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LEGISLATIVE ACTS AND OTHER INSTRUMENTS

Subject:	COUNCIL RECOMMENDATION with a view to bringing an end to the situation of an excessive government deficit in Portugal

COUNCIL RECOMMENDATION

of

with a view to bringing an end to the situation of an excessive government deficit in Portugal

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(7) thereof,

Having regard to the recommendation from the European Commission,

Whereas:

(1) In accordance with Article 126 of the Treaty, Member States are to avoid excessive government deficits.

(2) The Stability and Growth Pact 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.

(3) On 2 December 2009, the Council decided, in accordance with Article 126(6) of the Treaty, that an excessive deficit exists in Portugal and issued, in accordance with Article 126(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[1], a recommendation to correct the excessive deficit by 2013 at the latest ("Council Recommendation of 2 December 2009"). In order to bring the headline government deficit below the 3 % of gross domestic product (GDP) reference value by 2013, an average annual fiscal effort of 1¼ % of GDP over the 2010-2013 period was recommended. In calculating the average annual fiscal effort, the 2011 deficit in the Commission services' 2009 Autumn Forecast was taken as the starting point. The total fiscal effort needed to reach the nominal below 3 % deficit target by the deadline was then calculated by assuming a gradual closure of the output gap by 2015.

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1 OJ L 209, 2.8.1997, p. 6.

(4) On 15 June 2010, the Commission concluded that Portugal had taken effective action in compliance with the Council Recommendation of 2 December 2009 to bring its government deficit below the 3 % of GDP reference value and considered that no additional step in the excessive deficit procedure was therefore necessary.

(5) In accordance with Article 3(5) of Regulation (EC) No 1467/97, the Council may decide to adopt a revised recommendation under Article 126(7) of the Treaty, if effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation. The occurrence of unexpected adverse economic events with major unfavourable budgetary effects is to be assessed against the economic forecast underlying the Council recommendation.

(6) In accordance with Article 126(7) of the Treaty and Article 3 of Regulation (EC) No 1467/97, the Council is required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a deadline of six months at the most for effective action to be taken by the Member State concerned to correct the excessive deficit. Furthermore, in a recommendation to correct an excessive deficit, the Council should request the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and temporary measures, of at least 0,5 % of GDP as a benchmark.

(7) After recording a significant contraction in 2009, when real GDP fell by 2,9 %, the Portuguese economy rebounded in 2010 to positive growth of 1,4 %, largely due to exceptional factors that boosted exports and private consumption. The economy fell back into recession in 2011 when real GDP fell by 1,7 %, but this decline was smaller than initially expected as strong net exports partly compensated for the substantial decline in private consumption and investment. At the same time, the labour market situation continued to worsen. In 2012, according to the most recent update by the Commission services of the economic outlook for Portugal, which takes into account the fiscal measures presented by the Portuguese authorities during the fifth review of the Economic and Financial Adjustment Programme ("Programme") in early September, real GDP is expected to contract by 3,0 % in 2012, reflecting a further deterioration of domestic demand, particularly investment activity. At the same time, exports are holding up well and, despite their deceleration from last year on the back of a worsening of external demand, are set to record further market share gains. Growth will continue to be sluggish in 2013, reflecting weaker import growth in euro-area trading partners and additional budget consolidation measures, but is expected to move into moderate positive territory around mid-year due to a recovery in exports and investment activity. For the year as a whole, GDP growth is projected to decline by about 1 %. Unemployment is expected to peak at somewhat above 16 % in 2013.

