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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.

2. INTRODUCTION

Portugal submitted its Draft Budgetary Plan for 2018 on 16 October 2017 and an updated version on 31 October in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Portugal is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium term budgetary objective (MTO).

As the debt ratio was 130.1% of GDP in 2016, during the three years following the correction of the excessive deficit Portugal is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark. .

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2017 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2017 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis on the composition of public finances and on the implementation of fiscal-structural reforms~~,~~ including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

3. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

After growing by 1.5% in 2016, Portugal's economy is expected to accelerate to 2.6% in 2017 and to moderate at 2.2% in 2018, according to the country's 2018 Draft Budget Plan (DBP). This scenario indicates a substantial improvement from the macroeconomic projections in the latest stability programme, where growth has been set at 1.8% in 2017 and 1.9% in 2018. The upward revision reflects the strong economic performance in the first half of 2017, particularly the rebound in investment supported by a large capacity upgrade in the automotive industry. In 2018, both private consumption and investment are expected to decelerate somewhat but to remain key contributors to overall growth. Exports and imports are also set to slow down though the net external contribution is projected to improve from slightly negative to neutral. The HICP inflation forecast is revised slightly downwards to 1.2% in 2017 and 1.4% in 2018.

The macroeconomic scenario is broadly consistent with the Commission 2017 autumn forecast with overall growth being fully identical in 2017 and only marginally higher in the DBP scenario for 2018. While the Commission HICP inflation forecast is slightly higher, the GDP deflators appear identical to the DBP forecast in both years. As regards main GDP components, the Commission forecasts a slightly lower growth in private consumption that is counterbalanced by a slightly better outlook on the external sector. Both exports and imports are expected to grow at a much faster rate in the Commission forecast for 2018 due to the estimated impact of the expansion in the car industry, which is not fully reflected in the DBP scenario. The Commission also expects a slightly higher employment growth and lower unemployment amid more subdued wage developments.

Overall, the DBP macroeconomic scenario appears plausible. The risks are related mostly to the country's vulnerability to potential external shocks.

Box 1: The macro economic forecast underpinning the budget in Portugal

The macroeconomic forecast underlying Portugal's DBP for 2018 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.

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 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 on the institution's website since the day of the DBP submission to the Commission. The CFP opinion concludes that the DBP macroeconomic scenario is plausible. The opinion also includes a recommendation that the budget plans should be accompanied by a medium-term macroeconomic projection allowing for a better assessment of the envisaged policies.

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	1.5	1.8	2.6	2.6	1.9	2.2	2.1
Private consumption (% change)	2.1	1.6	2.2	1.9	1.6	1.9	1.6
Gross fixed capital formation (% change)	1.6	4.8	7.7	8.1	5.1	5.9	5.3
Exports of goods and services (% change)	4.1	4.5	8.3	8.0	4.5	5.4	7.3
Imports of goods and services (% change)	4.1	4.1	8.0	8.0	4.1	5.2	7.2
Contributions to real GDP growth:							
- Final domestic demand	1.7	1.7	2.7	2.6	1.8	2.2	2.0
- Change in inventories	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	0.0	0.1	-0.1	0.1	0.1	0.0	0.1
Output gap[1]	-0.9	-0.1	0.5	0.4	0.2	1.3	1.1
Employment (% change)	1.6	1.3	2.7	2.9	1.0	0.9	1.2
Unemployment rate (%)	11.2	9.9	9.2	9.2	9.3	8.6	8.3
Labour productivity (% change)	-0.1	0.5	-0.1	-0.3	0.8	1.2	0.9
HICP inflation (%)	0.6	1.6	1.2	1.5	1.7	1.4	1.4
GDP deflator (% change)	1.4	1.4	1.3	1.3	1.5	1.4	1.4
Comp. of employees (per head, % change)	2.1	2.0	1.7	1.6	2.2	2.2	1.7
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.0	1.1	0.8	1.0	1.5	1.0	1.1

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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

4. RECENT AND PLANNED FISCAL DEVELOPMENTS

4.1. Deficit developments

As compared to the 2017 Stability Programme, the 2018 DBP projects a slight improvement of the general government balance from -1.5% of GDP to -1.4% of GDP. While tax revenue projections have been revised upwards by a nominal amount worth 0.5% of GDP and interest expenditure downwards by 0.2% of GDP, this positive impact has been almost offset by an upward revision by 0.6% of GDP in current primary expenditure (in particular other current expenditure, social transfers and compensation of employees). While overall capital expenditure has remained broadly stable, a downward revision by 0.3% of GDP in gross fixed capital formation has been almost offset by an upward revision in other capital expenditure. The Commission 2017 autumn forecast projects the same deficit of 1.4% of GDP for 2017. Compared to the 2018 DBP, the autumn forecast projects a slightly divergent breakdown of tax revenue and slightly higher current expenditure compensated by slightly lower capital expenditure.

