PORTUGAL

STABILITY AND GROWTH PROGRAMME

Update for the period 2005-2007

December • 2004

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I. INTRODUCTION

1 After an economic growth that averaged 4% in the second half of the 90s, GDP began to progressively decelerate, having reached a 1.2% drop in 2003. The building of macroeconomic imbalances during the upturn made it impossible to postpone the adoption of corrective policies to put the economy back on the path of a healthy and sustainable growth. In this context, since 2002, the Government has pursued a fiscal policy aiming at public finances consolidation. At the same time, structural reforms in all key areas were launched to promote productivity, competitiveness and to support medium-term fiscal consolidation.

2 Given that it was impossible to drastically reduce public expenditure, the fiscal policy priority was to immediately slowdown the vigorous growth of outlays that took place during the second half of the 90s. With the deceleration of tax revenues that followed the downturn, one-off measures were necessary in order to keep the deficit below the 3% limit, as required by the Stability and Growth Pact. The underlying strategy foresaw the implementation of structural reforms that would have a lagged effect on expenditure, allowing the future phasing out of one-off measures while still respecting the 3% deficit objective.

3 Carrying out such a strategy necessarily implied bearing short-term costs. In 2004, for the third year in a row, Portugal will grow less than the European Union average. Nevertheless, in the near future the process of catching up with European standards will be resumed, with a more solid economic growth.

4 This update of the Stability and Growth Programme (SGP) is hampered by recent political events. The caretaker government is limited to current management until the next elections are held towards the end of February 2005. Given that Parliament has been dissolved, it is impossible to abide by Law 48/2004, especially Article 58 no. 1 that establishes that "for the assessment of Parliament, the Government submits the annual update of the Stability and Growth Programme, elaborated in accordance with EU regulations".

5 In the context of the previous paragraph, in keeping with Article 99 of the European Union Treaty, the Government submits this update of the Stability and Growth Programme that is confined to the issues approved by Parliament within the framework of the State Budget for 2005 (OE 2005). The section on "Fiscal Policy's Medium-Term Trend" pertaining to the period 2006-2007, along with the estimates for 2004 and the projections for 2005 detailed in the Report of the State Budget for 2005, are the basis for this update of the SGP. However, it is worth mentioning that the present international outlook is more negative than the one included in the macroeconomic scenario of the 2005 Budget and a downward revision of the economic growth would be advisable.

Due to the limitations regarding to the political moment, referred to in point 4, it is not possible to do so.

6 The trajectory for the adjustment of public accounts foresees that in 2007 Portugal will have a General Government budget deficit of 1.8% of GDP, i.e. 1 percentage point below the objective set by the Budget for 2005. The true consolidation effort becomes clearer using the deficit excluding one-off measures that in this period will have to be cut by 2.1 percentage points of GDP.

7 Keeping in mind the present circumstances, in this update of the SGP the Government simply enumerates the policy measures set out for 2005 and already included in the State Budget that was approved by Parliament.

8 Nevertheless, it is worth highlighting that the consolidation of public finances that this document foresees will only be possible if the ongoing structural reforms proceed and are further deepened. Implicitly, additional measures have to be adopted to ensure the long-term sustainability of public finances in the context of an ageing population.

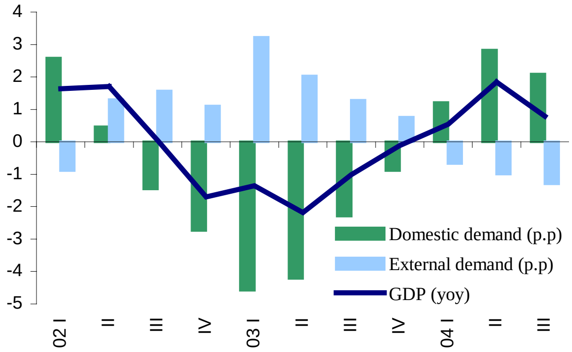
9 This Programme was built with the information available on the 15th December 2004.

II. THE MACROECONOMIC SETTING

RECENT DEVELOPMENTS

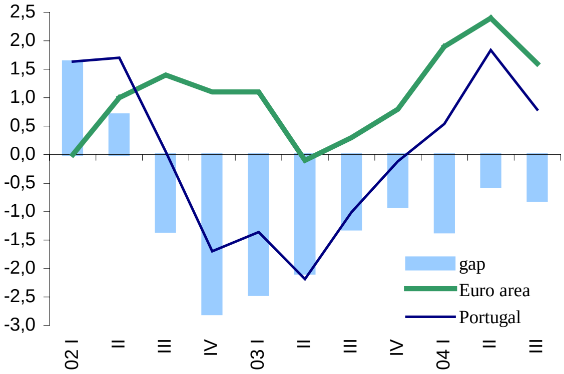
10 Following a 1.2% contraction of GDP in real terms in 2003, in 2004 economic activity began to recover – GDP is estimated to grow by 1%. Domestic demand will be the engine of this recovery, while net external demand will have a negative contribution, thus changing the composition of economic growth observed in the last two years. GDP's rebound, linked to weak employment growth, should translate into an apparent increase in labour productivity. The economic growth differential between Portugal and the Euro Area should narrow from 1.7 percentage points in 2003 to 1 percentage point.

Chart II-1. Contribution to GDP growth
(year on year and percentage points)



Source: INE.

