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ISSUER COMMENT

Portugal: Constitutional Court Decisions Complicate Fiscal Consolidation Path

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Summary

Portugal's 2014 fiscal target still on track, but court's rulings raise question marks about expenditure-focused consolidation strategy thereafter

On 30 May, the Portuguese Constitutional Court deemed unconstitutional three fiscal measures contained within the government's 2014 budget worth an estimated €500 million (0.3% of 2014 estimated GDP).[1]

The Court's decisions are not unexpected as it was not the first time that the country's Supreme Court rejected budgetary measures[2]. The government indicated that it might have to resort to tax increases, but will await the Constitutional Court's rulings on two further budgetary measures before it announces alternative initiatives.

Despite the decision, we believe this year's fiscal target of 4% of GDP for the general government – which was agreed with Portugal's international lenders – to remain achievable. Our view is driven by (1) the limited fiscal impact of the rejected measures in 2014; (2) the better than expected starting point for this year's budget, given that last year's budget deficit outperformed targets by around 1% of GDP[3]; (3) the fact that economy is expected to outperform growth forecasts at the time of the budget formulation in October 2013; and (4) the government's strong commitment to fiscal consolidation.

At the same time, the court's decisions clearly complicate the fiscal consolidation task. Given the high level of expenditure and the steep tax increases already implemented in the past few years, we believe that it will be difficult to materially and consistently reduce the budget deficit in the coming years if the government is unable to address its key spending areas. Our Ba2 government bond rating for Portugal is currently on review for upgrade, pending the government's response to the court's ruling and our assessment of the country's medium-term fiscal prospects.

1 The measures rejected by the constitutional court are (i) cuts to public sector salaries of more than €675 a month; (ii) changes in the way widows' and widowers' pensions are calculated; and (iii) levies on sickness pay and unemployment benefit. A fourth measure, relating to pension complements at specific state-owned enterprises (budgetary impact of €6 million) was upheld.

2 The recent Constitutional Court decision is the fifth adverse ruling on fiscal measures since mid-2012.

3 See Issuer Comment Portugal Comfortably Meets 2013 Budget Deficit Target, a Credit Positive

2014 budget deficit target remains achievable despite court rulings...

We believe that despite the negative rulings the 2014 budget deficit target of 4% of GDP (2013: 4.9% of GDP) should be achievable. Firstly, the rejected measures will not be reinstated for the past months but only apply for the remainder of the year. The Portuguese authorities estimate the overall impact of the rejected measures on the 2014 budget performance at close to €500 million (0.3% of 2014 estimated GDP), compared to their full-year impact in the 2014 budget of €800 million. Secondly, the starting point for this year's budget has improved significantly following the outperformance last year, when the general government deficit was €1.7 billion (1% of GDP) lower than targeted.

Thirdly, the economy is performing more strongly than expected in the 2014 budget; i.e., the budget was based on real GDP growth of 0.8%, while our current forecast assumes a growth rate of 1%. Indeed, the budget execution for the first four months of the year points to a reasonably strong revenue performance (+4.4% year-on-year compared to assumption of +1.7% underlying the budget). Spending has also been kept under tight control over the same period (+0.8% compared to last year).

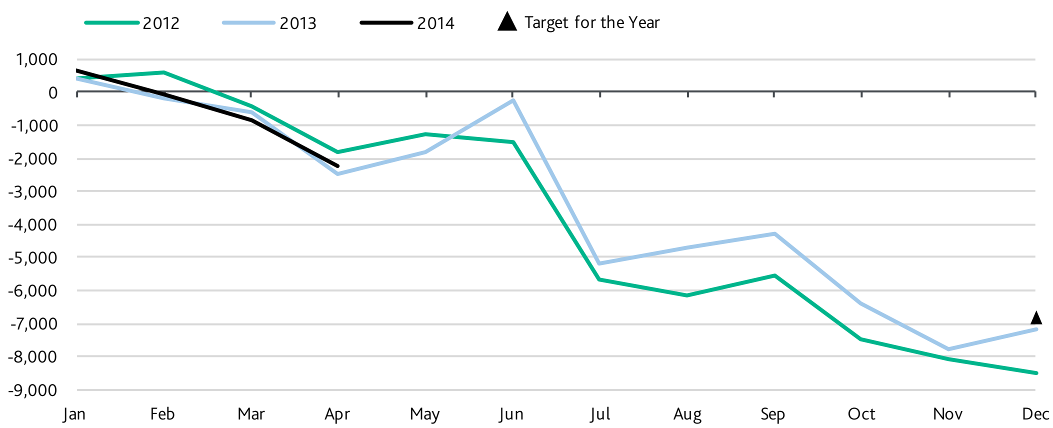
Lastly, as in past rulings, the court's main objection relates to the "proportionality" and "fairness" of the measures, meaning the government could to introduce alternative measures or tone down and amend those that had previously been rejected. We consider the commitment of the government to fiscal consolidation to be very strong.