(8) The general government deficit reached -9,8 % of GDP in 2010, slightly down from -10,2 % of GDP in 2009. The poor performance was mostly due to the statistical reclassification of some state-owned enterprises (SOE) and public-private partnerships (PPP) within the general government as well as the costs relating to the rescue of two troubled banks. These effects were only partly compensated by the one-off effect of the transfer of a pension fund to the Portuguese Government and somewhat better revenues than in the previous year. In 2011, the deficit outturn was 4,4 % of GDP compared with a 5,9 % of GDP target. The better nominal performance is explained by a transfer of banks' pension funds to the social security system which was used to close a fiscal gap amounting to 1½ % of GDP. The Portuguese Government reacted promptly to correct budgetary underperformance during the first half of the year by adopting additional revenue measures such as a one-time tax surcharge on personal income and raising the value added tax (VAT) rate on electricity and natural gas from the reduced to the standard rate while tightening expenditure. Hence, the fiscal gap is explained mainly by non-recurrent deficit-increasing factors, namely non-tax revenue underperformance at the level of concessions and real estate, the recording of the debts of an SOE and a PPP both in the remit of the Madeira regional government and the reclassification of a PPP within the general government after the introduction of tolls.

(9) According to the most recent update by the Commission services of the economic outlook in Portugal, the general government deficit in 2012 is projected at 5,3 % based on unchanged policies, which compares with an expected deficit of 4,5 % of GDP in the 2012 Budget Law and the 2012 Stability Programme. The 2012 budget, as amended by its March supplement, includes consolidation measures estimated at 5½ % of GDP. Expenditure-reducing measures include wage and pension cuts together with lower public sector employment and a reduction in health, education and SOEs' capital and current expenditures. Revenue-raising measures are based on higher indirect taxation by shifting certain goods and services from the reduced and intermediate to higher VAT rates. Changes in direct taxation mostly aimed at broadening the tax base by reducing deductions and exemptions applicable to personal and corporate income taxation.

(10) In 2012, the projected deviation from the budget plan is about 1¾ % of GDP, mainly linked to a faster-than-expected rebalancing of the economy towards less tax-intensive exports and higher-than-projected unemployment weighing on social security budgets. Revenue shortfalls are broad-based and relate to lower-than-expected direct and indirect taxes but also to social security contributions. The change in tax bases has led to an overall shortfall of about 2 % of GDP compared to the revenues projected in the 2012 budget, while ¼ % of GDP is due to one-off operations. Overall expenditure is developing better than planned, with higher expenditure on unemployment benefits balanced by savings in other areas, particularly compensation for employees. Savings amounting to 1,5 % of GDP – lower net interest payments and the reprogramming of Union structural funds - and, possibly, one-off revenues from an airport concession help to partly offset the revenue shortfalls. As some of the deficit-reducing factors in 2012 are one-off, the 2012 gap translates into a carry-over of about 1½ % of GDP in 2013 caused by the shrinking of tax revenue bases and labour market developments.

(11) According to the most recent update by the Commission services of the economic outlook in Portugal, on the basis of unchanged policies, the government deficit in 2013 is projected at 4,5 % of GDP which compares with an original target of 3 %. Within the framework of the Programme for Portugal, the unchanged policies scenario takes into account the measures agreed in Council Implementing Decision 2011/344/EU of 17 May 2011 on granting Union financial assistance to Portugal[1] and the fourth update to the Memorandum of Understanding on Specific Economic Policy Conditionality between the European Commission, acting on behalf of the European Union, and the Republic of Portugal ("Memorandum of Understanding"). The fourth update to the Memorandum of Understanding considered fiscal consolidation measures worth about 2 % of GDP in 2013 including a sizeable decrease in expenditures through lower compensation for employees and cuts in the areas of education and health coupled with gains from restructuring the central administration and SOEs. On the revenue side, measures aimed at broadening the tax base by reducing tax benefits and tax deductions in corporate and personal income taxes and by increasing excise duties. Along the same lines of action, the 2012 Stability Programme considers fiscal consolidation measures worth about 1,4 % of GDP.

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[1] OJ L 159, 17.6.2011, p. 88.

(12) The latest update by the Commission services of the economic outlook in Portugal shows that the structural deficit was -8,7 %, -8,5 % and -6,3 % of GDP in 2009, 2010 and 2011 respectively. It is expected to reach -4,2 % of GDP in 2012. This implies an average apparent fiscal effort, measured as the difference between the structural deficits, of 1,5 % of GDP between 2010 and 2012, which is above the minimum required average annual fiscal effort of 1¼ % of GDP specified by the Council in 2010-2013. Correcting for the change in the macroeconomic scenario between the projections underlying the Council Recommendation of 2 December 2009 and the current forecast, the estimated average annual fiscal effort between 2010 and 2012 would be about 0,8 percentage points of GDP higher. Portugal has thus taken effective action as regards the path for the structural deficit up to 2012.

