COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL RECOMMENDATION TO PORTUGAL

with a view to bringing an end to the situation of an excessive government deficit

(presented by the Commission)

EXPLANATORY MEMORANDUM

THE EXCESSIVE DEFICIT PROCEDURE FOR PORTUGAL

On 9 June 2005, Portugal submitted the most recent update of its stability programme covering the period 2005-2009. This update reveals the plans for a general government deficit in excess of the 3% of GDP reference value of the Treaty for the years from 2005 to 2007. Specifically, after a reported deficit outturn of 2.9% in 2004[1], Portugal plans to record a government deficit of 6.2% of GDP for 2005, which is to be reduced to 4.8% in 2006, 3.9% in 2007 and 2.8% of GDP in 2008. Over the same years, the debt-to-GDP ratio is projected to further increase from a reported figure of 61.9% in 2004 to a peak of 67.8% of GDP in 2007.

The application of the excessive deficit procedure (EDP) is governed by Article 104 of the Treaty and by Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact.[2] In its assessment the Commission has taken due account of the 20 March 2005 Ecofin Report to the European Council on 'Improving the implementation of the Stability and Growth Pact', endorsed by the latter on 22 March 2005[3].

The Commission report according to Article 104(3) of the Treaty provided evidence that the Treaty requirements concerning both the deficit and the debt criteria are not fulfilled.

Article 104(4) of the Treaty states that "the Committee provided for in Article 114 (i.e. the Economic and Financial Committee) shall formulate an opinion on the report of the Commission". In its opinion of 4 July 2005, the Committee concluded "that the planned budgetary developments in Portugal in 2005 are such that both criteria in the second paragraph of Article 104 are not respected". In particular, the Committee considered that the deficit planned for 2005 of 6.2% of GDP is not close to the 3% of GDP reference value, and its excess over the reference value cannot be considered exceptional and temporary; in addition, government debt exceeds the 60% of GDP reference value and is planned to rise further as percent of GDP over the next two years. The Committee also noted that economic prospects for the next two to three years remain subdued and expressed concern about the high level and the trend of the structural deficit. While the Committee examined all other relevant factors, it concluded that these factors would not be taken into account in its assessment.

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1 These figures are subject to ongoing discussions between Eurostat and the Portuguese statistical authorities.

2 OJ L 209, 2.8.1997.

3 See Presidency conclusions of the Brussels European Council of 22 and 23 March 2005 (7619/05) and the (Ecofin) Council report to the European Council of 20 March 2005 (7423/05).

The Commission, having taken into account its report and having regard to the opinion of the Committee, is of the opinion that an excessive deficit exists in Portugal. This opinion, adopted by the Commission on 20 July 2005, has been addressed to the Council, according to Article 104(5) of the Treaty. The Commission has also issued a recommendation for a Council decision on the existence of an excessive deficit in Portugal in accordance with Article 104(6). In addition, the Commission is herewith submitting to the Council this recommendation for a Council recommendation to be addressed to Portugal with a view to bringing the situation of an excessive deficit to an end, in accordance with Article 104(7) of the Treaty.

THE CORRECTION OF THE EXCESSIVE DEFICIT

Council Regulation (EC) No 1467/97 says that "The Council recommendation should (...) establish a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances". In the case of Portugal, unless there are special circumstances, the correction of the excessive deficit should therefore be completed by 2006. In its 20 March 2005 report, the Council agreed that the determination of the existence of special circumstances should take into account a balanced overall assessment of other relevant factors.

The following elements need to be taken into account in deciding whether there are special circumstances.

A rapid correction of the excessive deficit in Portugal appears essential given the high level of the structural deficit (the cyclically-adjusted deficit, excluding one-offs and other temporary measures) and the high debt-to-GDP ratio, and considering that persistent budgetary imbalances weigh on confidence and ultimately affect output growth. The budgetary situation of Portugal progressively and significantly deteriorated over the recent years. In particular, the structural primary balance has declined from a situation of close to balance or in surplus in the second half of the nineties to an average deficit of about 1.5% of GDP since 2001 (at the same time, the average structural deficit widened from 3 ¾% of GDP to 4 ½%). This trend exposes the country to considerable risks, which call for a lasting improvement in the public finances. However, in determining the adjustment path, consideration needs also to be given to the current economic situation and the size of the required budgetary correction. While in the case of Portugal budgetary consolidation is essential for growth in the medium term, especially if it is of the right composition and it strengthens confidence, too large an effort in too short a period may prove economically costly, in particular considering the current cyclical weakness.

