REPÚBLICA PORTUGUESA

Effective Action Report

17 October 2016

MINISTÉRIO DAS FINANÇAS

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Executive Summary

The Portuguese Government is committed to fiscal consolidation in the context of growth and social cohesion.

The effective action taken by the Portuguese Government will deliver, in 2016, the best primary surplus, 1.9%, and headline deficit, 2.4%, of the last 40 years. The headline deficit will stay below the 2.5% target set by the Council of the European Union and post a structural adjustment of 0.2%. This will be achieved mainly through measures taken on the expenditure side.

The rigorous implementation of the 2016 State Budget, the ongoing stabilization of the banking sector and a recovering economy will pave the way for a more competitive economy and a better society. A society battered by a prolonged recession, which embarked in a 10-year long reform process and lost a quarter million of young workers in the last five years.

Portugal considers that the improvement of European institutions needs to be accomplished through better risk sharing and risk reduction. The contribution of the Portuguese Government has been effective in the course of 2016. It improved public finances, external accounts and the robustness of the financial sector.

Portugal will put an end to the excessive deficit situation in 2016. It will respect both the nominal and the structural targets set forth by the Council of the European Union. Portugal will remain faithful to its long standing European principles.

I - The Portuguese Economy and the Financial Sector: Recent trends

From May 2014 to mid-2015

After a long and severe recessionary period, which began in 2008, the Portuguese economy started its recovery in the second half of 2013. The exit of the Adjustment Programme in May 2014 could have delivered sustained growth. Unfortunately, that did not materialize. Just after the Programme end, the third largest Portuguese bank was resolved. This had undesirable consequences for the recovery of the economy.

The acceleration of growth rates, which characterizes recovery periods, lasted only a few quarters. One year after, in the second half of 2015, the economy came to a sudden stop, growing by meagre 0.3% relatively to the 1st semester. Investment plummeted in the 3rd quarter of 2015 and exports decelerated due to severe difficulties in trading partners, such as Angola and Brazil.

Economic conditions started improving again at the end of 2015. Hindered, but not stopped, by the banking system crisis in Europe, the refugees' crisis and Brexit. For a small open economy, the external cyclical conditions were not positive. However, Portuguese firms and households delivered an output growth close to potential.

The straightening of the legacy of the financial and banking sector

When the XXI Constitutional Government took office in November 2015, the financial sector was extremely fragile. The Adjustment Programme had failed to identify and, therefore, correct the major weakness of the Portuguese economy. Banco Espírito Santo was resolved in August 2014; Banif would be resolved at the end of December 2015. The stability of the financial and banking sector became a priority for the new Government.

Policy decisions have been taken aiming at strengthening the capital base of banks and promoting mechanisms that facilitate the recovery process of NPLs and legacy assets.[1]

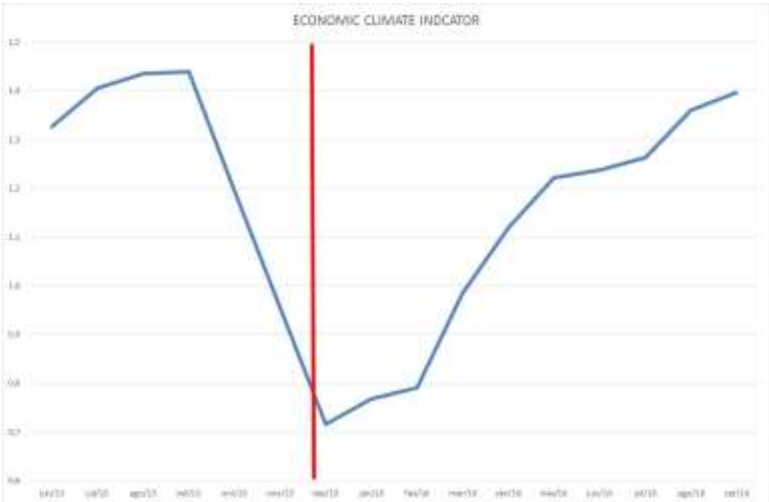
Special attention was paid to the recapitalization of Caixa Geral de Depósitos (CGD). The recapitalization was designed in full coordination with DG COMP to guarantee its non-state-aid nature. A fully market-based management model was adopted for CGD.

