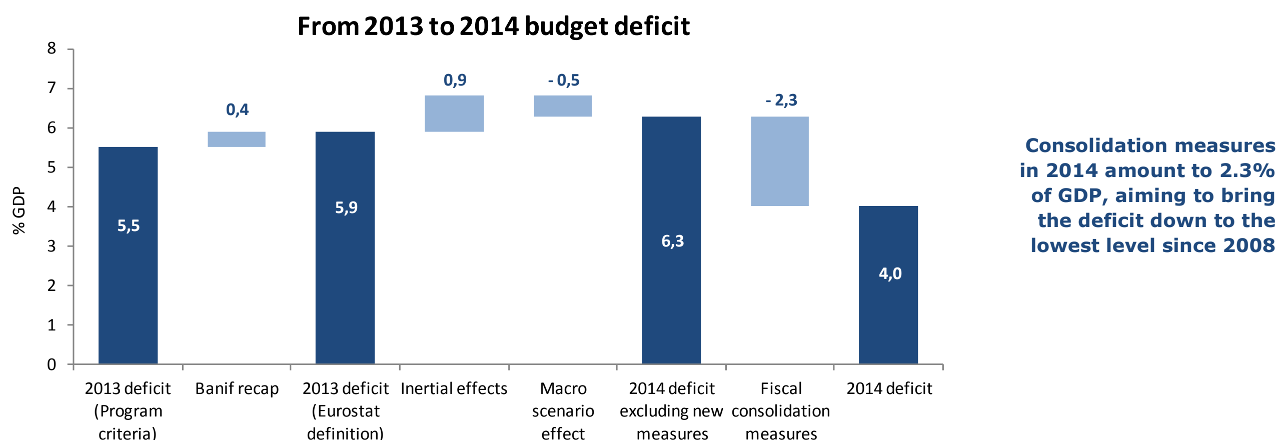
Notes from the 2014 Budget

- **Budget deficit to decrease from expected 5.9% of GDP in 2013 (5.5% according to Program's criteria, which excludes Banif recap) to 4.0% in 2014**
- **Consolidation measures amount to €3.9 bn (or 2.3% of GDP) and are mainly focused on cutting expenditure; namely, reducing public servants wage bill and pensions**
- **More than 80% of the primary balance adjustment in 2014 stems from expenditure cuts, rebalancing the process towards a more growth-friendly adjustment**
- **The corporate income tax rate is reduced by 2pp and a number of other measures are implemented in order to simplify fiscal obligations and promote investment**
- **Since the 2009 peak, the structural primary deficit has already decreased by 6.6pp and is projected to decrease another 1.0pp in 2014**
- **Financing needs net of EU-IMF loans until end-2014 are estimated at €10.7 bn and shall be funded by tapping the MLT debt market and enlarging the scope of retail instruments**

Budget measures for 2014 are over 80% based on the expenditure side

As agreed with the EU-IMF mission team, the deficit target for 2014 was set at 4.0% of GDP, an adjustment of 1.9pp relative to the 2013 deficit.



Source: Ministry of Finance.

Consolidation measures in 2014 amount to 2.3% of GDP, aiming to bring the deficit down to the lowest level since 2008

The 2013 deficit is in line with the 5.5% Program target, when excluding the capital injection of Banif (€0.7 bn; 0.4% of GDP). The overall balance according to Eurostat's definition will stand at 5.9% of GDP (excluding one-offs[1] it is estimated at 5.8% of GDP).

Fiscal consolidation measures also need to take into account the impact of PPP payments that enter into force in 2014, as well as other inertial effects. These are mitigated by a favorable macro scenario, which is projected to have a positive impact of 0.5% of GDP.

[1] One-offs comprise: (i) +0.4pp of Banif recap; (ii) -0.4pp of exceptional scheme to regularize fiscal debts; and (iii) +0.1pp of extraordinary credit to investment.

The structural adjustment is sustained by a strong contraction of primary spending, which will result in an overall primary surplus in 2014, for the first time since 1997. Also, the cyclically adjusted primary balance is estimated to be positive for the second consecutive year in 2013 and is projected to increase further to 1.5% of potential GDP in 2014.

