Conselho das Finanças Públicas
Portuguese Public Finance Council

Analysis of the Draft State Budget for 2013

Report by the Portuguese Public Finance Council

No. 3/2012

November 2012

The Portuguese Public Finance Council was set up by the Budget Framework Law (Law no. 22/2001 of 20 August, with the wording given by Law no. 22/2011 of 20 May) and its Statutes were approved by Law no. 54/2011 of 19 October. The Council's mission is to conduct an independent assessment of the consistency, compliance with the stated objectives and the sustainability of public finances, while promoting fiscal transparency, so as to contribute to the quality of democracy and of political economic decisions and so strenghten the State's financial credibility.

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Executive Summary

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The Portuguese Public Finance Council's (CFP) analysis of the Draft State Budget focuses on the extent to which it fits into a corrective course for public sector indebtedness leading to the sustainability of Portuguese public finances. This includes two equally essential vectors: control over public debt and restructuring of the economy in order to promote stable growth.

Portugal has tended to produce optimistic budget forecasts and make use of temporary and one-off measures so as to facilitate the achievement of budget deficit targets. This approach delays the introduction of indispensable reforms, thereby increasing the strain of adjustment and raising the associated costs, eventually leading to loss of confidence in the process.

Currently the CFP is not in a position to produce alternative macro-fiscal forecasts to those published by the government. However, the available indicators suggest that the macroeconomic forecast that underlies the Draft State Budget for 2013 (SB/2013) remains optimistic and may underestimate the effects of budgetary measures, in particular on the expectations of economic agents, which impact upon private consumption, investment and employment. It should also be noted that the macroeconomic forecasts under the Economic and Financial Assistance Programme (EFAP) have also tended to be revised downwards.

As regards the fiscal forecast, even the results for 2012 are as yet a simple estimate, while the complete data will only be known at the end of the first quarter of 2013. The fiscal forecasts for 2013 do not explicitly incorporate the effects of the significant risks listed in detail in the SB/2013 Report. Neither is specific consideration given to other risks stemming from the difficulty in assessing the budgetary impact of the tax changes and the uncertainty related to the decrease of disposable income and, more importantly, of permanent income.

SB/2013 is the first, albeit incomplete and far from transparent, application of the multiannual framework laid down in the budget framework law (BFL). As such, it shows that the rule as formulated allows for the multiannual framework approved by Parliament in the spring not being binding even for the budget proposed in the autumn, meaning that it does not provide for effective medium-term control over expenses. Therefore further steps are required to improve the legislation in a number of fields, including the possible introduction of an expenditure rule to strengthen the credibility of the structural balance rule laid down in the BFL.

In contrast to the forecast in the Fiscal Strategy Document of April 2012 (FSD/2012), 2012 turned out a difficult year for Portuguese fiscal policy. Compared to 2011, revenue is now expected to fall by 4.4 percentage points (p.p.) of GDP, largely due to less reliance on temporary and one-off measures, which increased revenue by 4 p.p. of GDP in 2011. The government responded to the negative change in revenue by reducing expenditure by more than planned at the beginning of 2012. It now expects to cut expenditure by 3.8 p.p. of GDP (compared to the 1.4 p.p. forecast in FSD/2012) by the end of 2012. However, 0.8 p.p. of the additional cuts in 2012 relate to temporary and one-off measures, in particular revenue from concessions (which are subtracted from other capital expenses), as in the as yet unconfirmed case of ANA (the Portuguese airport operator).

One important implication of the Draft SB/2013 is the fact that the primary fiscal balance remains negative in 2012 and 2013, leading to rises in the public debt ratio versus the original projections. According to the October revision of the EFAP, the maximum projection for this ratio reaches 123.7% of GDP in 2013 (vs. 115.3% in the July revision), remaining practically stable (123.6%) in 2014 and falling to 118.4% in 2016.

On average, over the four years from 2013 to 2016, the forecast public debt ratio exceeds the previous projection (published in April during the course of the 3rd regular review of the EFAP) by 8.4% of GDP. Such rise will increase interest payments in subsequent periods, thus putting additional pressure on the fiscal adjustment by increasing the level and rigidity of future expenditure. This confirms the need for the fiscal strategy goals to be met, in particular as regards overall and primary fiscal deficits in 2014 and subsequent years.

Portugal has recently experienced very negative debt dynamics. Taking into account the forecast in the Draft Budget, over the five year period from 2008 to 2013, the debt ratio will increase by 52 p.p. of GDP. The main contributor to this rise was the unfavourable dynamic relationship between the rate of interest and the rate of output growth (21.3 p.p. of GDP), followed by the impact of persistent primary deficits (15.6 p.p. of GDP) and deficit-debt adjustments (15.1 p.p. of GDP).

Since there is little leeway in this field, the CFP suggests that, in order to safeguard the goal of recovering public finance sustainability in the near future, it would be advisable to maintain the expenditure ratio targets set in FSD/2012.

From 2010 to 2012 approximately half of the fall in the overall fiscal balance reflects the effects of temporary measures and special factors. These figures show the dependence on adjustments based heavily on short-term measures that cannot be expected to guide economic agents' expectations and reduce the uncertainty as to the policy stance. Clearly what matters in terms of borrowing are the non-adjusted figures. However, analysis of the quality of the adjustment, based on the adjusted data, shows the need to adopt permanent instead of temporary and one-off measures.

The breakdown of the planned fiscal adjustment, after adjusting for temporary measures, one-off measures and special factors, shows that 61.9% of the adjustment from 2010 to 2013 is based on revenue side measures. On the expenditure side, the structural adjustments to current expenditure make practically no contribution to the forecast adjustment in the overall fiscal balance, given that the rise in interest payments almost completely offsets the reduction in primary current expenditure.

The fiscal policy stance continues to have a negative impact on domestic demand, since it reflects the need to correct the country's high level of indebtedness, which has eliminated any fiscal room for manoeuvre and removed space for adopting a countercyclical policy stance. Not only would an increase in the deficit be unfinanceable, but such an approach would worsen the public debt ratio, with the interest payments absorbing the illusory benefit of the stimulus. Worse still, this illusion would continue to delay efforts to redirect the economy to the tradable goods sector, a development that is under way, as shown by the

solid performance of exports, but which needs to be pursued and strengthened in order to bring about a stable improvement in the standard of living of the Portuguese.

The CFP offers some suggestions aimed at reinforcing the medium-term course of Portuguese fiscal policy and also improve public expenditure governance by increasing its efficiency, enhancing its efficacy and ensuring compliance with an effective expenditure rule. International experience calls for unmistakable and sustained political involvement in this type of exercise and underlines the role of communication and transparency in the process, along with the participation of those concerned by the changes, all critical steps in ensuring the support of stakeholders and the general public.

1 INTRODUCTION

Since 2010 Portugal has seen its room for manoeuvre severely constrained by the debt dynamics inherited from decades of debt accumulation, aggravated since the beginning of the millennium by the mediocre rate of growth of the economy. Faced with the change in the financial market sentiment towards risk in general and the Euro Area in particular, Portugal must restore credibility in its solvency if it is to recover and maintain full and normal access to market financing. This calls for a reversal of the debt dynamics and implies several necessary conditions for a change in the fiscal regime:

(i) a credible phase of fiscal consolidation, predominantly front-loaded, establishing the commitment to a new attitude and a long-term vision concerning public finance management;

(ii) the design and implementation of permanent measures addressing the need to correct the rigidity and increase the efficiency of public expenditures, an area that requires more time and a high degree of political consensus and commitment, essential to ensure a sustainable consolidation;

(iii) measures to adjust the tax system, making it simpler, more stable and reliant on non-distortionary taxes, and taking full account of the international constraints in which it will have to operate;

(iv) structural measures addressing the need to provide a more competitive environment for investment and sustained growth.

By nature, in its early phase, the adjustment tends to rely primarily on revenue increases and across-the-board expenditure cuts. This was the case in Portugal in 2010/12 and was accepted as an unavoidable step on the way to stabilisation.

However, this first phase should be brief, as otherwise it turns into austerity without a purpose and loses credibility and public support. It therefore requires that, from the beginning, the government concentrates on studying, discussing with social and political partners, and implementing the measures of a more structural nature that will bring about the desired adjustment. The emphasis on structural reform is also critical in public finances, where fiscal consolidation must go hand in hand with adopting properly designed fiscal rules, an enforceable medium-term expenditure framework applied to all subsectors of general government, and reforming public expenditure management.

This must start with the adoption of an effective and enforceable budget framework, leading to long-term fiscal sustainability. International experience suggests that, to be reliable, such a framework needs to be approved by a qualified Parliamentary majority. In Portugal, since 2010 some progress was made concerning the Budget Framework Law, with the introduction of expenditure ceilings in the context of a multi-year budget framework. However, in its May report[1], the CFP pointed out some of the shortcomings that still require improvement in this area. Since then, well into the second year of the adjustment program, such shortcomings have become more visible.

[1] CFP (2012a).

As mentioned in the CFP May Report,

> *A critical ingredient to a successful fiscal adjustment strategy, especially in countries that need to reverse a severe loss of confidence in financial markets, is the signalling of a paradigm shift by the government in terms of the restructuring of expenditure and tax policies, as well as in reforming the fiscal policy framework. Signalling policy commitment must, of course, be underpinned by high standards of transparency.*

As explained then, a new fiscal framework should ensure a stronger enforcement of appropriately designed fiscal rules and a higher degree of transparency and comprehensiveness of binding expenditure ceilings. These points have not until now figured in the political debate. The same is true of progress on public expenditure management, requiring a number of subsidiary reforms, e.g. concerning financial accounting and reporting, as well as the establishment of a spending review type of mechanism to rationalise the allocation of resources across expenditure areas, as a basis for improving efficiency and setting viable and effective expenditure ceilings.

The delays in these areas, together with the effect of optimistic forecasts that underestimated the impact of the first phase of consolidation on economic growth and employment, made the preparation of the 2013 budget a very demanding task. Again, the CFP May Report mentioned that a reliable fiscal strategy depends on the quality of the macro-fiscal forecast, stressing that how credible a fiscal strategy is depends critically on how well the forecasts are reasoned and explained. This point is dealt with in the CFP Note no. 1/2012[2], published with this Report.

According to the Fiscal Strategy Document analysed in the CFP May Report, 2013 should be the year when most of the fiscal adjustment started being based on the spending side. We advised then that *even more important than the extent and speed of the fiscal consolidation, is the quality of the adjustment. A lasting adjustment that incorporates cuts in non-productive outlays and increases in non-distortionary taxes has been found to help public debt sustainability, directly by improving the budget balance, and more important, indirectly by contributing to economic growth. Empirical evidence implies, for example, that instead of cutting or compressing government wages across the board, governments should rationalize the public work force by cutting red-tape and training and reallocating civil servants to more productive employment.* We observe, however, that the budget proposal continues to rely heavily on revenue increases, this time based primarily on raising personal income tax rates.

The experience of 2012 proved disappointing in what concerned reliance on revenue increases. The VAT and other indirect tax revenue is now expected to fall considerably short of the original forecast. The indirect negative impact on economic activity and employment was clearly underestimated in that case. The forecasts were rendered more difficult by the amplitude of the adjustment, the changes in rate structures and the possible effect on tax evasion, despite the efforts on the part of the tax administration, though probably also impaired by the non-discriminating nature of the expenditure cuts. There is reason to believe that similar effects will take place in 2013, even if these cannot be estimated with any degree

[2] CFP (2012c).

of precision. Most important, however, are the harmful effects this course change can have on confidence on the overall effectiveness of the measures used to bring about the required adjustment.

This being said, it is important to stress that what is at stake is not simply trading revenue increases for stopgap expenditure cuts. As mentioned above, the efforts needed to effectively change the debt dynamics and restore credibility imply deep and lasting structural reforms. Other countries experience suggests that these require the adoption, by a qualified political majority, of properly designed fiscal rules, an enforceable medium-term expenditure framework, with wide institutional coverage, together with effective methods of public expenditure management.

