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(Information)

COUNCIL

COUNCIL OPINION

of 12 July 2005

on the updated stability programme of Portugal, 2005-2009

(2005/C 228/01)

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 [1], 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 12 July 2005, the Council examined the updated stability programme of Portugal, which covers the period 2005 to 2009. The programme complies with the data requirements of the 'code of conduct on the content and format of stability and convergence programmes' [2]. However, the programme does not provide projections on the long-term sustainability of public finances. Accordingly, Portugal is invited to achieve full compliance with the data requirements of the code of conduct.

(2) The update of the stability programme is built around the need to correct a government deficit which at 6,2 % of GDP in 2005 is planned to be well in excess of 3 % of GDP. This figure follows a deficit of 2,9 % of GDP in years 2002 to 2004 [3], as recently reported by the Portuguese authorities reflecting discussions with Eurostat, and is considerably worse compared with the target of 2,2 % of GDP for 2005 in the previous programme update. This deterioration is explained by weaker-than-expected growth, a reassessment of expenditure growth, over-runs compared to the budget and the non-introduction of one-off measures planned in the previous programme, as well by a corrective package of some 0,6 % of GDP adopted by the new government in June 2005. For the reduction of the deficit, the update outlines a strategy that envisages the implementation of structural measures rather than the extensive reliance on one-off and temporary measures, which indicates a change with respect to the budgetary strategy outlined in the previous updates. The government deficit is expected to continuously improve over the coming years, but will exceed the 3 % of GDP reference value until 2007.

[1] OJ L 209, 2.8.1997, p. 1.
[2] The Portuguese authorities had submitted an updated programme in December 2004, thereby complying with the formally required date of submission. However, in view of the upcoming general elections in Portugal, it was at the time decided not to assess that programme, but to wait for the update to be presented by the new government.
[3] The deficits were 4,1 %, 5,4 % and 5,2 % of GDP, respectively in 2002, 2003 and 2004, when excluding major one-off and temporary measures.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will progressively pick up from 0,8 % in 2005 to 3,0 % in 2009, with growth rates of successively 1,4 %, 2,2 % and 2,6 % in the intermediate years. On the basis of current information, the growth projections for the first part of the programme period are plausible, while there are more risks to the programme's outer years. Structural measures addressing productivity and competitiveness and restoring confidence are essential if the projected growth path is to be realised.

(4) The programme aims at reaching a government deficit below the 3 % of GDP reference value by 2008. The government deficit ratio is expected to decline from 6,2 % of GDP in 2005 to 4,8 % in 2006, 3,9 % in 2007, 2,8 % in 2008 and 1,6 % in 2009. Calculations by the Commission services applying the commonly agreed methodology to the information in the programme show that the cyclically-adjusted deficit, after widening to 5,3 % of GDP in 2005, will decline progressively to 1,4 % in 2009. The consolidation effort will extend over the entire programme period with front-loading, since a substantial consolidation will take place in 2006. In the early part of the programme period, consolidation is relying mainly on increasing revenues, through higher tax rates (notably an increase in the standard VAT rate from 19 % to 21 %), lower tax credits and improved tax collection, which partly offset the one-off revenues foregone. In the outer years, the increased contribution from expenditure restraint is foreseen to come from measures of a permanent nature, such as the reform of the public administration, containment of the wage bill and changes in the social security retirement schemes, whose budgetary effects will be significant mainly in the medium term. The share of investment in total government expenditure is to decline only slightly over the programme period.

(5) The budgetary outcome as projected in the programme is subject to several risks. First, the acceleration in economic activity may be slower than expected, depending on the effective impact of the fiscal consolidation measures and given the expected increase in international competition in the Portuguese export markets. Second, the revenue-raising and expenditure-restraining measures may be less effective than projected or take longer to produce the desired results. The higher tax rates heighten the risk of tax evasion, notwithstanding the significant measures being taken to increase tax compliance, including closer administrative cooperation focused on cross-border VAT fraud. Moreover, most of the announced restraint on expenditure still needs to be legally implemented. In view of this assessment, the government might be called to fulfil its commitment to take additional measures in order to avoid the deficit exceeding 3 % of GDP for longer than planned. Moreover, even if the projected path is adhered to, the budgetary stance in the programme does not provide a sufficient safety margin against breaching the deficit ceiling with normal macroeconomic fluctuations until at least 2009. It is also insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance is achieved within the programme horizon, in spite of a reduction in the underlying deficit from 2005 to 2009 of around 4 percentage points of GDP. A sensitivity analysis shows that the deficit would still be at 3 %, or very close to it, in 2009, in the event of unfavourable macroeconomic developments.

