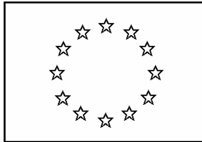

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2002 UPDATE

OF THE CONVERGENCE PROGRAMME OF PORTUGAL

(2003-2006)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS

After a period of strong growth driven by buoyant domestic demand, which caused the emergence of a number of imbalances, the economy is undergoing a period of adjustment since 2001, which is far from being completed. This adjustment basically reflects the efforts of private sector agents to rebalance their accounts, following the sharp rise in their debt-to-income ratios in previous years. In the 2002-2003 period, the unfavourable impact of this adjustment on economic activity is being reinforced by the cyclical downturn in Europe, and the need to consolidate public finances after the unsustainable budgetary position reached in 2001.

Portugal submitted its fourth and most recent update of the stability programme, covering the 2003-2006 period, on 17 January 2003. The Commission services have carried out a technical evaluation of this updated programme, namely taking into account the Communication from the Commission to the Council and to the European Parliament of 27 November on strengthening the co-ordination of budgetary policies[1], and the 2002 Broad Economic Policy Guidelines (BEPGs).

The information provided in the updated programme broadly complies with the revised "code of conduct on the content and format of stability and converge programmes"[2]. The updated programme was adopted by the government on 20 December and presented to parliament, which discussed it and adopted early in January a declaration of approval by a large majority, including the support of the main opposition party. The updated programme was then formally submitted to the Commission. The Portuguese authorities have thus effectively kept the commitment made to the Council on 5 November, upon the application of Article 104(7), to present before the end of 2002 an updated stability programme.

Overall, the economic policies as reflected in the planned measures in the programme update are broadly consistent with the 2002 BEPGs.

Implementation in 2002 of the previous update was severely hampered by the significant budgetary slippage registered in 2001, which led the Council on 5 November 2002 to decide that an excessive deficit exists in Portugal. In fact, the extent of the budgetary slippage registered in 2001 has had considerable knock-on effects in 2002, not least because of the long recognition lag. However, even in a situation of incomplete information, the Portuguese authorities realised in April 2002 that the budgetary situation was developing less favourably than foreseen in the stability programme update of December 2001, requiring corrective measures. Therefore, a rectifying budget was presented to parliament, which became law in June. It included consolidation measures totalling about 0.6% of GDP, notably a rise in the normal VAT rate from 17% to 19%, and a reduction in investment expenditure[3]. Following the

[1] COM (2002) 668 final, 27.11.2002.

[2] *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

[3] The rectifying budget included other measures, notably the freezing of hiring by the government, the closure and merger of public institutes, and the end of new interest rate subsidies to mortgage loans. The rectifying budget also provided for the sale of government property.

approval of the rectifying budget, the new deficit target for 2002 was raised by 1 pp to 2.8% of GDP.

During 2002, budgetary execution in the state sector developed less favourably than projected in the rectifying budget, basically reflecting weaker activity than expected (GDP growth estimated at 0.7% as against an initial forecast of 1¼%), faltering domestic demand, particularly in the second half of the year, disappointing revenues from the sales of government property, and overspending in some areas. With a view to bringing the deficit below 3% of GDP and in the light of the Council recommendation, under Article 104(7), these developments, as well as uncertainties regarding the outcome for the health sector and local authorities led the Portuguese authorities to adopt a number of one-off measures at the end of the year, notably a tax amnesty, which in total are estimated to have brought in additional revenue amounting to about 1½% of GDP. As a result, the government deficit for 2002 is currently estimated by the Portuguese authorities at about 2.6% of GDP (as against 4.2%[4] in 2001), thereby below the target of 2.8%. A first official estimate for the general government deficit in 2002 will be available in the EDP notification to be delivered by 1 March. At that time, and after validation by Eurostat, the Commission will form its views on the matter; however, it can be said at this stage that the deficit was reduced below 3% of GDP in 2002.

The debt-to-GDP ratio increased by 3.4 pp in 2002, which to a large extent reflects financial operations, associated with the implementation of some aspects of the reform in the health sector, and the payment of expenditure arrears linked to the budgetary slippage of 2001. They are not expected to be followed by any further significant net financial operations in future years.

The update's macroeconomic scenario shows a small acceleration of GDP growth to 1.3% in 2003 (from an estimated growth rate of 0.7% in 2002), which basically corresponds to the Commission services Autumn forecast. For the 2004-2006 period, the programme update foresees a gradual acceleration of economic activity (from 2.7% in 2004 to 3.5% in 2006), which is basically caused by the recovery of domestic demand, following sluggish growth in 2001-2003 driven by the correction of major imbalances in the economy, notably a large balance of payments disequilibrium, which peaked at about 8½% of GDP in the period 2000-2001. By 2006, domestic demand is projected to expand again at a pace similar to that of output (i.e. 3½%), while the positive contribution of net exports to growth declines from 1¼ pp of GDP in 2003 to close to zero in the period 2004-2006, reflecting the acceleration in import growth caused by the strengthening of domestic demand.

The baseline macroeconomic scenario underlying the programme update appears plausible as far as the pace of economic recovery is concerned, although the assumed pattern of growth can be questioned for resting excessively on the gradual strengthening of domestic demand in the 2004-2006 period; in fact, the process of correction of the current major macroeconomic imbalances might not have been completed by then, and such a growth pattern does not seem to take fully into account

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[4] According to ESA-95. According to Regulation (EC) N°3605/93 as modified by Regulation (EC) N°475/00, the general government deficit amounted to 4.1% of GDP.

the impact of structural reform on the supply-side of the economy, which could provide for an economic recovery relying more on the strength of export growth.

There are basically two major risks associated with the macroeconomic scenario of the programme update. First, economic growth in the short-term might turn out weaker than projected, following a delay in the economic recovery, particularly in Europe. Second, wage settlements in the private sector might continue to give an excessive weight to domestic variables, which could lead to unwarranted wage raises. In this regard, the government's decision to use from 2003 onwards as the benchmark for wage negotiations in the government sector the average inflation forecast for the euro-area, should have a favourable spill-over effect in the private sector of the economy. Portugal has lost price-competitiveness for a number of years. In order to secure a gradual recovery of economic activity, as foreseen in the programme update, it is paramount not only to avoid further losses, but also to partly unwind the cumulative deterioration in price-competitiveness registered in recent years. In this respect, wage settlements and labour productivity developments will play a crucial role.

As regards budgetary projections, the magnitude of the budgetary slippage registered in 2001 has rendered outdated the targets set in the previous programme update. Therefore, the new update has revised upwards the entire adjustment path for both the deficit and the debt, taking into consideration the shifts in the respective starting positions. The new programme update projects a gradual reduction in the deficit-to-GDP ratio over the 2003-2006 period (2.4% in 2003, 1.9% in 2004, 1.1% in 2005, and 0.5% in 2006). In particular, the budgetary target for 2003 implies a considerable fiscal consolidation effort, which to a large extent is caused by the need to make up for the considerable amount of one-off measures adopted in 2002.

The debt-to-GDP ratio is projected to remain below the 60% of GDP and to recede by a cumulative 6 pp of GDP between 2003 and 2006, attaining 52.7% in the last year of the programme, thereby unwinding the sharp deterioration registered between 2000 and 2002, which *inter alia*, resulted form the budgetary slippage in 2001, and financial operations totalling nearly 5 pp of GDP.

The budgetary outcome for 2003 is central for the successful implementation of the consolidation strategy defined in the current programme update. In this respect, the Council recommendation addressed to the Portuguese Republic under Article 104(7) of the Treaty, emphasised the need to ensure that the government deficit in 2003 be further reduced clearly below 3% of GDP and that the government debt ratio be kept below the 60% of GDP reference value. According to the latest estimate of about 2½% of GDP by the Portuguese authorities for the 2002 deficit, the projected reduction to 2.4% in the actual deficit for 2003 is thus small. However, the corresponding improvement in the underlying deficit between 2002 and 2003 is estimated by the Commission services to amount to 2 full points of GDP (from about 3½% to 1½%), reflecting the wearing-off of the significant amount of one-off measures adopted in 2002, together with the fact that no new one-off measures are planned for 2003. Furthermore, current unfavourable cyclical conditions may also prevent budgetary execution as planned, possibly requiring the introduction of additional saving measures.

