

4Q 2020

THE SLOW PATH BACK TO RECOVERY

Macro perspectives on Spain and
its regional governments' finances

BFF Banking Group

Paseo de la Castellana 81 - 9ª planta

28046 Madrid - Spain

Communications and Institutional Relations Office

+34 912 102 151

newsroom@bffgroup.com

Author: Cristina Nogaledo Castaño, policy analyst

December 2020

NOTE TO THE READER

The present document seeks to provide an overview of the performance of the Spanish economy during the fourth quarter of 2020, thus resting on BFF Banking Group's intention of promoting a broader and constructive debate on key market aspects that shape and impact the decision making of organizations.

The assessment contained herein was produced by an external analyst for BFF Banking Group in December 2020 and it was built on available market statistics at time of reporting, which are under continuous updating. Furthermore, and in order to produce an assessment that would remain valid for the whole quarter, most figures reflect fourth quarter data and are compared and contrasted with the current developments and impacts that the global pandemic is likely to produce at the start of 2021 on the economic performance of the country and its regions.

It should also be noted that the assessment contained herein is for information purposes only and does not constitute a recommendation to invest or to carry out any trade or transaction. As it reflects theoretical opinions, its content is purely informative and should therefore not be used for portfolio or asset valuation, nor serve as a basis for investment recommendations. Neither BFF Group nor any of its affiliates, directors, employees or advisors assume any responsibility for such information, or for any unauthorized use thereof.

Index

1. The Spanish economy macro picture in 2021-2022: moving towards the post-pandemic era	7
An uneven economic recovery	7
The monetary and fiscal policies anchor the economic activity	9
2. The Spanish government macro scenario in 2021-2022 vs AIReF & Bank of Spain estimates	15
Bank of Spain 2020-2022 macro forecasts	19
A look into the future	25
3. The regional macro picture in 2020-2021	27
4. Key macro risks for the Spanish economy	31
5. Fiscal consolidation will be the main challenge for the Spanish economy	35
6. The Spanish regional deficit targets: can they be met?	44
7. The COVID-19 pandemic and the debt sustainability of the Spanish public administrations	45
8. Fiscal risks of the COVID-19 pandemic	50
9. Spanish regions' fiscal stability in the COVID-19 times	51
10. Spanish regions: the fiscal picture in 2021	60
11. The harmonization of regional taxes and the reform of the regional financing system	64
12. The financial debt status of Spanish regions	68
13. A temporary respite, but the 2022-2023 period looks challenging for regional fiscal consolidation	71
14. Local entities will also suffer the impact of the pandemic	72
15. A look at the Spanish largest local entities	74
16. State support in preventing a sharp increase in average payment time to suppliers (PMP/ATS)	78

1. The Spanish economy macro picture in 2021-2022: moving towards the post-pandemic era

The COVID-19 crisis continues to pose a fundamental challenge to public health and growth prospects. The recent worsening of the pandemic and the high degree of uncertainty that persists about its future development keeps the population plunged in an environment of uncertainty that has a very severe impact on economic activity. In just a few weeks, the perception of the evolution of most economies has turned more pessimistic as the seriousness of this second wave was confirmed, which, although it began with some delay compared to Spain, has produced stubbornly high figures in both infections and deaths in the United States and Europe.

The Spanish economy recorded a historical contraction of the gross domestic product in the second quarter of the year, higher than that of other neighboring countries due to five idiosyncratic factors: a) **the intensity of the pandemic in Spain**, which required stricter confinement measures for the population than those implemented in other countries in the immediate environment; b) **the influence of some structural characteristics of the Spanish economy**: the high specialization in activities that require greater social interaction and particularly in the added value of the commerce, transport and hospitality sector, which contributes to explain 53% of the decline of the economic activity observed in the first three quarters of the year; c) **the greater relative presence of microenterprises and SMEs**, which are more vulnerable to liquidity constraints caused by the paralysis of economic activity; d) **the duality that still persists in the Spanish labor market**, which caused almost a million temporary employees to lose their job in the first days of confinement : according to EPA, in the third quarter the destruction of temporary employment explains 85% of the difference in employment levels compared to the previous year; and finally, e) **the lesser implantation or viability in Spain of teleworking**.

An uneven economic recovery

The progressive de-escalation of the mobility restriction measures allowed the economic activity to become more dynamic than expected during the summer months. The quarterly accounting data for the third trimester of the year show that the economy's gross domestic product grew at a high rate in that period, at -16.7% q/q, in line with the most optimistic scenario by the Bank of Spain, after the 17.8% drop in the **second quarter of the year**. This dynamism was generalized to all components of demand, with very large growth in private consumption, gross fixed capital formation and exports of goods and services. This expansion occurred even though restrictions on international mobility made the influx of tourists during the summer months very moderate. Other economies in our environment also registered notable quarter-on-quarter growth.

However, the economic recovery has been a partial one, as evidenced by the fact that in the period from July to September 2020 **the level of the Spanish GDP was still 9.1% lower than at**

end-2019, prior to the outbreak of COVID-19, while in the economies of the euro area this gap was around 4%. Furthermore, the improvement in activity lost momentum as the quarter progressed due to the increase in the pace of infections over the summer. Specifically, this led to the progressive implementation in numerous countries of measures discouraging their citizens from travelling to Spain by the authorities, which had a significant adverse impact on tourism.

The recovery is also very uneven per sector and autonomous community. In activities that require greater social interaction, recovery has been modest. Particularly noteworthy is the drop in activity observed in the tourism sector during the summer months, affected by the continuous outbreaks and the imposition of restrictions on international mobility by some countries: in September there were 8.1 million overnight stays, which represents a fall of almost 80% compared to the previous year (-78% y/y). Hotel occupancy levels in the summer months barely reached 40%. This is reflected in sharp drops in activity in some regions such as the Balearic and Canary Islands, the communities most dependent on tourism.

Likewise, **the crisis is particularly affecting some segments of the population that were already more vulnerable before the crisis.** At the individual level, the impact of the crisis is also being heterogeneous since a high proportion of the jobs affected by the crisis are held by young people and women, who work to a greater extent in service sectors that involve social interaction and where the possibility of telework is less of an option. It must also be considered that these groups already showed greater financial vulnerability before the crisis, as can be seen from the Household Finance and Consumption Survey (HFCS) prepared by the European Central Bank (ECB), **which indicates that almost 40% of Spanish households do not have enough savings to survive two months covering their basic expenses.** According to this survey, among the factors that stand out for increasing the financial vulnerability of households are: being a woman, having a low level of education and being young, as well as being part of the group of low-income workers.

In Q4, the deterioration of the epidemiological situation both in Spain and - with a certain delay - in other European countries led to the implementation of new measures to contain infections. In comparison with those introduced in spring, these measures were more focused, aiming to restrict movement selectively and to limit activity in sectors involving a higher degree of social contact. In line with these measures, mobility indicators from mobile phone and road and air traffic networks available for Spain reflect a weakening in Q4 (albeit less intense than in other European economies). In addition, the conjunctural information available suggests a somewhat sharper year-on-year fall in GDP in Spain in the most recent period which, in principle, is not expected to be very pronounced, due to the selective nature of the containment measures.

The PMI indicator based on the surveys carried out with the purchasing managers of companies, which is closely related to economic activity, registered a deterioration as of September, remaining below the value of 50, thus suggesting a fall in economic activity. The deterioration was concentrated in services, which already accumulated several consecutive months of decline. In terms of consumption of durable goods, car registrations suffered a new decline in year-on-year terms. For its part, the improvement of affiliations in the private sector

stagnated and the decline in workers affected by furlough schemes (ERTE) has slowed down and there could even be increases in some regions that have implemented restrictions on hospitality activities and the restaurant segment.

The monetary and fiscal policies anchor the economic activity

In the financial sphere, **the implementation of the ECB's asset purchase programs has allowed the financing conditions of the economy to remain favorable.** European sovereign bond yields were below pre-crisis levels. In particular, the yield on the Spanish 10-year bond stands in negative territory at December 20th, five basis points (bp) below the historical low registered in August 2019. Risk premiums remain stable at levels close to those of February. Specifically, Spanish and Italian risk premiums are currently below the pre-crisis level, at 62 and 117 bp respectively (below the average for the last year).

Governments continue to deploy measures to mitigate the effects of the crisis. In the monetary field, and after noting that the recovery of the euro area is losing steam more quickly than expected, the European Central Bank, has just announced that in the coming months it will carry out a recalibration and intensification of the extraordinary measures of provision of liquidity, granting of credit and purchase of assets that it has been so far implementing in response to the crisis.

International organizations such as the International Monetary Fund and the European Commission continue to point out the need for governments to maintain an expansive fiscal policy. Likewise, European institutions have made progress in implementing the mechanisms created to deal with the crisis.

In particular, the European Commission has disbursed a total of EUR 6,000 mn to Spain in the first tranche of financial aid provided through the SURE facility (Support to mitigate Unemployment Risks in an Emergency), which is aimed at mitigating the associated cost of unemployment and partial suspension of employment schemes in EU countries.

An essential element of this response is the European Recovery Fund-Next Generation EU (NGEU), which is highly influential in determining the macroeconomic and budgetary outlook. The EUR 750 bn size of the program will be earmarked to mitigate the effects of the crisis caused by the coronavirus and to drive the structural transformation of European economies. In any case, essential aspects remain to be defined, such as the macroeconomic conditionality associated with the perception of resources (which may imply, for example, that funds are no longer received if fiscal rules are not complied with) or the degree of demand for structural reforms associated with compliance with the recommendations of the European Semester.

Figure 1 Breakdown of the Next Generation European Union Fund by component (EUR mn)

	EUR mn
Facility of recovery and resilience, of which	672.500
Loans	360.000
Transfers	312.500
ReactEU (similar to traditional structural funds but without national co-financing and with direct distribution to the Central Administration)	47.500
Horizon Europe (research program)	5.000
Invest EU (business development)	5.600
Rural development	7.500
Just transition fund	10.000
RescEU (civil protection and humanitarian aid)	1.900
Total	750.000

Source: AIReF Conclusions of the European Council in July 2020

Beyond the current quarter, **the economic outlook continues to be highly influenced by epidemiological developments**. Recent experience has shown that as for as long as as an effective medical solution to the pandemic is not available, new outbreaks requiring the adoption of containment measures will likely arise. Also, the extension of these measures over a protracted period is being accompanied by an effort by agents to adapt their behavior to the restrictions, with the aim of minimizing the effects of these restrictions on their economic decisions. However, estimating in quantitative terms the intensity of this adaptation and the learning challenges it poses, there are significant practical difficulties.

Finally, **the recent news regarding the development of several vaccinations have reduced the uncertainty about when an effective medical solution against the virus will be available**. At the same time, these developments have brought about greater awareness of the magnitude of the challenge which the production and distribution of a vast number of doses entailed to vaccinate the population at large. As a result, although the progress made in obtaining vaccines has reduced these uncertainties significantly, others persist in connection with the time horizon required for a fully successful application of an effective medical solution to enable the health crisis to be completely overcome.

Impact of the Recovery, Transformation and Resilience Plan

According to the Spanish government estimates, **the funds channeled through the Recovery, Transformation and Resilience Plan will have an impact on GDP growth of 2.6 pp in 2021**, which we consider feasible, although the risk of delays in the execution of the projects is high. The PRTR represents an historic opportunity, with the possibility of displaying particularly relevant effects on growth in the medium term if the increase in investment is accompanied by reforms aimed at increasing the productivity of the economy and the qualification of human capital.

The European Council of July 2020 reached an historic agreement for the creation of a Recovery Fund called Next Generation EU (NGEU). The purpose of this fund is to mitigate the effects of the coronavirus crisis in the most affected economies and promote the structural transformation of those most in need of reforms.

The agreement is a milestone in the history of the EU. This is so not only because of the amount of the NGEU (higher than 5% of the EU GDP), but because for the first time the EU offers a common, forceful and redistributive response to face a severe crisis of an exogenous nature and that is having asymmetric effects across countries. Also, for the first time, EU community debt issues will be carried out to finance this common capacity.

The NGEU has a size of EUR 750 billion of which EUR 390,000 mn will be transfers and the rest in the form of loans with the aim of alleviating the effects of the crisis and promote digital and ecological transformation. These transfers are assigned with a strong redistributive character towards the states with the highest levels of unemployment and / or those most affected by the pandemic. The most important component is the **Recovery and Resilience Mechanism (MRR)** (EUR 672.5 bn at 2018 prices, of which EUR 312.5 bn are grants and the rest are loans) whose main objective is to finance digitization and environmental transformation projects as well as structural reforms that increase the resilience of economies.

Each Member State must agree with the European Commission on its Recovery and Resilience Plan. Moreover, each country must specify the reforms and investments that it intends to rely on to promote recovery and generate solid foundations for long-term growth. Resource mobilization will be done on the basis of a calendar where the main milestones and objectives of the measures included in the plan are established; as they are fulfilled, the EU Commission will disburse the resources. Although governments must concentrate their investment efforts in the first three years (2021-2023), the effective disbursement of funds can be delayed until 2026, so that each government can borrow in the markets to advance the execution of expenses associated with the Plan.

The Spanish government estimates that the transfers received by the Spanish economy can reach EUR 72,000 mn between 2021 and 2023 (7% of GDP) of which EUR 59,168 mn correspond to the Reconstruction and Resilience Mechanism (MRR), and EUR 12,436 mn will come from the REACT-EU program. The Spanish government has not ruled out to apply for loans depending on the needs and financing conditions. On October 7, the Government announced the strategic lines of the Recovery, Transformation and Resilience Plan (PRTR) that it will present to the European institutions. For 2021, the PRTR assumes the mobilization of EUR 25bn of the MMR and EUR 2.4bn of the REACT-EU instrument, which are incorporated into the spending ceiling of the State Budget (PGE) in 2021.

Figure 2 Distribution of the reconstruction and resilience fund and React-EU 2021 (%GDP)

Distribution of the reconstruction and resilience fund and React-EU 2021 (% GDP)	Total Public Administrations	Central Administration	Social Security Funds	Autonomous Communities	Local Entities
Non-financial resources	2,8	2,2	0,1	1,5	0,1
Current revenues	0,7	0,5	0,1	0,5	0,0
Current transfers between public administrations	0,7	0,5	0,1	0,3	0,0
Current international cooperation				0,2	
Capital resources	2,2	1,7	0,0	1,1	0,1
Capital transfers between public administrations	2,2	1,7	0,0	0,6	0,1
Investment aid				0,5	0,0
Non-financial jobs	2,8	2,2	0,1	1,5	0,1
Current jobs	0,6	0,4	0,1	0,5	0,0
Compensation of employees	0,0	0,0		0,2	0,0
Intermediate consumption	0,3	0,1			0,0
Social benefits other than social transfers in kind	0,1		0,0	0,1	
Social transfers in kind: production acquired in the market	0,1	0,3		0,1	
Current transfers between public administrations	0,1		0,1		
Other current transfers				0,1	
Capital jobs	2,2	1,8	0,0	1,1	0,1
Gross fixed capital formation	1,4	0,5			0,1
Capital transfers between public administrations	0,9	0,7	0,0	0,8	
Investment aid		0,6		0,3	

Source: AIReF

Part of the European funds to be received by the State will be transformed into transfers to the autonomous communities, the local entities and to the Social Security, who will be in charge of carrying out a large part of the final expenditure. Specifically, of the total of EUR 26,634 mn of funds managed by the State, EUR 10,793 mn will be channeled to the Autonomous Communities, EUR 1,483 mn will be transferred to the local entities, and EUR 1,143 mn to the Social Security Funds.

Furthermore, the Spanish regions will also receive funds directly from the EU, EUR10bn from the REACT-EU facility, EUR 8,000 mn in 2021 and the rest in 2022. However, the distribution among the Autonomous Communities is pending, as these funds need to be included the EU regional operations programs (ERDF and ESF) after negotiation with the European Commission. In parallel, the PRTR will be subject to negotiation between the Government and the European Commission, **its final presentation being scheduled before April 30, 2021.**

According to the information disclosed by the Spanish government, a high percentage of these resources will go to **industry and energy** (21.1%), followed by **R&D&I and digitalization** (17.8%) and **resilient infrastructure and ecosystems** (17.6%). Another part of the funds will be used to promote entrepreneurship, the improvement of education and continuous training and the reinforcement of inclusion policies, among other elements. Regarding the macroeconomic impact, the Government expects the Plan to have a positive impact of 2.6 pp on annual GDP growth, during the 2021-2023 period, as we commented above. As stated in the Presentation of the PGE 2021, the evaluation of this impact has been carried out using general equilibrium models with a bottom-up approach, taking into account the specific plans that make up the Plan.

The average GDP growth multiplier stands at 1.2x, although it is heterogeneous by project, especially the one associated with increased spending on innovation and digitalization (close to 2x). In the government simulations, the different projects are transmitted to the economy through various channels such as the improvement of total factor productivity, the promotion of private investment and export capacity, the increase of qualification and digital capabilities and efficiency improvements in the labor market. Consequently, according to government estimates, the long-term potential growth of the economy (2030) **could be between 4 and 5 tenths above that projected in the absence of this Plan.**

In summary, the resources received can have a high impact on growth if the projects meet the requirements necessary to promote the modernization and digitalization of the Spanish economy. Indeed, if reforms are introduced that have an impact on improved productivity, competitiveness or training, the effects could be extended and prolonged over time.

However, **the risks of delays in the implementation of these projects are high.** Extrapolating the experience in the absorption of structural funds is not appropriate given that the European Plan does not require co-financing of the projects and occurs at a unique moment, in which the political will to put these projects into practice can be remarkable. However, the magnitude of the resources allocated can lead to delays in the implementation of projects. We must also acknowledge the possibility that some resources may not have the desired

impact if the selection of specific projects is not optimal in such a way that the multiplier effect associated with spending would be reduced. On the other hand, the government simulations incorporate some supply channels (which are reflected in the boost in exports produced as a result of the Plan) that can be expected to take longer to deploy. On the other hand, the government's estimates do not include possible spillover effects associated with the implementation of the Plan in other countries.

One of the most obvious risk is that **the selected projects are not adequate to achieve the desired effects on the economy**. MRR and REACT-EU funds are provided for the purpose of boosting economic activity in EU countries that has been seriously affected by the crisis arising from the pandemic. The ultimate purpose of these European Funds is not to temporarily finance the stoppage or economic slowdown during the months that the pandemic lasts, **but rather to undertake the necessary structural reforms in each country to improve their potential growth**. It is about preventing the COVID-19 crisis from causing a drop in potential product at a structural level. In this context, it is essential that the selected projects are adequate to achieve the aims pursued.

Another risk would be related to an insufficient rhythm of project execution in 2021. The 2021 State Budget contemplates a high execution of the EU Funds in 2021. Only in 2021 the government expects the execution of spending projects worth about EUR 26,600 mn, representing 2.2% of GDP. This assumption constitutes the ideal scenario since, the sooner the funds are executed, the sooner the positive effects on the economic activity of a country begin to be observed. However, if this scenario does not materialize and it is not possible to execute all the projects planned in 2021, there is a risk that the recovery of the economy will be slower and as a result the impact on public revenues will be delayed. Ultimately, thus would make it difficult to reach the reference deficit levels.

Likewise, **the design of the PRTR could lead to an increase in the structural deficit once its implementation is completed**. The projects that make up the PRTR will have a duration that will go beyond the implementation period of the PRTR itself and, therefore, the financing that the Plan provides. For this reason,, there is a risk that part of the PRTR expenditure will become structural and that permanent financing has not been contemplated.

2. The Spanish government macro scenario in 2021-2022 vs AIReF & Bank of Spain estimates

The macroeconomic scenario of the State Budget (PGE 2021) incorporates a **GDP contraction of 11.2% in 2020** as a result of the healthcare crisis and the restrictions on mobility necessary to mitigate it. On the other hand, the government expects a **GDP growth of 7.2% in 2021**, before incorporating the macroeconomic effects associated with the Recovery Plan, Transformation and Resilience (PRTR). If the latter is considered, the government's scenario contemplates a **notable recovery in economic activity, with an increase in GDP of 9.8%**. However, in the last two months, global growth prospects have turned towards more pessimistic scenarios as the severity and extension of the second wave of the coronavirus pandemic is verified.

Thus, in the central scenario in which the pandemic is supposed to persist but a generalized confinement of the population is not necessary, **AIReF estimates that the Spanish GDP could decrease by 11.1% in 2020 and that it would recover in 2021 until reaching a GDP growth of 8.2%** (5.5% in the inertial macro scenario excluding the impact of the PRTR funds), almost two points lower than the forecast of the 2021 State Budget. In contrast, **in an optimistic scenario**, in which current outbreaks are assumed to be controlled and confidence and spending recover rapidly, GDP growth in 2021 could rise to 10% in 2021 after falling by 10.7% in 2020. On the other hand, under AIReF's pessimistic scenario, the Spanish GDP growth in 2021 would be almost four points lower than the government forecast.

