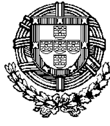

PORTUGUESE REPUBLIC

STABILITY AND GROWTH PROGRAMME

2005- 2009

June 2005

This Stability and Growth Programme for the 2005 to 2009 period has been submitted to the European Commission by the Portuguese Government within the framework of the multilateral supervision of budgetary positions and the coordination of economic policies within the European Union. The Programme was approved in the Council of Ministers on 2 June 2005 and was then discussed in Parliament on 9 June 2005. The presentation of the Programme is behind schedule (the normal point in the calendar being December) because of the general election in February of 2005. Political conditions precluded the presentation of a complete update at the end of 2004.

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1. Summary and main objectives

The Portuguese Stability and Growth Programme is based on a strategy for economic development and consolidation of public accounts for the 2005 to 2009 period. Measures and reforms are included which seek to come to terms with the very worrying current Portuguese budgetary situation and create the conditions for sustained economic growth.

The independent commission chaired by the Governor of the Bank of Portugal (the Constâncio Commission), in its Report of 23 May, stated that the Budget for 2005 was likely to take the budget deficit to 6.8% of GDP by the end of the year if no additional consolidation measures were taken. This stemmed from the structural trend towards growth in social expenditure, the budget-related decisions taken during 2004 and shortfalls in the 2005 Budget.

In tandem, the public debt ratio has been climbing steeply. From the 2000 figure of nearly 53% of GDP, it moved up to such an extent that it topped the 60% of GDP reference figure in 2003 and stood at 62% at year-end 2004. According to the Constâncio Commission, we would be looking at a figure close to 67% by the end of 2005, in the absence of additional measures.

The measures taken in Portugal between 2002 and 2004 to control the deficit had a twofold aim: to rein in current primary expenditure (above all by freezing salary scales in the public service and by making horizontal cuts in central government intermediate consumption); and to increase tax receipts (specifically by raising VAT from 17% to 19%). The figures available for 2002 relating to the variation in the underlying primary balance show a slight consolidation (0.5% of GDP). This balance is defined as the cyclically-adjusted primary balance[1] net of temporary measures and asset sales. However in 2003 and 2004 there was a steep rise in expenditure, above all in health and social security. To this should be

[1] Using the same method as for the European Commission staff.

added the fact that the measures focusing on expenditure constraint were fundamentally to hold off increases and were not complemented by structural reforms that would ensure sustained control of public expenditure and attack the causes of its growth. Moreover, on the revenue side, the steps taken failed to achieve the effects expected by the Government, as the economy slid into recession. Thus, in the last two years, the Portuguese budget deficit was only formally below the 3% of GDP limit. The actual figure was over 5% of GDP when excluding the effects of huge extraordinary receipts. On top of this, the Budget for 2005 gave contradictory signs of the direction of budgetary policy and failed by a long shot to reflect the true dimension of the deficit and the size of public expenditure. The reasons for this were underestimates of budget expenditure and forecasts for massive extraordinary receipts that were in fact unfeasible or non-existent.

The weak growth of the Portuguese economy over recent years has clearly contributed to making the budgetary situation more serious. In the 2002-2005 period, the annual average rate of GDP growth looks to have been less than 0.3% (nearly one percentage point less than the average in the euro area).

The Portuguese Government has taken this budgetary situation into consideration, along with the highly unfavourable dynamics of public debt. In this Programme it asserts its determination to follow a coherent budgetary consolidation strategy. It will adopt structural measures to curb the expansion of current primary public expenditure. Given the size of the deficit and the fragile economic and social situation in Portugal, which has been dragging on for years, the Government has adopted a gradual approach in its budgetary consolidation policy. Nonetheless, this is to be carried out with a tight and unflinching rein over the next few years, without losing track of the goals of achieving economic growth and job creation.

The Government’s Programme was spelt out in Parliament on 22 March of this year. It established that budgetary consolidation will be carried out without recourse to accounting expediencies. These frequently artificially improve the picture in a given year while deteriorating the budget situation in future years. The Government is determined to increase the transparency of the public accounts, as well as its own budgetary procedures. It believes that this transparency is an important factor in making the economic and financial policy credible and galvanising Portuguese society for the real consolidation effort that lies ahead.

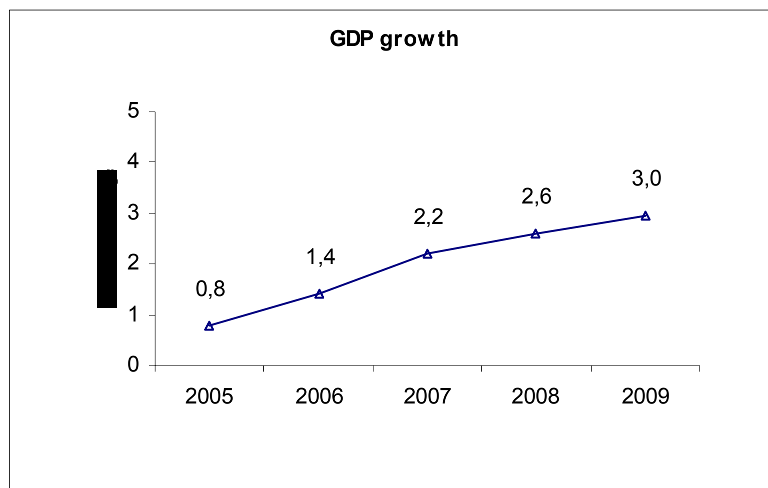
The Stability and Growth Programme therefore takes the following as its crucial aims for the 2005-2009 period: an economic growth path allowing the economy to convergence towards European levels, reaching a GDP growth rate of 3% by 2009; a sharp reduction in the overall deficit from the current 6.8% (without additional measures) to a figure below 3% in 2008; and a reduction of public debt from the current 67% to 64.5% in 2009.

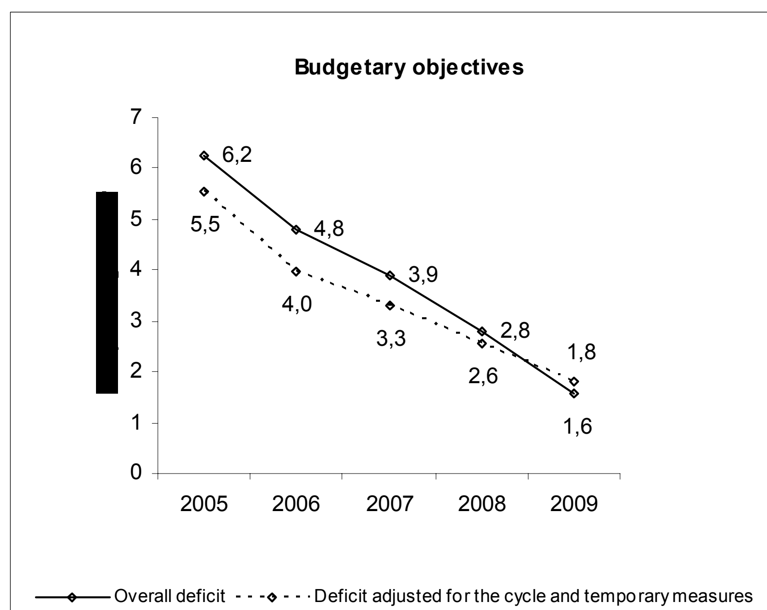
In terms of budgetary consolidation, the Government's top priority is therefore to reduce the deficit from the forecast of 6.8% of GDP (by the Constâncio Commission, assuming no additional measures) to below 3% in 2008 (without recourse to temporary measures). To do all this, the Programme has mapped out a steady but strict downward path for the budget deficit. The deficit should be down to 6.2% this year and then 4.8%, 3.9%, 2.8% and 1.6% in the following years, up to and including 2009 (see Chart 1.1).

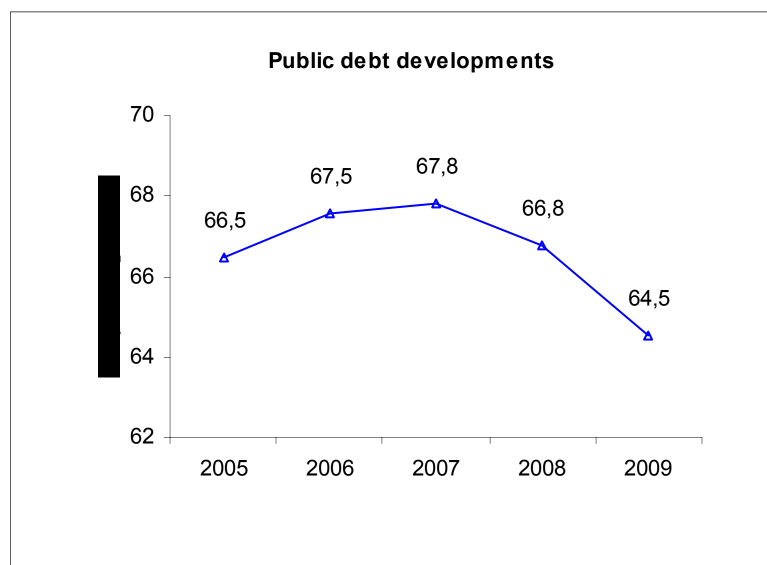
The Government is well aware that stability and growth programmes should present, at least for the final year of the period, a balance of the public accounts as a percentage of GDP consistent with a medium-term objective. This objective should ensure, among other things, a safety margin sufficient to avoid the 3% deficit ceiling being topped in normal cyclical conditions, when the automatic budgetary stabilisers cut in. The level of public debt must also, of course, be borne in mind. According to the European Commission staff, the desirable medium-term objective should mean, for Portugal, an underlying deficit of around 0.5% of GDP. However, the point of departure is high. The consolidation path will require immense effort. As a result, the underlying deficit estimated for 2009 stands at 1.8% of GDP. It is not realistic to consider going farther in this timeframe. This means that the budgetary consolidation now under way will not peter out at the end of the Government's mandate: the curbing of public expenditure growth will have to continue.

Although the Government has put together an ambitious package of budgetary measures for this Programme and will continue with the privatisation of state-owned enterprises, the public debt ratio will continue to rise until 2007, when it will reach 68% of GDP. This inertia is inevitable given the high point at which the deficit now stands and the still sluggish growth projected. In 2008 and 2009, with lower deficits and greater economic dynamism, the public debt ratio will start to go down again and will stand, as mentioned above, at a figure slightly below 65% of GDP in 2009.

Chart 1.1
GDP growth and budgetary projections







The Government's Stability Programme is also a Programme for Growth. The aims are for economic growth, real convergence and a bolstered competitive edge, following the guidelines set down in the Lisbon agenda.

In this field, it is important to notice that efforts will be made to ensure that budgetary consolidation is not undertaken at the expense of public investment. Public investment, in its component non co-funded by the EU, will rise by an average of some 15% per year through the Government's term in office. This will offset in part the expected slowdown in the flow of structural funds towards the end of the III Community Support Framework and in the early years of the next Financial Framework.

This investment effort - framed within a Technological Plan recently adopted by the Government - will be pinpointed first and foremost to building a knowledge-based society, with skilled human resources, technological progress and innovation. These, in short, are the decisive factors for improvement in productivity and competitiveness. There must be close articulation with the country's entrepreneurs, especially focused on companies in export-oriented sectors.

The Government is aware that the Portuguese economy will only develop over the coming decades if there is a response to the growing competition in the economic global market and the increasing path of technological transformation in innovatory sectors. The Technological Plan is therefore not fundamentally a programme of public investment or of State intervention but an appeal to the capacities of people and companies. The overall idea is to foster scientific research, spur the interchange of know-how between universities and enterprises and promote policies that simplify the creation and growth of enterprises at the cutting edge, especially those associated with new technologies and the creation of skilled jobs.

This and other options in the Government's economic policy, which is not circumscribed to the budgetary consolidation strategy, can play their part in cutting back the potential negative impact on economic growth that may come in the wake of the consolidation measures being put into place.

The reduction of the structural deficit will come above all from the effects of the package of measures adopted by the Government. The cumulative progress of the so-called underlying balance (the balance adjusted for cyclical effects, temporary measures and sales of assets - the method proposed by the European Commission staff) will stand at 2.8 p.p. of GDP between 2004 and 2009. The consolidation effort for each of these years, except for 2005, goes beyond the annual minimum recommended, i.e. 0.5 percentage points. For 2005, although the measures taken by the Government only impact on the second half of the year, the improvement in the balance will come in at 0.6%, in relation to the forecast of the Constâncio Commission.

Among the measures described in this Programme, it should be highlighted those concerning the reform of public administration and on personnel expenditure, a particularly important item of current primary expenditure. The Government is aware of one of the great challenges facing the Portuguese economy in the coming years: tight control of growth in personnel expenditure to reduce its share on GDP, without hindering a significant improvement in the quality of public services.

The Government intends to adopt structural measures to curb expenditure. Within all the legal procedures, the Government will approve, in 2006, to be in force from the beginning of 2007, a new career and remuneration system geared to the creation of incentives for staff performance, giving managers of public bodies the management tools to streamline the use of human resources. In a more immediate phase, before the new system is adopted, the up-grading of salary scales will be limited and automatic career promotion will be frozen.

The Government will also limit fringe benefits and pay for top management of state-owned enterprises. This measure will be taken for reasons of justice and fair play, although it would not have any direct effect on the public accounts.

Revised conditions will also come into play related to the allocation of public servants on a Surplus Staff Exchange. The purpose of this is to increase mobility in the public service and adapt human resources more efficiently to service requirements.

A wide-ranging programme is set to begin on the restructuring and modernising of the public services. Each ministry will revise functions, hierarchical organisation and procedures, streamlining services, leading to curbing expenditure and increasing public expenditure effectiveness.

Independently of the outcome of the overall restructuring, the Government will submit sectoral programmes with measures involving various ministries. The aim is immediate intervention to tackle excess expenditure, in particularly in health and education.

There will also be measures to rationalise the management of State assets and administrative logistics.

State budgets and the new laws covering regional and local finances will also contain measures to ensure that regional and local government contribute to budgetary consolidation and control of expenditure.

The Government's Programme stipulates specific measures for social security, designed to ensure its sustainability and fairness. The measures will have a positive impact on the structure of public expenditure, yet will not mean foregoing more social justice and action to reduce poverty, which still afflicts a proportion of the population, especially the old.

One of the most intractable problems of social security sustainability is the public servants' sub-system, where benefits are much greater than those in the private sector social security system. With this in mind, the government is going to adopt an ambitious reform programme, which will seek to close the gap between the public and private sectors. People's rights will be upheld, but the public service system will gradually be dovetailed with the private sector system.

From January 2006, newly recruited public servants will not be covered by the provisions of the specific pension scheme that exists now, CGA – Caixa Geral de Aposentações. They will be covered by the standard terms for private sector system.

For those now working in public service a number of changes will take place in the way their pensions are calculated, the age of retirement and the years of service required for pension purposes, moving towards the conditions in the private sector system.

There are also a number of special regimes which will be overhauled or cut out altogether. They cover retirement age, the way pensions are calculated and special benefits for various bodies and also for those holding public office.

As far as the private sector social security system is concerned, a working group has been set up to assess its long-term sustainability. This will enable the Government to take decisions with respect to the needed measures.

Certain relevant measures will be shortly taken. Early retirement schemes will be cut back, unless they are related to disability. And the same applies to special situations where the law as it stands allows for an under-65 retirement age.

For the self-employed, the minimum contribution for social security will no longer be based on one minimum salary but one and a half.

One of the Government's aims is social justice. It will therefore not forego measures to reduce the numbers below the poverty line in Portugal. A top-up income scheme will gradually be introduced, for the benefit of the very elderly. This will guarantee a minimum income of 300 euros per month.

Some of the measures on the expenditure side will take some time to cut in while it is necessary to immediately offset the worsening financial situation of the social security system, including the CGA scheme. For this reason, the Government is raising the standard rate of VAT from 19% to 21% as and from 1 July of this year. The revenue generated will be channelled into the private sector social security system and the CGA.

The country's budgetary imbalance is so large that other measures to boost fiscal revenues are needed in addition to hold down public expenditure. Two indirect taxes will therefore be adjusted upwards in real terms. These are the tax on oil products (ISP) and tobacco tax. In addition, a new personal income tax bracket will be introduced, for reasons of justice and fairness. Personal annual income above 60 thousand euros will be subject to a marginal rate of 42%, ensuring that taxpayers on higher incomes will have a bigger part to play in the budget consolidation process.