From 2004 onwards, budgetary consolidation is to be achieved through a reduction in the total primary expenditure-to-GDP ratio, resulting from a vast programme of structural reforms bearing fruit, together with rigorous restraint on government consumption expenditure, especially as regards the compensation of government employees. This strategy is in line with the general recommendations in the Broad Economic Policy Guidelines, which advocate budgetary consolidation relying mainly on the expenditure side of the budget. This is expected to lead to an underlying budgetary position close-to-balance at the end of the period, while at the same time offsetting the revenue losses caused by a substantial lowering in corporate taxes[5], which are planned to be phased-in over a number of years in order to strengthen the international competitiveness of the economy.

According to Commission services calculations, the cumulative improvement in the cyclically-adjusted balance (CAB) between 2002 and 2006 will amount to about 2 pp of GDP (from some 2% to zero), corresponding to a strengthening in the underlying balance of approximately 3½ pp. The difference is due to the substantial amount of one-off measures adopted in 2002, whose wearing-off in 2003 requires a considerable improvement in the underlying balance in order to comply with the actual deficit target for that year; therefore, the overall adjustment effort is markedly front-loaded to 2003. Between 2003 and 2006, the programme update plans an annual reduction of about ½ pp of GDP both in the actual and in the underlying deficits, reaching a position close-to-balance by the end of the period. This is in line with the commitments made by Portugal in application of Article 104(7) and would mean compliance with the Stability and Growth Pact in the later years of the programme. A sensitivity analysis suggests that in the event of the low-growth scenario considered in the programme update materialising, the actual balance may deteriorate significantly in the absence of offsetting discretionary measures.

The update of the stability programme gives a systematic and detailed presentation of an ambitious programme of structural reforms, which is in line with the broader strategy defined by the Lisbon European Council. The major aims of these reforms are: first, the pursuit of the process of budgetary consolidation on a sustainable basis, and second, to enhance the growth potential of the economy. About all of the announced reforms are likely to eventually have a positive impact on budgetary consolidation, either by fostering a more efficient use of resources, or by broadening tax bases, stemming from the successful implementation of supply-side policies. However, the programme does not quantify their individual contribution to budgetary consolidation. This constitutes a manifest shortcoming, among other reasons, because it does not allow for a discussion of the implementation lags which are involved.

On the basis of current policies, Commission services calculations suggest that the risk of unsustainable public finances in terms of emerging budgetary imbalances cannot be excluded. To achieve a fast pace of debt reduction prior to the budgetary impact of ageing populations taking hold, it is therefore essential that Portugal achieves and sustains a budget position of close to balance or in surplus. This is a necessary but not a sufficient step to ensuring the sustainability of public finances. It has to be

[5] Although the reduction in the tax rate is to be accompanied with measures to broaden the tax base, the reform of corporate taxation is admittedly revenue reducing. The loss in revenue is estimated to augment from 0.2 pp of GDP in 2004 to 0.7 pp in 2006.

supplemented by the determined implementation of the structural reforms outlined in the programme update in order to curb the growth dynamics of age-related expenditure, broaden the tax bases, and increase the overall growth potential of the economy.

1 INTRODUCTION

The Portuguese stability programme update was adopted by the Council of Ministers on 20 December 2002 and presented to parliament, which discussed it and adopted early in January a declaration of approval by a large majority, including the support of the main opposition party[6]. The updated programme was then formally submitted to the Commission. The Portuguese authorities have thus effectively kept the commitment made to the Council on 5 November, upon the application of Article 104(7), to present before the end of 2002 an updated stability programme. This is the fourth annual update of the programme presented originally in December 1998. The previous update of December 2001 covered the period 2002-2005. Following its assessment by the Commission and the Economic and Financial Committee, the Council gave its opinion on 12 February 2002[7].

The 2003 programme update is broadly in line with the Code of Conduct endorsed by the Council[8], and the planned measures are broadly consistent with the 2002 BEPGs.

The current update covers the period 2003-2006. For 2003, the macro-economic scenario corresponds to the lower-end of the assumed range underlying the state budget for 2003 presented to Parliament in October 2002. Beyond 2003, and although economic activity is expected to remain below potential output by 2006, the programme update assumes a steady recovery of the pace of growth driven basically by the improvement of supply conditions, which the programme claims will be brought about by the progress achieved on fiscal consolidation, and the implementation of a wide range of structural reforms.

As defined in the January 2003 programme update, the economic strategy of the Portuguese government is based on two axes: firstly, the pursuit of fiscal consolidation; and secondly, the introduction of a wide range of economic reforms to improve overall competitiveness and secure a sustained rise in productivity.

The updated stability programme highlights the paramount importance of structural reforms to obtain a sustained improvement in the underlying budgetary position. In the short-term, the slowdown in economic growth in Europe, together with faltering domestic demand caused by the efforts of households and firms to redress their balance sheets, is depressing tax revenue. In addition, and as envisaged in the programme update, corporate taxes should be lowered over the medium-term in order to strengthen the international competitiveness of the Portuguese economy. This leaves open only one road to ensure fiscal consolidation on a sustainable basis, namely the restraint of current primary expenditure growth, which in turn requires the introduction of

[6] A first version of the programme update, which is nearly identical to the final one, was made public in the internet in December 2002 (www.portugal.gov.pt.).

[7] OJ, C51/8 26.2.2002.

[8] On 10 July 2001, the Ecofin Council endorsed the Opinion of the Economic and Financial Committee on the revised "code of conduct on the content and format of stability and convergence programmes".

structural reforms. This strategy is in line with the general recommendations in the BEPGs, which advocate budgetary consolidation relying mainly on the expenditure side of the budget, because experience has shown that such consolidation has a higher resilience to economy fluctuations, besides limiting the inefficiency costs associated with high marginal tax rates.

The programme update includes a detailed list of planned structural reforms, notably: i) the revision of labour laws in order to reinforce incentive mechanisms, raising productivity growth; ii) the setting-up of an independent competition authority; iii) the gradual phasing in of a significant reduction in the corporate tax rate to strengthen the international competitiveness of the economy; and, iv) the creation of an agency to promote and facilitate foreign direct investment in Portugal.

In 2001, the government deficit in Portugal was equal to 4.1% of GDP[9], thereby clearly exceeding the reference value of 3%. Following the procedure laid down in Article 104 of the Treaty and Regulation (EC) N° 1467/97, the Ecofin Council on 5 November 2002, and upon a recommendation by the Commission, decided that an excessive deficit existed in Portugal, and addressed a Recommendation to Portugal with a view to bringing an end to the situation. Before the Council decision, and in accordance with Article 104(3) of the Treaty, the Commission had prepared a report, which analysed the causes leading to the budgetary slippage[10]. Among these, it was noted that the execution of budgetary plans was hampered by lack of timely data for various branches of the general government, together with the need to strengthen budgetary co-ordination and enforce fiscal discipline across all levels of government with a view to meeting the Stability Programme's targets. In order to address the lack of co-ordination, and to shorten the recognition lag for the identification of budgetary slippages, and the implementation lag to adopt corrective measures, the Portuguese parliament adopted in 2002 a *Budgetary Framework Law*. In addition, and following the recommendations of the Ecofin Council, which, *inter alia*, called for the Portuguese authorities *to continue to improve the collection and processing of general government data*, Portugal intends to publish quarterly accounts for the general government sector as from 2003.

2 IMPLEMENTATION OF THE PREVIOUS UPDATE

In the September 2002 deficit and debt notification[11], the reported values for the period 1998-2001, notably the general government net borrowing figures, were significantly revised upwards in comparison with the previous EDP notification (March 2002), and the preceding update of the stability programme (December 2001). In particular, the general government deficit outcome in 2001 was 4.1% of GDP, which compares with an initial target of 2.2% (December 2001). It should be mentioned that the deviation from budgetary targets had become apparent as from early 2002 when the stability

[9] According to Regulation (EC) N°3605/93 as modified by Regulation (EC) N°475/00. Figures derived on that basis are relevant for the excesive deficit procedure. According to the ESA 95, the general government deficit amounted to 4.2% of GDP.

[10] ECFIN/436/02.

[11] Council regulation (EC) N° 3605/93 as amended by the Council Regulation (EC) N°475/00.

programme update of December 2001 announced a figure already twice as high as envisaged for the same year in the previous programme update of January 2001[12].

