PORTUGAL

STABILITY AND GROWTH PROGRAMME

UPDATED FOR THE PERIOD 2003-2006

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INTRODUCTION

Economic policy in Portugal has two main goals:

- To accelerate real convergence with the EU average;
- To prepare the economy, and public accounts in particular, to the long-term demographic changes under way.

The first of these objectives is to be attained through structural reforms, aiming at increasing labour productivity and the competitiveness of the Portuguese economy. Among these reforms stand out the labour market regulation and competition enhancing policies in goods and services markets. The reform of public administration shall receive particular attention, enabling the release of productive resources to the private sector, increasing the supply of goods and services, and improving Portuguese well-being. This reform will also allow for changes to the tax system, allowing it to become an instrument of growth, both by promoting an increase in the supply of labour and capital, and by attracting foreign investment, essential to the reduction of the external account and the technological capacity deficits.

Polices that increase the potential growth of the Portuguese economy will allow to reap the benefits from EU enlargement and the growing openness of international markets. To postpone reforms would lead Portugal to a protracted period of growth divergence with other EU countries, with higher unemployment and lower social cohesion.

Fiscal policy shall take into consideration the important long-term implications of ageing, namely by generating significant surpluses, allowing for a substantial reduction of the public debt to GDP ratio. Current economic policy cannot ignore future problems. In preparing a socially sound future it is essential to assure the financial sustainability of social security regimes. Above all, it is important to warrant that current social security regimes do not become in the near future a severe hindrance to the growth of the Portuguese economy.

The current vulnerability of Portuguese public accounts, which in 2001 were in excessive deficit, results from the fiscal policy implemented since 1997. In fact, the decrease in interest payments stemming from lower interest rates, as a consequence of EMU accession, was not used to consolidate public accounts. In the period between 1997 and 2001, while interest expenditure fell 1.1 p.p. of GDP, current primary expenditure rose 2.8 p.p. of GDP; the overall deficit adjusted by the business cycle during this period was on average above 3% of GDP.

It is under these circumstances that the government presents this Stability and Growth Programme update for 2003-2006, with the objective of reaching fiscal balance in the last year of the programme, through an average reduction of the underlying deficit by 0.5 p.p. of GDP a year. Fiscal consolidation is a necessary condition for sustainable growth, given the current macroeconomic imbalances, such as the inflation differential against the euro area average, and the high external deficit. In this context, demand management policies are inadequate. On the contrary, structural policies, which impact on the supply side and have slower but permanent effects on growth and employment, are required.

Structural reform, covering strategic areas, is crucial for ensuring that Portugal benefits from globalisation and from the enlargement of the EU and to accelerate the process of convergence. The Programme for Productivity and Growth, the measures identified in chapter IV of this document and the gradual reduction of the corporate tax rate will further provide an environment favourable to economic growth based on productivity gains, investment and innovation. This strategy corrects distortions and disincentives to entrepreneurship and to work, which are key to the sustainable growth of the economy and to job creation and to the progressive reduction of macroeconomic disequilibria.

The goal of more and better productive employment should be supported by structural measures that stimulate productivity gains and increase entrepreneurship. Thus the sustained increased of employment will be supported by a regulatory framework more adjusted to the needs of the economy, by more demanding education and training systems, and by a reduction of disincentives to work and sustained increase of competition.

The reduction in the corporate tax will be compensated by measures designed to increase the tax base and by further reform of the State. Improving the provision of public goods by the State is key to reinforce the dynamics of the private sector and is crucial for sustainable job creation process.

Under this programme, real convergence should accelerate as the Portuguese economy is expected to grow on average 0.4 p.p. above euro area average during 2003-2006, and the public debt to GDP ratio to decline by 6 p.p.

Reliable and regularly disclosed public accounts are a fundamental instrument for sound resource allocation. Recent revisions to these accounts have shown the deficiencies in the Portuguese statistical system. The correction of already identified problems, in the shortest possible time frame, is one of the objectives underlying the Stability and Growth Programme.

The adjustment pace implicit in the present Programme is a necessary condition for the attainment of the long-term objectives of the Portuguese economy. Portuguese society cannot do without the re-establishment of fundamental macroeconomic balances – the external and public accounts balances, therefore the relationship between investment and saving.

I. INSTITUTIONAL FRAMEWORK OF FISCAL POLICY

Economic policy is aimed at achieve convergence to the best EU standards. Macroeconomic stability is the most favourable framework to carry out this convergence process in a durable way. Fiscal discipline is essential to ensure the required stability.

The Treaty establishing the European Community, the Stability and Growth Pact and the Excessive Deficit Procedure provide a coherent set of rules and procedures to safeguard fiscal discipline and reinforce the sustainability of public accounts. The Community institutional framework contributes to reinforce the credibility of fiscal policies in the euro area. The follow up of the fiscal and financial conditions of member states is a mechanism to assure the effective implementation of stability-oriented policies. The Portuguese government reaffirms its commitment in complying with these rules of conduct.

According to the Excessive Deficit Procedure, the Ecofin Council of November 5, 2002 decided, based on article 104(6) of the EC Treaty, that a situation of excessive deficit exists in Portugal, as the General Government overall deficit in 2001 surpassed the reference value stated in the Protocol annexed to the above mentioned Treaty.

The Council also addressed recommendations to the national authorities to end the situation of excessive deficit, in accordance to article 104(7) of the Treaty and article 3(4) of (EC) Regulation 1467/97. Portugal must, until the end of 2002, take the necessary measures to avoid the continuation of the excessive deficit situation; implement measures to ensure that the 2003 deficit is clearly below 3% of GDP and that the public debt to GDP ratio remains below 60%; present an update to the Stability Program for the 2003-2006 period which should include the path of fiscal consolidation towards the objective of close to balance or in surplus, and an adjustment of the cyclically adjusted budget balance of more than 0.5 p.p. in each year.

To ensure medium-run financial and fiscal stability, the Portuguese Parliament approved the Budgetary Stability Law, a fundamental instrument to reach lasting and sustainable public finances, compatible with the objectives of the Treaty and the Stability and Growth Pact. The Budgetary Stability Law represents the consensus in Portuguese society on the need to have sound and sustainable public finances, that is, balanced or in surplus.

BOX I. BUDGETARY STABILITY LAW

The Budgetary Stability Law is an organic law, having therefore a reinforced legal value, which establishes the budgetary principles and procedures Public Administration bodies have to comply with.

According to this Law, the above mentioned bodies are subject, when approving and implementing their budgets, to three fundamental principles:

- **Budget stability –** defined as “a situation of balanced budget or in surplus, calculated according to the definition of the European System of National Accounts”;
- **Reciprocal solidarity –** meaning that all subsectors of public administration shall “contribute proportionally to materialise the principle of budget stability”. Under this principle, the State budget may limit transfers to any subsector in General Government to amounts “lower than the ones that would result from specific financial laws, applicable to each subsector” and set limits to its indebtedness. If a public body exceeds the latter, State transfers may be reduced “in the proportion of the non compliance”. It is, for example, according to this principle, that the State Budget for 2003 prohibits the increase in net debt by local authorities, except for the responsibilities arising from the preparation of Euro 2004;
- **Budget transparency** – which implies the existence of a duty of information disclosure among public entities. This duty of information is, reinforced by the possibility of suspension of transfers from the State Budget to the bodies that do not fulfil disclosure duties.

The Budgetary Stability Law also stipulates that autonomous services and funds which in the economic years of 2000 and 2001 “have not had at least two thirds of own revenues in relation with total expenditures, will become subject to the regime of administrative autonomy alone”, except for the National Health service, supervision and regulation bodies or others whose status of administrative and financial autonomy stem from a constitutional imperative. Such a change will allow greater management control over a significant number of services, a fact that in itself, will allow for important savings in administration expenditure.

The implementation of the Public Official Accounting Plan, already in place in some sectors and which will proceed until its full application to the whole Public Administration, will provide coherent data on the budget on a cash basis, as well as on commitments and assets and liabilities.

In 2002 the new Revenue Management System came into operation, which allows more timely and reliable information on the revenues of the State subsector. In the health sector a new system of processing and collection financial information directly from the units that are part of the National Health Service will come into force in 2003.

Meanwhile, in 2003, the publication of General Government Quarterly Accounts by INE (Official Statistics Institute), with the inherent collection of additional statistical information, will improve the data bases on this sector. The planned production of quarterly accounts of General Government as set at EU level (financial and non financial accounts), to which Portugal attaches major priority, will provide a coherent set of data on the sector. General Government accounts compiled under this context will be more reliable, as annual information will from now on be preceded by a systematic work of collection and analysis of quarterly information.

