



COMMISSION OF THE EUROPEAN COMMUNITIES

COMMISSION STAFF WORKING DOCUMENT

**Technical document by the Commission Services accompanying the Report on Portugal
prepared in accordance with Article 104(3) of the Treaty**

1. INTRODUCTION

This technical document, prepared by the Commission services to accompany the report according to Article 104(3)¹, presents recent and current budgetary developments in Portugal and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government. Specifically, section 2 analyses macroeconomic developments and prospects. Section 3 examines the situation of public finances in Portugal, assessing developments in headline and structural deficits, as well as in government debt. Finally, section 4 considers other relevant factors, determining the medium-term economic and budgetary position, as well as those needed for a comprehensive assessment of the excess of the deficit over the reference value.

2. MEDIUM-TERM ECONOMIC DEVELOPMENTS AND PROSPECTS

Portugal's economic fortune over the last ten years has been rather uneven. After a boom in the second half of the nineties, economic growth slowed down markedly after 2000, and the economy slipped into recession in late 2002 and 2003, with GDP falling by 1.1% in the latter year. Growth resumed in 2004, at 1% in real terms. According to the Commission services spring 2005 economic forecast, it will accelerate only gradually, to 1.1% in 2005 and 1.7% in 2006. Information made available after the cut-off date for the forecast points to further downward risks to economic growth in 2005, suggesting a rate rather below the forecast. The June 2005 update of the Portuguese Stability Programme assumes real GDP growth of 0.8% in 2005. Since 2001, GDP growth has been at only ½% per annum, clearly below the euro area average of 2%.

Table 1: Macroeconomic developments and outlook

	1999	2000	2001	2002	2003	2004	2005		2006	
							COM	SP	COM	SP
Real GDP (% change)	3.8	3.4	1.7	0.4	-1.1	1.0	1.1	0.8	1.7	1.4
Contribution: Domestic demand	6.0	3.6	1.6	-0.3	-2.7	2.1	1.6	1.3	2.0	1.4
Change in inventories	0.3	-0.3	0.1	0.0	0.0	0.2	-0.2	-0.2	0.0	0.0
External trade	-2.6	0.1	0.0	0.8	1.8	-1.3	-0.4	-0.5	-0.3	0.1
Employment growth	1.9	1.7	1.7	0.4	-0.4	0.1	0.3	0.1	0.3	0.4
Unemployment (% of labour force)	4.5	4.1	4.0	5.0	6.3	6.7	7.0	7.4	7.0	7.7
Nominal unit labour costs (% change)	3.4	5.0	5.4	4.4	3.3	2.1	2.2	2.5	1.9	2.2
HICP (% change)	2.2	2.8	4.4	3.7	3.3	2.5	2.3	2.5	2.1	2.9
Real GDP in euro area (% change)	4.3	3.5	1.6	0.9	0.6	2.0	1.6		2.1	

Source: Eurostat, Commission services spring 2005 forecast (COM) and June 2005 Stability Programme update (SP)

Buoyant growth in the late 1990s was driven by lively domestic economic activity. Internal demand benefited from an easing of monetary conditions in a context of quickly falling interest rates, the expected elimination of the exchange rate risk and the easing of liquidity constraints with EMU entry in prospect. Altogether, these elements supported strong real GDP growth of almost 4 % p.a. on average between 1996 and 2000, compared with 2.6% for the euro area as a whole. However, at the same time, with domestic demand rising faster than income, saving rates declined and private indebtedness rose sharply. In parallel, the second half of the 1990s saw a marked deterioration in Portugal's external competitiveness position.

¹ SEC(2005) 836 final

As a result, Portugal lost exports market shares and the external account deficit reached a peak of 9% of GDP in 2000².

Starting in late 2000, the accumulated macro-economic imbalances started to unwind. In the face of high indebtedness and rising interest rates, coupled with a more gloomy growth outlook, household consumption decelerated and the savings rate headed up. Corporations started to hold back with investment, and from mid-2002 onwards, the government sector adopted a tighter fiscal policy. The simultaneous spending restraint led to a fall in domestic demand by around 2.7% in 2003 and of real GDP by 1.1% – the poorest performance in the EU-15. Simultaneously, Portugal’s external imbalance narrowed progressively, with net foreign borrowing falling to 3.5% of GDP in 2003.

In 2004, economic activity picked up, but imbalances recurred. Domestic demand, in particular private consumption, supported the recovery, partially boosted by lower saving rates. While exports were lively, strong imports led to a highly negative contribution of the external sector to GDP growth and to a widening of the external deficit to over 6% of GDP. As from the middle of the year, the recovery lost steam and the economy relapsed into technical recession.

Portugal’s subdued economic activity is not primarily a cyclical phenomenon. Labour productivity per hour worked continues to be the lowest in the euro area, at less than 60% of the euro area average over the 2000-2003 period. Severe impediments are the low level of formal education of the labour force, poor innovation and investment in R&D and modest take-up of ICT. Moreover, for more than a decade, real unit labour costs have increased vis-à-vis major foreign competitors. Hence, Portugal’s competitive position remains vulnerable, notably with regard to the challenges from transition and emerging economies³.

The buoyant growth of the late 1990s outpaced potential growth for some years, giving rise to a positive output gap since 1998. In 2000, the gap peaked at 2.5% of potential GDP and started declining afterwards. In 2003, the output gap turned negative – to the tune of 2% of potential GDP and is expected to continue widening in 2005, becoming 2.8% of GDP, before narrowing thereafter.

Table 2: Sources of potential output growth

	1999	2000	2001	2002	2003	2004	2005		2006	
							COM	SP ^b	COM	SP ^b
Potential GDP growth ^a	2.8	2.6	2.3	1.9	1.4	1.4	1.4	1.4	1.6	1.6
<i>Contributions:</i>										
- Labour	0.8	0.8	0.8	0.7	0.6	0.6	0.5	0.6	0.5	0.6
- Capital accumulation	1.7	1.6	1.4	1.1	0.7	0.7	0.7	0.7	0.7	0.7
- TFP	0.3	0.2	0.1	0.0	0.1	0.1	0.2	0.1	0.3	0.2
Output gap (% of potential GDP)	1.7	2.5	1.9	0.4	-2.0	-2.5	-2.8	-2.7	-2.7	-2.8

Notes:

^aBased on the commonly agreed method.

