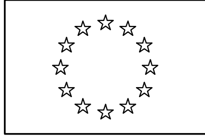

COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION OPINION

on the existence of an excessive deficit in Portugal – Application of Article 104(5) of the Treaty establishing the European Community

(presented by the Commission)

EXPLANATORY MEMORANDUM

On 25 July last, the Commission received official confirmation from the Portuguese authorities that the general government deficit in 2001 amounted to 4.1% of GDP, thereby clearly exceeding the reference value of 3% of GDP. The figure was confirmed in Portugal's submission by 1 September under the semi-annual reporting of government deficits and debt levels. Based on this evidence, the Commission initiated the Excessive Deficit Procedure for Portugal.

The application of the excessive deficit procedure (EDP) is governed by Article 104 of the Treaty (ex 104c), Council Regulation N°1467/97 "on the speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact. It is also affected by the political commitments enshrined in the Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997.

In an initial step of the EDP, the Commission prepared a report according to Art. 104.3 of the Treaty. That report was adopted by the Commission on 24 September. It concluded that in 2001, the general government deficit in Portugal had risen to 4.1% of GDP, significantly exceeding the reference value of 3%. Gross government debt went up to 55.5% of GDP by end-2001, still remaining below the 60% reference value. The excess of the Portuguese deficit in 2001 over the reference value did not result from an unusual event outside the control of the Portuguese authorities, nor was it the result of a severe economic downturn. On developments in 2002 the report concluded that while it was clear that the deficit would be reduced, it was not yet possible to assess whether the deficit would stay below the 3% of GDP reference value. Moreover, given that the debt-to-GDP ratio was projected at just under the 60% reference value, any slippage in budgetary execution or a deceleration in nominal GDP growth could imply a breach of the debt ceiling.

Treaty Art. 104.4 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". The Committee issued its opinion on 3 October (document EFC/ECFIN/476/02 rev 1), concluding that "budgetary developments in Portugal last year were such that the first criterion in the second paragraph of Article 104 *[i.e. the ratio of the government deficit to GDP not exceeding the 3% reference value]* was not respected. Consideration of other relevant factors supported the assessment based on this criterion. The EFC also took note of the strong commitment by the Portuguese authorities to take all the necessary measures in 2002 to correct the situation, but considered that the budgetary data so far this year did not as yet confirm a correction.

The Commission, having examined the relevant factors taken into account in its report and having regard to the opinion of the EFC, is of the opinion that an excessive deficit exists in Portugal. This opinion, adopted by the Commission on 16 October, is herewith addressed to the Council, according to Article 104.5 of the Treaty. The Commission recommends that the Council shall decide accordingly, in conformity with Article 104.6. In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Portugal with a view to bringing an end to the situation of an excessive government deficit, according to Treaty Article 104.7.

COMMISSION OPINION

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GENERAL CONSIDERATIONS

On 1 January 1999, the third stage of economic and monetary union has started. According to Article 104 of the Treaty, Member States shall avoid excessive government deficits. Decisions on the existence of an excessive deficit are ruled by the excessive deficit procedure (EDP) specified by article 104 of the Treaty and Council Regulation (EC) No. 1467/97.[1]

Article 104(2) of the Treaty requires the Commission to monitor the developments of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular, the Commission shall examine compliance with budgetary discipline on the basis of two criteria, one for the ratio of the planned or actual government deficit to gross domestic product (GDP) and one for the ratio of government debt to GDP. The statistical data on these variables are provided by the Commission on the basis of reporting by the Member States twice a year[2].

Article 104(3) of the Treaty requires the Commission to prepare a report if the requirements under one or both of the criteria of Article 104(2) are not fulfilled or if, notwithstanding the fulfilment of the requirements under the criteria, the Commission is of the opinion that there is a risk of an excessive deficit in a Member State. On the basis of the most recent information available the Commission has adopted such a report for Portugal on 24 September 2002The Commission report takes account of whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State, as required by Article 104(3) of the Treaty[3].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee has formulated an opinion on the report of the Commission on 3 October 2002

Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. In order to reach a conclusion on whether an excessive deficit exists or may occur, the Commission considers that account should be taken of: (i) the findings of its own report, namely whether the requirements under one or both of the criteria of Article 104(2) of the Treaty are not fulfilled, and the relevance of all other factors mentioned in article 104(3) and (ii) the opinion of the Economic and Financial Committee on the report of the Commission.