II. THE PORTUGUESE ECONOMY: RECENT DEVELOPMENTS AND FORECASTS

II.1. Recent Development

The adjustment process of the Portuguese economy and the slowdown of the international economy have led, in the last years, to a significant slow down of the economic activity, following a period of strong growth between 1996 and 1999 that reached an average annual rate of 4% (1.4 p.p. above the EU average). This growth was mainly due to the increase in domestic demand, supported by a strong increase in households and corporate indebtedness driven by the drop of interest rates, as Portugal became a member of the euro area.

The most recent period has witnessed a significant slowdown of economic activity, as the international economic, financial and geopolitical outlook had been unfavourable and the adjustment of the domestic economy has proceeded, following to the sharp increase in private indebtedness.

The estimates presented in table 1 show the change occurred in the growth pattern, which started in 2000 and became stronger in 2002. GDP growth in 2002 is estimated between 0.5% and 1% with no contribution from domestic demand.

In the labour market, employment growth softened, while the unemployment rate has increased and the wage growth has slowed down. Nevertheless, compensation of employees per head grew above productivity. Therefore, unit labour costs growth has decelerated, but remains high.

In 2002, the inflation rate was around 3.6%, below the level of 2001 (4.4%). This reduction was mainly due to the deceleration of unprocessed food prices, the reduction of imports prices and moderate wages growth. On the other hand, several factors had a negative impact on prices, namely the conversion of escudos into euros and the increase of the standard VAT rate from 17% to 19% last June.

Despite having decreased, the inflation rate remained high, as significant wages increases have occurred in the recent past and competition has remained imperfect in some markets. Wage moderation and negative output gap throughout the whole Programme period should lead to a reduction of the inflation rate towards EU average levels.

The change occurred in the growth pattern contributed to reduce the size of the main macroeconomic imbalances, namely the reduction of net external borrowing requirements in 2002, since the deficit of the current and capital account is expected to be between 5.25% and 6.75% of GDP (8% of GDP in 2001).

II.2. Medium term Macroeconomic Scenario (2003 - 2006)

The short-term growth prospects changed significantly in the recent past. The persistence of instability in financial markets, worsened by geopolitical risks, has increased uncertainty about the pace of the recovery in major advanced economies and has led international organisations to revise down their forecasts.

The macroeconomic scenario for the Portuguese economy concerning the period from 2003 to 2006 is based on the last forecasts (autumn 2002) for the international economic growth provided by international organisations. Those forecasts point towards a recovery of the world economy beginning in the second half of 2003. For the EU, growth is projected at an average annual rate of 2.4% in the 2003-2006 period, which represents a downward revision of 0.5 p.p. from the previous Stability Programme Update (December 2001)

The rather high level of uncertainty associated to the projections made by international organisations has led to frequent and successive downward revisions of the forecasts for most countries. Current growth forecasts for the Portuguese economy reflect the information on both the domestic and the international outlook, with growth in 2003 foreseen at the lower end of the bracket presented in the scenario underlying the 2003 Budget. From 2004 onwards, growth is expected to resume to rates close to potential. These forecasts include the temporary and limited effects of budgetary adjustments. Also the implementation of structural reforms should accelerate the pace of economic growth, promote sustainability and reinforce credibility and confidence.

Medium term projections are based on the following assumptions:

- exports projected to grow at the same pace as the expected growth of main exports markets;
- real wages to grow in line with the average growth rate of labour productivity;
- productivity improvements, supported by economic reforms;
- investment acceleration, due to lower corporate tax rate, the increase of exports and the measures contemplated in the Programme for Productivity and Growth.

The acceleration of exports, the investment upturn and a more stable financial situation should lead to the recovery of private consumption, expected to grow 3% in 2006.

The declining cost of capital and the correction of the distortions in the economy, brought by the reduction in the corporate tax rate and the new approach adopted in the Operational Programme for the Economy, will provide a strong boost to domestic and foreign direct investment, thereby contributing to the modernisation and diffusion of technologies, which are key to the improvement of productivity.

Productivity growth and the acceleration of economic activity should contribute to an improved performance of the labour market by the end of the projection period.

The negative output gap and wage moderation should remain important factors in the evolution of the inflation rate, forecasted at around 2% in 2004-2006 period.

Table 1. Central Macroeconomic Scenario

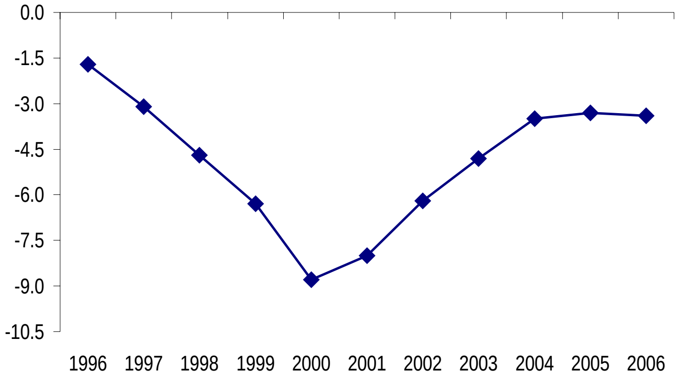
	2002	2003	2004	2005	2006
GDP, real growth rate (%) (7+8+9)	0.7	1.3	2.7	3.1	3.5
GDP, current prices (10^9 euros)	129.5	135.0	142.7	151.0	160.3
GDP deflator (change rate,%)	4.5	3.0	2.9	2.7	2.6
Private employment growth (change rate, %)	0.5	0.4	1.0	1.8	2.1
Public employment growth (change rate, %)	1.0	-1.9	-1.7	-1.9	-1.0
HICP (change rate, %)	3.5	2.5	2.2	2.2	2.0
Real growth rate (%)					
1. Private Consumption	0.5	0.2	1.4	2.3	3.0
2. Government Consumption	1.4	-0.5	-0.3	-0.5	-0.7
3. Gross Fixed Capital Formation	-2.1	0.1	6.6	6.4	7.4
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	3.2	4.7	7.5	8.7	9.7
6. Imports of goods and services	0.8	0.5	5.9	7.2	9.0
Contribution to GDP growth					
7. Domestic Demand (Excluding 4.)	0.1	0.0	2.5	3.0	3.6
8. Changes in inventories and net acquisition of valuables (=4)	0.0	0.0	0.0	0.0	0.0
9. Net exports	0.7	1.2	0.2	0.1	-0.2
Basic assumptions					
Short-term interest rate (annual average)	3.3	2.8	3.2	3.5	3.5
Long-term interest rate (annual average)	5.1	4.9	5.2	5.4	5.6
Exchange rate 1 Euro = ...USD (annual average)	0.940	0.980	0.970	0.970	0.970
World GDP (real growth rate)	2.6	3.6	4.0	3.8	3.7
EU-15 GDP (real growth rate)	1.0	2.0	2.6	2.3	2.3
Growth rate of relevant foreign markets	-0.1	5.6	6.8	7.0	7.0
World import volumes, excluding EU (growh rate, %)	3.1	6.6	7.3	7.3	7.3
Oil price (US$/bbl)	25.5	24.1	22.5	22.3	22.3

Sources: European Commission, OECD and Ministry of Finance.

According to these forecasts, employment growth should increase from 2004 onwards to 1.6% in 2006 (0.6% in 2004). Private sector employment should grow 1% in 2004 and over 2% in 2006. The lagged effect of activity on the labour market also shows on the evolution of the unemployment rate, expected to stand slightly above 5.5% in 2004, and to fall to 4.8% in 2006, close to the level recorded in 2002. On what concerns productivity gains, the modernization of the regulatory framework for the labour market and the implementation of economic reform measures, described in Box III, should contribute to a sustained increase of productivity gains, significantly improving competitiveness.

The necessary correction of the external imbalance should proceed during the forecasting period. According to available data, the current plus capital account deficit should be 6.2% of GDP in 2002 (8.8% in 2000 and 8% in 2001), and is forecasted to narrow to 4.8% in 2003 and to about 3.5% in 2006 (see Chart 1), a more appropriate level for an economy with high investment efforts. The sharp reduction of the external deficit and the acceleration of FDI in the country, will correspond to less external financing needs.

Chart 1. Current Aggregate Balance and Capital Account
(% of GDP)



Sources: Banco de Portugal, Ministério das Finanças.

