

EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility, AAI (AIReF) has to issue a report on the draft General State Budget for 2023 (GSB). Previously, AIReF issued its endorsement of the macroeconomic forecasts at the request of the Government on October 4th. This report analyses the draft General State Budget for 2023 (GSB) presented on October 6th. Therefore, it focuses on the sub-sectors of the Central Government and the Social Security Funds. AIReF will subsequently issue a report on the situation of the General Government (GG) as a whole once it has analysed in detail the content of the Budgetary Plan that the Government submitted to the European Commission on October 15th, as well as that of the other sub-sectors. AIReF will also publish the individual reports on the Autonomous Regions (ARs) and the Local Government (LG) sub-sector.

It should be noted that application of fiscal rules remains suspended in 2023. However, AIReF's fiscal oversight remains fully in force, becoming even more important as a guarantor of the sustainability of public finances.

The macroeconomic scenario of the GSB for 2023

On October 4th, AIReF endorsed the Government's macroeconomic scenario that accompanies the 2023 GSB. AIReF considers that nominal GDP growth that has served as the basis for drawing up the budgets is likely, although there are downside risks to real growth. AIReF also highlights the lack of information on the measures included in the budget and on the degree of effective implementation of the RTRP at the time of the endorsement, which makes it difficult to properly assess the Government's macroeconomic scenario in the current circumstances.

The Government's scenario projects real GDP growth of 4.4% in 2022 and 2.1% in 2023, while in nominal terms growth would fall from 8.6% in 2022 to 6% in 2023. For its part, the growth of the GDP deflator dips slightly from 4% in 2022 to 3.8% in 2023. AIReF's diagnosis on the basis of its own forecasting scenarios reveals that nominal GDP growth estimates lie within the central range of the probability intervals estimated by AIReF, while the estimates for real growth are in the high range.

Compared with AIReF's scenario, the Government's macroeconomic outlook assumes significant growth in investment and exports. This is unlikely in the context of uncertainty, high energy prices and deterioration in our main export markets, which is not adequately reflected in the technical assumptions of the Government's scenario. In addition, the Government's scenario assumes that wage increases will moderate, which entails risks if workers try to regain some of the purchasing power lost in 2022.

Moreover, AIReF believes that there are significant sources of uncertainty associated with the recent escalation of geopolitical tensions with Russia, doubts about the security of energy supply at reasonable prices, the persistence of inflation and its effects on households' purchasing power and on the financing conditions of the economy, among other factors, which pose risks to real GDP growth and to inflation.

Budgetary scenario

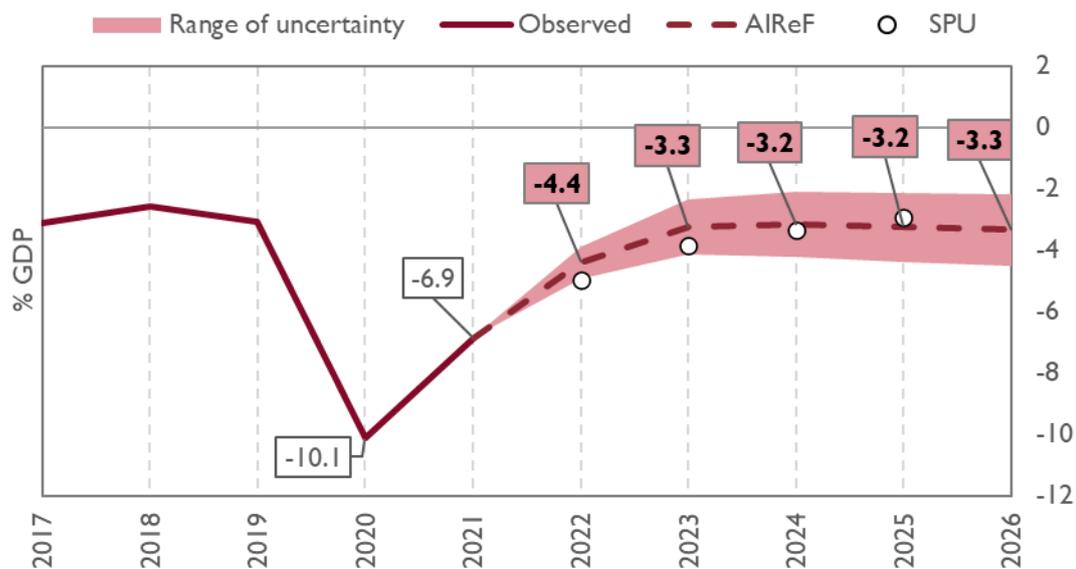
AIReF estimates a deficit of 3.3% of GDP for the GG as a whole in 2023, without including any extension of the measures and without incorporating the information contained in the Budgetary Plan. After closing 2022 with a deficit of 4.4% of GDP, the deficit would fall by 1.1 points if the measures to mitigate the energy crisis were not extended. In both years, AIReF's estimates are below the reference rates set by the Government of 5% for 2022 and 3.9% for 2023. The trend that began with the suspension of fiscal rules of presenting lax reference rates that do not realistically and transparently reflect the state of public finances thus continues. This is not conducive to reducing the structural deficit even when allowed by the economic and fiscal situation.

