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Analysis by the Commission services of the budgetary situation in Portugal following the adoption of the COUNCIL RECOMMENDATION to Portugal of 9 October 2012 with a view to bringing an end to the situation of an excessive government deficit

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Portugal

{COM(2013) 394 final}

1. INTRODUCTION

On 2 December 2009, the Council decided, in accordance with Article 126(6) of the Treaty on the Functioning of the European Union (TFEU), that an excessive deficit existed in Portugal and issued a recommendation to correct the excessive deficit by 2013 at the latest, in accordance with Article 126(7) TFEU and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[1].

On 15 June 2010, the Commission concluded that Portugal had taken effective action in compliance with the Council recommendation of 2 December 2009 to bring its government deficit below the 3% of GDP reference value and considered that no additional step in the excessive deficit procedure was therefore necessary[2].

On 9 October 2012, the Council decided, in accordance with Article 3(5) of Council Regulation (EC) No 1467/97[3], that effective action had been taken but that unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of the 2 December 2009 recommendation. Notably, a worsening in the growth outlook and the shift to a less tax-rich growth composition had major negative budgetary implications. The Council therefore adopted a revised recommendation under Article 126(7) TFEU ("the revised EDP recommendation") and recommended Portugal to correct the excessive deficit by 2014 at the latest[4]. In order to bring the headline government deficit below the 3% of GDP reference value by 2014, Portugal was recommended to deliver an improvement in the structural balance by 2.3% of GDP in 2012, 1.6% of GDP in 2013 and 1.3% of GDP in 2014, based on the Commission services' October 2012 update of the economic outlook in Portugal. The headline deficit targets consistent with the requested improvements in the structural balance were 5.0% of GDP for 2012, 4.5% of GDP for 2013 and 2.5% of GDP in 2014.

Portugal was also recommended to implement the measures adopted in the 2012 budget and in its March supplement and to take additional consolidation measures worth 0.3% of GDP. For 2013, Portugal was recommended to implement permanent consolidation measures worth 3.0% of GDP considering also contingency measures to cater for potential budgetary slippages. For 2014, Portugal was recommended to implement permanent consolidation measures of 1¾% of GDP drawing on the results of a comprehensive Public Expenditure Review (PER). The medium-term budgetary strategy would be further developed in the 2013 Stability Programme. In addition, Portugal was asked to further improve public financial management by reforming the Budget Framework Law to comply with the new European Union fiscal governance rules and to deepen transparency and control at all budgetary stages

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1 All documents related to the excessive deficit procedure of Portugal can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/portugal_en.htm

2 http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/communication_to_the_council/2010-06-15_be_cz_de_ie_es_fr_it_nl_at_pt_si_sk_communication_on_action_taken_en.pdf

3 OJ L 209, 2.8.1997, p. 6.

4 http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-07_council/2012-10-09_pt_126-7_council_en.pdf

as well as ensuring adherence to the medium-term budgetary framework and targets for all levels of general government.

2. RECENT MACRO-ECONOMIC DEVELOPMENTS

After a 1.6% contraction in 2011, real GDP fell by 3.2% in 2012 and, according to the Commission services' May 2013 forecast, is projected to fall by a further 2.3% in 2013 (see Table 1). Economic activity is expected to bottom out in the second half of this year and to start growing in 2014 with an annual average rate of 0.6%. The necessary private and public-sector deleveraging is expected to remain a drag on domestic demand over the forecast horizon. At the same time, the rebalancing of the economy towards export-oriented sectors has taken place faster than expected with significant gains in export market shares as trade has been redirected towards extra-EU markets. This export-driven growth is, however, expected to temporarily loose some momentum on the account of decelerating external demand. The outlook for the labour-market remains bleak, with employment having fallen by a cumulated 5.7% over 2011 and 2012 and expected to drop further by 3.9% and 0.5% in 2013 and 2014, respectively, driven largely by the contraction of job-intesive domestically-oriented sectors such as construction and the resizing of the public administration.

