EUROPEAN
COMMISSION

Brussels, 20.11.2019
SWD(2019) 925 final

COMMISSION STAFF WORKING DOCUMENT

Analysis of the Draft Budgetary Plan of Portugal

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of Portugal

{C(2019) 9115 final}

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1. INTRODUCTION

Portugal submitted its Draft Budgetary Plan for 2020 on 15 October 2019 in compliance with Regulation (EU) No 473/2013. Given the caretaker nature of the government in place on 15 October 2019 following the general elections of 6 October 2019, the budgetary projections for 2019 and 2020 in the Draft Budgetary Plan are based on the assumption of unchanged policies. Portugal is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective.

As the debt ratio was 131.5% of GDP in 2016 (the year in which Portugal corrected its excessive deficit), exceeding the 60% of GDP reference value, during the three years following the correction of the excessive deficit Portugal is also subject to the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark. Following the end of the transition period, Portugal will be subject to the debt reduction benchmark. As the debt ratio is projected to be 119.5% of GDP in 2019, exceeding the 60% of GDP reference value of the Treaty, Portugal also needs to comply with the debt reduction benchmark as of 2020.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2019 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 2019 autumn forecast. Section 4 assesses the recent and planned fiscal developments in 2019-2020 (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 in the context of the European Semester adopted by the Council in July 2019, 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

Portugal's economic growth is expected to moderate from 2.4% in 2018 to 1.9% in 2019 and to slightly improve to 2.0% in 2020, according to the country's 2020 Draft Budgetary Plan. Domestic demand is forecast to remain the main growth driver in 2020 although exports are also expected to improve and to substantially reduce the negative net external contribution to GDP growth. In this scenario, the overall GDP growth is very close to the macroeconomic projections in the 2019 Stability Programme where it was set at 1.9% in both 2019 and 2020. Across components, investment is revised significantly upwards in 2019 amid a more negative external contribution to growth. In 2020, the main revision refers to a stronger increase in private consumption. Inflation is revised downwards to 0.8% in 2019 but is projected to rebound to 1.6% in 2020 amid a moderate wage growth and a further improvement in labour market indicators.

The Draft Budgetary Plan’s macroeconomic scenario appears broadly consistent with the Commission 2019 autumn forecast for 2019 but somewhat optimistic for 2020. In 2019, the Commission forecast shows a lower increase in investment and imports, as well as a slightly higher increase in private consumption, resulting in a GDP growth of 2.0%. In 2020, the Commission projects a weaker GDP growth of 1.7% due to a more subdued export performance while the other elements of the forecast are identical to the Draft Budgetary Plan

scenario. This more conservative projection on exports is based on a broadly stable demand from main trading partners in the context of significant uncertainty in the external environment. As regards inflation, the difference in the projected GDP deflators is insignificant but the Commission forecast on consumer prices (Harmonised Index of Consumer Prices) is lower in both years. The Commission forecast for the labour market is very close to the Draft Budgetary Plan scenario with identical numbers for the unemployment rates and very minor differences in the employment and wage dynamics.

Overall, the Draft Budgetary Plan's macroeconomic scenario appears plausible in 2019 and favourable in 2020. The risks are related mostly to the country's vulnerability to potential external shocks.

Box 1: The macroeconomic forecast underpinning the budget in Portugal

The macroeconomic forecast underlying Portugal's Draft Budgetary Plan for 2020 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) as an independent body with a mandate that includes the analysis of government forecasts. The endorsement by the CFP is attached to the Draft Budgetary Plan publication and is available on the institution's website since the day of the Draft Budgetary Plan submission to the Commission. The CFP opinion notes that the absence of comparable macroeconomic forecasts produced by other institutions makes it difficult to qualify the probability of the Draft Budgetary Plan's macroeconomic scenario at the time of the endorsement. It also points out that some forecast components, in particular exports and imports in 2020, do not allow the scenario presented to be considered as prudent, given the high downside risks pending on the projected acceleration of economic activity in 2020.

