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COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Portugal following the adoption of the COUNCIL RECOMMENDATION to Portugal on 21 June 2013 with a view to bringing an end to the situation of an excessive government deficit and the COUNCIL DECISION of 12 July 2016 establishing that no effective action has been taken by Portugal in response to the Council Recommendation of 21 June 2013

Accompanying the document

Recommendation for a
COUNCIL DECISION

giving notice to Portugal to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit

{COM(2016) 520 final}

1. INTRODUCTION

Portugal has been under the excessive deficit procedure since 2 December 2009. Due to unforeseen adverse economic circumstances, the Council adopted revised recommendations to correct the excessive deficit in two occassions after 2009; first in 2012 and then in 2013.

Specifically, on 21 June 2013, following a recommendation from the Commission, the Council adopted a revised recommendation under Article 126(7) TFEU and set a 2015 deadline to correct the excessive deficit. In order to bring the general government deficit below the Treaty reference value of 3% of GDP by 2015 in a credible and sustainable manner, Portugal was recommended to undertake the following adjustment path: a headline deficit of 5.5% of GDP in 2013, 4.0% of GDP in 2014 and 2.5% of GDP in 2015, which was deemed consistent with an improvement in the structural balance of 0.6% of GDP in 2013, 1.4% in 2014 and 0.5% in 2015.[1]

According to the budgetary data notified by Portugal and validated by Eurostat on 21 April 2016, the general government deficit reached 4.4% of GDP in 2015. As a result, Portugal did not correct its excessive deficit by the recommended 2015 deadline. The headline deficit included the deficit-increasing one-off impact of 1.4% of GDP stemming from the financial sector support measure in the context of the Banif resolution at the end of 2015; taking into account also the deficit-reducing one-off measures, the headline deficit net of one-offs would still have been above the Treaty reference value. In addition, the cumulative fiscal effort over 2013-2015 is estimated at 1.1% of GDP, significantly below the 2.5% of GDP recommended by the Council.

On 12 July 2016, following a Commission's recommendation in compliance with Article 126(8) TFEU, the Council adopted a decision establishing that no effective action had been taken by Portugal in response to the 2013 Council Recommendation.[2] In compliance with Article 126(9), within two months form the Council decision establishing non effective action the Council shall give notice to the country on a new deadline for the correction of the excessive deficit with a specified adjustment path.[3]

This document proposes a new deadline for the correction of the excessive deficit and an adjustment path that could ensure a durable correction of the excessive deficit. To this end, Sections 2 and 3 present the recent macro-economic and budgetary developments and outlook for 2016, respectively. Section 4 presents a proposal for a new fiscal adjustment path and the last section concludes.

[1] See SWD(2016) 240 final for additional information on Portugal's EDP.
[2] See ECOFIN 678 UEM 264
[3] In addition to the requirements of EDP recommendations under Article 126(7), the Council decision to give notice under Article 126(9) shall not only set the new budgetary targets but also "indicate measures conducive to the achievement of those targets" according to Article (5)1 of Council Regulation No 1467/1997.

2. RECENT MACRO-ECONOMIC DEVELOPMENTS AND OUTLOOK FOR 2016

According to the Commission 2016 spring forecast, the economic recovery is set to continue moderately in 2016 and real GDP is projected to grow by 1.5% y-o-y at the same pace as in 2015. Private consumption is expected to lose momentum due to higher indirect taxes and the slight recovery in energy price inflation. The strong rebound in the consumption of durable goods in the first half of 2015 is not forecast to be maintained as still high unemployment and high debt levels are projected to keep upward pressures on household savings. Most of the soft investment indicators point to a weaker investment performance in 2016 as well. Business investment already decelerated significantly over the second half of 2015 and is not expected to resume its previous growth rate soon despite the relatively high capacity utilisation rate. Exports are forecast to grow in line with foreign demand, but imports are still expected to outbalance exports over the forecast horizon. As a result, the contribution of net trade to GDP growth would remain slightly negative. Employment creation is set to slow down in 2016, thereby becoming more aligned with GDP growth. Therefore, the unemployment rate is estimated to decrease to 11.6%. HICP inflation is projected to increase only marginally to 0.7% in 2016, mainly driven by higher taxes. HICP inflation is expected to increase to 0.7% in 2016, mainly driven by higher indirect taxes. While downward risks to the outlook have increased since the publication of the spring forecast, data on the first quarter of 2016 and preliminary information on the second quarter overall confirm the outlook of the forecast for the rest of the year.

