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Public Expenditure and Fiscal Consolidation in Portugal

by
Jorge C. Cunha *and* Cláudia R. Braz*

This article analyses the evolution of Portuguese public expenditure from 1990 to 2004, in order to assess the current position and the prospects for future developments in the absence of corrective measures and structural reforms.

* Jorge Cunha and Cláudia Braz work in the Economics and Research Department of the Bank of Portugal.

1. Introduction

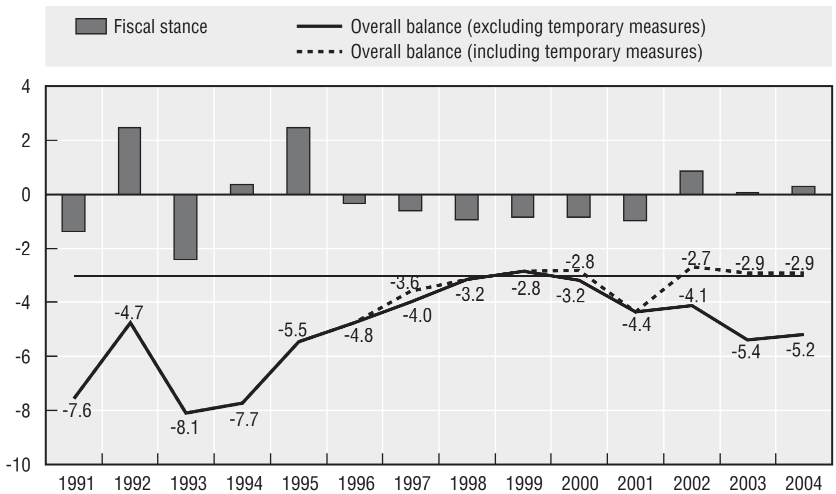
At the beginning of the 1990s, Portugal still recorded in most years general government deficits exceeding 7% of GDP. However, the country was able to qualify for participation in EMU. The convergence period was characterised by a tightening of fiscal policy in 1994-95 but a slight loosening in 1996-97 (Figures 1 and 2). The soft fulfilment of the fiscal convergence criteria was basically allowed by a pronounced decline in interest expenditure, stemming from the impact of disinflation and the credibility effects associated with nominal convergence. From 1997 to 2001, the structural position of public finances worsened considerably. Nevertheless, until 2000, the sizeable impact of the buoyant economic activity and the decline in interest payments more than offset the significant pro-cyclical loosening of fiscal policy. In 2001, the effects of the cyclical downturn and the continuation of an expansionary fiscal policy gave rise to an excessive deficit in the context of the Stability and Growth Pact. The cyclically adjusted deficit then reached 5.6% of GDP. Some consolidation measures were implemented since 2002. They included, essentially, increases in indirect taxes and a tighter control of some expenditure items. The government also adopted a very significant amount of temporary measures (1.4%, 2.5% and 2.3% of GDP in 2002, 2003 and 2004, respectively). The cyclically adjusted deficit, excluding the effects of temporary measures, still amounted to 4% of GDP in 2004.

The lack of fiscal consolidation before 2002 is largely responsible for the current budgetary situation. Between 1997 and 2001, the significant loosening was mostly explained by a strong increase in current primary expenditure. The main goal of this article is to analyse the evolution of the Portuguese public expenditure from 1990 to 2004, in order to assess the current position and the prospects for future developments in the absence of corrective measures and structural reforms.

The article is organised as follows. Section 2 presents the main features of the evolution of public expenditure in Portugal in the context of the European Union. Section 3 analyses the main explanatory factors behind the growth of public expenditure in Portugal in the period from 1990 to 2004. Section 4 describes the measures aiming at the control of public expenditure implemented in the period 2002-04. Section 5 briefly assesses the quality of public expenditure in Portugal. Section 6 concludes.

Figure 1. **General government overall balance and the fiscal stance in Portugal**

Per cent of GDP

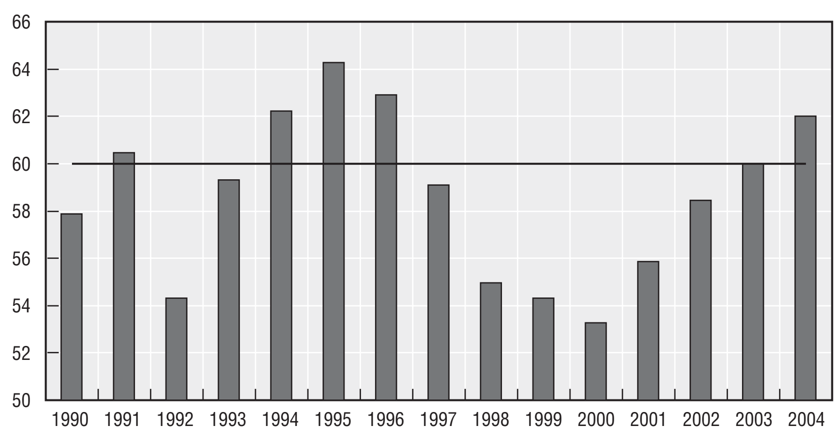


Note: The fiscal stance is measured by the change in the cyclically adjusted primary balance, excluding the effects of temporary measures.