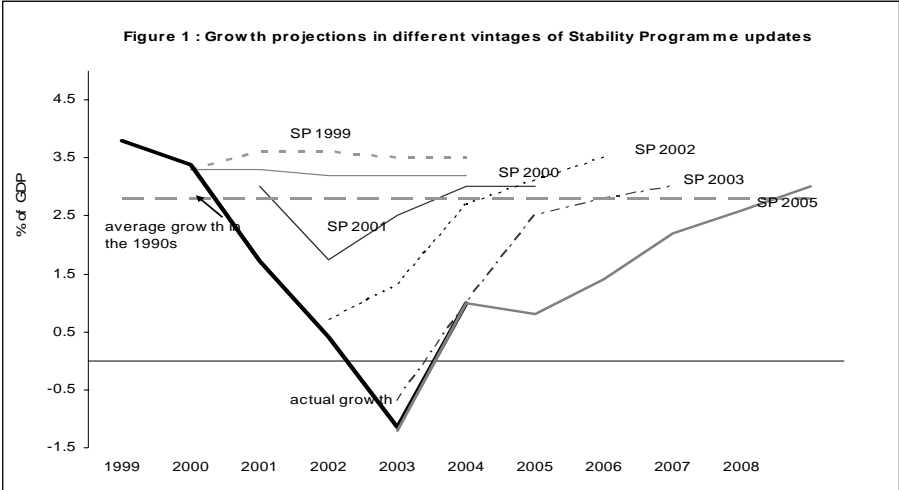
^bCommission services calculations on the basis of the information in the stability programme update

Source: Eurostat, Commission services spring 2005 forecast (COM) and June 2005 Stability programme update (SP)

² Net lending/borrowing vis-à-vis the rest of the world = current account + capital account. According to the currents balance of payments manual and system of national accounts, this corresponds to the former concept of the “balances of payments on current account” mentioned in Article 121(1) of the Treaty.

³ For further insight on these issues, see, e.g., “The Portuguese economy after the boom”, Directorate-General for Economic and Financial Affairs, occasional paper 8, April 2004.

Potential growth has been revised down substantially since the beginning of the 1990s when it was close to 4%. Towards the end of the last decade it averaged 2.8% and is currently estimated at 1 ½% p.a. While the contribution of labour has been broadly constant over time, lower contributions from capital accumulation⁴ and, in particular, meagre total factor productivity growth have undermined potential as well as actual output growth. Figure 1 illustrates the successive downward revisions of growth expectations underlying the annual stability programme updates. While part of the corrections has been due to disappointing developments in the external environment, the inherent domestic constraints to growth have also been under-estimated. Hence, the national projections over the last years exhibit an optimistic bias vis-à-vis the Commission services forecasts.



Overall, the analysis of macroeconomic developments in recent years suggests the following conclusions: (i) the rate of economic growth has decreased sharply since 1999, when GDP grew by 3.8%, eventually becoming negative at -1.1% in 2003; the economy returned to positive economic growth in 2004 and, on the basis of current available information, should remain on an, albeit gradual, upward trend for the years to come; (ii) the slowdown has been accompanied by a substantial weakening of potential output growth, due to a series of mutually reinforcing structural weaknesses; (iii) the output gap, measuring the cumulated loss of output, has been clearly negative since 2003, and may marginally widen to 2.8% of potential output in the current year, which compares with output gaps of 4.5% and 7.5% observed in the two previous recessions.

⁴ A significant part of which, moreover, has been accounted for by residential building.

3. THE SITUATION OF PUBLIC FINANCES

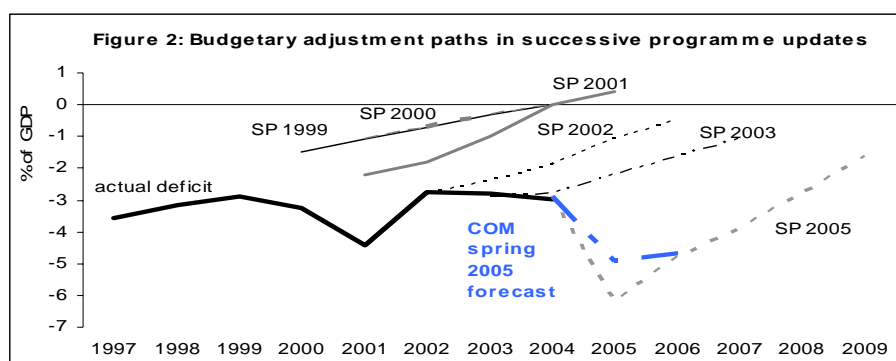
According to the March 2005 EDP notification, the 2004 general government deficit stood at 2.9% of GDP⁵ unchanged from 2003 (p.m. 2002 deficit: 2.7% of GDP). Deficits below 3% of GDP were achieved with the support of significant one-off or temporary measures, in a context of weak economic activity.

The general government deficit planned by the Portuguese authorities for 2005 is 6.2% of GDP, as documented in the June 2005 update of the Stability Programme for Portugal⁶. This figure is not only clearly in excess of the Treaty reference value of 3% of GDP, it also marks a massive revision from the projection of 2.9% of GDP communicated in the EDP reporting of 1 March 2005. Already in early April, the Commission services spring 2005 economic forecast projected a large fiscal imbalance with a government deficit in excess of 5% of GDP in 2005, before the consideration of one-off revenues.

Portuguese government debt has been exceeding the 60% of GDP reference value since 2003. According to the June 2005 update of the Portuguese Stability Programme, the debt ratio is projected to continue increasing in the coming years from 61.9% of GDP in 2004 to a peak of 67.8% of GDP in 2007.

3.1 Budgetary developments until 2005

In the run-up to EMU, Portugal had been successful in improving its budgetary situation, moving from an average general government deficit of 5.2% of GDP over the first half of the nineties, to 2.8% of GDP in 1999.



The budgetary consolidation observed until 1999 was the result of changes in both revenues and expenditure levels. Since 1994 and for most of the years up to 2001, fiscal revenue grew strongly. Lively economic activity, fuelled by buoyant domestic demand, supported a favourable revenue outturn, helped also by the increase in a number of tax rates, the widening

5 In its News Release of 18 March 2005, Eurostat communicated the existence of “ongoing discussions between Eurostat and Portugal on the consistency between accrual and cash-based data provided by Portugal”. Subsequent information provided by the Portuguese authorities indicate small upward revisions for the years 2000, 2002 and 2003, yielding deficit ratios of 2.9% of GDP for each of these years. Eurostat is currently reviewing a number of technical issues.

