EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 27.02.2007
ECFIN F2 D(2007) REP 50890-EN

ECONOMIC ASSESSMENT OF THE STABILITY PROGRAMME OF PORTUGAL (UPDATE OF DECEMBER 2006)

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of Portugal's stability programme was submitted on 15 December 2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 6 February. Comments should be sent to Pedro L. Cardoso (Pedro.Cardoso@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 13 February 2007. The ECOFIN Council adopted its opinion on the programme on 27 February.

* * *

All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

Table of contents

SUMMARY AND CONCLUSIONS[1]

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as Portugal, has to submit a stability programme and annual updates thereof. The most recent programme, covering the period 2006-2010, was submitted on 15 December 2006. Under the corrective arm of the Pact, Portugal was placed in excessive deficit by the Council in September 2005. The deadline for correcting the excessive deficit is 2008.

After a phase of strong economic growth reflecting dynamic domestic demand and a boost in productivity in the second half of the nineties, in the run-up to euro adoption, low growth after 2000 implied a halt in the convergence process. This resulted from a number of causes. First, the adjustment on the supply side seems to have been insufficient to support the catching-up process in a sustainable way. At the same time, important sectors are still adjusting to the challenges of globalisation. Second, as spending exceeded income and production, private debt is at high levels and the external deficit has been sizeable, mainly driven by a trade deficit. Third, public finances have been fragile largely as the result of the missed opportunity to consolidate in "good times" and of the significant increase in the deficit during the downturn. The overarching challenge for Portugal is to simultaneously consolidate public finances and lift the economy's growth potential in a sustained way. Reinforcing productivity will crucially depend on structural measures at the microeconomic and institutional levels, including changes in product and labour markets as well as improving investments in human and physical capital.

The overriding fiscal challenge is to put public finances on a sound track. Pressing ahead with consolidation is essential as it is clear that fiscal problems go beyond the economy's current cyclical weaknesses: against the background of low potential growth in the coming years, fiscal consolidation is a prerequisite for macroeconomic stability in the medium term. A second challenge is to improve the efficiency and effectiveness of government expenditure, which can be instrumental to support higher productivity levels, thereby contributing to the potential growth of the wider economy. This would include an improvement of human and physical capital, for instance by addressing the effectiveness of education spending and carefully selecting public investment projects in the context of the Lisbon Strategy and the National Strategic Reference Framework, while maintaining firm control over public expenditure overall. Finally, given the strong dynamism of old-age pension expenditure and the rising debt ratio, ensuring the sustainability of public finances through the reduction of the high deficit and debt ratios is also essential to accommodate better the budgetary impact of an ageing population. Whereas recent measures mitigate the risks to sustainability in the long-term, the projected budgetary cost of an ageing population is large.

The macroeconomic scenario underlying the updated stability programme envisages that real GDP growth will pick up from 1.4% in 2006 to 1.8% in 2007, 2.4% in 2008, and eventually to 3% per year over the rest of the programme period. The programme's

---

[1]The analysis takes into account (i) the Commission services' autumn 2006 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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

macroeconomic scenario seems to project the fast export growth that has been observed since mid-2005 to persist in the future. With a time lag, this raises domestic demand, which gradually takes over the role of driver of GDP growth in the medium-term. Assessed against currently available information, this scenario appears to be based on favourable growth assumptions, notably for the outer years, with the output gap closing rapidly. The programme's projections for inflation appear realistic. According to the Commission services' autumn 2006 economic forecasts, the output gap has been negative at 2% of potential GDP in 2005 and 2006 and will slightly narrow in 2007 and 2008 to 1¾% and 1½%, respectively. Consequently, Portugal can be considered to be in bad economic times.

For 2006, the general government deficit is estimated at 4.6% of GDP both in the Commission services' autumn 2006 forecast and in the new update, which would correspond to the target set in the previous update of the stability programme. According to the new update, both total government revenue and expenditure level targets have been largely met. As a percent of GDP, both ratios are somewhat lower than in the Commission services' autumn 2006 forecast. Recent and preliminary cash statistics suggest a budgetary execution possibly better than budgeted.

The main goal of the programme's medium-term budgetary strategy is a lasting correction of the large fiscal imbalances, notably a reduction of the general government deficit to below the 3% of GDP reference value in the year 2008 and further budgetary consolidation thereafter. The government deficit is targeted to decline gradually from 4.6% of GDP in 2006 to 0.4% in 2010; the adjustment path for the primary balance is similar, with an improvement from a deficit of 1.7% of GDP in 2006 to a surplus of 2.5% in 2010. The planned deficit reduction is to be achieved mainly by curbing primary expenditure. Corrective measures of a structural nature are envisaged to concentrate on restructuring central government, personnel and public services and also on controlling social security and health expenditure. In the earlier years of the programme, higher tax revenues coming mainly from an increase in some rates, lower tax benefits and improved tax collection should also contribute to fiscal consolidation. The programme confirms the planned budgetary adjustment outlined in the December 2005 update of the stability programme against a largely unchanged macroeconomic scenario. Government gross debt is estimated to have reached 67½% of GDP in 2006. The programme projects the debt ratio to increase in 2007 and to decline by close to 6 percentage points over the rest of the programme period, driven by the return to primary surpluses and the acceleration in GDP.

The structural balance calculated according to the commonly agreed methodology is planned to improve from a deficit of around 3½% of GDP in 2006 to ½% by 2010. Over the programme period, the structural balance is planned to be reduced by an average of almost ¾% of GDP per year. The medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 0.5% of GDP, which is in line with the Pact, and is planned to be achieved by 2010.

The budgetary targets are subject to downside risks deriving, in particular, from the impact of the measures to contain government spending. Against the backdrop of a difficult macroeconomic environment, the government has recently implemented decisive measures to tackle expenditure growth, notably in public administration, health care and social welfare, in addition to the new legal framework to improve the fiscal discipline of regional and local governments. Other measures relating partly to the government sector are still in preparation. However, the budgetary relief to be expected from these measures is subject to considerable uncertainty, notably for 2008 and beyond. Since fiscal consolidation relies crucially on expenditure retrenchment, further progress with the ongoing improvement of the budgetary framework and implementation of mechanisms of assessing and controlling budgetary execution will also be instrumental to the achievement of the budgetary targets. The assumptions about the elasticity of tax revenue to economic activity appear somewhat optimistic in 2007 and depend on the planned further improvement in tax collection, although they seem more plausible for the rest of the programme period. Finally, the performance of public enterprises provides a budgetary risk in the medium term. The evolution of the debt ratio is subject to the risks to the budgetary targets mentioned above and continued uncertainty about the stock-flow adjustment, which has tended to be large and predominantly debt-increasing in the past.

In view of this risk assessment, the budgetary stance in the programme is broadly consistent with a correction of the excessive deficit by 2008 as recommended by the Council, provided the measures announced in the programme are fully and effectively implemented and reinforced in case of lower-than-projected economic growth. Following the correction of the excessive deficit, the programme targets an adjustment that is in line with the Pact. However, taking into account the risks to the budgetary targets, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations until the end of the programme period. Consequently, the MTO might not be reached by 2010, as envisaged in the programme. Thus, in the years following the correction of the excessive deficit, the adjustment towards the MTO outlined in the programme could require reinforcing the measures to be 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 and that the adjustment should be higher in good economic times and could be lower in bad economic times. The debt ratio would start to diminish towards the reference value at the end of the programme period, subject to these risks.

Portugal has recently enacted pension reforms aimed at strengthening the sustainability of the public finances. Estimates in the programme suggest that the overall increase in age-related expenditure over the coming decades would be significantly lower as a result of the reform, but remain sizeable. The initial budgetary position, albeit improved compared with 2005, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Overall, Portugal appears to be at high risk with regard to the sustainability of public finances. The planned budgetary consolidation coupled with further containment of the age-related expenditure would contribute to reducing such risks.

The Implementation Report of the National Reform Programme (NRP) of Portugal, provided in the context of the renewed Lisbon Strategy for Growth and Jobs, was submitted on 20 October 2006. The NRP identifies as key challenges/priorities: strengthening budgetary consolidation; reform of public administration; fostering scientific and technological development; and increasing the qualification levels of the population. The Commission's assessment of that programme showed that Portugal is making good progress on implementing the measures in the NRP, especially in the macro and micro-economic areas. On employment related policies, there has also been progress, especially on reforming education and training, but the important area of the adaptability of the labour market and flexicurity is not yet being fully addressed. Considerable further efforts across all policy areas will be necessary to fully achieve the objectives of the programme, given their welcome ambition and Portugal's point of departure. Against the background of strengths and weaknesses identified, Portugal was recommended to take action in the areas of: fiscal consolidation and public administration; education and vocational training; and employment protection and labour market segmentation. The stability programme and the NRP are well integrated. For instance, both programmes address the linkages between public administration reform and the fiscal consolidation strategy and provide complementary information on various policy measures.

The overall conclusion is that the updated stability programme is broadly consistent with a correction of the excessive deficit by 2008, conditional on a full and effective implementation of the measures announced therein and on the reinforcement of such measures in case of lower-than-projected economic growth. After the correction of the excessive deficit, the programme envisages adequate progress towards the medium-term objective, but the assessment of the programme highlight risks to the achievement of the budgetary targets. Despite recent policy measures, Portugal remains at high risk as regards the sustainability of public finances.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010
Real GDP (% change)	**SP Dec 2006**	**0.4**	**1.4**	**1.8**	**2.4**	**3.0**	**3.0**
	COM Nov 2006	0.4	1.2	1.5	1.7	n.a.	n.a.
	SP Dec 2005	*0.5*	*1.1*	*1.8*	*2.4*	*3.0*	*n.a.*
HICP inflation (%)	**SP Dec 2006[6]**	**2.5**	**3.2**	**2.2**	**2.2**	**2.1**	**2.1**
	COM Nov 2006	2.1	2.9	2.2	2.1	n.a.	n.a.
	SP Dec 2005[6]	*2.3*	*2.3*	*2.2*	*2.2*	*2.1*	*n.a.*
Output gap (% of potential GDP)	**SP Dec 2006[1]**	**-2.5**	**-2.6**	**-2.4**	**-1.8**	**-0.7**	**0.2**
	COM Nov 2006[5]	-2.0	-2.0	-1.8	-1.5	n.a.	n.a.
	SP Dec 2005[1]	*-2.3*	*-2.7*	*-2.5*	*-1.8*	*-0.7*	*n.a.*
General government balance (% of GDP)	**SP Dec 2006**	**-6.0**	**-4.6**	**-3.7**	**-2.6**	**-1.5**	**-0.4**
	COM Nov 2006	-6.0	-4.6	-4.0	-3.9	n.a.	n.a.
	SP Dec 2005	*-6.0*	*-4.6*	*-3.7*	*-2.6*	*-1.5*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2006**	**-3.3**	**-1.7**	**-0.7**	**0.4**	**1.5**	**2.5**
	COM Nov 2006	-3.3	-1.7	-1.0	-0.7	n.a.	n.a.
	SP Dec 2005	*-3.2*	*-1.7*	*-0.6*	*0.6*	*1.5*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Dec 2006[1]**	**-4.9**	**-3.4**	**-2.6**	**-1.8**	**-1.2**	**-0.5**
	COM Nov 2006	-5.1	-3.7	-3.2	-3.2	n.a.	n.a.
	SP Dec 2005[1]	*-5.0*	*-3.4*	*-2.6*	*-1.8*	*-1.2*	*n.a.*
Structural balance[2] (% of GDP)	**SP Dec 2006[3]**	**-4.9**	**-3.4**	**-2.6**	**-1.8**	**-1.2**	**-0.5**
	COM Nov 2006[4]	-5.1	-3.7	-3.2	-3.2	n.a.	n.a.
	SP Dec 2005	*-5.0*	*-3.4*	*-2.6*	*-1.8*	*-1.2*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2006**	**64.0**	**67.4**	**68.0**	**67.3**	**65.2**	**62.2**
	COM Nov 2006	64.0	67.4	69.4	70.7	n.a.	n.a.
	SP Dec 2005	*65.5*	*68.7*	*69.3*	*68.4*	*66.2*	*n.a.*

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]There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.

[5]Based on estimated potential growth of 1.2% in the period 2005-2007 and 1.4% in 2008.

[6]Private consumption deflator.

Source:

Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The Portuguese authorities submitted the most recent update of the Portuguese stability programme on 15 December 2006[2]. The update covers the period from 2006 to 2010. After its approval by the Cabinet, the programme was discussed by Parliament on 14 December 2006. It takes on board the 2007 Budget Law adopted in November 2006.

The programme deviates on material points from the model structure and data provision requirements for stability and convergence programmes specified in the code of conduct. In particular, the programme does not follow the model structure of the former[3]. The programme provides all required and most of the optional data prescribed by the code[4]. Annex 3 provides a detailed overview of all aspects of compliance with the code of conduct.

2. ECONOMIC TRENDS AND POLICY CHALLENGES

The section consists of five parts. The first part provides a brief overview over the Portuguese macroeconomic performance in terms of growth and other major macro-variables. The second presents the results of a growth accounting exercise and tries to identify the main reasons for the deviations of growth in Portugal vis-à-vis the euro area. The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. Based on the picture outlined in the first four parts, the fifth identifies major economic challenges with fiscal policy implications for Portuguese public finances.

2.1. Economic performance

When analysing the Portuguese economic performance over the past ten years, two rather distinct periods can be identified: a "boom" phase up to the years 2000 and 2001 on the back of the expansionary conditions created by euro adoption, and a "bust" phase afterwards as the result of attempts to unwind imbalances that had been accumulated during the boom[5].

In the second half of the 1990s, Portuguese GDP growth was in excess of 4% p.a., which clearly surpassed the euro area average and thus allowed for a catching-up towards levels

2 The code of conduct allows Portugal to deliver no later than 15 December. The English version of the programme was submitted on 23 December 2005.

3 The programme rather presents five sections: Executive Summary; Macroeconomic and Budgetary Situation; Macroeconomic and Budgetary Forecasts; Long-term Sustainability of Public Finances; and Institutions, Processes and Budgetary Rules.

4 Examples of missing optional data are: HICP; Public consumption deflator; Investment deflator (Table 1b of the Code of Conduct: Price developments) and Compensation of employees (Table 2: General government budgetary prospects).

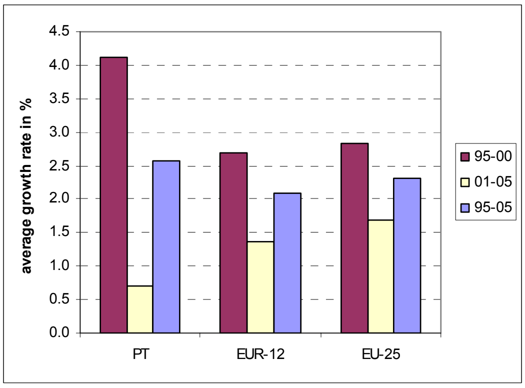
5 A comprehensive analyses of the Portuguese economy is in European Commission (2004), The Portuguese economy after the boom, DG ECFIN, European Economy, Occasional Paper No. 8. An analysis of the adjustment of a number of economies (including Portugal) to the context of the monetary union is presented in European Commission (2006), Adjustment Dynamics in the Euro Area – Experiences and Challenges, EU Economy 2006 Review, European Economy 06/2006.

closer to the euro area average (see Figure 1). However, after 2000, growth weakened and GDP has increased at one of the lowest paces in the euro area and the EU, with an average growth of less than ¾% p.a. until 2005, implying a reversal in the convergence process (see Table 1 for an overview of economic indicators). Indeed, between 1995 and 2000, the Portuguese GDP per capita, relative to the EU-15 average, grew from less than 68½% to 73½%, but it receded to around 69% in 2005[6].

The inflation differential vis-à-vis the euro area declined throughout the 1990s, reaching 0.7 percentage points in 2000. Afterwards, the differential widened again but inflation in Portugal declined to the euro area average in 2005. The strongest upward pressure came from price increases in services, as a result of the nominal convergence process itself, but apparently also of weak competition in some sectors.

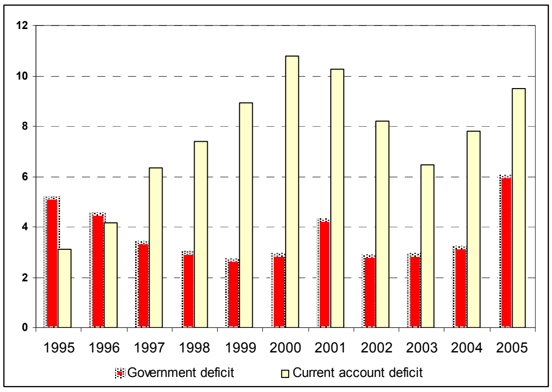
Over the last ten years, labour market participation rates have been high and above the euro area average. The unemployment rate has broadly followed the economic cycle: it declined to 4% of the labour force in 2000, one of the lowest in the euro area, but in recent years it jumped to 7½%. Employment rates have been comparatively high, even for groups often under-represented in the labour market such as older workers, women, or workers with few years of formal education.

Figure 1: Average GDP growth: Portugal vs. EU12 and EU25



Source: Commission services

Figure 2: Current external account and government deficits (in % of GDP)



Source: Commission services

In the second half of the 1990s, economic activity in Portugal was closely related to the easing of financial conditions brought about by the run-up to the euro. Indeed, the rapid decline in nominal interest rates converging towards the substantially lower German level resulted in expansionary conditions during those years. Additionally, the prospects of further integration and of catching-up with other EU countries seem to have played a role in the formation of overly optimistic expectations by Portuguese economic agents about their level of permanent income. A phase of strong economic growth ensued on the back of a buoyant domestic demand fuelled by easier access to credit: private consumption expanded swiftly and investment strengthened considerably, amidst strong credit growth to the private sector. At the same time, household saving rates declined. The shock on financial conditions was clearly reinforced by changes in the financial sector brought about by liberalisation and privatisation, which had started already in the

6 Data in purchasing power standards. Source: Banco de Portugal (2006), 2005 Annual Report.

late 1980s[7]. Households essentially used credit for house purchases, thereby generating a boom in construction[8]. Government expenditure heated up economic activity further.

The supply side did not adjust as quickly as demand. In particular, over the late nineties, the external demand contribution to GDP growth was persistently negative and therefore unable to support the economy's catching up process. Import growth was very strong and supported the buoyant domestic demand but exports trailed behind external demand growth, implying significant export market share losses over those years. Portugal's productivity gap with the euro area narrowed (from 60% of the area average in 1995 to 66% in 2000), but, nevertheless, improvements in unit labour costs were jeopardized by large wage increases in a labour market tightened by a lively domestic demand. At the same time, the inflation differential vis-à-vis the euro area further hurt price competitiveness. Altogether, the external competitiveness position of Portugal suffered, with the real effective exchange rate (REER) increasing faster than in the rest of the euro area[9]. Thus, the external balance deteriorated significantly with high and rising deficits: in 2000, the current account deficit (i.e., the balance of goods and services, primary income and transfers) peaked at almost 11% of GDP (see Figure 2)[10] and the net borrowing vis-à-vis the rest of the world at some 9% of GDP.[11]

After the year 2000, and in times of a global slowdown, Portugal entered a severe economic adjustment process to correct the imbalances in debt levels and external deficit. A downward adjustment of expenditure by domestic agents led to a recession in 2003, as consumption stagnated and investment slumped. Thereafter, household spending regained some momentum, with indebtedness reaching some 120% of disposable income in 2005 (84% of GDP). Such spending recovery seems to have taken place earlier than warranted by fundamental variables affecting consumption, suggesting that the adjustment process in household balance sheets is not complete. Instability is heightened by the predominance of floating rates loans, which make household finances more vulnerable to changes in monetary conditions[12]. Investment has remained on a negative trend, with a strong contraction in construction investment being a big drag, yet corporate debt went further up to some 94% of GDP by 2005, up from an average of 62½% in the second half of the nineties.

---

7 For instance, intermediation margins of the banking sector declined by some 5 percentage points between 1995 and 2005, [Banco de Portugal (2006), 2005 Annual Report].

8 At the same time, and unlike what happened in other countries, the expansion of credit to the private sector was not associated with very large average house prices rises, as in fact they were among the lowest in the euro area. Significant supply response and excess supply from the first half of the 1990s may have contributed to this.

9 Such outcome came on top of the strong currency appreciation in the first half of the nineties – in fact, the strongest among the group of future euro participants.

