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2003 Update of the Stability Programme of Portugal (2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSION[1]

The fifth update of Portugal's stability programme largely complies with the revised "code of conduct on the content and format of stability and convergence programmes". The Portuguese authorities provided additional information not required in the "code of conduct" which has been useful for the computation of potential real GDP growth estimates, using the commonly agreed production function methodology. However, information on expected privatisation revenue and on the breakdown of social transfers by major category would have been desirable[2].

On 5 November 2002, following a significant breach of the Treaty reference value for the general government deficit in the year 2001[3], the Council decided that an excessive deficit existed in Portugal and issued recommendations requesting Portugal to bring this situation to an end by 2003 at the latest. In 2002 already, the nominal deficit dropped to 2.7% of GDP. However, this early correction took place in a worse-than-expected economic environment[4] and was largely achieved via recourse to substantial one-off measures, amounting to 1.5% of GDP.

In 2003, the economic recession in Portugal -where the latest data suggest that real GDP and real domestic demand have declined by an estimated 1% and 2½% respectively- has hampered considerably the pursuit of fiscal consolidation. In fact, the previous update of the stability programme (January 2003), had put real GDP growth at 1.3% for 2003. A deviation of this magnitude, together with the high sensitivity of tax revenue to macroeconomic conditions, produced a massive shortfall in tax revenue. As regards government expenditure, the available information suggests that current primary expenditure is growing below budgetary plans, and therefore seems under control. These revenue and expenditure developments would, however, have led to a government deficit significantly above 3% of GDP in 2003. In order to prevent this without having to adopt an unduly restrictive policy stance, and to give extra-time for the ongoing broadly-based programme of structural reforms to yield the expected benefits in terms of expenditure savings, the Portuguese authorities relied, for a second year running, on sizeable one-off measures, amounting to 2 percentage points of GDP. Thereby, according to the programme update, the nominal deficit would be kept just under 3% of GDP.

According to data on budgetary execution for the state sector (on a public accounts basis), a general government deficit slightly below the 3% of GDP reference value of the Treaty may actually be achieved in 2003. The Commission Autumn 2003 forecast had projected a deficit of 2.9% of GDP, including the one-off measures envisaged by the authorities. A deficit below the 3% reference value needs to be confirmed by the regular reporting of deficit and debt figures of March 2004. On that basis, the Commission will carry out an assessment of compliance with the recommendation addressed to Portugal under article 104(7)[5].

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1 This assessment has been carried out on the basis of information available as of 13.02.2004.

2 The data set of the programme update falls short of the requirements of the revised "code of conduct" on three counts: (i) no details regarding the breakdown of social transfers between those in kind and those other than in kind; (ii) lack of information on some explanatory variables of the change in gross government debt, namely privatisation receipts and the implicit interest rate on the debt; and (iii) lack of detailed information on the factors determining the long-term sustainability of public finance.

3 In 2001, the general government deficit reached 4.4% of GDP.

4 In 2003, the output gap amounted to -2.3% of GDP, according to the commonly agreed methodology.

5 The recommendation calls for bringing the excessive government deficit to an end by 2003 at the latest.

For 2004, the Portuguese authorities project real GDP growth at 1.0%, which is identical to the Commission services' Autumn 2003 forecast. In the programme update, the government deficit is projected to decline only marginally from 2.9% of GDP in 2003 to 2.8% in 2004, while the amount of planned one-off measures is expected to drop from 2 percentage points of GDP in 2003 to about 1.1 percentage point in 2004.

Some degree of uncertainty surrounds the outcome for tax revenue in 2004. The Commission services reiterate their assessment made in the Autumn 2003 forecast that the outturn for tax revenue in 2004 might be lower than anticipated by the Portuguese authorities in their budget for 2004 and now also in the 2003 programme update[6]. This different assessment for tax revenue prospects in 2004 warrants the Commission's higher deficit forecast of 3.3% of GDP of last autumn. Moreover, a tax shortfall in 2004 (compared with the programme update), accompanied by any slippage in restraining growth in social transfers to the extent (implicitly) envisaged in the programme already for 2004, would have repercussions throughout the entire programme period, requiring either appropriate offsetting measures or a revision of budgetary targets. However, further one-off measures and/or better-than-expected growth conditions could lead to a deficit below 3% of GDP.

For the period 2005-2007, the programme projections are based on a (central) scenario, in which real GDP growth averages 2¾% per year. Alternative scenarios are only briefly sketched (but not fully developed) for the purpose of a sensitivity analysis. Employment growth is expected to pick up from 0.4% in 2004 to 1.3% on average in the period 2005-2007. Declining from 3.3% in 2003, HICP inflation is expected to stabilise at 2% throughout the period from 2004 to 2007.

The macroeconomic scenario underlying the programme update seems plausible. After an adjustment period that peaked in 2003, domestic demand is expected to recover in the next years, although at more moderate rates than in the second half of 1990s. Major stimulus to growth should thus be provided by external forces, underpinned by domestic wage moderation. In this regard, the programme scenario incorporates an element of prudence that could absorb moderate unfavourable shocks. This "caution bias" is built upon two assumptions: (1) an average growth rate only ¼ of a percentage point above the figure projected for the EU as a whole, an acceptable deviation for a catching-up country; and (2) constant export market-shares, in spite of the expected moderate gains in (labour) productivity and a significant deceleration in wage growth, in line with the Commission's Autumn 2003 forecast.

Under these assumptions, the government deficit is projected to decline from 2.8% of GDP in 2004 to 2.2% in 2005, 1.6% in 2006 and 1.1% in 2007. According to Commission services' estimates based on the projections of the programme, using the commonly agreed methodology, the cyclically-adjusted balance would improve by about 0.4 percentage point per year with the deficit falling eventually to 0.7% of GDP in 2007.

The medium-term budgetary consolidation strategy of the 2003 programme update is similar to that adopted in the previous update. It is centred on three axes: (1) an ambitious programme of structural reforms, with a particular incidence in those areas which bear directly on public finance, such as public administration, health-care, and education; (2) a sustained policy of curbing government consumption through wage moderation and a quasi-employment freeze; and (3) a gradual improvement in productivity and competitiveness to be fostered, *inter alia*, by a substantial cut in the corporate tax rate. In addition, the adoption in 2002 of a Budgetary Framework Law ("*Lei de Estabilidade*

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[6] For 2004, total tax revenue is projected to grow by about 2% and 2¾%, respectively, in the Commission's Autumn forecast and in the programme update.

Orçamental") is expected to have reinforced the co-ordination of budgetary policy across all levels of government.

For the period 2004-2007, the Portuguese authorities project that the implementation of this medium-term strategy will bring about a cumulative decline by 3.2 percentage points in the primary expenditure-to-GDP ratio, which however will be partly offset by a cumulative reduction in the tax revenue ratio amounting to 0.7 percentage point of GDP.

This adjustment strategy[7], by relying on expenditure restraint rather than on tax increases, is both in line with the Broad Economic Policy Guidelines and is likely to improve the confidence of private economic agents, thereby leading to expansionary effects over the medium-term, while also being favourable to securing a lasting improvement, because of its higher robustness to adverse macroeconomic conditions. However, a number of qualifications and risks need to be stressed.

First, a high degree of uncertainty surrounds the outcome for tax revenue over the projection period, basically on account of the planned cut in the corporate tax rate, the reform of real estate taxation, and the high sensitivity of tax revenue to macroeconomic conditions, which could lead to overall significant tax shortfalls when compared with the programme's targets. At unchanged policies and embodying part of these risks, the Autumn 2003 forecast projected a deficit of 3.9% of GDP in 2005.

Second, in order to maximise the chances of being conducive to growth, a budgetary consolidation strategy based on expenditure restraint should not be achieved at the expense of the most "productive" components of government expenditure. However, according to the data in the programme update, roughly one-fourth of the total adjustment in government expenditure is planned to be achieved through a reduction in government investment.