The tax system is being simplified and made fairer. The major points are cuts in the special schemes, a revision of the tax benefit system and improvement to the efficiency of the Tax Administration. In tandem, the Programme sets in place measures for drastic cuts in tax evasion and fraud. Such action is also necessary for greater fairness in sharing the cost of budget consolidation. One special measure stands out: fiscal secrecy will partially be eliminated, meaning that personal gross annual income will be made public, creating a disincentive to tax fraud.

The management of the State's financial assets and real estate will also be rationalised. In terms of financial assets, the State's portfolio of holdings will be redefined and rationalised. Companies in non-strategic sectors will be privatised, a process that will help counter the negative dynamics of the public debt stock.

As for state-owned real estate, there will be a better use of space by public services, a cut in the number of public administrative structures and an improved management of real estate property in excess. Efficient use of unused property will increase, either by disposals, or by reallocation of services that at the moment are located in rented private property.

The raft of measures to be taken demonstrates the Portuguese Government's determination to tackle the budgetary crisis in a sustained fashion. But the projections in the Programme cannot hide the uncertainty in the underlying macroeconomic projections, and these include the very size of the adjustments that are needed. If the margin of error in the projections is taken into consideration, then the aim of reaching a deficit figure below 3% of GDP as and from 2008 could be jeopardised if certain risks materialise and no additional corrective measures are taken. This may happen, for instance, if the external environment worsens during the period under review or if there are more serious negative effects than assumed on export market shares that will result from the opening of trade to products from China. Another factor that could dampen growth, and impact negatively on the budgetary situation, is the possibility of interest rates rising more steeply than assumed in the baseline scenario.

The Portuguese Government will monitor the situation very carefully, and, as long as changes in the macroeconomic scenario are not too big, it undertakes to adopt additional measures to achieve a budget deficit below 3% of GDP in 2008 even if a worsening economic climate persists. From the opposite angle, were favourable conditions for growth to come into play, the Government pledges not to loosen the reins on the package of measures in this Programme: favourable conditions will mean that the medium-term objective for budgetary consolidation will be more quickly reached.

The Government is seeking, through this Stability and Growth Programme, to reach real budgetary consolidation as quickly as possible. This is a necessary, though not sufficient, condition for the Portuguese economy to gain greater momentum and for its economic growth not to be buffeted so much by wildly veering cyclical winds.

2. Macroeconomic and budgetary framework

2.1. The Portuguese economy in 2004

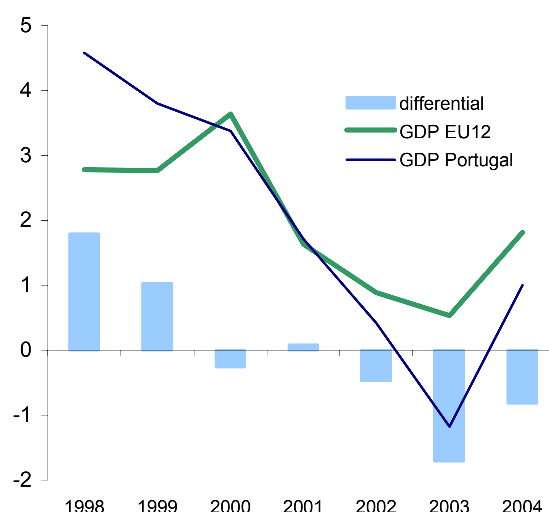
The Portuguese economy grew 1.0% during 2004, after the 2003 fall of 1.1% (see Table 2.1). The pattern of recovery over the year was patchy, with a significant spurt in the first half and then a slowdown in the second half. In spite of the recovery, the rate of growth of the economy was still, for the third year running, below the euro area average (Chart 2.1).

Table 2.1
GDP and expenditure components
Real rate of change, %

	2001	2002	2003	2004
Private consumption	1,2	1,1	-0,3	2,3
Public consumption	3,3	2,3	0,3	1,2
Investiment (GFCF)	0,8	-5,1	-9,9	1,3
Domestic demand	1,5	-0,3	-2,5	2,1
Exports	1,4	2,0	5,0	5,1
Imports	1,1	-0,2	-0,1	7,0
GDP	**1,7**	**0,4**	**-1,1**	**1,0**
Contributions to real GDP growth (percentual points):				
Domestic demand	1,7	-0,2	-2,6	2,0
Net exports	0,0	0,7	1,5	-1,0

Source: INE - Quarterly National Accounts and Ministry of Finance.

Chart 2.1
Gross Domestic Product
Real year-on-year rate of change, %



Source: INE and Eurostat.

The factors behind the negative differential in 2004 were, however, not the same as in previous years. The differential in 2002 and 2003 was caused by the negative contribution of domestic demand to GDP growth. In 2004, the domestic demand contribution became positive and relatively high, and it was the contribution of net exports – which had been positive in the previous two years – that cancelled out part of the recovery in domestic demand.

Table 2.2
GDP and main components of aggregate demand

Year-on-year real rate of change

	2003				2004			
	I	II	III	IV	I	II	III	IV
Private consumption	-1,3	-0,9	-0,2	1,2	1,7	2,9	2,2	2,6
Government consumption	0,7	0,2	0,0	0,2	0,6	1,1	1,5	1,8
GFCF	-12,8	-12,8	-8,2	-4,9	0,5	3,6	2,0	2,2
Exports (FOB)	7,3	1,8	4,8	6,2	5,3	8,2	4,1	3,0
Imports (FOB)	-1,2	-3,1	0,4	3,4	5,8	9,4	6,1	6,7
GDP	**-1,4**	**-2,2**	**-1,0**	**0,0**	**0,7**	**1,8**	**0,9**	**0,6**

Source: INE (National Statistical Institute).

Private consumption and gross fixed capital formation (GFCF) reached their most negative year-on-year rates of change in the first half of 2003 but began to track up gradually in the second half of that year. Growth accelerated in the first half of 2004 and peaked in the second quarter (Table 2.2). The recovery then slowed down but domestic demand still came in with a considerable rate of change. For both private consumption and GFCF, year-on-year growth remained above 2%.

Private consumption in 2004 was accompanied by a considerable fall in household’s savings rate. This fall was around 1.5 p.p. of disposable income. It may be that households thought that the worsening of labour market conditions would not be so serious and that the budgetary consolidation process would have less impact than initially thought in 2002. Maybe this helped to improve consumer confidence, especially in terms of durable goods purchases. Still another element can be factored in to explain the behaviour of private consumption and the savings rate: financial conditions were very advantageous. Interest rates stayed very low and expectations of a rise in rates ebbed. Bank credit was not difficult to obtain and debt service conditions became more attractive (for instance, through extended repayment periods for housing loans), due to greater competition in the sector. On the back of all this, household expenditure grew strongly. As a last point, the European football championships in June also added – though in a temporary way – to a climate where growth in private consumption was the order of the day.

As for GFCF, the recovery in the private component of this aggregate was probably due to the prospect of improved domestic and external demand at the end

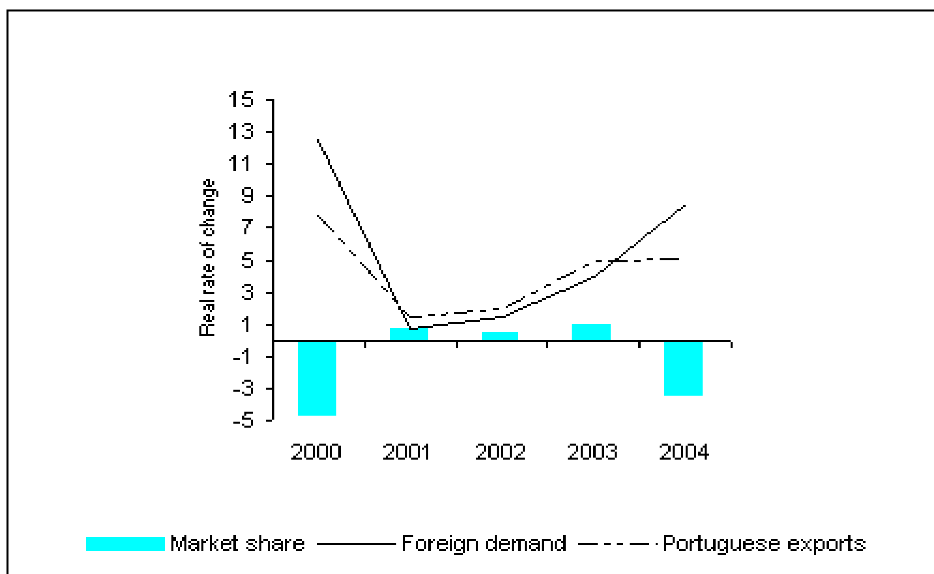
of 2003 and the start of 2004. Favourable financial conditions and some investments connected to the Euro 2004 championships are other significant factors.

The contribution of net exports, already mentioned, offset part of the dynamics of domestic demand and was a decisive factor in the moderate GDP growth.

Exports of goods and services in 2004 came in with a real growth of around 5%, close to the 2003 figure. The second half of the year was considerably off the pace (the real year-on-year rate of change was 3.0% in the fourth quarter, compared with an 8.2% peak in the second quarter). The average annual rate merely held steady from 2003 to 2004, even though the international scene was considerably more favourable to export growth. The global economy picked up at the highest rate for the last 25 years (5.1%) and global trade in goods and services rose by roughly 10% (double the 2003 figure). Conditions in international financial markets were also better overall. In this context, the rise in the growth of relevant foreign markets for Portuguese goods and services – from 3.9% in 2003 to 8.5% in 2004 – implied that Portuguese exports lost market share considerably (see Chart 2.2), above all in the second half of the year.

The European football championships led to considerable expansion in the exports of services: more than 8% in real terms. Therefore, loss of market share fell heavily on the exports of goods, both for the euro area and for the rest of the world. There are specific factors that can account for this heavy loss of market share: the appreciation of the euro and some trade diversion towards the domestic market, triggered by the growth in domestic demand. Another important factor would seem to have been increased competition from goods emanating from the EU new member states and several Asian countries, specifically China.

Chart 2.2
Portuguese exports market share



Source: INE and European Comission.

The surprising rise in imports was another worrying feature of the economy's loss of competitiveness in 2004. Imports of goods and services rose by 7.0% at constant prices, after hardly any variation in the two previous years. The rising euro made products from outside the euro area more affordable, and the structure of domestic demand also in part explains the boost in purchases from abroad. There was in particular a rise in imports of vehicles, computer products, radios and televisions, and all kinds of telecommunications equipment. Imports in 2004 also, however, reflect the growing foreign penetration in more traditional products such as garments and footwear.

The real evolution of imports and exports of goods and services, compounded by a loss in the terms of trade (due in large part to the hike in the price of oil), led to a widening deficit in the goods and services account: 7.7% of GDP, up from 6.4% (see Table 2.3). There was also a significantly higher deficit in the income account. This was above all associated with a base effect in 2003, when there was an abnormal rise in dividends and profits distributed from companies located offshore in Madeira. Meanwhile, the surplus of the capital account, which reflects the capital transfers received from the European Union, fell from 2.0% to 1.6% of GDP, thus also playing a part in the increase in the Portuguese economy's net borrowing vis-à-vis the rest of the world. The deficit in the current and capital accounts, which corresponds to such net borrowing, worsened from 3.3% to 5.9% of GDP. The trend towards a reduction in the Portuguese external imbalance, seen in the previous two years, therefore came to a halt.

Table 2.3
Balance of Payments

As a percentage of GDP

	2001	2002	2003	2004
Current account	-10,1	-7,6	-5,4	-7,5
Goods	-12,4	-10,5	-9,1	-10,8
Services	2,3	2,6	2,7	3,1
Income	-3,1	-2,0	-1,2	-1,8
Current transfers	3,0	2,3	2,2	2,1
Capital account	1,0	1,6	2,0	1,6
Current and capital accounts	**-9,1**	**-6,0**	**-3,3**	**-5,9**
Financial account (a)	9,4	4,2	3,5	6,2
Direct investiment	0,1	1,3	-0,5	-3,0
excluding off-shore (b)	0,2	-1,2	-0,1	-0,8
Portfolio investment	1,7	2,4	-3,9	0,9
Financial derivatives	0,3	0,0	0,0	0,0
Other investment	7,9	2,6	3,5	8,0
Reserve assets	-0,8	-0,9	4,4	1,1
Errors and omissions	-0,1	0,6	-0,3	-1,1

Source: Bank of Portugal.

Note:

(a) A (+) sign means an increase in foreign liabilities or a decrease in foreign assets, i.e. a financial inflow. A (-) sign means a decrease in foreign liabilities or an increase in foreign assets, i.e. a financial outflow.

(b) Madeira and Santa Maria dos Açores

The widening external deficit in 2004 reflected higher borrowing requirements of resident households and corporations. The solution was above all for Portuguese banks to rack up their debt on international markets and thus keep the expansion of domestic credit coming. However, 2004 also saw a move towards direct foreign financing by non-financial enterprises, through the issue of commercial paper and more trade credit. Portuguese public debt placement to non-residents continued to be of importance, accounting for 4% of GDP, a figure close to that of the previous year. As for direct investment flows, 2004 followed the trend of recent years: the figure was negative but rather small as a percentage of GDP (-0.8 percent, excluding offshore Madeira and Santa Maria dos Açores), either in terms of foreign direct investment in Portugal or Portuguese investment abroad.

Table 2.4
Labour Market Indicators

Year-on-year rates of change

	2002	2003	2004	2004		2005
				III	IV	I
Wages set by collective bargaining	3,7	2,9	2,9	2,9	2,9	2,7
Compensation per employee, industry	4,5	2,9	2,9	3,1	2,9	2,3
Compensation per employee, retail trade	3,7	4,0	4,4	4,2	4,4	4,1
Total employment	0,5	-0,4	0,1	-0,1	0,3	-0,3
Unemployment rate (% of labour force)	5,0	6,3	6,7	6,8	7,1	7,5

Source: Ministry for Labour and Social Solidarity and INE (National Statistical Institute).

In the labour market, employment levels virtually stagnated, whereas the unemployment rate rose from 6.3% to 6.7% of the labour force. The extra notch was bigger in the second half of the year, when the economy slowed down again. The trend continued in the first quarter of 2005, reaching 7.5%. Given the available information, the rate of increase of the average nominal compensation per worker across the economy remained relatively stable in 2004. Taking into account an increase in average labour productivity close to 1.0%, the increase in unit labour costs in the Portuguese economy seems to have slowed down by close to 1 percentage point. Estimates by the Bank of Portugal point to a 1.6% increase in unit labour costs in 2004, around 1 percentage point higher than in the euro area as a whole. Besides the abovementioned exchange rate factor and the opening of markets, the systematically positive differential in labour costs vis-à-vis the main export markets continues to hamper the competitiveness of the Portuguese economy.