Table 1: Comparison of macroeconomic developments and forecasts

	2011	2012		2013		2014	
	outturn	COM Oct 2012	outturn (COM May 2013)	COM Oct 2012	COM May 2013	COM Oct 2012	COM May 2013
Real GDP (% change)	-1.6	-3.0	-3.2	-1.0	-2.3	1.2	0.6
Contributions to real GDP growth (pp)							
Domestic demand	-5.5	-7.1	-7.2	-2.7	-4.2	0.3	0.0
Changes in inventories	-0.6	0.1	0.1	0.0	0.0	0.0	0.0
Net exports	4.5	4.1	4.0	1.8	1.9	1.0	0.6
Employment (% change)	-1.5	-3.9	-4.2	-1.6	-3.9	0.3	-0.5
GDP deflator (% change)	0.5	0.3	-0.1	1.2	1.7	1.0	1.3
Output gap (% of potential GDP)	-1.8	-4.3	-3.5	-4.5	-4.6	-3.0	-3.5
Potential output growth (% change)	-0.5	-1.2	-1.5	-0.8	-1.3	-0.4	-0.5

Source: COM Oct 2012: Commission services' October 2012 update of the economic forecast; COM May 2013: Commission services' May 2013 update of the economic forecast

In the macroeconomic scenario of the revised EDP recommendation of October 2012, real GDP was projected to contract by 3% in 2012 and start expanding in the second half of 2013, resulting in an annual average growth rate of -1.0% in 2013. As the recovery was expected to materialise earlier, annual real GDP growth was also forecast to be higher in 2014. Eventually, real GDP growth in 2012 turned out somewhat more negative than foreseen in the revised EDP recommendation. This was mainly due to a smaller contribution of net exports to GDP growth but also a somewhat larger contraction in domestic demand than expected at the time of the revised EDP recommendation. Importantly, however, both economic activity and employment fell particularly strongly in the last quarter of 2012, which significantly worsened the carry-over effect and the outlook for the year 2013. Moreover, the outlook for external demand also deteriorated since the Commission services' October 2012 forecast. As a result, the Commission services' May 2013 forecast projects a sharper contraction of real GDP in 2013 and a more subdued recovery in 2014 than the macro-economic scenario underlying the revised EDP recommendation. This includes a sharper drop in domestic demand in both years and a more protracted slump in employment.

3. ASSESSMENT OF EFFECTIVE ACTION

3.1 Background information

The current assessment of effective action is based on the Commission services' May 2013 forecast. It takes into account the economic and budgetary developments since 9 October 2012, when the revised EDP recommendation was issued. The seventh review mission of the Economic Adjustment Programme to Portugal, which took place between 25 February and 14 March 2013, and subsequently between 14 and 17 April 2013 and between 8 and 11 May 2013, concluded that the programme implementation was broadly on track against a difficult economic background. A condition for the finalisation of the review was the full specification of the measures planned under the PER. The objective of the PER was to reduce redundancies across the public sector functions and entities, and reallocate resources towards growth-friendly spending areas. In addition, the government had committed to adopt and publish a medium term fiscal framework by end-April, in which the PER measures were to be fully specified, as a prior action for the conclusion of the seventh review.

Table 2: Key macroeconomic and budgetary variables underlying the October 2012 recommendation addressed to Portugal

% of GDP	2011	2012	2013	2014
Revenues	44.7	41.7	43.0	42.7
Current revenues	40.3	40.2	41.7	41.4
Discretionary measures with impact on current revenue (EUR bn)[5]	4.2	2.4	3.8	-
Expenditure	48.9	46.7	47.5	45.2
Real GDP growth (%)	-1.7*	-3.0	-1.0	1.2
Nominal GDP growth (%)	-1.0	-2.7	0.3	2.2
Potential GDP growth (%)	-0.6	-1.2	-0.8	-0.4
Structural balance	-6.3	-4.1	-2.5	-1.2
General government balance	-4.2	-5.0	-4.5	-2.5
p.m Output gap (% of pot. Output)	*-2.5*	*-4.3*	*-4.5*	*-3.0*

** revised later to -1.6%*

On 5 April, the Portuguese Constitutional Court ruled against key measures in the 2013 budget, thereby opening a budgetary gap amounting to 0.8% of GDP. A replacement and/or redesign of the measures annulled by the Constitutional Court became necessary and thus another prior action for the conclusion of the seventh review.

In response to these requirements, the government adopted in the course of April and early May a package of permanent savings measures, predominantly on the expenditure side, with a cumulative yield of EUR 4.7 billion or 2.8% of GDP over 2013-2014.

