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Country Report Portugal 2016

**Including an In-Depth Review on the prevention
and correction of macroeconomic imbalances**

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EXECUTIVE SUMMARY

This country report assesses Portugal's economy in light of the Commission's Annual Growth Survey published on 26 November 2015. The survey recommends three priorities for the EU's economic and social policy in 2016: re-launching investment, pursuing structural reforms to modernise Member States' economies, and responsible fiscal policies. At the same time, the Commission published the Alert Mechanism Report that initiated the fifth annual round of the macroeconomic imbalance procedure. The Alert Mechanism Report identified Portugal as warranting a further in-depth review (IDR).

Portugal's economy has been on a moderate recovery path since mid-2013 amid rising business and consumer confidence and improving financing conditions. The recovery was initially led by exports but has increasingly become broad-based as private consumption, in particular, has picked up. Labour-market conditions have been improving, with employment increasing and the unemployment rate falling, but the absorption of the large pool of long-term unemployed remains a challenge. Recent labour market improvements are largely the result of a reduced rate of job destruction, while the rate of job creation has increased more moderately.

The moderate recovery is set to continue, while risks stem from high fiscal imbalances and financial market volatility. In 2015, the economy continued its gradual recovery on the back of strong domestic demand, while weaker external demand has been weighing on growth. Real GDP is forecast to accelerate slightly in 2016 and 2017 but employment creation is expected to slow down over the forecast horizon, thereby becoming more aligned with GDP growth. Still, the unemployment rate is projected to gradually fall to below 11% in 2017. Low external price pressures and persistent slack in the economy are expected to constrain consumer price inflation in the short-term.

The level of external debt remains very high. High external debt is the consequence of the significant debt accumulated in the non-financial private and public sectors. Corporate deleveraging continued in 2015, but indebtedness remains elevated. High and rising levels of non-performing loans in the business sector are weighing on balance sheets of both the non-financial and the

financial sector and are an important obstacle to investment.

During the crisis, high fiscal deficits and significant assumption of liabilities of public enterprises have resulted in a sharp increase in public debt. In recent years, fiscal consolidation has been predominantly based on revenue-increasing measures rather than permanent expenditure reductions, also benefitting from the cyclical recovery of the economy and favourable financing conditions. However, in absence of further structural consolidation measures, the very high level of public debt is set to come down only slowly in the near term due to elevated general government deficits and subdued growth. Risks to public debt sustainability are aggravated by interest rate volatility, shortcomings in the management of public finances and a high share of public expenditure.

A low growth potential is limiting the economy's capacity to grow out of debt. Rigidities in product and labour markets may act as barriers to investment, and emigration entails long-term risks for Portugal's growth potential. Weaknesses in the business environment are a main bottleneck to growth and to a more efficient allocation of resources. The rigidities in product, factor and service markets and an inefficient judicial system pose powerful barriers to the development of economic activity.

Even though overall wage developments have been moderate and supportive of rebalancing, the characteristics of the collective bargaining system limit the scope of firm level adjustment. Wages have decreased in nominal terms in 2014 and have remained stable in 2015. However, existing provisions for firms to temporarily derogate from sectoral collective agreements under specific circumstances have proven largely ineffective. Recent and planned increases in the minimum wage could result in a further compression of the wage structure, posing upward pressure on the overall wage structure and, if not matched by productivity increases, risking affecting employment perspectives and competitiveness of labour-intensive industries.

Overall, Portugal has made some progress in addressing the 2015 country-specific recommendations. As regards public finances,

there has been some progress in enforcing the commitment control law, improving tax compliance and enhancing the medium and long-term sustainability of the pension system. Wage developments have been moderate, and in line with productivity over a medium-term horizon; collective bargaining at sectoral level has been supportive of the process. Measures have been taken to improve the efficiency of Public Employment Services and there was some progress in ensuring adequate coverage of social assistance. Some progress has also been made in reducing the corporate debt overhang and allowing the private sector to deleverage. Limited progress has been made in improving transparency as regards concessions and public-private partnerships at local and regional level.

Regarding the progress in reaching the national targets under the Europe 2020 Strategy, Portugal is on track in reducing greenhouse gas emissions, the overall renewable energy target and energy efficiency. More effort is needed regarding the employment rate, R&D investment, reducing early school leaving, tertiary education attainment and reducing poverty.

The main findings of the in-depth review contained in this country report and the related policy challenges are:

- **Even though Portugal has managed to improve the current account balance and external competitiveness, large net external liabilities still constitute vulnerabilities.** Previously high current account deficits have been turned into surpluses. Nevertheless, the external indebtedness of the Portuguese economy remains high. Continued improvements in productivity and external competitiveness could contribute to accelerate the reduction of external debt.
- **High indebtedness of the private sector remains a major vulnerability of the Portuguese economy.** Non-financial corporations are adjusting their balance sheets, but to a lesser extent than households. The high level of corporate debt weighs on firms' performance and investment and the large level of non-performing loans continues to pose risks to financial stability while hampering the

productive allocation of credit. The policy response to high corporate indebtedness has been appropriate, but results are slow to come. Ensuring the continuation of the gradual deleveraging in the current context of low interest rates could help to restore a more balanced financial position of the private sector. At the same time, high levels of non-performing loans in the corporate segment are weighing on the balance sheets of banks and constrain their capacity to support the recovery through adequate credit supply. Start-ups and small and medium-sized enterprises have only limited access to finance via the capital market.

- **General government debt remains at a very high level.** The gross public debt-to-GDP ratio is expected to decline moderately in the short term and stabilise in the medium term. While public debt is considered sustainable under plausible scenarios, debt dynamics are vulnerable to adverse economic developments. Budgetary discipline and growth-enhancing structural reforms would support fiscal sustainability and the achievement of a significant reduction of debt.
- **The recovery of the Portuguese labour market continued in 2014 and 2015, but the absorption of the large pool of long-term unemployed remains a challenge.** The latter weighs heavily on both economic growth and the social situation. Firm-level bargaining is not picking up, which might hinder an effective wage adjustment that takes into account differences across firms. Increases of the minimum wage, while potentially reducing the intensity of in-work poverty, could also result in a further compression of the wage structure and put upward pressure on wages at all levels. If not matched by productivity increases, this could worsen employment prospects of the low-skilled, result in a deterioration of competitiveness and affect firms' capacity for deleveraging.

Other key economic issues analysed in this report which point to particular challenges of the Portuguese economy are the following:

- **Indicators of poverty and social exclusion have deteriorated since the onset of the**

crisis. Households with children have been particularly concerned. The risk of poverty affects also those at work through a combination of increased incidence of low wage earners and low work intensity. The severe material deprivation rate remains high despite a recent drop.

- **The low average skill level of the labour force is holding back productivity and competitiveness.** Weak cooperation between universities and business remains a challenge as it is detrimental to the employability of graduates and innovation. Portugal's innovation performance remains below the EU average, hampering the transition to a more knowledge-intensive economy.
- **Recent reforms have made the pension system financially more sustainable by reducing coverage and benefit levels in the longer term.** However, pension payments are not fully covered by contributions to the pension system. Future adequacy will depend heavily on increased labour force participation, longer working lives and efforts to improve the demographic outlook.
- **Portugal has made efforts to ensure access to quality healthcare in a sustainable manner, but spending is projected to increase in the long term.** Portugal faces the double challenge of achieving long-term fiscal sustainability in the healthcare sector while at the same time maintaining the level of access to healthcare by improving efficiency in the system. The projected increase of public healthcare expenditure as a proportion of GDP by 2060 is the highest in the EU.
- **Portugal has undertaken a comprehensive overhaul of its corporate and personal income tax systems, but the debt bias in corporate taxation remains relatively high and tax compliance low.** The perceived high level of uncertainty in the tax system may weigh on Portugal's attractiveness as a destination of foreign investment.
- **Despite progress, regulatory barriers and weak institutional capacity are still hampering business' growth and**

competitiveness. Portuguese businesses are smaller than in other European Member States, weighing on their productivity. Regulatory barriers and weak institutional capacity seem to be hampering the process of resource reallocation towards more productive firms, weighting on overall firms' size and productivity. There are still restrictions to the access to a number of highly regulated professions. Also, access to finance remains a major concern for SMEs. Registering a business has become easier, but licensing remains cumbersome. Furthermore, low efficiency of the judicial system, for example in relation to tax litigation, and a lack of transparency in public procurement are detrimental to business dynamics and FDI attraction. Transparency remains a challenge for public-private partnerships (PPPs), particularly at the local and regional level, and concession contracts.

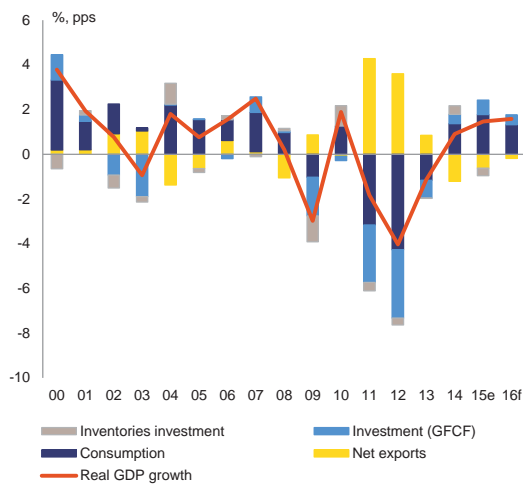
- **Re-launching investment in Portugal is key after the strong decline experienced during the economic crisis.** Investment used to be concentrated in non-tradable sectors such as construction. Since 2009, investment in Portugal has declined by more than the European average, mainly due to a drop in dwellings and equipment investment. The high level of corporate debt is a major impediment for investment. Other investment barriers include complex and unpredictable administrative procedures as well as the inefficiency of the judicial system, licensing procedures and administrative burden to comply with taxes.

1. SCENE SETTER: ECONOMIC SITUATION AND OUTLOOK

Growth drivers and outlook

Portugal experienced weak GDP growth for more than a decade before the onset of the economic and financial crisis in 2009. Potential output growth constantly declined due to low productivity growth and deep-rooted structural weaknesses, while rising labour costs undermined external competitiveness. After a prolonged recession, the Portuguese economy started to pick up in 2013. This gradual recovery continued in 2015, predominantly driven by cyclical factors.

Graph 1.1: Real GDP growth and its components



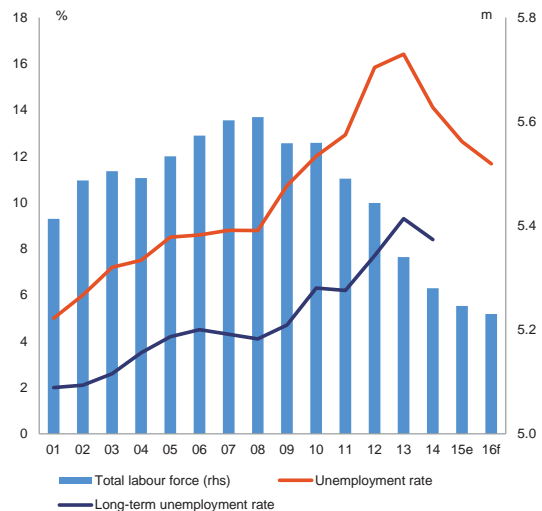
Source: European Commission

Economic activity slowed down at the end of 2015. Short-run economic indicators point to some moderation of economic activity towards the end of 2015. Weaker business and consumer confidence contributed to a slowdown in domestic demand and slowed the pace of job creation. Gross fixed capital formation took a hit in the third quarter of 2015 but is expected to have stabilised by the end of 2015 (see Box 1.2). On the external side, both exports and imports grew at lower rates than in the first half of 2015, reflecting a weakening global trade outlook. Nonetheless, due to the strong first half of the year real GDP rose by 1.5% in 2015. GDP is forecast to slightly accelerate to 1.6% in 2016, as trade is projected to have a less negative impact, while inventories are likely to make a neutral contribution. Risks to the economic outlook are, however, tilted to the downside and relate to the nature and pace of

deleveraging of households and particularly corporations. In addition, policy uncertainty could increase risk premia and lead consumers to delay spending and businesses to postpone investments.

Consumer price inflation turned positive in 2015 and is projected to rise moderately in the medium term. In the crisis years, consumer price inflation was held back by falling domestic demand, wage restraint in the private sector and subdued consumer expectations. More recently, the demand-driven economic recovery, several tax-increasing fiscal measures and the weakening of the euro have exerted upward pressure on consumer prices. HICP inflation reached 0.5% in 2015 and is expected to increase only moderately to 0.7% in 2016 due to low external price pressures and persistent slack in the economy.

Graph 1.2: Unemployment and labour force, 2001-2016



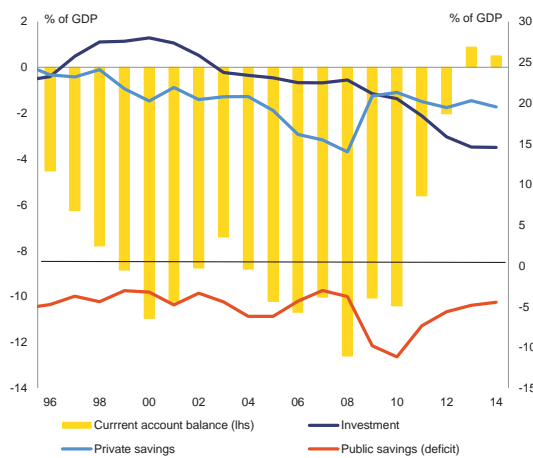
Source: European Commission

The labour market performance remained strong in 2015. However, job creation slowed in the second half of 2015, resulting in a 1.1% increase for the year as a whole. The unemployment rate fell to 12.6% in 2015 as a consequence of improving labour market conditions and a shrinking labour force (0.6% on average) reflecting demographic and migration trends. A further moderate decrease in the labour force, coupled with employment growth forecast at 0.8% is expected to bring unemployment down to 11.7% in 2016 (Graph 1.2).

External adjustment

Portugal borrowed substantially from the rest of the world after joining the European Monetary Union. This allowed domestic spending to outpace income developments and led to persistent and significant current account deficits and the accumulation of sizeable external debt as public and private sector indebtedness increased. Until 2002, this current account deterioration was mirrored by increasing investment and falling savings relative to GDP. From 2003 to 2009, the current account deficits were driven mainly by the decrease in the savings ratio, while the investment ratio remained broadly stable. Since 2013, Portugal has been posting current account surpluses in the context of a recovery in private savings, fiscal consolidation and investment stabilisation (Graph 1.3).

Graph 1.3: Savings and investment balance, 1996-2014

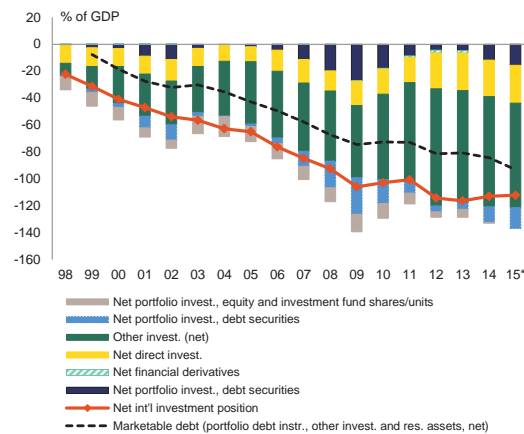


Source: European Commission

Portugal's Net International Investment Position (NIIP) remains very negative and tilted towards debt financing, despite the substantial current account adjustment since 2010. Portugal has made limited progress to date in reducing its sizable external debt. The negative NIIP improved by only 2 pps to -113.3% of GDP in 2014 after its peak in 2013, reflecting a net external lending position (Graph 1.4), which continued to be positive in 2014 as a result of the ongoing deleveraging of households and non-financial corporations and the reduction of the general government deficit. Nonetheless, Portugal still reports one of the most negative NIIPs within the

EU and the distance to the Alert Mechanism Report scoreboard threshold (-35% of GDP) remains substantial.

Graph 1.4: Breakdown of Portugal's Net International Investment Position (NIIP)



* indicates estimated figure using quarterly data.

Source: European Commission

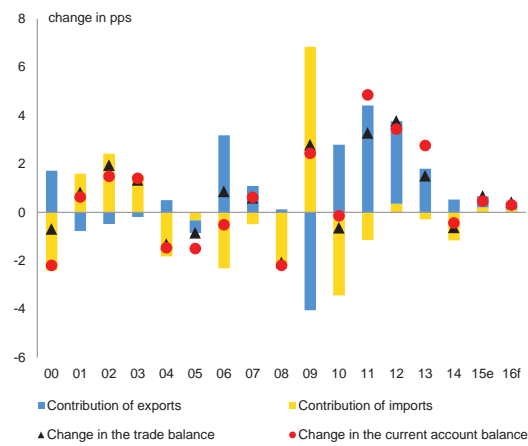
Continued substantial current account surpluses would improve the external position, which is very negative at present. Portugal would need to post annual current account surpluses of around 1.8% of GDP over the next decade to halve the negative NIIP by 2024. Annual current account surpluses of around 0.8% of GDP would reduce the NIIP to -65% of GDP by 2024.

Exports contributed markedly to the external adjustment. Improvements in competitiveness, resulting from adjustments in relative prices and improvements in product quality, enabled exports to make a growing contribution to the external balance adjustment, particularly between 2010 and 2013. During that period, exports accounted for an average of over 3 pps and the trade balance for an average of 2 pps of the adjustment of the current account (Graph 1.5). More recently, the trade surplus has stabilised due to robust import growth in response to more vigorous domestic demand. As a result the current account surplus is set to stay at around 1% of GDP in 2016.

Cyclical drivers continue to play a limited role in the current account adjustment between 2014 and 2016. Despite the domestic demand compression during the recession, cyclical drivers played a limited role in the current account

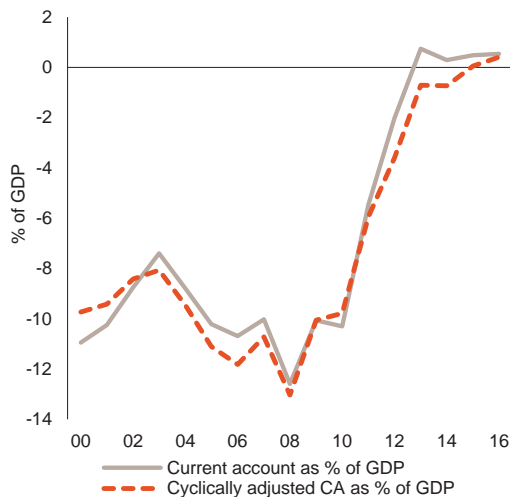
adjustment since 2010 (Graph 1.6). However, the most recent trend in current account developments indicates that the expected improvement in the current account surplus in 2015-2016 is linked mainly to the favourable effect of falling oil prices.

Graph 1.5: **Factors contributing to the percentage change in the current account**



Source: European Commission

Graph 1.6: **Non-cyclical current accounts**



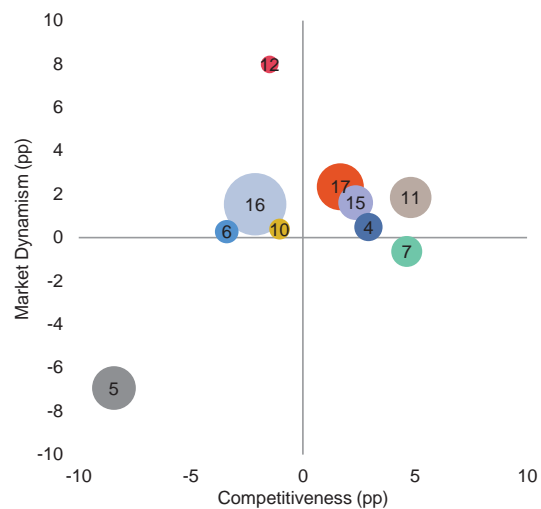
Source: European Commission

Competitiveness dynamics

The share of exports in GDP is still relatively low. Despite improvements in recent years, exports still accounted for only 40 % of GDP in 2015, which is low compared with other small and open euro area economies. A sectoral breakdown of

exports indicates that Portugal has recently lost market share in half of its ten largest export sectors, which, in total, account for more than 80 percent of total exports (Graph 1.7). This suggests that the progress achieved in 2010-2012, when Portugal gained market shares following the same pattern of specialisation, is stalling.

Graph 1.7: **Dynamism and competitiveness of exports (goods) in top-10 sector (2013-2014)**



(1) The size of the bubble indicates the share in total exports. Market dynamism is the difference between the annualised growth rates of world exports per market and global world exports. Competitiveness is the difference between the annualised growth rates of Portugal's exports per market and world exports per market.

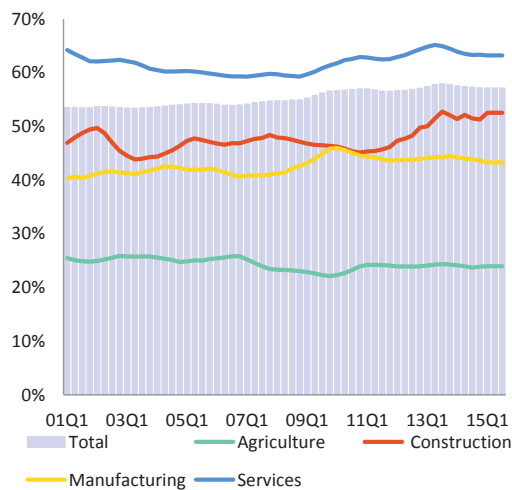
(2) The numbers refer to sectors: 4. Prepared food, beverages, tobacco; 5. Mineral products; 6. Chemical products; 7. Plastics; 10. Paper; 11. Textiles; 12. Footwear, headgear; 15. Base metals; 16. Machinery; 17. Vehicles

Source: European Commission

Portugal shows a persistent productivity gap with the euro area. Total labour productivity in Portugal remained at around 60% of the euro area levels in 2013-2014, although it varies considerably across sectors (Graph 1.8). Portugal's persistent productivity gap relative to average euro area levels is partly due to differences in the level of R&D spending and innovation. Both are still relatively low, as is also evidenced by the low share of exports of high-tech products (Graph 1.9). The low average skill level of the Portuguese labour force, including company management, is holding back investment activity and innovation (see Section 3.7). However, Portugal has retained its comparative advantage in the production of labour-intensive and low to medium value added

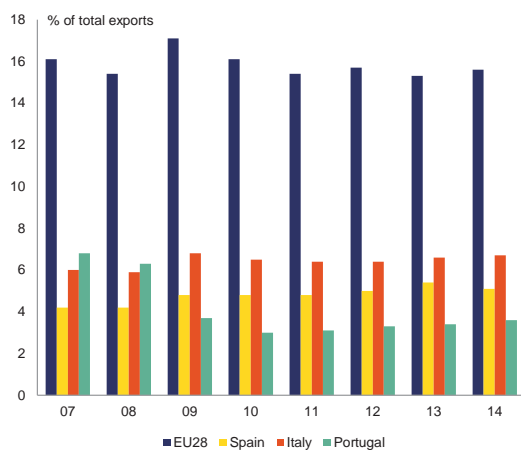
activities such as the processing of beverages, mineral products, paper and wood. Improvements in the business environment could yield significant gains in productivity and competitiveness (see Box 1.2).

Graph 1.8: Labour productivity relative to the EA-19



Source: European Commission

Graph 1.9: Exports of high technology products as a share of total exports

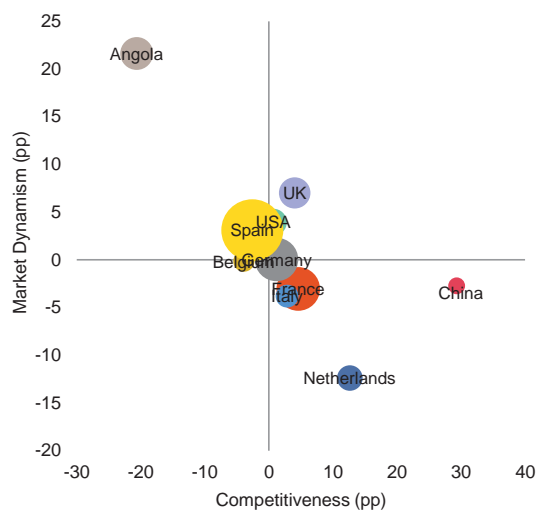


Source: European Commission

A more efficient resource allocation would provide an additional boost to productivity. In the early 2000s, the production mix was characterised by a relatively high and stable share of non-tradable sectors in total Gross Value Added. However, tradable sectors, exposed to international competition, have more incentives to

innovate and restructure their production processes. Shifting production to the tradable sectors, besides aiding the external rebalancing process, also serves to boost total factor productivity and ultimately contributes to more robust economic growth (see Box 1.2 and Section 3.7).

Graph 1.10: Dynamism and competitiveness of exports (destinations) on top-10 sector destinations (2013-2014)



(1) The size of the bubbles indicates the share of each destination in Portugal's total exports at the end of the period. Market dynamism means the difference between the annualised growth rates of world exports per market and global world exports. Competitiveness means the difference between the annualised growth rates of Portugal's exports per market and world exports per market.

Source: European Commission

Portugal's export performance with respect to its main destinations over 2013-2014 showed a mixed picture. Export market shares were lost in Angola, while there were strong gains in China and the Netherlands (Graph 1.10). Angola continues to pose downside risks to Portugal's export performance, as low oil prices are weighing on Angola's economic prospects. The trade channel is one of the main sources of inward spillovers to Portugal, given its relatively strong trade links with other EU economies. The weak economic outlook in relevant emerging markets, such as Brazil, China and Angola, may hit Portuguese exports, albeit to a lesser extent than a downturn in the country's main EU trade partners, such as Spain, France, Germany or the United Kingdom, would do (see Box 1.1).

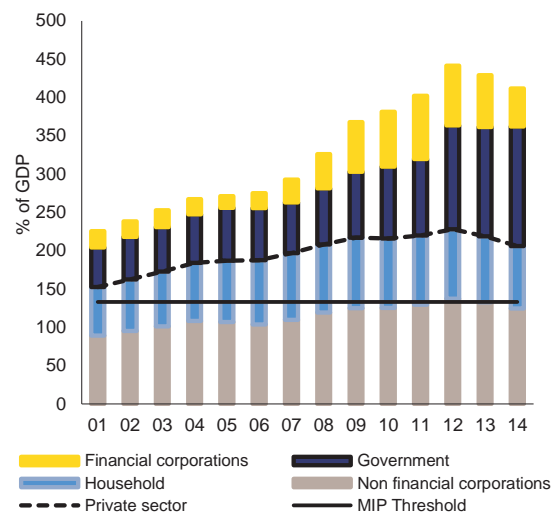
The loss of momentum in the current account improvement endangers the sustainable external adjustment process. A reallocation of more resources to tradable sectors with higher-productivity could remedy this development. On the demand side, buoyant domestic consumption and the high import content of Portuguese exports are complicating the external adjustment. According to the OECD database, imports represented 39% of Portuguese exports from 2005 to 2009 and the share rose to 46% for manufactured goods. The high import content in exports reflects Portugal's successful integration in international value chains and is also due to a relatively large share of basic industries (e.g. refined oil) in the export structure. However, export capacity-enhancing investments using more domestically produced goods would contribute to a faster external rebalancing and a more sustainable medium-term growth outlook.

Debt overhang

Portugal's total economy gross debt peaked at around 370% of GDP in 2012, and the deleveraging process is ongoing. Corporate indebtedness remained high at around 108% of GDP and represented a little over half of total private indebtedness by the end of 2014. The high level of corporate debt weighs on companies' balance sheets and impedes new investment, thereby obstructing economic growth. Both businesses and households have experienced a remarkable deleveraging process since 2012, with corporate indebtedness falling by 11 pps and household indebtedness contracting by 9 pps to 81% (Graph 1.11). Nonetheless, private sector indebtedness is still among the highest in the EU, at 189.6% of GDP by the end of 2014, and it poses serious risks to the economic recovery. The lack of FDI and the prominence of international bank lending and portfolio flows implied additional vulnerabilities for the Portuguese economy, as bank credit is usually more fickle and less favourable to growth than FDI⁽¹⁾.

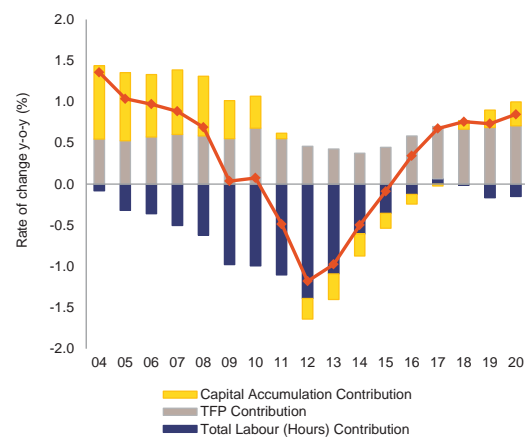
(¹) Tong, H. and S. Weil (2009), 'The Composition Matters: Capital Inflows and Liquidity Crunch During a Global Economic Crisis', IMF Working Paper 09/164.

Graph 1.11: Debt breakdown by sectors in 2001-2014



Source: European Commission

Graph 1.12: Contributions to potential growth in 2004-2020



Source: European Commission

Potential growth is not projected to resume the growth rates seen in the early 2000s. The main impediments to a further acceleration of potential output are subdued investment due to persistent deleveraging pressures, an unfavourable demographic outlook, high unemployment and subdued technological progress (Graph 1.12). As economic conditions are expected to improve and investment to pick up, capital accumulation would eventually raise the growth potential. Prospects for labour force development are less optimistic. Demographic factors are likely to weigh more heavily on potential growth after 2018. The poor total factor productivity performance (TFP) of the

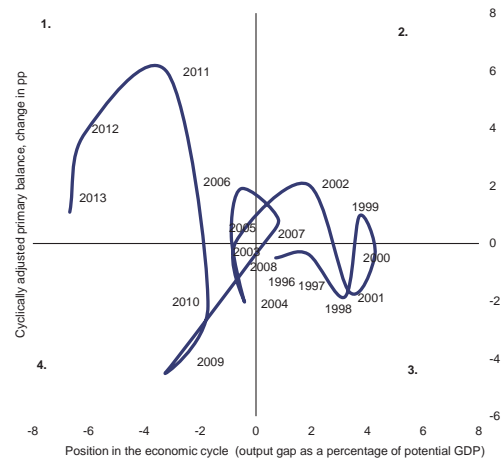
Portuguese economy is expected to improve slightly in the medium term. However, the low, although improving, average skill level of the labour force and the low level of innovation are forecast to drag on TFP.