III. Recent developments in Public Finances

In 2001, Portugal recorded an excessive deficit, with the overall balance of General Government reaching 4.1% of GDP. The cyclically adjusted deficit had already reached 4% in 2000, increasing to 4.8% in 2001. This development was mainly due to the increase in primary current expenditure and to a decrease in tax revenues as percentage of GDP.

To overcome this situation the Government adopted a set of measures (see box II) envisaging the reduction of public expenditure growth and the increase of tax revenues.

In what concerns expenditure, the following measures should be highlighted: the introduction of limits to expenditure growth for autonomous services and to the level of indebtedness of Local and Regional Administration, the elimination of interest subsidies on mortgages, the freeze of civil servants admission, measures that allow for civil servants mobility and the winding-up and merger of public bodies. Additionally, measures for the immediate reduction of expenditure were taken, particularly in the Education, Health and Social Security sectors.

However, GDP growth is forecast to be 0.5% to 1% in 2002, 0.5 p.p. below the forecast underlying the amendment to the State Budget Law, made in May 2002. This steeper than projected slowdown brought the need to introduce additional restrictions on capital expenditure.

The goal for the Public Administrations overall deficit in 2002 was established at 2.8% of GDP, that is, a reduction of 1.3 p.p. of GDP from to the previous year. This outcome shall have been reached through 9.5% revenue increase and a slowdown of expenditure to 6.2% (8.6% in 2001). The primary balance should improve, as a percentage of GDP (+1.3 p.p.), thus becoming positive.

Current revenue is estimated to have increased 0.9 p.p. of GDP, as a result of the improvement of tax collection on goods and services (0.5 p.p. of GDP), as well as in sales revenues and other current revenues. Following the VAT standard rate raise, the tax burden will increase from 35.3% to 35.7% of GDP.

Considering current expenditure, both the compensation of employees and social transfer are expected to have slowed down, to 6.4% and 7.2%, respectively, versus 7.8% and 7.5% in the previous year.

The change in capital revenue comes mainly from the increase of Community Funds, from 1.4 billion euros in 2001 to 2.6 billion euros in 2002.

In what concerns capital expenditure, measures were taken to restrain expenditure, through a greater selectivity of investment projects, with priority given to those with community financing. Still as regards capital operations, a policy to rationalize the use of existing equipments was adopted and underused real estates were sold.

Table 2. General Government Accounts (2001-2003)

Unit: million euros

	2001	2002	2003	Change rate (%)		% of GDP		
				2002	2003	2001	2002	2003
Current revenue	49 420	53 233	56 550	7.7	6.2	40.2	41.1	41.9
Capital revenue	2 309	3 402	3 419	47.3	0.5	1.9	2.6	2.5
Total revenue	51 729	56 635	59 968	9.5	5.9	42.1	43.7	44.4
Current expenditure	49 409	53 191	55 946	7.7	5.2	40.2	41.1	41.4
Capital expenditure	7 488	7 128	7 327	-4.8	2.8	6.1	5.5	5.4
Total expenditure	56 897	60 319	63 273	6.0	4.9	46.3	46.6	46.9
Primary current expenditure	45 550	49 261	51.544	8.1	4.6	37.0	38.0	38.2
Primary balance	-1 309	245	1 098			-1.1	0.2	0.8
Net borrowing (-) / net lending (+)	-5 168	-3 684	-3 305			-4.1	-2.8	-2.4

Source: Ministério das Finanças

BOX II. MEASURES ADOPTED WITH IMPACT ON THE CONSOLIDATION OF PUBLIC FINANCES

- Overcome, in 2002, the excessive deficit situation: approval of the Budgetary Stability Law which creates the necessary conditions to better control public expenditure and allows for the burden sharing of budget consolidation efforts among Public Administration sub sectors;
- Extinction of the Instituto de Partipações do Estado;
- Revision of the legal framework for capital gains in order to only tax speculative capital gains;
- Approval of legislation establishing that tax payers with tax debts or debts to Social Security shall not benefit from tax privileges or benefits;
- VAT standard rate raised, from 17% to 19%;
- New measures to fight tax evasion, namely through the cooperation between tax collecting bodies and the Polícia Judiciária (criminal investigation police). A rigorous regime to control all tax payers presenting negative results and deviate from the activity's average indicators has been introduced;
- Approval of legislation allowing the cross checking of data relative to vehicle and real estate with income statements.

Reduce the excessive weight of Public Administration:

- Approval of the Law for Mobility in Public Administration, which establishes the regime to reallocate workers belonging to services and bodies winded-up, merged or restructured, envisaging the rationalisation of human resources management. The

establishment of an "employment pool" comprising redundant workers is a management instrument which will allow for improve flexibility in the allocation of human resources and will reduce, without damage to services, the hiring of new civil servants;
- Approval of measures to control Public Administration hiring, as well as the re-evaluation of job contracts, re-dimensioning of services according to efficiency and quality principles;
- Extinction of 28, merger of 8 and restructuring of 5 services, services and public institutes;
- Adoption, in the 2003 Budget, of measures that reduce incentives to early retirement.

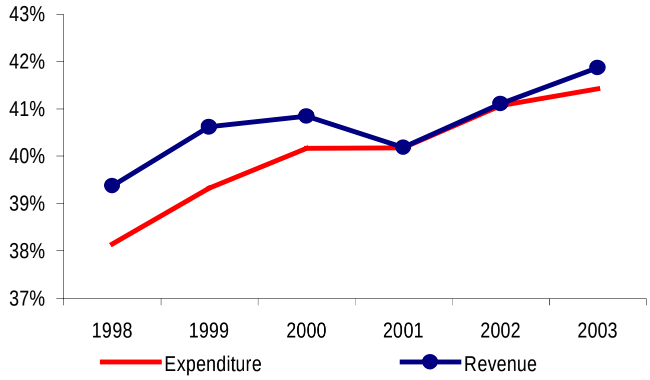
Implement structural reforms:

- Modernization of labour laws through the draft law for the new Labour Code, expected to be approved in early 2003. This reform includes:
    - relaunch of collective bargaining;
    - increase flexibility in labour relations;
    - fight absenteeism;
    - create incentives to assiduity.
- Eligibility criteria to the minimum income (Social Insertion Income) have been changed, introducing more rigour in grating the subsidies and reducing incentives to dependency;
- Approval of the new Basic Law on Social Security;
- Approval of the new Hospital Management Law, stating principles of financing according to valuation of services actually rendered, job evaluation based on merit, the promotion of an incentives system, the accountability of hospital managers including the termination of managerial for failure in complying with targets and resources management. New management models and accountability and incentives systems were adopted, namely the introduction of entrepreneurial management in 34 hospitals, through their transformation in public capital societies, in order to obtain efficiency gains, more autonomy and flexibility together with increased accountability in the accomplishment of goals.
- Approval of a public/private partnership regime in the health sector, in order to allow for the construction and management of 10 new hospitals;
- Co-payments by the State to be based on a reference price list for medical acts and procedures,
- For therapeutic groups for which generic drugs are available, co-payments shall be based on a reference price list;
- Generalization of a standard prescription form, the first step for the creation of an electronic prescription and for the simplification of the control of co-payments by the State.

Budgetary policy, for 2003, aims to continue with the consolidation of public finances and to correct macroeconomic disequilibria. The 2003 Budget is built on selectivity and the criteria of rigorous use of available resources. It comprises reforms on functioning of public administration, on the provision of basic services and on the way sovereignty functions are undertaken.

The goal for the General Government deficit is 2.4% of GDP, which corresponds to a consolidation effort of the cyclically adjusted deficit of 1,0 p.p. of GDP. For 2003, activity will most probably be close to the lower end of the bracket presented in the Report on the 2003 State Budget Law. Such a development affects the revenue forecast, thereby requiring additional measures to contain the deficit within the target of 2.4% of GDP.

Chart 2. Current Expenditure and Revenues General Government
(% of GDP)



Sources: INE, Ministério das Finanças.

The primary surplus is expected to continue to grow, reaching 0.8% of GDP (+0.6 p.p. than in 2002). This will result from an increase in current revenues, of 0.8 p.p. of GDP, a 0.1 p.p. reduction of the primary current expenditure, and a stabilisation of the capital balance.

The growth of current revenue relatively to 2002 (+6.2%) shall result from an increase in tax revenue and social contributions (+5.4%) and in non-tax revenue (12.6%). The growth of non-tax revenue will result from an increase in public services fees in several sectors, particularly in health and education.

