Brussels, 21.11.2018
C(2018) 8024 final

COMMISSION OPINION

of 21.11.2018

on the Draft Budgetary Plan of Portugal

{SWD(2018) 524 final}

COMMISSION OPINION

of 21.11.2018

on the Draft Budgetary Plan of Portugal

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 2019 submitted on 16 October 2018 by Portugal, 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 19 October 2018 asking for further information and the reply by Portugal of 22 October 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 SGP. On 13 July 2018, the Council recommended Portugal to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.7 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP towards the medium-term budgetary objective (MTO) of 0.25% of GDP, and to use windfall gains to accelerate the reduction of the general government debt ratio.[1] As its public debt amounted to 129.2% of GDP in 2016, the year in which the excessive deficit was corrected, Portugal also needs to make sufficient progress towards compliance with the debt reduction benchmark.

5. According to the Commission 2018 autumn forecast, the Portuguese economy is expected to grow by 2.2% in 2018 and 1.8% in 2019. The macroeconomic scenario in the 2019 Draft Budgetary Plan appears broadly consistent with the Commission 2018 autumn forecast for 2018, while projecting a noticeably higher growth of 2.2% for 2019. The main difference originates from a lower investment projection in the Commission 2018 autumn forecast reflecting more negative assumptions on the external environment. Overall, the macroeconomic scenario underlying the Draft Budgetary Plan appears plausible in 2018 and favourable in 2019. Portugal complies with the requirement of Regulation (EU) No 473/2013 since the draft budget is based on independently endorsed macroeconomic forecasts. In its endorsement of the forecasts, the Public Finance Council nevertheless flagged some reservations on the growth projections for 2019, particularly as to risks of lower-than-projected investments.

[1] Council Recommendation of 13 July 2018 on the 2018 National Reform Programme of Portugal and delivering a Council opinion on the 2018 Stability Programme of Portugal, OJ C 320, 10.9.2018, p. 92–97

6. The 2019 Draft Budgetary Plan projects a general government headline deficit of 0.7% of GDP in 2018. For 2019 the headline deficit is planned to decrease to 0.2% of GDP. The structural balance[2] is projected to improve by 0.4% of GDP to a deficit of 0.9% of GDP in 2018. For 2019 the Draft Budgetary Plan plans an improvement of the (recalculated) structural balance by 0.2% of GDP to a deficit of 0.7% of GDP.

The Commission 2018 autumn forecast also projects a headline deficit of 0.7% of GDP for 2018, with a slightly different composition of revenue and expenditure. For 2019 the Commission 2018 autumn forecast projects a headline deficit of 0.6% of GDP. The 0.4% of GDP difference as compared to the Draft Budgetary Plan stems from more conservative assumptions regarding the evolution of some revenue items, partly related to the Commission's more prudent macroeconomic forecast, and higher pressures for some expenditure items, in particular compensation of employees. For 2018 the Commission 2018 autumn forecast's structural balance projection is broadly in line with the Draft Budgetary Plan. For 2019 the Commission 2018 autumn forecast projects the structural balance to remain broadly unchanged, resulting in a difference of 0.2% of GDP with the Draft Budgetary Plan, which mainly reflects the 0.4% of GDP difference in the headline deficit projection, partially offset (by 0.2% of GDP) by a lower cyclical adjustment[3] and a less positive variation of the impact of one-off measures.

