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Country Report Portugal 2017
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 COUNCIL, THE EUROPEAN CENTRAL BANK AND THE EUROGROUP

2017 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

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EXECUTIVE SUMMARY

This report assesses Portugal's economy in the light of the Commission's Annual Growth Survey published on 16 November 2016. In the survey the Commission calls on EU Member States to redouble their efforts on the three elements of the virtuous triangle of economic policy – boosting investment, pursuing structural reforms and ensuring responsible fiscal policies. In so doing, Member States should put the focus on enhancing social fairness in order to deliver more inclusive growth. At the same time, the Commission published the Alert Mechanism Report (AMR) that initiated the sixth round of the macroeconomic imbalance procedure. The in-depth review, which the 2017 AMR concluded should be undertaken for the Portuguese economy, is presented in this report.

While the Portuguese economy has continued to recover for the fourth consecutive year, it remains vulnerable to shocks. Growth in domestic demand is still fuelled by strong private consumption. The conditions for investment remain challenging and continue to drag on growth. However, investment is expected to recover in the medium-term with the support from EU funds. This will help rebalance the economy by increasing the share of the tradable sectors.

Recently, there has been a large increase in the contribution made by net external trade, possibly driven by temporary causes. A steady increase in the terms of trade has helped improve the trade balance of goods. Yet, unit labour costs have risen recently putting pressure on competitiveness. Improvements in terms of trade are expected to fade out while robust domestic demand will contribute to boosting imports and weakening the trade balance. Price pressures are expected to re-emerge again, mainly owing to higher oil prices. Employment is set to improve further, albeit more slowly, becoming more aligned with GDP growth. Taken together, real GDP is forecast to have decelerated slightly in 2016 before picking up again in 2017 and 2018. Uncertainty about investment, the banking sector and the implementation of structural reforms pose some downside risks to the sustainable recovery.

Public finances are expected to improve, while the fiscal outlook remains subject to downside risks. The headline deficit is projected to decrease further to 2.0 % of GDP in 2017, mainly as a result of the moderate economic recovery and good financing conditions. However, uncertainty about the macroeconomic outlook, the potential impact on the deficit of banking support measures and possible spending slippages pose risks. Following a steep increase during the economic crisis, public debt has stabilised at around 130.0 % of GDP since 2013**.** Supported by the projected continuing moderate economic recovery and primary surpluses, the debt-to-GDP ratio is expected to fall gradually from 2017 onwards. The stock of public debt, which is still large, coupled with still relatively high deficit levels and low growth, makes Portugal nevertheless vulnerable to changing economic conditions and rising financing costs.

Overall Portugal has made limited progress on addressing the 2016 country-specific recommendations. There has been some progress in conducting an expenditure review. Expenditure is now subject to more controls and expenditure containment with the launch of spending reviews in some sectors. Some progress has also been made in ensuring the long-term sustainability of the healthcare sector. There has been limited progress towards reducing the reliance of the pension system on budgetary transfers. No progress has been made to restructure the state-owned enterprises sustainability, especially those in the transport sector. In the labour market, limited progress has been made towards keeping minimum wage developments at a level which promotes employment and competitiveness although employment risks have so far not materialised. There has also been limited progress in ensuring the effective activation of long-term unemployed, improving the coordination between employment and social services. Yet, some progress has been made in strengthening incentives for firms to hire through permanent contracts. In the financial sector, limited progress has been made in tackling the high level of non-performing loans and improving the access to finance for start-ups and small and medium-sized enterprises via the capital market. Some progress has been made in the debt bias in corporate taxation. There has been some progress in increasing transparency in public procurement, accelerating tax litigations, and incentivising cooperation between universities and businesses. Limited progress has been made in accelerating licensing procedures as well as in reducing regulatory barriers especially in business services.

Regarding progress in reaching the national targets under the Europe 2020 strategy, Portugal is performing well in reducing greenhouse gas emissions, the renewable energy target and energy efficiency, as well as reducing early school leaving. There are still considerable obstacles in attaining the targets on employment rate, R&D investment, tertiary education attainment and poverty reduction.

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

- **Potential growth still lags behind its pre-crisis level and is below EU average**. It is affected by persistent bottlenecks and rigidities in product and labour markets as well as major external imbalances. Efforts to reduce debt and the stock of banks' non-performing loans have been limited, holding back more sustained credit recovery and investment. At the same time, public debt sustainability and the reduction of interest rate costs hinge on fiscal discipline and the necessary fiscal adjustment.

- **The external rebalancing of the Portuguese economy is underway, but at a moderate pace.** The current account rebalancing, influenced by stronger export performance, is still having a limited impact on the large stock of net external liabilities. High external debt and the vulnerability in the external sector at large are linked to weak productivity and competitiveness, including limited specialisation in sectors with higher value added.

- **The private business sector in Portugal is over-indebted.** This is closely related to the ongoing adjustment of the Portuguese banking sector. The authorities are taking some policy measures to tackle the high level of non-performing loans especially in the corporate sector, facilitate business restructuring simplifying administrative processes, improving the insolvency framework and adjusting taxation requirements.

- **The large stock of corporate non-performing loans continues to pose challenges for the banking sector.** Besides the high level of non-performing loans, Portuguese lenders' vulnerabilities stem from different sources: thin capital buffers, large amounts of foreclosed real estate assets, elevated exposures to the Portuguese sovereign debt, as well as weak business models and profit rates of Portuguese banks. Although some measures have been taken to reduce incentives to debt financing, corporate taxation still shows a relatively high debt bias.

- **Ensuring public debt sustainability in the medium and long term hinges on a solid budgetary consolidation.** It also relies on growth enhancing structural measures as well as expenditure containment and growth-friendly optimisation of revenue flows e.g. regarding the efficiency of indirect taxation. While reforms in the pension system have reduced its long-term costs, it still relies on extraordinary budgetary transfers over the medium term. In the healthcare sector, measures to promote prevention and primary care have been put forward and could probably help cut costs in the long term. However, the growing stock of arrears in hospitals and recent measures concerning public sector working hours weigh on the capacity to improve healthcare infrastructure and services. Indebtedness of state-owned enterprises remains high, mainly in the transport sector. A plan to improve monitoring is being set up, but there are no concrete measures to ensure cost efficiency, and sound debt management. The negative operational performance and delay in setting up a governance framework for metropolitan transport further exacerbate the risks of a debt increase. Finally, the current spending review would benefit from a more comprehensive and strategic approach.

- **Unemployment keeps falling and employment growing, while long-term and youth unemployment still remain high.** Half of the unemployed have been jobless for a year or more, while a quarter of young workers are unemployed. Long-term unemployment can make it harder to return to work harming Portugal's growth potential.

Other key economic issues which point to particular challenges facing Portugal's economy are as follows:

- **The rising minimum wage may help reduce in-work poverty, but it poses some employment risks.** Between 2015 and 2017 the minimum wage rose faster than prices and average productivity. This can reduce in-work poverty and impact aggregate demand positively. At the same time, it is becoming increasingly binding, covering a fifth of all workers by 2016. Employment risks seem less pressing in the current context of job recovery, but remain a challenge, especially as regards young and low-skilled workers.

- **While incentives for firms to hire through permanent contracts were strengthened, the labour market remains segmented.** Although financial incentives for permanent hiring have been adopted, some aspects of labour law may still discourage employers from hiring permanent workers. This has potentially negative social consequences and hampers productivity growth. Extensive use of temporary contracts may increase labour market turnover. Younger people are more likely to be on such contracts and are thus more vulnerable to unemployment spells. As they have higher levels of formal skills, this may harm potential growth.

- **The proportion of people at risk of poverty or social exclusion fell in 2015**. This is in line with labour market improvements, but the overall level remains high. Income inequality also declined. In-work poverty remained one of the highest in the EU in 2015, partly due to low quality jobs and a high involuntary part-time employment. It is still not reflecting the recent recovery in the labour market. Measures in the area of social assistance were taken in 2016 to improve income conditions of people in low income households

- **School outcomes are improving but the skill level of the labour force, including digital, remains low**. Tertiary attainment has stagnated below EU average and higher education offer is scattered. In spite of efforts made, obstacles to more structured university business cooperation and knowledge transfer remain, hampering innovation and the transition to a knowledge based economy.

- **Regulatory and administrative barriers, restricting investment and efficient resource allocation, have been tackled partially.** The government has put forward measures to ease businesses' financing needs. Yet, access to finance remains a concern for small and medium-sized business. The authorities are putting forward a framework for assessing the regulatory burden of new legislation on entrepreneurs. At the same time, there still are weaknesses in the areas of the judicial system, the energy sector, transport, the business environment and the innovation framework. There are also barriers to the access to certain regulated professions and to more simplified authorisation procedures. Previous reforms targeting the most restrictive business services, including regulated professions, have been halted and, sometimes, reversed.

- **Progress with reforming Portugal's public administration is incomplete.** There is still a lack of a comprehensive reform to effectively rationalise public administration. Coordination between the central and local levels is weak without homogenous implementing procedures across the different layers of the public sector. There are gaps in anti-corruption measures and an overarching anti-corruption strategy is not yet in place. In the judiciary, in spite of efforts made, efficiency indicators remain poor, especially for tax and insolvency courts.