Primary current expenditure growth will be limited to 4.6%. Due to the increase in interest payments, current expenditure should record smaller slowdown (5.2% growth against 7.7% in 2002). This slowdown requires a severe restraint of intermediate consumption and in the wage bill, which should growth at moderate paces (0.4% and 2% respectively). Social transfers should increase 7.9% and subsidies should increase 12%. Subsidies include increases in transfers to public companies, to better reflect the real cost of the public service rendered.

In 2003, total expenditure and total revenue shall grow 4.9% and 5.9%, respectively, corresponding to increases of 0.3 and 0.7 p.p. of GDP. In order to make the restrain of expenditure more effective, the 2003 State Budget Law establishes that any budget changes, affecting expenditures included in the budgets of Autonomous Funds and Services, need to be authorized both by Minister of the sector and by the Minister of Finances.

The basic assumption underlying the 2003 Budget, which hinges upon the Public Administration reform, is a decrease in the wage bill of 0.4 p.p. of GDP, as result of both the reduction of public employment (by almost 2%) and very limited wage increases.

The remaining policy measures, underlying the implementation of the 2003 Budget, are presented in box II and section IV.

IV. MAIN ECONOMIC POLICY MEASURES (2003-2006)

The economic policy strategy is underpinned by budgetary stability, public sector reforms and economic reforms. Structural reform in the public sector is crucial for compliance with the targets set in this Programme. The focus on Public Administration missions and on the provision of services to citizens is of special relevance in this context, in order to redefine ways in which to provide basic services and to accomplish sovereignty functions.

The set of economic reforms[1] is developed in the Programme for Productivity and Growth (PPG), which together with the strengthening of the National System for Science and Technology, will allow for a sustainable increase in the productivity and competitiveness of the Portuguese economy. The PPG encompasses time-scheduled measures that reinforce competition, improve regulation, foster productive investment and exports, strengthen the enterprise sector, support innovation and entrepreneurship and reduce red tape. Among many other measures, special relevance should be given to the establishment of the Competition Authority, to the entering into operation of the Portuguese Agency for Investment, to the launching of programmes that support applied research and technology based enterprises, as well as to the thorough revamp of the Operational Programme for the Economy and to the strong boost given to venture capital. Emphasis should also be given to the new Labour Code proposal presented to Parliament, which will allow Portuguese labour legislation to become closer to that of other European countries. Structural reforms in the areas of Social Security, Education and Health add to the accomplishment of a thorough change of the environment in which firms operate in Portugal, creating a much more attractive business environment, as well as the conditions required for the beginning of a sustainable process of recovery of the productivity gap vis-à-vis the European Union.

The reduction in the corporate tax rate by about 10 p.p. in the period 2004-2006, together with the broadening of the tax basis and budgetary stability, will strengthen competitiveness of firms and of the economy, in general.

BOX III. ECONOMIC REFORMS MEASURES

- **Promote sound competition**
  - Establishment of the Competition Authority, a regulator with an independent status and overarching control span;
  - Approval of the new Competition Project Law, establishing a modern and more effective regulatory framework, consistent with the recent trends at the european level.

- **Promote productive investment**
  - Establishment of the Portuguese Agency for Investment, a one-stop shop for large scale investment projects and foreign investors;
  - Adoption of a new approach and of new instruments for the Operational Programme for the Economy, included in the III Community Support

[1] See Report on economic reform 2002, available in www.dgep.pt and more detailed information in www.portugal.gov.pt.

Framework;
- Introduction of a tax reserve for investment and a cut of 10 p.p. in the corporate tax rate;
- Establishment of an Investment Code;
- Programmes for the financing and improvement of Tourism;
- New Labour Code.

• **Foster innovation and applied research and development**
  - Programme IDEIA, a joint programme of the Ministries of Economy and of Science and Higher Education, aiming at granting support to projects for the creation of new products and technologies and to the registration of patents;
  - Programme NEST, jointly promoted by the Ministries of Economy and of Science and Higher Education, to support the creation of new technology based enterprises;
  - Industrial Property Code, integrating the most recent community directives;
  - Reinforcement of the role and of the instruments assigned to Innovation Agency;
  - Programme QUADROS – partial financing of high-shrilled staff hiring by SME.

• **Facilitate the creation, licensing, installation and development of enterprises**
  - New industrial licensing code, streamlining the process, establishing a *single go between* and shortening delays;
  - New regime for Areas of Enterprise Localization
  - Establishment of 4 new Business Formality Centres;
  - New tax regime for mergers, concentrations and restructuring of enterprises;
  - New bankruptcy and enterprise consolidation law
  - Privatisation of Notary;
  - Restructuring of Public Administration services in charge of the direct provision of services to citizens, reducing red tape and increasing the effectiveness in complying with business needs.

• **Fostering Foreign Trade and Tourism**
  - Adoption of a new model of international promotion based on the concept of economic diplomacy;
  - Implementation of the System of Information for Enterprises;
  - Project "Portuguese's Brands";
  - Outsourcing to private firms the realization of promotion actions.

• **Improve SME Financing**
  - Complement private financing in the framework of the OPE, with financing instruments based on the principles of merit reward and risk sharing;
  - New legal and tax regime for Corporations and Risk Capital Funds, aligned with the best European practices;
  - Establishment of a Risk Capital Syndication Fund;
  - Establishment of a Guarantee Fund for Securitized Credit;
  - Establishment of new Mutual Guarantee Societies included one for Tourism.

• **Reduce the weight of the State in the Economy**
  - Continue the privatisation programme (in the paper and paper pulp sector and in the water, energy, transports, and tourism sectors);
  - Extinguish the public holding IPE.

IV.1. Public Administration

In the early nineties, the public sector wage bill in Portugal amounted to 11.8% of GDP, the same as in the European Union, on average. In 2001, the proportion shrunk to 10.3% in the European Union, while it rose to 15.3% in Portugal. In that year, Portugal ranked third in the EU, relatively to wage expenditures, the ranking not having been certainly the same if quantity and quality of goods and services were at stake. In this context, one of the main goals of the current Programme is the reduction, as a share of GDP, of primary current expenditure, especially in public consumption, while at the same time improving the quality of goods and services provided. Among several others measures aimed at the fulfilment of this goal, reference should be made to the following:

In the framework of **budget management and the public sector**:

- Set up multiannual budgeting, based on targets;
- Introduce time limits on subsidies, benefits and other forms of support, adopt periodic evaluation and revision;
- Improve real estate management and sell unnecessary assets;
- Redraw the State-owned business sector.

In the framework of the rationalization and **restructuring of Public Administration**:

- Rationalise and simplify existing structures, through the redefinition of the functions of the State;
- Revise the rules that apply to the creation of autonomous services, as well as the operation and auditing;
- Contract the management of public services, on the basis of goal targeting and resources utilisation efficiency, associated with an increased flexibility in the management of both human and financial resources.

In the framework of **human resources management**:

- Contain new hiring in Public Administration;
- Establish an employment pool, providing information *on-line* on the supply and demand of employment in Public Administration, promoting mobility and restraint in new hiring;
- Set up a system of information on permanent staff as well as on fixed-term contracts in Public Administration;
- Review of the status of top officials, reinforcing accountability and skills;
- Review the performance evaluation regime in order to establish differentiation mechanisms which will restrain promotions and automatic progressions;
- Promote the development of IT.

IV.2. Education

Portuguese Government faces the challenge of developing modern and high quality educational standards, thereby reducing the gap in outcomes vis-à-vis other European countries. This goal will be achieved through improvements in the organization and management of the educational system, namely through the adoption of the following measures, some of them allowing for savings:

- Reorganize the network of primary schools (the first cycle of compulsory education), through the progressive closing down of schools with less than 10 students;
- Reduce the number of teachers without teaching burden, as well as the number of teachers in non-teaching functions;
- Implement as from 2004/2005, the reform of the secondary education curriculum reducing the number of subjects taught and class time length;
- Reform adult recurrent education;
- Rationalize real estate allocated to the Ministry of Education, reducing the number of rented buildings and releasing others, in Lisbon and elsewhere; redundant premises will be integrated in the State Heritage with the possibility of being alienated later;
- Evaluation of the quality of schools and of teachers, making financing conditional on actual outcomes.
- Revision of the system of job openings and of the status of non-tertiary teachers, introducing more demanding and rigorous procedures for hiring and of teachers tenure;

In spite of increasing expenditure the following measures will be taken, given its positive effects on the quality of education:

- Enlargement and improvement of the social network of kindergarten, in order to achieve an average rate of coverage of about 90% for the age group comprised between 3 and 5 years old;
- Develop technological education and vocational education in order to give adequate skills to youngsters that enter the labour market after finishing basic compulsory education.