Table 2.5
CPI - total and main aggregates

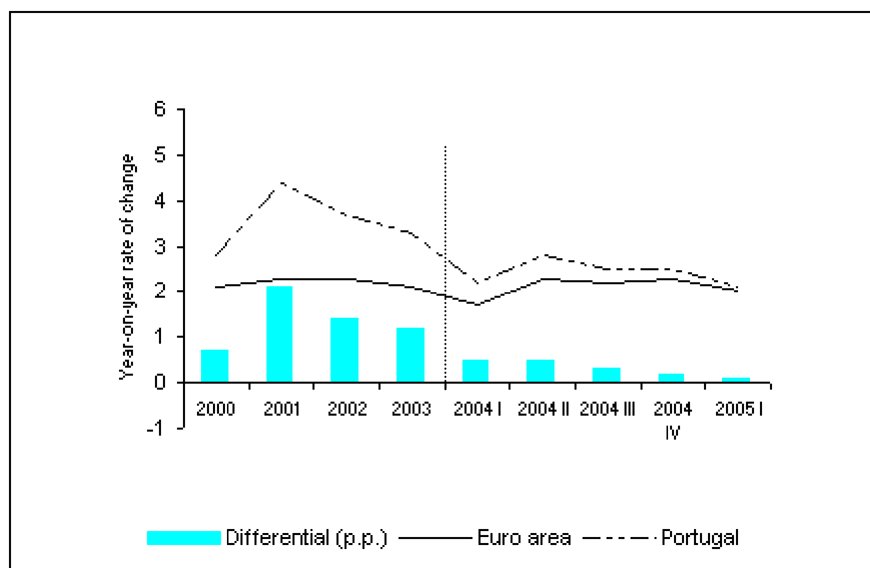
Average rates of change (2000 - 2004) and year-on-year rates of change (2004:I - 2005:I)

	2000	2001	2002	2003	2004	2004				2005
						I	II	III	IV	I
Total	2,9	4,4	3,6	3,3	2,4	2,2	2,5	2,4	2,4	2,1
Main aggregates										
Goods	2,2	4,2	2,4	2,7	1,6	1,3	1,7	1,6	1,8	1,7
Food	1,9	6,1	1,9	2,9	1,4	1,8	2,0	1,4	0,2	0,0
Unprocessed	2,5	8,8	0,3	2,6	0,0	0,3	0,8	-0,1	-1,0	-0,6
Processed	1,4	3,1	3,8	3,1	2,9	3,5	3,3	3,0	1,6	0,6
Industrial	2,4	3,1	2,7	2,6	1,7	1,0	1,6	1,7	2,6	2,6
Non energy	1,4	2,5	3,1	2,0	0,8	0,9	1,0	0,4	0,9	1,2
Energy	6,1	5,2	1,2	4,9	5,4	1,1	3,6	7,0	9,8	8,1
Services	4,2	4,8	6,0	4,5	3,8	3,9	3,9	3,9	3,5	3,0

Source: INE (National Statistical Institute).

Price rises had slowed very considerably in 2003 as domestic demand contracted. The consumer price index (CPI) year-on-year rate of change hardly moved in 2004 from the figure at end-2003. The high point over the year was in early summer, when the European football championships took place (affecting above all prices charged for accommodation). In average annual terms, consumer inflation (as measured by the variation in CPI) fell from 3.3% in 2003 to 2.4% in 2004. A slight fall in year-on-year inflation has occurred in early 2005, the figure in April standing at 2.1%. This downturn should continue until June, bearing in mind that the basis for comparison is the period of the Euro 2004 championships. Hence, despite the increase in the price of oil and of many raw materials, the moderate variation in the prices of imported consumer goods and the increased competition from these goods in the domestic market made it possible to stabilize year-on-year inflation during 2004, and to slightly decrease it in the early part of 2005. The fall this year also reflects the slowdown in price rises for certain services over recent months.

Chart 2.3
Harmonised index of consumer prices



Source: INE and European Commission.

From mid-2000, there was a substantial year-on-year inflation differential between Portugal and the euro area (measured by the Harmonised Index of Consumer Prices - HICP), coming in around or above one percentage point. Towards the end of 2003 the situation began to change and the gap narrowed substantially. The economic recession contributed to this, along with the fading effect of the rise in the standard rate of VAT in mid-2002. During 2004, the differentials vis-à-vis the euro area, except for June and July, the months of Euro 2004, were marginal. This was even more so after August, and there were even some months when the figure became marginally negative.

2.2. Public finances in 2004

The general government deficit in 2004, on a national accounts basis, stood at 2.9% of GDP, the same as in 2003 (see Table 2.6). In both years, the deficit only came below the 3% limit as a result of very large extraordinary receipts, some of which with “self-reversing” effects, therefore exacerbating the deficit in coming years. Leaving these extraordinary receipts aside, the public deficit was 5.4% of GDP in

2003 and 5.2% of GDP in 2004. If the sale of assets is also left out, the deficit would have stood at 5.7% of GDP in 2003 and 5.3% of GDP in 2004.

The extraordinary receipts for 2004 tallied up to €3,052 million. This figure only takes the direct effects into consideration, not any subsequent increase in expenditure. The receipts were made up of the transfer of pension funds from state-owned companies to the CGA, the body that manages the pensions for public servants. The breakdown was:

- Caixa Geral de Depósitos, €2,504 million;

- Navegação Aérea de Portugal, €236 million;

- Aeroportos de Portugal, €174 million;

- Imprensa Nacional Casa da Moeda, €138 million.

In three cases (the exception is the Caixa Geral de Depósitos) the transfer does not cover future pensions liabilities towards the respective employees, because there was a clear shortfall in the pension funds provisions[1]. As for the net sale of assets by general government (a minus item in capital expenditure), the total for 2004 stood at €198 million.[2]

[1] In 2003, the Portuguese post office (CTT) pension fund – also under-provisioned – had been transferred and recorded as a general government capital revenue, totalling €1,300 million. The other important extraordinary receipt in 2003 (accounting for nearly 1.3% of GDP) was the sale of overdue tax and social contributions claims to a financial corporation that securitised them and placed them on the market.

[2] The figure for 2003 was € 384 million.

Table 2.6
General Government accounts including and excluding extraordinary receipts in 2003 and 2004

	As a percentage of GDP				Change from 2003 to 2004 excluding extraordinary receipts	
	Including extraordinary receipts		Excluding extraordinary receipts			
	2003	2004	2003	2004	Rate of change	p.p. of GDP
TOTAL REVENUE	44,6	45,4	42,1	43,2	6,0	1,0
Current revenue	41,8	41,6	40,3	41,6	6,8	1,3
Current taxes on income and wealth	9,2	9,2	8,7	9,2	9,3	0,5
Taxes on production and imports	15,5	15,0	14,8	15,0	4,7	0,2
Social contributions	12,8	13,0	12,6	13,0	6,8	0,4
of which: State transfer to CGA	*1,9*	*2,3*	*1,9*	*2,3*	*22,2*	*0,4*
Other current revenue	1,8	2,0	1,8	2,0	12,5	0,2
Sales of goods and services	2,4	2,4	2,4	2,4	6,3	0,1
Capital revenue	2,8	3,8	1,8	1,6	-11,0	-0,3
TOTAL EXPENDITURE	47,6	48,4	47,6	48,4	5,2	0,8
Current expenditure	43,0	43,7	43,0	43,7	5,1	0,7
Current transfers	21,4	22,0	21,4	22,0	6,2	0,6
to households	17,2	17,9	17,2	17,9	8,0	0,7
of which: Pensions	*10,7*	*11,3*	*10,7*	*11,3*	*9,6*	*0,6*
to corporations (subsidies)	1,6	1,6	1,6	1,6	6,3	0,0
other current transfers	2,7	2,5	2,7	2,5	-5,0	-0,2
Interest expenditure (including swaps and FRAs)	2,9	2,8	2,9	2,8	1,4	-0,1
Compensation of employees	15,0	15,0	15,0	15,0	3,9	0,1
Intermediate consumption	3,7	3,8	3,7	3,8	6,1	0,1
Capital expenditure	4,6	4,7	4,6	4,7	6,9	0,2
Gross fixed capital formation	3,3	3,3	3,3	3,3	3,3	0,0
of which: sales of real estate and other assets	*0,2*	*0,2*	*0,2*	*0,2*	*-19,3*	*0,0*
Net acquisition of non-financial non-produced assets	-0,1	0,0	-0,1	0,0	n.a.	0,1
Capital transfers	1,3	1,4	1,3	1,4	8,3	0,1
OVERALL BALANCE (EDP)	-2,9	-2,9	-5,4	-5,2		0,2
Overall balance excluding net sales of assets (a)	-3,2	-3,0	-5,7	-5,3		0,4
Public debt	60,1	61,9				
Stock-flow adjustment (w.r.t. EDP overall balance)	-0,4	0,9				

Source: INE (National Statistical Institute), Ministry of Finance and Bank of Portugal

Note:

(a) Obtained from overall balance (EDP) by subtracting the sales of real estate and other assets (a minus item in gross fixed capital formation) and adding the net aquisition of non-financial non-produced assets (which is negative when disposables exceed acquisitions).

The rise in the ratio of public debt showed no signs of abating in 2004. The steep increase recorded since 2000 took it to 61.9% of GDP by the end of the year, 1.8 p.p. of GDP higher than at the end of 2003. There were various factors behind the rise: the positive differential between the implicit interest rate on public debt and the rate of nominal GDP growth; and a high stock-flow adjustment stemming fundamentally from the payment of previous years' trade debts, stipulated in the Supplementary Budget for 2004, approved in the last quarter of the year.

At first sight, there seems to have been some tightening of fiscal policy in 2004. The public deficit has gone down from 5.4% of GDP in 2003 to 5.2% in 2004, if the extraordinary receipts are excluded (and from 5.7% to 5.3% of GDP if the sale of assets is also excluded), with GDP growing at a moderate pace. Even the indicators normally used point in this direction: the underlying overall balance improved 0.5 p.p. and the underlying primary balance 0.4 p.p. of GDP in 2004 (see Table 2.7). These indicators, however, merely give the broad picture and do not reflect a number of special factors. These are smaller than the extraordinary receipts detailed above, but they made a significant overall contribution to improving the 2004 balance, while implying in some cases a worsening of the balance for 2005.

Table 2.7
Underlying budgetary balances [(a)]

As a percentage of GDP

	2000	2001	2002	2003	2004
Overall	-4,1	-5,1	-4,4	-5,0	-4,5
Primary	-1,0	-1,9	-1,4	-2,1	-1,7

Source: European Commission, INE (National Statistical Institute) and Ministry of Finance.

Note:
(a) Adjusted for the cycle (European Commission method), for temporary measures and for asset sales proceeds.

The existence of factors such as these becomes clear when analysing the main contributions from the various revenue and expenditure items to the variation in the deficit between 2003 and 2004, as a percentage of GDP and excluding extraordinary receipts (Table 2.6). Current revenue is 1.3 p.p. of GDP higher and current primary expenditure is 0.8 p.p. higher.

In terms of current primary expenditure, the variation was above all in the current transfers to households (0.7 p.p. of GDP more than in 2003), though the intermediate consumption of general government also rose 0.1 p.p. of GDP. As in previous years, the rise in transfers to households is above all a reflection of the increase in pension payments (0.6 p.p. of GDP). Expenditure on health accounts for most of the remaining rise. It was therefore not current primary expenditure that explains the slight fall in the 2004 deficit. The improvement in the underlying balance indicators is only the result of the substantial increase in the Government's current revenue, from 40.3% of GDP in 2003 to 41.6% in 2004. The increase took place across the board, but above all in current taxes on income and wealth and in social contributions.

As far as social contributions are concerned, the improvement is a mirage. It is based on the State transfer to CGA, the purpose of which is to cover the deficit in the public servants' pensions scheme.[1] As for taxes on income and wealth, the increase was predominantly from corporate income tax (IRC), which was up 0.4 p.p. of GDP on 2003. Against the backdrop of sluggish economic growth and the cut in the statutory rate of the tax itself from 30% to 25% introduced in the 2004 Budget, this increase in revenue can be explained fundamentally by (i) a number of special factors in tax collection [2], (ii) efforts by the tax service to improve the collection of overdue tax payments, and (iii) the fact that the rate cut has not led most companies to suspend their pre-payments due at the end of 2004 (which means it will impact negatively on tax collection in 2005). This means that the revenue item that contributed the most to the improvement in the 2004 balance was precisely the one where there had been a discretionary decision to lower the tax rate – a vivid illustration of the limitations of the standard underlying balance indicators when applied to the 2004 Portuguese budgetary situation.

Revenue from taxes on production and imports also increased in 2004, by 0.2 p.p. of GDP. More than half of this rise (€150 million) relates to a special factor in

[1] The increase therefore does not mean an improvement in the public deficit, but rather a worsening, since the same amount is recorded on the expenditure side under the heading of compensation of employees and it indicates that the increase in pensions paid to former public servants is higher than the increase in other CGA sources of financing.

[2] One of these special factors was the increase in proceeds from the so-called "special pre-payment" (pagamento especial por conta), whose final instalment for 2003 was only paid in 2004. Another base effect was the highly encouraging result of self-assessment made in 2004 on 2003 tax situations, suggesting that in the year before IRC pre-payments (stipulated in Articles 96 and 97 of IRC code) were lower than what should be expected in the light of company results when they came in.

the collection of the tax on tobacco. The State Budget for 2005 includes an increase of this tax, which led to the main producer introducing large quantities of tobacco onto the market at the previous tax rate, bringing in supplies before the increase. A decision in the Budget for 2005 therefore boosted 2004 tax proceeds, and, *ipso facto*, cuts the 2005 revenue.

Finally, a word about dividends paid into the budget by corporations owned (partially or wholly) by the State, included under the heading "Other current revenue." This item was boosted in 2004 by temporary receipts and by the early payment of dividends that should have been received by the Government, under normal circumstances, only in 2005.

2.3. Public finances in 2005 without additional measures: the Constâncio Commission

Following the early general election in February 2005, and in a context of widespread doubts about the plausibility of the budgetary projections for 2005 set down in the State Budget approved at the end of 2004, the Government decided to appoint a specialist independent commission to look into the matter. Chaired by the Governor of the Bank of Portugal, it became known as the Constâncio Commission. The Commission's remit was to reassess the budgetary projections for 2005 and look for situations where revenues might have been overestimated and expenditure underestimated. The Commission's analysis took into account the discretionary measures set out in the 2005 Budget but not any additional measures envisaged by the new Government. The Commission was made up of specialists from the Bank of Portugal and the INE (the National Statistical Institute). Their findings, after two months of analysis and consideration, were made public on 23 May.[1]

[1] The report is available on the Government website www.portugal.gov.pt/rdonlyres/8C462111-828C-4DA2-A1D4-CEFB37F85ABB/O/RelatorioComissao OE2005.pdf)

Table 2.8
Revisions by the Constâncio Commission to the 2005 overall balance as in State Budget for 2005

		Million euros	% of GDP
(1)	**Overall balance of general government, as in State Budget 2005 (National Accounts basis)**	**-3.999,8**	**-2,86**
(2)	Cancellation of one-off measures:		
	Transfers of pension funds	-422,0	-0,30
	Dividends from GALP	-548,0	-0,39
	Sales of assets	-500,0	-0,36
	Sales of concessions	-500,0	-0,36
		-1.970,0	-1,41
(3)	Revisions to the overall balance:		
	Tax revenue of general government	-23,9	-0,02
	Dividends (correcting for corporate income tax on dividends)	-740,3	-0,53
	"Frozen" expenditure (a)	-614,1	-0,44
	Appropriation for contingent expenditure	-180,0	-0,13
	Compensation of employees	-360,0	-0,26
	Capital expenditure	180,0	0,13
	National Health Service	-1.512,8	-1,08
	Estradas de Portugal, E.P.E.	-458,3	-0,33
	Private sector social security system	-598,8	-0,43
	Public servants social security system (CGA)	-228,3	-0,16
	Public investment	796,2	0,57
	GNP-based contribution to the EU	85,3	0,06
	Reclassification of capital injections	-55,7	-0,04
	Interest expenditure	-52,0	-0,04
		-3.582,7	-2,56
(4)=(1)+(2)+(3)	**Overall balance of general government, revised by the Commission (National Accounts basis)**	**-9.552,5**	**-6,83**

Source: Constâncio Commission.

Note: (a) Relates to expenditure foreseen in the State Budget, but that can only be made by special authorisation.

The Commission selected and analysed information relating to a range of areas where there seemed to be possible budgeting problems[1] (Table 2.8). The following conclusions are worth highlighting:

- the forecast for tax revenue included in the Budget was relatively prudent and did not require major adjustments, in spite of the significant lowering of projected growth;
- the forecast for dividends from state-owned enterprises overestimated by € 740 million the amount now considered to be accurate;

[1] Some important areas, such as regional and local finances, were not analysed by the Commission because of lack of time or available information.

- the financing requirements of several public bodies had been grossly underestimated, among them the National Health Service (revised upwards by €1,513 million), social security (revised upwards by €599 million for the private sector system and by €228 million for CGA) and Estradas de Portugal (revised upwards by €458 million).[1]

- some other budgetary assumptions proved unrealistic and in need of revision, including that "frozen" expenditure[2] would not eventually have to be made (upward revision of €614 million) and that the appropriation for contingent expenditure would be sufficient to cover both unexpected outlays and the public service wage scale update of 2.25% (upward revision of €180 million).