Chart II-2. Gross Domestic Product
Real growth rate (year on year , percentage)

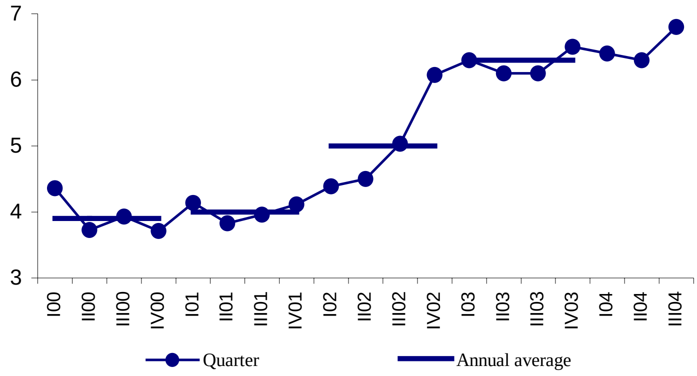


Source: INE and Eurostat.

11 In the first nine months of 2004, **GDP** registered a year-on-year growth rate of 1.1% in real terms, corroborating the annual estimate of 1% and reflecting a strong recovery of domestic demand, most components of which exhibited a favourable behaviour. During this period, **private consumption** registered a growth rate of 2.2% (-0.5% in 2003), in line with improved consumers' expectations, in particular, with respect to developments on the unemployment front, the persistence of low interest rates and more moderate price increases. After two years of contraction, **investment** (GFCF) grew by 1.6% in the first three quarters, benefiting from a dynamic foreign demand, a global improvement of the economic environment and the maintenance of favourable financing conditions. For the whole of 2004, investment is expected to grow faster than GDP, as is usual during upturns, but it will probably not reach the 2.5% annual estimate underlying in the central scenario of the State Budget for 2005. In the first nine months of the year, foreign trade was quite dynamic: **exports** accelerated as a result of favourable developments in external markets, while **imports** rebounded strongly in line with the recovery of domestic demand. A significant increase of imported investment goods and durable consumer goods took place, both kinds of goods having high business-cycle elasticities. These developments led to a negative contribution (-1.1 p.p.) of net exports to the GDP growth (vs. a positive contribution of 1.7 p.p. in 2003), thus worsening the financing requirements of the Portuguese economy that reached -6.2% of GDP in the first three quarters of 2004 (-4.0% in 2003.)

12 Conditions in the **labour market** improved in 2004, in line with the gradual recovery of economic activity, and further progress is expected in 2005. In the first three quarters of 2004, employment remained unchanged vis-à-vis the same period of 2003 (it fell 0.4% in the whole of 2003) and unemployment rose 5.6% (26.5% in the whole of 2003). Recent developments on the unemployment front are in line with the usual lag with respect to the upturn of economic activity. Actually, after rising to 6.3% for the whole of 2003, during the first three quarters of 2004 the unemployment rate reached 6.5%, even with economic activity picking up.

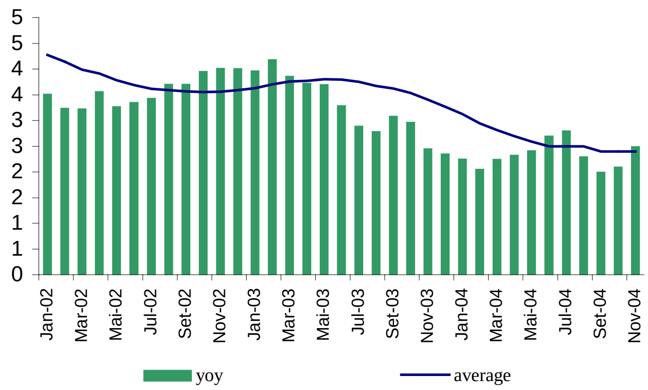
Chart II-3. Unemployment rate
(%)



Source: INE, Quarterly employment survey.

13 The average annual **inflation rate**, measured by the Consumer Price Index (CPI) fell to 2.4% in the first eleven months of 2004 (3.3% in 2003), and the estimate for 2004 (2.4%) that underlies the macroeconomic scenario of the State Budget (OE 2005) is expected to hold. This deceleration of prices is the result of a number of factors, namely the euro’s appreciation and a domestic setting characterized by moderate economic activity and moderate wage growth. Nevertheless, on a year-on-year basis there was some tendency towards acceleration, influenced by the evolution of energy prices.

Chart II-4. Consummer Price Index
(growth rates %)



Source: INE.

MEDIUM-TERM MACROECONOMIC SCENARIO (FROM 2005 TO 2007)

14 The macroeconomic scenario for the Portuguese economy for the period 2005 to 2007 used in this update is the same as the one included in the State Budget for 2005. It was elaborated with the information available until 23 September 2004.

15 Regarding the main assumptions that underlie this scenario, those pertaining to the external setting are:

a) A real growth of GDP in the European Union of 2.3% in 2005 and an annual average of 2.4% over 2006-2007. These figures were, at the time the scenario was elaborated, the most recent projections of international institutions;

b) Based on developments in Portugal's main trading partners, the external demand relevant to the Portuguese economy was projected to grow at 6.9% in 2005, 7.3% in 2006 and 6.8% in 2007;

c) The projection of crude oil price was based on the trajectory that was implicit in the futures market at the beginning of September and that pointed to average prices of USD 38.70 and USD 35 per barrel of Brent in 2005 and in 2006-2007, respectively.

