Overview & Executive Summary

Analysis of the 2019 Draft Budget Plan

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OVERVIEW

Pursuant to its duties and on the basis of the additional information provided by the Ministry of Finance (MF), in this report the Portuguese Public Finance Council (CFP) examines the Draft State Budget for 2019 (DSB/2019), having published its opinion on the underlying macroeconomic scenario in due time. Following detailed analysis of the information, the CFP has concluded that the current budget consolidation strategy continues to benefit, in the main, from the decrease in interest and the favourable phase of the business cycle. By their very nature both of these factors are subject to fluctuations over which national policies have little influence, but for which they must be prepared in order to soften their effects.

To that end the decline in the budget deficit and public debt during favourable periods must have a structural nature, that is to say, must not stem primarily from the benefits of the business cycle growth phases. These are reversed in periods of decline and have a direct impact on the decrease in revenue and the increase in expenditure which, as in the case of unemployment benefit, acts as an automatic stabilizer. Thus, even in the absence of counter-cyclical policies, the recession phases give rise to deterioration in the budget balance. When, from the outset, there is already a deficit, the use of fiscal policy to combat recession situations is only viable if the country has access to borrowing under favourable terms. These are dependent upon monetary policy, but also on the nation's risk premium, which is a function of its growth potential and level of debt. Therefore, retaining access to borrowing presupposes economic policies that favour the economy's potential growth, along with prudent fiscal policies, particularly in regard to developments in inelastic expenditure.

Generally speaking and despite the European rules defined by the Stability and Growth Pact, the Portuguese fiscal framework has not favoured sufficiently prudent management, but rather has permitted a build-up of budget deficits and public debt, during both expansions and recessions. The depletion of the fiscal space they produced has aggravated the international crisis's impact on the Portuguese economy and made the need to comply with the rules more compelling. This is an outcome that is being achieved gradually, but which is still insufficient in terms of structural indicators, for instance in regard to the structural budget balance and the expenditure benchmark, as documented in this report.

Even more important than strict compliance with the numerical rules is, from the nation's standpoint, the lack of attention paid to the fundamental factors that determine potential economic growth and access to borrowing. One item that clearly illustrates this stance is the apparent disinterest in the fact that the State Budget for 2019 should have been the first to be drawn up within the model laid down in the Budgetary Framework Law (BFL) that was approved in 2015,[1] and which foresaw a transitional period of three years prior to its full implementation. From the legal standpoint there is no problem, as the law was later amended[2] to extend the deadline. However, neither this legal formality nor the lack of importance assigned to the subject in public debate can take away from its relevance. Indeed,

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[1] Law nº 151/2015, of 11 September.

[2] Law nº 37/2018, of 7 August.

the 2015 BFL sets out the basis for a fiscal framework that is effectively integrated in the design of medium-term economic policy, as well as for the setting and managing of the spending limits required to ensure stability and fiscal sustainability.

In this regard the law foresees, first of all, the reformulation of the Major Options Law, to be published at the same time as the Stability Program, and submitted to Parliament for approval, including the multiyear framework for public expenditure. This constitutes a fundamental change that should finally bestow on the Major Options Law an important role in the design of economic policy, rather than being a mere list of measures which, being vaguely integrated in the macroeconomic goals and ignoring the funding required to implement them, does not give rise to the definition of options and priorities. These are nonetheless prior conditions for adopting an effective system of program budgeting, which the BFL also determines, along with the design and redefinition of the instruments that are key to its implementation.

Closely related to this redefinition is the effective incorporation of the annual budget in the medium term framework. This ensures the programs are inserted in this time horizon, while also setting and respecting the spending limits set on the same basis and in keeping with the economic policy options adopted by the parliament. This gives rise to the need for a profound change in the role of the various actors in the budget process, reinforcing the MF's responsibility for setting and monitoring macro-fiscal goals, but reducing its involvement in the detailed and case-by-case control of expenditure which, as well as its planning and management, should be the responsibility of the line ministries.

