



Portuguese Republic

Stability and Growth Programme 2005-2009

December 2005 Update

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1. Executive Summary

This document forms part of the Portuguese State's obligations to the European Union, in particular in relation to the Stability and Growth Pact. It entails the update of the Stability and Growth Programme (SGP) that Portugal submitted in June 2005, following the formation of the Government resulting from the general election in February 2005.

This update of the SGP, just like the version of last June, forms part of the Government's strategy to firmly tackle the country's problems – which, besides being due to the economic climate, are also structural in nature. Portugal is faced with a particularly delicate economic situation, requiring reforms that, besides creating a macroeconomic environment with firmer foundations, shall stimulate initiative and entrepreneurship, scientific and technological development, and innovation and modernisation. The Government views these reforms with courage and determination, but they require that companies and the general public adopt a similar stance, otherwise economic and social development may be jeopardised (probably for more than one generation).

Thus, in addition to complying with the obligations to the European Union, this update integrates a series of documents that seek to convey the Government's strategy for economic growth – with particular emphasis on the Technological Plan (PT) and the National Action Programme for Growth and Jobs (PNACE), which advances, within the European Union, the implementation of the Lisbon Strategy¹. Given that Portugal is under an ongoing Excessive Deficit Procedure (EDP) of the Stability and Growth Pact, the SGP focuses, in particular, on the budgetary consolidation process presently underway².

The Government views the sustainability of public finances as a pre-requisite for sustained economic growth, which, in turn, is an essential factor in the pursuit of economic development and social cohesion policies. In this vein, budgetary consolidation is, in a particularly focused manner in 2006, at the centre of the immediate objectives of budgetary policy. Consequently, the groundwork relative to the majority of the measures that comprise the consolidation process was performed and/or initiated in 2005. Of note amongst the many measures already implemented is the increase in the retirement age of civil servants from 60 to 65 years of age, the abolition of special, excessively favourable retirement and social welfare schemes, the suspension of automatic career progression mechanisms existing in the civil service and the launch of an ambitious Restructuring Programme for the State's Central Administration (PRACE), which is presently in the analysis phase and is set to commence implementation in the second half of 2006. Legislation that has already been approved, often with the explicit opposition of professional, economic and regional interest groups, as well as the advance of work relative to the drafting of legislation of a more structural nature, unquestionably prove that this

¹ cf. www.governo.gov.pt

² cf. the decision taken in Council of Ministers on 2 June 2005 (www.governo.gov.pt).

Government does not disown the responsibility that it undertook, before the Portuguese people, relative to the disturbing situation of public finances. In other words, the measures already taken and those included in the 2006 State Budget (recently passed in the Portuguese Parliament) are the best guarantee of credibility of the multi-year budgetary consolidation process.

In spite of the present economic climate and the immediate outlook indicating a very fragile recovery of economic activity, structural budgetary consolidation is clearly strengthened in this updated SGP. The Government now undertakes to further intensify the structural reduction of public spending, so as to honour the budgetary consolidation commitments, which are:

- (i) The achievement of the objective of a 6.0% deficit of GDP in 2005 (base 2000 figures) through the implementation of a series of measures specified in the 2005 Supplementary State Budget, acting on revenue and public spending, without needing to generate one-off revenue;
- (ii) The gradual reduction of the nominal deficit ratio until it achieves a value below 3% in 2008; this reduction maintains exactly the same format as that specified in June 2005 – a reduction of 1.4 percentage points in 2006, 0.9 p.p. in 2007 and 1.1 p.p. in 2008;
- (iii) Budgetary consolidation based on measures that are structural in nature, as opposed to employing one-off measures providing a transitory impact; the commitment made to European partners, embodied in the recommendations of the Council of the European Union, of September 2005, in the context of the EDP, is wholly honoured, given that it is forecasted that the measures shall lead to reductions of 1.60, 0.78 and 0.73 percentage points of the share of the structural deficit in GDP (i.e. the ratio of the deficit, net of cyclical effects and one-off measures, relative to GDP), in 2006, 2007 and 2008 respectively³.
- (iv) The continuation, at a rate of no less than 0.5 p.p. per year, of reductions to the deficit in 2009 and following years until a balance of at least -0.5% of GDP is attained, which is, in view of Portugal's needs for economic growth and the restrictions imposed by the trends of public debt, the Medium-Term Objective (MTO) that the Portuguese Government has committed itself to in the context of the Stability and Growth Pact.
- (v) After an immediate initial effort, inevitably through boosting tax revenue, budgetary consolidation shall be distinctly implemented along the lines of reducing current primary expenditure and, consequently, the State's share in the economy; further proof of this course of action is that the additional effort presently required given the current outlook for economic growth shall be directed at current expenditure and not public investment nor revenue.

³ Recommendation of the ECOFIN Council of 5-6 September (www.europa.eu.int), recommending that the Portuguese authorities reduce the budget deficit in a sustained and credible manner to below 3% of GDP by 2008, by preferring the implementation of medium-term measures, thereby excluding one-off or temporary measures.

This update of the SGP contains, for the first time, an analysis of the long-term sustainability of public finances, based on the methods recommended by the Code of Conduct of the SGP and on the Report on Social Security Sustainability attached to the 2006 State Budget Report. That analysis indicates, without a doubt, the sustainability problems that public policies in Portugal face regarding Social Security and healthcare support for the elderly, in line with most of the country's European partners. The main cause lies in the unfavourable population trends, which have been confirmed through demographical figures and forecasts. Even though the Government is already drafting a number of measures to tackle the problem of long-term non-sustainability, not all of the necessary conditions are yet in place to permit the immediate implementation of more in-depth structural reforms in this field. However, the Government is not willing to compromise inter-generational solidarity, which is the reason why it is committed to preparing these reforms forthwith, during 2006, with the necessary endeavour of all Portuguese citizens of all generations.

The fiscal consolidation outlined in this Stability and Growth Programme shall create a framework of financial sustainability and stability that shall fortify the macroeconomic fundamentals and generate greater confidence in the growth of the Portuguese economy. The structural policies on which the sustainability of this budgetary consolidation is based permit, in turn, the development of Science, Technology and the Information Society, the improvement to the level of qualification of the Portuguese population, and, by means of an in-depth reform of the public administration, the reduction of bureaucracy and simplification of the tax system. These policies shall create an environment in which private initiative, by both individuals and companies, may assert itself and fulfil its basic and unsurpassable role of kick-starting economic growth, identifying opportunities, taking on risks, investing and creating employment. Only through this decisive contribution shall it be possible to place Portugal back on the road to economic development and social cohesion, steering us up to the higher standards of the European Union.

2. Macroeconomic and Budgetary Situation

2.1. The Portuguese Economy and Public Finances in 2005

2.1.1. Macroeconomic Developments in 2005

During 2005, Portuguese economic growth, just like that of its Euro Area partners, has been subject to successive forecast downgrades. Only now, close to the end of the year, signs of an improvement, though fragile, from 2006 onwards are beginning to appear. Even so, private consumption is very likely to exhibit real growth above the level of GDP, given that, to now, the performance of this aggregate has translated into year-on-year variations of 2.9% and 3.0% for the first and second quarters of 2005, respectively. This trend will certainly have been aided by historically low interest rates (an analysis of banking credit aggregates shows the stability and even upturn of these values in the third quarter of 2005, as the interest rates on loans to households for house purchases, consumption and other purposes attain values below those recorded in 2004) as well as by the level of competition in the bank loan market (exemplified by the increased repayment periods on loans), which is a scenario that favours another fall in the savings rate (though it is expected to be less pronounced than the fall recorded in 2004). Data that has meanwhile become available indicates, however, a possible slowdown in the third quarter of the year, which is observed in relation to the purchase of both durable and current goods. This correction is associated to the fact that purchases were brought forward to June, triggered by the 2 percentage point rise in the standard rate of VAT. This was particularly visible in relation to the sale of motor vehicles, where sales grew by 33.7% in June (producing 8.6% growth in the first half-year of 2005).

Table 2.1.1. Domestic Expenditure
(Real year-on-year growth rates, %)

	2003	2004	2004				2005	
			Q1	Q2	Q3	Q4	Q1	Q2
Private Consumption	-0.4	2.5	2.0	2.7	2.5	2.7	2.9	3.0
Public Consumption	0.3	2.4	1.8	2.5	2.7	2.4	1.7	0.9
Investment (GFCF)	-10.1	0.6	-0.5	2.2	0.5	0.3	-1.6	-2.8
Domestic Demand	-2.5	2.2	1.5	2.8	2.3	2.3	1.7	1.0
Exports	4.5	4.6	5.0	8.5	3.0	1.9	-0.9	-0.1
Imports	-0.7	6.7	5.4	9.2	5.8	6.3	3.5	1.2
GDP	-1.2	1.2	1.1	2.0	1.1	0.6	0.1	0.5
Contributions to real GDP growth (p.p)								
Domestic Demand	-2.8	2.4	1.7	3.0	2.6	2.5	1.9	1.0
Net Exports	1.6	-1.3	-0.6	-1.0	-1.5	-2.0	-1.8	-0.5

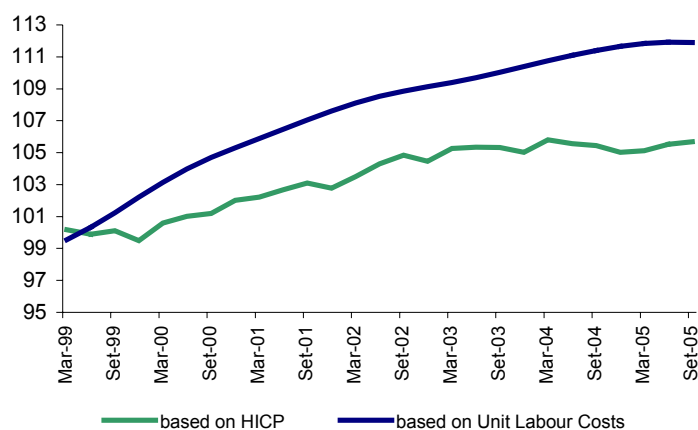
Source: INE, Quarterly National Accounts.

Investment (GFCF) has grown negatively over the first two quarters of 2005. Thus, and despite the fact that financing conditions have remained very favourable, investment should record a fall of at least 2% in real terms in 2005. The slow recovery of the economy will contribute to this trend, as well as the build up of factors of uncertainty, which inhibit investment decisions taken by economic agents. Of note in this field is the unfavourable trend of the price of oil as well as reservations regarding the

manner in which economic adjustments will be handled in view of the imbalances that have been gradually increasing over the last few years. Recent data suggests a levelling off of this indicator, due to the influence of investment in construction and in machinery and equipment.

The slowdown in the real growth of exports, which commenced in the middle of 2004, has extended to the first half of 2005, with a real year-on-year growth rate recording negative values. Some signs of recovery, though, have become evident during the third quarter, aided by the favourable international economic climate.

Chart 2.1.1. Real Effective Exchange Rate vis-à-vis the Euro Area
(1999=100)



Source: European Commission.

Even though the data referring to more recent periods have evidenced a certain level of recovery (a trend that should be continued in September, according to the industrial turnover index for foreign markets), the loss of market share by Portuguese exports must not go without being highlighted (see Chart 2.1.4, page 11). This is the result of the decline in the external competitiveness of our economy (since the end of 2000 the real effective exchange rate has been appreciating, as indicated in Chart 2.1.1) and the increased competition provided by products from the new Member States of the European Union and from certain Asian countries (China in particular). The nature of Portuguese exports, where low-technology, low-human capital goods continue to account for a significant share, also contributes to this fact.

The Portuguese economy's lower capacity to attract foreign investment, as a focal point for boosting foreign-orientated trade, has likewise jeopardised the performance of exports, when compared to the important position that these occupied in the economic recovery that occurred in the previous economic cycle.

After strong growth recorded in 2004, imports of goods and services have significantly slowed in 2005. The lower dynamism of domestic demand and the disappearance of the effects related to the appreciation of the euro contributed to this slowdown. The rise in the euro had, in recent years,

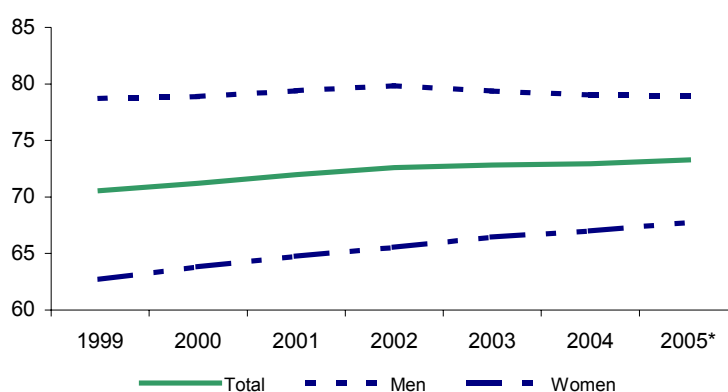
favoured imports from outside the European Union and the replacement of a proportion of domestic production by imported goods at relatively lower prices.

