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**COMMISSION OPINION**

**of 22.11.2017**

**on the Draft Budgetary Plan of Portugal**

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#### GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area for ensuring that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact (SGP) and the European Semester for economic policy coordination.
2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan presenting by 15 October the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year.

#### CONSIDERATIONS CONCERNING PORTUGAL

3. On the basis of the Draft Budgetary Plan for 2018 submitted on 16 October 2017 by Portugal, as updated by Portugal on 31 October 2017, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013. The Commission sent a letter to Portugal on 27 October 2017 asking for further information and highlighted a number of preliminary observations related to the Draft Budgetary Plan. Portugal replied to the Commission's letter on 31 October 2017. This information has been taken into account in the Commission's assessment of budgetary developments and risks.
4. Portugal is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its medium term budgetary objective (MTO) of 0.25% of GDP. In 2017, it should achieve an annual fiscal adjustment of at least 0.6% of GDP. In 2017 and 2018 it should take action to ensure the durability of the correction of the excessive deficit. In 2018, it should pursue a substantial fiscal effort, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of Portugal's public finances. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal growth rate of net primary government expenditure which does not exceed 0.1% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP. As the debt ratio was 130.1% of GDP in 2016, during the three years following the correction of the excessive deficit Portugal is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark.
5. The macroeconomic scenario in the 2018 Draft Budgetary Plan appears plausible. Portugal's GDP growth is expected to increase to 2.6% in 2017 and to moderate at 2.2% in 2018, showing a substantial improvement from the latest stability programme, where growth has been forecast at 1.8% in 2017 and 1.9% in 2018. The upward revision reflects the strong economic performance in the first half of 2017, particularly the rebound in investment. In 2018, both private consumption and investment are expected to decelerate somewhat but to remain key contributors to overall growth. The macroeconomic scenario in the 2018 Draft Budgetary Plan is

broadly consistent with the Commission 2017 autumn forecast. The risks are related mostly to the country's vulnerability to potential external shocks.

6. Portugal complies with the requirement of Regulation EU No 473/2013 that the draft budget has to be based on independently endorsed or produced macroeconomic forecasts. The macroeconomic forecast underlying the Draft Budgetary Plan has been endorsed by the Portuguese Public Finance Council. In its endorsement of the forecast, the Portuguese Public Finance Council nevertheless included a recommendation that the budget plans should be accompanied by a medium-term macroeconomic projection allowing for a better assessment of the envisaged policies.
7. As compared to the 2017 Stability Programme, the 2018 DBP projects a slight improvement of the general government balance from -1.5% of GDP to -1.4% of GDP in 2017. The positive impact of higher projected tax revenue (revised upwards by a nominal amount worth +0.5% of GDP) and lower interest expenditure (-0.2% of GDP) has been broadly offset by higher current primary expenditure (+0.7% of GDP), in particular other current expenditure, social transfers and compensation of employees. As regards capital expenditure, a downward revision by 0.3% of GDP in gross fixed capital formation has been almost offset by an upward revision of other capital expenditure. The DBP maintains the headline deficit target for 2018 unchanged as compared to the Stability Programme at 1.0% of GDP. As compared to the Stability Programme, the deficit-improving impact from mostly macro-related upward revisions of indirect taxes (0.5% of GDP) and social security contributions (0.1% of GDP) and downward revisions of interest expenditure (0.4% of GDP) is broadly offset by increases in current expenditure (+1.1% of GDP), in particular for other current expenditure, social transfers and intermediate consumption. The planned increase of capital expenditure by 0.3% of GDP (mostly gross fixed capital formation) is broadly compensated by planned increases in capital revenue and sales.

The DBP projects the structural balance<sup>1</sup> to improve slightly by some 0.1% of GDP to -1.8% of GDP in 2017, a slight deterioration compared to the 0.3% of GDP improvement projected in the SP. For 2018 the DBP plans an improvement of the (recalculated) structural balance by 0.4 percentage points to a deficit of 1.4% of GDP, i.e. 0.2 percentage points below the 0.6% of GDP improvement to -1.0% of GDP targeted in the Stability Programme.

The DBP expects the decrease in the debt-to GDP ratio to accelerate in 2017 by around 1.5 percentage points as compared to the Stability Programme to 126.2% thanks to higher nominal growth, lower interest payments and more favourable stock-flow adjustments. The pace of the decrease in the ratio is projected to slow down slightly in 2018 reaching 123.5%. Portugal has managed to benefit to a larger extent from the current low interest rate environment. The DBP accordingly expects interest expenditure to decrease from 4.2% of GDP in 2016 to 3.9% in 2017 and 3.6% in 2018. Against the background of falling interest expenditure, while the structural balance is projected to improve in 2017-18 (+0.1% and +0.4% of GDP respectively), the structural primary balance is projected to deteriorate slightly in 2017 and to stabilise in 2018 (-0.1% and 0.0% of GDP respectively).