Third, in recent years, total social transfers grew at a very strong pace, a situation which has recently worsened on account of the phased convergence of the lowest pensions towards the minimum wage, which is to be completed by 2006 at the latest. Against this background, the programme implicitly assumes a sharp deceleration in the average annual growth rate of total social transfers from almost 10% in the period from 2000 to 2003 to about 4½% in the period from 2004 to 2007, which broadly corresponds to a small decline of its GDP ratio. However, the programme does not spell out the measures required to secure this result. In particular, the measures necessary to complete the reform process of pension regimes are absent from the detailed list of structural reforms to be implemented during the programme period.

According to Commission services' calculations, the projected improvement in the cyclically-adjusted balance is slightly lower than the required minimum of ½ percentage point of GDP per year. However, Portugal converges towards a close-to-balance budgetary position in cyclically-adjusted terms by the end of the programme period (-0.7% of GDP in 2007). This outcome, somewhat less favourable than projected by the Portuguese authorities, is due to the fact that the Commission services, using the commonly agreed methodology, estimate a significantly lower growth rate for potential output of only 2.0% in the period from 2004 to 2007 than the Portuguese authorities' estimate of 2.7%.

Given the recurrent postponement of the balanced-budget target, the Portuguese authorities should maintain their efforts at complying with expenditure plans and on strengthening the effectiveness of the tax administration. Once economic growth returns to normal values, such a strategy would eliminate the need for recurrent one-off measures (required only to give extra-time for more structural/permanent measures to take effect).

7 Together with the successful curbing of expenditure growth below the planned target in 2003.

The debt ratio is set to rise by almost 7 percentage points of GDP between 2000 and 2004, largely on account of substantial nominal deficits and sluggish growth, reaching exactly the value of 60% in 2004. Subsequently, it is projected to abate to 57% of GDP by 2007.

On the basis of current policies, risks of imbalances in the long term cannot be ruled out. The high deficit may undermine the sustainability of public finances in the longer term, hence the timely achievement of a budgetary position close to balance is imperative. Failure to do so would imply a rising debt ratio over time once the impact of ageing takes place. The imminent wave of population ageing heightens the urgency of completing the reform process, above all in the more sensitive age-related expenditure areas, before the current window of opportunity closes.

Finally, the economic policies as reflected in the 2003 update are broadly consistent with the recommendations of the Broad Economic Policy Guidelines, specifically those with budgetary implications. Although plans for the period from 2004 to 2007 involve an improvement in the cyclically-adjusted balance by only 0.4 percentage point of GDP on average per year, and thus below the 0.5 percentage point benchmark, the composition of the budgetary adjustment follows the recommendation that calls for deficit reduction to be obtained mainly through expenditure restraint. Moreover, the recommendation requesting Portugal to undertake structural reforms in areas with a direct impact on budgetary consolidation is being timely followed.

1. INTRODUCTION

The Portuguese government adopted the update of the stability programme in December 2003. This is the fifth annual update of the stability programme presented originally in December 1998.

The current update covers the period from 2004 to 2007. For 2004, the macroeconomic scenario roughly corresponds to the central point of the state budget projections for that year. Beyond 2004, and although economic activity is expected to remain below potential output throughout the entire programme period, the update projects a sustained recovery of the pace of growth brought about by both the gradual improvement of supply conditions and the resumption of domestic demand after the progressive correction of the large macroeconomic imbalances that accumulated in the second half of the 1990s.

The projected economic growth in the period from 2004 to 2007 largely relies on the steady improvement of labour productivity, the outcome of an economic strategy which complements the pursuit of fiscal consolidation with a broadly-based programme of structural reforms and a substantial cut in the corporate tax rate. Moreover, the programme update also highlights the importance of strict abidance to a number of budgetary rules to curb the pace of current expenditure growth.

Given the significant impact of the economic recession in 2003 on public finance, particularly on the revenue side, the programme postpones the attainment of a balanced-budget. The general government deficit is projected to average 1.9% of GDP in the period from 2004 to 2007, gradually falling to just above 1% in 2007. According to the calculations presented in the programme update, the cyclically-adjusted balance is expected to improve by 0.5 percentage point of GDP on average per year, as set out in the Broad Economic Policy Guidelines (BEPGs), attaining a position close to balance by 2006.

The adoption in 2002 of a Budgetary Framework Law ("*Lei de Estabilidade Orçamental*"), which takes precedence over all legislation concerning budgetary matters, is expected to be an important instrument to strengthen the co-ordination of budgetary policy across all levels of government. Underpinned by this new Framework Law, local authorities and regional governments should attain zero net borrowing requirements in 2004; otherwise they could suffer offsetting cuts in central government transfers in the following year.

2. MACROECONOMIC ASSESSMENT

2.1 External economic assumptions

The external macroeconomic assumptions included in the programme update are broadly similar to the Commission's Autumn Economic Forecasts for the period 2003-2005 (GDP growth on average per year of 1.7% and 1.6% respectively). For the following years 2006-2007, the programme assumes a modest acceleration of GDP growth, about ¼ percentage point above an average for the EU as a whole of 2½%.

2.2 Domestic macroeconomic developments

The 2003 stability programme update largely complies with the guidelines set in the Council opinion of July 2001 on the revised "code of conduct"[8]. · However, information on expected privatisation revenue and on the breakdown of social transfers by major category would have been desirable[9]. Real GDP is estimated to have fallen by 0.8% in 2003 and a growth rate of 1% is projected for 2004. For the years from 2005 to 2007, the update projects a gradual recovery of economic activity, reaching a GDP growth rate of 3% by 2007. The progressive strengthening of economic activity is underpinned by the projected gains in labour productivity and competitiveness, resulting from the programme of structural reforms, a continued period of wage moderation, and significant cuts in the corporate tax rate.

Table 1

Macroeconomic scenario – forecast comparison

(Annual growth rate in % unless stated otherwise)	2002	2003		2004		2005		2006	2007
	National accounts	SP	Comm.	SP	Comm.	SP	Comm.	SP	SP
GDP	0.4	-0.8	-0.8	1.0	1.0	2.5	2.0	2.8	3.0
Private consumption	0.6	-0.7	-0.9	0.5	0.8	2.0	0.9	2.5	2.7
Government consumption	2.9	-1.3	-0.9	-0.5	-0.2	0.0	0.1	0.2	0.2
GFCF	-5.1	-7.0	-9.2	2.5	1.0	5.0	5.2	6.2	6.5
Exp. of goods and services	2.1	2.9	3.1	5.6	5.1	6.4	7.0	6.6	6.6
Imp. of goods and services	-0.5	-2.6	-2.9	4.0	3.9	5.2	5.5	6.3	6.4
HICP	3.7	3.3	3.4	2.0	2.6	2.0	2.5	2.0	2.0
Employment	0.3	-0.8	-1.0	0.4	-0.1	1.2	0.5	1.3	1.4
Unemployment[a]	5.1	6.4	6.4	6.7	7.0	6.1	7.1	5.4	4.8
Labour productivity	0.2	0.0	0.2	0.7	1.1	1.3	1.5	1.4	1.6
Deficit (as % of GDP)	**-2.7**	**-2.9**	**-2.9**	**-2.8**	**-3.3**	**-2.2**	**-3.9**	**-1.6**	**-1.1**
Debt (as % of GDP)	**58.1**	**59.5**	**57.7**	**60.0**	**58.8**	**59.7**	**60.2**	**58.6**	**57.0**

Sources: The 2003 update of the stability programme, and the Commission's Autumn 2003 Economic Forecasts.
a) As percentage of the labour force.
SP: Stability programme update.
Comm.: Commission.

According to national accounts data for the third quarter of 2003 (-0.5% quarter-on-quarter), the estimates (both in the programme update and in the Commission's Autumn 2003 forecast) of -0.8% for the decline of real GDP in 2003 appear now to be on the optimistic side. Given the rise in the negative carry-over at the end of 2003, the estimates (both in the programme update and in the Commission's Autumn 2003 forecast) of 1% for real GDP growth in 2004 appears also to be on the optimistic side, although remaining a plausible figure.

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8 Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

9 The data set of the programme update falls short of the requirements of the revised "code of conduct" on three counts: (i) no details regarding the breakdown of social transfers between those in kind and those other than in kind; (ii) lack of information on some explanatory variables of the change in gross government debt, namely privatisation receipts and the implicit interest rate on the debt; and (iii) lack of detailed information on the factors determining the long-term sustainability of public finances.

