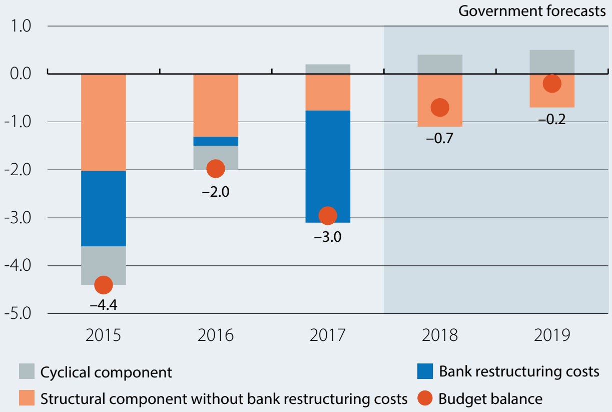
Rapid correction of the budget deficit

It seemed difficult to imagine that Portugal's budget deficit would fall below 1% of GDP shortly after coming out of the excessive deficit procedure (EDP). However, in 2017, the general government budget deficit reached its lowest level since 1974.[1] This recent trend contrasts with what was observed previously: Portugal exceeded the deficit limit of 3% of GDP virtually every year since 2009 and the European Commission included it in the EDP until 2017. What is more, the encouraging figure for 2017 does not seem to be a one-off: the information available so far this year suggests that the deficit will reach a new low in 2018 (possibly even lower than originally planned). What factors have contributed to this fiscal adjustment? What is the outlook for 2019? What does the draft State Budget (SB) recently submitted by the Government tell us?

Portugal: budget balance
(% GDP)



Source: *CaixaBank Research, based on data from the European Commission and Portuguese Government forecasts.*

How are the public accounts evolving in 2018?

With three quarters of the year now passed, the assessment of the health of the public accounts in 2018 is positive: the budget execution up to September reinforces the expectation that the year will end with a public deficit of 0.7% of GDP, well below the 1.1% expected a year ago in the 2018 SB. One of the reasons for this improvement is the economy's positive cyclical performance.

In this regard, tax revenues and social security contributions are likely to exceed the Government's initial forecasts. In fact, the sensitivities of these revenues to GDP[2] and the Government's macroeconomic forecasts suggest that the forecast included in the 2018 SB for these revenue categories was conservative. Specifically, the assumed growth in employment and labour compensation[3] was lower than that finally recorded in the first half of the year: employment has grown by 2.6%[4] year-on-year, while labour compensation has increased by 4.0%. Furthermore, in the first half of the year, private consumption grew by 2.5%, 0.6 pps higher than initially estimated by the Government, and this has benefited indirect tax revenues.

Similarly, on the expenditure side, the economy's positive cyclical performance could also provide upside surprises. Given that the scenario for the labour market assumed in the 2018 SB was conservative, it is possible that the expenditure on social benefits will end up being lower than initially forecast. In particular, the SB assumed an unemployment rate of 8.6%, clearly higher than the figure observed to date (7.2% on average so far this year, with data up to August). Thus, despite some measures[5] being implemented during 2018 that have boosted the increase in social benefits, it is possible that the overall expenditure will remain below that initially anticipated.

In addition, public investment could also result in a lower execution of expenditure. In the year to date up to September, the data point towards an execution of around 61% of what was initially budgeted. At the same time, as was the case in previous years, with the recent presentation of the draft 2019 SB, the Government has revised the estimated investment amount down by 0.2% of GDP. Specifically, compared to an initially anticipated growth in investment of 40.4% year-on-year, the Government now expects a growth of just 16.3%. One of the main reasons behind this revised figure could be the delay in the receipt of funds from the EU under the Portugal 2020 investment programme.[6]

On the other hand, staff costs could be higher than expected. The 2018 SB indicated an increase of 0.3%, which seemed insufficient to finance various measures relating to the civil service that were announced in the

1. –0.9% of GDP excluding the recapitalisation of Caixa Geral de Depósitos and –3.0% including it.
2. Analysis performed considering the growth rates set out in the 2018 SB and using the reference values of the OECD («New Tax and Expenditure Elasticity Estimates for EU Budget Surveillance»).
3. The Government has forecast a growth of 0.9% year-on-year in employment (definition of employed population consistent with the national accounts) and an increase in wages of 3.2% year-on-year.
4. Increase of 2.7% (average up to August) according to monthly data from the National Statistics Institute of Portugal.
5. Extraordinary update of Social Security pensions and of the General Retirement Fund, an increase in the number of pensioners and an update to the Social Security reference index for calculating contributions, pensions and other benefits.
6. See Bank of Portugal, Economic Bulletin for October 2018.

budget.[7] Upon submitting the draft 2019 SB, the Government has revised its estimate for these expenditures for 2018 up to 2.6%.

What is the outlook for 2019?