Public finances

Public finances have benefitted from the recovery in 2015. Having reached 7.2% of GDP in 2014 (3.4% of GDP without one-offs), the general government headline deficit is estimated to have declined to 4.2% of GDP (3.0% of GDP net of one-offs) in 2015 due to the improved macroeconomic outlook. Strong overall tax collection, in line with the budgetary target, and lower unemployment expenditure are among the main contributors to the reduction in the headline deficit. However, some slippages in other expenditures, in particular other capital expenditure, compensation of employees and intermediate consumption, and a decrease in non-tax revenue have prevented a further improvement in the headline balance. According to the Commission's 2016 winter forecast, taking into account the Draft Budgetary Plan submitted on 22 January 2016, the headline deficit is forecast to reach 3.4% of GDP in 2016, as new balance-improving measures are forecast to compensate only to a limited extent for balance-deteriorating expansionary measures. Due to its earlier cut-off date, the winter forecast does not yet take into account the additional balance-improving measures of around 0.5% of GDP announced by the Portuguese government on 5 February. Still, risks to the fiscal outlook for 2016 are tilted to the downside due to uncertainties regarding the macroeconomic outlook, possible spending slippages and risks of failure to reach political agreement on further consolidation measures for 2016.

The fiscal consolidation effort up to 2014 has been replaced by a pro-cyclical loosening of the fiscal stance in 2015. Thus, the structural balance is estimated to have deteriorated by ½% of GDP in 2015. Based on the Commission winter forecast, the structural balance is set to worsen by an additional 1.0% of GDP in 2016. The current budgetary strategy is hence considered to be less sustainable than the one in place at the end of the Macroeconomic Adjustment Programme.

Graph 1.13: Fiscal stance, 1996-2014



(1) 1. Quadrant. Pro-cyclical fiscal tightening (consolidation); 2. Anti-cyclical fiscal tightening (consolidation); 3. Pro-cyclical fiscal easing; 4. Anti-cyclical fiscal easing

Source: European Commission

Public debt had reached 130% of GDP by the end of 2014 and is forecast to only slightly decrease in 2016. A pro-cyclical easing of fiscal policy in particular during the early 2000s, contributed to the build-up of public debt (Graph 1.13). After reaching a peak of 130.2% of GDP at the end of 2014, the gross debt-to-GDP ratio is forecast to have fallen slightly to 129.1% of GDP by the end of 2015 and to fall to 128.5% of GDP in 2016. The fall of the public debt ratio in 2015 was slower than previously expected due to the postponement of the Novo Banco sale, the impact of the Banif resolution and other statistical revisions. The ratio is expected to fall only slightly to 128.5% in 2016, as a result of a projected increase in Treasury deposits. However, a rather more pronounced fall to 127.2% is expected in 2017, in line with the projected continued economic recovery and primary budget surplus.

Table 1.1: Key economic, financial and social indicators

	2003-2007	2008	2009	2010	2011	2012	2013	2014	forecast		
									2015	2016	2017
Real GDP (y-o-y)	1.1	0.2	-3.0	1.9	-1.8	-4.0	-1.1	0.9	1.5	1.6	1.8
Private consumption (y-o-y)	1.5	1.4	-2.3	2.4	-3.6	-5.5	-1.2	2.2	2.6	1.9	1.8
Public consumption (y-o-y)	1.5	0.4	2.6	-1.3	-3.8	-3.3	-2.0	-0.5	0.3	0.4	0.4
Gross fixed capital formation (y-o-y)	-1.0	0.4	-7.6	-0.9	-12.5	-16.6	-5.1	2.8	4.3	3.0	4.7
Exports of goods and services (y-o-y)	5.6	-0.3	-10.2	9.5	7.0	3.4	7.0	3.9	4.9	4.3	5.3
Imports of goods and services (y-o-y)	4.5	2.5	-9.9	7.8	-5.8	-6.3	4.7	7.2	6.5	4.9	6.0
Output gap	-0.7	0.4	-2.6	-0.8	-2.2	-5.0	-5.2	-3.8	-2.3	-1.1	0.0
Potential growth (y-o-y)	1.2	0.7	0.0	0.1	-0.5	-1.2	-1.0	-0.5	-0.1	0.3	0.7
Contribution to GDP growth:											
Domestic demand (y-o-y)	1.1	1.1	-2.8	1.1	-5.7	-7.3	-2.0	1.8	2.4	1.8	2.0
Inventories (y-o-y)	0.1	0.1	-1.2	0.9	-0.4	-0.3	0.0	0.4	-0.3	0.0	0.0
Net exports (y-o-y)	0.0	-1.1	0.9	-0.1	4.3	3.6	0.9	-1.2	-0.6	-0.2	-0.2
Contribution to potential GDP growth:											
Total Labour (hours) (y-o-y)	-0.2	-0.6	-1.0	-1.0	-1.1	-1.4	-1.1	-0.6	-0.4	-0.1	0.1
Capital accumulation (y-o-y)	0.8	0.7	0.5	0.4	0.1	-0.3	-0.3	-0.3	-0.2	-0.1	0.0
Total factor productivity (y-o-y)	0.5	0.6	0.6	0.7	0.6	0.5	0.4	0.4	0.4	0.6	0.6
Current account balance (% of GDP), balance of payments	-9.2	-12.1	-10.4	-10.1	-6.0	-2.0	1.4	0.5	.	.	.
Trade balance (% of GDP), balance of payments	-7.9	-9.4	-6.7	-7.1	-3.7	0.1	1.8	1.3	.	.	.
Terms of trade of goods and services (y-o-y)	-0.1	-2.3	4.8	-1.3	-2.0	0.5	1.7	1.5	3.2	1.6	0.8
Capital account balance (% of GDP)	1.5	1.2	1.2	1.4	1.5	2.1	1.6	1.5	.	.	.
Net international investment position (% of GDP)	-73.4	-95.1	-107.9	-104.3	-100.7	-114.2	-116.3	-113.0	.	.	.
Net marketable external debt (% of GDP) ¹	-43.1*	-67.2*	-74.6*	-72.6*	-72.9	-81.3	-80.8	-84.3	.	.	.
Gross marketable external debt (% of GDP) ¹	169.7	193.8	215.3	215.3	205.7	218.1	206.0	213.7	.	.	.
Export performance vs. advanced countries (% change over 5 years)	4.8	-1.1	-0.3	0.7	-0.2	-6.7	1.3	1.82	.	.	.
Export market share, goods and services (y-o-y)	-0.5	-4.1	0.1	-9.1	0.8	-4.7	6.7	2.3	.	.	.
Net FDI flows (% of GDP)	0.0	-0.9	-0.8	-5.1	2.5	-8.4	-1.4	-1.4	.	.	.
Savings rate of households (net saving as percentage of net disposable income)	1.4	-1.1	2.7	1.3	-0.9	-0.5	-0.2	-2.3	.	.	.
Private credit flow (consolidated, % of GDP)	12.8	15.9	5.3	5.3	-0.9	-2.8	-3.6	-8.7	.	.	.
Private sector debt, consolidated (% of GDP)	172.2	196.2	204.1	201.5	204.2	209.6	201.4	189.6	.	.	.
of which household debt, consolidated (% of GDP)	79.6	89.0	92.1	90.7	90.5	90.7	86.0	81.5	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	92.5	107.2	112.0	110.8	113.7	118.9	115.4	108.1	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-4.8	-9.3	-3.6	-1.2	0.7	2.7	3.5	6.1	4.6	3.6	3.9
Corporations, gross operating surplus (% of GDP)	19.7	20.4	20.8	20.8	21.0	21.2	21.3	21.3	21.5	21.6	22.0
Households, net lending (+) or net borrowing (-) (% of GDP)	1.7	1.6	4.4	3.4	2.6	2.9	3.6	2.8	1.8	2.2	2.0
Deflated house price index (y-o-y)	-1.8	1.0	0.9	-1.0	-6.5	-8.7	-2.7	3.6	.	.	.
Residential investment (% of GDP)	5.8	4.7	4.1	3.6	3.3	2.9	2.5	2.3	.	.	.
GDP deflator (y-o-y)	3.1	1.7	1.1	0.6	-0.3	-0.4	2.3	1.0	1.7	1.5	1.3
Harmonised index of consumer prices (HICP, y-o-y)	2.7	2.7	-0.9	1.4	3.6	2.8	0.4	-0.2	0.5	0.7	1.1
Nominal compensation per employee (y-o-y)	3.3	2.6	2.4	2.1	-1.8	-3.1	3.6	-1.4	0.1	1.6	1.4
Labour productivity (real, person employed, y-o-y)	1.5	-0.2	-0.3	3.4	0.1	0.1	1.8	-0.5	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	1.8	2.8	2.7	-1.2	-2.0	-3.2	1.8	-0.9	-0.3	0.8	0.3
Real unit labour costs (y-o-y)	-1.3	1.0	1.6	-1.9	-1.7	-2.8	-0.5	-1.8	-1.9	-0.7	-1.0
Real effective exchange rate (ULC, y-o-y)	1.0	0.5	0.0	-2.5	-2.1	-5.8	2.6	-1.3	-3.7	0.0	.
Real effective exchange rate (HICP, y-o-y)	1.4	0.6	-0.6	-3.1	0.7	-1.6	0.3	-0.5	-2.6	0.9	-0.8
Tax wedge on labour for a single person earning the average wage (%)	22.4	22.8	22.6	22.9	24.5	22.8	27.2	27.3	.	.	.
Tax wedge on labour for a single person earning 50% of the average wage (%)	14.0*	14.1	13.8	13.9	14.2	11.0	11.0	11.0	.	.	.
Total Financial Sector Liabilities, non-consolidated (y-o-y)	9.8	3.0	6.7	6.3	-8.4	-3.9	-4.1	0.8	.	.	.
Tier 1 ratio (%) ²	.	6.2	7.5	7.9	8.1	11.0	11.7	11.0	.	.	.
Return on equity (%) ³	.	1.2	4.2	6.3	-5.4	-5.0	-11.9	-21.8	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (4)	.	1.6	2.5	3.7	5.3	7.0	7.8	12.7	.	.	.
Unemployment rate	8.4	8.8	10.7	12.0	12.9	15.8	16.4	14.1	12.6	11.7	10.8
Long-term unemployment rate (% of active population)	3.8	4.1	4.7	6.3	6.2	7.7	9.3	8.4	.	.	.
Youth unemployment rate (% of active population in the same age group)	20.3	21.6	25.3	28.2	30.2	38.0	38.1	34.7	32.0	.	.
Activity rate (15-64 year-olds)	73.2	73.9	73.4	73.7	73.6	73.4	73.0	73.2	.	.	.
People at-risk poverty or social exclusion (% total population)	25.9	26.0	24.9	25.3	24.4	25.3	27.5	27.5	.	.	.
Persons living in households with very low work intensity (% of total population aged below 60)	6.7	6.3	7.0	8.6	8.3	10.1	12.2	12.2	.	.	.
General government balance (% of GDP)	-4.8	-3.8	-9.8	-11.2	-7.4	-5.7	-4.8	-7.2	-4.2	-3.4	-3.5
Tax-to-GDP ratio (%)	34.3	34.9	33.4	33.7	35.5	34.5	37.2	36.9	37.1	36.3	35.9
Structural budget balance (% of GDP)	.	.	.	-8.0	-6.2	-3.0	-2.5	-1.4	-1.9	-2.9	-3.5
General government gross debt (% of GDP)	65.1	71.7	83.6	96.2	111.4	126.2	129.0	130.2	129.1	128.5	127.2

(1) Sum of portfolio debt instruments, other investment and reserve assets.

(2),(3) Domestic banking groups and stand-alone banks.

(4) Domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.

(*) Indicates BPM5 and/or ESA95

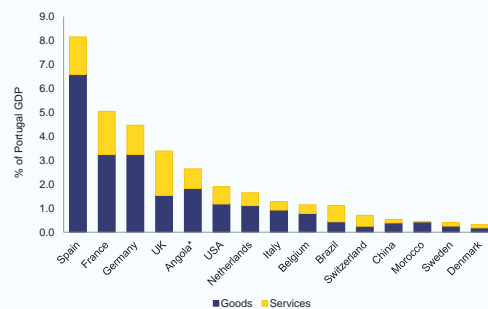
Source: European Commission, winter forecast 2016; ECB

Box 1.1: Inward spill-overs to Portugal

Trade, foreign direct investment (FDI) and changes in the valuation of European sovereign bonds are the main potential sources of inward spill-overs to Portugal¹. The country has strong trade links with other EU economies and some non-EU economies, such as Angola and the United States. The weak economic outlook for emerging markets has already triggered negative inward spill-overs to Portugal, e.g. a significant reduction in exports to Angola. However, the main impact is likely to come from second-round effects. In addition, Portugal is highly dependent on inward FDI from the EU. A slowdown in emerging market economies could adversely affect the economies of Portugal's main trading partners in the EU, thus lowering Portugal's exports to those EU countries and reducing FDI inflows to Portugal from the EU economies concerned.

In 2013, exports to Spain, France, Germany and the United Kingdom together accounted for more than 20% of GDP (Graph 1) and about 50% of the total exports. In contrast, extra-EU trade accounted for only 30% of total exports and about 10% of GDP. Angola, Brazil and China are the emerging markets most relevant to Portugal as regards both trade and FDI. If their economic performance weakens, economic growth in Portugal may therefore be affected

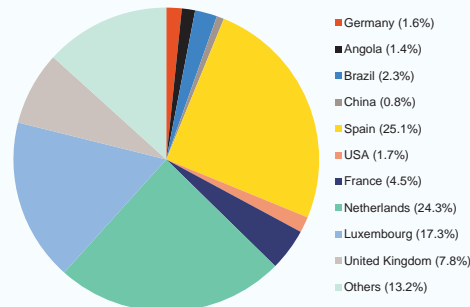
Graph 1. Exports by destination, 2013



*Note: The data on exports of services to Angola are for 2012, as there are no data available for 2013. Source: Banco de Portugal

Source: European Commission, UN

Graph 2. Stock of inward FDI by geographical origin, Q3-2015



The bulk of Portugal's stock of inward FDI came from the EU, with a relatively small proportion coming from emerging markets. The stock of inward FDI stood at 58.4% of GDP in 2013, 9 pps above the EU average. FDI from Spain, the Netherlands and Luxembourg² accounted for 38% of Portugal's GDP and almost 67% of the total stock of inward FDI in the third quarter of 2015 (Figure 2). FDI inflows as a share of total investment peaked in 2011 and 2012 at around 26%³. Some emerging markets (Angola, Brazil and China) were among the top five sources of inward transactions in 2014. However, the economic downturn in emerging markets caused FDI from these countries to contract again in 2015, while the share of inward flows from other European countries regained prominence.

¹ Spill-overs are defined as the result of shocks in one economy which are transmitted to another economy. They can work through a number of channels, including trade, confidence or financial exposures. See European Commission (2014), 'Cross-border spillovers in the euro area', Quarterly Report on the Euro Area Vol. 13 No 4.

² The figures for the Netherlands and Luxembourg may be distorted, as many international companies have their headquarters in these countries.

³ Source: UNCTAD database. Total investment is measured using gross fixed capital formation from the National Accounts.

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Box (continued)

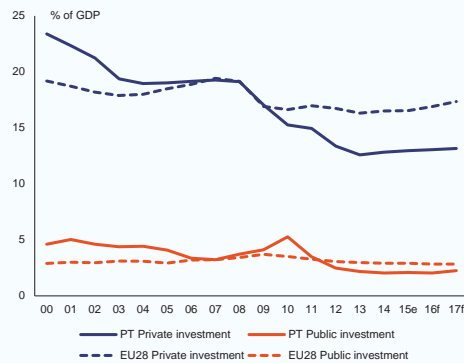
The financial channel is an additional conduit for spill-overs. Portuguese foreign assets are held mainly by residents of the United Kingdom, the Netherlands and Spain. In the first half of 2015, the Portuguese banking sector was particularly exposed to Poland and Spain, with claims worth respectively 8% and 6% of Portuguese GDP. In the same period, the only EU banking sector significantly exposed to the Portuguese economy was that of Spain. The impact was modest elsewhere, below 1% of each counterpart's GDP.

Box 1.2: Investment challenges

Macroeconomic perspective

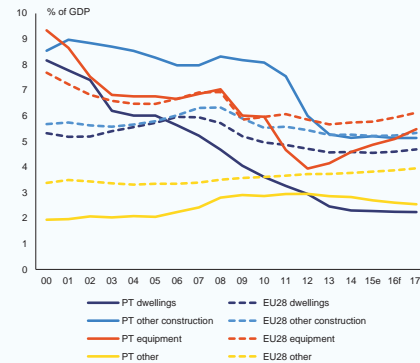
Investment activity in Portugal is gradually recovering but stronger growth in total investment would be required to converge towards the EU average. Investment as a share of GDP was above the EU average in the pre-crisis period (2000-2007), both for private and for public investment (Graph 1). After this, total investment as a share of GDP contracted by almost 8 pps by 2014, mainly as a result of falling private investment. Investment recovered markedly in the first half of 2015 and it is expected to have grown by 4.3% in 2015 as a whole. In the medium term, private investment should pick up again as uncertainty in global markets and deleveraging needs are expected to diminish. In addition, EU structural funds could help stabilise the public investment-to-GDP ratio in the coming years (see Section 3.6). Nevertheless, the overall investment gap with respect to the EU average will remain significant for some years to come.

Graph 1. Private and public investment as a percentage of GDP, 2000-2017, Portugal and EU average



Source: European Commission

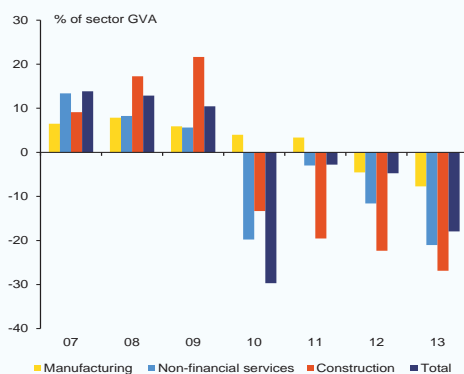
Graph 2. Investment by components as a percentage of GDP, 2000-2017, Portugal and EU average



Source: European Commission

In the early 2000s, investment in Portugal was concentrated in non-tradable sectors, such as construction, to a far greater extent than the EU average (Graph 2). Until 2012, investment in Portugal declined by more than the EU average, mainly as a result of declining investment in dwellings and equipment. Equipment has since been the main driver of the recovery in investment, and it is expected to have increased by 9.3% in 2015. Construction (dwellings and other) grew at similar rates to GDP between 2013 and 2015 (Graph 2).

Graph 3. Investment by sector



The high level of corporate debt is a major impediment to investment and potential output growth. Portuguese non-financial corporations are among the most indebted in the euro area, and they are in the process of deleveraging, which is weighing on investment. Non-tradable sectors such as construction and real estate have shown the weakest investment performance since 2010. In contrast, manufacturing has performed better although this sector posted negative investment rates in 2012 and 2013 (Graph 3).

Graph 3. Note 1: Investment is measured as the yearly change in tangible fixed assets as a percentage of the gross value added (GVA) per sector.

Note 2: The substantial fall in investment in the electricity and gas sector in 2010 (not shown in the figure) partially explains the drop in total investment in that year.

Source: European Commission, BACH database

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Box (continued)

Structural barriers to investment

Despite recent progress, investment barriers in Portugal remain in key areas:¹

Financing conditions for small and medium-sized businesses remain difficult (Section 2.1). Implementation of the corporate deleveraging strategy is well advanced, including a revamping of the PER and SIREVE insolvency tools in February 2016 and the changes in the tax treatment of debt financing that took effect in 2013. However, payments by the public sector in commercial transactions are still seriously delayed, which is detrimental to financing conditions, in particular for SMEs.

Limited scope for wage adjustment at firm level and the low average skill levels of the labour force can negatively affect investment (Section 2.2). Reforms of the wage-setting mechanisms were introduced in the recent past, aiming to promote firm-level bargaining and prevent automatic renewal of expired collective agreements. However, firm-level bargaining is not picking up, partly because of structural factors (i.e. small average firm size). More relaxed conditions for extending sector-level agreements were reintroduced in 2014, contributing to keep wage-setting at a centralised level. The framework adopted in 2014 to allow firms to temporarily suspend sector-level agreements is proving scarcely effective. In addition, the large proportion of low-skilled workers in the labour force is hampering productivity and holding back specialisation in higher value-added sectors.

The overall complexity and unpredictability of administrative procedures are a concern for Portuguese businesses (Section 3.4). The business environment has been improved in recent years. Starting in 2014, measures have been taken to reduce unnecessary administrative burden, adopt better regulation principles and reduce competition bottlenecks in the service sector. Yet there are still implementation hurdles at local level as most improvements targeted only the central administration. Moreover there is a heavy regulatory burden on service providers and access to some regulated professions is still restricted. The lack of stability and predictability in the legislative framework makes doing business more difficult. Portugal has undergone a comprehensive review of its tax legislation, including a shift towards a more growth-friendly tax structure in 2014 and 2015. However, reforms of the Tax and Administrative Tribunals are proceeding at a slower pace than other judicial reforms, and the number of hours that medium-sized firms spend preparing, filing and paying taxes is still high.

Innovation-friendly framework conditions could help increase R&I investment (Section 3.4) Portugal has made significant progress in building its R&I capacities, significantly increasing the number of persons with tertiary education and science and engineering graduates. However, the country is underperforming in science-business cooperation and in the commercialisation of knowledge and incentives to improve cooperation between public research organisations and the business sector remain weak and fragmented.

Network industries continue to suffer from competition bottlenecks and impediments to investment (Section 3.5). In the transport sector, Portugal has made progress in modernising its regulatory framework, improving competition and cost-effectiveness in the ports, urban transport and railways. However, the port sector reforms still suffer from implementation delays and obstacles to the entry of new players given the lack of a general framework for concessions. In the energy sector, Portugal has taken measures to reduce the electricity tariff debt, with three reform packages launched between 2012 and 2014. However, there are some concerns about the electricity tariff debt increases that create obstacles to investments in the energy sector.

¹ See 'Challenges to Member States' Investment Environments', SWD(2015) 400 final (http://ec.europa.eu/europe2020/challenges-to-member-states-investment-environments/index_en.htm).

Box 1.3: Contribution of the EU Budget to structural change

Portugal is an important beneficiary of European Structural and Investment Funds (ESIF) and is eligible for up to EUR 25.8 billion in the 2014-2020 programming period. This is equivalent to 2.0% of GDP (on an annual basis) and 79.3% of the expected national public investment in areas supported by the ESI funds.

A number of reforms were passed in the form of ex-ante conditionalities (EACs) in areas to benefit from the Funds to ensure successful investments (for instance research and innovation and SME competitiveness). However, by end-2016 EAC actions plans are still to be completed in 7 key thematic areas, including strategies in areas such as transport, energy efficiency and water. All action plans are being followed closely. Where ex-ante conditionalities are not fulfilled by end 2016, the Commission may suspend interim payment to the priorities of the programme concerned.

Portugal was until 2014 under programme support and only received CSRs for the first time in 2015. In that light the Funds will contribute to the Europe 2020 objectives and focus on four key thematic areas (competitiveness and internationalisation, sustainability and efficiency in the use of resources social inclusion, employment and human capital) and two cross-cutting dimensions (the reform of public administration and promoting integrated intervention at territorial level). Portugal also benefits from EUR 160 million under the Youth Employment Initiative (matched by the same amount from the European Social Fund) to support young people to find their way to the labour market, get involved into traineeship projects or continue their education.

Financing under the new European Fund for Strategic Investments (EFSI), Horizon 2020, the Connecting Europe Facility and other directly managed EU funds are supplementary to the ESI Funds. Following the first rounds of calls for projects under the Connecting Europe Facility, Portugal has signed agreements for EUR 151 million for transport projects. For more information on the use of ESIF in Portugal, see: <https://cohesiondata.ec.europa.eu/countries/PT>.

2. IMBALANCES, RISKS, AND ADJUSTMENT ISSUES

This section provides the in-depth review foreseen under the Macroeconomic Imbalances Procedure (MIP)⁽²⁾. It focuses on the risks and vulnerabilities flagged in the Alert Mechanism Report 2016. The section analyses the reasons behind the high level of public debt, the developments in debt of households and the corporate sector and the related deleveraging process, and the sustainability of Portugal's external debt position. Moreover, the role of the financial sector in helping the deleveraging process and more broadly in supporting the recovery is subject of discussion, as is the adjustment capacity of the labour market to support a more balanced growth model. The section concludes with the MIP assessment matrix which summarises the main findings.

2.1. PRIVATE AND PUBLIC DEBT OVERHANG

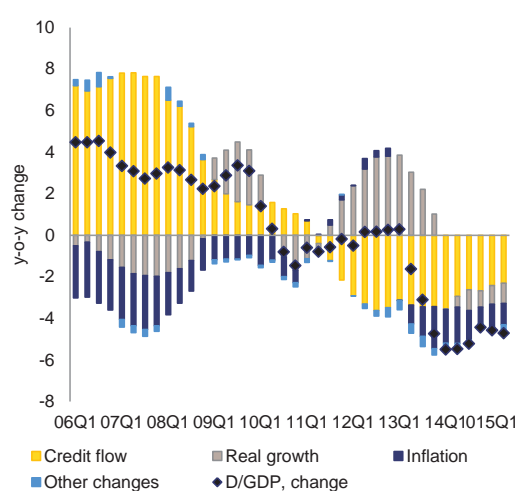
Deleveraging dynamics in the private sector

The high indebtedness of the private sector, especially the non-financial corporate sector, remains a major vulnerability of the Portuguese economy. Preserving financial stability in Portugal implies continued deleveraging efforts by households and firms and maintaining their net lending positions. Not long ago, both households and firms benefited from falling interest rates, which created some room for growth in private consumption and investment. However, this did not prevent the share of non-performing loans from growing, by about one percentage point in the course of a year, to 13.8% of total credit outstanding in June 2015. It is essential to ensure that gradual deleveraging continues in the current context of low interest rates if the private sector is to be restored to a more balanced financial position. To achieve this, the reallocation of credit resources to more creditworthy borrowers would have to continue, to the detriment of non-viable borrowers. The adoption of more prudent criteria from the side of banks when assessing new loans to households and firms, focusing on the borrower's ability to generate future cash-flows, in particular in a higher interest rates environment, would further contribute to a more balanced financial position.

The household sector's balance sheet is improving, though it remains challenged by high indebtedness. Significant efforts have been made to reduce private sector imbalances, both during and after the economic adjustment programme. In particular, the household sector has decreased its leverage, as its debt has been reduced since 2009 by around 10 percentage points of GDP

to below 85% of GDP in the third quarter of 2015. Households' balance sheet deleveraging accelerated since the end of 2013 (Graph 2.1.1). The main drivers were positive nominal output growth and the contraction of credit to households since beginning 2011. This trend is expected to continue in 2016, but at a slower pace, as household credit is projected to recover gradually. In addition, the household saving rate fell sharply to 4.0% in the third quarter of 2015, from nearly 6% in 2014, as private consumption expenditure outpaced disposable income. On the other hand, according to Banco de Portugal, the ratio of non-performing household loans remained stable at 4.4% and it even fell in the consumer loans segment to 15.9% in June 2015, from 17% at the end of 2014.

Graph 2.1.1: Breakdown of year-on-year changes in debt-to-GDP ratios, households



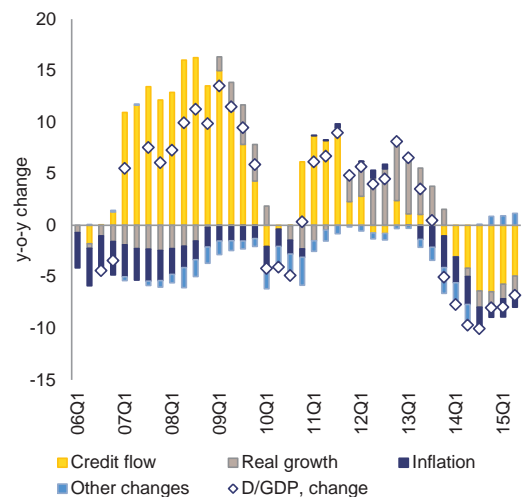
Source: European Commission

⁽²⁾ According to Article 5 of Regulation (EU) No 1176/2011.

Non-financial corporations are adjusting their balance sheet, but the progress is moderate. The very high indebtedness of non-financial corporations, both by historical standards and compared with other euro area economies, remains a major vulnerability of the Portuguese economy. There is a vast literature confirming the impact that liquidity, financial structure and financial distress have on a firm's performance. Empirical studies, often based on experience from previous economic and financial crises, suggest that corporate debt levels above 90% of GDP⁽³⁾ can act as a major drag on economic growth, as companies shouldering the debt burden are less likely to invest and hire. According to the Banco de Portugal, Portuguese private corporate debt stood at 146% of GDP on a non-consolidated basis in October 2015, some 20 percentage points below the peak level of 167.4% in 2012 but still over 20 percentage points above the euro area average. This deleveraging was the result of both nominal output increases ('passive deleveraging' through the denominator effect) and 'active deleveraging' through negative credit growth (Graph 2.1.2). Further reductions in the corporate indebtedness ratio are expected in 2016. These may be driven predominantly by output growth and, to a lesser extent, by the recovering but still negative trend in credit developments.

⁽³⁾ Cecchetti, S. G., M. S. Mohanty and F. Zampolli, 'The real effects of debt', *BIS Working Papers* No 352.

Graph 2.1.2: Breakdown of year-on-year changes in debt-to-GDP ratios, non-financial corporations



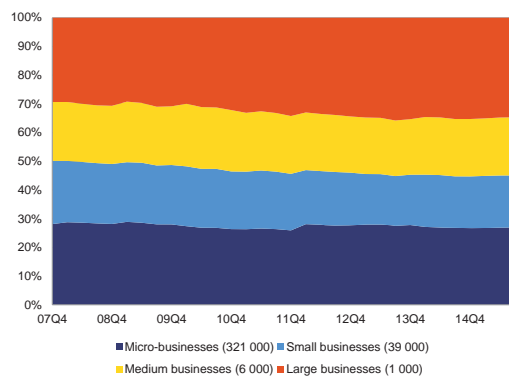
Source: European Commission

The leverage picture and the deleveraging effort are mixed across size and economic sectors.

