Brussels, 15.1.2020
SWD(2020) 5 final

COMMISSION STAFF WORKING DOCUMENT

Analysis of the updated Draft Budgetary Plan of Portugal

Accompanying the document

COMMISSION OPINION

on the updated Draft Budgetary Plan of Portugal

{C(2020) 196 final}

1. INTRODUCTION

On 15 October 2019, Portugal submitted a Draft Budgetary Plan on the basis of unchanged policies in compliance with Regulation (EU) No 473/2013. This was due to the fact that, after the general election on 6 October 2019, the new government only took office on 26 October 2019. On 17 December 2019, Portugal submitted an updated Draft Budgetary Plan for 2020 in compliance with Regulation (EU) No 473/2013. Compared with the no-policy-change Draft Budgetary Plan submitted on 15 October 2019, the updated Draft Budgetary Plan includes fiscal policy measures adopted by the new government. Portugal is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective.

As the public 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 of the Treaty, 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 public debt ratio is projected to be 119.2% 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 updated Draft Budgetary Plan and provides an assessment based on the Commission ad-hoc forecast. The following section presents the recent and planned fiscal developments, according to the updated Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission ad-hoc 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 the 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

According to the updated Draft Budgetary Plan, Portugal's economic growth is expected to moderate from 2.4% in 2018, to 1.9% in both 2019 and 2020. This is identical to the macroeconomic projections in the 2019 Stability Programme. Domestic demand is forecast to remain the main growth driver over the forecast horizon. This comprises an upward revision to private consumption and investment growth to 2.2% and 7.3% in 2019, respectively, and to 2.0% and 5.4% in 2020. That more favourable projection for domestic demand is however fully offset by a more negative contribution from net exports. Inflation is revised downwards to 0.4% in 2019, but it is projected to rebound to 1.1% in 2020, amid moderate wage growth and further improvements in labour market developments.

The macroeconomic projections in the updated Draft Budgetary Plan appear broadly consistent with the Commission ad-hoc forecast.[1] For 2019, compared with the updated Draft

[1] In order to assess the updated Draft Budgetary Plan, the Commission produced an ad-hoc forecast, in particular by updating its 2019 autumn forecast to take into account the information in the updated plan.

Budgetary Plan, the Commission forecasts a lower increase in investment and imports, but a slightly higher increase in private consumption, resulting in GDP growth of 2.0%. For 2020, the Commission projects weaker GDP growth of 1.7%, mainly due to a more subdued investment growth and a slightly weaker contribution of net exports. That more conservative projection for 2020 in the Commission ad-hoc forecast reflects expectations for a broadly stable demand from Portugal's main trading partners in the context of significant uncertainty in the external environment. As regards inflation, the Commission forecast for both consumer prices and the GDP deflator is very close to the projections in the updated Draft Budgetary Plan. This is also the case for labour market developments, where the projections for notably employment and wage dynamics appear quite similar.

Overall, the macroeconomic scenario underlying the updated Draft Budgetary Plan appears to be plausibe for both years. The risks are mostly related 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 updated Draft Budgetary Plan for 2020 has been prepared by the Department of Planning, Strategy, Evaluation and International Relations (*Gabinete de Planeamento, Estratégia, Avaliação e Relações Internacionais*, GPEARI) of 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) as an independent body with a mandate that includes the analysis of government forecasts. The endorsement by the CFP is attached to the updated Draft Budgetary Plan and has been available on the institution's website since the submission of the updated Draft Budgetary Plan. For 2019, the CFP considered that the macroeconomic forecast in the updated Draft Budgetary Plan appeared to be the most likely as regards GDP growth and the evolution of most of its components. For 2020, the CFP considered that the assumption in the updated Draft Budgetary Plan of keeping the same profile for real GDP growth as in 2019 carries downward risks, given the uncertainty in the international economic outlook and the persistance of trade tensions that have been detrimental to the growth of Portugal's main trading partners, in particular given the vulnerability of the Portuguese economy to external shocks.

