PORTUGAL'S FISCAL POLICY
IN A CONTEXT OF LOW GROWTH AND MACROECONOMIC IMBALANCES

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This paper develops the presentation made at the 15th Banca d'Italia Public Finance Workshop. The data was updated with the information available in 2013. The text is organized as follows. Section 2 summarises macroeconomic developments in Portugal from 1995 to 2012, emphasising low growth and increasing indebtedness since the turn of the century. The main features of fiscal developments in Portugal are analysed in Section 3, with a special focus on the factors underlying the evolution of public expenditure. Section 4 tries to explain the very limited success of the efforts of expenditure containment even after Portugal incurred for the first time in excessive deficit. Section 5 presents the most important measures included in the fiscal block of the ongoing Economic and Financial Assistance Programme to Portugal, assessing its results up to now, as well as its main merits and limitations. Finally, Section 6 draws some key lessons for the conduct of fiscal policy in Portugal in the coming decades.

1 Introduction

In the last three decades the Portuguese economy has been subject to very important structural changes and shocks, driven by both domestic and external developments. Among the structural changes it is noteworthy the increase in the degree of economic and financial integration and the participation in EMU. Concerning shocks, the accession of new countries to the world markets, the 2008 financial crisis and the Great Recession are good examples of external developments with a major impact on the Portuguese economy.

In the second half of the nineties, Portugal was still growing above the euro area, mainly on account of an increase in domestic demand, but this trend reversed after 2000. On the contrary, net exports were never able to contribute to GDP growth until the recent past. In this context, the indebtedness of the private and public sectors, in particular after 2000, reached historically high levels, ultimately leading to the Portuguese government demand of economic and financial assistance in 2011.

The full extent of the role of fiscal policy and public policies in general in Portugal's meagre macroeconomic performance after the inception of the euro is yet to be established. Certainly they contributed to the excessive growth of domestic demand, in particular public consumption, and to the shift of resources from the tradable sector to the non-tradable sector, amplifying macroeconomic imbalances and the overall indebtedness of the Portuguese economy. Further the postponement and/or the lack of ambition of structural reforms limited the potential growth of the economy. The Economic and Financial Assistance Programme to Portugal agreed with the European Commission, the ECB and the IMF tackles all this issues but it is too soon to evaluate its success. In this context, this paper focuses on fiscal developments in Portugal, with a particular emphasis on expenditure growth and the difficulty in ensuring its effective control.

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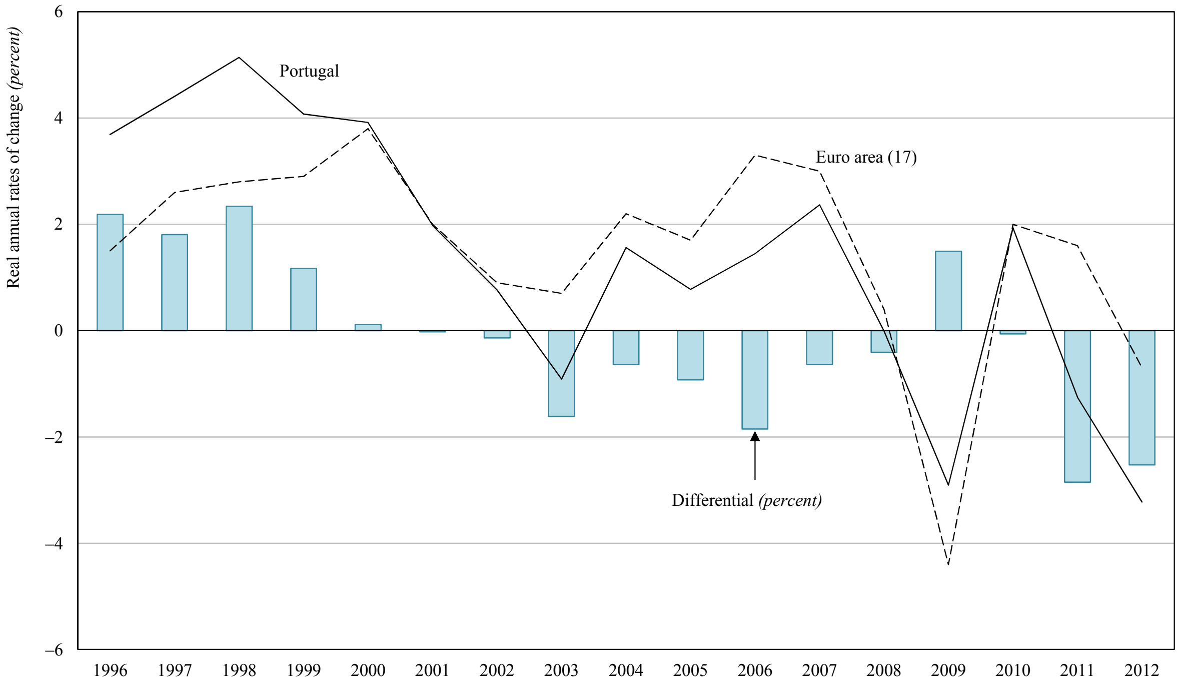
The opinions and findings expressed in the text represent the views of the authors, which do not necessarily reflect those of Banco de Portugal or the Eurosystem.

Figure 1

GDP



Sources: Eurostat, Statistics Portugal and Banco de Portugal.

2 Basic facts on growth and macroeconomic imbalances

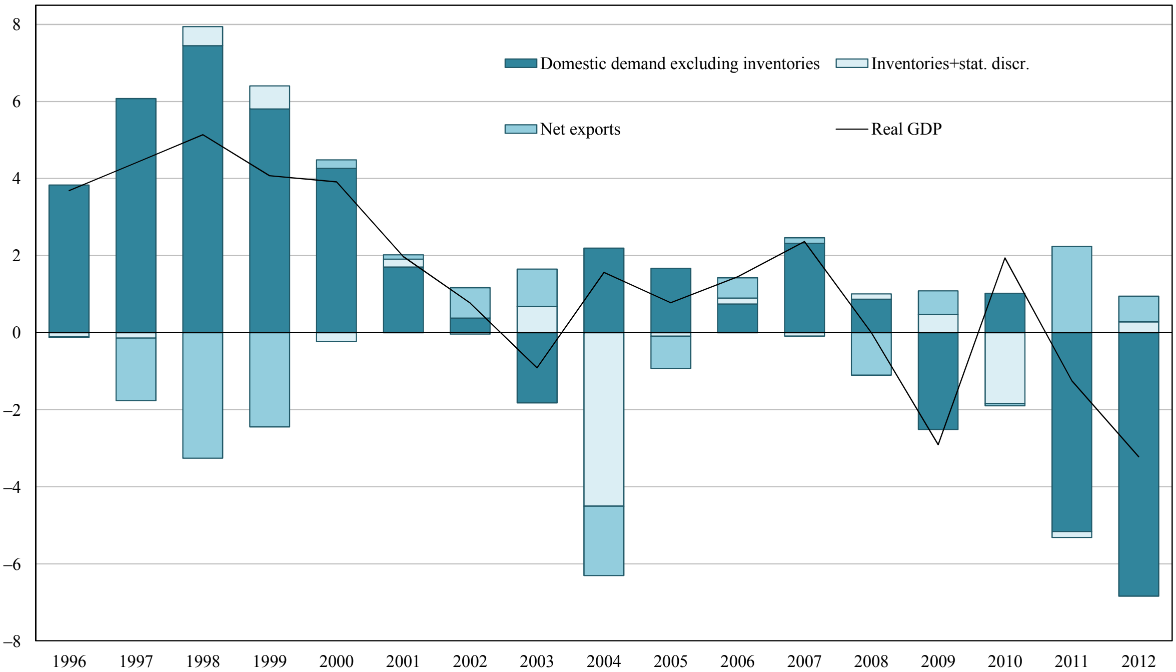
In the second half of the nineties, Portugal was growing above the euro area (at an average rate of 4 per cent) but the situation reversed after 2000 (Figure 1). Since then, Portugal has shown a poor economic performance, diverging in relation to the euro area as a whole. Indeed, in the period from 2001 to 2012, GDP in Portugal grew on average 0.2 per cent per year, while the comparable figure for the euro area as a whole was 1.1 per cent.

Domestic demand recorded a fast expansion until 2000, but its growth afterwards was subdued (Figure 2). The strong increase of domestic demand occurred in a context where access to credit was facilitated by financial integration and low interest rates. In the 1996-2000 period, private consumption[1] and investment grew on average 4.3 and 8.3 per cent per year, respectively. After 2001 (and until 2010), both aggregates recorded a marked deceleration as their average growth rates declined to 1.3 and –0.3 per cent, respectively. Public consumption also followed the same pattern, with expansionary policies leading to an average annual growth rate of 4.1 per cent up to 2000, while some deceleration took place afterwards, though much less pronounced than that that of private consumption and investment. On the opposite, net exports were not able to contribute to GDP growth, in particular until 2010. This situation was reversed in the last years, given the ongoing adjustment process. Indeed, in a context of subdued growth of external demand, behind the evolution of exports were important gains in market share (of around 3 per cent per year).

[1] Private consumption in Portugal represents around 64 per cent of GDP, in nominal terms.

Figure 2

Contributions to Real GDP Rate of Change
(percent)



Source: Statistics Portugal.

As a result of the external imbalances, the current plus capital account deficit stood at very high levels, reaching a maximum of 11.1 per cent of GDP in 2008 (Figure 3). In 2009 and 2010, this deficit declined slightly, but the biggest improvement occurred in 2011 and 2012, year where a small surplus was already recorded. The negative contribution of the goods and services component was evident over the entire period, with the exception of 2012.

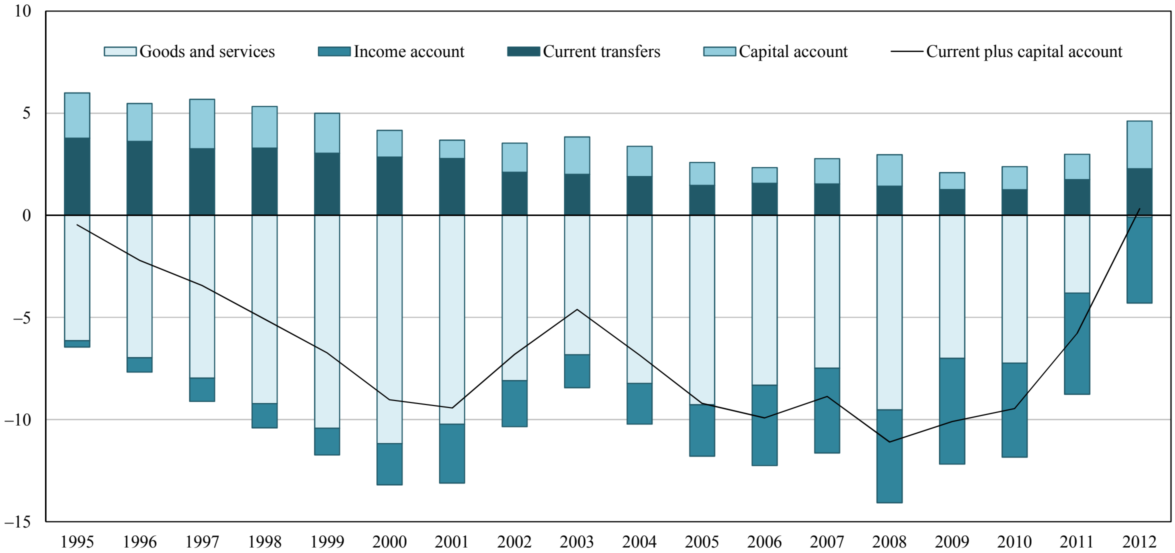
In this context, the significant deterioration of the international investment position was unavoidable, which peaked in 2009 at around 10 per cent of GDP, declining only to a minor extent afterwards and deteriorating again in 2012 (Figure 4).