This Report is organised as follows: section 2 deals with the macroeconomic and macro-fiscal forecasts underlying the budget proposal for 2013 (SB/2013); section 3 analyses issues concerning the structural balance and temporary and one-off measures, a point that must precede the analysis of the fiscal stance; section 4 assesses the current budget proposal against the strategy laid out in the government's Fiscal Strategy Document and the benchmarks set out in the Economic and Financial Assistance Programme (EFAP), also taking into account the commitments derived from the new European strategy in this area; section 5 presents some principles and experiences with respect to the definition of fiscal rules and public expenditure planning and management.

2 MACRO-FISCAL FORECASTS UNDERLYING THE BUDGET

In the Council's opinion an analysis of the State Budget should focus on the extent to which it is consistent with a corrective path for public sector indebtedness leading to the sustainability of Portuguese public finances. The high public debt ratio and its deterioration, as a result of both high budget deficits and weak economic performance over the last decade, have made this variable a priority and a key constraint on economic policy. This point is reinforced by a number of factors: firstly the private sector is also highly indebted; secondly the nation's debt was mainly financed by foreign creditors; thirdly the public debt risk perceived by the markets extends to the private debt risk, thereby increasing the level and cost of borrowing for the Portuguese economy, to the detriment of its competitiveness; fourthly, notwithstanding the important pension system reform undertaken in 2007 and the later adjustments, the ageing of the population will continue to put pressure on pension and health spending, magnified in the latter case by the technological progress in the sector.

It is clear that the debt ratio priority includes two equally essential vectors: control over public debt and restructuring of the economy in order to promote stable growth. As the CFP underlined in its Report no. 1/2012[3], which assessed the fiscal strategy for the five year period 2012-2016, a budgetary framework appropriate to this context should adopt a forward looking approach, including the drawing up of multi-annual budgets and compliance with precisely defined, comprehensive spending ceilings subject to continuous and transparent monitoring. These themes will be taken up again in the next sections of the report. Furthermore, in order to fit in with this strategy, the annual budgets should be based on prudent forecasts, both at the macroeconomic level and as regards the budget projections they give rise to and interact with.

The optimistic bias of macro-fiscal forecasts puts fiscal consolidation in jeopardy, to the extent that these forecasts serve as a basis for defining policies which appear to match the desired goal but eventually prove to be unsuitable. A benign interpretation of this type of development can be applied in the short-term, accepting the failure to reach the target as the result of one-off factors beyond the government's control, and justifying the adoption of temporary measures to fill the gap without changing the fiscal stance. However, the continued reliance on optimistic forecasts and temporary measures aimed at formal compliance with the set target eventually makes clear that it is the actual policy stance that is in question and requires correction, especially when reversal of the debt trend is the main goal.

However it must not be forgotten that macro-fiscal forecasts are particularly precarious in times of fast fiscal and structural adjustment, at the national and international level. There is a high risk of both over- and underestimating the impact of budget consolidation measures or the international framework. If it is overestimated, the resulting scenario may prove to be too distressing, undermining confidence in the country's ability to undertake the proposed adjustment, and even bringing about social or political disruption that prevents its completion; in other words, pessimistic forecasts may undermine the probability of success of the budget adjustment.

[3] CFP (2012a).

On the other hand, if the economic impact of the fiscal adjustment is underestimated, the targets will not be met. In fact optimistic forecasts tend to give rise to a vicious circle: the monitoring of results becomes more lenient since the situation is expected to improve with time; however, when it becomes clear that that is not the case, new restrictive measures of the same type become imperative, the impact of which continues to be underestimated. This risks bringing about a long-lasting contractionary spiral inherent in this vicious circle. In addition to the associated economic and social burdens, such a procedure reduces confidence in the adjustment program's ability to restore economic growth and the sustainability of public finance. On top of this, optimistic forecasts lead to the adoption of temporary or one-off measures that delay the adjustment and may themselves contribute to a loss of confidence.

Naturally the preferred method is to opt for a realistic pre-assessment of the impact of the adjustment measures, but the risks of underestimating the impact of such measures must always be borne in mind. On the one hand this should lead to a more cautious pre-assessment of the program's realism and possibly to its improvement; on the other, it favours continuous and rigorous monitoring.

As the following section shows Portugal has tended to produce optimistic budget forecasts and make use of temporary and one-off measures so as to facilitate the achievement of budget deficit targets. In this way the fiscal stance is not corrected as desired, which calls for the maintenance – or even the reinforcing – of austerity measures required to ensure the country's financing while it fails to consolidate confidence in its long-term solvency.

In this context short-term stimulus measures would be counterproductive: since they require additional funding, they would be impractical or would worsen the debt ratio, leading to a further loss of confidence in the economy's solvency. Therefore only a structured budget consolidation and management program, in parallel with measures that ensure a stable climate that favours investment and economic activity, may bring about the desired economic and employment upturn, under conditions that also guarantee creditor confidence and, consequently, stable financing. In other words, when creditor confidence is undermined, the option of delaying or slowing consolidation does not exist. Rather the solution lies in speeding it up through credible spending and taxation reforms that improve economic prospects and public governance. Resorting to optimistic macro-fiscal forecasts is a doomed attempt to give the budget consolidation a swifter and easier appearance. In practice the delaying of indispensable reforms only prolongs and increases the costs.

It is not only Portugal that needs to change its stance in regard to the forecasts underlying fiscal policy. At the EU level, that change was set out in the guidelines in Directive 2011/85/EU, of 8 November 2011[4] in which article 4 states:

> 1. *Member States shall ensure that fiscal planning is based on realistic macroeconomic and budgetary forecasts, using the most up-to-date*

[4] EU (2011).

information. Budgetary planning shall be based on the most likely macro-fiscal scenario or on a more prudent scenario. […]

[…]

6. *The macroeconomic and budgetary forecasts for fiscal planning shall be subject to regular, unbiased and comprehensive evaluation based on objective criteria, including* ex post *evaluation. The result of that evaluation shall be made public and taken into account appropriately in future macroeconomic and budgetary forecasts. […]*

In Portugal, the CFP is legally *responsible for evaluating the macroeconomic scenarios adopted by the government and the consistency of budgetary projections with those scenarios* — Law no. 54/2011, of 19 October, article 6 (a). The Council is currently organising the technical means essential to the task, but as yet it is not in a position to produce alternative macro-fiscal forecasts to those published by the government[5]. However the available indicators suggest that the macroeconomic forecast that underlies the Draft State Budget for 2013 (SB/2013) is optimistic, and may underestimate the impact of budgetary measures, in particular on the expectations of economic agents which impact upon private consumption, investment and employment. The budget forecasts reinforce this optimism in a number of ways.

— Firstly, the estimate of the budget outturn in 2012 is not guaranteed, and will only be known at the end of the first quarter of 2013; therefore the figures currently available do not cover an important part of the year, in which revenue (in particular VAT revenue) may be negatively impacted by the possible deterioration in consumer expectations.[6] Clearly a poor degree of execution in 2012 will reflect unfavourably upon 2013.

— Secondly, these forecasts do not express the impact of the major risks that the SB/2013 Report itself lists extensively - a positive change that should be welcomed.

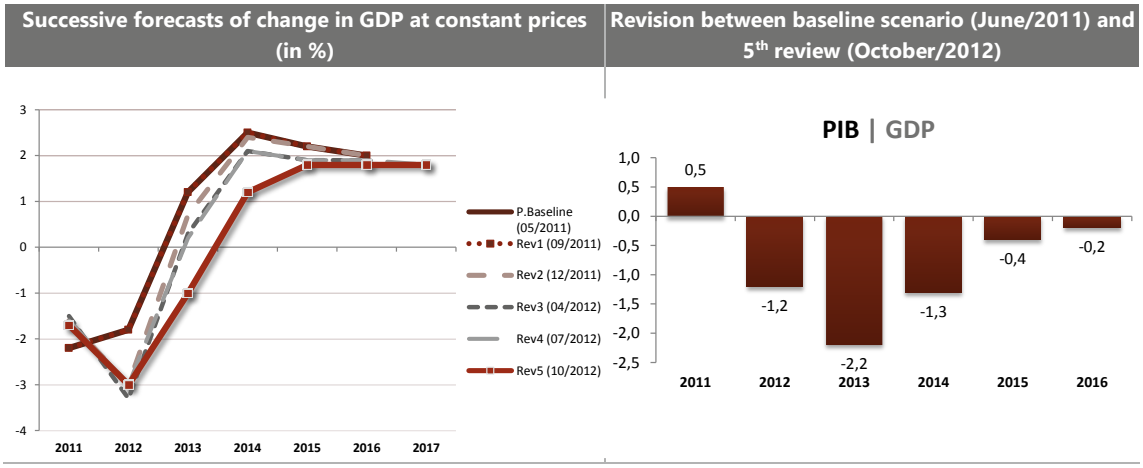
— Finally, they do not explicitly consider other risks stemming from the difficulty in assessing the budgetary impact of the tax rate hike, the changes to the tax bands, and the uncertainty associated with the reduction in disposable income and, more important, in permanent income. As stated at the outset, while the Council recognizes that some of these factors are very difficult to quantify, it is nonetheless forced to conclude that the SB/2013 scenario does not reveal the degree of prudence which would be appropriate in the light of the earlier considerations.

[5] The preparation of this type of forecasts is a complex task that calls for highly specialised human resources. Their recruitment and subsequent work on collecting and processing information and designing suitable models for the Portuguese economy is a time-consuming task, even more so as there is no precedent in Portugal, under the terms required by the CFP. See CFP (2012c) for a description of the type of work these forecasts require.

[6] The adjusted cash method used to compute revenues in the national accounts means that ¾ of the net VAT revenue (from the cash standpoint) for January and February 2013 are relevant to 2012 revenues. Therefore the level of 2012 revenues in the national accounts is partly contingent on macroeconomic developments, in particular consumption, which extend into the first two months of 2013.

This conclusion is reinforced by an examination of the change in the forecasts contained in the Economic and Financial Assistance Programme (EFAP). In fact, we find that GDP growth forecasts for 2012 to 2015 have been repeatedly revised downwards as compared to the assistance programme baseline scenario (Chart 1).[7] The sharpest revision relates to 2013. For that year the baseline scenario predicted growth of 1.2%, while the latest forecast is a decrease of 1%. The forecasts for 2012 and 2014 were also revised significantly downwards (over 1 percentage point).

Chart 1 – Assistance Programme Forecasts

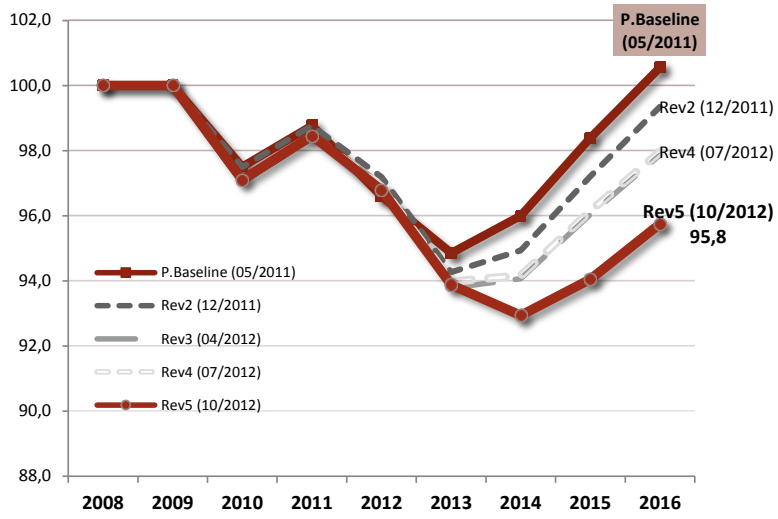


Source: IMF (Country Reports no. 11/127, 11/279, 11/363, 12/77, 12/179 and WEO October 2012).

