REPORT ON THE MEDIUM-TERM STRUCTURAL-FISCAL PLAN 2025-2028

REPORT 51/24

Executive Summary

November 5th, 2024

AIReF

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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EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility (AIReF) must report on the Medium-Term Structural-Fiscal Plan (MTP) that replaces the Stability Programme Update in the new European fiscal governance framework. However, the draft General State Budget for 2025, as well as the Budgetary Plan, have not yet been presented, exceeding the legally established dates. Accordingly, with the limited information available to date, AIReF reports on the MTP as a core element of the new European fiscal framework. Together with this report, AIReF publishes the Report on the Main Lines of the Draft Budget of the General Government (GG) for 2025, in which it updates its macroeconomic and fiscal forecasts at constant policies up to 2029, which serve as the basis for the analysis of the MTP.

While the MTP may be in line with the European Commission's June guidelines, it does not provide sufficient detail to be considered a useful medium-term budgetary planning tool. Firstly, it does not contain any information on the budgetary scenario beyond 2024, neither for the General Government sector as a whole nor by sub-sector. Nor does it include a detailed macroeconomic outlook beyond 2026. Secondly, although it contains a regulatory commitment to the evolution of primary expenditure net of revenue measures, the MTP does not explicitly state how this commitment is to be met, either in the form of specific measures or broad lines of action, or the degree of effort to be made by each sub-sector. In short, the content of the MTP is a clear step backwards with regard to the information in the Stability Programme Update - the document it replaces as the central element of the Member States' medium-term budgetary planning.

Consequently, AIReF's analysis of the MTP is based on stylised simulations of a scenario at constant policies and a second scenario in which it is assumed that the MTP commitment will be met, maintaining the rest of AIReF's forecasts on revenue growth, interest, etc. unchanged.

In addition to the lack of information, the plans have some methodological peculiarities. Specifically, the need for European fiscal policy to return to a framework of rules, after several years of suspension, has meant that, in this first round, the long-term macroeconomic scenarios that underpin the debt sustainability analyses and determine the required structural adjustment and the spending path are based on certain technical assumptions and methodologies that were not designed for this purpose and which, in practice, reveal some inconsistencies: e.g. the upward profiles of potential growth in the long term inconsistent with demographic ageing.

In terms of national ownership, one of the elements that conceptually underpins the new framework of rules is differentiation by country. AIReF has reiterated that this is reinforced not only by giving countries the initiative to shape their own fiscal strategy but also by encouraging their preparation to be transparent, consensual and through dialogue with the main national stakeholders. In this regard, the lack of involvement of the Autonomous Regions (ARs) and Local Governments (LGs), the absence of presentation or discussion of the Spanish plan in Parliament, and the lack of participation of AIReF in the preparation process - something that has happened in other countries - all stand out. The way in which the medium-term structural-fiscal plans are prepared and drawn up, their content and ambition are decisive in terms of putting the final goals of the reform into practice.

Lastly, AIReF would like to point out that there is still a significant degree of institutional uncertainty that stems from both the implementation of the new European fiscal framework and the national fiscal framework. On the one hand, certain issues exist that are currently being negotiated and which will be turned into the code of conduct for implementing the European fiscal framework, referring to essential elements for the effectiveness of the new framework such as the definition and treatment of discretionary revenue measures or the functioning of the annual and cumulative control account.

As for the national framework, the uncertainty stems, firstly, from the need to apply the new European fiscal framework to the reality of the General Government in Spain. The European legislation explicitly states the need to transpose the new European fiscal framework, although it grants a deadline of December 2025. However, the different GG authorities are already drawing up their budgets, which must be compatible with the commitments of the MTP, although the plan itself does not contain any detail on the application of its commitments in each sub-sector. Moreover, no proposals have been made for the reform of the national fiscal framework to date, nor has there been any indication of how to guarantee compliance with the MTP's commitments through the current framework.

Secondly, the lack of approval of the stability targets applicable in the coming years according to the current regulations hampers the budgetary processes of all GG authorities. To date, only the reference rate of the expenditure rule is known: 2.6% for 2024, 3.2% for 2025, 3.3% for 2026 and 3.4% for 2027.

