EUROPEAN
COMMISSION

Brussels, 27.2.2019
SWD(2019) 1021 final

COMMISSION STAFF WORKING DOCUMENT

Country Report Portugal 2019
Including an In-Depth Review on the prevention and correction of macroeconomic imbalances

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN CENTRAL BANK AND THE EUROGROUP

2019 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011

{COM(2019) 150 final}

CONTENTS

LIST OF TABLES

LIST OF GRAPHS

LIST OF BOXES

EXECUTIVE SUMMARY

A positive economic performance combined with past reforms is enabling Portugal to address its structural challenges ([1]). The current economic expansion has facilitated strong job creation, contributing to a sizeable reduction in unemployment. Public and private debt has also been reduced. However, they remain too high, and there has been little progress in correcting imbalances, including low productivity and high liabilities with foreign creditors. Portugal's policies in areas such as education, skills, innovation, the business environment and access to finance are helping to address these challenges, but a sustained commitment to reform is required.

Economic performance is moderating with growth expected to slacken. GDP growth is expected to slacken as the impact from the volatile international environment dampens exports and private investments. However, domestic demand is projected to remain strong in the short term helped by further improvement on the labour market and an accelerated use of EU funds. Robust job creation continues, although it was slowing down in 2018, amid moderate wage growth.

Portugal continues to correct its macroeconomic imbalances. Although all main indicators are moving in the right direction, public and private sector debt and foreign debt are still significantly above the benchmarks set. This continues to have a negative impact on the country's external position, where the pace of adjustment is expected to slow down. The decline in non-performing loans (or 'bad' loans) along with the improved profitability is reducing the balance of risks in the banking sector. Imbalances in the labour market have been corrected and the main risks are now insufficient skills and low productivity.

Public finances have continued improving, while strongly relying on higher revenue, declining interest expenditure and relatively low public investment. Higher revenue, lower interest expenditure and relatively low levels of public investment have contributed to further improvements in the headline and structural public deficits, while the structural balance excluding interest expenditure has remained broadly stable. The current economic expansion and favourable financing conditions allow for further reductions in the structural deficit to ensure a sustainable budgetary position over the medium term. This strengthens the case for the government to contain overall expenditure growth and use gains from windfall revenue and lower interest expenditure to reduce public debt faster.

Higher public and private investment in innovation, upskilling, resource efficiency, transport infrastructure and modern employment policies would strengthen the long-term sustainable growth potential of Portugal. The country has one of the lowest investment rates in the EU. Insufficient maritime and railway connections make it difficult for export-oriented businesses to fully benefit from the potential of the single market. Research and development investment has recently regained strength but remains insufficient to upgrade the Portuguese national research and innovation system. Investments in resource efficiency would contribute to achieving long-term sustainable growth. The low qualification level of workers is an obstacle to investment and productivity growth. Using the full potential of the labour force also requires reinforcement of public employment services and effective active labour market policies. People's lack of digital skills hinders their inclusion in society and their employability and reduces the potential for higher productivity. Annex D identifies key priorities for support by the European Regional Development Fund, the European Social Fund Plus and the Cohesion Fund over 2021-2027, building on the analysis of investment needs and challenges outlined in this report.

([1]) This report assesses Portugal's economy in light of the European Commission's Annual Growth Survey published on 21 November 2018. In the survey, the Commission calls on EU Member States to implement reforms to make the European economy more productive, resilient and inclusive. In so doing, Member States should focus their efforts on the three elements of the virtuous triangle of economic policy — boosting investment, pursuing structural reforms and ensuring responsible fiscal policies. At the same time, the Commission published the Alert Mechanism Report (AMR) that initiated the eighth round of the macroeconomic imbalance procedure. The AMR found that Portugal warranted an in-depth review, which is presented in this report.

Portugal has made some (2) progress in addressing the 2018 country specific- recommendations.

There has been some progress in the following areas.

- Promoting an environment conducive to hiring on permanent contracts, including by reviewing the legal framework in consultation with employers and trade unions.
- Increasing the skills level of the adult population, as well as the number of people in higher education.
- Increasing the efficiency of insolvency and recovery proceedings, reducing impediments to the secondary market for the resale of non-performing loans, and improving access to finance for businesses.
- Improving the efficiency of administrative courts and reducing administrative burden.

There has been limited progress in the following areas.

- Strengthening expenditure control, cost effectiveness and adequate budgeting in the health sector. Improving the financial sustainability of state-owned enterprises, in particular by increasing their overall net income and reducing their debt.

There has been no progress in the following area.

- Removing persistent regulatory restrictions by ensuring a proper implementation of the framework law for highly regulated professions.

Regarding progress in reaching the national targets under the Europe 2020 strategy, Portugal is making good progress in reaching its targets for renewable energy and greenhouse gas reduction. There has been significant progress in raising the employment rate, which currently stands above the target of 75 %. Further progress was made in 2017 in lowering the school drop-out rate ("early school leaving") but is still above the target of 10 %. Significant challenges remain to achieve the targets for research and development investment, higher education attainment and poverty reduction.

The Social Scoreboard accompanying the European Pillar of Social Rights highlights some challenges for Portugal. While the recent labour market performance marked a significant improvement in employment and unemployment rates, income inequality remains high and the effectiveness of social transfers (other than pensions) in reducing poverty remains limited. Moreover, despite a recent improvement, the high proportion of early leavers from education and training points to challenges in education. On the positive side, Portugal continues to have one of the highest rates of participation in formal childcare for children under 3 years old, although with a decrease in 2017, and it is still difficult to find childcare in some areas of the country.

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

- **External adjustment remains insufficient**. The correction of flow imbalances has been partially based on cyclical factors. The recent reversal in the current account points to a slowdown in external adjustment. A more substantial adjustment could be achieved through gains in competitiveness, benefitting both the current account balance and GDP growth.
- **The country's high public debt has started to decrease, and further growth-friendly fiscal consolidation would help to keep it steadily declining.** The ratio of public debt to GDP started decreasing in 2017 and is projected to decline further between 2018 and 2020, albeit at a slower pace. Continued fiscal consolidation and progress with growth-enhancing structural reforms are key to strengthening Portugal's fiscal sustainability. It therefore remains essential to ensure adequate budgeting and effective spending control across all government sectors, in combination with decisive measures to tackle the persistently high hospital arrears and improve the financial

(2) Information on the level of progress and actions taken to address the policy advice in each respective subpart of a CSR is presented in the Overview Table in the Annex A.

sustainability of state-owned enterprises and the pension system. This could be complemented by a clear top-down focus on containing overall spending and deploying a comprehensive strategy for medium-term public administration reform, while making the tax system and public expenditure more growth-friendly.

- **Private debt is steadily going down but still remains too high.** Household and corporate debt ratios are declining but are still beyond the estimated country-specific prudential thresholds and are weighing on investments and potential growth. However, the exposure to risk is mainly in the corporate sector, which still accounts for the largest share of non-performing loans.

- **Portuguese banks have steadily reduced their stock of non-performing loans while keeping their capital broadly stable.** Banks' profitability has also improved, which mainly reflects lower impairments. All major banks in the system have now accessed the secondary market for non-performing loans and are managing their stock of bad assets actively. However, the quality of assets is still low compared to those of banks in other Member States of the euro area. Therefore, it is essential Portugal continues its efforts to reform the insolvency framework and tackle various other legal bottlenecks to deal with non-performing loans.

- **Strong job creation has led to a significant improvement in employment indicators.** The labour market continued to improve during 2018, though at a decelerating pace. The unemployment rate dropped below 7 % in the fourth quarter of 2018, well below the euro area average, and in line with pre-crisis levels. Long-term unemployment decreased to 3 % and it is now close to the EU average (2.9 %). Youth unemployment is also declining, but is still sizeable compared to the EU average. On the back of these trends, the number of people looking for work has shrunk, while remaining sizeable, and there are indications of labour supply shortages in certain market segments. Yet, there is room to get more people into the labour market, especially in view of pronounced population ageing.

- **Low worker productivity is a key challenge for improving competitiveness and potential growth.** Worker productivity is still restrained by insufficient investment and structural rigidities in the product and labour markets, including a high share of low-skill employees and labour market segmentation. A significant proportion of small businesses is having difficulties growing, in part due to the heavy regulatory and taxation footprint and difficulties in accessing finance and capital. On the positive side, there are signs that credit and investment are increasingly being channelled to specific sectors, especially tradable sectors where there is a greater potential for growth and higher productivity.

Other key structural issues analysed in this report, which point to particular challenges for Portugal's economy, are the following:

- **Amidst a favourable economic cycle, increases in the minimum wage do not seem to have hampered job creation among low-skill individuals so far.** The minimum wage was raised to EUR 580 in 2018 and again to EUR 600 in 2019. During 2018, employment creation has been strong also among low-skilled workers, although overall job creation has decelerated. The minimum wage is now among the highest in the EU relative to the national median wage. The resulting narrowing in the differences in wages deserves monitoring, as it decreases the education premium, i.e. the difference in earnings between the more and the less highly educated, and therefore potentially reduces the incentive to upgrade lower skill levels.

- **An improved labour market has not helped to tackle the high share of temporary contracts, although new measures are on the table to reduce it.** A tripartite agreement was reached in June 2018 to reduce labour market segmentation through an action plan to tackle precariousness and promote collective bargaining. However, measures have not been legislated yet. While strictly limiting fixed-terms contracts can help to reduce labour market segmentation, there is a risk that such contracts negatively affect investment and job creation, particularly in seasonal sectors, such as tourism-related services. Boosting the capacity of the labour inspectorate may help to tackle the misuse of temporary contracts by employers.

- **Poverty and inequality continue to improve on the back of an improving labour market.** With improved labour conditions, the share of people at risk of poverty or social exclusion decreased in 2017 and is now below pre-crisis levels. However, the rate of poverty among those who are in work remains above the EU average. With the exception of pensions, social transfers are not effective in lifting people out of poverty. The improved labour market also seems to be behind the mild improvement in income inequality, which remains significantly above the EU average.

- **Various programmes are aiming to upgrade education and skills.** The Portuguese workforce has low qualifications. Digital skills are a particular challenge, with 50 % of the Portuguese population lacking basic digital skills compared to an EU average of 43 % (European Commission, Digital Scoreboard). Early school leaving decreased in 2017, but is still above the EU average. Progress in these areas follows from policies that have improved the vocational, educational and training system, launched programmes to enhance digital skills, and introduced measures to increase higher education enrolment. While the share of higher education graduates is increasing overall (from a low level), the number of graduates in information and communication technologies remains low.

- **Less administrative burden and greater judicial efficiency are improving the business environment, while regulatory restrictions are still holding back competition.** The SIMPLEX+ programme is Portugal's main policy tool to help reduce administrative burden, but is not as efficient in addressing barriers in specific sectors, particularly when it comes to licensing. Regulations are restricting some professional business services more than the EU average and are a significant barrier to competition. Various measures are in place to improve judicial efficiency. Overall, the justice system is becoming more efficient but is facing critical challenges with disposition time (i.e. the time it takes to hand down a decision) and the backlog of cases, which are both too high. Shortcomings in planning and monitoring of public procurement hinder competition.

- **Bottlenecks in the innovation system are affecting Portugal's productive specialisation and hindering structural change.** After various years of decline, the share of research and development expenditure over GDP increased recently. In parallel, some export sectors have been able to increase their technology intensity and policy support to start-ups is improving. Nonetheless, Portugal remains specialised in low and medium-low technology sectors, with multiple challenges constraining its ability to tap into knowledge-intensive sectors. Insufficient links between academia and business hinder the effectiveness of the innovation system. Policies are being deployed to improve the working conditions and employability of scientific professionals, promote investment in intangible assets, and raise digital skills.

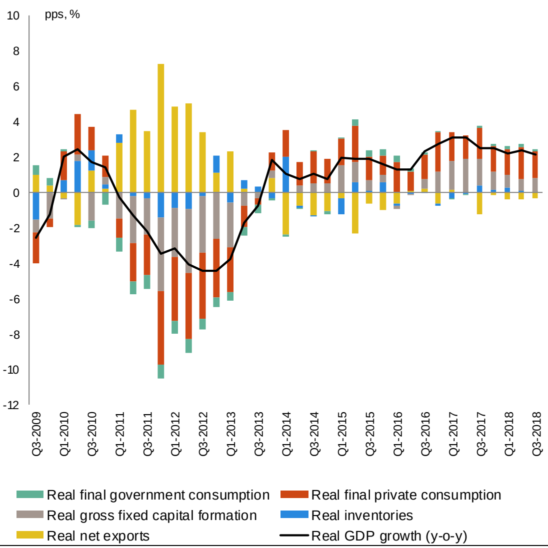
- **Energy prices in Portugal are above the EU average and there is room for greater investment and better internal and external connectivity of the Iberian Peninsula.** Energy prices in Portugal are above the EU average, mainly due to the relatively high level of taxation. Further cooperation with Spain and France is fundamental for developing key energy infrastructure projects. The transport infrastructure's development would benefit from higher investment in maritime port infrastructure, and greater integration of the railway system with Spain.

1. ECONOMIC SITUATION AND OUTLOOK

GDP growth

GDP growth slowed to 2.1 % in the third quarter of 2018 mainly due to weaker external demand. Household consumption growth in the third quarter of 2018 eased to 2.3 % year-on-year in line with some moderation in job creation and consumer credit growth. A significant deceleration in durable goods consumption indicates a normalization path in private consumption developments. Gross fixed capital formation growth accelerated slightly to 4.3 % year-on-year in the third quarter of 2018, driven by stronger equipment purchases, while construction investment remains weak. As broadly expected, external trade growth continues to lose momentum, particularly in terms of services, leading to a negative net external trade contribution to growth. According to the Commission latest forecast, economic growth is estimated to moderate further in the fourth quarter of 2018, mainly reflecting the slowdown in external demand and full-year growth is projected at 2.1 %.

Graph 1.1: **Contributions to real GDP growth**



Source: Eurostat

The moderate slowdown is forecast to continue over the medium term driven by lower external trade and higher uncertainty. The slowdown in job creation points to some further deceleration in household spending, which would be only partly offset by moderate increase in wage growth. The household savings rate, which deteriorated in the second quarter of 2018 reflecting improvements in the financial situation and still very low interest rates, is expected to stabilise in 2019 and 2020. Private consumption growth is therefore forecast to weaken to 2.0 % and 1.8 % in 2019 and 2020. Investment is set to rebound somewhat in 2019, as the implementation of certain projects supported by EU structural funds scheduled for 2018 was postponed. Net external trade is expected to increase its negative contribution to growth in 2019, reflecting weaker export demand and solid import growth in line with still robust domestic demand evolution. GDP growth is expected to stabilise at 1.7 % in both 2019 and 2020. The trend reflects a move towards the estimated potential growth and negative impacts from the less dynamic external environment on exports. Risks to growth appear on the downside, as the increased global uncertainty could have a negative spill-over effect on business investment decisions.

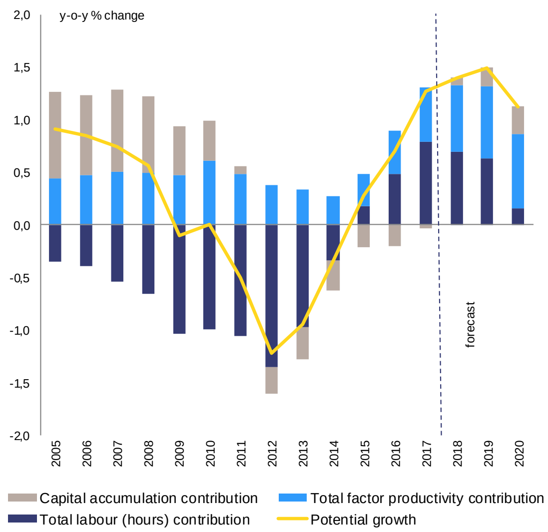
Export growth slows but its share in GDP continues rising. The positive cycle in tourism and the automotive industry expansion kept exports growing above global trade volumes, leading to an increase in Portugal's global market share between 2015 and 2017, forecast to continue also in 2018. However, export growth is expected to weaken with the maturing of the cycle and the deterioration in the global outlook. The growth pattern in tourism is also expected to change somewhat as the number of overnight stays is stabilising while travel revenues remain dynamic.

Potential growth

Potential growth converges towards the euro area average. The strong economic performance in the country over the past years has been partly driven by the economic cycle but potential growth has also improved significantly. According to the Commission 2018 autumn forecast, potential growth is already identical to the EU average at 1.6 % in 2018 and 1.7 % in 2019. This indicates a significant improvement from the trough of -1.3 % in 2012. The positive economic development over the past years has stabilised the country's per capita income relative to the EU average in the range of 77-78 % but is still insufficient to bring a noticeable convergence. The medium-term outlook, based on potential growth estimates, shows that the income gap is likely to remain broadly stable unless a further structural improvement is achieved.

Job creation turns into a major contributor to potential growth. Since 2014, employment growth has generated the largest contribution to output and its importance has been particularly strong since 2016 (see Graph 1.2). Total factor productivity has also contributed substantially, but less so in 2017 and 2018. High public and private debt, including a large share of non-performing loans, have constrained the contribution of capital accumulation, which has moved from negative values by 2017 to neutral in 2018 and is estimated to be only slightly positive over the forecast period. The extent of further deleveraging is thus set to remain an important limiting factor to growth in the medium term along with the more negative demographic situation in Portugal relative to the EU average. While employment growth has been quite strong recently, the deterioration in demographic trends is already weakening the prospects of improving potential growth through job creation. This is further raising the importance of increasing labour productivity in order to bridge the income gaps vis-à-vis more advanced Member States.

Graph 1.2: **Contributions to potential growth**

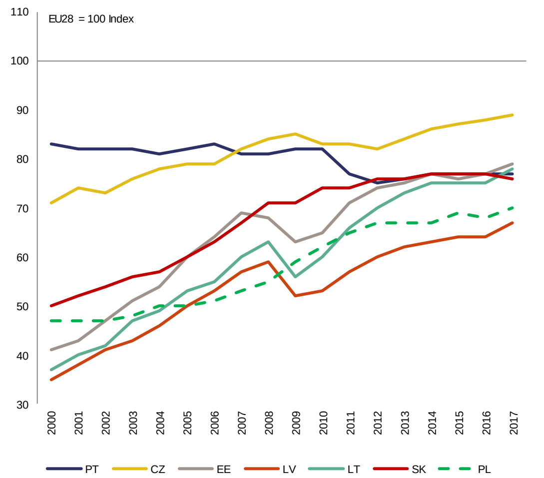


Source: European Commission

Regional disparities

Portugal has diverged from the EU average in terms of GDP per capita over the last 10 years. During the years before the crisis, the GDP per head in Purchasing Power Standards has fluctuated slightly above 80 % of the EU average but declined after bottoming down at 75 % in 2012. Since 2013, data show a slight rebound, however insufficient to recover the ground lost, as Portugal was at 76.7 % of the EU average in 2017, nearly five percentage points lower than the pre-crisis period of 82 % in average. Thus, in terms of per-capita-income Portugal is still a long way off (see Graph 1.3) and has not improved over the last two decades, in particular compared to the Baltics or the Visegrád countries.

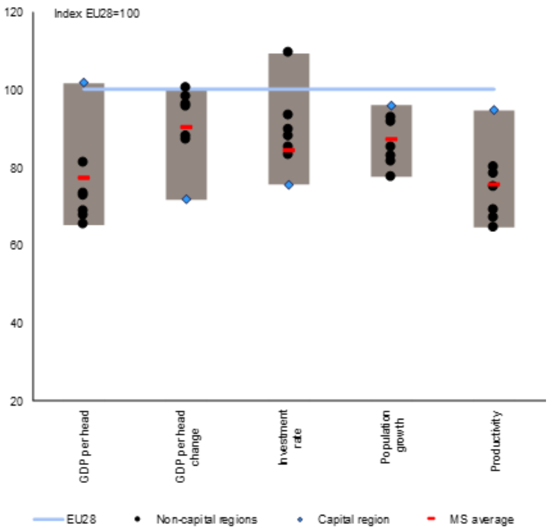
Graph 1.3: **GDP per capita in PPP**



Source: Eurostat

GDP per capita ranges from 102 % of the EU average in Lisbon to 65 % in the Norte region. At a lower level of disaggregation (Nomenclature of Territorial Units for Statistics III), differences are higher, ranging from 109 % of Alentejo Litoral to 48.5 % of Tamega and Sousa. Overall, the regional differentiation is more pronounced between the capital region and the rest of the country, and between the coast and the interior of the country. Despite a slow recovery since 2013, investment levels in Portugal remain low in all regions. When considering the period 2009-2016, the highest decline was registered in the Autonomous Region of Madeira (-58 %) while the region Norte, standing out in terms of the openness of its economy, and the capital region, have witnessed a decline of investment more limited than the rest of the country.

Graph 1.4: **Regional Convergence in Portugal**



GDP per head in PPS (2016); change in GDP per head (2011-2016); Investment as % of GDP (average 2010-2015); population growth (2010-2016); Productivity as GVA per person employed (2016).
Source: Eurostat, European Commission

Inflation

Despite the increase in energy prices, inflation remains low. Inflation experienced significant volatility on monthly basis in 2018 driven by accommodation prices and a significant rebound in energy prices. Nevertheless, the year-average inflation remained low at 1.2 % and is projected to increase only marginally to 1.6 % by 2020. Core inflation stood below the headline rate in 2018 but is expected to increase at a slightly faster pace over the forecast period, as service prices are expected to pick up in line with more dynamic wage developments. Following a two-year period of acceleration, house prices moderated somewhat from an annualised growth rate of 12.2 % in Q1-2018 to 11.2 % in Q2-2018 and 8.5 % in Q3-2018. This follows an annual average growth of 9.2 % in 2017. The recent statistics on construction volumes, along with the slowdown in tourism, indicate that supply of real estate properties is likely to gradually catch up with demand.

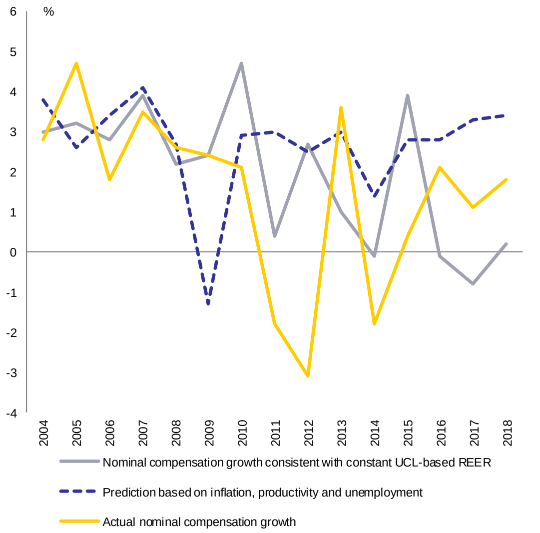
Labour market

Strong job creation continues, accompanied by a significant fall in unemployment. Unemployment rate level kept declining to an annual average of 7 % in 2018, a rate not observed since 2003. Employment growth has been rapid, with an annual rate of more than 3 % in 2017 (doubling the average growth rate observed between 2014 and 2016) and decelerated to 2.1 % in the year to the third quarter of 2018. Unemployment has consistently fallen faster than expected based on observed economic growth (European Commission, 2018a), pointing to a particularly job rich recovery, while regional disparities are limited. Meanwhile, the activity rate has been inching up since the start of the recovery reaching 81 % in the third quarter of 2018. As a reflection of labour market improvements, migration inflows surpassed outflows for the first time since 2010. Nonetheless ageing population and low birth rates represent a challenge for the labour market in the medium to long term (see Section 4.3.1).

Many permanent jobs were created, but the share of temporary contracts held steady. Job creation continued both for permanent and temporary contracts in 2017 and 2018. Despite the creation of about 78 000 permanent jobs during the year to the third quarter of 2018 (age 20-64), the share of workers with temporary contracts decreased only by 0.1 percentage points from 2016 to reach 21.6 % in Q3-2018, still among the highest in the EU. Meanwhile, the share of self-employed workers (without employees) in total employment continued decreasing (to 10.7 % in 2017, against 14.9 % in 2012).

Wages are expected to grow at a rate of about 2 % in 2018 and 2019. After years of moderation, nominal compensation growth returned to a pace close to 2 % in 2016 and kept steady since. According to the European Commission's Autumn Forecast, the growth rate of nominal compensation per employee is expected to be 1.8 % in 2018 and 2.1 % in 2019. This wage growth is still slower than what could be expected based on the historical relationship between nominal compensation growth and inflation, productivity and unemployment in the EU (see Graph 1.5). At the same time, it implies a slight appreciation of the real effective exchange rate (based on unit labour costs), an indicator of external cost competitiveness. There are many reasons behind the appreciation, including low productivity growth, wage moderation in other euro area Member States, as well as a relatively strong euro.

Graph 1.5: **Nominal compensation growth: actual and predicted based on economic fundamentals**



Source: Eurostat, European Commission

Social developments

Poverty and social exclusion indicators continue to improve on the back of the employment recovery. The at-risk-of-poverty or social exclusion rate has decreased from 25.1 % in 2016 to 23.3 % in 2017, more than 4 percentage points below the peak reached in 2014 and below pre-crisis levels. This is related to a drop in the share of severely materially deprived people and in the percentage of people living in low work intensity households (now below the EU average). The at-risk-of poverty rate (a measure of relative poverty) is also decreasing, from 19 % to 18.3 % thanks to improving income conditions of people at the bottom of the earnings distribution. National data point to a continuing fall in both rates in 2018 (income year 2017), respectively to 21.6 % and 17.3 %; an improvement in the latter is also suggested by Eurostat flash estimates ([3]). Still, improved labour market conditions are not leading to a significant reduction in the in-work poverty risk which only declined by 0.1 percentage points to 10.8 % in 2017 (against an EU average of 9.6 %; more details in Section 4.3.2). The effectiveness of social transfers (except pensions) in lifting people out of monetary poverty remains low (see Section 4.3.2).

Income inequality has been declining in recent years but remains above the EU average. In 2017, the ratio of incomes earned by the top 20 % to the bottom 20 % of the income distribution (the S80 / S20 ratio or income quintile ratio, measured after taxes and transfers) decreased from 5.9 to 5.7, down from a peak of 6.2 in 2014, but significantly higher than the EU average of 5.1. The recent improvement was mostly driven by an increase in the share of income earned by the lowest part of the distribution, possibly related to improving labour market conditions, the impact of recent minimum wage increases on lower incomes and improved adequacy of some benefits. At the same time, the Gini coefficient ([4]) slightly decreased from 33.9 in 2016 to 33.5 in 2017, and is now below pre-crisis levels but above the EU average (30.3). Wealth indicators (e.g. the Gini coefficient of net wealth or the share of net wealth owned by the wealthiest 10 % households, as measured by European Central Bank) are close to the euro area average.

External position and competitiveness

The country's net international investment position (NIIP) ([5]) remains a significant source of vulnerability. At -104.9 % of GDP at the end of 2017, it is one of the largest in the EU and goes beyond the estimated prudential and fundamentally-explained thresholds, which stand at -48 % and -26 % ([6]) respectively. At the same time, the current account is projected below the estimated benchmark of 2.4 % for closing the gap to the net international investment position

([3]) https://ec.europa.eu/eurostat/web/experimental-statistics/income-inequality-and-poverty-indicators

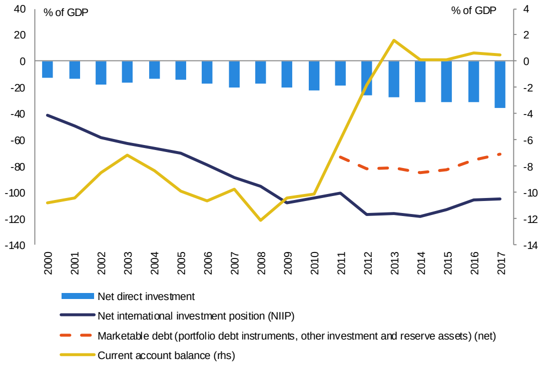
([4]) The Gini coefficient ranges between 0 and 100. Lower values indicate higher equality.

([5]) Net international investment position is defined as the difference between the country's external financial assets and liabilities.

([6]) The country-specific prudential threshold denotes the NIIP level beyond which the risk of an external crisis becomes relatively high. The NIIP level explained by fundamentals represents the NIIP that would result if a country had run its current account in line with fundamentals since 1995. For details regarding the estimation of NIIP benchmarks see Turrini and Zeugner (2018). For details regarding the estimation of current accounts based on fundamentals, see Coutinho et al. (2018)

prudential level over a 10-year ([7]). On the positive side, the structure of the net international investment position has improved at a faster rate over the past years due to increased inflows of foreign direct investment. The net international investment position excluding non-defaultable instruments is estimated at -60.9 % of GDP at end-2017, improving from -66.5 % a year earlier. The ratio of net external debt to GDP is also improving but remains high.

Graph 1.6: **Current Account and Net International Investment Position**



Source: Eurostat

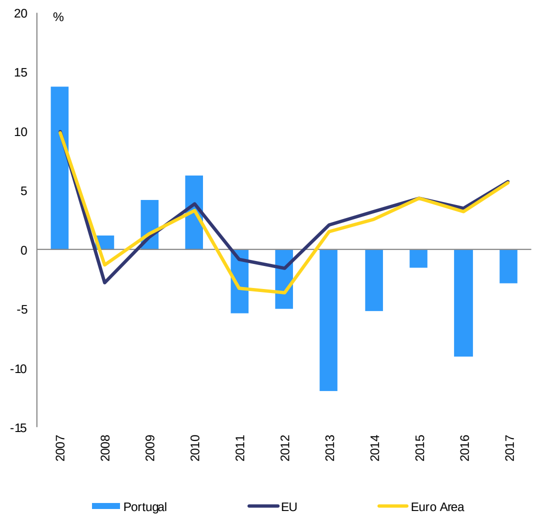
The current account is expected to deteriorate over the medium term. It is projected to move from a slightly positive balance in past years to a neutral level in 2018 and slightly negative in 2019-2020, mainly reflecting deterioration in the balance of goods and a slowdown in tourism. In 2018, oil prices have also adversely affected the terms of trade and the nominal balance of trade. The projected increase in absorption of EU structural funds and lower interest cost for domestic borrowers should only partially offset the negative evolution of other factors. As regards competitiveness, Portuguese exporters are forecast to gain market shares in 2018 helped by the still strong nominal revenues in tourism and the capacity expansion in the automotive sector. However, exports are projected to perform broadly in line with external demand over the medium term (see Section 4.4).

The weak dynamics in labour productivity weighs negatively on unit labour costs. However, pressure on cost competiveness remains modest as unit labour cost continue to move broadly in line with trading partners due to sustained modest wage developments. As regards non-cost indicators on competitiveness, Portugal has continued to gain market shares over the past years. This improvement is observed for both goods and services and is explained by cyclical and structural factors (see Section 4.4).

Financial sector

Financial sector performance is improving but vulnerabilities are still in place. Portuguese banks have steadily reduced their stocks of non-performing loans. This has been helped by increased investor interest, favourable economic conditions and higher property prices. Banks' profitability also improved in the first half of 2018. These trends are set to continue but the main indicators on asset quality and capital adequacy are still weak compared to the aggregated balance sheets of the euro area. In addition, there are still legal bottlenecks in the insolvency framework and the legacy of non-performing loans is still weighing negatively on lending conditions. (see Sections 3 and 4.2).

Graph 1.7: **Return on equity (%), domestic banks**



Source: European Central Bank

([7]) The current account required to reach a certain NIIP target represents the average current account balance as % of GDP, based on Commission T+10 projections for nominal GDP, assuming zero cumulated NIIP valuation effects, and a stable capital account balance. See also European Commission, 2015.

