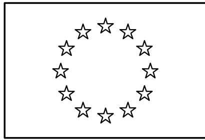

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2004
SEC(2004) 190 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997

on the updated stability programme of Portugal, 2004-2007

(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 (formerly 109c) of the Treaty (from 1 January 1999, 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 in December 1998 and assessed by the Council on 8 February 1999[2].

Portugal submitted its fifth and most recent update of the stability programme, covering the period 2004-2007, in December 2003. The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the revised "code of conduct"[3], the Autumn forecast as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

> The fifth update of Portugal's stability programme largely complies with the revised "code of conduct on the content and format of stability and convergence programmes". The Portuguese authorities provided additional information not required in the "code of conduct" which has been useful for the computation of potential real GDP growth estimates, using the commonly agreed production function methodology. However, information on expected privatisation revenue and on the breakdown of social transfers by major category would have been desirable[5].
>
> On 5 November 2002, following a significant breach of the Treaty reference value for the general government deficit in the year 2001[6], the Council decided that an excessive deficit existed in Portugal and issued recommendations requesting Portugal to bring this situation to an end by 2003 at the latest. In 2002 already, the nominal deficit dropped to 2.7% of GDP. However, this early correction took place in a

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1 OJ L 209, 2.8.1997. The documents referred to in this text can be found at the following web site: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 OJ C 68, 11.3.1999.

3 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.

4 COM(2002) 668 final, 27.11.2002.

5 The data set of the programme update falls short of the requirements of the revised "code of conduct" on three counts: (i) no details regarding the breakdown of social transfers between those in kind and those other than in kind; (ii) lack of information on some explanatory variables of the change in gross government debt, namely privatisation receipts and the implicit interest rate on the debt; and (iii) lack of detailed information on the factors determining the long-term sustainability of public finance.

6 In 2001, the general government deficit reached 4.4% of GDP.

worse-than-expected economic environment[7] and was largely achieved via recourse to substantial one-off measures, amounting to 1.5% of GDP.

In 2003, the economic recession in Portugal -where the latest data suggest that real GDP and real domestic demand have declined by an estimated 1% and 2½% respectively- has hampered considerably the pursuit of fiscal consolidation. In fact, the previous update of the stability programme (January 2003), had put real GDP growth at 1.3% for 2003. A deviation of this magnitude, together with the high sensitivity of tax revenue to macroeconomic conditions, produced a massive shortfall in tax revenue. As regards government expenditure, the available information suggests that current primary expenditure is growing below budgetary plans, and therefore seems under control. These revenue and expenditure developments would, however, have led to a government deficit significantly above 3% of GDP in 2003. In order to prevent this without having to adopt an unduly restrictive policy stance, and to give extra-time for the ongoing broadly-based programme of structural reforms to yield the expected benefits in terms of expenditure savings, the Portuguese authorities relied, for a second year running, on sizeable one-off measures, amounting to 2 percentage points of GDP. Thereby, according to the programme update, the nominal deficit would be kept just under 3% of GDP.

According to data on budgetary execution for the state sector (on a public accounts basis), a general government deficit slightly below the 3% of GDP reference value of the Treaty may actually be achieved in 2003. The Commission Autumn 2003 forecast had projected a deficit of 2.9% of GDP, including the one-off measures envisaged by the authorities. A deficit below the 3% reference value needs to be confirmed by the regular reporting of deficit and debt figures of March 2004. On that basis, the Commission will carry out an assessment of compliance with the recommendation addressed to Portugal under article 104(7)[8].

For 2004, the Portuguese authorities project real GDP growth at 1.0%, which is identical to the Commission services' Autumn 2003 forecast. In the programme update, the government deficit is projected to decline only marginally from 2.9% of GDP in 2003 to 2.8% in 2004, while the amount of planned one-off measures is expected to drop from 2 percentage points of GDP in 2003 to about 1.1 percentage point in 2004.

Some degree of uncertainty surrounds the outcome for tax revenue in 2004. The Commission services reiterate their assessment made in the Autumn 2003 forecast that the outturn for tax revenue in 2004 might be lower than anticipated by the Portuguese authorities in their budget for 2004 and now also in the 2003 programme update[9]. This different assessment for tax revenue prospects in 2004 warrants the Commission's higher deficit forecast of 3.3% of GDP of last autumn. Moreover, a tax shortfall in 2004 (compared with the programme update), accompanied by any slippage in restraining growth in social transfers to the extent (implicitly) envisaged in the programme already for 2004, would have repercussions throughout the entire programme period, requiring either appropriate offsetting measures or a revision of

[7] In 2003, the output gap amounted to -2.3% of GDP, according to the commonly agreed methodology.

