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PORTUGAL: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE JANUARY 2009 UPDATE OF THE STABILITY PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term budgetary programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not.

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 25 February 2009. Comments should be sent to Pedro CARDOSO (pedro.cardoso@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' January 2009 interim forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. 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 25 February 2009. The ECOFIN Council adopted its opinion on the programme on 10 March 2009.

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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

1. INTRODUCTION

This document assesses the January 2009 update of Portugal's stability programme. It takes into account all currently available information, notably the Commission services' January 2009 Interim Forecast and the short-term fiscal stimulus measures adopted by the Portuguese authorities in response to the economic downturn. The programme, which was submitted on 30 January 2009[1], covers the period 2008-2011 and builds also on the draft 2009 supplementary budget law. The update was approved by the government and it was presented to the Parliament for a debate without a vote, according to the Portuguese Budgetary Framework Law.

2. MAIN CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

Over the current decade, the Portuguese economy has been growing at an average rate of 1% per year, consequently below the euro-area average and below potential. In 2008, GDP stagnated primarily influenced by sluggish external demand, reflecting the financial crisis and cooling activity in the main trading partners. Domestic demand growth also fell, driven by a falling gross fixed capital formation.

In parallel, the Portuguese economy has been marked by a sizeable external deficit, which points to unsustainable patterns. Despite some ups and downs over the past decade, mirroring mainly the pattern of domestic demand and external demand, the deficit of the balance of goods and services has been the key driver of the external deficit. In addition, the deficit of the primary income balance has widened in recent years, on account of an increasingly negative net asset position – reflecting itself the accumulation of past deficits –, higher interest rates and, to a much lesser extent, growing profits of foreign direct investment.

Cost competitiveness has been hurt by unit labour cost growth and, for most of the years, inflation rates in excess of those in various trade partners, despite some stabilisation in the cost competitiveness position in recent years. Furthermore, the competitive position has been weakened by feeble productivity growth. That seems to be constrained by structural aspects such as low stocks of human and physical capital or a still relatively high share of labour-intensive sectors in the product mix, which have been facing increased competition from emerging economies with low levels of labour costs. Nevertheless, despite the significant net foreign borrowing needs, the first impact of the ongoing financial crisis for this small euro-area participant has so far been very mild as the domestic banking sector has shown relative resilience and credit growth has decelerated more or less continuously but without major disruptions.

According to the Commission services' January 2009 interim forecast, the output gap is estimated to have turned slightly positive in 2007/2008 but is expected to turn again negative in 2009. Consideration of other factors beyond the output gap and the GDP growth path such as the quickly weakening demand confirm a change in economic patterns around the year 2008. In short, Portugal seems to be slipping again into 'bad economic times'.

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[1] The English language version was submitted on the same day.

For a large number of years, fiscal policy has been characterised by an overall pro-cyclical tone: first, adding to the expansion of the late nineties on account of a strong expansion of primary spending, and doing somewhat the opposite in most of the years of the current decade, notably in 2002-2003 and, more visibly, after 2005. Overall, public finances have shown fragilities, namely an underlying deficit in excess of 3% of GDP for various years until 2006 and a rising government debt ratio until that year.

In mid-2005, and under an Excessive Deficit Procedure (EDP) open at that time, Portugal embarked into a process of fiscal consolidation. The budget deficit declined from 6.1% of GDP in 2005 to 2.6% of GDP in 2007 on the back of both falling expenditure and rising revenue ratios. On the basis of an outturn below the 3% of GDP reference value, the EDP was abrogated in mid 2008. The 2008 government deficit is estimated at 2.2% of GDP, reflecting a stagnating GDP as well as much weaker consolidation efforts than in earlier years.

The Portuguese authorities have adopted various measures to stimulate economic activity in 2009 in line with the European Economic Recovery Plan (EERP). This package, announced in December, combines higher expenditure and tax cuts and includes, for instance, support to the employability for the vulnerable, such as young and old workers, assistance to the liquidity of firms through changes in the procedures and timing of tax payments, support to investment by granting tax credits and backing credit and insurance market mechanisms to improve the competitiveness and exports of Portuguese firms. Against the backdrop of the ongoing downturn, the discretionary measures on public finances limit the space for further fiscal impulses without risking the long-term sustainability of public finances.

All in all, the Portuguese economy is facing various challenges. In particular, the gap between income and spending, as reflected in the external imbalance, seems to raise concerns in the light of the present financial crisis to the extent that stricter credit conditions may constrain the space available for a smooth adjustment of demand. At the same time, the recessive backdrop in external markets, especially in its largest trading partners, hampers the margin for a strong re-balancing of GDP growth towards external demand. In addition, the current juncture is the result of not just adverse cyclical developments and external shocks but also of structural elements such as subdued productivity growth, eroded competitiveness, or vulnerable balance sheet positions of private agents, especially of corporations. On this respect, efforts to support the resilience of the supply side continue to be necessary. After efforts to reduce the government deficit in previous years, public finances seem to be visibly affected by the downturn, which clearly limits the space for further fiscal impulses without jeopardising sustainability of public finances.

Box: Measures to help stabilise the financial system

Besides the above mentioned budgetary measures, the Portuguese authorities have adopted various other measures to help stabilising the financial sector. These measures include:

First, strengthening information disclosure obligations by financial institutions;

Second, increased bank deposit guarantees (from 25 000 to 100 000 euro per account holder and bank);

Third, granting of guarantees to borrowing by Portuguese banks up to a total of € 16 bn. (9½% of GDP) until end 2009;

Fourth, possibility of reinforcing the core capital of domestic banks through government investment up to a total of € 4 bn. (2½% of GDP).

3. MACROECONOMIC SCENARIO

The macroeconomic scenario underlying the programme envisages that GDP will contract by 0.8% in real terms in 2009 and recover in 2010 and 2011 with real GDP growth at 0.5% and 1.3% respectively, with a gradual upswing in all demand components. These projections take into account the impact of various stimulus measures to economic activity taken by the Portuguese authorities, notably those taken in the context of the EERP.

The programme's GDP prospects exceed those of the Commission services January 2009 interim forecast and do so by a sizable margin, as the latter projects GDP to shrink by 1.6% in 2009 and by 0.2% in 2010. In other words, the Commission forecast projects a sharper and more protracted downturn. In addition, the programme foresees growing positive contributions of domestic demand to GDP growth right after 2009, the reverse in the Commission forecast.

Other differences between the update and the Commission forecast on the macroeconomic scenario stem mainly from the different assumptions for the GDP path. The labour market outlook for 2010 is an example, being more benign in the update. Inflationary pressures are assumed to ease significantly in 2009 and to increase to around 2% thereafter, which is in line with the patterns foreseen in the Commission services' January 2009 interim forecast. The programme envisages a decline of net foreign borrowing from 10½% of GDP in 2008 to 7½% of GDP in 2011 on the back of a reduction in the deficits of the balances of goods and services and of primary income and current transfers. Assessed against the Commission forecast, the outlook for this latter component of the external balance seems optimistic in light of the net foreign position path on account of the accumulation of external deficits and the consequently rising burden of serving external debt.

The cyclical conditions implied by the update (as measured by the output gap recalculated by the Commission services based on the information provided in the programme following the commonly agreed methodology) are expected to deteriorate considerably over the programme period. In particular, after the positive readings for the years up to 2008, the output gap is estimated to fall to -2% of GDP in 2009 and to -2½% of GDP in both 2010 and 2011.

Assessed against currently available information[2], this scenario appears to be based on favourable growth assumptions over the programme period. In particular, it reflects the relatively optimistic projections for domestic demand, notably the modest contractions of gross fixed capital formation in the programme scenario for 2009 and 2010. Hence, a scenario of lower-than-expected GDP growth is a genuine possibility. Finally, the programme's projections for inflation appear to be realistic.

[2] The assessment notably takes into account the Commission services' January 2009 interim forecast, but also other information that has become available since then.

Table I: Comparison of macroeconomic developments and forecasts

	2008		2009		2010		2011
	COM	SP	COM	SP	COM	SP	SP
Real GDP (% change)	0.2	0.3	-1.6	-0.8	-0.2	0.5	1.3
Private consumption (% change)	1.4	1.2	-0.2	0.4	0.1	0.6	1.0
Gross fixed capital formation (% change)	-0.8	-0.8	-5.5	-0.9	-3.8	-0.3	1.7
Exports of goods and services (% change)	0.3	0.1	-3.8	-4.4	0.8	1.9	3.1
Imports of goods and services (% change)	2.3	1.0	-2.8	-1.3	-0.4	1.3	1.7
Contributions to real GDP growth:							
- Final domestic demand	0.8	0.7	-1.3	0.2	-0.6	0.5	1.0
- Change in inventories	0.2	0.1	-0.2	0.0	0.0	0.1	0.0
- Net exports	-0.8	-0.4	-0.1	-0.9	0.4	0.1	0.3
Output gap[1]	0.2	-0.4	-1.7	-2.1	-2.5	-2.5	-2.5
Employment (% change)	0.6	0.6	-0.9	-0.7	-0.2	0.1	0.3
Unemployment rate (%)	7.8	7.7	8.8	8.5	9.1	8.2	7.7
Labour productivity (% change)	-0.4	-0.3	-0.6	-0.1	-0.1	0.5	1.0
HICP inflation (%)	2.7	2.6	1.0	1.2	2.0	2.0	2.0
GDP deflator (% change)	2.0	1.6	3.8	2.4	1.7	2.5	2.5
Comp. of employees (per head, % change)	3.3	3.6	2.3	2.1	2.7	2.0	2.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-10.2	-10.5	-8.2	-9.2	-8.7	-8.4	-7.6

Note:

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

Source :

Commission services' January 2009 interim forecasts (COM); Stability programme (SP)

4. BUDGETARY STRATEGY

4.1. Budgetary implementation in 2008

The 2008 general government deficit is estimated at 2.2% of GDP in the January 2009 stability programme update and the Commission services' January 2009 interim forecast, which is slightly better than the deficit target of 2.4% of GDP included in the previous programme update of December 2007.

The estimated slight overachievement of the 2008 budgetary target was made possible by a better-than-expected base effect from 2007, since the deficit outturn for that year was almost ½% of GDP lower than estimated in the December 2007 update (see Table 1 in Annex 2). That overachievement owed to a higher-than-planned revenue ratio by about ¾ of a percentage point of GDP, which was nevertheless partially off-set by an expenditure slippage of around ¼ of a percentage point of GDP.

Besides that base effect, the 2008 outturn was also affected by two other main factors of opposite sign. On the one hand, the slowdown in activity and the reduction of the standard VAT rate by one percentage point to 20% from 21% in July 2008 dampened tax revenue growth in the very final part of 2008, especially at the level of indirect taxes. That lower-than-planned tax revenue also reflects what appeared to be ex-ante optimistic projections for

indirect taxes proceeds in the December 2007 update, as highlighted in the Macro Fiscal Assessment thereof.

On the opposite direction, the 2008 budgetary execution benefited from unforeseen one-off sales of concessions by the government for the construction and exploitation of electric dams and motorways worth some ¾% of GDP (compared with similar operations in 2007 worth 0.1% of GDP). As the proceeds of this kind of operations are recorded as expenditure-reducing items in national accounts, they brought the estimated expenditure growth rate below the plans outlined in the December 2007 update. Controlling for the impact of these unforeseen one-off operations, overall expenditure growth in 2008 was largely in line with the December 2007 update plans, though departing from a higher starting level on account of the aforementioned slippage in 2007.[3] In this respect, it is worthy to highlight that those sales of concessions were classified as one-off or temporary measures by the Commission services in the January 2009 interim forecast, whereas the programme does not classify them as such. This different classification reflects different views on whether those operations have a recurrent nature or not, or taking into account the letter of the revised Code of Conduct, whether they lead or not to a sustained change in the inter-temporal budgetary position – with the answer being negative in the case of the Commission services and apparently positive in the case of the Portuguese authorities.[4] Therefore, these different views spill into the assessment of the underlying fiscal effort in 2008 and 2009.

4.2. Near-term budgetary strategy

The programme outlines a significant fiscal expansion in 2009 with the general government deficit planned to rise to 3.9% of GDP in 2009, largely on account of a higher expenditure-to-GDP ratio. The programme incorporates all the discretionary measures taken by the Portuguese authorities in response to the downturn until its date of submission and its budgetary plans coincide with those contained in the draft 2009 supplementary budget submitted to Parliament on the same day.