In **Higher -Level Education**, the following measures should be stressed:

- Implement a new financing model in public tertiary -level education, abiding by autonomy principles, including contract programs and development contracts in order to improve the standards in education and to develop a closer relationship with the private sector;
- Increase social support schemes, granting financing according to students economic background;
- Restructure the network of public tertiary education, adjusting for the trends in potential candidates; courses with low standards or for which demand is shrinking could be discontinued;
- Change the financing of higher-level education and of research in order to increase own revenues;
- Revision of the status of educational staff in higher education and of the Law on autonomy of Public higher education institutions.

IV.3. Health

In the health sector decisions have been taken to reform the National Health Service in order that citizens perceive the value added in health services provided. . Among the measures already taken or to be adopted soon, the following can be highlighted:

In the area of human resources organization and financing:
- Introduce entrepreneurial management, increasing participation of private and social sectors;
- Transform hospitals into corporate entities, with greater entrepreneurial management autonomy, accountability and management efficiency;
- Finance hospital activities according to a price list for medical procedures and services actually rendered;
- Promote public/private partnerships in health care;
- Introduce economic regulation and monitoring of the accomplishment of performance and quality criteria;
- Introduce financing in health centres on a per capita basis;
- Increase fees and other current revenue.

In the area of drugs policy:
- Base co-payments of drugs on reference prices;
- Promote the use of generics;
- Adopt prescriptions according to the International Common Designation;
- Introduce a new model for prescriptions, including the renewable prescription;
- Direct payment to pharmacies of co-payments relating to drugs.

IV.4. Social Security

The Government recognizes the need to reform Social Security, ensuring its sustainability and reinforcing social justice and equality. In this context, several measures have already been taken, including the approval of the new Basic Law on Social Security, while other measures are underway:

Management
- Restructure the Social Security Ministry allowing for a decrease in real expenditure in 2003 and limited real growth throughout the consolidation path;
- Grant more autonomy to auditing and monitoring activities, which will allow for an improved intervention capacity.

Social assistance
- Social assistance policy will be underpinned by new management tools and procedures designed to improve efficiency in the allocation of resources and thereby to increase social assistance to citizens in greatest need.

Sickness subsidy
- Introduce differentiation between long-term and short-term sickness leaves, discriminating negatively the latter and reinforce control;
- Tax sickness subsidies in order to eliminate the incentive to claim the subsidy. Reinforce control, cross-checking with the data basis of the Ministry of Health.

Social Insertion Income
- Change eligibility criteria and tighten access conditions, in order to increase rigour and control of subsidies granted.

V. MEDIUM TERM FINANCIAL PROGRAMMING OBJECTIVES

In accordance with the State Budget Framework Law, the multi-annual financing programme is submitted to Parliament for discussion, each year in May. This procedure allows to set priorities for public spending consistent with the current Stability and Growth Programme update, before the preparation of the State Budget.

The priority of the Government is gradual budgetary consolidation, together with measures to foster competitiveness, both underpinned by structural reforms.

The effort to contain public expenditure that has been carried out in 2002 is expected to allow for a decline in the overall deficit from 4.1% of GDP to 2.8%, in spite of the rather difficult current situation of weak growth. The Budget approved by the Parliament for 2003 foresees the maintenance of this effort in order to reach an overall deficit of 2.4% of GDP, corresponding to a reduction of 1 percentage point (p.p.) of the cyclically adjusted deficit.

The attainment of this target implies a reduction of public consumption, as a percentage of GDP, which will require a significant effort to contain public spending, bearing in mind that a pronounced increase in social expenditure is foreseen, associated namely with the updating of low pensions.

Table 3. General Government Accounts (2002-2006)

% of GDP	2002	2003	2004	2005	2006
Overall Balance of Public Administration by subsectors					
General Government	-2.8	-2.4	-1.9	-1.1	-0.5
Central Administration	-3.4	-3.0	-2.5	-1.9	-1.3
Local Administration	-0.1	0.0	0.0	0.0	0.0
Social Security Funds	0.7	0.5	0.6	0.7	0.9
General Government (S13)					
Total revenue	43.7	44.4	43.9	43.6	43.0
Total expenditure	46.6	46.9	45.8	44.7	43.5
Overall balance	-2.8	-2.4	-1.9	-1.1	-0.5
Interests	3.0	3.3	3.1	3.0	2.9
Primary Balance	0.2	0.8	1.2	1.9	2.5
Revenue Components					
Taxes	24.5	24.6	24.4	24.4	24.1
Social contributions	12.0	12.2	12.2	12.1	12.1
Other	7.3	7.5	7.3	7.0	6.8
Total revenue	43.7	44.4	43.9	43.6	43.0
Expenditure Components					
Public consumption	20.7	19.7	19.3	18.9	18.4
Social transfers, ex.social transfers in goods	14.4	14.9	14.9	14.7	14.4
Interests	3.0	3.3	3.1	3.0	2.9
Subsidies	1.8	2.0	1.8	1.7	1.6
Fixed Capital Gross Formation	3.7	3.8	3.6	3.5	3.4
Other	3.0	3.2	3.1	2.9	2.7
Total expenditure	46.6	46.9	45.8	44.7	43.5

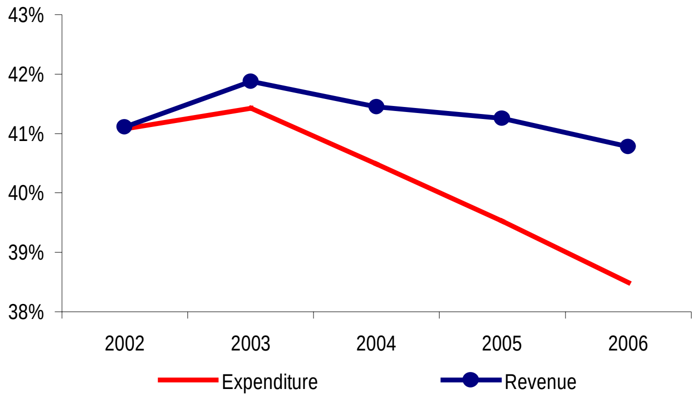
Source: Ministry of Finance.

The forecasts for 2004 to 2006 take into account the impact of the reforms in public administration, health and education which will be gradually phased-in, leading to a dynamic of change that will allow a sustainable reduction of current expenditure.

The forecasts are based upon an annual average rate of growth of 3%, 0.6 p.p. above the average of EU12, thereby reflecting a real convergence with the EU.

Forecasts for tax revenue take into account the impact of the foreseen cut in the corporate tax rate, which will be reduced by 10 p.p. up to the end the forecasting period, to be set at 20% by 2006. The impact on fiscal revenue should be gradual throughout the period, reaching 0.2 p.p. of GDP in 2004, 0.5 in 2005, and 0.7 in 2006.

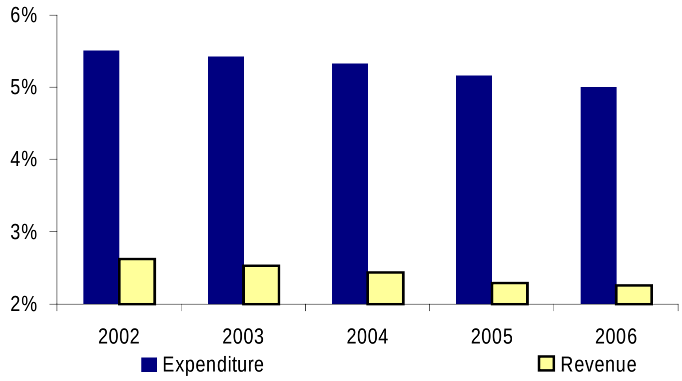
Chart 3. General Government Current Revenue and Expenditure
(% of GDP)



Source: Ministério das Finanças.

Among European countries, Portugal records one of the highest corporate tax, notwithstanding the cuts that took place in the last few years. Currently, it stands at 30%, which compares with 10% in Ireland and 18% in Hungary. According to OECD, corporate tax revenue as a percentage of GDP reached 4% in Portugal in1999, against to 3.5% in the EU and 2.8% in Spain. Together with policies conducive to the reduction of macroeconomic imbalances, it is necessary to stimulate investment to allow the country to attain a rate of growth ensuring convergence towards the European Union.