Added to these revised figures is the cancellation of various extraordinary receipts, either insufficiently specified or about which Eurostat had already raised doubts regarding compliance with accounting standards. These came to 1.4% of GDP. In overall terms, the Constâncio Commission considered that the corrected figure for the 2005 deficit was 6.8% of GDP, an upward revision of 4 p.p. of GDP. This figure was a correction of the amount recorded in the Budget submitted and approved in the last quarter of 2004, assuming no additional measures apart from those considered in the Budget itself.

The Commission's projection implies a 1.6 p.p. of GDP increase in the deficit relative to 2004, when the receipts from pension fund transfers in that year are excluded and no additional measures are contemplated. As mentioned in the previous section, this difference has been magnified by a number of special factors that boosted revenues in 2004 and will drag down the figure for 2005. Such factors were taken into consideration in the Constâncio Commission projections, a conservative estimate being that they account for at least 0.5 p.p. of the difference between the 2004 deficit and the projected figure for 2005.

Another explanation for the difference is the big cut in expected 2005 dividends paid to the budget by corporations (at least in part) owned by the State. The figure represents 0.3-0.4 p.p. of GDP. These dividends were €426 million in 2003 and €484 million in 2004. They will only be €38 million in 2005, in line with the

[1] This company, previously known as the Instituto de Estradas de Portugal, had been wrongly withdrawn from the general government sector in the 2005 Budget, given that its sales are far from covering 50% of its costs.

[2] Relates to expenditure foreseen in Budget, but that can only be made by special authorisation.

best available forecast (Table 2.9). More than half of the cut in revenue stems from the forecast of non-payment of dividends by the state-owned bank Caixa Geral de Depósitos, which sustained capital losses on the transfer of part of its employees' pension fund to CGA. Along with this, the early drawing-down of dividends payments mentioned at the end of Section 2.2 is also a reason for the cut in dividend forecast for 2005. In addition a considerable Treasury holding was partly sold and partly transferred to bolster the statutory capital of Caixa Geral de Depósitos. Then, the dividends generated by these shares will not contribute to general government revenue in 2005.

Table 2.9
Dividends from corporations received by General Government

Million euros

	2003	2004		2005	
	Outcome	Budget	Outcome	Budget	Outcome
Dividends and participation in the profits of non-financial corporations and quasi-corporations	111,1	59,3	176,7	792,5	12,4
of which: GALP	*12,8*		*24,1*	*548,0*	
Dividends and participation in the profits of financial corporations	313,4	245,0	306,8	275,5	25,0
of which: CGD	*271,1*		*272,3*		
Participation in the profits of general government	1,4	1,7	n.a.	0,5	0,5
TOTAL	425,9	306,0	483,5	1068,5	37,9

Source: Ministry of Finance and Constâncio Commission.

The remainder of the difference between the 2004 deficit and the forecast deficit for 2005 excluding any additional measures is explained by the structural trend towards strong growth in social expenditure, especially with pensions and health. After the corrections to these items, the transfers to households, according to the Constâncio Commission findings, are likely to rise by 0.7 p.p. of GDP, while intermediate consumption (which includes part of the operating expenses of the National Health Service) is likely to grow by 0.2 p.p. of GDP (Table 2.10).

Table 2.10
Decomposition of the change in the budget balance from 2004 to 2005

As a percentage of GDP

	2004 (excluding temporary measures)	**Change in cyclical component**	**Effects of discretionary measures**	**Other effects**	**2005** (Constâncio Commission)	**Change 2004-2005**
TOTAL REVENUE	**43,1**	**0,0**	**-0,4**	**-0,2**	**42,6**	**-0,6**
Current revenue	41,6	0,0	-0,4	-0,1	41,1	-0,5
Tax revenue	37,1	0,0	-0,4	0,4	37,2	0,0
Current taxes on income and wealth	9,2	0,0	-0,5	0,0	8,8	-0,5
Taxes on households	5,8	0,0	0,0	0,2	6,0	0,2
Taxes on corporations	3,4	0,0	-0,5	-0,2	2,7	-0,7
Social contributions	12,9	0,0	-	0,0	13,0	0,0
Actual	11,9	0,0	-	0,0	11,9	0,0
Private sector social security system	7,9	0,0	-	-0,1	7,8	-0,1
Public servants (CGA)	3,9	-	-	0,1	4,0	0,1
Imputed	1,1	-	-	0,0	1,1	0,0
Taxes on production and imports	15,0	0,0	0,1	0,3	15,4	0,4
Sales of goods and services	2,4	-	-	0,0	2,4	0,0
Other current revenue	2,0	-	-	-0,5	1,5	-0,5
Capital revenue	1,6	-	-	-0,1	1,5	-0,1
TOTAL EXPENDITURE	**48,3**	**0,1**	**0,3**	**0,6**	**49,3**	**1,0**
Current expenditure	43,6	0,1	0,3	0,8	44,8	1,2
Compensation of employees	15,0	-	0,1	0,2	15,3	0,3
Intermediate consumption	3,8	-	0,1	0,1	4,0	0,2
Interest expenditure	2,8	-	-	0,1	3,0	0,1
Current transfers	22,0	0,1	0,2	0,5	22,7	0,7
to households	17,9	0,1	0,2	0,4	18,5	0,6
other than in kind	14,9	0,1	0,2	0,3	15,5	0,6
o/ w: unemployment benefits	1,2	0,1	-	0,0	1,3	0,1
pensions - private sector	7,3	-	0,1	0,2	7,6	0,3
pensions - public servants (CGA)	4,0	-	0,0	0,1	4,1	0,2
In kind	3,0	-	-	0,1	3,1	0,1
Subsidies	1,6	-	-	0,0	1,7	0,0
other transfers	2,5	-	-	0,1	2,6	0,1
Capital expenditure	4,7	-	-	-0,2	4,4	-0,2
Investment	3,3	-	-	-0,1	3,2	-0,1
Net acquisition of non-financial non-produced assets	0,0	-	-	0,0	0,0	0,0
Other capital expenditure	1,4	-	-	-0,1	1,2	-0,1
OVERALL BALANCE	**-5,2**	**-0,1**	**-0,7**	**-0,8**	**-6,8**	**-1,6**
p.m.:						
Current primary expenditure	40,8	0,1	0,3	0,9	42,1	1,3
Capital balance	-3,1	-	-	0,2	-2,9	0,2
Primary balance	-2,3	-0,1	-0,7	0,8	-3,9	-1,6

Source: Constâncio Commission.

3. A budgetary consolidation strategy for the legislature

3.1 The Portuguese budgetary crisis

The most visible feature of the Portuguese budgetary crisis is the existence of extremely high public deficits, net of temporary measures. The public deficit in Portugal has reached excessive proportions, even when adjusted for cyclical effects. This shows that the budgetary crisis is not simply the consequence of the current low growth of the economy, although this is obviously an important aspect of the worsening situation. High public deficits imply a drain on resources earmarked for productive purposes and higher risk for economic agents in the private sector, with a negative effect in the long-run on growth and employment.

Table 3.1 shows the path of the main items in the public accounts for the period between 1990 and 2004, net of temporary measures in the last three years. The table gives us a better understanding of the underlying trends. A comparison between 1995 and 2004 is particularly enlightening, for two reasons. Firstly, both years followed a period of weak growth in the country's economy, so the comparison is not very distorted by cyclical effects. Secondly, the value of the deficit, as a proportion of GDP, was similar for both years.

The first point to make is that there has not been a problem of current revenue growth. Between 1995 and 2004, tax revenue rose, as a percentage of GDP, by 1.7 p.p. (due above all to indirect taxes). Contributions to the private sector social security system (the responsibility of employers and employees) rose 0.7 p.p. during the same period (the contribution of public servants to social security remained stable at 1.1% of GDP). On the other hand, the ratio of public debt service to GDP fell by 3.5 p.p., in the wake of a considerable fall in interest rates.

These favourable developments were, however, offset by the trend towards major growth in transfers for households, compensation of employees and intermediate consumption. These figures were 3.6, 2.0 and 0.7 p.p. of GDP respectively. The figures take into consideration the breaks in the series caused by the transfer of various hospitals to private management at the end of 2002. Wages in the public service rose and their proportion of GDP went up by 1.1 p.p. (in spite of the fact that the salary scale was practically frozen in the last two years of the period). The remaining 0.9 p.p. increase in compensation of employees is explained

Table 3.1
General government accounts developments: 1990-2004

As a percentage of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 (*)	2003 (*)	2004 (*)
Total revenue	**35,2**	**37,4**	**41,4**	**39,8**	**38,4**	**39,6**	**41,0**	**41,2**	**41,0**	**42,4**	**42,3**	**41,9**	**42,3**	**42,1**	**43,1**
Current revenue	**33,8**	**35,6**	**39,3**	**38,0**	**36,6**	**37,7**	**39,0**	**38,9**	**39,4**	**40,6**	**40,8**	**40,2**	**40,5**	**40,3**	**41,6**
Taxes on income and wealth	7,6	8,4	9,5	8,7	8,4	8,9	9,5	9,6	9,3	9,8	10,4	9,9	9,3	8,7	9,2
Taxes on production and imports	12,8	12,9	13,7	13,1	13,6	13,6	14,0	13,8	14,3	14,8	14,4	14,2	14,6	14,8	15,0
Social contributions	9,4	9,9	10,3	10,7	10,8	11,0	10,9	11,2	11,2	11,4	11,8	12,0	12,1	12,5	12,9
Actual contributions	8,5	9,0	9,2	9,5	9,7	10,1	10,2	10,5	10,5	10,6	10,9	11,1	11,2	11,6	11,8
actual - private sector social security system	n.d.	n.d.	n.d.	n.d.	n.d.	7,1	7,0	7,3	7,3	7,4	7,5	7,8	7,7	7,8	7,8
actual - public servants social security system	n.d.	n.d.	n.d.	n.d.	n.d.	2,9	3,1	3,2	3,2	3,2	3,4	3,3	3,5	3,7	4,0
of which: employees' contributions	n.d.	n.d.	n.d.	n.d.	n.d.	1,1	1,1	1,1	1,1	1,1	1,1	1,2	1,2	1,2	1,2
Imputed contributions	0,9	1,0	1,1	1,2	1,1	0,9	0,7	0,7	0,7	0,7	0,9	0,9	0,9	1,1	1,1
Other current revenue	2,2	2,6	3,9	3,7	1,9	2,4	2,6	2,3	2,2	2,2	1,7	1,7	2,1	1,8	2,0
Sales of goods and services	1,8	1,7	1,8	1,9	1,9	1,9	2,0	2,1	2,2	2,5	2,5	2,3	2,4	2,4	2,4
Capital revenue	**1,4**	**1,8**	**2,1**	**1,9**	**1,7**	**1,9**	**2,1**	**2,3**	**1,6**	**1,8**	**1,4**	**1,8**	**1,8**	**1,8**	**1,6**
Total expenditure	**41,8**	**44,9**	**46,1**	**47,9**	**46,1**	**45,0**	**45,8**	**44,8**	**44,1**	**45,2**	**45,1**	**46,3**	**46,4**	**47,5**	**48,3**
Current expenditure	**36,7**	**39,6**	**40,2**	**42,0**	**41,0**	**39,8**	**39,8**	**38,5**	**38,1**	**39,3**	**40,1**	**40,8**	**41,7**	**42,9**	**43,6**
Current transfers	13,3	14,3	14,9	16,8	17,4	16,2	16,8	16,5	16,9	17,5	17,5	18,2	19,0	21,4	22,0
to households	10,4	11,2	11,5	12,7	14,0	13,2	13,4	13,3	13,4	13,6	14,0	14,5	15,0	17,1	17,9
other than in kind	9,3	10,0	10,2	11,3	12,7	11,8	11,8	11,7	11,7	11,9	12,4	12,7	13,2	14,3	14,9
in kind (**)	1,1	1,2	1,3	1,5	1,4	1,4	1,5	1,6	1,6	1,7	1,7	1,8	1,9	2,9	3,0
to corporations (subsidies)	1,7	1,6	1,9	2,4	1,7	1,3	1,5	1,2	1,5	1,7	1,1	1,3	1,5	1,6	1,6
Expenditure on training financed by the ESF	n.d.	n.d.	n.d.	n.d.	n.d.	0,6	0,7	0,6	0,7	0,8	0,4	0,5	0,8	0,6	0,7
compensatory payments to state-owned corporations	n.d.	n.d.	n.d.	n.d.	n.d.	0,0	0,3	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,3
interest relief grants for house purchase	n.d.	n.d.	n.d.	n.d.	n.d.	0,0	0,2	0,2	0,3	0,3	0,4	0,3	0,4	0,4	0,2
other transfers to corporations	n.d.	n.d.	n.d.	n.d.	n.d.	0,8	0,3	0,2	0,3	0,4	0,1	0,3	0,1	0,4	0,4
other	1,2	1,5	1,4	1,7	1,6	1,6	1,9	2,0	2,1	2,2	2,4	2,5	2,5	2,7	2,5
Interest expenditure (including swaps and FRAs)	8,5	8,7	8,5	7,8	6,6	6,3	5,4	4,2	3,5	3,2	3,2	3,2	3,0	2,9	2,8
Compensation of employees (**)	11,8	12,8	13,8	14,1	13,6	13,6	13,7	13,8	14,0	14,4	15,0	15,1	15,4	15,0	15,0
Intermediate consumption (**)	3,1	3,8	3,0	3,3	3,4	3,7	3,9	3,9	3,8	4,2	4,4	4,3	4,3	3,7	3,8
Capital expenditure	**5,1**	**5,3**	**5,9**	**5,9**	**5,0**	**5,3**	**6,0**	**6,3**	**6,0**	**5,9**	**5,0**	**5,5**	**4,7**	**4,5**	**4,7**
Gross fixed capital formation	3,3	3,5	3,9	4,0	3,7	3,7	4,2	4,4	3,9	4,1	3,8	4,0	3,6	3,3	3,3
of which: Sales of real estate and other assets	n.d.	n.d.	n.d.	n.d.	n.d.	-0,1	-0,1	-0,1	-0,2	-0,2	-0,2	-0,1	-0,1	-0,2	-0,2
Other GFCF	n.d.	n.d.	n.d.	n.d.	n.d.	3,9	4,3	4,4	4,1	4,4	4,0	4,1	3,7	3,5	3,5
Net acquisition of non-financial non-produced assets	0,0	0,0	0,0	0,0	0,0	0,0	0,1	0,1	0,1	0,0	-0,2	0,0	0,0	-0,1	0,0
Capital transfers	1,8	1,8	2,1	1,8	1,3	1,5	1,7	1,9	1,9	1,8	1,4	1,5	1,1	1,3	1,4
Net lending (+) / net borrowing (-) (EDP)	**-6,6**	**-7,6**	**-4,7**	**-8,1**	**-7,7**	**-5,5**	**-4,8**	**-3,6**	**-3,2**	**-2,8**	**-2,8**	**-4,4**	**-4,1**	**-5,4**	**-5,2**

Source: INE (National Statistical Institute) and Ministry of Finance.

Notes: (*) Excluding temporary measures.
(**) Series break at the end of 2002, due to the reclassification of corporate hospitals (formerly part of the general government sector). This reclassification led to an increase in current transfers in kind to households of 1.1 % of GDP and, as a counterpart, to a decrease in compensation of employees and intermediate consumption (around 0.6 % of GDP in both cases) and to a reduction in sales receipts (0.2 % of GDP).

by the rise in Government contributions to social security.

The budget accounts were not being consolidated, with current primary expenditure growing at an unsustainable rate. And if we take the 2005 figures into account, based on the Constâncio Commission's forecast and net of additional budgetary measures, the situation is even more perilous.

In recent years there has also been a powerful dynamic movement towards a ballooning public debt. This has come about because of the size of budget deficits, the recourse to a raft of temporary measures with negative knock-on effects for future budgets, debt taken on, capital injections into state-owned enterprises and the differential between the implicit interest rate on public debt and the nominal rate of GDP growth. The level of public debt soared from the 2000 minimum of 53 percent of GDP to nearly 62 percent of GDP by the end of 2004. If nothing was done to put the brakes on, financial markets would be demanding ever-increasing risk premia to finance the borrowing requirements of the Portuguese Republic and this would exacerbate the debt problem ever more and put a straight-jacket on economic growth itself.

