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DECEMBER 2005 UPDATE OF THE STABILITY PROGRAMME OF PORTUGAL (2005-2009)

AN ASSESSMENT

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1.

SUMMARY AND CONCLUSIONS [1]

(1) The Portuguese authorities submitted the most recent update of the Portuguese stability programme on 15 December 2005[2]. The update covers the period from 2005 to 2009. The programme provides the compulsory data required for stability and convergence programmes specified in the new code of conduct, although it deviates on material points from the model structure[3].

(2) On 20 September 2005, the Council decided that Portugal was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit has to be corrected by 2008. Following the expiry of the six-month period foreseen by the recommendation, the Commission is due to carry out an assessment of the action taken by the Portuguese authorities in order to achieve the 2006 deficit target. In its opinion of 12 July 2005 on the previous update of the stability programme, covering the period 2005-2009, the Council invited Portugal to limit the deterioration of the fiscal position in 2005; achieve a sustained correction of the excessive deficit, taking a substantial step in 2006; bring the gross debt ratio onto a firm downward path; control the evolution of expenditure and improve the quality and ensure the long-term sustainability of public finances; and to further improve the processing of general government data.

(3) After averaging 4% per year over the period 1995-2000, accompanied by a pro-cyclical fiscal expansion, Portuguese economic growth declined significantly to only ½% per year between 2001 and 2005, lagging behind the euro area average. GDP per capita in purchasing power terms is expected to have fallen below 70% of the area average in 2005. Apart from adverse cyclical influences from abroad, the subdued performance reflects a weak competitive position, which explains the sizeable external deficit, and the low potential growth. The fiscal position has been weak since the turn of the decade, with the persistence of a high structural deficit. The challenge for policy is to raise the growth potential and thereby facilitate the unwinding of the main imbalances in the economy.

(4) The macroeconomic scenario presented in the update projects real GDP growth to pick up over the programme period, from 0.5% in 2005 to 1.1% in 2006 and 1.8%

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1 This technical analysis, which is based on information available up to 14 February, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 22 February. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Pedro Cardoso (Pedro.Cardoso@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

2 The code of conduct allows Portugal to deliver no later than 15 December.

3 In particular, the programme does not follow the model structure of the new code of conduct, it rather presents four sections: Summary; Economic and budgetary backdrop; Economic and budgetary outlook and Sustainability of public finances. The programme provides all compulsory data and most optional data prescribed by the new code of conduct.

in 2007 to eventually 3% in 2009. Growth is assumed to be driven by domestic demand and exports, although the external contribution is expected to be close to neutral over the programme period. The output gap is foreseen to narrow from around -2½% of GDP in 2006-2007 to less than -1% at the programme horizon. The growth assumptions for 2006 and 2007 are above those from the Commission services' autumn 2005 forecast. For the outer years, GDP growth is clearly above the potential estimated by the Commission services according to the commonly agreed methodology based on the programme. The upward trend of domestic demand may turn out flatter than assumed in the programme against a backdrop of a relatively high private indebtedness and a possible tightening of financial conditions. The external sector's contribution to GDP growth is a major source of uncertainty as the weak competitive position makes it difficult to increase or even maintain export market shares as assumed in the programme. Overall, the programme's growth assumptions are favourable, especially in the outer years of the programme. Inflationary pressures are foreseen to remain low, but there are risks for 2006, coming from recent tax rate increases, and towards the end of the programme period. The large external deficit is expected to remain broadly unchanged.

(5) In 2005, the general government deficit is estimated to have reached 6% of GDP according to the Commission services' autumn 2005 forecast, against a target of 6.2% of GDP set in the previous update of June 2005. This small difference is entirely due to an upward revision of the GDP series. In addition to the sizeable increase in expenditure in 2005, the sharp deterioration from the previous years was largely due to the government no longer raising revenues through sizeable one-off measures.

(6) The programme aims at a lasting correction of the large fiscal imbalance, reducing the general government deficit to below the 3% of GDP reference value in the year 2008 and pursuing further fiscal consolidation thereafter. It envisages the consolidation of public finances to take place on the back of structural measures with substantial steps in each year. After widening to 6% of GDP in 2005, the general government deficit is targeted to decline to 4.6% in 2006 and further to 3.7% of GDP in 2007, 2.6% in 2008 and 1.5% of GDP in 2009. The projected time profile for the primary balance is similar, with an improvement from a deficit of 3.2% of GDP to a surplus of 1.5% of GDP between 2005 and 2009. The fiscal adjustment is helped by both the revenue and the expenditure side. In the short term, in particular in 2006, consolidation is relying mainly on additional revenues generated by higher tax rates and improved tax collection. Expenditure restraint extending to all major primary expenditure categories is expected to support fiscal consolidation in a progressive manner over the period, with the most sizeable savings to come from changes in public administration, including personnel, and changes in social protection schemes. According to the programme, the fiscal targets do not include one-off or temporary deficit-decreasing transactions. Compared with the previous update, the December 2005 update of the stability programme largely confirms the planned adjustment against lower growth assumptions, although still favourable against currently available information.

(7) Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance (i.e. the cyclically-adjusted balance, net of one-off and other temporary measures) is

planned to improve by some 3½ percentage points over the programme period. A tight fiscal stance is foreseen to prevail over the entire programme period, with some front-loading: the structural deficit is targeted to move from some 5% of GDP in 2005 to around 3½% of GDP in 2006, and further to almost 2½% in 2007, 1¾% in 2008 and 1¼% of GDP in 2009. The planned fiscal efforts are projected to take place against a backdrop of a narrowing negative output gap. The programme identifies a medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact of "at least -0.5% of GDP", which it does not aim to achieve within the programme period. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(8) The assessment of the stability programme highlights several risks that the budgetary outcomes could be worse than projected in the programme. While the programme assumptions about the tax intensity of economic activity seem broadly plausible, the growth outlook underpinning the budgetary targets is favourable, especially in the outer years. Moreover, the update outlines an ambitious medium-term plan to curb expenditure growth and several measures have been recently enacted, but nevertheless important measures related to the strategy still have to be defined and implemented, in particular changes in public administration, which are expected to yield substantial savings from 2007 onwards. Their full implementation will be crucial for the attainment of the budgetary targets. Finally, the programme outlines measures that should improve the framework of budgetary execution and control, which if properly implemented are expected to contribute to the achievement of the budgetary objectives.

(9) Taking the programme's budgetary targets at face value, and assuming (i) a full implementation of the measures announced therein for 2006 and (ii) that further significant measures in 2007 and beyond are adopted, also to take into account the possible lower-than-expected economic growth, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by 2008 as recommended by the Council in recommendation under Article 104(7) of 20 September 2005. Provided the risks to the budgetary targets highlighted above are duly addressed, the pace of the adjustment towards the programme's MTO is fully in line with the Stability and Growth Pact. The latter specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and may be lower in bad economic times. However, the budgetary stance in the programme seems insufficient to ensure that the programme's MTO is achieved by the end of the programme period. In addition, it does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations in the year following the planned correction of the excessive deficit.

(10) The debt ratio is estimated to have reached 65.5% of GDP in 2005, above the 60% of GDP Treaty reference value. The programme projects the debt ratio to

further increase to some 69% of GDP in 2007 and to decline thereafter to slightly above 66% of GDP in 2009. The drivers of the rising debt ratio are the primary deficit and a sizeable positive stock-flow adjustment, with the reduction in the outer years being triggered by the return to primary surpluses, the acceleration of GDP growth and by the end of stock-flow adjustments, helped also by privatization proceeds. The evolution of the debt ratio might be less favourable than projected in the programme given the risks to the budgetary targets mentioned above, the uncertainty about the stock-flow adjustment and the possible lower-than-expected economic growth. Although the debt reduction strategy in the update is consistent with the Council recommendation under Article 104(7) of 20 September 2005, as debt developments reflect progress in reducing the deficit and a fall of debt-increasing financial operations, the debt ratio keeps rising in the short term. Therefore, and in view of this risk assessment, ensuring the attainment of the budgetary targets specified in the programme seems necessary to achieve a sufficiently diminishing debt ratio towards the reference value.

(11) With regard to the sustainability of public finances, Portugal appears to be at high risk on grounds of the projected budgetary costs of ageing populations. The currently high level of gross debt and the weak budgetary position indicate the necessity for implementing rigorously the planned consolidation of public finances over the medium-term and to ensure the attainment of the budgetary targets in order to reduce risks to public finance sustainability. However, the projected increases in pension and health care expenditures over the projection period clearly indicate the necessity of a comprehensive strategy in dealing with the challenge posed by ageing populations that goes beyond improving the currently weak budgetary position. The ongoing introduction of changes to the pension and health-care systems should go some way in making these systems more sustainable. However, further reforms are required to curb the projected growth of age-related expenditures.

(12) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, they aim at a correction of the excessive deficit in a structural way as further specified in the Council recommendation under Article 104(7) of 20 September 2005 and the outlined fiscal policy is expected to contribute to a correction of the external deficit. Nevertheless, the planned evolution of government debt in the first half of the programme period represents a notable deviation from what is expected in the guidelines.

(13) The National Reform Programme of Portugal, submitted on 21 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges in the area of public finances: (i) enhancing economic growth and promoting the sustainability of public finances; and (ii) the reform of public administration. The measures envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme in the area of public finances. In fact, the NRP took on board the substance of June 2005 update. The most recent update of the stability programme confirms the strategy. However, it does not spell out the budgetary implications of the actions outlined in the National Reform Programme in the various policy areas.

In view of the above assessment, the programme is broadly consistent with a correction of the excessive deficit by 2008, subject to a full implementation of the measures announced in the programme and the adoption of further measures still necessary to underpin the fiscal strategy. In the light of the recommendations under Article 104(7) of 20 September 2005, it would be appropriate for Portugal to:

(i) adopt and implement with rigour the structural measures envisaged in the programme in order to ensure the correction of the excessive deficit by 2008 in a credible and sustainable manner; create margins to deal with the budgetary impact of possible lower-than-projected economic growth;

(ii) enact decisively the planned measures to control expenditure; improve the budgetary process at all levels of general government, possibly through the more extensive use of binding expenditure ceilings and, as outlined in the programme, by strengthening mechanisms of monitoring, controlling and reporting expenditure and revenue;

(iii) improve the long-term sustainability of public finances, in particular by implementing the measures already envisaged in the programme and by enacting further reforms in the area of pensions and health care;

(iv) bring the government gross debt ratio onto a firm downward path by ensuring that it reflects both the progress in the reduction of the government deficit and the projected privatisation proceeds, and by considering carefully the impact on debt of major public investment projects, including those in partnership with the private sector.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	**SP Dec 2005**	1.2	0.5	1.1	1.8	2.4	3.0
	COM Nov 2005	1.2	0.4	0.8	1.2	n.a.	n.a.
	SP Jun 2005	*1.0*	*0.8*	*1.4*	*2.2*	*2.6*	*3.0*
HICP inflation (%)	**SP Dec 2005***	2.4	2.3	2.3	2.2	2.2	2.1
	COM Nov 2005	2.5	2.2	2.7	2.2	n.a.	n.a.
	SP Jun 2005	*2.5*	*2.5*	*2.9*	*2.5*	*2.5*	*2.4*
Output gap (% of potential GDP)	**SP Dec 2005[1]**	**-1.5**	**-2.3**	**-2.7**	**-2.5**	**-1.8**	**-0.7**
	COM Nov 2005[6]	-1.3	-2.0	-2.4	-2.6	n.a.	n.a.
	SP Jun 2005[1]	*-2.1*	*-2.7*	*-2.8*	*-2.3*	*-1.6*	*-0.7*
General government balance (% of GDP)	**SP Dec 2005**	**-3.0**	**-6.0**	**-4.6**	**-3.7**	**-2.6**	**-1.5**
	COM Nov 2005	-3.0	-6.0	-5.0	-4.8	n.a.	n.a.
	SP Jun 2005	*-2.9*	*-6.2*	*-4.8*	*-3.9*	*-2.8*	*-1.6*
Primary balance (% of GDP)	**SP Dec 2005**	-0.3	-3.2	-1.7	-0.6	0.6	1.5
	COM Nov 2005	-0.3	-3.1	-2.0	-1.6	n.a.	n.a.
	SP Jun 2005	*-0.1*	*-3.3*	*-1.6*	*-0.5*	*0.7*	*1.8*
Cyclically-adjusted balance (% of GDP)	**SP Dec 2005[1]**	**-2.3**	**-5.0**	**-3.4**	**-2.6**	**-1.8**	**-1.2**
	COM Nov 2005	-2.4	-5.1	-3.8	-3.6	n.a.	n.a.
	SP Jun 2005[1]	*-2.2*	*-5.3*	*-3.8*	*-3.1*	*-2.3*	*-1.4*
Structural balance[2] (% of GDP)	**SP Dec 2005[3]**	**n.a.**	**-5.0**	**-3.4**	**-2.6**	**-1.8**	**-1.2**
	COM Nov 2005[4]	-4.6	-5.5	-4.2	-3.7	n.a.	n.a.
	SP Jun 2005[5]	*-4.5*	*-5.5*	*-3.8*	*-3.1*	*-2.3*	*-1.4*
Government gross debt (% of GDP)	**SP Dec 2005**	59.4	65.5	68.7	69.3	68.4	66.2
	COM Nov 2005	59.4	65.9	69.8	72.1	n.a.	n.a.
	SP Jun 2005	*61.9*	*66.5*	*67.5*	*67.8*	*66.8*	*64.5*

Notes:
[1]Commission services calculations on the basis of the information in the programme.
[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3]There are no one-off and other temporary measures in the programme.
[4]One-off and other temporary measures taken from the Commission services' autumn 2005 forecast: 2.2% of GDP in 2004, 0.4% of GDP in 2005 and 0.4% of GDP in 2006 and 0.1% of GDP in 2007; all deficit-reducing.
[5]One-off operations taken from the June 2005 programme: 2.3% of GDP in 2004 and 0.2% of GDP in 2005; all deficit-reducing.
[6]Based on estimated potential growth of 1.3%, 1.1%, 1.2% and 1.4% respectively in the period 2004-2007.
*Private consumption deflator

Source:
Stability programmes (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

2. INTRODUCTION

The Portuguese authorities submitted the most recent update of the Portuguese stability programme on 15 December 2005[4]. The update covers the period from 2005 to 2009. It was approved by the government on 7 December and discussed by parliament on 14 December 2005. It was based on the 2006 budget law adopted in November 2005.