The central macroeconomic scenario for the years 2005 to 2007 appears credible and consistent with the necessary degree of caution that should underpin a prudent fiscal strategy. Alternative scenarios are only briefly sketched (but not fully developed) for the purpose of a sensitivity analysis. The growth projections for the period 2005-2007 assume an acceptable growth deviation, for a catching-up country, of ¼ percentage point from the EU annual average of 2½%.

The macroeconomic scenario of the update takes adequately into consideration the consequences of the unavoidable adjustment of domestic demand. In the second half of the 1990s, growth in domestic demand outpaced growth in GDP, thereby building-up considerable imbalances across the economy (i.e. government, households, and enterprises). As a result, the external balance of payments[10] moved from a balanced position in 1995 to a deficit of 9% of GDP in 2000. Since 2001, domestic demand has been growing below GDP on account of the continuous efforts of private sector agents to restore the sustainability of their balance sheets and of the tightening of fiscal policy after the massive budgetary slippage registered in 2001. The programme update sensibly assumes that the ongoing adjustment of domestic demand peaked in 2003, partly due to the international conjuncture, being expected to gradually decrease in importance in the coming years as the adjustment process nears its completion. Therefore, the assumption that domestic demand is expected to gradually recover, but remaining well below the average growth attained in the second half of the 1990s, seems reasonable.

The scenario for the economic recovery is typical for a small open economy. Firstly, exports are projected to rise in line with foreign demand. Secondly, the projected increase in export volumes (from about 3% in 2003 to around 6¼% on average per year in the period 2004-2007) is expected to induce a strong rise in private investment. Thirdly, private consumption is expected to recover with a certain lag (on exports and investment) basically on account of the delayed reaction of employment in the economic cycle. Such pattern for the economic recovery is supported by favourable supply-side effects, stemming from competitiveness and productivity developments. Moreover, it could be argued that these developments could (at least) warrant a moderate improvement in export market-shares, instead of the assumed stabilisation throughout the programme period. Therefore, the set of programme assumptions explicitly incorporates an element of prudence that could absorb moderate unfavourable shocks, should these occur.

According to the Portuguese authorities, the HICP inflation rate is projected to decline from 3.3% in 2003 to 2% in 2004 and to remain at that level in the following years of the programme. A stable inflation rate, despite the gradual recovery of economic activity, reflects a number of factors, notably the persistence, according to calculations presented in the update, of a large negative output gap by 2007 (-3.5% of GDP), and favourable cost developments both on account of import prices and a sustained period of wage moderation from 2003 onwards.

The analysis of potential real GDP growth estimates suggests that the central macroeconomic scenario of the programme update seems broadly plausible. In fact, when applying the commonly agreed methodology to the figures of the programme update, the real potential growth rate averages 2% per year in the period 2004-2007, a level close to that estimated by the Commission in its Autumn 2003 forecast (2.1%).

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10 This is the net borrowing/lending vis-à-vis the rest of the world, or in other words the sum of the current account and capital balances in the terminology of the 5th Balance of Payments (BoP) Manual, which is equivalent to the current account concept in the 4th BoP Manual.

Table 2

Real GDP growth, potential real GDP growth, output gap and the cyclically-adjusted balance (CAB)

	2002	2003	2004	2005	2006	2007
Results based on the commonly agreed methodology by the Council applied to the figures of the programme						
Potential real GDP growth	2.2	1.8	1.8	2.1	2.0	2.2
Contribution of:						
Labour factor	*0.7*	*0.7*	*0.6*	*0.7*	*0.4*	*0.4*
Capital accumulation	*1.1*	*0.8*	*0.8*	*0.9*	*1.0*	*1.1*
Total factor productivity (Solow residual)	*0.3*	*0.3*	*0.4*	*0.5*	*0.6*	*0.7*
Output gap	0.2	-2.3	-3.0	-2.6	-1.9	-1.2
For information:						
Real GDP growth	0.4	-0.8	1.0	2.5	2.8	3.0
Government balance (as % of GDP)	-2.7	-2.9	-2.8	-2.2	-1.6	-1.1
Cyclically-adjusted balance (as % of GDP)	-2.8	-2.1	-1.7	-1.3	-0.9	-0.7
Results based on the Portuguese methodology						
Potential real GDP growth	---	1.9	2.4	2.6	2.8	2.8
Output gap	---	-2.3	-3.5	-3.7	-3.7	-3.5
For information:						
Cyclically-adjusted balance (as % of GDP)	---	-1.7	-1.1	-0.6	-0.1	0.4

Note: the Portuguese authorities provided all the necessary information for the calculation of potential real GDP using the commonly agreed production function methodology, including data not required by the revised "code of conduct", such as wage inflation in the whole economy, and the unemployment rate.

Sources: Commission calculations and the 2003 programme update.

However, this figure differs significantly from the value of 2.7% calculated by the Portuguese authorities (see Table 2). Although both sets of estimates start with an identical value of -2.3% for the output gap in 2003, the annual differences between potential real GDP growth estimates cumulate into significantly different output gaps by 2007: -3.5% of GDP and -1.2% respectively. The methodology used by the Portuguese authorities departs from the commonly agreed production function methodology[11], leading to considerably higher total factor productivity growth.

3. BUDGETARY TARGETS AND THE MEDIUM TERM PATH OF PUBLIC FINANCES

3.1 Programme overview

Compared with the previous update, the target path for the general government balance is revised downwards by some 0.5 to 1 percentage point of GDP for all the years which overlap with the previous programme. The general government deficit is projected to gradually decrease from 2.9% of GDP in 2003 to just above 1% in 2007 (see Table 3).

11 There are mainly three methodological differences: (i) the Portuguese authorities use a CES production function instead of a Cobb-Douglas function; (ii) the Portuguese authorities use a higher labour income share than the Commission; and (iii) use of different data series for labour variables.

Table 3 GDP growth and general government balance: comparison of the last two updates						
		2003	2004	2005	2006	2007
Real GDP growth in %	December 2002	1.3	2.7	3.1	3.5	---
	December 2003	-0.8	1.0	2.5	2.8	3.0
	Difference	-2.1	-1.7	-0.6	-0.7	---
General government balance as % of GDP	December 2002	-2.4	-1.9	-1.1	-0.5	---
	December 2003	-2.9	-2.8	-2.2	-1.6	-1.1
	Difference	-0.5	-0.9	-1.1	-1.1	
Sources: The 2002 and 2003 updates of the stability programme.						

From 2004 to 2007, the budgetary consolidation strategy adopted in the current update is based on the curbing of both current and capital expenditure. This is largely the strategy defined in the last update, although with a main difference: the current update incorporates a substantial cut in corporate taxes, the first stage of which has already been implemented with the 2004 budget.

Curbing expenditure relies basically on newly-introduced expenditure rules and better fiscal co-ordination across all levels of government, on top of a comprehensive programme of structural reforms (see Section 4).

As regards expenditure rules, a new feature in the current update is the setting up of ceilings for the annual growth rates of nominal expenditure in a number of areas with a record of overspending, such as health-care, and education.

