REPORT ON BUDGETARY EXECUTION, PUBLIC DEBT AND THE EXPENDITURE RULE 2023

REPORT 22/23

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.

AIReF Contact:

C/José Abascal, 2, 2º planta. 28003 Madrid, Tel. +34 910 100 599

Email: Info@airef.es

Website: www.airef.es

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EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility, AAI (AIReF) has the legal mandate to report on the budgetary execution, public debt, and expenditure rule in 2023 of the different sub-sectors of the General Government (GG). In this report, AIReF updates its macroeconomic and fiscal forecasts in accordance with the latest information available and the new measures adopted by the different tiers of government. AIReF also publishes the individual reports on each Autonomous Region.

AIReF forecasts real GDP growth for 2023 as a whole at around 2.3%, compared with the spring forecast of 1.9%. This upward revision is due to the incorporation of new Quarterly National Accounts estimates of the National Statistics Institute (INE), while the growth forecasts of our peer economic countries and of global trade have worsened at the same time as the financing conditions of the economy have been further toughened. As regards prices, AIReF estimates a rise in the GDP deflator of 4.8% in 2023, identical to the spring forecast. Accordingly, the nominal growth of the economy would rise to 7.2%.

As regards the fiscal scenario, AIReF maintains its deficit forecast of the GG as a whole at 4.1% of GDP in 2023. The update of the macroeconomic scenario, together with the latest data on tax collection and budget execution offset the cost of the measures adopted since the previous report.

How has the macroeconomic scenario evolved?

The recent revisions of the Quarterly Accounts of the INE suggest that the Spanish economy maintained a higher rate of growth than initially estimated by this body, both in the second half of 2022 and in the first quarter of 2023. Furthermore, the information available for the second quarter points towards somewhat lower real growth than in the previous quarter, but higher than for the euro area as a whole. This has led to a revision of the GDP growth estimates to 2.3% from 1.9% estimated in the spring.

The Spanish economy would thus have better managed the energy crisis over the last three quarters than the euro area as a whole. However, a moderation in the rate of growth is expected in the second half of the year, due to the transfer of the interest rate rises to the real economy, which is expected to fully materialise in the second half of 2023 and in 2024. Furthermore, the persistence of high interest rates in the euro area as a whole could result in a more restrictive tone of monetary policy for a longer period of time.

As regards prices, there has been a noteworthy containment of inflation, due to the base effects associated with the energy component and the moderation of gas and oil prices on the international markets. However, core inflation remains at high rates. As a whole, CPI growth of 3.7% is expected in 2023, somewhat lower than the spring forecast, while the GDP deflator would rise to 4.8%.

How has AIReF modified its budget forecasts?

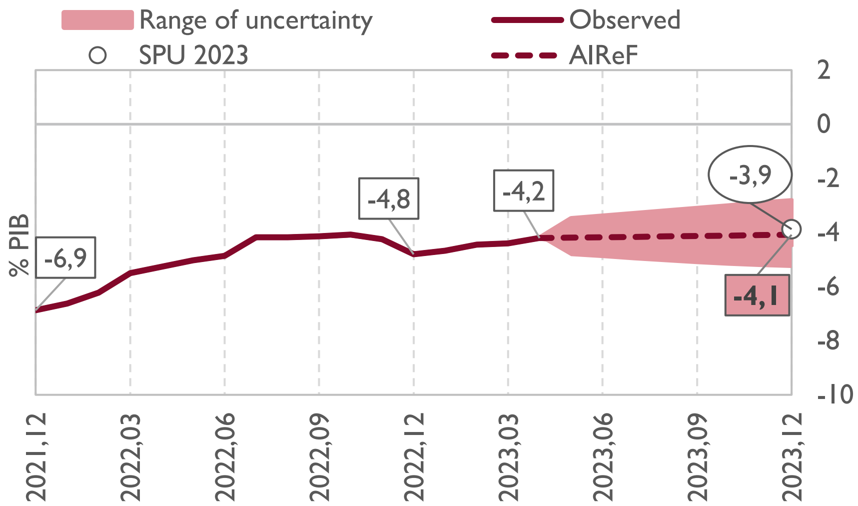
AIReF forecasts a General Government (GG) deficit of 4.1% of GDP in 2023, 0.2 points above the reference rate figure set by the Government. The extension of the measures to tackle the energy crisis, the price rises and the effects of the war in Ukraine amount to a rise in the deficit of 0.2 points of GDP. This increase is offset by the effect of the revision of the macroeconomic outlook on the public accounts and the latest collection data.

Consequently, the deficit reduction in 2023 would amount to 0.7 points of GDP from the 4.8% posted in 2022. Following the approval of Royal Decree-Laws 4/2023 and 5/2023, the measures adopted to alleviate the effects of the war in Ukraine and the energy crisis amount to 1.1% of GDP in 2023, 0.3 points lower than in 2022. In addition, the rest of the revenue measures incorporated in the 2023 GSB and in the laws approved in parallel contribute to reduce the deficit by 0.2 points. Furthermore, the reduction in expenditure associated with COVID still contributes 0.1 points to this reduction. Lastly, the pension rises offsets growth in revenue higher than the inertial evolution of the rest of the spending.

Revenue in 2023 will amount to 42.7% of GDP, without including the Recovery, Transformation and Resilience Plan (RTRP), almost 0.1 points higher than the level forecast in the previous report. This amounts to growth of 7.5% compared with year-end 2022. The extension of the reduction in the VAT rates amounts to a fall in tax collection of a little over €500m, if core inflation will stand below 5.5% in September in accordance with AIReF's macroeconomic scenario. In the opposite direction, the revision of the macroeconomic scenario and the latest data published on tax collection amount to an increase in the collection forecasts of almost 0.2 points, mainly in social contributions, Corporate Income Tax and Personal Income Tax. However, this increase in the level forecast will be partially offset in terms of weight on GDP due to the rise in the nominal GDP estimate for 2023.

Expenditure, also excluding the RTRP, will stand at 46.8% of GDP, less than 0.1 points above the level forecast in the previous report. On the one hand, the extension of the measures, including the public transport price discount and fuel discount for professionals, will amount to 0.1 points of GDP. In addition, the latest execution data lead to a slight upward revision of public consumption and social transfers. Overall, AIReF raises its growth forecast of expenditure to 5.9% compared with the rate in 2022. In the same way as with revenue, the effect of higher nominal GDP partially offsets the rise in terms of weight on the GDP.

FIGURE 1. EVOLUTION OF NET LENDING/BORROWING OF THE GENERAL GOVERNMENT



Source: AIReF, IGAE and SPU

What changes have taken place at the sub-sector level?

Compared with the previous report, the deficit forecast of the Central Government (CG) is worse by less than 0.1 points to remain at 3.4% when incorporating the cost of the extension of the measures. In contrast, the Social Security Funds improve their forecast by 0.1 points to -0.5% of GDP, due to the rise in social contributions forecast because of the changes in the macroeconomic scenario. For their part, the balance forecast of the Autonomous Regions (ARs) worsens by almost 0.1 points according to the latest budget execution data to stand at -0.4 points while the Local Governments (LGs) forecast remains at 0.2%.

TABLE 1. EVOLUTION OF NET LENDING/BORROWING BY SUB-SECTOR

		AIReF estimate	
	2023 SPU Government	2023 Report on SPU	2023 Current
GG	**-3,9**	**-4,1**	**-4,1**
CG	-3,1	-3,4	-3,4
SSFs	-0,5	-0,6	-0,5
Ars	-0,3	-0,3	-0,4
LGs	0,0	0,2	0,2

Source: AIReF, IGAE and SPU

What are the implications from a sustainability point of view?

Following the sharp rise caused by the pandemic, the debt ratio shows a downward trend, with eight straight quarters of reductions, which has led to the correction of approximately half of the increase caused by the pandemic (a total of 12.9 points from the ceiling hit in the first quarter of 2021). Despite this, debt levels remain high compared with the recent part and other European countries.

In the case of the GG, under the macro-fiscal forecasts prepared by AIReF, it projects a reduction in the debt-to-GDP ratio of 3.1 points on the level recorded in 2022, which would place the ratio at 110.1% by the end of 2023. This reduction would mainly be based on nominal GDP growth, with a high contribution from the deflator. This forecast is in line with recent projections from the IMF and the European Commission and is slightly more optimistic than that prepared by the Government in the SPU for 2023 (111.9%).

In the medium term, the new monetary cycle, along with the high level of existing debt, exceeds 100% of GDP, placing the sustainability of the public finances in a situation of vulnerability, since the GG will have to service high levels of debt over the coming years, of around 20% of GDP at significantly higher interest rates, in a context in which the demand for debt securities by the ECB disappear and in which many countries will maintain their debt levels and high refinancing needs.

What recommendations does AIReF make in this context?

After four years in which the fiscal rules have been suspended at a European and national level, the deactivation of the escape clause will take place in 2024 in a context of institutional uncertainty originating from the confluence of the reform of the European fiscal framework and the lack of budgetary stability targets and of a reference rate of the expenditure rule at a national level. Furthermore, the reform process of the national fiscal framework has not yet begun.

For 2024, AIReF's forecasts for the General Government, presented in the Report on the Stability Programme Update, would be compatible with compliance with the expenditure growth limit of 2.6% set in the recommendation to Spain by the European institutions, provided that the temporary revenue and expenditure measures adopted to alleviate the effects of the price crisis are removed. At a sub-sector level, this implies that the ARs would close with a surplus of 0.4% and the LGs of 0.3% of GDP, mainly as a result of the temporary rise in revenue from the settlement of the financing systems relating to 2022.

However, with a view to the process of drawing up the budgets of the different GG sub-sectors, the only existing reference is the forecast contained in the Stability Programme Update at the level of the balance of the sub-sectors: balanced for the ARs and a surplus of 0.2% for the LGs for 2024. Considering AIReF's revenue forecast contained in the Report of 11 May, a situation of balanced budget in 2024 would be compatible with growth in expenditure by the sub-sector, excluding the RTRP and REACT, of 7% for the ARs and 6% for the LGs.

In short, growth in expenditure by the ARs and LGs compatible with the forecasts on the balance by sub-sector contained in the Stability Programme Update would be hard to combine with compliance with the Country Specific Recommendation (CSR). In fact, if the balance of the AR and LG sub-sectors stood within the forecast of the SPU in 2024, growth in primary expenditure net of revenue measures of the GG, excluding the RTRP, could stand at 4%, 1.4 points higher than the level of the CSR.

Consequently, AIReF recommends that the Ministry of Finance, when preparing the budgets for all the GG sub-sectors, should propose reference rates of growth in primary expenditure net of revenue measures for the different GG sub-sectors that take into account the temporary or structural nature of the expenditure and revenue of each sub-sector for 2024 and the way in which these can be coherent with compliance with the CSR issued by the Council of the European Union.

Given that general elections have been called, the rest of the GG sub-sectors will need to begin the process of drawing up their respective budgets before the formal approval of the budget execution targets and the establishment of the reference rate of the expenditure rule. Furthermore, pursuant to prevailing legislation, the reference rate of the national expenditure rule would stand at around 3% for 2024.

Accordingly, AIReF recommends that those ARs and LGs under the common regime should avoid increased expenditure and reduced revenue of a structural nature financed by increasing the temporary revenue that will take place in 2024 and consider the application of the expenditure rule in 2024, even though this means temporarily achieving a surplus.

Although the ARs and LGs under the *foral* regime are virtually unaffected by the settlements of the financing systems, their forecasts also stand regarding the path set for the sub-sector in the SPU for 2024. Considering this, AIReF recommends that the ARs and LGs under the *foral* regime avoid increased expenditure and reductions in revenue that are not permanently financed and take into account the application of the expenditure rule in 2024.

1. INTRODUCTION

With the issuance of this report, AIReF fulfils the legal mandate to report on budgetary execution, public debt and the expenditure rule for 2023 by July 15th. In accordance with Article 17 of Law 6/2013 of November 14th, on the establishment of AIReF, and Article 19 of Royal Decree 215/2014 approving its Organic Statute, AIReF has the obligation to issue an opinion on compliance with budgetary stability and public debt targets and the expenditure rule prior to July 15th each year.

As the fiscal rules are suspended in 2023, the assessment is instead made with respect to the latest Government deficit forecasts for 2023 contained in the 2023-2026 Stability Programme Update. In the absence of fiscal rules for 2023, the meeting of the Council of Ministers of July 22nd, 2022 set a reference deficit for 2023 of 3.9% of GDP for the GG as a whole. This reference rate is spread as follows: a deficit of 3.2% of GDP for the Central Government (CG), 0.5% of GDP for the Social Security Funds (SSFs) and 0.3% of GDP for the Autonomous Regions (ARs), with the Local Governments (LGs) having a surplus of 0.1% of GDP. However, AIReF has considered the Government's latest forecasts included in the 2023-2026 Stability Programme Update sent to Brussels last April, where the forecast for 2023 of the GG matches the set reference rates. The CG has a forecast deficit of 3.1% of GDP. The improvement of 0.1 points is offset by the worsening of the forecast for the LGs, which are now expected to achieve a balanced budget.

In the current context of suspended fiscal rules, AIReF's fiscal supervision takes on greater importance as a guarantor of the sustainability of the GG. The suspension of fiscal rules during the last four years, first as a result of the pandemic and then due to the uncertainty of the energy crisis and the war in Ukraine, reinforces the need for AIReF to monitor the fiscal situation of the GG in order to guarantee the sustainability of public finances. Although the growth in expenditure, deficit and debt do not entail any corrective measures, it is important to bear in mind that the return to fiscal discipline is scheduled for 2024 with the reactivation of fiscal rules. Therefore, the ongoing monitoring of these fiscal indicators, regardless of the revisions that take place at the time of their reactivation, provides valuable information on the fiscal position and evolution of each public authority.

In this report, AIReF updates its macroeconomic and fiscal forecasts for 2023 in accordance with the latest available information. AIReF has already pronounced on the 2023 macroeconomic and fiscal forecasts in three milestones of the budget cycle:

- Firstly, in the last quarter of 2022, when reporting on the main lines of the 2023 budgets: Report on the draft GSB for 2023[1], followed by the report on the main budgetary lines and draft budget of the General Government and regional and local governments[2], which was later completed with the individual reports on the ARs[3] and the LGs.[4]
- Secondly, in April, when reporting on the initial budgets for 2023: Report on the initial budgets of the GG for 2023[5], followed by the individual reports on the ARs[6] and the LGs[7]
- Thirdly, in May, when reporting on the 2023-2026 Stability Programme Update (SPU)[8], with a medium-term analysis focused on the General Government as a whole.

In this report, AIReF updates the forecasts since the publication of the Report on the SPU, incorporating into the analysis the measures taken by the Government, all the new information published and provided by the GG on

[1] Report on the main budgetary lines and draft budget of the GG: 2023 GSB

[2] Report on the main budgetary lines and draft budget of the GG: ARs and LGs 2023

[3] Individual reports on the main budgetary lines and draft budgets of the ARs for 2023

[4] Report on the main budgetary lines and draft budgets of the LGs, analysed individually

[5] Report on the initial budgets of the General Government 2023

[6] Individual reports on the initial budgets of the ARs 2023

[7] Supplementary report individual evaluation of initial budgets of the LGs 2023

[8] Report on the 2023-2026 Stability Programme Update.

the execution of its budgets this year and year-end forecasts, as well as the evolution of the macroeconomic environment.

The macroeconomic and budgetary evaluation for 2023 set out in this report is divided into six sections. Following this introduction, Section Two sets out the purpose and scope of the report. Section Three updates the macroeconomic scenario that underpins the fiscal projections, stating the reasons why it has changed. Section Four refers to the budgetary scenario, analysing in detail the changes that have taken place in the estimate of revenue and expenditure for 2023 for the GG as a whole and for each one of the sub-sectors in relation to the forecasts in AIReF's Report on the 2023-2026 SPU. That is followed by an update on the impact of fiscal policy measures and an analysis of the main contingent liabilities and fiscal risks for this year. Section Five, after analysing recent developments in public debt and medium-term projections, assesses the challenges for the sustainability of public finances. Finally, Section Six presents the recommendations emerging from the analysis conducted.

2. PURPOSE AND SCOPE

The purpose of this report is to analyse the stability and debt forecasts of the GG for 2023, updating the assessment made in the Report on the SPU. AIReF updates the macroeconomic and fiscal forecasts of the GG for 2023 contained in the Report on the SPU issued in May. For this purpose, it incorporates into its assessment the latest published data on budgetary execution, the measures approved by the Government, the new information available to date on both the macroeconomic and fiscal environment and other additional information received. In particular, this report includes: the latest data published by the General State Comptroller (IGAE) in national accounting terms (month of May for the State, month of April for the CG, SSFs and ARs and first quarter for LGs), the budgetary execution of the different sub-sectors (month of May for the Central State Administration, Social Security System, SEPE, FOGASA and month of April for the ARs), monthly information on tax collection from the State Tax Administration Agency (AEAT) also for the month of May, and pensions paid out (eSTADISS database) and unemployment benefits statistics. In addition, the information on the annual Personal Income Tax (PIT) campaign is included, as published in the press release of the State Tax Administration Agency.

This analysis is carried out for all the sub-sectors, including the individual analysis by AR and is completed with the overall vision for the GG as a whole. In particular, AIReF has analysed:

- The Central Government sub-sector.
- The Social Security Funds sub-sector.

- The Autonomous Regions sub-sector and each of them.
- The Local Governments sub-sector.

The analysis by sub-sector is completed with the overview of the situation for the GG as a whole.

Subsequently, AIReF will complete its assessment with the publication of the individual evaluation of the budgets of the LGs. In particular, the 24 large Local Governments will be analysed, that is, 16 local councils with more than 250,000 inhabitants, the Provincial Councils of Barcelona, Valencia and Seville, the Island Council of Tenerife and the Island Council of Mallorca and the Provincial Councils of Gipuzkoa, Bizkaia and Araba/Álava). In addition, Local Governments with significant sustainability risks will be evaluated, according to AIReF's selection and rating methodology.

The subject of the report continues to be conditioned by the uncertainty of the energy crisis and the war in Ukraine. The uncertainty arises mainly from the persistence of inflation and the energy crisis, against an uncertain geopolitical backdrop due to the continuation of the war in Ukraine. Similarly, inflation, which is largely associated with the above factors, also has an impact on the public accounts. This is distinctly positive in the short term because of its direct and automatic impact on revenue and negative in the medium term because of its less direct and lagged impact on expenditure. In addition, the tightening of monetary conditions feeds through to interest expenditure. Therefore, AIReF's assessment remains conditioned by uncertainty and the estimates made should be treated with greater caution than usual.

In addition, other limitations common to previous reports are maintained. These include the lack of budgets in national accounting terms and complete and updated information on the impact of the main contingent liabilities that might have an impact on the deficit for the year. Another limitation that is of particular relevance since the approval of the RTRP in July 2021 is the lack of transparency on its degree of execution in national accounting terms. From a macroeconomic point of view, this lack of information is a limitation in terms of knowing which funds are reaching the final recipient and, therefore, which are influencing the economy. In addition, from a fiscal point of view, it limits the analysis of the evolution of revenue and expenditure that are not related to the RTRP and that constitute the ordinary activity of the GG.

3. MACROECONOMIC SCENARIO

The Spanish economy maintained a high growth rate in the second half of 2022 and in the early months of 2023. The moderation of energy prices and the good performance of the labour market and exports against a backdrop of wage moderation over recent years have made it possible to avoid the most adverse scenarios expected in the autumn of 2022, as reflected in the most recent figures of the Quarterly National Accounts (QNA) published by the INE. Thus, expectations of real GDP growth for 2023 are being revised upwards, with AIReF projecting growth of 2.3%, compared with the 1.9% expected in the spring.