Chart 4. General Government Capital Revenue and Expenditure
(% of GDP)

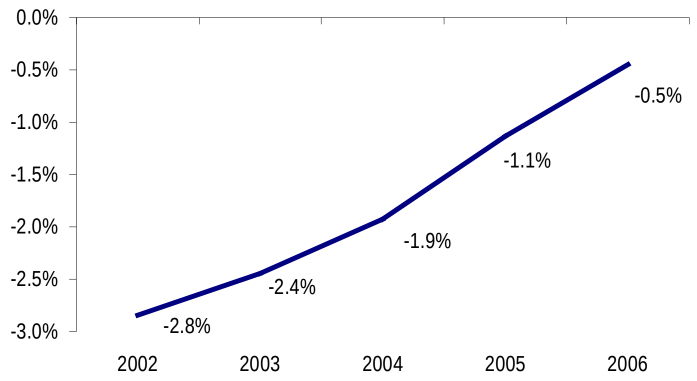


Source: Ministério das Finanças.

In general, tax revenue projections are rather conservative, meaning that any possible gains arising from improvements in the efficiency of the tax administration were not taken into account. Barring corporate tax reform, as a general rule changes in tax stance will be designed as to be neutral vis-à-vis tax revenue.

Accordingly, during the time frame of the Programme, tax revenue will decline progressively, from 36.1% of GDP in 2003 to 35.5 in 2006. Current revenue reduction should be somewhat more pronounced (1.1 p.p. of GDP between 2003 and 2006), as a result of a reduction in other current revenues.

Chart 5. General Government Borrowing Requirements
(% of GDP)



Source: Ministério das Finanças.

BOX IV. FINANCIAL PROGRAMMING ASSUMPTIONS

a) Employment reduction at an annual average rate of about 1.5% throughout the period, underpinned by a reform of Public Administration. The reduction shall be achieved through a stringent restraint of new hiring in Public Administration;
b) Severe wage restraint;
c) Nominal growth in expenditures of goods and services below inflation;
d) Increase of own revenue and introduction of efficiency gains in the health sector consistent with an increase in public transfers to the sector of 4% a year, on average;
e) Efficiency gains in tertiary education and own resources collection (tuition fees) compatible with a zero increase in nominal transfers to this sector;
f) Annual nominal increase of 1.6%, in resources allocated to basic and secondary education;
g) Overall increase at an annual rate of 2.5% in users charges for public services, in addition to those already foreseen for 2003;
h) Moderate growth in State transfers to the pension system for civil servants.

Public finance consolidation relies mainly on the current expenditure side, which will experience a reduction, as a percentage of GDP from 41.4% in 2003 to 38.5% in the last year of the Programme. The largest reduction in current expenditure is foreseen to arise from the wage bill, with an expected decline of 1.1 p.p. of GDP over the same period. Subsidies and the remaining current expenditure are expected to fall by 0.6 pp of GDP, while interest rate expenditure will decline 0.3 p.p. of GDP, due to the reduction in the debt to GDP ratio.

The capital balance is expected to improve slightly throughout the period, leading to a reduction of the corresponding deficit from 2.9%of GDP in 2003 to 2.7% in 2006.

The rate of reduction in primary current expenditure required to achieve budgetary consolidation in 2006 is of about 0.9 p.p. of annual GDP, which translates into a annual decline of 0.7 p.p. of GDP of the General Government overall deficit.

Table 4. Public Debt

% of GDP	2002	2003	2004	2005	2006
1. General Government gross debt	58.8	58.7	57.5	55.3	52.7
2. Change in General Government gross debt (-3+4+5)	3.4	-0.2	-1.2	-2.2	-2.6
Contributions to gross debt change					
3. Primary balance	0.2	0.8	1.2	1.9	2.5
4. Interest effect and GDP nominal growth	0.2	0.7	-0.1	-0.2	-0.3
5. Other	3.3*	-0.1	0.1	-0.1	0.1

* of which 1.6% of GDP is due to arrears and 1.4% to net assets acquisitions, including the change of hospitals into corporate entities.
Source: Ministério das Finanças.

In line with the forecasts for the overall deficit of Public Administrations, the debt to GDP ratio is expected to fall to 52.7% corresponding to a reduction of 6 p.p. of GDP in the period 2003-2006.

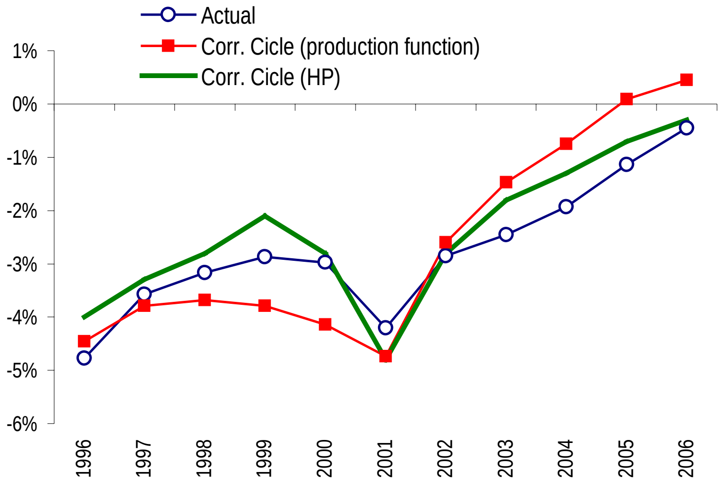
Estimates of the cyclically adjusted overall balance of Public Administrations using the methodology of the Hodrick-Prescott filter shows a surplus of 0.3 p.p. of GDP in 2006. According to the same methodology, the cyclically adjusted primary surplus rises from 0.3% of GDP in 2003 to 2.6% in 2006. Fiscal consolidation requires an annual growth of the primary surplus of 3.2 p.p. in the period of 2002-2003, followed by annual increases of the latter balance of 0.4 p.p. of GDP in the remaining years of the period.

Table 5. Cyclical Developments

	2002	2003	2004	2005	2006
1. GDP growth at constant prices	0.7	1.3	2.7	3.1	3.5
2. Actual balance (% of GDP)	-2.8	-2.4	-1.9	-1.1	-0.5
3. Interest (% of GDP)	3.0	3.3	3.1	3.0	2.9
4. Potential GDP growth	2.5	2.5	2.6	2.7	2.8
5. Output gap	-0.3	-1.5	-1.4	-1.0	-0.3
6. Cyclical budgetary component	-0.1	-0.6	-0.6	-0.4	-0.1
7. Cyclically-adjusted balance (2-6)	-2.8	-1.8	-1.3	-0.7	-0.3
8. Cyclically-adjusted primary balance (7+3)	0.3	1.4	1.7	2.3	2.6
By memory: Production Function Methodology					
Output gap	-1.0	-2.3	-2.7	-3.0	-2.7
Cyclically-adjusted actual balance	-2.6	-1.5	-0.7	0.1	0.4

Source: Ministério das Finanças.

Chart 6. General Government Overall Balance



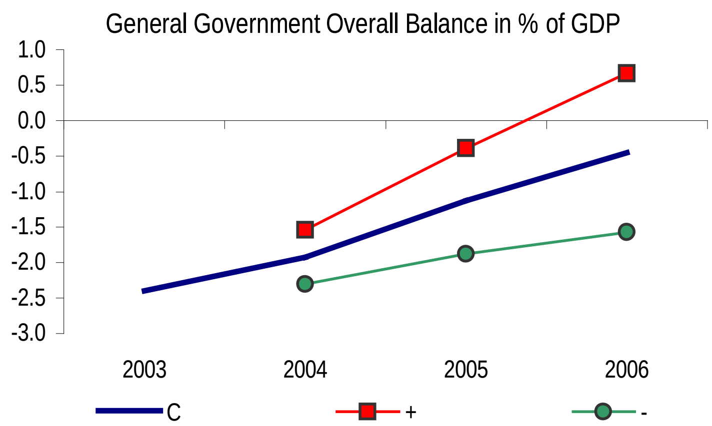
Sources: INE, Ministério das Finanças.

The estimation based on the production function methodology (see Chart 6) leads to a more pronounced effect of the economic cycle on the General Government overall balance, as a consequence of a larger output gap. According to this methodology, the cyclically adjusted overall balance would change from a deficit of 2.6% in 2002 to a surplus of 0.4% of GDP in 2006.