6 When taking office in March 2005, the government entrusted an ad-hoc commission under the overall responsibility of Bank of Portugal Governor Vitor Constâncio with an assessment of the state of public finances. On 23 May, the commission submitted its findings, projecting at unchanged policies a general government deficit of 6.8% of GDP for the current year.

of certain tax bases, and improved tax collection. Overall, the tax burden⁷ increased from 33.6% of GDP in 1995 to 36.4% in 2000, the total revenue ratio followed a similar path, jumping from 39.6% in 1995 to 42.3% in 2000. Simultaneously, the ratio of current expenditure to GDP decreased somewhat since 1993. This was entirely due to falling interest expenditure on government debt, as interest rates declined sharply in the run up to EMU. However, current primary expenditure, after an expansion in the early 1990s driven by rising compensation to employees and social benefits, grew roughly in line with nominal GDP up to 1998.

Table 3: GDP growth and general government balance and debt

(% of GDP, unless otherwise indicated)	1990	1995	1999	2000	2001	2002	2003	2004	2005		2006	
									COM	SP	COM	SP
Real GDP (% change)	4.0	4.3	3.8	3.4	1.7	0.4	-1.1	1.0	1.1	0.8	1.7	1.4
General government balance	-6.6	-5.5	-2.8	-2.8	-4.4	-2.7 ^b	-2.9	-2.9	-4.9	-6.2	-4.7	-4.8
Primary balance	2.0	0.8	0.4	0.4	-1.3	0.3	0.0	-0.1	-2.0	-3.3	-1.6	-1.6
Total expenditure	42.1	45.0	45.3	45.2	46.3	46	47.6	48.4	48.2	49.1	47.9	48.7
- of which: investment	3.3	3.7	4.1	3.8 ^a	4.0	3.6	3.3	3.3	3.2	3.3	3.0	3.0
interest	8.6	6.3	3.2	3.3	3.2	3.1	2.9	2.9	3.0	2.9	3.1	3.3
Total revenue	35.5	39.6	42.4	42.3	41.9	43.3	44.6	45.4	43.2	42.9	43.2	43.9
- of which: capital taxes	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0	0.1	-	0.1	-
<i>Cyclically-adjusted balance (CAB)</i>	-7.7	-4.5	-3.4	-4.0 ^a	-5.0	-2.9	-2.2	-2.0	-3.9	-5.3	-3.7	-3.8
<i>Cyclically-adjusted primary balance (CAPB)</i>	0.9	1.7	-0.2	-0.8 ^a	-1.8	0.2	0.7	0.8	-1.0	-2.4	-0.7	-0.5
<i>One-off measures</i>	-	-	-	-	-	1.4	2.5	2.3	0.3	0.2	-	-
<i>CAB excluding one-off measures</i>	-0.2	-1.2	-3.4	-4.0 ^a	-5.0	-4.3	-4.7	-4.3	-4.2	-5.5	-3.7	-3.8
<i>CAPB excluding one-off measures</i>	-0.2	-1.2	-0.2	-0.8	-1.8	-1.2	-1.8	-1.5	-1.3	-2.6	-0.7	-0.5
General government gross debt	58.3	64.3	54.3	53.4	55.9	58.5	60.1	61.9	66.2	66.5	68.5	67.5

^a Excluding UMTS proceeds (0.3% of GDP)

^b The deficit and the debt may need to be slightly adjusted upwards yielding, for 2000 and 2002, deficit ratios of 2.9% of GDP.

Source: Eurostat, Commission services spring 2005 forecast (COM) and June 2005 Stability programme update (SP)

As from 1999, the tax revenue and government expenditure patterns started to change. Fiscal revenue growth moderated from the high pace of previous years. Simultaneously, all the major components of current primary expenditure started to grow faster than GDP⁸. First, social transfers had the greatest impact on expenditure expansion, mainly driven by rising old-age pension outlays. Second, the already high wage bill was inflated further by higher wages and increasing numbers of civil service personnel. Third, expenditure on health care area also boosted government consumption as a ratio of GDP. Overall, current primary expenditure consistently expanded strongly. However, unlike in earlier years, the marginally falling interest expenditure no longer offset the current primary expenditure overrun, such that total current expenditure grew faster than GDP.

⁷ Total tax burden excluding imputed social security contributions.

⁸ When analyzing the composition of government expenditure, the different institutional arrangements must be borne in mind. In fact, different organisation of the government sector over time and also across countries may affect the identification of current primary expenditure over time, independent of its level. Relevant examples are the health care and education sectors, which can be classified outside the general government sector even if heavily government-financed. Nevertheless, a composition of public expenditure along the lines followed here gives a broad idea of the pattern of expenditure by category.

Portugal's fiscal policy in the second half of the nineties followed a pro-cyclical stance, being expansionary against the background of lively economic growth. The leeway created by high tax revenue growth and falling interest expenditure was not used for a substantial consolidation of public finances. Indeed, the government deficit stayed close to the 3% of GDP ceiling, leaving no safety margin to avoid breaching the cycling in less favourable cyclical circumstances. The pro-cyclical character of fiscal policy is confirmed by the trend in the cyclically-adjusted deficit, which narrowed since the mid-1990s to an average of 3.4% of GDP in the period 1997-1999, but widened again thereafter. The cyclically-adjusted primary balance swung from an estimated surplus of 1.7% of GDP in 1995 to a deficit of 1.8% in 2001.

The loose fiscal stance eventually pushed Portugal into a situation of excessive deficit in 2001. Fiscal revenue grew but modestly under the impact of decelerating domestic activity as private agents sought to correct their financial imbalances. Government expenditure, however, kept rising unabated. In the end, the 2001 general government deficit turned out at 4.4% of GDP. When the definitive figure became known in mid-2002, the Commission initiated the excessive deficit procedure for Portugal.

