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PORTUGAL: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE DECEMBER 2007 UPDATE OF THE STABILITY PROGRAMME

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 14 December 2007.

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 (DG ECFIN) of the European Commission, was finalised on 5 February 2008. Comments should be sent to Pedro L. Cardoso (Pedro.Cardoso@ec.europa.eu) and Paulo R. Bastos (Paulo.Bastos@ec.europa.eu). The main aim of the 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.

The analysis takes into account (i) the Commission services' autumn 2007 forecasts, (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. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 13 February. The ECOFIN Council is expected to adopt its opinion on the programme on 4 March 2008.

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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

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SUMMARY AND CONCLUSIONS

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 2007-2011, was submitted on 14 December 2007. 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.

From a phase of high economic growth in the second half of the nineties, the Portuguese economy moved to a situation of sluggish GDP growth after 2000, accompanied by rising unemployment. All factors added to budgetary fragilities. This marked change in economic performance was rooted in the accumulation of large budgetary and external deficits. Pro-cyclical fiscal policies compounded the imbalances of the private sector, and fed uncertainty. At the beginning of this decade, private domestic demand moderated considerably reflecting the adjustment of spending to levels more in line with income patterns. At the same time, public primary expenditure had to slow down from previous unsustainable trends, while the competitive position has remained vulnerable reflecting a lasting misalignment between wages and productivity growth. Whereas recent economic growth has been led by export growth, accompanied by considerable restructuring in some important industries in the face of increased external competition, weaknesses of a more structural nature stand in the way of a lasting improvement in economic performance. In particular, overall productivity is low, mainly due to relatively low educational attainment, and the efficiency and effectiveness of the public sector needs particular attention. In recent years, significant progress has been achieved to overcome this situation, in particular in containing public finances imbalances. In all, continuing fiscal consolidation, improving the quality of public finances, and proceeding with structural reforms with a view to improving potential GDP growth remain major challenges to put back the Portuguese economy on a sustainable and dynamic catching-up path.

The macroeconomic scenario underlying the programme envisages a continuation of the upswing in economic activity, with real GDP growth picking up from 1.8% in 2007 to 2.2% in 2008 and further to 2.8% in 2009 and 3% in 2010 and 2011. The acceleration of GDP growth is foreseen to be largely driven by a greater dynamism of private consumption and investment, with a positive, albeit declining contribution from the external sector in the years up to 2009. Assessed against the Commission services' autumn 2007 forecasts and more recent information, this economic outlook appears to be based on favourable growth assumptions. In particular, growth rates for private demand components seem to be on the high side, especially for investment. The programme expects the labour market to improve gradually over the programme period, but the employment outlook appears optimistic. The projections for consumer inflation may be on the low side in the light of the recent surge in food and oil prices. The economy's competitiveness position is expected to improve in the coming years, with unit labour costs growing more slowly than in most of its trading partners. Nonetheless, a subsiding demand from external markets may hinder export growth. The programme envisages a marked decline of the sizeable external deficit, from 8.8% of GDP in 2006 and an estimated 7% of GDP in 2007 to 4.7% of GDP in 2011. Assessed against current information, however, the underlying improvement of the deficit in the balance of current transfers and primary income projected in the update might be difficult to achieve. According to the Commission services' 2007 autumn forecasts, the output gap is

projected to remain negative, although narrowing, up to 2009. Overall, Portugal can be considered to be in bad economic times.

For 2007, the general government deficit is estimated at 3% of GDP in the updated programme and in the Commission services' autumn 2007 forecasts, against a target of 3.7% of GDP set in the previous update of the stability programme. More recent and preliminary data on budgetary execution suggest that the 2007 deficit outturn is likely to be lower than 3% of GDP. This development is in line with the invitation in the Council opinion of 27 February 2007 on the previous update to implement measures so as to correct the excessive deficit by 2008. It is also in line with the April 2007 Eurogroup orientations for budgetary policies as the better-than-expected outcome in 2006 was used to pursue a more ambitious target in 2007.

The update of the stability programme aims at further fiscal consolidation over the medium term, notably to achieve the medium-term objective (MTO) of a structural deficit, i.e., cyclically-adjusted deficit net of one-off and other temporary measures, of 0.5% of GDP by 2010. The headline general government deficit is targeted to decline gradually from 3% of GDP in 2007 to 2.4% of GDP in 2008, 1.5% in 2009, 0.4% in 2010 and eventually 0.2% of GDP in 2011. The path for the primary balance is similar, improving from a slight deficit in 2007 to a surplus of 2.5% of GDP in 2011. The structural deficit calculated according to the commonly agreed methodology is projected to narrow by around 0.5 percentage point of GDP per year on average until 2010 and to broadly stabilise at around 0.5% of GDP in 2011. The planned fiscal consolidation is to be achieved by continued expenditure moderation thanks to corrective measures to contain the cost of public employment and, to a lesser extent, social transfers. A rise in the revenue ratio is expected to also contribute somewhat to fiscal consolidation. Building on the better-than-budgeted deficit outturns in 2006 and 2007, the programme largely confirms the planned structural adjustment path outlined in the December 2006 update of the stability programme against a little changed macroeconomic scenario. Government gross debt, estimated at 64.4% of GDP in 2007, is projected to accelerate its decline, which would amount to almost 8 percentage points of GDP over the period, falling below the 60% of GDP Treaty reference value in 2010.

The budgetary outcomes could overall be worse than projected in the programme update. In particular, as noted above, the macroeconomic scenario appears to be based on favourable GDP growth assumptions. Also, the expenditure savings that can be generated over the medium term from recently implemented measures are still subject to some degree of uncertainty. However, some of these risks could be partially offset if the better-than-estimated outcome for 2007 is confirmed, which depending on its extent and composition would create a benign base effect for 2008. In view of the negative risks to the budgetary targets, the evolution of the debt ratio could also be less favourable than projected in the programme.

In view of this risk assessment, the budgetary stance in the programme seems consistent with a durable correction of the excessive deficit by no later than 2008 as recommended by the Council. Following the marked reductions in 2006 and 2007, the update targets a further decline of the structural deficit of 0.5 percentage point of GDP in 2008. According to the programme, a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations would be reached in 2009. However, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2010, as envisaged in the programme. Although the planned pace of consolidation towards the MTO is in line with the Stability and Growth Pact, the adjustment may require additional efforts in view of the risks mentioned above.

The reforms of old-age pension schemes adopted by Portugal in 2006 and 2007 contribute markedly to containing the increase in age-related expenditure and allow an improvement in the rating of risks to the sustainability of public finances from high to medium risk, bringing the long-term budgetary impact of ageing in Portugal close to the EU average. Nevertheless, the current level of gross debt is above the Treaty reference value. At the same time, the budgetary position in 2007 as estimated in the programme, albeit clearly improved compared with the starting position in the previous update, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Further budgetary consolidation, as planned in the programme, would contribute to reducing risks to the sustainability of public finances.

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 in October 2007. The NRP identifies as key priorities: consolidating public finances, whilst improving its sustainability; improving the efficiency of the educational system; and modernising employment protection to curb the segmentation of the labour market. On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Portugal's national reform programme.[1] The Commission's assessment was that Portugal has made good progress in implementing its NRP over the 2005-2007 period. Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Portugal was recommended to give the highest priority to the challenges in the areas of: fiscal consolidation and quality and sustainability of public finances; efficiency of the educational system; and, modernisation of employment protection and reduction of labour market segmentation. In addition, Portugal should also focus on the areas of: the current account deficit; the linkages between research, higher education, industry and the private sector; effective competition, notably in energy and financial services markets; better regulation; transposition of EU legislation into national law; green house gas emissions; and social cohesion. The stability programme is consistent with the NRP. In particular, the medium-term fiscal consolidation plans have been included in the NRP. In parallel, the stability programme elaborates on progress achieved in implementing some of the national reform programme measures and on their impact on public finances and the broader economic outlook. Indeed, the two programmes provide complementary information on common policy measures. The budgetary strategy in the stability programme is broadly in line with the country-specific broad economic policy guidelines included in the integrated guidelines and the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy.

The overall conclusion is that the stability programme is consistent with a correction of the excessive deficit no later than 2008. The programme aims at further fiscal consolidation over the medium term, including the achievement of the MTO by 2010, and foresees a declining path for the government debt ratio over the entire programme period. However, achieving these objectives is subject to an effective implementation of the measures announced in the programme and may require additional efforts, notably in the light of the risk of lower-than-projected economic growth. Further progress with

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[1] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12. 2007, COM(2007)803.

fiscal consolidation, as planned, could also help to address the external imbalances and improve the prospect of the long-term sustainability of public finances, for which Portugal is considered to be at medium risk, after the significant reform of the pension system. Finally, envisaged improvements in the quality and efficiency of public expenditure, including the public administration and the budgetary framework, can have a favourable impact on potential GDP growth and thereby help resume the catching-up process.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Dec 2007**	**1.3**	**1.8**	**2.2**	**2.8**	**3.0**	**3.0**
	COM Nov 2007	1.3	1.8	2.0	2.1	n.a.	n.a.
	SP Dec 2006	*1.4*	*1.8*	*2.4*	*3.0*	*3.0*	*n.a.*
HICP inflation[4] (%)	**SP Dec 2007**	**3.0**	**2.3**	**2.1**	**2.1**	**2.1**	**2.1**
	COM Nov 2007	3.0	2.4	2.4	2.3	n.a.	n.a.
	SP Dec 2006	*3.2*	*2.2*	*2.2*	*2.1*	*2.1*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Dec 2007**	**-2.4**	**-2.2**	**-1.8**	**-1.1**	**-0.2**	**0.5**
	COM Nov 2007[2]	-2.1	-1.7	-1.2	-0.8	n.a.	n.a.
	SP Dec 2006	*-2.6*	*-2.4*	*-1.8*	*-0.7*	*0.2*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Dec 2007**	**-8.8**	**-7.0**	**-5.8**	**-5.6**	**-4.9**	**-4.7**
	COM Nov 2007	-8.8	-7.9	-7.7	-7.7	n.a.	n.a.
	SP Dec 2006	*-7.5*	*-7.3*	*-6.9*	*-6.3*	*-6.0*	*n.a.*
General government balance (% of GDP)	**SP Dec 2007**	**-3.9**	**-3.0**	**-2.4**	**-1.5**	**-0.4**	**-0.2**
	COM Nov 2007	-3.9	-3.0	-2.6	-2.4	n.a.	n.a.
	SP Dec 2006	*-4.6*	*-3.7*	*-2.6*	*-1.5*	*-0.4*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2007**	**-1.1**	**-0.1**	**0.5**	**1.3**	**2.2**	**2.5**
	COM Nov 2007	-1.1	-0.1	0.3	0.5	n.a.	n.a.
	SP Dec 2006	*-1.7*	*-0.7*	*0.4*	*1.5*	*2.5*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Dec 2007**	**-2.8**	**-2.0**	**-1.6**	**-1.0**	**-0.3**	**-0.4**
	COM Nov 2007	-2.9	-2.2	-2.1	-2.1	n.a.	n.a.
	SP Dec 2006	*-3.4*	*-2.6*	*-1.8*	*-1.2*	*-0.5*	*n.a.*
Structural balance[3] (% of GDP)	**SP Dec 2007**	**-2.8**	**-2.1**	**-1.6**	**-1.0**	**-0.3**	**-0.4**
	COM Nov 2007	-2.9	-2.3	-2.1	-2.1	n.a.	n.a.
	SP Dec 2006	*-3.4*	*-2.6*	*-1.8*	*-1.2*	*-0.5*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2007**	**64.8**	**64.4**	**64.1**	**62.5**	**59.7**	**56.7**
	COM Nov 2007	64.8	64.4	64.7	64.5	n.a.	n.a.
	SP Dec 2006	*67.4*	*68.0*	*67.3*	*65.2*	*62.2*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 1.5%, 1.5%, 1.6% and 1.6% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2007 (deficit-reducing) according to the most recent programme and the Commission services' autumn forecasts.

[4] Private consumption deflator for the December 2006 update of the stability programme.

Source:
Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The Portuguese authorities submitted the most recent update of the Portuguese stability programme on 14 December 2007.[2] The update covers the period from 2007 to 2011. After its approval by the Cabinet, the programme was discussed by Parliament on 13 December 2007. It takes on board the 2008 Budget Law adopted in November 2007.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Portugal, with a particular focus on the implications of compensation of government employees for fiscal developments and the role of public sector wages in macroeconomic adjustment within EMU. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the stability programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key economic indicators of past economic performance (Annex 2).

[2] The code of conduct allows Portugal to deliver no later than 15 December. The English version of the Programme was submitted on 20 December 2007.

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON ADJUSTING IN EMU: THE ROLE OF PUBLIC SECTOR WAGES

2.1. Introduction

The Portuguese public finances have been fragile for a number of years as revealed by the continuously high general government deficit either close to or above the 3% of GDP reference value, most notably since 2001. Apart from the impact of the sharp economic downturn, the persistently large budgetary deficits have been rooted in a lasting upward trend of government primary expenditure. In fact, the structural deficit (i.e., the fiscal balance excluding the impact of the economic cycle and one-off and temporary measures) deteriorated around the years 2000 and 2001 and remained little changed at high levels for most of the decade up to 2006, with improvements being noted since then.

Between 1995 and 2005, current primary expenditure grew systematically faster than GDP, a trend that was reversed only in 2006. Compensation of employees was until very recently the most sizeable item of general government expenditure. Its weight has changed over time, with a marked growth in late 1990s and early 2000s largely contemporaneous to the deterioration in the general government balance, and some stabilisation afterwards. In 2006, a decline in compensation of government employees was the main driver of the expenditure retrenchment and the subsequent improvement in the fiscal balance. Wage bill moderation in the public sector remains a key challenge to ensure fiscal consolidation in a durable manner in Portugal.

A second challenge is to restore price competitiveness with a view to achieving a more balanced position for the external sector and thereby putting GDP on a sustainable growth path, which will then have a benign impact on public finances. In the second half of the 1990s, price and labour costs inflation stood above the average of trading partners. Hence, the economy's competitiveness position eroded gradually, feeding an imbalance on the goods and services account, while the external sector put a big drag on GDP growth. Despite the cooling of domestic demand after the year 2000, those developments remained somewhat unabated with prices and wages growing still faster than in a number of trading partners. Since compensation of government employees also represents a significant share of the overall economy's compensation of employees (at some 29% of total compensation of employees), it has a direct impact on income and thereby on aggregate domestic demand and competitiveness developments. This fact makes it useful to deepen on the relations between government wage policy and the broader economy's wage behaviour.

This section analyses developments of compensation of government employees and its impact on fiscal developments and wage behaviour of the overall economy. A first objective is to better understand the importance of this expenditure item for past fiscal outcomes as well as the possibilities of further fiscal consolidation by reining in it. Given the above-mentioned competitiveness deterioration, it is also important to analyse the relevance of government wage behaviour beyond the sphere of public expenditure, especially its impact on the economy's global wage growth (and inflation when product markets are competitive). Finally, in the light of what seems to be a situation of low potential GDP growth, it is worth to reflect on how changes in government employment and wage policies can contribute to improve the quality of public finances, the efficiency of the public sector and help the wider economic outlook.

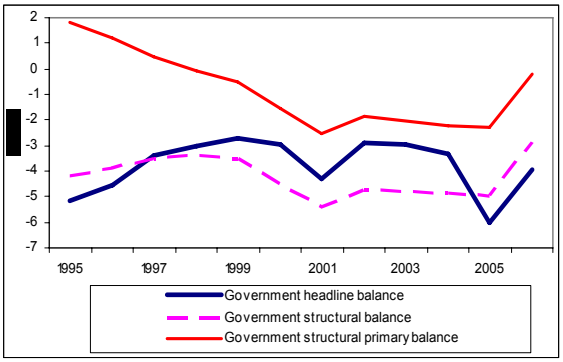
In its economic assessment of the stability programme of Portugal last year, the Commission pointed out that the overriding fiscal challenge was to put public finances on a sound track, the more so as fiscal problems go beyond a cyclical weakness. On top of this, the Commission considered that improving the efficiency and effectiveness of government expenditure can be instrumental to support higher productivity levels, thereby contributing to the potential growth of the wider economy. Being compensation of employees a major item of government expenditure, a proper selection of options for personnel policies can help achieving those two objectives. In fact, on top of a containment of the public wage bill helping fiscal consolidation, a proper allocation of human resources and well-fitted pay structures may pave the way for a more efficient use of public resources.

This section is organised as follows. Sub-section 2.2 describes the main developments in the budgetary stance and cost competitiveness. Sub-section 2.3 assesses the impact of compensation of government employees on the overall fiscal position. Sub-section 2.4 looks at the drivers of the government wage bill and discusses possible spillovers into the private sector wage behaviour. The final sub-section summarises and identifies major challenges for government employment and wages in Portugal, notably its implications for fiscal and competitiveness developments.

2.2. Budgetary situation and cost competitiveness developments

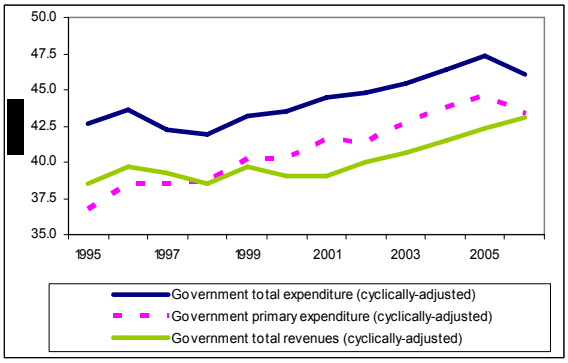
Apart from the sharp economic downturn after the year 2001, the lasting upward trend of government primary expenditure has been the major driver of the persistently large government deficits (Figure 1 and Figure 2). Between 1995 and 2005, the weight of current primary expenditure on GDP went up from just below 32% to almost 41% as the result of a continued expansion in all spending items, with such a trend being reversed only in 2006 when current primary expenditure fell to 40¼% of GDP resulting in a notable improvement in the budgetary balance.