The GSB forecasts do not include the possible extension of the measures adopted over 2022 to mitigate the effects of the energy crisis and the Russian invasion of Ukraine. AIReF has therefore applied the same assumption to ensure the comparability of the scenarios. However, given that the macroeconomic scenario does not assume that 2023 will see the alleviation of the circumstances that gave rise to the adoption of these measures, it is logical to think, as the Government has stated, the measures will be extended with a scope and duration that will be decided even before the end of the

parliamentary passage of this draft GSB. Therefore, the deficit estimate of 3.3% of GDP for 2023 would rise according to the horizon and scope of the extension or extensions that are adopted over the year, and as a result of any new measures that may be adopted depending on the evolution of the economic and geopolitical situation. As an indicator of the magnitude of the potential impact of these extensions, the annual cost of the measures in force amounts to 1.3% of GDP. Consequently, if all the measures are extended for the whole year, the GG deficit would reach 4.6% of GDP.

In the medium term, AIReF estimates that the GG deficit will stabilise at around 3.2% of GDP, with a slight upturn in 2026 to 3.3% of GDP. Assuming the measures adopted on both the expenditure and revenue sides are temporary, once the current crisis is over, the margin for reducing the deficit without additional measures is exhausted. This results in a level above the 3% limit set in the Stability and Growth Pact.

EVOLUTION OF THE NET LENDING/BORROWING OF THE GG



Source: AIReF and IGAE

Central Government

After analysing the GSB, AIReF estimates a deficit of 3% of GDP for the CG in 2023, without including the extension of the measures, after reaching 3.2% in 2022. These forecasts are below the reference rate set by the Government for the CG, 3.8% for 2022 and 3.2% for 2023. In this regard, it should be noted that AIReF estimates a smaller reduction in the deficit in 2023, 0.2 points of GDP compared with the 0.6 points of the Government.

The tax revenue forecasts contained in the draft GSB are below AIReF's estimates, thus continuing the trend observed since the fiscal rules were

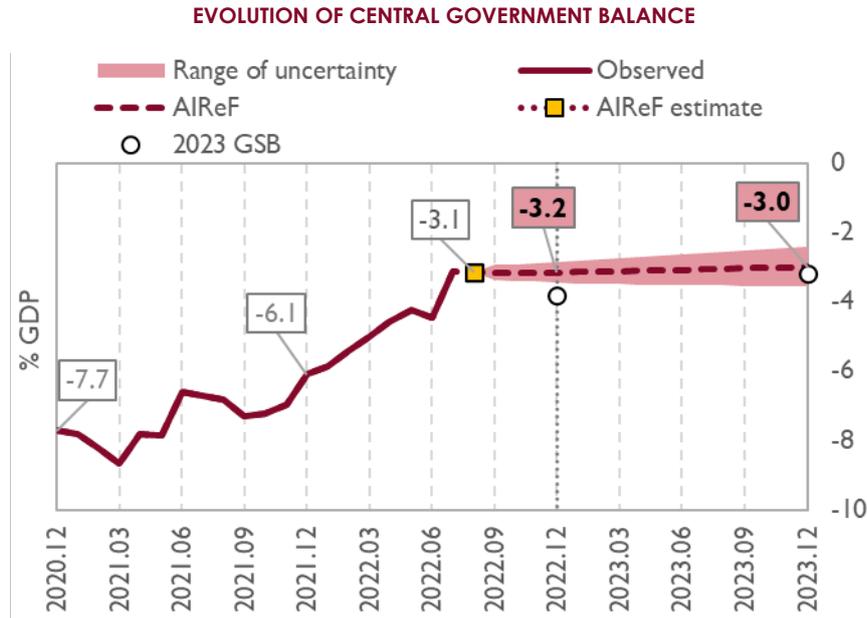
suspended. AIReF's higher forecast mainly stems from the estimated 2022 year-end figure, which is slightly offset by a more contained evolution in 2023. AIReF estimates higher revenue of 0.6 points of GDP, mainly in Personal Income Tax (PIT), Value Added Tax (VAT) and Corporate Income Tax (CIT). In addition, this revenue would be 1.8 points higher than that included in the previous GSBs. For 2023, the forecast difference is reduced to 0.5 points of GDP due to the fact that AIReF estimates growth in tax revenue of 7.2% compared with the 7.7% included in the GSB.

