REPORT ON THE MAIN LINES OF THE GENERAL GOVERNMENT BUDGET FOR 2025

REPORT 52/24

Executive Summary

November 5th, 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.

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EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility (AIReF) must report on the main lines of the draft budget of the General Government (GG). AIReF must also report on the Medium-Term Fiscal and Structural Plan (Spanish acronym: PFEMP) that replaces the Stability Programme Update in the new European fiscal governance framework. However, the draft General State Budget for 2025 and the Budgetary Plan have not yet been presented, exceeding the legally stipulated dates. Accordingly, with the limited information available to date, AIReF updates its macroeconomic and fiscal forecasts at constant policies up to 2029 and analyses the main lines of the budgets of the Autonomous Regions, which, for yet another year, also include a medium-term fiscal scenario at constant policies, as well as the Report on Local Governments (LGs) subject to individual monitoring. At the same time, AIReF presents its Report on the Medium-Term Fiscal and Structural Plan 2025- 2028 in a separate document.

AIReF received from the Government the request for endorsement of the macroeconomic scenario for 2025 and 2026 that accompanies the Draft General State Budget for 2025 (GSB-2025) and the Medium-Term Structural-Fiscal Plan. AIReF endorsed the Government's economic scenario on September 24th, highlighting strong limitations on this occasion derived, among other factors, from the lack of information on the economic policy measures that will need to be designed to meet the requirements of the European fiscal framework.

In its macroeconomic scenario, AIReF notes that the Spanish economy maintains a high rate of growth in 2024, with real GDP growth of 2.9% expected this year. For 2025 and 2026, GDP growth rates are projected to be 2.3% and 2%. In the following years, GDP growth will gradually converge to its potential, with an increase of 1.6% in 2029. These rates are similar to those forecast by the Government for the period 2024-2026, of 2.7%, 2.4% and 2.2% respectively. However, AIReF notes that, due to a lack of information, its scenario does not include the possible fiscal adjustment measures that the Government will need to design to meet its commitments under the European fiscal framework. Furthermore, the Government is projecting higher growth of the deflator than AIReF such that the nominal GDP growth forecast is somewhat optimistic overall, albeit within the probability bands.

At a fiscal level, AIReF considers that the withdrawal of the measures will make it possible to reduce the General Government deficit to 2.7% in 2025, rising to 2.9% in 2029 in the absence of additional measures as from 2028.

For its part, the sustainability analysis indicates that debt will continue to fall to 98% of GDP in 2029, albeit at a significantly slower pace than in recent years due to the slowdown in nominal economic growth.

These macroeconomic and fiscal forecasts have been prepared under the assumption of constant policies and thus do not incorporate the adjustment path committed to in the PFEMP, due to the absence of detail on its implementation.

A significant degree of institutional uncertainty remains, stemming from both the implementation of the new European fiscal framework and the national fiscal framework. Regarding the national framework, the uncertainty stems from the need to apply the new European fiscal framework to the reality of the General Government sector in Spain. Secondly, the lack of approval of the stability targets applicable in the coming fiscal years in accordance with 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 GG authorities will draw up budgets that do not comply with the European and national fiscal frameworks, 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 for a large number of the General Government authorities and it states the same in this report for 2025.

The medium-term macroeconomic scenario

The Spanish economy continues to show high growth in an adverse international environment, marked by the stagnation of the main European economies. Against this backdrop, AIReF has revised upwards the growth forecast for 2024 to 2.9%, compared with the estimate of 2.3% made in July. In a scenario at constant policies, AIReF expects growth to slow to 2.3% in 2025 and 2% in 2026 and gradually decline to 1.5% in 2029. This downward profile is mainly due to a weaker boost from demand associated with a less expansive fiscal policy and the dissipation of the effects on public investment associated with the RTRP. Furthermore, although AIReF's scenario considers that immigration flows will continue to contribute to economic growth in the short term, in the medium term this effect will ease as the inflow of immigration moderates. The Government's macroeconomic scenario considers real GDP growth of 2.7% in 2024, 2.4% in 2025 and 2.2% in 2026, rates that hover around the central probability bands estimated by AIReF's own forecasts.

As regards prices, AIReF projects a comparatively faster slowdown in the GDP deflator than that of the Government, in line with the recent evolution of inflation. After rising by 2.9% in 2024 and 2.3% in 2025, its rate of increase stabilises at an annual rate of 2.1%, slightly above that of the CPI. These rates are lower than those projected by the Government. In particular, the Government's deflator forecast stands at 3.1% in 2024, 2.7% in 2025 and 2.4% in 2026, 0.8 points higher over the three years in total.