However, the persistence of core inflation, the tightening of financial conditions and the deterioration in economic activity in the euro area point to a slowdown in activity in the second half of the year. On the one hand, the pass-through of the tightening of monetary policy to the real economy will occur with greater intensity in the second half of 2023 and in 2024. On the other hand, the persistence of inflation in the euro area as a whole has led the European Central Bank to hint at a further tightening of financial conditions in the coming months, which could further weaken economic activity in the euro area, in technical recession in the first few months of this year. Added to this is the slowdown in world trade.

3.1. AIReF's economic forecasts for the Spanish economy in 2023

AIReF updates its macroeconomic outlook for 2023 and improves the GDP growth forecast from 1.9% to 2.3%. This update, which is limited to 2023, incorporates the most recent evolution of current economic indicators, new exogenous assumptions about commodity prices, euro area growth, interest rates, etc., and fundamentally, the effect of the revisions of the national accounting data for 2022 and the first quarter of 2023. Table 1 shows the breakdown of the projections for 2023.

By component, in 2023 the contribution of the external sector to growth is expected to remain positive, although lower than in 2022, while all components of domestic demand slow down significantly. The revisions to the macroeconomic framework revolve around a greater contribution of the external sector to GDP growth compared with the scenario of the 2023-2026 Stability Programme Update and a slight downward revision of domestic demand. Regarding prices, the CPI growth estimate is revised downwards, in line with the latest data observed and the new exogenous assumptions.

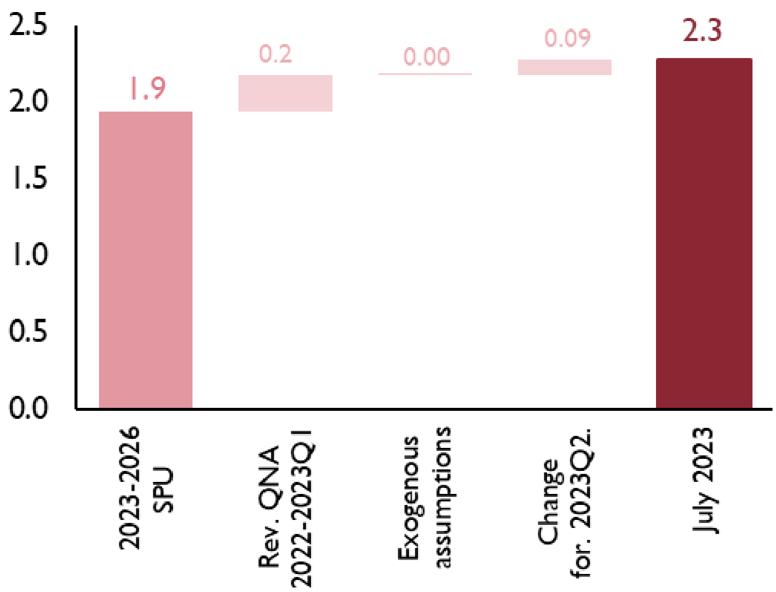
TABLE 2. AIREF'S 2023 MACROECONOMIC OUTLOOK

Year-on-Year Rates of Change	*2022*	*2023*	*Revision 2023*
Private Domestic Final Consumption Expenditure	4.4	0.8	-0.2
General Government Final Consumption Expenditure	-0.7	1.3	0.0
Gross Capital Formation	3.5	2.0	0.3
GFCF Equipment and Cultivated Assets	*4.1*	*1.0*	-0.2
GFCF Construction and Intellectual Property	*4.9*	*2.6*	0.0
Domestic Demand*	***3.1***	**1.1**	**-0.03**
Exports of Goods and Services	14.4	6.1	0.1
Imports of Goods and Services	7.9	3.5	-0.8
External Balance*	***2.4***	**1.1**	**0.37**
Gross Domestic Product	**5.5**	**2.3**	**0.34**
Nominal Gross Domestic Product	**10.0**	**7.2**	**0.36**
Gross Domestic Product Deflator	**4.3**	**4.8**	**0.00**
CPI	**8.4**	**3.7**	**-0.31**
Full-Time Equivalent Employment	3.8	1.5	0.1
Unit Labour Cost	0.4	4.0	0.1
Productivity per Full-Time Employee	1.6	0.8	0.3
Compensation per Employee	2.0	4.8	0.4
Unemployment Rate (% of Active Population)	12.9	12.4	-0.1
Household and NPISH Savings Rate (% Gross Disposable Income)	7.2	8.3	1.1

* Contribution to GDP growth
Source: INE and AIReF forecasts.

The revision of the growth estimate of the Spanish economy for 2023 is mostly due to the incorporation of the national accounting figures published in June. The upward revision in the GDP growth figures for the first quarter of 2023 with respect to the figure published in the QNA flash estimate in April, together with the change in the quarterly growth profile for 2022 – much more accelerated as from the second quarter – results in a mechanical revision of the estimate for 2023 of 0.25 percentage points.

FIGURE 2. BREAKDOWN OF THE SOURCES OF REVISION OF THE GDP GROWTH RATE IN TERMS OF VOLUME FOR 2023 WITH RESPECT TO THE MACROECONOMIC SCENARIO OF THE SPU



Source: INE and AIReF

The revision of exogenous assumptions has little impact on the growth outlook for 2023. The impact on expected economic growth of the subdued outlook for the growth in energy commodity prices and long-term interest rates is modest and offset by the expected worse evolution of short-term rates.

TABLE 3. EXOGENOUS ASSUMPTIONS OF AIREF'S MACROECONOMIC OUTLOOK FOR 2023

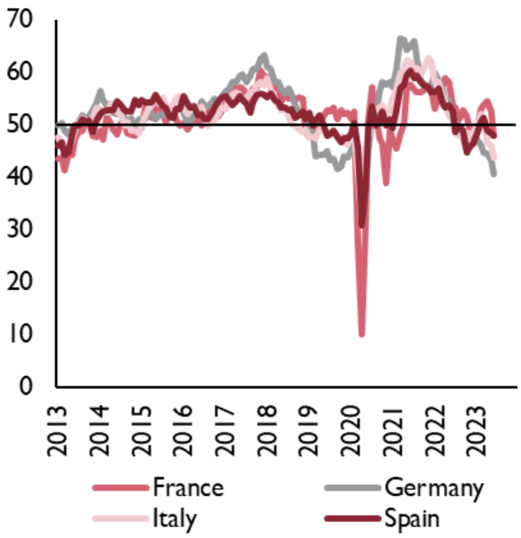
	2022	2023	Revision 2023
Euribor 3 months (%)	0.3	3.4	▲ 0.1
Interest Rate 10-year State Debt (%)	2.2	3.3	▼ -0.2
Broad NEER	116.8	121.9	▲ 0.5
Exchange rates $/€	1.05	1.08	▼ 0.0
Oil (US $/barrel)	103.7	77.7	▼ -5.3
TTF gas (€/Mwh)	132.2	43.6	▼ -6.5
MIBGAS (€/Mwh)	99.0	41.8	▼ -4.5
Export merc. (annual %)	7.9	1.9	▬ 0.0

Source: IMF, Refinitiv and MIBGAS

The good performance of the economic indicators for the second quarter of the year would also lead to an upward revision in growth expectations for 2023. Social Security affiliation grew strongly in the second quarter, with a focus on permanent employment contracts. Even though the June figures show a moderation, which might be due to the slowdown in economic activity detected in other indicators, but also to possible changes in seasonal hiring patterns. At any event, in the quarter, affiliation recorded very positive results, with a growth rate of 2.8% compared with the same quarter of 2022. For their part, opinion indicators such as the Purchasing Managers' Index (PMI) point in June towards a moderation in economic dynamism, with a marked heterogeneity between manufacturing and services. In general, indicators related to industrial activity point to a stagnation or decrease in this sector's output, while services continue to expand, albeit with less favourable prospects compared with the early months of the year due to the deterioration in the global context. Overall, the current information received up to July 5th puts the real-time estimate of the quarter-on-quarter rate of GDP for the second quarter of the year at 0.42% in the case of AIReF's MIPred model. This rate is similar to the 0.4% obtained with the unweighted average of other analysts who make real-time estimates[9].

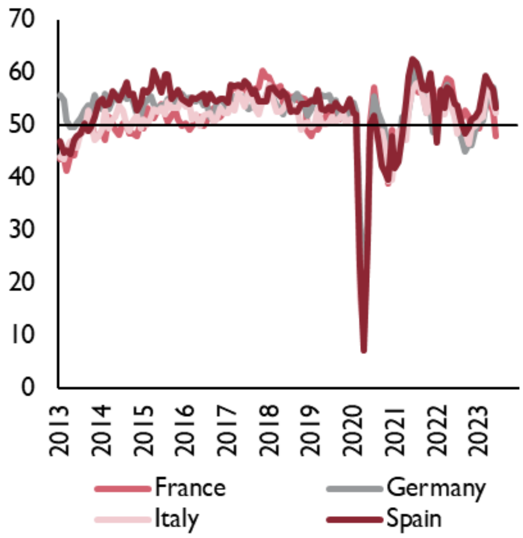
FIGURE 3. PMIS OF SERVICES AND MANUFACTURING INDUSTRY IN VARIOUS EURO AREA COUNTRIES (>50 INDICATES EXPANSION/<50 INDICATES CONTRACTION)

FIGURE 3 A. MANUFACTURING PMI



Source: S&P Global

FIGURE 3 B. SERVICES PMI



Source: S&P Global

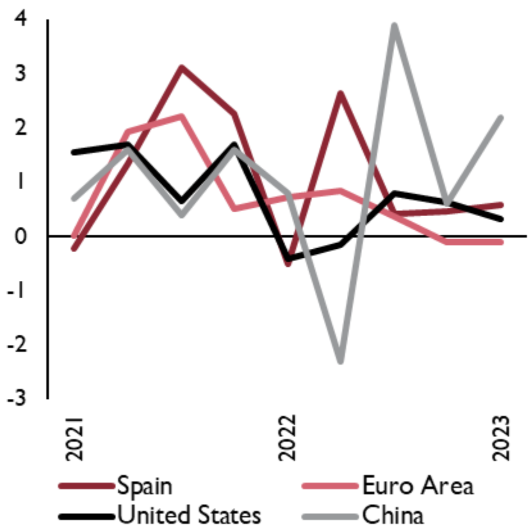
Despite buoyant growth in the first half of the year, a slowdown is expected in the second half due to the tightening of the economy's financing conditions and the deterioration of the global economic situation. The Spanish economy has weathered the energy crisis better in the last three quarters than the euro area, which has recorded two consecutive quarters of falling GDP (0). However, as already shown in the Report on the SPU, interest-rate hikes are

[9] Panel of FUNCAS, Consensus Forecasts, EsadeEcPol and Oxford Economics.

expected to fully pass through to the real economy in the second half of 2023[10] and over 2024. This is in addition to the deterioration in economic activity currently taking place in the euro area and in China in the most recent data compared with the expectations of a few months ago. As can be seen in 0, the economic surprise indices for the main economic blocs, except for the US since mid-May, have recorded negative values compared with the early months of the year.

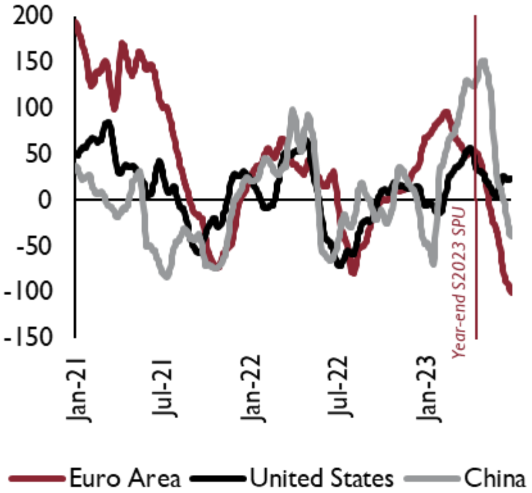
FIGURE 4. RECENT EVOLUTION OF GDP AND ECONOMIC SURPRISE INDICES IN THE EURO AREA, THE US AND CHINA

FIGURE 4 A. REAL GDP. QUARTER-ON-QUARTER RATE (%)



Source: Eurostat, FRED database, INE and OECD

FIGURE 4 B. CITIGROUP ECONOMIC SURPRISE INDEX (10-DAY AVERAGE)



Source: Refinitiv

Inflation has moderated significantly in Spain and a negative gap with the euro area average remains. The flash estimate of the CPI places inflation in Spain at 1.9% in June, over one point below the figure for the previous month and far from the rates of above 10% observed in the middle of last year. Inflation has been contained mainly as a result of the base effects associated with energy and the fall in energy commodity prices compared with the previous year, while lower energy costs seem to be shifting to the prices of non-energy industrial goods and services. All this has led to a downward revision of the expected growth of inflation to 3.7% for 2023, from the 4% projected in the spring. However, in the coming months, once the strong base effects caused by the tensions in the energy markets of the third quarter of 2022 disappear, the containment of inflation could be curbed by the drought, by the acceleration of negotiated wages that are growing at a rate of more than 4%

[10] See Box 2 of Report 21/23 (pp. 56-60).

in the agreements signed in 2023, after the moderation of the previous year, and by the expansion of business margins (see the [Business Margins Monitor - Bank of Spain (bde.es)]).

FIGURE 5. HARMONISED INDEX OF CONSUMER PRICES, COMPARISON SPAIN-EMU, YEAR-ON-YEAR CHANGE

FIGURE 5 A. HEADLINE HICP

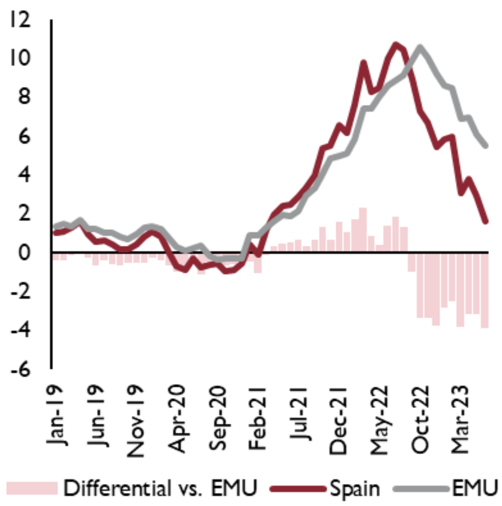
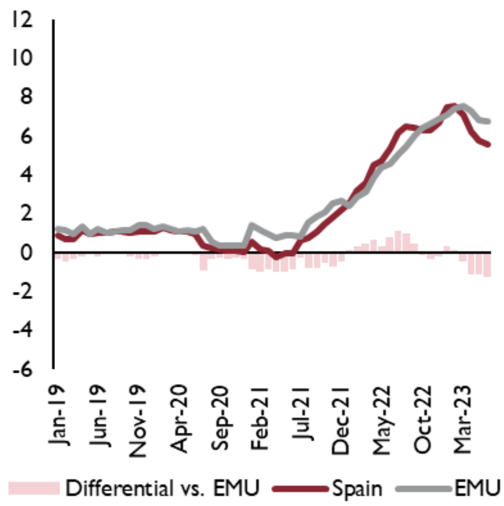


FIGURE 5 B. HICP EXCLUDING ENERGY AND UNPROCESSED FOODS



Source: Eurostat

Persistent inflation, weak global economic activity and worsening geopolitical and trade tensions are the main sources of risk. On the domestic front, uncertainty persists about the pace of implementation and impact of the Recovery, Transformation and Resilience Plan (RTRP):

i) **The persistence of high core inflation in the euro area, supported** by higher growth in wages and business margins, could lead to a more restrictive monetary policy stance for a longer period of time, as some members of the Governing Council of the ECB have already suggested. This could weaken the financial situation of the most indebted households and companies and curb their consumption and investment decisions to a greater extent than expected.

ii) The tightening of financial conditions converges with a **continuation or aggravation of geopolitical and trade tensions at a global level**, which could affect the evolution of world trade. In contrast, an early resolution of the war in Ukraine could improve the growth outlook for the euro area.

iii) **In this context, the outlook for growth of the world economy is deteriorating** in the United States, the United Kingdom and Germany, without the growth of emerging economies and, in particular, China, being able to offset this weakening. This all leads to the expectation of a very complex scenario for European and Spanish industry.

iv) On the domestic front, uncertainty persists over the **pace of implementation of the Recovery, Transformation and Resilience Plan (RTRP) and its effects on the real economy**. AIReF's macroeconomic scenario for 2023 assumes implementation of the Plan that would have an associated impact on the level of GDP of 1.7%, compared with a scenario without the RTRP (higher than the 0.5% impact on the level of GDP estimated in 2022, compared with a scenario without the RTRP). A lower deployment of the RTRP compared with the assumption entails downside risks around the expected growth of investment in 2023.

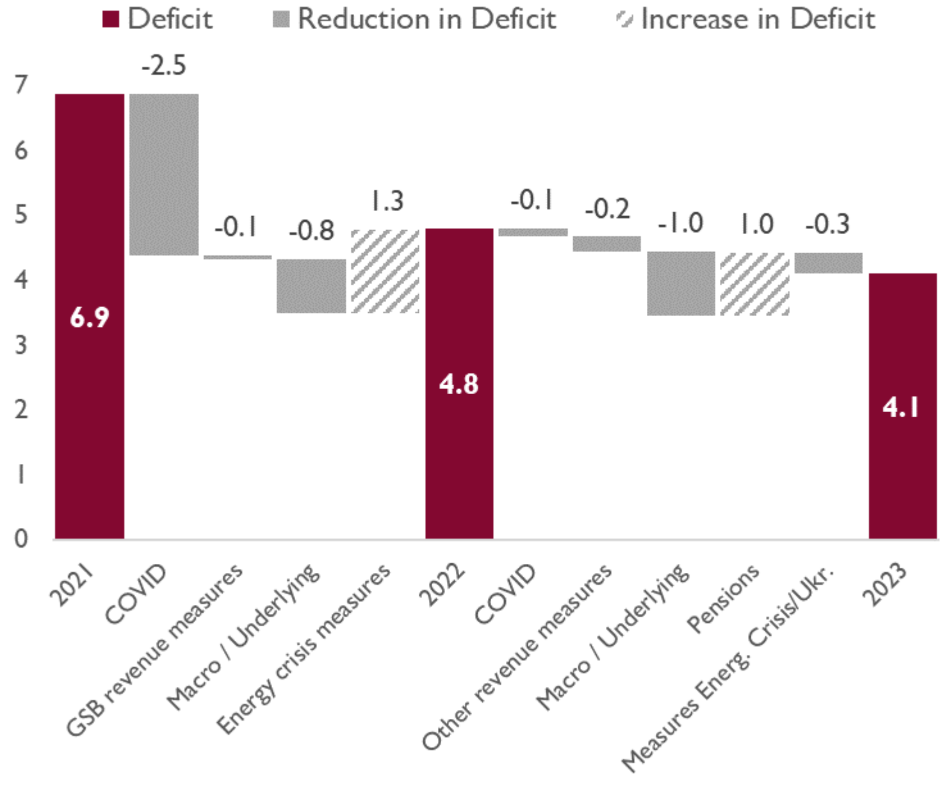
4. ANALYSIS OF BUDGETARY STABILITY AND THE EXPENDITURE RULE

4.1. General Government

AIReF estimates that the GG deficit in 2023 will stand at 4.1% of GDP, the same level as that estimated in the previous report. AIReF's forecast is 0.2 points above the reference rate set by the Government at 3.9% of GDP. Although the deficit estimate is maintained since the publication of the Report on the 2023-2026 SPU, deviations have been detected with respect to the fiscal scenario outlined in May, which is updated in this report. Firstly, updating the cost of the measures already assessed in the previous report reduces the deficit by almost 0.1 points, while estimating the cost of the two packages of measures approved in Royal Decree-Law 4/2023 and Royal Decree-Law 5/2023 raises it by 0.2 points. Secondly, the update of the macroeconomic scenario is included with a deficit reduction impact of 0.1 points, mainly because of the increase in the estimate of the compensation of employees on contributions and Personal Income Tax (PIT). Finally, the incorporation of the latest published data has an impact on the various headings but is neutral.

