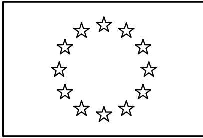

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DIRECTORATE GENERAL
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JUNE 2005 UPDATE OF THE STABILITY PROGRAMME OF PORTUGAL (2005-2009)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The Portuguese authorities submitted the most recent update of the Portuguese stability programme on 9 June 2005. The update covers the period from 2005 to 2009 and was submitted by the government that was installed following the general elections of 20 February 2005. It was approved by the government on 2 June in accordance with the Portuguese domestic procedures (Law on Budgetary Framework), and discussed by Parliament on 9 June 2005. The Commission services have carried out a technical evaluation of this update, taking into account the results of their own spring 2005 economic forecasts, having regard to the code of conduct,[2] the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the report of the Ecofin Council of 20 March 2005 on 'Improving the implementation of the Stability and Growth Pact', endorsed by the European Council on 22 March 2005.[3]

The update complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes"[4],[5]. However, it does not present projections on the long-term sustainability of the public finances, but instead only refers to a task force set up by the government to assess the long-term sustainability of the social security system.

The update of the stability programme is built around the need to correct a government deficit which at 6.2% of GDP in 2005 is planned to be well in excess of 3% of GDP. This figure follows a deficit of 2.9% of GDP in years 2002 to 2004, as recently reported by the Portuguese authorities reflecting discussions with Eurostat, and is considerably worse compared with the target of 2.2% of GDP for 2005 in the previous programme update. This deterioration is explained by weaker-than-expected growth, a reassessment of expenditure growth, over-runs compared to the budget and the non-introduction of one-off measures planned in the previous programme,[6] as well by a corrective package of

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1 This technical analysis, which is based on information available up to 24.06.2005, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme. It has been carried out by the staff of the Directorate-General of Economic and Financial Affairs of the European Commission and approved by Klaus Regling, Director-General of Economic and Financial Affairs. The views expressed in the assessment do not necessarily correspond to those of the European Commission. Comments should be sent to Mr. Pedro Cardoso (pedro.cardoso@eu.cec.int).

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

3 See Presidency conclusions of the Brussels European Council of 22 and 23 March 2005 (7619/05) and the (Ecofin) Council report to the European Council of 20 March 2005 (7423/05).

4 The Portuguese authorities had submitted an updated programme in December 2004, thereby complying with the formally required date of submission. However, in view of the upcoming general elections in Portugal, it was at the time decided not to assess that programme, but to wait for the update to be presented by the new government.

5 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

6 The government which came into office in March 2005 entrusted an ad-hoc commission under the overall responsibility of the Central Bank Governor with the assessment of the state of government

some 0.6% of GDP adopted by the new government in June 2005. For the reduction of the deficit, the update outlines a strategy that envisages the implementation of structural measures rather than the reliance on sizeable one-off and temporary measures, which indicates a change with respect to the budgetary strategy outlined in the previous updates. The government deficit is expected to continuously improve over the coming years, but will exceed the 3% of GDP reference value until at least 2007.

The macroeconomic scenario presented in the programme projects real GDP growth to increase from 1% in 2004 and 0.8% in 2005 to 1.4% in 2006, 2.2% in 2007, 2.6% in 2008 and 3.0% in 2009. This profile is driven by accelerating domestic demand. The external contribution is expected to diverge little from a neutral position, either on the positive or negative side. The growth projections for 2005 and 2006 are slightly below the Commission services' forecasts, reflecting the most recent developments. For the outer years, the projected GDP growth is clearly above the trend estimated by the Commission services according to the commonly agreed methodology; the output gap will narrow over the programme period, and is expected to be closed by the programme horizon. However, it cannot be excluded that the budgetary consolidation efforts may weigh on growth to a higher degree than implicitly assumed in the programme. On the other hand, the perception that an unsustainable fiscal situation is being addressed may generate favourable confidence effects. Moreover, weak competitiveness against the background of heightened competition on Portuguese export markets may hurt the net contribution of the external sector to growth. The projected acceleration in economic activity therefore hinges on addressing structural deficiencies in productivity and competitiveness, and on the capacity to restore confidence. All in all, in the light of the experience of past years, the growth projections for 2007 to 2009 seem to reflect optimistic assumptions and therefore contain an element of risk. The programme's projections for inflation for 2005 and 2006 also appear to be on the low side, given the planned increase in indirect taxes.

The update projects the general government deficit to reach 6.2% of GDP in 2005, following deficit ratios of 2.9% of GDP in both 2003 and 2004[7] (excluding one-off and temporary measures, these ratios would have been 5.4% and 5.2% of GDP respectively). The deficit is projected to decline to 4.8% of GDP in 2006, 3.9% in 2007 and 2.8% in 2008. For 2009, the programme projects a further decline of the deficit ratio to 1.6% of GDP. The primary balance is projected to follow a similar path: -3.3% in 2005, -1.6% in 2006, and -0.5% of GDP in 2007. Primary surpluses of 0.7 and 1.8% of GDP are projected for 2008 and 2009. The programme focuses on measures having medium-term impact and does not rely on sizeable temporary measures as the means to improve the budget balance. Accordingly, the consolidation effort will take place over the entire programme period with front-loading, since a substantial consolidation effort will take place in 2006. Calculations by the Commission services applying the commonly agreed methodology to the information in the programme show the cyclically-adjusted deficit to widen substantially to 5.3% of GDP in 2005 but to decline gradually to 1.4% of GDP in

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finances for 2005. In mid-May, the commission presented its findings, projecting for 2005 at unchanged policies a deficit of 6.8% of GDP.

[7] In its news release No 34/2005 of 18 March 2005, Eurostat communicated the existence of "ongoing discussions between Eurostat and Portugal on the consistency between accrual and cash-based data provided by Portugal, for the period 2001-2004." Subsequent information provided by the Portuguese authorities indicate small upward revisions for the years 2000, 2002 and 2003, yielding deficit ratios of 2.9% of GDP for each of these years. Eurostat is currently reviewing these revisions.

2009. The detailed projections of revenue and expenditure until 2009 show that consolidation efforts will be helped by both the tax revenue and primary expenditure sides, with a progressive contribution of the focus on the latter. In the early part of the programme period, consolidation is relying mainly on increasing revenues, through higher tax rates (notably an increase in the standard VAT rate from 19% to 21%), lower tax credits and improved tax collection, which partly offset the one-off revenues foregone. In the outer years, the increased contribution from expenditure restraint is foreseen to come from measures of a permanent nature, such as the reform of the public administration, including the containment of the wage bill and changes in the social security retirement schemes, whose budgetary effects will be significant mainly in the medium term. The share of investment in total government expenditure is to decline slightly over the programme period.

There are several elements of risk weighing on the budgetary projections. First, the acceleration in economic activity, in particular from 2007 onwards, may be slower than expected. Second, the revenue and expenditure trajectories may be less favourable than planned. Indeed, the higher tax rates heighten the risk of tax evasion, and most of the announced restraint on expenditure still needs to be legally implemented. For 2005, the government plans to submit a corrective budget by the end of June. For the outer years, expenditure reforms may nevertheless take longer to implement, and, as result, their short- and medium-term effects may turn out less significant than expected. In the event, the government might be called to fulfil its commitment to take additional measures in order to avoid the deficit exceeding 3% of GDP for longer than planned. Even if the projected path is adhered to, for 2008 and 2009, the budgetary stance in the programme does not provide a sufficient safety margin against breaching the deficit threshold with normal macroeconomic fluctuations. It is also insufficient to ensure that the Stability and Growth Pact’s medium-term objective of a budgetary position of close to balance is achieved by the end of the programme period.

The debt-to-GDP ratio breached the 60% of GDP reference value of the Treaty in 2003, moving up to 61.9% in 2004. According to the update, after reaching 66.5% of GDP in 2005, the debt ratio will peak in 2007 at 67.8% of GDP, and decrease thereafter to 64.5% in 2009. The evolution of gross debt may turn out less favourable than projected given the risks to economic activity and to the government deficit targets and the likelihood, based on past experience, of debt-increasing stock-flow adjustments, in particular the accumulation of financial assets.

With regard to the long-term sustainability of the public finances, Portugal appears to be at risk on grounds of the projected budgetary cost of an ageing population. In the absence of further measures, the high deficit and the rising debt-to-GDP ratio will undermine the sustainability of public finances, hence the timely achievement of a budgetary position close to balance is imperative. The structural reforms measures enacted to date, in particular in the areas of pension and health care, should ease the budgetary impact of ageing. However, these reforms do not appear sufficient to ensure sustainability. The reforms outlined in the update, notably on retirement provisions for the civil service, could contribute to this end if implemented thoroughly.

Overall, the economic policies outlined in the update are partly consistent with the country-specific Broad Economic Policy Guidelines in the area of public finances. As recommended, the programme projects the consolidation of public finances to take place to a large extent from the expenditure side, albeit in a progressive manner, and does not rely on sizeable one-off or temporary measures. Moreover, its projections, if adhered to,

imply an improvement in the cyclically-adjusted primary balance (net of one-off and temporary measures) of more than 0.5% of GDP each year. However, the programme does not plan to reduce the deficit below 3% of GDP before 2008, and the planned expenditure restraint will be insufficient to achieve the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance by the end of the programme period.

In the light of the deficit and debt figures for 2005 and following years presented in the updated stability programme, the Commission initiated the excessive deficit procedure for Portugal on 22 June. The Council, when deciding on the existence of an excessive deficit in Portugal, will also issue a recommendation for the correction of the excessive deficit; such recommendation will include, inter alia, a deadline for the correction of the excessive deficit.

In view of the above assessment, it would be appropriate for Portugal to: (i) limit the deterioration of the fiscal position in 2005, by ensuring rigorous implementation of the announced corrective measures; (ii) achieve a sustained correction of the excessive deficit as soon as possible, taking a substantial step in 2006 followed by a significant decrease each year, and enacting decisively the planned measures to reduce government expenditure; seize any opportunity to accelerate the reduction of the budget deficit, in particular to create margins to deal with the budgetary impact of possible lower-than-projected growth; (iii) bring the gross debt ratio onto a firm downward path, by ensuring that debt developments reflect progress in the reduction of the deficit and avoiding debt-increasing financial transactions; (iv) control the evolution of expenditure, possibly through the announcement of binding ceilings for specific expenditure categories, within a comprehensive reform programme improving the quality and ensuring the long-term sustainability of public finances; (v) further improve the processing of general government data.