10 Also the decline in the remittances surplus and the deterioration of the primary income deficit fed the external imbalance, contributing to with an accumulated deterioration of some 3% of GDP between 1995 and 2000.

11 It is worth mentioning that G. Fagan and V. Gaspar (2007), Adjusting to the Euro, ECB Working Paper 716, argue that developments on the demand side are enough to explain a number of features of the pattern of converging economies participating in the euro area, namely, external deficits, rising indebtedness by households, and real exchange rate appreciation.

12 More information on Portuguese households over the last decade can be found in P.L. Cardoso (2005), Household behaviour in a monetary union: what can we learn from the case of Portugal?, European Commission, ECFIN Country Focus, Vol. II, no 20.

In the post-2000 bust phase, external demand was on average broadly neutral for GDP growth. Portugal experienced a narrowing of the external imbalance until 2003, with a marked containment in imports in the wake of weakening domestic demand, together with a more benign export performance, as the trend of falling export market shares bottoms out.

Productivity growth slowed down considerably, partly for cyclical reasons, and consequently, despite lower wage growth, the unit labour cost position weakened vis-à-vis most trade partners. Hence, the REER appreciated sharply between 2000 and 2003. Against this cost competitiveness deterioration, export performance could not recover in a more lasting way and the current account remained negative even when internal demand was contracting. Additionally, in 2004 and 2005, the correction of the external imbalance was hampered by the domestic demand recovery in the former year, with adverse terms of trade developments playing also an important role in the latter.

In addition to cost factors, other aspects seem to have played a role in the weak performance of the external sector. Notably, exports kept relying on a product mix with only moderate growth potential and in labour-intensive sectors where Portugal lost comparative advantages to emerging economies[13]. In fact, while the export composition has changed towards more sophisticated goods, low technology items continued to account for almost 40% of goods exports in 2005, down from 55% in 1995[14]. Another relevant dimension for competitiveness developments is the evolution of FDI. Between EU accession in 1986 and the mid-1990s, Portugal had been successful in attracting sizeable FDI to export-oriented manufacturing projects. However, in the late 1990s, those FDI flows declined up to the point of becoming firmly negative in some years. Portugal started losing attractiveness relative to new locations, including some recently acceded EU Member States, which have lower production costs and more luring economic prospects.

---

[13] It worth noting that the large export market share losses registered in 2004 and 2005 were contemporaneous to additional steps in world trade liberalisation in early 2005.

[14] According to S. Cabral and P. Esteves (2006), Portuguese Export Market Shares: An Analysis by Selected Geographical and Product Markets, Banco de Portugal, Economic Bulletin, Summer 2006, the product mix accounted for an export market share loss of almost 5 percentage points out of a total loss of 16 percentage points between 2000 and 2005 in a sample of markets representing 60% of Portuguese exports. The authors also found that in those markets where Portugal's share losses were the most significant, the biggest share gains were mostly achieved by developing Asian economies and Central and Eastern Europe countries. However, it is interesting to consider that Blanchard (2006), Adjustment within the euro: The difficult case of Portugal, Paper presented at the conference Desenvolvimento Económico Português no Espaço Europeu, mentioning research by L. Fontagné, suggests that Portugal is not more exposed to competition from China than Germany is.

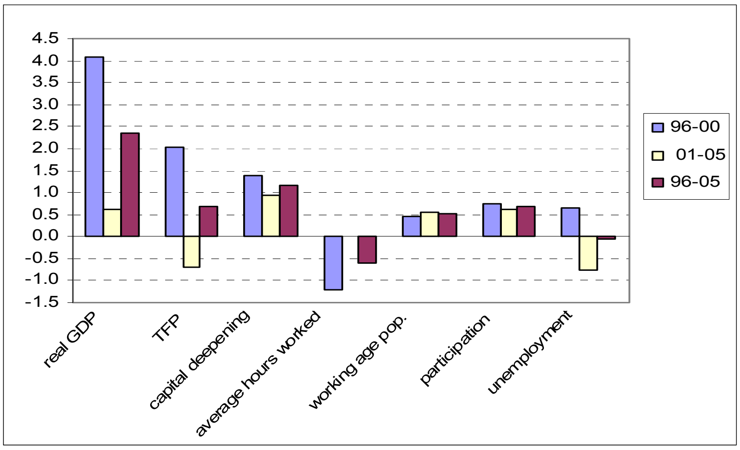
2.2. Anatomy of medium-term growth

Within the framework of a traditional growth accounting exercise carried out on the basis of a Cobb-Douglas production function, this section dissects the sources of average growth as well as differences in economic growth in Portugal vis-à-vis the euro area.

Over the past ten years, GDP growth in Portugal was mainly driven by capital accumulation (see Figure 3). The overall labour contribution was slightly positive. TFP growth was the major contributor to GDP growth in the second half of the nineties, but became a drag after the year 2000.

Compared with the euro area average, the capital deepening effect was more growth-supportive in Portugal throughout the last decade, but the difference declined significantly in the more recent bust phase (see Figure 4). The contributions of employment trailed slightly behind the area average due to a decline in average hours worked in 1996 and 1997 and a quick rise in unemployment in the second half of the period. The sharp fall in TFP growth is key to understanding the poor growth performance in recent years compared with the euro area average.

Figure 3: Real GDP growth and its components



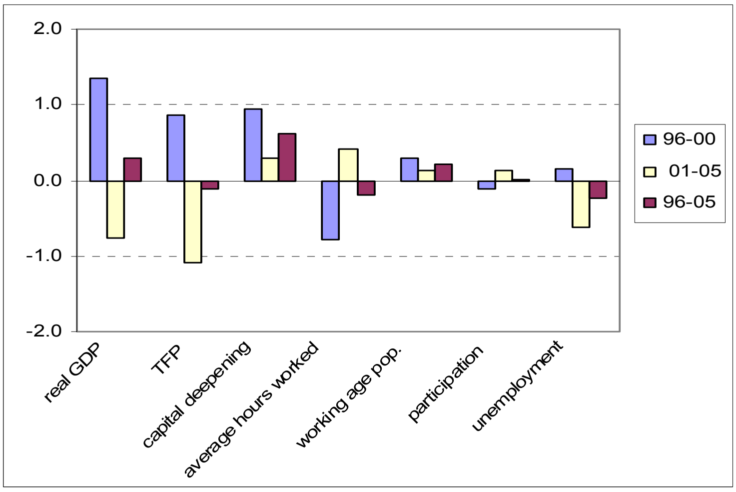
Note: Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^{\alpha} K^{1-\alpha}$ where Y denotes the level of *GDP, L* employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L} \right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1 - ur)$ where *WP* stands for working age population, *PART* denotes the participation ratio as a share of *WP* and *ur* the rate of unemployment. In terms of growth rates *g* this is:

$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source: Commission services

Figure 4: Real GDP growth and its components: Difference vis-à-vis euro area



Note: see Note of Figure 3.
Source: Commission services

To disentangle the driving forces behind the TFP evolution, it is useful to assess the evolution of labour productivity by sectors. Notably, it appears that gains in manufacturing productivity lifted the average. However, small productivity gains in services, which account for the largest and a growing share of employment, have been dampening the economy's overall labour productivity[15]. Looking ahead, the fact that the sector most exposed to external competition was the one that performed best, leaves some hope about the capacity of the supply side to adjust.

Beyond the current cyclical sluggishness, TFP growth seems to be hampered by more structural features. A weakness is found in the educational levels, even for the youngest cohorts, which among other things may constrain the capacity to innovate. Not only is early school leaving relatively high, even if it is falling, but also educational achievement is low. Furthermore, the enrolment in tertiary education in science and technology areas is low, particularly in the former[16]. At the same time, ICT and R&D spending are low when compared with more advanced economies. Another dimension is product market regulation, which seems to be more restrictive in Portugal than in most OECD countries[17], and which can limit the speed of structural adjustment by erecting barriers to market entry and thus reduces the benefits of competition and firm selection. Last, a high protection for permanent labour contracts might hamper a swifter adjustment of

---

15 Overall, the better performance of manufacturing seems to be a lasting feature of the Portuguese economy. Duarte and Restuccia (2006), Transformação Estrutural e Produtividade Agregada em Portugal, Proceedings of the conference Desenvolvimento Económico Português no Espaço Europeu, found that productivity gains in manufacturing drove convergence of Portugal to the US level over the period 1955-1995, while relative productivity levels in agriculture and services remained at their mid-1950's levels.

16 See OECD (2006), Economic Review – Portugal, and also Guichard and Larre (2006), Enhancing Portugal's human capital potential, OECD Economics Department Working Paper 505.

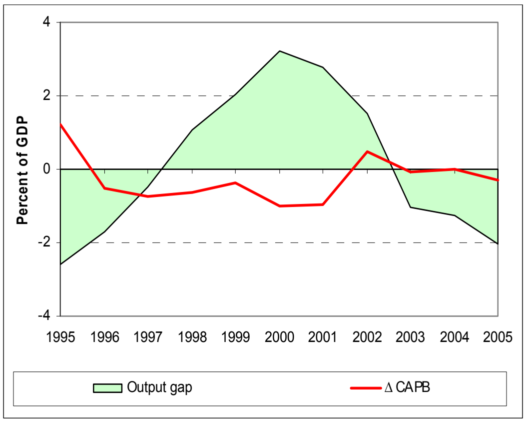
17 OECD (2006), Economic policy reforms: Going for Growth 2006: overview and country priorities, Economic Policy Committee WP1(2006) 12.

employment across firms and sectors as well as hurting the incentives for human capital investments. This is only partly compensated for by a large share of temporary contracts.

2.3. Macro-policies against the backdrop of the economic cycle

Figure 5 clearly shows that over the second half of the 1990s, GDP grew above potential with the subsequent widening of a positive output gap, which peaked at the turn of the century at more than 3% of GDP. Afterwards, the growth momentum abated sharply: the output gap closed quickly and soon turned negative, remaining firmly negative since. Overall, whereas the cyclical fluctuations in Portugal have largely followed the direction of the overall euro area, their volatility was markedly higher over both the boom and the bust phases (see Figure 6).

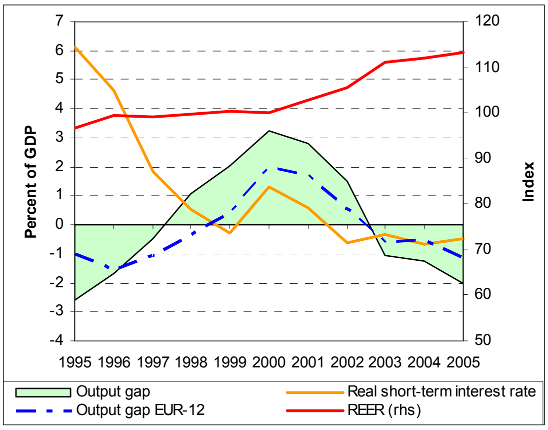
Figure 5: Output gap and fiscal stance



Note: CAPB – cyclically adjusted primary budget balance; Excluding one-off measures in the years 1997, 2000 and 2002-2004.

Source: Commission services

Figure 6: Output gap and monetary conditions



Source: Commission services

Figure 5 assesses the stance of fiscal policy, measured by the change in the cyclically-adjusted primary balance (CAPB), against the cyclical position, proxied by the output gap evolution. It shows that Portuguese fiscal policy was expansionary over most of the past ten years, especially between 1996 and 2001. Moreover, it is evident that the worsening of the CAPB coincided with the widening of a large positive output gap up to 2000: under such conditions, the continuous deterioration in the CAPB points to a loose fiscal stance in "good times". After a tightening in 2002, when the cyclical conditions worsened, the fiscal stance became close to neutral in times of a negative output gap.

Therefore, it becomes clear, first, that a pro-cyclical budgetary stance reinforced the economy's cyclical fluctuations over the boom phase until 2000. Second, after a temporary tightening in the beginning of the bust phase, fiscal policy was not a driving force of the downturn in the more recent years. In all, fiscal policy exacerbated the boom movements of the economy, but played a more neutral role during the bust[18].

---

[18] According to simulations presented in European Commission (2004), The Portuguese economy after the boom, DG ECFIN, European Economy, Occasional Paper No. 8, if the Portuguese government expenditure had grown at the same rate as in the euro area average, GDP growth would have been about 2/3 of a percentage point lower than it was between 1998 and 2001. In 2002 and 2003, the impact would have been neutral on average.

Figure 6 shows that monetary conditions in Portugal have been favourable to economic growth. As mentioned before, the run-up to the third stage of EMU resulted in a continuous and substantial easing of financial conditions coming from the quick convergence to the substantially lower German interest rates. After a temporary tightening in 2000, the monetary conditions were further softened up to the point of real interest rates becoming negative. With interest rates set for the euro area as a whole, the relatively high inflation in Portugal crucially pushed real interest rates into negative territory. This may be key for understanding why debt increased continuously and attempts to consolidate balance sheets, especially of households, have been short-lived.

2.4. Public finances

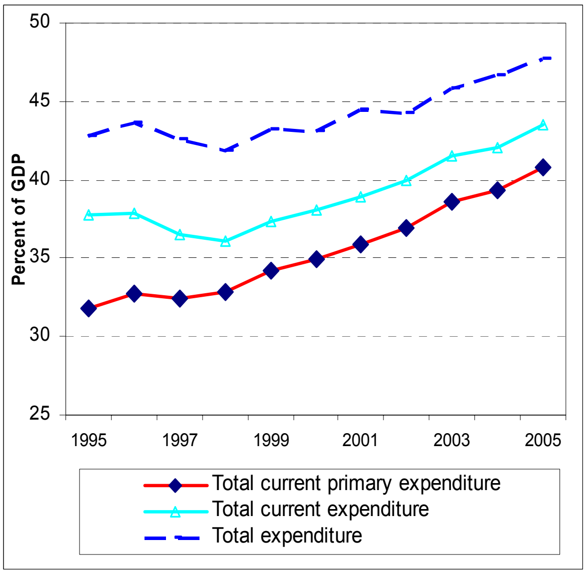
Portuguese public finances have been fragile over the past ten years, with their weakness being revealed openly in the recent bust phase.

Starting from an average general government deficit of more than 5% of GDP over the first half of the nineties, Portugal was successful in improving its budgetary situation to meet both Maastricht deficit and debt ratios requirements, allowing it to join the euro from its outset. However, the government deficit always stood close to 3% of GDP, leaving no safety margin to accommodate less favourable cyclical circumstances.

In the second half of the nineties, public finances were helped by strong revenue growth resulting from the lively behaviour of domestic demand described in subsection 2.1. Some additional contributions came from the increase in a number of tax rates and the widening of certain tax bases. Overall, the tax burden and the total revenue ratio increased as a share of GDP over those years.

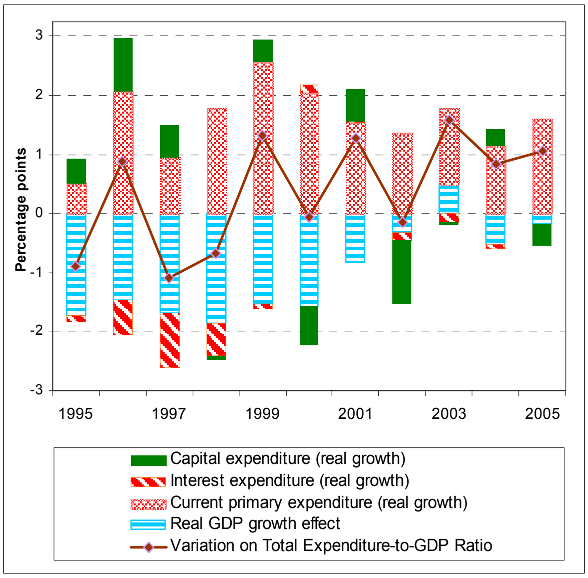
On the expenditure side, two opposing forces were at play. On the one hand, interest expenditure on government debt fell, as interest rates declined sharply. On the other hand, current primary expenditure, until 1998, grew close to the pace of nominal GDP. Since then it rose at a faster pace, mainly reflecting a deepening of welfare protection, with higher cash transfers, including old-age pensions, and health expenditure and also higher personnel expenditure. In all, the expansion of primary expenditure was made possible by quickly declining interest expenditure on government debt as interest rates declined sharply (see Figures 7 and 8).

Figure 7: Government expenditure pattern in Portugal



Source: Commission services

Figure 8: Drivers of the Government expenditure ratio[19]



Source: Commission services

If the buoyant growth allowed for a budgetary improvement, the economic downturn revealed a weak fiscal position. With the cooling of GDP growth after the turn of the century, fiscal revenue growth moderated from the high pace of previous years. Simultaneously, current primary expenditure kept growing but, unlike in earlier years, the only marginal fall in interest expenditure no longer offset the current primary expenditure overruns, such that total current expenditure grew faster than GDP (see Figures 7 and 8).

It is now obvious that the boom phase, in particular the leeway created by high tax revenue growth and falling interest expenditure, was not used for a substantial consolidation of public finances. While over-optimism over future economic developments – as revealed by successive downward revisions of actual and potential GDP growth – may have played a role in the accumulation of the fiscal imbalance, the

---

[19] The decomposition of the change in the government expenditure ratio is obtained as:

$$\frac{EXP_t}{GDP_t}-\frac{EXP_{t-1}}{GDP_{t-1}}=\frac{EXP_{t-1}}{GDP_t}-\frac{EXP_{t-1}}{GDP_{t-1}}+\frac{\Delta EXP_t}{GDP_t}$$

$$\Delta\left(\frac{EXP}{GDP}\right)_t=\frac{EXP_{t-1}}{GDP_{t-1}}*\left(\frac{-y_t}{1+y_t}\right)+\frac{\Delta CPEXP_t}{GDP_{t-1}*(1+y_t)}+\frac{\Delta CapEXP_t}{GDP_{t-1}*(1+y_t)}+\frac{\Delta IntEXP_t}{GDP_{t-1}*(1+y_t)}$$

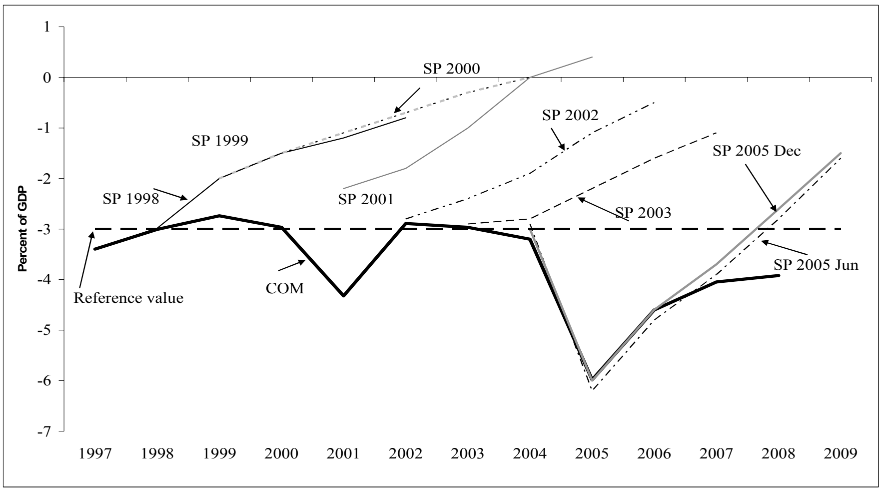
$$\Delta\left(\frac{EXP}{GDP}\right)_t=-\frac{EXP_{t-1}}{GDP_{t-1}}*\frac{{}^{g}GDP_t}{1+y_t}+\frac{CPEXP_{t-1}}{GDP_{t-1}}*\frac{{}^{g}CPEXP_t}{1+y_t}+\frac{CapEXP_{t-1}}{GDP_{t-1}}*\frac{{}^{g}CapEXP_t}{1+y_t}+\frac{IntEXP_t}{GDP_{t-1}}*\frac{{}^{g}IntEXP_t}{1+y_t}$$

Where t is the time subscript, *EXP* represents the government total expenditure, *CPEXP* the current primary expenditure, *CapEXP* capital expenditure and *IntEXP* the interest expenditure; g represents the real growth rate of the different variables and the growth rate of nominal GDP.

The first term of the RHS measures the effect of real GDP growth level in dragging down the expenditure ratio. The other terms of the RHS indicate the contribution of the three different expenditure categories to the change in the expenditure ratio.

situation deteriorated considerably as expenditure kept rising. Indeed, upwards revisions of expenditure projections became frequent after the year 2000 and the same happened to the fiscal balance (see Figure 9).

