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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of PORTUGAL

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of PORTUGAL

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1. INTRODUCTION

Following its exit from the economic adjustment programme on 28 June 2014, Portugal has submitted its Draft Budgetary Plan (DBP) for 2015 on 15 October 2014 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Portugal is currently subject to the corrective arm of the Pact. The Council opened the Excessive Deficit Procedure (EDP) for Portugal on 2 December 2009. Subsequently, the Council adopted revised Recommendations on 9 October 2012 and on 21 June 2013. The country is recommended to correct the excessive deficit by 2015.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission forecast. The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2014-2015 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest Country-Specific Recommendations (CSRs) adopted by the Council on 8 July 2014, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

According to the DBP, Portugal is expected to continue its moderate economic recovery. Having contracted by 1.4% in 2013, real GDP is forecast to grow by 1.0% in 2014 and then accelerate to 1.5% in 2015. In the DBP scenario, economic growth is foreseen to be mainly driven by domestic demand while the net export contribution to GDP growth is estimated to be negative in 2014, but to turn positive in 2015. Private consumption is expected to continue its strong recovery in the coming quarters, further supported by ongoing improvements in the labour market and solid disposable income growth. Consequently, the authorities have revised upwards private consumption growth by 1 pp. in 2014 and 2015 compared with the Fiscal Strategy Document (FSD)[1]. In contrast, gross fixed capital formation has been revised down

[1] Pursuant to Regulation (EU) No 472/2013, Portugal was exempted from the obligation to submit its National Reform Programme and its Stability Programme (SP) for the duration of the macroeconomic adjustment programme. Nevertheless, it submitted an updated Fiscal Strategy Document (FSD) on 30 April 2014 (*Documento de Estratégia Orçamental*) and a letter from the Government providing an update on developments on the Europe 2020 targets. Figures reported under SP in the following tables refer to the FSD.

by 1.8 pps. in 2014 and 2015 based on slower construction recovery and the postponement of some investments, such as the purchase of new passenger aircrafts. Due to fading external demand, export growth is also expected to slow down, with an annual growth rate of 3.7% in 2014 and 4.7% in 2015, weaker than expected in the FSD (+5.7% y-o-y in both years). The labour market is further improving and employment is forecast to expand by 1.4% in 2014 and by 1% in 2015, somewhat stronger than anticipated in the FSD. HICP is projected to accelerate slightly from the end of this year, bringing the average annual inflation rate to zero in 2014 and to 0.7% in 2015.

The macroeconomic scenario in the DBP for 2015 is more optimistic than the projections under the Commission 2014 autumn forecast. Real GDP growth in 2015 is expected to be 0.2 pp. stronger than in the Commission forecast, mainly on the back of a bigger contribution of net exports and higher private consumption growth. Despite the high level of household indebtedness, the DBP foresees a further acceleration in private consumption to 2.0% in 2015 while under the Commission 2014 autumn forecast scenario private consumption growth is expected to decrease in line with more subdued disposable income growth. On the external side, the DBP projects lower import growth (by 0.3 pp. compared to the Commission 2014 autumn forecast), despite a higher forecast for domestic demand.

According to the National Statistical Office's flash estimate of 14 November, real GDP expanded in the third quarter by 0.2% q-o-q, which is in line with the Commission 2014 autumn forecast. Better-than-expected employment data for the third quarter indicate some upside risks for the projected labour market trends. However, the risks to the Commission 2014 autumn forecast remain tilted to the downside. In particular, a further deterioration of the external environment would weigh on export prospects. In addition, the high level of private sector indebtedness points to deleveraging pressures on households and corporations, which could have a more negative impact on private consumption and fixed investment.

Box 1. Portugal's Public Finance Council and its assessment of the macroeconomic projection underpinning the Draft Budgetary Plan for 2015

The macroeconomic forecast underlying Portugal's DBP for 2015 has been prepared by the Department of Planning, Strategy, Evaluation and International Relations within the Ministry of Finance. The Public Finance Council (*Conselho das Finanças Públicas*, CFP), assessed and endorsed the macroeconomic forecast underpinning the DBP.

The CFP was established through the May 2011 reform of the Budgetary Framework Law (Article 12-I BFL) and its Statutes were laid down in an annex to the Law No. 54/2011 of 19 October 2011. The CFP is a legal entity which has the nature of an independent body according to Article 5 in its Statutes, and its board cannot request or receive instructions from other public or private institutions. Clear stipulations underpin the CFP access to relevant information. The institution has been operational since February 2012.

Article 12-I BFL provides a mandate to the CFP to analyse government forecasts and under Article 6 of the CFP Statutes, the body is entitled to implement the aforementioned task.