Figure 1: Government deficit



Source: Ameco

Figure 2: Government revenue and expenditure

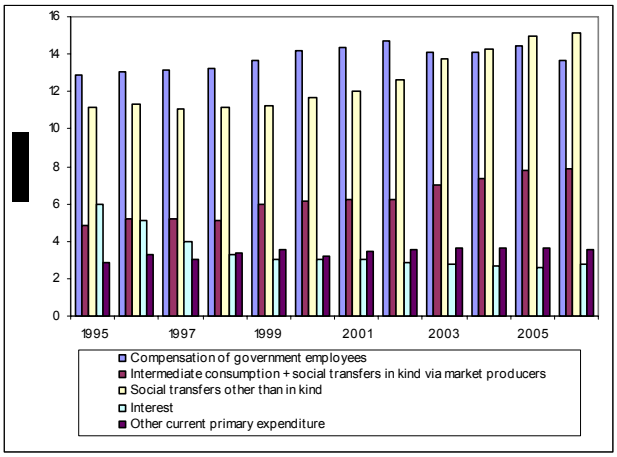


Note: Corrected for one-off measures
Source: Ameco

Compensation of employees has been a sizeable component of Portuguese government expenditure, representing on average more than 38½% of government current primary expenditure (31% of total expenditure) and about 14% of GDP since the mid-nineties (Figure 3), becoming clearly the highest in the euro area (see Table 1 for data on

compensation of government employees in the various euro area participants). In particular, it has been until very recently the largest item of public spending. At the same time, even if other current primary expenditure items have had a more pronounced expansion after the turn of the century, especially social benefits, compensation of employees has played a role in the evolution of the overall fiscal balance, notably in the deterioration in the late 1990s and the improvement in 2006.[3]

Figure 3: Composition of government current expenditure



Source: Ameco

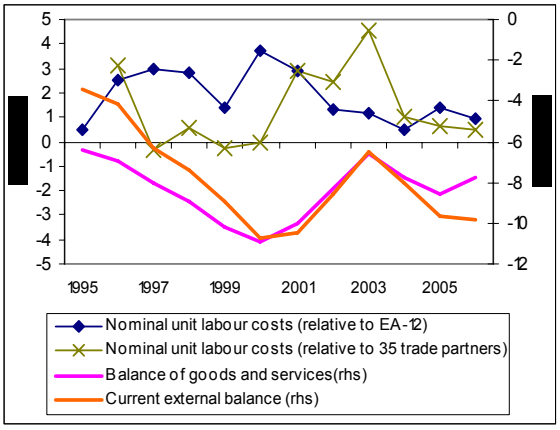
In parallel, the competitiveness of the Portuguese economy has eroded and external imbalances have been sizeable, which makes their correction a necessary condition to put the economy on a sustainable GDP growth path.

Persistent unit labour cost growth and inflation differentials vis-à-vis trade partners have fed the deterioration in cost competitiveness (Figure 4 and Figure 5). Wage growth has somewhat mirrored unemployment developments. Wages grew strongly until 2000 and since have only slowly decelerated. Moreover, a still relatively high share of labour-intensive sectors in the export-product mix has made the Portuguese economy rather vulnerable to competition from emerging economies with low levels of labour costs. Whereas the existence of an inflation differential over the 1990s was contemporaneous to a strong domestic economic activity, a differential has persisted in times of a more adverse cyclical position in Portugal than in the rest of the euro area. Therefore, Portugal

[3] Data shown in Figure 3 and Figure 6 are not corrected from changes in the perimeter of government services, in particular the incorporation of various government hospitals as private companies and subsequent drop-out from the government sector in 2002 and 2005. This detracted some 0.7% and 0.2% of GDP from compensation of employees, respectively. Total government expenditure stood however largely unaffected to the extent that services provided by those hospitals continued to be financed by the government and recorded in national accounts as transfers in kind to households. It is also worth noticing that according to the ESA95 rules, government expenditure related with social transfers to its current and former employees is recorded as compensation of employees as well as social transfers (in kind or other than in kind, depending upon the nature of the various benefits). Therefore, this takes the form of a double counting of the same item on the expenditure side, which is offset by its record as social contribution on the revenue side.

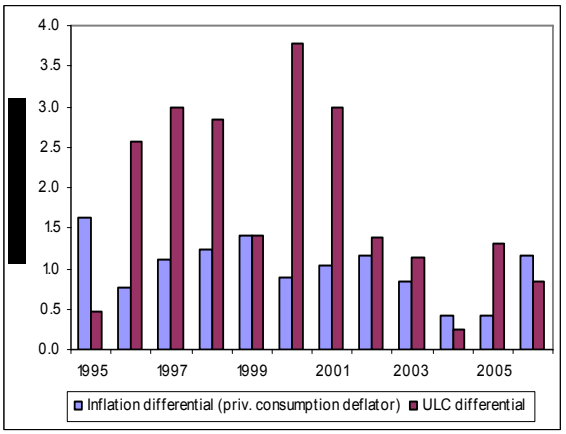
accumulated losses in external competitiveness and consequently the balance of goods and services has recorded high deficits, even if somewhat lower in recent years.

Figure 4: Competitiveness and external imbalances



Source: Ameco

Figure 5: Inflation and cost differentials – Portugal vis-à-vis the euro area

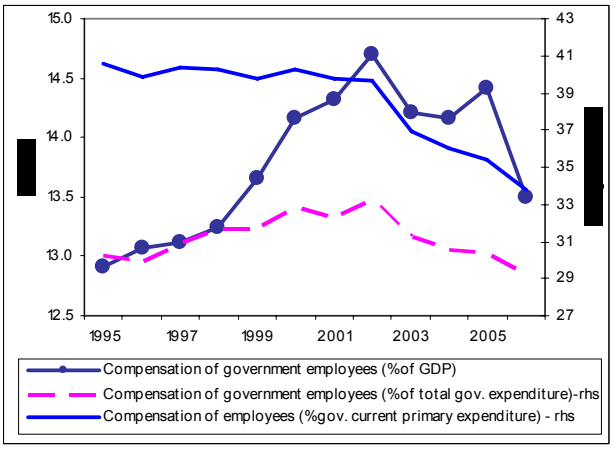


Source: Ameco

2.3. Compensation of government employees and fiscal developments

The evolution of compensation of government employees since the mid-1990s has followed a hump-shaped profile. An expansion of the government personnel bill in terms of both GDP and government expenditure took place in the late nineties and earlier years of this decade. Between 2003 and 2005, the personnel bill to GDP ratio was more stable. In 2006, it declined more notably on the back of a number of discretionary policy measures (Figure 6).

Figure 6: The weight of compensation of government employees

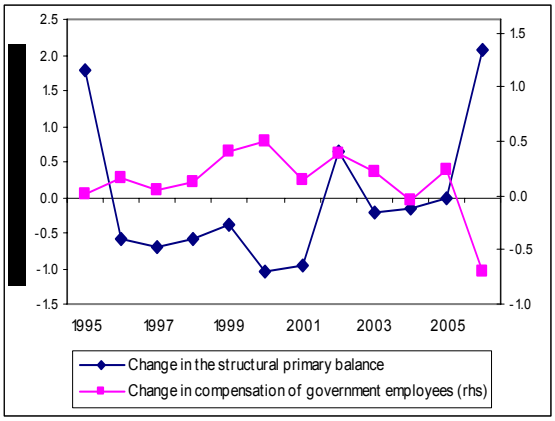


Note: Primary balance corrected for budgetary one-off measures.

Source: Ameco

During most of the past ten years, the government wage expenditure has evolved broadly in tandem with the fiscal stance – measured here by the change in the structural primary balance: rising with a fiscal expansion and cooling in times of tighter budgetary constraints (Figure 7). The share of government labour costs in GDP increased when the fiscal stance was loosened in the second half of the 1990s as revealed by the continuous deterioration of the structural primary balance; in more recent years it has remained more stable in terms of GDP coinciding with a more neutral fiscal stance on average. In 2006, the retrenchment on personnel spending drove the fiscal tightening. Overall, government personnel spending has largely had a pro-cyclical behaviour, adding to the economy's cyclical fluctuations in both the upward and downward phases of the cycle (Figure 8). [4]

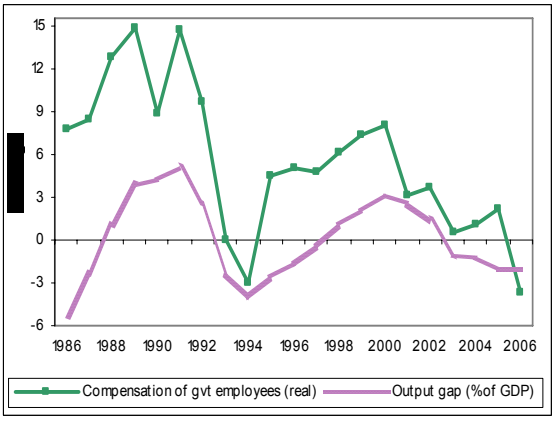
Figure 7: Compensation of government employees and fiscal stance



Note: Data corrected for some sizeable changes in the perimeter of general government (see footnote 2)

Source: Ameco

Figure 8: Compensation of government employees vis-à-vis the economic cycle



Source: Ameco

A simple cross-country comparison reveals that Portugal has clearly the highest expenditure in government personnel among euro-area participants, with this item representing on average 35.2% of current primary expenditure and 14.3% of GDP in the period 2000-2005 (Table 1). It is important to notice, however, that this gap is largely accounted for by above the average personnel expenditure in education and health, two functional areas in which different arrangements for production of government-financed services induce substantial dispersion in spending patterns across countries. Excluding education and health, Portugal's spending pattern becomes substantially closer to the euro-area average, although still exceeding it. In fact, the dispersion in total government expenditure on health and education is substantially lower than that of government compensation of employees in the same areas.

[4] According to Lamo, Pérez and Schuknecht (2007), the pro-cyclical behaviour of compensation of government employees (often with a lag of one or two years) seems to have been a feature common to euro area economies. Lamo, Ana, Javier Pérez and Ludger Schuknecht (2007); *The cyclicality of consumption, wages and employment of the public sector in the euro area*; ECB Working Paper Series no. 757, May 2007.

Yet it is interesting to notice that whereas Portugal has the largest proportion of expenditure in education, its scores in this area are relatively low in international comparisons. This illustrates how important it is to improve the efficiency of public expenditure in Portugal. In all, it seems that options that affect the shape of compensation of employees can only benefit from considering the functional allocation of government resources and the broader setting of public spending.[5]

Table 1: Compensation of government employees in euro area countries (average 2000-2005)

	Total		Education	Health	Total excl. education and health
	% of current primary expenditure	% of GDP	% of current primary expenditure		
BE	28.8	12.0	12.0	0.7	16.1
DE	18.7	7.8	6.4	0.1	12.2
IE	32.3	8.9	7.3	11.7	13.3
EL	32.2	10.9	6.4	4.8	21.0
ES	32.1	10.1	9.6	7.3	15.3
FR	29.1	13.4	9.7	4.9	14.5
IT	27.8	10.7	9.2	6.0	12.6
LU	22.7	7.9	9.1	0.2	13.4
NL	25.0	9.8	8.0	0.6	16.4
AT	22.1	9.7	9.1	1.8	11.2
PT	**37.7**	**14.3**	**14.1**	**7.0**	**16.5**
SI	29.1	11.8	10.1	6.3	12.6
FI	30.2	13.3	7.1	7.3	15.8
EA-12 (unweighted)	28.3	10.8	9.1	4.5	14.7
Coefficient variation	0.17	0.18	0.23	0.76	0.17

Source: Ameco

2.4. Drivers of compensation of government employees and possible spillovers into the private sector wage behaviour

Compensation of government employees encompasses the average current wage rate, the number of employees and social benefits related namely to health-care and old-age pension schemes (Figure 9) for current and retired government employees. The aim of this section is, first, to look at the contribution of those different items to the evolution of the overall government personnel spending and, second, to assess the extent to which public sector wages may have played a role in the overall labour market situation, and thereby on competitiveness developments.

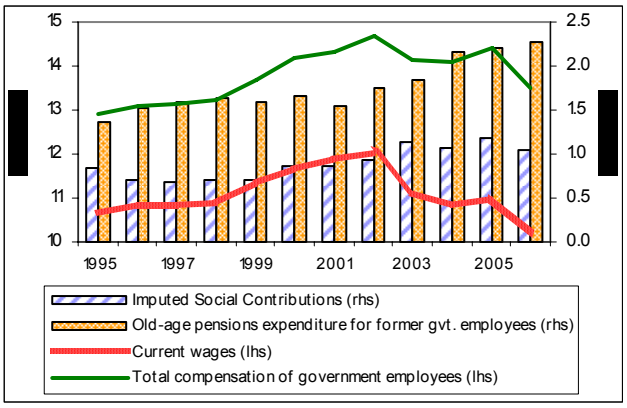
In terms of employment, general government represented 14.6% of the economy's total employment in both 2005 and 1999, up from 13.3% in 1996.[6] Central government accounted for about three quarters of the general government employment in 2005, regional governments over 5%, and local governments less than one fifth of the total. Public employment expanded strongly in the late nineties until 2001, stabilising thereafter thanks to a near freeze of employment in central government as from mid-

[5] Analyses of composition of government expenditure have been presented in the Economic Assessment of recent stability programme updates for a number of countries (see June 2005 for the case of Portugal).

[6] On the basis of the public administration census of 1996, 1999 and 2005.

2002.[7] In 2006, this situation gave place to an only partial replacement of workers that leave the central government, with on average one hiring for every two withdrawals (Figure 10 and Figure 11).[8] In all, employment variations in the public sector have been significantly more volatile than in the overall economy (Figure 11), consequently adding to the economy's fluctuations.

Figure 9: Decomposition of compensation of government employees



Source: Ameco and CGA

Also government wage growth has cooled in recent years after the fast growth of the late nineties. The change in the average compensation per government employee has been more volatile than decreed wage increases.[9] In particular, the wage drift seems to have been rather strong in the late nineties and earlier years of this century, apparently on the account of revisions in a number of particular career and wage scales within the public sector, and the expansion of some areas whose wages are typically above the government average. Restraints on promotions and seniority-related pay increases in more recent years have contributed to contain the wage drift, while reductions of the importance of above-average wage areas have dragged down the average wage rate.

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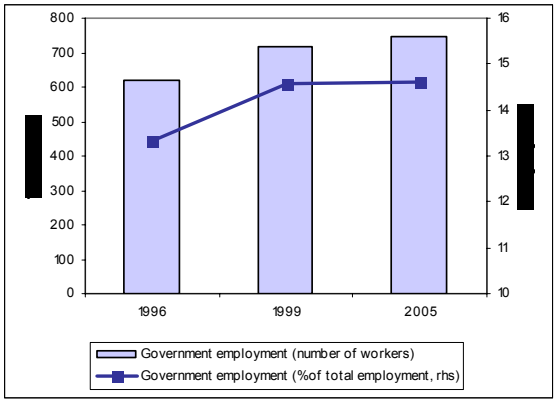
[7] Essentially, employment was nearly frozen in central government, but hiring was permitted in selected areas, for instance, armed and security forces, education, and health services.

[8] Against a backdrop of no up-to-date register of government employees, some proxies were used for the annual change in public employment (Figure 11). Departing from the hard data from the 1996, 1999 and 2005 census, the evolution between the three observation points was proxied by the change in the number of subscribers to the government employees old-age pension scheme (CGA) – i.e., inflow of new subscriptions minus outflow due to retirement –, resulting in a first series for the annual change in government employment. However, since that series does not reflect one-to-one changes in government employment, namely due to an imperfect accounting of outflows from the public sector, assumptions had to be made to take these aspects into account. All in all, the concern is more about the profile rather than pinpointing precise annual variations and consequently the figures have to be analysed in the light of this constraint.

[9] Nominal wage increases are decreed by the Cabinet on an annual basis towards the end of the preceding year and applied to the whole general government sector; consultations and negotiations with trade unions take place but are not binding. The wage drift accounts for the difference between the change on the average compensation per government employee and the decreed wage increase. It comes, first, from promotions and seniority-related pay increases and, second, from changes in the wage distribution.

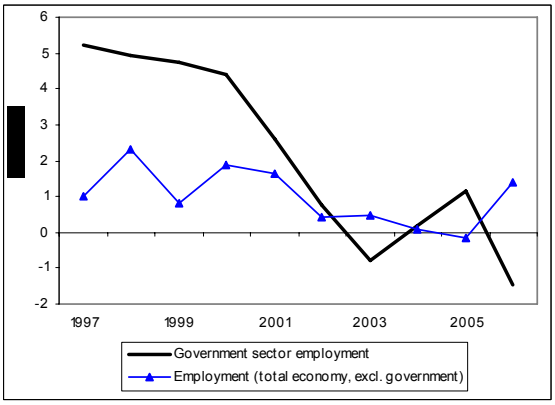
Decreed wage increases in the public sector have been generically lower than negotiated wage rises in the private sector (Figure 12). However, this difference has been often compensated by the wage drift, such that, overall, annual changes in public and private wages have been somewhat correlated, even if with a more contained pattern of the former in recent years (Figure 13). Wage increases in the overall economy have somewhat mirrored the earlier decline and later rise in unemployment. Yet in more recent years wage inflation appears to have been somewhat muted despite the rising unemployment levels at about 8% of the labour force.