(13) According to the Commission services' 2009 Autumn Forecast, which was underlying the Council Recommendation of 2 December 2009, the Portuguese economy was expected to grow by 0,3 % in 2010 and by 1,0 % in 2011. The years 2012 and 2013 were beyond that forecast's horizon period, but implicitly higher growth than in 2011 was expected for 2012 and 2013 given the assumption of a gradual closure of the large negative output gap by 2015. The outcome of real GDP for 2010 and 2011 was very much at odds with the projected path in the 2009 Autumn Forecast, with, largely due to exceptional factors, higher non sustainable growth in 2010 and much lower growth in 2011. In addition, the composition of economic growth was much less based on domestic demand. The accumulated contribution of domestic demand for 2010 and 2011 was -5 percentage points of GDP, compared with a forecast of 0,6 percentage points. At the same time, the labour market deteriorated to a larger extent and more rapidly than foreseen in the Commission services' 2009 Autumn Forecast. The latest update by the Commission services of the economic outlook in Portugal expects significant negative growth rates for 2012 and 2013. Furthermore, the growth composition is likely to continue to be tilted towards net exports. These growth projections show that the Portuguese economy has been hit by unexpected events.

(14) Gross public debt rose from 93,3 % in 2010 to 107,8 % of GDP in 2011 and, according to the latest update by the Commission services of the economic outlook in Portugal, is expected to rise to 119,1 % of GDP in 2012 and to reach 123,7 % of GDP in 2013, thus exceeding the Treaty reference value in all years. This increase in the debt ratio is mainly driven by higher interest payments including payments linked to the Programme loans and, to a lesser extent, by the dynamics of the primary deficit. The stock-flow adjustment is sizeable in 2012, contributing 3,3 percentage points of GDP to the increase, and is linked to the plan to settle invoices of providers of public bodies and other outstanding operations.

(15) The budgetary position has deteriorated substantially compared with the assumptions in the Council Recommendation of 2 December 2009, due to a worse-than-expected economic outlook, which is also less tax-rich. Moreover, the sizeable contraction of the economy is affecting employment and unemployment in a very negative way. This is having negative effects on both the revenue and expenditure side, with a shortfall of social contributions and higher social transfers. Considering all these factors, and given in particular the marked deterioration in the fiscal outlook since the Council Recommendation of 2 December 2009 and the fact that Portugal has taken effective action, an additional year for the correction of the excessive deficit would therefore be warranted.

(16) Granting an additional year for the correction of the excessive deficit requires the attainment of intermediate headline deficit targets of 5,0 % of GDP for 2012, 4,5 % of GDP for 2013 and 2,5 % of GDP for 2014, as provided for in Implementing Decision 2011/344/EU, as amended by Council Implementing Decision 2012/…/EU[1*]. On the basis of the latest update by the Commission services of the economic outlook in Portugal, the underlying required improvement in the structural fiscal balance resulting from these headline targets is 2,3 % of GDP in 2012, 1,6 % of GDP in 2013 and 1,3 % of GDP in 2014. The Portuguese authorities will adopt additional measures to achieve the deficit targets in 2012, 2013 and 2014 in the light of the needs identified in the fifth review of the Programme. In addition, the authorities will develop contingency measures for the following years in case of slippages, given possible implementation risks.

(17) Despite some relief over the past few months, market pressure on Portuguese sovereign debt remains high and there is a need to underpin the credibility of Portugal's consolidation effort. This would require specifying in detail all the structural measures that are necessary to achieve the budgetary targets in 2013 and 2014, and accelerating the reduction of the deficit if economic or budgetary conditions turn out better than currently expected. The importance of taking timely action to avoid the risk of future slippages warrants the setting of a deadline of three months instead of six months to take effective action.

