COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Portugal, 2006-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. General background

The Stability and Growth Pact, which entered into force on 1 July 1998, 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. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first stability programme of Portugal was submitted in December 1998. In accordance with the Regulation, the Council delivered an opinion on it on 8 February 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

2. Background for the assessment of the updated programme

The Commission has examined the most recent update of the stability programme of Portugal, submitted on 15 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(3) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme) and

(4) the Commission's assessment of the October 2006 national reform programme.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). 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

2.1. Recent economic and budgetary performance

After a phase of strong economic growth reflecting dynamic domestic demand and a boost in productivity in the second half of the nineties, in the run-up to euro adoption, low growth after 2000 implied a halt in the convergence process. This resulted from limited progress on key features of the economy. First, the adjustment on the supply side seems to have been insufficient to support the catching-up process in a more substantial way. At the same time, important sectors are still adjusting to the challenges of globalisation. Second, as income has not expanded as quickly as spending, debt is at high levels and the external deficit has been sizeable, mainly driven by a trade deficit. Third, public finances have been fragile largely as the result of the missed opportunity to consolidate in "good times" and of the significant increase in the deficit during the downturn.

2.2. The excessive deficit procedure for Portugal

On 20 September 2005, the Council adopted a decision stating that Portugal had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2008. In particular, Portugal was recommended to limit the deterioration of the fiscal position in 2005 and to ensure a correction of the structural deficit of some 1.5% of GDP in 2006, followed by a further decrease of, at least, ¾% of GDP in both 2007 and 2008.

After the expiry of the 6-months deadline established by the Council for the Portuguese government to take effective action in order to achieve the 2006 deficit target, the Commission carried out an assessment of the efforts made by the Portuguese authorities. The conclusions of the Commission communication adopted on 22 June 2006 were as follows: based on the information available at the time, it appeared that Portugal had taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council and that no further steps in the excessive deficit procedure of Portugal were necessary. In its meeting of 11 July 2006, the Council concurred with this assessment.

2.3. The assessment in the Council opinion on the previous programme

On 14 March 2006, the Council adopted its opinion on the previous update of the stability programme, covering the period 2005-2009. The Council was of the opinion that “the programme is broadly consistent with a correction of the excessive deficit by 2008, subject to a full implementation of the measures announced in the programme that need to be reinforced for the years 2007 and beyond to accommodate the downward risks to the budgetary targets”. The Council invited Portugal to

“(i) adopt and implement with rigour the structural measures envisaged in the programme in order to ensure the correction of the excessive deficit by 2008 in a credible and sustainable manner; ensure a continued adjustment towards the MTO, once the excessive deficit has been corrected, in line with the SGP requirements; and create margins to deal with the budgetary impact of possible lower-than-projected economic growth;

(ii) enact decisively the planned measures to control expenditure; improve the budgetary process at all levels of general government, possibly through the more extensive use of binding expenditure ceilings and, as outlined in the programme, by strengthening mechanisms of monitoring, controlling and reporting expenditure and revenue;

(iii) improve the long-term sustainability of public finances, in particular by implementing the measures already envisaged in the programme and by enacting further reforms in the area of pensions and health care;

(iv) and, bring the government gross debt ratio onto a firm downward path by ensuring that it reflects both the progress in the reduction of the government deficit and the projected privatisation proceeds, and by considering carefully the impact on debt of major public investment projects, including those in partnership with the private sector".

2.4. The Commission assessment of the October 2006 national reform programme

The Implementation Report of the National Reform Programme of Portugal, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 20 October 2006. Portugal's National Reform Programme identifies as key challenges/priorities: strengthening budgetary consolidation; reform of public administration; fostering scientific and technological development; and increasing the qualification levels of the population.

The Commission's assessment of that programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that Portugal is making good progress on implementing the measures in the National Reform Programme, especially in the macro and micro-economic areas. On employment related policies, there has also been progress, especially on reforming education and training, but the important area of the adaptability of the labour market and flexicurity is not yet being fully addressed. Considerable further efforts across all policy areas will be necessary to fully achieve the objectives of the programme, given their welcome ambition and Portugal's point of departure.

Against the background of strengths and weaknesses identified, Portugal was recommended to take action in the areas of: fiscal consolidation and public administration; education and vocational training; and employment protection and labour market segmentation.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;

[2] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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3 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

4 "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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On the updated stability programme of Portugal, 2006-2010

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[5], 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 [27 February 2007] the Council examined the updated stability programme of Portugal, which covers the period 2006 to 2010.

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will pick up from 1.4% in 2006 to 1.8% in 2007 and 2.4% in 2008 and eventually to 3% per year over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on favourable growth assumptions, notably for the outer years, with the output gap closing rapidly. The programme's projections for inflation appear realistic.