Indebtedness by company size as a share of total indebtedness has increased more than 6 pps. for large corporations since the end of 2007, from 29.4% of the total to 36% (Graph 2.1.3). Measuring indebtedness against the level of aggregate economic activity conceals some major differences between sectors (Graph 2.1.4). The total debt of private non-financial corporations fell by about 2% year-on-year in the third quarter of 2015. It was the transport and storage segment of the economy that deleveraged most heavily, reducing its debt by nearly 6% year-on-year. On the other hand, seriously leveraged sectors such as the real estate business and construction reduced debt by only 2.4% year-on-year. Reflecting the shift of the credit flow towards the tradable sectors, credit to the manufacturing sector and exporting companies expanded by 2.3%. Moreover, the total NFC debt-to-equity ratio has changed little since 2014, remaining at 2.3, while for large SMEs it has actually risen from 1.9 to 2.1. Nonetheless, SMEs' operating profitability rose to 7.7% (up from 6.6% in June 2014). There is also a clear trend towards extending debt maturities and lower interest rates – the average cost of SMEs' debt fell by some 30 basis points in one year to 3.6% in June 2015. There was also progress on the average accounts receivable and

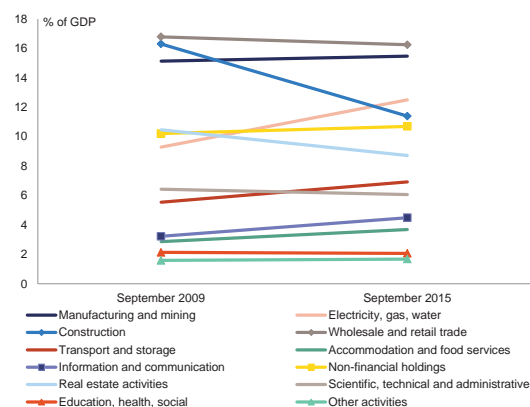
payable as measured by days of sales – at 77 days of sales in mid-2015, down from over 80 days in the previous year.

Graph 2.1.3: Trends in the indebtedness share of Portuguese NFCs by company size, 2007-2015



Source: Banco de Portugal

Graph 2.1.4: NFC debt of various economic sectors as a share of total NFC debt



Source: Banco de Portugal

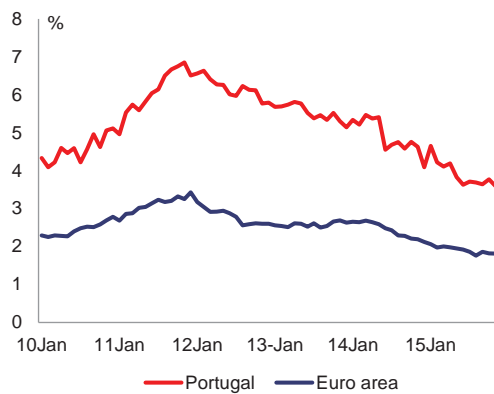
The policy response to high corporate indebtedness has been appropriate, but results are slow to come. Most Portuguese NFCs are chronically short of capital. At the end of 2014, one out of three companies stood in negative shareholder equity. 42% of private NFCs had negative profits, while debt at risk⁽⁴⁾ represented

25% of corporate liabilities. Action has been taken at various levels to address the multiple and challenging aspects of the complex high corporate indebtedness issue. The restructuring of indebted companies that are found viable is expected to continue at an accelerated pace. The debt restructuring mechanism inspired by US Chapter 11 provisions was added to the bankruptcy code two years ago to allow fast-track restructuring before an insolvency proceeding begins. One of its features is that courts can enforce out-of-court agreements between the debtor and a majority of creditors. For micro-businesses and small firms, a specific out-of-court mechanism (SIREVE) has introduced more rapid mediation by a new public mediator agency with electronic platforms to reduce paperwork and guarantees to companies and creditors during the negotiation phase. SIREVE and PER (special revitalisation process) have both been refined. The government also enacted the Insolvency and Corporate Recovery Code (CIRE — Código da Insolvência e da Recuperação de Empresas) introducing an early warning mechanism that aims to facilitate timely signalling of financial difficulties. Furthermore, there is a new ‘pre-executive extrajudicial procedure’ (Procedimento extrajudicial pré-executivo) which gives creditors prior knowledge of debtors’ attachable assets, thus enabling better decisions to be taken on further action. All these initiatives have had a positive impact on reducing financial difficulties and indebtedness in the corporate sector. Debt restructuring tools have been made available to highly leveraged corporations and incentives to capitalise have been set up. Despite significant progress in tackling high corporate indebtedness, a difficult task still lies ahead.

instalment or interest payments, overdue for a period of 90 days and over; (c) Total amount of credit with principal instalments or interest overdue for at least 90 days, but on which there is evidence to warrant classification as credit at risk, notably a debtor’s bankruptcy or winding-up.

⁽⁴⁾ According to the Banco de Portugal, debt at risk or credit at risk correspond to the following elements as a whole: (a) Total amount of outstanding loans with principal instalments or interest overdue for a period of 90 days and over; (b) Total amount of outstanding restructured loans not covered by the preceding sub-paragraph, whose

Graph 2.1.5: Interest rates for one-year loans up to EUR 1 m, Portugal vs euro area



Source: ECB

SMEs remain largely dependent on bank funding, and relatively high interest rates are still weighing on the financing capacity of Portuguese SMEs. Bank loans are the main source of external funding for corporations in most Member States, including Portugal, where the share of bank loans in the balance sheet is around 40%. Debt securities play a more important role in funding corporations than in most EU countries, with bonds accounting for about 8% of the corporate balance sheet. However, listed shares as a source of funding for corporations in Portugal only amount to about 8% of the balance sheet. SMEs have few alternatives to bank lending, since they cannot easily access capital markets. Despite the overall improvement in bank financing conditions in the EU over the last year, interest rates for one-year loans up to EUR 1 m of almost 4% are reported in Portugal, much higher (about 200 basis points) than the Euro Area average (Graph 2.1.5).

Credit conditions have been gradually improving, but access to finance remains a concern for Portuguese SMEs. According to the October 2015 ECB Survey on access to finance (SAFE), banks' willingness to lend remains an issue for the SMEs that took part in the survey. The number of applications rejected exceeded the EU average (11% vs 8%) and there was a substantial net increase in the collateral and other loan requirements that banks imposed on successful applicants. Indeed, 20% of the Portuguese SMEs that responded were unable to get the full bank loan financing they had planned

for during 2015 (21% EU); 11% had their loan applications rejected, 8% received a smaller loan than requested, and 1% judged the offer made unacceptable.

In parallel, limited alternatives to bank financing exist. The government has taken measures to improve access to credit for SMEs. Several Portuguese financial institutions have signed agreements to receive funds from the EIB with EIF investing in private equity and venture capital funds. Through European Structural Funds and national funds the Portuguese authorities have also made available resources for investments in equity and venture capital and a 'new line of business angels' (Nova linha de Business Angels). The government is also reviewing the rules governing investment in venture capital (Revisão do regime aplicável ao exercício da atividade de investimento em capital de risco) and has extended existing credit lines (SME Growth 2015-PME Crescimento 2015, Enterprise revitalising support line, Credit line Mezzanine Financing IFD 2015). Despite these efforts, alternative sources of funding such as private equity, venture capital, crowdfunding or business angels remain marginal and very underdeveloped in Portugal.

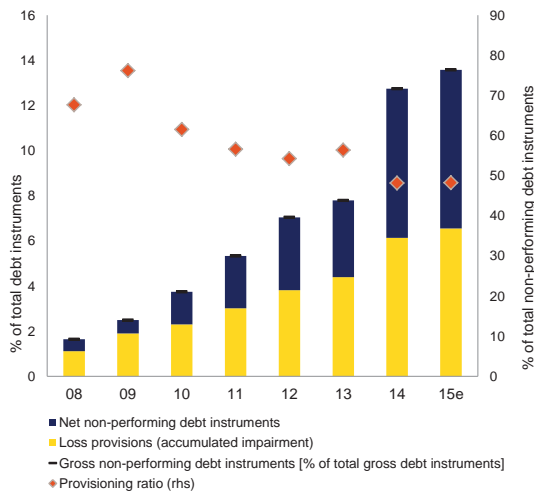
Delays in payment by public authorities aggravate companies' financing difficulties According to Intrum Justitia, Portugal had the third longest average delay in public sector payments in Europe (94 days) in 2015, after Italy and Spain, at respectively 144 and 103 days. Late payments are hampering investment and can even force some firms to exit the market.

The share of non-performing loans continues to increase in the Portuguese banking system.

Lenders still have a long way to go to complete the adjustment process that started with the outbreak of the financial crisis. Non-performing loans (NPL) have been burdening banks' balance sheets for the last few years, increasing from under 2% in 2008 to 13.4% by September 2015 (Graph 2.1.6) with NPLs in the tradable sector remaining significantly below the level in the non-tradable sector (see Box 2.1.1). The vulnerability of Portuguese lenders is evidenced by generally weak core profitability metrics and highlighted by their significant exposure to certain asset classes, such as real estate, sovereign debt securities, emerging

markets in general and Angola, Brazil and China in particular (see Box 1.1 and Graph 2.1.7).

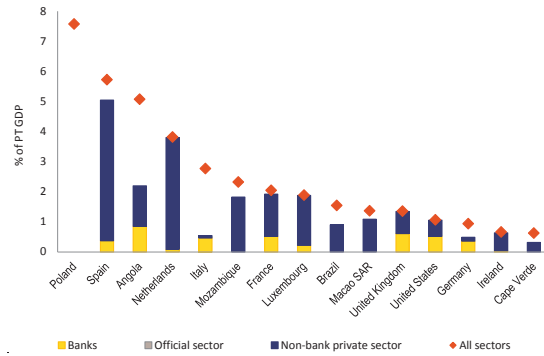
Graph 2.1.6: Non-performing debt



Source: European Commission, ECB

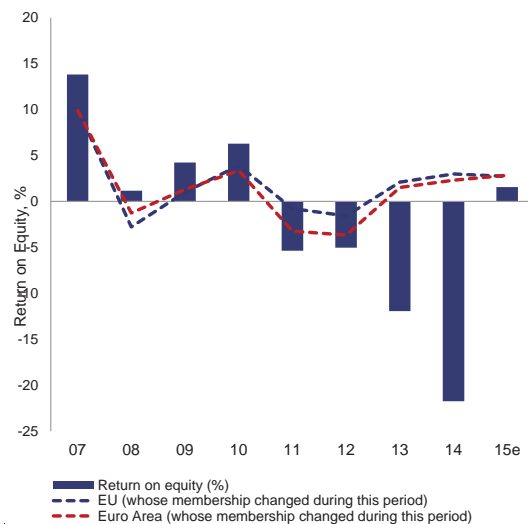
Banks' profitability levels remain subdued, but progress was made in the structural liquidity and solvency positions. The improvement in the liquidity position reflects the resilience of deposits and a contraction in credit, while the significant improvement in the solvency position points to a higher loss absorption capacity for most banks. However, the banking system has persistently low profitability levels (Graph 2.1.8), reflecting an array of adverse factors: low net interest income, contraction in credit demand, recognition of substantial impairment levels and, finally, the banking sector's rather limited progress in cutting operational costs.

Graph 2.1.7: Foreign claims of Portuguese banks (top 15 counterparts, by sector, 2015Q2)



Source: European Commission, BIS, IMF

Graph 2.1.8: Portuguese banks' return on equity



Source: European Commission, ECB

The authorities strived to preserve financial stability throughout 2015, a year marked by the resolution of Banco Internacional do Funchal (Banif). In December 2015, the Banco de Portugal decided to place Banif into resolution in December 2015, after it became clear that Banif's viability could not be restored on a stand-alone basis. In addition, the Portuguese banking system was impacted by the announcement of the Banco de Portugal's decision to transfer five selected senior bonds out of Novo Banco to remedy its capital shortfall identified under the European Central Bank's stress test of November 2015. The actions in relation to Novo Banco were taken to safeguard the stability of the financial system and to take away the uncertainty surrounding the bank's capital position in the previous sales process.

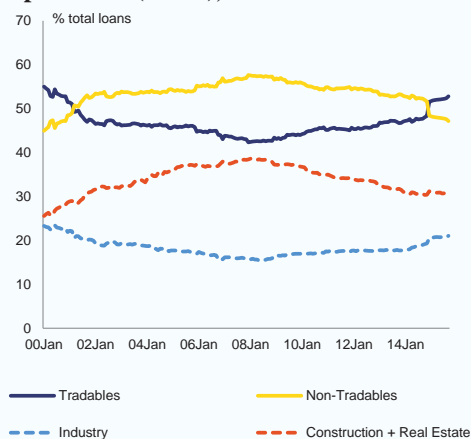
Acting in its supervisory capacity, Banco de Portugal also announced three different measures to boost the banking system's solvency level. In particular, it announced that it would be bringing forward the setting up of a capital conservation buffer to January 2016. This prudential measure means that credit institutions and certain types of financial corporation will have to hold a capital conservation buffer of up to 2.5%, in accordance with the Capital Requirements Directive IV and the Legal Framework of Credit Institutions and Financial Companies. The underlying capital buffers of domestic systematically important institutions must fall into a range between 0 and 2% of risk-weighted assets. Finally, at the end of 2015 Banco de Portugal established a countercyclical capital buffer based on a quarterly assessment of credit developments ⁽⁵⁾.

⁽⁵⁾ Banco de Portugal, the CCB in Q1 2016 was set at nil and will be reassessed for Q2 2016.

Box 2.1.1: Bank lending and economic activity from a sectoral perspective

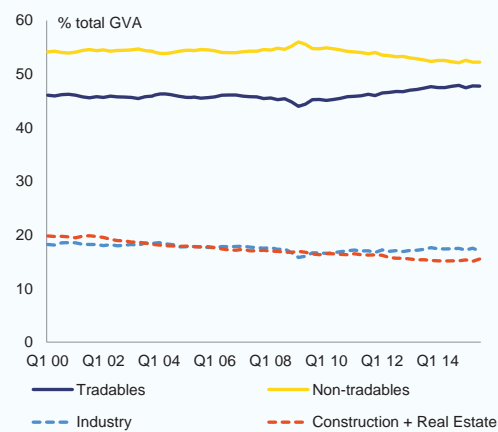
Up to 2008, Portugal's non-tradable sectors steadily increased their share of total bank loans¹ (Graph 1). In particular, the real estate and construction sectors accumulated debt, though without fuelling housing bubbles of similar proportions to Spain or Ireland. This trend started reversing in 2008, driven by deleveraging in the construction sector. In the third quarter of 2015, loans to the tradable sectors accounted for almost 53% of total loans, and there has been an increase of over 10 pps since the end of 2007. However, the share is still relatively low, particularly in the industry sector, which only receives about 21% of total loans. This may also reflect the fact that companies in the tradable sector are less dependent on bank lending, as they have access to alternative sources of financing, such as issues of bonds and equities, or trade credit.

Graph 1. Sectoral breakdown of domestic loans to Portuguese non-financial corporations (NFCs), 2000M1-2015M9²



Source: European Commission, Banco de Portugal

Graph 2. Sectoral gross value added shares, 2000Q1-2015Q3



Source: European Commission

Overall, the strong credit growth to non-tradable sectors, such as construction and real estate, contributed to the high level of total corporate indebtedness and limited the expansion of productive capital stock in Portugal. Past excessive bank lending to the non-tradable sectors has become a challenging legacy for Portuguese banks, as is evidenced by the high share of non-performing loans (NPLs) in these sectors. At around 20%, this ratio remains about 10 percentage points above the similar ratio of NPLs to the tradable sectors. The increasing share of loans to the tradable sectors and lower shares of NPLs in these sectors bear testimony to the reallocation of resources from the non-tradable to the tradable sectors.

¹ The non-tradable sector comprises construction; financial and insurance activities; real estate activities; professional, scientific and technical activities; administrative and support activities; public administration, defence, education, human health and social work activities; arts, entertainment and recreation and other service activities. The tradable sector includes agriculture, forestry and fishing; industry (except construction); wholesale and retail trade, transport, accommodation and food service activities; and information and communication.

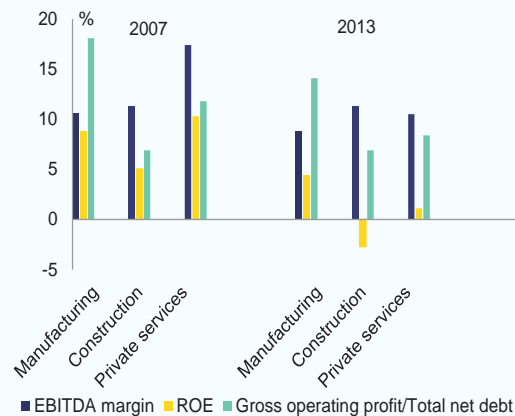
² The sectoral classification of some entities was changed in December 2014, following the ECB's new methodological guidelines, which were in line with the European System of Accounts (ESA) 2010. A substantial number of non-financial corporations, e.g. non-financial holdings (in the non-tradable sector), were reclassified as financial corporations or general government. This explains the substantial shift in the share of loans from the non-tradable to the tradable sector that took place in December 2014. See BdP (2015), Statistical Press Release No 3 February 2015.

(Continued on the next page)

Box (continued)

The higher productivity and profitability of firms in the tradable sector, compared with those in the non-tradable sector, have also contributed to improve the allocative efficiency of the Portuguese economy.

Graph 3. Profitability and debt repayment ratios



Note: EBITA margin is calculated dividing EBITDA (Earnings before interest, taxes, depreciation and amortisation) by total net turnover.

Source: European Commission, BACH database

The consolidated financial and income statements of Portuguese firms until 2013 showed that construction is the worst performer in terms of profitability and financial performance indicators, while trends in manufacturing were more favourable than in the corporate sector as a whole. Operating profitability in manufacturing, measured by the EBITDA margin, is still below that of construction and private services and has somewhat deteriorated from its pre-crisis level. However, total profitability shows a different picture, with manufacturing presenting a higher return on equity (ROE) than construction and services in 2013, even though the measure still ranks below the pre-crisis ratio (Graph 3). In addition, despite some weakening in debt indicators during 2007-2013, the manufacturing sector remains the one that is least leveraged and most able to meet its debt service requirements.

Developments in profitability, labour productivity and indebtedness indicators point out that the manufacturing sector has become more attractive than the non-tradable sectors and that a sustainable rebalancing of the economy is underway.

The trends in bank lending are also reflected in Portugal's Gross Value Added (GVA) structure. The share of GVA in Portugal's non-tradable sectors peaked at 56% at the beginning of 2009 but retreated by mid-2015 to 52%, while the GVA share of tradable sectors increased in the same period to 48% of the total GVA (Graph 2). This contributed to improved medium-term growth prospects as tradable sectors tend to use new and advanced technologies which serve to boost total factor productivity and, ultimately, accelerate potential growth.

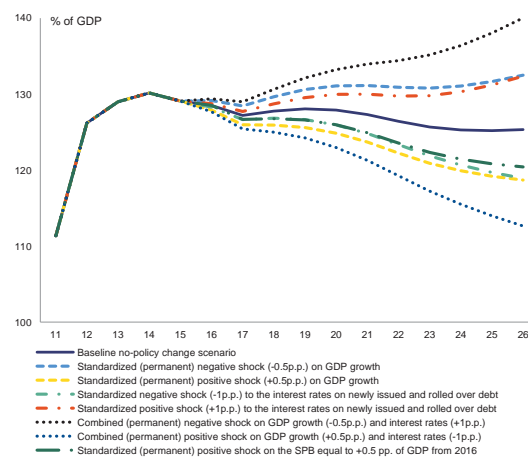
Public debt sustainability

General government debt remains very high. In the context of the global financial crisis and subsequent recession, very high fiscal deficits, the reclassification of off-balance items and entities into the general government perimeter and stabilising interventions in the financial system resulted in a steep rise in general government debt by over 30 pps of GDP between 2010 and 2013. Subsequently, the gross debt-to-GDP ratio stabilised at around 130% of GDP in 2014, the third highest public debt level in the euro area. The projections in the following analysis are based on the Commission's 2016 winter forecast that took into account the Draft Budgetary Plan submitted by Portugal on 22 January but did not yet include the additional consolidation measures publicly announced by Portugal on 5 February because of the forecast's earlier cut-off date⁽⁶⁾. Following postponement of the Novo Banco sale and other statistical revisions, the fall to around 125%, previously expected to take place already in 2015, is now expected only towards 2024. The primary balance, which is estimated to have reached 0.5% of GDP in 2015 (taking into account the Banif resolution costs of 1.2% of GDP), is expected to remain above 0.8% of GDP in 2016 and 2017, thereby moderating future financing needs.

The gross public debt-to-GDP ratio is expected to decline moderately in the short term and to stabilise in the medium term. While public debt is considered sustainable under plausible scenarios, debt dynamics are vulnerable to adverse shocks. Supported by the projected continued economic recovery, expected primary surpluses and debt-reducing operations, the debt-to-GDP ratio is expected to fall to 128.5% of GDP in 2016 and 127.2% in 2017. Furthermore, model simulations of debt sustainability have been carried out that incorporate the scenario of the 2016 winter forecast until 2017 and other technical assumptions for the medium term (i.e. a structural primary fiscal balance at 0.9% of GDP surplus as of 2018; inflation converging to 2.0% by 2020 and the

nominal long-term interest rate on new and rolled-over debt converging linearly to 5% by the end of the 10-year projection horizon; real GDP growth rate of around 1-1.5%; ageing costs in line with the Commission's 2015 Ageing Report). For the baseline scenario, the results suggest that, following a moderate decline in the short-term, the debt ratio will stabilise in the medium term at around 125% of GDP. Given the very high starting point and the relatively low structural primary surplus, the debt ratio is projected not to decrease below 125% of GDP for many years to come, remaining at 125.3% of GDP in 2026, the last year of the projection. The winter forecast baseline scenario however does not yet take into account the 0.5% of GDP in additional structural fiscal consolidation measures announced by the Government on 5 February 2016. Their full implementation was simulated as a standard permanent positive shock on the structural primary balance (SPB) equal to +0.5pp of GDP from 2016 onwards. This permanently improved structural primary balance would lead to a decrease of the gross debt-to-GDP ratio by close to 1pp of GDP per annum and thus ensure a more solidly declining path down to 120% of GDP by 2026 (see Graphs 2.1.9 and 2.1.10).

Graph 2.1.9: Combined interest rate and GDP growth shock



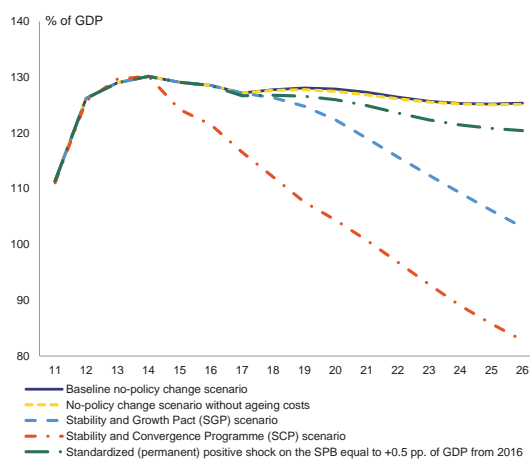
Source: European Commission

The stabilising debt-to-GDP trajectory in the baseline scenario is sensitive to potential rises in sovereign yields and vulnerable to adverse economic developments. Overall, the debt sustainability analysis reveals that the debt

⁽⁶⁾ An updated comprehensive fiscal analysis including the most recent developments for the 2016 deficit after the Draft Budgetary Plan's completion with additional structural consolidation measures, after state budget adoption and after full update of the medium-term outlook, will be provided in the Commission assessment of the upcoming Stability Programme.

stabilisation path of the baseline is broadly robust across a number of reasonable scenarios, but plausible shocks could considerably worsen the dynamics of Portugal's public debt (see Graphs 2.1.9 and 2.1.10). Shortfalls in nominal growth, sharp interest rate rises or decreasing fiscal efforts could put the public debt ratio out of control. An unsustainable debt trajectory could adversely affect Portugal's economic stability and could have negative outward spill-overs via the sovereign risk channel.

Graph 2.1.10: **Fiscal consolidation**



Source: European Commission

The very high level of government debt is a heavy burden on public finances and thus a major source of vulnerability for the economy. High public debt implies a smaller fiscal margin for manoeuvre to absorb adverse macroeconomic shocks and cope with possible rises in interest rates. The high interest bill (estimated at 4.8% of GDP in 2015 as compared to 2.4% on average for the euro area) also restricts the scope for public investment spending.

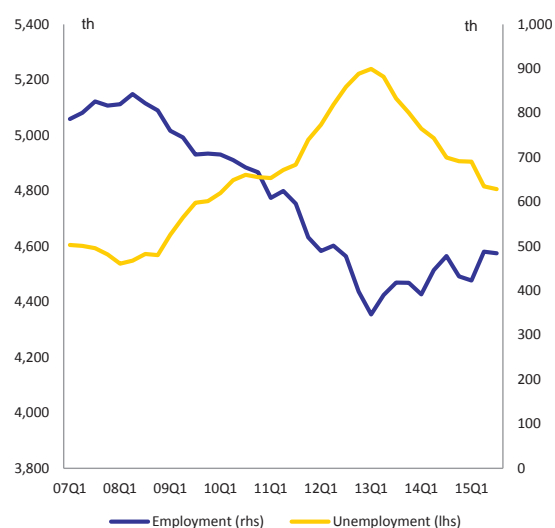
In the absence of further fiscal consolidation and growth-enhancing structural reforms, safeguarding fiscal sustainability and significantly reducing the debt path will be a challenge. The very high debt ratio implies a significant adjustment burden, which requires the conditions for falling debt to be steadily maintained in the coming decades. In particular, sustainability can be safeguarded only if budgetary discipline is maintained over time. This implies adequate yearly progress towards the medium-term

budgetary objective (a structural balance target currently set at -0.5% of GDP for Portugal) and maintaining compliance once that objective is met. The timely and stringent implementation of the reformed budget framework law and further improvements in revenue collection may significantly contribute to achieving the required fiscal adjustment. Healthcare expenditure now accounts for the largest share of ageing costs. In this context it would be appropriate to adopt a long-term perspective when tackling the cost of ageing. As detailed in Section 3.3, recent reforms appear to ensure the medium and long-term sustainability of the pension system. Finally, economic growth in the medium and long term is needed to reduce high debt levels. Perseverance with structural reforms would contribute to adequately raise potential growth.

2.2. LABOUR MARKET ADJUSTMENT

The recovery of the Portuguese labour market continued in 2014 and 2015, but the absorption of the large pool of long-term unemployed remains a challenge. The latter weighs heavily on both economic growth and the social situation. The Portuguese labour market started to recover in the first half of 2013. Unemployment reacted faster to the pickup of economic activity than expected on the basis of its historical relationship with output. In 2014 and 2015, the economy continued to add jobs against the background of strengthening economic growth, while the labour force continued to shrink on account of demographic change and migration. Although labour market segmentation remains a challenge, recent increases in employment were concentrated in permanent contracts, suggesting that previous reforms of employment protection legislation helped reduce the bias towards temporary employment. Wage developments continued to be supportive of the process of adjustment of the Portuguese economy. While unemployment has fallen significantly, long-term unemployment has been slower to decline, raising risks in the social domain and for longer-term growth prospects.

Graph 2.2.1: **Employment and unemployment**

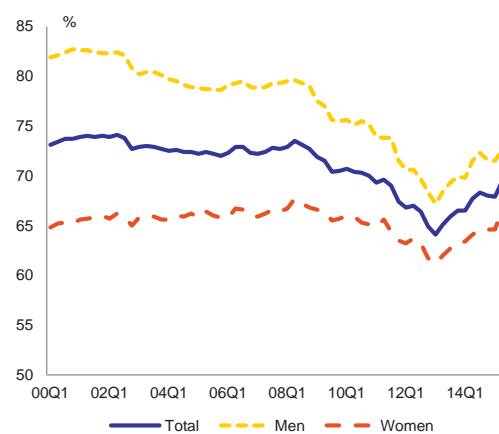


(1) Employment (thousand): national concept, total, ages 15 and over, non-seasonally adjusted; Unemployment (thousand), total, ages 15-74, seasonally adjusted
Source: European Commission

The Portuguese economy added about 106 thousand jobs in the two years to the third quarter of 2015, thereby reaching 4.58 million people in employment (an increase of about 2.4% in two years). During the same period, unemployment fell by about 204 thousand to 629 thousand (Graph 2.2.1).

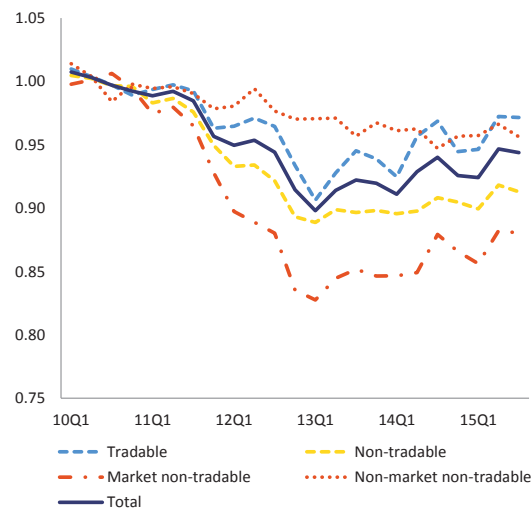
The overall employment rate made up about half of the ground lost since 2008. The employment rate for people aged between 20 and 64 climbed up to just below 70% in the third quarter of 2015 (Graph 2.2.2). Improvements over the last two years proceeded in parallel for men and women, but there is a clear disparity in terms of long-term trends. The employment rate of women is close to its pre-crisis high, while men's employment has recovered less than half of the losses accumulated during the crisis. This reflects a long-term trend of a falling employment rate for men that started before 2000.

Graph 2.2.2: **Employment rates, ages 20-64**



(1) Employment rates ages 20-64, non-seasonally adjusted
Source: European Commission

Employment developments since 2010 have been supportive of sectoral realignment. Employment losses were more moderate in tradable than in non-tradable sectors (most significantly in market sectors and primarily, construction) before 2013, and employment growth has been slightly more rapid in tradable than in non-tradable sectors since 2013 (Graph 2.2.3). The sectoral realignment towards tradables is consistent with wage developments across sectors (see below).

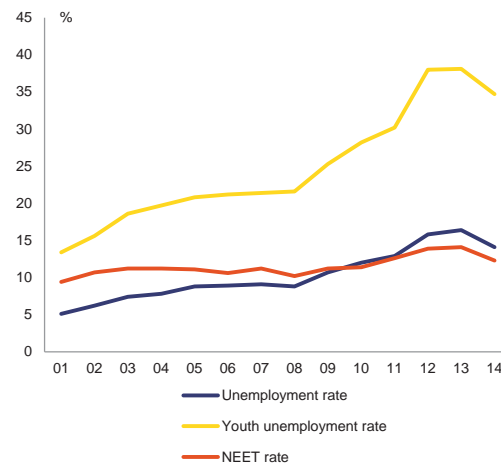
Graph 2.2.3: **Employment in tradable and non-tradable sectors, 2010=100**

(1) Tradable sectors include: (i) agriculture and fishing (ii) industry (excluding construction) (iii) wholesale and retail trade, transport, accommodation and food service activities (iv) information and communication. Market non-tradable sectors include (i) construction (ii) finance and insurance (iii) real estate (iv) professional, scientific and technical activities; administrative and support activities (v) arts, entertainment and recreation; other services; activities of household and extraterritorial organisations and bodies. Non-market non-tradable sectors include public administration, defence, education, human health and social work. Non-seasonally adjusted data.