[1] The excessive deficit procedure is jointly determined by Article 104 of the Treaty, the Protocol on the excessive deficit procedure annexed to the Treaty and Council Regulation No. 1467/97 "on the speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact. It is also affected by the political commitments enshrined in the Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997.

[2] Government accounts data are to be reported before 1 March and before 1 September, in the terms of Council Regulation (EC) 3605/93 amended by Council Regulation (EC) 475/00 and by Commission Regulation (EC) No. 351/2002

[3] The Commission's report of September 2002 in accordance with Article 104(3) was established using information available until 20 September 2002, which is also the information underlying this opinion.

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On the basis of these elements, the Commission has established a number of considerations for Portugal.

CONSIDERATIONS CONCERNING PORTUGAL

1. In 2001, the government deficit in Portugal was equal to 4.1% of GDP, thereby clearly exceeding the reference value of 3%. In 2000, the deficit ratio had been 2.9%. Government debt at the end of 2001 was 55.5% of GDP, compared with 53.3% one year earlier. For 2002, the Portuguese authorities are planning a general government deficit of 2.8% of GDP and estimate the government gross debt ratio to reach 59.3% of GDP. Government debt is therefore increasing and approaching the reference value of 60% of GDP.

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2. Under the provisions for the excessive deficit procedure, Member States are required to report to the Commission twice a year actual and planned figures for their government deficits and debt[4]. In March 2002, the Portuguese authorities had reported a deficit of 2.2% of GDP for 2001. This figure was twice as high as envisaged for the same year in the previous update of the Stability Programme. Anticipating the deviation from the original target, accompanied by the risk of the 3% of GDP reference value for the budget deficit being exceeded, prompted the Commission to recommend in late January 2002 that an early warning be sent to Portugal under the SGP framework. In the reporting of September 2002, the deficit was revised upwards to 4.1% of GDP. The revised deficit figure had been established by an ad-hoc commission under the responsibility of the governor of the Bank of Portugal, entrusted by the Portuguese government with the review of the government accounts for 2001. The commission clarified a number of statistical issues and could draw on new information on budgetary execution, leading altogether to a substantial upward revision of the deficit ratio by 1.9 percentage points of GDP for 2001.

Of this difference, about 1 percentage point (pp) is due to the adjustment in the previously reported government accounts to bring them in line with agreed definitions in application of the European System of Accounts 1995, the rest to an update of budgetary execution estimates. More specifically, the government accounts have been adjusted in two ways:

(i) Regulation n°2516/2000[5] on the recording of direct taxes and social contributions has been applied, following the expiration on 30 June 2002 of the derogation granted to Portugal (accounting for an upward revision of the deficit ratio by 0.6 pp);

(ii) the statistical recording of certain operations has been changed, which concerns the following items:

- subsidies to public enterprises originally classified as capital injections[6] (+0.2 pp);

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[4] See footnote 2.

[5] Regulation (EC) No. 2516/2000 of the European Parliament and of the Council of 7 November 2000 states that taxes and social contributions recorded in the accounts may be derived from two sources: amounts evidenced by assessment and declarations or cash receipts. If assessments and declarations are used, the amounts shall be adjusted by a coefficient reflecting assessed and declared amounts never collected. If cash receipts are used, they shall be time-adjusted so that the cash is attributed when the activity took place to generate the liability. Following a recommendation of the ad-hoc commission to analyse public finance in 2001, the Portuguese authorities opted for the cash method with slight time adjustments, notably as regards the recording of VAT taxes. Portugal was granted a derogation to the application of Regulation n° 2516/2000 up to 30 June 2002. Since the expiry of the derogation, Portugal is applying the cash method.

- expenditure arrears to be paid in 2002 but resulting from commitments made in 2001 (+0.3pp);

- the recording of EU structural funds resources in order to secure a neutral impact on the general government deficit (-0.1pp).

These revisions have revealed serious deficiencies in the collection and processing of general government statistical data in Portugal. Meanwhile, the corrected figures for 2001, as reported by the commission and confirmed in the semi-annual notification of 1 September 2002, have been validated by Eurostat. On the basis of the corrections made by the commission which reviewed the government accounts for 2001, figures for previous years have also been revised.