The assessment of effective action starts by comparing the recommended fiscal effort in the revised EDP recommendation with the apparent fiscal effort, measured by the change in structural budget balance, and with the adjusted structural effort. The adjustment of the structural balance takes into account (i) the impact of revisions in potential output growth relative to the one underlying the growth scenario of the Council recommendation and (ii) the

5 Measures clearly specified and committed to by government ahead of the recommendation.

impact on revenue of revisions of the tax intensity of economic activity (composition of economic growth or of other windfalls/shortfalls) relative to the assumptions underlying the revised EDP recommendation. This top-down approach in the assessment is complemented by a bottom-up assessment of consolidation measures undertaken by the Portuguese government.

3.2 Assessment of effective action

3.2.1 Budgetary implementation in 2012

The general government deficit in 2012 reached 6.4% of GDP, which is above the 5.0% EDP target. The headline deficit was affected by a number of one-off operations which were not known at the time of the revised EDP recommendation. These operations include: a capital injection into the state-owned bank CGD (0.5% of GDP); the re-routing through government of the conversion into equity of shareholder loans of Parpública to SAGESTAMO, two companies outside the general government perimeter, (0.5% of GDP); the impairments associated to the transfer of assets from BPN (0.1% of GDP). In addition, following an advice by Eurostat the sale of the operating concession for the major airports in Portugal was treated as equity withdrawal and hence not impacting the general government balance, contrary to what the government had foreseen in the budget (0.7% of GDP). Excluding the impact of these one-off factors, the general government deficit would have amounted to 4.7% of GDP, thus below the target (see Table 3).

Fiscal consolidation in 2012 was nonetheless remarkable with an improvement in the structural balance by 2.4% of GDP, which is above the 2.3% required in the revised EDP recommendation of 9 October 2012 (see Table 4). Accounting for the downward revision of potential output since the time of the revised EDP recommendation, the estimated fiscal effort in 2012 would increase by 0.2 pp. In addition, the estimated change in the structural balance was affected by revenue shortfalls compared with the scenario underlying the EDP recommendation when applying standard revenue elasticities. These shortfalls amounted to 0.4 pp. Overall, taking these effects into account, the adjusted change in the structural balance in 2012 amounted to 3.0% of GDP, thus well above the effort required under the revised EDP recommendation.

Table 3: Composition of the budgetary adjustment

	2011	2012		2013		2014	
	Outturn	Outturn	COM October 2012	COM October 2012	COM May 2013	COM October 2012	COM May 2013
	(% of GDP)	(% of GDP)	(% of GDP)	(% of GDP)	(% of GDP)	(% of GDP)	(% of GDP)
Revenue	**45.0**	**41.0**	**41.7**	**43.0**	**42.6**	**42.7**	**42.1**
of which:							
- Taxes on production and imports	13.7	13.6	13.7	13.8	13.2	13.7	13.3
- Current taxes on income, wealth, etc.	9.9	9.2	9.5	11.0	11.0	10.9	10.6
- Social contributions	12.2	11.6	11.7	11.6	12.0	11.6	12.0
- Other (residual)	9.2	6.5	6.8	6.6	6.4	6.5	6.1
Expenditure	**49.4**	**47.4**	**46.7**	**47.5**	**48.0**	**45.2**	**46.1**
of which:							
- Primary expenditure	45.3	43.0	42.2	42.8	43.6	40.2	41.7
of which:							
Compensation of employees	11.4	9.9	9.8	9.9	10.5	9.5	9.3
Intermediate consumption	4.7	4.6	4.5	4.4	4.4	4.1	4.3
Social payments	22.0	22.6	22.1	22.4	23.9	21.7	23.3
Subsidies	0.7	0.6	1.0	1.0	0.5	0.8	0.5
Gross fixed capital formation	1.4	1.8	2.0	1.7	1.8	1.5	1.7
Other (residual)	5.2	3.5	2.8	3.4	2.5	2.6	2.6
- Interest expenditure	4.0	4.4	4.5	4.7	4.4	5.0	4.4
General government balance (GGB)	**-4.4**	**-6.4**	**-5.0**	**-4.5**	**-5.5**	**-2.5**	**-4.0**
Primary balance	**-0.4**	**-2.0**	**-0.5**	**0.2**	**-1.1**	**2.5**	**0.4**
One-off and other temporary measures	3.0	-0.6	1.0	-	0.2	-	-0.3
Structural balance	**-6.6**	**-4.2**	**-4.1**	**-2.5**	**-3.6**	**-1.2**	**-2.2**
Change in structural balance	*2.2*	*2.4*	*2.2*	*1.6*	*0.6*	*1.3*	*1.4*
Corrected change in structural balance due to revision of potential output growth (alpha)	-	-	*2.5*	-	*0.8*	*1.4*	-
Real GDP growth	-1.6	-3.2	-3.0	-1.0	-2.3	1.2	0.6
GDP deflator	0.5	-0.1	0.3	1.2	1.8	1.0	1.3
Nominal GDP	-1.0	-3.3	-2.7	0.3	-0.6	2.2	1.8