Private indebtedness

Private debt has declined over recent years and the outlook remains favourable. In consolidated terms, the private debt-to-GDP ratio has fallen steadily from its peak of 210.3 % at the end of 2012 to 162.2 % at the end of 2017, declining in both the corporate and the household sectors. Data for 2018 confirm that the process of deleveraging continues albeit at a slower pace. Yet, debt ratios remain above the estimated country specific prudential and fundamental thresholds. For households, the debt ratio dropped to 69 % of GDP at the end of 2017 relative to prudential and fundamental levels estimated at 38 % each. For corporates, the debt ratio dropped to 93 % of GDP relative to prudential and fundamental benchmarks of 57 % and 66 % respectively.

Public finances

Public finances are benefiting from higher revenue on the back of strong domestic demand and favourable labour market conditions, as well as from decreasing interest expenditure. The general government headline deficit is projected to have decreased from 3.0 % in 2017 (0.9 % of GDP net of one-offs ([8])) to 0.7 % of GDP in 2018 (0.3 % of GDP net of one-offs ([9])) according to the Commission's 2018 Autumn Forecast, mainly due to higher cyclical-related revenue, decreasing interest expenditure and lower-than-budgeted public investment. The structural balance is projected to have improved by around 0.3 % of GDP to -0.9 % of GDP, reflecting the corresponding decline in interest expenditure, while the structural primary balance is projected to have remained unchanged at 2.5 % of GDP.

In 2019 and 2020, the general government headline deficit net of one-offs and the structural deficit are expected to remain broadly stable in the absence of further fiscal consolidation. According to the Commission's 2018 Autumn Forecast, the headline deficit is projected to decrease only slightly to 0.6 % of GDP in 2019 (0.2 % of GDP net of one-offs), as higher cyclical-related revenue, higher property income and lower interest expenditure are used to compensate for increases in primary expenditure and reductions in tax revenue. The structural balance is accordingly also projected to remain broadly stable in 2019 (at -0.9 % of GDP), while the structural primary balance is set to slightly deteriorate (to 2.4 % of GDP). Under the forecast's no-policy-change assumption, absent any new one-off impact, the headline deficit is set to go down slightly to 0.2 % of GDP in 2020, while the structural balance is set to remain broadly unchanged. Risks to the fiscal outlook are tilted to the downside and are linked to uncertainties surrounding the macroeconomic outlook and the potential deficit-increasing impact of bank support measures.

The debt-to-GDP ratio is projected to continue its gradual decrease, albeit at a decelerating pace. After falling by 4.5 percentage points to 124.8 % in 2017, the general government gross debt-to-GDP ratio is forecast to further decline to 121.5 % in 2018, 119.2 % in 2019 and 116.8 % in 2020, mainly due to primary budget surpluses and the impact of nominal GDP growth. While expected to have still exceeded more than 3 percentage points in 2018, the decrease in the debt ratio is set to decelerate to around 2 percentage points in 2019 and 2020 mostly due to higher stock-flow adjustments.

([8]) In 2017 the one-offs include in particular the 2.0 % of GDP impact of the public recapitalisation of *Caixa Geral de Depósitos*.

([9]) In 2018 the one-offs include in particular the 0.4 % of GDP impact of the activation of the *Novo Banco* contingent capital mechanism.

Table 1.1: **Key economic and financial indicators - Portugal**

	2004-07	2008-12	2013-15	2016	2017	forecast 2018	2019	2020
Real GDP (y-o-y)	1.7	-1.4	0.5	1.9	2.8	2.1	1.7	1.7
Potential growth (y-o-y)	0.9	-0.3	-0.2	0.8	1.4	1.6	1.7	1.6
Private consumption (y-o-y)	2.0	-1.6	1.1	2.4	2.3	.	.	.
Public consumption (y-o-y)	1.5	-1.1	-0.4	0.8	0.2	.	.	.
Gross fixed capital formation (y-o-y)	0.6	-7.7	0.9	2.3	9.2	.	.	.
Exports of goods and services (y-o-y)	6.1	1.6	5.8	4.4	7.8	.	.	.
Imports of goods and services (y-o-y)	5.7	-2.6	7.0	4.7	8.1	.	.	.
Contribution to GDP growth:								
Domestic demand (y-o-y)	1.8	-2.8	0.8	2.1	3.0	.	.	.
Inventories (y-o-y)	0.2	-0.2	0.2	-0.1	0.0	.	.	.
Net exports (y-o-y)	-0.3	1.5	-0.5	-0.1	0.0	.	.	.
Contribution to potential GDP growth:								
Total Labour (hours) (y-o-y)	-0.3	-1.1	-0.1	0.8	1.1	1.2	1.0	0.8
Capital accumulation (y-o-y)	0.8	0.3	-0.3	-0.2	-0.1	0.0	0.1	0.2
Total factor productivity (y-o-y)	0.5	0.4	0.2	0.3	0.4	0.5	0.6	0.6
Output gap	-0.3	-1.2	-3.0	-0.7	0.7	1.2	1.4	1.5
Unemployment rate	8.7	12.0	14.4	11.2	9.0	7.1	6.3	5.9
GDP deflator (y-o-y)	3.0	0.6	1.7	1.8	1.5	1.4	1.5	1.5
Harmonised index of consumer prices (HICP, y-o-y)	2.5	1.9	0.3	0.6	1.6	1.2	1.3	1.6
Nominal compensation per employee (y-o-y)	3.2	0.4	0.7	1.7	1.6	1.8	2.1	2.1
Labour productivity (real, person employed, y-o-y)	1.8	0.6	0.6	0.3	-0.5	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	1.3	-0.2	0.2	1.4	2.1	1.8	1.6	1.2
Real unit labour costs (y-o-y)	-1.6	-0.8	-1.5	-0.3	0.5	0.4	0.1	-0.4
Real effective exchange rate (ULC, y-o-y)	0.0	-2.1	-0.8	1.6	2.2	1.3	-0.6	-0.7
Real effective exchange rate (HICP, y-o-y)	0.4	-0.8	-1.0	1.7	0.7	0.9	-1.0	-0.4
Savings rate of households (net saving as percentage of net disposable income)	1.0	0.3	-2.2	-3.7	-4.1	.	.	.
Private credit flow, consolidated (% of GDP)	13.9	4.3	-3.0	-2.1	1.3	.	.	.
Private sector debt, consolidated (% of GDP)	174.7	203.3	190.7	169.3	162.2	.	.	.
of which household debt, consolidated (% of GDP)	81.6	90.5	81.5	72.1	68.9	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	93.1	112.7	109.2	97.1	93.3	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	1.2	4.1	11.9	14.4	11.0	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-5.3	-2.1	4.1	1.7	3.0	0.8	0.4	0.1
Corporations, gross operating surplus (% of GDP)	19.8	20.9	21.6	21.9	21.3	21.3	21.6	21.9
Households, net lending (+) or net borrowing (-) (% of GDP)	1.7	3.0	2.6	1.3	1.0	0.9	1.0	0.9
Deflated house price index (y-o-y)	-1.6	-2.9	1.1	6.1	7.9	.	.	.
Residential investment (% of GDP)	5.7	3.7	2.5	2.6	2.8	.	.	.
Current account balance (% of GDP), balance of payments	-9.7	-8.1	0.6	0.6	0.5	0.2	0.1	0.0
Trade balance (% of GDP), balance of payments	-8.1	-5.4	1.5	2.0	1.8	.	.	.
Terms of trade of goods and services (y-o-y)	-0.1	-0.1	2.0	1.7	-0.7	-0.1	0.2	0.2
Capital account balance (% of GDP)	1.4	1.5	1.4	1.0	0.9	.	.	.
Net international investment position (% of GDP)	-76.2	-104.9	-116.0	-105.5	-104.9	.	.	.
NIIP excluding non-defaultable instruments (% of GDP) (1)	.	.	-75.7	-66.5	-60.9	.	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	.	.	211.4	192.9	186.4	.	.	.
Export performance vs. advanced countries (% change over 5 years)	5.5	-1.5	0.7	2.8	9.5	.	.	.
Export market share, goods and services (y-o-y)	.	.	2.1	4.1	3.4	.	.	.
Net FDI flows (% of GDP)	0.2	-2.5	-1.3	-1.7	-4.3	.	.	.
General government balance (% of GDP)	-4.9	-7.6	-5.5	-2.0	-3.0	-0.7	-0.6	-0.2
Structural budget balance (% of GDP)	.	.	-2.3	-2.0	-1.3	-1.0	-1.0	-1.0
General government gross debt (% of GDP)	66.7	97.8	129.5	129.2	124.8	121.5	119.2	116.8
Tax-to-GDP ratio (%) (3)	34.3	34.4	37.1	36.6	36.9	37.3	37.2	37.3
Tax rate for a single person earning the average wage (%)	22.3	23.1	27.6	27.6	.	.	.	.
Tax rate for a single person earning 50% of the average wage (%)	13.9	13.4	11.0	11.0	.	.	.	.

(1) NIIP excluding direct investment and portfolio equity shares
(2) domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation
Source: Eurostat and ECB as of 31-1-2019, where available; European Commission for forecast figures (Winter forecast 2019 for real GDP and HICP, Autumn forecast 2018 otherwise)

2. PROGRESS WITH COUNTRY-SPECIFIC RECOMMENDATIONS

Since the start of the European Semester in 2011, 66 % of all country-specific recommendations (CSRs) addressed to Portugal have recorded at least 'some progress' ([10]). 34 % of the country-specific recommendations recorded 'limited' or 'no progress' (see Graph 2.1). Most progress was observed for CSRs associated to challenges in the labour market, education and social policies, the financial sector, and the business environment. Progress with regard to challenges related to fiscal-structural issues has been more limited. In all, further effort is warranted to effectively tackle these challenges.

Over recent years, Portugal has made limited progress in addressing fiscal-structural challenges. Portugal started a bottom-up efficiency-enhancing spending review in 2016 that has been progressively broadened to cover additional policy areas. The entry into force of the new accrual-based public accounting framework and of the 2015 Budget Framework Law have however witnessed repeated delays, with full effective implementation having been postponed to January 2019 and April 2020, respectively. Although efforts were made to improve the financial sustainability of state-owned enterprises, the objective of achieving an overall net income close to equilibrium has been moved forward by one year to 2019. While past reforms had improved the long-term sustainability of the pension system, recent balance-deteriorating initiatives and the growing pressure from the ageing population would point to the need for compensatory balance-improving measures of a structural nature to strengthen the overall sustainability of the pension system. Despite steady efficiency-improving efforts in the health sector, hospital arrears continue to pose a substantial challenge. A new programme for 2019 aiming to address the underlying causes of persistent hospital arrears represents a promising first step in the right direction. Finally, progress has been made towards improving tax compliance and making tax collection more efficient.

Over the past years Portugal improved debt restructuring mechanisms and reduced the debt bias. The high private indebtedness and large share of non-performing loans accumulated during the crisis increased the need for debt restructuring mechanisms. These have been put in place allowing viable firms to engage in restructuring processes at an early stage. In order to provide incentives for firms to use more capital financing Portugal has also reduced the debt bias in taxation. Measures have also been taken to improve the sustainability of state-owned enterprises but their indebtedness remains high.

The vocational educational and training system has a wider offer and active labour market policies improved. In a context of low-skilled adult population, Portugal provided more vocational training opportunities to different educational levels and is achieving an increased share of employability for these graduates. In order to tackle youth and long-term unemployment, active labour market policies are improving in terms of outreach and engagement while public employment services upgraded coordination with social services. Nevertheless, effectiveness is still an issue when comparing with EU Member States and requires monitoring.

Portugal has adopted measures to improve the business environment, as well as the efficiency of network industries. Various measures have been effective in reducing the administrative burden, although sector-specific procedural rules remain a significant challenge. Energy efficiency has improved on the back of measures targeting the sustainability of the energy system. There has also been progress in improving efficiency in the transport sector, particularly in railways and maritime ports.

The transparency and efficiency of the judicial system has improved. Measures have been able to reduce the case backlog. Although direct awards remain sizeable, greater transparency has been achieved with regard to concessions and public private partnerships.

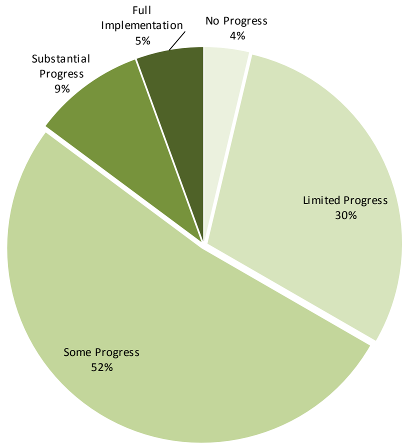
Portugal has made some progress ([11]) in addressing the 2018 country-specific

[10] For the assessment of other reforms implemented in the past, see in particular Section 4.

([11]) Information on the level of progress and actions taken to address the policy advice in each respective subpart of a CSR is presented in the Overview Table in the Annex. This overall assessment does not include an assessment of compliance with the Stability and Growth Pact

recommendations. Limited progress has been made with respect to the fiscal-structural part of country-specific recommendation 1, with the government continuing to promote cost-effectiveness measures in the health sector. Yet, hospital arrears continue to pose a substantial challenge. There has also been limited progress in improving the financial sustainability of state-owned enterprises. There has been some progress in addressing country-specific recommendation 2, with Portugal promoting hiring on open-ended contracts, including by reviewing the legal framework in consultation with social partners. There has also been some progress on skills and education thanks to new policy measures (in particular to increase enrolment in higher education) and the implementation of programmes such as *Qualifica* and the National Adult Literacy Plan. For country-specific recommendation 3, there has been some progress on increasing the efficiency of insolvency and recovery proceedings, and for improving access to finance. With regard to the business environment, there has been some progress through simplifications for business-administration relations (such as E-government initiatives), largely through measures within the SIMPLEX+ programme. There is also some progress improving judicial efficiency. Portuguese Administrative proceedings continue, however, to be among the most lengthy in the EU. No progress has taken place removing regulatory restrictions in professional services. The Competition Authority jointly with the Organisation for Economic Cooperation and Development (OECD) presented to the government suggested reforms to lift restrictions in 13 self-regulated professions. Portugal is expected to follow up such recommendations but at this stage no clear timeline is set.

Graph 2.1: **Overall multiannual implementation of 2011-2018 CSRs to date**



* The overall assessment of the country-specific recommendations related to fiscal policy excludes compliance with the Stability and Growth Pact
** 2011 annual assessment: Different CSR assessment categories
** The multiannual CSR assessment looks at the implementation until 2019 Country Report since the CSRs were first adopted.
*** The multiannual CSR assessment looks at the implementation until 2019 Country Report since the CSRs were first adopted.
Source: European Commission

Table 2.1: **Assessment of 2018 CSR implementation**

Commitments	Summary assessment
2018 country-specific recommendations (CSRs)	
	Limited progress in addressing CSR 1
CSR 1: Ensure that the nominal growth rate of net primary government expenditure does not exceed 0.7 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP. Use windfall gains to accelerate the reduction of the general government debt ratio. Strengthen expenditure control, cost effectiveness and adequate budgeting, in particular in the health sector with a focus on the reduction of arrears in hospitals. Improve the financial sustainability of state-owned enterprises, in particular by increasing their overall net income and by reducing debt.	• **Limited Progress** Limited progress has been achieved in putting persistently-high hospital arrears on a steadily declining path. • **Limited Progress** Limited progress has been achieved in improving the financial sustainability of state-owned enterprises (SOEs).
	Some progress in addressing CSR 2
CSR 2: Promote an environment conducive to hiring on open-ended contracts, including by reviewing the legal framework in consultation with social partners. Increase the skills level of the adult population, including digital literacy, by strengthening and broadening the coverage of the training component in adult qualification programmes. Improve higher education uptake, namely in science and technology fields.	• **Some progress** in promoting an environment conducive to hiring on open-ended contracts • **Some progress** in increasing the skills level of the adult population, including digital literacy. • **Some progress** in improving higher education uptake, namely in science and technology fields.
	Some progress in addressing CSR 3
CSR 3: Increase the efficiency of insolvency and recovery proceedings and reduce impediments to the secondary market for non-performing loans. Improve access to finance for businesses. Reduce the administrative burden by shortening procedural deadlines, using more tacit approval and reducing document submission requirements. Remove persistent regulatory restrictions by ensuring a proper implementation of the framework law for highly regulated professions. Increase the efficiency of administrative courts, inter alia by decreasing the length of proceedings.	• **Some progress** in increasing the efficiency of insolvency and recovery proceedings and reduce impediments to the secondary market for non-performing loans. • **Some progress** has been made to improve access to finance. • **Some progress** in reducing the administrative burden. • **No progress** in removing persistent regulatory restrictions. • **Some progress** in increasing the efficiency of administrative courts.

Source: European Commission

Box 2.1: EU funds and programmes contribute to addressing structural challenges and fostering growth and competitiveness development in Portugal

Portugal is one of the largest beneficiaries of EU funds. Financial allocation from European Structural and Investment Funds aimed to support Portugal in facing development challenges, amount to up to EUR 25.9 billion in the current multiannual financial framework, potentially representing around 1.9 % of GDP annually. By the end of 2018, some EUR 21.1 billion had already been allocated to specific projects. In addition, EUR 674 million had been allocated to specific projects on transport networks, energy and digital projects, through the Connecting Europe Facility. Furthermore, numerous Portuguese research institutions and firms have benefited from other EU funding instruments, notably Horizon 2020 which provided EUR 560 million.

EU funding has helped to address policy challenges identified in the 2018 CSRs. Actions financed include promoting research and innovation and synergies between academia and business; improving access to finance for small and medium-sized enterprises, stimulating entrepreneurship and innovation. This has paved the way for over 13 000 enterprises to receive support with over 1 000 receiving support to introduce new products and 600 enterprises cooperating with research institutions, favouring overall the creation of 37 000 new jobs. EU investments supported by the European Social Fund contribute to increasing the skills level, reducing early school leaving and favouring the educational attainment.

The Commission can provide tailor-made technical support upon a Member State's request via the Structural Reform Support Programme to help Member States implement growth-sustaining reforms to address challenges identified in the European Semester process or other national reforms. Portugal, for example, is receiving support to develop the legal foundations and new processes for the new Budget Framework Law and to implement the new Accounting Framework. The Commission is also assisting the authorities in their efforts to improve the functioning of the inter-ministerial coordination platform, which estimates the administrative burden in the existing regulatory framework in order to promote a better regulatory framework and to reduce gold-plating of EU legislation. In addition, in 2018, work has started on designing a National Plan for Adult Literacy. Moreover, in the financial sector, support is being delivered to identify impediments to and reform priorities for enhanced access to capital markets.

EU funds strengthen the administrative capacity of national, regional and local authorities and the civil society. European Structural and Investment Funds alone mobilise additional private capital by allocating about EUR 726 million in the form of loans, guarantees and equity. In addition, the European Fund for Strategic Investment has allocated EUR 2.4 billion to projects in Portugal, which is set to trigger a total of EUR 8.7 billion in additional private and public investments. Portugal ranks 3rd as to the overall volume of approved operations as a share of GDP. 25 projects involving Portugal have so far been approved under the infrastructure and innovation window of European Fund for Strategic Investment. They amount to EUR 1.2 billion in total financing, which should, in turn, generate EUR 4.3 billion in investments. Under the small and medium-sized enterprises component, 15 agreements with intermediary banks have been approved for a total of EUR 1.3 billion, which should mobilise around EUR 4.4 billion of total investment. 11 951 small and medium-sized enterprises and mid-cap companies are expected to benefit from this support. ‘Science4You’ is a notable example of such projects in Portugal. ‘Science4You’ is a Portuguese company specialised in developing and producing scientific and educational toys to improve the cognitive capacities of children. The European Investment Bank is providing the company a EUR 10 million loan to develop new products and expand its sales.

https://cohesiondata.ec.europa.eu/countries/PT

3. SUMMARY OF THE MAIN FINDINGS FROM THE MIP IN-DEPTH REVIEW

Introduction

The 2019 Alert Mechanism Report concluded that a new in-depth review should be undertaken for Portugal to assess the persistence or unwinding of imbalances (European Commission, 2018b). In Spring 2018, Portugal was identified as having macroeconomic imbalances (European Commission, 2018a). The imbalances identified related in particular to external, public and private debt, banking sector vulnerabilities and weak labour productivity. This chapter summarises the findings of the analyses in the context of the MIP in-depth review that is contained in various sections in this report ([12]) ([13]).

3.1. IMBALANCES AND THEIR GRAVITY

Portugal's net international investment position remains a significant source of vulnerability. It is one of the most negative in the EU and goes beyond the estimated prudential and fundamentally-explained thresholds, which stand at -48 % and -31 %, respectively. On the positive side, the structure of the net international investment position has improved at a faster rate over the past years due to increased inflows of foreign direct investment. The ratio of net external debt to GDP is also improving but remains high.

Current account developments point to a slowdown in external adjustment. The current account moved to a small surplus in 2016-2017. However, the latest estimates point to a broadly balanced performance in 2018 and small deficits thereafter. This is well below the current account value required to reach the net international investment position target over a 10-year period. The capital account is set to retain a broadly stable surplus supported by net inflows of EU transfers. Overall, the combined impact of the projected current and capital accounts suggests that the balance of external flows would bring only a very slow adjustment to the stock of external imbalances. Consequently, it is expected that the net international investment position would only reach the estimated prudential threshold by around 2030.

Private debt is on a steady downward path but remains above prudential and fundamental benchmarks ([14]). Both the corporate and household debt ratios are beyond the estimated country-specific prudential and fundamentals-based benchmarks. The legacy of non-performing loans remains a key weakness in the financial system. The risk exposure is mainly to the corporate sector, which accounts for two thirds of all non-performing loans.

Public debt continues to exceed significantly the Treaty reference value of 60 % of GDP. However, the general government gross debt-to-GDP ratio started declining in 2017 and is set to remain on a downward path over the forecast horizon. Upgrades in credit ratings have also been contributing to more favourable financing conditions. Nevertheless, the interest burden remains one of the highest in the EU. In 2018, episodes of volatility in the European bond markets had only limited repercussions on Portuguese sovereign yields but potential contagion risks require continuous monitoring.

The strong increase in job creation in 2017 and the first half of 2018 substantially improved the country's labour market performance. Headline unemployment dropped to 7 % in 2018, which is well below the euro area average and close to the EU average. Long-term and youth unemployment also decreased significantly and the labour market is not considered an imbalance or adjustment issue anymore.

([12]) Analyses relevant for the in-depth review can be found in the following sections: Public finances (Section 4.1); Financial sector and private sector debt (Section 4.2); Labour market (Section 4.3); and Investment (Section 4.4).
([13]) An asterisk indicates that the analysis in the section contributes to the in-depth review under the MIP.

([14]) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodologies are describe in European Commission (2017) and updates to the methodology have been subsequently proposed in European Commission (2018).

Low productivity continues to restrain Portugal's growth potential. It is also negatively affecting the country's capacity to correct stock imbalances and dampens income convergence. The weak performance is mainly explained by low labour skills and low level of investment and capital accumulation while total factor productivity has been rising over the past years. Specialisation in low value added sectors as well as the large share of small firms also weigh negatively on Portugal's productivity rates vis-à-vis the EU average.

Risks linked to the increase in house prices appear to be contained for the time being. The rebound in house prices since 2016 is seen as a correction from previously low levels of valuation and construction activity and is currently not considered an imbalance. Moreover, the stock of housing loans relative to GDP is declining and new housing loans are substantially below the rates reached before the crisis in 2008. Nevertheless, it warrants closer monitoring if the current rapid pace of real house price growth is sustained over the medium term. The increase in house prices also risks having a negative impact on the affordability of housing for socially vulnerable groups (see Section 4.3.2).

3.2. EVOLUTION, PROSPECTS AND POLICY RESPONSES

Policy efforts to address external imbalances are focused on measures to support exports and improve the business environment. This includes targeted support to firms entering global markets and measures to reduce the administrative burden, increase competition in business services and regulated professions, and improve the judicial system. Some of these policies promote the adoption of digital technologies by small and medium-sized enterprises, through the Indústria 4.0 programme. Portugal is one of the least restrictive host economies to foreign direct investment and has taken tailored measures to attract this type of capital. Yet, a number of weaknesses in the administrative framework persist, including the areas of professional and transport services.

Private debt has declined over recent years and the outlook remains favourable. Data for 2018 confirm that the process of deleveraging continues albeit at a slower pace driven mainly by the positive denominator impact of economic growth (see Section 4.2). Since the peak in 2012, private debt dropped from 210.3 % of GDP to 162.2 % at the end of 2017. This shows that more than 60 % of the deviation from the indicative threshold of 133 % has been corrected in this period. Overall, the pace of adjustment appears adequate.

The high stock of non-performing loans remains a key weakness in the financial system but the adjustment process is advancing. The aggregate non-performing loans ratio dropped but remains among the highest in the EU and well above the EU average. Portugal is implementing a three-pillar non-performing loans reduction strategy. The reduction in non-performing loans is broadly in line with the targets in the strategy where the banks with the largest non-performing loans ratios have submitted plans for substantial reduction in bad loans by 2021.

Public debt started declining in 2017 and is projected to decrease further to around 117 % of GDP by 2020. The recent upward revision of debt-increasing stock-flow adjustments and deficit-increasing one-offs, as shown in both the 2019 draft budgetary plan and the Commission's 2018 Autumn Forecast, have made the structural adjustment needed to comply with the minimum

Table 3.1: **Sensitivity analysis: current account balance and net international investment position**

	Low nominal GDP growth (2% avg 2018-27)	Baseline scenario (3% avg 2018-27)	High nominal GDP growth (4% avg 2018-27)
NIIP stabilisation	-2,9	-3,9	-4,9
NIIP at -70% of GDP	0,9	0	-0,7
NIIP at -48% of GDP	3,3	2,5	1,9
NIIP at -35% of GDP	4,7	4	3,4

The table above shows the annual average current account balance required to reach a certain NIIP by 2027, based on different assumptions for GDP growth, assuming no NIIP valuation effects and a stable capital account set at its median forecast over 2017-19 (0.9 % of GDP). See also European Commission, 2015, 'Refining the methodology for NIIP-based current account benchmarks', LIME Working Group 17 June 2015.
Source: European Commission

linear structural adjustment more demanding. The Commission's debt sustainability analysis points to a high level of sustainability risks over the medium-term (see section 4.1.1). In particular, it indicates that the debt-to-GDP ratio remains highly sensitive to shocks to nominal GDP growth, interest rates and changes to the structural primary balance as compared with the Commission's no-policy-change baseline scenario. The public spending review in place since March 2016 is slowly being translated into implemented measures. The review was originally focused on education, healthcare, state-owned enterprises, public real estate management and centralised public procurement, and the government has since committed to add the justice and internal affairs sectors. However, hospital arrears continue to pose a substantial challenge despite recurrent capital injections, while attempts to tackle underfunding and inefficiency may only progress gradually (see section 4.1.2).

The labour market continues to improve at a strong pace. Unemployment dropped to below the levels prior to the crisis. Employment growth also remained significant although slowing. The activity rate (20-64 years old) stabilised at 81 % in 2018 as the labour slack, though still relevant, declined substantially. Growing signs of labour supply shortages in some market segments put upward pressures on wages helped also by the unfreezing of career progressions in the public sector. Yet, wage growth is projected to remain moderate in the medium term along with the expected slowdown in the economic growth.

Labour productivity declined slightly in 2016-2017 and was broadly stable in 2018. The weak performance is mostly cyclical due to the high rate of job creation in labour intensive sectors such as tourism-related services and residential construction in the absence of stronger capital accumulation. In the second half of 2018, labour productivity has started to improve slightly as the pace of job creation dropped slightly below GDP growth in annualised terms. Productivity is projected to gradually improve in 2019 and 2020 on expectations for a less strong and more broad-based increase in employment. Still low investment levels and some product and labour markets' rigidities are still having a negative impact on strengthening investment and productivity. The low level of qualification of the adult population also plays an important role.

3.3. OVERALL ASSESSMENT

Portugal continues to correct its macroeconomic imbalances. A major progress has been achieved in terms of labour market indicators. Strong employment growth has resulted into a drastic correction of the unemployment rate, which has fallen significantly below the euro area average, and is now in line with pre-crisis levels. Deleveraging in the private sector is advancing at an adequate, albeit slowing, pace and banks are reducing their non-preforming loans as planned. As of 2017, the public debt has also moved on a downward trend benefiting from the favourable economic conditions. The main areas of slow adjustment refer to the net external position, where the pace of improvement has weakened, and labour productivity, which remains below the EU average and is projected to increase only marginally. Productivity and potential growth remain restrained by the low level of investment, as Portugal's share of gross fixed capital formation in GDP is among the lowest in the EU.

Stock imbalances are still high despite positive flows. Although all main indicators on the stocks of imbalances are moving in the right direction, distance to relevant benchmarks remains significant. The main vulnerabilities relate to the high stock of public debt and external liabilities. Private indebtedness is also among the highest in the EU but the underlying risks have subsided substantially. As imbalances in the labour market have been largely corrected over the past years, the main challenges are now concentrated on addressing skills and removing bottlenecks that impact investment and productivity.

Policy progress differs across areas. While measures are being deployed to address hospital arrears, debt sustainability requires further budgetary consolidation and growth-enhancing structural measures. Various measures address challenges related to the administrative burden and judicial efficiency, while the progress on addressing barriers to competition is more modest.

Table 3.2: **MIP assessment matrix**

	Gravity of the challenge	Evolution and prospects	Policy response
	Imbalances (unsustainable trends, vulnerabilities and associated risks)		
External balance	The net international investment position (NIIP) remains very negative (-104.9 % of GDP at the end of 2017) standing well beyond the estimated prudential threshold of -48 %. Risks are however partly offset by the increased share of non-defaultable instruments. The current account posted a surplus of 0.2 % of GDP in 2017, which is still short of the estimated 2.4 % of GDP per year that would be required to reach the country specific prudential NIIP benchmark over a 10-year period.	Portugal has made significant progress in adjusting its external imbalances, including improving competitiveness and current account flows. Yet, the pace of external adjustment has slowed and the current account is projected to be broadly balanced in 2018 and slightly negative in both 2019 and 2020. These projections suggest that the pace of adjusting the stock of external imbalances is slowing. Unit labour costs are increasing at a rate similar to main trading partners. Exports have recently gained market shares but their medium-term growth is set to weaken.	Progress has been made in past years to tackle rigidities in product and labour markets. But further measures to boost productivity and improve cost and non-cost competitiveness remain essential to a more significant external balance improvement. Risks that the positive economic cycle increases upward pressure on unit labour cost (ULC) and slows down the export-led recovery warrants continuous caution on the side of policy makers for balancing income growth and competitiveness targets.
Private debt	High private sector debt is still weighing negatively on investment and growth. However, the pace of deleveraging is strong. Consolidated private debt fell from a peak of 210.3 % of GDP at end-2012 to 162.2 % at end-2017. Both the corporate and household sectors contributed to the deleveraging process. The high level of non-performing loans harms financial stability and banks' profitability.	Private debt has declined over recent years and the outlook remains favourable. The process of deleveraging continues albeit at a slower pace. Since the peak in 2012, private debt dropped from 210.3% of GDP to 162.2% at the end of 2017. The high stock of non-performing loans remains a challenge. Although the aggregate non-performing loans ratio has dropped, it is still one of the highest in the EU. Banks are however committed to continue decreasing the NPL stock in a steadily way, according to the plans submitted to the supervisor.	A three-pillar non-performing loans reduction strategy is being implemented. The strategy includes supervisory action under which banks with the largest non-performing loans ratios submitted plans for a significant reduction in bad loans by 2021.

