PORTUGAL

STABILITY AND GROWTH PROGRAMME

UPDATE FOR THE PERIOD 2002-2005

December de 2001

C O N T E N T S

S U M M A R Y

The outlook of economic growth for the period 2002-04 has been substantially changed in the recent past.

Notwithstanding the less favourable economic and financial framework compared to the previous Stability and Growth Programme (2001-04), the Government reasserts its commitment to balance the budget in 2004. The budgetary strategy includes, among other policy measures, the adoption of a 4% threshold for the nominal growth rate of the primary current expenditure and a level of 4.3% of GDP for public investment in the period 2003-05.

To sustain the ceiling for the growth of primary current expenditure, several measures will be adopted for priority areas such as Public Administration, Social Security, Health and Education; efforts against tax evasion and to broaden the tax base will be intensified, as well as adjustment of taxes with a positive impact on environment. The implementation of the new Framework Law for the State Budget and the increase of Parliamentary budgetary supervision from January 2002 will allow for a faster adoption of necessary measures to fulfil the targets set for primary current expenditure.

The fiscal consolidation effort is equivalent to around 2 percentage points of GDP in the period 2003-04, mainly supported by the reduction of the weight of primary current expenditure in GDP.

I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

This update of the Stability and Growth Programme for the period 2002-2005 has been prepared in accordance with the Council Regulation (EC) nº1466/97, of 7 of July, and with the Code of Conduct adopted by the Ecofin Council of July 2001, and complies with the Broad Economic Policy Guidelines recommendations adopted in the Gothenburg European Council, as well as the commitment, in accordance with the Stability and Growth Pact, to "respect the medium-term budgetary objective of positions close to balance or in surplus".

In particular, and facing a deterioration in global economic prospects, which implied, for the Portuguese economy, a lower growth rate than the one expected in the last revision of the programme, the Government reasserts, in the present update, the central aim of balancing the budget in 2004.

In so far as the level of revenues is lower than initially forecasted in the budget, it becomes necessary to intensify efforts to reduce the weight of primary current expenditure in GDP. Therefore, the Government adopts the intermediate target of limiting primary current expenditure to an annual nominal growth rate of 4% during the period 2002-2005.

The strategy for the consolidation of public finances relies on the following fundamental instruments:

- the Framework Law for the State Budget, which includes the following fiscal policy principles:
    - new definition of fiscal balance of the Funds and Autonomous Services and restrictions on access to debt finance;
    - information on the multiannual responsibilities of services;
- the Fiscal Stability Law, currently in preparation, shall imply a participation in the efforts of fiscal consolidation from all levels – central, regional and local – of the General Government;
- the ongoing reform of the social security system in order to guarantee the sustainability of public finances in the medium and long term. The implementation of the new Framework Law for Social Security, in particular the new formula for pensions recently agreed with Social Partners, will reduce the impact, on public finances, from an ageing society;
- new measures shall be adopted in order to increase productivity in the Public Administration, through the:
    - rule of one admission for each four departures;
    - creation of a Mobility Staff to restrain employment growth and allow for the requalification of public servants;
    - implementation of the Administration on-line project.
- the ongoing reform of the health system, with structural measures that shall improve substantially the quality of expenditure and reduce waste, while increasing health gains and promoting administrative modernisation of the Health Ministry and the management of the National Health System. The implementation of internal and external contract practices, based on the

preparation and negotiation of budget by activity and evaluation of outcomes and assessment of responsibilities;

- the reform of education includes the following priorities:
  - the rationalisation of the school networks;
  - the fight against early drop outs;
  - diffusion of new technologies;
  - evaluation of universities and polytechnics;
  - increase of the supply of professional and vocational courses.

This update of the Stability and Growth Programme for the period 2002-2005 has been approved by the Council of Ministers on 13 December 2001.

II. ECONOMIC OUTLOOK

II.1. The Portuguese Economy in 2001 and 2002

In 2001, industrialized economies witnessed a stronger deceleration in activity than expected. The adjustment process in the high-tech sector, the drop of equity prices and the increase of oil prices were some of the factors that led to a quick slowdown in economic growth. In this context, and enhanced by the 11 September events, expectations of economic agents deteriorated sharply.

The slowdown of domestic demand and the weakening of the international economy slowed down domestic activity. The growth rate of Portuguese economy fell in 2001 to an estimate of 2% (3.3% in 2000), 1.3 percentage points below the forecast of the previous programme.

Private consumption decelerated further in 2001 as consumer confidence fell and the adjustment process stepped up, due to the strong increase of private indebtedness in the last years. The demand for durable goods was particularly affected. Investment also slowed down, specially concerning transport material and residential construction segments. Nevertheless, investment in public infrastructures has remained dynamic.

External trade flows were less dynamic, in tandem with the deterioration in the international economy.

Despite the slowdown of the economy, labour market conditions remained favourable. In the first three quarters, the average unemployment rate and the employment growth were 4% and 1.7%, respectively. Nevertheless, other indicators point to a weak outlook. Concerning prices behaviour, the increase of oil prices, the effects of animal diseases and the adverse weather conditions led to higher inflation rate.