As a result of these revisions, according to the latest IMF forecast, the Portuguese economy's real output in 2016 will still be 4.2% lower than the pre-crisis level (2008), while the program's baseline scenario estimated it would exceed this level (Chart 2).

Chart 2 – Cumulative change in GDP as per successive Assistance Programme forecasts

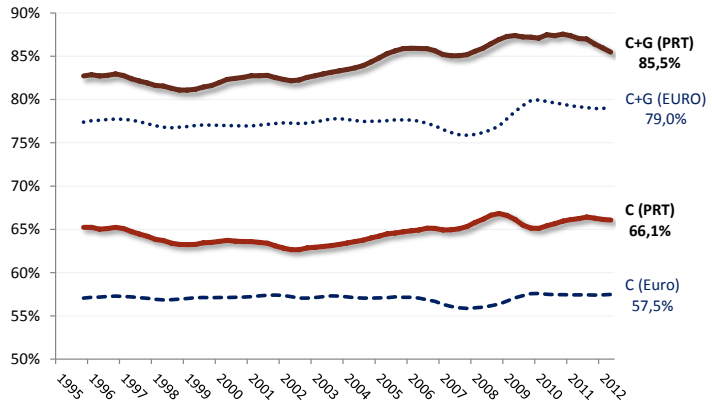
(at constant prices, 2008=100)



[7] The exception was 2011 when growth was higher than expected.

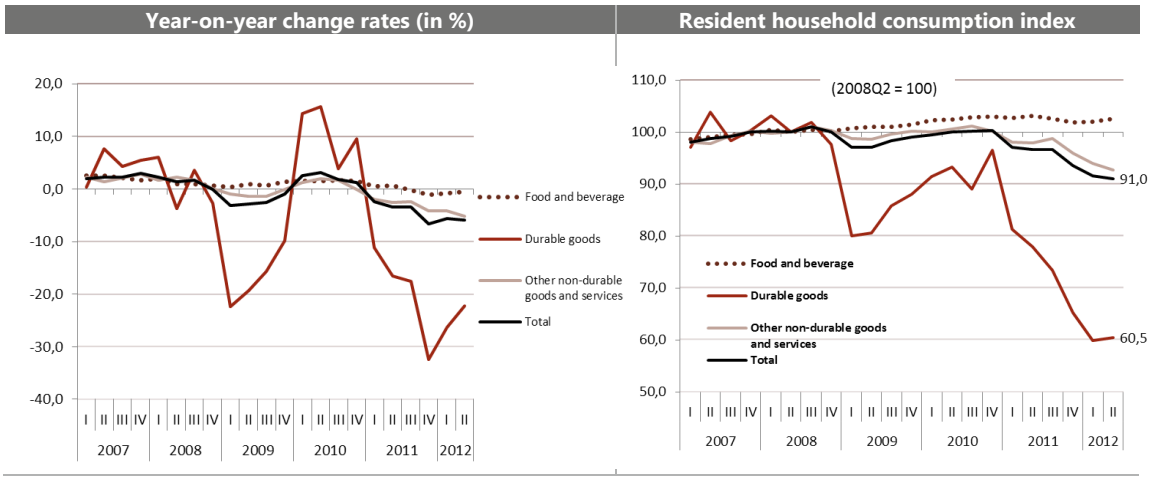
As for macroeconomic developments, from the 1st quarter of 2011 we find a significant adjustment in the Portuguese economy's external borrowing requirement which over the twelve months ending in the 2nd quarter of 2012 totalled 2.2% of GDP whereas in the middle of 2008 it stood at around 12% of GDP. That adjustment stems from the drop in domestic demand and in imports, and also from the positive contribution of exports (Chart 4 to Chart 6). Chart 3However it should be stressed that, despite the fall in private consumption of durable goods, the relative weight of private and total consumption in total expenditure is clearly above the average for the euro area (Chart 3).

Chart 3 – Relative weight of private consumption and public consumption in GDP, Portugal and the euro area



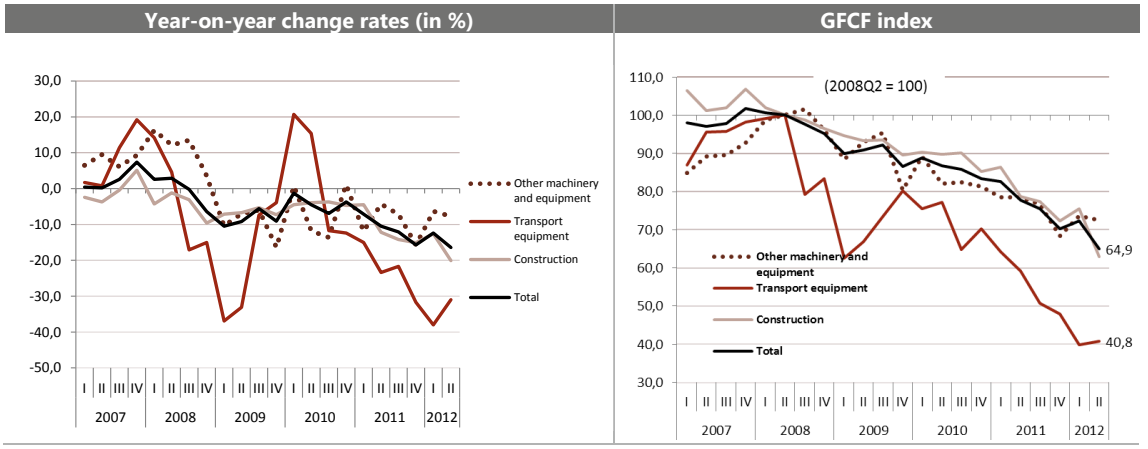
Source: Eurostat. | Notes: C refers to private consumption and G to public consumption.

Chart 4 – Resident household consumption



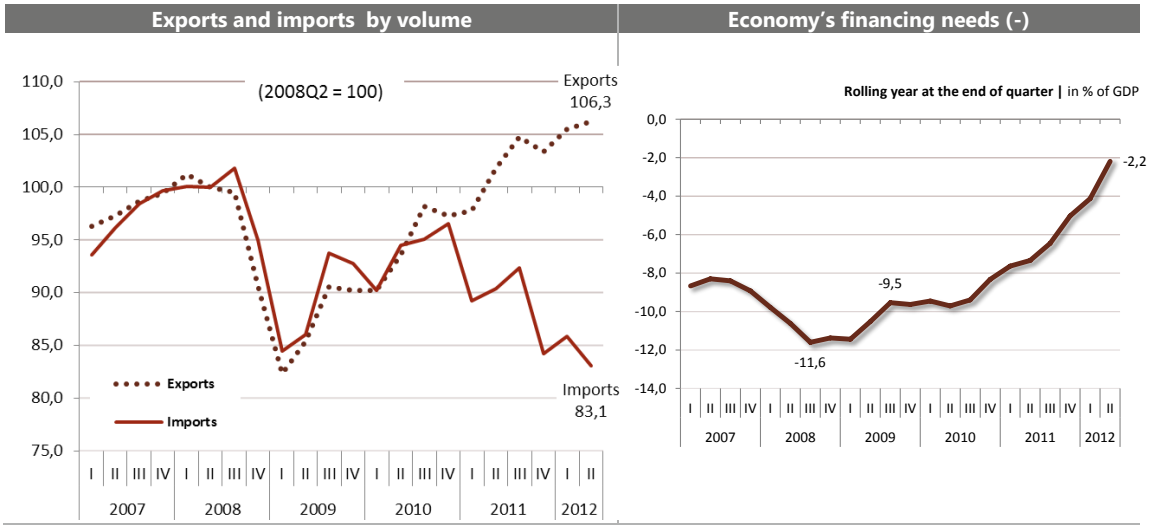
Source: INE, quarterly national accounts for September 2012. Resident household final consumption expenditure – chain linked volume data (reference year =2006).

Chart 5 – Gross Fixed Capital Formation (GFCF) Components



Source: INE, quarterly national accounts for September 2012. Gross fixed capital formation – chain linked volume data (reference year=2006). | Note: selected components.

Chart 6 – Exports, imports and Portuguese economy's financing needs



Source: INE, quarterly national accounts for September 2012. For exports and imports, chain linked volume data (reference year=2006); economy's financing needs at current prices, expressed in percentage of GDP at current prices, 4 period rolling average, which corresponds to the twelve months ending in the reference quarter.

3 FISCAL POLICY ANALYSIS

As will be seen later, a significant part of the budget aggregate adjustment has been based on short-term or unrepeatable operations. To allow for a correct evaluation of the fiscal stance, both in 2013 and since the beginning of the adjustment process in 2010, the following sections seek to identify those operations and show how they have impacted the main budget aggregates. Therefore this section aims at identifying and quantifying the so-called temporary measures and one-off measures and comment upon the fiscal policy stance.[8] The analysis below shows it would be appropriate to improve the definitions of these operations and take into account a third category that we call special factors. The section begins by showing the part they play in the difference between observed balances and structural balances, bearing in mind the increasing attention European Union Member States must pay to the overall structural fiscal balance. Having made the distinction, we move on to assessing the fiscal policy stance set out in the Draft SB/2013.

3.1 FROM THE OBSERVED BALANCE TO THE STRUCTURAL BALANCE

Both the Portuguese State's international obligations and national legislation call for a budget balance rule defined in structural terms.[9] The structural balance corresponds to the observed budget balance (on a national accounts basis), adjusted for the effects of the business cycle and the temporary measures and one-off measures.[10]

The structural balance is not directly observable, and must be estimated. In that process there are two critical stages: i) the cyclical adjustment method; and ii) the identifying of temporary measures and one-off measures.

The cyclical adjustment is a complex calculation that calls for an estimate of the economy's potential output and the application of revenue and public expenditure sensitivity parameters to estimate the output gap. The methodology commonly accepted within the European Union employs a production function to obtain the potential output, which leads on to the estimate for the output gap. That calculation is the object of revisions that have been particularly significant in recent times. So it is difficult to obtain a good estimate for the

[8] The official translation of the Stability and Growth Pact into Portuguese refers to one-off measures as extraordinary ("extraordinárias", as per Council Regulation (EC) no. 1466/97 of 07/07/1997, in consolidated version of 13/12/2011). The CFP prefers the expression "one-off" ("não recorrentes") or "unrepeatable" ("irrepetíveis") since the adjective "extraordinary" brings an ambiguity which hinders the analysis.

[9] In keeping with the provisions of the Stability and Growth Pact, article 12-C (1) of the Budgetary Framework Law (BFL) requires that "the budgetary balance of general governments, defined pursuant to the European System of National and Regional Accounts, corrected for cyclical effects and temporary measures, shall not be less than the medium-term objective", from 2015 onwards. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) states that the budgetary position of the general government of a Contracting Party, as in the case of Portugal, shall be balanced or in surplus, and this rule shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0.5% of gross domestic product at market prices. At the same time there must be swift convergence towards the medium-term objective.

[10] This is the legal definition adopted in the European Union — see. Article 3 (3) (a) of the TSCG. Attention is drawn to the fact that the BFL uses a different definition, that omits the exclusion of "one-off" measures (see footnote 9 above).

output gap in real time.[11] This difficulty, common to all methodologies, is compounded under the current circumstances of the Portuguese economy, where there is great uncertainty as to how the potential output components will develop.

As the Council is not yet in a position to produce its own estimate of the output gap, this Report uses the Finance Ministry's estimate, together with the EU method of calculating the cyclical component of the budgetary balance. Therefore the figures shown for the structural balance in this Report should not be construed as the Council's estimate.