The expansionary stance of monetary policy, through low interest rates and easy access to credit, and the loosening of fiscal policy led to a significant increase of the indebtedness of the private and public sectors, in particular after 2000 when nominal GDP evolved more unfavourably, reaching historically high levels (Figures 5 and 6).

In this period, the Portuguese economy displayed a number of structural weaknesses which are closely related to the poor macroeconomic performance. The progressive reallocation of resources from tradable to non-tradable sectors and the decline in corporate and public investment in recent years are among these factors. In this context, it is worth mentioning that an inefficient judicial sector did not provide a secure environment crucial for promoting investment decisions. Concerning human capital, the average qualification of the population, which has been improving but is still at a very low level, stands as a major structural handicap for the evolution of the Portuguese economy. In addition, population is ageing rapidly given the very low fertility rate and the rise in life expectancy. Another structural weakness relates to the high degree of segmentation

Figure 3

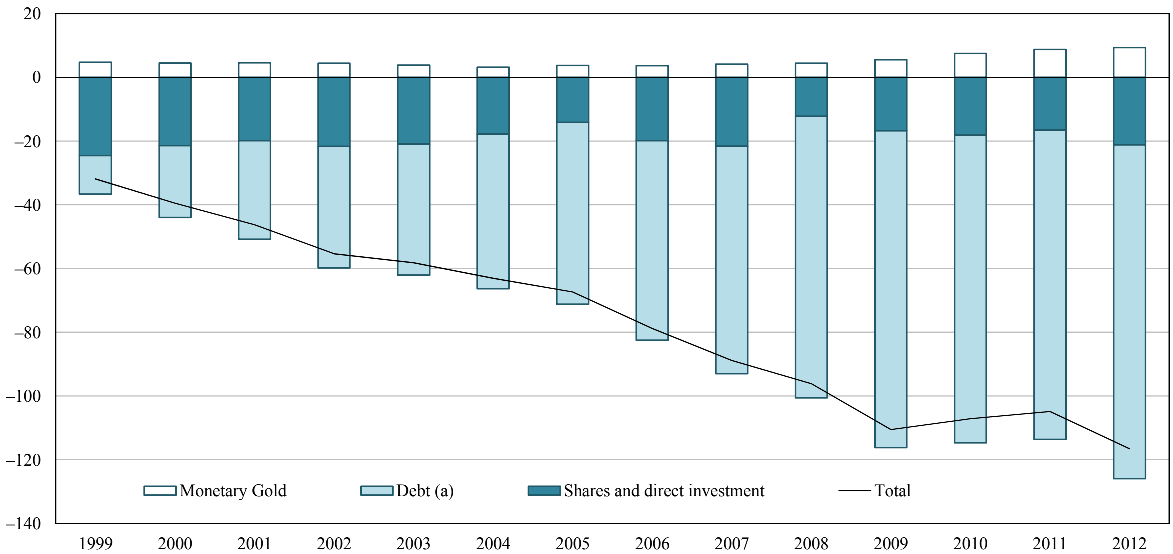
Current Plus Capital Account
(percent of GDP)



Sources: Statistics Portugal and Banco de Portugal.

Figure 4

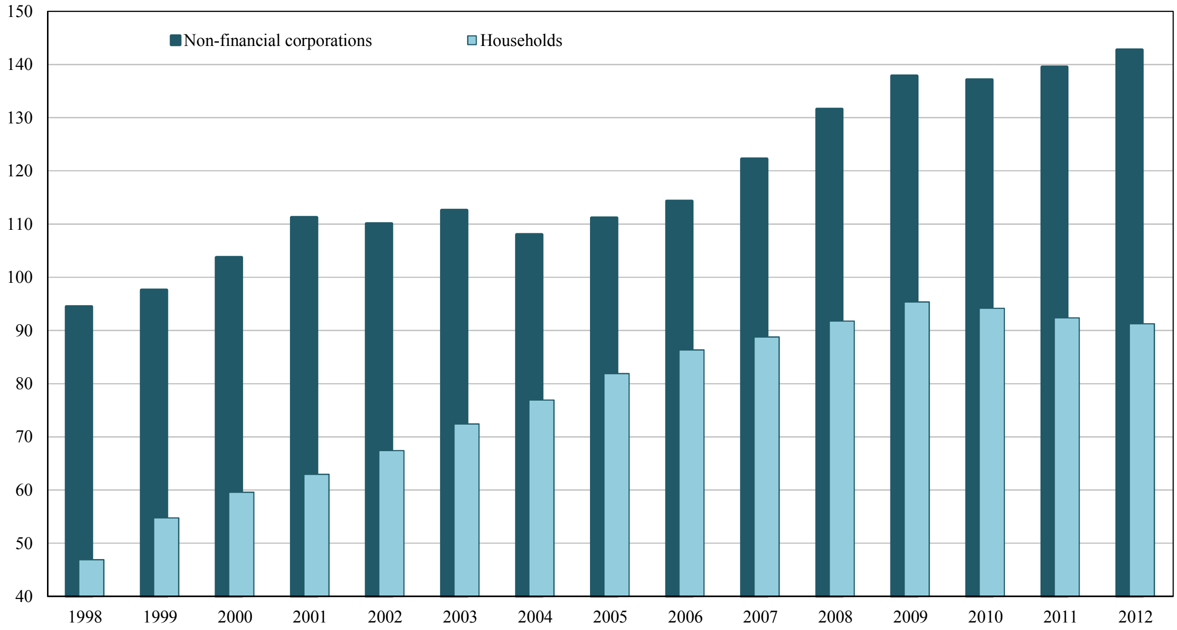
International Investment Position
(percent of GDP)



Sources: Statistics Portugal and Banco de Portugal.
Note: (a) Includes debt securities, other investment, fi nancial derivatives, participation units in investment funds, securitisation units and others. This debt concept is different from the one published in Table A.3.2 of the Statistical Bulletin of Banco de Portugal, since participation units in investment funds, securitisation units and other participation securities are recorded as debt. Additionally, the debt concept used here does not include the difference between direct investment assets and liabilities, presented as other capital, regarding available funds and liabilities over subsidiaries and direct investors. In this chart these elements are included in "Shares and direct investment". This way, this different treatment does not change the total value of the International Investment Position.

Figure 5

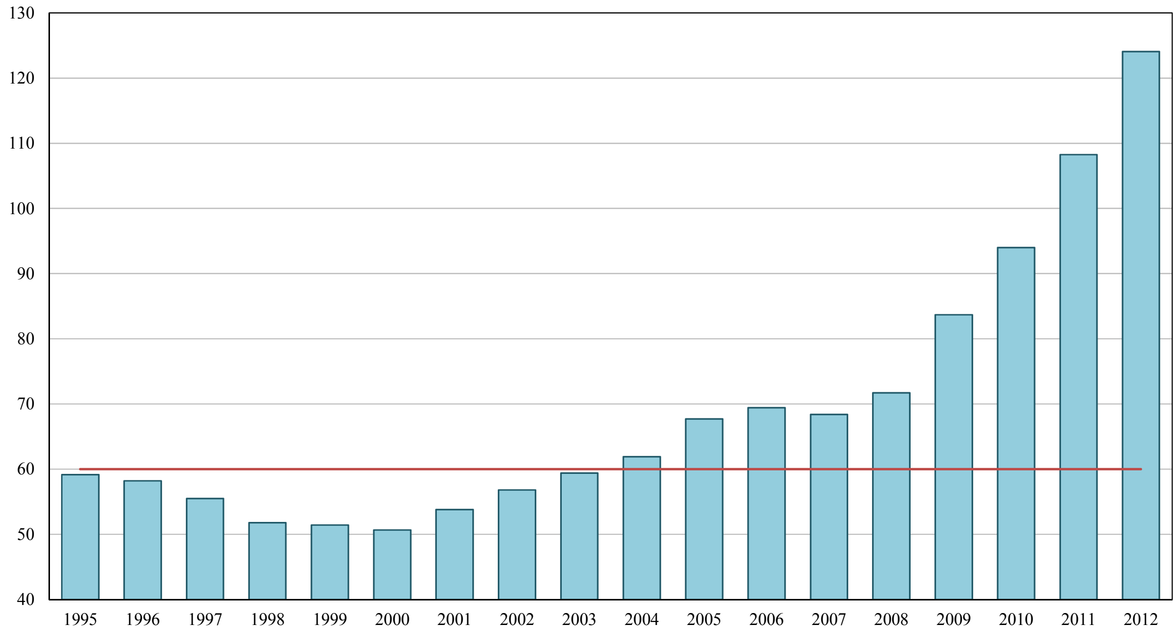
Indebtedness of the Non-financial Private Sector
(percent of GDP)



Sources: Statistics Portugal and Banco de Portugal.

Figure 6

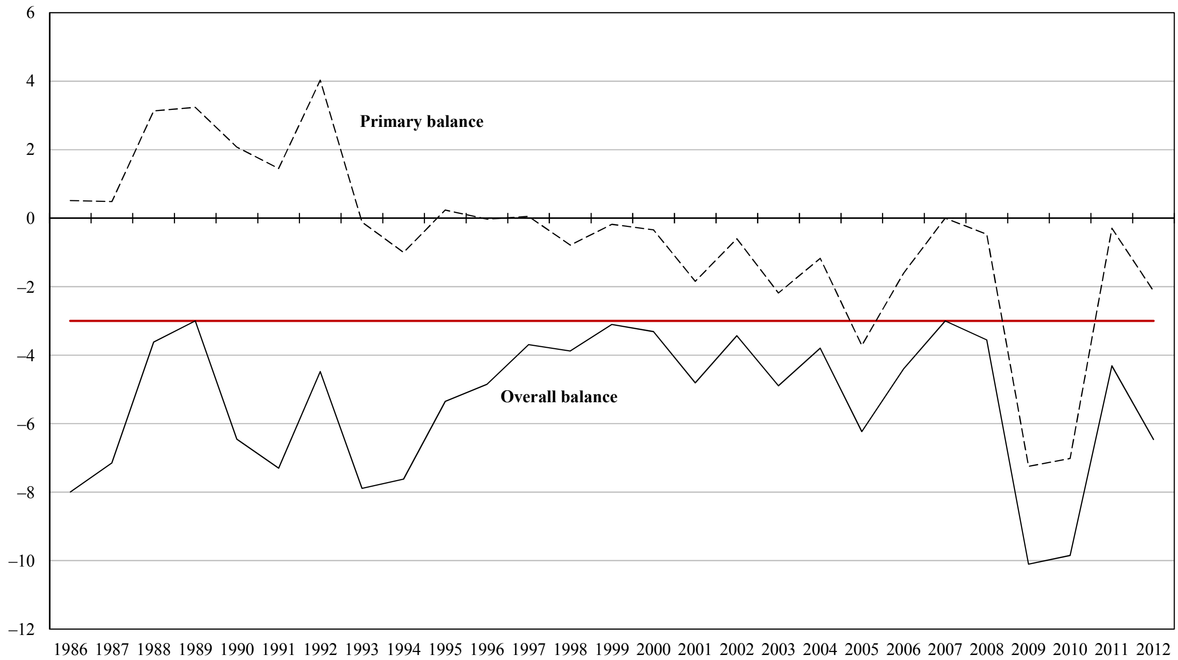
Public Debt, EDP Definition
(percent of GDP)



Sources: Statistics Portugal and Banco de Portugal.