7. The 2019 Draft Budgetary Plan reports a package of new structural fiscal measures with a net impact of +0.01% of GDP on revenues and -0.07% of GDP on expenditure. On the revenue side a 0.05% of GDP decrease in corporate income tax anticipation payments is broadly compensated by a 0.06% of GDP increase in other taxes. On the expenditure side, a 0.14% of GDP discretionary increase in social transfers is planned to be more than compensated by 0.11% of GDP of savings from the spending review and 0.09% of GDP in savings in interest expenditure. In addition to fiscal policy measures of a structural nature, the 2019 budget balance is also set to be affected by a 0.04% of GDP one-off tobacco tax revenue decrease, by 0.1% of GDP in estimated dividends from *Caixa Geral de Depósitos*, by 0.06% of GDP in estimated higher dividends from *Banco de Portugal* and by 0.3% of GDP in one-off capital transfer expenditure[4]. Taking into account all fiscal measures presented in the Draft Budgetary Plan, the Draft Budgetary Plan reports a slightly negative budgetary impact of revenue and expenditure measures of -0.15% of GDP on the headline balance in 2019. The Commission 2018 autumn forecast takes into account all measures at their yield specified in the Draft Budgetary Plan. While not considering them discretionary fiscal measures, the forecast also factors in the estimates for higher dividends and interest expenditure savings. Overall, based on the reported measures, the consolidation strategy would be based slightly more on the expenditure-side relying on containment of intermediate consumption via the spending review and savings in interest expenditure. However, the overall volume of the reported measures appears limited in view of meeting the fiscal adjustment requirement. Windfall gains from lower interest expenditure and expected higher dividends from *Banco de Portugal* and *Caixa Geral de Depósitos* do not appear to be used for accelerating the reduction of the general government debt-to-GDP ratio but

[2] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

[3] Resulting from a less positive variation of the output gap in the Commission forecast than in the DBP

[4] Related to a new activation of the Novo Banco contingent capital mechanism, the compensation of *Banco Espírito Santo* clients and expected payments by the Lisbon Municipality resulting from a court ruling

to compensate for reductions in tax revenue and increases in primary expenditure. As regards the fiscal-structural recommendations in the Recommendation of 13 July 2018, the measures reflect the expenditure-decreasing impact of the spending review.

In terms of progress in addressing the fiscal-structural elements in the Recommendation of 13 July 2018 (i.e. to strengthen expenditure control, cost effectiveness and adequate budgeting, in particular in the health sector, and to improve the financial sustainability of state-owned enterprises), expenditure control and cost effectiveness continue to be tackled within the framework of the spending review, including in the health sector. While hospital arrears have remained at high levels, they are planned to be reduced via further capital injections and a recently announced pilot project to improve hospital management and financing. Regarding the financial sustainability of State-owned enterprises (SOEs), while the target of an overall net result close to equilibrium has been postponed to the end of 2019, a range of measures continues to be implemented to enhance the monitoring of SOEs and ensure compliance with their budgetary plans, including new incentives for employees and managers to improve performance and good governance. Improvements in the capital structure are planned to be prioritised for those SOEs that have positive operational results but high levels of debt.

8. In its 2018 Stability Programme, Portugal indicated that the budgetary impact of the large-scale wildfires that occurred in 2017 was significant and should be considered as an unusual event outside the control of the government, for the purposes of Articles 5(1) and 6(3) of Regulation (EC) No 1466/97. Specifically, providing adequate evidence of the scope and nature of these additional budgetary costs, Portugal requested a temporary deviation from the adjustment path towards the MTO of 0.07 % of GDP in 2018 in relation to exceptional expenditure for preventive measures to protect the national territory against wildfires. The 2018 Stability Programme set out expenditure related to management of emergencies, classified as one-off measures, and to prevention. Due to the integrated nature of those expenditures and due to the direct link with the large-scale wildfires of 2017, the specific treatment of wildfire-prevention expenditure could be considered in application of the 'unusual event clause'. In the Recommendation of 13 July 2018, Portugal was provisionally assessed to be eligible for an allowance of 0.07% of GDP in relation to costs considered by the Commission to have a clear and direct link to exceptional wildfire-prevention expenditure following the unprecedented large-scale wildfires of 2017. The provisions set out in Articles 5(1) and 6(3) of Regulation (EC) No 1466/97 cater for that additional expenditure, in that the unprecedented large-scale wildfires of 2017 are considered unusual events, their impact on Portugal`s public finances is significant and sustainability would not be compromised by allowing for a deviation from the adjustment path towards the MTO. The Commission will make a final assessment, including on the eligible amounts, in spring 2019 on the basis of observed data for 2018 as provided by the Portuguese authorities.