Table 1. Comparison of macroeconomic developments and forecasts

	2018	2019			2020		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	2.4	1.9	1.9	2.0	1.9	2.0	1.7
Private consumption (% change)	3.1	1.8	2.2	2.3	1.8	2.1	2.0
Gross fixed capital formation (% change)	5.8	5.3	8.2	6.5	4.9	5.0	4.8
Exports of goods and services (% change)	3.8	3.8	2.9	2.7	3.8	3.9	2.7
Imports of goods and services (% change)	5.8	3.9	5.4	4.6	3.9	4.1	3.9
Contributions to real GDP growth:							
- Final domestic demand	3.1	2.1	3.0	2.8	2.1	2.4	2.3
- Change in inventories	0.1	-0.2	0.0	0.0	-0.1	-0.4	0.0
- Net exports	-0.8	-0.2	-1.0	-0.8	-0.2	-0.1	-0.6
Output gap[1]	1.6	0.9	1.5	1.7	0.6	1.6	1.5
Employment (% change)	2.3	0.6	1.1	1.0	0.6	0.7	0.5
Unemployment rate (%)	7.0	6.6	6.3	6.3	6.3	5.9	5.9
Labour productivity (% change)	0.1	1.3	0.8	1.0	1.3	1.2	1.2
HICP inflation (%)	1.2	1.4	0.8	0.3	1.5	1.6	1.1
GDP deflator (% change)	1.6	1.5	1.3	1.4	1.5	1.4	1.5
Comp. of employees (per head, % change)	2.5	2.7	2.7	3.2	3.0	2.9	2.8
Net lending/borrowing vis-à-vis the rest of	1.2	0.4	0.3	0.8	0.5	0.4	0.6

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 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3. RECENT AND PROJECTED FISCAL DEVELOPMENTS

3.1. Deficit developments

For 2019, as compared to the 2019 Stability Programme, the 2020 no-policy-change Draft Budgetary Plan has slightly improved the headline balance projection from -0.2% of GDP to -0.1% of GDP. While overall revenue is projected to remain broadly stable as compared to the Stability Programme, the revenue from social security contributions and indirect taxes has been revised upwards by around 0.2% and 0.1% of GDP respectively, which has been broadly offset by downward reductions of revenue from direct taxes and other non-tax revenue by 0.2% of GDP and 0.1% of GDP respectively. While overall expenditure is expected to decrease by around 0.1% of GDP, social transfers and compensation of employees have been revised upwards by around 0.2% and 0.1% of GDP respectively, which was slightly more than offset by downward reductions of interest expenditure, gross fixed capital formation and other expenditure by around 0.1%, 0.1% and 0.2% of GDP, respectively.

Similarly to the 2020 no-policy-change Draft Budgetary Plan, the Commission 2019 autumn forecast also projects a headline balance of -0.1% of GDP for 2019. While overall revenue is broadly in line with the Draft Budgetary Plan, the Commission forecast projects somewhat lower revenue from social security contributions (-0.1% of GDP) which is broadly offset by

higher revenue from direct taxes in line with standard elasticities. On the expenditure side, the Commission forecast's slightly higher projection for compensation of employees (+0.1% of GDP) as compared to the Draft Budgetary Plan is broadly offset by a slightly lower projection for gross fixed capital formation and other expenditure.

For 2020, the no-policy-change 2020 Draft Budgetary Plan projects only a minor further improvement of the headline balance to 0.0% of GDP, which corresponds to a downward revision by 0.3% of GDP as compared to the 2019 Stability Programme projection of a surplus of 0.3% of GDP in 2020. On the revenue side, overall projected revenue has been revised upwards by around 0.1% of GDP due to higher social security contributions (+0.2% of GDP) which are partially offset by lower direct taxes (-0.1% of GDP). On the expenditure side, overall projected expenditure has been revised upwards by around 0.4% of GDP as higher social transfers (+0.3% of GDP), compensation of employees (+0.1% of GDP) and other expenditure (+0.1% of GDP) have only been slightly compensated by lower gross fixed capital formation (-0.1% of GDP).