The volume effect associated to the developments in imports and exports and the decline of terms of trade attributable to the rise in oil prices on international markets led to the increase of the goods account deficit in the first three quarters of 2005, compared to the same period of the previous year (-11.986 and -10.632 billion euros, respectively). The other components of the aggregate current and capital accounts have likewise developed adversely over the same period of time, particularly the income account, services account (bolstered by the baseline contribution of the 2004 European Football Championship and growth in the import of tourism services), current transfers (where the downward trend in remittances sent to Portugal by emigrants associated to the increase in overseas remittances by immigrants is especially of note) and the capital account (due to the decrease in capital transfers received by Portugal from the European Union). As a result, the net borrowing of the Portuguese economy vis-à-vis the rest of the world, was 8.657 billion euros in the first three quarters of 2005.

It is forecast that the 0.1% growth rate of employment in 2005 will not avoid an increase in the unemployment rate. The third quarter of this year recorded a 0.9 percentage point increase in the unemployment rate relative to the same period of 2004 (6.8%).

It should be emphasised that the growth in the unemployment rate is also underpinned by the still significant growth of the labour force, associated to the growing participation of women in the job market (see Chart 2.1.2) and to demographical developments.

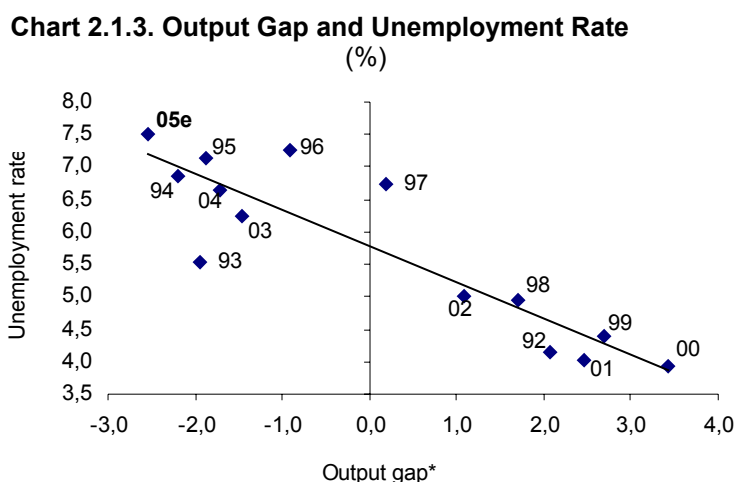
Chart 2.1.2. Participation Rate (15-64 years age group)
(as a percentage of the total population)



Source: INE, Employment survey; * Up to the 3rd quarter.

The developments in the unemployment rate are in line with the developments in economic activity and in accordance with past evidence. As a matter of fact, the expected increase in the unemployment rate in 2005 occurs in a context of the widening of the (negative) output gap as indicated by Chart 2.1.3. Conversely, the increase in the rate of long-term unemployment, besides having a cyclical

effect, may also give rise to an increase in structural unemployment. In actual fact, long-term unemployment accounted for 48.7% of total unemployment in the second quarter, compared to the average rate of 43.8% for 2004 (35% in 2003).



Sources: INE, Employment survey and Ministry of Finance. *Computed using European Commission methodology. e- estimate.

In sectoral terms, employment in the construction industry in the third quarter underwent a 3.2% year-on-year increase, after falling 0.6% in the previous quarter. Employment in manufacturing industries continued to contract, undergoing a 4.0% reduction in the third quarter of 2005 (year-on-year). Service industries maintain an upward trend, recording a 1.1% year-on-year rise in the third quarter.

Available information on pay in the service, construction, retail and industrial sectors seems to confirm the slowdown in wage growth – with the industrial sector even recording a year-on-year reduction in September.

This slowdown in wage growth should, however, be more than compensated for by the downturn of apparent productivity, probably resulting in a slight increase in unit labour costs. According to data from the European Commission, labour unit costs in Portugal continued to grow faster than the rest of the euro area during the first half of 2005, even though a differential below the 2004 average was recorded. It is a fact that real wages per worker recorded, on average, growth above labour productivity in the period from 1998 to 2004, contrary to that which occurred in other Member States (see Chart 2.1.5).

There exists, therefore, a pressing need to curb the gradual process of the loss of competitiveness, which, in the short-term and in the context of monetary union, is only possible by moderating the growth of nominal wages. The positive impact associated to the implementation of the Technological Plan and the National Action Programme for Growth and Jobs, expected in the medium and long-term, will allow the current emphasis placed on the need for wage moderation to subside. This adjustment effort, primarily aimed at enhancing the skills level of human resources, technological progress and innovation, shall certainly contribute to the growth and development of Portugal.

TECHNOLOGICAL PLAN

The 17th Constitutional Government's strategy to promote sustained development in Portugal is the Technological Plan. The Technological Plan is not another analysis. It is an action plan to implement a series of articulated policies that aim to promote the creation, dissemination, uptake and use of knowledge as a lever to transform Portugal's economy into a dynamic force capable of making its mark in the world economy.

The philosophy behind the Technological Plan is that **the market has a fundamental role to play** as a steering and regulatory mechanism of economic activity. Innovation involves a number of different actors, but it commences in the marketplace and it is driven by competition.

However, the existence of **market failures** is acknowledged, particularly in relation to investment in human capital and in the fields of innovation, research and development. Under the existing national innovation system, the failures that have been identified are liaison-related, in other words the inter-connection and cooperation between public R&D laboratories, higher education establishments, companies and business associations.

The Technological Plan consists of the following three lines of action:

. **Knowledge – Enhancing the skills level of the Portuguese to create a knowledge society**, providing structural measures aimed at raising the average level of education of the population, creating an all-encompassing and diversified life-long learning system and mobilising the population with regard to the information society.

. **Technology – Overcoming scientific and technological backwardness**, focusing on the strengthening of national technological and scientific skills, both in the public and private sectors, acknowledging the role of companies in the creation of qualified employment and in research and development (R&D).

. **Innovation – Providing a new stimulus to innovation**, facilitating the adaptation of the productive structures to the challenges placed by globalisation through the dissemination, adaptation and use of new processes, forms of organisation, services and products.

The Technological Plan also complies with the requirement of acting **transversally** in fields of intervention that are fundamental to a strategy of sustained growth.

Incentives to education and innovation may promote economic growth but they are definitely not a sufficient condition and they would certainly not drive growth if they were indiscriminately applied. In this vein, the Technological Plan seeks to steer the intervention, in order to achieve a range of transversal objectives.

On the one hand, some of the Technological Plan's actions contribute to the **development of institutions** that regulate the markets and which govern the system of incentives in which the economic agents operate, in order to make them more open to endeavour and innovation. A favourable institutional climate and suitable economic policies are a necessary pre-requisite for economic growth based on innovation and knowledge.

The design of the Technological Plan aims to develop and exploit **networking** at different levels, based on a 'system' philosophy, encouraging **interaction** between the different innovation actors, both public and private, and not excluding the relationship in place with the **territory**.

Lastly, the Technological Plan, by establishing **alternative financing mechanisms**, seeks to bypass the failures in the market that impede the financial sector, on its own, from providing the necessary finance for economic actors to optimise their education, research, development and innovation-based investment plans.

LISBON STRATEGY – PORTUGAL ANEW

National Action Programme for Growth and Jobs - 2005/2008

The 2005/2008 National Action Programme for Growth and Jobs is a comprehensive and practical programme that Portugal shall implement, within the context of the European Union, responding to the challenges of a globalised economy and society in which the country has to compete and be assertive.

The programme thus represents a guide for implementation of a national reform and modernization strategy, with design based on the references and priorities framework of the Lisbon Strategy. It is conceived as a global response to the guidelines adopted by the European Council, in a **macroeconomic, microeconomic and employment** context, to the general recommendations on economic policy and employment policy formulated by the European Commission for Portugal, and to the priorities identified by the European Commission for Portugal in the drafting framework of the National Reform Plan, i.e. **the sustainability of public accounts and external deficit, research, development and innovation, service competitiveness, employment, labour market organization, and lifelong education and training.**

By implementing these policies, Portugal intends to make a positive contribution to a new cycle of European Union assertiveness on a worldwide scale, **and to be able, by 2008, to reduce the country's public deficit to 2.8% of GDP, increase public investment and create conditions for the triplication of private investment in research and development (as a contribution to the EU's 3% of GDP goal for R&D, by 2010), and attain an annual growth rate above 2% of GDP and a global employment rate close to 70%.**

The following priorities were adopted for the implementation of the Lisbon Strategy in Portugal. These then served as the basis for the development of 125 measures.

Macroeconomic Area

- Promote growth, consolidate public accounts and control the external deficit.
- Redirect the allocation of public resources, giving priority to investment that generates growth and job creation.
- Safeguard the fairness and sustainability of the social protection system.
- Cut procedural red tape in the context of the State's regulatory and supervisory role, and ensure better conditions for free competition.
- Promote strategic agreements in the fields of labour relations and the broad development options for the country.
- Re-enter a trend of real convergence towards the levels of the European Union.

Microeconomic Area

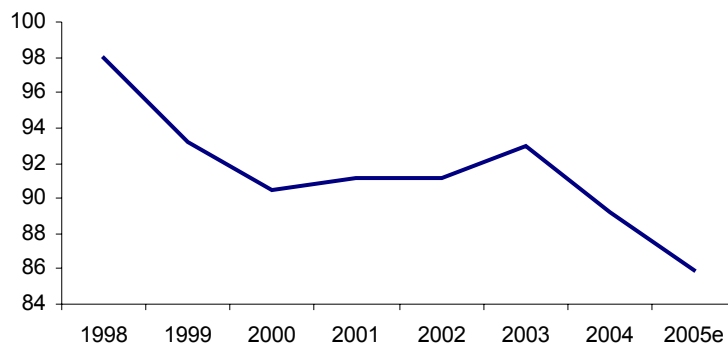
- Create a more attractive business climate for private initiative, in a context of reinforced regulation, cutting red tape and developing a business ethos.
- Increase both public and private investment in research and development and promote the incorporation of results in productive processes, thus raising the competitiveness of Portuguese companies.
- Promote innovation, disseminate access to information technology in an inclusive manner, exploiting competitive advantages and bolstering companies' capacity to create value.
- Improve market efficiency and, in particular, service regulation, assuring higher levels of effective competition, greater competitiveness and access to productive inputs in more favourable conditions.
- Promote a more sustainable use of natural resources.

- Preserve a dynamic and evolving Social State, by promoting social, territorial and environmental cohesion.

Employment, Qualification and Social Cohesion Area

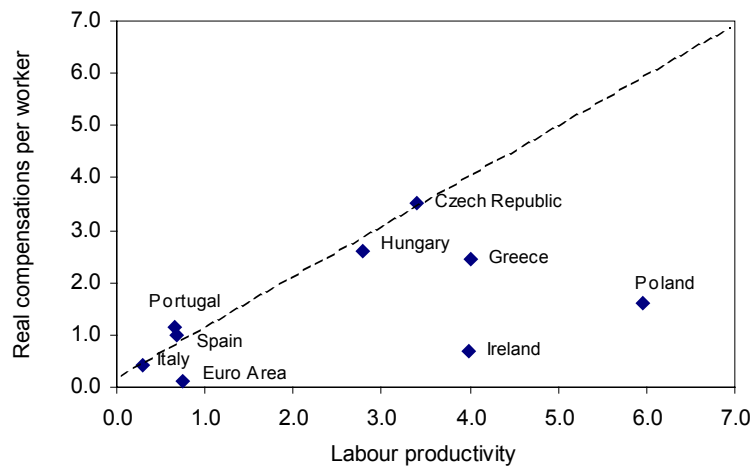
- Promote job creation and attract and maintain large numbers in employment, preventing and fighting unemployment, in particular youth and long-term unemployment.
- Manage in a pre-emptive and anticipative manner corporate restructuring and delocalization procedures.
- Promote job flexibility with security, in a framework of greater social dialogue and consensus.
- Augment investment in qualification and education and adapt education and training systems to the requirements of new capabilities' creation.
- Modernize the social protection system.
- Develop the inclusive nature of the labour market, by promoting equal opportunities for all, the acquisition of new skills and reinsertion, the compromise of social life with professional life, and gender equality.

Chart 2.1.4. Market Share of Portuguese Exports (1995=100)



Sources: European Commission, Economic Forecasts Autumn 2005 and Ministry of Finance.

Chart 2.1.5. Real Wages and Productivity (1998-2004)
(Average annual growth rate)



Source: OECD, Economic Outlook.

