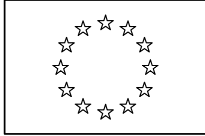

COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

Portugal

Report prepared in accordance with Article 104(3) of the Treaty

{SEC(2005) 838}

This Report, prepared by the Commission according to Article 104(3), assesses recent and current budgetary developments in Portugal and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government. The analysis underpinning the conclusions of the Report is provided in an accompanying technical document[1]. In preparing this Report, the Commission has taken due account of the 20 March 2005 Ecofin Report to the European Council on 'Improving the implementation of the Stability and Growth Pact', endorsed by the latter on 22 March 2005[2].

1. INTRODUCTION AND REASONS FOR THE REPORT

An excessive deficit procedure was opened for Portugal in 2002 on the basis of the evidence of a deficit above 4% of GDP in 2001. On 5 November 2002, the Council decided that an excessive deficit existed[3] and, in line with Article 104(7), addressed a recommendation to Portugal with a view to bringing that situation to an end by 2003 at the latest, by taking the appropriate measures by 31 December 2002. In 2002 and 2003, the general government deficit was notified at 2.7% and 2.8% of GDP respectively[4]. Portugal had thereby fulfilled the recommendation, as it had been formulated, for two consecutive years. In addition, in early 2004, the Portuguese authorities committed themselves to implement the necessary measures to keep the deficit below the reference value in 2004 (which was the actual outcome for that year, as notified in March 2005). On 11 May 2004, the Council considered that Portugal had complied with its recommendation and decided to abrogate its decision of November 2002[5], thereby closing the excessive deficit procedure.

In spring 2005 the Commission forecast the Portuguese government deficit at 5.2% of GDP, clearly above the target set by the (previous) government, which relied on sizeable, but not yet specified, extraordinary measures. The new government, when empowered in March, announced its intention not to make use of extraordinary measures to reduce the government deficit[6] .

On 9 June 2005, Portugal submitted an update of its stability programme covering the period 2005-2009. This update reveals the plans for a general government deficit in excess of the 3% of GDP reference value of the Treaty for the years from 2005 to 2007. More specifically, after a reported deficit outturn of 2.9% in 2004[7], Portugal plans to record a government deficit of 6.2% of GDP for 2005, which is to be reduced to 4.8% in 2006, 3.9% in 2007 and 2.8% of

1 Technical document by the commission services accompanying the report on Portugal prepared in accordance with Article 104 (3) of the Treaty [ECFIN/xxxxx/05-EN]

2 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).

3 OJ L 322, 27.11.2002, p. 30.

4 First outcome reported; the deficit for 2003 was revised to 2.9% of GDP afterwards.

5 OJ L 47, 18.2.2005, p. 24.

6 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.

7 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.

GDP in 2008. Over the same years, the debt-to-GDP ratio is projected to further increase from a reported figure of 61.9% in 2004 to a peak of 67.8% of GDP in 2007.[8]

The planned figures for both the deficit and the debt provide *prima facie* evidence of the existence of an excessive deficit in Portugal within the meaning of the Treaty and the Stability and Growth Pact. In the light of this evidence the Commission has decided to initiate the excessive deficit procedure (EDP) for Portugal.

Table 1: General government balance and debt (% of GDP)

	1999	2000	2001	2002	2003	2004	2005		2006	
							COM	SP	COM	SP
General government balance	-2.8	-2.8	-4.4	-2.7	-2.9	-2.9	-4.9	-6.2	-4.7	-4.8
General government gross debt	54.3	53.4	55.9	58.5	60.1	61.9	66.2	66.5	68.5	67.5

NB: According to recent information provided by the Portuguese authorities, the reported government deficit for 2000 and 2002 should be revised upwards to 2.9% of GDP in both years.
Source: Eurostat, Commission services spring 2005 forecast (COM) and June 2005 Stability Programme update (SP)

The application of the EDP is governed by Article 104 of the Treaty and Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP). According to Article 104(2) of the Treaty, the Commission shall monitor compliance with budgetary discipline on the basis of two criteria: (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds the reference value of 3%, unless: either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; and (b) whether the ratio of government debt to gross domestic product exceeds the reference value of 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Article 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State."

[8] In parallel to the elaboration of this Report, the Commission is proceeding to the assessment of the updated Portuguese stability programme, transmitted on 9 June 2005 and produced a recommendation for a Council Opinion.

2. DEFICIT CRITERION

In both 2003 and 2004, the general government deficit reached 2.9% of GDP. The June 2005 update of the stability programme shows a planned government deficit of 6.2% of GDP for 2005, projected to decline to 4.8% in 2006 and 3.9% in 2007. Only for 2008 is the expected government deficit, at 2.8% of GDP, below the Treaty reference value.

