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 for Portugal, 2003-2006

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty, the Economic and Financial Committee. The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures.

Portugal's first stability programme covering the 1999-2002 period was submitted on December 1998 and assessed by the Council on 8 February 1999[2]. The first update of the programme, covering the 2000-2004 period, was submitted to the Commission on February 2000 and assessed by the Council on 13 March 2000[3]. The second update of the stability programme, covering the 2001-2004 period, was submitted on January 2001 and assessed by the Council on 12 March 2001[4]. The third update of the stability programme, covering the 2002-2005 period, was submitted on December 2001 and assessed by the Council on 12 February 2002[5].

Portugal submitted its fourth and most recent update of the stability programme, covering the 2003-2006 period, on 17 January 2003. The Commission services have carried out a technical evaluation of this updated programme, taking into account the Communication from the Commission to the Council and to the European Parliament of 27 November on strengthening the co-ordination of budgetary policies[6]. This evaluation warrants the following assessment:

> The information provided in the updated programme broadly complies with the revised "code of conduct on the content and format of stability and convergence programmes"[7]. The updated programme was adopted by the government on 20 December and presented to parliament, which discussed it and adopted early in January a declaration of approval by a large majority, including the support of the main opposition party[8]. The updated programme was then formally submitted to the Commission. The Portuguese authorities have thus effectively kept the commitment made to the Council on 5 November, upon the application of Article 104(7), to present before the end of 2002 an updated stability programme.

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1 OJ L209, 2.8.1997
2 OJ C 68, 11.3.1999.
3 OJ C 111, 18.4.2000
4 OJ C109/4 10.4.2001.
5 OJ C51/8 26.2.2002.
6 COM (2002) 668 final, 27.11.2002.
7 *Revised Opinion of the Economic and Financial Committee on the content and format of the stability and convergence programmes*, document EFC/ECFIN/404/01-Rev 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.
8 A first version of the programme update, which is nearly identical to the final one, was made public in the internet in December 2002.

Overall, the economic policies as reflected in the planned measures in the programme update are broadly consistent with the 2002 Broad Economic Policy Guidelines.

Implementation in 2002 of the previous update was severely hampered by the significant budgetary slippage registered in 2001, which led the Council on 5 November 2002 to decide that an excessive deficit exists in Portugal. In fact, the extent of the budgetary slippage registered in 2001 has had considerable knock-on effects in 2002, not least because of the long recognition lag. However, even in a situation of incomplete information, the Portuguese authorities realised in April 2002 that the budgetary situation was developing less favourably than foreseen in the stability programme update of December 2001, requiring corrective measures. Therefore, a rectifying budget was presented to parliament, which became law in June. It included consolidation measures totalling about 0.6% of GDP, notably a rise in the normal VAT rate from 17% to 19%, and a reduction in investment expenditure[9]. Following the approval of the rectifying budget, the new deficit target for 2002 was raised by 1 pp to 2.8% of GDP.

During 2002, budgetary execution in the state sector developed less favourably than projected in the rectifying budget, basically reflecting weaker activity than expected (GDP growth estimated at 0.7% as against an initial forecast of 1¼%), faltering domestic demand, particularly in the second half of the year, and disappointing revenues from the sales of government property, and overspending in some areas. With a view to bringing the deficit below 3% of GDP and in the light of the Council recommendation, under Article 104(7), these developments, as well as uncertainties regarding the outcome for the health sector and local authorities led the Portuguese authorities to adopt a number of one-off measures at the end of the year, notably a tax amnesty, which in total are estimated to have brought in additional revenue amounting to about 1½% of GDP[10]. As a result, the government deficit for 2002 is currently estimated by the Portuguese authorities at about 2½% of GDP (as against 4.2%[11] in 2001), thereby below the target of 2.8%. A first official estimate for the general government deficit in 2002 will be available in the EDP notification to be delivered by 1 March. At that time, and after validation by Eurostat, the Commission will form its views on the matter; however, it can be said at this stage that the deficit was reduced below 3% of GDP in 2002.

The debt-to-GDP ratio increased by 3.4 pp in 2002, which to a large extent reflects financial operations, associated with the implementation of some aspects of the reform on the health sector, and the payment of expenditure arrears linked to the budgetary slippage of 2001. They are not expected to be followed by any further significant financial operations in future years.

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9 The rectifying budget included other measures, notably the freezing of hiring by the government, the closure and merger of public institutes, and the end of new interest rate subsidies to mortgage loans. The rectifying budget also provided for the sale of government property.

10 In mid November 2002, the government declared an amnesty for interest surcharges on the payment of arrears on tax and social security contributions if paid before the end of 2002. The tax amnesty was a huge success, the extent of which was largely unanticipated, having brought in an additional € 1367 million (or about 1% of GDP).