Proper implementation of these mechanisms presupposes, first of all, that planning takes into account the costs associated with the various activities, as well as the expected benefits, and that fiscal policy is devised within a multiyear framework that includes an evaluation of the various measures' costs and benefits, on top of the direct fiscal impact. In addition to the existence of sectoral autonomy and management capability, the devising and monitoring of these programs requires adequate information, namely at the accounting level, which the law also provides for and which is currently being implemented, although some key elements, related to the centralization and consolidation of accounts and to their use in budget decision making are still missing.

As the CFP stressed in its Opinion on the Bill that resulted in Law 151/2015, all these matters presuppose, first of all, a new way of looking at the budget and economic policy, that recognises that fiscal policy cannot be almost the sole factor determining economic developments, despite its key role in the adoption of strategies based on an assessment of the opportunities but also the constraints they face. This assessment should give rise to the creation of incentives that encourage behaviour leading to economic development and financial stability, while avoiding the building up of unrealistic expectations as to the State's financial capacity, that itself depends on sustained economic growth. In addition, this requires a thorough reform of public finance management techniques and practices. This will put big demands on the quality of information and information processing techniques, as well as call for greater autonomy, accountability and managerial skills on the part of all players.

As was forecast when the law was approved, its implementation calls for major changes to the workings of the various institutions and to the decision making process. In some areas, under the guidance of the Implementation Unit, notable progress has been made. However, even here they lack resources – in particular IT resources – needed to complete the work required to implement the legislation. Therefore the lack of interest the subject seems to generate is particularly worrying, with the current debate still focused on the *status quo,* and centred on themes like underbudgeting or the blocking of funds. These are relevant because of the negative impact their intensive use has, in the short term, on the quality of public management and, in the longer term, on fiscal stability and sustainability. However, only the actual implementation of the new framework will create the conditions to eliminate them, by laying the foundations for designing and managing fiscal and economic policy on basis consistent with the State's responsibilities, especially in the social fields.

EXECUTIVE SUMMARY

The Draft State Budget for 2019 (DSB/2019) confirms the deficit goal of 0.2% of GDP for 2019, put forward in April in the Stability Program. The path towards correction of the budget imbalance continues in 2019 with the nominal deficit falling to 385 M€, down 1071 M€ on the Ministry of Finance (MF) estimate for 2018.

The improvement in the budget balance is still dependent upon the effects of the economic climate, the decrease in expenditure on interest, the dividends to be received from the Bank of Portugal and from Caixa Geral de Depósitos (CGD) and a reduction in the support to the financial sector. The impact of the discretionary measures proposed for 2019 will actually make a negative (albeit minor) contribution to budget deficit reduction. The negative contribution is larger if, unlike the DSB/2019, we do not count savings on interest as a policy measure. In fact sufficient details are not provided to allow us to exclude the possibility that this saving stems almost entirely from more favourable market conditions than those foreseen when drawing up the 2018 Stability Program. The 2019 budget exercise will be further burdened by the significant negative contribution to the balance (-981 M€) resulting from the carry-over effect of measures introduced in previous years. Lastly, the improving stemming from the economic climate is subject to the downside risks for economic growth identified by CFP in the Report Macroeconomic forecasts underlying the 2019 Draft State Budget.

Structural Adjustment

Removing the impacts of the business cycle and temporary and one-off measures, the structural balance underlying the Draft State Budget as recalculated by the CFP for 2019 should shorten the distance to the Medium Term Objective (MTO). Underlying this movement towards the MTO is a structural balance estimate for 2018 and 2019 that provides the safety margin needed in relation to the 3% of GDP ratio for the nominal budget deficit, if the economy is to face normal cyclical fluctuations without entering into an excessive deficit position. The fiscal policy stance is considered neutral, taking into account the planned path of the structural primary balance.