16 Under these assumptions, GDP growth is expected to accelerate to 2.4% in 2005 and to 2.8% in 2007.

Table II-1. Macroeconomic Scenario

	2003	2004	2005	2006	2007
GDP, real growth rate (%) (7+8+9)	-1,2	1,0	2,4	2,7	2,8
GDP current prices(billion euros)	130,0	134,0	140,4	147,5	154,9
GDP deflator (growth rate, %)	2,3	2,0	2,3	2,3	2,2
HICP (growth rate, %)	3,3	2,4	2,0	2,0	2,0
Employement (growth rate, %)	-0,4	0,3	1,2	1,6	1,5
Labour Productivity (growth rate, %)	-0,9	0,7	1,2	1,1	1,2
Real growth rates (%)					
1. Private consumption expenditure	-0,5	1,8	2,3	2,5	2,7
2. Government consumption	-0,4	0,3	0,0	0,2	0,2
3. Gross fixed capital formation	-9,8	2,5	5,2	6,2	6,5
4. Change in inventories and net aquisition of valuables (% of GDP)	0,0	0,1	0,0	0,0	0,0
5. Exports of goods and services	4,0	5,9	6,2	6,4	6,4
6. Imports of goods and services	-0,9	7,0	5,6	6,1	6,5
Contribution to GDP growth					
7. Domestic demand (1+2+3)	-2,8	1,8	2,6	3,0	3,3
8. Change in inventories and net aquisition of valuables (=4)	0,0	0,1	0,0	0,0	0,0
9. External balance of goods and services	1,6	-0,8	-0,2	-0,3	-0,5

Source: Ministry of Finance and Public Administration.

17 This update of the SGP should consider the European Commission's autumn 2004 forecasts that foresee a higher crude oil price than the used in this scenario (USD 45.10 per barrel in 2005 and USD 40.10 per barrel in 2006). On the other hand, using the Commission's current forecasts for the volume of imported goods by Portugal's main trading partners would yield a lower growth rate of external demand relevant for the Portuguese economy (6.8% in 2005 and 6.7% in 2006). As such, the external setting for 2005 and 2006 is more pessimistic than the one assumed in this SGP update, and a downwards revision of the GDP growth rate would be probably advisable.

18 GDP's trend is slightly more favourable than what is expected for the EU as a whole, meaning that Portugal's catching-up process is expected to resume in 2005.

19 **Private consumption** is expected to accelerate, reflecting an improvement in households' real disposable income, in a context of low interest rates and a more positive outlook for the labour market. **Private investment** is foreseen to accelerate over the projection period, in line with firms' looser financial restrictions and an improved economic environment. The projected evolution for the **export** of goods is close to the growth assumed for the external demand that is relevant for the Portuguese economy.

20 Towards the end of the projection horizon GDP is expected to return to a growth rate near the potential. The GDP gap remains negative throughout the projection period, although it progressively narrows. This assumption, along with the wage moderation assumption and the restrained increase in the price of imported goods (taking into account the assumptions on exchange rates and international commodities' prices) are the main determinants of the **inflation rate** that is expected to remain close to 2% over 2005-2007.

21 The recovery would allow an average increase of 1.7% in employment over 2005-2007. The **unemployment rate** would return then, to its natural level (currently estimated at slightly above 5%), averaging 5.4% over that period.

III. PUBLIC FINANCES

DEVELOPMENTS IN 2004

22 In 2004, the fiscal burden, net of one-off measures, is expected to increase by 1.0% of GDP. The growth of fiscal revenue, in particular State revenue, will accelerate compared to 2003, as direct taxation grew by 6.3% and indirect taxation by 5.3% in the first eleven months of the year[1]. The growth of 2.3% of social security contributions is a result of both moderate wage increases and the lagged response of the labour market to the recovery of the economy.

23 Total revenue increases only 0.2% of GDP in 2004. However, excluding the effect of one-off measures, the rate of increase is around 1,5%. of GDP. To a large extent this is due to favourable developments in fiscal revenue, reflecting improvements in economic activity.

Table III-1. General Government Revenues (1995-2004)

	1995	2000	2001	2002	2003e	2004p
Growth rates (%)						
Total Revenue		6,6	5,1	8,1	5,4	3,5
Current Revenue		7,5	4,2	8,1	2,9	2,7
Taxes on production and imports		4,3	4,3	10,5	5,7	0,3
Taxes on income and wealth		13,2	0,9	3,6	-3,5	0,4
Social Security contributions		10,9	7,8	7,2	6,2	3,1
Other current revenue		-2,4	2,2	13,6	-1,3	14,7
Capital transfers		-13,8	31,6	7,3	60,5	16,1
Memo items:						
Total Revenue excluding one-off measures		6,6	5,1	5,8	1,6	6,7
Percentage of GDP						
Total Revenue	39,6	42,3	41,9	43,2	45,0	45,2
Current Revenue	37,7	40,8	40,1	41,4	42,1	41,9
Taxes on production and imports	13,6	14,4	14,2	15,0	15,6	15,2
Taxes on income and wealth	8,9	10,4	9,9	9,8	9,3	9,1
Social Security contributions	11,0	11,8	12,0	12,2	12,8	12,8
Other current revenue	4,3	4,2	4,1	4,4	4,3	4,8
Capital transfers	1,9	1,4	1,8	1,8	2,9	3,3
Memo items:						
Total Revenue excluding one-off measures	39,6	42,3	41,9	42,3	42,5	44,0
Fiscal burden excluding one-off measures	32,6	35,8	35,2	35,3	35,3	36,2

e- Estimate; p- Forecast

[1] This growth path doesn't reflect the tax debt securitisation done in 2003. The Table III-1 has values that consider the effect of this operation.

