OPINION ON FISCAL RISKS

OPINION 1/25

EXECUTIVE SUMMARY

Independent Authority
for Fiscal Responsibility

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

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Recent years have been marked by a succession of shocks of an extreme and unexpected nature. These include the financial crisis and the sovereign debt crisis in the euro area in the second half of the 2000s, the COVID-19 pandemic, the energy crisis as a result of the Ukraine war, the US-China trade war and other military conflicts. In addition to the greater exposure of the economy to these types of shocks, there has been a greater frequency and intensity of adverse natural phenomena, such as the isolated high-altitude depression (DANA) that recently affected the region of Valencia. All these phenomena have had a significant economic and fiscal impact and highlight the vulnerability of public finances to unexpected shocks and the need for adequate provisioning.

These extreme and unexpected events may lead to the materialisation of fiscal risks. The International Monetary Fund (IMF) Manual on Fiscal Transparency, published in 2018, defines fiscal risks as factors that may cause fiscal outcomes to deviate from expected or planned outcomes. The manual also distinguishes between macroeconomic risks and specific risks arising from natural disasters and environmental phenomena, the financial sector, legal actions against the State, local and regional authorities, public enterprises, public-private partnerships, changes in the valuation of public sector assets and liabilities or natural resources. This Opinion uses both the Manual on Fiscal Transparency's definition of fiscal risk and the risk classification it proposes.

The analysis of fiscal risks is crucial for the sustainability of public finances. The materialisation of fiscal risks entails a significant cost for public finances which, according to international evidence, may be as high as 10% of the Gross

Domestic Product (GDP). Deviations in the headline deficit and public debt caused by fiscal risks condition fiscal sustainability. In a global context where the frequency and intensity of fiscal risks may increase in the future, fiscal risk management contributes to improving the medium-term planning underpinning the new European fiscal framework and to ensuring sounder public finances and greater macroeconomic stability.

At present in Spain, fiscal risk analysis is carried out in a fragmented and incomplete manner. In 2021, AIReF published Opinion 1/21 on Fiscal Transparency in General Government in Spain. In that Opinion, it was noted that some budgetary documents include sensitivity analyses of the forecasts to certain unexpected shocks and a list of contingent liabilities, such as the one included in the Medium-Term Structural-Fiscal Plan, following European guidelines. However, there is a lack of a more exhaustive evaluation that analyses the presence and cost of these shocks in the past with a view to incorporating their implications for the public accounts and developing management and mitigation mechanisms.

The incomplete nature of fiscal risk analysis in Spain and its importance for fiscal sustainability has led AIReF to formulate this Opinion on Fiscal Risks. The shortcomings in fiscal risk analysis and management, together with the realisation that some of these risks may have a very significant impact on public finances have prompted AIReF, as part of its mandate to ensure effective compliance by the General Government (GG) with the principle of budgetary stability, to draw up its First Opinion on Fiscal Risks.

This Opinion presents a first analysis, pioneering for Spain, of the fiscal risks considered most relevant. The analysis of fiscal risks is a broad and complex subject and hence a step-by-step approach is necessary. The aim of this Opinion is to identify the sources of certain fiscal risks, quantify their potential fiscal cost and diagnose areas for improvement in the analysis and management of fiscal risks. Accordingly, this Opinion focuses on those risks considered most relevant: i) macroeconomic risks, which, according to historical experience, tend to be the most frequent and have the greatest impact on public accounts; ii) environmental risks, the frequency of which has recently increased worldwide; and iii) risks of legal actions against the State. In addition, the Contingency Fund, which is currently the main instrument for mitigating fiscal risks in Spain, is analysed. Given the heterogeneity of the fiscal risks considered in this Opinion and the novelty of Spain's case, a diverse methodology is followed, including both econometric analysis and case studies through the development of new models and an exhaustive analysis of information sources and databases. In the future, the analysis will be

extended to other specific risks such as those derived from the financial sector, public enterprises, public guarantees and environmental risks.