The recent developments in both public and private banks are consistent with an effective stabilization of the system. CGD will be recapitalized by the end of 2016; BPI shareholder composition has been clarified; Millennium Bank has a firm offer from a relevant investor to enter its capital structure; all other banks have been adapting their business plans to the new demanding economic and financial reality. The selling process of Novo Banco is advancing and will deliver results soon. The financial and banking sector can again become a springboard to promote growth in Portugal.

The return to growth: Confidence and economic recovery

Economic confidence plummeted in the second half of 2015. Output growth came almost a halt. In a pattern common to all sectors, confidence levels dropped dramatically in the last quarter of 2015 (Figure 1). However, confidence indicators recovered. By the end of September 2016, confidence had reached the pre-election level.

Figure 1 - Economic Climate Indicator



Source: Statistics Portugal – www.ine.pt

For 2016, GDP is forecasted to increase 1.2%, a downward revision of 0.8p.p. compared with the Stability Programme (Table 1). More important than the revision is the intra-annual growth profile. The growth in the first quarter of 2016 was low, but not lower than in the second half of 2015. In the second quarter, a slight acceleration was already observed, 0.3% quarter-on-quarter. This corresponds to an annualized acceleration of 0.4p.p.

[1] For more details refer to the Draft Budgetary Plan - action on Country Specific Recommendation #4.

This pattern is expected to continue into the second half of the year. The economic activity coincident indicator of Banco de Portugal released last week points to a recovery of the growth rate trend in the third quarter.

At the beginning of 2016, the external macroeconomic environment relevant for the Portuguese economy was forecasted to increase 4.2%. In the course of the year, the forecast changed and external demand growth stands now at 2.9%.

The Portuguese Government still projects a small gain in the market share of Portuguese exports, but a smaller increase than the figure projected in the Stability Programme (SP, submitted in April 2016). Exports will increase by 3.1 in 2016.

Table 1. Macroeconomic projections

	2015	2016
	rate of change	
1. Real GDP	**1,6**	**1,2**
2. Potential GDP	**0,0**	**0,6**
3. Nominal GDP	**3,7**	**3,2**
Components of real GDP		
4. Private final consumption expenditure	2,6	2,0
5. Government final consumption expenditure	0,8	0,6
6. Gross fixed capital formation	4,5	-0,7
7. Changes in inventories and net acquisition of valuables (% of GDP)	0,3	0,3
8. Exports of goods and services	6,1	3,1
9. Imports of goods and services	8,2	3,2
Contributions to real GDP growth		
10. Final domestic demand	2,6	1,3
11. Changes in inventories and net acquisition of valuables	0,0	0,0
12. External balance of goods and services	-1,0	-0,1

Private consumption will grow 2%. This figure follows the recovery in households' income and allows for a slight recovery of the savings rate.

The deceleration in global demand was also associated with the revision in investment. However, the dramatic reduction in investment observed in the third quarter of 2015 seems now over, with investment expected to recover already in the second half of 2016.

The labour market dynamics developments surpassed all forecasts, with lower unemployment and more employment (Table 2).

Table 2. Labour Market

	2015	2016
	rate of change	
1. Employment, persons[1]	1,4	0,8
2. Unemployment rate[2] (%)	12,6	11,2
3. Labour productivity, persons[3]	0,2	0,4
4. Compensation of employees	2,4	2,8
5. Compensation per employee	-0,2	1,5

[1] Occupied population, domestic concept national accounts definition; [2] Harmonised definition, Eurostat; levels; [3] Real GDP per person employed.