Table: Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	**SP Jun 2005**	**1.0**	**0.8**	**1.4**	**2.2**	**2.6**	**3.0**
	COM April 2005	1.0	1.1	1.7	–	–	–
	SP Jan 2004	*1.0*	*2.5*	*2.8*	*3.0*	–	–
HICP inflation (%)	**SP Jun 2005**	**2.5**	**2.5**	**2.9**	**2.5**	**2.5**	**2.4**
	COM April 2005	2.5	2.3	2.1	–	–	–
	SP Jan 2004	*2.0*	*2.0*	*2.0*	*2.0*	–	–
General government balance (% of GDP)	**SP Jun 2005**	**-2.9**	**-6.2**	**-4.8**	**-3.9**	**-2.8**	**-1.6**
	COM April 2005	-2.9	-4.9	-4.7	–	–	–
	*SP Jan 2004**	*-2.8*	*-2.2*	*-1.6*	*-1.1*	–	–
Primary balance (% of GDP)	**SP Jun 2005**	**-0.1**	**-3.3**	**-1.6**	**-0.5**	**0.7**	**1.8**
	COM April 2005	-0.1	-2.0	-1.6	–	–	–
	SP Jan 2004	*0.1*	*0.9*	*1.5*	*2.0*	–	–
Cyclically-adjusted balance (% of GDP)	**SP Jun 2005**[1]	**-2.2**	**-5.3**	**-3.8**	**-3.1**	**-2.3**	**-1.4**
	COM April 2005	-2.0	-3.9	-3.7	–	–	–
	SP Jan 2004[1*]	*-1.7*	*-1.3*	*-0.9*	*-0.7*	–	–
Government gross debt (% of GDP)	**SP Jun 2005**	**61.9**	**66.5**	**67.5**	**67.8**	**66.8**	**64.5**
	COM April 2005	61.9	66.2	68.5	–	–	–
	*SP Jan 2004**	*60.0*	*59.7*	*58.6*	*57.0*	–	–

Note:
[1]Commission services calculations on the basis of the information in the programme.
* Including one-off and temporary measures.
Sources:
Stability programmes (SP); Commission services spring 2005 economic forecasts (COM); Commission services calculations.

1. INTRODUCTION

The Portuguese authorities submitted the most recent update of the Portuguese stability programme on 9 June 2005. The update covers the period from 2005 to 2009 and was submitted by the government that was installed following the general elections of 20 February 2005. It was approved by the government on 2 June in accordance with the Portuguese domestic procedures (Law on Budgetary Stability), and discussed by Parliament on 9 June 2005.

The update complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes". However, it does not address the sustainability of the public finances, but instead only refers to a task force set up by the government to assess the long-term sustainability of the social security system.

Upon the evidence of a planned general government deficit of 6.2% of GDP for 2005 presented in the updated stability programme, the Commission initiated the excessive deficit procedure for Portugal on 22 June 2005[8].

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario presented in the programme projects real GDP growth to increase from 1% in 2004 and 0.8% in 2005 to 1.4% in 2006 and further up to 2.2% in 2007, 2.6% in 2008 and 3.0% in 2009. The acceleration is assumed to be driven by domestic demand, notably investment is projected to expand strongly as from 2007. While exports are also assumed to grow briskly, the external contribution is expected to be close to neutral.

The external assumptions underlying the programme's macro-economic scenario are for export markets growth at 7% p.a. in 2006 and beyond (6.6% in 2005). Oil prices are assumed to marginally decrease from just over 50 USD/barrel in 2005/2006 to 46 USD/barrel by 2009. In this regard, the outlook is somewhat more cautious than the Commission services spring 2005 economic forecast.

The growth projections for 2005 and 2006 are slightly below the Commission services spring 2005 forecasts. Overall, on the basis of recent information, the short-term prospects seem plausible. The programme scenario reflects the most recent cyclical developments and internalises possible short-term effects of recent policy changes, notably tax hikes, on domestic demand. However, it cannot be excluded that the budgetary consolidation efforts may weigh on growth to a higher degree than implicitly assumed in the programme, in particular in the current year. On the other hand, the perception that an unsustainable fiscal situation is being addressed may generate favourable confidence effects.

[8] SEC(2005) 836 final. See also the accompanying technical document by the Commission Services.

Table 1: Comparison of macroeconomic developments and forecast

	2004		2005		2006		2007	2008	2009
	COM	SP	COM	SP	COM	SP	SP	SP	SP
Real GDP (% change)	1.0	1.0	1.1	0.8	1.7	1.4	2.2	2.6	3.0
Contributions:									
- Final domestic demand	2.1	2.0	1.6	1.3	2.0	1.4	2.1	2.8	3.4
- Change in inventories	0.2	0.0	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0
- External balance on g&s	-1.3	-1.0	-0.4	-0.5	-0.3	0.1	0.1	-0.2	-0.4
Employment (% change)	0.1	0.1	0.3	0.4	0.3	0.7	1.1	1.3	1.5
Unemployment rate (%)	6.7	6.7	7.0	7.4	7.0	7.7	7.6	7.3	6.9
HICP inflation (%)	2.5	2.5	2.3	2.5	2.1	2.9	2.5	2.5	2.4
GDP deflator (% change)	2.4	2.5	2.3	2.9	2.4	3.4	3.2	3.2	3.0
Net lending vis-à-vis rest of the world (% of GDP)	-6.1	-5.9	-6.1	-6.2	-6.0	-6.0	-5.7	-5.4	-5.3

Sources:
Commission services spring 2005 economic forecasts (COM); Stability programme (SP)

For 2007 and beyond, while the economy should remain on gradual upward trend, the projected path seems optimistic. First, it consistently exceeds the empirical estimates of potential output of both the update and the Commission services. Second, exports are foreseen to grow in excess of the assumed foreign market growth in 2007 and thereafter, thus Portuguese exports are expected to gain market shares. However, in the absence of substantial improvements in competitiveness, the strong export performance is unlikely to materialise, also considering that real unit labour costs have been increasing vis-à-vis major foreign competitors. The projected acceleration in economic activity therefore hinges on addressing structural deficiencies in productivity and competitiveness. All in all, and also in the light of the experience of past years, the growth projections for 2007 to 2009 seem to reflect favourable assumptions and therefore represent a risk.

Regarding the net lending vis-à-vis the rest of the world, the updated stability programme foresees only a gradual improvement despite the favourable assumptions on exports. According to the update, a deterioration in the income and capital balances will partly offset the expected improvement in the balance of goods and services.

The programme foresees HICP inflation to rise from 2.5% in 2004 and 2005 to 2.9% in 2006 and to stabilize around 2.5% thereafter. While the subdued pace of economic activity in the short term should hold back upward pressure on prices, as projected in the Commission services spring 2005 forecast, the increase in indirect taxes taking effect in the second half of 2005 will likely cause an at least temporary hike in inflation.

Table 2: Sources of potential output growth

	2004		2005		2006		2007	2008	2009
	COM	SP[3]	COM	SP[3]	COM	SP[3]	SP[3]	SP[3]	SP[3]
Potential GDP growth[1]	1.4	1.5	1.4	1.4	1.6	1.6	1.6	1.8	2.1
Contributions:									
- Labour	0.6	0.8	0.5	0.6	0.5	0.6	0.5	0.5	0.4
- Capital accumulation	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.9	1.0
- TFP	0.1	0.0	0.2	0.1	0.3	0.2	0.4	0.5	0.6
Output gap[1,2]	-2.5	-2.1	-2.8	-2.7	-2.7	-2.8	-2.3	-1.6	-0.7

Notes:
[1]based on the production function method for calculating potential output growth

[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the stability programme update (SP)

Sources:
Commission services spring 2005 economic forecasts (COM); Commission services calculations

Commission services calculations based upon the information provided in the programme, according to the commonly agreed methodology, estimate potential output growth to increase from an average of 1 ½% between 2004 and 2007 to just above 2% in 2009. The profile for potential GDP growth in the current and the next year is similar to the Commission services Spring forecast results. According to the update, the main contributors to the assumed acceleration of potential GDP are total factor productivity gains, which was close to zero in 2004, and also a higher contribution from capital accumulation in the outer years of the programme. The labour contribution will marginally decrease. The acceleration in labour productivity, which remains rather low compared with the euro area average, hinges on tackling the severe impediments of a low level of formal education of the labour force, poor innovation and investment in R&D and modest take-up of ICT. The significantly negative output gap is expected to reach a peak at around 2 ¾% of GDP in 2005/2006 and to gradually narrow thereafter.

3. Budgetary implementation in 2004 and 2005

After a general government deficit below the 3% of GDP reference value in 2002 and 2003, in May 2004, the Council decided to abrogate the excessive deficit procedure in Portugal that had been initiated in November 2002.

The reported general government deficit in 2004 was 2.9% of GDP, which compares with a target of 2.8% of GDP in the previous update. Such outturn was achieved thanks to one-off revenues worth almost 2.3% of GDP, received in exchange for the takeover by the government sector of the pension liabilities of four state-owned enterprises (the bank CGD and three other smaller enterprises). In spite of the broad achievement of the targeted headline government deficit, the comparison of the deficit net of one-off measures suggests an underachievement of the target for 2004: while in the budget for 2004, one-off revenues were targeted at around 1.1% of GDP in 2004, the final outturn was more than twice as high. Therefore, the underlying deviation from the target was around 1 ¼% of GDP, in spite of the macroeconomic scenario being broadly in line with projections. Such development was entirely due to a slippage on expenditure, since fiscal revenue was above plans: against an expected total expenditure ratio of 46.6% of GDP in the 2003 update, the 2004 outturn was 48.4% of GDP, mainly on account of higher-than-targeted social transfers and public consumption.

The government which came into office in March 2005 entrusted an ad-hoc commission under the responsibility of Central Bank governor Vítor Constâncio with the assessment of the state of government finances. In mid-May, the commission presented its findings, projecting for 2005 at unchanged policies a deficit of 6.8% of GDP (see Box 1). Already in early April, the Commission services Spring 2005 economic forecast projected persistently large fiscal imbalances. These forecasts point to a large slippage compared with both the 2004 outturn of 2.9% of GDP and the 2005 budget target of 2.8% of GDP. The deterioration is explained by a reassessment of expenditure growth, over-runs compared to the budget and the non-introduction of sizeable one-off measures.

Preliminary data on a cash basis, for the State and social security sub-sectors, up to May and April, respectively, reveal revenue and expenditure profiles growing in excess of the

budgetary targets. So far, current fiscal revenues seem to be holding up well against subdued economic activity, growing in excess of the budgetary targets for the year as whole, which were built on the assumption of real GDP growth of 2.4% in 2005. Direct and indirect taxes are up by 1.3% and 10.8%, respectively, year-on-year compared with targets of 0.4% and 6.6% for the year as a whole. Yet such outturn has been partially supported by specific effects linked to the timing of tax collection, which will vanish for the year as a whole. Social contributions have been growing by 3.7% up to April against a budgetary target of 5%.

The data on the budgetary implementation suggest a significant expenditure slippage: current expenditure of the State sub-sector is up by 3.8% year-on-year until May, on the back of higher transfers to social security, personnel expenditure and interest payments. This figure compares with a budgetary target for the year as whole of some 2.5% growth. In social security, old-age pension outlays have been growing by more than 9% up to April¸ clearly above nominal GDP growth and other cash transfers have also been growing strongly. Overall, current expenditure is up by 8.7% against a target of 4.5% for the year as whole.

