ANALYSIS OF THE STATE BUDGET 2020 AMENDMENT

EXECUTIVE SUMMARY

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In accordance with Article 7 of the Bylaws of the Portuguese Public Finance Council (CFP) and Article 19 of the Budgetary Framework Law (BFL), this report analyses the Proposed State Budget Review Law for 2020.

Fiscal transparency

The Budgetary Framework Law provides that the approval and execution of the budgets of government departments and entities is subject to the principle of fiscal transparency. In the CFP's understanding, this proposed budget review should be accompanied by sufficient information to justify the changes that radically modify the approved State Budget for 2020, presenting a level of detail at least equivalent to those that accompanied the draft law of the State Budget for 2020. This is not the case.

As stated by the CFP in May, the absence of essential information elements "constitutes an important gap in terms of fiscal transparency, with possible consequences on the confidence of economic agents, one of the most relevant dimensions of the current crisis and, more generally, on the capacity for public scrutiny of the measures and policies that have been adopted in this very adverse context".

The accompanying report includes macroeconomic forecasts for 2020 and 2021. These forecasts were not subject to prior assessment by the CFP. In this respect it should be borne in mind that as this is a budgetary review and not the budget proposal, there is no legal obligation to submit the forecasts to such prior assessment (endorsement procedure). However, the option of not using this mechanism undermines the institutional soundness and the very credibility of these forecasts as a point of reference in the formation of expectations of economic operators.

Review of the macroeconomic scenario

The macroeconomic scenario underlying the State Budget Amendment for 2020 (SBA/2020) represents considerable budgetary risks by having an apparently optimistic outlook when compared to the most recent official forecasts for 2020 in important macroeconomic aggregates.

The new scenario of the Ministry of Finance (MF) anticipates a contraction of economic activity of 6.9% in the current year due to the incorporation of information regarding the impact of COVID-19 on the Portuguese economy. This forecast is at the upper limit of the projection range of official institutions (EC, BdP, IMF, OECD). If only the scenarios published in June are considered, the MF scenario is outside the range of values, delimited by the CFP in its base scenario (-7.5%) and Banco de Portugal (BdP) (-9.5%).

Review of the budgetary scenario for 2020

The new MF budgetary forecast for 2020 points to a significant update of the balance compared to that presented in December. A deficit of 12579 M€ is now forecast, while the implicit forecast for the State Budget for 2020 anticipated a surplus of 515 M€. This review mainly reflects the impact of the deterioration of the macroeconomic scenario resulting from the pandemic crisis, but also the budgetary impact of the exceptional measures in response to the economic, social and health effects triggered by that epidemiological phenomenon.

Two thirds of the planned budgetary balance revision of 13 billion is explained by the deterioration of the macroeconomic scenario. The action of automatic stabilisers, which is reflected to a greater extent in the loss of tax revenue and contributions, and to a lesser extent in the increase in expenditure on unemployment benefits, justifies 7792 M€ of the review of general government revenue (8717 M€) and around 8100 M€ of the downward update of the budgetary balance forecast for 2020.

Budgetary response measures to the economic impact of the pandemic are expected to account for 80% of the public expenditure forecast update and approximately a quarter of the balance review foreseen for 2020. This estimate of the CFP, which points to a direct budgetary impact of those measures on the balance of 3408 M€ (1.7% of GDP), is based on the quantification of measures carried out by the MF and additional information requested from it, although incomplete and hampered by the lack of clarification of relevant issues. Conditional to this limitation, the calculations of the CFP point out that the measures are mainly reflected in an increase in subsidies and the loss of social contributions. The financial support to entities external to the general government and the reinforcement of the financial contribution to the European Union explain a further 1700 M€ of public expenditure, accentuating the review of the balance in relation to that foreseen in the State Budget for 2020. The direct impact of these measures on the economy amounts to 2% of GDP.

After the surplus reached in 2019 (0.2% of GDP), the MF anticipates that by 2020 the general government sector will reach a deficit of 6.3% of GDP, the largest deterioration in a single year in the budgetary balance in the comparable statistical series of national accounts, available from 1995 onwards.

The primary balance, which excludes interest charges, should also reach a deficit position after five consecutive years of primary surpluses. This change in the primary balance sign reflects a deterioration (6.4 p.p. of GDP) higher than the accumulated surpluses in the two previous years (2018, 2019).

Revenue

According to the Government, public revenue should reach 43.4% of nominal GDP in 2020 (+0.5 p.p. of GDP compared to 2019), as a result of the increase in other current revenue and capital revenue. In turn, the share of tax revenue and social contributions in GDP is expected to fall, causing the tax burden to fall to 34.2% of GDP in 2020 (34.7% in 2019). In nominal terms, public revenue is expected to stand at 86 598 M€ in 2020, a decrease of 4410 M€ (-4.8%) compared to 2019 and a downward revision of 8717 M€ (-9.1%) compared to that forecast in the State Budget for 2020. The tax and contributory revenue essentially explains this drop, mainly determined by the automatic stabilisers given the economic contraction.

Taking into account the new macroeconomic framework, MF expects tax revenue to be 4123 M€ (-7.8%) less than in 2019, with net VAT and corporate income tax revenues being the determining factor for this evolution. Justifying the fall in these two taxes is the assumption of substantially high implicit elasticities, which contrasts with the expected rigidity of personal income tax revenues, which, in a context of strong contraction in compensation of employees (-7%), is expected to remain practically unchanged. Thus, and even though in the total tax revenue the MF forecast is relatively prudent vis-à-vis the macroeconomic forecast (elasticity of 1.3 vis-à-vis nominal GDP in a recessive context), there is a risk that its composition will be different from the one anticipated in the SBA/2020, due to the apparent imbalance of the elasticities assumed for the most relevant components of tax revenue. According to the MF, social contributions are also expected to contract considerably in 2020 (1283 M€; -5.1%) Even so, and discounting the impact of the measures adopted, it is noted that, as for IRS, the MF assumes an elasticity of effective social contributions in relation to abnormally low salaries (0.5), which carries a risk for the pursuit of the overall goal of public revenue registered in the SBA/2020.

