

EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility, AAI (AIReF) has to issue a Report on the Draft Budget and Main Budgetary Lines of the General Government (GG). To date, AIReF published a report on October 4th in which it endorsed the macroeconomic forecasts of the draft General State Budget for 2023 (GSB) and issued a second report on October 18th on the GSB, focusing on the Central Government (CG) and the Social Security Funds (SSFs) with a preliminary approximation of the fiscal situation of the GG. This report completes the analysis of the GG as a whole, including a medium-term scenario up to 2026, and of the Autonomous Region (AR) and Local Government (LG) sub-sectors. In addition, AIReF will also publish the individual reports of the ARs and the LGs that are subject to individual monitoring.

After presenting the draft GSB for 2023 on October 6th, the Government sent the 2023 Budgetary Plan to the European Commission on October 15th, in which, with the same macroeconomic scenario as the GSB, it presented two budgetary scenarios with the same reference deficit rate - 5% of GDP for 2022 and 3.9% for 2023. In theory, Scenario 1 would be aligned with the forecasts contained in the 2023 GSB and would not contain the extension of the measures adopted since 2021 to mitigate the effects of the energy crisis and the war in Ukraine. Scenario 2 would include a more realistic revenue forecast in 2022, new measures for 2022 and the extension of part of the existing measures for 2023. However, AIReF observes significant inconsistencies in the construction of the two scenarios that could stem from the fact that both scenarios share the same deficit forecast for both years.

AIReF's fiscal forecasts do not include any extension of the measures due to a lack of information on the matters both in the Budgetary Plan and in the GSB. Neither the GSB nor Scenario 1 of the Budgetary Plan reflect the extension of the measures. In contrast, Scenario 2 includes, in quantitative terms, new measures in both 2022 and 2023, but since the measures are not specifically identified, it is not possible to incorporate them into AIReF's forecasts. Finally, AIReF's forecasts, as a new aspect with respect to the report of October 18th, include the new measures approved by Royal Decree Law 18/2022. Consequently, the comparability between the two scenarios, the budget figures and AIReF's forecasts is limited by the lack of homogeneity in their starting assumptions.

In addition, AIReF's macroeconomic and budgetary forecasts incorporate a medium-term vision up to 2026 that helps contextualise and understand the state of public finances. This medium-term vision is also what AIReF has been recommending to the different regional and local governments as a framework for the development of their budgetary procedures.

The medium-term macroeconomic scenario

The macroeconomic scenario that serves as the basis for the preparation of this report exactly matches that published by AIReF on October 18th, both for 2023 and in the medium term, and that used on October 4th to endorse the Government's macroeconomic scenario that accompanies the 2023 GSB.

AIReF considers that the nominal GDP growth that has served as the basis for the preparation of the 2023 GSB and the scenarios of the Budgetary Plan is feasible as it is in the central range of AIReF's probability intervals. However, there is an inconsistency arising from the fact that the Government's macroeconomic scenario is not modified to take into account the macroeconomic impact of the various fiscal measures that are incorporated in Scenario 1 and Scenario 2.

On the other hand, AIReF considers that there are downside risks to the real growth expected by the Government, whose 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, AIReF estimates real growth of 4.4% in 2022 and 1.5% in 2023 and nominal growth of 8.2% and 5.9%, respectively.

Compared with AIReF's scenario, the Government's macroeconomic outlook includes significant growth in investment and in imports and exports, which is unlikely in the context of uncertainty, high energy prices and the deterioration of our main export markets. This is not adequately reflected in the technical assumptions of the Government's scenario. Furthermore, the Government's

scenario sets out a slightly more favourable evolution of employment than AIReF's and estimates that wage increases remain moderate, which carries risks if workers try to recover part of the purchasing power lost in 2022.

In addition, AIReF considers 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 the purchasing power of households and on the financing conditions of the economy, which pose downside risks to real GDP growth and upside risks to inflation.