Sources: National Statistical Institute, Ministry of Finance and authors' calculations.

Figure 2. **Portugal: General government gross debt**

Per cent of GDP



Sources: Ministry of Finance and Banco de Portugal.

2. Public expenditure in Portugal in the context of the European Union

At first sight, according to the currently available national accounts data on general government expenditure, Portugal does not appear to be a singular case among the European Union member states. Indeed, in 2002, the ratio of public expenditure to GDP reached 46% in Portugal, below the EU15 average for the same year which stood at 47.7% of GDP (Table 1). However, the comparison with other EU member states with a similar per capita income level suggests that Portugal is a relatively high spending country, exceeding the ratio of the overall public expenditure to GDP recorded in Spain and the ratio of primary expenditure to GDP in Greece.

Table 1. **Public expenditure in the European Union and in Portugal, 1995 and 2002**

Economic classification, per cent of GDP

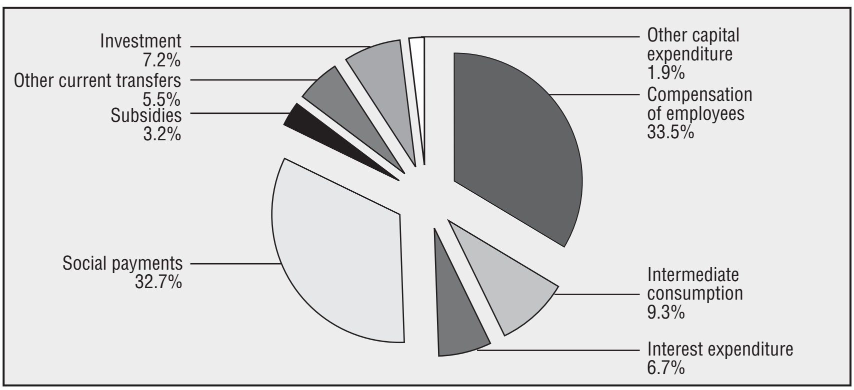
	1995		2002		Change	
	EU15	Portugal	EU15	Portugal	EU15	Portugal
Current expenditure	47.1	39.8	44.3	41.8	–2.8	2.0
Compensation of employees	11.4	13.6	10.9	15.4	–0.5	1.8
Intermediate consumption	5.6	3.7	6.2	4.3	0.6	0.6
Interest expenditure	5.4	6.3	3.4	3.1	–2.0	–3.2
Social payments	21.5	13.2	20.5	15.0	–1.0	1.8
Subsidies	1.6	1.3	1.2	1.5	–0.4	0.1
Other current transfers	1.6	1.6	2.1	2.5	0.5	0.9
Capital expenditure	6.3	5.3	3.4	4.2	–2.9	–1.1
Investment	2.7	3.7	2.3	3.3	–0.4	–0.4
K2	–0.0	0.0	–0.0	–0.2	0.0	–0.3
Capital transfers	3.7	1.5	1.2	1.1	–2.5	–0.4
Total expenditure	**53.4**	**45.0**	**47.7**	**46.0**	**–5.7**	**0.9**
Memo item:						
Primary current expenditure	41.7	33.5	40.9	38.7	–0.8	5.2

Source: NewCronos database.

In any case, as far as the relative weight of the public sector in the economy is concerned, Portugal's most distinctive feature in the context of the EU15 is not the current position, but previous developments. Actually, on average in the EU15, public expenditure as a percentage of GDP declined by 5.7% between 1995 and 2002[1] while in Portugal it increased by 0.9%. This different pattern is mostly a result of the buoyant growth of primary current expenditure in Portugal, which rose by 5.2% of GDP in the period under analysis, in sharp contrast with the trend in the EU15 as a whole where a decrease of –0.8% of GDP was recorded. It should be noted that from 1995 to 2002 primary current expenditure as a percentage of GDP only increased in Greece (+3.4%), Italy (+1.5%), Belgium (+0.9%) and Germany (+0.3%).[2] Public expenditure developments in Portugal will be analysed in more detail in the next section.

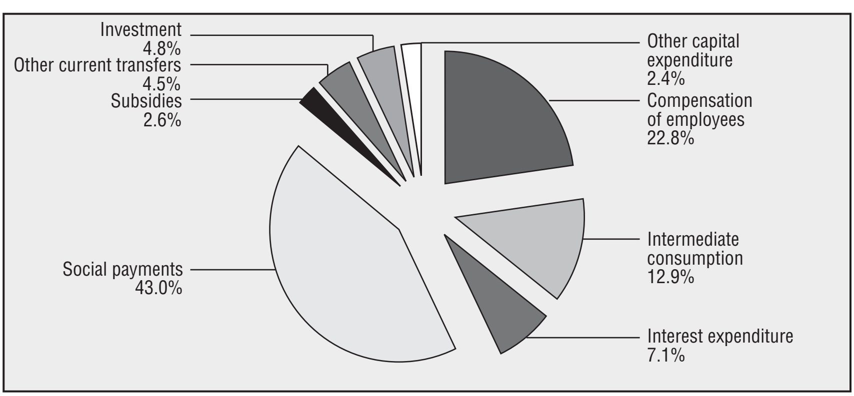
Regarding the composition of public expenditure in Portugal and in the EU15, according to the economic classification of expenditure, the most striking differences show up in the items "compensation of employees" and "social payments". Based on the 2002 national accounts data, the share of compensation of employees in the overall public expenditure is substantially higher in Portugal than in the EU15 (33.5% in Portugal, to be compared with 22.8% in the EU15), while the share of social payments is considerably lower (32.7% in Portugal and 43% in the EU15; see Figures 3 and 4). Additionally,

Figure 3. **Public expenditure in Portugal, 2002**
Economic classification



Source: NewCronos database.