Industrial production prices have been on the rise from 2004 onwards, due to the strong influence of the price of energy, caused by the significant increase in the price of oil. The rise in oil prices has also reflected on consumer prices, though in a more moderated manner. There has even been a slowdown in the year-on-year change, during the first half of 2005, caused by the price reduction of unprocessed foods and the moderation of non-energy industrial goods, which has led to the reduction of import prices of a number of different types of goods, reflecting the growing participation of low-cost producers in international trade. This trend reversed from July onwards, mainly as the result of the steep increase in the price of energy goods (which accounts for around 40% of the year-on-year growth recorded for this period) and partly due to the 2 percentage point increase in the standard rate of VAT in July (Table 2.1.2).

Table 2.1.2. CPI - Total and Main Aggregates

Average annual growth (2003 to 2004) and year-on-year growth (2004:III to 2005:III)

	2003	2004	2004		2005		
			III	IV	I	II	III
Total	3.3	2.4	2.4	2.4	2.1	1.8	2.5
Aggregates							
Goods	2.7	1.6	1.6	1.8	1.7	1.3	2.2
Food	2.9	1.4	1.4	0.2	0.0	-0.4	-0.2
Unprocessed	2.6	0.0	-0.1	-1.0	-0.6	-0.9	-0.7
Processed	3.1	2.9	3.0	1.6	0.6	0.2	0.3
Industrial	2.6	1.7	1.7	2.6	2.6	2.1	3.5
Non-energy	2.0	0.8	0.4	0.9	1.2	0.6	1.0
Energy	4.9	5.4	7.0	9.8	8.1	8.1	12.8
Services	4.5	3.8	3.9	3.5	3.0	2.9	3.1

Sources: INE and Bank of Portugal.

In the third quarter of 2005 the trend of convergence of the year-on-year growth of the Harmonised Consumer Price Index between Portugal and the Euro Zone intensified. Such a trend was significantly driven by the development of food and services prices.

2.1.2. Public Finances in 2005

The general government deficit for this year, on a national accounts basis and as a percentage of GDP (base 2000), is forecast at 6.0%.

Notwithstanding the growth of tax revenue, the expected trend for current revenue is, even so, below the rate of growth forecast for total current expenditure. This is largely explained by the growth in social expenditure, in particular pensions (both those of the general pension scheme and those of the civil service scheme) and unemployment benefits, and the growth in personnel expenditure, which still

reflects the impact of the automatic promotion scheme. Of further note is the forecast reduction of the income from property item, associated to the reduction in dividends payable to the State. Such a trend was compounded by the one-off revenue measures implemented in 2004, in particular the early payment of dividends (which, under normal circumstances, should only have been paid in 2005), and the non-payment of dividends by Caixa Geral de Depósitos bank (due to the effect on the income for the financial year of the transfer of part of the staff pension fund to Caixa Geral de Aposentações - CGA).

The analysis of the general government accounts on a national accounts basis, as specified in the September reporting under the terms of the Excessive Deficit Procedure, indicates the relative stabilisation of social contributions in percentage of GDP between 2004 and 2005 and an increase in the relative share of taxation on income and assets and on production and imports (for the reasons referred to above). In terms of expenditure, the increased weight of current expenditure is noteworthy, due to the inclusion of healthcare benefit expenditure that had previously been under-budgeted, as clearly identified in the Constâncio Commission Report.

Public debt maintained its upward trend for the fifth consecutive year. According to the September notification under the Excessive Deficit Procedure, it is forecast that this shall account for around 65.5% of GDP by the end of 2005, which signifies an increase of more than 6 percentage points over the 2004 figure. The effect of primary balance (with an estimated impact of 3.2 percentage points), the positive differential between the interest rate associated to the debt and the growth of output and deficit-debt adjustments, which may reach 1.9 percentage points of GDP according to forecasts, will have contributed to this change. The relatively high value of the deficit-debt adjustment reflects, largely, the increase in borrowing requirements in order to pay expenditure detailed in the 2004 Supplementary State Budget, in other words, the issue of government bonds during the extension of 2004 budget implementation into January 2005.

2.2. The Budgetary Consolidation Strategy

Over the last few years the budgetary deficit has been kept at a level compatible with the targets enshrined in the Stability and Growth Pact. But this has been achieved artificially, as detailed in the Constâncio Committee Report. The Portuguese economy did not gain anything from this and the financial markets, warned by the main financial rating agencies, penalised this strategy by increasing the interest rates on the State's debt and also on important segments of corporate debt.

Current primary expenditure has been primarily responsible for the deficit, embodied, in particular, in the growth of specific items thereunder, such as current transfers to households, expenditure related to general government personnel and intermediate consumption, which, as a whole, increased between 1995 and 2004.

In the last few years there has likewise been strong growth in public debt, due to the high budget deficits that have been recorded, the implementation of a series of temporary containment measures that have been responsible for worsening budgetary results in following years, the running up of debt, injections of capital into state-owned companies and the positive differential between the interest rate associated to debt and the nominal growth rate of GDP, previously referred to.

The general consensus is that the success and credibility of a fiscal consolidation process significantly depends on the quality of the adjustment measures adopted. Taking the above-described Portuguese budgetary situation as the reference line, it makes every sense to suppose that the consolidation process shall only be considered credible if tight control of the upward spiral of current primary balance is implemented. The intervention in areas of particular relevance of current primary balance, such as expenditure on personnel and on intermediate consumption, should be a priority, due to the relative share held by these. In tandem, the consolidation strategy must advance, without ever neglecting the objective of improving the quality of the public services provided, in important areas such as Education, Health, Justice and Social Security. The latter is especially significant given the pressure that it has placed public accounts under. Measures guaranteeing the medium and long-term sustainability of Social Security must also be adopted, since this area is a fundamental parameter of consolidation success. Lastly, the budgetary consolidation has to be based on structural reforms that guarantee that expenditure related to new policies fomenting potential economic growth is harmonised with the taxation burden that the country is prepared to and able to bear in the medium and long-term.

Therefore, the budgetary consolidation strategy to be pursued must be based on five main guidelines:

- i) Reform of public administration and, in particular, the management of its human resources, seeking to contain personnel expenditure and, in tandem, to nurture flexibility in the management of services and reward employee performance;
- ii) Foster conditions for the long-term sustainability of Social Security and ease the short and medium-term budgetary pressure stemming from an ageing population and improvements to the present system;
- iii) Improve the quality of current public expenditure and investment;
- iv) Simplify and moralise the tax system, improving the efficiency of the Tax Administration and fighting tax evasion and fraud;
- v) Reduce the State's weight in the economy, following a privatisation policy based on reducing the State's presence in the business sector of the economy and, thus, leading to a more efficient use of resources and bolstering the sustainability of public finances.

It can thus be noted that the budgetary consolidation strategy is fundamentally based on measures to permanently reduce public spending, as opposed to temporary measures, although, in the short-term, and while the reforms have yet to make an impact, the strategy may be supplemented by measures implying an additional burden on taxation.

Economic literature indicates that budgetary consolidation strategies based on expenditure reductions are generally more successful than those based on tax increases. On the other hand, a policy of curbing and streamlining public spending can not only increase the potential for medium and long-term economic growth (by impacting on supply) but it can also increase economic levels in the short-term (by strengthening expectation vis-à-vis demand). This stimulus, which can be significant enough to juxtapose conventional Keynesian effects, is inextricably connected to the level of confidence in the economy and, therefore, to the credibility of budgetary policy. Private investment may be particularly stimulated by a credible budget deficit reduction strategy.

2.2.1. Details of the Main Consolidation Measures

The main budgetary consolidation measures are in four main categories:

- A) Measures to restructure Public Administration, human resources and public services;
- B) Measures to curb Social Security and Health co-payment expenditure;
- C) Measures to improve budgetary control and institutional solidarity of regional and local authorities;
- D) Measures regarding the simplification and moralisation of the tax system, to improve the efficiency of the Tax Administration and to tackle tax evasion and fraud.

A. Restructuring Public Administration, Human Resources and Public Services

The restructuring of Public Administration, besides being essential to the structural reduction of current primary expenditure and the consequent reduction of the State's weight in the economy, is fundamental to ensure that human resources in government are valued and used to their full advantage, with the objective of modernising and improving the effectiveness of public services.

A.1. PRACE: Restructuring Programme for the State's Central Administration

The objective of PRACE is the reorganisation of central government in order to cut costs and raise efficiency by simplifying and modernising Public Administration and streamlining its structures, through the organisational reassessment of the different ministries and the analysis of the respective duties, operating regulations, size, resources and procedures. This programme is based on the following principles:

- (i) Assess the current duties of central government in order to establish those that must be maintained, eliminated or transferred to other public or private entities;
- (ii) The devolution of duties to local and regional levels, in order to move Public Administration closer to the general public, companies and communities;
- (iii) The decentralisation of duties to local authorities, particularly in the areas of provision of public services, without contravening the principles and mechanisms that aim to control public spending;
- (iv) The reduction of administrative structures, conjugated with the improvement to the quality of services provided to the general public and companies;
- (v) The simplification, streamlining and re-engineering of administrative procedures.

The restructuring of regionalised services is in compliance with the geographical layout of NUTS II.

The restructuring of services devolved to sub-regional and local levels is conducted through:

- (i) The creation of one-stop shops, which combine the policy of approaching Public Administration to the general public and the streamlining of public services already existing at that level;
- (ii) Fostering the provision of multiple services by each public office whenever the demand for a particular service does not warrant its continued provision by a dedicated public office.

The restructuring of the centralised services of ministries shall especially involve the progressive organisation of duty-sharing services and common activities, particularly in the context of general secretariats.

A.2. The Reorganisation of Education, Healthcare, Justice and Local Government Networks

Fundamental national public services shall be streamlined through the re-allocation of resources, leading to improvements in quality.

In the Health field:

- (i) All hospitals of the National Health Service (SNS) shall adopt the corporate public entity model. This will allow the improvement of management practices, including the accountability of managers for the results achieved. The new model will help to break the chain of budget overruns in the SNS and improve the service's transparency;

- (ii) Sub-regional health authorities shall be gradually phased out up to the end of 2006. The aim is that the regional decentralisation of the SNS is performed solely at the level of the five regional health authorities;
- (iii) The reformulation of the duties carried out by the regional health authorities and health centres, along with the intensive training and re-allocation of those becoming surplus to requirement following the reorganisation;
- (iv) The reorganisation of the entire emergency network, from January 2006, with the purpose of streamlining compliance with safety regulations for beneficiaries and correcting resource allocation defects.

In Education, primary schools (1st cycle) with less than 10 pupils are being closed down. In addition, the schools' network shall be re-planned, in liaison with municipal councils and local government, with the aim of permitting the better management of resources and improving education quality. The expansion of the pre-school network, through the opening of new infants' schools, the generalisation of the teaching of English to Years 3 and 4 of the 1st cycle, the co-payment of meals in the 1st cycle and the hiring of monitors to cover extra-curricular activities arising from the extension of primary school opening hours are planned.

In relation to the justice system the following steps shall be taken, taking into consideration the additional concern of safeguarding security and improving the internal discipline of the system:

- (i) The reform of prison establishments;
- (ii) The reform of the judicial territorial map (courts);
- (iii) The reform of the social reinsertion territorial map (educational centres);
- (iv) The reform of the registrars' territorial map (civil and land registrars' offices).

In relation to Local Government, a study of the streamlining of the number of parishes is in progress.

A.3. Management of Human Resources

A.3.1. Reform of Civil Service Careers and Wages and Performance Assessment

The existing system of civil service careers and pay is both too complex and rigid. There are close to 1,050 different professional careers and most of the automatic promotion and pay-rise mechanisms are free from performance assessment. The Government has committed itself to a comprehensive reform of this system by the end of 2006. The number of careers shall be substantially reduced, drastic limits will be set to automatic promotion and mechanisms introduced to associate pay rises to performance assessment. An integral part of the performance appraisal shall be the assessment of services against established targets, with the creation of accountability mechanisms relative to managerial positions, which shall be reflected in the respective budget allocations.

In the Education sector, where the management of human resources is particularly significant, the following effective measures are of note:

- (i) The status of trainee teachers shall be altered, redefining the legal position of the trainee and fostering greater equality in the handling of trainees of different sub-systems - university and polytechnic;
- (ii) Teachers in the retirement year shall be given teaching duties, thereby fostering greater equality with respect to all other public administration staff as well as providing for greater equality and optimisation in the use of available teaching staff;
- (iii) Including hours used to perform educational duties in the calculation of the reduction to the number of teaching hours that teachers benefit from pursuant to article 79 of the Rules governing the teaching profession (ECD), thereby strengthening the realistic use of the resources available through the more balanced organisation of teaching activities;
- (iv) The reduction in *destacamentos* (temporary redeployment to trade unions and other institutions, without loss of wage), through reducing the number of authorisations (50% less postings than the figure recorded for 2004/05) in order to optimise the human resources available for teaching;
- (v) The alteration to the contracting system and reform of the ECD (the aim of this measure is to furnish the processes of temporary and permanent contracting of teachers with greater exigency and thoroughness, as well as to alter the recruitment system and promotion system).