The upward revision of the 2001 deficit amounted to about 1.9 pp of GDP. Two types of reasons contributed to this result, in roughly equal proportions: firstly, the adjustment of the previously reported government accounts to bring them in line with agreed definitions in application of ESA 95; and secondly, slippage in budgetary execution.

The slowdown in economic growth from 3.7% in 2000 to 1.7% in 2001 played a minor role in the slippage from budgetary targets, because it had been largely anticipated in the programme update of December 2001, which assumed an economic growth rate of 2% for 2001.

Table 1: Difference from the 2001 Stability and Growth Programme

	2002	2003	2004	2005	2006
REAL GDP GROWTH (% from previous year)					
SP December 2001	1.8	2.5	3.0	3.0	--
SP January 2003	0.7	1.3	2.7	3.1	3.5
DIFFERENCE	-1.1	-1.2	-0.3	0.1	--
GENERAL GOVERNMENT BALANCE (% of GDP)					
SP December 2001	-1.8	-1.0	0.0	0.4	--
SP January 2003	-2.8 [a)]	-2.4	-1.9	-1.1	-0.5
DIFFERENCE	-1.0	-1.4	-1.9	-1.5	--
GENERAL GOVERNMENT GROSS DEBT (% of GDP)					
SP December 2001	55.7	55.5	54.0	51.9	--
SP January 2003	58.8	58.7	57.5	55.3	52.7
DIFFERENCE	3.1	3.2	3.5	3.4	--

Source: The January 2003 update of the stability programme. [a]*) According to the Portuguese authorities, the government deficit outturn for 2002 is estimated at 2½% of GDP.*

In July 2002, the European Commission decided to initiate the Excessive Deficit Procedure (EDP) for Portugal based on the public release of the conclusions of an ad-hoc Task Force[13], which had been entrusted by the Portuguese government to review the general government accounts for 2001[14]. On 5 November 2002, the Ecofin Council decided that an excessive deficit exists in Portugal[15]. Simultaneously, the

[12] This deviation by a wide margin from the original target, together with the risk of the 3% of GDP reference value for the budget deficit being exceeded prompted the Commission to recommend in late January that an early warning be sent to Portugal under the SGP framework.

[13] This ad-hoc Task Force was named the Commission for the Analysis of Public Accounts. It was made up of representatives from the Ministry of Finance, the Bank of Portugal, and the National Institute of Statistics. It was under the direct responsibility of the governor of the Bank of Portugal.

[14] Its conclusions were confirmed in the September 2002 EDP notification.

[15] OJ, L322/30, 27.11.2002.

Council addressed recommendations[16] to Portugal with a view to correcting the situation as rapidly as possible. The Council established a deadline of 31 December 2002 for the Portuguese government to take measures to bring the excessive deficit to an end. The Council also welcomed the commitment of the Portuguese authorities to continue to improve the collection and processing of general government data, and to reinforce the co-ordination mechanisms of budgetary policy.

Implementation in 2002 of the previous update was severely hampered by the significant budgetary slippage registered in 2001, the extent of which has had considerable knock-on effects in 2002, not least because of the long recognition lag, as the report of the above-mentioned Task Force was published only in July 2002. However, even in a situation of incomplete information, the Portuguese authorities realised in April 2002 that the budgetary situation was developing less favourably than foreseen in the stability programme update of December 2001, requiring corrective measures. Two factors accounted for this: a) the growing evidence that a significant budgetary slippage had occurred in 2001, and b) the increasing shortfall in tax revenue caused by the weakening of economic activity. Therefore, a rectifying budget was presented to parliament, which became law in June. It included consolidation measures totalling about 0.6% of GDP, notably a rise in the normal VAT rate from 17% to 19%, and a reduction in investment expenditure[17]. Following the approval of the rectifying budget, the new deficit target for 2002 was raised by 1 pp to 2.8% of GDP.

During 2002, budgetary execution in the state sector developed less favourably than projected in the rectifying budget, basically reflecting weaker activity than expected (GDP growth estimated at 0.7% as against an initial forecast of 1¼%), faltering domestic demand, particularly in the second half of the year, disappointing revenues from the sales of government property, and overspending in some areas. With a view to bringing the deficit below 3% of GDP, these developments, as well as uncertainties regarding the outcome for the health sector and local authorities led the Portuguese authorities to adopt a number of one-off measures at the end of the year, notably a tax amnesty, which in total are estimated to have brought in additional revenue amounting to about 1½% of GDP[18]. As a result, the government deficit for 2002 is currently estimated by the Portuguese authorities at about 2½% of GDP (as against 4.1% in 2001), thereby below the target of 2.8%[19]. A first official estimate for the general government deficit in 2002 will be available in the EDP notification to be delivered by 1 March next. At that time, and after validation by Eurostat, the Commission will form its views on the matter; however, it can be said at this stage that the deficit was reduced below 3% of GDP in 2002. According to Commission services calculations, and using

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[16] Council of the European Union, 13964/02. These recommendations were not made public.

[17] The rectifying budget included other measures, notably the freezing of hiring by the government, the closure and merger of public institutes, and the end of new interest rate subsidies to mortgage loans. The rectifying budget also provided for the sale of government property.

[18] In mid November 2002, the government declared an amnesty for interest surcharges on the payment of arrears on tax and social security contributions if paid before the end of 2002. The tax amnesty was a huge success, the extent of which was largely unanticipated, having brought in an additional €1367 million (or about 1% of GDP).

[19] A first official estimate for the general government deficit in 2002 will be available in the EDP notification of 1 March 2003.

the latest information available, the underlying budgetary position[20] improved from a deficit of about 4½% of GDP in 2001 to one close to 3½% in 2002. The debt-to-GDP ratio increased by 3.4 pp in 2002, which to a large extent reflects one-off financial operations (see below).

3 MACROECONOMIC ASSESSMENT

3.1 Main assumptions

The macroeconomic scenario for 2003 corresponds to the lower-end of the assumed range underlying the state budget for 2003 presented in October 2002. The external assumptions for the period 2003-2004 are basically those of the Commission's Autumn economic forecast. Economic activity in Portugal is projected to gradually accelerate over the period 2004-2006 to an average growth rate of around 3% per year, although a negative output gap is expected to remain by 2006[21]. This appears plausible given the ongoing adjustment process in the economy, where households and firms are lowering expenditure-to-income levels to reduce debt exposure, and the general government resumes budgetary consolidation.

3.2 Macroeconomic developments

For the 2002-2003 period, the programme's macroeconomic projection is virtually identical with that of the Commission's Autumn forecast. For the 2004-2006 period, the programme update foresees a gradual acceleration of economic activity (from 2.7% in 2004 to 3.5% in 2006), which is basically driven by the recovery of domestic demand, following sluggish growth in 2001-2003 caused by the correction of major imbalances in the economy, notably a large current external deficit, which peaked at about 10% of GDP in the period 2000-2001. By 2006, domestic demand is projected to expand again at a pace similar to that of output (i.e. 3½%), while the positive contribution of net exports to growth declines from 1¼ pp of GDP in 2003 to close to zero in the period 2004-2006, reflecting the acceleration in import growth caused by the strengthening of domestic demand.

The levelling-off of domestic demand in the period 2001-2003 is expected to reduce significantly the deficit on the foreign balance of goods and services, from 11.4% of GDP in 2000 to an estimated 6¼% in 2003[22]. However, the pick-up in economic activity after 2003 is projected to nearly stabilise the trade and services deficit at about 5¾% of GDP by 2006. Other things equal, this will imply a marked reduction in the pace of correction of the foreign imbalance after 2003. This evolution reflects, on the one hand, the assumption of broadly stable market shares throughout the programme period; and on the other hand, the implicit assumption of a pro-cyclical import

[20] The underlying budgetary deficit is defined as the deficit "net of transitory effects and especially the effects of cyclical fluctuations on budgets". Commission communication of 27 November 2002, COM (2002) 668 final of 27.11.2002.

[21] Using the production function approach to calculate output gaps, the stability programme estimates an output gap of -2.7% of GDP in 2006, while Commission services put it just at –1.2. Possible reasons for this difference are discussed below in the section on the cyclically-adjusted budget balances.

