Overview

Analysis of the Draft State Budget for 2018

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OVERVIEW

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After the Economic and Financial Adjustment Program (EFAP) came to an end in 2015, and the budget deficit in 2016 fell below the 3% of GPD limit which defines an "excessive deficit", Portugal has entered in 2017 a period when both the economic and fiscal plans must focus on structural adjustment. In addition to the progress made, the country is benefitting from the favourable economic and financial climate, which brings into play the "stability and growth" option that is the bedrock of the Pact the country signed up when joining the Economic and Monetary Union, the preventive arm of which is now in force. Reducing public and private indebtedness remains a priority that heightens the need for adjustment, not only to comply with the rules, but also to promote the country's development and social welfare.

Such an option supposes that, as well as defining generally consensual goals – growth in income and jobs, greater equality, efficient public services – fiscal policy also truly contributes to their sustainable achievement. This implies adhering to principles that put aside practices that have characterised Portuguese fiscal policy for decades. The first one is the Keynesian principle that covers short/medium-term implications and calls for using favourable conditions to build up sufficient fiscal space to adopt, when necessary, stabilisation measures without risking financial collapse. The second is of a structural nature and supposes concern for promoting efficient public spending and a tax policy that encourages private sector investment and saving. The preference for ignoring these principles at the fiscal policy level explains, to a large extent, the poor economic performance and high degree of indebtedness which are features of the Portuguese economy. Recognising the implications of these principles calls for substantive changes, not in terms of the policy goals, but rather in the direction fiscal policy must take to bring about their effective achievement.

The Draft State Budget for 2018 (DSB/18) incorporates some items that are part of this rationale, such as the commitment to reduce the fiscal deficit and debt ratio, prioritising compliance with European rules – now those that belong to the preventive arm of the Stability and Growth Pact (SGP) – and pursuing an expenditure review, albeit this task is still in its infancy. However, the aforementioned principles are still far from underlining the fiscal stance set out in the DSB.

As regards fiscal rules DSB/18 still mostly takes advantage of the favourable economic climate, while compliance with the rules is mostly concerned with annual numerical outcomes needed to avert the European Commission's disapproval. In fact, the DSB proposes measures that use most of the leeway afforded by favourable external demand and financing conditions – measured by the increase in tax and social security contributions revenue and the decrease in interest payments – to increase investment, but also the less elastic components of primary expenditure.

On top of this the DSB takes full advantage of the ambiguity of the rules, and the frailties that are still a feature of public accounts reporting in Portugal, in order to formally comply with the SGP's preventive arm, without truly reflecting its underlying structural nature. The rules are based on the definition of a medium-term objective for the cyclically adjusted budgetary balance net of temporary and one-off measures. The specific rules governing the assessment of this objective are technically complex, including not only observed outcomes but also forecasts, and there is a certain degree of ambiguity which calls for judicious interpretation, for example when classifying measures as temporary.

These are the unavoidable characteristics of rules that apply in a wide range of situations and policies whose effects may only be assessed in the future. For this reason, compliance with the rules supposes a commitment to the principles which underlie the wording of the rule and goes beyond annual compliance with a numerical value. Not only the figures on which that value is based are necessarily subject to review, but also this exclusive concern is not sufficient to ensure the desired consistency with the stated goals. At the European level the recognition of this fact has led to a more demanding attitude in regard to the plausibility and/or prudence of the macroeconomic forecasts underlying the budgetary plans. In this context the Portuguese Public Finance Council (CFP) endorsed the short-term macroeconomic scenario underpinning DSB/18, whilst stressing the "advantage for the macroeconomic frameworks underlying the different budgetary programming documents to be produced for the medium-term. Only then will it be possible to evaluate the longer term effects of the adopted policies and their sustainability", which continues not to be the case in this Draft.

Furthermore, as mentioned, the rule relates to the cyclically adjusted balance net of temporary and one-off measures. The cyclical adjustment is especially fallible given the circumstances of the Portuguese economy, which for decades has known serious instability, not only of a cyclical nature but also from exogenous shocks, both national and international. To recognise this fact does not, however, equate to undermining the importance of structural indicators, but rather to provide supplementary microeconomic and qualitative information and to give priority to the second of the aforesaid principles, that is to say, the promotion of efficient public expenditure and a tax policy that encourages private sector investment and saving, which will lead to sustained growth in potential output. We are dealing with a complex assessment that cannot be reduced to a single indicator, a fact the European framework takes into account in its fiscal policy coordination and surveillance procedures.

Lastly, another important aspect of the structural balance assessment is the exclusion of temporary and one-off measures. In this field the CFP's assessment reaches conclusions that differ from the reasoning underlying DSB/18. This difference of opinion may be due in part to the shortage of information as to the nature of the transactions taken into consideration by the Ministry of Finance. This Report sets out in detail the reasons for the differences in interpretation, given the information available up to the time of publication. As well as the specific nature of the transactions in question, one matter that must be stressed in this context is the excessive importance of these transactions in the assessment of the structural balance implicit to DSB/18. Given the complexity of this assessment, the relative weight of these "measures" is coupled with the leeway provided by the favourable economic climate to fund the increase in the less elastic primary expenditure items, thus increasing the weakness of the forecast adjustment.

Even with reference to compliance with the numerical rules, it is not clear that it is actually guaranteed with respect to the period 2017/2018. In fact, on the basis of the information available and its own classification of temporary and one-off measures, the CFP estimates that the planned improvement in the structural balance underlying DSB/18 will be 0.1 p.p. in 2017 and 0.3 p.p. of GDP in 2018. These figures contrast with the recommended change of 0.6 p.p. of GDP each year, given the economic setting. Similarly, the deviation of planned growth in primary expenditure, net of discretionary revenue measures, exceeds on average the applicable benchmark by 1% of GDP in both years.