The planned rate of adjustment puts at risk compliance with the requirements of the preventive arm of the Stability and Growth Pact (SGP) in relation to expenditure developments and the recommended improvement in the structural balance. On the basis of the information available and its own classification of temporary and one-off measures, the CFP estimates that the planned improvement in the structural balance underlying the Draft State Budget is 0.2 p.p. of GDP in 2019 and 0.1 p.p. in 2018. In both years the progress is less than required to achieve the 0.5 p.p. of GDP improvement laid down in the Budgetary Framework Law (BFL) and the 0.6 p.p. of GDP improvement under the Stability and Growth Pact. Despite not guaranteeing the minimum adjustment recommended for 2019, the planned improvement in the structural balance points to fiscal progress consistent with compliance with the debt criterion in the final year of the transition period (2019).

As for the benchmark for adjusted primary expenditure, the rate of adjustment forecast for 2019 will not ensure compliance. The planned nominal growth in primary expenditure net of discretionary measures on the revenue side and of temporary and one-off measures exceeds the 0.7% increase recommended by the European Council and the applicable benchmark (also 0.7%). The difference is equal to a deviation of 0.8 p.p. of GDP, which exceeds the 0.5 p.p. margin that sets the basis for the risk of a significant deviation in 2019. The nature of the deviation remains when account is taken of the average for 2018 and 2019 (1.3 p.p. of GDP). Under the law, assessment of compliance with the Pact's preventive arm should be conducted on the basis of the reported figures, which will take place in May.

Revenue

Underlying the Draft State Budget is an increase in the weight of general government revenue for the second year running, as it is expected to represent 43.3% of nominal GDP in 2019 (90 719 M€). The change is founded on the increase of the weight on GDP of social security contributions and "sales and other current revenue".

Growth in revenue from tax and contributions represents around 70% of expected growth in total General Government (GG) revenue, with the increased revenue from indirect taxes (1 323 M€) and social contributions (975 M€) accounting for almost the entire increase in tax and contributions revenue (2462 M€). The contribution of direct taxes' is expected to be smaller since its growth (165 M€) is affected by the forecast impact of policy measures on this aggregate (-367 M€), including the carry-over effect of change to PIT made in the State Budget for 2018 (SB/2018).

The expected performance of direct taxes, where the annual rate of growth is expected to reach 0.8%, is the decisive factor in the forecast slight decline in the tax burden from 34.7% of GDP in 2018 to 34.6% of GDP in 2019, as the Ministry of Finance expects growth in indirect taxes (4.1%) and actual social contributions (5.1%) to exceed the rate of growth in the economy next year (3.6%). In particular, the elasticity implicit in the VAT revenue increase before policy measures (4.5%) is greater than one, reflecting the expectation that VAT revenue will rise more than nominal private consumption (3.3%), which may put at risk the meeting of the target. Also, according to the Draft State Budget, actual social contributions should continue to grow by 2 p.p. above the expected change in the compensation of employees, which also constitutes a risk.

As for non-tax and non-contributions revenue, the growth target (8.1% or 1 081 M€) will depend, in the main, on the attainment of the financial gains to come from the Caixa Geral de Depósitos and Bank of Portugal dividends (326 M€), from the impact of European funds received under the Portugal 2020 program (145 M€), as well as the robust performance of sales.

Expenditure

The Ministry of Finance foresees general government expenditure of 91 104 M€ next year, an increase of 2 471 M€ over 2018. This increase is brought about by current primary expenditure and, to a lesser extent, by capital expenditure, which is offset by the forecast decrease in expenditure on interest for the fifth year running. Over half of the growth in current primary expenditure forecast for 2019 comes from social transfers, an item that should see an increase equal to that estimated for this year (3.8%) by the Ministry of Finance and to which the proposed discretionary measures will make a contribution of 0.3% of GDP.

Due to the expectation of a smaller unfavourable impact of temporary measures than this year, the rate of growth in expenditure should fall from 4.4% in 2018 to 2.8% in 2019, according to the Draft State Budget. The effect stemming from the temporary measures is mainly reflected in the forecast change in "other capital expenditure", by way of the expected decrease in support to the financial system. It should be noted that there is a risk this decrease may not materialise. The MF also predicts a slowdown in the rate of growth of intermediate consumption. The Draft State Budget points to greater growth in Gross Fixed Capital Formation and compensation of employees, in the case of the latter, due to the continuation of the phased payment of the unfreezing of civil service promotions.