The 2018 DBP maintains the headline deficit target for 2018 unchanged as compared to the Stability Programme at 1.0% of GDP. The deficit-reducing impact from mostly macro-related upward revisions of indirect taxes (corresponding to a nominal amount worth 0.5% of GDP) and social security contributions (0.1% of GDP) and downward revisions of interest expenditure (0.4% of GDP) is broadly offset by increases in current expenditure (+1.1% of GDP), in particular for other current expenditure, social transfers and intermediate consumption. The planned increase of capital expenditure by 0.3% of GDP (mostly GFCF) is broadly compensated by planned increases in capital revenue and sales.

The Commission 2017 autumn forecast projects a headline deficit of 1.4% of GDP in 2018, i.e. 0.4% of GDP worse than the 2018 DBP deficit target of 1.0% of GDP. The difference stems from more conservative assumptions regarding the evolution of some revenue items and higher pressures for some expenditure items. On the revenue side, the Commission projects 0.1% of GDP lower indirect taxes in 2018 using more conservative assumptions based on standard elasticity trends with reference to private consumption. On the expenditure side, higher spending adding up to 0.3% of GDP is expected in particular on compensation of employees (0.2% of GDP based on the track record of rising public employment in 2016 and 2017 as opposed to planned decreases) and for social transfers (0.1% of GDP based on track record in 2016 and 2017). The Commission forecast also used more conservative assumptions for revenue from sales and for expenditure for gross fixed capital formation, based on the recent track record for these items. As the effect on revenue and expenditure is however of similar size, the overall effect of the more conservative assumptions for these two items is broadly neutral. Risks to the budgetary targets are tilted to the downside, linked to uncertainties surrounding the macroeconomic outlook, spending slippages and the potential deficit-increasing impact of banking support measures.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Portugal currently standing at 2.01%[1]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure in Portugal is expected to fall from 4.2% of GDP in 2016 to 3.9% in 2017 and is projected to decrease further next year, to 3.6% of GDP, well below the 4.9% recorded back in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from the DBP is broadly confirmed by the Commission 2017 autumn forecast.

As regards compliance with national numerical fiscal rules, the assessment of the 2018 Draft Budget by the Portuguese Fiscal Council of 9 November 2017 points to risks of non-compliance with the rule of a minimum annual adjustment of the structural balance by 0.5% of GDP and with the expenditure benchmark as long as the MTO is not reached, as laid down in Article 12-C (6) of the currently applicable Budget Framework Law (BFL)[2].

[1] 10-year bond yields as of 6 November 2017. Source: Bloomberg.

[2] Law n.º 41/2014 of 10 July (Eighth modification of Law n.º 91/2001, of 20 August) (Budget Framework Law)

The DBP projects the structural balance[3] to improve slightly by some 0.1% of GDP from a deficit of 2.0% of GDP in 2016 to 1.8% of GDP in 2017, as compared to the 0.3% of GDP improvement to 1.7% of GDP projected in the SP. For 2018 the DBP plans an improvement of the (recalculated) structural balance by 0.4% of GDP to 1.4% of GDP, as compared to the 0.6% of GDP improvement to 1.0% of GDP targeted in the Stability Programme. The lower improvement of the structural balance as compared to the Stability Programme is mainly due to a more positive variation of the output gap in the DBP. While for 2017 the Commission 2017 autumn forecast's structural balance projection is broadly in line with the DBP, for 2018 the Commission 2017 autumn forecast projects the structural balance to remain broadly unchanged at 1.8% of GDP, resulting in a difference of 0.4% of GDP with the DBP. The difference in 2018 mainly reflects the Commission forecast's 0.4% of GDP higher headline deficit projection.

Against the background of falling interest expenditure, the projected improvement in the (recalculated) structural balance in 2017-2018 (0.1% and 0.4%, respectively) is accompanied by a less pronounced improvement in the (recalculated) structural primary balance by 0.1% in 2017 and no further improvement in 2018 (0.0% of GDP) according to the DBP. As was the case for the structural balance, also the structural primary balance of the Commission forecast is broadly in line with the DBP for 2017. For 2018, the Commission forecast however projects a deterioration of the structural primary balance by 0.3% of GDP instead of the stabilisation in the DBP. The difference is related to the Commission forecasts' less favourable evolution of the structural balance as compared to the DBP (mainly stemming from the difference in the headline balances).