8. The 2018 draft budgetary plan reports a package of structural fiscal measures with a net impact of -0.1% of GDP on revenue and -0.3% of GDP on expenditure. On the revenue side a 0.25% of GDP decrease in personal income tax (PIT) (additional

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<sup>1</sup> Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

carry-over impact of PIT surcharge reversal plus change in PIT brackets) is only partially compensated by a 0.1% of GDP increase in indirect taxes and revenue collection improvements. On the expenditure side, a 0.25% of GDP discretionary increase in public wages and social transfers (unfreezing of career progressions, extraordinary increases of pensions and other social benefits) is planned to be more than compensated by 0.4% of GDP of expenditure-containment measures (nominal freeze of intermediate consumption and other current expenditure, spending review) and 0.15% of GDP in savings in interest expenditure. In addition to fiscal policy measures of a structural nature, the 2018 budget balance is also set to be impacted by a 0.1% of GDP one-off corporate income tax revenue decrease, by 0.1% of GDP in estimated higher dividends from Banco de Portugal, by 0.1% of GDP in one-off capital transfer expenditure and by some limited wildfire emergency costs. In our assessment these emergency costs have been duly taken into account as one-offs. Taking into account all fiscal measures, the DBP reports a balanced budgetary impact of revenue and expenditure measures on the headline balance. The Commission 2017 autumn forecast takes into account most measures at their yield specified in the DBP<sup>2</sup>. However, while taking into account the expected savings from the spending review, the Commission 2017 autumn forecast does not factor in ¼% of GDP nominal freezing of intermediate consumption and other current expenditure based on insufficient specification and the recent track record of these measures. Moreover, the nominal freezing measures do not seem to be fully consistent with the overall amounts in the Draft Budgetary Plan for the corresponding expenditure items, in particular intermediate consumption, that show nominal increases above nominal GDP growth in 2018.

9. In line with the Draft Budgetary Plan, the Commission 2017 autumn forecast projects a general government deficit of 1.4% of GDP for 2017 with only small divergences in the breakdown by revenue and expenditure items. For 2018, the Commission 2017 autumn forecast also projects a headline deficit of 1.4% of GDP, i.e. 0.4% of GDP worse than the 2018 DBP deficit target of 1.0% of GDP. The difference reflects more conservative assumptions regarding the evolution in 2018 of some revenue items and higher increases in some expenditure items. On the revenue side, the Commission projects 0.1% of GDP lower indirect taxes while on the expenditure side it expects higher spending adding up to 0.3% of GDP, in particular on compensation of employees (0.2% of GDP) and on social transfers (0.1% of GDP) based on their track record in 2016 and 2017. While the Commission forecast also used more conservative assumptions for revenue from sales and for expenditure for gross fixed capital formation (based on the recent track record for these items), the overall budgetary effect for these two items together is broadly neutral. Broadly in line with the Draft Budgetary Plan, the Commission 2017 autumn forecast projects an acceleration of the decrease of the debt-to-GDP ratio to 126.4% in 2017 followed by a small deceleration in the pace of reduction to 124.1% in 2018. The lower decrease in the Commission 2017 autumn forecast as compared to the DBP mostly reflects the autumn forecast's higher 2018 headline deficit projection. Risks to the budgetary targets are tilted to the downside, linked to uncertainties surrounding the macroeconomic outlook, spending slippages and the potential deficit-increasing impact of banking support measures.

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<sup>2</sup> While not considering them discretionary fiscal measures, the forecast also factors in the higher estimates for Banco de Portugal dividends and interest expenditure savings.

10. The Draft Budgetary Plan does not include sufficient information to assess compliance with the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark. According to the Commission 2017 autumn forecast, Portugal is projected to make sufficient progress towards compliance with the debt reduction benchmark in 2017 and 2018 as a result of the allowed annual deviation of 0.25% of GDP. However, since Portugal would take advantage of the room for manoeuvre embedded in the rule, a stronger adjustment would have to be made in the remaining year of the transition period to ensure compliance with the benchmark at the end of the transition period.

11. For 2017, Portugal is required to pursue an annual structural adjustment towards the MTO of at least 0.6% of GDP. While the expenditure benchmark points to a risk of significant deviation (gap of 1.0% of GDP), the structural balance points to a risk of some (but close to significant) deviation (gap of 0.5% of GDP). Taking into account the negative impact of medium-term potential growth on the expenditure benchmark and the positive impact of revenue windfalls and lower interest costs on the structural balance, both indicators would point to a significant deviation. Based on the overall assessment, the planned structural adjustment in the DBP thus points to a risk of significant deviation from the recommended structural adjustment towards the MTO. This risk of significant deviation for 2017 is confirmed by an overall assessment based on the Commission 2017 autumn forecast.

