ANALYSIS OF THE DRAFT STATE BUDGET FOR 2021

EXECUTIVE SUMMARY

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From the 2020 estimate to the 2021 budget forecast

In the context of the pandemic crisis, where its continuing effects are unknown, the State Budget proposal for 2021 (DSB/2021) foresees a budget deficit of 9132 M€, corresponding to 4.3% of Gross Domestic Product (GDP). [1] This forecast is based on the recovery of the economy and the reversal of part of the exceptional fiscal response measures to the effects of COVID-19, and points to a deficit reduction of 2.9 p.p. of GDP compared with the estimate for 2020, which in absolute terms translates into a lower deficit of 5292 M€. The lower forecast amount of government financial support to the financial sector and aviation in 2021 compared to 2020, combined with the reimbursement of pre-paid margins to the European Financial Stabilisation Fund (EFSF), contribute to this reduction in the expected budget deficit. Measures aimed at protecting employment and income, as well as those planned for public investment, both reflected in expenditure, account for almost all of the net impact of 3643 M€ calculated by the CFP on the basis of the measures explained in DSB/2021.

The analysis of the consistency of budgetary forecasts is hampered by the absence of a clear, objective and disaggregated quantification of the actual budgetary impact of the pandemic crisis response measures considered by the MF in the 2020 estimate and the 2021 budget forecast.

On the basis of the available evidence, it can be concluded that the recovery of economic activity envisaged by the government, a smaller amount of expenditure measures related to the pandemic, the already mentioned smaller support to specific sectors, "other unidentified and unexplained effects" and the recovery of the commission paid to the EFSF will be determinant for a deficit of 4.3% of GDP in 2021.

[1] Unless otherwise stated, in this report GDP is measured in nominal terms and the figure considered for the year 2021 is 210 833.22 M€.

Budgetary developments expected for revenue and expenditure in 2021

The share of public revenue is expected to reach 43.5% of GDP next year, increasing by 0.9 p.p. of GDP compared to the figure expected by the Ministry of Finance (MF) for 2020, as a result of the increase in the share of tax revenue and non-tax and non-contributory revenue.

In nominal terms, tax and contributory revenue should explain approximately 60% of the growth of total General Government (GG) revenue (7159 M€), mostly based on the behaviour of revenue from taxes (3340 M€) and, to a lesser extent, on the increase in actual social contributions (1068 M€).

The expected dynamics of tax revenue explains exclusively the projected increase in the tax burden from 33.9% of GDP in 2020 to 34% of GDP in 2021, since, according to the MF, the share of actual social contributions is expected to fall by 0.1 p.p. of GDP next year. The decline in the share of these contributions in GDP results from the expectation of a slower pace of growth (5.3%) than that projected by the MF for nominal output (6.3%). The same should not happen with tax revenue, which projected growth of 7.1% is above the pace considered by the MF for the evolution of economic activity in 2021, implying an elasticity of tax revenue to GDP above the unit.

As regards non-tax and non-contributory revenue, the MF projects an annual rate of change substantially above that expected for economic activity when measured by GDP developments in 2021. Contributing to this performance will be, fundamentally, the robust increase in transfers from the European Union under the Recovery and Resilience Plan (RRP) and the Recovery Assistance for European Cohesion and Territories (REACT EU) initiative, which will have a positive impact on capital and other current revenue respectively.

The share of public expenditure in GDP is expected to fall from 49.9% in 2020 to 47.8% in 2021. This reduction of 2.1 p.p. of GDP is influenced by a strong denominator effect, as the MF expects nominal output to grow by 6.3% in 2021, after a contraction of 7.1% estimated for 2020.

The DSB/2021 foresees general government expenditure to reach 100 755 M€, following an increase of 1867 M€ compared to 2020, driven by current primary expenditure and, to a lesser extent, capital expenditure. Interest expenditure is expected to fall for the seventh year in a row, though less markedly than in recent years.

The primary current expenditure may register an increase of 2 thousand M€ in 2021, driven by social benefits and compensation of employees, which are the most rigid expenditure items and together account for about two-thirds of public expenditure planned for 2021. However, the growth rate of both is expected to decelerate in 2021, to 3.3% and 3.5% respectively. Still within current primary expenditure, intermediate consumption is the only item which growth is expected to accelerate in 2021 (to 4.1%), while only expenditure on subsidies is expected to decrease next year (-1251 M€/-40.2%, due to a lower impact from measures associated with COVID-19 than estimated for 2020).

Capital expenditure is expected to increase in 2021 because the increase in Gross Fixed Capital Formation (GFCF) by 1135 M€/23.2% should be more than enough to compensate the reduction of "other capital expenditure". MF forecasts indicate that GFCF will increase for the fifth year in a row and register the most significant increase in recent years. The expected reduction in "other capital expenditure" is mainly due to the expectation that the net impact on the budgetary balance of expenditure with the Novo Banco and TAP Air Portugal will be less unfavourable.

