Budgetary Plan. This reduction in the deficit would be mainly driven by the progressive withdrawal of the measures implemented to mitigate the effects of the COVID–19 crisis. The tax changes included in the GSB for 2021 also have an impact on the reduction of the deficit. In addition, the economic recovery translates into higher revenue. However, its contribution to the reduction of the deficit is more than offset by the underlying evolution of expenditure, determined both by baseline expenditure and by the decisions and measures included in the General Government budget.

EVOLUTION OF GENERAL GOVERNMENT BALANCE
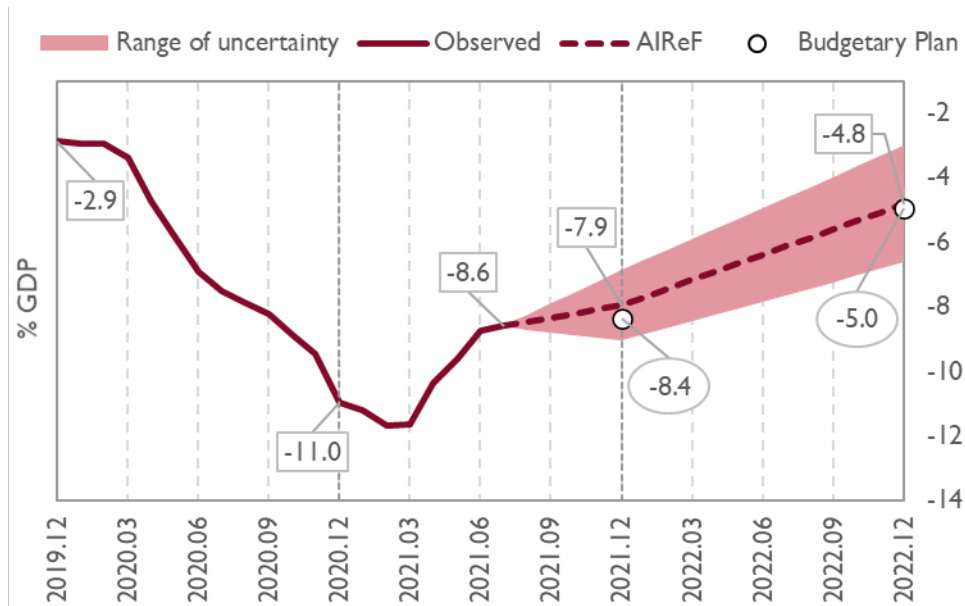
AIReF forecasts that revenue will stand at 40.2% of GDP in 2022, excluding revenue from REACT-EU and the RTRP, compared with the 39.8% forecast in the Budgetary Plan. This difference is entirely due to the denominator effect as AIReF's GDP forecast is lower in nominal terms than that of the Government and the revenue forecast by AIReF in nominal terms is slightly lower than that included in the Budgetary Plan. Including the REACT-EU and RTRP funds, revenue would

stand at 42.6% of GDP in 2022. Tax revenue moderates its growth in 2022, resuming an elasticity with respect to macroeconomic variables in line with the historical average, following the high rates recorded in 2021. By component, AIReF estimates lower growth in indirect taxes and social contributions compared with the Budgetary Plan because of a more unfavourable macroeconomic scenario. AIReF also forecasts a more negative development of other revenue. In contrast, AIReF expects a more positive evolution of direct taxes.

Expenditure, excluding REACT-EU and the RTRP, will stand at 45.2% in 2022, according to AIReF's estimates, compared with 44.7% in the Budgetary Plan. The progressive withdrawal of the measures implemented in 2021 will be partially offset by the evolution of expenditure set out in the draft budget and consolidation of part of the healthcare expenditure. In nominal terms, expenditure would fall by 1.6% according to AIReF's estimates, compared with 2.1% in the Budgetary Plan. This evolution has been conditioned by the inflation forecasts for 2022, which in the GSB have been translated into a 2% increase in the salary of public employees across the GG and the revaluation of pensions according to the inflation expected for 2021. In addition, the compensation for the difference between inflation and the approved pension revaluation of 0.9% in 2021 is also included. AIReF expects a higher level of expenditure in the components of public consumption and capital expenditure than that included in the Budgetary Plan, which is mainly offset by higher forecast savings in interest and unemployment benefits. The implementation of the RTRP and REACT-EU will place expenditure at 47.5% of GDP.

By sub-sector, the Central Government (CG) will continue to take on part of the deficit of the other sub-sectors, Social Security Funds (SSFs) and Autonomous Regions (ARs), through direct transfers. Furthermore, the implementation of the RTRP will affect all sub-sectors, even though it is also neutral for each of the authorities. Regarding the reference rates included in the Budgetary Plan, AIReF estimates similar forecasts for the CG and SSFs in 2022, while the positive impact of the REACT-EU funds will also allow the ARs to achieve the reference rate. Finally, AIReF estimates a surplus of 0.2 points in the LGs compared with the balanced budget forecast in the Budgetary Plan.