(6) The debt-to-GDP ratio breached the 60 % of GDP reference value of the Treaty in 2003, moving up to 61,9 % in 2004. According to the update, after reaching 66,5 % of GDP in 2005, it will peak at 67,8 % of GDP, declining thereafter until it reaches 64,5 % in 2009. The evolution of the gross debt ratio may also turn out less favourable than projected, given the risks to economic activity, the budgetary targets and the possible occurrence, as in the past, of debt-increasing stock-flow adjustments, in particular the accumulation of financial assets.

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

(8) Overall, the economic policies outlined in the update are partly consistent with the country-specific Broad Economic Policy Guidelines in the area of public finances. As recommended, the programme projects the consolidation of public finances to take place to a large extent from the expenditure side and does not rely on one-off or temporary measures. Its projections, if adhered to, also imply an improvement in the cyclically-adjusted primary balance (net of one-off and temporary measures) by more than 0,5 % of GDP each year. However, it does not plan to reduce the deficit below 3 % of GDP before 2008, and the planned expenditure restraint will be insufficient to achieve the medium-term objective of the Stability and Growth Pact of a budgetary position of close to balance by the end of the programme period.

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

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

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

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

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

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

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

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	**SP Jun 2005**	**1,0**	**0,8**	**1,4**	**2,2**	**2,6**	**3,0**
	COM April 2005	1,0	1,1	1,7	—	—	—
	SP Jan 2004	*1,0*	*2,5*	*2,8*	*3,0*	—	—
HICP inflation (%)	**SP Jun 2005**	**2,5**	**2,5**	**2,9**	**2,5**	**2,5**	**2,4**
	COM April 2005	2,5	2,3	2,1	—	—	—
	SP Jan 2004	*2,0*	*2,0*	*2,0*	*2,0*	—	—
General government balance (% of GDP)	**SP Jun 2005**	**– 2,9**	**– 6,2**	**– 4,8**	**– 3,9**	**– 2,8**	**– 1,6**
	COM April 2005	– 2,9	– 4,9	– 4,7	—	—	—
	SP Jan 2004 (*)	*– 2,8*	*– 2,2*	*– 1,6*	*– 1,1*	—	—

		2004	2005	2006	2007	2008	2009
Primary balance (% of GDP)	**SP Jun 2005**	**– 0,1**	**– 3,3**	**– 1,6**	**– 0,5**	**0,7**	**1,8**
	COM April 2005	– 0,1	– 2,0	– 1,6	—	—	—
	SP Jan 2004	*0,1*	*0,9*	*1,5*	*2,0*	—	—
Cyclically-adjusted balance (% of GDP)	**SP Jun 2005** (1)	**– 2,2**	**– 5,3**	**– 3,8**	**– 3,1**	**– 2,3**	**– 1,4**
	COM April 2005	– 2,0	– 3,9	– 3,7	—	—	—
	SP Jan 2004 (1)	*– 1,7*	*– 1,3*	*– 0,9*	*– 0,7*	—	—
One-off measures (% of GDP)	**SP Jun 2005**	**2,3**	**0,2**	**0**	**0**	**0**	**0**
	COM April 2005	2,3	0,3	0	—	—	—
Cyclically-adjusted balance net of one-off measures (% of GDP)	**SP Jun 2005** (1)	**– 4,5**	**– 5,5**	**– 3,8**	**– 3,1**	**– 2,3**	**– 1,4**
	COM April 2005	– 4,3	– 4,2	– 3,7	—	—	—
Government gross debt (% of GDP)	**SP Jun 2005**	**61,9**	**66,5**	**67,5**	**67,8**	**66,8**	**64,5**
	COM April 2005	61,9	66,2	68,5	—	—	—
	SP Jan 2004 (*)	*60,0*	*59,7*	*58,6*	*57,0*	—	—

Note:

(1) Commission services calculations on the basis of the information in the programme.

(*) Including one-off and temporary measures.

Sources:

Stability programmes (SP); Commission services spring 2005 economic forecasts (COM); Commission services calculations.