This Opinion does not analyse the impact of factors that have an impact on the long-term sustainability of public finances, such as climate change or demographics. It is important to note that this risk analysis does not incorporate risks associated with demographics or climate change - beyond those associated with natural disasters - two long-term phenomena with a high probability of materialisation but with uncertainty about their impact. Fiscal risks are thus separated from the long-term fiscal pressures that should be incorporated in the central scenario forecasts, irrespective of the fact that they are phenomena that are difficult to quantify. The implications of these phenomena from the perspective of the sustainability of public finances are incorporated in the Opinion on Long-Term Sustainability that AIReF will publish in March 2025, illustrating the uncertainty based on sensitivity and scenario analyses.

Macroeconomic risks

Macroeconomic risks materialise when unanticipated macroeconomic shocks lead to unexpected deviations in fiscal outcomes. Unexpected macroeconomic shocks have a direct effect on fiscal variables, generating deviations in the fiscal balance and public debt, leading to the materialisation of macroeconomic risks. These risks can materialise in the form of extreme events such as the 2007 financial crisis, the 2012 sovereign debt crisis or the COVID-19 pandemic crisis that compromise the sustainability of public finances. However, they also materialise on an ongoing basis when unexpected changes in national and international economic conditions occur due to unanticipated factors such as changes in interest rates, exchange rates, commodity prices or economic policies.

Macroeconomic risk analysis is related to the study of forecast errors. The materialisation of macroeconomic risks is reflected in a forecast error in macroeconomic variables that is transferred to forecast errors in fiscal variables. This Opinion therefore carries out a study of the Government's macroeconomic and fiscal forecast errors over the period 2000-2023. The results show that the largest forecast errors in nominal GDP, as the main determinant of the fiscal position, are related to the shocks that have affected the Spanish economy: i) financial conditions (financial crisis and sovereign debt crisis; ii) cost and commodity price shocks; iii) immigration shocks; iv) the pandemic-related crisis; and v) external demand shocks. In turn, these forecast errors in nominal GDP correlate with public revenue, fiscal balance and public debt errors, which would be indicative of the materialisation of fiscal risks.

The quantification of the impact of fiscal risks using econometric techniques shows the relevance of macroeconomic shocks for macroeconomic risks. The quantification of macroeconomic risks, in line with international best practices, requires analysing the impact of macroeconomic shocks on fiscal variables. To this end, this Opinion has developed a structural Bayesian Vector Autoregressive (BVAR) model with sign restrictions that allows us to identify the most relevant shocks that have affected the Spanish economy and to study their impact on fiscal variables. The results of the analysis highlight the importance of demand-side shocks in explaining the unexpected movements in real GDP growth and inflation. According to this analysis, it is precisely this type of shock that has the greatest influence on fiscal variables, as it affects real growth and inflation with the same sign.

The relevance of macroeconomic risks makes it necessary to improve their analysis by evaluating the impact of their materialisation on central fiscal forecasts. The analysis in this Opinion illustrates how macroeconomic risks have frequently materialised in recent years, especially in the case of extreme events. It is therefore necessary to analyse them in greater depth so that the central forecasts of fiscal variables made by the Government are accompanied by an evaluation of the possible deviations in the event of the materialisation of macroeconomic risks. For its part, AIReF intends to extend the analysis of the impact of macroeconomic risks by carrying out sensitivity exercises on the macroeconomic risks that are identified as most significant at any given time and calculating their potential impact on the fiscal variables.

Environmental risks

Environmental fiscal risks arise from the occurrence of natural disasters. Natural disasters are a source of fiscal risks as they cause unexpected fiscal costs for the GG through two main channels: i) the costs of repairing damage caused by natural disasters; and ii) disaster relief measures. Accordingly, the materialisation of environmental risks will depend on both the frequency of disasters and the institutional design of the public sector disaster response.