Figure 10: Government employment



Source: Finance and Public Administration Ministry

Figure 11: Government employment (a proxy for annual variations)



Note: See footnote 1.

Source: Finance and Public Administration Ministry, CGA, Commission services calculations.

Beyond annual changes, it is also important to analyse remuneration levels between the public and the private sector as well as possible differences within the government sector. In this respect, comparing wage rates in the public and private sectors from the Labour Force Survey for the period 1998-2000, Portugal and Centeno (2001) found that, after controlling for observable worker attributes, a sizeable hourly wage premium existed for public sector workers in Portugal (on average, some 13% for men and 26.5% for women). In fact, the authors claim that whereas a public sector wage premium is frequent in most of EU-15 Member States, it reached its maximum in the case of Portugal.[10]

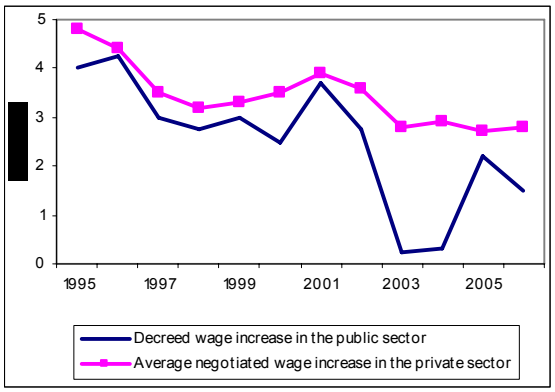
Using individual level data on government workers from the 1999 census, Centeno and Coutinho Pereira (2005)[11] looked at some aspects of public sector wages. A finding was that the hourly wage distribution in the government sector is plurimodal reflecting high

[10] Portugal, Pedro and Mário Centeno, (2001); *Wages of civil servants*; Bank of Portugal, Economic Bulletin, September 2001. On the basis of the 1995 wave of the European Union Household Panel (data did not include Finland and Sweden).

[11] Centeno, Mário and Manuel Coutinho Pereira (2005); *Wage determination in general government in Portugal*; Bank of Portugal, Economic Bulletin, Autumn 2005.

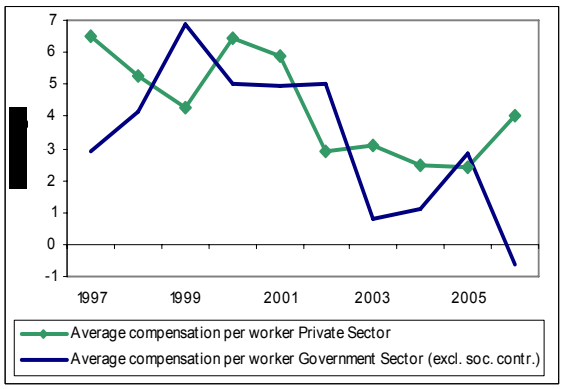
levels of career segmentation, indeed higher than in the private sector.[12] The authors found also that whereas returns on formal education were very high, as it is also the case in the private sector,[13] the reward for human capital accumulated beyond formal education seems to be limited, thus likely hindering the incentives for performance. In fact, promotion seems to be often associated with tenure and tends to be faster in the earlier half of working careers, which may limit incentives for productivity increases in later years.

Figure 12: Decreed government wage increases and negotiated private-sector wage increases



Source: Ministry for Labour and Social Security; Finance and Public Administration Ministry

Figure 13: Government sector vs. total economy: annual change in average compensation per worker



Source: Ameco; Commission services calculations

Finally, social contributions to finance a number of benefits for government employees have been creating a strong upward pressure on the expenditure ratio since 2002 (Figure 9). Expenditure related to pensions for retired government employees grew by about ¾ percentage points of GDP since then. This path has been the result of significant increases in the dependency ratio mainly due to markedly stronger retirement flows from the civil service in these years.[14] Additional pressure on spending has resulted from average pension outlays for new retirees substantially higher than those for existing retirees, on the account of longer contributory careers. Imputed social contributions added some additional spending pressure, notably since the year 2000, on the back of rising health benefits for current and retired government employees.

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[12] The large number of careers in the government may be attributed to historical reasons, especially due to the developments of the different functions in different periods of time as well as the specificity of some tasks. Nonetheless, such a fragmentation brings the question about the existence of power by interest groups. Indeed, according to the interest group theory, interest groups are more effective in exercising pressure and extracting benefits the more homogenous they are.

[13] This result was largely driven by the fact that a minimum level of formal education (e.g., a university degree) is required for access to some specific careers in the government.

[14] An anticipation of retirement as a reaction to tightening of retirement and pension conditions in recent years seems to have added to retirement outflows. In fact, a jump was particularly noticeable around the year 2003 coinciding with a tightening in retirement conditions and outlays generosity.

To sum up, over the late 1990s and early 2000s, the wage bill of the Portuguese government was inflated by both strong employment and wage growth. More recently, restraint on employment and wages has led to a more contained spending pattern, which, however, has been partially offset by raising old-age-pensions-related expenditure.

Having examined the drivers of the government wage bill, it is now interesting to look at possible interlinkages between the government and the private sector wage developments. As it is well known, in a monetary union setting, wage behaviour, and subsequently the labour market, are key to restore competitiveness in the short and medium term as more fundamental changes on the supply side often take time to bear fruit. The preceding analysis suggests that the functioning of the labour market in general and wage setting in particular seem to be hampering a smoother adjustment of imbalances of the Portuguese economy, especially the correction of the eroded competitiveness position. It is therefore important to analyse if wage restraint in the government sector can, besides supporting fiscal consolidation directly, help narrowing a number of imbalances in the Portuguese economy, particularly in terms of external competitiveness.

The focus is mainly on the possible leadership role played by public wages vis-à-vis the private sector, in particular to shed light on whether wage developments in the government sector have spilled over to the private sector. As Figure 12 and Figure 13 illustrate, the wage developments in both sectors are moderately synchronised with the annual wage increases being fairly similar on average. Whereas it might be difficult to conclude in favour of causality going into a specific direction, there are a number of elements that suggest an impact of the government wage policy, in particular the decreed annual wage variations, on the private sector. First, the government is a big employer and wages are decided at a centralised level, consequently not allowing differentiation for different layers of government. Second, annual wage increases for the government sector tend to be known earlier than those in the private sector, being therefore able to play a signalling role when private sector agreements are settled. Third, wage bargaining in the private sector may be regarded as being insufficiently coordinated to be a reference for government or even other parts of the private sector, at least on a timely basis.[15]

[15] Government wage increases are decreed towards the end of the previous year, whereas most of the agreements in the private sector are signed up already in the earlier months of the relevant year (retrospectively to January, as a rule). In the past, an element that may have helped a possible leadership by the government sector was the existence of a number of state-owned enterprises as big employers, which essentially followed the government sector wage developments. Although most of those enterprises were privatized over the 1990s, the habit of looking to the wage behaviour of the government sector may have been formed by the private sector and may have not faded away completely. Private sector wage bargaining typically takes place at the industry level and sometimes at the firm level. Whereas broad nation-wide agreements, essentially on an indicative nature, can be signed up by social partners with the government mediation, none has been achieved in the past ten years.

2.5. Looking ahead

Current primary expenditure has been a key determinant of the imbalances in Portugal's public finances. Compensation of employees has been the major item of government expenditure and an important driver of fiscal developments in Portugal. Public spending, and consequently the government wage bill, is bound to be further trimmed to support budgetary consolidation. Measures implemented in recent years are expected to allow a more moderate growth of government personnel expenditure. They include a reform of old-age pension schemes and some tightening of social benefits for government employees. Furthermore, public employment is bound to decline with the application of the only partial replacement of workers that leave the central government. In addition, the wage rules that have just entered into force in the context of the public administration reform seem to lead to a contained wage drift in the coming years, which will be a departure from what was observed in some prior years. The lower expected wage drift in the public administration will also fit better with the coming more integrated labour market across the public and the private sector. Finally, the public administration reform has been announced as introducing a marked shift in the management of human and physical resources. Nonetheless, unless productivity grows strongly, the room for sustained increases in average compensation seems limited.

Additionally, the gap between Portugal's domestic demand and GDP, as revealed by the sizeable external current account deficit, has to be narrowed. Whereas for an economy with below EU average income levels, the ambition should be to boost income with a sustained lift in productivity growth, domestic spending still needs to be kept under tight control, with a strict fiscal policy giving a key contribution to that aim.

As much as wage developments in the government sector are echoed in the overall labour market, containment of the government wage bill can be partially followed by the rest of the economy, and thereby help pushing labour costs and price developments into patterns more supportive of external competitiveness. With stronger cost competitiveness, the external sector could then give a sustained contribution to economic growth on the back of a continued strong export performance, which would later on feed investment and employment and finally consumption growth. This virtuous circle, and the sustainable GDP growth pattern that comes with it, would then add to the stabilisation of public finances.

Besides its role in fiscal consolidation and economic stabilisation, compensation of government employees is important for other dimensions. In particular, government wage policies may work as an important device to boost the efficiency of the public sector, which, given its large weight in the economy, can positively impact overall productivity, and consequently its ability to foster economic growth and well-being. The latter is the more relevant as the Portuguese economy seems to be characterised by a low potential GDP growth. Therefore, it seems justified to argue that a thorough reform of government services, going hand-in-hand with a proper prioritising of public spending towards efficiency-enhancing measures, can give an important contribution to lift the economy's growth potential.

Moreover, the efforts to boost the efficiency of the public sector require proper incentives for staff performance and to reward merit while keeping expenditure under tight control. At the same time, since the new guidelines for government employment go

in the direction of aligning public employment conditions with those prevailing in the private sector, a more integrated labour market is expected to prevail in future.[16] Hence, for similar skills or job profiles, wages in the government and private sectors are bound to converge over the medium to long term, which could also be a challenge for fiscal affairs.

In addition, long-term trends in demand for public services and their possible impact on public spending in general and compensation of employees in particular have to be timely taken into account. They can derive, for instance, from the shift in citizens' preferences and demands implied by ageing populations (e.g., increased demand for health and long-term care services). Other challenges can come from an increasing decoupling between financing and provision of public and merit goods, or recourse to options such as contracting out or public-private partnerships observed in a number of developed economies. At the same time, citizens and firms might increasingly ask for the possibility of choosing between competing government service providers.

Finally, policy options that affect the shape of compensation of employees can only benefit from being framed in the broader context of the overall fiscal consolidation, functional allocation of government resources and public administration reform. Such a broader view in conducting fiscal policy will likely reinforce the call for more thorough assessments of efficiency and effectiveness of government expenditure and reduce the probabilities of inefficient decisions that could be taken if the broader setting of public spending was not to be fully internalised. Some steps in this direction, like the development of performance budgeting through a multi-annual budgetary framework should be fostered.

[16] This has been particularly noticeable for retirement and old-age pension conditions, with the present value of future benefits declining considerably. The de facto implications for job security in the government sector remain still to be seen.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes how the macroeconomic vulnerabilities identified in the preceding section are expected to develop according to the programme.

3.1. Economic activity

The macroeconomic outlook presented in the update projects real GDP growth to increase from 1.8% in 2007 to 2.2% in 2008, 2.8% in 2009 and eventually to 3% in both 2010 and 2011 (Table 2). The acceleration of GDP in real terms is foreseen to be largely driven by a greater dynamism of private consumption and investment, with a positive, albeit declining contribution from the external sector in the years up to 2009.[17]

Private consumption is projected to expand over the entire period at gradually higher rates (from 1.2% in 2007 to 2.4% in 2011), but systematically below GDP. Investment is foreseen to accelerate briskly as from 2008, with growth rates rising from 1% in 2007 to 4% in 2008 and about 7% per year on average in the 2009-2011 period. This expansion is foreseen to be mainly accounted for by a strong increase in private investment (especially in capital goods), which is expected to benefit from the dynamism of exports and a more favourable business environment. Government consumption is targeted to decline in real terms throughout most of the programme period, turning to positive growth rates only in 2011.

The contribution of the external sector to GDP growth is projected to fall continuously over the programme period, moving gradually from positive to negative grounds. Such profile is largely due to the acceleration of imports (in line with the expected expansion of domestic demand), while exports are foreseen to post strong growth in every year, always in excess of external demand by about ½ of a percentage point per year on average.

The growth projections of the update for 2008 and 2009 are more optimistic than the Commission services' 2007 autumn forecasts, especially in 2009: 2.2% against 2.0% in 2008, 2.8% in 2009 compared with 2.1% in the Commission forecasts. The GDP growth projections of the update for 2010 and 2011 are twice as high as the average estimate of potential growth for the period 2007-2009 in the Commission services' autumn 2007 forecasts.

Overall, the composition of real GDP growth (i.e. the split between the relative contributions of domestic and net external demand to GDP growth) envisaged in the update does not differ markedly from the Commission services' autumn 2007 forecasts. Yet the latter projects lower growth rates for all private demand components, especially for gross fixed capital formation.

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[17] The external outlook behind the programme's macroeconomic scenario is broadly in line with that in the Commission services' autumn 2007 forecasts.

In all, the update's macroeconomic outlook seems to build on favourable GDP growth assumptions, especially in the outer years. Indeed, whereas a gradual recovery of domestic demand seems plausible, its expansion will still be constrained by the high levels of indebtedness of households and corporations and relatively high unemployment. Furthermore, the prevailing uncertainty over financial prospects associated with the financial turmoil may add uncertainty and restrain investment decisions. Lastly, recent indicators point to the risk of a downward revision in growth projections across the euro-area, in the face of the credit crisis, soaring oil and food prices, and the appreciation of the euro vis-à-vis the dollar. If confirmed, such developments are likely to impose further constraints on attaining the update's GDP growth prospects.

Table 2: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010	2011
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.8	1.8	2.0	2.2	2.1	2.8	3.0	3.0
Private consumption (% change)	1.2	1.2	1.3	1.4	1.7	2.1	2.3	2.4
Gross fixed capital formation (% change)	0.9	1.0	2.3	4.0	3.4	6.7	7.0	7.2
Exports of goods and services (% change)	6.7	6.9	5.6	6.7	4.9	6.0	6.3	6.5
Imports of goods and services (% change)	3.4	3.8	3.3	3.9	3.8	4.8	5.6	6.6
Contributions to real GDP growth:								
- Final domestic demand	0.9	1.1	1.4	1.5	1.9	2.6	3.0	3.3
- Change in inventories	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	0.7	0.7	0.6	0.7	0.2	0.1	0.0	-0.3
Output gap[1]	-1.7	-2.2	-1.2	-1.8	-0.8	-1.1	-0.2	0.5
Employment (% change)	0.3	0.4	0.6	0.9	0.9	1.4	1.5	1.5
Unemployment rate (%)	8.0	7.8	8.0	7.6	7.7	7.2	6.9	6.6
Labour productivity (% change)	1.5	1.4	1.4	1.3	1.2	1.4	1.5	1.5
HICP inflation (%)	2.4	2.3	2.4	2.1	2.3	2.1	2.1	2.1
GDP deflator (% change)	2.9	2.9	2.4	2.7	2.3	2.6	2.6	2.6
Comp. of employees (per head, % change)[2]	2.7	2.3	2.8	2.4	2.8	2.4	2.7	3.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-7.9	-7.0	-7.7	-5.8	-7.7	-5.6	-4.9	-4.7

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

[2] Data on this item were not provided in the December 2007 update, but were subsequently made available by the national authorities on a bilateral basis.

Source:

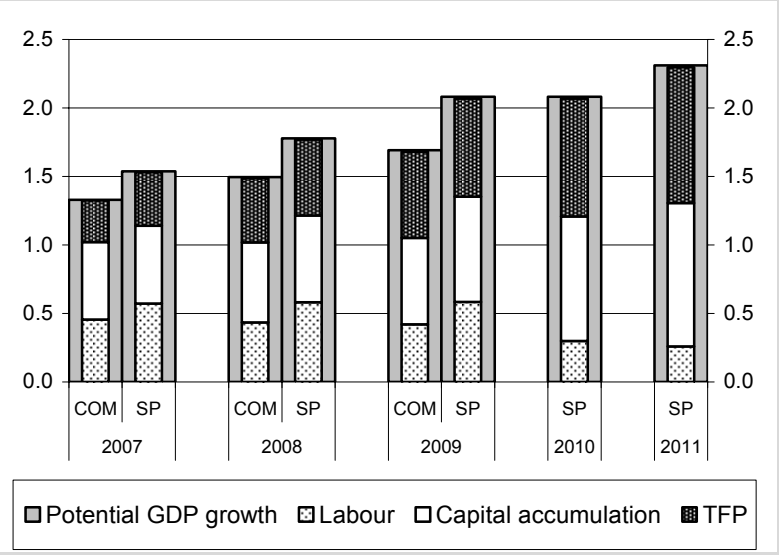
Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP)

The cyclical conditions implied by the programme (as measured by the output gap calculated by the Commission services according to the commonly agreed methodology based on the information provided in the programme) are expected to improve over the programme period, with the negative output gap gradually vanishing till 2011. In the years up to 2009, the output gap is expected to narrow from -2.2% in 2007 to -1.8% in 2008, and -1.1% in 2009 (Table 2). Although projecting a broadly similar trajectory, the Commission services' 2007 autumn forecasts foresee a less negative output gap for all three years. Despite such discrepancies, both the programme's projections and the autumn 2007 forecasts point to a clearly negative output gap in 2008 and 2009, thus suggesting that the qualitative conclusions on the cyclical conditions are not fundamentally different.

