REPORT ON THE INITIAL BUDGETS OF THE GENERAL GOVERNMENT FOR 2024

REPORT 2/24

EXECUTIVE SUMMARY

April 11th, 2024

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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The Independent Authority for Fiscal Responsibility (AIReF) has the legal mandate to assess the initial budgets of the General Government (GG) from the perspective of their compliance with fiscal targets, focusing its assessment, as laid down by its organic law, on the main changes with respect to the draft budgets and main budgetary lines, for which a report was issued on October 26th, 2023. 2024 is a critical year insofar as it marks the return to fiscal rules after four years of suspension, as well as the transition to the implementation of the now agreed new European fiscal framework, which will also lead to a reform of the national fiscal framework.

In this report, AIReF updates its macroeconomic and fiscal forecasts up to 2028, incorporating the impact of the measures approved or extended since the last report, as well as the latest data available. In this context, AIReF presents a new macroeconomic scenario that raises the forecasts for real growth in gross domestic product (GDP) for 2024 to 2%, while in the medium term the forecast gradually converges to the potential growth of the economy.

AIReF maintains the deficit forecast for the GG as a whole in its central scenario at 3% of GDP for 2024. The cost of the measures taken or extended since the previous report - 0.2 points of GDP - is offset by the upward revision of the macroeconomic forecasts. The revision of the medium-term forecasts confirms the stabilisation of the deficit above 3% in the absence of additional measures.

This year is also set to be the starting point for the medium-term fiscal strategy that will have to be set out in the medium-term fiscal-structural plan that Spain will have to submit in September. In this regard, the European institutions addressed a specific quantitative recommendation to Spain aimed at restricting the growth in primary expenditure net of revenue measures in 2024 to 2.6%. According to AIReF's estimates, growth will stand at 4%, which is a breach of the recommendation, placing net expenditure at 0.6 points of GDP higher than the level that would ensure compliance with the recommendation. Under AIReF's revenue scenario, compliance with the recommendation would require reaching a deficit figure in 2024 of 2.4% instead of the 3% currently forecast by AIReF, i.e. a reduction in the deficit of 1.2 points of GDP with respect to the deficit recorded in 2023.

Until the new European fiscal framework is transposed into the national legal system, national fiscal rules are once again in force in their current configuration in 2024. On the one hand, the budgetary stability and public debt targets proposed by the Government were rejected by the Senate. On the other hand, the publication of the Report on the Situation of the Spanish Economy has shown that the reference rate of the national expenditure rule stands at 2.6% for 2024, which is mandatory according to the regulations in force for the Central Government, the Autonomous Regions (ARs) and the Local Governments (LGs).

AIReF considers that there is a risk of non-compliance with the national expenditure rule in 2024 by the Central Government, all the ARs and ten of the LGs subject to individual monitoring by AIReF. Furthermore, non-compliance with the national expenditure rule also compromises compliance with the Council's specific recommendation for Spain. Beyond the legal consequences that might arise from the formal breach of the current national fiscal framework or the specific recommendation, high growth in eligible expenditure in 2024 will result in a deterioration of public finances in the medium term in a context of high public debt, which would also increase the adjustment required by the new European fiscal framework.

Consequently, AIReF recommends that these GG authorities monitor the execution of their budget and adopt the measures they deem appropriate to correct the growth of eligible expenditure for the purposes of the expenditure rule and thus avoid the structural deterioration of their accounts over the medium and long term.

In addition, this year is critical as a starting point for determining the path of primary expenditure net of revenue measures that Spanish GG authorities will be required to follow after the approval of the medium-term fiscal-structural plan. This plan should be drawn up over the summer on the basis of the reference trajectory that the European Commission will provide in June and will now mark the process of drawing up the budgets for 2025, taking as a starting point the year-end 2024 forecast.