The deficit will fall by 0.7 points of GDP compared with 2022. The reduction of 2.1 points between 2021 and 2022 was mainly explained by the progressive withdrawal of most of the COVID measures and by the positive progress of the economy, while the measures approved to mitigate the energy crisis raised the deficit by 1.3 points. Between 2022 and 2023, the good performance of the economy is offset by the impact of increasing pensions with the CPI of the previous year, with the reduction in the deficit due to the approval of a series of revenue measures, mainly the IEM, and the lower cost of the measures approved to mitigate the energy crisis this year. In addition, the reduction in COVID spending would still contribute 0.1 points to reducing the deficit in 2023.

FIGURE 6. EVOLUTION OF DEFICIT BY COMPONENT, AIREF (% GDP)



Source: IGAE and AIReF

AIReF estimates that revenue will stand at 42.7% of GDP excluding the RTRP in 2023 and 44.2% in the case where the Plan is included. Both the macroeconomic scenario and the updating of the estimate of the measures contribute to the growth in revenue. In the opposite direction, the new measures approved result in a reduction in revenue. Finally, the denominator effect, with a higher GDP, offsets the increase in the revenue forecast, with the weight over GDP estimated in the previous report maintained.

Expenditure, excluding the RTRP, will stand at 46.8% of GDP, almost 0.1 points higher than the forecast in the previous report. Including the RTRP, the figure would stand at 48.3%. The updating of the cost of the measures and the inclusion of the measures approved in Royal Decree-Laws 4/2023 and 5/2023 push spending up, although this increase is offset by the denominator effect. In addition, the latest execution data lead to a slight upward revision of public consumption and social transfers in cash, partially offset by a reduction in other headings.

TABLE 4. AIREF FISCAL SCENARIO WITHOUT RTRP (% GDP)

	2023 (Rep. SPU)	2023 (Current)
REVENUE	42.6	42.7
EXPENDITURE	46.7	46.8
NET LENDING/ BORROWING	-4.1	-4.1

Source: AIReF estimate

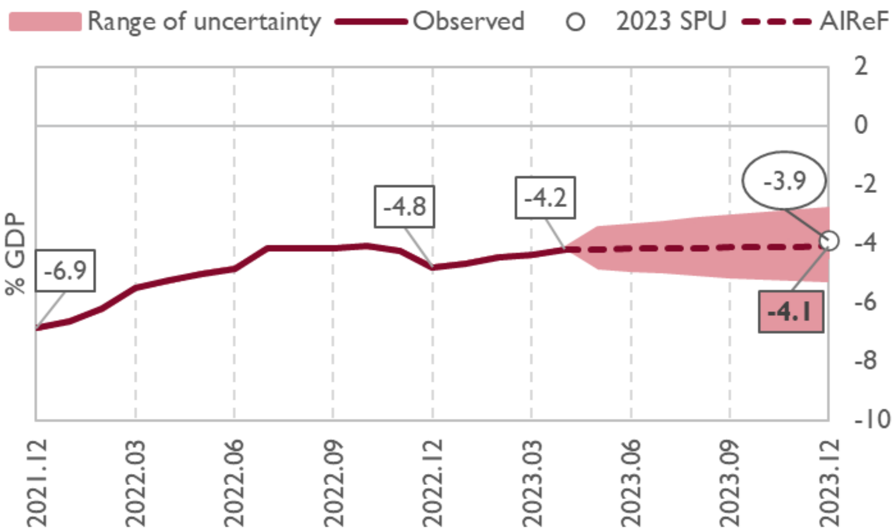
TABLE 5. AIREF FISCAL SCENARIO WITH RTRP (% GDP)

	2023 (Rep. SPU)	2023 (Current)
REVENUE	44.2	44.2
EXPENDITURE	48.3	48.3
NET LENDING/ BORROWING	-4.1	-4.1

Source: AIReF estimate

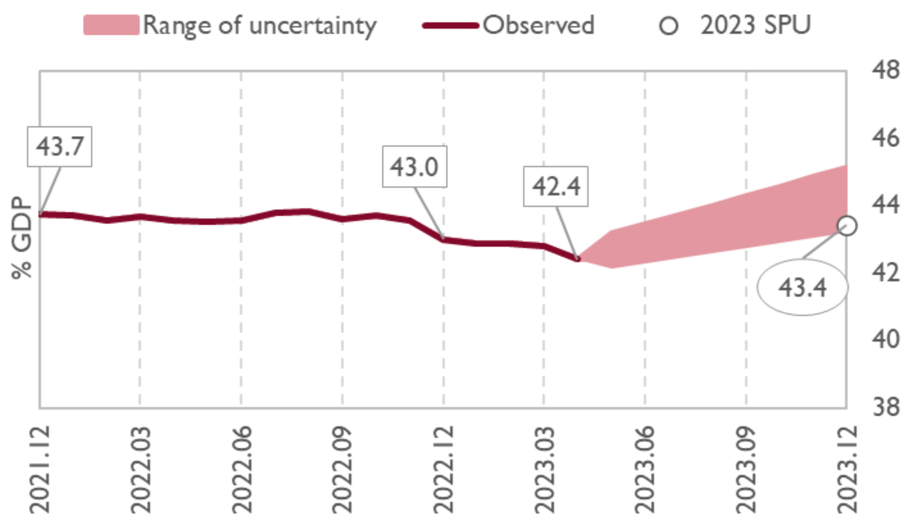
FIGURE 7. TOTAL GENERAL GOVERNMENT

FIGURE 7 A. NET LENDING/BORROWING OF THE GG (% GDP)



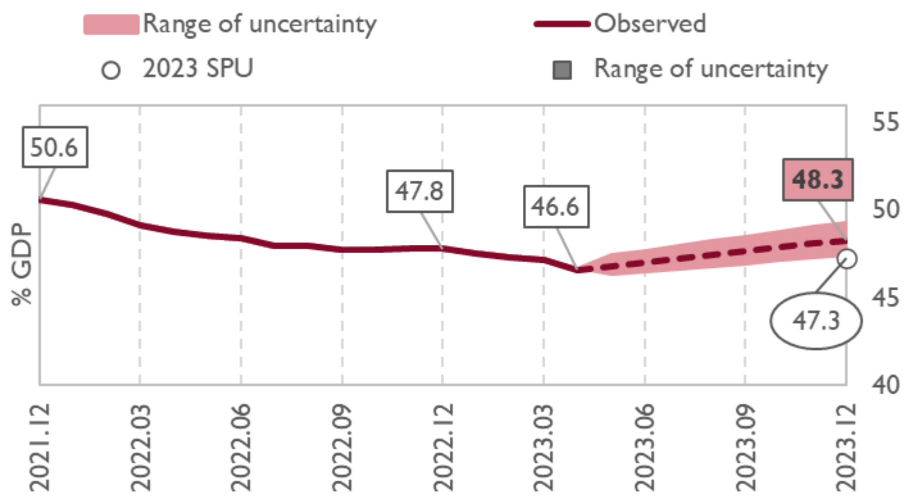
Source: IGAE and AIReF

FIGURE 7 B. GG REVENUE WITH RTRP (% GDP)



Source: IGAE and AIReF

FIGURE 7 C. GG EXPENDITURE WITH RTRP (% GDP)



Source: IGAE and AIReF

4.2. Evolution of General Government revenue

AIReF raises revenue growth to 7.5% in 2023 compared with the 7% estimated in the previous report, raising the weight over GDP by almost 0.1 points. By heading, taxes on income and contributions are revised upwards, by around 0.1 points each, while the weight of taxes on production falls by just over 0.1 points. The revision of the former is due to the greater dynamism of the observed collection data and the revision of the macroeconomic scenario, in particular because of the increase in the estimate of compensation of employees. On the other hand, the incorporation of the latest collection data, together with the downward revision of domestic demand and the extension of VAT rate reductions on certain foods, reduces the forecasts of taxes on production. Other revenue items increase their weight over GDP by less than 0.1 points.

TABLE 6. COMPARISON OF AIREF SCENARIOS: REVENUE WITHOUT RTRP (% GDP)

	2023 Rep. SPU	2023 Current	Current-SPU Difference
REVENUE	**42.6**	**42.7**	**0.1**
TAXES	24.9	24.8	-0.1
On production	11.8	11.7	-0.1
On income	12.6	12.6	0.1
Capital	0.5	0.5	0.0
CONTRIBUTIONS:	13.6	13.7	0.1
Other revenue	4.1	4.2	0.01

Source: AIReF estimate

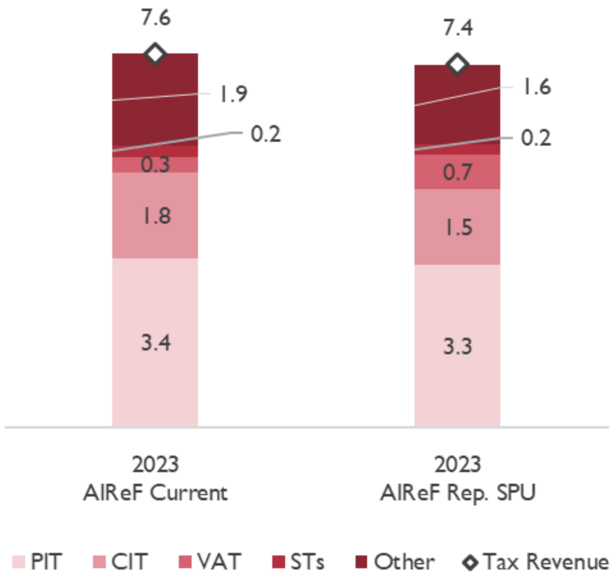
TABLE 7. COMPARISON OF AIREF SCENARIOS: REVENUE WITH RTRP (% GDP)

	2023 (Rep. SPU)	2023 (Current)	Current-SPU Difference
REVENUE	**44.2**	**44.2**	**0.0**
TAXES	24.9	24.8	-0.1
On production	11.8	11.7	-0.1
On income	12.6	12.6	0.1
Capital	0.5	0.5	0.0
CONTRIBUTIONS:	13.6	13.7	0.1
Other revenue	5.7	5.7	0.0

Source: AIReF estimate

AIReF estimates a greater increase in tax revenue in national accounting terms and places its annual rate of change at 0.2 points above that of the May report. The estimate of revenue from taxes under the ordinary regime, before their transfer to the Autonomous Regions and Local Governments, is revised upwards as a result of the update of the latest available information and the macroeconomic scenario. On the one hand, they cause an increase in the forecasts of revenue from PIT, from Corporate Income Tax and from other tax revenue. On the other hand, they generate a reduction in the forecast for VAT due to lower dynamism in the latest collection data, the downward revision of domestic demand and the extension of the rate reduction for certain foods until the end of the year (see Section 4.5 Impact of the measures on the General Government accounts).

FIGURE 8. EVOLUTION OF TAX REVENUE UNDER THE ORDINARY TAX REGIME IN NATIONAL ACCOUNTING CONTRIBUTION OF THE MAIN TAX CATEGORIES TO THE CHANGE (% YEAR-ON-YEAR CHANGE)

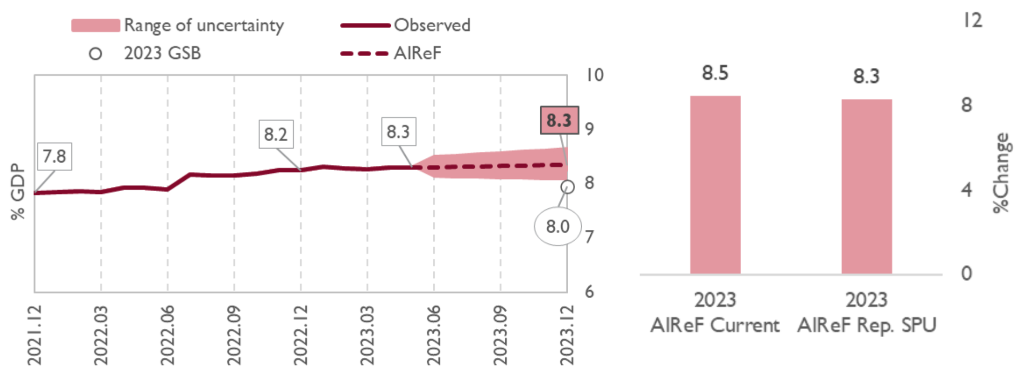


Source: AIReF estimate

1.1.1. PIT

AIReF estimates that revenue in cash terms from PIT will amount to 8.3% of GDP, less than 0.1 points below the previous report. After the incorporation of the information provided by the tax bases for the first quarter, the collection up to May, the closing data on the 2022 PIT campaign and the update of the macroeconomic scenario, the PIT forecasts are revised upwards. However, the denominator effect, caused by the increase in forecasts of nominal GDP compared with the previous report, lead to the weight of PIT over GDP falling by less than 0.1 points.

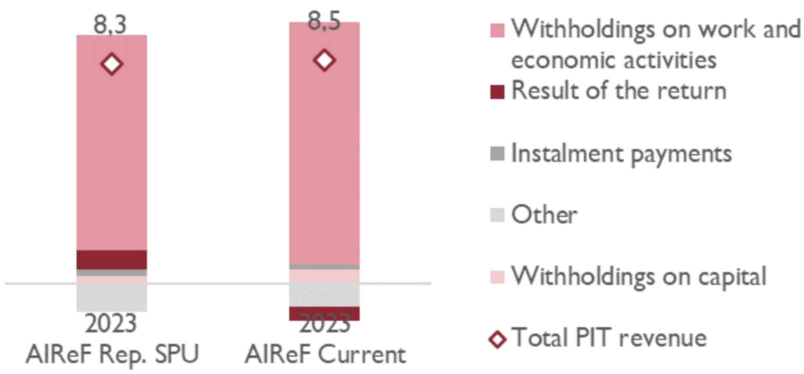
FIGURE 9. EVOLUTION OF PIT IN CASH (% GDP AND % YEAR-ON-YEAR CHANGE)



Source: IGAE and AIReF

The growth in PIT revenue stands at 8.5%, less than 0.2 points above the figure in the previous report. This increase is mainly due to the upward revision of withholdings on work, which add a point of growth compared with the previous report, in addition to a further 0.2 points due to the increase in withholdings on capital and the other PIT headings, respectively. In the opposite direction, the contribution to the growth of the result of the 2022 tax return is reduced by 1.2 points.

FIGURE 10. CONTRIBUTION BY COMPONENT TO THE GROWTH OF CASH PIT (% YEAR-ON-YEAR CHANGE)



Source: AEAT, AIReF estimate

The general increase in average remuneration and the increase in pensions, together with the increases in the associated effective rates, are responsible for the increase in withholdings on work. Wages are the main estimated growth factor for PIT, with a contribution of six points on the increase in the total accrued amount, which is estimated at 11%. In 2023, withholdings on wages will mainly grow as a result of the increase in average wages and their associated effective rates, in both the public and private sectors. However, it should be noted that, during the first quarter, a third of the increase in private wages was driven by employment growth, while the growth in public wages was mostly due to the increase in average remuneration. Pensions will add 2.4 points of growth due to their increase and the consequent increase in rates. However, during the first quarter they show lower growth than estimated at the end of the year as the compensatory payment for the increase in prices is included in the January 2022 collection.

FIGURE 11. CONTRIBUTION BY COMPONENT TO THE GROWTH OF ACCRUED PIT (% YEAR-ON-YEAR CHANGE)

FIGURE 11 A. PIT ACCRUED

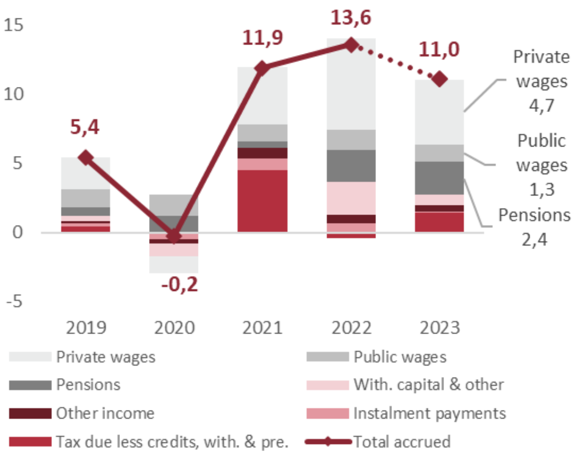


FIGURE 11 B. PRIVATE WAGES

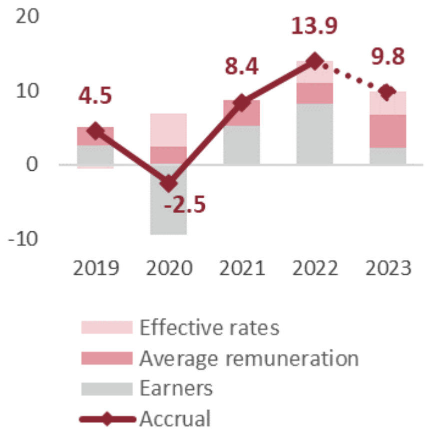


FIGURE 11 C. PUBLIC WAGES

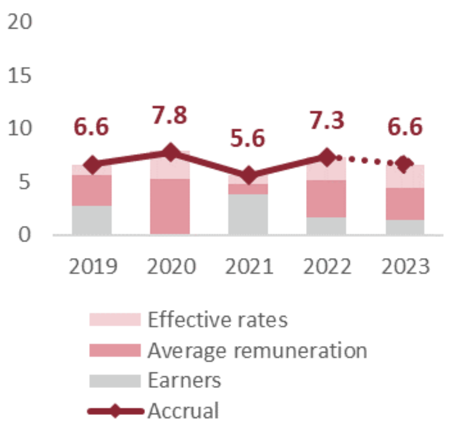
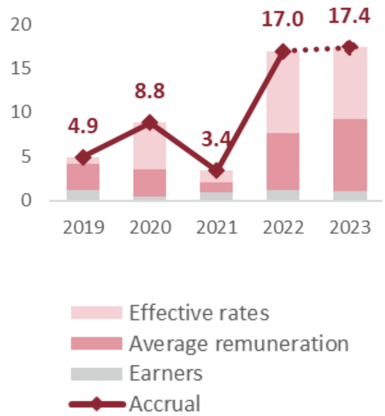


FIGURE 11 D. PENSIONS



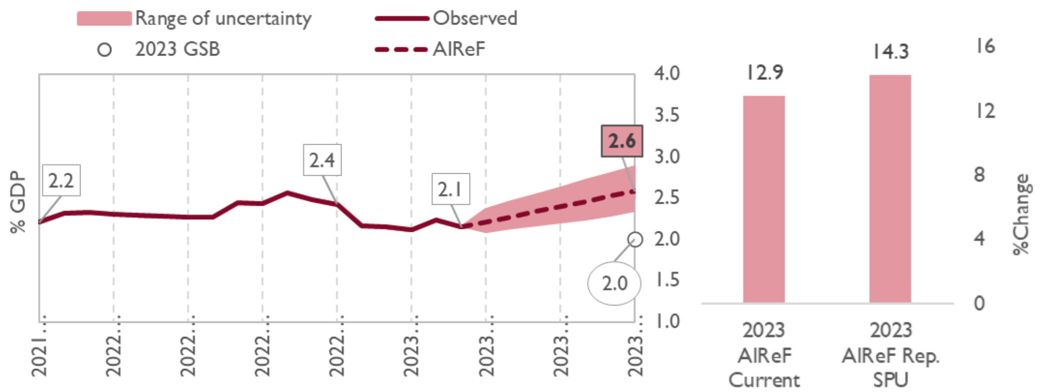
Source: AEAT, AIReF estimate

The weight of PIT over GDP in national accounting terms will be 8.7%, the same as the previous estimate. The revision of the estimates in cash terms and their effect on the collection mechanism causes a larger national accounting adjustment by shifting revenue to its accrual month. Consequently, the year-on-year rate of change rises by 0.3 points compared with the previous year, to stand at 7.9% at year-end 2023. However, this increase is offset in terms of weight over GDP by the denominator effect.