According to the updated stability programme of June 2005, the government targets a general government deficit corresponding to 6.2% of GDP for 2005, without relying any longer on sizeable one-off budgetary measures. To that end, a corrective package for 2005 of some 0.6% of GDP was adopted by the new government, the main element of which is an increase in the normal VAT rate from 19 to 21% (see Box 2).

Box 1: The Constâncio commission results on the 2005 deficit forecast

In early April, the Portuguese government, which came into office in mid-March, installed an ad-hoc commission under the responsibility of Central Bank Governor Vítor Constâncio (*Comissão para a Análise da Situação Orçamental*, referred to hereafter as Constâncio commission) for an independent assessment of the state of public finances for 2005, on a no-policy-change basis. The commission mandate did not extend to an analysis of earlier years' fiscal figures nor to a forecast beyond the current year. On 23 May, the commission presented its results in a report to the government.

The commission forecast a deficit figure of 6.8% of GDP for 2005 in national accounts terms. This figure compares with a reported deficit outturn of 2.9% in 2004. The public debt was forecast at 67.2% of GDP, up from 61.9% in 2004.

Table: The Constâncio commission 2005 deficit forecast compared with the 2004 outturn

as % of GDP	2004 outturn*	Cyclical component	Discretionary policy decisions	Other effects	2005 commission forecast	Change 04-05
Total revenue	43.1	-	-0.4	-0.2	42.6	-0.6
Current revenue	41.6	-	-0.4	-0.1	41.1	-0.5
Fiscal income	37.1	-	-0.4	0.4	37.2	0
Taxes production & imports	15.0	-	0.1	0.3	15.4	0.4
Sales	2.4	-	-	-	2.4	0
Other current revenue	2.0	-	-	-0.5	1.5	-0.5
Capital income	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
Personal	15.0	-	0.1	0.2	15.3	0.3
Consumption	3.8	-	0.1	0.1	4.0	0.2
Interest	2.8	-	-	0.1	3.0	0.1
Current transfers	22.0	0.1	0.2	0.5	22.7	0.7
Capital expenditure	4.7	-	-	-0.2	4.4	-0.2
of which investment	3.3	-	-	-0.1	3.2	-0.1
Balance total	*-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
p.m.: Primary balance	-2.3	-0.1	-0.7	-0.8	-3.9	-1.6

* It does not include one-off measures on the revenue side worth almost 2.3% of GDP.
Source: Constâncio commission report

According to the Constâncio commission results, the expected deterioration from the 2004 outturn is to be found mainly on the expenditure side. The table above decomposes the commission forecast for the 2005 deficit vis-à-vis the 2004 deficit outturn into three components: cyclical; effects of discretionary policy measures; "other effects". The impact of cyclical expenditures on the deficit slippage is very low. As regards discretionary policy choices, their impact on the expenditure side is expected to be of about 0.3% of GDP because of higher wages and pension outlays (included in current transfers). Finally, concerning the remaining part of the variation of expenditure, it seems that an important part of the projected deterioration comes from higher current transfers against a background of the maturing of the pension systems and also stronger transfers in kind. Higher intermediate consumption will add to the expenditure ratio, while capital expenditure is expected to marginally decrease in 2005.

Fiscal revenue is projected to remain broadly constant as percentage of GDP, the Constâncio commission concludes. In spite of tax cuts enacted in 2004 for the corporate tax and 2005 for the personal income tax, assumed improved tax collection will keep fiscal revenue at the level of 2004, in terms of GDP. Yet other current revenues are revised downwards by amount of 0.5% of GDP, on account of lower dividend payments.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Evolution of budgetary targets in successive programmes

The update projects the general government deficit to reach 6.2% of GDP in 2005, following deficit ratios of 2.9% of GDP in both 2003 and 2004[9]. The deficit is projected to decline to 4.8% of GDP in 2006, 3.9% in 2007 and 2.8% in 2008. For 2009, the programme projects a further decline of the deficit ratio to 1.6% of GDP.

The budgetary strategy outlined in the programme involves a very substantial revision compared to the previous two updates, notably due to a hike in the government deficit in 2005, which is now targeted at 6.2% of GDP, no less than four percentage points above the January 2004 update. This deterioration is explained by a significant upward revision of the expenditure profile and the non-introduction of sizeable one-off measures planned in the previous programme. In 2006 and 2007, the government deficit is now projected to be on average some three percentage points higher than in the January 2004 update.

Table 3: Evolution of budgetary targets in successive programmes

		2004	2005	2006	2007	2008	2009
General government balance (% of GDP)	**SP June 2005**	**-2.9**	**-6.2**	**-4.8**	**-3.9**	**-2.8**	**-1.6**
	SP January 2004	-2.8	-2.2	-1.6	-1.1	-	-
	SP January 2003	-1.9	-1.1	-0.5	-	-	-
General government expenditure (% of GDP)	**SP June 2005**	**48.4**	**49.1**	**48.7**	**48.0**	**47.1**	**46.0**
	SP January 2004	46.6	45.5	44.5	43.5	-	-
	SP January 2003	45.8	44.7	43.5	-	-	-
General government revenues (% of GDP)	**SP June 2005**	**45.4**	**42.9**	**43.9**	**44.1**	**44.3**	**44.5**
	SP January 2004	43.7	43.2	42.9	42.5	-	-
	SP January 2003	43.9	43.6	43.0	-	-	-
Real GDP (% change)	**SP June 2005**	**1.0**	**0.8**	**1.4**	**2.2**	**2.6**	**3.0**
	SP January 2004	1.0	2.5	2.8	3.0	-	-
	SP January 2003	2.7	3.1	3.5	-	-	-

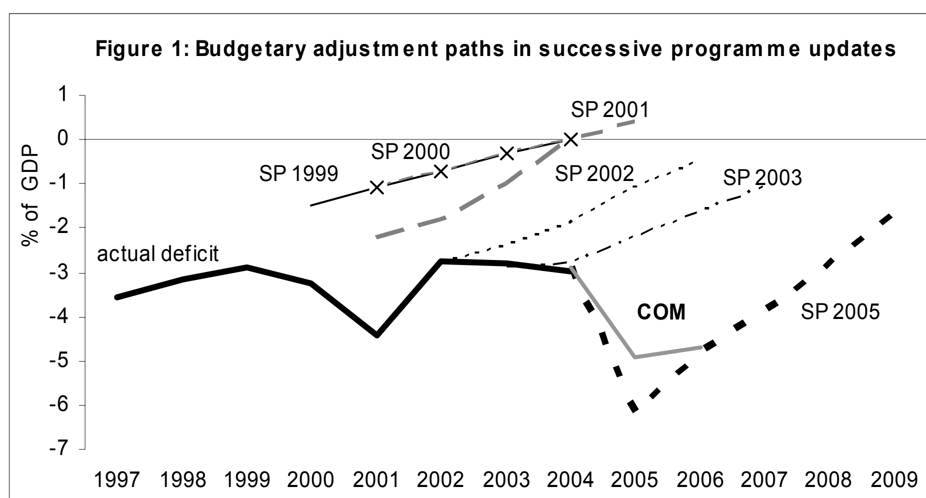
Sources:
Stability programmes (SP)

Both the expenditure and revenue profiles have been revised significantly when compared with the January 2004 update. The envisaged pace of reduction in the expenditure ratio is now less marked than in the previous update and, moreover, it departs from a starting point in 2005 that is considerably worse than before since the expenditure ratio in 2005 was revised upward by some 3.5 percentage points. Regarding the revenue ratio, it will sharply decrease in 2005 because of the non-introduction of one-off measures considered in the previous update. However, it will marginally increase in 2006 and beyond against a continued reduction foreseen in the previous update.

Figure 1 presents the budgetary targets envisaged by the Portuguese authorities in the programme updates since 2000. Looking back in time, there has been a trend of

[9] In its news release No 34/2005 of 18 March 2005, Eurostat communicated the existence of "ongoing discussions between Eurostat and Portugal on the consistency between accrual and cash-based data provided by Portugal, for the period 2001-2004." Subsequent information provided by the Portuguese authorities indicate small upward revisions for the years 2000, 2002 and 2003, yielding deficit ratios of 2.9% of GDP for each of these years. Eurostat is currently reviewing these revisions.

successive downward revisions of the budgetary targets, in line with failures to achieve the medium-term targets.



NB: The difference for the years 2000 and 2001 between the actual deficit and the programme update for those same years were due to a revision of the data series.

4.2. Budgetary targets in the updated programme

The updated programme acknowledges that the 2005 deficit ratio will largely exceed the Treaty reference value. The programme aims at progressively reducing the deficit in the coming years in such a way that it will fall below 3% of GDP in 2008. Departing from the budgetary strategy and outcome of the last years, the targets for the years 2005 through 2009 do not include sizeable one-off deficit-decreasing transactions.

More specifically, the update projects the general government deficit to reach 6.2% of GDP in 2005, following deficit ratios of 2.9% of GDP in both 2003 and 2004[10]. The deficit is projected to decline to 4.8% of GDP in 2006, 3.9% in 2007 and 2.8% in 2008. For 2009, the programme projects a further decline of the deficit ratio to 1.6% of GDP. The primary balance is projected to follow a similar path: -3.3% in 2005, -1.6% in 2006, and -0.5% of GDP in 2007. Primary surpluses of 0.7 and 1.8% of GDP are projected for 2008 and 2009.

The consolidation efforts are spread over the entire programme period, with some front-loading since a reduction of the deficit by some 1.5% of GDP is envisaged in 2006. Thereafter, the deficit ratio is expected to improve by an average of 1 percentage point per year until 2009, supported also by higher economic growth.

The detailed projections of revenue and expenditure until 2009 show that the Portuguese authorities plan to act on both the revenue and primary expenditure sides, with a progressive contribution to consolidation from the latter. In fact, in the early years of the 2005-2009, the consolidation is relying mainly on the revenue side (see Figure 2). The expenditure restraint is expected to give its contribution to budgetary consolidation in a progressive manner over the update period.