The programme deviates on some material points from the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct. In particular, the programme does not follow the model structure of the new code of conduct, it rather presents four sections: Summary; Economic and budgetary backdrop; Economic and budgetary outlook and Sustainability of public finances. The programme provides all compulsory data and most optional data prescribed by the new code of conduct[5]. Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

3. ECONOMIC OUTLOOK

After averaging 4% per year over the period 1995-2000, Portuguese economic growth declined significantly to only ½% per year between 2001 and 2005, lagging behind the euro area average. GDP per capita in purchasing power terms is expected to have fallen below 70% of the area average in 2005. Apart from adverse cyclical influences from abroad, the subdued performance reflects a weak competitive position as reflected by a sizeable external deficit. The fiscal position has been weak since the turn of the decade with the persistency of a high structural deficit. The challenge for policy is to raise the growth potential and thereby facilitate the unwinding of the main imbalances in the economy.

The macroeconomic scenario presented in the programme projects real GDP growth to pick up from 0.5% in 2005 to 1.1% in 2006, 1.8% in 2007 and eventually 3% in 2009 (see Table 1). The cyclical conditions implied by the programme, as measured by the output gap calculated by the Commission services' according to the commonly agreed methodology based on the information provided in the programme, are expected to improve over the programme period with the negative output gap gradually closing after 2006.

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[4] The code of conduct allows Portugal to deliver no later than 15 December. The English version of the programme was submitted on 21 December 2005.

[5] Missing optional data are: HICP; Public consumption deflator; Investment deflator (Table 1b of the Code of Conduct: Price developments); Compensation of employees (Table 2: General government budgetary prospects); General government expenditure by function (Table 3); Stock-flow adjustment decomposition: no data on "differences between cash and accruals" and on "valuation effects and others"; Liquid financial assets and net financial debt (Table 4: General government debt developments); Potential GDP growth and its contributors (Table 5: Cyclical developments).

Table 1: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008	2009
	COM	**SP**	**COM**	**SP**	**COM**	**SP**	**SP**	**SP**
Real GDP (% change)	0.4	0.5	0.8	1.1	1.2	1.8	2.4	3.0
Contributions:								
- Final domestic demand	1.1	1.1	0.7	1.0	1.5	1.6	2.5	3.2
- Change in inventories	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
- External balance on g&s	-0.4	-0.5	0.2	0.1	-0.2	0.2	-0.1	-0.2
Output gap[1]	-2.0	-2.3	-2.4	-2.7	-2.6	-2.5	-1.8	-0.7
Employment (% change)	0.1	0.1	0.2	0.6	0.4	0.9	1.2	1.5
Unemployment rate (%)	7.4	7.4	7.7	7.7	7.8	7.7	7.4	7.0
Labour productivity growth (%)	0.3	0.4	0.6	0.5	0.8	0.9	1.2	1.5
HICP inflation[2] (%)	2.2	2.3	2.7	2.3	2.2	2.2	2.2	2.1
GDP deflator (% change)	2.0	2.6	2.2	2.3	2.5	2.8	2.7	2.8
Compensation of employees (% change)	3.0	3.7	2.9	3.2	3.0	3.2	3.6	4.0
External balance (% of GDP)	-7.9	-6.8	-8.1	-6.7	-8.0	-6.8	-6.8	-6.6

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 2 below.
[2]Private consumption deflator
Source:
Commission services' autumn 2005 economic forecasts (COM); stability programme update (SP)

The growth pattern is assumed to be driven by domestic demand, notably private investment is projected to expand briskly as from 2007. While exports are also assumed to grow strongly, the external contribution is expected to be close to neutral over the programme period. The growth assumptions for 2006 and 2007 are more favourable than the Commission services' autumn 2005 forecasts, notwithstanding the external outlook behind the programme's macroeconomic scenario being in line with the Commission services' autumn 2005 forecasts. Moreover, the growth assumption in the outer years of the programme are significantly above current estimates of potential output growth (see also Table 2).

The assessment of the stability programme highlights risks to the macroeconomic scenario. The slowdown of domestic demand may be stronger than assumed in the programme. Private consumption may be hindered by a weaker labour market outlook and a re-assessment of households' financial position against a relatively high level of indebtedness and a possible tightening of financial conditions, with the possible need to affects additional resources to marginally higher debt servicing costs. Investment can be expected to recover from its 2002-2005 contraction. However, the recovery may be more moderate than projected reflecting encouraging but still modest business prospects.

The assumptions of increasing or even constant export market shares as assumed in the programme seem optimistic. As highlight above, cost competitiveness has deteriorated for several years and structural weaknesses further add to the vulnerability of Portugal's competitive position. The foreseen wage moderation does not seem sufficient to leverage export growth so briskly.

Overall, the programme's medium-term macroeconomic scenario seems favourable, especially in the outer years of the programme. The programme mentions the implementation of the just launched Technological Plan and the National Reform Plan as strategies geared towards enhancing human capital and innovation and in those ways to increase the economy's growth potential. However, no estimates of their possible impact on productivity and GDP over the programme period are provided.

According to the programme, employment will increase with the upswing in economic activity: one half of GDP growth is assumed to be linked to employment, with the other half being the result of augmented productivity, which seems to extrapolate the average composition of the last decade. However, it is plausible that success in countervailing the features that weaken Portugal's competitive positive would be associated with a stronger productivity content of GDP growth, and consequently with lower employment gains in the short to medium-term. The path of moderate wage growth is plausible but the weakening of the labour market and the need to avoid cost-competitiveness deterioration in the short term may put additional downward pressures on wages.

The programme projects inflation to be broadly stable during the entire period[6]. Inflation has been rekindled by higher energy prices and the increase in the normal VAT rate from 19 to 21% in July 2005. Recent data show that shocks have not been fully passed on to prices, possibly due to a profit-margin squeezing, nevertheless a carry-over should be felt in 2006. In addition, excise taxes on oil and tobacco went up in January 2006. Therefore, even if the large negative output gap limits the room for prices increases, there are upwards risks to the programme inflation projection of 2.3% in 2006. As of 2007, lower import prices growth is assumed to be important in keeping inflation stable. In the outer years, if the programme's assumptions about domestic demand and wage growth materialize, inflationary pressures might ceteris paribus be stronger than projected.

Commission services' calculations according to the commonly agreed methodology, based on the information provided in the programme, point to potential output growth to increase from 1¼% in 2005 to 1½% in 2006 and to become stable from 2007 onwards at almost 1¾% (see Table 2). The profile for potential GDP growth in the current and the next year is above that of the Commission services' autumn 2005 forecast. According to the update, that will be essentially the result of additional production factor accumulation. After lagging below potential GDP since 2001, actual GDP is expected to broadly equalize it in 2007 and to exceed it thereafter thus gradually closing the negative output gap, yet not completely, by 2009.

Table 2: Sources of potential output growth

	2005		**2006**		**2007**		**2008**	**2009**
	COM	**SP[2]**	**COM**	**SP[2]**	**COM**	**SP[2]**	**SP[2]**	**SP[2]**
Potential GDP growth[1]	1.1	1.3	1.2	1.5	1.4	1.7	1.6	1.8
Contributions:								
- Labour	0.3	0.7	0.3	0.8	0.3	0.9	0.6	0.5
- Capital accumulation	0.5	0.5	0.5	0.5	0.5	0.6	0.7	0.9
- TFP	0.3	0.1	0.4	0.1	0.5	0.2	0.3	0.4

Notes:
[1]based on the production function method for calculating potential output growth
[2]Commission services' calculations on the basis of the information in the programme

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

[6] The inflation is measured as the variation of the private consumption deflator since the programme does not supply HICP data.

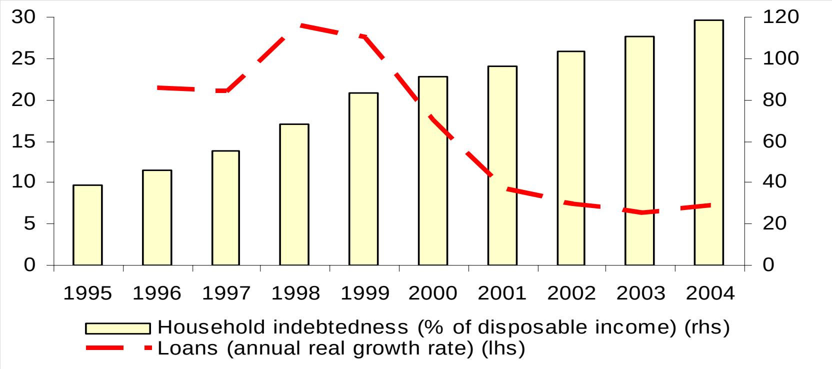
As regards the external deficit, the programme expects it to remain at a high level throughout the programme period. It largely reflects a sizeable goods and services balance deficit: the expected slow improvement, from -8.4% of GDP in 2005 and 2006 to -7% of GDP in 2009, which seems consistent with the macroeconomic scenario and the assumed terms of trade, is offset by projected lower net current and capital transfers. The picture of a persistent high net external borrowing is in line with the Commission services' autumn 2005 forecast but with two differences: first, the 2005 external borrowing may be higher by around one percentage point than assumed in the programme and, second, in 2006 net borrowing may still increase from its 2005 level. As for the private sector balance, it is expected to deteriorate over the programme period. While such deterioration seems to be broadly consistent with the internal demand upswing assumed in the programme, the already high private sector indebtedness may not leave much room open for further substantial borrowing (see Box 1 on Households). This conclusion adds to the above expressed concern that the internal demand expansion may turn out more modest than foreseen in the programme.

Box 1: Households credit growth and indebtedness

Since the late 1990s, real interest rates have been lower in Portugal compared with the euro area as a whole, to the point of becoming negative as from 2001. With EMU, the prospects of deeper economic and monetary integration within a richer area fed expectations of higher future income flows and paved the way for a boom of domestic demand over the second half of the nineties. The rosy prospects created the demand for consumption smoothing over the lifecycle of the higher (expected) permanent income. Financial deregulation and liberalisation were deepened through the 1990s, which opened the way for more competition in the banking industry and was followed by financial innovation. With EMU, banks' liquidity constraints were significantly loosened with enhanced opportunities to borrow abroad with the integration in a broader monetary area and the elimination of the exchange rate risk.

Both demand and supply worked to make the late1990s a period of a credit boom against a background of higher permanent income expectations, less restrictive liquidity constraints and innovation in financial intermediation. Households made use of their increased borrowing capacity as an instrument to smooth a higher level of wealth and changes in the credit supply side made the financial industry more capable to satisfy the buoyant credit demand. The net result was a rapid expansion of credit and debt, essentially financed at short-term variable interest rates and the subsequent rising household indebtedness (see Figure).

Figure: Households credit growth and indebtedness



Source: Banco de Portugal

The household debt ratio has been on an upward trend, reaching 118% of disposable income in 2004, which in the euro area was only surpassed by the Netherlands. Housing seems to have been the main target of the credit boom, representing some 80% of the outstanding household debt. Indeed, part of the indebtedness increase went hand in hand with wealth accumulation: households’ net wealth (financial and housing assets minus financial liabilities) seemed to have steadily increased up to 2000, when it was nearly four times as large as disposable income, yet slightly declining thereafter. Such debt and wealth accumulation was accompanied by a boom in construction but real estate prices accelerated moderately, which seems to have avoided the risk of a real estate price bubble. Consumer credit grew also rapidly, albeit from a low base. Overall, low interest rates made loans more attractive, at least in the short-term: the fall in interest rates seem to have offset the higher indebtedness ratios, since over the last ten years the interest paid on loans remained broadly stable and close to an average of some 5% of disposable income.