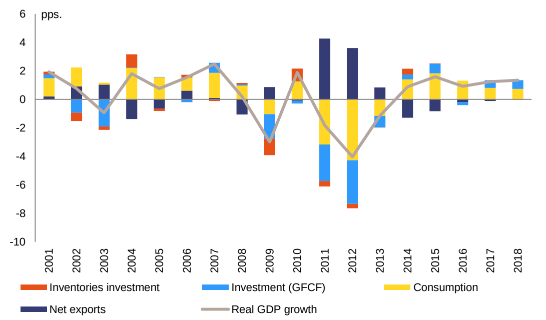
- **In public procurement, progress was made in transparency and reliability of data, while competition is still a problem and the use of direct awards remains high.** Other weaknesses in tendering include limited ex-ante and ex-post controls, lack of capacity, failure to provide satisfactory justification for the recourse of direct awards and contract splitting.

1. ECONOMIC SITUATION AND OUTLOOK

GDP growth

Portugal's economic recovery continues, supported by a rebound in net exports but held back by weak investment. Annual real GDP growth accelerated significantly to 1.6 % in the third quarter of 2016. This was due to a strong resurgence in exports of goods and services, which outweighed imports and increased the external contribution to economic growth to 0.7 percentage points. Domestic demand, which had strongly fuelled expansion in 2015, reduced its positive contribution to 1 pp. in the third quarter of 2016. This drop was driven by falling investment and slower growth in the consumption of durable goods. Investment is estimated to have improved only marginally by the end of 2016, due to stabilisation in construction activity, while employment growth is set to drive private consumption up. Overall, the Commission's 2017 winter forecast estimates that real GDP growth moderated to 1.3 % in 2016.

Graph 1.1: **Real GDP growth and its components**



Source: European Commission

Economic recovery is expected to pick up modestly in 2017 and 2018. Growth in private consumption is also projected to remain modest, reflecting more stable consumption of durable goods, a sustained high level of household debt and higher oil prices. Coming from a low level in 2016, investment is set to gather pace in 2017. This is driven by the gradual increase in EU co-financing during the new programming period and further support from external demand. However, risks to the forecast are tilted to the downside, as acceleration in growth will crucially depend on investment, which has so far remained volatile and sensitive to shocks.

Inflation

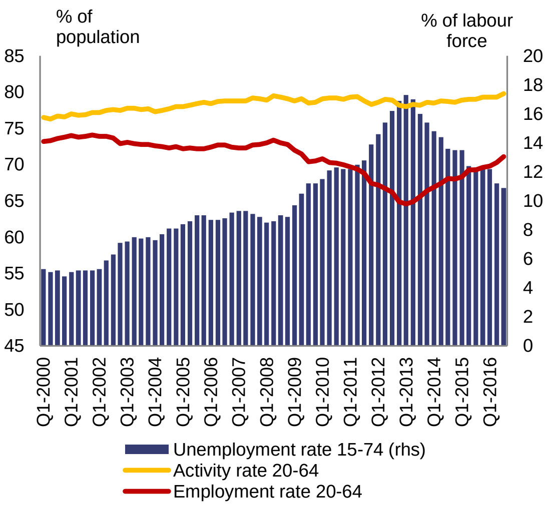
Inflation is projected to rise moderately in the medium term. HICP inflation increased to around 1 % in annualised terms towards the end of 2016 on the back of higher prices of energy and, to a lesser extent, services. The annual average rate however remained lower at 0.6 % reflecting downward energy price effects from the beginning of the year. HICP inflation is forecast to climb gradually to 1.4 % in 2018 under the assumption of higher oil prices and related second-round effects on energy-intensive services.

Labour market and social conditions

The recovery of the Portuguese labour market continued in 2016. Employment growth continued at a robust pace of 2 % year-on-year in Q3-2016, mainly due to stronger demand for labour, especially services. At the same time, the unemployment rate fell to 10.5 % in Q4-2016. The activity rate for the 20-64 age group remained close to its historical highs at just below 80 % in Q3-2016. Long-term unemployment remained high at around 60 % of total unemployment in 2016 and weighed negatively on potential growth. Youth unemployment, although decreasing, was also high at 26.1 % in the third quarter of 2016.

The Portuguese labour market showed strong recovery over 2014-2016. The fall in unemployment between 2014 and 2016 was about 4.5 pps. faster than was to be expected on the basis of the past relationship between GDP growth and unemployment. This overshooting was the largest in the EU (European Commission, 2016a). The relatively job-rich recovery is probably linked to factors including strong wage adjustment in the previous years and with recent labour market reforms. Strong growth in tourism, particularly in 2016, is also estimated to have had a substantial positive impact on employment growth, as the sector itself and many related services are labour intensive. Overall, labour market conditions are expected to continue to improve over the medium term. Employment growth is however set to slow down over the forecast horizon. Along with a moderate decrease in the labour force, it is expected to bring the unemployment rate from around 11 % in 2016 to 9.4 % in 2018.

Graph 1.2: **Activity, employment and unemployment rates (quarterly)**



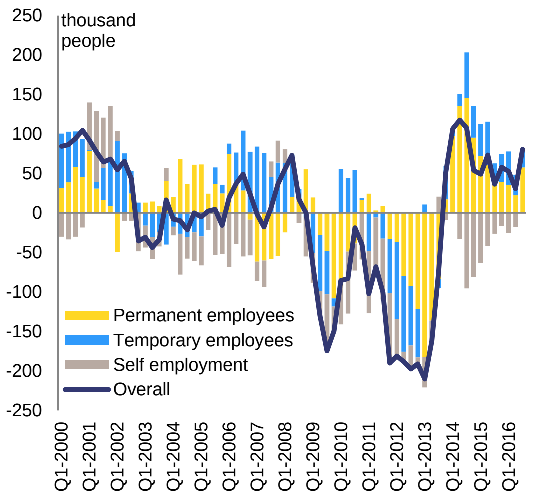
(1) Activity and employment rates (% of population), total, ages 20-64, seasonally adjusted
(2) Unemployment rate (% of labour force), total, ages 15-74, seasonally adjusted

Source: Eurostat

Portugal has witnessed negative net migration flows since 2011. The average balance was about 32 000 people per year leaving the country between 2011 and 2014. More recently, the situation has been stabilising, along with improving labour market conditions. In 2015 net emigration declined to 10 500 people (or 1 per 1 000 inhabitants). Young people between 15 and 29 accounted for more than 40 % of total emigration between 2011 and 2014 and there are indications that the high-skilled are over-represented (European Commission 2016b).

Hiring on permanent contracts continued, while labour market segmentation remains an issue. The Portuguese economy continued to add both temporary and permanent jobs in 2015 and 2016 (Graph 1.3). At the same time, the creation of permanent jobs was not sufficient to drive down the share of temporary contracts in the economy. Employees with fixed-term contracts accounted for 22.4 % of total employees in Q3-2016, one of the highest proportions in the EU. About a quarter of temporary employees move on to a permanent contract every year (27.3 % in 2015, stable from 2014 and slightly higher than the EU average of 23 % in 2014, EU-SILC data). The wage premium of permanent over temporary workers, not adjusted for the different composition of the two groups, is one of the highest in the EU (47 %, Eurostat 2014 structure of earnings survey). After adjusting for personal characteristics (such as age, gender and occupation) it falls to less than half of this, but it still remains among the highest.

Graph 1.3: **Employment by type (permanent, temporary, self-employed), year-on-year changes**



Source: European Commission

After two years of stagnation, the rate of persons at-risk-of-poverty or social exclusion declined in 2015. It reached 26.6 % ([1]), still nearly 3 pps. above the EU average. Children are particularly affected, but their situation is slowly improving. In-work poverty is one of the highest in the EU, with a sharp increase by 0.2 pps. between 2014 and 2015 (still, not reflecting the recent minimum wage increases as it is based in 2014 increases). The main reasons for this are low-quality employment and insecure labour relationships.

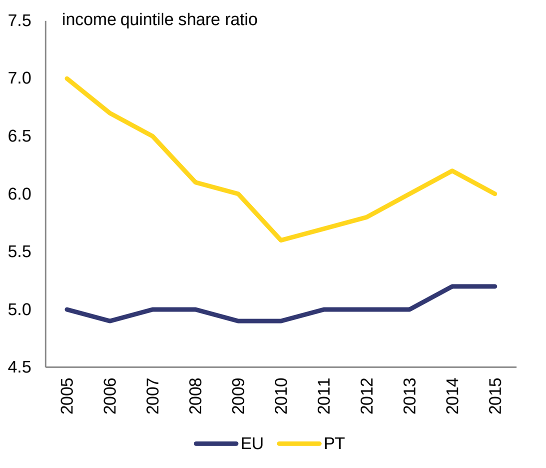
Portugal has one of the highest income inequalities in Europe. Inequality, as measured by the income quintile share ratio ([2]), has historically been higher than in other EU countries, though it was moving towards the EU average

([1]) Provisional figures from the national statistical institute for 2016 point to a further decrease in the at-risk-of-poverty or social exclusion rate to 25.1% and to a stable in-work poverty rate at 10.9%.

([2]) The ratio of total income received by the 20 % of the population with the highest income (top quintile) to that received by the 20 % of the population with the lowest income (bottom quintile).

before the crisis [3]. This trend reversed since 2010 as market incomes of poorer households have been steadily eroded, due to rising unemployment and low wage growth. The tax-benefit system seems to have dampened the effect throughout the crisis, reducing inequality as measured by the Gini coefficient by about a third [4]. In 2015, there has been a modest decline in income inequality, driven by falling unemployment. There was a decline in wealth between 2011 and 2015 for all quintiles of the wealth distribution. However, this drop was more severe for the poorest quintile signalling a worsening of net wealth [5] inequality which is still within the range observed in other EU countries for which data were collected in 2013-2014 (ECB 2016). Inequalities in access to healthcare remain critical. The gap between the poorest households and the richest in self-reported unmet needs for medical examination increased to 6.7 pps. in 2014 (EU average: 4.9), from just 2.3 in 2008 (see Section 4.3.2).

