ANALYSIS OF THE 2020 DRAFT BUDGET PLAN

OVERVIEW & EXECUTIVE SUMMARY

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OVERVIEW

In this report, the Portuguese Public Finance Council (CFP) analyses the proposed State Budget for 2020 (POE/2020) in detail. The following lines make a general appraisal of the document.

The budget proposal for 2020 is what could be called a continuity budget. This idea of continuity arises from two ways that complement each other.

On the one hand, this budget continues the budgetary consolidation strategy of recent years. In 2019, according to the proposal we are now considering, the deficit was EUR 174 million, a figure already close to balance. A budget surplus of EUR 533 million, around 0.2 per cent of GDP, is expected for 2020. This surplus thus follows the successive reductions in the budget deficit in recent years.

There are, however, risks in this budget proposal which should be noted. In addition to the pressures resulting from the State's current expenditure, the desired budget surplus depends, on the revenue side, on the achievement of the economic growth projected in the scenario, whose associated risks are downward and mainly of an external nature. The need for support for the financial sector also applies, with the possibility that it may exceed the amounts already provided for in the budget proposal.

The budget balance, or the moderate surplus that is expected, allows, in conjunction with economic growth, the reduction of the weight of public debt in our economy. If the forecasts contained in the proposal are met, this debt will reach 116.2% of GDP by the end of 2020. It is certainly a high figure, but, for this very reason, the continuation of its downward trajectory, in the order of 2.7 percentage points of GDP, cannot fail to be considered as good news. In addition to compliance with national and European rules, reducing the burden of debt allows public resources to be freed up for purposes other than paying interest and is a condition for freeing up budgetary space which may become important in more adverse times. In addition, the reduction dynamics itself has allowed for the greatest ease and lowest cost in public financing, in a virtuous process that keeps itself going.

This is a continuity budget in another, stricter sense. Regardless of their social and political quality, the new policy measures planned for 2020 are not particularly relevant from a financial point of view. They adversely affect revenue by some EUR 10 million, and expenditure is increased by EUR 99 million. That is, they contribute negatively to the balance by about 109 million. This relatively small figure contrasts with the importance of *carrying over the* measures previously taken, EUR 800 million on the expenditure side and increased revenue by EUR 246 million. From this point of view, it is, therefore, a budget with little "news".

The reduction in the burden of public debt that we have already mentioned allows one of the budgetary rules, the public debt rule, to be complied with. CFP calculations, on the other hand, point to some departure from the rules regarding the adjustment path of the structural balance towards the medium-term objective and, more significantly, the expenditure reference value. It should be noted that the latter depends, among other factors, on the measurement of the output gap, an unobserved variable, and on the classification of temporary and non-recurring measures, and they themselves certainly deserve to be revisited and discussed in their methodological and operational aspects.

The Portuguese Public Finance Council once again emphasizes the importance of the multi-annual perspective with regard to public accounts and, therefore, the implementation of the Budgetary Framework Law of 2015, which is currently postponed until April 2020. Programme budgeting in a multi-annual context will make it possible to overcome the still prevailing annual cash logic, with an emphasis on inputs. The perspective of performance and results, combined with accounting transparency, will certainly allow the design of more efficient, and also more democratically controlled, budgetary and public policies.

The Portuguese Public Finance Council endorsed, in a previous document, the macroeconomic estimates, and forecasts underlying the proposed State Budget. It is true that recent economic growth, and which looks to the near future, has made it possible to reduce and eliminate the budget deficit and to lower the public debt ratio. However, it should be noted that this growth has resulted more from the absorption of unemployment levels which in the recent past have been placed at abnormally high levels, than from increases in the productivity of productive factors which demonstrate unequivocal economic progress. In other words, current estimates for potential output growth in Portugal remain lower than what could be hoped for, with a view to lasting real convergence towards production and income levels that characterise more advanced countries. If fiscal consolidation is a necessary condition for this convergence, higher growth will also contribute to an improved soundness of public accounts.

Higher growth and productivity depend on a more favourable environment for investment in a context of increasing international competitiveness. This will imply progress in taxation, education and vocational training, the selectivity of public investment, the efficiency of the judicial system and, in general, the quality of spending and public administration. The definition of structural public policies, geared towards growth, would greatly benefit from the context of the budget in multi-annual and strategic terms.

In short, in the legislature that is now truly beginning with the 2020 budget, in addition to maintaining the necessary budgetary discipline efforts (first and foremost with a view to a more expressive reduction of public debt in GDP), the strengthening of the Portuguese economy's productivity should definitely be placed at the centre of the attention of the country's political leaders and economic agents.

