

Fiscal policy commitments and macroeconomic scenarios

This brief report details the fiscal policy commitments for the 2016 budget and assesses how the impact of lower economic growth can be dealt within the framework of the current budget. It briefly touches upon the fiscal strategy for 2017, which will be fully detailed in October in the context of the Draft Budgetary Plan. It presents also a brief update on the financial sector and on the measures implemented to address the Country Specific Recommendations along the lines presented in the Portuguese National Reform Program.

1. Fiscal policy

The Portuguese government is fully committed to the abrogation of the Excessive Deficit Procedure in 2016. For that purpose, it is ready to adopt fiscal measures this year to correct any eventual budget execution deviations. The Government has established in the Budget Law approved in Parliament an additional buffer of expenditure cuts amounting to 0.2 p.p. of GDP. These take the form of budgetary captives. At this stage, we strictly commit not to unfreeze these additional appropriations, as already highlighted in the Stability Programme (p.11), as long as they are needed to achieve the targets.

1.1 The budget in 2016

This section describes 2016 budget execution and analyses the potential impact of some measures that have been implemented on the budget balance.

1.1.1 The budget execution up to May

National accounts data for the first quarter of 2016 published by the National Statistical Office (INE) show an improvement of 2.3 p.p. of the budget deficit. It decreased from 5.5% of GDP in 2015 to 3.2% in 2016.

This improving trend is confirmed with data up to May released by the Budget Office (DGO). The overall balance improved 453 million euros, to stay at only -395 million euros. This is due to an increase of 1.6% of revenue and a stabilization of expenditure (+0.1%). Primary expenditure is down 0.8 p.p.. Intermediate consumption, excluding PPPs, is falling 1.9%, while the budget forecasts a

nominal freeze. Social Security data also posted an improved balance. This is due to an increase of 3.5% of revenue, mainly social security contributions, while expenditure is increasing only 1.1%. As a result, up to May, the primary surplus reached 2.9 billion euros, more 745 million than in the same period of 2015.

On the one hand, these are signs of the Government's commitment to control expenditure, which is at the heart of wise consolidation measures. On the other hand, it also shows that the economy and the labor market are posting positive results, even if below their potential. Overall, the first six months of 2016 are an excellent stepping stone for the final half of the year. Despite this, the Government has mechanisms in the budget to control for any deviation that may occur in the forthcoming months.

1.1.2 Captives and reserves

The Ministry of Finance setup a close monthly monitoring process, which has not yet revealed any significant deviation. Nonetheless, this year's Budget Law introduced an extraordinary layer of captives, a form of expenditure cuts that can become effective immediately. These additional *captives* are worth 346.2M€, approximately 0.2 p.p. of GDP.

Note that the forecasted budget deficit of 2.2% of GDP includes these captives as potential expenditure. However, to commit these funds for expenditure, public services require explicit approval by the Minister of Finance. *Ceteris paribus*, if the utilization of these captives is not authorized, the budget deficit would be 2.0%.

These additional appropriations were applied on public institutions with projected increases on their expenditures compared with 2015, which makes it credible that these appropriations can be kept frozen until the end of the year.

In fact, captives do not show as available financial resources in the budgetary information system. Spending authorizations require this system to present enough available resources to execute them. This is then an effective mechanism to control expenditure.

In addition, the 2016 budget includes also reserves worth 196.6M€, which are also subject to approval. These can be used in case of larger deviations. Overall, the 2016 budget has contingent measures in the amount of 542.8M€ (0.3 p.p. of GDP).

The budget execution up to June shows a more conservative use of regular captives compared with last year. As a result, when compared to 2015, the total amount of captives and reserves available is 597 million euros higher. The direct implication is that services have been forced to contain expenditure up to June. The Ministry of Finance will maintain this stance and reinforce it, should any expenditure slippage become evident.