On 15 October, the Government presented the draft budget for 2019. In this draft, it gives continuity to the trend observed in 2018 and to the deficit reduction, supported by a positive economic environment. In particular, with an expected GDP growth of 2.2%, the Government foresees a reduction of the deficit down to –0.2% of GDP in 2019.

On the revenue side, together with the increase in wages, the Government expects job creation (forecast to be 0.9% in 2019) to help keep the growth in social security contributions above 4.0% in 2019, a forecast that could be somewhat optimistic.[8] In addition, private consumption, one of the drivers of the economy, will support the increase in indirect tax revenue. On the other hand, the growth expected in direct tax revenue could be somewhat conservative (given that the elasticities of these taxes in relation to nominal GDP growth predict a greater increase in tax revenues, in accordance with the Government's own GDP forecasts). On the whole, according to the Government's scenario, the tax burden is likely to remain at around 35% of GDP.[9] Furthermore, the increase in dividend revenues (related to Caixa Geral de Depósitos and the Bank of Portugal) could offset the impact of the revenue reduction measures (equivalent to 0.2% of GDP). In general, therefore, the total revenues estimated by the Cabinet seem to be reasonable.

On the expenditure side, of particular note are the increases in staff costs and in social benefits.[10] Even so, the anticipated reduction in the unemployment rate down to 6.3% in 2019 should help to mitigate this increase with a 4.3% reduction in unemployment benefits.[11] However, the Government's forecast for the unemployment rate may be optimistic (our scenario considers a smaller decrease, down to 6.6%) and, therefore, the savings on unemployment benefits could end up being lower than expected. On the other hand, expenditure on interest payments should continue to fall as a result of the low market interest rates: the Government foresees savings of 0.1% of GDP, while the implicit cost of debt[12] is expected to fall to nearly 2.8%, an all-time low. Finally, the growth anticipated in public investment will be backed up by a greater execution of the structural funds associated with the Portugal 2020 programme.[13]

Overall, the deficit target anticipated by the Government is ambitious, but seems feasible, especially in light of the good performance of recent years. Nevertheless, the scenario envisaged by the Government faces some risks that could make this target difficult to achieve. At the macroeconomic level, the risks are predominantly external in origin, with fears of a rise in protectionism posing a particular risk. That said, a greater than expected rise in oil prices or the uncertainties surrounding some of the hotbeds of political risk (such as Italy) could also have a notable effect on the growth of the economy. With regards to budgetary variables, the greatest risk is an increase in interest rates, due to the State's high borrowing:[14] the Government considers that an increase in the average rate of 100 bps would increase interest expenditure by 0.2 pps of GDP and the deficit would reach 0.4%.

Portugal: revenues and expenditure of the general government (national accounts)

	% of GDP			Change (%)		
	2017	2018	2019	2017	2018	2019
Revenues	42.7	43.2	43.3	4.0	4.9	4.1
Tax revenues	25.1	25.3	25.1	5.1	4.7	2.9
Taxes on income and wealth	10.1	10.2	9.9	3.5	4.5	0.8
Taxes on production and imports	14.9	15.1	15.2	6.2	4.9	4.3
Social security contributions	11.7	11.8	11.8	4.9	4.7	4.1
Expenditure	45.7	43.9	43.5	6.4	4.4	2.8
Staff costs	10.9	10.8	10.8	1.9	2.6	3.1
Intermediate consumption	5.4	5.3	5.2	2.4	2.2	1.7
Social benefits	18.3	18.3	18.3	1.4	3.8	3.8
Interest payments	3.8	3.5	3.3	–4.7	–6.3	–1.4
Gross fixed capital formation	1.8	2.1	2.3	24.9	16.3	17.1
Other capital expenditures	2.6	1.0	0.7	41.2 *	92.7	–28.9
Total balance	–0.9 *	–0.7	–0.2	–	–	–
Primary balance	2.9	2.7	3.1	–	–	–

Note: ** Excludes the recapitalisation of Caixa Geral de Depósitos, for a total of 3,944 million euros (2.0% of GDP).*
Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal and the Portuguese Ministry of Finance.*

7. Reactivation of careers in the general government and a programme to formalise precarious labour relations in the general government.
8. Our analysis of the elasticities compared to nominal GDP suggests a growth in social security contributions of around 3% in 2019.
9. According to the effective social security contributions presented in the budget analysis conducted by UTAO, somewhat lower than those reflected by the Government and presented in the table attached.
10. With measures related to professional careers, such as the possibility for people over 60 who have accumulated 40 years of social security contributions to retire without their pension being affected, increased social benefits in groups at risk of exclusion, and an extraordinary increase in pensions.
11. Estimates contained in the draft 2019 State Budget.
12. Charges with interest payments as a proportion of the total debt in the previous year.
13. Draft 2019 State Budget.
14. See the article «How will the State be financed in 2019?», available at http://www.caixabankresearch.com/.