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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plans of Portugal

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Portugal

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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plans of Portugal

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Portugal

1. INTRODUCTION

Portugal has submitted its Draft Budgetary Plan (DBP) for 2017 on 17 October in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Portugal is currently subject to the corrective arm of the Stability and Growth Pact. The Council opened the excessive deficit procedure for Portugal on 2 December 2009.

On 12 July 2016 the Council decided that Portugal had not taken effective action in compliance with the Council's recommendations. On 8 August 2016 the Council gave notice to Portugal to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit. Portugal was given a deadline of 15 October 2016 to take effective action to ensure a sustainable correction of the excessive deficit by 2016. The Council decided that Portugal shall reduce the general government deficit to 2.5% of GDP, without including the impact of the direct effect of potential bank support. The recommended budgetary target was deemed to be consistent with an unchanged structural balance in 2016 and additional consolidation measures for the amount of 0.25% of GDP as compared to the Commission 2016 spring forecast. If Portugal effectively achieves a correction of its excessive deficit by 2016, it will be subject to the preventive arm of the Stability and Growth Pact as of 2017, as well as to transitional arrangements as regards compliance with the debt reduction benchmark in the period 2017-2019.

Alongside the DBP, Portugal on 15 October 2016 also submitted a report on action taken in response to the Council's Decision 11553/16[1] giving notice to Portugal to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit in accordance with Article 126(9) of the TFEU. On 21 October, Portugal also submitted an

[1] http://data.consilium.europa.eu/doc/document/ST-11553-2016-INIT/en/pdf

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economic partnership programme in accordance with Articles 9(1) and 17(2) of Regulation (EU) No 473/2013.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2016 autumn forecast. The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission forecast. It also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2016-2017 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. This also includes an assessment of the effective action report presented in response to the recent Council's decision giving notice to Portugal. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations (CSRs) adopted by the Council on 12 July 2016, including those to reduce the tax wedge. Section 6 provides a summary.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

According to the DBP for 2017, real GDP growth is expected to accelerate modestly from 1.2% in 2016 to 1.5% in 2017. In the DBP, economic growth is forecast to be mainly driven by domestic demand albeit at a less robust pace than in the Stability Programme presented in April 2016. In particular, private consumption is expected to decelerate even more to 1.5% (compared to 1.8% in the Stability Programme) in line with higher oil prices and lower income growth. The outlook for gross fixed capital formation (GFCF) is weaker in the DBP, with an increase of only 3.1% being projected (compared to 4.8% in the Stability Programme), mainly supported by higher EU fund absorption, after a contraction by 0.7% in 2016. The DBP projects acceleration in exports in line with the assumptions on the expected growth in foreign demand, which is projected to outpace import growth. As a result, the contribution of net trade to GDP growth is forecast to be positive in 2017 (0.2 pp.) contrary to the more negative expectations in the Stability Programme (-0.1 pp.). The labour market is further improving and employment is forecast to expand by 1% in 2017. HICP is projected to accelerate from the end of 2016, bringing the average annual inflation rate to 1.5% in 2017.

The macroeconomic scenario in the DBP for 2017 is more optimistic than the projections of the Commission 2016 autumn forecast. The DBP projects real GDP growth of 1.5%, compared to 1.2% in the Commission 2016 autumn forecast. While the DBP's and the Commission's projections of the growth contribution of domestic demand in 2017 are broadly the same, evolution of major components is different. In particular, the Commission is less optimistic with respect to private consumption growth in 2017 (1.1 % compared to 1.5%) in line with more stable durable goods consumption, higher oil prices and still high debt pressure. The expectations with regard to the average growth of wages and salaries are lower in the Commission 2016 autumn forecast than in the DBP (1.1% vs 1.5%). On the contrary, the autumn forecast projects investment growth of 3.7% in 2017 (as compared to 3.1% in the DBP), mainly based on the assumption of a stronger crowding-in effect on private investment from the acceleration of the absorption of EU funds. In the Commission forecast, net exports are projected to contribute negatively to GDP growth, as imports are expected to slightly outbalance exports mainly due to increased investment. As a result, the contribution of net trade to GDP growth is forecast to remain negative in 2017.

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Risks to the Commission 2016 autumn forecast for 2017 are tilted to the downside as the economic recovery depends on a rebound in investment, which has so far remained subdued and sensitive to any negative shock. Overall, the DBP uses more favourable growth assumptions for 2017 as compared to the Commission 2016 autumn forecast.

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Box 1: The macroeconomic forecast underpinning the budget in Portugal

The macroeconomic forecast underlying Portugal's DBP for 2017 has been prepared by the Department of Planning, Strategy, Evaluation and International Relations within the Ministry of Finance. The Public Finance Council (Conselho das Finanças Públicas, CFP) assessed and endorsed the macroeconomic forecast.

The CFP was established through the May 2011 reform of the Budgetary Framework Law (Article 12-I BFL) and its Statutes were laid down in an annex to Law No. 54/2011 of 19 October 2011. The CFP is a legal entity which has the nature of an independent body according to Article 5 in its Statutes, and its board cannot request or receive instructions from other public or private institutions. Clear stipulations underpin the CFP access to relevant information. The institution has been operational since February 2012.

