

## 6. PUBLIC FINANCES<sup>1,2</sup>

### 6.1. Overview

In 2008, the evolution of public finances in the euro area Member-states was already affected by the economic crisis, in particular in the last months of the year. In Portugal, recent budgetary developments did not differ substantially from those observed in this group of countries. Thus, for the second year in a row, the general government deficit in national accounts stood at 2.6 per cent of GDP (Table 6.1.1), which is a less favourable outcome than the official target of 2.2 per cent of GDP, but still below the reference value of 3 per cent of GDP. The 2008 outturn was marked by the evolution of primary current expenditure, which increased 0.9 p.p. as a ratio to GDP and a very significant amount of temporary measures (1.1 per cent of GDP, to be compared with 0.1 per cent of GDP in 2007). In fact, revenues derived from extending the concession period or from new concessions for hydroelectric production and motorways exploitation, deducted in national accounts from capital expenditure, were classified as temporary measures, according to the definition used in the Eurosystem.<sup>3</sup>

The public debt ratio, after interrupting in 2007 the upward trend shown since 2001, increased significantly in 2008 (2.9 p.p.), reaching 66.4 per cent of GDP at the end of the year. This outcome was greatly influenced by deficit-debt adjustments and by the negative effect of the differential between the implicit interest rate on public debt and the growth rate of nominal GDP, which were only partially offset by the slightly positive primary balance.

**Table 6.1.1**

FISCAL INDICATORS					
As a percentage of GDP					
	2005	2006	2007	2008	2007-2008
Total revenue	41.6	42.3	43.1	43.2	0.1
Tax revenue	36.0	36.7	37.5	37.5	0.0
Primary expenditure	45.1	43.5	42.9	43.0	0.1
Primary current expenditure	40.8	40.1	39.4	40.3	0.9
<b>Primary balance</b>	-3.5	-1.2	0.2	0.3	0.1
Interest expenditure	2.6	2.7	2.8	2.9	0.1
<b>Overall balance</b>	-6.1	-3.9	-2.6	-2.6	0.0
Temporary measures <sup>(a)</sup>	-0.1	0.0	0.1	1.1	1.0
<b>Public debt</b>	63.6	64.7	63.5	66.4	2.9

Sources: INE and Banco de Portugal.

Note: (a) It includes: in 2005, the impact of the adjustment of the Portuguese financial contribution to the Community budget regarding previous years, following the upward revision of the GNP level, associated with the change in national accounts base year; in 2007, the concession of the Alqueva dam (€195 million); in 2008, the extension of the already existing dams' concessions (€759 million), concession contracts for new dams (€624 million), and road concessions (€471 million, of which €200 million for the 'Douro Litoral' motorway and €271 million associated with the extension of several concession periods in contracts with Brisa).

(1) This chapter is based on the excessive deficit procedure notification and the provisional general government accounts, compiled on a national accounts basis, sent by INE to Eurostat at the end of March. Changes mentioned in this chapter may not necessarily correspond to the differences in values as a percentage of GDP presented in the tables due to rounding.

(2) For an analysis of structural developments, see "Section 2.2 Fiscal policy", of this Report.

(3) For details on the methodology, see "Box 2.2 The Stability and Growth Pact and temporary measures", Annual Report 2007.

## 6.2. Current revenue

General government current revenue recorded a very moderate growth in 2008 (2.1 per cent), mainly explained by a small rise in tax revenues (1.9 per cent) which as a ratio to GDP remained unchanged at 37.5 per cent, after a sharp increase in the previous two years (Table 6.2.1). The additional gains generated by the improvement in tax administration procedures were no longer determinant for the evolution of the tax burden as a whole. Its stabilization stemmed, fundamentally, from the negative impact of some legislative changes and the still positive contribution of macroeconomic developments. In fact, in a context of strong deceleration of economic activity, the composition of economic growth was favourable to tax revenues, as private consumption and particularly the private sector wage bill grew above GDP. The stabilisation of tax revenue as a ratio to GDP resulted from the increase in the receipts of taxes on income and wealth (0.2 p.p. of GDP), the rise in social contributions (0.3 p.p. of GDP) and the reduction of the proceeds from taxes on production and imports (0.4 p.p. of GDP).