The worsening of the 2009 budget balance is mainly explained by the adoption of a number of discretionary measures in response to the economic downturn and in line with the EERP Those measures focus on investment, support to firms and exports, and support to employment and social protection (see Table II). The total cost of this expansionary fiscal effort is 1¼% of GDP, of which 0.8% of GDP is financed by the Portuguese authorities – i.e., impacts negative the 2009 budget balance by 0.8% of GDP – whereas the remaining ½% of GDP is financed through a frontloading of EU funds; however, these fund inflows are neutral for the budget balance to the extent that they generate an equal amount of expenditure.

The stimulus package complies with the general principles of the EERP. Notably, the fiscal expansion is timely as it largely starts taking effect from beginning of 2009. It also appears to be targeted to address some of the challenges posed by the downturn. Such is the case with

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[3] Regarding spending composition, public consumption grew slightly more than estimated, the reverse for social transfers.

[4] The option taken by the Commission services is also consistent with the treatment given to past operations of a similar type, for instance the sale of UMTS licenses around the year 2000 in various EU countries or some other sales of concessions in Portugal.

the support to the employability of groups that seem to be more vulnerable, e.g., as young and old workers, through a targeted lowering of social contributions in 2009; some help to the liquidity of firms through changes in the procedures and timing of tax payments; or support to investment by means of a tax credit in 2009; and support to competitiveness and exports by backing some specific credit and insurance market mechanisms. Finally, the stimulus is temporary as the measures are foreseen to be in place only in 2009, or in other words, to imply a fiscal deterioration only in 2009. An exception seems to be tax credits for investment in 2009 that can lower corporate tax revenues over four years, but their amount is projected to be rather small in terms of GDP.

These measures taken in the context of the EERP add to a number of other separate measures that had already been announced earlier in 2008 – and included in the 2009 Budget – to support households and firms amounting to a total of 0.4% of GDP and to the reduction of the standard VAT rate by one percentage point from 21% to 20% in July 2008 (see bottom part of Table II). In addition, the worsening of the headline balance will also visibly reflect the flooring of the aforementioned one-off sales of concessions recorded in 2008 as well as the working of automatic stabilisers.

The programme assumes that the fiscal impact of these discretionary measures will be mitigated by the effect of consolidation measures taken in earlier years to contain expenditure, particularly compensation of government employees and social transfers. On this respect, it is important to bear in mind that the programme includes a break between 2008 and 2009 in the series of government expenditure and revenue due to a change in the recording of payments to the government employees' pension scheme. Without such a break, both series would be some 1½% of GDP higher as from 2009. While this change has no impact on the government balance and debt levels, it hampers a direct comparison between past data and medium-term plans for revenue and expenditure in general and compensation of employees in particular[5],[6] as well between the latest plans and those presented in previous updates.

According to the Commission services' calculations on the basis of the data in the programme and according to the commonly agreed methodology, the structural balance is projected to deteriorate from a deficit of 2% of GDP in 2008 to one of 3% of GDP in 2009, against a backdrop of clearly widening negative output gap. However, if the Commission assessment of one-off and other temporary measures in 2008 is used as spelled out in section 4.1, the structural deficits become at some 2¾% and slightly over 3% of GDP in 2008 and 2009 respectively.

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[5] The consistency of this change with ESA95 will be scrutinised by Eurostat in due time. This change would have an impact on a number of deflators, on nominal GDP (by around -1½%) and consequently on GDP ratios. Note, however, that these implications do not seem to have been fully considered in the programme.

[6] The aforementioned recording in national accounts of the sizeable sales of concessions in 2008 as expenditure-reducing operations following the ESA 95 rules also affect the comparison of expenditure ratios between different years.

Table II. Main budgetary measures for 2009 (impact on budget balance)

Revenue measures[1]	Expenditure measures[2]
Measures in response to the downturn	
• Temporary reduction of social contributions for some selected groups (-0.2% of GDP) • Support to firms liquidity through changes in the procedures and timing of some tax payments (-0.1% of GDP)	• Renewal of schools premises (0.2% of GDP) • Investment (and support to investment) in energy and telecommunications infra-structure (0.2% of GDP) • Special support to activity, exports and SMEs (0.1% of GDP)
Other measures	
• Reduction of the VAT standard rate by one percentage point as from July 2008 (-0.15% of GDP) • Lower tax burden related to housing assets (-0.1% of GDP)	• Support to household income (0.2% of GDP) • Support to firms (0.1% of GDP)

Note:

[1] Estimated impact on general government revenue

[2] Estimated impact on general government expenditure

Source: Commission services and January 2009 stability programme update

Table III: Composition of the budgetary adjustment

(% of GDP)	2007	2008		2009		2010		2011	Change: 2008-2011
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenue	**43.1**	**44.2**	**43.5**	**42.6**	**44.1**	**42.4**	**43.6**	**43.6**	**0.1**
of which:									
- Taxes on production and imports	15.0	14.9	14.8	14.5	14.8	14.6	15.0	15.0	0.2
- Current taxes on income, wealth, etc.	9.8	10.1	9.9	9.7	9.8	9.5	9.6	9.7	-0.2
- Social contributions	12.7	13.0	12.8	11.4	11.4	11.7	11.5	11.4	-1.4
- Other (residual)	5.6	6.2	6.0	6.9	8.1	6.5	7.5	7.5	1.5
Expenditure	**45.7**	**46.3**	**45.8**	**47.2**	**48.0**	**46.8**	**46.5**	**45.9**	**0.1**
of which:									
- Primary expenditure	42.9	43.3	42.8	44.3	44.7	43.7	43.1	42.5	-0.3
of which:									
Compensation of employees	12.9	12.8	12.8	11.2	11.1	11.2	10.9	10.7	-2.1
Intermediate consumption	4.1	4.4	4.5	4.4	4.6	4.5	4.6	4.6	0.1
Social payments	19.2	19.8	19.5	20.9	20.8	21.3	20.8	20.7	1.2
Subsidies	1.2	1.5	1.1	1.8	1.9	1.2	1.1	1.1	0.0
Gross fixed capital formation	2.3	2.3	2.4	2.6	2.9	2.1	2.4	2.5	0.1
Other (residual)	3.2	2.5	2.5	3.3	3.6	3.3	3.3	3.0	0.5
- Interest expenditure	2.8	3.0	3.0	2.9	3.3	3.1	3.4	3.4	0.4
General government balance (GGB)	**-2.6**	**-2.2**	**-2.2**	**-4.6**	**-3.9**	**-4.4**	**-2.9**	**-2.3**	**-0.1**
Primary balance	**0.2**	**0.8**	**0.8**	**-1.7**	**-0.6**	**-1.3**	**0.4**	**1.1**	**0.3**
One-off and other temporary measures	0.1	0.7	0.0	0.1	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-2.7**	**-2.9**	**-2.2**	**-4.7**	**-3.9**	**-4.4**	**-2.9**	**-2.3**	**-0.1**
Output gap[2]	0.8	0.2	-0.4	-1.7	-2.1	-2.5	-2.5	-2.5	-2.0
Cyclically-adjusted balance[2]	-3.0	-2.3	-2.0	-3.8	-3.0	-3.3	-1.8	-1.2	0.8
Structural balance[3]	**-3.1**	**-3.0**	**-2.0**	**-3.9**	**-3.0**	**-3.3**	**-1.8**	**-1.2**	**0.8**
Change in structural balance		*0.0*	*1.1*	*-0.9*	*-1.0*	*0.6*	*1.2*	*0.6*	
Structural primary balance[3]	-0.3	0.0	1.0	-1.0	0.3	-0.3	1.6	2.2	1.2
Change in structural primary balance		*0.2*	*1.3*	*-1.0*	*-0.7*	*0.8*	*1.3*	*0.6*	

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' January 2009 interim forecasts (COM); Commission services' calculations

4.3. Medium-term budgetary strategy

After the fiscal expansion of 2009, the stability programme aims at resuming fiscal consolidation with a gradual reduction of the general government deficit to 2.9% of GDP in 2010 and 2.3% of GDP in 2011. The changes in the primary balance are essentially identical as interest expenditure would be very little changed in terms of GDP: it is projected to move from a deficit of 0.6% of GDP in 2009 to surpluses of 0.4% and 1.1% of GDP in 2010 and 2011 respectively.

The programme expects the outlined fiscal path to support the resumption of convergence to the Medium-Term Objective (MTO), which remains unchanged compared with the previous update as a structural balance (i.e., the cyclically-adjusted balance net of one-off and other temporary measures) of -0.5% of GDP. Nonetheless, the structural deficit would still be in excess of the MTO in the final year of the programme. In particular, based on Commission services' calculations on the basis of the programme and according to the commonly agreed methodology, the structural balance is projected to be -1¾% and -1¼% of GDP in 2010 and 2011 respectively. Therefore, a continued fiscal effort, as measured by the change in the structural balance, is targeted over the update period with fiscal policy acquiring a restrictive tone after 2009.

According to the programme, the budgetary adjustment in 2010 and 2011 is to be achieved by curbing current primary expenditure and helped by gradually higher GDP growth. According to the programme, primary expenditure will decline by almost 1½ percentage point of GDP in 2010 and just over ½ percentage point in 2011 (see Table III).

More specifically, the post-2009 expenditure containment is planned to be the result of the dissipation of the 2009 fiscal stimulus, which would mean lower spending in items such as gross fixed capital formation or subsidies. In addition, budgetary outcomes would be helped also by corrective measures taken in earlier years, which are expected to continue supporting expenditure containment for some more years. Indeed, the update does not outline new sizeable fiscal consolidation measures, instead it focuses on the on-going implementation of earlier plans. Those early-taken policy decisions include a large number of changes at the level of public administration, notably the on-going reduction in government employment, largely due to an only partial replacement of workers that leave the central government by means of only one recruitment for every two departures, on average; or changes in government services in the areas of health (including changes to governance of hospitals) and education. At the same time, social transfers other than in kind would peak in 2009 and decline very marginally in terms of GDP thereafter, thereby ending the continued expansion recorded for more than a decade. That is announced to be the reflection of the old-age pension schemes reforms enacted in 2006 and 2007 (with additional measures entering into force in 2008 or later), which are to gradually lead to lower replacement ratios and extended working careers.

After being hurt severely by the 2009 recession,[7] the tax burden is forecast to stay constant in 2010 and 2011 (see Table 3 in Annex 2). Non-tax revenue is expected to decline by ½ percentage point of GDP in 2010 – but the programme does not provide details thereon.

4.4. Risks to the budgetary targets

As highlighted in section 3, the programme's macroeconomic assumptions are favourable, namely, the outlook for real GDP growth seems to be on the high side. In addition, the GDP growth composition itself can create some risks to the extent that GDP growth may rely somewhat less on tax-rich domestic demand that foreseen in the programme. Therefore, if economic growth turns out weaker than assumed in the programme, the relief for government finances will be more limited than planned, consequently implying a negative risk for the

[7] After taking into account the methodological change in 2009 concerning compensation of government employees.

fiscal outturns. The materialisation of lower-than-expected GDP growth would not only impact tax revenues but would also hamper the projected falls of expenditure in terms of GDP by means of a denominator effect even in the case expenditure growth in nominal terms follows the path targeted in the programme scenario.

As described above, after the temporary impulse of 2009, the stability programme update aims at budgetary consolidation hinging upon expenditure restraint supported by structural measures that have been adopted in recent years. In particular, a reduction in compensation of government employees and a containment of social payments, often yielding results in a lagged way, are expected. Against a backdrop of a comprehensive consolidation package made up of a large number of measures, the estimates of the impact of those corrective efforts are subject to high uncertainty. Even for some measures already adopted, time elapsed so far is short to draw firm conclusions on the potential to keep expenditure growth at low pace for a continued number of years.

Concerning the major primary expenditure items, the uncertainty surrounding the scope for expenditure restraint 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. Whereas important steps have been taken, for instance in implementing new structures for central government services or in closing a considerable number of local services in the areas of education and health, and expressive results being achieved such as the reduction of government employment over the past three years, uncertainty remains regarding the budgetary savings that can be achieved through these measures. Reduction of government employment continues to be the largest driver of fiscal consolidation largely through hiring restrictions coming from the only partial replacement of workers that leave the central government. Since a very important part of staff outflows from the government sector have been associated with retirement, the room for a reduction in the government staff figures depends on the retirement decisions of current employees, which depend on individuals' preferences. After the relatively high flows recorded over most of this decade, it is not clear how retirement patterns are going to evolve from now on.