Overall, the Government's nominal GDP growth forecast is identical to AIReF's in 2024, but it is more optimistic in 2025 and 2026. In fact, the Government's estimate for nominal GDP growth in 2025 and 2026 would stand at the upper end of the central range of AIReF's forecasts.

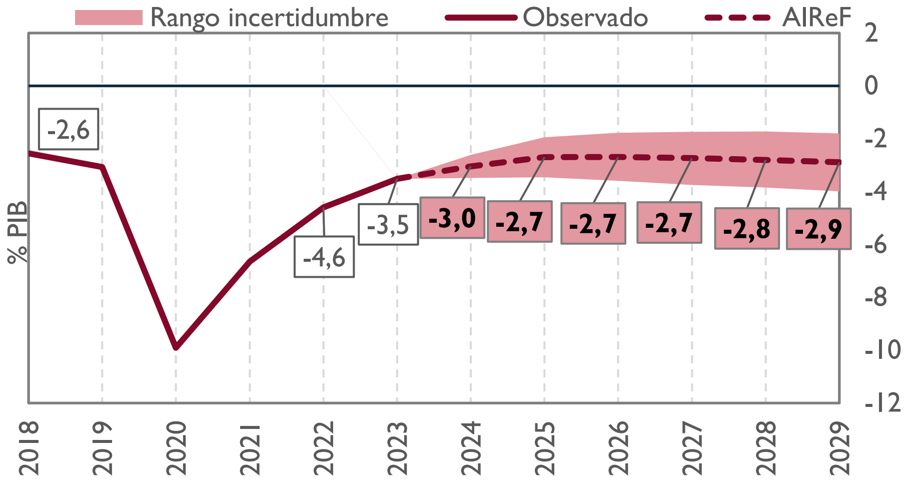
However, the Government's growth scenario is somewhat optimistic if we bear in mind that AIReF's scenario is an inertial scenario that does not incorporate the impact of the fiscal adjustment committed to, due to a lack of information on the measures that will be implemented to comply with the expenditure forecast committed to in the Medium-Term Structural-Fiscal Plan. As mentioned in the report on the endorsement, the implementation of a possible structural adjustment programme of 0.4 percentage points per annum over a seven-year horizon would reduce AIReF's forecasts for GDP growth in volume terms in 2025 and 2026 to 2% and 1.8%, respectively. Although this year should be seen as an approximation, as the specific measures to be adopted and the time profile of the adjustment are unknown, under these assumptions it can be seen how in the case of real GDP the Government's scenario remains within AIReF's central probability ranges. However, in the case of nominal GDP, the

Government's forecast would stand above the 60th percentile, which points to a certain optimism in nominal growth in the GSB scenario for 2025, while the forecast for 2026 would be above that level.

Budgetary scenario

AIReF estimates that the deficit will stabilise at 2.7% of GDP between 2025 and 2027 for the General Government sector, after closing 2024 with a deficit of around 3%. Subsequently, the deficit will start an upward path to end at 2.9% in 2029. After the withdrawal of the measures to alleviate the price and energy crisis in 2025, the margin for reducing the deficit without additional measures is exhausted.

FIGURE 1. EVOLUTION BORROWING CAPACITY/NEEDS OF GG



Source: AIReF and IGAE

Revenue, excluding the Recovery, Transformation and Resilience Plan (RTRP), will reach 41.9% of GDP in 2029, after closing 2024 at 41.4%, with growth rates slightly above 4%. After a slight reduction in the weight of revenue in 2026 due to the withdrawal of temporary measures to increase revenue, such as taxes on the energy and banking sectors, revenue will continue on an upward path in terms of the weight of GDP, mainly driven by income taxes, particularly Personal Income Tax. Taxes on production will lose some weight due to the evolution of special taxes and the withdrawal of temporary measures, while other revenue will remain stable. Social Security contributions will stabilise at around 13.3% of GDP, driven by the dynamic labour market and the measures associated with the pension reform.

AIReF estimates that expenditure, excluding the RTRP, will continue to reduce its weight of GDP until it reaches 44.1% of GDP in 2026 and then start an upward path to reach 44.8% of GDP in 2029. The rate of expenditure growth will slow due to the easing of inflationary pressures and the recovery of fiscal rules. AIReF expects the weight of social transfers to increase during this period, as a result of the growing impact of ageing on public accounts. The weight of expenditure on interest and gross capital formation will also increase, while expenditure on the compensation of employees and other expenditure will fall.

TABLE 1. EVOLUTION OF BORROWING CAPACITY/NEEDS OF GG BY SUB-SECTOR

	2023	2024	2025	2026	2027	2028	2029
BS	**-3,5**	**-3,0**	**-2,7**	**-2,7**	**-2,7**	**-2,8**	**-2,9**
CG	-2,0	-2,4	-2,0	-2,0	-2,3	-2,5	-2,5
SSF	-0,6	-0,4	-0,2	-0,2	-0,2	-0,2	-0,2
AR	-0,9	-0,3	-0,5	-0,5	-0,4	-0,3	-0,3
LG	0,0	0,1	0,0	0,0	0,1	0,1	0,1

Source: AIReF

Central Government

Continuing with the withdrawal of measures, the Central Government will reduce its deficit in 2025 to 2% after the increase in 2024 due to the settlement of the territorial financing systems. The deficit will then start an upward path to 2.5% of GDP in 2029, weighed down by the increase in the interest burden and the rise in military investment.

Social Security Funds

The deficit of the Social Security Funds is set to stabilise at 0.2% of GDP over the entire projection horizon, after recording 0.4% in 2024. Growth in spending on pensions is set to moderate once inflationary pressures that feed through directly to pension revaluation are overcome, while the weight of unemployment spending as a percentage of GDP will fall. On the revenue side, contributions will moderate their growth in the coming years in line with the evolution of employment and wages, also incorporating the impact of the introduction of the Intergenerational Equity Mechanism and the Solidarity Tax.

Autonomous Regions

According to AIReF's forecasts, the deficit of the Autonomous Regions will rise again in 2025 to -0.5% due to the normalisation of the flows of the financing system. Subsequently, the fiscal balance will improve slightly to stabilise in 2028 and 2029 at -0.3% of GDP. The evolution of revenue will be influenced by the functioning of the financing system. On the expenditure side, growth is expected to moderate once inflationary pressures ease and follow the return to fiscal rules.

Local Governments

AIReF estimates that the LGs will stabilise in the medium term at a surplus of 0.1%, after reaching zero in 2025 and 2026, once the growth in spending observed in the years of higher inflation moderates and the suspension of the fiscal rules is lifted.

Fiscal policy stance

Current estimates suggest that the primary expenditure net of revenue measures would grow in 2024 at a higher rate than that allowed by the Country Specific Recommendation (CSR) for Spain made by the European Council in July 2023. According to AIReF's forecasts, the net primary expenditure variable will grow this year at a rate of 4.1%, i.e. 1.5 percentage points higher than the recommendation. It is worth mentioning that for this same year - 2024 - the Medium-Term Structural-Fiscal Plan submitted by the Government assumes growth in nationally financed net primary expenditure of 5.3%, which exceeds the CSR as well as AIReF's estimate.

In the event that expenditure growth is close to that rate, in line with AIReF's revenue estimates, it is likely that the deficit target of 3% committed to will not be achieved in 2024, which could result in the European Commission initiating an excessive deficit procedure.

For its part, nationally financed public investment maintains its weight of GDP in 2024, although its rate of change is lower than in the previous year. This slowdown in the evolution of investment is mainly due to the constraint in defence spending in 2024, according to AIReF's current estimates.

Lastly, the discretionary fiscal effort (DFE) indicator shows that the aggregate fiscal policy stance - including expenditure charged to the NGEU funds in addition to nationally financed expenditure - would be practically neutral in 2024.

Debt sustainability

In its medium-term inertial projection, AIReF estimates a reduction in the debt ratio of 7.2 points of GDP with respect to the 2023 level, falling to 98% in 2029. The reduction in the ratio will be underpinned by nominal GDP growth (25.4 points), with the deflator making a very significant contribution (13.6 points). The public deficit contributes to the increase in debt by 16.8 points, of which 15.9 points are interest.

These projections imply a slowdown in the pace of reduction of the debt ratio, which is expected to be exhausted by the end of the decade. The moderation in the contribution of nominal growth, which will gradually fall over the period 2024-2029 (from 5.9% to 3.5%), with interest rates evolving upwards (from 2.4% to 2.9%) and the primary balance stabilising at around 0%, will result in a slowdown in the pace of reduction of the debt ratio, which is expected to be exhausted by the end of the decade.