(Continued on the next page)

Table (continued)

Productivity	Weak productivity dynamics weighs on competitiveness and potential growth, limiting the capacity to bridge the income gap with the EU average and to enable a more inclusive pattern of growth. This is linked to the low investment rate in the country and skills gaps, remaining rigidities in product and labour markets as well as to weaknesses in public administration and the judiciary.	Productivity is expected to improve in 2019 and 2020, amidst milder and more broad-based increase in employment. Low investment levels and rigidities in product and labour markets continue inhibiting productivity.	Various measures have been taken to address rigidities in the labour market and investment barriers from high corporate debt. Important challenges remain in these areas. Bottlenecks to productivity growth are also related to innovation, low qualification of the workforce, and restrictions in certain regulated professions. Several policy initiatives have been put in place recently, including Qualifica and In.CoDe2030.

Conclusions from IDR analysis

- Despite the progress achieved over the past years, the Portuguese economy continues to be characterised by a large stock of imbalances. This mainly relates to external and internal debt, both public and private, high share of non-performing loans and low productivity growth. The pace of deleveraging in the private sector is advancing, albeit at a slowing pace, and non-performing loans are reducing as planned, helped by both policy measures and favourable economic conditions. As of 2017, the public debt is also set on a downward path but remains high and vulnerable to shocks. The main areas of slow adjustment refer to the net external position, where the pace of improvement has weakened, and labour productivity, which has performed weakly over the last three years.

- Private debt is declining in both the corporate and household sectors and the pace of adjustment is considered adequate despite the recent slowdown. Despite the projected downward path, the public debt-to-GDP ratio is set to remain at a very high level and weighs on the stock of external liabilities. The country's net international investment position (NIIP) remains a significant source of vulnerability. It improved only marginally in 2017 and the projected pace of adjustment is also slow, as the country's current account deteriorated somewhat in 2018. On the other hand, the structure of external liabilities improved over recent years due to a shift from debt to foreign direct investment (FDI). The high stock of non-performing loans also remains a key weakness but the adjustment is advancing in accordance with the strategy implemented by banks and national authorities.

- Policy progress differs substantially across areas. As regards public finances, the spending review is set to continue and a new project is being implemented to address persistent hospital arrears, while measures on state-owned enterprises are delayed. In the real sector, goals like the reduction of the administrative burden or the improvement of the judicial system are advancing amidst various measures. Reforms addressing the barriers to competition progress at a more modest pace, particularly regarding license requirements and procedures. More structural challenges, such as labour segmentation or the skill endowment of the adult population require a longer timeframe to register an impact from the measures being implemented.

Source: European Commission

4. REFORM PRIORITIES

4.1. PUBLIC FINANCES AND TAXATION

4.1.1. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS*

The general government gross debt-to-GDP ratio is projected to continue to go down, while remaining very high. With the last global financial crisis and economic recession that followed, very high headline deficits, the reclassification of off-balance sheet items and entities into general government and stabilising interventions in the financial system led to a steep rise in the debt-to-GDP ratio by over 30 percentage points between 2010 and 2013. After hovering around 130 % between 2014 and 2016, Portugal's debt-to-GDP ratio posted a first substantial decline to 124.8 % in 2017, while remaining the third highest in the EU. Backed by solid primary surpluses and the favourable nominal growth-interest rate differential — whereby the combined debt-reducing effects of continued real GDP growth and inflation offset the sizeable, yet gradually diminishing, interest burden on the high debt overhang —, the debt-to-GDP ratio is expected to gradually decline from 121.5 % in 2018, to 116.8 % in 2020, under the customary no-policy-change assumption.

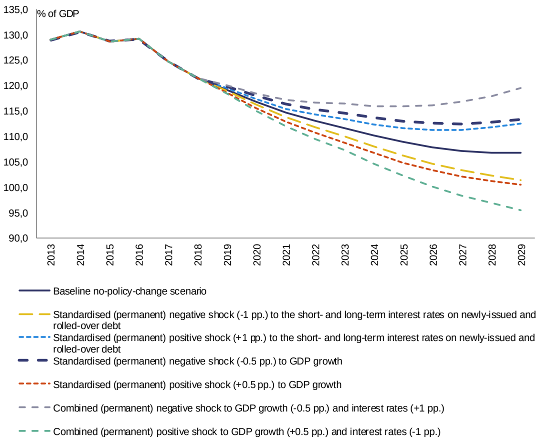
Despite the high general government debt-to-GDP ratio, there are no significant fiscal sustainability risks in Portugal in the short term. The S0 indicator that evaluates fiscal sustainability risks in the short term, stemming from the fiscal, macro-financial or competitiveness sides of the economy is below its critical threshold (European Commission, 2019a). In particular, both the fiscal and the financial competitiveness sub-indices have values below their critical thresholds. This is confirmed by the lower and stable spreads of credit defaults swaps and a gradually improving credit rating, which allows Portuguese sovereign debt holdings to be included in wide institutional investor portfolios based on the investment grade credit assessment by all four relevant rating agencies.

Having said that, Portugal is projected to face high fiscal sustainability risks in the medium term. The S1 indicator that evaluates fiscal sustainability risks in the medium term suggests that a cumulated additional improvement in the structural primary balance by 4.3 % of GDP over 5 years, compared with the Commission's no-policy-change baseline scenario, would be required to bring the debt-to-GDP ratio down to the Treaty reference value of 60 % by 2033. This very high value for the S1 indicator is mainly due to the distance of the debt-to-GDP ratio from the Treaty reference value of 60 % (contribution of 4.1 percentage points).

The Commission's debt sustainability analysis confirms that the debt-to-GDP ratio remains at high risk in the medium term. In a debt sustainability analysis incorporating the Commission's 2018 Autumn Forecast and other technical assumptions (see Annex B) ([15]) for the medium term, the debt-to-GDP ratio is expected to gradually decline by around 1 percentage point per year and to reach approximately 107 % in 2029. Partly due to the projected unfavourable nominal growth-interest rate differential and increasing ageing costs in the projection's outer years, the debt-to-GDP ratio is projected to remain still significantly above the Treaty reference value of 60 % (see Graph 4.1.1).

([15]) These assumptions comprise: (i) a structural primary balance, before ageing costs, of 2.3 % of GDP as of 2020; (ii) inflation converging to 2.0 % by 2023 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 (as for all Member States); (iii) real GDP growth rates of around 1 %; and (iv) ageing costs in line with European Commission (2018c). More details on the assumptions in the different scenarios can be found in European Commission (2019a).

Graph 4.1.1: **General government gross debt projections under baseline and alternative nominal GDP growth and interest rate scenarios**

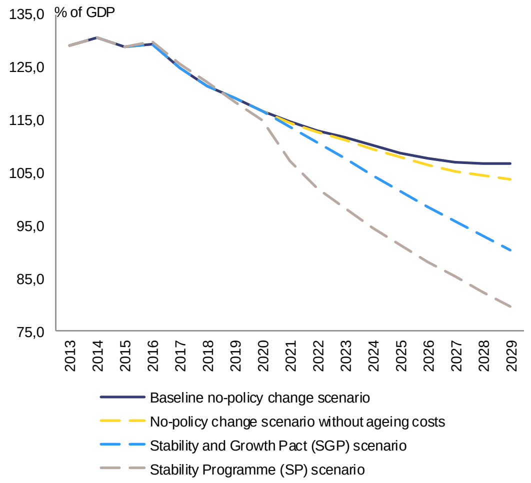


Source: European Commission

The high debt-to-GDP ratio constitutes a long-lasting burden on Portugal's public finances, which reduces fiscal policy's capacity to absorb macroeconomic shocks and reduce business cycle fluctuations. The Commission's debt sustainability analysis shows that the projected moderately declining path of the debt-to-GDP ratio is sensitive to shocks to nominal GDP growth, interest rates and the structural primary balance compared with the Commission's no-policy-change baseline scenario. Alternative scenarios incorporating plausible potential shortfalls in nominal GDP growth, sharp interest rate hikes or a less ambitious structural fiscal adjustment would actually put the debt-to-GDP ratio back on an upward path, with clear penalising effects for Portugal's overall economic performance and potential outward negative spill-over effects via the sovereign risk channel.

Without continued fiscal consolidation and with no progress on growth-enhancing structural reforms, it will be difficult to safeguard fiscal sustainability and keep the debt-to-GDP ratio on a steady downward path. The Commission's debt sustainability analysis shows that if Portugal's structural adjustment were consistently in full compliance with the requirements of the preventive arm of the SGP, the debt-to-GDP ratio would substantially decrease to close to 90 % by 2029, 16 percentage points below the Commission's no-policy-change baseline scenario (see Graph 4.1.2). Conversely, if Portugal's structural primary balance were to revert back to its historical trend (this is, to gradually converge to its last 15-year historical average at a structural primary deficit of 0.5 % of GDP), the debt-to-GDP ratio would reach as much as 126 % by 2029, 19 percentage points above the Commission's no-policy-change baseline scenario. Against this background, the full implementation of the reformed Budget Framework Law and enhanced revenue collection could positively contribute to stronger fiscal sustainability. Moreover, renewed efforts to tackle the increasing ageing costs at their roots — this is, healthcare expenditure and pensions — could help identifying new sources of efficiency savings.

Graph 4.1.2: **General government gross debt projections under baseline and alternative fiscal consolidation scenarios**



Source: European Commission

4.1.2. FISCAL-STRUCTURAL ISSUES, INCLUDING PENSIONS AND HEALTHCARE*

Portugal's pension system is under continuous pressure from adverse demographic trends. The old-age dependency ratio — i.e. the proportion of people aged 65 and over relative to those between 16 and 64 — stood at 32.1 % in 2016, above the euro-area average of 29.6 % (European Commission, 2018c). Importantly, the ratio is projected to increase significantly by 35.1 percentage points, reaching 67.2 % by 2070. This implies that Portugal would go from having 3.1 working-age people for every person aged over 65 years to only 1.5 working-age people. On the other hand, steps were taken in the past to strengthen the long-term sustainability of the pension system, notably by increasing the statutory retirement age from 65 to 66 years and by linking future increases to rises in life expectancy ([16]), and by restricting access to early retirement. The average effective exit age in 2017 is estimated at 64.4 years, above the euro-area's average of 63.4 years. The duration of retirement is estimated at 18.3 years for men and 22.8 years for women, both below the euro-area's averages of 19.3 and 23.5 years, respectively.

While past reforms improved the long-term sustainability of the pension system, recent initiatives have entailed discretionary increases in pension spending. In August 2017 and August 2018, lower pensions benefitted from special increases — i.e. on top of the regular pension indexation linked to inflation and real GDP growth —, with a full-year deficit-increasing impact of around EUR 140 million. In particular, the increases were focused on those pensions that had not been updated between 2011 and 2015. Such special increases are planned to continue in January 2019, leading to an estimated deficit-increasing impact of EUR 137 million in 2019. In addition, a new special pension supplement was announced for 2019, applicable to minimum pensions that start to be paid in that year. This should lead to an estimated limited deficit-increasing impact of around EUR 26 million ([17]).

Pathways to early-retirement for workers with long careers are being broadened. In October 2017, a new early retirement scheme for very long careers entered into force. It allowed early retirement without penalty for citizens aged at least 60 years who had paid contributions for at least 48 years into the social security system or into the legacy civil service pension system ([18]). This early retirement scheme was broadened in October 2018 to also cover citizens who had paid contributions for at least 46 years and started when they were 16 years old or under. A further phase in the flexibilisation of early retirement started in January 2019 and is applicable to citizens who at age 60 had paid contributions for at least 40 years. The new scheme will allow them to retire early without the sustainability factor penalty but will maintain a penalty proportional to the distance in months to the legal retirement age. Beginning in January 2019, this new modality will be open to citizens aged at least 63 years and will then be extended to citizens aged at least 60 years beginning in October 2019. The authorities have estimated the associated deficit-increasing impact in 2019 at EUR 66 million.

The projected surplus of the social security balance appears to mainly reflect the current economic expansion, casting doubt on its overall sustainability if the economic cycle turns. Indeed, improvements in the labour market are projected to continue translating into higher social contributions and lower unemployment-related expenditure. Nonetheless, the contributions are complemented by general transfers from the State budget and specific State transfers. related to consigned tax revenue coming from a percentage of the revenue from the value added tax, the surcharge on the real estate tax (*Adicional ao Imposto Municipal sobre Imóveis*) and, finally, a percentage of the revenue from the corporate income tax — 0.5 % in 2018, rising by 0.5 percentage points per year up to 2 % in 2021. In view of the potential balance-deteriorating effect of the ongoing special pension increases, early retirement reforms and the growing pressure from the ageing population, in combination with the lack of compensatory balance-improving fiscal-structural reforms, the overall sustainability of the pension system may be at risk of not having improved in a durable manner.

While healthcare expenditure in Portugal has been below the EU average, its long-term increase is expected to be among the largest in the EU. Owing to pressures from the ageing population and non-demographic determinants, healthcare expenditure is projected to increase by approximately 40 % in the long term, from 5.9 % of GDP in 2016 (below the EU average of 6.8 %) to 8.3 % of GDP in 2070 (above the EU average of 7.7 %). This expected increase by 2.4 percentage points significantly exceeds the projected increase

([16]) On that basis, the statutory retirement age rose to 66 years and 4 months in 2018 and is planned to continue rising to 66 years and 5 months in 2019.

([17]) Both the special update and the special pension complement are limited to pensioners receiving an overall pension amount equal to or below 1.5 × IAS (*Indexante dos Apoios Sociais*, this is the reference value for social benefits set at EUR 428.9 in 2018).

([18]) Or, alternatively, for those aged 60 years who paid contributions for at least 46 years and started when they were 14 years old or under.

by 0.9 percentage points for the EU as a whole (European Commission, 2018c). Importantly, the projected increase in public expenditure on healthcare due to demographic change over 2016-2070 is estimated at 2.7 percentage points of GDP, which is one of the highest in the EU.

The short–term financial sustainability of the health system continues to be a concern, although progress has been made in some areas. The balance of the Portuguese National Health Service deteriorated by EUR 389 million in cash terms in 2018 compared with 2017, with expenditure growth exceeding revenue growth by 4 percentage points (Portuguese Ministry of Finance, 2018). The underlying factors for such a deterioration included a year-on-year increase in expenditure for medicines and other healthcare goods and services (including complementary means of diagnosis and therapeutic use, and material for clinical consumption) and an increase in the healthcare workforce and in the wage bill (partially related to the switch to the 35 hour working week also for private sector contracts in July 2018). Some savings have nevertheless been achieved, for instance, by relying more on centralised purchasing and making a greater use of generics and biosimilars. While there are plans to make even greater use of centralised procurement and generics in the future, the latter might be challenging, as the share of generics appears to have levelled off in recent years. The need to invest in the National Health Service remains substantial in view of the construction of new hospital centres, reinforcements in primary health care and medical equipment updates (European Observatory on Health Systems and Policies, 2018).

Despite substantial clearance measures, hospital arrears continue to pose a substantial challenge. Hospital arrears stabilised at somewhat lower levels in the first half of 2018, primarily as a result of a capital injection of EUR 500 million at the end of 2017. They resumed their increase in September 2018, reaching EUR 903 million in November 2018 (compared with EUR 1 103 million in November 2017). An additional capital injection of EUR 500 million in the second half of 2018 (in addition to customary year-end clearance measures) has helped to reduce hospital arrears to EUR 484 million in December 2018 (compared with EUR 837 million in December 2017). A high stock of hospital arrears has an adverse impact on supply chain relationships, limiting the scope for cost-savings.

A new programme for 2019 aims to address the underlying causes of persistent hospital arrears. It was launched in early 2018 as a joint initiative between the Ministry of Finance, the Ministry of Health and the *Administração Central do Sistema de Saúde* — an entity responsible for managing the financial resources of the Portuguese National Health System — to improve the sector's overall financial sustainability. This led to recommendations for a programme to address hospital arrears, which is to move forward in 2019. The joint collaboration between these three parties is key to the programme's ultimate success.

The new programme to address hospital arrears intends to introduce a new governance model for public hospitals, coupled with a substantial increase in their annual budgets. In so doing, it aims to help identify the specific causes of arrears by differentiating, at hospital level, between inadequate budgeting and hospital management practices. The programme is to be implemented in such a way as to apply both positive and negative management incentives to increase accountability, reduce moral hazard and reward efficiency savings. According to the programme, public hospitals will be grouped into three categories based on their efficiency, measured as an average adjusted cost per patient ([19]). The most efficient hospitals, in the first category, will be granted more autonomy and have their budgets increased to close the gap between budgeted funds and actual expenditure. The less efficient hospitals, in the second and third categories, will undergo increased scrutiny and receive greater policy assistance according to the magnitude of their efficiency shortfalls. They will also receive more conditional increases in funding. A total of EUR 500 million has been committed to increase hospital budgets. Although the

([19]) Some stakeholders have expressed concerns about the average adjusted cost per patient used to allocate hospitals per efficiency group. While the authorities aim at differentiating between hospitals' management deficiencies and structural limitations, the lack of available data may interfere with their ability to do so effectively by taking all relevant factors into account. This concern is however partly addressed by the fact that the authorities have performed the analysis considering similar hospital groupings.

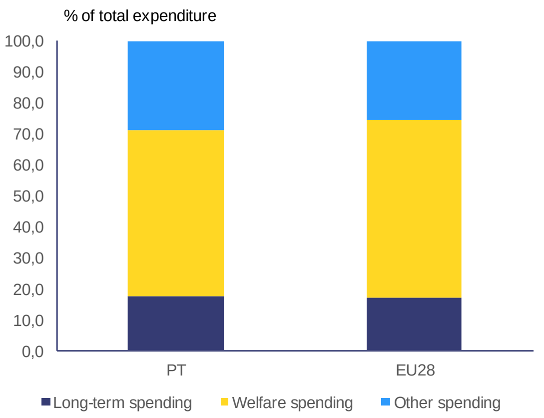
programme represents a promising first step in the right direction, it remains to be seen whether it will lead to a sizeable slowdown in the accumulation of hospital arrears in the short term.

4.1.3. FISCAL FRAMEWORK AND STATE-OWNED ENTERPRISES*

Improving framework conditions for fiscal policy is key to achieving a growth-friendly path for structural fiscal consolidation. In this context, the full effective implementation of the Budget Framework Law — which entered into force in 2015 — remains essential. The Budget Framework Law is designed to make budget units more accountable and strengthen the medium- to long-term focus of public finances. It allowed for a three-year transitional period for applying most new features. The implementation unit of the Budget Framework Law has convened regularly, and preparatory work mostly involving IT systems set-up has been progressing, in particular for the State accounting entity project ([20]). However, due to repeated delays, the entry into force of the main provisions of the revised Budget Framework Law was postponed by 1 and a half years to 1 April 2020 via the amending law 37/2018 of 7 August. Thus, only the 2021 budget is planned to be prepared under the new rules. Some elements might however become operational at an earlier stage. In terms of regulatory preparation, a series of decree-laws will require adjustment and consolidation, and the decree-law on the set-up of the new budgetary programmes will need to be prepared ([21]). The full effective application of the new accrual-based public accounting framework that was last set to start in January 2018 has been rescheduled to January 2019, following delays in particular for local authorities and social security.

Government expenditure with direct positive effects in long-term economic growth represents less than 20 % of total expenditure. The composition of government expenditure can be broken down into three categories: spending for the long term, welfare spending and other spending ([22]). Empirical studies typically find that government expenditure on both human and physical capital through investment in education and infrastructure is associated with positive growth effects in the long term, while spending on other categories is usually found to have no such impact (European Commission, 2016). In Portugal, expenditure for the long term — which includes education, transport and R&D expenditure — accounted for 7.7 % of GDP in 2016, slightly below the EU average. However, while the country's welfare spending — which includes expenditure on social protection and health – was below the EU average in 2016 (24.1 % of GDP compared with 26.6 % of GDP), Portugal deployed comparatively more resources on other spending — which mostly covers expenditure on general public services.

Graph 4.1.3: **Government expenditure by function in 2016**



Source: European Commission

A series of initiatives across the public sector aim at improving the quality of public expenditure. Many of these are included in the ongoing spending review exercise, which is expected to yield savings of EUR 236 million (around 0.1 % of GDP) across a series of public sectors in 2019. Around half of the savings is expected to come from health and education, while

([20]) A first preliminary opening balance sheet has been established as of 1 January 2018.
([21]) The amendment to the BFL sets a new deadline by June 2019 for the approval of the corresponding decree-law on budgetary programmes.
([22]) More precisely in terms of the classification of the functions of government (COFOG): "Spending for the long run" includes categories GF09, GF05, GF0405, GF0406 and the sum of GF0105, GF0204, GF0305, GF0408, GF0505, GF0605, GF0705, GF0805, GF0907 and GF1008 (which are grouped together as R&D expenditure). "Welfare spending" includes categories GF10, GF0601, GF0602 and GF07. Finally, "Other spending" consists of the remaining COFOG categories.

the other half should come from measures in the justice system and internal administration and from the growing use of centralised procurement and a shared services strategy. Having said that, concrete measures still need to be specified in sufficient detail. Furthermore, the exercise is not yet undergoing a regular and independent evaluation, in particular regarding the quantification of the savings effectively achieved. This has so far only been done for selected cases on an ad-hoc basis by the authorities. Overall, while broadening the ongoing spending review is set to have a positive effect, the resulting bottom-up savings should be complemented with a clear top-down focus on containing overall expenditure growth and deploying a comprehensive strategy for medium-term public administration reform, in combination with strengthening the growth-friendliness of public expenditure.

There appears to be continued pressure to increase the number of employees and the wage bill beyond the authorities' own budget targets. The wage bill increased by 2.1 % in cash terms in 2018, significantly above the 2018 budget target, while the average headcount of public employees rose by 1.6 % year-on-year in the year ending on 30 September 2018, with more pronounced growth in the areas of local administration, state-owned enterprises (SOEs) and education. This occurred despite the planned decrease based on the target 3:2 replacement ratio rule for 2018. At the same time, the wide-ranging programme to convert temporary contracts for permanent tasks in the public sector into permanent ones is expected to be concluded by the end of 2018 (concerning an estimated number below 20 000). The planned extension of the 35 hour week in the health sector to employees with private sector contracts (around 40 % of the workforce in the sector) has put additional pressure on the headcount and the wage bill (e.g. via extra hours compensation) since 1 July 2018. The unfreezing of career progression — which had been frozen since 2010 — has started since January 2018. The additional payments are gradually being phased in (25 % by January 2018, 50 % by September 2018, 75 % by May 2019 and 100 % by December 2019) with an estimated incremental cost of around 0.2 % of GDP in both 2018 and 2019 (and another 0.1 % of GDP in 2020 according to the 2018 stability programme). In 2019, the unfreezing of career progression will also imply performance awards (by 50 % of their amount and up to the available funding).

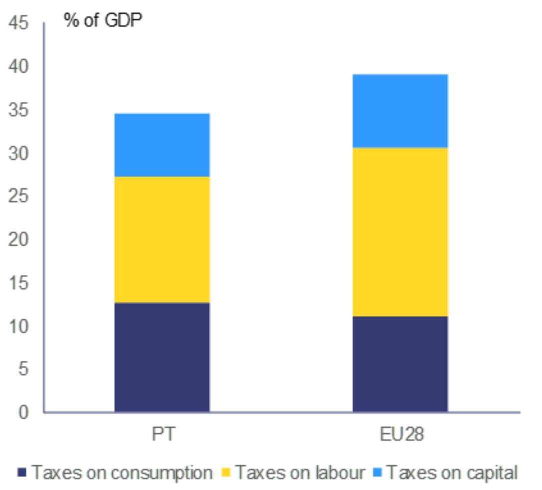
There has been progress in local administration reforms in recent years, but employment has been growing at accelerating rates. Local and regional arrears have remained broadly stable in 2018, while the overall local and regional budgetary surplus improved in 2018. Employment in local administration increased by 4.3 % year-on-year in the year ending on 30 September 2018, around 2.5 times the growth rate observed for the general government as a whole. While the Financial Coordination Council set up in 2014 has not been convening, there have been quarterly meetings of the Regional Coordination Council. Portugal's Directorate-General for Local Administration supported by *Unidade Técnica de Acompanhamento e Monitorização do Setor Público Empresarial* — a unit in the Ministry of Finance specialising in State-Owned Enterprises (SOEs) —, and the country's Directorate-General for Budget have improved the monitoring of local SOEs and public-private partnerships. This is supported by a decree-law from July 2017 creating the obligation for local SOEs to provide direct information without going through the local authorities, while information on local public-private partnerships has been reported quarterly since 2016.

While overall the net incomes of SOEs improved in 2017, they are expected to have remained negative on the aggregate and to vary significantly at the sectoral level. The authorities are planning net incomes of SOEs to approach as a whole a level close to, but still below, equilibrium in 2019; this corresponds to a one-year delay as compared with earlier announcements aiming at a similar outcome already in 2018. The underlying operational results have been developing very differently across SOEs, with significant improvements in the transport and financial sector in 2017, and substantial and rising deficits in the health sector. The unconsolidated debt of public non-financial corporations included in general government has fallen from 19.1 % to 17.6 % of GDP between September 2017 and 2018 (Bank of Portugal, 2019). Looking ahead, a range of measures is being envisaged to improve the monitoring of SOEs and to ensure closer adherence to their initial budgetary plans. This involves moving forward with the automatic exchange of information between SOEs and *Unidade Técnica de Acompanhamento e Monitorização do Setor Público Empresarial*. There are plans to introduce new incentives for employees and managers to improve reporting standards. The authorities have also indicated that SOEs that have fulfilled their purposes, that are economically unviable or that can be merged to generate savings will continue to be liquidated. Also, there are plans to prioritise improvements in the capital structure for those SOEs that have positive operational results but high levels of debt. Overall, planned rationalisation efforts and increased monitoring have still yet to translate into corrective action where needed.

4.1.4. TAXATION ISSUES, INCLUDING TAX ADMINISTRATION*

Tax revenue as a share of GDP has slightly increased in 2017. The overall tax revenue-to-GDP ratio, meaning the sum of revenue from taxes and net social contributions as a percentage of GDP, stood at 34.4 % in 2017, slightly higher than in 2016. Portugal's tax revenue relies relatively heavily on consumption taxes (12.7 % of GDP in 2017, compared with 11.1% of GDP in the EU in the same year) (European Commission, 2019d).

Graph 4.1.4: **Tax revenue by economic function in 2017**



Source: European Commission

Changes in direct taxes were primarily to personal income tax in 2018, while some relatively minor further adjustments are planned for 2019. In 2018, in addition to the already planned full abolishment of the personal income tax surcharge, including for higher tax brackets, both the number of tax brackets and the value of the net income guarantee (*mínimo de existência*) increased. The authorities estimated that the result of these measures will be a combined loss in revenue to the general government of EUR 230 million in 2018 and EUR 156 million in 2019 (i.e. when the 2018 personal income tax statements are filled). While no major changes to general personal income tax rules have been included in the 2019 budget, a new specific temporary 5-year tax regime has been put forward for emigrants who return to live in Portugal in 2019 and 2020 ([23]).

The corporate income tax rate applicable to high taxable profits remains among the highest in the EU. This relative position was reinforced by the 2018 increase of the State surcharge from 7 % to 9 % for large companies, i.e. with taxable profits exceeding EUR 35 million (with additional revenue estimated at EUR 60 million), which brought the corresponding statutory corporate income tax rate to 31.5 % in 2018, significantly above the EU average of 21.9 %. Portugal's effective average corporate income tax rate of 27.5 % in 2017 is the 4th highest among the EU Member States and compares with an effective average corporate income tax rate of around 20 % in the EU (OECD, 2018e). The budget adopted for 2019 includes some additional minor changes to the corporate income tax, notably the end of the special advanced payment (estimated revenue loss of EUR 140 million) and new tax benefits for reinvested profits and firms located in the interior of the country (around EUR 50 million as a whole). Overall, the proliferation of both size- and location-dependent preferential corporate income tax rules may put a drag on productivity and investment growth; in particular, by privileging smaller-sized firms and/or those operating in specific — possibly less productive — areas, such policies may detract businesses from scaling up and/or benefiting from agglomeration spill-over effects that could help achieve greater economies of scale and efficiency gains, while providing scope for profit-shifting within the country.

([23]) Eligibility is conditional on having been a non-resident in Portugal for tax purposes for at least 3 years.

Additional changes to direct taxes in 2019 include a tax on the renewable energy sector and a new bracket in the surcharge on the real estate tax. The authorities estimate that the tax on the renewable energy sector will yield EUR 30 million in additional revenue. Furthermore, the additional bracket in the surcharge on the real estate tax introduced by the budget adopted for 2019 is also expected to yield EUR 30 million in additional revenue. The revenue from recurrent property taxes was relatively low in Portugal in 2017, representing 0.8 % of GDP (or 2.3 % of total tax revenue), compared with the EU average of 1.6 % of GDP (or 4.0 % of total tax revenue) (European Commission, 2019d). More ample changes to benefits concerning direct taxes are only planned to be decided once the dedicated working group on the evaluation of tax benefits will have presented their report (expected for March 2019).

For indirect taxes, besides the new value added tax (VAT) payment scheme for imports (reverse-charge mechanism), implemented in 2018, some changes are planned for 2019. On the one hand, the budget adopted for 2019 includes rate increases for excise duties and changes to the stamp tax on credit contracts (with additional revenue estimated at EUR 75 million). On the other hand, the decrease for gasoline of the petroleum tax supplement in 2019 is estimated to generate a revenue loss of EUR 48 million. The new VAT payment scheme for imports is expected to generate some short-term revenue shortfalls from customs VAT in 2018 and 2019, which overall should be largely compensated by lower reimbursements. The budget adopted for 2019 also includes the application of the reduced VAT rate of 6 % to the contracted power in electricity and to the fixed cost of access to the gas network (estimated revenue loss of around EUR 19 million). Moreover, the 2019 budget has extended the reduced VAT rate of 6 % to electronic books, newspapers and periodicals, thereby aligning the VAT treatment of electronic and physical publications. The reduced VAT rate of 6 % will also apply to other supplies such as cultural services (estimated revenue loss of around EUR 10 million), the rental of certain medical equipment and forest cleaning.

VAT collection has become significantly more efficient in recent years. The VAT gap — which provides an estimate of revenue loss due to tax fraud, evasion and avoidance, among other factors — has been steadily declining since 2011, falling by more than 5 percentage points between 2012 and 2016, from 16 % to 10 % of the VAT total tax liability (Centre for Social and Economic Research, 2018). Therefore, the VAT gap in Portugal remained visibly below the EU average of 12 %. Having said that, Portugal's VAT policy gap — which provides an estimate of revenue loss due to the use of reduced VAT rates and exemptions —, remained high, at 51.5 % in 2016, compared to an EU average of 44.8 %. In particular, the actionable VAT policy gap — which excludes tax liability from imputed rents, public services and financial services — amounted to 19.6 % in 2016, being above the EU average of 16.5 %. The high actionable VAT policy gap is composed of the rate gap and the actionable exemption gap. Given that the actionable exemption gap is slightly below the EU average, the comparatively high actionable VAT policy gap in Portugal mostly results from the relatively high rate gap (13.9 % in Portugal, compared with 10.0 % in the EU), reflecting the use of reduced VAT rates. However, as far as inequality matters are concerned, reduced VAT rates are generally a rather poorly targeted tool to support low-income households and direct mechanisms such as income-tested cash transfers should be preferred.

