PRESS RELEASE
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AIReF ASSERTS THAT ANALYSIS OF FISCAL RISKS IS FRAGMENTED AND INCOMPLETE AND MAKES PROPOSALS TO IMPROVE IT

- **The Independent Authority for Fiscal Responsibility (AIReF) has published its Opinion on Fiscal Risks, a pioneering analysis in Spain of the most relevant risks to public finances: macroeconomic, environmental and legal actions against the State**

- **AIReF maintains that the analysis of fiscal risks is crucial for the sustainability of public finances and for improving medium-term planning**

- **AIReF carries out a study of macroeconomic shocks and their fiscal impact and proposes to improve the analysis of forecast errors and quantify the risks underlying macroeconomic and fiscal forecasts**

- **AIReF notes that the total fiscal cost of environmental risks materialised between 2005 and 2023, including the pandemic and at 2023 prices, would have been approximately €47.157bn and considers improving the quantification of these risks, the explicitness of fiscal costs and the design of mitigation measures**

- **AIReF indicates that court rulings unfavourable to the interests of the State had an average cost of €1bn per annum in the period 2014-2023, and proposes measures to prevent legal disputes, minimise their impact and improve transparency**

- **AIReF sees the Contingency Fund as a useful tool for mitigating fiscal risks, but detects that 43% of the spending financed under this fund is not related to unforeseen shocks and proposes limiting its use to improve the effectiveness of the instrument**

- **AIReF reiterates the proposal made in the Opinion on Fiscal Transparency regarding the need to draw up a global fiscal risk report that contains the potential risks that may affect fiscal projections**

The Independent Authority for Fiscal Responsibility (AIReF) published the Opinion on Fiscal Risks on its website today. This is a pioneering analysis in Spain of the most relevant fiscal risks to public finances, given the economy's vulnerability to unexpected shocks such as the financial crisis, the sovereign debt crisis, the COVID-19 pandemic, the energy crisis, and armed conflicts. AIReF asserts that the analysis of these risks is fragmented and incomplete in Spain, highlighting the

need to make adequate provisions to ensure sustainability and making proposals to improve this analysis.

AIReF uses the definition of fiscal risk from the International Monetary Fund (IMF) Fiscal Transparency Handbook, which defines fiscal risks as factors that may cause fiscal results to deviate from forecasts. AIReF points out that analysing these risks is crucial for the sustainability of public finances, since their materialisation can entail a significant cost which, according to international evidence, could account for 10% of GDP. In a global context where the frequency and intensity of fiscal risks may increase, AIReF considers that their management contributes to improving the medium-term planning on which the new European fiscal framework is based and guarantees more robust public finances and greater macroeconomic stability.

In its opinion, AIReF concludes that the analysis of fiscal risks is fragmented and incomplete in Spain. It aims to identify the sources of certain fiscal risks, quantify their potential fiscal cost, and diagnose aspects for improvement in analysis and management. Specifically, AIReF focuses on the risks considered most important: macroeconomic risks, which tend to be the most frequent and have the most significant impact on public accounts; environmental risks, the frequency of which has increased recently; and risks of legal action against the State. It also analyses the Contingency Fund as the main instrument for mitigating fiscal risks. The analysis will now be extended to other specific risks such as those derived from the financial sector, public enterprises and public guarantees. It will also continue to look more closely at environmental risks. The opinion does not analyse the impact of factors that affect the long-term sustainability of public finances, such as climate change or demographic factors, which are incorporated into the Opinion on Long-term Sustainability that AIReF will publish in March 2025.

Macroeconomic risks

Macroeconomic risks materialise when unforeseen macroeconomic shocks cause unexpected deviations in fiscal results. These risks can materialise in the form of extreme events (the financial crisis of 2007, the sovereign debt crisis of 2012 or the COVID-19 crisis) or continuously in the face of unforeseen changes in the domestic and international economic situation due to unanticipated factors such as changes in interest rates, exchange rates, commodity prices or economic policies.

Within the framework of analysing these risks, AIReF has studied the Government's macroeconomic and fiscal forecast errors in the period 2000-2023 to approximate the materialisation of macroeconomic risks. The results show that the most significant errors in nominal GDP, as the primary determinant of the fiscal position, relate to financial conditions, the effect of shocks on the costs and prices of commodities, immigration shocks, the crisis associated with the pandemic and external demand shocks. To quantify these risks, AIReF is developing a macroeconometric model to identify the most important shocks that have affected the Spanish economy and their impact on fiscal variables. The results make it possible to highlight the importance of demand-side shocks. According to this analysis, precisely these types of shocks have the most significant influence on fiscal variables.

Given the frequency with which these risks have materialised in recent years, AIReF proposes to improve the analysis of forecast errors and include an analysis of the forecast errors of macroeconomic and fiscal projections and the correlation between the two in the fiscal planning reports (Medium-Term Structural-Fiscal Plan and its updates, Budgetary Plan and General State Budget). Furthermore, it is proposed that AIReF, in the context of the new European economic governance, be allocated the power to perform a systematic evaluation of the quality of the macroeconomic and budgetary forecasts of the General Government. In addition, these reports are proposed to quantify the macroeconomic risks underlying the macroeconomic and fiscal forecasts, carrying out scenario or sensitivity analyses to shocks or changes in exogenous assumptions.

