Conselho das Finanças Públicas

Portuguese Public Finance Council

Analysis of the Draft State Budget for 2014

Report by the Portuguese Public Finance Council

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The Portuguese Public Finance Council is an independent body, set up under article 3 of Law no. 22/2011 of 20 May which was the 5th amendment to the Budget Framework Law (Law no. 22/2001 of 20 August, republished by Law no. 37/2013 of 14 June).

The decision to set up the Council was taken following the publishing of the final report of the Taskforce to the European Council on economic governance in Europe, and became a reality in October 2010 after agreement was reached between the Socialist Party (PS), in Government, and the Social Democratic Party (PSD). The final version of its Statutes was approved by Law no. 54/2011 of 19 October.

The Council began its work in February 2012 and its 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 strengthen the State's financial credibility.

The Portuguese version of this publication was made available on 7th November 2013.

In the publications section at www.cfp.pt, a spreadsheet is available for download that contains all the figures used to build the charts and tables in this report.

This report incorporates the information available up to 5th November 2013, and has benefitted from additional explanations provided by the Ministry of Finance's DGO and GPEARI.

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Report no. 7/2013

Lisbon, November 2013

Available at www.cfp.pt

List of abbreviations

Abbreviation	Meaning
ADSE	Civil Servants Health System
AGR	Average Gross Rate
AMECO	Annual macro-economic database of the European Commission
ANA	ANA – Aeroportos de Portugal, S.A.
AR	Autonomous Region
ASB	Amending State Budget
ASF	Autonomous Services and Funds
B€	Billion euros
BANIF	Banco Internacional do Funchal
BCP	Banco Comercial Português
BFL	Budgetary Framework Law
BoP	Bank of Portugal
BPI	Banco Português de Investimento
BPN	Banco Português de Negócios
CC	Cyclical Component
CFP	Portuguese Public Finance Council
CGA	Civil Servants Pension Agency
CGD	Caixa Geral de Depósitos
CIT	Corporate Income Tax
CPI	Consumer Price Index
CTT	CTT - Correios de Portugal, S.A.
DGO	Direção Geral do Orçamento (Directorate-General for Budget)
DSB	Draft State Budget
EC	European Commission
EDP	Excessive Deficit Procedure
EFAP	Economic and Financial Assistance Programme
EFSF	European Financial Stability Facility
EGREP	EGREP - Entidade Gestora de Reservas Estratégicas de Produtos Petrolíferos, E.P.E.
ESA	European System of National and Regional Accounts
ESM	European Stability Mechanism
EU	European Union
FDI	Foreign Direct Investment
FRB	Fixed Rate Bond
FSD	Fiscal Strategy Document
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GG	General Government
GNI	Gross National Income
GPEARI	Planning, Strategy, Evaluation and International Relations Office (at the Ministry of Finance)
HCPI	Harmonised Consumer Price Index
IGCP	Agência de Gestão da Tesouraria e da Dívida Pública - IGCP, E.P.E.
IMF	International Monetary Fund

Abbreviation	Meaning
IMI	Municipal Property Tax
IMT	Municipal Property Transfer Tax
INE	Statistics Portugal (Portuguese Statistical Authority)
ISE	Equity instruments eligible for inclusion in Core Tier 1
IUC	Single Road Tax
LE	Large Enterprises
LFL	Local Finance Law
M€	Million euros
MBPF	Multi-annual Budgetary Planning Framework
MF	Ministry of Finance
MoU	Memorandum of Understanding
MSF	Municipal Social Fund
MTO	Medium-Term Objective
NBR	Net Borrowing Requirements
NFC	Non-Financial Corporation
NHS	National Health Service
OECD	Organisation for Economic Co-operation and Development
OSTD	Other Short-Term Debts
p.p.	Percentage points
PALOP	Portuguese Speaking African Countries
PC	Public Corporations
PDSF	Public Debt Settlement Fund
PIT	Personal Income Tax
PPL	Bill
PPP	Public-Private Partnerships
RFL	Regional Finance Law
RPC	Reclassified Public Corporations
SB	State Budget
SC	Savings Certificates
SF	Special Factors
SIGO	Budget Management Information System
SILOPOR	SILOPOR - Empresa de Silos Portuários S.A.
SME	Small & Medium Enterprises
SS	Social Security
SSFSF	Social Security Financial Stabilisation Fund
TB	Treasury Bills
TC	Treasury Certificates
TFEU	Treaty on the Functioning of the European Union
VAT	Value Added Tax
WEF	World Economic Forum
WEO	World Economic Outlook
YoY	Year over Year

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Overview

OVERVIEW

The State Budget for 2014 and the EFAP

The State Budget for 2014 will be the last to be approved under the Economic and Financial Assistance Programme (EFAP) which was entered into in the spring of 2011 and will expire in June 2014. Therefore the explicit goal of the Draft State Budget for 2014 (DSB/2014) is to ensure the Programme will be completed within the deadline. This requires the country to meet the targets set and embark on "a new cycle of long lasting consolidation and economic growth", as acknowledged in the DSB/2014. These are prerequisites for the rebuilding of national and international creditor confidence, which in turn will restore Portugal's access to financial markets, allowing it to finance and manage its debt. However, in addition to the targets set out in the DSB/2014, it will also be necessary to convince the financial markets and the public at large that a sustained reduction in the burden of public debt is part of the new cycle.

A first take on the adjustment programme

Therefore, now is the time for a first take on the outcome of the adjustment programme, as regards both the fiscal targets and the structural adjustment of the economy which will allow it to enter the sought after new cycle.

From the fiscal standpoint, substantial progress was made until 2013[1], which should continue in 2014. Thus, using only structural balance indicators – that is, indicators adjusted for the cyclical effect and the effects of temporary measures and one-off measures – net of special factors[2], which better reflect the adjustment effects, we find that from 2010 to 2013 the structural balance went from -8.2% to -3.9% of GDP, while the primary balance went from a 5.4% deficit to an estimated 0.4% surplus. In 2014 the relevant figures in the DSB/2014 are -3.0% and 1.4%, respectively.[3]

The degree of consolidation achieved is therefore significant and all the more so when considering that it took place in unfavourable internal and international contexts. Internally the private sector was also faced with the need to strengthen both the corporate and household balance-sheets, adding to the public sector's efforts the contraction in demand brought on by the increase in household savings. Internationally, the sluggish recovery in the main markets hampered export growth, the variable on which the ability to return to a sustained economic recovery first and foremost depends.

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[1] Taking into account the estimated outturn included in the DSB/2014.

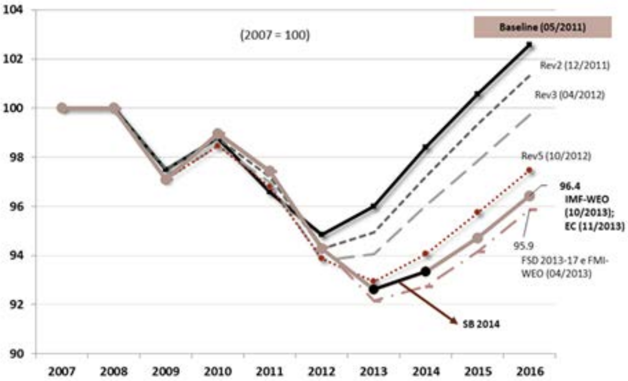
[2] See Box 5 of Report No. 7/2013: Analysis of the Draft State Budget for 2014.

[3] The cyclical adjustment was calculated using the MF estimate for the output gap. After the calculations were complete the European Commission published its autumn 2013 forecast. There the output gap estimate is more negative to the tune of 0.4 and 0.5 p.p. of potential GDP than the figure used in this Report for the years 2013 and 2014, respectively. Therefore if the CFP had used that estimate the (negative) cyclical component of the budget balance would have been higher by 0.2 and 0.3 p.p. of GDP in 2013 and 2014, respectively. That would give rise to a lower structural deficit than considered in this report: 3.8% of GDP in 2013 and 2.7% of GDP in 2014. In terms of annual changes the differences would be smaller, with a structural improvement of 0.5% of GDP in 2013 and 1.1% of GDP in 2014.

An optimistic initial programme

The effect of these factors was not fully taken into account at the beginning of the adjustment programme and this led to a more negative impact on economic growth than forecast. While in the initial programme, following the negative shock of the adjustment, GDP in real terms was expected to return to the 2007 level during 2015, more recent forecasts suggest that by the end of 2014 the economy will still be around 7 p.p. below that figure.

Chart 1 – Comparison of changes in GDP estimates (at constant prices)



Source: INE, Ministry of Finance, European Commission and IMF.

Naturally that change also affected the fiscal outturn, calling for additional restrictive measures so as to ensure compliance with the deficit goals (set in nominal terms, that is to say, not adjusted for the cyclical change) and increasing the snowball effect on the public debt ratio development[4]. That ratio was also affected by factors external to fiscal developments throughout the programme, which included support to the financial system and the increase in deposits linked to the pattern of programme disbursements. The various reclassifications made immediately before the onset of the programme (corresponding, among other things, to the recording of commercial debts and the incorporating into general government of entities previously classified as public corporations) also accounted for the ratio increase.

The DSB/2014 anticipates that, once the figure of 127.8% of GDP has been achieved at the end of this year, there will be a downturn in the debt ratio in 2014 as a consequence of the first positive primary balance (0.3% of GDP) foreseen for that year (headline figures). However, it should be noted that there is still the risk of possible new reclassifications of public corporations, resulting from the change in national accounts criteria, following the implementation in 2014 of the revised European System of National and Regional Accounts (ESA2010).

A long road ahead

In these circumstances, even after achieving a structural balance of -3% of GDP in 2014, in line with the DSB/2014, the budget consolidation process in Portugal will still have a long road ahead of it.

On the one hand, having met that target in 2014, the country will still have to make the adjustment required to comply with the medium-term objective set by the European legislation, which requires the structural deficit not to exceed 0.5% of GDP.

[4] Resulting from the difference between the average debt interest rate and nominal GDP growth rate.

On the other hand, achieving public debt sustainability requires a significant reduction of its ratio, on which depends not only the interest cost to be borne by the State Budget, but also access to the markets in order to (re)finance debt. To that end the effort demanded of the Portuguese economy goes far beyond the minimum required to correct the budget deficit. As the CFP stressed in Report no. 3/2013: Analysis of the Fiscal Strategy Document 2013-2017, even if high economic growth occurs, significant progress is still needed in this area, in particular to achieve significant primary fiscal balances over a considerable length of time.

Programme lessons

The experience gained over the course of the programme may provide some important lessons for mobilising – and hopefully minimising – the necessary effort. In addition to recognising that the adjustment required covers the entire economy and its institutional framework, important aspects to be taken into account in the specific field of fiscal policy are the prudence and the time frame of forecasts, the breakdown of the adjustment effort and the transparency of the measures and their monitoring.

The importance of multi-annual budget forecasts

Concerning the forecasts on which fiscal policy is based, it should be noted that they must be consistent with a demanding European legal context covering their prudence and multi-annual framework. Most importantly, the outcome of the Portuguese experience, always based on strictly annual and generally optimistic programming, illustrates the risks of such a strategy and calls for greater attention to be paid to European requirements. In particular the multi-annual budgetary framework should not be regarded as a mere ritual that is restarted every year and always puts off the adjustment to the end of the period concerned. On the contrary, it should be a rational exercise that assesses the fiscal resources available (basically tax revenue and the sustainable indebtedness potential) and the factors, such as the demographic, technological and external context, that influence them as well as the expenditure that they finance. On such a basis, strategies can be defined for the adjustment of the economy and the public expenditure planning that are commensurate with the liabilities generated, not only each year, but over a period of time appropriate to take into account the rigidity generally associated, to a greater or lesser extent, with expenditures.

A multi-annual exercise makes it possible to reduce instability and encourage growth. On the one hand, the transparency of the decision-making process enhances confidence in fiscal policy; on the other, it allows economic agents to ponder the future impact of the change in expenditure, in particular the pressure on taxes and/or the public debt, and accordingly on the economy and social well-being. To put it another way, and in line with wide empirical evidence, the proper placing of fiscal policy in a multi-annual framework contributes to eliminate the illusion that increases in debt can be financed indefinitely and may therefore be regarded as equivalent to real increases in wealth.

Inadequacy of institutional mechanisms

In this field the institutional mechanisms in place in Portugal continue to be inadequate. That is the case with the Fiscal Strategy Document (FSD) or the updating of the Stability Programme, renewed annually and not clear as to the strategies adopted (both from the economic and budgetary standpoints) and the measures for implementing, monitoring and assessing them. The end of the EFAP and the continuing consolidation effort reinforce the need for a thorough review of the budgetary framework, so that the annual budget may be inserted into a time horizon that reflects these concerns. This point is of particular relevance to the efficient planning of public expenditure and to a budget adjustment that will enhance economic growth.

Incomplete adaptation to European legislation

In general these matters are provided for in European legislation, especially in *Regulation (EU) No. 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficits of Member-States in the euro area*. Those rules are particularly demanding in terms of macroeconomic and budgetary forecasts, which in Portugal, even in the case of annual forecasts, are still characterised by insufficient fundaments and transparency.

Furthermore, Portugal has still not adopted the provisions of article 4 (4) of the mentioned regulation, which states that

> *National medium-term fiscal plans and draft budgets referred to in paragraphs 1 and 2 shall be based on independent macroeconomic forecasts, and shall indicate whether the budgetary forecasts have been produced or endorsed by an independent body. Those forecasts shall be made public together with the national medium-term fiscal plans and the draft budgets that they underpin.*

Presumably the fact that the forecasts were endorsed by the bodies making up the troika has been considered sufficient. However, taking into account that the programme sponsored by the troika will come to an end in mid-2014, it is imperative that the Portuguese institutional structure adopts the principles required to comply with the aforesaid provisions. More importantly, their adoption must take into account the need, greater in the Portuguese case, for a framework that limits the bias seen in the past, which contributed significantly to the current imbalance.

Contents of the forecasts underlying the DSB/2014

In 2014, the expected recovery, following growth observed from the second quarter of this year, stems to a large extent, from a smaller decline in domestic demand, due to private consumption and investment, while net exports fall, although continuing to make the largest contribution to growth. The expected slight recovery in private consumption probably assumes that the budget restrictions contained in the DSB/2014 were already incorporated into consumers' expectations. In addition to doubts over this assumption, the main issue is that the driving force behind sustainable economic growth, in an economy stressed by a high level of public and private indebtedness, cannot result from a reduction in savings, but rather from a stimulus to investment in tradable sectors that increases the economy's competitiveness and generates its own financing.

In recent years the economy has shown a significant ability to adapt to appropriate incentives, which led, for example, to growth in national exports through increased market shares in traditional markets and the search for new markets. This change must now be complemented by a significant increase in investment, aimed at enhancing exports and reducing the import content of domestic demand.

The importance of the adjustment strategy…

Portugal cannot influence foreign demand, but the ability to attract investment capable of taking advantage of it must become a policy priority. It is interesting to note that the *Global Competitiveness Report 2013-14*[5], which ranks Portugal as 51st among 148 economies, ranked the country 118th in wastefulness of government spending, 132nd in burden of government regulation and 139th on effects of taxation policy on incentives to invest. The macroeconomic environment is the pillar in which the country scores least. On the contrary, the quality of its infrastructure, health, primary education and innovation are the pillars where it is favourably placed.

… and its disclosure

These indicators, which represent the investors' view of the country, should lead to defining their improvement as a high priority of the adjustment strategy. This should be made explicit and reflected in the macroeconomic forecasts, and its implementation duly monitored and assessed. In its Report analysing the FSD 2013-2017, the CFP noted that:

> *the FSD does not integrate an analysis of the expected effect of major economic policy measures the Government envisages for the programming period, such as those contained in the Strategy for Growth, Employment and Industrial Development 2013-2020, released by the Government on 23 April. Given the close link between the budget constraint and the economy's prospects, as the FSD's risk analysis clearly underlines, it would be useful to find in the FSD a first analytical attempt at combining fiscal consolidation measures with growth inducing measures in the medium run.*

A similar comment can now be made in regard to the reform of the State, which was the subject of a Government proposal made public on 30 October[6]. Despite being a discussion paper, clear and quantified linkages to the fiscal strategy would contribute greatly to the mutual credibility of both.

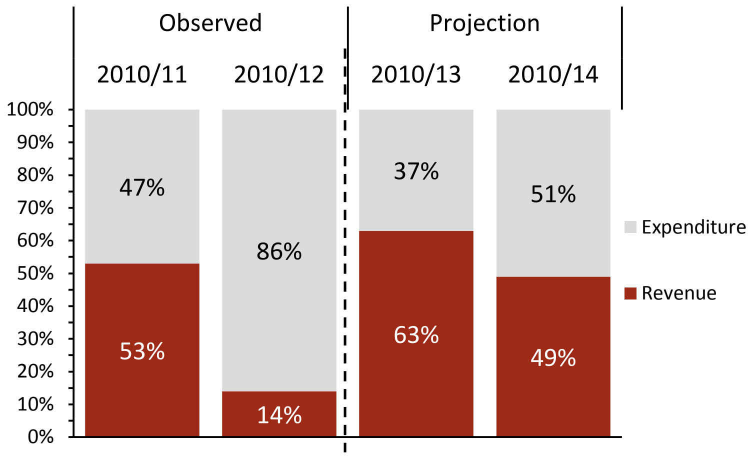
[5] *World Economic Forum, Global Competitiveness Report 2013-14*.
[6] Um Estado melhor – Guião para a reforma do Estado.

Empirical evidence shows that a strategy based on spending cuts tends to lead to a more permanent consolidation, with fewer costs in terms of economic growth than one stemming from an increase in tax revenue.[7] One reason for this is the fact that sustained spending cuts should be the result of stable contractual changes, rather than reversible or temporary measures that are unable to produce a shift in expectations or behaviour conducive to the efficiency gains essential to consolidation. However, such contractual changes suppose a consensual political reform which means they are accepted and understood by society as a whole.

How the adjustment worked

The composition of the fiscal adjustment made in Portugal so far has been inadequate. It was expected to be mainly based on a decline in the weight of expenditure, but the lack of a suitable institutional basis forced a change of course in 2013, when the spending cuts rejected by the Constitutional Court were replaced by a rise in tax revenue. The DSB/2014 provides for a correction next year, but this is still dependent on legislative changes whose final approval is uncertain. The indetermination in this field increased the uncertainty as to the fiscal policy stance and jeopardised its ability to guide economic agents' saving and investment decisions in line with budget consolidation. In practice it involved qualitative and quantitative changes in the measures. As a consequence, even if the goals of the DSB/2014 were fully met, the adjustment (assessed in adjusted structural terms) would be due almost equally to an increase in revenue and a decline in expenditure, whereas the original goal was for the latter to account for two-thirds of the adjustment. At the same time, across the board cuts were often introduced rather than efficiency gains which would restrict the recessive effect of the measures, an approach that further deteriorated the quality of the adjustment.

Chart 2 – Cumulative composition of the structural adjustment



Source: INE and Ministry of Finance. CFP calculations. | Note: If the European Commission's estimate for the output gap in its autumn 2013 forecasts were used, spending's share of the budget consolidation effort from 2010 to 2014 would rise to 54% (and to 40% from 2010 to 2013).

Fiscal transparency

This report ends with a chapter on fiscal transparency. It is worth quoting the definition of that concept:

[7] See for example, OECD (2010), Making Reform Happen. Lessons from OECD Countries.

Fiscal transparency is defined as openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities, so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implications.

In this field Portugal has made important progress but still faces a long road ahead.

In a report on the observance of transparency standards dated from 2003[8], the IMF noted that progress but also identified a series of issues requiring improvement. The need to improve public accounts and broaden their scope, to be mindful of the proliferation of PPP, to better integrate the annual budget into a medium-term framework, to enhance the quality of budget projections, and to strengthen budget execution, reporting, and accounting processes were some of the items mentioned.

Subsequent experience has shown their importance and has also shown that there is still much to do. At the same time, deteriorating circumstances turned fiscal transparency (and the credibility it brings) into a crucial issue to improve public debt financing, to gain the confidence of economic agents and also to introduce adjustments in public spending capable of producing the efficiency gains essential to a sustained budget consolidation and to stimulating business. In this respect, enhancing the scope and the transparency of the comprehensive spending review outlined in the DSB/2014 continues to be essential.

One area where the DSB/2014 shows considerable progress has to do with the listing and partial quantifying of risks, in terms of both the macroeconomic scenario and budget projections. These are accompanied by a provision ("provisional appropriation") of the type used in the SB/2013. For transparency and fiscal confidence sake, a more explicit link between that provision and the listed risks seems warranted.

The Local Finance Law (LFL) and the Regional Finance Law (RFL) are areas where important institutional progress was recorded recently, the results of which should begin to be felt next year. It is therefore regrettable that the DSB/2014 once again adopts the practice – long established and authorised by the Budgetary Framework Law – of repealing the existing rules even, as in this case, when they have just been approved[9]. The resulting uncertainty is counterproductive to the extent that it undermines confidence in the stability of the

[8] "Portugal: Report on the Observance of Standards and Codes — Fiscal Transparency Module", *IMF Country Report* No. 03/373, November 2003.

[9] Article 83 (2) of the DSB/2014 suspends compliance with article 35 of the LFL, thus allowing for decreases in SB transfers for individual municipalities greater than 5%, compared to the SB/2013 endowments. The allocation for the MSF, set out in article 83 (1) (b) of the DSB/2014, corresponds to 1.6% of the arithmetic average of the State taxes covered by the calculations, rather than the 2% laid down in article 82 of the LFL. Article 93 of the DSB/2014 imposes new debt reduction duties that go beyond the debt stock ceiling laid down in article 52 of the LFL, while article 140 of the DSB/2014 prohibits an increase in net indebtedness in 2014, even if such increase would comply with the ceiling set in article 40 of the RFL. The same provision of the DSB/2014 reintroduces the possibility of case-by-case exceptions by the Ministry of Finance, other than force majeure justifications, an old practice that the CFP had criticised and was subsequently eliminated in the new RFL.

legislation (a point that equally applies to tax legislation, for example), and prevents the planning required for a long-lasting and positive adjustment to subnational finances.

The Report that follows provides detailed analysis of the DSB/2014 which was the basis for this overview.

1 MACROECONOMIC SCENARIO

1.1 INTRODUCTION

The macroeconomic scenario underlying the DSB/2014 confirms, to a large extent, the forecast published in the FSD 2013-2017 (table I.5), and even includes more favourable forecasts for the change in GDP in 2013 (-1.8% in the DSB/2014 *versus* -2.3% in the FSD 2013-2017) and 2014 (+0.8% *versus* +0.6%, respectively). This change is based on the developments witnessed throughout 2013, a year in which most forecasts relating to the Portuguese economy were revised upwards.

Goods and services exports continued to perform favourably up to August and exceeded expectations, especially in view of the negative change in relevant external demand.

In the first half of the year there was also a less sharp drop in private consumption, as confirmed by the improvement in most confidence indicators available up to September. As a matter of fact in September there was a new positive change in the coincident indicators calculated by the Bank of Portugal (BoP) with a similar trend in economic activity and in private consumption.

The indicators relating to Gross Fixed Capital Formation (GFCF) continued to be negative, although their decline slowed considerably in the first two quarters of the year.

However, export's positive performance had no impact on the external contribution to growth in GDP, which was practically identical to the original forecast. This was due to the improvement in domestic demand which led to an increase in imports whose trend became positive over the year. That did not prevent the current and capital accounts to retain a positive balance up to August, corresponding to a net external financing capacity.

The predicted positive performance of GFCF in 2014 (+1.2%), although lower than forecast in the FSD 2013-2017 (+2.5%), is based on positive indicators recorded up to September 2013, namely the purchase of equipment, cement consumption and the sale of commercial vehicles.

In 2013 corporate credit continued on the downward trend recorded since 2008, while credit to exporting companies has been rising since 2011, in line with export performance over the same period.

