REPORT ON STABILITY PROGRAMME UPDATE 2023-2026

REPORT 21/23

EXECUTIVE SUMMARY

May 11th, 2023

Independent Authority for Fiscal Responsibility

The mission of the Independent Authority for Fiscal Responsibility, AAI (AIReF) is to ensure strict compliance with the principles of budgetary stability and financial sustainability enshrined in Article 135 of the Spanish Constitution.

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The Independent Authority for Fiscal Responsibility, AAI (AIReF) is commissioned with reporting on the Stability Programme Update 2023-2026 (SPU), both in regard to the macroeconomic forecasts and its fiscal scenario, responding to the mandate contained in Articles 14 and 16 of Organic Law 6/2013 creating AIReF. Previously, on April 28th, AIReF endorsed the macroeconomic forecasts of the SPU, warning of the existence of downside risks beyond the short term, stemming from the drastic change in the financial conditions of the economy that have emerged in recent months.

This year's SPU is framed in a context of transition towards a new framework of fiscal governance which, following the presentation of the European Commission's (EC) legislative proposals on April 26th, must be firmed up in the coming months with a view to their entry in force in 2024. This new framework is designed with a vocation to strengthen the medium-term stance of fiscal policy, placing debt sustainability at its heart. It also proposes targets differentiated by country that each EU Member State must materialise through the so-called structural-fiscal plans.

In fact, despite maintaining the escape clause active this year, the European Commission, in its guidelines on the design of fiscal policy, recommended that the Stability or Convergence Plans for the period 2023-2026 should already include medium-term structural-fiscal plans to guarantee that (i) debt remains on a plausible downward and continuous path or at prudent levels, and that (ii) the deficit should fall to below 3% in the period covered by the Stability Programme and remain below this reference rate at constant policies in the medium term[1].

This year's SPU has followed the same design as in previous years. In this regard, as AIReF has mentioned on several occasions, the SPU does not constitute a genuine medium-term planning instrument, since the commitments and

[1] Fiscal policy guidance (europa.eu).

targets are revised year on year, without an analysis of the factors that justify this revision. Nor do the programmes contain details of the fiscal measures beyond those approved in the Budget for the year underway.

On the one hand, the SPU 2023-2026 complies with the commitment to reduce the public deficit to below 3% of GDP in the projection horizon, although AIReF estimates the deficit will stabilise to close to 3% as from 2024. Furthermore, in this period, debt on the GDP will fall, mainly driven by the nominal growth of GDP, both in the scenario of the SPU and of AIReF.

However, in this new context, the analysis of the sustainability of the public finances and of the factors that underpin it take on even greater importance, if possible, such as medium-term growth, demographics and other fiscal risks, such as those associated with climate change, etc.

In this regard, AIReF's forecasts show that debt will commence an upward path as from 2030, in the absence of additional measures. Consequently, AIReF estimates that, when the new framework enters into force and if this is maintained in line with the EC's legislative proposals, additional adjustment measures will be needed to place the debt path on a downward slope over the coming years with sufficient plausibility.

Macroeconomic scenario 2023-2026

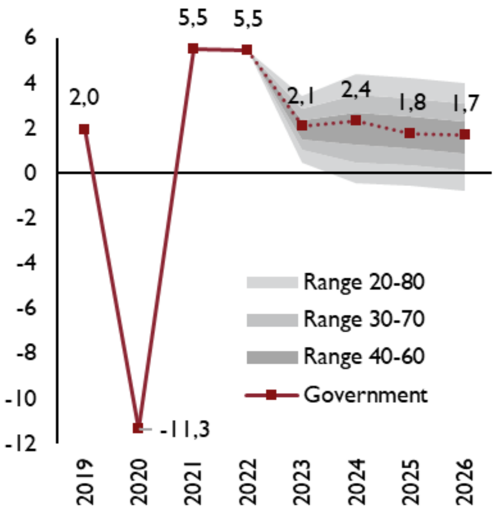
AIReF considers that the macroeconomic scenario of the SPU for the period 2023-2026 is feasible, which it thus endorsed on April 28th. The Government's scenario forecasts real GDP growth of 2.1% in 2023, which will rise to 2.4% in 2024. In 2025 and 2026, real growth with fall to converge towards potential growth, which the Government estimates at 1.6%. As regards prices, the Government's scenario provides for high growth in the GDP deflator and in private consumption in 2023 (of 4% and 3.9%, respectively), which will moderate in the next few years to converge at rates of close to 2% at the end of the projection period. Consequently, expected nominal growth will remain high in the medium-term horizon, particularly in 2023 and 2024, at rates of 6.1% and 5.9%, respectively, which will drop to 3.9% and 3.6% in 2025 and 2026.