Excluding the impact of both the reversal of the temporary measures in 2022 and the new measures in 2023, the growth in tax revenue in cash terms would be 4.7%. This growth is mainly supported by PIT, with net growth of 7.7%, driven by the increase in pensions and the increase in public and private wages. This growth will be reduced to 6.6% due to the impact of the measures on withholdings on work and income from business activities. In addition, underpinned by inflation, VAT will grow by 7.2%, 4.9% without including the reversal of the 2022 measures. For its part, the cash collection of CIT falls by 4.9% compared with 2022 as a result of the growth in the request for refunds in the 2022 annual tax return.

Although the GSB still does not include information in national accounting terms, AIReF makes its own estimates to translate the budgetary forecasts of the GSB into the national accounting headings. On the one hand, the revenue of the CG will reach 19.3% of GDP in 2023 without including the RTRP, with a level similar to that of 2022 as a result of the financing systems of the territorial administrations. This figure includes the new temporary levies on financial institutions and the energy sector.

On the other hand, the weight of expenditure excluding the RTRP as a proportion of GDP will fall to 22.2% as the GSB for 2023 does not include the measures to mitigate the effects of the energy crisis. This means that all headings grow except intermediate consumption and subsidies and other expenditure. The fastest growing headings include compensation of employees due to wage increases, interest as a result of the rise in interest rates and social transfers in cash due to the increase in civil servant pensions.

In budgetary terms, the State's non-financial expenditure limit grows by 1.1% compared with 2022, which rises to 1.9% if the Next Generation EU funds are excluded. If we also consider the extraordinary transfers to other administrations in 2022 that are not repeated in 2023, the expenditure ceiling rises by 6.3% in like-for-like terms, which amounts to €9bn. This increase is mainly earmarked for interest (€1.1bn), civil servant pensions (€2.5bn), compensation of employees (€1.2bn) and capital transfers (€1.9bn).

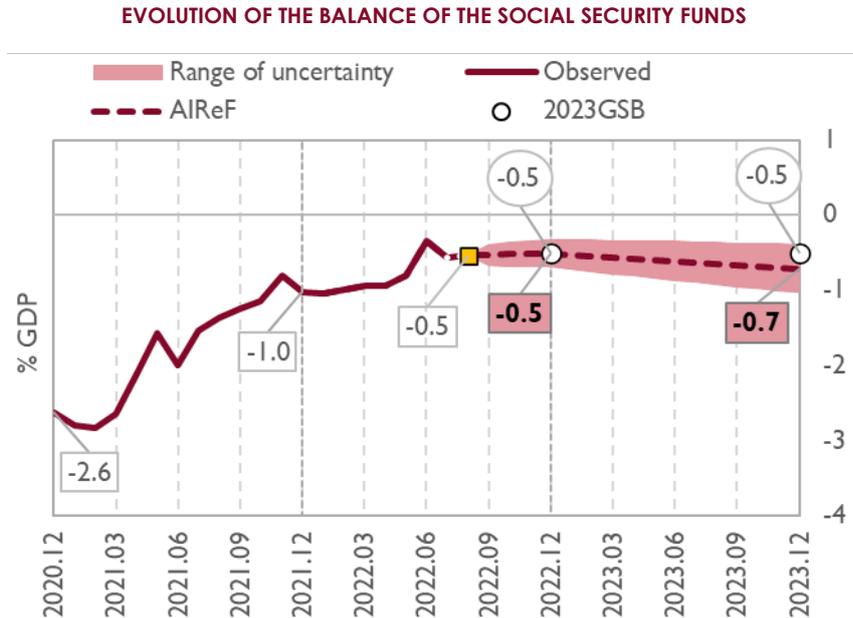


Source: AIReF and IGAE

Social Security Funds

AIReF estimates a deficit in 2023 of 0.7% of GDP in the Social Security Funds, after reaching 0.5% in 2022. While in 2022 this forecast is in line with the Government's reference rate, in 2023 it is 0.2 points higher. The increase in the deficit is mainly explained by the increase in pensions with the 2022 CPI, which, according to AIReF's macroeconomic scenario, will stand at 8.9%. As a result, pension expenditure will grow by 11.2% in 2023, €17.3bn more than in 2022. In addition, unemployment spending will rise by 1.5% in 2023 after falling by 23.9% in 2022. Overall, the expenditure of the SSFs will amount to 16.9% of GDP, 0.4 points higher than in 2022.

