ECONOMIC AND FINANCIAL RESEARCH
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Portugal: Deficit dropped to 2.1% of GDP in 2016

March 2017

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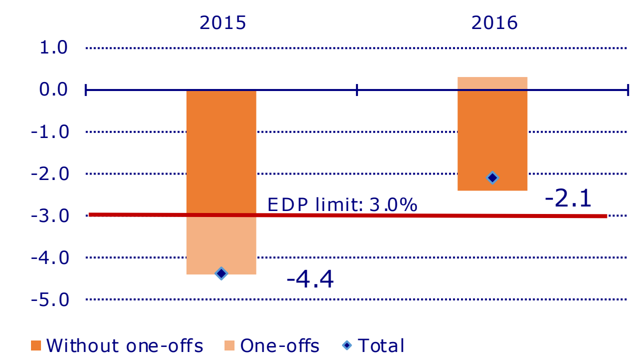
Spending consolidation together with some extraordinary measures ensured deficit well below 3%

The budget deficit in 2016 decreased to 2.1%, 2.3 percentage points lower than in 2015, according to INE. This figure beats all predictions, including our own, and is actually lower than the initial target proposed by the Government, at 2.2%. As previously mentioned by us and other entities, this was partly the result of an extra curb in spending (namely in public investment and the purchase of goods and services) to compensate for revenues below what was expected**.**

Fiscal consolidation

(% of GDP)

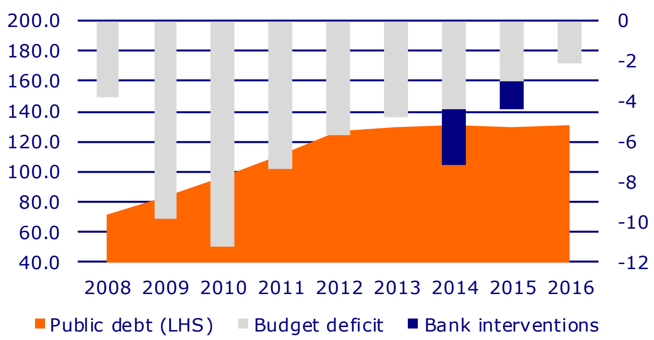


Source: Min.Fin. UTAO

Without one-off measures, and using UTAO criteria on what is considered to be one-off, the consolidation was smaller. In 2015, one has to account for the Banif intervention in the end of the year (worth EUR 2460 million, increasing the deficit from 3.0% to 4.4% in that year). In 2016, the difference derives mostly from 2 measures taking effect in December 2016: revenue from an extraordinary tax debt repayment scheme, worth 0.2% of the GDP; the repayment by the EFSF of the prepaid margin retained at the disbursement of the troika loan, worth 0.15% of the GDP. **This amounts to a still considerable consolidation, at 0.7 percentage points: the budget deficit net of one-off measures would represent 2.4% of the GDP.**

Budget deficit

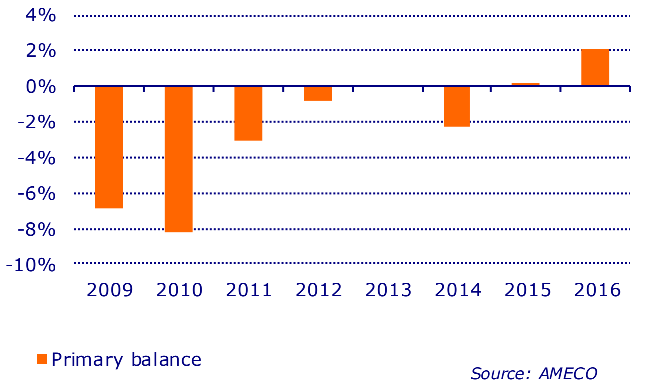
(% of GDP)



Source: Ameco, INE, IMF, IGCP, DGO

Primary balance

(% of GDP)



Source: AMECO

Nevertheless, this is still the lowest budget deficit in the history of the Portuguese democracy (at 2.06%, it beats the previous record of 2.13% in 1989). Moreover, this is now the 6th consecutive year of fiscal consolidation (excluding bank interventions). The budget deficit gradually decreased from a maximum of 11.2% towards 2.1%, 9.1 p.p. in 6 years, a remarkable achievement considering that the GDP decreased in 2011, 2012 and 2013. What is more, the primary surplus was 2.1% of the GDP in 2016, in what would be the third year of a visible primary surplus if it were not for the interventions in the banking sector. **It should be noted that, according to DBRS, the debt-stabilising primary balance "is modest at 0.6%", if the present financing costs and GDP growth are maintained.**

Revenue increased about EUR 700 million to EUR 79.6 billion, a rise of 0.9%. This was particularly due to an increase of 1.4% in operational revenue, as capital revenue dropped 27.9% (from a significant reduction of European Union funds). The increase in operational revenue, of about EUR 1 billion, was caused by increases in indirect taxes (+3.9%) and social contributions (+3.9%), while direct taxes saw a decrease of 1.9% in revenue. The EUR 588 million of the extraordinary tax debt repayment scheme were also very important.

Expenditure reduction was the most important factor in fiscal consolidation, as State spending dropped more than EUR 3 billion. However, this reduction was entirely achieved on a shrinking of capital spending, of about EUR 4 billion: out of this, the largest part is explained by the impact of the EUR 2.5 billion spent on the Banif resolution in 2015; however, the other EUR 1.5 billion were actual cuts in investment spending, of about 28.9% (also partly due to lower EU funds), accounting for about 0.6% percentage points in the budget deficit reduction. Operational spending increased 0.8%, with a 2.8% increase of wage expenditure, for example. On a more positive note, interest expenditure dropped 4.3%, on account of lower financing costs. **It should be noted that there are some doubts regarding the sustainability of the expenditure cuts: investment, in particular, but also the curbed growth of purchases of goods and services, as these were achieved by budgetary captives, meaning that these were planned expenses that did not occur because the Ministry of Finance did not disburse the relevant amounts.** It could be that these somewhat discretionary cuts are not easily maintained in 2017-2018, particularly in the case of investment.

The present data thus puts the budget deficit clearly below 3%. Moreover, the current plan for 2017 entails a path of budget deficit reduction, and, although public debt has not yet started a consistent decreasing path, it likely will decrease in 2017. Contributing for this is the fact that the CGD capital raise, which will be accounted for in the budget deficit of 2017 (if it is accounted at all), was already financed in 2016. Thus, although the final decision regarding the exit of the Excessive Deficit Procedure can only be taken by the European Commission, this scenario is a very realistic possibility.

In 2017, while a 1.6% deficit (the Government goal) might seem overly optimistic, a reasonable reduction is expected, in part also due to extraordinary measures but also due to a more dynamic economy: there is a significant probability that growth might surprise on the upside, which, if confirmed, would make the official forecasts for the behavior of some budget items easier to accomplish**.** Higher dividends from the central bank are expected to contribute with an additional EUR 303 million, while the recovery of a State guarantee from BPP (a private bank in liquidation process) should amount to EUR 450 million. Put together, these amount to 0.4 p.p. in reduction of the budget deficit; moreover, the Executive expects the economic recovery to bring about an improvement of EUR 917 million in the deficit (at a point when current forecasts for the GDP might now be on the short side); thus, extraordinary effects and an acceleration of economic activity could amount on its own to an improvement of 0.9 p.p.. If the Government predictions for 2017 are considered, there will be a net improvement of 0.8 p.p., meaning that the aforementioned factors are more than 100% of the consolidation (other factors are a net negative for the deficit). Still, these predictions expected a 2.4% budget balance without the extraordinary tax repayment scheme, meaning that the 2017 budget would bring about a slightly higher deficit, 1.8%. **Overall, all factors considered, it should be possible to reach a deficit for 2017 well below the expected level for 2016 (excluding any impact from the CGD capital raise, financed by the State in EUR 2.7 billion).**

Main fiscal measures	EUR million	% of GDP
Budget balance in 2016	**-4538**	**-2.4**
Revenue		
Additional real-estate tax	160	0.1
Soda fat tax	80	0.0
Fuel tax changes	70	0.0
Phased elimination of Income tax surcharge	-200	-0.1
Restaurant VAT reduction	-175	-0.1
Revenue revision	75	0.0
Backtax pardon scheme	100	0.1
Central bank earnings	303	0.2
BPP guarantee recovery	450	0.2
Other measures	-90	0.0
Total revenue measures	**773**	**0.4**
Expenditure		
Public wage cut reversals	181	0.1
Public employment: 2 for 1 rule	-104	-0.1
35 hours	25	0.0
Pension increases	187	0.1
New handicapped social payment	60	0.0
Expenditure revision	-75	0.0
Interest	-60	0.0
Other measures	-47	0.0
Total expenditure measures	**167**	**0.1**
Macroeconomic effects	**917**	**0.5**
Budget balance in 2017	**-3016**	**-1.6**

Source: Min. Fin.

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