VI. Sensitivity Analyses

Public finance consolidation in 2006 requires a severe adjustment in public expenditure. A rate of growth of GDP 1 p.p. lower than assumed in the underlying scenario would entail an annual negative effect on the overall deficit of about 0.4 p.p. of GDP, amounting to 1.1% of GDP throughout the period. Bearing in mind that there is very limited scope for additional reductions in expenditure, the fulfilment of the assumed target would be put under severe jeopardy, in the event of a less favourable economic outturn.

Chart 7. Alternative real rates of growth of GDP
Basic Scenario; Plus (+)/ Minus (-) 1 percentage point



The wide set of reforms mentioned above and the combination of macro and micro economic policy tools not only grant strong confidence to the forecasts corresponding to the central scenario but also allow for the feasibility of an higher rate of growth and thereby of a faster convergence. It is worthwhile to stress that one main reason for the stoppage of the convergence process was the sustained loss of market shares of Portuguese firms in the domestic market. This was the result of a continued loss of competitiveness, due to the inadequacy of the policies adopted in the new framework of Portuguese participation in EMU. With the new policies and a different behaviour of enterprises an increase in competitiveness will be possible, thereby opening the possibility of a recovery of the market losses experienced in the last few years. Cumulated market share losses in the last six years amounted to 4% of GDP. A full recovery of this trend within a period of four years would add 1 p.p. per year to the growth rate induced by domestic and foreign demand, thus increasing the feasibility of the most favourable scenario.

The Programme shall not be changed if the actual economic outcome is better than forecasted, allowing for a surplus in 2006. In that event, additional revenue will be translated into a reduction of the General Government deficit.

Table 6. Sensitiveness to different rates of growth of GDP

	2003	2004	2005	2006
GDP (C)	1.3	2.7	3.1	3.5
GDP (+)		3.7	4.1	4.5
GDP (-)		1.7	2.1	2.5
General Government Balance (C)	-2.4	-1.9	-1.1	-0.5
General Government Balance (+)		-1.5	-0.4	0.7
General Government Balance (-)		-2.3	-1.9	-1.6

Chart 8. Alternative rates of interest

Basic Scenario; Plus (+)/ Minus (-) 1 percentage point

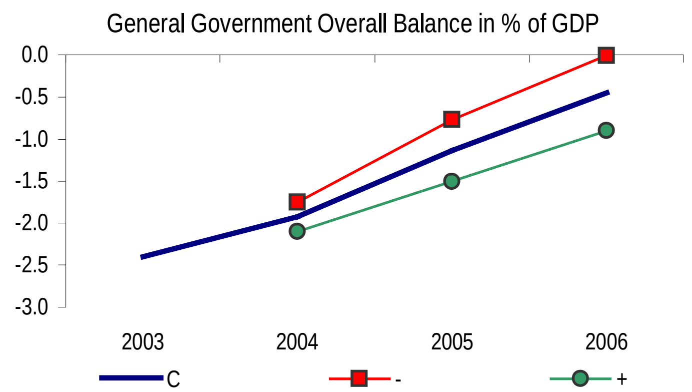


Table 7. Sensitiveness to different rates of interest

	2003	2004	2005	2006
GDP (C)	1.3	2.7	3.1	3.5
GDP (+)		2.6	2.9	3.3
GDP (-)		2.8	3.3	3.7
General Government Balance (C)	-2.4	-1.9	-1.1	-0.5
General Government Balance (+)		-2.1	-1.5	-0.9
General Government Balance (-)		-1.7	-0.8	0.0

In a scenario of higher interest rates a cumulative deficit of 0.4 p.p. of GDP would occur, which could be accommodated without preventing the eventual target of budgetary consolidation in 2006.

Table 8. Comparison with the January 2001 SGP forecasts

	2002	2003	2004	2005	2006
Real GDP growth					
previous update	1.8	2.5	3.0	3.0	-
latest update	0.7	1.3	2.7	3.1	3.5
difference	-1.0	-1.2	-0.3	0.1	-
Actual budget balance (% of GDP)					
previous update	-1.8	-1.0	0.0	0.4	-
latest update	-2.8	-2.4	-1.9	-1.1	-0.5
difference	-1.0	-1.4	-1.9	-1.5	-
Gross debt levels (% of GDP)					
previous update	55.7	55.5	54.0	53.2	-
latest update	58.8	58.7	57.5	55.3	52.7
difference	3.1	3.2	3.5	2.1	-

Source: Ministério das Finanças.

As seen in Table 8, the current programme is based upon an economic growth scenario considerably lower than the one underlying the previous programme, the cumulative difference amounting to 2.3 p.p. of GDP, in the period 2002-2005. Due to the 2001 excessive deficit, the 2002 starting point lags 1.1 p.p. behind the target, entailing the postponement of fiscal consolidation to 2006.

VII. Long-term Scenarios for Social Security

VII.1. Medium-term Prospects

In the period 2002-2006, Social Security payments are expected to increase from 8.7% to 9% of GDP, corresponding an annual nominal average growth of 6.8%.

This trend reflects both inherent features of the pension system, associated with the pattern of demographic evolution and the maturity of the system as well as the foreseen convergence of minimum pensions to net minimum wage.

Portugal faces undoubtedly a problem of poverty of the elderly population, which is [*vd.* Table 9] associated to the low levels of old-age pensions.

Table 9. Percentage of Population with Incomes below 50% of Median Disposable Income in Total Population, by Age Group

16-24	25-49	50-64	65-74	75+
15.6	4.6	12.1	33.2	50.0

Source: Ministério das Finanças, based on INE [IOF 2000-2001].

In a such context, to achieve the convergence of minimum pension of the contributory scheme and of the non-contributory social pension to amounts indexed to the statutory minimum wage in the period of 2003 to 2006, net of social contribution, is an important step to ensure that the pension system operates a needed redistribution of income to reduce poverty.

VII.2. Long-term Prospects

Concerning the long-term, the most recent projections [*vd.* National Report on the Strategy on the Future of Pension Systems] show the need for policy measures to ensure the financial sustainability of the system.

Table 10. Expenditure in Pensions of the General Scheme [in % of GDP]

	2001	2010	2020	2030	2050	2075
According with Law 17/2000						
Total Expenditure	9.6	10.3	10.5	10.7	10.9	11.1
Balance of the Reserve Fund	4.9	11.0	7.1	0.0	0.0	0.0

Source: National Report on the Strategy on the Future of Pension Systems.

Table 11. Expenditure in Pensions of the Civil Servant's Scheme [in % of GDP]

	2001	2010	2020	2030	2050	2075
Expenditure in Pensions	3.7	4.4	5.0	5.0	4.4	5.0

Source: National Report on the Strategy on the Future of Pension Systems.

On the other hand, the policy measures in the context of Law 17/2000 increased the pressure on the system financial sustainability and did not reduce the incentives to early retirement or strategic behaviours.

VII.3. Reform Strategies

The reform introduced by the new Basic Law on Social Security preserves the functions of the State as a fundamental element of people's protection. It is underpinned by a reform whose main principles are:

- Social co-responsibility of the State, enterprises and families;
- An increased balance between entitlements (pay-as-you-go) and the capitalization of future benefits;
- Positive discrimination *towards the most disfavoured*.

In accordance with these principles, the following measures should be stressed:

- Convergence of the minimum old age and disability pensions of the contributory scheme, which will be set, within the next four years, between 65% and 100% of the minimum wage, net of social contribution, according to the: contributory career of each individual; non contributory social pensions will be set at 50% of the net minimum wage, within the same time span, while agricultural sector pensioners will be entitled to a pension amounting to 60% of the net minimum wage;

- Development of the supplementary social security scheme, through the adoption of contributory ceilings, on an optional basis, which will allow beneficiaries to combine the public and the supplementary social security systems and the pay-as-you-go and capitalisation regimes, as well as risk sharing; the development of the supplementary system represents a significant step towards the achievement of financial sustainability of the social security system and the reinforcement of the second pillar;
- Revision of the legal regime of sickness benefits, discriminating between short term and long term sickness leaves for the computation of the allowance, and introducing caps to net benefits which shall not be higher than the reference net labour income; to improve the scope and design of the rules in order to prevent abuse and fraud and to reinforce supervision;
- Increased flexibility in eligibility for retirement, adopting mechanisms that provide for a balanced combination of part time work and part time retirement;
- Revision of the legal regime of family benefits, reinforcing differentiation in the benefits granted, through the combination of criteria that provide for a better adjustment of benefits to incomes, namely to income per capita;
- Revision of the social assistance policy in order to introduce positive discrimination, according to its nature and outcomes and to introduce social co-responsibility of the State, enterprises and families.