Forecasts for 2002 point to further slowdown, as the adjustment process of domestic demand continues and the international background remain vulnerable. Therefore, Portuguese GDP is expected to increase at a rate of 1¾% in 2002. In fact, although the recovery of the US economic growth is expected to occur in the second half of 2002, uncertainty remains high, since investment has decreased sharply and confidence levels remain low. On the other hand, the US macroeconomic imbalances could limit the strength of the recovery.

Nevertheless, some positive features for the Portuguese economy can be pointed out:

- the confidence of economic agents is expected to improve, associated with the gradual recovery of European economy;
- public finances consolidation should reduce macroeconomic imbalances;
- the private consumption should benefit from lower interest rates and the increase of social transfers;
- public investment should continue vigorous supported by the III Community Support Framework;
- private investment could benefit from gains in terms of trade and competitiveness improvement, namely because of the application of community funds.

In 2002, oil and food prices behaviour should be favourable and wages increase should be moderate. In consequence, inflation is expected to decelerate.

II.2. Medium term macroeconomic scenario (2003 – 2005)

The macroeconomic scenario concerning the period from 2003 to 2005 is based on the forecasts for the international economic growth provided by international organisations. Those forecasts point to the recovery of the international economy beginning in the second half of 2002. In the European Union, the pace of economic growth should return to rates around 3% (annual average) in 2003-2005 period. Concerning Portugal, a similar pattern for economic growth is projected.

Despite the uncertainty that surround the present projections, the prospects concerning the Portuguese economy growth remain favourable. In fact, the expansion period, expected to begin in 2003, should be a path of sustainable growth once the imbalances, that characterized the previous expansion phase (1994-2000), are further reduced, namely the external deficit and the high level of private indebtedness.

The medium term projections are based on assumptions, such as that exports grow in line with the behaviour of the main export markets and that wages grow in line with the average growth of labour productivity. The improvement of competitiveness, due to ongoing economic reforms and the implementation of projects in the context of the Operational Programme for the Economy, should support the dynamism of productive investment.

Table 1. Growth and associated factors

	2001	2002	2003	2004	2005
GDP growth at constant market prices (7+8+9)	2,0	1,75	2,5	3,0	3,0
GDP level at current market prices (10^9 EUR)	122,8	129,0	136,4	144,6	153,4
GDP deflator	4,7	3,3	3,2	3,0	3,0
HICP change	4,4	2,8	2,3	2,1	2,0
Employment growth	1,5	0,9	0,9	1,0	1,0
Labour productivity growth	0,5	0,8	1,6	1,9	2,0
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	1,5	1,3	1,9	2,4	2,4
2. Government consumption expenditure	1,8	0,9	0,6	0,3	0,2
3. Gross fixed capital formation	2,0	3,3	6,1	6,7	7,0
4. Changes in inventories and net acquisition of valuables as a % of GDP	0,0	0,0	0,0	0,0	0,0
5. Exports of goods and services	4,5	2,7	6,5	7,4	7,5
6. Imports of goods and services	3,0	2,3	6,0	6,8	7,1
Contribution to GDP growth					
7. Final domestic demand	1,8	1,9	2,9	3,4	3,5
8. Change in inventories and net acquisition of valuables (=4)	0,0	0,0	0,0	0,0	0,0
9. External balance of goods and services	0,1	-0,1	-0,5	-0,5	-0,6
Basic assumptions					
Short-term interest rate (annual average)	4,2	3,0	3,8	4,0	4,0
Long-term interest rate (annual average)	5,2	5,0	5,4	5,5	5,5
USD/Euro exchange rate (annual average)	0,896	0,905	0,905	0,905	0,905
World GDP growth	2,1	2,2	3,7	3,9	3,9
EU-15 GDP growth	1,7	1,4	2,9	2,9	2,9
Growth of relevant foreign markets	2,4	2,4	6,5	7,0	7,0
World import volumes, excluding EU	0,0	1,2	5,8	5,8	5,8
Oil prices	24,9	22,3	24,8	25,0	25,0

Source: Ministry of Finance, OECD.

III. GENERAL GOVERNMENT BALANCE AND DEBT

III.1. Strategy

The main economic policy goals are the promotion of sustained economic development and the reinforcement of conditions that stimulate convergence to European standards. Along with these general goals specific policies, that promote equity and reduce social exclusion, are being implemented. Public finances consolidation is an instrument of this strategy and aimed at the improvement of the quality and quantity of public services within a framework of efficient use of resources.