The performance of taxes on income and wealth reflected the growth of revenue from taxes on households, by 3.7 per cent, and taxes on corporations, by 4.2 per cent. Regarding taxes on households, it is worth highlighting that its evolution was greatly determined by the revenue from the Personal Income Tax which, in a context characterised by the negative effect of an update in the withholding tables higher than inflation and of some legislation changes of a small magnitude<sup>4</sup>, increased below the wage bill of the economy. On its turn, the growth in revenue from taxes on corporations derived, to a large extent, from the Corporate Income Tax collection, which was strongly influenced by firms' good results in

**Table 6.2.1**

GENERAL GOVERNMENT CURRENT REVENUE							
	Values as a percentage of GDP				Percentage changes		
	2005	2006	2007	2008	2006	2007	2008
Current revenue	40.1	41.2	42.2	42.3	7.0	7.6	2.1
Tax revenue	36.0	36.7	37.5	37.5	6.3	7.2	1.9
Taxes on income and wealth	8.4	8.8	9.7	9.9	9.1	15.9	3.9
Taxes on households	5.6	5.7	5.9	6.0	6.7	9.5	3.7
Taxes on corporations	2.9	3.1	3.8	3.9	13.8	27.5	4.2
Taxes on production and imports	15.0	15.4	15.0	14.6	7.0	2.5	-1.1
<i>of which:</i>							
Value added tax	8.6	8.7	8.6	8.5	5.6	4.2	0.7
Tax on oil products	2.1	2.1	2.0	1.9	1.7	4.4	-4.1
Tax on motor vehicles sales	0.8	0.8	0.7	0.6	-0.6	2.5	-19.8
Social contributions	12.5	12.5	12.7	13.0	3.5	7.0	4.0
Actual	11.4	11.4	11.7	11.9	4.5	7.7	4.1
Social Security subsystem	7.6	7.6	7.7	7.9	4.6	6.6	4.8
Caixa Geral de Aposentações subsystem	3.8	3.8	4.0	4.0	4.3	10.0	2.6
Imputed	1.2	1.1	1.0	1.0	-5.4	-0.5	3.2
Sales of goods and services	2.4	2.4	2.5	2.5	5.7	9.7	0.6
Other current revenue	1.8	2.1	2.2	2.3	24.3	11.3	5.8

Sources: INE and Banco de Portugal.

(4) Essentially, changes in taxation approved in previous years (particularly in the 2007 and 2008 State Budgets), such as the gradual increase in taxation of pension income, and the changes in the tax calculation for individuals with disability.

2007, and also by some additional gains generated by the increased effectiveness of tax collection, though much smaller than in the preceding years.

The reduction in the ratio of taxes on production and imports to GDP resulted from the evolution of the Value Added Tax (VAT), the Tax on Oil Products, the Tax on Motor Vehicles Sales and the Municipal Tax on Real Estate Transactions. In fact, the main indirect taxes did not show expressive growth rates. The biggest increases were observed in the revenue from the Tobacco Tax, the Stamp Duty and the Municipal Tax on Real Estate that have stabilised as a ratio to GDP. Regarding VAT revenue, in national accounts, it had an almost nil growth which was particularly influenced by the sharp deceleration of its proceeds over the last months of the year and the beginning of 2009. The performance of VAT collection in 2008 benefited from the behaviour of private consumption, whose growth stayed above GDP's rate of change, and was negatively influenced by the reduction in the standard VAT rate from 21 to 20 per cent by mid-2008. The revenue from the Tax on Oil Products decreased by 4.1 per cent, influenced by the decline in fuel consumption (6.4 per cent for petrol and 1.7 per cent for diesel), as tax rates were not updated. On its turn, the Tax on Motor Vehicles Sales presented a significant decrease (19.8 per cent)<sup>5</sup> mainly due to legislation changes in the taxation of vehicles introduced by mid-2007, which globally reduced the amount of tax to be paid, particularly regarding the acquisition of less polluting vehicles. In fact, during 2008, motor vehicle sales, despite some deceleration, rose again, partly as a consequence of the reduction of the standard VAT rate and the anticipation of purchases of some types of motor vehicles in response to changes in legislation in force after the beginning of 2009. The increase in sales might not have had such a strong impact on the Tax on Motor Vehicles Sales receipts, since it was driven by sales in the lower range of vehicles, usually less polluting and with lower engine capacities. The revenue from Tobacco Tax grew by 10.5 per cent, influenced by the 11 per cent increase of the component per unit of the tax on cigarettes in the State Budget for 2008 and a base effect resulting from the fact that the introduction of tobacco in distribution circuits was significantly brought forward at the end of 2006 (which hampered 2007 revenue), only partially offset by the sharp decrease in quantities consumed. On its turn, the Stamp Duty increased at a pace close to nominal GDP. As regards the main local taxes, it is worth mentioning that the Municipal Tax on Real Estate increased by about 7.6 per cent, while the Municipal Tax on Real Estate Transactions showed a significant reduction (13.3 per cent), associated with the decline in transactions in the real estate market.