Compared to AIReF's baseline scenario, the government's forecasts contemplate a notably stronger recovery in economic activity in 2021. The differences are not so much due to the estimated impact of the funds channeled through the Recovery, Transformation and Resilience Plan - although there are risks of absorption and implementation - but rather to the **inertial recovery** that underlies both macroeconomic scenarios. This, in turn, is strongly linked to the assumptions about the evolution of the pandemic that the Government views with more optimism than AIReF.

There are also important differences between the central government forecasts and AIReF's ones in the different underlying components of the GDP, as seen in Figure 3.

Figure 3 AIReF macro scenarios in 2020-2021 vs government forecasts. Comparative.

	2020					2021			
Interannual variation rate	2019	Optimistic	Central	Pesimistic	Government	Optimistic	Central	Pesimistic	Government
Private national final consumption expenditure	0,9	-13,0	-13,5	-13,8	-12,6	8,3	7,0	5,3	8,3
Final consumption expenditure of public administrations	2,3	6,0	6,0	6,0	6,3	-0,8	-0,8	-0,8	0,5
Gross fixed capital formation. Capital goods and cultivated assets	4,3	-15,4	-16,5	-17,6	-21,2	10,9	5,4	3,7	8,7
Gross fixed capital formation. Construction and intellectual property	1,9	-13,5	-14,0	-14,5	-16,9	7,8	4,0	3,3	6,6
National demand *	1,4	-9,1	-9,6	-9,9	-10,0	6,1	4,5	3,4	6,2
Export of goods and services	2,3	-19,8	-20,0	-20,1	-22,7	11,7	9,5	5,8	11,7
Import of goods and services	0,7	-16,6	-16,9	-17,2	-20,0	8,5	7,0	4,9	8,6
External balance*	0,6	-1,6	-1,6	-1,5	-1,5	1,1	0,9	0,4	1,1
Gross domestic product	2,0	-10,8	-11,2	-11,4	-11,2	7,3	5,5	3,8	7,2
Nominal gross domestic product	3,4	-10,1	-10,5	-10,8	-11,2	8,5	6,5	4,6	8,1
Gross domestic product deflator	1,4	0,8	0,8	0,8	0,0	1,1	1,0	0,8	0,9
Full-time equivalent employment	2,3	-8,4	-8,7	-9,0	-8,4	6,2	3,9	1,9	5,6

Source: AIReF

In **AIReF's central scenario**, it is considered that, in the very short term, the severity of the contagion processes and the necessary measures to contain the pandemic generate significant uncertainty that weighs down economic growth. Although it is assumed that a generalized confinement of the population may not be necessary, it should not be forgotten that the measures to contain the pandemic in Spain are focused on reducing mobility in large cities, where a significant part of GDP is originated, and in sectors where social proximity is necessary, which have great weight in the Spanish productive structure. On the other hand, the persistence of continuous outbreaks implies continued uncertainty about the possible imposition of measures to reduce mobility, which has a negative influence on expectations, weighing down private consumption and investment.

In addition, the worsening of the pandemic at a global level and the measures that other countries are introducing are slowing down the recovery of world trade and the influx of tourists. But in the medium term, **the central scenario implies a gradual normalization of activity**. In particular, the development of vaccines or treatments for the disease is supposed to reduce contagion, facilitating a recovery of confidence and of activities that involve greater

social interaction in the second half of 2021. Despite the persistence of the pandemic, it is assumed that the productive fabric does not register structural damage in that time.

On the other hand, **AIReF's pessimistic scenario assumes that the spread of the pandemic requires strict measures to restrict the mobility of the Spanish population** in the final months of 2020 and that structural damage occurs in the productive activities that hinders subsequent recovery. In line with what has been observed in many European economies, the restrictions on mobility incorporated in this scenario are not as severe as those implemented in March and April, which for a time came to mean the prohibition of non-essential activities, so that the impact on economic activity is not so severe. Throughout 2021 the contagion would remain more controlled, which would allow a gradual recovery of the activity. However, the greater persistence of the pandemic and the deterioration in confidence would make inevitable the appearance of structural damage in the form of corporate bankruptcies and job losses that slow the intensity of the recovery.

If it is assumed that the containment of the second wave requires more severe measures to restrict mobility and economic activity or a greater persistence of the pandemic is assumed throughout 2021, the forecast of GDP growth for 2021 would be reduced to 6.5% (3.8% in an inertial growth scenario, excluding the impact of the PRTR funds). In these three scenarios, the impact of the Recovery, Transformation and Resilience Plan (PRTR) and of the measures contained in the 2021 State Budget of 2.7 percentage points (pp) is incorporated in 2021 as estimated in AIReF's econometric model.

Finally, **AIReF's optimistic scenario assumes that the pandemic can be controlled throughout 2021, either by the appearance of an effective treatment, a vaccine or by improvements in the management of its transmission.** In this scenario, it is considered that the severity of the current outbreaks of COVID-19 remits in the first months of 2021 and measures to reduce mobility in and between cities, as well as capacity restrictions in public establishments, can be progressively eliminated. In addition, and as in the central scenario, throughout 2021 there are advances in obtaining a vaccine or treatment that are effective enough to allow the normalization of social interaction and economic activity without causing structural damage. This scenario has increased its probability of occurrence in our opinion after the successive announcements of vaccines with efficiencies above 90% during the month of November.

Based on these scenarios, the macroeconomic scenario of the 2021 State Budget could be achievable if favorable circumstances converge both regarding the evolution of the pandemic, as well as the execution and impact of the funds received through the Recovery Mechanism and Resilience (MRR) and the other Next Generation EU (NGEU) funds, which in the Spanish Government scenario constitute the lever on which the economic recovery is sustained.

It is important to highlight the risk of less benign scenarios associated with lower growth rates. The differences between AIReF's forecasts and those of the Spanish government are not so much due to the estimated impact of the PRTR as to the speed of the expected recovery, **but to the hypotheses on the evolution of the pandemic.** The recent worsening of the pandemic removes the possibility of the hypothesis on which the government's

macroeconomic forecasts are based, which assume that the outbreaks remain controlled and concentrated, without giving rise to strict containment measures.

In addition, the Spanish government's forecasts assume that throughout 2021 there will be significant progress in the fight against the pandemic that allows a progressive recovery of normality. This assumption is key to sustaining the high growth in household spending on which the Government supports its forecasts in the inertial growth scenario since the end of 2020 (before incorporating the effects of the PRTR).

We consider that despite advances in the development of a vaccine and treatments against COVID-19, **it is still very uncertain when they could be available for massive use among the population and the degree of coverage they could achieve**, in such a way that they would allow to solve the health crisis effectively and thus eliminate the measures to contain the pandemic that are weighing on economic growth.

The more adverse evolution of the pandemic observed in recent weeks and the introduction of more stringent mobility limitation measures than those of the third quarter, will probably result in a **containment of spending and a later recovery of the sectors that involve greater social interaction**, which would delay the recovery of employment and spending and increase the probability of structural damage to productive activities.

The macroeconomic impact associated with the PRTR that is incorporated into the Government's scenario amounts to 2.6 pp of GDP growth in 2021, with a multiplier effect of approximately 1.2x, which would mean closing the gap in economic activity opened by the coronavirus crisis in 2022. According to the information available, this boost comes from the transfers received through the Recovery and Resilience Mechanism (MRR), which in the simulations carried out by the Government are assumed to amount to EUR25bn euros in 2021.

No macroeconomic effect is incorporated from the Recovery Assistance Program for Cohesion and the Territories of Europe (React-EU), which is included in the limit of non-financial spending of the 2021 State Budget (for an amount of EUR 2bn). According to the 2021 State Budget, the resources received through the MRR will be mainly oriented towards public investment in infrastructure and intangible assets associated with innovation and digitization. Another part of the funds will be used to increase energy efficiency and environmental transformation, the promotion of entrepreneurship, the improvement of education, continuous training and the reinforcement of inclusion policies, among other elements.

Bank of Spain 2020-2022 macro forecasts

Bank of Spain forecasts also include three type of severity scenarios, **baseline**, **mild** and **severe**, that differ on the basis of the assumptions made about the future course of the pandemic, the severity and duration of the containment measures applied, and the time required to successfully implement a medical solution to the disease. Other differentiating aspects of the scenarios are the depth of the consequences of COVID-19 on agents' behavior and the magnitude of the possible persistent damage to the productive system even after the pandemic is controlled.

The baseline scenario envisages the possibility of fresh outbreaks of the disease arising in the coming months, of similar intensity to the latest ones, thus requiring restrictions similar to those currently in place to contain it. Consequently, the impact on activity would, in principle, be relatively limited, directly restricted to sectors linked to leisure and hospitality, while the other sectors would only be indirectly affected through spillover effects. The distribution of an effective medical solution from early 2021 would allow for a **gradual reduction of the containment measures until their full phase-out in early 2022**.

Under the **mild scenario**, a somewhat more favorable unfolding of the pandemic as of the first quarter of 2021 is expected and so is an earlier successful distribution of vaccines resulting in the impact of the possible containment measures not being so high in the coming months. This would help lower the uncertainty under which agents must adopt their consumer and investment decisions. Also, in this scenario it is assumed that households and enterprises have adjusted their behavior with respect to the containment measures more rapidly, which, for a given degree of these measures, leads to higher spending levels, even as early as the last quarter of 2020. Lastly, this scenario entails less erosion of the productive system and, therefore, less adverse consequences on the economy's medium-term growth potential.

Finally, **the severe scenario envisages the possibility of a resurgence of the disease in the short term**, which would require implementing more stringent measures above the levels in place in the most recent period. These restrictions would not only cause greater harm to the services sectors with a high degree of social interaction, but they would also directly affect other productive sectors. Also, this scenario incorporates a lower degree of adaptation to the pandemic, resulting in a more unfavorable trend in activity in the last few months of 2020. In addition, achieving the population's immunity later on would make the impact of the crisis on activity more persistent, with more serious adverse effects on the productive system, in part as a result of financial amplification phenomena through which the deterioration of the solvency of firms and households, on the one hand, and of financial institutions, on the other, would feed back into each other.

The three scenarios incorporate the implementation of spending projects under the NGEU programme over the three years of the projection horizon, although, the degree of uncertainty surrounding aspects such as the volume of effective execution of the programme or the multiplier effect on the economic activity of the projects carried out continues to be very high.

Under any of the three scenarios considered regarding the unfolding of the pandemic, the sharp contraction of GDP in 2020 would be followed by a relatively strong recovery in the following three years, although the crisis would have persistent effects on the levels of activity (see Figure 4). In 2020 specifically, GDP would fall by 10.7%, 11.1% and 11.6% in the mild, baseline and severe scenarios, respectively (Figures 4 and 5). In 2021 the economy's output would grow by 6.8% in the baseline scenario, rising to 8.6% in the mild scenario and dropping to 4.2% in the most adverse scenario.

A substantial part of this difference is explained by the different vaccination periods for the population, which lead, inter alia, to an uneven pace of recovery for activities involving greater social interaction, in particular those related to tourism. As a result of the persistent impact of the health crisis on activity, recovery of the pre-COVID-19 level of GDP would not take place until mid-2023 in the baseline scenario, while in the severe scenario the economy's output at the end of the projection horizon would still be 2.8% below the level at end-2019. In the mild scenario, this level would be reached between end-2021 and early 2022, thanks to the swift resolution of the health crisis and the scant magnitude of the lasting damage to the economy's productive capacity. The inclusion in these projections of the projects carried out under the NGEU framework contributes to raising projected GDP growth in 2021 by 1.3 pp.

Figure 4 Slump in activity in 2020 and subsequent recovery

		September 2020 Projections						June 2020 Projections		
		Stage 1			Stage 2			Gradual recovery		
	2019	2020	2021	2022	2020	2021	2022	2020	2021	2022
GDP	2.0	-10,5	7,3	1,9	-12,6	4,1	3,3	-11,6	9,1	2,1
Harmonised Index of Consumer Prices (HICP)	0.8	-0,2	1,0	1,2	-0,3	0,8	1,1	-0,2	1,2	1,5
Harmonised Index of Consumer Prices excluding energy and food	1.1	0,7	0,8	1,0	0,6	0,5	0,8	0,8	1,0	1,1
Unemployment rate (% labour force). Annual average	14.1	17,1	19,4	18,2	18,6	22,1	20,2	19,6	18,8	17,4
General government net lending (+)/ net borrowing (-) (% GDP)	-2,8	-10,8	-7,0	-5,8	-12,1	-9,9	-8,2	-11,2	-6,8	-6,1
General government debt (% of GDP)	95.5	116,8	115,4	118,0	120,6	125,6	128,7	119,3	115,9	118,7

Source: Bank of Spain and INE. Projections cut-off date: 10 September 2020

Figure 5 Projections for the main macroeconomic aggregates of the Spanish economy (annual rate of change) (a)

	December and September 2020 projections															
	GDP				HICP				HICP excluding energy and food				Unemployment rate (% labour force) (b)			
	2020	2021	2022	2023	2020	2021	2022	2023	2020	2021	2022	2023	2020	2021	2022	2023
December 2020																
Mild scenario	-10,7	8,6	4,8	1,9	-0,3	0,7	1,3	1,4	0,5	0,6	1,1	1,3	15,7	17,1	14,0	12,4
Baseline scenario	-11,1	6,8	4,2	1,7	-0,3	0,6	1,2	1,3	0,5	0,5	0,9	1,1	15,8	18,3	15,6	14,3
Severe scenario	-11,6	4,2	3,9	1,5	-0,3	0,5	0,9	1,1	0,5	0,2	0,6	0,8	16,2	20,5	18,1	17,6
September 2020																
Scenario 1	-10,5	7,3	1,9	–	-0,2	1,0	1,2	–	0,7	0,8	1,0	–	17,1	19,4	18,2	–
Scenario 2	-12,6	4,1	3,3	–	-0,3	0,8	1,1	–	0,6	0,5	0,8	–	18,6	22,1	20,2	–

Sources: Bank of Spain and INE

Note: Latest QNA figure published: 2020 Q3

(a) projections cut-off date: 25 November 2020

(b) annual average

All components of private domestic demand will decline sharply in 2020, as seen in Figure 6. The sharp contraction in private consumption, expected to stand at around 13% in the baseline scenario, is due to three factors. First, **the unavoidable decline in spending on certain non-essentials** as a result of the sectoral shutdowns during the first wave of the pandemic. Second, **the heightened uncertainty over the economic outlook**, which has led households to adopt a more cautious attitude in their spending decisions. The third and last factor is **the fall in household income owing to the deterioration of the labour market** which, nevertheless, has been cushioned by the fiscal support measures implemented during the pandemic.

Household spending is expected to gradually return to normal over the projection horizon. Spending on other goods and services, encompassing those activities hardest hit by the social distancing measures, was still 15% below the figures posted at the end of 2019. This type of spending will gradually recover as the containment measures imposed on certain activities are eased, as the uncertainty over the course of the pandemic diminishes and as the purchasing power of the households most affected by the labour market downturn improves. Private consumption is expected to return to its pre-pandemic level in early 2022 under the mild scenario, while expectedly remaining slightly below that level at 2023YE under the baseline scenario. This gap is expected to widen to almost 5% under the severe scenario. The household savings rate will tend to remain relatively high until the end of the projection horizon, albeit considerably lower than that observed in 2020.

Residential investment is expected to recover as from early next year. Nevertheless, the improvement over the forecasting horizon will be incomplete, particularly while the health uncertainties persist. At end-2023, this aggregate will still stand between 5 pp and 11 pp below its pre-pandemic level.

Investment of non-financial corporations will post a very steep decline of around 16% in 2020, in keeping with the strong slide in final demand (which has prompted a notable decrease in current capacity utilization) and uncertainty about how it will perform in the future. In any event, these factors have had a very uneven effect on the different sectors. The high impact of the measures on the demand of firms operating in certain sectors triggered a highly significant reduction in their revenue and, consequently, in the funds they have available for new investments.

Figure 6 Bank of Spain: Projections for the main macroeconomic aggregates of the Spanish Economy in 2020-2022

	December 2020 projections												
	Mild scenario					Baseline scenario				Severe scenario			
	2019	2020	2021	2022	2023	2020	2021	2022	2023	2020	2021	2022	2023
GDP	2,0	-10,7	8,6	4,8	1,9	-11,1	6,8	4,2	1,7	-11,6	4,2	3,9	1,5
Private Consumption	0,9	-12,3	10,3	5,2	1,6	-12,9	7,2	4,5	1,5	-13,7	3,8	4,5	1,5
Government Consumption	2,3	4,6	0,6	-0,7	1,4	4,7	0,9	-1,0	1,4	4,8	1,4	-1,6	1,4
Gross Fixed Capital Formation	2,7	-14,8	10,4	8,3	2,1	-14,9	10,2	7,9	1,8	-14,9	8,5	7,4	1,7
Exports of goods and services	2,3	-22,0	11,9	8,2	5,6	-22,1	10,9	7,8	5,3	-22,5	8,0	7,3	4,5
Imports of goods and services	0,7	-19,5	10,6	7,7	5,1	-19,7	9,8	7,4	4,8	-19,9	8,2	7,1	4,6
National demand (contribution to the growth)	1,4	-9,2	8,0	4,5	1,6	-9,6	6,3	3,9	1,4	-10,1	4,1	3,7	1,4
Net external demand (contribution to the growth)	0,6	-1,5	0,6	0,3	0,3	-1,5	0,5	0,3	0,3	-1,5	0,1	0,2	0,1
HIPC	0,8	-0,3	0,7	1,3	1,4	-0,3	0,6	1,2	1,3	-0,3	0,5	0,9	1,1
HIPC excluding energy and food	1,1	0,5	0,6	1,1	1,3	0,5	0,5	0,9	1,1	0,5	0,2	0,6	0,8
Employment (persons)	2,2	-4,4	-0,8	5,0	2,5	-4,5	-0,9	4,1	2,2	-5,0	-3,9	3,5	1,2
Employment (hours worked)	1,5	-10,4	8,6	4,7	2,2	-10,6	7,4	3,9	1,7	-11,4	5,0	3,3	0,9
Unemployment rate (% of labour force) Annual average	14,1	15,7	17,1	14,0	12,4	15,8	18,3	15,6	14,3	16,2	20,5	18,1	17,6
National net lending (+)/ net borrowing (-) (%GDP)	2,5	1,7	2,9	2,9	3,0	1,7	2,8	2,8	2,9	1,7	2,5	2,3	2,1
General government net lending (+)/net borrowing (-) (%GDP)	-2,9	-10,3	-6,7	-4,0	-3,2	-10,5	-7,7	-5,2	-4,5	-10,9	-9,6	-7,1	-6,7
General government debt (%GDP)	95,5	116,1	113,7	111,7	111,5	116,7	117,1	116,8	118,0	117,8	122,8	124,9	128,7

Source: Bank of Spain

Note: latest QNA figure published: 2020 Q3. Projections cut-off date: 25 November 2020

Furthermore, due to their limited revenue, firms have been required to borrow, heavily in certain cases, to cover fixed costs, which has meant that **the financial position of certain segments of non-financial corporations has weakened**, potentially influencing the capacity for investment to recover over the forecasting horizon.

The pandemic has reduced the movement of goods and persons among different countries. The movement of goods was interrupted temporarily and was essentially limited to last spring when many countries adopted strict confinements. However, the limitations on the international movement of persons are much more persistent, with a very high impact on tourism flows, **which is highly significant for Spain where this industry accounts for such a significant share of GDP.** As a result, exports of goods and services will globally decline by approximately 22% in 2020. Travel services will fall by more than 70%.

Looking ahead, **tourism flows can be expected to continue to be affected by resurgences of the pandemic** and the consequent containment measures, both directly, through restrictions imposed by the authorities, and indirectly, insofar as potential tourists want to limit the potential health risk of large groups gathering and travelling on public transport. In this setting, inbound tourism is not likely to recover significantly until an effective medical solution has been deployed against COVID-19.

The recovery of overall sales to the rest of the world of goods and services will be limited by two additional factors. On the one hand, the appreciation of the euro exchange rate since the outbreak of the pandemic has had a negative impact on the competitiveness of exports to non-euro area countries. On the other, the projections include the assumption that a trade agreement will not be reached between the European Union (EU) and the United Kingdom before the Brexit transition period expires at end-2020. Given all these conditioning factors, total Spanish exports to the rest of the world are not estimated to reach pre-pandemic levels over the projection horizon, except for the mild scenario, in which these would reach pre-pandemic levels at the end of 2023.

The disruption to international trade flows of goods and services has also severely affected purchases from the rest of the world. In fact, in 2020 total imports will post a higher decline - of around 20% than exports, in keeping with the comparatively more unfavorable performance of the final demand in Spain than among its trading partners as a whole, and, in particular, in the rest of the euro area. The towering drop in Spanish imports is also a result of an especially heavy decline in those final demand components with a high import content, such as investment in capital goods and exports. In the future, purchases from the rest of the world are projected to recover from early 2021, in line with final demand. To the resemblance of exports, tourism of Spanish residents in the rest of the world will remain very weak for a relatively longer period, weighed down by the health crisis.

The unemployment rate would increase more markedly this year to slightly below 16% in the baseline and mild scenarios and to slightly above this figure in the severe scenario. The decline in this variable beginning around the second half of 2021 would not prevent the average unemployment rate of the following year from increasing with respect to 2020 in all the scenarios considered. At the end of 2023 the unemployment rate would still slightly

exceed 14% in the baseline scenario, somewhat higher than its pre-pandemic levels, and would be 3 pp higher in the severe scenario.

The health crisis has also caused public finances to deteriorate very markedly (Figure 7). The measures implemented to counter the pandemic's impact on public health and economic activity combined with the automatic stabilizers will propel the general government deficit in 2020 to 10.5% of GDP in the baseline scenario. Over the projection horizon, the budget balance is expected to improve substantially, as a result of the temporary nature of some of the discretionary measures adopted and of the cyclical improvement. Nevertheless, **in 2023 the government deficit will remain at very high levels still (4.5% of GDP in the baseline scenario)**. Public debt will rise steeply in 2020 to around 120% of GDP in any of the three scenarios. Subsequently, the differences between the scenarios, in terms of GDP and the general government deficit, will give rise to uneven developments in the path of the debt ratio until 2023. Thus, whereas in the baseline scenario debt would tend to stabilize around this year's level, in the mild scenario it would decrease by around 5 pp, and in the severe scenario it would rise by approximately a further 10 pp.

Figure 7 Public Finances: changes in general government debt and deficit (% of GDP)

As a % of GDP	Stage 1				Stage 2		
	2019	2020	2021	2022	2020	2021	2022
General government balance	-2,8	-10,8	-7,0	-5,8	-12,1	-9,9	-8,2
General government debt	95,5	116,8	115,4	118,0	120,6	125,6	128,7

Source: Bank of Spain

The gradual recovery in demand for consumer goods and services, particularly in the sectors hardest hit by the containment measures, would lead, throughout 2021, to gradual increases in the rate of change of the core inflation component, which would be stronger in the second half of the year, once the base effects which have marked this component since last summer have been overcome. The rise in core inflation will probably not be even across the different categories of goods and services. In particular, the more sluggish and incomplete recovery in hospitality and leisure sectors will likely cause inflation for these services to hold at very moderate levels for a longer period.

Although the rates of change in core inflation are rising, they will nevertheless be moderate throughout the projection horizon. Thus, after averaging 0.5% in 2020 and 2021, the rate of change in the HICP - excluding food and energy -, would gradually climb to 1.1% in 2023 in the baseline scenario. The rise would be somewhat less pronounced in the mild scenario (to 0.8%) and somewhat more marked in the severe scenario (to 1.3%). The headline HICP is estimated to begin to post positive rates as from spring 2021 in line with the anticipated quickening of the energy component. In terms of the annual average rate, the headline HICP would grow by 1.3% in the baseline scenario in 2023 (which would be 0.2 pp higher than in the mild scenario and 1 pp lower than in the severe scenario).

The second wave of the virus has led to the adoption of new restrictions on mobility and on activity in certain sectors. This has, in recent weeks, enabled the incidence of the pandemic to be contained to some degree, as reflected by the widespread decline (albeit uneven by country and region), in the number of new cases detected. In Spain, the containment measures were reinstated earlier than in other neighboring economies as the second outbreak emerged sooner, which also explains why the likely slowdown in economic activity in Q3 and Q4 is comparatively less marked than in the euro area as a whole, **where the quarter-on quarter contraction in GDP projected for Q4 under the baseline scenario is substantially higher (2.2%).**

The loss of momentum in activity in Spain is apparent in the results of the survey of a sample of firms conducted by the Bank of Spain. **Almost half (48.5%) of the non-financial corporation's surveyed reported that their turnover in 2020 Q4 was lower than in Q3, with firms in the services sector, particularly those engaging in hospitality and leisure activities, being by far the hardest hit.** Moreover, the adoption of more severe restrictions in other European countries could have an adverse effect on their demand for Spanish products. Aside from this short-term economic information, accurately assessing the changes in economic activity in Spain in Q4 is fairly complex, as it has been since the onset of the pandemic. In circumstances such as the present ones, the fact that the momentum of activity is so affected by the containment measures introduced by the authorities and by the voluntary restrictions and changes in the behavior of private agents considerably undermines the usefulness of the short-term forecasting tools commonly used in normal conditions to estimate such developments.

A look into the future

After the sharp drop this year, **the Spanish economy's GDP will grow at a fast pace in 2021.** However, there are very notable differences depending on the epidemiological scenario considered. The path of recovery lasting over the following two-year period would give rise to progressively more modest activity growth, which would enable, under the baseline scenario, **the pre-pandemic GDP level to be reached by mid-2023**, while, under the severe scenario, GDP would still be some distance from its pre-pandemic level at the end of the projection horizon.

Consequently, **the crisis will leave scars on economic activity even after the constraints on its normal course imposed as a result of the pandemic are finally removed.** The economy's productive capacity will be undermined on account of the disappearance of a portion of the capital stock, insofar as the measures implemented to avoid business insolvencies may not be able to prevent, in some cases, some bankruptcies from occurring and with varying intensity depending on the scenario considered,. In addition, the crisis will have an adverse impact on the workforce. Despite the recourse to furlough schemes and the suspension of self-employment, there will be jobs that will not overcome the crisis, giving rise to a slight increase in long-term unemployment.

In the following three-year period, the recovery will be underpinned largely by the domestic component, although the external sector's contribution to GDP growth will also be positive, albeit modest.

But the global environment allows the recovery of the Spanish economy to continue and that its speed depends almost exclusively on the success with which national policies and companies and households manage the way out of the crisis. Expectations are that there will be a gradual improvement in the health situation as the vaccines are distributed, that central banks and fiscal authorities will continue with stimuli for as long as necessary until pre-crisis activity levels recover, while keeping the financial tensions at very controlled levels.

Faced with this favorable context, **the recovery of the Spanish economy depends fundamentally on ourselves**. To do this, it is essential to satisfy the following conditions necessary to accelerate recovery. First, reach consensus that is as broad as possible on a reform agenda, in line with the specific recommendations of the European Commission to Spain. These reforms are an essential condition for applying for NGEU aid and would increase its long-term effects, facilitating digitization and transition to an emissions-neutral economy, increasing potential growth, productivity and the employment rate.

Second, **it is important to maximize the effects of the NGEU funds with a good design and a selection of projects, enhancing its fiscal multiplier, public-private collaboration, concurrency between projects, and its fast and efficient execution.**

Third, **generate confidence and certainty with State Budgets consistent with a clear and transparent medium and long-term roadmap on the path of fiscal and tax consolidation**, which facilitates the planning of long-term decisions for companies and economic agents. The debate on reducing the public deficit usually focuses on the trade-off between cutting spending and increasing taxes, leaving aside the priority and effective consolidation strategy in the medium and long term: **increasing potential growth and reducing structural unemployment.**

Fourth, **protect the productive activities and facilitate an efficient and agile restructuring of those viable companies that need it**, with flexible and fast extrajudicial mechanisms. And fifth, **avoid generating uncertainties with changes in the regulations of the labor markets, goods and services that harm investment and job creation.**

3. The regional macro picture in 2020-2021

The impact of the crisis has been very uneven by sector, which in turn is reflected in the individual macroeconomic forecasts at the regional level. The almost disappearance of international tourism - the number of tourists between January and October was barely 24% of those received in the same period last year - and the restrictions on activity and mobility imposed by the authorities to control the expansion of the pandemic, **have meant that the sectors most seriously affected by the crisis are services such as hospitality, transport and culture, as well as, to a lesser extent, commerce.**

Within the industrial sector, **the activities most affected at the beginning of the crisis were those of automobile, textiles and clothing**, although after the end of confinement their recovery was very fast. On the contrary, **the primary sector and the agri-food industry have hardly suffered**. The services of the public administrations, health and education have also remained solid despite the consequences of this crisis.

The main indicators available show that the impact of the crisis on each autonomous community has been determined, to a large extent, by the relative weight of each of these sectors within its productive structure.

Thus, the regions that have suffered a more intense fall in their economic activity in the first three quarters of the year have been those where the sectors most affected by the crisis have a higher weight, such as the **Balearic and Canary Islands** (Figure 9). They are followed by **Madrid**, where the weight of these sectors is not particularly high, but the presence of the least exposed sectors is also very low, so that this community has not benefited from its mitigating effect. The next most affected region has been **Catalonia**, which is characterized both by a higher share than the average of the most affected sector by the pandemic, and a lower weight of the sectors which have suffered no significant damage from the crisis.

On the contrary, the regions where the economic indicators have registered more moderate decreases have been **Murcia, Extremadura and Castile-La Mancha**, which have in common a lower weight than the average of the most exposed sectors to the pandemic, and a higher weight than the average in the less exposed ones such as agri-food and the public sector.

Regarding the labor market, the fall in employment has been very limited thanks to protection schemes such as the ERTes or extraordinary benefits for the self-employed.

However, both the decline in social security affiliations and the use of these schemes reflect the same differential regional pattern. Thus, the Balearic Islands and the Canary Islands are the regions where the impact on employment has been the highest, whether it is measured through the decline in the number of social security affiliates (Figure 8), or if it is measured in terms of effective employment - that is, excluding workers in ERTE situation and the self-employed with extraordinary benefit of the total number of affiliates- **Murcia, Extremadura and Castile-La Mancha** are the regions where the volume of jobs affected has been lower with both criteria.

Figure 8 Net Employment creation by region (YoY% change)

Autonomous Communities	2016	2017	2018	2019	2020	2021
Andalusia	2,4	4,1	2,8	2,9	-4,9	1,0
Aragon	2,3	2,2	1,4	2,3	-2,1	0,6
Asturias	2,7	2,5	0,9	-1,3	-2,3	0,2
Balearic Islands	4,1	1,2	4,1	2,1	-7,5	1,2
Canary Islands	3,2	3,5	6,7	0,9	-5,9	1,0
Cantabria	3,0	1,0	1,7	1,1	-3,8	0,5
Castile-Leon	2,8	0,8	1,0	0,9	-2,8	0,4
Castile-La Mancha	3,2	4,0	2,9	2,5	-3,0	0,7
Catalonia	3,5	2,9	2,7	2,3	-4,9	1,0
Extremadura	1,9	0,6	3,7	3,1	-3,8	0,3
Galicia	2,3	1,2	2,4	1,6	-4,0	0,4
Madrid	0,9	2,5	2,9	3,6	-3,9	0,7
Murcia	6,1	3,4	1,9	3,6	-3,4	0,8
Navarre	1,2	4,2	1,3	2,3	-2,9	0,6
Basque Country	2,8	0,4	2,2	1,1	-2,8	0,5
La Rioja	1,7	1,4	2,7	1,8	-2,7	0,2
Valencia	3,2	3,1	2,7	2,1	-4,6	0,9
Spain	2,7	2,7	2,7	2,3	-4,2	0,8

Source: INE 2020

According to FUNCAS forecasts, the region most affected by the crisis will be the Balearic Islands, where a decline in GDP of more than 20% is expected (Figure 8). The impact will also be very severe in the Canary Islands, although less than that of the Mediterranean archipelago, thanks to a more contained fall in international tourism. They follow Madrid and Catalonia, both with GDP decline above the national average. In the rest of the autonomous communities, the decline in GDP will be below average. Murcia will be the least affected community, along with Extremadura and Castilla-La Mancha, all of them with decreases of less than 8%.

Figure 9 Spanish regions GDP growth estimates in 2020-2021

Autonomous Communities	2016	2017	2018	2019	2020	2021
Andalusia	2,6	2,7	2,2	2,1	-11,3	6,3
Aragon	2,9	2,6	3,0	1,7	-8,2	4,2
Asturias	1,7	2,2	1,9	1,3	-10,4	4
Balearic Islands	4,4	3,1	2,4	1,7	-22,0	11,7
Canary Islands	2,8	3,6	2,4	1,8	-17,9	9,9
Cantabria	2,7	2,8	2,8	1,5	-8,5	4,1
Castile-Leon	2,5	1,2	2,0	1,1	-9,6	4,7
Castile-La Mancha	3,4	1,9	2,5	1,3	-7,5	5,7
Catalonia	3,4	2,5	2,2	1,8	-13,5	7,6
Extremadura	1,5	3,7	1,9	1,4	-7,9	4,4
Galicia	2,8	2,7	2,2	1,9	-11,1	6
Madrid	3,6	3,9	3,1	2,5	-13,6	7,9
Murcia	3,7	3,1	1,0	2,3	-7,3	3,8
Navarre	2,7	3,6	2,6	2,8	-8,7	5,8
Basque Country	2,8	2,4	2,0	1,9	-9,7	6,1
La Rioja	2,0	0,5	1,5	1,5	-9	4,9
Valencia	2,6	3,4	1,9	2,3	-10,7	6,2
Spain	3,0	2,9	2,4	2,0	-12	6,5

Source: INE 2020

The estimates for 2021 are subject to an unusually high degree of uncertainty, due to the persistence of a significant health risk and restrictions on activity until the application of the vaccine, its impact on the behavior of economic agents and the capacity management of the European funds, among other factors. Therefore, the results of these forecasts should be interpreted with caution.

Assuming that throughout the first semester a significant part of the population is vaccinated so that the restrictions on economic activity and mobility can be definitively lifted, **the recovery would be palpable mainly in the second half of the year**, in line with the forecasts for Spain.

The services most affected by the crisis in 2020 will be the sectors that will show the highest growth rate in 2021, due to the recovery of activity from extraordinarily low levels in 2020, although this level of activity will still be much lower than before the crisis. The number of tourists will also be well below the level of 2019, but in all circumstances it will represent a very significant growth compared to 2020.

The regions where the weight of these services is the highest, that is, those that have suffered the most from the impact of the crisis in 2020, will therefore, in general, be those that will grow the most in 2021. On the other hand, these sectors will suffer a very pronounced

permanent impact on their level of activity, so that the autonomous communities where they have larger expression, despite the higher growth expected in 2021, **will also be the ones that will take the longest to recover the GDP levels prior to the pandemic.**

Thus, the **Balearic Islands** and the **Canary Islands** are the autonomous communities where the expected 2021 GDP level will have suffered the largest decline compared to the GDP level of 2019, followed by **Catalonia, Asturias** and **Madrid**. **Castile-La Mancha, Navarre, Murcia** and **Extremadura** will, on the contrary, be the regions where their 2021 GDP will be closest to the levels prior to the pandemic, due mainly to the reduced share of the most negatively impacted sectors and the higher weight vs. the average of the most resilient economic activities.

4. Key macro risks for the Spanish economy

The outlook for economic activity continues to be highly shaped by developments in the **epidemiological situation**, particularly over the coming quarters, while uncertainty remains as to the scale of potential outbreaks of the pandemic. The announcements of the imminent availability of various vaccines tend to lessen uncertainty as the projection horizon unfolds. However, it has only been partially dispelled, given the relative uncertainty about the timeframe needed to immunize the whole population. In any event, the progress announced in the development of the vaccines eases uncertainty compared with the projections we showed in September.

At present, the baseline scenario is expected to be the most likely. However, **the risks to GDP growth under this scenario would be moderately on the downside**, essentially owing to the possibility of epidemiological developments being more adverse than those underlying its construction, requiring the introduction of restrictions for a lengthier period of time. Moreover, a modest amplification of the crisis through the financial system could be possible, on the assumption that economic policies will be effective in limiting such phenomena, as has occurred so far. However, there may be more adverse developments in terms of the availability and cost of financing to the private sector, the possible materialization of which would give rise to **solvency problems for these agents**, with adverse consequences for banks' balance sheets.

The other risks are more balanced. The high volume of resources that Spain should receive under the NGEU programme has the potential capacity to boost the post-pandemic recovery and, in the more medium term, modernize the productive system and foster the potential capacity for sustainable economic growth. However, the degree to which all these positive consequences will actually materialize is subject to notable uncertainties arising from how the aspects relating to the implementation of the NGEU will be defined. Included here are the volume of resources that the authorities will mobilize, the distribution of these resources over time, and their multiplier effect on the economy as a whole, which in turn will hinge on the nature of the projects developed.

Moreover, there are two risk factors of a geopolitical nature outside the euro area. The first derives from the outcome of the **Brexit negotiations**. The Eurosystem's projection exercise is based on the assumption that there will be no deal at the end of the transition period, which would lead to the application of tariff and non-tariff barriers, hampering future bilateral trade between the EU and the United Kingdom. However, the scenarios presented do not include the possibility that, together with this trade channel, the hypothetical event of there actually being no deal could have adverse consequences on the financial markets, with the consequent negative impact on economic activity in Spain. By contrast, **the possibility that a deal is ultimately reached before the expiry of the deadline set for the end of the year, as it finally happened with the agreement reached on Christmas day, represents an upside risk to Spanish GDP.**

Although Spain's commercial and financial exposure to the United Kingdom is lower than that of the euro area on average, it must be taken into account that this economy represents 20% of foreign tourist arrivals. The Bank of Spain estimates that the cumulative impact of a no-deal Brexit could amount to -0.7 pp of GDP growth after five years; on a positive note, and following the agreement between the both sides reached on Christmas day, the most negative of the scenarios will be avoided, although in any case there will be a negative impact on the services sector as it was not contemplated in the trade deal.

The second factor of geopolitical uncertainty arises from the fact that information is **not yet available on the economic policies that will be deployed by the new US administration** (which will take office in January) in areas as relevant as its positioning vis-à-vis the multilateral framework of trade.

In turn, **the risks to inflation are on the downside**. These would result from a hypothetical materialization of more adverse scenarios from the economic standpoint associated with the possibility of a weaker consumer price reaction to the recovery in demand than that envisaged in the scenarios, potential financial amplifications of the crisis and, lastly, the possibility of agents giving substantial emphasis to the recent period of systematic very low price growth when forming their expectations about future inflation.

In the economic field, **the restructuring processes of those companies with debt sustainability problems and the financial tensions that may arise in some emerging economies will have to be well managed** and risks can also materialize on the international scene associated with commercial, geopolitical and social tensions.

The worsening of the pandemic since early November is an additional risk. The government's scenarios are based on the hypothesis that the outbreaks that arise may be contained with partial restrictions on mobility and that throughout 2021 there will be advances in the availability of the vaccine or an effective treatment that allows to recover normality. In the short term, the recent worsening of the pandemic, which is leading many countries to impose a stricter and more generalized confinement of the population, **suggests that the economic impulse from abroad will be more reduced**. Especially highlights the impact that these restrictions may have on the tourism sector in the last months of 2020 - some islands have their peak season at Christmas. In the medium term, after the November news about vaccine developments, **there is now greater certainty about an effective treatment that will allow first steps into recovery**.

The high levels of savings that emerge from the financial accounts of the families show the **fragility of the recovery in a scenario of persistence of the pandemic**. Thus, in the second quarter of 2020, families increased their saving rate by more than 12 pp, reaching 22.5% of disposable income in seasonally adjusted terms, the historical maximum in this series. Although much of it is forced saving associated with the period of confinement, the deterioration in confidence and employment prospects suggest that there may also be precautionary saving, which could be weighing down the recovery of household spending.

An additional factor of risk is associated with the implementation of the **Recovery, Transformation and Resilience Plan**. As mentioned, the risks of delays in the absorption of these resources and in the execution of these projects are high. Adding to this, there's the possibility that some resources may not have the desired impact if the selection of projects is not adequate. On the other hand, if the increase in investment spending was accompanied by structural reforms aimed at increasing the efficiency of the economy, the impact of the Plan could be greater and longer lasting,- although probably not visible in 2021.

The persistence of the pandemic increases the risk of structural damage to productive activities and the labor market. Despite the measures aimed at preserving liquidity and business solvency, the duration of the illness increases the probability of permanent damage to companies, especially in those sectors where restrictions on mobility have a greater impact.. Studies carried out by the Bank of Spain suggest that, although Spanish companies have faced the crisis with a more solid financial position, the figures from the Central Balance Sheet show a sharp fall in profits and business profitability. In fact, this entity has carried out simulations in which it suggests that in an adverse scenario of persistence of the disease, the percentage of companies with liquidity needs would increase to 70% in the last quarter of the year and only 50% of those liquidity needs could be covered with liquid assets and lines of credit.

Measures to preserve liquidity and business solvency are key to slowing down the deterioration of credit risk indicators. The relationship between the rate of non-performing loans and bankrupt companies is affected by the protection measures for debtors - mortgages and non-mortgages - and credit lines with public guarantees. The increase in moratoriums, as in the case of furloughs (ERTEs), is mainly concentrated around the activities of the retail and wholesale trade, the hospitality industry, professional and technical activities and market services linked to recreational services. The persistence of the pandemic makes the maintenance of these measures necessary to ensure its liquidity (and solvency) in the coming months. On the other hand, the number of companies contributing to social security has recovered, but it still maintains levels much lower than those registered before the crisis.