Source: European Commission

The unemployment rate saw a turning point in the course of 2013. In 2014, the average yearly unemployment rate fell for the first time since 2008, from 16.4% to 14.1% (for the 15-74 age group), and continued to fall in 2015 to 12.6%, the lowest annual figure since 2011. By the last quarter of 2015, unemployment had fallen to 12.2%. For the first time in over a decade, the youth unemployment rate also fell in 2014, decreasing by 3.4 pps to the still very high level of 34.7%. The proportion of young people (aged 15-24) not in employment, education or training (NEET) fell to 12.3% in 2014 (Graph 2.2.4). Although the NEET rate (15-24) has fallen and in 2014 was around the EU average (12.3% in Portugal, 12.5% in the EU), the high and persistent youth unemployment rate (31.0% in December 2015) increases the risk of disengagement from the labour market. The youth employment rate is well below the EU average (24.2% in Portugal in the third quarter of 2015, 34.1% in the EU), and long-term unemployment among young people, which

has tripled since 2008, was still at record levels, at 12.6% in 2014.

Graph 2.2.4: **Unemployment, youth unemployment and NEET rate**

(1) Unemployment rate (% of labour force), total, ages 15-74; Youth unemployment rate (% of labour force), total, ages 15-24; NEET: Not in employment education or training (% of population), total, ages 15-24

Source: European Commission

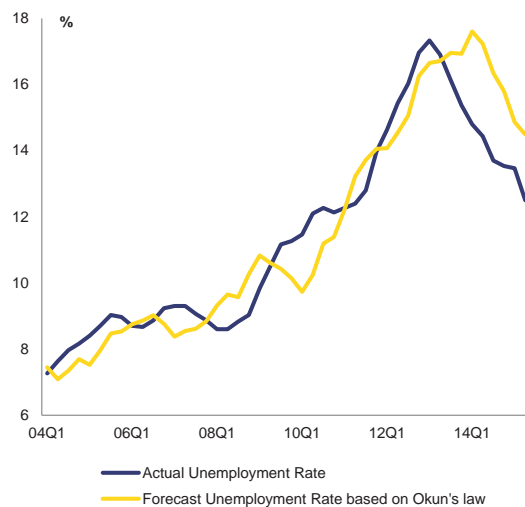
The unemployment rate fell faster than was expected on the basis of GDP growth. This can be partly explained by emigration and increased participation in ALMPs⁽⁷⁾. During the crisis, the surge in unemployment was often above what could be explained by the decline in output alone (Graph 2.2.5). This trend reversed in the second quarter of 2013, when the unemployment rate started to fall one year before the turning point predicted on the basis of GDP growth. The labour market's stronger reaction to the recovery in economic growth was observed across the EU in 2014⁽⁸⁾, but driving forces specific to Portugal also appear to have contributed. The fall in unemployment was not a result of workers leaving the labour market, as activity rates remained resilient during the recovery, and the number of

⁽⁷⁾ 'Okun's law' describes a statistical relationship between GDP growth and unemployment which can vary across countries and over time. Since 2000, and on average over EU Member States, unemployment fell by one-third of a percentage point for each additional percentage point of real GDP growth, while a growth rate of 0.7% was required to keep unemployment rising.

⁽⁸⁾ 'Labour Market and Wage Developments in Europe 2015. European Commission, Directorate-General for Employment, Social Affairs and Inclusion'.

discouraged jobseekers fell slightly in the course of 2014. However, outward migration has been a channel of labour market adjustment, as net migration has been negative since 2011. On average, the number of people leaving Portugal exceeded arrivals by about 30 thousand per year between 2011 and 2014, causing the working age population to shrink about twice as fast as it would have based on demographic trends. While geographic mobility and migration eases labour market adjustment in the short run, large-scale emigration poses a risk to long-term growth prospects. The increase in enrolment on activation programmes (by about 60% a year on average between 2012 and 2014, although at a falling rate) may also have brought unemployment figures down more rapidly, as workers on ALMPs are not considered unemployed for statistical purposes.

Graph 2.2.5: **Unemployment rate: actual and predicted on the basis of economic growth**

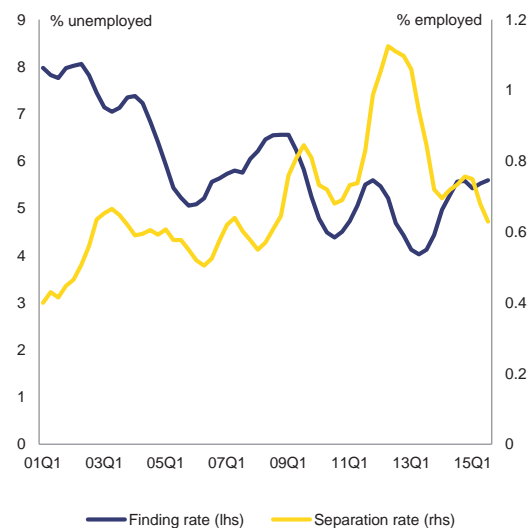


Source: European Commission

Recent labour market improvements are the result of a reduced rate of job destruction, while the rate of job creation has increased more moderately. During both the crisis and the recovery phase, the Portuguese labour market has been driven more by changes in job destruction than job creation (Graph 2.2.6). The separation rate increased more rapidly during the crisis period, and fell faster since 2012, than the job finding rate. This also means that, during the recovery, inflows to unemployment slowed down considerably, but

outflows out of unemployment increased only moderately.

Graph 2.2.6: **Job finding and separation rates (smoothed series)**

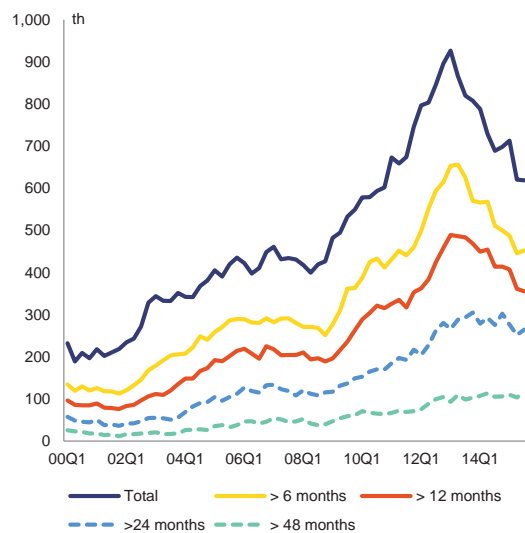


(1) Separation rate: share of jobs in the economy for which a separation of the employee from his or her post is observed during a given period of time. Job-finding rate: share of unemployed people who find a job during a given period of time. Average over 4 quarters: reference quarter and previous 3 quarters.

Source: European Commission

Long-term unemployment is decreasing more slowly than overall unemployment. Since the improvement in overall employment is due mostly to a decrease in lay-offs rather than a rapid increase in hirings, the situation of the long-term unemployed (those unemployed longer than 12 months) is improving only slowly. Short-term unemployment has fallen considerably faster than long-term unemployment, while very long-term unemployment (those unemployed for longer than 24 months) is still near its peak (Graph 2.2.7). Persistent long-term unemployment involves, on top of its impact on poverty and social inclusion, the risk that cyclical unemployment may turn structural as the human capital and skills of the long-term unemployed may erode.

Graph 2.2.7: Unemployment by duration

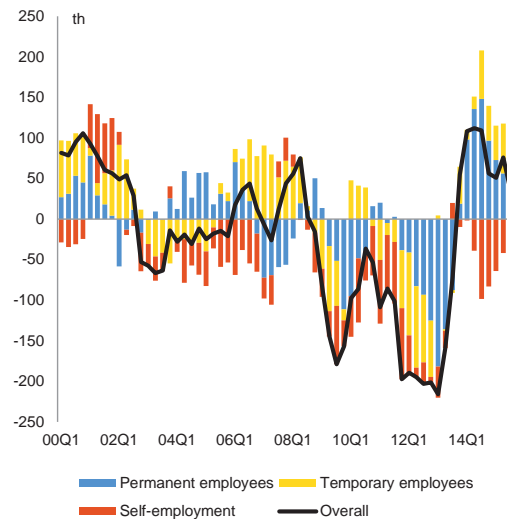


(1) Unemployment (thousand), total, ages 15-74, non-seasonally adjusted

Source: European Commission

The last two years have seen robust hiring on permanent contracts, for the first time in more than a decade. In contrast, previous episodes of job growth (e.g. between 2006 and 2008) were driven by increases in temporary contracts, sometimes at the cost of permanent jobs (Graph 2.2.8). This suggests that the reforms of employment protection legislation (EPL) implemented during the adjustment programme (2011-2014) might have an effect in supporting the labour market recovery through an increase in regular employment. Although the OECD's EPL indicators suggest that Portugal's regulations on permanent contracts are still relatively restrictive, their stringency has been decreasing. The reforms eased the definition of dismissal based on redundancy and unsuitability and lowered severance payments for open-ended contracts more than for fixed-term contracts. The main objective of these reforms was to increase hiring on temporary contracts, reducing segmentation. The government has contracted out a detailed study on the impact of the recent labour market reforms, including the EPL reform, to the OECD. This should be available by the spring of 2016.

Graph 2.2.8: Employment by type (permanent, temporary, self-employed), year-on-year changes

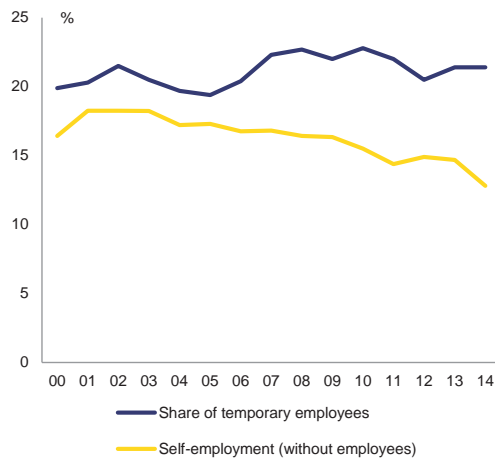


Source: European Commission

The share of temporary contracts in 2015 remains stable at slightly below pre-crisis levels, while the share of self-employment within total employment continues to fall. Due to the robust creation of permanent contracts in 2014 and early 2015 the share of temporary contracts did not start to increase during the recovery in 2014. In previous years, changes in the share of temporary contracts were determined by firms' downsizing: in downturns lay-offs firstly concentrated on workers on temporary contracts because it was less costly to terminate these than permanent contracts. Accordingly, the share of temporary contracts fell between 2010 and 2012 (Graph 2.2.9). Its increase in 2013 was still caused by the composition of dismissals, probably because downsizing firms moved to dismiss workers on permanent contracts. In any case, segmentation in the labour market remains significant, as in 2014 Portugal had the fourth highest share of temporary workers in the EU, with 21.4% (unchanged from 2013, against the EU average of 14%), while the transition rate towards permanent contracts is low at 27.2%⁽⁹⁾ in 2014, though increasing compared to 2013 (when it stood at 24%). During the same period of downturn and recovery, the trend of falling self-employment continued.

⁽⁹⁾ Commission's computation on Eurostat, SILC data.

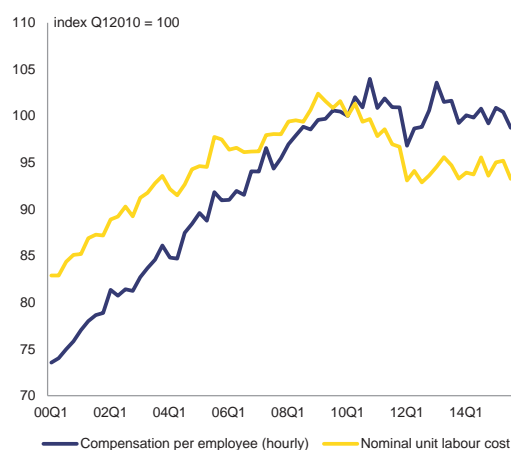
Graph 2.2.9: Temporary employment and self-employment



(1) Self-employment (without employees) and part-time employment (% of total employment), total, ages 15-64. Temporary employment (% of employees), total, ages 15-64

Source: European Commission

Graph 2.2.10: Wages and unit labour cost (2010Q1=100), whole economy

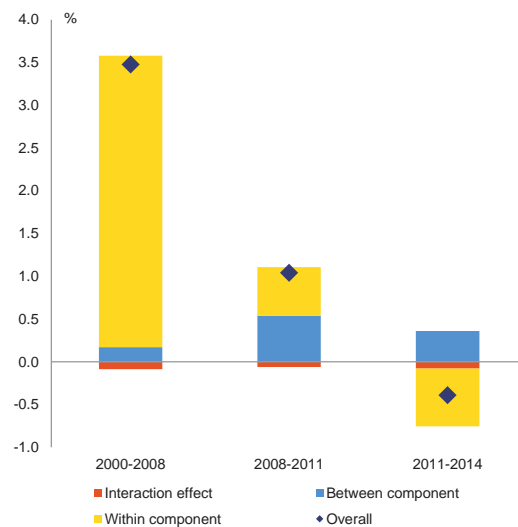


Source: European Commission

The wage development remains moderate in a context of economic recovery. Wages continued to adjust in nominal terms during 2014, when hourly compensation per employee dropped 1.4% (Graph 2.2.10). This was mostly driven by nominal wage decreases in market services sectors and the public administration. In 2015, the hourly remuneration started to rise again in the first half of the year, consistent with a continuing improvement in labour market conditions and a pick-up in inflation. It then fell in the third quarter,

by 2% compared to the same period in 2014. In combination with stable labour productivity (indicating that the current recovery is very labour-intensive), this translated into a 2.4% fall in the nominal unit labour cost over the same period. Overall, this indicator remains significantly below the peak achieved in 2009.

Graph 2.2.11: Breakdown of wage growth



(1) This chart shows the breakdown of wage growth (defined as the growth of hourly nominal compensation per employee; average yearly figures), into three components (wage developments within sectors, changes because of employment reallocation between sectors, and a residual, or interaction term) using a 10- industry disaggregation.

Source: European Commission

Wage growth has been broadly supportive of macroeconomic rebalancing. Results from a wage benchmarking analysis conducted by the Commission at EU level show that in 2014 nominal wages in Portugal grew at a slower rate than predicted on the basis of economic fundamentals (i.e. growth in domestic prices, unemployment and productivity) and at a slower than that consistent with a constant real effective exchange rate⁽¹⁰⁾. Figures from the first three quarters suggest that these developments were expected to continue in 2015. Reallocation of employment to sectors with higher wages (and

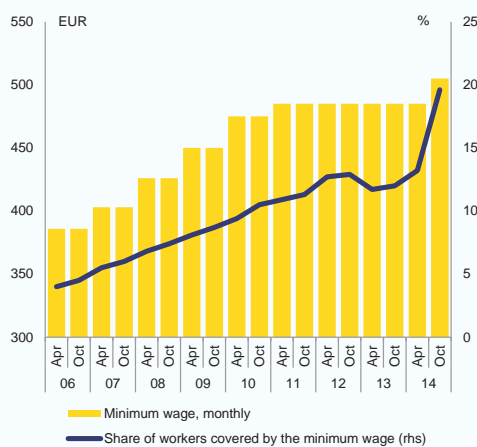
⁽¹⁰⁾ Arpaia, A. and Kiss, A. (2015), 'Benchmarks for the assessment of wage developments: Spring 2015', European Commission Analytical Web Note 2/2015.

Box 2.2.1: Latest developments in minimum wage

The statutory minimum wage (RMMG) rose by 5% on 1 January 2016 from EUR 505 to EUR 530 a month (14 instalments due per year)¹. The previous increase, from EUR 485 to EUR 505 a month, occurred in October 2014 after a three-year freeze between May 2011 and June 2014, agreed in the context of Portugal's adjustment programme. On both occasions, in order to partially offset its impact on labour cost, the increase was accompanied by a temporary reduction of 0.75% pps in employer's social security contribution for workers who had already been receiving the minimum wage.

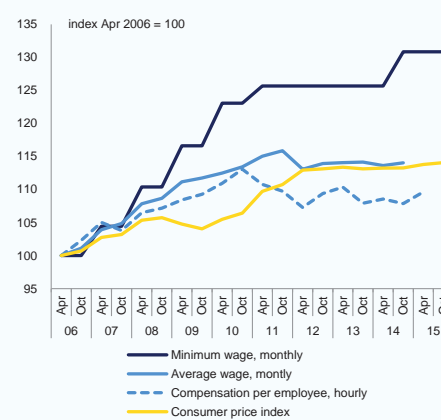
The evidence available allows a preliminary reading of the effects of the 2014 increase on the Portuguese labour market. After the increase, the share of workers covered by the minimum wage in the business economy rose significantly, namely from 13.2% in April 2014 to 19.6% in October 2014 and further to 21.4% in April 2015 (latest figure available). As is shown by Graph 1, this appears to be a larger increase than that observed following similar minimum wage increases in the recent past. This suggests that, at the moment of the increase, the bottom part of the wage distribution was concentrated to some extent around the new threshold (i.e. around EUR 500 a month). The implication is that, for a significant share of workers the higher minimum wage did not mean an actual increase in remuneration. However, the resulting increased wage compression risks creating distortions in the labour market (by reducing returns on skills while, at the same time, harming low-skilled workers' job prospects).

Graph 1. Monthly minimum wage and share of workers covered



Source: European Commission

Graph 2. Minimum wage and relevant economic variables



Source: European Commission

Most workers earning the minimum wage are concentrated in manufacturing, construction and some labour-intensive services (no data are available for agriculture). Looking at those sectors where the share of minimum wage workers has increased most (at least by 5pps) conclusions are mixed. Between Q3-2014 and Q3-2015 a sizable increase in employment was recorded in manufacturing (25.8 thousand), human health and social work activities (41.6 thousand) and wholesale and retail trade (25.0 thousand). On the other hand, employment fell over the same period in construction (5.8 thousand), real estate activities (4.8 thousand) and administrative and

¹ Decree-Law n.º54-A/2015.

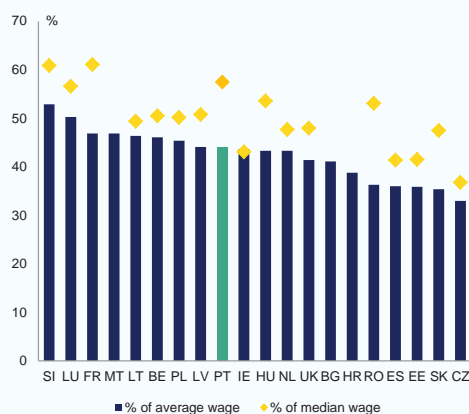
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Box (continued)

support services (12.3 thousand). It is difficult to say conclusively whether the minimum wage hike of October 2014 constrained job creation.

Looking at the trend in the minimum wage against relevant economic variables over the last decade (Graph 2), it emerges that from 2008 on it rose significantly faster than the consumer price index and average monthly remuneration in the business sector. The bulk of this divergence built up between 2008 and the beginning of 2011, when the minimum wage rose EUR 403 to EUR 485 a month. Such a rapid increase might explain the near doubling of the coverage rate over that period. The 2014 increase in the minimum wage, however is roughly in line with the rise in consumer prices during the ‘freeze’ period, i.e. between 2011-2014.

Graph 3. Minimum wage as a share of average and median wage



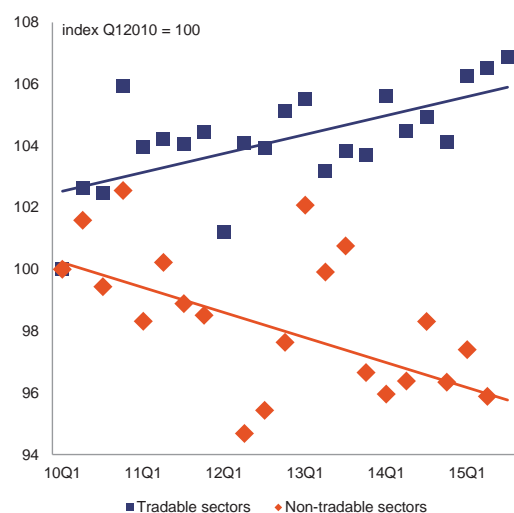
Following these developments, in 2014 the minimum wage came to 44.1% of the monthly average wage in the business sector and 57.5% of the median wage. In comparative terms, Portugal is in the middle of the EU ranking for average wages, but is among the countries with the highest minimum wage as a percentage of median wage (Graph 3). This discrepancy suggests that the wage distribution in Portugal is very biased towards lower wages, and that further increases in the minimum wage in a context of overall wage moderation might rapidly increase the share of workers covered.

Source: European Commission

The latest increase in the minimum wage up to EUR 530 a month, and government plans to further increase it to EUR 600 in 2019 (with intermediate steps of EUR 557 in 2017 and EUR 580 in 2018) should be carefully considered in this perspective. According to data provided by the Ministry of Economy (Quadros de Pessoal), 41.6% of employees had a monthly income below EUR 600 in 2014. Although this share is expected to fall by 2019 (as a result of wage increases across the distribution), its magnitude suggests that the share of workers covered by the minimum wage might increase substantially. Following the latest minimum wage increase, the government claimed that the share of employees covered would rise to almost 25% of the total. Taking into account planned minimum wage increases up to 2017, a preliminary analysis based on EU-SILC income data (assuming that the distribution of wages would not change over time) suggests that it is reasonable to expect a further increase in coverage of between 25% and 30% of employees by 2017. While such a development could help reduce the intensity of in-work poverty in Portugal (see Section 3.2), it would also result in a further compression of the wage structure, putting upward pressure on the overall wage structure. If not matched by productivity increases, it risks harming the employment and competitiveness outlook for labour intensive industries.

productivity) has limited the apparent fall in wages at aggregate level. By breaking down wage growth (Graph 2.2.11), to disentangle the component due to the increase in remuneration *within* sectors from the component due to the reallocation of employment *between* sectors, the wage adjustment within sectors (i.e. keeping each sector's employment share constant) between 2011 and 2014 is shown to have been even more pronounced than the aggregate figure. In relative terms, wage growth has been more sustained in tradable than in non-tradable sectors (Graph 2.2.12). This is consistent with the relatively higher labour productivity and employment growth in the tradable sectors.

Graph 2.2.12: **Wage growth in tradable and non-tradable sectors (2010Q1=100)**



(1) Tradable sectors include: (i) agriculture and fishing (ii) industry (excluding construction) (iii) wholesale and retail trade, transport, accommodation and food service activities (iv) information and communication. Non-tradable sectors include: (i) construction (ii) finance and insurance (iii) real estate (iv) professional, scientific and technical activities (v) administrative and support activities (vi) public administration, defence, education, human health and social work (vii) arts, entertainment and recreation, other services, activities of household and extraterritorial organisations and bodies

Source: European Commission

Collective agreements have been supportive of wage moderation. Wage increases agreed in collective agreements were broadly in line with inflation during 2014 and 2015 (the latest data available point at a yearly increase of 0.8% in the third quarter of 2015, aligned with the rise in the consumer price index). Overall, figures show a

mild pick-up in collective bargaining. In 2014 and the first months of 2015, the number of agreements signed and workers covered by those agreements increased after the substantial decline observed in recent years (Graph 2.2.13). In contrast to the situation in 2014, when firm-level agreements constituted the bulk of newly signed collective agreements (80 out of 152, that is 52.6%), in 2015 most new agreements were signed at branch level, firm-level ones representing only 38% of the total (53 out of 138). Evidence shows that most firm-level agreements are renegotiations of contracts already in force, typically in larger firms⁽¹¹⁾. There is evidence that the collective bargaining system remains highly centralised, despite recent reforms extending the scope for decentralised wage setting. This reflects both the tradition of centralised social dialogue (social partners meet regularly in a Permanent Commission for Social Dialogue and the agreements signed at macro level are of tripartite) and structural factors in the Portuguese economy, including the small average firm size (see Section 3.2.4) and the consequent low diffusion of work councils.

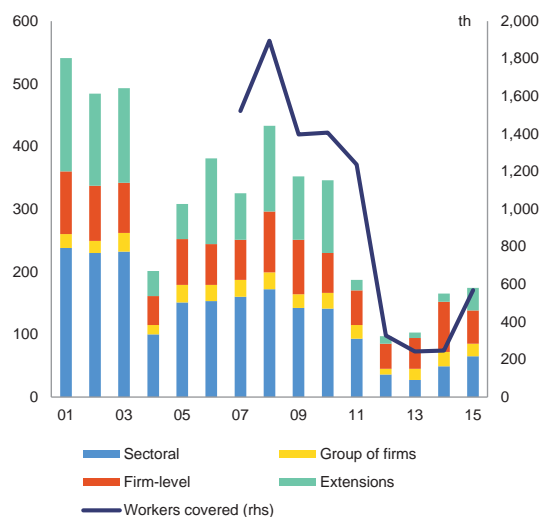
Temporary opt-outs at firm-level are not picking up, which might hinder an effective wage adjustment that takes into account differences across firms. According to information provided by the Portuguese authorities, collective agreements have been suspended in only two cases since the law allowing for this possibility at firm level was adopted in August 2014. This suggests that the formula adopted, which requires the agreement of the original signatories of sector-level agreements, may not have provided companies with an effective framework for temporarily opting out. After the rules on the administrative extension of sector agreements were relaxed in June 2014⁽¹²⁾, the number of extensions of collective agreements

⁽¹¹⁾ Only 6 of the 53 firm-level agreements signed in 2015 are new, while the other 47 are revisions of previous agreements.

⁽¹²⁾ During the economic adjustment programme the rules on extending collective agreements were changed. It was stipulated that collective agreements could be extended to all workers in a sector only if the companies signing them employed at least 50% of the workers in the sector concerned. In June 2014, this criterion was altered, so that it is now sufficient if SMEs account for 30% of employers' associations signing the agreement. This means that most sector agreements now meet the conditions for extension, as 99% of firms in Portugal are SMEs.

rose moderately in 2014 and 2015 (13 and 36 extensions were granted, compared with 9 in 2013). As a proportion of newly signed sector agreements, the increase was more substantial (extensions accounted for 55% of new sector agreements signed in 2015, compared with around 30% over 2012-2014), but still largely below figures observed in the early 2000s. Information is not available about the representativeness of the signatory parties in the sectoral collective agreements subject to extension.

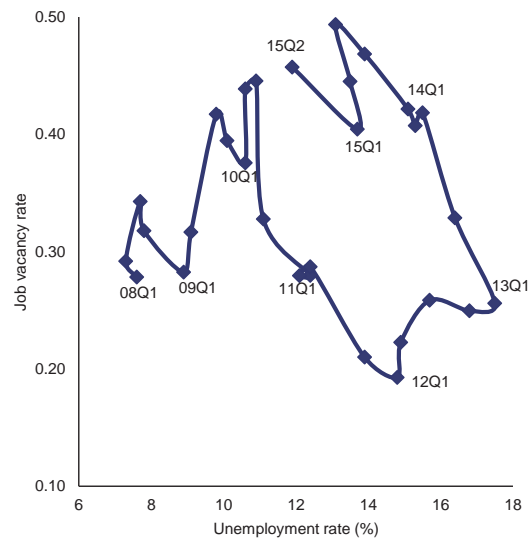
Graph 2.2.13: **Number of collective agreements signed and workers covered**



Source: MSESS — DG for Employment and Industrial Relations

Labour market matching deteriorated during the crisis, but recently there have been signs of improvement. The relationship between the unemployment rate and the vacancy rate (the ratio of job vacancies to all jobs in the economy), also known as the Beveridge curve, is a good indicator of labour market matching (see Graph 2.2.14). During recessions, unemployment increases and vacancies decrease (as in 2010-2011 in Portugal), while the opposite happens during recoveries (as in 2013-2014). Between the end of 2011 and the beginning of 2013, both vacancies and unemployment increased, indicating a potential deterioration of labour market matching in Portugal. However, most recent data indicate that labour market matching has been improving, reversing the previous deterioration.

Graph 2.2.14: **The relationship between unemployment and vacancies (Beveridge curve)**

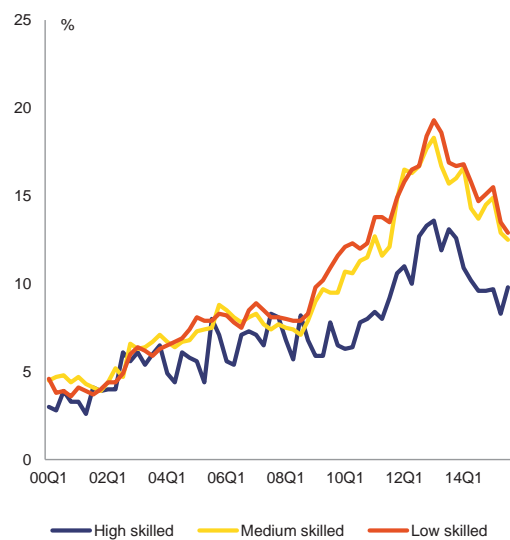


Source: INE, European Commission calculations

While discrepancies between labour market outcomes for various skills groups have increased in Portugal since 2008, they are moderate by comparison with the overall EU picture. The macroeconomic aspect of skills mismatches can be measured by the discrepancy between labour market outcomes, in particular employment and unemployment rates, for low, medium, and highly skilled workers. If different skill groups have very different chances on the labour market, this is an indication that there is a large gap between the skills that workers have and the skills sought by employers. Unemployment rates were very similar across skill groups in Portugal before 2008. Since then, all skill groups have seen significant increases, although the increase has been somewhat smaller for the high-skilled (Graph 2.2.15). Developments across skill groups have also been largely similar as regards employment rates, although the low-skilled groups saw a relative deterioration (Graph 2.2.16). Despite the divergence, discrepancies between labour market outcomes across skill groups remain lower in Portugal than in most EU Member

States⁽¹³⁾ suggesting that macroeconomic skills mismatches, though on the rise, are still limited.