Graph 1.4: **Inequality of income distribution (S80/S20 income quintile share ratio)**

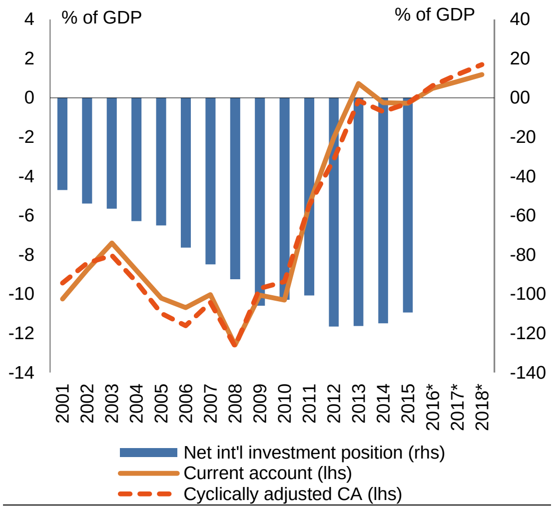


Source: European Commission

External rebalancing

The strong upswing in the current account over the past decade prevented a further deterioration of the NIIP but has not yet been sufficient to markedly improve Portugal's external position. The current account improved strongly over the past decade, from large deficits to modest surpluses. However, current and projected surpluses fall short of the estimated benchmark of 1.6 % required to halve the negative NIIP by 2025.

Graph 1.5: **NIIP and Current Account evolution**



(1) The cyclically-adjusted CA is defined as the current account balance that would emerge at a zero output gap in both the country of reference and the partner countries.
* denotes a forecast figure
Source: European Commission

The most important component of the sustainable reversal of external imbalances was stronger exports while compressed imports played a smaller role. Improvements in competitiveness, resulting from adjustments to relative prices and product quality, enabled exports to make a growing contribution to reducing the current-account deficit, particularly between 2010 and 2013. From the second half of 2015, export performance was hindered by a weak global outlook, particularly in markets outside the EU. Yet, it improved significantly in the third quarter of 2016. This progress was driven mainly by exceptionally strong growth in tourism which, however, is not expected to sustain such a fast pace in the next few years. Moreover, the recent rebound in labour costs poses further risks to the country's external competitiveness. In the medium term, exports are forecast to grow in line with foreign demand. At the same time imports are

(3) From 1995 to 2002, the income of the 10 % poorest %households rose by 12.3 % and continued rising until 2007 but have been falling steadily since.

(4) The gap between the Gini coefficient before taxes and benefits and the Gini after taxes and benefits was 21.5, greater than the EU average (19.3, EU-SILC 2015). The Gini coefficient is a value between 0 and 1. Lower values indicate higher equality.

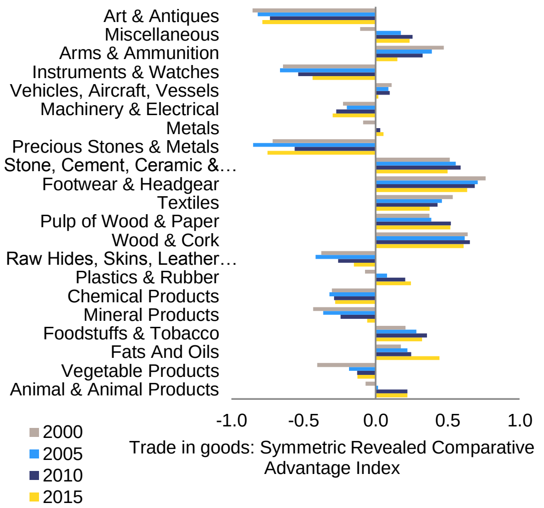
(5) Difference between total assets and total liabilities.

expected to slightly outweigh exports, mainly due to increased investment.

The improvement in external trade has been driven mainly by services, in particular tourism and transport. Both sectors have benefitted from positive external developments; a longer-term stable development would depend on increased investment and efficiency. While the negative trade balance of goods almost reached 13 % of GDP in 2008, it fell to around 4 % in 2016. A steady increase in the terms of trade has helped improve the trade balance of goods. Yet this price effect is expected to reverse due to the increase in energy import prices as of the second half of 2016. In addition, domestic demand is expected to push up imports over the forecast horizon.

However, exports of goods in Portugal are still mostly concentrated in low technology and high labour intensive sectors. Portugal retains a comparative advantage in the production of construction material, textiles and leather production (Graph 1.6). The lack of technological innovation could hold back potential growth in the export sector in the medium term. The scope of specialisation in sectors with higher value added is relatively low, which limits the potential for expanding market shares. Therefore, the sustainability of the rebalancing process depends largely on the extent to which the structural challenges in the export sector can be resolved (see section 4.4.4).

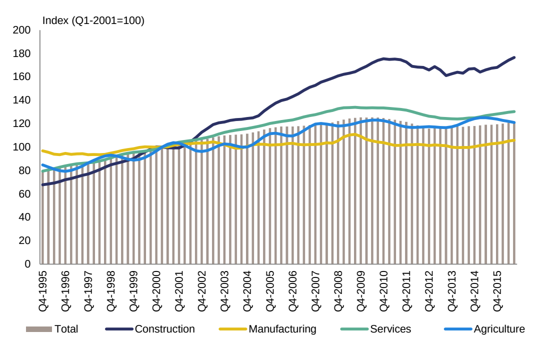
Graph 1.6: **Revealed Comparative Advantage Index (goods)**



Source: European Commission

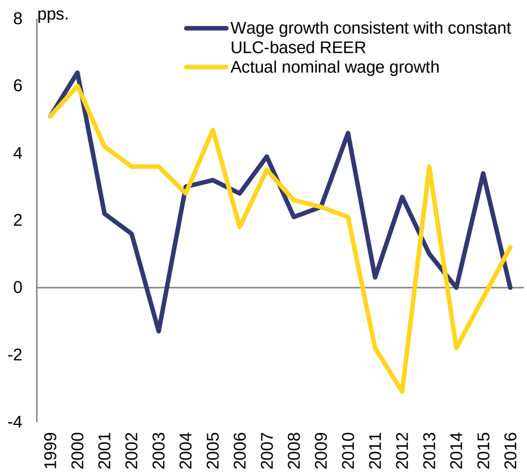
The resurgence of exports over the past years was supported by a decline in labour costs and growing productivity. This led to a decline in the nominal unit labour costs (ULC) in 2010-2015. ULC started to rise again towards the end of 2015 and the growth rate picked up substantially to 2.5 % year-on-year in the third quarter of 2016. The rebound was more significant in the non-tradable sector (Graph 1.7), particularly in construction. However, since 2016, ULC have increased across all sectors except agriculture. ULC are projected to increase only marginally from 2017 due to slower increases of labour costs. Risks to competitiveness remain as wages are expected to increase (see section 4.3.1) more than productivity (see sections 4.3.3 and 4.5).

Graph 1.7: **Nominal ULC, index 2001Q1=100**



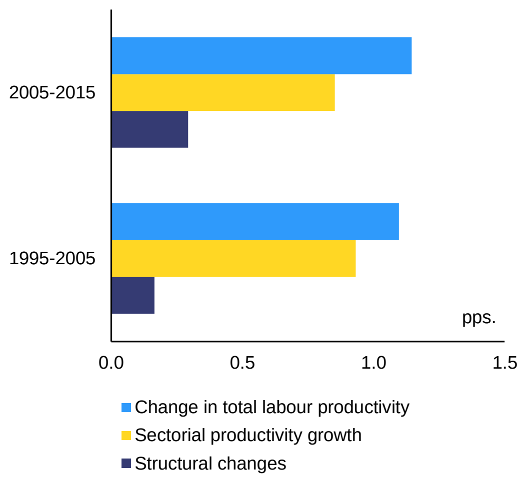
Source: European Commission

Graph 1.8: **Wage growth consistent with constant external competitiveness and actual wage growth**



Source: European Commission based on the methodology described in Arpaia and Kiss (2015)

Graph 1.9: **Productivity decomposition in the overall economy**



Source: European Commission

Nominal wage growth is estimated to have turned positive in 2016 in a context of declining productivity. Before that, wage dynamics and rising labour productivity helped boost competitiveness in almost every year since the crisis, as measured by the real effective exchange rate (REER) adjusted for ULC (Graph 1.8). In 2016, nominal wage growth is estimated to have turned positive but moderate (around 1 %). This was driven by the readjustment of public sector wages, an increase in the minimum wage, and wage hikes agreed in collective bargaining. Wage growth is expected to stabilise just slightly above 1 % in 2017 and 2018 and labour productivity just below 1 %, according to the Commission 2017 winter forecast. Price setting mechanisms, in particular minimum wage decisions, can hurt competitiveness if not compensated by productivity gains.

Deleveraging

Portugal's high private indebtedness ratios are expected to decline further, driven by output expansion and weak credit flows. Since the peak in indebtedness in 2012, the private sector has reduced its debt. Aggregate bank credit is expected to pick up only gradually in the medium term as debt levels of the non-financial sector remain high compared with international standards. Furthermore, the banking system profitability remains burdened by the large stock of non-performing loans (NPLs). Contracting GDP pushed the debt-to-GDP ratio up until mid-2014 while the subsequent resumption of growth helped reduce the debt-to-GDP ratio (see section 4.2.4). Overall, deleveraging is expected to slow down gradually but continue until a more sustainable level is reached ([6]).