[8] The recommendation calls for bringing the excessive government deficit to an end by 2003 at the latest.

[9] For 2004, total tax revenue is projected to grow by about 2% and 2¾%, respectively, in the Commission's Autumn forecast and in the programme update.

budgetary targets. However, further one-off measures and/or better-than-expected growth conditions could lead to a deficit below 3% of GDP.

For the period 2005-2007, the programme projections are based on a (central) scenario, in which real GDP growth averages 2¾% per year. Alternative scenarios are only briefly sketched (but not fully developed) for the purpose of a sensitivity analysis. Employment growth is expected to pick up from 0.4% in 2004 to 1.3% on average in the period 2005-2007. Declining from 3.3% in 2003, HICP inflation is expected to stabilise at 2% throughout the period from 2004 to 2007.

The macroeconomic scenario underlying the programme update seems plausible. After an adjustment period that peaked in 2003, domestic demand is expected to recover in the next years, although at more moderate rates than in the second half of 1990s. Major stimulus to growth should thus be provided by external forces, underpinned by domestic wage moderation. In this regard, the programme scenario incorporates an element of prudence that could absorb moderate unfavourable shocks. This “caution bias” is built upon two assumptions: (1) an average growth rate only ¼ of a percentage point above the figure projected for the EU as a whole, an acceptable deviation for a catching-up country; and (2) constant export market-shares, in spite of the expected moderate gains in (labour) productivity and a significant deceleration in wage growth, in line with the Commission’s Autumn 2003 forecast.

Under these assumptions, the government deficit is projected to decline from 2.8% of GDP in 2004 to 2.2% in 2005, 1.6% in 2006 and 1.1% in 2007. According to Commission services’ estimates based on the projections of the programme, using the commonly agreed methodology, the cyclically-adjusted balance would improve by about 0.4 percentage point per year with the deficit falling eventually to 0.7% of GDP in 2007.

The medium-term budgetary consolidation strategy of the 2003 programme update is similar to that adopted in the previous update. It is centred on three axes: (1) an ambitious programme of structural reforms, with a particular incidence in those areas which bear directly on public finance, such as public administration, health-care, and education; (2) a sustained policy of curbing government consumption through wage moderation and a quasi-employment freeze; and (3) a gradual improvement in productivity and competitiveness to be fostered, *inter alia*, by a substantial cut in the corporate tax rate. In addition, the adoption in 2002 of a Budgetary Framework Law (“*Lei de Estabilidade Orçamental*”) is expected to have reinforced the co-ordination of budgetary policy across all levels of government.

For the period 2004-2007, the Portuguese authorities project that the implementation of this medium-term strategy will bring about a cumulative decline by 3.2 percentage points in the primary expenditure-to-GDP ratio, which however will be partly offset by a cumulative reduction in the tax revenue ratio amounting to 0.7 percentage point of GDP.

This adjustment strategy[10], by relying on expenditure restraint rather than on tax increases, is both in line with the Broad Economic Policy Guidelines and is likely to

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[10] Together with the successful curbing of expenditure growth below the planned target in 2003.

improve the confidence of private economic agents, thereby leading to expansionary effects over the medium-term, while also being favourable to securing a lasting improvement, because of its higher robustness to adverse macroeconomic conditions. However, a number of qualifications and risks need to be stressed.

First, a high degree of uncertainty surrounds the outcome for tax revenue over the projection period, basically on account of the planned cut in the corporate tax rate, the reform of real estate taxation, and the high sensitivity of tax revenue to macroeconomic conditions, which could lead to overall significant tax shortfalls when compared with the programme's targets. At unchanged policies and embodying part of these risks, the Autumn 2003 forecast projected a deficit of 3.9% of GDP in 2005.

Second, in order to maximise the chances of being conducive to growth, a budgetary consolidation strategy based on expenditure restraint should not be achieved at the expense of the most "productive" components of government expenditure. However, according to the data in the programme update, roughly one-fourth of the total adjustment in government expenditure is planned to be achieved through a reduction in government investment.