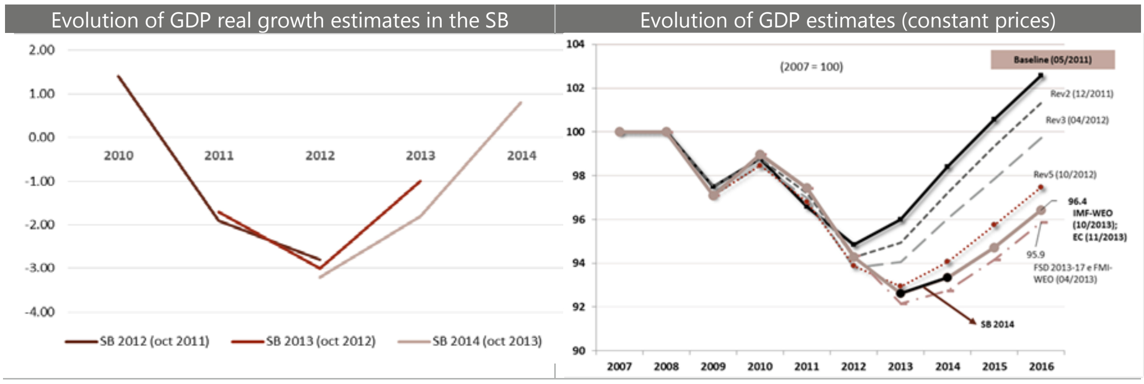
However, current data on the Portuguese economy's competitiveness, such as the World Economic Forum rankings, continues to show a gradual loss of competitiveness, based above all on the inefficiency of public institutions, on the macroeconomic context and on the lack of efficiency in the labour market. The more positive figures making up Portugal's rank relate to the pillars of competitiveness associated to human capital and innovation (further details on these classifications are given below). These two observations show the importance of macroeconomic stabilisation and institutional reform aimed at encouraging investment in tradable sectors, on which balanced economic growth depends.

1.2 REVISING EXPECTATIONS AND THE MOMENT OF GROWTH

The output growth estimates are more favourable than those presented in the medium–term Fiscal Strategy Document published in April 2013 and improve the growth forecasts in 2013 from -2.3% to -1.8% and in 2014 from 0.6% to 0.8%. For the first time since the adjustment programme began a Draft State Budget includes a positive forecast for GDP growth in the year to which the budget relates (left hand panel of Chart 3).

The revised growth trend implicit in the DSB/2014 (and the IMF forecasts[10] and the European Commission November forecasts) marks the beginning of a convergence, in real terms, towards the 2007 figure, but it is still very far off, not just from that level but also from the forecast in the EFAP baseline scenario[11] (right hand panel of Chart 3). This change is supported by all official sources that updated their forecasts in the second half of 2013 (see Table 1).

Chart 3 – Change in the estimates for real growth in GDP in the SB and the EFAP reviews



Source: INE, Ministry of Finance, European Commission and IMF.

The forecasts for the Portuguese economy were significantly revised upwards between autumn 2012 and autumn 2013, following the slowdown at the beginning of the current year, which led to a sharp downward revision in the projections underlying the SB/2013.

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[10] International Monetary Fund (2013), *World Economic Outlook October 2013*, Washington.

[11] CFP Report No. 3/2013 "Analysis of the Fiscal Strategy Document 2013-2017" stated: ***Since the beginning of the EFAP the forecasts therein have been repeatedly revised downwards***. *The macroeconomic forecasts included in the FSD, for the period 2013-17, are in line with those published recently by the international institutions that provide financial assistance to Portugal. However, it should be borne in mind that in the past the short run forecasts were also aligned and proved to be overoptimistic. Note that the European legislation governing these matters requires forecasts to be* "based on the most likely macro-fiscal scenario or on a more prudent scenario". [….] *Part of the explanation for these revisions is the existence of a harsher than expected external environment, due in particular to the sovereign debt crises that hit the Euro area. In fact the Euro area growth forecasts were also revised downwards and had a major influence on the projections for Portugal, as the EFAP baseline scenario estimated net exports would make a substantial contribution over the time frame considered."*

Table 1 – Macroeconomic projections for the Portuguese economy

	2012	2013					2014		
	INE	Inicial budget	FSD	EC	BoP	SB14	FSD	BoP	SB14
		oct-12	apr-13	jun-13	oct-13	oct-13	apr-13	jul-13	oct-13
Real GDP	**-3.2**	**-1.0**	**-2.3**	**-2.3**	**-1.6**	**-1.8**	**0.6**	**0.3**	**0.8**
Private consumption	-5.4	-2.2	-3.2	-3.5	-2.2	-2.5	0.1	-1.4	0.1
Public consumption	-4.7	-3.5	-4.2	-2.6	-2.0	-4.0	-3.1	-3.2	-2.8
Gross Fixed-Capital Formation (GFCF)	-14.3	-4.2	-7.6	-7.7	-8.4	-8.5	2.5	1.1	1.2
Exports (goods and services)	3.2	3.6	0.8	0.8	5.8	5.8	4.5	5.5	5.0
Imports (goods and services)	-6.6	-1.4	-3.9	-3.9	2.0	0.8	3.0	2.1	2.5
Contributions to change in GDP									
Domestic demand *(p.p.)*	-6.9	-2.9	-4.1	-4.0	-3.1	-3.7	-0.1	-1.1	-0.3
Net exports of goods and services *(p.p.)*	3.8	1.9	1.8	1.8	1.4	1.9	0.6	1.4	1.1
Prices									
Inflation rate**	2.8	0.9	0.7	0.7	:	0.6	1.0	0.8	1.0
GDP Deflator	-0.3	1.3	1.8	1.7	:	1.9	1.3	:	0.9
Labour market									
Unemployment rate	15.7	16.4	18.2	18.2	:	17.4	18.5	:	17.7
Employment growth	-4.2	-1.7	-3.9	-3.9	:	-3.9	-0.6	:	-0.4
Current account (inc. capital transfers)	0.2	1.0	1.4	1.7	:	2.3	2.0	:	3.5
International environment									
Growth of relevant foreign markets	-0.2	2.8	-0.4	:	:	-0.6	4.2	:	3.5
Oil prices (Brent, USD/barrel)	111.6	96.9	113.7	:	:	107.8	106.4	:	102.8
Short-term interest rate (annual average)	0.6	0.4	0.2	:	:	0.2	0.4	:	0.4
EUR/USD exchange rate (annual average)	1.28	1.3	1.3	:	:	1.33	1.3	:	1.35
Memo items:									
GDP at current market prices	165.6	166.8	164.5	164.5	:	162.2	167.5	:	166.7
General gov. balance (% GDP)	-6.4	-4.5	-5.5	-5.5	:	-5.9	-4.0	:	-4.0
Public Debt (% GDP)	124.1	123.7	122.3	122.9	:	127.8	123.7	:	126.7

Source: INE, Ministry of Finance, Bank of Portugal (BoP), European Commission (EC) | Notes: (**) EC inflation projections correspond to the standard consumer price index; FSD 2013-2017 forecasts are similar to those in the 1st ASB/2013 and the EC forecasts were published in the context of the 7th Review of the EFAP; the BoP autumn bulletin only updated the forecasts for 2013 and so the summer bulletin forecasts were used for 2014. The latest IMF forecasts in WEO October 2013 and those of the European Commission in November 2013 are practically identical to DSB/2014.

The economic prospects for 2014 included in the DSB/2014 Report were revised upwards (from 0.6% to 0.8%), compared to the FSD 2013-2017 and to the 7th EFAP review. This revision was due to the expected larger contribution from net exports; since the negative contribution of domestic demand increased (GFCF should rise by 1.2% and not the previously estimated 2.5%).[12] The downward revisions in the GDP deflator and relevant external demand should also be mentioned.

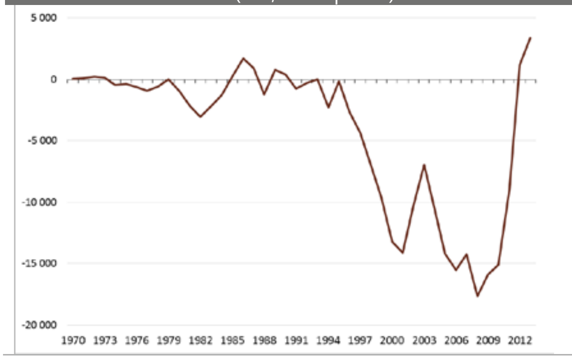
Portugal achieved a positive outcome on the Current and Capital Account up to August 2013. That was due, to a large extent, to the decline in imports (linked to a decrease in all domestic demand components) combined with the growth in goods and services exports. The achievement of a surplus (in 2012 and 2013) on this account, which determines the external lending/borrowing capacity, should be highlighted as it has not arisen since 1993 (see left hand panel of Chart 4) and it is a prerequisite for the rebalancing of the Portuguese economy and thus one of the goals of the adjustment programme. In order to maintain a

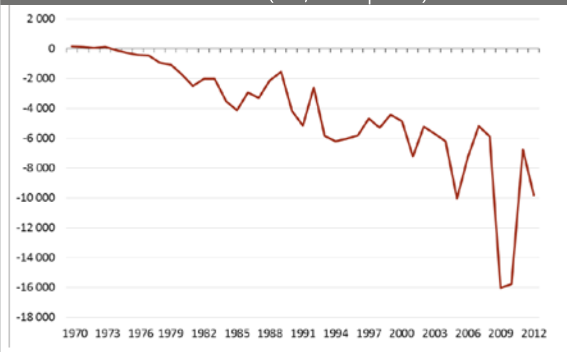
[12] Note that the estimated investment (GFCF) in 2013 was also revised down, going from -7.6% to -8.5%.

downward trend in the relative weight of external debt this outcome must be consolidated through structural changes to domestic demand and to aggregate supply in such a way that may guarantee the compatibility of GDP growth and an improved external position.

Chart 4 – Current and Capital Accounts balance and general government borrowing requirements

Current account (inc. capital transfers) 1970 to August 2013 (M€; 2005 prices)	Borrowing requirements of general government from 1970 to 2012 (M€; 2005 prices)





Source: Bank of Portugal and INE; GDP deflator, AMECO series. CFP calculations.

The GDP growth estimate in the DSB/2014 is the expected outcome of developments in expenditure items consistent with the return to a sustained growth trend:

- **Slight increase in private consumption** (ending a series of decreases since 2011);
- **Decline in public consumption**, albeit less significant than in previous years (in nominal terms the slowdown in the decrease is more significant);
- **Investment growth** and increase of its share in GDP (which has not occurred since 1999);
- Maintenance of the **exports growth** cycle;
- **Growth of imports**, as a result of the growth in investment and exports, but at a lower rate than the latter.

It is a combination that expresses the desired effects of the adjustment process, at the macroeconomic level, while reducing net exports' contribution to growth but maintaining the economy's external lending capacity.

Box 1 – The effects of optimistic bias on macro-fiscal forecasts

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 target 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 it 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.

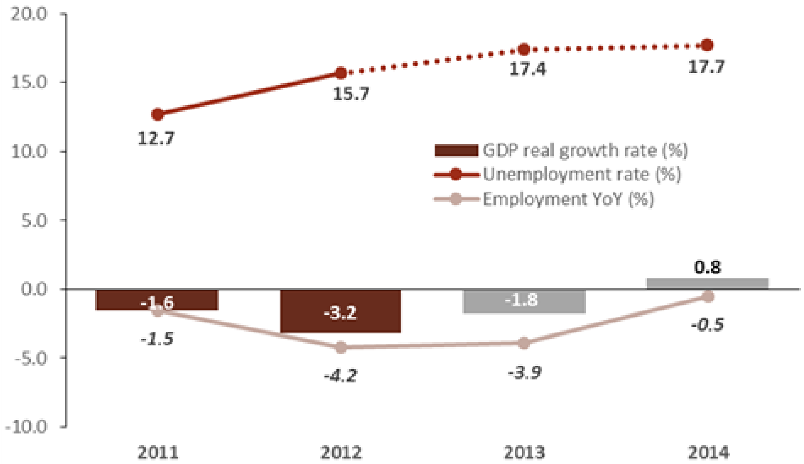
On the other hand, if the economic impact of the fiscal adjustment is underestimated, the targets will not be met. In fact optimistic forecasts tend to give rise to a vicious circle: the monitoring of results becomes more lenient since the situation is expected to improve with time; however, when it 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 risk brings 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 programme's ability to restore economic growth and the sustainability of public finances. 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 programme's realism and possibly to its improvement; on the other, it favours continuous and rigorous monitoring.

Source: CFP (2012), *Report No. 3/2012, Analysis of the Draft State Budget for 2013*, pp. 4 and 5

Over the coming years the rate of unemployment will remain high. The DSB/2014 estimates that unemployment will continue to rise in 2014 (+0.3 p.p., up from 17.4% to 17.7%), following last year's increase of 1.7 p.p. The DSB/2014 Report highlights the risks underlying the unemployment rate forecasts, namely the effect of reallocating resources within a framework of economic restructuring from non-tradable sectors, sometimes labour intensive (such as construction), to tradable sectors.

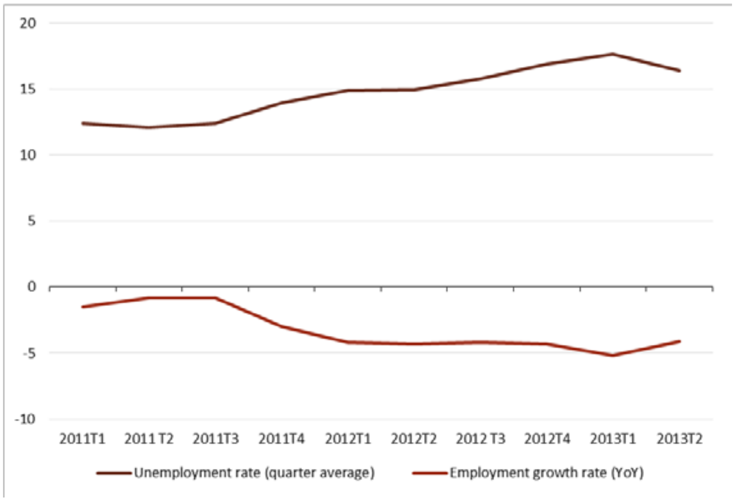
Chart 5 – Growth in GDP, employment and unemployment rate



Source: Ministry of Finance and INE.

The estimated change in employment and unemployment, although subject to significant risks associated with GDP performance, appears to be consistent with the known data (see Chart 6), in particular the trend already observed in 2013 of a fall in the unemployment rate in the second quarter and the reversal of the trend in the year-on-year change in employment.

Chart 6 – Unemployment rate and change in employment – quarterly figures



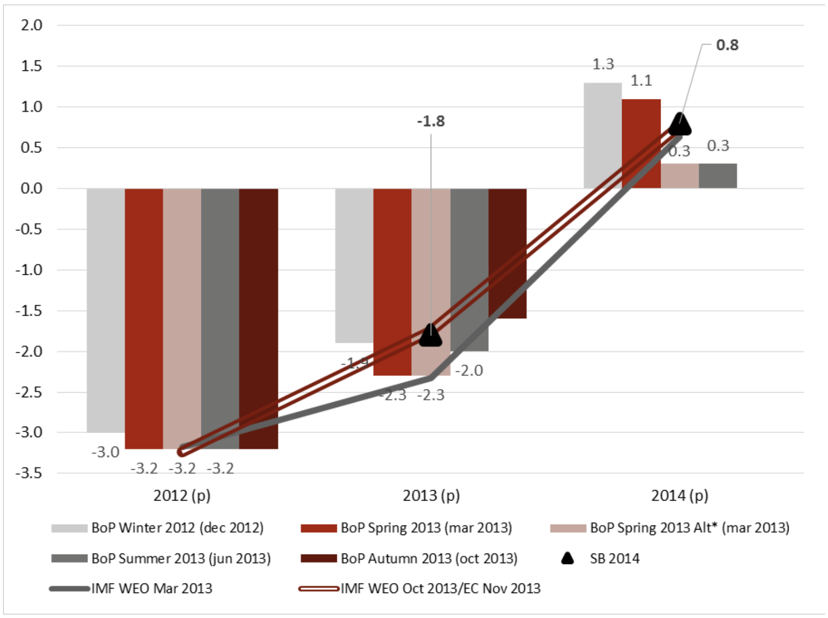
Source: INE – Employment Survey.

However, despite the positive developments, unemployment will remain at historically high levels, maintaining the pressure on the general government accounts.

1.3 MACROECONOMIC SCENARIO RISKS

The macroeconomic scenario considered in the DSB/2014 is very similar to the IMF forecasts of October 2013 and the European Commission forecasts published in November 2013 (see Chart 7) and although it differs in some ways from the Bank of Portugal's forecasts in its summer Economic Bulletin, it is in line with the basic trajectory predicted in the latter (which has not been updated with the DSB/2014). As the CFP highlighted in early reports, closeness to the troika forecasts have not, in the recent past, prevented budget forecasts from being overoptimistic and from underestimating the impact of internal and external shocks on the adjustment process.

Chart 7 – GDP growth forecasts



Source: Ministry of Finance, European Commission, Bank of Portugal and IMF. | Note: p = prevision. * Alternative scenario.

The DSB/2014 Report identifies relevant macroeconomic scenario risks, in particular concerning the European financial system (sovereign debt and the quality of bank assets) and the repercussions of the banking sector deleverage on the real economy.

However, four additional forecasting risks should have deserved a more thorough explanation: (i) the risk of the reversibility of the consolidation measures; (ii) the risk of underestimating the impact of consolidation measures on private consumption; (iii) the risk of an overoptimistic estimate of investment growth and (iv) the risk of the sustainability of the contribution of external demand to GDP growth.

1.3.1 Reversibility of budget consolidation measures

There is still no structured and consensual budget consolidation and management programme to encompass the measures and budget forecasts presented. In the absence of a broad and contractual consensus as to how the consolidation measures should develop in the future, there is the risk of those measures being reversed.

1.3.2 Recovery of private consumption

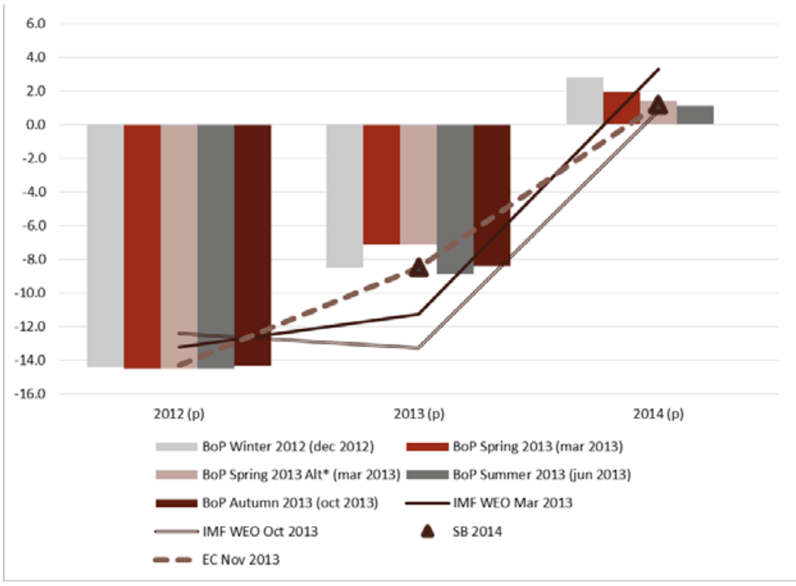
The consolidation measures set out in the DSB/2014 will have a significant, direct impact on disposable income and it is difficult to assess their impact on private consumption. Furthermore, the effect of GDP growth does not point yet to a fall in unemployment, but merely a slowdown in the rate of the net job destruction. Combined with the high level of household indebtedness, these factors constrain the recovery of private consumption that is forecast in the DSB/2014.

A less positive change in private consumption will put pressure on the economic growth estimate and on the budget outturn, although it should be noted that the estimate for VAT collection is lower in the DSB/2014 than in 2013.

1.3.3 Sustaining investment

The elements provided are insufficient to support the growth forecast for gross fixed capital formation, a key element of sustained economic recovery in a time of low public investment. The DSB/2014 Report does not include any specific point on the development of investment or its driving factors, although it is a key variable in the sustainability of the economic potential growth and a driving force of its structural change.

Chart 8 – Investment growth forecasts



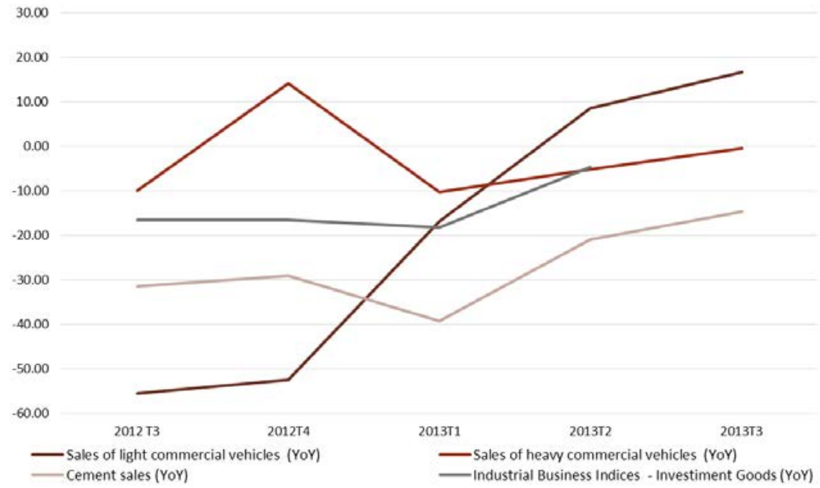
Source: Ministry of Finance, European Commission, Bank of Portugal and IMF | CFP calculations based on IMF forecasts of investment's relative weight in GDP.

The chapter of the DSB/2014 Report that analyses the performance of financial markets identifies a number of effects that could become active restrictions on investment growth, both in terms of funds available and their price. Considering the volume of investment implicit in the MF estimates[13] the quantitative restriction (availability and cost of credit) may become an active restriction, and is not a negligible risk. Nonetheless, the data

[13] This corresponds to an additional investment of 622 M€ against the expected level for 2013 and already includes the compensation for a reduction in public investment of 81 M€ forecast in DSB/2014.

available for 2013 suggests some change in the evolution of the investment indicators (Chart 9) which may be positive signs, although they are not fully consistent.

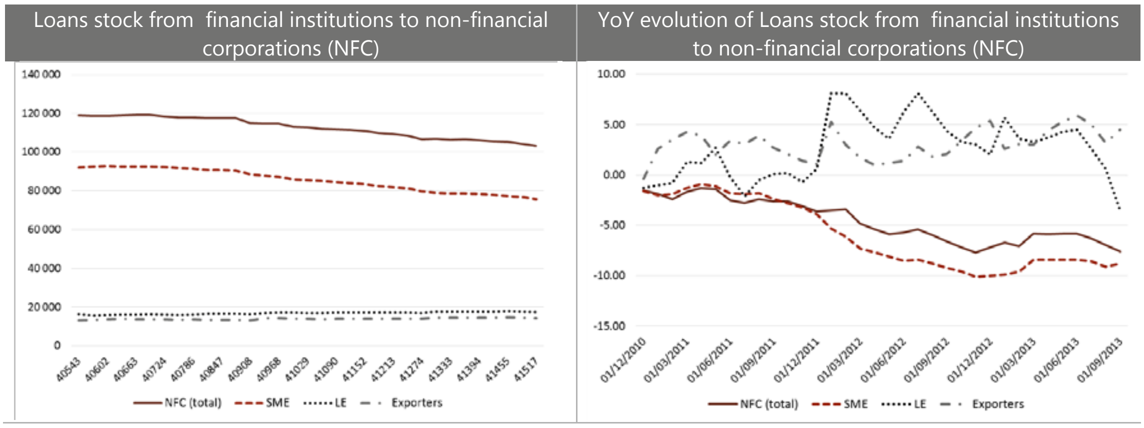
Chart 9 – Economic indicators: investment (in %)



Source: Bank of Portugal, Economic indicators, October 2013 | CFP calculations.