24 Fiscal consolidation is noticeable in the deceleration of current primary expenditure growth from 7,7% in 2002, to 4,8% in 2004 and in public consumption, whose rate of growth declined from 6% in 2002, to 1,8% in 2004.

25 Social expenditures kept growing at a quick pace in 2004. In the period from January to October unemployment subsidy payments rose 12.5%, while the growth in general social security system pensions amounted to 9%, driven in particular by old age pensions, which increased by 10,4%. Civil servants' social security related payments also recorded sharp increases, with payments and transfers by the State rising 11.4% on a year-on-year basis. These developments in social expenditures increased current primary expenditure by 6 p.p. of GDP in 2004. However, in 2004, the share of current primary expenditure adjusted for social expenditures remains at the same level than in 2003 - 23,1% of GDP.

26 The near freezing of public sector wages, together with a strong restraint in new admissions into civil service and in promotions, kept the growth of the wage bill at 0,4%, until November. General Government total compensation of employees is forecasted to grow by no more than 1,9% in 2004, configuring a consecutive three year decline of its share in GDP, which now stands at 14,9%, against 15,4% in 2002.

27 In 2004, capital expenditure should decline by 0.5 p.p. of GDP. However, if corrected from the effect due to real state selling, it would grow by 0,3 p.p. of the GDP. Therefore, overall expenditure, excluding one-off measures, should grow by 1,0 p.p. of GDP.

28 Given that the share of interest payments in GDP will remain at the same level of 2003, primary expenditure will follow the same pattern as total expenditure, i.e, a worsening of 0.2 p.p. of GDP.

Table III-2. General Government Expenditure (1995-2004)

	1995	2000	2001	2002	2003e	2004p	Change in 2004
Growth rates (%)							
Current expenditure		9,2	7,9	7,1	4,7	4,7	
Intermediate consumption		13,0	4,5	3,6	-11,0	3,5	
Compensation of employees		11,0	6,8	6,9	-1,0	1,9	
Social Transfers		10,4	9,2	9,0	15,8	6,7	
Interest		7,8	5,1	-0,3	-4,2	4,6	
Subsidies		-32,0	28,0	18,7	5,5	25,5	
Other		16,9	9,0	7,4	9,4	-1,4	
Capital expenditure		-10,0	15,9	-19,8	12,2	-7,6	
GFCF		-0,8	10,0	-13,2	1,8	-18,9	
Other		-31,1	35,6	-37,5	51,1	21,0	
Total Expenditure		6,7	8,8	3,9	5,4	3,5	
Memo items:							
Current primary expenditure		9,4	8,2	7,7	5,4	4,8	
Current primary expenditure excluding social transfers		8,8	7,6	7,0	-1,3	3,3	
Primary expenditure		6,6	9,1	4,2	6,0	3,5	
Percentage of GDP							
Current expenditure	39,8	40,2	40,9	41,7	43,2	43,9	0,7
Intermediate consumption	3,7	4,4	4,3	4,3	3,8	3,8	0,0
Compensation of employees	13,6	15,0	15,1	15,4	15,1	14,9	-0,2
Social Transfers	13,2	14,0	14,5	15,0	17,2	17,8	0,6
Interest	6,3	3,3	3,2	3,1	2,9	2,9	0,0
Subsidies	1,3	1,1	1,3	1,5	1,5	1,9	0,3
Other	1,6	2,4	2,5	2,5	2,7	2,6	-0,1
Capital expenditure	5,3	5,0	5,5	4,2	4,6	4,2	-0,5
GFCF	3,7	3,8	4,0	3,3	3,3	2,6	-0,7
Other	1,5	1,2	1,5	0,9	1,3	1,5	0,2
Total Expenditure	45,0	45,2	46,3	45,9	47,8	48,0	0,2
Memo items:							
Current primary expenditure	33,5	36,9	37,7	38,7	40,3	40,9	0,7
Current primary expenditure excluding social transfers	20,3	22,9	23,2	23,6	23,1	23,1	0,1
Primary expenditure	38,8	41,9	43,1	42,8	44,9	45,1	0,2

e- Estimate; p- Forecast

29 The General Government deficit in 2004 is forecasted at 2.9% of GDP, which compares with 2,8%in the year before. To reach this target, the Government will have to resort to one-off measures amounting to 2% of GDP, 0,5 p.p. less than in 2003. Among these measures, several of which are still under preparation while others are already concluded, it is worth mentioning the transfer of pension funds from a number of institutions to the Caixa Geral de Aposentações in an amount of 1980 million euros. Furthermore, the sale of real

estate is under preparation and is expected to be complete by the end of the year.

Table III-3. Overall and Primary Balance (1995-2004)

	1995	2000	2001	2002	2003e	2004p
Percentagem do PIB						
Overall balance	-5,5	-2,8	-4,4	-2,7	-2,8	-2,9
Primary balance	0,8	0,4	-1,2	0,3	0,1	0,1
Overall balance excluding one-off measures	-5,5	-3,2	-4,4	-4,1	-5,4	-4,8

e- Estimate; p- Forecast

30 The primary balance remains at the same level as in the previous year. Nevertheless, progress in fiscal consolidation in 2004 is manifest in the reduction of the overall deficit, adjusted for one-off measures, by a magnitude of 0,6 p.p.