Similarly to the Draft Budgetary Plan, the Commission 2019 autumn forecast, under a no-policy-change assumption, also projects a general government headline balance of 0.0% of GDP in 2020 while there are some differences in the breakdown by revenue and expenditure items. As regards the revenue side, the Commission forecast has more conservative assumptions for social security contributions (-0.2% of GDP), in line with standard elasticities, and for revenue from sales and other current revenue (-0.1% of GDP), based on the recent track record for these items. These lower projections are however broadly offset by higher projections for direct taxes (+0.2% of GDP) and for indirect taxes (+0.1% of GDP) in line with standard elasticities. On the expenditure side, the Commission forecast expects some pressures of around 0.2% of GDP, mostly from compensation of employees, based on the track record of continuously rising public employment in 2016-2019 and the ongoing unfreezing of careers. These pressures are however projected to be broadly compensated by slightly lower estimates for gross fixed capital formation, interest costs and other expenditure.

Risks to the budgetary projections are tilted to the downside, linked to uncertainties surrounding the macroeconomic outlook and the potential deficit-increasing impact of a further activation of the Novo Banco contingent capital mechanism that could exceed the 0.3% of GDP already included in the Draft Budgetary Plan's 2020 headline deficit projection.

The no-policy-change Draft Budgetary Plan projects the structural balance[1] to improve by 0.3% of GDP in 2019 from a deficit of 0.6% of GDP in 2018 to a deficit of 0.3% of GDP in 2019. This corresponds to a higher projected annual improvement as compared to the 0.1% of GDP projected in the Stability Programme, however from a more negative starting point. For 2020, the Draft Budgetary Plan projects a deterioration of the (recalculated) structural balance by 0.1% of GDP to a deficit of 0.5% of GDP, as compared to the 0.3% of GDP improvement to a surplus of 0.3% of GDP targeted in the Stability Programme. The more negative change in the structural balance in 2020 as compared to the Stability Programme mainly reflects the corresponding more negative evolution of the headline balance (while the impact of the more positive variation of the output gap in the Draft Budgetary Plan is broadly offset by a more negative variation of the impact of one-off measures).

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

The Commission 2019 autumn forecast projects the structural balance to improve by 0.2% of GDP in 2019 to a deficit of 0.4% of GDP. The slightly lower improvement as compared to the Draft Budgetary Plan mostly reflects a more positive variation of the output gap in the Commission forecast for 2019. For 2020, the Commission 2019 autumn forecast projects the structural balance to remain unchanged at a deficit of 0.4% of GDP. The slight difference as compared to the 0.1% deterioration in the Draft Budgetary Plan is mainly the result of a more negative variation of the output gap (and accordingly a lower variation of the cyclical adjustment) in the Commission forecast.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Portugal currently standing at 0.24%[2]. 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 3.4% of GDP in 2018 to 3.1% in 2019 and is projected to decrease further next year, to 3.0% of GDP, well below the 4.9% recorded in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Member States' plans is broadly confirmed by the Commission forecast.

As regards compliance with national numerical fiscal rules, the projected structural balance evolution and expenditure developments point 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 medium-term budgetary objective is not reached, as laid down in Article 12-C (6) of the currently applicable Budget Framework Law (BFL)[3].

[2] 10-year bond yields as of 28 October 2019. Source: Bloomberg.
[3] Law n.º 41/2014 of 10 July (Eighth modification of Law n.º 91/2001, of 20 August) (Budget Framework Law)