According to Article 104(2) of the Treaty, the Commission is obliged to examine whether the "planned or actual government deficit" exceeds the reference value. Article 104(3) stipulates that, if a Member State does not fulfil the requirements for this criterion, the Commission shall prepare a report.

According to the planned figure for 2005 of 6.2% of GDP, the deficit is in excess of the 3% of GDP reference value and not close to it.

The excess over the 3% of GDP reference value is not exceptional. It does not result from an unusual event, nor the growth performance accompanying the occurrence of an excessive deficit in Portugal in 2005 and beyond qualifies as a severe economic downturn. The rate of economic growth, which has decreased sharply since 1999 also reflecting a substantial fall in Portugal's rate of potential output growth, is due to a series of mutually reinforcing structural weaknesses. The economy has returned to positive economic growth since 2004 and, on the basis of current available information, should remain on an upward, albeit gradual, trend for the years to come. Overall, the output gap, measuring the cumulated loss of output, has been clearly negative since 2003, and may marginally widen to 2¾% of potential output in the current year. While the output gap is substantial and may justify part of the excess of the deficit over the reference value, this compares with estimated negative output gaps of 4.5% and 7.5% in the previous two recessions.

The excess over the 3% of GDP reference value is not temporary. According to the plans of the Portuguese authorities, the deficit will be in excess of the Treaty reference value in three consecutive years – from 2005 to 2007. Such fiscal path is partially due to the intention of the government of no longer implementing sizeable one-off measures with a significant budgetary impact. Nevertheless, even disregarding one-offs, the structural deficit is expected to widen markedly in the current year, and will remain well above the reference value in the coming years even if economic growth picks up. Overall, the June 2005 update of the Portuguese stability programme confirms and indeed strengthens the finding of persistent imbalances in the Portuguese public finances as highlighted in the Commission services spring 2005 economic forecasts.

This analysis suggests that the Treaty requirement concerning the deficit criterion is not fulfilled.

Table 2: Macroeconomic and public finances developments

	1999	2000	2001	2002	2003	2004	2005		2006	
							COM	SP	COM	SP
Real GDP (% change)	3.8	3.4	1.7	0.4	-1.1	1.0	1.1	0.8	1.7	1.4
Potential GDP growth	2.8	2.6	2.3	1.9	1.4	1.4	1.4	1.4	1.6	1.6
Output gap (% of potential GDP)	1.7	2.5	1.9	0.4	-2.0	-2.5	-2.8	-2.7	-2.7	-2.8
General government balance[a]	-2.8	-2.8	-4.4	-2.7	-2.9	-2.9	-4.9	-6.2	-4.7	-4.8
Primary balance	0.4	0.4	-1.3	0.3	0.0	-0.1	-2.0	-3.3	-1.6	-1.6
Gross fixed capital formation of government sector	4.1	3.8	4.0	3.6	3.3	3.3	3.2	3.3	3.0	3.0
Cyclically-adjusted balance (CAB)	-3.4	-4.0[b]	-5.0	-2.9	-2.2	-2.0	-3.9	-5.3[c]	-3.7	-3.8[c]
Cyclically-adjusted primary balance (CAPB)	-0.2	-0.8[b]	-1.8	0.2	0.7	0.8	-1.0	-2.4[c]	-0.7	-0.5[c]
One-off measures	-	-	-	1.4	2.5	2.3	0.3	0.2	-	-
CAB excluding one-offs	-3.4	-4.0	-5.0	-4.3	-4.7	-4.3	-4.2	-5.5[c]	-3.7	-3.8[c]
CAPB excluding one-offs	-0.2	-0.8	-1.8	-1.2	-1.8	-1.5	-1.3	-2.6[c]	-0.7	-0.5[c]

Source: Eurostat, Commission services spring 2005 forecast (COM) and June 2005 Stability Programme update (SP)

[a] See comments in Table 1

[b] Already excluding UMTS receipts (0.3% of GDP).

[c] Commission services calculations applying the commonly agreed methodology to the information in the programme

3. DEBT CRITERION

The debt-to-GDP ratio breached the 60% of GDP reference value of the Treaty in 2003, moving up to 61.9% in 2004. Between 2000 and 2004, the ratio has increased by 8.5 percentage points of GDP i.e. on average by 1.7 percentage points of GDP p.a.

The increase in the debt ratio in the years 2000-2004 took place despite historically low interest rates that reduced the cost of servicing the debt, and can be explained by a very low primary surplus – even a primary deficit in some years –, the existence of a sizeable stock-flow adjustment, where debt-increasing, below-the-line operations more than offset significant privatisation proceeds in most years, as well as by the low nominal GDP growth. Over the period 2000-2004, the stock-flow adjustment accounted on average for close to ¾ percentage point per year in the increase of the debt ratio.