31 A range of measures adopted from 2002 onwards has supported this progress in consolidation in 2004. New hiring into civil service remained closed, the freeze in wages over 1000 euros was maintained and restructuring and promotions were kept on hold. Employment in Central Government is expected to decline in 2004, for the second consecutive year. During the first ten months of this year, the decline in Central Administration employment was of 1500 persons, while in 2003 the reduction was of about 5 600.

32 Structural reforms proceed during 2004. New rules for retirement in the civil service came into force in 2004 aimed at progressively aligning the social security regime of civil servants with that of the general social security system. The new Labour Code was enacted and reforms were carried out to simplify administrative procedure and to improve the business environment. In the health sector, the market share of generic drugs increased, allowing for savings both for households and the State Budget, while corporatized hospitals managed to keep expenditure under control. In the education sector, reference should be made to the entry into force of the new curriculum for secondary education. Furthermore, indicators concerning progress towards the knowledge society recorded a markedly favourable trend.

THE STATE BUDGET FOR 2005 AND THE MEDIUM TERM PATH OF PUBLIC FINANCES

THE STATE BUDGET FOR 2005

33 The State Budget for 2005 seeks to reconcile further progress on the fiscal consolidation path with an economic environment that supports growth and enhances the competitiveness of the Portuguese economy, bearing in mind the increased uncertainties of the international setting.

34 The 2005 Budget reflects the impact of the decrease in the tax rate upon firm's profits (IRC), from 30% to 25%, decided upon in 2003. This fall should impact positively upon private investment. Furthermore, a significant increase in capital expenditure by the public sector is foreseen, which is reflected in the worsening of the capital deficit, adjusted for one-off measures.

Table III-4. General Government Account (2004-2005)

Percentage of GDP	2004	2005	Change in pp. of GDP
Current Revenue	41,9	41,7	-0,25
Taxes on production and imports	15,2	15,5	0,26
Taxes on income and wealth	9,1	8,6	-0,46
Social Security contributions	12,8	12,7	-0,13
Other current revenue	4,8	4,9	0,07
Current Expenditure	43,9	42,5	-1,34
Intermediate consumption	3,8	3,6	-0,17
Compensation of employees	14,9	14,4	-0,45
Social Transfers	17,8	17,4	-0,35
Interest	2,9	2,9	-0,02
Subsidies	1,9	1,4	-0,46
Other	2,6	2,7	0,11
Gross saving	-2,0	-0,9	1,10
Capital Transfers	3,3	2,2	-1,06
Total Revenue	45,2	43,9	-1,26
Capital Expenditure	4,2	4,2	0,06
GFCF	2,6	2,8	0,15
Other	1,5	1,5	-0,09
Total Expenditure	48,0	46,8	-1,29
Overall Balance(-)	-2,9	-2,8	0,03
Memo:			
Fiscal burden	36,2	36,1	-0,18
Public consumption	21,1	20,3	-0,83

35 In 2005, current revenue is expected to resume the rate of growth recorded in 2001, as a result of an increase in tax revenue of a magnitude of 3.9%, led by economic growth, as well as by a number of discretionary measures whose effect will partly be offset by the decline in corporate tax income (-14.1%). Other tax income is foreseen to grow quicker than nominal GDP, with the exception of revenue generated by the tax on vehicles.

36 The target embodied in the 2005 State Budget foresees a cut of 1.3% of GDP in current expenditure, resulting from cuts in all expenditure items, with the exception of other current expenditures. Further implementation of a policy aiming at reducing employment in the civil service, together with keeping on hold the restructuring of careers, will more than offset the increase in

expenditure coming from the moderate rise in wages, warranted by the present fiscal situation. On the other hand, the change in the financing method[2] of the old age pension scheme for civil servants will reduce the share of civil servants wage cost in the GDP. Social payments out of social security funds are expected to decelerate from a growth rate of 8,2% in 2004, to 6,4% in 2005, due mainly to:

- the erasing of the effect of the surge in the old age reforms of civil servants occurred in 2003, before the increase in the minimal age needed to require old age reform;
- the revision of the early retirement pension regime, which introduces a heavier penalty for early retirement;
- the change in sickness allowances regime – the short duration sickness allowances, which constitute 80% of the overall sickness allowances, are penalised;
- the change in unemployment allowance with a shortening of the time length of the coverage;

Social payments by the Central Administration are foreseen to decline by about 11%, reflecting both a reduction in payments in kind entailed by a change in co-payments by the State of medical care and by a foreseen increase in efficiency of the corporatized Hospitals functioning with new management rules. Subventions will decline by 0,5% of GDP, meaning the same weight in GDP as in 2003.

37 The weight of capital expenditure in GDP will remain at the same level as in 2004. Therefore, total expenditure is expected to decline in 2005 by 1.3 p.p. of GDP.

38 The overall balance is forecasted at 2.8% of GDP, slightly below the value recorded in 2004. Less reliance is however put on one-off measures, as these are expected to decline to 1.4% of GDP, when compared to 2% in 2004

39 In short, the fiscal consolidation path is supported by a moderate growth in current primary expenditure, which translates into an improvement of the underlying current primary balance of about 0.5 p.p. of GDP. The improvement in the underlying primary balance is somewhat less significant, 0.3 p.p. of GDP, due to the development in the capital balance. Deceleration forecasted for 2005 comes, to a major extent, from expenditure items under public consumption, in particular the compensation of employees, purchases of goods and services and transfers in kind to households.

