Conselho das Finanças Públicas
Portuguese Public Finance Council

Seventh Amendment to the Budgetary Framework Law: Bill no. 124/XII

Opinion of the Portuguese Public Finance Council

22 February 2013

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I. The need to review the BFL

The explicit goal of the Bill under discussion relates to the commitment made under the Memorandum of Understanding to review the Budgetary Framework Law (BFL), with the "structural aim" of transposing the new European architecture relating to fiscal rules and procedures into Portuguese law.

At the same time it is an important step for *"Creating an institutional basis for public finance sustainability"*, a project that the Ministry of Finance launched in October 2012 and is described in Appendix 1 to the *State Budget Report for 2013*. However in that project the government states its intention to, "in an extended horizon, yet to be defined, (…) propose a more comprehensive change to the BFL, so as to undertake its reorganisation and simplification, and thus bring its structure and contents closer to international best practice."

The CFP thinks that it is essential not to lose sight of the link between these two goals. In effect, experience of Portuguese public finance instability shows that up to now and despite introducing the rules defined by the European architecture, the BFL failed to incorporate into national principles, procedures and practices the provisions required to ensure compliance. This point is even more important since what is at stake is not just the international commitment – which is irrefutably important – but also the suitability of the entire national fiscal policy framework to ensure its ability to perform stably it's given functions[2] and which constitute a cornerstone of both society's well-being and of confidence in the economy. Up to now, particularly in the macroeconomic area, the Portuguese budgetary framework has lacked a well-defined link between the annual budget and the multiannual framework required to provide genuine substance to the goals of economic stabilisation and public debt sustainability. If these goals are frustrated then the functions relating to income redistribution and provision are also jeopardised.

The Portuguese legislation principles and procedures that call for a revision include the setting of clear rules as to the drawing up, scope and outturn of the annual budget, in a medium-term framework that sets realistic and efficient rules for correcting observed deviations. This requires a comprehensive, transparent and timely report on annual outturn, together with regular monitoring of developments that affect achievement of medium-term goals.

[1] Opinion presented to the Portuguese Parliament's **Committee on Budget, Finance and Public Administration**, at the invitation of its Chairperson.

[2] Functions relating to resource allocation, income distribution and macroeconomic stabilisation as per the Musgrave classification.

The experience of several countries has shown that anchoring the budgetary balance rule in a wide ranging, realistic and practical spending rule is an important step in achieving compliance with it in both the short- and medium-terms. In effect, the structural balance rule governs the progress in the budgetary balance, but compliance with it can only be checked *a posteriori*, very often after a significant delay, since it sets out to correct the effects of cyclical economic development. On the other hand the value of revenue which depends heavily upon economic growth, cannot be directly set by the budget, but merely influenced by decisions taken in regard to tax rates or changes to the tax system. Expenditure, on the contrary, responds to a wide change of discretionary decisions, useful to timely correct deviations that may jeopardise compliance with the balance rule. Therefore a clear, realistic expenditure rule that is observable in real time and includes explicitly and precisely defined safeguard clauses, is key to ensure fulfilment of commitments made. At the same time, it makes an important contribution to the removal of deficit bias, which casts doubts upon fiscal policy's ability to act as a macroeconomic stabiliser.

The current multiannual framework is not anchored in any expenditure rule and a rule of this nature is not a specific requirement of the new European architecture. However, Directive 2011/85/EU of 8 November 2011 clearly lays down that:

> *<u>Each Member State shall have in place numerical fiscal rules</u> which are specific to it and which effectively promote compliance with its obligations deriving from the TFEU in the area of budgetary policy over a multiannual horizon for the general government as a whole. Such rules shall promote in particular:*
>
> *(a) compliance with the reference values on deficit and debt set in accordance with the TFEU;*
>
> *(b) the adoption of a multiannual fiscal planning horizon, including adherence to the Member State's medium-term budgetary objective.*
>
> (Our emphasis).

Thus bearing in mind the above reasoning and the empirical evidence that has been widely analysed[3], both the proper defining of the multiannual budgetary framework and the introduction of an expenditure rule plus the mechanisms required to monitor and enforce it, should be priorities in the fundamental reform of the Portuguese Budgetary Framework Law proposed by the Ministry of Finance. Appendix 1 to Budget Report 2013 refers, in some detail, to matters that are to be dealt with in a more comprehensive reform of the BFL, and covers many of the points raised here. The CFP applauds the intention, recognises the need for an extended horizon to fulfil it and states its willingness to take part in the debate over this project, within the scope of its powers. To that end the CFP's Report no. 3/2012 already

[3] The relevant quotes can be found in CFP Report nº 3/2012 on the Draft State Budget for 2013, available at http://www.cfp.pt/publications/analysis-of-the-draft-state-budget-for-2013/?lang=en

contains a set of suggestions for improving the Portuguese legislation and the Council is currently preparing a Report on this topic.