Table 2. Composition of the budgetary adjustment

(% of GDP)	2018		2019			2020			Change: 2018-2020
	COM	**DBP**	**SP**	**DBP**	**COM**	**SP**	**DBP**	**COM**	**DBP**
Revenue	**43.0**	**43.0**	**43.8**	***43.4***	**43.3**	**43.7**	***43.3***	**43.4**	**0.3**
of which:									
- Taxes on production and imports	15.2	15.2	15.3	*15.2*	15.2	15.2	*15.1*	15.2	-0.1
- Current taxes on income, wealth,	10.1	10.1	10.2	*9.9*	10.0	10.1	*9.9*	10.0	-0.2
- Capital taxes	0.0	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	11.7	11.7	11.9	*12.0*	11.9	12.0	*12.1*	11.9	0.4
- Other (residual)	6.0	6.0	6.4	*6.2*	6.2	6.3	*6.3*	6.2	0.3
Expenditure	**43.5**	**43.5**	**43.9**	**43.4**	**43.4**	**43.4**	**43.4**	**43.4**	**-0.1**
of which:									
- Primary expenditure	40.1	40.1	40.7	40.3	40.3	40.3	40.4	40.4	0.3
of which:									
Compensation of employees	10.7	10.7	10.8	10.7	10.8	10.7	10.7	10.8	0.0
Intermediate consumption	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	-0.1
Social payments	18.2	18.2	18.3	18.4	18.4	18.3	18.4	18.4	0.2
Subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.0
Gross fixed capital formation	1.9	1.9	2.1	2.0	2.0	2.3	2.2	2.2	0.4
Other (residual)	3.5	3.5	3.7	3.4	3.4	3.2	3.3	3.3	-0.2
- Interest expenditure	3.4	3.4	3.3	3.1	3.1	3.0	3.0	2.9	-0.4
General government balance (GGB)	**-0.4**	**-0.4**	**-0.2**	**-0.1**	**-0.1**	**0.3**	**0.0**	**0.0**	**0.4**
Primary balance	**2.9**	**2.9**	**3.1**	**3.1**	**3.0**	**3.3**	**2.9**	**2.9**	**0.0**
One-off and other temporary measures	-0.7	-0.7	-0.6	-0.6	-0.6	-0.3	-0.4	-0.4	0.2
GGB excl. one-offs	**0.2**	**0.2**	**0.4**	**0.5**	**0.5**	**0.6**	**0.4**	**0.4**	**0.2**
Output gap[1]	1.6	1.6	0.9	1.5	1.7	0.6	1.6	1.5	0.0
Cyclically-adjusted balance[1]	-1.3	-1.3	-0.6	-0.9	-1.0	0.0	-0.9	-0.8	0.4
Structural balance (SB)[2]	**-0.6**	**-0.6**	**-0.1**	**-0.3**	**-0.4**	**0.3**	**-0.5**	**-0.4**	**0.1**
Structural primary balance[2]	2.8	2.8	3.2	2.8	2.7	3.3	2.5	2.5	-0.3

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 corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

The Portuguese authorities had indicated in the 2018 Stability Programme that the budgetary impact of the exceptional expenditure for wildfire prevention was significant and should be considered as an unusual event outside the control of the government, as defined in Article 5.1 and Article 6.3 of Regulation (EC) No 1466/97. More specifically, this expenditure had been estimated at 0.07% of GDP in 2018. In relation to this, Portugal had requested a temporary deviation from the adjustment path towards the medium-term budgetary objective of 0.07% of GDP in 2018.

A letter of 9 May 2019 sent in the context of the 2019 Stability Programme submission confirmed an amount of 0.04% of GDP for preventive measures based on 2018 outturn data. According to the ensuing Commission assessment in spring 2019, the eligible additional expenditure in 2018 amounts to 0.04% of GDP for preventive measures. Overall, the Commission assessed that Portugal could benefit from an overall temporary deviation of 0.04% of GDP due to the exceptional additional expenditure in 2018 related to preventive measures to protect the national territory against wildfires.

Thus, the carry-forward effect in 2020 of the exceptional expenditure in 2018 related to preventive measures for the protection of the national territory against wildfires following the large-scale wildfires of 2017 is estimated at 0.04% of GDP.

3.2. Debt developments

Following a decrease by 3.8 percentage points in 2018 to 122.2% of GDP, the debt-to-GDP ratio is forecast to continue a downward path by an average 3.0 percentage points in 2019 and 2020 according to the Draft Budgetary Plan and by an average 2.6 percentage points according to the Commission 2019 autumn forecast. As compared to the Stability Programme, the Draft Budgetary Plan expects the decrease in the debt ratio to decelerate by 0.7 percentage points in 2019, mostly due to higher stock-flow adjustments (resulting in particular from a higher cash deficit projection) and by 0.3 percentage points in 2020 (mainly due to the lower projected primary surplus). The smaller decrease in the debt-to-GDP ratio in the Commission 2019 autumn forecast, as compared to the Draft Budgetary Plan, mostly reflects higher expected stock-flow adjustments (mainly from updated higher cash deficit projections) and a lower real GDP growth projection for 2020. Some limited risk to the debt reduction profile could arise from a further activation of the contingent capital mechanism included in the Novo Banco sales agreement that could exceed the 0.3% of GDP already included in the Draft Budgetary Plan 2020 headline deficit projection.