Despite improvements, productivity remained low compared with other industrialized countries with severe structural impediments persisting. In other words, the augmented purchasing and borrowing capacities did not go hand in hand with an expansion of production capacity as reflected by a sizeable external deficit. Against such a backdrop, some balance-sheet adjustment took place in the household sector but households’ demand for credit has been clearly outpacing a now more sluggish gross disposable income growth. On the demand side, the downward adjustment seems to reflect cyclical developments, in particular for non-housing loans, and also a curb on tax subsidies for mortgages interest enacted in 2002. On the supply side, the financial sector was able to react by marketing new borrowing modalities for the debt service and the competitive conditions have resulted in a further compression of margins. Nonetheless, credit overdue and credit delinquency seem to be at low levels.

Consumption is often taken as a key proxy to economic welfare. Therefore, consumption and housing investment expansion as the one just described could be considered as generating welfare gains. In addition, the indebtedness levels could not be seen as a concern as they have been mainly used to finance asset accumulation and there are no signs of a bubble in the real estate market. Nevertheless, the concern is that household behaviour may have been evolving along an unsustainable path with diverging income and spending patterns resulting in rising indebtedness. Furthermore, the high debt ratio makes households more vulnerable to current or expected adverse economic conditions like an increase in interest rates, a deterioration of the labour market or an anticipation of a fiscal retrenchment. Furthermore, even if households’ inter-temporal budget constraint is respected, the reactions of the household sector to an adverse shock may affect the wider economy, thus magnifying the shock. A first case is a change in financial conditions as the high debt ratio makes households more sensitive to interest rate changes, which is more of a vulnerability for Portuguese households due to the predominance of variable rate contracts and the subsequent quick transmission of monetary stance changes. Whereas financial innovation and competition might result in a softening of the shock faced by borrowers, in the end, a rising interest burden may be hard to avoid. In the same vein, a negative shock on household current and expected income tightens their options. This is more relevant the worse the labour market performs and the longer the current weak productive and competitive position lasts. In addition, given the persisting budgetary imbalances and the need to address them in a sustained and fast way, an anticipation of fiscal tightening by households may play a role as well, resulting, for instance, in additional precautionary savings.

4. General government balance

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous stability programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

4.1. Targets in successive programmes and implementation in 2005

The December 2005 update of the stability programme targets a marked reduction of the general government deficit from 6% of GDP in 2005 to 4.6% of GDP in 2006 (see Table 3). The deficit is projected to further gradually decline to 1.5% of GDP in 2009.

The outlined government deficit targets conform to those of the June 2005 update[7]. The latter revealed a substantial change in the budgetary strategy of the Portuguese authorities as decided in the aftermath of the general elections and a new government taking office in March 2005. Compared with the January 2004 update, the December update confirms a sharp rise in the government deficit in 2005 to 6% of GDP due to the decision of no longer implementing sizeable deficit-reducing one-off measures[8], a marked worsening of the economic scenario and an upward revision of government expenditure growth. The government deficit targets for 2006 and 2007 are also higher than in the January 2004 update. Figure 1 presents the budgetary targets envisaged by the Portuguese authorities in the programme updates since 1998.

[7] Compared with the June 2005 programme, the nominal general government balances have "mechanically" been revised down by some 0.2 percentage point of GDP entirely due to a revision of the GDP series implemented in September 2005, which raised the GDP level by almost 5%.

[8] In 2004, the proceeds of one-off operations were close to 2.2% of GDP.

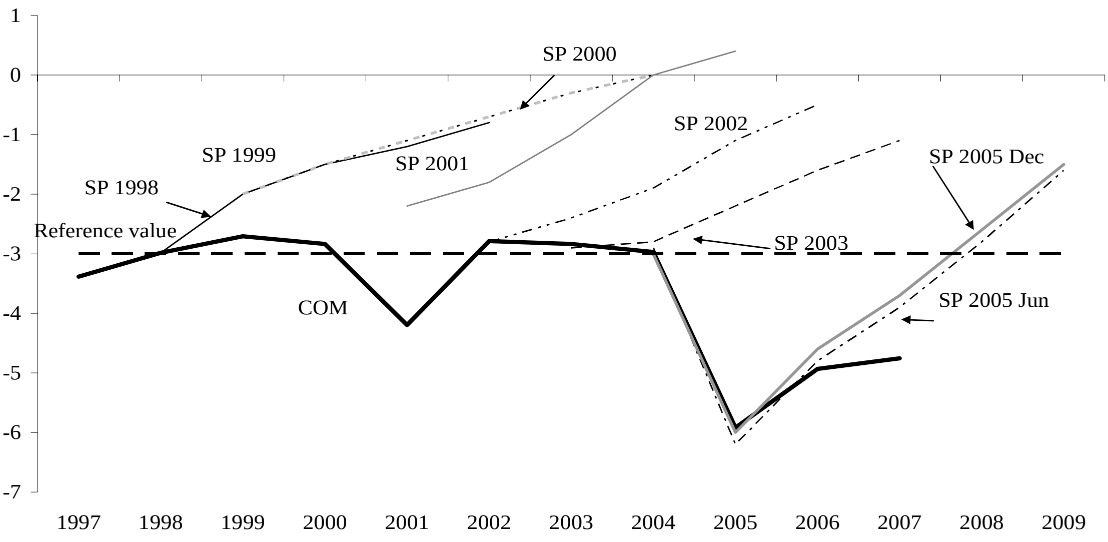
Table 3: Evolution of budgetary targets in successive programmes

		2004	2005	2006	2007	2008	2009
General government balance	**SP Dec 2005**	**-3.0**	**-6.0**	**-4.6**	**-3.7**	**-2.6**	**-1.5**
	SP Jun 2005	-2.9	-6.2	-4.8	-3.9	-2.8	-1.6
(% of GDP)	*SP Jan 2004**	*-2.8*	*-2.2*	*-1.6*	*-1.1*	n.a.	n.a.
	COM Nov 2005	-3.0	-6.0	-5.0	-4.8	n.a.	n.a.
General government expenditure	**SP Dec 2005**	**46.5**	**47.4**	**47.0**	**46.1**	**45.1**	**43.9**
	SP Jun 2005	48.4	49.1	48.7	48.0	47.1	46.0
(% of GDP)	*SP Jan 2004*	*46.6*	*45.5*	*44.5*	*43.5*	n.a.	n.a.
	COM Nov 2005	46.5	47.7	47.8	48.0	n.a.	n.a.
General government revenues	**SP Dec 2005**	**43.5**	**41.4**	**42.3**	**42.4**	**42.5**	**42.4**
	SP Jun 2005	45.4	42.9	43.9	44.1	44.3	44.5
(% of GDP)	*SP Jan 2004*	*43.7*	*43.2*	*42.9*	*42.5*	n.a.	n.a.
	COM Nov 2005	43.5	41.7	42.8	43.2	n.a.	n.a.
Real GDP	**SP Dec 2005**	**1.2**	**0.5**	**1.1**	**1.8**	**2.4**	**3.0**
	SP Jun 2005	1.0	0.8	1.4	2.2	2.6	3.0
(% change)	*SP Jan 2004*	*1.0*	*2.5*	*2.8*	*3.0*	n.a.	n.a.
	COM Nov 2005	1.2	0.4	0.8	1.2	n.a.	n.a.

Source:
Stability programmes (SP) and Commission services' autumn 2005 economic forecasts (COM)
* Including one-off and other temporary measures.

In the December 2005 update, the expenditure and revenue ratios are lower than those in the June 2005 update essentially due to the upward revision of the GDP level[9]. The time pattern of the expenditure ratio reduction over the programme period is slightly steeper than in the June update, while the revenue ratio is now flatter from 2006 onwards.

Figure 1: General government balance projections in successive stability programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive stability programmes

9 See footnote 7. Controlling for the higher GDP level, the expenditure and revenues ratios targeted in the most recent update as compared to those in the June 2005 update are slightly higher up to 2007 and nearly equal thereafter.

In mid-2005, the Portuguese parliament adopted a supplementary budget targeting a general government deficit of 6.2% of GDP, reflecting already the strategy outlined in the June 2005 stability programme. It took on board a corrective package of some 0.6% of GDP, the main element of which was an increase in the normal VAT rate from 19 to 21% as from 1 July. The December update suggests a marginal overachievement of that target due to the upward revision of the GDP series[10].

Preliminary data on a cash basis reveal revenue growing well and above plans. Direct and indirect taxes were up, respectively, by 2.1% and 11% for the year as a whole, which compare with middle-of-the-year budgetary targets of 0.9% and 10.5%. In fact, controlling for the revision of GDP, the revenue ratio in the December update is 0.3 percentage points higher than in June. This expansion was in excess of what the pace of economic activity would indicate even controlling for the July VAT hike. Pulling in the opposite direction was the reduction of the corporate tax rate from 30 to 25% enacted by the 2004 budget and whose full effects were felt for the first time in the 2005 outturn (everything else being equal, rough estimates point to a drag between 0.3% and 0.4% of GDP). Social contributions have been up by 5.3% year-on-year until November against a budgetary target of some 4%. Overall, these developments on the revenue side suggest a further improvement in tax collection, stronger than in 2004. Such favourable tax outturn seems to have limited the need of raising proceeds through the sale of real estate assets as assumed in the June 2005 update (0.2% of GDP) and in the more recent 2006 budget, but the update does not supply information on this.

As regards expenditures, the target for the State sub-sector is well within reach, but recent information is scanter for other sub-sectors. While slippages cannot be excluded, developments appear to be such not to compromise the overall fiscal target. In fact, the stronger-than-budgeted revenues will offset slightly higher-than-planned expenditure and furthermore, the mid-year supplementary budget already accounted for a rather strong upward pressure on expenditure in various government areas also on the basis of the budgetary execution up to spring as total expenditure was targeted to increase by some 5¾% for the year as a whole. All in all, the 2005 general government deficit should not exceed the 6% of GDP target, with risks slightly skewed to the positive side.

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[10] See footnote 7.

Box 2: The excessive deficit procedure for Portugal

On 20 September 2005 the Council decided that Portugal had an excessive deficit. On the same date, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2008. In particular, Portugal was recommended to reduce the general government deficit by taking action in a medium-term framework.

Specifically, Portugal was recommended to limit the deterioration of the fiscal position in 2005 and to ensure a correction of the structural deficit of some 1.5% of GDP in 2006 from 2005, followed by a further decrease of, at least, ¾% of GDP in each of the two subsequent years. At the same time, Portugal was invited to rapidly implement reforms to contain and reduce expenditure and to stand ready to adopt the additional measures which may be necessary to achieve the correction of the excessive deficit by 2008. In addition, the Portuguese authorities were recommended to ensure that the government gross debt ratio is brought onto a downward path also by avoiding debt-increasing financial transactions, and by considering carefully the possible impact on debt of major public investment projects.

The Council established the deadline of 19 March 2006 for the Portuguese government to take effective action in order to achieve the 2006 deficit target. Concomitantly, after that date, the Commission is due to carry-out an assessment of the efforts made by the Portuguese authorities.

4.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

The programme aims at a lasting correction of the large fiscal imbalance, reducing the general government deficit to below the 3% of GDP reference value in the year 2008 and pursuing further fiscal consolidation thereafter. In line with the Council recommendation under Article 104(7) of 20 September 2005, it envisages to consolidate public finances on the basis of structural and permanent measures with substantial steps in every of the coming three years.

The programme outlines consolidation efforts over the entire programme period with some front-loading. After widening to 6% of GDP in 2005, the general government deficit is projected to decline to 4.6% in 2006 and further to 3.7% of GDP in 2007, 2.6% in 2008 and 1.5% of GDP in 2009 (see Table 4), i.e. an annual reduction of 1½ percentage point in 2006, and around 1 percentage point per year thereafter. Thus, in total, the programme targets a cut in the general government deficit by 4.5 percentage points in nominal terms between 2005 and 2009. The profile for the primary balance is similar, with an improvement from a deficit of 3.2% of GDP in 2005 to a surplus of 1.5% of GDP at the end of the programme period.

Compared with the previous programme, the December 2005 update largely confirms the planned adjustment against a slightly less favourable macroeconomic scenario.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004	2005	2006	2007	2008	2009	Change: 2009-2005
Revenues *of which:*	43.5	41.4	42.3	42.4	42.5	42.4	**1.0**
- Taxes & social contributions	36.5	36.6	37.5	37.7	38.0	37.9	**1.3**
- Other (residual)	7.0	4.8	4.9	4.6	4.5	4.5	**-0.3**
Expenditure	46.5	47.4	47.0	46.1	45.1	43.9	**-3.5**
of which:							
- Primary expenditure	43.8	44.6	44.1	43.0	42.0	40.8	**-3.8**
of which:							
Collective consumption	7.8	7.8	7.5	7.3	7.1	6.8	**-1.0**
Social transfers in kind	13.1	13.3	13.0	12.8	12.4	12.0	**-1.3**
Social transfers other than in kind	14.3	14.8	15.0	14.9	14.7	14.4	**-0.4**
Subsidies	1.5	1.6	1.5	1.3	1.2	1.2	**-0.4**
Gross fixed capital formation	3.1	3.2	2.9	2.9	2.8	2.9	**-0.3**
Other (residual)	4.0	3.8	4.1	3.8	3.7	3.6	**-0.2**
- Interest expenditure	2.7	2.8	2.9	3.1	3.1	3.1	**0.3**
General government balance (GGB)	-3.0	-6.0	-4.6	-3.7	-2.6	-1.5	**4.5**
Primary balance	-0.3	-3.2	-1.7	-0.6	0.6	1.5	**4.7**
One-off and other temporary measures	2.2	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-off & other temporary measures	-5.2	-6.0	-4.6	-3.7	-2.6	-1.5	**4.5**
Source: *Convergence programme update; Commission services' calculations*							

4.2.2. The composition of the budgetary adjustment in the programme

The planned fiscal consolidation efforts are spread over the entire programme period with the deficit reduction being based on permanent measures rising the tax burden and curbing primary expenditure. According to the programme, the fiscal adjustment does not include one-off and other temporary deficit-decreasing transactions. In outset of the programme period, the consolidation relies mainly on revenues with the expenditure restraint being expected to give its contribution to fiscal consolidation in a progressive manner over the period.