The macroeconomic scenario underlying the 2016 Budget is more optimistic than the Commission 2016 spring forecast. The Commission expects a slower economic recovery than the Portuguese authorities (1.5% vs. 1.8% real GDP growth), mostly on account of a lower expected contribution of domestic demand to GDP growth (1.5 pps. in the spring forecast against 2.4 pps. in the 2016 Budget). The Commission is less optimistic with respect to investment and private consumption which are set to grow by 1.6% and 1.8% respectively in 2016, as opposed to 3.9% and 2.4% in the 2016 Budget. The projections also differ on the nominal side of the economy, as the Commission estimates a significantly lower increase of the GDP deflator in 2016 (1.4% compared to 2.1% in the 2016 Budget). Nonetheless, the expectations with regard to labour market developments in 2016 are broadly in line in both projections.

Table 1 – Recent macroeconomic developments and outlook

	2015	2016	
	COM	COM	SP
Real GDP (% change)	1,5	1,5	1,8
Private consumption (% change)	2,6	1,8	2,4
Gross fixed capital formation (% change)	3,9	1,6	4,9
Exports of goods and services (% change)	5,2	4,1	4,3
Imports of goods and services (% change)	7,4	4,3	5,5
Contributions to real GDP growth:			
- Final domestic demand	2,5	1,5	2,4
- Change in inventories	-0,1	0,0	0,0
- Net exports	-0,9	-0,1	-0,6
Output gap[1]	-2,3	-1,1	-1,3
Employment (% change)	1,4	0,9	0,8
Unemployment rate (%)	12,6	11,6	11,4
Labour productivity (% change)	0,1	0,6	1,0
HICP inflation (%)	0,5	0,7	1,2
GDP deflator (% change)	1,9	1,4	2,1
Comp. of employees (per head, % change)	-0,6	1,6	2,4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1,1	1,5	1,6

Note:

[1]In % of potential GDP, with potential GDP growth recalculated by

Source :

Commission 2016 spring forecast (COM);Stability Programme (SP).

Real GDP in Q1-2016 is in line with the Commission forecast but its composition points to a higher than expected contribution from private consumption. Real GDP grew by 0.9% y-o-y and 0.2% q-o-q in Q1-2016, in line with the Commission 2016 spring forecast quarterly profile. Nonetheless, private consumption grew above expectations and investment came in more negative than projected in the Commission 2016 spring forecast. Net external demand also posted a bigger negative contribution reflecting feebler exports outlook (-1.1 pops. vs -0.4 pops). As the higher growth in private consumption is not expected to be maintained and as long as there is no sign of pick-up in investment and exports, there is a risk of downward revision of the headline GDP in 2016 and some negative carry over effect in 2017. As regards the nominal side, GDP deflator grew by 2.4% in Q1-2016, reflecting some upside risks to the Commission 2016 spring forecast as well.

Risks to the macro outlook are tilted to the downside, also on account of new uncertainty emerging from the outcome of the referendum in the United Kingdom on the

membership of the European Union. Were the risks associated with the outcome of the referendum in the United Kingdom on the membership of the European Unionto materialize, the envisaged slight recovery for exports and investments would be very unlikely. Trade flows with the U.K. and other EU countries would decline, while uncertainty in the business environment would have an adverse impact on investment and weigh negatively on a still recovering financial sector. This could result in a downward revision of the headline GDP in 2016 and negative carry over effect in 2017.