These forecasts stand, over the course of the projection period, within the central probability range defined around AIReF's own estimates, both at current and constant prices. Accordingly, they are considered feasible and are thus endorsed.

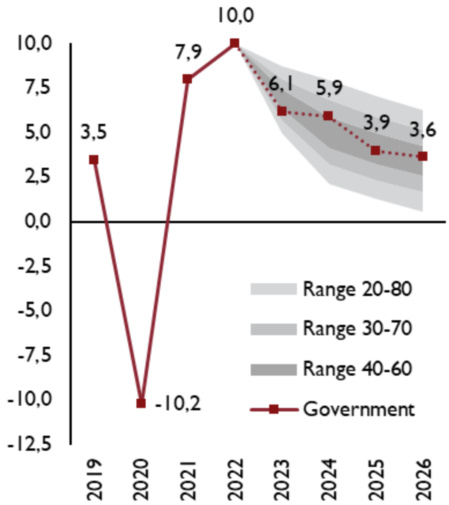
Short-term GDP growth continues to surprisingly rise, driven by the relaxation of the pressures on bottle-necks in global value chains and by relatively less intensive inflationary pressures on energy raw materials and by the fiscal policy measures to counteract price hikes and sustain gross disposable income. In contrast, the rapid and intense rise in official interest rates can now be seen in the tightening of the financial conditions of the economy and it is expected that its effects will begin to be felt more intensely in the second half of 2023 and in 2024. Overall, AIReF forecasts a rise in real GDP that will remain at close to 2% in 2023 and 2024, somewhat lower than the Government's forecast. In the following years, as the boost from the Recovery, Transformation and Resilience Plan (RTRP) on the GDP growth rate disappears, growth will fall to around 1.7%, practically in line with the Government's estimates.

Furthermore, AIReF's inflation forecasts are higher than the Government's, particularly in 2023. In AIReF's scenario, the acceleration of wage demands envisaged in 2023 to partially recover the purchasing power lost in 2022 will contribute to slow the short-term fall in inflation. In contrast, in the medium term, the disappearance of supply tensions and the gradual transition of financial conditions to demand will allow prices to be contained.

GRAPH 1. GROSS DOMESTIC PRODUCT. VOLUME. (YEAR-ON-YEAR RATE OF CHANGE)



GRAPH 2. NOMINAL GDP (YEAR-ON-YEAR RATE OF CHANGE)

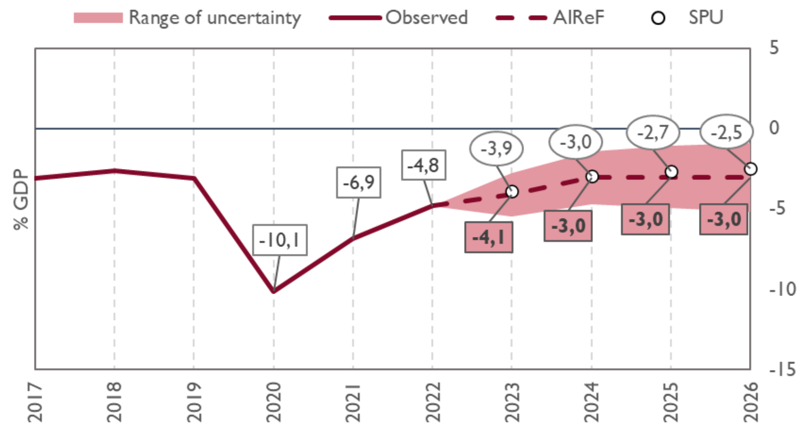


Source: Ministry of Economic Affairs and Digital Transformation and AIReF

Fiscal scenario 2023-2026

AIReF estimates that the General Government (GG) deficit will stand at 3% of GDP in 2026, 0.5 points higher than the SPU forecast. For 2023, AIReF considers that the deficit will stand at 0.2 points above the reference rate, while in 2024 both AIReF and the SPU expect a reduction of close to 1 point of the deficit, mainly as a result of the withdrawal of the temporary measures. As from 2025, the forecasts diverge once again, whereby the SPU forecasts a gradual reduction of the deficit between 2024 and 2026, while AIReF forecasts stabilisation of close to 3% as from 2024.