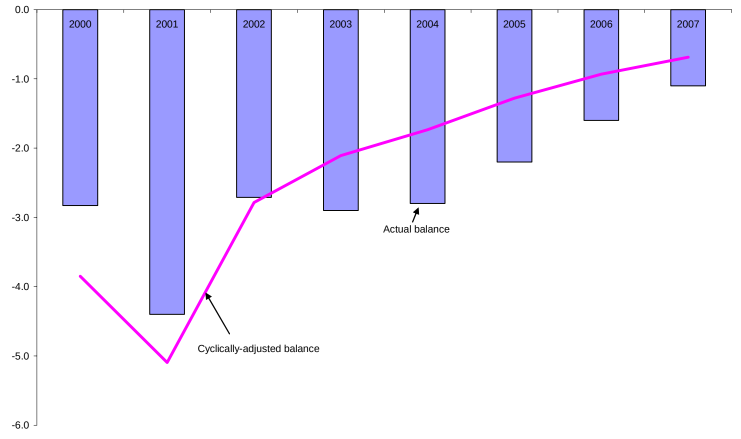
Table 4 **Projections for general government finances**								
	2003		2004		2005		2006	2007
(as % of GDP)	SP	Comm.	SP	Comm.	SP	Comm.	SP	SP
General government balance	-2.9	-2.9	-2.8	-3.3	-2.2	-3.9	-1.6	-1.1
Primary balance	-0.1	0.0	0.1	-0.6	0.9	-1.0	1.5	2.0
Total revenue	44.1	44.2	43.7	42.8	43.2	42.6	42.9	42.5
of which								
Taxes	23.8	23.1	23.7	22.7	23.5	22.7	23.4	23.0
Social security contributions	12.4	12.4	12.7	12.8	12.6	12.8	12.6	12.6
Total expenditure	47.0	47.1	46.6	46.2	45.5	46.5	44.5	43.5
of which								
Public consumption	20.9	21.2	20.1	20.9	19.6	20.4	19.2	18.7
Social transfers	16.2	16.1	16.5	16.4	16.4	16.5	16.3	16.2
Subsidies	1.7	1.5	1.8	1.5	1.8	1.5	1.7	1.6
Interest expenditure	2.9	2.9	2.9	2.8	3.1	2.8	3.0	3.0
Gross fixed capital formation	3.5	3.4	3.0	2.6	2.9	3.2	2.8	2.6
General government gross debt ratio	59.5	57.7	60.0	58.8	59.7	60.2	58.6	57.0
Sources: The 2003 update of the stability programme and the Commission's 2003 Autumn forecast. *SP: Stability programme update.* *Comm.: Commission.*								

In order to secure a high degree of fiscal co-ordination across all levels of government, a Budgetary Framework Law ("*Lei de Estabilidade Orçamental*") was approved in 2002. This law is an important instrument, because it takes precedence over all legislation on budgetary matters, effectively empowering the (state) government to set zero net borrowing requirements for local authorities and regional governments; otherwise they could suffer offsetting cuts in government transfers in the following year. In addition, autonomous funds and services will have to run balanced budgets or post surpluses.

In the 2003 programme update, the Portuguese authorities stated their commitment, even under conditions less favourable than those foreseen in the central macroeconomic scenario, to keep the government deficit below the 3% of GDP ceiling, although government expenditure would not be curbed any further in order to comply with announced targets. However, in the event of better than expected macroeconomic developments, and given the seriousness of the current budgetary situation, the Portuguese authorities are committed to allocate (at least partially) the additional revenue to the speeding up of budgetary consolation.

The 2003 stability programme update provides estimates for the cyclically-adjusted government balance. However, the adjustment method applied by the Portuguese authorities leads to significantly different results compared with those obtained applying the commonly agreed methodology to the figures of the programme. The application of the commonly agreed methodology to the data of the programme suggests that the macroeconomic and budgetary projections of the central scenario are consistent with an improvement in the cyclically-adjusted balance of 0.4 percentage point of GDP on average per year. The cyclically-adjusted deficit would still amount to an estimated 0.7% of GDP in 2007, which compares with a surplus of 0.4% according to the methodology used by the Portuguese authorities (see Table 2).

Graph 1: Actual and cyclically-adjusted balance (as % of GDP)

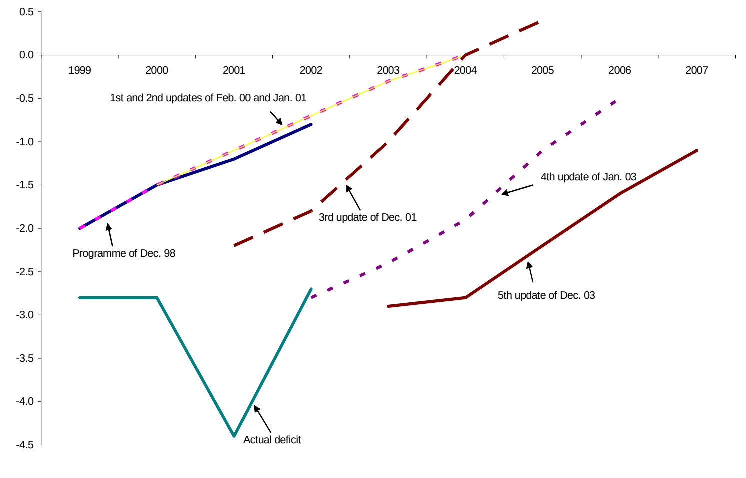


Source: Commission calculations based on the 2003 update of the stability programme.

3.2 Implementation of the 2003 stability programme

The implementation of the original stability programme and of subsequent updates shows a poor compliance record (Graph 2). In fact, the path for deficit reduction has often been postponed on account of negative surprises affecting both the outturn for GDP and budgetary variables.

Graph 2: Government balance paths for the original and all subsequent updates, and the actual deficit (as % of GDP)



Sources: The stability programme and national accounts.

Budgetary execution in 2003 was severely hampered by the recession which was not anticipated at the time of publication of the 2002 programme update. In addition, the tax system showed a high sensitivity to cyclical conditions in excess of what would have been expected given the estimated tax elasticities.

Box 1 : The EDP procedure for Portugal

The general government deficit in Portugal amounted to 4.4% of GDP in 2001, therefore exceeding the reference value of the Treaty. Based on this evidence, the Commission initiated the Excessive Deficit Procedure for Portugal on 24 September 2002, with the adoption of the report foreseen in Article 104(3) of the Treaty. The Commission adopted on 16 October 2002 an Opinion stating that an excessive deficit exists in Portugal. The Council adopted a decision in this sense, in conformity with Article 104(6), on 5 November 2002. At the same time, the Council adopted a recommendation addressed to Portugal with a view to bringing the situation of an excessive government deficit to an end in 2003 at the latest, according to Article 104(7) of the Treaty. The Council established the deadline of 31 December 2002 for the Portuguese government to take the appropriate measures to this end.

In 2002, the general government deficit amounted to 2.7% of GDP, involving one-off measures totalling 1.5% of GDP. According to data on budgetary execution for the state sector (on a public accounts basis), together with one-off measures worth 2% of GDP, a general government deficit slightly below the 3% of GDP reference value of the Treaty may actually be achieved in 2003. The Commission Autumn 2003 forecast had projected a deficit of 2.9% of GDP, including the one-off measures envisaged by the authorities. A deficit below the 3% reference value needs to be confirmed by the regular reporting of deficit and debt figures of March 2004. On that basis, the Commission will carry out an assessment of compliance with the recommendation addressed to Portugal under article 104(7), which called for bringing the excessive government deficit situation to an end by 2003 at the latest.

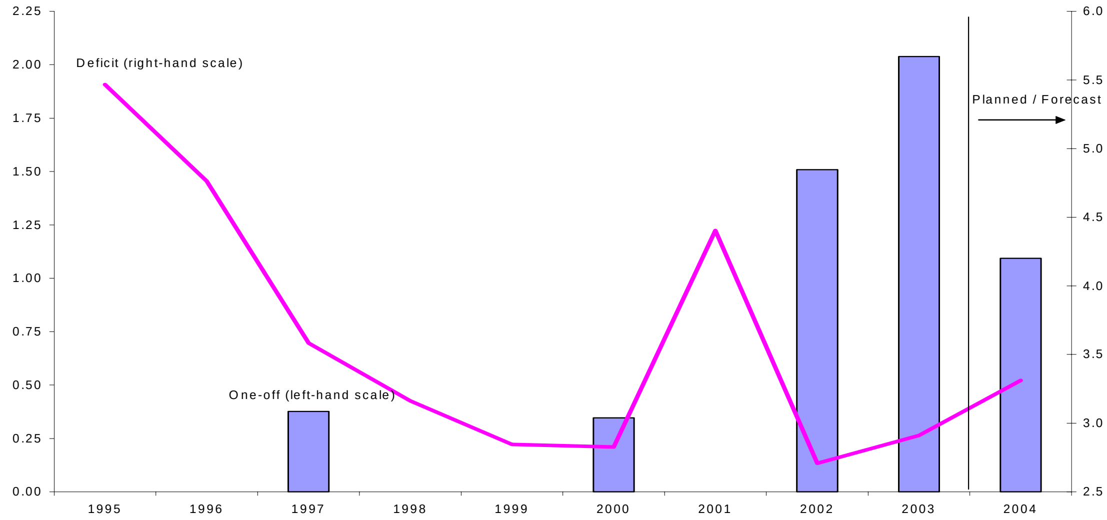
As regards government expenditure, the available information suggests that current primary expenditure is growing below budgetary targets in 2003. This corresponds to a significant deceleration in the annual growth rate from 8.1% in 2002 to about 4¼% in 2003. However, the expenditure-to-GDP ratio continued to rise in 2003, basically because nominal GDP increased by only about 2%, i.e. approximately 3 percentage points below the rate of 2002. The progress made on curbing current primary expenditure growth in 2003 reflects basically the strong deceleration in the growth of government consumption from 6.9% in 2002 to an estimated 2¾% in 2003, largely on account of a significant slowdown in the compensation of employees and a quasi-employment freeze. Social transfers grew by more than 12% in 2003, partly on the back of the phased convergence of lower pensions towards the minimum wage. In the medium-term, bringing the growth rate of social transfers more in line with nominal GDP growth will be necessary in order to restrain overall expenditure growth.