3. RECENT BUDGETARY DEVELOPMENTS AND OUTLOOK FOR 2016

The Commission 2016 spring forecast is less optimistic than the authorities' budget. Taking into account an assessment of the fiscal policy measures specified in the 2016 Budget that entered into force on 31 March, the Commission 2016 spring forecast projects the general government deficit to fall to 2.7% of GDP in 2016. The structural balance is expected to slightly deteriorate further by about 0.25% of GDP in 2016. The 2016 Budget targets a general government deficit of 2.2% of GDP and an improvement of the structural balance by 0.3% of GDP. The 2016 Budget intends to more than offset revenue-decreasing measures of around 0.3% of GDP (notably the partial reversal of the PIT surcharge and the reduction of the VAT rate for restaurants) through revenue-increasing measures of around 0.5% of GDP, of which about two thirds relate to increases in indirect taxes (on petroleum products, tobacco, vehicles and the stamp duty), complemented by a series of smaller measures concerning direct taxes and enhanced compliance in both tax collection and Social Security. Expenditure-increasing measures amounting to 0.4% of GDP (mostly the gradual reversal of the public sector wage cuts, increases in a series of social benefits and the unfreezing of pension indexation) are planned to be more than compensated by expenditure-decreasing measures of close to 0.5% of GDP (most of which relate to the nominal freeze of intermediate consumption - except for PPPs-, efficiency gains in other current expenditure, expenditure control in social transfers and a new civil servants rotation policy (2:1 replacement rule)). The tax revenue included in the 2016 Budget is however also affected by negative carry-over effects of tax measures of previous years amounting to around 0.25% of GDP. The Commission 2016 spring forecast incorporates more conservative yield estimates for some of the 2016 Budget measures, in particular as regards the nominal freeze of intermediate consumption and other current expenditure. The Commission forecast's less optimistic macroeconomic scenario also leads to lower projected revenue from taxes and social contributions, as well as higher social transfers. The Portuguese Public Finance Council in its analysis of the State Budget also sees important risks to the macroeocnomic scenario which would have implications on tax revenue, and deems the savings from the measures indicated not sufficiently specified.

Table 2 – Composition of budgetary adjustment

(% of GDP)	2015	2016
	Outturn	Forecast
Revenue	**43,9**	**44,0**
of which:		
- Taxes on production and imports	14,5	15,0
- Current taxes on income, wealth, etc.	10,8	10,3
- Social contributions	11,5	11,5
- Other (residual)	6,9	7,2
Expenditure	**48,3**	**46,6**
of which:		
- Primary expenditure	43,7	42,2
of which:		
Compensation of employees	11,3	11,2
Intermediate consumption	5,9	6,3
Social payments	19,2	18,9
Subsidies	0,7	0,8
Gross fixed capital formation	2,2	1,9
Other (residual)	4,4	3,1
- Interest expenditure	4,6	4,5
General government balance (GGB)	**-4,4**	**-2,7**
Primary balance	**0,2**	**1,8**
Output gap (*)	-2,3	-1,2
Structural balance (SB)	**-2,0**	**-2,2**

(*) % of potential GDP
Source: Commission 2016 spring forecast

Budgetary execution until May 2016 has been broadly on track, but risks for the rest of the full-year execution remain high. The general government balance in National Accounts for the first quarter improved to 3.2% of GDP as compared to 5.5% of GDP in the first quarter of 2015, the best first-quarter balance since 2008. Although the first quarter deficit typically tends to be higher than in the full year, the 3.2% of GDP is still one percentage point above the full year budget target of 2.2%. Looking at budgetary execution until May, using cash data, there is indeed an improvement of the overall general government balance compared to May last year, due to an overall increase of revenue and a containment of expenditure. However, the increase in revenue is not as strong as the one implied by the budget for the whole year, and the containment in spending is largely due to a reduction in investment and purchases of goods and services that appear to have been restrained by the late entry into force of the 2016 budget on 31 March. The corresponding underspending was broadly offset by increases of interest payments and compensation of employees above the budget targets pointing to several challenges for the full-year achievement of the budget target. These are aggravated by the series of budgetary measures that are backloaded towards the second half of

the year (quarterly reversal of public sector wage cuts, 35hour week from 1 July, VAT rate reduction on meals in restaurants).

Progresses in fiscal structural reforms have been mixed. The short-term sustainability of the pension system is not yet ensured and is further challenged by the government's reversal of expenditure-saving measures. Arrears in the health sector are still very high which calls for a more effective enforcement of the Commitment Control Law, while the implementation of the new Budgetary Framework Law (BFL) to be completed by 2018 is experiencing important delays. Revenue administration is proceeding with its reforms and a series of tax policy shifts' foreseen in the plans of the new government are under study. Recent backtracking in reforming state-owned enterprises (SOEs) and partial reversal of a privatisation may entail fiscal risks. As structural consolidation in Portugal requires a durable reduction of the high level of public expenditure, a comprehensive spending review with a clear political mandate and a set target for savings would be crucial.