A.3.2 Freezing of Automatic Progression

While the legislation regarding the reform of careers is being drafted, automatic progression mechanisms are frozen.

A.3.3 Recruitment Rules

In relation to the recruitment of new civil servants, there will not be one-to-one replacement of workers who leave the service, either through retirement (which will be less than in recent years as retirement age gradually rises) or through leaving the civil service altogether. The indicative rule will be, on average, one new recruit for every two civil servants leaving. There will also be changes to legislation to effectively restrict the recruitment of new civil servants in the regional and local government sub-sector, where there has been continued expansion, even in recent years.

A.3.4 Enhancing the Supernumerary Staff Exchange

This measure aims to increase the effectiveness of the management and mobility of civil servants in the Supernumerary Staff Exchange through the adoption of measures providing training, changes in profession and the support of professional activities in other sectors.

B. Curbing Social Security and Health Co-payment Expenditure

B.1 General Social Security Scheme

A number of different measures shall commence implementation in 2006. These aim to guarantee the sustainability of the Social Security system. The most noteworthy of these are:

- (i) Bolster the Plan for Combating Contribution and Benefit Fraud and Evasion, through the implementation of new inspection and debt recovery instruments and mechanisms, in particular:
 - A new administrative exaction process for benefits unduly paid;
 - A new system for providing proof of absences to control and inspection actions;
 - Centralised and automatic notification through the internal IT system or by cross-checking information with other databases of the State;
 - A new debt management model based on the commencement of legal proceedings and automatic management of assets seized for Social Security;
 - A new debt settlement and compulsory exaction scheme;
 - A new contributor manager profile, aimed at the preventive management of debt;
 - The publication of lists of debtors.
- (ii) The establishment of a ceiling to pensions, equivalent to the value of the pension of the Portuguese President, and the freezing of updates to pensions that already surpass that threshold.
- (iii) The increase of the applicable contribution base and alteration of the more favourable rates, in the context of the drafting of the Contributor's Code, with the objective of making the Social Security system more sustainable from an economic and financial standpoint;
- (iv) The reform of the unemployment safety net, strengthening the role of public services related to employment, the control in the award of benefits and combating fraudulent and passive behaviour amongst beneficiaries;
- (v) Accelerating the transition to the new formula for the calculation of pensions, particularly in relation to the self-employed, increasing the potential impact of these new rules on Social Security equilibrium.

These measures shall be combined with others already existing, namely promoting an active old age, amendments to the allowance mechanisms for self-employed workers and the approval of a new Social Security Contributor's Code.

Some of the financial resources resulting from these measures shall be gradually re-allocated, from 2006 onwards, to supplement the old age pensions of the poorest. It is forecast that the amount of this supplement shall be around 200 million euros by 2009.

B.2 Convergence of the Social Protection System and the Healthcare Sub-systems of Civil Servants

From 1 January 2006, there shall be no new registrations in CGA. New civil servants shall be registered in the general Social Security scheme.

To safeguard the sustainability of the Social Security scheme of civil servants registered in CGA, the contributions of entities with administrative and financial autonomy that possess staff with pensions covered by the civil service's social protection scheme shall increase to 13% of the part of the wage that is subject to fixed-percentage deductions.

In order to further safeguard the sustainability of the pensions scheme for civil servants, the retirement age shall gradually rise from 60 to 65 over a period of ten years, in blocks of six months per year. The number of years of service necessary to become eligible for retirement on a full pension shall also gradually increase from 36 to 40 years.

Lastly, the retirement pension of civil servants that commenced before 1993 shall be calculated, from 2006 onwards, in a manner more appropriate to the principle of convergence to the general scheme. The new calculation formula shall consist of two components: one corresponding to the number of years of service up to 2005 and the other to the number of years of service from 2006 onwards.

In relation to the convergence of the Health sub-systems of the public administration, the existing Health sub-systems of certain categories of civil servants shall be restructured so that there is convergence with the broad public administration scheme - ADSE. This process has already been completed with regard to the sub-systems of the three branches of the armed forces, the sub-system of GNR and PSP [Portuguese police forces] and the sub-system of the justice sector.

B.3 Policy on the Co-payment of Medicaments

Relative to the medicament policy or, more specifically, the reduction of co-payments of medicaments, a 6% reduction in the public retail price of all medicaments, a 5% reduction to the maximum co-

payment category and the removal of the 10% surcharge on the co-payment of generic medicaments have already been implemented.

B.4. Reform of the Procurement Agreements of Health Services

On 24 June 2005, the Council of Ministers, through Resolution no. 102/2005, approved the analysis, appraisal and possible amendment of all agreements that the SNS has entered into. In this vein, and without prejudice to the study that shall permit the in-depth reform of the model used by the referred to agreements, given the urgency in taking measures to aid balance public finances, Legislative Order no. 22620-B/2005 (Series II), dated 31/10/2005, down-rated the prices in force in some of the areas in which agreements exist. This piece of legislation came into force on 1 November 2005. The prices were reduced by about 4% on average.

C. Budgetary Control and Institutional Solidarity of Regional and Local Authorities

C.1 Reform of Legislation on the Financing of the Autonomous Regions and Local Government

Legislation regarding the financing of the autonomous regions and local government is undergoing review in order to safeguard that, besides other objectives, the budgetary consolidation effort is shared by all levels of general government, specifically through the adoption of systematic rules of fiscal discipline.

C.2 Provisional Budgetary Discipline Measures for the Autonomous Regions and Local Government

In the context of the Budgetary Framework Law, for reasons of institutional solidarity with regards to budgetary consolidation, during 2006, and while the referred to review process continues, the financing of the autonomous regions and local government shall be frozen, in nominal terms, at 2005 values. The usual formulas used to calculate the amounts transferred by the State shall not apply.

The 2006 State Budget also stipulates that local government personnel expenditure may not surpass 2005 figures. Equally significant is that all administrative mechanisms regarding the transfer of civil servants of the autonomous regions and local government to central government have been suspended.

C.3 Improved Compliance with the Duty to Report Budgetary Data

The financial reporting obligations of central and local government bodies and autonomous funds and services shall be strengthened and more effectively enforced. Mechanisms relative to the accountability of managers regarding the management of public financial resources shall also be strengthened.

The same data reporting mechanisms relative to public administration human resources shall also be bolstered. The lack of existing data on the size of the workforce of the public administration and other related data is well known. This is why the obligations of public bodies to provide human resources data for input in the Public Administration Database (BDAP) and the update of the same have been strengthened.

C.4 Creation of the Position of Financial Controller in each Ministry

This measure creates the position of financial controller in each ministry of the government. The position shall be answerable to the Minister of State and Finance and the minister of the respective governmental area. The mission is:

- (i) Monitoring financial management and the identification and notification of trends posing a risk to the consolidation objectives of public finances;
- (ii) Monitoring the body's compliance with financial obligations to third parties;
- (iii) Monitoring the drafting of medium and long-term strategic plans, operational plans and budgetary plans;
- (iv) Intervening in the financial scheduling of programmes, measures and projects/activities.
- (v) Analysing areas of significant consequence to budgetary implementation;
- (vi) Analysing and consolidating information, in the scope of compliance with established objectives, calculating the impact on the general government deficit and debt;
- (vii) Intervening prior to decisions that may imply contracting commitments that exceed certain thresholds and/or comply with the expense's specifics;
- (viii) Identifying and developing improvements to processes with a financial impact, as well as guaranteeing consistency in the design of information systems;
- (ix) Fostering, in conjunction with the bodies, initiatives to improve the quality of the financial information provided and accounting transparency, particularly in relation to the drafting of the ministry's consolidated accounts.

In order to guarantee that intra-governmental synergy is taken advantage of, the different financial controllers shall act in a coordinated manner under the guidance of the Minister of State and Finance.

The necessary legislation shall be drafted and approved at the end of 2005, so that the measure may be implemented in January 2006.

D. Simplification and Moralisation of the Tax System, Improvement of the Efficiency of the Tax Administration and Tackling Tax Evasion and Fraud

The Portuguese tax system is extremely complex due to the variety of special schemes and tax benefits that have been introduced over time. They have irredeemably distorted the principles of simplicity, fairness and transparency that should steer the system. Even if the initial intention of these

special or subsidised tax arrangements was to further a more just fiscal system, hypothetically speaking, it ended up stimulating organized economic interests to indulge in "aggressive tax planning" (the use, in other words, of tax loopholes to drastically cut the amount of tax payable). In other cases, inertia has set in, impeding the repeal of special schemes or benefits when the conditions that led to their implementation no longer apply (or may have even reversed). All told, the multiple special schemes and benefits also have the extremely pernicious effect of making it much more difficult and burdensome to stamp out fraud and tax evasion.

In this context, tax policy will focus on three areas: simplification and moralisation of the tax system, improving the efficiency of the tax administration and tackling tax evasion and fraud.

D.1 Simplification and Moralisation of the Tax System

In the context of simplifying procedures and the moralisation of the tax system, benefits and relief will be limited over an array of taxes, changes will be made to personal income tax (IRS) and the simplified taxation scheme will be reformed. The Government approved, during 2005, an initial packet of transversal simplification measures, primarily aimed at reducing bureaucracy and reducing the cost of complying with tax obligations. These measures also introduced a series of cuts to tax benefits in force, which were of a more pressing nature. These include limitations to the scope of article 69 of the Corporate Tax Code, related to carry over of losses from one year to the next, and to paragraph no. 4 of article 33-A of the Regulations governing tax benefits, relative to the Madeira and Santa Maria offshore areas. Effective mechanisms preventing the so-called "laundering" of dividends were also introduced and legislative measures aimed at guaranteeing greater control of taxable operations, vis-à-vis IT supports and different features, were implemented.

In terms of personal income tax, changes to the law were also introduced, which will come into force in 2006. These include the gradual convergence of tax relief on pensions to the value of the specific allowances of employed workers' pay. An additional tax bracket will be created with a marginal rate of 42%, applicable to annual incomes above 60,000 euros.

The Government reintroduced, as from 2006, tax breaks for retirement-orientated savings, without calling into question the budgetary consolidation effort. The aim of this measure was to strengthen the complementary nature of such savings relative to the public Social Security scheme. Other measures shall be taken in accordance with the conclusions of two commissions set up by the Government. One of these published its findings last September. The recommendations in this report shall be taken into consideration in the comprehensive reform of existing tax benefits in force in Portugal, which shall be performed during 2006. These measures may include the abolition and modification to tax incentives so as to guarantee transparency, equality and efficiency in the respective allocation. The second commission was set up to recommend measures to simplify the tax system and in particular to create simplified taxation schemes for small businesses. The recommendations of this commission shall be

published in the second quarter of 2006, and the measures in this field put into effect at the beginning of 2007.

D.2 Improving the Efficiency of the Tax Administration and Tackling Tax Evasion and Fraud

The Government shall implement a comprehensive range of legislative, operational and technological measures to improve the efficiency of the Tax Administration and tackle tax evasion. The goal is to encompass every relevant angle of a complex and multi-faceted phenomenon. Among the broad array of legislation to be implemented in the short-term, the following are of particular significance:

- (i) Endowments in cash will be subject to stamp duty (in force since August 2005);
- (ii) The publication of a tax debtors list with outstanding fiscal or tax contribution debts (already approved in the 2006 State Budget Law);
- (iii) Adjustments to penalties for certain infractions, such as the design and use of IT material to fraudulently alter tax liability or the sale of unlawfully manufactured tobacco products (already approved in the 2006 State Budget Law);
- (iv) The adoption of anti-abuse measures relative to Value Added Tax, which prevent tax fraud and evasion related to property operations between entities with special relationships and the right to the full or partial relief on this tax (to be implemented during 2006);
- (v) The alteration to the legal framework regarding the assessment statute expiration date, so that if the correct assessment of the tax to pay is dependent on facts determined in criminal proceedings, then the timeframe for the settlement of the tax is extended to one year beyond the proceedings dismissal date or the date the final ruling is passed by the court (already approved in the 2006 State Budget Law).
- (vi) The standardisation of technical conditions for the issue, safekeeping and storage of bills or similar such documents issued by electronic means, pursuant to the VAT Code. Thus, notwithstanding the fact that the issue, safeguarding and storage of bills or equivalent by electronic means should be based on criteria removed from the technological sphere, the referred to billing systems must permit the effective and efficient implementation of control operations by the Tax Administration.
- (vii) The introduction of the compulsory requirement to issue a receipt, therefore doing away with the billing system that was in force for the services provided by restaurants, bars and other such establishments (in force from 1 January 2006).