Figure 4. **Public expenditure in the EU15, 2002**
Economic classification



Source: NewCronos database.

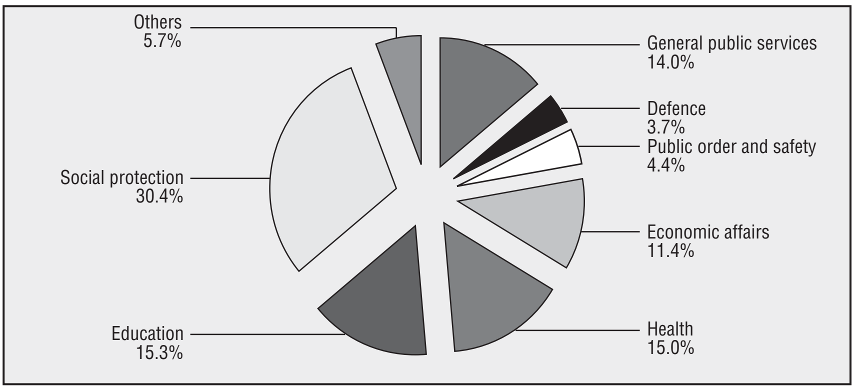
there are also smaller differences in the shares of intermediate consumption and investment, but the sum of the two items is more or less the same in Portugal and in the EU15.

Three points should be made at this stage. First, the comparisons carried out in this section are influenced by the delimitation of the general government sector. Indeed, it is important to know for each country the degree of outsourcing in the supply of some goods and services usually provided publicly, in particular in the areas of health and education. The differences in the general government perimeter may only have an effect on the composition of public expenditure, for example in the case of health services financed publicly but provided by entities classified outside the general government sector, or, alternatively, may also have an impact on the time pattern of government expenditure (and, as such, on its level in each period), as happens with many public-private partnerships. Second, differences in the tax system concerning the taxation of social benefits and the existence of tax allowances and tax credits instead of explicit expenditure might have a non-negligible impact on the level of overall public expenditure as measured in the national accounts. Finally, other country-specific factors, like the recording of the expenditure related to the civil servants pension system in Portugal, might also distort international comparisons of public expenditure.

Having in mind these considerations, it is worth noting that in Portugal, in 2002, most health and education services were provided by entities classified inside the general government sector, explaining, to some extent, the relatively high share of compensation of employees in public expenditure. At the end of 2002, some public hospitals were transformed into public corporations, which resulted in an increase in social payments in kind and a decline in compensation of employees and intermediate consumption in the general government accounts. In addition, in Portugal, the actual social contributions of general government entities as employers are not calculated as a fixed rate on wages but as the amount required to ensure the financial balance of the civil servants pension system. As in the last few years expenditure on pensions of former civil servants has been increasing significantly, the figure for compensation of employees is substantially influenced by this sort of recording mechanism. A simple exercise, calculating actual social contributions of general government entities on the basis of a rate compatible with the one used in the private sector social security system, would reduce the share of personnel outlays in total expenditure in 2002 from 33.5% to 32.8%. Concerning social payments, the relatively low share of this item in Portugal suggests that the Portuguese social security system is much less generous or that its degree of maturation is lower than in the other EU15 countries. If the explanation is predominantly the second one, the above-mentioned figures provide a clear indication of the expected evolution of this item in the coming years if no major reforms are implemented.[3]

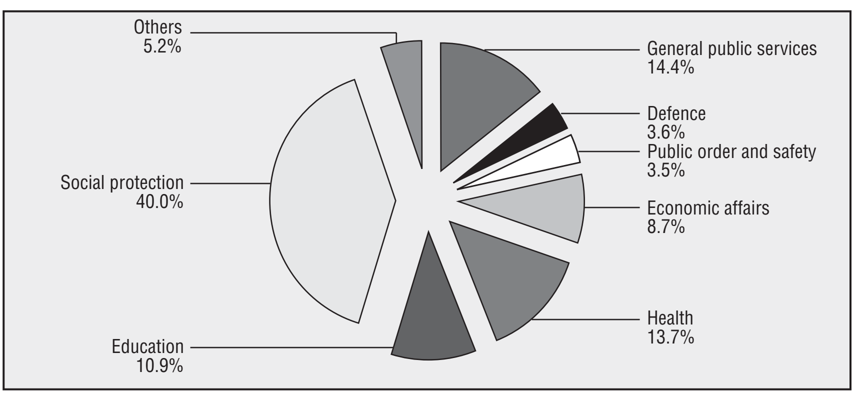
Figures 5 and 6 split public expenditure in Portugal and the EU15 in 2002, following the functional classification. According to these data, the share of general government expenditure on health and education is higher in Portugal (15% and 15.3%, to be compared with 13.7% and 10.9% in the EU15), while expenditure on social protection is considerably lower in Portugal (30.4% in Portugal compared to 40% on average in the EU15).

