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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No. 1466/97 of 7 July 1997

On the Updated Stability Programme for Portugal, 2002-2005

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

Portugal's first stability programme covering the period 1999-2002 was submitted on 30 December 1998 and assessed by the Council on 8 February 1999[2]. The first update of the programme, covering the period 2000-2004, was submitted to the Commission on 17 February 2000 and assessed by the Council on 13 March 2000[3]. The second update of the stability programme, covering the period 2001-2004, was submitted on 18 January 2001 and assessed by the Council on 12 March 2001[4].

Portugal submitted its third and most recent update of the stability programme, covering the period 2002-2005, on 13 December 2001. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment:

> The Portuguese stability programme update was adopted by the Council of Ministers on 13 December 2001; on the 17 December the government resigned in the aftermath of local elections. The new update of the Portuguese stability programme presents macro-economic and government finance projection for the period 2002-05. The current update is broadly in line with the revised code of conduct which has been agreed for stability and convergence programmes[5].
>
> The updated programme estimates output growth in 2001 to reach 2%, considerably below the value of 3.3% projected in the update of January 2001. This is due basically to a slowdown of domestic demand, which was only partly compensated by improved export growth. The slowdown in domestic demand reflects, *inter alia*, efforts of private sector agents to redress their balance sheets, following the sharp rise in their indebtedness in recent years.
>
> Slower economic growth than expected is an important factor behind the considerable worse than targeted budgetary outcome in 2001. The general government deficit is estimated to be 2.2% of GDP in 2001 (1.8% in 2000 excluding UMTS proceeds), which compares with a deficit target of 1.1% of GDP in the January 2001 update. While lower growth can explain a part of the shortfall other factors are behind, notably an underestimation of the revenue losses implied by the

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1 OJ L209, 2.8.1997
2 OJ C 68, 11.3.1999.
3 OJ C 111, 18.4.2000
4 OJ C109/4 10.4.2001.
5 On 10 July 2001 the ECOFIN Council endorsed the opinion of the Economic and Financial Committee and the revised code of conduct on the content and format of the Stability and Convergence Programmes.

reform of direct taxes implemented in 2001, lower-than-projected efficiency gains in tax collection and administration and overruns in current primary expenditure. As a result, the cyclically adjusted government position worsened to -2½ % of GDP, far above the value implicit in the deficit target of the January 2001 update (1.2%).

After identifying significant tax shortfalls together with overruns in current primary expenditure already early summer of 2001, the government adopted a corrective budget in June including current primary expenditure cuts worth 0.6% of GDP. However, these retrenchment measures were not sufficient to prevent expenditure from exceeding the plans set in the previous update of the programme, while the Broad Economic Policy Guidelines (BEPGs) called for a strict adherence to expenditure plans.

The updated programme projects output growth to bottom out in 2002 at 1.75 %, to accelerate slightly to 2.5% in 2003 and to level off at 3% in the years 2004/05, implying a significant downward revision in comparison with the previous update. An average growth of some 2½ % over a 4-years period appears indeed relatively low for a catching-up country like Portugal. But in view of the current imbalances in the Portuguese economy, the ongoing adjustment process is likely to continue for some time to come, thereby dampening medium-term output growth. Domestic demand is likely to grow slowly and not sufficiently compensated by export growth namely because of the strong rise in unit labour cost in recent years with its adverse effects on the external competitiveness. For these reasons it appears appropriate that the updated programme takes a cautious line regarding the outlook for the Portuguese economy over the programme period. The composition of growth assumed by the programme appears, however, tilted towards domestic demand, with the external contribution to growth remaining negative, which is a hardly sustainable growth pattern in the medium term.

In spite of the budgetary slippage in 2001, the updated programme maintains the objective to balance the government finances by 2004 (for 2005 even a small surplus is projected) as recommended by the Council opinion and the Broad Economic Policy Guidelines. Naturally, the budgetary efforts required by the programme's objectives are now much stronger taking account also of the much less favourable macroeconomic environment. The projected deficit path for the intervening period has shifted upwards. In particular, the deficit target for 2002 is 1.8% of GDP, which compares with the target of the previous update of 0.7%. Adjusting for the influence of the cycle, the deficit in the period 2002-2004 is now estimated to be about ¾ of a pp above the values projected in the previous update, suggesting a significant deterioration in the structural position of the general government accounts. Under the projected path, government finances in Portugal will comply with the requirements of the Stability and Growth Pact of a position "close to balance or in surplus" only from 2004 onwards.

The consolidation strategy is based on expenditure restraint as recommended by the Broad Economic Policy Guidelines. For central government finances, current nominal expenditure will be capped at 4% per year until 2005, i.e. about 1¾ pp below average nominal GDP growth. Furthermore, structural policies are to be pursued in various areas with a direct impact on public finances, notably in the domains of health care and public pensions. The social security sector is expected to contribute significantly to the overall consolidation during the programme period.

The reform measures which will be necessary to achieve the required increase in the surplus of the social security sector remain, however, largely unspecified.