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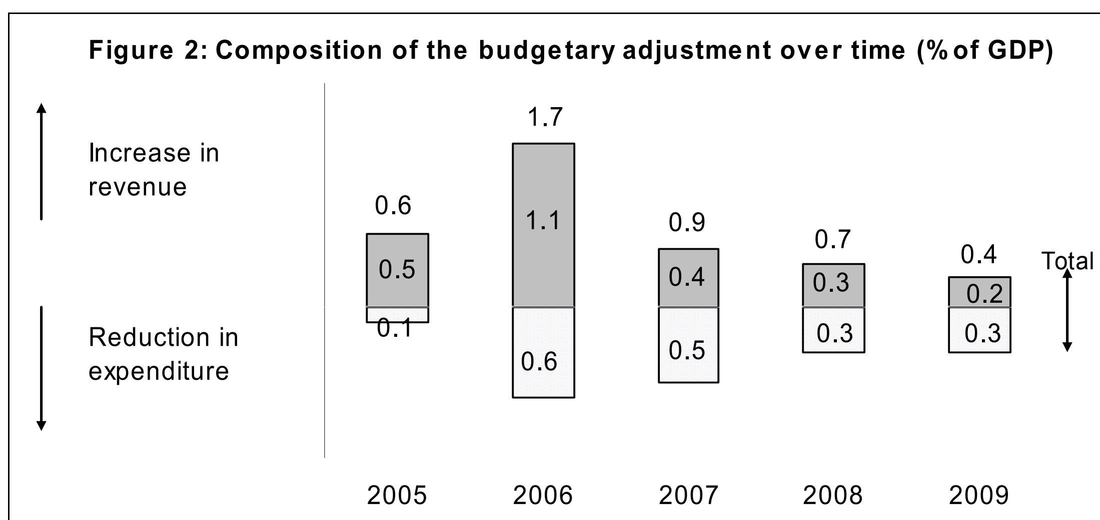
[10] Excluding one-off and temporary measures, the deficit ratios of 2003 and 2004 would have been 5.4% and 5.2% of GDP respectively.



In the early part of the programme period, consolidation is relying mainly on increasing revenues, through higher tax rates, a curb on tax credits and improved tax collection, which only partly offset the one-off revenues foregone. In the outer years, the increased contribution from expenditure restraint is foreseen to come from measures of a more permanent nature, such as the reform of the public administration, including the containment of the wage bill and changes in the retirement schemes, whose budgetary effects will become more significant in the medium term.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004	2005	2006	2007	2008	2009	Change: 2009-2004
Revenues	**45.4**	**42.9**	**43.9**	**44.1**	**44.3**	**44.5**	**-0.9**
of which:							
- Taxes & social security contributions	37.9	37.9	39.1	39.4	39.7	40.1	**2.2**
- Other (residual)	7.5	5.0	4.8	4.7	4.6	4.4	**-3.1**
Expenditure	**48.4**	**49.1**	**48.7**	**48.0**	**47.1**	**46.0**	**-2.4**
of which:							
- Primary expenditure	45.6	46.2	45.4	44.6	43.7	42.6	**-3.0**
of which:							
Gross fixed capital formation	3.3	3.3	3.0	2.8	2.7	2.8	**-0.5**
Public consumption	21.4	21.7	21.3	21.0	20.6	20.0	**-1.4**
Soc. transfers other than in kind	14.9	15.6	15.6	15.5	15.3	15.1	**0.2**
Subsidies	1.6	1.6	1.5	1.5	1.5	1.4	**-0.2**
Other (residual)	4.3	4.0	3.9	3.7	3.6	3.4	**-0.9**
- Interest payments	2.8	2.9	3.3	3.4	3.4	3.4	**0.6**
Budget balance	**-2.9**	**-6.2**	**-4.8**	**-3.9**	**-2.8**	**-1.6**	**1.3**
Primary balance	**-0.1**	**-3.3**	**-1.6**	**-0.5**	**0.7**	**1.8**	**1.9**
Sources: Stability programme update; Commission services calculations							

According to the programme, the revenue-to-GDP ratio will increase by almost 2 full percentage points between 2005 and 2009. The increase in the tax burden is even stronger: 2.5 points from 2004 to 2009, as non tax revenue (for instance, dividends and sales) are expected to decline over the next four years. The higher tax burden will result

from the increase in the VAT standard rate from 19% to 21%, applicable as from July 2005, the progressive increase in the taxes on petroleum and the excises on tobacco as from 2006 and the increase in the income tax rate for high earnings. Moreover, the programme plans to intensify the measures against tax evasion and to reduce a number of tax benefits. Correctives measures will be incorporated in a supplementary budget for 2005, which the government plans to submit by the end of June.

As far as expenditure is concerned, the expenditure ratio will continue its upward trend in 2005, to be followed by a reduction by some 3 percentage points until 2009. According to the update, two-thirds of the envisaged correction will come from a curb on current expenditure and the remaining one-third from lower capital expenditure. On the side of current expenditure, restraint is to be exerted on government personnel expenditure and social transfers. The programme outlines a number of measures notably to contain the wage bill: civil service wages will increase by 2% p.a. – always below the projected HICP inflation –, the wage drift and the number of government employees are to be reduced. Moreover, the government plans savings in both the general social security and the civil servant pension schemes. Finally, the share of investment in total government expenditure is projected to decline slightly over the programme period.

Overall, while the revenue-raising measures, if fully and timely implemented, should increase the revenue ratio (notably the tax burden) to the target, the announced measures on the spending side may not suffice to reduce the expenditure ratio by the envisaged 3 percentage points between 2005 and 2009. Therefore, while the projected consolidation relies on both revenue and expenditure, with some focus on the latter, further corrective measures may have to be announced and implemented over the programme period to reach the announced targets.

There are several risks weighing on the budgetary projections. As explained above, the acceleration in economic activity, in particular from 2007 onwards, may be slower than expected. Moreover, government revenue and expenditure trends may also be less favourable than planned. The increase in tax rates heighten the risk of tax evasion and may counteract the measures to increase the efficiency of tax collection. Moreover, most of the announced restraint on expenditure still needs to be legally implemented. Expenditure reforms may in fact take longer to implement, and, as result, their short- and medium-term effects may turn out less significant than expected.

Table 5: Output gaps and cyclically-adjusted (primary) balances (CA(P)B)

	2004		2005		2006		2007	2008	2009	Change 2009-2004
	COM	SP	COM	SP	COM	SP	SP	SP	SP	SP
Budget balance[2]	-2.9	-2.9	-4.9	-6.2	-4.7	-4.8	-3.9	-2.8	-1.6	1.3
Output gap[1,3]	-2.5	-2.1	-2.8	-2.7	-2.7	-2.8	-2.3	-1.6	-0.7	1.4
CAB[1,2]	-2.0	-2.2	-3.9	-5.3	-3.7	-3.8	-3.1	-2.3	-1.4	0.8
CAB excluding one-off measures[1,2]	*-4.3*	*-4.5*	*-4.2*	*-5.5*	*-3.7*	*-3.8*	*-3.1*	*-2.3*	*-1.4*	*3.1*
CAPB[1,2]	0.8	0.7	-1.0	-2.4	-0.7	-0.5	0.3	1.1	2.0	1.3
CAPB excluding one-off measures[1,2]	*-1.5*	*-1.5*	*-1.3*	*-2.6*	*-0.7*	*-0.5*	*0.3*	*1.1*	*2.0*	*3.5*

Notes:
[1]Commission services calculations on the basis of the information in the stability programme (SP)
[2]in percent of GDP
[3]in percent of potential GDP
Sources:
Commission services spring 2005 economic forecasts (COM); Commission services calculations

According to calculations by the Commission services applying the commonly agreed methodology to the information provided in the update, the cyclically-adjusted balance (CAB), will widen by some 3 percentage points to around -5 ½% of GDP in 2005. Afterwards, as can be observed in table 5, the programme projects a significant correction of the CAB by some 1.5 percentage points in 2006 and a steady reduction in the CAB of at least ¾ percentage points per year afterwards until 2009, when it will be close to -1 ½% of GDP. Therefore, the figures for the deficit adjusted for cyclical fluctuations suggest that the fiscal policy effort will be significant in every year until 2009, with a particularly substantial effort in 2006.

Although the programme projects that the deficit ratio will fall below 3% of GDP in 2008, the planned budgetary stance until 2009 does not provide a sufficient safety margin against breaching the deficit ceiling with normal macroeconomic fluctuations[11]. It is also insufficient to reach that the Stability and Growth Pact's medium-term objective of a budgetary position of close-to-balance.

Overall, the economic policies outlined in the update are partly consistent with the country-specific recommendations in the Broad Economic Policy Guidelines in the area of public finances. As recommended, the programme projects the consolidation of public finances to take place to a large extent from the expenditure side, albeit in a progressive manner, and does not rely on sizeable one-off or temporary measures. Moreover, its projections, if adhered to, imply an improvement in the cyclically-adjusted primary balance (net of one-off and temporary measures) of more than 0.5% of GDP each year. However, as already mentioned, the programme does not plan to reduce the deficit below 3% of GDP before 2008, and the planned expenditure restraint will be insufficient to achieve the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance by the end of the programme period.

[11] In the case of Portugal, the latest estimate for the "minimal benchmark" is -1.2% of GDP (see 2002 edition of the Public Finance report).

Box 2: Fiscal consolidation measures announced in the June 2005 stability programme

The updated stability programme announces several consolidation measures which aim at increasing revenue and reducing expenditure and should contribute to reach the projected deficits from 2005 through 2009.

On the revenue side, all announced measures concern taxes: increases in tax rates, reduction in fiscal benefits and fight against tax fraud. Non-tax revenue is projected to decline over the next years. According to the government plans, the announced measures will lead to an increase in the tax burden of 2½% of GDP as in the projected revenue accounts. The announced tax measures, and their cumulative impact on the tax burden, are as follows:

Concerning expenditure, the announced measures will reduce the expenditure-to-GDP ratio, though investment is projected to increase. The consolidation efforts will be concentrated in the area of social security, in particular old-age pensions and the civil service by containing the wage bill.

Table: Cumulative impact of policy measures

(%) of GDP, 2005 prices	2005	2006	2007	2008	2009
Measures to increase revenue					
Income tax: reduction of several tax benefits and increase in tax rates for high-income earners	-	0.2	0.2	0.3	0.3
VAT: increase in the standard VAT rate from 19% to 21% and reduction of several tax benefits	0.3	0.7	0.7	0.7	0.7
Tax and petroleum products: progressive increase in the tax rate	-	0.2	0.3	0.4	0.4
Excises on tobacco: progressive increase in the tax rate	-	0.1	0.3	0.4	0.5
Improved tax collection: additional revenue from the various taxes	0.2	0.4	0.5	0.5	0.6
Total revenue	**0.5**	**1.6**	**2.0**	**2.3**	**2.4**
Measures on the expenditure side					
Social security expenditure: reduction in expenditure for both civil servants and private sector protection schemes (charges in the retirement age and pension benefits); Increase in expenditure to fight elderly poverty)	-	0.3	0.6	0.9	1.2
Expenditure with medicines: change in rules of co-payments	-	0.1	0.1	0.1	0.1
Wage bill: wages increases of 2% (below inflation), reform of the civil service wage and career scales (lower wage drift), reduction of government employment (vis-à-vis no increase in number of employees)	0.1	0.3	0.6	0.8	1.0
Increase in investment *(minus sign means an increase in expenditure)*	-	-0.1	-0.1	-0.3	-0.6
Real estate: sale of empty property	0.1	0.1	0.1	0.1	0.1
Total expenditure	**0.1**	**0.7**	**1.2**	**1.5**	**1.7**
Total (cumulative)	**0.6**	**2.3**	**3.2**	**3.8**	**4.1**

Source: Stability programme (SP); Commission services calculations

4.3. Sensitivity analysis

The programme update examines the budgetary impact of two alternative growth scenarios. The first scenario assumes that the growth of external demand is lower (-1 percentage point each year) and that oil prices are higher (remaining at 50/USD barrel throughout the entire period) than in the central macroeconomic scenario. The second scenario is built around the assumption of higher interest rates, which will be higher by 1 full percentage point since mid-2005. Both scenarios hurt growth and the consolidation of public finances to the point of clearly jeopardizing a deficit below the 3% of GDP reference value in 2008. Nonetheless, the results presented in the update indicate that, if these scenarios prevail, the government deficit will not exceed the 3% of GDP ceiling in 2009.