Identifying the temporary measures and one-off measures is also essential to calculating the structural balance. The so-called *code of conduct*[12] on the implementation of the Stability and Growth Pact defines temporary and one-off measures as *measures having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position*. Generally speaking they are measures with no permanent effect, designed to reduce the budget deficit. As the European Commission has stated,[13] the economic literature suggests that resorting to this type of measure, which can improve the deficit position for a lower immediate political cost, tends to be more prevalent in countries with high deficits and weaker, less transparent budgetary frameworks.

The aim of calculating the structural balance is to find the budget balance that would be observed if the economy was performing at its potential level and excluding the effects of fiscal policy measures that have no permanent impact on public sector borrowing requirements, so as to be able to observe the underlying trend in budgetary developments. Therefore the adjustment for temporary measures and one-off measures should ensure that measures that lower the deficit in a purely transitory (or temporary) manner are not interpreted as if they were structural measures. However, the opposite risk also arises, i.e. the risk of classifying as temporary measures operations that increase the deficit permanently. Accordingly the identifying of temporary and one-off measures should take a prudent approach in regard to all types of measures that increase the budget deficit. Thus the aforesaid European Commission document advocates the general rule that no measures which increase the deficit should be excluded from the fiscal effort calculation. Exceptions to this asymmetric criterion may only be considered when there is a high degree of certainty as to the transitory or unrepeatable nature of those operations, as is the case with expenditure resulting from natural disasters or other exceptional circumstances, or the costs of legal decisions (or European Commission decisions).

In Portugal, recent years have been marked by the existence of a large number of operations of a temporary or one-off nature with significant budgetary impact. Among these the most important examples are the transfer to the State of ownership of Portugal Telecom's pension fund assets (1.6% of GDP in 2010) and those of credit institutions (3.5% of GDP in 2011), in return for taking on future liabilities in regard to the pensioners concerned, as well as the

[11] These revisions stem from the need to use forecasts relating to several variables (such as the level of employment, the investment rate, working population, participation rate, hours worked) in order to be able to smooth out the series and thereby minimise the problem of end-point bias.

[12] European Commission (2012).

[13] European Commission (2006), (Part II, Chap. 4).

income from various concessions, including that of the airport operator ANA, Aeroportos de Portugal, yet to be confirmed by the statistical authority (0.7% of GDP in 2012).[14]

In addition, very recent years were marked by a series of other large scale operations that tended to increase the budget deficit. Many of those operations have been classified as temporary or one-off, in the context of European Union fiscal policy surveillance procedures. This was the case with the delivery of submarines, various statistical reclassifications and the capital operations relating to the Madeira region, among others. In the Council's opinion, however, these transactions, which increase the public sector deficit momentarily, are not measures of a "temporary or one-off" nature. They are simply large scale operations that do not occur regularly, and for this reason affect the progress of public finance aggregates and influence their respective analysis. These operations are classified in this Report as "special factors", whose correction makes it possible to analyse each year's fiscal stance more directly, although it would not be correct to eliminate them when calculating the structural balance.[15] Table 1 provides a list of the effects taken into account.

Table 1 – Temporary measures, one-off measures e special factors (2010-2012

In % of GDP	2010	2011	2012
Temporary & one-off measures *(impact on b. balance)*	**1,7**	**4,0**	**1,1**
Revenue side	**1,7**	**4,0**	**0,3**
Transfer of pensions funds	1,6	3,5	0,1
Taxes on repatriation of capitals	0,0		0,1
PIT surcharge of 3.5% on 2011 taxable income		0,5	0,1
Expenditure side	**0,0**	**0,0**	**-0,8**
Proceeds from concessions	-0,1	0,0	-0,2
Concession of ANA - airports			-0,7
One-off payment to the EU Budget (due to revision of GNI series)	0,1		0,1
Special factors *(impact on budget balance)*	**-2,8**	**-1,2**	**0,0**
Expenditure side	**2,8**	**1,2**	**0,0**
Delivery of submarines	0,5		
BPN, BPP capital expenditure	1,3	0,4	
Reclassification of PPP into general governmt.	0,4	0,1	
Recording of Madeira region debt	0,6		
Madeira capital operations (SESARAM & recl. Via Madeira)		0,3	
Madeira region- debts from program-contracts & to football clubs		0,1	
Reclassification of support fund to health service		0,3	
Temporary, one-off and special factors	**-1,1**	**2,9**	**1,1**

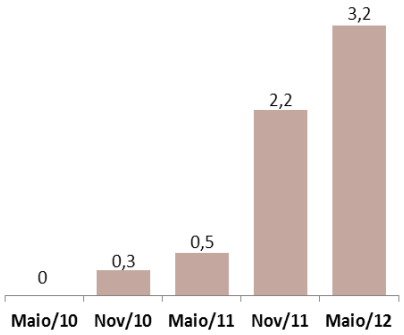
[14] It should be stressed that in the national accounts revenue from concessions is set against other capital expenditure, thus contributing to a reduction in the recorded expenditure.

[15] The Council's approach in this field is similar to that of the Bank of Portugal in its Board of Directors Report 2011, which held that special factors were "transactions that affect the public sector deficit momentarily but which under the Eurosystem definition may not be treated as temporary measures". Temporary measures include factors that have a positive or negative impact on the budget balance, but a cautious approach is taken to classifying measures that contribute to its deterioration.

Note: Comma is used as the decimal separator. Totals do not necessarily match the differences of the GDP percentage values due to rounding.
Sources: INE, Finance Ministry, Bank of Portugal.

Non-permanent operations tend to occur late in the fiscal year when it becomes clear that the budget targets will not be met without resorting to additional deficit reduction measures. A good example is 2011, since the European Commission only managed to identify the majority of the temporary measures and one-off measures for that year in the spring of 2012. A year earlier the forecast was 0.5%; this forecast was revised to 2.2% in the autumn of 2011 and to 3.2% in May 2012 (Chart 7). Thus the list set out in Table 1 is still provisional, in particular as regards 2012. The SB/2013 Report identifies no operation of this type in 2013.

Chart 7 – Change over time of EC estimate of temporary measures in 2011 (% of GDP)



3.2 FISCAL POLICY STANCE

As stated above, the change in the headline budget balance in Portugal since 2010 has been greatly marked by the impact of temporary measures and special factors ().[16] The year 2011 is a fine example in this respect: the improvement in the overall fiscal balance (headline balance) was 5.4 percentage points (p.p.) of GDP; however, temporary measures and one-off measures totalled 4 p.p. of GDP. Therefore, even after discounting the effect of special operations that had a positive impact on the deficit, the improvement in the balance adjusted for total non-permanent operations was 1.4 p.p. of GDP.

However, the use of temporary measures or one-off measures does not bring a permanent improvement to the fiscal balance and in practice only transfers to subsequent year(s) the adjustment that was not permanently achieved. An example of this is the correction estimated for 2013. Since the estimate for the 2012 balance is based on the use of temporary measures valued at 1.1 p.p. of GDP, to achieve an improvement of 0.5 p.p. of GDP in the headline deficit requires an improvement of 1.6 p.p. in the deficit adjusted for temporary and one-off measures (which shows us the true fiscal effort).

Table 2 – Budget indicators

	% of GDP						Annual change (p.p. of GDP)				
Budget balance	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2009**	**2010**	**2011**	**2012**	**2013**
Primary (EDP)	-0,6	-7,3	-7,0	-0,4	-0,8	-0,2	-6,7	0,4	6,6	-0,4	0,6
Actual (headline), EDP	-3,6	-10,2	-9,8	-4,4	-5,0	-4,5	-6,5	0,3	5,4	-0,6	0,5
Adjusted of temporary & one-off measures	-4,7	-10,2	-11,5	-8,4	-6,1	-4,5	-5,4	-1,3	3,0	2,3	1,6
Adjusted of temporary & one-off measures & special factors	-4,4	-10,2	-8,7	-7,3	-6,1	-4,5	-5,7	1,5	1,4	1,1	1,6
Cyclically adjusted	-3,7	-8,9	-9,2	-3,3	-3,1	-2,5	-5,2	-0,3	5,9	0,2	0,6
Structural	-4,7	-8,9	-10,8	-7,3	-4,2	-2,5	-4,1	-2,0	3,5	3,1	1,7
Structural net of special factors	-4,5	-8,9	-8,0	-6,1	-4,2	-2,5	-4,4	0,9	1,9	2,0	1,7
Structural primary	-1,7	-6,1	-8,0	-3,3	0,0	1,8	-4,3	-1,9	4,7	3,3	1,8
Structural primary net of special factors	-1,5	-6,1	-5,2	-2,1	0,0	1,8	-4,6	0,9	3,1	2,2	1,8
memo items											
temporary measures	1,1	0,0	1,7	4,0	1,1	0,0	-1,1	1,7	2,4	-2,9	-1,1
special factors	-0,3	0,0	-2,8	-1,2	0,0	0,0	0,3	-2,8	1,6	1,2	0,0
temporary measures e special factors	0,8	0,0	-1,1	2,9	1,1	0,0	-0,8	-1,1	4,0	-1,7	-1,1
output gap (M. Finance)	0,1	-2,8	-1,4	-2,5	-4,3	-4,5	-2,9	1,4	-1,1	-1,8	-0,2
cyclical component*	0,0	-1,3	-0,6	-1,1	-1,9	-2,0	-1,3	0,6	-0,5	-0,8	-0,1
interest payments (EDP)	3,0	2,8	2,9	4,0	4,2	4,3	-0,2	0,0	1,2	0,2	0,1

Notes: Comma is used as the decimal separator. The changes do not necessarily match the differences of the GDP percentage figures due to rounding. *The cyclical component was calculated using the EU methodology and the Finance Ministry's output gap estimate. In 2008 temporary measures corresponded to concessions, and the depreciating of the REN tariff deficit was deemed a special factor.

Sources: INE, Finance Ministry and Bank of Portugal. CFP calculations.

[16] The change in the structural balance figures is highly influenced by operations that tend to increase spending in 2010 and 2011, such as the support for Banco Português de Negócios (BPN) and Banco Privado Português (BPP), the submarine delivery, the statistical reclassifications relating to the Madeira region, among others. For this reason the structural balance net of these effects (special factors) is also given.

Recent changes in public debt, shown in Table 3 and Chart 8, have revealed a very unfavourable trend. Taking into account the forecast in the SB/2013, over the five year period from 2008 to 2013, the debt ratio will increase by 52 p.p. of GDP. The main contributor to this rise is the unfavourable dynamic relationship between the rate of interest and the rate of output growth (21.3 p.p. of GDP), followed by the impact of persistent primary deficits (15.6 p.p. of GDP) and deficit-debt adjustments (15.1 p.p. of GDP).[17]

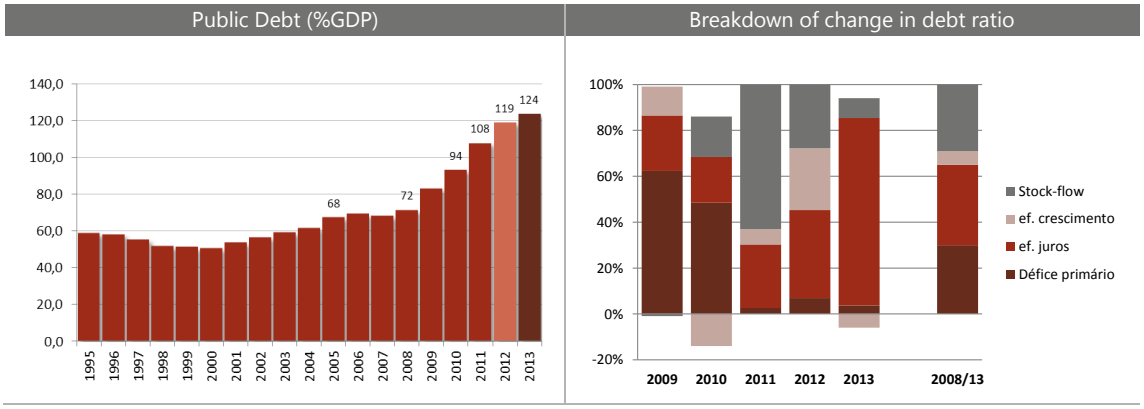
The dynamic effect, also known as the snowball effect, arises from debt accumulated in the past. This effect is unfavourable when the (nominal) implicit interest rate in public debt exceeds the (nominal) GDP growth rate. In such cases the very existence of an accumulated stock of debt causes the GDP debt ratio to rise automatically.[18] As stated previously, from 2008 to 2013 that effect will be unfavourable every year. On the contrary whenever economic growth exceeds the debt interest rate there is a favourable dynamic effect leading to a fall in the debt to GDP ratio. Thus, it is necessary to regain credibility so that interest rates may fall, as well as promote (structural) reforms that drive growth.