11 According to ESA-95. According to Regulation (EC) N°3605/93 as modified by Regulation (EC) N°475/00, the general government deficit amounted to 4.1% of GDP.

The update's macroeconomic scenario shows a small acceleration of GDP growth to 1.3% in 2003 (from an estimated growth rate of 0.7% in 2002), which basically corresponds to the Commission services Autumn forecast. For the 2004-2006 period, the programme update foresees a gradual acceleration of economic activity (from 2.7% in 2004 to 3.5% in 2006), which is basically caused by the recovery of domestic demand, following sluggish growth in 2001-2003 driven by the correction of major imbalances in the economy, notably a large balance of payments disequilibrium, which peaked at about 8½% of GDP in the period 2000-2001. By 2006, domestic demand is projected to expand again at a pace similar to that of output (i.e. 3½%), while the positive contribution of net exports to growth declines from 1¼ pp of GDP in 2003 to close to zero in the period 2004-2006, reflecting the acceleration in import growth caused by the strengthening of domestic demand.

The baseline macroeconomic scenario underlying the programme update appears plausible as far as the pace of economic recovery is concerned, although the assumed pattern of growth can be questioned for resting excessively on the gradual strengthening of domestic demand in the 2004-2006 period; in fact, the process of correction of the current major macroeconomic imbalances might not have been completed by then, and such a growth pattern does not seem to take fully into account the impact of structural reform on the supply-side of the economy.

There are basically two major risks associated with the macroeconomic scenario of the programme update. First, economic growth in the short-term might turn out weaker than projected, following a delay in the economic recovery, particularly in Europe. Second, wage settlements in the private sector might continue to give an excessive weight to domestic variables, which could lead to unwarranted wage raises. In this regard, the government's decision to use from 2003 onwards as the benchmark for wage negotiations in the government sector the average inflation forecast for the euro-area, should have a favourable spill-over effect in the private sector of the economy. Portugal has lost price-competitiveness for a number of years. In order to secure a gradual recovery of economic activity, as foreseen in the programme update, it is paramount not only to avoid further losses, but also to partly unwind the cumulative deterioration in price-competitiveness registered in recent years. In this respect, wage settlements and labour productivity developments will play a crucial role.

As regards budgetary projections, the magnitude of the budgetary slippage registered in 2001 has rendered outdated the targets set in the previous programme update. Therefore, the new update has revised upwards the entire adjustment path for both the deficit and the debt, taking into consideration the shifts in the respective starting positions. The new programme update projects a gradual reduction in the deficit-to-GDP ratio over the 2003-2006 period (2.8% in 2002, 2.4% in 2003, 1.9% in 2004, 1.1% in 2005, and 0.5% in 2006). In particular, the budgetary target for 2003 implies a considerable fiscal consolidation effort, which to a large extent is caused by the need to make up for the considerable amount of one-off measures adopted in 2002.

The debt-to-GDP ratio is projected to remain below the 60% of GDP and to recede by a cumulative 6 pp of GDP between 2003 and 2006, attaining 52.7% in the last year of the programme, thereby unwinding the sharp deterioration registered between December 2000 and December 2002, which *inter alia*, resulted form the budgetary slippage in 2001, and financial operations (see above) totalling nearly 5 pp of GDP.

The budgetary outcome for 2003 is central for the successful implementation of the consolidation strategy defined in the current programme update. In this respect, the Council recommendation addressed to the Portuguese Republic under Article 104(7) of the Treaty, emphasised the need to ensure that the government deficit in 2003 be further reduced clearly below 3% of GDP and that the government debt ratio be kept below the 60% of GDP reference value. According to the latest estimate of 2½% of GDP by the Portuguese authorities for the 2002 deficit, the projected reduction to 2.4% in the actual deficit for 2003 is thus small. However, the corresponding improvement in the underlying deficit between 2002 and 2003 is estimated by the Commission services to amount to 2 full points of GDP (from about 3½% to 1½%), reflecting the wearing-off of the significant amount of one-off measures adopted in 2002, together with the fact that no new non-recurrent measures are planned for 2003. Furthermore, current unfavourable cyclical conditions may also prevent budgetary execution as planned, possibly requiring the introduction of additional saving measures.

From 2004 onwards, budgetary consolidation is to be achieved through a reduction in the total primary expenditure-to-GDP ratio, resulting from a vast programme of structural reforms bearing fruit, together with rigorous restraint on government consumption expenditure, especially as regards the compensation of government employees. This strategy is in line with the general recommendations in the Broad Economic Policy Guidelines, which advocate budgetary consolidation relying mainly on the expenditure side of the budget. This is expected to lead to an underlying budgetary position close-to-balance at the end of the period, while at the same time offsetting the revenue losses caused by a substantial lowering in corporate taxes[12], which are planned to be phased-in over a number of years in order to strengthen the international competitiveness of the economy.