The increase in the ratio of revenue from social contributions to GDP resulted, to a large extent, from the positive evolution of actual contributions to the Social Security subsystem, since actual contributions to the *Caixa Geral de Aposentações (CGA)* subsystem and imputed contributions globally maintained their ratios to GDP. In the case of actual social contributions, note that those of the Social Security subsystem, although decelerating from 2007 outcomes, grew by 4.8 per cent, in line with the increase in the private sector wage bill. On its turn, actual social contributions to the CGA subsystem presented a more moderate increase than in 2007, largely reflecting the 3.4 per cent rise in the State subsidy (including VAT receipts allocated to the CGA), whose deceleration was faster than that of expenditure with retirement pensions of former public sector employees. Finally, note that imputed social contributions increased by 3.2 per cent, despite the reduction of State expenditure with the Directorate-General for the Protection of Civil Servants (-1.5 per cent).

Revenue from sales of goods and services ratio to GDP remained almost unchanged, while other current revenues showed a slight increase. This one reflects, to a large extent, the continuation of a strong growth of dividends and interest received by general government. Note that the evolution of other cur-

(5) The Tax on Motor Vehicles Sales replaced the Car Tax. The growth rate presented refers to the comparison between the revenues from Tax on Motor Vehicles Sales and the Single Tax on Circulation in 2008, with the receipts from Car Tax (up to June 30 of 2007) and the Tax on Motor Vehicles Sales plus Single Tax on Circulation (after July 1 of 2007) recorded in 2007.

rent revenue remained negatively affected by transfers from the European Social Fund, which decreased again in national accounts, although less sharply than in 2007.

### 6.3. Current expenditure

In 2008, primary current expenditure increased by 4.1 per cent, rising 0.9 p.p. as a ratio to GDP (Table 6.3.1). This outcome contrasts with what happened in the two previous years, in which the rates of change were more moderate and the contribution for the deficit reduction was positive. The developments of this aggregate in 2008 were determined by an increase in pension expenditure and, to a lesser extent, the evolution of intermediate consumption, while compensation of employees, subsidies and other current transfers stabilised as a ratio to GDP.<sup>6</sup>

In 2008, compensation of employees as a ratio to GDP interrupted the decline recorded in the last two years, having stabilised at 12.9 per cent. This outcome is associated with the update in the public wage scale (2.1 per cent compared to 1.5 per cent in 2006 and 2007) and apparently a smaller net reduction in the number of public employees. Still, wages presented a moderate growth (1.3 per cent), in part due

**Table 6.3.1**

	Values as a percentage of GDP				Percentage changes adjusted for the effect of corporate hospitals <sup>(a)</sup>		
	2005	2006	2007	2008	2006	2007	2008
	GENERAL GOVERNMENT CURRENT EXPENDITURE						
Current expenditure	43.4	42.9	42.2	43.2	3.2	3.6	4.3
Compensation of employees	14.4	13.6	12.9	12.9	-0.2	1.4	2.6
Current transfers	22.1	22.4	22.4	23.0	4.1	3.4	4.2
to households	18.5	18.8	19.2	19.9	4.2	5.5	4.6
in cash	14.9	15.1	15.1	15.6	5.3	5.5	5.1
of which:							
Unemployment benefits	1.2	1.2	1.0	0.9	1.8	-8.1	-7.4
Pensions - Social Security subsystem	7.2	7.3	7.4	7.7	6.9	6.1	5.8
Pensions - CGA subsystem	3.8	3.9	4.0	4.2	6.6	7.5	5.6
in kind	3.5	3.7	4.1	4.3	-0.2	5.6	2.9
Subsidies	1.6	1.4	1.2	1.2	-4.6	-14.8	1.6
Other transfers	2.1	2.2	2.0	2.0	9.5	-3.2	1.6
Intermediate consumption	4.2	4.1	4.1	4.4	6.0	9.7	9.6
Interest on public debt	2.6	2.7	2.8	2.9	9.8	7.6	4.9
<i>Memo:</i>							
Primary current expenditure	40.8	40.1	39.4	40.3	2.8	3.3	4.1

Sources: INE, Ministry of Finances and Banco de Portugal.

Note: (a) The adjustment to eliminate the break in the series due to the transformation of some hospitals into public corporations is made by Banco de Portugal. In this table, however, the adjustment reflects only the correction of the break in the series on the rates of change.