Third, in recent years, total social transfers grew at a very strong pace, a situation which has recently worsened on account of the phased convergence of the lowest pensions towards the minimum wage, which is to be completed by 2006 at the latest. Against this background, the programme implicitly assumes a sharp deceleration in the average annual growth rate of total social transfers from almost 10% in the period from 2000 to 2003 to about 4½% in the period from 2004 to 2007, which broadly corresponds to a small decline of its GDP ratio. However, the programme does not spell out the measures required to secure this result. In particular, the measures necessary to complete the reform process of pension regimes are absent from the detailed list of structural reforms to be implemented during the programme period.

According to Commission services' calculations, the projected improvement in the cyclically-adjusted balance is slightly lower than the required minimum of ½ percentage point of GDP per year. However, Portugal converges towards a close-to-balance budgetary position in cyclically-adjusted terms by the end of the programme period (-0.7% of GDP in 2007). This outcome, somewhat less favourable than projected by the Portuguese authorities, is due to the fact that the Commission services, using the commonly agreed methodology, estimate a significantly lower growth rate for potential output of only 2.0% in the period from 2004 to 2007 than the Portuguese authorities' estimate of 2.7%.

Given the recurrent postponement of the balanced-budget target, the Portuguese authorities should maintain their efforts at complying with expenditure plans and on strengthening the effectiveness of the tax administration. Once economic growth returns to normal values, such a strategy would eliminate the need for recurrent one-off measures (required only to give extra-time for more structural/permanent measures to take effect).

The debt ratio is set to rise by almost 7 percentage points of GDP between 2000 and 2004, largely on account of substantial nominal deficits and sluggish growth, reaching exactly the value of 60% in 2004. Subsequently, it is projected to abate to 57% of GDP by 2007.

On the basis of current policies, risks of imbalances in the long term cannot be ruled out. The high deficit may undermine the sustainability of public finances in the longer term, hence the timely achievement of a budgetary position close to balance is imperative. Failure to do so would imply a rising debt ratio over time once the impact of ageing takes place. The imminent wave of population ageing heightens the urgency of completing the reform process, above all in the more sensitive age-related expenditure areas, before the current window of opportunity closes.

Finally, the economic policies as reflected in the 2003 update are broadly consistent with the recommendations of the Broad Economic Policy Guidelines, specifically those with budgetary implications. Although plans for the period from 2004 to 2007 involve an improvement in the cyclically-adjusted balance by only 0.4 percentage point of GDP on average per year, and thus below the 0.5 percentage point benchmark, the composition of the budgetary adjustment follows the recommendation that calls for deficit reduction to be obtained mainly through expenditure restraint. Moreover, the recommendation requesting Portugal to undertake structural reforms in areas with a direct impact on budgetary consolidation is being timely followed.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated stability programme of Portugal and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997

on the updated stability programme of Portugal, 2004-2007

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 co-ordination of economic policies[11], 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 [9 March 2004], the Council examined the 2003 update of the stability programme of Portugal which covers the period from 2004 to 2007. The updated programme was submitted in December 2003 and largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes". However, information on expected privatisation revenue and on the breakdown of social transfers by major category would have been desirable.

On 5 November 2002, the Council decided that an excessive deficit existed in Portugal and issued a recommendation requesting Portugal to bring this situation to an end by 2003 at the latest.

The medium-term budgetary consolidation strategy of the 2003 update of the stability programme is similar to that adopted in the previous update. It is centred on three axes: (1) a comprehensive programme of structural reforms with a particular incidence in areas that bear directly on public finances, such as public administration, health-care, and education; (2) a sustained policy of curbing government consumption via wage moderation and a quasi-employment freeze; and (3) a gradual improvement in productivity and competitiveness to be fostered, *inter alia*, by a substantial cut in the corporate tax rate. In addition, the adoption in 2002 of a Budgetary Framework Law ("*Lei de Estabilidade Orçamental*") is expected to have reinforced fiscal co-ordination between different government levels. As a consequence, the Portuguese authorities project that the implementation of this medium-term adjustment strategy will bring about a cumulative decline by 3.2 percentage point in the

[11] OJ L 209, 2.8.1997.

government primary expenditure-to-GDP ratio over the period 2004 to 2007, partly offset by lower tax revenue to the amount of 0.7 percentage point of GDP.

The budgetary consolidation strategy adopted by the Portuguese authorities appears to be economically sound. In fact, an adjustment strategy that relies on expenditure restraint rather than on tax increases is considered to improve the confidence of private economic agents, thereby supporting growth over the medium-term. Moreover, such a strategy should secure a lasting improvement in public finances, and prevent the emergence of major imbalances in the private sector of the economy.