The endorsement by the CFP is attached to the DBP publication and is available at the institution's website since the day before the DBP release. The CFP opinion includes a more detailed assessment where the minor discrepancies between the DBP macroeconomic forecast and the latest ones by other institutions are pointed out. Regarding the conclusions, it states that the macroeconomic forecasts underlying the DBP for 2015 show no noteworthy biases. The CFP's main concern is the optimistic export projection in 2015. The CFP sees the main

downside risk to the macroeconomic forecast underlying the DBP in the external environment, and particularly the euro area. The CFP also reports the substantial time constraint to analyse the DBP macroeconomic scenario and it requests a Memorandum of Understanding with the Government to establish procedures and timetables when assessing future Stability Programmes and DBPs, following the Code of Conduct under the Two-Pack regulation.

Table 1. Comparison of macroeconomic developments and forecasts

	2013	2014			2015		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	-1.4	1.2	1.0	0.9	1.5	1.5	1.3
Private consumption (% change)	-1.4	0.7	1.8	1.6	0.8	2.0	1.5
Gross fixed capital formation (% change)	-6.3	3.3	1.5	1.9	3.8	2.0	2.4
Exports of goods and services (% change)	6.4	5.7	3.7	3.6	5.7	4.7	4.6
Imports of goods and services (% change)	3.6	4.1	4.7	4.5	4.2	4.4	4.7
Contributions to real GDP growth:							
- Final domestic demand	-2.3	0.5	1.4	1.2	0.8	1.3	1.3
- Change in inventories	0.0	-0.2	0.0	0.0	0.0	-0.1	0.0
- Net exports	1.0	0.7	-0.3	-0.3	0.7	0.2	0.0
Output gap[1]	-6.4	-4.2	-5.0	-5.0	-2.8	-3.5	-3.4
Employment (% change)	-2.9	1.0	1.4	1.6	0.8	1.0	0.8
Unemployment rate (%)	16.4	15.4	14.2	14.5	14.8	13.4	13.6
Labour productivity (% change)	1.6	0.2	-0.4	-0.7	0.7	0.5	0.5
HICP inflation (%)	0.4	0.4	0.0	0.0	1.1	0.7	0.6
GDP deflator (% change)	2.3	0.7	1.4	1.1	0.9	1.5	1.4
Comp. of employees (per head, % change)	3.5	-0.9	-0.7	-0.4	0.9	1.2	0.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.3	2.9	1.5	1.4	3.4	1.5	1.7

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Stability programme (SP); Draft Budgetary Plan (DBP); Commission 2014 autumn forecast (COM); Commission calculations.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

For 2014, Portugal's DBP projects a general government deficit of 4.8% of GDP, considerably higher than the April 2014 FSD deficit target of 4% of GDP. The difference mainly reflects the recording of the costs of the debt management operations of transport state-owned enterprises (SOEs) with high legacy debt burden (approximately 0.7% of GDP, signalled as a fiscal risk in the FSD) and the write-off of non-performing loans of BPN Crédito (0.1% of GDP, unforeseen at the time of the FSD). The DBP projects a deficit net of temporary measures of 3.7% of GDP, 0.2% of GDP lower than the estimate of the FSD, mainly reflecting upward revisions of tax revenue and the slight downward revision of some expenditure items.

Furthermore, the DBP plans a different composition of the adjustment than the FSD for 2014, less based on expenditure compression and more reliant on the projected macro-related revenue performance. This results from the government not having fully replaced the permanent expenditure-reducing measures overturned by successive Constitutional Court (CC) rulings after the FSD was issued. Thus, the second 2014 Supplementary Budget, that entered into force on 1 October 2014, compensated the fiscal gap resulting from the CC decisions and identified pressures on budget execution (0.4% of GDP) by the assumed impact on the budget of macroeconomic revisions (improved labour market situation and private consumption outlook) and by an upward revision of tax collection owing to improved efficiency in the fight against tax fraud.

The Commission forecast projects the general government deficit for 2014 to be slightly higher, at 4.9% of GDP, on account of a somewhat weaker yield of some measures and a less optimistic view of tax revenue collection as well as on some expenditure items, notably on compensation of employees and social benefits. The projected headline deficit is affected by deficit-increasing one-offs, which do not deteriorate the baseline carried-forward to 2015. The deficit excluding these one-off operations is forecast by the Commission at 3.9% of GDP.

Neither the DBP nor the Commission forecast includes the one-off operation related to the resolution of Banco Espírito Santo, which is still subject to analysis by the statistical authorities and could eventually push up the 2014 headline deficit by about 2.8% of GDP.

Portugal plans to correct the excessive deficit in 2015, in line with the June 2013 Council Recommendation. However, the DBP is targeting a headline deficit of 2.7% of GDP, i.e. exceeding the 2.5% of GDP deficit recommended by the Council and targeted in the FSD. According to the Portuguese authorities, the successive unfavourable rulings of the CC on expenditure-reducing measures have limited the scope for further reduction of expenditure on the most relevant items (compensation of employees and social benefits) as a result of which compliance with the 2.5% of GDP deficit target would require additional tax increases. First, it should not be taken for granted that expenditure cannot be reduced further in current circumstances. Second, not only does the DBP exclude any new measures in these fields, but it also foresees the partial reversal of public sector wage cuts currently in place and the abolition of the extraordinary solidarity contribution from pensions (CES). Both measures proved to be effective consolidation instruments in past years.