Furthermore, the projected debt figures for the years 2005 to 2007, revealed in the June 2005 stability programme update and in line with the debt projections of the Commission services spring 2005 forecast, suggest a sharp increase in the debt ratio in 2005 and until 2007. This conflicts with the Treaty requirement that, in the event of an excess over the 60% of GDP reference value, the "debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace". The behaviour of the projected debt ratio will reflect high primary deficits until 2007 and the low growth rate of nominal GDP until at least 2006. The targeted debt ratio would peak at 67.8% in 2007, to start declining thereafter as a result of the planned correction of the deficit.

This analysis suggests that the Treaty requirement concerning the debt criterion is not fulfilled.

Table 3: Debt dynamics

in % of GDP	1999	2000	2001	2002	2003	2004	2005		2006	
							COM	SP	COM	SP
Government gross debt ratio	54.3	53.4	55.9	58.5	60.1	61.9	66.2	66.5	68.5	67.5
Change in debt ratio	-0.7	-0.9	2.5	2.6	1.6	1.8	4.3	4.6	2.3	1.1
Contributions:										
Primary balance	-0.4	-0.4	1.3	-0.3	0.0	0.1	2.0	3.3	1.6	1.6
"Snowball" effect [a] *of which:*	-0.4	-0.3	0.1	0.5	2.0	0.9	0.9	0.7	0.5	0.2
Interest expenditure	*3.2*	*3.3*	*3.2*	*3.1*	*2.9*	*2.9*	*3.0*	*2.9*	*3.1*	*3.3*
Real GDP growth	*-2.0*	*-1.7*	*-0.9*	*-0.2*	*0.7*	*-0.6*	*-0.7*	*-0.5*	*-1.1*	*-0.9*
Inflation (GDP deflator)	*-1.6*	*-1.8*	*-2.2*	*-2.3*	*-1.6*	*-1.4*	*-1.4*	*-1.7*	*-1.5*	*-2.2*
Stock-flow adjustment *of which:*	0.1	-0.3	1.1	2.3	-0.4	0.9	1.4	0.6	0.2	-0.7
Cash/accruals differences (primary items and statistical discrepancies)	*0.0*	*0.1*	*1.3*	*-0.1*	*-0.1*	*0.9*	-	-	-	-
Shares, excl. privatisation	*0.4*	*1.2*	*0.5*	*0.7*	*0.4*	*0.6*	*1.1*	-	-	-
Privatisation proceeds	*-1.4*	*-2.0*	*-0.3*	*-0.3*	*0.0*	*-0.8*	-	*-0.3*	-	*-1.1*

Source: Eurostat, Commission services spring 2005 forecast (COM) and June 2005 Stability Programme update (SP)
[a] The snowball effect measures the combined effect of interest expenditure and economic growth on the debt ratio. The first has an increasing impact; the second a decreasing impact.

4. OTHER RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State". The Ecofin report of 20 March 2005 also refers to the need to consider other relevant factors in the Commission report and clarifies the framework within which such relevant factors should be taken into account. The following three subsections therefore consider in turn the medium-term economic position, the medium-term budgetary position and other factors relevant for the purpose of this report.

I. Medium-term economic position

Cyclical conditions and potential growth. According to the available evidence, the economic prospects over the coming years will remain subdued. The convergence of economic growth towards the potential rate currently estimated at around 1 ½% is expected to be moderate. Hence, the output gap is expected to persist around current negative levels in the current and next year. The output gap is seen as narrowing gradually thereafter, eventually closing by the end of the decade. This cyclical situation is accompanied by a sizeable external account imbalance. As to the medium-term prospects, despite reforms aiming at increasing competitiveness, the potential growth rate remains low since many structural weaknesses hampering factor efficiency remain largely unaddressed. The low rate of potential growth calls for ambitious fiscal targets to allow a reduction in the debt ratio.

Recent structural reforms. In 2002, Portugal launched a programme of structural reforms in policy areas with significant budgetary impact, such as education, healthcare and some areas of public administration. These reforms are intended to support the process of budgetary consolidation and enhancing the economy's growth potential. However, there is little evidence so far of significant savings deriving from such measures. More recently, efforts have been made to improve Portugal's business environment, potential growth and labour market conditions. The implementation of a new labour code was finalised in 2004. In April 2005, the government launched a "Technological Plan" to foster competitiveness and potential economic growth. One of the first measures is the creation of a system of tax incentives for R&D. However, it is difficult to assess at this stage the impact of this plan on potential growth and public finances.

II. Medium-term budgetary position

Public investment. Since 2001, the general government deficit has not exceded the government investment. The latter has in this period decreased as a share of GDP, falling to a ratio of 3.3% of GDP in 2004[9]. However, if the government deficit is considered net of one-off measures, it has exceeded the investment expenditure for the last four years, a situation which is expected to continue in 2005 and 2006.