Figure 9: General government balance projections in successive stability programmes



Source: Commission services and national stability programmes

Fiscal policy turned around in mid-2002. Policy changes concentrated on tax increases, in particular on VAT, and on curbing the growth of social transfers and personnel expenditure. However, such corrective efforts had limited success, with expenditure growth mainly driven by the strong increase in old-age pension spending as a result of the quick increase in the number of retirees as well as of the average pension due to longer contribution years of individual claimants. The expenditure ratio went further up also because of the very low GDP growth (see Figure 8). At the same time, the economic downturn continued eroding revenues, in particular in 2003, when the economy fell into recession. The government balance was brought under the 3% of GDP ceiling for some years crucially owing to temporary measures[20].

In mid-2005, the fiscal consolidation strategy was revised with a reinforced reliance on structural measures on both the revenue and expenditure side. While substantial improvements in tax collection in more recent years have partly offset the budgetary impact of the weak economic momentum, the lack of lasting progress in consolidation based on structural measures to contain spending, heightened concerns about public finance imbalances.

The fiscal evolution of Portugal is reflected in the U-shape evolution of the government debt ratio: between 1995 and 2000, the government debt-to-GDP ratio declined by some 10 percentage points to about 50%, but afterwards moved up to some 64% in 2005.

[20] The budgetary impact of the operations amounted to some 1.4, 2.4, and 2.1% of GDP, respectively in 2002, 2003 and 2004.

2.5. Medium and long-term policy challenges

After a phase of strong economic growth reflecting dynamic domestic demand and a boost in productivity in the second half of the nineties, in the run-up to euro adoption, low growth implied a halt in the convergence process after 2000. This resulted from limited progress on reforming key features of the economy. First, the adjustment on the supply side seems to have been insufficient to support the catching-up process in a more substantial way. At the same time, important sectors are still adjusting to the challenges of globalisation. Second, as income has not expanded as quickly as spending, debt is at high levels and the external deficit has been sizeable, mainly driven by a trade deficit. Third, public finances have been fragile largely as the result of the missed opportunity to consolidate in "good times" and of the persistently high deficits during the downturn.

All these facts are relevant to understand the current shape of the Portuguese economy. The challenge is now to simultaneously consolidate public finances and lift the economy's growth potential in a sustained way. Reinforcing productivity will crucially depend on structural measures at the microeconomic and institutional levels, including changes in product and labour markets as well as upgrading investments in human and physical capital. The analysis above leads to the identification of a number of budgetary policy challenges for Portugal in the years ahead.

On stabilisation: the overriding fiscal challenge is to put public finances on a sound track. Pressing ahead with consolidation is essential, because it is clear that fiscal problems go beyond a cyclical weakness: against the background of low potential growth in the coming years, fiscal consolidation is a prerequisite for macroeconomic stability in the medium term.

On efficiency: improving the efficiency of government expenditure can be instrumental to support higher productivity levels, thereby contributing to the potential growth of the wider economy. This would include an improvement of human and physical capital, for instance by addressing the effectiveness of education spending and carefully selecting public investment projects in the context of the Lisbon Strategy and the National Strategic Reference Framework, while maintaining firm control over public expenditure overall.

Finally, on sustainability: given the strong dynamism of old-age pension expenditure and the rising debt ratio described in section 2.4, ensuring the sustainability of public finances through the reduction of the high deficit and of the debt-to-GDP ratio is also essential to better accommodate the budgetary impact of an ageing population. Whereas recent measures can mitigate the risks to sustainability in the long-term, the projected budgetary cost of an ageing population is large.

Table 1: Key economic indicators

	PT						EUR-12					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96–'05	'96–'00	'01–'05				'96–'05	'96–'00	'01–'05			
Economic activity												
Real GDP (% change)	2.4	4.1	0.6	-1.1	1.2	0.4	2.1	2.7	1.4	0.8	2.0	1.4
Contributions to real GDP growth:												
Domestic demand	3.0	5.4	0.6	-2.4	2.4	0.8	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	-0.6	-1.3	0.1	1.2	-1.1	-0.4	0.1	0.1	0.1	-0.7	0.2	-0.2
Prices, costs and labour market												
HICP inflation (% change)	2.8	2.4	3.2	3.3	2.5	2.1	1.9	1.7	2.2	2.1	2.1	2.2
Labour productivity (% change)	1.2	2.2	0.3	-0.7	1.1	0.3	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	0.3	0.4	0.2	1.1	-1.4	0.1	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Employment (% change)	1.1	1.9	0.4	-0.4	0.1	0.0	1.2	1.5	0.9	0.7	0.7	0.8
Unemployment rate (% of labour force)	5.7	5.5	5.9	6.3	6.7	7.6	9.1	9.8	8.5	8.7	8.9	8.6
Competitiveness and external position												
Real effective exchange rate (% change) (1)	1.7	0.8	2.6	5.1	1.0	1.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	-2.1	-2.4	-1.7	-0.2	-3.1	-5.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s (% of GDP)	-8.7	-9.0	-8.4	-6.8	-8.0	-8.9	1.9	1.7	2.0	2.1	2.1	1.5
Public finances												
General government balance (% of GDP)	-3.6	-3.3	-3.9	-2.9	-3.2	-6.0	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	55.8	54.0	57.6	57.0	58.6	64.0	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-4.8	-4.8	-5.1	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
Financial indicators (4)												
Long term real interest rate (%) (5)	1.9	2.7	1.2	1.4	1.3	0.8	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% of GDP) (6)	59.7	45.6	73.8	73.9	78.5	84.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	76.3	62.6	90.0	91.9	90.0	94.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

More detailed tables summarising the economic performance of the country are included in Annex 4.

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source:

Commision services

3. MACROECONOMIC OUTLOOK

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, economic activity, potential output growth, the labour market, costs and prices and sectoral balances. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic 'good' or 'bad' times.

3.1. External assumptions

The external outlook behind the programme's macroeconomic scenario is in line with the Commission services' autumn 2006 economic forecasts until 2008. For the years 2009 and 2010, the exchange is assumed to remain constant and interest rates largely unchanged; at the same time, external demand is assumed to decelerate moderately to 6%, whereas oil prices follow a slightly downward trend reaching 63 and 60 USD in 2009 and 2010, respectively.

3.2. Economic activity

The macroeconomic scenario presented in the programme projects real GDP growth to pick up from 1.4% in 2006 to 1.8% in 2007, 2.4% in 2008 and eventually 3% in both 2009 and 2010 (see Table 1). The higher growth rates are assumed to be driven by a gradual expansion of domestic demand, with the external sector giving a positive, albeit declining, contribution to GDP growth. The cyclical conditions implied by the programme (as measured by the output gap calculated by 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 narrowing, up to the point of closing in 2010 (see Table 2).

The programme projections represent a marked departure from the trend observed in past years, notably since 2001: GDP growth is projected to improve from the subdued performance of this decade described in section 2, with the divergence from EU growth projected to end in 2008. In terms of demand components, exports are foreseen to become systematically more buoyant than before.

The programme growth assumptions for 2007 and 2008 are above the Commission services' autumn 2006 economic forecasts. Whereas both macroeconomic scenarios project a gradual recovery of economic activity, the latter foresees a milder expansion.

The growth pattern is assumed to be increasingly driven by domestic demand with exports playing also a very important role in the earlier part of the programme. Notably private investment is projected to expand briskly as from 2009. Private consumption is forecast to grow over the entire period at gradually higher rates, but systematically below GDP. Government consumption is targeted to decline in real terms throughout the programme period. The contribution of the external sector to GDP growth is expected to be positive but diminishing. Such pattern is the result of an acceleration of imports – in line with the domestic demand expansion – since exports are assumed to grow strongly every year – in fact, always in excess of the relevant external demand.

All in all, the programme's macroeconomic scenario seems to build on the assumption of a "virtuous" circle of economic growth, with the fast export growth that has been observed since mid-2005 being projected to persist in the future, which, with a time lag, would push domestic demand, which gradually takes over the role of driver of GDP growth in the medium-term.

Overall, the growth composition, i.e., the split between the *relative* contributions of domestic and net external demand to GDP growth, seems broadly plausible and does not differ markedly from the Commission services' autumn 2006 economic forecasts. However, the latter assumes more moderate growth rates for all private demand components. Indeed, there are arguments supporting a more cautious projection. First, even if exports grow at healthy pace in the coming years on the back of the good momentum of world trade and possibly benefit from some orientation of Portuguese producers to external markets in the light of subdued economic prospects at home, the programme projections seem to be on the high side. In particular, it seems difficult that exports can expand quickly enough to support the continued market share gains surmised in the programme in the light of the competitiveness situation described in section 2. Second, while a gradual recovery of domestic demand seems plausible, it will still be hampered by the high debt levels of both households and corporations and the subsequent need to consolidate balance sheets in view of possibly tighter financial conditions. In addition, a weak labour market and some slowdown in transfers may limit household income, and uncertainty on economic prospects may delay investment decisions.

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009	2010
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.2	1.4	1.5	1.8	1.7	2.4	3.0	3.0
Private consumption (% change)	1.1	1.0	1.3	1.3	1.4	2.0	2.3	2.4
Gross fixed capital formation (% change)	-2.6	-2.6	0.4	1.9	2.2	4.0	6.8	7.0
Exports of goods and services (% change)	7.9	8.6	5.4	7.2	5.5	6.8	7.0	7.2
Imports of goods and services (% change)	2.9	2.8	3.0	3.7	3.6	4.3	5.4	6.1
Contributions:								
- Final domestic demand	0.2	0.0	1.0	1.0	1.3	1.9	2.7	2.9
- Change in inventories	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	1.2	1.4	0.5	0.8	0.3	0.5	0.2	0.1
Output gap[1]	-2.0	-2.6	-1.8	-2.4	-1.5	-1.8	-0.7	0.2
Employment (% change)	0.6	0.9	0.6	1.0	0.7	1.2	1.5	1.5
Unemployment rate (%)	7.6	7.6	7.7	7.5	7.7	7.2	6.6	6.3
Labour productivity growth (%)	0.6	0.5	0.9	0.8	1.0	1.2	1.5	1.5
HICP inflation (%)	2.9	-	2.2	-	2.1	-	-	-
GDP deflator (% change)	2.2	2.3	2.1	2.6	2.3	2.6	2.6	2.6
Comp. of employees (per head; % change)	2.9	3.6	2.8	2.5	2.8	2.2	2.3	2.5
Real unit labour costs (% change)	0.1	0.8	-0.2	-1.0	-0.5	-1.6	-1.7	-1.6
External balance (% of GDP)	-7.4	-7.5	-7.3	-7.3	-7.0	-6.9	-6.3	-6.0

Note:

[1]In percent of potential GDP, with potential GDP growth as reported in Table 4 below.

Source:

Commission services' autumn 2006 economic forecasts (COM); Stability programme

The programme's growth assumptions imply improving cyclical conditions. The negative output gap as calculated by the Commission services' according to the commonly agreed methodology based on the information provided in the programme is projected to stay broadly unchanged in 2007 and to start narrowing thereafter. In 2008, the programme projections imply a faster narrowing of the output gap than the Commission services' autumn 2006 economic forecasts. In other words, the negative cyclical conditions may take more time to improve than projected in the programme[21].

Table 3 presents, for the period 2006-2008, the output gap estimates in the last three programme updates and in the last four Commission services economic forecasts exercises. The data presented therein point out that uncertainty of estimates of the output gap is an issue of some concern in the case of Portugal. Overall, the estimates from successive Commission services' forecast rounds would suggest a changing assessment of the cyclical conditions over time. However, despite these revisions, the Commission services' output gap estimates have remained clearly negative, thus suggesting that the qualitative conclusions on the current cyclical conditions has not changed fundamentally.

Table 3: Output gap estimates in successive Commission services' forecasts and stability programmes

	2006		**2007**		**2008**	
	COM	SP[1]	COM	SP[1]	COM	SP[1]
SP Dec 2006	-	-2.6		-2.4	-	-1.8
Autumn 2006	-2.0	-	-1.8	-	-1.5	-
Spring 2006	-2.2	-	-2.3	-	-	-
SP Nov 2005	-	-2.7	-	-2.5	-	-1.8
Autumn 2005	-2.4	-	-2.6	-	-	-
Spring 2005	-2.7	-	-	-	-	-
SP Jun. 2005	-	-2.8	-	-2.3	-	-1.6

Note:

[1] Commission services' calculations according to the commonly agreed method based on the information in the programme.

Source: Commission services' forecasts, national Stability programme and Commission services.

3.3. Potential growth and its determinants

Commission services' calculations on the programme data point to acceleration of potential GDP from 1½% in 2006 and 2007 to 1¾% in 2008 and 2009, and 2% by 2010 (see Table 4). TFP growth is the driver of this projected pattern, with increasing capital accumulation compensating a declining labour contribution in the outer years of the programme. Overall, the profile for potential GDP growth is systematically above that of the Commission services' autumn 2006 economic forecasts for the years 2006-2008, with the lower labour contribution in the Commission forecast explaining most of that difference.

It is interesting to note that, after lagging behind potential GDP since the year 2001, actual GDP is expected to be continuously in excess of potential in 2007 and beyond. In

[21] There is a sizeable difference between the programme's output gap levels as recalculated by the Commission services and those in the Commission services' autumn 2006 economic forecasts. (For example, for 2005 the difference was at ½% of GDP). This difference seems to be linked with higher potential output growth in the programme, coming from a stronger labour contribution.

particular, the growth assumption in the outer years of the programme are significantly above current estimates of potential output growth.

Table 4: Sources of potential output growth

	2006		2007		2008		2009	2010
	COM	SP[2]	COM	SP[2]	COM	SP[2]	SP[2]	SP[2]
Potential GDP growth[1]	1.2	1.5	1.2	1.6	1.4	1.8	1.8	2.0
Contributions:								
- Labour	0.3	0.5	0.2	0.5	0.2	0.5	0.2	0.1
- Capital accumulation	0.5	0.5	0.5	0.5	0.5	0.6	0.7	0.9
- TFP	0.4	0.4	0.5	0.5	0.6	0.7	0.8	0.9

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 2006 economic forecasts (COM); Commission services' calculations

3.4. Labour market developments

According to the programme, employment will increase with the upswing in economic activity, as revealed by higher GDP growth and a narrowing negative output gap. The unemployment rate will decline from 7½% in 2005-2007 to 7.2% in 2008 and further afterwards. Broadly one half of GDP growth is assumed to be linked to higher employment, with the other half being the result of augmented productivity, which seems to mimic the average composition of the past decade.

The programme's labour market outlook is more benign than the one presented in the Commission services' autumn 2006 economic forecasts. The difference seems to be mainly accounted for by smaller increases in economic activity in the Commission forecasts. In addition, it is possible that success in improving Portugal's competitive position would be associated with a stronger productivity content of GDP growth and consequently with milder employment gains in the short to medium term. Finally, a lagged response of employment to economic activity and a retrenchment of government employment are likely to limit the overall employment prospects.

3.5. Costs and price developments

After a hike in 2006, the programme projects consumer inflation to decline in 2007 to 2.2% and to stay at that level afterwards[22]. The jump in 2006 seems to have been a reflection of higher energy prices and the increase in the standard VAT rate from 19 to 21% in July 2005. Looking forward, lower import price growth is assumed to be important in keeping inflation stable in 2008 and beyond. Additionally, the programme's scenario builds on the assumption of some profit margin squeezing to contain price pressures. The projected price developments are close to the ones in the Commission services' autumn 2006 economic forecasts for the years 2007 and 2008. An exception is

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

the GDP deflator projection for 2007, which is 0.5 percentage points higher in the programme, apparently due to a higher investment deflator.

Wage growth is expected to slow down in 2007 and 2008 from a high growth in 2006, and is expected to be slightly higher in the outer years of the programme. In real terms, the wage growth presented in the programme remains between neutral and slightly positive and below labour productivity growth. Such assumptions are below those in the Commission services' autumn 2006 economic forecasts, in particular for 2008. To some extent, the programme seems to assume a stronger reaction of wages to the persistence of high unemployment levels than the one that has been observed. On this respect, it could be that very recent changes in unemployment benefit legislation, going in the direction of tighter eligibility requirements, exert some downward pressure on reservation wages.

3.6. Sectoral balances

The macroeconomic scenario of the stability programme update implies a small improvement of the sizeable external deficit. Net borrowing vis-à-vis the rest of the world is expected to decline from -7.5% of GDP in 2006 to -6% of GDP in 2010 thanks to a reduction of the goods and services deficit from -8% of GDP in 2006 to -4.6% of GDP in 2010, in line with the assumed trade developments. However, such improvement is offset by a deterioration in the balance of primary income, linked to the service of the rising external debt, and falling transfers, with EU transfers playing a role. The projected developments in 2007 and 2008 are similar to those in the Commission services' autumn 2006 economic forecasts.

Taking into account the planned improvement in the government balance, the net borrowing position of the private sector as a whole should deteriorate over the programme period from -2.9% of GDP in 2006 to -5.7% of GDP in 2010. Such a deterioration seems to be broadly consistent with the domestic demand upswing assumed in the programme. Nonetheless, in the light of the already high private sector debt levels, the projected continued borrowing supports the assessment presented in subsection 3.2 about the strength of the domestic demand expansion foreseen in the programme.

3.7. Assessment

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic 'good' or 'bad' times.

3.7.1. Plausibility of the macroeconomic scenario

The programme's macroeconomic scenario assumes real GDP growth to pick up from 1.4% in 2006 to 1.8% and 2.4% in 2007 and 2008, respectively, and to eventually 3% in 2009 and 2010. The programme scenario represents a marked departure from the trend observed in past years, as GDP growth is expected to improve from the subdued performance of previous years. 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 output gap narrowing in every year, and more markedly in the final years of the programme.

The assessment in previous sections highlights risks to the programme's macroeconomic scenario. The programme growth assumptions for 2007 and 2008 are above the

Commission services' autumn 2006 economic forecasts, with the latter foreseeing a slower recovery of both domestic demand and exports. For 2009 and 2010, the programme assumes GDP growth well in excess of potential. Regarding GDP components, the assumption of increasing export market shares seems optimistic against the current shape of Portugal's competitive position. At the same time, the improvement in domestic demand may be milder than assumed in the programme, particularly in view of the need of balance sheet consolidation. To sum up, on the grounds of current information, the update's macroeconomic scenario seems to build on favourable GDP growth assumptions, notably in the outer years, with the underlying growth composition being broadly plausible.

Inflation is expected to stabilize as from 2007 and the labour market to improve gradually. The risks to the former projections seem balanced but the latter projections face some negative risks.

3.7.2. Economic good vs. bad times

According to the Commission services' autumn 2006 economic forecasts, the output gap has been negative at 2% of potential GDP in 2005 and 2006 and will slightly narrow in 2007 and 2008 to 1¾% and 1½%, respectively. As underscored in subsection 3.2, the Commission services' output gaps estimates have been revised downward over the last forecast exercises, but without resulting in a change in the qualitative assessment of negative cyclical conditions. Consequently, Portugal can be considered to be in bad economic times.

4. General government balance

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new update, including the programme's medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2006

The December 2005 update of the stability programme targeted a marked reduction of the general government deficit from 6% of GDP in 2005 to 4.6% of GDP in 2006 (see Table 5). That deficit estimate has been confirmed in the December 2006 update and coincides with the Commission services' autumn 2006 economic forecasts.

Both government revenue and expenditure ratios of the December 2006 programme are some 0.7% of GDP lower than those in the December 2005 update. The apparent overachievement was due to a more favourable denominator effect, because the GDP series was revised in early 2006 resulting in an upward shift of the GDP level by about 1½%[23]. In absolute terms, both total government revenue and expenditure outturns projected in December 2006 were very close to the plans of one year earlier, with growth rates of 3½% and ½%, respectively, yet the 2005 outturns were both somewhat higher than estimated in the December 2005 update by almost 0.9% of GDP.

Regarding the budgetary improvement from 2005, when the deficit jumped to 6% of GDP, the December 2006 programme reveals an adjustment composition different from the one outlined one year earlier. The December 2005 programme targeted a larger contribution of revenues (almost 1% of GDP higher in 2006) and a smaller one from the spending side (½% of GDP). However, the December 2006 programme estimated a revenue-to-GDP ratio unchanged from the 2005 outturn, with the whole improvement of 1.4% of GDP being achieved thanks to expenditure containment. Such difference seems to be associated mainly with downward revisions by 0.6% of GDP of both "other revenue" and "other expenditure" items. Also taxes on production and imports rendered a smaller contribution (0.3% of GDP below plans) while, on the spending side, subsidies helped the government balance (lower by 0.3% compared with original projection)[24].