The materialisation of environmental risks in Spain is frequent due to droughts, wildfires, floods and meteorological phenomena. In the case of environmental risks, the analysis presented in this Opinion is pioneering as there is no public strategy to identify, quantify and manage environmental risks to public finances. The analysis of the historical materialisation, based on publicly available sources, shows that the main environmental risks for Spain come from climatological (fires and droughts), hydrological (floods), meteorological (rainstorms and extreme temperatures) phenomena. Other risks such as geophysical or biological risks are much less frequent, although their materialisation translates into extreme events such as, for example, the

COVID-19 pandemic. In addition, some limitations are identified in the sources of information on disasters, in relation to the data required for a comprehensive analysis of fiscal risks.

The fiscal cost of the materialisation of environmental risks in terms of support for victims and damage repair is significant. With regard to the quantification of the fiscal cost of the materialisation of environmental risks, the results show a significant impact of hydrological and climate risks, both in terms of emergency works to repair damage and in terms of support and subsidies to victims. In the period 2005-2023, these costs would have amounted to some €3.6bn at 2023 prices. Compensation from the Insurance Compensation Consortium (CCS) for hydrological, meteorological and geophysical risks is also very high, amounting to around €7.8bn at 2023 constant prices between 2005 and 2023. In addition, the response to the COVID-19 pandemic would have cost more than €35bn at 2023 prices. These results only constitute an approximation of the fiscal cost of environmental risks, based on the sources available and the databases developed to draw up this Opinion. Accordingly, a more in-depth study is required, expanding the sources, ideally recording actually spending executed, and extending the analysis to other natural phenomena such as geophysical and meteorological phenomena.

The high frequency of natural disasters and their fiscal cost make it advisable to analyse and actively manage these environmental risks. In Spain, there are environmental risk mitigation instruments that limit deviations in fiscal variables due to the fiscal cost of disasters. For example, compensation for extraordinary natural disaster risks settled by the CCS is financed through surcharges on insurance premiums, which mutualises risks. However, there is room for improvement in the analysis and management of these risks by: i) improving the information available on natural disasters, which is, in general, extensive but very fragmented; and ii) making the fiscal costs of disasters explicit in the budget, for better monitoring and design of mitigation measures.

Legal action against the State

Legal actions against the State have also constituted a significant fiscal risk. The analysis of legal actions against the State presented in this Opinion shows that in recent years they have represented a significant risk for GG finances. In the last decade, numerous court rulings have been unfavourable to the interests of the State, mainly affecting taxes such as the Hydrocarbons Tax (HT), Personal Income Tax (PIT), Non-Residents' Income Tax (NRIT), Corporate Income Tax (CIT), the Water Tax (WT), the Tax on the Increase in Value of Urban Land (TIVUL) and penalties related to the declaration of assets abroad. However, litigation has also been considered in relation to non-tax matters, such as the financing of the electricity social voucher and compensation for

the closure of the Castor gas storage facility. The high cost of compensation and indemnities stemming from unfavourable rulings evidences the negative impact of these cases on fiscal stability.

The court rulings analysed reveal some recurring errors responsible for the materialisation of certain fiscal risks. These include the inappropriate use of legal instruments, especially the royal decree-law (RDL), which has led to several rulings of unconstitutionality, as in the case of Corporate Income Tax (RDL 2/2016 and RDL 3/2016) and the compensation for the closure of the Castor gas storage facility (RDL 13/2014). Furthermore, the overreaching of regulations with respect to what is regulated in the law has given rise to two important rulings, such as the one related to the Water Tax and the ruling in favour of Endesa for energy remuneration. In addition, there are matters that have been the subject of repeated appeals for similar reasons, such as the first three financing schemes for the electricity social voucher (2009, 2014 and 2017), annulled for being discriminatory, or the regional tax rates for the Tax on Retail Sales of Certain Hydrocarbons, whose incompatibility with European regulations led to its annulment in 2014 and again in 2024.

