Overview

Public Finance: Position and Constraints 2015-2019 - Update

CFP Report no. 9/2015

Lisbon, October 2015

1 OVERVIEW

Following completion of the international assistance programme Portugal still faces significant challenges in terms of economic policy generally and fiscal policy in particular. The build-up of budget deficits over decades and the resulting weight of public debt mean that the main priorities of fiscal policy must be continued through fiscal consolidation and an in-depth review of the budgetary process. At the same time the country needs to find a stable economic and employment growth model, based on greater productivity and economic competitiveness, rather than one based on indebtedness and increased public spending.

The experience of the first decade of the millennium illustrates this. From 2000 to 2010 the Portuguese economy grew by 7.6% (0.7% per year), compared to 12.3% across the Euro area; real wages per worker grew by 29.9%, while productivity (measured in terms of production per employed person at constant prices) rose 11.4%, partly as a result of the 3.4% decline in employment. In the Euro area productivity increased by 7.1%, while employment rose by 6.3% and real wages per worker were up by 20.5%. The weak growth was unstable and based mainly on indebtedness. Private consumption increased by 45.6%, (35% in the Euro area), while household indebtedness, which was still very low in the mid-nineties, overtook disposable income. Private investment fell 8.6% (compared to growth of 19.3% in the Euro area), while at the same time corporate indebtedness exceeded 150% of GDP. The State ran up budget deficits over the entire period (5.5% of GDP on average) and the public debt ratio rose from 50.3% to 96.2% of GDP.[1] Most of the debt was financed by foreign financial markets, directly where the State was concerned and via the banking system in the case of private debt.

Taken together these indicators increased the economy's vulnerability and showed that access to abundant finance had not been incorporated into a public and private governance model, capable of generating increased income leading to economic growth and lower indebtedness ratios over time. Now that the acute phase of the financial crisis is over, the country faces the challenge of finding a model capable of correcting the allocation of resources in a stable manner, so as to improve at the same time productivity, employment, economic competitiveness and solvency.

In this context the changes in the economic climate over the last two years, whilst favourable, have revealed a number of concerns. GDP growth was once again based on domestic demand, in particular private consumption, the increase in which was linked to a decline in the already very low savings rate. The recovery in investment, while notable, was still weak given the sharp drop in recent years, following a decline that started at the beginning of the past decade. In the meantime foreign demand contribution to growth has again become

[1] Source: European Commission, AMECO database, May2015.

negative, as the sharp rise in imports exceeded export growth, despite the latter performing well.

The positive changes in the economic climate have been beneficial, kick starting the recovery in consumer and business confidence which is essential to the recovery of investment and employment. The fact that they were driven by private consumption and involved an increase in employment and the wage bill, also had a positive impact on the State Budget, especially in regard to the increase in revenue from indirect taxes and social security contributions, plus the reduced spending on social transfers. However, past experience shows that a positive climate of this type not only falls far short of ensuring the desired goal of stable growth in earnings and employment, but it may also give rise to a perverse incentive to adopt policies that jeopardize it. This risk is even greater when the external environment of the Portuguese and European economies is uncertain, which calls for special prudence on the part of a still very vulnerable economy.

Therefore the constraints on Portuguese public finances in the coming years are not the need to create an apparently more favourable economic climate. As has been shown in the past, such a situation could again become an instability factor to which fiscal policy continues to be unable to respond, since the necessary leeway has been eaten up by decades long accumulation of debt. Rather the actual constraints are associated with the need to correct the established fiscal policy practices, which requires changing its institutional framework.

In this light a fundamental constraint on fiscal policy in the coming years is the implementation – and where necessary the fine tuning – of the budgetary framework law passed in June (Law no. 151/2015, of 11 September). Giving real purpose to the "Main Options Law" by turning it into a strategic economic policy tool that incorporates its financing capacity and how it is used should be the basis for an effective Stability Programme which, for its part, frames an annual budget covering general government as a whole including expenditure commitments. This is a principle that should already be followed as regards the Stability Programme and the State Budget for 2016.

The baseline scenario underlying this report suggests, first, that the mere absence of fiscal policy measures – which would lead to the elimination of the personal income tax surcharge and the full reversal of civil servant salary cuts in 2016 – would compromise the abrogation of the Excessive Deficit Procedure, since the deficit projection for 2016 would exceed 3% of GDP. Equally important is the significant risk of such a policy making short-run economic growth unsustainable. That would be the case if growth were again driven by private consumption and a decline in savings, leading to a rise in imports and the worsening of the current account balance.

In what concerns budgetary policy, although under this scenario the deficit would once again be below the 3% of GDP limit from 2017 onwards, it would fall short of the goal of eliminating the fiscal imbalance as laid down in the 2015 Stability Program, a target required by European rules and recommended by Portuguese economic experience. In the absence of policy measures there would be a significant deviation in the structural balance path, compared to the Medium Term Objective, of over 2 p.p. of GDP. Even ignoring the risks mentioned in this report, in 2019 the public debt ratio would still be over 120% of GDP, a level that implies a high risk to economic stability and growth, not only on account of its cost, but also because it would have to be largely financed by foreign sources under conditions that this scenario would make more volatile.

In short the scenario presented in this report does not set out to be optimistic nor pessimistic; rather it attempts to project developments of the current climate in the absence of fiscal policy measures. Thus it calls attention to the dilemma Portuguese economic policy faces. Gullible optimists could interpret it as showing that as a result of a tough adjustment programme a policy geared to the short-term and based on minimal budget consolidation could be viable once again. However, the scenario shows that not only would such a policy not comply with the current European rules but also that its implications for the nation's level of indebtedness and its poor competitiveness call for a medium-term outlook which focuses on stable growth, based on a coherent programme of reforms aimed at removing both weaknesses, something which fiscal expansionism has already shown it cannot provide.

This requires making investment in the tradable sectors and exports the driving forces behind growth. Since Portugal is a small open economy, increased consumption, investment and exports will always lead to increased imports. Therefore economic policy will have to calibrate the incentives to ensure that exports lead the way and so provide for a fall in the country's external debt ratio.

The necessary incentives include building up a business environment that encourages the desired investment, one that does not rely on the non-tradable sectors and does not place an additional burden on the State Budget. Increasing interest and social charges require the budget's role in the economy to be one of reinforcing confidence in the State's ability to meet its obligations and to set rules of the game that are consistent with stable and balanced economic development, renouncing short-lived interventions in areas outside its calling.

By definition such goals cannot be incorporated in a baseline macroeconomic scenario. However, what the scenario shows is that if these goals are not well defined and met, the economy's fragility and its vulnerability to the external environment and the volatility of the financial markets are not remedied but heightened. Hence the need to focus economic policy on institutional and structural matters that guide microeconomics, rather than seeking to influence it through macroeconomic stimuli that weaken it.