The risk increases that the persistence of the pandemic could trigger financial difficulties globally and in the banking system. In its recent financial stability report, the Bank of Spain has warned of the risk of the intensity of the second wave of contagion and the extension of the crisis ends up having a negative impact on the solvency of the banking system, with the consequent reduction of credit which could cause a financial crisis that would delay recovery. In fact, the results of the Bank Loan Survey show that, during the third quarter of the year, both Spain and the euro area saw a general contraction in the supply of credit, which would be linked to the increase in perceived risks. At the international level, there are many institutions that warn about the possibility that the duration of the crisis could end up generating financial difficulties in some countries, especially in vulnerable economies such as those in Latin America that have important financial ties with Spain.

In the job market, it is still too early to see permanent damage, but this is a notable risk for next year. However, taking into account unemployment according to the time of job search,

it is perceived that, although the increase is especially concentrated among those unemployed for less than a year, the percentage of people who have been looking for a job for more than one year also increases significantly, despite the fact that ERTes are constituting an important unemployment buffer during the current crisis. Another element to consider is that the crisis has affected to a greater extent households and people with greater financial fragility and lower wages, whose jobs are carried out in the service sectors most affected by social distancing.

5. Fiscal consolidation will be the main challenge for the Spanish economy

In terms of fiscal consolidation, AIReF's baseline scenario considers a deficit of the Spanish Public Administrations of **8% of GDP in 2021, after reaching 11.6% in 2020**, higher in both cases than the figures included in the State Budget: 11.3% in 2020 and 7.7% in 2021 (Figure 10). The economic recovery, the progressive withdrawal of the measures implemented to alleviate the effects of the COVID-19 crisis, and the tax modifications included in the State Budget will drive this deficit reduction.

Figure 10 Spanish public administrations estimated deficit by component: AIReF vs central government (% GDP)

	2020			2021	
	2019	State Budget	AIReF	State Budget	AIReF
Public Administrations (AAPP)	-2,9	-11,3	-11,6	-7,7	-8,0
Central Administrations (AC)	-1,3	-6,6	-7,2	-5,2	-5,6
Social Security Fund (FSS)	-1,3	-4,1	-3,8	-1,3	-1,5
Autonomous Communities (CCAA)	-0,6	-0,6	-0,6	-1,1	-0,8
Local Entities (CCLL)	0,3	0,0	0,0	-0,1	-0,1

Source: AIReF 2020

In 2020, AIReF estimates public revenues at 41% of GDP, while public expenditure will amount to 52.5% of GDP. In nominal terms, revenues would decline by 6.4% compared to 2019, better than the decline in nominal GDP, which explains the increase in the public revenues share over GDP. On the contrary, public expenditures will rise by 11.8% y/y, which, together with the drop in nominal GDP, implies that public expenditure will increase its weight in GDP by 10.5 points. The decline in revenues is produced essentially as a consequence of the decline in economic activity due to the COVID-19 crisis, while the growth in expenses is mainly due to the measures implemented to mitigate the effects of the crisis in the different dimensions, both healthcare as well as economic and social components.

The new spending measures included in the 2021 State Budget imply a slower reduction in the deficit. It is assumed that the Recovery, Transformation and Resilience Plan (PRTR) will have a neutral effect on the 2021 deficit, in accordance with the Government's forecasts in the State Budget, representing an increase in both income and expenses of 2.8 points of GDP; although there may be in practice temporary gaps between the revenues and expenditure dynamics, in the medium term the impact will be neutral and assuming this hypothesis for 2021 allows a better analysis of the evolution of the deficit.

The improvement in the macroeconomic environment in 2021 explains 1.6 points of GDP reduction in the deficit, while the progressive withdrawal of the measures will mean a

reduction of 2 points. In 2020 the weight of the deficit over GDP increases by 8.7 points, from 2.9% in 2019 to 11.6% according to AIReF's central forecast; 4.4 points of this variation are justified by the fall in economic activity that it drags down the public accounts, and 4.2 points are caused by the measures implemented to alleviate the effects of the crisis on households.

In 2021, a recovery in economic activity is expected as the effects of the pandemic fade, causing an improvement in public accounts that will help reduce the deficit by 1.6 points, as shown above in Figure 10. This includes the increase in revenues due to the economic recovery, the inertial evolution of expenditures and the denominator effect due to the nominal growth of GDP. To this, it must be added a reduction of two more points due to the progressive withdrawal of the measures approved in 2020 to mitigate the effects of the pandemic. Both effects will put the 2021 deficit at 8% of GDP.

After a 6.4% decline in 2020, AIReF forecasts that public revenues will grow by 6.2% y/y in 2021, up to 39.7% of GDP (42.5% including the revenues from the Recovery Plan). This forecast is based on macroeconomic scenarios that contemplate a rapid and effective implementation of the Recovery, Transformation and Resilience Plan (PRTR) and on the State Budget (PGE) approved on December 3 and that includes several tax modifications (VAT, Personal Income Tax, Corporation Tax, Special Taxes and insurance premiums), as well as new tax figures (Tax on Financial Transactions, Tax on Certain Digital Services, Tax on Waste and Single-use Plastics).

According to AIReF's estimates, excluding the PRTR, public expenditure will be at 47.6% of GDP vs 48% of GDP in the State Budget in 2021, , after peaking at 52.5% of GDP in 2020. The progressive withdrawal of the implemented measures in 2020 would be partially offset by the measures contemplated in the 2021 State Budget and the consolidation of part of the healthcare spending. However, the implementation of the PRTR will boost spending growth, reaching 50.5% of GDP. AIReF's central scenario estimates continue to be subject to a high degree of uncertainty due to the evolution of the COVID-19 health crisis and its effects on economic activity, in addition of the risks of the implementation of the PRTR if it is less efficient than expected, which would reduce fiscal multipliers in the short and medium term and their effect on the potential growth of the economy, thus wasting opportunities for the modernization of our economy.

By public administration, **the Central Administration will continue to assume part of the deficit of the Social Security Funds and Autonomous Communities through direct transfers**. On the other hand, the implementation of the PRTR will affect all administrations, although it is also neutral for each one of the administrations. Regarding the reference deficit rates included in the State Budget, AIReF estimates deviations in the case of the central administration and the Social Security, partially offset by a lower deficit in the Autonomous Communities.

The measures against COVID-19 will still account for 1.7% of GDP in 2021 vs 4.2% of GDP in 2020. The central government and the governments of the different territorial administrations adopted a wide variety of measures in 2020 to mitigate the effects of the crisis. Most of the measures adopted are temporary and revert automatically and therefore they would cause

a reduction in the deficit when they expire, which is associated with the duration of the pandemic. Therefore, during 2021 they will still have a significant impact on the deficit, although more reduced than in 2020.

The COVID-19 pandemic will still require maintaining a significant part of the increase in healthcare spending in 2021, estimated at 0.4 points of GDP. The increase in healthcare spending in 2020, 0.8 points of GDP, comes mainly on the back of the Autonomous Communities, 0.7 points, although it has been mostly financed by the Central Administration through the COVID-19 Fund. **We do expect that a part of the higher expenditure incurred in 2020 for personnel, intermediate consumption, social transfers in kind and investment in equipment will still have an impact in the Autonomous Communities in 2021 depending on the evolution of the pandemic.** It is still difficult to predict how much of this increase in spending will be structural in nature as a reinforcement of the health system. On the other hand, the PRTR will also assume part of the health expenditure associated with the pandemic, such as the acquisition of the future vaccine.

Given the fact that the payments of the regional and local financing systems are determined by the State Budget, the difference between the real tax collection and the forecasted one only affects the central administration. For 2021, the central administration continues to assume an amount similar to the one of 2020 of transfers to the Autonomous Communities and Social Security Funds to offset the effects of COVID-19. Lastly, it should be noted that the central administration will manage the funds from the Recovery and Resilience Mechanisms and a part of the REACT-EU funds, channeling a relevant part of them to other subsectors via transfers.

AIReF estimates that the central administration deficit could reach 7.2% in 2020, reducing to 5.6% in 2021. The sharp deterioration of the deficit in 2020 is explained by, on the one hand, a) the decrease in revenues derived from the decline in economic activity, which is estimated at 11.5% y/y, together with b) the maintenance of the State account transfers to the regional and local financing system at 2019 levels. Furthermore, there is an increase in public expenditure in the central administration justified to a large extent due by the increased transfers that the State provides to the Social Security Funds and the autonomous communities.

In 2021, **AIReF expects the deficit figure of the central administration to improve by 1.6 points of GDP** driven by the recovery in activity and the new measures included in the 2021 State Budget. Taking also into account the impact of the PRTR, revenues would grow by 24.6% y/y; if we exclude the effect of the PRTR, revenues would grow by 10.7% y/y, and excluding both the measures in the Budget and the PRTR, revenues would grow by 8.8% y/y. On the expenditure side, AIReF expects an increase of 13% y/y in 2021, as 8.7% of the total expenditure would be financed with the PRTR. In addition, in 2021 the extraordinary financing to other subsectors continues, as the transfers to the Social Security funds and the autonomous communities' subsectors is again consolidated and even increased in 2021, representing about 12% of the total central administration expenditure. However, part of the transfers to the Social Security Funds will become permanent according to the conclusions and recommendations of the Toledo Pact.

Regarding the Social Security Funds, and after reaching a peak of 3.8% of GDP in 2020, the deficit of the Social Security would be reduced to 1.5% of GDP according to AIReF estimates. The 2021 State Budget foresees a higher deficit in 2020 and a smaller one in 2021 vs AIReF estimates. The reduction of the deficit in this subsector would be explained by the progressive withdrawal of measures such as furloughs (ERTEs), the end of the compensations of social security contributions for the self-employed, the recovery of employment and the maintenance of the transfers from the central administration.

The deficit of the Autonomous Communities would grow in 2021 to 0.8% from an expected deficit figure of 0.6% in 2020. This evolution is more positive than the one foreseen by the 2021 State Budget, which places the regional deficit at 1.1% of GDP in 2021. The difference in these figures is mainly due to the assumptions about the degree of consolidation of the spending associated with the pandemic, since AIReF considers that part of the 2020 increase would be temporary. In addition to implementing the Recovery and Resilience Mechanisms projects financed by conditional transfers from the central administration, the Autonomous Communities must also implement the REACT-EU programs for an amount of EUR 8,000 mn in 2021, which will significantly increase their spending in parallel with their income.

Local Corporations would incur a deficit in 2021 of 0.1% of GDP, after closing in equilibrium in 2020. This subsector will also play a role in the implementation of the PRTR, although quantitatively less than the one of other subsectors.

Fiscal figures of the Spanish public administrations up to September 2020

It is important to bear in mind that this is an atypical year marked by the measures introduced to deal with the pandemic generated by COVID-19. As expected, **the COVID-19 pandemic has had a very negative impact on public accounts due to the impact that the pandemic has had on health spending**, the effect of automatic stabilizers and the measures implemented by the Administrations to minimize the impact of the crisis in rent.

As it is clear from Figure 11, **practically all the fiscal impact is being absorbed by the Central Administration and to a lesser extent by Social Security.** This is for two reasons: a) The first is that the bulk of the measures (ERTES, Minimum Vital Income, etc.) have been implemented by the Central Administration; b) secondly, **the State took the political decision to shield the Autonomous Communities from the budgetary effects of this pandemic**, by setting the State account transfers aligned with the pre-pandemic GDP growth forecast for 2020 of 1.6%, when the economy will fall above two digits according to all estimates, and by launching additional resources (COVID-19 Fund¹, Extraordinary Social Fund, etc.) aimed at offsetting both the

¹The Covid-19 Fund amounts to EUR 16,000 mn and four tranches: i) Tranches 1 and 2 are distributed based on representative criteria for healthcare spending (EUR 6,000 and EUR 3,000 mn, respectively), ii) Tranche 3 is distributed on the basis of representative criteria for spending on Education (EUR 2,000 mn) and iii) Tranche 4 (EUR 5,000 mn) is mainly distributed, on the basis of criteria related to the reduction of regional revenues from the decline in economic activity. Of this last tranche, EUR 800 mn are earmarked to be distributed according to criteria associated with the estimated budgetary impact in the public transport services.

additional expenses in Health and Education and the fall in regional taxes that this pandemic is going to have in regional governments.

Figure 11 Budgetary deficit (-)/ surplus (+) of the Public Administrations: September 2019-2020

Subsectors	Millions euros		Variation		% GDP	
	2019	2020	Millions eur	%	2019	2020
<i>Central Administrations</i>	-9.728	-57.141	-47.413	487,4	-0,78	-5,17
State	-8.276	-56.498	-48.222	582,7	-0,66	-5,11
Central Administration bodies	-1.452	-643	809	-55,7	-0,12	-0,06
<i>Autonomous Communities</i>	-3.613	2.597	6.210	-171,9	-0,29	0,23
<i>Social Security Funds</i>	-6.341	-20.873	-14.532	229,2	-0,51	-1,89
Social Security system	-8.342	-7.589	753	-9,0	-0,67	-0,69
Employment protection system	1.892	-13.195	-15.087	-797,4	0,15	-1,19
FOGASA	109	-89	-198	-181,7	0,01	-0,01
Public Administrations	-19.628	-75.417	-55.735	283,2	-1,58	-6,82
Financial Aid (net balance)	18	14	-4	-22,2	0,00	0,00
Public Administrations with financial aid	-19.664	-75.403	-55.739	283,5	-1,58	-6,82
GDP used	1.244.772	1.105.359				

Source: Finance Minister 2020

According to the latest data published by the Ministry of Finance, until September 2020, the combined deficit of the Central Administration, the Social Security Funds and the Regional Administration, excluding the financial assistance to bans, was EUR 75,417 mn, which is equivalent to **6.82% of GDP**. Excluding the support to financial institutions, the deficit would be of EUR 75,403 mn, also 6.82% of GDP.

The Central Administration has registered a deficit of 5.17% of GDP excluding the financial aid, estimated at EUR 14mn until September. The Social Security Funds have registered a deficit of 1.89% of GDP, which more than triples the figure registered in the same period of the previous year - 0.51% of GDP -, due to the economic effects caused by the pandemic, especially on social benefits. Until September, revenues have increased by 12.6% y/y, mainly due to the increased transfers received from the State, but non-financial expenditure has further increased by 23.1% y/y.

All in all, the combined expenditure from the public administrations continues to increase strongly, reaching EUR 160,834mn in September (+23.1% y/y), mainly due to the impact of the pandemic. In this regard, the consolidated expenditure of the Social Security Funds associated with the COVID-19 pandemic, according to the information available to date, stands at EUR 24,281 mn, which represents 2.2% of GDP, and represents 80.5% of all the

The Covid-19 Fund accounts for 1.4% of GDP. The Foral regions will receive a lower amount, around 0.8-0.9% of GDP, because they do not participate in Tranche 4, which is intended to offset the drop in regional revenues.

increase in expenditure registered up to September, including the transfer of EUR 14,003 mn received from the State in June.

The aggregate figure of autonomous communities has registered a surplus of EUR 2,597mn,(0.23% of GDP), compared to the deficit of 0.29% of GDP registered a year ago. This positive evolution is due to several measures adopted by the Government to guarantee the necessary resources to the regions to meet the expenses derived from the emergency caused by the pandemic. Regarding Autonomous Communities, the corrected budget balance improved in all regions, **except in the Basque Country and Navarre, where revenues declined by c.20% y/y**, as illustrated in Figure 12.

Figure 12 Budgetary deficit/surplus of Autonomous Communities (EUR mn, % of GDP). Base 2010. September 2019-2020

Autonomous Communities	2019		2020	
	Millions euros	%GDP	Milliones euros	%GDP
Andalusia	-478	-0,29	846	0,57
Aragon	-213	-0,56	162	0,48
Asturias	-60	-0,25	263	1,24
Balearic Islands	35	0,10	272	0,91
Canary Islands	540	1,14	679	1,62
Cantabria	-78	-0,55	85	0,67
Castile-La Mancha	-465	-1,09	-80	-0,21
Castile-Leon	-505	-0,85	231	0,44
Catalonia	-401	-0,17	848	0,40
Extremadura	-209	-1,01	99	0,54
Galicia	-287	-0,44	399	0,69
Madrid	-546	-0,23	650	0,31
Murcia	-344	-1,05	-122	-0,42
Navarre	60	0,28	-335	-1,77
La Rioja	-15	-0,17	129	1,65
Valencia	-1202	-1,04	-192	-0,19
País Vasco	555	0,74	-1337	-2,01
Spain	-3613	-0,29	2597	0,23
GDP used	1.244.772		1.105.359	

Source: Finance Minister

Regional revenues grow 9% y/y up to September. We would highlight the increase in tax revenues by 7.3% y/y, due to the increase in State transfers and the definitive settlement of the 2018 financing system and the increase registered in transfers received from other public administrations by 14% y/y, due to the higher resources received from the State coming from both the regional financing system and the Covid-19 Fund (EUR 7,964 mn have already been transferred from Sections I and III), EUR 300 mn from the Extraordinary Fund of basic social

services, EUR 300 million from the health benefits program and an additional EUR 75mn linked to other programs to contain the impact of the pandemic.

Likewise, it must be considered that, both in 2019 and 2020, there has been an extension of the 2018 State Budget, although in 2020, by virtue of Royal Decree-Law 7/202 of urgent measures to respond to the economic impact of COVID-19, the update of the State account transfers was fully disbursed in March and April.

On the other hand, regional taxes decline by 24.5% y/y, highlighting the 23.8% decrease in stamp duties tax collection linked to real estate operations.

The non-financial regional spending has increased by 4.2% YTD, driven by the increase in intermediate consumption (+9% y/y), on the back of the higher health and education spending, strongly influenced by the pandemic. The compensation of public employees has increased by 5.5% y/y due to the salary increases and the impact of COVID-19 until September. On the other hand, social transfers in kind grew by 2.6% y/y, highlighting the increase in spending on healthcare and educational arrangements, subsidies rose by 12% y/y and social benefits by 5.4% y/y.

Among the regional expenses that show a y/y decline, we would highlight transfers between Public Administrations, which decline by 2.6% y/y, as well as interest and investment, which show a y/y decline YTD of 14.8% and 3.1%, respectively.

All the Autonomous Communities (except Navarre and the Basque Country) show a better fiscal performance until September 2020 than a year ago. In addition, except for these two regions, Castile la Mancha, Valencia and Murcia, **the remaining 12 Autonomous Communities show a budgetary surplus YTD.**

The impact of the pandemic on the normal status regions is fundamentally reflected in the accounting chapter labeled “ other revenues”, which fundamentally comprises: i) the Inheritance and Donations Tax ii) the Tax on Patrimonial Transmissions and Documented Legal Acts (ITP and AJD), iii) fees iv) revenues from regional patrimony v) patrimony sales (disposals of real investments) vi) current transfers vii) capital transfers and viii) the rest of direct and indirect taxes (the wealth tax, the regional section of the hydrocarbon tax, the registration tax, the Canarian IGIC, etc.).

These revenues represent approximately 15% of the total non-financial income in aggregate terms of the normal-status regions. According to latest data available, these revenues have been rapidly reflecting the economic effects of the restrictions to face the healthcare crisis, showing a decline of 22.9% y/y for the aggregate of normal-status regions. Y/y declines are relevant in the Inheritance and Donations Tax (-27.5% y/y), Real Estate Transfers and Documented Legal Acts (ITP and AJD, -25.8% y/y), other regional Taxes (-20.8% y/y), capital transfers (-17.9% y/y), capital income (-51.9% y/y), the Rest of Current Transfers (-21.7% y/y) and the rest of direct and indirect taxes (-18.9% y/y).

It should be noted that a part of this decline in tax collection is going to be recovered in the coming months as it is driven by the postponement and suspension of deadlines measures in the settlement of taxes introduced as a result of the Royal Decree of the State of Alarm. The revenues coming from the Disposal of Real Investments is the one that have decreased the least (-12.8% y/y), but this item is practically irrelevant in the aggregate revenues of the Autonomous Communities.

Although, as previously stated, the growth rate of the “rest of revenues” of the Autonomous Communities as a whole has been significantly reduced, there is a lot of heterogeneity between the different regions. On the one hand, the decline in the “rest of income” in Castile-Leon (-55.8% y/y), Cantabria (-44.0% y/y) and Asturias (-32.5% y/y) stands out. On the other hand, the lowest y/y declines would be in the Balearic Islands (-13.6%), Galicia (-8.2%) and La Rioja (-2.0%).

According to the information disclosed by the autonomous communities, the impact derived from COVID-19 till September amounts up to EUR 5,275 mn in social and health spending, as shown in Figure 13.