[22] Commission services' calculations are based on the volume growth rates of the programme update and assume constant terms of trade. This estimate roughly coincides with the Commission's Autumn 2002 forecast.

elasticity of demand. The former assumption does not seem to take fully into account the expected improvement in supply conditions, arising from structural reform, together with the assumption of wage developments in line with labour productivity.

The programme update projects a current external deficit[23] of 3½% of GDP for 2006, which is considered to be an adequate level for a catching-up economy that has significant financing needs covered only partly by domestic savings. However, according to Commission services' calculations, a balance of payments deficit of around 3½% of GDP by 2006 seems to be too optimistic given the expected evolution of the trade and services balance, because it implicitly assumes terms-of-trade gains and/or an improvement in some items of the balance of payments other than the goods and services balance. The rise in the foreign debt-to-GDP ratio, arising from the accumulation of balance of payments deficits, puts upward pressure on the incomes balance, which already posts a deficit, while the capital inflows, associated with the implementation of a third Community Support Framework, have largely been normalised in 2002, therefore no further significant increases are to be expected in the coming years.

The outlook for the labour market is broadly consistent with both the underlying economic growth scenario, and the envisaged programme of structural reforms. However, given that the situation in the labour market has deteriorated rapidly in the second half of 2002, with the unemployment rate increasing from below 4½% in the first half of 2002 to more than 6% in the fourth quarter, the labour market projections in the programme update look optimistic, basically because of the weaker starting position.

A major pillar of budgetary consolidation is the planned reduction in general government employment by about 1½% per year in the period 2003-2006. As a rule, the hiring of new employees is frozen, the reduction in government employment resulting from the expected flows into retirement. Employment in the private sector is expected to grow by about ½% per year in 2002-2003, accelerating thereafter to 2% by 2006. As regards unemployment, the programme update notes that the unemployment rate is expected to peak at around 5½% in 2004, somewhat lagging the cycle, falling to 4.8% by 2006. Labour productivity is implicitly assumed to rise to nearly 2% per year in the 2005-2006 period, reflecting the economic recovery, and the early impact of structural reforms.

As regards wage developments, the programme briefly notes that real wages should grow in line with labour productivity. This assumption seems to be at odds with cyclical conditions and the authorities' stated aim of curbing the upward drift in the government wage bill. In fact, on the one hand, given the current depressed conjuncture, the flexibility of real wages, and the tendency of wage settlements to lag the cycle, it is more likely that real wages in the private sector will grow on average below labour productivity in the period 2003-2006. On the other hand, the government plans to reduce the general government wage bill-to-GDP ratio in the coming years, both by lowering employment levels, and by pursuing a policy of wage restraint. As

[23] This corresponds to the sum of the balances of goods, services, incomes, current transfers, and capital transactions.

regards the latter, government wages are planned to increase by about 3% in 2003, which represents a marked deceleration from previous years.

Portugal has lost price-competitiveness for a number of years. In order to secure a gradual recovery of economic activity, as foreseen in the programme update, it is paramount not only to avoid further losses, but also to partly unwind the cumulative deterioration in price-competitiveness registered in recent years. In this respect, wage settlements and productivity developments will play a crucial role.

Inflation in Portugal is amongst the highest in the euro-area. Although headline inflation decelerated from 4.4% in 2001 to 3.7% in 2002, the underlying rate[24] rose from 3.6% to 4.5%. Inflation should decline in 2003, and in particularly in the second half of the year, due to cyclical conditions and the drop out from the index of the rise in the normal VAT rate in June 2002 by 2 pp to 19%. As projected in the programme update, consumer price inflation is likely to slow down throughout the period covered by the programme due to persistent negative output-gaps.

Table 2 – Macro-economic projections in the January 2003 update and the Commission Autumn economic forecasts (2001–2006)

(Annual growth rate in % unless otherwise mentioned)		2002		2003		2004		2005	2006
	2001	**SP 2002**	**Com.**	**SP 2002**	**Com.**	**SP 2002**	**Com.**	**SP 2002**	**SP 2002**
GDP at constant prices	1.6	0.7	0.7	1.3	1.2	2.7	2.5	3.1	3.5
Private consumption	1.2	0.5	1.0	0.2	0.9	1.4	1.5	2.3	3.0
Government consumption	2.8	1.4	1.4	-0.5	0.2	-0.3	0.3	-0.5	-0.7
Gross fixed capital formation	0.0	-2.1	-3.5	0.1	-1.0	6.6	3.6	6.4	7.4
Exports of goods & services	1.4	3.2	2.6	4.7	4.4	7.5	6.9	8.7	9.7
Imports of goods & services	0.3	0.8	0.2	0.5	1.7	5.9	4.3	7.2	9.0
HICP	4.4	3.5	3.5	2.5	2.9	2.2	2.5	2.2	2.0
Employment in the private sector	-	0.5	-	0.4	-	1.0	-	1.8	2.1
Employment in the general government	-	1.0	-	-1.9	-	-1.7	-	-1.9	-1.0
Total employment	1.6	0.6	0.7	0.0	0.2	0.6	1.2	1.2	1.7
Total labour productivity	0.0	0.1	0.0	1.3	1.0	2.1	1.3	1.9	1.8
Contribution to real GDP growth									
Domestic demand	1.2	0.1	-0.1	0.0	0.4	2.5	1.8	3.0	3.6
External trade	0.4	0.7	0.8	1.2	0.8	0.2	0.6	0.1	-0.2

Sources: The January 2003 update to the stability programme of Portugal; Commission services, Autumn 2002 economic forecasts.

The baseline macroeconomic scenario depicted in the programme update appears plausible as far as the pace of economic recovery is concerned, although the assumed pattern of growth, which rests entirely on the gradual strengthening of domestic demand in the 2004-2006 period, raises some doubts, because the process of correction of the current major macroeconomic imbalances will likely not be completed by then, and such a growth pattern does not seem to take fully into account the impact of structural reform on the supply-side of the economy.

[24] The overall HICP, excluding energy and unprocessed food.

Moreover, and as argued above, real wages are likely to growth below labour productivity in the 2003-2006 period, partly unwinding the deterioration in price-competitiveness registered in recent years. This makes it likely that Portugal will gain export market shares in the coming years, allowing for a higher contribution to economic growth from the external sector of the economy than that projected in the programme update.

There are basically two major risks associated with the macroeconomic scenario of the programme update. First, economic growth in the short-term might turn out weaker than projected, following a delay in the economic recovery, particularly in Europe, combined with the direct impact of additional restrictive budgetary measures, notably those that should be necessary to offset the one-off measures taken in 2002. Second, wage settlements in the private sector of the economy might continue to give an excessive weight to domestic variables, which could lead to unwarranted wage raises. In this regard, the government's decision to use from 2003 onwards as the benchmark for wage negotiations in the government sector the average inflation forecast for the euro-area, should have a favourable spill-over effect in the private sector of the economy, partly contributing to unwinding the deterioration in price-competitiveness registered in recent years.

4 BUDGETARY TARGETS AND MEDIUM-TERM PATH OF PUBLIC FINANCE

4.1 Programme overview

The January 2003 update of the stability programme significantly revises downward the budgetary targets set in the previous update, which largely reflects the considerably less favourable starting position, following the corrections made to the general government deficit for 2001, and to the debt level for 2002. In addition, output growth was revised downwards (see Table 2 above), and the recovery of economic activity is being delayed by approximately one year to 2004.