Table 4: Change in structural balance corrected for revisions in potential output gap and revenue windfalls/shortfalls[6]

	Uncorrected fiscal effort (ΔS)			Fiscal effort corrected for **α** and **β** (ΔS^*)			*Required fiscal effort in the latest Council recommendation (**R**)*			Deadline for correction
	2012	**2013**	**2014**	**2012**	**2013**	**2014**	***2012***	***2013***	***2014***	
PT	2.4	0.6	1.4	3.0	1.3	1.8	*2.3*	*1.6*	*1.3*	2014

6 Detailed calculations for parameters 'alpha' and 'beta' are provided in the Annex.

Table 5: Main discretionary measures in 2012-2014 (% of GDP)

Revenue	Expenditure
2012	
• VAT change in tax structure and energy rates (1.2% of GDP) • Excise tax rate increases (0.1% of GDP) • Other indirect taxes exemptions (0.1% of GDP) • PIT and CIT reduction of tax benefits (0.4% of GDP) • PIT surcharge (0.1% of GDP) • PIT taxation capital gains (0.1% of GDP) • CIT surcharge (0.1% of GDP) • Other non-tax revenues (0.1% of GDP) **Total: 2.2% of GDP**	• Employment restraint (0.3% of GDP) • Elimination of the 13th and 14th salary (1.0% of GDP) • Elimination of the 13th and 14th pension (1.0% of GDP) • Social transfers reduction (0.1% of GDP) • Health reform (0.6% of GDP) • Reduction of intermediate consumption (0.2% of GDP) • Reduction of investment in various sectors (0.6% of GDP) **Total: 3.7% of GDP**
2013	
• PIT restructuring and surcharges (1.6% of GDP) • CIT base broadening (0.1% of GDP) • Real estate tax base broadening (0.2% of GDP) • Extraordinary solidarity contribution on pensions (0.3% of GDP) • Broadening of social security base and other non-tax revenues (0.2% of GDP) • Excise taxes and other indirect taxes (0.1% of GDP) • Larger use of EU funds (0.3% of GDP) **Total: 2.8% of GDP**	• Lower wage bill - employment restraint and remuneration- (0.9% of GDP) • Reduction in other social benefits (0.4% of GDP) • Savings in intermediate consumption across line ministries (0.3% of GDP) • Savings in SOEs and PPPs (0.3% of GDP) • Savings in health sector (0.1% of GDP) • Other savings (0.2% of GDP) • Reinstatement of the 13th and 14th salary (-1.5% of GDP) **Total: 0.7% of GDP**
2014	
• Higher contributions to special health subsystems (0.1% of GDP) • Pension sustainability contribution –if needed (0.2% of GDP) **Total: 0.3% of GDP**	• Employment restraint (0.5% of GDP) • Upfront costs associated to employment restraint (-0.3% of GDP) • Revision of wage/supplement scales (0.3% of GDP) • Savings in intermediate consumption across line ministries (0.3% of GDP) • Change to sustainability factor/retirement age (0.2% of GDP) • Convergence civil servant's pension regime (CGA) to the general regime (0.4% of GDP) **Total: 1.4% of GDP**
Note: Negative sign denotes a deficit increasing measure. Some measures are grouped by sector. Only measures yielding more than 0.1% of GDP are listed.	