In order to achieve these goals the following instruments will be used:

- structural reforms in several areas, mainly health, education, and public administration;
- increase of Portuguese companies competitiveness, through the reduction of their costs to European standards, promotion of training and qualification, diffusion of new technologies and creation of specific programmes to support their development;
- proceed with the public finances consolidation programme which envisages: the improvement of public services quality; the development of infra-structures that promote productive investment growth and improve welfare; the establishment of a competitive tax policy, within the European Union framework, that promotes equity;

III.2. Current stand and implications for the 2002 Budget

The 2001 Budget was prepared in a context where economic growth was expected to reach 3.3%. Within this framework tax revenue would increase by 1.1 percentage points (p.p.) of GDP while total revenue would increase 2.8 p.p. of GDP, with the difference between the two being explained by the increase of transfers from the European Union, related to the CSF III. On what concerns expenditure, primary current expenditure was expected to increase 0.5 p.p. of GDP. General Government overall deficit was programmed to decrease from 1.5% of GDP in 2000 to 1.1% in 2001. Excluding UMTS revenues, the effort needed was expected to be 0.7p.p. of GDP.

Currently economic growth is lower than previously expected, reaching 2%. This slowdown, together with the reduction in income taxes, had an important effect on tax collection. Thus, General Government tax revenue is expected to under perform the target by one thousand million euros, 0.8 p.p. of GDP. Relatively to 2000 a decrease of 0.6 % of GDP is anticipated and mainly due to lower income and property taxes collection.

The gap between taxes revenue and the forecast in the SGP is due to: economic growth lower than expected; the impact of tax reform greater than expected; the increase of tax evasion, which tends to be more intensive in a period of economic slowdown. Lower direct taxes revenue particularly affected tax collections, with the loss of sub-sector State being 670 million euros. A loss of 795 million euros is expected in indirect taxes, reflecting the slowdown in private consumption, with an estimated real growth rate of 1.5%, half of the rate anticipated in the previous SGP. Additionally, due to economic slowdown, other items of current revenue will not achieve the target set in the SGP, thus increasing the gap in total revenue of General Government to 1.7 p.p. of GDP.

In a context of lower revenue, the Government has implemented a programme, reducing expenditure, thus minimizing the impact on the overall deficit. Hence, in June an amended budget was approved, in which current expenditure was reduced by 750 million euros (0.6% of GDP). Thus, expenditure as percentage of GDP is expected to achieve, in 2001, the value forecasted in the SGP (2001-04) and total expenditure is expected to be 0.6 p.p. of GDP lower than the target set in the original budget.

General Government overall deficit should be 2.2% of GDP, 1.1 p.p. above the value forecasted in the SGP. This gap is explained by lower revenue collection, partially compensated by expenditure reduction.

The outturn for 2001 led to the adoption of new measures, some of them are in the 2002 Budget, in order to reform public expenditure and reinforce the fight against tax evasion and fraud. The following measures stand out:

a) growth of primary current expenditure limited to 4%;
b) restrain of State discretionary current expenditures- 3.1% growth in 2002, against 8.9% in 2001;
c) implementation of structural reforms in order to improve the effectiveness of public resources;

Within the framework of economic slowdown, the 2002 Budget includes measures that envisage the increase of competitiveness:

a) 15.8% growth of capital expenditure, that is, 11 p.p. above GDP nominal growth;
b) reduction of corporate income tax rate to 30%;
c) privatisation of GALP Energy, Portucel S.A. and TAP S.A..

The goal established for the General Government overall deficit is 1.8% of GDP, due to a revenue growth of 0.5 p.p. of GDP and a 0.1 p.p. increase of total expenditure relatively to 2001. Tax revenue should increase just 0.1 p.p. of GDP while public consumption should decrease by 0.5 p.p. of GDP.

Strong growth of capital expenditure, 0.5 p.p. of GDP, is projected, mainly due to the co-financing effort of CSF III.

Table 2. General Government Account

(as percentage of GDP)

	2001	2002	2003	2004	2005
Global Balance of Public Administrations by subsectors					
1. General Government	-2,2	-1,8	-1,0	0,0	0,4
2. Central Administration	-2,5	-2,7	-2,1	-1,3	-1,0
3. Local Administration	0,0	0,0	0,0	0,0	0,0
4. Social Security Funds	0,4	0,9	1,1	1,3	1,4
Public Administrations (S13)					
5. Total revenue	44,0	44,5	44,2	44,1	44,0
6. Total expenditure	46,2	46,3	45,2	44,1	43,6
7. Global Balance	-2,2	-1,8	-1,0	0,0	0,4
8. Interests	3,1	3,1	2,9	2,7	2,7
9. Primary Balance	0,9	1,3	1,9	2,7	3,1
Revenue Components					
10.Taxes	24,8	24,9	24,9	25,1	25,1
11. Social contributions	11,8	12,1	12,3	12,4	12,5
12. Other	7,4	7,5	7,0	6,6	6,3
13. Total revenue	44,0	44,5	44,2	44,1	44,0
Expenditure Components					
14. Public consumption	20,2	19,8	19,4	19,0	18,5
15. Social transfers, ex.social transfers in goods	12,4	12,6	12,8	12,8	12,9
16. Interests	3,1	3,1	2,9	2,7	2,7
17. Subsidies	1,3	1,4	1,1	0,9	0,9
18. Fixed Capital Gross Formation	4,1	4,3	4,3	4,3	4,3
19. Other	5,0	5,1	4,8	4,4	4,2
20. Total expenditure	46,2	46,3	45,2	44,1	43,6
by m. Primary current expenditure	36,9	36,5	35,9	35,2	34,6

Source: Ministry of Finance.