Public finances

Public finances continue to benefit from the moderate economic recovery and the favourable monetary policy stance. Having reached 4.4 % of GDP in 2015 (3.1 % of GDP net of one-offs), the general government deficit is estimated to have fallen to 2.3 % of GDP in 2016,

([6]) According to empirical estimates, a private debt-to-GDP level that is higher than 90 % of GDP or 110 % according to some other studies is negatively associated with growth performance (Cecchetti et al. (2011); Arcand et al. (2012)).

according to the Commission's 2017 winter forecast. Lower regular revenue collection is estimated to have been largely offset by the containment of expenditure, in particular due to lower public investment and the freezing of intermediate consumption, and by the revenue from the extraordinary debt settlement scheme PERES. Borrowing costs were moderated by the monetary policy stance (particularly via the European Central Bank's public sector purchase programme). The headline deficit is projected to fall further to 2.0 % of GDP in 2017, mainly due to a one-off operation (a recovery of a guarantee to the BPP bank worth ¼ pps. of GDP), the continued moderate economic recovery and the continued effects of the ECB's public sector purchase programme.

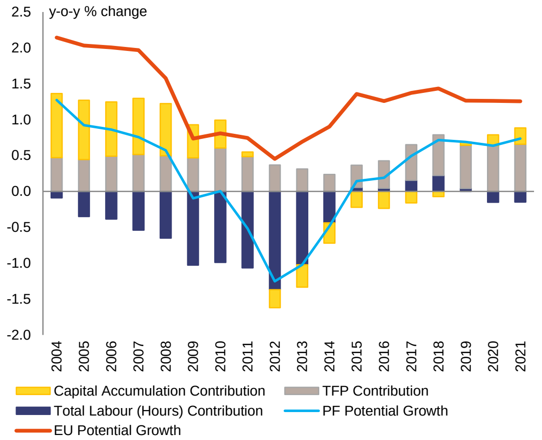
Risks to the fiscal outlook are tilted to the downside. They are linked to the uncertainties surrounding the macroeconomic outlook, the potential deficit impact of banking support measures (from the *Caixa Geral de Depósitos* recapitalisation, for example) and possible spending slippages. After the pro-cyclical loosening of the fiscal policy stance in 2015, the fiscal policy stance is projected to have been and continue to be broadly neutral in both 2016 and 2017.

After reaching 129 % at the end of 2015, Portugal's gross public debt-to-GDP ratio is estimated to have risen to 130.5 % in 2016. The main reason for the increase was higher issuance of government debt for the planned recapitalisation of the state-owned bank *Caixa Geral de Depósitos*. Public debt net of central government deposits is estimated to have slightly declined by around 0.5 pps. of GDP in 2016.The gross public debt-to-GDP ratio is forecast to fall to 128.9 % in 2017 and to 127.1 % in 2018, due to primary budget surpluses and continued economic growth.

Potential growth

Potential growth perspectives are being dampened by the still low level of investment. While back to positive and increasing as of 2015, potential growth remains below the European average. Different factors are behind the long-term decline in Portugal's potential growth including deteriorating demographics (both due to emigration and ageing), low productivity growth and a capital accumulation process that was predominantly channelled to investments with low productivity. The observed negative investment gap was generated mainly by a fall in the productivity of capital or by overinvestment in the non-tradable sectors. Thus, the decline in investment observed in Portugal since 2010 is driven mainly by a fall in investment in the non-tradable sector which then also implies an adjustment of investment to tradable, more productive, sectors. Portugal still faces quite a few obstacles that prevent more sustainable acceleration of capital accumulation. These are related to the vulnerability of the financial sector, weaknesses of the corporate sector, and some structural gaps in business environment (Box 4.4.1).

Graph 1.10: **Potential growth and its components**



Source: European Commission

Outward migration and ageing are reducing the working-age population which weighs on the long-term growth potential. The projected decline in the working-age population is hindering the convergence of the country's growth potential towards the EU average. Emigration of youth (whose education levels are increasingly higher than in the rest of the workforce 67 % being mid or highly educated of those between 25-34 against only 38 % of population above 35) combined with high levels of youth unemployment in the wake of the crisis involves the risk of erosion in human capital, with a negative impact on potential growth.

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

									forecast		
	2004-2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP (y-o-y)	1.4	-3.0	1.9	-1.8	-4.0	-1.1	0.9	1.6	1.3	1.6	1.5
Private consumption (y-o-y)	1.9	-2.3	2.4	-3.6	-5.5	-1.2	2.3	2.6	2.1	1.6	1.2
Public consumption (y-o-y)	1.3	2.6	-1.3	-3.8	-3.3	-2.0	-0.5	0.8	0.6	0.4	0.5
Gross fixed capital formation (y-o-y)	0.6	-7.6	-0.9	-12.5	-16.6	-5.1	2.3	4.5	-1.5	3.8	4.2
Exports of goods and services (y-o-y)	4.9	-10.2	9.5	7.0	3.4	7.0	4.3	6.1	3.9	4.1	4.2
Imports of goods and services (y-o-y)	5.0	-9.9	7.8	-5.8	-6.3	4.7	7.8	8.2	3.9	4.3	4.3
Output gap	0.0	-1.9	0.0	-1.3	-4.1	-4.3	-3.1	-1.6	-0.7	0.2	0.9
Potential growth (y-o-y)	0.9	-0.1	0.0	-0.5	-1.2	-0.9	-0.4	0.1	0.4	0.7	0.9
Contribution to GDP growth:											
Domestic demand (y-o-y)	1.6	-2.8	1.1	-5.7	-7.3	-2.0	1.7	2.5	1.3	1.7	1.5
Inventories (y-o-y)	0.2	-1.2	0.9	-0.4	-0.3	0.0	0.4	0.0	0.0	0.0	0.0
Net exports (y-o-y)	-0.5	0.9	-0.1	4.3	3.6	0.9	-1.3	-0.8	0.0	-0.1	0.0
Contribution to potential GDP growth:											
Total Labour (hours) (y-o-y)	-0.4	-1.0	-1.0	-1.1	-1.4	-1.0	-0.3	-0.1	0.1	0.2	0.3
Capital accumulation (y-o-y)	0.8	0.5	0.4	0.1	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	-0.1
Total factor productivity (y-o-y)	0.5	0.5	0.6	0.5	0.4	0.3	0.3	0.4	0.5	0.6	0.6
Current account balance (% of GDP), balance of payments	-10.1	-10.4	-10.1	-6.0	-1.8	1.5	0.1	0.4	.	.	.
Trade balance (% of GDP), balance of payments	-8.4	-6.7	-7.1	-3.7	0.1	1.9	1.1	1.8	.	.	.
Terms of trade of goods and services (y-o-y)	-0.6	4.8	-1.3	-2.0	0.5	1.7	1.2	3.4	1.1	-0.4	0.0
Capital account balance (% of GDP)	1.3	1.2	1.4	1.5	2.1	1.6	1.5	1.2	.	.	.
Net international investment position (% of GDP)	-80.0	-107.9	-104.3	-100.7	-116.5	-116.3	-114.9	-109.3	.	.	.
Net marketable external debt (% of GDP) (1)	-50.5*	-74.6*	-72.6*	-72.9	-82.0	-81.3	-84.6	-82.2	.	.	.
Gross marketable external debt (% of GDP) (1)	178.0	215.3	215.3	205.7	219.1	206.8	214.5	202.2	.	.	.
Export performance vs. advanced countries (% change over 5 years)	4.2	-0.3	0.7	-0.2	-6.7	1.5	1.6	4.97	.	.	.
Export market share, goods and services (y-o-y)	-2.2	0.0	-8.9	0.4	-4.5	6.8	1.4	-1.0	.	.	.
Net FDI flows (% of GDP)	0.0	-0.8	-5.1	2.5	-7.9	-1.8	-1.6	-0.5	.	.	.
Savings rate of households (net saving as percentage of net disposable income)	0.6	2.7	1.3	-0.9	-0.5	-0.2	-3.3	-4.0	.	.	.
Private credit flow, consolidated (% of GDP)	14.3	5.3	5.3	-0.9	-3.6	-1.8	-5.8	-2.3	.	.	.
Private sector debt, consolidated (% of GDP)	179.0	204.1	201.5	204.2	211.7	204.3	192.4	181.5	.	.	.
of which household debt, consolidated (% of GDP)	83.1	92.1	90.7	90.5	90.7	86.3	82.3	77.5	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	95.9	112.0	110.8	113.7	121.0	118.0	110.1	104.0	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-6.1	-3.6	-1.2	0.7	2.7	3.5	6.0	4.3	2.9	2.9	3.7
Corporations, gross operating surplus (% of GDP)	19.9	20.8	20.8	21.0	21.2	21.3	21.6	21.8	21.9	22.2	23.1
Households, net lending (+) or net borrowing (-) (% of GDP)	1.7	4.4	3.4	2.6	2.9	3.6	2.2	1.0	1.4	1.2	1.1
Deflated house price index (y-o-y)	-1.1	1.0	-1.0	-6.5	-8.7	-2.7	3.9	2.3	.	.	.
Residential investment (% of GDP)	5.5	4.1	3.6	3.3	2.9	2.5	2.5	2.5	.	.	.
GDP deflator (y-o-y)	2.7	1.1	0.6	-0.3	-0.4	2.3	0.8	2.1	1.5	1.4	1.4
Harmonised index of consumer prices (HICP, y-o-y)	2.6	-0.9	1.4	3.6	2.8	0.4	-0.2	0.5	0.6	1.3	1.4
Nominal compensation per employee (y-o-y)	3.1	2.4	2.1	-1.8	-3.1	3.6	-1.8	-0.3	1.4	1.2	1.2
Labour productivity (real, person employed, y-o-y)	1.4	-0.3	3.4	0.1	0.1	1.8	-0.5	0.2	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	1.6	2.7	-1.2	-2.0	-3.2	1.8	-1.3	-0.5	1.3	0.4	0.3
Real unit labour costs (y-o-y)	-1.1	1.6	-1.9	-1.7	-2.8	-0.5	-2.0	-2.5	-0.2	-0.9	-1.1
Real effective exchange rate (ULC, y-o-y)	0.0	0.0	-2.5	-2.3	-5.8	2.6	-1.7	-3.6	1.2	-0.6	-1.4
Real effective exchange rate (HICP, y-o-y)	0.5	-0.6	-3.1	0.7	-1.6	0.3	-0.5	-2.6	1.5	-1.1	.
Tax rate for a single person earning the average wage (%)	22.4	22.6	22.9	24.5	22.8	27.5	27.2	28.3	.	.	.
Tax rate for a single person earning 50% of the average wage (%)	14.0*	13.8	13.9	14.2	11.0	11.0	11.0	11.0	.	.	.
Total Financial sector liabilities, non-consolidated (y-o-y)	8.5	6.7	6.3	-8.4	-0.4	-4.9	0.9	-1.9	.	.	.
Tier 1 ratio (%) (2)	.	7.5	7.9	8.1	11.0	11.7	11.0	12.1	.	.	.
Return on equity (%) (3)	.	4.2	6.3	-5.4	-5.0	-11.9	-21.8	-1.6	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (4)	.	2.5	3.7	5.3	7.0	7.8	12.7	14.4	.	.	.
Unemployment rate	8.7	10.7	12.0	12.9	15.8	16.4	14.1	12.6	11.2	10.1	9.4
Long-term unemployment rate (% of active population)	3.6	4.2	5.7	6.2	7.7	9.3	8.4	7.2	.	.	.
Youth unemployment rate (% of active population in the same age group)	20.9	25.3	28.2	30.2	38.0	38.1	34.7	32.0	28.2	.	.
Activity rate (15-64 year-olds)	73.4	73.4	73.7	73.6	73.4	73.0	73.2	73.4	.	.	.
People at risk of poverty or social exclusion (% total population)	25.9	24.9	25.3	24.4	25.3	27.5	27.5	26.6	.	.	.
Persons living in households with very low work intensity (% of total population aged below 60)	6.6	7.0	8.6	8.3	10.1	12.2	12.2	10.9	.	.	.
General government balance (% of GDP)	-4.7	-9.8	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.3	-2.0	-2.2
Tax-to-GDP ratio (%)	34.5	33.4	33.7	35.5	34.5	37.2	37.1	37.1	37.2	36.9	36.6
Structural budget balance (% of GDP)	.	.	-8.5	-6.6	-3.5	-2.9	-1.7	-2.2	-2.2	-2.3	-2.6
General government gross debt (% of GDP)	67.7	83.6	96.2	111.4	126.2	129.0	130.6	129.0	130.5	128.9	127.1