Primary balance moving into surplus for the first time since 1997

Strong structural primary fiscal adjustment, representing 7.6pp of GDP since the trough in 2009

Fiscal indicators (% GDP)	2009	2010	2011	2012	2013	2014	2014 vs 2009
Primary balance	**-7,3**	**-7,0**	**-0,3**	**-2,1**	**-1,6**	**0,3**	**7,6pp**
Primary balance excluding one-offs	-7,3	-6,3	-3,3	-1,5	-1,5	0,2	**7,5pp**
Structural primary balance	-6,1	-5,9	-2,5	0,1	0,5	1,5	**7,6pp**
Overall balance	**-10,2**	**-9,8**	**-4,3**	**-6,4**	**-5,9**	**-4,0**	**6,2pp**
Overall balance excluding one-offs	-10,2	-9,1	-7,3	-5,8	-5,8	-4,1	**6,1pp**
Structural overall balance	-8,9	-8,7	-6,5	-4,2	-3,9	-2,9	**6,0pp**

Source: Ministry of Finance.

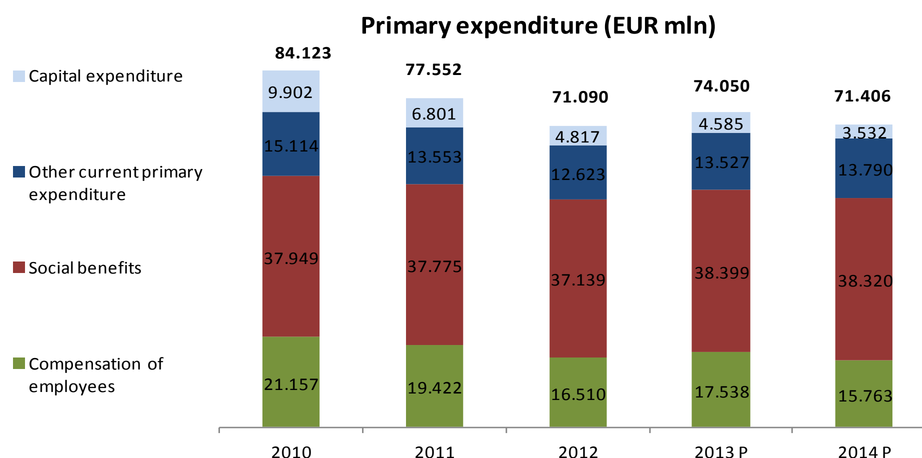
The composition of fiscal consolidation measures for 2014 is clearly tilted to the expenditure side, which accounts for more than 80% of the new measures.

The 2014 budget aims at rebalancing the adjustment towards more long-term growth-friendly measures, as expenditure reduction is the solution that simultaneously allows the accomplishment of fiscal targets and the creation of conditions for future sustainability of Portuguese public finances.

Between 2010 and 2013, and despite the setbacks introduced by some Constitutional Court's decisions, primary expenditure has declined more than €10 bn (or 3.9pp of GDP). In 2014 it is projected to decrease an additional €2.6 bn:

Primary expenditure declines €2.6 bn in 2014 (€12.7 bn since 2010)

Compensation of employees is set to decline 25% since 2010, on the back of wage cuts and a declining payroll



Source: Statistics Portugal and Ministry of Finance.

In 2014, compensation of employees accounts for the largest share in primary expenditure reduction (nearly €2 bn). Social benefits also decline, albeit a a lower pace, as pension cuts are mitigated by an increase in the number of retired and unemployed.

Capital expenditure, on the other hand, is expected to continue decreasing significantly, following the pattern of the previous 3 years, while other current primary expenditures present a slight increment in 2014. This is mainly justified by an increase of PPP payments amounting to €0.8 bn. Excluding PPPs, other current primary expenditure would decrease by about €0.5 bn.

The primary expenditure decline will allow for a gradual reduction of the tax burden moving forward. The 2014 budget already reflects this trend with an expected 0.4pp decline in total revenues-to-GDP.

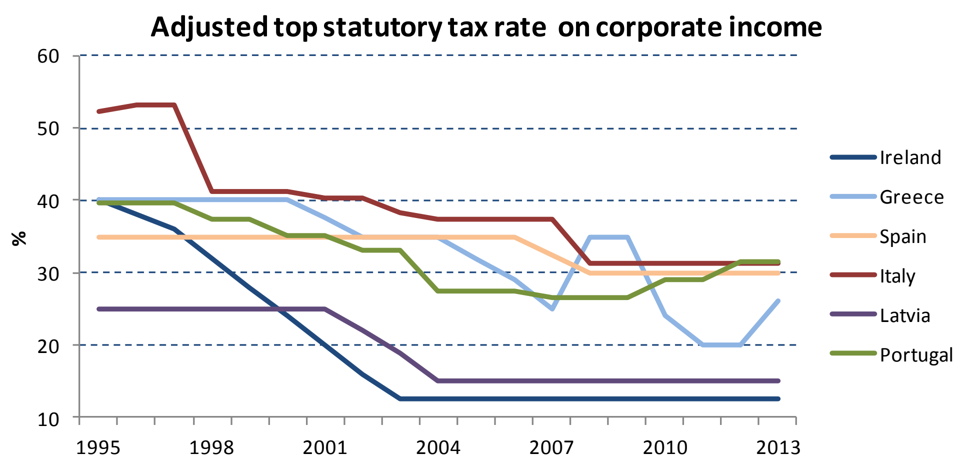
While tax revenue increases in absolute terms, in relative terms a reduction of the tax burden is expected

In fact, despite the strong fiscal consolidation effort, the **2014 budget also contemplates measures to foster growth and reduce financial constraints**.