The data on credit granted to the economy show a clear deleverage of non-financial corporations, resulting above all from the fall in credit to SME (left hand panel of Chart 10). Nevertheless, credit from banks to companies has continued to grow in the case of large enterprises and exporters (regardless of their size) (right hand panel of Chart 10).

Chart 10 – Credit from Banks to Non-Financial Corporations



Source: Bank of Portugal | CFP calculations.

However, CFP assesses that the greatest active risk in achieving a reversal of the investment growth trend relates to the creation of a stable environment that actively reduces investor uncertainty regarding the expected development and the context in which it takes place. The recent World Economic Forum Report on Competitiveness[14] clearly supports this view by identifying the factors that most hamper corporate activities in Portugal (Table 2).

[14] World Economic Forum (2013), *The Global Competitiveness Report 2013–2014: Full Data Edition*, World Economic Forum, Geneva.

Table 2 – Main problematic factors for doing business in Portugal

Access to financing
Inefficient government bureaucracy
Tax rates
Policy instability
Tax regulations
Restrictive labor regulations

Source: *World Economic Forum* (2013).

In this regard, note the indicators in which Portugal is ranked in the bottom quartile by the World Economic Forum (see Table 3). This shows the importance of factors that depend on fiscal policy.

Table 3 – Some WEF competitiveness index indicators

Indicators where Portugal is placed in the 4th quartile	RANK/148
Institutions	46
Wastefulness of government spending	118
Burden of government regulation	132
Efficiency of legal framework in settling disputes	122
Macroeconomic environment	**124**
Government budget balance, % GDP	116
Gross national savings, % GDP	106
General government debt, % GDP	143
Goods market efficiency	**72**
Effect of taxation on incentives to invest	139
Labor market efficiency	**126**
Hiring and firing practices	124
Redundancy costs	134
Effect of taxation on incentives to work	139
Pay and productivity	121
Country capacity to retain talent	111
Financial market development	**114**
Ease of access to loans	121
Soundness of banks	120
Legal rights index	118

Source: World Economic Forum (2013).

In contrast to these very negative indicators for the Portuguese economy's competitiveness, it should be stressed that **the country is ranked in the top quartile in areas of major importance such as health and primary education, higher education, and technological adoption and innovation**. Portugal was ranked in 11th in quality of its management schools, 16th in availability of scientists and engineers and 20th in quality of its scientific research institutions.

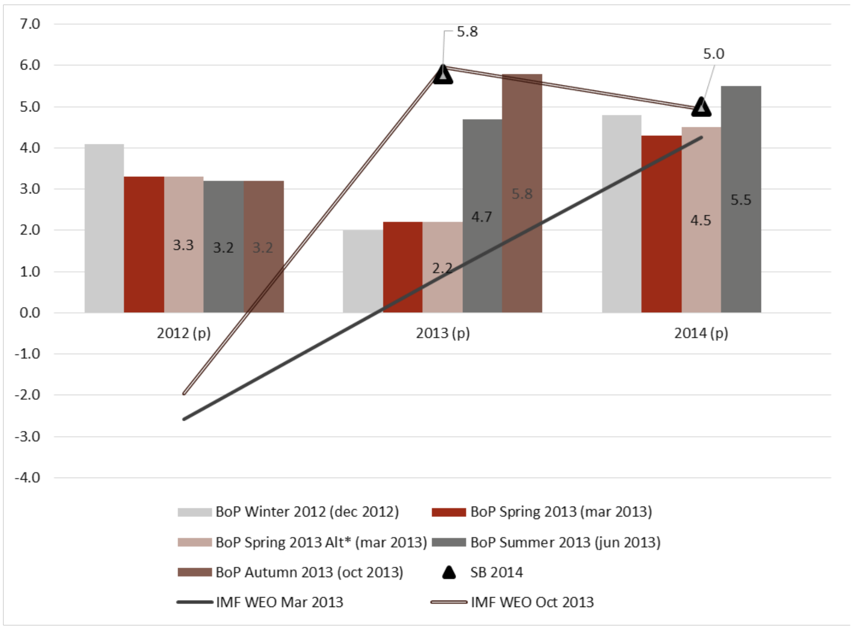
Note also that the recent signs of a change in the consumer and corporate confidence indicators, in Portugal and in the EU, are significant and constitute solid grounds for sustaining the growth trend predicted in the DSB/2014, which will be supported by the recovery of private productive investment.

The CIT reform that is underway may be an important factor, although not decisive, in changing the national investment incentive context. Note that the successive changes to the personal and corporate income tax rules (included in Table 3, among "effects of taxes on investment incentives") penalise investment, and it would be advantageous to devise stable and simple tax rules within a predictable fiscal framework. Otherwise the gradual decrease in the nominal tax burden might not be sufficient to attract FDI and encourage internal investment.

1.3.4 Sustainability of external demand's positive contribution

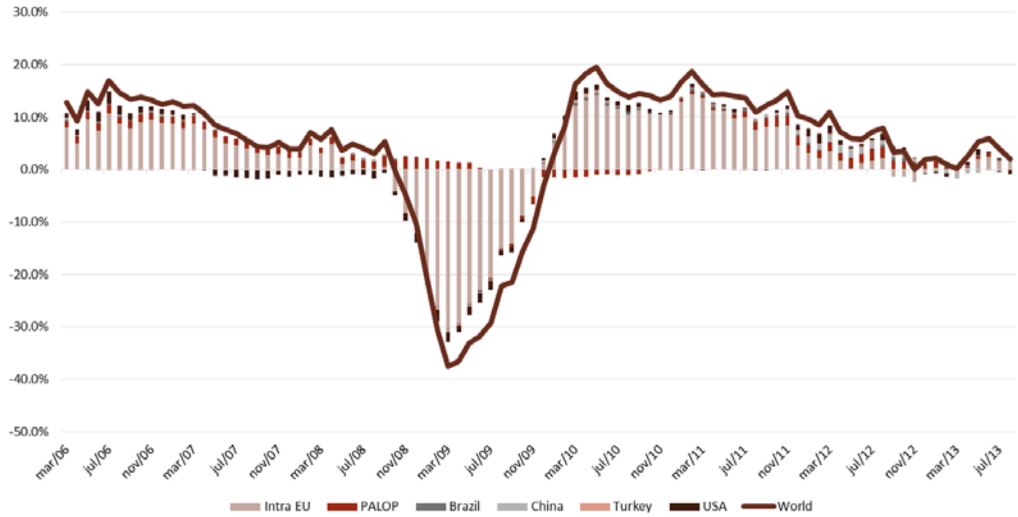
Although the export growth estimate is supported by the recent positive figures, it is not backed up by data that dispel doubts as to its sustainability. The attempt to quantify the risks associated with the external assumptions included in the Report (price of oil, interest rates and external demand) is pertinent and produces relevant results but, as it only takes into account negative effects, the estimates incorporated in the macroeconomic scenario projection may be biased. Export performance has been successively revised up (see Chart 11) and there is evidence of diversification into markets outside the European Union (see Chart 12), which has greatly reduced national exporters' dependence on the European market.

Chart 11 – Export growth forecasts



Source: Ministry of Finance, Bank of Portugal and IMF.

Chart 12 – Growth rate of exports of goods and contribution by countries/regions



Source: Exports of goods by destination - INE, International Trade in Goods Statistics | CFP calculations. The growth rate is given by the year-on-year change in the rolling average in the quarter ending in the month shown.

The main exported products have a significant imported component, which implies a close relationship between export and import volumes (Table 4).

Table 4 – Imported content of exports (as %)

	Import content of exports	Share of Products on Exports (%)
Machinery and equipment	53	14.8
Transport equipment	67	11.2
Fuels	82	10.6
Metalic products	45	8.0
Rubber and plastics	46	6.9
Chemicals	47	5.6
Textiles and clothing	38	5.2
Agriculture	30	5.1

Source: Ministry of Finance and Fátima Cardoso, Paulo Soares Esteves and António Rua (2013), "The imported content of overall demand in Portugal", *Bank of Portugal Economic Bulletin*, autumn 2013.

According to the figures provided by INE[15] over 50% of the growth in exported goods up to August 2013 was based on the growth in exported fuel. As Portugal is not an oil producer, the export of fuel is constrained by its refining capacity, which has been under less pressure due to the fall in domestic demand. The risks of this trend, i.e. exported goods continuing to be driven by fuel, are of a dual nature: on the one hand, the country's limited refining capacity; on the other hand, the possible pressure of domestic demand, in a scenario that anticipates stabilization and growth of private consumption. According to the figures available on the recent increase in the sale of passenger cars it seems reasonable to admit that the recovery in consumption will affect fuel consumption.

[15] Exports (€) of goods by destination and type of goods, output by activity; Cumulative monthly total - INE, International Trade in Goods Statistics. Final figures for 1993 to 2011, provisional figures for 2012 and preliminary figures for 2013.

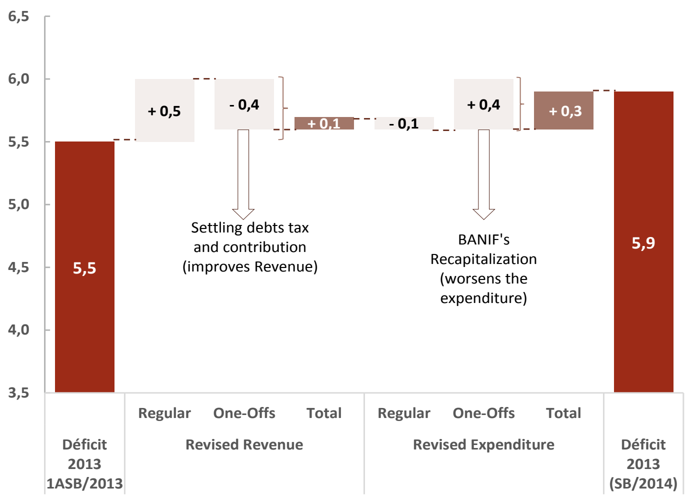
2 BUDGET AGGREGATES

In order to identify the budget consolidation effort, the budget aggregates under analysis in this section are net of the effects of temporary measures, one-off measures (impacting on revenue and expenditure) and special factors (whose impact is limited to the year in which the expense arises). However, it should be noted that these adjustments differ from those underlying the forecasts presented in the DSB/2014 Report. To be precise, the loss of revenue stemming from the investment tax credit (estimated at 200 M€ or 0.1% of GDP) was not deemed a temporary measure in 2013, nor was the impact of the compensations expected due to the mutual agreement termination scheme (227 M€ or 0.1% of GDP) in 2014. On the contrary, the effect of the latter measure was deducted from the impact of the permanent measures set out in the DSB/2014 Report. The details of the transactions and their impact on revenue and expenditure are described in Box 5.

2.1 REVISION OF ESTIMATE FOR 2013

The upward revision of the estimated budget deficit for 2013 to 5.9% of GDP is explained by budget developments not resulting from occasional factors.[16] The new MF estimate increases the 5.5% deficit of GDP laid down as a goal in the 1st amendment to the SB/2013 by 0.4 p.p.[17] As the transactions relating to the recapitalisation of BANIF (impacting on expenditure) and the implementation of the exceptional scheme for settling tax and social security debts (impacting on revenue) have an opposite impact of identical amounts, they cancel each other out, hence not contributing to the deficit revision. Excluding these effects, as shown in Chart 13, the 0.4 p.p. of GDP increase in the deficit is the result of the estimated drop in revenue (0.5 p.p. of GDP), despite an expected improvement in expenditure performance (-0.1 p.p. of GDP). However it should be noted that it is still an estimate and the outturn that will be published in March 2014 by the INE may differ from the estimates, above all in terms of the breakdown of revenue and expenditure.

Chart 13 – Factors that explain deficit revision in 2013



Source: Ministry of Finance and CFP calculations. | Note: - *(i)* Regular factors result from budget developments that are not influenced by one-off/temporary transactions; *(ii)* One-off/temporary factors considered include the BANIF recapitalisation (expenditure) and the extraordinary scheme for settling tax and social security debts, as explained in Box 5.

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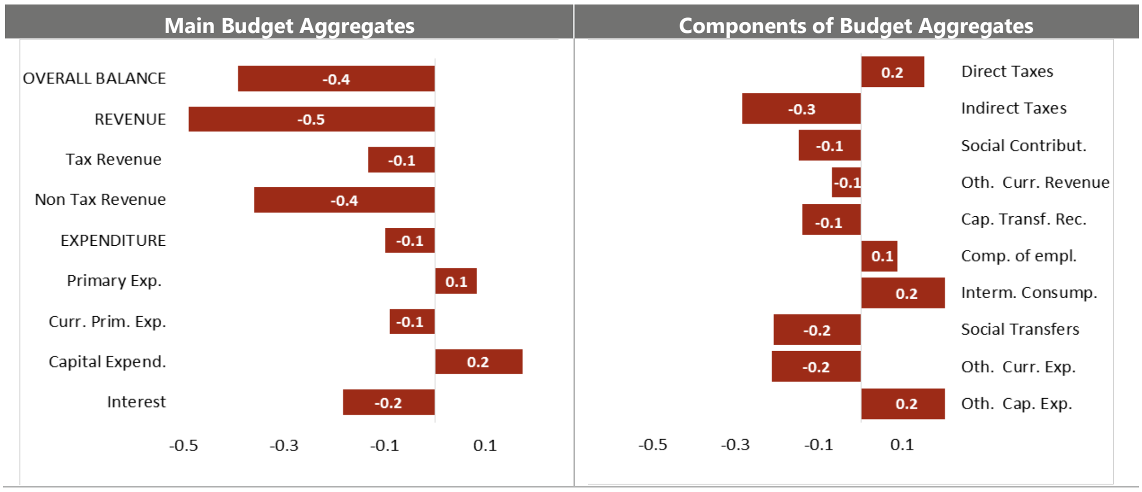
[16] Following the 7th regular review of the Programme, the general government budget deficit limits were revised to 5.5% of GDP in 2013, 4.0% in 2014 and 2.5% in 2015. This new review established the new fiscal goal for 2013 which was reflected in the Fiscal Strategy Document published in April of this year. The deficit originally forecast in the SB/2013 was 4.5% of GDP.

[17] On 1 November 2013 the Portuguese Parliament approved Bill no. 176/XII, which introduced the 2nd amendment to Law no. 66-B/2012 of 31 December, and which approves the State Budget for 2013, amends the Tax Benefits Act, approved by Decree-Law no. 215/89 of 1 June, and the Special Tax Scheme for Income from Debt Securities, approved by Decree-Law no. 193/2005 of 7 November. The impact of that change is detailed in Box 2.

Excluding the effect of the aforesaid occasional transactions, the change in the deficit estimate is mainly explained by expectations of a poorer performance of non-tax revenue compared to the amount estimated in the 1st ASB. In fact, the new estimate for 2013 points to a downward revision of revenue (-0.5 p.p. of GDP), with particular emphasis on non-tax revenue (-0.4 p.p.), mainly as regards social contributions and capital revenue (see Chart 14).[18] Even though tax revenue will benefit from a more favourable estimate of direct taxes, it was also revised downwards (by 0.1 p.p. of GDP).

Chart 14 – Revision of the estimate for 2013 vs. 1st ASB (p.p. of GDP)



Source: Ministry of Finance and CFP calculations. | Note: Figures adjusted for BANIF recapitalisation and revenue collected under the exceptional scheme for settling tax and social security debts.

The expenditure estimate is now more favourable (0.1 p.p. of GDP lower than in the 1st amendment to the SB/2013.[19] This decrease results from the downward revision in interest payments, social transfers and other current expenditures. The figure for intermediate consumption has been revised in the opposite direction, as well as the figures for compensation of employees and capital expenditure, the latter influenced by the non-fulfilment of the concession of the Port of Lisbon and by the moratorium on Greek debt).[20]

The new MF estimate for 2013 points to a lower pace of fiscal consolidation vis-à-vis the first two years of the adjustment. Excluding the effect of temporary measures, one-off measures and special factors, the estimated decrease in the general government deficit will be practically nil (0.1 p.p. of GDP) in 2013, a conclusion that could be drawn from the CFP analysis of 1st ASB/2013. According to the MF estimate, this marginal correction will be

[18] According to additional information provided by the DGO, the revised non-tax revenue estimate is essentially the result of a lower volume of investment aid from the European Union and from less revenue of the CGA social contributions.
[19] Note that this revision benefitted from the new GDP estimate for 2013, since in nominal terms the (adjusted) level of expenditure should be higher by 247 M€ on the 1st ASB estimate.
[20] According to the DGO, the revision of primary current expenditure components is explained on the following grounds: Intermediate consumption – (i) by the reclassification to this component of NHS transactions previously classified as social transfers in kind, following more detailed and more complete information; (ii) incorporating of the Azores Regional Government amending budget; (iii) information reported on the financial position of Oporto University that had not previously been considered; Compensation of Employees – updating of the outturn estimate for reclassified public entities, including the information on Oporto University; Other current expenditure – use of the provisional appropriation to cover most of the expenditure concerning community own resources, but also possible financing needs resulting from the payment of salaries.

sustained, essentially, by tax and social security revenue: the tax burden will rise 1.7 p.p. of GDP in 2013, which explains most of the 2.2 p.p. of GDP increase in revenue.[21] Expenditure will increase by 2.1 p.p. of GDP, of which 1.3 p.p. due to the cost of social transfers (0.7 p.p. of GDP) and compensation of employees as a result of restoring holiday and Christmas bonuses to civil servants and pensioners and, to a lesser extent, to the increase in unemployment benefits (+0.1 p.p.), following the deterioration in the labour market. The relative weight of the remaining items of expenditure in GDP will also rise: intermediate consumption (0.3 p.p. of GDP), subsidies and other current expenditure (0.3 p.p. of GDP) and investment (0.2 p.p. of GDP).

After adjusting the aggregates for the economic cycle effect and special factors, the fiscal adjustment in 2013 should be 0.4 p.p. of GDP in structural terms.[22] The structural balance reflects a better improvement vis-à-vis the budget balance, because the MF estimate for the output gap implies a further decline of 0.4 p.p. of GDP in the cyclical component.[23] The expected improvement in the structural balance, net of special factors, falls short of the FSD 2013-2017 projection (0.8 p.p. of GDP), is below both the minimum of 0.5 p.p. of GDP laid down in the Budgetary Framework Law and the target of 0.6% of GDP laid down in the Council Recommendation of 18 June 2013. However, given that the adjustment in 2013 will occur in an adverse environment, this deviation may be considered in compliance with the Council's recommendation.[24]

According to the MF estimate the fiscal target set in the adjustment programme should be met, despite the upward revision of the budget deficit to 5.9%. Under this programme it is worth clarifying that "*for the calculation of this deficit, the possible budgetary costs of bank support measures, in the context of the Government's financial sector strategy shall not be taken into account*".[25,26] As a result, the impact of the BANIF recapitalisation on the deficit is not relevant to the programme's established goal. However, as in 2012, during the course of 2013 under the programme, a new temporary measure has been accepted[27] to ensure compliance with the programme's budget target (deficit of 5.5% of GDP): the revenue from the exceptional scheme for settling tax and social security debts.[28]

[21] In this context it is worth mentioning: (i) the restructuring and the increase in Personal Income Tax (PIT); the increases in special taxes on consumption; (ii) the revising of Municipal Property Taxation and (iii) the increase in employees' contributions to health protection systems.

[22] The use of the output gap estimate contained in the European Commission's autumn forecasts, published on 5 November 2013, i.e. after this report's calculations were completed, together with the CFP's classification of temporary measures, one-off measures and special factors, would give rise to an improvement in the structural balance of 0.5 p.p. of GDP for 2013.

[23] The cyclical component is subtracted from the adjusted balance to compute the structural balance.

[24] In this regard recital no. 13 of the Council Recommendation identifies additional factors to be taken into account when assessing the structural adjustment, in particular the downward revision of potential GDP and a fall in revenue greater than in the cyclical component. These facts may justify a change in the structural balance forecast for 2013 lower than the minimum correction required under the legal duties laid down nationally and by the European Union.

[25] 2013/323/EU Council Implementing Decision of 21 June 2013, granting Union financial assistance to Portugal, which amends article 3 (3) of Council Implementing Decision (2011/344/EU) of 17 May 2011.

[26] For the purposes of achieving the Programme's fiscal target in 2013 the extraordinary investment tax credit has also been excluded and its impact on tax revenue and consequently on the balance is negative to the tune of 0.1 p.p. of GDP.

[27] The report relating to the 8th and 9th regular reviews of the programme, not yet available, will clarify the temporary measures taken into account for the purpose of achieving the budget target for 2013.

[28] Decree-Law no. 151-A/2013, of 31 October.

Box 2 – Fiscal impact of the 2nd amendment to the SB/2013 – Budget Tables

Bill no. 176/XII does not change the ceiling to the net overall direct indebtedness of the State, which remains at 15 480 M€, the amount approved under the 1st ASB/2013. The fiscal impact of the 2nd amendment to the SB/2013, which stems from the budget tables submitted to Parliamentary vote, regarding the State, Autonomous Services and Funds (ASF) and Social Security, in public accounting, reflects a higher forecast of revenue and a change in expenditure appropriations, in particular:

- Greater financial inflow from privatisations (1340 M€), up by 340 M€ on the original forecast, and consequently a lower need to resort to borrowing;
- Forecast of a higher level of tax and social security revenue as a result of the exceptional scheme for settling tax and social security debts in force until the end of 2013;
- Increase in the overall expenditure appropriation for the State subsector (mainly for social security and social assistance) and ASF[1], as well as a decrease in the social security expenditure allocations;

The State is the subsector that reflects the most revisions:

- The major budget changes in the MF which cover debt and public treasury management (privatisations and interest payments), social protection (ADSE) and community own resources (contribution to the European Union budget).
- The revising of the tax revenue forecast (+670 M€) and the capital revenue forecast (-227 M€). In the former case the change is mainly explained by the introduction of the exceptional scheme for settling tax debts which impacts on direct taxes (+703 M€) and indirect taxes (-33 M€), and in the latter case it reflects the fact that in 2013 the financial inflow expected from the Port of Lisbon concession is not expected to happen (-227 M€).[2] With no impact on this subsector's budget balance but worth mentioning is the increase in the financial assets revenue forecast, which reflects the new figures of the inflow from privatisations in 2013 and a lower forecast in financial liabilities, mainly in short-term instruments.
- The increase in the overall State expenditure appropriation of 135 M€ is explained by expenditure on transfers (+275 M€) mainly to the CGA (+180 M€); to Social Security (+5M€); the European Union contribution (+90 M€), partially offset by the fall in interest payments (-140 M€). The provisional appropriation has not been subject to any increase or write down.

The remaining budget impacts occur at the ASF and Social Security levels:

- The revenue forecasts and expenditure appropriations for ASF relevant for compiling the balance remains unchanged.[3] The budget impact in this subsector is the result of an increase in revenue and expenditure on financial liabilities by Parque Escolar (11.9 M€) – due to a short-term loan from the State to settle bank liabilities.
- The impact of the budget revisions at the Social Security level reflects an improvement in its balance (+54M€). The decrease in the overall spending appropriation results from a reduction in transfers to households, (mainly unemployment benefits -150 M€), which more than offsets the downward revision in revenue. This aggregate is also affected by lower transfers from the Rest of the World, (mainly from the European Social Fund) and the ASF, and benefits from an upward revision in social security contributions (+229 M€) from the exceptional scheme for settling social security debts to be received until the end of the year. Note the revision of spending on financial assets within the Previdential capitalisation system (reduction appropriations for purchase of shares and equity from the rest of the World in order to offset the increase for medium and long-term State instruments by 500 M€), which impacts the consolidated public debt but has no impact on the balance.

Notes:

[1] When analysing the budget impact on expenditure by functions, mention must be made of the increased appropriations relating to "Other functions – Public debt transactions" recorded at the State level (+200 M€ = 340 M€ from privatisation – 140 M€ from interest saved) and the ASF (340 M€) which reflects to a large extent the counterpart entry of the financial inflow from privatisations. Despite being financial revenue for the State, its transfer to the Public Debt Settlement Fund (PDSF) in order to purchase financial assets means that in accounting terms it must be recorded as a non-financial transfer from the State to the ASF (PDSF) and as financial expenditure by the Fund.