Table 3: General Government Budgetary Developments						
	2002	2003	2004	2005	2006	Change 2006-2002
BALANCE BY SUB-SECTORS (in % of GDP)						
1. GENERAL GOVERNMENT BALANCE	-2.8 [a)]	-2.4	-1.9	-1.1	-0.5	+2.3
2. CENTRAL GOVERNMENT	-3.4	-3.0	-2.5	-1.9	-1.3	+2.1
3. LOCAL GOVERNMENT	-0.1	0.0	0.0	0.0	0.0	+0.1
4. SOCIAL SECURITY	0.7	0.5	0.6	0.7	0.9	0.0
GENERAL GOVERNMENT (in % of GDP)						
5. TOTAL REVENUE	43.7	44.4	43.9	43.6	43.0	-0.7
6. TOTAL EXPENDITURE	46.6	46.9	45.8	44.7	43.5	-3.1
7. GENERAL GOVERNMENT BALANCE	-2.8	-2.4	-1.9	-1.1	-0.5	+2.3
8. INTEREST EXPENDITURE	3.0	3.3	3.1	3.0	2.9	-0.1
9. GEN. GOVN. PRIMARY SURPLUS (8-7)	0.2	0.8	1.2	1.9	2.5	+2.3
COMPONENTS OF REVENUES / EXPENDITURES (in % of GDP)						
10. TAXES	24.5	24.6	24.4	24.4	24.1	-0.4
11. SOCIAL CONTRIBUTIONS	12.0	12.2	12.2	12.1	12.1	+0.1
12. OTHER CURRENT RESOURCES	7.3	7.5	7.3	7.0	6.8	-0.5
13. TOTAL REVENUE	43.7	44.4	43.9	43.6	43.0	-0.7
14. GOVERNMENT FINAL CONSUMPTION EXPENDITURE	20.7	19.7	19.3	18.9	18.4	-2.3
15. SOCIAL BENEFITS OTHER THAN IN KIND	14.4	14.9	14.9	14.7	14.4	0.0
16. SUBSIDIES	1.8	2.0	1.8	1.7	1.6	-0.2
17. INTEREST EXPENDITURE	3.0	3.3	3.1	3.0	2.9	-0.1
18. OTHER CURRENT EXPENDITURE	3.0	3.2	3.1	2.9	2.7	-0.3
19. GROSS FIXED CAPITAL FORMATION	3.7	3.8	3.6	3.5	3.4	-0.3
20. TOTAL EXPENDITURE	46.6	46.9	45.8	44.7	43.5	-3.1

Source: The 2003 update of the stability programme. [a]) According to the Portuguese authorities, the government deficit outturn for 2002 is estimated at 2½% of GDP.

The budgetary target of the programme update for the current year implies a greater fiscal consolidation effort than the previous update (December 2001), although the actual government balance is projected to improve by only 0.4 pp of GDP (or even by less if one takes into consideration the latest information on budgetary execution which puts the deficit in 2002 at about 2½% of GDP), as against 0.8 pp in the 2001 update (see Table 1 above). This apparent contradiction is due primarily to the one-off measures taken in 2002, which totalled about 1½% of GDP. Given that the current programme update does not announce any new one-off measures for 2003, this suggests a significant structural tightening in the face of very weak cyclical conditions. Therefore, the current update of the stability programme represents a distinct shift towards a front-loaded consolidation strategy in contrast with past updates. According to Commission services calculations, the underlying balance is projected to improve by about 2 pp of GDP in 2003 (see Table 4 below).

Between 2003 and 2006, the programme update plans an annual reduction by about ½ pp of GDP both in the actual and in the underlying deficits, reaching a position close-to-balance by the end of the period. This complies with the general principle proposed in the Commission Communication to the Council and the European Parliament on "*strengthening the co-ordination of budgetary policies*"[25], which called for those countries with underlying deficits not in a situation close-to-balance or in

[25] COM (2002) 668 final.

surplus to achieve an annual improvement in the underlying budgetary position of at least ½% of GDP each year until the close-to-balance or surplus requirement of the SGP has been reached.

The debt-to-GDP ratio is projected to decline by about 6 pp of GDP between 2003 and 2006, attaining 52.7% of GDP in 2006. This decline results both from the planned increase in the primary balance from 0.8% of GDP in 2003 to 2.5% in 2006, together with the absence of any significant financial operations planned in this period, which is in sharp contrast with previous years (see the stock-flow adjustment in Table 5 below).

Given the current cyclical conditions, the budgetary consolidation strategy presented in the programme update is particularly demanding as regards 2003, basically because no new one-off measures are planned to replace the one-off measures adopted in 2002, and the exonerating budgetary impact of the ambitious programme of planned structural reforms will be felt only gradually.

4.2 Public finance in 2003

The 2003 state budget targets a deficit for the central government consistent with a general government deficit of 2.4% of GDP, following an estimated overall deficit outcome of around 2½% for 2002. However, since the presentation of the state budget (October 2002), the economic outlook has worsened, leading the programme update to adopt the lower-end of the assumed range of growth underlying the macroeconomic scenario of the state budget. Consequently, the programme update acknowledges that additional saving measures –further to those envisaged in the state budget- are likely to be necessary. Moreover, the programme update does not make any reference to the significant one-off measures adopted in 2002, which were instrumental in guaranteeing compliance with the target for that year.

The 2003 state budget plans a raise in direct taxes[26], and in non-tax revenue[27]. In addition, the increase in the normal VAT rate in June 2002 will have a revenue-boosting impact in 2003. However, the wearing off of the effect of the tax amnesty granted in 2002, which brought in about 1% of GDP in additional revenue, will put a significant drag on the growth of total revenue in 2003.

In 2003, the total expenditure-to-GDP ratio is planned to rise by about 0.3 pp of GDP, despite major efforts to curb expenditure growth for the compensation of employees, as reflected by the relative decline in government final consumption by 1 pp of GDP. Employment in the general government is expected to recede by close to 2%, reflecting the virtual freezing of new hires and the effect of outflows into retirement. However, given that the compensation of general government employees represents about 15% of GDP (i.e. about 5 pp more than the average in the EU), and the pension to the wage replacement ratio is estimated to be close to 9/10 for new pensioners in the government sector, the programme rightly notes that the reduction in employment levels has to be supported by a policy of strict wage restraint in order to effectively curb expenditure growth.

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[26] Tax brackets on personal income were indexed below the inflation forecast, and minimum payments on account of final corporate taxes were raised substantially.

[27] The government plans to increase user fees for public services in the education and health sectors.

The rise in the total expenditure ratio, despite the retrenchment adopted in the 2003 budget, reflects a number of factors, notably the rise of social cash benefits by 0.5 pp of GDP, arising from the decision to eliminate progressively, and up to 2006, the gap between minimum pensions and the net minimum wage; the increase in subsidies by 0.2 pp of GDP, reflecting a policy of increased transparency in covering the losses of public enterprises in the transport sector; and an expected rise of 0.3 pp of GDP in interest expenditure due basically to the rise in the debt level at the end of 2002.

Significant challenges remain in 2003 to achieve the deficit target of 2.4% of GDP and to put the deficit on a downward trajectory. Two factors appear particularly critical in this regard. First, in the light of recent economic data confirming the marked slowdown in economic activity in the second half of 2002, the programme's assumption for GDP growth of 1¼% for 2003 appears somewhat optimistic, and further budgetary tightening might be necessary. Second, the measures envisaged in the budget for 2003 may not be enough to offset the one-off measures implemented in 2002 as their exonerating impact wears off. Indeed, according to Commission services calculations, in order to comply with the actual deficit target for 2003, the underlying balance has to improve by close to 2 full points of GDP (see Table 4 below).

4.3 Targets and fiscal adjustment in 2004 and beyond

From 2004 onwards, the programme update projects a sustained reduction in the revenue-to-GDP ratio, stemming from the decision to lower the corporate tax rate in several steps from 30% in 2003 to 20% in 2006[28].

A declining trend for the total expenditure-to-GDP ratio is also expected to be set in motion in 2004, when presumably most of the structural measures envisaged will already have been adopted and began to bear the expected results. The total expenditure ratio is projected to decline by about 1 pp of GDP per year after 2003. According to the data in the programme update, about 2/3 of that retrenchment results from a decline in final consumption, and about 1/10 from a drop in investment. The former is to be achieved through a comprehensive strategy, involving wage moderation; a reduction in employment levels, as retirees are not replaced; the development of an internal labour market; and, the restructuring of careers to improve incentives, and thereby productivity.

As regards social benefits, the programme update foresees a stabilisation of their GDP ratio at around 14½%. This suggests that an implicit budgetary envelope for "social" spending has been set up, following the unsustainable pace of such expenditure in recent years. Total expenditure on pensions is likely to rise due to the policy of progressively narrowing the gap between low pensions and the net minimum wage. This seems to imply that other major categories of social expenditure, in particular health and education will have to make within tighter budgets.

[28] Despite the planned broadening of the tax base, the reform of corporate taxation envisaged in the programme is admittedly revenue reducing. The loss in revenue is estimated to augment from 0.2 pp of GDP in 2004 to 0.7 pp in 2006.

