Portugal: State Budget 2018 – Brief notes

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A budget that capitalizes on the favourable economic momentum

From a macro perspective, the preliminary draft of the State Budget for 2018 can be considered a credible budget, based on reasonable macroeconomic assumptions: indeed, the economic scenario is very similar to BPI own scenario for the Portuguese economy. Besides, it contains several remarkable goals as far as public accounts are concerned: it entails a deficit reduction in line with the long term scenario presented last April (Stability Program) which, if confirmed would be the lowest deficit for more than two decades; it aims achieving a significant primary surplus – more than 2% of GDP - for the third year in a row; finally, it envisages the reduction of the public debt ratio in circa 6 p.p. of GDP from 2016, which is notable given the resistance of public debt levels in recent past.

Despite these ambitious goals, the 2018 Budget is nevertheless dependant on the persistence of a favourable economic scenario as well as on the decline of the public debt burden; indeed, the consolidation is totally obtained with the enhancement of revenues, whereas on the expenditure site the more relevant contribute is interest paid on debt. Finally, from the point of view of the fiscal policy stance, the 2018 State Budget projects a decline of the structural deficit of 0.5% of GDP (when excluded interest on debt, the surplus improves 0.2 p.p. of GDP), in line with the European Commission requirements. Having said this, the dimension of the structural adjustment may be considered over-estimated by EC due to the uncertain nature of some of the measures supposed to generate savings (especially on the expenditure side).

...The macroeconomic scenario is in line with BPI and consensus

Portugal - Macroeconomic scenario

	2016	BPI		BoP Oct 17		IMF Jun 2017		Gov - SB 2018 Oct 17	
		2017F	2018F	2017P	2018P	2017P	2018P	2017P	2018P
Real GDP (% change)	**1.5**	**2.7**	**2.2**	**2.5**	**2.0**	**2.5**	**2.0**	**2.6**	**2.2**
Private Consumption	2.1	1.8	1.6	1.9	1.7	2.2	1.8	2.2	1.9
Public Consumption	0.6	0.0	0.2	0.3	0.6	0.6	0.5	-0.2	-0.6
Investment	1.6	10.0	5.7	8.0	5.3	6.9	5.7	7.7	5.9
Exports	4.1	7.6	4.6	7.1	6.8	7.6	5.2	8.3	5.4
Imports	4.1	7.4	4.4	6.9	6.9	7.3	5.1	8.0	5.2
Domestic demand (Contributes, p.p.)	1.6	2.8	2.2	2.6	2.2	2.6	2.1	2.7	2.2
Foreign demand (Contributes, p.p.)	-0.1	-0.1	0.0	-0.1	-0.2	-0.1	-0.1	-0.1	0.0
Inflation rate (annual average)	0.6	1.5	1.6	1.6	1.4	1.6	2.0	1.2	1.4
Unemployment rate (%)	11.1	9.1	8.0	9.0	8.2	9.7	9.0	9.2	8.6
Current account + Capital account (% GDP)	1.7	1.5	1.6	1.8	2.4	1.9	1.6	0.8	1.0
Budget balance (% GDP)	-2.0	-1.4	-1.3	-	-	-1.5	-1.4	-1.4	-1.0
Public debt (% GDP)	130.1	127.3	126.1	-	-	125.8	122.6	126.2	123.5

Source: Bank of Portugal, Ministry of Finance, European Commission, BPI, IMF

The baseline scenario assumed in the SB2018 draft is very similar to BPI own forecasts, assuming a GDP growth, in volume, of 2.2%, despite being slightly more optimistic as far as external demand is concerned. Trends assumed are globally in line with the consensual view: the economy is projected to decelerate while keeping a strong momentum vis-à-vis past performance since 2013; exports and investment should continue to be important growth determinants; the labor market is expected to maintain a favorable performance with sustained job creation; inflation is projected to gradually normalize. According to the SB18, nominal GDP is expected to expand 3.6% in 2018, in line with BPI own forecast.