Box 1: The Previous Excessive Deficit Procedure for Portugal

In July 2002, the Portuguese authorities disclosed that the general government deficit for 2001 had been equal to 4.1% of GDP*. This outturn exceeding the reference value of the Treaty, the Commission initiated the excessive deficit procedure for Portugal on 24 September 2002 with the adoption of the Report foreseen in Article 104(3) of the Treaty. An Opinion stating that an excessive deficit existed in Portugal was adopted by the Commission on 16 October 2002, in accordance with Article 104(5) of the Treaty. On 5 November 2002, following the step foreseen in Article 104(6), the Council considered that an excessive deficit existed** and, in line with Article 104(7), addressed a recommendation to Portugal with a view to bringing that situation to an end as rapidly as possible in accordance with Article 3(4) of Council Regulation No. 1467/97, i.e. by 2003 at the latest, by taking the appropriate measures by 31 December 2002.

In 2002 and 2003, the general government deficit stood at, respectively, 2.7% and 2.8% of GDP***. The deficit reductions were brought about by some curb on the pace of current primary expenditure growth. Moreover, temporary or one-off measures with a sizeable budgetary impact contributed to the reduction of the government deficit by 1.4% and 2.5% of GDP in 2002 and 2003, respectively (see Box: One-off measures in Portugal). The government debt ratio was kept at 58.0% of GDP in 2002, but increased to 59.4% of GDP in 2003****.

On 11 May 2004, based on the 2003 deficit outturn below the reference value of the Treaty, the Council considered that Portugal had complied with the recommendation of November 2002 issued under Article 104(7), i.e. the Council considered that the correction of excessive deficit was completed. On the basis of such assessment and the commitment by the Portuguese authorities to take additional measures to keep the deficit below 3% of GDP in 2004, the Council decided to abrogate the excessive deficit procedure according to Article 104(12) of the Treaty*****.

* This figure was officially reported on 1 September 2002 and validated by Eurostat; it was later revised to 4.4% of GDP.

** OJ L 322, 27.11.2002, p. 30.

*** First outcome reported on 1 March 2004; the deficit for 2003 was revised to 2.9% of GDP afterwards.

**** These figures were later revised to 58.5 and 60.1% of GDP, respectively.

***** OJ L 47, 18.2.2005, p. 24.

In reaction to a general government deficit in excess of the 3% of GDP reference value, the Portuguese authorities, as from mid-2002, took a set of corrective measures. The main features of the shift in policy were: i) control of current expenditure growth, mainly by implementing simultaneous near-freezes of public wages and employment; ii) tax increases, in particular of the normal VAT rate that was raised from 17 to 19%; iii) the launch of structural reforms in areas with a more direct budgetary impact: the health-care sector, education and public administration. Additionally, the Portuguese authorities implemented sizeable temporary or one-off measures on the revenue side to allow the deficit to stay below the 3% of GDP reference value. These measures were justified by, first, the structural measures would take some time to exert their full effect and, second, it was necessary to substitute tax revenues (temporarily) lost on account of the economic recession.

Despite these consolidation attempts, worrying fiscal developments persisted. The continuing economic downturn eroded revenues further, in particular in 2003 when the economy fell into recession. On the expenditure side, although some success was achieved in slowing the pace of current primary outlays (which grew by 5.5% in 2003 as compared with some 9% in 2001), this could not prevent expenditure rising further as a share of GDP. In 2004, expenditure exceeded its target level by close to 1.5% of GDP, with social retirement transfers and health care expenditures being the driving forces.

In every year since 2002, deficit ratios slightly below 3% of GDP were achieved owing to the sizeable one-off revenues raised by the government. Abstracting from such revenues, deficits would have been in excess of 5% of GDP in 2003 and 2004. Such intensive and protracted recourse to one-off revenue measures shows limited progress in achieving lasting fiscal consolidation. In fact, it suggests that at least the short-term effects of the structural reforms may be less important than expected and expenditure control still weak, in particular in the areas of social security and health care.

Adjusting the deficit figures for the cyclical fluctuations, some, though limited, improvement may be identified. Net of temporary measures, the cyclically-adjusted deficit decreased from 5% of GDP in 2001 to 4.3% of GDP in 2004. However, the lack of lasting progress in consolidation, based on permanent structural measures to contain spending while broadening the revenue base, has raised concerns about the persistence of public finance imbalances.

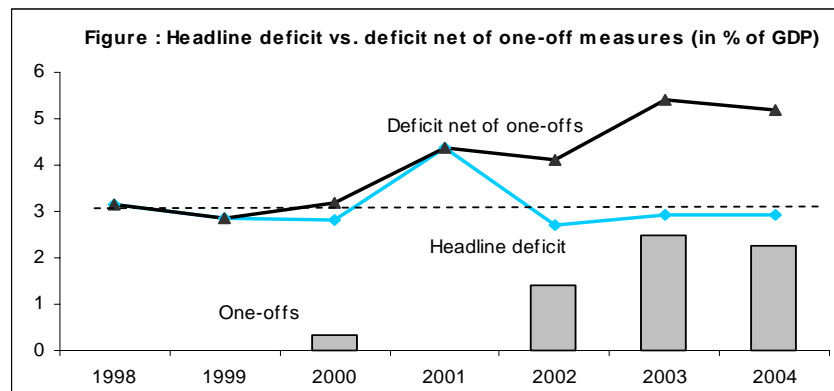
Box 2: One-off measures in Portugal

In each year since 2002, deficit figures below 3% of GDP have been achieved thanks to the implementation of sizeable one-off measures*.

In 2002, the Portuguese authorities raised an amount of 1.4% of GDP as deficit-reducing one-off measures. The government implemented an amnesty for interest surcharges on all tax and social security arrears, which generated revenues equal to 0.9% of GDP. Additionally, the fixed-line telecommunications network was sold to the incumbent operator by an amount of almost 0.3% of GDP and the government sold a concession to raise tolls in the Lisbon's outer ring motorway, by 0.2% of GDP**.

In 2003, the government deficit was reduced by temporary revenues worth 2.5% of GDP. The government received a lump-sum payment equal to 1% of GDP in exchange for taking over the pension responsibilities for employees of the post office company (CTT). Moreover, proceeds worth more than 1.3% of GDP were raised with the securitisation of non-performing tax and social security claims to a financial institution and additional revenue close to 0.2% of GDP came from the extension of the tax amnesty.

In 2004, the deficit was kept below the 3% of GDP reference value thanks to almost 2.3% of GDP of one-off revenues received in exchange for the takeover by the government sector of the pension liabilities for four state-owned enterprises (the bank CGD and three other smaller enterprises).