[2] The revising of direct taxes is explained by Personal Income Tax (PIT) and corporate income tax (CIT), respectively at 361 M€ and 342 M€. The downward correction of indirect taxes is explained by the Tax on Petroleum Products (-86M€) and Stamp Duty (-185 M€), notwithstanding the upward revision of VAT (+218 M€) and IUC (+44 M€).

[3] Although the ASF recorded an increase in revenue of 340 M€ due to the State transfer to PDSF of a privatisation revenue, that revenue is not considered in budget balance calculations. Note also that the increase in the State transfer to the CGA is not visible in the budget tables relating to the ASF, because it reflects a change between financing sources, since the fall in own revenues was offset by an increase in general revenue.

2.2 FISCAL FORECAST FOR 2014

2.2.1 Fiscal balances

The DSB/2014 anticipates a general government deficit of 4% of GDP, as stated in the fiscal strategy published in April. Following the 7th review of the EFAP, and taking into account the updating of the macroeconomic prospects conducted in May, the fiscal balance targets were revised downwards in line with the forecasts in the FSD 2013-2017, and the correction of the excessive deficit situation that was originally planned for 2014 has been put off until 2015.[29,30] Achieving the 2014 target implies a 1.9 p.p. of GDP improvement compared to the MF estimate for 2013, a correction well above the improvement expected in 2013 compared to 2012 (0.5 p.p. of GDP).

However, excluding the effect of the expected temporary and one-off measures, the adjusted budget deficit should total 7203 M€, in 2014 (i.e. 4.3% of GDP), which reflects an improvement of 1.6 p.p. of GDP over the previous year. The temporary and one-off measures forecast for 2014 (to the tune of 0.24% of GDP) are mainly revenues from concessions and the transfer of the CTT health care funds.[31] Note that the DSB/2014 considers the same reduction effort for the adjusted deficit in 2014 (1.6 p.p. of GDP) as expected in the FSD in April 2013. Considering that the estimated deviation for 2013 will have carryover effects in 2014, giving rise to a higher forecast of the adjusted deficit by 478 M€ than expected in the FSD for 2014, the achievement of the target agreed under the adjustment programme and the Excessive Deficit Procedure (a headline deficit of 4% of GDP) is partly dependent on the aforesaid temporary measures.

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[29] The aforementioned Council decision of 21 June (2013/323/EU) on granting financial assistance to Portugal revised the targets for the budget adjustment and for the deficit, setting deficit goals of 5.5% of GDP in 2013 and 4% of GDP in 2014. The cost of the financial sector recapitalisation is not taken into account when calculating this deficit.

[30] Under the terms of the Council Recommendation of 18 June 2013, pursuant to article 126 (7) of the TFEU, the deadline for correcting Portugal's excessive deficit was extended to 2015, and targets were set for the budget deficit as a percentage of GDP: 5.5% in 2013, 4.0% in 2014 and 2.5% in 2015.

[31] As stated at the beginning of this chapter, the impact of temporary or one-off measures considered in 2014 (0.2% of GDP) differs from the figure published by the Ministry of Finance (0.1%) because the CFP did not consider the effect of the compensations for terminations by mutual agreement to be a temporary measure. For further information on temporary measures, one-off measures and special factors see Box 5.

Table 5 – Fiscal balances by Subsector

	Milions of Euros		
	Non Adjusted Balance	Temporary Measures	Adjusted Balance
General Government - 2013	**-9 778**	**0**	**-9 778**
Central Government	-10 613	200	-10 413
Regional and Local Government	694	0	694
Social Security Funds	141	-200	-59
General Government - 2014	**-6 793**	**-410**	**-7 203**
Central Government	-8 128	-410	-8 538
Regional and Local Government	986	0	986
Social Security Funds	348	0	348
Change 2013/14	**2 985**	**-410**	**2 575**
Central Government	2 485	-610	1 875
Regional and Local Government	292	0	292
Social Security Funds	207	200	407

Source: Ministry of Finance. | CFP calculations.

The MF forecast the improvement in the fiscal balance relies on a positive contribution from all general government subsectors. The improvement in the adjusted deficit next year points to a sharp decline in the central government deficit (-1875 M€) and an increase in the surpluses of the regional and local government subsectors (+292 M€) and social security funds (+407 M€). This improvement is essentially based on expenditure cuts in all subsectors, and an increase in central government and social security revenues. Note that the latter subsector's balance will continue to reflect SB financing through extraordinary transfers, even though such transfers are expected to fall compared to 2013 (1391 M€, i.e. a decrease of 39.4 M€).

In non-adjusted terms the MF forecasts a positive primary fiscal balance in 2014, reversing the cycle of successive primary deficits. In 2014 a surplus of 0.3% of GDP is expected reflecting an improvement of 1.9 p.p. in the primary fiscal balance compared to the previous year. Adjusting for the effect of temporary measures and one-off measures, if the forecast is achieved, the primary balance will total 0.1% of GDP, reflecting an improvement of 1.6 p.p. of GDP. The last positive primary balance in the general government was recorded in 1995, with a figure of 0.2% of GDP. Achieving such an outcome could mark the beginning of a period of primary surpluses, essential to guarantee the sustainability of public debt.

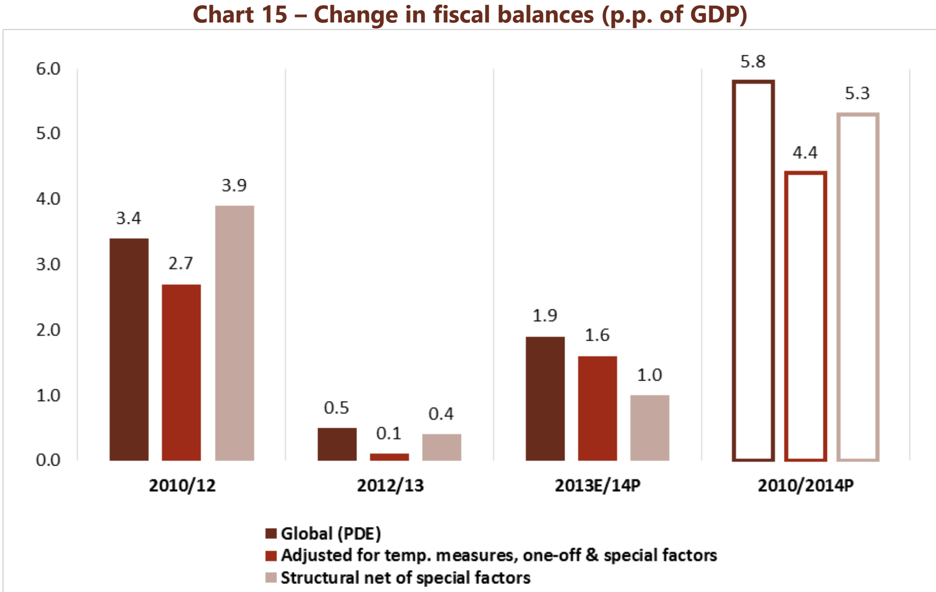
Table 6 – Budget indicators

Budget Balance	% of GDP 2010	2011	2012	2013	2014	Annual Change (p.p. of GDP) 2011	2012	2013	2014
Primary (EDP)	-7.0	-0.3	-2.1	-1.6	0.3	6.7	-1.8	0.6	1.9
Actual headline (EDP)	-9.8	-4.3	-6.4	-5.9	-4.0	5.5	-2.1	0.5	1.9
Adjusted of temporary & one-off measures	-10.2	-8.0	-6.4	-5.9	-4.3	2.2	1.6	0.5	1.6
Adjusted of temporary & one-off measures & special factors	-8.7	-7.1	-6.0	-5.9	-4.3	1.6	1.1	0.1	1.6
Cyclically adjusted	-9.4	-3.5	-4.8	-3.9	-2.7	5.9	-1.4	0.9	1.2
Structural	-9.7	-7.1	-4.8	-3.9	-3.0	2.6	2.3	0.9	1.0
Structural net of special factors	-8.2	-6.3	-4.4	-3.9	-3.0	2.0	1.9	0.4	1.0
Structural primary	-6.9	-3.1	-0.5	0.4	1.4	3.8	2.6	0.9	1.0
Structural primary net of special factors	-5.4	-2.2	0.0	0.4	1.4	3.2	2.2	0.4	1.0
memo items									
temporary measures	0.3	3.6	0.0	0.0	0.24	3.3	-3.7	0.0	0.2
special factors	-1.5	-0.9	-0.5	0.0	0.0	0.6	0.4	0.5	0.0
temporary measures & one-offs & special factors	-1.1	2.8	-0.5	0.0	0.2	3.9	-3.3	0.5	0.2
output gap*	-0.9	-1.8	-3.5	-4.2	-2.9	-0.9	-1.6	-0.8	1.4
cyclical component	-0.4	-0.9	-1.6	-2.0	-1.3	-0.4	-0.8	-0.4	0.6
interest payments (EDP)	2.8	4.0	4.3	4.3	4.4	1.2	0.3	0.0	0.0

Source: INE, Ministry of Finance. AMECO. CFP calculations. | Notes: *Difference between the observed output and the potential output estimate as a % of potential output. The output gap used is the Ministry of Finance's estimate. The cyclical component was calculated by the CFP using the community method. The identification of temporary measures and special factors falls within the remit of the CFP and they do not entirely match the classification used by the Ministry of Finance. Due to rounding the totals (and the changes) do not necessarily correspond to the sum (difference) between the figures presented.

Based on the MF estimate of the output gap, the change in the fiscal balance next year will benefit from an improvement in the macroeconomic conditions. The economic cycle's contribution to the improvement in the projected fiscal balance for 2014 will be positive (0.6 p.p. of GDP) reversing the trend of the last three years.

Chart 15 – Change in fiscal balances (p.p. of GDP)



Source: INE. Ministry of Finance. | CFP calculations based on Ministry of Finance's estimate for 2013 and forecast for 2014. See notes to previous Table.

The structural deficit should fall to 3% of GDP, reflecting an improvement of 1 p.p. of GDP compared to the previous year.[32] This figure stems from the CFP's classification of temporary and one-off measures and from the MF output gap estimate.[33] Although this result complies with the rule laid down in the Budgetary Framework Law (which implies a decrease in the structural balance of at least 0.5% of GDP)[34], it will fall short of the figure set out in the European Council Recommendation in which an improvement of 1.4% was expected.[35] Therefore, over the period of 2013 and 2014, the consolidation effort is expected to be 1.4 p.p. of GDP, less than the 2 p.p. decrease laid down in mentioned Recommendation.[36]

This estimate means that Portugal will still have to reduce its structural deficit in the coming years by 2.5 p.p. of GDP to meet the Medium-Term Objective, to comply with the Budgetary Treaty Stability and Growth Pact.[37] Note that the structural balance is a proxy of the fiscal balance relative to the GDP that would be achieved if GDP were at its potential level and there were no resort to temporary measures, one-off measures and special factors.

Table 7 – Composition of the Budget Adjustment Effort

	% of GDP			SB/2014		Change (p.p. of GDP)			
	2010	2011	2012	2013	2014	2010/12	2012/13	2013/14	2010/14
Strutural revenue	39.9	41.0	40.5	42.7	42.5	0.5	2.2	-0.1	2.6
Structural primary expenditue net s.f.	45.4	43.2	40.5	42.3	41.1	-4.9	1.7	-1.1	-4.2
of which: current primary	41.7	40.3	38.3	39.9	38.9	-3.3	1.6	-1.0	-2.7
of which: capital	3.7	2.9	2.2	2.3	2.2	-1.6	0.2	-0.1	-1.5
Structural primary balance net of s.f.	**-5.4**	**-2.2**	**0.0**	**0.4**	**1.4**	**5.4**	**0.4**	**1.0**	**6.8**
memo items									
Structural expenditure net s.f.	48.2	47.2	44.8	46.6	45.5	-3.4	1.8	-1.1	-2.7
Interest paid	2.8	4.0	4.3	4.3	4.4	1.5	0.0	0.0	1.6
Structural balance net of s.f.	**-8.2**	**-6.3**	**-4.4**	**-3.9**	**-3.0**	**3.9**	**0.4**	**1.0**	**5.3**

Source: INE, Ministry of Finance. CFP calculations.

If the MF forecasts prove to be true, the net structural primary fiscal balance will be positive for the third consecutive year. This indicator has been positive since 2012 and has offset the impact of the rise in interest payments on the (overall) structural balance. In 2014 a significant improvement (1 p.p. of GDP) is forecast, although slightly lower (-0.1 p.p. of GDP) than the adjustment forecast in the FSD.

[32] If the output gap estimate contained in the European Commission's autumn forecasts, published on 5 November 2013 after this report was completed, were used together with the CFP's classification of temporary measures, one-off measures and special factors, it would give rise to a structural deficit of 2.7% of GDP in 2014, as well as an improvement of 1.1 p.p. of GDP compared to 2013.

[33] Despite the differences in the classification of temporary measures, the SB/2014 Report also predicts an improvement in the structural balance of 1 p.p. in 2014 and 0.4 p.p. of GDP in 2013.

[34] As laid down in article 12-C (6) of Law no. 37/2013 of 14 June. Note that paragraph 10 of that article also states that "*the size of the adjustment (...) takes into account the economic cycle position*".

[35] Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Portugal, 18 June 2013.

[36] Note that in the European Commission's autumn forecasts of 5 November 2013 the change in the structural balance is expected to be 0.4 p.p. of GDP in 2013 and 1.1 p.p. of GDP in 2014. However the estimated level of the structural deficit is lower than in this report: 3.7% in 2013 and 2.6% of GDP in 2014. The differences results mainly from an output gap estimate with a much higher absolute value, as well as from differences in the classification of temporary measures and one-off measures.

[37] If the output gap estimate contained in the European Commission's autumn forecasts were used it would reduce this difference to 2.2% of GDP.

According to the MF forecast the improvement in the fiscal position in 2014 will be supported by a cut in expenditure, unlike what happened in 2013. Primary current expenditure will contribute decisively to the improvement in the structural primary fiscal balance net of special factors, (that should fall by 1 p.p. of GDP), as it reflects most of the budget consolidation measures (with a total impact of 1.8% of GDP).[38] The structural decline in revenue reflects the impact of measures, partially compensated by the loss of tax and social security revenue caused by expenditure measures with an impact on compensation of employees and pensions (in net terms, 0.3% of GDP), and a more favourable economic environment compared to the previous year.

2.2.2 Revenue

For the purposes of this analysis the impacts of temporary measures and one-off measures were excluded. Among others, the sums of 700 M€ in 2013 (estimated revenue from the Exceptional Scheme for settling Tax and Social Security Debts) and 240 M€ in 2014 (of which 180 M€ relates to the transfer of the CTT health care fund to ADSE) were excluded – see Box 5.

The net impact of the permanent measures on the revenue side accounts for 15% of the total budget consolidation measures in the DSB/2014. This represents a change in the strategy, since in the SB/2013 the net effect of the measures on the revenue side accounted for around 81% of the total. According to the DSB/2014 Report, and taking into account the permanent measures alone, those relating to the revenue side will have a net impact of 534 M€, equal to just 15.3% of the total consolidation measures. The net impact of the measures affecting tax and social contributions revenue should total 269 M€.[39] The expected inflow from the optimised use of Community funds for employment and social security (around 200 M€) should also be noted.[40]

Box 3 – Main tax measures forecast for 2014

The DSB/2014 Bill and the accompanying report identify a number of changes affecting general government revenue. The main ones are stressed below and their respective impact identified, whenever it has been disclosed by the MF.

a) Direct taxes

- An extraordinary tax on the energy sector that is expected to generate a revenue of 150 M€, of which 50 M€ will be earmarked to reduce the electricity sector debt and to energy efficiency measures.
- Increase of the extraordinary tax on the banking sector, the revenue from which should rise from 120 M€ to 170 M€.
- The DSB/2014 Bill does not include a section on CIT. This is because Bill no. 175/XII is currently being discussed in Parliament with a view to reform taxation of companies (by amending the CIT legislation). Of particular note in the proposed reform is the gradual reduction in the CIT rate: from 25% to 23% in 2014, until it is set at between 17% and 19% in 2016. The DSB/2014 Report does not quantify the (negative) impact of this decrease in 2014. According to additional information supplied by the MF, the overall cost of the CIT reform will be around 70 M€ in 2014.

[38] Total impact of the permanent measures forecast in the SB Report (page 47), net of the effect of paying compensation under the termination by mutual agreement programme (227 M€).
[39] According to the DSB/2014 Report (page 103), revenue from the extraordinary tax on the energy sector and the tax on the banking sector will be recorded as tax revenue in 2014. Therefore it is not clear why these two measures are classified as "other revenue" (non-tax) in Table II.3.4. of the DSB/2014 Report.
[40] According to the information provided by the MF, that optimisation will consist of an improved use of the European Social Fund to finance activities relating to employment and social inclusion.

- Increase in the autonomous tax on motor vehicles held by companies, so as to ensure that the vehicles assigned to middle and upper management positions are considered income in kind for PIT purposes.
- The MF estimates a loss of tax revenue of about 314 M€ due to the compensation of employees and social transfer measures.

b) Indirect taxes

- The new scheme for settling VAT on doubtful debts which allows debts for more than 24 months in arrears to be paid without a prior court decision. Also in regard to this tax, 2014 will be the first full year of the cash accounting scheme for VAT that came into force on 1 October 2013.
- Convergence of tax levels on all forms of tobacco, by means of an increase in the tax rates applying to fine-cut tobacco, pipe tobacco and other tobaccos.
- Increase in the Single Road Tax (IUC) rates applying to all classes of vehicles, as well as the introduction of an additional IUC on diesel passenger vehicles.
- A 50% reduction in the exemption granted to real estate investment funds and pension funds in relation to IMI and IMT.

Notwithstanding the above, the DSB/2014 anticipates a new increase in general government revenue, once again anchored on tax revenue. In adjusted terms (see Table 8), the revenue should rise by 936 M€,[41] following a very significant estimated increase for the current year (+3726 M€). The growth in tax revenue (3.3%, that is, up 1317 M€) and, to a lesser extent, in "other current revenue" (+208 M€) should more than compensate the expected fall in revenue from the sale of goods and services (-218 M€) and capital revenue (-275 M€).

The MF expects the negative trend of indirect taxes revenue to be reversed. After the decrease recorded in 2012 (-4.1%) and the new estimate for this year (-3.4%),[42] the MF forecast suggests that revenue from indirect taxes will increase by 3.7% in 2014 (see Table 9). This turnaround is supported by the expected growth in other indirect taxes (especially the tax on tobacco), as revenue from VAT should fall (although less sharply).

Growth in direct taxes is also anticipated. In adjusted terms, the revenue from direct taxes should record an increase of 2.9%, a change well below the new estimate for the current year (20.4%, which resulted from applying strong tax measures, such as the reduction in the number of PIT bands and the introduction of a PIT surcharge). However, the implicit change for 2014 is influenced by the recording of taxes on the banking and energy sectors.[43] Excluding these effects the increase in direct taxes revenue would be 2.1% (compared to 2.9%), a change above the forecast for GDP growth (1.8% in nominal terms).[44]

[41] Without the effect of the tax revenue loss (-314 M€) resulting from the measures that will affect taxable income, the increase would be 1250 M€.

[42] According to the data published by DGO in the summary of the budget outturn up to September 2013, general government revenue from indirect taxes recorded a year-on-year decrease of 5%. Therefore a recovery in the final quarter of the year is required in order to achieve the change implicit in the new estimate (-3.4%).

[43] The MF estimates that the introduction of the energy sector tax will have a net effect of 100 M€ and that the revenue from the extraordinary tax on the banking sector will rise by 50 M€ in 2014.

[44] The DSB/2014 Report only itemises the revenue forecast for each tax collected by the State subsector, from the cash perspective. Thus for PIT it forecasts a rise of 3.5%. However, in comparative terms, i.e. after correcting the effect of the change in the recording of the transfer of the municipalities' variable share of PIT revenue, the increase is 0.3%.

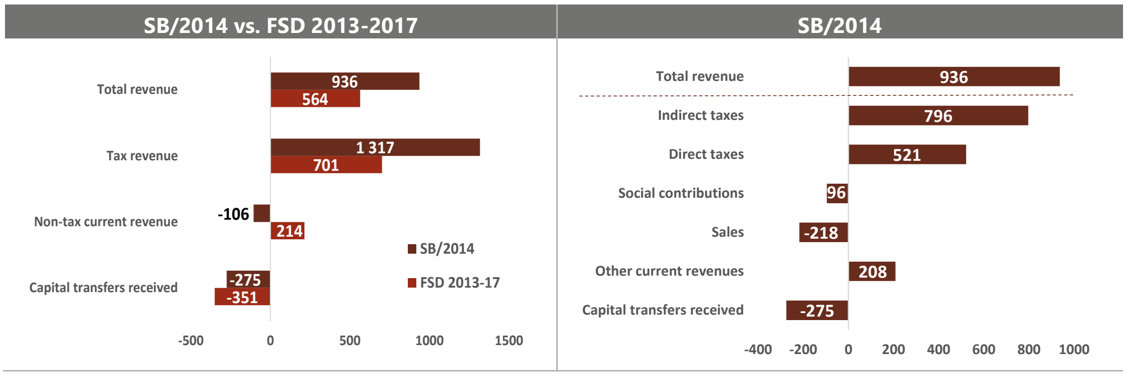
Table 8 – Adjusted general government revenue

	INE	Ministry of Finance		Difference		Change	
	2012	SB/2014		SB/2014 vs. FSD		SB/2014	FSD
		2013	2014	2013	2014	2013/14	
Total revenue	**67 034**	**70 760**	**71 696**	**672**	**1 044**	**936**	**564**
Current revenue	**64 892**	**68 818**	**70 029**	**602**	**899**	**1 211**	**915**
Tax revenue	37 626	39 924	41 241	200	816	1 317	701
Indirect taxes	22 539	21 766	22 562	45	211	796	630
Direct taxes	15 087	18 158	18 679	155	605	521	71
Social contributions	19 135	19 666	19 570	-110	-410	-96	204
of which: actual soc. contr. received	14 989	15 621	15 506	314	25	-115	174
Sales & other current revenues	8 130	9 227	9 217	512	493	-10	10
Sales	4 609	4 772	4 555	4 772	4 555	-217	0
Other current revenues	3 522	4 455	4 663	-4 260	-4 062	208	10
Capital transfers received	**2 142**	**1 942**	**1 667**	**70**	**146**	**-275**	**-351**

Source: INE, Ministry of Finance. | CFP calculations. | Notes: adjusted figures; FSD stands for the Fiscal Strategy Document of April 2013.

Compared to the FSD 2013-2017, published last April, the revenue forecast for 2014 has been revised up. The revision totals 1044 M€, of which 816 M€ are tax revenues. The forecasts for revenue from direct taxes and indirect taxes have been revised upwards by around 605 M€ and 211 M€, respectively.[45] The total for "sales and other current revenues" was revised upwards by 493 M€. However, revenue from actual social contributions is now forecast to fall, whereas in the strategy document there was an implicit increase. This change apparently derives from the effects of the fiscal consolidation measures presented in the meantime.

Chart 16 – Change in adjusted general government revenue in 2014 (in M€)



Source: Ministry of Finance. CFP calculations. | Notes: adjusted figures; the implicit change in the DSB/2014 is based on the estimate for 2013 contained in the SB/2013 report.

[45] The expected rise in tax collection is explained by the impact of better macroeconomic prospects, as well as by the increased in specific taxation.

Box 4 – Tax revenue forecasts in 2013

The forecast for general government tax revenue in 2013 has been subject to several revisions in opposite directions. In the Fiscal Strategy Document estimated tax revenue was sharply revised down (-1632 M€, of which 1062 M€ due to indirect taxes). In the 1st ASB/2013, published at the end of June 2013, that aggregate was revised up (+214 M€, and indirect tax revenue was adjusted upwards).