EXECUTIVE SUMMARY

The State Budget Proposal for 2020 (POE/2020) revises to 0.2% of GDP the budget surplus forecast advanced in April in the 2019-2022 Stability Programme. This objective corresponds to a positive budgetary balance of 0.1 p.p. of GDP lower than the one presented in the previous budgetary planning document, reflecting the higher impact of one-off expenditures.

The elimination of the fiscal imbalance foreseen for 2020 continues the path of improvement of the nominal balance, ensuring a budgetary position compatible with the Medium-Term Objective (MTO) of a structurally balanced budget balance. To this end, the MF forecast projects a nominal deficit of EUR 174 million in 2019 to turn into a surplus of EUR 533 million in 2020, equivalent to an improvement of 0.3 p.p. of GDP. The positive evolution of the balance, as a percentage of GDP, is mainly based on the reduction of the weight of debt interest and on the reduction of the unfavourable impact of temporary effects in a context of stabilisation of the economic environment and absence of new measures with significant financial impact. The possible need for support to the financial sector beyond that envisaged by the MF is a budgetary risk that should be noted.

The effects of the discretionary measures that the government proposes to introduce in 2020 have a net negative contribution to the budget balance. This contribution is justified not only by the greater expression of measures on the expenditure side, which are mostly expansionary in nature but also by the revenue that does not ensure measures to offset or mitigate that unfavourable effect. On the contrary, the last update of the Stability Programme resulted in a set of policy measures that would have a positive effect on the balance, and which are now not considered in the draft budget law, among others, the measures concerning the revision of tax benefits and revision of expenditure on social benefits. The negative contribution of permanent policy measures is further accentuated by the *carry-over* effect of measures approved in previous years that will increase the burden in the fiscal year 2020.

Structural Adjustment

Discounting the effect of the economic cycle and temporary and non-recurring measures, the structural balance underlying the Proposed State Budget for 2020, as recalculated by the CFP, is estimated to be negative at 0.1% of GDP. This result, close to the Medium-Term Objective (MTO), reflects a programmed improvement in the structural balance of 0.2 p.p. of GDP in 2020, in the context of a neutral stance of fiscal policy. The distance to that objective, although within the limit that an *ex-post* evaluation by the European Commission (EC) may consider a Member State to be in the vicinity of its MTO, signals as part of this *ex ante* evaluation the existence of a risk of deviation. The nature of this risk remains when taking the average of the deviations calculated for the years 2019 and 2020.

The expected development does not meet the expenditure benchmark. The planned nominal growth of primary expenditure net of discretionary measures and one-off and non-recurring measures calculated by CFP points to 4.2%, which exceeds the maximum recommended increase of 1.7% (expenditure reference rate), leading to a deviation from the planned growth of that primary expenditure of -0.9% of GDP in 2020. This deviation is higher than the permitted 0.5% margin, pointing to a risk of significant deviation in 2020.

In terms of compliance with the structural part of the fiscal rules, considering the overall reading provided by the two pillars assessing the adjustment path, it is concluded that the pace of adjustment envisaged for 2020 points to the risk of deviation from the Council recommendation and the requirements of the preventive arm of the Stability and Growth Pact. The expectation of compliance with the MTO can only be confirmed in an *ex-post* evaluation to be carried out by the EC in the spring of 2021. It should be recalled that the achievement of the MTO requires at the same time that the projection of the structural balance to be achieved at that time points to that position (of structural budget balance) being maintained in subsequent years. If these developments are not confirmed, a general assessment by the European authorities will be required to determine whether or not there has been a deviation from the recommended adjustment path.

As regards the measurement of the public debt rule, the path of evolution of the debt ratio for the years 2019 and 2020 presented in POE/2020 points to progress in compliance with the transitional debt rule in the last year of its application (2017-2019) and compliance with the general rule of debt reduction in 2020, to which Portugal will be subject from this year onwards.

Income

The share of general government (AP) revenue in GDP underlying the POE/2020 is expected to maintain its upward trend in 2020, reaching 43.8% of GDP (43.3% of GDP in 2019), as a result of the increase in the share of social contributions and non-tax and non-contributory revenue.

In nominal terms, tax and contributory revenue should explain more than 70% of the growth in total AP revenue (EUR 4102 million), sustained mainly by the evolution of taxes (EUR 1800 million) and the increase in effective social contributions (EUR 1166 million).

The expected behaviour for effective social contributions exclusively explains the forecast increase in the tax burden indicator from 34.9% of GDP in 2019 to 35.1% of GDP in 2020, since, according to the POE/2020, the weight of direct and indirect taxes on nominal output will remain unchanged. This stabilisation of the weight of tax revenue on nominal GDP results from an expectation of tax growth (3.4%) at a pace close to that forecast by the Ministry of Finance for the evolution of nominal economic activity (3.3%). The same is not true for the effective social contributions whose forecast growth of 5.7% is above the pace considered by the MF for the evolution of workers' wages in 2020 (3.8%). This forecast has implicit an elasticity higher than its macroeconomic basis, which may constitute a downside risk in relation to the fulfilment of the budgetary targets set in POE/2020, given the gains in collection efficiency already achieved.