Below, we will simulate a macroeconomic scenario with economic growth closer to the one forecasted by the European Commission, but incorporating 0.2 p.p. of expenditure cuts to compensate for potential revenue losses.

1.1.3 Working week: 35 hours

The reduction to a 35-hour working week in the public sector came into effect on the 1st of July. This measure affects less than 60% of all civil servants, and has a direct impact only on professions whose working time is arranged in continuous shifts, representing less than 15% of all public sector workers. While such a measure has the potential of increasing wage costs, it may also reduce operational costs.

However, a safeguard clause was introduced in the law to prevent that its implementation increases compensation of employees' costs this year. Whenever there are additional wage costs those need to be offset by cuts in current spending. This mechanism in the law provides the right incentives to increase labor productivity (control wage costs) and improve resource allocation (reduce current spending). The overall impact of the measure is also mitigated by the fact that some professionals, e.g. doctors or the military and security forces, have specific regular working hours that are not affected by the new law. Teachers are also not affected by this change in working time.

All Public Administration services that need to increase employment and/or hours in response to the 35-hour working week are required to notify the Ministry of Finance of the accommodating measures needed to finance the extra costs.

1.1.4 VAT on restaurant expenditures

The reduction in the VAT rate on restaurant spending from 23% to 13%, excluding beverage with the exceptions of water and coffee, came into effect on the 1st of July.

The measure is going to be evaluated by an evaluation group, that will produce three reports, in the coming 18 months, and that will cover prices, wages, employment and profitability measures (*Despacho nº 8591-C/2016*).

1.1.5 Wage costs

The discussion on wage costs has been blurred by misconceptions and failing to appreciate control mechanisms put into place.

Firstly, the gradual wage cut elimination will take place over three years; it *did not* take place only in 2016. The misconception results from failing to distinguish wage levels from wage costs and ignoring that 20% of the reversal had already occurred in 2015. In terms of wage levels, the remaining 80% of the wage cut are going to be gradually (¼ per quarter) reverted in 2016. However, in terms of wage costs, the full-year cost to the budget is only reflected at the end of 2017. It is important to acknowledge that the wage cuts were always a temporary measure, as made clear by the Constitutional Court rulings.

The most recent estimates of the Budget General Directorate, revised down the cost of the gradual elimination of the wage cuts. The current estimates are 97 million euros lower than what was initially predicted in the Budget, which generates an extra buffer in the budgetary execution.

Secondly, wages were frozen in 2010, hence the elimination of the cuts will reinstate wages at their nominal level from 2009. There are no nominal wage increases being implemented.

Thirdly, the discussion is not informed if it ignores that public employment dropped by close to 10%, twice as much as the figure underlying the Adjustment Program. Wage costs in 2017 will be below the 2009 ones, even though nominal wages in 2017 are going to be the same as in 2009.

Fourthly, the discussion needs to acknowledge that there are no career progressions or promotions in the Public Administration since 2006. This creates a negative wage drift – workers exiting typically earn wages at the top of their careers, while newly hired workers earn entry wages – that is also contributing to the reduction in wage costs.

Finally, it should be acknowledged that no human resources policy can produce efficient economic outcomes when incentive mechanisms are absent. This has been the case of the Portuguese public sector at least since 2006, but aggravated with the wage cuts of 2010 (meaning that these wage cuts

preceded the implementation of the Adjustment Program). A qualified Public Administration is fundamental to increase the potential output of the country.

Overall, this analysis shows that: (i) wage costs to the budget are lower than what is erroneously perceived; but also (ii) that the previous policy was economically inefficient. The focus on cutting spending should move on to intermediate consumption. This was the policy followed in the 2016 budget and reinforced by the spending review initiated in the 2nd quarter of 2016.

1.1.6 Spending review

The Government is also committed to a responsible evaluation and rigorous implementation of all the measures with impact of revenue and expenditure. Although the new Country Specific Recommendations for Portugal require a spending review, the Portuguese government had already started his own review (it was announced in the Budget Law for 2016, approved in March). This is key not only to control spending and improve revenue collection, but also for an efficient resource allocation.