(3) For 2006, the general government deficit is estimated at 4.6% of GDP in the Commission services' autumn 2006 forecast and in the new update, which would correspond to the target set in the previous update of the stability programme. According to the new update, both total government revenue and expenditure level targets have been largely met. As percent of GDP, both ratios are somewhat lower than in the Commission services' autumn 2006 forecast.

[5] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, 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

(4) The main goal of the programme's medium-term budgetary strategy is a lasting correction of the large fiscal imbalances, notably a reduction of the general government deficit to below the 3% of GDP reference value in the year 2008 and further budgetary consolidation thereafter. Substantial steps towards fiscal consolidation are planned throughout the programme period: the government deficit is targeted to gradually decline from 4.6% of GDP in 2006 to 0.4% in 2010; the adjustment path for the primary balance is similar, with an improvement from a deficit of 1.7% of GDP in 2006 to a surplus of 2.5% in 2010. The planned deficit reduction is to be achieved mainly by curbing primary expenditure, the overall level of which is to decline in real terms over the programme period thanks to corrective measures of a structural nature concentrated on restructuring central government, personnel and public services and also on controlling social security and health expenditure. In the earlier years of the programme, higher tax revenues coming mainly from an increase in some rates and lower tax benefits will also contribute to fiscal consolidation. The programme confirms the planned adjustment outlined in the December 2005 update of the stability programme against a largely unchanged macroeconomic scenario.

(5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve from a deficit of around 3½% of GDP in 2006 to ½% by 2010. Over the programme period, the structural balance is planned to be reduced by an average of almost ¾% of GDP per year. The medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 0.5% of GDP, which the programme aims to achieve by 2010, one year earlier than implicitly targeted in the previous programme. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(6) The budgetary outcomes are subject to downside risks deriving, in particular, from the impact of the measures to contain government spending. Against the backdrop of a difficult macroeconomic environment, the government has recently implemented decisive measures to tackle expenditure growth, notably in public administration, health care and social welfare, in addition to the new legal framework to improve the fiscal developments of regional and local governments. Others measures partly also relating to the government sector, are still in preparation. The budgetary relief to be expected from these measures is nevertheless subject to considerable uncertainty, notably for 2008 and beyond. Since fiscal consolidation relies crucially on expenditure retrenchment, further progress with the ongoing improvement of the budgetary framework and implementation of mechanisms of assessing and controlling budgetary execution will also be instrumental to the achievement of the budgetary targets. As mentioned above, the favourable macroeconomic scenario raises the risk of a less marked recovery of economic activity thus providing more moderate relief to government finances. The assumptions about the elasticity of tax revenue to economic activity appear somewhat optimistic in 2007, and depending on a further improvement in tax collection, although plausible for the rest of the programme period. Finally, the performance of public enterprises provides a budgetary risk in the medium term.

(7) In view of this risk assessment, the budgetary stance in the programme is broadly consistent with a correction of the excessive deficit by 2008 as recommended by the Council, provided the measures announced in the programme are fully and effectively implemented and reinforced in case of lower-than-projected economic growth. Following the correction of the excessive deficit, the programme targets an adjustment that is in line with the Pact. However, taking into account the risks to the budgetary targets, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations until the end of the programme period. Consequently, the MTO would not be reached by 2010, as envisaged in the programme. Thus, in the years following the correction of the excessive deficit, the adjustment towards the MTO outlined in the programme could require reinforcing the measures to be in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times.

(8) Government gross debt is estimated to have reached 67½% of GDP in 2006, above the 60% of GDP Treaty reference value. The programme projects the debt ratio to increase in 2007 and to decline by close to 6 percentage points over the rest of the programme period. The evolution of the debt ratio is subject to the risks to the budgetary targets mentioned above and continued uncertainty about the stock-flow adjustment, which has tended to be large and predominantly debt-increasing in the past. In view of this risk assessment, the debt ratio would start to be sufficiently diminishing towards the reference value at the end of the programme period.

(9) Portugal has recently enacted pension reforms aimed at strengthening the sustainability of the public finances. Estimates in the programme suggest that the overall increase in age-related expenditure over the coming decades would be significantly lower as a result of the reform, though remaining sizeable. The initial budgetary position, albeit improved compared with 2005, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Moreover, the current level of gross debt is above the Treaty reference value. Overall, Portugal appears to be at high risk with regard to the sustainability of public finances. The planned budgetary consolidation coupled with further containment of the age-related expenditure would contribute to reducing such risks.

(10) The stability programme contains a qualitative assessment of the overall impact of the October 2006 Implementation Report of the National Reform Programme within the medium-term fiscal strategy. In addition, it provides systematic information on the direct budgetary costs or savings of the main reforms envisaged in the National Reform Programme and its budgetary projections explicitly take into account the public finance implications of the actions outlined therein. The measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the National Reform Programme. In particular, both programmes address the linkages between public administration reform and the fiscal consolidation strategy and provide complementary information on various policy measures.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[6]. However, it deviates on some material points from the model structure specified in the code of conduct[7].

