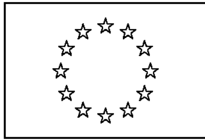

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 22.6.2005
SEC(2005) 834 final

Recommendation for a

COUNCIL OPINION

in accordance with Article 5(3) of
Council Regulation (EC) No 1466/97 of 7 July 1997

on the updated stability programme of Portugal, 2005-2009

(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 coordination of economic policies[1] stipulates that participating Member States, that is, those which have adopted the single currency, had 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 assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission, and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their stability programmes, which may also be examined by the Council in accordance with these same procedures. 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. Updates were presented every following year.

The Portuguese authorities submitted the most recent update of the Portuguese stability programme on 9 June 2005. The update covers the period from 2005 to 2009 and was submitted by the government that was installed following the general elections of 20 February 2005. It was approved by the government on 2 June in accordance with the Portuguese domestic procedures (Law on Budgetary Stability), and discussed by Parliament on 9 June 2005. The Commission services have carried out a technical evaluation of this update, taking into account the results of their own spring 2005 economic forecasts, having regard to the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the report of the Ecofin Council of 20 March 2005 on 'Improving the implementation of the Stability and Growth Pact', endorsed by the European Council on 22 March 2005[3]. This evaluation warrants the following assessment:

- The update complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes"[4]. However, it does not present projections on the long-term sustainability of the public finances, but instead only refers to a task force set up by the government to assess the long-term sustainability of the social security system.
- The update of the stability programme is built around the need to correct a government deficit which at 6.2% of GDP in 2005 is planned to be well in excess of 3% of GDP. This figure follows a deficit of 2.9% of GDP in years 2002 to 2004, as recently reported by the Portuguese authorities reflecting discussions with Eurostat, and is considerably worse

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

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

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).

4 The Portuguese authorities had submitted an updated programme in December 2004, thereby complying with the formally required date of submission. However, in view of the upcoming general elections in Portugal, it it was at the time decided not to assess that programme, but to wait for the update to be presented by the new government.

compared with the target of 2.2% of GDP for 2005 in the previous programme update. This deterioration is explained by weaker-than-expected growth, a reassessment of expenditure growth, over-runs compared to the budget and the non-introduction of one-off measures planned in the previous programme[5], as well by a corrective package of some 0.6% of GDP adopted by the new government in June 2005. For the reduction of the deficit, the update outlines a strategy that envisages the implementation of structural measures rather than the reliance on sizeable one-off and temporary measures, which indicates a change with respect to the budgetary strategy outlined in the previous updates. The government deficit is expected to continuously improve over the coming years, but will exceed the 3% of GDP reference value until at least 2007.

- The macroeconomic scenario presented in the programme projects real GDP growth to increase from 1% in 2004 and 0.8% in 2005 to 1.4% in 2006, 2.2% in 2007, 2.6% in 2008 and 3.0% in 2009. This profile is driven by accelerating domestic demand. The external contribution is expected to diverge little from a neutral position, either on the positive or negative side. The growth projections for 2005 and 2006 are slightly below the Commission services' forecasts, reflecting the most recent developments. For the outer years, the projected GDP growth is clearly above the trend estimated by the Commission services according to the commonly agreed methodology; the output gap will narrow over the programme period, and is expected to be closed by the programme horizon. However, it cannot be excluded that the budgetary consolidation efforts may weigh on growth to a higher degree than implicitly assumed in the programme. On the other hand, the perception that an unsustainable fiscal situation is being addressed may generate favourable confidence effects. Moreover, weak competitiveness against the background of heightened competition on Portuguese export markets may hurt the net contribution of the external sector to growth. The projected acceleration in economic activity therefore hinges on addressing structural deficiencies in productivity and competitiveness, and on the capacity to restore confidence. All in all, in the light of the experience of past years, the growth projections for 2007 to 2009 seem to reflect optimistic assumptions and therefore contain an element of risk. The programme's projections for inflation for 2005 and 2006 also appear to be on the low side, given the planned increase in indirect taxes.