Figure 13 Impact associated with Coronavirus SARS-CoV-2 by region as of September 2020 (EUR mn, % of GDP)

Autonomous Communities	Millions euros	% GDP
Andalusia	671	0,46
Aragon	99	0,29
Asturias	82	0,39
Balearic Islands	111	0,37
Canary Islands	144	0,34
Cantabria	57	0,45
Castile-La Mancha	371	0,98
Castile-Leon	322	0,61
Catalonia	1.026	0,49
Extremadura	87	0,48
Galicia	172	0,30
Madrid	962	0,45
Murcia	103	0,35
Navarre	73	0,39
Rioja	40	0,51
Valencia	612	0,60
Basque Country	345	0,52
Total Autonomous Communities	5.275	0,48
GDP used	1.105.359	

Source: Ministry of Finance 2020 -information supplied by every Autonomous Region-

Note: the amounts are calculated in terms of national accounts

Even though in November the Autonomous Communities received the remaining EUR 8,000 mn from the Covid Fund corresponding to the tranches II and IV, regional spending could accelerate due to the incorporation of more teachers and health workers into the workforce, and therefore it is estimated that the deficit of the Autonomous Communities would close at around 0.5%-0.6% of GDP in 2020.

6. The Spanish regional deficit targets: can they be met?

In the view of this report, the persistence from the Ministry of Finance in setting homogeneous targets or reference rates for all the Autonomous Communities except for 2013 does continue to discourage the most indebted autonomous communities from following a credible path of fiscal consolidation. In a nutshell, it is realistic to say that the establishment of deficit and debt objectives between the different levels of public administrations in general, and between the autonomous communities, does not follow any specific method. In essence, the current practice tries to distribute among the different Public Administrations the public deficit targets agreed in the European institutions using criteria that are not very aligned with a coherent framework of fiscal discipline.

The largest share of the public deficit that the government tends to assign to the central administration is done on the basis of intense work in economic stabilization by the latter and/or the efforts made to provide additional resources to the extraordinary financing mechanisms of the other territorial administrations, mainly the autonomous communities. As mentioned in the above paragraph, only on one occasion (2013) were asymmetric deficit targets established between the normal-status regions.

This situation leads to a distribution of the deficit targets that considers from the beginning the expected non-compliance with the targets from the Central Administration and the Social Security and the usual over-compliance of the Local Entities (EELL). On the Autonomous Communities side, the decision is usually left to the discretion of a) transferring discretionary resources or b) within the framework of the extraordinary financing mechanisms in order to meet any possible past, present or future financing needs. A clear example of a) is the update of the State account transfers decoupled from the conventional process of the State Budget approval and the Covid-19 Fund granted in 2020; an example of b) would be the increase of the resources coming from the extraordinary liquidity mechanisms (FFCAA) to cover deviations from the deficit target that are later consolidated into the public debt target for the following year.

Another criterion followed de facto in the establishment of the public deficit objectives of the Autonomous Communities lies in minimizing friction with and between them. This may explain the fact that only on one occasion during the period of validity of the Organic Law on Budgetary Stability and Financial Sustainability (LOEPSF) asymmetric deficit targets have been assigned between the normal-status autonomous communities. Given the heterogeneous starting situation and the different track records in fiscal consolidation efforts, **it would be reasonable to think of differentiated objectives based on a regulatory reduction of the regional debt stock at the individual regional level**, up to a previously set level and at a certain speed of convergence, particularly for those regions with adjusted financing per capita below the average, a situation that negatively affects their indebtedness level.

7. The COVID-19 pandemic and the debt sustainability of the Spanish public administrations

The high initial indebtedness of the Spanish economy, with a debt-to-GDP ratio of 95.5% at the end of 2019, represents an added difficulty when facing the challenges that will arise from the economic crisis caused by the pandemic. One of the main legacies of economic crises is the rapid increase in public debt, the reduction of which usually takes a much longer period of time. This has been the case in the Great Recession. **The 2008 crisis caused a 65-point increase in the debt-to-GDP ratio in just seven years, of which only 5 points have been reduced in the last five.** If the annual debt reduction requirements set forth in the Organic Law on Budgetary Stability and Financial Sustainability had been met, the debt-to-GDP ratio in 2019 would have been around 90% instead of the indicated value. The slow reduction in the debt ratio despite favorable growth conditions and historically low interest rates has limited the fiscal space to face a new crisis.^z

The paralysis of economic activity registered in the first half of 2020 and the increase in financing needs derived from the COVID-19 crisis have placed the debt-to-GDP ratio at around 110%, the highest value in the last one hundred years. In the first six months of the year, public debt totaled more than one hundred billion euros to reach 1.3 trillion euros, raising the debt-to-GDP ratio to 110.2%, which represents an increase of 14.7 points compared to the end of last year.

From the point of view of the sustainability of public finances, **the impact of the pandemic is more than appreciable.** The paralysis of economic activity and the increase in financing needs derived from the COVID-19 crisis **will cause a sharp increase, in principle temporary, in the public deficit** which in turn will lead to a permanent increase in the level of public debt on GDP, placing it at its highest value in the last hundred years. Thus, we project **an increase in the debt-to-GDP ratio of around 23 points in 2020, and a reduction of up to 2.4 points in 2021** under the scenario of full implementation of the Recovery, Transformation and Resilience Plan in 2021. As a result, **the Spanish public debt to GDP ratios would increase up to 118.4 and 116% in 2020 and 2021, respectively**, in line with the projection in the 2021 State Budget, which places the public debt ratio at 118.7% of GDP in 2020 and 117.4% in 2021.

AIReF estimates an increase of close to 23 points in the debt-to-GDP ratio in 2020, and a reduction of 2.4 points in 2021 under the hypothesis of the execution of all the projects included in the 2021 State Budget. The increase in the public deficit and the fall in growth projected for 2020 will lead to an increase of 22.8 points in the debt ratio, placing it at 118.4% of GDP. The rebound in economic growth driven by the Recovery Plan in 2021, together with an environment of interest rates at historical lows, project a reduction of 2.4 points in the ratio, to 116%.

The containment of the health crisis and the normalization of economic activity will be necessary elements for the stabilization of the debt-to-GDP ratio in the coming years. Growth above trend for several years, as the world economy emerges from the recession caused by COVID-19, **would stabilize the debt ratio at around 120% of GDP** in the absence of measures

(either contractionary or expansionary linked to the PRTR). A scenario of sustained growth that closes the negative output gap of 2020 over the next five years will cause, beyond the denominator effect, the improvement of the cyclical component of the public balance, helping to stabilize the debt-to-GDP ratio in the 120% level.

The implementation of the **European Next Generation EU Plan** will have a positive effect on economic activity in the short term, as well as on productivity and potential growth in the long term, which will translate into a better evolution of the fiscal position, **with a reduction of the debt-to-GDP ratio of between 4 and 10 points.**

The decline in interest rates in recent years has allowed a considerable reduction in the debt burden, as shown by debt interest payments at 2.3% of GDP at the end of 2019 from the peak of 3.5% in 2013. Since mid-2012, the effective cost of financing Public Administration debt has been systematically reduced to a total of 180 basis points (4.2% in 2012 vs 2.4% in 2019), which has made it possible to reduce interest expense even in absolute value, from EUR 35,442 mn in 2014 to EUR 28,349 mn in 2019.

After brief but significant upturn in sovereign debt yields and risk premiums in southern European countries -where the yield on the Spanish 10-year bond rose 100 bp -, the ECB's commitment to ensure the correct transmission of the monetary policy and thus avoiding fragmentation in the public debt markets through its Emergency Purchase Program against the Pandemic (PEPP) -, has once again placed the spreads close to the pre-crisis levels and the Spanish interest rate curve at the level registered in the month February, close to historical lows.

Despite the expected increase in debt levels, under current financing conditions, the financial burden does not represent a worrying spending pressure in the short term. The favorable financing conditions for sovereign debt (the average rate of new Treasury issues was 0.23% in 2019 and 0.21% until October 2020, with a yield curve trading negative for terms of less than five years), represent a containment to the increase in the financial burden, because the low average financing rates compensate for the higher stock of debt. However, this evolution generates a significant dependence on the environment of low interest rates.

The implementation of the European Next Generation EU Plan will have a positive effect on economic activity in the short term. At the same time, it could lead to an improvement in productivity and potential growth in the long term, which would translate into a better evolution of the fiscal position. The NGEU European Plan will provide a strong boost to public investment in the coming years without this resulting in a deterioration in the situation of public finances. The uncertainty about the impact of the Plan is great and its economic effects will depend, among other factors, on the ability to swiftly execute the public budget, on compliance with the associated milestones, and how and in what resources to invest and the reforms carried out to increase potential growth.

Under a scenario of execution of all the projects financed under the NGEU European Plan transfer modality in the next three years, and assuming different fiscal multipliers, **it would have an impact on the reduction of the debt-to-GDP ratio of between 4 and 10 points.** The

effect of the Plan on the improvement in the debt ratio will be determined both by the denominator effect - given RGE higher GDP growth -, and by an improvement in the public balance thanks to higher tax collection, without a counterpart of an increase in the issuance of debt, since the new investments will be financed via transfers. This effect will be greater depending on the type of project and the associated multiplier effect. Under a simulation of the impact on short-term growth with different fiscal multipliers (between 0.5 and 1.5), and an increase in long-term potential growth of 0.15 points, **the Recovery Plan will entail a decrease in the Debt-to-GDP ratio of between four and ten points in 2030.**

Once the crisis is over, the design of an adequate consolidation plan will be necessary to reduce the debt ratio to more prudent levels. A gradual and sustained reduction of the public deficit towards the objective of structural equilibrium, as indicated by our fiscal framework, would place the public debt ratio below pre-pandemic levels over the next decade.

The risks and challenges for the medium and long-term sustainability of public accounts are high. In this sense, one of the main risks of the current situation is that the recession will mutate into a depression so that in the future it will be necessary to face **not only a higher public debt ratio, but also a larger and more persistent structural deficit and a higher materialization of contingent liabilities of loans guaranteed by the State.**

Another notable risk in a context of high indebtedness is the greater dependence on favorable financing conditions such as the current ones, since a rise in interest rates can rapidly generate an increasing dynamic of the public debt ratio. We also need to include in the equation the known challenge of the aging of the population and higher spending on pensions, which, if not financed with additional income, will translate into a very significant increase in debt from historically very high levels.

The containment of the health crisis and the normalization of economic activity will be necessary elements for the stabilization of the debt-to-GDP ratio in the coming years. As mentioned above, the exceptional increase in the public debt ratio registered during 2020 has been caused by the COVID-19 crisis, and as far as the uncertainty about the factors that have contributed to such an increase (increase in public spending, decrease in tax collection, fall in GDP) persists over time, additional increases in the short-term debt ratio cannot be ruled out.

In summary, it is the view of this report that **a national fiscal strategy in the medium term should be established** that serves as fiscal orientation and guarantees in a realistic and credible way the financial sustainability of the public administrations. This requires having all levels of the administration, considering their fiscal realities in terms of resources and competences, to ensure adequate coordination and joint responsibility, as well as considering the levels of public debt and fiscal risks, especially those assumed by the managing of the COVID-19 crisis.

Therefore, when the crisis is overcome, **consolidation plans should be designed to generate a path of sustained reduction of the debt ratio to more prudent levels.** Beyond the containment and stabilization of the level of indebtedness generated because of the

pandemic, the financial sustainability of public accounts will require a path of reduction of the debt ratio towards a much more comfortable position. The tailwind of a foreseeable scenario with economic growth above the implicit interest rate of the debt will be a necessary, but not sufficient, condition for the generation of a downward dynamics of the debt ratio, which in any case will require correction structural imbalances in public accounts.

Thus, **the long-term maintenance of a structural deficit similar to that registered in 2019 would stabilize the debt at levels significantly above 100% of GDP.** A gradual and sustained reduction of the public deficit towards structural equilibrium, as indicated by our fiscal framework, will generate a more pronounced path of reduction in the debt ratio, placing it at pre-pandemic levels over the next decade.

One of the main risks of the current situation is that **the recession will mutate into a depression so that in the future we will have to face not only a higher public debt ratio, but also a larger and more persistent structural deficit.** The longer the period of economic crisis continues, the greater the probability that the bankruptcy of companies, the cancellation of investments, the deterioration of the capital stock and long-term unemployment will end up eroding the capacity to grow in the medium term (i.e. the potential growth). This would make it difficult to reverse part of the current increase in the public deficit, the relief of which is directly related to the intensity of the subsequent recovery.

The materialization of this risk would translate into losses in the contingent liabilities that the State is assuming with the umbrella guarantee program, which would be reflected in an increase in the level of public debt. For the purposes of quantifying the order of magnitude of the risk, estimates that an execution level of between 15 and 30% of the guarantees granted by the State in the next five years of validity of the guarantee line **would mean an additional increase in the debt ratio of between 1 and 2 points of GDP.**

Dependence on a low interest rate environment over a long-time horizon has become one of the most prominent aspects linked to the dynamics of debt sustainability. The current level of interest rates at historical lows favors debt sustainability, even allowing the stabilization of the debt ratio under a certain primary deficit. But given the high level of indebtedness, a rise in interest rates can quickly generate an increasing dynamic in the ratio, which, in order not to become unsustainable, will have to be offset by additional fiscal adjustments. Thus, a rebound of 100 b.p. interest rate expectations throughout 2021 would mean an increase in the financial burden of 1 point of GDP in 2030 and 1.4 in 2040, placing the item of interest expense at 2.8% and at 3.6% of GDP, respectively. **This would result in an increase of 6 points in the debt ratio in 2030 and 15 in 2040.**

On the other hand, the increase in pension spending associated with the aging of the population constitutes one of the main challenges for the sustainability of public finances in the medium term. AIReF estimates in its central scenario an increase in pension spending of 3.3 points of GDP compared to the level of 2019, placing it at 14.2% in 2050. This increase in spending will be determined by the aging process of the population, and it could increase significantly if some risk scenarios simulated by AIReF materialize, such as lower net migration flows, the stagnation of the labor market or the COVID-19 crisis having structural

effects.

A higher structural expense derived from the pension system that is not covered with additional income will lead to a very significant increase in debt from historically very high levels. The accumulation of debt derived from the financing of higher spending on pensions represents a risk factor for sustainability in the medium term. AIReF estimates an additional increase in the debt-to-GDP ratio of around 9 points at the end of this decade, and between 22 and 30 points in 2040.

8. Fiscal risks of the COVID-19 pandemic

It is important to highlight that **there is a risk that spending linked to the pandemic**, once it is gone, **will become structural**. Massive spending measures have been taken to deal with the health, economic and social crisis resulting from the pandemic. These measures are temporary in nature, since their origin is linked to an extraordinary and exceptional circumstance such as the pandemic. The consolidation of this extraordinary expense over time would imply an unjustified upward pressure on the deficit, putting at risk the future fiscal consolidation of the public administrations. This risk increases with the materialization of the optimistic scenario since a prompt resolution of the crisis could make certain increases in spending unnecessary for which financing has already been planned.

As a consequence of the crisis caused by COVID-19, the Government adopted numerous liquidity measures to ensure the maintenance of the productive activities. The measures to reinforce and create financing lines and guarantees on behalf of the State, the approval of deferral of debts and moratoriums and the implementation of different tax measures aimed at preserving the liquidity of the companies and the self-employed. This entire package of measures amounts to about **EUR 160 billion** (13% of GDP). All this financing has made it possible to mobilize to date more than EUR 102 bn in lending, mainly for SMEs and the self-employed.

According to the 2021 State Budget, these measures are not expected to lead to a further deficit in 2020, although no mention is made of the impact in 2021. In principle, **if the respective guarantees and/or guarantees are not executed, these measures do not lead to a higher public deficit**. In this sense, the State Budget does not estimate that any of these guarantees will be executed in 2020, so it does not foresee any budgetary impact for this year, given the fact that a) the most important guarantee measures are usually associated with a one-year grace period and b) since these liquidity measures usually require a solvency situation as of December 31, 2019, they have been aimed at companies that only have liquidity problems (and not solvency).

However, **we consider that there are important factors that increase the risk of execution of these guarantees**. On the one hand, the high number of guarantees and endorsements granted, up to 13% of GDP; and on the other hand, the uncertainty that persists about the evolution and duration of the pandemic. In this sense, the development of recent events in which restrictions on mobility and capacity proliferate is a serious obstacle to many businesses, in which SMEs and the self-employed are especially vulnerable. Therefore, there are objective circumstances that increase the probability of execution of these guarantees and, therefore, of their impact on the deficit in 2021 and/or in future years.

9. Spanish regions' fiscal stability in the COVID-19 times

As a consequence of the COVID-19 crisis, **the budget stability objectives are on hold after the activation of the escape clause provided for in article 11.3 of Organic Law 2/2012 on Budget Stability and Financial Sustainability** on the concurrence of exceptional circumstances and approved by the Spanish Parliament. As a result, non-binding reference deficit targets has been set in 2020-2021 for each one of the Spanish public administrations, as shown in Figure 14.

Figure 14 Reference deficit targets of the Spanish Public Administrations for 2021 (% GDP)

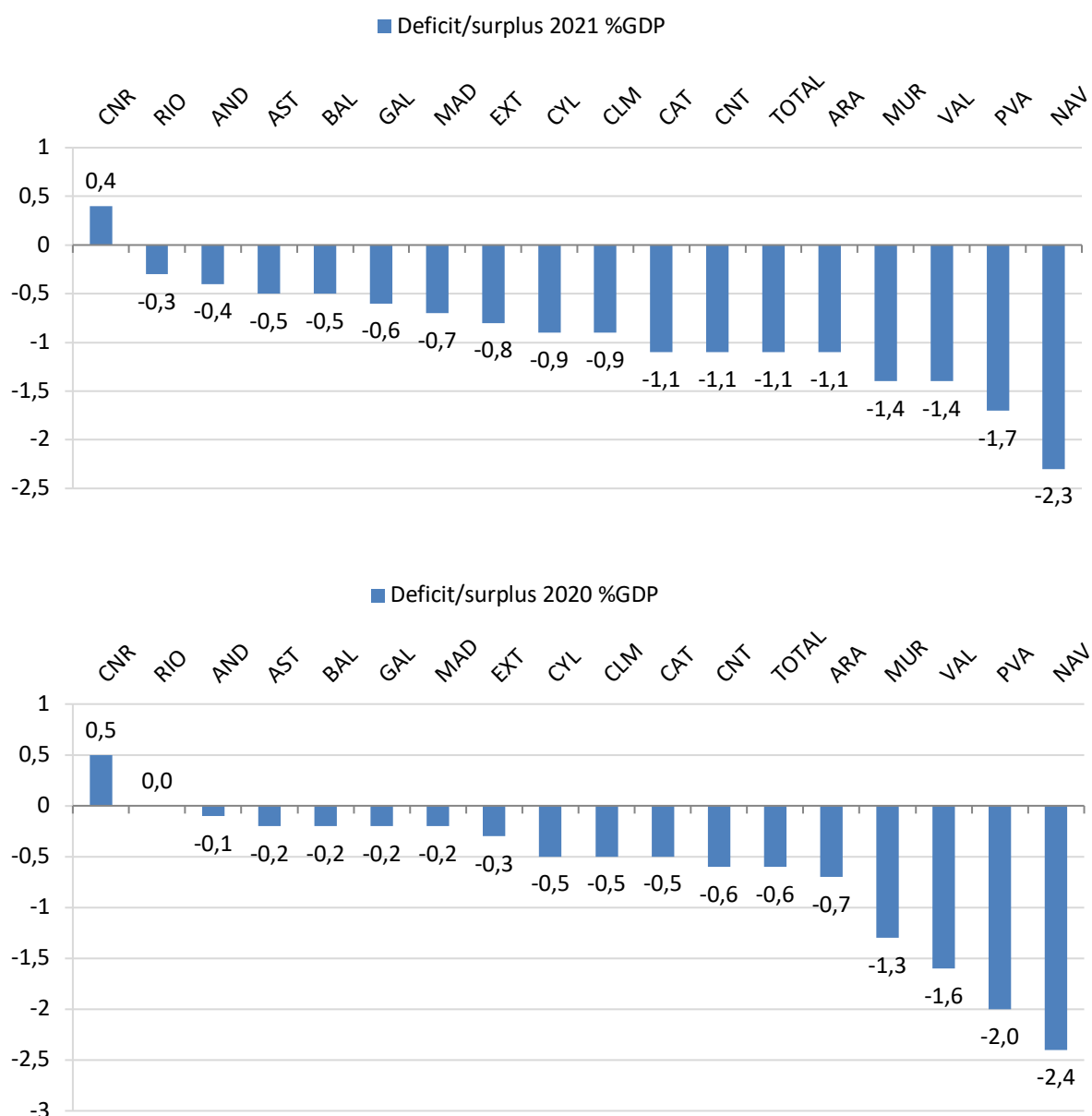
	Deficit reference rate for 2021
Central Administration (AC)	5,2
Autonomous Communities (CC.AA)	1,1
Local Entities (CC.LL)	0,1
Social Security Funds (FSS)	1,3
Total Public Administrations (AA.PP)	7,7

Source: AIReF

The deficit of the Autonomous Communities would increase in 2021 to 0.8% from the 0.6% expected in 2020, according to AIReF estimates. This evolution is more positive than the one foreseen by the 2021 State Budget, which places the reference rate for the regional deficit in 2021 at 1.1%. The difference in the estimates is fundamentally due to the assumptions about the degree of consolidation of spending associated with the health crisis, since AIReF considers that, part of these expenses would not be replicated in 2021 if taking into account its temporary nature and the evolution of the pandemic foreseen by the government.