2.3. Measures already Implemented or Undergoing Implementation

This section contains reference to the budgetary consolidation measures that have already been adopted or are at an advanced stage of implementation:

A. Restructuring Public Administration, Human Resources and Public Services

Decree Law no. 93/2005, of 7 June 2005

Transforms hospitals that are public limited companies into corporate public entities.

Council of Ministers Resolution no. 109/2005, of 30 June 2005

Approves a comprehensive set of measures on the management of the civil service.

Decree-Law no. 121/2005, of 26 July 2005

Introduces the third alteration to the Regulations governing the infant, primary and secondary education teaching career, and establishes measures aimed at frameworking certain aspects of the exercise of the teaching profession.

Council of Ministers Resolution no. 121/2005, of 1 August 2005

Implements guidelines aimed to promote exactitude and transparency in the actions, both of the State and of the top level management of corporate public entities and public limited companies controlled or partially controlled by the State, and further applies these measures, with the necessary adaptations, to public institutes.

Council of Ministers Resolution no. 124/2005, of 4 August 2005

This resolution establishes the objectives, principles, programmes and methodology relative to the restructuring of central government, under the terms of which the processes of organisational assessment have already commenced. It is expected that the final report shall be presented in March 2006.

Legislative Order no. 42/2005, of 18 August 2005

Establishes that the administration of all organisational units of the Ministry of Foreign Affairs shall be subject to the principle of management by objectives and it also establishes how this system is to be implemented.

Law no. 42/2005, of 29 August 2005

Amendments to the Law on the Organisation and Operation of Law Courts, to the Regulations governing the judges career , to the Regulations governing the public prosecution service and to the Regulations governing justice officers' service, reducing the length of time courts are closed for the summer break.

Law no. 43/2005, of 29 August 2005

Establishes, until 31 December 2006, that the length of service shall not be taken into account for the purposes of career progression and wage increases for all employees, agents and servants of the State.

Law no. 51/2005, of 30 August 2005

Establishes the rules for the appointment of high-ranking managerial staff of the public administration.

Decree-Law no. 161/2005, of 23 September 2005

Creates Instituto Superior de Estudos Militares [Higher Institute of Military Studies] with the objective of streamlining organizational structures.

Council of Ministers Resolution no. 155/2005, of 6 October 2005

Establishes a set of guidelines to make the wage and pension systems in public institutes and public owned companies fairer and more balanced.

Decree-Law no. 179/2005, of 2 November 2005

Amends articles 78 and 79 of the Regulations governing civil servants retirement, establishing the conditions on the basis of what which retired people may assume paid employment in any services of the State, public institutions or State-owned companies.

Decree-Law no. 194/2005, of 7 November 2005

Establishes the operational and financial parameters of the technical commission and working groups detailed in the Central Government Restructuring Programme, approved by the Council of Ministers Resolution no. 124/2005, of 4 August.

Draft 2006 State Budget Bill (approved on 30 November 2005)

- The suspension, until 31 December 2006, of the posting, requisition and transfer of regional and local authorities' civil servants to central government;
- The suspension, until 31 December 2006, of services restructuring and organizational changes;
- The requirement of an approving opinion from the Minister of State and Finance for the recruitment of civil servants, and the imposition of the rule that for every two civil servants leaving service only one shall be recruited;
- The requirement that personnel expenditure in local government must remain at the same level as that reported for 2005;
- The human resources database of the public administration must be compulsorily input with data.

Working Group to Enhance the Supernumerary Staff Exchange

Work aimed at enhancing the supernumerary staff exchange is currently in progress, and the publication of the respective legislation is forecast for the first quarter of 2006. In relation to the reform of the career and wage system of civil servants, it is forecast that the commission empowered with the task of steering the work shall publish its findings by June 2006. In the meantime, amendments to civil service retirement regulations have already been approved by Parliament.

B. Curbing Social Security and Health Co-payment Expenditure

Council of Ministers Resolution no. 102/2005, of 24 June 2005

Establishes the analysis, reform and revision of agreements endorsed by the SNS.

Council of Ministers Resolution no. 110/2005, of 30 June 2005

Approves the path and measures to be taken deemed necessary to strengthen the convergence of and equality between pensioners of the civil servant social security scheme (Caixa Geral de Aposentações) and those of the public social security scheme, in order to guarantee the sustainability of the social protection framework. Also approves measures to strengthen the equality and effectiveness of the general Social Security scheme.

Council of Ministers Resolution no. 111/2005, of 30 June 2005

Empowers the Ministries of Finance and of Labour and Social Solidarity, and the ministry with remit for the respective area to manage the process of assessing the special social security schemes with which they are endowed, benefiting specific groups of subscribers to Caixa Geral de Aposentações, at variance with Regulations governing retirement, so that those may be brought more into line with the general scheme.

Decree-Law no. 119/2005, 22 July 2005

Amends Decree-Law no. 328/93, of 25 September 1993, reforming the Social Security scheme for self-employed workers. It increases the taxable base amount, by raising the minimum contribution scale from 1 to 1.5 times the legal minimum wage.

Decree-Law no. 125/2005, of 3 August 2005

Suspends the scheme of age flexibility vis-à-vis early retirement on full pension, as established in paragraph no. 2 of article 23, paragraph no. 2 of article 26 and paragraph nos. 1 to 4 of article 38-A of Decree-Law no. 329/93, of 25 September and also repeals the scheme of early retirement for the unemployed, established in article 13 of Decree-Law no. 84/2003, of 24 April.

Decree-Law no. 129/2005, of 11 August 2005

Amends Decree-Law no. 118/92, of 25 June, which establishes the State's co-payment system regarding medicaments, eliminating the 10% benefit on the co-payment for generic medicaments, lowering medicaments co-payment category A from 100% to 95%, and adjusting the price of medicaments subject to co-payment downward 6%.

Decree-Law no. 157/2005, of 20 September 2005

Amends the retirement and pre-retirement schemes of personnel of the PSP police force.

Decree-Law no. 159/2005, of 20 September 2005

Amends Decree-Law no. 265/93, of 31 July, which approves the Rules governing the service of personnel of the Guarda Nacional Republicana police force (GNR), modifying the scheme on which GNR personnel can be allocated to reserves or retirement.

Decree-Law no. 158/2005, of 20 September 2005

Approves the assistance scheme in the event of illness for GNR and PSP personnel.

Decree-Law no. 167/2005, of 23 September 2005

Establishes the assistance scheme in the event of illness for armed forces personnel.

C. Budgetary Control and Institutional Solidarity of Regional and Local Authorities

Draft 2006 State Budget Bill (approved on 30 November 2005)

- The net indebtedness of each municipality may not exceed, on 31 December 2006, the value reported on the same date of the previous year;
- The Azores and Madeira Autonomous Regions may not contract new loans, including all forms of debt, that imply an increase to prevailing debt levels;
- In 2006, the transfers from the State to each autonomous region and municipality shall be maintained at 2005 levels.

Work relative to the reform of the financing laws for the autonomous regions and local government is in progress and the publication of its results is forecast for 2006.

D. Simplification and Moralisation of the Tax System, Improvement of the Efficiency of the Tax Administration and Tackling Tax Evasion and Fraud

On the operational side, a number of initiatives are in progress:

- Access to taxpayers' bank information in situations where there is a high risk of fraud and tax evasion;

- Focusing efforts on tax inspection, through a significant strengthening of personnel and improvement of operational equipment and methods, in order to achieve a faster and more effective performance;
- Furthering data cross-checking with other entities, namely Social Security, the Ministry of Justice, municipal services and notary public offices;
- The implementation of a compulsory tax assessment software system for income tax returns that have not been submitted to the tax administration (corporate and personal income tax);
- The implementation of an action plan directed to minimise the risk of reaching the collection statute expiration date;
- Personalised warnings sent to taxpayers with back tax to pay and that own assets that can be covered by a tax garnishment;
- The introduction of a Strategic Plan for Tax Efficacy and Fairness;
- Speeding up the valuation process on property sold;
- The introduction of an automatic clearing system for tax reimbursements to entities with back tax of any type due.

2.4. Summary of the Impact of the Main Measures, relative to the June Version of the Stability and Growth Programme

In the context of the quantitative appraisal of the measures established in the June version of the SGP, when compared to those underpinning the December update, the most noteworthy of these are the incorporation of the objective of reducing intermediate consumption by 10% during the term in government, which was already included in the June version of the SGP, but not reflected in the savings measures presented (the impact of which is already accounted for in the Multi-Year Current Expenditure Reduction Programme) and the favourable savings achieved through Restructuring Public Administration, Human Resources and Public Services, which shall provide a positive impact of around 100 million euros for each year of the referred to period. This correction is warranted by the reduction of the level of uncertainty regarding the quantification of impact that existed at the time the June version of the SGP was being drafted. The increase in certainty is associated to the advances achieved in the process of implementing the legislative mechanisms underpinning the reform of the public administration.

The forecasts relative to the revenue-related consolidation measures were likewise amended. In relation to taxation on oil products (ISP), growth below the forecast specified in the June SGP caused the expected revenue for 2006 to be adjusted downwards. In relation to tax on tobacco products, the downward adjustment is warranted by the update of the tax to 12.9%, below the initially forecast rate of 15%. Further justification for said adjustment is provided by the reduction in the quantity of tobacco consumed. It should, however, be noted that the reduced revenue from taxes on oil and tobacco

products is compensated, nonetheless, by other taxes, by efficiency and tax evasion and fraud combat measures not referred to in the June SGP and which have, in the meantime, been implemented.

These measures include, inter alia:

- a) The 2006 State Budget included the amendment to the scheme concerning the assessment statute expiration date (this is, as a rule of thumb, 4 years from the year following the one in which the taxable operation occurred, for periodic taxes, and 4 years from the date on which the taxable operation occurred for non-periodic taxes), in order to prevent that, if the correct assessment of the tax to pay is dependent on facts determined in criminal proceedings, then the timeframe for the settlement of the tax is extended to one year beyond the proceedings dismissal date or the date the final ruling is passed by the court. The aim of this amendment is, in the main, to prevent those that are under investigation for or even accused of tax-related offences from benefiting from not having to assess the tax, due to the assessment statute expiration date, causing the inherent discharge of tax obligations by virtue of having performed such offences. The intention is, thus, to infuse the taxation-legal domain with ethics and more effective instruments to combat tax evasion and fraud;
- b) The publication of tax debtors lists: it is expected that this measure shall have an effective and immediate impact on revenue;
- c) The bolstering of tax inspection human and technical resources, with special focus on tax fraud investigation and special actions directed to tackling tax evasion and fraud.

Given that the main thrust of additional consolidation measures, relative to the June version of the SGP, shall primarily involve greater adjustment to current expenditure, the growth of public investment non co-funded by the European Union remains unchanged in this update at nearly 15% per year, on average.

Equally unchanged is the firm commitment to not employ one-off and transitory measures.

Table 2.4.1. Direct Impact of the Main Consolidation Measures on Current Revenue and Expenditure of General Government ^(a)

EUR million, at 2005 prices

	2005	2006	2007	2008	2009
REVENUE INCREASE					
Taxes on income and wealth	150	605	815	875	925
VAT	530	1220	1220	1220	1220
ISP - tax on oil products (on top of the annual update to compensate for inflation)	0	200	400	600	600
Tax on tobacco	0	110	260	410	560
Social security contributions	130	270	405	463	520
EXPENDITURE REDUCTION					
Restructuring Public Administration, Human Resources and Public Services	100	475	1055	1635	2215
Curbing Social Security and health co-payment expenditure					
(i) general scheme (b)	0	110	280	310	350
(ii) civil servants	0	230	460	700	950
(iii) medicaments co-payment policy	25	100	100	100	100
DIRECT TOTAL SAVING (attributable to these measures)	935	3320	4995	6313	7440
DIRECT TOTAL SAVING (attributable to these measures) as % of GDP	0.6	2.3	3.3	4.1	4.7

(a) Impact forecast for each year through comparison with a scenario, from 2005 onwards, of non-implementation of budgetary consolidation mechanisms.

(b) This item includes, as a deduction, the sums corresponding to the Solidarity Supplement for the elderly.

3. Macroeconomic and Budgetary Forecasts

3.1. Baseline Scenario: Assumptions

The assumptions made with regard to the international environment for 2005 to 2007, underpinning the baseline scenario of this update to the SGP, are based on the European Commission's Autumn 2005 Economic Forecasts⁴. The figures for the last two years of the forecast horizon were obtained using, in general, technical assumptions that the figures forecast for 2007 would remain unchanged.