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3. In the second half of the nineties, when Portugal enjoyed strong economic growth that outpaced the euro-area average, progress in budgetary consolidation had been limited, with the general government deficit consistently remaining well above 2% of GDP. Thus, there had been little budgetary leeway to accommodate for the effects of a cyclical slowdown or of such changes in accounting as required to comply with Community rules.

From 1999 to 2001, according to the revised data, the government deficit increased from 2.4% to 4.1% of GDP. While economic growth slowed markedly during that period, the increase in the deficit mainly reflects a weakening in the underlying budgetary position. According to the Commission services' calculations, the cyclically adjusted deficit has widened by nearly as much as the actual deficit, reaching some 4 ½% of trend GDP in 2001[7]. Although the government adopted a rectifying budget in June 2001, involving cuts in expenditure to the amount of 0.6% of GDP, the deficit in that year increased for a number of reasons, relating to developments of both revenues and expenditures:

On the revenue side: (i) revenue losses implied by the reform of direct taxes implemented in 2001 have been underestimated; (ii) efficiency gains in tax collection and administration have turned out lowerthan anticipated. On the expenditure side: (i) the rise in the public sector wage bill has been above budgetary plans; (ii)social spending, notably on health care, exceeded ex-ante budget allocations.

4. The government gross debt ratio remained below 60% of GDP up to 2001. It declined from 54.4% in 1999 to 53.3% in 2000, but rebounded to 55.5% in 2001, mainly as a result of the rise in the government deficit and the deceleration of GDP growth.

5. A new government that came into office in April 2002 presented to parliament a rectifying budget for 2002, which became law in early June. The rectifying budget includes consolidation measures totalling about ½% of GDP, notably an increase in the standard VAT

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[6] Eurostat, in its press release n°35/2002 of 21/3/2002, stated that it was not in a position to certify the figures included in the notification of Portugal, due, among other reasons, to lack of information on capital injections from the Portuguese government to public corporations, which had been treated as acquisition of shares and other equities with no effect on the government deficit.

[7] The cyclically adjusted deficit has been estimated using the "Hodrick-Prescott" (HP) filter method. According to the available information, the output gap calculated using the production function method is substantially lower than using the HP filter, particularly for 2001. Although the two methods give different cyclically adjusted figures for the deficit level, the annual variation is likely to be of the same order of magnitude; the conclusion that a significant deterioration in the cyclically adjusted deficit occurred in the period under analysis remains unchanged.

rate from 17 to 19% and cuts in public investment spending[8]. The new budgetary target for 2002 is 2.8% of GDP, which compares with an initial target of 1.8% laid down in the last update of the stability programme. It can be concluded that, in the absence of the rectifying budget, the 2002 deficit could have been above 3½% of GDP. In order to ensure the deficit to be brought down below the 3% ceiling in 2002, the government has proposed to parliament, in addition to the saving measures already adopted, to sell, if needed, a number of public assets, most importantly the fixed telecom network.

6. While it can be expected that the deficit will be reduced in 2002, it appears uncertain whether the excessive deficit situation will be corrected. Indeed, such an assessment can only be made on the basis of budgetary results, which will not be available until early 2003. Moreover, in view of the severe deficiencies in the statistical base that long prevented the budgetary problems from being recognised, it has to be ensured that the recorded public accounts henceforth provide a true picture of the actual situation. The progress in consolidation to be achieved will depend on the determined efforts by the authorities, but also on overall economic developments. Indeed, the government debt ratio is projected to rise to 59.3% of GDP in 2002 , a level just under the 60% reference value. Any slippage in budgetary execution and/or a deceleration in nominal GDP growth could imply a deficit above 3% of GDP and a breach of the government debt reference value.

CONCLUSION

The monitoring of the budgetary situation in Portugal and, in particular, the examination of the compliance with the criteria laid down in Article 104(2) have led the Commission to prepare a report in accordance with Article 104(3) of the Treaty. The Commission, having examined the relevant factors taken into account in this report and having regard to the opinion of the Economic and Financial Committee, is of the opinion that an excessive deficit exists in Portugal.

[8] Other measures are, *inter alia*, the freezing in staff hiring, the closure and merger of public institutes, and the cessation of any new interest rate subsidies to mortgage loans, which in total are expected to reduce the deficit by some 0.1% of GDP in the rest of 2002. As regards public sector employment, an employment pool was created in order to enhance labour mobility within the public sector and to facilitate the re-organisation of the public sector, following the decisions taken on the closure and merger of public institutes.