Letter from the Editors

In the past few weeks, there has been a renewed sense of optimism in financial markets following the announcements from various vaccine producers regarding the high success rates in interim COVID-19 vaccine trails. A vaccine scenario would accelerate positive trends and underpin a more constructive near-term outlook for the global, and in particular, the Spanish economy.

In light of these scientific breakthroughs, we start off the November issue of *Spanish and International Economic & Financial Outlook (SEFO)* by assessing the anticipated impact of a COVID-19 vaccine on the path of Spain's recovery.

Spain has been one of the countries most affected by the COVID-19 crisis. Lack of consumer confidence is one of the key factors behind under-performance. Another is the size of tourism and other services sectors most dependent on mobility. Thus, while indicators point to an encouraging strengthening of manufacturing in recent months, output in the hospitality sector in September was 50% below pre-crisis levels. Looking forward, a vaccine would improve both consumer confidence and mobility prospects, thus triggering a sustained recovery. According to estimates presented in this article, by the end of the projection period, GDP would be slightly above 3% higher than in a no-vaccine scenario. However, a vaccine is not expected to make a significant dent in government debt, which could remain close to 120% of GDP. There are also risks associated with these forecasts related to the potential legacy of long-term unemployment and business failure, as well as the ability to absorb EU funds and the pace of economic reforms.

We then approach the topic of Spanish recovery from a longer-term, more structural perspective, exploring how the latest plan presented by the current administration will attempt to align its structural reform agenda with the general principles and priorities of the European recovery plan NGEU. In response to the economic damage wrought by COVID-19, on July 21st, 2020, the European Council agreed to an exceptional recovery package, the NGEU, sized at 750 billion euros. In examining the NGEU's potential effects on the Spanish economy, it is important to first note that despite much-needed progress on correcting imbalances and structural reforms post-financial crisis, Spain was already showing clear signs of reform fatigue before the onset of COVID-19. Indeed, convergence with the EU had, depending on the particular metric, either stalled or reversed. Thus, interrupting this trend must be a key goal of any recovery package for Spain. However, there are several obstacles that could undermine or minimise the effectiveness of the NGEU in Spain: (1) difficulty in reaching political and social consensus; (2) fund absorption deficits; and, (3) managerial issues. In the best-case scenario, assuming all those obstacles can be overcome, the effects of the structural reform programmes will only materialise in

the medium-to longer-term. For this reason, the biggest challenge policymakers must address is the timing mismatch between the urgency of the situation and the long-term nature of the recovery initiatives. The vital issue at present is to prop up as much of the productive business fabric as possible.

The November *SEFO* then shifts its focus to fiscal policy. We first provide an analysis of Spain's public finances at the regional level, taking into consideration the budgetary impact of COVID-19. Next, we discuss the estimated foregone revenues from Spain's current tax structure as regards to the country's main taxes. Finally, we provide an assessment of the tax on digital services, which remains stalled at the international level given lack of agreement, but has nonetheless been adopted by several Member States, including Spain.

Spain entered 2020 in a complicated financial situation with the budget from 2019 having carried over and the reduction of the deficit having stalled at 3% of GDP. However, any fiscal consolidation effort was halted by the EU's activation of the Stability and Growth Pact's escape clause in light of the COVID-19 crisis in March. As a result of a collapse in tax revenue and increased spending, the Funcas' consensus forecast anticipates that Spain will post a 12.4% deficit in 2020. In comparison to the central government, Spain's regional governments have presented a surplus of 0.44% in the first eight months of the year. This is attributed to both the amount of tax revenue transferred and advanced by the central government to the regional governments. Looking forward, the crisis will have a differential impact on regional finances and it will be necessary to reform the regional financing system in tandem with an overhaul of the Spanish tax system to address the financial consequences of the health crisis.