Sources: Eurostat, Ministry of Finance, Bank of Portugal, Commission services' calculations.

* Already in 2000, Portugal benefited from one-off revenues worth more than 0.3% of GDP from the sale of UMTS licences.

** Note that from the ESA 95 perspective, the two latter operations were recorded as negative capital expenditure rather than as revenue.

3.2. Short-term prospects

The government which came into office in March 2005 entrusted an ad-hoc commission under the overall responsibility of Central Bank governor Constâncio with the assessment of the state of government finances. In mid-May, the commission presented its findings, projecting for 2005 at unchanged policies a deficit of 6.8% of GDP. According to the updated Stability Programme of June 2005, the government targets a general government deficit corresponding to 6.2% of GDP for 2005, without relying any longer on one-off measures. . Already in early April, the Commission services spring 2005 economic forecast projected persistently large fiscal imbalances. Adjusting for cyclical factors, Commission services calculations on the basis of the information in the June 2005 update of the Stability Programme of Portugal and using the commonly agreed methodology indicate a planned cyclically-adjusted deficit of over 5% of GDP in 2005.

The budgetary execution, on a cash basis, for central administration and social security, for the year to April and March, respectively, confirm worrying fiscal developments. Despite the short observation period, current primary expenditure for the year appears to be off track, mainly on account of compensation of employees and transfers other than in kind (notably pensions) higher than anticipated in the budget. So far, tax revenues seem to be holding up against subdued economic activity.

According to the June 2005 update of the stability programme, the expenditure ratio will continue its upward trend in 2005, as it will become 49.1% of GDP (48.4% in 2004), with transfers other than in kind being the main driver. No major expenditure items will have their importance in terms of GDP reduced, except for capital expenditure.

Due to the phasing-out of one-off measures, and despite the increase in VAT, the total revenue ratio is planned to decrease from 45.4% in 2004 to 42.9% in the current year. Lower dividend payments from state-owned enterprises will also reduce the revenue ratio. The fiscal revenue ratio, at 41.6% of GDP, is expected to be little changed from last year.

For the years beyond 2005, the Portuguese authorities plan to redress the public finance situation, acting on both the revenue and expenditure side. The fiscal revenue ratio will go up by almost 2 full percentage points between 2005 and 2009, on the back of hikes in tax rates, in particular, indirect taxes, the assumption of increasing efficiency of tax collection and a curb on tax benefits. On the expenditure side, a reduction of its ratio by some 3 percentage points is planned, supported by lower personnel expenditures, but also by capital expenditure and social transfers other than in kind.

Box 3: The Constâncio commission results on the 2005 deficit forecast

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

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

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

<i>as % of GDP</i>	2004 outturn*	Cyclical component	Discretionary policy decisions	Other effects	2005 commission forecast	Change 04- 05
Total revenue	43.1	-	-0.4	-0.2	42.6	-0.6
Current revenue	41.6	-	-0.4	-0.1	41.1	-0.5
Fiscal income	37.1	-	-0.4	0.4	37.2	0
Taxes production & imports	15.0	-	0.1	0.3	15.4	0.4
Sales	2.4	-	-	-	2.4	0
Other current revenue	2.0	-	-	-0.5	1.5	-0.5
Capital income	1.6	-	-	-0.1	1.5	-0.1
Total expenditure	48.3	0.1	0.3	0.6	49.3	1.0
Current expenditure	43.6	0.1	0.3	0.8	44.8	1.2
Personal	15.0	-	0.1	0.2	15.3	0.3
Consumption	3.8	-	0.1	0.1	4.0	0.2
Interest	2.8	-	-	0.1	3.0	0.1
Current transfers	22.0	0.1	0.2	0.5	22.7	0.7
Capital expenditure	4.7	-	-	-0.2	4.4	-0.2
of which investment	3.3	-	-	-0.1	3.2	-0.1
Balance total	-5.2*	-0.1	-0.7	-0.8	-6.8	-1.6
p.m.: Current primary expenditure	40.8	0.1	0.3	0.9	42.1	1.3
p.m.: Primary balance	-2.3	-0.1	-0.7	-0.8	-3.9	-1.6

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

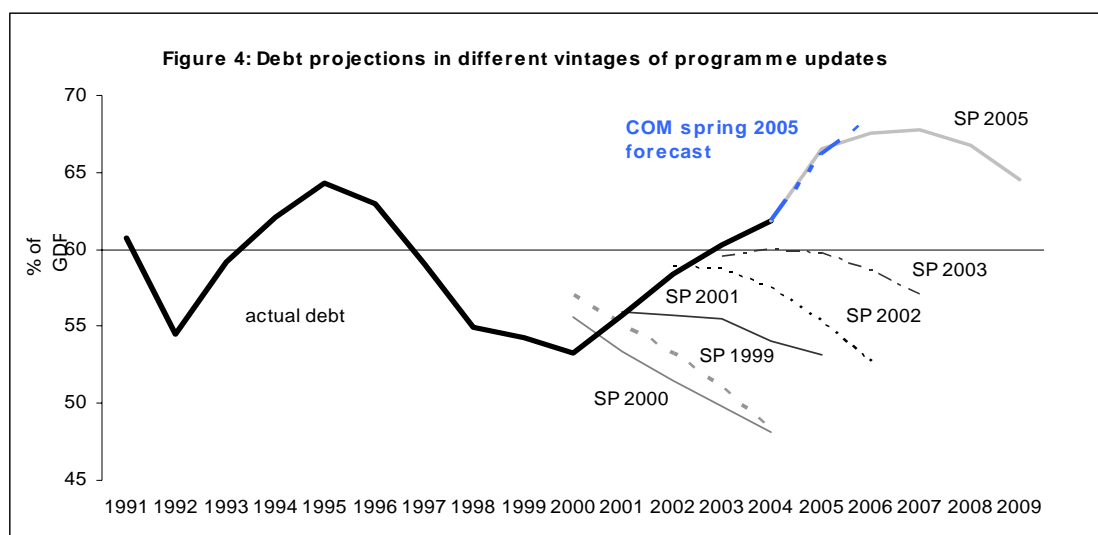
Source: Constâncio commission report

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

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

3.3 Debt developments

From 1995 to 2000, Portuguese public debt fell by 11 percentage points of GDP, from a peak of 64.3% of GDP to 53.4%. However, the reduction was interrupted in 2001, and the debt ratio has been rising in each year since then. In 2003, it breached the 60% of GDP reference value. Over the period from 2000 to 2004, it has increased by some 8.5 percentage points, to a ratio of 61.9% of GDP, thereby offsetting most of the reduction of the second half of the nineties.



