The Portuguese public accounts in the context of the pandemic

- **The COVID-19 crisis has obliged the government to redirect budget policy to support the economy.**
- **Portugal will amass a significant deficit in 2020, as a result of the fall in economic activity and the measures necessary to support the economy.**
- **In 2021, a reduction in the deficit is expected, driven by the economic revival and the arrival of European funds.**

The COVID-19 pandemic forced the Portuguese government to change its budget policy priorities: the strategy of consolidating and reducing public debt was interrupted by the need to protect households from the economic impact of the pandemic and help businesses not to destroy productive potential so that, when the economic revival comes, it is quicker and more complete. Given that economic activity will fall sharply in 2020 (by around 8%), the general government balance will go from a slight surplus in 2019 to a deficit of slightly more than 7% of GDP in 2020.

In fact, much of the deterioration of the public accounts is explained by the impact of the COVID-19 pandemic, which is affecting them through two channels. Firstly, the decline in economic activity means lower tax collections and higher expenditure on items such as unemployment benefits. This impact explains around half of the deterioration in the public accounts in 2020.[1] Secondly, the COVID-19 crisis makes it necessary to adopt discretionary measures to protect the economy and society, such as the costs of the National Health Service, sick leave benefits in the case of coronavirus infections and layoff schemes,[2] which explain around 3 pps of the deterioration in the public accounts.

The public accounts in 2021

According to the draft State Budget, the Portuguese government expects to being the deficit next year down to 4.3% of GDP. This reduction in the deficit is based on four positive factors: (i) an improvement in economic activity (1.9 pps of GDP);[3] (ii) the use of European funds (Recovery and Resilience Plan – or RRP – and REACT-EU) to fund measures to mitigate the crisis, amounting to 0.7% of GDP; (iii) the receipt of the pre-paid margin,[4] amounting to 1,088 million euros (0.5% of GDP), and (iv) the withdrawal of discretionary measures related to the COVID-19 crisis that have been implemented in 2020, with an impact of 2.7% of GDP (for instance, lower expenditure related to layoff schemes).

On the other hand, there are factors that have a negative impact on the accounts: (i) measures taken in previous years but affecting 2021, such as wage improvements and the unfreeze of public-sector workers' careers (0.9% of GDP), and (ii) new budgetary measures to continue to combat the COVID-19 crisis (1.7% of GDP).[5]

Overall, the draft budget is based on reasonable assumptions. However, our public deficit forecast is higher than the government's (we foresee a deficit of around 5.7% in 2021) because, faced with the prospect that the pandemic could continue to hold back the economy over the coming quarters, we expect to see a smaller rebound in GDP and a slower recovery in the labour market. In addition, our forecasts incorporate

Portugal: main indicators of the public accounts
(% of GDP, except where otherwise indicated)

	2019	2020	2021
GDP (%)	2.2	–8.5	5.4
Unemployment rate (%)	6.5	8.7	8.2
Total revenues	42.7	42.6	43.5
Tax and contributory revenues	36.7	36.2	36.1
Total expenditure	42.7	49.9	47.8
Staff costs	10.7	12.0	11.7
Social benefits	18.2	20.5	19.9
Interest charges	3.0	2.9	2.6
Government balance	0.1	–7.3	–4.3
Primary balance (excl. interest charges)	3.1	–4.3	–1.7
Structural balance (excl. impact of the business cycle)	–1.2	–3.0	–3.1
Public debt	117.2	134.8	130.9

Source: *CaixaBank Research, based on Portugal's draft General State Budget.*

1. The fall in nominal GDP (–7.0% according to the government) would imply a fiscal deterioration of 3.8 pps according to the semi-elasticities estimated by the European Commission (Mourre, Poissonnier y Lausegger, «The semi-elasticities underlying the cyclically-adjusted balance: an update & further analysis»), while the government's projections raise the impact to 4.8 pps.
2. These programmes have had a positive impact in terms of supporting employment: we estimate that, in their absence, the employed population would have fallen by more than 10% in the first half of 2020, instead of the 2% actually registered. This estimate is based on an exercise similar to that set out in the Focus «Recovery of employment and growth of the Portuguese economy» in the MR10/2018.
3. If we estimate this impact based on the nominal GDP projected by the government (6.3%) and the semi-elasticities estimated by the European Commission, the impact would amount to +3.4 pps.
4. Repayment of a commission related to a loan which Portugal received from the European Financial Stability Facility.
5. The most significant such measures, in terms of their importance and scale, include those to support employment and the resumption of economic activity (0.5% of GDP) and the extraordinary support for workers' incomes (0.2% of GDP).

a greater execution of guarantees related to credit facilities, while there is much uncertainty surrounding the need for a capital injection to the Novo Banco.