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	1.9	1.7
Private consumption (% change)	3.1	1.8	2.2	2.3	1.8	2.0	2.0
Gross fixed capital formation (% change)	5.8	5.3	7.3	6.5	4.9	5.4	4.8
Exports of goods and services (% change)	3.8	3.8	2.5	2.7	3.8	3.2	2.7
Imports of goods and services (% change)	5.8	3.9	5.2	4.7	3.9	4.4	3.9
Contributions to real GDP growth:							
- Final domestic demand	3.1	2.1	2.8	2.8	2.1	2.4	2.3
- Change in inventories	0.1	-0.2	0.1	0.1	-0.1	0.0	0.0
- Net exports	-0.8	-0.2	-1.1	-0.9	-0.2	-0.5	-0.6
Output gap[1]	1.6	0.9	1.7	1.7	0.6	1.5	1.5
Employment (% change)	2.3	0.6	1.0	1.0	0.6	0.6	0.5
Unemployment rate (%)	7.0	6.6	6.4	6.4	6.3	6.1	6.0
Labour productivity (% change)	0.1	1.3	0.8	1.0	1.3	1.3	1.2
HICP inflation (%)	1.2	1.4	0.4	0.3	1.5	1.1	1.1
GDP deflator (% change)	1.6	1.5	1.5	1.4	1.5	1.4	1.5
Comp. of employees (per head, % change)	2.5	2.7	2.7	3.2	3.0	3.2	2.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.2	0.4	0.5	0.7	0.5	0.2	0.5

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 ad-hoc forecast (COM); Commission calculations

3. RECENT AND PROJECTED FISCAL DEVELOPMENTS

3.1. Deficit developments

For 2019, compared with the 2019 Stability Programme, the updated Draft Budgetary Plan includes a downward revision of the planned headline deficit from 0.2% of GDP, to 0.1% of GDP. That downward revision reflects lower projected revenue being more than compensated by lower planned expenditure. Focusing on the revenue side, compared with the 2019 Stability Programme, the updated Draft Budgetary Plan projects lower tax revenue and other non-tax revenue (by -0.4% and -0.2% of GDP, respectively), only partly offset by higher revenue from social contributions (by +0.1% of GDP). Turning to the expenditure side, compared with the 2019 Stability Programme, the updated Draft Budgetary Plan projects somewhat lower other expenditure and interest expenditure (by -0.3% and -0.2% of GDP, respectively), coupled with slightly lower downward revisions also in intermediate consumption and public investment (both by -0.1% of GDP). By contrast, compared with the 2019 Stability Programme, the updated Draft Budgetary Plan expects expenditure on social payments to be slightly higher (by +0.1% of GDP).

Like the updated Draft Budgetary Plan, the Commission ad-hoc forecast also projects a headline deficit of 0.1% of GDP in 2019. While, overall, total revenue is broadly in line with the updated Draft Budgetary Plan, the Commission forecast projects somewhat higher tax

revenue (by +0.1% of GDP), in line with standard tax elasticities for Portugal, which is expected to be broadly offset by lower revenue from social contributions (by -0.1% of GDP). While, overall, total expenditure is also broadly in line with the updated Draft Budgetary Plan, the Commission forecast expects slightly higher expenditure on compensation of employees and intermediate consumption (jointly by +0.1% of GDP), broadly compensated by somewhat lower public investment (by -0.1% of GDP), reflecting recent in-year budget execution.

For 2020, compared with the 2019 Stability Programme, the updated Draft Budgetary Plan projects both higher revenue and expenditure (both by +0.1% of GDP), which combined translate into a downward revision (by -0.1% of GDP) of the planned headline surplus from 0.3% of GDP in the 2019 Stability Programme, to 0.2% of GDP in the updated Draft Budgetary Plan. Focusing on the revenue side, compared with the 2019 Stability Programme, the updated Draft Budgetary Plan projects lower revenue from direct taxes (by -0.2% of GDP), which is expected to be more than compensated by higher revenue from social contributions and other non-tax revenue (both by +0.1% of GDP). Turning to the expenditure side, compared with the 2019 Stability Programme, the updated Draft Budgetary Plan expects higher other expenditure and expenditure on compensation of employees (by +0.2% and +0.1% of GDP, respectively), which is projected to be only partly offset by lower intermediate consumption and interest expenditure (both by -0.1% of GDP).