Budgetary scenario

AIReF estimates a deficit of 3.3% of GDP in 2023 for the GG a whole, after closing 2022 with a deficit of 4.6% of GDP. AIReF therefore raises its forecast for year-end 2022 with regard to the report of October 18th as it includes the measures approved by Royal Decree Law 18/2022.

The deficit reduction of 1.3 points would only materialise if the measures adopted to mitigate the effects of the energy crisis and the invasion of Ukraine were not extended. The evolution of the deficit would be explained by several factors with opposite effects. Firstly, the progressive withdrawal of COVID-19-related measures, which accounts for most of the deficit reduction in 2022, still contributes 0.3 points in 2023. In addition, the revenue measures included in the GSB result in an additional reduction of 0.3 points, 0.1 points more than in 2022. Finally, the evolution of revenue offset by the baseline evolution of expenditure, excluding the increase in pensions, would contribute 0.3 points to the reduction in the deficit. These factors are offset by the rise in pension expenditure due to the increase in line with the 2022 CPI, amounting to 8.9% according to AIReF's forecasts.

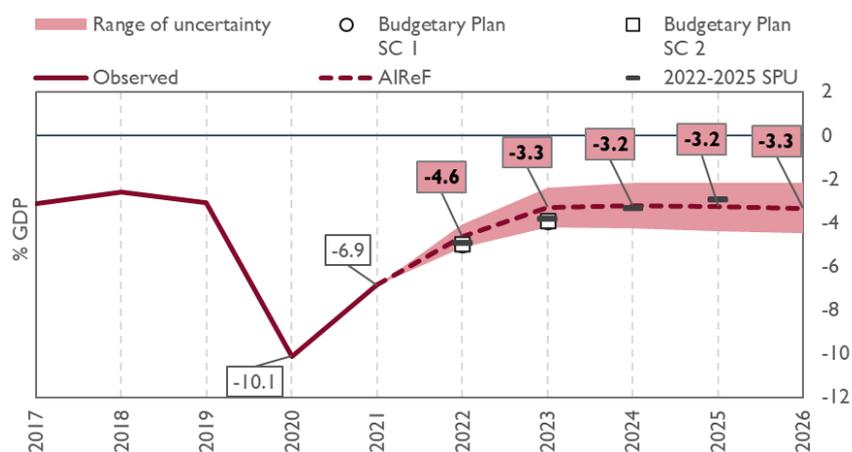
Both in 2022 and 2023, AIReF's estimates fall below the two scenarios of the Budgetary Plan, which forecast a deficit of 5% for 2022 and 3.9% for 2023. However, the two scenarios are not fully comparable as they include different assumptions about the measures, especially in 2023. For 2022, AIReF's forecasts remain below the forecasts of the two scenarios despite incorporating all the measures mentioned in the Budgetary Plan for this year. For 2023, AIReF's forecasts would be directly comparable with Scenario 1 as they do not include the extension of the measures.

In the absence of more detailed information, the comparison with Scenario 2 requires assumptions about the amount of the cost of the extension of the measures. As an approximation, it is possible to identify a rise in expenditure of 0.7 points in Scenario 2 compared with Scenario 1. With regard to revenue, it is stated that all the measures are extended, which, according to AIReF's

estimate, would mean slightly less than 0.4 points of deficit. As a whole, Scenario 2 would imply a cost of the extension of the measures of 1.1 points of GDP. Therefore, AIReF's deficit forecast for 2023, in the event of the extension included in the Government's Scenario 2, would rise to 4.4% of GDP, 0.5 points above the forecast in said scenario.

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 temporary nature of the measures adopted on both the expenditure and revenue side, once the current crisis is over, the margin for reducing the deficit without adopting additional measures is exhausted, resulting 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

In the event that the measures are not extended, revenue, excluding the RTRP, will reach 43.5% of GDP in 2023, after reaching 43% in 2022. These forecasts are higher for both years than forecast in Scenario 1 of the Budgetary Plan, by 0.9 points and 1.2 points, respectively. The gaps widen in 2023, as AIReF forecasts revenue growth of 7.2% without the extension of measures compared with 6.1% in Scenario 1. In contrast, once the effect of the extension of the measures is considered, the forecasts of Scenario 2 would be in line with those of AIReF in both 2022 and 2023, albeit with a different composition. AIReF forecasts lower revenue from taxes and higher revenue from social contributions and other revenue.