Box 1: Potential growth and its determinants

Commission services' recalculations using the commonly agreed methodology based on the information provided in the programme point to an acceleration of potential GDP from 1.5% in 2007 to 1.8% in 2008, 2.1% in both 2009 and 2010, and 2.3% in 2011. TFP growth and increased capital accumulation are the drivers of the projected profile, more than offsetting a diminishing labour contribution in the outer years of the programme.

Potential growth and its determinants



Overall, the pattern for potential GDP growth for the years 2007 to 2009 is systematically above that projected in the Commission services' autumn 2007 forecasts. For 2007 and 2008, this discrepancy is explained by the lower expected contributions of labour and TFP growth in the Commission services' autumn forecasts. For 2009, the programme's projections for each individual determinant of potential growth exceed those of the Commission forecasts.

It is also interesting to note that potential GDP growth in the years 2007 to 2009 is projected to stay significantly above the growth profile observed since 2001, albeit remaining below the average performance registered in the period 1996-2005 (see Annex 2).

3.2. Labour market and cost and price developments

The programme foresees that employment will increase with the upswing in economic activity. The unemployment rate is expected to decline continuously between 2007 and 2011 (from 7.8% to 6.6%), but at an increasingly faster pace towards the end of the programme period. In 2008, GDP growth is expected to be driven by increased productivity and to a lesser extent higher employment. In the remainder of the projection period, economic growth is projected to be equally accounted for by higher productivity and increased employment.

The employment outlook of the update is rosier than that presented in the Commission services' autumn 2007 forecasts, in line with the higher projected GDP growth in the update.

The programme projects consumer HICP inflation to decline from 2.3% in 2007 to 2.1% in 2008, stabilising at that level thereafter. Import price developments are expected to be important in keeping inflation stable in 2008 and beyond. The update's projected consumer inflation for 2008 and 2009 is slightly below that of the Commission services'

autumn 2007 forecasts, which sees the HICP stable at slightly higher levels in the 2007-2009 period. By contrast, the programme's projection for the GDP deflator over this period is slightly above that of the Commission services' 2007 autumn forecasts (Table 2). This is explained by implicit lower import prices and better terms of trade in the update scenario. In the light the recent surge in oil and food prices, the update's projections for inflation appear to be on the low side, whereas the converse applies to the GDP deflator.

Wage growth is foreseen to remain relatively stable in the years 2007-2009, and to mildly accelerate thereafter. In real terms, wages are projected to increase gradually over the programme period (but more markedly in the outer years), although always below labour productivity growth. The economy's competitiveness position is expected to improve in the coming years, with unit labour costs growing more slowly than in most of its main trading partners, a scenario that appears to be broadly consistent with the export growth profile envisaged in the update.

3.3. Macroeconomic challenges

Over the past decade, Portugal has accumulated sizeable and persistent external deficits. Net borrowing vis-à-vis the rest of the world represented -6.6% of GDP per year on average in the 1997-2006 period, and -8.8% of GDP in 2006. As pointed out in the previous section, the accumulation of these imbalances was largely rooted in a gradual erosion of the economy's competitiveness position, which fed an imbalance on the goods and services account, while the external sector put a big drag on GDP growth. Whilst recent economic growth has been led by the external sector, the competitive position remains vulnerable, reflecting still the lasting misalignment between wages and productivity growth. Achieving a more balanced position for the external sector remains, therefore, an open challenge to put the economy on a sustainable growth path.

The economic outlook of the update envisages a decline of the sizeable external deficit, with net borrowing vis-à-vis the rest of the world declining from -7% of GDP in 2007 to -4.7% of GDP in 2011. This improvement is mainly driven by a reduction of the deficit in the balance of goods and services, whose projected developments for 2008 and 2009 are broadly in line with the Commission services' autumn 2007 forecasts. Nonetheless, the programme foresees a containment of the deficit in the balance of current transfers and primary income, whereas the Commission services' forecasts project a deterioration driven by the external debt service. In fact, such an improvement might be difficult to achieve in the light of the rising external debt and despite higher (net) transfers related to EU funds in the period 2007-2009. In addition, the update's projections for the evolution of the trade balance face some additional negative risks in the face of the recent surge in oil and food prices, of which Portugal is clearly a net importer.

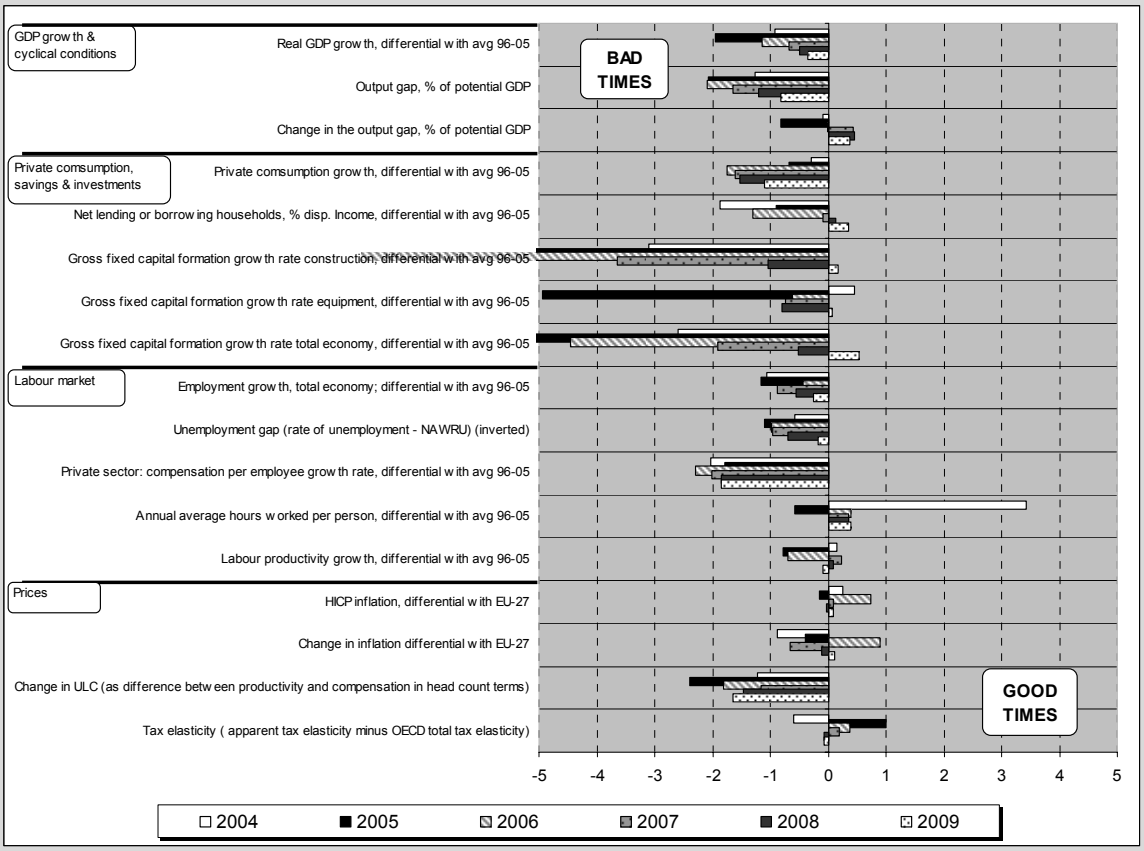
The projected decline in the external deficit in 2008 is driven by improvements in the net borrowing position of both the general government and the private sector. In the remainder of the programme period, the decline in the external deficit is foreseen to be exclusively driven by the targeted improvement of the government balance, with the net borrowing position of the private sector gradually deteriorating from -3.4% in 2008 to -4.5% in 2011. The latter development seems broadly consistent with the upswing in domestic demand projected in the update. Nevertheless, in the face of the already high levels of private sector indebtedness, the expected increase in borrowing adds to the reservations on the expansion of domestic demand projected by the programme.

Box 2: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecasts.

According to the Commission services' 2007 autumn forecasts, the output gap is projected to remain negative, although narrowing, in the years 2007 to 2009. In parallel, overall GDP growth is likely to remain subdued and unemployment little changed, at relatively high levels by historical standards, in the coming years. Overall, Portugal can be considered to be in bad economic times. The consideration of tax elasticities does not change this assessment. The marginally high tax elasticity to GDP in 2007 is largely accounted for by discretionary measures, increased tax compliance, and, to a lesser extent, by the apparent (lagged) recovery of profitability at the level of corporate tax payers.

Good versus bad times



4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 3 compares the 2007 revenue and expenditure targets (as a percentage of GDP) in the previous update of the stability programme with the results of the Commission services' autumn 2007 forecasts. The difference between the revenue and expenditure targets for 2007 and the projected outcome is split into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[18]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update of the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.

- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).

- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex-ante tax elasticities (or both).

The budgetary outturn for 2007 estimated in the update of the stability programme is a deficit of 3% of GDP, which coincides with the Commission services' autumn 2007 forecasts and compares with the original target of a deficit of 3.7% of GDP included in the December 2006 update and in the 2007 budget. Already in April 2007, following the presentation of the 2006 fiscal outturn, the government had revised the deficit target to 3.3% of GDP.

Table 3: Budgetary implementation in 2007

[18] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

	2006		2007	
	Planned	**Outcome**	**Planned**	**Outcome**
	SP Dec 2006	**COM**	**SP Dec 2006**	**COM**
Revenue (% of GDP)	41.7	42.5	41.7	42.5
Expenditure (% of GDP)	46.3	46.4	45.4	45.4
Government balance (% of GDP)	-4.6	-3.9	-3.7	-3.0
Nominal GDP growth (%)			4.5	4.7
Nominal revenue growth (%)			4.5	4.7
Nominal expenditure growth (%)			2.5	2.6
Revenue surprise compared to target (% of GDP)			**0.8**	
Of which [1] : 1. Base effect			0.8	
2. GDP growth effect on the denominator			-0.1	
3. Revenue growth effect			0.1	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than1 [2]			*0.0*	
Expenditure surprise compared to target (% of GDP)			**0.0**	
Of which [1] : 1. Base effect			0.1	
2. GDP growth effect on the denominator			-0.1	
3. Expenditure growth effect			0.1	
Government balance surprise compared to target (% of GDP)			**0.7**	
Of which: 1. Base effect			0.7	
2. GDP growth effect on the denominator			0.0	
3. Revenue / expenditure growth effect			0.0	

Notes:

[1]A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive denominator effect indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2]Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source:
Commission services

The overachievement of the very initial target of 3.7% of GDP was made possible by a benign base effect coming from the 2006 budgetary execution. In fact, the observed deficit for 2006 at 3.9% of GDP, compares with an estimate of 4.6% of GDP presented in the December 2006 update. This was the result of higher-than-expected revenue (see Table 3).

In 2007, the growth rates of total government revenue and expenditure and the pace of nominal GDP growth presented in both the December 2007 update of the stability programme and the Commission services' autumn 2007 forecasts are very close to the plans presented in the December 2006 update (see Table 3). In all, total revenue remained constant in terms of GDP and the expenditure-to-GDP ratio declined by about one full percentage point.

On the revenue side, tax proceeds grew at good pace, in particular direct taxes. That was the result of increased tax compliance, enhanced collection of tax arrears, some discretionary measures to increase the rates of some taxes and lower credits for others, and also a recovery of profitability at the level of some large corporate tax payers. The

tax burden is estimated to have increased by ½ of a percentage point of GDP. In the opposite direction, declining inflows from EU funds offset most of that expansion.[19]

On the spending side, a containment of primary expenditure materialised in 2007. In particular, a nominal reduction of compensation of government employees on the back of reductions in public employment and, to a lesser extent, wage restraint, were crucial for the expenditure outturn. At the same time, social transfers other than in kind decelerated considerably – in fact, for the first time in more than a decade they may had grown less than nominal GDP. To that result contributed a slowdown in old-age pension outlays and a reduction in unemployment benefits. The budgetary execution accounted also for a one-off measure worth 0.1% of GDP.[20]

Commission services' calculations on the basis of the programme update using the commonly agreed methodology, indicate that budgetary developments in 2007 correspond to a reduction of the structural deficit, i.e., the cyclically-adjusted deficit net of one-off and other temporary measures, by some ¾ of a percentage point of GDP – from 2¾% of GDP in 2006 to almost 2% of GDP in 2007 (see Table 4). This result is consistent with the Council opinion of 27 February 2007 on the previous update of the stability programme, as the Council had invited Portugal to implement the structural measures outlined in the programme to allow the correction of the excessive deficit by 2008 and to reduce the structural balance by at least ¾% of GDP. Indeed, steps were taken with a view to containing public expenditure in a structural way, most notably at the level of personnel spending and social payments.

More recent and preliminary budgetary execution data suggest that the 2007 deficit outturn is likely to be better than the revised target of 3% of GDP, helped by higher-than-estimated tax revenue, especially direct taxes, and lower-than-expected expenditure on subsidies and social transfers.

4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme – and how it compares with the one in the previous update – as well as the composition of the budgetary adjustment, including the broad measures envisaged.

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

The most recent update of the stability programme aims at further fiscal consolidation over the medium term, notably to achieve the medium-term objective (MTO) of a structural deficit, i.e., cyclically-adjusted net of one-off and other temporary measures, of 0.5% of GDP by 2010.

The programme plans annual improvements in the general government budget leading to an almost balanced position by the end of its period. After the estimated outturn of 3% of GDP in 2007, the budgetary deficit is targeted to decline gradually to 2.4% of GDP in 2008, 1.5% in 2009, 0.4% in 2010 and eventually 0.2% of GDP in 2011 (see Table 4). Therefore, an average annual reduction of the government deficit by about 1 percentage

[19] Amounts of EU funds received are also reflected in government spending and thereby the impact on the government balance is mitigated.

[20] Related to the long-term concession contract for the exploitation of a dam and recorded as reduction of other capital expenditure according to the ESA95 rules.

point of GDP until 2010 and a near stabilization in 2011 is targeted, resulting in a cumulative cut in the budgetary deficit by about 2½ percentage points of GDP between 2007 and 2010. The adjustment path for the primary balance is very similar given that there is only a minor decline of interest expenditure in terms of GDP. After a deficit of 0.1 % of GDP in 2007, the primary balance is projected to turn into a gradually higher surplus thereafter: from 0.5% of GDP in 2008, to 1.3% in 2009 and up to 2.5% of GDP in 2011.

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 a deficit of some 2% of GDP in 2007 to a deficit of ½% of GDP in 2011 (see Table 4). On average, the structural balance is foreseen to improve by an average of ½ percentage point of GDP in each year until 2010, and to stay largely unchanged in 2011. A similar pattern is projected for the structural primary balance. Therefore, a continued fiscal effort, as measured by the annual change in the structural balance, is targeted over the update period and plans are for fiscal policy to have a restrictive stance until 2010.

Box 3: The excessive deficit procedure (EDP) for Portugal

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 at the latest. 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.

In June 2006, 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 that Portugal had 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 its meeting of 11 July 2006, the Council concurred with the assessment in the Commission communication of June 2006.

The programme broadly confirms the medium-term fiscal consolidation plans outlined in the December 2006 update. The headline target for 2008 has been slightly revised to 2.4% of GDP, from 2.6% of GDP in the previous update. This revision of targets reflects the favourable base effect created by the better-than-expected outturn in 2007, which itself was made possible by the prior target overachievement in 2006. The deficit targets for 2009 and 2010 have remained unchanged. After some frontloading in 2006 and 2007, the speed of reduction of the structural deficit is essentially the same as in the prior update, except for 2008, as the planned consolidation effort for this year has been lowered by about a ¼ of a percentage point of GDP.

Table 4: Evolution of budgetary targets in successive programmes

		2006	2007	2008	2009	2010	2011
General government balance (% of GDP)	**SP Dec 2007**	**-3.9**	**-3.0**	**-2.4**	**-1.5**	**-0.4**	**-0.2**
	SP Dec 2006	*-4.6*	*-3.7*	*-2.6*	*-1.5*	*-0.4*	*n.a.*
	COM Nov 2007	-3.9	-3.0	-2.6	-2.4	n.a.	n.a.
General government expenditure (% of GDP)	**SP Dec 2007**	**46.4**	**45.4**	**45.1**	**44.4**	**43.5**	**43.3**
	SP Dec 2006	*46.3*	*45.4*	*44.0*	*42.7*	*41.5*	*n.a.*
	COM Nov 2007	46.4	45.4	45.4	45.2	n.a.	n.a.
General government revenue (% of GDP)	**SP Dec 2007**	**42.5**	**42.4**	**42.7**	**42.8**	**43.1**	**43.1**
	SP Dec 2006	*41.7*	*41.7*	*41.4*	*41.2*	*41.1*	*n.a.*
	COM Nov 2007	42.5	42.5	42.8	42.8	n.a.	n.a.
Structural balance[1] (% of GDP)	**SP Dec 2007**	**-2.8**	**-2.1**	**-1.6**	**-1.0**	**-0.3**	**-0.4**
	SP Dec 2006	*-3.4*	*-2.6*	*-1.8*	*-1.2*	*-0.5*	*n.a.*
	COM Nov 2007	-2.9	-2.3	-2.1	-2.1	n.a.	n.a.
Real GDP (% change)	**SP Dec 2007**	**1.3**	**1.8**	**2.2**	**2.8**	**3.0**	**3.0**
	SP Dec 2006	*1.4*	*1.8*	*2.4*	*3.0*	*3.0*	*n.a.*
	COM Nov 2007	1.3	1.8	2.0	2.1	n.a.	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2007 (deficit-reducing) according to the most recent programme and the Commission services' autumn forecasts

Source :

Stability programmes (SP); Commission services' autumn 2007 economic forecasts (COM)

The update's budgetary projections are based on a macroeconomic scenario that is little changed from the one presented in the December 2006 update. Real GDP growth rates are now lower by 0.2 percentage point in both 2008 and 2009. In terms of individual demand components, the major revisions were for private consumption growth in 2008 and for exports growth in 2009 (0.7 and 1 percentage point respectively).