Commission services simulations of the cyclically-adjusted balance under the assumptions of: (i) a sustained 0.5 percentage point downward deviation from the growth target in the programme over the 2004-2007 period; (ii) trend output based on the HP-filter[12] and (iii) no policy response, notably, with the expenditure level as in the central scenario[13], reveal that, by 2008, the cyclically-adjusted balance is some 0.5 percentage points of GDP below the update macro-economic scenario. Hence, in the case of persistently lower growth, additional measures, on top of those behind the programme targets for revenue and expenditure, of around 0.5 percentage points of GDP would be necessary to keep public finances on the path targeted in the document. Taking into account the conclusions reached in Section 2 above, namely that the risks to the macroeconomic framework of the programme are mainly to the downside, the achievement of the budgetary targets in the programme is therefore likely to require a significantly greater fiscal effort than envisaged in the programme.

To sum up, the 2008 budgetary targets will be at risk if a less favourable macro-economic setting should materialise. In the event, the government might be called to take additional measures in order to avoid the deficit exceeding 3% of GDP for longer than planned.

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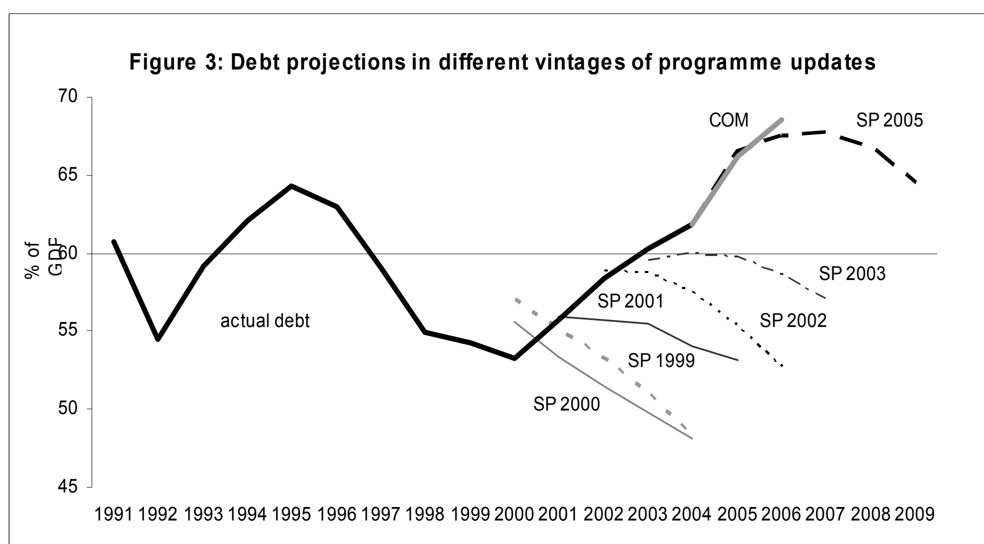
[12] In the absence of a fully-specified macro-economic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

[13] The effect of lower growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

5. EVOLUTION OF THE DEBT RATIO

The government gross debt-to-GDP ratio has been increasing since 2000, when it was 53.4%. In 2003, it marginally exceeded 60% and in 2004, the debt ratio stood at 61.9%. According to the June 2005 update, in 2005, the debt ratio is expected to be 66.5% of GDP. As compared with the update of December 2003, the 2004 debt exceeded the target by almost 2% of GDP, while the ratio for 2005 will be 7.2 percentage points above the previous target. The increase in the debt ratio in the years 2000-2004 can be explained by a very low primary surplus – even a primary deficit in some years –, the persistence of a sizeable stock-flow adjustment, as well as by the low nominal GDP growth.



According to the updated programme, the debt ratio will further increase in 2006 and 2007. By the end of 2007, the debt is projected to peak at 67.8% of GDP; such a debt ratio will be almost 15 percentage points higher than in 2000. A gradual reduction would start in 2008, triggered by the return to primary surpluses, the acceleration in (real and nominal) GDP, which will lead to a beneficial snowball effect, and a marked decrease in the stock-flow adjustment. Regarding the latter, the difference between the cash- and accrual-based deficit is projected to become progressively smaller, and the accumulation of financial assets will even become negative on the back of large privatisation proceeds and the implicitly assumed lower capital injections in public enterprises (see Table 6). (For a further elaboration on the stock-flow adjustment in Portugal, see Annex 1.)

Table 6: Debt dynamics

	average 2000 2003	2004	2005		2006		2007	2008	2009
			COM	SP	COM	SP	SP	SP	SP
Government gross debt ratio	**57.0**	**61.9**	**66.2**	**66.5**	**68.5**	**67.5**	**67.8**	**66.8**	**64.5**
Change in debt ratio (1 = 2+3+4)	1.4	1.8	4.3	4.6	2.3	1.0	0.3	-1.0	-2.3
Contributions:									
- **Primary balance** (2)	**0.1**	**0.0**	**2.0**	**3.3**	**1.6**	**1.5**	**0.5**	**-0.6**	**-1.8**
- **"Snow-ball" effect** (3)	**0.6**	**0.9**	**0.9**	**0.7**	**0.5**	**0.2**	**-0.1**	**-0.4**	**-0.4**
- Interest expenditure	3.1	2.9	2.9	2.9	3.1	3.3	3.4	3.4	3.4
- Real GDP growth	-0.5	-0.6	-0.7	-0.5	-1.1	-0.9	-1.4	-1.7	-1.9
- Inflation (GDP deflator)	-2.0	-1.4	-1.4	-1.7	-1.5	-2.2	-2.1	-2.1	-2.0
- **Stock-flow adjustment** (4)	**0.8**	**0.9**	**1.4**	**0.6**	**0.2**	**-0.7**	**-0.1**	**-0.1**	**0.0**
- Cash/accruals differences (5)	0.9	0.9		0.4		0.3	0.3	0.2	0.2
- Accumulation of financial assets (6)	-0.2	0.0		0.2		-1.0	-0.4	-0.3	-0.2
of which: Privatisation proceeds (-)	-0.7	-0.8		-0.3		-1.1	-0.5	-0.4	-0.4
Other	0.5	0.8		0.5		0.1	0.1	0.1	0.2
- Valuation effects & residual adj. (7)	0.1	incl in (5)		incl in (5)		incl in (5)	incl in (5)	incl in (5)	incl in (5)

Note: 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.

Sources: Stability programme update (SP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

The pace of debt reduction can be assessed by comparing the projections for the debt ratio in each year of the programme with the values obtained for the same year by applying an illustrative 'rolling debt reduction benchmark'[14]. This benchmark describes a

[14] The "rolling debt reduction benchmark" in the graph is shown for successive five-year periods through a recursive application of the formula:

$$\left(\frac{D_t}{Y_t}\right)_{rule} = 0.05 * \left[60 - \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{rule} \right] + \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{rule}$$

where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively (note that, in the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio). The change in the debt ratio can be decomposed as follows (assuming that the stock-flow adjustment is equal to zero):

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

where DEF is the government deficit and y represents nominal GDP growth. Noting that 0.05*60 = 3, the formula for the "rolling debt reduction benchmark" describes the path for convergence of the debt ratio towards the 60% of GDP debt reference value consistent with a deficit equal to the 3% of GDP reference value. Consistency is achieved for a nominal GDP growth rate of 5% of GDP. For nominal GDP growth rates higher than 5%, the minimum debt reduction benchmark can be respected with deficits in excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the minimum debt reduction benchmark necessitates deficits lower than 3% of GDP.

minimum reduction in the debt ratio over the previous years (usually five years). If the debt levels projected in the programme exceed those obtained by applying the rule, this is taken as an indicator of a slow reduction in the debt ratio.

In the case of Portugal, the rule cannot be applied until 2007, since the debt ratio is still increasing rather than declining. In 2008 and 2009, though declining, the debt ratio will still be much above the ratio of five years before. According to the illustrative rule, the government debt ratio could only be considered as declining at an acceptable pace after 2009 (see Figure 3). This is consistent with the idea that the minimum debt reduction should not be ensured year after year, but over the medium-term.

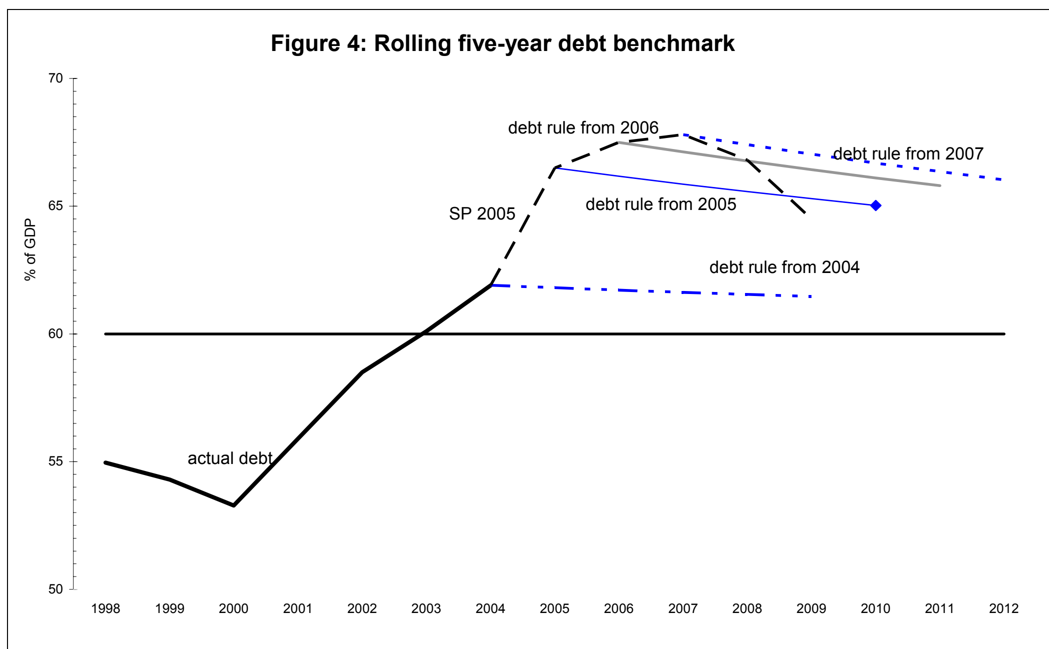


Figure 4: Rolling five-year debt benchmark

6. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

The June 2005 programme update announces the intention of, inter alia, enacting a reform of public administration, improving the quality of public spending and simplifying the fiscal system. Regarding the first item, the main measures will involve a restructuring of central administration and cutting intermediate consumption; new staff regulations and career scales in the civil service to be implemented in 2007; and, finally, a link between the inflow into and the outflow from the civil service: on average, for every two workers that leave the payroll, just one new will be hired. (see Box 3 for a detailed analysis of government expenditure developments since 1990).