Graph 2.2.15: Unemployment rate by level of skills

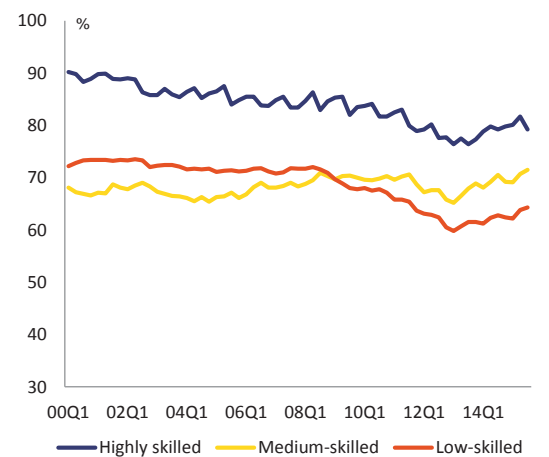


(1) Unemployment rates ages 20-64, non-seasonally adjusted

Source: European Commission

⁽¹³⁾ For the details of the international comparison, see Kiss A. and A. Vandeplas (2015): 'Measuring Skills Mismatch', Analytical Web Note 7/2015, European Commission (<http://ec.europa.eu/social/main.jsp?catId=738&langId=en&pubId=7860>).

Graph 2.2.16: Employment rate by level of skills

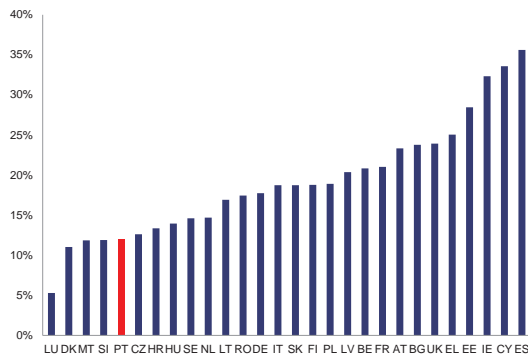


(1) Employment rates ages 20-64, non-seasonally adjusted

Source: European Commission

The low skill level of Portugal's labour force acts as a barrier to the country's competitiveness. Only 65% of the population aged 25-34 have attained at least upper secondary education, quite below the EU average of 83%. This might hamper the country's innovation potential by restricting firms' capacity to upgrade their activity to higher market value products and services, which would help transform the country's economy. Indeed, a high share of low-skilled workers might limit companies in their decisions to invest in technology, triggering a vicious circle: less investment in technology means less recruitment of highly qualified staff, holds back productivity, and ultimately provides disincentives for workers to improve their skills. Measured by the share of high-skilled employees working in occupations that do not require high skills, Portugal has a relatively small share of overqualified individuals, reflecting the relatively low supply of high-skilled labour in the economy.

Graph 2.2.17: **Share of high-skilled individuals working in occupations that do not require high skills, 2013**



(1) Occupations that do not require high skills are defined here as occupations with ISCO classification 4-9.

Source: Kiss, A. and A. Vandeplas (2015): "Measuring skills mismatch", Analytical web note 7/2015, European Commission

Substantial efforts have been made to reform activation policies, involving an increasing number of jobseekers in active labour market schemes, both employment and training measures, and in modernising the Public Employment Services (PES). In September 2015, 25% of the total 500 000 registered unemployed (130 thousand people) participated in active labour market policies (ALMPs) provided by Instituto do Emprego e Formação Profissional (both employment and training measures). The percentage of participants in such measures shows a substantial increase since 2011 (in October 2011, only 5% of people registered as unemployed participated in ALMPs). A total of 27 000 people participated in public work schemes (*CEI — Contract Employment-Insertion*). Financial support has become available for geographical mobility within Portugal, to encourage relocation that improves labour market matching. In addition, a new measure, *REATIVAR*, was introduced in 2015 to support six-month traineeships for long-term unemployed people aged over 30. A monitoring system to assess transition rates from active labour market measures to employment is now in place. However, coordination between employment and social services is weak and active measures have not developed for persons who are no longer entitled to unemployment benefits.

The caseload of the Public Employment Services has been improving since 2013, particularly due to the improved labour market

situation. The PES reform which started in 2012 has strengthened the performance management system, which continues to be reinforced by an increased capacity for quality management. While there is an ongoing shift towards digital services, shortcomings remain as regards digital channels, matching between registered jobseekers and potential employers, counselling, and the use of PES employer-oriented services. Partnerships with municipalities, training organisations and social economy actors are well developed, though progress in partnerships with private employment services and outsourcing services has been limited. Two pilot projects involving partnership with private employment services in Lisbon and Porto have been delayed, and a tender procedure has yet to be launched.

Measures have been taken to fight the high levels of youth unemployment, notably through the implementation of the Youth Guarantee scheme. Some progress has been made in increasing outreach to non-registered young people, although challenges in its implementation still persist. A broad network of partners engaged in implementing the Youth Guarantee has been set up — comprising public bodies and NGOs — to reach out to those under 30 who are not in employment, education or training (NEET). Additionally, a nation-wide outreach campaign was launched in the spring of 2015, targeting young NEETs who had not contacted employment services and students who might become NEETs on completing compulsory education. Another positive step has been the creation of a Youth Guarantee online platform where NEETs can register. Upon registration, applicants state whether they would like to find a job in Portugal or abroad, or return to studying or training. Depending on the choice, the request is automatically redirected to the relevant services. Around 300 000 NEETs up to the age of 30 have participated in Youth Guarantee measures.

2.3. MIP ASSESSMENT MATRIX

This MIP Assessment Matrix summarises the main findings of the in-depth review in the country report. It focuses on imbalances and adjustment issues relevant for the MIP. (*)

Table 2.3.1: MIP assessment matrix

	Gravity of the challenge	Evolution and prospects	Policy response
Imbalances (unsustainable trends, vulnerabilities and associated risks)			
External balance	<p>Portugal has made significant progress to date in adjusting its external imbalances, namely as regards improving competitiveness and current account outcomes. Nonetheless, Portugal still reports one of the most negative net international investment positions (NIIP) in the EU, accounting for -113% of GDP in 2014 and posing challenges for external sustainability (p.6). Continuous current account surpluses of around 1.8% of GDP per year would be required to halve the negative NIIP by 2024.</p>	<p>The large previous current account deficits have been turned into a slight surplus of 0.3% of GDP in 2014. Although the current account adjustment has recently slowed down due to increasing imports on the back of faster growing internal demand (pp. 5-7), the current-account surplus is expected to stay at around 1% of GDP in 2016 and 2017. Cost competitiveness has recovered since the onset of the crisis, but unit labour costs are expected to increase in 2016 due to sluggish productivity and rising wages.</p>	<p>A wide range of reform measures have been adopted during the adjustment programme to tackle nominal rigidities in product and labour markets and foster the reallocation of resources to the tradable sector.</p> <p>Weaknesses remain in key areas, including services and regulated professions, public administration, energy and transport and skills formation (pp. 39-64). At the same time, policies aimed at raising domestic demand risk stalling the external rebalancing progress.</p>
Private debt	<p>High private sector debt, about 190% of GDP in 2014 (<i>Annex B</i>), is weighing on the balance sheets of firms, banks and households, and impedes a further economic recovery.</p> <p>There are signs of financial distress in the household sector (p.17). Very high private corporate debt is weighing on corporate profitability impeding investment. Unviable debt and the relatively high level of non-performing loans harm financial stability and the productive allocation of credit.</p>	<p>In 2015, corporate non-consolidated debt stood some 20 pps below its 2012 peak.</p> <p>High private indebtedness ratios are expected to further decline in 2016 due to solid nominal output growth and weak growth of credit to non-financial corporations.</p> <p>Corporate non-performing loans reached 16% in September 2015, implying pressures on the Portuguese banking sector (p. 20).</p>	<p>Measures have been taken to reduce the corporate debt overhang and to expand the financing alternatives for corporates. The corporate insolvency and restructuring frameworks were revised with the aim of focusing on the recovery of firms (p. 19).</p> <p>The main challenge is to maintain an orderly corporate deleveraging while at the same time stimulating economic recovery. The latter remains a key factor for improving debt ratios and requires preserving reform progress and tackling remaining productivity bottlenecks.</p>
Public debt	<p>Portugal has a very high level of public debt, amounting to 130% in 2014, which is forecast to decline gradually from 2015 onwards (pp. 24-25).</p>	<p>Supported by the projected economic recovery, expected primary surpluses and debt-reducing operations, the debt-to-GDP ratio is expected to fall gradually from 2015 onwards. Without additional consolidation measures, debt would still be above 110% in 2026 (pp. 24-25).</p>	<p>Measures have been taken in the area of tax reforms, tax compliance, pensions, healthcare, state-owned enterprises and public administration. Policy gaps, however, persist in all these areas (pp. 44-48).</p>

(Continued on the next page)

Table (continued)

	The very large stock of public debt coupled with relatively high deficit levels makes Portugal vulnerable to changes in economic conditions and increasing financing costs. At the same time there are medium term sustainability risks.		Strict budget implementation and additional growth-enhancing structural measures are needed to ensure durable compliance with the Stability and Growth Pact.
Adjustment issues			
Labour market and unemployment	<p>The unemployment rate reached 12.3% in the third quarter of 2015, while the rates of youth and long-term were around 30% and 7% respectively in the second quarter of 2015. These rates remain among the highest in the EU.</p> <p>The large number of unemployed weighs on economic growth and the social situation, and increases the risk of labour market disengagement and human capital deterioration.</p> <p>A quick absorption of unemployment and skills upgrading are key to lift Portugal's growth potential.</p>	<p>Unemployment peaked in the second quarter of 2013 and has since been decreasing (p. 26). Labour market conditions are expected to further improve, in line with economic activity. As a result, the unemployment rate is projected to gradually decrease to below 11% in 2017. The adjustment carried out so far has increased the share of employment in tradable sectors.</p> <p>The main challenge is to further reduce unemployment, notably for youth and the long-term unemployed, which mostly needs to be absorbed by the tradables sector.</p>	<p>Measures have been taken to increase the number of job seekers in active labour market schemes and modernise Public Employment Services. The implementation of the Youth Guarantee has contributed to fight youth unemployment. Employment Protection Legislation reforms seem to have an impact with the last two years seeing robust hiring on permanent contracts. However, labour market segmentation remains a challenge.</p> <p>Wage developments have been overall supportive of rebalancing, but the wage setting system provides limited scope for firm-level adjustment. Increases in the minimum wage led to a sharp increase in the number of workers covered and, if not matched by productivity growth, risk affecting job creation and competitiveness in labour intensive industries.</p>
Conclusions from IDR analysis			
<ul style="list-style-type: none"> • The Portuguese economy is characterised by large imbalances in terms of external and internal debt, both public and private in a context of elevated unemployment. The NIIP is still very negative. Households' indebtedness has declined but corporate debt still weighs on firms' performance and a large stock of non-performing loans poses risks to banks' balance sheets. The combination of stock imbalances exposes Portugal to shocks or shifts in investor sentiment. • The tradable sector has gained in importance but robust growth of domestic demand could delay external rebalancing. The increasing path in public debt is expected to reverse in the short-term. Nonetheless, government debt will remain elevated, implying vulnerabilities to adverse shocks and a high interest burden on public finances. Unemployment remains high, though on a declining trend. • Progress has been made in stabilising the financial sector and improving the access to finance, insolvency procedures, labour market functioning, education and long-term fiscal sustainability. However, policy gaps persist in the areas of product and services markets, corporate debt restructuring, fiscal and labour market reforms. Maintaining the reform momentum is crucial for sustaining gains in competitiveness, corporate and household deleveraging and fiscal sustainability. 			

(*) The first column summarises 'gravity' issues which aim at providing an order of magnitude of the level of imbalances. The second column reports findings concerning the 'evolution and prospects' of imbalances. The third column reports recent and planned relevant measures. Findings are reported for each source of imbalance and adjustment. The final paragraphs of the matrix summarise the overall challenges, in terms of their gravity, developments and prospects, policy response.

Source: European Commission

3. ADDITIONAL STRUCTURAL ISSUES

In addition to the imbalances and adjustment issues addressed in Section 2, this section provides an analysis of other structural economic and social challenges for Portugal. Focusing on the policy areas covered in the Commission recommendation from 13 May 2015 relating to Portugal's 2015 National Reform Programme and 2015 Stability Programme, this section analyses issues related to fiscal structural policies, poverty and income inequality, the remaining weaknesses in the business environment and in the public administration efficiency in network industries, as well as the skill level and knowledge base of the Portuguese economy.

3.1. EVALUATION OF STRUCTURAL REFORMS

Portugal is making progress in assessing the impact of structural reforms but a systematic ex-ante and ex-post reform evaluation is not yet an integral part of the legislative process.

Evidence-based instruments remain underused in the regulatory process, hampering the quality of policymaking. According to the World Bank 'Doing Business 2016' Report, government effectiveness and regulatory quality in Portugal are below EU average and have decreased since 2009. The Portuguese authorities are undertaking, through an outsourced provider, a first ex-post evaluation of the structural reforms approved in recent years, starting from justice and education areas. They are also assessing, through the OECD, recently enacted employment protection legislation reforms. With a view to analysing possible effects of legislative proposals on SMEs and assessing costs and benefits of policy options, the authorities adopted in April 2015 the 'SME test'. Legislative initiatives with an impact on business, in particular SMEs, are subject to an impact assessment of economic and administrative costs which requires a binding Opinion of the Minister of the Presidency and Administrative Modernisation⁽¹⁴⁾. However, stakeholders are still not systematically consulted and a standard methodology has not been developed. This risks the SME test becoming an administrative compliance exercise rather than a balanced and comprehensive assessment to make legislation more SME friendly.

The National Reform Programme (NRP) is expected to include an assessment of the impact of announced and implemented reforms. Besides the first ex-post evaluation of selected structural reforms, the Portuguese authorities intend to systematically complement their NRP

with an assessment of the macroeconomic impact of reform measures, drawing on the work done at EU level.

The Commission has carried out an exercise considering reform measures put forward by Portugal since 2012. Selected reform measures were translated into quantitative shocks to be simulated by the QUEST model. Many measures are difficult to evaluate at a micro level and assessments relying on intermediate indicators are surrounded by uncertainties. Therefore, the analytical framework needs to combine evidence-based economic reasoning with expert assessment and knowledge, to be able to define and propose priorities. Despite these limitations and caveats the aggregate effects of the measures reported are positive, as described in the following.

On product market, the Commission analysed the liberalisation of highly regulated professions, services directive and network industries. In 2013 Portugal adopted a framework law (Law No 2/2013) for 19 regulated professions and implemented the professional qualifications directive, eliminating excessive restrictions and facilitating access to professions. The reform has been gradually implemented, but there are still legal restrictions that in practice reduce the importance of the reforms and negatively affect their impact in the economy (chapter 3.4). Nonetheless, the deregulation is expected to contribute to allocative efficiency and increased labour productivity, leading to an estimated reduction of the mark-up⁽¹⁵⁾ in Portuguese professional services from 21% to 20.5%. Portugal implemented the EU Services Directive as of 2012 by gradually removing restrictions in the legal

⁽¹⁴⁾ Council of Ministers' Resolution 95-A/2015, of 17 December.

⁽¹⁵⁾ A mark-up can be seen as the difference between the cost of a good or service and its selling price.

regimes of 67 out of 70 specific services, facilitating market entry and competition. It is estimated that in the long-term labour productivity in macroeconomic terms will be 0.28% higher than it would have been if the reforms introduced by the directive had not taken place. On network industries, the full privatisation of CTT and the sale of the state's golden share in PT Telecom (postal and telecommunication incumbents) imply less direct government intervention and more robustness of the regulatory framework. This is expected to improve transparency and the functioning of the market, thus lowering prices through a more competitive environment. It is estimated that the mark-up for the Portuguese communication services will fall from 24% to 22.6% as a result of these reforms. In railway, the unbundling of freight terminals and the privatisation of CP Carga (the incumbent freight railway operator) could prevent price dumping and spur price competition in the market with other private companies. This is expected to reduce the mark-up in Portugal's rail and road sectors from 11% to 10.8%.

Labour market reforms are expected to have a strong positive impact on the Portuguese economy. Portugal's reforms of Employment Protection Legislation (EPL) in 2011 and 2012 have reduced the discrepancy between the stringency of regulation under temporary and permanent employment contracts. This has helped reduce labour market segmentation by making it easier to dismiss individual regular workers. A one-point decrease in the summary OECD EPL indicator for regular workers is estimated to translate into an aggregate yearly labour productivity growth effect of 0.14 percentage points. The 2012 reform of unemployment benefits extended the system's coverage while reducing the maximum duration and the generosity of the benefit after six months. The consequence is a reduction in the unemployment benefit net replacement rate in Portugal from 59% in 2011 to 48% in 2013. This change has the potential to increase job search incentives.

Recent education sector reforms are also expected to contribute to higher productivity and GDP growth. A programme offering basic vocational courses as an alternative path to students at risk of leaving education started in 2013/2014 in secondary education, and in

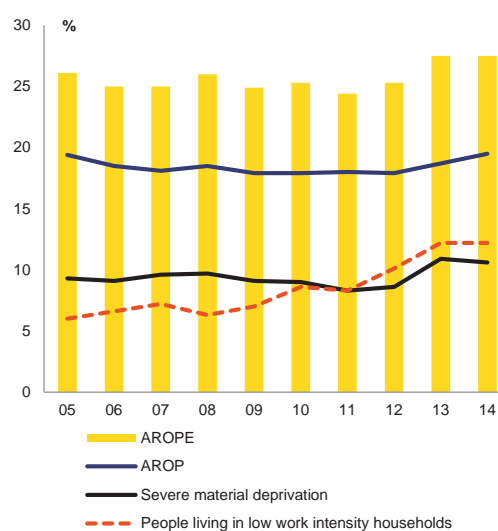
2014/2015 at upper secondary level as a pilot project. In March 2015, the government announced that it was to continue no longer as pilot project but as a long-term programme and called for public and private education providers to offer these vocational courses. This reform is designed to increase the share of medium-skilled workers and reduce the proportion of low-skilled workers in the labour force, the aim being to boost labour productivity. The reform has the potential to boost GDP by 0.53% by 2020 compared to the no-reform scenario.

The Commission estimates that product and labour market reforms, in conjunction with education reforms, will boost GDP by 1.9% by 2020. This increase is relative to the scenario without the reforms and covers measures taken over the last four years. In particular, reforms undertaken in Portugal to improve the functioning of product markets can yield a labour productivity rise of 0.3% over five years. In the long-term, by 2020, this could boost GDP by over 0.25% compared with the no-reform scenario. It is estimated that labour market and education reforms introduced in the same period can have an even stronger positive impact on Portugal's economy. The education reform will increase total GDP by 0.5% by 2020. The combined labour market reforms are expected to increase GDP by more than 1% by 2020.

3.2. SOCIAL POLICIES

Indicators of poverty and social exclusion have deteriorated in recent years, despite some mitigating measures which were taken to protect the most vulnerable groups. The at-risk-of-poverty rate rose from 17.9% in 2010 to 19.5% in 2014. The poverty gap⁽¹⁶⁾ in working age 18-64 continued to rise, reaching 30.3% in 2014 (the EU average is 24.7% in 2014). The severe material deprivation rate remains high despite the recent drop.

Graph 3.2.1: **At risk of poverty or social exclusion rate and its components**



Source: European Commission, EU-SILC

Disposable income, including at the lowest income deciles, has decreased due to rising levels of unemployment and following fiscal measures motivated by deleveraging needs. The number of jobless poor (at risk of poverty⁽¹⁷⁾ and living in low work intensity households) reached 556 000 in 2014 (after peaking at 564 000 in 2013). Cuts in non-pension benefits disproportionately affected the very poor (i.e. those in the bottom decile of the income distribution). 2014 saw new decreases in spending on family allowances (-3.7%), in the Solidarity Supplement

⁽¹⁶⁾ The poverty gap is defined as the difference between the equalised total net income of people below the at-risk-of-poverty threshold and those at risk of poverty, expressed as a percentage of the at-risk-of-poverty threshold. It gives an idea of the severity of poverty for those experiencing it.

⁽¹⁷⁾ A household is defined as 'jobless poor' if it is both 'at risk of poverty' and 'living in low work intensity household'.

for the elderly (-21%), in the minimum income scheme (RSI) (-6.6%) and in other benefits (-6%)⁽¹⁸⁾.

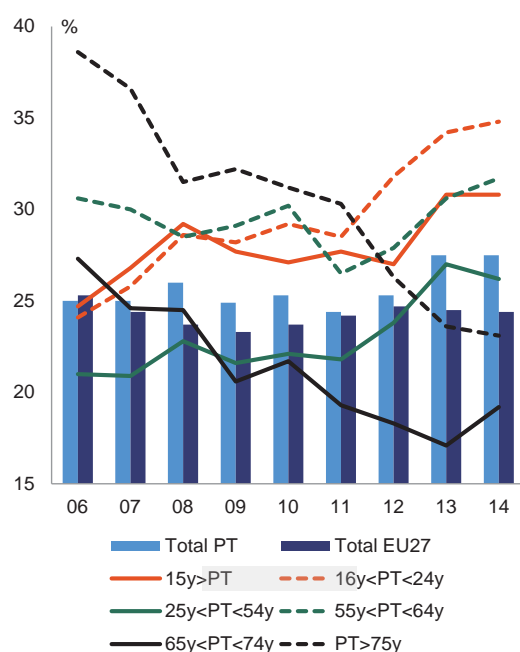
Many people in work are also at risk of poverty, given the increased incidence of low wage earners and low work intensity. In-work poverty in Portugal is the fifth highest in the EU. It stood at 10.7% in 2014, above the EU average of 9.6%. Traditionally, a significant proportion of the poor in Portugal have been in work. This is particularly the case for households with children. According to Eurostat, from 2010 to 2014, the in-work at-risk-of-poverty rate of households with dependent children increased from 10.8% to 12.6%. Low work intensity is another contributor to in-work poverty. Between 2008 and 2013, the share of low-work-intensity households increased by 5.9 percentage points (the fourth largest increase in the EU), remaining at 12.2% in 2014.

In 2014, households with children were at greater risk of poverty or social exclusion than the rest of the population. The risk of poverty or social exclusion within this particular group affected 31.4%, against 27.5% of the overall population, and is also due to a major reduction in childcare benefits, with two series of cuts implemented respectively in November 2010 and January 2012. Between October 2010 and December 2015, 652 674 beneficiaries lost access to child benefits, i.e. one in every three beneficiaries. Expenditure on family and child benefits (1.2% of GDP) is below the EU average (2.4% of GDP). As a result, social transfers, and in particular family benefits, have had a relatively low impact on child poverty. However, in January 2016, a decree-law was passed that increased child benefits⁽¹⁹⁾ by between 2% and 3.5%. It made child benefits progressive over the three income brackets and included a specific increase for single parent households (Decree-Law n.º2/2016). Although it is still too early to assess the impact of these measures, they may help lessen the risk of child poverty.

⁽¹⁸⁾ See De Agostini et al. (2014), 'The effect of tax-benefit changes on the income distribution in EU countries since the beginning of the economic crisis', EUROMOD Working papers 9/14 and Batista et al.(2014), European Semester Report — Portugal, European Social Policy Network.

⁽¹⁹⁾ Portaria n.º 11-A/2016 of 29 January 2016.

Graph 3.2.2: At risk of poverty or social exclusion rate by age



Source: European Commission

Older people have been relatively protected from the risk of poverty and social exclusion in recent years. While the proportion of people at risk of poverty and social exclusion below 65 years old has increased during the crisis, among the over-65s it has decreased from 27.7% in 2008 to 21.1% in 2014 (despite a slight increase since 2013; Graph 3.2.2). Since 2011, however, severe material deprivation increased in this age-bracket (from 7.7% in 2011 to 9.8% in 2014). Pensions, and in particular low pensions, have been curtailed less than other social benefits. Additionally, at the end of 2015 the new government decided to unfreeze the automatic indexation of social benefits to real GDP growth and inflation, with immediate impact on medium-low pensions (below EUR 629 a month), as well as to reinstate the reference value of the elderly solidarity supplement that had been reduced from EUR 5 022 per year to EUR 4 909 in 2013. Meanwhile, the situation of older women is worsening as the gender pay gap increased in Portugal (from 9.2% in 2008 to 14.5% in 2014), while it remained stable in the EU overall.

Inequality is increasing in Portugal. The disparity between the top and bottom 20% of the income distribution widened in 2014, and the Gini coefficient has increased to 34.5% (EU average level of 30.9%). The main reason for the increase in inequality is the loss of earnings in the bottom and middle sections of the income distribution — triggered by the economic crisis and the ensuing loss of employment — combined with inadequate family and working age benefits⁽²⁰⁾.

The cash value of minimum income is rather low in comparison with other EU Member States. The net incomes of recipients on minimum incomes are among the lowest in the EU in comparison to the national relative poverty threshold. According to the OECD, the net incomes of people receiving social assistance accounted for only 43% of the relative poverty threshold for a single person in 2013, and since then they have declined. Eligibility for the minimum income scheme (*Rendimento Social de Inserção*) has been narrowed following consecutive reforms between 2010 and 2013. As a consequence, the number of individuals benefiting from the minimum income scheme fell from 338 000 in June 2012 to around 206 000 in November 2015. While the reduction in the size of the programme has yielded minor savings, most of it was at the expense of large families, left without coverage. In January 2016 a decree-law was passed increasing the reference value and changing the equivalence scale of the minimum income scheme back to the 2012 level so as to widen its coverage. The impact of this measure in mitigating the severity of poverty and in providing support to the long-term unemployed who might have lost eligibility for the unemployment benefit scheme has yet to be assessed. No new specific measures have been taken on activation for minimum income scheme recipients.

⁽²⁰⁾ Arnold, Jens and Rodrigues, Carlos Farinha (2015). Reducing inequality and poverty in Portugal, Economics Department working papers No 1258, OECD.

3.3. FISCAL STRUCTURAL POLICIES

Pension system

Recent reforms have made the pension system more financially sustainable, by reducing coverage and benefit levels in the longer term.

The private pension funds, which dropped significantly during 2011 to below EUR 13 billion, have been recovering since 2012, reaching EUR 17.5 billion in the second quarter of 2015. However, they remain below the EUR 19 billion peak achieved at the end of 2010. Recent pension reforms linked the pension benefit to the increase in life expectancy and were designed to increase labour market participation. These reforms are expected to enable the pension system to cope with the demographic trends anticipated in the medium and long term. The 2015 Ageing Report projects an increase in public pension spending as a share of GDP by a full percentage point in the next 10 years, before benefit and coverage curbs take effect and reduce it by 0.7 pp. over 2013-2060. Portugal is classified as being at low risk in the long term according to the S2 indicator⁽²¹⁾ (1.8), and the pension system appears to be on a sustainable path. In the medium term, Portugal is classified as being at high risk according to the S1 indicator (6.4). This means a cumulated gradual improvement in the structural primary balance of 6.4 pps. of GDP (relative to the baseline no-fiscal policy change scenario) would be required over 5 years starting from 2018, if the objective was to reach the reference value of a 60% debt-to-GDP ratio by 2030. Pressures towards non-sustainable debt paths are mainly related to the large distance of the present debt-to-GDP ratio from the 60% reference value and only partially influenced by

⁽²¹⁾ The long-term sustainability indicator S2 shows the upfront adjustment to the current structural primary balance (then kept constant at the adjusted value forever) required to stabilise the debt-to-GDP ratio permanently, including financing for any additional expenditure arising from an ageing population. The medium-term sustainability indicator S1 shows the additional adjustment required, in terms of a cumulated gradual improvement in the government structural primary balance over 5 years (starting from the year after the forecasts, until 2022), to reach a 60% public debt-to-GDP ratio (the EU Treaty reference value) by 2030, including financing for any future additional expenditure arising from an ageing population (until the target date). A country is deemed to be at high risk in its respective timespans if S1 is above 2.5 pps. and S2 is above 6 pps. and at medium risk if above 0 pps. and 2 pps. respectively. See European Commission (2016), Fiscal Sustainability Report 2015. http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip018_en.pdf.

the evolution of the cost of ageing in the next 15 years.

Pensions already in payment have helped mitigate the impact of the economic crisis but rely partially on additional state transfers. As detailed in Section 3.2., low pensions at pay have been curtailed less than other social benefits and thus helped mitigate the impact of the economic crisis on older people. The recent reforms addressed future pension sustainability but did not decrease the weight of current pensions on younger generations. This will need to be confirmed in light of the lower incomes at younger ages and the maturity of the pension system. Public finances suffer this pressure too, as current contributions to the public pension systems cover less than 75% of pension-related expenditure.

The adequacy of the pension system in the future will depend to a large extent on increased participation in labour and longer working lives. According to the Commission's 2015 Pension Adequacy Report, theoretical replacement rates, i.e. the ratio of pension levels one year into retirement to earnings at pension take-up, are set to decline substantially over the next 40 years. The reduction is drastic for careers up to the age of 65, but milder for careers that start at the age of 25 and end at the rising statutory retirement age. Moreover, pensions are set to become more progressive, as the reduction in the replacement rates is projected to be larger for higher earnings. This means that it will be crucial to work longer in order to sustain pension adequacy. After a decades-long decline, the employment rate of older people (aged 55-64) rose from 51.6% in 2012 to 54.3% in 2014. Portugal is notable for the high employment rates of people aged over 65 (e.g. 18.6% in 2014 among those aged 65-69, almost twice the EU28 rate), and this is a sign of their inability to live on retirement income.

Healthcare sector

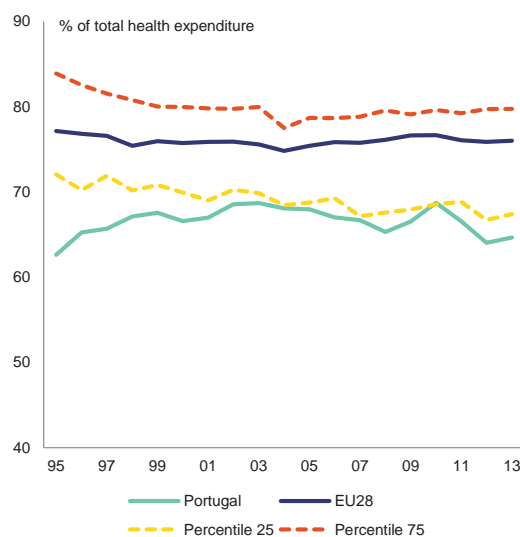
Even though health indicators do currently not reveal any significant accessibility issues, there are indications that maintaining existing levels of access to healthcare is difficult. As regards accessibility, out-of-pocket payments as a share of total health expenditure increased between 2007

and 2013 from 25.5% to 26.6%, while the EU average fell (from 16.5% to 16.1%)(²²). Unmet needs reversed the falling trend in 2012, with the percentage of the population reporting unmet needs for the reason ‘Too expensive or too far to travel or waiting list’ more than doubling (from 1.4% in 2011 to 3.3% in 2012, followed by a slight reduction to 3% in 2013). Unmet needs due to waiting times in 2012 also reversed the previous trend (from 0.1% to 0.5%); the data for 2013 showed that the situation had stabilised (0.5%)(²³). Ensuring that the whole population is covered by a family doctor is considered to be particularly important to improve access to primary healthcare in Portugal. As general practitioners are expected to retire at a faster rate in the near future and access to their services is spread unevenly across Portugal, this issue is expected to become more pressing. Authorities are now focused on ensuring an adequate number of both physicians and nurses covering the entire population based on the concept of family teams. Care outcome indicators in Portugal are good overall, although spending on prevention is relatively low by European standards.