[3] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**43.0**	**43.3**	***43.4***	**43.4**	**43.0**	***43.5***	**43.2**	**0.5**
of which:								
- Taxes on production and imports	14.8	14.8	*15.0*	14.9	14.8	*15.1*	15.0	0.4
- Current taxes on income, wealth, etc.	10.3	10.1	*10.2*	10.3	9.9	*9.8*	9.8	-0.5
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	11.7	11.8	*11.7*	11.7	11.7	*11.7*	11.7	0.0
- Other (residual)	6.3	6.6	*6.5*	6.5	6.6	*6.9*	6.6	0.5
Expenditure	**45.0**	**44.8**	**44.8**	**44.8**	**44.0**	**44.5**	**44.6**	**-0.5**
of which:								
- Primary expenditure	40.8	40.6	40.9	40.9	40.0	40.9	41.0	0.1
of which:								
Compensation of employees	11.3	11.1	11.1	11.2	10.8	10.8	11.0	-0.5
Intermediate consumption	5.6	5.6	5.6	5.6	5.4	5.6	5.7	0.0
Social payments	19.0	18.7	18.7	18.8	18.4	18.6	18.7	-0.4
Subsidies	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.0
Gross fixed capital formation	1.5	2.0	1.7	1.6	2.1	2.3	2.1	0.8
Other (residual)	3.0	2.7	3.3	3.2	2.8	3.1	3.1	0.2
- Interest expenditure	4.2	4.2	3.9	3.9	4.0	3.6	3.6	-0.6
General government balance (GGB)	**-2.0**	**-1.5**	**-1.4**	**-1.4**	**-1.0**	**-1.0**	**-1.4**	**1.0**
Primary balance	**2.2**	**2.7**	**2.5**	**2.5**	**3.1**	**2.6**	**2.2**	**0.3**
One-off and other temporary measures	0.4	0.2	0.2	0.2	0.0	-0.2	-0.2	-0.7
GGB excl. one-offs	**-2.4**	**-1.7**	**-1.6**	**-1.6**	**-1.0**	**-0.8**	**-1.2**	**1.6**
Output gap[1]	-0.9	-0.1	0.5	0.4	0.2	1.3	1.1	2.2
Cyclically-adjusted balance[1]	-1.5	-1.5	-1.7	-1.7	-1.0	-1.7	-2.0	-0.2
Structural balance (SB)[2]	**-2.0**	**-1.7**	**-1.8**	**-1.8**	**-1.0**	**-1.4**	**-1.8**	**0.5**
Structural primary balance[2]	2.2	2.5	2.1	2.1	3.0	2.1	1.8	-0.1

Notes*:*

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

4.2. Debt developments

As regards compliance with national fiscal rules, the assessment of the 2018 Draft Budget by the Portuguese Fiscal Council of 9 November 2017 points to risks of non-compliance with the debt-related provisions of Article 10-G(1) of the currently applicable BFL referring to the applicable provisions of Article (2) of Council Regulation (EC) 1467/97 for the preventive arm, i.e. currently the transitional debt rule requirements.

Following stabilisation at around 130% from 2013 to 2016, the debt-to-GDP ratio is forecast to follow a clear downward path by an average 3 percentage points in 2017 and 2018 according to both the DBP and the Commission 2017 autumn forecast. As compared to the Stability Programme the expected decrease in the ratio has accelerated significantly for 2017 by around 1.5 percentage points thanks to higher nominal growth, lower interest payments and a more favourable balance of stock-flow adjustments. The decrease in the ratio is projected to slow down slightly in 2018 due to the deceleration of growth and debt-increasing overall stock-flow adjustments outweighing the further decrease in interest expenditure. The lower decrease in the Commission 2017 autumn forecast as compared to the DBP mostly reflects the autumn forecast's higher 2018 headline deficit projection. Some limited risk to the debt reduction profile could arise from the contingent capital mechanism included in the Novo Banco sales agreement.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**130.1**	**127.9**	**126.2**	**126.4**	**124.2**	**123.5**	**124.1**
Change in the ratio	1.4	-2.3	-3.9	-3.7	-3.6	-2.8	-2.3
Contributions[2] *:*							
1. Primary balance	**-2.2**	**-2.7**	**-2.5**	**-2.5**	**-3.1**	**-2.6**	**-2.2**
2. "Snow-ball" effect	**0.5**	**0.1**	**-0.9**	**-1.0**	**-0.1**	**-0.8**	**-0.7**
Of which:							
Interest expenditure	4.2	4.2	3.9	3.9	4.0	3.6	3.6
Growth effect	-1.9	-2.3	-3.3	-3.3	-2.3	-2.6	-2.5
Inflation effect	-1.8	-1.7	-1.6	-1.7	-1.8	-1.7	-1.7
3. Stock-flow adjustment	**3.1**	**0.3**	**-0.4**	**-0.1**	**-0.4**	**0.6**	**0.6**

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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

4.3. Measures underpinning the draft budgetary plan

The 2018 draft budgetary plan reports a package of structural fiscal measures with a net impact of -0.1% of GDP on revenues and -0.3% of GDP on expenditure.

On the revenue side a 0.25% of GDP decrease in PIT linked to both the additional carry-over impact of the complete reversal of the PIT surcharge in 2017 and the change in PIT brackets in 2018 is only partially compensated by a 0.1% of GDP increase in indirect taxes (excise duty and tax on salty products) and a small further improvement of the Central Administration's revenue collection internal control system (EUR 50 million).

On the expenditure side, a 0.25% of GDP discretionary increase in public wages and social transfers (mostly linked to the unfreezing of career progressions and extraordinary increases of pensions and other social benefits) is planned to be more than compensated by 0.4% of GDP of expenditure-containment measures (concerning mostly the nominal freeze of intermediate consumption and other current expenditure and savings from the spending review) and 0.15% of GDP in savings in interest expenditure.

In addition to fiscal policy measures of a structural nature, the 2018 budget balance is also set to be impacted by a 0.1% of GDP one-off CIT revenue decrease (due to a CIT anticipation for electricity tariff debt sales in 2017), by 0.07% of GDP in estimated higher dividends from Banco de Portugal, by 0.1% of GDP in one-off capital transfer expenditure related to the conversion of deferred tax assets and payments to Greece and by some limited wildfire emergency cost (EUR 50 million)[4]. Taking into account all fiscal measures, the DBP measures table thus reports a balanced budgetary impact of revenue and expenditure measures on the headline balance in 2018.

The Commission 2017 autumn forecast takes into account most measures at their yield specified in the DBP[5]. However, while taking into account the expected savings from the spending review, the Commission forecast does not factor in ¼% of GDP nominal freezing of intermediate consumption and other current expenditure based on insufficient specification and the recent track record of these measures. Moreover, the nominal freezing measures do not seem to be fully consistent with the overall amounts in the DBP for the corresponding expenditure items, in particular intermediate consumption, that show nominal increases above nominal GDP growth in 2018.

Overall, based on the reported measures table, the consolidation strategy would be based more on the expenditure-side relying strongly on containment of intermediate consumption, other current expenditure and savings in interest expenditure. The overall planned evolution of the corresponding expenditure items in the DBP table on General Government Expenditure and Revenue Targets tends however to point to lower containment of the corresponding primary expenditure items, partially offset by further savings in interest expenditure.

Thus, if the nominal expenditure freezing measures are not taken into account, the overall contribution of the reported structural measures to meeting the fiscal country-specific recommendation would appear broadly neutral. Windfall gains from lower interest expenditure and expected higher dividends from Banco de Portugal do not appear to be used for accelerating the reduction of the general government debt-to-GDP ratio but to compensate for reductions in tax revenue and increases in primary expenditure. As regards the fiscal-structural country-specific recommendations, the measures reflect a stronger expenditure-decreasing impact of the spending review. As regards the health sector it remains unclear to what extent the expected savings can help to reduce the hospital arrears. The discretionary measures raising social transfers do not appear to be compensated for within the social

[4] As regards one-offs, the Commission forecast could not include the payments to Greece due to remaining uncertainties regarding their statistical recording in national accounts.

[5] While not considering them discretionary fiscal measures, the forecast also factors in the higher estimates for Banco de Portugal dividends and interest expenditure savings.

security system and would accordingly tend to deteriorate the sustainability of the pension system.

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)	
	2017	**2018**
Taxes on production and imports	0.1	0.1
Current taxes on income, wealth, etc.	0.0	-0.4
Capital taxes		
Social contributions	0.0	0.0
Property Income	0.1	0.1
Other	0.3	0.0
Total	0.5	-0.2

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 for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2017	**2018**
Compensation of employees	0.0	0.0
Intermediate consumption	-0.2	-0.2
Social payments	0.1	0.1
Interest Expenditure	-0.1	-0.2
Subsidies		
Gross fixed capital formation	0.0	0.0
Capital transfers	0.2	0.1
Other	0.0	0.0
Total	0.0	-0.2

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 for 2018

5. Compliance with the provisions of the Stability and Growth Pact

Portugal is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO. Box 2 reports the latest country specific recommendations in the area of public finances. Portugal is also subject to the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark.

Box 2. Council recommendations addressed to Portugal[6]

On 11 July 2017, the Council addressed recommendations to Portugal in the context of the European Semester. In particular, in the area of public finances the Council recommended that Portugal take action in 2017 and 2018 to: (i) ensure the durability of the correction of the excessive deficit; (ii) pursue a substantial fiscal effort in 2018 in line with the requirements of the preventive arm of the Stability and Growth Pact, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of Portugal's public finances; (iii) use windfall gains to accelerate the reduction of the general government debt-to-GDP ratio.

The Council recalled that: In 2018, in light of its fiscal situation and in particular of its debt level, Portugal is expected to further adjust towards its medium-term budgetary objective of a structural surplus of 0.25 % of GDP. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal growth rate of net primary government expenditure[7] which does not exceed 0.1 % in 2018. It would correspond to a structural adjustment of at least 0.6 % of GDP.

5.1. Compliance with the debt criterion

After it corrected its excessive deficit in 2016, Portugal is in the transition period for the following three years to make sufficient progress towards compliance with the debt reduction benchmark. This implies that, during this period, it is required to make sufficient progress (as defined by the minimum linear structural adjustment (MLSA)) towards compliance with the debt reduction benchmark at the end of the transition period.

The recent improvement in macroeconomic variables, in particular nominal and potential GDP growth, as shown in both the DBP and the Commission 2017 autumn forecast, has made the structural adjustment needed to comply with the MLSA less demanding.

[6] Council Recommendation of 11 July 2017, *OJ C 261, 9.8.2017, p. 92–97*

[7] Net government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

Table 5. Compliance with the debt criterion*

	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	130.1	127.9	126.2	126.4	124.2	123.5	124.1
Gap to the debt benchmark [1,2]							
Structural adjustment [3]	0.3	0.3	0.1	0.1	0.6	0.4	0.0
To be compared to:							
Required adjustment [4]		-0.2	n.a.	0.2	-0.3	n.a.	0.3

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

* An ex-ante assessment of planned compliance with the debt criterion can be based on the DBP only for the concerned countries providing extended data series (i.e. covering years up to t+4) in the DPB on a voluntary basis, as agreed at the EFC-A on 22 September 2014 and reflected in the updated Code of Conduct of the two-pack..

The DBP does not include sufficient information to assess planned compliance with the transitional debt rule.

Based on the Commission 2017 autumn forecast, Portugal is prima facie not projected to meet the transitional debt rule neither in 2017 nor in 2018 as the projected structural adjustments of 0.1% of GDP and 0.0% of GDP fall short of the required adjustments of 0.2% of GDP and 0.3% of GDP respectively. The deviation from the required adjustment for compliance with the transitional debt rule remains however below the allowed margin of ¼% of GDP in both years and, at any time during the transition period, the remaining annual structural adjustment would not exceed ¾% of GDP. According to an overall assessment based on the Commission 2017 autumn forecast, Portugal is thus making sufficient progress towards compliance with the debt reduction benchmark in 2017-2018. However, since Portugal would, according to the Commission forecast, take advantage of the room for manoeuvre embedded in the rule, a stronger adjustment would have to be made in the remaining year of the transition period to ensure compliance with the benchmark at the end of the transition period.

5.2. Adjustment towards the MTO

Portugal is subject to the preventive arm of the SGP as of 2017 and has to ensure compliance with the required adjustment towards the MTO. To this end, Portugal is required to pursue an annual structural adjustment[8] towards the MTO of at least 0.6% of GDP in 2017 and in 2018.

In 2017, according to the information provided in the DBP, the growth of real primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of -1.4%, leading to a deviation of 1.0% of GDP and thus pointing to a risk of significant deviation. The (recalculated) structural balance in the DBP is set to improve by only 0.1% of GDP, thus pointing to a risk of some (but close to significant) deviation from the recommended structural adjustment of 0.6% of GDP towards the MTO. This calls for an overall assessment. The difference between the two indicators stems mainly from two factors. First, the reading of the fiscal effort based on the expenditure benchmark pillar is negatively impacted by the medium-term potential GDP growth used therein, which reflects negative or exceptionally low potential GDP growth in and after the crisis years and is lower than the current potential GDP growth underpinning the 2017 structural balance. Second, the reading of the fiscal effort based on the structural balance pillar is positively impacted by revenue windfalls and lower interest expenditure, which are windfalls outside the control of the government and therefore excluded from the expenditure benchmark pillar. Taking these factors into consideration, both indicators would point to a risk of significant deviation from the requirements. Therefore, based on an overall assessment, the DBP projects a risk of significant deviation from the recommended structural adjustment towards the MTO in 2017.

In turn, based on the Commission 2017 autumn forecast, the real growth of primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of -1.4%, leading to a deviation of 1.3% of GDP[9] in the underlying fiscal position thus pointing to a risk of a significant deviation. The structural balance is expected to improve by 0.1% of GDP in 2017, pointing to a risk of some (but close to significant) deviation. This calls for an overall assessment. Taking into consideration the above-mentioned differences in potential GDP growth benchmarks, revenue windfalls and lower interest expenditure, both indicators would point to a risk of a significant deviation from the requirements. Therefore, based on an overall assessment, the Commission 2017 autumn forecast points to a risk of a significant deviation from the recommended structural adjustment towards the MTO in 2017.

[8] Portugal criticised the method used to assess the structural adjustment in its draft budget report sent to the national Parliament (Relatório, Caixa 1, pp. 30-31) and in its letter of 31 October 2017, claiming that alleged errors in the Commission's 2016 structural balance forecast would show the weakness of this indicator. However, the Commission 2016 winter forecast (of -1.0% change of the structural balance in 2016) has been made, as all forecasts, on the basis of information available at the time, i.e. under the assumption of no policy change from the submitted preliminary draft budgetary plan of 22 January 2016. In the wake of this forecast, Portuguese authorities specified some measures better (0.2% of GDP) and undertook previously not planned structural consolidation steps throughout the year totalling 0.8% of GDP. Taking this into account, the initial forecast of the change of the structural balance turned out to be very much in line with the outturn of +0.3% of GDP (of which 0.3 percentage points are largely explained by a windfall decrease in interest expenditure not expected neither in the Draft Budget 2016 nor the 2016 winter forecast).

[9] The higher deviation as compared to the DBP is due to slightly higher expenditure growth and slightly lower impact of discretionary revenue measures in the Commission autumn forecast.

In 2018, according to the information provided in the draft budgetary plan, the planned growth of nominal primary government expenditure[10], net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 0.1%, leading to a deviation of 1.0% of GDP in the underlying fiscal position and thus pointing to a risk of a significant deviation. The (recalculated) structural balance is expected to improve by 0.4% of GDP in the draft budgetary plan, planning some deviation from the recommended minimum structural adjustment towards the MTO of 0.6% of GDP. This calls for an overall assessment. Similarly to 2017, on one hand, the fiscal effort based on the expenditure benchmark pillar is negatively impacted by the medium-term potential GDP growth used therein. On the other hand, the fiscal effort based on the structural balance pillar is positively impacted by substantial revenue windfalls and lower interest expenditure. In the opposite sense, the structural balance pillar is strongly negatively impacted by the very high planned increase in gross fixed capital formation in 2018, while this is smoothed in the expenditure benchmark pillar. Taking all these factors into consideration, both indicators would point to a risk of significant deviation from the requirements albeit within a narrow margin to the threshold. Therefore, based on an overall assessment, the DBP plans significant deviation from the recommended structural adjustment towards the MTO in 2018. In addition, over 2017 and 2018 taken together, both the expenditure benchmark and the structural balance point to a risk of significant deviation albeit the deviation in terms of structural balance exceeds the threshold for significant deviation by a relatively small margin. Taking into consideration the above-mentioned effects, both indicators would still point to a risk of significant deviation from the requirements over 2017 and 2018 taken together. Therefore, based on an overall assessment, the DBP plans a significant deviation from the recommended structural adjustment towards the MTO over 2017 and 2018 taken together.

In turn, based on the Commission 2017 autumn forecast, the growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 0.1% in 2018, leading to a deviation of 1.3% of GDP in the underlying fiscal position pointing to a risk of a significant deviation. The structural balance is expected to remain unchanged in 2018, thus also pointing to a risk of a significant deviation from the recommended minimum structural adjustment of 0.6% of GDP towards the MTO. Over 2017 and 2018 taken together, both indicators also point to a risk of a significant deviation from the requirements. Taking into consideration the above-mentioned difference in potential GDP growth benchmarks, substantial revenue windfalls and lower interest expenditure, the risk of a significant deviation from the requirements in both 2018 and over 2017 and 2018 taken together would be confirmed. Therefore, based on an overall assessment, the Commission forecast points to a risk of a significant deviation from the recommended structural adjustment towards the MTO in 2018 and over 2017 and 2018 taken together.

[10] As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2017		2018	
Initial position[1]				
Medium-term objective (MTO)	0.3		0.3	
Structural balance[2] (COM)	-1.8		-1.8	
Structural balance based on freezing (COM)	-1.8		-	
Position vis-a -vis the MTO[3]	Not at MTO		Not at MTO	
(% of GDP)	**2017**		**2018**	
	DBP	**COM**	**DBP**	**COM**
Structural balance pillar				
Required adjustment[4]	0.6		0.6	
Required adjustment corrected[5]	0.6		0.6	
Change in structural balance[6]	0.1	0.1	0.4	0.0
One-year deviation from the required adjustment [7]	-0.5	-0.5	-0.2	-0.6
Two-year average deviation from the required adjustment [7]			-0.3	-0.5
Expenditure benchmark pillar				
Applicable reference rate[8]	-1.4		0.1	
One-year deviation adjusted for one-offs [9]	-1.0	-1.3	-1.0	-1.3
Two-year average deviation adjusted for one-offs [9]			-1.0	-1.3
PER MEMORIAM: One-year deviation [10]	-1.3	-1.5	-1.4	-1.6
PER MEMORIAM: Two-year average deviation [10]			-1.3	-1.6
Conclusion				
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Significant deviation
Conclusion over two years			Significant deviation	Significant deviation

<u>Notes</u>

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2016) was carried out on the basis of Commission 2017 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Cells highlighted in yellow point to some deviation, while cells highlighted in red point to significant deviation.

<u>Source</u> :

Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

The Commission Communication on the 2017 European Semester of May 2017[11] stated that the Commission stands ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment is particularly significant. The country-specific recommendations adopted by the Council on 11 July 2017 mentioned that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. Box 3 presents a qualitative assessment of the strength of the recovery in Portugal while giving due consideration to its sustainability challenges.

Box 3. Assessment of the cyclical situation of Portugal

Portugal does not face short-term sustainability challenges. However, government debt is projected at around 126% of GDP in 2017 and sustainability risks are considered to be high in the medium term, reflecting primarily the high debt level.

The recovery in Portugal does not appear fragile. Portugal's economic performance improved substantially in the first half of 2017 as both GDP and employment accelerated, helped by the positive cycle in the tourist sector and external demand. Based on the Commission 2017 autumn forecast, the output gap is estimated at a positive territory of 0.4% in 2017 and 1.1% in 2018. Estimates of other institutions (OECD and IMF) still show a slightly negative output gap but upward revisions to positive figures are expected shortly. In comparison to the pre-crisis period of 2007, the slack in the Portuguese economy has dropped substantially. Unemployment has already reached the level from 2007 and is expected to drop further in 2018. The rate of employment is still slightly lower but the slack is likely to be fully covered by 2018. As regards capacity utilisation, there is still a gap of 3.3% in the manufacturing sector, according to the latest available full-year data for 2016, relative to the long-term average prior to the crisis (1995-2007). The construction sector is also below the respective benchmark (-8.6%) while services are at higher level (+1.8%). Monthly indicators are pointing to substantial improvements in all of the three sectors, so that by 2018 only the construction sector is likely to be characterised by some remaining slack. Investment (GFCF) dropped by 8.8 percentage points from 1995-2007 due mainly to the deleveraging in the private sector, but is expected to rebound strongly in 2017-18. Price indicators do not point to inflationary pressures, as headline and core inflation rates are relatively low. Deflated house prices increased by 6% in 2016 and 6.9% year-on-year in the second quarter of 2017 but remained below the long-term average.

Overall, the framework indicates that the recovery does not appear to be fragile.

Overall, Portugal does not face short-term sustainability challenges although in the medium term the overall risks to fiscal sustainability are assessed as high. The recovery in Portugal does not appear fragile. In particular, the output gap is estimated at a positive territory and the slack in the Portuguese economy has dropped substantially in comparison to the pre-crisis period of 2007.

[11] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf

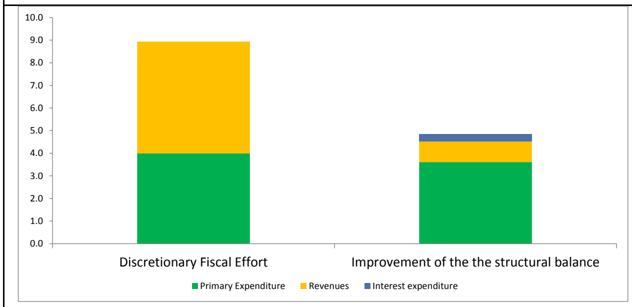
As a result, no additional elements in that regard need to be taken into account in the overall assessment. Therefore, the required fiscal adjustment according to the country-specific recommendations is considered appropriate.

6. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

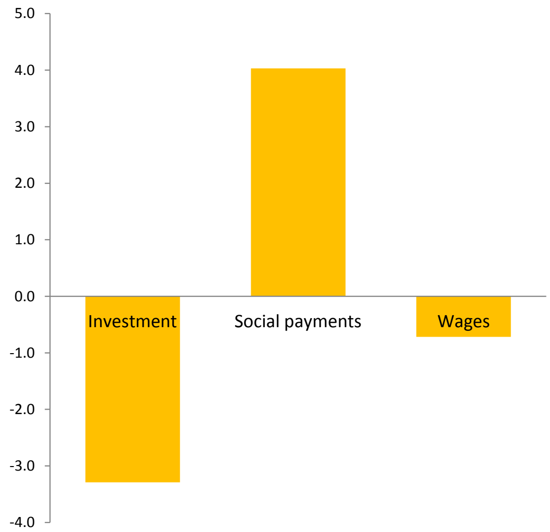
The composition of the planned adjustment between revenues and primary expenditure in 2018 in % of GDP is based on a slight increase of primary expenditure being offset by a slight increase in revenues. This contrasts with the past adjustment over 2011-2017 in which the adjustment effort, while mostly revenue-based according to the Discretionary Fiscal Effort Indicator, was also expenditure-based.

Portugal plans a strong increase in public investment in 2018 that sharply contrasts with the strong decrease in the share in total expenditure of investment during the period 2011-2017.

Graph 1: Composition of the fiscal effort (2011-2017), Portugal (% GDP)



Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Portugal (% change)



<u>Source</u>:

Draft Budgetary Plans 2018, European Commission 2017 autumn forecast. Graph 1 shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3 http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

In terms of fiscal structural reforms, the 2017 country-specific recommendation 1 includes four topics: Step up efforts to finalise a comprehensive expenditure review at all levels of public administration. Strengthen expenditure control, cost effectiveness and adequate budgeting, in particular in the health sector with a focus on the reduction of arrears in hospitals and ensure the sustainability of the pension system. To increase the financial sustainability of state-owned enterprises set sector-specific efficiency targets in time for the 2018 budget, improving state-owned enterprises' overall net income and decreasing the burden on the State budget.

As regards the expenditure review, it has so far focused on education, healthcare, SOEs, public sector real estate management and centralised public procurement, with justice and internal affairs being the most recent additions. The authorities have also identified a series of particular issues for savings in 2018. These include the improvement of public human resource management in order to reduce absenteeism, plans to reduce the costs and inefficiencies associated with the legal treatment of seized vehicles and a bonus scheme with the aim of incentivising civil servants to develop new ways of reducing expenditure.

The total projected savings from the spending review exercise in 2018 amounts to around EUR 290 million (around 0.14% of GDP) in a single year, compared to the planned cumulative savings of 0.1% of GDP over three years announced in the 2017 budget. Although a break-down has been provided in the draft budget, there remains a lack of specific measures to support the extent of savings planned for 2018. Overall, however, the inclusion of additional sectors and the introduction of more ambitious savings targets represent limited progress, although a broadening of the exercise to all levels of public administration would represent another positive step forward.

Hospital arrears continued to increase in 2017, growing by EUR 417 million up to September. A range of measures to reduce costs in the National Health Service (NHS) will be carried out in 2018 in an effort to reduce the debt of NHS entities. These include continuing the digitalisation of procedures; increasing the sharing and thus efficient use of existing NHS resources and increasing centralisation, notably of procurement. A Budget Analysis Unit will also be set up as a joint initiative between the Ministries of Health and Finance in order to strengthen the monitoring mechanisms of the budgetary execution of NHS entities. It remains unclear however to what extent these initiatives will be sufficient to deal with the growing flow of arrears that appear to be particularly linked to a certain number of underperforming hospitals. Overall, the progress to strengthen expenditure control in the health sector and to reduce arrears has to date been limited.

A new retirement scheme without penalty for very long careers entered into force in October 2017 and will be fully operational from 2018. The pension update mechanism, whereby pensions are updated based on inflation, was already unfrozen in 2016. In 2017 the Portuguese authorities earmarked the revenue deducted from the additional real estate tax (Adicional ao IMI – Imposto Municipal sobre Imóveis) to the reinforcement of the Social Security's Financial Stability Fund. For 2018, the State budget is envisaging the earmarking of up to 2% of the Corporate Income Tax revenue to the Social Security system in a progressive way. The government intends on continuing the fight against contributions fraud and evasion in order to increase financial resources. It will do so by facilitating administrative procedures and increasing the use of new technologies. Specific measures include the progressive introduction of improvements to the remuneration declarations (DR) procedure, such as the implementation of a default earnings declarations file. Inspection activities will also be stepped up, while the mechanisms for debt collection are set to be simplified and strengthened. Overall, no progress appears to have been achieved on making the pension system more sustainable as the DBP plans another extraordinary pension increase and conditions for early retirement for very long careers have been made less restrictive while the yields of offsetting measures remain unclear.

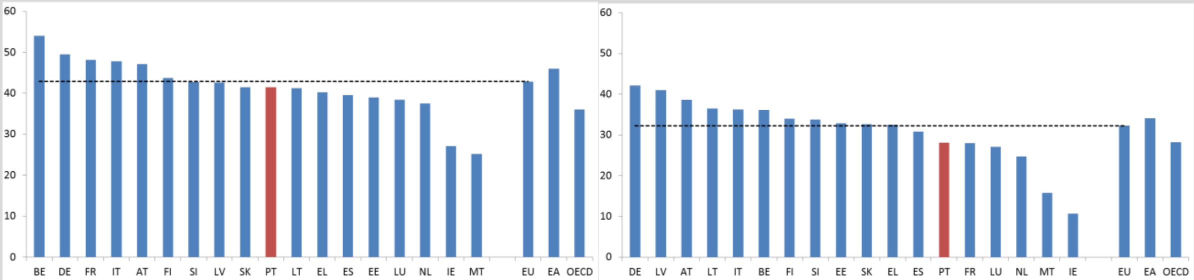
According to the authorities, SOEs may for the first time present a net result that is balanced or very close to equilibrium in 2018. The government estimates a total net income of non-financial public companies of EUR -461 million in 2017, which it projects to improve to EUR -118 million in 2018 – this is down from EUR -1293 million in 2014. In addition to the recapitalisation of SOEs by the State, efforts will continue towards the objective to limit net debt growth to 2%, net of capital increases and the financing of new investments. The Portuguese authorities are planning to evaluate SOEs more comprehensively, notably through their submitted Activity and Budget Plans (PAO). Efforts will also be made to enhance SOE management as well as to encourage the renegotiation of public service contracts, particularly in the transport sector. The updated data collection and monitoring system (SIRIEF) will be implemented in 2018. Overall progress in improving state-owned enterprises' overall net income and decreasing the burden on the State budget seems to have been limited.

Box 4 – Addressing the tax burden on labour in the euro area

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 a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker’s net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Portugal for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Portugal at the average wage and at low wage (2016)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.
Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

Portugal's Draft Budgetary Plan contains the following measures that affect the tax wedge on labour: the carry-over effect in 2018 of the complete reversal of the PIT surcharge in 2017 and the change in PIT brackets in 2018. While the complete reversal of the PIT surcharge will benefit high-income earners for whom the surcharge had been maintained until November 2017, the change in PIT brackets is intended to be targeted mostly to low income earners. While the revised brackets are planned to become effective as of January 2018, the overall budgetary effect is likely to be partially delayed to 2019 upon declaration of 2018 revenues. The measures appear to be only partially compensated by an increase of indirect taxes (excise duty, salty products tax).

7. OVERALL CONCLUSION

Based on the Commission 2017 autumn forecast, taking into account the applicable margins, Portugal makes sufficient progress towards compliance with the debt reduction benchmark in 2017 and 2018. However, since Portugal would, according to the forecast, take advantage of the room for manoeuvre embedded in the rule, a stronger adjustment would have to be made in the remaining year of the transition period to ensure compliance with the benchmark at the end of the transition period.

Following an overall assessment of the DBP, the planned structural adjustment points to a risk of significant deviation with the adjustment path towards the MTO recommended by the Council in both 2017 and 2018 and over the two years taken together. For 2018 the projected deviation however exceeds the threshold for a significant deviation by a narrow margin. An overall assessment based on the Commission 2017 autumn forecast points to a risk of significant deviation from the adjustment path towards the MTO recommended by the Council in both 2017 and 2018 and over the two years taken together.