The policy measures that support these targets are part of a multiannual package that is described in chapter IV of this report.

III.3. Public Debt

Public Debt forecasts for 2002-2005 are based on the following assumptions:

- net financing needs in line with budget consolidation trend;
- the State only uses two financing instruments: medium and long term Treasury bills and savings certificates;
- interest rates and exchange rates are according to table 1.

General Government gross debt, estimated according to national accounts basis, should decrease from 55.9% in 2001 to 53.2% in 2005. The continuous increase of the primary surplus explains the reduction of the debt to GDP ratio during the forecasting period.

Table 3. Public debt
(as percentage of GDP)

	2001	2002	2003	2004	2005
General Government gross debt	55,9	55,7	55,5	54,0	53,2
Change in General Government gross debt	2,2	-0,2	-0,2	-1,5	-0,8
Contributions to gross debt changes					
Primary deficit	-0,9	-1,3	-1,9	-2,7	-3,1
Interest effect and GDP nominal growth	-0,4	0,3	-0,2	-0,6	-0,5
Other	3,5	0,8	1,9	1,8	2,8

Source: Ministry of Finance.

Public debt management will continue to consider the following strategic goals for State financing:

- minimization of direct and indirect costs in the long run;
- guarantee of a balanced distribution of costs among the several annual budgets, thus preventing an excessive concentration of payments;
- non exposure to excessive risks;
- promotion of a balanced and efficient functioning of financial markets;

IV. Quality of Public Finances

IV.1. General Government Expenditure

The economic slowdown, that emerged after the last SGP (2001-2004) update, has strongly impacted on the budgetary consolidation path. Despite the efforts to control primary current expenditure, the budget outturn in 2001 did not lead to further consolidation due to weak revenues, and the general government deficit reached 2.2% of GDP. The Government adopted measures to restrain public expenditure in 2001 and further measures are included in the 2002 budget.

To achieve consolidation in 2004 the primary current expenditure has to be reduced by about 2 p.p. of GDP in 2003-04. Compared with the previous SGP, fiscal policy has to be tighter to achieve balance by 2004. When the equilibrium is achieved, total expenditure will be 44.1% of GDP, versus 46% in the previous SGP (see charts).

Chart 1. Primary Expenditure
(in % of GDP)

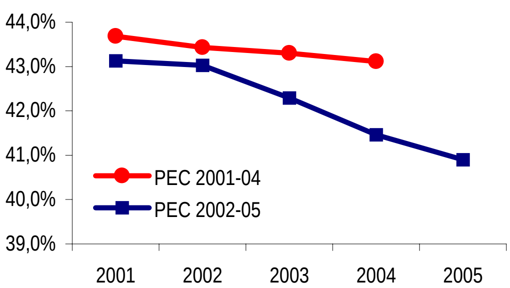
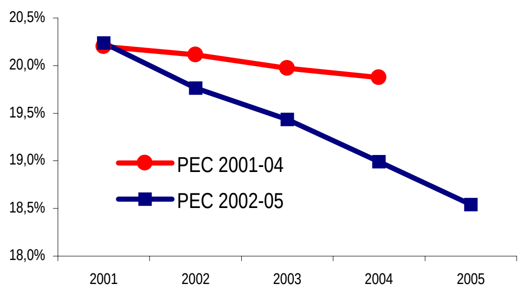


Chart 2. Public Consumption
(in % of GDP)



Reinforcing the competitiveness of Portuguese firms precludes increases in the tax burden. Therefore, priority will be given to the rationalization of public expenditure, which will be supported by a multiannual reform programme and by the principle of budgetary stability. The annual nominal growth of primary current expenditure will respect the ceiling of 4% a year. Besides, a Budgetary Stability Law is being prepared establishing the principle of solidarity in expenditure restraining within General Government, namely:

a) fixing budgetary balances in line with the target for the budgetary deficit;
b) Cutting transfers to sectors of General Government that do not respect their budgetary limits.

The medium term programme anticipates measures in several areas such as expenditure control, treasury and property management, reorganization and rationalization of the National Health Service and health public subsystems, human resources policy and Public Administration reorganization.

The programme foresees a reduction in the weight of the wage bill in GDP by applying a set of measures, namely:

c) Setting a ratio of one admission for each four exits;
d) Hiring workers for fixed term only in specific, duly justified, situations;
e) No restructuring of careers until the end of 2005.

These measures will be carried out together with a new instrument of administrative control of human resources in Public Administration. Each department should establish the targets for human resources management. The resulting information will be consolidated by ministry and at the Central Administration level. The Head of the department will be directly held responsible for the accomplishment of the targets set for human resources. This new control instrument has already been adopted and its effects will be appraised until the end of 2002.