The latest estimate included in the DSB/2014 Report points to a figure similar to the 1st ASB/2013, although with a different composition: indirect tax revenue is once again revised down (-356 M€) and this change was practically offset by the upward correction to direct tax revenue (+342 M€). Finally it should be noted that the tax revenue growth rate in 2013 should be 3.8 p.p. lower than the figure originally forecast in the SB/2013.

Table 9 – General government tax revenue (adjusted) (M€)

	INE		Ministry of Finance				Change (%)					
	2011	2012	2013			SB/2014	2012	2013				2014
			SB/2013	1st Amend.	Estimate			inicial	FSD	1st Amend.	Estimate	
Tax revenue	**39 540**	**37 626**	**41 357**	**39 938**	**39 924**	**41 241**	**-4,8**	**9,9**	**5,6**	**6,1**	**6,1**	**3,3**
Indirect taxes	23 499	22 539	22 783	22 122	21 766	22 562	-4,1	1,1	-3,6	-1,8	-3,4	3,7
Direct taxes	16 042	15 087	18 573	17 816	18 158	18 679	-5,9	23,1	19,3	18,1	20,4	2,9

Source: INE and Ministry of Finance. CFP calculations. | Notes: figures adjusted for temporary measures, one-off measures and special factors; FSD stands for Fiscal Strategy Document 2013-2017.

2.2.3 Expenditure

In adjusted terms, total expenditure forecast for 2014 exceeds the April forecast contained in the FSD by 1522 M€. This difference is explained by the upward revision of primary expenditure (+1509 M€), explained by an increase in all expenditure items with the exception of compensation of employees which is expected to fall by 902 M€. This change in the level of expenditure in 2014 reflects, a base effect due to the increase in the estimate for the current year's expenditure, where only social transfers, other current expenditure, GFCF and interest were revised downwards, as well as a change in the impact and composition of the budget consolidation measures (see Box 6).

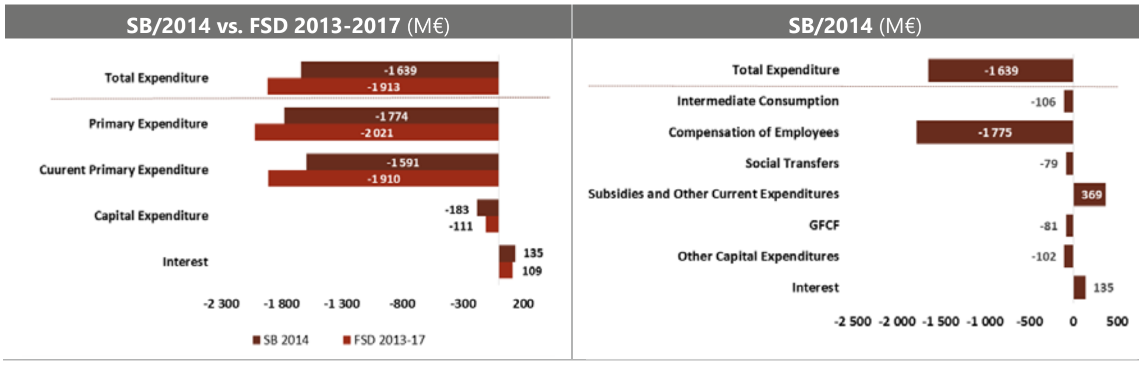
Table 10 – Adjusted general government expenditure (M€)

	INE	Ministry of Finance		Difference		Change	
	2012	SB/2014		SB2014 vs. FSD		SB/2014	FSD
		2013	2014	2013	2014	2013/14	
Total Expenditure	**76 885**	**80 538**	**78 900**	**1 248**	**1 522**	**-1 639**	**-1 913**
Primary expenditure	**69 760**	**73 349**	**71 575**	**1 262**	**1 509**	**-1 774**	**-2 021**
Current primary expenditure	66 171	69 464	67 873	756	1 075	-1 591	-1 910
Intermediate consumption	7 400	7 864	7 758	669	446	-106	117
Compensation of employees	16 510	17 538	15 763	91	-902	-1 775	-782
Social transfers	37 139	38 399	38 320	-839	244	-79	-1 162
other than in kind	29 645	30 975	31 031	-512	503	56	-958
Subsidies	1 009	1 212	1 272	323	401	60	-17
Other current expenditures	4 113	4 452	4 760	511	886	309	-67
Capital expenditures	3 589	3 885	3 702	506	434	-183	-111
GFCF	2 745	3 085	3 004	-3	54	-81	-139
Other capital expenditures	844	800	699	509	380	-102	27
Interest (EDP)	**7 126**	**7 189**	**7 324**	**-13**	**13**	**135**	**109**

Source: INE. Ministry of Finance. | CFP calculations.

The decrease in (adjusted) public spending in 2014 will be less than expected in the FSD in April. According to that document, total expenditure for 2014 was projected to fall by 1913 M€. The decrease underlying the DSB/2014 is now 274 M€ lower (standing at 1639 M€). Although all expenditure items were revised compared to the FSD, the major differences are concentrated in compensation of employees and social transfers. In fact, in April of this year savings expected on social transfers were higher (this expenditure was forecast to decrease by 1162 M€ against the previous year) and lower on compensation of employees (which was expected to drop 782 M€). As mentioned in the CFP Report no. 3/2013 the magnitude of these revisions shows the insufficient specification of the consolidation measures designed to support the downward trend in expenditure, which might have contributed to the low implementation of these measures in 2013.

Chart 17 – Change in adjusted general government expenditure in 2014



Source: Ministry of Finance. CFP calculations. | Note: The change implicit in the DSB/2014 is based on the estimate for 2013 contained in that report.

In adjusted terms, the change in public expenditure depends critically on the impact of budget consolidation measures. Of the package of permanent measures proposed, which totals 3491 M€ or 2.1% of GDP[46] (page 47 of the DSB Report), around 85% are expenditure side measures (2957 M€).[47] Without the impact of these measures, adjusted public expenditure would rise by 1318 M€. The fiscal measures for 2014 also compensate for a higher expenditure starting point than in the previous year (due to the increase of expenditure on pensions,[48] unemployment and the cost of PPP), which puts an additional pressure on primary expenditure.[49]

The decrease in adjusted primary expenditure will determine whether the budget adjustment forecast for 2014 is achieved. The projected decline in primary expenditure is 1774 M€, which is mainly explained by the fall in compensation of employees (-1775 M€), since the expected increase in subsidies e other current expenditure (+369 M€) will be offset by the fall in intermediate consumption, social transfers and capital expenditure (-368 M€, overall). Expenditure on interest continues to rise and is expected to increase by 135 M€, a change higher than estimated for 2013.

[46] Deducting from the impact of the measures, the effect of the upfront costs of the mutual agreement termination scheme which according to the DSB/2014 Report (page 53), is estimated at 227 M€.
[47] In the Overview, the composition of the budget adjustment is measured in structural terms over the period 2010/2014, unlike the analysis in this section where the composition was not adjusted for the effects of the economic cycle and refers only to one year (Government forecast for the effort in 2014).
[48] Due to the increase in pensioners and to the maturation of the pension systems which leads to higher average pensions for new pensioners.
[49] In the DSB/2014 Report the legal obligation to set aside a provisional appropriation laid down the Budgetary Framework Law is considered a budgetary pressure, although it represents no change compared to the previous year. This appropriation is slightly higher than the budgeted figure in 2013, (+3.8 M€), which is why it is not considered to bring additional pressure.

Approximately ⅔ of the expected saving on the expenditure side stems from measures covering compensation of employees and social transfers. In fact, the measures with the largest fiscal impact concern compensation of employees and social transfers (1093 M€ and 912 M€, respectively). Although there is a strong concentration of measures in these two items, the composition of expenditure will not be significantly changed (69% in 2014, which is identical to the figure in 2012).[50] Despite the large cuts in social transfers' expenditure, these will only contain growth in 2014 and smoothen the upward trend in the coming years.

The DSB/2014 forecasts a slowdown in the growth in expenditure on unemployment benefits. As regards expenditure on unemployment benefits and employment support, which has contributed significantly, in recent years, to the deterioration of the social security subsector balance, a slight increase is expected (1.2% in 2014, 8.4% in 2013). This reflects not only a slowdown in the rise of the unemployment rate (from 17.4% to 17.7%) but also the impact of the measures implemented in 2012 under the EFAP,[51] as well as a decrease in transfers for active employment policies.[52] This forecast involves some risks associated with the macroeconomic scenario (see chapter 1 of this report).

Although large scale savings are forecast for intermediate consumption (460 M€), the expected fall in this item is only 106 M€. This outcome shows the difficulty in containing intermediate consumption expenditure, which includes, for example, the cost of PPP that, according to the MF, should total 1325 M€ (i.e. 0.8% of GDP) accounting for an increase of 756 M€ over 2013.[53] Thus, in regard to intermediate consumption, in addition to the impact of measures estimated at 460 M€, around 301 M€ will be retained in this item. In the DSB/2014 Report no specifics are given as to the concrete measures that explain a significant part of the savings forecast in this item, which inhibits external monitoring of performance and may compromise this target. Note that this year expenditure on this item was revised up by 401 M€ compared to the 1st ASB/2013.[54]

Other current expenditure remains at a high level, reflecting a 309 M€ increase compared to the previous year. In contrast with the expected change in the other expenditure outlays (with the exception of subsidies), "other current expenditure" should increase in 2014. According to the MF, this increase is due to the fact that this item includes the budget reserve (279 M€), whereas in 2013 that sum was assigned to the compensation of employees budget item. In 2014 this item also includes the provisional appropriation (524 M€), a figure similar to 2013 (520 M€, part of which will have to be used to finance the increase in the contribution to the European Union budget).

[50] In 2012 compensation of employees accounted for around 21% of total expenditure, and is expected to fall to 20% in 2014. As for social transfers the situation is the opposite as its relative weight should go from 48% to 49% next year.
[51] Note that in 2012 the legal framework for unemployment underwent a reform, aiming at reducing the average payment and the eligibility period. The effects of this reform will have a progressive impact on expenditure as the beneficiaries subject to the new measures replace the beneficiaries whose benefits are calculated under the previous rules.
[52] According to table XI – Social Security Expenditure by Functional Classification, a decrease in the appropriation for Active Employment Policies of around 28.3 M€ is expected.
[53] This figure was calculated taking into account the gross cost of road and rail PPPs and excluding the cost of PPPs whose assets were reclassified to the general government sector and were therefore not classified as intermediate consumption.
[54] As stated in point 2.1 of this report, and in line with the MF, this revision was due in part to a reclassification of NHS expenditure to the sum of 220 M€ and a corresponding decrease in spending on social transfers in kind.

Box 5 – Temporary Measures, One-off Measures and Special Factors

The identification of temporary measures and one-off measures is essential to calculate the structural balance. The code of conduct 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 budget position. As a rule this type of measure does not produce permanent effects that provide for a reduction in the budget deficit. Therefore in order to identify the structural consolidation effort the budget aggregates must be adjusted for the respective effects.

Transactions which depend upon Government action and which increase expenditure solely in the year in which they occur and do not produce a permanent change at the expenditure level are classified as special factors. Since they do not have a permanent impact these transactions are deducted from expenditure for assessing the structural position of the public accounts. In previous reports the CFP has considered bank recapitalisation operations under the financial sector assistance programme to be special factors. In this report a change in methodology has been adopted as regards their classification and they are now included as temporary or one-off measures; for this reason they are no longer identified as special factors in 2013 and 2014.

The table below sets out and updates the temporary and one-off measures and the special factors as classified by the CFP in its analysis of the public accounts for 2013 and 2014 included in the DSB/2014. In 2013 the temporary measures and one-off measures considered were the revenue expected from the Exceptional Scheme for Settling Tax and Social Security Debts and, on expenditure side, the capital transfer to BANIF under the financial sector recapitalisation. Contrary to the MF approach, the tax credit on investment approved by Decree-Law no. 49/2013 of 16 July (0.1% of GDP) was not considered a one-off measure in 2014, since it is a measure that increases the budget deficit. In addition it is not possible to guarantee with a high degree of certainty that it will not be extended. Its classification as a one-off measure would lead to an artificial improvement in structural terms, biasing the analysis. Also on the revenue side, the PIT surcharge in 2013 and 2014 was not considered a temporary measure, since it differs from the surcharge applied in 2011 (to the Christmas bonus month or its equivalent) which proved to be discontinued over time. Furthermore the surcharge implemented in 2013 is to be maintained in 2014, hence it does not have a transitory fiscal effect.

Table 11 – Impact of temporary and one-off measures and special factors on fiscal balance

% GDP	2010	2011	2012	2013	2014
Temporay & one-off measures ***(impact on b. balance)***	**0.3**	**3.6**	**0.0**	**0.0**	**0.2**
Revenue	**1.7**	**4.0**	**0.3**	**0.4**	**0.1**
Transfer of pension funds	1.6	3.5	0.1		
EGREP Dividends					0.0
Transfer of CTT health care fund obligations					0.1
Taxes on repatriation of capitals	0.1		0.2		
Exceptional Scheme for Settling Tax and Social Security Debts - VAT				0.1	
Exceptional Scheme for Settling Tax and Social Security Debts -PIT ; CIT				0.2	
Exceptional Scheme for Settling Tax and Social Security Debts - social contributions				0.1	
PIT sucharge		0.5	0.1		
Expenditure	**1.3**	**0.3**	**0.4**	**0.4**	**-0.1**
Proceeds from concessions	-0.1		-0.2		-0.1
Capital transfers (Banking sector)	1.3	0.4	0.5	0.4	
One-off payments to the EU Budget	0.1		0.1		
Special factors ***(impact on b. balance)***	**-1.5**	**-0.9**	**-0.5**	**0.0**	**0.0**
Expenditure	**1.5**	**0.9**	**0.5**	**0.0**	**0.0**
Delivery of submarines	0.5				
Capital transfers (Sagestamo)	0.0		0.5		
Reclassification of PPP into general government	0.4	0.1			
Recording of Madeira region debt	0.6				
Madeira capital transactions (SESARAM & reclass. of Via Madeira)		0.3			
Madeira region debts from programme contracts & football clubs		0.1			
Reclassification of support fund to health service		0.3			
Temporay measures, one-off measures and special factors	**-1.1**	**2.8**	**-0.5**	**0.0**	**0.2**

Source for figures: INE and Ministry of Finance. | Note: CFP is responsible for the calculations and classification.

In 2014, on the revenue side the CFP considered the amounts relating to dividends from EGREP-Entidade Gestora de Reservas Estratégicas de Produtos Petrolíferos, E.P.E., and the transfer of liabilities of CTT – Correios de Portugal S.A. employees to the ADSE system. On the expenditure side, revenue from the concession agreements covering SILOPOR and the Port of Lisbon (which are written off against capital expenditure) were classified as temporary and one-off measures. Unlike the MF, the CFP did not consider the cost of the compensations under the termination by mutual agreement scheme as a one-off measure, as it is a measure that increases expenditure (and thus the deficit) and because its frequency can only be assessed *à posteriori*, since the duration of the programme, laid down by Ministerial Order no. 221-A/2013 of 8 July, may be extended beyond 2013. Nonetheless, the impact of this measure was considered a temporary measure by the MF.

Note: The code of conduct referred to above is that of the European Commission (2012*), Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes,* September, Brussels: Directorate General for Economic and Financial Affairs. Available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

Box 6 – Budget consolidation measures

When evaluating the FSD 2013-2017, the CFP called attention to the need for future projections for general government accounts to be accompanied by specific and detailed information about the underlying measures, as this would contribute both to the proper interpretation of the projections and to the enforcement of those measures within the expected deadlines. In the same document it also recommended that, following the approval of the fiscal consolidation measures, the Government should update the composition of the adjustment underlying the general government account for the period 2013-2017, in order to match the estimated changes in the various revenue and expenditure items to the estimated change in the fiscal balance. This recommendation has not been followed which makes it difficult to compare the DSB/2014 and the FSD.

Meeting the budget goals set for 2014 will depend crucially upon the implementation of permanent measures and therefore they must be specified and quantified in a timely manner so that their impact on the public accounts can be duly considered, also taking into account secondary effects (changes in income and in other variables endogenous to the macroeconomic model that impact on the expenditure side). In the SB Report a set of measures is identified that may be organised, taking into account their effects: across the board and sectoral effects and their impact on the pension systems. The CFP notes progress in the quality of the information on the across the board measures as compared to FSD. However, there is insufficient information on sectoral measures, the specifics of which are not given.

Comparing the impact of the measures in the DSB/2014 Report and the effects in the documents published officially in May/June by the European Commission (EC) and by the IMF under the review of the EFAP and the excessive debt procedure, we find that the DSB/2014 includes an increase of permanent measures (2.1% of GDP) vis-à-vis the requirements identified in June by those bodies (1.7% of GDP). This comparison reveals further differences in terms of the composition of the measures discussed in the various documents and of their respective impacts, highlighting the significant increase in sectoral measures.

Table 12 – Comparison of fiscal measures for 2014 (% of GDP)

	2014		
	EFAP*	EDP	SB/2014
	IMF	EC	MF
MEASURES ON THE REVENUE SIDE	0.0	0.3	0.3
Tax and across the board measures	0.0	0.3	0.1
Sectoral measures	0.0	0.0	0.2
MEASURES ON THE EXPENDITURE SIDE	1.7	1.4	1.8
Across the board measures	0.5	0.5	0.4
Pension Systems	0.8	0.6	0.4
Sectoral measures	0.3	0.3	0.9
Total impact of measures	2.0	2.0	2.2
Total impact net of upfront costs of mutual agreement termination scheme	1.7	1.7	2.1
Nominal GDP (M€)	167 512	167 512	168 152

Source: European Commission, IMF, Ministry of Finance. | Note: * Information published following the 7th review of the Economic and Financial Adjustment Programme. The separate accounting methods (for revenue and expenditure) of the sustainability contribution that was forecast for 2014 justifies the fact that the EC identifies measures on the revenue side with an impact of 0.3% of GDP when evaluating Portugal's budget position in order to reduce the excess deficits.

The main measures in the DSB Report are as follows:

1. On the revenue side:
    - Tax or across the board Measures:
        - Introduction of a new tax on the energy sector.
        - Increase in the tax on the banking sector.
        - Autonomous tax on motor vehicles held by companies, to ensure that the vehicles assigned to middle and upper management positions are declared as income in kind for PIT purposes.
        - CIT reform.
        - Introduction of stamp duty on financial transactions in the secondary market.
        - Increase in the tax on tobacco and alcoholic beverages.
        - Additional Single Road Tax for diesel passenger vehicles.
        - 50% cut in the IMI and IMT exemptions applying to investment funds.
        - Increase in ADSE contributions.
    - Sectoral Measures:
        - Increase in inspections and enforced collection of social security contributions.
        - Optimisation of the use of European funds in the Employment and Social Security fields.

2. On the expenditure side:
    - Across the board Measures:
        - Change in income policy through a progressive decrease of between 2.5% and 12% of the monthly salary of general government employees, State-owned companies' employees and holders of political office and high public office.
        - Reduction of the number of employees through retirements and recruitment control.
        - Introduction of a 40-hour work week and decrease in the cost of overtime work.
        - Implementation of the termination by mutual agreement scheme applying to operational staff and the creation of new specific programmes for sectors with overemployment.
        - Use of the employee retraining system.
    - Pension Systems Measures:
        - Convergence of the CGA pension formula to the social security pension formula.
        - Change in the benefit formula for calculating the unified pension.
        - Change in the eligibility age for old age pension to 66, making it dependent on average life expectancy and the sustainability factor, for which the baseline reference year changes from 2006 to 2000.
        - Introduction of means test for survivor's pensions above 2000€.
    - Sectoral Measures: with the exception of the decrease in compensatory payments, no specific measures are identified in order to meet the targets set in the DSB Report.

The breakdown by budget item of the effect of the consolidation measures identified in the DSB Report provides a clearer interpretation of their impact on the budget aggregates in the national accounts in 2014, as shown in the table below.

Table 13 – Impact of fiscal measures for 2014 (M€)

	SB 2014				
	Millions of euros			Impact	
	2013	2014	2013/14	M€	% GDP
ADJUSTED FIGURES					
Total Revenue	**70 960**	**71 696**	**736**	**534**	**0.3**
Current Revenue	**69 018**	**70 029**	**1 011**	**534**	**0.3**
Tax revenue	40 124	41 241	1 117	245	0.1
Indirect taxes	21 766	22 562	796	170	0.1
Direct taxes	18 358	18 679	321	76	0.0
Social contributions	19 866	19 570	-296	23	0.0
of which: actual social contributions	15 621	15 506	-114	23	0.0
Sales & other current revenues	9 227	9 277	50	266	0.2
Other current revenues	4 455	4 723	268	266	0.2
Capital revenues	**1 942**	**1 847**	**-95**		
Total Expenditure	**80 538**	**78 900**	**-1 639**	**-2 957**	**-1.8**
Primary expenditure	**73 349**	**71 575**	**-1 774**	**-2 957**	**-1.8**
Current primary expenditure	69 464	67 873	-1 591	-2 667	-1.6
Intermediate consumption	7 864	7 758	-106	-460	-0.3
Compensation of employees	17 538	15 763	-1 775	-1 093	-0.7
Social transfers	38 399	38 320	-79	-912	-0.5
other than in kind	30 975	31 031	56	-891	-0.5
Subsidies	1 212	1 272	60	-154	-0.1
Other current expenditures	4 452	4 760	309	-48	0.0
Capital expenditures	3 885	3 702	-183	-290	-0.2
GFCF	3 085	3 004	-81	-290	-0.2
Interest (EDP)	**7 189**	**7 324**	**135**		
General Government Balance (EDP)	**-9 578**	**-7 203**	**2 375**	**3 491**	**2.1**
Primary Balance (EDP)	**-2 389**	**121**	**2 510**	**3 491**	**2.1**
Nominal GDP	**165 332**	**168 152**			**100.0**

Source: Ministry of Finance. CFP calculations. | Note: The effect of the compensation payable under terminations by mutual agreement, the value of which is stated in the DSB report, was deducted from the impact of the measures identified on page 47 of said Report.

Comparing the change forecast in the DSB/2014 and the effects of the measures by budget item reported by the MF (net of the impact of measures that increase expenditure and reduce revenue), it appears that a substantial part of the impact of these measures is offset by increases in various budget items. The sharper fall in compensation of employees should stem from the fall in social contributions paid by public entities (CGA and ADSE), as a result of the consolidation measures that reduce the level of wages and salaries.

The main focus of the fiscal consolidation for 2014 is on the compensation of employees (1093 M€) and social transfers (912 M€) items. According to the DSB/2014 Report, in addition to the across the board measures, compensation of employees will include sectoral measures with an impact of 363 M€, especially in the education sector (219 M€). However, the measures that lead to this cut in expenditure are not described in DSB/2014.

As for social transfers, their impact will fall short of that predicted in June. One explanation for this difference may be that in the SB no mention is made to the sustainability contribution, which was envisaged in the aforementioned European Commission and IMF documents. Furthermore, in June the impact of the decrease in the extraordinary solidarity contribution was not identified. This is the result of the fall in CGA pensions reduced by the convergence of the CGA and Social Security pension formula which totals 340 M€. The downward revision in this revenue will have an impact on the estimated expenditure on pensions, since in national accounts the impact of this contribution has been recorded as a decrease in expenditure.

In addition to the measures that affect compensation of employees and social transfers, the DSB/2014 anticipates a very considerable rise in savings from sectoral measures, almost doubling the impact forecast in June (rising from an estimate of 795 M€ in June to 1651 M€ in net terms).

3 MULTI-ANNUAL BUDGETARY PROGRAMMING FRAMEWORK

The setting of a spending ceiling financed by central government general revenue, consistent with the deficit goal set for the general government sector in the national accounts, derives from various budgetary assumptions. This expenditure ceiling is set considering the national accounts balance target and expected adjustments to attain a balance in the public accounting perspective.[55] The central government balance is then computed taking the latter restriction into account and the projected balances for the regional and local governments and social security. In 2014 projections indicate this balance cannot exceed an 8343 M€ deficit. The forecast for central government revenue, especially own revenue, underlying the fiscal balance target is critical to determine the maximum level of expenditure covered by general revenue. This expenditure ceiling, calculated in a cash perspective, is subject to the limit laid down in the Multi-annual Budgetary Programming Framework (MBPF).