The DBP forecasts the budgetary adjustment in 2015 to be achieved mostly by increasing revenue, mainly of indirect taxes and social contributions, outpacing GDP growth, which is explained by macroeconomic developments and further efficiency gains in tax collection reflected in the significant increase in tax elasticities relative to their average value in the past. The evolution of almost all expenditure items is below the assumed GDP growth.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2013	2014			2015			Change: 2013-2015
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**45.2**	**43.2**	***44.5***	**44.6**	**43.3**	***44.6***	**44.4**	**-0.6**
of which:								
- Taxes on production and imports	13.7	13.7	*13.9*	14.0	13.9	*14.6*	14.5	0.9
- Current taxes on income, wealth, etc.	11.3	11.3	*10.8*	10.7	11.4	*10.7*	10.8	-0.6
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	11.9	11.8	*11.8*	11.8	11.7	*11.7*	11.5	-0.2
- Other (residual)	8.2	6.4	*8.0*	8.0	6.3	*7.6*	7.6	-0.6
Expenditure	**50.1**	**47.1**	**49.2**	**49.5**	**45.8**	**47.3**	**47.7**	**-2.8**
of which:								
- Primary expenditure	45.1	42.8	44.2	44.5	41.5	42.4	42.7	-2.7
of which:								
Compensation of employees	12.4	9.7	11.6	11.7	9.1	10.9	11.0	-1.5
Intermediate consumption	5.7	4.6	5.8	5.8	4.3	5.8	5.9	0.1
Social payments	20.3	22.9	19.5	19.6	22.4	19.2	19.3	-1.1
Subsidies	0.6	0.7	0.8	0.9	0.7	0.5	0.6	-0.1
Gross fixed capital formation	2.2	1.8	2.4	2.5	1.7	2.4	2.4	0.2
Other (residual)	4.0	3.1	4.1	4.1	3.3	3.6	3.5	-0.4
- Interest expenditure	5.0	4.3	5.0	5.0	4.3	4.9	5.0	-0.1
General government balance (GGB)	**-4.9**	**-4.0**	**-4.8**	**-4.9**	**-2.5**	**-2.7**	**-3.3**	**2.2**
Primary balance	**0.1**	**0.4**	**0.3**	**0.1**	**1.8**	**2.2**	**1.6**	**2.1**
One-off and other temporary	0.3	0.0	-1.1	-1.1	0.0	0.1	0.1	-0.2
GGB excl. one-offs	**-5.2**	**-4.0**	**-3.7**	**-3.9**	**-2.5**	**-2.8**	**-3.4**	**2.4**
Output gap[1]	-6.4	-4.2	-5.0	-5.0	-2.8	-3.5	-3.4	2.9
Cyclically-adjusted balance[1]	-1.6	-2.0	-2.3	-2.4	-1.2	-0.9	-1.6	0.7
Structural balance (SB)[2]	**-1.9**	**-2.0**	**-1.2**	**-1.3**	**-1.2**	**-1.0**	**-1.7**	**0.9**
Structural primary balance[2]	3.0	2.3	3.8	3.7	3.1	3.9	3.3	0.9

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability programme 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.

The Commission 2014 autumn forecast foresees a general government deficit of 3.3% of GDP in 2015, markedly higher than in the DBP. The discrepancy is to a large extent due to different assumptions about revenue growth (mainly of indirect taxes and social contributions). In particular, the DBP projects higher revenue growth in 2015 than assumed in the FSD, explained by a growth composition increasingly driven by domestic demand, and by an assumed generous additional impact of measures to fight tax fraud and evasion. By contrast, the Commission forecast is less optimistic about the improvement in the balance driven by changes in the growth composition: partly due to the less optimistic macroeconomic

outlook and also because it considers a more cautious impact of the macroeconomic developments on the budget, in accordance with standard elasticities. In addition, the Commission forecast factors in uncertainty about the ex-ante estimated additional yields from anti-fraud measures. These factors contribute altogether to explain around 0.5% of GDP of the difference in the 2015 deficit forecast with the DBP. Other factors underlying the divergence concern a base effect from a slightly worse baseline carried forward from 2014 (0.1% of GDP of the difference), as well as a more cautious assessment of some of the consolidation measures included in the DBP for 2015, which have repeatedly failed to perform in the past (0.1% of GDP of the difference, see below).

Risks to the fiscal forecast are tilted to the downside. For 2014, the one-off operation related to Banco Espírito Santo could be accounted as deficit-increasing by statistical authorities. For 2015, taking into account the latest information, fiscal risks related to the economic outlook have become more balanced. Nevertheless, significant downside risks remain related to the projected improvement in the efficiency of revenue collection. In addition, further risks also relate to possible slippages on the execution of some expenditure items, also in view of the track record of overruns in the past. Implementation risks of some measures in view of upcoming elections add to the risks of the fiscal outlook.