II. Bill 124/XII

The present review (Bill 124/XII) has a more urgent and therefore more modest goal: that of "transposing the new European architecture relating to fiscal rules and procedures into Portuguese law". Bearing in mind what was said earlier in regard to the need to adjust national rules and procedures, that transposition is necessarily incomplete and in the main seeks to set out principles laid down in the European architecture that should guide the future reform, while at the same time it aims to correct flaws that have already been detected and may be remedied. We offer some observations on the current Bill along these lines.

<table>
<tr><th>Bill 124/XII</th><th>Comment</th></tr>
<tr><td colspan="2">Article 10-G
Public debt limit</td></tr>
<tr><td>1- When the ratio of the public debt to gross domestic product (GDP) exceeds the 60% reference value, the Government shall reduce any excessive public debt, at a rate of one twentieth per year calculated as an average over 3 years.</td><td>The applicable European legislation – Stability and Growth Pact and article 4 of the Treaty on Stability, Coordination and Governance in the EMU – includes a safeguard that has been omitted in the current proposals, namely:
… the Government shall reduce any excessive public debt at a rate of one twentieth per year <u>as a benchmark</u>, calculated as an average over 3 years (Our emphasis)
Whilst the desire for greater rigour is understandable, given the Portuguese situation, this dependens more upon the introduction of national legislation governing the necessary requirements (see above) than upon the formulation of the principle. We therefore believe that the safeguard laid down in the European legislation should be retained, and at the same time a pledge should be made to introduce those requirements in the next review of the BFL.</td></tr>
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Conselho das Finanças Públicas
Portuguese Public Finance Council

<table>
<tr><th>Bill 124/XII</th><th>Comment</th></tr>
<tr><td colspan="2">Article 10-H
Structural budgetary balance rule</td></tr>
<tr><td>3- The structural balance, which corresponds to the general government budgetary balance defined in accordance with the European System of National and Regional Accounts, <u>corrected for cyclical effects and net of extraordinary measures</u>, <u>may not be less than the goal set annually in the Stability and Growth Programme</u>.</td><td>General Observation:
The Budgetary Treaty[4] begins with the statement (Article 3, no. 1):
a) The budgetary position of the general government of a Contracting Party shall be balanced or in surplus.
In the Portuguese legislation this basic principle should also precede the points covering the structural balance that are instrumental to it.

Second observation:
The current Article 12-C, which is not amended, contains a different definition of the structural balance:
1- The general government budget balance, defined in accordance with the European System of National and Regional Accounts, <u>corrected for cyclical effects and temporary measures</u>, may not be less than the medium-term objective. (Our emphasis)
The expression “extraordinary measures” is not an established definition. It appears to be more wide reaching than “temporary measures” (including for example one-off measures), but it should be defined. In addition we believe it would be appropriate to use a single concept for structural balance in the one law.

Third observation:
In regard to the structural deficit limit the Bill refers to the limit set annually in the Stability Programme. However, the Budgetary Treaty refers to the medium-term objective and also establishes a quantitative limit. Therefore a wording more in keeping with the Treaty would be:

The structural balance (…) may not be less than the medium-term objective<u> as defined </u>in the <u>Stability and Growth Pact</u>, <u>with a lower limit of a structural deficit of 0.5 % of the gross domestic product at market prices.</u></td></tr>
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[4] Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

Bill 124/XII	Comment
	Fourth observation: Although it will not apply to Portugal in the near future, this article should include an additional subparagraph, with a wording equivalent to that of Article 3 (1) (d) of the Budgetary Treaty: *Where the ratio of public debt to gross domestic product at market prices is significantly below 60 % and where risks in terms of long-term sustainability of public finances are low, the lower limit of the medium-term objective specified under point (b) can reach a structural deficit of at most 1.0 % of the gross domestic product at market prices.* **Fifth observation:** Article 12-C could be revoked as it contains provisions similar to, but not entirely coincidental with, those of 10-H. Its revocation would require the aforesaid amendment to be made to paragraph 3 of article 10-H (medium-term objective)
Current Article 12-I **Portuguese Public Finance Council**	
	In order to reflect the provisions added to the Bill, it is necessary to amend this article. We suggest the following wording for paragraph 1: *An independent body is set up, the Portuguese Public Finance Council, whose mission is to give its opinion as to the proposed goals in the light of the macroeconomic and fiscal scenarios, <u>the</u> long-term sustainability of public finance, compliance with the structural budgetary balance rule, laid down in articles <u>10-H</u> and 12-C, <u>the deviation correction mechanism, laid down in article 72-C</u>, <u>recognition of exceptional circumstances, laid down in article 72-D, compliance with</u> the central government spending rule, laid down in article 12-D, <u>compliance with the provisions of paragraph 5 of article 10-H</u> and the indebtedness rules for autonomous regions and local authorities as laid down in the respective financing laws.*