Table 3.1.1. International Environment – Main Assumptions

	2004	2005	2006	2007	2008	2009
		Estimate	Forecasts			
Relevant foreign demand growth (%)	8.5	5.6	6.1	5.9	6.0	6.0
Oil price (Brent, USD/barrel)	38.2	55.0	61.4	60.3	60.3	60.3
Nominal effective exchange rate (a)	0.6	-0.2	-0.4	0.0	0.0	0.0
USD/EUR exchange rate (annual average)	1.24	1.25	1.21	1.22	1.22	1.22
Short-term interest rate (annual average, %) (b)	2.1	2.1	2.5	3.0	3.0	3.0
Long-term interest rate (annual average, %) (c)	4.1	3.3	3.6	3.9	3.8	3.8

Sources: European Commission, Economic Forecasts Autumn 2005 and Ministry of Finance.

(a) Annual rate of change, as % (positive/negative change means appreciation/depreciation of euro)

(b) 3-month Euribor rate. (c) 10-year Treasury bonds.

⁴ European Commission forecasts for 2006 imply a reassessment of the external economic climate assumed in the State Budget Report (p.52). This reassessment is, however, small in dimension and involves both the upward and downward adjustment of variables, causing the macroeconomic scenario of the Portuguese economy in 2006, as per this Programme, to remain unchanged.

As a general rule, this SGP update is limited by a foreign economic climate that is less favourable to the growth of the Portuguese economy than that forecast in the previous update. As a matter of fact, the European Commission adjusted the economic growth forecasts of some of Portugal's main trading partners downwards, which influenced the forecast growth of relevant foreign demand for Portuguese exports.

This SGP update is further based on a set of assumptions specific to the Portuguese economy, in particular the set of measures and reforms with a budgetary impact that have already been detailed in the previous update to the SGP, in the 2006 State Budget and in the present update.

3.2. Baseline Scenario: Macroeconomic Forecasts

The Portuguese economy should record gradual growth acceleration over this Programme's horizon (see Table 3.2.1), achieving real GDP growth of 2.4% and 3.0% in 2008 and 2009 respectively, which should place the country back on track for European Union mean income levels. The growth rates forecast for the Programme's first years shall, however, be slightly below the scenario underpinning the June update, with rates of 0.5%, 1.1% and 1.8% for 2005, 2006 and 2007.

Table 3.2.1. Main Macroeconomic Indicators – 2004-2009

	2004	2005	2006	2007	2008	2009
		Estimate	Forecasts			
Real growth rates (%)						
GDP	1.2	0.5	1.1	1.8	2.4	3.0
Private consumption	2.5	2.3	1.3	1.5	2.2	2.5
Public consumption	2.4	0.8	-1.3	-0.8	-0.9	-1.0
Investment (GFCF)	0.6	-2.1	1.7	3.6	5.7	7.8
Exports of goods and services	4.6	1.2	5.7	6.1	6.5	7.2
Imports of goods and services	6.7	2.1	4.2	4.3	5.6	6.4
Unemployment rate (%)						
Unemployment rate (%)	6.7	7.4	7.7	7.7	7.4	7.0
Total employment (growth rate, %)	0.1	0.1	0.6	0.9	1.2	1.5
Private consumption deflator (growth rate, %)						
Private consumption deflator (growth rate, %)	2.4	2.3	2.3	2.2	2.2	2.1
Household saving rate (%)						
Household saving rate (%)	9.5	9.1	9.0	8.9	8.9	8.9
Output gap (%) (a)						
Output gap (%) (a)	-1.8	-2.6	-2.9	-2.5	-1.7	-0.4

Source: Ministry of Finance (based on 2004 data provided by INE).

(a) (actual output/potential output-1)x100.

Economic growth in Europe in 2005 is proving to be significantly below the level of forecasts made at the year's start: according to the European Commission's recent autumn forecasts, the real GDP of the EU15 should grow at a rate of only 1.4%, half a percentage point lower than the spring forecasts. A slowdown in the growth of world trade and, above all, the strong rise in oil prices have contributed to this slower growth. The high level of dependence on imported energy that the Portuguese economy

possesses and the high proportion of the country's exports channelled to the EU15 (close to 80%) mean that the referred to unfavourable developments have particularly acute consequences in Portugal. Thus, the June update growth of exports of goods and services is subject to a large reduction (from 3.3% to 1.2%), and in a less boisterous business climate, GFCF is also affected (moving from 1.1% to -2.1%). The downward adjustment of European growth and upward revision of energy prices shall also be felt in 2006, though in a more diminished sense. Also of note for this year is the real contraction of public consumption (with growth of -1.3%, which compares with 0.3% in the June update), reflecting budgetary consolidation in areas such as personnel expenditure, intermediate consumption or social benefits in kind.

From 2007 onwards a significant upturn in growth continues to be forecast, based on investment and exports. A favourable foreign climate is assumed, as well as the strict and timely compliance with the budgetary consolidation strategy contained in this Programme, which shall boost the confidence of economic actors and the potential for medium and long-term economic growth. The other economic governance lines of action shall produce similar impact, emphasizing the improvement to competitiveness through measures related to raising the skills level of workers, and to innovation and technology⁵. It is assumed that a climate of wage restraint will exist, with positive real wage growth but below increases in productivity, thereby permitting the reversal of a trend of accumulated loss of competitiveness in relation to unit labour costs. This series of factors forms the basis on which increases in market share are forecast for 2007, 2008 and 2009. These forecast increases are moderate and prudent, since, as a whole, they just compensate the loss of market share that occurred in 2005.

Inflation should remain under control, and may even slope slightly downwards up to 2009. The 2005 estimate (2.3%) favourably contrasts with the forecast figure of the June update (2.7%), demonstrating that in spite of the rise in fuel prices a significant portion of the increase in the standard VAT rate was absorbed by companies in their profit margins and not passed on to retail prices. Forecasts for 2006 and subsequent years are appropriate to a context of wage restraint and absence of pressures on productive capacity (the output gap should remain negative, though closing), and have not failed to take into consideration the delayed impact of the rise in VAT as well as the repercussions on prices as the result of adjustments to other indirect taxes (taxation on oil and tobacco products).

The growth of employment shall allow the unemployment rate, after reaching a maximum of 7.7% in 2006/2007, to fall in subsequent years. Unemployment will therefore develop in a slightly less favourable manner than that portrayed in the June update, which is due, of course, to a slower economic recovery than that forecast in June. The upward adjustment of the unemployment rate is, however, small (one decimal point increases in 2007, 2008 and 2009), due both to the supposition that wage restraint shall remain in place – which, once again, is central to the scenario mapped out herein

⁵ The global strategy is contained in PNACE (National Action Programme for Growth and Jobs) and detailed in some of the respective attachments (the National Employment Plan and the Technological Plan, for example).

– and to the pro-cyclical nature of the participation rate, which, compared to the June update, is a limiting factor in the growth of the labour force.

The unfavourable international climate in 2005 signifies the deterioration of external accounts, taking the economy's net borrowing to an estimated 6.8% of GDP. In 2006 the assumption that the annual average price of oil will rise shall still impact negatively on terms of trade. The balance on goods and services is forecast to recover from 2007 onwards, an improvement roughly cancelled by the very prudent assumptions adopted in relation to external transfers, both current and capital. A scenario of a certain degree of containment of the external imbalances of the Portuguese economy is therefore forecast, which is aligned with the expected development of the households' savings rate – virtual stabilisation from 2006 onwards, at a figure close to 9% of disposable income.

Table 3.2.2. Current and Capital Accounts – Main Components

Balances as a percentage of GDP						
	2004	2005	2006	2007	2008	2009
		Estimate	Forecasts			
Current and capital accounts	-5.9	-6.8	-6.7	-6.8	-6.8	-6.6
Current account	-7.9	-8.7	-8.8	-8.4	-8.1	-7.8
Goods and services	-7.9	-8.4	-8.4	-7.7	-7.3	-7.0
Incomes	-1.4	-1.9	-2.0	-2.1	-2.1	-2.0
Current transfers	1.4	1.6	1.6	1.4	1.3	1.2
Capital account	2.0	2.0	2.1	1.6	1.4	1.2

Sources: Ministry of Finance (based on data provided by INE and Bank of Portugal for 2004 and 2005).

3.3. Baseline Scenario: Budgetary Forecasts

The budgetary scenario described in this update reaffirms the path of reduction of the deficit as a percentage of GDP stipulated last June, with the values duly adjusted taking into consideration the move to base 2000 in national accounts. Given that economic growth for the initial years of the Programme horizon was adjusted downwards, the preservation of the path referred to is, in reality, an additional consolidation endeavour.

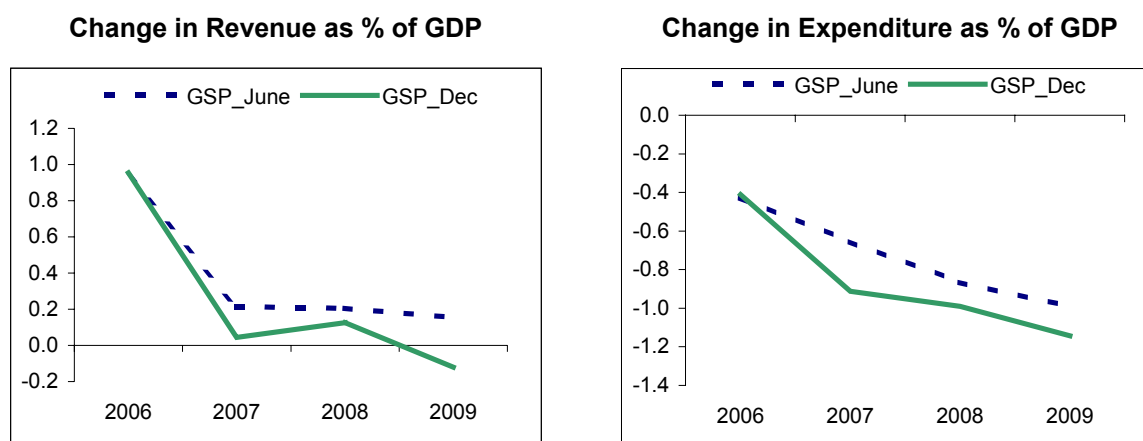
This endeavour is principally steered onto current primary expenditure, which from 2006 to 2009 shall present a more intensive reduction in share of GDP than that detailed in the previous update. It shall diminish from 40% in 2006 to 37.4% in 2009.

The growth of total revenue from 2006 to 2009 is lower than the figure established in the June update (by 0.5 percentage points of GDP). This update forecasts that the tax burden shall stabilise in 2009 at the level reached in 2008. This stabilisation, together with the commencement of the decline of the percentage of GDP that total revenue accounts for, indicates the possibility of reducing the per capita

tax burden, in a responsible manner, aiming to reduce the State's weight in the economy, once the recovery of public accounts has been consolidated.

Successful experiences generally show that even in relation to consolidation processes based on structural reforms acting on expenditure, the increase in revenue is essential to obtaining immediate results and increased levels of credibility. As these good practices have shown, good budgetary consolidation is a dynamic process in which the initial structural alterations to expenditure only produce a direct impact after a certain period of time has gone by. Chart 3.3.1 eloquently shows the characteristics and dynamics of the budgetary consolidation process⁶. Both the June version and this version of the SGP initially back increases in revenue (not though, it is reminded, by means of one-off measures) so that later on, as the structural measures start to make an impact, the focus is transferred to act decisively on expenditure. It is also evident that the additional effort now required, as a consequence of the down-adjustment of forecast GDP, is almost exclusively focused on expenditure. In other words, the Government has opted to let the automatic stabilisers on the revenue side perform their task while it focuses additional efforts on expenditure, bolstering structural measures.

Chart 3.3.1



The aforementioned bolstering of structural measures in view of the economic outlook result in a heightened reduction of the structural deficit, as table 3.3.1 indicates.

Table 3.3.1. Change in Cyclically-Adjusted Balances (p.p. of GDP)

	2006	2007	2008	2009
Structural overall balance	1.60	0.78	0.73	0.45
Structural primary balance	1.68	0.98	0.73	0.39

⁶ In Chart 3.3.1, the GDP values underlying the June SGP and this version of the SGP are both in base 2000, in order to make comparison clearer.

As regards public debt, the behaviour of its ratio to GDP from 2005 to 2009 (Table 3, appendix) is similar to that forecast in the June version of the SGP – rising up to 2007, then falling as consolidation advances. The increases to 2007 are greater than those forecast in the June version of the SGP, due to the downwards adjustment of the economic growth rate and of inflation assessed using the GDP deflator. It should be noted, however, that the increase in 2007 is already lower than the public deficit for that year, reflecting efforts in privatisation and in efficient management of the public debt.