From 2004 onwards, budgetary consolidation is to be achieved through the reduction in the total primary expenditure-to-GDP ratio, arising basically from the exonerating effects of a vast programme of structural reform, together with rigorous retrenchment for government consumption expenditure, especially as regards the compensation of government employees. This strategy is expected both to achieve an underlying budgetary position close-to-balance at the end of the period, while offsetting the revenue losses caused by a substantial lowering in corporate taxes. Although the programme update gives a systematic and detailed presentation of the various structural reforms to be implemented (see Section 6 below), it does not quantify their individual contribution to budgetary consolidation. This constitutes a manifest shortcoming, because it does not enable a thorough analysis of the budgetary consolidation process and the implementation lags involved.

4.4 Cyclically-adjusted budget balances

The programme update provides estimates of budgetary balances adjusted for the impact of the economic cycle on the basis of output gaps calculated using both the production function (PF) and the Hodrick-Prescott (HP) methods. However, and contrary to what has been agreed in the Ecofin Council of 12 July 2002, the programme update of Portugal does not adopt the PF approach for the estimation of output gaps as the reference method for assessing the underlying budgetary position. Instead, the programme update bases its analysis on the HP methodology, with scant references being made to the PF approach.

Table 4. Cyclically-Adjusted Budget Balance

% GDP	2001	2002	2003	2004	2005	2006
1. GDP growth at constant prices	1.8	0.7	1.3	2.7	3.1	3.5
2. Net borrowing	-4.2	-2.5[a)]	-2.4	-1.9	-1.1	-0.5
3. Interest payments	3.1	3.0	3.3	3.1	3.0	2.9
4. Potential GDP growth	3.3 (3.2)	2.6 (2.9)	2.5 (2.6)	2.8 (3.1)	2.5 (3.4)	2.9 (3.2)
5. Output gap	0.9 (1.2)	-1.0 (-1.0)	-2.2 (-2.3)	-2.3 (-2.7)	-1.8 (-3.0)	-1.2 (-2.7)
6. Cyclical budgetary component	0.3 (0.7)	-0.4 (-0.2)	-0.8 (-0.9)	-0.8 (-1.2)	-0.6 (-1.2)	-0.4 (-0.9)
7. Cyclically-adjusted balance (7=2-6)	-4.5 (-4.9)	-2.1 (-2.3)	-1.6 (-1.5)	-1.1 (-0.7)	-0.5 (0.1)	-0.1 (0.4)
8 Measures with transitory effect	0.0[b)]	1.5[a)]	0.0[b)]	0.0[b)]	0.0[b)]	0.0[b)]
9 Underlying balance (9=7-8)	-4.5	-3.6	-1.6	-1.1	-0.5	-0.1
10. Cyclically-adjusted primary balance (10=7+3)	-1.4 (-1.8)	0.9 (0.7)	1.7 (1.8)	2.0 (2.4)	2.5 (3.1)	2.8 (3.3)
Pro memoria: the Hodrick-Prescott methodology						
11. Output gap	-	-0.4 (-0.3)	-1.7 (-1.5)	-1.7 (-1.4)	-1.4 (-1.0)	-0.8 (-0.3)
12. Cyclically-adjusted balance	-	-2.4 (-2.5)	-1.8 (-1.8)	-1.3 (-1.3)	-0.6 (-0.7)	-0.2 (-0.3)

Source: Commission services calculations using the production function method on the basis of the projections of the January 2003 updated stability programme; in parenthesis, the estimates provided in the update, corrected by considering that deficit outcome in 2002 was 2½% of GDP. [a)] According to the

Portuguese authorities, the government deficit outturn for 2002 is estimated at 2½% of GDP. [b)] *value not available.*

In order to allow the Commission services to estimate, using the PF approach, the potential output values that underlie the macroeconomic projections of the programme update, the Portuguese authorities provided all the necessary data, including those that are not required by the Code of Conduct[29]. However, the quantitative results obtained by the Commission services (for the PF approach) differ substantially from those reported in the programme update in particularly for the years 2005 and 2006, although the qualitative results are similar[30].

The calculations made by the Commission services call for the following comments. The projected cumulated improvement in the CAB between 2001 and 2006 amounts to about 4½ pp of GDP. The CAB is expected to be close-to-balance by 2005, an year earlier than the actual balance. An attempt was made to calculate the improvement in the underlying budgetary position by eliminating the measures of transitory effect. Other things equal, and in the absence of one-off operations, the underlying balance would have to improve by about 2 pp of GDP in 2003 (see Table 4, line 9) in order to be consistent with actual budgetary targets. Given the weakness of the current cyclical position, an improvement of this magnitude appears difficult to attain without having some recourse to further one-off measures in 2003.

4.5 The debt ratio

Between 2000 and 2002, the debt-to-GDP ratio increased by 5.7 pp. This resulted both from the budgetary slippage in 2001, and the significant amount of financial operations made in this period. In 2002, the change in the debt ratio, not explained either by the primary balance or the underlying macroeconomic variables that determine debt-dynamics, amounted to about 3½ pp of GDP, of which 1.6 pp are due to the regularisation of expenditure arrears, and 1.4 pp result from the acquisition of assets, notably the transformation of a significant number of public hospitals into publicly owned corporations, an operation which is not to be followed by any additional capital injections in the future.

After the budgetary slippage of 2001, when the primary balance registered the only deficit since the introduction of the current system of national accounts (ESA-95), the significant consolidation efforts made in 2002 are estimated to have improved the cyclically-adjusted primary balance by about 2¼ pp of GDP in 2002 (see Table 4, line 10). This improvement is expected to continue during the period covered by the programme update, supported by the acceleration in economic growth after 2003. Consequently, the debt-to-GDP ratio is projected to decline by a total of 6 pp of GDP between 2003 and 2006, attaining 52.7% of GDP in the last year of the programme. The reduction in the debt ratio is obtained under the assumption that no significant net financial operations are to take place in the coming years, in contrast with developments in previous years.

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[29] Data for total wage compensation, and the unemployment rate.

[30] It turns out that the methodologies followed by the Commission and the Portuguese authorities are not directly comparable, notably because the former uses a Cobb-Douglas production function, while the latter uses a Constant Elasticity of Substitution production function.

Table 5: General Government Debt Developments						
% of GDP	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
GEN. GOV. CONSOLIDATED GROSS DEBT	55.4	58.8	58.7	57.5	55.3	52.7
CHANGE IN THE DEBT RATIO	2.2	3.4	-0.1	-1.2	-2.2	-2.6
CONTRIBUTION TO CHANGES IN GENERAL GOVERNMENT CONSOLIDATED GROSS DEBT						
PRIMARY SURPLUS	1.1	-0.2	-0.8	-1.2	-1.9	-2.5
INTEREST	3.1	2.9	3.2	2.9	2.8	2.7
NOMINAL GDP	-3.2	-2.8	-2.4	-3.2	-3.2	-3.2
OTHER FACTORS AFFECTING THE GENERAL GOVERNMENT CONSOLIDATED DEBT						
STOCK-FLOW ADJUSTMENT	1.3	3.5	0.0	0.2	0.1	0.4
Of which						
Regularisation of expenditure arrears	-	1.6	-	-	-	-
Net acquisition of assets	-	1.4	-	-	-	-

Note: The decomposition of changes in the gross debt ratio is based on the following equation for the budget constraint:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{D_{t-1}}{Y_{t-1}} \frac{i-y}{1+y} - \frac{P_t}{Y_t} + \frac{S_t}{Y_t}$$

D_t = government debt, P_t = primary balance , Y_t = GDP at current market prices, i = implicit interest rate on government debt, y = nominal GDP growth rate, and S_t = the stock-flow adjustment.

Source: The January 2003 update of the stability programme

4.6 Sensitivity analysis

The stability programme update provides alternative scenarios of high and low growth by changing by ±1 pp per year from the baseline scenario the pace of GDP. According to the results reported in the programme update, the lower growth scenario would bring about a deterioration of about 0.4 pp of GDP per year in the general government balance, yielding a deficit of 1.6% of GDP in 2006, as against a deficit of 0.5% in the central scenario.

A useful exercise is to calculate a hypothetical CAB (HCAB), which corresponds to the low growth scenario in the programme update. The HCAB results from adjusting revenue and expenditure to the GDP ratios in the baseline scenario, using the potential output of the low growth scenario (see Table 6)[31]. The difference between this calculation and the CAB for the baseline scenario gives an indication of the fiscal adjustment necessary to meet the budgetary targets of the baseline scenario in a different growth environment. This analysis suggests that in the event of the low growth scenario materialising, the CAB may deteriorate significantly, failing to attain a cyclically-adjusted close-to-balance position by 2006, in the absence of offsetting policy measures.