Table 3 – Debt and change in debt

	2007	2008	2009	2010	2011	2012	2013	2008/13
Public debt (% of GDP)	**68,4**	**71,7**	**83,2**	**93,5**	**108,1**	**119,1**	**123,7**	**52,0**
Change in debt (in p.p. of GDP)	**-1,1**	**3,3**	**11,5**	**10,3**	**14,5**	**11,0**	**4,6**	**52,0**
Primary deficit	0,2	0,6	7,3	7,0	0,4	0,8	0,2	15,6
Dynamic effect (snow ball eff.)	-0,5	2,0	4,3	0,9	5,0	7,2	4,0	21,3
- interest effect	2,9	3,0	2,8	2,9	4,0	4,2	4,3	18,2
- growth effect	-3,5	-1,1	1,5	-2,0	1,0	3,0	-0,3	3,1
Stock-flow adjustment (residual)	-0,7	0,7	-0,1	2,5	9,2	3,1	0,5	15,1

Note: Comma is used as the decimal separator.
Sources: INE, Finance Ministry and Bank of Portugal. CFP calculations.

Chart 8 – General government debt



Note: Comma is used as the decimal separator.
Source: INE, Bank of Portugal and Finance Ministry. CFP calculations.

[17] In 2011 the change in general government deposits resulting from receipt of sums released under the assistance programme explains 6.2 p.p. of the total adjustment. In 2012 the purchase of financial assets involving holdings in financial sector capital and contingent capital stood at 4 p.p. of GDP.

[18] This gives rise to the term snowball effect. When the dynamic effect is unfavorable, the increase in the debt's relative weight in GDP in a given year is greater than the budget deficit for that year, expressed as a percentage of GDP.

The size of the unfavourable dynamic effect forecast for 2013 illustrates the harmful effects of public debt accumulation, resulting from persistent budget imbalances and poor economic growth. In 2013, even if the primary balance were achieved, the debt ratio would automatically rise to 4 p.p. of GDP. Based on the SB/2013 scenario, for stabilising the public debt ratio in 2013, it would be necessary to generate a primary surplus of 4.4% of GDP, which, coupled with interest charges (4.3% of GDP), would require an overall budgetary surplus of 0.1% of GDP, compared to the expected deficit of 4.5%.

The budget options in a particular year are not independent of the choices made in the past, nor are they indifferent to decisions to be taken in the future. The public debt is the link between budget options in different time periods, acting as an intertemporal budget constraint. A budget deficit corresponds to a borrowing requirement, which in turn means a rise in debt. While for its part public debt accumulation increases the level and rigidity of future spending by precommiting the value of interest charges, reducing fiscal leeway and the ability to finance other spending.

4 THE DRAFT STATE BUDGET FOR 2013 IN THE FISCAL STRATEGY CONTEXT

In April 2012 the government defined a new medium-term strategy for consolidating public finance. Therefore it makes sense to examine how the Draft SB/2013 fits in with the multi-annual framework of fiscal planning that is part of that strategy. This section fulfils that purpose and then looks at the implications of the SB/2013 for the implementation of the medium-term strategy, in particular the adjustments required in subsequent years.

4.1 THE DRAFT STATE BUDGET FOR 2013 AND THE MULTI-ANNUAL FRAMEWORK OF FISCAL PLANNING

The multi-annual framework of fiscal planning was approved by Law no. 26/2012, of 31 July, following the Fiscal Strategy Document for 2012-2016 (FSD/2012). In its Report no. 1/2012 published in May, the Council underlined the importance of that strategy and the need to reverse the practice common to previous Stability Programmes which, every year, ignored previous commitments and perpetuated optimistic forecasts for the final years of each programme and thus repeatedly put off the structural measures required to achieve budget consolidation. The Report also praised the country's adoption of a medium-term budgetary framework. However, it also called attention to certain flaws in the current rules governing the medium-term budgetary framework, as well as in its first application when advanced as part of the procedure for executing FSD/2012 and the corrective Budget for 2012. The inadequacy of these rules became clearer when Draft SB/2013 was presented.

The multi-annual framework of fiscal planning is set out in article 12-D of the budgetary framework law (BFL).[19] This framework requires the definition of the general government spending financed by general revenues, pursuant to the targets laid down in the Stability Programme. According to this guideline the spending ceilings set by the fiscal planning are binding during the first subsequent economic year [the year relating to the next Budget or year t+1); those set for programme groupings by policy area for year t+2; and those set for all programmes combined for years t+3 and t+4. Therefore total general government spending by programmes, financed by general revenues, is subject to binding ceilings for the four subsequent economic years.[20] As stated in the Council's May Report, the flaws in this definition include the partiality of State spending covered by the upper limits and the accounting criteria used (cash flows).

The effective spending ceilings for the period 2013 to 2016 approved by Law no. 28/2012, of 31 July, correspond to the first implementation of the multi-annual framework of budgetary planning, and those relating to the period 2014 to 2016 are recommendations (and not binding)[21]. The Law allows budget changes to take into account organic alterations, "without prejudice to the retention of annual spending levels".[22] Accordingly, it was to be expected that Draft SB/2013 would abide by the spending ceiling set for 2013.

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[19] The BFL was approved by Law no. 91/2001, of 20 August, amended and with the wording given by Law no. 52/2011, of 13 October. The multi-annual framework also complies with the provisions of article 2 of Minsterial Order (*Portaria*) no. 103/2012, of 17 Abril.

[20] Paragraph no. 5 of article12-D of the BFL.

[21] *Vide* article 2 of Law no. 28/2012, of 31 July.

[22] *Vide* article 3 of Law no. 28/2012, of 31 July.

However, article 170 of the SB/2013 Bill[23] raises by 2,066 million euros the limit laid down in Law no. 28/2012, of 31 July, replacing the appendix approved by that Law — see Table 4. This legislative change makes use of the prerogative set out in article 12-D (3) of the BFL, which allows the multi-annual framework for the four years subsequent years to be updated annually in the State Budget Law .

The raising of the spending ceiling by 4.7% (2,066 million euros) stems mainly from the increase in the solidarity and social security programme limit, as well as from across-the-board factors relating to civil servants pay (such as restoring one allowance).[24]

Table 4 – General government spending ceilings financed by general revenues (cash flows)

	Appendix to Law no. 28/2o12				Article 170 of PPL no. 103 XII				Revision for 2013	
	2013	2014	2015	2016	2013	2014	2015	2016	M€	Rel.
P001 - Sovereign bodies	2.824				2.868				44	1,6%
P002 - Governance and Culture	221				222				1	0,5%
P005 - Foreign Representation	312				319				7	2,2%
P008 - Justice	646				679				33	5,1%
Sovereignty Grouping	**4.003**	**3.676**			**4.087**	**3.676**			**84**	**2,1%**
P006 - Defence	1.778				1.843				65	3,7%
P007 - Internal Security	1.725				1.827				102	5,9%
Security Grouping	**3.503**	**3.497**			**3.669**	**3.497**			**166**	**4,7%**
P011- Health	7.546				7.841				295	3,9%
P012- Basic & Secondary Education & School Administration	5.077				5.232				155	3,1%
P013 -Science & Higher Education	1.208				1.262				54	4,5%
P014 - Solidarity & Social Security	6.683				8.871				2.188	32,7%
Social Grouping Subtotal	**20.514**	**20.139**			**23.205**	**20.139**			**2.691**	**13,1%**
P003 - Finance & Public Administration	7.485				6.874				-611	-8,2%
P004 - Public Debt Management	7.551				7.276				-275	-3,6%
P009 - Economy & Employment	165				160				-5	-3,0%
P010 - Agriculture, Sea & Environment	407				422				15	3,7%
Economic Grouping Subtotal	**15.608**	**16.379**			**14.732**	**16.379**			**-876**	**-5,6%**
Program Groupings	**43.628**	**43.691**	**44.761**	**46.320**	**45.694**	**43.691**	**44.761**	**46.320**	**2.066**	**4,7%**
Annual change, program groupings	n.d.	0,1%	2,4%	3,5%	n.d.	-4,4%	2,4%	3,5%	:	:

Notes: Comma is used as the decimal separator, and the point as the thousand separator. According to the DGB, the 2012 figures do not include 1500 M€ for payments in arrears in the Health field; the figures for the Finance and Public Administration Programme and the total for economic functions do not include the provisional allocation.

Also, as shown in Table 4, the recommended ceilings for 2014 to 2016 were not revised, which automatically implies a nominal cut of 4.4% in total central government expenditure financed by general revenues in 2014, when previously it was expected to remain at the same level.

Thus we conclude that the first application of the multi-annual framework actually shows that the BFL allows for the multiannual framework approved by Parliament in the spring not being

[23] Bill no. 103/XII/2.ª.

[24] According to the Draft SB/2013 the increase in the social security programme stems from the greater flows from the State Budget to Social Security under the Social Emergency Programme (SEP), from the exceptional transfer from the SB to finance the Social Security deficit, as well as the accounting change for social VAT, which is now treated as a transfer from the State subsector, whereas up to 2012 it had been treated as Social Security consigned revenue.

binding even for the budget proposed in the following autumn; this means that it does not provide for effective medium-term control over expenses.[25]

The fact that the draft budget report does not even mention the 2013 ceiling for general government expenditure financed by general revenues reveals the incomplete and less than transparent implementation of the multi-annual framework in the 2013 budget. This ceiling is only referred to in the aforesaid article 170 of the State Budget Bill. The report also does not include the 2012 estimate for the aggregate subject to the ceiling, nor any time series that illustrates the change in that aggregate and its correlation with expenditure on a national accounts basis. In addition, the budget outturn bulletins, published monthly by the Budget Directorate-General, (DGB), do not refer to the execution of general government expenditure financed by general revenues, which precludes the monitoring and external assessment of budget performance in this respect. Therefore, in general terms, progress needs to be made in order to improve the transparency of the implementation of the multi-annual framework.

As stressed in the Council's May Report, transparency matters inasmuch as it builds confidence and, ultimately, leads to the credibility of the government's commitment to the announced strategy. Furthermore, as recognised in the introduction to FSD/2012, *the medium-term framework is also an important benchmark for reducing the uncertainty among companies and households as to the future conduct of fiscal policy, allowing them to take better decisions and thus contribute to improving economic efficiency*.

Appendix A1 to the draft budget report recognises the need to change the "*paradigm as regards institutions, rules and procedures in the public finance field*", so as to ensure that budget outcomes do not differ from aims defined in a manner consistent with the medium- and long-term sustainability of public finance.[26] The same appendix also refers to the next edition of the multi-annual framework, to be approved in 2013, which will include improvements in the field baseline scenarios and in the detailed costing of policy measures.[27] Notwithstanding the importance of fulfilling these intentions, in the Council's view, the legislation requires a number of improvements in different fields so that the multi-annual fiscal planning can indeed constitute a *medium-term anchor for Portuguese public finance:*

- *Scope* – The spending ceiling should cover expenditure by all entities belonging to the general government, whatever the source of financing. And the conditions should exist for this ceiling to be defined on a national accounts basis.
- *Binding nature* – The spending ceilings approved by Parliament in the spring of each year should constitute binding restrictions on the budget negotiations held in the summer and autumn; the ceilings set for years t+2 to t+4 should preferably be binding, only being raised under duly justified exceptional circumstances (such as those the government cannot possibly foresee).