Figure 7

Fiscal Balances in Portugal: 1986-2012
(percent of GDP)



Source: Statistics Portugal.

in the labour market, as permanent contracts enjoy large returns to tenure and fixed-term contracts bear the bulk of the quantity and price adjustment costs.

3 Key features of fiscal developments in Portugal

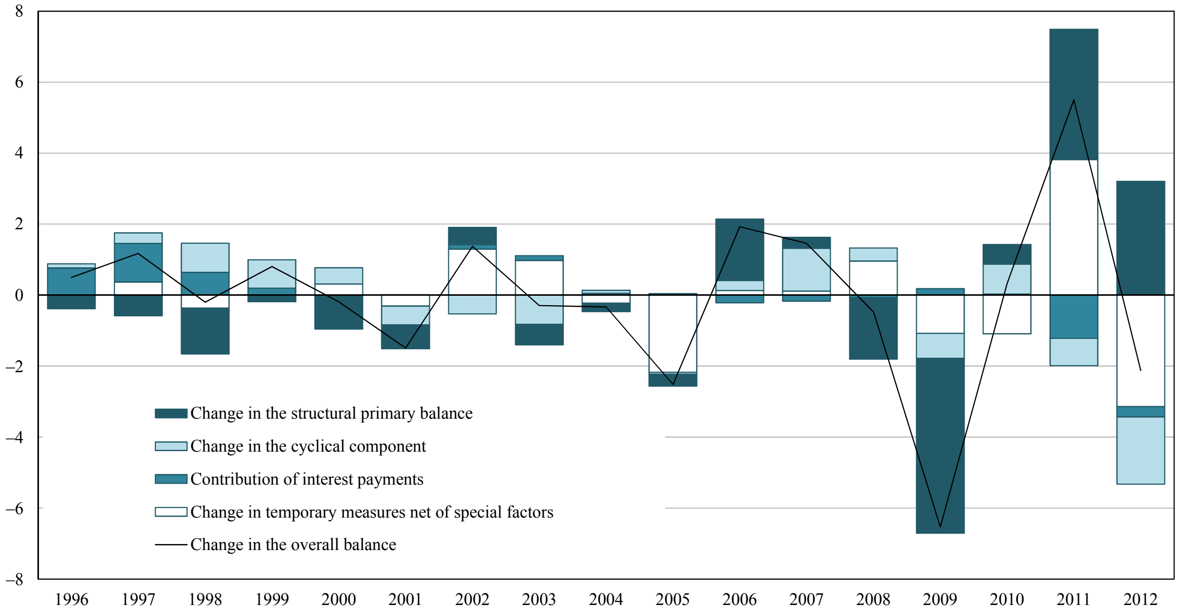
3.1 Main indicators

After the accession to the European Community (as in the preceding period) inadequate fiscal policies from the perspective of the sustainability of public finances contributed decisively to the vulnerability of the country in the context of the current economic and financial crisis. One of the main aspects of fiscal developments since 1986 is that the general government deficit in Portugal never stood durably below 3 per cent of GDP. However, the primary balance followed a downward trend from 1992 to 2005, posting consistently negative figures up to the present. This pattern, characterized by high and persistent fiscal imbalances, is illustrated in Figure 7.

The nineties were largely a missed opportunity to ensure the sustainability of Portuguese public finances. Indeed, the leeway created by the reduction in interest expenditure resulting from the process of nominal convergence and the rapid economic growth were not used to ensure a structural improvement in the fiscal position. Rather, it served to accommodate expansionary fiscal policies, while respecting the limit of 3 per cent for the deficit, according to the statistical rules then in force. Consequently, conditions were created for the occurrence of an excessive deficit, as soon as the macroeconomic environment became less favorable. The effect of the decrease in interest

Figure 8

Breakdown of the Change in the Overall Balance
(percent of GDP)



Sources: Statistics Portugal and Banco de Portugal.

expenditure and the expansionary stance of fiscal policy (measured by the change in the structural primary balance) in the period referred to, are shown in Figure 8, which breaks down the change in the total balance in its several components.

Since 2000, the debt ratio followed a rising trend in the context of an economy with a very low growth. As it is clear from Figure 9, this trend became more marked from 2008 up to the present.

Deficit-debt adjustments had a significant impact on the change in the debt ratio in some years. As can be seen in Figure 10, this impact reduced the debt ratio from 1996 to 1998 due to sizeable receipts from privatizations, and, on the contrary, increased the debt ratio in the 2010-12 period, mainly due to an accumulation of assets.

The primary current expenditure and the tax burden recorded in the decade and a half prior to the current financial and economic crisis growing trends, but much more pronounced on the expenditure side. As it appears clearly from Figure 11, with regard to primary current expenditure, the gap to the average of the euro area (as a ratio to GDP) was basically closed in 2005.

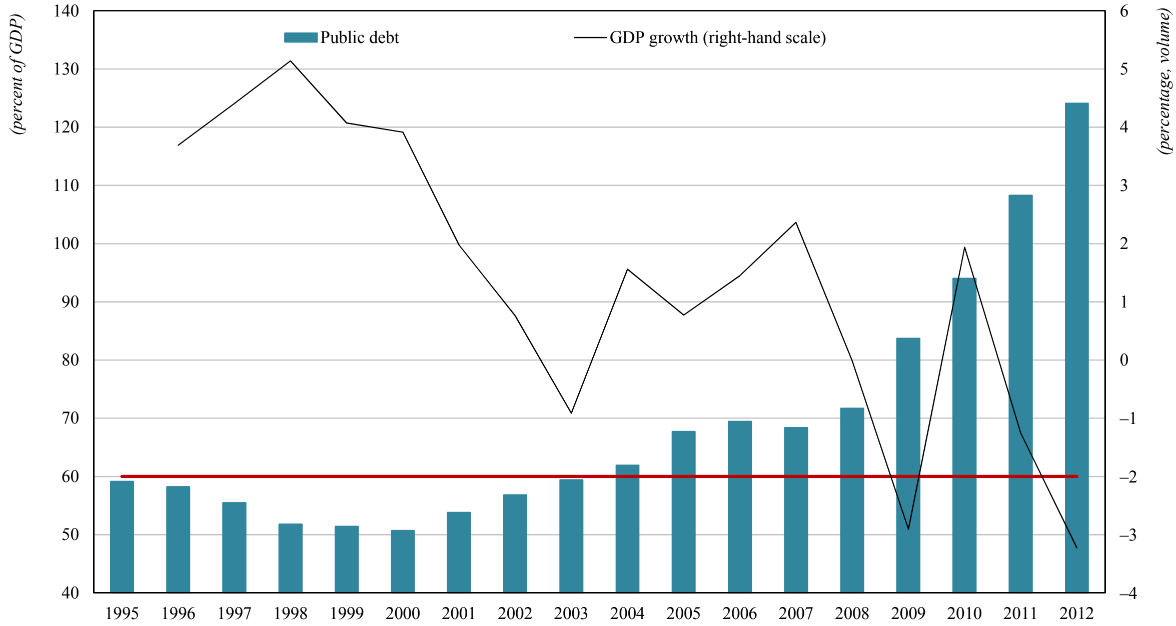
3.2 Expenditure developments

Regarding the economic classification of public expenditure in Portugal,[2] the two most important items are social benefits and compensation of employees. Indeed, in 2012, they represented 48 and 21 per cent of total spending, respectively.

[2] The analysis for Portugal carried out in the next paragraphs is based on expenditure values that exclude the effects of temporary measures and special factors.

Figure 9

Public Debt Ratio and GDP Growth in Portugal

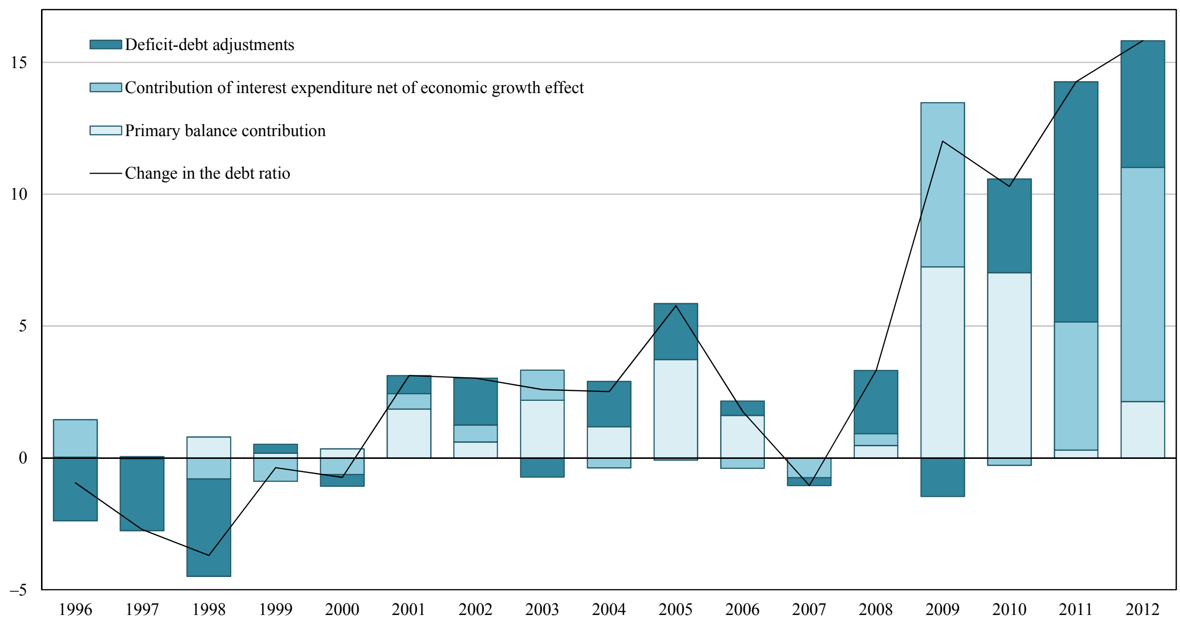


Sources: Banco de Portugal and Statistics Portugal.