The BFL provides a mandate to the CFP to analyse government forecasts and under Article 6 of the CFP Statutes, the body is entitled to assess the macroeconomic scenarios adopted by the government and the consistency of budgetary projections with these scenarios.

The endorsement by the CFP is attached to the DBP publication and is available on the institution's website since the day when the DBP was submitted to the Commission. The CFP opinion includes a detailed assessment where the major discrepancies between the DBP macroeconomic forecast and the latest ones by other institutions are pointed out. Regarding the conclusions, it states that the macroeconomic forecasts underlying the DBP for 2017 present relevant downside risks. The CFP's main concerns are downside risks related to the external demand and investment recovery.

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Table 1. Comparison of macroeconomic developments and forecasts

	2015	2016			2017		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	1.6	1.8	1.2	0.9	1.8	1.5	1.2
Private consumption (% change)	2.6	2.4	2.0	1.8	1.8	1.5	1.1
Gross fixed capital formation (% change)	4.5	4.9	-0.7	-1.4	4.8	3.1	3.7
Exports of goods and services (% change)	6.1	4.3	3.1	2.8	4.9	4.2	3.7
Imports of goods and services (% change)	8.2	5.5	3.2	3.3	4.9	3.6	4.1
Contributions to real GDP growth:							
- Final domestic demand	2.5	2.4	1.3	1.1	1.9	1.3	1.4
- Change in inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-0.8	-0.6	-0.1	-0.2	-0.1	0.2	-0.1
Output gap[1]	-1.5	-1.3	-0.7	-0.8	-0.6	0.2	0.0
Employment (% change)	1.4	0.8	0.8	1.0	0.7	1.0	0.7
Unemployment rate (%)	12.6	11.4	11.2	11.1	10.9	10.3	10.0
Labour productivity (% change)	0.2	1.0	0.4	-0.1	1.1	0.5	0.5
HICP inflation (%)	0.5	1.2	0.8	0.7	1.6	1.5	1.2
GDP deflator (% change)	2.1	2.1	2.0	1.8	1.6	1.5	1.7
Comp. of employees (per head, % change)	-0.3	2.4	1.5	1.2	2.0	1.5	1.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.9	1.6	1.7	1.6	1.8	2.2	2.0

Note:

[1] In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP projects a general government deficit of 2.4% of GDP in 2016, which is 0.2% of GDP above the 2016 Stability Programme target. As indicated by the Portuguese authorities, the difference stems mostly from the authorities' revision of the macroeconomic outlook, which led to a downward adjustment of real and nominal growth by 0.6 pp. and 0.7 pp., respectively. Such deterioration in the macroeconomic outlook contributed to almost a 0.3%-of-GDP shortfall in tax revenue projections. On the expenditure side, as reported in the effective action report, two one-off events are expected to increase the general government deficit (one related to Oitante, the asset defeasance vehicle of Banif resolution and the other related to the cancellation of two concessions). Such deficit-increasing factors are expected to

be partly offset by the freezing of intermediate consumption, corresponding to 0.24% of GDP, which has been enforced in response to the latest Council's decision to give notice.

The Commission 2016 autumn forecast projects a general government deficit of 2.7% of GDP in 2016. Half of the divergence between the autumn forecast and the DBP stems from a less optimistic macroeconomic scenario in the autumn forecast, which affects most tax bases (private consumption, compensation of employees). The remaining discrepancy results from some larger expenditure pressures in the autumn forecast than in the DBP and the effective action report projections, notably on compensation of employees and intermediate consumption.

For 2017, the DBP plans a general government deficit of 1.6% of GDP, against the 1.4% targeted in the 2016 Stability Programme. The revision is mainly due to the carry-over of the 2016 difference between the DBP and the SP. In the DBP, the budgetary impact of the slightly worse overall macroeconomic outlook in 2017 compared to the Stability Programme is partially compensated by higher social contributions driven by improved expected developments in the labour market. While the effect of fiscal policy measures is slightly negative this is more than compensated by expected higher dividends from Banco de Portugal (BdP).[2] A detailed description of the new fiscal policy measures is provided in Section 3.3.

The Commission 2016 autumn forecast expects a general government deficit of 2.2% of GDP in 2017, 0.6% of GDP above the DBP target. Such a deviation from the DBP is due to the carry-over of the discrepancy between the autumn forecast and DBP deficits in 2016, the less optimistic macroeconomic scenario in the Commission forecast (which explains close to half of the difference); the different estimated yield for one of the planned fiscal policy measures and different expected profiles for some spending and revenue items, in particular social transfers, intermediate consumption, and sales, whose projections were not fully underpinned by concrete fiscal policy measures in the DBP.

For both 2016 and 2017, risks to the Commission autumn forecast are tilted to the downside. These are linked to uncertainties surrounding the macroeconomic outlook, the potential budgetary impact of bank support measures and possible spending slippages. On the upside, the adopted programme launched to address overdue tax payments might already yield some revenue gains in 2016[3].

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[2] An expected recovery of around ¼% of GDP in state guarantees from BPP was already part of the Stability Programme scenario.