As regards non-tax and non-contributory revenue, MF forecasts an acceleration of its growth above economic activity. This development will be mainly driven by the robust increase in sales and transfers from the European Union, the latter being responsible for the largest expected contribution to growth in "Other current revenue" and capital revenue in 2020.

Expenses

The share of public expenditure in GDP is expected to increase in 2020, after having declined in the last two years. MF forecasts point to an increase of 0.2 p.p. of GDP this year, with public expenditure accounting for 43.5% of GDP.

In nominal terms, POE/2020 projects general government expenditure to reach EUR 94 782 million in 2020, increasing by EUR 3395 million compared to last year. Around 80% of this increase should be justified by current primary expenditure, and an increase in capital expenditure is also foreseen. Interest charges are expected to decrease for the sixth consecutive year, although the reduction foreseen for 2020 is less significant.

Almost half of the nominal growth in current primary expenditure projected for 2020 stems from social benefits, although MF forecasts point to a decline in the pace of growth of these benefits due to a lower impact of discretionary measures. Personnel expenditure is also likely to increase, largely due to the effect of the end of the phasing-out of pay cuts resulting from the unfreezing of careers in public administration. This will be the fifth consecutive year of increase in personnel expenditure, although at a lower rate than estimated for 2019. Intermediate consumption is the only item of current primary expenditure whose growth is expected to accelerate in 2020, namely in the sub-sector of regional and local government.

Capital expenditure is expected to increase in 2020, after a reduction last year. According to this Budget Proposal, the growth rate of Gross Fixed Capital Formation will almost double, while "other capital expenditure" is expected to increase, after having decreased in 2019. The impact of temporary measures in the latter item is expected to be EUR 1050 million, a lower amount than in 2019, due to the expectation that the capital injection in the Novo Banco will be lower than in 2019.

Public debt

For 2020, the Ministry of Finance forecasts that the public debt ratio will reach 116.2% of GDP, continuing the path of reduction initiated in 2017. This result represents a reduction of 2.7 p.p. of GDP against the estimated for 2019. This is explained by the favourable contribution of the primary balance (-3.2 p.p.) and to a lesser extent by the dynamic effect (-0.9 p.p.), which reflects nominal GDP growth above the interest effect. The deficit-debt adjustments according to the MF forecast are expected to maintain a negative contribution to debt reduction similar to that estimated for 2019. Following the path of reduction of the debt ratio, the MF continues to forecast a decrease in the interest burden as a percentage of GDP, which in 2020 is expected to stand at 2.9% of GDP, compared to 4.9% in 2014 at the end of the Economic and Financial Adjustment Programme (PAEF). This development mirrors recent favourable financing conditions, which have even allowed for early repayment of part of the loans obtained under the PAEF.

Gross government borrowing requirements are expected to decrease as a result of lower debt repayments and cancellations, contrary to the estimate for 2019.

Government sub-sectors

The expected fiscal surplus of the MF for the general government as a whole is based on the expected budget surpluses for the Social Security Funds and the Regional and Local Government. These surpluses equivalent to 1.6% of GDP are large enough to cancel out the deficit of 1.3% of GDP forecast for the Central Government, which is affected by transfer expenditure under the respective financing laws for the remaining sub-sectors. However, the largest contribution to the improvement in the general government balance (0.3 p.p. of GDP) comes from the central government sub-sector. The remaining sub-sectors as a whole present a zero contribution to the evolution of the general government balance, since the increase in the projected surplus (0.1 p.p. of GDP) for Social Security Funds is offset by the deterioration of the Regional and Local Government balance.

Multiannual Budgetary Planning Framework

The proposed Multiannual Budgetary Planning Framework (QPPO) calls for an upward revision of the limits on central government expenditure financed by general revenues for the next four years, compared with the project presented in the Stability Program, submitted in April 2019. For 2020, the limit on central government expenditure financed by taxes increases by 2769 million in relation to what was estimated for 2019, with the largest reinforcements being concentrated in the groupings of budgetary programmes in the Social (Health, in particular) and Economic areas.

The experience with the implementation of the QPPO continues to show the ineffectiveness of this instrument in ensuring medium and long-term fiscal accountability. The usefulness of the QPPO in supporting the formulation and implementation of public policies from a multi-annual perspective depends to a large extent on the respect of the established expenditure ceilings. However, and similarly to the previous QPPO, Draft Bill No. 6/XIV, which includes the new QPPO, states that the limits for the years 2021 to 2023 are indicative, contrary to the provisions of the budgetary framework law, in the articles currently in force.