Compared with the updated Draft Budgetary Plan, the Commission ad-hoc forecast projects a slightly lower headline surplus of 0.1% of GDP in 2020. This is due to a slightly different composition of public finances in 2020, reflecting projections of both lower revenue and higher expenditure. As regards the revenue side, the Commission forecast projects higher tax revenue (by +0.2% of GDP), which is however more than offset by more conservative assumptions for the revenue from social contributions and other non-tax revenue (both by -0.1% of GDP). As regards the expenditure side, the Commission projects higher expenditure on compensation of employees (by +0.2% of GDP), in view of the track record of continuously rising public employment over the period 2016-2019 and the ongoing unfreezing of careers in the civil service, coupled with expected higher expenditure also on intermediate consumption and social payments (both by +0.1% of GDP). Those developments are projected to be only partly compensated by lower public investment (by -0.2% of GDP), reflecting the persistent trend of subdued public investment in Portugal for a number of years.

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 foreseen in the updated Draft Budgetary Plan.

The updated Draft Budgetary Plan projects the (recalculated) structural balance[2] to improve by 0.1% of GDP in 2019, to a structural deficit of 0.5% of GDP. The planned structural effort for 2019 is in line with the 2019 Stability Programme, despite the higher structural deficit projected in the updated Draft Budgetary Plan. In turn, the updated Draft Budgetary Plan expects the structural balance to improve by 0.3% of GDP in 2020, reaching a structural deficit of 0.2% of GDP. As a result, the planned structural effort for 2020 is somewhat below the one in the 2019 Stability Programme, partly reflecting the updated plans for the headline balance in both 2019 and 2020.

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

Like the updated Draft Budgetary Plan, the Commission ad-hoc forecast also projects the structural balance to improve by 0.1% of GDP in 2019, to a structural deficit of 0.5% of GDP. In turn, the Commission forecast expects the structural balance to improve by 0.2% of GDP in 2020, to a structural deficit of 0.3% of GDP. The resulting difference for 2020, compared with the updated Draft Budgetary Plan, mainly reflects the lower headline surplus in the Commission forecast.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Portugal currently standing at 0.42%.[3] As a consequence, total interest payments by the general government have continued to decrease as a ratio of GDP. Based on the information included in the updated Draft Budgetary Plan, interest expenditure in Portugal is expected to fall from 3.4% of GDP in 2018, to 3.1% of GDP in 2019, and further to 2.9% of GDP in 2020, well below the peak of 4.9% of GDP recorded in 2012, at the height of the euro-area sovereign debt crisis. The picture stemming from Portugal's plan is 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 pillar as long as the medium-term budgetary objective is not reached, as laid down in Article 12-C (6) of the currently applicable Budgetary Framework Law (BFL).[4]

[3] 10-year bond yields as on 2 January 2020; source: Bloomberg.