Figure 10

Breakdown of the Change in the Public Debt Ratio

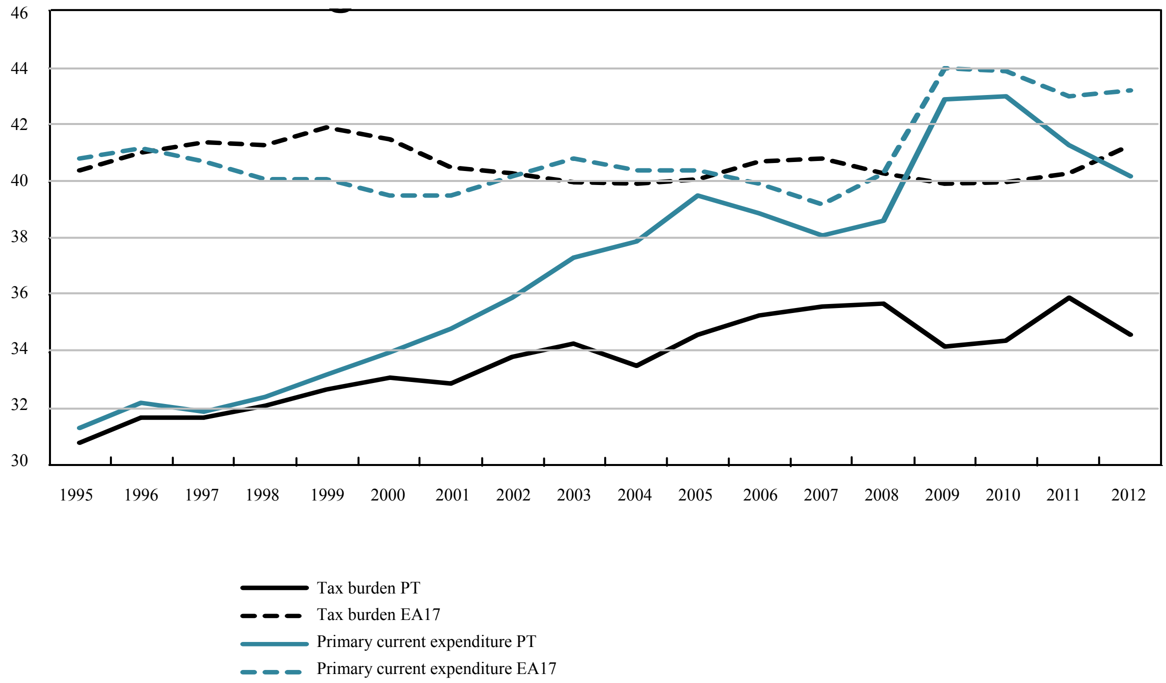
(percent of GDP)



Sources: Statistics Portugal and Banco de Portugal.

Figure 11

Tax Burden and Primary Current Expenditure: Portugal *vis-à-vis* the Euro Area
(percent of GDP)



Sources: Statistics Portugal and Eurostat.
Note: Tax burden is defined as the ratio of revenue from taxes and social contributions to GDP.

Between 1995 and 2012, social benefits increased by 7.9 p.p. of GDP,[3] of which more than 90 per cent resulting from the expansion of transfers to households in cash and the remainder associated with social benefits in kind (Figure 12 and Table 1). In the case of social benefits in cash, more than 75 per cent of the observed variation in the period (corresponding to 5.5 p.p. of GDP) stems from the evolution of pension expenditure. This is undoubtedly one of the main factors accounting for the strong growth in primary spending, particularly after 2000. Underlying its evolution there is a significant growth both in the number of pensioners and the average pension (excluding the annual update) (Figure 13). These developments are partly explained by the maturation of the Social Security subsystem. In terms of annual updates of pensions, in the period prior to the Social Security reform,[4] there were several years with discretionary increases above expected inflation, particularly in the general scheme. After 2008, a new pension indexation formula is in force, which relates the yearly update of pensions with inflation, real GDP growth and the level of pensions. It should be noted that the application of the formula was suspended in 2010 and since then the value of pensions has been frozen, with the exception of minimum pensions. The new Social Security Law also introduced a sustainability factor, changed the initial pension calculation formula and increased penalties for early retirement. This reform, whose effects will be mainly felt in the medium and long term, was an important step towards improving the sustainability of public finances. This result has naturally as a counterpart the reduction in the value

3 Correcting for the structural breaks associated with the transformation of hospitals into public corporations.

4 See Law No. 4/2007 of January 16 and Decree-law no. 187/2007 of May 10 for specific regulation.

Figure 12

Public Expenditure in Portugal: Economic Classification
(percent of GDP)

Sources: Statistics Portugal and Banco de Portugal.
Notes: The items are corrected by the effects of temporary measures and special factors. They reflect, however, the structural breaks associated with the transformation of hospitals into public corporations from 2002 onwards.

Table 1

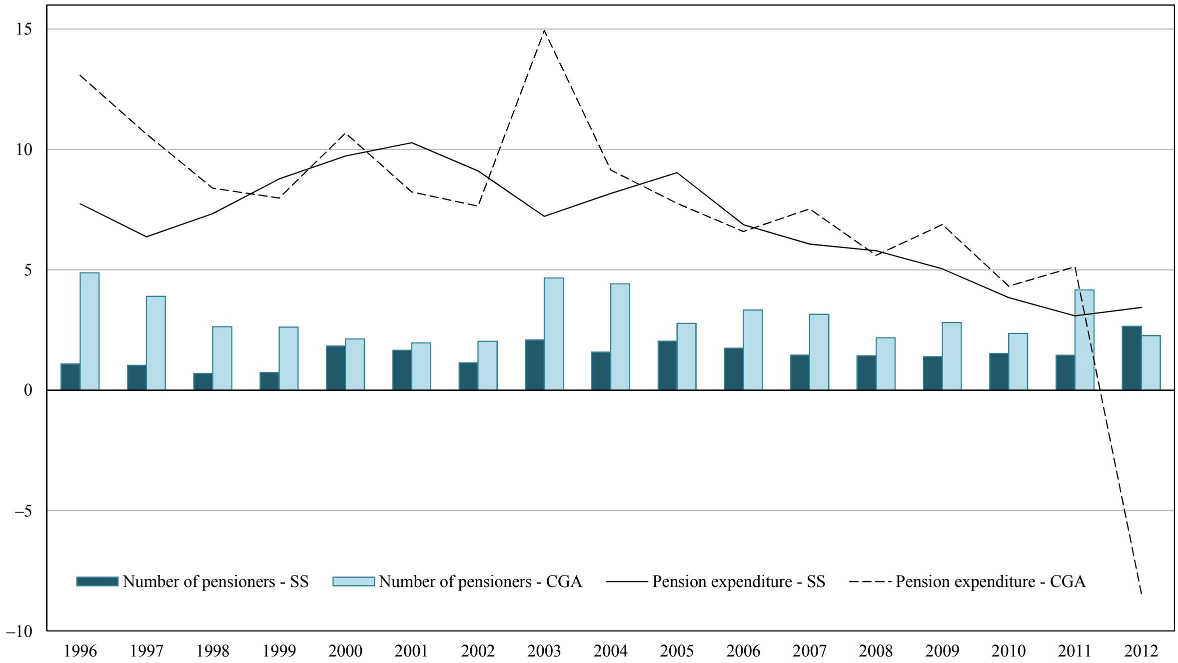
Evolution of the Main Expenditure Items
(percent of GDP)

	1995-2002	2002-12*	1995-2012
Social benefits	1.7	6.2	7.8
in cash	1.3	5.9	7.1
in kind	0.4	0.3	0.7
Wage bill	1.1	–2.7	–1.5
Intermediate consumption	0.3	1.1	1.4
Investment	0.4	–2.2	–1.8
Interest	–2.8	1.5	–1.3

* Correcting the structural breaks associated with the transformation of hospitals into public corporations.

Figure 13

Change in Pension Expenditure and in the Number of Pensioners
(percent)



Sources: Social Security and Caixa Geral de Aposentações.

of future pensions relative to what had been expected before the reform. Note that this decrease in replacement rates will also occur in the euro area as a whole.[5] As for the *Caixa Geral de Aposentações* subsystem, the very favourable rules are being changed since 2003, but in the meantime with some acceleration of the convergence to the rules of the general scheme.[6] Transfers of pension funds to the general government, by contrast, given its self-reversing nature,[7] have contributed to one-off increases in the level of pension expenditure in both public subsystems.[8] In 2012, pension expenditure decelerated sharply following the suspension of the summer and Christmas bonuses, but it is expected to return to a significant growth in 2013 as a result of the reintroduction of these bonuses. Altogether, the impact of policy measures largely explains the decrease in the growth rate of spending on pensions. The remaining social benefits in cash[9] also

5 See Economic Policy Committee and European Commission (2012).

6 The succession of changes in the rules of the Caixa Geral de Aposentações subsystem have led to a considerable increase in requests for retirement, an important part of which corresponds to early retirement, subject to penalties.

7 The transfers of pension funds to general government benefit the deficit in the year they occur, but increase pension expenditure of this institutional sector in the following years. In principle, the amount initially received should equal the present value of the additional pensions payable in the future. The calculation of this value is, however, dependent on several factors, in particular related to the discount rate and mortality tables, which involve some uncertainty.

8 The impact of these transfers in general government pension expenditure amounted to about 0.3 per cent of GDP in each of the subsystems in 2012. In terms of the number of pensioners, the effect on the Social Security subsystem reaches around 32,000 individuals, while in the Caixa Geral de Aposentações subsystem was close to 40,000 retirees.

9 This aggregate includes, among other benefits, unemployment benefits, subsidies for sickness, family allowances and social programmes for the support of the elderly and poor households.

increased gradually as a ratio to GDP, only having recorded a decline in the last three years as a result of control measures and changes in eligibility rules.

Developments in social benefits in kind should be analysed in conjunction with the evolution of compensation of employees and intermediate consumption. Indeed, the transformation of hospitals into public corporations that occurred since 2002, although fundamentally neutral for the deficit, led to an increase in social benefits in kind, through the payment of services to corporate hospitals, and a reduction in compensation of employees and intermediate consumption.[10] With regard to social benefits in kind, the increase reached 3.0 p.p. of GDP between 1995 and 2012 (0.7 p.p. of GDP excluding the amounts related to the payment of services to corporate hospitals). A substantial set of measures adopted in the health sector, with a particular focus on spending on medicines, has been contributing to mitigate the growth trend of this item.

Apart from the above-mentioned effect related to corporate hospitals, compensation of employees also reflects the treatment of *Caixa Geral de Aposentações* in National Accounts in the period prior to 2005.[11] The wage bill (which is not affected by the issue of the treatment of *Caixa Geral de Aposentações*) decreased by 3.2 p.p. of GDP between 1995 and 2012. If this evolution is adjusted by an estimate of the impact of the transformation of hospitals into public corporations, the reduction would amount to 1.7 p.p. of GDP. Indeed, the strong growth of this item, particularly until 2002 (which amounted to 1.1 p.p. of GDP), was associated with a very significant increase in the number of general government employees and extraordinary revisions of careers. These developments are illustrated in Figure 14 that shows the rates of change in expenditure on wages and the number of general government employees, as well as the difference between the two series. This difference essentially captures the effects of the updates of the wage scale, regular promotions and progressions, extraordinary revisions of careers and changes in the average wage due to inflows and outflows (mainly for retirement) of public employees. Note that, until 2002, the analysis is not affected by the creation of corporate hospitals, classified outside the general government sector. Thereafter, the two series represented in the Figure reflect the breaks associated with the corporatisation of hospitals, which implies that only the difference between them is relevant for the analysis.[12] Since 2002, several factors contributed to moderate and afterwards to revert the growth trend of this item. Firstly, the stricter control of admissions together with outflows for retirement.[13] Secondly, changes in the promotions and career progressions schemes.[14] Thirdly, some tightening in the annual update of the wage scale, with an almost freeze in 2003, 2004 and 2010, but far above inflation in 2009. Finally, in 2011, the 5 per cent average cut in salaries and in 2012 the suspension of the Christmas and summer bonuses (to be reversed in 2013). The wage reduction of 2011, as well as the suspension of the summer and Christmas bonuses in 2012, was made in progressive terms, contributing to the narrowing of the wage premium relatively to the private sector which, in 2005, was slightly positive for higher wages.[15] As for the number of

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10 See 2007 Banco de Portugal Annual Report, Box 6.1 Corporate hospitals and public expenditure.

11 In the period prior to 2005, employer contributions related with general government employees who were subscribers of Caixa Geral de Aposentações were still calculated as the amount needed to balance the system in each year. As pension expenditure of this subsystem was growing substantially in this period, contributions and consequently compensation of employees increased on average at a higher rate than the wage bill.

12 The difference itself may still be affected by the corporatisation of public hospitals as this also influences, beyond the number of workers, the average wage in the general government sector.