[25] In fact this was mentioned by UTAO in its analysis of the draft revision of the BFL «Article 12-D (3) does not appear to introduce any material limitation on the extent of the revision/updating, which is undertaken annually, over the four subsequent years, in the Budget Law (with the exception of the duty to comply with the targets of the Stability and Growth Program, which can also be unlimitedly revised annually).» See UTAO (2011).

[26] *Vide* p. 228.

[27] *Vide* pp. 240-1.

— *Transparency* – the credibility of multi-annual budget planning requires the timely and public disclosure of information that provides for the external assessment of compliance with the legal ceilings applying to the various expenditure aggregates. As the CFP stated in its Report no. 1/2012, *respect for communicating promises helps keeping stakeholders involved and engaged with delivering terms. Deviations from announced* ex ante *planning should be avoided and duly explained whenever they occur*.

— *Introduction of an expenditure rule* – an expenditure rule defined in a manner consistent with the structural balance rule would reinforce compliance with the latter. The structural balance rule regulates changes in the fiscal balance, without making a specific reference to revenues or to expenditures and seeks to correct the business cycle effect. This implies that compliance with the rule can only be checked *a posteriori*, sometimes after a considerable delay. On the other hand, revenues are strongly dependent on economic growth, and their value cannot be directly set in the budget, but merely influenced by decisions taken in regard to tax rates and changes to the tax system, including its efficiency. On the contrary, expenditure offers a wide range of discretionary measures that are useful in a process of budgetary stabilization and consolidation. An explicit expenditure rule, properly defined and including tightly worded safeguard clauses, may also contribute to timely monitoring of the budget rule. As the Council noted in its Report no. 2 on subnational public finance, an expenditure rule also has the advantage of providing a focus for public debate on these issues.

— *Scheduling of a transitional period until full implementation of the multi-annual framework* – the designing of a realistic multi-annual framework is a very demanding task and so, given the lack of experience in this field, a viable schedule for gradual implementation should be adopted, which clearly defines the various stages. The established schedule should be strictly adhered to or else credibility would be lost.

— *Definition of implementation details* – guarantee of consistency with the goals in national accounts; methodologies for preparing the baseline scenario and the costing of new measures; rules relating to the transfer of balances; rules relating to the incorporation of a safety margin and the setting of conditions to be met when there is a revenue shortfall or an increase in compulsory expenditure above a certain limit.

The current multi-annual framework is not anchored to any expenditure rule. However, as highlighted in the OECD's latest *Economic Survey* of Portugal (August 2012), an expenditure rule is one way of making the structural balance rule operational, since it provides for its compliance to be assessed against an observable target – spending - while the structural balance itself is not directly observable, but estimated, and the estimates are subject to significant revisions over time.[28]

[28] To quote the OECD (2012), "The framework could be better anchored and made more transparent by adding an expenditure rule for general government consistent with revenue projections and the deficit target and in line with the European fiscal framework. Such a rule would help to prevent the upward creep in spending that has characterised policy until recently and ensure that all general government spending is under control. Compliance is easily observed (unlike a structural deficit), and it would not be especially procyclical in that most automatic

The importance of anchoring spending changes is best understood when considering that the inability to meet the medium-term targets set for the fiscal balance in successive Stability Programme revisions is due, in the main, to expenditure exceeding the forecast figure.[29]

4.2 OVERALL EVALUATION OF THE MULTI-ANNUAL ADJUSTMENT STRATEGY

As the CFP mentioned in its May Report, successful fiscal adjustments, i.e. fiscal adjustments that last and enable successive governments to maintain the sustainability of public finances, depend critically on the strategy chosen to bring about the adjustment. Concomitantly, in the Portuguese case, a more immediate goal is that of restoring market access, an essential step in financing the economy's borrowing requirements.

The May assessment of the government's fiscal strategy for the period 2012-2016, based on data adjusted for temporary and one-off measures, noted that the strategy pointed in the right direction, opting for strong frontloading and focusing on a reduction in expenditure after the first two years of the programme, so that the total fiscal adjustment would eventually be based mainly on reduced government spending. Furthermore, the strategy aimed at primary surpluses from 2012, which were to be reinforced in the following years, and would contribute to restoring the sustainability of Portuguese public finances. Therefore it is important to assess to what extent the fiscal projections set out in the draft SB/2013 are consistent with the existing medium-term strategy.

Table 5 reports the fiscal developments since 2010. The upper panel shows the fiscal outturns for 2010 and 2011, the estimated outturn for 2012 according to the draft SB/2013 and the budgeted figures for 2013, all in percent of GDP. The last three columns of the upper panel give the fiscal developments as foreseen in the FSD/2012 for comparison. The lower panel of that table reports the fiscal outturns for 2010 and 2011 and the estimated outturn for 2012, all adjusted for temporary measures, one-off measures and special factors.[30]

2012 has turned out to be a difficult year for Portuguese fiscal policy. As Table 5 shows, current revenues fell short of projections even from the FSD/2012 of last April, the difference amounting to 2.3 p.p of GDP. Compared to 2011, revenues are now expected to fall by 4.4 p.p. of GDP. Comparing the upper and the lower panels of Table 5 shows that most of the difference is due to the large revenue effect of one-off measures in 2011, which increased government revenues by 4.0 p.p. of GDP. In terms of the adjusted figures, revenues are expected to fall by only 0.7 percent of GDP in 2012. The decline in revenues can be attributed partly to the economic recession, but also to structural changes during the current year, such as the shift of aggregate demand from domestic to foreign sources and the fact that exports do not generate VAT revenues.

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stabilisers work through the revenue side. Given the need to reduce both the deficit and the scale of government spending, such a rule would initially have to set expenditure growth below nominal GDP growth."

[29] As recorded in the CFP Report no. 1/2012, the real time deficit was, on average, higher than 3 percentage points (p.p.) of GDP for the last two years of Stability Programme projections. Most of this error is due to actual spending exceeding projected spending. On average in the 3rd and 4th years of the projection, actual spending exceeded the targets set in the Stability Programme by 2.3 and 3.5 p.p. of GDP, respectively, which is a very high overrun. *Vide* section 3.3.4 of said Report.

[30] See previous section for the measures stated therein.

The government responded to the negative revenue shock by cutting expenditures more than it had foreseen earlier in 2012, expecting a reduction in total government spending by 3.8 p.p. of GDP in 2012 (versus the 1.4 p.p. of GDP foreseen in the FSD). However, of the further reductions in 2012, 0.8 p.p. of GDP will be due to temporary and one-off measures.

With regard to 2013, the government expects to finish the year with total (current) revenues of 42.3 (41.7) per cent of GDP, against the 42.9 (41.6) per cent forecasted for that year in the FSD/2012 and the 40.6 (39.3) now expected for 2012. Total government spending for 2013 (46.8% of GDP) is 0.9 p.p. of GDP higher than foreseen in the FSD/2012[31] and 1.2 p.p. of GDP higher than the present estimate for 2012.

Table 5 —Budget aggregates, 2010 to 2014

(as percentage of GDP)

	INE		OE2013		DEO		
	2010	2011	2012	2013	2012	2013	2014
Valores não ajustados | *Headline figures*							
Receita Total | *Total revenue*	**41,4**	**45,0**	**40,6**	**42,3**	**42,9**	**42,9**	**42,8**
Receita corrente | *Current revenue*	38,7	40,5	39,3	41,7	41,6	41,6	41,5
Receitas de capital | *Capital transfers received*	2,7	4,4	1,3	0,6	1,4	1,3	1,3
Despesa Total | Total expenditure	**51,2**	**49,4**	**45,6**	**46,8**	**47,5**	**45,9**	**44,6**
Despesa Primária | *Primary expenditure*	**48,4**	**45,4**	**41,3**	**42,5**	**42,7**	**41,3**	**39,9**
Despesa Corrente Primária | *Current primary expend.*	42,7	41,4	39,5	40,4	39,7	38,6	37,5
Despesas de capital | *Capital expenditure*	5,6	4,0	1,8	2,1	3,1	2,7	2,4
Juros (PDE) | *Interest paid (EDP)*	**2,9**	**4,0**	**4,2**	**4,3**	**4,7**	**4,6**	**4,7**
Saldo global (PDE) | *General government balance (EDP)*	**-9,8**	**-4,4**	**-5,0**	**-4,5**	**-4,5**	**-3,0**	**-1,8**
Saldo Primário (PDE)| *Primary balance (EDP)*	-7,0	-0,4	-0,8	-0,2	0,2	1,6	2,9
Carga fiscal | *Tax burden*	31,3	33,0	32,3	34,2	33,9	33,9	34,0
Despesa corrente | *Current expenditure*	**45,6**	**45,4**	**43,7**	**44,7**	**44,4**	**43,2**	**42,2**
Valores ajustados | *Adjusted for one-offs & special factors*							
Receita Total | *Total revenue*	**39,7**	**41,0**	**40,3**	**42,3**	**42,8**	**42,9**	**42,8**
Receita corrente | *Current revenue*	38,7	40,0	39,2	41,7	41,5	41,6	41,5
Receitas de capital | *Capital transfers received*	1,1	0,9	1,1	0,6	1,3	1,3	1,3
Despesa Total | Total expenditure	**48,4**	**48,2**	**46,4**	**46,8**	**47,7**	**45,9**	**44,6**
Despesa Primária | *Primary expenditure*	**45,6**	**44,2**	**42,2**	**42,5**	**43,0**	**41,3**	**39,9**
Despesa Corrente Primária | *Current primary expend.*	41,9	41,3	39,4	40,4	39,7	38,6	37,5
Despesas de capital | *Capital expenditure*	3,7	2,9	2,7	2,1	3,3	2,7	2,4
Juros (PDE) | *Interest paid (EDP)*	**2,9**	**4,0**	**4,2**	**4,3**	**4,7**	**4,6**	**4,7**
Saldo global (PDE) | *General government balance (EDP)*	**-8,7**	**-7,3**	**-6,1**	**-4,5**	**-4,9**	**-3,0**	**-1,8**
Saldo Primário (PDE)| *Primary balance (EDP)*	-5,8	-3,2	-1,9	-0,2	-0,2	1,6	2,9
Carga fiscal | *Tax burden*	31,2	32,5	32,2	34,2	33,8	33,9	34,0
Despesa corrente | *Current expenditure*	**44,8**	**45,3**	**43,7**	**44,7**	**44,4**	**43,2**	**42,2**

Note: Comma is used as the decimal separator.

Sources: INE; Report on Draft State Budget/2013; Fiscal Strategy Document of April 2012 (FSD) and data used to quantify temporary measures, one-off measures and special factors in that Report.

Notes: Totals do not necessarily match the sums of GDP percentage values due to rounding. In order to achieve maximum possible methodological consistency, in the case of FSD figures, the adjustment for the impact of temporary measures, one-off measures and special factors does not take into account measures that only became known after the Fiscal Strategy Document of April 2012 was made public and for that reason could not be included therein. Such is the case with, in 2011, debts relating to programme contracts and to Madeira football clubs, the reclassifying of the NHS support fund (identified in the DSB of September 2012); and in 2012, the one-off payment to the EU and the ANA, aeroportos de Portugal concession.

[31] This is due to the fact that the reduction foreseen for expenditure is smaller than the downward revision in nominal GDP, while in absolute values budgeted expenditure in 2013 decreases by 376 million of euros vis-à-vis the FSD.

