Overview and Conclusions

Portuguese Public Finance Council

Analysis of the 2014-2018 Fiscal Strategy Document

Report no. 3/2014

Lisbon, May 2014

OVERVIEW AND CONCLUSIONS

The 2014-2018 Fiscal Strategy Document (FSD/2014) will probably be the last of these series of publications, which throughout the Economic and Financial Assistance Programme (EFAP) replaced the Stability Programmes required under the Stability and Growth Pact. This gives a special importance to the strategy it sets for the coming years because such strategy must ensure that the economy enters into a stable growth and financially sustainable path, in line with the confidence return by the public in general and national and foreign investors in particular.

The macroeconomic scenario adopted in the FSD/2014 foresees economic developments that meet these criteria as it is based on sustained external balance and moderate economic growth, as a result of the recovery in investment, productivity and employment, framed by fiscal stability and public finance sustainability goals in accordance with European rules.

Progress of this type was made possible by the tough adjustment programme that provided a return to external balance equilibrium and the conditions to achieve a budget primary surplus in 2014. However, the confirmation of this scenario in the medium/long run requires a deep change in the behaviour of the Portuguese economy by re-entering a growing environment based on normal financing terms. Such a change will not depend solely on fiscal policy measures for 2014/15. On the one hand, to ensure a sustainable path for public debt, a significant primary structural balance must be maintained far beyond that time span, even if the economic recovery proves to be more favourable in the medium and long run than forecasted in the FSD/2014. On the other hand, growth recovery without losing the external balance surplus calls for a macroeconomic strategy that must be explicit and sufficiently detailed so as to provide economic agents with the guidance needed to align their behaviour with the strategy proposed by the Government.

A programme such as the FSD (and the following Stability Programme) should be capable of establishing this commitment for the fiscal policy strategy and the corresponding framework, in line with the vision of the Government proposing it. To that end it must be explicit, both as regards the strategy goals pursued and the measures required to achieve them, which should be defined for the entire period covered by the programme. The possibility of an annual update of these documents has normally allowed each revision to ignore the forecasts and even the measures published the year before. This practice prevented the documents from being seen as a governance commitment and an effective anchor for economic agents' expectations. Updating the strategy over time is inevitable but abiding by it requires regular monitoring of the outturn of the planned measures over the entire programme period, an assessment of their results and, whenever necessary, the disclosure of the reasons behind any amendments to or rejection of them. In addition it requires that any alternative strategies comply with identical transparency criteria.

These documents should comprise a no policy change macroeconomic scenario, as a basis for adopting the measures and for assessing their expected impacts. This item, while mandatory by current European regulation, is not included in the FSD, therefore hindering a proper evaluation and monitoring of the proposed measures.

Equally important is the need to rethink the legal procedures which allow a new law to amend, as often as the parliamentary majority requires, the measures it defined as strategic or binding for a number of years. This is, for instance, the case with the Multiannual Budgetary Programming Framework (MBPF) whose "binding" multiannual limits are amended as often as the laws that set them (or even on the basis of a mere Government announcement to Parliament). Clearly the intention here is not to curb the Parliament's or the Executive's powers, but rather to stress that the credibility and effectiveness of the legislature's decisions depend on its ability to respect them.

Setting and meeting spending limits is essential in order to ensure the stability and sustainability of public finances. This is especially the case when the country has exhausted the options of public debt and tax burden growth and has to rely on quality private investment, headed to the tradable sectors and increased productivity, to fulfil the strategy that the FSD/2014 properly proposes. Spending limits are also required as a basis for enabling the autonomy and accountability of public services management, leading to efficiency gains and the elimination of incrementalism (positive or negative) that have featured Portuguese fiscal policy. To that end, setting expenditure limits calls for a precautionary reserve appropriation whose eventual use is subject to a clear explanation of the underlying reasons, and must not result in an automatic increase of the limits set for the following years, calling instead for measures to correct it.