13 As well as the reduction in the number of teachers and other personnel with term contracts in the recent period.

14 The process began in 2004 and is currently ruled by Law No. 66-B/2007 of December 28, which established the integrated management and performance evaluation system for public administration (SIADAP). In practice, the progressions in careers are actually slower and linked to the performance of workers.

15 In this regard see Campos and Pereira (2009). According to the authors, the wage premium (*i.e.*, the wage gap between general government and the private sector workers that remains after controlling for a set of observable characteristics) when evaluated at

(continues)

Figure 14

Change in the Wage Bill and in the Number of General Government Employees
(percent)

Sources: Statistics Portugal and authors' calculations.

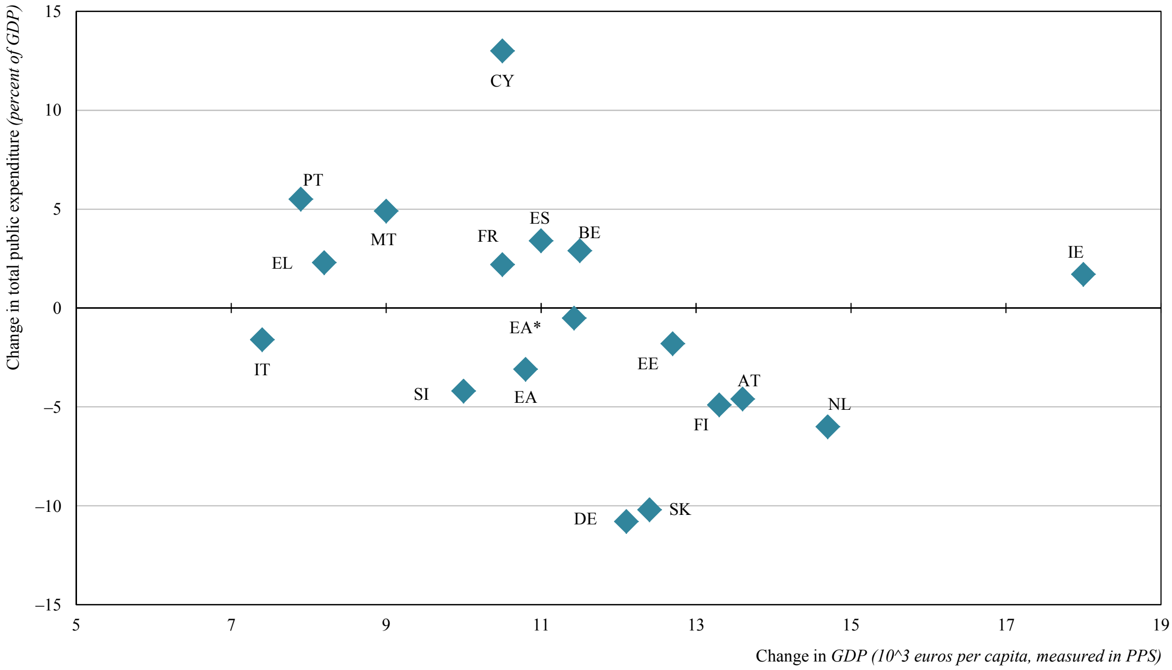
general government employees, an estimate of the authors that corrects the breaks due to the corporatisation of hospitals point to an increase by about 44,000 individuals (approximately 7 per cent) in the period from 1995 to 2012, which can be broken down in an increase of approximately 120,000 until 2002, and a reduction of around 76,000 afterwards. In this respect, in the current context of a significant number of retirements, the importance of avoiding that the reduction in the number of public employees undermines the materialization of the priorities established for the provision of public services should be highlighted.

Intermediate consumption as a percentage of GDP, corrected for the impact of the corporatisation of hospitals, shows an increase in almost every year until 2009, recording a decline only in the last two years of the period under analysis. As a consequence, the value of 2012 is about 1.5 p.p. of GDP higher than in 1995. The opposite occurred regarding public investment, which reduced its ratio to GDP from a peak of 5.3 per cent in 1997 to a historical low level of 1.8 per cent in 2012. Part of this trend is explained by the creation of public-private partnerships in this period and the fact that this item of expenditure is easier to cut in times of budgetary difficulties. It should be noted, however, that in economic terms the reduction of public investment does not necessarily corresponds to an unfavourable evolution, if it allows the elimination of projects with very low or even negative rates of return.

the mean of the distribution of wages amounted to about 17 per cent in 2005. However, it declined along the wage distribution, being particularly reduced in the last deciles.

Chart 15

Change Between 1995 and 2012 of Total Expenditure as a Ratio to GDP and GDP Per Capita Measured in PPS



Sources: Eurostat, Statistics Portugal and Banco de Portugal.
Notes: Luxembourg is not considered. The simple average of the euro area is represented by EA*.

Figure 15 shows the change in levels of total public expenditure as a ratio to GDP in each of the euro area countries[16] and its relation to the variation of the respective GDP *per capita*, measured in purchasing power standard (PPS), between 1995 and 2011. This analysis shows that Portugal was a Member-state of the euro area that, despite the negligible increase in GDP *per capita*, recorded one of the highest rises in public spending as a percentage of GDP.

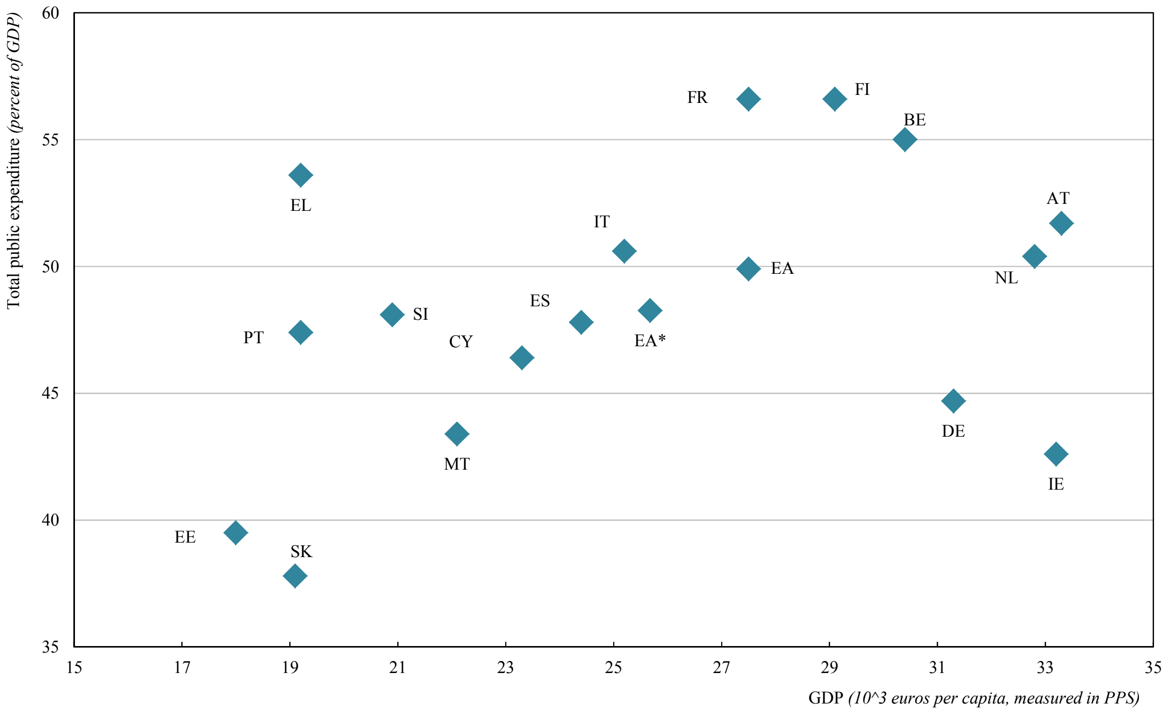
Figure 16 illustrates the international comparison between the level of public spending as a percentage of GDP and the level of GDP *per capita*, measured in PPS in 2011. As can be seen, Portugal appears with a level of total public expenditure as a ratio to GDP above that of many countries, including some with a substantially higher GDP *per capita*.

Figure 17 shows the results for a euro area country-by-country analysis of the relationship of expenditure and the respective GDP for the most relevant functions in 2011: defence and public order and safety, health, education and social protection. In this perspective, it is worth mentioning that Portugal had a level of expenditure as a percentage of GDP relatively high, even compared to countries with higher per capita income, particularly in defence, public order and safety and education. As for public spending on education, Portugal is often referred to in the literature as a country with a high proportion of staff costs. In this respect, it is worth mentioning that the difference in the share of compensation of employees in total expenditure on education compared to the euro area average peaked at about 11 p.p. in 2008, decreasing substantially in the following

[16] Luxembourg is not considered as it is clearly an outlier in this analysis.

Figure 16

Total Public Expenditure as a Ratio to GDP and GDP Per Capita Measured in PPS, 2012



Sources: Eurostat, Statistics Portugal and Banco de Portugal.
Notes: Luxembourg is not considered. The simple average of the euro area is represented by EA*.

years (in 2011, the difference stood at 5.4 p.p.). This development is certainly explained to a large extent by both the general measures affecting the wages of general government workers, and the reduction of the number of teachers hired. In contrast, public spending on health and social protection in Portugal is below the euro area average, although pension expenditure as a ratio to GDP has already reached a value close to the euro area.