1.1.2. Corporate Income Tax

AIReF reduces its forecast of revenue in cash terms from Corporate Income Tax, although it maintains its weight at 2.6 points of GDP, as in the previous report. Following the incorporation of the latest available data, which include the first instalment payment of the year, the estimates are updated considering an increase of about €600m due to the revision of the regulatory measures assigning a greater impact in 2023 to the time limit established on the intra-group offsetting of tax losses (see Section 4.5.2 Other Central Government Revenue Measures). In contrast, the forecast is reduced because of including the refunds of the month of April of a court ruling amounting to €1bn related to the payment of a refund for tax credits due requested in 2018. As a result, the year-on-year rate of change falls by 1.3 points compared with the forecast in May to stand at 12.9%. However, this fall does not result in a change in terms of weight over GDP. The relevant information on the evolution of the full year is still subject to uncertainty as two of the largest instalments and the settlement of the 2022 campaign are recorded in the second half of the year.

FIGURE 12. EVOLUTION CORPORATE INCOME TAX IN CASH (% GDP AND % YEAR-ON-YEAR CHANGE)



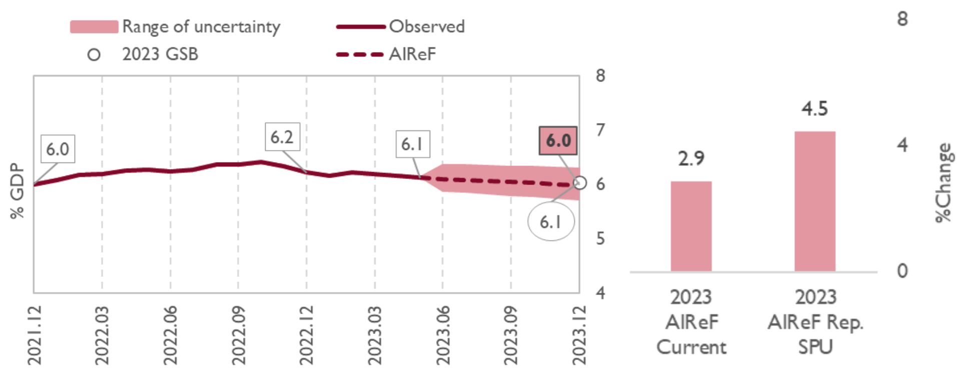
Source: IGAE and AIReF

In national accounting terms, AIReF maintains its projections for Corporate Income Tax at 2.6% of GDP. In contrast to the revision in cash terms, the update of the available information increases the estimates of Corporate Income Tax in national accounting, raising the year-on-year rate of change to 14.3%, 1.9 points above the previous report. This is because in national accounting terms the court ruling linked to the deferred tax credits of 2018 does not result in lower revenue, but higher expenditure that was already recorded in that year, as indicated in the IGAE report on the main indicators of the economic and financial activity of the State relating to December 2018[11]. As is the case in cash terms, these changes do not imply a change in the estimated values of weight over GDP.

1.1.3. VAT

AIReF reduces its forecast of VAT collection to 6% of GDP, 0.1 points lower than in the previous report. The incorporation of the latest observed data, which has reduced its dynamism in recent months, and the downward revision of domestic demand - a macroeconomic variable linked to the evolution of final expenditure subject to VAT - reduce the estimates by just over 0.05 points of GDP with respect to the previous forecast. The regulatory measures deduct 0.05 points as they incorporate, among other aspects, the extension of the reduction in rates on certain food products adopted until December 2023 in Royal Decree-Law 5/2023 (see Section 4.5 Impact of the measures on the General Government accounts). As a result of this, AIReF forecasts that VAT will grow by 2.9% at year-end 2023, 1.6 points below the May report.

FIGURE 13. EVOLUTION OF VAT IN CASH (% GDP AND % YEAR-ON-YEAR CHANGE)



Source: IGAE and AIReF

The weight of VAT over GDP in national accounting terms also falls by 0.1 points compared with the previous report, to stand at 6%. With a downward revision of 1.2 points compared with the previous estimate, the year-on-year rate of change stands at 1%.

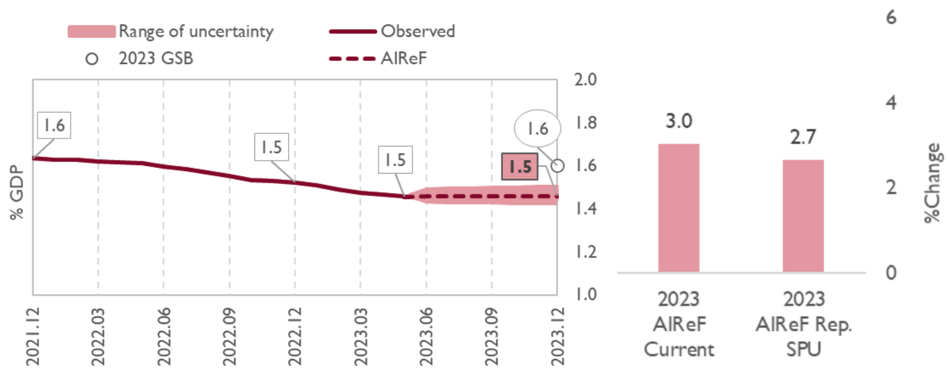
1.1.4. Special Taxes

AIReF maintains its forecast on the collection of Special Taxes with respect to the previous report at 1.5% of GDP. With a slight upward revision after the

[11] https://www.igae.pap.hacienda.gob.es/sitios/igae/es-ES/Contabilidad/ContabilidadNacional/Publicaciones/Documents/Ind-2018/2018_12.pdf

incorporation of the latest available information, the year-on-year rate of change stands at 3%, 0.3 points above the previous forecast.

FIGURE 14. STS IN CASH (% GDP AND % CHANGE)



Source: IGAE and AIReF

1.1.5. Other tax revenue

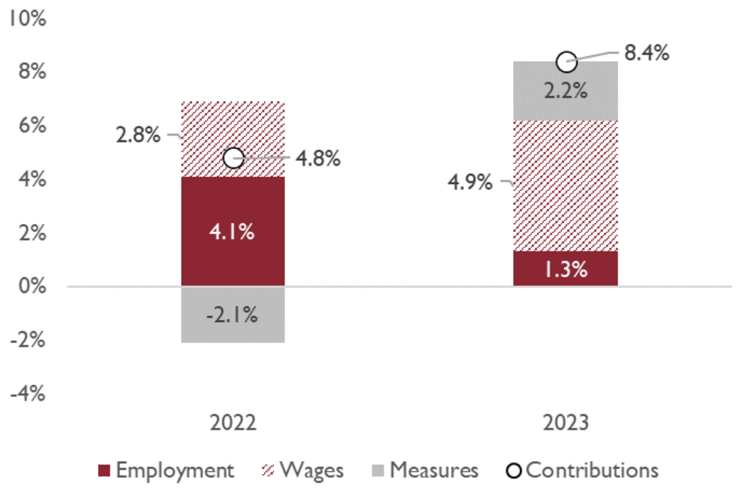
Other tax revenue in national accounting terms maintains its weight over GDP at 1.2%, as in the previous report. Although its weight over GDP is maintained, the year-on-year rate of change is increased by 4.9 points, mainly due to the revision of Non-Resident Income Tax after the incorporation of the latest available information.

1.1.6. Social contributions

AIReF expects the weight of contributions as a proportion of GDP to rise from 13.6% in 2022 to 13.7% in 2023, 0.1 points higher than in the previous report. This revision is primarily explained by the upward revision of the forecast for compensation of employees and employment for 2023 in the update of the macroeconomic outlook. In addition, the new information leads to an upward revision of €400m in the transfer of contributions for vocational training from SEPE to the Central Government, which is accounted for as a fictitious Social Security contribution.

Employment moderates its contribution to the growth in social contributions, while wages increase their positive contribution, between 2022 and 2023. The measures change from a negative to a positive contribution since in 2022 the COVID-19 measures continue disappearing, while in 2023 the positive impact of the new Intergenerational Equity Mechanism and the increase in the maximum contribution bases predominate.

FIGURE 15. BREAKDOWN OF GROWTH IN SOCIAL CONTRIBUTIONS (% CHANGE)



Source: IGAE and AIReF estimate

1.1.7. Other revenue

The weight of other revenue, excluding the RTRP, will stand at 4.2% of GDP, less than 0.1 points higher than the estimate made in the previous report. The latest collection information received since the last report results in a slight upward revision of the forecast for this revenue.

4.3. Evolution of General Government expenditure

According to AIReF's estimates, expenditure in 2023, excluding the RTRP, will stand at 46.8%, 0.1 points more than in the previous report. In this case, the new spending measures approved by the Government in Royal Decree-Laws 4/2023 and 5/2023 push expenditure up by 0.1 points. However, this increase in expenditure is almost entirely offset by the dynamism of the macroeconomic scenario, through the denominator effect. Including the RTRP, expenditure would rise to 48.3% of GDP.

TABLE 8. COMPARISON OF AIREF SCENARIOS: EXPENDITURE WITHOUT RTRP (% GDP)

	2023 (Rep. SPU)	2023 (Current)	Current-SPU Difference
EXPENDITURE	**46,7**	**46,8**	**0,0**
Compensation of employees	11,3	11,3	0,0
Intermediate consumption	5,8	5,8	0,1
Social transfers in kind via market	2,9	2,8	-0,1
Social benefits in cash	17,5	17,5	0,0
Interest	2,4	2,4	0,0
Gross capital formation	2,8	2,8	0,0
Subsidies and other expenditure	4,1	4,1	0,1

Source: AIReF and IGAE

TABLE 9. COMPARISON OF AIREF SCENARIOS: EXPENDITURE WITH RTRP (% GDP)

	2023 (Rep. SPU)	2023 (Current)	Current-SPU Difference
EXPENDITURE	**48,3**	**48,3**	**0,0**
Compensation of employees	11,3	11,3	0,0
Intermediate consumption	5,9	5,9	0,0
Social transfers in kind via market	2,9	2,8	-0,1
Social benefits in cash	17,5	17,5	0,0
Interest	2,4	2,4	0,0
Gross capital formation	3,3	3,3	0,0
Subsidies and other expenditure	4,9	5,0	0,1

Source: AIReF and IGAE

4.3.1. Main components of public consumption expenditure

AIReF maintains the forecast of the previous report for all the main components of public consumption at 20% of GDP for 2023. AIReF maintains the same weight over GDP of all the main components of public consumption (compensation of employees, intermediate consumption, and social transfers in kind) with respect to the previous report, although the revision has different effects by component. While it does not estimate changes in the weight of compensation of employees over GDP, it forecasts an increase of almost 0.1 points of GDP in intermediate consumption and a reduction of 0.1 points in social transfers in kind. With the current forecast, the main components of public consumption without the RTRP would grow by 5.4% compared with 2022, 0.3 points more than estimated in the previous report.

Compensation of employees maintains its weight at 11.3% of GDP. AIReF slightly increases this expenditure at a regional level, where a greater dynamism is observed according to the execution data published, to which must be added the incorporation of personnel measures reported by the Autonomous Regions. In any case, the upward revision of the GDP estimate for 2023 offsets this increase in nominal expenditure, keeping its weight over GDP constant.

AIReF increases the growth of intermediate consumption by almost 0.1 points of GDP but maintains its weight at 5.8% of GDP. This expenditure is revised upwards in the CG, ARs and LGs, driven by the published execution data. In addition, the main increase for the CG is due to the reclassification of the concerted action for refugees into intermediate consumption with the corresponding decrease in other current transfers. Currently, the estimated growth rate for this expenditure heading is 6.8% compared with 2022, up from the 5.4% expected in the previous report.

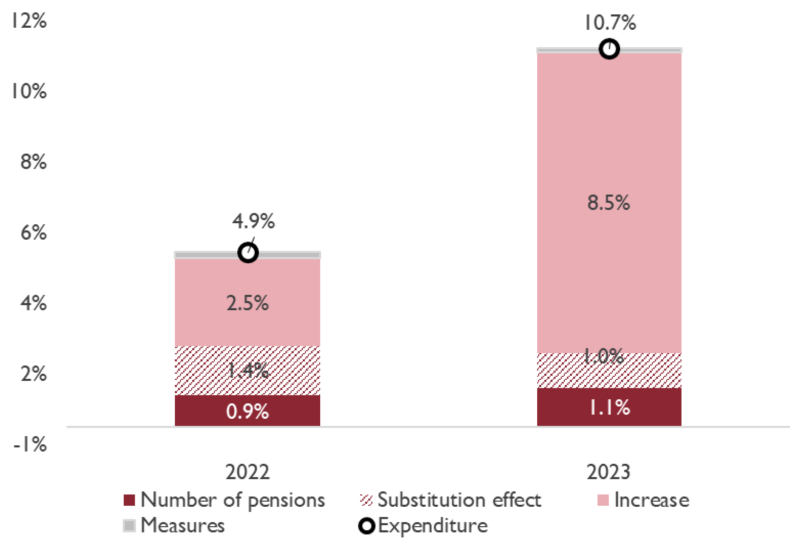
In contrast, AIReF reduces the estimate of social transfers in kind by almost 0.1 points of GDP, falling to 2.8% of GDP. This decrease mainly occurs for the CG, where the reduction is explained by the reclassification of the measure to promote the use of transport for the general public, which is no longer recorded as a social transfer in kind and is to be charged as subsidy expenditure. However, the approval of discounts on transport prices for young people during the summer, which are recorded as social transfers in kind, partly offsets this decrease. In addition, a slight decrease in this expenditure is estimated in the scope of the ARs due to a lower rate of execution than expected by AIReF.

4.3.2. Social benefits in cash

AIReF maintains the forecast for social benefits in cash for 2023 at the 17.5% of GDP estimated in the previous report. The increase in the weight of social benefits in cash between 2022 and 2023, from 17.2% to 17.5% of GDP, is mainly the result of the rise in pension expenditure due to the increase in line with the 2022 CPI.

AIReF estimates that pension expenditure will rise by 10.7% in 2023, 0.3 points above the rate estimated in the Report on the 2023 SPU. The evolution of pension expenditure is explained by the sum of the increase in the number of pensions, the annual increase in those pensions, the substitution effect and the measures approved. The main factor that explains the increase in pension expenditure between 2022 and 2023 is the effect of the increase in the pension amount. In accordance with the current regulation approved in 2021, which entered into force in January 2022, pensions will be increased at the start of each year in accordance with the average annual inflation recorded between December of two years ago and November of the previous year, which stood at 8.5% in 2022. In addition to this factor, there is the growth in the number of pensions, which is estimated at 1.1%, a substitution effect of 1%, and the measure of the increase in non-contributory pensions of 15% adopted in Royal Decree-Law 20/2022. The reduction in the substitution effect compared with 2022 is because of the increase on the average retirement pension, which is not carried over to this year's newly registered pensioners. The revision of the growth in pension expenditure estimated in the Report on the 2023 SPU is due to the upward correction in the growth in the number of pensions and the substitution effect estimated for 2023 in response to the evolution observed in the most recent data.

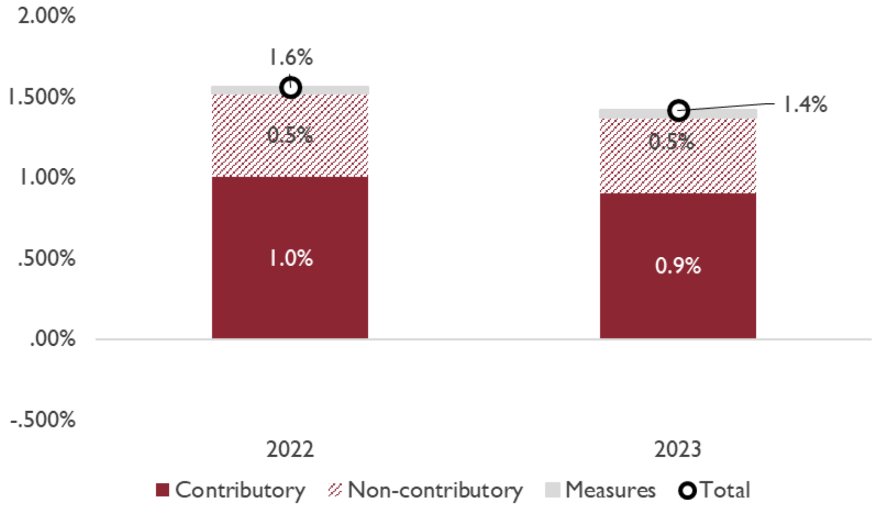
FIGURE 16. GROWTH IN PENSION EXPENDITURE (% CHANGE). AIREF PROJECTIONS



Source: AIReF and Social Security

Unemployment benefits fall from 1.6% of GDP in 2022 to 1.4% in 2023, the same estimate as in the SPU. The decrease in spending on unemployment benefits between 2022 and 2023 is mainly due to the moderation in the unemployment rate.

FIGURE 17. UNEMPLOYMENT EXPENDITURE (% OF GDP). AIREF'S FORECASTS



Source: SEPE and AIReF

The weight of the other benefits included in social transfers in cash over GDP remains at 3.9% of GDP, similar to the figures included in the Report on the 2023 SPU. Following the withdrawal of COVID measures in 2022, the weight of other benefits remains stable. This heading includes the impact of the line of direct support to people with a low level of income.

4.3.3. Interest

AIReF maintains its forecast of interest expenditure for 2023 at 2.4% of GDP. This estimate reflects expectations of inflation and financing conditions over 2023. The tightening of monetary policy is passed through to sovereign debt yields, with an impact on new issues. However, the high duration of the debt portfolio (between eight and ten years) implies a slow pass-through of interest rate increases in this year. At the same time, financing conditions, which have tightened significantly over the last year, will gradually begin to have an impact on the evolution of the debt service, with interest and repayments that will increase. However, the improvement in GDP expected for 2023 acts to reduce the weight of interest expenditure over GDP. For all the above reasons, AIReF keeps its forecast in line with the estimate in the previous report.

4.3.4. Gross capital formation

The weight of gross capital formation remains at the 2.8% of GDP forecast in the previous report, excluding the RTRP. The forecast for this expenditure is revised slightly downwards for the ARs in line with the execution observed up to April and as a result of updating the forecasts of investment associated with

REACT and traditional European funds. In contrast, this expenditure rises slightly for the CG as a result of recording the investment work in the hydrographic districts to combat drought approved by Royal Decree-Law 4/2023.

4.3.5. Subsidies and other expenditure

Other expenditure excluding the RTRP remains at 4.1% of GDP in 2023, although it rises by almost 0.1 points compared with the previous report. The main factor that explains this increase comes from the increase in subsidy expenditure that incorporates the bulk of the expenditure measures approved in the last two royal decree-laws. In this regard, the CG accounts for most of the increase in direct support to the primary sector and sea transport, as well as fuel discounts for transporters and farmers. In addition, for the CG, the measure to promote the use of transport for the general public is reclassified as a subsidy. Subsidies rise in the AR and LG sub-sectors because of the extension of the reduction in the price of urban and interurban public transport. There are changes in the heading of other current transfers, which rises due to the higher expenditure allocated to activities of social interest in the field of the CG and the ARs. However, it falls in the scope of the CG as the concerted action for refugees is no longer recorded under this heading. These increases are offset by the denominator effect. Regarding the other items, there are no significant changes with respect to the estimate included in the previous report.

4.4. Analysis by sub-sector

AIReF estimates an improvement of 0.1 points for the SSFs, offset by the increase in the deficit in the ARs and the CG. In the revision of the balance by sub-sector, the deficits of both the CG and the AR worsen in nominal terms, although in GDP terms, there is no change for the CG, while for the ARs, it worsens by almost 0.1 points to -0.4% of GDP. The LGs maintain a similar surplus, both in nominal terms and in GDP terms, while the SSFs improve their situation by 0.1 points as a result of the increase in contributions due to the improvement in compensation of employees.