Figure 5. **Public expenditure in Portugal, 2002**
Functional classification



Source: NewCronos database.

Figure 6. **Public expenditure in the EU15, 2002**
Functional classification



Source: NewCronos database.

3. The growth of public expenditure in Portugal in the period from 1990 to 2004: main explanatory factors

Portugal witnessed a period of strong growth of primary current expenditure during the 1990s, which made its evolution quite exceptional in the European Union context. The objective of this section is to analyse the main explanatory factors underlying the growth of public expenditure in Portugal between 1990 and 2004.

Following the Portuguese general government national accounts, cyclically adjusted public expenditure[4] as a percentage of nominal trend GDP[5] increased by 3.8% from 1990 to 2004 (Table 2). In the same period, interest payments declined substantially (–6.1% of nominal trend GDP), in particular in the period from 1990 to 1998, as a result of the disinflation process and the decline in the risk premium. A simple exercise to decompose the evolution of interest payments into the effect of the decline in the implicit interest rate on public debt and the effect of the stock of debt shows that almost all the observed change is indeed explained by the first factor (around –6.4% in an overall change of –6.1%). Since capital expenditure remained broadly unchanged in the period under analysis, the rise in cyclically adjusted current primary expenditure was very significant, reaching 10.6% of nominal trend GDP. The two items that contributed most to this outcome were social payments (+6.6% of nominal trend GDP) and compensation of employees (+2.5% of nominal trend GDP). The analysis of data according to the functional classification of public expenditure, without making any adjustment for cyclical developments, leads to conclusions mostly in line with the ones based on the data following the economic classification, cyclically adjusted. Indeed, in the period from 1990 to 2002, the highest increase occurred in expenditure on social protection (4% of nominal trend GDP), which is mainly composed of social payments (85.9% in 2002) on health (2.9% of nominal trend GDP) and on education (1.8% of nominal trend GDP). It is worth mentioning that these two last items of expenditure include a high proportion of personnel outlays in their composition (47.9% and 79.7% of the overall expenditure of the category, respectively), confirming the perspective resulting from the analysis based on data according to the economic classification (see Table 3).

3.1. The evolution of compensation of employees

Concerning compensation of employees as a ratio to nominal trend GDP, a rising trend can be observed between 1990 and 2002. As already mentioned, part of this evolution stems from the current mechanism of recording actual social contributions of general government institutions as employers, which ensures the financial balance of the civil servants pension system. Figure 7 presents the decomposition of compensation of employees into three components: the wage

Table 2. **Cyclically adjusted public expenditure in Portugal**

Economic classification, per cent of nominal trend GDP, changes

	1990-1998	1998-2002	2002-2004	1990-2004
Current expenditure	–0.1	3.9	0.6	4.5
Compensation of employees	1.8	1.5	–0.8	2.5
Intermediate consumption	0.5	0.5	–0.6	0.4
Interest expenditure	–5.4	–0.4	–0.3	–6.1
Social payments	2.5	1.8	2.3	6.6
Subsidies	–0.3	0.0	0.1	–0.2
Other current transfers	0.9	0.4	–0.1	1.2
Capital expenditure	0.7	–1.3	–0.1	–0.7
Investment	0.5	–0.3	–0.4	–0.2
K2	0.1	–0.1	0.0	0.0
Capital transfers	0.1	–0.8	0.2	–0.5
Total expenditure	**0.6**	**2.7**	**0.5**	**3.8**
Memo item:				
Primary current expenditure	5.4	4.3	0.9	10.6

Sources: National Statistical Institute, Ministry of Finance and authors' calculations.

bill, actual employer's social contributions and imputed social contributions. The part of the evolution of compensation of employees in the last decade to be explained by actual social contributions is more or less half of the overall change observed in this item and results, to a large extent, from the rise in expenditure on pensions of former civil servants, which will be analysed in more detail later in the text.

Table 3. **Public expenditure in Portugal**

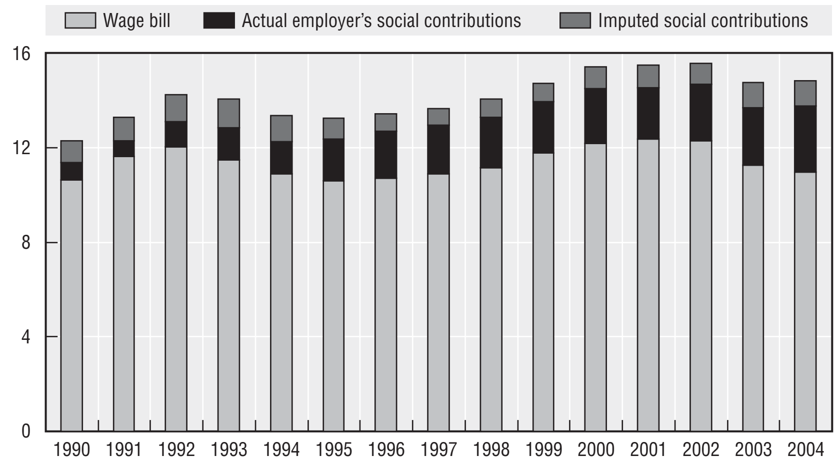
Functional classification, per cent of nominal trend GDP, changes