An important line of reform that should be stressed is the foreseen adoption of the Law on the social income for social and professional integration (Rendimento Social de Inserção), which introduces changes in eligibility and in the regime of proofs that together with the reinforcement of supervision will provide for a more effective tool to fight poverty and social exclusion.

Two additional areas where thorough reforms should be introduced are the following:

- Structure of the Social Security System - a restructuring will be carried on leading to the reorganisation and modernization of the services; to the improvement and deployment of human resources; to the elimination of red tape and simplification of procedures; and to the reinforcement of management, operation and supervision; a model of entrepreneurial management will be adopted together with an approach focused on the organization of the service and on the quality of the attendance provided to citizens;
- Management of revenue - a debt and contributions/contributors management system will be implemented, as well as an effective system to fight fraud and evasion; the model which will specify debt as a management target, will have a wider scope, in management and in operational terms; its design aims at improving the collection of contributions and at preventing the building up of debt, checking information related to debt, as well as to create tools to address non compliance situations; social security legislation will be revised, among others, in areas related to the settlement of debts , financial obligations towards social security, administrative offences, fines and crimes, while supervision will be strengthened.

ANNEXES:

Measures to be implemented in 2003-2006

Public Administration:
Set up multianual budgeting, based on targets;
Introduce time limits on subsidies, benefits and other forms of support; adopt periodic evaluation and revision;
Improve real statye management and sell unnecessary assets;
Redraw State-owned business sector;
Rationalize and simplify existing structures, through the redefinition of the functions of the State;
Revise the rules that apply to the creation of autonomous services, as well as its operation and auditing;
Contract the management of public services, on the basis of management targets and required resources, associated with an increased flexibility in the management of both human and financial resources;
Contain new admissions into Public Administration;
Establish an employment pool, with information on-line on the supply and demand of employment in Public Administration, promoting mobility and restraint in new admissions;
Set up a system of information on permanent staff as well as on fixed-term contracts in Public Administration;
Review of the status of top officials, reinforcing accountability and skills;
Review the performance evaluation regime in order to establish differentiation mechanisms which will restrain promotions and automatic progressions;
Promote the development of IT in order to rationalize human and financial resources management and ensure the flow of information.
Non-tertiary education:
Reorganize the network of primary schools through the progressive closing down of schools with less than 10 students;
Reduce the number of teachers without teaching burden, as well as the number of teachers in non-teaching functions;
Implement as from 2004/2005, the reform of the secondary education curriculum reducing the number of subjects taught and class time length;
Reform adult recurrent education;
Rationalize real estate allocated to the Ministry of Education, reducing the number of rented buildings and releasing others;
Evaluation of the quality of schools and of teachers, making financing conditional on actual outcomes
Revision of the system of job openings and of the status of non-tertiary teachers, introducing more demanding and rigorous procedures for hiring and of teachers tenure;
Enlargement and improvement of the social network of kindergarten, in order to achieve an average rate of coverage of about 90% for the age group comprised between 3 and 5 years old;
Develop technological education and vocational education in order to give adequate skills to youngsters that enter the labour market after finishing basic compulsory education.
Tertiary Education:
Implement a new financing model in public tertiary -level education, abiding by autonomy principles, including contract programs and development contracts in order to improve the standards in education and to develop a closer relationship with the private sector;
Increase social support schemes, granting financing according to students economic background;
Restructure the network of public tertiary education, adjusting for the trends in potential candidates; courses with low standards or for which demand is shrinking could be discontinued;
Change the financing of higher-level education and of research in order to increase own revenues;
Revision of the status of educational staff in higher education and of the Law on autonomy.

Health:
Introduce entrepreneurial management, increasing participation of private and social sectors;
Transform hospitals into corporate entities, with greater entrepreneurial management autonomy, accountability and management efficiency;
Finance hospital activities according to a price list for medical procedures and services actually rendered;
Promote public/private partnerships in health care;
Introduce economic regulation and monitoring of the accomplishment of performance and quality criteria;
Introduce financing in health centers on a per capita basis;
Increase fees and other current revenue;
Base co-payments of drugs on reference prices;
Promote the use of generics;
Adopt prescriptions according to the International Common Designation;
Introduce a new model for prescriptions, including the renewable prescription;
Direct payment of to pharmacies of co-payments relating to drugs.
Social Security:
Development of the supplementary social security scheme, through the adoption of contributory ceilings, on an optional basis;
Revision of the legal regime of sickness benefits, introducing the principle that net benefits shall not be higher than the reference net labour income;
Increased flexibility in eligibility for retirement;
Revision of social assistance policy in order to introduce positive discrimination, according to its nature and outcomes and to introduce social co-responsibility of the State, enterprises and families;
Restructure the Social Security Ministry allowing for a decrease in real expenditure in 2003 and limited real growth throughout the consolidation path;
Grant more autonomy to auditing and monitoring activities, which will allow larger intervention capacity;
Introduce differentiation between long-term and short-term sickness leaves, discriminating positively the latter and reinforce control;
Tax sickness subsidies in order to eliminate the incentive to claim the subsidy. Reinforce control, cross-checking with the data basis of the Ministry of Health;
Change eligibility criteria and tighten access conditions, in order to increase rigour and control of subsidies granted.

The Corporate Tax in the EU

Tax systems evolve over time, adopting solutions adjusted to the different problems they face. These differences hamper ready comparison of systems. However the comparison of the tax rates and of the weight of revenue in GDP allows to draw sounder conclusions. The table below shows that although the corporate tax rate in Portugal is close to rates adopted in other EU countries, the average effective rate is comparatively higher, as it is the revenue as a percentage of GDP.

Direct taxes introduce significant distortions in the economy, with inherent costs in efficiency, which rise with the tax rate increases.

Corporate Tax

	Efective tax	Revenue (% of GDP)	Nominal tax
	1999	**2001**	**2002**
Austria	29.8	5.0	34.0
Belgium	34.5	3.5	40.2
Denmark	28.8	0.6	30.0
Finland	25.5	3.4	29.0
France	37.5	3.7	34.3
Germany	39.1	2.7	38.4
Greece	29.6	7.6	25/35
Irland	10.5	4.1	16.0
Italy	29.8	2.7	40.3
Luxembourg	32.2	2.8	30.4
Netherlands	31.0	3.0	29/34.5
Portugal	32.6	3.6*	33.0
Spain	31.0	2.8	35.0
Sweden	22.9	3.0	28.0
United Kingdom	28.2	3.6	30.0

Source: 3rd column - KPMG's Corporate Tax Rate Survey, January 2002; other - "Revenue Statistics 1965-2001", OECD (2002);
Company taxation in the internal market CE (October 2001).
* estimate of MF.

With the enlargement of the European Union, Portugal will have to compete, as an inward foreign investment country, with countries where corporations profits are subject to a marginal rate of taxation that is already, or will soon become, lower than the current tax rate in Portugal. Many of these countries are geographically closer to the main European markets than Portugal. In addition, they have a skilled labour force, earning lower wages.

Business Taxes in selected European Countries

	1999	2000	2001	2002	2003	2004
Check Republic	35%	31%	31%	31%	28%	
Hungary	18%	18%	18%			
Leetonia	25%	25%				
Poland	34%	30%	28%	28%	24%	22%
Slovenia	30%	25%				

Source: “European Tax Hand Book” International Bureau of Fiscal Documentation.

These features negatively affect Portugal's comparative advantage, as an inward foreign investment country. Foreign investment, as already stressed, is a key component of Portuguese economic policy for the next years. It will determine the speed in reducing macroeconomic imbalances and influence the pace of technological progress in the next years. In short, it will mark the pattern of real convergence towards European Union average standards.

The foreseen reduction in the marginal rate of the corporate tax, throughout the period covered by this Programme, envisages the recovery of the lost advantages of Portugal as an inward foreign investment country. It further aims at stimulating domestic investment and at reducing the fiscal drag. The reduction will be complemented with the simplification of the corporate tax code and with the reduction of some types of tax allowances. Although allowing for an enlargement of the tax basis, these measures will not be sufficient to compensate for the loss in revenue due to the reduction in the tax rate. This reduction will have to be compensated by an increased effort to contain expenditure. A policy of budgetary consolidation will therefore be launched, according to which the decline in expenditures will be a condition for the realization of cuts in direct taxes on business.