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Recommendation for a

COUNCIL DECISION

giving notice to Portugal to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit

{SWD(2016) 264 final}

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(9) thereof,

Having regard to the recommendation from the European Commission,

Whereas:

- (1) According to Article 126 of the Treaty on the Functioning of the European Union, Member States shall 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. The Stability and Growth Pact includes Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure¹, which was adopted in order to further the prompt correction of excessive general government deficits.
- (3) On 2 December 2009, the Council decided, in accordance with Article 104(6) of the Treaty establishing the European Community (TEC), that an excessive deficit existed in Portugal and issued a recommendation to correct it by 2013 at the latest, in accordance with Article 104(7) of the TEC and Article 3 of Council Regulation (EC) No 1467/97. Following the request by the Portuguese authorities for financial assistance from the European Union, the Member States whose currency is the euro and the International Monetary Fund (IMF), the Council granted financial assistance to Portugal². The Memorandum of Understanding on Specific Economic Policy Conditionality (the "Memorandum of Understanding") between the Commission and the Portuguese authorities was signed on 17 May 2011. Since then, the Council has addressed two new recommendations to Portugal (on 9 October 2012 and 21 June 2013) on the basis of Article 126(7) of the Treaty on the Functioning of the European Union, which extended the deadline for correcting the excessive deficit to 2014 and 2015 respectively. In both recommendations, the Council considered that Portugal had

¹ OJ L 209, 2.8.1997, p. 6.

² Council Implementing Decision 2011/344/EU of 30 May 2011 on granting Union financial assistance to Portugal, OJ L 159, 17.6.2011, p. 88.

taken effective action, but unexpected adverse economic events with major unfavourable consequences for government finances had occurred.³

- (4) According to the provisions of Article 126(8) of the Treaty, the Council decided on 12 July 2016 that Portugal did not take effective action in response to the Council Recommendation of 21 June 2013.
- (5) If actual data pursuant to Regulation (EC) No 479/2009 indicate that an excessive deficit has not been corrected by a participating Member State within the time limits specified in a recommendation issued under Article 126(7) of the Treaty, the Council should immediately take a decision under Article 126(9) of the Treaty.
- (6) The Commission 2016 spring forecast projects a moderate recovery of the Portuguese economy. In 2016, real GDP is projected to grow by 1.5%, at the same pace as in 2015, mainly driven by domestic demand amid still high macroeconomic imbalances. Private consumption is expected to lose momentum in 2016 due to higher indirect taxes and a slight recovery in energy price inflation. The strong rebound in the consumption of durable goods in the first half of 2015 is not forecast to be maintained over the medium term as still high unemployment and debt levels are projected to keep upward pressures on household savings. Business investment already decelerated significantly over the second half of 2015 and is not expected to resume its previous growth rate soon, despite a relatively high capacity utilisation rate. Total investment is anticipated to gain some pace in 2017, supported by EU structural funds and the improvement in financing conditions. Exports are forecast to grow in line with foreign demand, but imports are still expected to outbalance exports. As a result, the contribution of net trade to GDP growth is forecast to remain slightly negative although significantly less so than in 2015. HICP inflation is expected to increase to 0.7% in 2016, mainly driven by higher indirect taxes. While downward risks to the outlook have increased since the publication of the spring forecast, data on the first quarter of 2016 and preliminary information on the second quarter overall confirm the outlook of the forecast for the rest of the year.
- (7) According to the Commission 2016 spring forecast, the general government deficit is expected to decrease to 2.7% of GDP in 2016. The 2016 Budget, which entered into force on 31 March 2016, targets a deficit of 2.2% of GDP, which was confirmed in the 2016 Stability Programme. The difference between the government's target and the Commission forecast is due to the Commission's less optimistic macroeconomic scenario, leading to lower tax revenues and higher social expenditure, as well as the Commission's more conservative assessment of the yields of some consolidation measures, in particular as regards planned savings in intermediate consumption and other current expenditure. The Commission 2016 spring forecast projects the general government deficit to decline further to 2.3% of GDP in 2017. The projected improvement is largely linked to a deficit improving one-off operation linked to the expected recovery of the Banco Privado Português (BPP) bank guarantee worth about ¼% of GDP. Adjusted for this one-off budgetary impact, the deficit would be projected to reach 2.6% of GDP in 2017. Based on the Commission's assessment of the yields of the measures indicated in the 2016 Budget and in the 2016 Stability Programme, the structural deficit is expected to deteriorate by ¼% of GDP each year in 2016 and 2017 according to the Commission 2016 spring forecast.