The projected improvement in the structural balance[2] in the DBP is estimated at 0.8% and 0.1% of GDP in 2014 and 2015, respectively. The estimated annual change in the structural balance of the April FSD was slightly lower for 2014 (0.7% of GDP)[3] and higher for 2015 (0.8% of GDP), which is consistent with the less ambitious headline deficit target for 2015 in the DBP, the slightly improved baseline and the recourse to one-off measures. Relative to the DBP, the Commission autumn forecast projects a lower structural improvement in 2014 (0.6% of GDP) and a deterioration in structural balance in 2015 (by 0.3% of GDP), reflecting the entirely cyclical, and not structural, nature of the projected deficit reduction next year.

3.2. Debt developments

General government consolidated gross debt has increased markedly since 2010, in the context of the global financial crisis and subsequent recession, very high fiscal deficits and the reclassification of off-balance items and entities in the general government perimeter. This resulted in a debt-to-GDP ratio of 128% by the end of 2013. The DBP projects the ratio to be on a downward path, expecting it to stand at 127.2% of GDP by the end of 2014 and 123.7% of GDP in 2015.

The comparison with the FSD numbers is somewhat distorted by the introduction of the new ESA 2010 statistical methodology in September 2014, which has led to numerous revisions of Portugal's national accounts. Statistical revisions affecting the debt-to-GDP ratio were mainly related to the reclassification of a number of public institutional units inside the general government perimeter as well as a significant upward revision of the nominal GDP level. Overall, these changes shifted down the level of the debt-to-GDP ratio compared to ESA 95.

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[2] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

[3] Due to significant revisions in economic and fiscal aggregates following the transition to ESA 2010, the change in the structural balance estimated in the FSD cannot be based on the 2013 structural balance displayed in the table. The 2013 structural balance estimated in May 2014 still under ESA 95 stood at -2.4% of GDP (see "*The Economic Adjustment Programme for Portugal, 2011-2014*", European Economy Occasional Papers 202, October 2014).

Table 3. Debt developments

(% of GDP)	2013	2014			2015		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**128.0**	**130.2**	**127.2**	**127.7**	**128.7**	**123.7**	**125.1**
Change in the ratio	3.2	1.2	-0.8	-0.3	-1.5	-3.5	-2.7
Contributions[2]:							
1. Primary balance	**-0.1**	**-0.4**	**-0.3**	**-0.1**	**-1.8**	**-2.2**	**-1.6**
2. "Snow-ball" effect	**3.8**	**1.9**	**2.0**	**2.5**	**1.3**	**1.2**	**1.6**
Of which:							
Interest expenditure	5.0	4.4	5.1	5.0	4.3	4.9	5.0
Growth effect	1.7	-1.5	-1.2	-1.2	-1.9	-1.9	-1.6
Inflation effect	-2.8	-1.0	-1.9	-1.4	-1.1	-1.8	-1.7
3. Stock-flow adjustment	**-0.5**	**-0.2**	**-2.5**	**-2.7**	**-0.9**	**-2.5**	**-2.6**
Of which:							
Cash/accruals difference		n.a.	0.0		n.a.	0.0	
Net accumulation of financial		n.a.	-2.0		n.a.	0.0	
of which privatisation proceeds		n.a.	-0.2		n.a	0.0	
Valuation effect & residual		n.a.	-1.0		n.a.	0.0	

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability programme 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.

The main stock-flow adjustments impacting debt projections since the FSD concern, among others, on the debt-increasing side: loans from banks to the Bank Resolution Fund related to the Banco Espírito Santo / Novo Banco resolution (0.3% of GDP), and less than initially projected purchase of national public debt Social Security Fund (0.3% of GDP) as some operations were postponed to next year; on the debt-reducing side: the redemption of CoCos has advanced faster than expected (0.6% of GDP). The reduction in the debt-to-GDP ratio is projected to be supported by Social Security Fund purchases of national public debt, the use of cash reserves, primary balance surpluses and more importantly for the next years, the expected growth of nominal GDP.

The Commission 2014 autumn forecast predicts a somewhat higher public debt level for both 2014 and 2015, due to the higher fiscal deficit and in particular lower nominal GDP projections.

Risks to the debt projections are tilted to the downside due to the negative risks to the macroeconomic and the fiscal forecast. Moreover, given the high volatility in financial markets, interest payments could also turn out higher than expected. On the positive side, the

Treasury has accumulated significant cash reserves, which may cushion the impact of negative developments on the gross public debt-to-GDP ratio.

3.3. Measures underpinning the draft budgetary plan

The DBP reports discretionary measures for 2015 with an expected overall yield of 0.7% of GDP, of which 0.1% of GDP consist of one-off measures. The permanent measures are roughly equally split between revenue increases and expenditure savings. This package is of lower value and quality than the one planned in the FSD, which amounted to 0.8% of GDP of permanent measures and predominantly on the expenditure side (and deemed sufficient to reach the 2.5% of GDP target back in April), of which, however, measures worth 0.3% of GDP have been overturned by the CC over summer.