Public expenditure's weight in GDP is expected to fall from 43.9% in 2018 to 43.5% in 2019, on the basis of nominal growth in output of 3.6% being higher than that of public expenditure (2.8%).

Public debt

The Ministry of Finance estimates that in 2018 Maastricht debt will be equal to 121.2% of GDP, a decrease of 3.6 p.p. compared to 2017. This year the State's gross borrowing requirements in public accounts should stand 1 300 M€ above the level forecast in the State Budget for 2018. This rise is due to the increase in early repayments to the International Monetary Fund (IMF) – including an early repayment of 2 000 M€ to be paid at the end of this year – as well as higher repayments on Treasury Bonds, only partially offset by a lower than expected budget deficit. The strategy of advancing IMF repayments has been carried out since 2015 and has led to a considerable decrease in the loan interest rate since January 2018.

According to the MF, in 2019 debt should once again record a drop to 118.5% of GDP, continuing its downward path. This development is brought about by the primary balance's favourable contribution and, to a lesser extent, the dynamic effect (as the effect of growth in GDP exceeds, in absolute terms, the interest effect). Nonetheless, the State's gross borrowing requirements in public accounts should increase by 2 400 M€ in 2019. This increase will, to a large extent, flow from the larger volume of debt amortisation compared to 2018.

General Government Subsectors

The Draft State Budget foresees an improvement in the budget balance across all General Government subsectors, in particular Central Government and Regional and Local Government. The Central Government subsector, which provides transfers to other subsectors under the relevant financing laws, will continue to be responsible for the largest contribution to the General Government deficit in 2019 (-1.4% of GDP). Of the 0.5 p.p. of GDP improvement in the General Government budget balance, 0.3 p.p. of GDP corresponds to Central Government's contribution to the decrease in the deficit and the remaining 0.2 p.p.

of GDP to the improvement in the Regional and Local Government surplus. Social Security Funds' contribution is approximately zero as a percentage of GDP, due to the effect of growth in the denominator, despite the predicted nominal increase in the subsector's surplus.

Multiyear Budget Programming Framework

The Multiyear Budget Programming Framework (MBPF), revised by the Draft State Budget, sets ceilings on Central Government expenditure covered by general revenue for the next four years that are higher than those in the Stability Program update submitted last April. These changes mean the ceilings increase by a total of 7 320 M€ from 2019 to 2022. For 2019, the ceiling is up by 1 454 M€, as all budget program groupings see increases, in particular those in the Social and Economic area.

Experience shows that the Multiyear Budget Programming Framework is ineffective when it comes to fiscal accountability over the medium and long term. Its usefulness as a support tool for designing and implementing public policies from a multiyear standpoint requires the set spending ceilings to be respected and the annual update introduced by the State Budget to be in keeping with that set out in the Stability Program, which is not the case in the Draft State Budget for 2019.

Transparency

The drawing up of this report on the Draft State Budget continues to be hindered by the shortage of fiscal transparency in the documents that accompany it, as well as by the difficulty in obtaining the relevant additional information from the Ministry of Finance in a complete and timely manner.

The problems with the way policy measures are described and quantified in the Draft State Budget Report have been repeatedly identified by the CFP, and persist in regard to 2019, thus reducing the transparency of the budget process. In order to assess the consistency of the budget proposal the CFP has opted to add a series of measures referred to in the document, but not included in the table designed to do so. The explanation for the quantification of the policy measures continues to be inadequate and is made worse by the continued practice of not conducting *ex post* assessments.

The absence of a clear, systematic and suitably detailed presentation is particularly significant in the cases of: revenue and expenditure linked to the use of structural funds; the quantification of savings from the expenditure review, which groups effects that do not stem from policy measures and others that should be taken into account in the baseline scenario (demographic factors, for example); the identifying of interest savings that are dependent upon new policy measures, excluding those that arise because of measures implemented in previous years and the improvement in market conditions.