Compared to the May CFP Report, differences arise in the way temporary and one-off measures are classified so as to be consistent with the classification employed in this Report.

Although the government has so far not changed the 2014 budgetary targets laid out in the April FSD, the most recent update of the Memorandum of Understanding of the EFAP (published on October 14), foresees a deficit target of 2.5% of GDP for 2014. This would require a reduction in the deficit to GDP ratio of 2.0 percent of GDP relative to 2013. Returning in 2015 to the adjustment path laid out in the FSD/2012, which specified a deficit target of 1 percent of GDP for that year, would then make a further deficit reduction by 1.5 percent of GDP necessary. On the basis of the projections for total government revenues in 2013 (as per SB/2013) and 2014 (as per FSD/2012), this would require a further (mild) increase in total revenues relative to GDP between 2013 and 2014, which seems compatible with the expectation of a return of the Portuguese economy to positive growth rates in the second half of 2013 and beyond. However, it would also imply a stronger reduction in total expenditures (0.9 p.p. of GDP) than foreseen in FSD/2012, resulting in a reduction of the budget deficit larger than the one foreseen in the FSD (2.7% of GDP instead of 1.8%). Hence, the combination of fiscal slippage on the revenue side of the budget during 2012 with the budgeted increase in spending in 2013 over the current year leads to further fiscal contractions in 2014 and 2015, if the government remains committed to the targets beyond 2014 laid out in its FSD of last April.

An important implication proposed in the 2013 budget is that the primary balance will remain negative in 2012 and 2013, implying larger increases in the public debt to GDP ratio than originally foreseen. This will change the level at which the public debt ratio will peak (123.7% of GDP in 2013 according to the 5th EFAP Review, issued in October 2012, against 115.3% in the July review). The debt ratio is forecasted to be practically flat at 123.6 percent in 2014 and to decrease to 118.4 percent in 2016. On average over the four years from 2013 to 2016, public debt will be about 8.4 percent of GDP higher than foreseen in April in the 3rd ESAP Review. This increase in debt will lead to an extra interest burden on the economy in subsequent years, putting additional pressure on the fiscal adjustment and confirming the need to comply with the fiscal strategy goals, in particular the overall and the primary deficits in 2014 and beyond.

Deficits exceeding these objectives would push the stabilisation of the debt ratio further out in time and make it more difficult to achieve. Given the absence of much leeway left in that direction, the CFP concludes that, in order to safeguard the goal of regaining sustainability of public finances in the near future, it is advisable to stay with the ratio of total public spending to GDP set in the government's FSD/2012. This demonstrates the importance of the fiscal targets laid out in the Spring, in the annual FSD, being subject to a parliamentary decision and regarded as binding for the following year's budget proposal, as recommended by the CFP in its May Report. Furthermore, it confirms the need for a binding and comprehensive expenditure rule, together with the necessary means to enforce compliance.

Comparing the upper and the lower panels of Table 5 reveals the importance of one-off measures and special factors in the fiscal adjustment. Thus, in 2011, of the increase in total revenues by 3.6 p.p. of GDP, only 1.3 p.p. of GDP came from structural measures and cyclical effects. 65.3 percent of the fiscal adjustment on the revenue side thus came from non-permanent measures. In 2012, this number is 83.7 percent. On the expenditure side, 91.3 of

the adjustment in 2011 and 51.2 percent of the adjustment in 2012 will be due to non-structural measures.[32] These figures show the dependence on adjustments based heavily on short-term measures that cannot be expected to guide economic agents' expectations and reduce the uncertainty as to the policy stance.

Table 6 shows the breakdown of fiscal adjustments since 2010. The upper panel of the table considers the actual adjustment for 2011, the adjustments for 2012 and 2013 as foreseen by the draft SB/2013, as well as the composition of the adjustments as foreseen by the FSD published in April. The lower panel looks at the composition of the structural adjustments in 2011, 2012 and 2013, all compared to 2010. For example, of the improvement in the total budget balance of 5.4 percent of GDP between 2010 and 2011, 3.6 percent of GDP came from the increase in revenues relative to GDP and this amounts to 65.8 percent of the total adjustment. Considering the quality of the total fiscal adjustment over the period from 2010 to 2013 as implied by the draft SB/2013, 17.1 percent would come from the revenue side and 82.9 percent from the expenditure side, using headline figures. Compared with international experience, this combination would make a successful consolidation likely. A critical aspect, however, is that the adjustment on the spending side is primarily based on cutting capital expenditure, which contributes 66.4 percent to the total adjustment. A careful evaluation of these cuts should assure that they do not compromise the future development of productivity and potential output of the Portuguese economy.

Turning to the breakdown of the planned fiscal adjustment in terms of structural measures, however, provides a quite different impression. As the lower panel of Table 6 indicates, 61.9 percent of the total structural adjustment over the 2010-2013 period is based on revenue measures. On the expenditure side, structural adjustment of current spending contributes almost nothing to the planned fiscal adjustment, since the contribution of the reduction in current primary expenditure is offset by the increase in interest payments, which almost cancels out the reduction in current primary expenditure. Comparing the adjustments for 2010-2012 and 2010-2013 indicates a reversal of the government's strategy, with a return to a predominantly revenue-based adjustment.

Our analysis, based on 2010, the year the adjustment programme began, makes clear the importance expenditures classified as special factors had that year. As stated earlier these expenses were effectively incurred, were large and infrequent in nature. Any analysis which failed to correct for their impact would overstate the spending cuts in subsequent years. This correction therefore allows us to better assess the cut in regular expenditure, which will have a sustained effect over time.

[32] Generally, from 2010 to 2012 approximately half of the fall in the overall fiscal balance reflects the effects of temporary measures and special factors.

Table 6 — Breakdown of fiscal adjustment

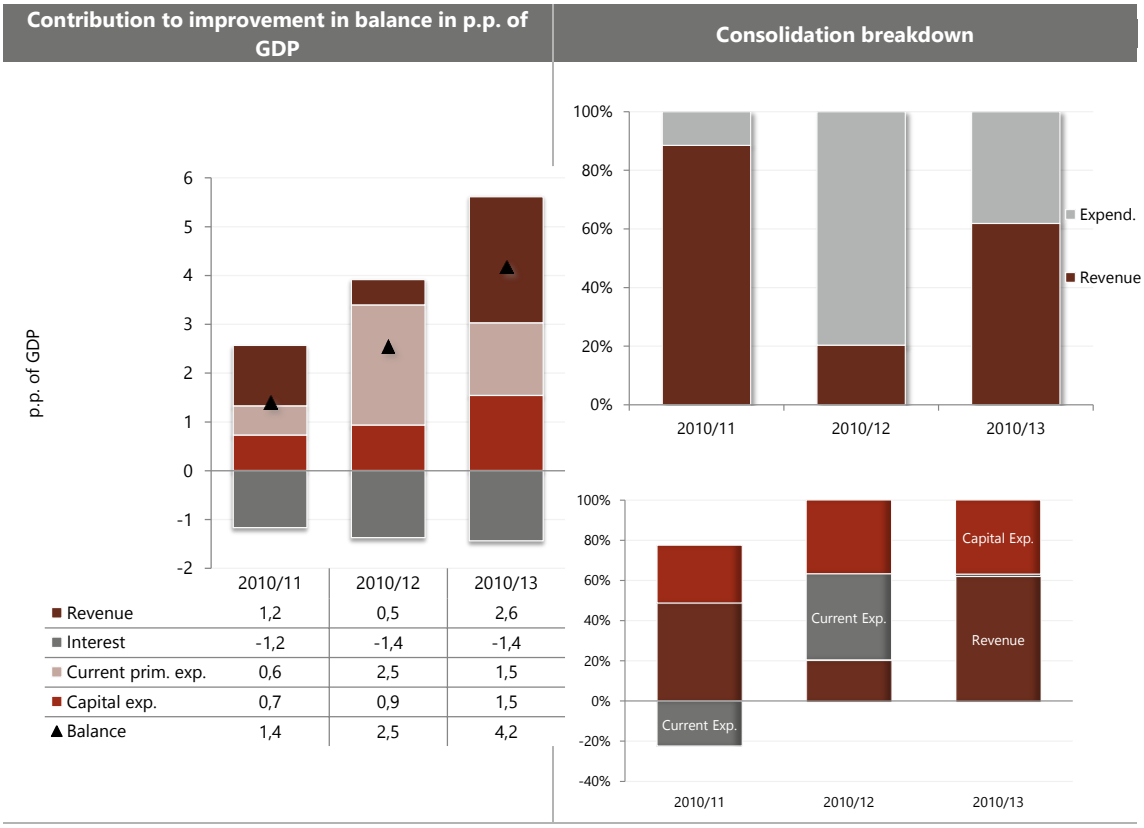
(as percentage of change in overall fiscal balance)

	INE	OE2013		DEO		
	2010/11	2010/12	2010/13	2010/12	2010/13	2010/14
Valores não ajustados | *Headline figures*						
Receita Total | *Total revenue*	**65,8**	**-17,6**	**17,1**	**28,9**	**21,7**	**17,3**
Receita corrente | *Current revenue*	33,5	11,5	55,7	54,2	42,2	34,6
Receitas de capital | *Capital transfers received*	32,3	-29,1	-38,5	-25,3	-20,5	-17,4
Despesa Total | Total expenditure	**34,2**	**117,6**	**82,9**	**71,1**	**78,3**	**82,7**
Despesa Primária | *Primary expenditure*	**55,7**	**146,1**	**109,9**	**106,6**	**104,1**	**105,4**
Despesa Corrente Primária | *Current primary expend.*	25,3	67,0	43,5	57,6	60,4	64,5
Despesas de capital | *Capital expenditure*	30,5	79,1	66,4	49,0	43,7	40,9
Juros (PDE) | *Interest paid (EDP)*	**-21,6**	**-28,5**	**-27,0**	**-35,5**	**-25,8**	**-22,7**
Saldo global (PDE) | *General government balance (EDP)*	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**
Saldo Primário (PDE)| *Primary balance (EDP)*	121,6	128,5	127,0	135,5	125,8	122,7
Carga fiscal | *Tax burden*	30,9	21,5	55,4	51,2	39,5	34,1
Despesa corrente | *Current expenditure*	**3,7**	**38,5**	**16,5**	**22,1**	**34,6**	**41,8**
Valores ajustados | *Adjusted for one-offs & special factors*						
Receita Total | *Total revenue*	**88,5**	**20,4**	**61,9**	**87,4**	**58,5**	**46,3**
Receita corrente | *Current revenue*	98,2	19,3	72,1	80,7	54,2	42,8
Receitas de capital | *Capital transfers received*	-9,7	1,0	-10,2	6,7	4,3	3,5
Despesa Total | Total expenditure	**11,5**	**79,6**	**38,1**	**12,6**	**41,5**	**53,7**
Despesa Primária | *Primary expenditure*	**95,0**	**133,6**	**72,5**	**66,7**	**74,1**	**81,3**
Despesa Corrente Primária | *Current primary expend.*	42,7	96,9	35,6	55,6	55,7	61,5
Despesas de capital | *Capital expenditure*	52,3	36,8	36,9	11,1	18,4	19,7
Juros (PDE) | *Interest paid (EDP)*	**-83,5**	**-54,0**	**-34,4**	**-54,0**	**-32,7**	**-27,6**
Saldo global (PDE) | *General government balance (EDP)*	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**
Saldo Primário (PDE)| *Primary balance (EDP)*	183,5	154,0	134,4	154,0	132,7	127,6
Carga fiscal | *Tax burden*	88,0	38,3	71,8	74,8	49,9	41,4
Despesa corrente | *Current expenditure*	**-40,9**	**42,9**	**1,2**	**1,6**	**23,0**	**33,9**

Note: Comma is used as the decimal separator. Calculations made using the unrounded figures shown in Table 5.