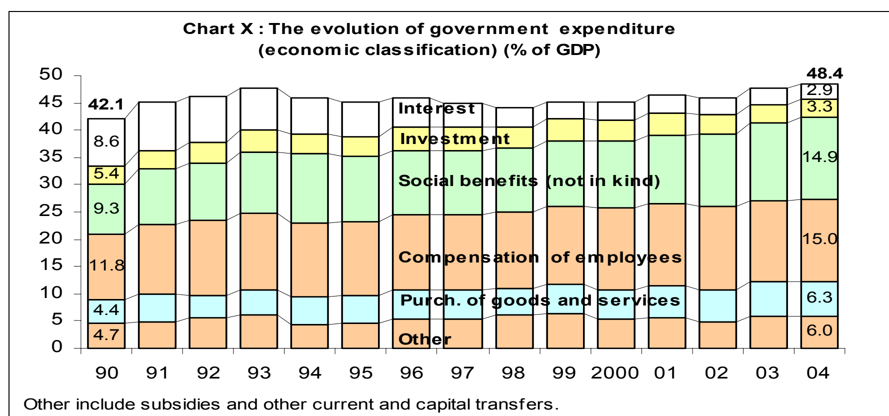
With the aim of improving the quality of public spending, the update outlines plans to change the real-estate asset management of the government, with the core idea being to force public institutions to internalise the costs of their premises. However, this measure will be implemented only in 2007. Reforms in the areas of health, education and justice are announced as priorities. In the area of health, all hospitals will have their management scheme changed and the reimbursement of medicines is made less generous as of mid-2005. In the area of primary and secondary education, the objective is to curb underutilisation of teachers working time.

Finally, the programme reveals some intentions regarding the tax system. They aim first, to simplify the tax system and to broaden the tax base by limiting fiscal exemptions and, second, to curb tax evasion.

Overall, most of the measures still need to be implemented and, according to the update, will not take effect before 2007. Additionally, some are apparently still under consideration, such that it is yet too early to assess their possible impact on the quality of public finances. Nevertheless, the planned reforms address a country-specific recommendation in the 2003-2005 BEPG, i.e. to undertake structural reforms in areas with a more direct impact on budgetary consolidation, notably in public administration, education, health-care, and social security.

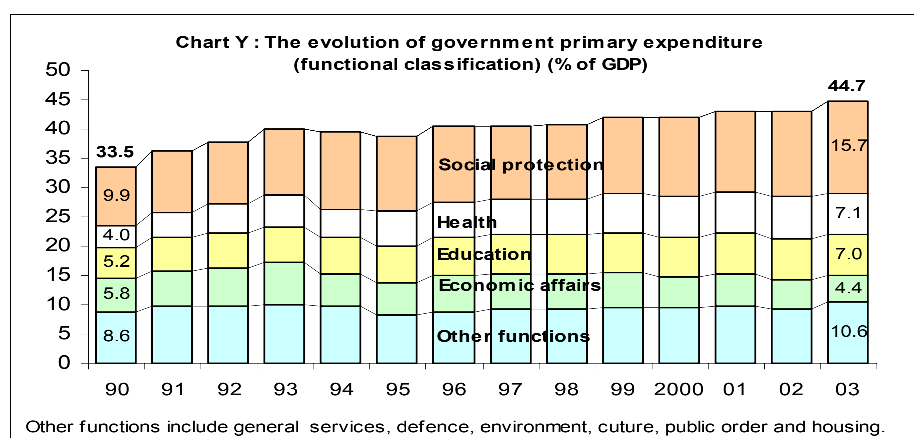
Box 3: The level and composition of government expenditure in Portugal since 1990

Over the last 15 years, Portuguese government expenditure has changed considerably both in terms of size and of composition. In 1990, total government expenditure amounted to 42.1% of GDP, significantly below the expenditure ratio of 51.2% in the group of countries that now constitute the euro area. Indeed, Portugal was the country of the euro area with the lowest expenditure ratio. From 1990 to 2004, the ratio of government expenditure increased by 6.3 percentage points, now reaching 48.4% (Chart X), virtually the same as the euro area average which decreased to 48.6% of GDP.



The fast increase in government expenditure is even more evident, if interest payments are excluded: the ratio of primary expenditure increased by more than 11 points. Thus, the significant reduction in interest payments of 5½ points of GDP – which was mainly due to the reduction in the market interest rate, as the debt ratio in 2004 is nearly the same as fifteen years ago – has been entirely offset by the increase in other expenditure categories. While primary expenditure in most other euro-area countries stabilised or slightly fell from a peak in the mid-1990s, it kept increasing in Portugal.

The increase in expenditure was mainly concentrated in the categories which were already the largest and are difficult to restrain in periods of fiscal consolidation as they are based on legal commitments: social benefits to households increased by 5.6 percentage points and compensation of employees by 3.2 points. Investment has declined by 2 points, but remains well above the government investment ratio in the euro area (3.3% as compared 2.6% of GDP).



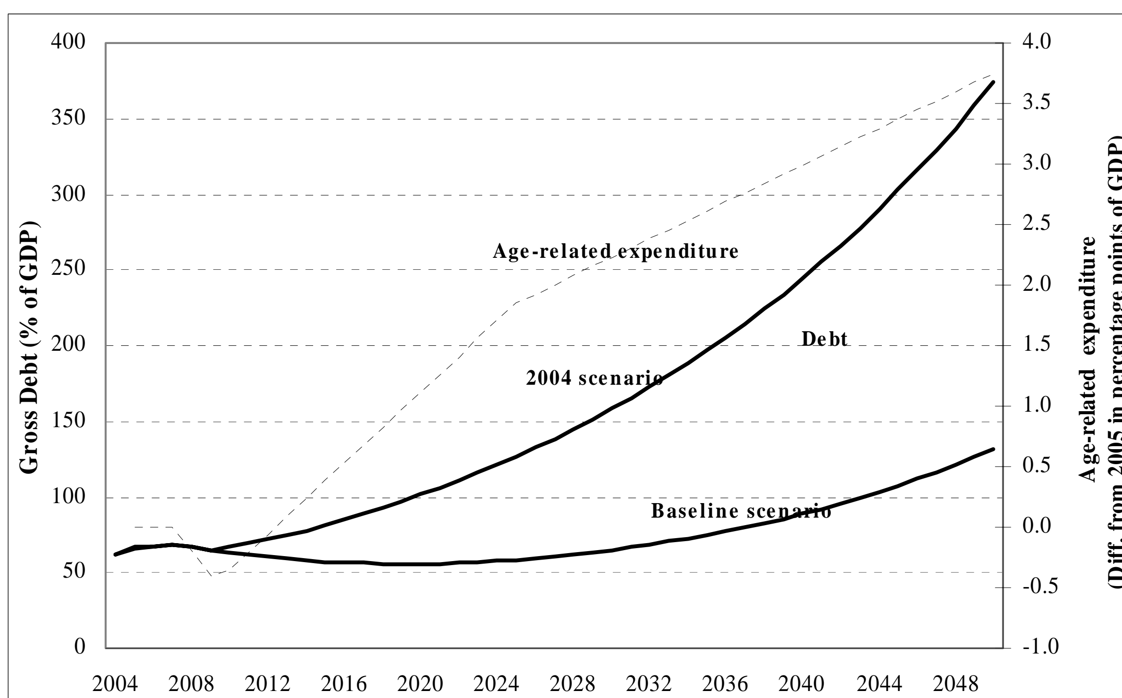
The evolution of government expenditure can also be considered by looking at the functional classification of spending. Data in Chart Y reveal that the increase by more than 11 percentage points in primary expenditure stemmed mainly from the maturity of the welfare system. Driven both by the rising number of beneficiaries and more generous entitlements, expenditure on social protection (which includes unemployment benefits, old-age and survivor pensions, family allowances and social assistance) increased by almost 6 percentage points to 15.7%, though it is still significantly lower than in the euro area (19.5% of GDP). Spending in health and education has also been very dynamic; increasing by 3.1 and 1.8 percentage points, respectively. For these two categories, it should be noted that the public spending ratio in Portugal is higher than in many other euro area countries: 7.1% of GDP in health in Portugal, as compared with 6.6% in the euro area, and 7% in education in Portugal, against 5% in the euro area.

7. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of the Portuguese public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario (baseline) assumes that the medium-term objective set up in the programme is actually achieved, while the "2004" scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

The graph below presents the gross debt development according to the two different scenarios. On the basis of the programme[15], age-related expenditure is foreseen to increase by 4.1% of GDP between 2010 and 2050 (see Annex 3 for a breakdown of different age-related expenditures). The gross debt ratio is projected to assume a rising path after 2020[16]. If the planned budgetary consolidation in the medium-term does not materialise (the 2004 scenario), an even more accentuated explosive gross debt path would emerge and the gross debt-to-GDP ratio would reach almost 380% of GDP in 2050.

Long-term sustainability: summary results



Sustainability gap

	S1*	S2**	RPB***
Baseline scenario	1.4	2.1	3.8
2004 scenario	5.1	6.2	4.1

Notes:

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[15] The 2005 updated SP does not include projections of long-term age-related expenditure. The long-term projections previously provided were therefore used. The information in the 2005 update on expenditure for pensions and unemployment benefits up to 2009 were incorporated in the projections.

[16] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.
** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: 2.6 %
*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance required in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050)[17]. S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy, Portugal should raise its tax ratio by 2.1 percentage points compared with the projected one at the end of the programme period. This would lead to a sustainable debt ratio by the middle of the century[18]. However, if the planned budgetary consolidation up to 2009 does not materialise, the tax ratio should be raised by 6.2 percentage points compared with the projected one at the end of the programme period, reflecting a high underlying primary deficit in 2004. In order to maintain a gross debt ratio below 60% of GDP in 2050, according to the S1 indicator, the tax ratio should be raised by at least 1.4 percentage points compared with the projected one in 2009. The budgetary effort over the first 5 years of projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of almost 4% of GDP on average, compared with a primary balance of 1.8% of GDP targeted for the last year of the programme period (measured in underlying terms).