(6) The following analysis, item by item, is based on estimates of values adjusted for the transformation of public hospitals into corporations, which are now included in the sector of non-financial corporations. In particular, the change in primary current expenditure by items in 2008, compared to the previous year, is affected by the remaining impact of the transformation of some hospitals into public corporations in February and August 2007, and the transformation of new hospitals in September and October of 2008. This change in the perimeter of the general government sector affects negatively compensation of employees and intermediate consumption, and positively social payments in kind. For details regarding the corrections for previous years, see "Box 6.1 Corporate hospitals and public expenditure", Annual Report 2007.

to the decrease in average wages resulting from the flows of hiring and retirement.<sup>7</sup> Additionally, the 2008 outturn benefited from the fact that promotions may still not have been representative of what will be the steady-state according to the new rules. Regarding other staff costs, note that they continued to present a considerable rate of change (5.5 per cent), above the increase in both imputed contributions and actual employers' social contributions to the CGA subsystem, already mentioned.

The ratio of social payments in cash to GDP increased in a very significant way in 2008 (0.5 p.p.). In particular, pension expenditure, despite continuing to decelerate, still recorded an expressive growth, both in the Social Security subsystem (5.8 per cent) and in the CGA subsystem (5.6 per cent), originating as a whole a contribution of 0.4 p.p. to the increase in primary current expenditure. Note that in the CGA subsystem the slowdown was more pronounced, reflecting developments regarding the number of pensioners and the average pension. In fact, in the Social Security subsystem, the number of old age and survivor pensioners grew by 2.0 per cent, slightly above last year's growth, while in the CGA subsystem, there was a smaller increase (2.1 per cent, compared with 3.1 per cent in 2007). The growth of the average pension was a result of the annual pension update, close to 2.0 per cent in both subsystems, and of the positive composition effect (resulting from the fact that new retirees receive on average higher pensions than those already in the system), which was lower in the CGA subsystem. In turn, the ratio of expenditure with unemployment benefits to GDP decreased 0.1 p.p., due to the reduction in the average number of unemployed receiving these subsidies (6.7 per cent), and to a stabilisation in the amount of the average benefit. Unlike this item, other social payments in cash increased significantly, particularly as a consequence of measures introduced by mid-2008. These included the broadening of the supplement to senior citizens and the introduction of further health benefits, as well as the increase in family allowance for low income households and the creation of transport passes for students.

Transfers to households in the form of payments in kind remained practically unchanged as a ratio to GDP. Unlike what happened in 2007, National Health Service expenditure in 2008 benefited of a more moderate growth in payments made to corporate hospitals (1.7 *vis-à-vis* 7.1 per cent, on a comparable basis, adjusting for the effect of new hospitals transformed into corporations). In turn, expenditure with medicine co-payments and contracts with private health care providers recorded a positive rate of change (5.6 *vis-à-vis* -1.4 per cent in 2007), not yet significantly influenced by the cut in prices regarding the majority of generic drugs, which only came into force in October 2008. Also subsidies and other current expenditure remained unchanged as a ratio to GDP. It is worth noting that the former shows a marked reversal of the very negative rate recorded in the previous year, which was due, among other factors, to a smaller decrease in expenditure on professional training co-financed by the European Social Fund.

Expenditure on intermediate consumption grew significantly, rising by 0.3 p.p. of GDP. This outcome is associated with an increase in payments to private consortia involved in the construction and exploitation of SCUTs (motorways without tolls), but also in other spending on goods and services included in intermediate consumption. Note that the latter grew significantly in the regional and local government subsector.

Expenditure on public debt interest, despite recording a deceleration (4.9 per cent in 2008, compared to 7.6 per cent in 2007), rose slightly as a ratio to GDP (0.1 p.p.). Its evolution is mainly associated with the hike in the public debt stock (in line with the rise in borrowing requirements), since the implicit interest rate only increased very slightly.

(7) On average, the wage of employees leaving the general government institutions, mainly for retirement, is higher than that of new public employees hired.

## 6.4. Capital revenue and expenditure

The capital balance excluding temporary measures deteriorated slightly in 2008, standing at -2.9 per cent of GDP, after having reached -2.7 per cent in 2007 (Table 6.4.1). This result reflects, predominantly, the developments regarding the part of capital expenditure that is not considered public investment.

General government capital revenue recorded a growth of 6.0 per cent, after three consecutive years of sharp falls. In turn, capital expenditure (excluding the impact of temporary measures) increased by 7.5 per cent, which represents a rise of 0.2 p.p. as a ratio to GDP. In what regards public investment, there was a nominal reduction of 5.8 per cent, which was affected by a strong acceleration in the proceeds from the sale of real estate.<sup>8</sup> In fact, excluding this effect, the rate of change would be positive, in contrast to the slightly negative evolution observed in 2007. Finally, other capital expenditure recorded again a very strong growth (31.0 per cent), to a large extent because in national accounts the amortisation of the tariff deficit in the electricity sector is classified as a capital transfer.