Table 14 – From the fiscal balance in national accounts to MBPF expenditure limit (in M€)

GENERAL GOVERNMENT (GG)	2014
1. General Government balance (EDP)	**-6 793**
2. Adjustments to the Public Accounts balance	**-637**
Accrual (Commitments adjustments - Cash)	-335
Difference between interested paid and accrued	172
Other accounts receivable	-188
Other accounts payable	-320
Differences due to General Government perimeter	-3 309
Other adjustments	3 007
3. General Government Balance (Public Accounts) [(3)=(1)+(2)]	**-7 430**
a) Regional and Local Government Balance	653
b) Social Security Balance	260
3.1. Central Government Balance [(3.1) =(3)-(a)-(b)]	**-8 343**

CENTRAL GOVERNMENT - Public Accounts	2014
Central Government Balance *(transited value of 3.1)*	**-8 343**
c) Revenue	52 626
Tax Revenue	36 961
Other current revenue	13 873
Capital transfers received	1 793
d) CG Maximum Expenditure Limit [(d)=(c)-(3.1)]	**60 969**
e) Financed by own Revenues	15 300
f) Financed by general Revenue [(f)=(d)-(e)]	**45 669**
Memo : Primary expenditure financed by general revenue	***38 430***

ANNUAL CEILING OF MBFP		
f') Expenditure Ceiling financed by General Revenue [(f')=(g)+(h)+(i)+(j)		**45 669**
Sovereignty	P001 - Sovereign Bodies	2 975
	P002 - Governance and Culture	226
	P005 - Foreign affairs	285
	P008 - Justice	658
g) Subtotal		4 144
Security	P006 - Defense	1 694
	P007 - Internal Security	1 615
h) Subtotal		3 309
Social	P012 - Health	7 621
	P013 - Basic and Second. Educ. and Sch. Adm.	4 938
	P014 - Science and Higher Education	1 296
	P015 - Solidarity, Employm. and Soc. Security	9 358
i) Subtotal		23 213
Economic	P003 - Finance and Public Administration	7 172
	P004 - Public debt management	7 239
	P009 - Economy	222
	P010 - Enviroment, P. Territory and Energy	41
	P011 - Agriculture and Sea	328
j) Subtotal		15 002

Source: Ministry of Finance. CFP calculations.

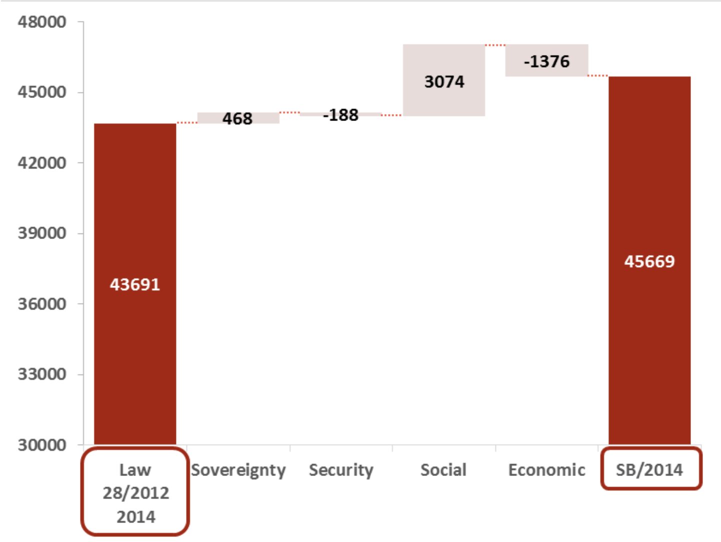
The MBPF included in the DSB/2014 changes the limits for the years of 2014 to 2016 for the first time, covering the restoring of the holiday and Christmas bonuses (Table 15). In the two previous revisions of the expenditure limits covered by general revenue established by Law no. 28/2012 of 31 July, only the figures for 2013 had been amended.[56]

[55] The difference between the two perspectives (637 M€) is explained by the effect of the "accrual principle", by the adjustment for "universe differences" and by "other adjustments". The following items contribute to the first effect: the difference regarding interest paid and interest incurred, the time adjustment for indirect taxes and social security contributions, and the settling of previous years' debts of the Madeira Autonomous Region and of municipalities, in the latter case under the Local Economy Support Programme. In regard to the adjustments resulting from "universe differences" and "other adjustments", their symmetrical impact reflects in the case of the former the increase in the capital appropriations received by transport and infrastructure companies, and in the case of the latter it reflects the State's capital injections in these companies (financial assets expenditure), which in the national accounts affect the balance, as they are capital transfers.

[56] According to the SB/2013 Report, the figures for 2014 to 2016 were to be revised in the FSD 2013-2017, which did not occur.

The DSB/2014 introduces the first upward revision to the figures for 2014 (+1978 M€) and 2015 (+661 M€) and downwards for 2016 (-511 M€). These adjustments take into account the decision to restore the holiday and Christmas bonuses. Furthermore, this MBPF sets, for the first time, a public spending limit for 2017, given that it covers a new four-year period.

Chart 18 – Annual review of MBPF (M€)



Source: Ministry of Finance.

Thus the draft SB forecasts an increase of 1978 M€ (+5%) in the limit of central government expenditure financed by general revenue for 2014 compared to that laid down in the appendix to Law no. 28/2012. The programme groupings in the sovereignty and social areas are responsible for the increase forecast in 2014. The Draft revises up the limits previously set for the sovereignty area (+468 M€), and above all for the social area (+3074 M€), which should reflect the increase in expenditure resulting from the restoring of bonuses to retired persons and pensioners and the increase of expenditure financed by revenue now classified as general revenue,[57] as well as social support. However, in the opposite direction, the DSB/2014 forecasts a decrease in the expenditure limit relating to the programme groupings in the security area (-289 M€) and a major decrease in the programme groupings in the economic area (-1376 M€), which minimise the impact of the upward revision of the spending limit.

[57] The extraordinary transfer to finance the Previdential System (1391 M€), Social VAT (725 M€) and the Social Emergency Programme as well as the Extraordinary Social Support to Energy Consumers (251 M€).

Table 15 – Multi-annual Budgetary Programming Framework 2014-2017 (M€)

	PROGRAMME	Proposed Law n.º 178/XII (SB/2014)				PPL n.º 178/XII (OE/2014) *vs* Appendix to Law 28/2012		
		2014	2015	2016	2017	2014	2015	2016
SOVEREIGNTY	P001 - Sovereign Bodies	2 975						
	P002 - Governance and Culture	226						
	P005 - Foreign affairs	285						
	P008 - Justice	658						
	Subtotal	**4 144**	**3 981**			**468**		
SECURYTY	P006 - Defense	1 694						
	P007 - Internal Security	1 615						
	Subtotal	**3 309**	**3 208**			**- 188**		
SOCIAL	P012 - Health	7 621						
	P013 - Basic and Second. Educ. and Sch. Adm.	4 938						
	P014 - Science and Higher Education	1 296						
	P015 - Solidarity, Employm. and Soc. Security	9 358						
	Subtotal	**23 213**	**22 853**			**3 074**		
ECONOMIC	P003 - Finance and Public Administration	7 172						
	P004 - Public debt management	7 239						
	P009 - Economy	222						
	P010 - Enviroment, P. Territory and Energy	41						
	P011 - Agriculture and Sea	328						
	Subtotal	**15 003**	**15 379**			**- 1 376**		
Expenditure ceilings financed by general revenues		**45 669**	**45 422**	**45 809**	**46 302**	**1 978**	**661**	**- 511**
% GDP		**27.2**				**1.2**		

Source: Ministry of Finance. CFP calculations.

The programme groupings in the social and economic areas account for 84.3% of the 2014 expenditure limit. The solidarity, employment and social security and health programmes are the most significant within the social area and account for 20.5% and 16.7%, respectively, of the total spending limit. In the case of the economic area, the public debt and finance management and general government programmes have the largest contributions to the expenditure limit with 15.9% and 15.7%, respectively.

Box 7 – Multiannual Budgetary Programming Framework: change in expenditure subject to multiannual limits

The Multiannual Budgetary Programming Framework (MBPF) was set up pursuant to article 12-D of the Budgetary Framework Law (BFL), which provides for the framework to be updated annually, for the following four years, in accordance with the goals laid down in the Stability and Growth Pact. In compliance with the mentioned provision, the framework for the period 2013 to 2016 was approved by Law no. 28/2012 of 31 July. The MBPF defines the multiannual limits for central government expenditure financed by general revenue (in essence revenue from tax collection) from the cash basis standpoint.

The BFL establishes expenditure limits for each budget programme, for each programme grouping and for the programmes as a whole. They are binding, respectively, for the first, the second and for the third and fourth subsequent economic years. However, possibly envisaging a more flexible transitory regime, the law that approved the MBPF for the period 2013-2016 determined that only the expenditure limits set for 2013 would be binding and the limits for the following three-year period 2014-2016 would be merely indicatory. The SB/2014 Bill includes the MBPF for the period 2014 to 2017, without having amended the rule that states that the limits for the period 2014 to 2016 are indicatory. Thus, in practice the Government would only be bound to comply with the expenditure limit for 2017, notwithstanding the prevalence of the Budgetary Framework Law provision, given its higher authority. Therefore the CFP recommends that the rule in question should be revoked (article 2 (2) of Law no. 28/2012), so as to guarantee compliance with the BFL provisions in this matter.

Change in expenditure subject to multiannual limits

Using the DGO database, the CFP compiled the central government expenditure financed by general revenue over the last three years, as well as the estimates for 2013 and 2014 (see table below). Note that it was only from 2010 onwards that, in general, each ministry became covered by a single programme (previously there were a series of programmes that were common to a number of ministries). Accordingly, the table below shows expenditure by programme since 2010, although the subsequent analysis refers to the evolution in total expenditure financed by general revenue since 2005.

Table 16 – Central government expenditure financed by general revenue, by programme (M€)

Program	Budget outturn			2013 (p)				2014 (p)	
	2010	2011	2012	MFPB	SB/2013	1st Amend.	Estimate	MFPB	SB/2014
1. SOVEREIGNTY	***4 563***	***4 493***	***3 909***	***4 003***	***4 088***	***4 133***	***4 161***	***3 676***	***4 144***
Sovereign Bodies	3 172	3 012	2 811	2 824	2 868	2 871	2 871	:	2 975
Governance and Culture	288	285	187	221	222	222	222	:	226
Foreign affairs	363	333	283	312	319	319	306	:	285
Justice	740	863	628	646	679	721	762	:	658
2. SECURITY	***3 680***	***3 666***	***3 250***	***3 503***	***3 670***	***3 669***	***3 475***	***3 497***	***3 309***
Defense	1 994	1 910	1 702	1 778	1 843	1 842	1 730	:	1 694
Internal Security	1 686	1 756	1 548	1 725	1 827	1 827	1 745	:	1 615
3. SOCIAL	***25 069***	***22 771***	***23 610***	***20 514***	***23 249***	***24 122***	***24 094***	***20 139***	***23 213***
Health	8 776	8 326	9 322	7 546	7 841	7 913	7 912	:	7 621
Basic and Second. Educ. and Sch. Adm.	6 762	6 188	5 172	5 077	5 232	5 475	5 429	:	4 938
Science and Higher Education	1 762	1 515	1 243	1 208	1 305	1 367	1 349	:	1 296
Solidarity, Employm. and Soc. Security	7 770	6 743	7 873	6 683	8 871	9 367	9 404	:	9 358
4. ECONOMIC	***14 529***	***14 894***	***15 193***	***15 608***	***14 732***	***14 689***	***14 577***	***16 379***	***15 002***
Finance and Public Administration	8 819	8 155	7 754	7 485	6 874	7 166	7 286	:	7 172
Public debt management	4 970	6 038	6 849	7 551	7 276	6 941	6 803	:	7 239
Economy	222	199	155	165	160	160	125	:	222
Enviroment, P. Territory and Energy	519	503	435	407	422	422	363	:	369
5. TOTAL (1+2+3+4)	**47 842**	**45 824**	**45 962**	**43 628**	**45 737**	**46 613**	**46 306**	**43 691**	**45 669**
Memo:									
6. Central Adm. total expenditure	58 630	56 779	58 881	:	61 224	62 396	62 245	:	60 969
7. Weight , in % [(5)/(6)]	81,6	80,7	78,1	:	74,7	74,7	74,4	:	74,9

Source: DGO and SIGO database. CFP calculations. | Notes: figures on a cash basis; the limit on central government expenditure financed by general revenue, approved under the SB/2013 (45 737 M€) differs from the sum calculated on the basis of the information in the DGO database (45 691 M€); although the data relating to 2010 and 2011 has been adapted to the current programme structure, corrections have not been made for bodies that were transferred from one ministry to another, nor for reclassifications made in the meantime, so some prudence is required when interpreting the data by budget programme (for example, from 2014 onwards transfers to transport sector companies to compensate for the provision of a public service were included in the "Economy" programme, whereas in previous years they were in the "Finance and Public Administration" programme).

The analysis of the information gathered reveals that:

- From 2005 to 2010 central government expenditure financed by general revenue increased progressively (+7557 M€ in cumulative terms);

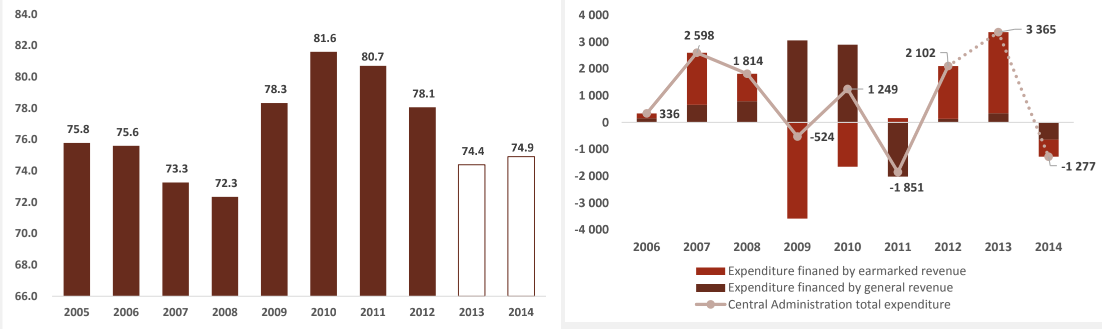
- In 2011, the year in which the EFAP began, there was a decrease of 2018 M€ (the significant increase recorded in the "Public debt management" programme was more than offset by the decline in spending in the grouping of social programmes), whilst in 2012 there was an increase of 570 M€ (notwithstanding the suspension of holiday and Christmas bonuses, large extraordinary SB transfers were made to the NHS and to the social security system);

- The recent estimate for 2013, included in the DSB/2014 Report, points to expenditure falling short of the limit approved in the 1st ASB/2013 (-307 M€). Note however that the limit for 2013 was revised upwards twice: in the SB/2013 the limit rose by 2109 M€ compared to that approved in the original MBPF, and as a result of the 1st amendment to the SB/2013, it was raised by 876 M€. These revisions (even though they are due to extraordinary transfers), show that the binding nature of the limit in the first year was not complied with;

- In the SB/2014 Bill the MBPF for the period 2014 to 2017 is subject to approval. In relation to the expenditure limit for 2014, which had never been altered since the original MBPF was approved, an upward revision is proposed (+1978 M€). The new limit for 2014 is based on a decrease in expenditure of 637 M€ compared to the estimate for the current year.

Chart 19 – Change in central government expenditure

Share of expenditure financed by general revenue in total expenditure of central government (%)	Change in central government expenditure (M€)



Source: DGO and SIGO database. CFP calculations.

The relative share of expenditure financed by general revenue in total expenditure of the central government increased considerably in 2009 and 2010 (reaching 81.6%) and then fell in 2011 and 2012. In 2013 and 2014 its relative weight is expected to stabilise at around 75%, thus returning to the levels recorded before the financial crisis of 2009.

Central government expenditure has recorded an irregular development as a consequence of occasional measures – having risen by 5723 M€ from 2005 to 2012. The new estimate for the current year implies an increase of 3365 M€, fully explained by expenditure financed by earmarked revenue. The CFP requested the DGO to identify the factors contributing to that development but so far no answer has been obtained (the DGO stated the answer requires more time).

4 INDEBTEDNESS, GROSS BORROWING REQUIREMENTS AND PUBLIC DEBT DEVELOPMENTS

This chapter analyses the State subsector indebtedness forecast for 2014 and the estimated development in Maastricht debt. The first section examines the financing in the fiscal period that leads to the State's net overall direct indebtedness limit. That is followed by an analysis of the borrowing requirements that result from the writing down of funded debt (gross borrowing requirements). The chapter ends with the debt dynamics and an analysis of its affordability. CFP Notebook no. 1/2013 describes the main concepts referenced in this chapter.

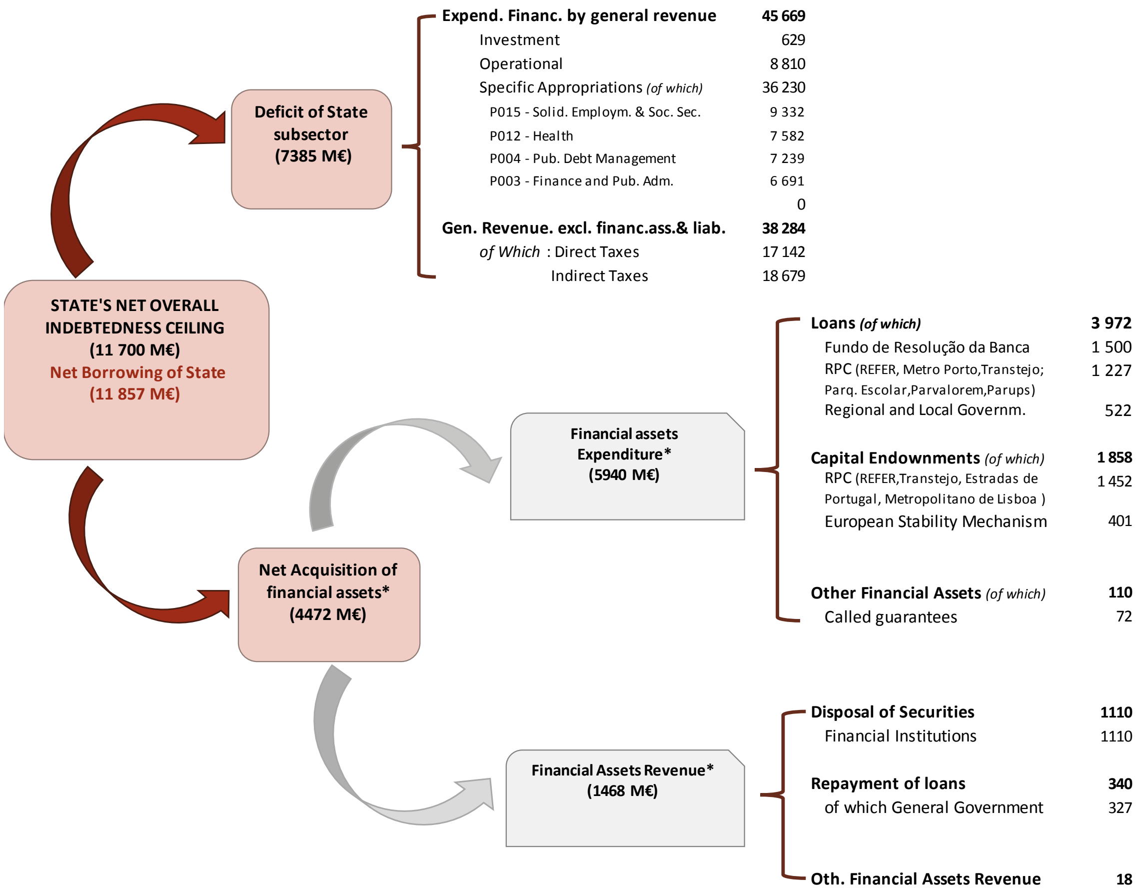
4.1 STATE NET OVERALL DIRECT INDEBTEDNESS

The State's net direct indebtedness limit set out in the DSB/2014 is lower than the net borrowing requirements that will stem from implementing next year's budget. The DSB/2014 sets the maximum indebtedness limit at 11 700 M€.[58] That figure is 157 M€ lower than the net State borrowing requirements resulting from the budget deficit[59] for 2014 and the net acquisition of financial assets forecast for that year (see Chart 20). According to additional information provided by the MF, the difference is justified by the fact that part of the appropriations for expenditure on financial assets included in chapter 60 – Exceptional Expenditure might not become a liquidity requirement that is to say there may be no need to resort to indebtedness.

[58] As per article 129 (1) of the SB/2014 Bill.

[59] This subsector's deficit results from the imbalance between spending covered by general revenue and general revenue collected by the State that does not come from indebtedness.

Chart 20 – Factors that explain the State's net overall direct indebtedness limit



Source: Ministry of Finance and CFP calculations. | Note: (*) - (i) Financial asset expenditure does not include the financial support forecast under EFAP for bank recapitalisation; (ii) Financial asset revenue does not include the financial return from privatisations.

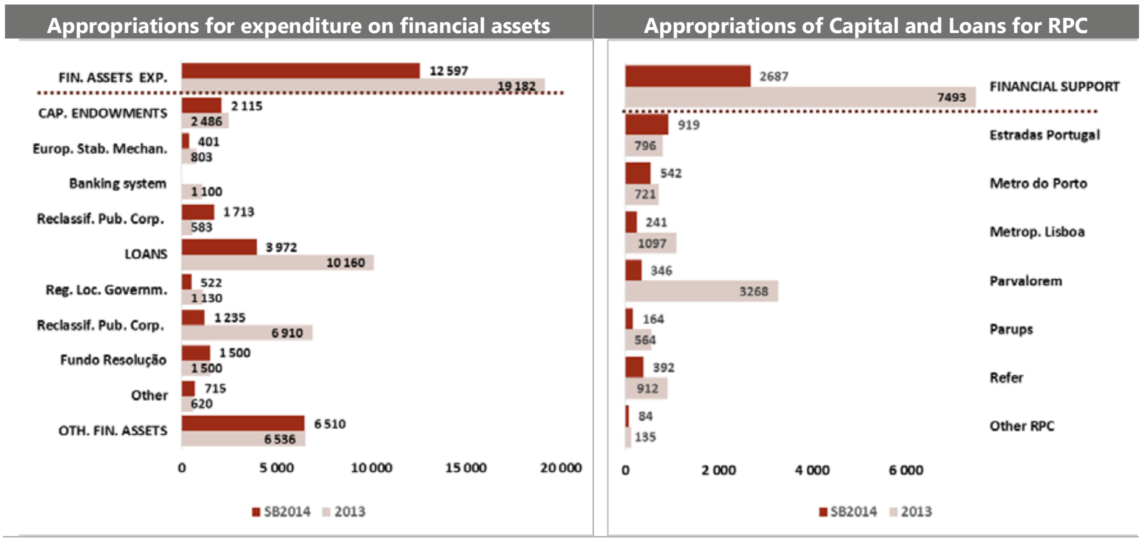
Compared to the limits approved in the last two years, the authorised net indebtedness level requested for 2014 is lower. The limit proposed for 2014 is 3497 M€ and 4700 M€ lower than that initially approved in the SB/2012 and in the SB/2013, respectively. This reduction is explained by the lower deficit of the State subsector and by a lower net acquisition of financial assets (the latter is a consequence of the decrease in the limit for loans granted and other asset transactions).[60] In fact almost ⅔ of the limit for 2014 is to be explained by the State deficit,[61] and the remainder by the net acquisition of financial assets, intended, to a large extent, to finance Reclassified Public Corporations (2679 M€).