- The update projects the general government deficit to reach 6.2% of GDP in 2005, following deficit ratios of 2.9% of GDP in both 2003 and 2004[6] (excluding one-off and temporary measures, these ratios would have been 5.4% and 5.2% of GDP respectively). The deficit is projected to decline to 4.8% of GDP in 2006, 3.9% in 2007 and 2.8% in 2008. For 2009, the programme projects a further decline of the deficit ratio to 1.6% of GDP. The primary balance is projected to follow a similar path: -3.3% in 2005, -1.6% in 2006, and -0.5% of GDP in 2007. Primary surpluses of 0.7 and 1.8% of GDP are projected for 2008 and 2009. The programme focuses on measures having medium-term impact and does not rely on sizeable temporary measures as the means to improve the budget balance.

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[5] The government which came into office in March 2005 entrusted an ad-hoc commission under the overall responsibility of the Central Bank Governor with the assessment of the state of government finances for 2005. In mid-May, the commission presented its findings, projecting for 2005 at unchanged policies a deficit of 6.8% of GDP.

[6] In its news release No 34/2005 of 18 March 2005, Eurostat communicated the existence of "ongoing discussions between Eurostat and Portugal on the consistency between accrual and cash-based data provided by Portugal, for the period 2001-2004." Subsequent information provided by the Portuguese authorities indicate small upward revisions for the years 2000, 2002 and 2003, yielding deficit ratios of 2.9% of GDP for each of these years. Eurostat is currently reviewing these revisions.

Accordingly, the consolidation effort will take place over the entire programme period with front-loading, since a substantial consolidation effort will take place in 2006. Calculations by the Commission services applying the commonly agreed methodology to the information in the programme show the cyclically-adjusted deficit to widen substantially to 5.3% of GDP in 2005 but to decline gradually to 1.4% of GDP in 2009. The detailed projections of revenue and expenditure until 2009 show that consolidation efforts will be helped by both the tax revenue and primary expenditure sides, with a progressive contribution of the focus on the latter. In the early part of the programme period, consolidation is relying mainly on increasing revenues, through higher tax rates (notably an increase in the standard VAT rate from 19% to 21%), lower tax credits and improved tax collection, which partly offset the one-off revenues foregone. In the outer years, the increased contribution from expenditure restraint is foreseen to come from measures of a permanent nature, such as the reform of the public administration, including the containment of the wage bill and changes in the social security retirement schemes, whose budgetary effects will be significant mainly in the medium term. The share of investment in total government expenditure is to decline slightly over the programme period.

– There are several elements of risk weighing on the budgetary projections. First, the acceleration in economic activity, in particular from 2007 onwards, may be slower than expected. Second, the revenue and expenditure trajectories may be less favourable than planned. Indeed, the higher tax rates heighten the risk of tax evasion, and most of the announced restraint on expenditure still needs to be legally implemented. For 2005, the government plans to submit a corrective budget by the end of June. For the outer years, expenditure reforms may nevertheless take longer to implement, and, as result, their short- and medium-term effects may turn out less significant than expected. In the event, the government might be called to fulfil its commitment to take additional measures in order to avoid the deficit exceeding 3% of GDP for longer than planned. Even if the projected path is adhered to, for 2008 and 2009, the budgetary stance in the programme does not provide a sufficient safety margin against breaching the deficit threshold with normal macroeconomic fluctuations. It is also insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance is achieved by the end of the programme period.

– The debt-to-GDP ratio breached the 60% of GDP reference value of the Treaty in 2003, moving up to 61.9% in 2004. According to the update, after reaching 66.5% of GDP in 2005, the debt ratio will peak in 2007 at 67.8% of GDP, and decrease thereafter to 64.5% in 2009. The evolution of gross debt may turn out less favourable than projected given the risks to economic activity and to the government deficit targets and the likelihood, based on past experience, of debt-increasing stock-flow adjustments, in particular the accumulation of financial assets.