As regards compliance with national fiscal rules, the debt-related provisions of Article 10-G(1) of the currently applicable BFL refer to the applicable provisions of Article 2 of Council Regulation (EC) 1467/97 for the preventive arm, i.e. the transitional debt rule requirements for 2019 and the debt reduction benchmark for 2020.

Table 3. Debt developments

(% of GDP)	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**122.2**	**118.6**	**119.3**	**119.5**	**115.2**	**116.2**	**117.1**
Change in the ratio	-3.8	-3.6	-2.9	-2.7	-3.4	-3.1	-2.5
Contributions[2]:							
1. Primary balance	**-2.9**	**-3.1**	**-3.1**	**-3.0**	**-3.3**	**-2.9**	**-2.9**
2. "Snow-ball" effect	**-1.5**	**-0.7**	**-0.8**	**-0.9**	**-0.9**	**-1.0**	**-0.8**
Of which:							
Interest expenditure	3.4	3.3	3.1	3.1	3.0	3.0	2.9
Real growth effect	-3.0	-2.2	-2.3	-2.3	-2.2	-2.3	-2.0
Inflation effect	-1.9	-1.8	-1.6	-1.7	-1.8	-1.7	-1.8
3. Stock-flow adjustment	**0.6**	**0.3**	**0.9**	**1.2**	**0.9**	**0.9**	**1.3**

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 effects.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

As the Draft Budgetary Plan was prepared on a no-policy-change basis, it does not report any new discretionary fiscal policy measures for 2020[4]. As regards one-off measures that are outside the control of the government, the no-policy change Draft Budgetary Plan projects a deficit-increasing impact of 0.4% of GDP, mainly corresponding to the impact of capital transfers to Novo Banco and the impact of an unfavourable court ruling on the Lisbon Municipality.

4. 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 medium-term budgetary objective. 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 in 2019 and subject to the debt reduction benchmark as of 2020.

Box 2. Council recommendations addressed to Portugal

On 9 July 2019, the Council addressed recommendations to Portugal in the context of the European Semester. In particular, in the area of public finances the Council recommended

[4] Measures from previous years that have an additional budgetary impact in 2020 are included in the no-policy-change scenario and accordingly are also not reported as new fiscal measures in the Draft Budgetary Plan.

Portugal to achieve the medium-term budgetary objective in 2020, taking into account the allowance linked to unusual events for which a temporary deviation is granted, and to use windfall gains to accelerate the reduction of the general government debt ratio.

In view of the autumn 2019 forecast projecting that Portugal will be 0.4% of GDP away from its medium-term budgetary objective in 2019, the nominal growth rate of net primary government expenditure should not exceed 1.7%, corresponding to an improvement in the structural balance by 0.4% of GDP.

4.1. 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 towards compliance with the debt reduction benchmark at the end of the transition period.

The Draft Budgetary Plan does not provide sufficient information to assess compliance with the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark in 2019.

According to the Commission 2019 autumn forecast, the transitional debt rule translates into a slightly negative required minimum linear structural adjustment for 2019 (of -0.3% of GDP). Based on the change in the structural balance of +0.2% of GDP projected in the Commission 2019 autumn forecast, Portugal is expected to make sufficient progress towards compliance with the debt reduction benchmark in 2019.

As the debt ratio is projected at 119.5% of GDP in 2019, Portugal needs to comply with the debt reduction benchmark as of 2020. The Draft Budgetary Plan 2020 does not provide sufficient information to assess compliance with the debt reduction benchmark in 2020. Based on the Commission 2019 autumn forecast, the debt reduction benchmark is expected to be met in 2020 (with a negative gap of 0.6% of GDP).

Table 4. Compliance with the debt criterion

	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	**122.2**	**118.6**	**119.3**	**119.5**	**115.2**	**116.2**	**117.1**
Gap to the debt benchmark [1,2]					-5.2		-0.6
Structural adjustment [3]	0.8	0.1	0.3	0.2			
To be compared to:							
Required adjustment [4]	0.4	-1.4		-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 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

4.2. Adjustment towards the medium-term budgetary objective

In 2019, the Council recommended Portugal to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.7 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP.