4.2.2. The composition of the budgetary adjustment

The budgetary adjustment is planned to be achieved by curbing current primary expenditure, on the back of corrective measures, and helped by gradually higher economic growth. According to the stability programme update, primary expenditure will decline in terms of GDP by almost ½ of a percentage point per year on average over the programme period (see Table 5). Some additional help to fiscal consolidation is foreseen to come from an increase in revenue, by around ¾ of a percentage point of GDP between 2007 and 2010.

The bulk of the adjustment on government expenditure seems to fall on compensation of employees. Social payments are expected to give some marginal relief to public finances in 2009 and beyond.

Table 5: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	2011	Change: 2011-2007
Revenue	**42.5**	**42.4**	**42.7**	**42.8**	**43.1**	**43.1**	**0.7**
of which:							
- Taxes on production and imports	15.5	15.2	15.4	15.4	15.4	15.4	**0.2**
- Current taxes on income, wealth, etc.	8.8	9.4	9.3	9.3	9.3	9.3	**-0.1**
- Social contributions	12.5	12.5	12.4	12.4	12.3	12.3	**-0.2**
- Other (residual)	5.7	5.3	5.6	5.7	6.1	6.1	**0.8**
Expenditure	**46.4**	**45.4**	**45.1**	**44.4**	**43.5**	**43.3**	**-2.1**
of which:							
- Primary expenditure	43.6	42.5	42.2	41.6	40.8	40.6	**-1.9**
of which:							
Compensation of employees	13.6	12.8	12.2	11.7	11.3	11.0	**-1.8**
Intermediate consumption	4.1	4.1	4.1	4.0	4.0	4.0	**-0.1**
Social payments	18.8	19.0	19.1	19.0	18.9	18.8	**-0.2**
Subsidies	1.4	1.2	1.2	1.3	1.3	1.3	**0.1**
Gross fixed capital formation	2.3	2.2	2.2	2.3	2.4	2.6	**0.4**
Other (residual)	3.3	3.2	3.2	3.2	3.1	2.9	**-0.3**
- Interest expenditure	2.8	2.9	2.9	2.8	2.7	2.7	**-0.2**
General government balance (GGB)	**-3.9**	**-3.0**	**-2.4**	**-1.5**	**-0.4**	**-0.2**	**2.8**
Primary balance	**-1.1**	**-0.1**	**0.5**	**1.3**	**2.2**	**2.5**	**2.6**
One-off and other temporary measures	0.0	0.1	0.0	0.0	0.0	0.0	**-0.1**
GGB excl. one-offs	**-3.9**	**-3.1**	**-2.4**	**-1.5**	**-0.4**	**-0.2**	**2.9**
Output gap[1]	-2.4	-2.2	-1.8	-1.1	-0.2	0.5	**2.7**
Cyclically-adjusted balance[1]	-2.8	-2.0	-1.6	-1.0	-0.3	-0.4	**1.6**
Structural balance[2]	**-2.8**	**-2.1**	**-1.6**	**-1.0**	**-0.3**	**-0.4**	**1.7**
Change in structural balance		*0.7*	*0.5*	*0.6*	*0.7*	*-0.1*	
Structural primary balance[2]	0.0	0.8	1.3	1.8	2.4	2.3	**1.5**
Change in structural primary balance		*0.8*	*0.5*	*0.5*	*0.6*	*-0.1*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability programme; Commission services' calculations

Compensation of employees is targeted to decline by an average of ½ of a percentage point of GDP per year over the programme period. In real terms, it implies a marked and continued reduction after an already noticeable fall in 2007. In fact, after retrenchments in real terms in 2006 and 2007, the update foresees government personnel spending declining by about -2¾% in 2008, -1½% in 2009 and an average of -¼% in both 2010 and 2011. According to the programme's plans, most of that consolidation effort will be the result of a reduction in employment in the government sector, largely due to an only partial replacement of workers that leave the central government, with only one recruitment for every two departures, on average. Part of the staff reduction and thereby of the containment of the wage bill is made possible by the ongoing reform of the State's central administration (*PRACE*), which overhauls central government structures. In addition, the re-shaping of a number of government services networks, especially in the

areas of education and health, is leading to the closure of various services (e.g., primary schools or first-aid posts in less populated areas) and subsequently to lower staff needs.[21]

Some additional measures are foreseen to help curbing personnel spending, including savings from wage cuts for government employees found redundant under the so-called special mobility schemes; the tightening of a number of health care benefits for government employees; and more limited wage supplements. Wage moderation, after having helped fiscal consolidation in previous years, on the back of below-inflation wage increases and freezes of seniority-related pay, is planned to be essentially neutral to public finances. The application of the new career and pay scales for government employees starting in 2008 is announced as allowing for only a limited wage drift in the coming years.

According to the programme, after continued strong expansion for more than a decade, social payments – both in kind and other than in kind – will peak in terms of GDP in 2008 and decline very marginally thereafter. That reflects some containment at the level of social transfers in kind (supplied by market producers), which seems to come from restraint in the area of health care. This assumed spending containment is expected to stem from improved operational performance by a number of government-owned hospitals following a process of statutory change of those hospitals into private companies, which started in 2002. This process has been associated also with a marked change in their financing by the government, with a move from cost-covering payments towards revenues based on contracted production.

Additionally, social transfers other than in kind are expected to grow less briskly than in the past thanks to the recent reforms of old-age pension schemes. In this respect, the reforms enacted in 2006 and 2007 (with additional measures entering into force in 2008 or later) will have lagged expenditure-containing effects over the coming years. They will cushion the pressure on spending associated with the strong growth of both the number of pensioners and the average pension mainly due to the longer career contribution of new retirees. Over the programme period, the most important measures seem to be the tightening of retirement conditions for government employees and the adoption of a new rule for annual pension benefit updates. The latter establishes a direct link between the increases in pension outlays on the one hand, and GDP growth and inflation on the other hand, thereby limiting somehow changes in pension spending in terms of GDP.[22] Nonetheless, the programme's figures for expenditure on social transfers other than in kind are higher than those included in the previous update, with annual growth rate being now higher by more than 2 percentage points per year on average between 2008 and 2010.

Interest expenditure is expected to decline only marginally in terms of GDP in 2009 and 2010, such that it will decline by some ¼ of a percentage point of GDP over the entire programme period. At the same time, government investment is projected to advance considerably in 2009 and beyond, with its weight in GDP targeted to increase by almost ½ of a percentage point over the entire programme period. The latter development will

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[21] For a more detailed and retrospective look at compensation of government employees see Section 2.

[22] For more information on the pension reforms see Technical Assessment of the December 2005 update of the stability programme and the Economic Assessment of the December 2005 update of the stability programme, as well as Section 5.2 below.

represent a notable change from the pattern of recent years, when marked reductions in government investment took place.[23]

Finally, government revenue is planned to increase somewhat as a share of GDP over the programme period, such that by 2010 it is projected to represent more ¾ of a percentage point of GDP than in 2007. Other revenue is the driver of that pattern: in 2008 and, to a lesser extent, in 2009, thanks to EU funds (notably the European Social Fund), in the context of the implementation of the new National Strategic Reference Framework;[24] the programme does not elaborate on the increase in 2010. Additionally, the tax burden is forecast to increase by almost ¼ of a percentage point in 2008 thanks to higher indirect taxes and to stay constant thereafter.

Box 4: The budget for 2008

The budget for 2008 was presented on 12 October 2007 and approved by Parliament on 23 November. The budget targets a general government deficit of 2.4% of GDP in 2008. The bill's macroeconomic and fiscal scenarios coincide with the ones of the current update of the stability programme.

Current revenue is targeted to increase by 5.8% compared with its 2007 estimated outturn, with tax revenue up by 5.1%. The fastest growth rates are forecast to occur in indirect taxes, 6.7%, especially at the level of VAT and taxes on oil products. Examples of revenue-increasing measures in the bill are increases in excise taxes on tobacco product and a further lowering of allowances for income from pensions.

On the expenditure side, the budget bill targets total government expenditure to grow by 4.4% in nominal terms in 2008, with current expenditure up by 4.3%. Rather than introducing new measures per se, the budget rather reflects the targeted expenditure evolution taking on board a number of measures introduced by other legal documents, such as the curbs on central government employment (Cabinet Resolution 76/2006 of 18 April), the public administration reform, reduction of health-care benefits for parts of the civil service or the reforms of old-age pension schemes. In terms of functional composition, the most noticeable fact is a near freeze of the budgets of the education and health ministries.

Some measures underpinning the 2008 budgetary targets

Revenue measures	Expenditure measures*
o Increase in excise taxes on tobacco products; o Lowering of allowances for income from pensions.	o Reduction in central government employment (-0.3% of GDP); o Savings with redundant staff; revision of overtime pay and wage supplements; reduction of health-care benefits for parts of the civil service (-0.3% of GDP).

* Estimated impact on general government expenditure.
Sources: 2008 Budget report, Commission services and December 2007 update of the stability programme (for the estimated impact).

[23] Part of that reduction may have been related with the increasing use of public-private partnerships (PPPs) for the construction (and exploitation) of some public infrastructures (e.g., motorways) that used to be built by the government directly.

[24] Concomitantly, these inflows will also imply additional spending, notably at the level of subsidies. This indicates that other types of expenditure within this category would have to be curbed markedly for the update's plans to be met.

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors, starting with the macroeconomic scenario, and looking afterwards to expenditure plans and revenue projections. For the period until 2009, Table 6 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecasts, which are derived under a no-policy change scenario, with those in the updated programme.

Table 6: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010	2011
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenue	**42.5**	**42.5**	**42.4**	**42.8**	**42.7**	**42.8**	**42.8**	**43.1**	**43.1**
of which:									
- Taxes on production and imports	15.5	15.3	15.2	15.3	15.4	15.3	15.4	15.4	15.4
- Current taxes on income, wealth, etc.	8.8	9.4	9.4	9.5	9.3	9.6	9.3	9.3	9.3
- Social contributions	12.5	12.5	12.5	12.4	12.4	12.3	12.4	12.3	12.3
- Other (residual)	5.7	5.3	5.3	5.6	5.6	5.6	5.7	6.1	6.1
Expenditure	**46.4**	**45.5**	**45.4**	**45.4**	**45.1**	**45.2**	**44.4**	**43.5**	**43.3**
of which:									
- Primary expenditure	43.6	42.5	42.5	42.4	42.2	42.3	41.6	40.8	40.6
of which:									
Compensation of employees	13.6	12.8	12.8	12.4	12.2	12.2	11.7	11.3	11.0
Intermediate consumption	4.1	4.1	4.1	4.0	4.1	4.0	4.0	4.0	4.0
Social payments	18.8	19.1	19.0	19.3	19.1	19.3	19.0	18.9	18.8
Subsidies	1.4	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.3
Gross fixed capital formation	2.3	2.2	2.2	2.2	2.2	2.2	2.3	2.4	2.6
Other (residual)	3.3	3.2	3.2	3.3	3.2	3.4	3.2	3.1	2.9
- Interest expenditure	2.8	2.9	2.9	2.9	2.9	2.9	2.8	2.7	2.7
General government balance (GGB)	**-3.9**	**-3.0**	**-3.0**	**-2.6**	**-2.4**	**-2.4**	**-1.5**	**-0.4**	**-0.2**
Primary balance	**-1.1**	**-0.1**	**-0.1**	**0.3**	**0.5**	**0.5**	**1.3**	**2.2**	**2.5**
One-off and other temporary measures	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-3.9**	**-3.1**	**-3.1**	**-2.6**	**-2.4**	**-2.4**	**-1.5**	**-0.4**	**-0.2**
Output gap[2]	-2.1	-1.7	-2.2	-1.2	-1.8	-0.8	-1.1	-0.2	0.5
Cyclically-adjusted balance[2]	-2.9	-2.2	-2.0	-2.1	-1.6	-2.1	-1.0	-0.3	-0.4
Structural balance[3]	**-2.9**	**-2.3**	**-2.1**	**-2.1**	**-1.6**	**-2.1**	**-1.0**	**-0.3**	**-0.4**
Change in structural balance		*0.6*	*0.7*	*0.3*	*0.5*	*0.0*	*0.6*	*0.7*	*-0.1*
Structural primary balance[3]	-0.2	0.6	0.8	0.9	1.3	0.9	1.8	2.4	2.3
Change in structural primary balance		*0.7*	*0.8*	*0.3*	*0.5*	*0.0*	*0.5*	*0.6*	*-0.1*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

As highlighted in section 3, the programme's growth assumptions are favourable, especially in the outer years of the programme. In fact, the outlook for GDP growth in both real and nominal terms underpinning the programme's fiscal projections seems to be on the high side. Whereas the growth composition seems overall more balanced, it is worth bearing in mind the uncertainty surrounding some individual variables such as

household consumption and employment, which are key determinants of tax revenues. Therefore, if economic growth in the years to come turns out weaker than assumed in the programme, the relief for government finances will be more limited than planned and consequently will imply a negative risk for the fiscal outturns.[25]

The risks stemming from possibly worse-than-expected macroeconomic developments are exemplified by the results of sensitivity analyses. The programme includes sensitivity analyses of its main variables with respect to different assumptions for oil prices and short-term interest rates. In the first case, oil prices are assumed to be higher (lower) 20% and external demand lower (higher) than in the baseline scenario. Compared with the latter, higher oil prices would decrease real GDP growth by 0.2 percentage point in 2008 and 0.3 percentage point in 2009, lift the private consumption deflator by 1.2 percentage points and improve the government deficit by 0.1 percentage point of GDP in 2008.[26] In the case of the interest rate hike, rates are assumed to be higher by 1 full percentage point compared with the baseline scenario. Such a hike would hurt real GDP growth by 0.3 percentage point in 2008 but the effects on the government balance would last longer: the deficit would worsen by 0.2 percentage points of GDP in 2008 and 0.3 percentage points in 2009 and beyond.

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 2007-2011 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, by 2011, the cyclically-adjusted balance is over ¾ of a percentage point of GDP below that of the central scenario. Hence, in the case of persistently lower real growth, additional measures over ¾ of a percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.

As described in subsection 4.2.2, the stability programme update aims at considerable budgetary consolidation in the coming years hinging upon plans to rein in government expenditure. That adjustment is to be supported by measures of a structural nature that have been adopted recently and which are targeted at reducing compensation of government employees and containing social payments, yielding often lagged results.

Against a backdrop of a comprehensive consolidation package made up of a large number of measures, the estimates of the fiscal impact of those corrective efforts are subject to high uncertainty. Even for some measures already adopted, time elapsed so far is rather short to draw firm conclusions. In other words, the extent of expected expenditure savings has still to be confirmed.

The observation presented above is particularly relevant for the measures in the area of public administration, which are expected to have an impact on personnel spending and, to a lesser extent, on intermediate consumption. In fact, important steps have been taken, for instance in designing the new structures of central government services with a

[25] In addition, it is important to note that the materialisation of lower-than-expected GDP growth for a number of years would have a negative impact on potential GDP growth too and thereby lower output gaps, with possible effects for the indicators concerning the economy's cyclical position and the fiscal stance.

[26] The effects of lower oil prices are reported as being symmetric to those of higher prices.

reduction in the number of services by about a quarter; in closing a considerable number of local services in the areas of education and health; or, in adopting new rules for pay, career and employment relations for government employees. However, uncertainty remains regarding the budgetary savings that can be achieved through these measures. For instance, the impact of the new pay and career scales over the medium-term is difficult to forecast. First, wage increases are decided on a discretionary annual basis and, second, with the new rules, a ceiling for personnel spending will be allocated to the various government services, but also on an annual basis. In other words, the envisaged high degree of restraint on personnel spending is also dependent on future decisions.

A major source of uncertainty comes from the fact that an important part of the planned expenditure savings seems to be dependent on workers' retirement behaviour, especially those of the government sector. This is relevant as the reduction of government employment seems to be the largest single driver of fiscal consolidation through hiring restrictions coming from the only partial replacement of workers that leave the central government. At the same time, evidence shows that most of staff outflows from the government sector have been associated with retirement. The combination of these two factors implies that the room for a reduction in the government staff figures depends on the retirement decisions of current employees, which depend on individuals' preferences. Besides the evolution of staff figures in terms of persons, other aspect relevant for personnel spending is the relation between the average wages of replaced workers and those of theirs successors: the steeper the wage profile, the higher the savings. However, it must be recognised that in both 2006 and 2007 compensation of government employees turned out to be slightly lower than budgeted.

The measures in the area of health are ambitious and, in fact, difficult measures have been taken by closing a number of local services. Furthermore, as mentioned above, an important contribution is expected to be given by better performance of incorporated hospitals, which is foreseen to allow a stabilisation of expenditure in real terms in this area. On this respect, the programme presents data suggesting a noticeable success of those hospitals in stabilising costs in 2006 and 2007 and of the National Health System in complying with budgetary plans. To these results helped the reductions in medication costs, which are not foreseen to be repeated in the future but, looking ahead, the creation of the purchasing agencies in the area of health may generate savings from a proper use of increased bargaining power. However and overall, experience also from other countries suggests that it is often difficult to fully control demand and production levels in the area of health. Nevertheless, the programme outlines a number of measures on information reporting, monitoring and share of best practices among hospitals, which can be of help to timely track developments and take corrective action whenever necessary.[27]

[27] Still related to the process of incorporating more hospitals from the National Health System, capital injections in newly incorporated units amounting to a cumulative ¼% of GDP are planned up to 2009. The bulk of that amount is expected to be recorded as financial transactions without a direct impact on the government deficit. Nevertheless, should the precise recording of some of those operations be revised, government expenditure would be higher in the relevant years.