(²²) World Health Organisation, European health for all database (HFA-DB). <http://data.euro.who.int/hfad/>

(²³) Eurostat. Self-reported unmet needs for medical examination. Last update: 26-03-2015.

Graph 3.3.1: **Government expenditure as a percentage of total health expenditure**



Source: European Commission

Portugal has made efforts to ensure access to quality healthcare in a sustainable manner, but spending is projected to increase. Portugal has one of the lowest shares of public expenditure in total health expenditure. In 2013, public spending accounted for 64.7% of total health expenditure, and Portugal was one of the quarter of EU countries with the lowest shares of public spending in total health expenditure (see Graph 3.3.1). However, the country still faces a long-term fiscal sustainability challenge in the healthcare sector. While in 2013 public healthcare spending came to 6% of GDP (below the EU average of 6.9%), the projected increase by 2060 is, at 2.5% of GDP, the highest in the EU. Further cost pressures might arise from demographic trends and the growing prevalence of chronic disease.

Implementation of the hospital reform and consolidating the international non-proprietary name prescription and the electronic prescription could be leveraged for cost-effectiveness. The hospital reform proceeds together with the expansion of family health and community care units. Accurate budget planning and implementation in hospitals remain of critical

importance to ensure arrears clearance in the sector and improve its financial sustainability in the longer run. Measures have been taken in recent years to reduce prices on the pharmaceutical market. For 2016, the national pharmaceuticals authority (Infarmed) estimates savings at EUR 14 million for the users and EUR 68 million for the state (EUR 27 million in the ambulatory and EUR 41 million in the hospital services). In addition, the average price of the generic medicines provided by the NHS fell from EUR 15.5 to EUR 7.2 between 2010 and Q3-2015, thus bringing the average price of medicines in general down by 27.4%, from EUR 16.8 to EUR 12.2. However, market penetration of generics is still below its full potential. Complementary measures have been introduced, such as prescribing medicines with an international non-proprietary name and electronic prescription. A close monitoring could ensure that they are rolled out and consolidated properly.

Taxation

The Portuguese tax system has recently been comprehensively overhauled, especially as regards corporate income tax (2014), personal income tax (2015) and environmental taxation (2015). Portugal also took several measures between 2011 and 2013 to broaden its VAT base and improve VAT compliance. More generally, any consideration of tax reforms would need to take account of the tax system's stability. The Portuguese system's reputation for high levels of uncertainty not only damages the activity of its domestic economic actors but also makes the country less attractive for foreign investors.

Labour taxation on second earners is high. According to the Commission's 2015 report on tax reforms in EU Member States⁽²⁴⁾, the tax burden on secondary earners is very high in Portugal. This risks creating disincentives to work resulting in a high theoretical inactivity trap⁽²⁵⁾ of 40.4% and a

⁽²⁴⁾ European Commission, Report on Tax Reforms in EU Member States, 2015. See tables 2.3 and 3.1 on p.26 and 37 respectively.

http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip008_en.pdf

⁽²⁵⁾ The inactivity trap measures the financial disincentive for an inactive person not entitled to unemployment benefits (but potentially receiving other benefits such as social assistance) to move from inactivity to paid employment. It

low wage trap⁽²⁶⁾ of 46.5%. The second 'trap' seems more relevant in practice, especially where the second earner has limited earnings potential (as elementary occupations are common among secondary earners), while the overall female activity rate is high (at 70% in 2014 in the age group 15-64, compared to 66.5% in the EU).

Recent VAT reforms have to some extent broadened the tax base, limiting the use of reduced VAT rates. Portugal is among the Member States with the lowest VAT gap as a percentage of theoretical VAT liability (9% compared with an EU average of 14.5%) indicating a relatively high level of efficiency in VAT collection. However, it is also one of the Member States with the highest VAT policy gap (51.9% as compared to an EU average of 47.2%). This is because it has the EU's highest VAT rate gap (19% compared with an EU average of 9.8%), while the exemption gap is in line with the EU average⁽²⁷⁾. As the still broad use of reduced rates implies significant revenue losses, it may have to be reassessed. As regards real estate taxation, Portugal has scope for a shift from transaction taxes to recurrent property taxes as transaction tax rates are relatively high and their share in revenue from property taxation is significantly above the EU average (see the Commission's Report on Tax Reforms in EU Member States, 2015, pp.42-43).

The corporate debt bias in taxation remains high. In the past few years, the government has tried to tackle this problem by introducing thin

is defined as the rate at which the additional gross income of such a transition is taxed.

⁽²⁶⁾ The low wage trap measures the financial disincentive to increase a low level of earnings by working additional hours. It is defined as the rate at which the additional gross income of such a move is taxed.

⁽²⁷⁾ The VAT policy gap is the gap between the VAT theoretical tax liability (VTTL, i.e. the VAT legally due under the current system), and the 'ideal' tax liability without reduced rates or exemptions (expressed as a percentage of the ideal tax liability). The VAT policy gap can be further broken down into the rate gap and the exemptions gap: while the rate gap represents the loss of potential revenue as a result of reduced rates, the exemption gap represents the loss of potential revenue because of exemptions (CPB/CASE, 2015, Study to quantify and analyse the VAT Gap in the EU Member States, 2015 Report, TAXUD/2013/DE/321. http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/vat_gap2013.pdf).

capitalisation rules and an Allowance for Corporate Equity (ACE). In 2013, deductibility of interest was limited to 70% of EBITDA for companies exceeding a threshold of EUR 3 million in net interest payments (the threshold was reduced to EUR 1 million in 2014), and this ceiling is to be gradually brought down to 30% by 2017 under transitional arrangements. Since 2014, Portugal has had an ACE which allows SMEs to deduct up to 5% of their taxable income. In 2015, the difference in the cost of capital (before and after taxation) between debt and equity-funded investments remained one of the highest in the EU⁽²⁸⁾.

The tax system is not conducive to investment as compliance costs for businesses are high and tax incentives ineffective. Well-designed R&D tax incentives could help stimulate private investment. Portugal already offers a tax credit system for R&D expenditures (SIFIDE II) which appears to be in line with good practice⁽²⁹⁾ and as mentioned in Section 3.7. could contribute to a more knowledge-based economy. However, to ensure that new starters and small companies can benefit, monitoring uptake rates and holding regular evaluations would be required. Portugal also offers a range of other tax incentives to encourage investment. In addition, an extraordinary tax credit was put in place for the investments made in 2013 (CFEI).

Significant steps have been taken towards a more efficient tax administration and improved tax compliance. In recent years, considerable efforts have been made to curb tax evasion by further improving the efficiency of the tax administration. Examples include beefing up the Large Taxpayer Office set up in 2012 and developing tax-related IT systems. In 2014, about 4.8 million⁽³⁰⁾ e-invoices were issued, a 12.3% increase over the previous year, when the e-invoicing system was introduced. The Strategic Plan to combat tax and customs fraud and evasion, which runs from 2015 to 2017, includes new baseline measures. It is designed to further explore

the potential of the e-invoicing system and ensure stronger data cross-checking. Implementing these measures thoroughly is considered a priority by the authorities.

There is room for further reforms of the tax administration that would improve tax compliance and enforcement and increase investment. Despite the progress made, scope remains for strengthening tax compliance, especially as regards the housing market. Compliance costs and the existing administrative burden for taxpayers are among the highest in the EU. Complying with overall tax obligations took an average of 275 hours in 2014⁽³¹⁾. This is well above the EU average of 186 hours although all forms can be completed and taxes paid online. Reforming the tax administration to make it more efficient would also help encourage investment. There is also ample scope for making the judicial system more efficient in dealing with tax litigation. The level of disputed tax debt as a percentage of the annual net revenue collection remains high (24.2% in 2013)⁽³²⁾, while the historical shortage of judges in tax courts has not been tackled. Although thresholds for tax appeals have been raised, it seems that only a deeper reform of the judicial system would increase its efficiency.

⁽³¹⁾ World Bank (2016), *Doing Business 2016: Measuring Regulatory Quality and Efficiency*. World Bank, Washington DC.

⁽³²⁾ OECD (2015), *Tax Administration 2015: Comparative Information on OECD and Other Advanced and Emerging Economies*. OECD Publishing, Paris.

⁽²⁸⁾ ZEW (2015) and Commission services.

⁽²⁹⁾ CPB (2014) Study on R&D tax incentives. The study commissioned by the European Commission. Taxation Working Paper N. 52 – 2014.

⁽³⁰⁾ Governo de Portugal (2015): *Relatório de Combate à Fraude e Evasão Fiscais e Aduaneiras 2014*.

Box 3.3.1: EUROMOD based simulation of the impact of the 2015 PIT reform

In 2015 Portugal implemented a PIT reform affecting several aspects of the personal income tax system, notably introducing a family quotient and restructuring tax credits. To measure the size of the ensuing revenue and distributional effects the EUROMOD tax-benefit microsimulation model was used on the basis of EU-SILC (Statistics on income and living conditions) data of 2012 in a joint simulation exercise by the JRC-IPTS (Joint Research Centre – Institute for Prospective Technological Studies – Seville) and DG ECFIN.

The most important element of the 2015 PIT reform was the introduction of a family quotient replacing the previous conjugal quotient. Up to 2014 the tax base for joint returns was divided by 2 to determine gross imposable income, whereas the 2015 reform changed this quotient to $2+0.3n$, where n is the number of dependent persons (children or parents). A quotient of $1+0.15n$ is applied in individual taxation of couples, while $1+0.3n$ is applied for single parents. To avoid large revenue losses, the tax savings derived from the quotient can however not exceed certain limits between EUR 300 in the case of individual tax return and one dependent person up to EUR 2 000 in the case of joint taxation and three or more dependent persons. As regards the restructuring of tax credits, the 2015 reform most prominently removed the personal tax credit that each taxpayer could directly deduct from the gross tax liability replacing it by a new tax credit for general expenses. The tax credit for general expenses allows every taxpayer to deduct 35% of all types of household expenses as long as an invoice is issued to include the taxpayer identification number. The tax credit is capped at EUR 250 per taxpayer. As almost any expenditure can be used to obtain the credit, the EUROMOD simulation assumed that all taxpayers will effectively reach the EUR 250 limit. Another major modification in terms of tax credits was the 50% increase of the child tax credit from EUR 213.75 to EUR 325.

The simulation used 2014 Portuguese tax-benefit calculation rules as a baseline scenario. The application of the reform rules results in an overall negative revenue impact of EUR 600 million. Close to EUR 300 million of this revenue loss is due to the introduction of the family quotient whereas the other half of the impact relates to the changes in tax credits, i.e. in particular the replacement of the personal tax credit by the higher general expenses tax credit and the 50% increase of the child tax credit. While the revenue impact of the general expenses tax credit will only become effective upon declaration in 2016, a major part of the revenue loss related to the family quotient and the increase of the child tax credit already materialised in 2015 to the extent that the retention tables already reflected the new PIT rules. According to the simulation, the distributional effect of the reform is mixed: it makes the personal income tax more progressive but less redistributive as a result of the combination of higher tax credits and the family quotient. The higher progressivity is due to the fact that poorer households face a relatively higher reduction in their tax liabilities, but this is overcompensated by the significant tax revenue reduction, that limits the redistributive potential of the tax.

Fiscal framework

The reformed Budget Framework Law is being implemented. The Law is in particular designed to make budget units more accountable and strengthen the medium to long-term focus of public finances by introducing programme-based budgeting. The reformed Law also aligns the deadlines for the presentation of the stability programme and the draft budget to the Parliament on European Semester requirements. It provides for a three-year transitional period for applying most new features. The Ministry of Finance is to set up a unit to monitor the implementation of the reformed Law within six months of its entry into force, i.e. by early March. The same deadline also applies for government approval of a decree-law defining the setup of the budgetary programmes. A further decree-law containing specifications and guidance on implementing the programmes is to be approved by September. If the reduction in arrears that has been achieved is to be maintained, the Commitment Control Law must be enforced effectively and consistently. This law has already addressed the accumulation of arrears in various subsectors of the public administration by improving discipline and budgetary control of the bodies concerned. However, its underlying principles have not been fully enforced and its implementation in some ministries needs to be closely monitored so as to prevent a new accumulation of arrears.

The Portuguese Public Finance Council (Conselho das Finanças Públicas or CFP) is now well established and fully playing its role as an independent monitoring institution on public finance issues. The CFP was established through the May 2011 reform of the Budgetary Framework Law and its Statutes were laid down in an annex to the Law 54/2011 of 19 October. The CFP is a legal entity which has the nature of an independent body according to Article 1 of its statutes, and its board cannot request or receive instructions from other public or private institutions. Clear stipulations underpin the CFP's access to relevant information. The institution has been operational since February 2012. Pursuant to Regulation (EU) 473/2013, the assessment of the macroeconomic forecast underpinning the draft budgetary plans and the stability programme was assigned to the CFP. The Council is also fully pursuing its legal mandate of independently providing assessments and commenting publicly on national budgetary objectives and compliance with the numerical fiscal rules. The Portuguese Public Finance Council has become more prominent in the general debate on fiscal policy making in particular via its regular publications on short- and medium-term budgetary evolutions. On several occasions it has expressed concerns about risks associated with certain fiscal policy options.

3.4. PRODUCT MARKET REFORMS

Product market reforms and mark-ups

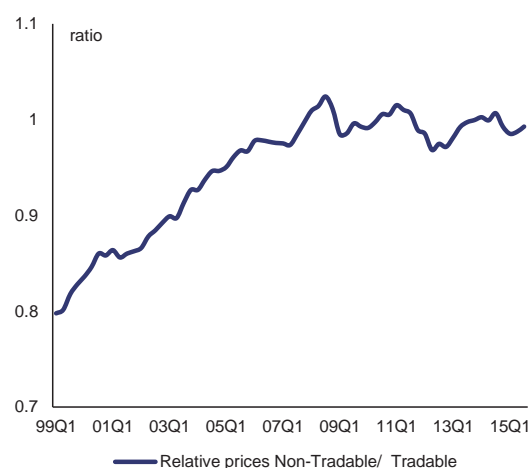
Product market reforms and framework conditions are important to increase productivity and potential growth. Less restrictive product market regulation or increased competition may have positive effects on growth by reducing mark-ups and prices. Before the economic adjustment programme, mark-ups and relative prices in the non-tradable sectors were significantly higher than in the tradable sector. This triggered investment in the non-tradable sectors and contributed to the build-up of imbalances in the economy. Structural reforms under the programme have reduced mark-ups and prices, although their levels remain high. Relative prices of non-tradables are still high in Portugal compared with the early 2000s⁽³³⁾.

Business environment and framework conditions

The overall business environment has improved in recent years. According to the World Bank's 'Doing Business 2016' Report, there has been progress in all areas except in the financing of businesses (table 3.4.1), allowing Portugal to move up in international rankings. Portugal performs well above the EU average on entrepreneurship, with the second-best score of all EU countries. However, challenges remain in various areas, including services, regulated professions, and better regulation.

⁽³³⁾ OECD studies confirm that one way of stimulating growth performance is to boost competition through policies to improve the functioning of the product markets by deregulating and facilitating entry or the threat of entry (Nicoletti and Scarpetta, 2003; Barone and Cingano, 2011). European Commission studies show that reforms facilitating market entry and boosting the level of competition on goods and service markets could bring productivity gains of between 2.3 and 3.2% over a 10-year period (Commission staff working document 'Assessment of the 2014 national reform programme and stability programme for Portugal', COM(2014) final, 2014 pp. 25-26. Thum-Thyssen A., Canton E., 'Service sector mark-ups and product market regulation', European Commission, 2013, p. 13; IMF, Country Report for Portugal No 14/56, p. 32.

Graph 3.4.1: Relative prices of tradables and non-tradables in Portugal



(1) Tradable sectors include: (i) agriculture and fishing; (ii) industry (excluding construction); (iii) wholesale and retail trade, transport, accommodation and food service activities; (iv) information and communication. Market non-tradable sectors include (i) construction; (ii) finance and insurance; (iii) real estate; (iv) professional, scientific and technical activities; administrative and support activities; (v) arts, entertainment and recreation; other services; activities of household and extraterritorial organizations and bodies.

Source: European Commission

Registering a business is easier than in most Member States, but licensing remains cumbersome. According to the Commission's 2015 SME performance review, Portugal is among the five EU Member States in which a business can be set up in a day⁽³⁴⁾. Over the last year, the Portuguese authorities have made progress towards further simplifying and speeding up procedures, by approving the revised System for a Responsible Industry (SIR), the Single Environmental Licensing (LUA) and measures to make it easier to obtain construction permits. However, challenges still exist, particularly as regards procedures for obtaining a construction permit and effective implementation of streamlined environmental licensing rules.

⁽³⁴⁾ A survey on the cost of doing business in Portugal published in October 2015 by INE shows that most of the companies that responded do not regard starting a business as a major obstacle. However, they continue to view some licensing and certification processes, notably the environmental procedures in manufacturing and utilities, as challenging.

Table 3.4.1: Distance to frontier according to World Bank's 'Doing Business'

Year	Overall	Starting a business	Dealing with construction permits	Getting electricity	Registering property	Getting credit	Protecting minority investors	Paying taxes	Trading across borders	Enforcing contracts	Resolving insolvency
2010*	71.5	90.2	56.7	82.0	70.8	50.0	60.0	75.7	84.7	70.0	74.8
2014	75.9	96.3	77.3	82.0	83.7	50.0	60.0	77.9	85.1	70.0	77.1
2015	77.4	96.3	76.3	84.7	80.3	45.0	56.7	77.8	100.0	73.0	84.2

(1) The distance to frontier score calculated by the World Bank shows the distance of each economy to the 'frontier', which represents the best performance observed on the relevant indicator. This allows to see the gap with respect to the best performance. An economy's distance to frontier is reflected on a scale from 0 to 100, where 0 represents the lowest performance and 100 represents the frontier. An increasing score implies that the economy is getting closer to the best practice and thus improving.

Source: World Bank

Portugal continues to tackle major regulatory burdens on business. The government is drawing up a new Simplex programme to propose new measures for legislative and administrative simplification, both at central and local level. The 2016 Simplex Programme should be launched in May and reviewed annually. Building on the first inventory of burdensome regulations in industry, commerce and services, drawn up in 2014, Portugal is currently working on a second inventory covering outstanding sectors (e.g. tourism, construction and agriculture). The Inter-Ministerial Network for Administrative Modernisation (RIMA) will coincide with the Simplex Programme's network of focal points. RIMA is expected to continue strengthening the governance framework for administrative simplification, although progress has been slow over the last year and its capacity is still limited to the central administration, excluding local government. Furthermore, Portugal plans to improve its 'Entrepreneur's Desk' (Balcão do Empreendedor) and launch a 'Single Declaration' initiative to tackle the need to complete the same information in more than one public administration form.

The regulatory burden on service providers remains high. According to an in-depth assessment of the regulation of business services published by the Commission in October 2015⁽³⁵⁾, Portugal has some of the most restrictive regulations in the EU on certain regulated professions: restrictive activities, insurance requirements and charges. The reforms that were planned on services including legal, university, construction and retail activities have either not been completed, or, in some cases, have been

reversed. The European Services Directive has not yet been fully implemented as regards access to e-procedures for foreign users, coordination between the authorities concerned and the information available at points of single contact, which are supposed to facilitate cross-border trade in services. As shown in Section 3.1., reforms implemented so far in terms of services liberalisation had a positive impact in productivity and GDP. Completing the reform process would therefore likely yield even more positive results.

Reforms have progressively improved access to a number of highly regulated professions, but some restrictions remain. Legislation on professional companies still restricts the setting-up and operation of corporate groups. The by-laws governing professional bodies, particularly provisions regarding their statutes and internal rules, are restrictive and may prevent both natural and legal persons from gaining access to the professions concerned. They may also create obstacles to multidisciplinary practices and advertising which could affect fees. Portugal played an active part in the mutual evaluation of requirements for obtaining access to and practising regulated professions and did introduce some measures aimed at facilitating access to non-highly regulated professions. However, notwithstanding persistent restrictions as regards access to and practising some regulated professions, the government concluded that there is no need for further reform. Section 3.1. shows that reforms done so far are leading to increased productivity and GDP.

Existing regulatory barriers in some business services sectors prevent resources from being allocated efficiently. The existing barriers in some sectors such as legal and accounting services lower allocative efficiency and create above-average profit rates in those sectors, implying high prices

⁽³⁵⁾ Details are available at the following link: <http://ec.europa.eu/DocsRoom/documents/13328/attachments/1/translations/en/renditions/native>.

for consumers. The challenge exists to remove regulatory bottlenecks with the aim of reducing excessive profit rates, cutting consumer prices and increasing the proportion of fast growing companies in the Portuguese business sector - currently among the lowest in the EU. Persistent barriers to establishment of universities from other Member States and high and potentially disproportionate administrative fees charged of construction service providers are of particular concern.

The implementation of the new legislation on the retail sector deserves close attention.

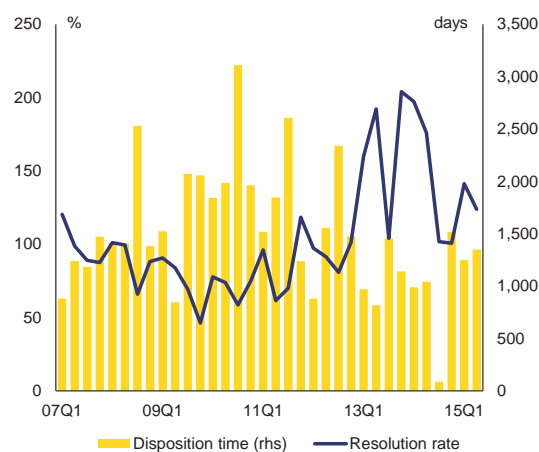
Decree-Law No 10/2015, enacted in January 2015, simplified rules in the retail sector to some extent, exempting certain types of shop from the authorisation procedure and reducing the number of bodies the authorisation procedure involves. However, the fact that Portaria No 60-B/2015 imposes a retail fee linked to the authorisation process needs to be assessed, as this may constitute a barrier to entry into the Portuguese market.

An efficient judicial system remains key in order to make business more dynamic and attract FDI.

An efficient justice system is an important factor when making investment decisions or launching new business operations. Improving the efficiency of civil justice, for instance by improving courts' case management and stepping up the use of alternative dispute resolution methods could positively affect entry rates and FDI attraction. According to the Commission, a 10% reduction in the length of proceedings in civil and commercial cases could increase the entry rate of firms by almost 1 percentage point⁽³⁶⁾. Confidence in the justice system is also related to the length of proceedings, essential for certainty of transactions and investment return. Portugal saw some improvements in enforcement case flows in 2015, although the case backlog remains an issue. The rate at which cases are resolved has improved. It stood at 123.8% in the second quarter of 2015, with an increase of 62.3 percentage points over the minimum level of 61.5% in the second quarter of 2011 (Graph 3.4.2). The disposition time of

enforcement cases was 1 350 days in the second quarter of 2015, with an increase of 29.7% over the figure recorded a year earlier and a decrease of 32.0% compared to the peak in the second quarter of 2010. The first half of 2015 showed an improved enforcement outlook. There were more completed civil enforcement cases than incoming ones, although the absolute value remains low (Graph 3.4.3)

Graph 3.4.2: **Disposition time and resolution rate of enforcement cases**

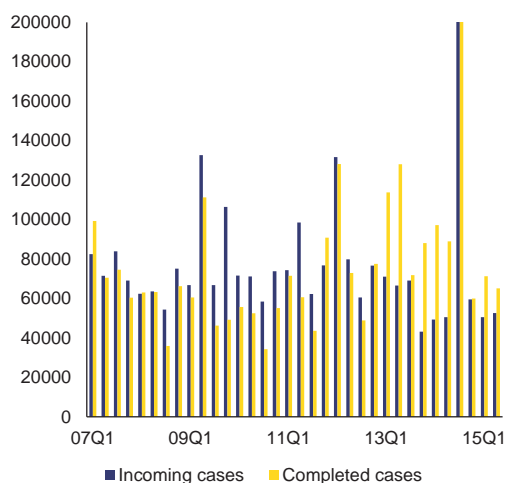


Source: Portuguese authorities, quarterly statistical bulletin No 21

The efficiency of Portugal's justice system is low. This relates in particular to the evaluation of courts' activities, the use of online tools and surveys of court users or legal professionals. The Portuguese authorities are working to improve the courts' case management through the systematic collection of detailed statistics on case flows, trial length, and judges' workload. In particular, they are making efforts to overcome operational problems that have arisen in recent months due to the non-functioning of the central database for court files (CITIUS) and the poor quality of the database for tax courts (SITAF). Continuing this work could help to ensure timely and good-quality judicial statistics, particularly as regards length of procedures, disposition time, clearance rate and the number of pending cases in civil and commercial courts, insolvency courts, tax and administrative courts and for enforcement cases.

⁽³⁶⁾ European Commission, Market reforms at work in Italy, Spain, Portugal and Greece, European Economy 5/2014, p. 46.

Graph 3.4.3: Incoming and completed enforcement cases



(1) In Q3-2014 the number of incoming and completed case was exceptionally high, as a result of internal transfers following the implementation of Law 62/2013 on the judicial reorganisation. The value of incoming cases reached 1 036 868 and the value of completed cases reached 1 054 487.

Source: Portuguese authorities, quarterly statistical bulletin No 21

Lack of transparency and weak public governance and corruption have an impact on investment and economic growth, as explained in the 2016 Annual Growth Survey. According to the business Eurobarometer corruption is perceived to be a problem for doing business in Portugal by 49% of companies, while 40% regard patronage and nepotism as problematic. Public procurement is largely transparent in Portugal, and e-procurement has been mandatory since 2009. A dedicated online platform ('BASE') collects and publishes a large amount of data on public contracts, including at execution stage. However, data gaps remain due to filing mistakes, entry errors and blank fields. Contracting authorities in Portugal often use the direct award procedure, which over the 2013-2015 period constituted on average 87.3% of all public contracts, representing 47% of total amounts contracted. Mitigation measures to increase transparency and avoid favouritism are legally in place, but findings suggest that they might not be consistently applied⁽³⁷⁾. Perceptions that procurement

⁽³⁷⁾ The 2015 Report of the Portuguese Association of Public Procurement (APMP)'Direct awards' and 'procurement intelligence' estimates that 60% of contracts passed by

procedures are vitiated by conflicts of interests, favouritism, and non-competitive and collusive practices, are widespread among businesses.

Transparency remains a challenge for public-private partnerships (PPPs), particularly at local and regional level, and as regards concession contracts. UTAP, the taskforce on public-private partnerships at the Ministry of Finance, only covers a set of PPPs managed by central government. PPPs in the water sector, for instance, and at regional and local level, are thus excluded and remain unsupervised despite significant fiscal risks. Authorities are aware of these loopholes and concur with the need to find a solution, but no concrete timeline has yet been put forward. In the area of conflict of interests, incompatibilities and revolving doors, legislation is largely in place, but there are still significant shortcomings as regards preventing corruption through effective monitoring, implementation and penalties. Outstanding challenges include prosecuting high-level and complex corruption and economic and financial crimes effectively, improving final conviction rates, and making penalties more of a deterrent⁽³⁸⁾.

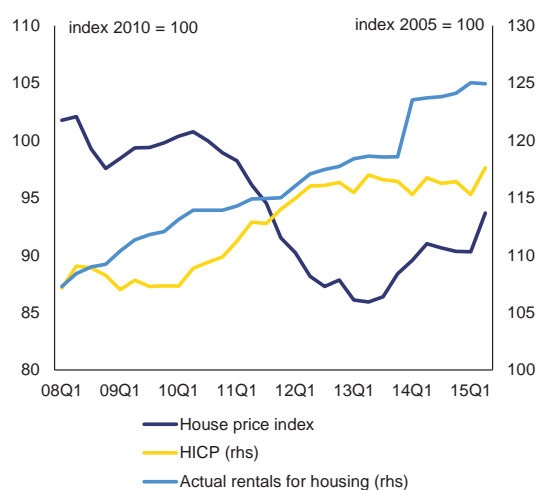
The authorities have taken action to increase the level of internationalisation of Portuguese SMEs. According to the World Bank's 'Doing Business 2016' Report and the 'SBA factsheet 2015', Portugal ranks number one in trading across borders. The cost and the number of documents required to export and import goods are below the EU average, while the time required to export (15 days) and import (13 days) remains longer than the

direct award fall outside the electronic procurement platforms

⁽³⁸⁾ FLASH EB 428 Business attitudes towards corruption in the EU and REGIO study on procurement. As regards conflicts of interest, in 2012 the Council for the Prevention of Corruption recommended implementing a better disclosure system that would enable an automated system for checking whether such situations arise in public procurement decisions. European Commission, Collection of official data on corruption offences. Over the three years for which criminal statistics are available, Portugal has seen almost even rates of final convictions and final acquittals in corruption related cases and a rather high ratio of suspended sentences for corruption related-offences, with 73% of the final sentences being suspended in 2011, 61% in 2012 and 74% in 2013. See <http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=21215&no=2>.

EU average (11.6 and 10.6 days respectively). To further promote the internationalisation of Portuguese companies, the authorities are implementing various policy measures on which legislation was adopted in recent years. These include the ‘National Strategic Reference Framework’ programme (QREN), which provides credit lines for exporting SMEs, internationalisation ‘one-stop-shops’ that prepare SMEs for doing business beyond national borders, and the establishment of ‘Marca Portugal’ (Brand Portugal), designed to boost the image of Portuguese exports, promote the image globally, and integrate SMEs further into international supply chains.

Graph 3.4.4: Price dynamics in the housing and rental markets



Source: European Commission

Progress in housing market reforms has not yet been locked in. During the economic adjustment programme, the urban lease market was reformed to ease strict rent controls and tenants-landlord regulations, improve the supply of rental housing, increase residential mobility, incentivise renovation work and make judicial proceedings between tenants and owners more flexible. However, housing statistics are still under-developed, making it harder to conduct a comprehensive evaluation of the overall legislative framework, some amendments introduced after the end of the economic adjustment programme, and a recent constitutional court ruling. Rental price increases above the rate of the HICP increase suggest that the rental market is becoming more

dynamic. Past reforms might have contributed to this by making rental conditions more flexible and judicial proceedings regarding rental contracts easier (see Graph 3.4.4).