In 2019, according to the information provided in the no-policy-change Draft Budgetary Plan, the projected growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 0.7%, leading to a deviation of 1.2% of GDP from the requirement and thus pointing to a risk of significant deviation. The (recalculated) structural balance is expected to improve by 0.3% of GDP in the Draft Budgetary Plan and to remain at a distance of 0.6% of GDP from the medium-term budgetary objective applicable over 2017-2019 – a structural surplus of 0.25% of GDP – thus projecting some deviation from the recommended structural adjustment of 0.6% of GDP towards the medium-term budgetary objective. This calls for an overall assessment. The fiscal effort based on the structural balance pillar is positively impacted by revenue windfalls and declining interest expenditure, which are excluded from the expenditure benchmark pillar. Furthermore, the divergence between the two indicators also stems from differences between the potential GDP growth underlying the structural balance and the medium-term potential growth rate used to set the expenditure benchmark. An overall assessment confirms that both indicators would point to a risk of significant deviation from

the requirements in 2019. Therefore, an overall assessment based on the Draft Budgetary Plan points to a risk of significant deviation from the recommended structural adjustment towards the medium-term budgetary objective in 2019.

In turn, based on the Commission 2019 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 0.7%, leading to a deviation of 1.4% of GDP from the requirements and thus pointing to a risk of significant deviation in 2019. The structural balance is expected to improve by 0.2% of GDP in 2019, thus pointing to a risk of some (but close to significant) deviation by 0.4% of GDP from the recommended structural adjustment of 0.6% of GDP towards the medium-term budgetary objective. An overall assessment based on the Commission forecast, taking into consideration the above-mentioned effects, confirms the risk of significant deviation from the requirements in 2019.

In 2020, the Council recommended Portugal to achieve the medium-term budgetary objective, taking into account the allowance linked to unusual events for which a temporary deviation is granted. Based on the no-policy-change Draft Budgetary Plan, taking into account the flexibility granted due to the wildfire-prevention related unusual event clause, the projected growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 1.7% in 2020. Thus, the expenditure benchmark points to a risk of a significant deviation (of 0.8% of GDP). The structural balance is expected to slightly deteriorate by 0.1% of GDP according to the Draft Budgetary Plan, thus pointing to a risk of significant deviation by 0.5% of GDP from the recommendation to reach the medium-term budgetary objective (corresponding to a recommended structural adjustment of 0.4% of GDP). This calls for an overall assessment. The fiscal effort based on the structural balance pillar is positively impacted by declining interest expenditure and slightly negatively impacted by projected revenue shortfalls, which are both excluded from the expenditure benchmark pillar. Furthermore, the divergence between the two indicators also stems from differences between the potential GDP growth underlying the structural balance and the medium-term potential growth rate used to set the expenditure benchmark. An overall assessment confirms that both indicators would point to a risk of significant deviation from the requirements in 2020. Over 2019 and 2020 taken together, both the expenditure benchmark and the structural balance pillars point to a risk of significant deviation. An overall assessment confirms that both pillars point to a risk of significant deviation from the requirements over 2019 and 2020 taken together. Therefore, an overall assessment based on the Draft Budgetary Plan points to a risk of significant deviation from the recommended structural adjustment towards the medium-term budgetary objective in both 2020 and over 2019 and 2020 taken together.

In turn, based on the Commission 2019 autumn forecast, also taking into account the flexibility granted due to the wildfire-prevention related unusual event clause, the planned growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 1.7% in 2020. Thus, the expenditure benchmark points to a risk of significant deviation in 2020 (of 0.9% of GDP). The structural balance is expected to remain unchanged at -0.4% of GDP according to the Commission forecast and, therefore, to remain at a distance of 0.4% of GDP from the new applicable medium-term budgetary objective of a balanced budgetary position in structural terms. Hence, the structural balance points to a risk of some deviation from the recommendation to reach the medium-term budgetary objective. This calls for an overall assessment. The fiscal effort based on the structural balance pillar is positively impacted by

declining interest expenditure, which are excluded from the expenditure benchmark pillar. Furthermore, the divergence between the two indicators also stems from differences between the potential GDP growth underlying the structural balance and the medium-term potential growth rate used to set the expenditure benchmark. An overall assessment confirms that both indicators would point to a risk of significant deviation from the requirements in 2020. Over 2019 and 2020 taken together, both the expenditure benchmark and the structural balance pillars point to a risk of significant deviation, which is confirmed following an overall assessment. Therefore, an overall assessment based on the Commission 2019 autumn forecast points to a risk of significant deviation from the recommended structural adjustment towards the medium-term budgetary objective in both 2020 and over 2019 and 2020 taken together.