GRAPH 3. EVOLUTION OF THE GENERAL GOVERNMENT BALANCE



Source: IGAE, SPU and AIReF

AIReF forecasts that the weight of revenue over GDP, without including the RTRP, will stand at 43.2% in 2026, 0.6 points below the level forecast in the SPU. These differences can be seen for year-end 2023 and present an uneven profile in the rest of the period. In AIReF's scenario, the evolution of revenue is strongly conditioned by the schedule for the withdrawal of the temporary measures, both in the reduction and the increase in revenue. Accordingly, the withdrawal of the measures that will lower revenue and the validity of those that raise it imply an increase in revenue in 2024. Subsequently, in 2025 the withdrawal of the temporary tax rates and other measures to increase income take effect, with the resulting reduction in revenue, which will be offset by the cyclical evolution of income. Finally, the evolution in 2026 would mainly be explained by macroeconomic factors.

Differences can also be appreciated by component. The SPU presents a higher level of taxes, of 0.9 points of GDP in 2026, and social contributions, of 0.1 points of GDP, while AIReF estimates higher income from other revenue, of 0.4 points of GDP. By type of tax, the differences are concentrated in income taxes, with a higher amount of 0.7 points in the SPU in 2023, which rises to 1.3 points in 2026. As regards other taxes, AIReF's forecast is 0.3 points higher in 2026 than in the SPU. These differences would not be explained by the differences in the underlying macroeconomic scenario.

Expenditure, without including the RTRP, reduces its weight in AIReF's central scenario to 46.2% of GDP in 2026, 0.1 points below the forecast contained in the SPU. This reduction is concentrated in 2023 and 2024 due to the gradual withdrawal of the measures to alleviate energy and food price increases.

Subsequently, expenses would then grow on average by close to 4% following their inertial evolution. As regards their composition, AIReF estimates that the components of public consumption will reduce their weight compared with 2022. In addition, the withdrawal of the measures will result in a reduction on the weight of subsidies and other expenses and will maintain the level of investment. In contrast, the weight on the GDP compared with 2022 of social transfers in cash and expenditure on servicing debt will rise. Compared with the SPU, AIReF forecasts lower spending on public consumption, on social benefits and on subsidies and higher spending on capital.

By sub-sector, the profile of the balance is strongly conditioned by the impact of the settlements of the financing system of the Territorial Governments and transfers between sub-sectors. In 2024, the settlement of the financing systems will be high, which drives an improvement in the balance of the Autonomous Regions (ARs) and Local Governments (LGs) and a worsening of the Central Government (CG), despite the withdrawal of the temporary measures. This settlement will be lower in 2025, exercising the opposite effect and will tend to normalise by 2026. Consequently, by 2026, the CG deficit will be partially offset by the AR and LG surplus. Although the profile is different, the SPU also forecasts a surplus of the Territorial Governments in 2026 and a lower deficit than forecast by AIReF for the CG. For their part, the Social Security Funds (SSFs), incorporating the new measures, will see their deficit stabilise at close to 0.3% of GDP as from 2024, reaching -0.2% in 2026. The differences of the SSFs with the SPU may be due to different assumptions about the transfers from the CG.

BOX 1, EVOLUTION OF THE BALANCE BY SUB-SECTOR

	AIReF				SPU			
	2023	2024	2025	2026	2023	2024	2025	2026
GG	**-4,1**	**-3,0**	**-3,0**	**-3,0**	**-3,9**	**-3,0**	**-2,7**	**-2,5**
CG	-3,4	-3,5	-3,2	-3,2	-3,1	-3,0	-2,8	-2,8
SSFs	-0,6	-0,3	-0,3	-0,2	-0,5	-0,2	-0,1	0,0
ARs	-0,3	0,4	0,2	0,2	-0,3	0,0	0,1	0,1
LGs	0,2	0,3	0,2	0,2	0,0	0,2	0,1	0,2

Direction of fiscal policy

The direction of fiscal policy over the projection horizon is crucially conditioned by the RTRP. The increase in spending charged to the NGEU funds in 2023 will determine the expansive tone that fiscal policy will adopt, which the dynamic nature of nationally-financed investment will also contribute to, albeit to a lesser extent. In contrast, nationally financed current primary expenditure, net of income measures, will grow below the potential medium-term rate – in line with the recommendation made by the European Council to Spain and partially offsetting the expansive tone of the previous elements.