This analysis is confirmed by a more in-depth analysis of the budgetary developments in 2012, including a bottom-up assessment of measures taken. Confining the deficit in 2012 was challenging in view of the macro-driven underperformance of revenues that required a tight budgetary execution on the expenditure side and the implementation of consolidation measures on top of those foreseen in the original budget. A supplementary budget was approved in March, with the total amount of measures reaching 5½% of GDP. In order to compensate for the higher-than-expected revenue shortfalls additional expenditure measures of 0.3% of GDP were taken in the last quarter of the year, particularly in the areas of the public wage bill, with the reduction in public employment proceeding ahead of plans, intermediate consumption and capital expenditure. The budgetary execution of regional and local governments also turned out better than expected. On the whole, Portugal adopted permanent consolidation measures amounting to nearly 6% of the GDP in 2012, of which about one-third were on the revenue side and two-thirds on the expenditure side (see Table 5).

3.2.2 Budgetary developments in 2013

According to the Commission services' updated forecast, the government deficit is projected to reach 5.5% of GDP, compared with the EDP target of 4.5% of GDP. Hence, the headline deficit target for 2013 is not expected to be met. The primary balance is expected to improve by 0.9 pp. Budgetary consolidation needs to compensate for a large negative primary balance drift which reflects more subdued labour market and growth developments as well as the continued rebalancing towards a more export-driven but also less tax-intensive economy than expected at the time of the revised EDP recommendation. GDP growth was revised downwards to -2.3% and the unemployment rate was revised upwards to 18.2%. In addition, a Constitutional Court ruling against several measures of the 2013 budget opened a fiscal gap of 0.8% of GDP. In particular, the Court annulled the cut of one of the two bonus payments for public sector workers, the cut of 90% of one of the two bonus payments for pension beneficiaries and the introduction of social security contributions on unemployment and sick leave benefits.

The Commission services' May 2013 forecast projects the structural deficit to decrease by 0.6% of GDP compared with a recommended effort of 1.6% of GDP. Correcting for the change in the estimated potential growth between the projections underlying the revised EDP recommendations and the May 2013 forecast would increase the estimated fiscal effort by 0.2 pp. In addition, correcting for changes in expected revenue raises the effort by 0.5 pp. reflecting the large amount of revenue-based consolidation measures foreseen in 2013. This brings the adjusted fiscal effort to 1.3% of GDP, which is somewhat below the effort required by the revised EDP recommendation.

The budgetary adjustment in 2013 is underpinned by consolidation measures with a net worth of 3.5% of GDP. These include the measures defined in the 2013 budget law, to be amended by a supplementary budget by end-May, the frontloading of expenditure-reducing measures identified in the context of the PER as well as other measures to replace the budget measures that were ruled unconstitutional. Given the timing of the Constitutional Court ruling well within the budgetary year and the subsequent need for a rapid reaction, some of the measures in 2013 are of temporary nature which will be replaced by permanent measures in 2014. On the whole, revenue increases will bear the brunt of the adjustment in 2013 but the balance between revenue and expenditure-based consolidation will be re-established in 2014 (see Table 5).

On the revenue side, a comprehensive reform of the personal income tax (PIT) was implemented by reducing the number of brackets and increasing the average tax rate in line with European standards, while preserving progressivity and curbing tax benefits. In addition, a tax surcharge is imposed on incomes above a certain threshold. Corporate tax revenues will be increased by means of limiting the deductibility of interest costs, reducing the threshold for applying the highest surcharge on profits and changing the methodology for special prepayment to companies, among others. The budget also considers changes in indirect taxation by means of higher excises on tobacco, alcohol and natural gas and broadening the scope of property taxation after revaluation of properties. In addition, social contributions will also rise as they will be also charged on supplementary payments for public employees and on unemployment and sick leave benefits. The latter reform will be redesigned so as to accommodate the Constitutional Court ruling. An extraordinary solidarity contribution will be levied on pensions.

On the expenditure side, a comprehensive package of measures is implemented to reduce the public sector wage bill through employment restraint and a reduction in overtime payments and compensations. These include the measures foreseen in the 2013 budget law and additional measures decided by the government in April and May. In particular, it foresees a further reduction in public employment through the transformation of the Special Mobility Scheme into a Requalification Programme and the convergence of public and private sector working rules – especially by raising working hours in the public sector from 35 to 40 hours per week, the increase in the public employees' contributions to the special health insurance schemes and the reduction of fringe benefits. Rationalisation efforts across line ministries, SOEs and PPPs will be deepened plans and social spending will be further streamlined. In addition, the government will also adopt non-permanent measures including a frontloading of revenue from of EU Funds through the transfer of Cohesion Fund resources from less mature projects to more advanced ones and a reduction in investment. These will be replaced by permanent measures the following year.