AIReF estimates that expenditure will fall to 46.8% of GDP in 2023, after reaching 47.6% in 2022. Apart from the measures, AIReF estimates higher growth in expenditure than contained in the Budgetary Plan in the two years. For 2022, these forecasts are 0.5 points above Scenario 1 and 0.2 points below Scenario 2 and incorporate all the measures mentioned in Scenario 2 of the

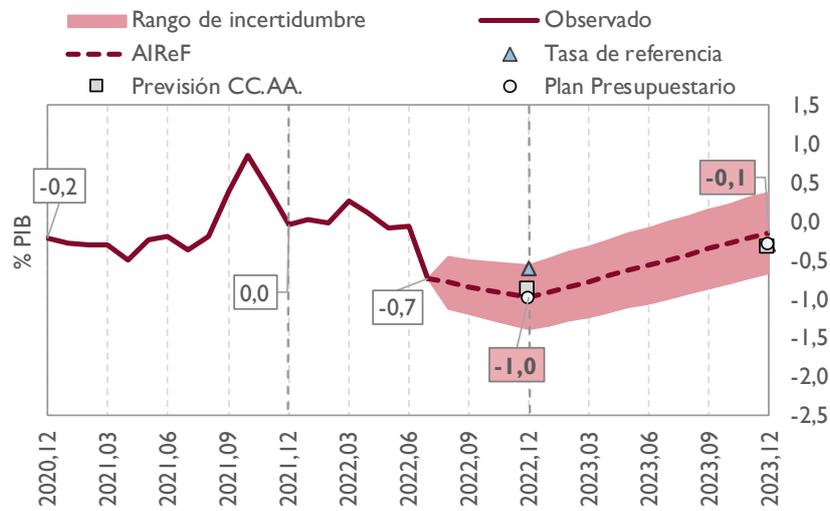
Budgetary Plan. For 2023, AIReF forecasts expenditure growth of 4.2% without the extension of measures, more than half a point above that forecast in both scenarios of the Budgetary Plan. Therefore, without extension of the measures, AIReF expects expenditure in 2023 to be 0.6 points higher than in Scenario 1. This difference is mainly concentrated in the components of public consumption and in other expenditure. If we add a cost of extension of measures of 0.7 points to allow comparison with Scenario 2, the expenditure forecast by AIReF would stand at 47.5% of GDP, also 0.6 points above that forecast in Scenario 2.

In the medium term, AIReF estimates a reduction in the weight of revenue over GDP, after reaching a peak in 2023, to 42.5% in 2026. This reduction is supported by the gradual withdrawal of temporary measures, which will be implemented in 2023 and which extend their effects until 2025, such as the new temporary levies on the energy and banking sectors, the tax on large fortunes and the limitation of the offsetting of losses in Corporate Income Tax. Expenditure will continue to reduce its weight over GDP until it stabilises at 45.8% in 2026. Particularly noteworthy is the increase in interest expenditure of 0.3 points of GDP from the low recorded in 2021.

Autonomous Regions

According to AIReF's forecasts, the balance of the ARs will improve substantially in 2023, reaching a deficit of 0.1% of GDP after closing 2022 with a deficit of 1% of GDP. This improvement is mainly explained by the evolution of the revenue from the financing system, which grew by 23.9%, driven by the growth in interim payments and, to a greater extent, by the settlement which is again positive after the exceptionally negative value of 2022. In the medium term, this irregular evolution of the financing system's revenue linked to the settlement of previous years will provide extraordinary revenue of a mainly short-term nature. Thus, in 2024, the ARs will record a surplus of 0.4% of GDP, which will deteriorate until reaching a balanced budget in 2026, a year with a settlement of the financing system at normal levels. With regard to expenditure, after stronger growth in 2023, AIReF projects more moderate growth once inflationary tensions have been overcome and fiscal rules have been restored.