[4] Law n.º 41/2014 of 10 July (Eighth modification of Law n.º 91/2001, of 20 August), the so-called Budgetary 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**	***43.3***	**43.3**	**43.7**	***43.8***	**43.7**	**0.8**
of which:									
- Taxes on production and imports	15.2	15.2	15.3	*15.2*	15.2	15.2	*15.2*	15.3	0.0
- Current taxes on income, wealth, etc.	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*	12.0	0.4
- Other (residual)	6.0	6.0	6.4	*6.2*	6.2	6.4	*6.5*	6.4	0.5
Expenditure	**43.5**	**43.5**	**43.9**	**43.4**	**43.4**	**43.4**	**43.5**	**43.6**	**0.1**
of which:									
- Primary expenditure	40.1	40.1	40.7	40.3	40.3	40.3	40.6	40.7	0.5
of which:									
Compensation of employees	10.7	10.7	10.8	10.8	10.8	10.7	10.8	11.0	0.1
Intermediate consumption	5.4	5.4	5.4	5.3	5.4	5.4	5.3	5.4	-0.1
Social payments	18.2	18.2	18.3	18.4	18.4	18.3	18.3	18.4	0.1
Subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.1
Gross fixed capital formation	1.9	1.9	2.1	2.0	1.9	2.3	2.3	2.1	0.4
Other (residual)	3.5	3.5	3.7	3.4	3.4	3.2	3.4	3.4	-0.1
- Interest expenditure	3.4	3.4	3.3	3.1	3.1	3.0	2.9	2.9	-0.5
General government balance (GGB)	**-0.4**	**-0.4**	**-0.2**	**-0.1**	**-0.1**	**0.3**	**0.2**	**0.1**	**0.7**
Primary balance	**2.9**	**2.9**	**3.1**	**3.0**	**3.0**	**3.3**	**3.2**	**3.0**	**0.2**
One-off and other temporary measures	-0.7	-0.7	-0.6	-0.5	-0.5	-0.3	-0.4	-0.4	0.3
GGB excl. one-offs	**0.2**	**0.2**	**0.4**	**0.4**	**0.4**	**0.6**	**0.7**	**0.5**	**0.4**
Output gap[1]	1.6	1.6	0.9	1.7	1.7	0.6	1.5	1.5	-0.1
Cyclically-adjusted balance[1]	-1.3	-1.3	-0.6	-1.0	-1.0	0.0	-0.6	-0.7	0.7
Structural balance (SB)[2]	**-0.6**	**-0.6**	**-0.1**	**-0.5**	**-0.5**	**0.3**	**-0.2**	**-0.3**	**0.4**
Structural primary balance[2]	2.8	2.8	3.2	2.6	2.6	3.3	2.8	2.6	0.0

Notes:

[1] Output gap (in % of potential GDP) and cyclically adjusted balance according to the Plan/Programme as recalculated by Commission on the basis of the Plan/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 ad-hoc 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, that 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 submission of the 2019 Stability Programme confirmed an amount of 0.04% of GDP for preventive measures based on 2018 outturn budgetary 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. Therefore, the carry-forward effect into 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% of GDP in 2018, to 122.2%, the public debt-to-GDP ratio is forecast to remain on a steady downward path, falling on average by 3.0% of GDP in 2019 and 2020 according to the updated Draft Budgetary Plan, and on average by 2.7% of GDP according to the Commission ad-hoc forecast. Compared with the 2019 Stability Programme, the updated Draft Budgetary Plan expects the decrease in the debt-to-GDP ratio to decelerate by 0.3% of GDP in 2019 and by 0.7% of GDP in 2020, mostly due to planned higher stock-flow adjustments in both years. Likewise, compared with the updated Draft Budgetary Plan, the more moderate pace of reduction of the public debt-to-GDP ratio in the Commission forecast mostly reflects higher expected stock-flow adjustments, combined with a lower projection for real GDP growth specifically for 2020. Some limited risk to the public debt reduction profile could arise from the potential debt-increasing impact of a further activation of the Novo Banco contingent capital mechanism that could exceed the 0.3% of GDP already foreseen in the updated Draft Budgetary Plan.

As regards compliance with national fiscal rules, the public debt-related provisions of Article 10-G(1) of the currently applicable BFL refer to the provisions of Article 2 of Regulation (EC) No 1467/97 for the preventive arm of the Stability and Growth Pact, this is, the transitional debt rule 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**	**118.9**	**119.2**	**115.2**	**116.2**	**116.7**
Change in the ratio	-3.8	-3.6	-3.3	-3.0	-3.4	-2.7	-2.5
Contributions[2]:							
1. Primary balance	**-2.9**	**-3.1**	**-3.0**	**-3.0**	**-3.3**	**-3.2**	**-3.0**
2. "Snow-ball" effect	**-1.5**	**-0.7**	**-0.9**	**-0.9**	**-0.9**	**-0.9**	**-0.8**
Of which:							
Interest expenditure	3.4	3.3	3.1	3.1	3.0	2.9	2.9
Real growth effect	-3.0	-2.2	-2.2	-2.3	-2.2	-2.2	-2.0
Inflation effect	-1.9	-1.8	-1.7	-1.7	-1.8	-1.6	-1.7
3. Stock-flow adjustment	**0.6**	**0.3**	**0.6**	**0.9**	**0.9**	**1.3**	**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 ad-hoc forecast (COM); Commission calculations