Environmental risks

Environmental fiscal risks stem from natural disasters that result in fiscal costs for the General Government through two main channels: the costs of repairing damage and the measures to support those affected. AIReF's analysis is groundbreaking, as no public strategy in Spain identifies, quantifies and allows the management of environmental risks to public finances. Using available public sources, AIReF shows that the main risks for Spain come from climatological phenomena (wildfires and droughts), hydrological phenomena (floods) and meteorological phenomena (rainstorms and extreme temperatures). Other risks, such as geophysical or biological phenomena, are much less frequent, although their materialisation translates into extreme events such as the COVID-19 pandemic.

AIReF notes that the fiscal cost of the materialisation of environmental risks is significant. Between 2005 and 2023, the total fiscal cost of the disasters considered, including the pandemic, would have been €47.157bn. These results only include an approximation based on available sources and the databases developed to draw up this opinion, so it would be necessary to carry out a more in-depth study, expanding the sources and extending the analysis to other events such as geophysical or meteorological phenomena.

AIReF considers that the information available on natural disasters should be improved, which is generally extensive but very fragmented; the fiscal costs of disasters should be made explicit in the budget, for better monitoring; and mitigation measures should be designed. Specifically, AIReF proposes improving the sources of information related to wildfires, droughts, earthquakes, floods, and making them more exhaustive. It also proposes to specify the cost of repairing damage to public infrastructure caused by natural disasters in the budgets of the Ministry for Ecological Transition and the Demographic Challenge and of the Ministry of Transport and Sustainable Mobility, and the cost of support and subsidies to victims in the budget of the Ministry of the Interior. Lastly, it is also considered desirable to create a database of the fiscal cost of natural disasters, and for both Central Government and the Autonomous Regions to develop management strategies that may have a budgetary impact.

Legal action against the State

On another note, an analysis of lawsuits against the State shows that they have represented a significant risk to public finances in recent years. In the last decade, numerous court rulings have been unfavourable to the interests of the State, affecting taxes such as the Hydrocarbon Tax (HT), Personal Income Tax (PIT), Non-Resident

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. Litigation has also been considered concerning non-tax matters, such as financing the subsidised electricity voucher and compensation for closing the Castor gas storage facility. AIReF estimates that in 2014-2023, court rulings unfavourable to the interests of the State have resulted in an average cost of €1bn per annum.

In addition, recurrent errors have been detected that are responsible for the materialisation of certain fiscal risks, such as the inappropriate use of legal instruments, especially Royal Decree-Laws (RDL), which has led to several rulings of unconstitutionality, such as in the case of Corporate Income Tax and the compensation for the closure of the Castor gas storage facility. Furthermore, the overstepping of regulations with regard to what is established by law has given rise to two important rulings: the first concerning the Water Tax and the second in favour of Endesa for energy remuneration. In addition, some matters have been the subject of repeated appeals on similar grounds, such as the first three financing regimes for the subsidised electricity voucher (2009, 2014 and 2017), cancelled as discriminatory, or the regional tax rates of the Tax on Retail Sales of Certain Hydrocarbons, which are incompatible with European regulations, leading to their cancellation in 2014 and again in 2024.

AIReF also notes that unfavourable court rulings have recently been handed down against the General Government involving significant amounts, the effect of which is expected to extend to 2024 and subsequent years. In addition, there are still pending legal risks due to the numerous ongoing processes, which could aggravate the headline deficit in the coming years, including international arbitrations in the field of energy, disputes in the transport sector and tax issues yet to be resolved in national and international courts.

According to AIReF, this illustrates the need for the Government to implement prudent fiscal policies and adopt strategies that minimise exposure to such litigation. Specifically, to prevent legal conflicts and reduce the likelihood of rulings against the State, it is proposed that the Ministry of Finance, or the competent General Government authority, reinforce the evaluation of the potential financial and legal impact before implementing significant changes and consult with European or international organisations to avoid litigation stemming from the lack of alignment with European regulations. AIReF proposes adopting a proactive legal strategy to mitigate the impact of unfavourable rulings, acting quickly to avoid protracted litigation and increased spending. AIReF also proposes that the Ministry of Finance create a centralised database that integrates all information to improve transparency.

The Contingency Fund

Lastly, the opinion analyses the functioning of the Contingency Fund as a valuable tool for mitigating fiscal risks. AIReF notes that a significant part of the spending financed by the Contingency Fund is recurrent, such as peacekeeping operations or tax allocations for activities of social interest. Specifically, the sum of the recurrent expenditure categories commits, on average, 43% of the Fund allocated annually in the budget, limiting its capacity to meet truly unforeseen expenses in that proportion.

According to AIReF, the discretionary use of the Contingency Fund increases the risk of deviations and compromises the transparency of the budget. On the one hand, it reduces

the revenue available to address fiscal risks, and on the other hand, it generates a lack of transparency in the budget preparation by not adequately funding these items from the outset. According to AIReF, this practice weakens the fund's effectiveness as a fiscal risk management tool, reducing its room for manoeuvre. In this regard, it proposes restricting its use to recurring spending.

Lastly, AIReF reiterates the proposal already made in the Opinion on Transparency regarding the need to prepare a fiscal risk report to include the potential risks that may affect fiscal projections. This should include information on the risks arising from the financial sector, the indebtedness of public companies, territorial entities, natural disasters, public-private partnerships, public guarantee programmes, court rulings and legal action against the State and the management of assets and liabilities, as well as a quantification of their impact. The risk mitigation strategy should also be made explicit.