SSF revenue will stand at 16.2% of GDP in 2023, with growth of 6.8%. Social contributions will grow by 8% as a result of the evolution of the labour market and especially of wages, the implementation of the Intergenerational Equity Mechanism and the increase in the maximum contribution bases. Transfers from the CG will continue to grow in compliance with the recommendations of the Toledo Pact, although those earmarked for the SEPE disappear.



Source: AIReF, IGAE, Social Security and SEPE

Evaluation of the Specific Recommendation of the European Council on fiscal matters

The Country Specific Recommendations adopted this year set a quantitative reference for fiscal policy in 2023 for high-debt countries, such as Spain. In particular, Spain is recommended to limit the increase in nationally financed current primary public expenditure below medium-term potential growth.

For the GG as a whole, AIReF forecasts in 2023 growth in current primary expenditure net of revenue measures of 3.6%, which would fall within the range defined for the evaluation of the Council's fiscal recommendation.

However, if all measures are extended for the whole of 2023, the evolution of current primary expenditure of the GG would be clearly above the range of compliance with the recommendation. The additional cost of the extension of the measures would imply an increase in current primary expenditure net of revenue measures of almost 7% per year in 2023, well above the references compatible with compliance with the fiscal recommendation.

Debt sustainability

In a context of high nominal growth, the debt ratio remains on a downward path, which AIReF expects to continue in the coming years. Specifically, for 2023, AIReF estimates a reduction in the debt ratio of 7.2 points of GDP compared with the 2021 level, mainly supported by the growth in nominal GDP (15.3 points), where the deflator will play a very significant contribution (8.7).

The public deficit will continue to contribute significantly to the increase in debt.

In the medium term, the projection of a primary deficit that will remain stable at around 1%, together with declining nominal growth and an increasing financial burden, gradually translates into a slowdown in the pace of reduction in the debt ratio, until it stabilises at 108.5% of GDP in 2026.

It should be noted that in 2022 there was already a turning point in the evolution of debt financing costs, in the context of a general tightening of monetary policy.

Recommendations

The GSB still does not provide information in national accounting terms, which hampers analysis of the budget and its consistency with other documents such as the Budgetary Plan submitted to the European Commission. In addition, the year-end forecasts for 2022 are unrealistic both in terms of revenue and balance, thus undermining the forecasts for 2023. While prudence in the preparation of budgets is advisable, a realistic starting point for proper budget planning is necessary. Another fundamental element that hampers the proper analysis of this budget is the lack of specific information on the possible extension of the measures adopted to mitigate the effects of the energy crisis. In this regard, AIReF has been warning since its creation through its reports and opinions of the repeated shortcomings of the draft GSBs, which are exacerbated in this year. For this reason, AIReF recommends to the Government that next year the draft State Budget should recover its central role as an instrument of fiscal and economic policy and an element of design, planning, execution, control and supervision of the activity of the public sector.

Furthermore, although it would have been more appropriate to include information on the measures in the GSB and/or the Budgetary Plan, AIReF recommends that the Government incorporate and publish in any extension of the measures an evaluation of their effectiveness and efficiency that specifies the conditions that trigger their extension or withdrawal both at the time of their approval and in the future. This would make it possible to integrate the measures into a medium-term national fiscal strategy that provides predictability and reconciles the preservation of economic growth and the reduction of the structural deficit with the aim of bringing public debt back to less vulnerable levels and ensuring long-term sustainability. Finally, AIReF once again recommends that the GSB should incorporate information in national accounting terms.



These recommendations are in addition to those made in the endorsement of the macroeconomic outlook of October 4th. Specifically, AIReF made a new recommendation for the Ministry of Economic Affairs to consult AIReF on the Report on the Situation of the Spanish Economy that serves as the basis for the GG budgets. It also repeats the need to have information on the budgetary and fiscal measures included in the macroeconomic scenario and the degree of execution of the RTRP in national accounting terms. Finally, it reiterates the need for the endorsement process to be regulated by a memorandum of understanding.