Table 7: Assessment of tax projections

	2008			2009			2010	2011
	SP	COM	OECD[3]	SP	COM[1]	OECD[3]	SP	SP
Change in tax-to-GDP ratio (total taxes)	0.0	0.0	0.1	0.0	0.0	0.1	-0.1	0.0
Difference (SP – COM)	0.0		/	0.0		/	/	/
of which [2] :								
- discretionary and elasticity component	*0.2*		/	*0.2*		/	/	/
- composition component	*-0.2*		/	*-0.2*		/	/	/
Difference (COM - OECD)	/	-0.1		/	-0.1		/	/
of which [2] :								
- discretionary and elasticity component	/	*0.1*		/	*0.0*		/	/
- composition component	/	*-0.2*		/	*-0.1*		/	/
p.m.: Elasticity to GDP	1.0	1.0	1.1	1.0	1.0	1.1	1.0	1.0

Notes:

[1]On a no-policy change basis.

[2]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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

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

Source :
Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

Overall, tax revenue is expected to evolve largely in tandem with economic activity, with a unitary elasticity being assumed throughout the programme period (see Table 7). Therefore, they do not seem to pose a clear budgetary risk. Nonetheless, for 2008, there are risks that the revenue from indirect taxes may be lower than planned, as their elasticity with respect to private consumption seems to be skewed to the high side, even after taking into account the expected impact of policy measures.[28] Possibly mitigating this negative risk, the programme's assumed elasticity for direct taxes is below its historical average, the more so as the 2007 direct taxes inflows seem bound to turn out higher than estimated and, as a whole, already very close to the levels expected for 2008.

A more fundamental issue about medium-term tax projections is related to the revenue buoyancy of recent years and the extent to which it will persist in the future. In fact, tax revenue has been growing in excess of GDP since 2004, with part of that expansion not being accounted for by changes in nominal tax rates or in the composition of economic growth. Instead, it could be ascribed to improved tax collection stemming from efficiency gains at the level of tax administration.[29] The latter seems to build on two main factors: first, lower levels of tax evasion and tax fraud, i.e., improved compliance

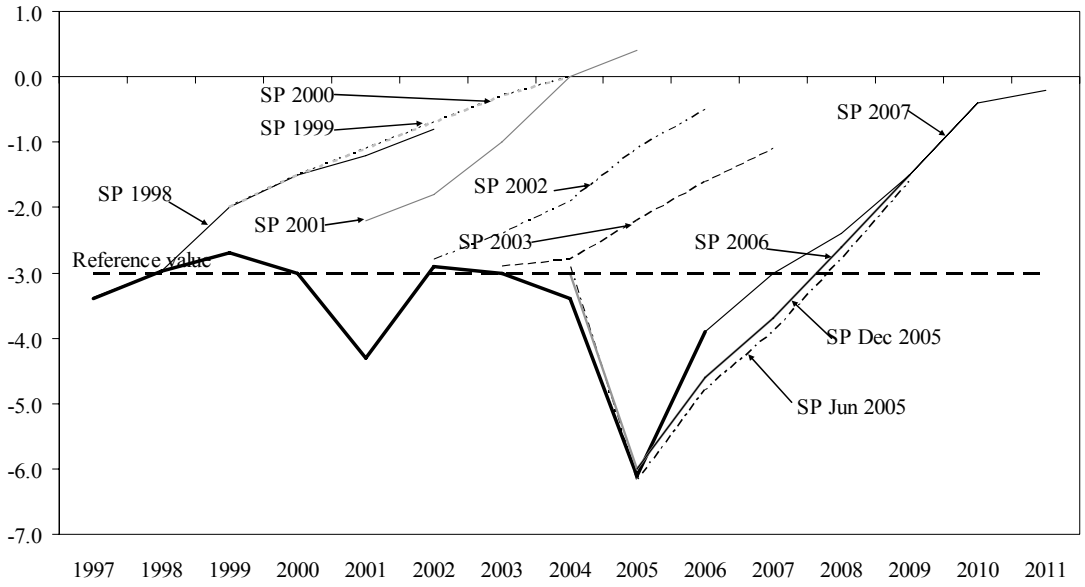
[28] The programme update mentions the impact of a quicker processing of reimbursements of VAT due to taxpayers that took place 2007, which hurt fiscal proceeds for that year but ceteris paribus will allow a strong growth in 2008 due to the lower base effect from 2007.

[29] For an analysis of the evolution of tax revenue in Portugal for more detail on tax revenue developments in Portugal in the past decade, see Economic Assessment of the December 2006 stability programme.

and, second, higher rates of success in collecting tax arrears.[30] The first type of effects can be assumed to represent a more or less permanent increase in tax revenue levels. However, the second effect may have a less lasting nature and tend to fade away, especially so if enhanced compliance limits the inflow of new arrears and eventually leads to a shrinking arrears stock. This implies that when the marginal gains in tax collection are sufficiently low – and they can even be negative in the case of the arrears – they will ceteris paribus drag down the observed elasticity of overall tax revenue.

Therefore, and whereas the programme assumes gains from improved tax collection to be substantially lower than those observed in recent years,[31] looking ahead, it seems appropriate to consolidate recent tax windfalls, notably those that may have been linked to efficiency gains in tax administration. Moreover, it may also be important to bear in mind that, departing from the enlarged revenue bases of recent years, tax elasticities might fall below their long-term averages when marginal gains of tax administration vanish. All in all, sticking to conservative tax revenue projections can increase the resilience of public finances to unexpected shocks.

Figure 14: Government balance projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes

[30] These may have added a second round effect by stimulating voluntary and timely compliance by taxpayers.

[31] Additional revenue of 0.1% of GDP in both 2008 and 2009.

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 update. A major risk arises from lower-than-projected GDP growth, especially in the outer years of the programme. The fiscal impact of the various corrective measures on the expenditure side is subject to uncertainty, the more so as it will also depend on workers' retirement decisions that are out of the government control. On the positive side, the fiscal prospects can benefit from a 2007 budgetary outturn better than estimated in the update depending on the extent and composition of that overachievement. In addition, the high level of attachment to the targets outlined in previous updates – and even their overachievement in 2006 and 2007 on the back of critical contributions from higher-than-budgeted tax revenue – may bode well for achievement of the targets in the coming years.

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 and, second, the final assessment also taking into account risks.

Table 8: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Consistency with correction of excessive deficit by 2008 deadline	Yes	Yes (can take place in 2007)
b. Safety margin against breaching 3% of GDP deficit limit[1]	From 2009 onwards	Not before 2010
c. Achievement of the MTO	In 2010	Not before 2011
d. Adjustment towards MTO in line with the Pact[2] (after the correction of the excessive deficit)?	In line	May require additional efforts

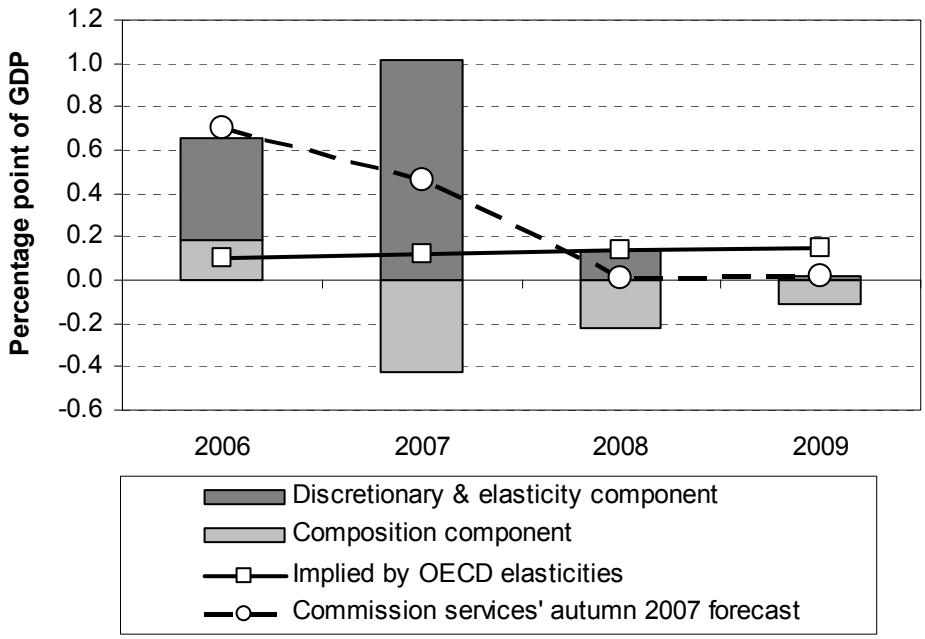
Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the minimum benchmark (estimated as a deficit of around 1½% of GDP for Portugal). These benchmarks represent 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.
[3]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 consistent with a correction of the excessive deficit by 2008 at the latest as originally recommended by the Council (see Box 3 above). Recent data on budgetary execution suggest that a deficit below the 3% of GDP reference value may be within reach already in 2007. Nonetheless, the budgetary plans for 2008 are not in line with the improvement in structural terms of ¾% of GDP in this year requested by the Council in the recommendation under Article 104(7), as the change in the structural balance envisaged in the programme update is only ½% of GDP. However, when putting this apparent underachievement into the broader picture of medium-term consolidation, the cumulative reduction of the structural deficit in 2006, 2007 and 2008, at some 3½% of GDP, is about ½ of a percentage point above the Council requirement.

Taking into account the risks to the budgetary targets, the programme's fiscal stance risks not providing a sufficient safety margin against breaching again the 3% of GDP deficit threshold with normal macroeconomic fluctuations in 2008 and 2009.

Figure 15: 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' 2007 autumn forecast (for 2009, 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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

Source:
Commission services

The structural improvement towards the MTO after the planned correction of the excessive deficit is slightly back loaded, at almost ¾% of GDP in 2010 after some ½% of GDP in both 2008 and 2009. Nevertheless, such a pace of adjustment towards the MTO would be slightly in excess of the requirements of the Stability and Growth Pact, which require an average of 0.5% of GDP, possibly higher (or more limited) in economic good (bad) times. That path is targeted against a backdrop of bad economic times as described in subsection 3.3, with the consideration of tax elasticities not changing that assessment: the overall tax elasticity falls marginally behind the ex-ante OECD elasticity in 2008 and 2009, and the composition of GDP growth is slightly detrimental to the tax-to-GDP ratio as domestic demand is expected to track behind GDP in these years (see Figure 15).

Nonetheless, taking into account the risks to the budgetary targets, the pace of adjustment towards the MTO may be lower than planned – and lower than 0.5% of GDP on average – thus possibly hindering the achievement of the MTO by 2010, as targeted. In particular, the Commission services' autumn 2007 forecasts projected an improvement in the structural balance of ¼% of GDP in 2008. Therefore, in the light of risks to the targets, the pace of adjustment towards the MTO implied by the programme may have to be backed up with additional efforts to be in line with the Stability and Growth Pact.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

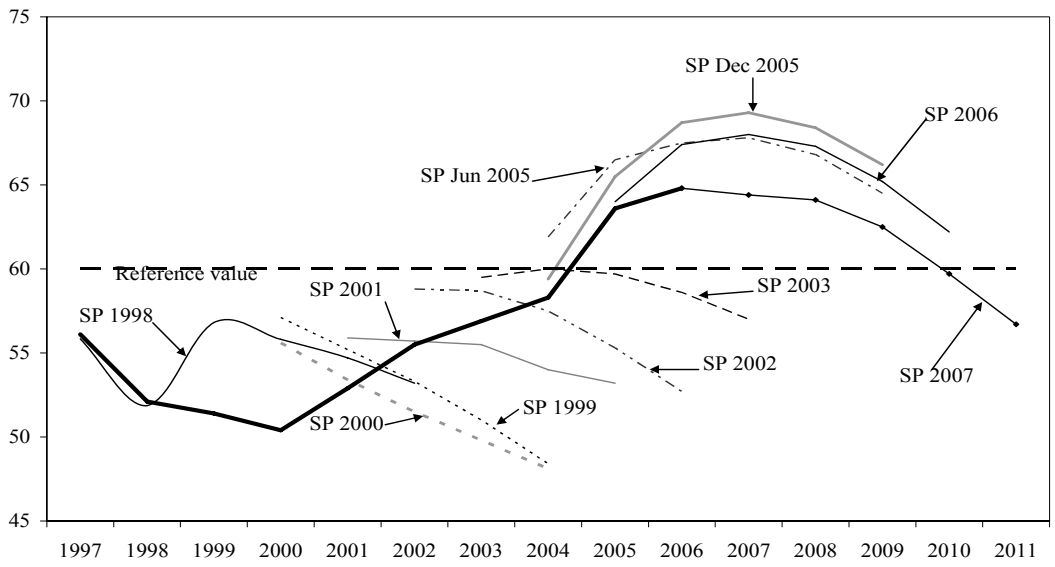
This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The government debt ratio was on an upward trend between 2001 and 2006 as the result of high and persistent government deficits, continued low GDP growth and sizeable debt-increasing stock-flow adjustments in some years. Furthermore, debt has exceeded the 60% of GDP reference value since 2005. According to the most recent programme update and the Commission services' autumn 2007 forecasts, that upward trend seems to have halted in 2007: the debt ratio is estimated to have reached 64.4% of GDP, easing off slightly from its 2006 level of 64.8% of GDP thanks to the lower deficit, the debt-reducing stock-flow adjustment helped by privatisations proceeds and an acceleration of GDP. The 2007 estimated government debt outturn is 3½ percentage points of GDP lower than forecast in the December 2006 update, on account of lower deficits in both 2006 and 2007 and a marginally higher GDP level due to a revision in national accounts data.

Figure 16: Debt projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecasts (COM) and successive stability programmes

The programme update projects the government debt ratio to be on a declining path over its entire period and to fall below the 60% of GDP threshold in 2010. In particular, it is projected to come at 64.1% of GDP in 2008, and to go further down to 62.5% in 2009 and eventually to fall under 57% of GDP in 2011. Compared with the update of December 2006, the government debt ratio is now foreseen to be lower than before by

almost 3 percentage points of GDP on average thanks to a more benign 2007 departure point, as the speed of debt reduction has been tweaked down (see Figure 16).

The downward path envisaged for the coming years 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 essentially neutral after 2008. Regarding its composition, privatisation proceeds are assumed in every year, amounting to a total of 1% of GDP between 2008 and 2011, with their impact on debt largely offset by the acquisition of financial assets. The implicit difference between the cash- and accrual-based deficit – derived from the programme information assuming that the valuation and residual effects are zero – is projected to be 0.4% of GDP in 2008 and just over 0.1% of GDP in other years on average.

Table 9: Debt dynamics

(% of GDP)	average 2002-2005	2006	2007		2008		2009		2010	2011
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**58.6**	**64.8**	**64.4**	**64.4**	**64.7**	**64.1**	**64.5**	**62.5**	**59.7**	**56.7**
Change in the ratio	2.7	1.1	-0.4	-0.4	0.3	-0.3	-0.2	-1.6	-2.8	-3.0
Contributions [2] *:*										
Primary balance	**1.1**	**1.1**	**0.1**	**0.1**	**-0.3**	**-0.5**	**-0.5**	**-1.3**	**-2.2**	**-2.5**
"Snow-ball" effect	**0.8**	**0.2**	**0.0**	**0.0**	**0.2**	**-0.1**	**0.2**	**-0.4**	**-0.7**	**-0.5**
Of which:										
Interest expenditure	2.7	2.8	2.9	2.9	2.9	2.9	2.9	2.8	2.6	2.7
Growth effect	-0.3	-0.8	-1.1	-1.1	-1.2	-1.3	-1.3	-1.7	-1.8	-1.7
Inflation effect	-1.6	-1.8	-1.8	-1.8	-1.5	-1.7	-1.4	-1.5	-1.5	-1.5
Stock-flow adjustment	**0.8**	**-0.2**	**-0.5**	**-0.5**	**0.4**	**0.4**	**0.1**	**0.0**	**0.0**	**0.1**
Of which:										
Cash/accruals diff.	0.2	-0.1		n.a.		n.a.		n.a.	n.a.	n.a.
Acc. financial assets	0.6	-0.3		-0.1		-0.3		-0.2	-0.1	0.0
Privatisation	*-0.3*	*-1.0*		*-0.5*		*-0.4*		*-0.3*	*-0.2*	*-0.1*
Val. effect & residual	0.0	0.1		n.a.		n.a.		n.a.	n.a.	n.a.

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 (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The assessment of the stability programme highlights some risks to the government debt projections. First, achieving the programme targets crucially hinges upon meeting the ambitious deficit reduction targets. Second, in line with the risks to the macroeconomic scenario pointed in section 3, GDP developments can give less relief to the debt ratio than foreseen in the update. Third, the minor stock-flow adjustments require keeping capital injections to public enterprises below the average of prior years. In fact, the programme projections for the government debt ratio are more optimistic than the Commission services' autumn 2007 economic forecasts, with the latter suggesting no improvements in the ratio in 2008 and 2009.

The update includes a sensitivity analysis of government debt with respect to short-term interest rates higher by 1 full percentage point compared with the baseline scenario. This shows that by 2011, the debt ratio would be higher by 0.9 percentage points of GDP as compared with the baseline. In fact, with the bulk of government debt issued at fixed rates, changes in interest rates will have an essentially lagged impact on debt and interest expenditure, which will depend on the differential between the rates of new and old bonds. Given the profile of interest rates since the late 1990s, it might even happen that rates on new bonds turn out to be lower than those on bonds to be repaid in coming years.