In 2013, the Government started an in depth reform of the Corporate Income Tax aiming at attracting investment, based on three fundamental pillars:

CIT reform designed to enhance competitiveness, simplify fiscal obligations and promote investment

- Simplification of the fiscal obligations to reduce administrative burdens and introduction of a new simplified regime for SMEs;
- Promote investment, namely by introducing a new regime of fiscal incentives for reinvested profits by SMEs, allowing firms to deduct up to 10% of the investment on their taxable income;
- Enhance competitiveness, namely by reducing the base tax rate from 25% to 23% in 2014 (with the aim of bringing it lower to 17%-19% by 2016) and by eliminating double taxation on investments outside EU.



The reform foresees a gradual reduction of the tax rate (6 to 8pp until 2016), to bring it closer to other EU peers

Source: European Commission

Additionally, the Government created the VAT cash-based regime allowing SMEs to defer VAT payments until they book the receipts from customers (entered into force in October).

2014 fiscal consolidation highlights

Expenditure reduction measures

The adjustment will be focused on the expenditure side (more than 80%), with total public permanent expenditure cuts amounting to €3.2 bn. These may be divided into 3 main categories:

Expenditure cuts mainly aimed at the two largest components of public expenditure: compensation of employees (€1.3 bn) and social benefits (€0.9 bn)

- Compensation of employees (€1.3 bn):
  - Wage reduction between 2.5% and 12% applicable to all public sector employees with a monthly income exceeding €600. This measure substitutes the income reduction introduced by the 2011 Budget Law (which envisaged a cut between 3,5 and 10% for monthly incomes above €1,500) and is expected to generate an extra saving of about €643 mln;
  - 40-hour work week, reduction in the number of public servants through retirements and reduction of the payments for extra hours of work, amounting to €153 mln;
  - Mutual agreement termination program (€102 mln) and employees requalification scheme (€59 mln);
  - Structural reforms on education and other sectorial measures should allow an additional cut on the compensation of employees amounting to €363 mln.

- Social benefits (€0.9 bn):
  - Convergence between public (CGA) and private sector (SS) pension systems (€728 mln), which does not accumulate with the extraordinary solidarity contribution (*CES*) already introduced in the 2011 Budget Law (-€340 mln); the net effect is estimated at €388 mln;
  - Retirement age adjustment based on a sustainability factor. In accordance, in 2014, the retirement age will be raised from 65 to 66 years, with an impact of €205 mln;
  - Introduction of means-testing on survival pensions, with an estimated impact of €100 mln;
  - Other measures targeted to specific sectors amounting to €198 mln.

A large number of sectorial measures are also introduced, with expected savings of €1 bn

- A wide range of sectorial measures (amounting to roughly €1 bn), that resulted from the 'Public Expenditure Review' carried out in all ministries will allow a structural expenditure reduction, namely:
  - Healthcare reform and cost optimization (€207 mln);
  - Costs rationalization and processes redefinition on Security and Defense (€124 mln);
  - Reduction of SOE compensation (€90 mln);

Revenue increase measures

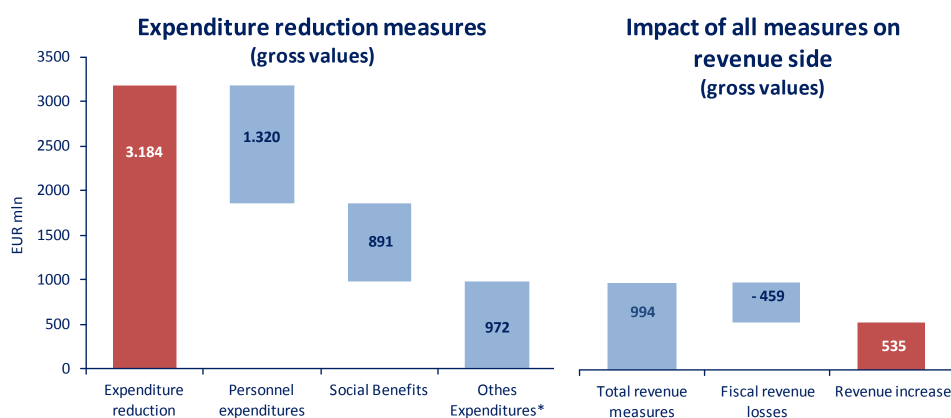
On the revenue side, the measures amount to about €1 bn:

- Increase in direct taxes amounting to €240 mln, namely by raising the autonomous taxation of the service vehicles;
- Measures on indirect taxation may raise an additional revenue of €170 mln from the increase in the taxes on diesel vehicles and on tobacco and alcohol;
- Introduction of an extraordinary contribution on the energy sector (€100 mln) and increase in the contribution of the banking sector (€50 mln);
- Increase in the civil servants contributions to the public health insurance systems, decreasing the expenditure financed through public funding (savings of €132 mln);
- Reform of the social protection regime of the self employed.

These measures are partially offset by the negative impact of the reduction on compensation of employees and social benefits. Thus the overall impact amounts to about €0.5 bn.

Measures on the revenue side cover different specific distortions in the economy

Overall, in order to bring the fiscal deficit from 5.9% to 4.0% of GDP, the 2014 budget envisages a fiscal consolidation effort amounting to €3.9 bn (or 2.3% of GDP), of which €3.7 bn have a permanent impact:



* Social benefits in kind, intermediate consumption, subsidies, investment and other current expenditure
Source: Ministry of Finance.

External accounts continue improving as the economy moves back to positive performance

The macroeconomic scenario for 2013-2014 is in line with the projections presented in the 8th and 9th reviews of Economic Adjustment Program.

GDP is projected to contract 1.8% in 2013, an upward revision of 0.5pp compared to previous projections, justified by stronger exports (+5.8% vs 0.8%) and a slower decline of private consumption (-2.5% vs -3.2%).

GDP revised upwards in both 2013 and 2014

Macroeconomic scenario					
	2012	2013		2014	
		Apr-13	2014 budget	Apr-13	2014 budget
Real GDP (yoy %)	**-3,2**	**-2,3**	**-1,8**	**0,6**	**0,8**
Private consumption	-5,4	-3,2	-2,5	0,1	0,1
Public consumption	-4,7	-4,2	-4,0	-3,1	-2,8
GFCF	-14,3	-7,6	-8,5	2,5	1,2
Exports	3,2	0,8	5,8	4,5	5,0
Imports	-6,6	-3,9	0,8	3,0	2,5
Current+Capital account (% GDP)	**0,2**	**1,4**	**2,3**	**2,0**	**3,5**
Goods	-4,7	-3,1	-2,6	-2,5	-1,7
Current account	-1,9	-0,3	0,5	0,5	1,9
Capital account	2,1	1,7	1,8	1,5	1,5
Unemployment (% labor force)	**15,7**	**18,2**	**17,4**	**18,5**	**17,7**
GDP deflator (yoy %)	**-0,3**	**1,8**	**1,9**	**1,3**	**0,9**

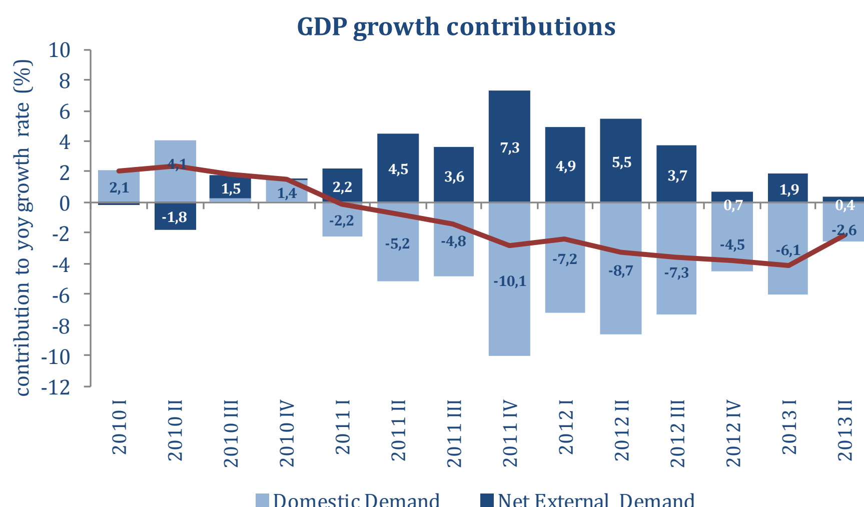
Source: Ministry of Finance (Budgetary Strategy Document, Apr-13 vs 2014 Budget).