The rate of economic growth has decreased sharply since 2000, to the point of becoming clearly negative in 2003. The slowdown was accompanied by a decline in potential output growth, due to a series of mutually reinforcing structural weaknesses. The economy returned to moderate positive economic growth in 2004 and is expected to remain on a gradual but still moderate upward trend for the years to come. As revealed in the June 2005 update of the Portuguese stability programme, after a reported deficit of 2.9% of GDP in 2004, the planned 2005 deficit-to-GDP ratio is 6.2% of GDP, already supported by a corrective package of some 0.6% of GDP adopted in mid-2005. Assuming no additional measures in 2005, and, in line with the June 2005 update of the Portuguese stability programme, GDP growth accelerating to

1.4% in 2006 from 0.8% in 2005, bringing the deficit below 3% of GDP in 2006 would require an adjustment, in structural terms, of almost 3% of GDP from 2005.

All in all, in view of the current cyclical weakness in Portugal and the size of the required adjustment to bring the deficit below the 3% of GDP reference value by 2006, special circumstances appear to exist, which allow an extension of the deadline for the correction beyond 2006. In this regard, it should be noted that the Portuguese authorities embrace a strategy of sustained, if stepwise, correction, no longer relying on sizeable one-off measures. In addition, in the current case, the year of identification and the year of occurrence of the excessive government deficit coincide, given that the identification is made on the basis of planned data and not actual data which become available only in the subsequent year. Such an early identification of an excessive government deficit and the subsequent expedited procedure should also be taken into account. Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework. The stability programme update submitted by Portugal in June 2005 and the Council Opinion thereon provide a basis for this recommendation concerning the adjustment path for the correction of the excessive deficit.

A credible adjustment path would require the Portuguese government to: (i) limit the deterioration of the fiscal position in 2005, by implementing with rigour the corrective measures announced in the June 2005 update of the stability programme. Assuming GDP growth of 0.8% in 2005, this would lead to a nominal deficit of, at most, 6.2% of GDP; and (ii) take the necessary measures to ensure a sustained and marked correction of the structural deficit, by taking a very substantial step in 2006 of a reduction of some 1 ½% of GDP followed by a significant decrease of, at least, ¾% of GDP every year until the correction of the excessive deficit. If the projections of the June 2005 update of the Portuguese stability programme materialise, with GDP growth recovering to 1.4% in 2006 and to 2.2% in 2007 and 2.6% in 2008, a structural correction of the above-indicated size would result in a general government deficit ratio of 4.8% of GDP in 2006 and just below 4% and 3% in 2007 and 2008, respectively.

The correction should be achieved by enacting decisively the necessary measures to reduce and control the evolution of government expenditure and to improve tax collection, by seizing any opportunity to accelerate the reduction of the budget deficit, in particular by creating as soon as possible margins to deal with the budgetary impact of possible lower-than-projected growth, all against a backdrop of improved quality and sustainability of the public finances. In addition, the budgetary adjustment needs to be framed within a comprehensive reform strategy, including the reform of the public administration and of the private sector social security system, aiming at tackling the deep-rooted structural problems that have ridden the Portuguese economy for several years, which were also highlighted in the report according to Article 104(3) approved by the Commission on 22 June. The update of the stability programme to be adopted by the end of 2005 should consider a more ambitious frontloading of the adjustment path, if it appears necessary to ensure the fulfilment of the targets defined for the correction of the excessive deficit.

The high level of government debt and its upward trend since the year 2001 are a cause for concern. In a context of low potential output growth, ensuring that the government gross debt ratio is brought onto a firm downward path and approaches the reference value at a satisfactory pace would require restoring an adequate level of the primary surplus as soon as possible. In addition, it would be paramount to address factors other than net borrowing that have contributed to the change in debt levels, in particular by avoiding debt-increasing financial transactions.