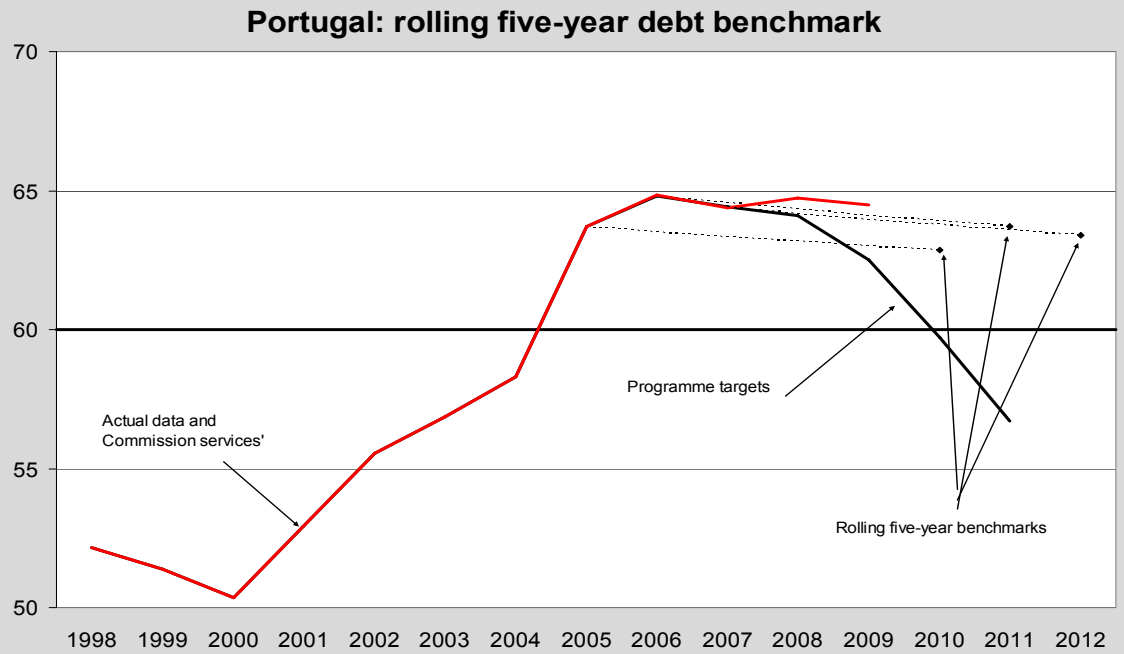
The government debt reduction strategy outlined in the update is consistent with the Council recommendation under Article 104(7) of 20 September 2005 in the sense that debt is planned to be on a downward path and developments reflect a fall of debt-increasing financial operations. In addition, the debt ratio could be considered as sufficiently diminishing towards the reference value at the end of the programme period (see Box 5). Yet, as stated above, the envisaged reductions crucially depend on achieving the targeted lower government deficits, and can be jeopardised by the downward risks to GDP. Overall, in the light of this risk assessment, the evolution of the debt ratio may be less favourable than projected in the programme update.

Box 5: The rolling debt reduction benchmark

The debt ratio has exceeded the 60% of GDP reference value since 2005.

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 2007 forecasts until 2009 (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.

The graph shows that the planned reduction of the debt ratio in the update is more than implied by the five-year rolling debt reduction benchmark only at the 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:

$\left(\frac{D_{t+1}}{Y_{t+1}}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right]$, 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 which 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

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

5.2.1. Sustainability indicators and long-term debt projections

Table 10 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 and property income received by general government according to an agreed methodology. [32] Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

[32] See the accompanying "methodological paper" for a description of the property income projections.

Table 10: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change up to 2050
Total age-related spending	23.7	24.7	25.3	26.0	28.0	29.6	5.9
- Pensions	10.5	11.9	12.6	13.4	15.0	16.0	5.5
- Healthcare	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
Property income received	0.5	0.6	0.6	0.5	0.5	0.5	0.0

Source: Economic Policy Committee and Commission services.

Portugal has implemented a pension reform in 2006 and new projections of age-related expenditure have been endorsed by the EPC in October 2007.[33] This reform has significantly reduced the increase in age-related expenditure by around 4 p.p. of GDP between 2004 and 2050. The impact of the 2006 pension reform, as validated by the EPC, is included in the baseline calculations below.

The projected increase in age-related spending in Portugal is above the average of the EU, rising by 5.9p.p. of GDP between 2004 and 2050. The increase in expenditure on pensions is projected to be above the EU average, rising by 5.5 p.p. of GDP. The increase in health-care expenditure is projected to be 0.5p.p. of GDP, lower than on average in the EU. For long-term care, the projected increase of 0.4p.p. of GDP up to 2050 is also below the average in the EU.

Table 11: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	1.9	3.6	4.2	0.2	2.0	4.1
of which:						
Initial budgetary position (IBP)	0.2	0.4	-	-1.4	-1.2	-
Debt requirement in 2050 (DR)	0.0	-	-	-0.1	-	-
Long-term change in the primary balance (LTC)	1.7	3.2	-	1.7	3.2	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 11 shows the sustainability indicators for the two scenarios; the "2007 scenario" assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the "programme scenario" assumes that the programme's budgetary plans are fully attained.

In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 3.6 p.p. of GDP.[34] The sustainability gap is considerably lower than in last year's assessment, by about 4¾ p.p. of GDP. First, the cost of ageing is

[33] See EPC opinion of 29 October 2007, CEFCPE01/2007/REP/54828.

[34] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 1.9% of GDP.

reduced by 3½ p.p. of GDP following the 2006 pension reform.[35] Second, the structural primary balance has significantly improved in 2007 (0.8 p.p. of GDP) compared to 2006 (-½ p.p. of GDP as measured in last year's programme).

The initial budgetary position is not sufficiently high to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances before considering the long-term budgetary impact of ageing.

According to both sustainability gaps, the long-term budgetary impact of ageing is close to the EU average.

The programme plans a structural primary budgetary consolidation of 1.5 p.p. of GDP between 2007 and 2011. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances by reducing the S2 sustainability gap to around 2 p.p. of GDP ("programme scenario").

The difference between the initial budgetary position in the "2007 scenario" and the "programme scenario" illustrates how the full respect of the stability programme targets would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is almost 4¼% of GDP, higher than the structural primary balance of about 2¼% of GDP in the last year of the programme's period.

The sustainability gap indicators would increase by up to 0.3p.p. of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made 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/GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 17.

The gross debt ratio is currently above the 60% of GDP reference value, estimated in the programme at 64.4% of GDP in 2007. According to the "2007 scenario", the debt ratio is projected to increase throughout the projection period up to 2050, reaching 160% of GDP. In the "programme scenario", debt would fall below 60% of GDP during the programme period and, thanks to the stronger budgetary position in 2011, would remain so over most of the projection period.[36]

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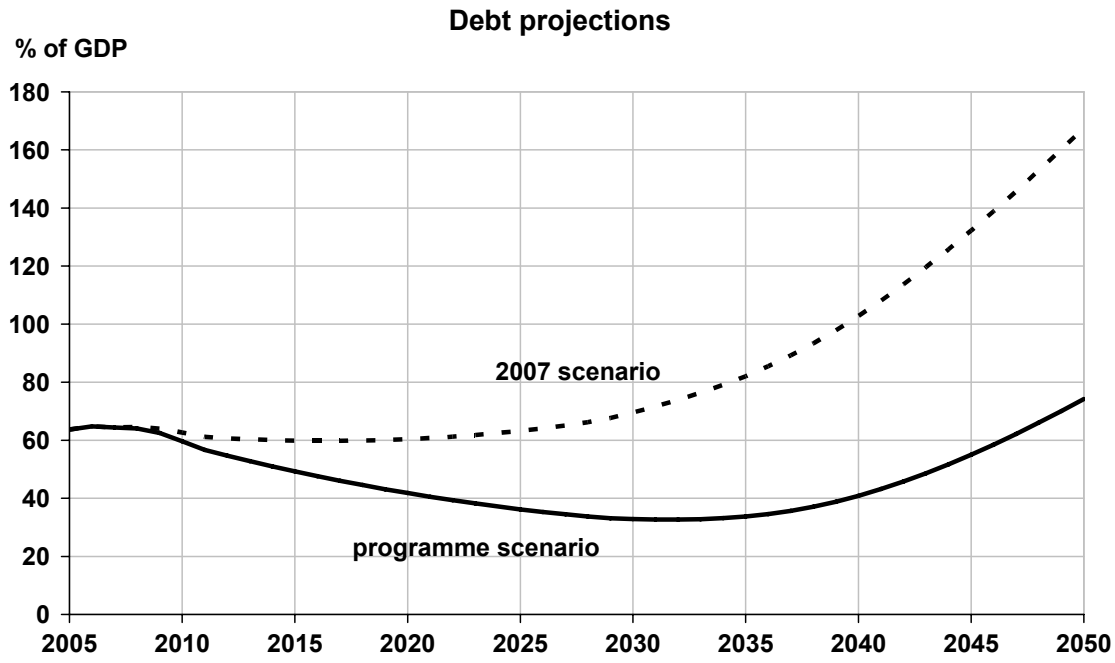
[35] More precisely, the new pensions projections include (i) the impact of the 2006 pension reform (-2.5p.p. of GDP on the sustainability indicator) and (ii) a better modelling of the pension scheme for civil servants (-1 p.p. of GDP on the sustainability indicator).

[36] 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.

Figure 17: Long-term projections for the government debt ratio



Source: Commission services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, Portugal's current level of debt is higher than 60% of GDP. A reduction of debt to below the 60% of GDP reference value at a rapid pace would strengthen the resilience of the public finances to adverse shocks and reduce the risks to public finance sustainability.

Second, the benefit ratio[37] in Portugal is projected to decrease relatively markedly by around 27% between 2004 and 2050, notably after the 2006 pension reform. This is explained in part by the technical assumption underlying the long-term projections that workers would not change their retirement age following the introduction of the 2006 pension reform, despite the strong financial incentives such as the sustainability factor[38] to postpone the retirement age. Therefore, if people chose to work longer in the future, they could increase their pension rights and, therefore, limit the decrease in the benefit ratio.

[37] This is the ratio of the average pension and the average wage.

[38] The sustainability factor indexes the value of the pension to the increase in life expectancy at the age of 65.

5.2.3. Assessment

Portugal appears to be at medium risk with regard to the sustainability of public finances.

The long-term budgetary impact of ageing in Portugal is slightly above the EU average, with the 2006 pension reform contributing markedly to containing the increase in age-related expenditure.

The budgetary position in 2007 as estimated in the programme, albeit improved compared with 2006, 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, as planned in the programme, would contribute to reducing risks to the sustainability of public finances.

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

The programme update highlights a set of initiatives aimed at improving the quality and efficiency of public expenditure. Within this domain, particular attention is devoted to improvements in the area of public procurement, with the creation of a National Public Purchasing Agency, which is expected to be instrumental in promoting cost reductions through economies of scale, increased bargaining power and reduced red tape.

In addition, the programme contains an overview of recent structural reform initiatives aimed at improving potential GDP growth. In particular, the update highlights a set of measures seeking to promote a business climate more favourable to entrepreneurship and investment, and to stimulate the modernisation of the economy's competitive base, also with a view to addressing the challenges imposed by fiercer international competition. Since higher GDP growth is expected to translate into increased fiscal outturns, such reforms may have a positive impact on public finances via that route.

In order to improve the business climate, the national authorities have put forward a set of initiatives aimed at reducing the red tape costs inflicted upon small and medium enterprises. These measures have been implemented within the context of a broader programme of administrative simplification – the SIMPLEX – and include projects such as "On the Spot Firm" and "On the Spot Brand", the Simplified Business Information return, the simplification and elimination of trade register acts and the dematerialisation of tax acts and procedures using new information technology. In recognition of the success of these initiatives, Portugal has recently registered significant improvements in its positioning in several well established international rankings on business climate and e-government issues, such as the World Bank's 2008 Doing Business report and the Online Public Services Ranking promoted by the European Commission.

Within the context of measures aimed at furthering advances in science, technology and innovation, the update dedicates especial attention to public investment projects on the areas of information, communication and technology – such as the initiative "Connecting Portugal" – and to various R&D partnerships between national and international science and technology institutions. The latter initiatives include, among others, partnerships with North American higher education institutions such as Harvard University and the University of Texas at Austin.

Institutional features

The programme summarises measures that were implemented in 2005 and 2006 to frame institutions for budgetary execution – in fact, many of them had been presented in updates and assessed at that time. They include, inter alia, better reporting of budgetary execution for the various government subsectors; creation of the budgetary technical support unit close to the Parliament (UTAO); or, the installation of financial controllers in various ministries. No new measures are outlined in the programme.

The programme confirms the earlier plans to develop performance budgeting characterised by assessment of spending effectiveness and efficiency, multi-annual budgetary framework and numerical rules. Pilot projects are foreseen to be included in the 2009 budget.

Public Enterprises

In the Economic Assessment of the December 2006 update of the stability programme of Portugal, a suggestion was made for the inclusion of information on the financial situation of public enterprises in stability and convergence programmes, with a view to allowing an encompassing fiscal surveillance.[39] Indeed, the accumulation of losses and debt by public enterprises can be a drag on public finances, for instance, if a government rescue may be needed at some stage, especially if the financial sector regards public enterprises as low-risk borrowers benefiting from explicit or implicit state guarantees. The most recent update of the stability programme reacted positively to that call by presenting a subsection on the government corporate sector. It includes data on the financial performance of public enterprises for 2005 and 2006 and describes recent measures in the area.

It seems that the losses of non-financial public enterprises were 0.1% of GDP in 2006 after 0.4% in 2005 and an average of some ½% of GDP per year between 2001 and 2005, however the improvement was driven by a single holding (including its financial results), with the rest not showing significant changes. The transport sector continued to be the biggest loss maker. At the same time, the financial sector had profits of 0.5% of GDP. In 2006, the whole public enterprises paid dividends worth about 0.3% of GDP to the government, which was almost identical to the amount of payments from the government to the public enterprises universe in the form of capital injections (0.05% of GDP) or subsidies for the performance of public services obligations (0.25% of GDP). However, according to the report "*Sector Empresarial do Estado – Relatório 2007*"[40], total debt of non-financial corporations was almost 17% of GDP in 2006, clearly up from 14½% of GDP in 2005, apparently related with some asset accumulation. Enterprises in the area of transports and related infrastructures accounted for most of the debt stock (over 60% of the total) and its increase in 2006. As for 2007, the update highlights the likelihood of more negative financial results amid the higher interest rates.

The programme reports the measures introduced in 2007 concerning the control, planning and performance of public enterprises. They are mainly related with objective-setting policies for enterprises and respective managers, improved financial information reporting and control. In addition, a taskforce was recently created within the Treasury to monitor the performance of public enterprises and public-private partnerships. Whereas these measures seem to address relevant aspects, is needless to say that experience with their implementation is rather short as to draw credible views about their appropriateness.

Finally, still in the area of public enterprises, government-owned hospitals became subject to especial and reinforced mechanisms for financial control. These include also a new model of internal control and audit. At the same time, sharing of best practices among the various hospitals seems to be envisaged.

All in all, the fact that non-financial public enterprises have continued accumulating losses and debt can put the medium-term fiscal stability at risk.

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[39] See Box 4 therein.

[40] Published by the Ministry of Finance and Public Administration and available at http://www.dgt.pt/docs/SEE_Relatorio_2007.pdf.

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 with the progress recorded in the Implementation Report of the National Reform Programme (IR-NRP) submitted in October 2007 in the context of the renewed Lisbon strategy for growth and jobs. In particular, the NRP identified strengthening budgetary consolidation and public administration reform 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 information on the direct budgetary impact of the main reform areas envisaged in the NRP. Moreover, the budgetary projections in the updated stability programme take into account the public finance implications of the actions envisaged in the IR-NRP.

In summary, i) the measures described in both programmes, the IR-NRP and the December 2007 update of the stability programme, are consistent with one another; ii) a qualitative assessment of the overall impact of NRP for the fiscal strategy has been made; iii) the information on reform costs/revenues has been taken into account in budgetary projections. Accordingly, the two programmes are fully consistent.

Box 6: The Commission assessment of the October 2007 implementation report of the National Reform Programme for Portugal

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Portugal's National Reform Programme[41], here summarised as follows.

Portugal's National Reform Programme 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 is that Portugal has made good progress in implementing its National Reform Programme over the 2005-2007 period.

Against the background of the strengths and weaknesses identified, the Commission recommends that Portugal: corrects fiscal imbalances, reforms public administration and redirects public spending to support more potential economic growth; further implements measures to strongly improve the efficiency of the educational system, fights early school leaving and develops a vocational training system relevant to the labour market needs; continues efforts to modernise employment protection and reduces the high levels of labour market segmentation, within the flexicurity approach.

Against the background of the progress made, the Commission recommends that Portugal be encouraged also to: narrow its current account deficit; pursue the implementation of the Technological Plan, consolidate the linkages between research, higher education and industry and the private sector; ensure effective competition, notably in energy and financial services markets; further implement a better regulation programme; reduce the deficit in transposing EU legislation

[41] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12. 2007, COM(2007)803.

into national law; reduce green house gas emissions; and address factors undermining social cohesion.

The tables below provide 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 issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendations and points to watch, and the recommendations for the euro area, adopted by the Council in March 2007. The budgetary strategy in the stability programme is broadly consistent with the country-specific recommendations for the euro area.