Environmental tax revenues rely mostly on transport-related taxes. Transport-related taxes accounted for 0.7% of GDP in 2017, compared with an EU average of 0.5% of GPD. Taxes on pollution and resources accounted for 0.02 % of GDP, compared with an EU average of 0.08 % in 2017 (European Commission, 2019d). Having said that, Portugal has relatively high subsidies for company cars (among the highest in the EU in 2015) (European Commission, 2017a). Although diesel has a higher carbon and energy content than gasoline, the applicable excise duty rates on the former have been higher than on the latter. Despite progress to address the issue over the past 4 years, Portugal still has a significantly low ratio of diesel to gasoline excises (0.71 in the country in 2018, compared with 0.81 in the EU).

Overall, despite some improvements, there is scope to strengthen the growth-friendliness of the Portuguese tax system. As a result of the introduction of a Notional Interest Deduction ([24]) regime (effective from 1 January 2017), the so-called debt bias ([25]) in corporate taxation has decreased substantially and is now zero (Centre for European Economic Research, 2017). The same holds for family businesses that tend to have a higher share of equity-financing. This low debt-bias could in particular reward investments by young, innovative and high-risk firms that usually rely more on equity financing. The same holds for family businesses that tend to have a higher share of equity-financing. However, it remains burdensome to comply with taxes in Portugal. According to the Paying Taxes 2019 Report (World Bank, 2018a) despite ranking 34th ([26]) overall as regards the ease of doing business, the time needed to pay and file taxes in Portugal remained 243 hours in 2017, the 4th longest in the EU. This is both significantly above the unweighted EU average of around 172 hours and median of around 143.3 hours. Furthermore, while Portugal offers one of the highest implicit R&D tax subsidy rate for large profitable companies in the EU (OECD, 2018f), private R&D expenditure as a percentage of GDP remains relatively low compared with the EU average. Closely monitoring and evaluating the different R&D tax measures would help better understand their effectiveness, notably in boosting investment.

([24]) See European Commission (2018a) for a more detailed description of the regime.
([25]) Measured as the additional rate of return before taxes that an equity-financed investment needs to achieve to break even in comparison to a debt-financed investment.
([26]) Out of 190 countries.

4.2. FINANCIAL SECTOR

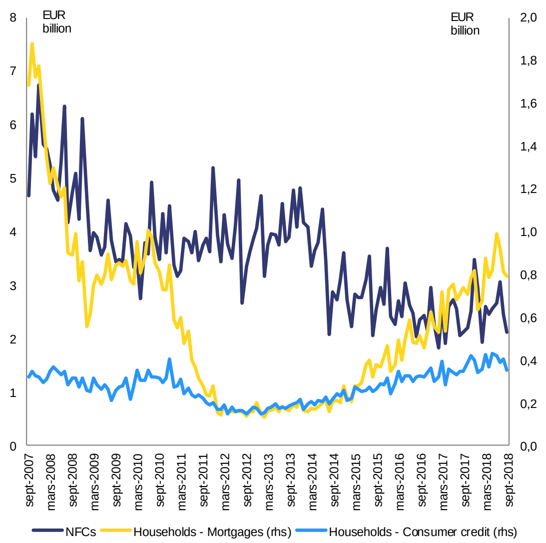
4.2.1. BANKING SECTOR*

Financial stability metrics continue to improve on the back of a favourable operating environment. Banks' profitability increased sharply in the first half of 2018 reflecting a decreasing flow of impairments and provisions (respectively down by 30.5 % and 39 % year-on-year), a reduction in staff costs (by 7.7 %) and, to a lesser extent, an increase in income from services and commissions (up by EUR 72 million or 5.2 % year-on-year). Liquidity and funding remained at comfortable levels as deposits have gradually increased and the loan-to-deposits ratio dropped to 87.1 % in mid-2018. Asset quality improved gradually each quarter (down to 11.7 % in the second quarter of 2018 from a peak at 17.9 % in mid-2016) and the non-performing loan coverage ratio ([27]) increased to 53.4 % at the end of June 2018, close to 10 percentage points higher than in June 2016. In nominal terms the progress in reducing the stock of legacy non-performing loans is substantial, at EUR 18 billion or 36 % of the original stock from the second quarter of 2016. Solvency ratios remained broadly stable with the total capital adequacy ratio at around 15 % in June 2018 and the common equity tier 1 ratio – an alternative measure of bank solvency that gauges a bank's capital strength - at 13.4 %. The banking system's assets began increasing again in the first half of 2018, reversing the downward trend seen in recent years, in which the total assets of the sector shrank by over a quarter after 2011.

The Portuguese banks' total assets stabilised at around EUR 400 billion - around twice the level of GDP. This compares with EUR 580 billion (345 % of GDP) in March 2012. With deposits growing slightly and loans remaining stable, the loan-to-deposit ratio fell to 89 % in June 2018- the lowest ratio since euro introduction.

Consumer loans are growing rapidly, while gross mortgage lending remains subdued. Overall, loans to households increased by only 0.6 % between June 2017 and June 2018, but consumer loans grew by 11.3 %. Monthly new consumer loans amounted to less than EUR 200 million in 2012-2013, but are now at around EUR 400 million (see Graph 4.2.1). New mortgages were on average below EUR 175 million per month in 2012-2013, having fallen from EUR 1.5 billion per month in 2004-2007. Since summer 2017, they have been consistently above EUR 700 million. But despite double-digit growth in new mortgage attribution, redemptions still outweigh new housing loans. Consequently, the stock of outstanding mortgages fell by 1 %. Loans for other purposes fell by 2.4 %.

Graph 4.2.1: **New loans granted**

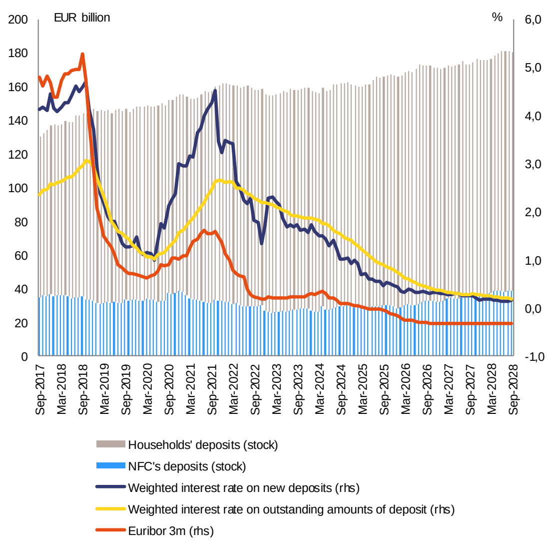


Source: Bank of Portugal

Deposits have reached a new all-time high driven by growth in corporate deposits. Remuneration of deposits is relatively higher than in the Netherlands, Germany or Luxembourg where banks pay on average negative interest rates on their corporate deposits since early 2017. Unlike other EU-jurisdictions, Portuguese banks are forbidden by law to charge negative interest rates, even to large companies. This restriction increases the incentives for corporate savings in Portugal. Consequently, the latter has been experiencing year-on-year growth in the double digits since early 2017, pushing aggregate deposits to ever-higher record levels, while household deposits have remained stable at around EUR 140 billion since June 2016. Whereas the average interest rate for new deposits was 0.15 % in June 2018, the interest rate on the overall stock of savings was 0.22 %. This is the result of very high interest rates in 2011-2012 (see Graph 4.2.2).

([27]) Loan-loss reserves to cover expected losses relative to non-performing loans

Graph 4.2.2: **Saving with domestic banks**



Source: Bank of Portugal

While the ratio of non-performing loans remains high, there has been a considerable reduction as the secondary market gains momentum. Portuguese banks have steadily decreased their stocks of non-performing loans and non-performing loan ratios in line with guidance from the Single Supervisory Mechanism. Lenders either work out bad debts internally, jointly through a servicing platform or increasingly put them up for sale on the secondary market. As the Portuguese property market is experiencing a strong period of growth, the secondary market for non-performing loans (often backed by real estate) is becoming increasingly competitive, with many foreign players actively looking to purchase non-performing assets. In 2017, the total value of non-performing loan secondary market transactions reached about EUR 2.3 billion. Given the strong pipeline of new deals, this figure is set to be surpassed in 2018.

The aggregate non-performing loans fell by roughly one third over the last two years. It stood at 11.7 % in June 2018. The ratio of non-performing loans in the corporate segment was still very high at 22.3 % but also fell by over 5 percentage points year-on-year. Non-performing loans in the consumer loans and mortgages segments stood at 12.6 % and 4.9 %, respectively, decreasing year-on-year from 15 % and 6.5 %. Non-performing loan disposals have improved the ratios numerator while, more recently, loan growth has helped lower the ratio. In parallel, banks are focusing on the non-performing loans coverage ratio, which stood at 52.8 % in mid-2018, 9.7 percentage points above the level recorded in June 2016, when the non-performing loan ratio reached its peak. While the coverage ratio for mortgages was relatively low at 26 %, due to the importance of collaterals, it stood at 57.9 % in the segment of non-financial corporations, and 60.9 % in the consumption and other purposes segment.

The Portuguese banking system is increasingly profitable, reflecting lower loan losses and past cost-cutting. Return on equity stood at 3.1 % in June 2018, improving from 0.2 % 12 months earlier. The cost-to-income ratio stood at 57.7 % in Q2-2018, which represents a 8.2 percentage points decline compared to March 2017 and compares well with the EU's average of 65 %. Operational expenses decreased by 4.5 % over those 12 months. Banks are starting to reap the fruits of past cost cutting and re-sizing, and should continue adapting their systems. Operating income increased by 8.3 % over that time period, due mainly to significant impairment reduction and slightly better interest intermediation revenue based on lower deposit remuneration.

Portuguese banks managed to issue shares and to attract new shareholders, yet their capital ratio is converging to the EU's average. The system's total capital and reserves amounted to EUR 59 billion in June 2018, compared to EUR 34.3 billion in June 2007. Between June 2017 and June 2018 the common equity tier 1 ratio increased slightly by 0.2 percentage points to 13.4 %. Since late 2016 CGD, Novo Banco, Banco Comercial Português, and Montepio strengthened their capital to the tune of EUR 4.9, 2.2, 1.63, and 0.25 billion respectively, adding close to EUR 9 billion capital to the system. Yet even after those recapitalisations, Portuguese banks are still among the EU's least capitalised, and only the Italian and Spanish banking systems have lower overall common equity tier 1 ratios. Portuguese banks will have to further improve profitability to generate capital organically. Speeding-up non-performing loans disposal would also improve the capital ratios' denominator.

In July 2018, Banco de Portugal started to apply the recommendations on borrower-based macro-prudential measures to new mortgage

Table 4.2.1: **Financial stability indicators**

(%)	2010	2011	2012	2013	2014	2015	2016	2017	Q2-2018
Non-performing debt	3.7	5.3	7.0	7.8	13.6	14.4	14.4	11.0	9.5
Non-performing loans	-	-	-	-	16.6	17.5	17.2	13.3	11.7
Non-performing loans NFC	-	-	-	-	27.9	28.3	29.4	25.2	22.3
Non-performing loans HH	-	-	-	-	9.7	9.4	8.7	7.1	6.4
Coverage ratio	61.5	56.6	54.3	56.4	37.9	40.6	45.4	49.9	53.4
Loan to deposit ratio*	123.9	116.1	119.5	111.4	104.9	99.3	93.6	90.1	87.1
Tier 1 ratio	8.3	8.6	11.3	12.2	11.4	12.6	11.7	14.5	14.1
Capital adequacy ratio	10.3	9.8	12.6	13.7	12.3	13.3	12.3	15.2	15.2
Return on equity**	6.7	-4.2	-3.3	-9.3	-3.5	0.9	-5.5	-0.8	3.1
Return on assets**	0.4	-0.2	-0.3	-0.7	-0.2	0.1	-0.3	0.0	0.3

**ECB aggregated balance sheet: loans excl to gov and MFI / deposits excl from gov and MFI*

***For comparability only annual values are presented*

Source: ECB

and consumer loans to prevent the accumulation of financial imbalances. Against the background of easing credit conditions, these recommendations comprised a shortening of upper limits for the loan maturities and upper limits for the loan-to-value ([28]) ratio. The recommendations also included ceilings on the debt-service-to-income ([29]) ratio and a requirement for regular payments of interest and capital.

Developing the market for distressed asset transfers remains a priority, along with improving the insolvency and recovery frameworks. Portugal has been struggling with both high corporate debt and a high level of non-performing loans in the banking sector. Both often go hand in hand, so addressing these issues has been a priority over the past few years. In particular, it was important that new servicing companies entered the secondary market for non-performing loans to allow the market to develop and gain momentum. Also, further facilitating the transfer of non-performing loans portfolios through a system allowing mass registration of the transfer of collateral and mass communication to courts in insolvency proceedings, as foreseen in *Plano Capitalisar*, will be key milestones in supporting faster market transactions. The length of insolvency proceedings remains the weak point of the system, although a set of measures has already been introduced to expedite proceedings through the use of technology and the creation of insolvency practitioners acting as mediators for viable companies and/or assisting the debtors in both court and out-of-court procedures.

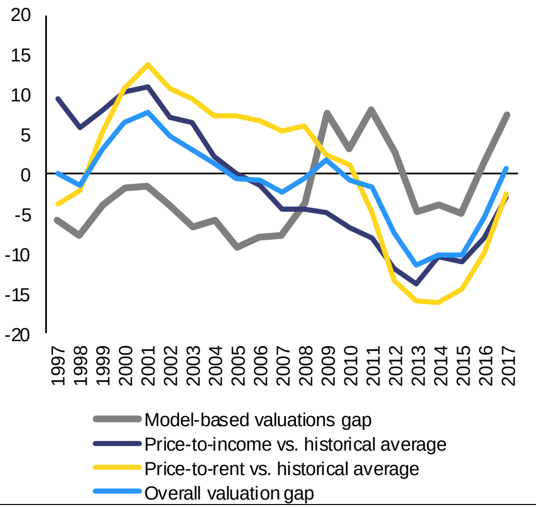
4.2.2. HOUSING MARKET*

House prices continued accelerating in 2017 and the first quarter of 2018. In annualised terms, the growth in house prices peaked to 12.2 % in Q1-2018 but moderated somewhat afterwards to 11.2 % in Q2-2018 and 8.5 % in Q3-2018. This compares to a year-average growth rate of 9.2 % in 2017. The recent statistics on construction volumes and newly issued construction permits show substantial growth. Along with the slowdown in tourism, these developments indicate that supply of real estate properties is likely to gradually catch up with demand. Therefore, the increase in house prices is set to slow down over the medium run. However, a more significant rebalancing effect from the recent growth in construction is likely to be seen as of 2019, as many projects are still in the pipeline and will not have an immediate impact on the market.

([28]) Loan-to-value is the ratio between housing loan(s) and the minimum between the purchase price and the appraisal value of the house granted as collateral.

([29]) Debt-service-to-income is the ratio between the total monthly amount of a borrower's repayment obligations resulting from all credit agreements and the borrower's total available annual net income.

Graph 4.2.3: **Valuation gap on price/income, price/rent and fundamental model valuation**



Source: European Commission

The increase in the deflated house price index is expected to exceed again the 6 % indicative threshold in the macroeconomic imbalance procedure scoreboard in 2018. This would mark the third consecutive breach of the threshold after 8.0 % in 2017 and 6.1 % in 2016. However, the rebound in house prices is seen as a correction from previously low levels of valuation and construction activity and the stock of mortgage loans is still on a downward trend relative to GDP. The market was mainly driven by tourism and foreign capital inflows, particularly in the main cities of Lisbon and Porto where the price hikes are well above the average. This is moving prices not only in popular tourist areas but affects also residential quarters. This is thus having implications on housing affordability, particularly for socially vulnerable groups (see Section 4.3.2).

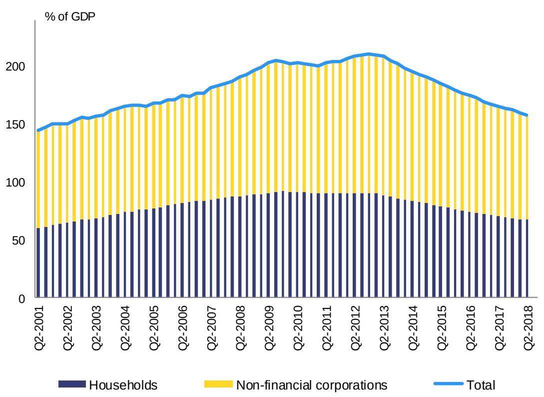
The impact of foreign capital flows is linked to purchases of properties by both non-residents and non-habitual residents[30]. It is estimated that about 20 000 non-habitual residents, including about 7 000 directly attributable to targeted regulation and financial incentives, have been attracted between 2012 and 2018. These incentives have drawn over EUR 4 billion in additional investment, mostly concentrated on real estate acquisitions.

Property valuations appear broadly in line with fundamentals. The estimated price-to-income and price-to-rent ratios in 2017 are still below the long-term average (see Graph 4.2.3). The gap based on deviation from equilibrium values based on demand and supply fundamentals shows an overvaluation of 7.5 % in 2017 but the estimated overall house price gap is close to zero. House prices are therefore not considered a source of imbalances for the moment given also the non-debt nature of factors behind the recent price drivers. However, these developments warrant a closer monitoring under the macroeconomic imbalances procedure.

4.2.3. PRIVATE INDEBTEDNESS*

Private debt retains a steady downward trend. Benefiting from upward revisions to GDP in 2016 and 2017, the share of consolidated private debt dropped to 162.2 % of GDP at the end of 2017 from previously reported 163.5 %. The new ratio indicates even a faster adjustment path from the peak of 210.3 % reached in 2012 (see Graph 4.2.4). The distance to the relevant Macroeconomic Imbalances Procedure threshold of 133 % was thus substantially reduced over the five-year period.

Graph 4.2.4: **Private sector indebtedness**



Source: Bank of Portugal

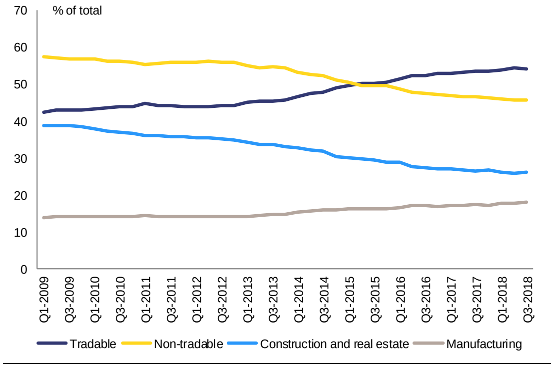
Both the corporate and household sectors contributed to the deleveraging process. At the end of 2017, consolidated corporate debt

30 The Non-Habitual Resident status applies to those who become tax residents in Portugal, which requires them to live more than 183 days a year in the country. The status enables them to receive a preferential tax treatment over a period of ten years.

accounted for 93.3 % of GDP relative to 68.9 % for households. Yet, the debt ratios in both sectors remain well above the country-specific prudential and fundamental thresholds. For households, these thresholds are estimated at 38 % each. For corporations, the benchmarks are estimated at 57 % and 66 % respectively.

The corporate sector is expected to deleverage faster than households in the medium term. The latest statistics show that the corporate sector retains a substantial pace of active deleveraging in terms of bank loans. This is seen from the fall in the consolidated stock of bank loans to private corporations up to August 2018. However, the consolidated stock of loans to households has slightly increased in absolute terms since the start of the year while still declining as a share in GDP. The monthly statistics, available only in non-consolidated terms, clearly show that the corporate sector is deleveraging much faster than households over the past months, benefiting from improved profit rates and foreign direct investment inflows allowing for non-debt financing of investments.

Graph 4.2.5: **Sectoral breakdown of domestic loans to non financial corporations (NFCs)**



Source: Bank of Portugal

The corporate credit allocation pattern changed in a way that increasingly favours the tradable sectors in detriment of the non-tradable ones Earlier analysis indicated that strong credit growth to non-tradable sectors before the financial and economic crisis contributed not only to the high level of indebtedness but thereby also limited the expansion of the productive capital stock. Recently, in terms of sectorial dispersion, loans to tradable sectors reached 61 % of the total loans at the end of 2017 and finally generated positive growth. These data indicate a more efficient credit allocation in the economy.

Non-bank financing is increasing. The share of debt securities in GDP widened from 17.3 % at the end of 2016 to 17.8 % at the end of 2017, while the share of bank loans fell from 41.4 % to 38.0 % for the same period. The increasing share of foreign direct investment in the net international investment position also indicates an improved access to loans from foreign-owned parent companies. The data thus imply that at aggregate level the ongoing process of deleveraging, particularly in the banking sector, is not having a significant negative impact on private investment, which have risen strongly in 2017 though from a low base. The potential for corporate investment is also supported by the improving profitability in many sectors of the economy. The high indebtedness is however still posing constraints on smaller firms, companies in a difficult financial situation as well as new entrants with limited access to alternative (non-bank) financing.

Access to finance remains challenging, along with an underdeveloped capital market. Loans to non-financial corporations continued to decline, but at a slower pace compared to 2017. The loans' contraction affects also exporting firms and firms with growth potential, with the latter being likely to finance investments with own resources, at times leading to sub-optimal levels of investment. Furthermore, the non-negligible share of zombie firms in the economy (although reducing) provides evidence of misallocation of resources by banks (Alexandre et al., 2017). Credit access is also constrained by the limited availability and awareness of alternative sources of financing. The share of venture capital investments as a percentage of GDP is one of the lowest among OECD countries and still below the pre-crisis level. In this context, various government initiatives aim to facilitate access to finance. Notably, the credit lines of the programme *Capitalizar* have been increased from EUR 1.6 billion in 2017 to EUR 2.7 billion in 2018. Additionally, the programme StartUp Portugal+ includes an initiative on international co-investment funds as well as co-financing lines with incubators and accelerators, among others. Further diversification of financing sources and risk finance remains key to increase investment.

4.3. LABOUR MARKET, EDUCATION AND SOCIAL POLICIES

4.3.1. LABOUR MARKET

Key labour market indicators are close to pre-crisis levels as the labour market situation continues to improve, though at a decelerating pace. The unemployment rate has reached 2008 levels and stood at 6.7 % in Q4-2018 (below the euro area average of 8 %), while the employment rate (seasonally adjusted, age group 20-64) continued to grow steadily up to 75.4 % in Q3-2018 (above the Europe 2020 target of 75 %) decelerating somehow from 75.3 % in the previous quarter. The long-term unemployment rate fell from 4.3 % in Q3-2017 to 3 % in Q3-2018, now close to the EU average of 2.9 %. Conversely, although decreasing, youth unemployment (15-24 year olds) remains sizeable (19.3 % in Q3-2018 compared to 14.9 % in the EU), though the share of young people (15-24) neither in employment nor in education or training (NEET) of 9.3 % in 2017 was the below EU average of 10.9 %. Regional differences on key labour market indicators are moderate (the unemployment rate ranged between 6.9 % and 10.4 % in 2017).

Labour market reserves are larger than suggested by the unemployment rate. In particular, the share of workers available to work but not seeking a job remains above the EU average (3.4 % in Q3-2018 as a share of the active population, compared to 3.1 % in the EU). Although the overall activity rate is above the EU average (see Section 1), this evidence suggests that there is room for further increasing labour market participation, which will be critically important in view of Portugal's ageing population and low birth rates ([31]).

Youth Guarantee measures have been far reaching and contributed to lower youth unemployment and NEET rates. On average during 2017 almost 6 out of every 10 NEETs aged under 25 were registered in the Youth Guarantee scheme (compared to an EU average of 40.5 %). More than half of those who left the Youth Guarantee in 2017 (54 %) were in employment or in education and training six months later. Follow-up data on the long-term outlook suggest that outcomes are sustainable. However, achieving the target of providing an offer within four months is proving difficult. The percentage of young people still in the preparatory phase (i.e. not having received a quality offer of employment, education or training) after 4 months stood at 58 % in 2017, above the EU average (51 %). This is delaying labour market access and may slow down the reduction of long-term unemployment among young people.

Active labour market policies achieved positive results but there is scope for wider coverage and focus on upskilling. Hiring support measures like *Contrato-Emprego* and traineeship programmes like *Estágios Profissionais* (which includes a bonus award for traineeship to open-ended employment contract conversion called *Prémio-Emprego)* brought about good results in terms of outreach and engagement of the main target groups. The take-up of both measures is high (above 70 % under *Contrato-Emprego* and around 95 % for *Estágios Profissionais*) and the main targets are widely covered (open-ended hiring and youth). However, the envisaged two-fold measure *Contrato-Geração*, that combines hiring support and exemptions from social security contribution, which was announced in late 2017, remains on hold and according to national authorities will only be implemented in 2019. By promoting young people's integration into the labour market while allowing the elderly to make a smooth transition to retirement, this measure has the potential to promote intergenerational fairness and cushion the expected impact of population ageing, which represents a key challenge and a priority for investment. As labour market conditions improve, addressing the low qualification level of the labour force (see section 4.3.3) appears a priority for future investment in active labour market policies. Currently, training programmes account for around 65 % of total coverage of jobseekers by active labour market programmes (compared to below 60 % in late 2016).

([31]) The 2018 Ageing Report estimates a decline in population from 10.3 million in 2016 to 9.9 million in 2030 and 9.1 million in 2050, with fertility rates in a range between 1.3 and 1.5 (among the lowest in the EU and well below the replacement level of about 2.1). The old-age replacement ratio is set to double within the same period.

Box 4.3.1: Monitoring performance in light of the European pillar of social rights in Portugal

The European Pillar of Social Rights is designed as a compass for a renewed process of upward convergence towards better working and living conditions in the European Union ([1]). It sets out twenty essential principles and rights in the areas of equal opportunities and access to the labour market; fair working conditions; and social protection and inclusion.

SOCIAL SCOREBOARD FOR PORTUGAL		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Weak but improving
	Gender employment gap	Better than average
	Income quintile ratio (S80/S20)	To watch
	At risk of poverty or social exclusion (in %)	On average
	Youth NEET (% of total population aged 15-24)	On average
Dynamic labour markets and fair working conditions	Employment rate (% population aged 20-64)	Better than average
	Unemployment rate (% population aged 15-74)	Better than average
	Long-term unemployment rate (population aged 15-74)	Better than average
	GDHI per capita growth	On average
	Net earnings of a full-time single worker earning AW	To watch
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Critical Situation
	Children aged less than 3 years in formal childcare	Good but to monitor
	Self-reported unmet need for medical care	On average
	Individuals' level of digital skills	To watch

Members States are classified according to a statistical methodology agreed with the EMCO and SPC Committees. The methodology looks jointly at levels and changes of the indicators in comparison with the respective EU averages and classifies Member States in seven categories (from "best performers" to "critical situation"). For instance, a country can be flagged as "better than average" if the level of the indicator is close to EU average, but it is improving fast. For methodological details, please consult the draft Joint Employment Report 2019, COM (2018)761 final. Data update of 29 January 2019. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

While the social and employment situation is recovering, Portugal faces challenges with regard to some indicators of the Social Scoreboard supporting the European Pillar of Social Rights. The recent labour market performance drove a significant improvement of employment and unemployment rates and a reduction in the share of people at risk of poverty or social exclusion. Nonetheless, income inequality remains high and the percentage of early leavers from education and training still represents a challenge. On the positive side, Portugal continues to be among the best performers in terms of participation to formal childcare for children aged less than three, though with a slight reduction in 2017, and though provision of childcare is still insufficient in some areas of the country.

The impact of social transfers (other than pensions) on poverty reduction remains limited, highlighting a critical situation when compared to the EU average. While transfers contributed to a reduction of the poverty rate by 22.5 % in 2017, this impact has decreased in recent years and lies below the EU average of 34 %. Portugal has reinforced some benefits in recent years, however this has not changed the overall trend. In particular, while the minimum income scheme has increased its take-up by 14 500 people since September 2017, its adequacy is among the lowest in the EU: on average, the net income of a minimum income recipient amounts to around 40 % of the national poverty threshold.

Portugal faces a low average qualification level of the adult population, with potentially negative effects on labour market adaptation and productivity growth, in a context of ageing population. The lack of skills of the population, notably digital, prompted the Portuguese authorities to reprogram their European Social Fund operational programmes in order to reinforce interventions linked with skills upgrading and adult education while, simultaneously, aligning them with the country-specific recommendations. The largest share of the ESF reprogramming was allocated to the Qualifica programme (launched in 2017), which aims to raise qualifications, facilitate tailored training pathways and better align training provisions to labour market needs (see Section 4.3.3).

([1]) The European Pillar of Social Rights was proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission: https://ec.europa.eu/commission/priorities/deeper-and-fairer-economic-and-monetary-union/european-pillar-social-rights/european-pillar-social-rights-20-principles_en

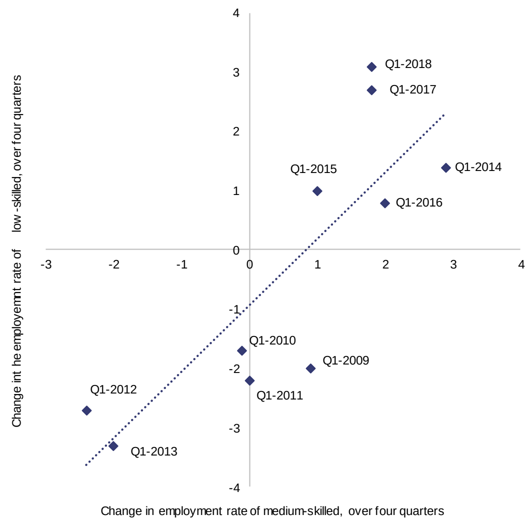
Portugal is implementing measures to tackle long-term unemployment, but effectiveness remains a challenge. Monitoring data of the Council Recommendation on the integration of long-term unemployed reveals a very high share of implementation on all segments (around 98 % and well above the EU average of 83 %), as well as a high share of sustainability (73 % of users with 2016 job integration agreements in employment 12 months after exiting versus an EU average of 60.7 %). However, effectiveness remains low with only 16.8 % transiting to employment in 2017 and around half of the 2016 users still unemployed 12 months after receiving a job integration agreement.

Multi-level governance and cooperation between Public Employment Services (PES), companies and training organisations is not always effective. At 36.7 % in 2017 the share of unemployed people using public employment services to find a job is among the lowest in the EU and has been steadily decreasing since 2008 when it stood at 60.3 % (Eurostat, Labour Force Survey). Changes in the working methods of PES were introduced to allow more focus on job-seekers less likely to find a job, such as the low-skilled and long-term unemployed. While a better segmentation of clients to provide individualised services and focus on re-skilling and up-skilling needs is welcome, the effectiveness of these measures is to be monitored and further investment may be required. There is still limited cooperation of PES with other stakeholders, but authorities are working to improve their matching function both by upgrading the online vacancy database and by strengthening the cooperation with employers, namely by introducing dedicated case managers for relevant employers (*Gestor+*).

Public Employment Services have introduced an online interface for job-seekers and employers, setting up a "one-stop shop" for employment. The new *IEFPonline* tool is designed to allow users to obtain full responses without physical presence in the employment service. This initiative contributes to fully implement the Council recommendation on the integration of the long-term unemployed. Effective inter-institutional connectivity and information sharing (e.g. with social security) is assured every year in the budget law (the 2019 draft envisages a new connection between employment and health services). However, some features could be improved (e.g. the implementation of job integration agreements for other areas beyond employment/training, like health, education or social action).

In June 2018 the government and social partners signed a tripartite agreement envisaging measures to tackle labour market segmentation. As shown in Section 1 and in past country reports, the Portuguese labour market has one of the highest shares of workers on temporary contracts in the EU (with negative consequences for job quality, earnings and career perspectives). The agreement, which was officialised in a government resolution (*Resolucão do Conselho de Ministros n. 72/2018*), aims at addressing segmentation through an "Action Plan to tackle precariousness and promote collective bargaining" (see description in Box 4.3.2). Other related measures, notably the reinforcement of the labour inspectorate, are ongoing with the procedures to recruit 122 labour inspectors almost completed. In 2019, the Labour Ministry plans to open a new call to recruit 48 extra workers for the Labour Conditions Authority.