[3] Following the authorities' own approach in the DBP, the autumn forecast does not include any yields in 2016 for the recently adopted programme for the settlement of overdue tax debts.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2015	2016			2017			Change: 2015-2017
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**44.0**	**43.7**	***43.6***	**43.7**	**43.4**	***44.1***	**44.0**	**0.1**
of which:								
- Taxes on production and imports	14.5	14.9	*14.8*	14.8	14.9	*14.8*	14.7	0.2
- Current taxes on income, wealth, etc.	10.8	10.2	*10.2*	10.2	10.0	*10.2*	10.2	-0.6
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	11.6	11.5	*11.6*	11.7	11.4	*11.7*	11.6	0.1
- Other (residual)	7.1	7.1	*7.0*	7.0	7.1	*7.4*	7.5	0.4
Expenditure	**48.4**	**45.9**	**46.1**	**46.4**	**44.8**	**45.7**	**46.1**	**-2.7**
of which:								
- Primary expenditure	43.8	41.5	41.8	42.0	40.6	41.3	41.8	-2.5
of which:								
Compensation of employees	11.3	11.1	11.2	11.3	10.8	11.0	11.1	-0.3
Intermediate consumption	5.8	6.2	5.7	5.8	5.9	5.6	5.7	-0.2
Social payments	19.3	18.6	19.0	19.1	18.4	18.7	18.8	-0.6
Subsidies	0.6	0.8	0.6	0.6	0.6	0.6	0.6	0.0
Gross fixed capital formation	2.3	1.9	1.9	1.8	2.0	2.2	2.2	-0.1
Other (residual)	4.6	2.9	3.4	3.5	2.9	3.2	3.4	-1.3
- Interest expenditure	4.6	4.4	4.3	4.3	4.2	4.3	4.4	-0.2
General government balance (GGB)	**-4.4**	**-2.2**	**-2.4**	**-2.7**	**-1.4**	**-1.6**	**-2.2**	**2.8**
Primary balance	**0.2**	**2.2**	**1.9**	**1.7**	**2.8**	**2.8**	**2.2**	**2.6**
One-off and other temporary measures	-1.3	0.2	0.1	0.1	0.2	0.2	0.2	1.5
GGB excl. one-offs	**-3.1**	**-2.3**	**-2.5**	**-2.7**	**-1.6**	**-1.8**	**-2.4**	**1.2**
Output gap[1]	-1.5	-1.3	-0.7	-0.8	-0.6	0.2	0.0	1.9
Cyclically-adjusted balance[1]	-3.6	-1.5	-2.1	-2.3	-1.1	-1.7	-2.2	1.8
Structural balance (SB)[2]	**-2.3**	**-1.7**	**-2.2**	**-2.4**	**-1.3**	**-1.9**	**-2.4**	**0.3**
Structural primary balance[2]	2.3	2.7	2.1	2.0	2.9	2.4	2.0	0.1

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

Euro area sovereign bond yields remain at historically low levels, with a yield for the entire euro area benchmark 10-year government bond at 0.735 basis points in September 2016 (ECB). Although declining, the rates for Portugal however remain relatively high, above 3%, around 2 pps. above Italian and Spanish bonds, in October 2016. Total interest payments by the general government have continued to decrease slowly as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure in Portugal for 2016 has been revised downwards from the 4.5% of GDP targeted in the Stability Programme to 4.3%, and is expected to remain at 4.3% in 2017, well below the 4.9% recorded back in 2012 at the peak of the euro area sovereign debt crisis. These numbers are also confirmed by the Commission forecast. Given the size of interest payments in the total general government budget balance, potential substantial increases in interest rates represent a major risk for the country's medium-term debt sustainability.

The DBP and the effective action report project a positive structural adjustment at face value of 0.2% and 0.6% of GDP, in 2016 and 2017, respectively. On the basis of the information provided in the DBP, the recalculated structural balance[4] is expected to remain unchanged in 2016, while the Commission 2016 autumn forecast projects a 0.1% of GDP deterioration in the structural balance. For 2017, the recalculated structural balance according to the DBP would point to an improvement by 0.3% of GDP, against an unchanged structural balance in the Commission forecast.

3.2. Debt developments

From 129% in 2015, the DBP expects an increase of the debt-to-GDP ratio to 129.7% in 2016 and then a decline to 128.3% in 2017. Thus, the DBP debt-to-GDP ratio projection for 2016 is almost 5% of GDP higher than what was projected in the Stability Program. Such an upward revision is due to lower revenue expectationsfor sales of financial assets and the issuance of EUR 2.7 billion in government debt in view of the planned bank support to Caixa Geral de Depósitos (CGD)[5]. Incorporating the latter two developments, the Commission 2016 autumn forecast projects a debt-to-GDP ratio of 130.3% in 2016.

For 2017, the debt-to-GDP ratio in both the DBP and the Commission forecast are projected to benefit from the improved nominal macroeconomic prospects and a lower primary deficit. These would more than compensate the projected debt-increasing stock-flow adjustments of 0.8% of GDP, largely related to a credit line to the European Single Resolution Board.

