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MINISTRO DAS FINANÇAS

Lisbon, 27.10.2016

M. Valdis Dombrovskis
Vice-President of the European Commission

M. Pierre Moscovici
Member of the European Commission

Portugal's Draft Budgetary Plan (DBP) for 2017 was submitted to the European Commission on the 17th of October, following thorough exchanges between my cabinet and EC services. I welcome this constructive approach.

Following your letter on the 25th of October, additional contacts were made. These contacts confirmed the issues on the DBP that deserved further clarification to guarantee the robustness of the Plan.

The additional exchange of technical data between my cabinet and the European Commission services has already taken place. In this letter, I present to you further information to reduce the discrepancies between the budgetary exercises.

The budgetary plan for 2017 puts forward a substantial consolidation effort and is fully compliant with the goals and objectives of the Stability and Growth Pact.

The Portuguese economy faces significant domestic and external challenges to the materialization of its potential growth. At the domestic level, the stabilization of the financial sector was initiated as soon as our Government took office, requiring time to be transmitted to the real economy. Additionally, current and past structural reforms are still maturing – to different degrees – but constitute the seeds to future growth. On the external front, the deceleration of global growth and the severe economic crisis in important export markets for Portuguese goods and services have temporarily slowed down our recovery path.

As a consequence, the gap between potential and actual growth in Portugal diminished in the course of 2016. The cyclical and structural factors aforementioned, namely, the banking sector stabilization, the structural reforms and the global economy slowdown, do not grant a downward revision of potential growth. The still high unemployment and the very subdued price dynamics point to the persistence of a substantial negative output gap. In fact, the stabilization of the financial sector and the materialization of structural reforms should materialise in an upward revision of potential output.

The external demand slowdown is of a cyclical nature and, therefore, is a demand side effect that does not impact the potential output of the Portuguese economy. Since April, when the Stability Programme was submitted and accepted by the European Commission, no event contributed to a downward revision of our potential output. The mechanical estimation of a latent variable using a statistical algorithm, which ignores the nature of the policies and events unfolding, leads to downward biased estimate of the Portuguese potential output. This incorrect

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estimate has significant policy implications for the evaluation of the Portuguese public finances stance.

Below, I address the specific issue raised in your letter, namely the assumptions underlying the projection of tax revenues and social security contributions and transfers. Please note that the request for updated tax outturn up until September had been shared with the EC services on October 21st. Finally, we also clarify the mechanisms behind the tax settlement scheme and specify its expected outcome.

Tax revenue

Overall, tax revenue is expected to increase 2.9% in 2017, below nominal GDP growth. As it is made clear in the technical exchanges with the EC services, the assumptions are extremely conservative. To mention only two examples that have upsides for our 2017 tax forecast: the corporate income tax (CIT) and the tax settlement scheme.

The CIT forecasts for 2016 and 2017 consider a revenue of EUR 125M/year due to the asset revaluation scheme introduced in the 2016 state budget. Although we only have preliminary figures, these already exceed the annual forecast by several millions. This amount will also affect the 2018 forecast, because the asset revaluation scheme is spread evenly over a 3-year period.

The assumptions underpinning the tax settlement scheme (TSS) are also very conservative. Back in 2013, the Government announced an extraordinary two-month period for the payment of tax and social security overdue debts, including "unknown debts" pertaining to previously undeclared income and other taxable operations. In this short period and without the benefit of an instalment scheme, the measure raised EUR 1 230M. In our forecast, we are considering a revenue stream of EUR 100M per year. If we consider that the average payment period is 10 years and that there is an upfront payment of 8%, this would amount to EUR 1 090M, well below the 2013 value. This is an obvious underestimation because taxpayers can spread the financial effort over up to 150 months, they are paying already declared taxes and it makes them eligible to apply for investment funding. Moreover, we are not considering in this estimate the positive effects generated by the increase in corporate investment.

Social Security

The Social Security forecast is also based on solid grounds with the strong developments from the labor market. We expect an increase in the surplus of the Social Security balance. Contributions are expected to increase at the same rate as in 2016. This is explained by a solid increase in salaried employment and a moderate increase in wages. The expenditure in unemployment benefits is expected to decrease 6.7%, less than half the rate of observed, thus far, in 2016, -14.5%. This is a conservative estimate as we project a reduction of unemployment that is similar in both years. Other expenditure items evolve according to policy decisions (e.g. pensions) and demographic trends. Recent developments have a positive impact on the economy such as the increase in the fertility rate, but increase the expenditure on parenthood leave and childhood benefits.

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The Portuguese Government reaffirms its commitment to meet the targets recommended in the Council Decision of the 2nd of August with the aim of abrogating the excessive deficit procedure by 2016. In 2017, the government will continue to ensure a sustainable fiscal consolidation in a socially inclusive and growth-friendly manner.

Yours sincerely,

Mário Centeno

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Finance Minister

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