Recent and preliminary cash statistics indicate a budgetary execution of the State sub-sector better than budgeted, mainly due to higher-than-forecast non-fiscal revenue and also lower-than-budgeted capital expenditure. In other government levels, there is no evidence of sharp deviations from plans for the first three quarters of the year.

---

[23] This revision was due to a change in the accounting treatment of FISIM.

[24] It should be noted also that the earmarking of part of VAT receipts to the civil servants' pension scheme (*CGA*) as from July 2005 (1% out of a 21% standard tax rate) has led to the reduction in social contribution paid by the State to *CGA*. Without this earmarking, both the government expenditure and revenue ratios would be higher by some 0.3% of GDP in 2006, after an impact of 0.1% in 2005 (and thus would have no impact on the general government balance).

Table 5: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009	2010
General government balance (% of GDP)	**SP Dec 2006**	-6.0	-4.6	-3.7	-2.6	-1.5	-0.4
	SP Dec 2005	-6.0	-4.6	-3.7	-2.6	-1.5	n.a.
	SP Jun 2005	-6.2	-4.8	-3.9	-2.8	-1.6	n.a.
	COM Nov 2006	-6.0	-4.6	-4.0	-3.9	n.a.	n.a.
General government expenditure (% of GDP)	**SP Dec 2006**	47.8	46.3	45.4	44.0	42.7	41.5
	SP Dec 2005	47.4	47.0	46.1	45.1	43.9	n.a.
	SP Jun 2005	49.1	48.7	48.0	47.1	46.0	n.a.
	COM Nov 2006	47.8	47.1	46.6	46.4	n.a.	n.a.
General government revenues (% of GDP)	**SP Dec 2006**	41.7	41.7	41.7	41.4	41.2	41.1
	SP Dec 2005	41.4	42.3	42.4	42.5	42.4	n.a.
	SP Jun 2005	42.9	43.9	44.1	44.3	44.5	n.a.
	COM Nov 2006	41.7	42.5	42.5	42.5	n.a.	n.a.
Real GDP (% change)	**SP Dec 2006**	0.4	1.4	1.8	2.4	3.0	3.0
	SP Dec 2005	0.5	1.1	1.8	2.4	3.0	n.a.
	SP Jun 2005	0.8	1.4	2.2	2.6	3.0	n.a.
	COM Nov 2006	0.4	1.2	1.5	1.7	n.a.	n.a.

Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM)

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 imbalances, notably at a reduction of the general government deficit to below the 3% of GDP reference value in the year 2008 and the pursuit of 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 each of the coming four years. Other goals are to reach the MTO of a deficit of 0.5% of GDP in 2010 (see sub-section 4.2.3 below) and to reinforce the long-term sustainability of public finances (see section 5.2 below).

The programme outlines considerable consolidation efforts over its entire period. After an estimated general government deficit of 4.6% of GDP in 2006, the budgetary deficit is targeted to decline gradually to 3.7% of GDP in 2007, 2.6% in 2008, 1.5% in 2009, and eventually 0.4% of GDP in 2010 (see Tables 5 and 6). Therefore, an average annual reduction of the deficit by about 1 percentage point until the end of the decade is targeted, resulting in a cumulative cut in the general government deficit by more than 4 percentage points between 2006 and 2010. The adjustment path for the primary balance is similar, with an improvement from a deficit of 1.7% of GDP in 2006 and of 0.7% of GDP in 2007 to a surplus thereafter that is projected to reach 2.5% of GDP at the end of the programme period (see Table 6).

The December 2006 update fully confirms the planned adjustment of the fiscal balance outlined in the December 2005 programme, in both nominal and structural terms, against a largely unchanged macroeconomic scenario.

Table 6: Composition of the budgetary adjustment

(% GDP)	2005	2006	2007	2008	2009	2010	Change: 2010-2006
Revenues	41.7	41.7	41.7	41.4	41.2	41.1	**-0.5**
of which:							
- Taxes & social contributions	36.3	36.6	36.9	36.8	36.8	36.7	**0.1**
- Other (residual)	5.5	5.0	4.8	4.5	4.5	4.5	**-0.6**
Expenditure	47.8	46.3	45.4	44.0	42.7	41.5	**-4.7**
of which:							
- Primary expenditure	45.0	43.4	42.4	41.0	39.7	38.6	**-4.7**
of which:							
Collective consumption	8.3	8.0	7.6	7.3	7.0	6.7	**-1.3**
Social transfers in kind	13.0	12.7	12.1	11.6	11.1	10.7	**-2**
Social benefits other than in kind	14.9	15.0	15.0	14.8	14.5	14.2	**-0.8**
Subsidies	1.6	1.2	1.1	0.9	0.9	0.8	**-0.4**
Gross fixed capital formation	2.8	2.5	2.3	2.3	2.4	2.6	**0.1**
Other (residual)	4.4	4.1	4.3	4.1	3.9	3.8	**-0.3**
- Interest expenditure	2.7	2.9	3.0	3.0	3.0	2.9	**0.0**
General government balance (GGB)	**-6.0**	**-4.6**	**-3.7**	**-2.6**	**-1.5**	**-0.4**	**4.2**
Primary balance	**-3.3**	**-1.7**	**-0.7**	**0.4**	**1.5**	**2.5**	**4.2**
One-offs[1]	0.0	0.0	0.0	0.0	0.0	0.0	
GGB excl. one-offs	**-6.0**	**-4.6**	**-3.7**	**-2.6**	**-1.5**	**-0.4**	**4.2**

Note:
[1]One-off and other temporary measures.

Source:
Stability programme update; Commission services' calculations

Box 1: The excessive deficit procedure for Portugal

According to the excessive deficit procedure (EDP), the Commission and the Council monitor the development of the budgetary position in each Member State, notably in relation to the reference values of 3% of GDP for the deficit and 60% of GDP for the debt, in order to assess the existence (or risk) of an excessive deficit and to ensure its correction. The EDP is laid down in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.

On 20 September 2005, the Council adopted a decision stating that Portugal had an excessive deficit in accordance with Article 104(6). At the same time, 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, followed by a further decrease of, at least, ¾% of GDP in both 2007 and 2008. At the same time, Portugal was invited to rapidly 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.

After the expiry of the 6-months deadline established by the Council for the Portuguese government to take effective action in order to achieve the 2006 deficit target, the Commission carried out an assessment of the efforts made by the Portuguese authorities. The conclusions of the Commission communication adopted on 22 June 2006 were as follows: "On current information, it appears that Portugal has taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council" and that no further steps in the excessive deficit procedure of Portugal were necessary.

In particular, the Commission concluded that Portugal: "has achieved a general government deficit outturn in 2005 in line with plans; has adopted a comprehensive package of corrective measures since mid-2005, including in the 2006 budget law, which, if fully implemented and effective, would achieve a reduction in 2006 of the cyclically-adjusted deficit, excluding one-off and other temporary measures, that is in line with the Council recommendation; has set a nominal government deficit target of below 3% for 2008 and plans to gradually decrease the cyclically-adjusted deficit for the years 2007-2008, excluding one-off and other temporary measures, in line with the Council recommendation; has implemented or initiated a number of measures of a permanent nature aiming to contain and reduce expenditure, and has kept the announced fiscal targets despite a more cautious re-assessment of GDP growth prospects; plans to bring the government gross debt ratio onto a declining path as from 2008 by means of the envisaged return to primary surpluses, the inflow of large proceeds from privatisation and the scaling back of debt-increasing financial operations; has improved the quality of general government data."

In its communication, the Commission emphasised that "the correction of the excessive deficit by the 2008 deadline and the reduction in the debt ratio are subject to significant risks and uncertainties. Particularly, (…) the achievement of the deficit targets for 2007 and beyond crucially rely upon a quick translation into legislation and an effective implementation of all the announced corrective measures." In its meeting of 11 July 2006, the Council concurred with the assessment in the Commission communication of June 2006.

4.2.2. The composition of the budgetary adjustment

The planned deficit reduction is to be achieved by curbing expenditure, on the back of corrective structural measures and helped by gradually higher economic growth. Total revenue is planned to stay constant as a share of GDP in the earlier part of the programme and to marginally decline as from 2008.

Primary expenditure restraint is targeted to give an increasing contribution to fiscal consolidation. According to the programme, in 2007, primary expenditure will decline, in terms of GDP, by around 1 percentage point compared with 2006, and in the following years its importance in terms of GDP will decrease by an average of some 1¼ percentage points per year until the programme horizon, yielding a total reduction of the primary expenditure ratio of about 4¾ percentage points over the entire period (see Table 6). All primary expenditure categories seem to contribute towards consolidation, with the reductions in social transfers in kind and collective consumption being the most sizeable. In order to achieve this, primary expenditure levels would need to decline in real terms in every year, with the strongest drag being in 2008 by 1%.

The envisaged expenditure restraint is planned to come from measures of a permanent nature, which concentrate on public administration and social security (see Box 2).

Against a scenario of unchanged policies at the end of 2006, public administration reform would yield a deficit-reducing impact of 1.4% of GDP by 2010 (1.1% of GDP by 2008; see Box 2). The main policy measures in this area include the ongoing reform of the State's central administration (*PRACE*), which is intended to result in an overhaul of central government structures; the re-shaping of the education, security, health and justice networks, resulting in the closure of various services; new career and pay scales and evaluation schemes for civil servants; staff reductions – on the basis of an only partial replacement of workers that leave the government, with only one recruitment for every two departures, on average; mobility schemes for civil servants that can be associated with wage cuts for those found redundant; and changes in a number of social benefits for civil servants. In terms of fiscal impact, the programme plans measures linked to personnel expenditure to yield savings of 0.9% of GDP by 2010 and those related to efficiency gains of 0.5% of GDP.

Containment of expenditure in social security would help consolidation in the order of 0.8% of GDP over the programme period (0.5% of GDP by 2008). In this respect, the reform of the old-age pension scheme for the private sector workers enacted in January 2007 is foreseen to cushion the pressure on spending coming from a quick maturing of pension schemes as revealed by the significant growth in the number of pensioners and average pension due to the longer career contribution of new retirees and also policy changes regarding entitlements. Moreover, the impact of the reform of the pension scheme for civil servants enacted in 2005 is incorporated in the programme and will have effects lagged over the coming years, yielding most of the savings in this area.

Some additional expenditure restraint is projected to come from measures in the area of health, in particular medicaments co-payments and purchases, and from lower spending on some private-public partnerships for the construction and exploitation of motorways by the introduction of tolls therein.

The pattern of current primary expenditure is planned to be similar to that of overall current expenditure, as interest expenditure is expected to stay broadly constant in terms of GDP over the programme period. At the same time, public investment as a share of GDP is projected to decline temporarily by ¼ percentage point in 2007, but to return to its 2006 level by the programme horizon.

The revenue side will be neutral for budgetary consolidation in the earlier years of the programme and slightly drag down public finances as from 2008: overall, the revenue ratio will remain constant in the period 2005-2007 and decline by ½ percentage point thereafter. The decline is caused almost entirely by a reduction in other revenues, while the tax burden is forecast to be constant after 2007. In 2007, fiscal revenues will further edge up thanks to the progressive increase in taxes on petroleum products and tobacco, the cuts on tax allowances and deductions, notably on personal income tax, and also improved compliance with tax codes. However, this increase of the tax burden will be offset by lower capital transfers and imputed social contributions.

Box 2: The budget for 2007 and main consolidation measures in the stability programme

The budget for 2007 was presented on 16 October 2006 and approved by Parliament on 30 November. The budget largely builds upon the fiscal strategy outlined in the December 2005 update of the stability programme and targets a general government deficit of 3.7% of GDP in 2007. The bill's macroeconomic scenario coincides with the one in the December 2006 update of the stability programme.

Current revenue is targeted to increase by 5.7% compared with its 2006 estimated outturn. The fastest growth rates are forecast to occur in effective social contributions and direct taxes, which are forecast to be partly helped by the lagged effects of increases in rates and cuts on tax credits enacted in the 2006 budget. Examples of measures on the revenue side in the bill are increases in excise taxes on petroleum products and tobacco; a revision of tax benefits for disabled citizens; an increase in health insurance contributions for civil servants; and a further lowering of allowances for income from pensions.

On the expenditure side, the budget bill targets total expenditure to grow by 2.6% in nominal terms in 2007. Examples of measures included in the budget are nominal cuts in the expenditure plans (on a cash basis) of various ministries (e.g., Education) or near freeze in others (e.g., Health); a freeze in nominal transfers from central to local governments; and a freeze in automatic promotions for government employees.

The December 2006 stability programme update provides estimates of the direct impact of the main consolidation measures on government finances. The figures in the table below provide an indication of the additional revenues or expenditure savings in comparison with the end-2006 situation in the absence of fiscal consolidation (i.e., with the consideration of a trend increase of pension and personnel expenditure, in terms of GDP).

		2007	2008	2009	2010
REVENUE INCREASE			% of GDP		
Taxes		0.32	0.54	0.54	0.5
Taxes on income and wealth		0.17	0.24	0.24	0.24
VAT		0.00	0.01	0.01	0.01
ISP- Tax on oil products (beyond the annual increase to compensate for inflation		0.09	0.17	0.12	0.08
Tax on tobacco products		0.06	0.12	0.18	0.17
Social Security Contributions		0.08	0.12	0.13	0.14
Diversification of Funding Sources		0.04	0.04	0.04	0.04
Combat of Contributory Fraud and Evasion		0.04	0.08	0.09	0.09
Contributions To Healthcare sub-systems		0.06	0.07	0.07	0.07
Total of revenue increase	1	0.46	0.73	0.76	0.70
EXPENDITURE REDUCTION					
Restructuring Central Government, Human Resources and Public Services		0.87	1.07	1.24	1.39
Personnel Expenditure		0.61	0.72	0.82	0.89
Efficiency Gains		0.26	0.35	0.43	0.49
Curbing Social Security Expenditure		0.21	0.51	0.69	0.77
General Social Security Scheme		0.04	0.11	0.21	0.24
Improving the Efficiency and Combating Fraud of the Social Security System		0.01	0.02	0.02	0.01
Caixa Geral de Aposentacoes (CGA) - measures planned in 2005		0.15	0.36	0.44	0.50
CGA - incorporation of the principles of Social Security reform		0.00	0.02	0.02	0.02
Curbing Healthcare Expenditure		0.11	0.11	0.10	0.10
Medicaments co-payment policy		0.07	0.07	0.07	0.07
Procurement Agreements		0.02	0.02	0.02	0.02
Purchase of pharmaceutical products and clinical materials (NHS)		0.02	0.02	0.02	0.01
Revenue from the installation of tolls on SCUT motorways		0.02	0.07	0.07	0.07
Total of revenue increase	2	1.21	1.76	2.11	2.33
TOTAL DIRECT SAVING (attributable to these measures)	1+2	1.67	2.48	2.87	3.04
CUMULATIVE DEFICIT REDUCTION (from 2006)		0.9	2.0	3.1	4.2

Source:
Stability programme

4.2.3. The medium-term objective (MTO) and the structural adjustment

The December 2006 update confirms the medium term objective (MTO) of a budgetary deficit of 0.5% of GDP in structural terms (i.e. cyclically-adjusted and net of one-off and other temporary measures), which was set in the December 2005 update. According to the most recent update, the MTO will be achieved by 2010, whereas the previous update implicitly planned to reach it after that year.

Box 3: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific 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 MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct 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 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

The MTO indicated in the programme is at an appropriate level. It is more demanding than the "minimum benchmark", i.e. the estimated budgetary position in cyclically-adjusted terms that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value, thus its achievement should provide a safety margin against the (re-)occurrence of an excessive deficit. In the case of Portugal, the benchmark is currently estimated at a deficit of around 1½% of GDP. At the same time, the MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct. Finally, the MTO adequately reflects the debt ratio and average potential growth in the long run.

Based on Commission services' calculations on the basis of the programme and according to the commonly agreed methodology, the structural balance is projected to improve from some -3½% of GDP in 2006 to around -½% of GDP by the end of the programme period, i.e., 2010 (see Table 7).

A continued fiscal effort, as measured by the annual change in the structural balance, is planned over the programme period. The targeted annual improvements are of around ¾ percentage points in both 2007 and 2008 and marginally less in the subsequent years. Between end-2006 and 2010, the cumulative improvement in the structural balance is foreseen to be of some three percentage points (see Table 7). The developments on the structural primary balance will be similar given the very small variations of interest expenditure in terms of GDP. The planned consolidation efforts will take place against the backdrop of negative yet improving cyclical conditions as measured by a narrowing (negative) output gap. Overall, the planned fiscal stance is restrictive over the update period.

Table 7: Output gaps and cyclically-adjusted and structural balances

% of GDP	2005		2006		2007		2008		2009	2010	Change: 2010-2006
	COM	SP[1]	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]	SP[1]
Gen. gov't balance	-6.0	-6.0	-4.6	-4.6	-4.0	-3.7	-3.9	-2.6	-1.5	-0.4	4.2
One-offs[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-
Output gap[3]	-2.0	-2.5	-2.0	-2.6	-1.8	-2.4	-1.5	-1.8	-0.7	0.2	2.8
CAB[4]	-5.1	-4.9	-3.7	-3.4	-3.2	-2.6	-3.2	-1.8	-1.2	-0.5	3.0
change in CAB	*-2.5*	*-2.4*	*1.4*	*1.5*	*0.5*	*0.8*	*0.0*	*0.8*	*0.1*	*0.1*	-
CAPB[4]	-2.4	-2.2	-0.8	-0.6	-0.2	0.4	0.0	1.2	1.8	2.4	3.0
Structural balance[5]	-5.1	-4.9	-3.7	-3.4	-3.2	-2.6	-3.2	-1.8	-1.2	-0.5	3.0
change in struct. bal.	*-0.4*	*-0.3*	*1.4*	*1.5*	*0.5*	*0.8*	*0.0*	*0.9*	*0.6*	*0.7*	-
Struct. prim. bal.[5]	-2.4	-2.2	-0.8	-0.6	-0.2	0.4	0.0	1.2	1.8	2.4	3.0

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.

[3]In percent of potential GDP. See Table 2 above.

[4]CA(P)B = cyclically-adjusted (primary) balance.

[5]Structural (primary) balance = CA(P)B excluding one-offs and other temporary measures.

Source:
Commission services' autumn 2006 economic forecasts (COM); Stability programme update; Commission services' calculations

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2008, Table 8 compares the detailed revenue and expenditure projections in the Commission services' autumn 2006 economic forecasts, which are derived under a no-policy change scenario, with those in the updated programme.

As highlighted in section 3, the growth assumptions are favourable, notably in the outer years. This constitutes a negative risk, as economic growth in the medium term may turn out weaker than assumed in the programme and thus provide more limited help to government finances.