[31] This hypothetical CAB is computed under the assumption of unchanged policies, as follows: baseline revenues are adjusted for the estimated difference in potential output by applying the standard semi-elasticity; primary expenditure is the same in nominal terms than in the baseline scenario, thereby increasing its GDP share for lower GDP growth.

Table 6: Sensitivity analysis to GDP growth				
% of GDP	2003	2004	2005	2006
BASELINE SCENARIO				
GDP growth	1.3	2.7	3.1	3.5
General government balance	-2.4	-1.9	-1.1	-0.5
Potential GDP growth	2.5	2.8	2.5	2.9
Output gap	-2.2	-2.3	-1.8	-1.2
CAB	-1.6	-1.1	-0.5	-0.1
LOW GROWTH SCENARIO				
GDP growth	1.3	1.7	2.1	2.5
General government balance	-2.4	-2.3	-1.9	-1.6
Hypothetical CAB (HCAB)[a)]	-2.1	-1.7	-1.2	-1.0
Fiscal effort indicator[b)]: CAB-HCAB	0.5	0.6	0.7	0.9

Source: Commission services calculations based on figures provided in the stability programme update. Potential GDP growth is calculated using the production function methodology. a) Using the low growth scenario, see footnote 31. b) Fiscal effort required to meet the budgetary targets in the event of the low growth scenario materialising.

5 THE SUSTAINABILITY OF PUBLIC FINANCES

On the basis of current policies, the Commission services calculations suggest that the risk of unsustainable public finances in terms of emerging budgetary imbalances cannot be excluded (see Annex 2). To achieve a fast pace of debt reduction prior to the budgetary impact of ageing populations taking hold, it is therefore essential that Portugal achieves and sustains a budget position of close-to-balance or in surplus. This is a necessary but not a sufficient step to ensuring the sustainability of public finances. It has to be supplemented by the determined implementation of the structural reforms outlined in the programme update in order to curb the growth of age-related expenditure, broaden the tax bases, and increase the overall growth potential of the economy.

6 STRUCTURAL MEASURES AND OTHER REFORMS WITH LIKELY BUDGETARY IMPACT

The 2003 update of the stability programme outlines an ambitious programme of structural reforms, which is in line with the broader strategy defined at the Lisbon European Council. The major aims of these reforms are: first, the pursuit of the process of budgetary consolidation on a sustainable basis, and second, to enhance the growth potential of the economy. About all of the announced reforms are likely to eventually have a positive impact on budgetary consolidation, either by fostering a more efficient use of resources, or by broadening the tax bases as a result of successful supply-side policies.

According to the programme update, the policy of structural reform is designed to promote real convergence, permitting the Portuguese economy to resume growth above

the EU average from 2004 onwards, after an adjustment period between 2001-2003; and to create the conditions for a sustained reduction in the debt ratio, thereby preparing the economy to face the long term consequences of ageing.

Structural reform is envisaged in nearly all major policy areas. With regard to the labour market, a new labour code has been presented to parliament, of which the major objectives are: i) to increase flexibility; and ii) to improve labour productivity, and thereby competitiveness, by reinforcing incentive mechanisms. As regards the improvement of overall competitiveness in the Portuguese economy, an important number of measures are planned, *inter alia*, i) the establishment of an independent competition authority with powers similar to those in other EU countries, together with the approval of a new competition law in line with the more advanced legislation at the EU level; and ii) measures to facilitate the creation and licensing of new firms.

Some initiatives are directed to enhance the attractiveness of the Portuguese economy as a destination to foreign investors, notably i) the phasing in of a reduction in the corporate tax rate, totalling 10 pp[32], which will be only partly offset by a broadening of the tax base; ii) the creation of the Portuguese agency for direct foreign investment (API), entrusted with the active promotion of FDI inflows, and due to become a one-stop shop for foreign investors, combined with the compilation of a new code for foreign investment.

Structural reforms in the areas of the public administration, education, health, and social security are designed to have a more direct impact on budgetary consolidation. The government is targeting a vast array of measures to address the inefficient use of resources in the public administration, notably a) the setting up of pluri-annual budgetary targets; and b) the freeze in the hiring of new civil servants, combined with the creation of an effective internal labour market. In the education sector, the government envisages to curb excessive spending in those areas where current and prospective demographic trends point to a reduction in demand, in particular for primary and secondary education, while tuition fees for tertiary education are to be increased. In the heath sector, a wide range of measures has either already been adopted or is planned in order to improve the use of resources, *inter alia*, i) a significant number of public hospitals were transformed into publicly owned corporations, with an enhanced degree of entrepreneurial autonomy; ii) the financing of fixed costs was secured by a one-off capital increase in 2002, while medical services will be paid in the future according to a price list established for medical services/techniques; iii) the setting-up of a regulator agency for the health care sector to address, among others, the problem of adverse selection; iv) the implementation of a comprehensive policy as regards the consumption of medicines, involving the promotion of generic drugs, and the setting of ceilings for the reimbursement of drugs, according to reference prices, etc.; and v) the increase of users fees for medical acts. As regards the social security area, the 2003 budget reduced the replacement ratio for early retirement in the government sector, and measures are envisaged to reduce incentives to claim frequent sickness benefits of short duration.

[32] Starting in 2004, the corporate tax rate will be reduced from 30% in 2003 to 20% in 2006.

7 OVERALL ASSESSMENT OF COMPLIANCE WITH THE STABILITY AND GROWTH PACT

The budgetary consolidation effort is markedly front-loaded. In 2003 alone, the underlying budgetary position is required to improve by approximately 2 pp of GDP, which basically reflects the wearing off of the measures with transitory effect adopted in 2002, together with the fact that no new non-recurrent measures are planned for 2003. Furthermore, current unfavourable cyclical conditions may also prevent budgetary execution as planned, possibly requiring the introduction of additional saving measures in order to comply with the actual deficit target. Following 2003, the underlying deficit is expected to improve by about ½% of GDP per year.

Following the budgetary slippage of 2001, the current update of the stability programme projects the pursuit of fiscal adjustment over the next four years but from a starting position considerably worse than in the previous update. The programme foresees a steady improvement in the general government balance, reaching an underlying budgetary position close-to-balance in 2005, and an actual position close-to-balance a year later. The debt-to-GDP ratio is expected to decline by about 6 pp, attaining 52¾% in 2006.

According to Commission services calculations on the sustainability of Portuguese public finance, meeting the updated programme's target of a close-to-balance budgetary position seems to be a necessary step to ensure the sustainability of public finance, which however has to be supplemented by the determined implementation of the structural reforms outlined in the programme update in order to curb the growth dynamics of age-related expenditure. In fact, according to these calculations, it is paramount to achieve a significant reduction in the debt level prior to the effect of ageing on the budgetary position taking hold.

8 Annex 1 – Summary tables from the January 2003 stability programme update

Table 1. Growth and associated factors

	ESA Code	Year 2002	Year 2003	Year 2004	Year 2005	Year 2006
GDP *growth* at *constant* market prices (7+8+9)	B1g	0.7	1.3	2.7	3.1	3.5
GDP *level* at *current* market prices	B1g	129.5	135.0	142.7	151.0	160.3
GDP deflator		4.5	3.0	2.9	2.7	2.6
HICP change		3.5	2.5	2.2	2.2	2.0
Employment growth		0.6	0.0	0.6	1.2	1.7
Labour productivity growth		0.1	1.3	2.1	1.9	1.8
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	P3	0.5	0.2	1.4	2.3	3.0
2. Government consumption expenditure	P3	1.4	-0.5	-0.3	-0.5	-0.7
3. Gross fixed capital formation	P51	-2.1	0.1	6.6	6.4	7.4
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53	0.0	0.0	0.0	0.0	0.0
5. Exports of goods and services	P6	3.2	4.7	7.5	8.7	9.7
6. Imports of goods and services	P7	0.8	0.5	5.9	7.2	9.0
Contribution to GDP growth						
7. Final domestic demand (1+2+3)		0.1	0.0	2.5	3.0	3.6
8. Change in inventories and net acquisition of valuables	P52+P53	0.0	0.0	0.0	0.0	0.0
9. External balance of goods and services (5-6)	B11	0.7	1.2	0.2	0.1	-0.2
Basic assumptions						
Short-term interest rate (annual average)		3.3	2.8	3.2	3.5	3.5
Long-term interest rate (annual average)		5.1	4.9	5.2	5.4	5.6
USD/€exchange rate (annual average)		0.940	0.980	0.970	0.970	0.970
World GDP growth		2.6	3.6	4.0	3.8	3.7
EU-15 GDP growth		1.0	2.0	2.6	2.3	2.3
Growth of relevant foreign markets		-0.1	5.6	6.8	7.0	7.0
World import volumes, excluding EU		3.1	6.6	7.3	7.3	7.3
Oil prices (Brent)		25.5	24.1	22.5	22.3	22.3