For the individual analysis, the distribution of the extraordinary State transfers to reduce the deficit of the Autonomous Communities has been estimated, considering that for each one it will represent 1.1% of the regional GDP, being the criterion considered in most projects and budget lines. Under this criterion, **nine autonomous communities could close in 2021 with a deficit lower than the set reference, four with one similar to -1% and another four would reach a higher deficit**, as shown in Figure 15.

Figure 15 Evolution of the fiscal situation of the Autonomous Communities in 2020-2021 by AIReF (% of GDP)



Source: AIReF

It is estimated that the aggregate revenues of the Autonomous Communities in 2021 will remain stable compared to 2020, excluding the additional resources linked to the Recovery, Transformation and Resilience Plan (PRTR). On the one hand, the revenues linked to the autonomous financing system of the normal-status Autonomous Communities will be reduced by around 2% y/y, mainly due to the lower settlement of the 2019 financing system (to be paid in 2021) vs the 2018 one (disbursed in 2020). Likewise, the extraordinary transfer from the State to cover part of the deficit in 2021 is lower than the Covid Fund -19 that they received in 2020.

The reduction in the previous items would be offset by the recovery of the collection of own taxes and the rest of income. On the expenditure side, we estimate a 2% y/y increase in 2021, excluding the impact of the PRTR. Considering the assumptions about the evolution of the pandemic in its central scenario, AIReF has estimated that the healthcare expenses associated with the Covid-19 would be **approximately 60% of those incurred in 2020** under the assumption that the pandemic would subside in mid-2021.

Figure 16 AIReF forecast of the Covid-19 impact in 2020 and 2021. Autonomous Communities (% GDP)

	2020	2021
Covid measures	1,1%	0,7%
Health	0,7%	0,4%
Education	0,1%	0,2%
Others (income and expenses)	0,3%	0,1%
Macro impact	0,7%	-
Total	1,8%	0,7%

Source: AIReF

However, it is estimated that the education expenditure associated with the pandemic would **approximately double in 2021 vs 2020**, since the measures would be maintained throughout the whole academic year. We incorporate the growth in personnel expenses in accordance with the specifications of the basic regulations included in the 2021 State Budget, among other elements, and assumes an inertial growth of the rest of the expenditure not associated with the pandemic greater than that estimated for 2020.

However, most of the regional budgets contemplate a growth in expenditure, even excluding the impact of the PRTR, higher than the one estimated by AIReF, without specific information on the impact and nature of the measures that support these figures, which would further raise the regional deficits if the regional budgets were fully executed. If this increase finally materializes, **it could be structural in nature and would not have, in principle, permanent financing, increasing the existing structural deficit prior to the crisis**. On the other hand, the funds linked to the PRTR would increase the growth of regional expenditure by 11% y/y and the regional revenues one by 10% y/y, according to AIReF estimates, increasing their relative share over GDP to 18% and 17.2%, respectively. However, in terms of deficit, the effect would be neutral.

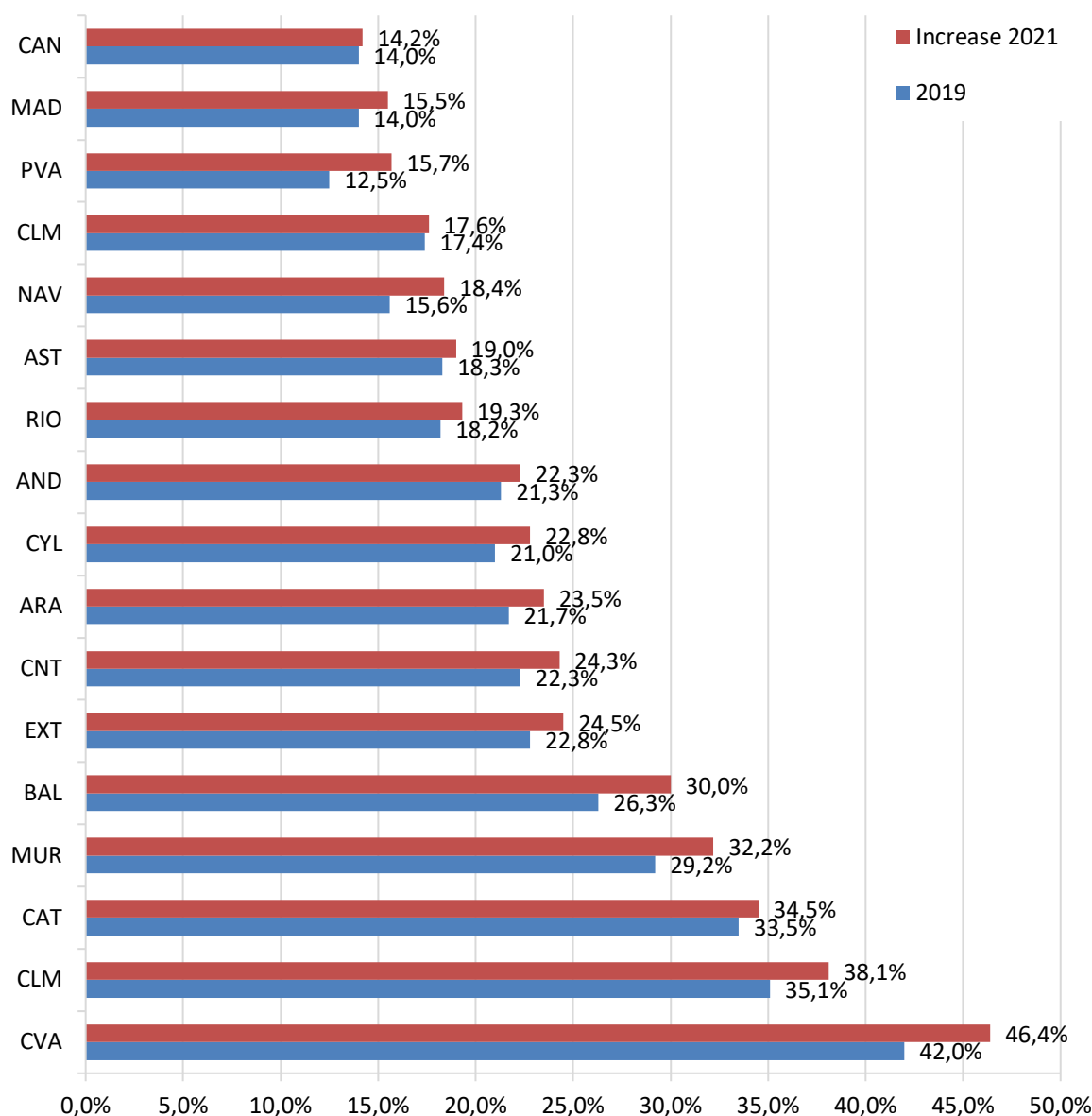
It is important to highlight the risk of lower availability of resources for the normal-status Autonomous Communities in 2022 and 2023 due to the impact of negative settlements from the Autonomous Financing System (SFA), the lower amount of funds linked to the PRTR and the absence of extraordinary transfers of the State. In 2022 a significant deterioration of the fiscal balance is expected due to the 2020 settlement in favor of the State from the State account transfers granted that year, a situation that will be replicated again in 2023 with the settlement of the 2021 State account transfers.

Lastly, the funds linked to the PRTR also present a decreasing profile in 2022 and 2023. This situation could be aggravated by the consolidation of a significant part of the expenditure incurred in 2020 and 2021. Regarding the aggregate of regional debt, **it is expected to stand around 26% of GDP in 2021**, 1.4 percentage points of GDP lower than the expected ratio in 2020 due to the positive contribution of the GDP (denominator effect); the expected level of indebtedness in 2021 would still be 1.6 points higher than that registered in 2019.

The increase in the debt ratio will be uneven in the different Autonomous Communities: **Valencia, the Balearic Islands and Murcia, would be the territories that would see their debt grow the most in 2021 in relation to 2019**, from pre-pandemic levels that were also quite elevated. In 2021, no Spanish region will comply with the reference debt limit of 13%, with the **Canary Islands, Madrid and the Basque Country** being the autonomies that would be closest to the legal reference (Figure 17).

The excess deficit expected in 2021 in some regions over the reference target set by the State and the settlement of the excess State account transfers granted in 2020 will mean increased financing needs in 2022, and, as indicated in previous paragraphs, the situation could worsen in 2023. Under a scenario of annual deficit correction of 0.25 points of GDP from 2023 for each region until budgetary balance is reached, **AIReF estimates that to return to the debt level of 23.7% of GDP registered by the end of the year 2019 it will necessary at least a decade**. This is a stark contrast with the projected scenarios prior to the crisis, where the level of 13% of GDP in regional financial debt would have been reached around 2035; as a result of the impact of the pandemic, AIReF estimates that the 13% debt level for Spanish regions, as mandated in the Budget Stability Law, **would not be reached before the year 2049**, even maintaining the budgetary balance of the subsector as a whole.

Figure 17 Debt over regional GDP ratio estimates by AIReF. Years 2019-2021 (% of GDP)



Source: AIReF

One relevant aspect for the future will be **if regions will be able to avoid a significant increase in structural expenditure** which is not correlated with the correspondent increase in structural revenues and to begin to draft their fiscal re-equilibrium strategy to set their future fiscal consolidation path. It is of utmost importance the establishment a national fiscal strategy in the medium term that serves as fiscal guidance and guarantees in a realistic and credible way the financial sustainability of the Spanish regions.

The uncertainty derived from the current context has delayed the presentation of the regional budget lines for 2021. The regional budgets have been drawn up ignoring the distribution between Autonomous Communities of the extraordinary transfer of EUR 13,486 mn included

in the 2021 State Budget, which will be determined by a Royal Decree of the Government. Additionally, there is still uncertainty about the specific total amounts that each region will be able to receive from the new European funds linked to the Recovery, Transformation and Resilience Plan (PRTR), as well as about their instrumentation, temporal impact, nature of the projects to be financed and their associated income and expenses.

The agreed suspension of fiscal rules in 2020 and 2021 conditions the possibility of making a detailed analysis of the path of fiscal consolidation next year. For 2021, only the 1.1% target for the regional subsector has been indicated as a non-binding reference.

In order to analyze the fiscal perspectives of the autonomous communities in 2021, we take the following hypotheses as the base scenario for 2021:

- **It is assumed that the healthcare crisis will end in the middle of next year, with the recovery beginning in the second semester.** This assumption conditions the estimates on the impact of the pandemic in 2021 and the evolution of the rest of revenues and expenses, in the absence of specific information on the nature and impact of the measures that support the regional scenarios.
- **It is considered that the new funds linked to the PRTR expected for 2021 at the regional level will have a neutral effect on the deficit.** This includes the Recovery Aid for Cohesion and Territories of Europe (REACT EU funds) and the Mechanism for Recovery and Resilience (MRR). These funds will be registered by the Autonomous Communities, either as transfers from the Central Administration (CA), or directly as EU funds.

In this regard, we assume a partial distribution of the funds allocated to the Autonomous Communities in proportion to the population (Figure 18). Therefore, the resulting distribution may differ from that included by the Autonomous Communities in their regional budgets and from the actual final distribution of funds, as the distribution criteria has not been defined yet.

Figure 18 Estimated distribution by region of the 2021 extraordinary transfer. Comparison with Covid-19 Fund distribution in 2020 (% of GDP)

Autonomous Communities	Covid 19 fund perceived in 2020 (% GDP)	Extraordinary transfer of the State for deficit		
		Community forecast	Estimated distribution of AIReF under GDP criterion	Distribution under adjusted population criterion
Andalusia	1,5	1,1	1,1	1,4
Aragon	1,2	1,1	1,1	1,1
Asturias	1,4	1,1	1,1	1,3
Balearic Islands	1,6	1,1	1,1	1,1
Canary Islands	1,4	0,5	1,1	1,4
Cantabria	1,3	1,1	1,1	1,2
Castile-Leon	1,5	1,1	1,1	1,3
Castile-La Mancha	1,9	1,1	1,1	1,4
Catalonia	1,5	1,1	1,1	0,9
Extremadura	1,4	1,5	1,1	1,6
Galicia	1,2	1,1	1,1	1,3
Madrid	1,0	-	1,1	0,8
Murcia	1,3	-	1,1	1,3
Navarre	0,9	-	1,1	0,9
Basque Country	0,8	-	1,1	0,9
La Rioja	1,6	1,1	1,1	1,1
Valencia	1,4	1,1	1,1	1,2

Source: AIReF

The distribution of the extraordinary State transfer has been estimated to reduce the deficit of the Autonomous Communities, considering that it will represent 1.1% of regional GDP for each region. Although other possibilities included in the regional forecasts are contemplated, this criterion is the one considered in most of the regional budgets. In accordance with article 118 of the State Budget, the definitive distribution criteria will be set by Royal Decree by the central government.

The Spanish regions and the COVID-19 fund

With the publication of the last two ministerial orders on November 25, which allows to complete the allocation of the total EUR 16bn of this mechanism enabled by the Government through the Royal Decree-Law 22/2020 that regulates the creation of the COVID-19 Fund and establishes the rules regarding its distribution in order to guarantee the resources of the regions after the impact of the pandemic. In July the autonomous communities received EUR 6,000 mn from the first healthcare tranche and in September they obtained an additional EUR 2,000 mn of the tranche associated with educational spending.

The third tranche of the Fund, endowed with EUR 3,000mn, corresponds to the second disbursement of the health tranche. The fourth tranche of the fund is endowed with EUR 5,000 mn and it will be distributed in December to the normal-status regions to compensate the lower tax revenues due to the reduction of economic activity.

In this way, Royal Decree-Law 22/2020, of June 16, is complied with, which regulates the creation of the COVID-19 Fund and establishes the rules regarding its distribution and release.

As previously commented in the Q3 Report, this fund is non-reimbursable, i.e., the autonomous communities will not have to return or generate more debt or interest payments, and **it represents the largest transfer ever from the State to the Autonomous Communities outside of the financing system**. The resources assigned to Madrid, Catalonia and Andalusia add up to almost 55% of the COVID-19 Fund's total.

Figure 19 Total distribution of the Covid-19 Fund by region (EUR mn)

Autonomous Communities and Ceuta and Melilla	Tranche 1	Tranche 2	Tranche 3	Tranche 4	Tranche 5
Catalonia	1.247	474	337	1.107	3.166
Galicia	268	150	93	224	735
Andalusia	598	392	384	826	2.199
Asturias	106	64	33	96	299
Cantabria	65	30	22	60	177
Rioja	58	29	13	28	127
Murcia	98	86	74	131	389
Valencia	450	263	214	559	1.486
Aragon	147	110	53	121	430
Castile-La Mancha	319	151	89	184	743
Canary Islands	159	99	87	206	551
Extremadura	96	58	43	80	277
Balearic Islands	105	65	50	219	438
Madrid	1.496	614	292	945	3.346
Castile-Leon	349	196	84	215	843
Basque Country*	329	152	87		568
Navarre*	89	57	29		175
Melilla*	12	6	7		25
Ceuta*	12	6	7		25
Total	6.000	3.000	2.000	5.000	16.000

* Basque Country, Navarre, Ceuta and Melilla don't participate in tranche 4 because of their specifications

Source: Ministry of Finance 2020

10. Spanish regions: the fiscal picture in 2021

AIReF forecasts that the deficit of the Autonomous Communities in 2021 will be 0.8% of GDP, lower than the reference rate set at - 1.1% of GDP. It is important to note that this forecast is subject to a high degree of uncertainty, since the data provided by the autonomous communities does not contain specific information on the measures that support most of their estimates, especially the ones related to expenditure. In any case, the previous figure of 0.8% includes the estimated 0.6% deficit figure for 2020, the impact of the pandemic, the updated revenues forecast by the foral territories, the review of the impact in 2021 of the measures adopted in previous years and the impact of the new measures for 2021 announced by the different regions.

At an individual level and as shown in Figure 15, **nine Autonomous Communities would have in 2021 a deficit lower than the reference target, four other regions would have a deficit close to the -1.1% area and another four regions would have deficits above the 1.1% target.** With the available information and under the assumptions by AIReF of the individual spending dynamics and the distribution of the State transfers to cover the regional deficit in proportion to the regional GDPs, **AIReF estimates that nine Autonomous Communities** (Andalusia, Asturias, the Balearic Islands, the Canary Islands, Catalonia, Galicia, Madrid, the Basque Country and La Rioja) **would post deficits in 2021 below the reference set for the subsector;** in fact, Asturias, the Canary Islands and Galicia have budgeted deficit targets below the 1.1% reference target. Aragon, Cantabria, Castile-Leon and Navarre would be around the 1.1% deficit target in 2021, while Castile - La Mancha, Extremadura, Murcia and Valencia would post regional deficits in 2021 above the 1.1% reference.

The individual situation of the regions, however, could change under other distribution criteria of the State's EUR 13.5bn extraordinary transfer in 2021. The application of a transfer distribution criterion based on the adjusted population would change the situation for several Autonomous Communities: as an example, Extremadura and Castile - La Mancha would improve their deficit figures to a level close to the 1.1% reference rate; Cantabria and Castile-Leon could post deficit figures below the reference rate.

On the other hand, the Basque Country would show a higher deficit figure in 2021, and both Aragon and Navarre would have deficits above the 1.1% reference target. In general, the Autonomous Communities register the transfer as 1.1% of their GDP, with some significant exceptions such as **Extremadura, the Canary Islands, the Basque Country and Navarre.** Extremadura includes a higher estimate, in line with the application of the population criteria, while the other three regions include resources from the extraordinary transfer below 1.1% of their respective GDPs. In fact, Basque Country and Navarre have not included any amount from this extraordinary transfer in their 2021 budgets and therefore they contemplate reaching a deficit of 2.2% in 2021, in line with the figure agreed as a reference rate in their respective Mixed Commission of their Economic Agreements.

If the previous 2.2% reference target is maintained for the foral territories and they do not receive any amount from the State, the situation could improve for the rest of the

Autonomous Communities or for the Central Administration, to the extent that the amount assigned to the Basque Country and Navarre would be distributed among the other regions. In the same way, the Canary Islands, which start from a situation of surplus in 2020, includes a lower amount than the 1.1% of the regional GDP from the extraordinary State transfer under either of the two previous criteria.

It is estimated that the aggregate revenues of the Autonomous Communities in 2021, without considering the PRTR funds, will remain at a level similar to that of 2020, slightly below the aggregate of regional estimates. It is also anticipated that the reduction in unconditional transfers from the State will be offset by the expected recovery in own taxes and other income, the positive evolution of the traditional structural funds of the European Union from the operational program 2014-2020 and, in the case of the Autonomous Community of the Basque Country, the increase in the contributions by the Provincial Councils (“Diputaciones Forales”).

The aggregate revenues from the financing system of the normal-status Autonomous Communities will decline in 2021 by 2% y/y. On the other hand, the extraordinary transfer from the State planned to cover the regional deficit, of EUR 13,486 mn, is 16% lower than the COVID-19 fund distributed in 2020 to face the pandemic. Together, **these revenues, which account for about 70% of total resources without the new PRTR funds, would decline by 3% y/y.**

Regarding the own regional taxes, AIReF expects a 5% growth in revenues from the Tax on Patrimonial Transmissions and Documented Legal Acts (ITPAJD), and a 11% growth in the rest of tax income. Furthermore, AIReF expects a 8% increase in the rest of the resources of the Autonomous Communities, which include, among others, the income associated with production, the revenues from the traditional EU structural funds and the contributions received from the Provincial Councils (“Diputaciones Forales”) of the Basque Country.

The aggregate of Autonomous Communities shows revenues estimates, without the PRTR funds, slightly higher than those estimated by AIReF, with more discrepancies in their composition. On the one hand as previously mentioned, the extraordinary EUR 13.5bn transfer from the State to cover the deficit is not incorporated in Navarre and the Basque Country and in the Canary Islands the amount budgeted is lower than the one which would correspond to the population weight. Furthermore, **the regional budget of Valencia includes as revenues to be received from the financing system**, as it has become customary in previous regional budgets, an amount that is EUR 1,300 mn higher than the one included in the 2021 State Budget. On the other hand, in aggregate terms, regional budgets include very sharp increases in EU structural funds derived from the 2014-2020 operational program and more optimistic estimates of the recovery of regional tax revenues, mainly in the ITPAJD.

