Conselho das Finanças Públicas
Portuguese Public Finance Council

Analysis of the Draft State Budget for 2013

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Executive Summary

EXECUTIVE SUMMARY

The Portuguese Public Finance Council's (CFP) analysis of the Draft State Budget focuses on the extent to which it fits into a corrective course for public sector indebtedness leading to the sustainability of Portuguese public finances. This includes two equally essential vectors: control over public debt and restructuring of the economy in order to promote stable growth.

Portugal has tended to produce optimistic budget forecasts and make use of temporary and one-off measures so as to facilitate the achievement of budget deficit targets. This approach delays the introduction of indispensable reforms, thereby increasing the strain of adjustment and raising the associated costs, eventually leading to loss of confidence in the process.

Currently the CFP is not in a position to produce alternative macro-fiscal forecasts to those published by the government. However, the available indicators suggest that the macroeconomic forecast that underlies the Draft State Budget for 2013 (SB/2013) remains optimistic and may underestimate the effects of budgetary measures, in particular on the expectations of economic agents, which impact upon private consumption, investment and employment. It should also be noted that the macroeconomic forecasts under the Economic and Financial Assistance Programme (EFAP) have also tended to be revised downwards.

As regards the fiscal forecast, even the results for 2012 are as yet a simple estimate, while the complete data will only be known at the end of the first quarter of 2013. The fiscal forecasts for 2013 do not explicitly incorporate the effects of the significant risks listed in detail in the SB/2013 Report. Neither is specific consideration given to other risks stemming from the difficulty in assessing the budgetary impact of the tax changes and the uncertainty related to the decrease of disposable income and, more importantly, of permanent income.

SB/2013 is the first, albeit incomplete and far from transparent, application of the multiannual framework laid down in the budget framework law (BFL). As such, it shows that the rule as formulated allows for the multiannual framework approved by Parliament in the spring not being binding even for the budget proposed in the autumn, meaning that it does not provide for effective medium-term control over expenses. Therefore further steps are required to improve the legislation in a number of fields, including the possible introduction of an expenditure rule to strengthen the credibility of the structural balance rule laid down in the BFL.

In contrast to the forecast in the Fiscal Strategy Document of April 2012 (FSD/2012), 2012 turned out a difficult year for Portuguese fiscal policy. Compared to 2011, revenue is now expected to fall by 4.4 percentage points (p.p.) of GDP, largely due to less reliance on temporary and one-off measures, which increased revenue by 4 p.p. of GDP in 2011. The government responded to the negative change in revenue by reducing expenditure by more than planned at the beginning of 2012. It now expects to cut expenditure by 3.8 p.p. of GDP (compared to the 1.4 p.p. forecast in FSD/2012) by the end of 2012. However, 0.8 p.p. of the additional cuts in 2012 relate to temporary and one-off measures, in particular revenue from concessions (which are subtracted from other capital expenses), as in the as yet unconfirmed case of ANA (the Portuguese airport operator).

One important implication of the Draft SB/2013 is the fact that the primary fiscal balance remains negative in 2012 and 2013, leading to rises in the public debt ratio versus the original projections. According to the October revision of the EFAP, the maximum projection for this ratio reaches 123.7% of GDP in 2013 (vs. 115.3% in the July revision), remaining practically stable (123.6%) in 2014 and falling to 118.4% in 2016.

On average, over the four years from 2013 to 2016, the forecast public debt ratio exceeds the previous projection (published in April during the course of the 3rd regular review of the EFAP) by 8.4% of GDP. Such rise will increase interest payments in subsequent periods, thus putting additional pressure on the fiscal adjustment by increasing the level and rigidity of future expenditure. This confirms the need for the fiscal strategy goals to be met, in particular as regards overall and primary fiscal deficits in 2014 and subsequent years.

Portugal has recently experienced very negative debt dynamics. Taking into account the forecast in the Draft Budget, over the five year period from 2008 to 2013, the debt ratio will increase by 52 p.p. of GDP. The main contributor to this rise was the unfavourable dynamic relationship between the rate of interest and the rate of output growth (21.3 p.p. of GDP), followed by the impact of persistent primary deficits (15.6 p.p. of GDP) and deficit-debt adjustments (15.1 p.p. of GDP).

Since there is little leeway in this field, the CFP suggests that, in order to safeguard the goal of recovering public finance sustainability in the near future, it would be advisable to maintain the expenditure ratio targets set in FSD/2012.

From 2010 to 2012 approximately half of the fall in the overall fiscal balance reflects the effects of temporary measures and special factors. These figures show the dependence on adjustments based heavily on short-term measures that cannot be expected to guide economic agents' expectations and reduce the uncertainty as to the policy stance. Clearly what matters in terms of borrowing are the non-adjusted figures. However, analysis of the quality of the adjustment, based on the adjusted data, shows the need to adopt permanent instead of temporary and one-off measures.

The breakdown of the planned fiscal adjustment, after adjusting for temporary measures, one-off measures and special factors, shows that 61.9% of the adjustment from 2010 to 2013 is based on revenue side measures. On the expenditure side, the structural adjustments to current expenditure make practically no contribution to the forecast adjustment in the overall fiscal balance, given that the rise in interest payments almost completely offsets the reduction in primary current expenditure.

The fiscal policy stance continues to have a negative impact on domestic demand, since it reflects the need to correct the country's high level of indebtedness, which has eliminated any fiscal room for manoeuvre and removed space for adopting a countercyclical policy stance. Not only would an increase in the deficit be unfinanceable, but such an approach would worsen the public debt ratio, with the interest payments absorbing the illusory benefit of the stimulus. Worse still, this illusion would continue to delay efforts to redirect the economy to the tradable goods sector, a development that is under way, as shown by the

solid performance of exports, but which needs to be pursued and strengthened in order to bring about a stable improvement in the standard of living of the Portuguese.

The CFP offers some suggestions aimed at reinforcing the medium-term course of Portuguese fiscal policy and also improve public expenditure governance by increasing its efficiency, enhancing its efficacy and ensuring compliance with an effective expenditure rule. International experience calls for unmistakable and sustained political involvement in this type of exercise and underlines the role of communication and transparency in the process, along with the participation of those concerned by the changes, all critical steps in ensuring the support of stakeholders and the general public.