Regarding social transfers, whereas the recent old-age pension reforms curtail the growth rate of average pension outlays and penalise early retirement, it is worthy to bear in mind that these items depend also on the retirement decisions of individuals, once again beyond the government complete control. On this respect, the expected deterioration of the labour market does not bode well, as retirement decisions tend to exhibit a pro-cyclical character, for instance by means of early retirement of unemployed old workers. Other social transfers could also be put under increasing pressure by growing levels of unemployment and poverty. Nonetheless, given their limited weight on total expenditure they should not be a major risk for fiscal targets. Finally, and on the positive side for expenditure, the current indexation rules for annual updates of cash transfers will yield quasi-stagnating payments in 2010 given the sluggish inflation outlook for 2009.

The uncertainty about the extent of possible expenditure savings is compounded by the puzzling fact that, in comparison with the previous programme, the new update presents a more contained path for primary expenditure growth rates. Hence, the targeted level of government expenditure by 2011 is now lower than in the previous update but the programme

does not present enough explanation for that fact.[8] The difficulty in interpreting that change is magnified by the fact that the underlying developments on the expenditure side – i.e., the scenario in the absence of policy measures – are not explicitly spelled out in the programme. On this respect, for instance, the update assumes that compensation of government employees will follow a growth path similar to the one in the previous update. However, at the same time, the foreseen impact of the reform efforts is now lower than in the December 2007 update by up to 1% of GDP in 2011, which suggests that the underlying trend would be now more benign than before. An opposite view holds for interest expenditure as the marginally lower interest rates can allow a milder growth of interest spending than foreseen in the programme, despite the rising debt stock.

Concerning tax developments, three remarks can be put forward against the current juncture. First, for 2009 the revenue may be lower than planned as relevant macroeconomic tax bases may be more affected by the recession than foreseen in the programme. Second, the downturn may have a lasting toll on tax bases, such that a GDP upswing may help tax proceeds only in a lagged way. For instance, as corporate profits and labour market developments are likely to exhibit a lagged response to the overall economic cycle, a toll on corporate and personal taxes may be expected beyond 2009. Against this backdrop, for 2010 and 2011 the programme seems to incorporate above-unit elasticities for tax revenues with respect to the relevant tax bases, although this is somewhat mitigated by the assumption of a weaker reaction of those bases to GDP growth. Third, and in line with what has been mentioned in assessments of previous updates, it remains to be seen whether the tax buoyancy observed in recent years can be fully preserved or whether the recessive environment is going to take a toll on it. In other words, the issue is whether that buoyancy was the result of a robust and largely permanent upward shift of revenue levels or could have benefited also from factors of a more transitory nature.

Concerning non-tax revenue, the programme does not inform on the drivers of the sharp increase foreseen in 2009 and the fall in 2010 other than the frontloading of EU funds inflows associated with the implementation of the EERP.

In summary, the overall assessment is that the budgetary outcomes are subject to downside risks throughout the programme period.

In addition, it cannot be ignored that the government granting of guarantees for borrowing by domestic banks in the context of the financial rescue package might create an additional risk should those guarantees be called at some point in the future.

[8] After taking into account the methodological change in 2009 concerning compensation of government employees.

5. DEBT DEVELOPMENTS AND LONG-TERM SUSTAINABILITY

5.1. Debt developments

According to the programme, the government debt ratio is estimated to have reached 65.9% of GDP in 2008 after 63.6% of GDP in 2007 as the reflection of the fall in GDP growth and a sizeable debt-increasing stock-flow adjustment on account of commercial debt repayments by the general government. The programme projects a further increase in the debt up to a peak of 70.5% of GDP in 2010 as the result of the rise in the government deficit, low GDP growth and a positive stock-flow adjustment in 2009 mainly reflecting commercial debt repayments and acquisition of financial assets in the context of the financial rescue package put in place by the Portuguese authorities. Some reversion of these factors is expected to allow a small decline in the debt ratio to 70% of GDP in 2011. Privatisation proceeds are assumed to amount to a total of 1.1% of GDP between 2009 and 2011, thereby contributing to the reduction of the debt.

The evolution of the debt ratio may be less favourable than projected in the programme, especially in 2010 and 2011, given the risks to the macroeconomic and budgetary scenarios highlighted in section 4 and the uncertainty about the stock-flow adjustment. The latter is related to possible financial assets acquisitions in the context of the financial rescue package implemented by the Portuguese authorities, specifically the possibility of reinforcing the core capital of domestic banks through government investment up to a total of 2½% of GDP. However, the increase in debt linked to recapitalisations of financial institutions could be (partly) reversed at a later stage if the support scheme and the financial operations linked to it were successful. At the same time, the minor stock-flow adjustments require continuing keeping capital injections to non-financial public enterprises below the average of prior years. Finally, the stock-flow adjustment may be less benign than assumed as the envisaged debt-reducing contribution of privatisation proceeds of 0.6% of GDP in 2009 can be difficult to achieve in times of a financial crisis. Taking into account these risks to the debt projections, the debt-to-GDP ratio may be increasing over the whole programme period.

Table IV: Debt dynamics

(% of GDP)	average 2002-06	2007	2008		2009		2010		2011
			COM	SP	COM	SP	COM	SP	SP
Gross debt ratio[1]	**59.8**	**63.6**	**64.6**	**65.9**	**68.2**	**69.7**	**71.7**	**70.5**	**70.0**
Change in the ratio	2.3	-1.1	1.0	2.3	3.6	3.8	3.5	0.8	-0.5
Contributions[2]*:*									
1. Primary balance	**1.1**	**-0.2**	**-0.8**	**-0.8**	**1.7**	**0.6**	**1.3**	**-0.4**	**-1.1**
2. "Snow-ball" effect	**0.6**	**-0.2**	**1.7**	**1.8**	**1.5**	**2.2**	**2.1**	**1.3**	**0.8**
Of which:									
Interest expenditure	2.7	2.8	3.0	3.0	2.9	3.3	3.1	3.3	3.4
Growth effect	-0.4	-1.2	-0.1	-0.2	1.0	0.5	0.2	-0.3	-0.9
Inflation effect	-1.6	-1.8	-1.2	-1.1	-2.4	-1.6	-1.1	-1.7	-1.7
3. Stock-flow adjustment	**0.6**	**-0.6**	**0.2**	**1.3**	**0.4**	**1.0**	**0.0**	**-0.1**	**-0.2**
Of which:									
Cash/accruals diff.	0.2	0.0		n.a.		n.a.		n.a.	n.a.
Acc. financial assets	0.5	-0.6		-0.1		0.1		-0.4	-0.2
Privatisation	-0.5	-0.4		-0.3		-0.6		-0.3	-0.2
Val. effect & residual	0.0	0.0		n.a.		n.a.		n.a.	n.a.

Notes:

[1]End of period.

[2]The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). 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' January 2009 interim forecasts (COM); Commission services' calculations

5.2. Long-term sustainability

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2006 according to the agreed methodology. Portugal has implemented a pension reform in 2006 and new projections of age-related gross expenditure have been endorsed by the EPC in October 2007.[9]

Table 4 in Annex 2 shows that the projected increase in age-related spending is rising by 4.9% of GDP between 2010 and 2050, above the EU average. Sustainability indicators for two scenarios are presented in Table 5 in Annex 2. Including the increase of age-related expenditure and assuming that the structural primary balance remained at its 2008 level, the sustainability gap (S2)[10] would amount to 3.6% of GDP, unchanged from last year's

[9] Economic Policy Committee and the European Commission (2006), 'The impact of aging on public expenditure: projections for the EU-25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-50)', *European Economy – Special Report* No. 1/2006. European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006. European Commission (2008), *Public finances in EMU – 2008*, *European Economy* No. 4/2008.

[10] The S2 indicator is defined as the change in the current level of the structural primary balance required to make sure that the discounted value of future structural primary balances (including the path of property income) covers the current level of debt.

assessment.[11] The starting budgetary position is almost sufficient to stabilize the debt ratio over the long-term, entailing a small risk of unsustainable public finances even before considering the long-term budgetary impact of ageing. However, if the 2009 budgetary position of the Commission services' January 2009 forecast was taken as the starting point, the sustainability gap would widen to 5½% of GDP.

In contrast to the "2008 scenario", the "programme scenario", which is based on the end-of-programme structural primary balance, shows a smaller gap. If the budgetary consolidation planned in the programme was achieved, risks to long-term sustainability of public finances would be somewhat mitigated.

Based on the assumptions used for the calculation of the sustainability indicators, Figure 4 in the Annex displays the projected debt/GDP ratio over the long-term.

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account. The programme reports national projections, in which a higher GDP growth rate reduces pension expenditure in relation to GDP. They are summarized in Table 6 in the Annex.

While the long-term budgetary impact of ageing is somewhat higher than on average in the EU, recently enacted pension reforms have helped to contain the projected increase in pension expenditure over the coming decades. Moreover, the current level of gross debt is above the Treaty reference value. Achieving higher primary surpluses over the medium term, as already foreseen in the programme, would contribute to reducing the medium risks to the sustainability of public finances.

6. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

The programme update presents a number of measures aimed at strengthening the budgetary framework, with some measures building on or intensifying efforts taken in earlier years. The main elements are the gradual implementation of programme budgeting and of multi-annual cycles with the preparation of budgetary plans for the entire legislative period associated with the setting of annual expenditure ceilings. Three pilot projects for programme budgeting started being implemented in 2009 after preparatory work carrier out already over 2007 and 2008. Besides these changes to ex-ante budget planning, further changes towards a swifter and more integrated reporting of ex-post budgetary execution are also envisaged. Overall, these efforts recognise the importance of strengthening the budgeting process and address two aspects where the Portuguese budgetary framework has shown needs of continued improvement, in particular planning fiscal policy in the broader medium-term setting and controlling expenditure developments in a more thorough way.

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[11] Please bear in mind that according to the Commission services the 2008 budgetary execution benefited from deficit-reducing one-off and temporary measures worth ¾% of GDP, whereas the programme considers that the budgetary execution did not benefit from such a kind of measures. Ceteris paribus, this yields differences between the structural primary balance figures in the Commission services forecasts and in the programme update.

The programme outlines measures to improve the efficiency and effectiveness of government services in the context of the public administration reform. The measures in this domain comprise changes in the mechanisms for planning, control and performance assessment of government services and theirs managers and workers. In addition, changes to the governance of state-owned enterprises are also outlined including, for instance, closer surveillance of operational and financial developments, setting of ceilings for state-owned enterprises' debt and changes to the granting of government subsidies for the provision of services by those enterprises.

Finally, the programme contains an overview of recent measures on the tax system with a view to support the business environment. In particular, the update highlights some simplification of procedures. Additionally, it mentions also the speeding up of VAT reimbursements and of commercial debt payments by the government to the private sector in 2008 and 2009. On this respect, the programme mentions a reinforcement of surveillance and sanctions for government services with excessive payment lags. Indeed, the existence of large stocks of arrears (i.e. expenditure pending payment) underpins the view that the efforts to address financial management within the general government sector are justified, assuring absolute compliance with the specialisation of exercise principle – bearing in mind also the need to strengthen expenditure accounting in accrual terms.

7. ASSESSMENT

This section assesses the budgetary strategy, taking into account risks, in the light of (i) the adequacy of the fiscal stimulus package in response to the Commission Communication of 26 November 2008 on the European Economic Recovery Plan (EERP) as endorsed by the European Council conclusions on the European Economic Recovery Plan (EERP) on 16 December 2008 and the overall fiscal stance (ii) the criteria for short-term action laid down in the above mentioned Commission Communication, and (iii) the objectives of the Stability and Growth Pact.

The programme aims at a significant temporary fiscal impulse in 2009 in line with the EERP, which represents an adequate response to the economic downturn and has the potential to support economic activity. Overall, the stimulus package is foreseen to be at the core of the overall mildly expansionary fiscal stance planned for 2009. Its withdrawal in 2010 is expected to make the fiscal stance to acquire a restrictive tone in that year. However, taking into account Portugal's limited fiscal space, it will weight on the medium-term fiscal position. In addition, it may also backload the narrowing of the savings-investment gap since by supporting activity it prevents overall demand, and consequently the borrowing needs of the economy, to recede.

The Portuguese response to the economic downturn is in line with the EERP. It is timely to the extent that it has the potential to quickly underpin economic activity; it is targeted as it is focused on well-defined areas; finally, it is temporary since it is foreseen to be limited to 2009 and reversed afterwards. Those measures focus on investment, support to firms and exports, and support to employment and social protection. This fiscal expansion amounts to 1¼% of GDP, of which 0.8% of GDP is financed by the budget, whereas the remaining ½% of GDP is financed through a frontloading of EU funds. These measures, announced in December 2008, add to a number of other measures announced earlier in 2008 to support households and

firms, amounting to a total of 0.4% of GDP. All these plans have been factory into the draft 2009 supplementary budget.