The outcome for the general government debt ratio in 2001 and the projected values announced for the coming years in the current update have been revised upwards compared to the projections of the previous update. The upward revision stays well above the expected impact from the new path of the general government deficit targets. Although the debt ratio is projected to remain well below the 60% ceiling, falling to 54% of GDP in 2004 (51.9% in 2005), the debt ratio target is now planned to be nearly 6 pp above the last update's value for 2004. This suggests the existence of financial operations which are, however, not detailed in the programme.

In view of the significant pressures for increased public spending due to an ageing population, the slow decline in the debt ratio remains a source of concern given the need to ensure the sustainability of government finances. If debt reduction is to make a noticeable contributions towards the sustainability of government finances, the target of a balanced budget position by 2004 must be reached. Structural reforms are necessary to strengthen the financial sustainability of the pension system. The reform of the pension system recently agreed by the social partners goes in the right direction although there is a need for further efforts. The main challenge facing Portugal is to complete the process of pension reform and to continue with the reforms of the health care sector.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No. 1466/97 of 7 July 1997

On the Updated Stability Programme for Portugal, 2001-2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [12 February 2002] the Council examined the updated stability programme for Portugal which covers the period 2002-2005. The updated programme projects general government finances to improve from a deficit of 2.2 % of GDP in 2001 to a balanced position in 2004, with a small surplus is expected in 2005. The government gross debt is expected to decrease from 55.9% of GDP in 2001 to 51.9% in 2005. The Council notes that the new update broadly complies with the requirements of the revised "code of conduct on the content and format of stability and converge programmes"[7].

The Council notes that the estimated deficit outcome for 2001 (2.2% of GDP) is clearly higher than projected in the January 2001 update (1.1 % of GDP). The Council acknowledges that this important nominal divergence is partly due to the slowdown in the economy, with 2001 real GDP growth around 1¼ percentage points below projections of the January 2001 update of the programme. However, the Council also notes that lower growth can explain only a part of the shortfall relative to the target. Factors not related to the growth slowdown contributed to this, notably an underestimation of the revenue losses implied by the reform of direct taxes implemented in 2001 and lower-than-projected efficiency gains in tax collection and administration. Moreover, overruns occurred in current primary expenditure which is not fully in compliance with the Broad Economic Policy Guidelines. The Council acknowledges that the Portuguese government took, in a corrective budget adopted in June 2001, measures

6 OJ L209/1, 2.8.1997

7 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

with a view to curtailing expenditure growth. These measures, which amounted to 0.6% of GDP, were, however, not sufficient to prevent expenditure from exceeding the target set in the previous update of the programme.

The baseline macro-economic scenario of the updated programme expects output growth to accelerate from 1¾ % in 2002 to 3% in the last two years of the programme, yielding annual average growth of some 2½ %. This seems realistic in view of the current imbalances in the Portuguese economy, with the necessary adjustment process likely to dampen output growth in the medium term. Given the strong rise in unit labour cost in recent years and its adverse effects on the external competitiveness of the Portuguese economy, the needed increase in export growth is not likely to be strong enough to make up for the shortfall in domestic demand. The Council considers that, for these reasons, the cautious line taken by the programme regarding the medium-term outlook for the Portuguese economy appears appropriate.

The Council notes that the Portuguese authorities maintain their intentions to balance the budget by 2004, as planned in last year's update and as recommended in the BEPGs. In cyclically adjusted terms the government accounts would move into a small surplus in 2004. Portugal would thus comply with the requirements of the Stability and Growth Pact from 2004 on. The Council welcomes the confirmation of a balanced budget target for 2004. While acknowledging that achieving a balanced budget target in 2004 requires a considerable effort the Council considers it necessary and encourages the Portuguese government to pursue it with determination. As a consequence, the Council recommends that discretionary budgetary measures above those already announced in the current update be implemented if necessary.

The Council notes that the budgetary outcome for 2001 departed from the Portuguese budgetary path towards a "close to balance or in surplus" position. The Council welcomes the intentions of returning to such a path in 2002 and considers that the budgetary objective for that year must be met. Given that Portugal has not yet achieved a sufficient safety margin against breaching the 3% of GDP deficit threshold, deviations from the objective must be timely addressed. With a view to securing the needed reduction in the deficit to create a safety margin to avoid breaching the 3% of GDP deficit laid down in the Treaty the Council has given to Portugal an early warning in the terms of the Stability and Growth Pact[8].

The Council urges the Portuguese authorities to ensure strict budgetary implementation for all sectors of government. Moreover, a number of important reforms have been announced in the programme update, particularly in some areas with a direct impact on public finances, whose timely and determined implementation will be paramount for a successful implementation of the budgetary consolidation strategy.

The Council notes that the debt ratio has been revised upwards throughout the programme period, although remaining clearly below the 60% ceiling. Only part of this revision can be explained by the developments of the government deficit and GDP growth, suggesting the existence of financial operations which are, however, not detailed in the programme.

The Council notes that the sustainability of government finances should be strengthened in light of the budgetary costs of ageing populations. If debt reduction is to make a noticeable contribution towards the sustainability of government finances, the target of a balanced budget position by 2004 must be reached. In addition, structural reforms are necessary

[8] O.J.

strengthen the financial sustainability of the pension system. The Council notes with satisfaction that the reform of the pension system recently agreed by the social partners goes in the right direction. The main challenge facing Portugal is to complete the process of pension reform and to continue with the reforms of the health care sector.