Executive Summary

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This report examines fiscal developments in the general government sector in the 1st half of 2016. In order to improve the analysis general government revenue and expenditure have been adjusted for effects that do not have a permanent impact on borrowing requirements.

Up to the end of the 2nd quarter of 2016 the budget deficit was 2510 M€ (2.8% of the half-year GDP). This figure represents an improvement in the fiscal balance both in year-on-year terms (1.8 p.p. of GDP or 1542 M€) and in comparison to the previous quarter (0.2 p.p. of GDP). However it is still higher than the SB/2016 forecast for the year as a whole (2.2%), and is also higher than the goal of 2.5% of GDP laid down in the Council of the European Union Decision of 2 August 2016 (excluding any support to the banking system). The improvement in the balance was based on the increase in tax and social contributions revenue (which contributed to an increase of 623 M€ in total revenue) and on the fall in spending (down 919 M€), in particular the cost of interest and, above all, capital expenditure, including public investment.

Up to June 2016, excluding expenditure on interest (3809 M€), there was a primary surplus of 1300 M€, equal to 1.4% of GDP. It should be noted that the General Government account has recorded a primary surplus since the third quarter of 2015.

In the 1st half of the year the growth in general government revenue slowed (to 1.7%) to below the figure forecast in State Budget for 2016 (SB/2016) for the year as a whole (3% in adjusted terms). Tax revenue performance in the 2nd quarter was the deciding factor in this slowdown. In the 2nd quarter tax revenue grew 0.5% in year-on-year terms, whereas in the 1st quarter it had grown by 6.5%. Nonetheless over the six month period tax revenue grew 3.4% (above the 3.1% forecast for the year). Non-tax and non-contributions revenue remained on the downward path seen the previous quarter (-5.6% cumulative year-on-year change for the half-year).

In the 2nd quarter indirect taxes saw their growth slow down, due to the performance of special taxes on consumption (STC). According to CFP calculations the tobacco tax (IT) was the main reason for this slowdown, since, as was to be expected, the strong growth in tax revenue recorded at the beginning of the year was not repeated in the 2nd quarter. While in the opposite direction the Tax on Oil and Energy Products (ISP) continued to perform well. However, despite the favourable development in the first half of the year (+158 M€ compared to the previous year) ISP recorded growth that is one-third lower than the increase forecast by the Ministry of Finance (MF) for 2016 (493 M€), suggesting an outturn deviation that is unlikely to be reversed.

The growth in VAT revenue accounts for a revenue increase one-third lower than that forecast in SB/2016 for the year as a whole. VAT revenue has experienced a slowdown throughout the year, where the net revenue collected in the 2nd quarter was practically half that recorded in the 1st quarter of 2016. The performance of VAT, which represents over one-third of total tax revenue and over half of the indirect tax revenue forecast in SB/2016, shows also a deviation that will be difficult to reverse. The loss of revenue resulting from the decrease in the VAT rate on catering, estimated by the MF to be 175 M€ in the second half of the year, combined
with the smaller than expected increase in private consumption, will hasten this tax downward drift away from the goal. As for the “remaining indirect taxes”, which account for around 13% of the total tax revenue forecast in SB/2016, the increase recorded in the 1st half of the year exceeded the expected increase for the year by 259 M€.

Direct taxes fell by 3.1% in the first half of the year, and PIT revenue accounted for over two-thirds of that decrease. The poor performance of this tax was more marked in the 2nd quarter (-7.2% against -0.2% in the 1st quarter). CIT revenue (-1.1%), which reversed the marginally positive performance seen in the first quarter (0.4%), followed the unfavourable trend in direct taxes and recorded a drop in the 1st half of the year greater than the MF forecast for the year as a whole (-3.7% compared to -0.7%).

As for social contributions, growth accelerated in the 2nd quarter, consolidating a rate of growth above the budgeted annual forecast. This positive change in social contributions in the 1st half of the year (3.5%) reflects the increase in both effective and imputed social contributions. This exceeds the level of growth forecast in SB/2016 (2.3%). Note that the increase in Social Security contributions in the 2nd quarter (4.3%) was greater than in compensation of employees (3%).

In the 2nd quarter expenditure continued to fall compared to the previous year (-1.6%), although the trend slowed compared to the beginning of the year (-3.0% in the 1st quarter). The decrease after six months (-2.3%) contrasts sharply with the annual increase forecast by the MF (+1.9% in SB/2016 and +1.5% in SP/2016).

All expenditure aggregates contributed to this development with the exception of compensation of employees and social transfers. Intermediate consumption recorded a year-on-year increase of 3.3% up to June, which compares to the 11.6% growth underlying SB/2016; other current expenditure fell 13%, contrasting with the budgeted 11.9% increase; interest fell 5.9%, and over the year should be less than the sum forecast in the SB.

Gross Fixed Capital Formation (GFCF) is also likely to be lower than the figure forecast in SB/2016. In the 1st half of the year GFCF fell by 26.6%, a faster rate than predicted in SB/2016 (-3.3%). Although investment normally picks up in the 2nd half of the year, achieving the figure forecast in SB/2016 (3775 M€) would require public investment to total 2556 M€ over that period (while the total sum invested in the first six months was 1219 M€).

For its part compensation of employees recorded higher growth in the 1st half of the year (2.1%) than that implicit to SB/2016 (0.2%) and to Stability Programme/2016 (1.7%), due to the increased cost of social contributions. That trend is likely to increase as a result of the growing impact of the wage reinstatement and the decrease in the civil servant working week.

The public debt ratio (Maastricht definition) stood at 131.7% of GDP at the end of June (compared to 128.9% of GDP at the end of March), with debt stock increasing by 6524 M€ to total 239,800 M€. The Maastricht debt net of central government deposits is equal to 121.8% of GDP, having increased 0.2 p.p. of GDP compared to the 1st quarter of the year and 2.7 p.p. of GDP compared to the end of 2015.

In prospective terms for the year, the CFP stands by its projection published in September, as well as the associated risk assessment, which stem from the specific nature of the 2016 budget exercise. In effect the increase in compensation of employees (due to the phased
reversal of the civil servants’ salary cut and the decrease in the civil servants’ working week from 40 to 35 hours from 1 July), the negative impact on VAT revenue of the cut in the rate on the catering sector from July onwards, along with the slowdown in the growth in tax revenue and national and international economic growth lower than estimated in the macroeconomic scenario underlying SB/2016 make the budget outturn exercise for the second half of the year (in particular the final three months) particularly difficult.

In addition the financial sector also carries risks for short-term and medium-term public finance. The recapitalisation of the CGD bank, plus the compensation for those subscribing to debt issued by Grupo Espírito Santo and sold at branches of Banco Espírito Santo, may have a negative impact on the fiscal balance and on public debt.

Note: M€ stands for million EUR.