Measures on the revenue side are front-loaded. In fact, in 2006, consolidation is relying mainly on additional revenues yielding a total revenue-to-GDP ratio higher by nearly 1 percentage point compared with its 2005 level of 41.4% of GDP and is projected to stay broadly constant thereafter (see Table 4). The tax burden evolution is slightly steeper with other revenues seeing their importance in terms of GDP slightly reduced. Higher revenues will result mainly from the increase in the VAT normal rate from 19% to 21%, enacted in July 2005, the progressive increase in the taxes on petroleum and on tobacco started in January 2006 (see Boxes 3 and 4). In addition, the programme assumes gains coming from measures addressing the efficiency of tax collection, notably by fighting tax evasion and simplifying the compliance with tax codes, and also by limiting tax allowances and deductions, notably on income taxes.

Expenditure restraint is targeted to give an increasing contribution to fiscal consolidation, in particular from onwards. According to the programme, in 2006, the primary expenditure ratio will decrease by almost ½ percentage point compared to 2005, and in the following years its importance in terms of GDP will decline by an average of 1 percentage point per year until the end of the programme period. All primary expenditure categories seem to help consolidation, with the reductions in collective consumption and social transfers being the most sizeable. An important part of the expenditure restraint is planned to come from sizeable measures of a permanent nature, which concentrate on reforming public administration, including government career and pay scales, and changing various pensions, retirement and health systems (see Box 4 for the expected impact of those measures; Sections 5 and 6 below will elaborate on the shape of policy changes). Interest expenditure is expected to increase by 0.3 percentage points over the programme period.

The share of public investment in total expenditure is projected to decline slightly. However, it is not clear whether it represents a fall in capital accumulation or sales of physical assets, which in national accounts would be recorded as expenditure-reducing transactions. This question stems from the inclusion in the June 2005 update of proceeds from the sale of real estate assets (between 0.1 and 0.2% of GDP per year over the entire period) in the context of the public administration reform, particularly its real-estate asset management. Also the 2006 budget seems to have considered such kind of proceeds (almost 0.4% of GDP). However, the December 2005 update remains silent on this issue. Should real-estate sales be foreseen to have a significant and temporary impact on the budget, the lack of information on them will not be in line with the new code of conduct and would also be in conflict with the assertion made in the programme according to which there are no one-off measures over the programme period.

Box 3: The budget for 2006

The budget for 2006 was presented on 17 October 2005 and approved by parliament on 30 November. The budget builds upon the fiscal strategy outlined in the June 2005 update of the stability programme and targets a general government deficit of 4.6% of GDP in 2006. The bill builds on a macroeconomic scenario equal to the one in the December 2005 update of the stability programme.

Current revenue is targeted to increase by 6% compared to its 2005 outturn, with the largest contribution coming from taxes on consumption, which are expected to jump by 7.7%, mainly on the back of tax rate increases. Examples of measures on the revenue side implemented by the budget bill are: i) an increase on excise taxes on petrol and tobacco with effect from 1 January 2006 (0.2% and 0.1% of GDP, respectively); ii) on the personal income tax, the creation of an additional bracket for incomes over € 60.000/year with a marginal tax rate of 42% (present top marginal rate: 40%); iii) lower allowances for income from pensions. In addition, the bill implements various measures aiming at fighting tax evasion, e.g., the publication of a tax debtors list with outstanding tax arrears. Curbs on tax benefits are also expected to help revenues.

On the expenditure side, for 2006, the budget bill targets a stabilization of current expenditure in real terms (nominal growth of 2.4% compared with an inflation rate of 2.3%). Examples of important measures enacted by the budget are: i) a freeze of nominal transfers from central to local and regional governments. In addition, the latter saw also their debt frozen and their compensation of employees to be fixed at its 2005 nominal level; and ii) only partial replacement of workers that leave the civil service (one new admission for every two that quit) to be applied in central government, together with the obligation of the Finance Minister’s approval of hiring of government employees.

Finally, the targets of the 2006 budget are to be supported by other measures enacted by legal procedures other than the budget bill itself, e.g., the increase of the normal VAT rate to 21% enacted in July 2005 and changes in pensions and health schemes (see also Box 4).

Box 4: Major medium-term fiscal consolidation measures

The most recent update of stability programme outlines sizeable fiscal consolidation measures of a structural nature which should support most of the envisaged fiscal adjustment. This box aims at providing some insight into those major corrective efforts, in particular their composition and marginal importance in the various years of the programme, according to the update content.

Measures on the revenue side, involve the increase in the VAT normal tax rate to 21% from 19% enacted in mid- 2005; gradual annual increases of taxes on petroleum products and on tobacco (up until 2008 and 2009, respectively); changes in personal income taxation, and higher social security contributions for some professional groups, and also a reduction in tax benefits. Additionally, increased efficiency of taxes and social security contributions collection backed by a fight against evasion and measures to ease compliance is expected to yield important revenues.

On the expenditure side, the major consolidation efforts will be concentrated in the areas of public administration (including personnel expenditure), old-age pensions and health systems. Sections 5 and 6 below provide details on these policy measures.

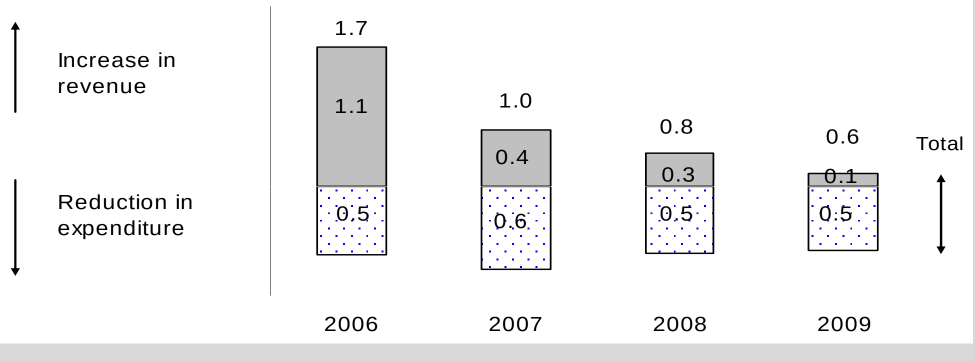
The cumulative impact of the main policy changes is as follows:

% of GDP, 2005 prices	2005	2006	2007	2008	2009
Measures to increase revenue					
Income and wealth tax	0.1	0.4	0.5	0.6	0.6
VAT	0.4	0.8	0.8	0.8	0.8
Tax and petroleum products	-	0.1	0.3	0.4	0.4
Excises on tobacco	-	0.1	0.2	0.3	0.4
Social security contributions	0.1	0.2	0.3	0.3	0.3
Total revenue	**0.6**	**1.6**	**2.1**	**2.3**	**2.4**
Measures to decrease expenditure					
Public administration reform (including personnel)	0.1	0.3	0.7	1.1	1.4
Social security and Health					
Private sector workers	-	0.1	0.2	0.2	0.2
Government employees	-	0.2	0.3	0.5	0.6
Payment of medicines	-	0.1	0.1	0.1	0.1
Total expenditure	**0.1**	**0.6**	**1.3**	**1.8**	**2.3**
Total (cumulative)	**0.6**	**2.3**	**3.3**	**4.1**	**4.7**

Note: values may not add up due to rounding
Source: Stability programme (SP); Commission services calculations

As shown in the figure below, the measures on the revenue side are largely front-loaded, in fact most of the measures have already been adopted, with the marginal impact of these measures lowering significantly from 2007 onwards. Structural measures on the expenditure side are planned to yield savings over the programme period.

Figure: Marginal efforts of budgetary adjustment (% of GDP)



The corrective measures outlined in the December 2005 update are conform to those in the June 2005 update. The efforts coming from these structural measures are now higher in the three outer years of the programme by 0.1 or 0.2 percentage points, with the expenditure restraint being somewhat sharper in 2008 and 2009, in particular the gains from the public administration reform are now more significant than they were in the June update.

4.2.3. *The programme's medium-term objective (MTO) and the adjustment path in structural terms*

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The December 2005 update of the Portuguese stability programme sets an MTO, as meant in the Stability and Growth Pact, of "at least -0.5% of GDP". The programme aims to follow the structural adjustment path for the years 2006-2008 recommended by the Council under Article 104(7) on 20 September, in order to correct the excessive government deficit by 2008. After such correction, the programme expects to achieve the MTO thanks to "the continuation, at a rate of no less than 0.5 percentage point per year, of reductions to the deficit in 2009 and following years until a balance of at least -0.5% of GDP is attained."

Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance is projected to improve from some -5% of GDP in 2005 to around -1¼% of GDP by the end of the programme period, i.e., 2009 (see Table 5). After a substantial weakening in 2005, a continued tightening of the fiscal stance, measured by the annual change in the structural balance, is planned over the entire programme period, with targeted annual improvements always in excess of ½ percentage points. The planned effort seems to be stronger in 2006, when an improvement of some 1½ percentage points in the structural balance is expected. The planned consolidation efforts will take place against a backdrop of negative yet improving cyclical conditions as measured by the output gap.

Table 5: Output gaps, cyclically-adjusted and structural balances

	2004		2005		2006		2007		2008	2009	Change: 2009-2005
	COM	SP[1]	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]	SP[1]
Gen. gov't balance	-3.0	-3.0	-6.0	-6.0	-5.0	-4.6	-4.8	-3.7	-2.6	-1.5	4.5
One-offs[2]	2.2	2.2	0.4	0.0	0.4	0.0	0.1	0.0	0.0	0.0	0.0
Output gap[3]	-1.3	-1.5	-2.0	-2.2	-2.4	-2.6	-2.6	-2.5	-1.8	-0.7	1.5
CAB[4]	-2.4	-2.3	-5.1	-5.0	-3.8	-3.4	-3.6	-2.6	-1.8	-1.2	3.8
change in CAB	0.1	n.a.	-2.7	-2.7	1.3	1.6	0.2	0.8	0.8	0.6	3.3
CAPB[4]	0.3	0.4	-2.2	-2.2	-0.8	-0.5	-0.4	0.5	1.3	1.9	4.1
Structural balance[5]	-4.6	-4.5	-5.5	-5.0	-4.2	-3.4	-3.7	-2.6	-1.8	-1.2	4.3
change in struct. bal.	0.1	n.a.	-0.9	-0.5	1.3	1.6	0.5	0.8	0.8	0.6	-
Struct. prim. bal.[6]	-1.9	-1.8	-2.6	-2.2	-1.2	-0.5	-0.5	0.5	1.3	1.9	4.5

Notes:
[1]Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme
[2]One-off and other temporary measures. Source of one-offs in 2004: Commission services' calculations
[3]In percent of potential GDP
[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.
[5]CAB excluding one-off and other temporary measures
[6]Structural primary balance = CAPB excluding one-off and other temporary measures

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

4.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

4.3.1. Appropriateness of the programme's medium-term objective

As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

4.3.2. Risks attached to the budgetary targets

The assessment of the stability programme highlights several risks that overall the budgetary outcomes could be worse than projected in the programme.

The programme assumptions about the economy's tax elasticity relative to GDP seem appropriate as the hikes on various tax rates and improved tax collection should in the early years of the programme support a temporary deviation from the historical elasticity relative to GDP estimated by the OECD (see Table 6; see also Box 4 for the projected impact of policy changes). Thus, the assumed increases in the tax intensity of economic activity seem attainable in 2006 and 2007. The assumption of a tax elasticity approaching the historical value towards the end of the programme period is plausible and sound.

Nevertheless, the gains of improved tax collection may start decreasing sooner than expected, or at least become more costly, also because the increases in tax rates heighten the risk of evasion, and consequently triggering an earlier-than-projected convergence of tax elasticity towards its historical average.[11]

Table 6: Assessment of tax projections

	2006		2007		2008	2009	p.m.:
	COM	SP	COM[2]	SP	SP	SP	OECD[1]
Total taxes							
Change in tax-to-GDP ratio	1.0	0.7	0.4	0.3	0.3	0.0	/
Difference	-0.3		-0.1		/	/	/
of which[3]: - elasticity component	-0.1		0.3		/	/	/
- composition component	-0.2		-0.4		/	/	/
p.m.: Observed elasticity to GDP	1.9	1.6	1.3	1.2	1.2	1.0	1.08

Notes:
[1]OECD ex-ante elasticity relative to GDP
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

A negative risk comes from favourable growth assumptions, especially in the outer years of the programme, as highlighted in section 2. In other words, economic growth in the medium term may turn out to be weaker than assumed in the programme.