These revenue and expenditure developments would have led to a government deficit above 3% of GDP in 2003. In order to prevent this, without having to adopt an unduly restrictive budgetary stance, and to give extra-time for the ongoing programme of structural reforms to yield the expected benefits in terms of expenditure savings, the Portuguese authorities had to rely, for a second year running, on sizeable one-off measures worth 2% of GDP (see Box 2).

Box 2 : One-off measures

Although one-off measures have been adopted in the past (e.g. the sale of UMTS licences in 2000), it has been since 2002, i.e. after the excessive deficit situation, that the Portuguese authorities have been systematically recurring to significant amounts of one-off measures. On a national accounts basis, these one-off measures have been recorded as non-financial operations, thereby reducing the general government net borrowing. All these operations have been cleared by Eurostat.

Graph 3: One-off measures and the government deficit as % of GDP



Sources: National accounts, DG-ECFIN and the budget for 2004.

Two significant one-off measures were introduced in 2003, together worth 2% of GDP.

The first measure is a lump-sum payment to the government of € 930 million (0.7% of GDP) by the Post Office (CTT). In exchange, the government assumes the responsibility for paying pensions to a group of CTT's employees and former employees that enjoy the same retirement conditions of civil servants. According to the Eurostat decision of 21 October 2003 (Eurostat press release n°120/2003), "the counterpart transaction to a payment received by the government from a public corporation in the context of a transfer of unfunded pension obligations should be treated as an unrequited transaction, classified as capital transfer". Therefore, the Post Office's payment has been recorded as government revenue, with a favourable impact on the government deficit. However, this improvement of the government balance will be offset in the future by an increase of government expenditure in pensions.

The second measure is the sale to a foreign-owned financial institution of the right to the amounts to be collected in future concerning tax and social contribution arrears. The financial institution is expected to securitise these claims on tax payers. The sale amounted to € 1760 million (1.3% of GDP), while the nominal value of the tax arrears was almost € 11 500 million (or 8.7% of GDP). However, since these arrears accumulated over more than 10 years, many of these claims will probably never be collected or only by amounts much below their nominal value. If amounts effectively collected from taxpayers in future exceed the price paid to the government by the financial institution, the government is entitled to a share of the difference (also called deferred purchase price).

Eurostat agreed that this sale could be recorded in government accounts as non-financial revenue with a favourable impact on the government deficit. The Eurostat decision was based on two elements. First, taxes and social contributions are recorded in the Portuguese national accounts on a cash basis (or on modified cash bases). Therefore, the tax arrears had never been recorded in past as government revenue. This means that the uncollected taxes had not been recorded as revenue when they accrued. Therefore, the sale of tax credits to a financial institution should be treated as if banks lent money to tax payers to allow the later to pay their arrears and benefit from a tax amnesty. Moreover, the transaction also fulfilled the criteria established by Eurostat for the recording of securitisation (Eurostat press release n°80/2002 of 3 July 2002). The operation was a definitive and irrevocable sale to a financial institution of a claim, involving a full transfer of risks from government to the purchaser; the government did not grant any kind of guarantees and the assets were sold at a fair price, thus implying that the expected deferred purchase price is lower than 15% of the initial payment.

3.3 Adjustment in 2004

For 2004, the stability programme update projects a marginal decline in the general government deficit to 2.8% of GDP from an estimated 2.9% in 2003[12]. The cyclically-adjusted balance is projected to improve by 0.6 percentage point of GDP, which is a large adjustment given the planned reduction in the amount of one-off measures from 2% of GDP in 2003 to about 1.1% in 2004. Excluding one-off measures, the improvement in the cyclically-adjusted balance as calculated by the Portuguese authorities would amount to about 1½ percentage point of GDP in 2004. An adjustment of this magnitude in the stance of budgetary policy does not seem to correspond to the budgetary impact of the planned discretionary measures. Implicitly, the Portuguese authorities seem to be banking on large windfall gains resulting from the ongoing programme of structural reforms. According to the Commission's Autumn forecast, the cyclically-adjusted balance is projected to deteriorate by 0.1 percentage point of GDP in 2004. Excluding one-off measures, this would correspond to an improvement in the cyclically-adjusted balance of about 0.8 percentage point of GDP.

On the revenue side, the two main measures introduced in 2004 are: (i) the cut in the corporate tax rate from 30% to 25%[13]; and (ii) the reform of real estate taxation. The former is clearly revenue reducing, although the bulk of its impact is likely to fall in 2005, while at the time of writing it is too early to evaluate the net impact of the latter on revenue. Although the government plans to adopt additional measures to combat tax evasion and fraud[14], the net effect of all these measures is likely to be revenue reducing.

The Commission services, in their Autumn 2003 forecast, presented a less favourable projection for government revenue in 2004 on account of basically two factors: first, a less favourable assessment of the impact of the reduction in the corporate tax rate; and second, a possible carry-over effect from 2003 caused by a shortfall in the tax revenue projected for that year when compared with the national authorities' forecast. These risks remain high.

Total expenditure is forecast to drop in 2004 by 0.4 percentage point of GDP to 46.6%[15]. Three factors are essential for this outcome: (i) the pursuit of a policy of strict wage moderation[16] and a quasi-employment freeze in the general government; (ii) a substantial reduction in government investment worth an estimated 0.5 percentage point of GDP; and (iii) a substantial deceleration in the growth rate of social transfers from an annual average of almost 10% in the period 2000-2003 to slightly less than 4% in 2004.

A number of factors are contributing to the decline in the compensation of employees-to-GDP ratio, namely the policy of wage moderation, the quasi-freeze in hiring in the civil service, and the classification in the non-financial corporate sector of the hospitals transformed into publicly-owned enterprises. However, these favourable factors will be partly offset by the expected increase in social transfers in kind associated with the health-care reform. The feasibility of the planned reduction in the government

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12 In the Autumn 2003 Economic Forecasts, the Commission's deficit forecast for 2003 was also 2.9% of GDP.

13 The cut in the corporate tax rate aims to foster the supply side of the economy, by improving the profitability of investment and the competitiveness of firms.

14 *Inter alia*, the sharing of relevant data for tax purposes among the various tax administration services, and facilitating the access to (banking) information for investigative purposes.

15 By 0.9 percentage point of GDP in the Commission's Autumn forecast.

16 In the Commission's 2003 Autumn forecast, the growth rate of the wage bill in the general government sector was projected to decelerate from 6¾% in 2002 to about 1% in 2003.

investment-to-GDP ratio is questionable in view of the co-financing requirements of investment projects supported by EU funds.

All considered, given that the pension reform process is not yet completed and the catching-up of the lowest pensions towards the minimum wage is to be continued, the expected sharp deceleration in the growth rate of social transfers is difficult to explain.

3.4 Adjustment in 2005 and beyond

In the central scenario of the 2003 update of the stability programme, the general government balance is projected to improve by approximately 0.6 percentage point of GDP per year as from 2005. The general government deficit is projected to decline from 2.2% of GDP in 2005, to 1.6% in 2006 and to 1.1% in 2007.