(1) Sum of portfolio debt instruments, other investment and reserve assets
(2.3) domestic banking groups and stand-alone banks.
(4) domestic banking groups and stand-alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.
(*) Indicates BPM5 and/or ESA95
Source: European Commission, ECB

2. PROGRESS WITH COUNTRY-SPECIFIC RECOMMENDATIONS

Progress with the implementation of the recommendations addressed to Portugal in 2016 ([7]) has to be seen in a longer term perspective since the introduction of the European Semester in 2011. Portugal successfully completed the three year EU-IMF financial assistance programme in 2014. In the course of the programme, it adopted a wide range of structural reforms. While implementing the programme, Portugal received only one country-specific recommendation to meet the programme commitments ([8]). As of 2014, Portugal returned to the regular cycle of EU economic surveillance under the European Semester and received a full set of recommendations.

The reform efforts over the period 2011-2016 have helped Portugal to become more competitive and attractive for investors. Portugal carried out an ambitious fiscal consolidation underpinned by a number of fiscal governance and structural-fiscal measures (organisation of public administration, public finance management, tax administration, SOEs and PPPs). A number of measures were carried out to unwind the public and private, internal and external imbalances and increase the growth potential, while mitigating negative social impacts. In light of the need of correcting the country's imbalances, the authorities introduced reforms to product markets (energy, housing, services, telecommunications, and transport), labour market (wage setting, working time arrangements, individual dismissal, unemployment benefits, active labour market policies), education system (increased number of compulsory education years, enhanced vocational and professional training, enhanced external evaluation and transparency), business environment (licensing, services and regulated professions), judicial sector (new insolvency, arbitration, competition laws and new judiciary map). Measures were also targeted at strengthening the banking sector. Despite those reforms, policy gaps persist regarding product and services markets, corporate debt restructuring, fiscal issues and selected areas of the labour market.

([7]) For the assessment of other reforms implemented in the past, see in particular section 4.

([8]) European Commission, Ex-post evaluation of the economic adjustment programme, Portugal 2011-2014, Institutional paper 040, November 2016

Overall, Portugal has made limited progress ([9]) in addressing the 2016 country-specific recommendations.

There has been limited progress towards making public finances more sustainable (CSR1). A solid budgetary consolidation relies on the timely and strict implementing the budget framework law, reviewing and rationalising public spending and further improving revenue collection. The restructuring of state-owned enterprises, to make them fiscally sustainable, has not still been fully addressed. The reliance of the pension system on budgetary transfers has only been reduced to a limited extent thus creating intergenerational inequalities. In the health sector, the government has adopted measures aimed at promoting disease prevention and public health policies. At the same time, given the lack of sound budget planning and implementation in hospitals they are not enough to guarantee arrears clearance and spending control.

Portugal made limited progress in ensuring that the minimum wage is consistent with the objectives of promoting employment and competitiveness across sectors (CSR2). After consulting the social partners, the government has raised the minimum wage by 5.1 %, beyond inflation and average productivity developments. While increasing aggregate demand and contributing to reducing in-work poverty, by growing faster than overall compensation per employee and covering an increasing share of workers, it may make the hiring of especially lower productivity workers harder. The government has established a structure to monitor the impact of minimum wage developments. Its quarterly reports are discussed with social partners.

Some progress has been made regarding the recommended reforms on the labour market (CSR3). While limited progress has been observed in effectively activating the long-term unemployed and coordinating employment and social services there is some progress in reducing labour market segmentation. A study has been conducted into the effectiveness of active labour market policies.

([9]) Information on the level of progress and the 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.

Based on its results, the government redesigned its employment support programme to promote hiring on open-ended contracts though the number of people covered by this measure is limited. At the same time, long-term unemployment remains high. The introduction of one stop shops for both employment and social services is also planned, but has not yet been implemented.

Progress in the financial sector (CSR4) remains limited. Despite some actions taken recently to address the high stock of non-performing loans, there is no comprehensive strategy. Efforts to provide alternative means of financing remain limited. The authorities have published a strategic plan to support the capitalisation of companies (the *Capitalizar* Programme) which has yet to be fully implemented. The debt bias in corporate taxation is addressed by broadening the scope of the allowance for corporate equity regime.

Some progress has been observed in removing regulatory barriers and improving the business environment (CSR5). The authorities have introduced some measures to make the justice system more efficient, especially as regards organisational improvements in the courts. However, the sector's overall performance remains low, especially where dealing with tax litigation is concerned. Measures are ongoing to improve transparency and reliability of public procurement data and practices. The government has established quarterly monitoring and reporting procedures related to local and regional public private partnership and concessions, but the relatively high use of direct awards remains a concern. Licensing has been reformed, but its uneven implementation across different layers of the public administration is detrimental to confidence and investment. Existing regulatory barriers in some business services sectors still prevent resources from being allocated efficiently. Portugal is developing a set of measures to improve university-business cooperation and the commercialisation of knowledge. The government is currently working on an international revision of the higher education system. Nevertheless, an overall strategy to foster cooperation between universities and the business sector has not so far been implemented.

Table 2.1: **Summary table on 2016 CSR assessment**

Portugal	**Overall assessment of progress with 2016 CSRs: Limited progress[1]**
	Limited progress
CSR 1: *Ensure a durable correction of the excessive deficit, in accordance with the relevant decisions or recommendations under the excessive deficit procedure, by taking the necessary structural measures and by using all windfall gains for deficit and debt reduction. Thereafter, achieve an annual fiscal adjustment of at least 0,6 % of GDP. Conduct, by February 2017, a comprehensive expenditure review and strengthen expenditure control, cost effectiveness and adequate budgeting at all levels of public administration. Ensure the long-term sustainability of the health sector, without compromising access to primary healthcare. Reduce the reliance of the pension system on budgetary transfers. By the end of 2016, refocus ongoing restructuring plans of state-owned enterprises. (MIP relevant)*	**Some progress** in conducting a comprehensive expenditure review **Some progress** in ensuring the long-term sustainability of the healthcare sector and access to primary care **Limited progress** in reducing the reliance of pension system on budgetary transfers. **No progress** in refocusing restructuring plans of State Owned Enterprises
	Limited progress
CSR 2: *In consultation with social partners, ensure that the minimum wage is consistent with the objectives of promoting employment and competitiveness across sectors. (MIP relevant)*	**Limited progress** as regards the minimum wage.
	Some progress
CSR 3: *Ensure the effective activation of the long-term unemployed and improve the coordination between employment and social services. Strengthen incentives for firms to hire through permanent contracts. (MIP relevant)*	**Limited progress** in ensuring effective activation of long-term unemployed and in improving the coordination between employment and social services. **Some progress** in strengthening incentives for firms to hire through permanent contracts.
	Limited progress
CSR 4: *Take measures, by October 2016, to facilitate the cleaning up of the balance sheets of credit institutions and address the high level of non-performing loans. Reduce the debt bias in corporate taxation and improve the access to finance for start-ups and small and medium-sized enterprises via the capital market. (MIP relevant)*	**Limited progress** in facilitating the cleaning up of the balance sheets of credit institutions **Some progress** in reducing the debt bias in corporate taxation. **Limited progress** in improving the access to finance for start-ups and small and medium-sized enterprises via the capital market
	Some progress
CSR 5: *Increase transparency and efficiency in public procurement as regards public-private partnerships and concessions. By the end of 2016, improve and accelerate administrative and licensing procedures, accelerate tax litigations and reduce regulatory barriers, especially in business services. Incentivise cooperation between universities and the business sector. (MIP relevant)*	**Some progress** in increasing transparency in public procurement. **Limited progress** in improving and accelerating licensing procedures by the end of 2016 **Some progress** in accelerating tax litigations by the end of 2016 **Limited progress** in reducing regulatory barriers especially in business services by the end of 2016 **Some progress** in incentivising cooperation between universities and the business sector

[1] This overall assessment of CSR1 does not include an assessment of compliance with the Stability and Growth Pact.