According to Commission services calculations, the cumulative improvement in the cyclically-adjusted balance (CAB) between 2002 and 2006 will amount to about 2 pp of GDP (from some 2% to zero), corresponding to a strengthening in the underlying balance of approximately 3½ pp. The difference is due to the substantial amount of one-off measures adopted in 2002, whose wearing-off in 2003 requires a considerable improvement in the underlying balance in order to comply with the actual deficit target for that year; therefore, the overall adjustment effort is markedly front-loaded to 2003. Between 2003 and 2006, the programme update plans an annual reduction of about ½ pp of GDP both in the actual and in the underlying deficits, reaching a position close-to-balance by the end of the period. This is in line with the commitments made by Portugal in application of Article 104(7) and would mean compliance with the Stability and Growth Pact in the later years of the programme. A sensitivity analysis suggests that in the event of the low-growth scenario considered in the programme update materialising, the actual balance may deteriorate significantly in the absence of offsetting discretionary measures.

The update of the stability programme gives a systematic and detailed presentation of an ambitious programme of structural reforms, which is in line with the broader strategy defined by the Lisbon European Council. The major aims of these reforms

12 Although the reduction in the tax rate is to be accompanied with measures to broaden the tax base, the reform of corporate taxation is admittedly revenue reducing. The loss in revenue is estimated to augment from 0.2 pp of GDP in 2004 to 0.7 pp in 2006.

are: first, the pursuit of the process of budgetary consolidation on a sustainable basis, and second, to enhance the growth potential of the economy. About all of the announced reforms are likely to eventually have a positive impact on budgetary consolidation, either by fostering a more efficient use of resources, or by broadening tax bases, stemming from the successful implementation of supply-side policies.

According to Commission services calculations on the sustainability of Portuguese public finance, meeting the updated programme's target of a close-to-balance budgetary position by 2006 seems to be a necessary step to ensure the sustainability of public finances, which however has to be supplemented by the determined implementation of the structural reforms outlined in the programme update in order to curb the growth dynamics of age-related expenditure. In fact, according to these calculations, it is paramount to achieve a significant reduction in the debt level prior to the effect of ageing on the budgetary position taking hold.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the Stability Programme update of Portugal and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

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

On the Updated Stability Programme for Portugal, 2003-2006

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[13], and in particular Article 5 (3) thereof,

Having regard to the recommendation by the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [7 March 2003] the Council examined the updated stability programme for Portugal, which covers the period 2003-2006. The updated programme projects general government finances to improve steadily, from a deficit of 2.8% of GDP in 2002 to a deficit of 0.5% of GDP in 2006. Government gross debt is expected to decrease from 58.8% of GDP in 2002 to 52.7% in 2006.

The Council notes that the updated programme broadly complies with the requirements of the revised "code of conduct on the content and format of stability and converge programmes"[14]. The updated programme was adopted by the government on 20 December and presented to parliament, which discussed it and adopted early in January a declaration of approval by a large majority, including the support of the main opposition party[15]. The updated programme was then formally submitted to the Commission. The Portuguese authorities have thus effectively kept the commitment made to the Council on 5 November, in the framework of the recommendation under Article 104(7), to present before the end of the year an updated stability programme. The Council considers that the economic policies as reflected in the planned measures in the programme update broadly comply with the 2002 Broad Economic Policy Guidelines.

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[13] OJ L 209/1, 2.8.1997.

[14] *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

[15] A first version of the programme update, which is nearly identical to the final one, was made public in the internet in December 2002.

The update's macroeconomic scenario shows a small acceleration of GDP growth to 1.3% in 2003 (from an estimated growth rate of 0.7% in 2002), which at the light of the most recent information available, pointing to a further deceleration in economic activity in the second half of 2002, looks rather optimistic. For the period 2004-2006, the macroeconomic scenario presented in the programme update appears plausible as far as the pace of economic growth is concerned (an average growth rate of close to 3% per year). However, the assumed pattern of growth, resting entirely on the gradual strengthening of domestic demand, is problematic: partly, because the unwinding of the current private sector imbalances will probably not be completed by then; and partly, because the planned measures of structural reform should generate beneficial supply-side effects, allowing the economy to rely on greater export strength.

The Council considers that regaining an appropriate level of external competitiveness is of paramount importance for Portugal. To that end, securing wage moderation and sustained increases in productivity are key requirements. In this context, the Council welcomes the government's decision to use, from 2003 onwards, the average inflation forecast for the euro-area as the benchmark for wage negotiations in the government sector. This measure should have favourable spill-over effects in the private sector of the economy.