3.2 The thrust of strategy

It makes sense that the Government's budgetary consolidation strategy should be based fundamentally on tight control of the growth of current primary expenditure. This has clearly been identified as the source of Portuguese budgetary problems. Successful experiments in other countries demonstrate that success for Portugal in the medium and long term will depend crucially on success in overhauling public expenditure. The challenge lies in matching tight control of this expenditure with a significant improvement in the quality of public service, covering areas such as education, health and justice. Comparative international studies are unanimous in recognising deep-seated public expenditure inefficiencies in these areas. The two objectives must dovetail. And determined action is also needed for social security. Improving the conditions necessary for long-term sustainability and controlling expenditure in the short- and medium-term are the ways to bring down the strong financial pressure that has been brought to bear on the public accounts.

The budgetary consolidation strategy needs, however, to rely also on a series of measures to increase revenue and bring down the deficit more quickly.

The goal of speedy deficit reduction has to be achieved for three main reasons:

(i) Structural reforms on the public expenditure side take some time to filter through and to produce significant effects on budgetary savings;

(ii) Only a rapid cut in the size of the deficit will curb the unfavourable dynamics of public debt before significant damage is inflicted on the Portuguese economy and on the country's ability to raise funds on international financial markets;

(iii) Respect for the country's commitments to the European Union treaties and to the Stability and Growth Pact demand the rapid implementation of measures designed to correct the public accounts.

Additional revenue will not be sought through temporary measures that jeopardise future budget balances. The Government made it clear, in its Programme recently presented to Parliament, that it was not prepared to use accounting expediencies to hide the real level of the deficit and create the illusion that the budgetary crisis had been solved. The extraordinary receipts of the past two years have been particularly serious for the Portuguese public accounts because they have increased expenditures or cut back revenue for following years. This has created even more difficulties for pegging back the budgetary overrun.

There are five strategic guidelines that the Portuguese Government, while respecting the principles outlines above, intends to pursue:

(i) To reform public administration, above all in the management of its human resources, seeking decisive containment of expenditure growth and, in tandem, nurturing flexibility in the management of services and rewards for performance;

(ii) To foster the conditions for long-term sustainability for social security and ease the short- and medium-term budgetary pressure stemming from an ageing population and an inadequate system;

(iii)To create incentives for enhancement of quality in public expenditure and in the way infrastructures and public resources are used;

(iv) To bring a simpler and more ethical approach to the fiscal system, improve the efficiency of the Tax Administration and fight tax evasion and fraud;

(v) To follow a privatisation policy based on reducing the State's presence in the business sector of the economy and thus improve the use of economic resources and bolster sustainability of the public finances.

The following point will detail the main measures and reforms that the Government will introduce in pursuit of its budgetary consolidation goal.

3.3. The main measures and reforms

3.3.1. Reform of public administration and management of its human resources

In terms of the unfavourable dynamics of public expenditure, the most relevant factor in the frame, along with the growth in pensions, is personnel expenditure. Personnel expenditures are the highest among all the euro area countries as a percentage of GDP. In the OECD countries, only Denmark and Sweden come out higher.[1] Expenditure on general government staffing since 1995 has in fact risen more as a percentage of GDP than in any other OECD country. Indeed, most countries actually cut the percentage. This figure reached 15% in Portugal in 2004. The average figure for the euro area is under 11%.

The increase in personnel expenditure in Portugal has stemmed from three factors combined: the increase in the number of public services and their size, the big increase in the number of public servants and in the level of average wages, which has far outstripped the growth rate of salary scales (the so-called public servants' wage drift).

Measures will be taken in the organisation of public administration and the management of its human resources. These measures seek to resolve the factors already identified, with an additional concern: to introduce mechanisms that allow for an effective budgetary saving while respecting established rules but also rewarding merit and performance.

a) <u>Overhaul of central administration</u>

1 See for example the OECD Economic Survey on Portugal 2004, Chapter 3 (available on http://www.oecd.org)

Reassessment of the State's functions is underway. Following it, there will be a wide-ranging overhaul and modernisation of public administration. This will involve each ministry separately embarking on a review of functions, organic structure, size, resources and procedures. The process will target improvements to the efficiency and effectiveness of services and selective cuts and quality control over public spending. The Government's target is a 10% cut in intermediate consumption across the board by the end of its term in office.

b) <u>Making the Surplus Staff Exchange effective</u>

Making the Surplus Staff Exchange effective is another basic building block in the reform of personnel management in public administration. The Government intends to introduce the necessary legislative changes this year. A Staff Exchange does in fact exist but it has never been used and its aims have been thwarted. The Government intends to redefine and enlarge its remit. Employees deemed to be surplus or unfitted for their post will be placed on the exchange while awaiting a new post. At the end of three months on the exchange, they will lose their so-called "job-related pay", which comes to approximately one-sixth of their previous pay. An employee on the exchange cannot refuse a post that is offered, on terms to be set down, at the risk of losing security of tenure. Finally, as an incentive to move into the private sector, any employee on the exchange will have an automatic right to take unpaid leave.

c) <u>Reform of the career and remuneration system of public servants</u>

The existing system covering career and pay is both extremely complex and rigid. There are close to 1,050 different professional careers, with automatic career-progress and pay-rise mechanisms, independent of professional performance. The Government has committed itself to a comprehensive reform of this system by the end of 2006. The number of careers will be substantially reduced and drastic limits will be set to automatic progression as it now exists.

Employee pay rises will be closely linked to performance appraisal. Employees who under-perform may not receive pay increases and quality performance by other employees will be rewarded through a mechanism that allows wider variation in pay. External appraisals of public service performance will be set in motion (using wherever possible objective indicators to gauge the quantity and quality of service provided). The appraisals will have a direct effect on salaries and the services with

poorest overall performance will be penalised. The Government's aim here is to staunch wage drift in public servants' pay. In tandem, suitable incentives will be introduced to improve the quality of public service without jeopardise salary adjustments. On the contrary, performance-related pay will mean quicker progression up the scale and larger salary increases for good performers' employees.

The reform is very complex and given the negotiations it implies, its exact features will not be defined and written into law before the end of summer 2006. The budgetary effect of the reform will therefore only be felt in the 2007 Budget. In the meantime, the Government intends to halt the overrun on personnel expenditure. All automatic career progressions for public servants will shortly be stopped and promotion will continue to be fenced in to the budgetary confines of each service, following recent practice.

In the health sector, the Government intends to review the pay scheme for doctors on emergency hospital and health centre work, the new set-up being similar to the one set out in Decree Law 117/98 of 5 May.

d) Limitations on new admissions of public servants

The Government will be using a range of devices to reduce the number of public servants. It will continue to exert a tight control over new admissions to central government, and there will not be one-to-one replacement of workers who leave the service, either through retirement (and these will be fewer than in recent years as retirement age gradually rises) or because they are leaving the public service altogether. The indicative rule will be, on average, one new admission for every two employees who leave.

There will also be changes to the law to restrict admission in the regional and local government subsector, where there has been continued expansion, even in more recent years.

3.3.2 Social security

Life expectancy is now more than 77 years. The figure has been growing steadily, by nearly 10 years in the last three decades. For 60- and 65-year olds (the

reference ages for retirement, the first for public servants, the second for those in the private sector social security system), life expectancy has increased by 3 to 4 years in the period between 1970 and 2000. For those aged 65 in 2000, life expectancy had increased by 15.3 years for men and 18.7 years for women. Figures for 60-year-olds at that date were 19.0 years for men and 23.0 years for women.[1] The increased life expectancy has come in the wake of advances in medicine and a marked improvement in the socio-economic conditions of the Portuguese population, especially as regards health care. Life expectancy can be expected to continue to rise.

This demographic phenomenon is one explanation for the sharp increase in pension payments, both in the public service and in the private sector system. In addition, as pensioner numbers increase, there has been a significant rise in average pensions in both schemes, much higher than the annual update of pension scales. This "composition effect" derives from the fact that pensions for new senior citizens are considerably higher than the pension of those whose lives come to an end.

The Government had girded up to tackle the worsening financial situation of social security and to eliminate the differentiation between the special public service scheme and the private sector system. This has been the source of unfairness and has hindered labour mobility between the general government sector and the private sector. The measures to be taken are:

a) CGA will be "closed" as a subsystem at the end of 2005. There will be no new entrants and this subsystem will gradually converge to the conditions prevailing in the private sector social security system. This measure involves the following points:
   - All public servants taken on after 1 January, 2006 will fall within the scope of the private sector social security system;
   - For new public servants, contributions will be in line with the private sector system, both for employee and employer (whether the latter is classified in the general government sector or not);
   - The legal retirement age for public servants will rises in stages from 60 to 65 during the period from 2006 to 2015 on the basis of six months for

[1] Source: United Nations and Eurostat (available data, will be found in http://esa.un.org/unpp and http://epp.eurostat.cec.eu.int).

each year. This means that retirement age will be 60 years and six months during 2006, 61 years during 2007 and so on;

- The number of years of service needed to receive a full pension will be extended in stages from 36 to 40 years during the period 2006-2013, on the basis of six months for each year;
- The formula used to calculate retirement pensions for public servants taken on before 1993 will be changed. The figure for the pension will be reached from the weighted average of the pension they would have received under the current formula (CGA) and the pension calculated applying the formula of the private sector social security system, with the weighting ascertained by the proportion of the contributory period up to the end of 2005 (CGA) and after 2005 (private sector system).[1]

b) From 1 July 2005, the health subsystems will take no new entrants. These subsystems exist for certain categories of public servants and are more generous than the ADSE general scheme applying to most public servants. From that date on, new employees, officials and other personnel from the armed forces, from the police and from services and institutions in the justice system will automatically be registered in the ADSE scheme. Employees on active service will stay in their own sub-systems, which will be brought into line with the ADSE by 1 October of this year.

c) Both with respect to public servants as well as within the private sector system, all special schemes of retirement will be reviewed where they allow for a statutory retirement age below 60 (for the public servants) or 65 (for the private sector social security system), with the aim of eliminating or drastically cut down the special retirement provisions.

d) In the private sector social security system, the Government will take structural measures which will generate additional budgetary savings. The

[1] As an illustration, an employee who has contributed from 1981 to the CGA will reach retirement age at the end of 2020 and will receive a pension which is a weighted average of the pension (s)he would have received if there had been no change to the system (with 25/40 weighting) and the pension calculated according to the private sector social security system (with 15/40 weighting).

figure for 2006 will be 150 milliion euros, and this will rise to 750 million euros in 2009. These measures, being structural, will seek to increase long-term system sustainability, bearing in mind the increase in life expectancy. A working group has been set up to study and assess a variety of measures. The report is scheduled for the last quarter of the year and it will provide the Government with the tools it needs to take the most suitable action.

e) Reduced rates of contribution (below 20%) to the CGA, currently enjoyed by some entities with employees registered in the CGA, will be eliminated.

f) The wage reference used by the self-employed to determine minimum contributions to social security will move from one minimum wage to 1.5 minimum wages.

g) Measures will also be taken to cut down significantly on the practice of granting early retirement for reasons other than disability. Early retirement may well be beneficial to the enterprises and workers directly involved, but they usually have a high financial cost for social security (because beneficiaries cease contributing when relatively young and receive a pension for exceptionally long periods).

h) Some of these measures will take time to produce effects and the social security finances have to be bolstered in the short and medium term. The standard rate of VAT will therefore go up by 2 p.p. from 1 July 2005. The additional revenue generated from this rise (from 19% to 21%) will be channelled into social security (including the CGA).

i) As a final point, the Government will bolster social justice and cut poverty among the country's senior citizens by introducing a top-up income scheme to guarantee a minimum monthly income of 300 euros. The measure will be phased in from 2006.

3.3.3 Improvement in the quality of public expenditure and in the use of public infrastructures and resources

a) Real estate

It is generally recognised in Portuguese society that there is more property belonging to the State than is needed and it is managed very badly. There are many properties which the State cannot justify owning. They may be urban and rural, unoccupied or rented to private individuals. Moreover, there are many situations where public services occupy spaces that do not respect basic efficiency standards. In addition, in spite of the surplus property, some services rent space from private entities and this plays its part in increasing inefficiency in the management of state-owned property. The Government intends to change this situation over time, with a two-pronged strategy.

Firstly, the Government will, this year, establish clear rules for the rapid reclassification of use and for urban listing of unused properties that belong to the State, to public institutions or to state-owned enterprises. These properties will be put on the market on a case-by-case basis.

Secondly, also in 2005, the Government will start an exhaustive inventory of all spaces currently occupied by central government services. The results of this will allow the Government to define benchmarks for the use of space. To do this it will bear in mind all the information relating to the size and nature of each service, along with the type of property that the service uses. This will provide a list of excess spaces to be reassigned or hived off.

In addition, starting in 2007, each service will receive from the Treasury an annual credit for a space considered adequate, and will pay a rent to the Treasury with respect to the space actually used. The potential savings here stem from the difference between the total space occupied currently by public services and the total occupied in terms of a benchmark. The payment of rent will, of course, be limited to properties belonging to the State and at present made available to the services for free. The definition of benchmarks will also be used for services that rent property from private entities. At the same time, it will be considered moving services from major central urban areas, where space has a high market value, to more peripheral areas, if this leads to significant budgetary savings without jeopardising the quality and efficiency of the service.

b) Sectoral reform programmes

Health, education and justice are also priority reform areas. The challenge is to make substantial improvements to the quality of service while holding public expenditure on a tight rein. The Government is committed to carrying out an appraisal of management practices over the next few months regarding public money in each of these sectors. There will be concrete proposals to solve problems and clear bottlenecks without increasing overall expenditure. These sectoral reform programmes will become part of multi-annual plans to cut current expenditure, to be presented to Parliament.

Health is one of the most critical areas in terms of pressure on budgetary expenditure. The strategy here will be to gradually extend the business organisation model to all the hospitals in the National Health Service (SNS). This will allow the improvement of management practices at these hospitals and its managers will be made responsible for the results achieved. The new model will help to break the chain of budget overruns in the SNS and eliminate its lack of transparency.

The so-called health sub-regions will be phased out by the end of 2006. This will tie in with the reformulation of the functions carried out by the Regional Health Administrations and health centres. Along with this there will be intensive training and re-allocation for those who have become surplus to requirement following the reorganisation.

In the very short term, in fact this very month of June, an initial series of measures will be taken to halt the worsening financial situation of the SNS. Among them are the following:

- Generic medicine will no longer receive the 10% subsidy it has had up to now;
- Revision of band A of the State subsidy on medicine, from 100% to 95%, with reimbursement of chronically ill persons who have an income equivalent to the national minimum wage or less (means tested);
- A 3.0% revision down in the price of all subsidised medicine;
- A 3 percentage point cut in the sales margins for medicine, both for wholesale and retail distribution;
- Furtherance of a new system to check third-party invoices and effectively reduce waste and fraud in the SNS;

- Changes to the law to hinder situations where aditional subsidization of medicine for low income pensioners is used abusively.

The Government will phase in tax increases on tobacco over its term in office to help finance the structural health sector expenditure growth. This will be carried out through adjustments to the quantity and/or *ad valorem* components of the tax. This will mean a nominal annual 15% rise in the tax levied per packet of cigarettes for each year between 2006 and 2009. The increase will bring in additional fiscal revenue and at the same time act as a further disincentive to smoking. And smoking is responsible, directly or indirectly, for a not so trivial part of the country's health costs.

The aim for both primary and secondary education is to exert effective control over the number of new teachers. There will be an array of measures designed to limit situations where teachers are able to partially or even totally cut their teaching load during the academic year. This will allow a reduction in the number of teachers hired on annually renewable contracts, with the correspondent budgetary savings. To this end, the Government will, in the short run:

- Revoke article 121 of the Teaching Profession Career Code, which allows teachers who would reach the legal retirement age in the middle of the academic year, not to be required to have a teaching load during that year;
- Change the terms of the Code so that a teacher who has pedagogical responsibilities outside the classroom benefits from the reduction in teaching load only if (s)he does not benefit already from a reduction according to article 79 of the said Code;
- Teachers who are totally or partially unable to fully perform their functions, and who were excused from their teaching load, will have the maximum time allowed for recovery reduced (this stands now at 2 years, paragraph (d) of clause 1, article 81 of the Code). In addition, the supervision and inspection of this kind of situation will be stepped up;
- Students on educational trainee work will not be put in charge of a school class, and so will not receive any payment for the work.

c) Additional financing for public policies

In spite of all the measures that the Government will be taking to control expenditure, including the sectoral programmes detailed above, it will still be necessary to raise more resources to finance public policies.