Overall, following overall assessments based on both projections, the Draft Budgetary Plan and the Commission 2019 autumn forecast, point to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective in 2019 and 2020.

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2018	2019		2020	
Initial position[1]					
Medium-term budgetary objective (MTO)	0.25	0.25		0.0	
Structural balance[2] (COM)	-0.6	-0.4		-0.4	
Structural balance based on freezing (COM)	-0.9	-0.4		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
	2018	**2019**		**2020**	
(% of GDP)	**COM**	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.6	0.6		0.4	
Required adjustment corrected[5]	0.6	0.6		0.4	
Change in structural balance[6]	0.9	0.3	0.2	-0.1	0.0
One-year deviation from the required adjustment [7]	0.3	-0.3	-0.4	-0.5	-0.4
Two-year average deviation from the required	0.3	0.0	-0.1	-0.4	-0.4
Expenditure benchmark pillar					
Applicable reference rate[8]	0.2	0.7		1.7	
One-year deviation adjusted for one-offs [9]	-1.5	-1.2	-1.4	-0.8	-0.9
Two-year average deviation adjusted for one-offs [9]	-1.0	-1.4	-1.4	-1.0	-1.1

Notes

[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 is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance corresponds to 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 ed. 2018, 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 2018) was carried out on the basis of Commission 2019 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.

Source :

Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations.

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

The no-policy-change Draft Budgetary Plan projects broadly stable revenue- and expenditure-to-GDP ratios in 2020. Focusing on the revenue-to-GDP ratio, the expected small increase of social security contributions and other non-tax revenue is projected to be offset by a decrease in projected tax revenue. Turning to the expenditure-to-GDP ratio, the increasing primary expenditure (where a 0.2 percentage points increase for gross fixed capital formation is not fully offset by slight decreases in compensation of employees and other expenditure) is broadly compensated by the decreasing share of interest expenditure.

Portugal plans a strong increase in public investment in 2020 that contrasts with the strong decrease in the share of investment in total expenditure during the period 2011-2016.

Portugal has undertaken a spending review over the last four years, aiming at improving the efficiency of public spending in a broad range of areas covering health, education, justice, internal affairs, public procurement and state assets and human resources management in general. The spending review exercise is expected to yield savings of around 0.1% of GDP in 2019. While the exercise was projected to be continued according to the 2019 Stability Programme, the no-policy-change Draft Budgetary Plan 2020 has not projected any additional such savings in 2020 owing to its underlying no-policy-change nature. In addition, due to its no-policy-change nature and the ensuing absence of any new fiscal policy measures measures for 2020, the Draft Budgetary Plan does not report any new environmentally friendly measures nor any new measures to enhance the growth-friendliness of the tax system in 2020.

In terms of fiscal-structural reforms, the 2019 country-specific recommendations include two main issues: (i) improve the quality of public finances by prioritising growth-enhancing spending while strengthening overall expenditure control, cost efficiency and adequate budgeting, with a focus in particular on a durable reduction of arrears in hospitals, and (ii) improve the financial sustainability of state-owned enterprises (SOEs), while ensuring more timely, transparent and comprehensive monitoring.

As regards enhancing the quality of public finances by prioritising growth-enhancing spending, the growth of public investment in 2019 is projected to fall significantly short of the 2019 budget target. The no-policy-change Draft Budgetary Plan still projects a year-on-year increase in general government gross fixed capital formation by 9.7% in 2019 (as compared to an outturn of 8.5% in 2018), and a further acceleration to 16.2% in 2020, bringing the ratio of public investment-to-GDP to 2.2%, approaching the level of 2.3% last recorded in 2015. Even so, the ratio of public investment-to-GDP would remain visibly below the ratios of 2.8% of GDP in the euro area and of 3.0% of GDP in the EU, projected for 2020 according to the Commission 2019 autumn forecast.