³ All documents related to the excessive deficit procedure of Portugal can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/portugal_en.htm

- (8) The general government gross debt-to-GDP ratio has broadly stabilised during the period 2013-2015, reaching 129.2% in 2013, 130.2% in 2014 and 129.0% in 2015. Taking into account significant debt-reducing stock-flow adjustments in 2016 and continued primary surpluses, the Commission 2016 spring forecast projects the debt ratio to decrease to 126% of GDP in 2016, and subsequently to 124.5% of GDP in 2017. Portugal does not appear to face considerable risks of fiscal stress in the short term, while short-term challenges are nevertheless not excluded (stemming from gross and net public debt, gross financing needs, the net international investment position, as well as the level and the change in the share of non-performing loans or general capital needs in the banking system). In the medium term, however, risks appear to be significant due to the high stock of debt and the high sensitivity of the debt ratio to possible interest rate increases and negative nominal growth shocks. In the long term, provided that adequate structural primary balances are consistently preserved, sustainability risks appear low owing to the pension reforms implemented in the past.⁴
- (9) Under the fiscal policy measures taken in the 2016 Budget, the general government deficit would be below 3% of GDP in 2016. However, according to the Commission 2016 spring forecast, the safety margin against breaching the Treaty reference value is narrow. Against the background of high uncertainties regarding economic and budgetary developments, the budgetary targets recommended for the correction year should be set at a level clearly below the Treaty reference value of 3% of GDP, in order to guarantee a durable correction of the excessive deficit situation within the requested deadline.
- (10) According to Article 5 of Regulation (EC) No 1467/97, in the Council decision to give notice to take measures for the deficit reduction in accordance with Article 126(9) of the Treaty, the Council shall request that the Member State achieve annual budgetary targets which, on the basis of the forecast underpinning the notice, are consistent with a minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures. As this Council decision to give notice is adopted in the second half of the year, and taking into consideration the current Commission estimates of the spring forecast, an unchanged structural balance would be warranted for 2016 to provide a sufficient safety margin towards a durable correction of the excessive deficit.
- (11) Therefore, a credible and sustainable adjustment path would require Portugal to reach a general government deficit of 2.5% of GDP in 2016, which is consistent with an unchanged structural balance with respect to 2015. Those budgetary targets take into account the need to compensate for second-round effects of fiscal consolidation on public finances, through its impact on the wider economy.
- (12) The deficit target implied by the proposed adjustment path does not incorporate the possible direct fiscal effect of potential bank support measures in the second half of 2016. This is because there is high uncertainty regarding the effective implementation and statistical recording of these measures, and hence their possible impact on deficit and debt. Any possible bank sector support measures should aim at limiting the fiscal impact to the minimum possible to ensure debt sustainability.
- (13) To attain the budgetary targets implied by the proposed adjustment path, additional consolidation measures with an estimated impact of 0.25% of GDP in 2016 are

⁴ European Commission (2016), "Fiscal Sustainability Report 2015", European Economy, Institutional Paper No. 018.

considered necessary, also in view of the structural deterioration identified in the Commission 2016 spring forecast. In particular, Portugal shall implement the measures included in the 2016 Budget as well as the expenditure control mechanism in the procurement of goods and services, which is currently highlighted in the 2016 Stability Programme. These savings would need to be complemented with other measures of a structural nature which could focus on the revenue side aiming at increasing the yields of indirect taxation by broadening the tax base and reducing tax expenditures. One way to achieve this could be by adjusting the still broad use of reduced VAT rates.