In a possibly more expressive form, Chart 9 provides a visual representation of the figures contained in the previous tables (lower panels, covering adjusted figures). The left hand panel shows the percentage change in the main budget items, adjusted for temporary measures, one-off measures and special factors. It corresponds directly to the lower panel in Table 5. The right hand panel of Chart 9 shows the same changes as a percentage of the change in overall fiscal balance, also net of the above measures and special factors. It corresponds to the lower panel of Table 6. The differences in the adjustment pattern of the main adjusted budget items between the periods under review become clear.

Chart 9 – Fiscal consolidation effort (adjusted values)



Note: Comma is used as the decimal separator. Calculations made using the unrounded figures shown in Table 5. The contribution of expenditure to the improvement in the fiscal balance corresponds to the symmetric of the change in expenditure (as p.p. of GDP). Thus the 1.5 p.p. of GDP contribution of primary current expenditure to the reduction in the deficit from 2010 to 2013 corresponds to a fall in primary current expenditure (adjusted) in the same amount. The negative contribution of interest corresponds to an increase in the weight of interest charges in GDP.

It is true that what matters in terms of borrowing are the non-adjusted figures. However, analysis of the quality of the adjustment, based on the adjusted data, shows the need to adopt permanent instead of temporary and one-off measures. The introduction of a comprehensive expenditure rule is a critical condition for that. It also assumes that fundamental changes are introduced in public expenditure control and management mechanisms to ensure compliance. These matters are discussed in the next section of this Report.

5 FISCAL RULES, MEDIUM-TERM PLANNING AND PUBLIC EXPENDITURE GOVERNANCE

In the present circumstances, as discussed in the foregoing section on fiscal stance, Portugal's government has a very narrow, if any, range of options in formulating a satisfactory fiscal policy stance. Indeed, without market access to finance the budget deficit, it is compelled to adopt a markedly contractionary procyclical stance, dictated by the availability of financing from official sources. However, as indicated, within this narrow adjustment path, the government can choose between various combinations of revenue hikes and expenditure cuts.

In the Draft SB/2013 the government benefitted from the increase in budget deficits set out in the 5th revision of the EFAP, but it had to offset revenue shortfalls only recognised in 2012, essentially through a significant increase in statutory personal income tax rates. In so doing, it veered off the medium-term path outlined in FSD/2012, which merits special mention given the importance the CFP assigns to the medium-term strategy in order to achieve sustainable fiscal consolidation.

While recognising the pressures from unforeseen macroeconomic developments, the Council seeks to outline an alternative route that is consistent with both the spirit and intent of the Budgetary Framework Law, the FSD, and the enhanced EU fiscal governance. More fundamentally, the latter is guided by the premise that in practice a rule-based macro-fiscal framework proves to be far superior to help restore macroeconomic stability and growth than discretionary policymaking. This premise is based on accumulated empirical literature.[33]

The experience of a number of countries both inside and outside the EU that have effectively abided by numerical policy rules that limit the level of the government deficit or debt or both may be useful in this regard. The evidence presented in Table 7 suggests that growth was higher and volatility lower (or in two cases equal) in countries complying with a relatively well-designed framework, than in comparable regions without one, even during the so-called Great Recession.[34]

Table 7 – Fiscal rules, growth and volatility

[33] See Taylor (2000), European Commission (2000), and Fatas and Mihov (2003).

[34] A notable exception among complying countries was Estonia, where volatility was twice as high as in the comparator region. This is not surprising as the government in recent years underwent a sharp procyclical fiscal adjustment to qualify for euro entry by 2011. On the other hand, in Bulgaria, Ireland and Spain compliance with deficit limits, as well as high growth rates, were largely attributable to a financial bubble, which in two of these countries culminated in a banking crisis.

	Effective Date	Growth 1/		Volatility 2/	
		Own	Comparator	Own	Comparator
Advanced economies 3/					
New Zealand	1994	2.6	2.2	0.8	0.8
Sweden	1998	2.6	1.6	1.1	1.3
Belgium (euro)	1998	1.8	1.6	0.9	1.3
Finland (euro)	1998	2.6	1.6	1.3	1.3
Ireland (euro)	1998	4.3	1.6	1.2	1.3
Luxembourg (euro)	1998	4.2	1.6	0.8	1.3
Netherlands (euro)	1998	1.9	1.6	1.1	1.3
Spain (euro)	1998	2.7	1.6	0.9	1.3
Norway	2001	1.5	1.2	1.0	1.9
Switzerland	2002	1.7	1.1	1.1	2.1
Emerging market economies 4/					
Bulgaria	1998	4.1	3.6	0.8	0.8
Estonia	1998	3.8	3.6	1.7	0.8
Poland	1998	4.0	3.6	0.4	0.8
Chile	2000	3.8	3.4	0.5	0.8
Peru	2000	5.5	3.4	0.6	0.8
Brazil	2001	3.6	3.3	0.7	0.8

Source: Kopits (2012).
Notes:
1/ Geometric mean of real GDP annual percent change from effective date of framework through 2010.
2/ Coefficient of variation in real GDP annual percent change from effective date of framework through 2010.
3/ Comparator regions: advanced economies or euro area
4/ Comparator regions: Central and Eastern Europe, or Latin America.

Admittedly, Portugal has yet to reach a stage where the rules under the Fiscal Compact are applicable, that is, when it regains full access to financial markets. In that event, the operating instrument under the structural balance rule will need to embody appropriately defined expenditure rules. However, the budget framework required to operate under the structural balance rule[35] is equally valid for operating under the current adjustment programme. And in fact the programme can be useful in paving the way for operating under the rules in the future.

The core elements of the budget framework are: first, a rolling multi-annual plan that sets limits on spending aggregates; second, annual spending limits derived (and revised if need be under predefined circumstances) from the plan, which provide a "top-down" approach to budget preparation and execution; and third, public expenditure management that ultimately ensures a coherent execution of the budget in compliance with the spending limits at a

[35] For the importance of a well-designed budget framework for the implementation of the "debt brake rule" (aka structural balance rule) in Switzerland, see Beljean and Geier (2012).

departmental level. These three elements are to be operated in an integrated, continuous and iterative manner.

It is in this context that the adjustment programme or fiscal rule can be predictable and its salutary effects durable over an extended time horizon in qualitative as well as quantitative terms.[36] Moreover, with sufficient transparency in terms of objectives, burden-sharing and performance, and the attendant support of key stakeholders—which assumes they are consulted ex ante—such an approach can contribute to anchoring the expectations of economic agents and financial markets.

The first element of the framework is directly determined by the adjustment trajectory or the fiscal rule (whichever is applicable) and is essential for the implementation thereof. Thus it requires a decision-making horizon that extends beyond the usual annual budget and is underpinned by a multiannual baseline macro-fiscal projection. Upon specifying explicitly major policy changes, the multi-annual plan yields indicative ceilings for the main expenditure categories, subject to a binding limit for overall expenditure. With clearly explained reasons, the ceilings can be modified during the planning period, which is annually extended by an additional year.

The second component, derived from the first, provides the basis for budget formulation, early in the annual exercise. This is the first step in the actual budgetary decision-making process. The top-down approach[37] ensures consistency of the budget decisions allocated by sector/programme with the overall adjustment programme or the fiscal rule—in contrast with a discretional bottom-up approach which typically leads to the well-known common-pool problem and deficit bias[38]. This was a major innovation in Sweden following the triple crisis (public debt, banking and currency crises) suffered in the early 1990s.

Perhaps the most important and painstaking area with most scope for innovation in Portugal's budgetary framework involves the third element. While a full treatment of the subject lies beyond the scope of this report, the Council wishes to highlight major improvements in public expenditure management that are indispensable for successful implementation of the adjustment program, and eventually, of the rule-based fiscal framework.

To start with, it is necessary to complete with all due speed the adoption of a uniform accruals-based accounting system, consistent with international standards (namely those prescribed by Eurostat). In addition, rapid progress is necessary toward implementation of an internal information system on the status of expenditure at the highest possible level of disaggregation, so as to accelerate the timely availability of information for decision-making purposes.

A high priority undertaking to be considered by the fiscal authority would be a comprehensive spending review. Following Canada's model of the 1990s, the United

[36] See Schick (2003).

[37] See Ljungman (2009).

[38] The common pool problem arises when a common fund (for example total tax revenue) is employed to the benefit of a portion of its holders while the burden is borne by all.

Kingdom government recently launched such a review.[39] Briefly, a spending review consists of an in-depth examination of existing expenditure programmes, in line with a well-defined spending strategy. The strategy provides clear criteria for assessing each programme's contribution to productivity, efficiency, fairness (i.e., through adequate targeting to most vulnerable households and areas) over the medium term. The actual review provides the basis for selective pruning of outlays for observance of expenditure ceilings, as opposed to reliance on uniform across-the-board cuts. Thus the review shares features with a zero base budget but is feasible since it is undertaken by those responsible for executing it within the overall budget framework. In addition, the review allows the preparation of a pipeline of contingency measures in the event of unanticipated revenue shortfalls or expenditure overruns, in contrast to improvised stop-gap measures (a perennial feature of adjustment programs under current IMF-EU stand-by arrangements).

More generally, the spending review provides a useful tool to express the government's programme and values in terms of spending priorities, which in turn are implemented in the pruning process. This process can only be materialized under the continuous oversight of a cabinet-level body chaired by the finance minister. The importance of this approach cannot be overstated, especially at a time of an extraordinary crisis such as the one currently experienced in Portugal.

A study published by the OECD[40] in 2005 is a useful historical reference and describes the steps taken to overhaul expenditure under conditions of financial stress by Canada (1994), New Zealand (1991) and Sweden (1995). In all three cases the budget position had deteriorated over the previous years and had led to a dramatic change in market access terms. All three countries set an initial target of 3% of GDP for the budget deficit, followed by a swift return to a breakeven position. They all reached their targets earlier than expected, benefitting from the upturn in economic growth and the drop in interest rates. When defining the expenditure overhaul policy, the three countries explicitly rejected the notion of across-the-board cuts (which they had previously employed unsuccessfully, together with successive public sector reform programs), and opted instead for spending reviews so as to cut expenditure in low priority areas and so benefit higher priority ones.

In all three cases emphasis was placed on the importance of resolute and sustained political involvement throughout the period, made necessary by the fact that the overhaul was often of an iterative nature, when the difficulty of meeting the budget targets arose. Other points to be stressed are the importance of communication and the transparency of the process,[41] as well as the involvement of those subject to the changes, which are essential to ensuring understanding of the complex changes underway and help drum up the necessary support of the agents involved and the general public.

The physiological impact of these measures (to use the OECD's expression) continued to influence civil servants' and ministers' behaviour in the years to follow, and gave rise to an improvement in the budget institutions and the upholding of prudent budget programming

[39] HM Treasury (2010)

[40] OECD (2005)

[41] See Institut Montaigne (2008).

systems. The cases of Sweden and New Zealand are of special note since at the end of 2011 their public debt stood at 37.9% and 38.2% of GDP, respectively.[42]

Many other cases of expenditure overhauls, both in the presence or absence of stress, have taken and continue to take place. Portugal finds itself in a position similar to that the above three countries were in in the early 1990s[43]. Like them it has undertaken, in vain, multiple public sector reforms, introduced across-the-board cuts and changed, somewhat timidly, its budgetary process. Experience shows that a much deeper and more determined change is required to recover credibility, which is a necessary condition for regaining investor confidence and that of economic players in general.

Whilst public governance is not one of the Council's specialist fields, it is our responsibility to call attention to an area that is key to the correcting of public indebtedness, as it involves both deficit and public debt cuts and the rekindling of economic growth.

[42] IMF, World Economic Outlook Database.

[43] Although the Portuguese position is considerably worse given a public debt ratio over 100% of GDP and the absence of an exchange rate to act as an additional adjustment tool.

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