The Constitutional Court is expected to rule on two further measures contained within the 2014 budget, the combined full-year impact of which are estimated at €200 million. The timing of these decisions is unclear, and the government indicated that it would wait for these rulings before presenting alternative measures. The government has also asked the court for clarification on the boundaries of accepted measures, although it is unclear whether it will do so.

EXHIBIT

Budget Execution On Track So Far In 2014

(€ Million, cumulative)



Source: Ministry of Finance, Moody's

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.. but targets for 2015 and beyond have become more uncertain

According to the government's recently published medium-term fiscal strategy, achieving its 2015 deficit target (2.5% of GDP) will require additional fiscal measures of around 0.8% of GDP (€1.4 billion), assuming full implementation of the 2014 measures. Following the court's decision, the government indicated that it might have to resort to tax increases to compensate for the impact of the rulings. While this underlines the government's commitment to reducing the fiscal deficit further, further tax rises also carry risks for the still fragile economic recovery.

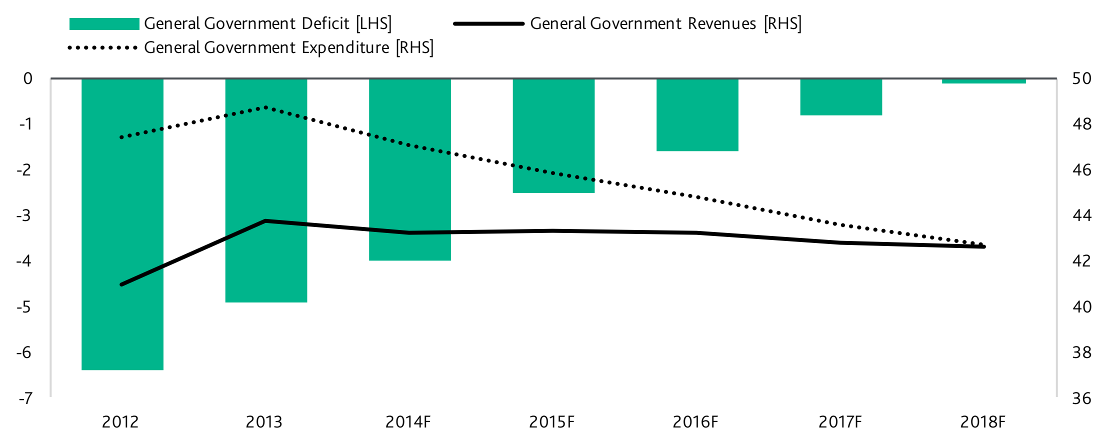
Over the longer term, the court's decisions raise question marks over whether the planned fiscal consolidation path – achieving a balanced budget by 2018 – can be achieved if important spending categories cannot be reduced. Given the elevated levels of expenditure – at around 49% of GDP in 2013 – and the significant tax increases implemented in 2013, the government has shifted the focus towards adjusting the size of the public sector and its overall spending levels. The public-sector wage bill and pensions are among the largest expenditure items, accounting for around 60% of total general government spending and 67% of government revenues (as of 2013). The court rulings render such an expenditure-focused fiscal consolidation strategy more difficult.

At the same time, we acknowledge that the court's objections mainly relate to the 'proportionality' and 'fairness' of the measures. This leaves the door open for the government to come up with alternative measures or amend those that have been rejected, which the government has done in similar circumstances in the past.

EXHIBIT 2

Consolidation Efforts To Rely Mostly on Expenditure-Side Measures

% of GDP



Source: Haver-Eurostat, Ministry of Finance, Moody's

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