TABLE 10. BALANCE BY SUB-SECTOR (% GDP)

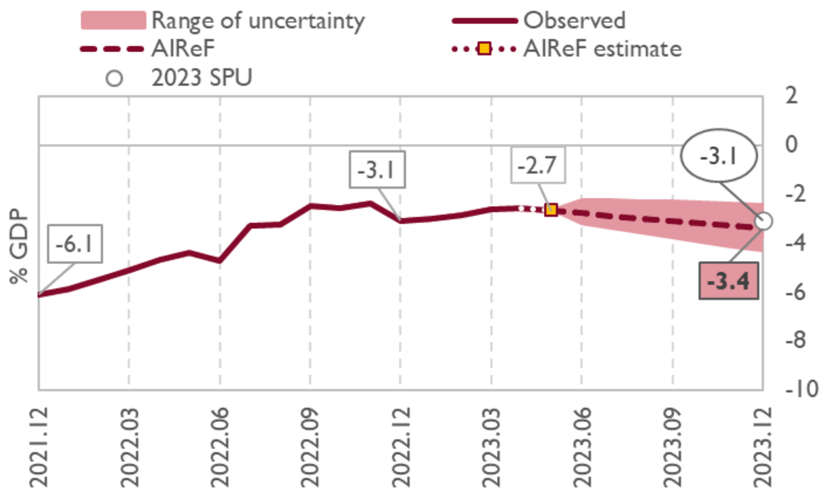
	2023 Government SPU	AIReF estimate 2023 Rep. SPU	AIReF estimate 2023 Current	Current-SPU Difference
GG	**-3.9**	**-4.1**	**-4.1**	**0.0**
CG	-3.1	-3.4	-3.4	0.0
SSFs	-0.5	-0.6	-0.5	0.1
ARs	-0.3	-0.3	-0.4	-0.1
LGs	0.0	0.2	0.2	0.0

Source: IGAE and AIReF

4.4.1. Central Government

AIReF estimates the CG deficit at 3.4%, in line with the forecast published in the Report on the SPU. This rate is 0.3 points higher than the reference rate published by the Government in its Stability Programme Update. The increase in expenditure and the decrease in revenue resulting from the cost of the two packages of anti-crisis measures approved in recent months by the Government is partially offset by the new information received on taxes on income and by the revision of the valuation of previously approved revenue measures. However, this deterioration in the balance is not enough to change the forecast in terms of GDP.

FIGURE 18. NET LENDING/BORROWING OF THE CG (% GDP)



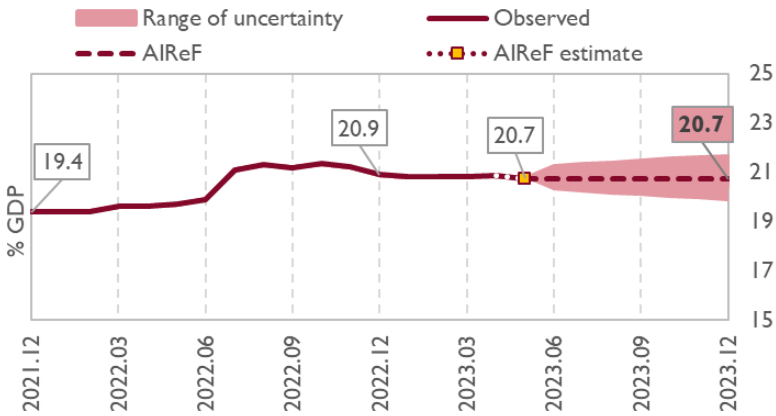
Source: IGAE, SPU and AIReF

4.4.1.1 Central Government revenue

AIReF forecasts that the CG's revenue will amount to 19.2% of GDP in 2023, excluding the RTRP, a similar level to that of the previous report. Overall CG revenue has been revised upwards. Since the transfer set by the financing system is fixed, all changes taking place with respect to the previous tax estimate are absorbed by this sub-sector. Therefore, the changes in the estimates, explained in the previous section, fall on the CG.

Tax revenue maintains its weight over GDP compared with the previous report, although its estimate is revised upwards. The increase is mainly due to the revision of taxes on income due to the new information, while the forecasts for taxes on production, affected by the new package of measures and the revision of the macroeconomic outlook, are lowered.

FIGURE 19. CG REVENUE WITH RTRP (% GDP)



Source: IGAE and AIReF

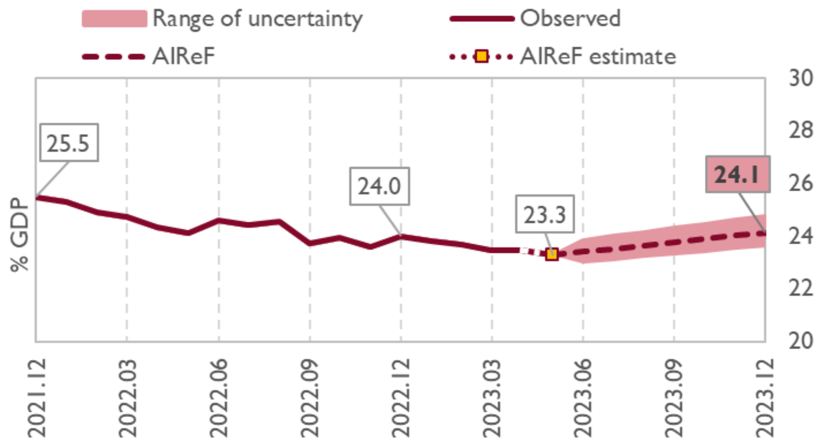
4.4.1.2 Central Government expenditure

AIReF forecasts that CG expenditure, excluding the RTRP, will amount to 22.6% of GDP in 2023, 0.1 points more than estimated in the Report on the SPU. Since the publication of the Report on the SPU, the Government has adopted new measures. Firstly, through Royal Decree-Law 4/2023, it approved measures to combat the energy crisis and the drought and, subsequently, through Royal Decree-Law 5/2023, it extended until the end of the year some of the measures to continue fighting inflation and the effects of the war in Ukraine, which were due to expire on June 30th. In addition, the Council of Ministers approved an increase in expenditure on activities of social interest in relation to PIT and CIT allocations. The estimated cost of these increases, together with the latest execution data and the new information available, have led to an upward revision in the estimate of CG expenditure by 0.2 points of GDP. However, this increase is partially offset by the upward revision in GDP, placing projected expenditure for 2023 at 22.6% of GDP. If RTRP expenditure is included, CG expenditure would amount to 24.1% of GDP.

The expenditure due to the measures approved in Royal Decree-Laws 4/2023 and 5/2023 mainly affects the expenditure on subsidies and in current transfers between GG sub-sectors. Based on the amount of the impact on CG expenditure, the main increases are expected in expenditure on subsidies, where direct support to the agricultural sector and sea transport are recorded, as well as discounts on diesel for transporters and farmers. Secondly, current transfers between GG sub-sectors are expected to rise because of those made by the State to the ARs and to the LGs to finance the extension of the reduction in the price of urban and interurban public transport. Expenditure on social transfers in kind is also expected to increase due to discounts for young people during the summer on train, bus and Interrail Pass tickets. Finally, a slight increase in capital expenditure is estimated due to the impact of the rest of the measures, including the works in the different hydrographic districts to mitigate the effects of the drought.

As for the evolution of eligible expenditure for the purposes of the expenditure rule, AIReF expects an increase of around 3.4% in 2023 on 2022, compared with the fall of 0.1% forecast in the Report on the 2023 Initial Budgets. The changes in the estimate are due to the new information that has come to light since AIReF's last assessment of the CG's expenditure rule for this year in the Report on the 2023 Initial Budgets. Since then, the eligible expenditure executed in 2022 has been published, which was lower than the AIReF forecast. Therefore, the lower starting point for calculating the change contributes to the increase in eligible expenditure in 2023. In addition, spending measures were approved to address the rise in energy prices and the effects of the war in Ukraine, as well as the effects arising from the drought, amounting to 0.1 points of GDP. This is another significant factor in the increase in eligible expenditure in 2023. Finally, AIReF continues to estimate a negative net impact of revenue measures for 2023. However, the expected amount of the decrease in revenue compared with 2022 is insignificant and it therefore has little effect on the change in eligible expenditure

FIGURE 20. CG EXPENDITURE WITH RTRP (% GDP)

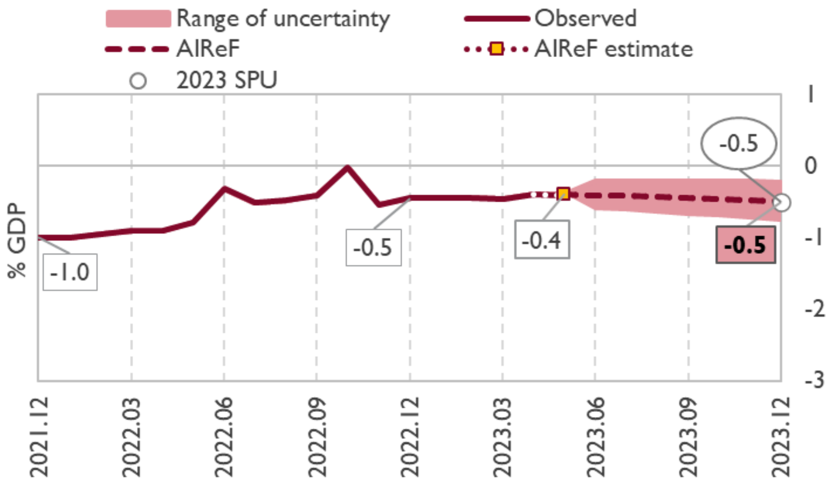


Source: IGAE and AIReF

4.4.2. Social Security Funds

AIReF forecasts a deficit of the Social Security Funds (SSFs) in 2023 of 0.5% of GDP, 0.1 points lower than estimated in the previous report. The moderation in the deficit is due to the upward revision of revenue, mainly resulting from the improvement in the employment forecast and the compensation of employees in the new macroeconomic outlook. This balance of the SSFs is similar to the Government's latest estimate published in the 2023-2026 Stability Programme Update.

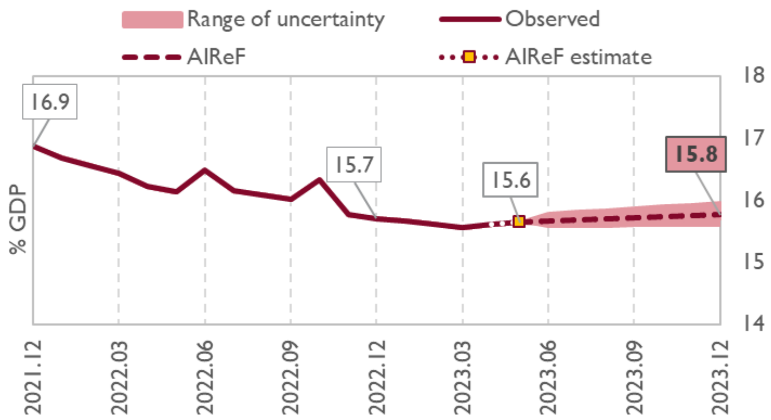
FIGURE 21. NET LENDING/BORROWING OF THE SSFS (% GDP)



Source: IGAE, SPU and AIReF

AIReF estimates that the weight of SSF revenue in 2023 will be 15.8% of GDP, 0.1 points higher than that estimated in the Report on the 2023 SPU. The upward revision of the forecast of compensation of employees and employment for 2023 in the update of the macroeconomic outlook explains this change. In addition, the new information leads to an increase of €400m in the transfer of contributions for vocational training from SEPE to the Central Government, which is accounted for as a fictitious Social Security contribution.

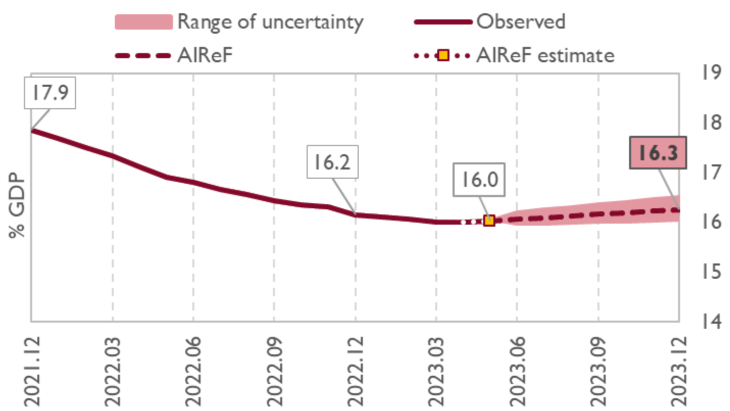
FIGURE 22. REVENUE OF THE SSFS WITH RTRP (% GDP)



Source: IGAE and AIReF

AIReF estimates that SSF expenditure will have a weight over GDP of 16.3 points in 2023, a value that matches the estimate of the previous report. The estimate of SSF expenditure in GDP terms remains stable as the increase in the growth of expenditure on pensions is offset by the increase in nominal GDP.

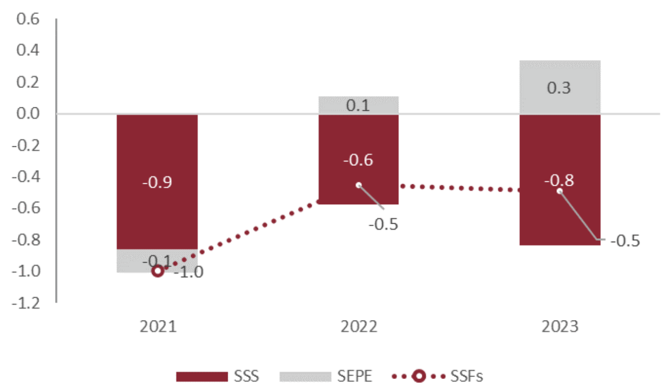
FIGURE 23. EXPENDITURE WITH RTRP OF THE SSFS (% GDP)



Source: IGAE and AIReF

This evolution does not affect the various agents of the Social Security Funds equally. The deficit of the Social Security Funds fell by 0.5 points of GDP in 2022, of which 0.3 points corresponded to the Social Security System and 0.2 to the SEPE, which after the pandemic presented a surplus again. SEPE expenditure falls as a result of the lower cost of job-retention scheme (ERTE) benefits to mitigate the impact of COVID-19 on the job market and the improvement in the unemployment rate. In the case of the Social Security System, the fall is due to a denominator effect. In 2023, the deficit remains at 0.5%. However, the deficit of the Social Security System has widened by 0.2 points, which is offset by the increase in the balance of the SEPE of the same size. The worsening of the balance of the Social Security System is mainly due to the increase in pension expenditure because of the annual increase in line with the CPI of the previous year.

FIGURE 24. BALANCE OF THE SOCIAL SECURITY FUNDS BY AGENT (% GDP)



Source: Social Security, SEPE, IGAE and AIReF

NB: FOGASA presents a balanced budget in this period

4.4.3. Autonomous Regions

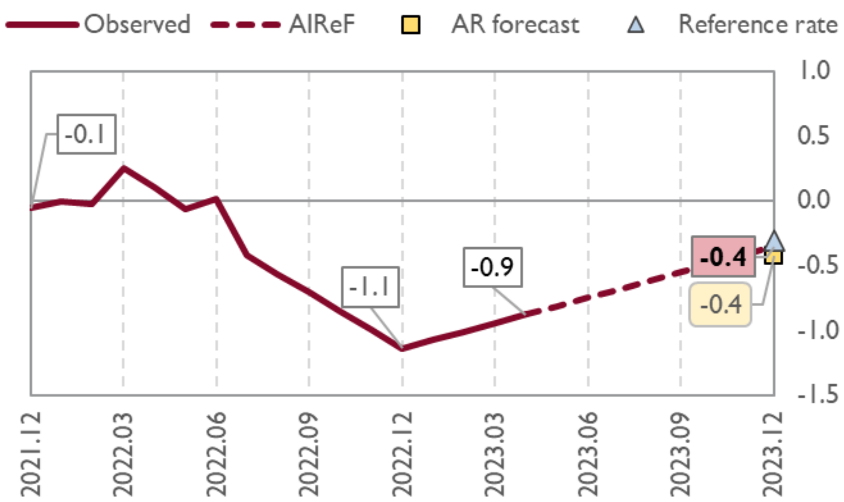
4.4.3.1 Analysis of the sub-sector

AIReF forecasts that the ARs will close 2023 with a deficit of 0.4% of GDP. AIReF slightly revises revenue downwards and raises the expected expenditure at year-end in the Autonomous Regions, increasing the deficit forecast compared with the previous report by 0.1 points to stand at 0.4% of GDP. The expected balance is worse than the set reference rate and worse than the Government's forecast contained in the SPU for the sub-sector. AIReF has revised its forecasts taking into account the execution data to date, the greater amounts of available information on year-end 2022 (mainly regarding the execution of European funds) and the forecasts, measures adopted, and other updated data provided by the ARs.

The regions worsen their forecasts overall, although with different positions at an individual level. In most cases, the ARs maintain the balance forecasts in

2023 contained in the medium-term budgetary plans. However, the estimates for Castile and Leon, Catalonia and Rioja worsen, while those of Andalusia, Extremadura, Navarre, and the Basque Country improve. Aggregate figures from individual forecasts would lead the sub-sector to a deficit of 0.4% of GDP, under an overall level of expenditure and revenue similar to that estimated by AIReF.

FIGURE 25. NET LENDING/BORROWING OF THE ARS (% GDP)



Source: IGAE, SPU, AIReF and forecasts of the ARs

AIReF forecasts that the revenue of the ARs in 2023, excluding the RTRP, will grow by 10%, to reach 15.5% of GDP. Overall, the revenue forecasts have not changed significantly compared with those set out in the Report on the SPU. However, there has been a downward revision of expected collection of Transfer Tax and Stamp Duty, and, in the opposite direction, improved revenue associated with European funds, the forecast for other taxes and the transfers from the State as a result of incorporation of the recent extension of the support for transport. Including revenue from the RTRP, total revenue would stand at 16.1% of GDP.

TABLE 11. EVOLUTION OF REVENUE EXCLUDING THE RTRP IN THE ARS (€M AND % CHANGE)

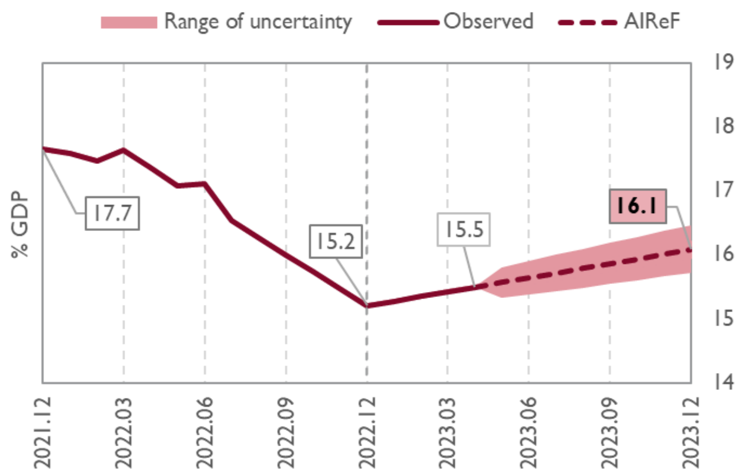
	Year-End 2022	AIReF forecast 2023	% change 23/22
Total net revenue	**202**	**229**	***13***
Net revenue without RTRP	**200**	**221**	***10***
Net RFS	110	136	24
Net IPs	*113*	*125*	*11*
Net settlement	*-3*	*11*	
Compensation	8	0	
Transfer Tax and Stamp Duty	12	11	-6
Inheritance and Gift Tax	3	3	-2
Other non-RFS tax	11	12	7
Other revenue	56	58	4
REACT-EU revenue	*3*	*3*	*5*
Other	*54*	*56*	*4*
RTRP revenue	*2*	*8*	*366*

Source: AIReF

Source: IGAE and AIReF

The regional forecasts maintain revenue like that estimated by AIReF. The current estimates of the ARs set an aggregate level higher than the previous forecasts, since, although they revise the expected collection of Transfer Tax and Stamp Duty downward, they improve collection of other taxes and European funds other than the RTRP. In general, there are no significant changes in the revenue measures adopted by the ARs with effects in 2023 and subsequent years. In short, the aggregate revenue forecast of the ARs resemble AIReF's revenue scenario.