For 2014 a significant slowdown in the decline of domestic demand is expected …

… while exports positive performance should continue to support GDP growth, on the back of an improved external environment

In 2014 GDP is expected to grow at 0.8% (0.2pp higher than previously anticipated), driven by a stabilization of private consumption, combined with yet another year of positive, though decreasing, contribution of net external demand (from 1.9pp in 2013 to 1.1pp next year).

The revised macro scenario reflects early signs of recovery in economic activity. In 2013Q2, real GDP registered a yoy change of -2.1% (-4.1% in Q1). The slowing pace of GDP contraction in Q2 was due to the less significant negative contribution of domestic demand (from -6.1pp in Q1 to -2.6pp), driven mainly by the less pronounced decrease of investment, particularly in construction.



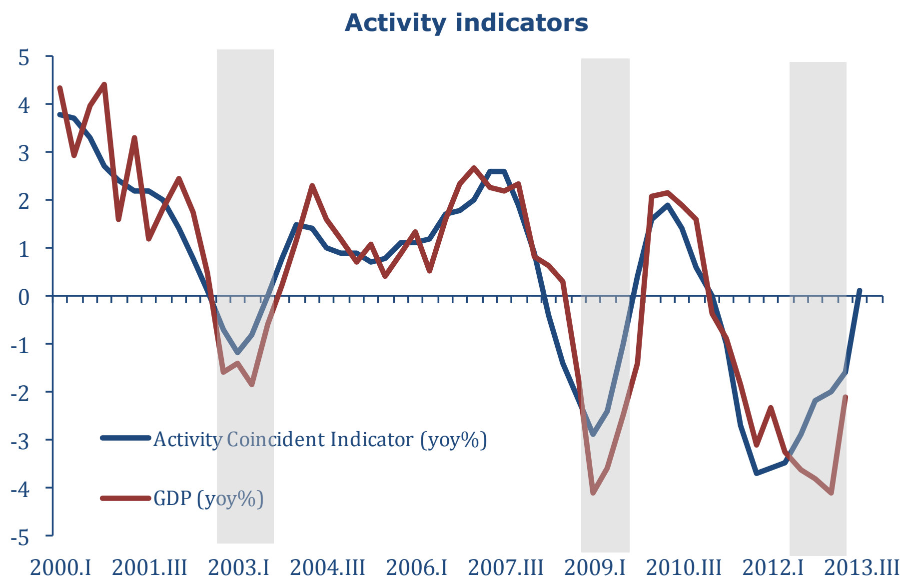
Source: Statistics Portugal

GDP came out of 10 consecutive quarters of recession with a strong 1.1% qoq growth rate in Q2

Comparing with the previous quarter, the economy grew 1.1% (-0.4% in Q1), the strongest GDP qoq growth among EU countries.

The coincident indicator of economic activity maintains a positive trend, increasing from a yoy change of -2.0% in Q1 to 0.1% in September, the first positive figure since March 2011. As shown below, GDP usually lags the activity coincident indicator at the inflexion point following a recession, but it consistently converges once recovery gains traction, suggesting yoy GDP growth rates will maintain a positive trend moving forward.

Confidence and coincident indicators signal a gradual economic recovery

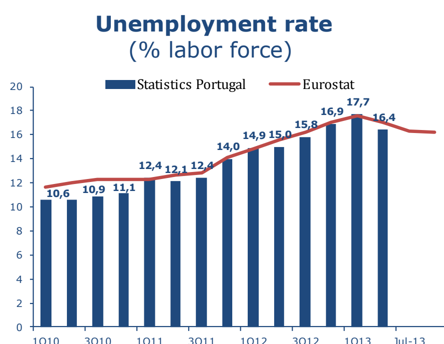


Source: Statistics Portugal and Banco de Portugal

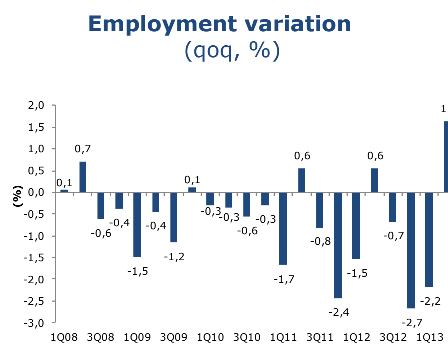
Labor market is also showing early evidence of stabilization

The labor market also showed evidence of an early stabilization in Q2, with the unemployment rate decreasing from 17.7% in Q1 to 16.4%. The employed population increased by 72k (or 1.6%) from the previous quarter. This quarterly change, the strongest since the beginning of the series in 1998, came mostly from an increase in the agriculture, forestry and fishing sectors, as well as in the services sector.