The update outlines an ambitious medium-term plan to curb expenditure growth but uncertainty remains on implementation. While several measures have been recently enacted, like changes to pension schemes for government employees, as stated in the programme, important elements to support the planned fiscal consolidation have still to be defined and implemented. This is particularly important for changes in public administration which are expected to yield substantial savings from 2007 onwards (e.g., savings of some ¾% of GDP in 2008 compared with 2006). Therefore, any delay in implementation will imply smaller expenditure savings.

Finally, while the programme outlines measures that should improve the framework of budgetary execution control and thus helping compliance with budgetary targets, it remains to be seen whether their implementation will be sufficient to impose strict fiscal discipline across general government (Section 5 below provides further details).

To sum up, in the light of this risk assessment, the achievement of the fiscal targets hinges upon the effective implementation of significant further measures, especially for 2007 and beyond. Such conclusion is implicit in the Commission services' autumn 2005 forecast, which on a no-policy change assumption foresees for 2007 a government deficit significantly larger that the programme target. Especially for the outer years, actions going beyond those envisaged in the programme seem necessary to achieve the announced targets.

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11 A more detailed assessment by major tax category is provided in Annex 4.

4.3.3. *Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact*

The most recent update of the stability programme conforms to the deficit reduction path specified by the Council on its recommendation under Article 104(7) of 20 September. In particular, it targets a government deficit of 2.6% of GDP in 2008 and outlines the structural deficit reduction path recommended by the Council.

Taking the programme's budgetary targets at face value, and assuming (i) a full implementation of the measures announced therein for 2006 and (ii) that further significant measures in 2007 and beyond are adopted, also to take into account the possible lower-than-expected economic growth, Portugal seems on track to correct its excessive deficit by the 2008 deadline set by the Council.

In the year following the planned correction of the excessive deficit, a further structural adjustment of 0.6% of GDP is planned. Provided the risks to the budgetary targets highlighted above are duly addressed, this would be fully in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark. However, the budgetary strategy outlined is not sufficient to ensure that the programme's MTO is achieved within the programme period. Moreover, it does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations in 2009.

Overall, the strategy for the general government balance outlined in the programme is broadly consistent with the broad economic policy guidelines in the area of public finances. In particular, it aims at a correction of excessive deficits as further specified in the Council recommendation under Article 104(7) of 20 September 2005. In addition the outlined fiscal policy is expected to contribute to the external deficit correction: if plans fully materialize, the government deficit reduction will give a contribution of 4½% of GDP to the curb of the external deficit.

4.4. Sensitivity analysis

The programme includes a sensitivity analysis of the main macroeconomic and budgetary variables[12] with respect to changes in oil prices and interest rates assumptions. The first variant assumes that oil prices are higher (lower) by 20% and that concomitantly the growth of external demand is lower (higher) than in the update baseline macroeconomic scenario. The second variant takes into account the possibility of different interest rates profiles, either higher by 1 full percentage point compared to the programme scenario or remaining at their current levels of 2.4 and 3.5%, respectively for short- and long-term. The analysis is not explicit about the underlying assumptions about how revenues and expenditure are projected to react to variations in economic variables.

[12] GDP real growth rate, Private consumption deflator, unemployment rate, external balance, government deficit and debt.

Compared to the baseline scenario, the oil prices hike would decrease GDP growth by 0.1 percentage point per year and result in a government deficit higher by 0.1 percentage point (i.e., -2.7% of GDP in 2008). The government debt ratio would increase by 0.5 percentage point by 2009. Lower oil prices would have symmetric effects. The effects of different interest rates could be more significant. The rate hike would hurt GDP growth by 0.5 percentage point in 2006 and 0.2 percentage point thereafter. The effects on the government balance and debt would be more severe: the deficit would deteriorate by at least 0.4 percentage point every year and decline to only 3.2% of GDP in 2008 and 2.3% of GDP in 2009; the debt ratio would deviate by an additional 0.7 percentage point every year, with a cumulative effect of 2.8 percentage points by 2009. A stabilization of interest rates at their current levels would help growth and faster deficit reduction by small margins, with the government deficit not falling below 3% of GDP before 2008.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2009 period; (ii) trend output based on the HP-filter[13] and (iii) no policy response (notably, the expenditure level is as in the central scenario[14]), reveal that, by 2009, the cyclically-adjusted balance is more than ½ percentage point of GDP above/below the central scenario. Hence, in the case of persistently lower real growth, additional measures of more than ½ percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.[15] Therefore, taking into account the conclusions reached in Section 2 above, namely that the risks to the macroeconomic scenario of the programme are mainly to the downside, the achievement of the budgetary targets in the programme would require a significantly greater fiscal effort than envisaged in the programme.

5. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

5.1. Debt developments in the programme

The government gross debt-to-GDP ratio has been on an upward trend since 2000 driven by a very low primary surplus and even a primary deficit in some years, the persistence of a sizeable positive stock-flow adjustment, as well as by the low nominal GDP growth. According to the December 2005 update, the government debt ratio is estimated to have reached 65.5% of GDP in 2005, above both the 60% of GDP reference value and its 2004 level of 59.4% of GDP, as the result of the very high government deficit and a sizeable stock-flow adjustment. The projection in update for the 2005 debt ratio is very close to the Commission services' autumn 2005 forecast. The projection is lower than in the June

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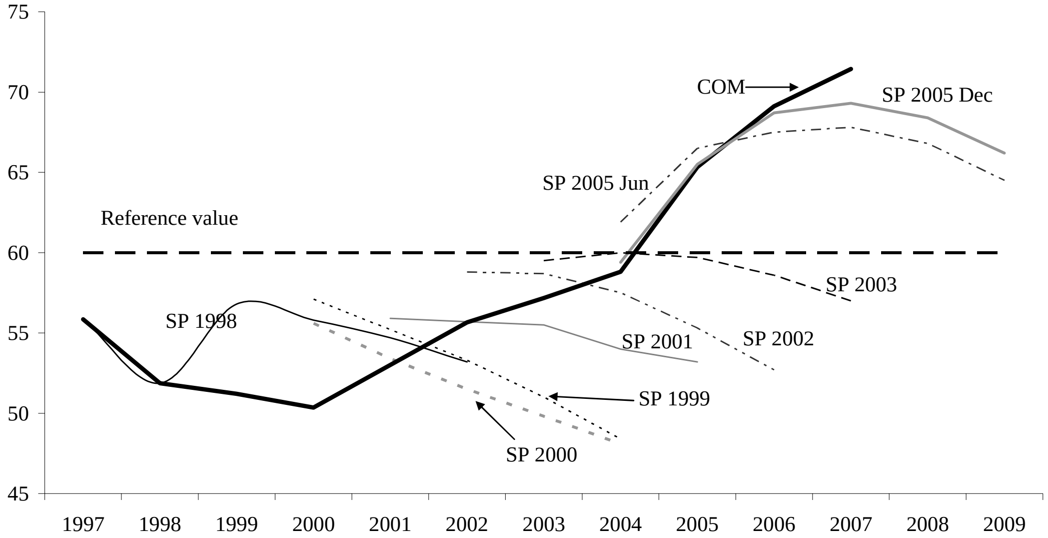
13 In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

14 The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

15 Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

2005 update by 1 full percentage point, but only because of a denominator effect coming from the revision of the GDP level by almost 5% in September 2005.

Figure 2: Debt projections in successive stability programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive stability programmes

The programme, projects the government debt ratio to further increase in 2006 and 2007 (see Figure 2). By the end of 2007, it is projected to peak at 69.3% of GDP, with a gradual reduction starting thereafter, triggered by the return to primary surpluses, the acceleration in GDP, and also by the end of debt-increasing stock-flow adjustments. Regarding the composition of the latter, privatisation proceeds are assumed in every year, more strongly in 2006 at 1.1% of GDP, and will be crucial to compensate an otherwise debt-increasing net acquisition of financial assets. The implicit difference between the cash- and accrual-based deficit – derived from the programme information assuming that the valuation and residual effects are zero – is projected to decline from 1.3% of GDP in 2005 to 1.1% in 2006 and 0.2% of GDP from 2007 onwards (see Table 7).

Table 7: Debt dynamics

	average 2000-2004	2005		2006		2007		2008	2009
	COM	COM	SP	COM	SP	COM	SP	SP	SP
Government gross debt ratio	**55.6**	**65.9**	**65.5**	**69.8**	**68.7**	**72.1**	**69.3**	**68.4**	**66.2**
Change in debt ratio (1 = 2+3+4)	1.4	6.6	6.1	3.8	3.2	2.3	0.6	-0.9	-2.2
Contributions:									
- **Primary deficit** (2)	**0.2**	**3.1**	**3.2**	**2.0**	**1.7**	**1.6**	**0.6**	**-0.5**	**-1.6**
- **"Snow-ball" effect** (3)	**0.6**	**1.4**	**1.0**	**1.1**	**0.8**	**0.7**	**0.0**	**-0.3**	**-0.6**
- Interest expenditure	2.9	2.8	2.8	3.0	2.9	3.2	3.1	3.1	3.1
- Real GDP growth	-0.6	-0.2	-0.3	-0.5	-0.7	-0.8	-1.2	-1.6	-1.9
- Inflation (GDP deflator)	-1.7	-1.2	-1.5	-1.4	-1.4	-1.7	-1.9	-1.8	-1.8
- **Stock-flow adjustment** (4)	**0.7**	**2.0**	**1.9**	**0.8**	**0.6**	**0.0**	**-0.1**	**0.0**	**0.0**
- Cash/accruals	0.5								
- Accumulation of financial assets	0.0								
of which: Privatisation proceeds	-0.5		-0.5		-1.1		-0.5	-0.4	-0.3
- Valuation effects & residual adj.	0.1								

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 2005 economic forecasts (COM); Commission services' calculations

5.2. Assessment

Overall, the debt outcomes could be worse than targeted. As compared with the Commission services' autumn 2005 economic forecast, the programme projections for the government debt ratio are more optimistic. By 2007, the difference comes close to some 3 percentage points largely due to higher primary deficits, which are on a no-policy change basis for 2007, and lower economic growth. Achieving the programme targets for the debt ratio crucially depends on achieving the ambitious deficit reduction targets and a stock-flow adjustment of zero. Additionally, in line with the risks to the macroeconomic scenario pointed in section 2, sluggish GDP growth will continue to hurt the debt ratio through a "denominator effect", likely more severely than foreseen in the update. As reported in subsection 3.4, according to the update, the debt ratio would show considerable sensitivity to a hike in the interest rate of 1 percentage point in excess of the upward cycle already assumed in the update scenario: with second-round effects on growth and deficit, by 2009, the debt ratio would be 2.8 percentage points higher than targeted.

The government debt ratio is not diminishing before 2007/2008. The envisaged reductions for 2008 and 2009 towards the reference value (1 and 2 percentage points of GDP, respectively) crucially depend on achieving the targeted lower deficits and stock-flow adjustments – the latter will go down to zero only because of privatisations proceeds – as well as on the higher GDP growth. The debt reduction strategy in the update is consistent with the Council recommendation under Article 104(7) of 20

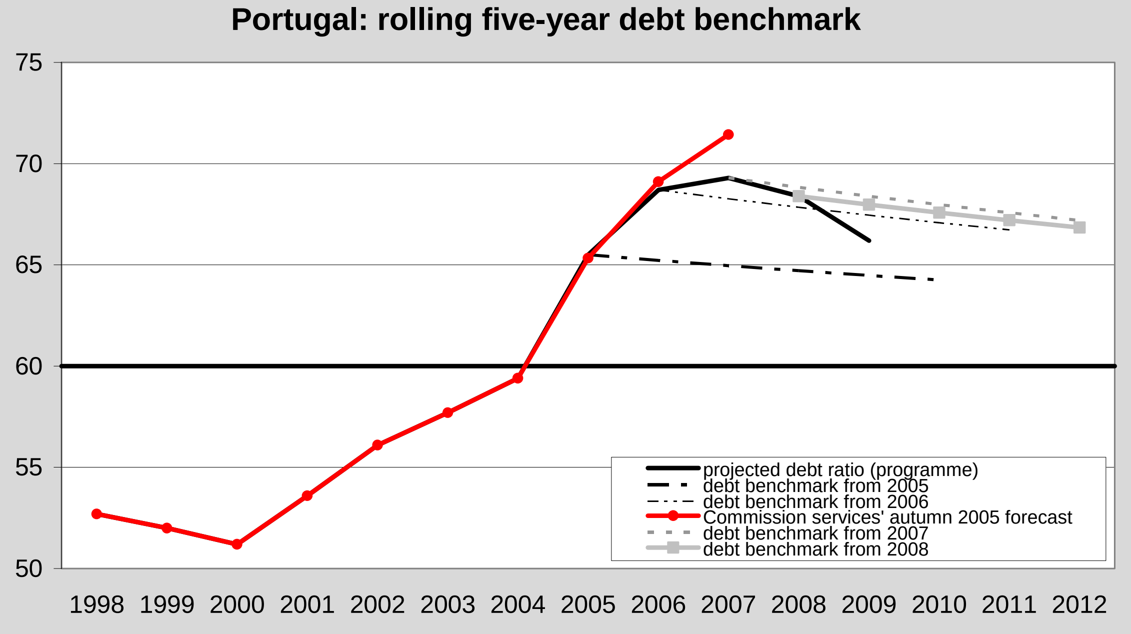
September 2005 in the sense that debt developments reflect progress in reducing the deficit and a fall of debt-increasing financial operations. Yet by 2009 the debt ratio will be above its 2005 level, which is also inconsistent with the broad economic policy guideline in the area of public finances in particular with the call for a government debt reduction to strengthen public finances.