[2] This change consists in setting an employers' contribution rate (at first using as reference the rate that applies to private sector earnings) to be paid by all entities (including services of the State) whose employees subscribe to CGA (the old age pension scheme of civil servants). Only these contributions will be registered as personnel expenditure. The additional expenditure aimed at assuring the system's financial balance will be a capital transfer borne by the State. The CGA financing will become more transparent with the splitting of what effectively consists personnel expenditure from what is the system deficit, which will appear as a capital transfer.

40 The 2005 State Budget encompasses a range of measures, of which the following are highlighted:

a) Revision of tax benefits and exemptions, in particular related to the corporate tax and to property trade, aimed at widening the tax base and reducing tax expenditure. Implementation of a rule according to which tax payments adjusted for tax benefits shall not be less than 60% of tax payments due in the absence of these tax benefits. Increase from 80% to 85%, of the minimum taxable profit generated by operations carried out outside offshore.
b) Extension of the regime of tax incentives for the development of hinterland areas, through the reduction of the corporate tax to 20% or to 15% in the case of the setting up of new enterprises;
c) Revision of the personal income tax, eliminating tax benefits and providing a differentiated adjustment in income tax brackets in order to favour low income groups;
d) Continue the fight against tax fraud and evasion by further relying on electronic tax administration, on the cross-checking of different sources of information and by carrying out tax-related investigations based on fraud risk assessments;
e) Further carry out structural reforms in health, education and in the social security system, in order to keep public expenditure under control and to achieve long-term fiscal sustainability;
f) Go ahead with public administration reform to enhance efficiency and productivity;
g) Ensure fiscal solidarity between different levels of General Government in fiscal consolidation efforts, i.e., budgets should be in balance or in surplus;
h) Enhance the quality of public investment;
i) As a rule, reduce operating expenditures by 15% vis-à-vis the previous year;
j) To allow for a significant margin in the budget to address slippage risks in the implementation of the budget, by means of freezing, as a rule, 15% of operating expenditure and 21.4% of investment expenditure financed out of domestic sources.

MEDIUM-TERM TREND OF PUBLIC FINANCES

41 The medium-term path assumed in the 2005 budget is supported by a conservative financial programme, which assumes maintaining fiscal consolidation. The sustained implementation of structural reforms is a fundamental piece of the Government strategy that aims at efficiency gains in the allocation of public resources. The final objective goes beyond reducing public expenditure. It aims at improving the quality of Government expenditure, ensuring that the resources are allocated to the strategic areas that most benefit the sustained growth of the country.

42 In broad terms, the policy options underlying this strategy aim to enhance economic growth through means other than the expansion of government consumption. The public administration reform aims at, simultaneously, improving the quality of the services offered to citizens and, through a better rationalization of public resources, to significantly increase the public administration productivity.

43 In the scenario adopted, the GDP real growth should accelerate in a sustained way, from 2.4% in 2004 to 2.9% in 2007. The output gap, expected to peak in 2004, is foreseen to close towards the end of the relevant period, 2008, when GDP should be near its potential.

44 The medium-term financial programme foresees a sustained decrease in the public administration's deficit, from 2.9% of the GDP in 2004 to 1.8% in 2007. The cyclically corrected deficit will remain at 1.3% of the GDP through the relevant period, although relying less and less on one-off measures. The budget consolidation path results obvious from the primary balance evolution, which starting from a value representing 0.1% of the GDP in 2004 will end, in 2007, as a primary surplus of 1.3% of GDP.

Table III-5**. General Government Account (2004-2007)**

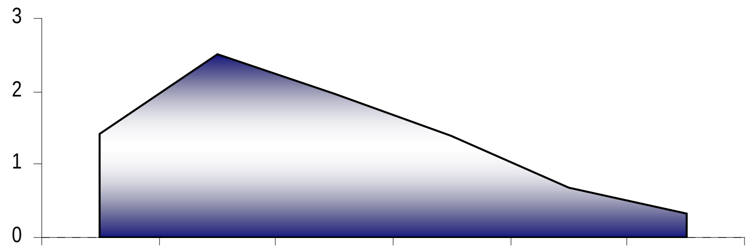
Percentage of GDP	2003	2004e	2005p	2006p	2007p
Overall Balance of Public Administration by subsectors					
General Government	-2,8	-2,9	-2,8	-2,5	-1,8
Central Government	-2,6	-3,0	-2,8	-2,5	-2,0
Local and Regional Administration	-0,3	0,0	-0,1	0,0	0,0
Social Security Funds	0,0	0,1	0,0	0,0	0,1
General Government					
Total revenue	45,0	45,2	43,9	43,3	42,8
Total expenditure	47,8	48,0	46,8	45,8	44,6
Overall Balance	-2,8	-2,9	-2,8	-2,5	-1,8
Interests	2,9	2,9	2,9	3,0	3,1
Primary balance	0,1	0,1	0,1	0,6	1,3
Revenue Components					
Taxes	25,0	24,3	24,1	23,8	23,7
Social contributions	12,8	12,8	12,7	12,7	12,8
Other	7,2	8,0	7,1	6,8	6,3
Total revenue	45,0	45,2	43,9	43,3	42,8
Expenditure Components					
Public consumption	21,4	21,1	20,3	19,6	18,9
Social transfers other than in kind	14,1	14,7	14,8	14,7	14,6
Interests	2,9	2,9	2,9	3,0	3,1
Subsidies	1,5	1,9	1,4	1,3	1,2
Gross fixed capital formation	3,3	2,6	2,8	2,6	2,5
Other	4,6	4,8	4,6	4,7	4,3
Total expenditure	47,8	48,0	46,8	45,8	44,6

e- Estimate; p- Forecast

45 As stated above, a budget consolidation rooted essentially in the expenditure side, as shown in the Table III.5, supposes both the deepening of structural reform and the carrying out of new measures, related namely with the sustainability of social system schemes.