In this regard and in line with previous recommendations and the provisions contained in the new European fiscal framework on the preparation of these plans, AIReF recommends that the Ministry of Finance initiate dialogue and work with all GG authorities on the drafting of this medium-term fiscal-structural plan. This should be done both at a bilateral level with the ARs and through the existing multilateral mechanisms for coordinating economic policy, such as the National Commission for Local Administrations and the Fiscal and Financial Policy Council and, as the case may be, the Conference of Presidents. This process should clarify the practical application of fiscal rules in 2024 and lay the foundations for a new national fiscal framework for the implementation of the medium-term fiscal-structural plan.

Revision of the macroeconomic scenario for 2023

AIReF revises the growth forecast for 2024 to 2%. From that year on, in its medium-term scenario, it considers that real GDP growth will gradually converge to the long-term potential, which AIReF still estimates at around 1.3%.

In 2023, employment growth driven, among other causes, by the influx of the foreign population, has favoured an expansion in consumption above the figure previously estimated in AIReF’s scenarios. Public consumption also rose by more than expected by AIReF and by the Government itself. For its part, tourism income has far surpassed pre-pandemic levels, which may be partly due to geopolitical instability in competing destination markets. In addition, exports of some business services remain notably buoyant, with exports growing in 2023 in line with AIReF's expectations. In the opposite direction, gross capital formation remained very moderate and grew well below the levels expected by AIReF and the Government.

The current weakness in investment is one of the most remarkable features of the recent growth pattern of the Spanish economy, particularly in a context in which some projects linked to the Recovery, Transformation and Resilience Plan are materialising. In addition, this scant progress in the degree of capitalisation of the economy (or even fall compared with 2019 if the depreciation of installed capital is taken into account) has been accompanied by a stagnation in productivity, which, following the ups and downs associated with the pandemic, maintains a level somewhat lower than that recorded in 2015.

In this context, AIReF forecasts that the economy will maintain significant growth of 2% in 2024, supported by the dynamism of private consumption and by an expansion of investment conditional on the rollout of investments associated with the RTRP. This GDP growth far exceeds the 0.6% expected by the ECB for the euro area as a whole.

From 2024 on, AIReF considers a scenario of gradual convergence towards long-term potential growth, which is still estimated at around 1.3%.

As regards prices, energy inflation is falling faster than expected in a context of a correction of the prices of these raw materials in international markets and, in particular, of gas prices, which have recovered levels similar to those recorded in mid-2021, before the start of the hike in prices. In contrast, some tourism-related services maintain high rates against a backdrop of expanding demand. In this regard, AIReF has revised the growth of the CPI expected for 2024 downwards to 3.1%, compared with the 4% expected in the autumn of 2023. In contrast, it maintains the expected growth of the GDP deflator at 3.2% in 2024, as this indicator reflects domestic price pressures to a greater extent. For the following years, a gradual convergence to 2% - the monetary policy benchmark rate - is expected.

As a result of the foregoing, nominal GDP growth is revised slightly upwards, to 5.2% in 2024, compared with the previous figure of 5%. In the following years, the nominal growth expected by AIReF stands at 4.1% in 2025, 3.7% in 2026, 3.6% in 2027 and 3.4% in 2028. In turn, the unemployment rate is expected to fall to 11.6% in 2024, from the 12.1% recorded in 2023, with progressive containment projected for it to stand at 10.3% in 2028.

Budgetary scenario of the GG

For its central scenario, AIReF estimates a GG deficit of 3% of GDP in 2024, in line with the Government's forecasts. In the medium term, AIReF expects the deficit to stabilise, in the absence of additional measures, at around 3.2% of GDP, in line with the previous report.

Before the end of the year, by means of Royal Decree-Law 8/2023, the Government partially extended the existing measures and approved additional measures for 2024 with an estimated cost of around 0.3 points of GDP. AIReF's fiscal scenario in its previous report already included 0.1 points of this cost. This in turn delays the full phasing out of the measures to mitigate the effects of the energy price crisis until 2025. In addition, some Autonomous Regions have approved additional tax reductions that are almost entirely permanent in nature.

