Overview

Public Finance: Position and Constraints 2016-2020 - Update

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OVERVIEW

Developments in the Portuguese economy in 2016 have confirmed – and in some cases enhanced – the risks highlighted by the Portuguese Public Finance Council (CFP) in its reports on the State Budget for 2016 (SB/2016) and the 2016-2020 Stability Programme (SP/2016), as well as its March report on Public Finance: Position and Constraints (Situação e Condicionantes das Finanças Públicas) which this document brings up-to-date.

The main risks highlighted at the time concerned the assumptions made as to changes in external demand and prices, as well as the impact stimulating private consumption would have on investment and economic growth. In fact the projections included here, which have been revised to take into account developments that have taken place in the meantime in both the world economy and in Portugal, suggest a GDP growth of 1% in 2016, significantly below the 1.8% forecast in SP/2016. In nominal terms the decrease is even sharper: 2.5% under the current projection compared to 3.9%.

These figures would appear to confirm the weakness of external demand and a rise in prices smaller than forecast, while at the same time private consumption is expected to see clearly lower growth than was predictable given the increase in disposable income. The lack of confidence in a sustained recovery in economic growth affected investment, and the current projection is for a slight fall (-0.3%) in Gross Fixed Capital Formation (GFCF) compared to the SP/2016 projection of 4.9%.

The CFP has repeatedly drawn attention to the need for a clear political commitment to a medium-term economic and fiscal programme, that is well substantiated, detailed and transparent in regard both to the proposed measures and to monitoring and reporting. Fiscal consolidation and the increasing of confidence among economic agents as to the borrowing capacity of the economy and the stability of tax policy are closely connected areas and are the essential basis for a programme of this nature, capable of establishing the conditions for sustained growth in such a financially fragile economy. The persistent use of public expenditure and abundant borrowing to drive growth not only failed to ensure that growth but also eroded the fiscal and financial space to pursue such path. The absence of measures capable of putting an end to the budgetary incrementalism has led to across the board spending cuts and subsequent reversals and to tax instability, moves which breed insecurity and are incapable of building confidence.

In 2016, the persistent stress in the banking sector had also a bearing on economic growth and the fiscal position, since it prevented the end to the Excessive Deficit Procedure (EDP), due to the impact on the 2015 deficit of the BANIF resolution. However, this setback, instead of contributing to the refocusing of fiscal policy on reaching annual targets, should underline the importance of its structural adjustment and medium-term consolidation as means of stabilising fiscal policy and ensuring the sustainability of public debt. As the first decade of the 21st century showed, concentrating on the annual deficit does not overcome, rather it worsens, the fiscal constraint, by taking the place of an effective consolidation stance and financial restraint.

After decades of accumulating deficits fiscal policy needs to concentrate on macro and micromanagement of public expenditure, and devise the tools that are key to properly define priorities according to the actual constraints and then systematically search for efficiency gains. Only in this way can democratic alternation take place and public finance cease to be a constant source of instability in terms of economic agents' expectations, making it an obstacle to growth and to the financial credibility of the economy.

In recent years and also in 2016, the budgetary programming documents have stated that spending review programmes are underway in order to complement the across the board cuts. The information on these programmes was always sparse and the institutionalisation of a systematic spending review process was never considered. However, a process of this nature is essential in order to promote fiscal consolidation and sustainability in Portugal, since it is fundamental for devising a medium-term framework which itself is essential to management based on the value for money principles: economy, efficiency, effectiveness and equity as regards expenditure.

Such institutionalisation requires a strong commitment to carefully defined targets, along with the setting up of the necessary data base and the defining and attributing of stakeholders' roles and responsibilities. Indeed the decentralisation of management responsibilities within a medium-term framework based on a solid commitment to fiscal consolidation constitutes the basis for sustained control over expenditure. The Budgetary Framework Law approved in September 2015 provided the conditions for applying those principles, and priority should be given to implementing that law and fully applying the Accounting Standards System for general government (SNC-AP).

In addition EU Member-States and OECD countries have a wide experience of using spending review systems, applied to very different stances as to the State's role in the economy, but always taking into account fiscal stability and the quality of expenditure. Portugal would learn a great deal from studying those experiences and resorting to the technical support available internationally in order to institutionalize its own system.

At the macroeconomic level fiscal consolidation based on these principles is the foundation for financial credibility without which lasting economic growth is not possible. This approach also supposes a reform programme capable of contributing to an improvement in the potential growth capacity of economy, in particular one that strengthens and diversifies the financial sector while eliminating the rigidity factors in commodities and labour markets that are a barrier to investment in the tradable sectors, to productivity gains and to the creating of skilled employment, the very conditions that determine the level of income growth and the country's financing capability.

The no-policy change scenario presented in this Report stresses the need for reform, at both the macro and micro level. Pursuing current policies will, at best, maintain budgetary deficits close to 3% of GDP, without a safety margin large enough to ensure that outcome whenever an adverse event arises. The public debt ratio will remain practically stable in the coming years, while economic growth will stand at 1% to 1.5%, compared to growth in external demand of around 4% and a strongly expansionist monetary policy. The possibility of the macro-fiscal aggregates performing more favourably than projected in this report is contingent on the institutional and political stance taken at the national level and on that depends the restoring of the confidence level required to ensure the economic growth desired.