FIGURE 26. REVENUE OF THE ARS WITH RTRP (% GDP)



Source: IGAE and AIReF.

AIReF forecasts that the expenditure of the ARs not associated with the RTRP will grow by 5%, to stand at 15.9% of GDP. AIReF has revised upwards the overall expenditure expected at the end of 2023 with respect to the estimates considered in the Report on the SPU. This is mainly due to the execution observed to date and the new measures reported by the ARs, incorporating the impact of the extension of the discounts for transport. Accordingly, the expenditure forecast at the end of the year has been increased, mainly in intermediate consumption and compensation of employees, and the estimates for other current and capital expenditure have been moderated. Considering expenditure financed by the RTRP, expenditure could amount to 16.4% of GDP.

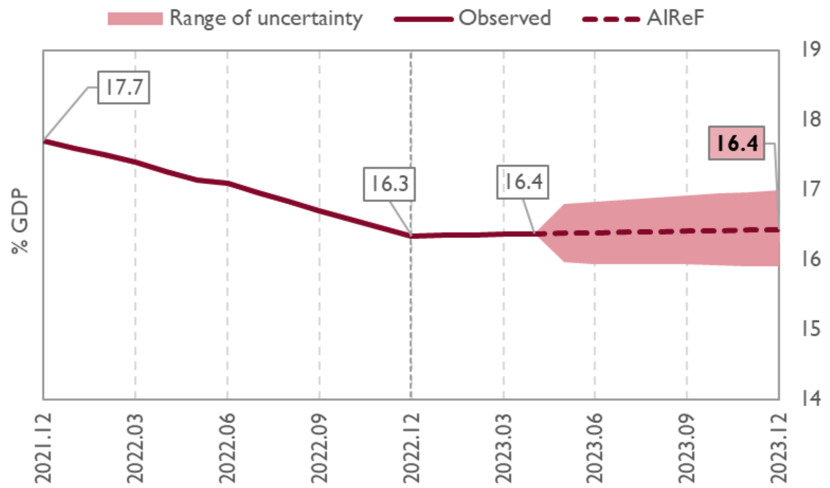
TABLE 12. EVOLUTION OF AR EXPENDITURE WITHOUT RTRP (€M AND % CHANGE)

	Year-End 2022	AIReF forecast 2023	% change 23/22
Total net expenditure	**217**	**234**	**8**
Net expenditure without RTRP	**215**	**226**	**5**
Healthcare*	86	91	6
Education*	52	55	6
Other expenditure*	77	80	3
Of this, REACT- EU expenditure	*3*	*3*	*5*
Support for companies Covid line	*1*		*-100*
Expenditure RTRP	*2*	*8*	*367*

* Functional distribution estimated by AIReF
Source: AIReF and IGAE

The updated forecasts of the ARs raise the expected level of expenditure not associated with the RTRP over that considered in their budgetary frameworks, moving away from AIReF's estimates. Without substantial changes at the aggregate level in the valuation of the expenditure measures adopted by the ARs, most ARs maintain or raise the forecasts of expenditure not associated with NGEU funds at the end of 2023. This raises the level of the sub-sector's expenditure by more than 0.1 points on the forecast in previous scenarios. Most of the increase is concentrated in current expenditure: expenditure on goods and services and current transfers and, to a lesser extent, staff costs. In contrast, forecasts for capital expenditure fall. This expenditure scenario is in line with that currently estimated by AIReF.

FIGURE 27. EXPENDITURE OF THE ARS WITH RTRP (% GDP)



Source: IGAE and AIReF.

AIReF estimates that the eligible expenditure for the purposes of the expenditure rule will grow by 5% in 2023. Based on a change of 5% in 2022, it is expected that the eligible expenditure for the ARs will rise in 2023 by a similar percentage.

4.4.3.2 Individual analysis

At an individual level, the changes are heterogeneous across the ARs, with balances improving for three ARs and worsening for eight. AIReF improves the forecasts contained in the reports on the initial budgets for Asturias, the Basque Country and Navarre and worsens its forecast for Andalusia, the Balearic Islands, Castile and Leon, Castile-La Mancha, Catalonia, Madrid, Galicia, and Rioja. It maintains the balance estimates in the other ARs. Under current forecasts, only four ARs (Catalonia, Castile-La Mancha, Murcia, and Valencia) would close with a deficit higher than the reference value for the sub-sector, i.e., 0.3% of GDP, six ARs at around said rate (Aragon, Cantabria, Castile and Leon, Extremadura, Madrid and Rioja), while seven ARs could achieve a surplus or balanced budget.

Most of the ARs still expect a deficit like the set reference rate. The current year-end forecasts for the Balearic Islands, the Canary Islands, Extremadura, and the Basque Country include a year-end 2023 that is more favourable than the set reference or agreed rate (-0.6% of GDP for the Basque Country and Navarre). In contrast, Castile and Leon, Catalonia and Navarre expect to achieve a deficit above the reference value.

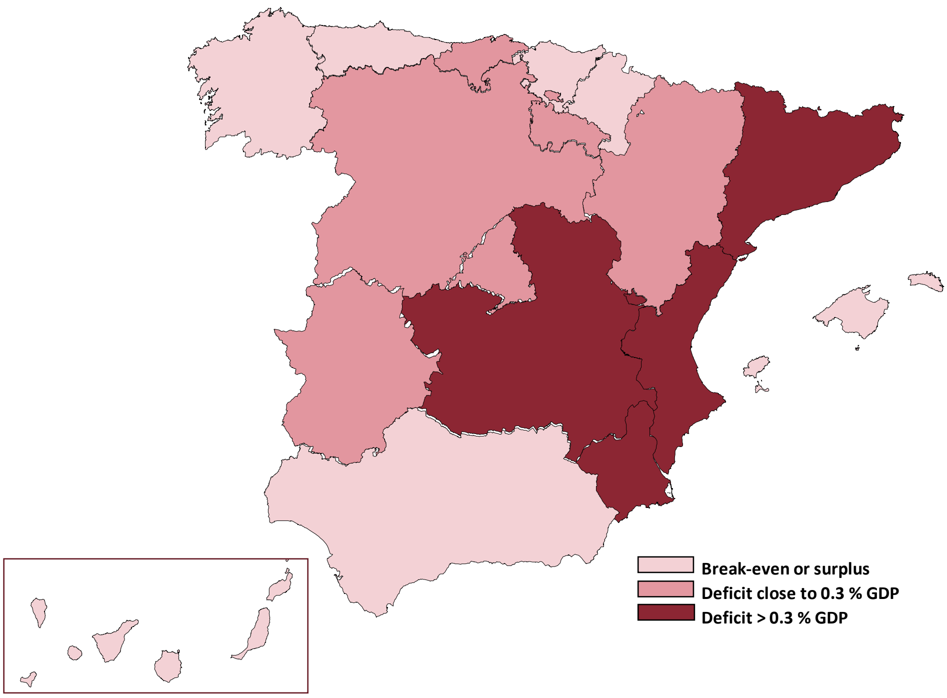
A detailed analysis of each AR is included in the individual reports published with this report.

TABLE 13. CHANGES IN THE BALANCE FORECASTS FOR 2023 BY AR (% GDP)

ARs	AIReF Forecasts		AR Forecasts	
	Current	Initial Budgets	Current	Initial Budgets
ANDALUSIA	0.0	0.1	-0.3	-0.6
ARAGON	-0.3	-0.3	-0.3	-0.3
ASTURIAS	0.6	0.4	-0.3	-0.3
BALEARIC ISLANDS	0.4	0.6	0.0	-0.1
CANARY ISLANDS	0.5	0.5	0.0	0.0
CANTABRIA	-0.1	-0.1	-0.3	-0.3
CASTILE AND LEON	-0.1	0.0	-1.1	-0.3
CASTILE-LA MANCHA	-0.9	-0.8	-0.3	-0.3
CATALONIA	-0.7	-0.6	-0.8	-0.3
EXTREMADURA	-0.2	-0.2	-0.2	-0.3
GALICIA	0.2	0.4	-0.3	-0.3
MADRID	-0.3	-0.1	-0.3	-0.3
MURCIA	-1.6	-1.6	-0.3	-0.3
NAVARRE	0.2	0.0	-0.8	-1.1
BASQUE COUNTRY	0.2	0.1	-0.1	-0.6
RIOJA	-0.3	-0.1	-0.3	-0.1
VALENCIA	-1.5	-1.5	-0.3	-0.3
TOTAL AUTONOMOUS REGIONS	**-0.4**	**-0.3**	**-0.4**	**-0.3**

Source: AIReF and AR forecasts

FIGURE 28. MAP OF AR NET LENDING/BORROWING IN 2023 IN RELATION TO THE SUB-SECTOR REFERENCE



Source: AIReF

4.4.4. Local Governments

AIReF maintains its surplus forecasts for the local sub-sector in 2023, at around 0.2% of GDP, above the Government's forecasts in the SPU. AIReF's forecasts for the local sub-sector update the data considered for the Report on the 2023 SPU based on the latest information published on the non-financial transactions of the first quarter of the year, the financial data on local debt and deposits at the end of the same period published by the Bank of Spain, as well as the information provided by the Information Centre of the Ministry of Finance and Civil Service and provided by the LGs.

In 2023, the local balance would be close to equilibrium and very similar to that of 2022, after stripping both years of extraordinary compensation. In homogeneous terms, deducting the effect in 2022 and 2023 of the settlements of the State financing system and the compensation in both years for the negative settlement of 2020, as well as the compensation of the VAT management system (SII) paid in 2022, the balance of the LGs would be close to equilibrium both in 2022 and in 2023.

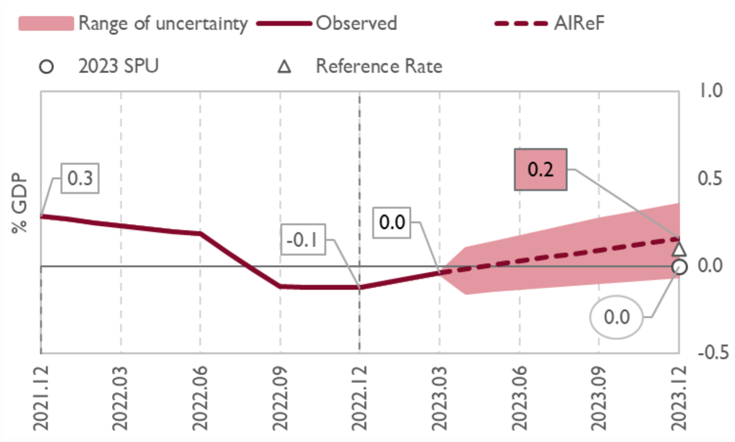
AIReF's estimates of the local surplus for 2023 are consistent with those sent to the Ministry of Finance and Civil Service by the LGs raised to the national total and stripped of extraordinary compensation. AIReF's current forecasts of the local balance to be obtained in 2023, stripped of extraordinary compensation from previous years, are consistent with the year-end information submitted by the Ministry of Finance and Civil Service based on the information sent by the LGs in April of each year together with the budgetary execution at the end of the first quarter. These forecasts have been adjusted for the same extraordinary revenue and the balance forecast for municipalities with fewer than 5,000 inhabitants that do not report periodic information to the Ministry of Finance and Civil Service has been incorporated. These year-end estimates of the LGs have a high degree of representativeness, exceeding 95%, which makes it possible to validate their consistency with AIReF's estimates for the total local sub-sector.

For 2023, AIReF places its estimates on the growth of local revenue at around 4%, homogenised from revenue from previous years arising from the financing system and NGEU funds. The revenue expected at the end of 2023 by AIReF, homogenised from those resulting from the State financing system from previous years and NGEU funds, would show a growth of almost 4% over 2022. This increase slightly improves on AIReF's estimates from last April. For 2023 and without homogenisation, the expected growth in revenue would be higher than 7%. The increase estimated by AIReF in local revenue in 2023 is mainly due to the increase in revenue linked to economic activity (especially that of the provincial councils of the Basque Country and some local taxes), due to the increase in the revenue to be received from the State financing system in the year including the compensation for the negative 2020 settlement (of almost €1.6bn), as well as due to the injection of EU funds linked to NGEU Funds.

In terms of expenditure, AIReF maintains its forecasts for 2023, estimating a year-on-year increase of almost 4% in like-for-like terms. AIReF estimates that expenditure in 2023, homogenised from payments from previous years to the State and NGEU funds, could grow by almost 4%. A major factor in this growth is the expected increase in current expenditure, particularly compensation of employees and intermediate consumption, which would amount to 5%. AIReF also estimates a considerable increase in transfers from the Basque Country provincial councils to the Basque Country Autonomous Region to share in the growth in transferred tax revenue. Without homogenisation, expenditure would grow by around 3%.

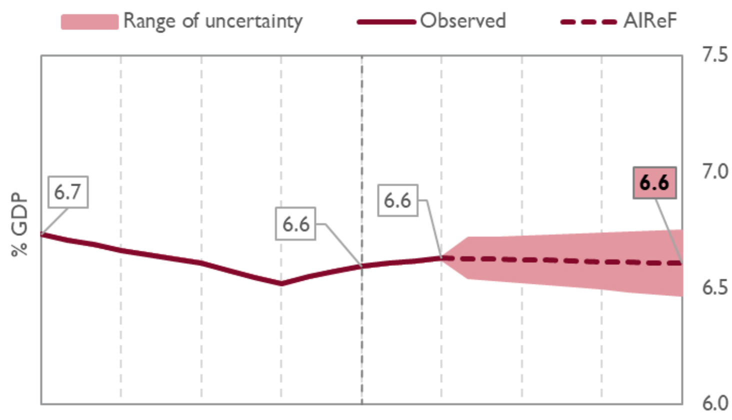
FIGURE 29. LOCAL GOVERNMENTS

FIGURE 29 A. NET LENDING/BORROWING OF THE LGS (% GDP)



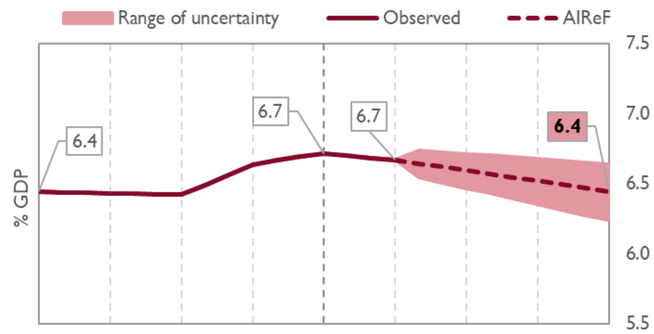
Source: IGAE, SPU and AIReF

FIGURE 29 B. REVENUE OF THE LGS WITH RTRP (% GDP)



Source: IGAE and AIReF

FIGURE 29 C. EXPENDITURE OF THE LGS WITH RTRP (% GDP)



Source: IGAE and AIReF

AIReF estimates that in 2023 eligible expenditure for the purposes of the expenditure rule will grow by almost 4%. The eligible expenditure of the LGs could rise in 2023 by around 4% on the level recorded in 2022, a year in which it grew by over 11%. If this forecast is met, local eligible expenditure would have risen by 22% between 2019 and 2023.

The information for 2023 sent to AIReF by the large LGs confirms the trend of growing expenditure observed since 2019. As is customary in AIReF's reports, this report will be supplemented soon by an individual assessment of the large LGs which, due to their relative importance in terms of population and budgets - over 25% of the total sub-sector - are monitored by AIReF. According to the data provided to AIReF by these large LGs on the forecast for the end of this year, the expected results of this group amount to 1% of their non-financial revenue, a worse figure than their April forecast.

4.5. Impact of the measures on the General Government accounts

AIReF incorporates the new measures approved since the previous report and updates the cost of the measures in accordance with the latest information available. Thus, the impact of Royal Decree-Law 4/2023, of May 11th, on urgent measures due to high temperatures and drought and Royal Decree-Law 5/2023, of June 28th, adopting and extending certain measures that began to be applied in mid-2022 are incorporated. Therefore, the revenue and expenditure measures approved to date are included: revenue measures considered in the Budgetary Plan and the General State Budget for 2023, measures approved in different royal decree-laws in response to the energy crisis and the drought, as well as the agreements and personnel measures approved or planned at a State and territorial level.

4.5.1. Measures in response to the energy crisis, the war in Ukraine and the drought

AIReF estimates that the total cost of the measures in response to the economic and social consequences of the war in Ukraine and the drought will be 1.1% of GDP in 2023, 0.2 points more than in the previous report. The impact considered by AIReF incorporates 0.2 points for the effect of the measures adopted in Royal Decree-Law 4/2023, of May 11th, and in Royal Decree-Law 5/2023, of June 28th, in response to the economic and social consequences of the war in Ukraine and to support the reconstruction of the island of La Palma and other situations of vulnerability, which is added to the update of the impact of the measures included in the six royal decree-laws passed to date.

The total cost of the spending measures for the CG caused by the economic crisis and the war in Ukraine amounts to 0.6% of GDP, almost €9bn. The impact for 2023 of the spending measures for the CG approved in response to the economic and social consequences of the Russian war has increased by about €1.7bn due to the extension of some of the measures already approved and the creation of new measures with respect to those considered in the Report on the 2023-2026 Stability Programme Update. The extended measures include the fuel subsidy per litre for the transport and agricultural sectors, the extension of which, until the end of the year, has an impact of just €300m on expenditure in 2023. An additional sum of almost €400m is due to the extension of direct support for urban and interurban public transport, channelled through the ARs and the LGs. In addition, the last two royal decree-laws approved include sectoral support of almost €850m, mostly aimed at alleviating the consequences of the drought in Spain through the FEGA

(Spanish Agricultural Guarantee Fund). As a new development, support for individuals includes that aimed at reducing the cost of train tickets for young people, which raises spending by over €160m for this year.

Revenue measures taken to mitigate energy and food price rises will result in a revenue reduction in 2023 of half a percentage point of GDP. The evaluation of their impact is revised mainly because of the extension of the reductions in the VAT rate on certain food products[12], initially established up to June 30th, 2023, and now extended through Royal Decree-Law 5/2023, of July 28th, due to the year-on-year rate of core inflation remaining above 5.5%. AIReF considers it feasible that core inflation will fall below that threshold next September and that the usual VAT rate on food will be recovered for the last two months of the year. Therefore, it considers that the approved extension will have an impact for four additional months with an estimated value of €520m reaching a total of €1.3bn for 2023. The impact of the other measures, all established up to December 31st, 2023[13], is revised with the latest information available in the monthly reports of the Tax Agency and with the updating of electricity futures prices, with revenue estimated to fall by €3.1bn as a result of the reduction to 5% of the VAT rate on electricity, natural gas, firewood and pellets, and by about €2bn as a result of the reduction to 0.05% of the rate of the Special Tax on Electricity. It should be noted that Royal Decree-Law 5/2023 also establishes until December 31st, 2024, an additional deduction in PIT and accelerated depreciation in Corporate Income Tax for the purchase of electric vehicles and charging systems, the impact of which will not affect 2023, but is carried over to 2024 and 2025 when the corresponding annual returns are filed.

AIReF estimates the impact of the loss of revenue resulting from the suspension of the Tax on the Value of Electricity Production to be around €2.7bn in 2023. Although the impact estimate is revised with the updating of electricity futures prices, the impact is maintained in deficit terms at the amount of the planned transfer to the electricity system in the GSB of €1.15bn[14] from the budget of the Ministry of Energy to the National Commission on Markets and Competition (Spanish acronym: CNMC).