46 The numbers mentioned in the above paragraphs do not give a complete understanding of the consolidation effort needed to fulfil the announced budgetary aims. In the descending phase of the economic cycle the Government was compelled to make use of a heavy amount of one-off measures in order to keep the deficit under the 3% threshold set by the Stability and Growth Pact. The budget consolidation path foreseen in this Programme assumes a sustained reduction in the importance of these measures, as can be seen in the graph below.

Chart III-1. One-off measures
(% of GDP)



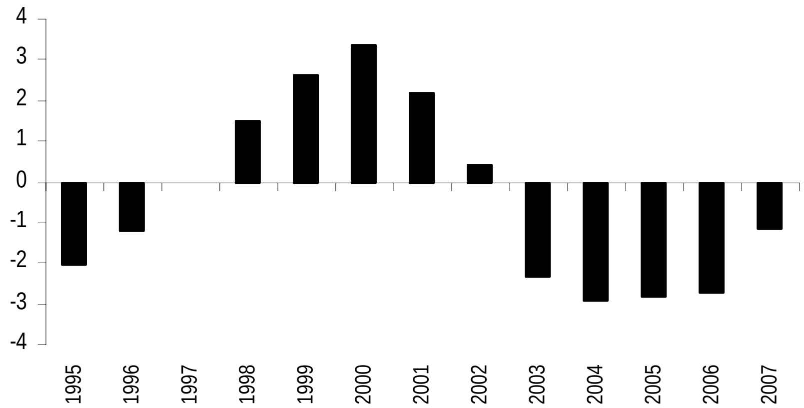
2002	2003	2004	2005	2006	2007
1,4	2,5	2,0	1,4	0,7	0,3

47 When excluding one-off measures from the global public administration deficit, the required consolidation effort becomes clearer. From 2004 to 2007 the deficit should contract from 4.9% to 2.1% of GDP – a reduction of 2.8 percentage points of GDP in three years. Certainly, the rebound of economic activity will generate a decrease of expenditures with unemployment benefits and an increase of the tax revenues. Notwithstanding, the exclusion of one-off measures from our computations shows a primary balance evolving from a deficit of 1.9% of GDP in 2004 to a surplus of 1% in 2007. In 2005 the primary deficit without one-off measures will register an improvement amounting to 0.6% of GDP.

CYCLICALLY-ADJUSTED BUDGET BALANCES

48 After a five-year period when economic growth was above the potential, in 2002 the output gap closed, turning negative and widening in the years that followed. This movement is only expected to reverse from 2007 onwards.

Chart III-2. Output gap (*)
(Gap between actual and potential GDP as a percentage of potential GDP)



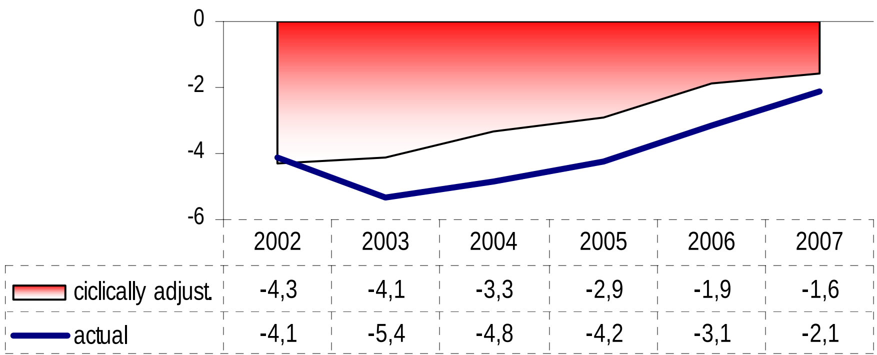
* Using the Production function methodology

49 The cyclical component of the budget balance became negative in 2003 and it is expected to remain negative until the end of the relevant period. The underlying deficit (without one-off measures and corrected of the business cycle) is foreseen to evolve from 3.3% of the GDP in 2004 to 1.6% in 2007.

Table III-6. Cyclical Developments

Percentage of GDP	2004	2005	2006	2007
GDP real growth rate	1,0	2,4	2,7	2,8
Overall balance	-2,9	-2,8	-2,5	-1,8
Interests	2,9	2,9	3,0	3,1
Potential output real growth rate	1,9	2,0	2,0	1,8
Output gap	-2,9	-2,8	-2,7	-1,2
Cyclical budgetary component	-1,5	-1,3	-1,3	-0,5
Cyclically-adjusted overall balance	-1,4	-1,5	-1,2	-1,3
Cyclically-adjusted primary balance	1,6	1,4	1,8	1,8

Chart III-3. Overall Balance excluding one-off measures



DEBT DEVELOPMENTS

50 In 2004 the debt ratio will increase by 1.7 percentage points of the GDP. This increase is the result of three effects – the usual budget deficit, an increase in financing needs resulting from a debt regularization foreseen in the 2004 supplementary budget and an increase in assets resulting from the absorption, by the Civil Servants Pension Scheme (CGA), of pension funds owned by some State owned enterprises (one of the one-off operations executed in 2004).