	1990-1998	1998-2002	1990-2002
General public services	–5.0	0.1	–4.9
Defence	–0.4	0.1	–0.3
Public order and safety	–0.3	0.1	–0.2
Economic affairs	–0.1	–0.6	–0.7
Environmental protection	0.2	0.0	0.2
Housing and community amenities	0.1	0.0	0.0
Health	2.0	0.9	2.9
Recreation, culture and religion	0.2	0.2	0.4
Education	1.4	0.4	1.8
Social protection	2.5	1.5	4.0
Total expenditure	**0.7**	**2.5**	**3.3**

Sources: National Statistical Institute and authors' calculations.

Figure 7. **Compensation of employees in Portugal, 1990-2004**

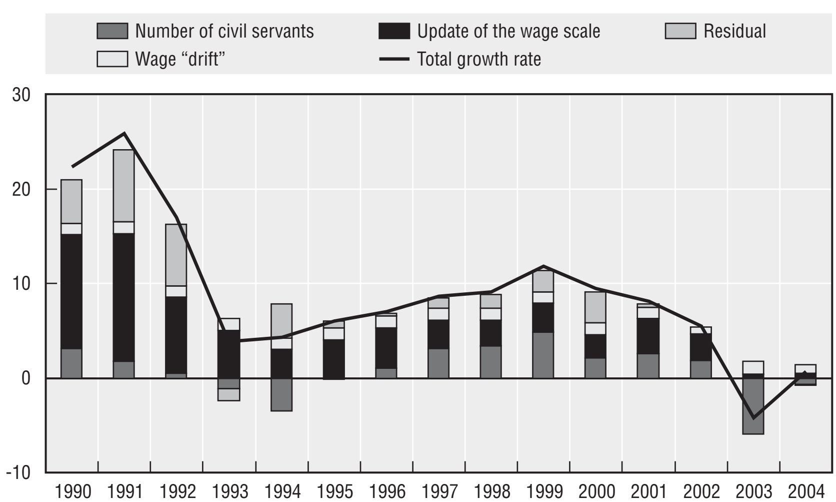
Per cent of nominal trend GDP



Sources: National Statistical Institute, Ministry of Finance and authors' calculations.

Regarding the wage bill, the strong growth observed in the period under analysis (1.6% of nominal trend GDP between 1990 and 2002) does not stem from annual updates of the civil servants wage scale above inflation. Actually, the annual updates were broadly in line with the inflation estimates assumed in the budgets, and these anticipated quite well the disinflation process.[6] Figure 8

Figure 8. **Components of the civil servants wage bill growth rate (per cent)**



Sources: National Statistical Institute, Ministry of Finance and authors' calculations.

shows the decomposition of the growth rate of the wage bill into four explanatory factors: the update of the wage scale, the wage "drift", the number of civil servants and a residual. The wage "drift" corresponds to the increase in wages due to normal promotions and the rise of the average wage resulting from the renewal of the population of civil servants, and it was assumed to be constant at 1.25% in the period under consideration. The wages residual represents essentially the effect of extraordinary revisions of careers. On the one hand, in the period from 1990 to 2002 a strong rise in the number of civil servants was recorded, in particular at the beginning of the decade and after 1997. In 2003, the transformation of some hospitals into public corporations, classified outside the general government sector, explains the reduction in the number of civil servants in that year. Nevertheless, correcting for this effect, the number of civil servants remained more or less constant in 2003, contrasting with the developments observed in the previous years. On the other hand, the residual effect was also very significant from 1990 to 1992 (mainly as a consequence of the introduction of the New Civil Servants Pay System[7]) and between 1997 and 2002 (due to additional revisions in some specific careers).[8]

3.2. The evolution of social payments

The evolution of social payments stemmed, mostly, from the behaviour of pension expenditure. Indeed, of the 6.6% of nominal trend GDP increase in cyclically adjusted social payments in the period from 1990 to 2004, 1.8% is related to social transfers in kind, which were affected by the already mentioned transformation of public hospitals into public corporations at the end of 2002. The remaining increase of social payments results predominantly from pension expenditure (4.2% of nominal trend GDP). Since in Portugal there are two main public social security systems, comprising the private sector workers (general system) and civil servants, they are analysed separately.

3.2.1. The general pension system

The strong increase in expenditure on old-age, disability and survival pensions of the private sector social security system between 1990 and 2004 (1.8% of nominal trend GDP) can be explained by three factors:

- the annual updates of pensions;
- the number of pensioners;
- a composition effect, which comprises, essentially, the change in the average pension, including the effect of some discretionary measures.[9]

Concerning the first factor, the general system pensions were updated above inflation in most years under consideration. However, among the three factors of pension growth, this is definitely the least important one in the last years. The strong rise in the number of pensioners, stemming mainly from population ageing, contributed on average 1.8% to the annual growth rate of the general system pension expenditure (around 2.7% for old-age pensions). It is worth mentioning that between 1994 and 1999 the slowdown in the growth rate of the number of pensioners is explained by the increase in the retirement age for women from 62 to 65 years old, six months per year. Having in mind the demographic composition of the Portuguese population, the continuation of strong increases in the number of pensioners is expected for the future, if no reform is actually implemented.[10] Finally, the hike in the average pension, excluding the annual update, has also been very significant in recent years, even in the absence of discretionary measures: 3.6% of the annual growth rate, on average. This effect is a consequence of the higher wages the new retirees received during their contributive careers, but it is also due to the fact that, on average, they contributed more years to the system. As the general pension system in Portugal has not yet reached its maturity, it is predictable that the increase in the average pension will persist. To sum up, if no reform in this sector is carried through, in the coming years the structural factors will continue to lead to a strong growth in expenditure on pensions of the general system, quite above the increase in nominal GDP, hindering the consolidation efforts of fiscal authorities. This effect will be stronger on years of low economic growth, like in 2003 and 2004 in Portugal, where the general system pension expenditure contributed 0.4% of GDP, in each of the years, to the deterioration of the underlying fiscal situation.

3.2.2. The civil servants pension system

Pension expenditure in the civil servants system increased by 2.4% of nominal trend GDP in the period from 1990 to 2004. The rate of change has the same explanatory factors as in the general system case. Concerning the update of former civil servants pensions, it is worth noting that they are annually adjusted in line with the update of the wage scale, which, as mentioned before, has followed inflation quite closely and was nearly frozen in 2003 and 2004. As far as the number of pensioners is concerned, a strong growth can be observed in all years of the period from 1990 to 2004 (around 4.7% on average in this period). It is worth mentioning that the substantial increase of the number of pensioners in 2003 is mainly the result of an extraordinary rise in requests for retirement before the entry into force of new rules for the calculation of the initial pensions from 1 January 2004 onwards, explained in more detail in the next section. In addition, there is a smaller effect, related to the inclusion of the pensions of former post office employees in general government expenditure, following the transfer of the pension fund of this public corporation to the civil servants pension system. The magnitude of the composition effect, which usually follows quite closely the change in the number of pensioners, has also been very significant in almost all years of the 1990-2004 period, due essentially to higher wages at the end of their contributive careers. Last, it should be noted that, similarly to the private sector system, the expenditure on pensions of the civil servants system will follow a structural growth trend in the coming years. However, this may be mitigated in about 25 years, at the time when the new retirees will have their pensions calculated according to the general system rules, which are less favourable.[11]

4. The measures to control public expenditure in the period 2002-04

Expenditure control was seen as the keystone of the fiscal consolidation strategy delineated by the government formed in the wake of the March 2002 legislative elections. The strategy included some structural measures, with a long-run impact on expenditure, and a package of restraint measures, with a sizeable effect in the short term, which by its own nature could not be repeated successively without hindering the working of most general government institutions. However, crucial reforms like the ones in the public administration, instrumental to curb the growth of compensation of employees, and the private sector social security system were barely initiated.

The structural measures on the expenditure side that were actually implemented from 2002 to 2004 concerned four major areas: the civil servants pension system, the National Health Service (NHS), the subsidisation of interest on loans for house purchase and the ceiling on municipalities' financing. The changes to the civil servants pension system, effective from the beginning of 2004 onwards, involved the definition of the initial pension – formerly the average gross wage of the last three months, now the average wage net of the civil servant social contributions of the last three months – and the introduction of penalties for those who retire before reaching age 60: –4.5% for each year below the age of 60. In the NHS, two major reforms were launched: the transformation at the end of 2002 of 34 public hospitals into 31 new public corporations, now financed according to the medical services provided, and the introduction of generic drugs and the change in the co-financing of pharmaceutical drugs rules. The interest relief grants for house purchase were eliminated for new credit contracts from October 2002 onwards. Finally, according to the Budgetary Framework Law revised in 2002, the budgets for 2003, 2004 and 2005 included ceilings on additional net indebtedness of municipalities, in order to ensure that all general government subsectors contribute to the fulfilment of Portugal's fiscal targets in the context of the EU (for more details on this issue see Cunha and Silva, 2002, and Cunha and Braz, 2004).

As the structural measures mentioned above are limited in their scope and take time to have a sizeable impact, expenditure control in recent years relied mostly on short-term measures not sustainable in the medium and long term. These measures concerned predominantly the civil servants wage bill and pensions, intermediate consumption and investment. An important part of the burden of expenditure restraint actually fell on the civil servants wage bill and pensions, through three main channels: the freezing of wages and pensions exceeding a certain amount (EUR 1 000 and EUR 1 021 per month in the framework of the 2003 and 2004 budgets, respectively); a stricter control of the hiring of civil servants in central government; and a freezing of extraordinary revisions in specific careers. Intermediate consumption and investment not co-financed by the EU were subject to important cuts at the level of central government. These cuts were implemented through initial freezing defined in the budget itself, which could be confirmed or lifted in the last months of the year, according to the room for manoeuvre in the budgetary execution.