Source: Ministry of Finance

The unemployment rate is 1.4p.p lower than in 2015 and better than envisaged in the Budget for 2016 and in the SP. The better stance of the labour market is reflected in the reduction of subsidized unemployment. A reduction of 22% in the number of subsidized unemployed according to the Labour Force Survey and a reduction of 15% in unemployment benefits expenditure.

For a period of five years, the Portuguese labour market suffered from an unprecedented reduction in its labour force. This is the biggest challenge to potential growth faced by the Portuguese economy. However, for the first time since early 2011, the latest statistics register an increase in the labour force.

The Portuguese economy is growing and the labour market is dynamic. The Budget and the National Reform Programme are stepping stones to support this growth path in the next years.

II - Measures taken to address budgetary pressures

In the statement issued by the Eurogroup on February 11, Portugal committed to take to the necessary measures when needed to ensure that the 2016 budget would be compliant with the Stability and Growth Pact. In August 2016 the Council of the European Union adopted a decision giving notice to Portugal to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit.

The budget approved by the Parliament included a significant amount of frozen appropriations to guarantee that public expenditure would be contained within the strict limits considered in the budget. These appropriations amounted to EUR 1.572 billion.

The appropriations were included from the beginning. They are the instrument deemed appropriate to monitor the budget execution. They have been limiting public expenditure from "day one". Although they control directly expenditure, they can also be tightened to account for lower tax collection.

Appropriations can be conceived as contingency measures. Public services were clearly aware of them since the Budget was designed and of the impact they would generate in the expenditure profile.

After the commitment assumed again in July, in the context of the reasoned request to the European Commission, the Portuguese Government reiterated its total availability to take effective action based on these appropriations.

From the original appropriations of EUR 1.5 billion, until September, EUR 461 million were used. Of the remaining still available EUR 1.1 billion euro, 445 million have been frozen permanently (Table 3).

Table 3 – Appropriations: Initial, permanently frozen and still available

in € millions

	Initial (1)	Already used (2)	Permanently frozen margins (3)	Still available (4) = (1)-(2)-(3)
Appropriations	**1 572,5**	**461,3**	**445,0**	**666,2**
of which:				
Compensation of employees	174,3	89,2	0,0	85,1
Purchase of goods and services	675,1	133,0	445,0	97,0

Source: Ministry of Finance

In September, the Ministry of Finance promoted bilateral communications with the line ministries in order to ensure that the current expenditure performance lasts until the end of the year. As a result of these interactions, EUR 445 million of the appropriations on potential expenditure of goods and services were made permanent, in the amount of EUR 445 million. Hence, the line ministries and all the respective services have been informed that the concerned appropriations would remain frozen and that the Ministry of Finance would not authorize their release. The services have also committed to a lower final expenditure ceilings, thus increasing ownership of the measure. The adoption of this decision is fully compatible with the budgetary targets implied in the consolidation path proposed by the Council.

Given the effective action was taken, there are still safety margins available worth EUR 666.2 million. As such, further savings can be achieved if they are required to attain the budget targets. Therefore, no additional measures are considered necessary as there are sufficient margins to overcome potential pressures. A thorough analysis of the 2016 forecasted budget balance and implied execution risks is provided in the following section.

Up until August, latest available data, the non-financial debt of the Central Government had decreased EUR 37.6 million relatively to the same period of 2015.

During 2016 the Portuguese Government has authorized reinforcements of EUR 332 million to lower the non-financial debt of the National Health System (Table 4). There are still about EUR 100 million available to be used until the end of the year (Article 1, nº 5, of the afore-mentioned Council Decision).

The 2017 Budget Proposal has EUR 400 million in appropriations set for the sole purpose of reducing Central Government’s arrears.

Table 4 – Appropriations for reduction of Central Government's non-financial debt

	in € millions	
	2016	2017
Total appropriations destined to reduce non-finantial debt	443,4	400,0
Implementation to date	332,1	
Ending balances generated in previous years	111,3	
2017 Budget appropriations		400,0

Source: Ministry of Finance

On 22nd September, the Council of Ministers approved the operating rules for the new Budgetary Framework Law's Implementation Unit. This is in line with the recommendation set forward in article 1, nº 5 of the Council Decision.