Non-tax and non-contributory revenue is expected to increase as a result of the growth in current and capital transfers from the European Union that partly fall within the scope of the response to the COVID-19 pandemic. The increase foreseen for the other current revenue (702 M€; 15.6%), and for capital revenue (711 M€; 95%) partially induced by those transfers fully explain the expected increase for the non-tax and non-contributory revenue (996 M€; 7.9%). Contrary to part of this growth are the sales of goods and services which should decrease by 418 M€ (-5.7%) in 2020.

Expenditure

After having decreased in the last two years, the share of public expenditure in GDP is expected to increase from 43.5% in 2019 to 49.7% in 2020, the highest figure since 2014, when the Novo Banco's capitalisation operation took place. Compared to the initial budget for 2020, there is an upward revision by 6.2 p.p. of GDP, largely due to the economic consequences of the COVID-19 pandemic and the discretionary measures adopted.

In nominal terms, the new MF forecast points to total expenditure of 99,177 M€ - 8573 M€ (or 9.5%) more than in 2019 - representing an upward revision of 4377 M€ from the initial budget. More than three-quarters of the increase this year is expected to be driven by current primary expenditure, with an increase in capital expenditure also foreseen. Interest expenditure is the only item of expenditure that is expected to decrease in comparison with 2019 and also the only one that was revised downwards in comparison with the State Budget for 2020.

In the area of current primary expenditure, the upward revision of subsidies and social benefits - on which most of the impact of the measures on the expenditure side adopted since the pandemic crisis will be focused - is particularly noteworthy, with each of these items projected to increase by 2 thousand M€ when compared to 2019. Intermediate consumption is expected to grow in 2020, after having fallen in the previous year, with most of the reinforcement of the Health Programme and the provisional allocation being incorporated in this heading. Personnel expenditure and "other current expenditure" are also expected to increase, even if the upward revision under these headings seems insufficient.

Capital expenditure is expected to increase by more than 2 thousand M€ in relation to that executed in 2019, to which will contribute Gross Fixed Capital Formation (GFCF) and "other capital expenditure". Under the latter item, a significant upward revision is noted because the loan that the State will grant to TAP (946 M€) is now incorporated, as well as a greater impact resulting from the capital injection into the Novo Banco, under the Contingent Capitalisation Agreement (435 M€ more than foreseen in the State Budget for 2020).

Public debt

According to the SBA/2020, the Maastricht debt is expected to increase by 16.7 p.p. in 2020 to 134.4% of GDP. The dynamic effect is crucial to this evolution (10.6 p.p.), mainly reflecting the unfavourable contribution of the GDP effect and, to a lesser extent, the interest effect. The primary balance effect and the deficit-debt adjustment also contribute to the worsening of the debt ratio respectively by 3.2 and 2.9 p.p. of GDP.

The Ministry of Finance foresees an increase in the gross financing needs of the State of 9.6 thousand M€ compared to the State Budget for 2020, mainly due to the larger budget deficit. The increase in financing will be based on the use of long-term debt issues, namely through Treasury Bonds. Despite the nominal increase in debt, a significant deterioration in the cost of financing is not anticipated, given the current monetary policy and the rating and risk perception of the Portuguese debt, thus preserving the implicit interest rate foreseen in the State Budget for 2020 (2.5%).

Multiannual Budgetary Programming Framework

The SBA/2020 recommends updating for the current year the limit of central government expenditure financed by general revenue. This proposed amendment to the MBPF entails raising the expenditure ceiling from 54 525 M€ to 58 247 ;€ (+3722 M€). Four social and economic area programmes are reinforced, revising downwards the Public Debt Management programme limit, reflecting the expectation of lower interest expenditure compared to that foreseen in the State Budget for 2020. It is not possible to assess the compatibility of the new expenditure ceiling with the budgetary balance in national accounts given the insufficient information provided.

Risks in the budgetary scenario

The risks of the fiscal scenario are historically high and mostly of a downward nature due to the current pandemic context, which fiscal impact in 2020 will depend on the spatial and temporal extension of this epidemiological phenomenon, and the risk of a new wave of contagion and further restrictions on economic activity to contain it cannot be excluded.

Since the beginning of the pandemic, measures have been adopted that do not have a direct impact from the fiscal point of view, but that in many cases constitute contingent liabilities of the general government (such as the financing lines with State guarantee and the public moratorium scheme) and may in certain circumstances aggravate the fiscal balance. This is mainly a risk that may burden fiscal balances and public debt in the coming years.

The projection for the contraction of private consumption seems optimistic in the scenario underlying the SBA/2020, which may imply a greater reduction in tax revenue than that foreseen in the Report accompanying the proposed law. On the expenditure side, it will be important to monitor the evolution of subsidies, since a large part of the impact of the new measures foreseen in the SBA/2020 (especially the simplified lay-off) will occur under this heading. On the capital expenditure side, the downward risk related to the possibility that the loan that the Portuguese State will make to TAP may reach 1200 M€ instead of the 946 M€ considered in the SBA/2020, in national accounts.