12. The State Budget.

Summary

This chapter clarifies the concept and scope of the State Budget, budget rules or principles and of the budget cycle, since it is prepared by the government until the approval of the State Account. The State Budget (OE) is an Act of Parliament (P), reflecting the government's draft law, which contains an estimate for of all revenues and expenditures of the State, Autonomous Funds and Services (AFS), and Social Security (SS), authorized by the Parliament for a period of one calendar year. It is a document that has important economic, legal and political dimensions. It shows government's policy priorities for a given calendar year. The State Budget Statute includes an annex with maps showing a breakdown of revenues and expenditures of those three sub-sectors. Accompanying the draft State Budget Statute the government must also deliver a report to inform Parliament of the nature and fiscal policy options followed, as well as relevant information on macro-economic forecasts underpinning the budget.
Excluded from the State Budget are the Budgets of the Autonomous Regions (Azores and Madeira) and municipalities, which are independent of it. Nevertheless included in the State Budget are transfers from the State to the Regions and Municipalities, under the regional and local finance acts. The preparation of the Budget obeys a set of rules, with appropriate exceptions. According to the rule of the *annual budget,* it is approved every year and covers one financial year. Exceptionally there may be a revised budget if during the course of the year the government reaches the expenditure threshold on some urgent expenditures (such as medicines for hospitals). The *unity and universality rule* (or completeness) indicates that the budget document is unique and that all revenues and expenditures of State entities (the three sub-sectors listed) are inscribed on it. The *non-earmarking rule*, states that all revenues must be used to fund all expenditures. However, there are exceptions. Own revenues of Autonomous Funds and Services (e.g. University fees, Hospitals' urgency fees) are earmarked to the respective AFS. The *non-compensation rule* (or gross principle) requires that revenue and expenditure must be registered by their gross basis without deducting any expenses in collecting revenue or income associated with the implementation of expenditure. The *specification rule* states that the Budget must specify in detail the revenues, according to an economic classification and organic (for ASF), and expenditure according to economic, organic and functional classifications. Both may also be classified into programs. The *economic classification* used in the three sub-sectors distinguishes between current and capital revenues and expenditures, both subdivided into multiple categories. It is this classification that allows an economic analysis, including the calculation of current, capital, global (or actual) and primary balances. The *organic classification*, used for revenue classification for the AFS and expenditure classification in the three State sub-sectors, provides information oin revenues and expenditures of each bureau and agencies of the State. Thus each department (Ministries, Public Institutions, etc.) know the maximum amount of expense authorized. The *functional classification* corresponds to the breakdown of government expenditure by function and sub-functions (sovereign functions, social function, economic and other) and gives a perspective on the financial implications of the political priorities of government.
The equilibrium rule, applied to the State Budget, is expressed in the Constitution of the Portuguese Republic (PRC) and determines that total revenue (including financial and non financial revenues) must cover total expenditure. In a sense it is correct that a budget is always balanced as there must be revenue to finance expenditure. However, it is important to distinguish between effective revenues and expenditures (non-financial) from financial revenues and expenses (from changes in assets and liabilities). In particular, income from financial liabilities (credit) give rise to future obligations (amortization) while effective revenues (e.g. tax revenues) do not. Thus, when referring to the existence of a budget deficit it is only in relationship with certain types of income. The overall balance, expresses the difference between effective (non financial) revenues and expenses and may be in deficit, balance or surplus. The stability and growth pact of the EU (see Chapter 15) provides that the budget deficit must be less than 3% of GDP. The Budget Framework Law (LEO)

provides that, in general, the *primary balance* of the State, and *global balances* of AFS and Social Security must be, at least, balanced.
The budget cycle has essentially four phases. The preparation of the Budget Proposal; the discussion and approval in Parliament; its implementation and monitoring; and finally the preparation, review and vote of the State Accounts. The preparation of the budget is a process of intensive technical and political activity that should be finished no later than 15th October, the deadline for government submission of Budget Proposal in Parliament. It involves necessarily the preparation of a macroeconomic scenario with forecasts for inflation, economic growth, unemployment (etc.), setting targets in relation to the overall budget balance, revenue forecasting, determination of ceilings for expenditures, both overall and for policy areas (Ministries), the preparation of the budgetary report, the classification of expenditures and revenues according to the classification systems refered to above, and finally the articles of the Budget Statute.
After approval by the Council of Ministers the Draft Budget Proposal enters the Parliament.
The process of discussion and approval of the Budget is regulated by the Portuguese Constitution, the Budget Framework Law, and the Rules of the Parliament. It should take place within 45 days after the deadline for submission, and discussion is done either in Plenary Session, where all the Members sit, or in the Permanent Committee responsible for evaluation of the bill. The Parliament's plenary session make a full discussion and approval of the State Budget, as well as specialized discussion and vote on issues respecting the matters relating to the tax system (creation / extinction of taxes, change fees, etc.). or borrowing. In the parliamentary committee responsible for discussion and approval of the Budget are discussed and voted all remaing articles of the Budget Law, and a report is done.
The *implementation* of the Budget, ie collecting revenues and making expenditures is the responsibility of government. In practice, it competes directly to Ministers, Secretaries of State Directors of the State sub-sector and the ASF. The payment of expenditure must respect the principle of legality (the respected legal framework), to be regularly appropriated (to be predicted and within the budget predicted value) and sound financial management. This means that stated expenditures are ceilings that cannot be surpassed. The raising of revenues requires only the principles of legality and regularity, which means being predicted in the Budget, but the actual amount of revenues may exceed the budget forecasts.
Budgetary control takes many forms. Administrative control is done primarily by their own administrative bodies, the Ministry of Finance (General Inspectorate of Finance and Directorate General of Budget) and inspections of each ministry. Judicial review is conducted by the Court of Audits, a sovereign body independent of political power that does audits for public sector administration and the public corporate sector. Political control is done by parliament, where the government is particularly scrutinized by the opposition parties.