More recently, Eurostat estimates that the seasonally-adjusted unemployment rate stood at 16.5% in August, declining for the sixth consecutive month.



Source: Statistics Portugal and Eurostat



Source: Statistics Portugal

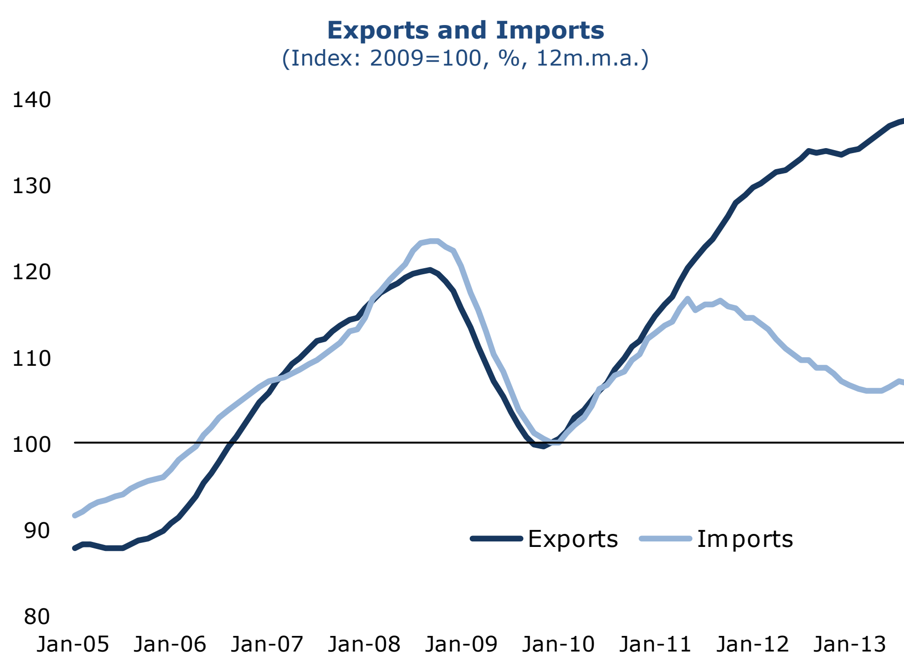
Nevertheless, the scenario agreed during the 8th and 9th reviews mission still estimates an increase of the unemployment rate over the next year (from 17.4 to 17.7%), a downward revision of 0.8pp when compared with previous forecasts: 18.2 and 18.5%, respectively.

The strong external adjustment observed since early 2010 has been prominently explained by a sustained recovery of exports of both goods and services, which increased by more than 30% between 2009 and 2012 in nominal terms.

While the pace of this recovery had slowed down in late 2012 and early 2013, partly as a result of temporary effects such as strikes in most relevant ports, figures reported since April suggest a further revival of exports growth.

After some stabilization in the 2nd half of 2012, exports have picked up again in the 1st half of 2013

Exports and Imports
(Index: 2009=100, %, 12m.m.a.)



Source: Banco de Portugal

The external adjustment continues to gain traction at a good pace. The combined surpluses of the current and capital accounts should improve further from 0.2% of GDP in 2012 to 2.3% this year and to 3.5% in 2014 (about 1pp of GDP higher than previously expected).

Moreover, the new estimate for the current account confirms the expectation of a surplus already in 2013, amounting to 0.5% of GDP, followed by further improvement to 1.9% in 2014.

State borrowing needs for 2014 to be financed by PGB and retail issuance

Market financing through 2013 has mainly served to pre-finance 2014 borrowing needs

The estimated borrowing needs for 2013 are fully covered and the State Treasury cash position is expected to stand above €13 bn at year-end.

Net financing needs for 2014 are projected at €11.8 bn, which together with remaining MLT debt redemptions of about €13.8 bn (part of the PGB maturing next year have already been bought back), place the total borrowing needs for next year above €25 bn.