Downside risks to the debt outlook over 2016-2017 could stem from budget execution falling short of expectations or from increasing borrowing costs. The current level of cash buffers would call for additional debt issuance, negatively impinging on the medium-term debt sustainability. On the upside, if substantial revenue from the sales of financial assets were to materialise in 2017, then acceleration of early repayments of debt to the IMF could be reconsidered.

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[4] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the DBP, using the commonly agreed methodology.

[5] In view of the downward revision of expected revenue from sales of financial assets and the CGD capitalisation, previously tentatively planned additional early repayments to the IMF of EUR 6.6billion in 2017 have been postponed.

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Table 3. Debt developments

(% of GDP)	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**129.0**	**124.8**	**129.7**	**130.3**	**122.3**	**128.3**	**129.5**
Change in the ratio	-1.6	-4.2	0.7	1.3	-2.5	-1.4	-0.8
Contributions[2] :							
1. Primary balance	**-0.2**	**-2.2**	**-1.9**	**-1.7**	**-2.8**	**-2.8**	**-2.2**
2. "Snow-ball" effect	**-0.1**	**-0.3**	**0.4**	**0.9**	**0.1**	**0.6**	**0.7**
Of which:							
Interest expenditure	4.6	4.4	4.3	4.3	4.2	4.3	4.4
Growth effect	-2.0	-2.2	-1.5	-1.2	-2.2	-1.8	-1.6
Inflation effect	-2.6	-2.6	-2.4	-2.2	-1.9	-1.9	-2.1
3. Stock-flow adjustment	**-1.3**	**-1.6**	**2.3**	**2.1**	**0.2**	**0.8**	**0.8**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

Overall, the DBP is underpinned by a package of deficit-increasing measures worth 0.1% of GDP. Within this, on the revenue side measures have a deficit-decreasing impact of 0.1% which is more than compensated by a deficit-increasing impact on the expenditure side of 0.2%[6].

On the revenue side, the main measures consist in (i) a property tax, which applies an additional rate of 0.3% to assets from properties valued more than EUR 600 000, and is expected to yield EUR 160 million, (ii) a special programme that provides incentives to overdue tax debt settlement through fee and interest reduction (*PERES*), expected to yield EUR 100 million, and (iii) a tax on sugary drinks, which would yield EUR 80 million. Other yields amounting to a total of EUR 175 million would result from a partial shift of tax levies

[6] It should be noted that the DBP only presents a package of 0.2% of GDP in deficit-decreasing measures, as it includes in its no-policy-change scenario the total reversal of the PIT surcharge as of 1 January 2017 (as opposed to a gradual phasing out throughout 2017 now included in the DBP) and the carry-over impact of the wage reinstatement policy. However, the carry-over effect of these measures is part of the total impact of fiscal measures in 2017 underlying the achievement of the 1.6% of GDP deficit target presented in the DBP and is accordingly also included in the measures presented in the draft budget report sent to the Portuguese Parliament.

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from gasoline to diesel (EUR 70 million), higher fees from the Ministry of Planning and Infrastructures (EUR 30 million), and improvements in the central administration's revenue collection internal control system (EUR 75 million). The DBP also accounts for the carry-over effect of the lower VAT for food in restaurants, which would imply a loss of EUR 175 million. Finally, the revenue measure package includes the gradual phasing out of the PIT surcharge until November 2017, which would imply revenue losses of about EUR 200 million.

On the expenditure side, the DBP includes as deficit-decreasing measures the 2:1 replacement ratio for civil servants (with estimated yield at EUR 122 million), and EUR 75 million coming from the ongoing spending review. These measures are more than offset by the carry-over impact in 2017 of the full reinstatement of public sector wages in 2016 (EUR 275 million), higher spending from pension indexation and an additional extraordinary pension update (EUR 187 million), a new social transfer for the disabled (EUR 60 million), and a higher wage bill in the health sector further to the reintroduction of the 35 hour working week (EUR 25 million).

In addition to fiscal policy measures of a structural nature, the 2017 budget balance is also set to benefit from the one-off impact of the recovery of the guarantee to Banco Privado Português (BPP), amounting to EUR 450 million (0.24% of GDP) and from EUR 303 million (0.16% of GDP) in estimated higher dividends from the BdP.

The Commission autumn forecast factors in all the above-mentioned fiscal policy measures, the BPP one-off operation and the increase in BdP dividends. For almost all measures, it maintains the yields presented in the DBP taking into account the carry-over effect of 2016 measures. It only applied a haircut of 50% to the yield of the 2:1 replacement ratio rule for civil servants, on account of the track record of this rule in 2016. Overall, the package of fiscal policy measures would have a 0.1% of GDP deficit-increasing impact. This is however broadly offset by the impact of the higher BdP dividends on the general government balance.

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Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	2017	2018
Taxes on production and	-0.1	0.1	0
Current taxes on income,	-0.2	0.1	0
Capital taxes			
Social contributions	0.0	0.0	0
Property Income			
Other	0.0	0.1	0
Total	-0.3	0.3	0

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2017

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	2017	2018
Compensation of employees	0	-0.1	0
Intermediate consumption	0	0.0	0
Social payments	0	0.1	0
Interest Expenditure			
Subsidies			
Gross fixed capital formation			
Capital transfers			
Other			
Total	0	0.0	0

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2017

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Portugal is currently subject to the corrective arm of the Stability and Growth Pact. Box 2 recalls the main features of the excessive deficit procedure opened by the Council on 2 December 2009 and the latest country-specific recommendations in the area of public finances.