GG DEFICIT BY SUB-SECTOR IN % GDP

	2020	2021		2022	
		DBP	AIReF	DBP	AIReF
GG	-11.0	-8.4	-7.9	-5.0	-4.8
CG	-8.4	-6.3	-6.3	-3.9	-3.9
SSFs	-2.6	-1.5	-1.5	-0.5	-0.5
Ars	-0.2	-0.6	-0.4	-0.6	-0.6
LGs	0.3	0.0	0.3	0.0	0.2

Central Government

After analysing the GSB, AIReF estimates a deficit of 3.9% of GDP for the CG in 2022, after reaching 6.3% in 2021, in line with the forecast contained in the Budgetary Plan. The revenue forecasts contained in the draft GSB can be described as feasible insofar as they show a deviation from AIReF's estimates of less than 0.1 points of GDP, compared with 0.6 points in the previous year. Although the GSB still does not include a breakdown of the adjustments that would make it possible to reconcile the budgetary balance with the reference rate of the Budgetary Plan in national accounting terms, AIReF has made its own estimates for transferring the expenditure forecasts in the GSB to the national accounting headings.

In this regard, the draft GSB involves a reduction in CG expenditure of 1.1% compared with the year-end 2021 forecast, excluding the expenditure financed by the RTRP and REACT-EU. The increase in expenditure in the components of public consumption, social benefits and other expenditure is more than offset by the reduction in expenditure on interest, transfers to other GG sub-sectors, subsidies, and gross fixed capital formation.

Social Security Funds

After reaching 1.5% of GDP in 2021, the deficit of the Social Security Funds will fall to 0.5% of GDP according to AIReF's estimates, in line with the Budgetary Plan. The reduction in the deficit is explained by the progressive withdrawal of measures such as the job retention schemes (ERTEs) and the cessation of activity of self-employed people, the recovery in employment and the increase in transfers from the CG to finance, on a structural basis, so-called "improper" expenditure. In addition, pension expenditure would grow to 4% with a revaluation above 2% in 2022, after including compensation for the higher expected inflation in 2021. Expenditure on unemployment would fall significantly, including the extension of ERTEs over the first two months of the year.

Autonomous Regions

The deficit of the regions will grow to 0.6% in 2022 from 0.4% at year-end 2021. This evolution is similar to that set out in the Budgetary Plan and more positive than that expected by the ARs as a whole in their main budgetary lines and draft budgets. This increase in the deficit is explained by a fall in revenue in 2022, excluding the effect of the REACT-EU funds and the RTRP, which is not fully offset by the gradual withdrawal of the pandemic-related measures and the positive effect of the REACT-EU funds. As a supplement to the sub-sector analysis contained in this report, AIReF will subsequently issue the individual reports on the ARs

Local Governments

Local Governments will record a surplus of 0.2% of GDP in 2022, after closing 2021 with a surplus of 0.3% of GDP. As is the case with the regions, AIReF will later issue

a report on the Main Lines of the budgets of the local governments, which it analyses individually.

Challenges foreseen from perspective of sustainability of public finances

The debt-to-GDP ratio stood at 122.9% at the end of the first half of 2021, an increase of 27.4 points on the level at the end of 2019. The negative contribution caused by the strong contraction in GDP in 2020 is already starting to be offset by the strong economic recovery that is taking place in 2021 and that is expected to continue in the coming years with the support of the RTRP. This improvement in the ratio's denominator, together with the recovery in the cyclical component of the public balance and the gradual disappearance of the pandemic-related emergency measures, make it possible to project a 4.3-point reduction in the debt ratio for 2022, placing it at 115.7% of GDP, in line with the estimates presented by the Government (115.1%) and other international agencies such as the IMF (116.4%).

Beyond a certain improvement in the short-term fiscal situation, AIReF's projections show an unfavourable medium and long-term debt trend under a no-policy change scenario. The debt-to-GDP ratio will resume an upward path under the assumption of a no-policy change scenario with a constant structural primary deficit of around two and a half points, a situation that is significantly aggravated by adding structural expenditure related to an ageing population, with a projected debt ratio of close to 190% of GDP by the middle of the century.

A gradual and sustained reduction of the public deficit towards structural equilibrium, as reflected in Spanish law, will be necessary to bring the debt back to more comfortable levels. The expectations of a lasting low interest-rate horizon offer greater room to manoeuvre to address the return to a balanced budget in a manner that is not detrimental to growth.

Recommendations

Although fiscal rules are on hold at an EU and national level, the sustainability of public finances remains essential for economic recovery. Therefore, 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 the General Government. The current situation, with an economic recovery that is buoyant but subject to various risks, once again reveals the need for the different GG sub-sectors to have medium-term strategies that integrate various elements, such as RTRP reforms and investments, consolidation of the recovery and reduction of the debt to less vulnerable levels.

The improvement in the healthcare and economic situation for 2021 is leading to a progressive withdrawal of the measures adopted to mitigate the effects of the COVID crisis and a recovery in tax revenue to pre-pandemic levels.

To the extent that this trend will continue in 2022, AIReF recommends that the entire GG should adopt the necessary measures so that the fiscal space left by the withdrawal of the measures to combat COVID and the positive evolution of

revenue are fully passed on to reducing the public deficit. Increases in structural expenditure that do not have a permanent source of funding should be avoided.

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. In addition, in relation to the Budgetary Plan, AIReF recommends that it should incorporate all the measures planned by the Government, as well as the impact of the REACT-EU funds and the RTRP on GG revenue and expenditure.