13. Fiscal Policy

Summary

This chapter discusses the fiscal policy (FP), ie the use of the budget as a means to achieve objectives of macroeconomic stabilization. This is because one of the important functions of the public sector, referred to in Chapter 1, is the stabilization function. In this context the aim of this chapter is to clarify objectives, instruments and indicators of fiscal policy, to present some empirical evidence for Portugal, and to discuss the nature and impact of fiscal policy in the context of a simple Keynesian model in an open economy.

The *objectives of the stabilization FP* are essentially three. Ensure a sustained economic growth, aim for high levels of employment and to avoid substantial external imbalances. In essence it is intended to further mitigate large swings in economic cycles, as strongly expansionary periods leads in general to an undesirable acceleration of inflation, and recessions leads to unemployment and an under-utilization or destruction of other productive factors.

The *instruments of FP*, are essentially those variables that are included in the State Budget and the government can manipulate, namely, on the expenditure side, public investment and public consumption (especially salary of civil servants and numerous social benefits) and on the revenue side, changes in tax rates or tax bases, and tax benefits.

The *indicators of the nature of fiscal policy* or that characterize the situation of public finances in a given country, can be distinguished into two types. Those that result directly from the national accounts (the overall, current, capital and primary balances and public debt, both in absolute terms, and in relation to GDP) and those indicators that can be constructed (cyclically-adjusted balance or structural balance, cyclical component of the budget balance, the output gap, etc.).. The *overall balance* (SO), if negative, gives approximate information on the net borrowing requirements of the public sector, ie the need to resort to additional borrowing. In turn the budget deficit should not exceed the costs of public investment, in what is known as the *golden rule of public finance*, it means that the loans are intended exclusively for capital expenditure.

The *primary balance* (PB), given by the difference between effective (non financial) revenues and primary expenditure (effective minus interest) also provides relevant information. However, anyone of these balances does not distinguish what is a discretionary government policy - that is, what he deliberately influence through the use of policy instruments - from what is exogenous to government - ie not manipulated by the government, whether it results from an automatic effect (automatic stabilizers) or because it is partially determined by another entity (such as the interest rate decided by the European Central Bank). It is therefore possible to decompose the *overall balance* as the sum of a *cyclical component* and a *structural component* (or set the cycle). The cyclical component (SOc) reflects the effects on the budget balance of fluctuations in economic activity around the trend level. It is a function of the *output gap* (positive or negative) that is the difference between the real output and potential output as a percentage of this. The *cyclical component* is positive (or negative) when the output gap is also positive (or negative), and depends on the sensitivity and operation of automatic stabilizers (revenue and expense variables that have an automatic adjustment and counter-cyclical role in the economic environment). The *structural component*, reflected by the cyclically-adjusted balance (SOe), which indicates the would be overall balance, if the economy was placed at the trend level, or if the real and potential GDP were identical. If we withdraw the interest expenditures, we obtain the *cyclically adjusted primary balance* (SOep), whose variation is the best indicator of the discretionary nature of fiscal policy. Since SOe = SOep-interest, then the overall budget balance (SO) can be given as the sum of the non discretionary component with the discretionary component. Thus: SO = (SOC-Interest) + SOep.

The *discretionary policy* can and should be used in an anti-cyclical way ie having an expansionary effect on the product (SOep decreasing) in a phase of economic recession, or a restritive effect (improving SOep) in a strong growth phase. It should never be pro-cyclical. A deliberate expansionary fiscal policy, results in an increase in the aggregate demand and can be achieved either with increased spending (investment, government consumption) or with tax cuts (or a combination of both). The inverse holds for a restritive policy.

Under a simple Keynesian model in an open economy some conclusions can be drawn. The multiplier effect of an increase in public spending in the product, which is positive and higher (in modulus) to the multiplier effect of the tax increase, which is negative. It follows that the *Haavelmo theorem* states that even with a growing balanced budget, increased spending in the same amount of a tax increase, has an expansionary effect. In fact this effect is obtained provided that the increase in expenditure is higher than *c* percent the increase in taxes (being *c* the marginal propensity to consume). Moreover, the multiplier effect of expenditure will be greater the higher the marginal propensity to consume and the lower the interest rate resulting from an increased demand for transactions.