Overview

Public Finance: Position and Constraints 2017-2021 – Update

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OVERVIEW

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The medium-term no-policy-change scenario discussed in this report illustrates the ability of the Portuguese economy to return to a path of moderate growth and renewed macroeconomic balance, following a strong adjustment, including budget consolidation measures and the establishing of conditions favouring an upsurge in exports and investment. Therefore, following expected growth of 2.7% 2017, thanks to the sharp rise in gross fixed capital formation (GFCF) and exports, and the associated drop in unemployment and restoring of confidence in the economy, the latter continues to experience growth rates which, whilst slowing, still allow for job creation, while maintaining external accounts close to equilibrium and approaching compliance with fiscal rules, in both nominal and structural terms. The budget deficit (excluding the impact of financial system support measures) remains below the 3% of GDP limit and is expected to be 1.4% in 2017 falling to 0.2% in 2021, while the debt ratio falls to 126.8% at the end of 2017, dropping to 112.9% in 2021. The projected changes include the impact of temporary and one-off measures in 2017 and 2021, so the deficit net of such effects goes from 1.6% in 2017 to 0.6% of GDP in 2021.

These projections update those published by the Portuguese Public Finance Council (CFP) in March. Pursuant to the criteria set for preparing reports on the Portuguese public finance position and constraints, this report is a mere **projection** of the outcomes to be expected if there are no changes in policy, and does not claim to be a **forecast** of the outcomes that will be achieved. In addition to the changes inherent in developments in the internal and international economic climate, a forecast will reflect the impact of all policy measures to be implemented, while a projection merely considers those that, at the time of the projection, are well defined, likely to be approved and have quantifiable effects. By projecting the expected development in public finance in the absence of new policy measures, this exercise is only a basis for taking decisions as to the nature and scale of such measures. The progress seen recently in the Portuguese economy and public accounts has confirmed the importance, always underlined in the CFP's analyses, of exports and investment as the driving forces behind economic growth and employment. In the absence of such forces simple fiscal stimuli that increase macroeconomic imbalances only end up thwarting the desired goals.

When presenting this projection, the CFP does not ignore the risk ever present in Portuguese politics of resorting to growth in public expenditure (or less commonly a cut in taxes) as soon as the improvement in the macroeconomic balances and the external borrowing conditions so permit. In the past, the need to stimulate economic growth and solve structural problems was ever presented as justification for that option, that also included increased State intervention in guiding private investment, by means of subsidies and/or financing facilities. At the same time fiscal problems were deemed to be of a purely cyclical nature or the result of external factors. Such options always led to a loss of economic competitiveness and investments aimed at sectors with low productivity, and entailed the procyclical nature of fiscal policy, which in times of recession had to introduce restrictive measures to correct the external deficit and the worsening of borrowing terms.

Membership of the EU should have put an end to this state of affairs thanks to the provision of finance through the structural funds and the implementation of what ought to be a hard budget constraint – the 3% of GDP budget deficit ceiling, a limit which did not exist in the Portuguese budgetary framework. However, the direct implications of this constraint – for example, as regards penalties or an increase in the Portuguese debt risk premium – proved to be much softer than the wording would suggest, which meant that from 2000 to 2016, the country was almost always either subject to the Excessive Deficit Procedure (EDP) or about to become subject to it.

The 2016 budget outcome, which met and even went beyond the deficit reduction target, and above all the political priority assigned to this aim, seem to have put an end to the instability that had so far frustrated the desired expansionist effects. In fact the high level of external indebtedness, of both the State and the country, calls for a genuine hard budget constraint which, as shown by other countries' experience, is a key element in financial stability - a requisite basis for economic growth and the fiscal space required to carry out anticyclical policies. In the Portuguese case this requirement is enhanced by unfavourable demographic changes that call for an additional effort to increase productivity, so as to make long-term commitments viable, especially in the health and social security fields.

A fiscal policy consistent with these requirements supposes more than annual compliance with the deficit limit. Two other institutional conditions are key to an effective budgetary process: prudent macro-fiscal forecasts and capable management of public expenditure. At the same time the structural measures aimed at stimulating economic growth should strengthen the private sector's financial independence and its ability to take on risks, and provide it with a stable business environment, which includes appropriate tax, regulatory and financial policies.

When a nation's fiscal space is exhausted, the use of prudent forecasts does not amount to the implementation of a restrictive policy, but rather ensures the space required to deal with negative surprises. If the outcome proves better than forecast, it will provide for a swifter decrease in debt and, thus, add to the capacity to deal with less favourable situations. If, on the other hand, forecasts always rely on positive factors, this will inevitably lead to the country not being equipped to deal with adverse conditions when they occur, thereby losing the benefits it thought it had guaranteed. The low level of income that remains a feature of the Portuguese economy when compared to its partners is proof of this.

Capable management of public expenditure is also essential if fiscal policy is to play a continued stabilising role. All economies are subject to fluctuations, often triggered by factors beyond the control of domestic policies. Therefore, economic management should provide conditions that reduce vulnerability to crisis situations. That implies taking into account the fact that, generally speaking, public expenditure is more rigid than revenue. Even in the case of expenditure that is dependent upon discretionary decisions, such as public investment, it is precisely in periods of recession that it needs to be increased in order to protect employment and reduce the impact on growth. Accordingly, during recessions the economy needs sufficient fiscal space to finance a deficit without putting financial stability at risk, which, should it arise, would imply restricted access to credit, or at least higher costs, thereby eliminating the desired benefit of the fiscal stimulus. However fiscal space must be created when circumstances are favourable, implying that at such times expenditure rises slower than revenue, and also that attempts be made to bring greater flexibility to expenditure, thus making its adjustment easier when needed.

That is the medium-term approach to expenditure management to which must be added a long-term perspective, significant in the case of an important – and growing – portion of expenditure, in particular that related to health and pensions spending. Changing demographics is a deciding factor in these cases and must be viewed from the long run. When it is positive it can support pay-as-you-go type pension schemes under which the contributions of those in work fund the pensions of retired people. However, when it is negative it supposes an important component of own savings in order to supplement the state pension. In other words, an ageing population calls for firm control over the value of pensions, along with an increase in labour productivity, so that the working population is able to fund the system and prepare its own pensions.

Here management of public expenditure operates in two ways: directly, by defining the pension regime, the values of pensions and social contributions, and indirectly by promoting full employment as well as labour productivity. The issue here is not simply how to manage aggregate demand to stabilise the economy, but above all how to devise a broad and systematic programme of policies focused on a sustained increase in productivity, beyond the political cycle.

These are the challenges that the Portuguese economy continues to face. Advantage must be taken of the recent good performance and the confidence it brings in order to deal with them, without once again giving in to the temptation of stimuli based on the immediate impact of an increase in public expenditure.