Structural deficit. Portugal's fiscal imbalances are evidenced by the high level of the structural deficit, i.e. the deficit net of cyclical factors and one-off measures. It sharply increased from an average of some 3½% of GDP in the 1997-1999 period to a peak of about 5% of GDP in 2001. Subsequently, the structural deficit declined to 4¼% of GDP in 2004, in the context of the correction of the excessive deficit which began in 2002; however, it is expected, on the basis of the information contained in the June 2005 update of the stability programme, to rebound to close to 5.5% of GDP in 2005. The structural primary balance deteriorated markedly over the second half of the nineties, becoming negative in 1999 to record deficits of around 1 ½ % of GDP on average since 2001. On the basis of the budgetary path envisaged in the June 2005 stability programme update, it is projected to reach a deficit of 2.5% of GDP in 2005 from just over 1.5% in 2004. These levels do not ensure a decline in the debt ratio.

Fiscal consolidation efforts in good times. Portugal significantly loosened its fiscal stance (i.e. net of both cyclical factors and one-off measures) in 1999 when actual growth was above potential growth, and, more notably, again in 2000 and 2001 when the output gap became markedly positive. The cyclically-adjusted deficit excluding one-off revenues widened by over 1.5 percentage points over these two years, while real GDP exceeded its potential level by about 2 percentage points. It can therefore be concluded that the worsening of Portugal's already weak structural budgetary position, masked by the heavy recourse to temporary measures, has its roots in the adoption of a pro-cyclical fiscal stance in good times.

Expenditure on education and R&D. Public expenditure on education has increased continuously since the early 1990s, from 6.3% of GDP in 1995 to 7.0% in 2003 (the last year for which a functional breakdown of government expenditure is available). It is worth noting that Portugal has one of the highest shares of government expenditure on education in the EU.

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[9] A small part of this reduction is explained by sales of assets, which are recorded as investment-reducing operations.

Portugal's public expenditure on R&D amounts to just over ½% of GDP. The trend increase observed in the last decade has levelled off since.

Temporary measures. For the last three years, in order to bring the government deficit below the 3% of GDP reference value, as recommended by the Council, Portugal has resorted to significant one-off operations. These amounted to 1.4% of GDP in 2002, 2.5% in 2003 and 2.3% in 2004. While a number of temporary or one-off measures implemented in recent years had a beneficial effect on the budget balance and the debt in the short term, some of them carry negative implications for the budget over the medium and long run, besides the need to replace them in the immediate with structural measures. The government is planning to avoid reliance on temporary measures for future years, which among other things explains the projected slippage in the deficit in 2005 and beyond, compared to the past stability programme.

Long-term sustainability of 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 latest update of the stability programme of Portugal could contribute to this end if implemented thoroughly.

III. Other relevant factors for a comprehensive qualitative assessment of the excess of the deficit over the reference value

A number of elements characterising public finance developments in Portugal over the past several years in existing institutions and procedures deserve attention. (i) Until 2004, the outturn of economic activity was systematically below the Portuguese authorities' forecasts. Part of the forecast errors can be attributed to the adverse cyclical conditions, which were not anticipated by most forecasters. But it also reflects the fact that budgetary plans have repeatedly been built upon overoptimistic assumptions about GDP growth, which has contributed to significant slippages in budgetary execution, also in cyclically-adjusted terms. (ii) Some under-budgeting of public expenditure has been observed. For some categories of expenditure, notably healthcare, the outturn has been significantly worse than budgeted, leading to an accumulation of spending arrears. These developments take place in a context where there is no high-profile forecasting body in Portugal whose projections can be regularly compared with the official forecasts for public finance. (iii) Portugal has no formal fast-track control mechanism to deal with deviation from the budgetary targets. In the past, reactions to such situations have been mainly ad hoc, such as the adoption of a supplementary budget or reinforcement of the one-off measures already foreseen in the budget. (iv) Despite progress over recent years, the recent revisions of public finance statistics[10] and the current allocation of responsibilities for the compilation of national accounts suggest that the processing of government data needs further improvement.

[10] See footnote 6

5. CONCLUSIONS

According to the June 2005 update of the Portuguese stability programme, the government deficit ratio will be well above the 3% of GDP reference value from 2005 until 2007. The excess of the Treaty reference value in the coming years will take place in a situation of slow growth, which cannot however be qualified as exceptional within the meaning of the Treaty and Council Regulation No. 1467/97. The excess over the 3% of GDP reference value cannot be considered exceptional or temporary or close to the reference value. This suggests that the Treaty requirement concerning the deficit criterion is not fulfilled.

The debt ratio is above the 60% of GDP reference value since 2003, it has augmented thereafter and is projected to increase further until 2007. The debt dynamics is affected by high primary deficits, debt-increasing below-the-line operations, and low nominal GDP growth. This suggests that the Treaty requirement concerning the debt criterion is not fulfilled.

The consideration of other relevant factors reinforces the above conclusions.