The consolidation package includes the budgetary impact in 2015 of two measures already adopted in 2014 but which will take effect only later in the year: the increased beneficiaries' contributions to the public sector's health systems and the mutual agreement terminations of public employment contracts (0.1% of GDP carry-over effect in 2015 altogether). The remaining measures include, from the expenditure side: savings from public employment reductions, planned to be attained mainly by attrition, non-renewal of some contracts in areas with over-employment and the requalification scheme; a further re-organisation and streamlining of SOEs; expenditure cuts across line ministries, including via increased savings from the health sector through a tax claw-back on health impacting industries (revenue side); the rationalization of ICT-related costs and of contracted studies, consulting and other projects; a newly planned cap on total social subsidies received by an individual and a solidarity contribution from the highest pensions. On the revenue side, discretionary measures include increases in excise duties and other minor revenues (from online gambling and increased bank levy) and higher contributions to road services.

Some of these consolidation measures are the continuation of reforms that took place during the economic adjustment programme (e.g. targeted public employment reductions, restructuring of SOEs and the health sector, etc.) and are considered consistent with the objective of rationalisation and improved efficiency of the public sector.

Nevertheless, some of the measures included in the Draft Budgetary Plan may underperform or are deemed to have significant implementation risks, since they have repeatedly failed to become operational or materialise in time in the past. This is in particular the case of one-off sales of concessions, the requalification programme and the intended cap on social benefits, which the Commission forecast considers to have a lower yield than assumed in the DBP. In view of the uncertainties on the yield of some of the consolidation measures included in the DBP package for 2015, the Commission 2014 autumn forecast has reduced their total budgetary impact to 0.6% of GDP.

At the same time, the DBP confirms the reversal of some measures that significantly contributed to consolidation in the last years, i.e. the reinstatement of 20% of the cuts in public employees' compensation as well as the abolition of the CES (as already announced in the FSD). These were meant to be temporary consolidation measures in the last years, to be replaced by durable structural measures in the same areas. The DBP, however, does not indicate possible avenues to contain the wage bill in a durable manner, nor does it present new comprehensive measures for improving the medium-term sustainability of the pension system (as recommended in the CSRs, with end-2014 deadline, see Section 5).

On tax policies, the DBP envisages the continuation of the corporate income tax reform initiated in 2014, by further reducing the standard rate by 2 pps., as well as further revenue

from property taxation, thus contributing to a more growth-friendly tax system, as recommended to Portugal in the CSRs. The DBP also announces plans to reform the personal income tax (PIT) and environmental taxes, which are not taken into consideration in the Commission forecast, as their content or budgetary impact are not sufficiently specified at the current stage. The DBP also reports the maintenance of the temporary 3.5% PIT surcharge, while including an additional provision for a tax credit that could be potentially used against the surcharge, should the effective tax revenue from PIT and VAT over perform the initial estimates. The tax credit would be used in the 2016 taxpayers' tax assessments and therefore it would have no fiscal impact in 2015. The plan is presented as an incentive mechanism to ensuring tax compliance (e.g. encouraging customers to demand invoices) insofar as any additional revenue from fighting tax fraud will revert to taxpayers rather than finance public expenditure. While the promise of financing tax reductions from additional revenue can create good incentives in the fight against fraud, the strategy ties the government's hands not to use any potential additional revenue for possible expenditure slippages (as was the case in the past) or for further deficit reductions.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by general government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2014	**2015**	**2016**
Taxes on production and	n.a.	0.2	n.a.
Current taxes on income, wealth,	n.a.	0.0	n.a.
Capital taxes	n.a.	n.a.	n.a.
Social contributions	n.a.	0.0	n.a.
Property Income	n.a.	n.a.	n.a.
Other	n.a.	0.0	n.a.
Total	n.a.	0.4	n.a.

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan 2015

B. Discretionary measures taken by general government - expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2014	**2015**	**2016**
Compensation of employees	n.a.	-0.1	n.a.
Intermediate consumption	n.a.	-0.3	n.a.
Social payments	n.a.	0.3	n.a.
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	n.a.	-0.1	n.a.
Gross fixed capital formation	n.a.	0.0	n.a.
Capital transfers	n.a.	n.a.	n.a.
Other	n.a.	-0.1	n.a.
Total	n.a.	-0.3	n.a.

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan 2015

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 2. Council recommendations addressed to Portugal

On 21 June 2013, the Council recommended Portugal under Article 126(7) of the Treaty to correct its excessive deficit by 2015. To this end:

"(1) Portugal should put an end to the present excessive deficit situation by 2015.

(2) Portugal should bring the headline deficit to 5.5% of GDP in 2013, 4.0% of GDP in 2014 and 2.5% of GDP in 2015, which is consistent with an improvement in the structural balance of 0.6% of GDP in 2013, 1.4% of GDP in 2014 and 0.5 %of GDP in 2015, based on the Commission services updated 2013 spring forecast.

(3) Portugal should implement measures amounting to 3½% of GDP to confine the 2013 deficit to 5.5% of GDP. These include the measures defined in the 2013 Budget Law and additional measures included in the Supplementary Budget, namely, reductions in the wage bill, increased efficiency in the functioning of public administration, lower public consumption and better use of Union funds.