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[12] 4% to 0% for all basic foodstuffs and 10% to 5% for olive and seed oils and pasta.

[13] Royal Decree-Law 20/2022

[14] This impact is reflected in the expenditure measures within the sectoral support.

TABLE 14. IMPACT OF MEASURES IN RESPONSE TO THE ENERGY CRISIS AND DROUGHT IN NATIONAL ACCOUNTING TERMS: AIREF ESTIMATE

Impact in 2023 In National Accounting terms (€m)	Measures approved before the start of 2023	Measures approved in 2023 (RDL 4/2023 and RDL 5/2023)	Total impact in 2023
Revenue Measures	**-5.907**	**-521**	**-6.428**
VAT	**-3.869**	**-521**	**-4.390**
VAT Electricity			
Reduction to **10%** electricity rate (RDL 12, 17 & 29/2021 & 6/2022 until June 30th, 2022)	-2.383		-2.383
Reduction to **5%** since July 1st, 2022 (RDL 11/2022 & 20/2022 to December 31st, 2023)			
VAT on gas, briquettes and pellets Reduction to **5%** gas rate (RDL 17/2022 and 20/2022 until December 31st, 2023)	-704		-704
VAT on foodstuffs			
Reduction from **4% to 0%** on basic foodstuffs	-643	-429	-1.072
Reduction from **10% to 5%** on oils and pasta	-139	-92	-231
(RDL 20/2022 until June 30th, 2022, RDL 5/2023 until December 31st, 2023)			
STs	**-2.038**		**-2.038**
ST Electricity Reduction electricity rate (RDL 17, 29/2021 & 6, 11/2022 until December 31st, 2023) (RDL 20/2022 to December 31st, 2023)	-2.038		-2.038
Expenditure Measures	**7.198**	**1.706**	**8.904**
Fuel allowance	1.355	312	1.666
Sectoral support	2.680	849	3.529
Direct support to individuals	600		600
Other support to individuals	2.396	546	2.942
Support to refugees	167		167
TOTAL	**-13.105**	**-2.227**	**-15.332**
TOTAL (% GDP)	**-0,9**	**-0,2**	**-1,1**
Other			
Tax on the Value of Electricity Production: Suspension (RDL 12, 17, 29/2021 & 6/2022) Extension to December 31st, 2023 (RDL 20/2022)	-2.680		-2.680

Source: AIReF estimates.

4.5.2. Other Central Governments revenue measures

AIReF estimates that the other tax measures approved to date will result in total additional revenue of a little over 0.2 points of GDP at year-end 2023, a similar impact to that forecast in the previous report. The temporary tax measures will add 0.3 points of GDP to total revenue, partially offset by structural measures that will reduce them by 0.05 points. In relation to the previous report, the estimate of the expected impact of regulatory changes is updated with the incorporation of the latest available information, raising it by just over €200m. However, in GDP terms, it maintains the same percentage of 0.2%. As a result of this update, the annual distribution of the impact of the temporary limitation of the offsetting of intra-group losses for the Corporate Income Tax of consolidated groups is revised. This results in a reduction of the impact on the tax payable, which is carried over to 2024, an increase in the impact on instalment payments in 2023, with a positive impact of €850m, compared with the €250m initially estimated. Negative impacts on revenue of about €450m are also included as a result of the deferral of VAT and PIT revenues, resulting from the new deferral regulation, approved in Order HFP/311/2023, and the increase in PIT of difficult-to-justify expenses in the direct estimation scheme up to 7% and the additional reduction in the objective estimate scheme up to 15%.

TABLE 15. OTHER CENTRAL GOVERNMENT REVENUE MEASURES IN CASH TERMS

Central Government Revenue Measures	Legislation	Total impact in €m	Total impact in % GDP
Structural revenue measures		**-565**	**0,0**
PIT		**-1.334**	**-0,1**
Reduction of contribution limit to pension plans from 2,000 to 1,500	22GSB	149	0,0
Increase in taxation on capital income	23GSB	0	0,0
Increase in the reduction in income from work and minimum taxation	23GSB	-1.247	-0,1
Reduced income from module system and increases difficult-to-justify expenses	23GSB	0	0,0
Extension of the maternity tax credit	Budgetary Plan 2023	-222	0,0
PIT - Extension of deferral guarantee exemption up to €50,000	Order HFP/311/2023	-14	0,0
Corporate Income Tax		**421**	**0,0**
Establishment of a minimum rate of 15% of the taxable income.	22GSB	400	0,0
Reduction to 40% of allowance under housing rental regime	22GSB	21	0,0
Reduction in the rate for small businesses	23GSB	0	0,0
VAT		**-258**	**0,0**
Reduction in rate to 5% on female hygiene products	23GSB	-24	0,0
Extension of deferral guarantee exemption up to €50,000	Order HFP/311/2023	-234	0,0
OTHER		**606**	**0,0**
Tax on Single-Use Plastics:	Law 7/2022	606	0,0
Temporary revenue measures		**4.047**	**0,3**
PIT		**-346**	**0,0**
Deductions for housing refurbishment.	RDL 19/2021	-30	0,0
Reduction in agricultural and livestock objective estimation return	Orden HFP/405/ 2023	-123	0,0
Increase in difficult-to-justify exp. (direct est.)	2023 GSB	-51	0,0
Additional reduction on net income (objective est.)	GSB 2023 and HFP/1172/2022	-142	0,0
CIT		**851**	**0,1**
Limitation on offsetting losses in consolidated groups.	23GSB	851	0,1
OTHER		**3.543**	**0,2**
Temporary Levy Financial Institutions	Law 38/2022	1.274	0,1
Temporary Levy Energy Companies	Law 38/2022	1.634	0,1
Solidarity tax on large fortunes	Law 38/2022	635	0,0
TOTAL		**3.482**	**0,2**

Source: Government and AIReF estimates

4.6. Contingent liabilities and fiscal risks

The materialisation of the risks related to the energy and price crisis and the drought has, to date, led to an increase in the deficit of 1.1% of GDP in 2023. As highlighted in the Report on the 2023-2026 SPU[15], there was a risk of a higher deficit if the Government were to adopt new measures or extend existing ones in response to persistent inflation and the drought situation. These fiscal risks have materialised with the approval of two packages of measures through Royal Decree-Laws 4/2023 and 5/2023. AIReF estimates that the combined impact of these measures will raise the deficit by 0.2% of GDP in 2023, almost 0.1 point as a result of the revenue measures and a further 0.1 points as a result of the expenditure measures (see Section 4.5 Impact of the measures on the General Government accounts). So far this year, the impact on the 2023 deficit of measures to mitigate the effects of the war in Ukraine and the energy crisis amounts to 1.1% of GDP.

In addition, uncertainty remains about the macroeconomic scenario that endangers the materialisation of the projected fiscal scenario. The uncertainty surrounding the macroeconomic scenario underpinning the 2023 deficit forecasts remains high. The persistence of inflation, the tightening of financing conditions, the continuation or aggravation of geopolitical and trade tensions and the slower pace of implementation of the RTRP included in the SPU scenario are some of the main risks that would have a negative impact on economic growth. All these elements remain key in the evolution of certain variables such as employment, wages, private consumption and gross operating surplus, which will affect the final path of tax revenue and contributions, as well as unemployment and interest expenditure, with an impact on the deficit for 2023. On the positive side, if the risks of the macroeconomic scenario do not materialise, revenue may have a more positive evolution than expected if the elasticity of collection in relation to macroeconomic variables remains in line with historical averages and not below, as forecast in AIReF's central scenario.

In addition to the fiscal risks originating in the macroeconomic scenario, there are risks related to the enforcement of court rulings. According to the latest information published in the General State Account for 2021, the risk of greater compensation to the concessionaire ACESA continues, which, given the discrepancies about the final amount claimed, could amount to an additional €3 billion to the compensation that has already been paid by the State in 2021. Furthermore, the dispute over renewable energies remains open and, although appeals are being lodged against the arbitration decisions, the

[15] AIReF Report on the 2023-2026 SPU

amount awarded in the unfavourable decisions for Spain will stand at least €1.18bn.

Lastly, there are other risks whose amount is repeatedly unknown, and no information is provided, especially on investments in defence modernisation programmes. Investments in defence modernisation programmes are underway and involve a significant volume of expenditure with a major impact on the deficit. In addition, the amount of defence spending is now more significant because of the Government's commitment to NATO to raise military spending to 2% of GDP in 2029. There is also no information on the possible impact of the risks assumed by public-private partnership contracts or loans granted by public authorities that might prove to be doubtful receivables.

5. PUBLIC DEBT

5.1. Total General Government

The Spanish debt-to-GDP ratio stood at 112.8% in the first quarter of 2023, a reduction of 0.4 points on the end of 2022 and an increase of 14.6 points on the pre-pandemic level. In monetary terms, public debt has continued to grow, albeit at a slower pace than nominal GDP, to reach €1.54tn.

FIGURE 30. DEBT (% GDP), QUARTERLY EVOLUTION UP TO 2023QI

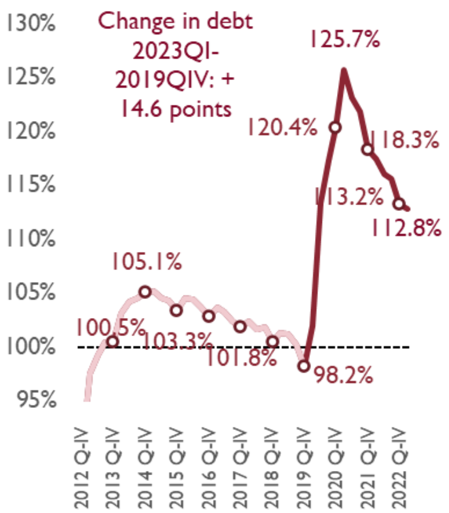
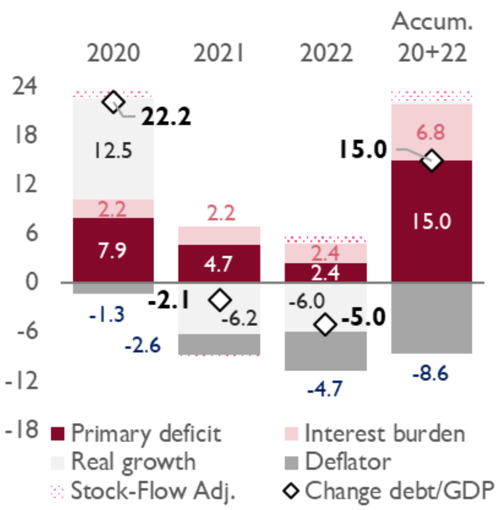


FIGURE 31. CONTRIBUTIONS TO THE CHANGE IN DEBT (% GDP) 2020-2022



Source: Bank of Spain, INE, and AIReF

Following the sharp initial increase caused by the pandemic, the debt ratio remains on a downward path. The quarterly profile of the debt ratio has shown a continuous path of reduction for eight quarters, which has led to a total decrease of 12.9 points from the ceiling reached in the first quarter of 2021 (125.7%). The correction of the public deficit together with the upturn in activity and much higher than expected inflation have managed to correct approximately half of the increase caused by the pandemic, placing the ratio on a downward path. However, Spain is currently one of the EMU countries with the highest levels of debt, behind Greece and Italy and with a level like that of Portugal and France.

AIReF's macro-fiscal forecasts project a reduction for this year in the debt-to-GDP ratio of 3.1 points on the level recorded in 2022, which would place the ratio at 110.1% at the end of 2023. This forecast is lower than the forecast presented by the Government in the SPU for 2023, which was 111.9%, and is in line with the latest projections of the IMF and the European Commission. The public deficit will continue to contribute to the increase in debt in a similar way to 2022 and the reduction in the ratio will mainly be supported by the nominal growth in GDP, where the deflator will make a very significant contribution.

FIGURE 32. DEBT FORECASTS (% GDP)

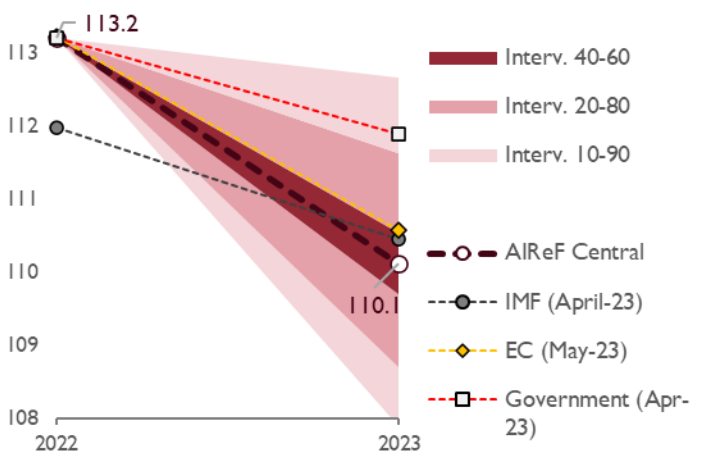
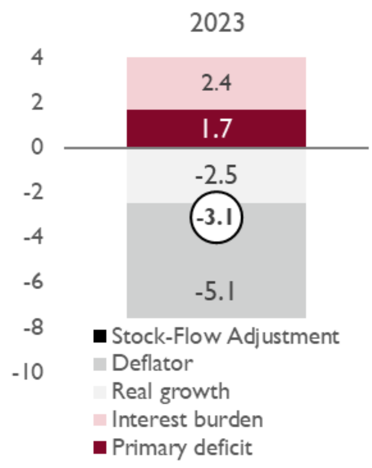


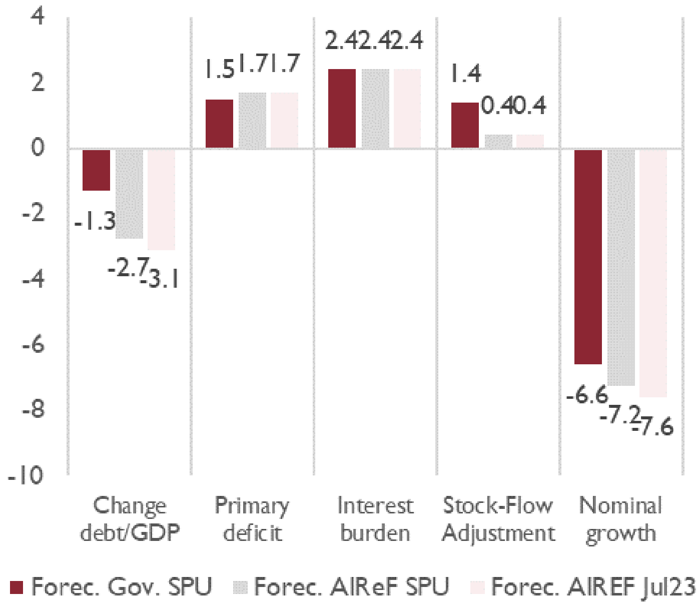
FIGURE 33. CONTRIBUTIONS TO THE CHANGE (GDP POINTS)



Source: AIReF

The update of the debt ratio projection represents an improvement of 0.4 points compared with that made by AIReF in May in the SPU. The improvement is supported by a greater contribution from nominal growth, due to the revision of the expected rate of change in real GDP to 2.3% from the previous 1.9%.

FIGURE 34. CONTRIBUTIONS TO THE CHANGE IN DEBT IN 2023 (GDP POINTS)



Source: AIReF

Financing conditions

Over the past year, sovereign debt financing conditions have tightened significantly. Never has there been such a rapid, intense, and widespread rise in interest rates by the different central banks. Overall, there has been a cumulative rise of almost 400 basis points in global interest rates in under a year after a decade of near zero or even negative yields in some countries. In the case of the Federal Reserve, the increase since March 2022 is close to 500 basis points, the fastest and most intense tightening cycle since the 1980s. For its part, the ECB has increased its main policy rates by almost 400 basis points since July of that year. Debt markets have quickly incorporated this new monetary cycle with rises in the last year of more than 250 basis points across all segments of the yield curve.

FIGURE 35. OFFICIAL INTEREST RATES

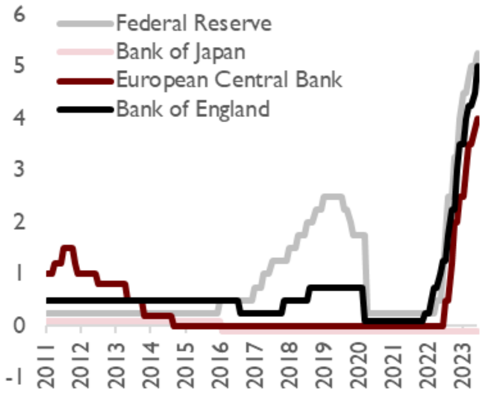
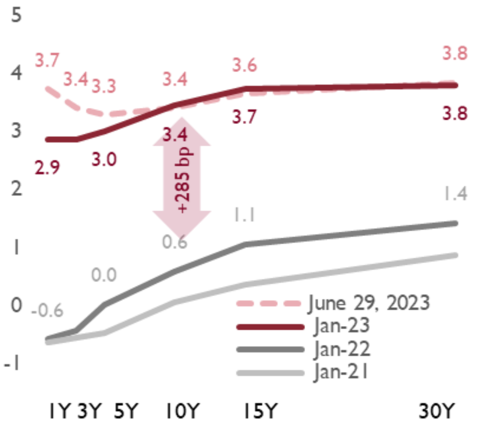


FIGURE 36. SPANISH DEBT YIELD CURVE (%)

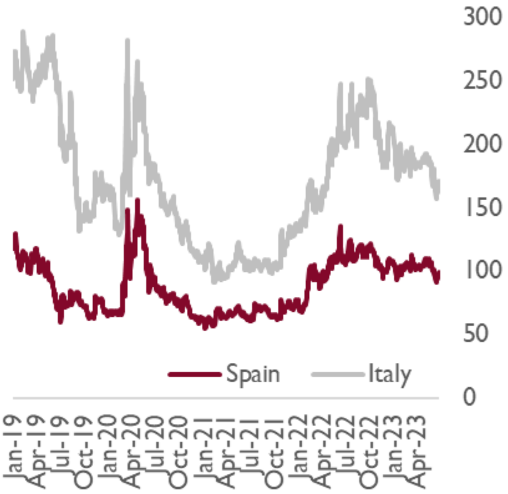


Source: Refinitiv and AIReF

The latest movements and statements made by the members of the main Central Banks indicate that the cycle of rises still has a long way to go. Regarding prices, there are no clear signs of moderation in core inflation, although headline inflation has moderated as a result of energy prices. In this regard, statements by members of the Governing Council suggest that the ECB still has some way to go in its cycle of increases and that, although rates are already in restrictive territory, they are not yet satisfied with the evolution they foresee for inflation, and they will therefore continue to act to bring it back into line. In the USA, statements by Fed. Chairman Jerome Powell show that almost all FOMC members are in favour of further rate hikes over the remainder of the year.

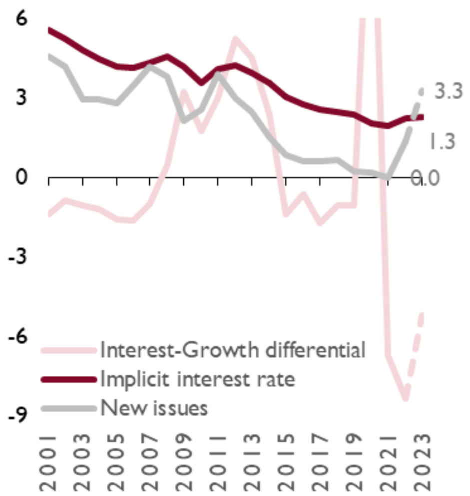
The rise in yields as a result of high inflation has been a global phenomenon that has not led to a significant widening of euro area risk premiums. The ECB's determination not to allow financial fragmentation of the euro area using instruments such as the reinvestment of PEPP maturities towards countries with stressed debt or the implementation of a new anti-fragmentation tool has contributed to risk premiums remaining at relatively low levels. In this regard, it should be noted that the yield on Spanish 10-year debt has maintained its spread with respect to German debt, at around 100 bps.