3.4. Sensitivity Analysis to Different Macroeconomic Scenarios

The price of oil has shown itself to be very volatile and it constitutes one of the main sources of uncertainty of the foreign economic climate. The balance of risks regarding developments in this variable is now less tilted than it was a few months ago, and it is plausible to project upward and downward revisions. Thus, alternative scenarios were taken into consideration, in which the price of oil rises or falls 20% against the baseline scenario, with the consequent repercussions on foreign demand and foreign inflation⁷: for example, a scenario of more expensive oil is also a scenario of lower foreign demand relevant to the Portuguese economy.

The generated forecasts are summarised in Table 3.4.1. In unfavourable circumstances (more expensive oil and lower foreign demand) there is a moderate rise in the rate of inflation, which is very concentrated in the first year (2006), and a contractionary impact on output and employment, which is temporally vaster but also weaker. Increases in foreign deficit reflect above all the decline in terms of trade. The consequences for public finances are negative but small in scale. It is estimated that the budgetary deficit will increase by 0.1 p.p. of GDP in each year compared to the baseline scenario. In favourable circumstances (cheaper oil and higher foreign demand), as would be expected, consequences that are virtually symmetrical to the previous situation are forecast.

⁷ In relation to foreign demand, oil price elasticities of -0.02 in the short-term and -0.04 in the long-term were used. In relation to foreign prices, elasticities of -0.01 in the short-term and -0.015 in the long-term were assumed.

Table 3.4.1. Sensitivity to the Oil Price and to Foreign Demand

	2006	2007	2008	2009
Oil more expensive [cheaper] and lower [higher] foreign demand				
GDP (real growth rate, %)	0.9 [1.2]	1.8 [1.9]	2.3 [2.4]	2.9 [3.0]
Private consumption deflator (annual growth, %)	2.8 [1.8]	2.2 [2.2]	2.1 [2.2]	2.1 [2.2]
Unemployment rate (%)	7.7 [7.7]	7.7 [7.6]	7.5 [7.3]	7.1 [6.9]
Current and capital accounts balance (% of GDP)	-7.2 [-6.3]	-7.2 [-6.4]	-7.1 [-6.4]	-6.9 [-6.3]
General Government net lending (% of GDP)	-4.7 [-4.6]	-3.7 [-3.6]	-2.7 [-2.5]	-1.7 [-1.4]
Gross public debt (% of GDP)	68.9 [68.6]	69.5 [69.0]	68.8 [68.1]	66.7 [65.7]
Differences relative to the baseline scenario				
GDP (real growth rate, %)	-0.1 [0.1]	-0.1 [0.1]	-0.1 [0.1]	-0.1 [0.1]
Private consumption deflator (annual growth, %)	0.5 [-0.5]	0.0 [0.0]	0.0 [0.0]	0.0 [0.0]
Unemployment rate (%)	0.0 [0.0]	0.1 [-0.1]	0.1 [-0.1]	0.1 [-0.1]
Current and capital accounts balance (% of GDP)	-0.5 [0.5]	-0.4 [0.4]	-0.4 [0.4]	-0.3 [0.3]
General Government net lending (% of GDP)	-0.1 [0.1]	-0.1 [0.1]	-0.1 [0.1]	-0.1 [0.1]
Gross public debt (% of GDP)	0.2 [-0.2]	0.2 [-0.2]	0.3 [-0.3]	0.5 [-0.5]

Source: Ministry of Finance.

Notes:

Increase [decrease] of 20% in the oil price relative to the baseline scenario, with repercussions on foreign prices and foreign income.

It is also important to analyse the impact of different interest rates. A pessimistic assumption is where the interest rate rise is even greater than that specified in the baseline scenario – in this context, short and long-term rates 1 p.p. above the rates of that scenario in all years (2006 to 2009) were projected. In a more optimistic scenario, there are no further interest rate rises in the Euro Zone: therefore, the short and long-term interest rates keep the same values all through the forecast, which are close to those recently recorded (2.4% and 3.5%, respectively).

Table 3.4.2 summarises the main results of these two alternative scenarios. In unfavourable circumstances economic growth is slower than that of the baseline scenario, and the impact is most noted in 2006. The unemployment rate rises, although always remaining below 8%. Imports grow more slowly, leading to an improvement in external accounts compared to the baseline scenario. Lower economic growth and the payment of higher interest imply that budgetary consolidation in this scenario is a little bit slower, with an effective deficit still somewhat above 3% of GDP in 2008 and a debt ratio that marginally surpasses 70% in that year and the previous one. In the event that interest

rates remain unchanged, GDP grows faster than in the baseline scenario from 2007 onwards⁸, reducing unemployment and slightly worsening the external deficit. The impact on budgetary consolidation is naturally beneficial. In both circumstances – a faster rise of interest rates or interest rates remaining unchanged – the effects on the inflation rate are negligible - always below 0.1 p.p..

Table 3.4.2. Sensitivity to Changes in Interest Rates

	2006	2007	2008	2009
Higher [lower] interest rates				
GDP (real growth rate, %)	0.6 [1.1]	1.6 [2.0]	2.2 [2.5]	2.8 [3.1]
Private consumption deflator (annual growth, %)	2.3 [2.3]	2.2 [2.2]	2.1 [2.2]	2.1 [2.1]
Unemployment rate (%)	7.9 [7.7]	7.9 [7.6]	7.7 [7.2]	7.4 [6.8]
Current and capital accounts balance (% of GDP)	-6.6 [-6.8]	-6.5 [-6.9]	-6.3 [-7.0]	-5.9 [-6.9]
General Government net lending (% of GDP)	-5.1 [-4.6]	-4.2 [-3.5]	-3.2 [-2.3]	-2.3 [-1.2]
Gross public debt (% of GDP)	69.4 [68.7]	70.6 [68.9]	70.5 [67.7]	69.0 [65.2]
Differences relative to the baseline scenario				
GDP (real growth rate, %)	-0.5 [0.0]	-0.2 [0.2]	-0.2 [0.1]	-0.2 [0.1]
Private consumption deflator (annual growth, %)	0.0 [0.0]	0.0 [0.0]	0.0 [0.0]	0.0 [0.0]
Unemployment rate (%)	0.2 [0.0]	0.2 [-0.1]	0.3 [-0.1]	0.4 [-0.2]
Current and capital accounts balance (% of GDP)	0.1 [0.0]	0.3 [-0.1]	0.5 [-0.2]	0.7 [-0.3]
General Government net lending (% of GDP)	-0.4 [0.0]	-0.5 [0.2]	-0.6 [0.3]	-0.7 [0.3]
Gross public debt (% of GDP)	0.7 [0.0]	1.4 [-0.4]	2.1 [-0.7]	2.8 [-1.0]

Source: Ministry of Finance.

Notes:

Higher interest rates: short and long-term rates 1 p.p. above those used in the baseline scenario.

Lower interest rates: short and long-term rates remain at levels similar to those recently in force (2.4% and 3.5%, respectively).

⁸ In 2006 the acceleration is negligible given that the interest rates during that year are virtually identical to those of the baseline scenario.

3.5. Comparison with the June 2005 Update

The above-described macroeconomic and budgetary forecasts of this Programme assumed a standpoint that included the comparison with the previous update. Table 5, in the appendix to this Programme, systematically details the main figures in this area.

4. Long-term Sustainability of Public Finances

The analysis presented herein is based on the methodologies recommended by the Code of Conduct of the SGP and on the Report on the Sustainability of Social Security attached to the 2006 State Budget Report.

It is to be highlighted that, at this stage, the analysis is limited to scenarios of population, employment and productivity developments, without corrective measures of public policy. In other words, this analysis, given that it does not consider possible corrective structural reforms, essentially serves to draw attention to the need to draft and implement such reforms.

The assumptions made are:

- (i) The forecasts for public expenditure on health, unemployment and training are those of the Ageing Working Group, a sub-group of the Economic Policy Committee (EPC) that assists ECOFIN;
- (ii) Forecast public expenditure on health assumes that unit costs grow 1% above the GDP per capita growth rate and a composite age profile, as suggested by the European Commission, was employed;
- (iii) Care expenditure for the 0 - 14 years age group grows in line with the behaviour of the ratio of the 0 - 14 years age group to the 15 - 64 years age group;
- (iv) Care expenditure for the 65 years and over age group grows in line with the behaviour of the dependence ratio;
- (v) Expenditure on employment creation policies is assumed to be a constant percentage of GDP from 2010 onwards;
- (vi) The real increase of pensions is 0.1%;
- (vii) The implicit interest rate on public debt is 5% from 2015;

- (viii) According to European Commission guidelines, assets in reserve funds do not include government bonds.

Two scenarios were analysed. The baseline scenario of the EPC follows the recommendations of the European Commission regarding the assumptions to adopt; in particular, from 2030 it is assumed that GDP grows 1% per year. The other scenario is the domestic baseline scenario, which employs domestic forecasts of public expenditure on pensions and employment benefits⁹. The macroeconomic outlook of the latter scenario is more optimistic given that it assumes that GDP grows by 2% per year in real terms from 2030. In this scenario it is also assumed that non age-related primary expenditure is 13% of GDP from 2010 onwards, as opposed to 13.6% in the EPC baseline scenario.

In the absence of corrective measures, the strong increase in expenditure on pensions and, to a lesser extent, on healthcare induces the appearance of significant primary deficits. The latter, combined with a real interest rate clearly above GDP growth rate (3%, as opposed to 1.5% of average real growth for the 2010-2050 period; 2.1% in the domestic baseline scenario), causes public debt to develop in a clearly unsustainable manner, reaching 246.5% of GDP in 2050 (130.4% in the domestic baseline scenario).

Table 3.5.1. Long-term Sustainability Indicators (% of GDP)

	S1	S2	RPB
EPC baseline scenario	3.5	7.2	8.4
Domestic baseline scenario	1.6	3.2	4.8

In addition to using the value of public debt as a percentage of GDP in 2050, the European Commission employs three indicators to assess the long-term sustainability of the public finances of a Member State.

The first indicator (S1) is the permanent improvement to the primary balance, as a percentage of GDP, that would be necessary for public debt not to surpass 60% of GDP in 2050. If this improvement were obtained on the expenditure side, a permanent reduction of non age-related primary expenditure of 3.5 % of GDP in the EPC scenario and 1.6% of GDP in the domestic scenario would be necessary.

The second indicator (S2) is the improvement to the primary balance, also as a percentage of GDP, that would comply with the government's intertemporal budget constraint. This is, in other words, the present value of primary surpluses must be equal to the current value of public debt. If the budgetary adjustment is carried out on the expenditure side, a permanent cut of 7.2% of GDP is required in the EPC scenario and a cut of 3.2% of GDP in the domestic scenario.

⁹ This forecast of the Social Security account revises the forecast submitted as an attachment to the 2006 State Budget Report, to the extent that it incorporates some parametric alterations and new values relative to civil servants updated with the new forecasts for Caixa Geral de Aposentações.

The RPB (required primary balance) is an indicator based on S2 and it measures the average cyclically-adjusted primary balance during the first five years of the forecast that guarantees, at the very minimum, compliance with the government's intertemporal budget constraint. A primary surplus of 8.4% of GDP is required in the EPC scenario and one of 4.8% in the domestic scenario.

This brief analysis produces two outstanding conclusions:

Despite the clearly positive impact that greater sustained growth of productivity has on the Social Security financial situation, it can be observed that the problem of the sustainability of public finances shall not be solved solely by more dynamic economic growth. If GDP accelerates, wages and social contributions will also be greater during the initial years under analysis – but, on the other hand, the pensions to be paid in the future shall be even greater.

In order to make public finances sustainable, in-depth reform of the social protection systems, to curb the growth of expenditure on pensions and care of the elderly, including healthcare, in addition to demographic policy measures that promote the rejuvenescence of the labour force, shall be necessary. Despite the fact that containment of non age-related primary expenditure is also important, it is not feasible that this is the area that bears the brunt of adjustment – as evidenced by the high S2 figure.

Appendix: Statistical Tables

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level (10 ⁶ euros)	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP¹	B1*g	137436.4	1.2	0.5	1.1	1.8	2.4	3.0
2. Nominal GDP	B1*g	141114.5	3.9	3.1	3.3	4.7	5.1	5.8
Components of real GDP								
3. Private Consumption expenditure	P.3	88291.1	2.5	2.3	1.3	1.5	2.2	2.5
4. Government Consumption expenditure	P.3	28202.3	2.4	0.8	-1.3	-0.8	-0.9	-1.0
5. Gross fixed capital formation	P.51	30523.1	0.6	-2.1	1.7	3.6	5.7	7.8
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P53	1038.8	1.0	1.0	0.9	0.9	0.9	0.9
7. Exports of goods and services	P.6	40207.1	4.6	1.2	5.7	6.1	6.5	7.2
8. Imports of goods and services	P.7	50826.0	6.7	2.1	4.2	4.3	5.6	6.4
Contributions to real GDP growth								
9. Final domestic demand		-	2.2	1.1	1.0	1.6	2.5	3.2
10. Changes in inventories and net acquisition of valuables	P.52 + P53	-	0.1	-0.1	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	-1.1	-0.5	0.1	0.2	-0.1	-0.2

¹ Real GDP is measured at 2003 prices.