The 2003 update projects real GDP to increase by 1.0% in 2004, after having declined by an estimated 0.8% in 2003. For the period from 2005 to 2007, real GDP growth is estimated to average by 2¾% per year. Employment growth is expected to pick up from 0.4% in 2004 to 1.3% on average in the period from 2005 to 2007. Declining from 3.3% in 2003, HICP inflation is expected to stabilise at 2% throughout the period from 2004 to 2007. The macroeconomic scenario underlying the update seems realistic, notably because the ongoing correction of major imbalances is about to be completed; moreover, it incorporates an element of prudence that could absorb moderate unfavourable shocks. The "caution bias" is built around two assumptions: (1) an average growth rate only ¼ of a percentage point above the figure projected for the EU as a whole, a plausible deviation for a catching-up country; and (2) constant export market-shares, in spite of the expected moderate gains in (labour) productivity and a significant deceleration in wage growth, in line with the Commission's Autumn 2003 forecast.

The update targets a general government deficit of 2.8% of GDP in 2004, following an expected deficit of 2.9% of GDP in 2003. In the subsequent years, the projections are for a gradual reduction in headline deficits, to a ratio of 1.1% of GDP in 2007. In cyclically-adjusted terms, based on Commission calculations according to the commonly agreed methodology, the deficit is set to fall by 0.4 percentage points to 1.7% of GDP in 2004, and eventually to 0.7% of GDP by 2007.

Largely on account of substantial nominal deficits and sluggish growth, the debt ratio is rising by almost 7 percentage points of GDP between 2000 and 2004, reaching exactly the reference value of 60% in 2004. Subsequently, it is projected to abate to 57% of GDP by 2007.

For 2003, the Portuguese authorities expect a general government deficit of 2.9% of GDP. Based on the available data (on a public accounts basis), which are still provisional and incomplete, a general government deficit slightly below the 3% reference value of the Treaty may be achieved, albeit largely due to the repeated recourse to sizeable one-off measures. On that basis, the Commission Autumn 2003 forecast had also projected a deficit below 3% of GDP. However, a number of uncertainties persist that might still lead to a breach of the 3% of GDP ceiling, *inter alia*, unexpected slippage in local or regional governments net borrowing requirements, and on health-care expenditure.

Compliance with the budgetary targets of the programme update is subject to two major risks: first, the likelihood of a tax revenue shortfall in 2004, and second, failure to restrain growth in total social transfers to the extent (implicitly) envisaged in the programme already in 2004. In such circumstances, a slippage in the budgetary targets for 2004 would have repercussions over the entire programme period, requiring either appropriate offsetting measures or a revision of budgetary targets. Naturally, the determined implementation of the structural reforms with a budgetary impact is crucial for the attainment of the programme objectives.

The Commission considers that, on the basis of the current policies, risks of imbalances in the long term cannot be completely ruled out for Portugal. The high deficit and the rising debt-to-GDP ratio may undermine the sustainability of public finances in the longer term, hence the timely achievement of a budgetary position close to balance is imperative. The budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. This strategy is mainly based on budgetary consolidation over the medium-term, resulting from government consumption restraint, and the expected gains from the completion of structural reforms. Failure to do so would imply a raising debt over time once the impact of ageing takes place.

Pension regimes are undergoing reform since 2001, a process which has not yet been completed. The long-term projections for pension expenditure presented in the 2003 programme update seem not to have taken into consideration the impact of some measures already adopted and of others which are planned. Moreover, an early assessment of the effects of the 2001 reform of the general social security pension regime seems to suggest that its long-term sustainability has not been improved. Against this background, the programme implicitly assumes a sharp deceleration in the average annual growth rate of total social transfers, without spelling out the measures required to secure this result.

The economic policies as reflected in the 2003 update are broadly consistent with the recommendations of the Broad Economic Policy Guidelines, specifically those with budgetary implications. Although plans for the period from 2004 to 2007 involve an improvement in the cyclically-adjusted balance by only 0.4 percentage point of GDP on average per year, and thus below the 0.5 percentage point benchmark, the composition of the budgetary adjustment follows the recommendation that calls for deficit reduction to be obtained mainly through expenditure restraint. Moreover, the recommendation requesting Portugal to undertake structural reforms in areas with a direct impact on budgetary consolidation is being timely followed.