The programme itself projects the headline deficit to breach the 3% of GDP in 2009 (3.9% of GDP), but to decline below the reference value thereafter. Hence, the update plans the resumption of fiscal consolidation as soon as the economy recovers. It expects a gradual reduction of the budget deficit to 2.9% in 2010 and 2.3% of GDP in 2011. After a further deviation from the MTO in 2009, the programme plans to resume a trajectory of convergence to it, defined in the update as a structural balance of -0.5% of GDP, although this target is not expected to be achieved in the programme period. Moreover, taking into account the balance of risks to the budgetary targets the pace of this adjustment is likely to be slower than planned. The overall risk assessment suggests that the budgetary outcomes are subject to downside risks throughout the programme period. The major source of uncertainty is related to the macroeconomic scenario, which appears to be based on favourable growth assumptions.

Progress with fiscal consolidation is also necessary to strengthen the long-term sustainability of public finances, which is assessed to be at medium risk in Portugal since the approval of the pension reform. In addition, further strengthening the budgetary framework can be instrumental to achieve the planned fiscal path. Finally, fostering the quality of public finances is important also to underpin a smooth adjustment of the economy in the light of the imbalances it is faced with, notably by supporting potential GDP growth, helping improving competitiveness and supporting the correction of the external deficit.

ANNEX 1. SPECIAL TOPIC: THE EFFICIENCY AND EFFECTIVENESS OF PUBLIC EXPENDITURE

1. INTRODUCTION

After a sluggish performance in the first half of this decade, economic activity expanded at a gradually faster pace in more recent years, with GDP growth reaching some 1.9% in 2007. In parallel, a significant fiscal consolidation brought the public deficit below the 3% of GDP reference value in 2007. Thanks to this achievement, the excessive deficit procedure initiated against Portugal in September 2005 was abrogated in 2008, one year before the correction deadline set by the Council. Notwithstanding these improvements, the economy is currently faced with a number of very significant challenges, against a backdrop of still fragile public finances, eroded competitiveness, a sizeable current account deficit, and a quickly deteriorating external environment.

Moreover, the economy's growth potential is hampered by a number of deeply rooted factors. In particular, overall productivity is low and the specialisation pattern is still significantly based on low-skill intensive industries, being thus especially vulnerable to the competition of emerging countries that have been quickly integrating into world trade. Within this setting, fiscal policy in Portugal faces a double challenge: containing public spending in a sustained manner and reorienting it towards uses more supportive of productivity growth and competitiveness gains.

In its economic assessment of the December 2007 update of the Portuguese stability programme, the Commission provided a detailed analysis of the behavior of wages and employment in the public sector and assessed its impact on public finances and overall wage developments. At the same time, the Commission highlighted that, besides continuing to put public finances on a sound track, improving the efficiency and effectiveness of public expenditure can play a key role in fostering productivity and bolstering economic growth. The analysis of this section seeks to go one step further to identify additional areas where a properly-designed public spending strategy might contribute to improve the efficiency and effectiveness of government resources, and overcome the structural weaknesses of the economy.

A first objective is to inspect the recent dynamics of the level and composition of public expenditure. With a view to assess the extent to which there is scope for achieving improvements in the use of public resources, the section reviews recent empirical evidence on the relative position of Portugal in cross-country analyses of public spending efficiency. Given the importance of human capital accumulation for productivity growth and competitiveness developments, particular attention is then drawn to the efficiency of public spending on education. Finally, the focus is shifted to the efficiency of expenditure on health, a functional area which has absorbed an increasing proportion of public resources in the past decade.

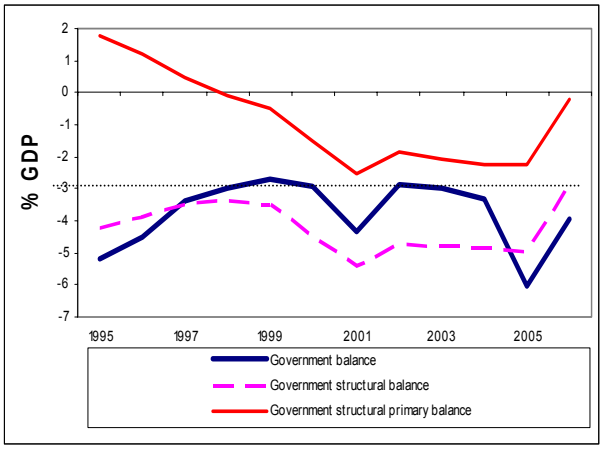
The remainder of the section is structured as follows. Sub-section 2.2 examines recent budgetary and economic growth developments. Sub-section 2.3 analyses the recent dynamics of public spending patterns vis-à-vis the euro-area. Sub-section 2.4 reviews the evidence on the relative efficiency of public spending in Portugal. It then devotes particular attention to the estimates on the efficiency of public spending on education and health. Finally, sub-section 2.5 summarises and identifies major challenges for public expenditure management in Portugal, notably its implications for fiscal consolidation and productivity growth.

2. BUDGETARY DEVELOPMENTS AND GROWTH POTENTIAL

The Portuguese public finances have been fragile for a number of years in the current decade, as revealed by the high budgetary deficits. The accumulation of fiscal imbalances was largely rooted in the missed opportunity to consolidate in 'good times', during the second half of the nineties, and in the deterioration of the public deficit that followed the marked downturn in economic activity after the beginning of the decade.

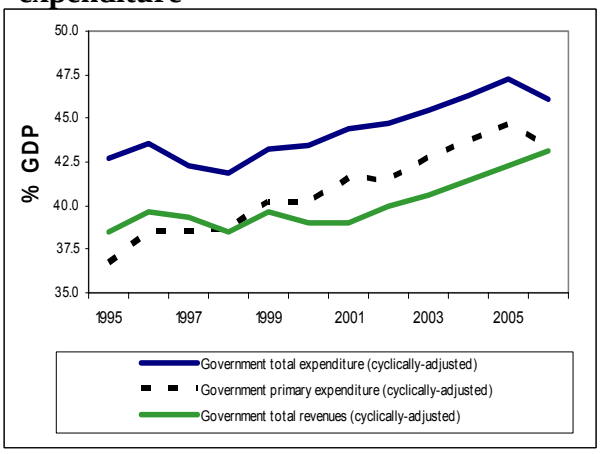
After 2001, the headline fiscal deficit was above the 3% of GDP reference value for a number of years (Figure 1). While increases in tax rates and improvements in tax collection have yielded rising revenue-to-GDP ratios since 2002, thereby mitigating the budgetary impact of the weak economic momentum, the lack of lasting progress in consolidating public spending heightened fiscal imbalances in several years. In fact, only recently has this trend been reversed, with the expenditure-to-GDP ratio declining in 2006 and 2007 (Figure 2). As a result, and for the first time in the current decade, the public deficit was brought below 3% of GDP in 2007, without resorting to sizeable one-off budgetary measures.

Figure 1: Government balance



Source: Ameco
Note: [1]Cyclically-adjusted balance excluding one-off and other temporary measures.

Figure 2: Government revenue and expenditure

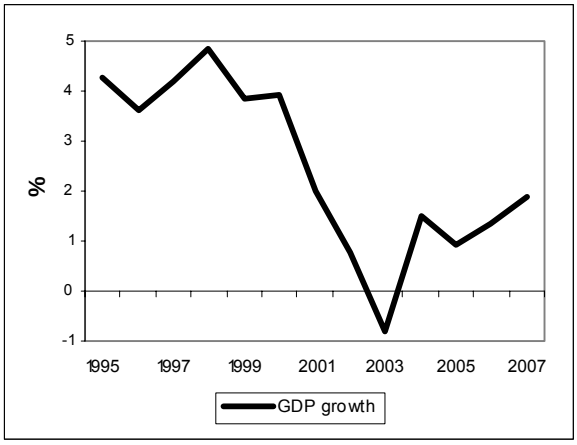


Source: Ameco
Note: excludes one-off measures

In addition to the problems on the budgetary front, the Portuguese economy has been characterised by low actual and potential GDP growth (Figures 3 and 4). After having expanded at an average rate of about 4% in the second half of the nineties, GDP grew on average at 1% per year in the post-2000 period. In parallel, potential GDP growth followed a steep downward path in the first half of this decade, reflecting mainly a significant decline in the contributions of capital accumulation and TFP growth. Currently estimated at 1⅓%, the growth potential of the economy is too low for yielding catching up towards the living standards of richer EU Member States.

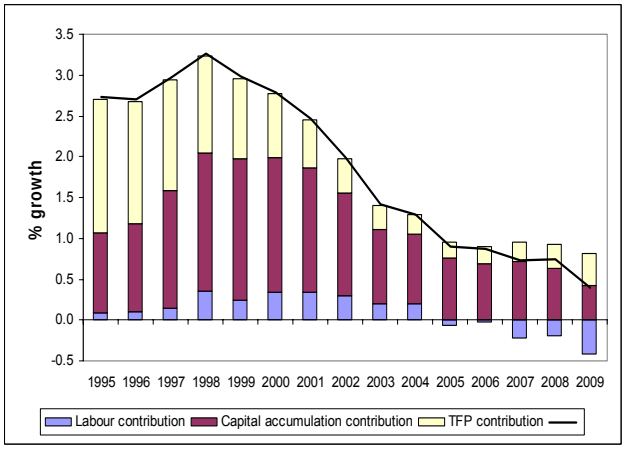
Low potential GDP growth requires expenditure containment in order to keep public finances under control. At the same time, reorienting public spending towards growth-enhancing items could provide a lift in productivity and competitiveness. Indeed, as the public sector represented over 45% of GDP in 2007, improvements in the efficiency and effectiveness of public resources may have significant spillovers to the overall economic performance.

Figure 3: Actual GDP growth



Source: Ameco.

Figure 4: Potential GDP growth and its determinants

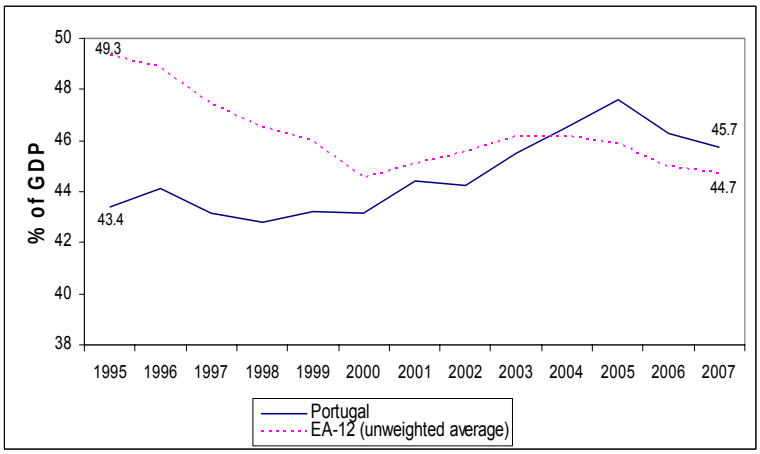


Source: Commission services.

3. THE LEVEL AND COMPOSITION OF PUBLIC EXPENDITURE SINCE 1995

Public expenditure has changed significantly in recent years, both in terms of level and composition. In the period 1995-2005, its weight in GDP rose from 43.4% to 47.6%, with this upward trend being reversed only in 2006, when the expenditure-to-GDP ratio declined to 46.3%. In 2007, continued expenditure containment brought this ratio further down to 45.7% of GDP.

Figure 5: The evolution of public expenditure vis-à-vis the euro-area, 1995-2007

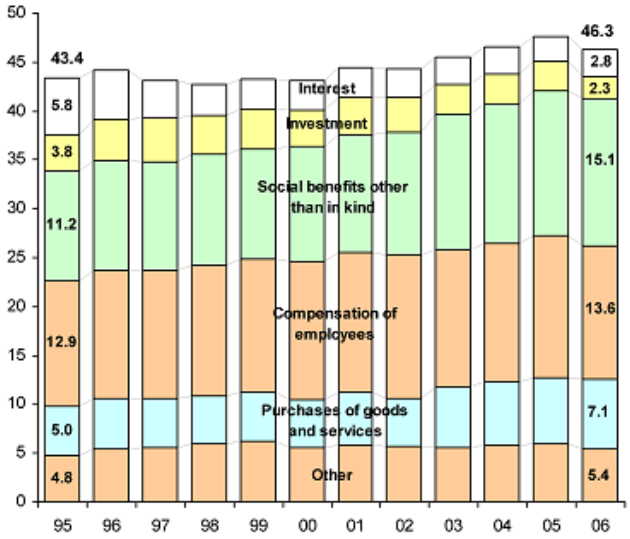


Source: Ameco
Note: excludes one-off measures

The behaviour of public spending in Portugal was significantly different from the euro-area average (Figure 5).[12] In 1995, the expenditure-to-GDP ratio was clearly below the euro-area (unweighted) average: 43.4% against 49.3%. Twelve years later, this situation was reversed (45.7% versus 44.7%), reflecting an increase in the expenditure-to-GDP ratio in Portugal and a significant fall in that of the euro-area.