The authorities have implemented a housing monitoring tool. It relies on the collection of data on signed lease agreements and includes information from various data sources (buildings’ registry, utilities’ contracts, means testing of households), based on the mandatory issuing of electronic income receipts through the Ministry of Finance’s portal. By the end of January 2016, the number of registered contracts on the portal exceeded 750 000 (of which 254 000 are new contracts). New contracts have already yielded over EUR 8 m in stamp duty, and the new database based on the e-rental invoice will be a rich source of information, enabling the tax affairs office to pursue its duty of tackling tax evasion and fraud in the commercial and housing lease market.

Regulation and business dynamics

Portuguese businesses are smaller than in other Member States, which weighs on their productivity and increases their vulnerability to shocks. The share of micro-businesses exceeds the EU average, while medium-size and large companies remain underrepresented (table 3.4.2). Low average firm size may be holding back economic growth, as larger companies tend to be more productive and profitable. This is particularly true in the case of Portugal, as the value added generated by small Portuguese firms has been relatively low, making them one of the least productive companies in the EU. Micro-firms represent over 40% of total employment but only 22.7% of value added produced in the economy. Medium-size and large firms, in contrast, combine little more than one third of total employment, but produce over half of the economy’s value added. Low productivity and small company size increased the vulnerability of Portuguese firms during the financial and economic crisis, as SMEs were particularly hard hit. Between 2008 and 2012, the Portuguese non-financial business sector lost 15% of its jobs, with 80% of those job losses due to SMEs closing down or shrinking.

Table 3.4.2: Key indicators of SME performance in Portugal and the EU, 2014, in %

	Number of enterprises		Number of persons employed		Value added	
	PT	EU28	PT	EU28	PT	EU28
Micro	95.4	92.7	42.5	29.3	22.7	21.1
Small	3.9	6.1	20.3	20.4	22.3	18.2
Medium-sized	0.6	1.0	16.0	17.3	22.0	18.5
SMEs	99.9	99.8	78.8	67.1	67.0	57.8
Large	0.1	0.2	21.2	32.9	33.0	42.2
Total	100					

Source: European Commission, Small Business Act for Europe

Table 3.4.3: Percentage change in employment, Portugal's total business economy, 2008-2012

Change in Total Employment	Proportion of the change in total employment during the period 2008-2012 that is due to:			
	Increase in average size of large enterprises	Decrease in average size of SMEs enterprises	Decrease in the number of large enterprises	Decrease in the number of SMEs
-15.45	4.2	5.31	14.42	76.07
	100			

Source: Entrepreneurship at a glance 2015, OECD

Graph 3.4.5: Total factor productivity in Portugal



Source: The Conference Board Total Economy Database, May 2015

The misallocation of resources to less productive firms seems to be keeping firm size and overall productivity low. The large inflow of capital that resulted from the introduction of the euro was not allocated in the most efficient way across firms in Portugal. This misallocation has contributed to a fall in Total Factor Productivity (TFP) growth. In Portugal, TFP growth was relatively stable until the end of the 1990s, but in 2000 it started on a downward trend. This has resulted in lower labour productivity in the Portuguese economy compared with other Euro

area countries (see Graph 1.7). Between 1996 and 2011, TFP growth across firms became more dispersed, owing to an increase in the share of low-TFP companies. A competitive economy will tend to select the least productive firms out of the market and reallocate more production factors to the more productive ones, reducing TFP dispersal. In contrast, a higher dispersal suggests the presence of resource misallocation and policies favouring the survival of inefficient firms⁽³⁹⁾.

Size-contingent rules benefiting smaller firms and an underdeveloped financial market could have contributed to a higher TFP dispersal in Portugal. As small firms tend to be less productive than medium-sized and large ones, policies that give support to smaller firms can reduce incentives to improve productivity and allow less productive firms to stay in the market, thus driving down TFP. There is evidence that between 1996 and 2011, when TFP dispersal was increasing, SMEs in Portugal were also benefiting from size-contingent rules. An underdeveloped financial market also seems to have contributed to capital misallocation. As financial integration in the early 2000s was not accompanied by financial deepening, Portugal had a capital market which offered mainly debt against collateral as a financing alternative. With banks unwilling to extend credit to productive firms if they were already operating at their collateral constraint, funds were often directed to the less productive firms which still had non-allocated collateral. Firms that had all their collateral already locked in

⁽³⁹⁾ Gopinath et al. (2015), 'Capital Allocation and Productivity in South Europe', NBER Working Paper 21453. Banco de Portugal (2014), 'Misallocation and productivity in the lead up to the Eurozone crisis', Dias et al.

loans were left with few alternatives to extend their financing⁽⁴⁰⁾.

Policies benefiting smaller businesses but ignoring the age of a firm are unlikely to promote job creation and productivity. There is a stark difference between young and older firms as regards their potential to create employment. In Portugal, both before and after the crisis, old firms were net job destroyers, while young firms contributed to net job creation (Table 3.4.4). Moreover, Portuguese firms which have recently entered the market have shown stronger productivity growth than more mature firms⁽⁴¹⁾. Therefore, policies promoting the growth of young firms, such as better access to finance and targeting age, instead of protecting incumbents through size-specific rules, can contribute to increasing the economy's TFP. Such policies would support firms with stronger growth potential in their early years and have a more natural phasing out as firms age, thus preventing open-ended support to less productive firms.

unnecessary red tape for businesses and adopt better regulation principles, although progress is slow in certain areas and there are still implementation hurdles at local level. The regulatory burden on service providers remains high, and there are restrictions to access to some regulated professions.

Table 3.4.4: **Young and old firms' contribution to net aggregate employment growth in Portugal, 2001-2010**

		Entrant	Exit	Incumbent	Total
2001 - 2007	Young	2.4	-0.75	1.68	2.72
	Old		-2.16	-0.92	-2.91
2007 - 2010	Young	2.3	-0.79	0.96	2.47
	Old		-2.13	-1.33	-3.46

(1) By margin of adjustment, as % of aggregate non-financial business sector employment

Source: C. Criscuolo, P. N. Gal and C. Menon (2014), 'The Dynamics of Employment Growth: New Evidence from 18 Countries', OECD

Implementation of product market reforms

Product market reforms are progressing but implementation gaps remain. Despite improvements in the overall business environment and in the degree of internationalisation of SMEs in recent years, firms remain relatively small on average. Measures have been taken to cut

⁽⁴⁰⁾ Braguinsky, Branstetter and Regateiro (2011), 'The Incredible Shrinking Portuguese Firms', NBER Working Paper 17265. Reis (2013), 'The Portuguese slump and crash and the euro crisis', Brookings Papers on Economic Activity, 46 (1). IMF (2015), 'Rethinking Financial Deepening: Stability and Growth in Emerging Markets', R. Sahay et. al.

⁽⁴¹⁾ Between 2006 and 2011 TFP growth of young firms was 7% while TFP of older firms decreased (source: OECD Economic Surveys Portugal 2014).

3.5. NETWORK INDUSTRIES AND STATE-OWNED ENTERPRISES

Transport sector reforms

Portugal has made substantial progress in modernising its transport regulatory framework, but full implementation is delayed.

A new legal framework was put in place to ensure the independence of the newly established transport regulatory authority (AMT), which took on the regulatory functions of the three transport authorities (rail, ports and road). The existing staff is still too small to deal effectively with the tasks assigned to the transport regulatory authority under to the new legal framework.

Structural reforms implemented in the ports system to improve competition and cost-effectiveness are already yielding positive results, but progress regarding concessions is still limited.

In the first half of 2015, the seven main commercial ports in mainland Portugal increased their throughput by 11.2% compared with the first half of 2014. The gradual elimination of port use fees (TUP-Carga) allowed a significant downward adjustment of port operating costs in general. Between 2012 and 2014, operating costs fell by 6.3%⁽⁴²⁾. Apart from the renegotiation of the container terminal in the port of Sines whereby the concessionaire has committed to additional investments to increase capacity without any compensation, all other renegotiations remain unfinished. Their conclusion would enable a larger share of the operating cost savings resulting from the new port labour law to be passed on to port users. It would also further improve competition and encourage investment, while achieving appropriate risk-sharing and aligning incentives between port authorities and private-sector operators. There is still no general framework law providing practical guidance on port concessions although the chronogram of port sector reforms makes provision for such a law which would contribute to strengthen competition and attract new players.

The privatisation of CP Carga has been concluded, while equity operations undertaken by the shareholder and better operating performance have improved the sustainability and profitability road and rail infrastructure

manager. Achieving operational balance of the rail infrastructure manager continues to be a major railway policy objective. Some progress was made through rationalisation of costs, closure of loss-making lines and staff reductions. REFER and EP (the former rail and road infrastructure managers) are now merged into IP (Portuguese Infrastructures). The possibility of addressing REFER's legacy debt by granting IP a long-term concession including revenue sharing between the two different modes of transport is being considered. In the meantime, a mix of equity injection and debt-to-equity conversion operations have improved equity to about EUR 3 billion and halved IP's remaining debt to about EUR 6 billion. A better operating performance improved IP's profitability in 2015. Following the unbundling of freight terminals, Portugal has concluded the full privatisation of CP Carga, allowing for a more open and competitive market.

The processes of TAP privatisation and the Lisbon and Porto urban transport concessions seem to be backtracking.

Their successful completion would yield public expenditure savings while introducing competition in the market and ensuring better design and closer monitoring of public service obligations. Due to a change in political priorities, the government is now considering reversing these measures. To ensure the financial sustainability of each state-owned enterprises (SOEs) such a move could involve concrete plans to offset a potential negative fiscal impact. There is a risk of a setback in the process of moving towards a competitive urban transport market based on public tendering procedures⁽⁴³⁾.

The most necessary investments in the railway infrastructure are already under way, but installed capacity is not being used to its full potential.

Portugal is completing the East-West international connections of the Atlantic Corridor with the missing link of the Sines/Lisboa-Madrid and Aveiro-Salamanca lines under way. This is being done in the context of the Connecting Europe Facility (see box 1.3). However, railway

⁽⁴²⁾ IMT (2015) 'Movimento de Carga e de Navios nos Portos do Continente'. Amado da Silva, Cardadeiro (2015), 'Índice do Custo Direto de Utilização dos Portos'.

⁽⁴³⁾ Regulation 1370/2007 on public passenger transport services foresees the award of urban transport public service contracts through public tendering procedures by 2019 and a gradual move towards competitive award procedures during the transitional period from 2009 to 2019.

interoperability with Spain is still an issue, owing to a lack of harmonisation in the height and width of railway vehicles. A bigger coordination effort in this area would help deliver the potential of the Atlantic Corridor. Also, the deployment of the European Railway Traffic Management System in Portugal is at the planning stage and no section has been contracted so far.

Electricity tariff debt and energy infrastructure

Portugal continues to take action to improve the cross-border integration of its energy networks.

The electricity interconnection capacity with Spain was 7% of the total installed generating capacity in 2014. This would increase to 12% in 2016 due to the commissioning of the current Projects of Common Interests (PCIs). Though Portugal is on the right path regarding the level of electricity interconnections, new PCIs are considered crucial to reach the Energy Union target of 15% interconnection capacity by 2030. As regards gas markets, the development of the Iberian gas hub (MIBGAS) started in December 2015. This regional market will reduce the concentration in the national gas market, increase the efficiency of the natural gas sector and foster wholesale and retail competition.

Portugal still has a very large tariff debt implying upward pressure on electricity prices until its complete elimination.

A wholesale price higher than the price implied in the regulated tariff in the years before retail tariff liberalisation, along with rising subsidies to renewable and conventional electricity production, have led to a large tariff debt. The resulting financial burden was borne by the last resort supplier of energy, EDP, and the need for repayment might lead to an increase in consumer energy prices. The second and third packages of measures to reduce the electricity tariff debt are now being implemented, although with some delay. As a result, total debt will only start declining this year and the target for its complete elimination, initially set for 2020, is now likely to be postponed. While electricity prices for medium-size industries in Portugal fell more than the EU average in 2015, they remain above the EU average, according to Eurostat. The medium-size household's electricity prices are also among the highest in Europe, and developments in 2015 raised them by a further 4.8%, more than double the EU average which remained at 2.2%.

Taking this evolution into account when designing the path for eliminating the tariff debt could contribute to avoid substantial increases in electricity prices. Therefore, market-oriented new investments in the energy sector could improve sustainability of the energy sector by avoiding subsidisation through the tariff system.

More cost-efficient support schemes maximising market orientation would contribute to energy efficiency and renewable targets.

To allow for cost efficiency, the remuneration of any new scheme to support renewable electricity would then need to avoid overcompensation and have a cost-reflective perspective. Energy-efficiency investments can make use of market-driven financing schemes allowing firms to reduce energy use through cost-saving measures⁽⁴⁴⁾. Putting in place the right regulatory framework, namely by transposing the European Directives on energy efficiency and buildings' performance would facilitate the leveraging of private investment.

The waste and water sectors and environmental policy

Despite the new political orientation to the waste, water and sewerage sector, the overall goal of the recent structural reforms undertaken does not seem at risk.

The reform implemented over the past few years included revision of the legal and the regulatory framework. This strengthened the regulatory authority's powers and independence and aligned the objectives stakeholders' objectives. While the state-owned waste management enterprise (EGF) was fully privatised after setting new strategic goals and revising the scope of its concessions under the new regulatory framework, the water and sewerage bulk activities have gone through operational restructuring by merging 19 SOEs into five with the aim of increasing operational efficiency and bringing about investment rationalisation in these capital-intensive sectors. Benefiting from cross-

⁽⁴⁴⁾ A recent study shows that for four sectors (food & beverages; energy, power & utilities; environmental technologies; construction) the savings that would strengthen SMEs competitiveness could amount to EUR 882 million in Portugal – *RPA (2015): Assessing the Potential Cost Savings and Resource Savings of Investments in 4 SME sectors, report for DG Environment, February 2015, Loddon, Norfolk, UK, p.30.*

subsidisation between systems in densely populated urban coastal areas and innermost regions, the new coast-to-interior regional SOEs ensure full cost recovery of the services provided while reducing the average tariff, applying of polluter-pays principle and managing natural resources sustainably, in line with EU directives. The solution found addressed challenges arising from the build-up of significant arrears and the accumulated tariff debt caused by annual increases in the tariff below those for which the original concession contracts made provision. While the new government will allow municipalities that opposed the mergers to opt out, it is committed to the second stage of the reform, merging municipal retail management services and promoting the integration of bulk and retail activities. This strategy will allow for tariff harmonisation and benefit from both economies of scale and scope stemming from the mergers and higher synergies in the value chain.

The national green growth strategy launched in 2015 sets quantitative targets and prescribes the measures to reach them by 2020 and 2030. As highlighted in box 1.3. — ESIF — Europe 2020 has sustainability and efficiency in the use of resources as a key theme. In a joint initiative with economic stakeholders, the authorities adopted the Green Growth Commitment (‘Compromisso para o Crescimento Verde’) in April 2015. This green growth strategy is comprehensive in scope, comprising an extensive range of measures designed to reach its quantitative targets for 2020 and 2030. The strategy is also a positive and promising step to encourage a transition to a more resource -efficient, green and low-carbon economy in Portugal. It is now essential to implement the numerous measures it includes, namely those addressing considerable challenges Portugal faces in terms of water and waste management and air quality.

Policy developments in network industries and state-owned enterprises

A modernised regulatory framework is being set up in the transport sector, but full staffing of the regulatory authority remains a challenge. Planned investments are being deployed, and the pending renegotiation of port concessions expiring after 2020 will further enhance the positive impact on competition and cost-effectiveness that the

structural reforms implemented in the port’s sub-sector are having. Despite positive developments over the last few years, the sustainability of state-owned enterprises is not yet ensured as the reversal of some privatisations and urban transport concessions is exerting further fiscal pressure. In this context, the impact of the policy shift proposed by the new government needs further assessment, also in terms of competition. In the energy sector, better integration with the rest of Europe remains a priority. The very large electricity tariff debt will only start declining this year and further action may be required, should the target become unattainable to fully clear the tariff by 2020. Market-oriented instruments to incentivise investments in the sector would contribute importantly to the sustainability electricity sector. Amid signs of some backtracking in the first stage of the water and sewerage sector reforms, the second stage is set to start. Maintaining sustainability and efficiency in the use of resources remain a key challenge for this sector.

3.6. THE ROLE OF STRUCTURAL FUNDS

Re-launching investment in Portugal is crucial after the significant decline experienced during the economic crisis. Portugal is one of the Member States where investment fell most during the economic crisis, and investment is the component of GDP which recorded by far the highest decline in Portugal. Between 2005-2007 and 2012-2014, investment contracted by about 41% in real terms, compared with a 7% decline in the euro area as a whole. Construction investment now accounts for around 5.5% of GDP, broadly in line with the EU average. However, the share of investment in equipment, at 5% of GDP, is still 2 percentage points of GDP below its pre-crisis level, suggesting an investment gap of around EUR 4 bn in Portugal.

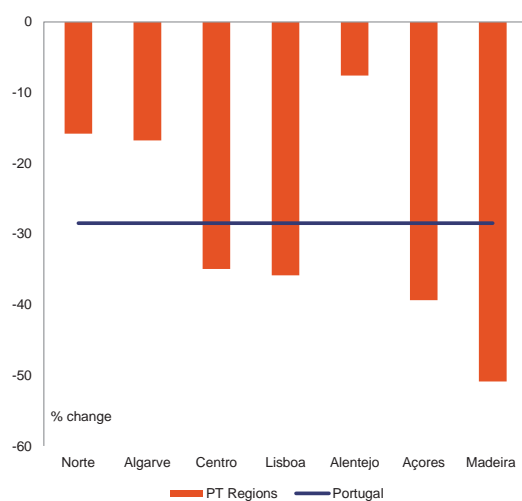
Table 3.6.1: **Total investment and GDP (2005-2007 average compared with the 2012-2014 average)**

	Rest of the euro area	Portugal
Investment	-7.0%	-41.0%
GDP	2.9%	-5.1%

Source: European Commission

The fall in investment has been uneven across Portugal's regions. Between 2000 and 2011, the decline ranged from over 40% in the two outermost regions, the Azores and Madeira, to under 20% in Norte, Alentejo and the Algarve.

Graph 3.6.1: **Change in total investment by region, 2000-2011**



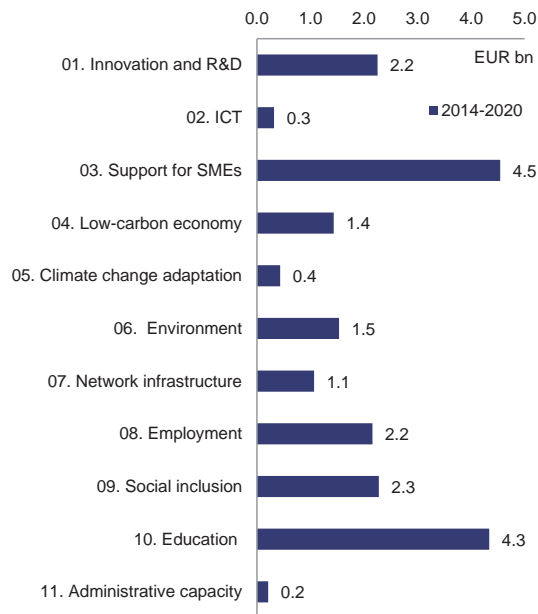
Source: European Commission

European cohesion policy has provided, in relative terms, a higher support in bad economic times, thus playing a counter-cyclical role. Since 2000, about EUR 47 bn (in 2010 prices) have been invested in Portugal through the Structural Funds (ERDF and ESF) and the Cohesion Fund. The share of the cohesion policy in total public investment varied considerably before the crisis, while it has increased dramatically in recent years, mostly because of the decline in public investment financed by the national and local budgets. From 30% in 2010, it rose to a peak of 121% in 2013.

The Partnership Agreement for the 2014-2020 programming period covers investment priorities that go beyond traditional infrastructure. They include human capital and the related social investment. The Agreement covers investment of over EUR 25.6 bn. 44% of the cohesion policy funds (ERDF, ESF and the Cohesion Fund) will be allocated to education, social inclusion and employment measures, while some 41% will be invested in innovation, ICT, support for SMEs and promoting a low-carbon economy (see box 1.3 for further details). The rest will be invested in network infrastructure, the environment and adaptation to climate change. By comparison with the previous programming period, investment in innovation, R&D, ICT, support for SMEs, and the low-carbon economy has increased significantly at the expense of the other categories, notably network infrastructure. This revamped allocation of the funds is fully in line with the objectives of rebalancing the Portuguese economy towards a higher share of the tradable sectors while also alleviating some of the adverse effects of economic adjustment on the most vulnerable sections of the population.

Additional investment targeting the most productive sectors could support growth and development. As the Partnership Agreement also states, Portugal can make full use of existing EU funds to support economic and social development investing in traditional infrastructure only where absolutely necessary. Investment in infrastructure would in this case need to be closely scrutinised and existing needs, planning and financial sustainability carefully assessed. (see box 1.3).

Graph 3.6.2: Allocation of funds, broken down by Portugal's thematic objectives, 2014-2020



(1) Excluding technical assistance

Source: European Commission, Partnership Agreements

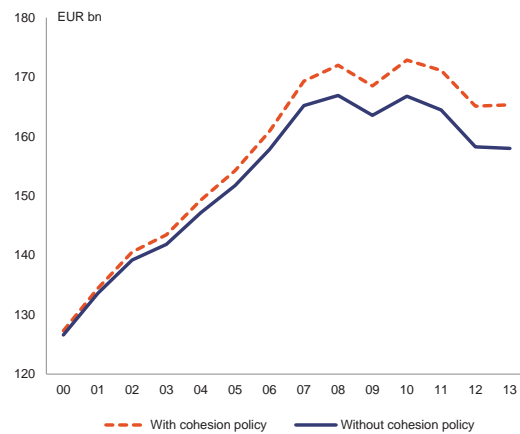
EU funds are believed to have had a significant impact on GDP, especially in the medium and long term. QUEST model simulations suggest that Portugal's GDP in 2015 was around EUR 9 bn higher than it would have been without the European cohesion policy funds invested in the country since 2000. Being a strong structural policy, designed to strengthen the supply side of the economy rather than the demand side, this impact is expected to be even higher in the years to come

Quality management and efficient use of EU funds in Portugal are important to improve the country's investment environment. EU structural funds account for a significant share of public investment⁽⁴⁵⁾ during the 2014-2020 programming period. Portugal could use this funding to SMEs in their investments to modernise, expand their portfolio of products and services and gain new markets, especially internationally if the right support mechanisms (in particular financial) are fully implemented. Closer links between research,

⁽⁴⁵⁾ The contribution made by cohesion funds amounted to 1.75% of GDP in 2014, almost equalling total public investment (2% of GDP in 2014).

innovation and businesses, together with training policies, could also play an important role in responding better to labour market needs.

Graph 3.6.3: Portugal's GDP, with and without cohesion policy investment, 2000-2013



(1) Simulations with QUEST

Source: European Commission

3.7. EDUCATION, RESEARCH AND INNOVATION

Education system and policy reforms

Portugal has significantly reduced its early school leaving rate, but the number of pupils repeating an academic year is increasing and school performance is not improving. According to OECD's PISA 2012 performance results, progress by Portuguese students started slowing down in 2009. The national programme launched in 2012 to improve school performance is now completed with the introduction of a new monitoring tool in 2013/14. Since 2009, Portugal has almost halved its early school leaving rate (from 30.9% to 17.4%) but pupils repeating an academic year has reached maximum rates since 2004 with a 50% increase between 2011 and 2014, currently at 5%, 11.4% and 13.3% respectively from the first to the third education cycle. According to the 2015 OECD skills diagnosis report on Portugal, repeating an academic year is too commonly used despite having been proved ineffective, costly for the system and reinforcing inequalities. Portugal provides continuous support to tailor-made school-based programmes to address school failure among socially disadvantaged children. For example, TEIP programmes (educational territories of priority intervention) give additional support to schools with a high percentage of disadvantaged students, covering 16% of schools. However, the socioeconomic condition of families continues to play a decisive role in students' performance and the increase in poverty among the most disadvantaged groups is an obstacle to the policies put in place to tackle school failure. Recruitment of fewer teachers over the past five years due to budget constraints has led to a significant fall in the total teacher numbers, and has contributed to an increase in the average age of teachers. More than 30% of the teaching force is over 50 with 41% in public education. Participation in early childhood education and care has proven an effective mean to prevent academic failure. However, following a significant increase in early childhood education and care enrolment rates, the last two years showed a reversing trend, with a 2.6 pp decrease between 2012 and 2014 of the number of children in early education. This was mostly due to a decrease in average family income and fewer available places for early childhood education and care offered by public providers.

Portugal's tertiary education attainment rate for 30-34 year-old has increased significantly over the past 10 years. It reached 31.3% in 2014, but is still below the EU average of 37.9% and challenges in terms of quality are emerging. According to the Commission's 2015 Bologna implementation report, completion rates in higher education have fallen by 19 pp since 2008 (the biggest decrease in Europe). According to Hays global skills index 2015, businesses report serious problems in matching job seekers with unfilled jobs. Unemployment among graduates, at 26.4%, is lower than the average rate for youth unemployment at 35%. Only the big universities in the urban centres could fill up to 90% of available places in 2014/2015, while smaller universities attracted low numbers of students. Poor professional career prospects and low wages create incentives for highly qualified young people to emigrate. The government is supporting the creation of regional clusters, as a way of rationalising the range of courses offered, making better use of the available resources and encouraging the exchange of best practices. An internationalisation strategy has been put in place to increase the potential for Portuguese universities to attract talents from abroad. The government has also set up a flagship short-cycle higher technical courses initiative (*TeSP*) designed to promote the link between higher education and the business sector and to attract students and businesses to higher education. They propose a strong technical and vocational component and include on-the-job training.

Stronger cooperation between universities and businesses remains a challenge to increase the employability of graduates in all sectors and foster innovation. The Portuguese academic and university representatives assess the barriers to university-business cooperation as being some of the highest in Europe. The biggest barriers identified are the lack of either public or private funding and excessive red-tape. University governance and finance systems and the academics career path do not provide a favourable environment to foster university-business cooperation. Academics claim a lack of awareness about the different cooperation modalities and universities consider that businesses are the only beneficiaries of these efforts. On the other hand, businesses often lack absorption capacity and perceive universities as being too bureaucratic to

invest in. Portugal does not count on a comprehensive strategy to address those economic and institutional barriers and no measures have been taken, or are anticipated, to provide incentives for academics engaged in cooperation with industry⁽⁴⁶⁾.

Portugal has increased substantially the enrolment rates in vocational education and training (VET) over the past four years, while taking steps towards improving its labour market relevance. Enrolment in apprenticeships increased by 60% between 2011 and 2014 and in 2015 the enrolment in the new TeSP courses increased almost seven times compared with the previous year. Yet the number of modalities provided by the VET programmes (i.e. different options/tracks for students and parents to choose from based on different education objectives), remains broad and includes overlaps playing against students' awareness and financial efficiency. For example, in 2015, the VET system provided in lower secondary education eight different modalities with different entry requirements; in upper secondary education 15 different VET modalities and in post-secondary and tertiary the TeSPs and CET (technological specialization courses) run simultaneously. The 2015 OECD skills diagnosis report sets the need for Portugal to make the VET system more coherent, better communicated and better aligned to the needs of the labour market, mainly by strengthening the work based learning component and streamlining the programmes offered. Related to structural policy measures, Portugal has introduced the '*Cheque Formação*' (training check) that allows students to set their own training path and fulfilment their training needs form a lifelong learning perspective.

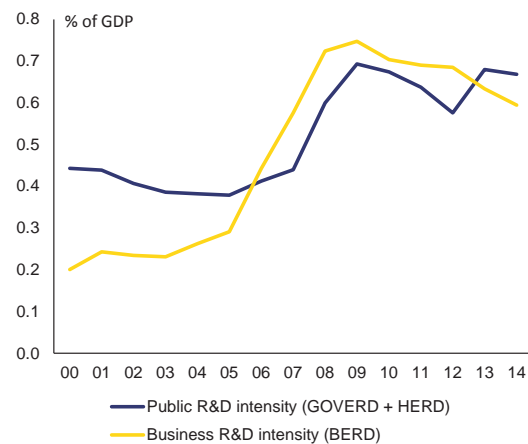
The research and innovation system

While the overall Research and Innovation system is expanding, investment in R&D has been falling mostly affected by a decline in business R&D. Portugal has strongly expanded its research and innovation system (R&I) from a very

⁽⁴⁶⁾ The State of University-Business Cooperation in Portugal (2013), European Commission, DG EAC and Research and Innovation Observatory Country Report Portugal 2014, JRC Science and Policy Report.

low base. For example, R&D investments increased from 0.72% of GDP in 2000 to 1.58 in 2009 and highly cited publications (publications in the 10% most-cited scientific publications worldwide) rose from 6.3 in 2000 to 9.37 in 2010. However, R&D intensity has been decreasing since 2009, moving away from the EU average (PT: 1.29%, EU: 2.03% in 2014). Due to the need for public deleveraging, public R&D investments started to fall in 2010: the trend in business R&D has also been downward since then. This trend is largely driven by a lack of innovation-friendly framework conditions for business R&I investment in Portugal and by weak and fragmented incentives for cooperation between science and business.

Graph 3.7.1: Trends in business R&D intensity and public R&D intensity, 2000-2014



(1) Business R&D intensity: Business enterprise expenditure on R&D (BERD) as % of GDP.

(2) Public R&D intensity: Government intramural expenditure on R&D (GOVERD) plus higher education.

(3) Public R&D intensity: Break in series between 2008 and the previous years.

Note: The soft recovery (from 0.58% in 2012 to 0.67% in 2014) showed on the graph is due to a break in series.

Source: European Commission

Leveraging business R&I through science-business cooperation remains a key challenge.

Portugal has shown significant progress over time in building its R&I capacity in terms of its human resource base. The country has significantly increased both the number of people with tertiary education and the number of science and engineering graduates. The share of the population aged 30-34 who have completed tertiary education increased from 11.3% in 2000 to 31.3% in 2014. The percentage of new graduates in science and engineering per 1 000 population aged 25-34 were

6.5% in 2000 and 18.7% in 2013. This development has had a positive impact on Portugal's scientific production and level of scientific excellence. However, the country remains well below the EU average in science-business cooperation and in the commercialisation of knowledge⁽⁴⁷⁾. It ranks low in public-private scientific co-publications per million population (PT: 15; EU: 50). The low level of public R&I financed by the private sector in relation to Portugal's overall level of business R&I investment is an indication that if the country wishes to foster science-business links, far-reaching reforms would still be necessary. At the same time, the institutional framework does not include incentives to foster cooperation between academia and industry. As private sector experience is not valued, academics have low incentives to follow dual careers or to engage in cooperation with industry. Moreover, companies remain focused on low knowledge-intensive activities and the absorption rate of knowledge produced in universities and public research organisations is very low. These factors limit the contribution of the science base to economic growth.