Additionally, a framework for labour mobility will be created, thus allowing for intra-services reallocation and for training to support that reallocation, according to the target of reducing employment and improving the quality of services.

The measures described will allow for a reduction of employment in the General Government of 1.8% per year in 2002-04. Fixed Capital Formation expenditures will be kept at an average of 4.3% of GDP during this period, about 2 p.p. above the European average.

The recently approved Budget Framework Law is an important instrument to support financial discipline of public accounts, mainly in a context of expenditure reduction as fast as anticipated in the present update of SGP.

The sectoral structural measures supporting reduction of the weight of expenditure in GDP are presented in chapter VII.

IV.2. General Government Revenue

The economic slowdown anticipated for 2002 limits tax revenues forecasts. In 2001 tax revenues were 24.8% of GDP and for 2002 a small increase to just 24.9% of GDP is anticipated, due to an increase in indirect taxes of 0.1 p.p. of GDP. The impact of the tax reform is expected to be null in 2002.

In order to reach this goal, measures to fight tax fraud will be intensified, namely tax evasion through the displacement of tax residence to off-shores. Capital gains, which in 2002 will be under a temporary tax regime, will be liable to a maximum 20% tax rate, with taxes being withheld by financial intermediaries. Concerning the personal income tax, 50% of the positive balance resulting from capital gains and losses will be added to taxable income.

In the future tax policy will continue to obey to the principles already established, namely envisaging: protection of low income families and individuals, enlargement of the tax basics and fight tax fraud and evasion, simplification of income statement and tax collection, introduction of incentives to the broad use of new technologies and training, use of tax instruments to support environment protection policies.

The next steps of tax reform include: proceeding with corporate income tax reduction, proceeding with the adoption of measures that reduce tax evasion, reforming property and automobile taxes in order to support an environment protection policy.

In this framework, the revenue forecast for the following three years is prudent, considering only a slight increase of tax revenues as a percentage of GDP along with an economic recovery path with GDP reaching 3% in 2004. Hence, tax revenue should increase, in 2003-2004 by 0.1 p.p. of GDP, reaching 25.1% of GDP in the final year of the programme.

In revenue forecast consideration was also given to the impact of some legal and administrative measures recently adopted, such as:

- The withdrawal of bank secrecy;
- The introduction of rules that invert the *onus* proof when taxpayers show evidence of wealth that is not compatible with their statement of income;
- Changes introduced in transfer prices;
- Introduction of a new tax regime for holdings;
- Penalties for confidential expenses;
- Measures to prevent the abusive use of off-shores;
- Simplified regimes for personal and corporate income taxes;
- More rigorous criteria for taxpayers control;
- Rationalization of human resources allocated to tax auditing.

V. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

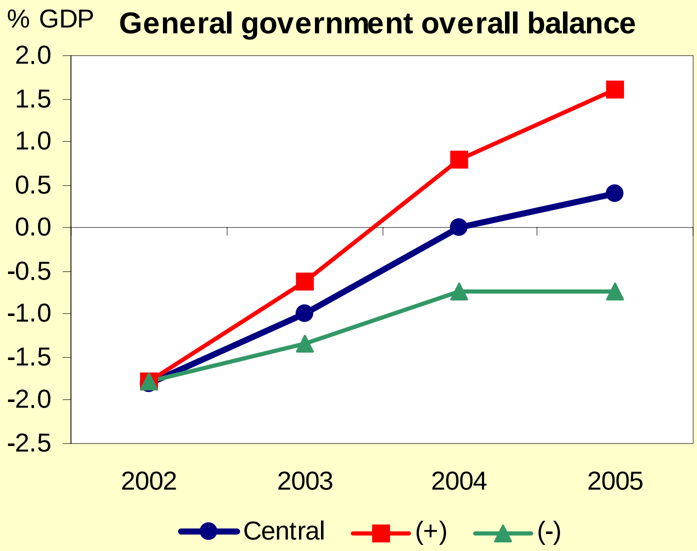
V.1. Sensitivity of the general government balance

The analysis of the sensitivity of public finances was performed by simulating a change of more (less) one-percentage point in the GDP growth. The results show that in the high-growth scenario, the general government balance would reach a surplus of 0.8% of GDP in 2004 (the cumulative impact of an annual increase in GDP of 1 percentage point in both years). In the lower growth scenario the result would be a deficit of 0.7% of GDP (see Box 1). Even in a period of slow growth, the projected general government deficit would be less than 1% in 2005.

Another simulation was carried out, to evaluate the impact of an increase (decrease) of one percentage point in the interest rate. In the case of a higher interest rate, the general government balance would be –0.2% of GDP in 2004, and in the case of a lower interest rate +0.2% of GDP.

Accordingly to the calculations, for each percentage point reduction of GDP growth, the general government deficit would increase by 0.4 percentage points. Therefore, a less favourable economic situation would not create a situation of excessive deficit during the present programme.