AIReF expects that the regional expenditures will grow in aggregate, without the application of PRTR funds, 2% above the 2020 level, somewhat below the aggregate estimates of the Autonomous Communities in their budgets. Without detailed and specific information on the impact and nature of the measures that support most of the allocation expenditure in the regional budgets, AIReF's forecasts consider three fundamental elements: the estimated

impact of the pandemic, the evolution of personnel expenses not related to it and an increase in other expenditure higher than that observed in 2020, as it is understood that the execution of expenses not associated with the pandemic will be normalized.

We estimate that the pandemic in 2021 will have a more limited impact than in 2020 according to the baseline hypotheses. Thus, the impact of the pandemic crisis in 2020, in line with the aggregate estimates of the Autonomous Communities, would reach 1.8% of GDP. Given that a more limited duration of the pandemic is expected in 2021, its impact on regional expenses is reduced by about 40% y/y; taking into account the expected recovery in regional revenues, **the combination would determine a lower impact of the pandemic in 2021 of more than one point of GDP.** The calculation has considered the transfer to 2021 of just over 60% of the extraordinary healthcare expenditure estimated for 2020, while in the educational field the effect of the measures adopted for the 2020/2021 academic year has doubled vs the one in 2020, that only affected the summer period.

AIReF considers an increase in personnel costs of around 3% y/y, lower than the one included in the aggregated regional forecasts. This estimate reflects the maximum growth of the wage bill of 0.9% set by the 2021 State Budget, the additional needs estimated by the expected impact of the pandemic, mainly in the areas of health and education, and where appropriate, the specific measures identified by the individual regions. Some of the regional budgets foresee expenditure increases higher than those estimated by AIReF, which could be structural in nature and whose materialization would raise the deficit of the subsector by 2 tenths. **The increase in structural expenditure which, would not, in principle, have permanent financing, further increasing the structural deficit that existed prior to the crisis.**

The incorporation of the new PRTR (Recovery, Transformation and Resilience Plan) funds in 2021 would raise the growth of regional revenues by 10% and the increase in regional expenditure by 11% y/y, increasing their respective relative shares vs GDP by one and a half points. These funds would have a neutral effect on the regional deficit, amounting to 1.5% of GDP (EUR 18,793 mn) in 2021. Part of the PRTR funds would address common healthcare, education and other needs, although it is expected that most of the PRTR funds received directly from the EU, as well as half of the funds REACT and most of the MRR funds from State transfers will finance investments and other capital uses.

Several regions such as Aragon, the Balearic Islands, Castille-La Mancha, Galicia, Catalonia, Rioja and Valencia have only included the REACT funds in their budgets and no allocation from the PRTR funds, although it does not have an impact on the expected regional deficits because the additional revenues from the EU funds will be fully applied to expenditures of diverse nature.

As highlighted previously in this report, one important aspect of concern is the impact of the lower availability of revenues in 2022 and 2023 due to the impact of the negative settlements of the regional financing system, the lower amount of funds linked to the PRTR and the absence of extraordinary transfers from the State, especially in a context of suspension of fiscal rules. In 2020 and 2021, a large part of the impact of the pandemic will be absorbed by the State thanks to the maintenance of State account transfers from the normal-status

regions financing system above the actual tax collection level and the exceptional transfers granted to regions both in 2020 and 2021 (COVID -19 fund and extraordinary transfer, respectively).

The settlements of the normal-status regions financing system are estimated at 0.4% of GDP in 2022 and 0.3% of GDP in 2023. As a result, in 2022 a significant deterioration of the regional fiscal balance would take place in the normal-status regions due to the liquidation in favor of the State of the excess State account transfers granted to the regions in 2020; a similar situation would be replicated in 2023 linked to the excess State transfers granted in 2021.

This foreseeable deterioration in the budget balance of the Autonomous Communities in 2022 and 2023 may be behind the announcements by the government to consider the reform of the financing regime of the normal-status autonomous communities, which will likely include a certain fiscal harmonization of the regional taxes. Lastly, the funds linked to the PRTR also show a decreasing profile in 2022 and 2023, which could further aggravate the regional deficits in the latter period with the consolidation of a significant part of the expenditure incurred in 2020 and 2021.

11. The harmonization of regional taxes and the reform of the financing system

The controversy around fiscal harmonization of regional taxes has been notably increasing in recent months and particularly after the approval of the 2021 General State Budget, in which as a condition to have the support from ERC in the Parliament, the Finance Minister Mrs Montero committed to a tax reform that would include a harmonization of regional taxes: inheritance & donations, property transfer tax and wealth tax. This reform would envisage that the regions cannot lower them beyond a minimum, nor raise them above a certain maximum and therefore avoiding the relocations of companies/high earners due to the “headquarters effect”, the de-legitimization of tax figures and fiscal dumping.

This controversy has particularly affected the region of Madrid, which stands out as the autonomous community that has used the most its regulatory capacity in certain regional taxes to introduce tax benefits, especially in the personal income tax, wealth tax, and inheritance and donations tax, in particular in the last two tributes. Other autonomous communities, mainly in the Mediterranean coast, have described the “low taxes” policy of the region of Madrid as exercising “fiscal dumping”. In this regard, the capital effect of Madrid would drag a certain type of high taxpayer population and companies that allow a structurally high tax collection while reducing the regional taxes, **something that other regions could not replicate**.

In any case, the fact that large companies settle in Madrid does not automatically imply a specific tax advantage, **because the corporate tax goes directly to the State and it is not shared with the regions** (with the exception of the foral territories). The personal income tax of workers goes to the region where they work. For example, employees of a large company based in Madrid, but assigned to factories or businesses throughout Spain, will pay personal income tax wherever they reside, regardless of the company's registered office. Furthermore, VAT and excise duties are distributed based on criteria that combine relevant consumption and equity.

The configuration of the autonomies communities' system in Spain has outlined several levels of Territorial Administrations, such as the General/Central Administration of the State, the Autonomous Communities and the local entities. In order to carry out their functions and competences, each one of the territorial administrations need financial resources in the form of public revenues and, especially, taxes; but it is well known that taxable objects are limited in real practice, **so it is necessary to assign taxes to the different levels of Public Administrations (state , regional and local) so that they can fulfill their functions**.

In this regard, there are three types of generic tax categories in Spain:

- **The State's own taxes**, such as, for example, the Corporate Tax.
- **Taxes shared between the State and autonomous communities**, such as personal income tax and VAT as the most relevant ones (excise taxes would also be included here).

- **Regional own taxes**, such as, for example, the Wealth Tax, the Tax on Inheritance and Donations and the Tax on real estate transmissions and Documented Legal Acts.

In the regional own taxes' category, the autonomous communities have the powers of collection, management and inspection. In the case of shared taxes, some of them such as personal income tax and, of course, in all the regional own taxes, **there is a certain regulatory capacity of the autonomies to modify these taxes upward or downward by modifying rates/thresholds and other tax elements, such as exempt minimums and deductions**, depending on their social needs and/or their ideology on the role of taxes as an instrument of economic impulse. This is the main reason that explains the discrepancies between the tax burden of the CCAAs.

The Article 156 of the Spanish Constitution defines the financial autonomy of the autonomous communities respecting the principles of coordination with the State Treasury and of solidarity with the rest of the regions. The financial autonomy of the Autonomous Communities is developed in the Organic Law of Financing of Autonomous Communities (LOFCA), which in its article 19.2 establishes the following competences for the autonomous communities:

- **Personal income tax (IRPF)**: determination of the personal and family minimum, the applicable rate and deductions to be applied in the regional tranche of this tax.
- **Wealth tax**: determination of the minimum exemption and the applicable rate, deductions and bonuses.
- **Inheritance and Donations**: determination of any reductions in the tax base, amount and coefficients to be applied to the pre-existing patrimony, bonuses and deductions.

Real estate transmissions and documented legal acts (ITP-AJD): management, regulation and bonuses/deductions to be applied.

Basically, **the main differences between the autonomous communities occur in three taxes**:

i) **the personal income tax**, where aggregate rates for the different regions can range from 18.5% as minimum to 49.5% as the maximum rate, with a significant variability in the design of the regional tranche and other tax elements among the regions ii) **the Wealth Tax** and iii) **the Tax on Inheritance and Donations**, where in the latter two some regions like Madrid are practically exempt in terms of taxes and the transfer of assets within the region, compared to other autonomous communities where relatively high rates are maintained in both taxes, such as **Asturias, Catalonia and Valencia**, with a much less generous system of bonuses and deductions.

In the last two decades, Madrid has opted for a tax model that reduces taxation both on the regional own taxes and on the PIT, in order to boost economic activity, freeing up resources so that private agents can invest and develop their businesses actively and safely, without compromising the coverage of public services and taking into account the restrictions imposed by budgetary stability laws. Specifically, and regarding the personal income tax, Madrid, the Balearic Islands and La Rioja are the only regions that have regulated the

minimum personal and family exemptions, increasing them over those applicable in the rest of the regions.

The minimum PIT rates in Madrid are among the lowest in Spain terms of regional rates, with 9% being the minimum rate and 21% as the maximum rate (regional tranche of the tax). Thus, Madrid has a lower regional rate than the rest of the regions, although comparisons are difficult because in many cases the number of sections does not coincide. In the Wealth Tax, the Community of Madrid has a 100% discount, so no taxpayer in this region must pay this tax; La Rioja has also established a 75% discount in this tax. On the other hand, in the Inheritance and Donation Tax, for the hereditary part due to inheritance between spouses, ascendants, descendants and adopted, they are practically tax-free in Madrid, in Andalusia, Cantabria, Extremadura and Murcia, as well as in the foral territories .

In the same line, there has been a significant reduction in the region of Madrid's own taxes. As an example, while Madrid applies two specific regional taxes, Catalonia has up to seventeen regional taxes. All of this makes Madrid the region with the lowest individual tax burden among the autonomous communities as a whole, making use of the financial autonomy provided by the LOFCA, which is why it cannot be described as a tax haven or tax dumping, but rather as a normative and constitutional use of the fiscal lever.

Given the need to distribute the fiscal resources among the State and the autonomous communities, it seems reasonable that the property taxes for possession and transmission of real estate assets should be assigned to the regions. However, it is worth noting their limited collection capacity in relation to the fundamental taxes on income and consumption. **However, it is considered that some degree of fiscal harmonization between the autonomous communities would be useful,** probably imposed by the national government, to avoid the potential strategic behavior by taxpayers seeking to avoid taxes through changes of tax residence. This is especially serious in the case of the Successions & Inheritance tax, where it could be reasonable to establish a tax floor in order to stop the race towards the practical disappearance of the figure, which is not justified either for reasons of tax collection sufficiency, or for reasons of intergenerational efficiency and fairness.

Regarding the **wealth tax, the opinion of most tax experts is that it should disappear since it is an unrecognizable figure in most of the EU countries** which generates problems of asset valuation, double taxation, fiscal fairness, tax avoidance and even confiscation in some relevant cases.

In the view of this report, the existence of tax competition between regions cannot necessarily be considered harmful. **Tax competition between regions and the design of different taxes allow adjusting to the needs and ideological patterns of the regional government in power, and adapting to the social demands of its citizens, which do not have to be identical in all regions of Spain.** These discrepancies should be located in a reasonable environment to avoid movements of capital and people in national territory for exclusively fiscal reasons. This can be achieved by introducing in the LOFCA a mechanism that allows **a certain fiscal harmonization between regions,** in a technical, reasonable and reasoned debate, **within the review of the autonomous financing model** and without having to reach the recentralization

of these taxes.

The way regional tax harmonization would be implemented is not easy either, since it cannot be done by a simple modification of the Law on Assignment of Taxes (Law 22/2009), since the regulation of regional financing, including the decision to provide specific competences to the autonomous communities in the field of regional taxes must be done through a complex legislative process, which requires an agreement in the fiscal and financial policy council (CPFF), the reform of an organic law such as the financing law of autonomous communities (LOFCA) and it cannot be done through an amendment to the State Budget to set a national minimum quota in the Wealth Tax. The Spanish Constitution also prohibits the creation of taxes through budget laws or their modification.

Therefore, any imposition of a minimum state quota on any of the regional taxes without reforming the regional financing will be **de facto legally impossible**, since a totally ceded tax would be turning into a partially ceded tax.

It should also be noted that the current regional financing system is complex, not very transparent and generates inequalities, but it seeks to guarantee certain fairness. All the regions contribute 75% of their regulatory tax collection to the common fund (calculated based on the normative tax capacity of the regions), and although they keep 25% of their tax collection, which could favor Madrid, the system has a complex system of pay-as-you-go funds that causes the final resources that a region receives not to have much relation to its income level. In this sense, if 100 is the average financing per capita adjusted among all the regions — which take into account aspects such as the school-age population, the degree of aging of the population, the geographical dispersion and other elements —, **Madrid would be the territory with the highest fiscal capacity with an index of 132.9, but the reality is that its final financing per adjusted inhabitant stood at 100.7, practically in line with the average.** These figures are calculated with a model that measures the revenues that the regions would collect before they have exerted their competencies to lower or raise taxes. In addition, the last available year where the regional fiscal balances were disclosed (2017), calculated according to the cost-benefit method (i.e., the difference between the benefits that its residents receive from the actions of a specific public administration and their tax contribution to finance it), concluded that Madrid had a deficit balance of around EUR 19,000 mn.

In conclusion, although Madrid may enjoy more economic dynamism due to the capital effect, the concentration of large companies and the State architecture that attract different centers of power, **there is no quantitative evidence that Madrid receives more resources from the financing system for that reason, but rather the opposite.**

12. The financial debt status of Spanish regions

It is expected that the autonomous communities' subsector will reduce their financial debt to around 26% of GDP in 2021, mainly due to the contribution of the GDP growth recovery in 2021. This would imply a reduction in the aggregate financial debt of Spanish regions of 1.4 percentage points of GDP from the 27.4% expected for 2020. The estimated GDP growth recovery in 2021 would offset the expected 2021 deficit from the Spanish public administrations, resulting in a decrease of the regional debt / GDP ratio.

Having said this, the expected level of regional financial debt in 2021 would be 1.6 percentage points above the level of 2019, therefore further worsening the pre-crisis situation. Regional debt levels will continue to increase in subsequent years, delaying the reduction in the debt ratio. The excess deficit expected in 2021 in some regions over the reference target set by the State and the settlement of the State account transfers granted in 2020 will mean increased borrowing needs in 2022 that will further delay the necessary fiscal adjustment, a situation that could worsen in 2023.

The already high levels of indebtedness and the increase in the availability of additional resources such as those associated with the PRTR funds make it advisable to control the growth of the regional debt. The existence of very high volumes of debt together with the possibility of making use of additional resources, such as those associated with the PRTR funds, to finance historically high spending volumes, imply the need to control debt growth to avoid structural increases in the deficit figures.

With the information available, under the spending evolution assumptions discussed above and the distribution of State transfers to cover the regional deficit in proportion to regional GDP, AIReF estimates that in 2021 there would be five autonomous communities with a debt ratio greater than 30%: Valencia, Castile-La Mancha, Catalonia, Murcia and the Balearic Islands would present a financial debt ratio above the 30% threshold, when there were only three regions that exceeded this ratio at the end of 2019. The increase in the debt ratio will be uneven in the different regions: Valencia, the Balearic Islands and Murcia would be the territories that would see their debt grow the most by 2021 from previous levels that were already higher than the average in 2019. In 2021, no region will comply with the 13% reference limit, with the Canary Islands, Madrid and the Basque Country as the autonomous communities that would be the closest ones to the legal reference.

The abrupt fall in economic growth, together with the deterioration in fiscal balances projected from 2022 onwards will mean an increase in the level of financial sustainability risk for the whole regional subsector. Although in 2020 and 2021 the exceptional transfers agreed in favor of the Autonomous Communities (COVID -19 Fund and the extraordinary transfer) will place part of the increased risk on the Central Administration, the deterioration of the fiscal balances expected from 2022 will cause an increase in the volume of regional debt that will cause the subsector's ratio to continue rising, despite the expected recovery in GDP. Despite the deterioration in the outlook for financial sustainability, the rating agencies have not lowered the rating of the autonomous communities, with the exception of Fitch, which has

lowered four regions from 'BBB' to 'BBB-': the Canary Islands, Cantabria, La Rioja and Madrid, although the agency continues to place their long-term debt within the investment grade category.

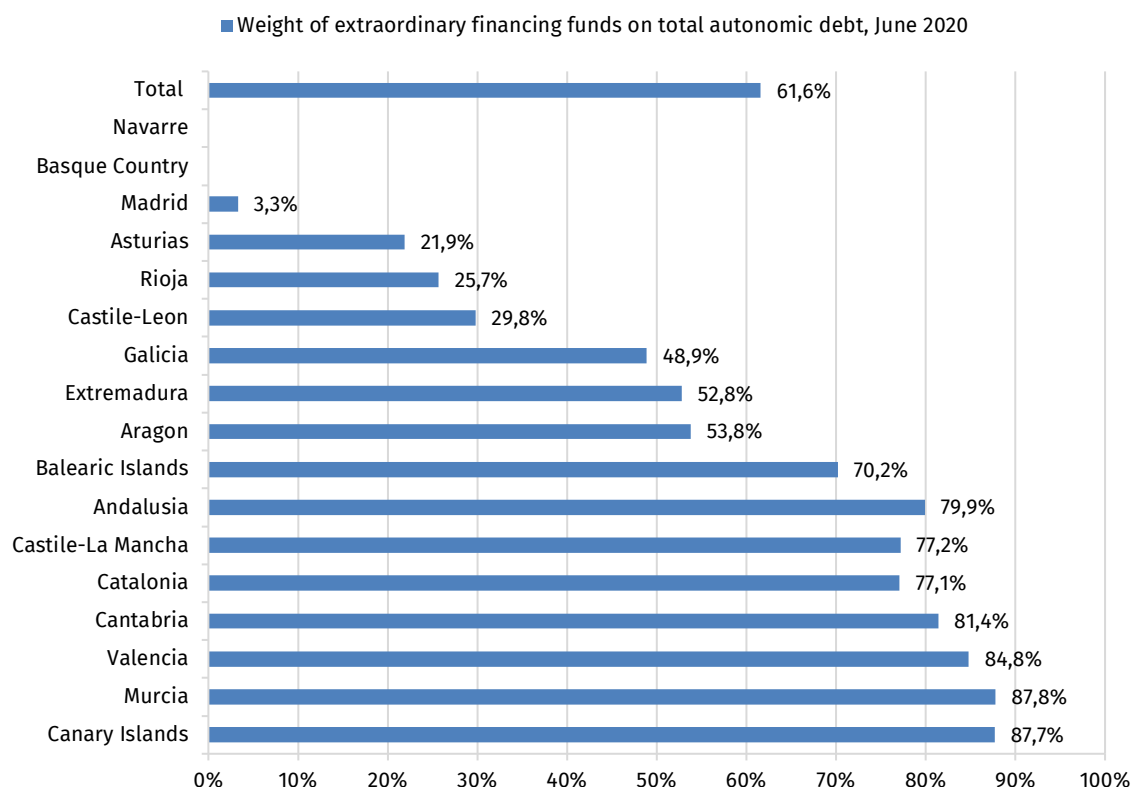
The extraordinary financing mechanisms will cover more than 90% of the debt needs for 2020 (Figure 20), providing liquidity to the regions at a very low cost and avoiding the payment of higher financial spreads in the case of the most indebted communities. The dependence on financing through these mechanisms, already very high for certain regions (they currently represent more than 70% of the debt of eight Autonomous Communities, and more than 80% for four of them), will continue to deepen (Figure 21).

Figure 20 Extraordinary liquidity fund (FFCA) disbursement to Spanish regions in 2020 (EURmn)

Autonomous Communities	1Q	2Q	3Q	4Q	Extra Fla I (75%)	Tranche III 0,2%GDP	Extra Fla II	Total FFCAA
Aragon	372,46	87,11	131,70	317,14	243,75	68,13	82,25	1.302,54
Asturias	0,00	0,00	0,00	0,00	55,50		11,50	67,00
Balearic Islands	798,73	86,95	288,19	70,86	81,00	59,83	52,00	1.437,56
Canary Islands	802,74	217,46	212,87	53,45		83,78		1.370,30
Cantabria	167,57	42,49	147,04	43,43	90,75	25,36	32,25	548,89
Castile-La Mancha	1.197,54	191,22	574,05	482,47	243,75	75,52	62,25	2.826,80
Castile Leon	222,46	291,38	378,94	287,50	231,00	105,56	64,00	1.582,84
Catalonia	5.620,02	550,63	2.412,60	1.594,82	819,00	420,08	401,00	11.769,03
Extremadura	226,12	116,43	110,96	89,46	156,75	36,65	42,25	778,62
Galicia	375,74	42,21	32,50	50,71	42,75	115,10	54,25	713,26
Rioja	154,00	0,00	0,00	18,13	22,50	15,59	7,50	218,32
Andalusia	2.984,22	329,99	1.301,15	702,16	210,00	294,69	186,00	6.008,21
Murcia	760,53	71,37	432,09	163,6	396,00	57,98	141,00	2.022,57
Valencia	3.120,24	338,51	1.880,46	759,09	1.559,25	204,87	567,75	8.430,17
Total	16.804,37	2.365,75	7.902,55	4.663,42	4.152,00	1.563,14	1.704,00	39.076,11

Source: Finance Minister

Figure 21 Relative share of the loans from the extraordinary financing funds on total regional debt, June 2020 (% over total financial debt)



Source: Finance Minister

Returning to the debt level of 23.7% registered at the end of 2019 would require at least a decade, under the assumption of a fixed annual correction of the deficit of 0.25 points of GDP. In contrast to the scenarios projected by AIReF prior to the crisis where a level of 13% would have been reached around the year 2035, now the previous limit would not be reached before the year 2049, even maintaining the budgetary balance of the subsector as a whole.