Finally, although recent revisions in government account data have been small and have not had a significant impact on the headline figures, the nature of these revisions, and the current allocation of institutional responsibilities point to the need for further improvement in processing government account data.

Recommendation for a

COUNCIL RECOMMENDATION TO PORTUGAL

with a view to bringing an end to the situation of an excessive government deficit

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof;

Having regard to the proposal from the Commission[4],

Whereas:

(1) According to Article 104 of the Treaty, Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The 20 March 2005 Ecofin Report to the European Council on 'Improving the implementation of the Stability and Growth Pact', endorsed by the latter on 22 March 2005, confirms that the Stability and Growth Pact is an essential part of the macroeconomic framework of the Economic and Monetary Union and presents proposals for strengthening and clarifying its application.

(4) The Council has decided on (xx Xxxx 2005), in accordance with Article 104(6), that an excessive deficit exists in Portugal.

(5) Having decided on the existence of an excessive deficit in Portugal, the Council, in accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97, is required to make at the same time recommendations to the Member State concerned with a view to bringing that situation to an end within a given period. The Council recommendation has to establish a deadline of four months at the most for effective action to be taken by Portugal to correct the excessive deficit as well as a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances. In its 20 March 2005 report, the Council agreed that the determination of the existence of special circumstances should take into account a balanced overall assessment of other relevant factors.

(6) In deciding on the existence of special circumstances, the following elements should be taken into account.

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[4] OJ C , , p. .

(7) A rapid correction of the excessive deficit in Portugal appears essential given the high level of the structural deficit (the cyclically-adjusted deficit, excluding one-offs and other temporary measures) and the high debt-to-GDP ratio, and considering that persistent budgetary imbalances weigh on confidence and ultimately affect output growth. The budgetary situation of Portugal progressively and significantly deteriorated over the recent years. In particular, the structural primary balance has declined from a situation of close to balance or in surplus in the second half of the nineties to an average deficit of some 1.5% of GDP since 2001. This trend exposes the country to considerable risks, which call for a lasting improvement in the public finances. However, in determining the adjustment path, consideration needs also to be given to the current economic situation and the size of the required budgetary correction. While in the case of Portugal budgetary consolidation is essential for growth in the medium term, especially if it is of the right composition and it strengthens confidence, too large an effort in too short a period may prove economically costly, in particular considering the current cyclical weakness.

(8) The rate of economic growth has decreased sharply since 2000, to the point of becoming clearly negative in 2003. The slowdown was accompanied by a decline in potential output growth, due to a series of mutually reinforcing structural weaknesses. The economy returned to moderate positive economic growth in 2004 and is expected to remain on a gradual upward trend for the years to come. As revealed in the June 2005 update of the Portuguese stability programme, after a reported deficit of 2.9% of GDP in 2004, the planned 2005 deficit-to-GDP ratio is 6.2% of GDP, already supported by a corrective package of some 0.6% of GDP adopted in mid-2005. Assuming no additional measures in 2005, and GDP growth accelerating to 1.4% in 2006, bringing the deficit below 3% of GDP in 2006 would require an adjustment, in structural terms, relative to 2005, of almost 3% of GDP.

(9) All in all, in view of the current cyclical weakness in Portugal and the size of the required adjustment to bring the deficit below the 3% of GDP reference value by 2006, special circumstances appear to exist, which allow an extension of the deadline for the correction of the excessive deficit beyond 2006. In this regard, it should be noted that the Portuguese authorities embrace a strategy of sustained, if stepwise, correction, no longer relying on sizeable one-off measures. In addition, in the current case, the year of identification and the year of occurrence of the excessive government deficit coincide, given that the identification is made on the basis of planned data and not actual data which become available only in the subsequent year. Such an early identification of an excessive government deficit and the subsequent expedited procedure should also be taken into account. Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework. The stability programme update submitted by Portugal in June 2005 and the Council Opinion thereon provide a basis for this recommendation concerning the adjustment path for the correction of the excessive deficit.