(4) Portugal should, building on the PER, adopt permanent consolidation measures worth at least 2.0% of GDP in view of attaining a headline deficit of 4.0% of GDP in 2014. Portugal should aim at streamlining and modernising the public administration, addressing redundancies across the public sector functions and entities, improving the sustainability of the pension system and achieving targeted cost savings in individual line ministries.

(5) Portugal should adopt the necessary permanent consolidation measures to achieve the 2015 deficit target of 2.5% of GDP.

(6) The Council establishes the deadline of 1 October 2013 for Portugal to take effective action and, in accordance with point (a) of Article 10(2) of Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of

economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, to report in detail the consolidation strategy that is envisaged to achieve the targets set out in recommendation (2).

Furthermore, Portugal should maintain reform momentum in public financial management by revising the Budget Framework Law by the end of 2013 to further enhance budgetary procedures and principles of budgetary management, accountability, transparency and simplification; to continue efforts to limit contingent liabilities stemming from SOEs and PPPs".

On 8 July 2014, the Council also addressed recommendations to Portugal in the context of the European Semester. In particular, in the area of public finances the Council recommended to Portugal to:

"Implement the necessary fiscal consolidation measures for 2014 so as to achieve the fiscal targets and prevent the accumulation of new arrears. For the year 2015, implement a revised budgetary strategy in order to bring the deficit to 2.5% of GDP, in line with the target set in the Excessive Deficit Procedure Recommendation, while achieving the required structural adjustment. Replace consolidation measures which the Constitutional Court considers unconstitutional by measures of similar size and quality as soon as possible. The correction of the excessive deficit should be done in a sustainable and growth-friendly manner, limiting recourse to one-off/temporary measures. After the correction of the excessive deficit, pursue the planned annual structural adjustment towards the medium-term objective, in line with the requirement of an annual structural adjustment of at least 0,5 % of GDP, more in good times, and ensure that the debt rule is met in order to put the high general debt ratio on a sustainable path. Prioritise expenditure-based fiscal consolidation and increase further the efficiency and quality of public expenditure. Maintain tight control of expenditure in central, regional and local administration. Continue the restructuring of the state-owned enterprises. Develop by the end of 2014 new comprehensive measures as part of the ongoing pension reform, aimed at improving the medium-term sustainability of the pension system. Control healthcare expenditure growth and proceed with the hospital reform. Review the tax system and make it more growth-friendly. Continue to improve tax compliance and fight tax evasion by increasing the efficiency of the tax administration. Strengthen the system of public financial management by swiftly finalising and implementing the comprehensive reform of the Budgetary Framework Law by the end of 2014. Ensure strict compliance with the Commitment Control Law. Effectively implement single wage and supplements' scales in the public sector from 2015 onwards."

4.1. Compliance with EDP recommendations

In 2013, the headline deficit target was overachieved, with a general government deficit of 4.9% of GDP, below the 5.5% of GDP target.

The headline deficit planned in the DBP for 2014 is at 4.8% of GDP, above the 4% of GDP deficit target recommended by the Council in June 2013. For 2015, the DBP foresees to correct the excessive deficit by 2015 as recommended by the Council. At the same time, the

DBP targets a headline deficit of 2.7% of GDP, which is also above the 2.5% of GDP deficit recommended by the Council.

In light of the 4.9% of GDP general government deficit projected for 2014 in the Commission 2014 autumn forecast, Portugal is seen to miss the 4.0% of GDP target recommended by the Council. The 2014 deficit is projected to exceed the target due to deficit-increasing one-off operations amounting to 1.1% of GDP which do not deteriorate the baseline carried forward to 2015. Moreover, according to the Commission forecast, the structural improvement is estimated at 0.6% of GDP, below the recommended improvement of 1.4% of GDP. The cumulative change in the structural balance over 2013-2014, at 1% of GDP, falls short of the cumulative required change of 2% of GDP of the EDP recommendation, even if the overall picture reflected by the structural effort indicators has been negatively affected by the ESA 2010 revisions as well as other recent methodological revisions[4].

In 2014, the adjusted structural effort is estimated to be 0.4% of GDP (and -0.5% of GDP over 2013-2014), well below the required effort. The amount of permanent consolidation measures taken under the programme and thereafter is estimated at 1.5% of GDP in 2014, showing a shortfall with respect to the 2% of permanent measures recommended under the EDP. Not included in this assessment are the yields of actions to fight tax fraud and evasion, which are likely to be underpinning improved tax collection, especially on the back of the e-invoicing reform successfully implemented in 2013. It is estimated that these may have accounted for a value of around 0.3% of GDP in 2014, with the caveats of limitations of empirical methods to accurately measure this effect. Overall, it appears that the fiscal effort in 2013-2014 has not been delivered.

For 2015, the Commission forecast projects the headline deficit at 3.3% of GDP, which is well above the recommended headline deficit target of 2.5% of GDP and points to considerable risks to a timely correction of the excessive deficit by 2015 as recommended by the Council. Moreover, the Commission forecast also points to a significant deterioration in structural balance in 2015 by 0.3% of GDP, well below the recommended improvement of 0.5% of GDP. The cumulative change in structural balance over 2013-2015, at 0.6% of GDP altogether, falls markedly short of the recommended 2.5% of GDP.