EVOLUTION OF THE NET LENDING/BORROWING OF THE ARS

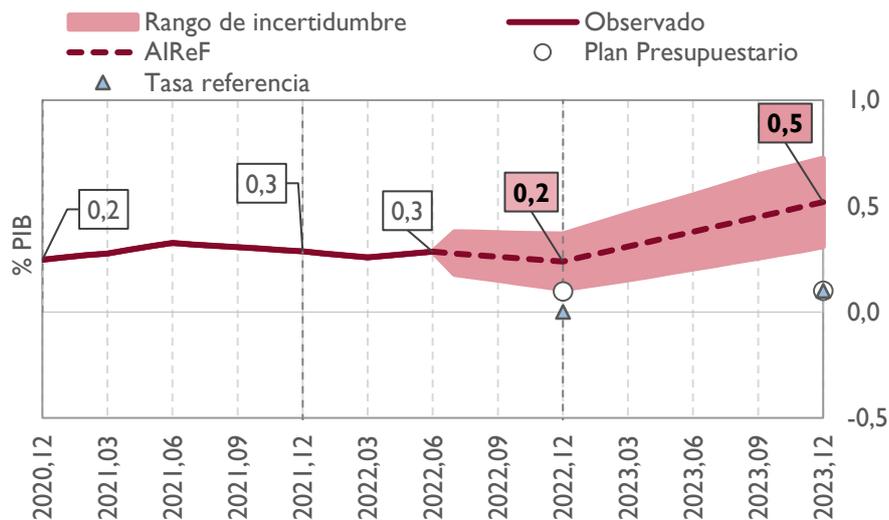


Source: AIRcF and IGAE

Local Governments

AIRcF estimates a surplus in 2023 of 0.5% of GDP in the LGs, after recording 0.2% in 2022. Similarly to the ARs, the evolution of the surplus is marked by the settlements of the financing system in addition to the compensations between 2022 and 2024 as a result of the negative settlement of 2020. Consequently, the surplus of the LGs will grow again in 2024 to 0.6% of GDP and will subsequently fall to 0.3% in 2026.

EVOLUTION OF THE NET LENDING/BORROWING OF THE LGS



Source: AIRcF and IGAE

Fiscal policy stance and assessment of the Specific Recommendation of the European Council on fiscal matters

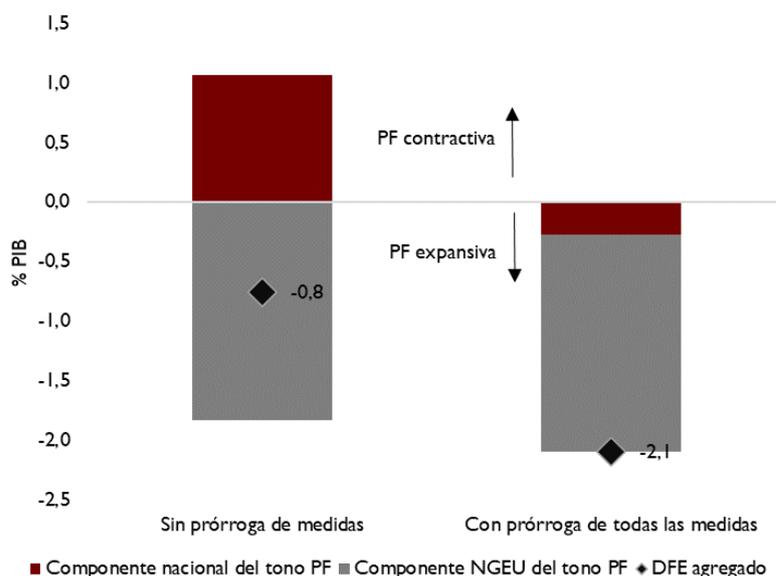
The first Country Specific Recommendation addressed to Spain this year states that the increase in nationally financed current primary expenditure should be below medium-term potential growth.