Conventionally, the debt dynamics can be decomposed into three components: the primary balance; the combined effect of interest expenditure, real GDP growth and inflation – the so-called “snow-ball effect”; and stock-flow adjustments.

Over the second half of the nineties, all these factors were favourable to a reduction of the debt ratio. The primary surplus was around ½% of GDP per year, although exhibiting a tendency to decline since 1997/98. Strong GDP growth and a fall in the implicit interest rate on government debt led to a favourable (i.e., negative) snowball effect. Finally, the stock-flow adjustment also contributed to the debt reduction, on the back of large privatisation receipts.

In 2001, the sign of each of those effects changed. The primary balance became strongly negative in 2001 in the face of the developments described in section 2. Subsequently, it hovered around zero only thanks to the contribution of the significant one-off revenues.

Also the snow-ball effect has been adding upward pressure to the debt ratio since 2001, due to the rather sharp reduction in GDP growth and although interest expenditure has remained stable at around 3% of GDP for the last three years. In other words, even in the absence of a primary deficit and of any stock-flow adjustment, the impact of nominal GDP growth on the debt ratio would not have been enough to offset the impact of interest expenditure.

Moreover, the stock-flow adjustment has also contributed to the increase in the debt ratio. Two main factors contributed to that outcome. First, since 2001, privatisation receipts have been significantly lower than they were until 2000. Moreover, these receipts have even been less significant than accumulation of equity, notably made up of capital injections into state-owned enterprises. Hence, the contribution of net accumulation of financial assets to debt accumulation has recently been positive or neutral. Second, the cash deficit, which is the

determinant of debt issuance, significantly exceeded the accrual-based deficit⁹, in particular in 2001 and 2004. This was due to lags in revenue collection and the settlement of large spending arrears.

Table 4: Debt dynamics

in % of GDP	1999	2000	2001	2002	2003	2004	2005		2006	
							COM	SP	COM	SP
Government gross debt ratio	54.3	53.4	55.9	58.5	60.1	61.9	66.2	66.5	68.5	67.5
Change in debt ratio (1=2+3+4)	-0.7	-0.9	2.5	2.6	1.6	1.8	4.3	4.6	2.3	1.1
<i>Contributions</i>										
-Primary surplus(-) (2)	-0.4	-0.4	1.3	-0.3	0.0	0.1	2.0	3.3	1.6	1.6
-Snow-ball effect (3)	-0.4	-0.3	0.1	0.5	2.0	0.9	0.9	0.7	0.5	0.2
-Interest expenditure	3.2	3.3	3.2	3.1	2.9	2.9	3.0	2.9	3.1	3.3
-Real GDP growth	-2.0	-1.7	-0.9	-0.2	0.7	-0.6	-0.7	-0.5	-1.1	-0.9
-Inflation (GDP deflator)	-1.6	-1.8	-2.2	-2.3	-1.6	-1.4	-1.4	-1.7	-1.5	-2.2
-Stock-flow adjustment (4)	0.1	-0.3	1.1	2.3	-0.4	0.9	1.4	0.6	0.2	-0.7
of which:										
-Cash-accrual differences	0.0	0.1	1.3	-0.1	-0.1	0.9				
-Accumulation of financial assets	-0.2	-0.9	-0.3	2.3	-0.2	0.0	1.1	0.2		-1.0
of which:										
-Share, excl privatisation*	0.4	1.2	0.5	0.7	0.4	0.6	1.1			
-Privatisation (-)	-1.4	-2.0	-0.3	-0.3	0.0	-0.8		-0.3		-1.1
-Other	0.3	0.4	0.1	0.1	-0.1	0.0				

* Mainly capital injections into state-owned enterprises.

Note:

The change in the gross debt ratio can be decomposed as follows:
$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$
 where t is a time subscript; D , PD , Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.

Source: Commission services calculations

The planned debt figures for the years 2005 to 2007, revealed in the June 2005 stability programme update, imply a continuation of the debt ratio upward trend up to a peak of 67.8% in 2007, concomitant with the debt projections of the Commission services spring 2005 forecasts.

According to the Portuguese authorities, over the coming years, the rise of the debt ratio will be the result of high primary deficits until 2007 and also of an adverse “snow-ball effect” until, at least, 2006. The stock-flow adjustment will support a debt reduction as from 2006, on the back of privatisation proceeds. Yet the planned debt ratio for 2009, at 64.5% of GDP, is still above the 2004 outturn of 61.9% of GDP.

⁹ Note however the reverse is true for interest. A significant share of the Portuguese government debt is in saving certificates (*Certificados de Aforro*). These liabilities do not regularly pay interest and interest that accrues every year is booked as expenditure and adds to the deficit, but is not paid until the certificate is redeemed. The stock of capitalised interest – 4.2% of GDP at the end of 2004 – is not included in the reported government debt, since the latter is defined at face value, and effectively constitutes a hidden liability.

4. QUALITY OF PUBLIC FINANCE DATA

During the latest number of years – notably since 2002 when the government deficit series was considerably revised upwards¹⁰ – the Portuguese government accounts have been carefully scrutinised by Eurostat. Portugal was among the Member States more frequently visited by Eurostat in the context of their follow-up missions on EDP data. On some occasions, the deficit figures were slightly adjusted either unilaterally by Eurostat or by the Portuguese authorities themselves, following bilateral contacts with the Commission services. Moreover, Portugal consulted Eurostat, on several occasions, on the accounting of complex transactions, such as the securitisation of non-performing tax arrears; the sale, leaseback and front-lease of real estate; or the recording of exceptional dividends paid by government-owned corporations.

On 18 March 2005, when publishing and validating the deficit and debt figures reported by Member States, Eurostat noted that, in relation to Portugal, “*there are ongoing discussions between Eurostat and Portugal on the consistency between accrual and cash-based data provided by Portugal, for the period 2001-2004*”, “*which may lead to a subsequent revision of the data*”. The Commission services had noticed that, according to detailed data reported by Portugal, payments by the government considerably exceeded expenditure booked as deficit-increasing transactions. While cash payments do not have to coincide with expenditure, and cash receipts do not have to coincide with revenue in each period, the two pairs of data (expenditure and revenue, in cash and accrual base) tend to converge in the medium term.