In the period from 2005 to 2007, fiscal consolidation results from a projected 2 percentage points decline in the total expenditure-to-GDP ratio, more than offsetting a decline in the total revenue-to-GDP ratio by 0.7 percentage point of GDP, mainly on account of a substantial tax relief due to the cut in the corporate tax rate.

The reduction in the total expenditure-to-GDP ratio is to be achieved basically through a significant decline in the GDP share of government consumption, accompanied by smaller reductions in the shares of social transfers and government investment. From 2005 to 2007, the reduction in the government consumption-to-GDP ratio is projected to attain 0.9 percentage point of GDP, stemming from a sustained policy of wage moderation, the reduction in employment levels (to be obtained by the partial replacement of retiring civil servants), the setting of ceilings for the annual growth rate of nominal expenditure, particularly in sensitive areas, such as health-care and education, and the expenditure savings resulting from a broadly-based programme of structural reforms.

However, a number of risks involve the ambitious objective of reducing the ratio of total expenditure-to-GDP by 2 percentage points of GDP from 2005 to 2007. First, the reforms of public administration and of health-care are in their early stages, making it hazardous to estimate their impact on the pace of growth of (government consumption) expenditure over the medium-term[17]. Second, the programme update projects a reduction in the GDP ratio of social transfers from 16.4% in 2005 to 16.2% in 2007, basically on account of lower expenditure on unemployment benefits resulting from the gradual improvement in the labour market situation. No mention is made of the measures required to curb the strong pace of pension expenditure. Third, the government investment expenditure-to-GDP ratio is projected to decline from 2.9% of GDP in 2005 to 2.6% in 2007. Consequently, in 2007 the ratio of government investment expenditure-to-GDP is projected to be a total of 0.9 percentage point below the figure of 2003. This continuous reduction in the GDP share of government investment may not be consistent with the needs of a catching-up country.

All in all, the budgetary objectives for 2005 and beyond hinge crucially on the successful implementation of the envisaged expenditure restraint. The main risks are: (i) a possible overestimation of the saving gains resulting from the ongoing programme of structural reforms, together with the lack of appropriate measures to curb pension expenditure; and (ii) negative carry-over effects resulting from a possible shortfall in tax revenue for 2004, combined with a possible underestimation of the impact on revenue of the planned cuts in the corporate tax rate.

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[17] A strategy that banks on uncertain expenditure savings might be particularly hazardous when applied in combination with significant tax cuts, which involve quantifiable revenue losses.

3.5 Sensitivity analysis

The programme update provides a section on sensitivity analysis with two separate simulations. The first refers to the sensitivity of public finance to economic growth, the second to the interest rate.

As regards the sensitivity of public finance to economic growth, the programme update provides two alternative scenarios to the baseline/central scenario for the period from 2005 to 2007[18], which assume that annual real GDP growth is either lower or higher than the baseline by 1 percentage point each year. The analysis reported by the Portuguese authorities (implicitly) assumes deviations in growth to be fully cyclical, thereby not affecting the underlying budgetary position and potential output. In contrast, the sensitivity analysis carried out by the Commission assumes that deviations in growth do affect the underlying budgetary position and potential output. More specifically, the Commission sensitivity analysis methodology builds on the assumption that nominal non-cyclical expenditure will be invariant with respect to changes in the level of potential GDP across the alternative growth scenarios (i.e. nominal levels of non-cyclical expenditure planned by the authorities are implemented regardless of economic developments), while on the revenue side a standard stable elasticity between tax revenue and economic growth is assumed.

The results of the sensitivity analysis, using the Commission's methodology, are reported in Table 5. They differ from those obtained by the Portuguese authorities; the latter showing a higher amplitude to growth deviations, presumably on account of the higher estimates for the growth rate of potential output (see Section 2.2 and Table 2).

Table 5: Sensitivity to GDP growth

Impact of higher/lower growth in the cyclically-adjusted balance of a ±1.0 percentage point deviation of the real GDP growth rate from the stability programme central scenario

in % of GDP	**Central scenario**		**Low-growth scenario**		**High-growth scenario**	
	Targeted budget balance	**CAB***	Actual deficit*	**CAB***	Actual deficit*	**CAB***
2003	-2.9	-2.1	-2.8	-2.6	-2.8	-1.8
2004	-2.8	-1.7	-3.1	-2.3	-2.4	-1.3
2005	-2.2	-1.3	-2.8	-2.0	-1.5	-0.7
2006	-1.6	-0.9	-2.5	-1.7	-0.5	0.0
2007	-1.1	-0.7	-2.2	-1.5	0.3	0.4

*Commission calculations.

Source: Stability programme update of 2003.

The main result of the sensitivity analysis of public finance on growth deviations is the following: the cyclically-adjusted balance is estimated to deteriorate by a cumulative 0.8 percentage point of GDP in the final year of the programme period compared with the central scenario, if the lower growth scenario were to occur. As a result, the close to balance or in surplus position would be postponed beyond the end-period of the programme and the annual budgetary consolidation would be lower than the ½% of GDP benchmark. Put differently, additional measures in the order of 0.8 percentage point of GDP would be

18 Notice that the Portuguese authorities have not carried out any sensitivity analysis for 2004, taking as "fixed" the projections/assumptions of the 2004 budget.

necessary to keep public finance on the path targeted in the central scenario. Conversely, in the event of higher growth, the close-to-balance or in surplus position in cyclically-adjusted terms would be achieved in 2006.

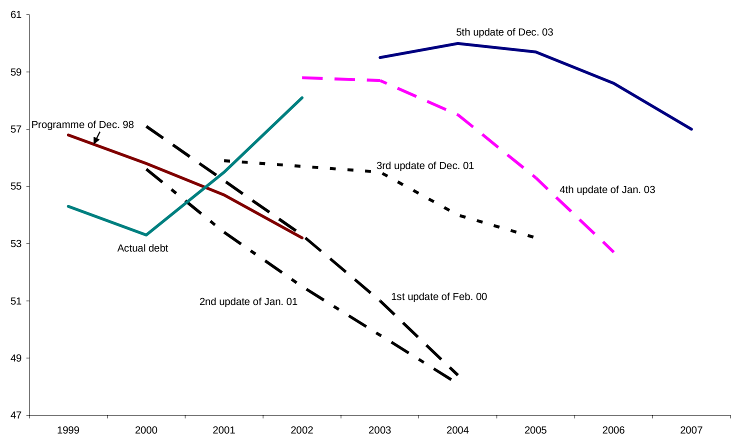
The programme also provides a sensitivity analysis of public finance on interest rates deviations. The effect of an upward/downward shift in the yield curve by 1 percentage point over the period 2005-2007 is calculated. The outcome of this simulation suggests that interest rate deviations have a markedly lower impact on public finance than those resulting from growth deviations.

3.6 The government debt ratio

The recent evolution of the general government gross debt-to-GDP ratio underlines the urgency of consolidating public finances. It is striking to observe that the debt ratio currently planned for 2004 is almost 12 percentage points of GDP higher than the figure planned only three years ago (2nd update, January 2001). This is the result of a number of factors, such as: (i) lower GDP growth than projected; (ii) repeated overruns of budgetary expenditure plans; (iii) the budgetary slippage of 2001; and (iv) significant financial operations.

The debt-to-GDP ratio is planned to decline by 3 percentage points of GDP between 2004 and 2007, attaining 57% in 2007.

Graph 4: Debt paths for the original and all subsequent updates, and the actual debt (as % of GDP)



Sources: The stability programme and national accounts.

According to Commission calculations (see Table 6), which roughly coincide with those in the programme update, changes in the debt ratio can be broken down basically between the contributions of the primary balance, interest payments and nominal GDP. In the period from 2003 to 2007, the stock-flow adjustment is estimated to account on average for just about 0.1 percentage point of the annual change in the gross debt ratio, although it is somewhat higher (in absolute value) in 2004 when the debt ratio attains the exact figure of 60% of GDP[19]. Therefore, the stock-flow adjustment is

[19] It should be highlighted that the programme update omits data for privatisation receipts, thereby it is not possible to calculate a "cash-based" deficit. A "cash-based" deficit can be calculated from the ESA-95 "accruals-based" deficit, basically by correcting for four factors: privatisation receipts, changes in total cash balances, exchange rate and other valuations effects, and one-off measures. An "accruals-based" deficit measure is particularly useful to spell out the transition between variations in government debt and the "accruals-based" deficit measure used in the framework of the excessive deficit procedure. On this issue see the Bank of Portugal's 2002 Annual Report, pages 97 to 101.