If we go into more detail, the second table shows that the government expects total revenues in 2021 to be 0.5% higher than in 2019, due to the receipt of the European funds. By item, the government assumes a lower recovery in tax revenues than its economic activity projections suggest: according to the draft budget, they would still be 2.6% lower than in 2019, a more significant decrease than expected for GDP (1% lower than pre-COVID levels). On the other hand, the government expects to receive 4% of the RRP funds in 2021, whereas the European Commission has indicated that the first disbursement in 2021 would amount to 10% of the total. Thus, the government's income projections, both in terms of taxes and the PRR funds, appear reasonably conservative.

Expenditure, meanwhile, will fall from around 50% of GDP, the highest level since 2013, to 47.8% of GDP. This reduction is due to the expected increase in GDP, since spending in absolute terms is expected to continue to grow. By item, the biggest increases are expected to occur in staff costs, social benefits and public investment. There are also some signs of greater rigidity in spending: in 2021, current primary expenditures (excluding social benefits) will remain around 13% above pre-pandemic levels.

The increase in public investment will be particularly significant, as the government expects it to reach around 3% of GDP, a level not seen since 2011. This increase is explained by the Next Generation EU programme[6] and the funds which Portugal expects to receive from the EU budgets. In total, it is estimated that Portugal will have 57,900 million euros available to it in the period 2021-2027 (around 27% of GDP in 2019).[7] However, there are doubts about Portugal's ability to execute this volume of public investment, at least in the short term, since it has historically been unable to meet the investment objectives that have been set (public investment execution in Portugal stood at 85% on average over the past five years) and Portugal is the EU country that spends the least on public investment as a percentage of its GDP.[8]

Portugal: trends in the main components of the public accounts

	% of GDP 2019	% of GDP 2020	% of GDP 2021	Increase 2019-2021 (EUR millions)	Growth 2019-2021 (%)
Total revenues	**42.7**	**42.6**	**43.4**	**462**	**0.5**
Indirect taxes	15.0	14.5	14.5	–1,544	–4.8
Direct taxes	9.8	9.3	9.4	–931	–4.5
Social contributions	11.8	12.5	12.2	459	1.8
Total expenditure	**42.7**	**49.9**	**47.8**	**9,771**	**10.7**
Staff costs	10.7	12.0	11.7	1,704	7.4
Social benefits	17.6	19.7	19.1	2,753	7.3
Interest charges	3.0	2.9	2.6	–844	–13.3
Investment	1,9	2,5	2,9	1,988	49,3

Source: *CaixaBank Research, based on Portugal's draft General State Budget.*

However, next year's performance remains subject to a high degree of uncertainty. On the one hand, the evolution of the pandemic in Portugal and around the world remains the major factor that will determine the economy's performance. In addition, the government expects the unemployment rate to decline from 8.7% to 8.2% in 2021, but the scars of the pandemic may hold back the recovery of the labour market. Similarly, there is much uncertainty over the degree to which public guarantees on credit facilities will be executed (the government estimates that they will amount to 0.1% of GDP), as well as regarding the capital needs of Novo Banco[9] and the cost of the TAP restructuring plan.

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6. The funds earmarked for Portugal under the Next Generation plan include transfers from the REACT-EU programme (1,800 million euros), the Recovery and Resilience Plan (13,173 million euros), the funds to support rural development (329 million euros) and the Just Transition Fund (116 million euros). Moreover, Portugal could access loans that are available under the Next Generation plan (10,800 million euros), although for now it seems that the government plans not to use them in order to avoid a deterioration in public debt.
7. This figure includes transfers from the Next Generation EU programme, but also those expected to be received under the Portugal 2020 programme and the 2021-2027 EU budget (with items such as the cohesion funds and the CAP).
8. 1.9% compared to 2.9% on average among the EU 27.
9. There is still 914 million euros available under the Contingent Capital Facility.