B O X 1. REAL GDP GROWTH RATE
ABOVE (+)/ BELOW (-) CENTRAL SCENARIO
(by 1 percentage point)



	2003	2004	2005
Real GDP growth (%)			
GDP (C)	2.5	3.0	3.0
GDP (+)	3.5	4.0	4.0
GDP (-)	1.5	2.0	2.0
% of GDP			
General government balance (C)	-1.0	0.0	0.4
General government balance (+)	-0.6	0.8	1.6
General government balance (-)	-1.4	-0.7	-0.7

V.2. Comparing results with the previous programme

In the central scenario of this programme, a reduction of the cyclically adjusted overall deficit is projected for 2002 and a slight structural surplus for 2004. The primary structural balance is positive in 2001, and will progressively increase to 3.1% of GDP in 2005.

Table 4. Cyclical Developments

	2001	2002	2003	2004	2005
1. GDP growth at constant prices	2,0	1,75	2,5	3,0	3,0
2. Actual balance (% of GDP)	-2,2	-1,8	-1,0	0,0	0,4
3. Interest (% of GDP)	3,1	3,1	2,9	2,7	2,7
4. Potential GDP growth	2,8	2,8	2,8	2,8	2,8
5. Output gap	0,6	-0,4	-0,7	-0,5	-0,4
6. Cyclical budgetary component	0,5	-0,2	-0,3	-0,2	-0,1
7. Cyclically-adjusted balance (2-6)	-2,7	-1,6	-0,7	0,2	0,5
8. Cyclically-adjusted primary balance (7+3)	0,4	1,5	2,2	2,9	3,1

Source: Ministry of Finance.

For the period 2001-04, in the present programme the annual average economic growth is 0.9 percentage point below the previous programme. The effort to the budgetary consolidation in 2003 is 0.8% of GDP and 1% in 2004. These projections are consistent with a current expenditure nominal growth limited to 4% and with the public investment set at 4.3% of GDP. The general government debt as percentage of GDP is higher in this programme due to the higher government deficits, the lower economic growth rates, the non-materialization of some privatisations during 2001 and the downward revision of the expected revenues of future privatisations. During the projection period, the government debt as percentage of GDP is expected to decline from 55.9% in 2001 to 53.2% in 2005.

Table 5. Divergence from previous update

	2001	2002	2003	2004	2005
Real GDP growth					
previous update	3,3	3,2	3,2	3,2	-
latest update	2,0	1,75	2,5	3,0	3,0
difference	-1,3	-1,4	-0,7	-0,2	-
Actual budget balance (% of GDP)					
previous update	-1,1	-0,7	-0,3	0,0	-
latest update	-2,2	-1,8	-1,0	0,0	0,4
difference	1,1	1,1	0,7	0,0	-
Gross debt levels (% of GDP)					
previous update	53,4	51,5	49,8	48,1	-
latest update	55,9	55,7	55,5	54,0	53,2
difference	2,5	4,2	5,7	5,9	-

Source: Ministry of Finance.

VI. SUSTAINABILITY OF PUBLIC FINANCES

VI.1. The Budgetary Impact of an Ageing Population

Recently, the **ageing of the population** has been the subject of careful analysis within the European Union, given the long-term budgetary implications it will have on the future sustainability of public pension schemes.

The continuous increase of the ratio between pensioners and employed workers is due not only to the inexorable rise in life expectancy, but also to the fact that longer schooling implies a later entrance into the labour market. Even so, it should be noted that, according to Eurostat's latest demographic projections, Portugal would have a slower ageing than the average of the EU. At the Community level, on the 6th of November the ECOFIN Council approved a report on the Budgetary Challenges posed by an ageing population. In accordance with the opinion of the ECOFIN Council relative to the 2001-2004 Portuguese Stability Programme, made public on the 12th of March, this chapter presents in a succinct form the Social Security Reform Strategy to face the challenges of an ageing population.

Portugal has already begun the **reform** of its public pension schemes, aiming at safeguarding long-term **financial sustainability** and strengthening intergenerational **equity**. It is therefore a deep and overarching structural reform that required a broad consensus with most of the Social Partners to reach an agreement on secondary legislation regarding the New Framework Law for Social Security. This finally happened on the 20th of November.

In this setting, the recent Social Security Reform comprises:

- **Greater earmarking** of State Budget revenues to finance social expenditure, namely that which does not have a specific contributory nature (Social Action and Non-Contributory Regimes);
- **Strengthening of the Reserve Fund**. A share of the employees' contributions (at least two percentage points) will be applied under capitalization in a Reserve Fund;
- It was agreed, by the Social Partners, the introduction of **optional limits** for the contribution to the pay-as-you-go social security system for salaries above 12 times the minimal wage;
- It was established that within one year the legislation of complementary occupation based regimes will be defined, as will also the need to create special incentives to implement these regimes so as to aid a solid implementation of the **2nd pillar** over the coming years;
- A **new pension formula**. Pensions will now be based on the whole contribution history;
- The **revalorisation** when calculating the reference wage will be based on the development of prices and wages.
- The **age of retirement is made more flexible**, incentives to stay on working are introduced, and disincentives to shorter periods are enforced.