Table III-7. General Government Debt

Percentage of GDP	2004	2005	2006	2007
General Government gross debt	62,0	63,1	62,7	61,4
Change in gross debt	1,7	1,1	-0,4	-1,3
Contributions to gross debt change				
Primary balance	-0,1	-0,1	-0,6	-1,3
Interest and GDP	1,1	0,0	0,0	0,1
Other factors	0,7	1,2 (*)	0,2	-0,1

(*) Includes 1,1% of GDP increase in assets regarding the creation of new corporate hospitals.

COMPARISON WITH PREVIOUS UPDATE

51 The gap between present and previous forecasts is constrained by two factors – lower growth and the phasing out of one-off measures, profiting from both the effects of the economic rebound and the expected results from the structural reforms being implemented. Therefore, the budget consolidation effort is more important than it seems, implying a reduction in the underlying deficit of 2.7 percentage points of GDP between 2004 and 2007.

Table III-8. Divergence from the previous update

	2004	2005	2006	2007
GDP real growth rate				
SGP 2004	1,0	2,5	2,8	3,0
SGP 2005	1,0	2,4	2,7	2,8
Difference	0,0	-0,1	-0,1	-0,2
Overall balance % of GDP				
SGP 2004	-2,8	-2,2	-1,6	-1,1
SGP 2005	-2,9	-2,8	-2,5	-1,8
Difference	-0,1	-0,6	-0,9	-0,7
Gross debt % of GDP				
SGP 2004	60,0	59,7	58,6	57,0
SGP 2005	62,0	63,1	62,7	61,4
Difference	2,0	3,4	4,1	4,4

IV. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

52 The analysis of the long-term sustainability of public finances is rooted in two scenarios that differ in the growth rate, from 2008 onwards, of public outlays expenditures unrelated to population ageing. With existing studies as a basis, using constant prices, the present value of the revenues and primary expenditures was computed. The macroeconomic scenario assumes the medium-term scenario of this Programme (ending in 2007), a GDP growth rate averaging 2.5% between 2008 and 2015, and a deceleration of this growth rate (on a linear basis) until 2050, when the GDP growth rate is assumed to be

0.75%. It is assumed that population ageing impacts negatively upon the potential growth and that business cycles are inexistent. Remaining assumptions refer to inflation (2% in the forecasting period), the implicit interest rate in servicing the debt (assumed as constant and identical to its present level, 5.4%) and to the inter-temporal discount rate (3.3%). The following table summarises the results for the public debt, budget balance and primary balance, as a percentage of GDP.

Table IV-1. Long-term Sustainability of Public Finances

(percentage of GDP)	**2010**	**2025**	**2050**
Scenario 1: Non- ageing related primary expenditure grows at the same real rate than GDP			
General government gross debt	56,5	68,7	178,5
Overall Balance	-1,9	-4,6	-11,9
Primary Balance	1,0	-1,1	-2,9
Change in percentage points of GDP			
Total Primary Expenditure	-0,7	1,5	3,4
Non-ageing related primary expenditure	-1,3	-1,3	-1,3
Ageing related primary expenditure	0,6	2,8	4,7
Social security pensions	0,4	1,7	3,1
Public servants pensions	0,3	1,1	0,8
Health	0,2	0,8	1,8
Unemployment subsidies	-0,1	-0,3	-0,6
Education	-0,2	-0,5	-0,4
Scenario 2: Non- ageing related primary expenditure grows at an average real rate of 1.3% until 2045 and afterwards at the same rate as GDP			
Overall balance	-1,2	0,4	1,2
Primary balance	1,7	2,2	1,0
Change in percentage points of GDP			
Total Primary Expenditure	-1,4	-1,7	-0,5
Non-ageing related primary expenditure	-2,0	-4,5	-5,2
Ageing related primary expenditure	0,6	2,8	4,7

53 The first scenario assumes that primary expenditure not related with ageing grows at the same rate as GDP after 2008. In this scenario public debt reaches 178.5% of GDP in 2050, while the deficit reaches 11.9% in the same year. The primary deficit represents, in 2050, 2.9% of GDP meaning that interest payments absorb 7 percent of GDP. The primary deficit is determined by the evolution of the ageing-related expenditures, which, in 2050, are expected to absorb an additional 4.7% of GDP than in 2005. Old age pensions are expected to increase, as a percentage of GDP, by 3.1 percentage points in the general protection scheme and by 0.8 percentage points in the civil servants pension scheme. Health-related expenditures are expected to increase by 1.8 percentage

points of GDP. Savings with unemployment benefits and education will not exceed 1 percent of GDP.

54 In the second scenario the primary expenditure not related with ageing grows at a rate that closes the sustainability gap found in the first scenario. The conclusion drawn from this exercise is that the sustainability gap will be eliminated if the primary expenditure not related with ageing is restricted to grow at most 1.3% a year until 2045. From 2045 to 2050 the sustainability gap would remain closed if non-ageing related expenditure grow in line with GDP.