9. In 2018, for Portugal to comply with the requirements of the preventive arm, the nominal growth rate of government expenditure, net of discretionary revenue measures and one-offs[5], should not exceed 0.1%, corresponding to an annual

[5] As part of the agreement on the EFC Opinion on "*Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm",* which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

structural adjustment of at least 0.6% of GDP. On the basis of the (recalculated) Draft Budgetary Plan, while the expenditure benchmark points to a risk of significant deviation (gap of 1.4% of GDP) in 2018, the structural balance points to a risk of some deviation (gap of 0.2% of GDP). Taking into account the negative impact of low 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 an overall assessment, the planned structural adjustment in the Draft Budgetary Plan points to a risk of significant deviation from the recommended adjustment path towards the MTO. This risk of significant deviation for 2018 is confirmed by an overall assessment based on the Commission 2018 autumn forecast. That conclusion would not change if the budgetary impact of the exceptional wildfire-prevention expenditure was deducted from the requirement.

In 2019, for Portugal to comply with the requirements of the preventive arm, the nominal growth rate of net primary government expenditure, net of discretionary revenue measures and one-offs, should not exceed 0.7%, corresponding to an annual structural adjustment of 0.6% of GDP. On the basis of the (recalculated) Draft Budgetary Plan, while the expenditure benchmark again points to a risk of significant deviation (gap of 1.1% of GDP) in 2019 and over 2018 and 2019 taken together (average gap of 1.3% of GDP), the (recalculated) structural balance points to risk of some deviation (gap of 0.4% of GDP) in 2019 and significant deviation over two years (average gap of 0.3% of GDP) from the recommended structural adjustment. The fiscal effort based on the expenditure benchmark pillar is negatively impacted by lower underlying potential growth while the fiscal effort based on the structural balance pillar is positively impacted by revenue windfalls and declining interest expenditure. An overall assessment confirms that both indicators would point to a risk of significant deviation from the requirements in 2019 and over the two years. Based on an overall assessment, the Draft Budgetary Plan plans a significant deviation from the recommended structural adjustment towards the MTO in 2019 and over 2018 and 2019 taken together.

The Commission 2018 autumn forecast also points to a risk of significant deviation from the recommended adjustment path towards the MTO in 2019, since the gaps for both the expenditure benchmark (1.4% of GDP) and the structural balance (0.6% of GDP) exceed the threshold for significant deviation. In addition, over 2018 and 2019 taken together, both indicators point to a risk of a significant deviation (average gap of 1.5% of GDP for the expenditure benchmark and of 0.4% of GDP for the structural balance). An overall assessment points to the risk of a significant deviation in both 2019 and over 2018 and 2019 taken together based on the Commission 2018 autumn forecast.

10. The Draft Budgetary Plan indicates that the government debt-to-GDP ratio will decline from 121.2% in 2018 to 118.5% in 2019, slightly below the Commission's projection of 119.2%. 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. Based on the Commission 2018 autumn forecast, Portugal is projected to make sufficient progress towards compliance with the debt reduction benchmark in 2018 but not in 2019.

11. Overall, the Commission is of the opinion that the Draft Budgetary Plan of Portugal 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 medium-term budgetary objective for both 2018 and 2019. Moreover, Portugal is not expected to make sufficient progress towards compliance with the debt reduction benchmark in 2019. Therefore, the Commission invites the authorities to take the necessary measures within the national budgetary process to ensure that the 2019 budget will be compliant with the SGP and to use windfall gains to accelerate the reduction of the government debt-to-GDP ratio.

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 13 July 2018 in the context of the European Semester and thus invites the authorities to accelerate progress. A comprehensive description of progress made with the implementation of the CSRs will be made in the 2019 Country Reports and assessed in the context of the country-specific recommendations to be proposed by the Commission in May 2019.

Done at Brussels, 21.11.2018

For the Commission
Pierre MOSCOVICI
Member of the Commission