Source: Commission Services

Box 2.1: **Contribution of the EU budget to structural change in Portugal**

Portugal is a significant beneficiary of European Structural and Investment Funds (ESI Funds), with an allocaton of up to EUR 25.8 billion until 2020. This is equivalent to around 2 % of GDP annually (over 2014-2017) and 73 % of the total public investment[1]. Out of the EU financing EUR 2.6 billion is planned to be delivered via financial instruments, which is five times higher than the previous period. By 31 December 2016, an estimated EUR 11.4 billion, which represents about 44 % of the total allocation for ESI Funds, have been allocated to concrete projects.

Financing under the European Fund for Strategic Investments, Horizon 2020, the Connecting Europe Facility and other directly managed EU funds is additional to the ESI Funds. By end 2016, Portugal has signed agreements for nearly EUR 573 million for projects under the Connecting Europe Facility. The EIB Group approved financing under EFSI amounts to EUR 1 billion, which is expected to trigger nearly EUR 3.4 billion in total investments (as of end 2016).

ESI Funds helped progress on a number of structural reforms in 2015 and 2016 **via ex-ante conditionalities[2] and targeted investment**. Examples include the creation of a national system of credits and a national quality assurance system for vocational education and training, and building administrative capacity of the Public Administration, the development of the transport plan which contributes to focus investments on mature and strategic projects, and of specialisation strategies which favour synergies between public and private partners aiming at concentrating efforts and investments on each region's relative strengths. These reforms have prepared the ground for better implementation of public investment projects in general, including those financed from national sources and from the other EU instruments mentioned above. The fulfilment of ex-ante conditionalities is on track. Administrative reforms support is also available through targeted financing under the European Social Fund, advice from the Structural Reform Support Service and, indirectly, through technical assistance.

The relevant CSRs focusing on structural issues were taken into account when designing the 2014-2020 programmes. Compared to the 2007-2013 programming period, there is a significant increase in innovation, R&D, SME support and low-carbon economy. This renewed focus of the funds reflects the need of rebalancing the Portuguese economy towards a higher share of the tradable sectors while alleviating the effects of the economic adjustment on the most vulnerable parts of the population and reducing social and territorial disparities.

In addition to challenges identified in the past CSRs, **ESI Funds address wider structural obstacles to growth, competitiveness and job creation.** These include improving the access to finance for small and medium-sized enterprises, incentivising research and cooperation between universities and the business sector, promoting the qualification of human capital and improving the functioning of employment and social services. EU investments are expected to support more than 24 500 enterprises, increasing the share of exports in the SMEs turnover (estimated to reach 27 % of SMEs turnover by 2023) and favouring job creation (more than 35 000 direct jobs estimated) and will incentivize innovative projects favouring cooperation between research institutions and more than 1 300 enterprises. R&D expenditure of companies is projected to rise considerably, from 1.2 % (2012) to 2 % of GVA by 2023, contributing to increase the overall R&D expenditure**.**

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

[1] National public investment is defined as gross capital formation + investment grants + national expenditure on agriculture and fisheries

[2] Before programmes are adopted, Member States are required to comply with a number of ex-ante conditionalities, which aim at improving framework and conditions for the majority of public investments areas. For Members States that did not fulfil all the ex-ante conditionalities by the end 2016, the Commission has the possibility to propose the temporary suspension of all or part of interim payments.

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

The 2017 Alert Mechanism Report called for further in-depth analysis to monitor progress in the unwinding of the excessive imbalances identified for Portugal in the 2016 MIP cycle. The selection was also motivated by the fact that Portugal was identified as having excessive imbalances in spring 2016, so that a new IDR is needed to assess how these imbalances evolve. The excessive imbalances arise from external liabilities, high levels of private and public debt levels and high unemployment in a low-growth environment.

Analyses integrated in this Country Report provide an in-depth review (IDR) of how the imbalances identified have developed. In particular, analysis relevant to the IDR may be found in the following sections: Public finances and taxation (see Section 4.1); Financial sector: banking sector, access to finance, private indebtedness, vulnerability linked to the highly negative net international investment position (see Section 4.2); Labour market: high youth and long-term unemployment (see Section 4.3); Investment: external competitiveness, private and public investment, business environment (see Section 4.4); Sectoral policies: R&I, competition in product and services markets (see Sections 4.5.1 and 4.5.2); Public administration: efficiency of public administration, public procurement, judicial system (see Section 4.6)

3.1. IMBALANCES AND THEIR GRAVITY

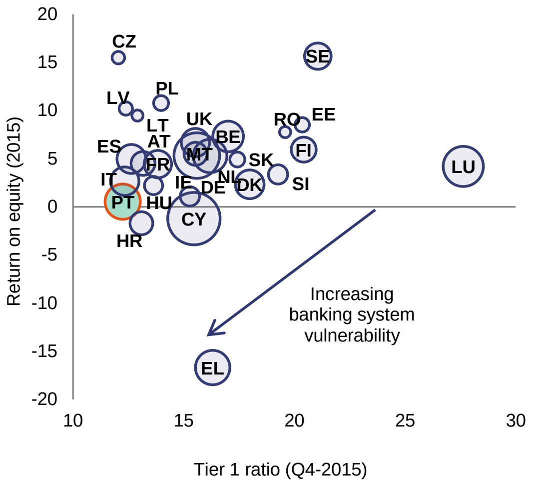
The net international investment position (NIIP) remains negative. It was close to -110 % of GDP in 2015, one of the most negative NIIPs in the EU, well beyond its estimated prudential level of -48 %. Moreover, its composition is tilted towards marketable debt rather than more stable FDI and equity components. Improved growth prospects and continuous current account surpluses of around 1.6 % of GDP per year would be required to halve the negative NIIP and reach a more sustainable position by 2025.

Some deleveraging efforts, in particular for households, notwithstanding, the private debt-to-GDP ratio remains high. Private debt is still well above prudent levels in a context of also high government debt and low potential growth and inflation. Total household non-consolidated debt reached 76 % of GDP in early 2016 and non-consolidated corporate debt was over 117 %. Corporate indebtedness remains amongst the highest in the EU and deleveraging needs in this sector are assessed at between 10 % and 20 % of GDP ([10]). The share of non-performing loans (NPLs) has stabilized although at a high level over the recent quarters, while it is still increasing in some sectors, in particular construction, real estate and trade.

The large stock of corporate non-performing loans, low profitability, exposure to sovereign debt risks and weak capital buffers are putting pressure on the banking sector. The deterioration in the quality of assets, in particular in the corporate sector where the ratio of overdue loans was 16.2 % in the end of first half 2016, weighs on the banking sector's aggregate balance sheet. It is one of the factors, along with demand for loans and low capital buffers to impede the productive allocation of credit and investment.

([10]) Although the exact figures differ among studies, it is estimated that a private debt-to-GDP level that is higher than 90 % of GDP or 110 % according to some other studies is negatively associated with growth performance (Cecchetti et al. (2011); Arcand et al. (2012)).

Graph 3.1: **Banking sector situation and domestic debt levels**



(1) The bubble size represents the magnitude of the public and private debt-to-GDP ratio as of year-end 2015.
Source: Eurostat and ECB

The level of public debt implies risks to fiscal sustainability, making Portugal vulnerable to adverse shocks. The government debt-to-GDP ratio remains high at around 130 %. Changes in financial or economic conditions could substantially increase financing costs. Moreover, the pace of downward adjustment hinges on the authorities' ability to maintain fiscal discipline and implement effective measures to guarantee the required fiscal adjustment.

Portugal still faces challenges in the labour market. Although unemployment has been declining, youth and long-term unemployment remain high. At 26 % in Q3-2016 youth unemployment is among the highest in the EU. Long-term unemployment at 6 % in the same period represents more than half of all those unemployed. Moreover, labour market segmentation continues to hinder productivity growth, leaving young people — who are more educated on average — with unstable contracts while labour market adjustment has had profound social implications. High levels of long-term and youth unemployment increase the risk that jobless people will disengage from the labour market, gradually losing their skills and employability.

3.2. EVOLUTION, PROSPECTS, AND POLICY RESPONSES

The net international investment position has improved somewhat from its low level. The current account has moved to a broadly balanced position since 2013. Small surpluses are expected from 2016 onwards, also in cyclically-adjusted terms and when controlling for REER effects. The NIIP is expected to continue slowly improving on the back of moderate nominal growth and modest current account surpluses which, on their own, are not however sufficient for a rapid return to a more sustainable external position.