3.2.3 Budgetary developments in 2014

The economic recovery should gather pace in 2014, albeit at a slower pace than foreseen in the October EDP recommendation, with real GDP forecast to grow by 0.6%, driven by net exports and investment as well as a turnaround in private consumption. The unemployment rate is forecast to reach 18½% in 2014 as a consequence of the weaker growth outlook and expected further cuts in public-sector employment. The government announced on 2 May a substantial package of permanent fiscal consolidation measures which were derived from the PER. Against the backdrop of weaker-than-expected growth prospects, these measures are, nonetheless, insufficient to bring the deficit below the 3% of GDP threshold by 2014. According to the Commission services' May 2013 forecast, the government headline deficit is projected to reach 4.0% of GDP in 2014. This would represent an improvement in the structural deficit by 1.4% of GDP, which is above the effort of 1.3% of GDP required by the revised EDP recommendation. The evolution of potential output between the projections underlying the revised EDP recommendations and the updated forecast would add 0.1 pp. to the estimated fiscal effort. In addition, adjusting for unexpected revenue shortfalls, the effort would increase to 1.8% of GDP. The adjusted structural effort in 2014 would thus be well above the amount required by the revised EDP recommendation.

The main impact of the PER measures will be in 2014 and beyond, acting along three main axes: (1) reduction of the public sector wage bill; (2) reduction of pension benefits and (3) sectoral expenditure cuts across line ministries and programmes. The PER measures are part of a wider effort to reform the state with the objective of increasing equity and efficiency in the provision of social transfers and public services. The package adopted on 2 May includes measures amounting to about 1.7% of GDP for 2014 – net of the estimated upfront costs (of EUR 500 million or 0.3% of GDP) of the planned voluntary redundancy scheme.

The reduction in the wage bill in 2014 aims at reducing the size of the public-sector work force while changing its composition towards higher-skilled employees, aligning the public sector work rules with those of the private sector and making the remuneration policy more transparent and merit-based. These include the utilisation of the new Requalification Programme, the further convergence of public and private sector work rules, the implementation of a voluntary redundancy scheme – with an upfront one-off cost of about 0.3% of GDP, the introduction of a single wage and supplement scales. Savings in intermediate consumption across line ministries will also be stepped up. Finally, a comprehensive pension reform will generate another important part of the savings and will be based on equity principles and income progressivity, thereby protecting the lowest pensions. Specifically, the reforms will take into consideration the need to reduce the current differences between the civil servants' regime (CGA) and the general system, increasing the statutory retirement age and applying – if necessary– a progressive sustainability contribution.

3.2.4 Public debt

Gross public debt rose from 108.3% in 2011 to 123.6% in 2012, above the 119% projected at the time of the recommendation. The upward shift in the projections for 2012 is mostly driven by the statistical treatment of the transfer of privatisation receipts from Parpública to the State as well as the effect of the lower GDP path and the revised deficit projections. The government will put forward various measures to curb the increase in the debt ratio such as the sale of foreign assets of a social security fund and the completion of privatisation efforts. Albeit small, a primary surplus is already expected in 2014 reflecting the strength of fiscal consolidation and the more benign macroeconomic developments. Public debt is expected to peak at about 124.2% of GDP in 2014 and to decline thereafter.

3.2.5 Budgetary framework

In the revised EDP recommendation of October 2012, Portugal was also required to maintain the reform momentum in public financial management by reforming the Budget Framework Law to comply with the new the principles of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (fiscal compact) and the six-pack and to continue improving transparency and control at all budgetary stages as well as ensuring adherence to its medium-term budgetary framework and targets for all levels of the general government.

The Budget Framework Law was amended to transpose, ahead of schedule, the principles of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (fiscal compact) and the six-pack. This reform shows the authorities' commitment towards fiscal sustainability over the medium term. An additional revision is foreseen by the end of 2013 to further enhance budgetary procedures and principles of budgetary management, accountability, transparency and simplification. The process will be conducted in consultation with the relevant stakeholders. Regional and local policy frameworks are also being strengthened. Draft Regional and Local Finance Laws were submitted to Parliament at the end of December 2012, applying the principles of the amended Budgetary Framework Law. The laws set improved coordination mechanisms between the central and the local and regional administrations, a multi-annual budgetary framework and tighter fiscal rules. The new framework law of local attributions and competences was adopted in Parliament and will provide the legal basis for a more efficient division of labour between the central and local administrations.