The budgetary deficit as it stands means that there are simply not enough resources available for requirements. This is above all true for critical sectors such as health, education, justice and public works. In terms of the last of these, it is important to continue with modernising and preserving infrastructures, with policies of national solidarity to support regional development, including through motorways without charge (tolls) to the users (SCUT). The country must also continue to make its contribution to investments co-financed by community funds.

In the Government's view, there has to be a phased increase in the tax on oil products (ISP) to the amount of 2.5 cents per litre on average,[1] to be introduced on 1 January 2006, 2007 and 2008. The increases will be on top of the annual increases needed to maintain the unit tax constant in real terms. If the price of oil on international markets comes down from the current high price, the tax increase may not generate higher prices to the consumer, and instead the decline in the prices would be smaller than if the ISP were not adjusted. The additional revenue stemming from this measure is estimated to be around 210 million euros in 2006, rising to 630 million euros in 2009.

d) Regional and local finances

In addition to any measures to be included in future budgets, the Government will set out proposals for reforming the financing of the autonomous regions and local authorities. The Government's Programme makes it clear that revisions to the regional and the local finance laws are essential if we are to improve the financial solidarity among central, regional and local governments. The revision should also ensure that the budgetary consolidation effort is spread evenly across the various strata of general government.

3.3.4 Bringing simple procedures and an ethical approach to the tax system, improvements in the efficiency of the Tax Administration and tackling evasion

[1] The specific increase for each product will depend on the price elasticity of its demand and on the prices at points of sale near the country's borders.

and fraud

The Portuguese tax system is extremely complex. There are a variety of special schemes and tax benefits that have been introduced over time. They have distorted the principles of simplicity, justness and transparency that should steer the system. Maybe the initial intention of certain special treatments or subsidies was to further some hypothetical fiscal justice. But it ended by stimulating organized economic interests to indulge in "aggressive tax planning" (understood as the use of tax loopholes to drastically cut down the payment of taxes). In other cases, inertia has set in, impeding the repeal of special schemes or subsidies when the conditions that led to their implementation no longer apply (or may even have changed upside down). Taken as a whole, the multiple special schemes and subsidies have had the extremely pernicious effect of making it much more difficult and expensive to stamp out fraud and tax evasion.

In this context, tax policy will concentrate on two areas: bringing a simple and ethical approach to the tax system, and improving the efficiency of the Tax Administration and tackling tax evasion and fraud.

a) Bringing a simple and ethical approach to the tax system

In the context of simplified procedures and an ethical approach to the tax system, benefits and deductions will be limited over an array of taxes. Changes will be made to personal income tax (IRS) and the simplified taxation scheme will be reviewed.

During this year, the Government will introduce a series of cuts to the tax benefits in force. Among them are the tax breaks for restructuring companies (DL 404/90), the rules for partial deduction of VAT, the scope of article 69 of the IRC code, and eliminate clause 4 of article 33-A of the tax benefit statute for offshore zones. Effective mechanisms will also be created to prevent the "laundering" of dividends by way of operations to park holdings or rights related to these holdings through agreements drawn up between entities subject to IRC and entities that are exempt from this tax or have a favourable tax treatment.

In terms of IRS, changes to the law will come into force as and from 2006. These include the gradual convergence of the deduction from pensions to the value of the specific deduction on employed workers' pay. An additional tax bracket will be created with a marginal rate of 42%. This will be applied to annual incomes

above 60 thousand euros.

Other measures may also be introduced after publication of the findings of two Commissions recently set up by the Government. One of these Commissions will analyse tax benefits and incentives. This Commission has a September 15 deadline by which to present proposals to simplify the tax system. It will then still be possible to include these measures in the 2006 Budget. This Commission will make a specific appraisal of the advantages and disadvantages of various forms of tax incentives for savings. These may or may not take the form of the incentives withdrawn in the 2005 Budget. In this specific area, the Government pledges to bring back tax incentives for savings without calling into question the budgetary consolidation effort. The second Commission was set up to study measures to simplify the fiscal system and in particular to create simplified taxation schemes for those running small businesses. The proposals of this Commission should be in the Government's hands in the course of 2006, and the measures in this area can then be put into effect at the beginning of 2007.

b) Improving the efficiency of the Tax Administration and tackling tax evasion and fraud

In this area, improving the efficiency of the Tax Administration and tackling tax evasion and fraud, the Government will implement a raft of legislative, operational and technological measures. The goal is to encompass every relevant angle of a complex and multi-faceted phenomenon. Among the wide array of legislation in the pipeline, the following initiatives will be presented in Parliament:

- Publication of individual taxpayers' gross annual income (proposal to be presented by the end of 2005);
- Publication of a list of companies with outstanding debts in the form of tax or contributions (proposal to be presented by September);
- Endowments in cash will be subject to stamp duty (proposal to be presented by September).

On the operational front, a number of initiatives are in progress:

- Access to the taxpayers' bank information in situations where there is a high risk of fraud and tax evasion;

- The cross-checking of data with other bodies, specifically social security, the Ministry of Justice, INGA, the municipal services and notaries;
- Implementation of a software system to allow tax office assessments when income tax returns (IRC and IRS) have not been duly made;
- An action plan to minimise the risk of back tax being lost as a result of reaching the statute of limitations;
- Personalised warnings sent to taxpayers with back tax to pay or assets that may have to be pledged;
- Speeding up of the valuation process on property put on or to be put on the market;
- Introduction of a system to offset reimbursement (of overpaid tax) against back tax due from any other source.

3.3.5 Privatization

The privatisation process carried out in Portugal over the past 20 years has helped to reduce the presence of the State in the business sector and boost competition. It has fostered an efficient use of economic resources and has given companies a competitive edge. Where the income generated by the disposal of assets was higher than expected future gains, the privatisation policy contributed to budgetary consolidation and the sustainability of public finances.

Over the next few years, the Government intends to take a more high-profile role in the definition of overall financial policies regarding the business area of State activity. It will define limits for the growth of the state-owned business sector debt and, working within the rules of competition, will improve its access conditions to the financial market through strengthening the bargaining position of these companies as a whole.

This approach is fundamentally the same as for any private shareholder. It will reinforce the control mechanisms over state-owned company financing and reduce the State’s indirect debt burden. This debt has been rising apace and has become a factor hobbling the future consolidation of the public accounts.

In this context, the Government intends to change the Council of Ministers' Resolution of 22 July, no. 55/93 such that from 2006 onwards more than 80% of the receipts from privatisation will be channelled into the amortisation of public debt. The aim is to optimise the management of the direct and indirect financial liabilities of the State. The measures taken should free up the national financial system's credit capacity for private enterprise. This will counter the crowding-out effect associated with the dysfunctional financial approach of the State and state-owned enterprises.

The Government intends to continue with a privatisation policy, which has a twofold purpose: it underpins the consolidation of the public finances, through the cut in public debt; and favours economic growth. The Government is seeking to dovetail two things: to use the privatisation receipts to cut the public debt and to restructure the companies which render public services, with clear goals and adequate execution. The restructuring process will imply also the privatisation of indirect holdings in non-strategic business areas for these state-owned enterprises and will slot into the overall rationalisation of the business area of the State's activity.

3.3.6 Overview of the effects of these measures and reforms during the legislature

Table 3.2 provides an overview of the measures and reforms described above. Also included are the estimated first order effects set out in the framework of the macroeconomic projections in Section 4 of this Programme.

Of particular interest is the cumulative effect of the measures, based on first order effects, and the adjustment features. On this last point, the adjustment in the first two years is predominantly the result of measures generating new budgetary revenue, while in the last two years the overwhelming effect is on the reduction of the public expenditure burden.

Table 3.2
CUMMULATIVE DIRECT EFFECTS OF THE MAIN BUDGETARY CONSOLIDATION MEASURES

EUR millions, constant prices 2005

	2005	2006	2007	2008	2009
REVENUE					
Taxes on income and wealth					
(i) Measures tackling tax evasion and improving the efficiency of Tax Administration	150	300	400	400	400
(ii) Tax benefits	0	200	300	350	400
-- Reduction in IRS specific deductions for the highest pensions income					
-- Tax breaks for restructuring companies (DL 404/90)					
-- Imposition of constraints within the scope of article 69 of IRC Code					
-- Elimination of clause 4 of article 33-A of the tax benefit statute for offshore zones					
(iii) Creation of an additional IRS tax bracket with a marginal rate of 42% to be applied to annual incomes above 60 thousand euros	0	25	25	25	25
VAT					
(i) Tackling tax evasion	100	200	200	200	200
(ii) Increasing standard rate from 19 to 21%	400	900	900	900	900
(iii) Tax benefits	30	100	100	100	100
-- Revision of the VAT exempt regime in the case of restructuring financial holdings					
-- Revision the rules for partial deduction of VAT					
ISP- tax on oil products (on top of the annual update to compensate inflation, including 2005)	0	210	420	630	630
-- An increase in ISP of 7.5 cents per litre to come into effect in three steps (€ 0.025/litre each) at the beginning of 2006, 2007 and 2008					
Tax on tobacco	0	180	360	540	720
-- A nominal annual 15% rise in the tax levied per packet of cigarettes for each year between 2006 and 2009					
Social security contributions					
(i) A rise in the wage reference to determine minimum contributions to social security of the self-employed from 1 to 1.5 minimum wages.	30	60	60	60	60
(ii) Measures to tackle the evasion and fraud	0	50	100	150	200
EXPENDITURE					
Control of social security expenditure					
-- Private sector	0	200	420	630	840
-- Public service	0	230	460	700	950
Top-up income scheme for senior citizens (fight against poverty)	0	-50	-100	-150	-200
Savings on medicine subsidies	25	100	100	100	100
Wage moderation in the public service	100	400	700	1000	1300
(i) Wage scale update of 2% per year					
(ii) Reduction in the wage drift (i.e. the average wage increase beyond the wage scale update), through:					
-- New public service wages ans careers structure from 1 January 2007 onwards					
-- Freeze on automatic career progressions until new career and remuneration system comes into force					
-- Constraints on promotions until new career and remuneration system comes into force					
-- Slower growth of public servants' imputed social contributions (a)					
-- Effective public servants placement on Surplus Staff Exchange (b)					
-- Revision of the rules on extra-time compensation for doctors					
-- Elimination of compensation for students on education trainee work					
Reduction in the number of public servants (relative to a 0% change benchmark), and better human resources management	0	75	150	225	300
(i) Partial replacement of public servants who retire					
(ii) Revision on teaching profession career code, to decrease the number of schoolteachers with reduced or zero classroom hours					
(iii) Workers who move from the Surplus Staff Exchange to the private sector					
(iv) Limitation on admission of new public servants in regional and local government					
Average annual growth of 15% in public investment non co-funded by the EU Relative to benchmark of 5% nominal growth	-40	-110	-190	-450	-850
Disposal of state-owned real estate	100	200	200	200	200
TOTAL 1st ORDER EFFECTS OF THE MEASURES IMPACTING ON DEFICIT	**895**	**3270**	**4605**	**5610**	**6275**
p.m. GDP	140094	142059	145197	148985	153392
TOTAL1st ORDER EFFECTS OF THE MEASURES IMPACTING DEFICIT(%GDP)	**0,6**	**2,3**	**3,2**	**3,8**	**4,1**

Notes: (a) Convergence of the health sub-systems to ADSE.
(b) At the end of three months on the exchange, public servants will lose their so-called “job-related pay".

4. Macroeconomic projections and budgetary objectives

4.1. The baseline scenario: assumptions

The macroeconomic and budgetary projections are grounded in the European Commission spring economic forecasts issued in April 2005. However, this has been updated to map out the external framework for the Portuguese economy. The Commission's forecast was that external demand for goods and services relevant to Portugal would grow by 7.6% in 2005 and 7.0% in 2006. Information on 2005 coming in after this recommends that the growth of this variable should be scaled down. Bearing this is mind, the Programme has taken 6.6% as the 2005 growth figure, 1 p.p. down on the Commission's spring forecast. The 7% figure – also given for the other years to Programme horizon – has been kept.

Table 4.1
Basic assumptions

	2004	2005	2006	2007	2008	2009
Relevant foreign markets growth (a)	8,5	6,6	7,0	7,0	7,0	7,0
Oil prices (*Brent*, USD/barrel)	37,9	50,1	50,3	49,0	47,0	46,0
Nominal effective exchange rate (a)	0,6	0,4	0,0	0,0	0,0	0,0
USD/EUR exchange rate (b)	1,2	1,3	1,3	1,3	1,3	1,3
Short-term interest rate (b)	2,1	2,1	2,5	2,9	3,3	3,6
Long-term interest rate (b)	4,1	3,9	4,5	5,0	5,0	5,0

Source: Ministry of Finance, based on information from the Bank of Portugal, Bloomberg and European Commission.
Notes:
(a) Annual rate of change.
(b) Annual average.

It has already been mentioned that Portuguese exports lost considerable market share in 2004 (see Section 2). Part of this stems from products coming from the new EU member states and China. In line with the European Commission's forecasts, and not considering any other determining factors for Portuguese

exports, the loss of market share in 2005 will be intense, but less so in 2006.[1] In this year, in fact, the loss will be partially offset by the likely increase in car exports as a new model from one of the main plants in the sector comes off the assembly line. From 2007 it is assumed that Portuguese structural market share will not continue to tail off. There might in fact even be a slight annual gain with the lag from the vehicle production mentioned above and mainly from the tourist industry.

In terms of interest rates and the exchange rate, a range of technical hypotheses was considered, and the following points are highlighted:

- Projections for short-term interest rates and the price of oil have 6 May 2005 as the cut-off date. The base point was reference to futures contracts traded on that day (with prices observed up to then factored in), using 3-month Euribor for interest rates and the price of Brent for oil (p.p.b. in US dollars);
- For the yield on 10-year Treasury bonds, the figures used for 2005 and 2006 were those used by the European Commission in its spring forecast. The rate for 2006 has been used for the remaining years to Programme horizon;
- The US dollar / euro exchange rate was estimated on the basis that the 6 May figure will carry over. This was also the assumption used for the effective nominal exchange rate for the Portuguese economy.

Underlying the baseline scenario presented in this Programme are the measures and reforms impacting on the budget, detailed in Section 3.

4.2 The baseline scenario: macroeconomic projections

Portuguese GDP growth should gather momentum to Programme horizon, coming in with 0.8% in real terms in 2005, rising to 3.0% in 2009 (se Table 4.2). As it picks up speed, it will benefit from the robust growth of external demand and the cushioning of the impact from increased competition in goods from the new member states and China. There was a sudden, unsustainable surge in domestic demand in

[1] It should be mentioned that the baseline macroeconomic scenario for this Programme has already factored in 2.5 p.p. for 2005 and 2.0 p.p. for 2006 as the likely contribution to the loss of market share.

2004. The main components of this will grow at a more moderate pace in 2005 and 2006, followed by a steady pick-up. The tighter fiscal policy will also have a role, in the short term, in dampening domestic demand, both directly and indirectly.

Table 4.2
Main macroeconomic indicators 2004-2009

Real rate of change	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
GDP	**1,0**	**0,8**	**1,4**	**2,2**	**2,6**	**3,0**
Private consumption	2,3	1,7	1,2	1,7	2,1	2,5
Public consumption	1,2	0,6	0,3	0,3	0,3	0,3
Investment	2,1	1,9	3,0	5,1	6,7	7,9
Exports of goods and services	5,1	3,3	6,5	8,1	7,9	7,9
Imports of goods and services	7,0	4,0	5,1	6,4	7,0	7,7
Unemployment rate (%)	6,7	7,4	7,7	7,6	7,3	6,9
Employment (rate of change)	0,1	0,4	0,7	1,1	1,3	1,5
Private consumption deflator (rate of change)	2,3	2,7	2,9	2,5	2,5	2,4
Households saving rate (% disposable income)	10,4	10,2	10,0	10,0	10,0	9,9

Source: Ministry of Finance (information for 2004 from INE - National Statistical Institute and Bank of Portugal).