For 2018, the nominal growth rate of net primary government expenditure should not exceed 0.1 %, corresponding to a structural adjustment of at least 0.6 % of GDP. While the expenditure benchmark again points to a risk of significant deviation (gap of 1.0% of GDP), the (recalculated) structural balance points to risk of some deviation (gap of 0.2% of GDP) from the recommended structural adjustment. Taking into account the negative impact of medium-term potential growth assumptions on the expenditure benchmark, the positive impact of revenue windfalls and lower interest costs on the structural balance and the negative impact of the high planned increase in gross fixed capital formation on the structural balance, both indicators would point to a risk of significant deviation. Taking into consideration the above-mentioned effects, both indicators would point to a risk of significant deviation from the requirements over 2017 and 2018 taken together, suggesting that the 2017 deviations are not planned to be compensated for in 2018. Therefore, based on an overall assessment, the DBP plans a significant deviation from the recommended structural adjustment towards the MTO over 2017 and 2018 taken together. The Commission 2017 autumn forecast also points to a risk of significant deviation from the recommended structural adjustment towards the MTO in 2018. Both the expenditure benchmark (gap of 1.3% of GDP) and the structural balance (gap of 0.6% of GDP) point to a risk of significant deviation. Also over 2017 and 2018 taken together, both indicators point to a risk of a significant deviation (average gap of 1.3% of GDP for the expenditure benchmark and 0.5% of GDP for the structural balance). Taking into consideration the above-mentioned elements, the risk of a significant deviation in both 2018 and over 2017 and 2018 taken together is confirmed based on the Commission forecast.

12. The country-specific recommendations adopted by the Council on 11 July 2017 mentioned that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. The Commission has carried out a

qualitative assessment of the strength of the recovery in Portugal while giving due consideration to its sustainability challenges. Portugal does not face short-term sustainability challenges although in the medium term the overall risks to fiscal sustainability are assessed as high. The recovery in Portugal does not appear fragile. In particular, the output gap is estimated at a positive territory and the slack in the Portuguese economy has dropped substantially in comparison to the pre-crisis period of 2007. As a result, no additional elements in that regard need to be taken into account in the overall assessment.

13. The composition of the planned adjustment between revenues and primary expenditure in 2018 in percentage of GDP is based on a slight increase of primary expenditure being offset by a slight increase in revenues. This contrasts with the past adjustment over 2011-2017 in which the adjustment effort, while more revenue-based, was also expenditure-based. Portugal plans a strong increase in public investment in 2018 that contrasts with the strong decrease in the share in total expenditure of investment during the period 2011-2017. Portugal's Draft Budgetary Plan contains two measures affecting the tax wedge on labour, namely the carry-over effect in 2018 of the complete reversal of the PIT surcharge in 2017 and the planned change in PIT brackets in 2018.

With regard to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017<sup>3</sup>, limited progress appears to have been achieved in terms of increasing the scope of the expenditure review, which now also includes justice and internal affairs as well as more ambitious savings targets. Despite a number of efficiency-enhancing initiatives in the health sector, it remains unclear to what extent these will contribute to stem the flow of hospital arrears. Overall, no progress appears to have been made in improving the sustainability of the pension system, as the DBP plans another extraordinary pension increase and conditions for early retirement for very long careers have been made less restrictive while the yields of offsetting measures remain unclear. Net results of state-owned enterprises (SOEs) continue to improve, although no concrete policy progress can be discerned yet. A new SOE monitoring system, reviews of public service contracts and a continued attempt to limit indebtedness are planned for 2018 as part of a continued effort to enhance SOE sustainability and profitability. Overall, progress in improving SOEs' overall net income and decreasing the burden on the State budget seems to have been limited.

14. Overall and after considering the need to balance the two objectives of strengthening the ongoing recovery and ensuring fiscal sustainability, the Commission is of the opinion that the Draft Budgetary Plan of Portugal, which is currently under the preventive arm and subject to the transitional arrangements as regards compliance with the debt reduction benchmark, is at risk of non-compliance with the provisions of the Stability and Growth Pact. In particular, the Commission projects a risk of significant deviation from the required adjustment towards the MTO for both 2017 and 2018. Therefore, the Commission invites the authorities to take the necessary measures within the national budgetary process to ensure that the 2018 budget will be compliant with the SGP.

The Commission is also of the opinion that Portugal has made limited progress with regard to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017 in the context of the 2017 European Semester and

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<sup>3</sup> *OJ C 261, 9.8.2017.*

thus invites the authorities to accelerate progress. A comprehensive assessment of progress made with the implementation of the country-specific recommendations will be made in the 2018 Country Reports and in the context of the Country Specific Recommendations to be proposed by the Commission in May 2018.

Done at Brussels, 22.11.2017

*For the Commission*  
*Pierre MOSCOVICI*  
*Member of the Commission*