Graph 4.3.1: **Annual change in the employment rate of low and medium-skilled workers (age 20-64) since Q1-2009**



Source: European Commission based on Eurostat, LFS

Achieving a proper balance between the currently tabled proposals will be key for their effectiveness in reducing segmentation while sustaining job creation. Introducing limitations to fixed-terms contracts in combination with incentives to open-ended hiring could help to reduce labour market segmentation. However, too strict constraints for hiring on temporary contracts could reduce investment and job creation, in a context where job creation is mainly in services with a significant share of seasonal activity, and some aspects of the legal framework for dismissals could still discourage open-ended hiring (as shown in the 2017 and 2018 country reports). Also, lengthy court procedures in case of employment disputes may be a disincentive to permanent hiring, though this has improved recently (the average length of labour trials in first instance decreased from 11 months in 2016 to 9 in 2017).

A further minimum wage increase took place in 2018. The monthly minimum wage increased from EUR 557 in 2017 to EUR 580 in 2018 and EUR 600 in 2019. In absolute levels, this is in the medium range as compared to other EU Member States ([32]). At the same time, it places the Portuguese minimum wage among the highest in the EU when compared to the median wage in the same country (the wage earned by the worker in the middle of the wage distribution), with a ratio of nearly 60 % (latest comparable OECD data for 2016). This high ratio implies a significant compression of the wage distribution, with more than 20 % employees earning the minimum wage, which by reducing the education premium may lower incentives for the low skilled to invest in education and training (see also Section 4.4.3).

Minimum wage increases were accompanied by rises in the employment rate of low-skilled workers, amidst strong job creation and a favourable economic cycle. Graph 4.3.1 shows that the employment rate is increasing for both low- and medium-skilled workers since 2013. In particular, the employment rate of low-skilled workers increased by 2.7 and 3 percentage points during the year to the first quarter of 2017 and 2018, respectively, against an increase of 1.8 percentage points in both years for medium-skilled workers. These two annual observations are above the dotted line representing the historical relationship, which implies that the employment rate of low-skilled workers is improving faster than expected. This evidence suggests that possible negative effects of the minimum wage on low-skilled employment are not evident in recent aggregate developments, in a context of cyclical upturn that may have favoured job creation among this group of workers ([33]). Disparities between the employment rates of high, medium, and low-skilled workers are smaller in Portugal than in most other Member States, and this is true for young workers as well (draft Joint Employment Report 2019, Fig. 22).

Legislation to address the gender pay gap was introduced in August 2018. Portugal has a higher than average gender pay gap, which has increased significantly in recent years (in unadjusted terms) from 8.5 % in 2007 to 17.5 % in 2017 (versus 16.2 % in the EU). While female labour market participation is high, the growing pay gap suggests that women are increasingly employed in lower-paid sectors and jobs, although they are on average more qualified than men. In addition, they may receive lower hourly wages compared to men with similar experience. Recent measures include an annual report ([34]) about differences in remuneration between women and men and an assessment per company, profession and level of qualifications (to be applied to companies with 250+ employees in the first 2 years, and with 50+ after that). Specific actions from the labour inspectorate and sanctions against employers or discriminatory treatment are envisaged.

Collective agreements are nearing pre-crisis levels. Data for 2017 ([35]) show a 42 % increase in the number of agreements from 2016. Data for 2018 show a further year-on-year increase of 6 % in the number of agreements and 10 % in coverage, reaching over 900 000 workers. The revival in collective bargaining points to improved

([32]) For comparability across countries, Eurostat calculates the minimum wage per 12 months, resulting in a level of EUR 700 in Portugal (equivalent to EUR 600 paid 14 times a year).

([33]) The Ministry of Labour has been monitoring the effects of minimum wage increases. For further details, see “Ministério do Trabalho, Solidariedade e Segurança Social, 2018”.

([34]) The law requires the Statistical Office of the Ministry for Labour, Solidarity and Social Security to produce regular data on pay disparities by sector and company (profession and qualification level) based on annual info provided by companies. Based on the statistical information, companies are notified by the labour inspectorate to present a plan to evaluate their pay disparities, to be implemented within 12 months. After implementation, the company has to either correct or justify pay disparities.

([35]) Direção-Geral do Emprego e das Relações de Trabalho, Ministério do Trabalho, Solidariedade e Segurança Social.

social dialogue conditions in Portugal, which is also suggested by a good level of stakeholders' involvement in policy design and monitoring. The broad consensus found among most social partners in the tripartite agreement on labour market reforms mentioned above and the regular consultation on monitoring the impact of minimum wage developments are good examples of such involvement.

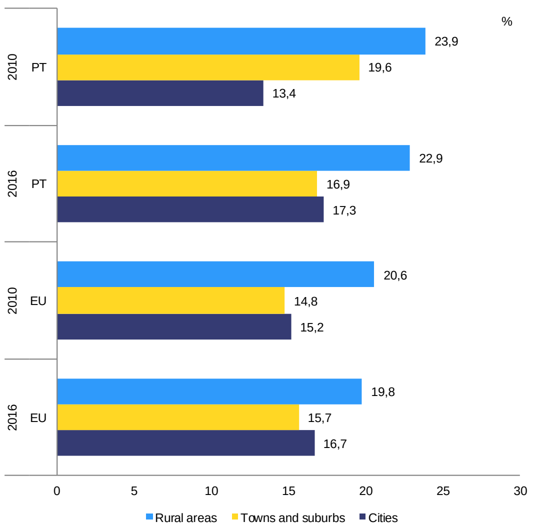
4.3.2. SOCIAL POLICIES

Portugal saw a substantial decrease in its poverty indicators. As shown in Section 1, the at-risk-of-poverty or social exclusion rate (AROPE) continues to decline, from 25.1 % in 2016 (referring to 2015 incomes) to 23.3 % in 2017 (referring to 2016 incomes), and is now closer to the EU average of 22.4 %. Significant progress has been recorded for children (0-17) as the indicator dropped by 2.8 percentage points in 2017 to 24.2 %, now below the EU average of 24.9 %. The improvement is related in particular to the increase in work intensity of households. Still, child poverty remains high in households with three or more dependent children and in lone-parent households. While improving, the situation of elderly people (65+) shows some vulnerabilities as their AROPE rates at 20.7 % in 2017 is 2 percentage points higher than the EU average. National data point to a further decrease of the AROPE to 21.6 % for the income year 2017. Notwithstanding some improvement, the share of people in a situation of material deprivation remains significant. In 2017, 18.0 % of Portuguese were materially deprived, and 6.9 % were severely materially deprived.

In spite of overall progress, reducing poverty of people in employment is less evident. The in-work poverty rate remains above the EU average, with an only minor decrease in 2017 (by 0.1 percentage point to 10.8 %, versus 9.6 % in the EU). The percentage of working poor people in households with high work intensity and with children is among the highest in the EU. In addition, the poverty rate among part-time workers has further increased in 2017 and remains significantly above the EU average (31.5 % compared to 15.8 % in the EU). The recent minimum wage increases (see Section 4.3.1) have so far shown only a limited impact in reducing in-work poverty though this can be related to the overall increase in median disposable income, while labour market segmentation remains a main driver.

The labour market situation of people with disabilities is improving, with a slight increase in their placements in the open labour market compared to the previous years, and a decrease in the number of registered unemployed (European Commission, 2019b). Nonetheless, challenges remain. Despite an employment rate slightly above the EU average (50.5 % vs. 48.1 %), the number of those employed in the mainstream labour market is very low in both the public and private sectors (where it represents 0.5 % of the workforce, against a quota stated by law of 2 %) ([36]).

Graph 4.3.2: **At-risk-of-poverty in Portugal and European Union (current composition), 2010 vs 2016**



Source: Eurostat

([36]) The current quota law applying to the public sector is 5 %, by Decree-law 29/2001, of 3 February

The risk of poverty remains high in rural areas. The proportion of people at risk of poverty is significantly larger in rural areas than in cities, with a larger gap than EU average (see Graph 4.3.2). Recent data show that, taking the national poverty threshold as the benchmark (EUR 5 610 in 2017), the Greater Lisbon area (Área Metropolitana de Lisboa) was the region with the lowest at-risk-of poverty rate (12.3 %) while the Autonomous Regions were the most affected by the risk of poverty (31.5 % in Azores and 27.4 % in Madeira). Nonetheless, pockets of poverty persist also in urban areas, notably in the capital region when computing the poverty threshold at regional level (see further details in Section 4.4.3).

Recent increases in house prices (see Section 4.2.2) can put housing affordability at risk in urban areas. Overall, indicators of housing cost overburden ([37]) do not signal a challenge for Portugal compared to the EU average. However, the share of tenants experiencing housing cost overburden, at 28.2 % in 2017, is above the EU average of 26.2 %. Moreover, the rate of severe housing deprivation in cities, though decreasing, is above the EU average (5.3 % vs. 3.8 %). The recent rise in housing prices is likely to worsen the situation for people who have low incomes, particularly in the country's two largest cities. The government launched a 'New Generation of Housing Policies' strategy in May 2018 which acknowledges the problem, notably for lone-parent households and young people. The strategy aims at promoting universal access to adequate housing, for instance by increasing the share of public supported housing and lowering the housing overburden within the rental regime.

Income inequality has declined but remains above the EU average. The ratio of incomes earned by the top 20 % to the bottom 20 % of the income distribution (the S80 / S20 ratio ([38]) decreased from 5.9 in to 5.7 in 2017 (against 5.1 in the EU). The improvement was driven by an increase in the income share of poorer households, with the bottom 20 % of the population's share of income increasing from 6.7 % in 2014 to 7.1 % in 2017. While market income inequalities are substantially higher than the EU average, the tax and benefit system helps to reduce some of these effects. According to the OECD (2018e), Portugal is among those countries where individuals with an income close to the median are more likely to experience downward mobility than to rise in the income hierarchy. On average, the descendants of a family within the lowest 10 % of the income

Box 4.3.2: The 2018 Tripartite Agreement

A tripartite agreement was signed in June 2018 to tackle precarious employment, reduce labour market segmentation and promote more dynamism in collective bargaining. The measures proposed in the agreement, subject to parliamentary approval (expected in 2019), seek to introduce changes in the labour code, the code of contributory schemes, the legal framework for the protection of employees, the framework of active labour market policies and other complementary legislation.

The approved action plan consists of three main strands of action. The first one tackles precariousness and seeks to reduce labour market segmentation, namely by limiting the scope for legal use of fixed-term contracts (e.g. reducing the maximum duration of fixed-term contracts) and reducing the safeguard period to access social unemployment benefits when unemployment is due to the expiry of fixed-term contracts. Other proposals aim to reduce the excessive use of fixed-term contracts, promote open-ended hiring (by increasing the length of the probationary period and by means of incentives) and to increase contract duration for seasonal activities.

The second strand of the proposal focuses on fostering collective bargaining as a shared effort to involve stakeholders with a view to improve labour market outcomes. This includes reducing individualisation of labour relations, preventing gaps from occurring due to the expiration of collective agreements and promoting the collective dimension for instruments of labour regulation.

The third strand is policy-driven and envisages the reinforcement of public means and instruments to regulate labour relations. It implies upgrading the capacity of the Labour Conditions Authority, reinforcing the mediation role of the Labour Administration and simplifying communication procedures regarding employment contracts.

distribution would need four or five generations to approach the average income. The Portuguese population ranks among the highest in the EU in setting social inequalities as the first of the three main challenges for Europe ([39]).

The impact of social transfers (other than pensions) on poverty reduction remains limited, as highlighted by the Social Scoreboard accompanying the European Pillar of Social Rights. While transfers contributed to a reduction of the poverty rate by 22.5 % in 2017, this impact has decreased in recent years (although the coverage and adequacy of benefits have increased to some extent) and lies below the EU average of 34 %. The at-risk-of-poverty gap, a measure of the depth of poverty, remains high in particular for children (30.2 % vs. 24 % in the EU). While the minimum income scheme has increased its take-up by 14 500 people since September 2017, its adequacy is among the lowest in the EU: on average, the net income of a minimum income recipient amounts to around 40 % of the national poverty threshold ([40]).

Recent changes in eligibility rules for unemployment benefit may increase their coverage. The share of short-term unemployed covered by unemployment benefits, at 29.9 % in 2017, is below the EU average of 32.4 % and has decreased recently ([41]). In this context, the recent reduction of the guarantee period of the social unemployment benefit from 180 to 120 days of work could support temporary workers experiencing cessation of activity, with an expected increase in their coverage rate. Still, the net replacement rate for a low wage worker (i.e. earning 67 % of the average wage) while high at the beginning of the unemployment period (75 %) drops to only 23 % after one year.

The coverage of childcare (0-3 years) is high, but a mismatch between supply and demand occurs in some areas. Portugal ranks among the highest in the EU for participation in formal childcare for children under 3 years old (47.6 % compared to an EU average of 34 % in 2017) though slightly decreasing from 49.9 % in 2016. However, the indicator for children aged 4-6 is below target (see Section 4.3.3). Moreover, the metropolitan areas of Lisbon and Porto suffer from an insufficient provision of childcare and supply exceeds demand in small inland towns. The National Strategy for Equality and Non-Discrimination - Portugal + Igual contains proposals for investment in childcare services, including an increase of coverage especially in urban centres ([42]).

A measure to ensure all children aged 4 and 5 have access to pre-school education is currently being implemented, although there are difficulties in accomplishing this target in the main metropolitan areas, especially in Lisbon. Some new facilities have been built in recent years, co-financed by the European Social Fund and the European Regional Development Fund. Work life balance depends significantly on the availability of childcare: while legislation provides that both mothers and fathers are entitled to flexible working hours until children are 12 years old, access to this scheme is often difficult.

Depopulation also linked to ageing puts pressure on the efficiency and quality of the public services. This is true in particular in rural regions, with particular challenges in health and long-term care, which also highlights the importance of pursuing active aging strategies. The 2014 national health survey found that about 458 000 of the 2.1 million people aged 65 or older reported difficulty in performing at least one activity of personal care; among those, 35 % needed help (or more help than they had) in order to perform such activities (INE/INSA, 2016). Over the last decade, the ageing population’s increasing need for care was addressed by developing a long-term care system based on the provision of community-based and institutional services, though informal care still plays a significant role (European Commission, 2018c) and further investment may be required. In June 2016, the 2017-2018 strategic plan for the development of palliative care was launched, and in February 2017

([39]) Eurobarometer on the Future of Europe (Social Issues) published in 2017 November.

([40]) According to the Benchmarking Framework on Minimum Incomes conducted within the SPC Committee. For details, see the draft Joint Employment Report 2019, COM(2018) 761 final.

([41]) According to the benchmarking exercise on unemployment benefits and active labour market policies. For details, see the draft Joint Employment Report 2019, COM(2018) 761 final.

([42]) Resoluçao do Conselho de Ministros n. 61/2018 in Diário da República n. 97/2018, Série I de 2018-05-21 the government announced the first 25 pilot projects of the long-term care network. Some action was taken towards a formal status for informal carers and training and empowerment is included in the National Reform Programme.

The health status of Portuguese citizens is good in many areas, but inequalities in access to healthcare remain. A 2.3 % share of the Portuguese population report unmet needs due to cost, distance or waiting time (2017) which despite a marginal improvement is now above the EU average of 1.6 %. Although financial protection mechanisms are in place to ensure equitable access to health through a system of exemptions on user charges (with a wide set of reforms introduced in 2016), the rate is substantially higher for the lowest income quintile (5.1) than for the highest (0.3), with a greater difference than the EU average. Out-of-pocket expenditure on healthcare is one of the highest in the EU at 27.8 % (2016). There are also significant differences in health indicators between the wider metropolitan areas of Lisbon and Oporto and the interior regions, and many living in rural areas face barriers (including geographic distance) to access quality health services.

While registrations with family doctors have increased substantially in the past decade, gaps in health care provision between regions remain. Healthcare resources, including the number of doctors per inhabitant as well as provisions of specialised care and primary care, are unevenly distributed between regions. High levels of investment in regional facilities and incentives for health personnel to move to underserved areas in recent years seek to address these geographical disparities. The health workforce is set to increase and the authorities have a target to further increase registrations with a general practitioner (92.7 % of National Health Service users in 2017). However, there are still challenges and investment needs to ensure recruitment, retention and an even distribution of health professionals. It is also projected that investment in medical equipment and infrastructure will be needed (see Section 4.1.2).

4.3.3. EDUCATION, VOCATIONAL TRAINING AND SKILLS*

Spending on education remains stable and is slightly above the EU average. In 2016, general government expenditure on education was 4.9 % as a share of GDP and 10.8 % as a share of total government spending (EU averages were 4.7 % and 10.2 % respectively). However, since 2015, spending has fallen by about 3 % in real terms, mainly for tertiary education. The annual expenditure on Portuguese educational institutions per student has increased significantly, but it remains below the EU average. Funding is not allocated on the basis of any comprehensive evaluation strategy and does not have flexibility to address specific challenges. Investment in education infrastructure is heavily dependent on EU financial support. Schools have very limited budgetary autonomy to respond to challenges.

Participation in pre-primary education for children 4 to 6 years old is decreasing, **moving away from the Europe 2020 national benchmark of 95 %**. In 2016, the participation rate in early childhood education and care was 92.5 %, below the EU average (95.3 %) – though participation for more than 30 hours a week is the highest in the EU. Household income influences significantly participation in early childhood care (children under age of 3), with only 36 % of children whose families are in the bottom third of the disposable income distribution enrolled (about 60 % in families in the top third). From 2016 to 2018, 193 new public pre-school classrooms were opened. The government aims to extend the network to provide universal access for children ages 3 to 5 by 2019 (see also Section 4.3.2). It also intends to improve teacher training, within the scope of the new curricula guidelines for pre-primary education.

Portugal still struggles with early school leaving and grade repetition, but is making headway to reduce it. Considerable progress was made in the last decade in reducing the early school leaving rate (from 28.3 % in 2010 to 12.6 % in 2017; rates are, however, over 20 % in the autonomous regions of Madeira and Azores). However, the rate remains high, as also highlighted by the Social Scoreboard accompanying the European Pillar of Social Rights (see Box 4.3.1). Moreover, grade repetition is high, with about one third of 15-year-olds having repeated at least one grade. The repetition rate varies across education levels and regions and is significantly higher in the Lisbon and southern regions than in the north and centre. Policy measures to promote school success, to provide extra support to students at risk of failing and to increase the vocational education offer have helped to steadily reduce repetition rates in recent years. Other measures have also contributed, such as the reduction of the student-teacher ratio and free school manual for public primary education. The early school leaving rate for people with disabilities remains at 27.4 % much higher than the EU average of 23.6 %. In this regard, the implementation of the new law on inclusive education is affected by lack of adequate resources.

The physical infrastructure of schools has improved but concerns persist about the overall quality of school infrastructure. In 2007, the government launched two programmes: one to expand pre-schooling and to requalify primary schools, through funding and technical support to municipalities, and the other to modernise and improve public secondary school infrastructures, implementing a management and maintenance model that relied on a state-owned private company *Parque Escolar*. About one-third of public secondary schools (173 out of 526) were renovated, ranging from 27 % in the central region to 54 % in the Alentejo. However, lack of financial resources resulted in the planned investment in the remaining secondary school facilities (around a hundred of interventions) being delayed or suspended. Apart from the re-qualified secondary schools buildings, school infrastructure experiences various states of disrepair. Capital expenditures correspond to less than 2 % of the total budget of education in Portugal. This low level of investment results in difficult learning conditions in many schools with old buildings lacking a proper maintenance.

Giving schools more autonomy remains high on the national policy agenda for education. During the 2017/2018 school year, 235 lower and upper secondary schools were involved in an experimental programme of autonomy and partial curriculum flexibility. The project defined guidelines on how the schools, in an autonomous way, could develop, operationalise and assess school curricula, so that students may successfully complete their 'profiles' at the end of compulsory education.

Teachers' competences require improvements and the ageing teacher population will pose challenges. As reported in the 2013 OECD Teaching and Learning International Survey, 9.2 % of lower secondary education teachers indicated they had a high need for professional development in information and communication technologies skills for teaching. In the same survey, 26.5 % of teachers indicated training needs for teaching students with special education needs. Over the past 15 years, there has been a substantial ageing of the teacher population: currently Portuguese teachers are on average in their upper 40s and the number of people entering the teaching profession has been going down. The government has announced public competitions to incorporate teachers as permanent staff.

Measures are being implemented to make higher education more attractive and increase the completion rate. Portugal's tertiary educational attainment level among 30-34 year olds (33.5 %) is still below the EU average (39.9 %). However, the employment rate of recent tertiary graduates (80.7 %) is slightly above the EU average (80.2 %). Measures to increase higher education enrolment include bolstering social support mechanisms for students from disadvantaged backgrounds through a significant increase in scholarships, the creation of specific scholarships for students with special educational needs corresponding to the amount of the fee effectively paid, a social scheme for paying tuition fees in multiple instalments, and the implementation of a redefined *+Superior* programme to promote and support enrolment in less densely populated regions and in regions where demand is lower. The tertiary education attainment rate of people with disabilities is below the EU average (25.5 % versus 30.3 % in the EU), and reasonable accommodation is not ensured for students with disabilities in post-secondary education.

Low graduate numbers in information and communication technologies may affect the country's innovative capacity and productivity growth. The number of people aged 20 to 29 holding science, technology, engineering and mathematics degrees per 1000 inhabitants at 18.6

is roughly in line with the EU average of 19.1. However, in 2016 the share of total graduates in information and communication technologies (1.2 %) was well below the EU average (3.4 %). Similarly, the share of graduates in the natural sciences, mathematics and statistics was below average (6.2 % versus 7.5 %). To promote enrolment in information and communication technologies, electronics and physics, the government has increased the study places available in these areas. In 2017, around 40 % of the students newly enrolled in higher vocational education and training courses (*Cursos Técnicos Superiores Profissionais*) were in science, technology, engineering and mathematics areas.

The review of the Higher Education System is ongoing. Following the presentation in early 2018 of the OECD Review on higher education, science, technology and innovation systems, the government approved a number of legal and programme initiatives notably for degrees and diplomas, for access of international students to higher education and for recognition of foreign degrees.

Portugal has made significant progress on the offer of vocational education and training opportunities. Vocational education and training is available at lower, upper, and post-secondary levels. Apprenticeship programmes and other vocational education and training programmes incorporate work-based learning. A range of adult education and training programmes, including certified modular training, and recognition, validation and certification of competences have been developed, particularly within the *Qualifica* programme. Data suggest a high share of employability amongst vocational education and training graduates (75.8 % and above the EU average of 74.8 % in 2017), but the share of 30-34 years old with vocational education and training or higher education is low when compared with the EU average (46.7 % versus 73.2 % in 2017). The main challenges of the vocational education and training system are the quality of training offers (and respective alignment with labour market needs) and the capacity of providers.

The average qualification level of the adult population is low. About 52 % of the population aged 25-64 has low educational attainment levels, well above the EU average of 22.5 % in 2017 (and reaching more than 60 % in Azores and Madeira). This poses a challenge, in view of the ongoing transformations in the labour markets and in a context of ageing population, as an investment priority. According to the European Investment Survey (European Investment Bank, 2018), the availability of skilled staff is the second most important obstacle to investment faced by the companies surveyed. In the particular area of adult learning, there is scope to further engage the low qualified (whose participation in learning is below the EU average) and to increase the coverage of targeted public incentives to small and medium-sized enterprises for training their staff. The National Skills Strategy, built with OECD support, is presently in its action phase and focuses on strengthening the adult learning system. Additionally, the reprogramming of structural funds that Portugal implemented in 2018 is a useful exercise to further address the low-skills challenge. It entails significant reinforcement of allocations and realignment of priorities on skills upgrading and adult education.

The *Qualifica* programme is an important tool to tackle the challenge of a low-skilled adult population. Launched in March 2017, this programme aims to raise qualifications, facilitate tailored training pathways and better align training provisions to market needs. By the end of 2018, the programme had reached around 278 000 adults. According to national data, up to December 2018 the majority of referrals had gone to training offers (71 %), of which 60 % were modular trainings and 23 % to adult education and training courses. 29 % of the adults were guided to recognition and certification of prior learning. Additionally, Portugal had in Q3-2018 49.6 % of the active population with upper secondary education (target for 2020 is 50 %), although participation in adult learning in 2017 is below the EU average (9.8 % against 10.9 %). National authorities have a new branch of the programme – *Qualifica AP* – in the pipeline for public servants. The need to implement a structural reform of the qualifications level of the population prompted the national authorities to dedicate the largest share of European Social Fund reprogramming allocations to *Qualifica* and to the operations of its 300 centres, not only at national level (with the human capital operational programme - *Programa Operacional Capital Humano*) but also at regional level.

Insufficient digital skills can hinder inclusion, employability and competitiveness. In 2017, 50 % of the Portuguese population still did not have basic digital skills, and 30 % had no digital skills at all. This compares with an EU average of 43 % and 17 % respectively. Vulnerable groups of the population, such as the elderly or those with low levels of education or on low incomes, are at risk of digital exclusion (see 2018 Country Report). Furthermore, 18 % of the Portuguese active labour force (employed and unemployed individuals) has no digital skills, compared with an EU average of about 10 % (European Commission, Digital Scoreboard).

Portugal initiated a number of initiatives to improve digital skills and competences in 2018. This was mostly done through INCoDe.2030, the country's national initiative in this domain, which consists of five main axes (inclusion, education, qualification, specialisation and research) and associated targets for 2020, 2025 and 2030. A budget of EUR 20 million (2018-2019) was allocated to training interventions, including mandatory ICT modules, for unemployed people with low qualifications (*Vida Ativa Qualifica+*). A workplan was defined for the Capacitar i4.0 initiative, which seeks to integrate Indústria 4.0 and INCoDe.2030 by increasing the digital preparedness of businesses (see also section 4.4). Promising initiatives to promote digital inclusion are also underway, such as ‘Creative Communities for Digital Inclusion’ (to develop the digital competences of vulnerable groups) and the development of an action plan to close the gender gap in digital technologies that is in line with EU-level actions in this area. Timely implementation and upscaling with adequate investment will be crucial for these and related measures (a number of which are at the pilot stage) to be effective.

Investment needs

Increased investment in education and training, modern employment institutions and services, and social inclusion policies are important for improving Portugal’s productivity and long-term inclusive growth. The low qualification level of the labour force is an obstacle to investment and productivity growth. Investment in education and training, including infrastructure, is key to addressing a high rate of early school leaving and improving employability and social mobility. Using the full labour potential, also in view of population ageing, requires investment in the capacity of employment services, effective active and preventative labour market policies, and measures to promote a better work-life balance. Persisting inequalities, high child poverty and in-work poverty call for investment in active inclusion, integration policies and supporting services, including healthcare and long-term care.

4.4. COMPETITIVENESS REFORMS AND INVESTMENT

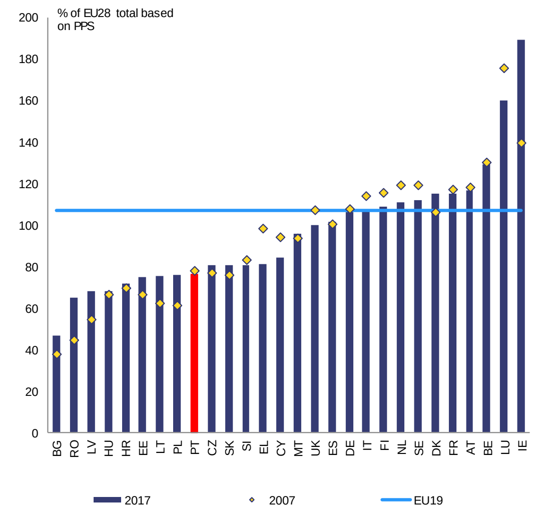
4.4.1. PRODUCTIVITY GROWTH AND INVESTMENT*

Productivity developments

Portugal is exhibiting feeble productivity growth. The weakness of the country's productivity dynamics also explains to some extent the absence of income convergence (see Graph 4.4.1). This is partially due to low investment and capital accumulation over the past years. The contribution of capital is still weaker than before the crisis, which explains why labour productivity and potential growth remain at a relatively low level. However, other specific structural factors also affected productivity performance. Total factor productivity has been growing over the last years, although at lower pace compared to euro area average, and slowing down in 2017 and 2018. Following the 2016 Council Recommendation, Portugal has appointed the *Conselho para a Produtividade* as National Productivity Board in March 2018

Labour productivity growth differs markedly across sectors and firm sizes. In market services, productivity is dragged down mainly by the financial and insurance services, real estate activities and information and communication technologies subsectors. By contrast, labour productivity growth in manufacturing was comparable to the euro area average since 2000. There are signs that credit allocation is being more responsive to sector differences, and increasingly channelled to tradable sectors with greater growth potential and productivity: loans to tradable sectors increased to 61 % of total loans at the end of 2017. Portuguese big corporates report higher productivity, profitability and easier capacity to repay debt across all main sectors of the economy. Although small and medium-sized enterprises increase their productivity more than large enterprises since the crisis period, the productivity gap between different non-financial corporations remains significant (European Commission, 2019c).

Graph 4.4.1: **Labour productivity**



Source: Eurostat

Investment

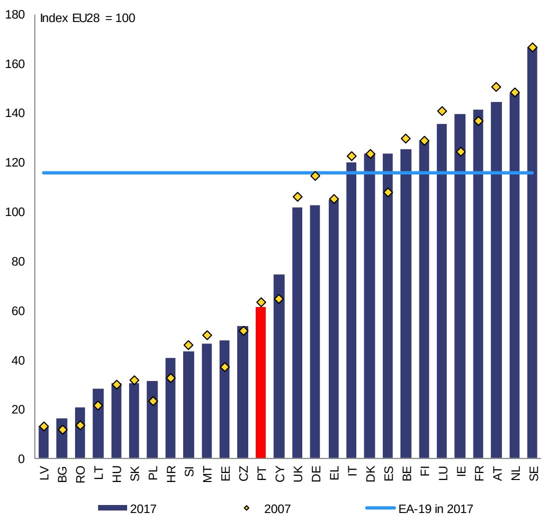
Investment is increasing but remains low. The ratio of investment over GDP reached 16.6 % in 2017, the highest since 2012. Despite this improvement, the investment rate in Portugal remains one of the lowest in the EU. The extended period of weak investment deteriorated existing capital stock and slowed down the rate of capital deepening, which still stands significantly below the EU average (see Graph 4.4.2). The gap in the capital deepening between Portugal and the EU accounts for a large proportion of the labour productivity gap.

Public investment rebounded during 2017 but remained well below pre-crisis levels. In 2017, public investment registered an increase of 23.4 % year-on-year. Yet, its share in total investment (11 %) is one of the lowest in the historical series. Over the medium term, public investment is expected to grow faster than nominal GDP reaching 2.6 % of GDP in 2020. Properly targeted public investment can do much to boost potential growth by fuelling productivity growth through improved human capital and more technological innovation. According to the empirical evidence, public investment in Portugal might also create a crowding-in effect by providing relevant infrastructure for private investment.

Foreign direct investment is helping to reduce the investment challenge that Portugal faces. Inflows of foreign direct investment increased 8.3 % year-on-year in 2017. Moreover, the stock of foreign direct investment liabilities to GDP (an indicator of *de facto* openness to foreign direct investment) stands at 62 %. In 2017, the services sector showed the highest increase in foreign direct investment liabilities (+10.3 %), especially in wholesale and retail trade (+21.7 %) and professional, scientific and technical activities (+12.5 %). The liabilities increased also in construction (+7.6 %), but continued to shrink in manufacturing (-19.9 %).

