

Portugal 2012 Budget

The Budget is an ambitious, conservative, transparent plan. The gap in the 2011 implementation means that the task is more arduous than was thought in the spring. Furthermore, the risks of derailment have increased, in particular due to the increased risks to economic growth.

2011 accounts off-target

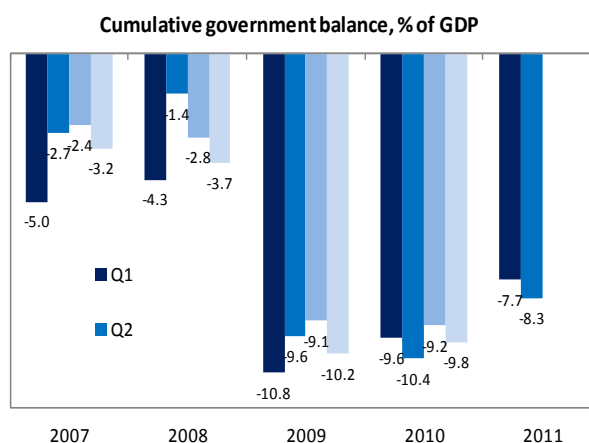
According to INE's provisional results, the Portuguese Government balance was 16 billion euro in 2010, or 9.8% of GDP. These figures, which are significantly higher than the 9.1% reported a few months ago, include Madeira's upwardly revised deficit and debt numbers, which were published over the summer. These new numbers imply that the effort to bring down the deficit in 2011 will be larger than previously thought. The agreement signed with the European Commission, the ECB and the IMF targets a deficit of just over EUR 10bn, which implies an adjustment of close to EUR 7bn, or 3.9% of GDP between 2010 and 2011.

Not only did 2011 start from a worse position, the figures available so far show that a significant gap emerged relative to the target set in May, when the government signed the memorandum of understanding with the EU Commission, the ECB and the IMF. According to the quarterly national accounts, the government balance was -7bn (8.3% of GDP) in the first semester. In order to reach the target of 10bn for 2011 as a whole, the government will need to reduce the deficit by more than half of the value in the first semester to just over 3bn in the second semester, an ambitious objective.

Data in the third quarter are mixed. Monthly cash flow data available up to August for the Central Government Social Security and Autonomous Services (Education, Health), show better-than-expected year-on-year growth in Central Government and Social Security revenues and a sharper-than-expected decline in Central Government spending. However, the data shows spending actually increased in the Autonomous services.

Overall, the Government expects that, in absence of corrective measures, the deficit would be 7.9% of GDP in 2011, a full 2 percentage points above the target of 5.9%. This gap is mostly explained by higher than expected spending (1.6% of GDP) owing to a lower reduction in the number of civil servants, the incorporation in the public accounts of the debt of two companies in Madeira, the impact of the sale of Banco Português de Negócios (BPN nationalised in 2008) and an increase in the interest paid by local authorities and public companies on their debt. The remaining 0.4% of GDP correspond to lower than expected income.

In order to correct for this gap, the Government implemented a number of one-off measures. In particular, a temporary increase in the personal income tax in 2011, which corresponds to 50% of the 14th month salary over and above the minimum wage and the transfer of the banking sector pensions to the state pension system. Moreover, the Government anticipated to 2011 the rise in the VAT tax rate of energy goods (electricity, gas,) from the intermediate to the normal rate, therefore implementing a measure that had already been approved at the European level.



Source: INE

Regardless of whether the government actually meets the deficit target of 5.9% of GDP in 2011, the temporary measures that have been implemented so far will have to be replaced in 2012, meaning the adjustment will be harder than previously expected.

Fiscal tightening close to 9% between 2010 and 2012

The significant reduction in the deficit in 2011 and 2012 is likely to have to a significant impact on activity in the next few years. The government now expects GDP with fall by 2.8% in 2012 after -1.9% in 2011, due to sharp declines in private consumption (-4.8%), public consumption (-6.2%) and investment (-9.5). The external balance is likely to support growth as exports are expected to rise moderately (+4.8%) but imports are likely to fall (-4.3%).

Against this backdrop, the government has estimated that the structural deficit (i.e. excluding one-off measures and adjusted for GDP growth) will decline by 4.4% of GDP in both 2011 and 2012, which corresponds to a cumulative fiscal tightening of close to 9% of GDP over two years. This is the first time since 1977 that such an effort is demanded of the Portuguese population.