In interpreting these results, several factors must be taken into account.

First, a reform of the general social security retirement scheme was implemented in 2001 which changed the benefit formula and retirement age rules. However, it is unclear to what extent this contributes substantially to the sustainability of the system and the transition period is quite long, therefore it will take a long time until the full effects build in. In 2004, important changes to the civil servants pension scheme came into force, involving: (i) the setting of a minimum retirement age of 60 years and (ii) the assessment of (low) pension rights of civil servants. The pension system for civil servants is to be phased out as those joining the civil service after 1993 were already covered by the less generous general social security rules. The most recent stability programme update outlines measures aiming at a significant shortening of the transition period to the general system, notably: (i) a gradual increase of the retirement age from 60 to 65 by 2015; (ii) the period to earn pension rights for a complete pension will be increased from 36 to 40 years by 2013, and; (iii) an adjustment of the pension benefit formula so that

17 The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible imbalances after the end of the projection period.

18 The debt ratio of around 3% in 2050 according to the S2 indicator illustrates that the sustainability gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the S1 indicator, which illustrates that a lower budgetary strengthening is compatible with the 60% reference value in 2050.

pension will be based on the wages during the entire working career instead of the last wage received. The measures taken so far will dampen the rise in pension expenditure, although a considerable increase is projected over the long-term. The future dynamic of pension expenditure is subject to considerable uncertainty. According to the update, the government has commissioned a report to assess the long-term sustainability of the social security system.

Second, Portugal launched in late 2002 a reform of its health-care system. The main elements are a clear separation between financing and provision of health care; changes in compensation for medical services; changes of drugs policy, involving the promotion of generic drugs and reimbursements aligned with reference prices. The efficiency and savings gains are expected to contribute towards bringing health expenditure growth to a more sustainable path in the light of the expected increasing demand due to demographic changes. Even though the precise budgetary impact of the ongoing reform remains still uncertain, this move constitutes a clear step in the right direction. The programme update states that health care is a priority area in the public administration reform and it announces marginally lower payments for medicines. However the update does not outline new significant structural measures concerning the health care system.

* * *

ANNEX 1: THE COMPOSITION OF THE STOCK-FLOW ADJUSTMENT IN PORTUGAL

The Portuguese government gross debt has increased very quickly in recent years. From 2000 to 2004, the debt ratio has increased by almost 9 percentage points, and 6 further points are expected to be added to the ratio until 2007. The evolution of the debt ratio has been mainly the result of the high deficit figures and low GDP growth. However, the stock-flow adjustment (SFA[19]) has also contributed significantly to debt developments. From 2001 to 2004, the SFA has been of 1.1% of GDP per year, on average. According to the updated stability programme, the stock-flow adjustment is projected to decline from 0.9% of GDP in 2004 and 0.6% in 2005, to – 0.7% in 2006 and to virtually to zero in 2007 to 2009.

An analysis of the SFA requires breaking it down in its components. Usually, the decomposition of the SFA involves three components: (i) differences between cash and accruals, (ii) accumulation of financial assets and (iii) valuation effects and other adjustments. Each of these components can also divided in sub-components. Details on the SFA composition are regularly transmitted by Member States in the EDP notifications. However, most data quoted in this annex, have been provided by the Portugal in May 2005, in answer to a questionnaire by the Commission services, as figures in the EDP notification of March 2005 contained a number of technical mistakes.

1. Differences between cash and accrual accounting

While the deficit is an accrual concept, the debt developments depend on the cash deficits, as these are those which imply debt issuance. It is normal that the outcome of cash and accrual accounting does not coincide in each period. Such a coincidence would exist only if there were no delays in the payment of expenditure and in the collection of revenue. However, the differences for each period should tend to cancel out in the medium term. Some discrepancies may persist in the medium term because of nominal growth, or in some rare cases with particularly long lags in the settlement of exceptional transactions.

In Portugal, the average difference between the cash- and the accrual-based deficit from 2000 to 2004 has been 0.4% of GDP. However, if interest expenditure are excluded from the analysis, the cash/accruals difference become 0.6% of GDP.[20] There is no ideal or acceptable limit for the accumulated discrepancy between cash and accruals over four or five years. However, if the difference between the cash- and accrual-based deficits for the EU as whole over the period 2000-2004 is taken as benchmark (0.2% of GDP), the discrepancy in the Portuguese accounts was much above what could be reasonably accepted without a proper explanation.

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[19] The SFA covers the factors other than the deficit which contribute to the evolution of the debt level. For further detail on the nature of the SFA, its components and data for other Member States, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of Public Finances in EMU 2005, European Economy n°3/2005.

[20] A significant share of the Portuguese government debt is in saving certificates which do not regularly pay interest. Interest will only be handed over to debt holders at redemption. Therefore, interest expenditure in a cash basis has been consistently less than interest in an accrual basis imputed into the deficit.

Table 1: **Cash – accruals differences** (% of GDP)							
	2000	**2001**	**2002**	**2003**	**2004**	**Sum***	**Average**
(1) Total	0.1	1.3	-0.1	-0.1	0.9	2.0	**0.4**
(2) Interest	-0.3	-0.3	-0.3	0.0	-0.2	-1.0	**-0.2**
(3) Total, excl. interest	0.4	1.6	0.1	-0.1	1.1	3.0	**0.6**
(4) - Financial transactions	0.0	0.0	-0.7	0.7	0.0	0.0	**0.0**
(5) Revenue	0.0	0.7	0.5	-0.1	0.9	1.9	**0.4**
(6) -Taxes & soc contributions	-0.1	0.2	0.1	0.0	0.3	0.6	**0.1**
(7) -EU transfers	0.0	0.4	0.4	-0.1	-0.4	0.4	**0.1**
(8) -Transfer pension funds	0.0	0.0	0.0	0.0	1.0	1.0	**0.2**
(9) Expenditure other than interest	0.5	0.9	0.4	-0.7	0.2	1.1	**0.2**
(10) -National health service (SNS)	-0.2	0.4	0.3	-0.6	-0.2	-0.3	**-0.1**
(11) -Other than SNS	0.7	0.6	0.0	-0.1	0.4	1.4	**0.3**
**Ratios for the sums are shown in this table as % of 2004 GDP.*							

As expected, part of the difference between accrual over cash accounts is related to taxes and social contributions (accrued revenue is on average 0.1% of GDP higher than effective collection). Another source of difference comes from the recording transfers from the EU budget (a cumulated 0.4% of GDP or 0.1% of GDP on average from 2000 to 2004). Such a difference was mainly accumulated in 2001 and 2002, during the first years of the Third Community Support Framework; it became negative in 2003 and 2004 and the prospects are that the cumulated difference in relation to the EU budget-related transactions will net out in coming years. Also in relation to revenue, the Portuguese authorities point out that 1% of GDP in relation to the transfer of pension funds to government – the most significant group of deficit-decreasing one-off operations in 2004 – was still due for effective collection at the end of 2004 and, therefore, contributed to the cash/accruals difference. Most of this account receivable will be settled in 2005; only a small fraction of it will be collected later on.

The average cash/accruals difference in relation to expenditure for the period 2000 to 2004 was 0.3% of GDP (0.2% of GDP, if the National Health Service (SNS) is also considered). This means that, from 2000 to 2004, there were more cash payments than expenditure booked as deficit increasing. At first sight, this is a surprising result and could suggest that the deficit was underestimated; the usual pattern is for effective cash payments to lag expenditure. In the case of Portugal, the counterintuitive difference between cash- and accrual-based data is explained in the large stock of spending arrears that was due for payment at the beginning of 2000 and its progressive settlement. The stock of arrears at the beginning of 2000 was above 2% of GDP, while at the end of 2004, it is reported to be only 0.2% of GDP.[21]

The Portugal's stability programme does not explicitly address the prospects for this SFA component. However, given the explanation above – notably the trend in the cash/accruals difference for the structural fund-related transactions and the settlement of the transfer to the government of pension-fund reserves – one should expect a considerable reduction in the difference between cash and accrual accounting over the next years.

2. Accumulation of financial assets

The net accumulation of financial assets by the Portuguese government has been relatively small: 0.2% of GDP, on average per year since 2000. By comparison, the EU average has been 0.5% of GDP per year. However, one should note that the EU average is biased upwards by the Member States in surplus which invest their surpluses in privately-issued financial assets. Moreover, the picture for Portugal changes quite considerably if one takes into account the privatisation programme and a non-negligible reduction in liquid assets. If privatisation proceeds and the reduction in deposits are excluded, then Portugal has spent around 1.2% of GDP per year in financial assets.

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[21] Data excluding SNS. The SNS's arrears at the end of 2004 were of around 0.8% of GDP (Source: Report of the *Constâncio Commission*, 2005).

Table 2: **Accumulation of financial assets** (% of GDP)							
	2000	**2001**	**2002**	**2003**	**2004**	**Sum***	**Average**
Deposits	-0.6	-1.5	1.2	-1.0	-0.2	-1.8	**-0.4**
Securities other than shares	0.4	0.7	0.4	0.0	0.2	1.5	**0.3**
Loans	0.1	0.3	0.2	0.3	0.1	1.0	**0.2**
Shares	-0.8	0.2	0.4	0.4	-0.2	0.0	**0.0**
Of which: Privatisation (-)	-2.0	-0.3	-0.3	0.0	-0.8	-3.1	**-0.6**
Other**	1.2	0.5	0.7	0.4	0.6	3.2	**0.6**
Non specified	0.0	0.0	0.1	0.0	0.1	0.2	**0.0**
Total	-0.9	-0.3	2.3	-0.2	0.0	1.0	**0.2**
Total excl. deposits and privatisation	1.7	1.4	1.4	0.8	1.0	5.9	1.2

**Ratios for the sums are shown in this table as % of 2004 GDP.*
***Mainly capital injections in public enterprises.*

Most of this accumulation of assets has consisted in capital injections in public enterprises. Capital injections on public enterprises are recorded either as financial transactions or as deficit-increasing expenditure depending on a number of criteria specified in the Eurostat's manual on deficit and debt. Besides the respect of the accounting rules on capital injections, it is not always obvious whether, from the economic viewpoint, the shares in public enterprises are worth the money has government paid for them, whether such financial spending is economically sound as it contributes significantly to increase the government debt. The same questions could also be asked in relation to some loans granted by the government. In some cases, there are doubts whether loans – e.g. loans and accumulation of unpaid interest by developing countries, or to SMEs – will ever be reimbursed at market conditions. Recording the accumulation of some of these financial assets as expenditure could be more meaningful and prudent accounting.