[12] Euro-area countries, except Cyprus, Malta and Slovenia.

Figure 6: The evolution of public expenditure (% of GDP)



Source: Ameco
Note: excludes one-off measures

The upward path of the expenditure-to-GDP ratio until 2005 and its correction in 2006 are even more evident if interest payments are excluded (Figure 6). Indeed, public primary expenditure rose systematically faster than economic activity until 2005, and its subsequent containment was the main driver of the fall in the expenditure-to-GDP that followed. In terms of individual components, the decline in compensation of government employees was the main contributor to the retrenchment of primary expenditure observed in 2006, but reduced public investment played also an important role.

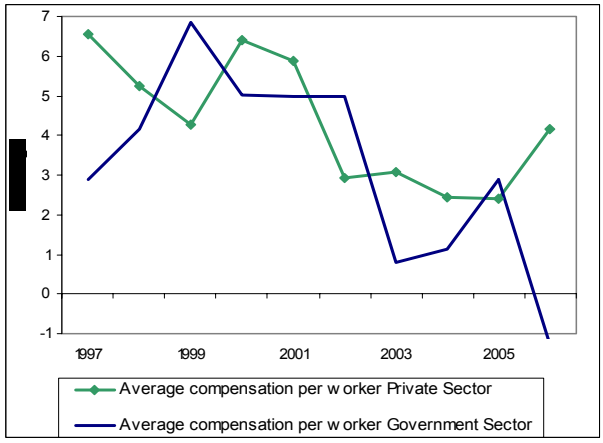
The recent decline of expenditure with government personnel was driven by the containment of wages and employment, which more than offset the increase in expenditure on social benefits for current and retired government employees. Government employment represented 13.7% of total employment in 2007, down from 14.6% in both 2005 and 1999. The number of government employees expanded strongly in the late nineties until 2001, stabilising thereafter as a result of a near freeze of central government employment since 2002. As from 2006, replacement rules have been further tightened with on average only one hiring for every two withdrawals, leading to a fall in the number of government employees (Figure 7).

Growth of average wages in the government sector has fallen significantly in recent years, after the fast pace of increase observed in the late nineties. This reflects not only a moderation of decreed public wage rises, but also a more restrained wage drift and a reduction of the importance of areas with above-average wages in the context of the public administration reform. In fact, since 2003 the accumulated increase in average wages in the public sector has been more contained than in the private sector (Figure 8).

Figure 7: Government employment

Source: Ameco; Finance and Public Administration Ministry

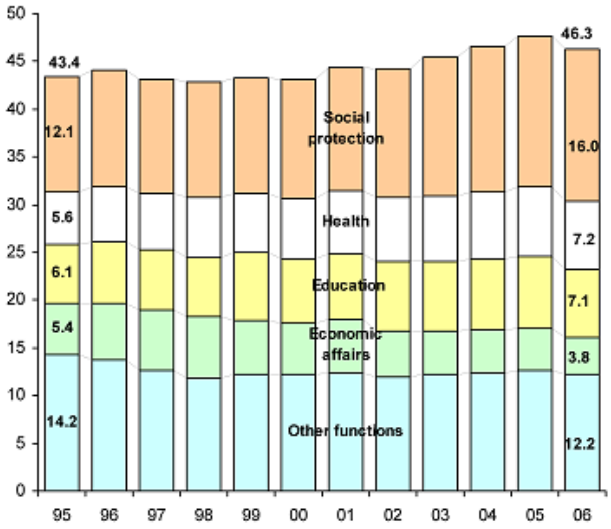
Figure 8: Annual change in compensation per employee: government vs. private sector



Source: Ameco; Commission services calculations

From a functional classification perspective, the overall upward path of public expenditure was mainly rooted in the continued increase of expenditure on social protection (Figure 9). Driven both by a rise in the number of beneficiaries and more generous entitlements, spending on social protection (which includes unemployment benefits, pensions, family allowances and social assistance) increased by some 4 percentage points during the 1995-2006 period to 16% of GDP, catching-up with the euro-area (Table 1).[13]

Figure 9: The evolution of public expenditure (functional classification, % of GDP)



Source: Ameco

Other major contributors for the overall increase in public expenditure were spending on education and health, two functional areas in which public spending rose faster than GDP in most years until 2005. While spending on education was already higher in Portugal than in the

[13] The increase in Portuguese social protection expenditure in 2002 and 2003 reflects also negative cyclical conditions. Historical data on public expenditure by function for Slovenia and Cyprus are unavailable and hence these countries were excluded from the analysis.

euro-area in 1995 (6.1% versus 5.3% of GDP), the gap widened significantly until 2006: expenditure rose to 7.1% of GDP in Portugal and decline to 4.9% in the euro-area. In 2006, however, Portuguese education expenditure fell by 0.5 pp. in terms of GDP, apparently due to the retrenchment in personnel expenditure and a consolidation of public services networks involving the closure of various local services. As to health expenditure, in Portugal it rose faster than GDP, reaching 7.2% of GDP in 2006 versus 6.4% in the euro-area.

Table 1: Functional composition of public expenditure vis-à-vis the euro-area

Public expenditure (% of GDP)	PT			EA-12 (unweighted average)		
	1995	2006	Δ	1995	2006	Δ
Total expenditure	43.4	46.3	2.9	50.2	45.2	-5.0
General public services	8.9	6.9	-2.0	9.4	6.5	-2.8
Defense	1.7	1.3	-0.4	1.5	1.2	-0.3
Public order and safety	1.6	1.9	0.3	1.5	1.5	0.0
Economic affairs	5.4	3.8	-1.5	5.8	4.5	-1.3
Environment protection	0.5	0.6	0.0	0.8	0.7	-0.1
Housing and community amenities	0.7	0.6	-0.1	1.3	0.8	-0.5
Health	5.6	7.2	1.6	5.6	6.4	0.8
Recreation, culture and religion	0.8	1.0	0.2	1.0	1.1	0.1
Education	6.1	7.1	0.9	5.3	4.9	-0.4
Social protection	12.1	16.0	3.9	18.3	17.7	-0.6

Note: EA-12 refers to euro-area countries, except Cyprus, Malta and Slovenia. Latest data for Germany refer to the year 2005.

Between 1995 and 2006, a number of spending items have lost relative importance in recent years both in Portugal and in the euro-area. This was the case, most notably, of expenditure on general public services, defence, economic affairs and housing and community amenities. In contrast, public expenditure on recreation, culture and religion rose faster than GDP both in Portugal and in the euro-area.

4. ESTIMATES OF THE EFFICIENCY AND EFFECTIVENESS OF PUBLIC EXPENDITURE

According to the European Commission (2008), public sector efficiency establishes the link between input of public resources and the output, while the concept of effectiveness relates inputs and outputs to the outcomes they create (e.g. higher labour productivity, higher quality of life, or faster technical progress).[14]

From an empirical perspective, however, analyses of public spending efficiency and effectiveness face several challenges. First, isolating all relevant inputs is far from trivial, given the presence of complementarities across spending in different areas of the public sector. Second, public sector outputs are often not subject to market transaction, implying that price data are generally unavailable and outputs most often difficult to quantify. Third, whilst empirical analyses can only benefit from a properly defined benchmark, cross-country comparisons are often troubled by the lack of strictly comparable data between countries. Fourth, public sector effectiveness is often difficult to measure, not least because the definition of the relevant goal is subject to political choice. Finally, the production process of

[14] European Commission (2008); *Public Finances in EMU*, Directorate General for Economic and Financial Affairs.

outputs and outcomes tends to be influenced by environmental factors (e.g. parents' education attainment impact that of their children and dietary habits affect health policy outcomes), which may be beyond government control, at least in the short run.
In the light of these difficulties, the bulk of analyses of public sector efficiency rely on the assessment of output indicators (e.g. educational attainments, the number of graduates, number of cured patients, life expectancy, or number of patents) against the relevant public expenditure or 'technical' inputs (such as the number of teachers, doctors, nurses and researchers). Whilst subject to several caveats, analyses of this sort can provide useful insights on the extent to which governments might be able to obtain more value for the money they spent.

4.1. Overview of the relative performance of the Portuguese public sector

Afonso et al. (2005) assess public sector performance in 23 developed countries, including Portugal.[15] Public sector performance is defined as the outcome of public sector activities, which is proxied by a composite of seven sub-indicators: four are opportunity indicators capturing outcomes in administration, education, health and infrastructure, while the remaining three seek to measure performance in the standard Musgravian tasks (distribution, stability and performance).

The analysis of opportunity indicators reveals that Portugal performs poorly in international comparison in almost all areas considered, leading to a modest overall public sector performance. Indeed, if equal weights are attributed to the sectoral indicators of performance, Portugal's overall score ranks second-to-last amongst the fifteen EU Member States considered in the analysis. A closer look at the scores in each of the underlying areas of the public sector reveals that the relative underperformance of the Portuguese public sector is mainly driven by below-the-average scores in the areas of administration, education, infrastructure and stability.

4.2. Efficiency of public spending on education

The subdued performance of the Portuguese economy in recent years reflects a series of deeply-rooted factors, especially the low level of educational attainment of the workforce. In 2005, the proportion of the population aged 25 to 64 that had attained at least upper secondary education in Portugal was less than half that of the OECD or the euro-area (Table 2). In fact, Portugal's attainment levels only have parallel in low- and medium-income countries, such as Brazil, Mexico or Turkey. Whilst significant improvements have been observed in more recent years, a sizeable gap subsists vis-à-vis other developed countries, even amongst the younger generations. Moreover, the poor performance of Portuguese students in international comparison, as revealed by the results of the 2006 Programme for International Student Assessment (PISA), suggests that the problems of education in Portugal concern not only quantity, but also the quality of provision.[16]

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[15] Afonso, A., Schuknecht, L. and V. Tanzi (2005); *Public sector efficiency: An international comparison*. Public Choice 123, pp. 321-347.

[16] The results of the 2006 PISA indicate that the performance of Portuguese students in science, reading and mathematics is significantly below the OECD average, and one of the poorest in the euro-area.

Table 2: Population that has attained at least upper secondary education, 2005 (% by age group)

	Age group				
	25-64	25-34	35-44	45-54	55-64
Portugal	26	43	26	19	13
EA-12 (unweighted average)	63	76	68	58	47
OECD (unweighted average)	69	78	72	65	55
Brazil	30	38	32	27	11
Mexico	21	24	23	20	12
Turkey	27	36	25	21	15

Note: EA-13 refers to euro-area countries, except Cyprus, Malta and Slovenia.
Data for Brazil refer to the year 2004.

Source: OECD (2007)

Given the importance of human capital for economic performance, raising the level and the quality of education in Portugal appears to be a necessary condition for enhancing the economy's productivity and competitiveness in a sustained manner. Indeed, the importance of this challenge for Portugal has been continuously stressed by the Council in the context of the Lisbon Strategy for Growth and Jobs.

Against this backdrop, assessing the extent to which there is scope for attaining efficiency gains in education in Portugal is particularly important.[17] Recent empirical studies in this domain point indeed to the existence of significant room for improvement. Afonso and St. Aubyn (2006a) evaluate efficiency in secondary education provision across 25 (mostly developed) countries, including Portugal.[18] Their estimates indicate that, for the same resources, education outputs in Portugal could be increased by about 16% if the system were to achieve the efficiency frontier.[19] Pereira and Moreira (2007) focusing on the efficiency of Portuguese secondary schools find that with the resources currently employed, students' scores could be 10% higher if Portuguese secondary schools were to achieve the efficiency frontier.[20]

Importantly, however, the available evidence also indicates that efficiency scores are significantly influenced by environmental factors, most notably parental education and local economic conditions, other than more direct school-inputs. In particular, Afonso and St.

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17 Gonand (2007) provides recent estimates for several OECD countries which suggest that efficiency gains in primary and lower-secondary education can bolster economic growth in the long-run, especially if they are used to increase educational outputs rather than to reduce inputs. Gonand, F. (2007); *The impact on growth of higher efficiency of public spending on schools*. OECD Economic Department Working Paper 547.

18 Afonso, A. and St. Aubyn, M. (2006a); *Cross-country efficiency of secondary education provision: A semi-parametric analysis with non-discretionary inputs.* Economic Modelling 23, pp. 476-491.