3.3. Measures underpinning the Draft Budgetary Plan

Compared with the no-policy-change Draft Budgetary Plan submitted on 15 October 2019, the updated Draft Budgetary Plan reports a package of new fiscal policy measures[5] of a structural nature and one-offs for 2020 implying, overall, a near zero impact on the revenue side and an increase by approximately 0.9% of GDP on the expenditure side. From them, new fiscal policy measures of a structural nature are, overall, planned to have a near zero impact on government revenue in 2020, while they are expected to increase expenditure by approximately 0.4% of GDP; the rest of the impact is due to one-off measures.

Focusing on the revenue side, the balance-deteriorating impact of some targeted decreases in Personal Income Tax, Corporate Income Tax, Value-added Tax and school fees is planned to be broadly compensated by the balance-improving impact of selective increases in stamp duty and measures to incentivise decarbonisation. Turning to the expenditure side, the most sizeable balance-deteriorating impact (by -0.33% of GDP) pertains to the ongoing process of gradual unfreezing of careers in the public service, coupled with additional revisions to careers and wage updates. Moreover, several measures are planned to lead to an overall increase in social payments and thus carry an additional balance-deteriorating impact (by -0.17% of GDP), notably through the ongoing early retirement reforms for long careers, the update of the social benefit for inclusion, the family allowance and the social supplement for

[5] The table of discretionary measures reported in the updated Draft Budgetary Plan shows for 2019 and 2020 only the planned impact of new fiscal policy measures or revisions to the expected impact of previous measures in the plan. Hence, the table does not cover the planned impact of fiscal policy measures from previous years included in the unchanged policies scenario that have an additional budgetary impact in 2019 and 2020.

the elderly, and the programme envisaging the reduction of public transport prices. The balance-deteriorating impact of those measures is planned to be partly compensated by a balance-improving impact (by +0.09% of GDP) stemming from additional efficiency savings in the context of the ongoing review of public expendiutre.

In addition to the above-mentioned fiscal policy measures of a structural nature, the headline balance in 2020 is also set to be affected by one-off measures implying an increase by approximately 0.1% of GDP on the revenue side and by close to 0.5% of GDP on the expenditure side. On the one hand, one-off measures cover the expected recovery of part of the guarantee granted to Banco Privado Português and, on the other, additional capital transfers to Novo Banco and an unfavourable court ruling on the Lisbon Municipality, among other smaller one-off balance-deteriorating impacts on the expenditure side.

The Commission ad-hoc forecast factors in all planned fiscal policy measures at the yields specified in the updated Draft Budgetary Plan. Overall, based on the reported fiscal policy measures, Portugal's fiscal strategy would continue being based on buoyant cyclical revenue, decreasing interest expenditure and subdued public investment as a means to finance the expansion of the public wage bill and higher social payments. In particular, windfall gains from low interest expenditure do not appear to be sufficiently used to accelerate the reduction of the public debt-to-GDP ratio. Broadening the ongoing review of public expenditure to achieve more ambitious efficiency savings could help tame the growing pressures on the expenditure side of the budget.