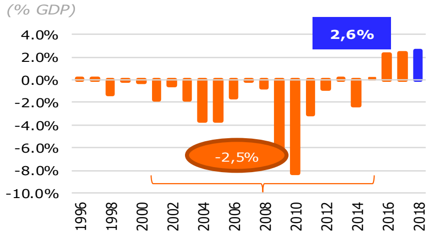
…Fiscal and Public debt indicators

Main fiscal indicators
(% GDP)

	2015	2016	2017e	2018P
Overall balance	**-4,4**	**-2,0**	**-1,4**	**-1,0**
Primary Balance	0,2	2,2	2,5	2,6
Interest on debt	4,6	4,2	3,9	3,6
One-off measures	-1,2	0,4	0,2	-0,2
Cyclic component	-0,8	-0,4	0,2	0,5
Structural Revenue	43,6	42,6	43,0	43,6
Structural expenditure	46,0	44,6	44,9	44,9
Primary Structural Expenditure	41,4	40,4	40,9	41,3
Structural balance	**-2,3**	**-2,0**	**-1,8**	**-1,3**
Var. structural balance	-0,6	0,3	0,2	0,5
Structural primary balance	**2,2**	**2,2**	**2,1**	**2,3**
Var. structural primary balance	-1,0	0,0	-0,1	0,2

Sources: INE and Ministry of Finance.

Primary Balance



Source: INE, State Budget 2018 (Draft)

The State Budget draft contains several remarkable goals as far as public accounts are concerned:

- Entails a **deficit reduction** in line with the long term scenario presented last April (Stability Program) which, if confirmed would be the lowest deficit for more than two decades;
- Aims achieving a **significant primary surplus** – more than 2% of GDP - for the third year in a row;
- Envisages the **reduction of the public debt ratio** in circa 6 p.p. of GDP from 2016, which is notable given the resistance of public debt levels in recent past.

The table below contains the main fiscal policy measures considered in the SB18; some of them, namely the ones that are highlighted, have uncertain probability of being achieved. Such is the case of "Exercise revision of Expenditure", "Nominal Freeze of Intermediate consumption", or "Contention of other current expenditure", measures that are vague and whose results are certainly difficult to estimate. **BPI forecast for the public deficit in 2018 implicitly considers a judgment based probability of achievement for the mentioned measures, fact that mostly explains our more conservative view for next year's budget balance: -1.3% of GDP**. Having said this, it is important to acknowledge that the **Government continues to have some flexibility of adjusting the GFCF execution next year, in case budget execution disappoints for some unexpected unfavorable reason**. Indeed, the Government used some of this leeway also in 2007: comparing the projected investment for 2017 in the 2017 State Budget (4.2 bln euros) with the respective expected execution in SB18 (3.2 bln euros), there was a decline of circa 0.5 p.p. of GDP, a significant contribute for the achievement of deficit targets. In 2018 public investment is seen to expand by 26%, according to the official projection, so there is a lot of room to accommodate unexpected unfavorable developments.

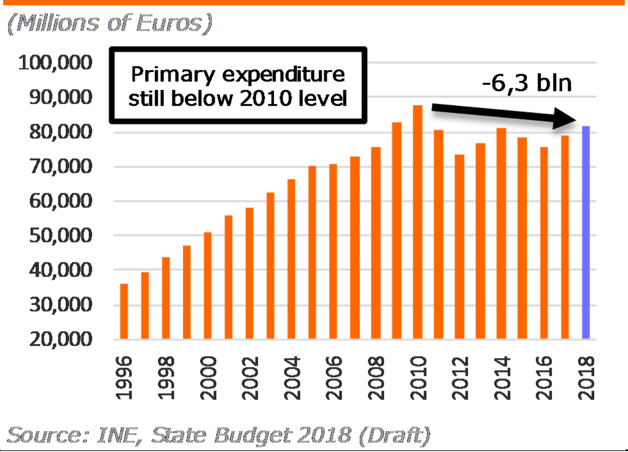
Main fiscal policy measures	million EUR		% of GDP	
	2017	2018	2017	2018
Revenue				
Additional to the Municipal Property Tax	130		0.1	-
Update to the Tax on alcohol and alcoholic beverages	80		0.0	0.0
Tax on products that are high in salt		30	-	0.0
Change in tax on oil products	70		0.0	0.0
Change in income ranges		-230	-	-0.1
Gradual elimination of surcharge of Income Tax	-200	-260	-0.1	-0.1
Change in excise duty		150	-	0.1
VAT in restaurants	-175		-0.1	-
Special program for the reduction of indebtedness for the State (PERES)	100		0.1	-
Exercise of Revision of revenues	75	50	0.0	0.0
Dividends of BdP	166	148	0.1	0.1
Structural funds	285	167	0.1	0.1
Total revenues measures	**531**	**55**	**0.3**	**0.0**
Expenditure				
Net direct effect of salary devolution	181		0.1	-
Net effect of the gradual unfreezing in the public sector careers		211	-	0.1
Public employment- 2017: Rule 2 per 1; 2018: 3 per	-122	-23	-0.1	0.0
Replacement of 35 working hours per week	25		0.0	-
Social benefit for the inclusion	20	79	0.0	0.0
Exercise of revision of expenditure	-75	-287	0.0	-0.1
Nominal freeze of intermediate consumption	-215	-300	-0.1	-0.2
Exceptional update in pensions	79	154	0.0	0.1
Retirement in long careers		48	-	0.0
Interests saving	-277	-307	-0.1	-0.2
Contention of other current expenditure	-50	-180	0.0	-0.1
Structural funds	143	178	0.1	0.1
Total expenditure measures	**-292**	**-427**	**-0.2**	**-0.2**
Impact on the budget balance	**823**	**482**	**0.4**	**0.2**