The risks stemming from possibly worse-than-expected macroeconomic developments are exemplified by the results of sensitivity analysis. The programme includes a sensitivity analysis of its main variables with respect to changes in oil prices. In particular, it assumes that oil prices are higher (lower) by 20% and external demand growth is lower (higher) than in the baseline scenario. Compared with the latter, that hike would decrease GDP growth by 0.2 percentage points in 2007 and 2008 (0.1 afterwards) and would worsen the government deficit by ¼ percentage points in 2007 and 2008, and 0.4 in 2009 and 2010. The government debt ratio would increase by two percentage points by 2010. Lower oil prices would have symmetric effects. In addition, Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point downward deviation from the real GDP growth projections in the programme over the 2006-2010 period; (ii) trend output based on the HP-filter; and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that the cyclically-adjusted balance is ¾ percentage point of GDP below that of the central scenario by 2010. Hence, in the case of persistently lower real growth, additional measures of around ¾ percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.[25]

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2005	2006		2007		2008		2009	2010
		COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenues	41.7	42.5	41.7	42.5	41.7	42.5	41.4	41.2	41.1
of which:									
- Taxes & social contributions	36.3	36.8	36.6	37.0	36.9	37.0	36.8	36.8	36.7
- Other (residual)	5.4	5.7	5.0	5.6	4.8	5.5	4.5	4.5	4.5
Expenditure	47.8	47.1	46.3	46.6	45.4	46.4	44.0	42.7	41.5
of which:									
- Primary expenditure	45.0	44.3	43.4	43.6	42.4	43.3	41.0	39.7	38.6
of which:									
Collective consumption	8.3	8.2	8.0	8.0	7.6	7.8	7.3	7.0	6.7
Social transfers in kind	13.0	12.6	12.7	12.2	12.1	11.9	11.6	11.1	10.7
Social benefits other than in kind	14.9	15.4	15.0	15.6	15.0	15.7	14.8	14.5	14.2
Gross fixed capital formation	2.8	2.5	2.5	2.3	2.3	2.3	2.3	2.4	2.6
Other (residual)	6.0	5.6	5.2	5.5	5.4	5.5	5.0	4.7	4.4
- Interest expenditure	2.7	2.9	2.9	3.0	3.0	3.2	3.0	3.0	2.9
GGB	-6.0	-4.6	-4.6	-4.0	-3.7	-3.9	-2.6	-1.5	-0.4
Primary balance	-3.3	-1.7	-1.7	-1.0	-0.7	-0.7	0.4	1.5	2.5
One-offs[2]	0.0	0.0	-	0.0	-	0.0	-	-	-
GGB excl. one-offs	-6.0	-4.6	-	-4.0	-	-3.9	-	-	-

Notes:

[1]On a no-policy change basis.

[2]One-offs and other temporary measures.

Source:

Commission services' autumn 2006 economic forecast (COM); Stability programme update (SP); Commission services' calculations

25 The programme includes also a sensitivity analysis with respect to the interest rates assumptions: either one percentage point higher than in the programme scenario or remaining at their current levels. Higher interest rates would have a detrimental impact on GDP in 2007 of 0.4 percentage points. The effects on the government balance and debt would be more severe: the deficit would deteriorate by 0.4 percentage points in 2007 and 2008 and 0.5 in 2009 and 2010. The debt ratio would deviate from plans by 2 percentage points by 2010. A stabilization of interest rates at their current levels would have minor budgetary impacts.

The ambitious budgetary consolidation outlined in the December 2006 stability programme update crucially hinges upon a medium-term plan to curb expenditure growth. As described in the subsection 4.2.2, this plan includes sizeable fiscal consolidation measures of a structural nature, which should support the envisaged adjustment, with most of the consolidation efforts being concentrated in the areas of public administration and social security. However, as the corrective measures outlined in the programme have been either implemented recently or not yet adopted, the potential savings stemming from those corrective efforts are subject to significant uncertainty, particularly in the first of those two areas.

In the area of social security, reforms of old-age pension schemes have been enacted. In January 2006, significant changes to civil servants' pension schemes entered into force, with the gist of those changes being the convergence towards the private-sector old-age pension scheme. In late 2006, a reform of the private-sector workers old-age pension scheme was enacted with a view to being implemented as from January 2007.

In the area of public administration, which is expected to be the main contributor to expenditure savings with a cumulative contribution of 1.1% of GDP in 2008 and 1.4% of GDP in 2010 (see Box 2), important steps have been taken, for instance in designing the new structures of Central Government services – which ought to reduce the number of services by about a ¼ –; in closing a considerable number of services in the areas of education, health and justice; the adoption of legislation for staff mobility; or the presentation of advanced proposals for new pay, career and employment schemes for government employees.

Yet critical steps in the definition and implementation of policies in the public administration area lay still ahead, particularly in 2007. Therefore, uncertainty remains on the budgetary savings that can be rendered by these efforts on both their amount as well as the timing of their realisation. The risk is magnified by the fact that the achievement of some of those savings builds also on marked changes in personnel management, which may face opposition. In particular, the de facto implementation of the new structures for Central Government services under PRACE, which is expected to render substantial savings at the levels of efficiency gains and personnel expenditure, is, according to the programme, due to take place in the course of the current year.

Overall, there is a heightened concern about the achievement of the targeted expenditure savings against a backdrop of steady increases in government spending in terms of GDP, which has been a driver of the persistent fiscal imbalances in recent years. This is all the more so as the low-growth environment implies that the reduction in the expenditure ratio can only be achieved through continued annual reductions in expenditure in real terms.

At the same time, achieving the planned savings is conditional on maintaining the recent compliance with fiscal targets throughout the medium-term. In this respect, a successful containment will rely also on the progress on the ongoing improvement of the budgetary framework. An effective use of the outlined mechanisms of monitoring, controlling and reporting budgetary execution would be instrumental to the achievement of the budgetary targets by imposing strict fiscal discipline across all the general government levels.

The assumptions about the elasticity of tax revenues to economic activity appear skewed to the high side in 2007 and dependent on the hikes of some tax and contribution rates as well as further gains in tax collection efficiency, as described before[26]. For the rest of the programme period, however, those assumptions are balanced and consequently may not pose significant budgetary risks. Regarding the impact of GDP growth composition on taxes, the programme projections seem to be neutral, if not cautious (see Table 9). Indeed, since in recent years tax elasticities in Portugal have been above their long-term average, even after taking into account the impact of some discretionary measures, a quick reversal to its average cannot be excluded. If elasticities would return to their long-term averages quicker than anticipated, future fiscal tightening would need to be to be stricter than planned[27].

Finally, over the medium term, a factor that may put pressure on government finances is the results of public or government-owned enterprises. They have been accumulating significant losses, which are a risk to fiscal stability over the medium term because the government might, at some stage, have to bail out loss-making enterprises. In other words, those losses could constitute hidden quasi-fiscal deficits (see Box 4).

To sum up, the assessment of the stability programme highlights that there are risks that the budgetary outcomes could be worse than projected in the programme. A major risk arises from the expenditure side and is linked with the rigour and timeliness of the implementation of all the announced corrective measures. Additionally, lower-than-projected GDP growth can put the achievement of the fiscal targets at risk, particularly in the outer years of the programme. Revenue projections seem on the whole plausible, although optimistic in 2007.

---

[26] A more detailed assessment by major tax category is provided in Annex 5.

[27] See also Box 5 for more detail on tax revenue developments in Portugal in the past decade.

Table 9: Assessment of tax projections

	2007			2008			2009	2010
	SP	COM	OECD[3]	SP	COM[1]	OECD[3]	SP	SP
Change in tax-to-GDP ratio (total taxes)	0.3	0.1	0.1	-0.1	0.0	0.1	0.0	-0.1
Difference (SP – COM)	0.2		/	-0.1		/	/	/
of which[2]:								
- discretionary and elasticity component	0.4		/	0.1		/	/	/
- composition component	-0.2		/	-0.2		/	/	/
Difference (COM - OECD)	/	0.0		/	-0.1		/	/
of which[2]:								
- discretionary and elasticity component	/	0.1		/	0.1		/	/
- composition component	/	0.0		/	-0.1		/	/
p.m.: Elasticity to GDP	1.2	1.1	1.1	0.9	1.0	1.1	1.0	0.9

Notes:

[1]On a no-policy change basis.

[2]The decomposition is explained in Annex 5.

[3]OECD ex-ante elasticity relative to GDP.

Source:

Commission services' autumn 2006 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)

Box 4: Fiscal surveillance and public enterprises

The public finances accounts that are the subject of surveillance under the provisions of the Treaty and the Stability and Growth Pact (SGP) are those of general government, compiled by the national statistical institutes and published by Eurostat according to the ESA95 rules. However, a number of other indicators and issues need to be taken into account for an encompassing and effective fiscal surveillance. This box raises the importance of considering the public enterprises' financial situation in the assessment of fiscal discipline and refers to a number of relevant indicators for Portugal.

A number of public enterprises in several EU Member States require financial support from government to survive. In many cases, this leads to a continuous flow of government expenditure. On other occasions, public enterprises are able to accumulate large losses for several years before the government intervenes. Indeed, financial markets may keep financing loss-making public enterprises for long periods, as their liabilities benefit from explicit or implicit state guarantees.

According to ESA95, public enterprises are generally classified in the corporate sector and not in general government. General government is defined in ESA95 on a functional basis, which does not follow control and ownership considerations. According to the accounting rules, government-controlled enterprises that are able to finance at least 50% of their operating costs with market resources (i.e. revenue from sales) are classified in the corporate sector. It should be noted that this criterion does not ensure that units classified in the corporate sector are profitable or economically viable. According to the ESA95 rules, the losses of public enterprises (or more precisely of public enterprises classified in the corporate sector) have no direct impact on the government deficit until there is a direct and effective government intervention, such as a capital injection or a debt assumption. Therefore, in the presence of structural loss-making public enterprises, the government accounts may convey an imprecise picture of the real situation. Public enterprises' losses might be characterised a hidden deficits and constitute a risk for sound public finances that government accounts fail to identify.

Notwithstanding several privatisations carried in Portugal over the last two decades* public enterprises still amount to a substantial part of the national economy. More than one hundred enterprises are directly owned and controlled by the State. Since 2001, the gross value added of those companies has fluctuated between 4% and 5½% of GDP. Moreover, one would have to add several other companies that are controlled indirectly through holdings or belong to regional and local governments. The state-owned enterprises cover a wide range of sectors ranging from the financial sector to transports, utilities, industry, information and broadcasting, healthcare and management of infrastructure.

The performance of Portuguese public enterprises varies widely. However many of them have been structural loss-makers. From 2001 to 2005, the losses of non-financial State-owned enterprises have been between 0.3% and 0.7% of GDP, per year. The quoted figures are net, i.e., they correspond to the aggregation of profits and losses of many different companies. [**] Some of these loss-making enterprises may not be viable without continuous State support, and have constituted a drain of public resources.

Payments from the government to these enterprises, in the form of capital injections, subsidies for the performance of public services obligations, loans and debt assumptions, amounted to 0.8% and 0.6% of GDP, respectively in 2004 and 2005. While debt assumptions and subsidies are recorded as government expenditure and contribute to the government deficit, loans and most capital injections have been recorded below the line, that is without a direct impact on the government deficit. As a comparison dividends paid to the State – including those by financial companies and the central bank – amounted to 0.3% in 2004 and 0.1% of GDP in 2005.

In spite of regular and large payments by the State, debts of non-financial State-owned companies to banks, bondholders and suppliers of goods and services amounted at the end of 2005 to 15% of GDP, one percentage point more than in 2004. Most of these liabilities are owed by companies operating in the sectors of transport and related infrastructures. These are also the companies that have recorded the largest losses. Liabilities by public enterprises benefiting from explicit State guarantees amounted to 5.3% of GDP at the end of 2005. However, one should note that most of these guarantees are never called – less than 0.2% of those guarantees were called in 2005.

The publication of detailed information on the financial situation of public enterprises contributes to the transparency of the wider public sector and to the assessment of the risks that public enterprises entail to public finances: most data quoted in this box come from the report "*Sector Empresarial do Estado–Relatório de Julho 2006*" [***] published by the Ministry of Finance and Public Administration. The inclusion of information on the financial situation of public enterprises in the stability and convergence programmes would contribute to the quality of the EU fiscal surveillance.

[*] From 1987 to 2006, privatisations receipts amounted to close 28% of GDP (this figure is the sum of the privatisation-to-GDP ratios for each year from 1987 to 2006). Portugal was one of the OECD countries were privatisation proceeds reached the largest amounts over the latest two decades.
[**] Weighted by the share capital own by the State (see Tables 4.1.2.2 and 4.2.1 of the report quoted below).
It should be noted that the concept of entrepreneurial profit/loss is not directly comparable to the surplus/deficit (more precisely net lending/borrowing) of ESA95. If public enterprises were classified in general government, the upward revision in the deficit would usually be larger than their losses. This is mainly because of investment expenditure, which is not a component of losses, but is to be taken into account when calculating the government deficit.
[***] Available at http://www.dgt.pt/docs/SEE_Relatorio_2006.pdf.

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

Table 10: Overview of compliance with the Stability and Growth Pact

	Based on programme[5] (with targets taken at face value)	**Assessment** (taking into account risks to targets)
a. Consistency with correction of excessive deficit by 2008 deadline	Yes	Conditional on addressing risks, i.e., only if the measures announced in the programme are fully and effectively implemented; and additional measures are adopted in case of lower-than-projected economic growth.
b. Safety margin against breaching 3% of GDP deficit limit[1]	In 2009	Possibly not within programme period
c. Achievement of the MTO	In 2010	Most likely not within programme period
d. Adjustment towards MTO in line with the Pact (after the correction of the excessive deficit)[2]?	Fully in line	Should be strengthened by backing it up with measures if necessary

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1½% of GDP for Portugal). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[5]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

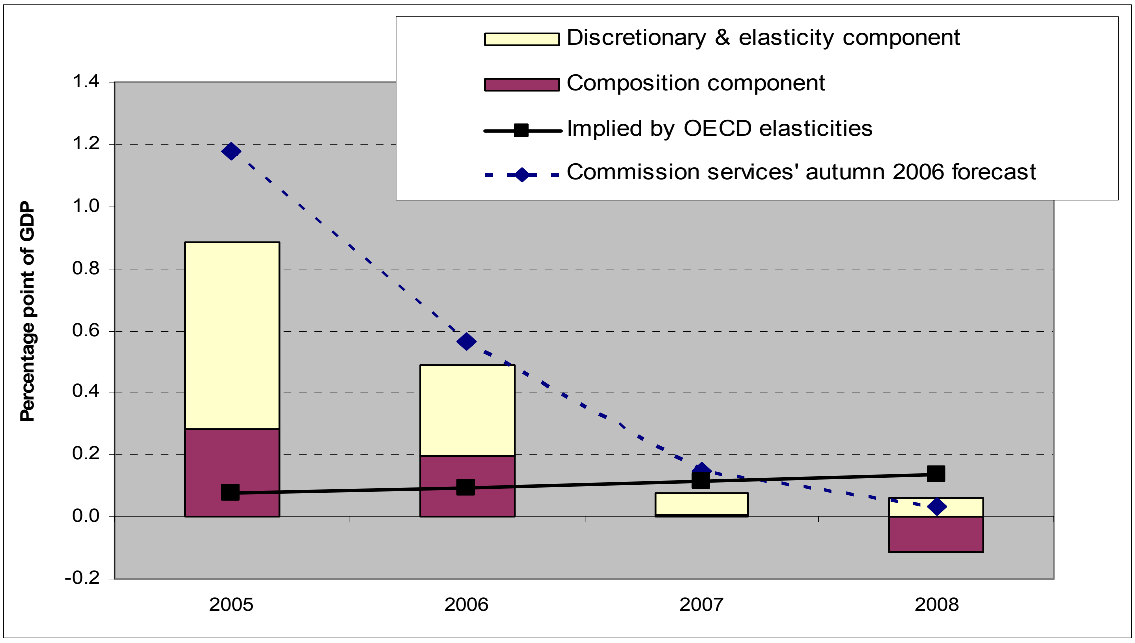
Source:
Commission services

In view of the above assessment of risks, the programme is broadly consistent with a correction of the excessive deficit by 2008 as recommended by the Council (see Box 1 above), conditional on a full and effective implementation of the measures announced in the programme and on additional measures in case of lower-than-projected economic growth. The budgetary plans for the years 2007 and 2008 are in line with the improvement in structural terms recommended by Council of ¾% of GDP in each year. However, also these efforts are critically dependent on addressing the downward risks to the budgetary projections pointed out above. This is particularly relevant for 2008, for which the Commission services' autumn 2006 economic forecasts project a halt in the structural correction on the basis of the no-policy change assumption (thus, excluding some measures adopted meanwhile).

However, taking into account the risks to the budgetary targets, the programme's fiscal stance does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations in 2009 and 2010, i.e., the years following the correction of the excessive deficit.

The structural improvement towards the MTO after the planned correction of the excessive deficit envisaged in the programme is evenly spread over time, averaging almost ¾% of GDP in 2009/2010. Nonetheless, taking into account the risks to the budgetary targets, the MTO would not be reached by 2010, as planned. Therefore, the pace of the adjustment towards it implied by the programme could require additional measures to be in line with the Stability and Growth Pact. All this happens against a backdrop of bad times since, as described in subsection 3.7.2, the output gap is expected to remain negative over the whole programme period. The consideration of tax elasticities does not change this assessment: after controlling for the impact of discretionary decisions on tax revenues, the tax elasticity falls slightly behind the ex-ante OECD elasticity in 2007 and 2008 (see Figure 10).

Figure 10: Changes in the tax-to-GDP ratio:
actual/projected changes vs. changes implied by OECD elasticity



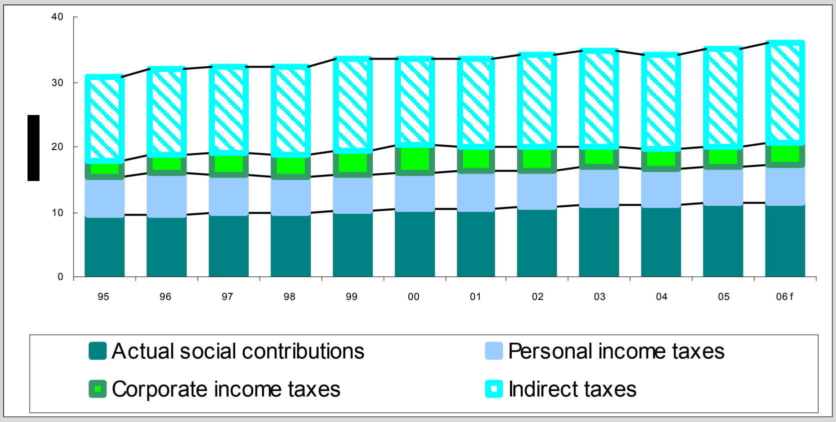
Note:
The dashed line displays the change in the tax ratio in the Commission services' 2006 autumn forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:
Commission services

Box 5: Tax revenue and fiscal imbalances in Portugal

Portugal's tax and social contributions revenue has been steadily increasing from 31% of GDP in 1995 to around an expected 37% of GDP in 2006 (see Figure 1). Given the large fiscal imbalances in Portugal since the turn of the decade, it is worthy to look at the evolution of tax revenue in order to understand its impact on the government balance. This is of heightened relevance as those imbalances have coincided with times of very weak economic growth.

Figure 1: The evolution of tax revenues in Portugal

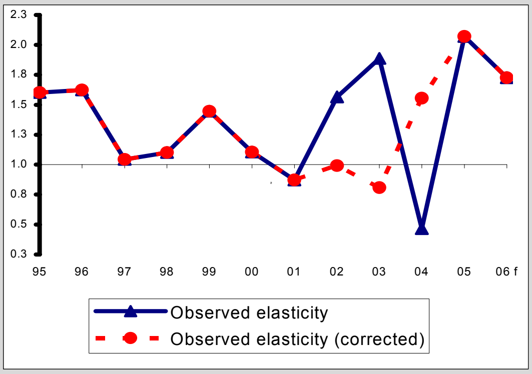


Source: Commission Services

Indirect taxes have been the major driver of the higher tax burden by adding some 2½ percentage points to it since 1995, representing around 15.5% of GDP in 2006. A similar pattern was followed by actual social contributions, which increased by almost 2 percentage points during the same period. Direct taxes (both corporate and personal income taxes) have had a more uneven behaviour over time, increasing until 2000/2001, declining until 2003 and increasing afterwards to some 9% of GDP in 2006.

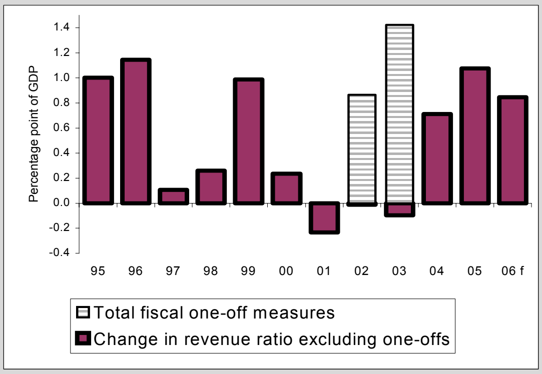
Figure 2 below shows the elasticity of tax revenue with respect to GDP (without considering changes in fiscal policy), including a variant that controls for one-off fiscal revenues in some years* and Figure 3 shows the annual changes in the tax burden. Overall, the figures show that in the second half of the nineties, in times of high GDP growth, revenue grew in excess of GDP. At the same time, the GDP slowdown and the emergence of an excessive deficit in 2001 coincided with less benign developments on the side of tax revenue. In 2002 and 2003, if it had not been for one-off revenues, tax revenue would have remained flat in the former and declined in terms of GDP in the latter. However, in 2004 and beyond, tax revenue has been growing well in excess of nominal GDP, thus yielding higher tax-revenue-to GDP ratios.