- (14) In addition, Portugal should reinforce structural reforms to enhance competitiveness and long-term sustainable growth in line with the Council Recommendations addressed to Portugal in the context of the European Semester and in particular those related to the correction of its excessive macroeconomic imbalances. In particular, further fiscal-structural measures are necessary to strengthen the resilience of Portugal's public finances. The timely and strict implementation of the revised Budget Framework Law and the Commitment Control Law as well as further improvements in revenue collection and expenditure control may significantly contribute to achieving and maintaining a healthy fiscal position. Portugal should present a clear schedule and implement steps to clear arrears fully and improve efficiency in the health care system, to reduce the reliance of the pension system on budget transfers and to ensure fiscal savings in the restructuring of State-owned enterprises.
- (15) According to Article 126(9) of the Treaty, the Council may, as part of its decision to give notice under this Article, request the Member State concerned to submit reports on the adjustment effort in accordance with a specific timetable. According to Article 5(1a) of Regulation EC (No) 1467/97, the Member State report should include the targets for government expenditure and revenue and specify the fiscal policy measures on both the expenditure and the revenue side, as well as information on the policy actions being taken in response to the specific Council decisions. In order to facilitate the monitoring of the deadline for compliance with the recommendations contained in this notice, as well as the deadline for correction of the excessive deficit, Portugal is requested to submit such a report before 15 October 2016, in parallel with its 2017 Draft Budgetary Plan.
- (16) By the same deadline, Portugal should also present an economic partnership programme in accordance with Articles 9(1) and 17(2) of Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013. The economic partnership programme should describe policy measures and structural reforms that are needed to ensure an effective and lasting correction of the excessive deficit, as a development of the national reform programme and the stability programme, and fully taking into account the Council recommendations on the implementation of the integrated guidelines for the economic and employment policies.
- (17) Portugal should also report to the Commission and the Economic and Financial Committee as required under Article 10 of Regulation (EU) No 473/2013 in accordance with the specifications laid down in Commission Delegated Regulation (EU) No 877/2013. The report should be submitted for the first time by 15 January 2017 and on a three-monthly basis thereafter.

HAS ADOPTED THIS DECISION:

Article 1

1. Portugal shall put an end to the present excessive deficit situation by 2016.
2. Portugal shall reduce the general government deficit to 2.5% of GDP in 2016. This target does not include the impact of the direct effect of potential bank support. This improvement in the general government deficit is consistent with an unchanged structural balance with respect to 2015, based on the Commission 2016 spring forecast. Portugal shall also use all windfall gains to accelerate the deficit and debt reduction.
3. In addition to the savings already included in the Commission 2016 spring forecast, Portugal shall adopt and fully implement consolidation measures for the amount of 0.25% of GDP in 2016. In particular, Portugal shall implement fully the consolidation measures incorporated in the 2016 Budget, including the additional expenditure control in the procurement of goods and services highlighted in the Stability Programme. Portugal shall complement those savings with further measures of a structural nature to achieve the recommended structural effort.
4. Portugal shall stand ready to adopt further measures should risks to the budgetary plans materialise. Fiscal consolidation measures shall secure a lasting improvement in the general government balance in a growth-friendly manner.
5. To ensure a durable improvement of public finances, Portugal shall strictly implement the Budget Framework Law and the Commitment Control Law and further improve revenue collection and expenditure control. Portugal shall present a clear schedule and implement steps to fully clear arrears and improve efficiency in the health care system, to reduce the reliance of the pension system on budget transfers and to ensure fiscal savings in the restructuring of State-owned enterprises.

Article 2

The Council establishes the deadline of 15 October 2016 for Portugal to take effective action and to submit a report to the Council and the Commission on action taken in response to the Council notice. The report shall include the targets for the government expenditure and revenue and specify the discretionary measures on both the expenditure and the revenue side, as well as information on the actions being taken in accordance with Article 1(5).

Article 3

This Decision is addressed to the Portuguese Republic.

Done at Brussels,

*For the Council
The President*