COMMISSION OPINION

of 16.11.2016

on the Draft Budgetary Plan of Portugal
COMMISSION OPINION

of 16.11.2016

on the Draft Budgetary Plan of Portugal

GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area for ensuring that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact (SGP) and the European Semester for economic policy coordination.

2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan presenting by 15 October the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year.

CONSIDERATIONS CONCERNING PORTUGAL

3. On the basis of the Draft Budgetary Plan for 2017 submitted on 17 October 2016, along with the report on action taken by Portugal in response to the Council decision of 8 August 2016 giving notice to Portugal to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit (the report on effective action), the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

4. The Commission opinion is to be seen in light of the latest economic and budgetary data. In this context, as indicated in the Commission recommendation for a Council Recommendation on the economic policy of the euro area as well as in the Commission Communication 'Towards a positive fiscal stance for the euro area', it is important that the aggregate fiscal stance of the euro area is positive and supports the ongoing recovery, while ensuring the long-term sustainability of national public finances.

5. Portugal is currently subject to the corrective arm of the SGP. The Council opened the excessive deficit procedure for Portugal on 2 December 2009. On 8 August 2016, the Council adopted a decision giving notice to Portugal under Article 126(9) of the Treaty to correct its excessive deficit by 2016. If Portugal effectively achieves a correction of its excessive deficit by 2016, it will be subject to the preventive arm of the SGP as of 2017 and also subject to the transitional arrangements as regards compliance with the debt reduction benchmark during the three years following the correction of the excessive deficit (2017-2019). In its recommendation issued in the context of the 2016 European Semester, the Council on 12 July 2016 recommended to Portugal to ensure a durable correction of the excessive deficit, in accordance with the relevant decisions or recommendations under the excessive deficit procedure, by taking the necessary structural measures and by using all windfall gains for deficit and debt reduction, and to achieve thereafter an annual fiscal adjustment of at least 0.6 % of GDP.

6. Overall, the macroeconomic scenario in the Draft Budgetary Plan for 2017 appears optimistic. The macroeconomic scenario underlying Portugal's 2017 Draft Budgetary Plan projects an acceleration of the economic recovery. Real GDP is estimated to
grow by 1.2% in 2016 and by 1.5% in 2017. In the DBP scenario, economic growth is forecast to be mainly driven by domestic demand supported by a positive net external demand contribution. The labour market continues to improve and employment is projected to increase further by 1% in 2017. Consequently, the unemployment rate is projected to decline from 11.2% in 2016 to 10.3% in 2017. The macroeconomic scenario for 2017 in the Draft Budgetary Plan is more optimistic than the Commission 2016 autumn forecast as real GDP is expected to grow more than the 1.2% forecast by the Commission, mainly on the back of a positive contribution of net external demand and more favourable private consumption.

7. Portugal complies with Regulation (EU) No 473/2013 that the draft budget must be based on independently endorsed or produced macroeconomic forecasts. The macroeconomic forecasts underlying the Draft Budgetary Plan have been endorsed by the Portuguese Public Finance Council. In its endorsement, the Portuguese Public Finance Council flagged downside risks to the macroeconomic outlook which are related to rather optimistic projections on external demand and gross fixed capital formation. The Portuguese Public Finance Council was established through the 2011 reform of the Budgetary Framework Law. The Public Finance Council Statutes laid down provisions aiming to ensure its independence.

8. The Draft Budgetary Plan projects a general government deficit of 2.4% of GDP in 2016, which is 0.2% of GDP above the 2016 Stability Programme target. The difference stems mostly from the downward revision of the macroeconomic outlook, and deficit-increasing one-off factors, which are only in part offset by the ¼% of GDP freezing of intermediate consumption, which has been enforced in response to the Council's notice to correct the excessive deficit by 2016. For 2017, the Draft Budgetary Plan plans a general government deficit of 1.6% of GDP, against the 1.4% targeted in the 2016 Stability Programme, due to the carry-over from 2016 and a slightly worse macroeconomic outlook. The (recalculated) structural balance in the Draft Budgetary Plan is projected to remain unchanged in 2016 compared to the ¼% of GDP improvement projected in the Stability Programme and it is expected to improve by about 0.3% of GDP in 2017, in line with the Stability Programme target. The debt-to-GDP ratio in the Draft Budgetary Plan is expected to be higher than in the Stability programme at 129.7% in 2016 and 128.3% in 2017, on the back of lower revenue expectations from sales of financial assets and an increase of government debt issuances in preparation for possible bank support operations.

Despite the current low interest rate environment, interest rates in Portugal remain relatively elevated and above 3% for 10-year government bonds, around 2 percentage points above Italian and Spanish government bond rates, in October 2016. After slowly declining until 2016, total interest payments by the general government are projected to stabilise at 4.3% of GDP for both 2016 and 2017. Therefore, the Portuguese economy remains vulnerable to sudden increases in interest rates, which may affect debt sustainability.

9. The Draft Budgetary Plan plans a reduction of the headline deficit by 0.8% of GDP from 2016 to 2017. This reduction stems exclusively from i) the positive assumptions in the macroeconomic scenario; ii) the positive impact of a one-off measure and dividends from Banco de Portugal, and iii) the compression of some expenditure lines and the increase of some revenue items that have not been explained by specific measures. As regards the specified fiscal measures, the Draft Budgetary Plan presents a package with an overall deficit-increasing impact of 0.1% of GDP. Main deficit-decreasing measures are a new property tax, a programme to address overdue
tax debt; the 2:1 replacement ratio rule for civil servants and savings from the spending review. Deficit-increasing measures include the carry-over effect of the wage cut reversals, the gradual phasing out of the personal income tax surcharge, the indexation of pensions and an extraordinary pension rise and the annual carry-over effect from reduced VAT for meals in restaurants.