Box 5: The rolling debt reduction benchmark

In 2005, the debt ratio is expected to have exceeded the 60% of GDP reference value.

A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the accompanying graph. It shows historical data, the Commission services' autumn 2005 forecasts until 2007 (which are on a no-policy change scenario) and the multi-annual debt projections in the update and compares them with the paths obtained by applying an illustrative "rolling debt reduction benchmark" (see Annex 5). The benchmark reflects the idea that a minimum debt reduction should be ensured not year after year but over a medium-term horizon (five years in the graph). For instance, the debt projection for 2010 is compared with the value obtained for the same year by applying the formula starting in 2005. Debt level projections in the programme exceeding those obtained by applying the benchmark are taken as an indicator of a slow reduction in the debt ratio.

In the current case of Portugal, the rule is of limited use before 2008, since the debt ratio is expected to remain on an upward trend until 2007. In 2008 and 2009, though declining, the debt ratio will still be above the ratio of 2005. The graph shows that the government debt ratio could only be considered as declining at an acceptable pace after the end of the programme period.



Source: Stability programme and Commission services

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The update announces the intention of enacting a reform of public administration, which builds on three key elements. First, an overhaul of central administration with the objectives of decreasing expenditure and raise efficiency. A thorough assessment of the duties, resources and procedures of the various ministries has been launched in the second half of 2005. Regarding duties, the reform includes the option of elimination or transfer to other levels of general government or private entities. A second pillar is the reorganization of the education, health, justice and local government networks, in order to improve the use of resources, as largely outlined in the June 2005 update. In particular, in the area of health care, it includes the transformation of hospitals from government units into government-owned corporations, with an augmented degree of entrepreneurial autonomy. The third pillar of the reform builds on human resources management, namely, new staff regulations and career scales in the civil service to be ready until end-2006, in time to be implemented in 2007. In addition, a link between the inflow into and the outflow from the civil service has now been established: on average, for every two workers that leave the payroll, just one new will be hired.

The update foresees a number of measures aiming at an improvement of the budgetary execution framework. A first measure is the installation of a financial controller in every Ministry, who will survey budgetary execution with a view to preventing deviations from the targets. Each controller will be dependent from the respective Minister and the Finance Minister, and the different controllers shall act in a coordinated way under the latter's guidance. Their installation is foreseen for early 2006. In addition, the update mentions the ongoing revisions of the regional and local governments financing laws with a view to have consolidation efforts shared also by these sub-sectors of general government. Meanwhile, the transfers to the latter were kept at their 2005 level by the 2006 budget and current year's personnel expenditure of local governments has to remain constant. Finally, the update announces the intention of enacting measures to improve the reporting of financial and human resources information by the various bodies of general government but no expected date of implementation is provided.

Both the foreseen public administration reform and the package of measures for the budgetary execution framework can support fiscal consolidation and improve the quality of public spending. However, various important elements still need to be fully defined and/or implemented, in particular those concerning public administration, and, according to the update will not take effect before 2007. Therefore, it is too early to assess their possible impact on the quality of public finances.

Finally, the programme reveals some intentions regarding the functioning of the tax system. They aim, first, at a broadening of the tax base by limiting fiscal exemptions, many of which have already been dealt with and, second, at a simplification of the tax system and consequently an expected easing compliance with tax codes, on the back of measures expected to be in place in 2007. Other measures focus on fighting tax evasion and thus on improving the efficiency of tax revenue collection.

The measures described above are consistent with the broad economic policy guidelines in the area of public finances, in particular with the call for assessing the relationship between public spending and the achievement of policy objectives. Those measures are also consistent with the National Reform Programme (NRP), submitted on 21 October

2005 in the context of the renewed Lisbon strategy for growth and jobs, which established as key policy areas the sustainability of public finances and public administration reform. In fact, the NRP took on board the substance of June 2005 update, which has now been largely confirmed in the most recent update. The December 2005 update does not address the budgetary implications of the actions envisaged in the NRP, which have not been always quantified in the NRP itself.

The Council on its recommendation under Article 104(7) of 20 September 2005, recommended to Portugal to implement reforms to contain and reduce expenditure and to improve the collection and processing of general government data. Overall, and conditional on their full implementation, the measures described above seem to be consistent with the Council recommendations.

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 debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The 'programme' scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The '2005' scenario assumes that the structural primary balance[16] remains unchanged at the 2005 level throughout the programme period.

The long-term projections in the programme have been made using the agreed assumptions in the current Economic Policy Committee (EPC) projections (see Table A1 in the Annex 6). On the basis of this information, age-related expenditure is foreseen to increase by 10.4% of GDP between 2009 and 2050, to which pension expenditures contribute the most by 8.6% of GDP (see Table A2 in the Annex 6). The Commission's analysis is based on the set of government expenditure items covered by the common projections carried out by the EPC[17] (see Table A2 in the Annex 6).

The gross debt-to-GDP ratio is currently above the reference value of 60% of GDP, at 65.5% of GDP. According to the '2005' scenario, debt-to-GDP ratio is expected to increase throughout the projection period, and be in ten years on an explosive path[18]. In the 'programme' scenario the debt-to-GDP ratio, the overall increase in debt ratio is more moderate as it projected to fall below the 60% of GDP reference value in around 10 years from now and increase thereafter (see Table A4 in the Annex 6).

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16 The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out.

17 Namely, government expenditure on pension, health-care, long-term care, education and unemployment benefits. Other expenditure items and revenues are assumed to remain constant as a share of GDP over the projection period. Thus, other age-related expenditures reported in the update, apart from the unemployment benefits, information on which was provided subsequently by the Portuguese Ministry of Finance, were considered to remain constant over the projection period.

18 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 should not be seen as a forecast.

As a consequence, a significant sustainability gap (S1) that ensures a debt level at 60% of GDP in 2050 emerges in the '2005' scenario. In the 'programme' scenario, the projected future impact of increasing age-related expenditures due to ageing populations up to 2050 is partly offset by the positive initial budgetary position, which underlines the importance of sticking to the consolidation path presented in the programme update. However, S1 only takes into account changes in the primary balance up to 2050, which underestimates the cost of ageing.

According to the government's inter-temporal budget constraint, captured by the S2 indicator, a sustainability gap of about 11½ % of GDP emerges in the '2005' scenario as a result of the weak initial budgetary position, relatively high current debt coupled with the future increases in pension expenditures. In the 'programme' scenario, the sustainability gap is lower, but still significant, indicating the necessity of a comprehensive strategy in dealing with the challenge posed by ageing populations that goes beyond improving the currently weak budgetary position. This sustainability gap translates into a required primary balance (RPB) of almost 8 ¾ % of GDP, significantly higher than the adjusted structural primary balance of 1.9% of GDP in the last year of the programme period.

Moreover, the sustainability gap, as measured by the S2 indicator, would increase by around ½% GDP if the (budgetary or structural) adjustment was to be postponed by 5 years (see table A3 in the Annex 6).

Table 8: Sustainability indicators and the required primary balance

	Sustainability indicators and RPB						
	2005 Scenario				Programme scenario		
	S1	S2		RPB	S1	S2		RPB
Value (of which)	**7.6**	**11.4**		**8.7**	**3.3**	**7.2**		**8.6**
initial budgetary position	*2.8*	*2.8*			*-1.4*	*-1.3*		
debt requirement in 2050	*0.2*	*:*			*0.1*	*:*		
future changes in budgetary position	*4.6*	*8.6*			*4.6*	*8.6*		

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio[19]. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See European Commission (2005), European Economy, 'Public finances in EMU – 2005, Section II.3 for a further description.

19 The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

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

The levels of the current deficit- and debt-GDP ratios above their respective reference values require a cautious assessment of the sustainability of Portuguese public finances. In this context, as well as in the light of the budgetary burden represented by ageing, it is necessary to achieve high primary balance for a prolonged period of time.

The assumptions underlying the long-term projections are those commonly agreed and used by the EPC in the current common projections exercise. In addition, the programme update includes "national base scenario" with national macroeconomic assumptions, where the real growth of GDP and labour productivity growth for the period 2020-2050 are more optimistic than those agreed by the EPC. The projection on the basis of the "national base scenario" includes a projected lower increase in the pension expenditures and a slight fall in other age-related expenditures largely due to more optimistic macroeconomic assumptions for the second half of the projection period[20]. The impact on the S2 indicator of incorporating these combined national projections would reduce it by 4 percentage points of GDP[21]. On the assumption that these additional national projections will materialise, they would imply lower sustainability risks.

The programme acknowledges that deep reforms to social protection schemes are necessary in order to tackle the projected budgetary burden of ageing. In 2005, significant changes to civil servants' pension schemes were implemented, following the announcements in the June 2005 update of the stability programme. The gist of those changes was to promote convergence towards the general or private-sector old-age pension scheme[22]. In addition, the rules for some government pension sub-schemes were also tightened.

As regarding general or private-sector old-age pensions, the most relevant policy measures enacted in 2005 concerned curbs on early retirement, with the aim of pulling the effective retirement age closer to the statutory age of 65 years.

In the area of health care, in 2005, some subsystems of health care for specific areas of the government were integrated into the broader civil servants health care system, and in addition payments for medicines were set at lower levels. Looking forward, the programme reveals the intentions to implement additional measures in 2006, namely: i) gradual incorporation of various government-run hospitals; ii) territorial re-organization of the National Health System shutting down some intermediate services; iii) re-organization of the national first-aid network.

[20] The "national base scenario" projects increase in pension expenditures of 3.6% of GDP over the period 2010-2050 against 8.6% under the EPC base scenario. According to the additional information from the Portuguese Ministry of Finance, "the national base scenario" also includes a fall in other age-related expenditure (child care, professional training programmes and other expenditures) of 0.2 % of GDP over the same period against 0.3% of GDP, under the EPC base scenario. It is worth noting, that the two projections presented in the update do not include policy changes, while the one based on the "national base scenario" incorporates some parametric alterations and new values relative to civil servants' pensions that have been updated with the new forecasts for Caixa Geral de Aposentações.

[21] The impact of these additional national long-term projections over the period 2010-2050 was calculated.

[22] Those joining the civil service after September 1993 were already covered by the general social security rules.

To sum up, with regard to the sustainability of public finances, Portugal appears to be at high risk on grounds of the projected budgetary costs of ageing populations. The currently high level of gross debt and the weak budgetary position indicate the necessity for implementing rigorously the planned consolidation of public finances over the medium-term and to further strengthen the budgetary position in order to reduce risks to public finance sustainability. However, the projected increases in old-age pension and health care expenditures over the projection period clearly indicate the necessity of a comprehensive strategy in dealing with the challenge posed by ageing populations that goes beyond improving the currently weak budgetary position. The ongoing introduction of changes to the pension and health-care systems should go some way in making these systems more sustainable. However, further reforms are required to curb the projected growth of age-related expenditures.