As part of the careful analysis, the adjusted structural effort of 2015 is at -0.1% of GDP (and -0.6% of GDP over 2013-2015). The cumulative adjusted structural effort is significantly below the non-adjusted effort due to corrections for windfall revenues predominantly in 2013 and to a lesser extent in 2014. Windfall revenues might, however, turn out lower if the fight against fraud was quantified as a measure to increase revenues. An ex-ante bottom-up assessment cannot be applied for 2015, as the EDP recommendation did not include a reference to the amount of measures necessary to reach the deficit target at the time of the recommendation.

[4] Various methodological and statistical changes introduced in 2014, had a negative impact on the estimated underlying improvement in the structural balance in Portugal. The largest impact concerns the structural effort estimate for 2013, which has been affected by significant ESA 2010-related revisions in the fiscal accounts in 2012, which have now shifted much effort from 2013 to 2012. Other recent methodological revisions also had some negative impact on the estimated cumulative structural effort over the EDP horizon. The total impact on the cumulative structural effort amounts to about -0.8% of GDP over 2013-15, out of which -0.6% of GDP were due to ESA 2010.

Table 5. Compliance with the EDP recommendation

(% of GDP)	2013	2014		2015	
	COM	DBP	COM	DBP	COM
Headline balance					
Headline budget balance	-4.9	-4.8	-4.9	-2.7	-3.3
EDP requirement on the budget balance	-5.5	-4.0		-2.5	
Fiscal effort - change in the structural balance					
Change in the structural balance[1]	0.4	0.8	0.6	0.1	-0.3
Cumulative change[2]	0.4	1.2	1.0	1.3	0.6
Required change from the EDP recommendation	0.6	1.4		0.5	
Cumulative required change from the EDP recommendation	0.6	2.0		2.5	
Fiscal effort - adjusted change in the structural balance					
Adjusted change in the structural balance[3]	-0.9	-	0.4	-	-0.1
of which: *correction due to change in potential GDP estimation (α)*	-0.1	-	0.0	-	0.1
correction due to revenue windfalls/shortfalls (β)	1.2	-	0.3	-	-0.1
Cumulative adjusted change [2]	-0.9	-	-0.5	-	-0.6
Required change from the EDP recommendation	0.6	1.4		0.5	
Cumulative required change from the EDP recommendation	0.6	2.0		2.5	
Fiscal effort - calculated on the basis of measures (bottom-up approach)					
Fiscal effort (bottom-up)	n.a.				
Cumulative fiscal effort (bottom-up)					
Requirement from the EDP recommendation					
Cumulative requirement from the EDP recommendation					

Notes

[1]Structural balance = cyclically-adjusted government balance excluding one-off measures. Structural balance based on DBP are recalculated by Commission on the basis of the Draft Budgetary Plan scenario using the commonly agreed methodology. Change compared to t-1.

[2] Cumulated since the latest EDP recommendation.

3 Change in the structural balance corrected for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendations.

Source :

Draft Budgetary Plan 2015 (DBP), Commission 2014 autumn forecast (COM), Commission calculations

5. IMPLEMENTATION OF FISCAL-STRUCTURAL REFORMS

The DBP contains an overview table (Table 6.a) providing a summary of measures intended to address Portugal's various CSR action items.

The DBP does not include new comprehensive measures towards a pension reform, aimed at improving the medium-term sustainability of the pension system (CSR 1). The CC had overturned on 14 August 2014 the planned structural sustainability contribution from pensions, which would have partially replaced from 2015 the CES, in place since 2011. Following this CC ruling, the Government has suspended the planned comprehensive pension reform, including the adjustment factor announced in the FSD and foreseen to link pension indexation to economic and demographic variables driving the expenditures and revenues of

the pension system. The comprehensive reform of the Budgetary Framework Law (BFL) by the end of 2014 (CSR 1), aimed at streamlining the budget appropriation structure, reducing budget fragmentation, strengthening accountability relations, and bringing a medium-term to long-term orientation to public finances, is ongoing. The Commission is currently assessing the transposition of the Fiscal Compact for all signatories.

The DBP explains that the implementation of the single wage scale and the single supplements scales in the public administration from 2015 onwards (CSR 1) have as main objectives a higher transparency and equity in public sector remuneration policies, but no impact on the budget is expected. The implementation of a programme ('Aproximar') with the main objectives of rationalising the public services network at local level while bringing them closer to the citizens is not expected to lead to budgetary savings already in 2015, contrary to the expected savings in the April 2014 FSD.

Table 6.a further takes stock of the non-fiscal CSRs (CSRs 2 to 8), which are focused on structural reform efforts intended to address rigidities in PT's economy and generally do not have a direct budgetary impact. The overall picture emerging from the information provided suggests that only modest progress has been made in most structural reform areas since the CSRs were issued. In what follows, a summary is provided on the small subset of action items within the structural reform CSRs that are of direct relevance in the context of assessing Portugal's budgetary plan.