As regards overall expenditure control, cost efficiency and adequate budgeting, a series of initiatives in these areas have been introduced within the framework of the spending review exercise, with a special focus on health, education and human resources management. As regards the control of arrears in hospitals, a task force for the sustainability of the health budget programme has been initiated in 2018, envisaging the full implementation of a new governance model for hospitals in the course of 2019, with increased annual budget allocation alongside a closer joint monitoring by the Ministry of Finance and the Ministry of Health. A five-year arrears clearance programme is accompanied by joint approval of activity business plans by the two ministries and elaboration of hospital-specific efficiency-enhancing recommendations. The task force's work is expected to be continued by the newly created Performance Evaluation and Accompaniment Structure, a formal structure for monitoring and evaluating hospital management practices, combining the relevant monitoring entities of both ministries. The level of arrears has indeed decreased by around EUR 200 million to around EUR 700 million by September 2019, as compared to 900 million in September 2018. However, this reduction still appears to have largely resulted from ad-hoc extraordinary clearance measures of EUR 1,200 million by late 2018 and additional EUR 300 million by August 2019, and it remains to be seen to what extent the improved financing and monitoring will effectively be able to slow down the dynamic of average monthly generation of new arrears. Overall, while the proposed plans represent an ambitious step towards overall

expenditure control, cost efficiency and adequate budgeting, in particular in the health sector, the still early stage of implementation of some of the measures, and the continued high level of hospital arrears in spite of high ad-hoc clearance measures point to limited progress to date.

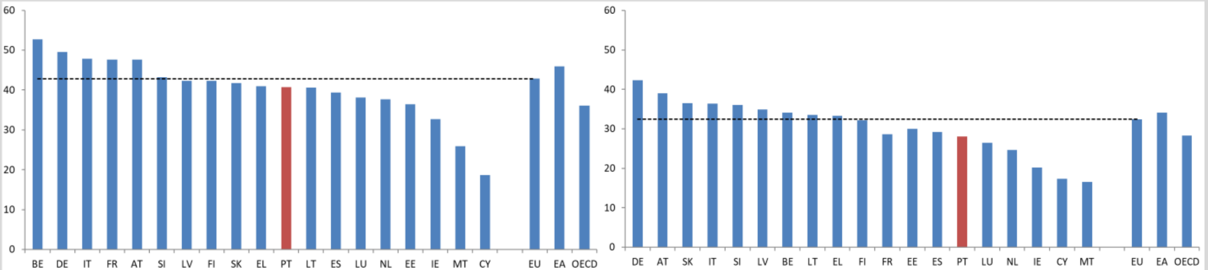
As regards improving the financial sustainability of SOEs, while ensuring more timely, transparent and comprehensive monitoring, the authorities project the SOE sector to deliver sustained financial improvements, after a deterioration in 2018, which was largely attributed to non-recurrent factors in that year (such as the unfreezing of wages) resulting in above-trend expenditure growth. Measures are being implemented to enhance the monitoring of SOEs and to ensure compliance with their initial budgetary plans. These include the continuation of in-depth analysis of activity plans and budgets with specific focus on assessment of investment plans and recruitment needs and quarterly analysis for timely identification of deviations being gradually implemented to become fully operational in 2020. Furthermore, the capital structure of a series of companies has been strengthened by major capital injections and the process of liquidation of unprofitable or redundant SOEs has been continued. The renegotiation of contracts to compensate specific SOEs for their public service obligations is expected to be a critical factor to allow these companies to become profitable or at equilibrium. That notwithstanding, timely publication of monitoring information does not seem to have been ensured and there appears to be scope to improve transparency regarding recapitalisation plans. Overall, limited progress has been made to date in improving the financial sustainability of SOEs.

Box 3 – 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 (2018)



Notes: 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.

As it has been prepared on a no-policy-change basis, Portugal's Draft Budgetary Plan does not report any fiscal policy measures and accordingly does not include any measures affecting the tax wedge on labour.

6. OVERALL CONCLUSION

Based on the Commission 2019 autumn forecast, Portugal is expected to make sufficient progress towards compliance with the debt reduction benchmark in 2019 and in 2020 it is expected to meet the debt reduction benchmark. Following an overall assessment of the Draft Budgetary Plan, the projected structural adjustment points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective in both 2019 and 2020. An overall assessment based on the Commission 2019 autumn forecast also points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council in both 2019 and 2020.