4. PROPOSED NEW FISCAL ADJUSTMENT PATH

Table 3 summarises the main elements from the Commission 2016 spring forecast that underpin the new adjustment path.

Table 3 – Forecast of key macroeconomic and budgetary variables under the baseline scenario

		2015	2016
Real GDP growth	%	1,5%	1,5%
Output gap	%	-2,3%	-1,1%
General government balance	%GDP	-4,4%	-2,7%
Structural balance	%GDP	-2,0%	-2,2%
Change in structural balance	pps	-0,6%	-0,2%

Source: Commission 2016 spring forecast

Taking into account the available time span and heightened risks to the macro and budgetary outlooks, additional measures of 0.25% of GDP could be considered in order to ensure that the public deficit remains under the 3% reference value. Under heigthened risks to the outlook and a still fragile financial system, an adjustment higher than the one envisaged in the authorities' budget would be warranted to ensure a durable correction of the excessive deficit for 2016. Taking into account the time span available for the correction and considering the possible secound round effects of a fiscal adjustment in the current economic context, the Commission is of the view that an adjustment that entails an unchanged structural balance with respect to 2015 would realistically bring the deficit durably below 3%. Compared to the baseline of the spring forecast, the proposed adjustment path would imply a reduction of the headline deficit to 2.5% of GDP. This adjustment path would be consistent with 0.25% of GDP additional measures to those implied in the baseline scenario. Taking into

account the second-round effects on economic growth of the additional consolidation measures needed, GDP growth would reach about 1.3%. Besides the measures included in the 2016 Budget, Portugal shall consider the expenditure control mechanism in the procurement of goods and services, which is currently highlighted in the 2016 Stability Programme. In addition, Portugal should focus on revenue side measures aiming at increasing the yields of indirect taxation by broadening the tax base and reducing tax expenditures. One way to achieve this could be by adjusting the still broad use of reduced VAT rates.

Table 4 – Forecast of key macroeconomic and budgetary variables under the EDP scenario

		2015	2016
Amount of measures	% GDP		0,2%
Real GDP growth	%	1,5%	1,3%
Output gap	%	-2,3%	-1,3%
General government balance	%GDP	-4,4%	-2,5%
Structural balance	%GDP	-2,0%	-2,0%
Change in structural balance	pps	-0,6%	0,0%
Source: Commission 2016 spring forecast			

5. CONCLUSIONS

On 12 July 2016, in compliance with Article 126(8) TFEU and following a Commission reccomendation, the Council issued a decision establishing that no effective action had been taken by Portugal in response to the 2013 Council recommendation. Hence, as prescribed by Article 126(9), the Council upon Commission reccomendation, shall give notice to the country to correct its excessive deficit, indicating the adjustment path.

Within this context, and taking into account the country's current macroeconomic conditions, achieving an unchanged structural adjustment which entails 0.25% of GDP of additional measures appears justified. This would lead to a headline deficit of 2.5% in 2016.

ANNEX – STANDARD TABLES

Table 5 – Forecast of key variables for the computation of the fiscal effort under the baseline scenario

			2016
Enters top-down	α	Structural expenditure (% of potential GDP)	45.7
		Potential GDP growth (%)	0.3
	β	Current revenue (national currency)	79,355.8
		Discretionary measures wih impact on current revenue (national currency)	-257.0
		Nominal GDP growth (%)	2.8
		p.m Elasticity on current revenue	1.0
		p.m Output gap (% of Pot. Output)	-1.1
Enters bottom-up		Discretionary measures wih impact on total revenue net of one-offs and other temporary measures (national currency)	-252.0
		Total expenditure net of one-offs and other temporary measures (national currency)	86,033.0
		Interest expenditure (national currency)	8,221.4
		Total unemployment	594,900.0
		Unemployment benefits (national currency)	2,684.5

Source: Commission calculations based on spring 2016 forecast