The overall conclusion is that the programme is broadly consistent with a correction of the excessive deficit by 2008, conditional on a full and effective implementation of the measures announced therein and on the reinforcement of such measures in case of lower-than-projected economic growth. After the correction of the excessive deficit, the programme envisages adequate progress towards the medium-term objective, but there are risks to the achievement of the budgetary targets. In view of the above assessment, and also in the light of the recommendation under Article 104(7) of 20 September 2005, Portugal is invited to:

(i) implement with rigour the structural measures envisaged in the programme so as to correct the excessive deficit by 2008 and stand ready to reinforce these measures to deal with the budgetary impact of possible lower-than-projected economic growth;

(ii) once the excessive deficit has been corrected, carry out the envisaged adjustment towards the MTO, backing it up with reinforced measures if necessary; and ensure that the debt-to-GDP ratio is reduced accordingly;

(iii) pursue the ongoing reform of public administration; continue strengthening the budgetary framework, including the assessment and control of budgetary execution at all levels of the general government, notably in order to attain the planned expenditure containment;

(iv) in view of the level of debt and the projected increase in age-related expenditure, improve the long-term sustainability of public finances by achieving the MTO and by securing and possibly enhancing the benefits of the adopted pension reforms.

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6 In particular, the data on HICP inflation and compensation of government employees are not provided.

7 The programme rather presents five sections: Executive Summary; Macroeconomic and Budgetary Situation; Macroeconomic and Budgetary Forecasts; Long-term Sustainability of Public Finances; and Institutions, Processes and Budgetary Rules.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010
Real GDP (% change)	**SP Dec 2006**	**0.4**	**1.4**	**1.8**	**2.4**	**3.0**	**3.0**
	COM Nov 2006	0.4	1.2	1.5	1.7	n.a.	n.a.
	SP Dec 2005	*0.5*	*1.1*	*1.8*	*2.4*	*3.0*	*n.a.*
HICP inflation (%)	**SP Dec 2006**[6]	**2.5**	**3.2**	**2.2**	**2.2**	**2.1**	**2.1**
	COM Nov 2006	2.1	2.9	2.2	2.1	n.a.	n.a.
	SP Dec 2005[6]	*2.3*	*2.3*	*2.2*	*2.2*	*2.1*	*n.a.*
Output gap (% of potential GDP)	**SP Dec 2006**[1]	**-2.5**	**-2.6**	**-2.4**	**-1.8**	**-0.7**	**0.2**
	COM Nov 2006[5]	-2.0	-2.0	-1.8	-1.5	n.a.	n.a.
	SP Dec 2005[1]	*-2.3*	*-2.7*	*-2.5*	*-1.8*	*-0.7*	*n.a.*
General government balance (% of GDP)	**SP Dec 2006**	**-6.0**	**-4.6**	**-3.7**	**-2.6**	**-1.5**	**-0.4**
	COM Nov 2006	-6.0	-4.6	-4.0	-3.9	n.a.	n.a.
	SP Dec 2005	*-6.0*	*-4.6*	*-3.7*	*-2.6*	*-1.5*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2006**	**-3.3**	**-1.7**	**-0.7**	**0.4**	**1.5**	**2.5**
	COM Nov 2006	-3.3	-1.7	-1.0	-0.7	n.a.	n.a.
	SP Dec 2005	*-3.2*	*-1.7*	*-0.6*	*0.6*	*1.5*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Dec 2006**[1]	**-4.9**	**-3.4**	**-2.6**	**-1.8**	**-1.2**	**-0.5**
	COM Nov 2006	-5.1	-3.7	-3.2	-3.2	n.a.	n.a.
	SP Dec 2005[1]	*-5.0*	*-3.4*	*-2.6*	*-1.8*	*-1.2*	*n.a.*
Structural balance[2] (% of GDP)	**SP Dec 2006**[3]	**-4.9**	**-3.4**	**-2.6**	**-1.8**	**-1.2**	**-0.5**
	COM Nov 2006[4]	-5.1	-3.7	-3.2	-3.2	n.a.	n.a.
	SP Dec 2005	*-5.0*	*-3.4*	*-2.6*	*-1.8*	*-1.2*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2006**	**64.0**	**67.4**	**68.0**	**67.3**	**65.2**	**62.2**
	COM Nov 2006	64.0	67.4	69.4	70.7	n.a.	n.a.
	SP Dec 2005	*65.5*	*68.7*	*69.3*	*68.4*	*66.2*	*n.a.*

Notes:

[1] Commission services calculations on the basis of the information in the programme.

[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

[3] There are no one-off and other temporary measures in the programme.

[4] There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.

[5] Based on estimated potential growth of 1.2% in the period 2005-2007 and 1.4% in 2008.

[6] Private consumption deflator.

Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations.