PORTUGAL – STABILITY AND GROWTH PROGRAMME 2010-2013

Memo, Ministry of Finance and Public Administration (08 March 2010)

The Stability and Growth Programme (SGP) for 2010-2013 must:

- Define a clear and credible strategy to reduce the General Government deficit and correct public debt growth by 2013;
- Prioritise the reduction and curbing of public expenditure;
- Maintain a general framework of tax stability that does not compromise competitiveness and employment;
- Guarantee the sustainability of public finances as a pillar for sustainable economic growth;
- Strengthen the budgetary framework, orientating it to a pluriannual budgeting;
- Ensure its articulation with structural reforms aiming for the modernization and competitiveness of the Portuguese economy and the decrease of external borrowing.

It is very important that the SGP is seen by economic agents, analysts and international institutions as an adequate and feasible strategy to achieve its objectives, and should therefore indicate the necessary measures. In other words, the SGP must be **credible**.

The credibility of the SGP depends on the:

- **Reliability and,** given the uncertainty that still exists, **the prudence of** its underlying macroeconomic **assumptions**
- Nature, magnitude and effectiveness of the proposed **measures**
- Perception of the **Government's ability** to implement such measures, which depends on its **reputation** and the existing political conditions for **governing**.

The **communication** of the SGP is crucial not only to the political management of the conditions of governance, but also to its credibility. **Realism** is required. The difficulty of the task to be carried out cannot be ignored, nor the demand and the effort associated with the measures to be adopted. A **fair and appropriate distribution of these efforts** among the different social groups is essential.

1 - Political and social consultation

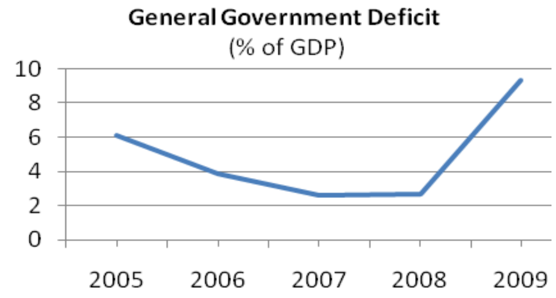
The Government, by presenting its proposed SGP before the approval of the State Budget for 2010 by the National Parliament, complies with the calendar it had publicly announced and to which it had committed itself in the dialogue held with the political parties with parliamentary representation.

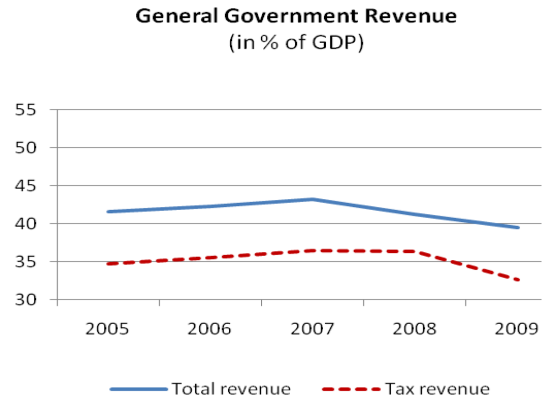
The Government's desire is that this strategic document steering economic and financial policy for the forthcoming years may obtain, where its objectives and fundamental options are concerned, the contribution and the responsible backing of the different political forces and social partners. Accordingly, in the preparation of the proposal for the SGP, besides having taken into account the different views on the country's economic and financial problems that have been expressed by the Portuguese society, the

Government will foster the necessary initiatives for dialogue and social consultation until the final approval of the document.

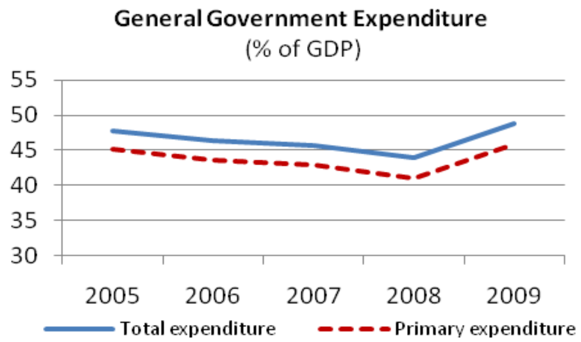
2 - Recent developments of public finances

Successful budgetary consolidation between 2005 and 2008. General Government deficit cut by 3.4 p.p. of GDP: 1.8 p.p. reduction in expenditure's share of GDP and 1.6 p.p. improvement in revenue share.
Implementation of major structural reforms such as those in Social Security, in Public Administration, in administrative processes, procedures and practices (SIMPLEX), in Education, Innovation, Science and Technology, Energy, etc, which besides having a positive budgetary impact, decisively contributed to cutting red-tape costs and, consequently, to the improvement of the country's business environment. The impact of the reform of Social Security is to be highlighted since it ensured that Portugal moved out of the group of high-risk countries as regards the sustainability of public finances, according to the European Commission.

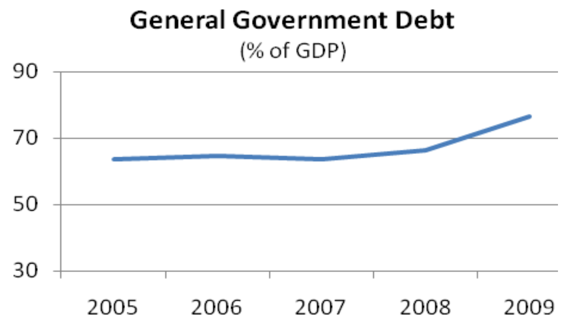




The development of the international financial crisis and its repercussions on the economic activity and employment, especially from the end of 2008, forced the adoption of extraordinary measures to stimulate the economy and support the poorest households and those most affected by the crisis. The impact of that budgetary effort together with the influence of automatic stabilizers, particularly reflected in the sharp fall in tax revenue, underlie the increase of the General Government deficit recorded in 2009.



The budget consolidation undertaken between 2005 and 2007 allowed a stable path for the public debt ratio during this period. This ratio has worsened in subsequent years as a result of the efforts to support the financial system and economic activity, in particular by reducing the average payment period of the State and the abovementioned extraordinary stimulus measures.



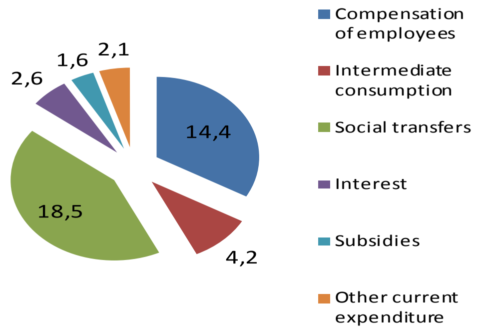
In 2010, besides the necessary extension of

Government support to the economy and to employment, the reduction of this excessive deficit needs to begin forthwith.

The weight of current expenditure in GDP remained stable between 2005 and 2008 (43.4% vs. 43.2%). However its structure has undergone significant change:

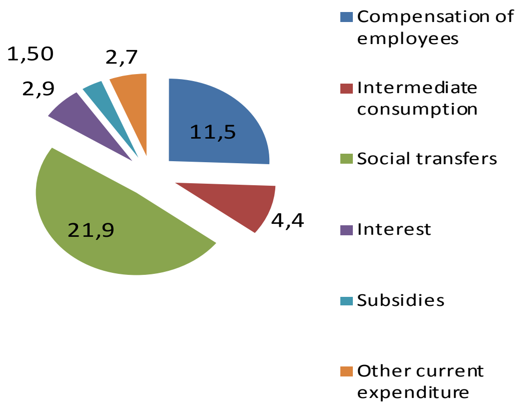
- Compensation of employees has declined in percentage of GDP from 14.4% to 11.5%;
- Social benefits have grown in weight of GDP from 18.5% to 21.9%;

Current expenditure breakdown in 2005



Compensation of employees and social benefits jointly accounted for 75% of current expenditure between 2005 and 2008. The share of compensation of employees decreased from 33% to 26% and the share of social benefits increased from 42% to 49%.

Current expenditure breakdown in 2008



3 – Macroeconomic scenario

	2010	2011	2012	2013
Technical Assumptions				
Growth of relevant foreign markets (%)	1,7	4,5	4,5	4,6
Oil price (Brent, USD/bbl)	76,6	82,0	84,8	86,5
HICP euro area (annual average, %)	1,1	1,2	1,4	1,6
Short-term interest rate (annual average, %)	1,2	2,4	2,9	3,2
Long-term interest rate (annual average, %)	4,5	5,1	5,3	5,2
Nominal effective exchange rate for Portugal	0,0	0,0	0,0	0,0
USD/Euro exchange rate (annual average)	1,4	1,5	1,5	1,5

	2010	2011	2012	2013
GDP and Expenditure Components (real terms)				
Private Consumption	1,0	0,8	0,9	1,0
Public Consumption	-0,9	-1,3	-1,5	0,2
Investment (GFCF)	-0,8	1,0	1,6	1,8
Domestic Demand	0,3	0,4	0,6	1,0
Exports of goods and services	3,5	4,1	4,5	4,6
Imports of goods and services	1,7	1,9	1,9	2,0
GDP	**0,7**	**0,9**	**1,3**	**1,7**
memo items				
CPI	0,8	1,9	1,9	2,0
HICP	0,8	1,9	1,9	2,0

	2010	2011	2012	2013
Labour Market - annual average				
Unemployment Rate (%)	9,8	9,8	9,5	9,3
Employment	-0,1	0,1	0,4	0,6
Net lending / borrowing (% of GDP)				
General Government	-8,3	-6,6	-4,7	-2,8
Vis-à-vis the rest of the world	-8,4	-8,8	-8,2	-8,2
Public Debt - % of GDP				
	85,4	88,9	90,1	89,3

4 – Reduction of the General Government deficit and correction of the public debt growth by 2013

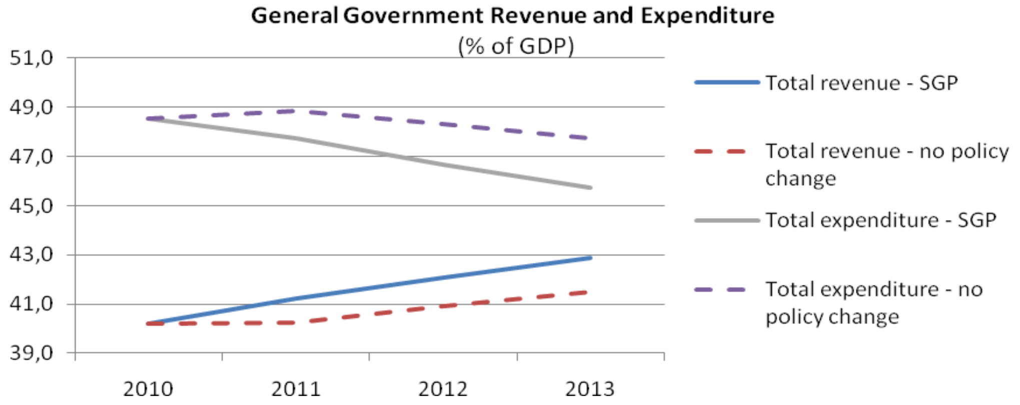
4.1 – Reduction of the General Government deficit by 2013

The State Budget for 2010, taking into consideration the prevailing domestic and international economic context and the uncertainties that still exist, already envisages a significant reduction of the General Government deficit from 9.3% to 8.3% of GDP. In the following years, 2011 to 2013, we must reduce the General Government deficit by 5.5 percentage points in order to achieve the goal of 2.8% of GDP in 2013. In terms of structural balance, a 1 percentage point reduction is achieved in 2010 and a reduction of 5 percentage points in 2011 to 2013.

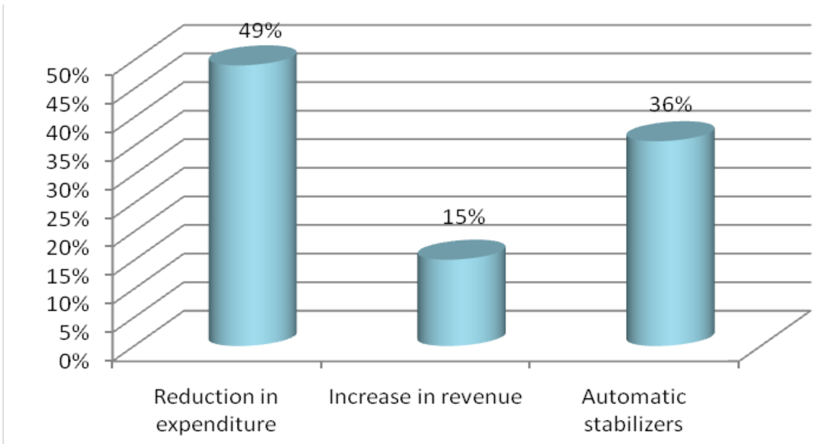
The General Government deficit reduction strategy is based on:

- Reducing the share of expenditure in GDP;
- Decreasing tax expenditure;

- Improving tax revenue, social contribution revenue and others;
- The automatic stabilisers as the economy recovers, exiting from the crisis.



The measures envisaged in the SGP will reduce the share of total expenditure by 2.7 percentage points of GDP and will improve revenue by 0.8 percentage points. Hence, the contribution to reduce the deficit will be as follows:



Fiscal consolidation based on the reduction and curbing of expenditure can not overlook the structure of expenditure, particularly the structure of current expenditure. The most significant and critical results for the success of the fiscal consolidation, will have to be based on the reduction and control of the most significant expenditure components.

i) Compensation of employees

The **compensation of employees** expenditure will be reduced to 10% of GDP in 2013, through a decrease of at least 100 million euros per year of the overall amount this expenditure. This goal will be achieved through:

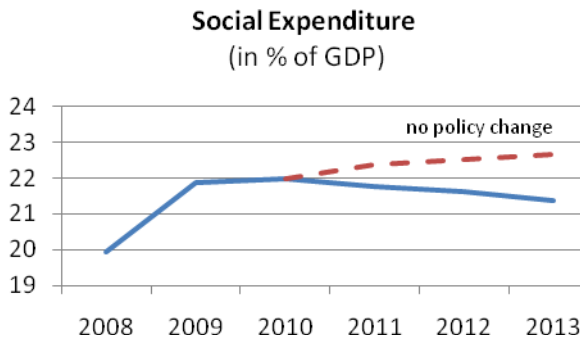
- the reinforced implementation of the "at least two out for one in" rule;
- a policy of strong wage constraints.

Note: the values for 2008 and 2009 were adjusted to ensure comparability with following years.

ii) Social Expenditure

Social benefits will be reduced from 21.9% of GDP in 2009 to 21.4% of GDP in 2013.
This will be achieved through:

- The definition of an expenditure ceiling for social benefits without a contributory base, in particular by setting a ceiling for the transfers from the State Budget to Social Security in order to fund such benefits. The measures envisaged for such, among others, are:
  - To maintain the nominal value of all non-contributory benefits until 2013;
  - To redefine the allocation criteria incorporating the widespread application of the means-tested rule;
  - To remove the temporary anti-crisis social support measures;
  - To strengthen mechanisms for management, control, supervision and penalties in order to promote efficiency and fight abuse and fraud;



- The change of the unemployment benefits scheme with the aim of promoting a faster return to work;
- The improvement of the management and control of health expenditure and medicine policy;
- The speed up of the convergence of the CGA (Civil Servants Pension Scheme) with the Social Security general scheme, in line with the measures already adopted in the State Budget for 2010.

iii) Intermediate consumption expenditure

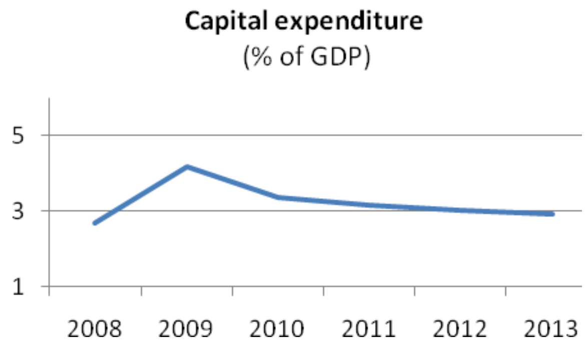
- Definition of outsourcing expenditure ceilings;
- Definition of a ceiling for expenditure on military equipment, through
  - 40% reduction in the amount defined in the LPM (Military Funding Programme);
  - not establishing any new commitments for military equipment purchasing.

- Reduction and rationalisation of current operating expenditure based, in particular, on the streamlining of public procurement and shared services processes.

iv) Capital expenditure and investment

The share of capital expenditure will stabilise in 2013 at 2.9% of GDP. Besides not taking any additional commitments, namely on the field of road infrastructure concessions, the implementation of some investment projects is being postponed.

- For instance, the implementation of the high-speed Porto-Vigo and Lisbon-Porto rail link was postponed for two years of (the call for tenders procedure will only start in late 2011), in order to avoid any financial impact until 2013.



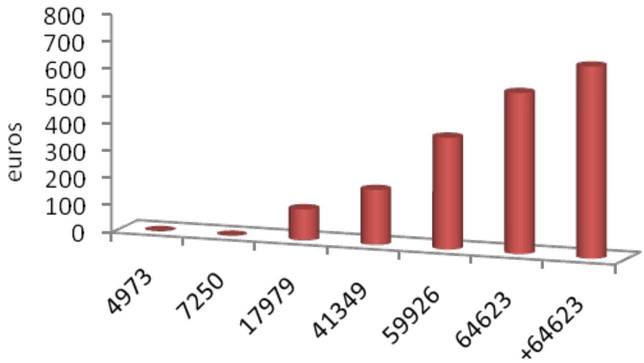
v) Reduction of tax expenditure and other measures to strengthen revenue

- Capital gains on securities subject to a 20% personal income tax rate;
- Equitative limitation of personal income tax allowances and benefits, making them dependent on the taxpayers' level of income;
- Alignment of the specific personal income tax allowance for pensions exceeding EUR 22500/year with the specific tax allowance for income of wage earners;
- Broadening and control of the Social Security contributory base;
- Introduction of tolls on current toll free motorways (SCUT), including both those already subject to a decision and others currently under evaluation, pursuant to the Government's Programme.

These measures are expected to improve revenue by 0.8 percentage points of GDP.

- Setting up, until 2013, of a special personal income tax rate of 45% for taxable annual income exceeding EUR 150000.

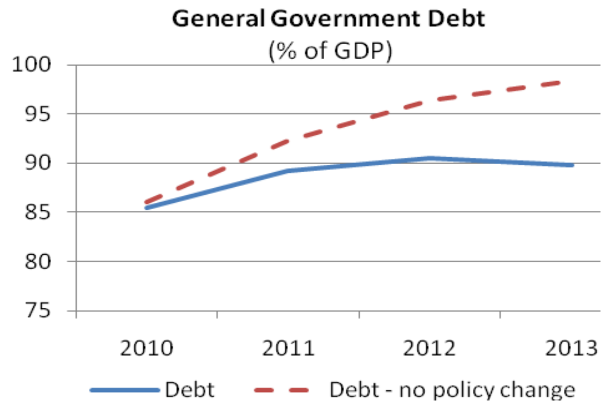
<u>Average annual impact per taxpayer on the limitation of tax allowances and benefits per personal income tax bracket</u>



4.2 – Correction of public debt growth and indebtedness

vi) Privatisation

The planned privatisations will yield a revenue around EUR 6000 million, which will reduce the general government net borrowing requirements during the SGP horizon. Thus, it is expected that this revenue will represent a 0.1% of GDP savings on the cost of the general government debt and curb the debt dynamics allowing the decrease in the debt to GDP ratio.



vii) Regional and Local Government

The rule of zero net borrowing requirements to all entities in this general government subsector will be adopted, excepting under emergency situations or, in terms to be defined, in case of EU co-funding.

viii) State-Owned Company Sector

Thresholds on net borrowing requirements will be defined for this sector. A policy of strong wage constraints will be pursued, in line with the General Government procedures, and pension and health plans without a contributory base will be revised.

Public services contracts established with State-Owned Enterprises will be revised aiming to reduce the amount of financial compensation due. The State, as a shareholder, will release, within 6 months, guidelines aimed at carrying out a reorganisation and restructuring of the State-Owned Enterprises, in order to improve efficiency.

5 – The SGP and the equitative distribution of the budgetary consolidation effort

The budgetary consolidation is a national challenge faced by all citizens and economic agents, requiring, therefore, the contribution of all. A contribution that is to be equitative, demanding more from those who have more. In this context, measures to be adopted under the SGP, whilst foreseeing reductions in significant components of public expenditure, also introduce significant initiatives to enhance tax equity:

- The taxation of capital gains on securities;
- Setting up, until 2013, of a special personal income tax rate of 45% for taxable annual income exceeding EUR 150000;
- Global thresholds on tax allowances and benefits applicable to higher income brackets;
- The limitation of the use of tax benefits, already considered in the State Budget of 2010, in order to increase the corporate income tax, especially on large companies.

6 – The SGP and the sustainability of public finances

In analysis of the sustainability of public finances, aiming to evaluate in what extent public finances are able to meet the additional costs associated with the ageing of the population, the European Commission typically uses two indicators whose values for Portugal, with reference of the horizon of 2060, are indicated in the table below:

- **S1**, which evaluates how much tax revenue as a percentage of GDP would have to increase (or public expenditure in other items would have to be reduced) permanently up to a certain year to finance the costs associated with the ageing population, in order to ensure a general government debt ratio of 60% in that year;
- **S2**, which corresponds to the permanent increase in tax revenue as a percentage of GDP (or the reduction of other expenditure items) needed to equal the present value of future primary balances with the current stock of gross public debt, or, in other words, to comply with the intertemporal budget restriction of an infinite horizon.

The sustainability of Portuguese public finances was significantly enhanced by the reforms made between 2005 and 2007, in particular the Social Security reform and the convergence of the Civil Servants Pension Scheme with the Social Security general scheme. The worsening of the General Government deficit in 2009 due to the international financial and economic crisis naturally affects the starting conditions for the medium and long-term projections of public finances on which these two indicators are based. Thus, in the 2009 baseline scenario, the values of S1 and S2 indicated in the Table below reflect that starting situation. In the SGP 2013 scenario, the values of S1 and S2 are the result of the starting budgetary situation that will result from the successful implementation of the SGP. It can therefore be seen that the successful implementation of this programme will very clearly increase the sustainability of Portuguese public finances.

	S1 (with reference to 2060)	**S2**
2009 baseline scenario	**4.7**	**5.5**
SGP 2013 scenario	**0.8**	**1.5**

Sources: European Commission and Ministry of Finance and Public Administration.

7 – The SGP, competitiveness and sustained growth

The correction of the excessive deficit caused by the international financial and economic crisis requires a budget policy of rigour and public spending restraint in forthcoming years. The success of that correction will increase, as referred to, the medium and long-term sustainability of public finances. Economic agents' perception of this strengthening reduces the assessment of country risk, improves general financing conditions and thereby encourages private initiative and investment.

However, despite the rigour and public spending restraint that must preside over the steering of fiscal policy, it should remain focused on policies that produce greater benefits in terms of fighting the crisis and encouraging growth and employment, including, by way of structural reforms, the modernisation and strengthening of the Portuguese economy structural competitiveness. The focus of economic policy will remain on enhancing the productive potential of the country, as well as improving its external competitiveness and the consequent reduction of indebtedness. Accordingly, it is necessary to:

- Proceed with the focus on education and training aimed at improving the qualifications of the Portuguese;
- Strengthen the innovation capacity and scientific and technological potential of the country;
- Pursue an energy policy that reduces our external dependence, promotes consumption efficiency and contributes to environmental sustainability;
- Contribute to better conditions for SME financing and support their competitiveness by maintaining a favourable tax environment;
- Promote an active and more aggressive internationalisation of the Portuguese economy;
- Modernise infrastructures crucial to strengthening our links to major international markets, thereby enhancing the centrality of the Portuguese economy as regards the global economy;
- Foster the use of available EU funds;
- Promote social justice and equality, thus strengthening social cohesion.