	2012	2013 E	2014 P	2015 P	2016 P	2017 P
State borrowing requirements	**34,5**	**19,6**	**25,5**	**20,4**	**14,8**	**11,1**
Net financing needs	**18,0**	**13,4**	**11,8**	**5,4**	**2,2**	**-1,1**
Overall deficit *	8,9	8,9	7,4	4,3	2,1	0,4
Private sector banks' recapitalizations	4,5	1,1				
Other acquisitions of financial assets **	6,8	4,7	4,5	1,1	0,1	-1,5
Privatizations (-)	-2,2	-1,3	-0,1	0,0	0,0	0,0
MLT Redemptions	**16,5**	**6,2**	**13,8**	**15,0**	**12,5**	**12,2**
Tbonds	16,5	6,2	13,8	14,5	9,9	8,6
IMF				0,5	2,6	3,6
State financing sources	**34,5**	**19,6**	**25,5**	**20,4**	**14,8**	**11,1**
Use of deposits	**-2,7**	**1,6**	**7,0**	**0,0**	**0,0**	**0,0**
Financing in the year	**37,2**	**18,0**	**18,5**	**20,4**	**14,8**	**11,1**
EU-IMF	27,5	10,0	7,9			
Tbonds (incl exchange offer)	3,6	5,4				
Tbills (net)	5,3	2,4				
Retail debt (net)	-1,6	0,5				
Other (net)	2,4	-0,4				
Additional financing needs	-	-	10,7	20,4	14,8	11,1
Total additional financing needs 2014-17						**57,0**
State Treasury cash position at year-end	**15,0**	**13,4**	**6,4**	**6,4**	**6,4**	**6,4**
of which: deposits for bank recap	3,5	6,4	6,4	6,4	6,4	6,4

** State sub-sector cash deficit in 2012-14. Projection for GG deficit in 2015-17 (Budgetary Strategy Document, Apr 2013).*
*** Includes refinancing of other public entities within General Government (namely SOEs and regions), which do not translate into higher GG debt. It also includes CGD recap, BPN resolution, ESM participation, and redemption of CoCos.*

Additional borrowing needs estimated at close to €11 bn

Importantly, the financing plan makes no use of the amount of €6.4 bn earmarked for bank recap

Roughly 60% of the 2014 borrowing needs are covered by current cash balances (€7.0 bn) and scheduled EU-IMF disbursements (€7.8 bn).

PGB issuance may be around €10 bn, including exchange offers

Additional financing needs (€10.7 bn) shall be mainly financed by PGB issuance, including exchanges, syndicates and the reintroduction of regular auctions.

The financing plan will be complemented by other instruments, in particular targeting domestic investors, in order to benefit from the strong improvement in household savings.

New retail instrument (GDP-linked) was designed to complement the traditional Savings Certificates and to attract investors with lower liquidity constraints

On October 31, IGCP will launch a new 5-year retail instrument (*Treasury Certificates Savings Plus*), which has a fixed return and an additional premium linked to GDP performance in the 2 years prior to maturity, with the objective of broadening the domestic investor base. In recent months, the issuance of Saving Certificates (retail instruments indexed to short-term rates) has accelerated markedly, with net issuance of about €100 mln/month.

Annex 1: General Government Account (accrual basis)

General Government Account (accrual basis)							
(EUR mln)	2009	2010	2011	2012	2013	2014	2014 vs 2013 *
Total revenue	**66.728**	**71.991**	**77.043**	**67.574**	**71.460**	**71.936**	**0,7%**
Current revenue	65.481	67.079	69.229	65.077	69.518	70.089	0,8%
Current taxes on income and wealth	15.146	15.222	16.882	15.272	18.494	18.679	0,3%
Taxes on production and imports	21.487	23.040	23.499	22.539	21.930	22.562	0,9%
Social contributions	21.032	21.270	21.048	19.135	19.867	19.570	-0,4%
Other current revenue	7.815	7.548	7.801	8.130	9.227	9.277	0,1%
Capital revenue	1.247	4.912	7.814	2.497	1.942	1.847	-0,1%
Total expenditure	**83.874**	**89.019**	**84.423**	**78.244**	**81.238**	**78.730**	**-3,1%**
Current expenditure	77.186	79.116	77.622	73.427	76.653	75.198	-1,8%
Social benefits	37.009	37.949	37.775	37.139	38.399	38.320	-0,1%
Compensation of employees	21.399	21.157	19.422	16.510	17.538	15.763	-2,2%
Interest	4.812	4.896	6.871	7.154	7.189	7.324	0,2%
Intermediate consumption	8.411	8.942	7.903	7.400	7.864	7.758	-0,1%
Subsidies	1.259	1.283	1.221	1.009	1.212	1.272	0,1%
Other current expenditure	4.296	4.889	4.429	4.215	4.452	4.760	0,4%
Capital expenditure	6.688	9.902	6.801	4.817	4.585	3.532	-1,3%
Gross fixed capital formation	5.251	6.577	4.469	2.481	3.085	3.004	-0,1%
Other capital expenditure	1.437	3.325	2.332	2.336	1.500	529	-1,2%
Overall balance	**-17.146**	**-17.028**	**-7.380**	**-10.669**	**-9.778**	**-6.793**	
Memo items							
Primary expenditure	**79.062**	**84.123**	**77.552**	**71.090**	**74.050**	**71.406**	
Primary balance	**-12.334**	**-12.132**	**-509**	**-3.515**	**-2.590**	**531**	

* Change of total revenues/expenditures and contribution of each item to total variation.