Bill 124/XII	Comment
Article 17-A Interest payments and public debt amortisation	
2. To ensure financial stability and protect the Portuguese Government's international reputation, interest payments and public debt amortisation are deemed priority.	We consider the reasoning given to be valid but feel it also applies at the national level. Therefore we suggest the word "international" be deleted.
Article 72-B Significant deviation	
2- For the purposes of the previous paragraph the observed value shall be calculated on the basis of the data contained in the excessive deficit procedure notice issued by the National Statistics Institute.	We suggest the following additional wording: *For the purposes of the previous paragraph the observed value shall be calculated on the basis of the data contained in the excessive deficit procedure notice issued by the National Statistics Institute <u>and of the method laid down in paragraph 4 of article 10-H</u>.* Points to be included in the future review should cover: • who calculates the deviation, the output gap and the cyclical component of the budgetary balance; • who identifies the "extraordinary measures".
Article 72-B and C Identification and correction of deviations	
Article 72-B 5- Recognition of the existence of a significant deviation shall fall to the government, following consultation of the Portuguese Public Finance Council, or to the European Council, through a recommendation addressed to the government under the terms of article 6 (2) of	Principle 7 of Communication from the Commission COM(2012) 342 final, of 20.06.2012, states: *[Role and independence of monitoring institutions] Independent bodies or bodies with functional autonomy acting as monitoring institutions shall support the credibility and transparency of the correction mechanism. These institutions would provide public assessments over: the occurrence of circumstances warranting the activation of the correction mechanism; of whether the correction is proceeding in accordance with national rules and plans; and over the occurrence of circumstances for triggering, extending and exiting escape clauses. <u>The concerned Member State shall be obliged to comply with, or alternatively explain publicly why they are not following the assessments of these bodies.</u> The design of the above bodies shall take into account the*

Bill 124/XII	Comment
Council Regulation (EC) No.1466/97, of 7 July. Article 72-C 5- The Government shall submit the correction plan to the Portuguese Public Finance Council for evaluation.	*already existing institutional setting and the country-specific administrative structure. National legal provisions ensuring a high degree of functional autonomy shall underpin the above bodies, including: i) a statutory regime grounded in law; ii) freedom from interference, whereby the above bodies shall not take instructions, and shall be in a capacity to communicate publicly in a timely manner; iii) nomination procedures based on experience and competence; iv) adequacy of resources and appropriate access to information to carry out the given mandate.* (Our emphasis). The inclusion of these principles, in addition to matching the express guideline in the Communication, would enhance fiscal policy transparency and the usefulness of the provisions of this review of the BFL.
Amendments concerning the multiannual framework	
	Positive points: • *Introduction of the planned policies description and the assessment of the impact on the long-term sustainability of public finance* • *Inclusion of forecasts for general and own revenues which improves transparency* However the setting of the multiannual framework remains inadequate: • *The contradiction between the 4–year binding limits (nº 5) and the annual revision in the State Budget Law (nº 3, renumbered) remains* • *The definition of general government expenditure covered by upper limits is still a partial definition and the information provided by the accounting criterion used (cash flows) prevents the type of monitoring that would allow timely correction of deviations* • *A deviation from the limits does not call for a compulsory correction, but merely a communication to Parliament.*

In short, in regard to the principles and practices that the multiannual framework of budgetary planning must obey, the current proposals do not appear to adequately transpose article 10 of Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member-States, which specifies that:

> *Annual budget legislation shall be consistent with the provisions of the medium-term budgetary framework. Specifically, <u>revenue and expenditure projections and priorities resulting from the medium-term budgetary framework</u> as set out in Article 9(2) <u>shall constitute the basis for the preparation of the annual budget. Any departure from those provisions shall be duly explained.</u>*
>
> (Our emphasis)

Bearing in mind the poor results up to now of Portuguese fiscal policy, stemming from the lack of a well-defined link between the annual budget and the multiannual framework, this remains an essential point to be taken into account when reforming the BFL under the *"Creating an institutional basis for public finance sustainability"* project.