Table 4: Main discretionary measures reported in the Draft Budgetary Plan

A. Discretionary measures taken by general government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2019	**2020**
Taxes on production and imports	0.01	0.02
Current taxes on income, wealth, etc.	-0.01	-0.05
Capital taxes	0.00	0.00
Social contributions	0.00	0.00
Property Income	0.00	0.00
Other	-0.01	0.06
Total	**0.00**	**0.03**

Note:

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

Source:

Draft Budgetary Plan for 2020

B. Discretionary measures taken by general government - expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2019	**2020**
Compensation of employees	0.32	0.33
Intermediate consumption	0.00	-0.09
Social payments	0.26	0.17
Interest Expenditure	0.00	0.00
Subsidies	0.00	0.00
Gross fixed capital formation	0.00	0.00
Capital transfers	0.00	0.48
Other	0.00	0.00
Total	**0.58**	**0.89**

Note:

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

Source:

Draft Budgetary Plan for 2020

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

Portugal is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards the medium-term budgetary objective. Portugal's medium-term budgetary objective as of 2020 is a balanced budgetary position in structural terms. 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 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. This is consistent with a maximum nominal growth rate of net primary government expenditure of 1.7%, corresponding to an annual structural adjustment of 0.4% of GDP in 2020.

4.1. Compliance with the debt criterion

After having 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 that period, Portugal 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 updated 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 ad-hoc 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 projected improvement of the structural balance by 0.1% of GDP in the Commission forecast, Portugal is expected to make sufficient progress towards compliance with the debt reduction benchmark in 2019.

As the debt ratio is projected at 119.2% of GDP in 2019, Portugal is required to comply with the debt reduction benchmark as of 2020. The updated Draft Budgetary Plan does not provide sufficient information to assess compliance with the debt reduction benchmark in 2020. Based on the Commission ad-hoc forecast, the debt reduction benchmark is expected to be met in 2020 (with a negative gap of 0.7% of GDP).

Table 5: Compliance with the debt criterion

	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	**122.2**	**118.6**	**118.9**	**119.2**	**115.2**	**116.2**	**116.7**
Gap to the debt benchmark [1,2]					-5.2		-0.7
Structural adjustment [3]	0.8	0.1	0.1	0.1			
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 ad-hoc 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 updated Draft Budgetary Plan, the projected nominal growth rate of net primary government expenditure is expected to exceed the applicable expenditure benchmark of 0.7%, leading to a deviation of 1.3% of GDP from the requirement and thus pointing to a risk of significant deviation in that year. Based on the updated Draft Budgetary Plan, the structural balance is expected to improve by 0.1% of GDP in 2019 and to remain at a distance of 0.7% of GDP from the medium-term budgetary objective applicable over 2017-2019 (this is, a structural surplus of 0.25% of GDP), thus pointing to a risk of some deviation by 0.5% of GDP from the recommended annual structural adjustment of 0.6% of GDP. 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 GDP growth rate used to set the expenditure benchmark. Based on the updated Draft Budgetary Plan, an overall assessment points to a risk of significant deviation from the recommended structural adjustment towards the medium-term budgetary objective in 2019, and over 2018 and 2019 taken together.

In turn, based on the Commission ad-hoc forecast, the nominal growth rate of net primary government expenditure is also expected to exceed the applicable expenditure benchmark of 0.7%, leading to a deviation of 1.5% of GDP from the requirement and thus pointing to a risk

of significant deviation in 2019. The structural balance is expected to improve by 0.1% of GDP in 2019, thus pointing to a risk of some deviation by 0.5% of GDP from the recommended annual structural adjustment of 0.6% of GDP. An overall assessment based on the Commission ad-hoc forecast, taking into consideration the above-mentioned effects, confirms the risk of significant deviation from the recommended structural adjustment towards the medium-term budgetary objective in 2019, and over 2018 and 2019 taken together.

For 2020, the Council recommended Portugal to achieve the medium-term budgetary objective applicable over 2020-2022 (this is, a balanced budgetary position in structural terms), taking into account the allowance linked to unusual events for which a temporary deviation is granted. This is consistent with a maximum nominal growth rate of net primary government expenditure of 1.7%, corresponding to an annual structural adjustment of 0.4% of GDP in 2020. The structural balance in the updated Draft Budgetary Plan as recalculated by the Commission using the commonly agreed methodology is estimated at a structural deficit of 0.2% of GDP and, therefore, considered to be close to the medium-term budgetary objective, taking into account the allowance linked to unusual events for which a temporary deviation is granted. Thus, the assessment based on the updated Draft Budgetary Plan indicates a risk of some deviation from the recommended structural adjustment towards the medium-term budgetary objective in 2020. At the same time, the expenditure benchmark pillar points to a risk of significant deviation from the requirement in 2020 (gap of 0.7% of GDP). If the structural balance is no longer projected to be close to the medium-term budgetary objective in future assessments, an overall assessment would need to take into account a possible deviation from the requirement.