The medium-term prospects accentuate the urgency of designing a coordinated rebalancing plan. Although the objectives of budget stability and debt are on hold, it is necessary to highlight the existence of high levels of indebtedness that will accentuate in the following years, which increases the importance of the fiscal supervision and the urgency of designing a path of fiscal consolidation.

13. A temporary respite, but the 2022-2023 period looks challenging for regional fiscal consolidation

In general, the nature and impact of the measures that support the regional budget scenarios are unknown. The forecasts entail, in some cases, a significant growth in spending above an already exceptionally high level in 2020, **which could lead the regions to even higher levels of deficit and public debt**. These increases in spending may be due to different reasons, such as a higher impact of the pandemic in 2021 compared to AIReF's central scenario, or different estimates about the projects that would eventually be co-financed by European funds or other temporary or permanent measures.

The implications from the point of view of sustainability are different in each case, assuming an additional fiscal risk if it materializes in structural increases in spending. On the other hand, there is still a high degree of uncertainty about the evolution of the health crisis. In the 2020-2021 period, there is a significant provision of resources to address the current exceptional situation and **in the absence of fiscal rules, there is a risk of maintaining high spending growth, not only temporarily but ultimately permanently**. It is therefore essential to insist on the need to use these resources in a flexible and efficient way, adapting it to the real needs of the pandemic and oriented towards actions that allow a better starting situation to be achieved to carry out the future fiscal consolidation process. **It is vitally important that the autonomous communities avoid structural increases in spending that are not accompanied by the corresponding structural increase in financing.**

Finally, **the fiscal deterioration is expected to continue in the following years**, because of the liquidations of the State account transfers and the withdrawal of the extraordinary transfers from the State, causing additional increases in debt levels. This situation could be aggravated if a significant part of the expenditure incurred in 2020 and 2021 is consolidated. In this context, **the design of the annual budgetary framework cannot ignore a broader perspective, so there are several factors that make it necessary to have a medium-term planning such as:** the requirement of the Organic Budget Stability Law (LOEPSF) in itself, the multi-year nature of the new PRTR funds, and the uncertainty derived from the pandemic. This makes it especially necessary for the regional budgets to be drawn up taking into account their medium-term impact and the possible integration of their actions into the Rebalancing Plan required in article 22 of the LOEPSF, the preparation of which should be addressed at earliest convenience by the regions, if possible within the framework of a national medium-term fiscal strategy.

14. Local entities will also suffer the impact of the pandemic

The fiscal, public debt and spending rule targets approved by the Government on February 11, 2020 for the Spanish public administrations and subsequently approved by the Spanish Parliament are not applicable this year and in 2021. As we explained in previous sections, the Government has set deficit reference targets for 2020-2021 in order to guide the ordinary operation of the public administrations. At the local entities level, **the fiscal reference targets are 0% of GDP for 2020 and - 0.1% of GDP for 2021**, with no further disclosure about how the target is distributed among the different local entities that make up the local public sector as a whole (more than 13,000 entities).

The only local entities with individualized reference rate in terms of fiscal stability are the Provincial Councils (DD.FF.) of the Basque Country, since, by agreement of the Mixed Commission of the Economic Agreement between the State and the Basque Country of September 30, 2020, the *Diputaciones Forales* were granted a deficit reference target of -0.9% of GDP in 2020 and -0.8% of GDP in 2021. Subsequently, the Basque Finance Council, of October 15, disaggregated between the three *Diputaciones Forales* the reference rate to be applied to each one of them.

We estimate that in 2020 the local subsector will achieve budgetary equilibrium, but in 2021 we forecast a 0.1% deficit, given the extent of the pandemic. The temporary suspension of compliance with the fiscal rules in the years 2020 and 2021, and given the fact that the announcement just came two months before the end of this year, will have a very limited impact in 2020 in terms of expenditure increase, **but will be the main factor behind the expected fiscal deterioration in 2021**.

Therefore, in 2021 local entities would post a deficit of 0.1% of GDP as a result of the expected increase in spending above the expected increase in revenues. We anticipate y/y revenue growth of 4% despite the continuing of the measures adopted by the local entities to alleviate the negative effects of the pandemic, which will also extend to 2021. However, the estimated growth in expenses is around 6% y/y and explain our estimated local entities deficit in 2021 at around -0.1% of GDP.

The increase in local entities revenues of 4% y/y mentioned above is fundamentally conditioned by the improvement in the revenues from the Basque Country Provincial Councils (DD.FF.) and the expected increase in the funds to be received from the EU. According to AIREF estimates, despite the continuity of the revenue reduction measures adopted or to be adopted by the local entities to alleviate the negative effects of the pandemic on the economic sectors and families most affected, the injection of resources from the EU's economic recovery mechanisms, of almost EUR 1,500 mn, and the expected growth of fiscal revenues in the foral territories provincial councils (*Diputaciones Forales*), due to the expected improvement in economic activity in both the Basque Country and Navarre, c. EUR 1,000 mn, will lead to an increase in local entities revenues of more than 4% in 2021. Excluding the impact on revenues from the *Diputaciones Forales* and the EU funds, the expected growth in local entities revenues would be below the 2% y/y threshold.

In parallel, **the local entities expenditure level would increase by almost 6% y/y**, as a result of the application of the available treasury surpluses from previous years to spending, the consolidation of extraordinary expenses derived from the COVID-19 pandemic, the higher expenditure financed with EU mechanisms such as MRR and the higher expenditure by the *Diputaciones Forales* due to the increased transfers to the Autonomous Community of the Basque Country. If we exclude the spending linked to the financing from EU projects, the expected growth in local entities revenues in 2021 would not exceed 4% y/y.

AIReF has estimated that the increased spending linked to the availability of treasury surpluses from previous years could amount to one tenth of GDP in 2021. The economic impact of applying the treasury surpluses from previous years to spending will be in any case below the treasury surplus generated in 2019, around EUR 4,000 mn, given that the spending capacity is limited by the compliance with the legal guarantees required by the contracting regulations, which delay the expenditure execution process, which would amount to, in the most optimistic estimates, half of the treasury surplus generated in 2019.

The extension of the state of alarm until May 2021, due to the prolonged impact of the healthcare crisis derived from the pandemic, has determined that we include in our forecasts the estimated effect, at least in the first half of the year, of the reduction in revenues and increase in expenses directly related to the economic and social crisis as a result of the pandemic. Consequently, we would pencil in a negative impact slightly above EUR 1,000 mn.

Likewise, with the regions the implementation of the PRTR funds will have no effect on the local entities' deficits. In the case of local entities, the estimated funds to be disbursed from the EU economic recovery mechanisms, around EUR 1,500 mn, as included in the 2021 State Budget, will have no effect on the deficit figures, since the higher revenues will be offset by their full application to expenditure plans in 2021.

Finally, there are uncertainties about the impact on the 2021 deficit of the measures linked to the pandemic to be adopted and their extension, as well as the treasury surpluses to be applied to spending and the amount of expenditure due to application of the MRR funds.

15. A look at the Spanish largest local entities

The data available from the 24 largest local entities shows (Figure 22), given their revenues and expenditure structures, a more stable budgetary dynamics than the rest of the local entities, both in times of economic growth and during recessions. This is so given that these large entities have very stable and cyclical income structures and, in addition, their spending structures are highly optimized so that the execution of the expenditure that allows compliance with the guarantees required by the legal regulations is carried out to the maximum possible, thus reducing the percentage of non-executions vs other smaller entities.

Figure 22 Financing capacity/need in 2018 and 2019 and estimates for 2020 and 2021 of the largest Local Entities (EUR mn, % of non-financial income)

Entitie	2018		2019		2020		2021	
	CNF	%	CNF	%	CNF	%	CNF	%
Madrid	1.072	20,9	549	10,7	230	4,8	181	3,6
Barcelona	4	0,2	47	1,7	-237	-8,9	-173	-5,6
Valencia	133	15,6	78	9,1	30	3,3	72	7,8
Sevilla	53	6,7	94	11,4	16	2,0	79	8,5
Zaragoza	90	12,0	115	15,3	5	0,8	33	4,4
Málaga	85	13,1	82	12,6	30	4,5	72	10,6
Murcia	20	5,1	10	2,5	1	0,3	32	8,1
Palma	75	17,1	70	15,4	-1	-0,3	–	–
Las Palmas GC	75	18,7	24	6,7	48	11,8	1	0,2
Bilbao	23	4,2	9	1,6	-27	-4,9	-26	-4,3
Alicante	44	15,8	46	17,0	11	4,0	0	0,1
Córdoba	48	16,1	35	12,4	7	2,7	35	11,5
Valladolid	15	5,7	4	1,5	-22	-8,7	15	5,4
Vigo	-4	-1,4	19	7,2	8	2,9	3	1,0
Gijón	13	5,5	14	5,9	-6	-3,0	0	0,0
L'Hospitalet	6	2,5	7	2,7	-10	-4,3	4	1,7
Barcelona council	39	5,0	-13	-1,5	45	5,4	208	24,7
Valencia council	49	10,2	12	2,7	41	8,6	5	1,0
Sevilla council	68	19,3	74	20,5	78	22,0	63	16,9
Island council Tenerife	118	13,2	113	12,7	15	2,0	15	1,8
Island consulate Mallorca	14	3,0	49	10,4	41	8,4	1	0,2
Added without provincial councils	2.042	11,8	1.440	8,3	302	1,8	620	3,6
Provincial council of Araba	29	4,0	23	3,0	-61	-9,8	-40	-5,7
Provincial council of Gipuzkoa	103	7,5	96	6,8	-56	-4,6	-96	-7,1
Provincial council of Bizkaia	152	6,1	128	5,1	-230	-9,4	-228	-8,2
Added provincial councils	284	6,2	247	5,3	-346	-8,1	-364	-7,5
Total	2.326	10,7	1.687	7,7	-44	-0,2	257	1,2

Source: AIReF

Large local entities, with healthy balance sheets and accumulated treasury surpluses, are the ones that, to a greater extent, can apply these surpluses to spending after the suspension of the fiscal rules in 2020 and 2021. The activation of the escape clause to the sub-national level for the years 2020 and 2021 will allow the local entities with savings accumulated from previous years to apply these own financial resources to non-financial expenses. Since the beginning of the application of the current budget stability regulations, the largest local entities have systematically demanded that the application of these resources to expenses not to be included in the spending rule compliance that would lead to the application of the corrective measures of the Budget Stability Law (LOEPSF) and particularly the need for approval of an economic-financial rebalancing plan (PEF) as the use of these resources would not generate any medium-term risk. With the suspension of fiscal rules this year and in 2021, the accumulated treasury surpluses from the local entities can be applied to expenses without incurring in a deviation from the budget stability laws, although this suspension is based on the need to make unforeseen expenses of an extraordinary nature as a result of the context of the pandemic.

The treasury surpluses are a magnitude that includes the accumulated savings or expenditure in successive years, while the surplus or deficit is an annual magnitude that does not include a cumulative result. In the largest entities group, the available accumulated surpluses add up to EUR 4bn but the application to spending in 2020 is estimated to be irrelevant, given that the suspension of the fiscal rules was approved at the end of October, where most of the decisions of expenditure of the year are already taken. In 2021, however, local entities could apply these savings to spending without any limitation beyond the maintenance of a certain level as working capital, raising potential future sustainability issues.

Likewise, the large local entities are the ones that have had the most expenses due to the COVID-19, given the higher intensity of the pandemic in the municipalities with the highest population density. In 2020 and, according to the projections of the extension of the health crisis in 2021, the large local entities would be the ones that would suffer again the greatest impact on their finances, as a result of the reduction in revenues and increased expenditure derived from the pandemic, due to the greater intensity of the pandemic in the most densely populated municipalities. The need to cover extraordinary expenses, fundamentally of a social nature, as well as the approval of measures to suspend/delay some of the most relevant municipalities taxes, will have an impact in their fiscal balances in 2020 and 2021 with an impact on the result of the entire local entities subsector.

The group of large local entities have adopted discretionary spending measures linked to the COVID-19 pandemic that have accounted for almost 2% of their total spending in 2020. The measures adopted by the large local entities directly related to the pandemic have supposed about a 2% increase in spending. Likewise, their revenues have been reduced, both due to their own measures of suspension or exemption of tax income and the reduction in economic activity, by roughly 9% y/y. In volume of spending / income, the discretionary spending measures due to the pandemic have meant around EUR 450mn and the reduction in income add up to c. EUR 3000mn, although in the later most of this decrease (EUR 2,500 mn) come

from the Provincial Councils (*Diputaciones Forales*), although most of this impact is transferred to the autonomous community of the Basque Country.

However, although the pandemic has had negative effects on the local entities fiscal balance, the increase in spending in 2019 has also been a determining factor. In 2019 the group of large local entities increased its computable expenditure by more than 4% y/y, when the approved reference rate was 2.7%, **with a very unequal distribution**, since four of them (Madrid, Bilbao, *Diputaciones* of Barcelona and Valencia) showed an increase of around 10% y/y. The higher than expected 2019 spending drove also the 2020 spending growth, which is estimated to be nearly 5% y/y. Debugging the impact on spending of the measures communicated by the large local entities due to COVID -19 and keeping the rest of the expense constant, the expected increase would be 1% y/y. However, this percentage does not include the substitution effect in terms of expenses, whereby part of the available credits would have been used for other purposes had it not been necessary to meet the needs that the pandemic had caused.

The city councils of **Bilbao, Madrid and Valencia** and the **Provincial Councils of Barcelona and Valencia** expanded the computable expenditure in 2019 more than double the one allowed by the approved reference rate. The generalized increase in local spending in 2019, which determined that the total subsector increased computable spending by 6% y/y (above what is allowed by the approved growth rate of 2.7%), is particularly important in some of the 24 largest local entities, whose relative weight in the total is relevant. Thus, the Bilbao and Madrid city councils and the Barcelona and Valencia Provincial Councils increased their computable spending in 2019 by approximately 10% y/y, and the Valencia City Council by slightly more than 7% y/y; these increases make the level of base spending for 2020 to rise significantly.

Consistent with the expected result in the whole local entities subsector, the group of large municipalities expect to reach a balance slightly below budgetary equilibrium in 2020, although as commented before this result is highly conditioned by the deterioration in the fiscal position of the *Diputaciones Forales*, as a result of the decrease in their revenues due to the effect of the pandemic, which almost consume the more than EUR 1600 mn of surplus obtained by the 24 large local entities in 2019. The situation of the Madrid City Council stands out, which since 2018, when EUR 1,000 mn of surplus was originated, the positive balance has been reduced by more than 75%, and the city expects to close 2020 with EUR 230mn in surplus.

By 2021, the largest local entities expect to slightly improve the 2020 results, back to a positive balance position, given the expected improvement in the economic situation when the pandemic is controlled, as shown in Figure 22. However, there are important uncertainties about the results of the large local entities in 2021, since they do not include, in general, the effect of the application of the treasury surpluses. There are important uncertainties about the suitability of the data included in the 2021 budgetary lines sent by the large local entities to anticipate the result at the end of the year, since, as indicated, these were prepared prior to the enactment of the suspension of fiscal rules and, as such, do not include the effect on the expansion of the expenditure from the application of the treasury surpluses from previous years.

Given the volume of the treasury surpluses available for the group of large local entities, of more than € EUR 3,000 mn, depending on the use of these funds the balance position of the large local entities can deteriorate, even though not the whole previous amount will be applied to expenses, due to the need to maintain a certain level of working capital and due to the limitations in the management of expenses derived from the contracting regulations.

AlReF foresees that the city councils of Barcelona, Palma, Bilbao, Valladolid, Gijón and l'Hospitalet de Llobregat and the 3 *Diputaciones Forales* will close 2020 with deficit and that the city councils of Barcelona, Bilbao and Vigo and the 3 *Diputaciones Forales* would also post a deficit in 2021, although in the latter case these results are highly conditioned by the effect on the fiscal position of the decline in income in the concerted taxes as a result of the pandemic.

16. State's support in preventing a sharp increase in the average payment time to suppliers (PMP/ATS)

Figures 23 and 24 show the latest monthly available data of average payment time to suppliers both from Spanish regions and the largest local entities, respectively. On the back of the unprecedented financing support from the State in 2020, we have not seen any significant deterioration of the average payment time to suppliers both in the autonomous communities and among the largest local entities, in contrast with the significant deterioration we saw in the past in recessionary periods.

In fact, **no autonomous community shows an average time to suppliers higher than the 60-day period**, the limit from which the Ministry of Finance begins to apply the measures provided for in the stability regulations.

Figure 23 Average Payment Time (PMP) by Autonomous Communities (days)

Autonomous Communities	Ratio of paid operations	Ratio of operations pending payment	Global Average payment period (PMP)
Andalusia	18,96	30,95	24,49
Aragon	28,11	49,49	39,01
Asturias	24,93	35,54	30,84
Balearic Islands	47,77	48,49	48,12
Canary Islands	11,28	35,56	22,48
Cantabria	17,23	16,11	16,65
Castile-Leon	31,60	37,51	34,53
Castile-La Mancha	15,08	33,73	23,01
Catalonia	40,76	52,17	46,90
Extremadura	27,67	44,89	33,80
Galicia	13,29	17,27	14,47
Madrid	28,50	58,08	43,69
Murcia	2,66	13,31	3,49
Navarre	30,20	39,61	34,57
Basque Country	24,21	22,01	23,46
Rioja	27,52	27,06	27,26
Valencia	20,43	44,49	29,91
Total Autonomous Communities	26,39	44,39	34,77

Source: AIReF

Figure 24 Average Payment Time (PMP) of the largest Spanish municipalities (days)

Local Entities	Ratio of paid operations	Ratio of operations pending payment	Average payment period
Malaga	25,07	29,58	27,07
Sevilla	22,57	55,16	35,73
Zaragoza	27,75	23,44	25,41
Palmas Gran Canaria	50,59	171,64	108,86
Barcelona	10,65	18,76	12,21
Madrid	23,56	33,00	27,08
Valencia	20,34	29,02	24,37
Coruña	24,19	30,30	26,33
Palma	16,38	72,27	38,91
Murcia	10,57	56,67	24,27

Source: AIReF

The amount of commercial debt amounts to EUR 4,486.08 mn, equivalent to 0.41% of the national GDP, a figure like the one before the pandemic. Of course, commercial operations of healthcare nature generated between March and October have increased with respect to the same period of 2019 by 12.04%.

Considering the increase in the volume of transactions processed to contain the commercial debt and the ATS, the increase in the volume of payments made by the Autonomous Communities as a whole has been essential. In this way, the payments made in the last eight months have amounted to EUR 39,020.43 mn (EUR 25,945.09 mn in the health field), which represents an increase of 6.99% (12.82% in the health field) with respect to the same period of the previous year.

To facilitate payments to the Autonomous Communities, the processing of funds destined to cover the financing needs derived from the deviation from the 2019 deficit target pending to be financed through the FLA and Financial Facility compartments stands out. Of the EUR 4,152 million approved linked to the deviation from the 2019 deficit target, EUR 4,056.54 mn were allocated to direct payments to suppliers and other creditors.

In addition, the liquidity measures adopted by the State to face the impact of the health crisis generated by COVID-19 have been decisive. In this regard, for the normal-status Autonomous Communities, we would highlight both the payment in the months of March and April of a global amount of EUR 2,862.55 mn corresponding to the update of the State transfers from the regional financing system, and the higher amount advanced in relation to the liquidation of the 2018 financing system that took place in July, which reached an amount of EUR 3,657.02 mn.

In addition, in accordance with Royal Decree-Law 22/2020, which regulates the creation of the COVID-19 Fund, during the month of July EUR 6,000 mn were disbursed to the Autonomous Communities and local entities, corresponding to the first tranche, fundamentally associated

with health spending; and in September, EUR 2,000 mn corresponding to Tranche 3, mainly associated with educational spending, was also disbursed.

This unprecedented support has allowed that until the month of October the levels of commercial debt and ATS of the autonomous communities have not been affected by the pandemic crisis.

bffgroup.com