The decrease in financial support for reclassified public corporations will contribute to a lower indebtedness of the State in 2014. Compared to 2013, the sharp decrease in State loans and capital injections in these companies (-4806 M€) is explained to a large extent by the reduced borrowing requirements of the special purpose vehicles set up when BPN was nationalised (-3322 M€) and, to a lesser extent, by the remaining companies, except Estradas de Portugal (+123 M€). The capital injections to be made in some RPC in 2014 will benefit

[60] Note that the limit for loans granted and other asset transactions laid down in article 117 (1) of the SB/2014 Bill (5000 M€) is 4600 M€ lower than the sum approved in the SB/201).
[61] The imbalance between effective State revenue and expenditure continues to require the resort to indebtedness.

from the conversion of medium and long-term loans granted by the State in previous years. Apart from these supports, there is also a decrease (of 401 M€) in the appropriation relating to Portugal's contribution to the European Stability Mechanism.

Chart 21 – State financial support (M€)



Source: Table of SB/2014 budget developments and the SB/2014 Bill. CFP calculations. | Note: The year 2013 corresponds to the appropriations approved under the SB/2013 and the 1st ASB/2013.

The SB/2014 maintains the possibility of that limit being raised to ensure greater financial stability and liquidity in the financial markets.[62] As in the SB/2013, this option includes the appropriation still available under the adjustment programme for recapitalising the banking sector (6400M€), as well as the sum of 1500 M€ earmarked, among other purposes, for conducting liquidity increasing transactions in the secondary market by the IGCP through public debt issues, or by the PDSF in the case of subscribing or selling public debt securities.[63]

4.2 GROSS BORROWING REQUIREMENTS (2014-2017)

The State's gross borrowing requirements (from the public accounting perspective) should increase significantly in 2014. These requirements should total 52.5 B€, which account for an increase of around 11.5 B€ (+27.9%) compared to the estimate for 2013, and are due to the volume of debt redemptions forecast. This represents a reversal of the expected position in 2013, when gross borrowing requirements are predicted to fall. The change in 2014 is essentially explained by the repayment of two Fixed Rate Bond (FRB) issues which fall due in June and October 2014 and which total 13.5 B€ and of Treasury Bills (TB) worth 18.9 B€.[64]

[62] As per article 135 (3) and (4) and article 138 of the SB/2014 Bill.

[63] Of the 12000 M€ forecast, 4500 M€ were used to recapitalise BCP and BPI in 2012 and 1100 M€ on BANIF in 2013.

[64] Furthermore revenue from privatisations will go from 1340 M€ in 2013 to 90 M€ in 2014 (privatisation of REN), and if this major decrease in revenue had not arisen, net borrowing requirements in 2014 would be lower. In addition, no provision is made for using funds for strengthening financial stability (bank recapitalisation) in 2014, even though 6400 M€ are still available for this purpose.

Table 17 – Borrowing Requirements (M€)

Borrowing requirements	2012		2013E		2014P		Change 2013/12		Change 2014/13	
	Amount	Contrib. (%)	Amount	Contrib. (%)	Amount	Contrib. (%)	Amount	%	Amount	%
1. Net borrowing requirements (a) + (b) + (c) - (d)	**18 034**	**32.9**	**13 410**	**32.7**	**11 768**	**22.4**	**-4 624**	**-25.6**	**-1 642**	**-12.2**
a) Budget deficit	8 896	16.2	8 923	21.7	7 385	14.1	27	0.3	-1 538	-17.2
Primary deficit	2 022	3.7	2 116	5.2	146	0.3	94	4.6	-1 970	-93.1
Interests	6 874	12.5	6 807	16.6	7 239	13.8	-67	-1.0	432	6.3
b) Net purchasing of financial assets (except privatisation)	6 846	12.5	4 727	11.5	4 473	8.5	-2 119	-31.0	-254	-5.4
c) Strengthening of financial stability	4 500	8.2	1 100	2.7	0	0.0	-3 400	-75.6	-1 100	-100.0
d) Privatisation revenues	2 208	4.0	1 340	3.3	90	0.2	-868	-39.3	-1 250	-93.3
2. Redemptions and cancellations [funded debt] (e) + (f) + (g) + (h) + (i)	**36 819**	**67.1**	**27 640**	**67.3**	**40 734**	**77.6**	**-9 179**	**-24.9**	**13 094**	**47.4**
e) SC + TC	2 229	4.1	923	2.2	360	0.7	-1 306	-58.6	-563	-61.0
f) Short-term euro-denominated debt	17 985	32.8	21 292	51.9	26 539	50.5	3 307	18.4	5 247	24.6
g) Medium and long-term euro-denominated debt	16 485	30.1	6 162	15.0	13 548	25.8	-10 323	-62.6	7 386	119.9
h) Non-euro-denominated debt	429	0.8	61	0.1	306	0.6	-368	-85.8	245	401.6
i) *Swaps capital flows* (net)	-309	-0.6	-798	-1.9	-19	0.0	-489	158.3	779	-97.6
3. Gross Borrowing requirements (1) + (2)	**54 853**	**100.0**	**41 050**	**100.0**	**52 502**	**100.0**	**-13 803**	**-25.2**	**11 452**	**27.9**

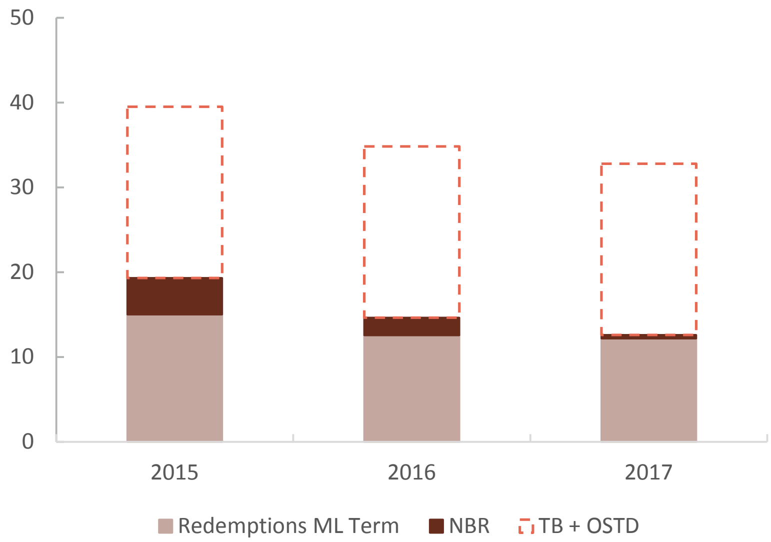
Source: Directorate General for Budget and Ministry of Finance. CFP calculations.

Over the next four years the repayment of Medium and Long-Term Debt (outstanding stock) should total 53 B€, which increases the importance of access to financial markets in order to manage those liabilities appropriately. Next year, the repayment of Medium and Long-Term Debt will total 13.8 B€, while debt that falls due in the near future will total 15.0 B€ in 2015, 12.5 B€ in 2016 and 12.2 B€ in 2017, respectively.[65] In 2016 a greater concentration of debt repayment (+4.8 B€) was forecast, which has been reduced since the maturity of the EFSF loans was extended by 7 years, from 12.5 years to 19.5 years.[66] In 2015 the first IMF repayment under the assistance programme will be made and between 2015 and 2017 around 30% (6.7 B€) of the outstanding stock is expected to be settled.

Under the assistance programme that ends in June 2014, Portugal will receive the final disbursements of the agreed amount. Therefore the funding under the EFAP will fall from 10030 M€ in 2013 to 7877 M€ in 2014. In order to offset the decrease in "troika" funds an increase of the same amount in FRB issues shall take place, from 5500 M€ in 2013 to 10500 M€ in 2014. At the end of 2014 the funding balance available for future years is expected to be nil, unlike the position in recent years.[67]

[65]Only existing debt stock was taken into account and no repayment estimate was made for debt that may arise in those years due to future issues.
[66] It is not expected that Portugal will have to refinance any of its EFSF loans before 2026
[67] Contrary to the estimate for the end of 2013 (4007 M€) and the situation in 2012 (6255 M€).

Chart 22 – Gross Borrowing Requirements 2015-2017 ('000 M€)



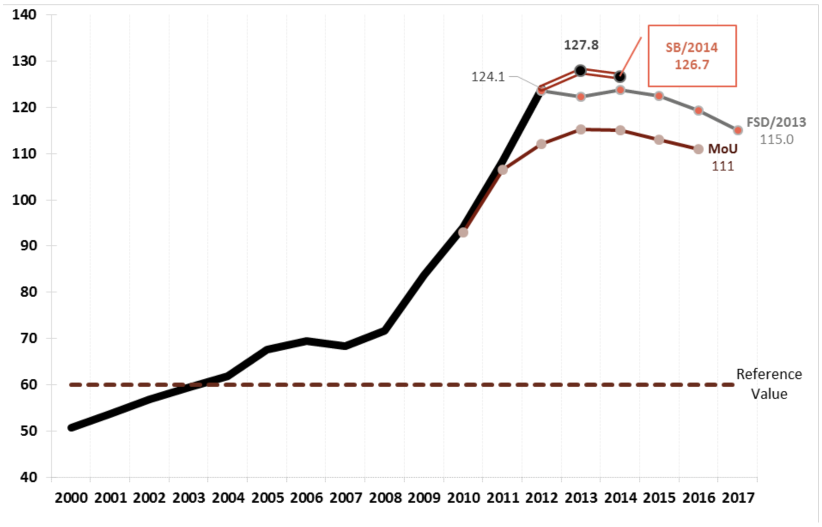
Source: IGCP and Ministry of Finance. CFP calculations. | Notes: TB + OSTD = Treasury Bills and other short-term debts; Redemptions ML Term = Redemptions of Medium and Long-Term Debt; NBR = net borrowing requirements. The NBR figure includes the GG budget deficit set out in the FSD 2013-2017 (interest payable over these 3 years would total 23.3 B€, a sum that would be partially offset by the primary surpluses accumulated over the period and totalling 16.4 B€). This calculation excludes the repurchase of ISE's (under banking recapitalisation), the net financing of other debt instruments and privatisation revenue. It is assumed that the value of short-term debt will remain at 20 000 M€ and that that stock will be renewed annually.

4.3 DEBT DYNAMICS

Public debt projections have repeatedly been revised up. Despite these upward revisions the turning point of the upward trend in debt in the current the DSB/2014 has been anticipated a year compared to the data in the FSD 2013-2017. The upward revisions in public debt projections have been justified by the change in the figures relating to financial transactions which, despite not being included in the budget deficit, impact on debt (stock-flow adjustments).[68] One example of this is the decrease in the amount allotted to the purchase of public debt securities by Social Security Funds in 2013 and the non-transfer of CGD shares to Parpública as a means of settling the State's debt to that company under the privatisation process.

[68] The concepts used here are described in detail in *CFP Notebook no. 1/2013*.

Chart 23 – Public Debt Developments (% of GDP)



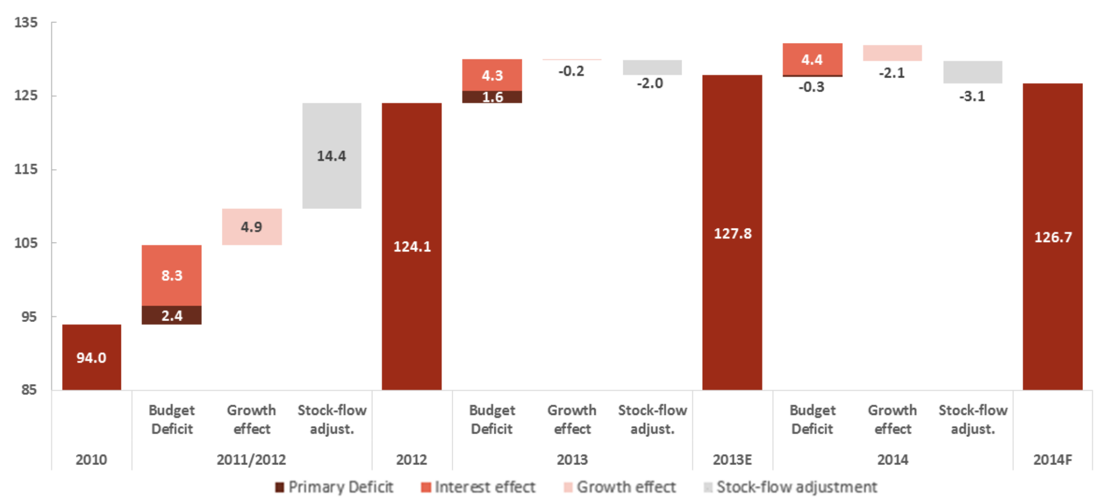
Source: Ministry of Finance.

The public debt ratio projections for 2014 show the reversal of the upward trend, and the ratio is expected to fall from 127.8% to 126.7%.[69] The items contributing to debt growth in 2013 are the primary deficit and the positive differential between the implicit (nominal) public debt interest rate[70] and the (nominal) GDP growth rate, as well as the reduction due to the stock-flow adjustment. That adjustment stems from the revenue from the privatisation of ANA - Aeroportos de Portugal, S.A. and from the investment in Portuguese public debt by the Social Security Financial Stabilisation Fund (SSFSF). The 2014 forecast points to a reduction in the debt ratio (for the first time since 2007), and that decrease is due to a large extent to the stock-flow adjustment and to a marginal extent to the primary surplus. The decrease in central government deposits and the additional purchase of public debt securities by Social Security explain to a large extent this adjustment. In 2014, as in previous years, the snowball effect alone[71] will contribute to an increase in the public debt ratio.

Interest paid has had a major impact on the increase in debt ratio. Since the beginning of the assistance programme (see Chart 24), interest has accounted for around 52% (17 p.p. of GDP) of the change in the public debt ratio (Maastricht concept), followed by the stock-flow adjustments (9.4 p.p. of GDP) and the primary deficits (3.7 p.p. of GDP). In that increase the output growth effect is the indicator that has the least impact (2.6 p.p. of GDP). It is clear that as the debt ratio grows, the effect of debt service charges is amplified, a situation that will persist, even in a scenario of primary fiscal balance, if the interest level is not offset by economic growth.

[69] However, in absolute terms public debt continues to rise, and in 2014 is expected to increase by 1.6 B€ *vis-à-vis* 2013.
[70] It corresponds to the ratio between interest for the year and debt stock in the previous year.
[71] The difference between the implicit (nominal) public debt interest rate and the (nominal) GDP growth rate, as detailed in the aforementioned CFP Notebook.

Chart 24 – Contributions to Public Debt Developments (% of GDP)



Source: Ministry of Finance. CFP calculations. | Note: E = Estimate e F = Forecast

In 2014 interest expenditure should total 4.4% of GDP, which represents a slight increase over the 2013 estimate. In 2014 interest expenditure should total 7324 M€ (4.4% of GDP)[72] which reflects an increase of 1.9% compared to 2013. In 2014, as in 2012 and 2013, the change in interest payments will stem exclusively from the increase in average public debt stock. On the contrary in 2011, the largest contribution to the change in costs resulted from the steeper borrowing costs.

Table 18 – Contributions to changes in interest

Year	Public Debt stock at the end of period (% do PIB) (A)	Average Public Debt stock (% of GDP) (B)	Interest (% of GDP) (C)	Implicit interest rate (D)	Interest change (E)	Contributions to interest Δ: Stock effect (F)	Price effect (G)	Cross effect (H)
2010	94.0	88.8	2.8	3.2%	-0.27	0.44	-0.67	-0.09
2011	108.2	101.1	4.0	4.0%	1.22	0.39	0.77	0.10
2012	124.1	116.2	4.3	3.7%	0.29	0.60	-0.29	-0.04
2013E	127.8	126.0	4.3	3.5%	0.03	0.36	-0.33	-0.03
2014P	126.7	127.2	4.4	3.4%	0.01	0.04	-0.04	0.00

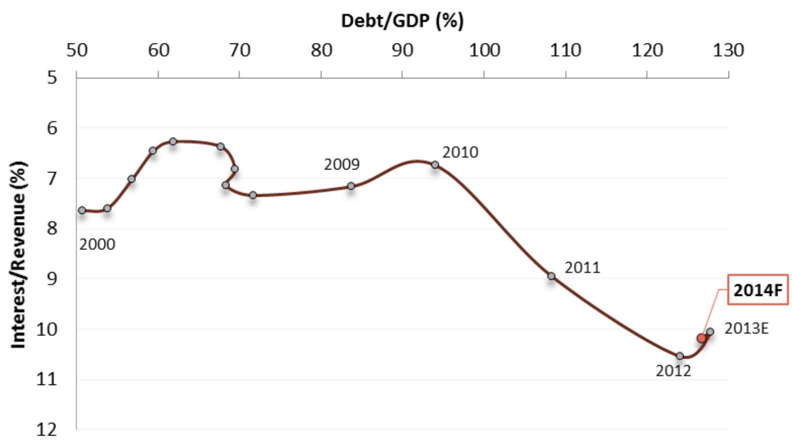
Source: Ministry of Finance. CFP calculations. Formula: Year=$_t$ and previous year=$_{t-1}$; A = DP/GDP
$B = [(A_t - A_{t-1})/2]$; C = Interest / GDP; $D = (C/B)$; $E = [D_{t-1}*(B_t-B_{t-1})]+[B_{t-1}*(D_t-D_{t-1})]+[(B_t-B_{t-1})*(D_t-D_{t-1})]$;
$F = [D_{t-1}*(B_t-B_{t-1})]$; $G=[A_{t-1}*(D_t-D_{t-1})]$; $H = [(B_t-B_{t-1})*(D_t-D_{t-1})]$

The estimated increases in interest expenditure and total revenue lead to a slight deterioration in the debt affordability indicator[73] in 2014 compared to 2013. This indicator measures the share of total general government revenue that has to be allocated to pay debt costs, and a downward curve indicates an adverse trend[74] (contrary to normal practice the y-axis shows an inverted scale, as shown in Chart 25). In 2013 an upward trajectory is expected thus reversing the trend witnessed since 2010. This is due to the fact that in 2013, a substantial increase is expected in total revenue and only a very slight rise in

[72] It represents a downward revision of 13.3 B€ *versus* the FSD 2013-2017.
[73] This indicator is used by risk rating agencies as a criterion for classifying a country's credit risk.
[74] For example, a figure above 10% is not consistent with a low credit risk rating.

interest thus reducing the size of the share of revenue allocated to interest payments. The slight deterioration in this indicator for 2014 is a result of the relative increase in interest expenditure exceeding the relative increase in total revenue.

Chart 25 – Debt Affordability



Source: Ministry of Finance. CFP calculations.

In 2014 the public debt path is constrained by the risk of an increase of Public Corporations that fall within the scope of general government. The DSB/2014 refers debt ratio risks stemming from the application of ESA2010 which, among other requirements, will change the way the market test is applied and which could lead to more corporations falling within the scope of general government, both in Portugal and probably other Member-States.[75] The impact on debt will depend on the magnitude of the financial liabilities that are on the balance sheets of the entities that come to be reclassified.

[75] The application of the new conceptual framework, ESA2010, from 2014 introduces new rules for sector delimitation, namely the inclusion of financial costs (interest) when calculating the market ratio. An entity is considered to be a non-market producer if its annual sales do not cover at least 50% of its costs over a sustained period. These new criteria may lead to the inclusion of more public corporations in the scope of general government, and accordingly have an impact on the public debt level.

5 COMPARISON WITH ADJUSTMENT PROGRAMME (2010-2014)

Given that the Adjustment Programme signed in May 2011 will end in June 2014, it is interesting to compare the baseline projections with the current Ministry of Finance forecasts for 2014. In practical terms the final full year before the beginning of the programme (2010) is compared with the forecast for 2014. Thus the analysis covers the correction effort and the adjustment of the budget aggregates for the four years covered by the programme vis-à-vis its original goals. The comparison assumes that the forecast for 2014 set out in the DSB/2014 is confirmed and is based on the amounts relating to GDP.

5.1 COMPARISON WITH ORIGINAL PROGRAMME ESTIMATE

If the MF forecast for 2014 is met, approximately 70% of the adjusted deficit correction implicit in the original adjustment programme will be achieved. In effect, adjusted for the impact of temporary measures, one-off measures and special factors, the DSB/2014 points to a 4.4 p.p. of GDP decrease in the budget deficit (2.8 p.p. up to 2013) against a 6.3 p.p. of GDP correction in the adjustment programme baseline between 2010 and 2014 (of which 5.7 p.p. of GDP up to 2013) [see panel B of Table 19]. In terms of the headline observable deficit the decrease accounts for ¾ of the adjustment programme goal.[76]

The deviation from the correction path implicit in the adjustment programme is fully attributable to expenditure, given that in 2014 its relative weight in GDP will remain above the figures in the programme baseline scenario, according to the official MF forecast. The decline in the relative weight of adjusted expenditure in GDP will be 2.1 p.p. lower than in the programme baseline scenario, as it should record a 1.7 p.p. of GDP decrease between 2010 and 2014 rather than the 3.9 p.p. implicit in that scenario.

Overall, the adjusted revenue-to-GDP ratio will increase in line with the baseline scenario. The MF forecast points to an increase of 2.7 p.p. of GDP between 2010 and 2014 against the 2.5 p.p. of the baseline scenario (thus 0.2 p.p. of GDP higher than assumed there). Tax revenue and "sales and other current revenue" will record a higher growth than assumed in the baseline scenario, 0.7 and 0.5 p.p. of GDP, respectively. Social security contributions will decrease by 0.7 p.p. of GDP over the four-year period, when the programme baseline scenario assumed its relative weight in output would be stable.

[76] This section uses as starting point, the INE estimate for 2010, which differs from the figure available at the time the Memorandum of Understanding was signed (May 2011). However this does not affect the comparison because: the programme goals were not amended in line with the statistical revisions made to the baseline information during 2011 (the budget goals were only altered under the 5th review); and a significant part of the statistical revisions relating to 2010 relates to transactions classified as "special factors" by the CFP, and therefore does not influence the comparison made in adjusted terms.

"Social transfers", "other current expenditure" and "intermediate consumption" explain the lower reduction of the relative weight of expenditure in GDP compared to the programme forecast. The deviations are 1.5 p.p., 1.1 p.p. and 0.8 p.p. of GDP, respectively. In the case of social transfers, if the MF forecast for 2014 is confirmed, there will be an increase of 0.9 p.p. of GDP between 2010 and 2014, against the 0.6 p.p. of GDP decrease in the programme baseline scenario. The relative weight of intermediate consumption should stabilise instead of declining by the 0.8 p.p. of GDP as assumed in the programme. As for "other current expenditure", it is not possible to draw a conclusion since, as referred above, the MF forecast for this item in 2014 includes the "provisional appropriation" and the "budget reserve", which will be apportioned among various expenditure items if used during the 2014 budget outturn. Capital expenditure should practically match the programme goals.

On the other hand, according to the MF forecast, in 2014 "compensation of employees" and interest charges, will stand below expected in the programme baseline scenario. Compensation of employees will fall between 2010 and 2014 by 2.9 p.p. of GDP rather than the 2 p.p. of GDP implied in the programme baseline scenario. The interest-to-GDP ratio will increase by 1.6 p.p., rather than 2.3 p.p. as assumed in the programme. Thus, the improvement of the adjusted primary fiscal balance compared to the originally anticipated in the programme (2.7 p.p. of GDP) will be higher than the progress expected in the adjusted overall balance (1.9 p.p. of GDP).