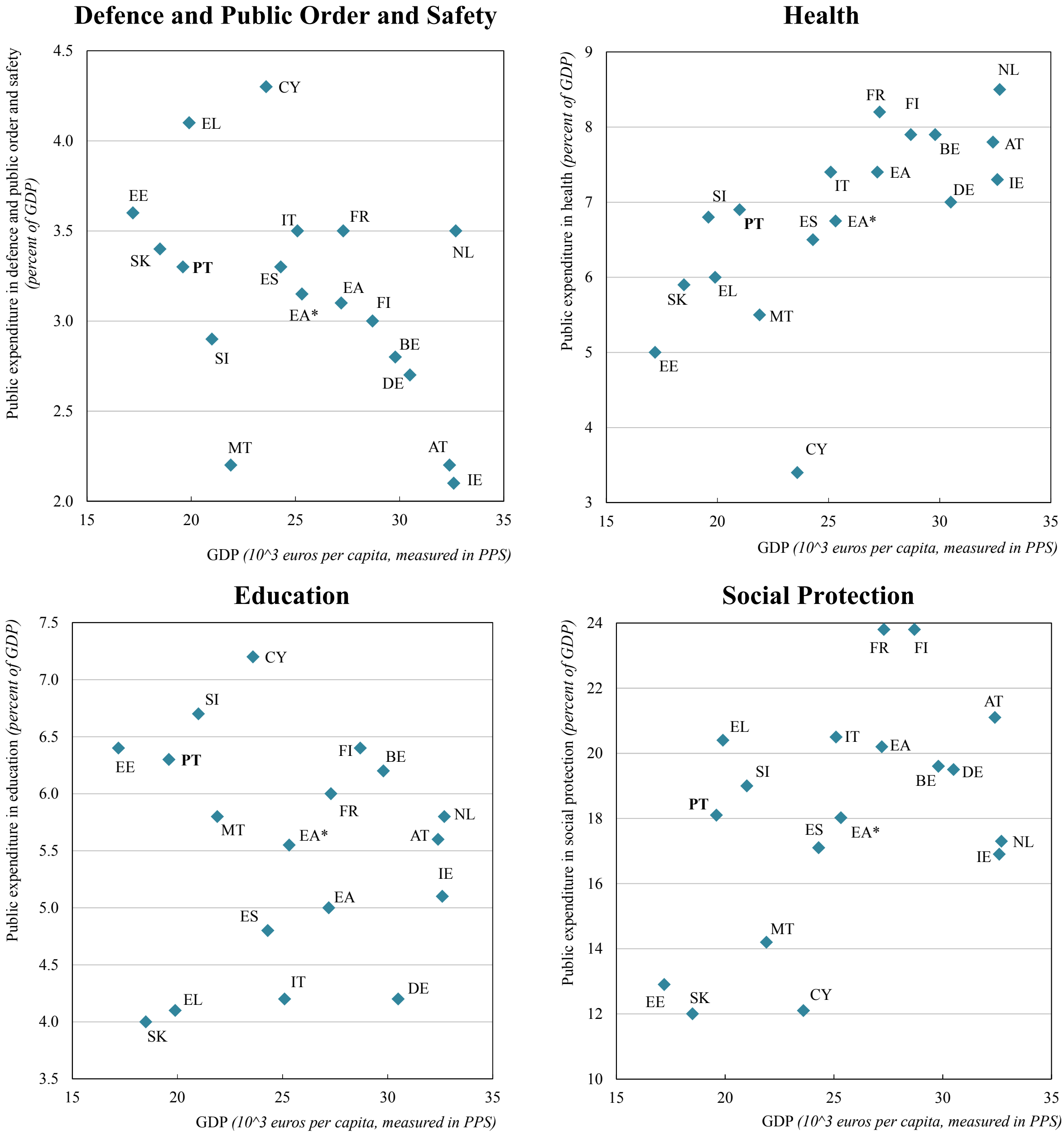
3.3 Revenue developments

As already highlighted, the increase in the tax burden was one of the driving forces of Portuguese public finances. In this context, it is worth mentioning that the basic structure of the current tax system as set down prior to the period under analysis. Indeed, both indirect and direct taxation were completely reshaped in the second half of the eighties. The first in 1986, with the introduction of VAT, and the latter in 1989, with the creation of the personal and corporate income taxes. Between 1995 and 2012, the tax burden in Portugal increased by 3.9 p.p. of GDP, reaching 34.8 per cent of GDP at the end of the period (Table 2). This evolution was due to all major categories of taxes and social contributions. In 2012, taking the euro area as a benchmark, Portugal recorded a lower tax burden as a ratio to GDP, with a higher level of receipts from indirect taxes, but lower as far as revenue from direct taxes and social contributions are concerned.

The drivers of the changes in the structural tax burden varied substantially along the years (Figure 18). Concerning legislation changes, the period up to 2001 witnessed discretionary measures aiming at the reduction of the tax burden, while from 2002 onwards this trend was

Figure 17

Public Expenditure and GDP, 2011



reversed. That change was closely related to the need to correct excessive deficits, in a first stage. In the two last years of the period under analysis, discretionary tax increases appeared as part of the fiscal consolidation measures adopted in the context of the Financial and Economic Assistance Programme. The fiscal drag and decoupling of the base from GDP did not have a major contribution to the change in the structural tax burden in most of the years. The magnitude of the residual was, however, important but it should be referred that its explanation may be related to some extent with the drawbacks of the cyclical adjustment methodology or an inaccurate quantification of policy measures. Additionally, the positive residuals in the period 2004-07 were

Table 2

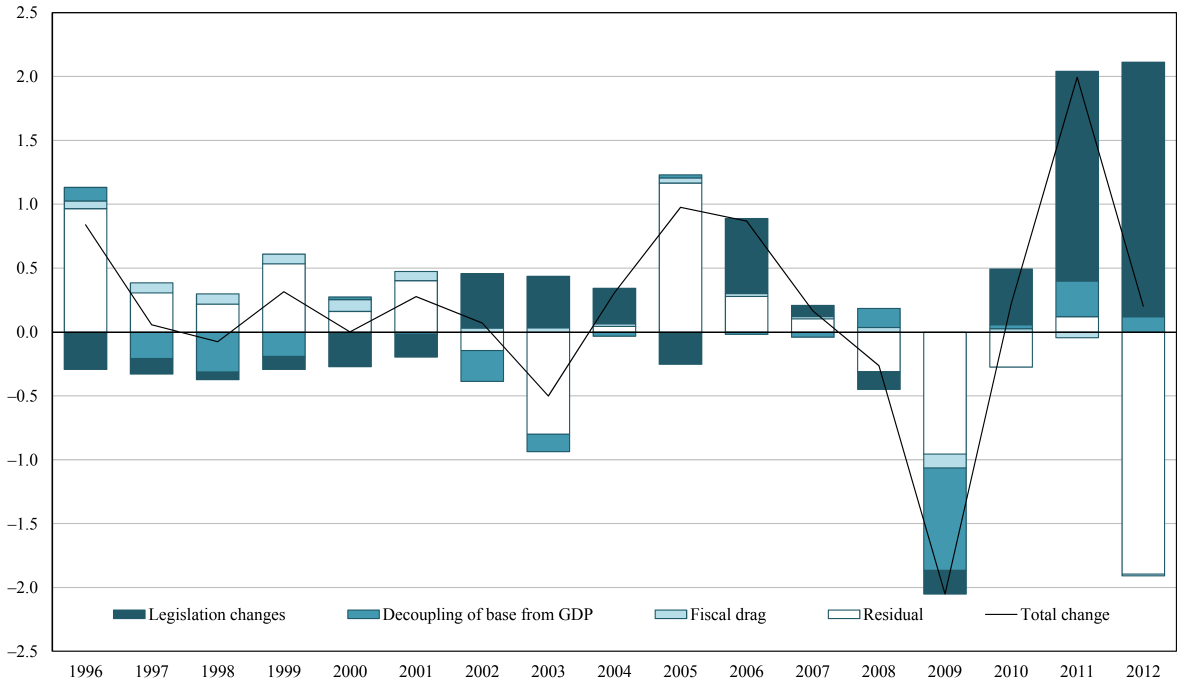
Evolution of the Tax Burden
(percent of GDP)

	Portugal			EA-17		
	1995	**2012**	**Change**	**1995**	**2012**	**Change**
Taxes on income and wealth	8.2	9.3	1.1	11.5	12.4	0.9
Taxes on production and imports	12.6	13.7	1.1	11.8	13.0	1.2
Capital taxes	0.1	0.2	0.1	0.3	0.3	0.0
Social contributions	10.0	11.6	1.6	17.1	15.9	–1.2
of which: imputed contributions	2.3	2.5	0.2	1.5	1.2	–0.3
Tax burden	**30.9**	**34.8**	**3.9**	**40.7**	**41.6**	**0.9**

Sources: Eurostat and Statistics Portugal.

Figure 18

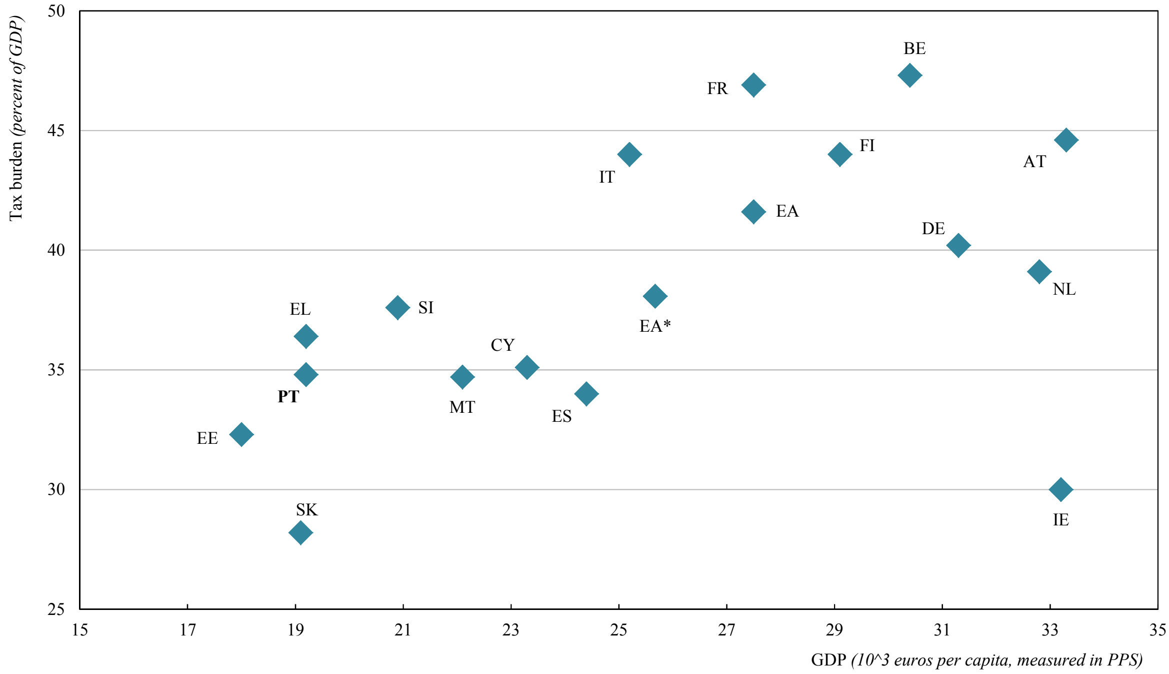
Breakdown of the Change in the Structural Tax Burden
(percent of trend GDP)



Sources: Authors' calculations.
Note: Excludes social contributions of the public employees subsystem.

Figure 19

Tax Burden as a Ratio to GDP and GDP Per Capita Measured in PPS, 2012



Sources: Eurostat, Statistics Portugal and Banco de Portugal.
Notes: Luxembourg is not considered. The simple average of the euro area is represented by EA*. The tax burden includes taxes on income and wealth, taxes on production and imports, capital taxes and social contributions.

mostly due to the enhancement of the effectiveness of tax administration, based on a wider use of information technology and stepped up human resources. The significant negative residuals in 2009 and 2012 were both strongly affected by VAT developments. In the first of these years, the performance of VAT collection below what could be expected given the evolution of the macroeconomic base still remains to be explained, while in the case of 2012 the situation occurred as a result of an overestimation of the impact of some measures.

Although the tax burden as a ratio to GDP in Portugal was significantly lower than in the euro area as a whole in 2012, when comparing with other countries individually, Portugal had a tax burden broadly in line with what would be expected given its level of GDP per capita measured in PPS (Figure 19). This situation differs significantly from the case of total expenditure mentioned before.