**Table 6.4.1**

GENERAL GOVERNMENT CAPITAL REVENUE AND EXPENDITURE Excluding temporary measures <sup>(a)</sup>							
	Values as a percentage of GDP				Percentage changes		
	2005	2006	2007	2008	2006	2007	2008
Capital revenue	1.4	1.1	0.9	0.9	-17.6	-17.4	6.0
Capital expenditure	4.3	3.4	3.6	3.8	-17.2	11.1	7.5
GFCF	2.9	2.4	2.3	2.1	-15.5	1.8	-5.8
Other capital expenditure <sup>(b)</sup>	1.4	1.0	1.3	1.7	-20.7	32.5	31.0
Capital balance	-2.8	-2.3	-2.7	-2.9	-	-	-

Sources: INE and Banco de Portugal.

Notes: (a) In the period of 2005-2008, there were temporary measures whose value affected the item "other capital expenditure" by 0.1 p.p. in 2007 and 1.1 p.p. in 2008. (b) Includes capital transfers and net acquisition of non-financial non-produced assets.

## 6.5. Public debt

In 2008, after the decline in the preceding year, the debt ratio increased again very significantly (2.9 p.p.), reaching 66.4 per cent of GDP at the end of the year (Table 6.5.1 and Chart 6.5.1). To this outcome contributed the effect of the differential between the implicit interest rate on public debt and nominal GDP growth rate (1.7 p.p.), as well as deficit-debt adjustments (1.4 p.p.). In fact, the primary balance had a very limited impact on the debt ratio (0.3 p.p.).

According to preliminary data, the positive value of deficit-debt adjustments reflects the contribution of an increase in financial assets held by general government (0.5 p.p. of GDP) and the reduction in the transactions of financial liabilities not included in public debt (0.7 p.p. of GDP) and also, to a lesser extent, valuation effects (0.1 p.p. of GDP).<sup>9</sup> Regarding financial assets held by general government, note that the increase in loans, shares and other equity more than offset the fall recorded in deposits and

(8) Note that the sales of real estate are recorded as negative capital expenditure.

(9) For more detailed information, see "Supplementary Tables A.6.5 and A.6.6", of this Report.

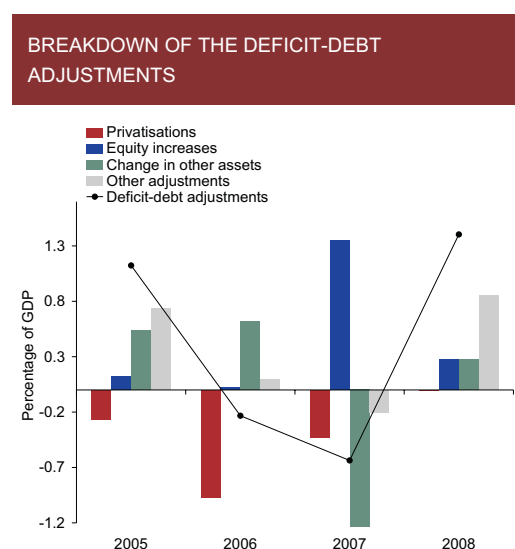
securities. Considering its importance, reference should be made to the fact that the loans were greatly influenced by advance payments by the National Health Service Support Fund amounting to €765 million, in order to settle part of general government debts to non-financial corporations. On its turn, shares and other equity went up influenced, to a large extent, by the equity injection to *Caixa Geral de Depósitos* (€400 million) and the acquisition of Exchange Traded Funds (€1 086 million). The latter was made by the Social Security subsystem, in order to allocate its surplus and recompose its investment portfolio.

Table 6.5.1

BRAKDOWN OF THE CHANGE IN THE PUBLIC DEBT RATIO		2005	2006	2007	2008
As a percentage of GDP					
Debt at the beginning of the year	(a)	58.3	63.6	64.7	63.5
Primary balance	(b)	-3.5	-1.2	0.2	0.3
Interest payments effect	(c)	2.6	2.7	2.8	2.9
Output growth effect	(d)	2.0	2.6	3.1	1.1
Deficit-debt adjustments	(e)	1.1	-0.2	-0.6	1.4
Debt at the end of the year	(a)-(b)+(c)-(d)+(e)	63.6	64.7	63.5	66.4

Sources: INE and Banco de Portugal.

Chart 6.5.1



Sources: INE and Banco de Portugal.