Annex 1: Summary tables from the stability programme update

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	137436.4	1.2	0.5	1.1	1.8	2.4	3.0
2. Nominal GDP	B1*g	141114.5	3.9	3.1	3.3	4.7	5.1	5.8
Components of real GDP								
3. Private consumption expenditure	P.3	88291.1	2.5	2.3	1.3	1.5	2.2	2.5
4. Government consumption expenditure	P.3	28202.3	2.4	0.8	-1.3	-0.8	-0.9	-1.0
5. Gross fixed capital formation	P.51	30523.1	0.6	-2.1	1.7	3.6	5.7	7.8
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	1038.8	1.0	1.0	0.9	0.9	0.9	0.9
7. Exports of goods and services	P.6	40207.1	4.6	1.2	5.7	6.1	6.5	7.2
8. Imports of goods and services	P.7	50826.0	6.7	2.1	4.2	4.3	5.6	6.4
Contributions to real GDP growth								
9. Final domestic demand		-	2.2	1.1	1.0	1.6	2.5	3.2
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.1	-0.1	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	-1.1	-0.5	0.1	0.2	-0.1	-0.2

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator			2.7	2.6	2.3	2.8	2.7	2.8
2. Private consumption deflator			2.4	2.3	2.3	2.2	2.2	2.1
3. HICP[23]								
4. Public consumption deflator								
5. Investment deflator								
6. Export price deflator (goods and services)			1.2	2.2	2.4	1.8	2.0	2.0
7. Import price deflator (goods and services)			2.0	2.7	2.7	1.2	1.3	1.3

23 Optional for Stability programmes.

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[24]		5103.0	0.1	0.1	0.6	0.9	1.2	1.5
2. Employment, hours worked[25]		4972.7	0.1	0.1	0.6	0.9	1.2	1.5
3. Unemployment rate (%)[26]		-	6.7	7.4	7.7	7.7	7.4	7.0
4. Labour productivity, persons [27]		27.7	1.1	0.4	0.5	0.9	1.2	1.5
5. Labour productivity, hours worked[28]		28.4	1.1	0.4	0.5	0.9	1.2	1.5
6. Compensation of employees	D.1	72572.0	3.0	3.7	3.2	3.2	3.6	4.0

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-5.9	-6.8	-6.7	-6.8	-6.8	-6.6
of which:							
- Balance on goods and services		-7.9	-8.4	-8.4	-7.7	-7.3	-7.0
- Balance of primary incomes and transfers		0.0	-0.3	-0.4	-0.7	-0.8	-0.8
- Capital account		2.0	2.0	2.1	1.6	1.4	1.2
2. Net lending/borrowing of the private sector	B.9/	-2.9	-0.8	-2.1	-3.1	-4.2	-5.0
3. Net lending/borrowing of general government	B.9	-3.0	-6.0	-4.6	-3.7	-2.6	-1.5
4. Statistical discrepancy		-	-	-	-	-	-

[24] Occupied population, domestic concept national accounts definition.

[25] National accounts definition.

[26] Harmonised definition, Eurostat; levels.

[27] Real GDP per person employed.

[28] Real GDP per hour worked.

Table 2. General government budgetary prospects

	ESA code	2004	2004	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	-4229.0	-3.0	-6.0	-4.6	-3.7	-2.6	-1.5
2. Central government	S.1311	-7716.0	-5.5	-5.8	-4.7	-3.9	-2.8	-1.7
3. State government	S.1312	-	-	-	-	-	-	-
4. Local government	S.1313	141.0	0.1	-0.1	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	3346.0	2.4	-0.1	0.1	0.2	0.2	0.2
General government (S13)								
6. Total revenue	TR	61365.0	43.5	41.4	42.3	42.4	42.5	42.4
7. Total expenditure	TE[29]	65594.0	46.5	47.4	47.0	46.1	45.1	43.9
8. Net lending/borrowing	EDP B.9	-4229.0	-3.0	-6.0	-4.6	-3.7	-2.6	-1.5
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	3832.0	2.7	2.8	2.9	3.1	3.1	3.1
pm: 9a. FISIM		-	-	-	-	-	-	-
10. Primary balance	[30]	-397.0	-0.3	-3.2	-1.7	-0.6	0.6	1.5
Selected components of revenue								
11. Total taxes (11=11a+11b+11c)		32764.0	23.2	23.9	24.7	25.1	25.5	25.6
11a. Taxes on production and imports	D.2	20345.0	14.4	15.2	15.8	16.1	16.4	16.5
11b. Current taxes on income, wealth, etc	D.5	12395.0	8.8	8.7	8.9	9.0	9.1	9.1
11c. Capital taxes	D.91	25.0	0.0	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	17576.0	12.5	12.3	12.2	12.1	12.0	11.9
13. Property income	D.4	1099.0	0.8	0.4	0.6	0.5	0.5	0.4
14. Other (14=15-(11+12+13))		9926.0	7.0	4.8	4.9	4.6	4.5	4.5
15=6. Total revenue	TR	61365.0	43.5	41.4	42.3	42.4	42.5	42.4
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[31]		48888.8	34.6	35.2	36.1	36.4	36.7	36.7
Selected components of expenditure								
16. Collective consumption	P.32	10961.0	7.8	7.8	7.5	7.3	7.1	6.8
17. Total social transfers	D.62	38644	27.4	28.1	28.0	27.6	27.1	26.4
17a. Social transfers in kind	P.31	18517	13.1	13.3	13.0	12.8	12.4	12.0
17b. Social transfers other than in kind	D.62	20127.0	14.3	14.8	15.0	14.9	14.7	14.4
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	3832.0	2.7	2.8	2.9	3.1	3.1	3.1
19. Subsidies	D.3	2161.0	1.5	1.6	1.5	1.3	1.2	1.2
20. Gross fixed capital formation	P.51	4397.0	3.1	3.2	2.9	2.9	2.8	2.9
21. Other (21=22-(16+17+18+19+20))		5598	4.0	3.8	4.1	3.8	3.7	3.6
22=7. Total expenditure	TE[32]	65594.0	46.5	47.4	47.0	46.1	45.1	43.9
Pm: compensation of employees	D.1							

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

30 The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

31 Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

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

Table 3. General government expenditure by function

% of GDP	COFOG Code	2003	2009
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure	TE[33]		

Table 4. General government debt developments

% of GDP		2004	2005	2006	2007	2008	2009
1. Gross debt[34]		59.4	65.5	68.7	69.3	68.4	66.2
2. Change in gross debt ratio		1.7	6.2	3.2	0.5	-0.8	-2.2
Contributions to changes in gross debt							
3. Primary balance[35]		-0.3	-3.2	-1.7	-0.6	0.6	1.5
4. Interest expenditure (incl. FISIM) [36]		2.7	2.8	2.9	3.1	3.1	3.1
5. Stock-flow adjustment		0.8	1.9	0.6	-0.1	0.0	0.0
of which: - Differences between cash and accruals[37]							
- Net accumulation of financial assets[38]		-0.1	0.6	-0.5	-0.3	-0.2	-0.2
of which: *privatisation proceeds*		0.5	0.5	1.1	0.5	0.4	0.3
- Valuation effects and other[39]							
p.m. implicit interest rate on debt[40]		4.9	4.9	4.6	4.8	4.7	4.7
Other relevant variables							
6. Liquid financial assets[41]							
7. Net financial debt (7=1-6)							

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

34 As defined in Regulation 3605/93 (not an ESA concept).

35 Cf. item 10 in Table 2.

36 Cf. item 9 in Table 2.

37 The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

38 Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

39 Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

40 Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

41 AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Real GDP growth (%)		1.2	0.5	1.1	1.8	2.4	3.0
2. Net lending of general government	EDP B.9	-3.0	-6.0	-4.6	-3.7	-2.6	-1.5
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41+FISIM	2.7	2.8	2.9	3.1	3.1	3.1
4. Potential GDP growth (%) (1)							
contributions:							
5. Output gap		-1.8	-2.6	-2.9	-2.5	-1.7	-0.4
6. Cyclical budgetary component		-0.8	-1.2	-1.3	-1.1	-0.8	-0.2
7. Cyclically-adjusted balance (2-6)		-2.2	-4.8	-3.3	-2.5	-1.8	-1.4
8. Cyclically-adjusted primary balance (7-3)		0.5	-2.0	-0.4	0.6	1.3	1.7

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

Table 6. Divergence from previous update

	ESA Code	2004	2005	2006	2007	2008	2009
Real GDP growth (%) **Previous update**		1.0	0.8	1.4	2.2	2.6	3.0
Current update		1.2	0.5	1.1	1.8	2.4	3.0
Difference		0.2	-0.2	-0.3	-0.4	-0.2	0.0
General government net lending (% of GDP) **Previous update**	EDP B.9	-5.2	-6.2	-4.8	-3.9	-2.8	-1.6
Current update		-3.0	-6.0	-4.6	-3.7	-2.6	-1.5
Difference		2.2	0.2	0.2	0.2	0.2	0.1
General government gross debt (% of GDP) **Previous update**		61.9	66.5	67.5	67.8	66.8	64.5
Current update		59.4	65.5	68.7	69.3	68.4	66.2
Difference		-2.5	-1.0	1.2	1.5	1.7	1.7

Table 7a. Long-term sustainability of public finances – EPC scenario

% of GDP	**2000**	**2005**	**2010**	**2020**	**2030**	**2050**
Total expenditure	43.7	47.4	43.8	46.0	48.8	62.2
Of which: age-related expenditures	24.2	27.3	27.2	29.6	31.4	37.2
Pension expenditure	9.7	11.3	11.4	13.6	15.4	20.0
Social security pension	6.1	7.5	8.0	9.4	11.2	16.2
Old-age and early pensions	4.0	5.4	5.9	7.2	8.8	13.1
Other pensions (disability, survivors)	2.1	2.1	2.1	2.2	2.4	3.1
Occupational pensions (if in general government)	3.6	3.8	3.4	4.2	4.2	3.8
Health care	5.3	5.8	5.8	6.1	6.2	6.9
Long-term care *(this was earlier included in the health care)*	0.3	0.5	0.5	0.6	0.7	1.1
Education expenditure	5.1	4.7	4.7	4.7	4.6	4.8
Other age-related expenditures	3.8	5.0	4.7	4.7	4.5	4.4
Interest expenditure	3.1	2.8	3.0	2.8	3.8	11.3
Total revenue	40.8	41.4	42.4	42.4	42.4	42.4
Of which: property income	0.0	0.0	0.0	0.0	0.0	0.0
of which: from pensions contributions (or social contributions if appropriate)	10.5	10.4	10.3	9.6	9.3	9.2
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)	0.7	2.1	2.0	1.9	2.0	2.6
Net lending						
Assumptions						

Labour productivity growth	1.1	0.4	2.1	2.5	1.7	1.7
Real GDP growth	3.4	0.5	2.4	2.2	1.0	1.0
Participation rate males (aged 20-64)	85.2	85.5	86.5	86.8	85.9	86.3
Participation rates females (aged 20-64)	68.4	72.4	75.1	77.7	78.2	79.1
Total participation rates (aged 20-64)	76.6	78.8	80.7	82.3	82.1	82.7
Unemployment rate	4.1	7.4	5.4	5.3	5.3	5.2
Population aged 65+ over total population	16.4	17.0	17.7	20.3	24.3	31.9

Table 7b. Long-term sustainability of public finances – National scenario

% of GDP	**2000**	**2005**	**2010**	**2020**	**2030**	**2050**
Total expenditure	43.7	47.4	43.3	45.3	47.3	51.4
Of which: age-related expenditures	24.2	27.3	27.3	29.7	31.0	32.3
Pension expenditure	9.7	11.3	11.4	13.7	14.9	15.0
Social security pension	6.1	7.5	7.9	9.3	10.6	11.9
Old-age and early pensions	4.0	5.4	5.9	7.2	8.4	9.6
Other pensions (disability, survivors)	2.1	2.1	2.0	2.1	2.2	2.4
Occupational pensions (if in general government)	3.6	3.8	3.5	4.4	4.3	3.1
Health care	5.3	5.8	5.8	6.1	6.2	6.9
Long-term care *(this was earlier included in the health care)*	0.3	0.5	0.5	0.6	0.7	1.1
Education expenditure	5.1	4.7	4.7	4.7	4.6	4.8
Other age-related expenditures	3.8	5.0	4.9	4.7	4.6	4.5
Interest expenditure	3.1	2.8	3.0	2.6	3.3	6.1
Total revenue	40.8	41.4	42.4	42.4	42.4	42.4
Of which: property income	0.0	0.0	0.0	0.0	0.0	0.0
of which: from pensions contributions (or social contributions if appropriate)	10.5	10.4	10.2	9.4	8.9	8.7
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)	0.7	2.1	2.0	2.0	2.0	2.1
Net lending						
Assumptions						
Labour productivity growth	1.1	0.4	1.5	2.0	2.2	2.5
Real GDP growth	3.4	0.5	2.8	2.0	2.0	2.0
Participation rate males (aged 20-64)	85.2	84.6	85.9	85.7	85.1	84.9
Participation rates females (aged 20-64)	68.4	71.6	74.6	77.0	77.5	77.8
Total participation rates (aged 20-64)	76.6	78.0	80.2	81.2	81.4	81.3
Unemployment rate	4.1	7.4	5.4	5.3	5.3	5.2
Population aged 65+ over total population	16.4	17.0	17.7	20.3	24.3	31.9

Table 8. Basic assumptions

	2004	2005	2006	2007	2008	2009
Short-term interest rate[42]	2.1	2.1	2.5	3.0	3.0	3.0
Long-term interest rate	4.1	3.3	3.6	3.9	3.8	3.8
USD/€ exchange rate	1.2	1.3	1.2	1.2	1.2	1.2
Nominal effective exchange rate	0.6	-0.2	-0.4	0.0	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)						
World excluding EU, GDP growth	5.9	5.1	4.9	4.6	4.4	4.5
EU GDP growth	2.4	1.5	2.1	2.4	2.3	2.3
Growth of relevant foreign markets	8.5	5.6	6.1	5.9	6.0	6.0
World import volumes, excluding EU	13.9	8.6	8.7	8.4	8.0	8.0
Oil prices, (Brent, USD/barrel)	38.2	55.0	61.4	60.3	60.3	60.3

42 If necessary, purely technical assumptions.

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the "format" requirements of the code, whereas point (iv) refers to its "content" requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].			Portugal submitted the programme on 15 December 2005, as specifically allowed for under the new code of conduct (see footnote 1 of this annex).
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.		X	It rather presents four sections: Summary; Economic and budgetary backdrop; Economic and budgetary outlook and Sustainability of public finances.
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.	X		
The programme provides all optional information in these tables.		X	The following data are missing: HICP; Public consumption deflator; Investment deflator (Table 1b); Compensation of employees (Table 2); General government expenditure by function (Table 3); Stock-flow adjustment decomposition: no data on "differences between cash and accruals" and on "valuation effects and others"; Liquid financial assets and net financial debt (Table 4); Potential GDP growth and its contributors (Table 5);

Guidelines in the new code of conduct	Yes	No	Comments
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.		X	Additional information have mentioned the status vis-à-vis the national parliament.
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.	X		
Significant divergences between the national and the Commission services' economic forecasts are explained[2].			n.a.
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		But only the external balance is analysed.
c. Monetary/exchange rate policy			
The <u>convergence</u> programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			n.a.
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			n.a.
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.			n.a.
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	X		
Information is provided on one-off and other temporary measures.	X		The programme states that no one-off or other temporary measures will be implemented.
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			n.a.
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary			n.a.