As for the direct effects on expenditure, public consumption will grow in real terms only slightly to Programme horizon. Public investment (excluding the disposal of assets) will come in on the down side until 2007. This fall in public investment stems fundamentally from the expected path of EU structural funds in the last years of the III Community Support Framework as it stands.[1] This is in spite of a considerable effort to increase investment not co-funded by the EU. Nominal growth here will be around 10% in 2005, 2006 and 2007 (with 20% in 2008 and 25% in 2009, without jeopardising the aim of bringing the public deficit on a steep downward path).

The indirect effects of fiscal policy on domestic expenditure will stem from the

[1] From the national accounts perspective (that is, on an accrual basis) the fall in the amount of funds will have more impact than in terms of cash flow. Accounting rules in force have meant that recorded capital receipts have been higher than those actually received in cash terms. This derives from advances made by the Treasury in recent years, against structural funds receivable. This being so, these amounts, as and when they are transferred from the Commission to the Portuguese government, will not be booked again as receipts.

impact on real disposable income from the adjustments to indirect taxes, specifically VAT and the tax on fuel (ISP). These effects are likely to be on the wane from 2007 to 2009 and this will allow private domestic demand to steam ahead again, without causing greater macroeconomic imbalance, as it did in 2004.

The average annual unemployment rate is likely to reach 7.4% in 2005. With economic activity remaining sluggish, we are only likely to see this figure starting to track down from 2007. This projection is consistent with historical evidence, which points to over 2% GDP growth as the threshold for unemployment to come down. Employment is likely to pick up gradually and this will allow for a steady rise in average productivity per worker over the period. After many years with real wages growing more than productivity, it is essential that wage bargaining should be realistic during the period of the Programme. Both sides must bear in mind the mounting competition for Portuguese products in international markets and at home. What is needed is moderate growth of real wages, rising below productivity. Big pay rises will only serve to trim competitiveness and rack up unemployment. In past cyclical troughs, the Portuguese labour market managed to adjust salaries and avoid bigger rises in unemployment. This Programme includes projections to horizon based on this kind of behaviour in real salaries, even though the macroeconomic framework is now different from past adjustments periods (with the inflation rate, for instance, being much lower).

With moderate pay rises, the consumer inflation rate is likely to stand at 2.7% this year (the annual average rate, compared with 2.3% in 2004) and then peak at 2.9% in 2006. To Programme horizon, inflation is likely to level off at 2.5%. The rise in inflation is a consequence of the increase in indirect taxes (VAT, ISP and tobacco tax) included in the budgetary adjustment programme. The price of oil may in fact follow the path set out in the baseline scenario, in which case a proportion of the rise in ISP could be offset by the gradual easing of international prices.

The household savings rate is likely to remain relatively stable at around 10% of disposable income to Programme horizon, after plummeting in 2004. As unemployment rises in 2005 and 2006, two effects are likely to cancel each other out: on the one hand, there will be the prudence associated to a growth in unemployment and on the other an effect of household consumption smoothing as the rise in inflation impacts on real disposable income. In the second part of the Programme, from 2007, the two effects tail off.

Table 4.3
Current and capital accounts

Balances as a percentage of GDP	2004	2005	2006	2007	2008	2009
Current and capital accounts	**-5,9**	**-6,2**	**-6,0**	**-5,7**	**-5,4**	**-5,3**
Current account	-7,5	-7,9	-7,6	-7,1	-6,7	-6,5
Goods and services	-7,7	-8,3	-7,6	-6,8	-6,2	-5,9
Income	-1,9	-1,8	-2,1	-2,4	-2,5	-2,5
Current transfers	2,1	2,1	2,2	2,1	2,1	2,0
Public	0,4	0,4	0,5	0,5	0,5	0,4
Private	1,7	1,7	1,7	1,6	1,6	1,6
Capital account	1,6	1,7	1,5	1,4	1,2	1,1
Of which: public capital transfers	1,7	1,7	1,5	1,4	1,2	1,1

Source: Ministry of Finance (information for 2004 from the Bank of Portugal).

Section 2 highlights the fact that in 2004 the deficit on current and capital accounts stood at 5.9% of GDP (Table 4.3). The projection is for a slight rise in this deficit to 6.2% and this will then only trim, in spite of the economic recovery. The abnormal growth in imports in 2004 has not been extrapolated to future projections and there is likely to be a return to a situation where this aggregate moves fundamentally in line with overall expenditure. This should bring about a gradual fall in the trade deficit from a peak of 8.3% of GDP in 2005 to 5.9% of GDP in 2009. This fall will not, however, reflect totally in the combined current and capital balances. There are two contrasting reasons for this. The deficit on the income account will rise gradually over the period, reflecting a more gloomy net external position and interest rates will rise. On top of this, the likely fall in capital transfers from the EU may well mitigate against an improvement in the balance for goods and services.

Table 4.4
Sectoral balances

As a percentage of GDP

	2004	2005	2006	2007	2008	2009
Net lending vis-à-vis the rest of the world = current account + capital account balances	-5,9	-6,2	-6,0	-5,7	-5,4	-5,3
Net lending of the private sector (a)	-0,7	0,2	-1,2	-1,8	-2,6	-3,8
Net lending of general government (a)	-5,2	-6,4	-4,8	-3,9	-2,8	-1,6

Source: Ministry of Finance (information for 2004 from the Bank of Portugal).
Note: (a) Excluding the general government extraordinary receipts in 2004 (€ 3051,5 million) and in 2005 (€ 200 million).

The deficit on current and capital accounts reflects the net borrowing requirements of resident economic agents in Portugal vis-à-vis the rest of the world. The projected levels for the public and external deficits in 2005 are very similar, which means that the external deficit is fundamentally a snapshot of the net borrowing requirements of general government (the public deficit). The net lending / borrowing of the private sector overall is relatively well balanced (see table 4.4). The projection is for a twin development over the period of the Programme: the borrowing requirement of general government will track down, and this will be partially offset by the increasing net borrowing requirement of Portuguese corporations, given their investment expansion then underway.

4.3. Baseline scenario: budgetary projections

Table 4.5
General government budgetary prospects

As a percentage of GDP

	2004	2005	2006	2007	2008	2009
Total revenue	**45,4**	**42,9**	**43,9**	**44,1**	**44,3**	**44,5**
Current revenue	41,6	41,6	42,7	43,0	43,3	43,5
o/w Indirect taxes	15,0	15,6	16,2	16,4	16,6	16,8
Direct taxes	9,2	8,9	9,2	9,5	9,8	10,2
Capital taxes	0,0	0,0	0,0	0,0	0,0	0,0
Social contributions	13,0	13,1	13,1	12,9	12,8	12,7
Capital revenue	3,8	1,3	1,2	1,1	1,0	0,9
Total expenditure	**48,4**	**49,1**	**48,7**	**48,0**	**47,1**	**46,0**
Current expenditure	43,7	44,7	44,7	44,4	43,6	42,7
o/w Compensation of employees	15,0	15,1	14,9	14,5	14,2	13,8
Social transfers in kind	3,0	3,1	3,0	3,0	3,0	2,9
Social transfers other than in kind	14,9	15,6	15,6	15,5	15,3	15,0
Pensions	11,3	11,8	11,8	11,8	11,7	11,6
Unemployment subsidies	1,2	1,4	1,4	1,4	1,3	1,2
Interest expenditure (including *swaps* and *FRAs*)	2,8	2,9	3,3	3,4	3,4	3,4
Capital expenditure	4,7	4,4	3,9	3,6	3,4	3,4
o/w Gross fixed capital formation	3,3	3,3	3,0	2,8	2,7	2,8
Overall balance	**-2,9**	**-6,2**	**-4,8**	**-3,9**	**-2,8**	**-1,6**
Primary balance	-0,1	-3,3	-1,6	-0,5	0,7	1,8
Current balance	-2,0	-3,2	-2,1	-1,4	-0,3	0,9
Capital balance	-0,9	-3,1	-2,7	-2,5	-2,4	-2,5
p.m:						
Overall balance excluding extraordinary receipts	-2,9	-6,4	-4,8	-3,9	-2,8	-1,6
Overall balance excluding extraordinary receipts and proceeds from real estate sales	-5,3	-6,6	-5,1	-4,1	-3,0	-1,8
Primary balance excluding extraordinary receipts and proceeds from real estate sales	-2,5	-3,6	-1,8	-0,7	0,4	1,6

Source: Ministry of Finance.

As the recovery gradually cuts in and economic growth takes a hold, the variation in real GDP will accelerate from 0.8% in 2005 to 2.6% and 3.0% in the last two years of the Programme. Bearing in mind the vast array of consolidation measures described in Section 3, the estimate is for a substantial reduction in the Portuguese budget deficit. The baseline scenario points to deficits of 6.2%, 4.8%, 3.9%, 2.8% and 1.6% of GDP to Programme horizon. This is consistent with the Government's target: to bring the budget deficit below 3.0% in 2008 and below 2.0% in 2009, without recourse to accounting expediencies (see Table 4.5).

The budgetary savings projection for the 2005-2009 period will be reached fundamentally through an increase in the current primary balance. There will only be a small dip in the capital deficit and a rise in the interest service burden (through the rise in interest rates and also, in the first years, a rise in the stock of public debt). The substantial improvement in the current primary balance between 2005 and 2009 will come through an increase in current receipts (1.9 p.p. of GDP) and a fall in current primary expenditure (2.5 p.p. of GDP).

In terms of components, on the current receipt side, the main contribution comes from fiscal receipts, a reflection of the consolidation measures. Social contributions are likely to remain steady as a proportion of GDP, dipping only slightly. On the current expenditure side, the biggest curb is on the growth in compensation of employees. This should be down by 1.3 p.p. of GDP by 2009, following the measures relating to changes in the career and remuneration system of public service, the Surplus Staff Exchange and the cut in new admissions to the public service. Where pensions are concerned, expenditure will stay virtually the same as a percentage of GDP, calling a halt to the steep upward shift in the pattern of debt.

The path of consolidation runs right through to Programme horizon. This can be confirmed from an analysis of the way the balance on the budget moves, corrected for cyclical effects, temporary measures and the disposal of assets[1] (see Table 4.6). As might have been expected, the indicator is steeper up to 2006 (1.5 p.p. cut in the deficit) and it then stays at over 0.5% of GDP in all following years. This indicator also brings us to a deficit below 3.0% of GDP in 2008 (2.6%) and this then comes on down to 1.8% in 2009. The starting point is so unfavourable that, even with the substantial consolidation effort, the level of the underlying deficit is still above the medium-term objective recommended by the European Commission for Portugal (0.5% of GDP).

[1] Specifically the proceeds from the sale of real estate.

Table 4.6
General government underlying balance developments

As a percentage of GDP

	2004	2005	2006	2007	2008	2009
Overall balance excluding extraordinary receipts and proceeds from real estate sales (1)	-5,3	-6,6	-5,1	-4,1	-3,0	-1,8
Primary balance excluding extraordinary receipts and proceeds from real estate sales (2)	-2,5	-3,6	-1,8	-0,7	0,4	1,6
Cyclical budgetary component (a) (3)	-0,8	-1,0	-1,1	-0,8	-0,4	0,0
Underlying balance (1)-(3)	-4,5	-5,5	-4,0	-3,3	-2,6	-1,8
Primary underlying balance (2)-(3)	-1,7	-2,6	-0,7	0,1	0,9	1,6

Source: Ministry of Finance.
Note:
(a) Calculated according to the European Commission method (production function).

As for the path of the public debt, the main objective is to keep it below 70% of GDP and reverse the rising trend towards Programme horizon. The projection for the baseline scenario is consistent with this objective. The maximum ratio is around 68% of GDP by the end of 2007 and this will fall in 2008 and then again in 2009, by which time it will be just below 65% of GDP (Table 4.7).

The variation projected for the debt ratio in 2005 is 4.6 p.p. of GDP. The reason behind this is the highly negative figure of the primary balance (which will reach -3.3 percent of GDP). The “snowball effect” (the effect of cost of debt net of GDP growth) will also play its part in the debt ratio increase (by 0.7 p.p. of GDP) while the remaining deficit - debt adjustments will have a estimated effect of 0.6 p.p. of GDP. Acquisition of financial assets (0.5 p.p. of GDP) is a particularly relevant part of this component, specifically in terms of capital endowments for the new “corporate hospitals”. These will be partially offset by receipts from the privatisation process, coming in this year at 0.3 p.p. of GDP. In addition, debt settlement should be equivalent to 0.4 p.p. of GDP.

From 2006, the primary balance should move up and continue to Programme horizon. There will also be a reduction in the growth differential between the interest rate implicit in the debt and the rate of change in the nominal GDP. In the deficit-debt adjustments there will be negative or nil contributions. All of this will lead to a lowering in the debt ratio as a percentage of GDP and the fall projected for this indicator in 2008 and 2009. The proceeds from privatisation

have an important position among the array of adjustments from cutting down the deficit to changing the pattern of debt (this revenue accounts for nearly 1 p.p. of GDP in 2006 and around 0.5 p.p. in following years). These proceeds are to be used fundamentally to debt redemption, given that the acquisition of financial assets is not to be significant as a GDP percentage from 2006.

Table 4.7
General government debt developments

As a percentage of GDP

	2004	2005	2006	2007	2008	2009
Gross debt	61,9	66,5	67,5	67,8	66,8	64,5
Change in gross debt ratio (1)	1,8	4,6	1,1	0,2	-1,0	-2,2
Contribution to change in gross debt ratio (a)						
Primary balance excluding extraordinary receipts (2)	-2,4	-3,4	-1,6	-0,5	0,7	1,8
Extraordinary receipts (3)	2,3	0,1	0,0	0,0	0,0	0,0
"Snow-ball" effect (4)	0,9	0,7	0,2	-0,1	-0,3	-0,4
Stock-flow adjustments (5)= (1)+(2)+(3)-(4)	0,9	0,6	-0,7	-0,1	-0,1	0,0
o/w: Net acquisition of financial assets (b)	0,0	0,2	-1,0	-0,4	-0,3	-0,2
- privatization proceeds	0,8	0,3	1,1	0,5	0,4	0,4

Source: INE (National Statistical Institute) and Ministry of Finance.

Notes:

(a) The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t}\right) + \frac{SF_t}{Y_t}$$

where *t* is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment, respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.

(b) Includes, with (-) sign, the privatization proceeds.

4.4. Sensitivity analysis to negative shocks

The fundamental scenario assumes robust growth in the relevant external demand for the Portuguese economy. This is taken as around 7 percent to Programme horizon. In terms of the international price of oil, we have assumed that it will stay relatively high, though starting to come down. There is a balance of risks associated with these assumptions – external demand might fall and the price of oil might rise. To test the impact of these possibilities on the Portuguese macroeconomic and budgetary scenario, another scenario (alternative I) with 1.1

p.p. less growth in external demand for every year was postulated.[1] This scenario also factored in a small drop in the price of Brent, based on the futures market and assuming that the price will stay at the average 2005 level (50.1 US dollars p.p.b.) to 2009.

Table 4.8 compares the projections from the baseline scenario. As might be expected, the growth differential for every year is negative and this knocks on: there is a bigger overall deficit and a higher level of public debt. Given this, if additional measures were not taken, the objective would not be reached – to bring the public deficit down to under 3.0% of the GDP by 2008. The objective would only be reached in 2009 and then only just. As for public debt, it will continue to rise in this scenario until 2008, although it will not top 70% of GDP in any one year.

There is a second scenario (scenario II) and this was also put together to test the sensitivity of projections in the case of a more marked rise in interest rates. Short- and long-term interest rates were postulated at 1 p.p. above the assumptions in the baseline scenario. This was taken from mid-2005 to Programme horizon.[2] The findings are also given in Table 4.8. Higher interest rates clearly impact on growth, above all in the early part of the Programme, just after the rise. As for the effect on the deficit and public debt, the impact of an extra debt service burden must be added to the likely slower growth. In the case of the country's public debt, we must add the favourable change in the implicit rate of interest and the nominal rate of GDP growth.

In this case, there would also need to be additional measures if the aim of bringing the deficit below 3% is to be reached. On top of this, the debt ratio rises more than in alternative I and will top 70% by a slight margin in 2007 and 2008.

[1] Including 2005. The latest European Commission forecast considers the relevant external demand for the Portuguese economy and in the light of this the differential in alternative i is -2 p.p. in 2005.
[2] This implies that average annual rates will rise by 0.5 p.p. in 2005 and 1 p.p. in the remaining years.