The Implementation Unit is responsible for coordinating and monitoring the projects, which will ensure the implementation of the Budgetary Framework Law. The Government is fully committed to a timely and rigorous implementation of the new Budget Framework Law.

Additionally, since the mid-2016, the Government is implementing an expenditure review intended to result in permanent efficiency gains.

Intermediate consumption, excluding PPPs, is set to be nominally frozen at the 2015 level. To meet this target, the Portuguese Government is conducting a spending review and it will continue to do so throughout the next three years. Together with the appropriations scheme, these two policies will guarantee that inefficient intermediate consumption will be curbed. According to national accounts data, in the first semester of 2016, intermediate consumption excluding PPPs is falling 0.2% year-on-year.

The current expenditure review has been concentrated in four major areas: health, education, public procurement and procurement in State-Owned Enterprises[2]. This review aims at producing a lasting improvement in the general government balance in a growth-friendly manner, as advised by the Council (Article 1, nº 4, of the afore-mentioned Council Decision). The measures coming out of the review will generate efficiency gains worth EUR 75 million in 2017. In the following years, the full implementation of these measures will generate EUR 135 million efficiency gains in the health sector - without jeopardizing access to health care services, as also requested by the European Council (Country Specific Recommendation nº 1) - EUR 50 million in various services of the Central Administration, and EUR 17 million savings in public procurement. In 2017, the expenditure review will be expanded, allowing for more efficiency gains and savings, further developing its long-term approach. The refocus of state-owned enterprises restructuring plan is ongoing.

The Government's Programme, approved by Parliament, envisaged the study of the diversification of Social Security Funding, in order to reduce the reliance of the pension system on budget transfers. The first results of this policy goals are being materialized. The 2017 State Budget envisages the use of a specific tax revenue (worth EUR 170 million) will be channelled to the Social Security Stabilization Fund. In order to further increase the resilience of the system, means tested will be applied to the new non-contributory benefits.

[2] Refer also to the Draft Budgetary Plan, action on Country Specific Recommendation nº 1

III - General Government accounts for 2016

The Portuguese Government is forecasting a budget deficit for 2016 of 2.4% of GDP, well below the 3% limit (Table 5). It is also below the 2.5% target of the recommendation of the EC (Article 1, nº 2, of the aforementioned Council Decision).