Box 2: Council recommendations addressed to Portugal

The Council opened the excessive deficit procedure for Portugal on 2 December 2009. Subsequently, the Council adopted revised recommendations under Article 126(7) of the Treaty on 9 October 2012 and on 21 June 2013, which extended the deadline for correcting the excessive deficit to 2014 and 2015, respectively. However, as a timely correction of the excessive deficit by 2015 was not achieved and the fiscal effort fell significantly short of Council recommendations, on 12 July 2016, the Council adopted a decision in accordance with Article 126(8) of the Treaty, establishing that Portugal did not take effective action to correct its excessive deficit by the 2015 deadline.

On 12 July 2016, the Council addressed country-specific recommendations to Portugal in the context of the European Semester. In particular, in the area of public finances, the Council recommended to Portugal to ensure a durable correction of the excessive deficit, in accordance with the relevant decisions or recommendations under the excessive deficit procedure, by taking the necessary structural measures and by using all windfall gains for deficit and debt reduction. Thereafter, Portugal was recommended to achieve an annual fiscal adjustment of at least 0.6% of GDP.

On 8 August 2016, the Council, in accordance with Article 126(9) of the Treaty, decided to give notice to the Portuguese authorities to correct the excessive deficit by 2016 and to reduce the general government deficit to 2.5% of GDP in the same year, without including the impact of the direct effect of potential bank support. The recommended budgetary target was deemed to be consistent with an unchanged structural balance in 2016. To this end, Portugal should adopt and fully implement consolidation measures for the amount of 0.25% of GDP in 2016. In particular, Portugal was requested to implement fully the consolidation measures incorporated in the 2016 Budget, including the additional expenditure control in the procurement of goods and services highlighted in the Stability Programme. Portugal should complement those savings with further measures of a structural nature to achieve the recommended structural effort. The Council demanded that the Portuguese government presented a report on action taken by 15 October, together with an economic partnership programme.

4.1. Compliance with EDP recommendations

The DBP and the effective action report project the headline deficit to reach 2.4% of GDP, i.e. slightly below the 2.5% of GDP target set in the Council decision of 8 August. According to the Commission 2016 autumn forecast, Portugal is projected to bring the headline deficit to 2.7% of GDP in 2016, above the recommended deficit target of 2.5% of GDP but below the Treaty reference value of 3% of GDP.

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The recommended fiscal effort of an unchanged structural balance is not projected to be met according to the Commission autumn forecast's projection of a slight deterioration by 0.1% of GDP in the unadjusted structural balance. While the headline deficit projection stays unchanged as compared to the Commission 2016 spring forecast, the unadjusted structural balance is however projected to improve by close to 0.2% of GDP due to the downward revision of the macroeconomic outlook. This warrants a careful analysis.

When corrected for the downward revision in potential growth and for revenue shortfalls compared to the Commission 2016 spring forecast underlying the Council decision, the adjusted change in the structural balance is estimated at 0.4% of GDP[7]. The fiscal effort is also projected to be met in the bottom-up assessment which estimates the size of the additional fiscal effort for 2016 on the basis of the discretionary revenue measures and the expenditure developments under the control of the government. The effort measured by the bottom-up method mainly reflects the permanent freezing of ¼% of GDP of intermediate consumption expenditure as highlighted by the effective action report and in line with the latest Council decision to give notice. The requested fiscal effort is thus expected to be achieved according to both the adjusted structural balance and the bottom-up measure of fiscal effort.

Overall, while the headline target is not projected to be met, the fiscal effort is projected to be met based on the adjusted structural balance and the bottom-up method. The Commission forecast projects the excessive deficit to be corrected in a durable manner as the headline deficit is forecast to remain below the Treaty reference value of 3% of GDP, further decreasing to 2.2% of GDP in 2017 and moderately increasing to 2.4% of GDP in 2018. However, the timing and magnitude of a potential deficit impact of the planned recapitalisation of *Caixa Geral de Depósitos* (CGD) are not yet known. This represents a risk to the timely and durable correction of the excessive deficit.

[7] A considerable share of such revenue shortfalls in 2016 is potentially linked to the protracted budgetary impact of fiscal policy measures taken in the previous year.

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Table 5. Compliance with the EDP recommendation

(% of GDP)	2016	
	DBP	**COM**
Headline balance		
Headline budget balance	-2.4	-2.7
EDP requirement on the budget balance	-2.5	
Fiscal effort - change in the structural balance		
Change in the structural balance[1]	0.0	-0.1
Cumulative change[2]	0.0	-0.1
Required change from the EDP recommendation	0.0	
Cumulative required change from the EDP recommendation	0.0	
Fiscal effort - adjusted change in the structural balance		
Adjusted change in the structural balance[3]	-	0.4
of which: *correction due to change in potential GDP estimation (α)*	-	0.0
correction due to revenue windfalls/shortfalls (β)	-	-0.4
Cumulative adjusted change [2]	-	0.4
Required change from the EDP recommendation	0.0	
Cumulative required change from the EDP recommendation	0.0	
Fiscal effort - calculated on the basis of measures (bottom-up approach)		
Fiscal effort (bottom-up)[4]	-	0.3
Cumulative fiscal effort (bottom-up)[2]	-	0.3
Requirement from the EDP recommendation	0.3	
Cumulative requirement from the EDP recommendation	0.3	

Notes

[1] Structural balance = cyclically-adjusted general government balance excluding one-off measures. Structural balance based on DBP is recalculated by the Commission on the basis of the Draft Budgetary Plant scenario using the commonly agreed methodology. Change compared to t-1.