Note that the most important novelty of the new system is the new pension formula by which an employee's **whole contribution history** is used. This measure, validated on the grounds of equity, seeks to avoid situations where workers would increase their contributions in the last 15 years of active life (these were the years that were until now relevant in calculating one's pension) thus increasing the value of their pensions.

On the other hand, by encouraging workers to contribute towards social security for longer periods of time, which is during their whole career, other objectives of the reform are obtained, namely the financial sustainability and a long-term equilibrium of the public social security system. This reform clearly strengthens the link between contributions and pension payments, thus introducing an automatic stabilizer in the system.

The changeover to a new pension formula is subject to a transition period that aims to safeguard acquired rights, and allows those that in the past had less responsible behaviour towards social security to timely change this behaviour so as not to be harmed with respect to the levels of social protection guaranteed to the population.

Preliminary projections suggest that the New Framework Law for Social Security will strengthen the financial sustainability of the system, mostly due to an increase in contributions and more significant savings as from around 2030.

In addition to pensions, public expenditure on health and long-term care are also expected to increase with the ageing of the population. A recent study submitted to the Economic Policy Committee of the EU suggests that, over the coming half century, public expenditure on health care will increase one percentage point of GDP. As of this writing, there is another ongoing study that should be completed in 2002 that aims to determine the impact of an ageing population on public expenditure on long-term care.

Table 6. Long-term financial sustainability of public finances
(in percent)

	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050
Total expenditure (in % of GDP)										
Pensions	10,9	11,8	12,6	13,1	13,3	13,6	13,7	13,8	13,9	13,2
Health care	5,3	5,3	5,4	5,5	5,6	5,8	5,9	6,0	6,1	6,1
(does not include long term care)										
Assumptions										
Growth of labour productivity	2,0	2,1	2,0	1,9	1,8	1,8	1,8	1,8	1,8	1,8
Participation rate of men aged 15-64	76,2	75,3	75,3	75,3	75,3	75,3	75,3	75,3	75,3	75,3
Participation rate of women aged 15-64	61,2	62,9	64,4	65,9	67,6	68,8	69,8	70,9	73,7	73,7

Source: Ministry of Finance and Ministry of Labour and Solidarity.

The following table presents a projection of public pension expenditure for the period 2003 through 2005.

Table 7. Public expenditure on pensions
(in percent of GDP)

	2000	2001 (estimate)	2002 (budget)	2003	2004	2005
Public expenditure on pensions	9.8	10.0	10.3	10.5	10.7	10.9

Source: Ministry of Finance and Ministry of Labour and Solidarity.

VII. OTHER MEASURES WITH IMPACT ON PUBLIC FINANCES

VII.1. Public Administration Reform

Preparing the Public Administration for the new challenges of competitiveness and to the information society will promote the modernization of the Portuguese economy and the transition to a knowledge based society. An active policy promoting the efficiency of public services should reduce, in due time, the resources used by the General Government (and withdrawn from the economy) and the direct and indirect costs that are imposed to the economy and citizens. Rationalization and modernization are, therefore, priorities of the process of economic reform, aiming at increasing the efficiency and competitiveness (and therefore employment and welfare) of the Portuguese society.

This effort in Public Administration modernisation is one of the basic assumptions of the present Program. It will be attained through an active policy for mobility, which will restrain public employment in a framework for the continuous adjustment of the size and type of public services to the real needs of the economy. Promoting the mobility of civil servants, their training, and qualification, while integrating them in services lacking resources, will increase the efficiency of the Administration with a minimum cost to civil servants. They will bear the temporary costs associated to the change of functions. They will gain, on the other hand, new professional skills without loss in their income. The services of origin will increase their labour productivity, while the arrival services will increase their human resources and, therefore, will be able to better serve to the needs of the society. They will both adjust their size in accordance to the ultimate goal of the Administration – provide the least cost public services.

Civil servants leaving their services of origin will be subject to a requalification period for training. The process will not be, therefore, without costs. But these costs will generate an increase of human resources quality and an increased adaptation to new technologies and demands. The objectives presented in this Program shall entail that those costs are offset by the benefits that arise from productivity increases and a better adjustment of the Administration to the society needs.

VII.2. Reform of the Health Sector

In the health sector, the reform will aim at the implementation of the following priority measures in order to guarantee health gains and efficiency. The measures of financial rationality are grouped on the following objectives:

- direct financial control;
- improvement of the quality of expenditure;
- increase of managers’ responsibilities;
- transfer or share of management risk;
- institutional reforms to rationalise the decision process.