In view of these principles the Portuguese Public Finance Council considers that there are aspects of the FSD/2014 that should be valued and vulnerabilities worthy of mention. The document identifies risks (concerning both the central macroeconomic scenario and the management of fiscal variables), reports on the long-term demographic scenarios and possible fiscal impacts and lists the reforms undertaken and under way which the Government believes to be most pertinent to improve the quality of public finances.

As stated above, the fiscal goals set out in the FSD/2014 are suitable considering the state of public finances and the economy. The need to pursue fiscal consolidation and continue to improve the outturns achieved over the period of the financial assistance programme is undeniable. When analysing the FSD/2013, the CFP considered as appropriate the assumption of public debt sustainability as a top priority of fiscal policy (Report no. 3/2013), given the cost of debt and the stable confidence restoration on the Portuguese economy that would emerge from that priority. Any one of these factors supposes the commitment to a clear and long-lasting fiscal consolidation strategy.

The goals published in the FSD/2014 are in line with current fiscal discipline rules. In effect they point to a general government deficit in 2015 below the 3% of GDP limit, which will allow the Excessive Deficit Procedure (EDP) to come to an end. After that year the document forecasts that the convergence trend to the Medium Term Objective (MTO) — currently set at a structural balance of -0.5% of GDP — will reached the target in 2017 and will surpass it in 2018. The substantial decrease in the planned deficit will allow a sharp decline in the general government debt ratio over the five-year period under review, thus complying with the transitional rule for the debt reduction over the first three years following the end of the EDP. Maintaining the structural deficit equal to the MTO beyond 2018 will make it possible to reduce public debt annually at the rate required by the debt rule that requires a decrease of the debt ratio in excess of the 60% of GDP benchmark.

In the long run, the update of the demographic scenarios reported in the FSD/2014 corroborates and underlines the priority of public debt sustainability. From 2013 to 2060, resident population is expected to fall by 22% and the dependency ratio to rise from 30% to 65%. An ageing population is a source of difficulties but it should also be regarded as a challenge for new economic policies. In fact, the demographic prospects call attention to the undeniable need for policies that increase productivity and act as a stimulus to a high rate of activity and high employment across all population segments, regardless of gender, age or academic qualifications. They also stress the importance of active reemployment policies. Such policies would offset the budgetary pressure from an ageing population, minimising the budget consolidation effort required to achieve the primary surpluses needed to comply with the structural balance rule.

The FSD/2014 consolidation measures identified to implement in 2014 and 2015 are very diverse and appear to be dictated by the need to achieve budget outcomes, albeit long lasting, rather than to propose the structural revision of the budget process and the reform of public services provided by the general government. On a positive note, the FSD/2014 sets out the consolidation measures to be included in the SB/2015, which brings credibility to the targets set for that year. However, there is still a need to include them in a well-defined medium and long-term strategy which, among other things, would gain from devising a governance model that clearly defines for each measure elements such as who is responsible for what and when, the scheduling of the necessary management or legislative acts, how the coordinators and implementers of the measures should interact, and the self-assessment process that will expedite the timely correction of any deviations. It is equally important to provide regular information that allows for external monitoring of the outturn of the various measures. In addition, the relative weight of the unspecified measures (0.7% of GDP in 2014 and 0.3% in the next year) is a risk that should be noted.

For the period from 2016 to 2018, the FSD does not describe the additional measures needed to meet the targets set therein. Although less detail is to be expected compared to the 2015 measures, the FSD/2014 should explain the direction and overall amount of the revenue and expenditure measures that are inherent in the macroeconomic scenario and the budgetary planning framework.

The period over which the European Structural and Investment Funds will be applied includes the entire period covered by the FSD/2014. However the document does not specify the link between the fund application strategy and the fiscal strategy. No mention is made of the conclusions of a possible analysis on the consistency of, on the one hand, the national public contribution rates agreed with the EU and, on the other, the macroeconomic scenario, the fiscal targets and the levels of public investment set out in the FSD. The credibility of the FSD would be significantly enhanced by the clarification of these matters, as well as of the foreseeable impact of the "Portugal 2020" Partnership Agreement implementation on the qualitative nature of the budget programmes measures and their annual financial planning.