A three-year action plan aimed at developing the institutional setting for the sustainability of public finances was published as an annex to the 2013 budget law. It proposes actions in three fronts: improving the legislative and procedural framework, raising technical capacity within the field of public finances and developing a broad-based reform of public administration. Several reforms are already in place to ensure progress in all areas.

4. PROPOSED NEW ADJUSTMENT PATH

Portugal will not meet the nominal budgetary targets established in the Council Recommendation of 9 October 2012. However, Portugal has implemented a structural effort in 2012 substantially above the effort required in the revised EDP recommendation. In 2013, primarily on the account of unexpected adverse economic developments and the timing of the Consitutional Court ruling well within the budgetary year, the structural effort required will not be met although the amount of consolidation measures implemented significantly exceeds the amount foreseen at the time of the recommendation. These unexpected adverse economic developments have entailed major unfavourable consequences for government finances. In particular, the decline in real GDP was more severe than expected. The economic recession has weighed on labour market developments with unemployment above the expectations at the time of the recommendation. Together with the changing composition of GDP growth, this has had adverse effects on both the revenue and expenditure side with a shortfall of current tax revenue and social contributions as well as higher expenditure on social transfers.

Considering all these factors and using the flexibility foreseen in the Stability and Growth Pact, and given in particular the marked deterioration in the growth outlook since the October 2012 recommendation, an additional year for the correction of the excessive deficit would therefore be warranted. This would translate into intermediate headline deficit targets of 5.5% of GDP in 2013, 4.0% of GDP in 2014 and 2.5% of GDP in 2015. The attainment of these deficit targets is consistent with an annual improvement in the primary balance (net of one-off measures) of 1.1% of GDP on average over the period 2013-2015. The improvement in the structural budget balance implied by the headline targets is 0.6% of GDP in 2013, 1.4% of GDP in 2014, 0.5% of GDP in 2015, the last corresponding to the minimum improvement required by Article 5(1) of Council Regulation (EC) No 1466/97 of 7 July 1997[7]. These targets for the annual improvement in the structural budget balance take into account the need to compensate for the negative second-round effects of fiscal consolidation on public finances, through its impact on GDP growth. The more gradual adjustment path takes into

[7] The required structural fiscal efforts have to be interpreted with great caution given the major uncertainties surrounding the methodological estimation of potential growth and output gaps in an economy like Portugal, facing profound structural transformations.

account the current difficult economic environment and the on-going major structural transformation of the Portuguese economy.

Achieving these targets will require the full implementation of the fiscal consolidation measures announced by the government. For 2013, this implies going beyond the 2013 budget by applying additional consolidation measures to compensate for the strongly negative carry-over from 2012 and the Constitutional Court ruling. While the envisaged expenditure compression appears feasible it will require sustained budgetary discipline at all levels of government. Moreover, as some of the compensating measures are of temporary nature there is a need for their replacement by permanent measures in 2014.

In 2014, the savings generated by the PER and other measures appear sufficient to meet the fiscal target. Moreover, the quality of the adjustment is higher than in 2013 as all measures are of a permanent nature. In addition, due to the upfront costs related to the voluntary redundancy scheme, one-off expenditure amounting to 0.3% of GDP will drop out after 2014, leading to a mechanical improvement in the 2015 budget balance. However, implementation risks of the measures are large. More importantly, there are also process-related risks as the measures are being discussed with social and political partners and the details are still to be defined.

It is therefore important to maintain reform momentum to strenghten the institutional framework as well as improving budgetary procedures at all stages which should ensure a smooth implementation of the proposed consolidation measures. Continued efforts to limit contingent liabilities stemming from SOEs and PPPs will also be necessary.