The stability programme projects a negative accumulation of financial assets over the years 2006 to 2009, on the back of relatively large privatisation proceeds (notably 1.1% of GDP in 2006). Although not explicitly indicated, data in the programme implicitly assumes a considerable reduction in capital injections into public enterprises.

3. Valuation effects and residual adjustments

The third component of the SFA consists in valuation effects, notably in relation to the foreign currency-denominated debt, early reimbursements and adjustments in relation to sectoral reclassifications. In the case of Portugal, this variable has been negligible and is not worth further consideration.

Table 3: **Valuation effects and residual adjustments** (% of GDP)							
	2000	**2001**	**2002**	**2003**	**2004**	**Sum***	**Average****
Revaluation of foreign debt	0.2	0.0	0.1	-0.1	0.0	0.1	**0.0** *(0.0)*
Other	0.2	0.1	0.0	0.0	0.0	0.4	**0.1** *(0.1)*
Total	0.4	0.1	0.1	-0.1	0.0	0.5	**0.1** *(0.1)*

**Ratios for the sums are shown in this table as % of 2004 GDP.*
*** Data which were available in autumn 2004 (see note "The SFA in the EU member states") are shown, for comparison, in italics and brackets.*

ANNEX 2: SUMMARY TABLES FROM THE STABILITY PROGRAMME UPDATE

Table A- 1: Growth and associated factors

		2004	2005	2006	2007	2008	2009
GDP *growth* at *constant* market prices (7+8+9)	B1g	**1.0**	**0.8**	**1.4**	**2.2**	**2.6**	**3.0**
GDP *level* at *current* market	B1g	**135035**	**--**	**--**	**--**	**--**	**--**
GDP deflator		**2.5**	**2.9**	**3.4**	**3.2**	**3.2**	**3.0**
HICP change		2.5	2.5	2.9	2.5	2.5	2.4
Employment growth		**0.1**	**0.4**	**0.7**	**1.1**	**1.3**	**1.5**
Labour productivity growth **		0.9	0.4	0.7	1.1	1.3	1.5
Sources of growth: percentage changes at constant prices							
1. Private consumption	P3	**2.3**	**1.7**	**1.2**	**1.7**	**2.1**	**2.5**
2. Government consumption expenditure	P3	**1.2**	**0.6**	**0.3**	**0.3**	**0.3**	**0.3**
3. Gross fixed capital formation	P51	**1.3**	**1.1**	**2.3**	**4.4**	**6.1**	**7.2**
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52 +P53	**0.9**	**0.7**	**0.7**	**0.7**	**0.6**	**0.7**
5. Exports of goods and services	P6	**5.1**	**3.3**	**6.5**	**8.1**	**7.9**	**7.9**
6. Imports of goods and services	P7	**7.0**	**4.0**	**5.1**	**6.4**	**7.0**	**7.7**
7. Final domestic demand (1+2+3)		**2.0**	**1.3**	**1.4**	**2.1**	**2.8**	**3.4**
8. Change in inventories and net acquisition of valuables (=4)		**0.0**	**-0.2**	**0.0**	**0.0**	**0.0**	**0.1**
9. External balance of goods and services (5-6)		**-1.0**	**-0.5**	**0.1**	**0.1**	**-0.2**	**-0.4**

* According to social security statistics. i.e. including persons on parental leave
** calculated on basis of effective labour force

Table A- 2. General government budgetary developments

% of GDP		2004	2005	2006	2007	2008	2009
Net lending (B9) by sub-sectors							
1. General government	**S13**	**-2.9**	**-6.2**	**-4.8**	**-3.9**	**-2.8**	**-1.6**
2. Central government	**S1311**	**-5.4**	**-6.0**	**-4.6**	**-3.8**	**-2.8**	**-1.6**
3. State government	**S1312**						
4. Local government*	**S1313**	**0.1**	**-0.2**	**-0.1**	**0.0**	**-0.1**	**-0.2**
5. Social security funds	**S1314**	**2.4**	**0.0**	**-0.1**	**0.0**	**0.1**	**0.2**
General government (S13)							
	ESA						
7. Total expenditures	**ESA**	**48.4**	**49.1**	**48.7**	**48.0**	**47.1**	**46.0**
8. Budget balance	**B9**	**-2.9**	**-6.2**	**-4.8**	**-3.9**	**-2.8**	**-1.6**
9. Net interest payments		**2.8**	**2.9**	**3.3**	**3.4**	**3.4**	**3.4**
10. Primary balance		**-0.1**	**-3.3**	**-1.6**	**-0.5**	**0.7**	**1.8**
Components of revenues							
11. Taxes	D2+D5	23.9	23.9	24.9	25.4	25.9	26.5
12. Social contributions	D61	13.0	13.1	13.1	12.9	12.8	12.7
13. Interest income**	D41	0.8	0.4	0.5	0.5	0.4	0.4
14. Other		7.5	5.0	4.8	4.7	4.6	4.4
15. Total receipts	ESA	45.4	42.9	43.9	44.1	44.3	44.5
Components of expenditures							
16. Collective consumption	P32	18.4	18.6	18.3	18.0	17.6	17.1
17. Social transfers in kind	D63	3.0	3.1	3.0	3.0	3.0	2.9
18. Social transfers other than in kind	D62	14.9	15.6	15.6	15.5	15.3	15.1
19. Interest payments	D41	2.8	2.9	3.3	3.4	3.4	3.4
20. Subsidies	D3	1.6	1.6	1.5	1.5	1.5	1.4
21. Gross fixed capital formation	P51	3.3	3.3	3.0	2.8	2.7	2.8
22. Other		4.3	4.0	3.9	3.7	3.6	3.4
23. Total expenditures	ESA	48.4	49.1	48.7	48.0	47.1	46.0

*** Local and Regional Administration**
****D4 Property income**

Table A- 3. General government debt developments

% of GDP		2004	2005	2006	2007	2008	2009
Gross debt level		61.9	66.5	67.5	67.8	66.8	64.5
Change in gross debt		1.8	4.6	1.1	0.2	-1.0	-2.2
Primary balance		-0.1	-3.3	-1.6	-0.5	0.7	1.8
Interest payments	**D41**	2.8	2.9	3.3	3.4	3.4	3.4
Nominal GDP growth	**B1g**	3.5	3.7	4.9	5.5	5.9	6.1
Other factors influencing the debt ratio							
Of which: Privatisation receipts		0.8	0.3	1.1	0.5	0.4	0.4
p.m. implicit interest rate on debt		5.0	4.9	5.1	5.3	5.4	5.4

Table A- 4. Cyclical developments

% of GDP		2004	2005	2006	2007	2008	2009
1. GDP growth at constant prices	**B1g**	1.0	0.8	1.4	2.2	2.6	3.0
2. Actual balance	**B9**	-2.9	-6.2	-4.8	-3.9	-2.8	-1.6
3. Interest payments	**D41**	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
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
8. Cyclically-adjusted primary balance (7-3)		0.7	-2.3	-0.5	0.3	1.1	1.8

Table A- 5. Divergence from previous update

% of GDP		2004	2005	2006	2007	2008	2009
	GDP growth						
previous	**B1g**	1.0	2.5	2.8	3.0	--	--
latest update	**B1g**	1.0	0.8	1.4	2.2	2.6	3.0
Difference		0.0	-1.7	-1.4	-0.8	--	--
previous	**Actual budget balance B9**	-2.8	-2.2	-1.6	-1.1		
latest update	**B9**	-2.9	-6.2	-4.8	-3.9	-2.8	-1.6
Difference* ⊺		-0.4	-2.6	-2.5	-2.5	--	--
	Gross debt levels						
previous		60.0	59.7	58.6	57.0	--	-
latest update		61.9	66.5	67.5	67.8	66.8	64.5
Difference**		1.9	6.8	8.9	10.8	--	--

* a positive sign denotes an improvement
* a positive sign denotes a deterioration
⊺ excluding one-off measures in both updates

Table A- 6. Long-term sustainability of public finances

% of GDP	**2005**	**2010**	**2020***	**2030**	**2050**
Total expenditure	--	--	--	--	--
Old age pensions	--	--	--	--	--
Health care (including care for the elderly)	--	--	--	--	--
Interest payments	--	--	--	--	--
Total revenues	--	--	--	--	--
of which: from pensions contributions	--	--	--	--	--
National pension fund assets (if any)	--	--	--	--	--
Assumptions					
Labour productivity growth	--	--	--	--	--
Real GDP growth	--	--	--	--	--
Participation rate males (aged 20-64)	--	--	--	--	--
Participation rates females (aged 20-64)	--	--	--	--	--
Total participation rates (aged 20-64)	--	--	--	--	--
Unemployment rate (EU-definition)	--	--	--	--	--

***2025**

Table 7. 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**
United States: short-term (three-month money market)	--	--	--	--	--	--
United States: long term (10-year government bonds)	--	--	--	--	--	--
USD/€exchange rate (annual average)	**1.2**	**1.3**	**1.3**	**1.3**	**1.3**	**1.3**
Nominal effective exchange rate for Portugal (annual % change)	0.6	0.4	0.0	0.0	0.0	0.0
Nominal effective exchange rate (euro area)	--	--	--	--	--	--
Nominal effective exchange rate (EU)	--	--	--	--	--	--
World GDP growth, excluding EU	**5.7**	**4.8**	**4.6**	**4.6**	**4.6**	**4.6**
United States, GDP growth	--	--	--	--	--	--
Japan, GDP growth	--	--	--	--	--	--
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 EU	**12.8**	**9.1**	**7.7**	**7.7**	**7.7**	**7.7**
World import prices (goods, in USD)	--	--	--	--	--	--
Oil prices (Brent, USD/barrel)	**37.9**	**50.1**	**50.3**	**49.0**	**47.0**	**46.0**
Non-oil commodity prices (in USD)	--	--	--	--	--	--

ANNEX 3: INDICATORS OF LONG-TERM SUSTAINABILITY

Main assumptions - baseline scenario (as % GDP)	2010	2020	2030	2040	2050	changes
Total age-related spending	23.6	25.0	26.1	26.9	27.7	4.1
Social security pensions	7.7	8.5	9.2	9.8	10.4	2.7
Civil servants' pension scheme	4.1	4.6	4.8	4.7	4.6	0.5
Health care	5.4	5.8	6.2	6.6	7.0	1.6
Education	5.3	5.1	5.0	5.1	5.1	-0.2
Unemployment benefits	1.2	1.0	0.9	0.8	0.7	-0.5
*Total primary non age-related spending**	19.1					
*Total revenues**	44.7					

* constant

Results (as % GDP)	2010	2020	2030	2040	2050	changes
Programme scenario						
Gross debt	62.8	55.9	64.9	88.7	132.1	69.2
i + 0.5*	62.6	58.7	71.3	100.8	154.0	91.4
2004 scenario						
Gross debt	67.0	101.4	158.4	244.4	374.2	307.2
i + 0.5*	73.5	113.0	178.9	280.8	439.3	365.7

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.