Source: Ministry of Finance.

General Government Account (accrual basis)							
(% GDP)	2009	2010	2011	2012	2013	2014	2014 vs 2013
Total revenue	**39,6%**	**41,6%**	**45,0%**	**40,9%**	**43,2%**	**42,8%**	**-0,4pp**
Current revenue	38,9%	38,8%	40,5%	39,4%	42,0%	41,7%	-0,4pp
Current taxes on income and wealth	9,0%	8,8%	9,9%	9,3%	11,2%	11,1%	-0,1pp
Taxes on production and imports	12,7%	13,3%	13,7%	13,7%	13,3%	13,4%	0,2pp
Social contributions	12,5%	12,3%	12,3%	11,6%	12,0%	11,6%	-0,4pp
Other current revenue	4,6%	4,4%	4,6%	4,9%	5,6%	5,5%	-0,1pp
Capital revenue	0,7%	2,8%	4,6%	1,5%	1,2%	1,1%	-0,1pp
Total expenditure	**49,8%**	**51,5%**	**49,3%**	**47,4%**	**49,1%**	**46,8%**	**-2,3pp**
Current expenditure	45,8%	45,8%	45,4%	44,5%	46,4%	44,7%	-1,6pp
Social benefits	22,0%	22,0%	22,1%	22,5%	23,2%	22,8%	-0,4pp
Compensation of employees	12,7%	12,2%	11,3%	10,0%	10,6%	9,4%	-1,2pp
Interest	2,9%	2,8%	4,0%	4,3%	4,3%	4,4%	0,0pp
Intermediate consumption	5,0%	5,2%	4,6%	4,5%	4,8%	4,6%	-0,1pp
Subsidies	0,7%	0,7%	0,7%	0,6%	0,7%	0,8%	0,0pp
Other current expenditure	2,5%	2,8%	2,6%	2,6%	2,7%	2,8%	0,1pp
Capital expenditure	4,0%	5,7%	4,0%	2,9%	2,8%	2,1%	-0,7pp
Gross fixed capital formation	3,1%	3,8%	2,6%	1,5%	1,9%	1,8%	-0,1pp
Other capital expenditure	0,9%	1,9%	1,4%	1,4%	0,9%	0,3%	-0,6pp
Overall balance	**-10,2%**	**-9,9%**	**-4,3%**	**-6,5%**	**-5,9%**	**-4,0%**	**1,9pp**
Memo items							
Primary expenditure	**46,9%**	**48,7%**	**45,3%**	**43,1%**	**44,8%**	**42,5%**	**-2,3pp**
Primary balance	**-7,3%**	**-7,0%**	**-0,3%**	**-2,1%**	**-1,6%**	**0,3%**	**1,9pp**

Source: Ministry of Finance.

Annex 2: Calendar of upcoming benchmark events

Upcoming events	
Date	**Event**
Oct 2013	Final vote on redraft of requalification mechanism *
Nov 1, 2013	General vote on 2014 budget
Nov 2013	Final vote on pension schemes convergence law *
Nov 26, 2013	Final vote on 2014 budget *
Nov 2013	12th EU-IMF review of Irish Program (with expected definition of exit mechanism)
Nov-Dec 2013	10th EU-IMF review

* Upon receiving the approved law, the PR has 8 days to possibly request the CC preventive assessment. If requested, the CC has 25 days to announce a decision.
Once a law enters into force, the PR or at least 10% of members of Parliament may request the CC successive assessment, for which there is no specific deadline for the CC decision.

Budget report and official presentation (in Portuguese):

- http://www.dgo.pt/politicaorcamental/Paginas/OEpagina.aspx
- http://www.portugal.gov.pt/pt/os-ministerios/ministerio-das-financas/mantenha-se-atualizado/20131015-mef-oe-2014.aspx

Further information on the Portuguese economy can be obtained from:

- **Ministry of Finance** www.portugal.gov.pt/en/the-ministries/ministry-of-finance
- **Banco de Portugal** www.bportugal.pt
- **Statistics Portugal** www.ine.pt
- **Portugal Economy Probe** www.peprobe.com

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