The Central Government finally decided not to present the draft General State Budget for 2024 and therefore the budget extension will be maintained throughout the year. However, the Government has expressed its intention to incorporate certain elements of the budget policy, such as the salary increase of public employees, through different legislative instruments. As a result, the confirmation of the budget extension does not result in significant changes on the previous forecast.

The changes in the macroeconomic scenario reduce the deficit by 0.3 points in 2024 due to improved tax collection and lower expected spending on unemployment benefits. In relation to revenue, there is a noteworthy increase in the forecast for compensation of employees, which raises the forecast for the collection of Personal Income Tax (PIT) and social contributions. In addition, improved labour market forecasts also imply lower growth in spending on unemployment benefits.

Finally, the incorporation of the latest information available, mainly the year-end 2023 data, results in significant changes at the level of GG authorities and headings, which in aggregate amount to an increase in the GG deficit as a whole of 0.1 points of GDP. On the one hand, the higher spending than expected by AIReF carried out by the regional and local authorities in 2023 is carried over to 2024 and the following years, thus worsening their medium-term fiscal position. On the other hand, part of the lower Central Government expenditure in 2023 has no impact on the 2024 forecast. This is the case of capital transfers associated with court rulings, whose amount in 2023 was lower than in previous years, but which in 2024 will rise again due to the recording of court rulings already handed down. Along the same lines, the fall in military investment in 2023 is deemed to be of a one-off nature. It is expected to rise again in 2024 bearing in mind the budgetary execution recorded in 2023 and the political commitment to raise military spending.

As a result of the above, the deficit in 2024 will fall by 0.6 points of GDP compared with 2023. The phasing out of the measures implemented to mitigate the effects of the energy and price crisis in 2024 will result in a reduction in the deficit of around 0.7 points. The underlying trend in other expenditure and revenue results in a reduction in the deficit of over 0.1 points of GDP, which is cancelled out by the increase in non-recurring expenditure linked to court rulings. In contrast, the rest of the revenue measures have a practically neutral impact on the deficit of 0.1 points, since the negative impact of the measures approved in the Central Government (CG) and the Autonomous Regions (ARs) offset the positive impact of those approved in the field of Social Security.

TABLE 1. EVOLUTION OF GENERAL GOVERNMENT BALANCE

	AIReF current					AIReF October 2023				
	2024	2025	2026	2027	2028	2024	2025	2026	2027	2028
GG	**-3**	**-2.9**	**-3.1**	**-3.2**	**-3.2**	**-3**	**-3.2**	**-3.2**	**-3.2**	**-3.2**
CG	-2.7	-2.2	-2.4	-2.5	-2.6	-3.1	-2.8	-2.8	-2.9	-2.9
SSFs	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
ARs	-0.1	-0.3	-0.3	-0.2	-0.2	0.2	0	-0.1	-0.1	-0.1
LGs	0.1	0	0	0	0	0.2	0.1	0.1	0.1	0.1

AIReF forecasts that revenue will grow by 6.2% in 2024, to stand at 42.5% of GDP, 43.9% if RTRP revenue is included. This level would be 0.2 points of GDP lower than that forecast in the previous report. Part of this reduction - 0.3 points - is due to the higher expected level of nominal GDP for 2024. The partial extension of the temporary tax measures in force in 2023 also lowers the revenue forecast by 0.2 points. The new macroeconomic scenario results in higher overall tax collection, which is particularly concentrated in Personal Income Tax (PIT) and social contributions due to the improvement in the forecast of compensation of employees.

In the medium term, AIReF estimates a gradual increase in revenue to reach 43% of GDP in 2028, 0.1 points lower than the figure estimated in the previous report. In the medium term, the improved macroeconomic scenario almost offsets the impact of the higher nominal GDP forecast for 2028.