For the period from 1998 to 2002, the Commission services estimate an average "cash-based" deficit of 6.5% of GDP compared with a value of 3.2% of GDP for the "accruals-based" deficit used in the framework of the excessive deficit procedure.

projected to nearly vanish during the programme period, in sharp contrast with the high value of about 1½% of GDP on average per year registered in the period from 1998 to 2002.

Table 6

Contributions to the change in the general government gross debt-to-GDP ratio

(as % of GDP)	2003	2004	2005	2006	2007
Change in the government debt ratio	**1.5**	**0.5**	**-0.4**	**-1.1**	**-1.5**
Contributions from:					
Primary balance	0.1	-0.1	-0.9	-1.5	-2.0
Interest expenditure	2.9	2.9	3.1	3.0	3.0
Real GDP growth	0.5	-0.6	-1.4	-1.6	-1.7
GDP deflator	-1.6	-1.3	-1.1	-1.2	-1.2
Stock-flow adjustment	-0.4	-0.5	0.0	0.1	0.3
Level of government debt ratio	**59.5**	**60.0**	**59.7**	**58.6**	**57.0**

Sources: Commission calculations and the 2003 programme update.

4. QUALITY OF PUBLIC FINANCES

Fiscal consolidation is planned to be achieved through a broadly-based programme of structural reforms, combined with a policy of restraint for government consumption and investment. As stated above, this strategy is projected in the update to bring about a cumulative decline of nearly 3.5 percentage point in the ratio of total government primary expenditure-to-GDP from 2003 to 2007. The information provided in the 2003 update, concerning the composition of the expenditure adjustment, suggests that about 1/4 of it falls on investment expenditure. The remaining adjustment in expenditure is planned to involve basically government consumption, which is expected to decline not only due to wage and employment restraint, but also because of the deceleration in the growth rate of health-care expenditure, brought about by a comprehensive reform of the sector. At the same time, the Portuguese authorities decided to cut the corporate tax rate, in a first step from 30% in 2003 to 25% in 2004 and, in a second step, to 20% in 2006. This measure aims to improve supply conditions by fostering the attractiveness of Portugal for investors and improve the competitiveness of firms. However, such measure is costly, implying (according to a conservative government estimate) a cumulative reduction of 0.8 percentage point of GDP in tax revenue in the period from 2003 to 2007.

Since 2001, pension schemes (both the general social security and the civil servants) are being reformed in order to strengthen their long-term sustainability. As regards the former, the formula used to calculate the reference wage was modified in 2001: benefits will eventually be based on the entire working career and no longer on the best 10 out of the last 15 contribution years, while the accrual rate was increased from a flat rate of 2% per year to a progressive schedule ranging from 2% to 2.3%. Calculations made for the *National Strategy Report* on the pension system by Rodrigues (2002)[20] find evidence suggesting that the abovementioned reform may have actually worsened the long-term sustainability of the general social security pension regime, because the expenditure savings resulting from use of

20 Rodrigues P. (2002), “Social Security in Portugal: An Update of Long-Term Projections”, DGEP Working Paper n°27.

the whole contributory record for the purpose of calculating the reference wage are dominated by the expenditure rising effect of increasing the accrual rate. As regards the civil servants pension scheme, legislation was ratified at the beginning of 2004 which reduced the generosity of this scheme when compared with the general social security pension scheme[21]. Starting in 2003, the Portuguese government is implementing a phased convergence of the lowest pensions towards the minimum wage, which is to be completed by 2006 at the latest. The long-term scenario for social security in the 2003 programme seems not to have been updated to take into consideration the effects of the reform of the civil servants' pension scheme, the planned convergence of the lowest pensions towards the minimum wage, and the projected capping of social security contributions (see the Portuguese 2003 *Cardiff Report*).

5. SUSTAINABILITY OF PUBLIC FINANCES

5.1 Quantitative indicators

The assessment of the sustainability of Portuguese public finances is based on both quantitative and qualitative indicators. The quantitative indicators are run on the basis of a commonly agreed methodology by the Economic Policy Committee (EPC)[22]. The purpose of the indicators is to signal possible imbalances on the basis of current policies and projected age-related expenditure trends. However, the limitations of this exercise are clear and results of these quantitative indicators need to be interpreted with caution. Being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of possible or even likely outcomes and should not be taken at face value. Instead, the indicators are a tool to facilitate policy debate and at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of "no policy change". The quantitative indicators project debt and budget balance developments according to two different scenarios, to take into account uncertainties over the medium-term. The "programme" scenario is calculated on the following basis:

- Macroeconomic assumptions on GDP growth from 2008 onwards, interest rates and inflation are based on the agreed assumptions used in the EPC;
- The projections for age-related expenditures come from the stability programme. This includes the EPC's projections on health-care, long-term care, education and unemployment benefits, while pension projections rely on national estimates which take into account the effects of the 2001 reform of the general social security pension regime;
- The projections for government revenues come from the programme update. They are kept constant at the (cyclically-adjusted) level of 2007;
- The starting levels for gross debt and the primary balance are those reported in the programme update for 2007.

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21 The changes to be implemented in January 2004 include: (i) the calculation of new pensions based on the last net wage (instead of the last gross wage), and (ii) penalties for retirement before 60 years of age even for pensioners with the full contributory career of 36 years. Entry to this regime was closed in 1 September 1993. After that date, the pension rights of new civil servants follow the same rules of the general social security pension scheme.

22 See the Report "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme" (October 2003), available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf.

The "<u>2003 position</u>" scenario is based on the budgetary data of the programme update for 2003. From 2008 to 2050, debt levels are extrapolated assuming that no budgetary consolidation takes place (i.e. the cyclically-adjusted primary balance in 2008 remains at the level of 2003), and no stock-flows operations.

Table 7 presents the debt and budget balance developments according to the two different scenarios. Overall, age-related expenditure is foreseen to increase by 1.4 percentage point of GDP from 2008 to 2050. Increases in pension and health-care expenditure are only partially offset by a slight decrease in education expenditure. According to the Portuguese programme update, changes in the general social security pension regime introduced in 2001 will reduce the increase of pension expenditure by 1.1 percentage point of GDP up to 2050.

Table 7

Long-term sustainability: summary results

Main assumptions - baseline scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Total age-related spending	22.5	22.6	23.4	23.7	23.8	23.8	1.4
Pensions	11.3	11.5	12.3	12.5	12.3	12.1	0.8
Health care	5.3	5.3	5.5	5.8	6.0	6.1	0.8
Education	5.4	5.3	5.1	4.9	5.0	5.1	-0.3
Unemployment benefits	0.5	0.5	0.5	0.5	0.5	0.5	0.0
*Total primary non age-related spending**	18.1						
*Total revenues**	43.9						

* constant

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Programme scenario							
Debt	53.8	48.0	24.8	5.3	-15.5	-42.4	-96.2
Net borrowing	0.3	0.4	0.9	1.6	2.7	4.1	3.8
2003 scenario							
Debt	62.2	60.9	62.1	72.1	94.3	127.6	65.4
Net borrowing	-2.3	-2.4	-3.1	-4.0	-5.3	-7.1	-4.8

Sustainability gap	S1*	S2**
Programme scenario	-0.8	-0.4
2003 situation scenario	1.6	1.8

* S1 measures the difference between the current tax ratio and the tax ratio that would ensure a debt level in 2050 as resulting from a balance budget position over the projection period. A positive sustainability gap indicates that there is a financing gap to reach this debt level in 2050. P.m. debt to GDP ratio at the end of the period: 11.6%

** S2 indicates the change needed in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

The two scenarios can be used to check whether the projected debt level ever breaches the 60% of GDP reference value of the Treaty. *A priori*, such an event would signal the risk of budgetary imbalances in the face of an ageing population, and the need to take discretionary measures to put public finances on a sustainable footing.