Table 2. General government budgetary developments

% of GDP	ESA code	2002	2003	2004	2005	2006
Net lending (B9) by sub-sectors						
1. General government balance	S13	-2.8	-2.4	-1.9	-1.1	-0.5
2. Central government	S1311	-3.4	-3.0	-2.5	-1.9	-1.3
3. Local government	S1313	-0.1	0.0	0.0	0.0	0.0
4. Social security	S1314	0.7	0.5	0.6	0.7	0.9
General government (S13)						
5. Total revenue	ESA	43.7	44.4	43.9	43.6	43.0
6. Total expenditure	ESA	46.6	46.9	45.8	44.7	43.5
7. General government balance	B9	-2.8	-2.4	-1.9	-1.1	-0.5
8. Interest expenditure		3.0	3.3	3.1	3.0	2.9
9. Gen. govern. primary surplus		0.2	0.8	1.2	1.9	2.5
Components of revenues						
10. Taxes	D2+D5	24.5	24.6	24.4	24.4	24.1
11. Social contributions	D61	12.0	12.2	12.2	12.1	12.1
12. Other current resources		7.3	7.5	7.3	7.0	6.8
13. Total revenue	ESA	43.7	44.4	43.9	43.6	43.0
Components of expenditures						
14. Government final consumption expenditure	P3	20.7	19.7	19.3	18.9	18.4
15. Social benefits other than in kind	D62	14.4	14.9	14.9	14.7	14.4
16. Subsidies	D3	1.8	2.0	1.8	1.7	1.6
17. Interest expenditure	D41	3.0	3.3	3.1	3.0	2.9
18. Other current expenditure		3.0	3.2	3.1	2.9	2.7
19. Gross fixed capital formation	P51	3.7	3.8	3.6	3.5	3.4
20. Total expenditure	ESA	46.6	46.9	45.8	44.7	43.5

Table 3. General government debt developments

% of GDP	ESA code	2002	2003	2004	2005	2006
Gross debt level		58.8	58.7	57.5	55.3	52.7
Change in gross debt		3.4	-0.2	-1.2	-2.2	-2.6
Contributions to change in gross debt						
Primary balance		0.2	0.8	1.2	1.9	2.5
Interest and nominal GDP growth		0.2	0.7	-0.1	-0.2	-0.3
Other		3.3*	-0.1	0.1	-0.1	0.1

* of which 1.6% of GDP is due to arrears and 1.4% to net assets acquisitions, including the change of hospitals into corporate entities.

Table 4. Cyclical developments

% of GDP	ESA Code	2002	2003	2004	2005	2006
1. GDP growth at constant prices	B1g	0.7	1.3	2.7	3.1	3.5
2. Net borrowing	B9	-2.8	-2.4	-1.9	-1.1	-0.5
3. Interest payments	D41	3.0	3.3	3.1	3.0	2.9
4. Potential GDP growth[33]		2.5	2.5	2.6	2.7	2.8
5. Output gap[34]		-0.3	-1.5	-1.4	-1.0	-0.3
6. Cyclical budgetary component		-0.1	-0.6	-0.6	-0.4	-0.1
7. Cyclically-adjusted balance (2-6)		-2.8	-1.8	-1.3	-0.7	-0.3
8. Cyclically-adjusted primary balance (7+3)		0.3	1.4	1.7	2.3	2.6

Table 5. Difference from previous update

% of GDP	ESA Code	2002	2003	2004	2005	2006
GDP growth	B1g					
SP December 2001		1.8	2.5	3.0	3.0	--
SP January 2003		0.7	1.3	2.7	3.1	3.5
Difference		-1.0	-1.2	-0.3	0.1	--
General government balance	B9					
SP December 2001		-1.8	-1.0	0.0	0.4	--
SP January 2003		-2.8	-2.4	-1.9	-1.1	-0.5
Difference		-1.0	-1.4	-1.9	-1.5	--
General government gross debt						
SP December 2001		55.7	55.5	54.0	51.9	--
SP January 2003		58.8	58.7	57.5	55.3	52.7
Difference		3.1	3.2	3.5	2.1	--

[33] Trend GDP, % change.
[34] Deviation from GDP trend, % change.

9 Annex 2 - A quantitative assessment of the sustainability of public finances

This is the second assessment of the sustainability of Portuguese public finances as part of the Stability and Growth Pact. The quantitative indicators are similar to those used last year, but have been adjusted in line with the recommendations of the Ageing Working Group of the EPC[35].

The stability programme of Portugal contains a section that assesses the sustainability of public finances and refers to the projections published in the National Report on the Strategy on the Future of Pensions. These projections show an increase in spending under the general and civil servant's scheme of some 2 pp of GDP between 2005 and 2050. While this increase is similar to the 2.4 pp of GDP in the EPC over the same period, there is a large discrepancy in the actual level of public spending on pensions between the two reports, which warrants clarification.

In assessing the sustainability of public finances, the Commission has to draw a balance between using national projections, which may be more comprehensive and up to date, and the need to ensure comparability across countries. The Commission ran the sustainability indicators using the projections for pensions included in the stability programme, but also included the EPC projections for spending on health care.

The table below presents the debt and budget balance developments, according to two different scenarios, a "programme scenario", and a "2002 situation scenario". The "programme scenario" is calculated on the following basis:

- the projections for age-related expenditures come from the EPC report;
- government revenues are held constant at the ratio projected for 2005;
- the starting point for gross debt and the primary surplus are the 2005 levels reported in the programme.

The "2002 situation scenario" is based on the budgetary data for 2002 in the programme. It assumes that no budgetary adjustment occurs during the time frame of the stability programme: in other words the primary balance remains unchanged at its 2002 level until 2006. This allows one to gauge the impact on the sustainability of public finances of the proposed change in the underlying budget position during the programme.

[35] 'How the sustainability of public finances was assessed using the 2001 updates of stability and convergence programmes: recommendations for improvements in future years', Note from the AWG to the EPC, EPC/ECFIN/396-02 of 23 July 2002.

Table 7: Quantitative indicators on the sustainability of public finances

Main assumptions - baseline scenario (as % GDP)	2006	2010	2020	2030	2040	2050	changes
Total age-related spending	16,4	17,1	18,6	19,4	19,8	19,3	2,9
Pensions	11,1	11,8	13,1	13,6	13,8	13,2	2,1
Health care	5,3	5,3	5,5	5,8	6,0	6,1	0,8
Other age related expenditures	0,0	0,0	0,0	0,0	0,0	0,0	0,0
*Total non age-related spending**	24,2						
*Total revenues**	43,0						

* constant

Results (as % GDP)	2006	2010	2020	2030	2040	2050	changes
Programme scenario							
Debt	52,7	46,1	42,1	51,4	74,8	107,3	54,6
Net borrowing	-0,4	-1,0	-2,0	-3,3	-5,0	-6,2	-5,8
2002 situation scenario							
Debt	58,3	60,7	81,3	120,4	187,5	281,2	222,9
Net borrowing	-3,1	-3,9	-6,2	-9,1	-13,1	-17,6	-14,5

Tax gaps	T1*	T2**	T3***
Programme scenario	1,3	1,0	2,0
2002 situation scenario	3,7	3,3	4,3

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 10.2

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

*** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

The table clearly indicates the risk of emerging budget imbalances under both scenarios. However, there is a striking difference in the results between both scenarios, which underlines the imperative of Portugal achieving and sustaining a budget position of close-to-balance or in surplus.