

# EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility, AAI (AIReF) has the legal mandate to evaluate the initial budgets of the General Government (GG) from the perspective of their compliance with fiscal targets, focusing its assessment, as laid down by its organic law, on the main changes with respect to the report on the main budgetary lines and draft budget dated October 25<sup>th</sup>, 2021. As the fiscal rules for 2022 are suspended, AIReF's fiscal supervision takes on greater importance as a guarantor of the sustainability of the General Government.

In this report, AIReF updates its macroeconomic and fiscal forecasts in line with the new geopolitical situation and the latest available information. Russia's invasion of Ukraine is having a strong impact on the global and Spanish economies, mainly through energy markets, and adds even more uncertainty to the current situation. Within the difficulty of assessing the economic consequences of this conflict, AIReF presents a new macroeconomic scenario that lowers forecasts for real GDP growth to 4.3%, while nominal GDP growth, particularly relevant for fiscal forecasts, stands at 8%. Geopolitical risks thus add to the uncertainty surrounding the pandemic and the impact of the Recovery, Transformation and Resilience Plan.

In its central scenario, AIReF revises the deficit forecast of the General Government as a whole to 4.2% of GDP from the 4.8% forecast in the previous report. This reduction can mainly be explained by the evolution of revenue in 2021 and early 2022, which has been more favourable than previously expected. This more than offsets the cost of the measures taken to mitigate the economic effects of the war in Ukraine. On the other hand, the revision of the macroeconomic scenario has a slightly negative effect as the reduction in real growth is offset by higher inflation.

## Revision of the macroeconomic scenario for 2022

The environment in which the Spanish economy operates remains characterised by extreme uncertainty, although the epicentre has shifted from the health sector to the economy's supply capacity and, in particular, to energy markets. The disruptions in production chains and energy markets that emerged over 2021 have been heavily amplified by the invasion of Ukraine by the Russian army in February 2022, generating inflationary tensions not seen since the 1970s. The Spanish economy has been affected to a greater extent than other neighbouring economies by this succession of supply shocks given its high energy dependence and the quick transmission of price increases in energy raw materials to electricity costs. Price tensions are causing a reduction in households' purchasing power and in competitiveness with other countries, while they have led to a change in the monetary policy stance and greater volatility in financial markets.

In this context, AIReF forecasts lower real GDP growth for 2022, from the 6.3% that served as the basis for preparing the report on the macroeconomic forecasts of the 2022 GSB to 4.3%. At the same time, expected inflation for 2022 is revised from the 1.8% forecast in October to the 6.2% currently expected. In addition to the impact of all the aforementioned shocks, these forecasts also incorporate a downward revision of the impact on growth associated with the RTRP in 2022 (from 2.5 pp to 1.8 pp of GDP). This is due to the fact that the revenue will reach the economy in a more adverse environment, characterised by bottlenecks and inflationary pressures and associated with a lower multiplier (which is revised from 1.2 to 0.9). The Government's forecasts used to prepare the budget projected real growth of 7% for this year and expected inflation of 1.3%.

In addition, the balance of risks is clearly on the downside for growth and on the upside for inflation. The persistence of the pandemic may cause supply shortages to last longer than projected in this scenario. In addition, the roots of the energy crisis go beyond the war in Ukraine, given the limited progress in renewable energy production, while the energy transition in Europe and, more recently, in China may lead to greater demand shifted towards less polluting fossil fuels, such as natural gas.

## Budgetary scenario of General Government

For its central scenario, AIReF estimates a General Government deficit of 4.2% of GDP in 2022, thus lowering its forecast by 0.6 points compared with the October report. The incorporation of the latest available information leads to a reduction in the deficit forecast of 1.3 points of GDP compared with October, mainly due to the year-end 2021 deficit figure of 6.9% of GDP, one

point lower than in the October report. At the end of 2021, the evolution of revenue was significantly more positive than previously expected and what might be inferred from the expected evolution of macroeconomic variables. Consequently, revenue ended the year 1.3 points above the forecast, which also made it possible to absorb some unforeseen expenditure, such as deferred tax credits or the allocation of bad debts due to COVID guarantees in 2021.