Source: Ministry of Finance.

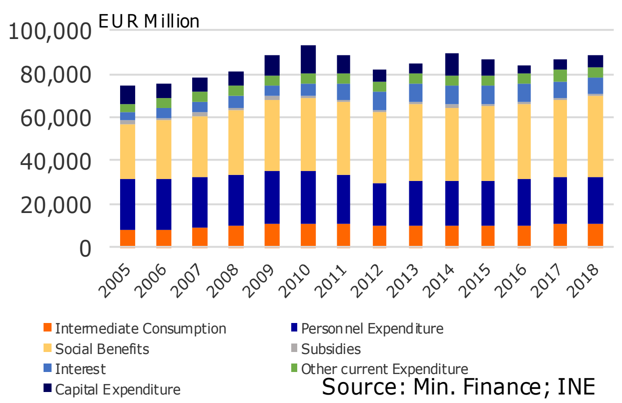
Additionally, we include also some graphs (next page) that illustrate the SB projections in context of recent past trends. We highlight the following ideas:

- GDP performance as well as the evolution of interest rates and the sovereign risk premia are key to SB18 goals;
- Total and Primary expenditure keep at lower absolute levels than the maxima reached in 2010, although its weight on GDP is now similar;
- Public investment will keep at historical low levels (2017 goals have been revised lower);
- The social security expenditure is expected to increase 4.3% on nominal terms, despite the decline projected on Unemployment Benefits (circa -4.3%) mostly due to the increase in pension expenditure (>60% of SS Current Expenditure) by 5.1%.
- The tax burden has not changed much since 2012, stabilizing at 37% of GDP (considering Taxes and Social Security contributions), despite the changes occurred in the structure of taxes, with an increasing trend in indirect taxation.

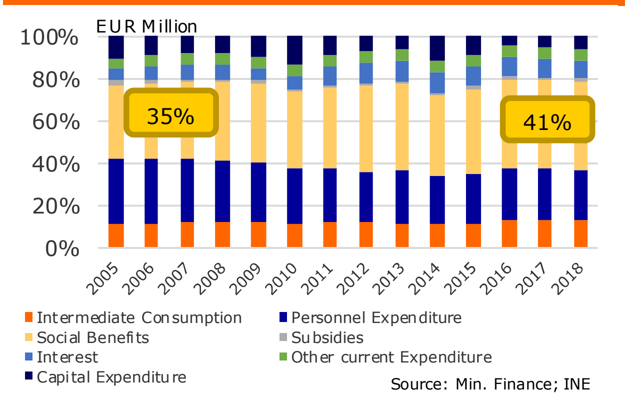
Primary Expenditure



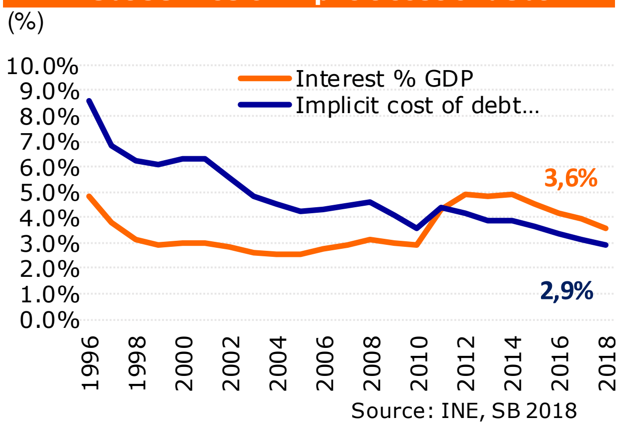
Public Administration Expenditure: Evolution