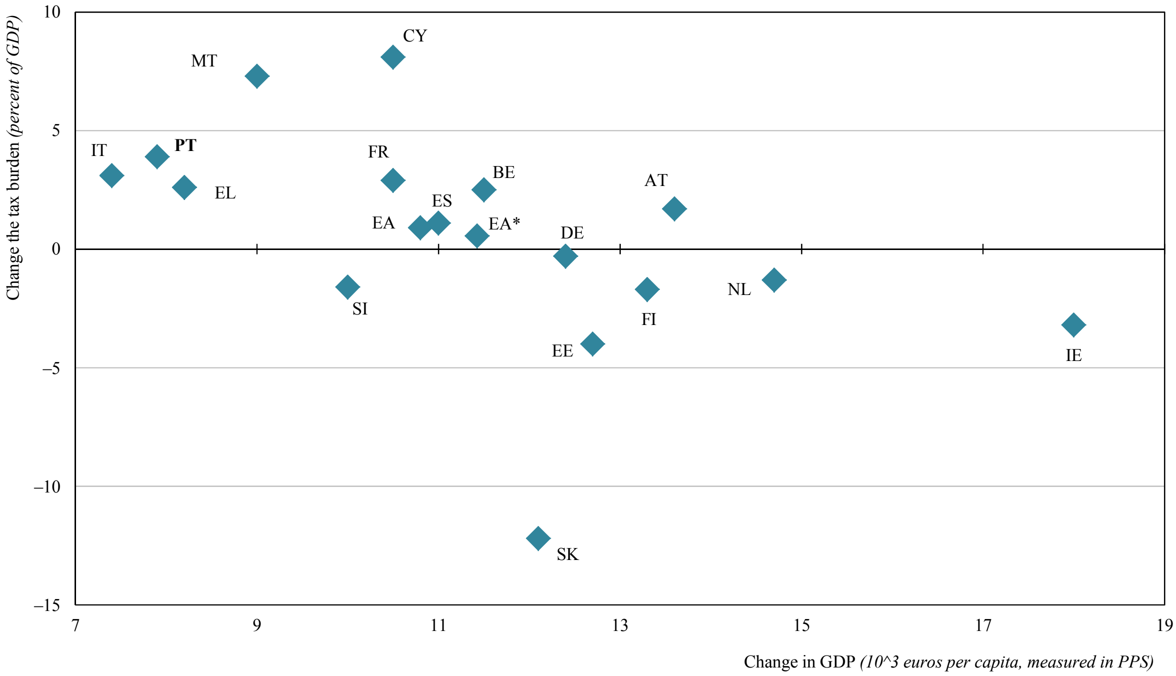
However, in terms of change, Portugal recorded one of the highest rises in its tax burden to GDP ratio among the euro area countries between 1995 and 2012, despite the negligible increase in GDP per capita (Figure 20).

4 Why was expenditure control so ineffective?

Portugal was officially the first country in the euro area to record an excessive deficit: it occurred in 2002 based on the 2001 fiscal developments. In 2005, for the second time, an excessive

Figure 20

Change Between 1995 and 2012 of the Tax Burden as a Ratio to GDP and GDP Per Capita Measured in PPS



Sources: Eurostat, Statistics Portugal and Banco de Portugal.
Notes: Luxembourg is not considered. The simple average of the euro area is represented by EA*. The tax burden includes taxes on income and wealth, taxes on production and imports, capital taxes and social contributions.

deficit situation was identified concerning the year itself. From 2002 to 2008 several packages of fiscal measures were approved aiming to correct or avoid excessive deficits. These packages involved: i) tax hikes, with particular emphasis on VAT (2002 and 2005), ii) increasing the efficiency/effectiveness of the tax administration, a process that started before 2005, but whose most visible effects emerged from 2005 to 2007; iii) temporary measures in the strict sense, mainly on the revenue side, iv) short-term measures on the expenditure side, possibly with a permanent impact on the level of spending, but only a transitory effect on its growth rate. In 2006 and 2007 were introduced some relevant structural reforms, but with a limited impact in the short term.

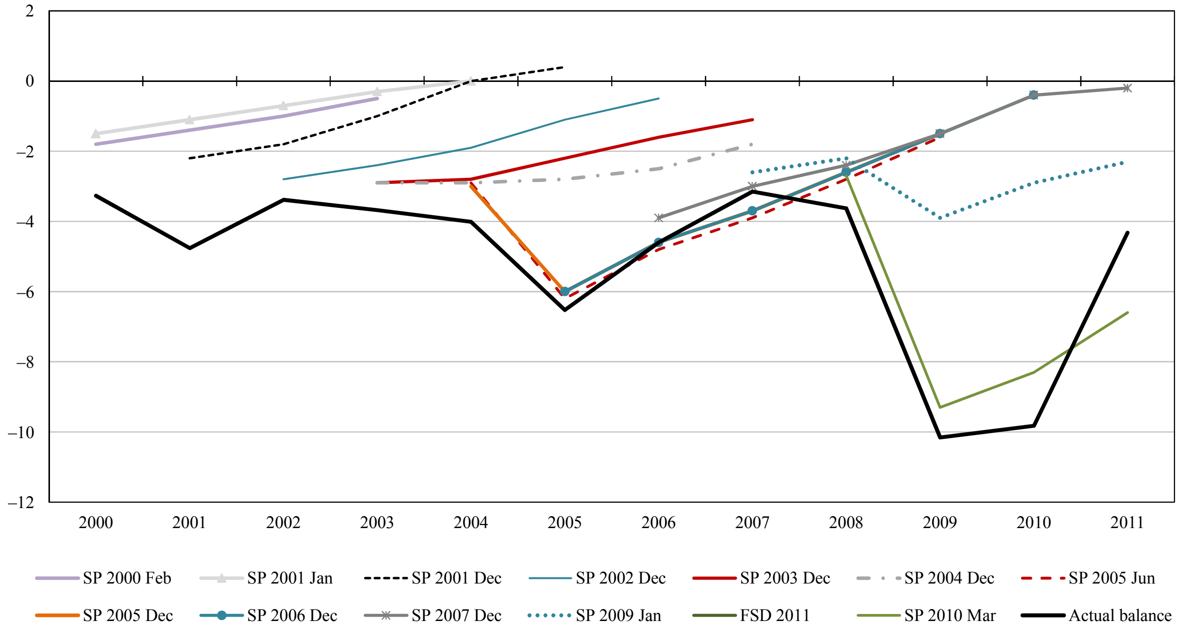
The March 2008 excessive deficit procedure notification confirmed that the deficit in 2007 had fallen short of 3 per cent of GDP, suggesting at first glance an optimistic assessment of the state of public finances in Portugal. It was understood then that there was room for stimulus measures, which indeed started to materialize. Firstly, the standard VAT rate was cut by 1 percentage point as early as April 2008. Shortly after, in July, a package of measures to protect vulnerable groups from the effects of a crisis that was expected to involve price and interest rates increases was implemented. In the last months of the year the budget for 2009 was approved, which included measures such as the increase of 2.9 per cent of the salaries of government workers, and the official package of stimulus measures, within the framework of an EU initiative. Throughout 2009 the control of public expenditure was effectively loosened. This set of measures, together with the effects of the international financial and economic crisis, led to an explosion of the deficit in 2009. The reluctance to accept the need for a fiscal adjustment of a considerable magnitude throughout 2010 and in the first months of 2011 worsened decisively the international investors' pressure about the Portuguese public debt, which culminated in the request for economic and financial assistance by Portugal, in April 2011.

Following the entry of Portugal into the European Community, it would be naturally expected a rapid expansion of public spending to reduce, at least partially, the difference between the levels of provision of public services and social protection relative to the other Member-states. But when the Portuguese economy slowed at the turn of the century, it would have been prudent to substantially adjust the pace of expansion of public expenditure. This did not happen due to a large number of factors. Below are highlighted some of the most relevant:

- The rights acquired as a result of past decisions, particularly generous, entailing a substantial rigidity in reducing expenditure. Among them are: i) the large wage increases resulting from the new salary system for civil servants and ii) the inability to dismiss civil servants; iii) automatic and rapid progression in their careers, in most areas of public administration, iv) the rules for setting the initial pensions in CGA.
- The delay in structural reforms, allowed by the use of very substantial temporary measures and measures that have only transitory impact on the rate of change in expenditure, as well as the reduction of government investment.
- The limitations of budgetary procedures, in particular: i) the absence of fiscal rules, in most of the relevant dimensions, ii) an emphasis on annual budgets, without a medium-term fiscal framework, iii) budgetary control focused on the use resources and not on the results, iv) the fragmentation of the budget, v) a system of accounts incomplete and, vi) the limited transparency of budgetary procedures. This framework allowed the politicians to ignore fundamental technical restrictions in making their decisions, did not induce a consistent behavior over the various areas and levels of government towards achieving the main budgetary objectives and hindered the evaluation of public policies by citizens in general and even by experts.
- The weaknesses of the system of multilateral fiscal surveillance in the EU, both before and after the reform of the Stability Pact, which limited their impact in countries such as Portugal, where budgetary best practices were not internalized by all political actors , the social partners and the public in general. At the root of these weaknesses has always been the fact that the most important decisions in terms of sanctions and even prevention were adopted with a high degree of discretion by the representatives of the Member-states, leading to the acceptance of medium-term programs often unrealistic and based on statistical information insufficiently controlled, as Figure 21 illustrates for the Portuguese case. Until the reform of the Pact, these problems were aggravated by excessive focus on the deficit, ignoring several important dimensions such as sustainability, efficiency of public spending and the quality of institutions nationwide.
- The long-term trend of population aging was also a factor of some importance in increasing spending. Note, however, that even in the areas that are the most affected by the demographic development, such as public pensions and health, aging alone explains a small part of expenditure growth: on average, close to a third of the rate of change of old age pensions of Social Security, as illustrated in Figure 7, and a little more than ten per cent of the growth rate of public expenditure on health. In the case of pension expenditure of the CGA, the relationship is difficult to establish, since the increase in the number of retirees reflects the demographic structure of specific employees of the public administrations, as well as being heavily influenced by successive waves of early retirements and transfers of pension funds.
- Finally, in terms of the context in which it operates fiscal policy, it must be stressed that some illusions about the potential growth of the Portuguese economy were retained, as evidenced by Figure 22. Indeed, the perception that growth based on domestic demand and easy access to credit would lead to stagnation of the economy took several years to become almost consensual.

Figure 21

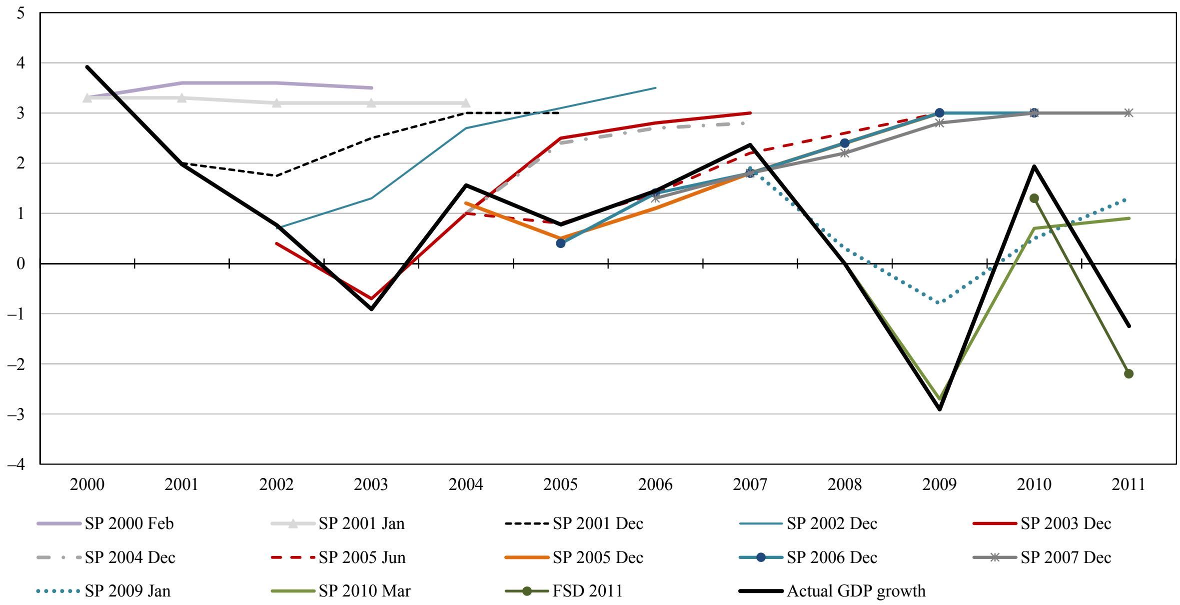
General Government Balance: Projections of the Stability Programmes and Actual Outcomes
(percent of GDP)



Sources: Updates of the Stability and Growth Programme and Statistics Portugal.
Notes: SP = Stability Programme; FSD = Fiscal Strategy Document.