According to information provided by the Portuguese authorities in May 2005, most of the apparent discrepancy was due to wrong recording of spending arrears. This had no consequence for the deficit and debt figures, but led to internal inconsistencies in the cash and accrual-based series of revenue and expenditure. The discrepancy in cash- and accrual-based data was also due to the large spending arrears since 2000, some of which were not recorded in the deficits of the previous years, and their settlement in the following years. Moreover, it also appeared that the deficit for 2000, 2001 and 2002, and the debt for 2004 needed to be adjusted slightly upwards (see footnote in Table 3).

5. PUBLIC INVESTMENT AND OTHER RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission Report “shall also take into account whether the government deficit exceeds government investment expenditure¹¹ and take into account other relevant factors, including the medium-term economic and budgetary position of the Member State”. The Ecofin Report of 20 March 2005 also refers to the need to consider other relevant factors in the Commission Report and clarifies the framework within which such relevant factors should be taken into account. The following subsections therefore consider in turn the medium-term economic position, the medium-term budgetary position and other factors relevant for the purpose of this Report.

¹⁰ The fiscal figures notified in September 2002 were significantly revised compared with the March 2002 notification. That revision was based on the conclusions of an ad-hoc audit commission, under the responsibility of the Central Bank Governor, for an assessment of the Portuguese government accounts.

¹¹ The Protocol on the Excessive Deficit Procedure specifies that “investment means gross fixed capital formation”

5.1. Medium-term economic position

5.1.1 Cyclical conditions and potential growth

According to the available evidence, including the Commission services spring 2005 economic forecast, the economic prospects over the coming years will remain subdued. At best, economic growth will be marginally below 1% in the current year and come just close to the potential growth rate currently estimated at 1.6% p.a. over the next two years. Hence, the protracted gap of real GDP relative to its potential, as measured by the output gap, is expected to persist at around current levels in the current and the next year. The negative output gap is seen as narrowing gradually thereafter, eventually closing by the end of the decade. As to the medium-term prospects, the potential growth rate remains low since many structural weaknesses hampering factor efficiency remain largely unaddressed.

5.1.2 Recent structural reforms

Recent efforts have been made to improve Portugal's business environment, potential growth and labour market. The basic rate for corporate income tax was reduced in 2004, and the red tape involved in setting up a new business and in closing a company has been simplified. Some competition-enhancing measures have been taken in the area of utilities, but effective competition is not yet assured, as there are still barriers to entry. The implementation of a new labour code was finalized in mid-2004, replacing the previous different pieces of labour legislation by a single text. It is expected to enhance labour market responsiveness, in particular by allowing for greater flexibility for some work arrangements. Additionally, fostering innovation and technological diffusion is given priority, by increasing training and investment in science and technology, reinforcing the fiscal incentives for private R&D and support for start-ups of innovative enterprises. The promotion of IT use through the *Portuguese Information Society Strategy* is starting to show visible results. In late 2002, Portugal launched structural reforms in various areas, notably pensions, health care and public administration.

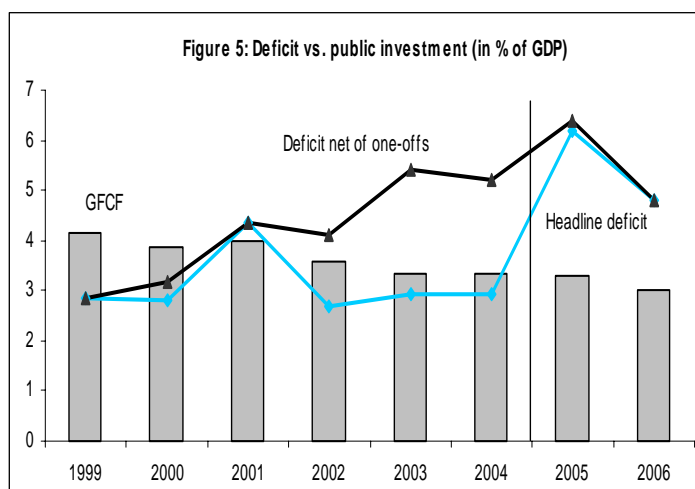
In April 2005, the Portuguese government launched the "Technological Plan" to foster competitiveness and potential economic growth. Among the first measures, the Portuguese government proposes the creation of a system of tax incentives for R&D, by opening the possibility of tax credits for corporate expenditure on R&D. Overall, the plan is not completely defined or developed. Therefore, at this stage, its impact on potential growth and on public finances are difficult to assess.

Reforms have also been introduced to the health and social retirement system (see 5.2.6 below). While the major steps taken since 2001 aim at gaining control over expenditure in order to ensure financial sustainability in the longer run, the implicit drive for greater efficiency and easing upward pressure on social contributions and labour cost should also improve conditions for growth.

5.2 Medium-term budgetary position

5.2.1 Public investment

Since 2001, public investment has exceeded the general government deficit (Figure 5). As from that year, public investment has decreased as a share of GDP, falling from an average of 4.0% of GDP in the 1999-2001 period to a ratio of 3.6% of GDP in 2002 and to 3.3% of GDP in both 2003 and 2004. However, a small part of that reduction is explained by sales of assets, which are recorded as investment-reducing operations, like the sale of the fixed-line telecommunications network by 0.3% of GDP in 2002. According to the June 2005 update of the Portuguese stability programme, public investment is projected to continue on a downward trend over the coming years. Planned sales of real-estate assets averaging 0.2% p.a. are assumed.



Given the sizeable one-off measures implemented since 2002, it is important to consider also the government deficit net of one-off measures. In that case, the conclusion would be reversed: indeed, as figure 5 shows, for the last four years, the deficit has exceeded investment expenditure.

From an economic point of view it should be noted that most of the investment expenditure is to replace depleted capital. Taking this into account, the deficit has financed a relatively modest net increase in the stock of government capital. Specifically, capital depreciation is estimated to have been stable at around 2% of GDP between 2000 and 2003, consequently, just the remainder of gross fixed capital formation – i.e. 1.2% of GDP in 2003 – actually refers to net additions to the capital stock, which is only half of the net capital formation of 1997.