Investment is also held back by a number of macroeconomic and structural factors (see Box 4.4.1). According to a recently published Eurobarometer Survey (Political and Social TNS, 2018), Portugal is among the EU countries with greater investment challenges. Only 48 % of Portuguese firms interviewed in the survey were able to make at least some of the desired investment. The most commonly mentioned factors preventing investment were a poor or uncertain outlook (at least a ‘minor obstacle’ for 84 % of respondents), the complexity and the stability of tax legislation (76 %) labour costs and administrative burdens (both 73 %).

Graph 4.4.2: **Net capital stock per person employed**



Source: European Commission

Investment challenges relate primarily to infrastructure, skills, innovation, climate change and the environment. Infrastructure deficits in transport and skill gaps are critical obstacles to investment (Box 4.4.1). Investments to improve rail connections with Spain and the maritime port infrastructure are key to export competitiveness. Skill shortages, in particular digital skills (see Section 4.3), may hinder productivity, especially for small and medium-size enterprises. Current R&D intensity is insufficient to upgrade the national research and innovation system and its connection to the real economy (see Section 4.4.1). Investment challenges in energy relate to the need to improve internal and external connectivity of the Iberian Peninsula, the digitisation and decentralisation of energy services, and the integration of renewables in the grid (see Section 4.4.2). Investment deficits are also present in the area of waste management, with Portugal being at risk of failing to meet the 2020 municipal waste recycling target (see Section 4.4.2). Prioritising investments and policies to meet EU decarbonisation needs and recycling targets would help to ensure the sustainability of economic growth and development.

Portuguese firms face challenges to grow. The proportion of micro firms in Portugal finding it difficult to grow is higher than the EU average. The fear of having to deal with increased regulatory and taxation footprint may act as a significant barrier for firms to grow and incentivise them to remain small. Newly born firms with less than 3 years have low survival rates (53.85 % in 2016), suggesting structural weaknesses and challenges, including scarce managerial skills and low financial literacy. In 2012-2016 Portugal was one of the countries with the highest death rates for firms in relation to active firms, amounting to 14.6 % (almost twice the EU average of 8.4 %). The small size is also likely to affect the capacity to invest: according to the survey on management practices performed by the Portuguese Statistical Institute, small and medium-sized enterprises tend to have less structured management and consequently lower investment. Other obstacles may stem from the difficulty to retain talents and limited availability of skilled workers. Moreover, the level of internationalisation of Portuguese firms remains low.

Box 4.4.1: **Investment challenges and reforms in Portugal**

Section 1. Macroeconomic perspective

After reaching growth of 9 % year-on-year in real terms in 2017, Portugal's gross fixed capital formation is expected to moderate in 2018 before gaining some momentum again in 2019-2020. Over the first half of 2018, investment growth moderated from double-digits a year ago to 4 % year-on-year on average. A lower-than-budgeted public investment and subdued external demand are expected to have weighed investment growth in 2018. Over the medium term, some rebound is expected, mainly driven by EU structural support.

Section 2. Assessment of barriers to investment and ongoing reforms

Public administration/ Business environment	Regulatory/ administrative burden	CSR
	Public administration	
	Public procurement /PPPs	
	Judicial system	CSR
	Insolvency framework	
	Competition and regulatory framework	
Labour market/ Education	EPL & framework for labour contracts	CSR
	Wages & wage setting	
	Education, skills, lifelong learning	CSR
Financial Sector / Taxation	Taxation	
	Access to finance	CSR
R&D&I	Cooperation btw academia, research and business	
	Financing of R&D&I	
Sector specific regulation	Business services / Regulated professions	CSR
	Retail	
	Construction	
	Digital Economy / Telecom	
	Energy	
	Transport	

Legend:

	No barrier to investment identified
CSR	Investment barriers that are also subject to a CSR
	No progress
	Limited progress
	Some progress
	Substantial progress
	Fully addressed

Portugal faces multiple constraints to investment. Several features of the financial sector hamper business' access to finance (see Section 4.2). Low qualification, particularly on digital skills, and a high share of temporary contracts due to labour market rigidities are prevalent (see Section 4.3). Investment gaps are also present in transport and energy infrastructure, in particular related to the internal and external connectivity of the Iberian Peninsula (see Section 4.4). Regulatory barriers restrict competition in business services, hampering competition and the choice and quality of the service (see Section 4.4.2). Challenges to the business environment include sector-specific barriers in licensing and inefficiencies in the justice system (see Section 4.4.4).

Main barriers to investment and priority actions underway:

Skill gaps and mismatches in the labour force compromise the ability of the economy to increase productivity and upgrade into knowledge-intensive sectors. Policies to facilitate these goals include the INCoDE.2030 programme, focused on raising digital literacy, as well as policies to expand vocational education and training in Science, technology, engineering, and mathematics areas. A final key initiative towards skills improvement is the *Qualifica* programme.

The development of transport infrastructure, particularly railway and ports, would help to underpin the external competitiveness of the economy. Railway connection with Spain remains a key challenge. Port infrastructure, and container terminals in particular, faces significant investment needs.

In Portugal, *Instituição Financeira de Desenvolvimento* is the national development financial company. It helps finance solutions for small and medium-sized enterprises - particularly in tradable industries -, while also offering consulting services in areas such as capital structure, corporate strategy, and mergers & acquisitions operations. In addition, *SPGM, Sociedade de Investimento S.A.* is the coordinating entity of the Mutual Guarantee System, which provides financial guarantees to small and medium-sized enterprises to facilitate their access to finance.

Portuguese small and medium-sized enterprises are lagging behind in digitalisation, and the share of digital technology investments in GDP has declined since 2000. Although the share of firms (excluding microenterprises) with high levels of digital intensity in Portugal is above the EU average (European Commission, Digital Scoreboard), the share of companies selling online is flattening out. The uptake of digital technologies is significantly lower among small and medium-sized enterprises. Microenterprises, in turn, are clearly lagging behind in digitalisation: in 2016, only 32 % of them had some sort of online presence and less than 10 % did business online. The implementation of the *Indústria 4.0* programme, which promotes the adoption of digital technologies by firms, has progressed: 60 measures have been launched out of the 64 announced. The authorities estimate that the programme will generate 4 200 new jobs and EUR 700 million worth of additional exports.

Research and innovation

After declining since the crisis, R&D intensity recovered in 2016, although it remains insufficient to upgrade the Portuguese national research and innovation system and its connection to the economy. R&D intensity reached 1.3 % of GDP in 2017 after steadily decreasing since 2010. Business R&D intensity, at 0.67 % of GDP, surpassed public R&D intensity (0.63 % of GDP) in 2017. A 2018 resolution adopted by the Portuguese government established the pillars for a national strategy on 'technological and business innovation' that includes revised targets for public and private investment in R&D: 3 % R&D intensity by 2030 with an ambitious share of one third public and two thirds business driven. The government's goal is to reach an R&D intensity of 1.8 % of GDP by 2020.

Portugal's economic structure is anchored in traditional low and medium-low tech sectors, slowing down structural change. There has been meagre progress to upgrade the country's economic structure towards higher shares of value-added in high-tech manufacturing and services. However, technological upgrading has taken place in traditional sectors, such as footwear and textiles that boosted their global competitiveness and labour productivity (PORDATA and AICEP, 2018). The resilience and internationalisation of these sectors resulted from clear priorities, strategically aligned with EU funding cycles, and early 'clusterisation' in close cooperation with universities and business associations. Other traditional sectors such as agriculture, benefiting namely from the support of EU funds, would benefit from continuing investment in technological upgrades and the qualification of its human resources in particular in the rural areas. Hence, relevant traditional sectors should benefit from the government's *Industry 4.0* programme to provide human resources with qualifications and tackle technological gaps. At the same time, emerging sectors such as information technology are creating new opportunities to upgrade the economic structure.

Promoting investment in intangible assets, including R&D but also economic and digital competences, offers significant potential for the country to boost its productivity (European Commission, 2018c). The *Qualifica* scheme for the overall upskilling of the population and INCoDe.2030, the country's national strategy to enhance digital competences, both seek to address this bottleneck (see Section 4.3.3).

Research careers lack stability and attractiveness, and new qualifications are needed to better address the needs of the labour market. Portugal has made significant progress in increasing the number of science and engineering graduates, reaching levels close to the EU average in 2016 (Eurostat). However, the number of graduates in computing remains below the EU average (see Section 4.3.3). Industry (including in information technology fields) expressed concerns about the difficulty to find qualified people. Portugal lacks enough specialised medium and high-skilled workers to cover the current and future labour market demand in the smart specialisation priority fields. The share of researchers in the labour force expanded but the absorption capacity of businesses remains an obstacle, although it is slowly improving. Research careers in the public sector do not offer stability or competitive salaries in relation to other EU Member States. Contracts are typically short-term and based on scholarships with limited social benefits. To improve the status of research careers, the *Scientific Employment* programme includes a fiscal incentive through which firms receive a 120 % fiscal rebate when they hire doctoral graduates and the Interface scheme, which provides funding to incentivise hiring doctoral graduates under longer-term contracts, funding 50 % of their salary during 3 years.

Bottlenecks in science-business links hamper the efficiency of the research and innovation system, and a package of measures has been set in motion. The share of public-private scientific co-publications in Portugal declined over the last decade with the country ranking among the lowest in the EU in 2017. Mutual trust between academia and business is not wide-spread, entrepreneurial research is not incentivised and knowledge transfer is not duly considered (European Commission, 2018a). To improve framework conditions for collaboration, Portugal has launched Interface Programme. Collaborative Laboratories were identified under the Interface scheme and the country's cluster policy was strengthened in 2017 to cover advanced technological sectors in the *Competitiveness Clusters* initiative. Moreover, 'Portugal 2020' launches calls for *co-promotion projects*, establishing joint research and innovation centres, demonstration projects and pilot lines. The forthcoming Organisation for Economic Cooperation and Development (OECD) Review preliminary recommends the setup of regional innovation platforms that give small and medium-sized enterprises access to critical resources for innovation, and support mutualisation and partnerships between knowledge-transfer organisations.

Portugal is a moderate innovator according to the 2018 European Innovation Scoreboard. Employment in fast-growing enterprises has increased over time, with Portugal ranking slightly above the average in the EU in 2015. The innovation performance of small and medium-sized enterprises has, however, deteriorated since 2010 for product, marketing and organisational innovations and for small and medium-sized enterprises collaborating with others. Fewer venture capital investments since the pre-crisis period (see Section 4.2) may undermine the scale-up of innovative firms, despite an overall improvement in the start-up ecosystem due to the implementation of *StartUp Portugal*.

4.4.2. THE SERVICES SECTOR AND SINGLE MARKET INTEGRATION*

Services sector

The level of regulatory restrictiveness in Portugal is higher than the Single Market average in several sectors. According to the new OECD intra-EU services trade restrictiveness index, the level of regulatory restrictiveness in Portugal in relation to other EU Member States is higher than the single market average in sectors such as accounting services, construction services and distribution services (including wholesale and retail services).

Regulatory barriers restrict competition for professional and business services. Despite considerable efforts to simplify rules and regulations with the introduction of a framework law in 2013 as part of the financial assistance programme, highly regulated professions are still subject to major restrictions. The longstanding restrictions on legal form, shareholding, management, multidisciplinary practices and advertising for legal services are in contravention of the 2013 framework law. A ban on corporate groups was introduced again in 2015 for all professional companies, deterring major EU players from operating in Portugal. Extensive reserves of activities for highly regulated professions, notably lawyers, legal agents, architects and engineers remain unreformed, keeping out competitors wishing to provide ancillary services. The recent OECD and Portuguese Competition Authority study (OECD 2018b) has suggested reforms in the regulation of professional services, in particular as regards the scope of reserved activities, as well as restrictions on legal form, shareholding, management, advertising ([43]) multidisciplinary restrictions and incompatibility rules. The study estimates that lifting the identified restrictions would have a positive impact on the economy of EUR 128 million per year (roughly 0.07 % of GDP) and a multiplier effect of 1.5 for legal and

([43]) The study covers 13 self-regulated professions: lawyers, solicitors, bailiffs, notaries, engineers, technical engineers, architects, auditors, certified accountants, customs brokers, economists, pharmacists and nutritionists.

accounting services ([44]). It is expected that the Portuguese government will follow up on the recommendations by the OECD and Portuguese Competition Authority to introduce reforms. However, the extent of the action and the timeframe are yet to be defined.

Barriers to competition in construction services remain. Market access for construction services in general was simplified in 2015. However, some steps still need to be implemented to reform the registration fee system. Construction services in specific segments of the market remain burdened by complex authorisation schemes, including lack of mutual recognition of installers of F-gas equipment from other Member States (Ecorys, 2018). The regimes for gas and electrical installations were the object of reform recently, but multiple overlapping procedures are still imposed on providers of installation works such as lifts, telecoms, water, sewage and alarms, which could benefit from simplification. Finally, building permits could be simplified, notably by streamlining procedural workflows across the country and eradicating prescriptive building standards, which still abound.

Portugal introduced new regulatory frameworks for short-term accommodation rentals and urban transport services. According to the 2018 Eurobarometer survey on the use of the collaborative economy, Portugal exhibits strong growth potential, since only 3 % of respondents offered services via collaborative platforms and 30 % indicated that they would consider offering them. Short-term lodging units increased by 50 000 over the last 2 years. Also, a survey by the European Commission shows that 1.6 % of labour force earned more than half of their income from platforms (against 2.3 % on average for the 14 Member States surveyed). To provide a clear legal framework to operators and reduce tax evasion, Law 62/2018 introduced an authorisation procedure for new establishments and new requirements for consumer protection. The Law also introduces the possibility for municipalities to declare ‘overloaded areas’, where quotas on establishments can be fixed. In a similar vein, Decree-Law 45/2018 regulates the electronic platforms that provide urban transport services by light passenger vehicle, introducing further requirements on both drivers and platforms intermediating their services. In particular, the law gives companies the exclusive right to provide the services (not private individuals) and introduces limitations in the determination of fees.

([44]) Meaning that EUR 1.00 of additional final demand for legal and accounting services leads to 1.49 times as much increase in output for business.

The retail sector shows good performance, but administrative burden persists in regulation and taxation. In recent years, Portugal has reduced regulatory constraints on retail business. Nevertheless, some elements of the regulatory and taxation frameworks could still be burdensome for companies, as reflected in the retail restrictiveness indicator (European Commission, 2018g): retail-specific taxes and para-fiscal fees, based on the outlet size, for the establishment or operation of a shop; complex authorisation procedures for the establishment of retail outlets.

Energy, environment and transport investment challenges

Significant investments are required to support the clean energy transition in line with the EU 2030 climate and energy framework and the national objective to achieve carbon neutrality by 2050. In December 2018, Portugal presented a roadmap to achieve carbon neutrality by 2050 with projected annual additional investments needs of around EUR 2 billion from 2020 to 2050. Some main focus areas for decarbonisation lie in buildings, a sharp increase in renewables electricity, and in mobility and electrification of the transport sector. The new roadmap will contribute to the integrated national energy and climate plans. In its national energy and climate plan, to be adopted by 31 December 2019 in line with the Regulation on the Governance of the Energy Union and Climate Action ([45]), Portugal will provide an overview of its investment needs up to 2030 for the different dimensions of the

([45]) Regulation (EU) 2018/1999 of the European Parliament and of the Council of 11 December 2018 on the Governance of the Energy Union and Climate Action, amending Regulations (EC) No 663/2009 and (EC) No 715/2009 of the European Parliament and of the Council, Directives 94/22/EC, 98/70/EC, 2009/31/EC, 2009/73/EC, 2010/31/EU, 2012/27/EU and 2013/30/EU of the European Parliament and of the Council, Council Directives 2009/119/EC and (EU) 2015/652 and repealing Regulation (EU) No 525/2013 of the European Parliament and of the Council (Text with EEA relevance.)

Energy Union. This will include renewable energy, energy efficiency, security of supply, and climate mitigation and adaptation. The information provided, including in the draft plan submitted on 31 December 2018, will further help to identify and assess Portugal's energy and climate-related investment needs.

Challenges remain to achieve the energy efficiency target. While primary and final energy consumption slightly increased in 2016, they were 1.7 % and 7.4 % below the 2020 indicative target. Increased efforts are needed to ensure the achievement of the cumulative end-use energy savings target according to Article 7 of the Energy Efficiency Directive. In Portugal there is still a wide margin to improve energy efficiency in buildings. Investments in this area, and in particular in the residential segment, are also an effective means to alleviate energy poverty, which is a key issue in Portugal ([46]). Additional investments are also needed to reduce energy consumption in business. Market uptake of available energy efficiency solutions, technological innovation, digitalisation and up-skilling of the workforce have the potential to drive the energy efficiency further up.

Portugal is on track to meet the national renewables target for 2020, but lagging behind planned trajectories under the national renewable action plan. With a renewable energy share of 28.5 % in 2016, Portugal is above the indicative trajectory to meet its 2020 binding target of a 31 % renewables share in final energy consumption. However, further investments seem necessary to ensure the 2020 target is timely met and to achieve the long-term decarbonisation objectives. Portugal's current renewable energy strategy is focused on solar, with the government having authorised one gigawatt of photovoltaic solar power plants and facing high demand for further renewables projects. The current constraints to further development seem to relate to the lack of grid capacity to accommodate higher shares of renewables and to burdensome licensing and permitting procedures. There is also a need to continue developing new renewable energy technologies that are not widely disseminated but which have great potential, such as ocean energy (waves, tides, salinity, etc.), geothermal and wind offshore.

Better connectivity of the Iberian Peninsula could enable more competition and facilitate the deployment of renewable energy. In 2017, Portugal's electricity interconnection level was still below the 2020 threshold of 10 %. Investments in the completion of ongoing projects of common interest will enable Portugal to achieve this target by increasing the Portugal-Spain interconnection capacity to 3.2 gigawatt by the end of 2022. Portugal will also benefit from further integration into the internal market thanks to new infrastructure developments completed in Spain and France in 2018 (Val de Saône gas pipeline in France) or under development (e.g. Biscay Bay project). Progress in integrating the Portuguese gas market in the Iberian market has been slow, with a bilateral agreement between Portugal and Spain still lacking. Regional cooperation between Portugal, Spain and France remains key to advance in the implementation of priority infrastructure projects and further integrate the Iberian Peninsula in the single electricity market.

Additional investment requirements relate to energy digitalisation, decentralisation, and the integration of renewables in the grid. Tenders are expected to be launched in 2019 for the concessions of the municipal low-voltage electricity grids. It is important that the conditions set out for such tenders support the clean energy transition and take into account the fact that investments will be needed for digitisation and decentralisation of energy services and the integration of renewables in the grid. The roll-out of smart metering in Portugal has not been formally launched yet, but pilot projects in urban areas already covered about 20 % of the national population at the end of 2017.

Energy prices (including taxes and levies) remain above the EU average. Electricity prices are above the EU average by 1 % for industrial users and 12 % for households ([47]). This is mainly due to the burden of levies and taxes, as the energy component is below the EU average. This burden

([46]) In 2017, according to the European Union Statistics on Income and Living Conditions energy poverty indicator "inability to keep the home adequately warm" 20.4 % of the population in Portugal was energy poor.

([47]) Based on data for 2017 (2018 Report Energy Prices and Costs in Europe) mainly stems from charges related to the need to repay the tariff debt in the sector and to financial commitments made to power producers. The government adopted measures to reduce the tariff debt, which under the current baseline scenario will be fully repaid by 2022. One of the measures is the allocation of part of the proceeds from carbon dioxide emissions licences to abate the tariff deficit. The tariff debt is also expected to decline as financial commitments to past contracts with feed-in tariffs will gradually expire over the coming decade. In the gas sector, household gas prices remain significantly higher than the EU average (+20 %), despite a significant decrease in the last few years ([48]). Gas prices for non-households also declined in the last 3 years and are now below the EU average. However, concentration on the gas and electricity retail markets remains high.

Although 2020 greenhouse gas emissions targets are within reach, additional effort and investments are necessary for the 2050 carbon neutral targets. Portugal committed to a greenhouse gas target in 2020 that involves a 1 % increase of emissions compared to 2005 levels. Portugal exceeds its 2016 annual greenhouse gas emissions targets under the Effort Sharing Decision by 17.1 % and is well in line to meeting its 2030 target under the Effort Sharing Regulation. Based on currently available data, total greenhouse gas emissions were reduced by 17.4 % between 2005 and 2017. However, greenhouse gas emissions in 2017 increased by 7.1 % compared to 2016, due to forest fires and the extreme drought. 2018 greenhouse gas inventory for 2016 indicate that the largest sectors in terms of greenhouse gas emissions were the energy sector (26 % of total) followed by transport (24 %), industry (20 %) and agriculture (10 %).

Anticipating the adverse effects of climate change, such as floods and forest fires, remains a challenging priority in Portugal. Intensification of natural hazards related to climate change such as severe droughts and extreme heat (which have increased the risk of forest fires, biodiversity loss and desertification), floods and coastal erosion have been identified as high risks. Policy and management options for reducing forest fires must address their root causes. Apart from investments into restoring the forests affected, more efforts are hence needed to prevent the outbreak of wildfires and to minimise the conditions for their spread and progression. Investments in risk prevention and preparedness, as well as in adaptation measures across the sectors are crucial to reduce its expected impacts on people, the environment and ultimately the economy.

Portugal still faces considerable environmental challenges and investment needs in the area of water and waste management, air quality and nature protection, as highlighted in the Commission’s Environmental Implementation Review. Portugal continues to adopt measures to promote the transition towards a circular economy, such as implementing the National Action Plan for Circular Economy 2017-2020. Portugal is at risk of failing to meet the EU target of recycling 50 % of its municipal waste by 2020. Hence, further effort to improve waste management is needed, in particular in the outermost region of Azores, which has the highest rate of landfilled municipal waste. Despite the progress achieved in recent years in water management, challenges remain, for instance with water governance and the need to close gaps in water investments, especially for wastewater and water body rehabilitation. At the municipal level, the sector remains highly fragmented and the reorganisation of the water and wastewater services has not yet shown its full potential.

Portugal performs well in broadband connectivity, although take-up levels remain relatively low. Broadband is available to all Portuguese homes and ultrafast broadband networks are already available to 95 % of households, well above the EU average of 58 % (European Commission, Digital Scoreboard). The extensive deployment of fibre-to-the-home puts Portugal in a good position to achieve the European broadband coverage objectives for 2020 and 2025. However, take-up and prices remain a challenge. Additional efforts are, therefore, still required to reach the last 5 % of households without next generation-access coverage as well as to increase take-up. In addition, existing optic fibre interconnections Continent-Azores-Madeira are expected to reach the end of their useful life around 2025.

([48]) Based on data for 2017 (2018 Report Energy Prices and Costs in Europe)

The lack of adequate container capacity in Sines and the Lisbon area limits the ports' impact on the regional and national economies. The continued increase in global export/import markets creates additional demand in particular for container handling capacity. Due to its geographical location, Portugal is a natural maritime entry point, especially for the transatlantic routes. Increasing container handling capacity would allow Portugal to capture a greater share of this increased demand. Timely investments in the new container terminals in Sines and in Barreiro (Terminal Vasco da Gama) would help reduce this lack of capacity. The finalisation of the ongoing investment projects in the other main Portuguese ports (Viana do Castelo, Leixoes, Aveiro, Figueira da Foz, Setubal) would also increase handling capacity. Finally, the renegotiation of port concessions other than Leixões would increase the participation of private investors in the financing of port infrastructure investments.

Railway interoperability is still a major bottleneck. Portugal is conditioned by the need to cross Spanish territory to reach central Europe. Railways are still widely underused in the connections to Spain (both East-West and North-South corridors). A strategy by Portugal and Spain, including specific planning for the deployment of rail interoperability in the Iberian Peninsula and ultimately its connection with the French rail network is in place, with projects on both sides of the border for the electrification of rail lines and train length augmentation. The main projects co-funded by the Connecting Europe Facility are now faced with delays which in some cases cannot be entirely made up for. There seem to be constraints in the number of personnel involved in the development of the Connecting Europe Facility co-funded projects and their level of expertise. Developing a comprehensive Iberian plan, including the identification of the intermediate steps, terminals, interconnections needed to benefit from the Spanish network upgrade and the development of the International Union of Railways gauge would help boost the Portuguese international rail performance. This is crucial to address the peripheral situation of Portugal and to exploit the potential of Portuguese ports, so far harmed by a 'road-only' model. Stepping up EU co-financed railway investments would also help optimise the use of EU financing and reduce the need for national funds (these corridors together account for an overall investment of over EUR 1.3 billion).

4.4.3. THE REGIONAL DIMENSION

Portugal is marked by territorial asymmetries, in terms of spatial distribution of resources and opportunities. 52 % of Portuguese GDP and 44 % of the population were concentrated in the metropolitan areas of Lisbon and Porto, which represent 5.1 % of the territory of mainland Portugal. Significant discrepancies in inequality and poverty exist across the country. As shown in Section 4.3.2, Azores, Madeira and the capital region were the areas most affected by the risk of poverty ([49]) in 2017, if regional poverty lines are considered (when using the national poverty threshold, the poverty rate in Lisbon is low). Social vulnerability is spatially concentrated especially in the more densely urban areas of the country (with some exceptions, such as the south coast in the Alentejo region; see Section 4.3). Investment priorities at regional and local level must deal in an integrated way with the multi-faceted territorial challenges of social and economic exclusion and environmental sustainability. In this regard, the National Program of Territorial Planning is intended to be a comprehensive framework to guide regional and local territorial strategies and investment.

Portugal faces particular challenges linked to urbanisation and demographic trends. The number of inhabitants is decreasing in rural and smaller urban areas, making them less attractive for business and increasing the cost of maintaining the level of public services. In 2017, the ageing index was higher in rural territories than in urban areas, and this asymmetry is particularly evident in the Beira Baixa (Centro) and Terras de Trás-os-Montes (Norte) subregions. At the same time, the metropolitan areas have experienced challenges related to urban sprawl, poverty increase, traffic congestion, and bad air quality. Investment strategies to enhance rural-urban linkages and deal with the above mentioned issues can be pursued in

([49]) Taking into account the proportion of people living with monetary incomes equivalent to less than 60 % of the median of the available monetary income distribution equivalents.

an integrated, multi-sectoral approach aiming at targeting functional territories and crossing administrative boundaries, involving citizens and local communities as well.

Portugal exhibited some divergence in terms of GDP per capita with the EU while regional disparities tended to narrow. The external divergence in GDP per inhabitant in purchasing power standard in the last decade coexisted with a reinforced internal cohesion among regions. However, a substantial part of the decrease in regional disparities is due more to the higher contraction of the capital region than to growth in the less developed regions (see Section 1).

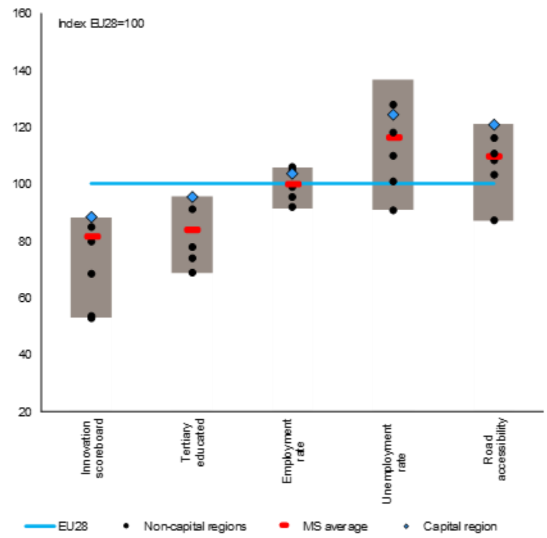
Despite a slow recovery since 2013, investment levels in Portugal remain low in all regions ([50]). When considering the period 2009- 2016 (latest year available in national statistics at regional level), the highest decline was recorded in the autonomous region of Madeira (-58 %) while the region of Norte, which stands out for the openness of its economy, showed a relative better resilience during the recession (-24 %). Since 2013, investment level is overall recovering in particular in the capital region.

Key labour market indicators reveal moderate regional differences, while disparities are more marked in terms of productivity. Portugal's unemployment rate varied from 10.6 % in Madeira to 7.1 % in the Centro region in 2017, while the capital region (9.3 %) is slightly above the national average, suggesting that different regional markets have different efficiency levels for absorbing available labour resources. Labour productivity dynamics remain weak (see Section 4.4.1), with significant differences across the country. The most productive region is the Lisbon Metropolitan Area, at 95 % of the EU average, while Norte is at the other end, at 65 %. The availability of skilled labour force also varies across regions. For instance, Lisbon is the best performing region regarding tertiary education attainment, while Alentejo and the Algarve are lagging behind (see Graph 4.4.3). The rate of school/training leavers decreased in all the regions, but remains relatively high in the two outermost regions: 27.8 % in Azores (2017) and 23.2 % in Madeira (2016).

According to the 2017 regional innovation scorecard of 2017, Portuguese regions are 'moderate' innovators. The Metropolitan Area of Lisbon and the region Norte had the highest R&D intensity, while Azores, Madeira and the Algarve had the lowest (see Graph 4.4.3).

Despite good overall broadband connectivity (see Section 4.4.2), coverage is insufficient in a number of rural areas, and regional disparities in next-generation access persist. Although Portugal has one of the highest levels of ultrafast broadband coverage, considerable differences in next-generation access coverage across regions subsist. In 2017, Alto Minho was the only region where next-generation access availability was below two-thirds of households (56.4 %). In addition, Alentejo Litoral and Tâmega e Sousa had next-generation access broadband coverage below 80 %. At 78.5 %, coverage in rural areas is considerably lower than in more densely populated areas, although it remains well above the EU average.

Graph 4.4.3: **Regions in Portugal and factor endowments**



Innovation Scoreboard 2017, Tertiary educated: % of population aged 30-34 (2017);Employment rate 2015-2017, Unemployment 2017, road accessibility: ratio population within 120km to population accessible with a 90 minute drive (2016)
Source: Eurostat, European Commission

([50]) Gross Fixed capital formation at current prices (2011), INE.Statistics Portugal.

Personal transport exacerbates seasonal problems with air quality and traffic congestion in the major metropolitan areas in Portugal, namely Lisbon and Porto. According to the Portuguese Statistical Office's 2017 Mobility Survey, around 80 % of the population travel every day and car journeys account for 68 % of all journeys in the Porto Metropolitan Area and 59 % in the Lisbon Metropolitan Area. Investments to improve the capacity, attractiveness and interconnectivity of urban public transport, together with increased support for soft mobility measures are necessary to promote a shift towards more environmentally friendly transport alternatives in urban areas.

The outermost regions of Madeira and Azores have unique geographical characteristics. Their remote location, insularity and specific topography, as well as higher vulnerability to climate change impose higher transport and communication costs, limited economies of scale and dependence on a few economic activities, which constrain their socio-economic growth and convergence with national indicators in several economic areas. Territorial strategies and specific investments to enhance accessibility and interconnectivity between the islands of each archipelago and strengthen the territorial cohesion of these regions are required.

4.4.4. INSTITUTIONAL QUALITY AND GOVERNANCE*

Public administration

A new decentralisation programme is to be gradually implemented over 3 years, starting in 2019. It envisages new transfers of responsibilities in a wide range of domains, in particular transport, education and healthcare. The purpose is to increase the share of resources spent at local level, while increasing inter-municipal cooperation, including at metropolitan level. Against that background, a framework agreement and a revision of the local finance law to adjust human resources and local finances were adopted on 16 August 2018. These are to be complemented later on by a series of sectoral decree-laws. The volume of financial transfers to the municipalities to compensate for the new tasks should total around EUR 1 to 1.2 billion and are to be implemented in a budget-neutral way.