Two of the main negative effects of the short-term policy which aimed at curbing the growth of general government expenditure in recent years were to make the recruitment of highly qualified professionals by public institutions and the renewal of civil servants even more difficult than previously, and to increase further the rigidity of public expenditure, as the few items which are not mandatory bear a disproportionate share of the fiscal effort. Table 4 illustrates the rigidity of state expenditure in recent years. These developments clearly highlight the limits of the strategy of financial squeezing across the board and, consequently, the urgency of speeding up structural reforms.

5. The quality of public expenditure in Portugal

There is currently the presumption that public expenditure is quite inefficient in Portugal – that is to say that services provided by general government institutions do not match the resources used, human and other. The main factor behind the poor performance of public institutions is certainly the lack of adequate incentives for civil servants, heads of the government departments and local authorities. Wages are defined according to rigid scales based on professional category and seniority. Promotions result predominantly from seniority, not merit. Mobility between services is very limited and it is virtually impossible to fire civil servants. The gap between public and private wages for identical characteristics of the workers is the highest in the EU (Portugal and Centeno, 2001). However, the general government institutions are seldom able to attract highly qualified professionals, even to ensure the management of key departments. Top wages are relatively low and are not connected with the performance of the services. Finally, local authorities take their expenditure decisions without bearing the political cost of raising additional revenue.

Table 4. **State budgeted primary expenditure**
Mandatory expenditure *versus* discretionary expenditure

	State budget for		
	1996	2002	2005
Primary current expenditure	**100.0**	**100.0**	**100.0**
Mandatory expenditure	80.8	82.7	87.4
Local Finance Law[1]	4.0	5.2	5.1
Social Security Framework Law	9.2	12.1	14.5
Caixa Geral de Aposentações, CGA (civil servants pension system)	8.1	8.8	11.2
National Health Service	17.0	18.9	18.8
ADSE (civil servants health system)	1.6	1.9	1.9
Financial contribution to the European Union	5.2	4.3	4.2
Compensation of employees (excluding CGA and other health subsystems)	33.5	28.6	29.1
Other mandatory expenditure[1]	2.3	3.0	2.6
Discretionary expenditure	19.2	17.3	12.6
Capital expenditure	**100.0**	**100.0**	**100.0**
Mandatory expenditure	26.2	30.0	41.0
Regional Finance Law	5.4	8.9	11.2
Local Finance Law[1]	18.6	19.7	24.7
Other mandatory expenditure[1]	2.2	1.4	5.1
Discretionary expenditure	73.8	70.0	59.0

1. The split between current and capital expenditure in these items is still provisional in the column with the 2005 budget data.

Source: Ministry of Finance.

The relation between inputs, activities and outputs in the provision of public services is in most cases difficult to quantify. Education and health are the main exceptions. Together, they represented close to a third of the overall public expenditure in Portugal in 2002.

Public expenditure in education as a ratio to GDP in Portugal is slightly above the OECD average. Costs per student in secondary education are higher in Portugal than in many OECD countries, as a consequence of a low student-per-teacher ratio and high teacher wages, in particular at end-career. However, the results are poor. According to the OECD PISA programme, which aims at assessing the ability of 15-year-old students to use their knowledge to solve problems, as well as their competences in the areas of reading, mathematics and sciences, Portugal is consistently in the last positions in all the dimensions taken into account. In 2003, among the 29 OECD countries included in the study, Portugal occupied the 25th place as far as the ability of students to solve problems is concerned and the 24th, 26th and 27th places regarding specific competences in reading, mathematics and sciences, respectively. Further, a significant share of students takes additional years to complete compulsory and secondary education. The general perception about the quality of non-university public education encourages an important number of middle-class families to choose private schools. The very centralised design of the non-university public education and the fact that parents are not able to choose the school for their own children are certainly among the main sources of the system's inefficiency, as they lead to an inadequate set of incentives for school directors, teachers and local authorities.

Public expenditure in health care grew very fast in the last two decades and is now already close to the OECD average as a percentage of GDP. This trend allowed a significant improvement in the health status of the population, reducing the gap *vis-à-vis* the rest of OECD countries, in particular regarding years of potential life lost and infant mortality.

However, the resources allocated to the sector would have justified better results. Actually, according to several studies, Portugal's health performance is still lagging behind the EU average. The sources of inefficiency have been related to several factors, including: the system of doctors' remuneration, which is not connected with productivity; budget constraints that are too "soft", and lack of incentives for hospitals and other health institutions to improve the performance of their units; inadequate co-ordination between public health institutions; and, finally, insufficient competition in health provision and sale of pharmaceuticals.

Most of these problems began to be addressed in a comprehensive reform of the National Health Service launched in 2002. The backbone of this reform was the transformation of 34 public hospitals into 31 public corporations, which started to operate in December 2002. This institutional change separated in functional terms the financing/purchaser entity from the provider of healthcare services. Payments are based upon contracted production levels, with production exceeding by 10% contracted levels paid at marginal cost. The other main aspect of the reform already under implementation concerns the introduction of generic drugs and the change in the co-financing of medicines by the National Health Service. These measures should improve the efficiency of public expenditure in the health sector, but have yet to be complemented by additional ones in order to become fully effective.