The adjustment will come mostly from a decline in current primary spending, which is expected to fall 1.4% of GDP between 2011 and 2012, and, to a lesser degree, on a tax revenue increase of 0.9% of GDP. The table below shows the main measures on the income and spending side and their impact on the public accounts.

Table: Public accounts, 2012 Budget

	EUR mn			%GDP			Change, p.p.		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Current income	67163.8	69144.8	69712.0	38.9	40.4	41.2	0.1	1.5	0.8
Taxes	38343.4	40123.4	41245.2	22.2	23.4	24.4	0.5	1.2	0.9
Taxes on production and imports	23005.4	23922.9	25653.7	13.3	14.0	15.2	0.7	0.7	1.2
Taxes on income and property	15338.0	16200.5	15591.5	8.9	9.5	9.2	-0.2	0.6	-0.2
Social contributions	21166.3	21369.0	20235.3	12.2	12.5	12.0	-0.3	0.2	-0.5
Other current income	7654.1	7652.4	8231.5	4.4	4.5	4.9	-0.2	0.0	0.4
Capital income	4653.1	5265.9	2288.3	2.7	3.1	1.4	1.8	0.4	-1.7
Total income	71816.9	74410.6	72000.2	41.6	43.4	42.5	1.8	1.9	-0.9
Current spending	78935.4	77628.8	74368.8	45.7	45.3	43.9	-0.1	-0.4	-1.4
Intermediate consumption	8666.8	7926.1	7785.5	5.0	4.6	4.6	0.1	-0.4	0.0
Employee spending	21093.0	19859.9	16929.9	12.2	11.6	10.0	-0.4	-0.6	-1.6
Social benefits	37884.5	37243.9	35641.3	21.9	21.7	21.1	0.0	-0.2	-0.7
Subsidies	1193.3	1506.1	1666.6	0.7	0.9	1.0	-0.1	0.2	0.1
Interest	5189.8	7296.3	8823.5	3.0	4.3	5.2	0.1	1.3	1.0
Other current spending	4908.0	3796.5	3522.0	2.8	2.2	2.1	0.3	-0.6	-0.1
Capital spending	9745.0	6802.1	5188.4	5.6	4.0	3.1	1.5	-1.7	-0.9
Gross fixed capital formation	6196.8	4145.7	3593.1	3.6	2.4	2.1	0.6	-1.2	-0.3
Other capital spending	3548.2	2656.4	1595.3	2.1	1.6	0.9	0.9	-0.5	-0.6
Total Spending	88680.4	84430.9	79557.2	51.3	49.3	47.0	1.5	-2.0	-2.3
Government balance	-16863.5	-10020.2	-7556.9	-9.8	-5.9	-4.5	0.4	3.9	1.4
Current primary spending	73745.5	70332.5	65545.3	42.7	41.1	38.7	-0.2	-1.6	-2.3
Primary spending	83490.5	77134.6	70733.7	48.3	45.0	41.8	1.3	-3.3	-3.3
Primary current balance	-6581.7	-1187.7	4166.7	-3.8	-0.7	2.5	0.3	3.1	3.2
Primary balance	-11673.6	-2723.9	1266.6	-6.8	-1.6	0.7	0.5	5.2	2.3
Excluding temporary measures									
Government balance				-11.4	-7.7	-4.5	n.d.	3.7	3.2
Primary balance				-8.4	-3.5	0.7	n.d.	4.9	4.2
Ex. temp measures and growth adjust.									
Government balance				-11.4	-7.0	-2.6	-1.8	4.4	4.4
Primary balance				-8.4	-2.7	2.6	-1.7	5.7	5.3

Source: INE and Ministry of Finance, Budget 2012

Many of these measures go well beyond what was agreed in the MoU. This is the case in particular for the high profile and contentious wage cuts which correspond to a progressive reduction in 13th and 14th month of salary for civil servants with a monthly salary above the minimum wage up to their complete elimination