19 These findings are in line with those reported by Afonso and St. Aubyn (2005), based on data from the 2000 PISA and on an equivalent set of inputs. Afonso, A. and St. Aubyn, M. (2005); *Non-parametric approaches to education and health efficiency in OECD countries*. Journal of Applied Economics 8, 227-246.

20 Box 1 provides further details on the data and methodology underpinning the estimates of the efficiency of secondary education in Portugal. Pereira, M. and Moreira, S. (2007); *A stochastic frontier analysis of secondary education output in Portugal*. Working Paper 6/2007, Banco de Portugal.

Aubyn (2006) find that when the efficiency estimates are corrected to account for the role of income per capita and the educational attainment of the adult population in each country, Portugal's scores become the highest amongst the 25 countries considered. This finding is corroborated by the several additional estimates. Accounting for the role of environmental factors, Sutherland et al. (2007) find that that Portugal's efficiency scores in primary and secondary education are among the highest in the EU.[21] The study by Pereira and Moreira (2007), on the other hand, reveals that, conditional on direct school-inputs, education outputs are positively associated with the living standards and education level at the school's municipality. Finally, Carneiro (2008), though not explicitly providing efficiency estimates, finds that the main factor driving inequality in the PISA scores of Portuguese adolescents is family background, whereas measurable school resources have only a limited explanatory power on educational achievement.[22]

In all, the available empirical evidence on the efficiency of secondary education in Portugal points to the existence of significant room for improvement. Yet it also suggests that traditional input-based school policies play only a partial role, and that the poor educational achievement of Portuguese adolescents is largely rooted in environmental factors, notably family background.

Box 1: Data and methods underpinning the estimates of education efficiency

Afonso and St. Aubyn (2006a) evaluate efficiency in secondary education provision in a cross-section of 25 countries. They employ a two-stage semi-parametric procedure, by which outputs are assessed against inputs directly employed in the secondary education system in each country. Education outputs are measured by the performance of 15-year-olds in the 2003 PISA in the reading, mathematics, problem solving, and science literacy scales, while inputs are captured by the instruction time in public institutions and the ratio of students per teacher. In a second stage, efficiency estimates are corrected to account for environmental factors, as measured by the income per capita and the adult education attainment of the adult population in each country.

Sutherland et al. (2007) evaluate efficiency in primary and secondary education in 29 OECD countries, using data at school- and country-level. Educational inputs are described both in physical terms and in terms of public spending per pupil. Environmental controls for socio-economic and language background are always included amongst the inputs. Outputs are measured by the mean of the 2003 PISA scores in four academic disciplines, and the estimates are obtained via both non-parametric and parametric methods.

The study by Pereira and Moreira (2007) draws on a cross-section of Portuguese secondary schools for the academic year 2004/2005 to estimate the efficiency of secondary schools through a Stochastic Frontier Analysis (SFA). Secondary-schools outputs are measured by the average score of the corresponding students in the 12th grade national exams for the academic year 2004/2005. These are then assessed against the inputs employed by each school, which are captured by indicators of teacher quantity (number of teachers per 100 students, number of teachers per class) and quality (seniority), and further complemented with controls for production scale, student quality, and private/public nature of the school. Living standards indicators in the schools' municipality are used as environmental controls.

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21 Sutherland, D., Price, R., Joumard, I. and Nicq, C. (2007). *Performance indicators for public spending efficiency in primary and secondary education*. OECD Economics Department Working Paper No. 546.

22 Carneiro, P. (2008); *Equality of opportunity and education achievement in Portugal*. Portuguese Economic Journal, vol. 7, pp. 17-41.

Carneiro (2008) makes use of individual-level data on 15 year old students surveyed by the 2000 PISA to examine the explanatory power of school, family and home attributes in explaining the scores in reading, mathematics and science. The statistical analysis is based on the Ordinary Least Squares estimator, followed by decomposition of variance. The set of school characteristics comprises the total number of students, the number of teaching hours per year, the ratio of students per teacher, the proportion of teachers with training in Pedagogy, and the average socio economic index of the school. The variables aimed at capturing the role of family and home background include measures of parental cultural communication, parental social communication, home educational resources, cultural possessions of the family, and the socio economic index of parents.

4.3. Efficiency of public spending on the health sector

As noted by the European Commission (2008), raising public spending efficiency in the health sector can support economic growth via two main channels. One the one hand, fiscally sustainable health systems contribute to alleviate government budgets from further pressures that would lead to an expansion of the overall size of government and/or crowd out other spending. On the other hand, health care systems, by providing insurance against the risk of illness, allow to smooth consumption and help prevent poverty.

As pointed out in subsection 2.3, rising public expenditure on health has been an important driver of the increase in the overall size of the public sector in Portugal, making it especially important to assess its efficiency. In this vein, Afonso and St. Aubyn (2006b) assess the performance and efficiency of spending on the health sector in 21 OECD countries, including Portugal.[23] The output efficiency estimates indicate that Portugal ranks fourth among the 15 EU Member States considered in the analysis.[24] Joumard et al. (2008) conduct a related assessment for 30 OECD countries and find that Portugal ranks third overall, and second amongst the 19 EU Member States included in the analysis.

Thus, the available evidence suggests that the health sector in Portugal is relatively efficient. It is worth noting, however, that efficiency estimates in this area are subject to very significant caveats, implying that conclusions should remain partial and tentative. Indeed, whereas PISA scores have been generally accepted as useful outcome indicators for measuring performance in education, the measures typically used to capture health outcomes are less consensual. In particular, it has been argued that indicators such as years of quality-adjusted life or number of avoidable deaths would be superior measures of outcome, but progress along these lines has been hampered by the unavailability of data for many countries (see, e.g., European Commission, 2008).

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[23] Afonso and St. Aubyn (2006b). *Relative efficiency of health provision: a DEA approach with non-discretionary inputs*. ISEG/UTL, Department of Economics, Working Paper No. 33/2006/DE/UEC. Box 2 provides further details on the data and methodology underpinning the estimates of health efficiency.

[24] However, it should be noted that, because of missing data, estimates accounting for environmental factors are not available for Portugal.

Box 2: Data and methods underpinning the estimates of health efficiency

Afonso and St. Aubyn (2006b) evaluate efficiency in health provision in a cross-section of 21 OECD countries. Data refer to the period 2000-2003. A two-stage semi-parametric procedure is employed, by which outputs are assessed against inputs directly employed in the health system in each country. Health outputs are measured by indicators such as life expectancy and infant mortality, whereas inputs include medical technology indicators and health employment. In a second stage, efficiency estimates are corrected to account for environmental factors, as measured by the income per capita, the level of education, smoking habits, and obesity in each country. However, due to data unavailability for tobacco consumption, Portugal is excluded from the second stage analysis.

Jourmard et al. (2008) assess the cost and technical efficiency in health provision using data for 30 OECD countries in 2004. Results are based on Data envelopment analysis, wherein health outputs are measured by life expectancy at birth, while inputs a health resources variable (alternatively health spending or health practitioners), a proxy for the economic, social and cultural status of the population, and a lifestyle variable (consumption of fruits and vegetables). Inputs with a negative effect on the health status (e.g. smoking and alcohol) have been excluded due to the absence of an appropriate protocol to apply to this sort of input.

5. LOOKING AHEAD

Portugal has made progress towards fiscal consolidation in recent years. Continued expenditure containment and enhanced tax collection brought the budgetary deficit below the 3% of GDP reference value in 2007. This progress notwithstanding, challenges ahead remain very significant, in the face of still fragile public finances, eroded competitiveness, sizeable external imbalances, and a quickly deteriorating economic outlook. Low potential growth implies that sustained expenditure containment is key for attaining further progress with fiscal consolidation, but also that spending containment must be accompanied by efforts to support the needed lift in productivity and competitiveness.

Important steps have been taken, or are due to enter into force in the coming years, in the area of public administration reform, which has been a pillar of the fiscal consolidation strategy pursued in recent years. These include, most notably, the restructuring of central government services, the introduction of new career and pay scales and employment standards for government employees, and performance evaluation for services, workers and managers. In addition, a consolidation of public services networks in several sectors is underway, leading to the closure of various local services. Whilst the impact of these measures on the efficiency and effectiveness of public expenditure is not yet fully materialised, it is anticipated that they have the potential to yield a more efficient use of public resources in several areas of the public sector.

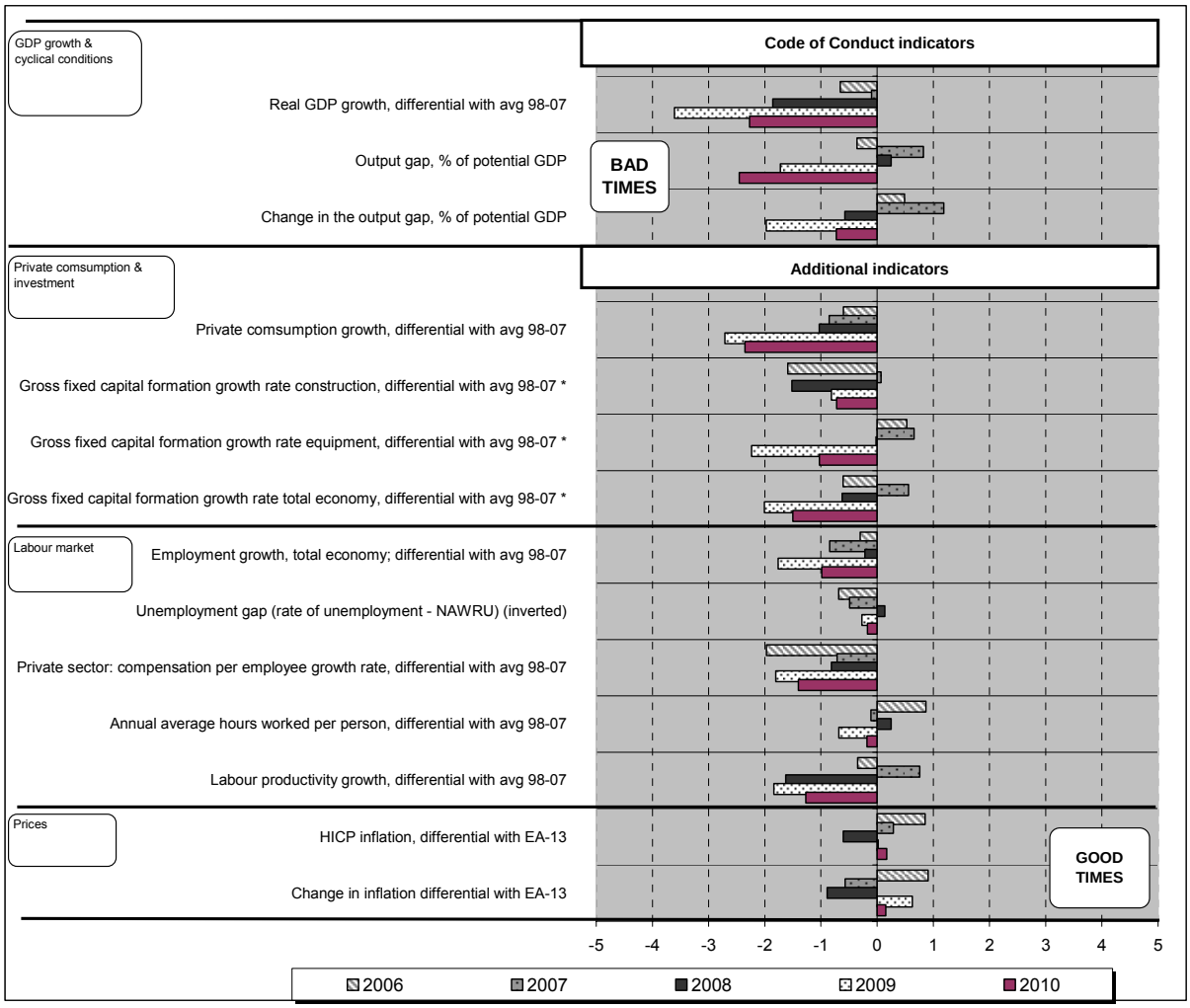
Given the importance of human capital accumulation for economic growth, the current low levels of educational attainment in Portugal, together with the poor performance of Portuguese students in international comparison, indicate that improvements in the quantity and quality of education would likely yield particularly high payoffs. Importantly, however, the problems in this area do not appear to be rooted in underinvestment. Indeed, the amount of public resources devoted to education in Portugal is already considerably above the euro-area average, suggesting that raising the efficiency and effectiveness of the educational system is a key challenge for fiscal and education policies in the years to come.