Table 19 – Comparison with the original estimate implicit in Programme 2011-2014 (%of GDP)

	INE	EFAP, May 2011		SB/2014		2010/2014		
	2010	2013	2014	2013	2014	EFAP (2011)	SB/2014	Difference
A. Headline figures								
General government balance (EDP)	**-9.8**	**-3.0**	**-2.3**	**-5.9**	**-4.0**	**7.5**	**5.8**	-1.7
Total Revenue	41.6	42.3	42.4	43.2	42.8	0.8	1.1	0.3
Total expenditure	51.5	45.3	44.8	49.1	46.8	-6.7	-4.7	2.0
Primary expenditure	48.7	40.2	39.6	44.8	42.5	-9.0	-6.2	2.8
Current primary expend.	42.9	38.2	37.6	42.0	40.4	-5.3	-2.6	2.7
Capital expenditure	5.7	2.1	2.0	2.8	2.1	-3.7	-3.6	0.1
Interest paid (EDP)	2.8	5.1	5.1	4.3	4.4	2.3	1.6	-0.8
Primary balance (EDP)	**-7.0**	**2.1**	**2.8**	**-1.6**	**0.3**	**9.8**	**7.3**	-2.5
B. Adjusted for temp. measures & special factors								
General government balance (EDP)	**-8.7**	**-3.0**	**-2.3**	**-5.9**	**-4.3**	**6.3**	**4.4**	-1.9
Total Revenue	40.0	42.3	42.4	42.8	42.6	2.5	2.7	0.2
Tax Revenue	22.1	23.8	23.9	24.1	24.5	1.7	2.4	0.7
Social contributions	12.3	12.3	12.3	11.9	11.6	0.0	-0.7	-0.6
Sales & other current revenue	4.4	4.9	5.0	5.6	5.5	0.7	1.1	0.5
Capital transfers received	1.2	1.3	1.3	1.2	1.0	0.1	-0.2	-0.3
Total expenditure	48.6	45.3	44.8	48.7	46.9	-3.9	-1.7	2.1
Primary expenditure	45.8	40.2	39.6	44.4	42.6	-6.2	-3.3	2.9
Current primary expend.	42.1	38.2	37.6	42.0	40.4	-4.5	-1.7	2.7
Intermediate consumption	4.7	3.8	3.8	4.8	4.6	-0.8	0.0	0.8
Compensation of employees	12.2	10.7	10.3	10.6	9.4	-2.0	-2.9	-0.9
Social transfers	21.9	21.5	21.3	23.2	22.8	-0.6	0.9	1.5
Subsidies	0.7	0.5	0.5	0.7	0.8	-0.2	0.0	0.3
Other current expenditure	2.5	1.7	1.7	2.7	2.8	-0.8	0.3	1.1
Capital expenditure	3.7	2.1	2.0	2.3	2.2	-1.7	-1.5	0.2
Interest paid (EDP)	2.8	5.1	5.1	4.3	4.4	2.3	1.6	-0.8
Primary balance (EDP)	**-5.9**	**2.1**	**2.8**	**-1.6**	**0.1**	**8.7**	**5.9**	-2.7
C. Public Debt								
Maastricht Debt	**94.0**	**115.3**	**115.0**	**127.8**	**126.7**	**21.0**	**32.7**	11.7

Source: IMF and European Commission for adjustment programme (EFAP) figures; INE for 2010 figures; Ministry of Finance for 2013 and 2014; and CFP for temporary and one-off measures and special factors used to calculate the adjusted figures shown in panel B of the Table. CFP calculations. | Note: The adjusted figures show the classification of temporary and one-off measures adopted by the CFP, which do not fully agree with those taken into account by the Ministry of Finance.

Part of the difference between the forecast outcome and the programme baseline scenario may be attributed to the more adverse economic conditions compared to the programme assumptions. To offset this effect a comparison is made in the Table below based on structural values, that is to say, net of the effects of the economic cycle and of temporary measures, one-off measures and special factors. In order to produce comparable figures, the output gap estimate produced in August 2011 by the MF was used as a proxy to calculate the structural figures implicit in the adjustment programme, since that figure was not published in the official European Commission publications and therefore was not a goal of the adjustment programme.[77]

According to the cyclical adjustment methodology in use in the EU, the impact of the economic conditions on the 2014 budget balance is 0.7 p.p. of GDP higher than expected in the 2011 estimate.[78] In August 2011 the MF estimate for 2014 pointed to a negative difference between potential output and effective output of 1.4% of potential GDP (output gap), compared to the current forecast of a negative difference of 2.9%.

Table 20 – Structural budget indicators relating to the programme period (% of GDP)

	2010, INE		EFAP, May 2011		SB/2014		2010/2014		
	CC11	CC13	2013	2014	2013	2014	EFAP (2011)	SB/2014	Diff.
T. structural Revenue net of S.F.	40.0	39.9	42.2	42.4	42.7	42.5	2.4	2.6	0.2
Tot. primary struct. expendit. net of S.F.	45.8	45.4	38.6	38.9	42.3	41.1	-6.9	-4.2	2.6
of which: primary current	42.1	41.7	36.6	36.9	39.9	38.9	-5.1	-2.7	2.4
of which: capital	3.7	3.7	2.1	2.0	2.3	2.2	-1.7	-1.5	0.2
Struct. Primary B. Balance net of S.F.	**-5.8**	**-5.4**	**3.5**	**3.5**	**0.4**	**1.4**	**9.3**	**6.8**	-2.4
Interest	2.8	2.8	5.1	5.1	4.3	4.4	2.3	1.6	-0.8
Structural B. Balance net of S.F.	**-8.6**	**-8.2**	**-1.5**	**-1.7**	**-3.9**	**-3.0**	**6.9**	**5.3**	-1.7
Tot. struct. expenditure net of S.F.	48.6	48.2	43.7	44.1	46.6	45.5	-4.5	-2.7	1.8
Memo:									
output gap *(Ministry of Finance)*	-0.1	-0.9	-3.2	-1.4	-4.2	-2.9	-1.3	-1.9	-0.6
cyclical component	0.0	-0.4	-1.5	-0.7	-2.0	-1.3	-0.6	-0.9	-0.3

Source: See previous table. | Note 1: the budget aggregates in this table are net of temporary measures, one-off measures and special factors, as in the previous table, and of the cyclical component. Note 2: CC11 and CC13 stand for the cyclical components for 2010 according to the Ministry of Finance output gap estimates made in August 2011 (in FSD) and October 2013, respectively. The cyclical component is calculated using the semi-elasticity's currently used by the European Commission's multilateral surveillance mechanism. Figures as a percentage of GDP, except the output gap which is expressed as potential GDP.

Based on the available information and if the MF forecast for 2014 is confirmed, between 2010 and 2014 ¾ of the improvement in the structural balance implicit in the programme baseline scenario will be achieved (5.3 p.p. of GDP). The information used points to an improvement of 5.3 p.p. of GDP in the structural balance net of special factors, compared to the 6.9 p.p. in the programme baseline scenario. Using figures not adjusted for the economic cycle this difference would be higher. However, these figures must be interpreted with caution because they are a "real time" estimate of the structural balance, which may be revised when new information is available.[79]

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[77] See European Commission Occasional Paper 79, June 2011.

[78] The impact of the output gap deterioration on the budget balance between 2010 and 2014 is up by 0.3 p.p. of GDP compared to the programme baseline scenario (causing a balance deterioration of 0.9 p.p. of GDP *versus* 0.6 p.p. of GDP).

[79] For instance, if the output gap estimate in the European Commission forecasts of autumn 2013 were used, the degree of realisation would be 80%, thereby reducing the difference to the programme baseline scenario to 1.4 p.p. of GDP.

The smaller structural adjustment compared to the programme (1.7 p.p. of GDP) stems from structural primary current expenditure. If the MF forecast is confirmed, this aggregate will decrease by 4.2 p.p. of GDP between 2010 and 2014, which compares adversely to the tune of 2.6 p.p. of GDP, with the 6.9 p.p. of GDP fall in the programme, essentially for the reasons referred to above.

Conditional on information available, the confirmation of the MF forecast for 2014 points to revenue having a larger share in the structural deficit reduction effort.[80] Based on the methodological assumptions below, and with the aforesaid reservations, the adjustment programme baseline scenario pointed to revenue making a 35% contribution and expenditure a 65% contribution.[81] The MF forecast for 2014 points to revenue contributing 49% and expenditure 51%, in cumulative terms between 2010 and 2014.

The public debt ratio developments will be more adverse than expected in the programme baseline scenario. The debt ratio underwent successive revisions under the regular programme reviews, as a consequence of the updating of the macroeconomic prospects and budget developments, for these reasons the worsening of the debt ratio will exceed GDP the figure originally forecast in the programme by 11.7 p.p. of.

5.2 EVOLUTION OF THE STRUCTURE OF PUBLIC EXPENDITURE SINCE 2000

In adjusted terms,[82] the relative weight of primary current expenditure has practically remained unchanged since 2005, accounting for 85-86% of total expenditure. Nonetheless, it is not possible to draw conclusions as to the relative weight of its components for a number of reasons. One is the transfer of attributions from the general government to the corporate public sector. Two examples: 1) the process of transforming State run hospitals into corporate hospitals affects the composition of this aggregate: these entities' expenses previously recorded as intermediate consumption and compensation of employees are now recorded as social transfers in kind, following the change in their legal status; 2) at the subnational level, several municipalities have, since the late nineties, delegated to multimunicipal public corporations (owned by the State and the municipalities) the public provision of water distribution (including upstream water supply) and sanitation sectors, which had an impact on expenditure. Another reason is the fact that general government intermediate consumption has been affected recently by payments to public-private partnerships.

[80] Net of special factors.

[81] It must be borne in mind that the methodological change in the breakdown of the cyclical component of the budget balance in revenue and expenditure made by the European Commission for all Member-States, during the programme affects this calculation. To ensure consistency between the figures, the CFP uses the new methodology both as regards the programme baseline scenario and the latest forecast.

[82] This section uses budget aggregates adjusted solely for one-off and temporary measures, that is to say, ignoring the adjustment for the cyclical component of output. The figures for 2013 and 2014 correspond to the forecast in DSB/2014.

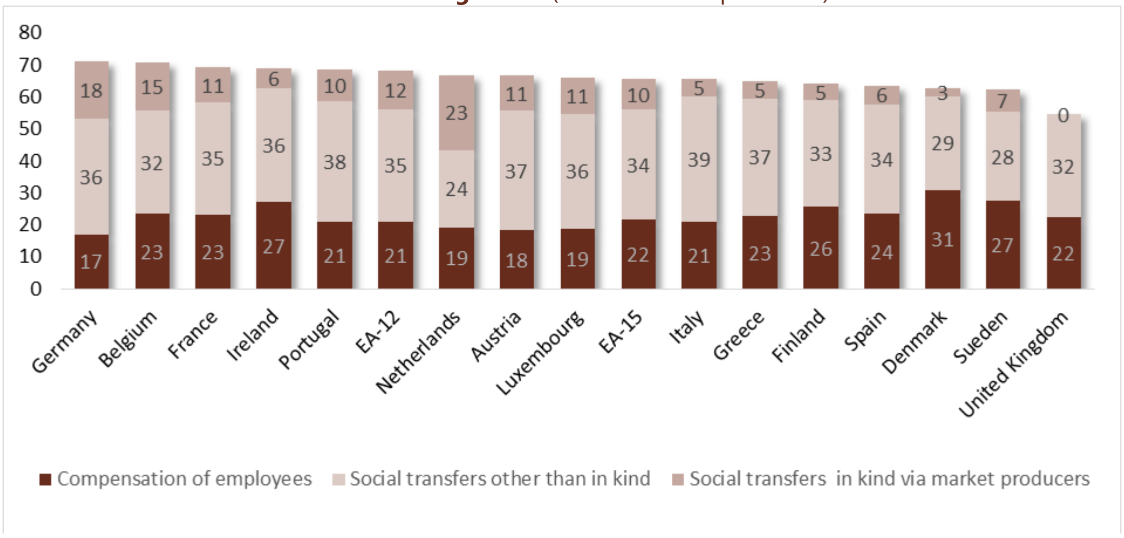
Table 21 – Composition of public expenditure 2000-2014 (as % of total expenditure)

Adjusted for temp. measures & special factors	INE				SB/2014	
	2000	2005	2007	2010	2013	2014
Total expenditure	**100**	**100**	**100**	**100**	**100**	**100**
Primary expenditure	**93**	**95**	**93**	**94**	**91**	**91**
Current primary expend.	81	85	86	87	86	86
Intermediate consumption	11	10	10	10	10	10
Compensation of employees	33	30	27	25	22	20
Social transfers	31	38	42	45	48	49
Subsidies and Oth. curr. expenditure	7	7	7	7	7	8
Capital expenditure	12	10	8	8	5	5
Interest paid (EDP)	**7**	**5**	**7**	**6**	**9**	**9**

Source: Ministry of Finance. CFP calculations. | Note: The adjusted figures reflect the CFP's classification of temporary measures, one-off measures and special factors, which differ from the Ministry of Finance's.

The increase in the relative weight of interest payments between 2005 (5%) and 2014 (9%) in total expenditure is arithmetically close to the decrease in the relative weight of "capital expenditure" in total expenditure. Capital expenditure, net of the effects of temporary and one-off measures, accounted for 10% of expenditure in 2005, and its relative weight has fallen to 5% in the forecast for 2014. However, it must be borne in mind that State investment has been favouring PPP which generally speaking are not taken into account in capital expenditure, except when the underlying asset is reclassified.

Chart 26 – Share of compensation of employees and social transfers in total expenditure in 2012 among EU-15 (as % of total expenditure)



Source: AMECO, May 2013 update.

Portugal is ranked 5th highest in the EU-15 considering the combined weight of compensation of employees and social transfers in general government expenditure. However, variability is low across the countries. The country where the combined weight in total public expenditure is the highest is Germany (71%). Portugal stands at 68% (a figure identical to the average for Euro-12). Sweden (62%) records the lowest figure, apart from the United Kingdom.[83] Although all these figures comply with ESA95, international comparability of these three items is hampered by national specifics. In particular there are differences in the treatment of contributions to the civil servant pension system in "compensation of employees", and in the classification of "public" hospitals within or outside the consolidation scope of the general government. These differences affect the international comparability of the "compensation of employees" and "social transfers in kind" items.

[83] The AMECO data base does not record social transfers in kind for the United Kingdom, so it was not taken into account in the text although it is shown in Chart 26.

6 FISCAL TRANSPARENCY

Since the 1994 Mexican financial crisis and the 1997 Asian crisis – ascribed to some extent to the scarcity of information on key indicators of vulnerability – widespread agreement on the need for a high degree of transparency in fiscal policymaking has emerged. Once again, however, in the run-up to the latest financial crisis, inadequate information on public finances was prevalent in a number of affected countries. This contributed decisively to the onset and to the deepening of the crisis. For this reason, much of the strengthening of the fiscal framework for the euro area is aimed at improving fiscal transparency, a prerequisite for the rules-based policy approach of the Stability and Growth Pact.

Portugal was no exception in this regard. This chapter presents some basic concepts and good practices in the field of fiscal transparency; analyses a number of powerful arguments for information symmetry with respect to public finances; and points out some of the fiscal transparency problems which remain in the Portuguese public sector, while identifying areas where there is scope for improvement.

6.1 FISCAL TRANSPARENCY: DEFINITION AND PRINCIPLES

In the first comprehensive treatment of the subject, Kopits and Craig (1998) proposed the following definition[84]:

> *Fiscal transparency consists of openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities, so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implications.*

The provision of reliable information on policy intentions, on the one hand, and of accurate statistical data on general government operations, quasi-fiscal activities outside the government, and balance-sheet information (incorporating implicit and contingent liabilities), on the other, are commonly discussed dimensions of transparency. Less frequently treated from the perspective of fiscal policy, but also relevant, is the behavioural dimension, which involves conflict-of-interest rules for public officials, freedom-of-information requests, regulatory clarity and simplicity, and open government procurement and employment practices. The aforementioned study identified a set of good practices which became the basis for the IMF Code of Good Practices on Fiscal Transparency. [85]

[84] See also Kopits (1998).

[85] The study was ordered and discussed in 1997 by the IMF Board, which approved its subsequent publication. The Council drew up and endorsed the Code in 1998. For updates and extensions, see IMF (2001; 2007; 2012).

Good practices in institutional transparency include: structure and functions of the public sector (delineation of boundaries between the public and private sectors, assignment of responsibilities and resources among government agencies, government levels, and extra-budgetary entities); budget process (clarity of policy intentions, open legislative debate and authorisation, disclosure of financial and performance audits, etc.); tax treatment (explicit statutory basis, tax expenditure budget, clear administrative procedures); financing operations (disclosure of terms and conditions, etc.); and regulations (clarity, simplicity, transparent costing, etc.).

Good practices in transparency of public accounts and statistical reports include: coverage (general government and quasi-fiscal activities, with sufficient detail); registration basis (accrual and cash-based conventions); valuation and recognition (clear and comprehensive balance sheet information, including implicit and contingent liabilities); and classification (economic, functional, etc.).

Good practices in transparency of fiscal indicators and projections include: direct indicators (various measures of effective fiscal balance, etc.); analytical indicators (structural budget balance indicators, debt sustainability indicators, etc.); short and medium-term fiscal projections (separate baseline – i.e. assuming no policy change – and policy projections, based on clear assumptions and methodologies, including risk assessment); and long-term debt scenarios (separate baseline and policy projections, based on clear assumptions and methodologies, including risk assessment).

6.2 THE CASE FOR FISCAL TRANSPARENCY

In a democracy, as a general principle, there is no justification for asymmetry of information between government and citizens. Exceptions include matters of public safety, national defence, and personal privacy. In addition, public officials should also be barred from disclosing information which risks defeating the purpose of policies or bestows an unfair advantage on certain economic agents – for example, information on a forthcoming exchange rate action. Transparency has undisputable advantages, both from the political and economic perspectives.

From the political perspective, the benefits of fiscal transparency are considerable. Transparency is the cornerstone of good governance. It empowers citizens, raises awareness and encourages participation in the political debate. In doing so, it stimulates voluntarism and tax compliance. Fiscal opacity, in contrast, fosters voter apathy and cynicism, and undermines taxpayer morality as well as confidence in government.

From an economic perspective, transparency is an indispensable condition – though admittedly not a sufficient one – for sound, sustainable public finances and good economic performance. Over time, transparency enhances government credibility in financial markets. Furthermore, it promotes confidence and policy predictability, thus encouraging investment and work effort, while also exposing favouritism and rent-seeking behaviour. In this sense fiscal transparency can be regarded as a public good, conducive to stability, fairness, efficiency, and growth. Fiscal opacity, on the other hand, tends to promote distortions in resource allocation, improvised procyclical policies, favouritism, corruption, and ultimately, debt sustainability problems and financial crises.

A number of empirical studies have attested to the relationship between transparent budgetary practices and fiscal discipline: Wagner (1976) in the United States, von Hagen and Harden (1994) in the European Union, and Alesina and others (1995) in Latin America. Hameed (2005) reports a positive link between fiscal transparency and economic performance across a broad range of countries.

In any case there are enough examples – the Mexican and Asian crises, recent events in the euro area – to illustrate the role of fiscal opacity in precipitating financial crises. The implication for a country as heavily indebted such as Portugal is clear: governments could benefit greatly from adopting good practices in fiscal transparency, as well as a culture of openness on all fronts.

6.3 FISCAL TRANSPARENCY IN PORTUGAL

Generally speaking, from the perspective of international standards, Portuguese public finances are relatively transparent. In a report issued ten years ago, the IMF (2003) noted that Portugal had made considerable progress with regard to fiscal transparency. Nonetheless, the report also identified a number of areas in need of improvement, summarised as follows:

> *… there are several areas where fiscal management and transparency should be strengthened. With the focus of the fiscal accounts being on general government, there has been a loss of focus on the finances of public institutions outside the general government, including the finances and operations of state-owned enterprises and the rapidly proliferating public-private partnerships. Also, budget preparation needs further strengthening, in particular with respect to better integrating the medium-term framework for budgetary policy with the annual budget process, and over time, developing a full-fledged medium-term budget. Similarly, improvements are needed to enhance the quality of budget projections and the analysis of fiscal risks, and to strengthen budget execution, reporting, and accounting processes. This needs to go hand in hand with further improvements in the systems of internal and external control.*

A decade after this report most of its recommendations remain valid. Unlike a few other EU governments (both within and outside the euro area), there is no evidence that the Portuguese authorities engaged in deliberate misrepresentation of facts. Instead, fiscal opacity in Portugal has been mostly the result of neglect and abusive application of otherwise justified practices. In certain cases, the consequences of opaque practices have become more apparent under the burden of the ongoing fiscal adjustment. Some of these practices, discussed next, are still prevalent.

Exclusion of state-owned enterprise (SOE) from government accounts is reasonable insofar as they operate as private enterprises, with a pecuniary objective function, and under direct market discipline. In Portugal, however, as in some other EU member countries, SOE operate at less than arm's length from the government and provide subsidized services against only occasional and partial compensation. Moreover, some large SOE losses are excluded from public accounts, since ESA95 only calls for the inclusion of entities whose annual sales cover less than 50% of operational costs (market test). Under the new ESA2010,[86] however, financial costs be taken into account in calculating market ratios.

A stricter application of the market test, which took place with the EFAP already in force, led some of the aforementioned companies to be included in the scope of general government. It is likely that, an earlier move towards greater transparency of information on such companies, would have contributed to a better management and to a more accurate definition of the subsidies involved. Hence, insofar as these companies were eventually re-classified, it can be argued that it would have been worth paying the price earlier on, in order to prevent the aggravation of the problem and mitigate the risk now materialised.

In recent years, governments have also resorted to public-private partnerships (PPP) to pursue investments of public interest. In principle, PPP are justified by the efficiency gains generated by private companies, under government contract, as compared to public entities undertaking such projects themselves – usually infrastructure investment and operation. In practice, however, governments in Portugal and elsewhere have promoted PPP not only having that in mind, but also with the intention to make such equipment's available to users earlier than the respective expense is recorded in the general government accounts, and thus help to alleviate or conceal the expenditure burden and indebtedness at present.

Also, under the scrutiny of financial markets and the European Commission, Portuguese governments – much like in several other EU countries – have tended to display a significant optimistic bias in their macro-fiscal projections.[87] The incentive for such a bias has been exacerbated during the recent crisis, partly to demonstrate resolve in containing a further build-up of public debt. In every instance, however, any possible short-term benefits from presenting an overly optimistic outlook have been overshadowed by the subsequent loss in credibility.

This optimistic forecast bias has been aggravated by fiscal management predicated on cash-based, rather than accrual-based, public accounting. While cash accounts are useful for monitoring short-term budget execution and financing, they can be completely misleading when it comes to determining the fiscal policy stance. While Portugal – as other EU Member-States –supplies Eurostat with accrual-based accounts in compliance with the standards set by the European System of National and Regional Accounts (ESA95, and ESA2010 from 2014), fiscal management is still based on the cash perspective. In fact, Parliament approves figures computed using this approach which lack information to reconcile these with the national accounts figures on which the EFAP and fiscal stance assessments rely.

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[86] Approved by Regulation (EU) No. 549/2013, of the European Parliament and of the Council of 21 May.

[87] Marinheiro (2011) assessed the accuracy of the forecasts included in the Stability Programmes over the period 1998-2008 and concluded that the national forecasts of some EU-15 Member-States (France, Italy and Portugal) performed worse than the European Commission forecasts in terms of all variables and all time horizons. For the year ahead (t+1), the European Commission growth forecasts were better than the official forecasts in Germany, the Netherlands, Sweden, Spain, the United Kingdom, Greece, Ireland, Luxembourg and for the EU-15 as a whole, in addition to the countries already mentioned (giving a total of 11 out of 15 countries).

Perhaps the most far-reaching breach of fiscal transparency in recent years can be found in the design of the medium-term stability program (under the Fiscal Strategy Document), which lacks a clear statement and quantification of policy intentions, measures, and their effects. More importantly, the annual budget and the policy measures included therein bear little resemblance to the medium-term program in either quantitative or qualitative terms. Furthermore, the program lacks any numerical assessment of the risks associated with the medium-term projections.

A major implication of this overview for the Portuguese government is that it has yet to make major strides toward more transparent public finances. High priority should be assigned to the preparation of more realistic short and medium-term macro-fiscal projections, as well as long-term quantitative scenarios, with full disclosure of underlying assumptions and methodology. Clear baseline (i.e., assuming no policy change) and policy projections should be presented and evaluated, including sufficient evidence that the induced effects of fiscal measures necessary to achieve budget targets have been taken into account. As a corollary, the medium-term budgetary program should be formulated as a solemn statement of policy intentions, which should then provide the basis for annual budget bills and their respective management.

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