Table 5 – General Government Accounts 2015 and 2016

	Nominal		Rate of Change		Percentage of GDP	
Tax revenue	45 541,8	46 319,3	4,5	1,7	25,4	25,0
1. Taxes on Production and Imports	26 103,6	27 353,6	6,3	4,8	14,5	14,8
VAT	*15 367,8*	*15 621,3*	*4,7*	*1,6*	*8,6*	*8,4*
Tax on oil products	*3 027,3*	*3 547,3*	*5,8*	*17,2*	*1,7*	*1,9*
Other	*7 708,5*	*8 185,0*	*9,7*	*6,2*	*4,3*	*4,4*
2. Taxes on Income and Wealth	19 438,3	18 965,7	2,3	-2,4	10,8	10,2
PIT	*13 128,2*	*12 637,1*	*-1,4*	*-3,7*	*7,3*	*6,8*
CIT	*5 613,6*	*5 551,8*	*13,9*	*-1,1*	*3,1*	*3,0*
3. Social Contributions	20 775,1	21 580,7	1,6	3,9	11,6	11,6
Of which: Actual Social Contributions	*16 201,7*	*16 921,3*	*4,0*	*4,4*	*9,0*	*9,1*
4. Sales	6 636,4	6 603,9	5,1	-0,5	3,7	3,6
5. Other Current Revenue	4 524,2	4 537,7	-11,6	0,3	2,5	2,4
6. Total Current Revenue (1+2+3+4+5)	77 477,5	79 041,6	2,7	2,0	43,2	42,7
7. Capital Revenue	1 527,0	1 804,5	-12,5	18,2	0,9	1,0
8. Total Revenue (6+7)	**79 004,5**	**80 846,1**	**2,3**	**2,3**	**44,0**	**43,6**
9. Intermediate Consumption	10 328,8	10 591,3	4,9	2,5	5,8	5,7
10. Compensation of Employees	20 272,9	20 703,6	-1,2	2,1	11,3	11,2
11. Social Transfers	34 637,3	35 113,1	1,6	1,4	19,3	19,0
Of which: Social Transfers other than in kind	*3 316,5*	*3 369,9*	*1,2*	*1,6*	*1,8*	*1,8*
12 Interest (EDP)	8 191,3	8 018,9	-3,4	-2,1	4,6	4,3
13. Subsidies	1 110,4	1 108,2	-9,7	-0,2	0,6	0,6
14. Other Current Expenditure	4 554,1	5 341,8	-3,5	17,3	2,5	2,9
15. Total Current Expenditure (9+10+11+12+13+14)	79 094,8	80 876,9	0,3	2,3	44,1	43,7
16. Gross Fixed Capital Formation	4 083,8	3 427,5	18,5	-16,1	2,3	1,9
17. Other Capital Expenditure	3 646,9	1 080,0	-49,8	-70,4	2,0	0,6
18.Total Capital Expenditure (16+17)	7 730,6	4 507,5	-27,9	-41,7	4,3	2,4
19. Total Expenditure (15+18)	**86 825,4**	**85 384,4**	**-3,1**	**-1,7**	**48,4**	**46,1**
20. Net lending (+)/Borrowing (-) (8 - 19)	**-7 820,9**	**-4 538,3**	**-**	**-**	**-4,4**	**-2,4**
For memory:						
Current Primary Expenditure	32 666,7	33 554,2	1,4	2,7	39,5	39,3
Total Primary Expenditure	70 903,5	72 858,0	0,7	2,8	43,8	41,8
Current Primary Balance	61 743,5	63 240,5	-	-	3,7	3,3
Primary Balance	370,4	3 480,6	-	-	0,2	1,9

Source: Ministry of Finance

The upward revision of the public deficit target is explained by a deceleration in the economy; the expenditure side is aligned with the initial forecast, but total revenue is lower than forecasted.

Lower private consumption and inflation will result in lower than expected tax revenue. On the other hand, labour market performance has exceeded by several marks all forecasts, resulting in a better Social Security balance with revenue growing above social expenditure. Public debt bond market developments will also result in a lower interest payment bill. Finally, two one-off events will most likely increase the public deficit: (i) Oitante, a spin-off of Banif resolution, will post worse than expected results; (ii) Silopor and IP Telecom concessions will not take place, contrarily to the initial budget forecast. Overall, the balance of these risks would result in a higher deficit. However, as detailed above, the Portuguese Government implemented an appropriations scheme that will reduce public expenditure by EUR 445 million, bringing the deficit to 2.4%, below the target set by the Council of the European Union.

The risks to the budget balance forecast are on the downside. Two factors contribute to expect a balance securely below 2.5%.

First, the Portuguese Government announced an instalments scheme to recover long overdue tax revenue and social security contributions. After the recent recessionary years, the scheme aims at allowing taxpayers to regularize their debt situation. This is important for companies to be eligible for Portugal 2020 support programs. Taxpayers can adhere to the programme until December 20th, upon which they will have to make an initial down payment of at least 8% of the total overdue amount. Secondly, quarterly deficits traditionally have a declining seasonal pattern. This pattern is the result of a larger stream of tax revenue in the second half of the year coupled with lower public expenditure. This year's quarterly deficits were 3.0% and 2.5%, combining to a reduction of 1.8 p.p. in the first semester deficit (4.6% in 2015 vs. 2.8% this year). Last year's second semester deficit, excluding the Banif resolution, was 1.3%, well below the level necessary to achieve the recommended target.