For the GG as a whole, AIReF forecasts 3.5% growth in current primary expenditure net of revenue measures in 2023 if the measures are not extended over the whole of next year. This increase would fall within the range considered by AIReF for the evaluation of the Council's Fiscal Recommendation. In this scenario, the evolution of the structural balance would show an effort to consolidate the national fiscal policy, resulting from the withdrawal of the measures.

However, if all the measures were extended in 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 would mean an increase in current primary expenditure net of revenue measures of 6.5% per year in 2023, which is well above the benchmarks compatible with compliance with the fiscal recommendation. At the same time, the extension would imply a slightly expansionary stance of national fiscal policy, taking into account the evolution of the structural balance.

From a macroeconomic point of view, the aggregate fiscal policy stance should be assessed including the boost associated with the *Next Generation EU* funds. In this case, the Discretionary Fiscal Effort (DFE) indicator points to a considerable fiscal expansion in 2023, regardless of whether the measures are extended. AIReF's current forecast incorporates an increase in expenditure in 2023 of around €25bn charged to these funds. If this boost materialises, it will determine the aggregate fiscal policy stance next year, either reinforcing a slight national expansion in the event that the measures are extended, or more than compensating for a certain containment of national expenditure in the event that they are not extended.

DISCRETIONARY FISCAL EFFORT INDICATOR, 2023



Source: AIReF

Debt sustainability

Following the sharp increase caused by the COVID-19 crisis, the debt ratio has recorded a period of five straight quarters of falls to stand at 116.1% of GDP in the first half of 2022. This significant cumulative reduction over recent quarters is mainly due to the denominator effect, given the strong upturn in economic activity and prices. However, it continues to represent a net increase compared with year-end 2019 of 17.9 points.

For 2023, AIReF estimates a reduction in the debt ratio of 6.9 points of GDP compared with the 2021 level, supported mainly by the growth in nominal GDP (15.3 points), where the deflator will make a very significant contribution (8.8). Accordingly, and in line with its stochastic projections, AIReF considers the reduction of 5.8 points projected by the Government for 2023 to be feasible. The pace of reduction in the debt ratio is projected to slow down in the medium term for it to stabilise at 108.5% of GDP.

With regard to debt financing costs, 2022 is a turning point. The low interest rate scenario recorded in 2020 and 2021 has turned sharply in 2022, when central banks around the world have had to react with historic rate hikes in an attempt to curb much higher and more persistent inflation than initially expected. Debt markets have quickly incorporated this scenario with year-to-date rises of more than 250 basis points across all segments of the yield curve. The deterioration in financing conditions will gradually begin to have an impact on the evolution of the debt service, with interest and repayments that will increase. However, the increase in percentage of GDP will not be very significant in the short term.

The favourable evolution both in the last year and in the short-term projection of the denominator of the debt ratio should not mask the need to reach a path of fiscal rebalancing in the medium term that would allow more fiscal space to be generated in an environment of major uncertainty and demographic pressures. This is because the significant stock of public debt resulting from the health crisis, on top of a previous high level, places the medium-term sustainability of public finances in a vulnerable position.

Recommendations

In the current context of fiscal rules suspended for several years, the Government decided, in the absence of budgetary stability targets, to set reference rates for the GG and for each sub-sector. These reference rates can be considered a success to the extent that they indicate the fiscal policy orientation and act as an anchor in the design of the budgets of each administration.

For this reason, when the reference rates are lax, as is currently the case, they do not encourage the necessary reduction in the structural deficit, even if allowed, in certain cases, by the economic and fiscal situation. This is the underlying risk in 2023 with the AR sub-sector, which, according to AIReF's estimates, could reach a lower deficit, 0.1% of GDP compared with the 0.3% of GDP of the sub-sector's reference rate. However, regardless of their previous situation, all the ARs have presented budgets in line with the reference rate of -0.3% of GDP or -0.6% in the case of the Basque Country and Navarre. Moreover, setting the same reference rate for all ARs under the ordinary regime is unrealistic, as it is excessively demanding for some and lax for others. This also applies to the General Government as a whole.

For this reason, AIReF recommends that the Ministry of Finance define reference rates for each administration taking into account their starting situation, so that they are demanding, but achievable.