Recent unfavourable rulings against the State may entail an additional fiscal cost in the coming years. Several unfavourable rulings have recently been handed down against the GG which could amount to large settlement payments, the effect of which is likely to extend to 2024 and beyond. In addition, there are still legal risks pending due to the numerous lawsuits under way, which could exacerbate the headline deficit in the coming years, including international energy arbitration, litigation in the transport sector and tax issues still to be resolved in national and international courts.

This illustrates the need for the Government to implement prudent fiscal policies and adopt strategies that minimise exposure to these lawsuits. In this regard, the final section of this Opinion contains a series of proposals drawn up by AIReF. Some of these proposals are of a preventive nature, focused on avoiding the filing of litigation, while others seek to reduce its impact once proceedings have commenced in order to limit the effect on the public deficit. Proposals have also been made to improve the transparency of information on legal proceedings under way and on the estimated effects of their resolution.

The Contingency Fund as a tool for mitigating fiscal risks

Finally, the Opinion also analyses the functioning of the Contingency Fund, which is the main mitigation tool considered in the General Budgetary Law to address unexpected spending. Its inclusion in the General State Budget (GSB) has helped reduce deviations from initially planned spending by absorbing

unexpected spending from extraordinary situations, such as natural disasters and the pandemic. This has prevented unplanned excessive increases in spending and has ultimately facilitated better control of the public deficit.

However, the analysis finds that, while fulfilling its risk mitigation function, a significant part of the spending financed from the Contingency Fund is of a recurrent nature. This is the case for peacekeeping operations or the tax allocation for activities of social interest. The sum of the categories of discretionary spending, unrelated to shocks of an unexpected nature, commits, on average, 43% of the Contingency Fund allocated annually in the GSB, limiting in that proportion the capacity of the fund to meet truly unexpected spending that may arise during the year and increasing the risk of deviations in budgetary execution.

Discretionary use of the Contingency Fund increases the risk of deviations and compromises budget transparency. On the one hand, financing discretionary spending from the Contingency Fund reduces the funding available to address fiscal risks, reducing the effectiveness of the fund and increasing the risk of deviations in budgetary execution. This, in turn, increases the likelihood of non-compliance with fiscal rules. On the other hand, this practice leads to a lack of transparency in the preparation of the GSB. By not adequately provisioning these items from the outset, the approved budget does not accurately reflect the actual spending planned, giving a distorted picture of the amount that will finally be executed at year-end.

This practice weakens the effectiveness of the fund as a fiscal risk management tool, limiting its impact on mitigating fiscal risks. The recurrent use of the fund to finance discretionary spending, such as peacekeeping operations or tax allocations for activities of social interest, compromises its ability to fulfil this purpose. These categories, which represent a significant share of the fund, reduce the room for manoeuvre in the face of truly unexpected spending and increase the risk of breaching fiscal rules.

The analysis of macroeconomic, environmental and legal action risks shows that there is room for improvement in risk management. Based on the conclusions derived from this analysis, measures and strategies are proposed to improve the analysis of fiscal risks and mitigate their impact. Some of these proposals are preventive in nature, focused on avoiding risk. Others seek to reduce their impact once they have started to limit the effect on the public deficit. The report also lists a series of proposals to improve the sources of information to further enhance the quantification of fiscal risks and anticipate their impact.

Proposals

Proposals to improve macroeconomic risk management

Given the importance of macroeconomic fiscal risks, it is proposed to improve the analysis of forecast errors as a source of macroeconomic risks and to include an analysis of the forecast errors in macroeconomic and fiscal projections and the correlation between the two in fiscal planning reports (Medium-Term Structural-Fiscal Plan and its updates, Budgetary Plan and General State Budget). It is also considered that AIReF, in the context of the new European economic governance, should be given the power to carry out a systematic evaluation of the quality of the macroeconomic forecasts and budgetary forecasts contained in the General Government's annual and multi-year fiscal planning. In addition, it is proposed that these reports should quantify the macroeconomic risks underlying macroeconomic and fiscal forecasts by conducting scenario or sensitivity analyses of shocks or changes in exogenous assumptions. Debt sustainability analyses should incorporate the formulation of stochastic projections.