In turn, based on the Commission ad-hoc forecast, the projected strucural deficit of 0.3% of GDP will be slightly more distant from the medium-term budgetary objective in 2020, compared with the structural balance in the updated Draft Budgetary Plan as recalculated by the Commission, and can therefore not be considered close to it. The nominal growth rate of net primary government expenditure is expected to exceed the applicable expenditure benchmark of 1.7%, leading to a deviation of 0.8% of GDP from the requirement and thus pointing to a risk of significant deviation in 2020. The structural balance is expected to improve by 0.2% of GDP in 2020, thus pointing to a risk of some deviation by 0.2% of GDP from the recommended annual structural adjustment of 0.4% of GDP. 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 GDP growth rate used to set the expenditure benchmark. Thus, an overall assessment based on the Commission ad-hoc forecast points to a risk of significant deviation from the recommended structural adjustment towards the medium-term budgetary objective 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 ad-hoc forecast points to a risk of significant deviation from the recommended structural adjustment towards the medium-term budgetary objective in 2020, and over 2019 and 2020 taken together.

Table 6: 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	-0.5		-0.3	
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	0.1	0.1	0.3	0.2
One-year deviation from the required adjustment[7]	0.3	-0.5	-0.5	-0.1	-0.2
Two-year average deviation from the required	0.3	-0.1	-0.1	-0.3	-0.3
Expenditure benchmark pillar					
Applicable reference rate[8]	0.2	0.7		1.7	
One-year deviation adjusted for one-offs[9]	-1.5	-1.3	-1.5	-0.7	-0.8
Two-year average deviation adjusted for one-offs[9]	-1.0	-1.4	-1.5	-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 ad-hoc forecast (COM); Commission calculations.

5. Composition of public finances and Implementation of fiscal structural reforms

The updated Draft Budgetary Plan projects for 2020 a strong increase in the revenue-to-GDP ratio (by +0.5% of GDP) and a moderately expanding expenditure-to-GDP ratio (by +0.2% of GDP). Focusing on the revenue side, the increase is explained by higher ratios of social contributions and other non-tax revenue to GDP, while the ratio of tax revenue to GDP is planned to remain roughly unchanged. Turning to the expenditure side, the moderate expansion mainly stems from the planned increase in public investment and other expenditure, which is expected to be only partly offset by lower interest expenditure.

The updated Draft Budgetary Plan reports new environmentally-friendly measures (including tax measures to incentivise decarbonisation) and new measures to enhance the growth-friendliness of the tax system in 2020 (including selective reductions of Personal Income Tax

for young workers and couples with children aged 3 or below, as well as of autonomous taxations under the Corporate Income Tax).

In terms of fiscal-structural reforms, the 2019 country-specific recommendations addressed two main concerns: (i) the need to 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) the need to improve the financial sustainability of State-owned enterprises, 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 short of the government plans in the 2019 budget. The updated Draft Budgetary Plan still projects public investment to increase to 2.0% of GDP in 2019 and to 2.3% of GDP in 2020. Compared with the 2019 Stability Programme, the updated Draft Budgetary Plan includes a downward revision of public investment by 0.1% of GDP in 2019, while keeping the government plans for 2020. At the same time, the Commission projects lower public investment in both 2019 and 2020. The ratio of public investment-to-GDP in Portugal would therefore remain significantly 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 forecast.

As regards overall expenditure control, cost efficiency and adequate budgeting, Portugal has undertaken a review of public expenditure 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 review is expected to yield somewhat limited efficiency savings of around 0.1% of GDP in both 2019 and 2020.