Innovation performance remains below the EU average hampering the transition to a more knowledge-intensive economy. According to the Innovation Union Scoreboard 2015, Portugal is a 'moderate innovator'. It performs below the EU average for most indicators of innovation and business involvement in innovation⁽⁴⁸⁾, which suggests a lack of innovation-friendly framework conditions. Furthermore, Portugal lags significantly behind in taking advantage of the opportunities of the digital economy with low broadband adoption, low internet use and low numbers of consumers shopping online or using online banking⁽⁴⁹⁾. This significantly hampers the

country's ability to fully derive value from online transactions. The structure of the economy, in particular the predominance of low- and medium-technology production sectors, means that medium- to high-tech goods contribute less to the trade balance and that knowledge intensive activities and fast-growing innovative firms account for a smaller share of employment⁽⁵⁰⁾. Furthermore, 52% of the population and 45% of the labour force have low digital skills or none at all⁽⁵¹⁾, which underlines the importance of encouraging the development the competences for needed for the digital economy and promoting digital inclusion and regular internet use. One specific important policy challenge for Portugal is therefore to ensure that the business environment is investment-friendly and capable of supporting the creation and scaling-up of fast-growing firms in innovative sectors so as to enable structural change towards a more innovation-driven economy.

Policy incentives for cooperation between public research and businesses remain weak and scattered. Portugal has relatively few PhDs employed in the business sector. Public support to R&I can come from reinforcing existing tools, such as the recent Innovation Agency (AdI) and the scheme for PhDs studentships in industry. A partnership between AdI and the business association for innovation (COTEC) was launched to encourage cooperation between research, academia and business, but no tangible results are visible so far. Besides this initiative, the country does not have a comprehensive strategy in place to address the economic and institutional barriers to science business cooperation. Initiatives such as the system of tax incentives for companies investment in R&D (SIFIDE II) and the new role of Portugal Ventures, the public venture capital

⁽⁴⁷⁾ Portugal ranks low in public-private scientific co-publications per million population (PT: 15; EU: 50). Portugal also has 0.67 PCT patents per billion GDP, well below the EU average (3.78) (Innovation Union Scoreboard 2015).

⁽⁴⁸⁾ License and patent revenues, SMEs product/ process innovations, exports in medium and high-tech products, exports in knowledge intensive services, R&D business expenditure, non-R&D innovation expenditures, and innovative SMEs collaborating with others.

⁽⁴⁹⁾ In Portugal in 2015, only 61% of households subscribed to fixed broadband (EU: 72%) and there were only 46 mobile broadband subscription per 100 people (EU: 75). (c.f. DESI

2016). In 2015, 28% of the Portuguese population had never used the internet (EU: 16%), and only 65% of the population used the internet at least once per week (EU: 76%). (c.f. DESI 2016). In 2015, 44% of Portuguese internet users shopped online (EU: 65%) and 41% used online banking (EU: 57%). (c.f. DESI 2016).

⁽⁵⁰⁾ The value added in high-tech manufacturing as % of total value added for Portugal is 0.6 while for the EU is 1.75. The share of employment in high-growth enterprises for Portugal is 7.55% while for the EU is 9.14%.

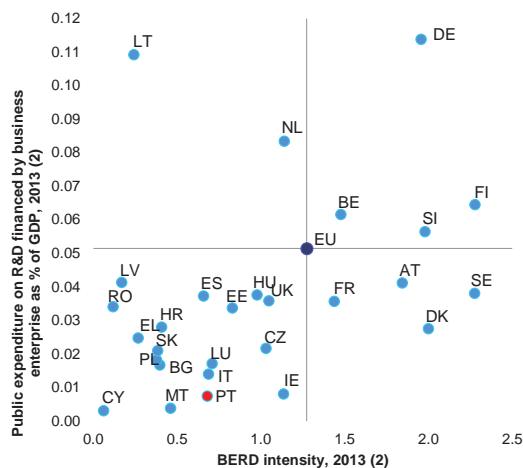
⁽⁵¹⁾ Digital Economy and Society Index – DESI 2016, Digital Agenda Scoreboard.

organisation, are also expected to help improve Portugal's productivity, competitiveness, and structural change towards a more knowledge-based economy.

businesses remain a barrier to improvements in the country's innovation performance and competitiveness.

Portugal has allocated 32.4% of its structural funds for core R&D activities and assistance to R&I. This is a significant change if compared with 11.4% in the previous programming period. Adequate roll out of its smart specialisation strategy will be instrumental in addressing these challenges, since the strategy focuses resources on areas in which Portugal has relative economic strengths. Portugal approved the conditions and requirements for the recognitions of competitiveness clusters in March 2015. This follows a recent evaluation on the effectiveness of cluster policy which concluded that the policy is still too dependent on European support programmes and lacks a systemic approach and clear definition of the governance model.

Graph 3.7.2: **Public expenditure on R&D financed by business enterprise as % of GDP versus BERD intensity**



(1) Public expenditure on R&D financed by business enterprise does not include financing from abroad.

(2) BE, AT: 2011; DE, IE, FR, IT, CY, PT, EU: 2012.

Source: European Commission

Portugal is expanding its R&I system and improving education outcomes, but innovation performance and the skills of the workforce remain low. Enrolment in vocational and education training has been increasing and monitoring of school outcomes is improving. However, the low skill level of the labour force and the weak links between universities and

ANNEX A

Overview Table

Commitments

Summary assessment⁽⁵²⁾

2015 Country specific recommendations (CSRs)	
<p>CSR1: Ensure a durable correction of the excessive deficit in 2015 by taking measures as necessary. Achieve a fiscal adjustment of 0,6% of GDP towards the medium-term budgetary objective in 2016. Use windfall gains to accelerate the deficit and debt reduction. Enforce the commitment control law to better control expenditure. Improve the medium-term sustainability of the pension system. Safeguard the financial sustainability of state-owned enterprises. Further improve tax compliance and the efficiency of the tax administration.</p>	<p>Portugal has made some progress in addressing CSR 1 (this overall assessment of CSR 1 excludes an assessment of compliance with the Stability and Growth Pact):</p> <p>There has been some progress on enforcing the commitment control law as arrears have continued to fall. In the health sector, however, underbudgeting by hospitals continues to prevent arrears from falling faster.</p> <p>There has been some progress towards making the pension system more sustainable in the medium-term. In the short to medium term, public finances are under pressure as the current contributions to the public pension systems cover less than 75% of the pension-related expenditure. There has been limited progress in developing new comprehensive measures as part of the ongoing pension reform.</p> <p>However, some previously decided measures are starting to have positive effects on medium and long-term sustainability such as the movable old-age pension that depends on life expectancy at the age of 65. The statutory retirement age, set at 66 in 2015, will now rise each year by 2/3 of the increase in life expectancy measured two years previously. The sustainability factor introduced in the calculation mechanism that determines the amount of early retirement pension entitlements has also started to contribute to medium- and long-term sustainability. The S1 indicator of fiscal sustainability reveals that there is a high risk in the medium term (6.4) relating mainly to the debt requirement.</p> <p>There has been some progress concerning the financial sustainability of state-owned enterprises (SOEs). As a result of rationalisation measures and mergers between companies, the operating</p>

⁽⁵²⁾ The following categories are used to assess progress in implementing the 2015 country-specific recommendations of the Council Recommendation: No progress: The Member State has neither announced nor adopted any measures to address the country-specific recommendation. This category also applies if a Member State has commissioned a study group to evaluate possible measures. Limited progress: The Member State has announced some measures to address the country-specific recommendation, but these measures appear insufficient and/or their adoption/implementation is at risk. Some progress: The Member State has announced or adopted measures to address the country specific recommendation. These measures are promising, but not all of them have been implemented yet and implementation is not certain in all cases. Substantial progress: The Member State has adopted measures, most of which have been implemented. These measures go a long way in addressing the country-specific recommendation. Fully addressed: The Member State has adopted and implemented measures that address the country-specific recommendation appropriately.

	<p>performance of SOEs has been improving. Equity operations carried out by the state have also strengthened several companies' financial position. Partial reversal of the privatisation of the air carrier TAP may imply additional fiscal risks. Cancelling the award of urban transport concessions in Lisbon and Porto will have an immediate fiscal impact during 2016, as the savings these concessions were supposed to deliver will not materialise. Political choices in the transport sector will need to go hand-in-hand with measures to ensure that these SOEs are financial sustainable.</p> <p>There has been some progress on improving tax compliance and making the tax administration more efficient. The planned integration of local tax offices into the Aproximar programme is under way. Measures are being taken to combat tax fraud in the housing market, improve arrangements for sharing information with financial institutions, and strengthen Portugal's anti-money-laundering framework.</p>
<p>CSR2: Promote the alignment of wages and productivity, in consultation with the social partners and in accordance with national practices, taking into account differences in skills and local labour market conditions as well as divergences in economic performance across regions, sectors and companies. Ensure that developments relating to the minimum wage are consistent with the objectives of promoting employment and competitiveness.</p>	<p>Portugal has made some progress in addressing CSR 2:</p> <p>Some progress on promoting the alignment of wages and productivity. The most recent data available show that wage developments have been moderate and in line with productivity over a medium-term horizon. Collective bargaining at sectoral level has been supportive of this process. However firm-level bargaining is not picking up, potentially limiting the scope for wage differentiation according to the dimensions mentioned in the CSR.</p> <p>No progress as regards the minimum wage. It was further increased in January 2016 from EUR 505 to EUR 530, in a context of low inflation and high unemployment, putting upward pressures on the overall wage structure with the risk of affecting employment and competitiveness perspectives.</p>
<p>CSR3: Improve the efficiency of public employment services, in particular by increasing outreach to non-registered young people. Ensure effective activation of benefit recipients and adequate coverage of social</p>	<p>Portugal has made some progress is addressing CSR 3:</p> <p>Some progress has been made in increasing</p>

<p>assistance, in particular the minimum income scheme.</p>	<p>outreach to non-registered young people but challenges in its implementation still persist. A broad network of partners engaged in the implementation of the Young Guarantee has been set to reach out to young people aged under 30 and not in employment, education or training (NEET). Another positive step has been the creation of a Youth Guarantee online platform where NEETs can register.</p> <p>Some progress has been made in improving the efficiency of the public employment services through a reinforced performance management and an ongoing shift towards digital services. While partnerships with municipalities, training organisations and social economy actors are well developed, there has been limited progress in binding partnerships with private employment services. The two pilot projects of partnership with private employment services in Lisbon and Porto have been delayed and a tender procedure has yet to be launched.</p> <p>There has been some progress in ensuring adequate coverage of social assistance, in particular through the minimum income scheme. There have been changes to the eligibility criteria of the minimum income scheme which may extend its coverage. Further measures in this area include an increase in child benefits, including for single parents households. No new specific measures have been taken on activation for minimum income scheme recipients.</p>
<p>CSR4: Take further measures to reduce the corporate debt overhang, to address the corporate non-performing loans ratio in banks and to reduce the debt bias for corporates under tax provisions. Improve the efficiency of debt restructuring tools for viable companies by introducing incentives for banks and debtors to engage in restructuring processes at an early stage.</p>	<p>Some progress has been made on reducing the corporate debt overhang and allowing the private sector to deleverage. This includes the well advanced implementation of the corporate deleveraging strategy, which includes the revamping of the PER and SIREVE insolvency tools and changes in the tax treatment of debt financing. However, at close to 190% of GDP Portugal's private sector is one of the most highly indebted in the EU. Moreover, access to credit remains costly and difficult for businesses, in particular SMEs. Therefore, there is still the need to continue to pay attention to the problem of high indebtedness and to encourage the banking sector to raise capital in order to be able to clean its balance sheet from the high burden of corporate non-performing credit.</p>

<p>CSR5: Accelerate measures and increase transparency as regards concessions, including in the transport sector, and private- public partnerships at local and regional level.</p>	<p>Limited progress has been made on transparency. A revised framework for public-private partnerships (PPPs) entered into force on 1 June 2012. The government has renegotiated several road PPPs. In most cases, the Court of Auditors has already expressed its view that no prior approval is required for the changes to be effective. As regards water concessions at local level and railway PPPs, the Court of Auditors expressed a negative opinion of the way the state had managed the contracts. Existing legislation does not empower UTAP, the Ministry of Finance's taskforce for PPPs, to cover concessions, regional and local PPPs or even central government PPPs/concessions in the water/sewerage/waste businesses (or any concession given to SOEs by law in an in-house relationship). The authorities are aware of these loopholes and agree there is a need to find a solution. However, no concrete suggestions or timeline has yet been proposed.</p>
<p>Europe 2020 (national targets and progress)</p>	
<p>Employment rate target (20-64 years old):75%</p>	<p>67.6% (2014). It has increased compared to 2013 (65.4%) after having fallen steadily since 2008, but remains well below the national target for 2020.</p>
<p>R&D target: 2.7% of GDP</p>	<p>No progress towards the target. Portugal set a national R&D intensity target for 2020 of 3%, where public-sector R&D intensity would reach 1% and business R&D intensity 2%.</p> <p>From 2000 up to the crisis years, Portugal made very significant progress towards the R&D intensity target. However, R&D intensity has been falling in Portugal since 2009 (1.58%) to 1.29% in 2014. Public sector R&D intensity is 0.67% and business R&D intensity 0.62%.</p>
<p>Greenhouse gas (GHG) emissions target: -National Greenhouse gas (GHG) emissions target: 1% in 2020 compared to 2005 (in non-ETS sectors)</p>	<p>According to the latest national projections and taking into account existing measures, it is expected that the target will be achieved: -25% in 2020 compared with 2005 (with a margin of 26 percentage points).</p>
<p>2020 Renewable energy target for Portugal: 31% Share of renewable energy in all modes of transport: 10%</p>	<p>In 2014, the renewables' share of gross final energy consumption attained 27% (over 50% in electricity), and therefore Portugal seems to be on track to reach its 31% target in 2020. However, there is a lack of effort in heating and</p>

	cooling and transport. With 3.43% share of renewable energy sources in transport, Portugal is lagging substantially behind the binding 10% renewable energy source target in transport.
<p>Energy Efficiency target.</p> <p>Portugal has set an indicative national energy efficiency target of 25% reduction of final energy consumption in 2020, which implies reaching a 2020 level of 22.5 Mtoe primary consumption and 17.4 Mtoe final energy consumption.</p>	Portugal is on track to reach its 2020 energy efficiency target. The target could have been set at a more ambitious level, as the final energy consumption is higher than the forecasted GDP development from 2014 to 2020.
Early school leaving target: 10%	The share of early school leavers was 17.4% in 2014. There has been some progress compared to 2013 (18.9%). However, the rate of early school leaving remains among the EU's highest.
Tertiary education target: 40%	31.3% (2014). There has been some improvement compared to 2013 (30%). However, attainment remains below the EU average.
Risk of poverty or social exclusion target: the target envisages reducing the number of person in or at risk of poverty and social exclusion by 200 000 persons in 2020.	The number of people at risk of poverty or social exclusion rose by 170 000 between 2010 and 2014. In spite of a decrease by 16 000 people between 2013 and 2014, the national target for 2020 remains far from reach.

ANNEX B

MIP scoreboard

Table B.1: **The MIP scoreboard for Portugal**

			Thresholds	2009	2010	2011	2012	2013	2014
External imbalances and competitiveness	Current account balance, (% of GDP)	3 year average	-4%/6%	-10.8	-10.9	-8.9	-6.0	-2.2	0.0
	Net international investment position (% of GDP)		-35%	-107.9	-104.3	-100.7	-113.4	-115.7	-113.3
	Real effective exchange rate - 42 trading partners, HICP deflator	3 years % change	±5% & ±11%	1.0	-3.1	-3.0	-4.0	-0.6	-1.8
	Export market share - % of world exports	5 years % change	-6%	-8.2	-7.0	-8.2	-16.2	-6.8	-4.7
	Nominal unit labour cost index (2010=100)	3 years % change	9% & 12%	6.6	4.2	-0.6	-6.3	-3.4	-2.3e
Internal imbalances	Deflated house prices (% y-o-y change)		6%	1.0	-1.0	-6.5	-8.7	-2.7	3.6
	Private sector credit flow as % of GDP, consolidated		14%	5.3	5.3	-0.9	-2.8	-3.6	-8.7
	Private sector debt as % of GDP, consolidated		133%	204.2	201.5	204.1	209.6	201.4	189.6
	General government sector debt as % of GDP		60%	83.6	96.2	111.4	126.2	129.0	130.2
	Unemployment rate	3 year average	10%	9.5e	10.5e	11.9	13.6	15.0	15.4
	Total financial sector liabilities (% y-o-y change)		16.5%	8.9	11.5	-4.5	-4.1	-4.8	-6.1
New employment indicators	Activity rate - % of total population aged 15-64 (3 years change in p.p)		-0.2%	-0.2	-0.2	-0.3b	0.0	-0.7	-0.4
	Long-term unemployment rate - % of active population aged 15-74 (3 years change in p.p)		0.5%	0.2e	2.0e	2.1b	3.0	3.0	2.2
	Youth unemployment rate - % of active population aged 15-24 (3 years change in p.p)		2%	4.1e	6.8e	8.6	12.7	9.9	4.5

e: estimated.

(1) Figures highlighted are those falling outside the threshold established in the European Commission's Alert Mechanism Report. For REER and ULC, the first threshold applies to euro area Member States.

Source: European Commission

ANNEX C

Standard Tables

Table C.1: **Financial market indicators**

	2010	2011	2012	2013	2014	2015
Total assets of the banking sector (% of GDP)	310.6	325.4	330.8	302.5	270.4	253.7
Share of assets of the five largest banks (% of total assets)	70.9	70.8	69.9	70.3	69.2	-
Foreign ownership of banking system (% of total assets)	22.2	21.4	20.6	19.4	20.3	-
Financial soundness indicators:						
- non-performing loans (% of total loans) ¹⁾	5.2	7.5	9.8	10.6	11.9	12.6
- capital adequacy ratio (%) ¹⁾	10.3	9.8	12.6	13.3	12.3	12.4
- return on equity (%) ¹⁾	7.5	-5.5	-5.4	-11.0	-17.9	6.0
Bank loans to the private sector (year-on-year % change)	1.7	-3.3	-6.0	-5.0	-5.2	-2.5
Lending for house purchase (year-on-year % change)	3.5	-0.5	-2.8	-3.5	-3.8	-3.8
Loan to deposit ratio	123.9	116.1	119.5	111.4	105.0	99.6
Central Bank liquidity as % of liabilities	8.9	9.7	11.7	11.6	8.1	7.1
Private debt (% of GDP)	201.5	204.1	209.6	201.4	189.6	-
Gross external debt (% of GDP) ²⁾ - public	55.5	58.4	80.5	85.9	97.6	93.0
- private	36.5	40.9	43.2	44.0	47.1	45.8
Long-term interest rate spread versus Bund (basis points)*	265.3	763.3	905.3	472.4	259.1	192.8
Credit default swap spreads for sovereign securities (5-year)*	253.0	772.8	818.7	355.8	173.0	137.4

1) Latest data in Q2 2015.

2) Latest data in September 2015. Monetary authorities, monetary and financial institutions are not included.

* Measured in basis points.

Source: IMF (financial soundness indicators); European Commission (long-term interest rates); World Bank (gross external debt); Eurostat (private debt); ECB (all other indicators).

Table C.2: Labour market and social indicators

	2010	2011	2012	2013	2014	2015 ⁽⁴⁾
Employment rate (% of population aged 20-64)	70.3	68.8	66.3	65.4	67.6	69.0
Employment growth (% change from previous year)	-1.4	-1.9	-4.1	-2.9	1.4	1.2
Employment rate of women (% of female population aged 20-64)	65.6	64.6	63.0	62.3	64.2	65.8
Employment rate of men (% of male population aged 20-64)	75.4	73.2	69.8	68.7	71.3	72.4
Employment rate of older workers (% of population aged 55-64)	49.5	47.8	46.5	46.9	47.8	49.7
Part-time employment (% of total employment, aged 15 years and over)	11.9	13.6	14.6	14.3	13.1	12.5
Fixed term employment (% of employees with a fixed term contract, aged 15 years and over)	22.8	22.0	20.5	21.4	21.4	21.9
Transitions from temporary to permanent employment	29.6	28.8	26.3	24.0	27.2	-
Unemployment rate ⁽¹⁾ (% active population, age group 15-74)	12.0	12.9	15.8	16.4	14.1	12.7
Long-term unemployment rate ⁽²⁾ (% of labour force)	6.3	6.2	7.7	9.3	8.4	7.3
Youth unemployment rate (% active population aged 15-24)	28.2	30.2	38.0	38.1	34.7	31.9
Youth NEET ⁽³⁾ rate (% of population aged 15-24)	11.4	12.6	13.9	14.1	12.3	-
Early leavers from education and training (% of pop. aged 18-24 with at most lower sec. educ. and not in further education or training)	28.3	23.0	20.5	18.9	17.4	-
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	24.0	26.7	27.8	30.0	31.3	-
Formal childcare (30 hours or over; % of population aged less than 3 years)	32.0	34.0	34.0	36.0	-	-

(1) Unemployed persons are all those who were not employed but had actively sought work and were ready to begin working immediately or within two weeks.

(2) The long-term unemployed are people who have been unemployed for at least 12 months.

(3) Not in education, employment or training.

(4) Average for the first three quarters of 2015. Data for total unemployment and youth unemployment rates are seasonally adjusted.

Source: European Commission (EU Labour Force Survey).

Table C.3: Labour market and social indicators (continued)

Expenditure on social protection benefits (% of GDP)	2009	2010	2011	2012	2013	2014
Sickness/healthcare	7.0	6.7	6.1	6.2	6.2	-
Invalidity	2.0	2.0	2.0	1.8	2.0	-
Old age and survivors	12.4	12.6	13.4	13.7	14.6	-
Family/children	1.4	1.3	1.2	1.2	1.2	-
Unemployment	1.3	1.4	1.3	1.7	1.8	-
Housing and social exclusion n.e.c.	0.0	0.0	0.0	0.0	0.0	-
Total	24.5	24.4	24.2	24.9	26.1	-
of which: means-tested benefits	2.5	2.4	2.1	2.2	2.2	-
Social inclusion indicators	2009	2010	2011	2012	2013	2014
People at risk of poverty or social exclusion ⁽¹⁾ (% of total population)	24.9	25.3	24.4	25.3	27.5	27.5
Children at risk of poverty or social exclusion (% of people aged 0-17)	28.7	28.7	28.6	27.8	31.7	31.4
At-risk-of-poverty rate ⁽²⁾ (% of total population)	17.9	17.9	18.0	17.9	18.7	19.5
Severe material deprivation rate ⁽³⁾ (% of total population)	9.1	9.0	8.3	8.6	10.9	10.6
Proportion of people living in low work intensity households ⁽⁴⁾ (% of people aged 0-59)	7.0	8.6	8.3	10.1	12.2	12.2
In-work at-risk-of-poverty rate (% of persons employed)	10.3	9.7	10.3	9.9	10.5	10.7
Impact of social transfers (excluding pensions) on reducing poverty	26.3	32.2	29.1	29.2	26.7	27.0
Poverty thresholds, expressed in national currency at constant prices ⁽⁵⁾	4726	4997	4777	4565	4364	4372
Gross disposable income (households; growth %)	-0.4	2.8	-3.7	-3.6	-0.2	0.8
Inequality of income distribution (S80/S20 income quintile share ratio)	6.0	5.6	5.7	5.8	6.0	6.2

(1) People at risk of poverty or social exclusion (AROPE): individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI).

(2) At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60% of the national equivalised median income.

(3) Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.

(4) People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20% of their total work-time potential in the previous 12 months.

(5) For EE, CY, MT, SI and SK, thresholds in nominal values in euros; harmonised index of consumer prices (HICP) = 100 in 2006 (2007 survey refers to 2006 incomes).

Source: For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table C.4: Structural policy and business environment indicators

Performance indicators	2009	2010	2011	2012	2013	2014
Labour productivity (real, per person employed, y-o-y)						
Labour productivity in industry	-0.32	7.29	2.10	1.02	0.68	-1.58
Labour productivity in construction	-2.08	-2.74	3.61	7.03	3.26	2.73
Labour productivity in market services	0.26	2.00	1.96	1.95	1.89	-2.29
Unit labour costs (ULC) (whole economy, y-o-y)						
ULC in industry	1.59	-3.28	-0.99	-1.31	0.25	3.07
ULC in construction	3.74	4.96	-1.51	-4.06	-2.00	-3.00
ULC in market services	0.63	0.34	-1.49	-2.37	-0.41	1.20
Business environment	2009	2010	2011	2012	2013	2014
Time needed to enforce contracts ⁽¹⁾ (days)	577	547	547	547	547	547
Time needed to start a business ⁽¹⁾ (days)	4.5	4.5	4.5	3.5	3.5	2.5
Outcome of applications by SMEs for bank loans ⁽²⁾	0.92	0.83	1.13	1.24	0.71	0.68
Research and innovation	2009	2010	2011	2012	2013	2014
R&D intensity	1.58	1.53	1.46	1.38	1.33	1.29
Total public expenditure on education as % of GDP, for all levels of education combined	5.79	5.62	5.27	4.94	na	na
Number of science & technology people employed as % of total employment	23	24	27	29	30	33
Population having completed tertiary education ⁽³⁾	13	14	16	17	18	20
Young people with upper secondary level education ⁽⁴⁾	56	59	65	68	70	72
Trade balance of high technology products as % of GDP	-2.16	-2.00	-1.72	-1.60	-1.55	-1.60
Product and service markets and competition				2003	2008	2013
OECD product market regulation (PMR) ⁽⁵⁾ , overall				2.12	1.69	1.29
OECD PMR ⁽⁵⁾ , retail				3.29	3.97	1.83
OECD PMR ⁽⁵⁾ , professional services				na	3.08	2.92
OECD PMR ⁽⁵⁾ , network industries ⁽⁶⁾				3.09	2.55	2.18

(1) The methodologies underpinning this indicator, including the assumptions, are shown in detail here:

<http://www.doingbusiness.org/methodology>.

(2) Average of responses to question Q7B_a. '[Bank loan]: If you applied for and tried to negotiate this type of financing during the past six months, what was the outcome?'. Answers were codified as follows: zero if the respondent was granted exactly what they applied for, one if most of it was granted, two if a limited part of it was granted, three if their application was refused or rejected. If the respondent replied that the application was still pending or that they didn't know what had happened, the response was codified as a missing value.

(3) Percentage of the population aged 15-64 having completed tertiary education.

(4) Percentage of the population aged 20-24 having attained at least upper secondary education

(5) Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail here: <http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm>

(6) Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).

Source: European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators); SAFE (for outcome of SMEs' applications for bank loans).

Table C.5: **Green growth**

Green growth performance		2009	2010	2011	2012	2013	2014
Macroeconomic							
Energy intensity	kgoe / €	0.16	0.15	0.15	0.15	0.15	-
Carbon intensity	kg / €	0.47	0.43	0.43	0.43	0.43	-
Resource intensity (reciprocal of resource productivity)	kg / €	1.31	1.20	1.13	1.08	0.96	0.96
Waste intensity	kg / €	-	0.11	-	0.09	-	-
Energy balance of trade	% GDP	-2.8	-3.4	-4.2	-4.7	-3.7	-3.5
Weighting of energy in HICP	%	10.92	11.68	12.73	13.79	8.59	7.86
Difference between energy price change and inflation	%	1.3	4.5	6.6	10.9	2.6	1.7
Real unit of energy cost	% of value added	16.1	16.1	16.1	-	-	-
Ratio of labour taxes to environmental taxes	ratio	5.2	5.2	5.7	5.9	6.5	6.4
Environmental taxes	% GDP	2.4	2.4	2.3	2.2	2.2	2.3
Sectoral							
Industry energy intensity	kgoe / €	0.23	0.22	0.21	0.20	0.19	-
Real unit energy cost for manufacturing industry	% of value added	36.4	36.4	36.4	-	-	-
Share of energy-intensive industries in the economy	% GDP	7.94	8.36	8.09	7.90	7.78	-
Electricity prices for medium-sized industrial users	€ / kWh	0.09	0.09	0.10	0.11	0.11	0.12
Gas prices for medium-sized industrial users	€ / kWh	0.03	0.03	0.04	0.04	0.04	0.04
Public R&D for energy	% GDP	0.02	0.02	0.02	0.02	0.02	0.02
Public R&D for environment	% GDP	0.03	0.03	0.03	0.03	0.03	0.04
Municipal waste recycling rate	%	39.2	38.0	41.1	45.6	49.5	-
Share of GHG emissions covered by ETS*	%	37.7	34.2	36.1	36.8	37.7	37.9
Transport energy intensity	kgoe / €	1.20	1.14	1.09	1.03	1.04	-
Transport carbon intensity	kg / €	3.10	2.90	2.72	2.52	2.52	-
Security of energy supply							
Energy import dependency	%	81.4	75.1	77.7	78.9	73.5	-
Aggregated supplier concentration index	HHI	19.0	20.0	27.5	27.6	28.0	-
Diversification of energy mix	HHI	0.33	0.35	0.32	0.29	0.31	-

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2005 prices)

Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)

Carbon intensity: greenhouse gas emissions (in kg CO₂ equivalents) divided by GDP (in EUR)

Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR)

Waste intensity: waste (in kg) divided by GDP (in EUR)

Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP

Weighting of energy in HICP: the proportion of "energy" items in the consumption basket used for the construction of the HICP

Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)

Real unit energy cost: real energy costs as a percentage of total value added for the economy

Environmental taxes and labour taxes : from European Commission, 'Taxation trends in the European Union'

Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR)

Real unit energy costs for manufacturing industry: real costs as a percentage of value added for manufacturing sectors

Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP

Electricity and gas prices for medium-sized industrial users: consumption band 500–20 00MWh and 10 000–100 000 GJ; figures excl. VAT.

Municipal waste recycling rate: ratio of recycled municipal waste to total municipal waste

Public R&D for energy or for the environment: government spending on R&D (GBOARD) for these categories as % of GDP

Proportion of greenhouse gas (GHG) emissions covered by EU Emission Trading System (ETS): based on greenhouse gas emissions (excl land use, land use change and forestry) as reported by Member States to the European Environment Agency

Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2005 EUR)

Transport carbon intensity: greenhouse gas emissions in transport activity divided by gross value added of the transport sector

Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels

Aggregated supplier concentration index: covers oil, gas and coal. Smaller values indicate larger diversification and hence lower risk.

Diversification of the energy mix: Herfindahl index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels

* European Commission and European Environment Agency

Source: European Commission (Eurostat) unless indicated otherwise.