Hitherto, the spending review has been focusing on four areas: (i) sectorial health and education analyses; (ii) general government procurement; (iii) real state usage and management; and (iv) SOEs budgetary analysis. The spending review will deliver results – both in terms of cutting costs, revenue and resources efficiency – already for the 2017 budget. The concrete measures resulting from the spending review will be discussed in the text of the budget.

1.2 The budget for 2017

The budgetary process for 2017 has just been initiated. It is being designed to reach the fiscal target compatible with the revised CSR1, which requires a structural adjustment of 0.6 p.p. of GDP. The adjustment will follow the general lines described in the Stability Program, namely a combined effort on the spending and revenue sides.

2. Macroeconomic risks: alternative scenario

The budgetary execution up to May and preliminary information for June point to developments in both fiscal revenue and spending which are compatible with the fiscal target. However, as usually, there are macroeconomic risks, such as those stemming from external sources, including the Brexit or of the specific large negative shocks affecting important and previously dynamic trading partners, namely Angola and Brazil. We thus conduct a sensitivity analysis of such risks and study the impact that the aforementioned spending cut measures (captives) may have on achieving the desired fiscal adjustment.

The macroeconomic forecasting exercise approximates the scenario put forward by the Commission in its Spring forecast. This sensitivity analysis addresses the availability of the Government to adjust the budgetary plans if the macroeconomic environment worsens.

The sensitivity scenario considers that a slower economy will reduce fiscal revenue by 0.3 p.p. of GDP. This is a strong impact, which is not supported by tax collection results up to June; an annualized impact would correspond to a decrease of 0.6 p.p. To counteract this shortfall in revenue, the scenario considers that captives worth 0.2 p.p. of GDP will not be made available for spending.

Overall, in this alternative scenario, the economy would slowdown to a real growth rate of 1.4%, the nominal budget deficit would stand at 2.3% and the structural adjustment would then reach 0.2 p.p. of GDP. The latter computations follow the standard methodology and have been checked for consistency with the European Commission services.

3. The financial sector

Financial stability is a key issue to foster investment, create jobs and promote sustained economic growth. Portugal needs to restore the ability of its financial system to intermediate funding, in particular through the banking system.

The restructuring of Portuguese banking system was not achieved under the Economic and Financial Adjustment Program. Hence, the Portuguese government considers this task a top priority. This has been made crystal clear in the letter of December 14th 2015 addressed to the President of the European Commission and the President of the European Central Bank. The Portuguese government

is committed to change for better the financial sector. The Government also aims at minimizing the use of taxpayer money involved in these measures. There are two main issues that are being addressed regarding the banking system.

3.1 Caixa Geral de Depósitos

The Portuguese government is committed to transform Caixa Geral de Depósitos, the state-owned bank and the largest Portuguese bank. This is being done in full cooperation with European institutions that regulate the banking sector.

Caixa Geral de Depósitos played the role of a safe-harbour during the prolonged (financial) crisis, ensuring that deposits withdrawn from troubled institutions did not exit the country, as it happened in other economies. However, Caixa Geral de Depósitos was also hardly hit by the crisis, namely by a large exposure to mortgage credit with thin spreads on EURIBOR and by a strong increase in the corporate sector non-performing loans.

The Portuguese government is taking decisive action on Caixa Geral de Depósitos to:

- i. implement a new industrial plan compatible with market-based rules, ruling out any state aid classification of the required capital injection subscribed by the Portuguese Republic. This is being coordinated with DG Comp;
- ii. adopt a new governance model based on executive board of experienced and reputed banking sector professionals. The non-executive board members are also experienced managers, including reputed foreign members with large experience in the financial sector;
- iii. change the incentive schemes by implementing a remuneration setting policy in line with the best practices in the banking sector, allowing Caixa Geral de Depósitos to attract professionals with adequate skills for managerial positions.