Table 1b. Price developments

	ESA Code	2004	2005	2006	2007	2008	2009
		rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		2.7	2.6	2.3	2.8	2.7	2.8
2. Private consumption deflator		2.4	2.3	2.3	2.2	2.2	2.1
3. Export price deflator (goods and services)		1.2	2.2	2.4	1.8	2.0	2.0
4. Import price deflator (goods and services)		2.0	2.7	2.7	1.2	1.3	1.3

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment (thousand individuals)		5103.0	0.1	0.1	0.6	0.9	1.2	1.5
2. Employment (thousand individuals, adjusted with hours worked)		4972.7	0.1	0.1	0.6	0.9	1.2	1.5
3. Unemployment rate (%)			6.7	7.4	7.7	7.7	7.4	7.0
4. Labour productivity, persons (10³ euros)¹		27.7	1.1	0.4	0.5	0.9	1.2	1.5
5. Labour productivity, hours worked (10³ euros)		28.4	1.1	0.4	0.5	0.9	1.2	1.5
6. Compensation of employees (10⁶ euros)	D.1	72572.0	3.0	3.7	3.2	3.2	3.6	4.0

¹ GDP per worker.

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-5.9	-6.8	-6.7	-6.8	-6.8	-6.6
of which:							
- Balance on goods and services		-7.9	-8.4	-8.4	-7.7	-7.3	-7.0
- Balance of primary incomes and transfers		0.0	-0.3	-0.4	-0.7	-0.8	-0.8
- Capital account		2.0	2.0	2.1	1.6	1.4	1.2
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	-2.9	-0.8	-2.1	-3.1	-4.2	-5.0
3. Net lending/borrowing of general government	B.9	-3.0	-6.0	-4.6	-3.7	-2.6	-1.5

Table 2. General government budgetary prospects

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	-4229	-3.0	-6.0	-4.6	-3.7	-2.6	-1.5
2. Central government	S.1311	-7716	-5.5	-5.8	-4.7	-3.9	-2.8	-1.7
4. Local government	S.1313	141	0.1	-0.1	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	3346	2.4	-0.1	0.1	0.2	0.2	0.2
General government (S13)								
6. Total revenue	TR	61365	43.5	41.4	42.3	42.4	42.5	42.4
7. Total expenditure	TE	65594	46.5	47.4	47.0	46.1	45.1	43.9
8. Net lending/borrowing	EDP B.9	-4229	-3.0	-6.0	-4.6	-3.7	-2.6	-1.5
9. Interest expenditure	EDP D.41	3832	2.7	2.8	2.9	3.1	3.1	3.1
10. Primary balance		-397	-0.3	-3.2	-1.7	-0.6	0.6	1.5
Selected components of revenue								
11. Total taxes (11=11a+11b+11c)		32764	23.2	23.9	24.7	25.1	25.5	25.6
11a. Taxes on production and imports	D.2	20345	14.4	15.2	15.8	16.1	16.4	16.5
11b. Current taxes on income, wealth, etc	D.5	12395	8.8	8.7	8.9	9.0	9.1	9.1
11c. Capital taxes	D.91	25	0.0	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	17576	12.5	12.3	12.2	12.1	12.0	11.9
13. Property income	D.4	1099	0.8	0.4	0.6	0.5	0.5	0.4
14. Other (14=15-(11+12+13))		9926	7.0	4.8	4.9	4.6	4.5	4.5
15=6. Total revenue	TR	61365	43.5	41.4	42.3	42.4	42.5	42.4
p.m.: Tax burden (a) (D.2+D.5+D.61+D. 91-D.995)		48889	34.6	35.2	36.1	36.4	36.7	36.7
Selected components of expenditure								
16. Collective consumption	P.32	10961	7.8	7.8	7.5	7.3	7.1	6.8
17. Total social transfers	D.62 + D.63	38644	27.4	28.1	28.0	27.6	27.1	26.4
17a. Social transfers in kind	P.31 =D.63	18517	13.1	13.3	13.0	12.8	12.4	12.0
17b. Social transfers other than in kind	D.62	20127	14.3	14.8	15.0	14.9	14.7	14.4
18.=9. Interest expenditure	EDP D.41	3832	2.7	2.8	2.9	3.1	3.1	3.1
19. Subsidies	D.3	2161	1.5	1.6	1.5	1.3	1.2	1.2
20. Gross fixed capital formation	P.51	4397	3.1	3.2	2.9	2.9	2.8	2.9
21. Other (21=22-(16+17+18+19+20))		5598	4.0	3.8	4.1	3.8	3.7	3.6
22=7. Total expenditure	TE	65594	46.5	47.4	47.0	46.1	45.1	43.9

(a) Excluding imputed social contributions (D612).

Table 3. General government debt developments

% of GDP		2004	2005	2006	2007	2008	2009
1. Gross debt		59.4	65.5	68.7	69.3	68.4	66.2
2. Change in gross debt ratio		1.7	6.2	3.2	0.5	-0.8	-2.2
Contributions to changes in gross debt							
3. Primary balance		-0.3	-3.2	-1.7	-0.6	0.6	1.5
4. Interest expenditure		2.7	2.8	2.9	3.1	3.1	3.1
5. Stock-flow adjustment		0.8	1.9	0.6	-0.1	0.0	0.0
- Net accumulation of financial assets		-0.1	0.6	-0.5	-0.3	-0.2	-0.2
of which:							
- privatisation proceeds		0.5	0.5	1.1	0.5	0.4	0.3
p.m. implicit interest rate on debt		4.9	4.9	4.6	4.8	4.7	4.7

Table 4. Cyclical developments

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Real GDP growth (%)		1.2	0.5	1.1	1.8	2.4	3.0
2. Net lending of general government	EDP B.9	-3.0	-6.0	-4.6	-3.7	-2.6	-1.5
3. Interest expenditure	EDP D.41	2.7	2.8	2.9	3.1	3.1	3.1
4. Output gap		-1.8	-2.6	-2.9	-2.5	-1.7	-0.4
5. Cyclical budgetary component		-0.8	-1.2	-1.3	-1.1	-0.8	-0.2
6. Cyclically-adjusted balance (2-5)		-2.2	-4.8	-3.3	-2.5	-1.8	-1.4
7. Cyclically-adjusted primary balance (6-3)		0.5	-2.0	-0.4	0.6	1.3	1.7

Table 5. Divergence from previous update

	ESA Code	2004	2005	2006	2007	2008	2009
Real GDP growth (%)							
Previous update		1.0	0.8	1.4	2.2	2.6	3.0
Current update		1.2	0.5	1.1	1.8	2.4	3.0
Difference		0.2	-0.2	-0.3	-0.4	-0.2	0.0
General government net lending (% of GDP)	EDP B.9						
Previous update		-5.2	-6.2	-4.8	-3.9	-2.8	-1.6
Current update		-3.0	-6.0	-4.6	-3.7	-2.6	-1.5
Difference		2.2	0.2	0.2	0.2	0.2	0.0
General government gross debt (% of GDP)							
Previous update		61.9	66.5	67.5	67.8	66.8	64.5
Current update		59.4	65.5	68.7	69.3	68.4	66.2
Difference		-2.5	-1.0	1.2	1.5	1.7	1.7

Table 6a. Long-term sustainability of public finances - EPC base scenario a/

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	43.7	47.4	43.8	46.0	48.8	62.2
Of which: age-related expenditures	24.2	27.3	27.2	29.6	31.4	37.2
Pension expenditure	9.7	11.3	11.4	13.6	15.4	20.0
Social security pension	6.1	7.5	8.0	9.4	11.2	16.2
Old-age and early pensions	4.0	5.4	5.9	7.2	8.8	13.1
Other pensions (disability, survivors)	2.1	2.1	2.1	2.2	2.4	3.1
Occupational pensions (CGA - public sector workers' pension scheme)	3.6	3.8	3.4	4.2	4.2	3.8
Health care	5.3	5.8	5.8	6.1	6.2	6.9
Long-term care (this was earlier included in the health care)	0.3	0.5	0.5	0.6	0.7	1.1
Education expenditure	5.1	4.7	4.7	4.7	4.6	4.8
Other age-related expenditures	3.8	5.0	4.7	4.7	4.5	4.4
Interest expenditure	3.1	2.8	3.0	2.8	3.8	11.3
Total revenue	40.8	41.4	42.4	42.4	42.4	42.4
<i>Of which: property income</i>	0.0	0.0	0.0	0.0	0.0	0.0
<i>of which: from pensions contributions (or social contributions if appropriate)</i>	10.5	10.4	10.3	9.6	9.3	9.2
Consolidated public pension fund assets (assets other than government liabilities)	0.7	2.1	2.0	1.9	2.0	2.6
Assumptions						
Labour productivity growth	1.1	0.4	2.1	2.5	1.7	1.7
Real GDP growth	3.4	0.5	2.4	2.2	1.0	1.0
Total participation rates (aged 20-64)	76.6	78.8	80.7	82.3	82.1	82.7
Males	85.2	85.5	86.5	86.8	85.9	86.3
Females	68.4	72.4	75.1	77.7	78.2	79.1
Unemployment rate	4.1	7.4	5.4	5.3	5.3	5.2
Population aged 65+ over total population	16.4	17.0	17.7	20.3	24.3	31.9

a/ EPC - Economic Policy Committee

Table 6b. Long-term sustainability of public finances - National base scenario

	2000	2005	2010	2020	2030	2050
Total expenditure	43.7	47.4	43.3	45.3	47.3	51.4
Of which: age-related expenditures	24.2	27.3	27.3	29.7	31.0	32.3
Pension expenditure	9.7	11.3	11.4	13.7	14.9	15.0
Social security pension	6.1	7.5	7.9	9.3	10.6	11.9
Old-age and early pensions	4.0	5.4	5.9	7.2	8.4	9.6
Other pensions (disability, survivors)	2.1	2.1	2.0	2.1	2.2	2.4
Occupational pensions (CGA - public sector workers' pension scheme)	3.6	3.8	3.5	4.4	4.3	3.1
Health care	5.3	5.8	5.8	6.1	6.2	6.9
Long-term care (this was earlier included in the health care)	0.3	0.5	0.5	0.6	0.7	1.1
Education expenditure	5.1	4.7	4.7	4.7	4.6	4.8
Other age-related expenditures	3.8	5.0	4.9	4.7	4.6	4.5
Interest expenditure	3.1	2.8	3.0	2.6	3.3	6.1
Total revenue	40.8	41.4	42.4	42.4	42.4	42.4
<i>Of which: property income</i>	0.0	0.0	0.0	0.0	0.0	0.0
<i>of which: from pensions contributions (or social contributions if appropriate)</i>	10.5	10.4	10.2	9.4	8.9	8.7
Consolidated public pension fund assets (assets other than government liabilities)	0.7	2.1	2.0	2.0	2.0	2.1
Assumptions						
Labour productivity growth	1.1	0.4	1.5	2.0	2.2	2.5
Real GDP growth	3.4	0.5	2.8	2.0	2.0	2.0
Total participation rates (aged 20-64)	76.6	78.0	80.2	81.2	81.4	81.3
Males	85.2	84.6	85.9	85.7	85.1	84.9
Females	68.4	71.6	74.6	77.0	77.5	77.8
Unemployment rate	4.1	7.4	5.4	5.3	5.3	5.2
Population aged 65+ over total population	16.4	17.0	17.7	20.3	24.3	31.9

Table 7. Basic assumptions

	2004	2005	2006	2007	2008	2009
Short-term interest rate (annual average)	2.1	2.1	2.5	3.0	3.0	3.0
Long-term interest rate (annual average)	4.1	3.3	3.6	3.9	3.8	3.8
USD/€ exchange rate (annual average)	1.24	1.25	1.21	1.22	1.22	1.22
Nominal effective exchange rate (annual change)	0.6	-0.2	-0.4	0.0	0.0	0.0
World excluding EU, GDP growth	5.9	5.1	4.9	4.6	4.4	4.5
EU GDP growth	2.4	1.5	2.1	2.4	2.3	2.3
Growth of relevant foreign markets	8.5	5.6	6.1	5.9	6.0	6.0
World import volumes, excluding EU	13.9	8.6	8.7	8.4	8.0	8.0
Oil prices (Brent, USD/barrel)	38.2	55.0	61.4	60.3	60.3	60.3