– With regard to the long-term sustainability of the public finances, Portugal appears to be at risk on grounds of the projected budgetary cost of an ageing population. In the absence of further measures, the high deficit and the rising debt-to-GDP ratio will undermine the sustainability of public finances, hence the timely achievement of a budgetary position close to balance is imperative. The structural reforms measures enacted to date, in particular in the areas of pension and health care, should ease the budgetary impact of ageing. However, these reforms do not appear sufficient to ensure sustainability. The reforms outlined in the update, notably on retirement provisions for the civil service, could contribute to this end if implemented thoroughly.

- Overall, the economic policies outlined in the update are partly consistent with the country-specific Broad Economic Policy Guidelines in the area of public finances. As recommended, the programme projects the consolidation of public finances to take place to a large extent from the expenditure side, albeit in a progressive manner, and does not rely on sizeable one-off or temporary measures. Moreover, its projections, if adhered to, imply an improvement in the cyclically-adjusted primary balance (net of one-off and temporary measures) of more than 0.5% of GDP each year. However, the programme does not plan to reduce the deficit below 3% of GDP before 2008, and the planned expenditure restraint will be insufficient to achieve the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance by the end of the programme period.

- In the light of the deficit and debt figures for 2005 and following years presented in the updated stability programme, the Commission initiated the excessive deficit procedure for Portugal on 22 June. The Council, when deciding on the existence of an excessive deficit in Portugal, will also issue a recommendation for the correction of the excessive deficit; such recommendation will include, inter alia, a deadline for the correction of the excessive deficit.

In view of the above assessment, it would be appropriate for Portugal to: (i) limit the deterioration of the fiscal position in 2005, by ensuring rigorous implementation of the announced corrective measures; (ii) achieve a sustained correction of the excessive deficit as soon as possible, taking a substantial step in 2006 followed by a significant decrease each year, and enacting decisively the planned measures to reduce government expenditure; seize any opportunity to accelerate the reduction of the budget deficit, in particular to create margins to deal with the budgetary impact of possible lower-than-projected growth; (iii) bring the gross debt ratio onto a firm downward path, by ensuring that debt developments reflect progress in the reduction of the deficit and avoiding debt-increasing financial transactions;(iv) control the evolution of expenditure, possibly through the announcement of binding ceilings for specific expenditure categories, within a comprehensive reform programme improving the quality and ensuring the long-term sustainability of public finances.(v) further improve the processing of general government data.

On the basis of 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 Article 5(3) of Council Regulation (EC) No 1466/97 of 7 July 1997

on the updated stability programme of Portugal, 2005-2009

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[7], 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:

(1) On […], the Council examined the updated stability programme of Portugal, which covers the period 2005 to 2009. The programme complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes"[8]. However, the programme does not provide projections on the long-term sustainability of public finances. Accordingly, Portugal is invited to achieve full compliance with the data requirements of the code of conduct.

(2) The update of the stability programme is built around the need to correct a government deficit which at 6.2% of GDP in 2005 is planned to be well in excess of 3% of GDP. This figure follows a deficit of 2.9% of GDP in years 2002 to 2004, as recently reported by the Portuguese authorities reflecting discussions with Eurostat, and is considerably worse compared with the target of 2.2% of GDP for 2005 in the previous programme update. This deterioration is explained by weaker-than-expected growth, a reassessment of expenditure growth, over-runs compared to the budget and the non-introduction of one-off measures planned in the previous programme, as well by a corrective package of some 0.6% of GDP adopted by the new government in June 2005. For the reduction of the deficit, the update outlines a strategy that envisages the implementation of structural measures rather than the reliance on sizeable one-off and temporary measures, which indicates a change with respect to the budgetary strategy outlined in the previous updates. The government deficit is expected to continuously