(10) In general, in the view of the Council, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality and the long-term sustainability of the public finances and reinforcing the growth potential of the economy. In the case of Portugal, the correction of the excessive deficit needs to be framed within a comprehensive reform strategy, including the reform of the public administration and of the private sector social

security system, aiming at tackling the deep-rooted structural problems that have ridden the economy for several years.

(11) A credible adjustment path would require the Portuguese government to: (i) limit the deterioration of the fiscal position in 2005, by implementing with rigour the corrective measures announced in the June 2005 update of the Portuguese stability programme. Assuming GDP growth of 0.8% in 2005, this would lead to a nominal deficit in 2005 of, at most, 6.2% of GDP; and (ii) take the necessary measures to ensure a sustained and marked correction of the structural deficit, by taking a very substantial step in 2006 of a reduction of some 1 ½% of GDP followed by a significant decrease of, at least, ¾% of GDP every year until the correction of the excessive deficit. If the projections of the June 2005 update of the Portuguese stability programme materialise, with GDP growth recover to 1.4% in 2006 and to 2.2% in 2007 and 2.6% in 2008, a structural correction of the above-indicated size would result in a general government deficit ratio of 4.8% of GDP in 2006 and just below 4% and 3% in 2007 and 2008, respectively.

(12) This correction should be achieved by enacting decisively the necessary measures to reduce and control the evolution of government expenditure and to improve tax collection, by seizing any opportunity to accelerate the reduction of the budget deficit, in particular by creating as soon as possible margins to deal with the budgetary impact of possible lower-than-projected growth, all against a backdrop of improved quality and sustainability of the public finances. The update of the stability programme to be adopted by the end of 2005 should consider a more ambitious frontloading of the adjustment path, if it appears necessary to ensure the fulfilment of the targets defined for the correction of the excessive deficit.

(13) Recent revisions in deficit and debt figures have been small and have not had a significant impact on the headline figures. However, the nature of these revisions, and the current allocation of institutional responsibilities point to the need for further improvement in processing government account data.

(14) The Commission and the Council, in accordance with article 10 of CR 1467/97, shall monitor the implementation of action taken by Portugal in response to this recommendation.

HEREBY RECOMMENDS:

- The Portuguese authorities should put an end to the present excessive deficit situation as rapidly as possible in accordance with Article 3(4) of Council Regulation (EC) No 1467/97;

- The Portuguese authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by 2008 by taking action in a medium-term framework. Specifically, to this end, the Portuguese authorities should:

  - limit the deterioration of the fiscal position in 2005, by ensuring a rigorous implementation of the announced corrective measures;

  - thoroughly implement the necessary measures to ensure a sustained and marked correction of the structural deficit, by taking a very substantial step of a reduction of some 1 ½% of GDP in 2006 from 2005, followed by a further significant decrease of, at least, ¾% of GDP in each of the two subsequent years;

  - rapidly implement reforms to contain and reduce expenditure over the coming years; seize any opportunity to accelerate the reduction of the budget deficit, and stand ready to adopt the additional measures which may be necessary to achieve the correction of the excessive deficit by 2008;

- The Council establishes the deadline of [xx Xxxx 200x] for the Portuguese government to take effective action regarding the measures envisaged to achieve the 2006 deficit target;

- The Portuguese authorities should ensure that the government gross debt ratio is brought onto a firm downward path and approaches the reference value at a satisfactory pace by ensuring that debt developments reflect progress in the reduction of the deficit, by avoiding debt-increasing financial transactions, and by considering carefully the possible impact on debt of major public investment projects, including those in partnership with the private sector;

- The Portuguese authorities should further improve the collection and processing of general government data.

In addition, the Council invites the Portuguese authorities to ensure that budgetary consolidation towards the medium term position of government finances close to balance or in surplus is sustained through a reduction in the cyclically-adjusted deficit, net of one-offs and other temporary measures, by at least 0.5% of GDP per year after the excessive deficit has been corrected.

This recommendation is addressed to the Portuguese Republic.

Done at Brussels,

For the Council
The President