Main measures of the 2012 Budget	M€	%PIB
Public Administration (PA)	1487.6	0.9
Human resources	1342	0.8
Wage cuts (cuts in the 13th and 14th months' salaries)	1065	0.6
Reduction in number of civil servants (through non-replacement of personnel that leaves)	277	0.2
Rationalization of resources	145.6	0.1
PA reform	89	0.1
Further developing Centralised public procurement	40	0
Other rationalizations of AP services	16.7	0
Social Policies	2803.3	1.7
Social security	1249.4	0.7
Pension cuts	951.5	0.6
Benefit cuts	154.9	0.1
Voluntary debt restructuring	40	0
Changes to the CGA pension system	23.2	0
Changes to the ADSE pension system	79.8	0
Education, Science and Higher Education	600.1	0.4
Suppression of non-core courses in Primary schools	102.2	0.1
Rationalizing the school network (e.g. school closures)	54	0
Other rationalization measures (e.g. increasing the number of students per class)	87.8	0.1
Higher Education and Science	147.4	0.1
Other	208.7	0.1
Health	953.8	0.6
Medication policy	173	0.1
Prescription and monitoring	46	0
Rationalization of resources and expenditure control	734.8	0.4
Economic policies	1038.9	0.6
Subsidies	87.7	0.1
Non-tax revenue	28.7	0
Capital expenditure cut (including property sale)	922.5	0.5
State Business Sector	438	0.3
Transfers to Regional and Local Administrations	175	0.1
Tax measures	3711.4	2.2
Taxes on production and imports	2359.2	1.4
Rationalisation of the structure of VAT rates (incl. changes in VAT rates on energy products)	2044	1.2
Rise in excise tax rates	180	0.1
Substantial reduction of exemptions from the local property tax (IMI)	50	0
Tax evasion and fraud fighting	85.2	0.1
Taxes on income and wealth	1352.2	0.8
Cuts in benefits and tax deductions in personal and company income tax (IRS and IRC)	756.4	0.4
Temporary rise in personal income tax (IRS surcharge)	185	0.1
Cconvergence of personal tax rates for pensions to the employment income rates	115	0.1
2.5% rise in income tax for individuals in the higher personal income tax bracket	16	0
Capital gains tax rate increase to 21.5%	3	0
Company income tax temporary rise by 3 p.p. (5 p.p.) for profits above EUR1.5m (EUR10m)	187	0.1
Fight against tax evasion	89.8	0.1
Total	9041.2	5.3
Measures introduced in previous years applicable in 2012	1308.3	0.8
Wage freeze	340	0.2
Pensions' freeze	628	0.4
Changes to Law of Military Program	340.3	0.2

for salaries above EUR1000. This measure will also apply to pensioners' income. The reason for penalising civil servants more than other employees is the gap between salaries in the public sector and the private sector, relative to productivity.

On other aspects, the Government was able to negotiate with its lenders different conditions from what had been agreed. Most notably, the employer's social contributions' ("Taxa Social Única") will not be cut but will be replaced by a half-hour rise in working-day in the private sector, in order to increase competitiveness. The impact of this measure is likely to be larger in the industrial than in the services' sector.

In any case, this Budget is more austere than had been planned in the spring.

An ambitious plan, with many risks

The 2012 Budget has several advantages. First, compared to previous years, there is a clear effort to make the Government plans more transparent. This is visible notably through the effort to reduce as much as possible the gap between the Public Accounts numbers using the National accounts (responsibilities) method and the Public accounts (cash-flow) method. This will introduce a break in the cash flow series in 2012 but it will improve significantly their transparency.

Second, the Government has made an effort to break with the past in terms of identification and correction of gaps in the implementation of the budget. Indeed, the Budget report includes a detailed chapter on the 2011 gap and shows what corrective steps have already been taken.

Third, the macroeconomic assumptions are conservative, even more so than most international organisations, which reduces the possibility of having surprises in 2012.

These characteristics should make international investors and authorities more confident that Portugal will effectively reduce its deficit and improve its solvency. However, several risks remain, mostly beyond the scope of the Government's control.

The major risk comes from the impact on activity. Portugal's solvency depends crucially on increasing potential growth. The austerity measures announced in this budget are likely to have a very sharp tightening impact in 2012-2013 while the measures to support the economy, mostly structural reforms negotiated with the European Commission, the ECB and the IMF, will affect GDP only with a long delay. Furthermore, the slowdown in global activity may turn out to be sharper than currently anticipated. There is also a significant risk that the austerity measures will throw the economy into such a recession that will fuel an increase in the deficit, like what is happening in Greece. Finally, the Portuguese Republic's ability to return to the financial markets depends more of the situation in Greece and how it is solved at the European level than of the Portuguese Government's actions. The rewards from implementing this very austere programme are not clear-cut, which may reduce the Government's incentive to keep on course.

Inês Domingos