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

8 The Portuguese authorities had submitted an updated programme in December 2004, thereby complying with the formally required date of submission. However, in view of the upcoming general elections in Portugal, it was at the time decided not to assess that programme, but to wait for the update to be presented by the new government.

improve over the coming years, but will exceed the 3% of GDP reference value until at least 2007.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will progressively pick up from 0.8% in 2005 to 3.0% in 2009, with growth rates of successively 1.4%, 2.2% and 2.6% in the intermediate years. On the basis of current information, the growth projections for the first part of the programme period are plausible, while there are more risks to the programme's outer years. Structural measures addressing productivity and competitiveness and restoring confidence are essential if the projected growth path is to be realised. The programme's projections for inflation for 2005 and 2006 appear to be on the low side, given the planned increase in indirect taxes.

(4) The programme aims at reaching a government deficit below the 3% of GDP reference value by 2008. The government deficit ratio is expected to decline from 6.2% of GDP in 2005 to 4.8% in 2006, 3.9% in 2007, 2.8% in 2008 and 1.6% in 2009. Calculations by the Commission services applying the commonly agreed methodology to the information in the programme show that the cyclically-adjusted deficit, after widening to 5.3% of GDP in 2005, will decline progressively to 1.4% in 2009. The consolidation effort will extend over the entire programme period with front-loading, since a substantial consolidation effort will take place in 2006. In the early part of the programme period, consolidation is relying mainly on increasing revenues, through higher tax rates (notably an increase in the standard VAT rate from 19% to 21%), lower tax credits and improved tax collection, which partly offset the one-off revenues foregone. In the outer years, the increased contribution from expenditure restraint is foreseen to come from measures of a permanent nature, such as the reform of the public administration, containment of the wage bill and changes in the social security retirement schemes, whose budgetary effects will be significant mainly in the medium term. The share of investment in total government expenditure is to decline slightly over the programme period.

(5) The budgetary outcome as projected in the programme is subject to several risks. First, the acceleration in economic activity may be slower than expected, depending on the effective impact of the fiscal consolidation measures and given the expected increase in international competition in the Portuguese export markets. Second, the revenue-raising and expenditure-restraining measures may be less effective than projected or take longer to produce the desired results. The higher tax rates heighten the risk of tax evasion, and most of the announced restraint on expenditure still needs to be legally implemented. In view of this assessment, the government might be called to fulfil its commitment to take additional measures in order to avoid the deficit exceeding 3% of GDP for longer than planned. Moreover, even if the projected path is adhered to, the budgetary stance in the programme does not provide a sufficient safety margin against breaching the deficit ceiling with normal macroeconomic fluctuations until at least 2009. It is also insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance is achieved within the programme horizon. A sensitivity analysis shows that the deficit would still be at 3%, or very close to it, in 2009, in the event of unfavourable macroeconomic developments.

(6) The debt-to-GDP ratio breached the 60% of GDP reference value of the Treaty in 2003, moving up to 61.9% in 2004. According to the update, after reaching 66.5% of GDP in 2005, it will peak at 67.8% of GDP, declining thereafter until it reaches 64.5%

in 2009. The evolution of the gross debt ratio may also turn out less favourable than projected, given the risks to economic activity, the budgetary targets and the likelihood, based on past experience, of debt-increasing stock-flow adjustments, in particular the accumulation of financial assets.

(7) With regard to the long-term sustainability of the public finances, Portugal appears to be at risk on grounds of the projected budgetary cost of an ageing population. The structural reform measures enacted to date, in particular in the areas of pension and health care, should ease the budgetary impact of ageing. However, these reforms do not appear sufficient to ensure sustainability. The reforms outlined in the update, notably on retirement provisions for the civil service, could contribute to this end if implemented thoroughly. The government has commissioned a report to assess the long-term sustainability of the social security system.