Regarding network industries (CSR 6), the DBP mentions the proposed extension until 2015 of the special levy on energy operators, which was first introduced for fiscal year 2014 (fiscal impact of 0.1% of GDP). On the transport sector, the DBP reports some measures with fiscal impact related to the considerable reduction of transport SOEs' operating subsidies, namely by (1) implementing the ongoing transport sector SOEs' restructuring, including the merger between Estradas de Portugal and REFER but also CP's rationalisation and (2) the proposed new concession model for Lisbon and Porto public services that is also expected to bring about explicitly quantified sizeable savings.

The 2015 DBP confirms Portugal's 2014 CSR 3 on the efforts to improve active labour market policies. The increase in spending in favour of vocational training centres is justified by the increase in training activity, namely the number of hours of training to long-term unemployed, with a view to improving employability and labour participation rates.

Positive developments involve also the CSR 4 in terms of efficient public expenditure in education, provided that the quality of the educational outcomes is maintained. According to the DBP education spending in primary and secondary schools is expected to be contained in 2015 by 11.3% relative to the 2014 estimate, as remedial measures are introduced including by the reorganisation of the schools mainly via the reduction of the number of schools and staff.

Box 3. Addressing the tax wedge

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed its commitment to effectively reduce the tax burden on labour. It will take stock of Member States' plans for reductions of the tax burden when discussing the draft budgetary plans.

The tax wedge in Portugal for a single person without children earning 50% of the average wage was at 28.1% below the EU average of 34% in 2013; for 67% of the average wage it was 34.7% (EU average: 37.7%); and for the average wage it was at the EU average of 41.1%[5]. At the same time, Portugal has a low employment rate. The employment rate was at 60.6% in 2013, substantially lower than the EU average of 64.1%. The youth employment rate at 21.7% in 2013 is much lower than the EU average of 32.3% and it has a counterpoint in a very high youth unemployment rate (38.1% in comparison with a EU average of 23.4%).

Portugal's DBP contains plans for various burden-reducing reforms of the personal income tax in 2015. First of all, while the temporary 3.5% surcharge is maintained, the draft budget includes an additional provision for a tax credit that could be potentially used against the surcharge, should the effective tax revenue from PIT and VAT over perform the initial estimates. Second, the plan announces a reform of the PIT aimed at a more family-friendly tax system, social mobility promotion and simplification of the tax structure. Although not formally linked to this PIT reform, the DBP also announces a green tax reform. Both of these are not formally included in the draft budget, but will be subject to legislation in parallel for implementation in 2015. The government had appointed at the beginning of 2014 two respective Commissions to prepare reform proposals for the PIT and green taxation, which submitted their proposals last September, including impact assessments and after public consultations.

The DBP presents the reforms as part of broader reforms of the tax system aimed at a more efficient, equitable and simple tax structure, but not directly as part of broader labour market or social security reforms.

The first measure cannot be considered ex-ante to possibly have any immediate significant effect on employment, as it is uncertain. The combination of the second burden-reducing PIT reform with the increase in environmental taxes constitutes a growth-friendly tax shift, which the government has announced as revenue-neutral. Effects on employment cannot be assessed at the current stage as the final design of the reforms is not yet known.

6. OVERALL CONCLUSION

The headline deficit planned in the DBP for 2014 and 2015 is, at 4.8% of GDP and 2.7% of GDP, above the 4% of GDP and 2.5% of GDP respective deficit targets recommended by the Council in June 2013. Based on the Commission forecast, the headline deficit is expected to reach 4.9% of GDP in 2014 and 3.3% of GDP in 2015, indicating substantial risks to a timely correction of the excessive deficit by 2015, as recommended by the Council. The underlying changes in the structural balance (annual and cumulated) also point to substantial shortfalls relative to the EDP recommendation (1.9% of GDP cumulated shortfall over 2013-2015

[5] The arithmetic average is used to calculate the average tax wedge for the EU; recent data for Cyprus and Croatia are not available; data from 2012 were used for Bulgaria, Latvia, Lithuania, Malta and Romania.

relative to the EDP recommendation), even if the overall picture reflected by the structural effort indicators has been negatively affected by the ESA 2010 revisions as well as other recent methodological revisions by about 0.8% of GDP. The required careful analysis also indicates that the recommended fiscal effort (annual and cumulated over 2013-2015) is not projected to be met.

Overall, the timely correction of the excessive deficit by 2015 is at risk, mostly due to the inadequate fiscal effort in 2014 and projected for 2015. This points to a need for additional structural consolidation measures for 2015 to underpin a credible and sustainable correction of the excessive deficit.

While the DBP points to progress on the reform of the Budgetary Framework Law and the implementation of the single wage scale and single supplements scale, the comprehensive pension reform seems to have come to a halt. In addition, the information provided suggests that only modest progress has been made in most structural reform areas. Finally, the DBP announces reforms of the PIT and green taxes. The former could potentially lead to a reduction of the tax wedge on labour.