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[1] OJ L … .

[*] OJ: please insert number and OJ references of Decision set out in doc st 13936/12.

(18) On 6 July 2012, the Council adopted country-specific recommendations for Portugal to implement the measures as laid down in Implementing Decision 2011/344/EU and further specified in the Memorandum of Understanding and its subsequent supplements. Overall, these measures aim at adopting a credible and balanced fiscal consolidation strategy supported by structural fiscal measures and better fiscal control over SOEs and PPPs, deep and frontloaded structural reforms in the products and services markets and efforts to safeguard the financial sector through recapitalisation supported by back-up facilities.

(19) In parallel to the regular reviews of the Programme for Portugal as provided for in Implementing Decision 2011/344/EU, the monitoring of Portugal's progress in implementing its excessive deficit procedure commitments will be carried out every three months.

(20) Portugal fulfils the conditions for the extension of the deadline for correcting the excessive general government deficit as laid out in Article 3(5) of Regulation (EC) No 1467/97,

HEREBY RECOMMENDS:

(1) That the Portuguese authorities put an end to the present situation of excessive deficit by 2014.

(2) That the Portuguese authorities deliver an improvement of the structural balance of 2,3 % of GDP in 2012, 1,6 % of GDP in 2013 and 1,3 % of GDP in 2014, in order to bring the headline government deficit below the 3 % of GDP reference value by 2014, based on the Commission services' update of the economic outlook in Portugal. The headline deficit targets should be 5,0 % of GDP for 2012, 4,5 % of GDP for 2013 and 2,5 % of GDP in 2014.

(3) That the Portuguese authorities implement the measures adopted in the 2012 budget and its March supplement and that they take additional measures worth 0,3 % of GDP to confine the deficit to 5,0 % of GDP. These include freezing some of the 2012 budget appropriations for investment projects not yet initiated, raising stamp duties on high-value properties and tax rates on investment income, frontloading some of the 2013 budget measures to reduce social benefits and applying other measures generating savings in intermediate consumption and revenue from sales.

(4) That the Portuguese authorities adopt permanent consolidation measures of 3,0 % of GDP to reach the 4,5 % of GDP target in 2013. Unless otherwise specified, the measures to be adopted with the 2013 Budget Law include: i) a reduction in compensation for employees, generated through a substantial reduction in the number of public employees, in overtime payments and in non-wage compensation; ii) improved means-testing and the scaling down of some social programmes and benefits; iii) deepening health care and SOEs reform. On the revenue side, the projected measures include: i) a reform of the personal income tax simplifying the tax structure, eliminating some tax benefits, increasing the average tax rate while improving progressivity, ii) broadening the corporate income tax base by eliminating interest deductibility and iii) raising property taxes. The Portuguese authorities will use contingency measures in 2013 if slippages occur.

(5) That the Portuguese authorities adopt permanent consolidation measures of 1¾ % of GDP to achieve the 2014 deficit target. A comprehensive expenditure review to fully specify measures amounting to about EUR 4 billion over 2014-2015 will be carried out for the sixth review of the Programme and measures will be fully specified by mid-February 2013. The fiscal consolidation plans for 2014-2015 will be fully detailed in the 2013 Stability Programme.

(6) The Portuguese Government is to take effective action to implement this Recommendation within three months of its adoption and, in accordance with Article 3(4a) of Regulation (EC) No 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets.

Furthermore, the Council invites the Portuguese authorities:

(a) in addition to the report provided for in recommendation (6) and in parallel to the requirements set out in Implementing Decision 2011/344/EU, to report on progress made in the implementation of this Recommendation every three months as well as in a separate chapter in the Stability Programmes which will be prepared until 2015;

(b) to maintain reform momentum in public financial management by reforming the Budget Framework Law to comply with the new European Union fiscal governance rules and to continue improving transparency and control at all budgetary stages as well as ensuring adherence to its medium-term budgetary framework and targets for all levels of general government.

This Recommendation is addressed to the Portuguese Republic.

Done at Brussels,

For the Council
The President