Guidelines in the new code of conduct	Yes	No	Comments
effects of possible ‘major structural reforms’ over time.			
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			n.a.
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	X		
In case of such “major structural reforms”, the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			n.a.
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country’s strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.			The long-term figures are on a no-policy change basis. Sustainability is at high risk.
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	X		A second, more favourable, scenario is also included.
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		The programme mentions a freeze of the debt of local and regional government; limits to the admission of government employees; measures aiming at a strengthening of the budgetary execution framework.
Notes: [1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on “budget day”, i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. [2]To the extent possible, bearing in mind the typically short time period between the publication of the			

Guidelines in the new code of conduct	Yes	No	Comments
Commission services' autumn forecast and the submission of the programme.			

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances included in the integrated guidelines for the period 2005-2008.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X		
– Member States should avoid pro-cyclical fiscal policies[2].			X (EDP)
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].	X		
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.	X		Only the government sector is contributing to the correction of the external balance
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.		X	
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X		Important measures have been taken but sustainability is still on high risk
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X		In particular, the public administration reform should help in improving a more efficient allocation of resources.
Notes: [1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. [2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times". [3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			

Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast. The table summarises the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)[43]. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY}Y = \left(\frac{dT_i}{dY_i}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity[44]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y}.$$

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43 Private and corporate income taxes are generally provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

44 The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i exante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex\,post}\frac{dB_i}{B_i}$.

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)^{'} - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\varepsilon^{'}_{T_i,B_i}\varepsilon^{'}_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$$

If $(\varepsilon^{'}_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i$; $(\varepsilon^{'}_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i$,

then $d\left(\frac{T_i}{Y}\right)^{'} - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\alpha_i\varepsilon_{B_i,Y} + \beta_i\varepsilon_{T_i,B_i} + \alpha_i\beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i\varepsilon_{B_i,Y}\frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i\varepsilon_{T_i,B_i}\frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i\beta_i\frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i\varepsilon_{T_tB_i}\varepsilon_{B_iY}$ with w_i the share of the *i-th* tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Table 6.

Assessment of tax projections by major tax category

	2006		2007		2008	2009	p.m.:
	COM	SP	COM[2]	SP		SP	OECD
Taxes on production and Change in tax-to-GDP ratio	15.7 0.7	15.8 0.6	16.0 0.2	16.1 0.3	16.4 0.3	16.5 0.1	 /
Difference *of which[3]: - elasticity component* *- composition*	0.0 0.0 -0.1		0.1 0.3 -0.2		/ / /	/ / /	
p.m. Observed elasticity to tax	2.0	2.0	1.4	1.8	1.6	1.4	1.0
Social contributions: Change in tax-to-GDP ratio	12.2 0.1	12.2 -0.1	12.1 0.0	12.1 -0.1	12.0 -0.1	11.9 -0.1	 /
Difference *of which[3]: - elasticity component* *- composition*	-0.2 -0.1 -0.1		-0.1 0.1 -0.1		/ / /	/ / /	/ / /
p.m. Observed elasticity to tax	1.1	0.8	1.0	1.2	1.2	1.2	1.0
Personal income tax[6]: Change in tax-to-GDP ratio	5.6 0.2	5.6 0.1	5.7 0.1	5.7 0.1	5.7 0.1	5.7 0.0	 /
Difference *of which[3]: - elasticity component* *- composition*	0.0 0.0 0.0		-0.1 0.0 -0.1		/ / /	/ / /	
p.m. Observed elasticity to tax	1.8	1.8	1.7	1.8	1.7	1.5	1.7
Corporate income tax[6]: Change in tax-to-GDP ratio	3.3 0.1	3.3 0.1	3.3 0.1	3.3 0.0	3.4 0.0	3.4 0.0	 /
Difference *of which[3]: - elasticity component* *- composition*	0.0 0.0 0.0		0.0 -0.1 0.1		/ / /	/ / /	

p.m. Observed elasticity to tax	2.2	1.7	1.6	1.0	1.0	0.8	1.0

Notes:
[1]OECD ex-ante elasticities
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4
[4]Elasticity relative to private consumption expenditure
[5]Elasticity relative to compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Elasticity relative to gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	**ex-ante**[1]	**COM**[2] **(observed)**	**ex-ante**[1]
Taxes on production and imports: Change in tax-to-GDP ratio	0.7	0.0	0.2	0.0
Difference *of which*[3]*: - elasticity component* *- composition component*	0.7 0.5 0.2		0.2 0.2 0.0	
p.m.: Observed elasticity: - of taxes to tax base[4]	2.0	1.0	1.4	1.0
- of tax base[4] to GDP	1.2	1.0	1.0	1.0
Social contributions: Change in tax-to-GDP ratio	0.1	0.0	0.0	0.0
Difference *of which*[3]*: - elasticity component* *- composition component*	0.1 0.0 0.1		0.1 0.0 0.0	
p.m.: Observed elasticity: - of taxes to tax base[5]	1.1	1.0	1.0	1.0
- of tax base[5] to GDP	1.1	0.9	1.0	0.9
Personal income tax[6]**:** Change in tax-to-GDP ratio	0.2	0.1	0.1	0.1
Difference *of which*[3]*: - elasticity component* *- composition component*	0.1 0.0 0.1		0.0 0.0 0.0	
p.m.: Observed elasticity: - of taxes to tax base[5]	1.8	1.7	1.7	1.7
- of tax base[5] to GDP	1.1	0.9	1.0	0.9
Corporate income tax[6]**:** Change in tax-to-GDP ratio	0.1	0.0	0.1	0.0
Difference *of which*[3]*: - elasticity component* *- composition component*	0.1 0.1 -0.1		0.0 0.1 0.0	
p.m.: Observed elasticity: - of taxes to tax base[7]	2.2	1.0	1.6	1.0
- of tax base[7] to GDP	0.9	1.2	1.0	1.2

Notes:
[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period

[7]Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Annex 5: The rolling debt reduction benchmark

The rolling debt reduction benchmark discussed in Box 5 is calculated for successive five-year periods through a recursive application of the formula:

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

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 60% of GDP, which would take place with the deficit at 3% of GDP and nominal GDP growth at 5%. For nominal GDP growth rates higher than 5%, the benchmark can be respected with deficits in excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the benchmark necessitates deficits lower than 3% of GDP.

Annex 6: Indicators of long-term sustainability

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	2.1	2.1	2.5	2.5	1.7	1.7	1.7	1.7
Real GDP growth	2.4	2.4	2.2	2.2	1.0	1.0	1.0	1.0
Participation rate males (aged 15-64)	81.6	n.a.	81.7	n.a.	80.9	n.a.	81.2	n.a.
Participation rates females (aged 15-64)	70.8	n.a.	73.0	n.a.	73.4	n.a.	74.1	n.a.
Total participation rates (aged 15-64)	76.2	76.2	77.4	77.4	77.1	77.1	77.7	77.7
Unemployment rate	5.6	5.4	5.6	5.3	5.6	5.3	5.6	5.2
Population aged 65+ over total population	17.7	17.7	20.4	20.3	24.4	24.3	32.1	31.9

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	2009	2010	2020	2030	2040	2050	changes	Impact on S2
Total age-related spending	23.3	23.3	25.9	27.8	30.8	33.7	10.4	8.6
Pensions	11.4	11.4	13.6	15.4	17.7	20.0	8.6	7.2
Health care	5.8	5.8	6.1	6.2	6.6	6.9	1.1	0.9
Long-term care	0.5	0.5	0.6	0.7	0.9	1.1	0.6	0.5
Education	4.7	4.7	4.7	4.6	4.7	4.8	0.1	0.1
Unemployment benefits	1.0	0.9	0.9	0.9	0.9	0.9	-0.1	-0.1
Total primary non age-related spending	17.5	17.5	17.5	17.5	17.5	17.5	0.0	0.0
Total revenues	42.7	42.7	42.7	42.7	42.7	42.7	0.0	0.0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

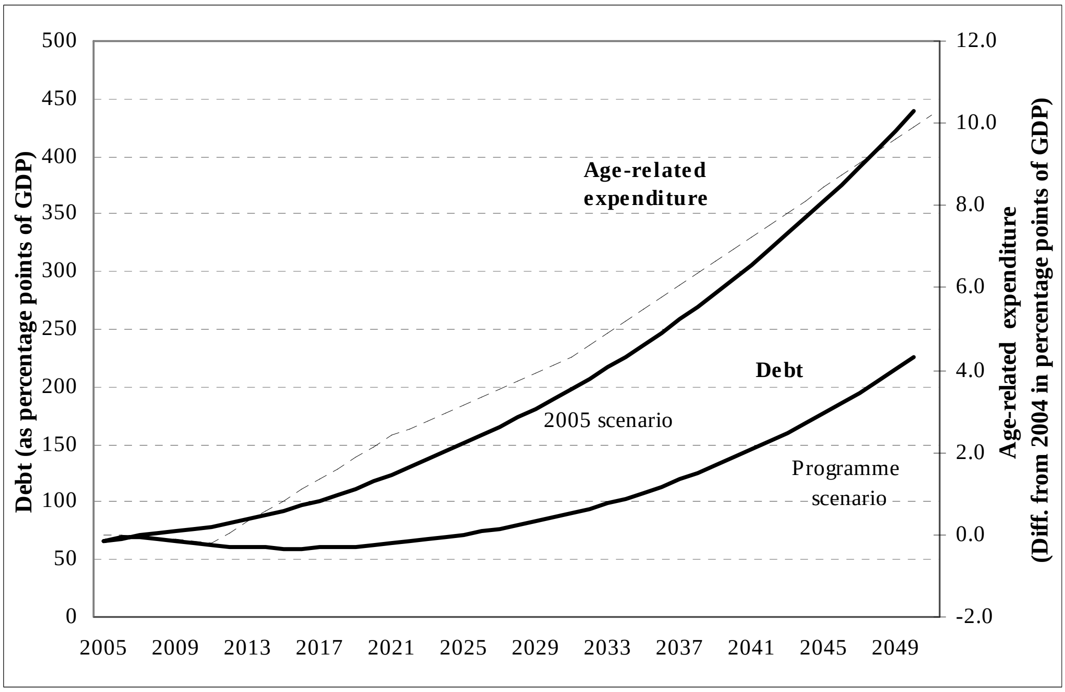
	S1	S2
2005 scenario	**1.2**	**0.5**
Programme scenario	**0.5**	**0.3**

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	2009	2010	2020	2030	2040	2050	changes
Programme scenario							
Gross debt	66.2	64.4	62.7	86.4	138.0	225.4	159.2
*Gross debt, i + 1*****	*66.2*	*64.9*	*69.7*	*102.3*	*168.3*	*280.0*	*213.9*
*Gross debt, i - 1*****	*66.2*	*63.7*	*56.3*	*73.1*	*114.6*	*185.3*	*119.2*
Adjusted gross debt	64.1	62.3	60.5	83.9	135.4	222.5	158.4
2005 Scenario							
Gross debt	74.0	76.3	117.7	189.4	293.7	438.8	364.8
*Gross debt, i + 1*****	*74.0*	*77.0*	*127.9*	*217.1*	*351.4*	*545.3*	*471.3*
*Gross debt, i - 1*****	*74.0*	*75.6*	*108.3*	*165.8*	*247.9*	*359.0*	*285.0*
Adjusted gross debt	71.9	74.2	115.4	186.9	291.0	435.9	364.8

* *i + 1* and *i + 1* represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.


Debt (as percentage points of GDP)
Age-related expenditure
(Diff. from 2004 in percentage points of GDP)
Age-related
expenditure
Debt
2005 scenario
Programme
scenario
500
450
400
350
300
250
200
150
100
50
0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
2005
2009
2013
2017
2021
2025
2029
2033
2037
2041
2045
2049