On 5 November 2002, in the light of a government deficit of 4.1% of GDP in 2001, the Council decided that an excessive deficit existed in Portugal and issued a recommendation to Portugal according to Article 104(7) of the Treaty. In the terms of this recommendation, the Portuguese authorities should

(i) implement with resolve their budgetary plans for 2002 which aim at reducing the deficit to 2.8% of GDP in that year. The Council established a deadline of 31 December 2002 for the Portuguese government to take all necessary measures to bring the excessive deficit to an end;

(ii) adopt and implement the necessary budgetary measures to ensure that the government deficit in 2003 is further reduced clearly below 3% of GDP and that the government debt ratio is kept below the 60% of GDP reference value.

The Council notes with satisfaction that, according to preliminary figures, the general government deficit has been reduced below 3% of GDP in 2002, in spite of weaker-than-anticipated growth. The Council acknowledges the firm resolve of the Portuguese government in pursuing budgetary consolidation. Budgetary developments in the further course of 2002 turned out less favourable than expected in the rectifying budget adopted in June, mainly due to the further weakening in economic activity, but also to lower-than-expected proceeds from sales of government property. As a consequence, and with a view to reducing the deficit as recommended by the Council, the Portuguese authorities adopted a number of measures with a transitory effect at the end of the year, which in total are estimated to have raised additional revenue of about 1½% of GDP.

The Council notes that substantial challenges remain in 2003 to achieve the deficit target of 2.4% of GDP and to put the deficit on a downward trajectory. Two factors appear particularly critical in this regard. First, in the light of recent economic data confirming the marked slowdown in economic activity in the second half of 2002, the programme's assumption for GDP growth of 1¼% for 2003 appears somewhat optimistic, and further budgetary tightening might be necessary. Second, the measures envisaged in the budget for 2003 may not be enough to offset the one-off measures implemented in 2002 as their exonerating impact wears off. The Council therefore urges the Portuguese authorities to take the necessary measures to ensure that the deficit remains well below 3% of GDP in 2003. A timely correction of the budgetary imbalance should help the revival of economic confidence. Moreover, the Council considers that an early and determined implementation of the comprehensive and ambitious programme of structural reform envisaged in the stability programme update should be conducive to greater confidence, enabling a faster recovery of economic growth.

The Council acknowledges the projected improvement in the underlying balance by more than ½% of GDP per year, taking the underlying deficit from about 3½% of GDP in 2002 to a situation close-to-balance by 2005, in line with the recommendations according to Article 104(7) of the Treaty. In 2003, however, the improvement in the underlying deficit amounts to approximately 2 percentage points of GDP, the adjustment effort being considerably higher due to the need to replace the transitory measures adopted in 2002. The underlying adjustment in 2003 might be lower if further non-recurrent measures would have to be taken to ensure that the deficit remains well below the 3% of GDP reference value. The consolidation strategy envisaged is thus front-loaded and in compliance with the objectives of the Stability and Growth Pact.

The Council also notes with satisfaction that the consolidation strategy adopted rests mainly on the restraint of government expenditure, to be achieved partly by tighter control of the public sector wage bill, and partly by the exonerating effects of a comprehensive programme of structural reform. Such a strategy is in line with the general recommendations of the Broad Economic Policy Guidelines. The Council urges the Portuguese authorities to ensure that the implementation of this strategy actually leads to an underlying budgetary position close-to-balance at the end of the period, while at the same time offsetting the revenue losses caused by the announced gradual phasing-in of a substantial lowering in corporate taxes. In this context, the Council draws the attention to the potential budgetary risks associated with a significant tax reduction that is not matched by firm control over government expenditure. A sensitivity analysis suggests that in the event of the low growth scenario considered in the programme update materialising, the actual balance may deteriorate significantly in the absence of offsetting discretionary measures.

The Council notes that while remaining below the 60% of GDP reference value, the government debt ratio has increased in recent years. The Council welcomes the Portuguese authorities' intentions to bring the debt level down to 52.7% of GDP by 2006, unwinding the sharp deterioration registered between 2000 and 2002. The reduction in the debt ratio over the programme period is to be achieved by the gradual improvement of the primary surplus, together with the assumption of no major net financial operations taking place in the coming years.

On the basis of current policies; the Council considers that the risk of unsustainable public finances in terms of emerging budgetary imbalances cannot be excluded. To achieve a fast pace of debt reduction prior to the budgetary impact of ageing populations taking hold, it is therefore essential that Portugal achieves and sustains a budget position of 'close to balance or in surplus'. This is a necessary but not a sufficient step to ensuring the sustainability of public finances. It has to be supplemented by the determined implementation of the structural reforms outlined in the programme update in order to curb the growth dynamics of age-related expenditure, broaden the tax bases, and increase the overall growth potential of the economy.