Given this lack of definition of the national fiscal framework, there is still a risk that governments will draw up budgets that do not comply with the European and national fiscal framework, as has also been pointed out in previous reports. In this regard, it should be recalled that AIReF has already warned of the risk of non-compliance with the expenditure rule in 2024 and 2025 for a large number of the GG authorities.

In view of the above, AIReF recommends that the Ministry of Finance should take advantage of the transposition of the Directive on national fiscal frameworks to design a credible and effective medium-term budgetary framework that ensures the coherence, consistency and effectiveness of the national fiscal framework. AIReF also makes recommendations to adapt the national expenditure rule to the European expenditure rule, both in its practical application and through the necessary regulatory changes.

Analysis of the Medium-Term Structural-Fiscal Plan

As already stated, AIReF's analysis of the MTP is based on stylised simulations of AIReF's scenario at constant policies, to which a second scenario is added in which it is assumed that the MTP commitment will be met in terms of net expenditure, maintaining the rest of AIReF's projections unchanged.

The MTP is based on a short-term macroeconomic scenario that the Government is drawing up for the period 2024-2026 and which was already endorsed by AIReF on September 28th, albeit with many caveats because the request for endorsement took place in the middle of the National Statistics Institute’s (INE) statistical revision process and, above all, because of the total lack of information on the fiscal scenario of the MTP. The macroeconomic scenario underpinning the MTP is more favourable after 2025 than that estimated by AIReF in the short term. The most significant discrepancies can be seen in the forecast of the deflators. Specifically, the macroeconomic scenario of the MTP considers an increase in real economic activity of 2.7%, 2.4% and 2.2% in the period 2024-2026. AIReF forecasts higher growth in volume terms than the Government for 2024 (2.9%), but not so in 2025 and 2026, when AIReF, in its scenario at constant policies, projects growth of 2.3% and 2% respectively, such that over the period as a whole the discrepancies are practically non-existent. In contrast, the GDP deflator forecasts, which in the new framework play a crucial role in the calculation of the fiscal adjustment, are more optimistic for 2025 and 2026, such that over the period as a whole, a cumulative discrepancy of almost 1 percentage point is generated. As a result, short-term nominal growth is more favourable than AIReF's forecast.

For its part, the long-term macroeconomic assumptions of the MTP are not very different on average from those projected by AIReF. However, there is higher growth in deflators and a lower cost of servicing debt. Furthermore, the upward profile of potential GDP growth profile forecast by the Government is difficult to explain in the context of expected demographic ageing.

At a fiscal level, AIReF bases its analysis on a complete fiscal scenario drawn up for the years 2024-2029. On the basis of this scenario, AIReF considers that the withdrawal of the measures will enable the General Government deficit to be reduced to 2.7% in 2025, rising, as from 2028 to 2.9% of GDP in 2029 in the absence of additional measures. The sustainability analysis indicates that until 2029, debt maintains a downward path due to nominal growth, although its fall would slow to stand at 98% of GDP in 2029. These macroeconomic and fiscal forecasts have been prepared under the assumption of constant policies and thus do not incorporate the adjustment path commitment contained in the MTP due to a lack of detail on its implementation.

The MTP contains a GG growth commitment of primary expenditure net of revenue measures of an annual average of 3% between 2025 and 2031. This is equivalent to cumulative growth of 23.3% until 2031 and with a downward profile over time (net expenditure growth of 3.4% on average from 2025 to 2028. This commitment is on average 0.3 points higher than the reference trajectory presented by the European Commission in June and its time profile is also different.

The analysis of the path of growth in expenditure net of revenue measures shows that it is necessary to adopt additional measures to those contained in AIReF's scenario at constant policies to ensure its compliance. While the MTP forecasts average growth of 3% in the period 2025 to 2031, AIReF's scenario estimates an annual average of 3.6%. Furthermore, there are also differences in the time profile.

With the exception of 2025, AIReF's scenario at constant policies shows higher rates of growth in net expenditure than the MTP, with the difference being greater at the end of the period. This means no additional measures would be necessary in 2025 to comply with the MTP forecast. However, between 2026 and 2028 - the end of the plan period - additional measures, either on the expenditure or revenue side, would be needed of around 0.2 points of GDP per annum. Between 2029 and 2031, the additional measures needed to achieve the MTP forecast would be between 0.3 and 0.4 points of GDP.

Alternatively, AIReF considers a scenario in which the evolution of net expenditure follows the forecast set out in the MTP until 2031, starting from the closure forecast by AIReF in 2024. As from 2031, AIReF applies its long-term revenue and expenditure forecasts until the deficit and debt path is completed up to 2041. As a result of lower net expenditure than in the scenario of constant policies, the government deficit would also be structurally reduced such that in 2031, the deficit would be 1.6% of GDP. This figure is higher than in the MTP, at 0.8% of GDP, due to differences in both revenue forecasts and discretionary revenue measures. The lack of detail on these variables in the MTP prevents the proper identification of the source of the discrepancies.

These differences widen to 2041, with a deficit in the MTP of 2% of GDP compared with 3.3% in AIReF's adjustment scenario. In this case, the differences are based on the methodologies used and on higher spending on interest associated with a higher level of debt. Whereas AIReF carries out a complete exercise of the revenue and expenditure forecasts, as contained in the Opinion on the Sustainability of the General Government, the MTP follows the methodology of the Commission's sustainability analysis, maintaining the structural primary balance constant and incorporating the cost of ageing calculated in the Commission's Ageing Report and the impact of the revenue measures on the pension system.

An alternative exercise is to estimate how much net expenditure could grow under AIReF's macroeconomic and fiscal scenario to reach the fiscal balance in 2031 contained in the MTP, at 0.8% of GDP. Respecting the time profile of the MTP and starting from the closure forecast by AIReF, if expenditure net of revenue measures were to grow by an annual average of 2.8% between 2025 and 2031 instead of the 3% commitment, the deficit would stand at the figure estimated by the MTP in 2031.

AIReF has also noted in successive reports the relevance of 2024 from the point of view of sustainability, as it is the starting point from which the new European framework is to be applied. In this regard, AIReF forecasts growth in net expenditure of 4.1% in 2024 compared with the 5.3% commitment contained in the MTP, which in turn is double the 2.6% growth recommended to Spain by the European Council. If the growth forecast in the MTP materialises, AIReF estimates that the deficit in 2024 will rise to 3.5% of GDP. In this case, the deficit that would be reached in 2031 with the MTP growth in expenditure forecast would stand at 2% of GDP and the level of public debt in 2041 would stand at 95.8% of GDP, showing an upward profile at the end of the period. If, in contrast, AIReF's forecast is finally met in 2024, depending on how the functioning of the control account in European legislation materialises, this would provide a margin against possible deviations in subsequent years. Accordingly, the result finally attained is crucial to guarantee the commitment to maintain a deficit below 3% and the debt reduction target until 2041.

Implications for the sustainability of public accounts

These differences in the fiscal balance forecast are also reflected in the evolution of debt. The debt reduction estimates considered by the Government in the MTP are very favourable compared with those of AIReF. Specifically, the Government's forecast is reduced by more than 40 points of GDP in the adjustment scenario, to stand at 76.8% of GDP in 2041.

AIReF, for its part, in the scenario at constant policies, places debt at 108.9% in 2041. However, in the adjustment scenario, it would not be reduced as much as the government envisages. The application of the rates of evolution of net expenditure of the fiscal commitment in the period 2025-2031, together with the rest of the macro-fiscal variables projected by AIReF (tax revenue, growth, interest rates), imply a reduction in the debt-to-GDP ratio of 21.4 points with respect to the scenario at constant policies at the end of the period, placing it at 87.5% of GDP in 2041.

Accordingly, under AIReF's revenue forecasts, compliance with the spending path commitment contained in the MTP, although it would represent progress in terms of sustainability, does not in itself guarantee the deficit and debt reduction contained in the MTP.