Proposals for improving natural disaster risk management

In order to enhance the analysis of the historical materialisation of natural disaster risks, a set of measures is considered to improve the sources of information related to wildfires, droughts, earthquakes and floods, and to make them more exhaustive. It is also proposed to make the cost of repairing natural disaster damage to public infrastructure explicit in the budgets of the Ministry for the Ecological Transition and Demographic Challenge and of the Ministry of Transport and Sustainable Mobility, and the cost of support and subsidies for victims in the budget of the Ministry of the Interior. Lastly, it is also considered desirable to create a database on the fiscal cost of natural disasters and for both the Central Government (CG) and the Autonomous Regions (ARs) to draw up fiscal risk management strategies for environmental risks that may have a budgetary impact. These strategies should be made public and revised periodically.

Proposals to mitigate the risks associated with legal action against the State

To prevent legal action and reduce the likelihood of court rulings against the State, it is proposed that the Ministry of Finance, or the competent public authority, strengthen the evaluation of the potential financial and legal impact before implementing significant changes in fiscal and economic policies and consult with European or international bodies to avoid litigation stemming from non-alignment with European regulations. This analysis should entail the identification of potential claims and background studies to avoid recurrent errors.

Proposals to minimise the impact of court rulings on the deficit

To mitigate the impact of unfavourable court rulings, it is essential for the State to adopt a proactive judicial strategy, acting swiftly to avoid prolonged litigation and increased spending. In the event that claims are filed, the likelihood of success should be studied and, if necessary, the regulations should be amended to reduce the time during which they remain in force and during which refunds are generated. This analysis should take into account signals issued by bodies such as the European Commission, which often warn about potential breaches of EU law, as well as details of previous court rulings and case law of the Court of Justice of the European Union (CJEU).

Proposals to improve transparency of information on fiscal risks stemming from court rulings

Currently, the information on court rulings and their effects on the public deficit is limited: it is partial, outdated and dispersed. The data are spread over several documents, which makes them difficult to consult and analyse. To improve the transparency of risks arising from court rulings, it is proposed that the Ministry of Finance create a centralised database that integrates all the information on the main court rulings that could have a significant impact on the public deficit.

Use of the Contingency Fund

As for the Contingency Fund, AIReF considers a series of proposals aimed at improving its effectiveness and ensuring its proper use as a tool for mitigating fiscal risks. These proposals focus on restricting the use of the fund for recurrent spending, thus making it possible to preserve the funding to cater exclusively for non-discretionary unexpected spending and strengthen the fund's capacity to fulfil its main function.

Proposals to improve fiscal risk management: drafting a Report on Fiscal Risk

Irrespective of the analyses made by AIReF through its opinions, the effective management of fiscal risks should ideally be carried out by the GG authorities that may be affected by the materialisation of fiscal risks and which have the power to establish mitigation strategies. To this end, the proposal made in (AIReF, 2021b) is reiterated and developed, aimed at drawing up a Report on Fiscal Risks that includes the potential risks that may affect fiscal projections. It should include information on the risks arising from the financial sector, the indebtedness of public enterprises and of local and regional authorities, natural disasters, public-private partnerships, public guarantee programmes, court rulings and legal actions against the State and asset and liability management. Once the fiscal risks have been identified and analysed, it

would be desirable to allocate probabilities of their occurrence and a quantification of their impact.

The risk mitigation strategy should also be made explicit, either for the whole or for individual risks, and the report on specific risks should be integrated into budgetary planning instruments, so that the fiscal risk report is updated with the Medium-Term Structural-Fiscal Plan and its updates and with the General State Budget or the Budgetary Plan.