According to the quantitative indicators, the risk of unsustainable public finances cannot be ruled out for Portugal. The consolidation path depicted for the medium-term will allow a reduction of the debt-to-GDP ratio, an outcome which would be facilitated by the completion of the ongoing process of pension reform. However, an upward trend emerges if Portugal fails to consolidate during the programme period. Under this scenario, the accumulated deficit and the increase in age-related expenditure could put Portugal on an unsustainable path.

A sustainability gap therefore arises if no consolidation takes place in the medium-term.

5.2 Additional qualitative features

As underlined in the EPC report on "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme" (October 2003)[23], several qualitative factors should be taken on board to avoid a mechanistic interpretation of quantitative indicators.

On the positive side, there is the commitment to control health-care expenditure over the medium-term, through expenditure ceilings and a comprehensive programme of structural reforms.

On the negative side, it is not sufficiently clear if the pension reforms already introduced will actually curb future pension expenditure[24]. The calculation reported in the programme update seems not to have taken into consideration the impact of some measures which have already been taken or are planned to be, notably the changes to the civil servants' pension regime ratified at the beginning of 2004, the phased convergence of the lowest pensions towards the minimum wage, and the planned capping of social security contributions. Therefore, at the time of writing, it is doubtful that the pension reforms already introduced will actually suffice to curb future growth in pension expenditure.

The high deficit level and the rising debt ratio also warrant attention. A comprehensive strategy to ensure long-term sustainability requires successful consolidation over the medium-term. It is particularly important to avoid that the savings resulting from curbing age-related expenditure will be squandered by increasing interest expenditure.

Completion of the pension reform process remains an issue. In part, because the 2001 reform of the general social security pension regime might not bring about the initially expected gains in terms of expenditure restraint due to the long transition period for the introduction of the new formula to calculate the reference wage, together with the rise in the accruals rate.

5.3 Overall assessment

The Commission considers that, on the basis of the current policies, risks of imbalances cannot be completely ruled out for Portugal. The high deficit and the rising debt-to-GDP ratio are a source of great concern for long-term sustainability, and it is imperative that Portugal reaches a balanced budget. Failure to do so would imply a rising debt ratio over time once the impact of ageing takes place.

The budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. This strategy is mainly based on budgetary consolidation over the medium-term, resulting from government consumption restraint, and the expected gains from the completion of structural reforms. A strict monitoring of pension and health-care expenditure trends is crucial to avoid future budgetary imbalances.

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[23] Available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf.

[24] The 2001 reform of the general social security pension regime has two main elements: first, benefits will eventually be based on the entire working career and no longer on the best 10 years of the last 15 contribution years; and second, the accrual rate is increased from a flat rate of 2% per year to a progressive schedule ranging from 2% to 2.3%. As discussed in Section 4 of the assessment, there is evidence suggesting that the latter effect (expenditure rising) may actually outweigh the former effect (expenditure reducing).

ANNEX 1:
SUMMARY TABLES DERIVED FROM THE 2003 STABILITY PROGRAMME UPDATE

Table A- 1: Growth and associated factors

	2002	2003	2004	2005	2006	2007
GDP *growth* at *constant* market prices (7+8+9)	0.4	-0.8	1.0	2.5	2.8	3.0
GDP *level* at *current* market prices (€ bn)	129.3	132.0	136.3	142.5	149.6	157.4
GDP deflator (% change)	4.6	2.8	2.2	2.0	2.1	2.1
HICP (% change)	3.7	3.3	2.0	2.0	2.0	2.0
Employment growth	0.2	-0.8	0.4	1.2	1.3	1.4
Labour productivity growth	0.2	0.0	0.7	1.3	1.4	1.6
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	0.6	-0.7	0.5	2.0	2.5	2.7
2. Government consumption expenditure	2.8	-1.3	-0.5	0.0	0.2	0.2
3. Gross fixed capital formation	-5.3	-7.0	2.5	5.0	6.2	6.5
4. Changes in inventories and net acquisition of valuables as a % of GDP	0.0	-0.2	0.0	0.0	0.0	0.0
5. Exports of goods and services	2.1	2.9	5.6	6.4	6.6	6.6
6. Imports of goods and services	-0.4	-2.6	4.0	5.2	6.3	6.4
Contribution to GDP growth						
7. Final domestic demand (1+2+3)	-0.5	-2.4	0.8	2.4	3.0	3.2
8. Change in inventories and net acquisition of valuables (=4)	0.0	-0.2	0.0	0.0	0.0	0.0
9. External balance of goods and services (5-6)	0.8	1.9	0.2	0.1	-0.2	-0.2
Basic assumptions						
Short-term interest rate (annual average)	3.3	2.3	2.3	3.2	3.3	3.4
Long-term interest rate (annual average)	5.0	4.2	4.5	4.9	5.1	5.2
Exchange rate USD/€ (annual average)	0.94	1.15	1.16	1.16	1.16	1.16
World real GDP growth	2.8	3.3	4.1	4.1	3.7	3.8
EU-15 real GDP growth	1.1	0.8	2.0	2.4	2.5	2.6
Growth of relevant foreign markets	1.5	3.1	5.7	7.1	7.2	7.5
World import prices	---	8.2	1.8	0.7	0.0	0.0
Oil prices (Brent, USD/barrel)	25.0	28.3	25.6	24.1	24.1	24.1

__Table A-2. General government budgetary developments__

as % of GDP	2002	2003	2004	2005	2006	2007
Net lending by sub-sectors						
1. General government	-2.7	-2.9	-2.8	-2.2	-1.6	-1.1
2. Central administration	-2.9	-3.6	-3.0	-2.4	-1.8	-1.5
4. Local and regional administration	-0.4	-0.1	0.0	0.0	0.0	0.0
5. Social security funds	0.7	0.8	0.2	0.1	0.3	0.4
General government						
6. Total revenue	43.3	44.1	43.7	43.2	42.9	42.5
7. Total expenditure	46.1	47.0	46.6	45.5	44.5	43.5
8. Budget balance	-2.7	-2.9	-2.8	-2.2	-1.6	-1.1
9. Interest expenditure	3.0	2.9	2.9	3.1	3.0	3.0
10. Primary balance	0.3	-0.1	0.1	0.9	1.5	2.0
Components of revenue						
11. Taxes	24.7	23.8	23.7	23.5	23.4	23.0
12. Social security contributions	12.2	12.4	12.7	12.6	12.6	12.6
13. Other	6.4	7.9	7.3	7.1	6.9	6.9
14. Total revenue	43.3	44.1	43.7	43.2	42.9	42.5
Components of expenditure						
15. Public consumption	21.1	20.9	20.1	19.6	19.2	18.7
16. Total social transfers	14.8	16.2	16.5	16.4	16.3	16.2
17. Interest expenditure	3.0	2.9	2.9	3.1	3.0	3.0
18. Subsidies	1.5	1.7	1.8	1.8	1.7	1.6
19. Gross fixed capital formation	3.4	3.5	3.0	2.9	2.8	2.6
20. Other	2.3	1.7	2.3	1.7	1.5	1.5
21. Total expenditure	46.1	47.0	46.6	45.5	44.5	43.5

Table A- 3: Revenue and expenditure projections: comparison of the last two updates

(as % of GDP)

		2002	2003	2004	2005	2006	2007
2003 update	Total revenue	43.3	44.1	43.7	43.2	42.9	42.5
	of which: tax and social contributions	36.9	36.2	36.4	36.1	36.0	35.6
	Total expenditure	46.1	47.0	46.6	45.5	44.5	43.5
	of which:						
	primary expenditure	43.1	44.1	43.7	42.4	41.5	40.5
	interest expenditure	3.0	2.9	2.9	3.1	3.0	3.0
	gross fixed capital formation	3.4	3.5	3.0	2.9	2.8	2.6
2002 update	Total revenue	43.7	44.4	43.9	43.6	43.0	---
	of which: tax and social contributions	36.5	36.8	36.6	36.5	36.2	---
	Total expenditure	46.6	46.9	45.8	44.7	43.5	---
	of which:						
	primary expenditure	43.6	43.6	42.7	41.7	40.6	---
	interest expenditure	3.0	3.3	3.1	3.0	2.9	
	gross fixed capital formation	3.7	3.8	3.6	3.5	3.4	

Sources: The 2002 and 2003 updates of the stability programme.