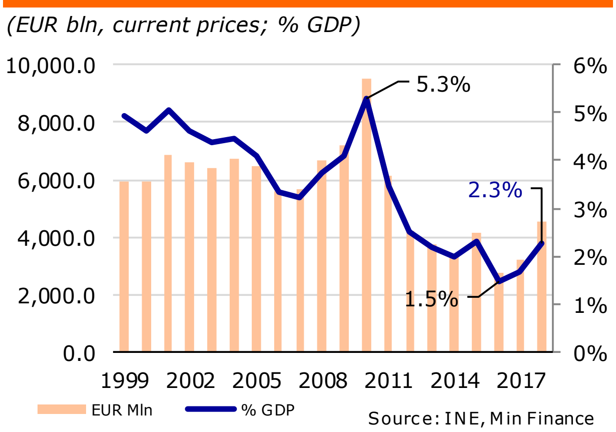
Public Administration Expenditure: Composition



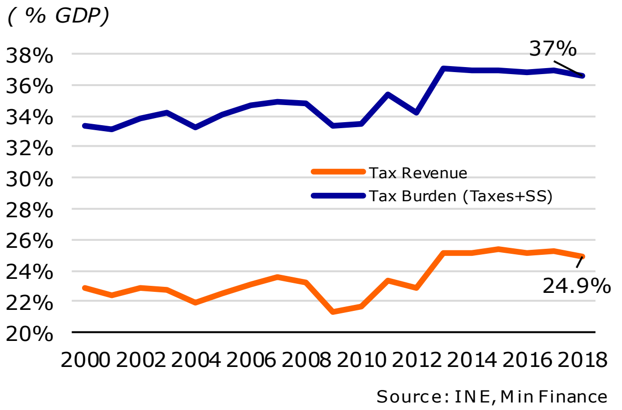
Debt service & Implicit cost of debt



Public Investment



Tax Burden has not changed much since 2012



ANNEX

Public Administration Accounts (accrual basis)

	2016 (mn EUR)	2017 E (mn EUR)	2018 SB (mn EUR)	yoy%			% GDP		
				2016	2017 E	2018 SB	2016	2017 E	2018 SB
Current Revenue	**78,909**	**82,212**	**85,364**	**2.0**	**4.2**	**3.8**	**42.6**	**42.7**	**42.8**
Fiscal revenues	46,428	48,563	49,747	1.8	4.6	2.4	25.1	25.2	25.0
Taxes on production & imports	27,347	28,880	30,166	4.9	5.6	4.5	14.8	15.0	15.1
Taxes on income & wealth	19,081	19,683	19,580	-2.3	3.2	-0.5	10.3	10.2	9.8
Social contributions	21,609	22,502	23,357	4.0	4.1	3.8	11.7	11.7	11.7
Sales	6,625	6,789	7,557	3.8	2.5	11.3	3.6	3.5	3.8
Other current revenues	4,247	4,358	4,704	-7.5	2.6	7.9	2.3	2.3	2.4
Capital Revenues	**796**	**1,296**	**1,361**	**-43.1**	**62.7**	**5.0**	**0.4**	**0.7**	**0.7**
Total Revenue	**79,706**	**83,507**	**86,725**	**1.2**	**4.8**	**3.9**	**43.0**	**43.4**	**43.5**
Current Expenditure	**79,818**	**81,717**	**83,265**	**1.0**	**2.4**	**1.9**	**43.1**	**42.5**	**41.8**
Compensation of employees	20,881	21,409	21,480	2.6	2.5	0.3	11.3	11.1	10.8
Intermediate consumption	10,418	10,772	11,256	4.2	3.4	4.5	5.6	5.6	5.6
Social benefits	35,113	36,057	37,056	1.2	2.7	2.8	19.0	18.7	18.6
Subsidies	975	1,010	1,094	-13.2	3.6	8.3	0.5	0.5	0.5
Interests	7,761	7,569	7,126	-5.5	-2.5	-5.8	4.2	3.9	3.6
Other current expenditure	4,671	4,900	5,252	1.2	4.9	7.2	2.5	2.5	2.6
Capital Expenditure	**3,552**	**4,540**	**5,493**	-53.7	27.8	21.0	1.9	2.4	2.8
GFCF	2,734	3,224	4,525	-32.4	17.9	40.4	1.5	1.7	2.3
Other capital expenditure	819	1,316	967	-77.4	60.8	-26.5	0.4	0.7	0.5
Total Expenditure	**83,371**	**86,257**	**88,758**	**-3,8**	**3,5**	**2,9**	**45,0**	**44,8**	**44,5**
Overall Balance	**-3,665**	**-2,750**	**-2,034**				**-2,0**	**-1,4**	**-1,0**

Source: Ministry of Finance

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