Governments provide tax breaks to both individuals and companies in the form of allowances, exemptions, rate relief, credits and deferrals. By focusing on tax breaks for personal income tax (PIT), value-added tax (VAT) and corporate income tax (CIT), which together account for 85% of Spain's total tax revenue in recent years, it is possible to determine the costs of these tax policies. The analysis conducted reveals that all of the foregone tax revenues, or tax expenditures, associated with these three taxes amount to 77.18 billion euros per annum, of which 61% is absorbed by VAT, 36% by PIT and the remaining 3% by CIT allowances and credit. In addition, the personal and household allowances in respect of personal income tax imply an additional annual collection cost of 24.53 billion euros. Those figures clearly indicate that there is adequate room for manoeuvre in the Spanish tax system to reduce the marginal tax burden without foregoing revenue. In other words, rationalisation of the existing tax benefits would be sufficient to finance a tax reform package that would deliver a more efficient and simpler tax system with greater revenue-collection.

The emergence of digital business models and the differing definitions of taxable presence adopted by countries has led to the significant erosion of tax bases and profit shifting (BEPS) from high-tax countries to low-tax jurisdictions. Although the EU Commission's proposal represents the most advanced and structured attempt to incorporate the concept of a virtual permanent establishment (PE) into the international income tax legal framework, resistance from some Member States has placed it on hold. Consequently, some Member States, including Spain, have introduced their own Digital Services Tax (DST). While implementation issues may be common to many taxes, there are unique structural and design challenges inherent to the DST. In terms of the former, there are issues relating to under which circumstances the DST applies, who would bear the burden of the levy, and the characterization of the equalization tax. The design issues focus on the taxable base, the scope, the rate, and the enforcement of the tax. In light of these challenges, an international approach would ultimately be better suited to achieve a multilateral and long-term solution to the international tax issues raised by the digital economy.

The last two articles of the November *SEFO* analyze COVID-19's impact on the financial sector. First, we discuss how increased profitability pressures on banks, exacerbated by lower-for-longer rates in the context of pandemic-driven

economic deterioration, have seemingly accelerated the prospects for consolidation within national borders across the Spanish financial sector.

The merger between CaixaBank and Bankia has sparked commentary surrounding the possibility of a new wave of consolidation across the European banking sector. In recent years, M&A activity had been muted compared with the period directly following the financial crisis. Specifically, there were 385 deals between 2009 and 2012, compared to 236 between 2016 and 2019. In Spain, the number of deposit-taking entities has declined by 31.4% (from 280 to 192) since 2007. Notably, evidence shows that there is still surplus capacity in the banking sector, thereby justifying additional consolidation. The changing nature of financial services, as well as the entrance of both Big Tech and larger fintech firms, has confirmed the benefits associated with scale such as data processing, multi-channel services, and digitalisation. Moreover, the economic consequences of COVID-19 have further depressed interest rates, necessitating a defensive cost-cutting strategy among Europe's banks. Nevertheless, it is important to underline that consolidation is just one of the strategies banks can pursue to boost their profitability and market value.

Second, we deconstruct the underlying trends that have resulted in the decreased profitability of the European, and Spanish, banking sectors – the further compression of net interest income as a consequence of the pandemic. Banks have taken a leading role in implementing the measures introduced to halt the economic effects of COVID-19. As a result, lending momentum has been altered significantly, marked by sharp growth in business lending and a slowdown in household lending compared to prior years. In the household segment, it is worth highlighting the moratoria extended on both mortgages and consumer loans, which impacted this trend. During the second quarter of 2020, the stock of outstanding business debt registered strong year-on-year growth, increasing almost 50 billion euros in one quarter. This comes after a decade long contraction in business lending and can be explained by the banks' participation in channelling 90% of the loans guaranteed by the government to businesses. Despite the increase in the stock of credit issued, banks experienced a contraction in net interest margin during the first half of 2020 (-3%). This paradox is due to the negative contribution of average loan book rates (driven by the downtrend in EURIBOR as well as narrower credit spreads), which more than offset the positive effect of the growth in the stock of outstanding credit.