Table 6: Forecast of key macroeconomic and budgetary variables (Commission services' updated forecast)

% of GDP	2011	2012	2013	2014	2015
Revenues	45	41	42.6	42.1	41.6
Current revenues	40.5	39.7	41.4	41.2	40.7
Discretionary measures with impact on current revenue (EUR bn)[8]	4.2	2.3	4.9	0.6	-
Expenditure	49.4	47.4	48	46.1	44.1
Real GDP growth (%)	-1.6	-3.2	-2.3	0.6	1.5
Nominal GDP growth (%)	-1.0	-3.3	-0.6	1.8	2.7
Potential GDP growth (%)	-0.5	-1.5	-1.3	-0.5	-0.1
Structural balance	-6.6	-4.2	-3.6	-2.2	-1.7
General government balance	-4.4	-6.4	-5.5	-4.0	-2.5
p.m CAB methodology revenue elasticity[9]	0.9	0.9	0.9	0.9	0.9
p.m Apparent revenue elasticity	3.2	2.3	7.0	0.2	0.6
p.m Output gap (% of pot. Output)	-1.9	-3.5	-4.6	-3.5	-1.9

Note: The projections reflect the authorities' commitments for 2013–14 under the EU/IMF-supported programme.

8 Measures clearly specified and committed to by government ahead of the recommendation.

9 The standard revenue elasticity has been revised in line with the recently endorsed by EPC methodology for computing cyclically-adjusted balances.

5. CONCLUSIONS

On current information, it appears that Portugal has taken effective action which represents adequate progress towards correcting the excessive deficit in 2012 and 2013 within the limits specified by the Council on 9 October 2012. In particular, Portugal has adopted sizeable consolidation measures of nearly 6% of GDP in 2012 and 3½% of GDP in 2013, based on bottom-up calculations. Correcting for revisions in potential output growth and for revenue shortfalls due to tax-poor growth, the estimated annual improvement in the structural balance is in line with the effort required by the Council in 2012. In 2013, the structural effort is expected to fall short of the required effort, primarily due to the unexpectedly adverse economic outlook as well as the implications of the Constitutional Court ruling well within the budgetary year. For 2014, the government has proposed a consolidation package that delivers a structural effort beyond the required one and compensates for one-off and temporary measures in the previous year. The specific measures are currently under negotiation with social and political partners and the necessary legislative changes are expected to be finalised well in time for the 2014 budget.

Progress to enhance fiscal governance has also been remarkable at all government levels and further improvements are still foreseen for this year.

The deterioration in the economic oulook which occurred since the last recommendation was issued, as well as the urgent need to offset the adverse budgetary impact of the recent Consitutional Court ruling well within the budgetary year, suggest that an extension of the deadline for correcting the excessive deficit is appropriate, in order to bring the headline government deficit below the 3% of GDP reference value by 2015. Granting an additional year for the correction of the excessive deficit would translate into intermediate headline deficit targets of 5.5% of GDP for 2013, 4.0% of GDP for 2014, 2.5% of GDP for 2015. The underlying improvement in the structural budget balance implied by these targets is 0.6% of GDP in 2013, 1.4% in 2014, 0.5% in 2015.

Annex

Table A1: Detailed calculations for the parameter α

	Pot. growth underlying Council recommendation (COM October 2012) (%) (1)	Pot. growth (COM May 2013) (%) (2)	Forecast error (%) (3)=(2)-(1)	Structural expenditure (% of pot. GDP) (COM May 2013) (4)	Correction coefficient α (% of nominal pot. GDP) (5)=[(3) x (4)]/100
2012	-1.2	-1.5	0.3	45.8	0.2
2013	-0.8	-1.3	0.5	42.8	0.2
2014	-0.4	-0.5	0.1	43.9	0.1

Table A2: Detailed calculations for the parameter β

	Change in current revenues (yoy) (billions of national currency)		Discretionary current revenue measures (billions of national currency)		Nominal GDP growth assumptions (%)		Current revenues in year t-1 (billions of national currency)		Revenue gap (billion of national currency)*	Correction coefficient β (% of nominal potential GDP)
	Oct-12	May-13	Oct-12	May-13	Oct-12	May-13	Oct-12	May-13		
	(1)	(1')	(2)	(2')	(3)	(3')	(4)	(4')	(5)=[(1')-(2')-ε*(3')*(4')]-[(1)-(2)-ε*(3)*(4)]	
2012	-2.4	-3.7	2.4	2.3	-2.7	-3.3	69.3	69.3	-0.8	-0.4
2013	2.9	2.5	3.8	4.9	0.3	-0.6	66.8	65.6	-0.9	-0.5
2014	1.0	0.9	0.0	0.6	2.2	1.8	69.7	68.1	-0.5	-0.3