Figure 2: Elasticity of tax revenue relative to GDP



Note: Elasticity (corrected) exclude one-off fiscal revenues in 2002 and 2003

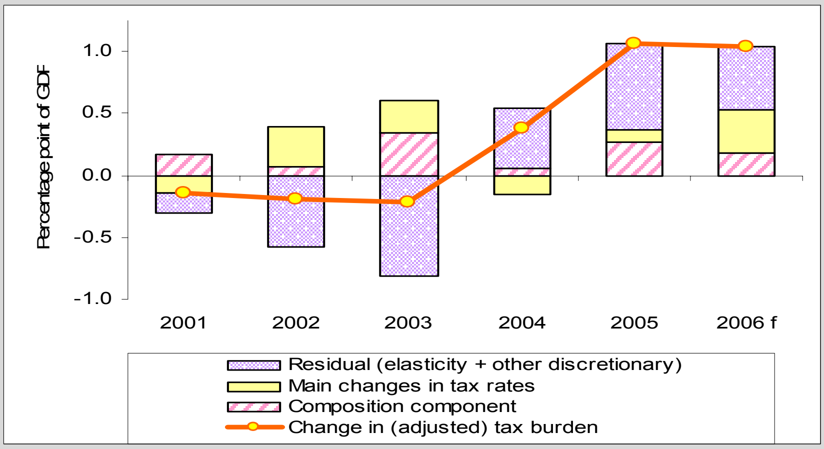
Figure 3: Change in tax-revenue-to-GDP ratio



Source: Commission Services

The different forces behind the evolution of tax revenue, in terms of GDP, may be linked with the impact of the macroeconomic developments, especially the behaviour of the different taxes to the cyclical fluctuations and of fiscal policy (changing tax rates and benefits). Figure 4 disentangles some of the main factors behind the changing tax burden in 2001 and beyond**. In particular, the difference between the elasticity of tax revenue (after controlling for one-off revenues and some changes in social contributions) and the historical elasticity is separated into three components. The first is the direct impact of the main changes in the major tax categories implemented since 2001 – essentially hikes in the VAT standard rate and a series of corporate tax cuts***; the second is the composition component, which captures the effect of differences in the composition of aggregate demand; the third indicates the elasticity elements as well as other discretionary elements being the residual part that is unexplained by the first two components (see Annex 5 for more details).

Figure 4: Drivers of tax revenue



Note: Revenues exclude one-off fiscal revenues and some social contributions related with pensions for government employees.
Source: Commission Services and CGA annual reports

After taking those factors into account, Figure 4 suggests that part of the evolution of the tax revenue is not explained by changes in nominal tax rates or the composition of economic growth. In particular, it seems that in 2001-2003 additional factors played a role in dragging down tax revenue more than the pace of economic activity would suggest and thus contributed to the looming fiscal imbalances. The reverse appears to have happened since 2004, with revenues growing above fundamentals and more than warranted by changes in tax rates. In other words, tax revenue has been growing at a relatively quick pace in the more recent years thanks to higher elasticities of tax revenue to GDP despite a still subdued pace of economic activity.

A number of additional factors may have played a role in the recent observed pattern of Portuguese tax revenue such as a plethora of changes in relatively less important tax categories (e.g., excises on oil and tobacco products, taxes on real estate sales and property tax); various changes in tax benefits and credits; variations in the time patterns of tax reimbursement and advanced payments; lagged effects of economic activity on tax inflows; changes in consumption patterns over the cycle as well as changes in income distribution, income tax brackets, or withholding tables. Finally, improved tax compliance and tax collection, particularly on corporate taxes, VAT, and, more recently, social contributions, may have also played a role in that evolution. Indeed, the unexplained increases have been contemporaneous to notorious changes in the work of the tax administration, such as improved data management, including cooperation between tax and social contributions administrations or the introduction of automatic systems for clearing tax payments or checking tax declarations.

Overall, behind Portugal's imbalanced public finances since the turn of the decade, one can disentangle two phases in the development of tax revenue. In the earlier years of this decade, underlying developments seem to have been detrimental to the government balance; the reverse seems to have been the case more recently. At the same time, this might imply that part of the calculated change in the structural balance may have been of a temporary nature: on the one hand, the earlier deterioration might have understated some tightening of fiscal policy; on the other hand, part of the more recent improvement in that balance might have benefited also from somehow temporary contributions.

* One-off measures that directly impacted on tax revenues: two tax amnesties undertaken in 2002 and 2003; a sale of tax and social security arrears in 2003 (0.9%, 0.1% and 1.3% of GDP, respectively).
** Imputed social contributions and (actual) social contributions related to pensions of civil servants were excluded in Figure 4 as they are also registered on the expenditure side, thus being neutral on the government balance. The former have varied between 0.9 and 1.2% of GDP between 2001 and 2006; the latter increased by about ½% of GDP over the same period.
*** The changes included are: the increases in the standard VAT rate from 17% to 19% in mid-2002 and then to 21% in mid-2005; and the cuts on corporate taxes (IRC), which decreased gradually from 34% in 2000 to 25% at the beginning of 2004.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role[28]. The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the stability programmes targets, compares them with the Commission services' forecasts and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

As described in subsection 2.4, the government gross debt-to-GDP ratio has been on an steep upward trend since 2000. According to the December 2006 updated programme, the government debt ratio is estimated to have reached 67.4% of GDP in 2006, above both the 60% of GDP reference value and its 2005 level of 64% of GDP, as the result of the high government deficit and a sizeable stock-flow adjustment. The estimate for the 2006 debt ratio is similar to the Commission services' autumn 2006 economic forecasts. It is 1.3 percentage points lower than in the December 2005 update, which seems to be largely the result of an higher GDP level due to an upward revision in the GDP series of early 2006[29].

---

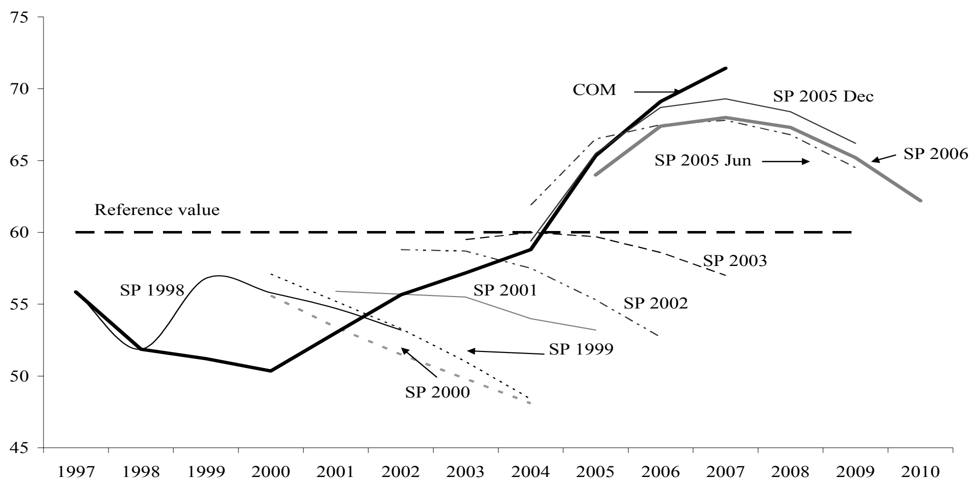
[28] On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

[29] In mid 2005, Portugal's GDP series was revised upwards by around 4% because of a large number of technical issues, including changes in sources, methods and concepts. This automatically reduced the debt ratio by about 2½ percentage points. In early 2006, with the first release of preliminary accounts for 2005, data on FISIM were incorporated leading to another upward revision of the GDP level by some about 1½ percentage points.

The programme projects the government debt ratio to increase further in 2007 to 68% of GDP. As from 2008, a gradual reduction of the debt ratio is projected to 62.2% in 2010. Compared with the updates of June and December 2005, the path for the government debt ratio targeted in the December 2006 programme is broadly unchanged, apart from the change brought about by the revisions in GDP (see Figure 11 and footnote 29).

While in 2007 debt increases due to the still high deficit, the downward path envisaged for 2008 and beyond is driven by the return to primary surpluses and the acceleration in GDP (see Table 9). At the same time, the stock-flow adjustment is projected to become largely neutral after being debt-increasing for a number of years. Regarding the composition of the latter, privatisation proceeds are assumed in every year and amounting to a total of 1.4% of GDP between 2007 and 2010, with acquisition of financial assets partly offsetting the impact of those proceeds on debt. 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 2006 to a residual of about 0.2% of GDP from 2007 onwards.

Figure 11: Debt projections in successive stability programmes (% of GDP)



Source:
Stability programme; Commission services

Table 11: Debt dynamics

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009	2010
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**58.6**	**64.0**	**67.4**	**67.4**	**69.4**	**68.0**	**70.7**	**67.3**	**65.2**	**62.2**
Change in the ratio	1.5	5.4	3.3	3.3	2.0	0.6	1.4	-0.7	-2.1	-3.0
Contributions[2]:										
Primary balance	0.3	3.3	1.7	1.9	1.0	0.8	0.7	-0.3	-1.4	-2.4
"Snow-ball" effect	0.5	1.0	0.7	0.5	0.7	0.0	0.5	-0.3	-0.7	-0.7
Of which:										
Interest expenditure	2.8	2.7	2.9	2.7	3.0	2.9	3.2	2.9	2.9	2.8
Growth effect (real GDP)	-0.7	-0.2	-0.8	-0.8	-0.9	-1.2	-1.1	-1.5	-1.9	-1.8
Inflation (GDP deflator)	-1.7	-1.5	-1.4	-1.4	-1.4	-1.7	-1.6	-1.7	-1.7	-1.6
Stock-flow adjustment	0.6	1.3	0.9	1.1	0.3	-0.1	0.1	0.0	0.1	0.2
Of which:										
Cash/accruals diff.	0.4	1.3	-	-	-	-	-	-	-	-
Acc. financial assets	0.1	0.0	-	-0.3	-	-0.1	-	-0.3	-0.2	-0.1
Privatisation	-0.7	-0.4	-	-0.8	-	-0.5	-	-0.4	-0.3	-0.2
Val. effect & residual	0.1	0.0	-	-	-	-	-	-	-	-

Notes:
[1]End of period.
[2]The change in the gross debt ratio can be decomposed as follows:

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

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:
Stability programme update (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The assessment of the stability programme highlights risks to the debt targets. The programme projections for the government debt ratio are more optimistic than the Commission services' autumn 2006 economic forecasts. By 2008, there is a difference of more than 3 percentage points explained by higher primary deficits in the Commission services' forecasts – which are on a no-policy change basis for 2008 –, weaker economic growth and higher stock-flow adjustments.

Achieving the programme targets for the debt ratio crucially hinges upon meeting the ambitious deficit reduction targets. At the same time, lowering the stock-flow adjustment would be achieved crucially thanks to privatizations proceeds – which are not detailed in the programme and thus impossible to assess – and a reduction in capital injections to public enterprises as compared to the recent past. Additionally, in line with the risks to the macroeconomic scenario pointed in section 3, sluggish GDP growth can be less favourable to the debt ratio than foreseen in the update.

As reported in subsection 4.3, according to the update, the debt ratio would show some sensitivity to a hike in the interest rate by 1 percentage point in excess of the upward cycle already assumed in the update scenario, such that by 2010, the debt ratio would be

2 percentage points higher than projected. In spite of the predominance of fixed-rate bonds in the structure of government debt, the government debt that is to be refinanced in the coming four years represents about ¼ of total debt. Therefore, interest rates hikes would have a direct, albeit lagged impact on debt and interest expenditure, the exact impact depending on the comparison between the rates of the current and the new bonds.

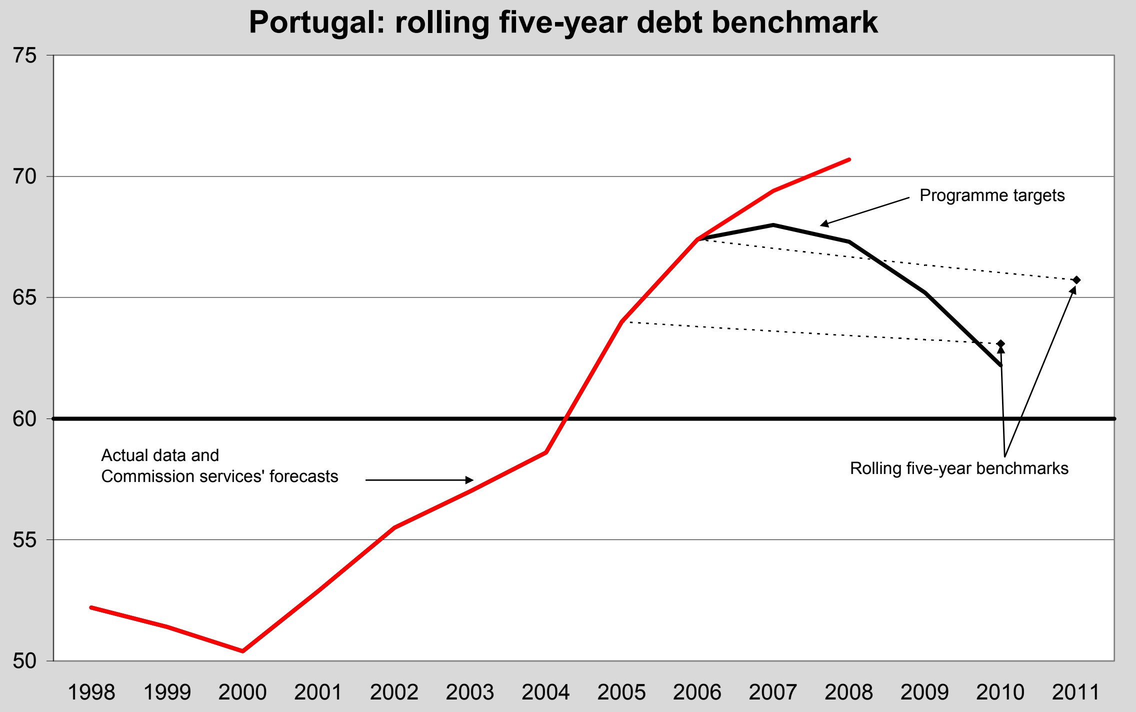
The debt reduction strategy in the update, if achieved, is consistent with the Council recommendation under Article 104(7) of 20 September 2005 in the sense that debt is planned to be brought on a downward path after 2007 and developments reflect progress in reducing the deficit and a fall of debt-increasing financial operations. However, the envisaged reductions for 2008 and beyond crucially depend on achieving the targeted lower deficits and stock-flow adjustments, with the GDP growth path adding an additional risk. Therefore, in the light of this risk assessment, the evolution of the debt ratio is likely to be less favourable than projected in the programme. Moreover, the debt ratio could be considered as sufficiently diminishing towards the reference value at the end of the programme period (see Box 6).

Box 6: The rolling debt reduction benchmark

The debt ratio has been exceeding the 60% of GDP reference value since 2005. It is expected to peak in 2007 at 68% of GDP, according to the programme.

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 2006 forecasts until 2008 (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" (*). 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 benchmark is of limited use before 2008, since the debt ratio is expected to remain on an upward trend until 2007 and to start declining only in 2008. In fact, only in 2010, would the debt ratio fall below its 2005 outturn. The figure below shows that the government debt ratio could only be considered as declining at an acceptable pace only at the very end of the programme period.



Source : Stability programme and Commission services

(*) The rolling debt reduction benchmark for successive five-year periods is defined as a reduction in the difference between the debt ratio and the 60% of GDP reference value of 5 percent per year:

$\left(\frac{D_t}{Y_t}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right]$, where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively. In the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio. Given the usual approximation of the change in the debt ratio $\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \frac{y_t}{1+y_t} \times \frac{D_{t-1}}{Y_{t-1}} \cong \frac{DEF_t}{Y_t} - y_t \times \frac{D_{t-1}}{Y_{t-1}}$ and assuming that the stock-flow adjustment is zero, it is easy to show that the rolling debt reduction benchmark describes the path for convergence of the debt ratio towards 60% of GDP that would take place with the deficit at 3% of GDP and nominal GDP growth at 5%. In other words, the 5 percent per year benchmark is the value that makes consistent a continuous respect of the 3% of GDP deficit threshold and an asymptotic respect of the 60% of GDP debt reference value.

5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.[30]

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

30 For a detailed analysis of long-term sustainability issues, see "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006 (hereinafter Sustainability Report).

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (see Box 7), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2010, the final year of the stability programme; it is called the "2006 scenario". Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2010 provided in the stability programme will be fully respected. This is the "programme scenario". Debt and primary balance projections in this scenario start in 2011. Both projections assume zero stock-flow adjustments. In addition to this quantitative analysis, other relevant factors are taken into account, like the recent pension reform, which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. *Sustainability indicators and long-term debt projections*

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections[31]. Non age-related primary expenditure and revenue is assumed to remain constant as a share of GDP.

Table 12: Long-term age-related expenditure: main projections

(% of GDP)	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	24.3	24.7	26.9	28.6	31.9	34.4	10.1
Pensions	11.1	11.9	14.1	16.0	18.8	20.8	9.7
Health care	6.7	6.8	6.7	6.6	6.9	7.2	0.5
Long-term care	0.5	0.5	0.5	0.6	0.7	0.9	0.4
Education	5.1	4.7	4.7	4.5	4.5	4.8	-0.4
Unemployment benefits	1.0	0.8	0.8	0.8	0.8	0.8	-0.1

Source: Economic Policy Committee and Commission services.

Note: the stability programme includes long-term projections which point to a lower increase in age-related expenditure, see section 5.2.2.

The projected increase in age-related spending in Portugal is significantly above the EU average, rising by 10.1 percentage points of GDP between 2004 and 2050[32]. This is particularly due to pension expenditure being projected to rise more than on average in the EU, by 9.7 percentage points of GDP. The increase in health-care expenditure is projected to be 0.5 percentage points of GDP, lower than on average in the EU. For long-term care, the projected increase of 0.4 percentage points of GDP up to 2050, is also below the average in the EU.

Based on the long-term budgetary projections, sustainability indicators can be calculated.

---

[31] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1, 2006 (hereinafter Ageing Report).

[32] Those projections (from the Ageing report) do not yet include the impact of the pension reform enacted in January 2007. It should be noted also that the new long-term projections have not yet been submitted to a peer review by the Ageing Working Group of the EPC. See subsection 5.2.2 below.

Table 13: Sustainability indicators and the required primary balance

	2006 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	5.6	8.3	7.5	2.5	5.3	7.4
of which:						
Initial budgetary position	1.4	1.6	-	-1.6	-1.4	-
Debt requirement in 2050	0.1	-	-	0.0	-	-
Future changes in budgetary position	4.1	6.7	-	4.1	6.7	-

Source: Commission services.

Box 7 – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the: (i) **initial budgetary position (IBP)**; (ii) **long-term change in the budgetary position (LTC)**.
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2011-2015) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		**Long-term changes in the primary balance**
S1*=**	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex I of the "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, in the case of S1, the decomposition also separates the impact of the debt position (60% of GDP in 2050); the debt requirement in 2050 (DR). In particular, if the current debt/GDP ratio is below 60% of GDP, debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and vice versa.

Table 13 shows the sustainability indicators for the two scenarios. In the "2006 scenario", the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 5.6% of GDP. The sustainability gap (S2) which satisfies the intertemporal budget constraint would be 8.3% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are lower by about 2¼% of GDP. This is mainly due to a lower structural primary deficit in 2006 (½% of GDP) compared to the structural primary deficit in 2005 estimated in spring 2006 (2½% of GDP) that was used in the Sustainability Report.