Business environment and administrative burden

The business environment improved considerably but challenges holding back investment remain. Portugal is ranked 34th in the Ease of Doing Business Ranking (World Bank 2018b), ahead of several EU economies. In some cases, Portugal exhibits a particularly business-friendly environment (for example, for creating a business or registering property). Yet, challenges like late payments from the public sector remain critical. Delays are particularly long in the health sector and for regional and some autonomous authorities (see Section 4.1). Since 2017, Portugal has been running the *Custa Quanto?* programme to assess the impact of new laws on firms. According to the unit in charge of the programme, which is carrying out an extensive training programme across ministries on the methodology to be applied, a consistent number of new laws has shown no extra costs for firms. However, at this stage firms and stakeholders have had limited involvement in the assessment work, which is being performed, for each law, by the ministries concerned. Excessive regulatory footprint and uncertainty remain among the most relevant obstacles to invest for the majority of firms (European Investment Bank, 2018). According to a recent survey by the Portuguese Statistical Office ([51]), the burden associated with licensing (along with the judicial system) remains one of the main barriers to investment, as per its indicator of framework regulation costs.

New measures have been introduced to reduce the administrative burden under the SIMPLEX+ programme. SIMPLEX+ remains the most relevant simplification programme to reduce administrative burden and to simplify business-government and citizens-government relations. Past and ongoing assessments of the measures implemented have shown significant savings (i.e. the *Fatura Sem Papel* measure launched in 2017 that allows firms not to print invoices has led to EUR 6 million in savings). In June 2018, following a participative approach to collect new ideas, a set of 175 new measures was

([51]) Inquérito aos Custos de Contexto 2017, INE, July 2018 introduced. These measures are combined with 93 multiannual measures initiated under SIMPLEX+ 2017.

However, simplification measures showed a limited sector-specific impact in addressing the main barriers to licensing. With some exceptions, such as the licensing of aquaculture and touristic activities, SIMPLEX+ showed limited achievements in reducing the burden stemming from complex procedural rules for licensing. Sector-specific initiatives under SIMPLEX+ remain often limited to the digitisation of control procedures that, although important, does not address the persistence of restrictive barriers in licensing. The reduction in the number of competent authorities involved, the widespread replacement of authorisation schemes by responsible statements in advance (without a need to submit multiple documents as supporting evidence), the shortening of long decision-making deadlines for the authorisation schemes and a more widespread use of tacit approval ("silence is consensus" rule) remain among the most critical challenges.

Justice system

The justice system in Portugal continues to become more efficient while still facing challenges mainly with the disposition time in Administrative and Tax Courts. According to data collected through the EU Justice Scoreboard, the clearance rate for administrative cases decreased in 2017 to 105 % from 112 % in 2016, while disposition time increased from 911 days in 2016 to 988 days in 2017.

Portugal introduced a set of measures to reduce case-backlogs, which remain a challenge. Decree-Law 81/2018 introduced rapid reaction teams, setting up teams of judges under the monitoring of the president of each court and of the High Council of the Administrative and Fiscal Courts, and the task of accelerating the resolution of pending cases in administrative and tax courts. Furthermore, incentives have been introduced for dropping cases or for bringing cases to arbitration**.** The decree-law provides that citizens and companies who give up their cases voluntarily against the State before the end of 2019 will be forgiven the justice (court-related) costs. In addition, the Tax Authority has to give up a case when it becomes clear it will not win the cause on the basis of the case law. The Decree-law also establishes the increased use of arbitration. This means that all cases that entered the regular courts before 2016 can 'migrate' the arbitration mechanism — *Centro de Arbitragem Administrativa* — with no costs associated; on average, the *Centro de Arbitragem Administrativa* takes 4.5 months to solve the case, in contrast with the 10-year average of the regular courts, which makes it a solution that the corporate sector praises.

Additional measures promoted more e-justice and the specialisation of courts. Ordinance 267/2018 on electronic proceedings introduced mandatory electronic filing for judicial proceedings in the administrative and tax courts. The Ordinance introduces measures to simplify and group together procedures (mainly in tax procedures). In September 2018, the government approved amendments to the legislative framework (Status) for the administrative and tax courts promoting further specialisation of the courts. The government's proposal, not yet approved by the Parliament, is to create 2 public procurement chambers with wide territorial jurisdiction, 10 administrative social chambers competent for public employment and social benefits disputes, and 11 tax enforcement and infraction review chambers competent for all claims involving tax enforcement/readdressing tax infractions.

There are new measures for insolvency proceedings, but the average duration of proceedings continues its increasing trend. Law 6/2018 introduced the business recovery mediator, who is a skilled and experienced professional who aids the debtor. The mediator is especially designed for medium and small enterprises, making an objective diagnosis and advising on the possible legal instruments tailored for company's situation. Law 8/2018 on the extrajudicial restructuring of firms includes further improvements on this proceeding. Additionally, Law 7/2018 introduced a legal regime for debt-to-equity swaps. This legislation applies in a situation of default and negative equity and concerns the restructuring of the balance sheet with the conversion of credits into equity by simplifying the existing procedures. Quarterly data show that between June 2017 and June 2018, the average full duration of insolvency and recovery proceedings increased from 45 to 53 months ([52]).

Fight against corruption

Efforts to crack down on corruption continue, but local prosecution offices could benefit from better resources. The specialised anti-corruption prosecution service *Departamento Central de Investigação e Acção Penal* (DCIAP) continued building a positive track record of investigations, including securing the first indictments for foreign bribery. It is expected that the office will become more effective thanks to anti-money laundering legislation granting the prosecution direct access to a series of databases and thanks to a recent protocol signed with the Institute for Monitoring Public Procurement (September 2018) which grants *Departamento Central de Investigação e Acção Penal* direct access to the procurement database of each contacting authority. The analytical and technical capacities of *Departamento Central de Investigação e Acção Penal* and the judicial police are also improving, but regional departments for penal actions and investigations remain poorly equipped, despite being in charge of investigating similarly complex cases ([53]).

Preventing corruption remains an issue due to the lack of a coordinated strategy and fragmented responsibilities ([54]). The council for the prevention of corruption has a limited mandate and few resources, focusing mainly on providing guidance for corruption risks and carrying out awareness campaigns in schools. The council also cooperates with various ministries to integrate corruption plans in audit exercises. The parliament is debating on creating a new entity for the transparency of political office within the Constitutional Court that would be in charge of verifying asset declarations. Currently, this competence belongs to the constitutional court and the attorney general ([55]), but enforcement has been ridden with problems. The capacity of the Public Prosecutor's Office attached to the Constitutional Court is extremely limited and acts as an obstacle to carrying out effective, timely and periodic verification of assets ([56]). To improve efficiency, there is a need to strengthen the Constitutional Court's capacity and to improve inter-institutional cooperation and exchange of information (2011 Annual Activity Report of the Attorney General).

There is little transparency around the work of the ad-hoc parliamentary committee created to streamline anti-corruption legislation. The committee is currently holding public hearings and aiming to finalise its work in 2019. Many of the anticorruption pledges introduced in the government programme of 2015 are therefore still pending ([57]). It is not clear whether a comprehensive approach to anti-corruption legislation will be adopted and there is no clear strategy steering this important legislative process.

Public procurement

There have been fewer direct awards since the entry into force of the new procurement code in January 2018 *(Código dos Contratos Públicos, Decree-Law 111-B/2017)*. Data from the dedicated online public procurement platform show a decline of about 24 % year-on-year (value) and 36 % year-on-year (number of procedures) in the first quarter of 2018. This reduction stems from the stricter restrictions on the use of direct awards and the inclusion of mandatory prior consultation of three

([52]) Quarterly Statistical Bulletin Q2-2018 of the Ministry of Justice on insolvency, recovery and creditors agreements (2007-2018).

([53]) As a rule, corruption cases are attributed to the relevant regional department, unless they involve more than one judicial district, in which case the Prosecutor General can attribute the case to DCIAP.

([54]) Legislative amendments introduced through Law 19/2008 allowed for an enhanced cooperation between the Attorney General and the Constitutional Court as far as verification of asset declarations is concerned.

([55]) Legislative amendments introduced through Law 19/2008 allowed for an enhanced cooperation between the Attorney General and the Constitutional Court as far as verification of asset declarations is concerned.

([56]) The Office employs only four prosecutors who must scrutinise the asset declarations of 15 000 to 16 000 political office holders and are also in charge of ensuring compliance with the incompatibility and disqualification rules. The Office does not cross-check the information entered by declarants with other official databases such as population and trade registries or with bank account information. The Office does not have a system for prioritising cases except when there is a specific complaint, otherwise declarations being examined by chronological order, which leads to significant delays.

([57]) These include dedicated lobbying regulation, a code of conduct to political offices holders, senior public officials and civil servants, a public registry of interests for local government officials and a ban on the acceptance of judicial cases against public bodies for Members of Parliament's work as lawyers tenders for higher value non-competitive procedures.

Verification by the Portuguese audit authorities of public procurement procedures has identified shortcomings in planning and in the monitoring and control capacities at the execution phase of contracts. The lack of appropriate, structured and quantified plans leads to a sometimes too broad interpretation of the notion of extreme urgency and undue use of direct awards. The contract manager figure was set to give support in technically and financially complex contracts and could improve the insufficient supervision of the execution phase of contracts.

The transparency and reliability of public procurement data are improving, but efficiency and competition in public procurement procedures leave scope for improvement. The Portuguese Competition Authority is making efforts to raise awareness of public procurement issues. Since January 2018, the Competition Authority, the General Inspection of Finances, the Court of Auditors and the Attorney General’s Office have direct access to the Portal Base database, which will allow them to download relevant information for statistical analysis and to develop and prevent non-competitive practices. The Institute for Monitoring Public Procurement and the Central Purchasing Body are training contracting authorities to ensure their professionalism. The Ministry of Finance’s unit for public-private partnerships is providing technical support for public-private partnerships. The national public suppliers portal has been set up for the SIMPLEX+ programme and introduced some administrative simplification.

ANNEX A: OVERVIEW TABLE

Commitments	Summary assessment ([58])
2018 country-specific recommendations (CSRs)	
CSR 1: Ensure that the nominal growth rate of net primary government expenditure does not exceed 0.7 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP. Use windfall gains to accelerate the reduction of the general government debt ratio. Strengthen expenditure control, cost effectiveness and adequate budgeting, in particular in the health sector with a focus on the reduction of arrears in hospitals. Improve the financial sustainability of state-owned enterprises, in particular by increasing their overall net income and by reducing debt.	Portugal has made **Limited Progress** in addressing CSR 1
Ensure that the nominal growth rate of net primary government expenditure does not exceed 0.7 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP. Use windfall gains to accelerate the reduction of the general government debt ratio.	**This overall assessment of CSR 1 does not include an assessment of compliance with the Stability and Growth Pact.**
Strengthen expenditure control, cost effectiveness and adequate budgeting, in particular in the health sector with a focus on the reduction of arrears in hospitals.	**Limited Progress** Limited progress has been achieved in putting persistently high hospital arrears on a steadily declining path. Cost effectiveness continued to be promoted in the health sector in 2018, including through an increased reliance on centralised purchasing, and a greater use of generics and biosimilars. However, despite substantial

([58]) The following categories are used to assess progress in implementing the country-specific recommendations (CSRs):
No progress: The Member State has not credibly announced nor adopted any measures to address the CSR. This category covers a number of typical situations to be interpreted on a case by case basis taking into account country-specific conditions. They include the following:
no legal, administrative, or budgetary measures have been announced
in the national reform programme,
in any other official communication to the national Parliament/relevant parliamentary committees or the European Commission,
publicly (e.g. in a press statement or on the government's website);
no non-legislative acts have been presented by the governing or legislative body;
the Member State has taken initial steps in addressing the CSR, such as commissioning a study or setting up a study group to analyse possible measures to be taken (unless the CSR explicitly asks for orientations or exploratory actions). However, it has not proposed any clearly-specified measure(s) to address the CSR.
Limited progress: The Member State has:
announced certain measures but these address the CSR only to a limited extent; and/or
presented legislative acts in the governing or legislative body but these have not been adopted yet and substantial further, non-legislative work is needed before the CSR is implemented;
presented non-legislative acts, but has not followed these up with the implementation needed to address the CSR.
Some progress: The Member State has adopted measures
that partly address the CSR; and/or
that address the CSR, but a fair amount of work is still needed to fully address the CSR fully as only a few of the measures have been implemented. For instance, a measure or measures have been adopted by the national Parliament or by ministerial decision but no implementing decisions are in place.
Substantial progress: The Member State has adopted measures that go a long way towards addressing the CSR and most of them have been implemented.
Full implementation: The Member State has implemented all measures needed to address the CSR appropriately.

	clearance measures, hospital arrears remain elevated and have not decreased in a steady and durable manner; after achieving an intra-annual minimum level in April 2018, hospital arrears have resumed their gradual increase in the following months. A mission structure was set up in 2018, on the basis of whose recommendations a new programme to address hospital arrears is to move forward in 2019. Although the programme is a promising first step in the right direction, it remains to be seen whether it will lead to a sizeable reduction in the short term.
Improve the financial sustainability of state-owned enterprises, in particular by increasing their overall net income and by reducing debt.	**Limited Progress** Limited progress has been achieved in improving the financial sustainability of state-owned enterprises (SOEs). The previous goal for SOEs as a whole to achieve a net income close to, but still below, equilibrium in 2018 was postponed until 2019. Overall, planned rationalisation efforts and enhanced monitoring were delayed and lagged to translate into corrective action where needed in 2018. Measures to enhance the monitoring of SOEs and to ensure closer adherence to their initial budgetary are to be implemented in 2019.
CSR 2: Promote an environment conducive to hiring on open-ended contracts, including by reviewing the legal framework in consultation with social partners. Increase the skills level of the adult population, including digital literacy, by strengthening and broadening the coverage of the training component in adult qualification programmes. Improve higher education uptake, namely in science and technology fields.	Portugal has made **Some Progress** in addressing CSR 2
Promote an environment conducive to hiring on open-ended contracts, including by reviewing the legal framework in consultation with social partners.	**Some Progress** New measures are on the pipeline following the new tripartite agreement signed in June 2018. The aim of the agreement is to tackle precarious employment, reduce labour market segmentation and promote more dynamism in collective bargaining. The measures proposed in the agreement, subject to parliamentary approval (expected in 2019) seek to introduce changes in the labour code, the code of contributory schemes, the legal framework for protection of employees, the framework of active labour market policies and other complementary legislation. Other initiatives include the reinforcement of human resources of the Labour Inspection Authority (aiming to reduce the abusive and illegal use of temporary contracts and other atypical forms of work) and a new programme towards the extraordinary regularization of

	precarious employment contracts in civil service.
Increase the skills level of the adult population, including digital literacy, by strengthening and broadening the coverage of the training component in adult qualification programmes.	**Some Progress** The qualification level of the adult population is low, which is a challenge in a context of ageing population. The Qualifica programme is an important tool to tackle the challenge of low-skilled adult population. Insufficient digital skills can hinder inclusion, employability and competitiveness
Improve higher education uptake, namely in science and technology fields.	**Some Progress** Measures are being implemented to strengthen the attractiveness and completion rate in higher education. The review of the Higher Education System is ongoing. Graduate numbers in information and communication technologies are low.
CSR 3: Increase the efficiency of insolvency and recovery proceedings and reduce impediments to the secondary market for non-performing loans. Improve access to finance for businesses. Reduce the administrative burden by shortening procedural deadlines, using more tacit approval and reducing document submission requirements. Remove persistent regulatory restrictions by ensuring a proper implementation of the framework law for highly regulated professions. Increase the efficiency of administrative courts, inter alia by decreasing the length of proceedings.	Portugal has made **Some Progress** in addressing CSR 3
Increase the efficiency of insolvency and recovery proceedings and reduce impediments to the secondary market for non-performing loans.	**Some Progress** Portugal has adopted plans to introduce an early warning system for companies in difficulties, which will help identify companies in financial difficulties at an early stage. Some measures aimed at shortening the long proceedings and improving the efficiency of the court system were implemented in 2018.
Improve access to finance for businesses.	**Some Progress** Some progress has been made to improve access to finance. Several programmes, such as Capitalizar or Internacionalizar, have included in 2018 credit lines to ease access to finance (notably the credit lines of Capitalizar have been increased compared to 2017). Other programmes, including those initiated in previous years, have targeted specific sectors. However, alternative sources of finance showed limited improvement (also due to limited awareness of available opportnities) and, although improvements, equity capital remains low, and venture capital investments (expressed as share of GDP) are among the lowest in OECD countries and still below pre-crisis levels.

Reduce the administrative burden by shortening procedural deadlines, using more tacit approval and reducing document submission requirements.	**Some Progress** Some progress has been made in reducing administrative burden. The SIMPLEX programme introduced further measures introducing some horizontal simplification and the implementation of the once-only principle has reduced some document submission obligations, however few sector-specific simplification has been achieved. The production of evidence by the applicant is still the norm rather than the exception; responsible declarations is a form of control seldom taken up by the Portuguese administration. Burdensome authorisation procedures remain the preferred manner of entry control for service providers, with long procedural deadlines for decision and absence of tacit approval persisting in too many instances.
Remove persistent regulatory restrictions by ensuring a proper implementation of the framework law for highly regulated professions.	**No Progress** No progress has been made in removing persistent regulatory restrictions for highly regulated professions, however some preliminary steps in the right direction have been taken. In July 2018 a study conducted jointly by the OECD and the Portuguese Competition Authority was published. It identified restrictions to competition in the legal framework of highly regulated professions and presented a number of reform recommendations. It is expected that the Portuguese Government will follow up on the reform recommendations, however the extent of the action as well as the timeframe are yet to be defined.
Increase the efficiency of administrative courts, inter alia by decreasing the length of proceedings.	**Some Progress** According to data provided by the Portuguese authorities the overall evolution as regards clearance rates in Administrative and Tax Courts between 2015 and 2017 showed a sustained improvement (79.9 % in 2015 and 105 % 2017 [1]). Disposition time remains high and its reduction for the same period is slow (2015: 992 days, 2016: 911 days, 2017: 988). Portugal introduced a set of measures to reduce case-backlogs and additional measures to promote further e-justice and the specialization of courts. As regards insolvency proceedings, new measures have been taken. All these measures are expected to have a positive impact on the efficiency of the PT Justice system in the near future.
Europe 2020 (national targets and progress)	

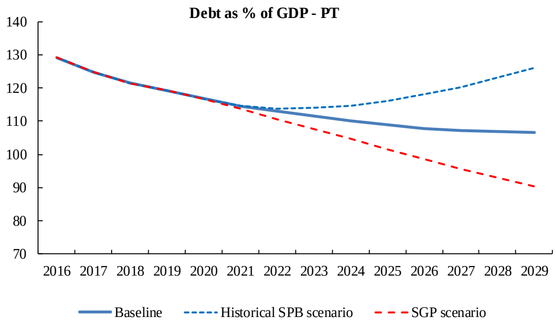
Employment rate target set in the NRP: 75 %.	Key labour market indicators are close to pre-crisis levels as the labour market situation continues to improve. The employment rate (age group 20-64) kept growing steadily up to 75.3 % in Q2-2018 (above the Europe 2020 target of 75 %).
R&D target set in the NRP: 2.7 % of GDP	R&D intensity had been on decline since 2010, but the negative trend was reversed in 2016. However, at 1.3 % of GDP in 2017, R&D intensity remains well below both the national and the EU R&D intensity targets. In 2017, the R&D intensity of Portugal was composed of 51% (0.67% of GDP) private investment and 48% (0.63% of GDP) public investment.
National greenhouse gas (GHG) emissions target: - 1 % in 2020 compared with 2005 (in sectors not included in the EU emissions trading scheme)	Portugal non-ETS emission decreased by 14 % between 2005 and 2017, and has achieved its 2017 target (an emissions decrease of 1 %) by a 13 percentage point gap. According to the latest national projections based on existing measures, non-ETS emissions will decrease by 17 % between 2005 and 2020. The 2020 target is consequently expected to be met by 18 percentage points.
2020 renewable energy target: 31 %	Provisional Eurostat data show that in 2017 Portugal achieved an overall renewables share in final energy consumption of 28.1 %, which is 0.32 percentage points below the share achieved in 2016 (28.42 %). This negative progress is due to both the annual increase in final energy consumption and the performance in the heating and cooling sector where the share of renewables decreased 0.7 percentage points to 34.39 %. In both the electricity and transport sectors the data show a slight increase in the renewables share to respectively 54.17 % and 7.93 %. Although Portugal is still above the indicative trajectory to meet the 31 % national binding target in 2020, further efforts seem necessary to ensure that this target is timely met, taking also into account that Portugal is lagging behind the indicative trajectories established in their renewables national plan.
Energy efficiency target: Portugal has set an indicative national energy efficiency target of 25 % reduction of final energy consumption in 2020, which implies reaching a 2020	Whereas 2016 figures showed that Portugal seems to be on track to meet its national target, the recent data for 2017 show that the energy consumption in Portugal is increasing. Based on provisional Eurostat data for 2017, the primary energy consumption was

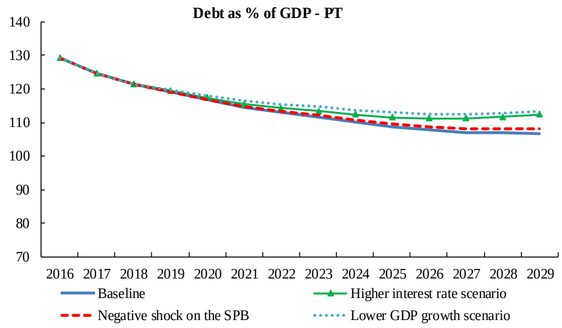
level of 22.5 Mtoe primary consumption and 17.4 Mtoe final energy consumption.	1.3 % higher than the target level (22.8 Mtoe while the target (2020) is 22.5 Mtoe). Regarding the final energy consumption, Portugal seems to be 4.9 % below the target for 2020 (16.6 Mtoe while the target (2020) is 17.4 Mtoe). Portugal still need efforts to keep energy consumption in check in the coming years and ensure that the levels of primary and final energy consumption remain below the indicative national 2020 targets.
Early school/training leaving target: 10 %.	Considerable progress was made in the last decade in reducing the early school leaving rate (from 28.3 % in 2010 to 12.6 % in 2017; rates are, however, over 20 % in the autonomous regions of Madeira and Azores). The early school leaving rate for people with disabilities remains at (27.4 %) much higher than the EU average of (23.6 %).
Tertiary education target: 40 % of population aged 30-34.	Portugal's tertiary educational attainment level among the 30-34 years old cohort (33.5 %) is still below the EU average (39.9 %). The tertiary education attainment rate of people with disabilities is below the EU average (25.5 % vs. 30.3 % in the EU)
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. (base year 2008).	The number of people at risk of poverty or social exclusion reduced in [-359.000 persons] meaning that Portugal has already surpassed the target towards achieving 200 000 persons in 2020.

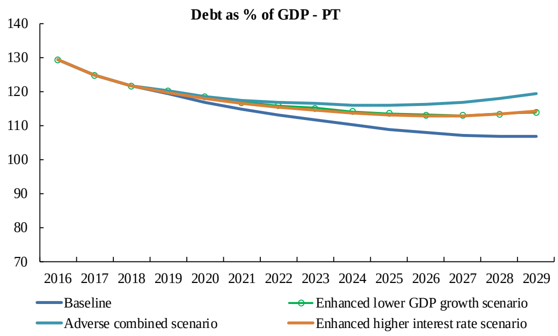
ANNEX B: COMMISSION DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

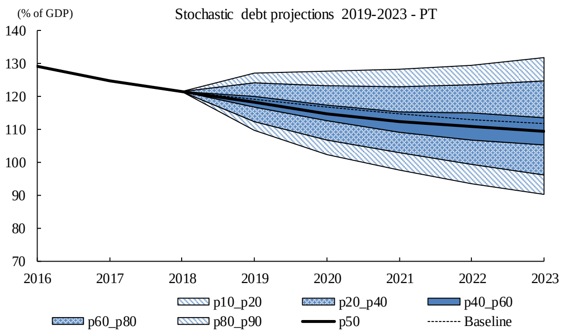
General Government debt projections under baseline, alternative scenarios and sensitivity tests

PT - Debt projections baseline scenario	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Gross debt ratio	**124.8**	**121.5**	**119.2**	**116.8**	**114.6**	**113.0**	**111.7**	**110.1**	**108.8**	**107.8**	**107.1**	**106.8**	**106.7**
Changes in the ratio (-1+2+3)	*-4.5*	*-3.3*	*-2.3*	*-2.4*	*-2.2*	*-1.6*	*-1.3*	*-1.6*	*-1.3*	*-1.0*	*-0.7*	*-0.3*	*-0.1*
of which													
(1) Primary balance (1.1+1.2+1.3)	**0.9**	**2.7**	**2.7**	**3.0**	**2.7**	**2.4**	**2.1**	**2.0**	**1.9**	**1.9**	**1.8**	**1.6**	**1.5**
(1.1) Structural primary balance *(1.1.1-1.1.2+1.1.3)*	***2.5***	***2.5***	***2.4***	***2.3***	***2.2***	***2.1***	***2.1***	***2.0***	***1.9***	***1.9***	***1.8***	***1.6***	***1.5***
(1.1.1) Structural primary balance (bef. CoA)	*2.5*	*2.5*	*2.4*	*2.3*	*2.3*	*2.3*	*2.3*	*2.3*	*2.3*	*2.3*	*2.3*	*2.3*	*2.3*
(1.1.2) Cost of ageing					*0.1*	*0.1*	*0.2*	*0.2*	*0.3*	*0.4*	*0.5*	*0.6*	*0.7*
(1.1.3) Others (taxes and property incomes)					*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
(1.2) Cyclical component	***0.4***	***0.6***	***0.7***	***0.7***	***0.5***	***0.2***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
(1.3) One-off and other temporary measures	***-2.0***	***-0.4***	***-0.4***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
(2) Snowball effect (2.1+2.2+2.3)	**-1.6**	**-0.9**	**-0.7**	**-0.6**	**0.5**	**0.7**	**0.8**	**0.4**	**0.6**	**0.8**	**1.1**	**1.4**	**1.4**
(2.1) Interest expenditure	*3.8*	*3.5*	*3.3*	*3.2*	*3.3*	*3.3*	*3.4*	*3.5*	*3.6*	*3.8*	*3.9*	*4.1*	*4.2*
(2.2) Growth effect	*-3.5*	*-2.6*	*-2.2*	*-2.0*	*-0.9*	*-0.5*	*-0.4*	*-0.9*	*-0.8*	*-0.8*	*-0.7*	*-0.7*	*-0.7*
(2.3) Inflation effect	*-1.9*	*-1.7*	*-1.8*	*-1.8*	*-1.9*	*-2.1*	*-2.2*	*-2.2*	*-2.2*	*-2.1*	*-2.1*	*-2.1*	*-2.1*
(3) Stock-flow adjustments	**-2.0**	**0.3**	**1.1**	**1.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**









Short term	Medium term	S1	Debt sustainability analysis (detail)	Baseline	Historical SPB	Lower GDP growth	Higher interest rate	Negative shock on SPB	Stochastic projections	DSA	S2	Long term
LOW (S0 = 0.3)	HIGH	HIGH (S1 = 4.3)	Risk category	HIGH	HIGH	HIGH	HIGH	HIGH	MEDIUM	HIGH	LOW (S2 = 0.7)	MEDIUM
			Debt level (2029)	106.7	126.0	113.4	112.4	108.2				
			Debt peak year	2018	2029	2018	2018	2018				
			Percentile rank	22.0%	55.0%							
			Probability debt higher						25.6%			
			Dif. between percentiles						41.7			

Note: For further information, see the European Commission Fiscal Sustainability Report (FSR) 2018.

[1] The first table presents the baseline no-fiscal policy change scenario projections. It shows the projected government debt dynamics and its decomposition between the primary balance, snowball effects and stock-flow adjustments. Snowball effects measure the net impact of the counteracting effects of interest rates, inflation, real GDP growth (and exchange rates in some countries). Stock-flow adjustments include differences in cash and accrual accounting, net accumulation of assets, as well as valuation and other residual effects.

[2] The charts present a series of sensitivity tests around the baseline scenario, as well as alternative policy scenarios, in particular: the historical structural primary balance (SPB) scenario (where the SPB is set at its historical average), the Stability and Growth Pact (SGP) scenario (where fiscal policy is assumed to evolve in line with the main provisions of the SGP), a higher interest rate scenario (+1 pp. compared to the baseline), a lower GDP growth scenario (-0.5 pp. compared to the baseline) and a negative shock on the SPB (calibrated on the basis of the forecasted change). An adverse combined scenario and enhanced sensitivity tests (on the interest rate and growth) are also included, as well as stochastic projections. Detailed information on the design of these projections can be found in the FSR 2018.

[3] The second table presents the overall fiscal risk classification over the short, medium and long-term.

a. For the short-term, the risk category (low/high) is based on the S0 indicator. S0 is an early-detection indicator of fiscal stress in the upcoming year, based on 25 fiscal and financial-competitiveness variables that have proven in the past to be leading indicators of fiscal stress. The critical threshold beyond which fiscal distress is signalled is 0.46.

b. For the medium-term, the risk category (low/medium/high) is based on the joint use of the S1 indicator and of the DSA results. The S1 indicator measures the fiscal adjustment required (cumulated over the 5 years following the forecast horizon and sustained thereafter) to bring the debt-to-GDP ratio to 60 % by 2033. The critical values used are 0 and 2.5 pps. of GDP. The DSA classification is based on the results of 5 deterministic scenarios (baseline, historical SPB, higher interest rate, lower GDP growth and negative shock on the SPB scenarios) and the stochastic projections. Different criteria are used such as the projected debt level, the debt path, the realism of fiscal assumptions, the probability of debt stabilisation, and the size of uncertainties.

c. For the long-term, the risk category (low/medium/high) is based on the joint use of the S2 indicator and the DSA results. The S2 indicator measures the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical values used are 2 and 6 pps. of GDP. The DSA results are used to further qualify the long-term risk classification, in particular in cases when debt vulnerabilities are identified (a medium / high DSA risk category).

ANNEX C: STANDARD TABLES

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

	2013	2014	2015	2016	2017	2018
Total assets of the banking sector (% of GDP)[1)]	302,5	271,4	250,3	229,6	202,3	197,5
Share of assets of the five largest banks (% of total assets)	70,3	69,2	72,3	71,2	73,1	-
Foreign ownership of banking system (% of total assets)[2)]	20,3	20,5	23,3	22,5	30,3	31,3
Financial soundness indicators:[2)]						
- non-performing loans (% of total loans)	-	16,6	17,5	17,2	13,3	11,7
- capital adequacy ratio (%)	13,7	12,3	13,3	12,3	15,2	15,2
- return on equity (%)[3)]	-9,3	-3,5	0,9	-5,5	-0,8	6,3
Bank loans to the private sector (year-on-year % change)[1)]	-5,0	-5,2	-2,6	-2,1	-0,8	0,9
Lending for house purchase (year-on-year % change)[1)]	-3,5	-3,8	-3,8	-2,3	-1,2	-0,3
Loan to deposit ratio[2)]	-	84,9	81,5	80,8	78,9	76,1
Central Bank liquidity as % of liabilities[1)]	-	8,1	7,1	6,3	6,9	5,8
Private debt (% of GDP)	202,4	190,5	179,4	169,3	162,2	-
Gross external debt (% of GDP)[2)] - public	86,4	98,5	91,9	78,3	72,5	70,3
- private	43,9	46,6	45,6	49,9	51,2	49,3
Long-term interest rate spread versus Bund (basis points)*	472,4	259,1	192,8	308,3	273,4	143,7
Credit default swap spreads for sovereign securities (5-year)*	355,9	173,0	137,4	216,7	136,1	54,3

1) Latest data Q3 2018. Includes not only banks but all monetary financial institutions excluding central banks.
2) Latest data Q2 2018.
3) Quarterly values are annualised.
* Measured in basis points.
Source: European Commission (long-term interest rates); World Bank (gross external debt); Eurostat (private debt); ECB (all other indicators).