6. Conclusions

The lack of fiscal consolidation before 2002 is largely responsible for the current difficult budgetary situation in Portugal. Between 1997 and 2001, there was a significant loosening, mostly explained by a strong increase in current primary expenditure. This growth was the most distinctive feature of Portugal's fiscal developments in the context of EU15.

An analysis of the main explanatory factors underlying the growth of public expenditure in Portugal between 1990 and 2004 shows that cyclically adjusted current primary expenditure rose by 10.6% of nominal trend GDP. The two items that contributed most to this outcome were social payments (+6.6% of nominal trend GDP) and compensation of employees (+2.5% of nominal trend GDP).

Concerning compensation of employees, the rising trend observed in almost all years between 1990 and 2002 is, to a large extent, explained by the increase in actual social contributions of general government entities as employers and the wage bill. The latter results predominantly from the strong rise in the number of civil servants, in particular at the beginning of the decade and after 1997, and from the residual effect, which was very significant from 1990 to 1992, mainly as a consequence of the introduction of the New Civil Servants Pay System, and between 1997 and 2002, due to additional revisions in some specific careers.

Regarding the cyclically adjusted social payments, the 6.6% of nominal trend GDP increase in the period from 1990 to 2004 stemmed, mainly, from rises in social transfers in kind (1.8% of nominal trend GDP) and in pension expenditure of both the private sector (1.8% of nominal trend GDP) and the civil servants system (2.4% of nominal trend GDP). The evolution of pension expenditure in both systems is justified, predominantly, by the increase in the number of pensioners and the considerable magnitude of the composition effect. Both of these structural factors should continue to contribute in the coming years to the strong growth of this item of expenditure.

The fiscal consolidation strategy delineated by the government formed in the wake of the March 2002 legislative elections included some structural measures, with a long-run impact on expenditure, and a package of restraint measures, with a sizeable effect in the short term, which by its own nature could not be repeated successively without hindering the working of most general government institutions. The structural measures on the expenditure side that were actually implemented from 2002 to 2004 concerned four major areas: the civil servants pension system, the National Health Service, the subsidisation of interest on loans for house purchase and the limits on municipalities' financing.

Concerning the quality of public expenditure in Portugal, the main factor behind the poor performance of public institutions is certainly the lack of adequate incentives for civil servants, heads of the government departments and local authorities. Public expenditure in education as a ratio to GDP in Portugal is slightly above the OECD average, but the results are quite poor. As far as health care expenditure as a percentage of GDP is concerned, there was a very fast growth in the last two decades, placing Portugal at the OECD average. This trend allowed a significant improvement in the health status of the population, reducing the gap *vis-à-vis* the rest of OECD countries. However, the resources allocated to the sector would have justified better results.

Notes

1. The period is not extended back to 1990 as the NewCronos database does not have available information on an ESA95 basis for all 15 EU member states.
2. It should be highlighted that the evolution of current primary expenditure between 1995 and 2002 in each country reflects, beyond the effects of discretionary measures and structural trends, a different impact of the economic cycle on expenditure, mainly through expenditure on unemployment benefits.
3. This conclusion still holds when social transfers in kind are excluded from the analysis, helping to corroborate the explanations presented.
4. Calculated according to the ECB harmonised methodology. For further details, see Bouthevillain, *et al.* (2001) and Neves and Sarmento (2001).
5. The objective is to eliminate the annual changes in ratios, which result from cyclical fluctuations of GDP. As such, nominal trend GDP is defined as the trend of real GDP multiplied by the unadjusted GDP deflator. The trend is derived by applying the Hodrick-Prescott filter with smoothing parameter $\lambda = 30$.
6. As noted in the next section, the measures to control the growth of public expenditure from 2002 onwards included the quasi-freezing of the update of the wage scale of civil servants in both 2003 and 2004.
7. The New Civil Servants Pay System was designed with two main objectives: the civil service pay system needed to regain internal fairness, and public sector salaries needed to become more competitive in relation to those paid by other sectors for the same job or the same qualifications.
8. A simulation was performed in another paper by the authors (Cunha and Braz, 2003), showing that the elimination of the residual component of the wage bill, plus keeping unchanged the number of civil servants, between 1990 and 2002 would have had a cumulative impact on the cyclically adjusted overall balance as a percentage of trend GDP of 3.9%.
9. For example, the introduction of the 14th month in the payment of pensions in 1990.
10. The last report of the Working Group on Ageing of the Economic Policy Committee (2001) showed that, according to official estimates, the increase in the private sector pension expenditure between 2000 and 2050 should amount to 3.4% of GDP, of which 6.7% of GDP was related to the dependency ratio, reflecting the effect of population ageing.
11. For the subscribers that joined the civil servants pension system after September 1993, the rules for the calculation of their initial pension will be those of the private sector system. This means that, in general terms, their contributive careers will have to be 40 years instead of 36 years to have access to a full pension, and also the replacement rate will be lower.

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