(8) Overall, the economic policies outlined in the update are partly consistent with the country-specific Broad Economic Policy Guidelines in the area of public finances. As recommended, the programme projects the consolidation of public finances to take place to a large extent from the expenditure side and does not rely on sizeable one-off or temporary measures. Its projections, if adhered to, also imply an improvement in the cyclically-adjusted primary balance (net of one-off and temporary measures) by more than 0.5% of GDP each year. However, it does not plan to reduce the deficit below 3% of GDP before 2008, and the planned expenditure restraint will be insufficient to achieve the medium-term objective of the Stability and Growth Pact of a budgetary position of close to balance by the end of the programme period.

(9) In the light of the deficit and debt figures for 2005 and following years presented in the updated stability programme, the Commission initiated the excessive deficit procedure for Portugal on 22 June. The Council, when deciding on the existence of an excessive deficit in Portugal, will also issue a recommendation for the correction of the excessive deficit; such recommendation will include, *inter alia*, a deadline for the correction of the excessive deficit.

* * *

In view of the above assessment, the Council is of the opinion that Portugal should:

(i) limit the deterioration of the fiscal position in 2005, by ensuring rigorous implementation of the announced corrective measures;

(ii) achieve a sustained correction of the excessive deficit as soon as possible, taking a substantial step in 2006 followed by a significant decrease each year, and enacting decisively the planned measures to reduce government expenditure; seize any opportunity to accelerate the reduction of the budget deficit, in particular to create margins to deal with the budgetary impact of possible lower-than-projected growth;

(iii) bring the gross debt ratio onto a firm downward path, by ensuring that debt developments reflect progress in the reduction of the deficit and avoiding debt-increasing financial transactions;

(iv) control the evolution of expenditure, possibly through the announcement of binding ceilings for specific expenditure categories, within a comprehensive reform programme improving the quality and ensuring the long-term sustainability of public finances.

(v) further improve the processing of general government data.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	**SP Jun 2005**	**1.0**	**0.8**	**1.4**	**2.2**	**2.6**	**3.0**
	COM April 2005	1.0	1.1	1.7	–	–	–
	SP Jan 2004	*1.0*	*2.5*	*2.8*	*3.0*	–	–
HICP inflation (%)	**SP Jun 2005**	**2.5**	**2.5**	**2.9**	**2.5**	**2.5**	**2.4**
	COM April 2005	2.5	2.3	2.1	–	–	–
	SP Jan 2004	*2.0*	*2.0*	*2.0*	*2.0*	–	–
General government balance (% of GDP)	**SP Jun 2005**	**-2.9**	**-6.2**	**-4.8**	**-3.9**	**-2.8**	**-1.6**
	COM April 2005	-2.9	-4.9	-4.7	–	–	–
	*SP Jan 2004**	*-2.8*	*-2.2*	*-1.6*	*-1.1*	–	–
Primary balance (% of GDP)	**SP Jun 2005**	**-0.1**	**-3.3**	**-1.6**	**-0.5**	**0.7**	**1.8**
	COM April 2005	-0.1	-2.0	-1.6	–	–	–
	SP Jan 2004	*0.1*	*0.9*	*1.5*	*2.0*	–	–
Cyclically-adjusted balance (% of GDP)	**SP Jun 2005**[1]	**-2.2**	**-5.3**	**-3.8**	**-3.1**	**-2.3**	**-1.4**
	COM April 2005	-2.0	-3.9	-3.7	–	–	–
	SP Jan 2004[1*]	*-1.7*	*-1.3*	*-0.9*	*-0.7*	–	–
Government gross debt (% of GDP)	**SP Jun 2005**	**61.9**	**66.5**	**67.5**	**67.8**	**66.8**	**64.5**
	COM April 2005	61.9	66.2	68.5	–	–	–
	*SP Jan 2004**	*60.0*	*59.7*	*58.6*	*57.0*	–	–

Note:
[1]Commission services calculations on the basis of the information in the programme.
* Including one-off and temporary measures.
Sources:
Stability programmes (SP); Commission services spring 2005 economic forecasts (COM); Commission services calculations.