These are key steps to allow Caixa Geral de Depósitos to deal with the legacy and at the same time restore its capital ratios. Caixa needs to access market and provide financial intermediation services

targeted at SMEs with profitable projects. The restructuring of Caixa, the largest bank, will create positive spillovers for the other banking institutions.

3.2 Novo Banco

The process of re-privatization of Novo Banco is being conducted by Banco de Portugal, the Resolution Authority. After the failure of the first attempt to sell the bank in mid-2015, Banco de Portugal re-launched the process in January and binding offers were submitted by June 30th. According to the commitments letter of the Portuguese Republic regarding Novo Banco, the bank will be sold up to August 2017, otherwise it will enter a process of orderly winding down. The Portuguese Government already expressed to the Banco de Portugal its deep concern with the sale process, namely because the Government does not consider the possibility of further state aid.

The Portuguese Government is committed with the stabilization of the financial system and considers that the fast and efficient conclusion of Caixa Geral de Depósitos and of Novo Banco files is of the essence to reduce uncertainty, namely in what respects to the liabilities of the Resolution Fund and the way they will be financed. In this vein, the Government is negotiating with the Resolution Fund new conditions for the Treasury loan that may render the fund solvent even in the case a very subdued price for the Novo Banco materializes in the sale process.

4. Structural reforms

The Portuguese Government has already presented a very ambitious National Reforms Program. On the 24th of May, the European Commission welcomed our National Reforms Program stating that it "*shows sufficient ambition to tackle excessive imbalances, outlines relevant measures to foster competitiveness and reduction of private debt*" and refers to the challenges in the 2016 Country Report and the euro area recommendations focusing on the need to re-launch investment and ensure sustainability of public finances.

The Government redefined the process of reforms to address the Country Specific Recommendations and to foster sustained economic growth that will translate into improved income conditions and address fiscal and external imbalances in a sustained manner.

Among the reforms included in the National Reforms Program, the administrative simplification and modernization plays a key role. The re-start of the SIMPLEX program that proved extremely effective in the past, aims at changing the relationship between the Public Administration, the Portuguese citizens and the private organizations. This new wave of reforms aimed at reducing the administrative burden and making the relationship with public administration easier and more effective is a huge opportunity to foster the utilization of new technologies promoting the participation of SMEs in the development of new techniques, while at the same time public administration finds more efficient ways to fulfill its role at lower costs concentrating human and financial resources where they are more needed and more effective. The SIMPLEX program has repercussions on the public spending reduction in the medium to long run, though they may imply some investment in the very short run.

The firm recapitalization program is the second key piece in the structural reforms agenda. The Portuguese firms are highly indebted and high indebtedness levels prevents viable firms to reward their shareholders appropriately thereby limiting the capacity of attracting capital. The program CAPITALIZAR aims at changing the incentives for firms to reduce their indebtedness levels and to increase their capital holdings. This program includes measures aimed at removing tax distortions that favor indebtedness *vis-a-vis* capital and provides tax incentives to reinvest capital gains in startups requiring seed capital.

Finally, a non-performing loans reduction program is key to unclog the sizeable amount of impaired credits in banks' balance sheets. The reduction of non-performing loans implies capacity of banks managers to present viable projects to existing and potential new shareholders that may allow for raising capital that may be used to negotiate with debtors and other creditors in advantageous conditions. In addition, a reassessment of the insolvency legal framework aimed at identifying bottlenecks and elaborating concrete proposals is being carried on by the Ministry of Finance, the Ministry of Justice and the Banco de Portugal in close cooperation with many stakeholders. A legal framework that promotes an early call for restructuring of trouble firms is crucial to increase successful recoveries and reduce the number of liquidation processes. Every time a firm is liquidated there is a destruction of value that will not be recovered. A process that minimizes value destruction is important.