10. The Commission 2016 autumn forecast projects a headline deficit of 2.7% of GDP in 2016 and 2.2% in 2017. The discrepancy vis-à-vis the DBP targets mostly reflects a less optimistic macroeconomic scenario and higher expenditure pressures. The Commission forecast includes most measures at full yields but applies more conservative estimates regarding some expenditure compression and revenue increases not explained by measures. The structural balance is projected to deteriorate very slightly in 2016. The change in the structural balance in 2017 is projected at 0.0% of GDP. This compares to the (recalculated) 0.0% and 0.3% of GDP changes reported by the authorities for 2016 and 2017 respectively, mostly reflecting the Commission forecast's less optimistic macroeconomic outlook and expected higher spending pressures. The Commission forecast projects a broadly stable debt-to-GDP ratio around 130% in 2016 and 2017 slightly higher than in the Draft Budgetary Plan mostly due to the different macroeconomic outlook. For both 2016 and 2017, downside risks to the fiscal outlook can originate from worse macroeconomic developments, spending slippages and the costs related to possible bank support operations.

11. For 2016, the Draft Budgetary Plan and the report on effective action project the headline deficit to reach 2.4% of GDP, i.e. slightly below the 2.5% of GDP target set in the Council decision of 8 August 2016. According to the Commission 2016 autumn forecast, Portugal is projected to bring the headline deficit to 2.7% of GDP in 2016, above the requested deficit target of 2.5% of GDP but below the Treaty reference value of 3% of GDP. The requested fiscal effort of an unchanged structural balance is not met according to the Commission's projection of a slight deterioration by 0.1% of GDP in the unadjusted structural balance. This warrants a careful analysis. When corrected for the downward revision in potential growth and for revenue shortfalls compared to the Commission 2016 spring forecast, which underlies the Council decision of 8 August 2016, the adjusted change in the structural balance is estimated at 0.4% of GDP, above the target set by the Council. The fiscal effort is also projected to be met on the basis of the bottom-up method, which estimates the size of the additional fiscal effort for 2016 as compared to the baseline scenario underlying the Council decision of 8 August 2016. Overall, while the headline target is not projected to be met, the fiscal effort is projected to be met based on the adjusted structural balance and the bottom-up methods. On the basis of the projected achievement of the required fiscal effort in 2016, Portugal can be considered to have taken effective action in response to the Council decision of 8 August 2016. Therefore, the excessive deficit procedure should be kept in abeyance at this stage.

12. Provided that Portugal achieves a durable correction of its excessive deficit in 2016, it would be in the transition period as regards the debt criterion for the following three years. The Draft Budgetary Plan does not include sufficient information to assess planned compliance with the transitional arrangements for the debt reduction benchmark. The change in the structural balance of 0.0% of GDP in 2017 projected by the Commission 2016 autumn forecast is below the requirement of 0.8% of GDP calculated on the basis of the Commission 2016 autumn forecast.
13. Provided that Portugal achieves a durable correction of its excessive deficit in 2016, it would be subject to the preventive arm of the SGP as of 2017 and would have to ensure compliance with the required adjustment of 0.6% of GDP in 2017 towards its medium-term budgetary objective (MTO) of a structural balance of 0.25% of GDP. The Draft Budgetary Plan targets an improvement of the (recalculated) structural balance by 0.3% of GDP thus planning some deviation from the required adjustment path towards the MTO in 2017. This is confirmed by an overall assessment: while the expenditure benchmark pillar points to a 0.5% of GDP deviation from the required adjustment path, i.e. slightly above the threshold for significant deviation, the difference between the two indicators stems mostly from revenue windfalls - improving the structural balance but not considered in the expenditure benchmark – which are, however, considered to be partially of a permanent nature. The Commission 2016 autumn forecast projects an unchanged structural balance in 2017 with respect to 2016, suggesting a risk of significant deviation from the required structural improvement by 0.6% of GDP on the basis of the structural balance pillar. The expenditure benchmark pillar points also to a significant deviation by 0.5% of GDP. As confirmed by an overall assessment, the Commission forecast points to a risk of a significant deviation from the recommended adjustment towards the MTO in 2017.

14. In accordance with the Council decision of 8 August 2016, Portugal also submitted an economic partnership programme on 21 October 2016. The Commission has examined the programme and concluded that, despite the mixed performance in terms of structural reforms and in particular those addressing country-specific recommendations, the document shows a firm commitment of the authorities to proceed with the reform policy agenda and to comply with the SGP.

15. Overall, the Commission is of the opinion that the Draft Budgetary Plan of Portugal, which is currently under the corrective arm of the SGP and could become subject to the preventive arm of the SGP from 2017, if a timely and sustainable correction of the excessive deficit is achieved, is at risk of non-compliance with the provisions of the SGP. In particular, the Commission forecast for 2017 projects a significant deviation from the required adjustment path towards the MTO and non-compliance with the debt reduction benchmark. The projected deviation however exceeds the threshold for a significant deviation by a very narrow margin. The risks seem therefore contained provided the necessary fiscal measures are delivered. In line with the Commission Communication 'Towards a positive fiscal stance for the euro area', the Commission therefore invites the authorities to take the necessary measures within the national budgetary process to ensure that the 2017 budget will be compliant with the SGP.

The Commission is also of the opinion that Portugal has made limited progress with regard to the structural part of the fiscal country-specific recommendations issued by the Council in the context of the 2016 European Semester, and thus invites the authorities to accelerate progress. A comprehensive assessment of progress made with the implementation of the country-specific recommendations will be made in the 2017 Country Reports and in the context of the country-specific recommendations to be adopted by the Council in 2017.
Done at Brussels, 16.11.2016

For the Commission
Pierre MOSCOVICI
Member of the Commission