The worsening macroeconomic scenario also affects fiscal forecasts through various channels with opposing effects. This produces a combined result of an increase in the deficit of under 0.1 point of GDP. Firstly, inflationary pressures generate a positive and automatic effect of increased revenue, especially in VAT, in the very short term. Approximately, each additional point of inflation results in just over €2bn of additional revenue. However, this shock also implies a reduction in real growth forecasts, which will in turn reduce public sector revenue. Once the effect of all the shocks indicated in the previous section have been incorporated, the macroeconomic scenario will contribute a rise in revenue of 0.3 points.

On the expenditure side, inflation has a direct and automatic impact on the interest rates of inflation-indexed bonds. In the longer term, it will also affect the goods and services purchased by the GG as the contracts are tendered or renewed. However, this effect will be limited in 2022 due to the existence of the already approved budget with limitations in the appropriations. In addition, interest expenditure will grow with new debt issues as inflation expectations and monetary policy normalisation feed through to interest rates. For 2022, the impact of inflation on expenditure would be around 0.4 points of GDP.

In addition, inflationary tensions in 2022 will also affect the evolution of expenditure in 2023. This impact is direct and automatic in the case of pensions, which will be increased in 2023 in line with the 2022 CPI, in accordance with the pension reform. This means that each additional point of inflation in 2022 will raise spending by around €1.5bn in 2023.

Finally, the new geopolitical situation and its effect on the macroeconomic scenario affects fiscal forecasts through the action of governments to mitigate its effects. As of the issue date of this report, the new measures adopted since the previous report imply a higher deficit in 2022 of 0.6 points of GDP.

As a result of the above, the deficit in 2022 will be reduced by 2.7 points of GDP compared with 2021. The progressive withdrawal of the measures implemented to mitigate the effects of the COVID-19 crisis is the main factor, contributing 2.4 points to the reduction in the deficit compared with 2021. In addition, the evolution of revenue associated with the economic cycle and

expenditure not linked to COVID or the new measures result in a further reduction in the deficit of 0.5 points in 2022. In addition, the measures put in place to mitigate the effects of the war exceed the effect of the tax measures incorporated in the GSB, jointly raising the deficit by 0.2 points in 2022 compared with 2021. Finally, AIReF assumes a neutral effect on the deficit of the implementation of the Recovery and Resilience Plan and the REACT-EU funds.

#### EVOLUTION OF GENERAL GOVERNMENT BALANCE

	2021		2022	
	Budgetary Plan 2022	Year-end	Budgetary Plan 2022	Initial Budgets 2022
<b>GG</b>	<b>-7.9</b>	<b>-6.9</b>	<b>-4.8</b>	<b>-4.2</b>
<b>CG</b>	-6.3	-6.1	-3.9	-3.3
<b>SSFs</b>	-1.5	-1.0	-0.5	-0.4
<b>ARs</b>	-0.4	0.0	-0.6	-0.7
<b>LGs</b>	0.3	0.3	0.2	0.3

AIReF forecasts that revenue will grow by 4.2% in 2022, to stand at 42% of GDP, 44% if RTRP revenue is included. This level would be 1.3 points higher than that forecast in the previous report. Collection data for the last few months of 2021 and the first few months of 2022 have been higher than expected in the previous report, particularly for VAT, corporate income tax and social contributions. In addition, lower forecast growth in real terms is accompanied by higher inflation. Therefore, the new macroeconomic scenario results in an increase in revenue of around 0.3 points of GDP. In contrast, the new measures announced result in a reduction of revenue of 0.3 points compared with the previous forecast.

Expenditure, excluding the RTRP, will stand at 46.2% in 2022, according to AIReF's estimates, compared with 45.5% in the previous report. The approval of new measures to mitigate the effects of the war on the economy involve an increase in expenditure of 0.4 points of GDP compared with the November forecast. In addition, the higher inflation results in an increase in spending of 0.4 points. Finally, according to AIReF, RTRP-related spending will boost overall spending growth by 2.9% to 48.2% of GDP.