Table C.2: **Headline Social Scoreboard indicators**

	2013	2014	2015	2016	2017	2018 [6]
Equal opportunities and access to the labour market						
Early leavers from education and training (% of population aged 18-24)	18.9	17.4	13.7	14.0	12.6	:
Gender employment gap (pps)	6.4	7.1	6.7	6.8	7.5	6.7
Income inequality, measured as quintile share ratio (S80/S20)	6.0	6.2	6.0	5.9	5.7	:
At-risk-of-poverty or social exclusion rate[1] (AROPE)	27.5	27.5	26.6	25.1	23.3	:
Young people neither in employment nor in education and training (% of population aged 15-24)	14.1	12.3	11.3	10.6	9.3	:
Dynamic labour markets and fair working conditions[†]						
Employment rate (20-64 years)	65.4	67.6	69.1	70.6	73.4	75.2
Unemployment rate[2] (15-74 years)	16.4	14.1	12.6	11.2	9.0	7.0
Long-term unemployment rate[3] (as % of active population)	9.3	8.4	7.2	6.2	4.5	3.2
Gross disposable income of households in real terms per capita[4] (Index 2008=100)	92.0	92.0	94.7	97.0	99.3	:
Annual net earnings of a full-time single worker without children earning an average wage (levels in PPS, three-year average)	15865	16207	16043	15984	:	:
Annual net earnings of a full-time single worker without children earning an average wage (percentage change, real terms, three-year average)	-2.3	-0.5	-2.2	-0.6	:	:
Public support / Social protection and inclusion						
Impact of social transfers (excluding pensions) on poverty reduction[5]	26.7	27.0	26.1	24.0	22.5	:
Children aged less than 3 years in formal childcare	38.0	45.0	47.2	49.9	47.5	:
Self-reported unmet need for medical care	3.0	3.5	3.0	2.4	2.3	:
Individuals who have basic or above basic overall digital skills (% of population aged 16-74)	:	:	48.0	48.0	50.0	:

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) 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.
3) Long-term unemployed are people who have been unemployed for at least 12 months.
4) Gross disposable household income is defined in unadjusted terms, according to the draft Joint Employment Report 2019.
5) Reduction in percentage of the risk of poverty rate, due to social transfers (calculated comparing at-risk-of poverty rates before social transfers with those after transfers; pensions are not considered as social transfers in the calculation).
6) Average of first three quarters of 2018 for the employment rate, long-term unemployment rate and gender employment gap. Data for unemployment rate is seasonally adjusted (annual series, for EE, EL, HU, IT and UK data based on first three quarters of 2018).
Source: Eurostat

Table C.3: **Labour market and education indicators**

Labour market indicators	**2013**	**2014**	**2015**	**2016**	**2017**	**2018** [4]
Activity rate (15-64)	73.0	73.2	73.4	73.7	74.7	:
Employment in current job by duration						
From 0 to 11 months	11.9	13.2	14.2	14.4	14.7	:
From 12 to 23 months	6.2	6.2	6.9	7.6	7.8	:
From 24 to 59 months	14.2	13.1	11.9	12.9	13.9	:
60 months or over	67.8	67.5	66.9	65.1	63.5	:
Employment growth* (% change from previous year)	-2.9	1.4	1.4	1.6	3.3	2.5
Employment rate of women (% of female population aged 20-64)	62.3	64.2	65.9	67.4	69.8	72.1
Employment rate of men (% of male population aged 20-64)	68.7	71.3	72.6	74.2	77.3	78.8
Employment rate of older workers* (% of population aged 55-64)	46.9	47.8	49.9	52.1	56.2	59.1
Part-time employment* (% of total employment, aged 15-64)	11.1	10.1	9.8	9.5	8.9	8.1
Fixed-term employment* (% of employees with a fixed term contract, aged 15-64)	21.4	21.4	22.0	22.3	22.0	22.0
Participation in activation labour market policies (per 100 persons wanting to work)	16.5	24.6	28.5	23.4	:	:
Transition rate from temporary to permanent employment (3-year average)	26.4	25.8	26.2	28.2	30.3	:
Youth unemployment rate (% active population aged 15-24)	38.1	34.7	32.0	28.2	23.8	20.2
Gender gap in part-time employment	5.8	5.0	5.4	5.3	5.6	4.7
Gender pay gap[1] (in undadjusted form)	13.3	14.9	17.8	17.5	:	:
Education and training indicators	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Adult participation in learning (% of people aged 25-64 participating in education and training)	9.7	9.6	9.7	9.6	9.8	:
Underachievement in education[2]	:	:	23.8	:	:	:
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	30.0	31.3	31.9	34.6	33.5	:
Variation in performance explained by students' socio-economic status[3]	:	:	14.9	:	:	:

* Non-scoreboard indicator
1) Difference between the average gross hourly earnings of male paid employees and of female paid employees as a percentage of average gross hourly earnings of male paid employees. It is defined as "unadjusted", as it does not correct for the distribution of individual characteristics (and thus gives an overall picture of gender inequalities in terms of pay). All employees working in firms with ten or more employees, without restrictions for age and hours worked, are included.
2) PISA (OECD) results for low achievement in mathematics for 15 year-olds.
3) Impact of socio-economic and cultural status on PISA (OECD) scores. Values for 2012 and 2015 refer respectively to mathematics and science.
4) Average of first three quarters of 2018. Data for youth unemployment rate is seasonally adjusted (annual series, for EE, EL, HU, IT and UK data based on first three quarters of 2018).
Source: Eurostat, OECD

Table C.4: **Social inclusion and health indicators**

	2012	2013	2014	2015	2016	2017
Expenditure on social protection benefits* (% of GDP)						
Sickness/healthcare	6.2	6.2	6.1	6.0	6.1	:
Disability	1.8	2.0	1.9	1.8	1.7	:
Old age and survivors	13.7	14.6	14.7	14.4	14.0	:
Family/children	1.2	1.2	1.2	1.2	1.2	:
Unemployment	1.7	1.8	1.5	1.1	0.9	:
Housing	0.0	0.0	0.0	0.0	0.0	:
Social exclusion n.e.c.	0.3	0.2	0.2	0.2	0.2	:
Total	24.9	26.1	25.5	24.7	24.1	:
of which: means-tested benefits	2.2	2.2	2.1	2.0	1.9	:
General government expenditure by function (% of GDP, COFOG)						
Social protection	18.3	19.2	18.8	18.4	18.0	:
Health	6.5	6.4	6.2	6.1	5.9	:
Education	5.8	5.9	5.7	5.1	4.9	:
Out-of-pocket expenditure on healthcare (% of total health expenditure)	28.2	27.0	27.7	27.7	27.8	:
Children at risk of poverty or social exclusion (% of people aged 0-17)*	27.8	31.7	31.4	29.6	27.0	24.2
At-risk-of-poverty rate[1] (% of total population)	17.9	18.7	19.5	19.5	19.0	18.3
In-work at-risk-of-poverty rate (% of persons employed)	9.9	10.5	10.7	10.9	10.9	10.8
Severe material deprivation rate[2] (% of total population)	8.6	10.9	10.6	9.6	8.4	6.9
Severe housing deprivation rate[3], by tenure status						
Owner, with mortgage or loan	2.5	3.5	4.0	3.2	3.4	3.1
Tenant, rent at market price	10.6	10.5	10.1	8.0	9.0	6.5
Proportion of people living in low work intensity households[4] (% of people aged 0-59)	10.1	12.2	12.2	10.9	9.1	8.0
Poverty thresholds, expressed in national currency at constant prices*	4565	4364	4372	4489	4650	4773
Healthy life years (at the age of 65)						
Females	9.0	9.3	5.6	5.4	6.4	:
Males	9.9	9.6	6.9	7.0	7.7	:
Aggregate replacement ratio for pensions[5] (at the age of 65)	0.6	0.6	0.6	0.6	0.6	0.7
Connectivity dimension of the Digital Economy and Society Index (DESI)[6]	:	:	54.4	57.3	63.0	67.4
GINI coefficient before taxes and transfers*	54.4	54.8	56.3	55.5	54.7	54.0
GINI coefficient after taxes and transfers*	34.1	34.2	34.5	34.0	33.9	33.5

* Non-scoreboard indicator
1) At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.
2) 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.
3) Percentage of total population living in overcrowded dwellings and exhibiting housing deprivation.
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) Ratio of the median individual gross pensions of people aged 65-74 relative to the median individual gross earnings of people aged 50-59.
6) Fixed broadband take up (33%), mobile broadband take up (22%), speed (33%) and affordability (11%), from the Digital Scoreboard.
Source: Eurostat, OECD

Table C.5: **Product market performance and policy indicators**

Performance indicators	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Labour productivity per person[1] growth (t/t-1) in %						
Labour productivity growth in industry	0.74	1.10	0.38	0.07	0.38	-1.06
Labour productivity growth in construction	6.42	3.63	-3.89	-1.28	-1.68	0.42
Labour productivity growth in market services	1.53	2.32	-3.38	-2.13	-1.03	-2.03
Unit Labour Cost (ULC) index[2] growth (t/t-1) in %						
ULC growth in industry	-1.31	0.25	0.10	0.67	1.90	4.01
ULC growth in construction	-3.98	-1.98	2.81	2.47	3.89	0.53
ULC growth in market services	-2.56	-0.51	0.72	3.74	2.33	3.14
Business environment	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Time needed to enforce contracts[3] (days)	870	870	870	755	755	755
Time needed to start a business[3] (days)	7.0	6.0	6.0	6.0	6.0	6.5
Outcome of applications by SMEs for bank loans[4]	1.24	0.71	0.68	0.55	0.60	0.54
Research and innovation	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
R&D intensity	1.38	1.33	1.29	1.24	1.28	1.32
General government expenditure on education as % of GDP	5.80	5.90	5.70	5.10	4.90	:
Employed people with tertiary education and/or people employed in science and technology as % of total employment	29	30	33	34	35	36
Population having completed tertiary education[5]	17	18	20	21	22	22
Young people with upper secondary education[6]	68	70	72	77	78	79
Trade balance of high technology products as % of GDP	-1.60	-1.56	-1.61	-1.56	-1.76	-1.83
Product and service markets and competition				**2003**	**2008**	**2013**
OECD product market regulation (PMR)[7], overall				2.12	1.69	1.29
OECD PMR[7], retail				3.29	3.97	1.83
OECD PMR[7], professional services				:	3.08	2.92
OECD PMR[7], network industries[8]				3.09	2.55	2.18

1) Value added in constant prices divided by the number of persons employed.
2) Compensation of employees in current prices divided by value added in constant prices.
3) The methodologies, including the assumptions, for this indicator are shown in detail here: http://www.doingbusiness.org/methodology.
4) Average of the answer to question Q7B_a. "[Bank loan]: If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?". Answers were codified as follows: zero if received everything, one if received 75% and above, two if received below 75%, three if refused or rejected and treated as missing values if the application is still pending or don't know.
5) Percentage population aged 15-64 having completed tertiary education.
6) Percentage population aged 20-24 having attained at least upper secondary education.
7) 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
8) 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.6: **Green growth**

Green growth performance		**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Macroeconomic							
Energy intensity	kgoe / €	0.13	0.13	0.13	0.13	0.13	0.13
Carbon intensity	kg / €	0.39	0.39	0.38	0.40	0.39	-
Resource intensity (reciprocal of resource productivity)	kg / €	0.99	0.87	0.91	0.90	0.87	0.87
Waste intensity	kg / €	0.08	-	0.09	-	0.08	-
Energy balance of trade	% GDP	-4.7	-3.7	-3.6	-2.3	-1.6	-2.1
Weighting of energy in HICP	%	13.79	8.59	7.86	8.25	8.11	8.30
Difference between energy price change and inflation	%	10.9	2.6	1.7	-1.9	-2.1	-1.9
Real unit of energy cost	% of value added	20.4	19.9	20.4	21.1	21.9	-
Ratio of environmental taxes to labour taxes	ratio	0.17	0.15	0.15	0.16	0.18	-
Environmental taxes	% GDP	2.2	2.2	2.3	2.4	2.6	2.6
Sectoral							
Industry energy intensity	kgoe / €	0.14	0.14	0.14	0.13	0.13	0.13
Real unit energy cost for manufacturing industry excl. refining	% of value added	16.1	15.4	15.8	16.3	16.9	-
Share of energy-intensive industries in the economy	% GDP	7.7	7.6	7.8	7.9	7.9	-
Electricity prices for medium-sized industrial users	€ / kWh	0.11	0.11	0.12	0.11	0.11	0.11
Gas prices for medium-sized industrial users	€ / kWh	0.04	0.04	0.04	0.04	0.03	0.03
Public R&D for energy	% GDP	0.00	0.01	0.01	0.01	0.01	0.01
Public R&D for environmental protection	% GDP	0.01	0.01	0.01	0.02	0.02	0.02
Municipal waste recycling rate	%	26.1	25.8	30.4	29.8	30.9	28.4
Share of GHG emissions covered by ETS*	%	38.9	38.2	37.7	41.8	38.2	-
Transport energy intensity	kgoe / €	0.89	0.90	0.94	0.95	1.00	0.99
Transport carbon intensity	kg / €	2.24	2.23	2.37	2.36	2.44	-
Security of energy supply							
Energy import dependency	%	79.5	73.3	72.1	78.2	74.0	79.9
Aggregated supplier concentration index	HHI	26.7	28.1	28.2	32.1	29.9	-
Diversification of energy mix	HHI	0.30	0.31	0.31	0.30	0.32	0.30

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2010 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 % of total value added for the economy
Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2010 EUR)
Real unit energy costs for manufacturing industry excluding refining : real costs as % 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.
Recycling rate of municipal waste: ratio of recycled and composted municipal waste to total municipal waste
Public R&D for energy or for the environment: government spending on R&D for these categories as % of GDP
Proportion of GHG emissions covered by EU emissions trading system (ETS) (excluding aviation): based on GHG 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 2010 EUR)
Transport carbon intensity: GHG emissions in transport activity divided by gross value added of the transport industry
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 covering natural gas, total petrol products, nuclear heat, renewable energies and solid fuels
* European Commission and European Environment Agency
Source: European Commission and European Environment Agency (Share of GHG emissions covered by ETS); European Commission (Environmental taxes over labour taxes and GDP); Eurostat (all other indicators)

ANNEX D: INVESTMENT GUIDANCE ON COHESION POLICY FUNDING 2021-2027 FOR PORTUGAL

Building on the Commission proposal for the next Multi-Annual Financial Framework for the period 2021-2027 of 2 May 2018 (COM (2018) 321), this Annex presents the preliminary Commission services views on priority investment areas and framework conditions for effective delivery for the 2021-2027 Cohesion Policy ([59]). These priority investment areas are derived from the broader context of investment bottlenecks, investment needs and regional disparities assessed in the report. This Annex provides the basis for a dialogue between Portugal and the Commission services in view of the programming of the cohesion policy funds (European Regional Development Fund, Cohesion Fund and European Social Fund Plus).

Policy Objective 1: A Smarter Europe – Innovative and smart industrial transformation
Portugal remains a "moderate" innovator and overall low research and development intensity hinders the upgrade of the economic productive structure. The implementation of smart specialisation areas, based on national and regional potential, strengthens innovation performance and fosters productivity growth. High priority investment needs ([60]) have been identified to **enhance research and innovation capacities and the uptake of advanced technologies**, aiming at complementarity and compatibility with Horizon Europe instruments, in particular to promote: • public and private investment in research and innovation, as a tool to move up the value added chain and to increase innovation in firms across sectors, and develop technologies for transition to a carbon neutral economy; • collaboration between public and private research and support technology transfers in a few specialisation identified areas; • mobility of qualified human resources between universities, research and development institutions, tech centres and companies.
Digital skills and uptake of digital technologies by firms and people remain low. Priority investment needs have been identified to increase uptake to **reap digitisation benefits for citizens, companies and governmental bodies and promote digital inclusion, and in particular to**: • promote the acquisition and development of digital skills and market-driven information and communication technology skills; • support the integration of digital technologies into businesses and production processes of micro and small and medium-sized enterprises, including by developing infrastructures and services like digital innovation hubs; • increase the range of digital services provided (e-government, e-procurement, e-inclusion, e-health, e-learning, e-skilling, e-commerce) and taken up by citizens, with special focus on rural, remote and outermost regions and on vulnerable groups of the population.

([59]) This Annex is to be considered in conjunction with the EC Proposal for a Regulation of the European Parliament and of the Council on the European Regional Development Fund and on the Cohesion Fund COM(2018) 372 and the EC Proposal for a Regulation of the European Parliament and of the Council on the European Social Fund Plus COM(2018) 382, in particular as regards the requirements for thematic concentration and urban earmarking outlined in these proposals.

([60]) The intensity of needs is classified in three categories in a descending order – high priority needs, priority needs, needs.

A predominance of micro and small companies affects innovation capacity and productivity. Internationalisation levels are relatively weak, with the share in medium-high and high-tech exports substantially lower than the EU average. High priority investment needs have been identified to **enhance small and medium-sized enterprises growth and competitiveness**, and in particular to: • enable firms to scale up, create jobs, internationalise and promote a climate neutral industrial transformation; • encourage the entrepreneurial ecosystem, networking, new marketing tools, strengthening of managerial skills and financial literacy, knowledge-sharing across sectors and national borders; • facilitate access to credit and to equity capital and improve awareness of the available funding opportunities and advanced business services for small and medium-sized enterprises.
Skills gaps hinder productivity, technological diffusion and affect the development of innovative competences. Priority investment needs have been identified to **develop skills for smart specialisation, industrial transition and entrepreneurship**, and in particular to: • stimulate training and re-skilling in smart specialisation areas, in particular in key enabling technologies and related skills and in the new emerging fields.
Policy Objective 2: A low carbon and greener Europe – Clean and fair energy transition, green and blue investment, circular economy, climate adaptation and risk prevention ([61]) ([62])
Additional effort is needed to focus on the long-term decarbonisation targets for 2030 and 2050. Priority investment needs have been identified to **promote energy efficiency measures and renewable energy**, and in particular to: • improve energy efficiency in public buildings and renovation of residential buildings, focusing on “energy poverty”; also in small and medium-sized enterprises, including their premises, installations and processes; • support the transition to renewable energy in heating and cooling; • support the integration of higher shares of renewables in the energy system through: support of renewable energy technologies, including decentralised energy production; smart energy systems at local level, including smart electricity distribution grids and storage solutions; joint production sites for renewable energy sources, joint access to small grids with neighbouring regions across the border, including blue investment in the Atlantic Strategy.
Portugal is one of the areas in Europe most vulnerable to climate change. High priority investment needs have therefore been identified to **promote climate change adaptation, risk prevention and disaster resilience**, and in particular to: • support prevention and climate-change adaptation cross-sectoral measures, to face multiplicity of impacts and vulnerabilities, wherever possible with a focus on ecosystem-based approaches and

([61]) Specific support to help islands generate their own sustainable, low-cost energy should be provided in the framework of the EU's Clean Energy for EU Islands initiative.
([62]) While outside of the scope of the ERDF and the Cohesion Fund (art. 6, paragraph 1(h), COM (2018)372), energy interconnectors could be financed by the Connecting Europe Facility in line with its objectives (art. 3, paragraphs 1 and 2 (b), COM(2018) 438).

biodiversity protection, also in a cross-border and transnational context; • strengthen management preparedness and response capacity, including early warning systems, equipment and awareness raising campaigns, including joint actions in a cross-border and transnational context.
Portugal still faces considerable challenges with water management. Investments needs have been identified to **promote sustainable water management**, and in particular to: • promote an efficient use of water resources throughout the whole water cycle; support the collection and treatment of waste water; support water body rehabilitation; support ecosystem-based measures to promote natural water storage and purification, including in a cross border and transnational context.
Portugal still faces considerable challenges with waste management. Priority investment needs have been identified to **promote the transition to circular economy**, and in particular to: • support shifting towards the highest steps of the waste management hierarchy, in order to reduce landfilling; develop separate correction of waste, namely for bio-waste; develop and modernise waste recycling and treatment facilities, taking into account waste management capacities in neighbouring regions and promote capacity-building and awareness for stakeholders, favouring sustainable consumption practices, actions and behaviour to increase resource efficiency in small and medium-sized enterprises.
Policy Objective 3: A more connected Europe – Mobility and regional Information and Communication Technology connectivity
Portugal's geographical position requires well-functioning and well-connected network infrastructure**.** It ranks 19th in the 2016 EU Transport Scoreboard, scoring lower on private research and development investments and low carbon aspects. Railways are widely underused for connections to Spain and interoperability is a major bottleneck**.** Priority investment needs have been identified to **develop sustainable, climate resilient, intelligent, secure and intermodal mobility**, and in particular to: • complete the Trans-European Transport Network - core and comprehensive rail networks, including cross border connections; • upgrade port infrastructure and support inter-modality for passengers and freight, including rail connections to Trans-European Transport Network ports and to logistic platforms; • support digitisation for more intelligent, cleaner, intermodal and safer transport systems; • upgrade and modernise other rail corridors; • improve accessibility and interconnectivity of the outermost Regions of Madeira and the Azores.
Personal transport exacerbates seasonal problems with air quality and traffic congestion in the major metropolitan areas, leading to health and economic costs. Portugal has one of the highest rates of car passenger transport in the EU. Priority investment needs have been identified to **promote sustainable multimodal urban mobility**, in particular aiming to promote: • a shift towards sustainable and accessible modes of transport, such as low-carbon public transport

(including support to urban rail rolling stock) and active modes of transport; • investments reducing the negative externalities of transport, in particular congestion, emissions (pollutants, Greenhouse gas, noise), and traffic accidents; • Intelligent Transportation System, digitisation and innovative solutions for Smart Cities, improving infrastructure use and service quality.
Policy Objective 4: A more social Europe – Implementing the European Pillar of Social Rights
Youth unemployment is high and labour market segmentation persistent. Priority investment needs have been identified to **improve access to employment for all jobseekers** and **to modernise labour market institutions and services**, and in particular to: • implement active and preventive labour market measures, well-designed recruitment subsidies, provide job and training mobility measures and engage with local communities with a view to enhancing outreach measures; • improve the capacity of public employment services by upgrading their IT equipment; increase collaboration with employers; establish relevant partnerships and provide lifelong guidance services and learning opportunities.
Overall participation in childcare (children under age of 3) is adequate, but poor households have limited access and supply is insufficient in some areas. Provision of early childhood education and care (4-6 years old) is below average especially in metropolitan areas. Priority investments have been identified to **promote an equal access and better work/life balance**, including access to: • affordable, sustainable and high-quality care services such as childcare and out-of-school care.
Early school leaving represents a serious challenge notably in Azores and Madeira; a large share of the adult workforce lacks basic skills. High priority investment needs have been identified to **improve education and training systems, promote equal access to, and completion of, adult education and learning and promote lifelong learning for all**, and in particular to: • promote early intervention and prevent early school leaving; invest in school education, including infrastructure, and enhance quality education for persons with disabilities; • promote vocational education and training, modernise education and training sectors and upgrade the basic skills of the adult population, in particular digital skills.
Demographic ageing is a pressing challenge and inequalities in access to healthcare remain. Priority investment needs have been identified to **promote equal and timely access to quality, sustainable and affordable healthcare**, **including long-term care,** and **active and healthy ageing policies**, and in particular to: • support re-skilling and upskilling of healthcare and long-term care workforce, contributing to its retention, thus ensuring adequate provision of services; • support the implementation of national active ageing strategies; • undertake infrastructure investments in health, social and long-term care, including community-based services and medical equipment in the health sector, with a view to reducing health

inequalities. Support strengthened provision of integrated care.
Inequalities, child poverty risks and in-work poverty risks persist, while access to services is in need of improvement. Priority investment needs have been identified to **foster active inclusion and address material deprivation**; **enhance equal and timely access to quality, sustainable and affordable services and modernise social protection systems**, and in particular to: • support the activation and rehabilitation of disadvantaged and people with disabilities through integrated and personalised service provision; • promote the social integration of children at risk of poverty and social exclusion; • tackle in-work poverty, promote inclusive working environments, skills development, training and life-long learning for all; • increase the socioeconomic integration of marginalised communities, migrants and disadvantaged groups; • support food provision and assistance to the most deprived.
Policy Objective 5 – A Europe closer to citizens by fostering the sustainable and integrated development of urban, rural and coastal areas and local initiatives
Population concentration in most of the coastal urban areas increased the pressure on the natural resources and land use, with effect on mobility, pollution, social inclusion and access to services. Priority investment needs have therefore been identified to **foster the integrated social, economic and environmental development of the urban areas**, and in particular to: • address urban challenges at functional area level in particular in deprived neighbourhoods and disadvantaged or de-industrialised areas, taking into account the different needs, according to the size, specialization and function of each area.
Depopulation and ageing lead to a reduction in the quality of basic services in low-density internal and rural areas. The geographical and socio-economic characteristics of the outermost regions pose as well specific challenges to be taken into account. Priority investment needs have therefore been identified to **foster the integrated social, economic and environmental local development of the rural and coastal areas**, and in particular to: • support sustainable integrated territorial strategies, focusing on enhancing access to basic services, favour urban-rural linkages and innovative solutions to enhance the endogenous potential of these areas and favour the sustainable attractiveness of the territories, taking into account the different needs at functional area level; • encourage joint actions with neighbouring regions and in sea-basin or functional areas with similar challenges.
Factors for effective delivery of Cohesion policy
• adoption of a national strategy to tackle inequalities and ageing (integrated care); • improved measures to prevent and address conflict of interest, fraud and corruption;

- improved performance on public procurement by tackling the weaknesses identified in the Single Market Scoreboard;

- development and implementation of a roadmap on administrative capacity building necessary for the effective administration and implementation of the Funds, in particular to increase local management capacities, providing assistance to local authorities and beneficiaries, and to eliminate overlaps and excessive documentation requirements;

- foster adequate participation and strengthened capacity of social partners, civil society and other relevant stakeholders in the delivery of policy objectives;

- enhancement of the delivery capacity of Public Employment Services;

- broader use of financial instruments, as well as exploiting synergies with InvestEU for revenue-generating and cost-saving activities.

REFERENCES

Alexandre, F. et al. (2018), "Investimento empresarial e o crescimento da economia portuguesa", Fundação Calouste Gulbenkian, 2018.

Amador, J, et al (2018), "Um retrato das empresas portuguesas no comércio internacional de serviços não turísticos", Revista de Estudos Económicos, pp. 1-26, Vol. IV, no. 3, Banco de Portugal, Lisboa, 2018.

Amador, J. and Stehrer, R., "Portuguese exports in the global value chains", Banco de Portugal, Lisboa, 2014

Bank of Portugal (2019), "Statistical Bulletin", Issue 2, 2019.

Benz, S. and F. Gonzales (2019), "Intra-EEA Stri Database: Methodology and Results", OECD Trade Policy Papers, No. 223, OECD Publishing, Paris.

Centre for European Economic Research (2017), "Final report 2017 – Effective tax levels using the Devereux/Griffith methodology", TAXUD/2013/CC/120, 2017.

Centre for Social and Economic Research (2018), "Study and reports on the VAT Gap in the EU-28 Member States: 2018 final report", TAXUD/2015/CC/131, 2018.

Coutinho, L., Turrini, A, Zeugner, S. (2018), "Methodologies for the assessment of current account benchmarks", European Commission, Discussion Paper 086, September 2018.

Dias, D., et al. (2014), "Resource allocation, productivity and growth in Portugal", Economic Bulletin, Bank of Portugal, October 2014.

Ecorys (2018), "Study on costs involved in accessing markets cross-border for provision of construction services – Final Report", 2018.

European Commission (2016), "Report on Public Finances in EMU 2016", Institutional Paper 045, December 2016.

European Commission (2017a), "Taxation of Company Cars in Belgium – Room to Reduce their Favourable Treatment", Economic Brief 26, 2017

European Commission (2017b), "Benchmarks for the assessment of private debt", European Commission note to LIME, October.

European Commission (2018a), "Country Report 2018", 2018.

European Commission (2018b), "Alert Mechanism Report 2019", SWD(2018) 466 final, November 2018.

European Commission (2018c), "The 2018 Ageing Report: Economic and Budgetary Projections for the EU Member States (2016-2070)", *Institutional Papers*, No 079, European Commission, 25 May 2018.

European Commission (2018d), "Tax Policies in the European Union, 2018 Survey", 2018.

European Commission (2018e), "Employment and Social Developments in Europe – Annual Review 2018", 2018.

European Commission (2018f), "ESPN Thematic Report on Challenges in long-term care – Portugal 2018", report prepared by the European Social Policy Network (ESPN)

European Commission (2018g), “Annual Report on European SMEs 2017/2018 – The 10th anniversary of the Small Business Act”, SME Performance Review 2017/2018, Final Report, 2018.

European Commission (2019a), "Fiscal Sustainability Report 2018”, European Commission, Institutional Paper No 094, January 2019.

European Commission (2019b), “European Semester 2018/2019 country fiche on disability”, report prepared by the Academic Network of European Disability experts (ANED)

European Commission (2019c), "The importance of intangible investment for productivity – industry level evidence”, DG JRC technical report, forthcoming.

European Commission (2019d), “Taxation Trends in the European Union – Data for the EU Member States, Iceland and Norway”, 2019 Edition.

European Investment Bank (2018), “EIB Group survey on investment and investment finance country overview: Portugal”, 2018.

INE (National Statistical Institute) (2018), “Inquérito de conjuntura ao investimento – inquérito de abril de 2018”, 2018.

Ministério do Trabalho, Solidariedade e Segurança Social (2018), “Retribuição mínima mensal garantida”, 10º Relatório, November 2018.

OECD (2017), “Economic surveys – Portugal 2017”, February 2017.

OECD (2018a), “OECD compendium of productivity indicators 2018”, Paris, 2018.

OECD (2018b), “Competition assessment reviews, Portugal”, Vol. II, 2018.

OECD (2018c), “Entrepreneurship at glance – Highlights 2018”, Paris, SDD 6, September 2018.

OECD (2018d), “Financing SMEs and entrepreneurs 2019: An OECD scoreboard”, Chapter 3 – Country Profiles, Paris, 27 September 2018.

OECD (2018e), “Corporate Tax Statistics”, First edition, 2018.

OECD (2018f), “OECD review of national R&D tax incentives and estimates of R&D tax subsidy rates”, 2017 edition, April 2018.

Pereira, M. Coutinho et al. (2018), “How long does it take to enforce a debt in the Portuguese judicial system?”, Economic Bulletin, Banco de Portugal, 2018.

Political & Social TNS, (2018), “Flash Eurobarometer 467 – The use of the collaborative economy”, 2018.

Portuguese Ministry of Finance – Directorate-General for Budget, "Síntese da Execução Orçamental Mensal", December 2018.

Serviço Nacional de Saúde (2018), “Relatório Anual – Acesso a cuidados de saúde nos estabelecimentos do SNS e entidades convencionadas”, Lisbon, 2017.

Turrini, A, and Zeugner, S. (2018), "Benchmarks for net international investment positions", European Commission Discussion Paper, forthcoming.

World Bank (2018a), "Paying Taxes 2019", November 2018.

World Bank (2018b), "Doing Business 2019 – Training for Reform"

World Bank (2018c), Doing Business in the European Union 2018: Croatia, the Czech Republic, Portugal and Slovakia.

European Observatory on Health Systems and Policies (2018), "Health System Review – Portugal, Phase I Final Report", April 2018.