Expenditure, excluding the RTRP, will stand at 45.4% in 2024 according to AIReF's estimates, also 0.2 points below the forecast in the previous report. As with revenue, the reduction in expenditure as a proportion of GDP is explained by the effect of higher nominal GDP. The improvement in the labour market, incorporated in the new macroeconomic scenario, also reduces the weight of expenditure, while the new information raises the forecast. Including the RTRP, expenditure would stand at 46.9% of GDP in 2024. In the medium term, expenditure will increase its weight over GDP to reach 46.2% in 2028, slightly more than 0.1 points lower than in the previous report.

In the new European fiscal framework, the main supervisory variable becomes primary expenditure net of revenue measures. Accordingly, AIReF has already begun to forecast its evolution in the medium term both at the level of the GG and at the level of the sub-sectors. According to AIReF's estimates, this net expenditure for the GG as a whole will grow at an average rate of 3.8% per annum in its central scenario between 2024 and 2028.

Central Government

AIReF estimates a deficit of 2.7% of GDP for the Central Government (CG) in 2024, a reduction of 0.4 points on the previous forecast. Regarding the expenditure rule, AIReF now estimates that the growth in eligible expenditure will stand at 6.8%, which is a deviation of over 0.4 points of GDP from the level that would be reached if the 2.6% limit were met. This sharp growth is conditioned, among other factors, by the allocation in 2024 of certain non-recurring operations not recorded in 2023. In addition, the forecast for the recovery of military investment after the one-off fall in 2023 also weighs down on the evolution of eligible expenditure.

The CG deficit will fall in 2025 and will subsequently stabilise at around 2.5% of GDP, once the measures are fully phased out and the flows derived from the settlements of the regional and local financing systems are normalised. Between 2024 and 2028, AIReF forecasts that primary expenditure net of revenue measures will grow on average by 3.7% per annum.

Social Security Funds

AIReF reduces the estimate for the Social Security Funds' deficit by 0.1 points to 0.3% of GDP in 2024, but it remains at 0.4% of GDP in the medium term. Between 2024 and 2028, AIReF estimates that primary expenditure net of revenue measures will grow by 3.9% per annum, including the impact of revenue measures linked to the pension reform.

Autonomous Regions

The deficit of the ARs will fall in 2024 to 0.1% of GDP, worsening the forecasts of the previous report by 0.3 points. The improvement in the deficit of the ARs in 2024 compared with year-end 2023 is mainly due to the extraordinary revenue from the settlement of the regional financing system. In addition, interim payments also grew by 8.3%. However, the deficit forecast has increased compared with the previous report, mainly as a result of the year-end 2023 data and the new information on the resources of the financing system forecast for 2024.

AIReF's forecasts for 2024 place the growth of eligible expenditure for the purposes of the expenditure rule at 5.7%, 0.4 points of GDP above the level set by the reference rate of 2.6%. At the individual level, all the ARs are at risk of non-compliance with the expenditure rule.

After the extraordinary settlement received in 2024, from 2025 onwards the balance of the ARs will deteriorate to stabilise at a deficit of around 0.2% of GDP. Between 2024 and 2028, primary expenditure net of revenue measures will grow by 3.7% per annum on average.

Local Governments

Local Governments (LGs) will improve their balance in 2024 to return to a surplus of 0.1% of GDP, 0.1 points lower than in the previous report. The change in forecasts is mainly due to the year-end 2023 figure, with a deficit of 0.1% compared with the forecast surplus. Similar to the ARs, the change to a surplus is mainly explained by the settlement of the financing system, which goes from a negative impact in 2022 to become positive in 2024. In addition, the compensation for the negative settlement of 2022 that the LGs will receive in 2024 also has a positive impact. According to AIReF's estimates, the eligible expenditure for the purposes of the national expenditure rule in 2024 would grow by around 3.7%, which highlights the risk of non-compliance with this rule for numerous Local Governments at the individual level.