Challenges appreciated from the perspective of the sustainability of the public finances

The reduction in the public deficit, together with the rebound of activity and much higher inflation than expected, have managed to correct approximately one third of the debt generated in the first year of the pandemic, placing it on a downward path. Under the macro-fiscal forecasts prepared by AIReF to evaluate the Stability Programme, a decline in the debt ratio over GDP of 5.9 points is forecast over the next four years to stand at 107.3% in 2026, a reduction that will be primarily underpinned by nominal GDP growth, where the deflator will play a very significant role. Accordingly, AIReF considers the Government's debt forecast included in the SPU for 2026 to be feasible, since, over the period as a whole, both the reduction in the ratio and the composition of the factors that determine its evolution, are similar to those estimated by AIReF.

The new monetary cycle, along with the high level of existing debt, place the sustainability of the public finances in a vulnerable starting position. AIReF forecasts a rising debt ratio in its long-term inertial scenario, following an initial period of certain stabilisation, whereby the foreseeable rise in spending associated with the ageing population is one of the main challenges to the sustainability of the public finances in the medium and long term. The high initial level of debt, together with unbalanced public accounts, will generate an unfavourable dynamic in the financial burden, even in a scenario of containing the costs of servicing the debt.

The generation of a fiscal space that allows future disruptions, such as those experienced in recent years, to be addressed, obliges a medium-term plan to be designed that guides the public accounts towards a balanced situation. In this regard, the European Commission guidelines, together with its proposed reform of the fiscal framework, represent an opportunity and a guide to draw up a structural-fiscal plan.

AIReF's simulations show that the design of a fiscal strategy that is compatible with the Commission's guidelines would require a more demanding path to be taken than contained in the Stability Programme Update. According to AIReF's calculations, the fiscal path that would comply with the Commission's guidelines for the period 2024-2027 would require additional measures to be taken, amounting to 0.46 points a year. This adjustment (a cumulative 1.84 points over four years) would lead to a reduction in the debt ratio of 24 points of GDP over the next 15 years, placing this on a clearly downward trend. AIReF's simulations applied to the Government's fiscal scenario also point to the fact that the design of a fiscal strategy compatible with the European Commission guidelines and with the proposed reform of the fiscal framework would require an adjustment which, in this case, would stand at close to 0.3 points per annum.

Recommendations

During the period of suspension of the fiscal rules, AIReF has been making recommendations designed to encourage the Government to establish a medium-term fiscal strategy that provides a fiscal stance and realistically and credibly guarantees the financial sustainability of the General Government.

The European Commission has now published a complete proposal of the reform of the framework of European fiscal rules, along with guidance on the content of the Stability Programme. In this regard, the SPU does not explicitly state whether, once the projection period has finalised, debt will remain on a downward and plausible path as specified by the Commission. Furthermore, although the European fiscal framework that is finally approved may be separate from the Commission's current proposal, it is already clear that it will not be fully compatible with the national fiscal framework. Accordingly, AIReF recommends that the Ministry of Finance and Civil Service:

- Commences the work to reform the national fiscal framework with the participation of the different tiers of the GG from an integral perspective.
- Incorporates in the Resolution of the Council of Ministers that establishes the stability targets an analysis of how the targets meet the requirement for debt to remain on a continuous downward and plausible path and of how each tier of government will achieve this to ensure the consistency of the distribution.

In addition, taking into account the importance of economic growth for the sustainability of the public finances, AIReF recommends the Ministry of Economic Affairs and Digital Transformation to design a model of governance of the evaluation of the RTRP for the next few years.

AIReF also recommended in its publication of the Endorsement on April 28th to submit better information that is provided with the request for endorsement, along with the establishment of an agreement or memorandum of understanding (MoU) that regulates the endorsement procedure.