As regards the control of arrears in hospitals, a new fully-fledged programme to strengthen the overall sustainability of the health system started being implemented in 2019. The programme is expected to introduce a new governance model for public hospitals, with substantial increases in hiring autonomy and annual budgets being combined with enhanced joint monitoring by the Ministries of Finance and Health. A formal structure to evaluate the managing of public hospitals along those goals was created in June 2019, but most of the hospitals' new business activity plans are yet to be agreed. After having decreased visibly in December 2018, mainly as a result of sizeable ad-hoc clearance measures in that year, hospital arrears are back on a steadily increasing path since July 2019. Prompt and effective implementation of the new programme would possibly help to slowdown the accumulation of hospital arrears in a more durable manner.

As regards improving the financial sustainability of State-owned enterprises, overall, they continue to struggle to achieve a balanced financial position. As a result, at the end of 2019, State-owned enterprises will, overall, likely be farther from balance compared with government initial plans. At the same time, the debt of non-financial State-owned enterprises included in general government has continued to decrease, though at a decelerating pace. Some measures to strengthen the sustainability of State-owned enterprises are only being implemented gradually, including the analysis of quarterly data aiming to identify and correct in a timely manner deviations from the approved budgets. Moreover, the capital structure of a series of State-owned enterprises has been strengthened through sizeable capital injections and the liquidation of unprofitable or redundant firms has been continued. Transparency

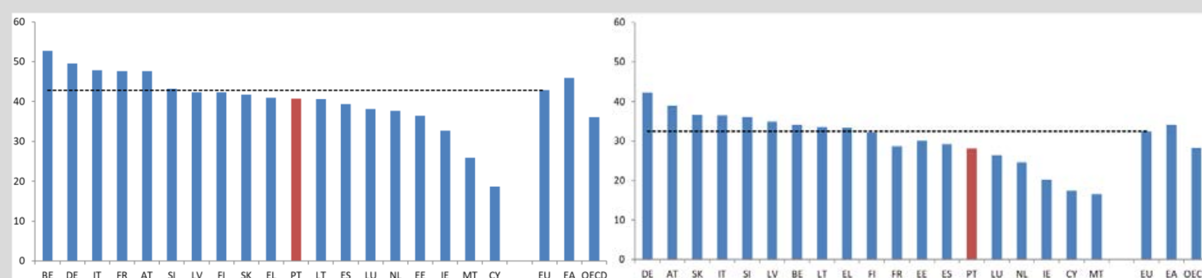
regarding the financial position of State-owned enterprises has been improved somewhat through the publication of aggregate quarterly financial data within a shorter timeframe.

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 that 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 those 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.

Portugal's updated Draft Budgetary Plan reports selective measures that are expected to slightly decrease the tax wedge on labour, notably through limited reductions in Personal Income Tax for young workers and couples with children aged 3 or below.

6. OVERALL CONCLUSION

Based on the Commission ad-hoc forecast, Portugal is expected to make sufficient progress towards compliance with the debt reduction benchmark in 2019 and it is expected to meet the debt reduction benchmark in 2020. Based on the updated Draft Budgetary Plan, an overall assessment points to a risk of significant deviation from the requirements of the preventive arm of the Stability and Growth Pact in 2019, and over 2018 and 2019 taken together. That

risk of significant deviation in 2019, and over 2018 and 2019 taken together, is confirmed by an overall assessment based on the Commission ad-hoc forecast. The structural balance in the updated Draft Budgetary Plan as recalculated by the Commission using the commonly agreed methodology is estimated at a structural deficit of 0.2% of GDP in 2020 and, therefore, close to the medium-term budgetary objective in that year, taking into account the allowance linked to unusual events for which a temporary deviation is granted. Thus, the assessment based on the updated Draft Budgetary Plan indicates a risk of some deviation from the recommended structural adjustment towards the medium-term budgetary objective in 2020. At the same time, the expenditure benchmark pillar points to a risk of significant deviation from the requirement in 2020 (gap of 0.7% of GDP). Based on the Commission ad-hoc forecast, an overall assessment points to a risk of significant deviation from the requirements of the preventive arm of the Stability and Growth Pact in 2020, and over 2019 and 2020 taken together.