Executive Summary

Fiscal risks and Public Finance Sustainability

CFP Report no. 08/2018

Lisbon, July 2018

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The Portuguese economy reacted well to the recovery in the European and international economies in 2017 and the macroeconomic and fiscal outcomes it achieved in recent years were better than initially forecast by national and international institutions. The efforts made by recent governments to achieve fiscal balance and lower public indebtedness led to an improvement in the country's borrowing terms, as well as an improved sovereign risk rating. Given its vulnerabilities, the Portuguese economy must remain on the budget consolidation path if it is to increase its resilience to shocks from an adverse external environment. Prudent public finance management during the favourable phases of the business cycle and the defining of strategies that strengthen the economy's resilience to shocks, both internal and external, are the essential foundation for fiscal policy and the structural reforms to be undertaken.

However, some very important fiscal risks remain at the various levels reviewed in this Report on Fiscal Risks and Public Finance Sustainability, which is the first in a new series of the Portuguese Public Finance Council (CFP) publications and will be updated every two years. Recognition of these risks and regular attempts to identify and quantify their impact are key to sound public finance management, since this is the only way to create the conditions for fiscal policy to cushion the impact of economic fluctuations and therefore to increase the resilience of economy to shocks.

The CFP has focused its risk analysis on five areas: macroeconomic performance, public revenue, public expenditure, contingent liabilities and public debt. In this Report *risk* means a measure of uncertainty as to the possible deviation from the expected outcome of a variable, which may be positive or negative. S*ustainability* means the State's ability to honour its commitments made to its citizens and creditors.

From our analysis we conclude that the main risks underlying the budgetary forecasts and consequently public finance sustainability stem from failure to achieve the growth path defined in the macroeconomic scenario used, due to direct consequences for forecast revenue and, to a lesser extent, public expenditure.

These macroeconomic risks flow from the business cycle and long-term growth potential. In the case of the business cycle, whilst it is sure that the economy will experience times of expansion and contraction, their extent is variable and the timing of downturns is uncertain as the forecasting models cannot easily predict them. Based on GDP developments from 1977 to 2017, the probability that Portugal is in recession in any one year is around 15%. Assuming the probability of a recession is independent every year, the probability of the Portuguese economy being in recession at any time over a five-year period is approximately 55%. On average a recession in Portugal "costs" 3.1% of GDP and the Portuguese economy takes the same length of time to recover to the previous GDP level as the duration of the recession itself, except for the last two recessions. As for the recession during the global financial crisis of 2008, the Portuguese economy can be expected to return to its pre-crisis real GDP level during 2018.

In the long-run and in the absence of shocks to the economy, economic growth flows from the performance of potential output. This is a concept linked to aggregate supply. The level and performance of potential output is dependent upon the capital stock, the labour force and the developments seen in the productivity of these factors (capital and labour). Thus, demographic trends constitute one of the most important structural developments for any country. Population growth provides for increased economic potential and, in normal conditions, develops slowly and predictably. At this level the *Ageing Report 2018* projections highlight a downturn risk underlying the Portuguese economy's potential growth in the medium to long-term. Overall the projections point to a decline in the Portuguese population from 2015 to 2070 of over 2.3 million people and the working population (15-64 years of age) is expected to drop sharply even if there is net immigration.

The labour productivity (resulting from the combination of the factors and calculated as real GDP / total hours worked in the economy ratio) is expected to return to a growth rate of 1.4% in the long-term (equal to the average growth rate during the pre-financial crisis period, 1996-2007). This outlook for sustained growth in productivity may make up for the decline in the working population, but carries high risks, given the high degree of instability revealed by the statistics. Particular attention is drawn to the risk of the low productivity growth pattern recorded in the post-crisis period (0.6% from 2008-2017; -0.2% from 2014-2017) and to a recovery that falls short of pre-crisis levels. In fact, the persistent slowdown in productivity during the post-crisis period has been seen in the advanced economies generally, although it is not so easy to explain and is unclear if the previous long-term trend will return. The projection used in the *Ageing Report 2018* and in this report's long-term projections may therefore be a risk factor that brings with it a demanding expectation from the standpoint of the economic policies that have to sustain it.

In Portugal there is a significant correlation between changes in public revenue and GDP. This sensitivity to business cycle fluctuations reflects the nature of the automatic stabiliser that is tax (and social contributions) revenue. However, the way in which the stabilising function of fiscal policy was managed for some time, which led to an increase in budget deficits that was not sufficiently offset by similar decreases in times of economic growth, forced the country to adopt measures (very often in a procyclical manner during the economic slowdown) aimed at correcting the unsustainable imbalances. Most measures have been applied to the revenue side leading to its persistent growth both in absolute terms and as a percentage of GDP. Accordingly, there has been a significant increase in the tax burden, that was particularly marked during the financial crisis, and in sovereign debt. It was only from 2014 onwards that the tax burden stabilised at 34 to 35% of GDP. Increasing the tax burden to overcome borrowing requirements brought about by the business cycle constitutes a major fiscal risk, since it tends to reinforce the effects of the economic contraction.