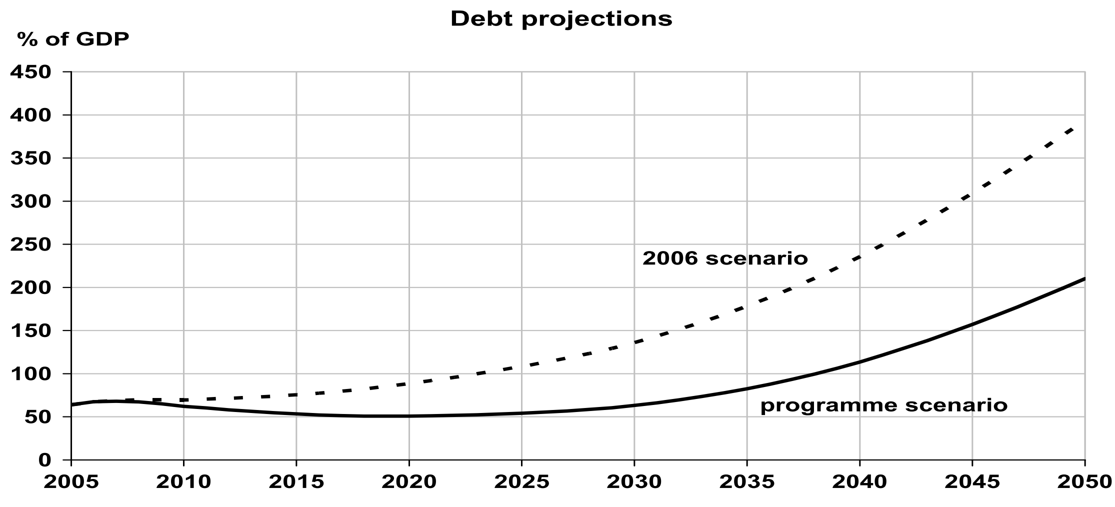
The initial budgetary position constitutes a risk of unsustainable public finances before considering the long-term budgetary impact of ageing. The programme plans a large improvement of the structural balance of around 3% points of GDP between 2006 and 2010. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances, reducing the S2 sustainability gap by about 3% of GDP ("programme scenario"). The difference between the initial budgetary position in the "2006 scenario" and the "programme scenario" illustrates how the full respect of the stability programme targets will contribute to tackling the budgetary challenges raised by the demographic developments. According to both sustainability gaps, the long-term budgetary impact of ageing in Portugal is above the EU average.

The required primary balance (RPB) is about 7½% of GDP, considerably higher than the structural primary balance of about 2.4% of GDP at the end of the programme period. Moreover, the sustainability gap (S2) would increase by around ½% of GDP if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt-to-GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 12.

The gross debt ratio is high, estimated in the programme update at 67.4% of GDP in 2006. According to the "2006 scenario", the debt ratio would be on an unsustainable path and increase progressively over the coming decades. In the "programme scenario", the debt dynamics would be somewhat more favourable than in the 2006 scenario thanks to the consolidation of public finances over the programme period; however, the debt-to-GDP ratio would be on an upward trend from 2020.[33]

Figure 12: Long-term projections for the government debt ratio



Source: Commission's services

[33] It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account that allow to better qualify the assessment with regard to where the main risks are likely to stem from.

First, Portugal has enacted a pension reform that entered into force on 1 January 2007. Some other measures (relating to civil servants) are envisaged to enter into force in the course of 2007. These changes, building on a tripartite agreement with the social partners in October 2006, include: (i) the inclusion of a sustainability factor which automatically links the level of the pensions with life expectancy; (ii) a faster transition to the new pension calculation formula which calculates the pension over the entire career compared with the best 10 out of the last 15 working years, until now; (iii) new indexation rules, which from now on will be differentiated depending on the level of the pension, inflation rate and GDP growth: the lower the pension, the higher its indexation[34]; (iv) convergence of the rules of the different pension schemes; (v) diversification of funding schemes (strengthening incentives for individual and collective supplementary savings schemes); and several other measures.

The update provides new long-term projections for pension expenditure following the reform, which include the impact of the measures that enter into force in 2007. Compared to the projections of the Ageing Report, summarised above, these new projections point to a lower increase in pension expenditure up to 2050.[35] Compared with the projections of the Ageing Report, those projections include (i) a change in the baseline GDP simply due to a higher GDP level in 2006 and in the years before, stemming from revisions in National Accounts[36]; (ii) slightly more dynamic projections prior to the reform due to the new data on number of pensioners and the average pension for 2005 and 2006[37]; (iii) the effect of the pension reform. The first two changes are mainly of a technical nature and almost offset each other. The impact of the reform on pension expenditure is estimated to be of around 4% of GDP in 2050,before considering the impact of the reform on employment of older workers and on GDP growth. It should be noted that Portugal's new long-term projections have not yet been submitted to a peer review by the Ageing Working Group of the EPC.

Table 14: Pension expenditure projections before and after reform (% of GDP)

	2004	2005	2010	2020	2030	2050	Change 2004-2050

[34] See p.7 of the 'Agreement on the reform of Social Security', Ministério do Trabalho e da Solidariedade Social, October 2006. See also section 6 below.

[35] The pension projections presented in the update include the impact of the measures that entered into force on 1 January 2007 and also those that are envisaged to enter into force during the course of 2007 (relating to civil servants).

[36] See footnote 29.

[37] The profiles in the updated projections were based on 2005 and 2006 data, which explains the new figures for those years (number of pensioners and the average pension) and also the slightly different dynamics over the long run.

Pre 2007 reform*	11.1	11.5	11.9	14.1	16.0	20.8	+9.7
Post 2007 reform**	10.4	11.0	11.3	12.7	13.4	16.5	+6.1

Source: Ageing Report (2006), December 2006 stability programme update

* Baseline scenario, Ageing Report (2006)

**EPC base scenario, December 2006 stability programme update. It should be noted that the projections also include base effects related to new data on pension expenditure and GDP. This takes into account the full impact of the pension reform, even though a part of it has not yet been entered into force.

If those projections, taking into account the impact of the reform on pension expenditure, were included in the calculation of the sustainability gap indicators, the latter would be reduced. The S2 indicator would be reduced by 2.8% of GDP, thus reaching 5.5% of GDP in the "2006 scenario" and 2.5% of GDP in the "programme scenario". The RPB of the latter would also decrease to about 4.8% of GDP but would still be higher than the structural primary surplus of 2.4% of GDP at the end of the programme period[38]. Therefore, although the recent measures contribute to improve the long-term situation of the Portuguese public finances, they do not ensure sustainability.

Second, the current level of debt, estimated in the update to be 67.4% of GDP in 2006 is above the Treaty reference value. A reduction in the debt to below the reference value, as projected in the stability programme, would strengthen the resilience of public finances to adverse shocks and reduce the risks to public finance sustainability.

5.2.3. Assessment

Portugal has recently enacted a pension reform aimed at strengthening the sustainability of the public finances. As a result, estimates in the programme suggest that the overall increase in age-related expenditure over the coming decades would be lower than previously estimated, though remaining above the EU average.

The initial budgetary position, albeit improved compared with 2005, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Moreover, the current level of gross debt is above the Treaty reference value. Further budgetary consolidation would contribute to reducing risks to the sustainability of public finances.

Overall, Portugal appears to be at high risk with regard to the sustainability of public finances.

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

Budgetary framework and rules

The stability programme update provides an overview of the governance of public finances and recent institutional changes that are being pursued to improve the budgetary

[38] The S1 indicator would decrease by around 1.8% of GDP, reaching 3.8% of GDP in the '2006 scenario' and 0.7% of GDP in the 'programme scenario'.

framework and fiscal control for regional and local government. As fiscal consolidation in Portugal is based on expenditure restraint, mechanisms that support compliance with budgetary plans across the different levels of general government are of heightened relevance.

The update elaborates on the new Autonomous Regions Finance Law[39]. This establishes that the growth rate of transfers from the State's budget to the autonomous regions will be the lowest between: the State's current expenditure growth rate (excluding some social security-related expenditure) and the growth rate of Portugal's GDP at current prices two years before[40]. The transfer to the individual regions will depend on a number of parameters like population and its age structure, indicators of geographical periphery and a tax-collecting effort index as well as the GDP per capita relative to the national average. In addition, the regions will be entitled to taxes due or collected in their territory. At the same time, the revised law also continues to foresee the establishment in the annual State budget of limits to the regions' debt variation, which must be such that the debt service (i.e., interest plus principal repayments) cannot exceed 25% of the region current revenues of the previous year (excluding transfers from the State)[41]. In case of violation of the debt limits, the law establishes penalties through lower transfers in the following year. Finally, the law forbids State guarantees for and bail-outs of the autonomous regions' loans, which will be a marked departure from what happened in the past.

The Local Government Finance Law was also revised very recently. It introduces changes in the financing of the different municipalities and parishes, including transfers from the State, which, for the local government as a whole, are fixed as percentage of tax revenues at national level two years before[42]. Regarding fiscal rules, the revised law foresees debt rules with a ceiling for a municipality's net debt at 125% (with the relevant debt concept including also commercial debt), and medium to long term loans at 100%, of an aggregate comprising most of their revenues; parishes face also limits on their debt stock. Like the Autonomous Region Finance Law, this law establishes penalties for municipalities and parishes that exceed those ceilings through an equivalent cut in transfers from the State, which, at the same time, is also forbidden to provide guarantees and bail-outs for municipalities and parishes loans.

Both the Autonomous Region Finance Law and the Law of Local Government Finances establish, on a permanent basis, obligations for regional and local government to report on budgetary execution; penalties under the form of cuts in State transfers are foreseen in case of no compliance.

---

[39] There are two 2 autonomous regions in Portugal, which account for about 5% of country's total resident population.

[40] In 2005, the regions' total expenditure and revenue were equal to some 1.4% of Portugal's GDP. Direct transfers from the State budget accounted for more than 20% of their revenues (some 0.3% of GDP).

[41] The 2007 budget includes a freeze on the regions' debt.

[42] In 2005, local government's expenditure amounted to 4.8% of GDP and direct transfers from the State budget under the Local Government Finance Law accounted for about 35% of that expenditure (1.7% of GDP).

Overall, the revised laws should help in ensuring the contribution of this sub-sector for fiscal consolidation. For instance, transfers to autonomous regions automatically reflect a tightening of expenditure at the State level; however, on the side of local government, transfers have a more lagged pro-cyclical nature[43]. Additionally, they reformulate and reinforce fiscal rules for regional and local government on a more permanent basis. However, at the level of autonomous regions, the ceiling on debt might prove not very restrictive if regions take recourse to loans with extended maturities. Finally, the fact that regional and local governments' loans cannot benefit from State guarantees and bail-outs implies that interest rates will better reflect the risk assessment by lenders and consequently tighten constraints.

Another development in terms of budgetary institutions is the creation of the budgetary technical support unit close to the Parliament (*UTAO*). The unit was installed in November 2006 and has as main duties the technical analysis of the annual draft Budget Law, monitoring budgetary execution and assessment of government annual accounts, analysis of the stability programme updates and assessment of the budgetary impact of legislative measures on request by the Speaker of Parliament.

Finally, the updated stability programme mentions plans for performance budgeting, which is to be implemented gradually until 2010. Performance budgeting is expected to allow an improved multi-annual planning of government spending as well as thorough assessments of different government policies. Successful work in this area can be instrumental in improving the efficiency of public expenditure as mentioned in sub-section 2.5.

Old-age pension reform, in particular its sustainability factor and indexation rules

As described in subsection 5.2.2, Portugal enacted the reform of the old-age pension scheme for private-sector workers in January 2007. While its impact will be felt mostly in the medium term, two elements – the sustainability factor and the indexation rules – have introduced an automatic adjustment of benefits as a function of demographic and economic developments.

The sustainability factor automatically links the level of a new retiree's pension with increases in life expectancy, in particular it adjusts the benefit outlay in the opposite direction of changes in residual life expectancy at the age of 65 compared with the situation in 2006[44]. All in all, the sustainability factor implies that, ceteris paribus, higher life expectancy will be automatically associated with lower benefits.

---

43 The Budgetary Stability Law foresees that the rules on transfers from the State to the Regional and Local Government may be suspended with a view to respect the SGP.

44 As from 2008, the pension of new retiree will be calculated as follows:

$$Pension_t^i = Benefit^i * \frac{RLE_{2006}}{RLE_{t-1}}$$

Where $Pension_t^i$ is the value of the pension that is going to be paid to individual *i* that retires in year *t*, $Benefit^i$ is the outlay computed according to the standard pension formula, RLE_{2006} is the residual life expectancy at age of 65 in the year 2006 and RLE_{t-1} is the residual life expectancy at age of 65 in the year before retirement.

The new pension reform also establishes rules for the annual updating of pension benefits as a function of inflation and real GDP growth, instead of deciding increases on an ad-hoc basis every year. The annual increases will be progressive in the sense that pensioners with lower pension, get a higher indexation, with the different pension categories being defined against the newly created public support index, which is intended to be the new reference for social transfers other than in kind, replacing the minimum wage on that role. At the same time, on average, annual increases will be higher, the higher real GDP growth is.

Table 15: Updating rules for old-age pensions

Real GDP growth	Public Support Index			
	<1.5	[1.5, 6[	[6, 12[	≥12
<2	CPI	CPI - 0.5 pp	CPI - 0.75 pp	-
[2,3[	CPI + 0.2 g	CPI	CPI - 0.25 pp	-
lower limit	*CPI + 0.5 pp*	-	-	
>3	CPI + 0.2 g	CPI + 0.125 g	CPI	-

Notes: CPI: consumer price index in the year before the update; g: average real GDP growth rate over the last two years
Source: Lei 53-B/2006; 2007 Budget Report

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The measures presented in the update of the stability programme are in line with the National Reform Programme (NRP) and the progress recorded in the Implementation Report of the National Reform Programme (IR-NRP) submitted in October 2006 in the context of the renewed Lisbon strategy for growth and jobs. In particular, the NRP identified strengthening budgetary consolidation and reform of public administration as two of the four strategic priorities.

The update of the stability programme contains a qualitative assessment of the overall impact of the National Reform Programme within the medium-term fiscal strategy and provides systematic information on the direct budgetary impact of the main reforms areas envisaged in the NRP. Moreover, the budgetary projections in the updated stability programme explicitly take into account the public finance implications of the actions envisaged in the IR-NRP. The budgetary costs of the actions foreseen in the IR-NRP is estimated at 1% of GDP over the years 2007-2009 and 1.2% in 2010 and are concentrated in the microeconomic and employment areas. The budgetary savings amount to 1.2% of GDP in 2007 and gradually increase to 1.8% in 2008, 2.1% in 2009 and 2.3% of GDP in 2010 and are the result of the planned fiscal consolidation.

Box 8: The Commission assessment of the implementation report of the National Reform Programme

The implementation report of the National Reform Programme of Portugal, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 20 October 2006. The Commission's assessment of this report, which was adopted on 12 December 2006 as part of its Annual Progress Report, can be summarised as follows.

The Portuguese 2005-2008 National Reform Programme (NRP) is built on four strategic priorities: strengthening budgetary consolidation; reform of public administration; fostering scientific and technological development; and increasing the qualification levels of the population. The Commission's 2006 Annual Progress Report (APR) shared this analysis, but considered that further attention should be given to; long-term sustainability of the public finances; effective competition in network industries, in particular telecommunications and energy; the modernisation of work organisation to improve the adaptability of enterprises; and further measures to ensure a less segmented labour market and to improve social cohesion.

Portugal is making good progress on implementing the measures in the National Reform Programme, especially in the macro and micro-economic areas. On employment related policies, there has also been progress, especially on reforming education and training, but the important area of the adaptability of the labour market and flexicurity is not yet being fully addressed. Progress towards meeting the commitments made at the 2006 Spring European is generally good. Considerable further efforts across all policy areas will be necessary to fully achieve the objectives of the programme, given their welcome ambition and Portugal's point of departure.

Important strong points of the reform process in Portugal include the extensive reforms launched to the public administration, the measures to facilitate business start-ups within an hour, the adjustment of old-age pension schemes and comprehensive consolidation measures in health care. Efforts to reinforce R&D have been strengthened and dovetailed into a coherent strategy through the ambitious Technological Plan. Extensive reforms are also being implemented in the education sector in particular with measures to increase literacy levels of the young and rationalise the national school network.

The policy areas in the Portuguese National Reform Programme where weaknesses need to be tackled with the highest priority are: improving educational attainment and lifelong learning; improving the adaptability of the labour market and addressing segmentation. These issues must be addressed in the context of further progress with the administrative reform and keeping rising spending on social transfers under control. Against this background Portugal is recommended to:

- in the context of the on-going correction of fiscal imbalances and public administration reform, redirect public spending towards uses more supportive to potential growth, while maintaining firm control over public expenditure overall;

- implement measures to strongly improve the education attainment levels of the young, and develop a vocational training system that is relevant to labour market needs and based on a "National Qualifications Framework";

- modernise employment protection, including legislation to foster flexibility and security to reduce the high levels of labour market segmentation.

In addition, it will be important for Portugal over the period of the National Reform Programme to focus on: ensuring that the promising Technological Plan is fully implemented, the linkages between research and industry consolidated and the involvement of the private sector strengthened; ensuring effective competition in energy and financial services markets; reducing emissions; reducing the deficit in transposing EU legislation into national law; and addressing the factors undermining social cohesion.

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, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 4.4 above, whereas that of the pace of debt reduction in guideline 2 is covered in subsection 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, in the light of the risk assessment, the budgetary strategy in the stability programme is broadly consistent with the broad economic policy guidelines.

Table 16: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	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
– 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		
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 (starts declining in 2008 only)		
– 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		

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
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		

Notes:
[1]As further specified in the Stability and Growth Pact and the 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 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.

Source:
Commission services

* * *

Annex 1: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also know as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance*, *primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme, code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance, budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt*.

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific 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, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a “safety margin” that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics.*

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

Table 1a. Macroeconomic prospects

	ESA Code	2005	2005	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	143564.9	0.4	1.4	1.8	2.4	3.0	3.0
2. Nominal GDP	B1*g	147378.4	3.0	3.7	4.5	5.1	5.6	5.6
Components of real GDP								
3. Private consumption expenditure	P.3	94156.5	2.0	1.0	1.3	2.0	2.3	2.4
4. Government consumption expenditure	P.3	29896.8	1.8	-0.2	-1.3	-1.5	-1.2	-1.1
5. Gross fixed capital formation	P.51	31001.0	-2.9	-2.6	1.9	4.0	6.8	7.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	479.2	0.7	0.8	1.0	1.0	1.0	1.0
7. Exports of goods and services	P.6	41157.5	0.9	8.6	7.2	6.8	7.0	7.2
8. Imports of goods and services	P.7	53126.1	1.8	2.8	3.7	4.3	5.4	6.1
Contributions to real GDP growth								
9. Final domestic demand		-	1.0	0.0	1.0	1.9	2.7	2.9
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-0.2	-0.1	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	-0.4	1.4	0.8	0.5	0.2	0.1

Table 1b. Price developments

	ESA Code	2005	2005	2006	2007	2008	2009	2010
		level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator			2.7	2.3	2.6	2.6	2.6	2.6
2. Private consumption deflator			2.5	3.2	2.2	2.2	2.1	2.1
3. HICP[1]								
4. Public consumption deflator								
5. Investment deflator								
6. Export price deflator (goods and services)			2.3	4.5	2.3	2.1	2.1	2.2
7. Import price deflator (goods and services)			3.9	5.6	2.3	1.3	1.0	1.5

[1] Optional for Stability programmes.