Measures to improve the direct financial control

- since September 2001, there is a centralised monthly information control of the financial outlets of hospitals and primary care network;
- agreement with pharmaceutical industry to fix financial ceilings for expenditure on **subsidised** drugs in pharmacies to the general public. Excess expenditures will return to the National Health System, for the ceiling of growth of 6,5% for 2001, 5% for 2002 and 4% for 2003;
- sampling at regional and lower level of drugs prescriptions and of other expenditures subsidized by the NHS to evaluate mistakes, anomalies or fraud in prescriptions.

Measures to improve the quality of expenditure

- progressive promotion of the prescription of drugs based on International Common Denomination in the National Health System, starting in the services of urgency and consultation and progressive application, in family medicine, until December 2003;
- progressive utilization of generic drugs through the spread of information on its quality-price relation;
- tighter control in staff workweek.

Measures to increase the responsibility of managers

- increase of responsibilities in financial arrangement to the regional health administrations, through improved agencies in charge of the contracts with the

services and hospital resources. Regional health authorities will have higher responsibilities in checking drugs expenditure and diagnostic costs;
- hospital managers will be responsible to tighten control on hospital drugs expenditure, namely in new drugs, through two hand budgets, one for current drugs another for new ones.

Measures of transfer or share of the financial management risk
- evaluate new management experiences, such as management concessions to the private sector and options of flexible public managerial models, improving them, with new models that transfer the management risk to managers with incentives to obtain efficiency gains;
- initiate the planning and construction of three new hospitals on a *Project Finance Initiative* (PFI), with public-private partnership and two others through a public partnership with local authorities and private enterprises with public capital. These experiments aim on sharing of risks, namely construction costs and management costs during the concession period;
- continue to engage on activity-based budgets with municipalities for the construction of health care centres, reducing deadlines and construction costs, and providing for possible sharing of management.

Institutional reforms to rationalize the decision process
- hospital managers will be selected administratively, transferring the representation of professions to technical bodies, and devolving management responsibility to the board of directors;
- adopting public enterprises charter by medium size hospitals with structural capacity and positive performance, allowing them, with special funding, to improve the conditions of quality and efficiency and clear old debts;
- restructure services of hospitals urgency into units with own management and staff specialized in urgency and emergency care, in order to better use resources for overtime work and speed up the reference system in urgencies.

The development of managerial models for hospitals and primary health care would be done according with the following modalities:
- concessions to private management of public hospitals;
- public-private partnerships and public-public partnerships;
- management contracts of health centres with cooperatives of doctors, through programme contracts;
- this process will deepen experiences undertaken in recent years, namely:
  - the hospital as a public managerial entity (Hospital Santa Maria da Feira);
  - the hospital integrated in a local health unity (Matosinhos);
  - the public hospital with private management (Hospital Amadora-Sintra);

The financial consequences of this process are:
  - profound change on the management model and health management;
  - contracting of medical procedures;
  - change of the role of the State vis-à-vis supplying entities. The State will switch from the supplier of funds to that of buyer, implying a change at the Public Administration level.

VII.3. Reform of Education

In the area of education, several measures will be adopted aiming at increased rationality of resources use, better planning of the school network, namely the demographic evolution, and stronger links between employment, educational and professional training policies.

Among the measures, it is important to stress in particular the following aims:

- adjust the school network through the grouping of schools of secondary levels, aiming at, for the latter, a better supply of general, artistic, technological and professional courses (through the implementation of existing legislation);
- requalification of buildings and school equipment, undertaking the Complete Schools Programme in tandem with the network and educational supply and training programme;
- fulfilment of the 75% target for the supply of pre-primary school, launch of the technological and professional courses for the secondary levels (during the next two years);
- revision of the curriculum of secondary levels and development of the 10th grade, in a way to adequate the school supply to the labour market needs and the students interests, while avoiding early dropouts;
- use of new information and communication technologies, including training for teachers in this area;
- reorganisation of the adult teaching, increasing the efficiency of the teaching for adults through the National Agency for the Education and Training of Adults;
- development of Technological Specialization courses, at post-secondary level, through programmes between universities, enterprises, training institutions and secondary level schools;
- evaluation of universities and polythecnics, with results being published by the Conselho Nacional de Avaliação do Ensino Superior;
- increase of courses in the area of health (doctors and nurses) to meet the demands of the National Health System;
- evaluation system for the quality of education in each school – namely through the Bureau for the Evaluation of Education;
- better value and reorganisation of the school and professional orientation services;
- in the context of the autonomy regime, start autonomy contracts, for administration and management of non-university institutions;
- starting with a tender for the year 2002-2003, a new recruitment and mobility regime for teachers;
- application of an organisational model of the Ministry of Education at a central and regional level and promotion of changes that lead to rationalisation and quality – in a culture of evaluation and rigor.

A high level of public expenditure in education in Portugal opens new perspectives and special responsibilities – defining the need for a careful evaluation of means and outcomes, the effective decentralization with higher responsibilities for the local authorities, already established by law (namely in what concerns the school network) and a more autonomous management, responsible and subject to evaluation.