Table 4.8
Sensitivity analysis

	2005	2006	2007	2008	2009
Alternative I - Less growth in external demand and constant oil price (a)					
Real GDP growth	0,5	1,1	1,8	2,1	2,5
Private consumption deflator	2,6	2,8	2,4	2,4	2,2
Unemployment rate (%)	7,6	8,0	8,1	8,0	7,8
Net lending vis-à-vis the rest of the world (% GDP)	-6,4	-6,3	-6,2	-6,0	-6,0
Net lending of general government (% GDP)	-6,4	-5,1	-4,5	-3,7	-2,9
Gross public debt (% GDP)	66,8	68,4	69,5	69,7	69,0
Comparison with the baseline scenario					
Real GDP growth	-0,3	-0,3	-0,4	-0,5	-0,5
Private consumption deflator	0,0	-0,1	0,0	0,0	-0,1
Unemployment rate (%)	0,1	0,3	0,5	0,7	0,9
Net lending vis-à-vis the rest of the world (% GDP)	-0,1	-0,3	-0,4	-0,6	-0,6
Net lending of general government (% GDP)	-0,1	-0,3	-0,6	-0,9	-1,4
Gross public debt (% GDP)	0,3	0,8	1,7	2,9	4,5
Alternative II - Higher interest rates (b)					
Real GDP growth	0,4	1,0	1,9	2,5	2,8
Private consumption deflator	2,7	2,8	2,4	2,4	2,2
Unemployment rate (%)	7,5	8,0	8,0	7,8	7,4
Net lending vis-à-vis the rest of the world (% GDP)	-6,4	-6,3	-5,8	-5,3	-5,1
Net lending of general government (% GDP)	-6,6	-5,5	-4,9	-4,0	-3,0
Gross public debt (% GDP)	67,1	69,1	70,4	70,6	69,7
Comparison with the baseline scenario					
Real GDP growth	-0,4	-0,4	-0,3	-0,1	-0,1
Private consumption deflator	0,0	0,0	-0,1	-0,1	-0,1
Unemployment rate (%)	0,1	0,3	0,4	0,5	0,5
Net lending vis-à-vis the rest of the world (% GDP)	-0,1	-0,3	0,0	0,1	0,3
Net lending of general government (% GDP)	-0,3	-0,7	-1,0	-1,2	-1,4
Gross public debt (% GDP)	0,6	1,5	2,6	3,8	5,2

Source: Ministry of Finance.

Notes:

(a) Scenario with 1 p.p. less in external demand growth than in the baseline and the price of Brent at the average 2005 level.

(b) Short- and long-term interest rates 1 p.p. above the assumptions of the baseline scenario from mid-2005 on.

4.5. Comparison with the December 2003 Programme

If we compare the fundamental scenario presented here with the December 2003 update and if we take out extraordinary receipts and asset disposals, the path for the deficit now is significantly higher for the years common to both programmes (2004-2007). The explanation for this rise in the net borrowing of general government is explained in part by the lower economic growth than anticipated earlier, specifically for 2005 and subsequent years. Since the 2003 update, there has been a worsening of the budgetary balances and this translates into a substantially higher projected public debt. It now goes above the GDP reference point of 60% (standing at between 2 p.p. and 8 p.p. higher during the period under review).

Table 4.9
Comparison with the December 2003 update

	2004	2005	2006	2007	2008	2009
Real GDP growth (%)						
Dec 2003 update (1)	1,0	2,5	2,8	3,0	-	-
June 2005 update (2)	1,0	0,8	1,4	2,2	2,6	3,0
Difference (2)-(1)	0,0	-1,7	-1,4	-0,8	-	-
Net lending of general government (% GDP)						
Dec 2003 update	-2,8	-2,2	-1,6	-1,1	-	-
Dec 2003 update, excluding temporary measures (1)	-4,8	-3,6	-2,3	-1,4	-	-
June 2005 update[(a)] (2)	-5,2	-6,2	-4,8	-3,9	-2,8	-1,6
Difference [(b)] (2)-(1)	-0,4	-2,6	-2,5	-2,5	-	-
Gross public debt (% GDP)						
Dec 2003 update (1)	60,0	59,7	58,6	57,0	-	-
June 2005 update (2)	61,9	66,5	67,5	67,8	66,8	64,5
Difference (2)-(1)	1,9	6,8	8,9	10,8	-	-

Source: INE (National Statistical Institute) and Ministry of Finance.

Notes:
(a) Current values exclude extraordinary receipts.
(b) Excluding extraordinary receipts in both updates.

5. Long-term sustainability of public finances

The Government has created a working group (as mentioned above) to look into the long-term sustainability of social security. As this work is still in progress, no analysis has been included of the long-term sustainability of the public finances.

ANNEX
Statistical Tables

Table 1.a Macroeconomic prospects

	ESA Code	2004 level (10^6 euros)	2004 rate of change	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change
1. Real GDP [1]	B1*g	131805	1,0	0,8	1,4	2,2	2,6	3,0
2. Nominal GDP	B1*g	135035	3,5	3,7	4,9	5,5	5,9	6,1
Components of real GDP								
3. Private consumption expenditure	P.3	82837	2,3	1,7	1,2	1,7	2,1	2,5
4. Government consumption expenditure	P.3	28015	1,2	0,6	0,3	0,3	0,3	0,3
5. Gross fixed capital formation	P.51	29868	1,3	1,1	2,3	4,4	6,1	7,2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53		0,9	0,7	0,7	0,7	0,6	0,7
7. Exports of goods and services	P.6	41276	5,1	3,3	6,5	8,1	7,9	7,9
8. Imports of goods and services	P.7	50974	7,0	4,0	5,1	6,4	7,0	7,7
Contributions to real GDP growth								
9. Final domestic demand			2,0	1,3	1,4	2,1	2,8	3,4
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		0,0	-0,2	0,0	0,0	0,0	0,1
11. External balance of goods and services	B.11		-1,0	-0,5	0,1	0,1	-0,2	-0,4

[1] Real GDP is calculated on the basis of previous year's prices.

Table1b. Price developments

	2004	2005	2006	2007	2008	2009
	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator	2,5	2,9	3,4	3,2	3,2	3,0
2. Private consumption deflator	2,3	2,7	2,9	2,5	2,5	2,4
3. HICP	2,5	2,5	2,9	2,5	2,5	2,4
4. Public consumption deflator	2,9	4,5	3,3	3,8	3,1	2,9
5. Investment deflator	2,1	2,5	2,7	2,4	2,5	2,7
6. Export price deflator (goods and services)	1,0	2,0	1,8	2,1	1,9	1,9
7. Import price deflator (goods and services)	1,9	2,3	0,8	1,0	0,7	0,8

Table 1c. Labour market developments

		2004	2004	2005	2006	2007	2008	2009
	ESA Code	level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons [1]		5122800	0,1	0,4	0,7	1,1	1,3	1,5
2. Unemployment rate (%) [2]			6,7	7,4	7,7	7,6	7,3	6,9
3. Labour productivity, persons [3]			0,9	0,4	0,7	1,1	1,3	1,5
4. Compensation of employees [4]	D1	68918	2,6	2,9	2,9	2,8	3,0	3,5

[1] Occupied population, Portuguese National Accounts definition.

[2] Harmonised definition, Eurostat.

[3] Real GDP per person employed.

[4] Rates of change of compensation per employee, excluding the State transfer to the public servants social security scheme (Caixa Geral de Aposentações - CGA).

Table 1d. Sectoral balances

% of GDP	2004	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis the rest of the world	-5,9	-6,2	-6,0	-5,7	-5,4	-5,3
of which: - Balance of goods and services	-7,7	-8,3	-7,6	-6,8	-6,2	-5,9
- Balance of primary incomes and transfers	0,2	0,3	0,0	-0,3	-0,4	-0,5
- Capital account	1,6	1,7	1,5	1,4	1,2	1,1
2. Net lending/ borrowing of the private sector	-3,0	0,0	-1,2	-1,8	-2,6	-3,8
2. Net lending/borrowing of general government	-2,9	-6,2	-4,8	-3,9	-2,8	-1,6

Table 2. General government budgetary prospects

	ESA Code	2004 level (10^6 euros)	2004 % of GDP	2005 % of GDP	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP
Net lending (B9) by sub-sector								
1. General government	S.13	-3953	-2,9	-6,2	-4,8	-3,9	-2,8	-1,6
2. Central government	S.1311	-7281	-5,4	-6,0	-4,6	-3,8	-2,8	-1,6
3. Local government	S.1313	103	0,1	-0,2	-0,1	0,0	-0,1	-0,2
4. Social security funds	S.1314	3225	2,4	0,0	-0,1	0,0	0,1	0,2
General government (S13)								
5. Total revenue	TR	61366	45,4	42,9	43,9	44,1	44,3	44,5
6. Total expenditure	TE (1)	65319	48,4	49,1	48,7	48,0	47,1	46,0
7. Net lending/ borrowing	EDP B.9	-3953	-2,9	-6,2	-4,8	-3,9	-2,8	-1,6
8. Interest expenditure	EDP D.41	3831	2,8	2,9	3,3	3,4	3,4	3,4
9. Primary balance	(2)	-122	-0,1	-3,3	-1,6	-0,5	0,7	1,8
Selected components of revenue								
10. Indirect taxes	D.2	20249	15,0	15,6	16,2	16,4	16,6	16,8
11. Direct taxes	D.5	11977	8,9	8,3	8,7	9,0	9,3	9,7
12. Capital taxes	D.91	19	0,0	0,0	0,0	0,0	0,0	0,0
13. Social contributions	D.61	17491	13,0	13,1	13,1	12,9	12,8	12,7
14. Property income	D.4	1079	0,8	0,4	0,5	0,5	0,4	0,4
15. Other (15=16-(10+11+12+13+14))		10551	7,8	5,6	5,3	5,2	5,1	4,9
16=5. Total revenue	TR	61366	45,4	42,9	43,9	44,1	44,3	44,5
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) (3)		49736	36,8	36,9	38,0	38,4	38,8	39,1
Selected components of expenditure								
17. Collective consumption	P.32	24812	18,4	18,6	18,3	18,0	17,6	17,1
18. Social transfers in kind	P.31= D.63	4015	3,0	3,1	3,0	3,0	3,0	2,9
19. Social transfers other than in kind	D.62	20156	14,9	15,6	15,6	15,5	15,3	15,1
20=8. Interest expenditure	EDP D.41	3831	2,8	2,9	3,3	3,4	3,4	3,4
21. Subsidies	D.3	2213	1,6	1,6	1,5	1,5	1,5	1,4
22. Gross fixed capital formation	P.51	4480	3,3	3,3	3,0	2,8	2,7	2,8
23. Other (23=24-(17+18+19+20+21+22))		5811,6	4,3	4,0	3,9	3,7	3,6	3,4
24=6. Total expenditure	TE (4)	65318,8	48,4	49,1	48,7	48,0	47,1	46,0
pm: compensation of employees (5)		17206	12,7	12,7	12,4	12,0	11,7	11,3
public servants wages(6)		15059	11,2	11,1	10,8	10,5	10,2	9,9
total compensation of employees	D1	20312	15,0	15,1	14,9	14,5	14,2	13,8

(1) Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

(2) The primary balance is calculated as (EDP B.9, item 7) minus (EDP D.41, item 8).

(3) Including those collected by the EU.

(4) Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

(5) Excludes the State transfer to CGA.

(6) Excludes employers' social contributions, imputed social contributions and the State transfer to CGA.

Table 3. General government debt developments

% GDP	2004	2005	2006	2007	2008	2009
1. Gross debt [1]	61,9	66,5	67,5	67,8	66,8	64,5
2. Change in gross debt ratio	1,8	4,6	1,1	0,2	-1,0	-2,2
Contributions to change is gross debt ratio [2]						
3. Primary balance [3]	-0,1	-3,3	-1,6	-0,5	0,7	1,8
4.“Snow-ball” effect	0,9	0,7	0,2	-0,1	-0,3	-0,4
5. Stock-flow adjustment	0,9	0,6	-0,7	-0,1	-0,1	0,0
of which:						
-Net accumulation of financial assets[4]	0,0	0,2	-1,0	-0,4	-0,3	-0,2
-privatization proceeds	0,8	0,3	1,1	0,5	0,4	0,4
p.m. implicit interest rate on debt [5]	5,0	4,9	5,1	5,3	5,4	5,4

[1] As defined in Regulation 3605/93 (not an ESA concept).

[2] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1+y_t}\right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment, respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.

[3] Cf. item 9 in Table 2.

[4] Includes, with (-) sign, the privatization proceeds.

[5] Proxied by interest expenditure divided by the debt level of the previous year.

Table 4. Cyclical developments

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Real GDP growth (%)		1,0	0,8	1,4	2,2	2,6	3,0
2. Net lending of general government	EDP B.9	-2,9	-6,2	-4,8	-3,9	-2,8	-1,6
2a. p.m. excluding temporary measures (a)		-5,3	-6,6	-5,1	-4,1	-3,0	-1,8
3. Interest expenditure	EDP D.41	2,8	2,9	3,3	3,4	3,4	3,4
4. Potential GDP growth (%)		1,5	1,4	1,5	1,5	1,6	1,8
contributions:							
- labour		0,7	0,7	0,7	0,5	0,4	0,3
- capital		0,6	0,6	0,6	0,7	0,8	1,0
- total factor productivity		0,1	0,1	0,2	0,3	0,4	0,5
5. Output gap		-2,0	-2,6	-2,7	-2,0	-1,1	0,0
6. Cyclical budgetary component		-0,8	-1,0	-1,1	-0,8	-0,4	0,0
7. Cyclically -adjusted balance (2-6)		-2,1	-5,2	-3,7	-3,1	-2,3	-1,6
7a. p.m. cyclically-adjusted balance, excluding temporary measures (2a-6)		-4,5	-5,5	-4,0	-3,3	-2,6	-1,8
8. Cyclically -adjusted primary balance (7-3)		0,7	-2,3	-0,5	0,3	1,1	1,8
p.m. cyclically-adjusted primary balance, excluding temporary measures (7a-3)		-1,7	-2,6	-0,7	0,1	0,9	1,6

(a) In 2004 and 2005, are excluded temporary revenue-increasing measures ascending to € 3051.5 million and € 200 million, respectively; the proceeds of real estate disposables are excluded in all years.

Table 5. Divergence from December 2003 update

	ESA Code	2004	2005	2006	2007	2008	2009
Real GDP growth (%) **Dec 2003 update**		1,0	2,5	2,8	3,0	-	-
Current update		1,0	0,8	1,4	2,2	2,6	3,0
Difference		0,0	-1,7	-1,4	-0,8	-	-
General government net lending (% of GDP) **Dec 2003 update**	PDE B.9	-2,8	-2,2	-1,6	-1,1	-	-
Dec 2003 update, excluding temporary measures		-4,8	-3,6	-2,3	-1,4	-	-
Current update (a)		-5,2	-6,2	-4,8	-3,9	-2,8	-1,6
Difference (b)		-0,4	-2,6	-2,5	-2,5	-	-
General government gross debt (% do PIB) **Dec 2003 update**		60,0	59,7	58,6	57,0	-	-
Current update		61,9	66,5	67,5	67,8	66,8	64,5
Difference		1,9	6,8	8,9	10,8	-	-

(a) Current values exclude extraordinary receipts.
(b) Excluding extraordinary receipts in both updates.

Table 6. Basic assumptions

	2004	2005	2006	2007	2008	2009
Short-term interest rate (annual average)	2,1	2,1	2,5	2,9	3,3	3,6
Long-term interest rate (annual average)	4,1	3,9	4,5	5,0	5,0	5,0
USD/€ exchange rate (annual average)	1,2	1,3	1,3	1,3	1,3	1,3
Nominal effective exchange rate (annual average)	0,6	0,4	0,0	0,0	0,0	0,0
World excluding EU, GDP growth	5,7	4,8	4,6	4,6	4,6	4,6
EU-25 GDP growth	2,4	1,6	2,3	2,3	2,3	2,3
Growth of relevant foreign markets	8,5	6,6	7,0	7,0	7,0	7,0
World import volumes, excluding EE	12,8	9,1	7,7	7,7	7,7	7,7
Oil prices, (Brent, USD/barrel)	37,9	50,1	50,3	49,0	47,0	46,0