Budgetary balances and fiscal policy stance

The DSB/2021 brings forward to 2020 an estimated budget deficit of 7.3% of GDP, a deterioration compared to the two previous budget planning documents (OE/2020 and PAOE/2020) published this year. For 2021, the MF foresees a reduction of the budget deficit to 4.3% of GDP, pursuing a consolidation strategy based mainly on reducing the expenditure-to-GDP ratio.

Excluding the effect of the business cycle and one-off and temporary measures, the structural balance underlying the proposed State Budget for 2021, recalculated by the CFP, is estimated to be negative at 3.3% of GDP. This result reflects a planned improvement in the structural balance of 0.2 p.p. of GDP in 2021, in the context of a broadly neutral fiscal policy stance. For the calculation of the structural balance, the PFP followed the same option adopted by the European Commission in assessing the 2020 Stability and Convergence Programmes, deciding not to classify as one-off and temporary measures the measures taken in response to the COVID-19 pandemic, given the specific circumstances and the great uncertainty surrounding their possible persistence beyond 2020. These measures are therefore not excluded from the estimation of the structural balance, nor from the baseline expenditure calculation.

Multiannual Framework for Public Expenditure

The Multiannual Framework for Public Expenditure (MFPE) provided for in the Budgetary Framework Law (BFL) is presented for the first time at the same time as DSB/2021 through the Draft Law on Major Planning Options. This medium-term budgetary programming instrument defines a total expenditure ceiling and per programme, from 2020 to 2024, including the projection of financing sources. The expenditure ceiling should be compatible with the objectives of the Stability Programme. The DSB/2021 report does not demonstrate the compatibility of the binding 2021 limit with the projected budget balance, so the CFP has carried out a tentative exercise to assess consistency with the 2021 expenditure ceiling. For the remaining time horizon, where the ceilings are indicative only, it is not possible to assess any compatibility as neither the DSB/2021 Report nor the 2020 Stability Programme presents the budgetary targets for 2022-2024.

The presentation of new non-consolidated expenditure limits in the MFPE, including expenditure on financial assets and liabilities (non-effective expenditure), does not benefit budgetary transparency. This situation stems from the partial implementation of the BFL, which still maintains many of the processes resulting from the previous accounting framework, albeit with adaptations, together with innovations that assumed the reform of public financial management instruments. It is therefore even more relevant that the next update of the MFPE demonstrates in a more explicit and sustained manner the link with the budgetary objectives underlying the medium-term path of public finances.

Budgetary risks

The budget forecast for 2021 carries non-negligible downside risks, starting with the inherent high degree of uncertainty about the magnitude, scope and duration of the pandemic situation, which does not rule out the possibility that the impact of policy measures in the context of the pandemic will turn out to be higher than expected.

On the revenue side, the forecast of taxes and social contributions points to a higher evolution of these fiscal variables than foreseen for their own macroeconomic bases. This forecast implies the verification of elasticities above the unit, for which the DSB/2021 report does not provide justification, which is a risk to be noted. This risk is reflected in the MF 2021 forecast for corporate income tax, VAT and social contributions.

On the expenditure side, in addition to a possible bigger impact that the measures to respond to the pandemic crisis may have, we identify the possibility that the unfavourable effect of expenditure on the Novo Banco and TAP could be greater than that considered in the forecast for 2021 in national accounts, as well as the risk associated with the possible activation of state guarantees granted under some of the measures to respond to the pandemic crisis (credit lines). Of a more uncertain dimension, the risk associated with the moratoria of credit granted by banks to economic agents should be noted, as the possible inability of these agents to solvency their commitments may imply losses to the Portuguese financial system and, consequently, require state intervention, through financial support.

Public debt

The Ministry of Finance forecasts that the debt ratio will resume its downward movement in 2021, from 134.8% to 130.9% of GDP, even if the debt grows in nominal terms. The main driver of this 3.9 p.p. of GDP decline in the ratio is GDP growth, which compensates for the unfavourable interest effect, resulting in a favourable dynamic effect (-5.4 p.p.) that more than justifies the reduction in the debt ratio. This effect, together with the slightly favourable stock-flow adjustment (-0.2 p.p.) in the DSB/2021 forecast, more than offsets the unfavourable contribution of the primary balance effect (+1.7 p.p.) to the change in the government debt ratio. Despite the rise in the stock of debt in nominal terms, the share of interest in GDP is set to fall further, to 2.9% and 2.6% of GDP in 2020 and 2021 respectively. This decline is explained by the contribution of the price effect, which reflects the current financing conditions of euro area members at historically low interest rates, more than offsetting the unfavourable stock-flow effect. Thus, the average cost of debt issued by the state until the end of August this year stood at 0.6%, compared with 1.1% in 2019.

Gross government borrowing requirements, according to the forecast underlying DSB/2021, are expected to increase slightly in 2021 compared to the previous year, as a result of the higher volume of medium and long-term debt repayments, justified mainly by the repayment of Floating Rate Bonds scheduled for 2021.