[2] Cumulated since the first year for correction in the lastest EDP recommendation.

[3] Change in the structural balance corrected for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendation.

[4] The estimated budgetary impact of the additional fiscal effort delivered on the basis of the discretionary revenue measures and the expenditure developments under the control of the government between the baseline scenario underpinning the EDP recommendation and the current forecast.

Source :

Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations.

4.2. Compliance with the debt criterion

Provided it achieves a durable correction of its excessive deficit in 2016, Portugal will be in the transition period as regards the debt criterion for the following three years. This implies that, during this period, it is required to make sufficient progress towards compliance with the debt criterion — as defined by the minimum linear structural adjustment (MLSA)) — and comply with the debt benchmark at the end of the transition period.

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The DBP does not include sufficient information to assess planned compliance with the transitional debt rule.

Based on the Commission 2016 autumn forecast, Portugal is not making sufficient progress towards compliance with the debt criterion in 2017 as the improvement in the structural balance of 0.0% of GDP falls short of the MLSA of 0.8% of GDP that would ensure compliance with the debt criterion at the end of the transition period.

Table 6. Compliance with the debt criterion

	2017		
	SP	**DBP**	**COM**
Gross debt ratio	122.3	128.3	129.5
Gap to the debt benchmark [1,2]			
Structural adjustment [3]	0.3	0.3	0.0
To be compared to:			
Required adjustment [4]			0.8

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

4.3. Adjustment towards the MTO

Provided that Portugal effectively corrects its excessive deficit in 2016, it would be subject to the preventive arm of the Stability and Growth Pact as of 2017 and would have to ensure compliance with the required structural adjustment towards the MTO.

Portugal would be required to pursue an annual structural adjustment towards the MTO of 0.6% of GDP in 2017.

According to the structural balance evolution set out in the plan as recalculated by the Commission using the commonly agreed methodology, the DBP targets an improvement of the structural balance of 0.3% of GDP in 2017, thus planning some deviation from the required adjustment path towards the MTO next year. According to the information provided in the DBP, the growth rate of government expenditure, net of discretionary revenue

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measures, in 2017 is planned to exceed the applicable expenditure benchmark rate (-1.4%), leading to a deviation of 0.5% of GDP, slightly above the threshold for a significant deviation. This calls for an overall assessment. The difference between the two indicators stems mostly from revenue windfalls - improving the structural balance but not considered in the expenditure benchmark – which are, however, considered to be partially of a permanent nature.

If this is factored into the calculation, the expenditure benchmark would point to the same deviation from the requirements as the structural balance. Based on the overall assessment, the DBP therefore plans some deviation from the recommended adjustment towards the MTO in 2017.

The Commission 2016 autumn forecast projects an unchanged structural balance in 2017, with respect to 2016. This suggests a risk of a significant deviation on the basis of the structural balance pillar from the required structural improvement of 0.6% of GDP. According to the Commission 2016 autumn forecast, the growth rate of government expenditure, net of discretionary revenue measures in 2017 is projected to exceed the applicable expenditure benchmark rate (-1.4%), leading to a deviation of 0.5% of GDP, also above the threshold for a significant deviation. This calls for an overall assessment. The small difference between the two indicators partially results from higher positive one-off revenue stemming from the BPP guarantee recovery operation, leading to a positive effect on compliance with the expenditure benchmark in 2017. If this factor were filtered out of the calculation, the expenditure benchmark would also point to a 0.6% deviation from the requirements.

In sum, deviations from the required adjustment towards the MTO are projected according to both the recalculated DBP scenario and the Commission 2016 autumn forecast. While the recalculated DBP scenario points to a risk of some deviation, the Commission 2016 autumn forecast points to a risk of significant deviation from the adjustment path towards the MTO in 2017, based on both the structural balance and the expenditure benchmark pillars.

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Table 7: Compliance with the requirements of the preventive arm

(% of GDP)	2017	
Initial position[1]		
Medium-term objective (MTO)	0.3	
Structural balance[2] (COM)	-2.4	
Structural balance based on freezing (COM)	-	
Position vis-a -vis the MTO[3]	Not at MTO	
(% of GDP)	**2017**	
	DBP	**COM**
Structural balance pillar		
Required adjustment[4]	0.6	
Required adjustment corrected[5]	0.6	
Change in structural balance[6]	0.3	0.0
One-year deviation from the required adjustment [7]	-0.3	-0.6
Expenditure benchmark pillar		
Applicable reference rate[8]	-1.4	
One-year deviation [9]	-0.5	-0.5
Conclusion		
Conclusion over one year	Overall assessment	Significant deviation

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 27.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations.

5. IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The DBP provides an assessment of the adequacy of the measures adopted to address the CSRs (Table 13 in the DBP). Regarding fiscal structural policies, the 2016 CSR1 addresses four topics: comprehensive expenditure review and expenditure control; long-term

sustainability of the health sector; sustainability of the pension systems; restructuring plans of state-owned enterprises (SOEs).

The spending review, whose completion has been recommended by February 2017, has started already in 2016, covering for the time being health and education sectors as well as public procurement and SOEs. The DBP (as detailed further in the draft budget report) projects a cumulative impact of EUR 238 million in savings until 2019, of which EUR 75 million in 2017. Within this, EUR 134 million would come from the health sector, EUR 51 million from central administration services, EUR 30 million from education, EUR 17 million from public procurement and EUR 6 million from police forces. In terms of expenditure control, both the effective action report and the 2017 DBP present measures to address the increasing stock of arrears. To this end, the authorities intend to strengthen the health ministry budget via the extension of alcoholic drinks tax (IABA) to sugary drinks in 2017. In addition, the 2017 DBP includes two appropriations centrally managed by the Ministry of Finance that may be allocated to arrears clearing: EUR 100 million to strengthen the sustainability of the National Health Service and an additional EUR 300 million earmarked to settle central government's commercial debt. Considering steps made so far, a preliminary assessment would point to some progress made for this part of the CSR.

Regarding the health sector CSR, the DBP does not address this part of the CSR in detail. The health sector is covered by the recently launched spending review. Overall, progress to ensure the long-term sustainability of the health sector has to date been limited.

Regarding the sustainability of the pension system, the DBP allocates the revenue of a new progressive tax on real estate portfolios to the social security's Financial Stabilisation Fund (expected to yield EUR 160 million in 2017). This is being presented by the government as a way to address the reliance on classical budgetary transfers highlighted in CSR1. Yet, the expenditure side of the sustainability of the pension system remains unaddressed, pointing to limited progresses in this part of the CSR.

Finally, the authorities are revising the operating model of SOEs providing bus urban transportation in Lisbon and Porto and further developments are expected until year-end. Contrary to what was previously foreseen, the DBP does not commit to 2017 deadlines for this measure, suggesting that these SOEs will have no incentive to re-focus their restructuring plans in compliance with the CSR. A preliminary assessment of the SOEs restructuring plans would also point to limited progress.

A comprehensive assessment of progress made in the implementation of the country-specific recommendations will be made in the 2017 Country Reports and in the context of the country-specific recommendations to be adopted by the Council in 2017.

Box 3: Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker

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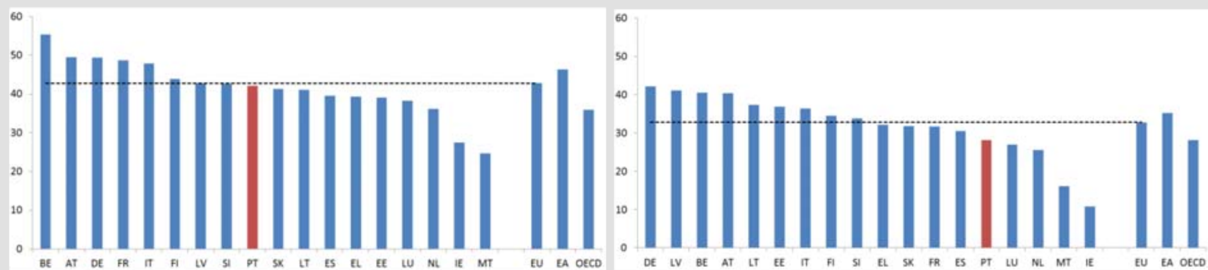
at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Portugal for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Portugal at the average wage and a low wage (2015)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

In the context of the 2016 European Semester, Portugal was not issued any specific recommendation on the tax wedge. This is also on account that tax burden on labour is below the EU average, in particular when it regards low income brackets.

As a measure that affects the tax wedge on labour Portugal's Draft Budgetary Plan contains the phasing out of the PIT surcharge, which entered into force in 2013, and implied a 3.5% surcharge on PIT for income above the minimum wage. Its reversal started in 2016 and is now planned to be completed via a gradual further phasing out throughout 2017. The measure entails total revenue losses of about 0.4% of GDP spread over three years due to a carry-over effect to 2018 of the gradual 2017 phasing-out.

While the DBP does not provide indication regarding the possible impact this measure might have on growth and employment, it would clearly work in the direction of lowering the tax wedge.