FIGURE 37. 10-YEAR SPREAD AGAINST GERMANY (BP)



Source: Refinitiv

FIGURE 38. INTEREST RATES (%) AND INTEREST RATE-GROWTH DIFFERENTIALS (POINTS)



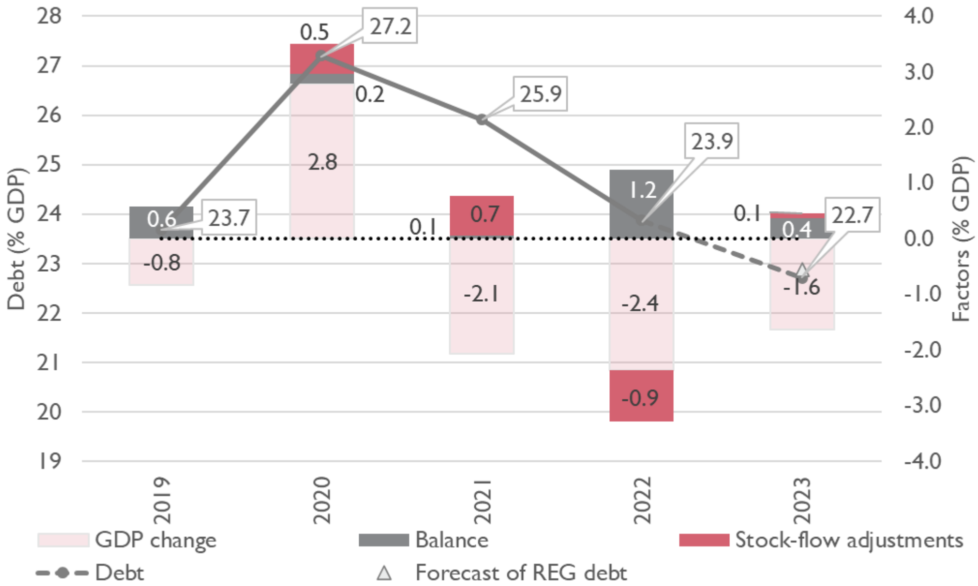
Source: AIReF

The new monetary cycle, together with the high level of existing debt, places the sustainability of public finances in a vulnerable situation. Spain maintains high debt levels, both in relation to other countries and in historical comparison. Despite it falling recently, spending pressures associated with the ageing population could push debt back on an upward path over the coming years. In this regard, the GG will have to finance high amounts of debt (around 20% of GDP) at significantly higher interest rates and in debt markets under increased stress as a result of the disappearance of the demand of the ECB and the high level of debt worldwide. The average Treasury issuance rate will rise from 0% in 2022 to 1.3% according to AIReF's forecasts for 2023 and will continue to rise to around 3% in the following years, which will gradually result in higher interest expenditure.

5.2. Autonomous Regions

AIReF estimates that the Autonomous Regions will reduce their level of debt by over one point of GDP, to stand at 22.7% at the end of the year. Starting from 23.9% in 2022, the ratio would improve by more than one point because of expected GDP growth, partially offset by the expected balance and by certain adjustments, such as the financing of the excess deficits of the previous year, the application of the outstanding excess financing at year-end 2022 and the postponement of the negative 2008-2009 settlement of the RFS.

FIGURE 39. EVOLUTION OF THE DEBT-TO-GDP RATIO OF THE ARS AND EXPLANATORY FACTORS (% GDP)

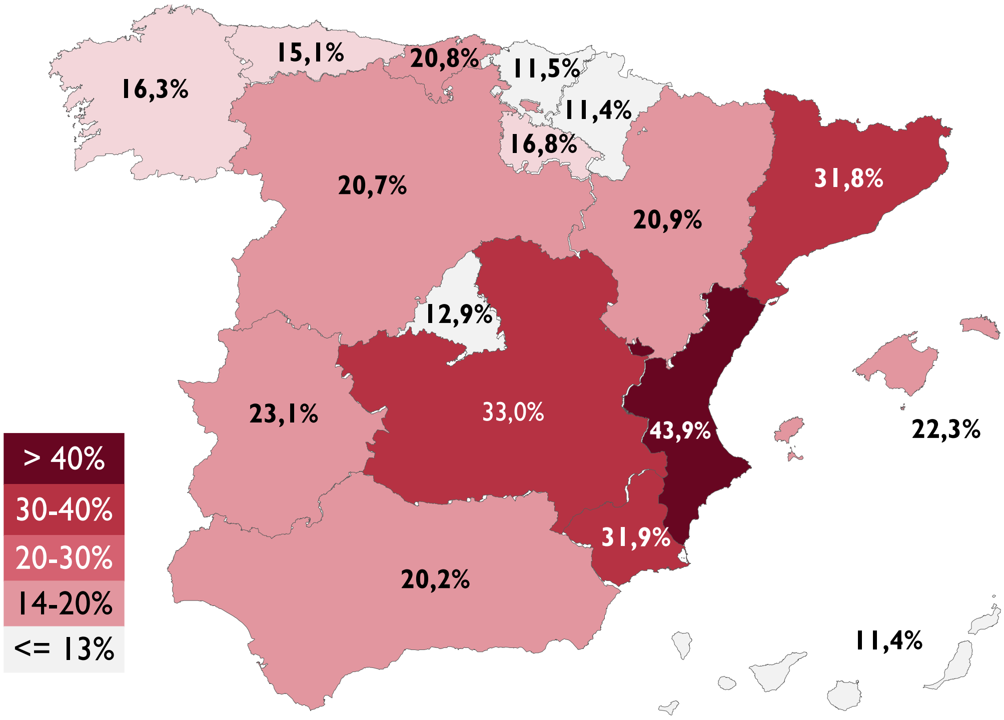


Source: Bank of Spain and AIReF

Most of the excess financing from previous years has been offset, but the risks of generating new excesses persist. The excess financing to be offset on December 31st, 2022, is substantially lower than that of the previous year. However, in 2023, there is still a risk of generating new excesses as some regions may receive debt authorisations based on the reference rate that are higher than those necessary to finance the deficit for the year. These excesses are independent of the cash flows derived from the funds of the RTRP and REACT-EU, which in 2022 have continued to have a positive net effect on the cash stock.

At an individual level, the debt-to-GDP ratio drops in all ARs, albeit unevenly. Due mainly to the effect of nominal GDP growth, all the ARs have seen their debt-to-GDP ratios fall compared with the previous year. The largest reductions in percentage points of GDP are found in the Balearic Islands, the Basque Country, Navarre, and Cantabria. Under the assumptions, the Canary Islands, Madrid, Navarre, and the Basque Country could place their debt in 2023 below 13%.

FIGURE 40. DEBT-TO-GDP RATIO OF THE ARS (% GDP)

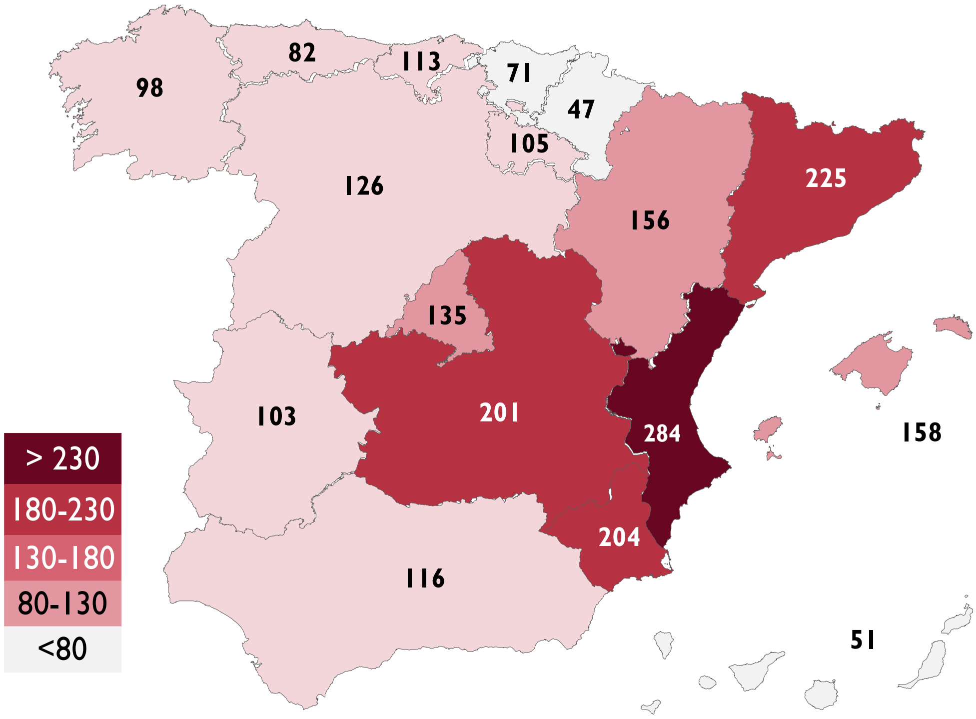


Source: Bank of Spain and AIReF

The debt-to-current revenue ratio[16] also falls in 2023 for all ARs. The sub-sector's debt-to-current revenue ratio will fall by 8% in 2023, to stand at 152%, because of the growth in revenue, particularly from the Regional Financing System. The largest reductions in the debt-to-current revenue ratio will occur in the Canary Islands, Asturias, the Balearic Islands, Galicia, Navarre, and the Basque Country. In the latter two cases, revenue growth is due to tax collection forecasts.

[16] AIReF calculates the revenue/debt ratio on the basis of the net current revenue in national accounting terms. The evolution of this ratio is dependent on the specific features of the regional financing system and the extraordinary transfers received by the Autonomous Regions in 2020 and 2021.

FIGURE 41. DEBT OVER CURRENT REVENUE OF THE ARS (%)



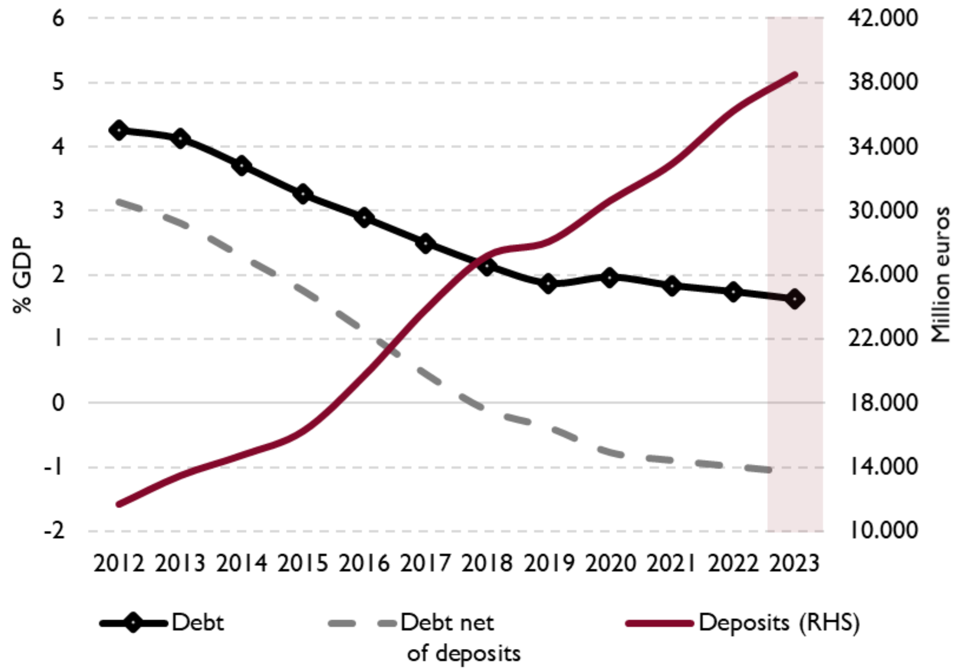
Source: Bank of Spain and AIReF

5.3. Local Governments

AIReF forecasts that the local sub-sector will reach a debt-to-GDP level of around 1.6% at the end of 2023. The latest data on debt and deposits in this sub-sector published by the Bank of Spain, corresponding to the end of the first quarter of 2023, show stabilisation of the level of debt and the debt-to-GDP ratio at 1.7%, as they did at the end of 2022. For the end of this year, AIReF forecasts a level of debt of the LGs like that of the previous year, although the debt ratio falls by 0.1 points because of the increase in GDP. This estimate is subject to uncertainty regarding the level of expenditure by the LGs at year-end in the current situation of the absence of fiscal rules, indicated for the non-financial balance.

AIReF estimates that the weight of LGs' bank deposits over GDP will stabilise at the level recorded at the end of 2022, around 2.7% of GDP. In 2022, despite the financial consequences of the crisis, the LGs increased their deposits by €3.3bn. In 2023, AIReF forecasts that this trend will continue, albeit attenuated, and that the weight of local deposits over GDP will stabilise. The information available on the net asset position for the first quarter of 2023 makes it possible to predict the year-end results. Debt net of deposits, which has been negative since 2018, as from then on deposits exceeded debt, stood at the end of 2022 at around -1% of GDP. AIReF expects this net asset position to slightly improve the level over GDP in 2023.

FIGURE 42. EVOLUTION OF DEBT AND DEPOSITS OF LOCAL GOVERNMENTS



Source: Bank of Spain and AIReF

6. RECOMMENDATIONS

6.1. New Recommendations

Recommendations for Territorial Administrations

After four years in which fiscal rules have been suspended at a European and national level, the escape clause will be deactivated in 2024 in a context of institutional uncertainty caused by the sum of several factors. At a European level, the reform of the fiscal framework is still at a preliminary stage of discussion. Firstly, the Commission has presented a comprehensive regulatory proposal that must now be discussed and agreed within the European institutions. Secondly, in line with the spirit of the proposal, the Country-Specific Recommendation issued by the Council for Spain sets a quantitative limit on the growth of primary expenditure net of revenue measures of 2.6%. At a national level, the general election was called before the budgetary stability targets and the expenditure rule reference rate were approved. In addition, the process of reforming the national fiscal framework has not been initiated.

For the General Government as a whole, AIReF's forecasts would be compatible with compliance with the 2.6% expenditure growth limit, provided that the temporary revenue and expenditure measures adopted to mitigate the effects of the price crisis are withdrawn. At a sub-sector level, this implies that ARs would close with a surplus of 0.4% of GDP, mainly because of the temporary increase in revenue due to the settlement of the regional financing system for 2022. This settlement will amount to 1.4% of GDP compared with the 0.7% forecast for 2023 and 2024.

However, for the process of drafting the budgets of the different authorities, the only existing reference is the forecast contained in the Stability Programme Update at the level of the balance by sub-sector, which, in the case of the ARs corresponds to a balanced budget for 2024. Considering the revenue forecast that AIReF set out in the Report of May 11th, a balanced budget in 2024 would be compatible with a growth in sub-sector expenditure, excluding the RTRP and REACT, of 7%.

Consequently, growth in the expenditure of the ARs compatible with the equilibrium reference set in the Stability Programme is hardly compatible with compliance with the Country-Specific Recommendation. In fact, according to AIReF's forecasts, if the AR sub-sector has a balanced budget in 2024, the growth in primary expenditure net of measures of the GG will be 3.6%, one point above the figure included in the Country-Specific Recommendation.

In addition, it is important to bear in mind that the situation is heterogeneous by AR. There are ARs with a deficit forecast even with the temporary increase in revenue, while other ARs would have a surplus above the average for the sub-sector. Therefore, the balanced-budget reference gives them greater margin to increase expenditure in the absence of a reference for the expenditure rule.

In this regard, there is a risk that the ARs will begin their budgeting process with the sole limitation of the budgetary balance and without considering that part of the revenue they will have in 2024 is temporary, especially in a context where there is no reference rate for the formally approved expenditure rule. In any case, it should be noted that, according to current legislation, the reference rate of the national expenditure rule would be around 3%.

In addition, in accordance with the revenue forecasts of the May report, if the ARs have a balanced budget in 2024, obtaining the surplus of 0.1% of GDP in 2025 and 2026 set out in the Stability Programme would entail a major containment of expenditure that would be difficult to implement in practice.

Therefore, AIReF recommends that the ARs under the ordinary regime should:

1. **Avoid increases in expenditure or reductions in revenue of a structural nature financed by the temporary increase in revenue that will occur in 2024 and consider the application of the expenditure rule in 2024, even if it means temporarily reaching a surplus situation.**

Although the ARs and LGs of the Basque Country and Navarre are practically unaffected by the settlements of the financing system, their forecasts for 2024 also stand above the path set for the sub-sector in the Stability Programme.

Therefore, AIReF recommends the ARs, and LGs of the Basque Country and Navarre should:

2. **Avoid increases in expenditure or reductions in revenue that do not have permanent funding and consider the application of the expenditure rule in 2024.**

This situation of institutional uncertainty also affects the LGs. Even though the impact is less than in the case of the ARs, the irregular profile of the revenue from the local financing system will generate temporary revenue in 2024 of around 0.3 points of GDP including the compensation for the negative settlement of 2020.

Similarly, the LGs will also begin their budgeting process with the reference of the forecast included in the Stability Programme Update at the level of balance by sub-sector, a surplus of 0.2% in 2024 for the LGs. Considering the revenue forecast that AIReF set out in the Report of May 11th, a balanced budget in 2024 would be compatible with growth in primary expenditure net of revenue measures for the sub-sector, excluding the RTRP, of 6%. In fact, if the LG sub-sector has a balanced budget in 2024, the growth in primary expenditure net of measures for the GG would be 3%, above the figure set out in the Country-Specific Recommendation.

In addition, if, in the absence of a reference rate of the expenditure rule, the LGs only take the budgetary balance required by law, the growth in primary expenditure net of revenue measures of the sub-sector, excluding the RTRP, could be close to 9%, thus raising that of the GG to 3.4%.

In any case, it should be noted that, according to current legislation, the reference rate of the national expenditure rule would be around 3%.

Therefore, AIReF recommends that the LGs under the ordinary regime should:

3. **Avoid increases in expenditure or reductions in revenue of a structural nature financed by the temporary increase in revenue that will occur in 2024 and consider the application of the expenditure rule in 2024, even if it means temporarily recording a surplus.**

Recommendation for the Ministry of Finance

The institutional uncertainty will not be fully resolved until the reforms of the European and national fiscal framework are approved and a medium and long-term fiscal strategy guaranteeing the sustainability of public finances is established, as AIReF has been recommending. Although the announcement of the general election has interrupted the process of approving the budgetary stability targets and setting the reference rate of the expenditure rule, the other authorities will have to begin the process of drawing up their respective budgets. In addition, the expenditure growth limit set in the Country-Specific Recommendation differs from the current national expenditure rule in its definition, quantification, and scope.

In the shorter term, it is therefore necessary to adopt measures for the coordination of fiscal policy for 2024 and to comply with the Country-Specific Recommendation for Spain for 2024 issued by the EU Council. This coordination is more significant given the potential inconsistencies identified between the fiscal stability path by sub-sector set out in the Stability Programme, the current national fiscal rules and the Country-Specific Recommendation.

In fact, if the balance of the AR and LG sub-sectors stands at the forecast in the Stability Programme in 2024, the growth in primary expenditure net of revenue measures of the GG, excluding the RTRP, could stand at 4%, 1.4 points above the level of the Country-Specific Recommendation.

AIReF therefore makes the following recommendations to the Ministry of Finance:

4. **For the preparation of the budgets of all public authorities, it should propose reference rates of growth in primary expenditure net of revenue measures for the different authorities considering the temporary or structural nature of the revenue and expenditure of each sub-sector for 2024 and in such a manner that they are consistent with compliance with the Country-Specific Recommendation issued by the Council of the European Union.**

The President of AIReF

Cristina Herrero Sánchez