#### Central Government

AIReF estimates a deficit of 3.3% of GDP for the Central Government (CG) in 2022, a reduction of 0.5 points compared with the previous forecast. In this case, the most significant factor is the incorporation of new information, especially regarding tax collection. In contrast, the new measures adopted

after approval of the GSB result in an increase in the deficit of around 0.6 points of GDP and higher interest expenditure of an additional 0.2 points of GDP.

### Social Security Funds

After reaching a peak of 1% of GDP in 2021, AIReF reduces the deficit estimate for the Social Security Funds by 0.1 points to 0.4% of GDP. The year-end 2021 figure was better than expected in the previous report. This was mainly as a result of a higher transfer from the State, which is not expected to be repeated in 2022, and an evolution of social contributions that was more positive than expected, which raises the starting point for 2022. In contrast, AIReF has raised the estimate for spending on temporary incapacity as a result of the effects of the sixth wave of COVID and, to a lesser extent, for spending on pensions due to higher inflation in 2021.

### Autonomous Regions

The deficit for the Autonomous Regions (ARs) will grow in 2022 to 0.7% after ending 2021 almost at equilibrium. The deterioration of the balance of the ARs in 2022 is due to the fact that revenue will fall as a result of lower State transfers compared with 2021, both extraordinary transfers and those associated with the financing system. On the one hand, instalment payments will grow by 6.3% according to the revenue forecasts for 2022. On the other hand, the negative settlement as a result of higher 2020 interim payments will result in a reduction in revenue in 2022. Along the same lines, the extraordinary transfers, which include compensation for the negative settlement and for the implementation of the VAT management system (SII), are lower than those received in 2021. Expenditure will grow very moderately, by 1.4%, as a result of the progressive reduction in COVID-related expenditure, although AIReF estimates that a part will become structural.

### Local Governments

In 2022, Local Governments (LGs) will maintain the surplus of 0.3% of GDP in AIReF's central scenario, 0.1 points higher than in the previous report. AIReF estimates expenditure growth in line with revenue growth, which consolidates the LG surplus.

### Challenges envisaged from a perspective of sustainability of public finances

In this complex context, the Spanish debt-to-GDP ratio stood at 118.4% at the end of 2021, a reduction of 1.6 points over the year. Although this year-end 2021 level is an improvement compared with all the forecasts, both from national and international organisations, it is 22.9 points higher than the pre-pandemic level. This year, AIReF's macro-fiscal forecasts project a reduction in the debt-to-GDP ratio of 4.5 points on the level recorded in 2021, placing the ratio at 113.9% in 2022.

The risks and challenges for the medium- and long-term sustainability of the public accounts are high. The new crisis scenario that has emerged following the invasion of Ukraine may alter the process of normalisation of monetary conditions that was expected over 2022 as a result of the sharp increase in inflation worldwide, accelerating the process of stimulus withdrawal and deteriorating financing conditions. The war in Ukraine generates new investment needs in the short and medium term associated with both defence spending and the greater urgency to increase renewable energy production capacity and reduce dependence on Russian energy. This 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

Since the activation of the escape clause for the suspension of fiscal rules as a result of the crisis generated by the pandemic in 2020, AIReF has been making recommendations for the Government to set out a medium-term fiscal strategy that will act as fiscal guidance and will realistically and credibly ensure the financial sustainability of the GG.

In addition, if the current geopolitical and economic context requires fiscal policy action, it is essential that, while the necessary short-term measures are taken, a medium-term strategy be established to achieve a realistic and credible path of debt reduction once the measures are withdrawn.

This planning must include the means for a gradual consolidation, where medium-term targets and goals should be set and, at the same time, provide for actions and fiscal margins to achieve them. Moreover, this strategy must be designed in such a way so as not to harm the country's economic growth. The current uncertain environment means that this strategy will inevitably be adapted flexibly to the changes that arise in the economic situation.

In this regard, AIReF considers that the Stability Programme Update would be a good opportunity to fully and adequately reflect all these elements.

In addition, in order to have complete information on the implementation of the RTRP, AIReF recommends that the Ministry of Finance and Civil Service publish separately the amounts corresponding to the revenue and expenditure of the RTRP in national accounting headings. It should also publish a breakdown in national accounting terms of the amount transferred and the recipient sub-sector of the current and capital transfers between GG sub-sectors corresponding to the RTRP.