6. ASSESSMENT OF THE ECONOMIC PARTNERSHIP PROGRAMME

The economic partnership programme supports and develops the strategy presented by the Portuguese Government in the National Reform Plan, aimed at supporting investment, improving the qualification of the Portuguese people and guaranteeing fiscal sustainability. Within this, the economic partnership programme indicates planned and future steps to

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address each CSR. Regarding CSR1 on the sustainability of public finance, the economic partnership programme confirms the authorities' commitment to deliver effective action in 2016 and ensure a durable correction of the excessive deficit this year. This would be achieved by a rigorous implementation of the State Budget in particular by EUR 445 million of frozen appropriations. The new scheme aimed at recovering overdue taxes and social contributions is considered an upward risk. Regarding 2017, the economic partnership programme conveys the authorities' commitment to an annual fiscal adjustment of at least 0.6% of GDP, through continued freezes of budgetary envelopes, spending and revenue reviews. The authorities are committed to continuing the work of spending and revenue reviews until 2019, and aim at covering large sectors of the budget. The authorities also confirm that the refocus of state-owned enterprises restructuring is currently ongoing.

Regarding the recommendation of reducing reliance of the pension system on budgetary transfers, the Government has adopted a multipronged approach. It is studying the diversification of funding sources, reassessing the exemptions and reductions in contribution rates, and the sustainability factor with a view to decrease the weight of budget transfers. These studies will be helped by the creation of a Statistics System of Social Security for a better evaluation of policy implications. They intend to reinforce the Financial Stabilisation Fund of Social Security, harmonise different pension regimes and boost inspection and monitoring tools to reduce evasion and fraud. Finally, to ensure the long-term sustainability of the health sector, without compromising access to primary healthcare , the new tax on sugary drinks while enhancing disease prevention (by limiting consumption of sugar) would provide direct revenues to the health service. In addition, much is being planned to enhance transparency, monitoring and auditing.

The effective action report also provides an assessment of progresses in other areas recommended in the EDP notice. Regarding the implementation of the Budget Framework Law, a new implementation unit has been created in September which would deal with the coordination and monitoring of projects. While specific follow-up on the implementation of the Commitment Control Law is missing, the report highlights containment of non-financial debt in the central administration and increases in available funds to clear arrears in the health sector. Moreover, a spending review has started, covering for the time being health and education sectors as well as public procurement and SOEs with an estimated cumulative impact of EUR 238 million in savings until 2019. Regarding the sustainability of the pension system, the report points to the planned allocation of the revenue of a new progressive tax on real estate portfolios to the social security's Financial Stabilisation Fund in the draft budget for 2017. Yet, the expenditure side of the sustainability of the pension system remains unaddressed. Finally, the effective action report refers to a refocus of state-owned enterprises restructuring plan as ongoing, without referring to specific progress in this area.

7. OVERALL CONCLUSION

Based on the Commission 2016 autumn forecast, Portugal is expected to achieve a headline deficit of 2.7% of GDP in 2016, above the target set by the Council. At the same time, the Commission expects that the structural effort will meet the target set in the Council decision, based on the adjusted change of the structural balance and the bottom-up method. While the autumn forecast projects headline deficits below the Treaty reference threshold over the forecast horizon, there are risks to the timely and durable correction of the excessive deficit in 2016 due to the possible deficit impact of bank support measures.

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Assuming that the excessive deficit is corrected in a timely and durable manner by 2016, Portugal would be subject to the requirements of the preventive arm of the SGP as of 2017.

Based on the autumn forecast the structural improvement in 2017 falls short of the MLSA to ensure sufficient progress towards compliance with the debt criterion.

Following an overall assessment of the DBP, the planned structural adjustment points to a risk of some deviation with the required adjustment path towards the MTO in 2017. An overall assessment based on the Commission 2016 autumn forecast points to a risk of significant deviation from the adjustment path towards the MTO in 2017.

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Annex. EDP related tables

Table A1. Forecast of key macroeconomic and budgetary variables under the baseline scenario

		2015	2016
Real GDP growth	%	1.5%	1.5%
Output gap	%	-2.3%	-1.1%
General government balance	% GDP	-4.4%	-2.7%
Structural balance	% GDP	-2.0%	-2.2%
Change in structural balance	pps	-0.6%	-0.2%
Source: Commission 2016 spring forecast			

Table A2. Forecast of key macroeconomic and budgetary variables under the EDP scenario

		2015	2016
Amount of measures	% GDP		0.2%
Real GDP growth	%	1.5%	1.3%
Output gap	%	-2.3%	-1.3%
General government balance	% GDP	-4.4%	-2.5%
Structural balance	% GDP	-2.0%	-2.0%
Change in structural balance	pps	-0.6%	0.0%
Source: Commission 2016 spring forecast			

Table A3. Forecast of key variables for the computation of the fiscal effort under the baseline scenario

			2016
Enters top-down	α	Structural expenditure (% of potential GDP)	45.7
		Potential GDP growth (%)	0.3
	β	Current revenue (national currency)	79,355.8
		Discretionary measures wih impact on current revenue (national currency)	-257.0
		Nominal GDP growth (%)	2.8
		p.m Elasticity on current revenue	1.0
		p.m Output gap (% of Pot. Output)	-1.1
Enters bottom-up		Discretionary measures wih impact on total revenue net of one-offs and other temporary measures (national currency)	-252.0
		Total expenditure net of one-offs and other temporary measures (national currency)	86,033.0
		Interest expenditure (national currency)	8,221.4
		Total unemployment	594,900.0
		Unemployment benefits (national currency)	2,684.5

Source: Commission calculations based on spring 2016 forecast

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