Figure 22

GDP Growth Rate: Projections *vis-à-vis* Actual Outcomes
(percent)



Sources: Updates of the Stability and Growth Programme and Statistics Portugal.
Notes: SP = Stability Programme; FSD = Fiscal Strategy Document.

The poor assessment of the growth trajectory of the economy has been particularly relevant in the area of budgeting, determining a too optimistic prospect about the sustainability of public finances.

Despite the inability to ensure a clear sustainability of public finances in Portugal, since the turn of the century until the beginning of the current financial and economic crisis, several notable reforms or other changes in the budgetary domain occurred. Without trying to be exhaustive, the most important are highlighted below:

- The reform of public pension systems, which was, at the European level, considered a good example, with visible and immediate impact on the sustainability assessment.
- The public administration reform, involving a multiplicity of aspects, with relative success. In terms of control/quality of expenditure it should be highlighted the new rules for career progression, which became slower and more variable, more clearly linked to performance evaluation, and now subject to quotas in the upper categories.
- Rationalization of networks for the provision of public services. For its quantitative relevance, deserve special mention the closure of schools with a small number of students and the creation of school groups in non-tertiary education, and the restructuring of the networks of some health services more differentiated, for example, maternity and emergency services.
- Increased transparency and quality of budgetary information, both from the viewpoint of public accounting and of national accounting. In the first of these aspects it should be noted the publication in the bulletin of the Directorate-General of the Budget of monthly data on a cash basis, covering almost all of the entities that are included in the general government sector from the perspective of national accounts (only in 2012 began to be published monthly information on the reclassified public corporations). In the second, it should be noted the compilation of general government non-financial national accounts, annual and quarterly, by Statistics Portugal. At the institutional level it should be highlighted the strengthening of the role of the Bank of Portugal, which compiles financial accounts and public debt statistics, and of the Court of Auditors. At EU level reference should be made to the strengthening of the means and the powers of Eurostat, in particular in the context of the excessive deficit procedure.

5 The Economic and Financial Assistance Programme to Portugal: The fiscal pillar

In the first months of 2011, financial markets triggered an increase in sovereign risk, affecting the domestic banking system and the economy as a whole (Figure 23).

The Economic and Financial Assistance Programme to Portugal will last from mid-2011 to mid-2014 and focuses its intervention in three main areas:

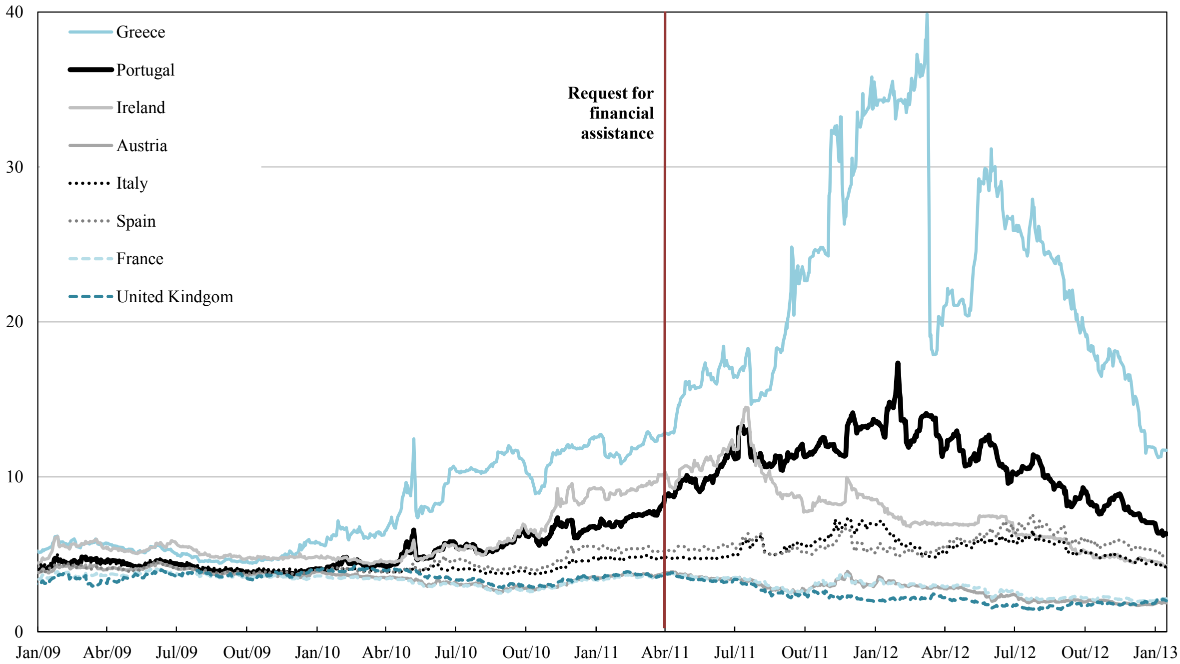
- Structural reforms to increase potential growth, create jobs and improve the competitiveness of the economy.
- Credible strategy for fiscal consolidation:
- Orderly process of deleverage in the financial sector through market mechanisms and supported by specific funds to recapitalise banks.

In the public finances domain, the adjustment programme has as one of its main objectives the reduction of the general government deficit, according to the rules of the excessive deficit procedure to below 3 per cent of GDP. The rapid correction of budgetary imbalances, based on a broad set of measures on both the revenue and the expenditure side, together with substantial receipts from privatizations, should allow a reversal of the public debt ratio rising trend. The programme also includes the implementation of structural reforms in the budgetary area, in order to ensure a path for public spending in line with the potential growth of the economy.

Figure 23

Public Debt Yields, 10 Year

(percent)



Source: Thomson Reuters.

On the revenue side, the main measures already implemented under the programme are the following: i) increase in VAT rates and change of some goods and services subject to reduced rates to the standard rate, ii) reduction of tax benefits in particularly within the personal and corporate income taxes, iii) surcharges, both within the personal and corporate income taxes, iv) increase in the final withholding rates, both in the personal and corporate income taxes, v) changes in the rate structure of the personal income tax, with a substantial increase of marginal and average rates, vi) revaluation of equity value of urban buildings, significantly expanding the collection of the municipal tax on property, vii) increase in the contribution rates of workers to CGA and ADSE and, viii) transfer of banking sector pension funds. Note that not all of these measures were included in the initial version of the programme, having been adopted subsequently in order to ensure the fulfilment of the deficit targets.

On the expenditure side, the most relevant measures already implemented in the context of the programme are as follows: i) wage freeze and cuts in general government, public enterprises and public pension systems, ii) strict control of admissions and sharp decline in the number of workers with fixed-term contracts; iii) Total/partial suspension of the Christmas and summer bonuses to public sector workers and pensioners of public systems, iv) accession to non-contributory social benefits subject to means testing, v) reduction of prices of medicines and medical acts co-financed and change in the rules of prescription and reimbursement, promoting the use of generic drugs, vi) cuts in public investment and, vii) new legislation on the control of expenditure commitments. Similarly to what occurred on the revenue side, not all measures listed were included in the initial programme, only having been considered subsequently given the difficulty in reaching the objectives for the deficit.

Regardless of the greater or lesser success in meeting the goals for the deficit and creating effective conditions for the sustainability of public finances, the budgetary block of the programme has several merits that should be underlined. Firstly, it encompasses key improvements in terms of fiscal governance. Indeed, it facilitated the adoption of the amendments to the Budgetary Framework Law in May 2011, and contributed, moreover, to create a culture of effective control of expenditure. Secondly, it includes consolidation measures that would not be possible to implement in normal times, breaking somehow the taboo relating to acquired rights and tackling important issues like public-private partnership arrangements and state-owned enterprises. Finally, by imposing strict budgetary discipline, it helps the clarification of the tradeoffs between the choices on the expenditure and taxation sides, emphasizing the relevance of the efficiency/effectiveness of spending.

However, from the point of view of the efficient functioning of public administrations and companies, in particular as regards the provision of goods and services, and the effects of the public sector in the potential growth of the economy, the budgetary block of the programme has serious limitations. Firstly, despite the emphasis on reducing expenditure and important revenue shortfalls, the use of tax increases is obviously excessive. In turn, the measures on the expenditure side are predominantly horizontal, with potentially significant costs in the operation of general government and public enterprises. These effects are compounded, in terms of efficiency, by the fact that the correction of the public sector wage *premia* was not properly made and by the suspension of the incipient performance incentive scheme. Finally, it follows very centralized procedures, leaving little leeway for the management of sectoral programmes and of public services and corporations. These limitations can be seen as inevitable given the magnitude of the structural adjustment required in the short term. But the efficient functioning of the public sector in the long term implies, from now on, a different approach, more selective and based on a proper incentive framework.

In terms of the main results of the programme up to now, it is worth highlighting that the initial targets for the deficit were not realistic: they were based on a poor assessment of the underlying fiscal situation and on a very optimistic macroeconomic scenario. This led to the adoption of temporary measures and the revision of targets (Table 3).

6 Concluding remarks: Key lessons for the conduct of fiscal policy

A thorough analysis of the evolution of public finances in Portugal after the accession to the European Community suggests some key lessons for the conduct of fiscal policy in the coming decades:

- The strict functioning of the budgetary surveillance at the European level and in particular in the euro area, reinforced in the context of the current crisis, is important to avoid unsound policies in some Member-states, with a negative impact in the EU as a whole. Rigorous implementation of fiscal rules is of the utmost importance in order to ensure, ultimately, the sustainability of public finances in Europe.
- The disciplinary role of financial markets is uncertain, as is well demonstrated by developments in recent years. In principle it may contribute to the adoption of prudent macroeconomic, fiscal and financial policies, but there is a risk that its impact will only be felt when the imbalances are already very pronounced.
- The establishment of a national fiscal framework in accordance with international best practices is essential to ensure the sustainability of public finances, without incurring in the disciplinary counter-cyclical action of multilateral surveillance and/or markets. The changes to the Budgetary Framework Law, in 2011, and some structural fiscal reforms under the Programme

Table 3

General Government Deficit (National Accounts)
(percent of GDP)

	2011	**2012**	**2013**	**2014**	**2015**
Initial targets (May 2011)	5.9	4.5	3.0	2.3	1.9
1st revision (5th review, August 2012)		5.0	4.5	2.5	1.9
2nd revision (7th review, February 2013)			5.5	4.0	2.5
Outturn	4.3	6.4	4.9		
Outturn excluding temporary measures and special factors	7.1	6.0	5.2		

Sources: Ministry of Finance and Statistics Portugal.

were important steps in the right direction. Still, the improvement and implementation of the new rules are crucial to ensure that sound budgetary practices become a part of the political and social culture in Portugal.

- A well designed and stable system of taxation and public expenditure programmes, reducing uncertainty and providing a framework of proper incentives to all economic agents, are essential to increase the potential growth of the economy.
- The efficiency/effectiveness in the provision of public services can play an important role in achieving sound public finances, ensuring the best use of the resources made available to the general public through taxes, in terms of social welfare.
- The creation/strengthening of managerial and technical capacity in general government services and public enterprises are a fundamental prerequisite for the design and implementation of good public policy.

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