Private sector debt is slowly declining, while the still high levels of non-performing loans represent obstacles to new lending. Private sector deleveraging has continued moderately in a difficult situation characterised by low banks' profitability, high NPLs and reduced capital buffers. Along with most EU countries affected by a high level of NPLs these have either stabilised or reduced in recent years, with the exception of the corporate segment of the portfolio, where the NPL ratio continued to increase.

Measures have been taken regarding the financial sector, access to finance and insolvency procedures. The level of private debt imbalances remains high, while alternative means of financing are still limited. Key areas of concern are Portuguese banks' low profitability, asset quality (the ratio of NPLs is high and increasing in the corporate segment), thin capital buffers, exposure to sovereign debt, and high corporate debt overhang. The main challenge is to maintain orderly corporate deleveraging while minimising the ensuing burden on the economy.

Public debt has stabilised at a high level. A contracting economy and high budget deficits put the gross public debt-to-GDP ratio on an increasing trend until 2013. Fiscal consolidation was difficult in a recessionary environment. The economic recovery has helped stabilise the gross public debt-to-GDP ratio at around 130 % since 2014. On the back of the projected continued moderate recovery and primary surpluses, it is expected to decline somewhat, to around 124 % of GDP by 2027. Adverse shocks, such as an increase in interest rate, may put Portugal's public debt ratio on an unsustainable path.

Although measures have been taken to make public finances more sustainable, challenges remain. The financial viability of the State-Owned Enterprises (SOEs) is not yet ensured. This is particularly true of highly-indebted SOEs, most of which are in the transport sector. In view of demographic and economic developments, the affordability of public pensions is under pressure in the short term. Even though partially tackled, there are also challenges to the short and long-term sustainability of the healthcare sector. Historically the health system has run losses and has been unable to clear its arrears.

Labour market duality remains an issue. The Portuguese economy continued to add both temporary and permanent jobs in 2016, but job creation on permanent contracts was not strong enough to lower the share of temporary employees, particularly among young workers. Measures were taken in the area of employment support to promote hiring on open-ended contracts, but their expected impact on reducing segmentation appears limited.

A rebound in potential growth to converge with the EU average would address medium-term challenges. Persistent bottlenecks and rigidities in the product and labour markets still imply limits to supply and demand of labour and thus to potential growth. This refers in particular to obstacles to job market access for young people and the long-term unemployed. High leverage in the private sector and high banks' stocks of NPL weigh on new credit to firms which would allow for a positive capital contribution to potential output. At the same time, a tight fiscal situation poses risks for public debt sustainability and also limits the productive use of public capital resources. Given the estimated need for deleveraging, inflows of non-debt financing such as FDI, could make a valuable contribution to expanding the country's investment and growth potential.

The current imbalances limit the resilience of the Portuguese economy to shocks, making it less capable to adapt to a constantly changing environment. Portuguese GDP growth is volatile relative to the EU average and remains vulnerable to the high volatility of the terms of trade. To buffer the economy from these and other shocks, reducing the stock of public debt would create the fiscal space needed to enable fiscal policy to offset future shocks. At the same time reducing corporate debt would make the private sector more flexible in dealing with sudden shocks, mitigating the spill-overs which shocks to firms have on the rest of the economy. Lower unemployment would prevent major negative impacts on aggregate demand, which could occur through a decline in consumption or an expansion in unemployment benefits. Overall, these adjustments would also help improve the NIIP, Measures designed to improve export competitiveness could also help.

While some progress has been made, there is further potential for structural reforms in several areas. Progress has been made so far in improving the efficiency of the Portuguese public administration. However, there is a lack of rationalising and modernising central, regional and local public administration. Measures have been taken to improve the operation of the judicial system, but efficiency indicators remain very poor especially for tax courts. It is still not possible to evaluate and monitor the housing market reforms properly. There is no systematic monitoring and reporting underpinned by precise and relevant data on key drivers of that market. There have been improvements in the dedicated online platform for public procurement which provides a large amount of data on public contracts. However, transparency remains a challenge for public-private partnerships. This is particularly applicable to the local and regional level, and to concession contracts. Portugal has one of the most restrictive business services regulation in the EU. As a result, productivity growth remains limited, it is more difficult for new players to enter the market, and the price for services is higher than it should be. There are outstanding barriers to access to professions and to more simplified authorisation which adversely affect external and internal competition within the Portuguese economy. Unfavourable framework conditions and weak links between public and private sector still limit Portugal's innovation performance. Delays in reforming the transport sector are hampering the sector's competitiveness. State owned transport companies lack a long-term financial sustainability plan to support future investments. The current rail infrastructure is not being used to its full potential thus compromising the performance of the freight sector. The renegotiation of existing port concession agreements and a new framework for port concessions aim at making Portuguese ports more competitive. Yet, both are being delayed. High structural costs in the energy sector together with an excess of installed capacity compromise the sustainability of the system. The government is putting forward measures to recover past undue rents and eliminate existing ones but a high tariff debt and a concentrated retail market put pressure on end-user prices.

3.3. OVERALL ASSESSMENT

Portugal continues to face important sources of imbalances arising from high external, private and government debt in a context of unemployment and low-growth. Private debt is slowly declining, while government debt has stabilised against the background of remaining consolidation needs. The competitiveness gains that materialised over the past few years are bottoming out. The high stock of non-performing loans, which has not yet stabilised, continues to put pressure on bank profitability and their workout could imply capital gaps that might require state intervention. Various policy measures have been taken to help reduce imbalances, but significant gaps remain. Despite some improvement in relevant flow indicators, Portugal still suffers from major sources of external and internal imbalances. Besides very high private and government debt levels persistent weaknesses concern, the exposure to sovereign debt risks, and thin capital buffers in the banking sector, as well as limited access to finance for corporations and SMEs. A number of policy measures have been taken to restructure the financial sector, ensure adequate capital buffers, and support the reduction of non-performing loans. Despite the restructuring of major banks, recapitalisation programmes and reforms of the insolvency framework, progress with NPL reduction remains slow and further recapitalisation needs remain likely. Public finances are not yet firmly on a stable footing; despite some progress in moving towards a spending review and addressing health expenditure sustainability, action on the front of State-Owned-Enterprises restructuring remain limited. Bottlenecks to productivity growth remain related to innovation performance, restrictions in some services and regulated professions, the public administration, and network industries. The labour market is improving but youth and long-term unemployment still weigh on the employment and social recovery. There is still no comprehensive growth strategy. Regulatory barriers and rigidities in labour and product markets continue to hamper business growth, competitiveness and investment in Portugal.

Table 3.1: **MIP assessment matrix - Portugal 2017**

	Gravity of the challenge	Evolution and prospects	Policy response
	Imbalances (unsustainable trends, vulnerabilities and associated risks)		
External balance	Portugal has made significant progress in adjusting its external imbalances, including improving competitiveness and current account outcomes. Nonetheless, the net international investment position (NIIP) remains very negative (-110 % of GDP in 2015) (pp.6,7,31, 32), and without significant growth improvements, continuous current account surpluses of around 1.6% of GDP per year would be required to halve the negative NIIP by 2025.	Large past current account deficits have declined significantly to 0.3% of GDP in 2015, although such adjustment has recently slowed down due to import dynamics (pp.7,31,32). A terms-of-trade improvement, not expected to last, has in part contributed to reduce the deficit. The current account should be positive in 2016 and 2017, although still below the level required for significant NIIP adjustment. Cost competitiveness has recovered, but unit labour costs are increasing due to sluggish productivity and rising wages.	External imbalances would decrease if economy-wide productivity and potential growth were to increase. Progress has been made in past years to tackle rigidities in product and labour markets. However, weaknesses remain in key areas, including services, regulated professions, public administration, energy and transport and skills formation (pp.46-53). At the same time, policies aimed at raising domestic demand risk stalling the external rebalancing progress. Structural reforms to boost productivity and to improve cost and non-cost competitiveness are limited.
Private debt	High private sector non-consolidated debt (about 190% of GDP in early 2016) impedes a further economic recovery. Despite a remarkable deleveraging process since the peak in 2012, the still very high corporate debt is weighing on profitability and impeding investment. The relatively high level of non-performing loans harms financial stability and the productive allocation of credit.	High private indebtedness ratios are expected to further decline in 2016 due to weak credit evolution and positive nominal output growth. The NPL ratio remains high, increasing to 19% in Q2 2016. (p.28). The Portuguese banking sector is also pressured by low profitability and relatively low provisioning ratios, which, in a low growth environment, are particularly harmful to the valuation of banks.	The main challenge is to maintain an orderly corporate deleveraging without over-burdening economic recovery. Growth conditions remain weak and negatively impact on debt ratios and productivity that is still locked by delayed reform progress. Limited progress has been made to reduce the corporate debt overhang and to expand the financing alternatives for corporates. The government has recently published a strategy for the capitalisation of firms that includes tax measures aimed at improving the neutrality in the taxation of equity and debt (p.31,41,59)
Public debt	Portugal's high public debt should decline only gradually from 2017 onwards (pp.21-22). A source of vulnerability to changes in economic conditions and increasing financing costs, such large stock of debt poses also medium term sustainability risks.	Debt-to-GDP ratio has increased during the crisis, due to negative growth and low inflation, and stabilised to 130% since 2013. Under a continued moderate recovery and primary surpluses, debt would gradually fall from 2017 onwards, but without additional consolidation measures it would be at 124% in 2027 (pp.21-22).	Budgetary consolidation and growth enhancing structural measures are the basis to ensure debt sustainability over the medium and long term. Measures have been taken in past years in the area of tax reforms, tax compliance, pensions, healthcare, state-owned enterprises and public administration. Policy gaps, however, persist in all these areas (pp.22-26).