Table 12: Consistency with the broad economic policy guidelines (integrated 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		
– 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		
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

Table 13: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
1. Country-specific recommendations				
In the context of the on-going correction of fiscal imbalances and public administration reform, redirect public spending towards uses more supportive to potential economic growth, while maintaining firm expenditure control overall;		X		
2. Points to watch				
In addition, it will be important for Portugal over the period of the National Reform Programme to focus on the following challenges for the future: narrowing its current account deficit in a sustained way		X		
3. Recommendations for euro area Member States				
– Make use of the favourable cyclical conditions to aim or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5% as a benchmark.				X
– Improve the quality of public finances by reviewing public expenditure and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability.		X		
Source: Commission services				

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Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The programme broadly adheres to the structure prescribed by the code of conduct. Although the update does not dedicate a separate section to "Institutional features of public finances", its main elements are broadly covered in the section "Quality of public finances".

(ii) Data requirements

The programme provides all required and most of the optional data prescribed by the code. Examples of missing optional data are: Public consumption deflator; Investment deflator (Table 1b of the code of conduct: Price developments); General government expenditure by function (whole Table 3); Stock-flow adjustment decomposition: no data on "differences between cash and accruals" and on "valuation effects and others"; Liquid financial assets and thus net financial debt (Table 4: General government debt developments); Potential GDP growth and its contributors (Table 5: Cyclical developments).

The tables on the following pages show the data presented in the December 2007 update of stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

December 2007 Update of the Stability Programme	**Yes**	**No**	**Comments**
a. Involvement of parliament			
The programme mentions status vis-à-vis national parliament.	X		
The programme indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
The programme uses "common external assumptions" on main extra-EU variables.	X		
The update explains significant divergences with Commission services' forecasts[1].			Not applicable
The update bears out possible upside/downside risks to economic outlook.	X		
The outlook for sectoral balances and, especially for countries with high external deficit, the external balance is analysed.	X		External balance only
c. Monetary/exchange rate policy			
The convergence programme presents 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 general government balance in relation to MTO and projected path for debt ratio.	X		
In case new government has taken office, the programme shows continuity with respect to budgetary targets endorsed by Council.			Not applicable
When applicable, the programme explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation, and provides information on them.			Not applicable

December 2007 Update of the Stability Programme	Yes	No	Comments
Budgetary targets are backed by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
The update specifies state of implementation of measures.	X		
e. "Major structural reforms"			
If MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
The update includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			Not applicable
f. Sensitivity analysis			
The update includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		
In case of "major structural reforms", the programme analyses how changes in assumptions would affect budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
The programme provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		Information provided, without explicit links to the BEPGs.
h. Quality of public finances			
The programme describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
The programme outlines strategies to ensure sustainability.	X		
The programme includes common budgetary projections by the AWG and all necessary additional information.	X		
j. Other information (optional)			
The programme includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme

[1]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

Table 1a. Macroeconomic prospects

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	*150784,6*	1.3	1.8	2.2	2.8	3.0	3.0
2. Nominal GDP	B1*g	*155131.1*	4.2	4.8	5.0	5.4	5.7	5.7
Components of real GDP								
3. Private consumption expenditure	P.3	*97743.3*	1.1	1.2	1.4	2.1	2.3	2.4
4. Government consumption expenditure	P.3	*31449.5*	-0.3	-0.4	-1.1	-0.6	-0.3	1.1
5. Gross fixed capital formation	P.51	*31743.9*	-1.6	1.0	4.0	6.7	7.0	7.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*1386.3*	1.2	1.2	1.7	1.7	1.7	1.8
7. Exports of goods and services	P.6	*46198.4*	8.9	6.9	6.7	6.0	6.3	6.5
8. Imports of goods and services	P.7	*57737*	4.3	3.8	3.9	4.8	5.6	6.6
Contributions to real GDP growth								
9. Final domestic demand		-	0.3	1.1	1.5	2.6	3.0	3.3
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.1	0.2	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	0.9	0.7	0.7	0.1	0.0	-0.3

Table 1b. Price developments

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		*n.a.*	2.9	2.9	2.7	2.6	2.6	2.6
2. Private consumption deflator		*n.a.*	3.3	2.5	2.3	2.1	2.1	2.1
3. HICP[1]		*n.a.*	3.0	2.3	2.1	2.1	2.1	2.1
4. Public consumption deflator		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
5. Investment deflator		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Export price deflator (goods and services)		*n.a.*	4.4	2.9	2.7	2.1	2.1	2.1
7. Import price deflator (goods and services)		*n.a.*	4.6	1.4	3.3	1.1	1.1	1.1

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*5153.3*	0.7	0.4	0.9	1.4	1.5	1.5
2. Employment, hours worked[2]		*4947.6*	0.4	0.4	0.9	1.4	1.5	1.5
3. Unemployment rate (%)[3]		*n.a.*	7.7	7.8	7.6	7.2	6.9	6.6
4. Labour productivity, persons[4]		*25*	0.6	1.4	1.3	1.4	1.5	1.5
5. Labour productivity, hours worked[5]		*26*	0.9	1.4	1.3	1.3	1.5	1.5
6. Compensation of employees	D.1	*77350*	3.0	3.0	3.4	4.0	4.3	4.6
7. Compensation per employee		*18.2*	0.8	2.3	2.4	2.4	2.7	3.0

[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	2006	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-8.8	-7.0	-5.8	-5.6	-4.9	-4.7
of which :							
- Balance on goods and services		-7.8	-6.4	-5.9	-5.1	-4.6	-4.3
- Balance of primary incomes and transfers		-2.0	-1.8	-1.7	-1.8	-1.6	-1.5
- Capital account		1.1	1.3	1.8	1.4	1.3	1.2
2. Net lending/borrowing of the private sector	B.9	-4.9	-4.0	-3.4	-4.1	-4.5	-4.5
3. Net lending/borrowing of general government	EDP B.9	-3.9	-3.0	-2.4	-1.5	-0.4	-0.2
4. Statistical discrepancy		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	*-6029*	-3.9	-3.0	-2.4	-1.5	-0.4	-0.2
2. Central government	S.1311	*-6649*	-4.3	-3.5	-2.8	-1.7	-0.6	-0.3
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*39*	0.0	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	*580*	0.4	0.5	0.4	0.2	0.2	0.1
General government (S13)								
6. Total revenue	TR	*65912*	42.5	42.4	42.7	42.8	43.1	43.1
7. Total expenditure	TE[1]	*71941*	46.4	45.4	45.1	44.4	43.5	43.3
8. Net lending/borrowing	EDP B.9	*-6029*	-3.9	-3.0	-2.4	-1.5	-0.4	-0.2
9. Interest expenditure	EDP D.41	*4313*	2.8	2.9	2.9	2.8	2.7	2.7
10. Primary balance[2]		*-1717*	-1.1	-0.1	0.5	1.3	2.2	2.5
11. One-off and other temporary measures[3]		*0*	0.0	0.1	0.0	0.0	0.0	0.0
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		*37660*	24.3	24.6	24.8	24.8	24.7	24.7
12a. Taxes on production and imports	D.2	*23995*	15.5	15.2	15.4	15.4	15.4	15.4
12b. Current taxes on income, wealth, etc	D.5	*13662*	8.8	9.4	9.3	9.3	9.3	9.3
12c. Capital taxes	D.91	*4*	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	*19360*	12.5	12.5	12.4	12.4	12.3	12.3
14. Property income	D.4	*987*	0.6	0.6	0.5	0.5	0.6	0.5
15. Other[4]		*7904*	5.1	4.7	5.0	5.2	5.5	5.6
16=6. Total revenue	TR	*65912*	42.5	42.4	42.7	42.8	43.1	43.1
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			35.7	36.2	36.4	36.4	36.4	36.4
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	*27593*	**17.8**	**16.8**	**16.4**	**15.8**	**15.3**	**15.0**
17a. Compensation of employees	D.1	*21165*	13.6	12.8	12.2	11.7	11.3	11.0
17b. Intermediate consumption	P.2	*6428*	4.1	4.1	4.1	4.0	4.0	4.0
18. Social payments (18=18a+18b)		*29221*	18.8	19.0	19.1	19.0	18.9	18.8
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*5788*	3.7	4.0	3.9	3.8	3.7	3.7
18b. Social transfers other than in kind	D.62	*23433*	15.1	15.0	15.2	15.3	15.2	15.2
19=9. Interest expenditure	EDP D.41	*4313*	2.8	2.9	2.9	2.8	2.7	2.7
20. Subsidies	D.3	*2155*	1.4	1.2	1.2	1.3	1.3	1.3
21. Gross fixed capital formation	P.51	*3612*	2.3	2.2	2.2	2.3	2.4	2.6
22. Other[6]		*5048*	3.3	3.2	3.2	3.2	3.1	2.9
23=7. Total expenditure	TE[1]	*71941*	46.4	45.4	45.1	44.4	43.5	43.3
p.m.: Government consumption (nominal)	P.3	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[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, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

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

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	n.a.	n.a.
2. Defence	2	n.a.	n.a.
3. Public order and safety	3	n.a.	n.a.
4. Economic affairs	4	n.a.	n.a.
5. Environmental protection	5	n.a.	n.a.
6. Housing and community amenities	6	n.a.	n.a.
7. Health	7	n.a.	n.a.
8. Recreation, culture and religion	8	n.a.	n.a.
9. Education	9	n.a.	n.a.
10. Social protection	10	n.a.	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	n.a.	n.a.

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

Table 4. General government debt developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Gross debt[1]		64.8	64.4	64.1	62.5	59.7
2. Change in gross debt ratio		1.1	-0.5	-0.2	-1.6	-2.8
Contributions to changes in gross debt						
3. Primary balance[2]		1.1	0.1	-0.5	-1.3	-2.2
4. Interest expenditure[3]	EDP D.41	2.8	2.9	2.9	2.9	2.8
5. Stock-flow adjustment		-0.2	-0.5	0.4	0.0	0.0
of which:						
- Differences between cash and accruals[4]		n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		-0.3	-0.1	0.0	-0.2	-0.1
of which:						
- privatisation proceeds		0.8	0.5	0.4	0.3	0.2
- Valuation effects and other[6]		n.a	n.a	n.a	n.a	n.a
p.m.: Implicit interest rate on debt[7]		4.5	4.7	4.8	4.8	4.7
Other relevant variables						
6. Liquid financial assets[8]		n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.

[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 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	2006	2007	2008	2009	2010	2011
1. Real GDP growth (%)		1.3	1.8	2.2	2.8	3.0	3.0
2. Net lending of general government	EDP B.9	-3.9	-3.0	-2.4	-1.5	-0.4	-0.2
3. Interest expenditure	EDP D.41	2.8	2.9	2.9	2.8	2.7	2.7
4. One-off and other temporary measures[1]		0.0	0.1	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
contributions:							
- labour		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- capital		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- total factor productivity		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Output gap		-2.4	-2.2	-1.7	-1.0	-0.1	0.6
7. Cyclical budgetary component		-1.1	-1.0	-0.8	-0.5	-0.1	0.3
8. Cyclically-adjusted balance (2 - 7)		-2.8	-2.0	-1.6	-1.1	-0.4	-0.4
9. Cyclically-adjusted primary balance (8 + 3)		0.0	0.9	1.3	1.7	2.3	2.2
10. Structural balance (8 - 4)		-2.8	-2.1	-1.6	-1.1	-0.4	-0.4

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2006	2007	2008	2009	2010	2011
Real GDP growth (%)							
Previous update		1.4	1.8	2.4	3.0	3.0	n.a.
Current update		1.3	1.8	2.2	2.8	3.0	3.0
Difference		-0.1	0.0	-0.2	-0.2	0.0	n.a.
General government net lending (% of GDP)	EDP B.9						
Previous update		-4.6	-3.7	-2.6	-1.5	-0.4	n.a.
Current update		-3.9	-3.0	-2.4	-1.5	-0.4	-0.2
Difference		0.7	0.7	0.2	0.0	0.0	-
General government gross debt (% of GDP)							
Previous update		67.4	68.0	67.3	65.2	62.2	n.a.
Current update		64.8	64.4	64.1	62.5	59.7	56.7
Difference		-2.6	-3.6	-3.1	-2.6	-2.4	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	43.1	47.8	44.7	44.6	44.8	50.5
Of which: age-related expenditures	20.0	24.3	24.7	25.3	25.9	29.7
Pension expenditure	8.4	11.0	11.9	12.6	13.4	16.0
Social security pension	5.6	7.0	7.6	8.3	9.1	13.2
Old-age and early pensions	3.8	5.1	5.7	6.5	7.4	10.9
Other pensions (disability, survivors)	1.8	1.9	1.9	1.8	1.8	2.3
Occupational pensions (if in general government)	2.8	3.9	4.3	4.3	4.2	2.8
Health care	5.3	6.7	6.8	6.7	6.6	7.2
Long-term care *(this was earlier included in the*	0.3	0.5	0.5	0.5	0.6	0.9
Education expenditure	5.1	5.1	4.7	4.7	4.5	4.8
Other age-related expenditures	0.9	1.0	0.8	0.8	0.8	0.8
Interest expenditure	3.0	2.6	2.7	2.0	1.6	3.5
Total revenue	40.2	41.6	44.2	44.2	44.2	44.2
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	9.8	9.8	9.4	9.2	9.3
Pension reserve fund assets	2.5	4.2	6.0	7.0	5.5	-35.3
Of which : consolidated public pension fund assets (assets other than government liabilities)	0.7	1.9	2.8	3.2	2.5	-16.2
Assumptions						
Labour productivity growth	1.1	0.4	2.1	2.5	1.7	1.7
Real GDP growth	3.9	0.5	2.4	2.2	1.0	1.0
Participation rate males (aged 20-64)	85.2	85.5	86.5	86.8	85.9	86.3
Participation rates females (aged 20-64)	68.4	72.4	75.1	77.7	78.2	79.1
Total participation rates (aged 20-64)	76.6	78.8	80.7	82.3	82.1	82.7
Unemployment rate	4.1	7.4	5.4	5.3	5.3	5.2
Population aged 65+ over total population	16.4	17.0	17.7	20.3	24.3	31.9

Table 8. Basic assumptions

	2006	2007	2008	2009	2010	2011
Short-term interest rate[1] (annual average)	3.1	4.3	4.2	4.2	4.0	4.0
Long-term interest rate (annual average)	3.9	4.4	4.4	4.4	4.2	4.2
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.26	1.36	1.42	1.42	1.42	1.42
Nominal effective exchange rate	0.2	0.8	0.5	0.0	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	-	-	-	-	-	-
World excluding EU, GDP growth	6.0	5.6	5.3	5.4	4.5	4.4
EU GDP growth	3.0	2.9	2.4	2.4	2.2	2.1
Growth of relevant foreign markets	8.4	6.8	6.2	5.8	5.8	5.8
World import volumes, excluding EU	8.5	8.1	7.4	7.9	7.9	7.9
Oil prices (Brent, USD/barrel)	65.1	72.5	80.8	77.9	77.9	77.9

Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Portugal. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the euro area.

	Portugal						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2.4	4.1	0.8	0.5	1.3	1.8	2.1	2.7	1.4	1.5	2.8	2.6
Contributions to real GDP growth:												
Domestic demand	*3.0*	*5.4*	*0.7*	*0.9*	*0.3*	*1.0*	*2.0*	*2.7*	*1.3*	*1.7*	*2.6*	*2.4*
Net exports	*-0.6*	*-1.3*	*0.1*	*-0.3*	*0.9*	*0.7*	*0.1*	*0.0*	*0.1*	*-0.1*	*0.2*	*0.2*
Real GDP per capita (PPS; EU27 = 100)	82	83	81	79	77	76	113	114	112	110	110	109
Real GDP per capita (% change)	1.9	3.7	0.2	0.0	0.9	1.4	1.6	2.5	0.8	0.9	2.3	2.2
Prices, costs and labour market												
HICP inflation (%)	2.8	2.4	3.2	2.1	3.0	2.4	1.9	1.5	2.2	2.2	2.2	2.0
Labour productivity (% change)	1.3	2.2	0.4	0.5	0.6	1.5	1.2	1.5	0.8	1.0	1.4	1.1
Real unit labour costs (% change)	0.1	0.3	0.0	-0.4	-1.0	-1.7	-0.5	-0.6	-0.5	-0.8	-0.9	-0.8
Employment (% change)	1.1	1.9	0.4	0.0	0.7	0.3	1.2	1.5	0.9	0.9	1.5	1.6
Unemployment rate (% of labour force)	5.7	5.5	5.9	7.6	7.7	8.0	9.1	9.8	8.5	8.9	8.3	7.3
Competitiveness and external position												
Real effective exchange rate (% change)	1.4	0.6	2.2	0.5	0.5	0.3	-1.3	-5.5	2.8	-2.6	-0.6	0.6
Export performance (% change)[1]	-2.1	-2.4	-1.8	-4.8	0.7	1.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-5.9	-5.0	-6.7	-8.1	-8.8	-7.9	0.8	0.9	0.7	0.3	0.0	0.1
Public finances												
General government balance (% of GDP)	-3.6	-3.3	-3.9	-6.1	-3.9	-3.0	-2.3	-2.1	-2.5	-2.5	-1.5	-0.8
General government gross debt (% of GDP)	55.7	54.0	57.5	63.7	64.8	64.4	70.6	72.2	69.0	70.3	68.6	66.6
Structural balance (% of GDP)[2]	n.a.	n.a.	-4.9	-5.1	-2.9	-2.3	n.a.	n.a.	-2.6	-2.1	-1.1	-0.7
Financial indicators												
Short-term real interest rate (%)[3]	0.6	1.6	-0.3	-0.6	0.2	1.3	1.3	2.5	0.6	0.3	1.2	2.0
Long-term real interest rate (%)[3]	1.9	2.7	1.2	0.7	1.0	1.5	n.a.	n.a.	1.9	1.5	1.9	2.1

Notes:
[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.
[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.
[3]Using GDP deflator.

Source:
Commission services