All in all, the policies put forward in the budget, which included the appropriation scheme, will contribute to a structural adjustment of 0.2 p.p. in 2016. This goes beyond the recommendation to achieve an unchanged structural balance with respect to 2015 (Article 1, nº 2, of the afore-mentioned Council Decision).

The Government is determined to use all windfall gains to accelerate the deficit and debt reduction, as proposed by the Council. Windfalls gains such as the BPP guarantee, the repayment of CoCos and the selling of the financial assets of Banif and Novo Banco will be used with that aim. Revenues from the instalments scheme devised to recover overdue taxes and social security contributions will also be applied to reduce debt. Furthermore, its instalment nature – instalments can last up to 150 months – translates into a structural measure. The same is true of the appropriation scheme, which although it might be seen as device to achieve a specific target, in practice it is part of a policy devised to control public expenditure.

IV - The implementation of the National Reform Programme

The State Budget for 2017 includes policy measures aligned with the priorities outlined in the National Reform Programme (NRP), a central element in the government's strategy for the coming years.

The NRP, approved in April 2016, presented an integrated development strategy for the country, tackling its structural problems and reinforcing priorities for public policy and investment. At the same time, it addressed recommendations under the European semester.

The NRP has more than half of its 140 measures being already developed and implemented. After six months of effective ground implementation, the NRP will have a first moment of evaluation in November. This is in line with the Council's decision calling for Portugal to reinforce structural reforms to enhance competitiveness and long-term sustainable growth in line with the Council (Preambulatory Clause nº 14).

Most priorities presented for in the State Budget respond to critical axis presented within the NRP. In the case of two structural constraints addressed in the NRP, related with the 'low levels of capitalisation of companies and the low degree of innovation in the companies', the State Budget presents, among others, the following measures:

• Full implementation of the fiscal measures of Capitalizar (new national programme for companies capitalisation);

• Semente Programme – income tax benefits for startup investors;

• Elimination of redtape and reduction of context costs.

Regarding Cohesion and Social Equality, the State Budget for 2017 follows the process initiated in 2016:

• Generalisation of preschool education at 3 years old;

• Expansion of the long-term care network;

• Development of a Plan to fight child poverty;

In the case of territorial enhancement, the State Budget for 2017 streamlines legal and administrative procedures to accelerate European structural and investment funds in 2017. This is the case of the Ferrovia 2020, the national plan for the development of the railway, where the implementation will be fastened during 2017.

Finally, the qualification of the Portuguese workforce will boosted with the implementation of the Qualifica Programme (created to overcome the delay in adult education and training, mainly for the ones within the labour market) and with additional scientific employment, through the hiring of teachers and researchers for Portuguese Universities and Polytechnic Institutes.

Conclusion

The most recent estimates of the Portuguese Government for the budget execution show a full compliance with the targets set for 2016, with the Council Decision to remedy the situation of excessive deficit and the Stability and Growth Pact. There is solid evidence of the effective action of the Portuguese Government to bring the public deficit and debt to commonly agreed objectives.

The evolution of the economy and some legacy issues from 2015 explain the small slippage observed in the Budget. More controls are in place in order to guarantee a correct budget execution until the end of the 2016.

This deviation will be corrected with the measures taken within the budgetary framework for 2016. The policy option to concentrate budgetary controls on the expenditure side, with EUR 445 million worth of appropriations, ensures no negative impact on the economy. Measures were also taken to reduce arrears. Moreover, structural measures both on the expenditure side and on the revenue side will generate effects on the medium term, contributing for the long-term fiscal sustainability. These measures are coupled with concrete actions to stabilize the financial sector and to implement structural reforms to overcome economic bottlenecks. Overall, these actions guarantee progress towards the Medium Terms Objective in a rigorous and equitable way, promoting fiscal sustainability, economic growth and social cohesion.