In addition, while the tax burden in Portugal stood at 34.4% in 2016, below the EU average of 38.8%, this differential is merely apparent and the country faces a risk should it attempt to increase the tax effort required of the economic agents concerned. This risk comes from the fact that some of the countries that compete with Portugal, especially in terms of attracting investment, have tax burden ratios even further below the European average and from the perception expressed by business people as to the negative impact of taxation on potential investment decisions.

This fiscal risk is enhanced by the fact that in recent years there has been an increase in the concentration of PIT and CIT among a smaller number of taxpayers. Being dependent upon less taxpayers (households and companies) brings the added risk of individual (idiosyncratic) behaviour acting as a constraint on a significant share of tax revenue, for instance, opting for more favourable tax jurisdictions.

As for expenditure, between 1995 and 2010 Portuguese GDP at current prices doubled while expenditure grew two and one-half times. Over the course of the Economic and Financial Assistance Programme (PAEF in Portuguese) and in the following years rates of growth were lower and, according to CFP projections, they even tend to stabilise. Expenditure on compensation of employees and social transfers accounts for almost 75% of adjusted primary expenditure, a relative weight that has been on the rise since 1995 (when it accounted for 66.5% of that aggregate), making it the main factor in the rise in public expenditure. These are inflexible items of expenditure and their use for fiscal consolidation purposes brings very considerable political costs and they are strongly affected by external factors such as changes in population.

Demographic changes are the deciding factor in public finance sustainability on the expenditure side. The combination of increased life expectancy and lower birth rates, plus lower net immigration enhances the ageing of the population and has a direct impact on public expenditure. Spending linked to the ageing of the population (mainly pensions and health care) has risen continuously over the years, bringing economic, fiscal and social challenges. According to the recent medium and long-term expenditure projections published in *Ageing Report 2018*, an additional effort will be required in terms of public finance to retain the level of social benefits currently available. Regarding health expenditure, the European Commission's projection for Portugal is an increase of 2.4 p.p. of GDP from 2016 to 2070, the second highest figure for the European Union as a whole.

Contingent liabilities are potential liabilities that only become actual costs if certain events arise. They can result from formal commitments such as contractual government guarantees or public-private partnerships (PPP), or from informal liabilities that involve a considerable degree of public commitment such as liabilities taken on by public corporations, even if they fall outside the scope of general government. In aggregate terms total contingent liabilities in Portugal increased from 70.5% to 76.5% of GDP from 2013 to 2016, which is above the average for EU Member-States (41.3% in 2016). However, the last three years for which figures are available have seen a decrease due mainly to contingencies linked to financial sector support becoming actual expenditure.

The impact of financial sector support as a result of the international crisis was felt in a large number of developed countries and, in the case of the euro area, revealed the fragilities that have persisted since it was created. Such support was particularly important in Ireland (21.6% of GDP in 2010), in Cyprus (8.5% of GDP in 2012) and in Slovenia (10.2% of GDP in 2013). In Spain the support peaked at 3.6% of GDP in 2012. In Portugal, this type of support totalled 8.6% of GDP up to 2017, but has taken a more diluted form, with the main transactions involving BPN (from 2010 to 2014), BES (2014), BANIF (2013 and 2015) and CGD (2012 and 2017).

Portugal is the EU country that has the largest GDP percentage of off-balance sheet liabilities relating to PPP (3.2%), which is 2.1 p.p. of GDP above the EU average, followed by Slovakia (3.1% of GDP), Hungary (1.7% of GDP) and the UK (1.5% of GDP).

This Report contains a debt sustainability analysis for the next 15 years. This is an extension of the time horizon used in the Public Finance: Position and Constraints 2018-2022 Report that the CFP published in March 2018, which simulates the sensitivity of the debt ratio to external shocks, on the basis of a central scenario that includes detailed information on the next four years and the trends underlying the long-term exercise in *Ageing Report 2018*. Based on these assumptions, public debt as a percentage of GDP falls in the early years of the projection. This is due above all to the build-up of primary surpluses and the favourable dynamic effect, with the GDP growth effect more than offsetting the unfavourable impact of interest. Thus, the projection points to public debt falling from 125.7% in 2017 to 106% of GDP in 2022. From 2023 onwards, the decrease is less marked given the assumption of lower primary balances and GDP growth rates, converging towards to 94.7% of GDP in 2033. The sensitivity analysis points to a debt ratio that is highly sensitive to shocks to GDP growth rate and to the assumed primary balance. Therefore, actual changes of +1 p.p. and -1 p.p. in GDP growth imply that debt will be 71.6% to 122% of GDP, respectively, in the final 15 years of the projection.