The plans for raising the allocative efficiency of public resources in the medium-term should also be directed to anticipating the dynamics of demand for public services, and its potential implications for the level and composition of public expenditure. In this regard, important challenges are likely to derive from the effects of ageing populations on the demand of health and social protection public services, two functional areas which have already absorbed an increasing proportion of domestic income over the past decade.

The overall efficiency and effectiveness of public spending could also benefit from improvements in the governance of public finances. In this domain, the Portuguese authorities have put forward plans to develop performance based budgeting, with a multi-annual budgetary framework and numerical budgetary rules, but implementation has not yet materialised. Moreover, the efficiency and effectiveness of public expenditure could be enhanced by the introduction of systematic and independent evaluation mechanisms of projects, programmes and policies, both ex-ante and ex-post. Besides providing for greater accountability, rigorous impact assessment should prove especially valuable in fostering dynamic learning, thereby enabling decision makers to improve existing programmes, and ultimately the allocation of public resources across different policies.

ANNEX 2. ADDITIONAL TABLES AND FIGURES

Figure 1: Good and bad economic times



Source: Commission services' January 2009 forecast (COM) and successive stability programmes

Table 1: Budgetary implementation in 2008

	2007		2008	
	Planned SP Dec 2007	**Outcome SP Jan 2009**	**Planned SP Dec 2007**	**Outcome SP Jan 2009**
Government balance (% of GDP)	-3.0	-2.6	-2.4	-2.2
Difference compared to target	**0.4**		**0.2**	
Of which : due to a different starting position end 2007			0.5	
due to different revenue / expenditure growth in 2008			-2.1	
p.m. Denominator effect and residual [2,3]			-0.1	
p.m. Nominal GDP growth (planned and outcome)			5.0	2.0
Revenue (% of GDP)	42.4	43.2	42.7	43.5
Revenue surprise compared to target [1]	**0.8**		**0.8**	
Of which : due to a different starting position end 2007			0.8	
due to different revenue growth in 2008			-1.2	
p.m. Denominator effect [2]			1.2	
p.m. Residual [3]			0.0	
p.m. Revenue growth rate (planned and outcome)			5.7	2.7
Expenditure (% of GDP)	45.4	45.7	45.1	45.8
Expenditure surprise compared to target [1]	**-0.3**		**-0.7**	
Of which : due to different starting position end 2007			-0.3	
due to different expenditure growth rate in 2008			0.9	
p.m. Denominator effect [2]			-1.3	
p.m. Residual [3]			0.0	
p.m. Expenditure growth rate (planned and outcome)			4.3	2.2

Notes:

[1] A positive number implies that the outcome was better (in terms of government balance) than planned.

[2] The denominator effect captures the mechanical effect that, if GDP turns out higher than planned, the ratio of revenue or expenditure to GDP will fall because of a higher denominator. Although the denominator effect can be very significant for revenue

[3] The decomposition leaves a small residual that cannot be assigned to the previous components. The residual is generally small, except in some cases where planned and actual growth rates of revenue, expenditure and GDP differ significantly.

Source : Commission services

Table 2: Evolution of budgetary targets in successive programmes

		2007	2008	2009	2010	2011
General government balance (% of GDP)	**SP Jan 2009**	**-2.6**	**-2.2**	**-3.9**	**-2.9**	**-2.3**
	SP Dec 2007	*-3.0*	*-2.4*	*-1.5*	*-0.4*	*-0.2*
	COM Jan 2009	-2.6	-2.2	-4.6	-4.4	n.a.
General government expenditure (% of GDP)	**SP Jan 2009**	**45.7**	**45.8**	**48.0**	**46.5**	**45.9**
	SP Dec 2007	*45.4*	*45.1*	*44.4*	*43.5*	*43.3*
	COM Jan 2009	45.7	46.3	47.2	46.8	n.a.
General government revenue (% of GDP)	**SP Jan 2009**	**43.2**	**43.5**	**44.1**	**43.6**	**43.6**
	SP Dec 2007	*42.4*	*42.7*	*42.8*	*43.1*	*43.1*
	COM Jan 2009	43.1	44.2	42.6	42.4	n.a.
Structural balance[1] (% of GDP)	**SP Jan 2009**	**-2.7**	**-2.0**	**-3.0**	**-1.8**	**-1.2**
	SP Dec 2007	*-2.1*	*-1.6*	*-1.0*	*-0.3*	*-0.4*
	COM Jan 2009	-3.1	-3.0	-3.9	-3.3	n.a.
Real GDP (% change)	**SP Jan 2009**	**1.9**	**0.3**	**-0.8**	**0.5**	**1.3**
	SP Dec 2007	*1.8*	*2.2*	*2.8*	*3.0*	*3.0*
	COM Jan 2009	1.9	0.2	-1.6	-0.2	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. There are no one-off and other temporary measures in the programme; according to the Commission services' January 2009 interim forecast they are 0.1% of GDP in year 2007, 0.7% in year 2008 and 0.1% in year 2009, all deficit-reducing.

Source:
Stability programmes (SP); Commission services' January 2009 interim forecasts (COM)

Table 3: Assessment of tax projections

	2009			2010			2011
	SP	COM	OECD[3]	SP	COM[1]	OECD[3]	SP
Change in tax-to-GDP ratio (total taxes)	-1.5	-2.4	0.1	0.1	0.2	0.1	0.0
Difference (SP – COM)	0.8		/	0.8		/	/
of which[2]:							
- discretionary and elasticity component	*0.7*		/	*0.7*		/	/
- composition component	*-0.2*		/	*-0.7*		/	/
Difference (COM - OECD)	/	-2.4		/	0.1		/
of which[2]:							
- discretionary and elasticity component	/	*-3.2*		/	*-0.1*		/
- composition component	/	*-0.3*		/	*0.3*		/
p.m.: Elasticity to GDP	-1.4	-1.9	1.1	1.1	1.4	1.1	1.0

Notes:

[1]On a no-policy change basis.

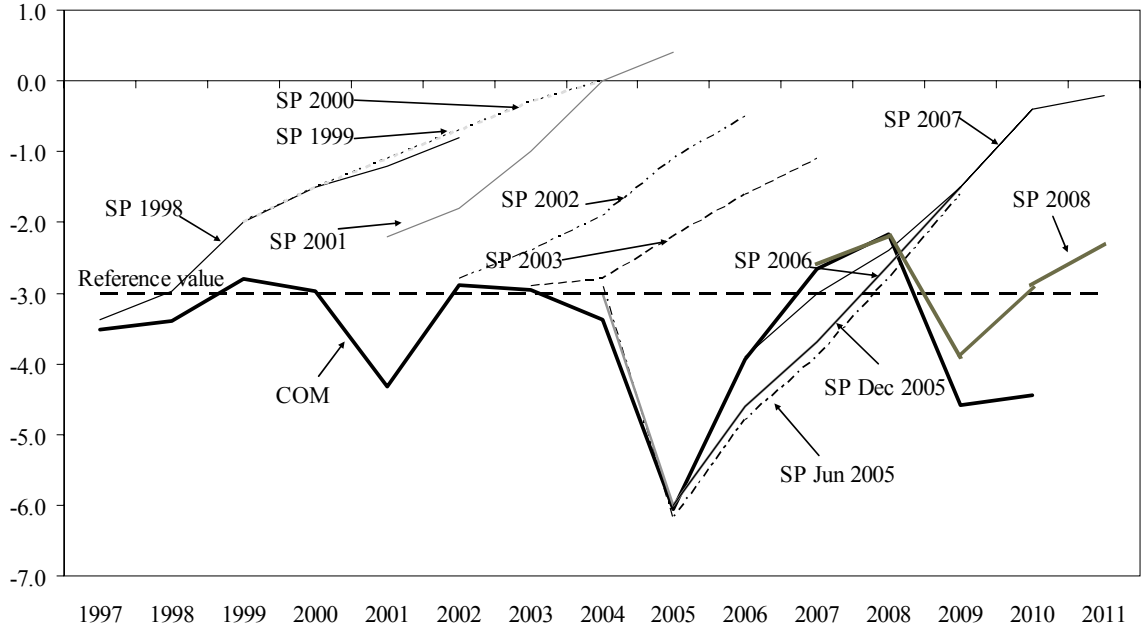
[2]The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system 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:

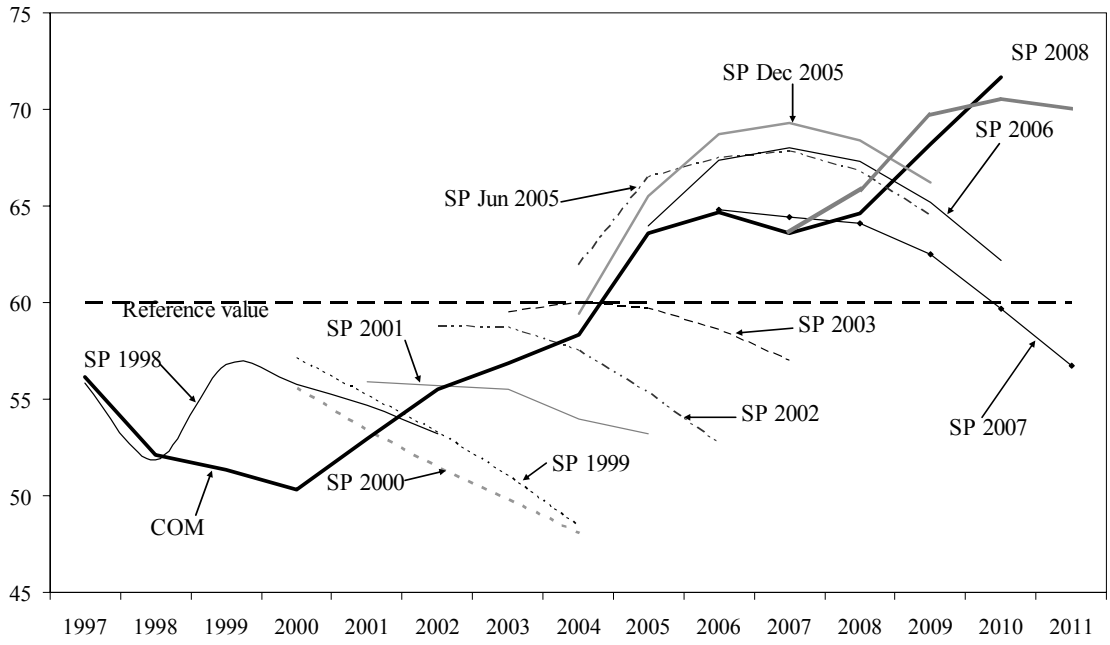
Commission services' January 2009 interim forecasts (COM); Stability programme (SP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive stability programmes

Figure 3: Debt projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive stability programmes

Table 4: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change 2010- 50
Total age-related spending	**23.7**	**24.7**	**25.3**	**26.0**	**28.0**	**29.6**	**4.9**
- Pensions	10.5	11.9	12.6	13.4	15.0	16.0	4.1
- Healthcare	6.7	6.8	6.7	6.6	6.9	7.2	0.4
- 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	0.1
- Unemployment benefits	1.0	0.8	0.8	0.8	0.8	0.8	0.0
Property income received	**0.5**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**-0.1**

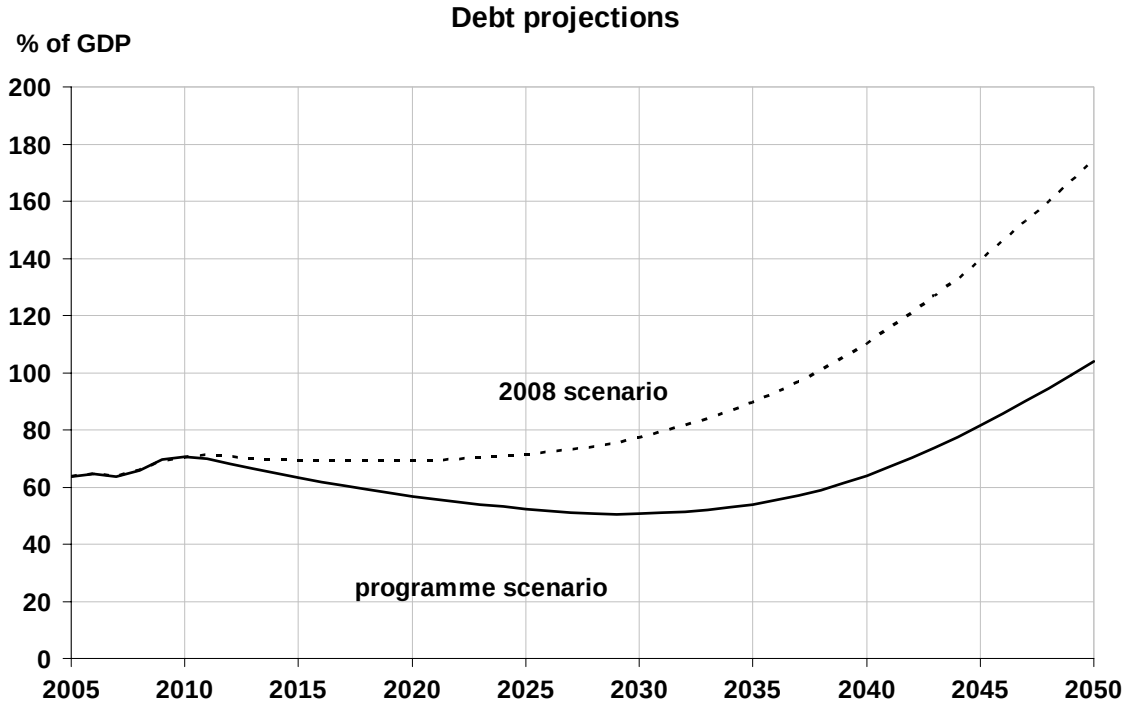
Source: Economic Policy Committee and Commission services.