In the medium term, AIReF estimates that the balance of the LGs will stabilise at around equilibrium, and expenditure net of revenue measures will grow at an average annual rate of 3.7% between 2024 and 2028.

Fiscal policy stance and evaluation of the Specific Recommendations of the European Council on fiscal matters for 2023 and 2024

The 2023 and 2024 Country-Specific Recommendations set quantitative benchmarks for fiscal policy in Spain.

Specifically, in 2023, the European Council recommended to Spain that the increase in nationally-financed current primary expenditure net of revenue measures should not exceed the nominal medium-term potential growth of the economy, which is currently estimated at 7.3%. Given that the net expenditure variable referred to in the recommendation grew by 4.7% last year, Spain would have complied comfortably. In a context of high deflators, this containment of net primary current expenditure would have set a clearly contractionary tone to the domestic component of the fiscal policy stance in 2023, only partially offset by the boost associated with the NGEU funds. For its part, nationally-funded public investment would have contributed neutrally to the aggregate stance last year.

For 2024, the Specific Recommendation for Spain states that the increase in nationally-financed primary expenditure net of revenue measures should not exceed 2.6% in 2024. However, for the GG as a whole, AIReF forecasts 4% growth in this variable in 2024, which means an excess of net primary expenditure with respect to the recommendation limit of 0.6 points of GDP.

Complying with the recommendation would require reaching a deficit figure of 2.4% in 2024 instead of the 3% currently forecast by AIReF. In turn, this would result in a neutral overall fiscal policy stance: the contraction associated with the domestic component would be offset by the boost provided by RTRP funds.

In addition, and in terms of the composition of public finances, it is recommended that Spain maintain nationally-financed public investment in 2024. This aspect of the recommendation would be fulfilled this year since, although there is some containment of the investment dynamism of the GG, in terms of GDP its weight would remain stable.

Challenges foreseen from a perspective of sustainability of public finances

The reduction of the public deficit together with the growth in activity and much higher than expected inflation have managed to correct approximately two-thirds of the increase in the debt ratio generated in the first year of the pandemic, placing it on a downward path. The update of the macro-fiscal forecasts prepared by AIReF projects a reduction in the debt-to-GDP ratio of 1.8 points this year, placing it at 105.8%. This reduction will be mainly driven by the growth in nominal GDP, where the deflator will make a very significant contribution. This forecast slightly improves the forecast presented by the Government in the Draft Budgetary Plan for 2024 (106.3%), and is in the range of the latest forecasts by the IMF (104.7%) and the European Commission (106.5%).

The new monetary cycle, together the high level of existing debt, places the sustainability of public finances at a highly vulnerable starting point. In its long-term baseline scenario, AIReF projects an increasing debt ratio following an initial period of a certain level of stabilisation. The expected increase in expenditure associated with the ageing of the population is one of the main challenges for the sustainability of public finances in the medium and long term. The moderation in the contribution of nominal growth, which will edge down slightly, together with an upward trend in interest rates that exceeds the reduction in the primary deficit, will end up translating into an unfavourable trend in the debt ratio. The high initial level of debt added to unbalanced public accounts will generate an increased financial burden even in a scenario of containment of the cost of servicing debt.

The creation of a fiscal space that will make it possible to address future shocks, such as those that have occurred in recent years, requires the design of a medium-term plan that will guide public accounts towards a situation of equilibrium. In this regard, the agreement to reform the fiscal framework represents an opportunity and a guide for drafting a fiscal-structural plan.

According to AIReF's calculations, the fiscal path that would comply with the guidance for calculating the reference trajectory contained in the reform proposal would require taking measures during the period 2025-2028 worth 0.63 points per annum. This adjustment (2.52 points accumulated over four years) would generate a reduction in the debt ratio of 25 points of GDP in the next 15 years, placing it on a clearly downward path. Extending the adjustment plan to seven years would reduce the annual adjustment by 0.2 points to 0.43 points of GDP, but would entail a greater adjustment in cumulative terms (3 points).