Overview

Portuguese Public Finance Council

Analysis of the Draft State Budget for 2014

Report no. 7/2013

Lisbon, November 2013

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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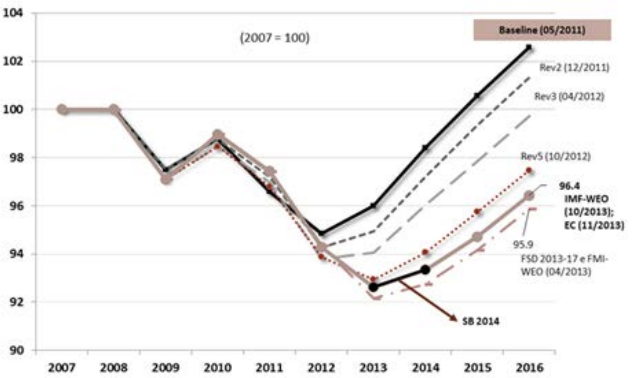
[1] Taking into account the estimated outturn included in the DSB/2014.
[2] See Box 5 of Report No. 7/2013: Analysis of the Draft State Budget for 2014.
[3] The cyclical adjustment was calculated using the MF estimate for the output gap. After the calculations were complete the European Commission published 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.

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

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.

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*

[5] World Economic Forum, Global Competitiveness Report 2013-14.

find in the FSD a first analytical attempt at combining fiscal consolidation measures with growth inducing measures in the medium run.

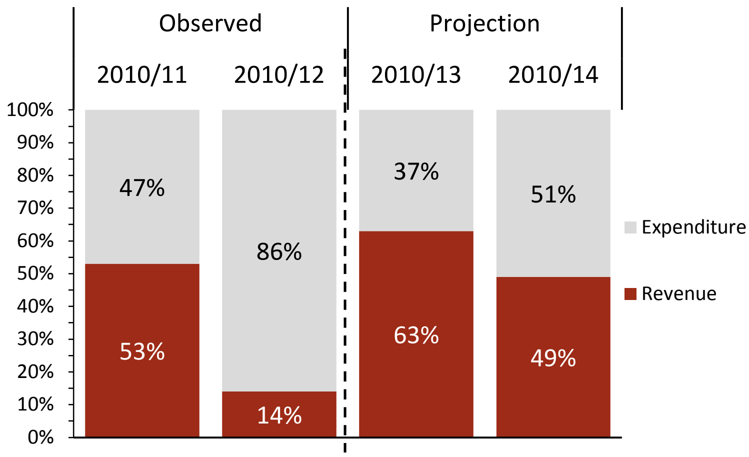
A similar comment can now be made in regard to the reform of the State, which was the subject of a Government proposal made public on 30 October[6]. Despite being a discussion paper, clear and quantified linkages to the fiscal strategy would contribute greatly to the mutual credibility of both.

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

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).

[6] Um Estado melhor – Guião para a reforma do Estado.
[7] See for example, OECD (2010), *Making Reform Happen. Lessons from OECD Countries*.

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.

Fiscal transparency

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

> *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

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

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 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.

Report No. 7/2013, which was the basis for this overview, provides detailed analysis of the DSB/2014.

[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.