Table 5: Sustainability indicators and the required primary balance

	2008 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	2.0	3.6	4.3	0.7	2.3	4.3
of which:						
Initial budgetary position (IBP)	0.1	0.3	-	-1.1	-0.9	-
Debt requirement in 2050 (DR)	0.2	-	-	0.1	-	-
Long-term change in the primary balance (LTC)	1.7	3.2	-	1.7	3.2	-

Source: Commission services.

Figure 4: Long-term projections for the government debt ratio



Note: 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.
Source: Commission services.

Table 6: Additional factors

	Impact on risk
Debt and pension assets	-
Decline in structural balance until 2010 in COM January 2009 interim forecast	na
Significant revenues from pension taxation	na
Alternative projection of cost of ageing	na
Strong decline in benefit ratio	-
High tax burden	na
Non-age related budgetary measures with intertemporal effect	na

Note: '-': factor tends to increase the risk to sustainability, '+': factor tends to decrease the risk to sustainability. 'na': not applicable.
Alternative projections are often presented in the programmes, whose assumptions often diverge from the common method. Projections currently discussed in the Economic Policy Committee but not yet published, are for the time being also considered "unofficial".
An explanation on these factors can be found in chapter IV of: European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006.
Source: Commission services.

ANNEX 3. COMPLIANCE WITH THE CODE OF CONDUCT AND TABLES FROM THE PROGRAMME

The programme adheres to the code of conduct for stability and convergence programmes as far as its table of contents is concerned, notably follows the model structure in Annex 1 of the code of conduct.

As regards the data requirements specified in the code of conduct, the programme presents some gaps in the optional data as detailed in Annex 2 of the code. In particular, missing data concern optional data on deflators of public consumption and of investment (table 1b); government consumption (table 2); expenditure by function (table 3); some details on stock-flow adjustment such as 'differences between cash and accruals' and 'valuation effects and others', liquid financial assets and net financial debt in the general government debt developments (table 4); potential GDP growth and components (table 5).

The tables on the following pages show the data presented in the January 2009 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.

Table 1a. Macroeconomic prospects

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	*158414.5*	1.9	0.3	-0.8	0.5	1.3
2. Nominal GDP	B1*g	*163083*	4.9	2.0	1.7	3.0	3.9
Components of real GDP							
3. Private consumption expenditure	P.3	*103231.4*	1.6	1.2	0.4	0.6	1.0
4. Government consumption expenditure	P.3	*32136.1*	0.0	-0.3	0.2	0.1	-0.1
5. Gross fixed capital formation	P.51	*34819.8*	3.1	-0.8	-0.9	-0.3	1.7
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*798.9*	0.3	0.3	0.3	0.3	0.3
7. Exports of goods and services	P.6	*51803*	7.5	0.1	-4.4	1.9	3.1
8. Imports of goods and services	P.7	*64374.7*	5.6	1.0	-1.3	1.3	1.7
Contributions to real GDP growth							
9. Final domestic demand		-	1.8	0.7	0.2	0.5	1.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.0	0.1	0.0	0.1	0.0
11. External balance of goods and services	B.11	-	0.1	-0.4	-0.9	0.1	0.3

Table 1b. Price developments

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		*n.a.*	2.9	1.6	2.4	2.5	2.5
2. Private consumption deflator		*n.a.*	2.7	2.9	1.2	2.0	2.0
3. HICP[1]		*n.a.*	2.4	2.6	1.2	2.0	2.0
4. Public consumption deflator		*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.
6. Export price deflator (goods and services)		*n.a.*	2.7	3.3	2.1	3.0	3.0
7. Import price deflator (goods and services)		*n.a.*	1.4	6.7	-0.7	2.6	2.4

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*5124.6*	0.0	0.6	-0.7	0.1	0.3
2. Employment, hours worked[2]		*4903.0*	-0.1	0.6	-0.7	0.1	0.3
3. Unemployment rate (%)[3]		*n.a.*	8.0	7.7	8.5	8.2	7.7
4. Labour productivity, persons[4]		*25.7*	1.9	-0.3	-0.1	0.5	1.0
5. Labour productivity, hours worked[5]		*26.9*	2.0	-0.3	-0.1	0.5	1.0
6. Compensation of employees	D.1	*80163.6*	3.1	4.4	1.5	2.2	2.6
7. Compensation per employee		*19.3*	3.4	3.6	2.1	2.0	2.2

[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	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-8.7	-10.5	-9.2	-8.4	-7.6
of which :						
- Balance on goods and services		-7.4	-9.2	-9.0	-8.8	-8.2
- Balance of primary incomes and transfers		-2.6	-2.8	-1.7	-1.1	-0.9
- Capital account		1.3	1.6	1.5	1.5	1.5
2. Net lending/borrowing of the private sector	B.9	-6.1	-8.3	-5.3	-5.5	-5.3
3. Net lending/borrowing of general government	EDP B.9	-2.6	-2.2	-3.9	-2.9	-2.3
4. Statistical discrepancy		n.a.	n.a.	n.a.	n.a.	n.a.

Table 2. General government budgetary prospects

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*-4218.0*	-2.6	-2.2	-3.9	-2.9	-2.3
2. Central government	S.1311	*-5216.0*	-3.2	-3.1	-4.6	-3.1	-2.5
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*-132.0*	-0.1	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	*1130.0*	0.7	0.8	0.6	0.2	0.1
General government (S13)							
6. Total revenue	TR	*70372.0*	43.2	43.5	44.1	43.6	43.6
7. Total expenditure	TE[1]	*74590.0*	45.7	45.8	48.0	46.5	45.9
8. Net lending/borrowing	EDP B.9	*-4218.0*	-2.6	-2.2	-3.9	-2.9	-2.3
9. Interest expenditure	EDP D.41	*4592.0*	2.8	3.0	3.3	3.4	3.4
10. Primary balance[2]		*374.0*	0.2	0.8	-0.6	0.4	1.1
11. One-off and other temporary measures[3]		*0.0*	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*40450.0*	24.8	24.7	24.6	24.6	24.8
12a. Taxes on production and imports	D.2	*24535.0*	15.0	14.8	14.8	15.0	15.0
12b. Current taxes on income, wealth, etc	D.5	*15905.0*	9.8	9.9	9.8	9.6	9.7
12c. Capital taxes	D.91	*10.0*	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	*20717.0*	12.7	12.8	11.4	11.5	11.4
14. Property income	D.4	*1202.0*	0.7	0.7	0.7	0.7	0.7
15. Other[4]		*8003.0*	4.9	5.3	7.4	6.8	6.7
16=6. Total revenue	TR	*70372.0*	43.2	43.5	44.1	43.6	43.6
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			36.5	36.6	35.0	35.2	35.3
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*27814*	17.1	17.3	15.6	15.6	15.3
17a. Compensation of employees	D.1	*21059*	12.9	12.8	11.1	10.9	10.7
17b. Intermediate consumption	P.2	*6755*	4.1	4.5	4.6	4.6	4.6
18. Social payments (18=18a+18b)		*31334*	19.2	19.5	20.8	20.8	20.7
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*6621*	4.1	4.1	4.6	4.6	4.6
18b. Social transfers other than in kind	D.62	*24713*	15.2	15.3	16.2	16.3	16.2
19=9. Interest expenditure	EDP D.41	*4592*	2.8	3.0	3.3	3.4	3.4
20. Subsidies	D.3	*1901*	1.2	1.1	1.9	1.1	1.1
21. Gross fixed capital formation	P.51	*3762*	2.3	2.4	2.9	2.4	2.5
22. Other[6]		*5188*	3.2	2.5	3.6	3.3	3.0
23=7. Total expenditure	TE[1]	*74590*	45.7	45.8	48.0	46.5	45.9
p.m.: Government consumption (nominal)	P.3	*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	2006	2011
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	2007	2008	2009	2010	2011
1. Gross debt[1]		63.6	65.9	69.7	70.5	70.0
2. Change in gross debt ratio		-1.1	2.3	3.8	0.8	-0.5
Contributions to changes in gross debt						
3. Primary balance[2]		-0.2	-0.8	0.6	-0.4	-1.1
4. Interest expenditure[3]	EDP D.41	2.8	3.0	3.3	3.4	3.4
5. Stock-flow adjustment		-0.6	1.3	0.9	-0.1	-0.1
of which:						
- Differences between cash and accruals[4]		n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		-0.8	-0.1	0.1	-0.4	-0.2
of which:						
- privatisation proceeds		0.5	0.3	0.6	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]		4.6	4.9	5.1	5.1	5.0
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	2007	2008	2009	2010	2011
1. Real GDP growth (%)		1.9	0.3	-0.8	0.5	1.3
2. Net lending of general government	EDP B.9	-2.6	-2.2	-3.9	-2.9	-2.3
3. Interest expenditure	EDP D.41	2.8	3.0	3.3	3.4	3.4
4. One-off and other temporary measures[1]		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		0.3	-0.1	-1.4	-1.8	-1.3
contributions:						
- labour		n.a.	n.a.	n.a.	n.a.	n.a.
- capital		n.a.	n.a.	n.a.	n.a.	n.a.
- total factor productivity		n.a.	n.a.	n.a.	n.a.	n.a.
6. Output gap		0.3	-0.1	-1.4	-1.8	-1.3
7. Cyclical budgetary component		0.1	-0.1	-0.6	-0.8	-0.6
8. Cyclically-adjusted balance (2 - 7)		-2.7	-2.2	-3.3	-2.1	-1.7
9. Cyclically-adjusted primary balance (8 + 3)		0.1	0.9	0.0	1.2	1.7
10. Structural balance (8 - 4)		-2.7	-2.2	-3.3	-2.1	-1.7

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

Table 6. Divergence from previous update

	ESA Code	2007	2008	2009	2010	2011
Real GDP growth (%)						
Previous update		1.8	2.2	2.8	3.0	3.0
Current update		1.9	0.3	-0.8	0.5	1.3
Difference		0.2	-1.9	-3.5	-2.4	-1.7
General government net lending (% of GDP)	EDP B.9					
Previous update		-3.0	-2.4	-1.5	-0.4	-0.2
Current update		-2.6	-2.2	-3.9	-2.9	-2.3
Difference		0.4	0.2	-2.4	-2.5	-2.1
General government gross debt (% of GDP)						
Previous update		64.4	64.1	62.5	59.7	56.7
Current update		63.6	65.9	69.7	70.5	70.0
Difference		-0.8	1.7	7.2	10.7	13.3

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 health care)*	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	40.7	42.1	44.8	44.8	44.7	44.7
Of which: property income	0.5	0.5	0.6	0.6	0.5	0.5
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

	2007	2008	2009	2010	2011
Short-term interest rate[1] (annual average)	4.3	4.6	2.2	2.8	2.8
Long-term interest rate (annual average)	4.4	4.6	4.2	4.4	4.1
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.37	1.47	1.34	1.33	1.33
Nominal effective exchange rate	0.8	1.3	-1.6	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	5.2	3.9	2.4	3.6	4.4
EU GDP growth	2.8	1.4	0.2	1.1	1.5
Growth of relevant foreign markets	5.5	2.5	-2.8	1.3	2.1
World import volumes, excluding EU	7.8	6.0	3.1	4.7	4.7
Oil prices (Brent, USD/barrel)	72.5	96.9	51.0	61.0	61.0

[1]If necessary, purely technical assumptions.

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