Table 1c. Labour market developments

	ESA Code	2005	2005	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		5136.0	0.0	0.9	1.0	1.2	1.5	1.5
2. Employment, hours worked[2]		4910.1	0.1	0.9	1.0	1.2	1.5	1.5
3. Unemployment rate (%)[3]			7.6	7.6	7.5	7.2	6.6	6.3
4. Labour productivity, persons [4]		28.7	0.4	0.5	0.8	1.2	1.5	1.5
5. Labour productivity, hours worked[5]		30.0	0.3	0.5	0.8	1.2	1.5	1.5
6. Compensation of employees	D.1	74479.0	3.2	4.6	3.5	3.4	3.8	4.0

[1] Occupied population, domestic concept national accounts definition.
[2] National accounts definition.
[3] Harmonised definition, Eurostat; levels.
[4] Real GDP per person employed.
[5] Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-7.9	-7.5	-7.3	-6.9	-6.3	-6.0
of which:							
- Balance on goods and services		-8.9	-8.0	-7.0	-6.0	-5.1	-4.6
- Balance of primary incomes and transfers		-0.6	-1.3	-2.1	-2.4	-2.5	-2.6
- Capital account		1.6	1.8	1.7	1.5	1.3	1.2
2. Net lending/borrowing of the private sector	B.9/EDP B.9	-1.8	-2.9	-3.7	-4.3	-4.9	-5.7
3. Net lending/borrowing of general government	B.9	-6.0	-4.6	-3.7	-2.6	-1.5	-0.4
4. Statistical discrepancy							

Table 2. General government budgetary prospects

	ESA code		2005	2005	2006	2007	2008	2009	2010
			Level	% GDP	% oGDP	% GDP	% GDP	% GDP	% GDP
Net lending (EDP B.9) by sub-sector									
1. General government	S.13		-8,894.5	-6.0	-4.6	-3.7	-2.6	-1.5	-0.4
2. Central government	S.1311		-8,937.6	-6.1	-4.7	-3.9	-2.8	-1.7	-0.5
3. State government	S.1312								
4. Local government	S.1313		-436.9	-0.3	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S.1314		479.9	0.3	0.1	0.2	0.2	0.2	0.2
General government (S13)									
6. Total revenue	TR		61,522.9	41.7	41.7	41.7	41.4	41.2	41.1
7. Total expenditure	TE[1]		70,417.4	47.8	46.3	45.4	44.0	42.7	41.5
8. Net lending/borrowing	EDP B.9		-8,894.5	-6.0	-4.6	-3.7	-2.6	-1.5	-0.4
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM		4,028.9	2.7	2.9	3.0	3.0	3.0	2.9
pm: 9a. FISIM									
10. Primary balance	[2]		-4,865.6	-3.3	-1.7	-0.7	0.4	1.5	2.5
Selected components of revenue									
11. Total taxes (11=11a+11b+11c)			35,046.7	23.8	24.4	24.7	24.7	24.7	24.6
11a. Taxes on production and imports	D.2		22,214.1	15.1	15.5	15.5	15.6	15.7	15.7
11b. Current taxes on income, wealth, etc	D.5		12,787.5	8.7	8.9	9.2	9.1	9.0	8.9
11c. Capital taxes	D.91		45.1	0.0	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61		18,443.6	12.5	12.2	12.2	12.1	12.1	12.1
13. Property income	D.4		739.0	0.5	0.5	0.4	0.4	0.3	0.3
14. Other (14=15-(11+12+13))			7,293.6	4.9	4.6	4.4	4.2	4.1	4.1
15=6. Total revenue	TR		61,522.9	41.7	41.7	41.7	41.4	41.2	41.1
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[3]			51,761.8	35.1	35.7	36.2	36.2	36.2	36.1
Selected components of expenditure									
16. Collective consumption	P.32		12,274.6	8.3	8.0	7.6	7.3	7.0	6.7
17. Total social transfers	D.62 + D.63		41,160.9	27.9	27.6	27.1	26.4	25.6	24.9
17a. Social transfers in kind	P.31 = D.63		19,148.8	13.0	12.7	12.1	11.6	11.1	10.7
17b. Social transfers other than in kind	D.62		22,012.1	14.9	15.0	15.0	14.8	14.5	14.2
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM		4,028.9	2.7	2.9	3.0	3.0	3.0	2.9
19. Subsidies	D.3		2,353.2	1.6	1.2	1.1	0.9	0.9	0.8
20. Gross fixed capital formation	P.51		4,183.1	2.8	2.5	2.3	2.3	2.4	2.6
21. Other (21=22-(16+17+18+19+20))			6,416.8	4.4	4.1	4.3	4.1	3.9	3.8
22=7. Total expenditure	TE[4]		70,417.4	47.8	46.3	45.4	44.0	42.7	41.5
Pm: compensation of employees	D.1								

[1] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[2] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).
[3] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.
[4] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP		2005	2006	2007	2008	2009	2010
1. Gross debt[1]		64.0	67.4	68.0	67.3	65.2	62.2
2. Change in gross debt ratio		5.4	3.3	0.6	-0.7	-2.1	-3.0
Contributions to changes in gross debt							
3. Primary balance[2]		3.3	1.7	0.7	-0.4	-1.5	-2.5
4. Interest expenditure (incl. FISIM) [3]		2.6	2.7	2.9	2.9	2.9	2.8
5. Stock-flow adjustment		1.3	1.1	-0.1	0.0	0.1	0.2
- Differences between cash and accruals[4]							
- Net accumulation of financial assets[5]		0.0	-0.3	-0.1	-0.3	-0.2	-0.1
of which - privatisation proceeds		0.4	0.8	0.5	0.4	0.3	0.2
- Valuation effects and other[6]							
p.m. implicit interest rate on debt[7]		4.5	4.4	4.5	4.5	4.5	4.5
Other relevant variables							
6. Liquid financial assets[8]							
7. Net financial debt (7=1-6)							

[1] As defined in Regulation 3605/93 (not an ESA concept).
[2] Cf. item 10 in Table 2.
[3] Cf. item 9 in Table 2.
[4] The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.
[5] Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.
[6] Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.
[7] Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.
[8] 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	2005	2006	2007	2008	2009	2010
1. Real GDP growth (%)		0.4	1.4	1.8	2.4	3.0	3.0
2. Net lending of general government	EDP B.9	-6.0	-4.6	-3.7	-2.6	-1.5	-0.4
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 + FISIM	2.7	2.9	3.0	3.0	3.0	2.9
4. Potential GDP growth (%) (1)							
contributions:							
- labour							
- capital							
- total factor productivity							
5. Output gap		-2.6	-2.7	-2.4	-1.8	-0.5	0.4
6. Cyclical budgetary component		-1.2	-1.2	-1.1	-0.8	-0.2	0.2
7. Cyclically-adjusted balance (2-6)		-4.9	-3.4	-2.6	-1.8	-1.3	-0.5
8. Cyclically-adjusted primary balance (7-3)		-2.1	-0.5	0.4	1.2	1.7	2.3

(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	2005	2006	2007	2008	2009	2010
Real GDP growth (%)							
Previous update		0.5	1.1	1.8	2.4	3.0	
Current update		0.4	1.4	1.8	2.4	3.0	3.0
Difference		-0.2	0.3	0.0	0.0	0.0	
General government net lending (% of GDP)	EDP B.9						
Previous update		-6.0	-4.6	-3.7	-2.6	-1.5	
Current update		-6.0	-4.6	-3.7	-2.6	-1.5	-0.4
Difference		0.0	0.0	0.0	0.0	0.0	
General government gross debt (% of GDP)							
Previous update		65.5	68.7	69.3	68.4	66.2	
Current update		64.0	67.4	68.0	67.3	65.2	62.2
Difference		-1.5	-1.3	-1.3	-1.1	-1.0	

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

% of GDP	**2000**	**2005**	**2010**	**2020**	**2030**	**2050**
Total expenditure	43.1	47.8	41.5	41.9	41.9	47.9
Of which: age-related expenditures	23.0	27.1	27.2	28.4	28.9	33.0
Pension expenditure	8.4	11.0	11.3	12.7	13.4	16.5
Social security pension	5.6	7.5	8.0	9.4	11.2	16.2
Old-age and early pensions	3.8	5.4	5.9	7.2	8.8	13.1
Other pensions (disability, survivors)	1.8	2.1	2.1	2.2	2.4	3.1
Occupational pensions (if in general government)	2.8	3.5	3.3	3.4	2.2	0.3
Health care	5.3	6.3	6.5	6.4	6.3	6.9
Long-term care *(this was earlier included in the health care)*	0.3	0.5	0.5	0.5	0.6	0.9
Education expenditure	5.1	4.8	4.5	4.4	4.3	4.6
Other age-related expenditures	3.9	4.5	4.5	4.4	4.3	4.2
Interest expenditure	3.1	2.7	2.9	2.0	1.6	3.5
Total revenue	40.2	41.7	41.2	41.2	41.2	41.2
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)	9.4	10.4	10.3	9.6	9.3	9.2
Pension reserve fund assets						
Of which: consolidated public pension fund assets	0.7	1.9	2.8	3.2	2.5	-16.2
(assets other than government liabilities)						
Labour productivity growth	1.1	0.4	2.1	2.5	1.7	1.7
Real GDP growth	3.9	0.4	3.0	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 based scenario

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	43.1	47.8	41.5	42.4	42.0	36.8
Of which: age-related expenditures	23.0	27.1	26.9	28.5	28.4	25.4
Pension expenditure	8.4	11.0	11.2	12.7	13.0	12.4
Social security pension	5.6	7.5	7.9	9.3	10.6	11.9
Old-age and early pensions	3.8	5.4	5.9	7.2	8.4	9.6
Other pensions (disability, survivors)	1.8	2.1	2.0	2.1	2.2	2.4
Occupational pensions (if in general government)	2.8	3.5	3.3	3.4	2.4	0.4
Health care	5.3	6.3	6.4	6.4	6.3	5.4
Long-term care *(this was earlier included in the health care)*	0.3	0.5	0.5	0.5	0.6	0.7
Education expenditure	5.1	4.8	4.4	4.4	4.3	3.6
Other age-related expenditures	3.9	4.5	4.5	4.5	4.3	3.3
Interest expenditure	3.1	2.7	2.9	2.1	1.9	-0.3
Total revenue	40.2	41.7	41.2	41.2	41.2	41.2
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)	9.4	10.4	10.2	9.4	8.9	8.7
Pension reserve fund assets						
Of which: consolidated public pension fund assets	0.7	1.9	2.8	4.6	5.2	3.0
(assets other than government liabilities)						
Labour productivity growth	1.1	0.4	1.5	2.0	2.2	2.5
Real GDP growth	3.9	0.4	3.0	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	6.8	5.5	5.5	5.5
Population aged 65+ over total population	16.4	17.0	17.7	20.3	24.3	31.9

Table 8. Basic assumptions

	2005	2006	2007	2008	2009	2010
Short-term interest rate[1] (annual average)	2.2	3.1	3.7	3.6	3.6	3.6
Long-term interest rate (annual average)	3.4	3.9	4.2	4.4	4.3	4.3
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.24	1.25	1.27	1.27	1.27	1.27
Nominal effective exchange rate	-0.2	0.2	0.3	0.1	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	5.5	5.7	5.2	5.2	4.5	4.5
EU GDP growth	1.7	2.8	2.4	2.4	2.3	2.3
Growth of relevant foreign markets	6.5	9.7	6.8	6.5	6.0	6.0
World import volumes, excluding EU	7.9	9.1	8.3	7.9	7.9	7.9
Oil prices, (Brent, USD/barrel)	54.4	65.6	66.3	68.0	63.0	60.0

Annex 3: 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 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.

Guidelines in the 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	
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 concepts used are in line with the European system of accounts	X		

Guidelines in the code of conduct	Yes	No	Comments
(ESA).			
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.	X		
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].			Not applicable
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		External balance only
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
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.			Not applicable
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.			Not applicable
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.			The programme states that only structural 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.			Not applicable
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 effects of possible 'major structural reforms' over time.			Not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			Not applicable
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	X		

Guidelines in the code of conduct	Yes	No	Comments
assumptions for the main extra-EU variables.			
In case of "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			Not applicable
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		Information provided, without explicit links to the BEPGs.
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.	X		
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		

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 Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the euro area.

Portugal - Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	2.4	4.1	0.6	-1.1	1.2	0.4
Private consumption % change	2.8	4.2	1.4	0.1	2.4	2.0
Government consumption % change	3.0	3.8	2.1	0.3	2.5	1.8
Investment % change	2.7	8.3	-2.9	-10.0	0.9	-3.0
Exports % change	4.4	6.3	2.5	3.7	4.5	0.9
Imports % change	5.1	8.6	1.7	-0.4	6.8	1.8
Contributions to real GDP growth						

Demand						
Domestic demand	3.0	5.4	0.6	-2.4	2.4	0.8
Net exports	-0.6	-1.3	0.1	1.2	-1.1	-0.4
Output gap	0.4	0.8	0.0	-1.0	-1.2	-2.0
Prices and costs						
HICP inflation % change	2.8	2.4	3.2	3.3	2.5	2.1
Unit labour costs % change	3.5	3.7	3.4	3.9	1.3	2.7
Labour productivity % change	1.2	2.2	0.3	-0.7	1.1	0.3
Real unit labour costs % change	0.3	0.4	0.2	1.1	-1.4	0.1
Comparative price levels (EUR25=100)	77.3	74.5	80.2	83.1	82.9	83.5
Labour market						
Employment % change	1.1	1.9	0.4	-0.4	0.1	0.0
Employment % of pop work age	70.2	69.1	71.3	71.1	70.9	70.5
Unemployment rate in %	5.7	5.5	5.9	6.3	6.7	7.6
NAIRU in %	5.5	5.2	5.9	5.9	6.1	6.5
Participation rate in %	74.5	73.1	75.8	76.0	76.0	76.4
Working age population % change	0.5	0.5	0.5	0.6	0.5	0.5
Competitiveness and external position						
Real effective exchange rate % change (1)	1.7	0.8	2.6	5.1	1.0	1.1
Export performance % change (2)	-2.1	-2.4	-1.7	-0.2	-3.1	-5.0
External balance of g & s	-8.7	-9.0	-8.4	-6.8	-8.0	-8.9
Net borrowing v-à-v RoW	-5.8	-5.1	-6.5	-4.0	-5.8	-7.9
FDI	2.7	2.5	2.8	4.2	1.3	1.7
Public finances						
Total expenditure % of GDP	44.3	42.9	45.8	45.8	46.7	47.7
Total revenue % of GDP	40.7	39.5	41.9	42.9	43.5	41.7
General government balance % of GDP	-3.6	-3.3	-3.9	-2.9	-3.2	-6.0
General government debt % of GDP	55.8	54.0	57.6	57.0	58.6	64.0
Structural budget balance % of GDP	n.a.	n.a.	n.a.	-4.8	-4.8	-5.1
Financial indicators (3)						
Short term real interest rate (4)	0.7	1.6	-0.3	-0.4	-0.7	-0.5
Long term real interest rate (4)	1.9	2.7	1.2	1.4	1.3	0.8
Household credit % change	18.6	26.4	10.9	9.9	10.3	10.2
Corporate sector credit % change (5)	12.3	15.7	8.8	6.1	1.8	7.6
Household debt in % of GDP	59.7	45.6	73.8	73.9	78.5	84.0
Corporate sector debt in % of GDP	76.3	62.6	90.0	91.9	90.0	94.0

Notes:
(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ
(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).
(3) Data available up to 2004
(4) Using GDP deflator
(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares
(6) Non-financial corporate sector debt, defined as loans and securities other than shares

EUR-12 - Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	2.1	2.7	1.4	0.8	2.0	1.4
Private consumption % change	2.0	2.6	1.4	1.2	1.5	1.3
Government consumption % change	1.7	1.7	1.7	1.8	1.2	1.4
Investment % change	2.6	4.3	1.0	1.0	2.2	2.5
Exports % change	5.8	8.1	3.5	1.1	6.8	4.3
Imports % change	5.9	8.4	3.4	3.1	6.7	5.3
Contributions to real GDP growth						
Demand						
Domestic demand	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	0.1	0.1	0.1	-0.7	0.2	-0.2
Output gap	-0.1	-0.1	0.0	-0.6	-0.5	-1.1
Prices and costs						
HICP inflation % change	1.9	1.7	2.2	2.1	2.1	2.2
Unit labour costs % change	1.3	0.8	1.7	2.0	0.9	1.0
Labour productivity % change	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs % change	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Comparative price levels (EUR25=100)	n.a.	n.a.	102.1	103.0	102.7	102.3
Labour market						
Employment % change	1.2	1.5	0.9	0.7	0.7	0.8
Employment % of pop work age	63.7	62.0	65.4	65.4	65.6	65.8
Unemployment rate in %	9.1	9.8	8.5	8.7	8.9	8.6
NAIRU in %	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate in %	69.9	68.5	71.2	71.4	71.7	71.8
Working age population % change	0.3	0.2	0.4	0.5	0.5	0.5
Competitiveness and external position						
Real effective exchange rate % change (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance % change (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s	1.9	1.7	2.0	2.1	2.1	1.5
Net borrowing v-à-v RoW	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI	2.4	2.5	2.2	1.9	1.1	n.a.
Public finances						
Total expenditure % of GDP	48.2	48.7	47.7	48.2	47.6	47.6
Total revenue % of GDP	45.8	46.5	45.1	45.1	44.8	45.1
General government balance % of GDP	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt % of GDP	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance % of GDP	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
Financial indicators (3)						
Short term real interest rate (4)	1.7	2.7	0.7	0.2	0.2	0.3
Long term real interest rate (4)	3.1	4.1	2.1	2.0	2.2	1.5
Household credit % change	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector credit % change (5)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

(4) Using GDP deflator

(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

Annex 5: Assessment of tax projections

Table 9 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)[45].

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:

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

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[46]. 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:

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

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

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

[45] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 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.

[46] 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: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i exante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex post}\frac{dB_i}{B_i}$.

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 $\varepsilon = \sum_i w_i \varepsilon_{T_t B_i} \varepsilon_{B_i Y}$ with w_i the share of the *i-th* tax in the overall tax burden.

Assessment of tax projections by major tax category

	2007			2008			2009	2010
	SP/CP	**COM**	**OECD[1]**	**SP/CP**	**COM[2]**	**OECD[1]**	**SP/CP**	**SP/CP**
Taxes on production and imports:								
Change in tax-to-GDP ratio	0.0	0.1	0.0	0.1	0.0	0.0	0.1	0.0
Difference SP/CP – COM	-0.1			0.1			/	/
of which[3]:								
- discretionary & elasticity component	0.1			0.1			/	/
- composition component	-0.1			0.0			/	/
Difference COM – OECD	/	0.1		/	0.0		/	/
of which[3]:								
- discretionary & elasticity component	/	0.1		/	0.1		/	/
- composition component	/	0.0		/	-0.1		/	/
p.m.: Elasticity								
- of taxes to tax base[4]	1.3	1.1	1.0	1.4	1.1	1.0	1.4	1.2
- of tax base[4] to GDP	0.8	1.0	1.0	0.8	0.9	1.0	0.8	0.8
Social contributions:								
Change in tax-to-GDP ratio	0.0	-0.1	0.0	-0.1	-0.2	0.0	0.0	0.0
Difference SP/CP – COM	0.1		/	0.0		/	/	/
of which[3]:								
- discretionary & elasticity component	0.2		/	0.2		/	/	/
- composition component	-0.1		/	-0.1		/	/	/
Difference COM – OECD	/	-0.1		/	-0.1		/	/
of which[3]:								
- discretionary & elasticity component	/	-0.1		/	-0.1		/	/
- composition component	/	0.0		/	0.0		/	/
p.m.: Elasticity								
- of taxes to tax base[5]	1.3	0.8	1.0	1.2	0.8	1.0	1.5	1.4
- of tax base[5] to GDP	0.8	0.9	0.9	0.7	0.9	0.9	0.7	0.7
Personal income tax[6]:								
Change in tax-to-GDP ratio	0.2	0.1	0.1	-0.1	0.1	0.2	-0.1	-0.1
Difference SP/CP – COM	0.1		/	-0.2		/	/	/
of which[3]:								
- discretionary & elasticity component	0.1		/	-0.1		/	/	/
- composition component	-0.1		/	-0.1		/	/	/
Difference COM – OECD	/	0.0		/	0.0		/	/
of which[3]:								
- discretionary & elasticity component	/	0.0		/	0.0		/	/
- composition component	/	0.0		/	0.0		/	/

p.m.: Elasticity								
- of taxes to tax base[5]	2.3	1.7	1.7	1.2	1.7	1.7	1.2	1.1
- of tax base[5] to GDP	0.8	0.9	0.9	0.7	0.9	0.9	0.7	0.7
Corporate income tax[6]:								
Change in tax-to-GDP ratio	0.1	0.1	0.0	0.0	0.1	0.0	0.0	0.0
Difference SP/CP – COM	0.0		/	-0.1		/	/	/
of which[3]:								
- discretionary & elasticity component	0.0		/	-0.1		/	/	/
- composition component	0.0		/	0.0		/	/	/
Difference COM – OECD	/	-0.1		/	-0.1		/	/
of which[3]:								
- discretionary & elasticity component	/	-0.1		/	-0.1		/	/
- composition component	/	0.0		/	0.0		/	/
p.m.: Elasticity								
-of taxes to tax base[7]	1.5	1.5	1.0	0.6	1.3	1.0	0.6	0.6
-of tax base[7] to GDP	1.2	1.1	0.9	1.3	1.1	0.9	1.3	1.2

Notes:

[1]Based on OECD ex-ante elasticities

[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 2006 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)