5.2.2 Structural deficit

The lack of fiscal consolidation is evidenced by the high level of the structural deficit, i.e. the deficit net of cyclical factors and one-off measures. It sharply increased from an average of 3.4% of GDP in the 1997-1999 period to a peak of 5% of GDP in 2001. Never falling below 4% of GDP subsequently, it is planned to reach 5.5% of GDP in 2005 on the basis of the information contained in the June 2005 stability programme update. The structural primary balance swung from a surplus during the second half of the nineties to a deficit of 1 ¾% of GDP as from 2001. In 2005, it is planned to be over 2.5% of GDP.

5.2.3 Fiscal consolidation efforts in good times

Portugal significantly loosened its fiscal stance (i.e. net of both cyclical factors and one-off measures) in 2000 and 2001 when the output gap was markedly positive. The cyclically-adjusted deficit excluding one-off revenues rose from around 3.5% of GDP in 1999 to 4% in 2000 and to 5% in 2001 while real GDP exceeded its potential level by about 2 percentage

points in the latter years. It can therefore be concluded that Portugal's weak structural budgetary position has its roots in the adoption of a pro-cyclical fiscal stance in good times.

5.2.4 Expenditure in education and R&D

Public expenditure in education has increased continuously since the early 1990s. Government expenditure on education increased from 6.3% of GDP in 1995 to 6.9% in 2000 and 7.0% in 2003 (last year for which a functional breakdown of government expenditure is available). It is worth noting that Portugal has one of the highest shares of government expenditure on education in the EU. On average, since 2000, 80% of that expenditure has been for compensation of employees.

Portugal's public expenditure on R&D, at around 0.55% of GDP, compares relatively favourably with the EU average. However, Portugal's total R&D expenditure of 0.8% of GDP is well below the EU average.

5.2.5 Temporary measures

As analysed in section 3, for the last three years, Portugal has brought the government deficit just below the 3% of GDP reference value, as recommended by the Council, by resorting to significant one-off operations. While the distinction between temporary and permanent is a complex and not fully settled issue, there is a taxonomy of measures which are explicitly considered as temporary¹². Based on that taxonomy the budgetary impact of one-off measures in Portugal increased from 1.4% of GDP in 2002 to 2.5% in 2003 and to 2.3% in 2004 (see Box 2 for more details on the individual operations).

While a number of temporary or one-off measures implemented in recent years had a beneficial effect on the budget balance and the debt in the short term, some of them will carry negative implications for future years. They may either increase expenditures, such as the transfers of pension obligations to the government, or decrease revenues over the medium-term, for instance the sale of non-performing tax and social security claims.

The decision to no longer rely on temporary measures as from 2005 is consistent with the recommendation of the 2003-2005 Broad Economic Policy Guidelines that call for consolidation from the expenditure side, without the recourse to such measures.

5.2.6 Long-term sustainability of public finances

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

Changes to the general social security scheme were implemented in 2001, regarding the benefit formula and retirement age rules. In 2004, changes to the civil servants pension scheme came into force concerning (i) the setting of a minimum retirement age of 60 years and (ii) the assessment of (low) pension rights of civil servants by basing the reference pension on net rather than on gross wages. Additionally, the pension system for civil servants

¹² The taxonomy is listed in 'Public Finances in EMU 2004', European Economy n. 3/2004.

is to be phased out as those joining the civil service after 1993 will be covered by the less generous general social security scheme. Yet in both schemes the transition periods are rather long and consequently it will take a long time until the full effects build in. On this respect, new measures for the civil servants pension scheme were outlined in the June 2005 update of the stability programme.

Portugal launched in late 2002 the first steps of a reform of its health sector. The main elements are a clearer separation between financing and provision of health care; changes in compensation for medical services; changes of drugs policy, involving the promotion of generic drugs and reimbursements aligned with reference prices. A main goal of the reform is to generate efficiency and savings gains to bring health expenditure growth to a more sustainable path in light of the foreseen increased demand against the background of looming demographic changes.

5.3 Other relevant factors for a comprehensive qualitative assessment of the excess of the deficit over the reference value

A number of elements characterising public finance developments in Portugal over the past several years reveals weaknesses in existing budgetary institutions and procedures.

(i) Over the latest number of years, the outturn of economic activity has been systematically below the official forecasts (see Figure 1). Part of the forecast errors can be attributed to the adverse cyclical conditions which were not expected beforehand by most forecasters. Yet, repeatedly there was also an optimistic bias compared with the Commission services economic forecasts, which contributed to the recurrent deviation of results from the budgetary targets.

Moreover, for some categories of expenditure, e.g. healthcare, the budgeted amounts have been consistently and significantly below the outcome, thus implying the accumulation of spending arrears or requiring the adoption of revised budgets during the implementation phase. In fact, in May 2005, the ad-hoc commission in charge of assessing the state of Portuguese government finances (*Comissão Constâncio*), in its report, pointed to under-estimation of the national health system deficit for the period 2001-2004 by an average of 0.7% of GDP p.a.

(ii) The government accounts reported to the Commission were object of a very significant revision in mid-2002.¹³ Since then, the revision in deficit and debt figures have been much smaller and not of magnitude distinct from most other Member States. The most recent revisions have had no significant impact on the headline figures. However, these revisions, and the current allocation of institutional responsibilities¹⁴ illustrate that the processing of government accounts data still needs further improvement.

¹³ The deficit for 2001 was revised upwards from 2.2% to 4.1% of GDP. In the meantime, the 2001 deficit was further revised upwards to 4.4% of GDP.

¹⁴ The formal responsibility for the production of national accounts (GDP, sectoral accounts, including the government sector) in Portugal is of the National Institute for Statistics (INE), while financial accounts are under the responsibility of the National Central Bank. However, in practice, the government accounts (according to ESA95) which are reported to the Commission in the context of the EDP, are compiled by the Ministry of Finance's services. In the latest EDP reporting, of 1 March 2005, the deficit figures for 2003 and 2004 were from the Ministry, and INE was only responsible for the year 2002 and earlier. The debt is also calculated under the responsibility of the Ministry, and even the reported GDP figures for the previous year are estimated by the Ministry.

(iii) In Portugal there is no formal fast-track control mechanism in the case of deviation from the budgetary targets. In the past, reactions to such situations have been mainly on an ad-hoc basis, such as with the adoption of a supplementary budget or, in more recent years, by reinforcing the one-off measures already foreseen in the budget.