(Continued on the next page)

Table (continued)

Productivity	Weak productivity dynamics weigh on competitiveness and GDP growth. This affects deleveraging, NIIP reduction and the labour market and is linked to rigidities in product and labour markets as well as to weaknesses in public administration and the judiciary.	Labour productivity growth is on a long-term decline and has been low since 2008 (taking into account the upward push from the spike in unemployment during the crisis).	While 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 also remain related to innovation performance, the low skill level of the labour force, restrictions in some services and regulated professions, the public administration, and network industries.
		Adjustment issues	
Labour market and unemployment	The unemployment rate dropped to 10.5% in Q4 2016. While still high in EU terms it has been steadily decreasing mostly due to job creation and, in smaller part, to outmigration and demographic developments. The working age population is decreasing but the number of employed is still growing due to the decrease in unemployment. Long-term and youth unemployment remain persistently high at 6.1% and 26.1% respectively in Q3 2016. This risks intensifying labour market disengagement and human capital deterioration, with negative impact on growth potential.	After steadily decreasing since Q2 2013 (pp.4,33), unemployment is expected to fall below 10% in 2017. Despite improvements in the labour market, the share of employment in tradable sectors has not improved over the last year. Low growth contributed to a rise in migration outflows which albeit lower still continues in 2016. If not matched by corresponding inflows it can have a negative impact on potential growth in particular to the extent that emigrants are young and well educated.	The impact of the 2011-13 Employment Protection Legislation reform is not clear as labour market segmentation remains. Measures have been taken to improve the effectiveness of active labour market schemes and to improve transition into permanent employment. The minimum wage and its coverage have been increasing; yet, if not matched by productivity growth, minimum wage increases risk affecting job creation and competitiveness. Another main challenge is unemployment reduction, notably long-term, and to ensure that this happens mainly in the tradable sector.

Conclusions from IDR analysis

- The Portuguese economy is characterised by large imbalances in terms of external and internal debt, both public and private, and continuous problems in the banking sector in a context of low productivity growth. The NIIP is still very negative. Households' indebtedness has declined but corporate debt still weighs on firms' performance and a large stock of non-performing loans and low profitability along with thin capital buffers pose risks to banks' balance sheets. The combination of stock imbalances exposes Portugal to shocks or shifts in investor sentiment.
- The tradable sector has gained in importance but rising import demand could delay external rebalancing. The increasing path in public debt is expected to reverse in the short-term. Nonetheless, government debt will remain elevated, implying vulnerabilities to adverse shocks, a high interest burden on public finances and risks to financial stability. Unemployment is on a declining trend but with persistent long-term and youth unemployment. Low productivity growth prevents a faster rebalancing.
- Progress has been made in stabilising the financial sector and improving the access to finance, labour market functioning, education and long-term fiscal sustainability. However, policy gaps persist in the areas of product and services markets, corporate debt restructuring, fiscal and in terms of labour market rigidities. Those rigidities are detrimental for sustaining gains in competitiveness, corporate and household deleveraging and fiscal sustainability.

Source: *Commission services*

4. REFORM PRIORITIES

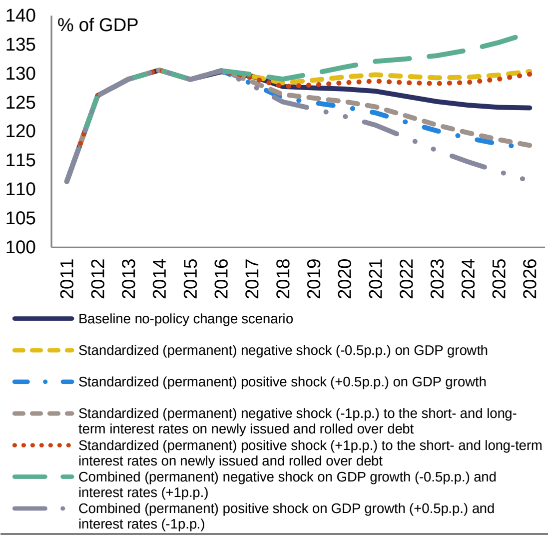
4.1. PUBLIC FINANCES AND TAXATION

4.1.1. FISCAL POLICY (PUBLIC DEBT AND DEBT DEVELOPMENTS)*([11])

General government debt remains high. In the context of the global financial crisis and subsequent recession, very high fiscal deficits, the reclassification of off-balance sheet items and entities into the general government perimeter and stabilising interventions in the financial system resulted in a steep rise in general government debt by over 30 percentage points of GDP between 2010 and 2013. Subsequently, the gross debt-to-GDP ratio has stabilised at around 130 % of GDP since 2014, the third highest public debt level in the euro area. The projections in the following analysis are based on the Commission's 2017 winter forecast. Following the downward revision in projected proceeds from sales of financial assets, including Novo Banco, the fall to around 126 %, previously expected to take place in 2016, is now not expected until 2022. The primary balance, projected to have reached 2.1 % of GDP in 2016, is forecast to be at 2.5 % in 2017 and 2.2 % in 2018, thereby moderating future financing needs.

The gross public debt-to-GDP ratio is expected to fall moderately in the short term and to stabilise in the medium term. While public debt is considered sustainable under plausible scenarios, debt dynamics are vulnerable to adverse shocks. Supported by the projected continuing economic recovery and expected primary surpluses, the debt-to-GDP ratio is expected to fall from 130.5 % in 2016 to 128.9 % in 2017 and 127.1 % in 2018. Model simulations of debt sustainability have been carried out that incorporate the scenario of the 2017 winter forecast until 2018 and other technical assumptions for the medium term ([12]). For the baseline scenario, the results suggest that, following a moderate decline in the short-term, the debt ratio will stabilise in the medium term at around 124 % of GDP (Graphs 4.1.1 and 4.1.2).

Graph 4.1.1: **Combined interest rate and GDP growth shock (chart to be updated)**

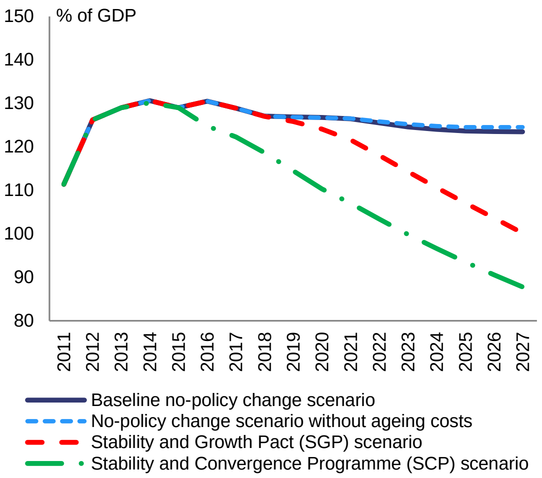


Source: European Commission

The stabilising debt-to-GDP trajectory in the baseline scenario is sensitive to potential rises in sovereign yields and vulnerable to adverse economic developments. Overall, the debt sustainability analysis reveals that the debt stabilisation path of the baseline is broadly robust across a number of reasonable scenarios. Yet, plausible shocks could considerably worsen the dynamics of Portugal's public debt (Graph 4.1.1). Potential shortfalls in nominal growth, sharp interest rate rises or decreasing fiscal efforts could put the public debt ratio on a non-sustainable path. An unsustainable debt trajectory could adversely affect Portugal's economic stability and could have negative outward spill-overs via the sovereign risk channel.

([11]) * MIP relevant
([12]) A structural primary fiscal balance, before cost of ageing, at 1.7 % of GDP surplus as of 2019; inflation converging to 2.0 % by 2021 and the nominal long-term interest rate on new and rolled-over debt converging linearly to 5 % by the end of the 10-year projection horizon; real GDP growth rates of around 1 %; ageing costs in line with the European Commission's 2015 Ageing Report. More details of the assumptions in the different scenarios can be found in the Debt Sustainability Monitor 2016.

Graph 4.1.2: **Fiscal consolidation**



Source: European Commission

The high level of government debt is a heavy burden on public finances. High public debt implies a smaller fiscal margin for manoeuvre to absorb adverse macroeconomic shocks and cope with possible interest rate rises. The high interest bill (projected at 4.3 % of GDP in 2016 as compared to 2.2 % on average for the euro area) also restricts scope for public investment spending.

In the absence of further fiscal consolidation and growth-enhancing structural reforms, safeguarding fiscal sustainability and significantly reducing the debt path will be a challenge. The very high debt ratio implies a significant adjustment burden, which requires the conditions for falling debt to be steadily maintained in the coming decades, including sustained economic growth. Sustainability can be safeguarded through permanent budgetary discipline, in line with the requirements of the Stability and Growth Pact (Graph 4.1.2). The implementation of the reformed budget framework law and enhanced revenue collection could contribute to fiscal adjustment. Healthcare expenditure now accounts for the largest share of ageing costs, with corresponding implications for long-term sustainability. Recent reforms appear to ensure the long-term sustainability of the pension system.

4.1.2. SHORT-, MEDIUM- AND LONG-TERM SUSTAINABILITY (INCLUDING PENSIONS AND HEALTHCARE)*

Fiscal risks assessment indicators point to a low risk in the short term but higher risks in the medium term. The short-term indicator for fiscal risk, S0, points to a low risk of fiscal stress, as the indicator for 2016 is below its critical threshold value. Rather than expressing the need for structural adjustments, this indicator provides a composite index that highlights shorter-term risks stemming from fiscal, macro-financial and competitiveness variables. Despite this favourable assessment, some vulnerabilities persist, associated with the short-term financing needs of public debt, the stock of private debt and the net international investment position. In the medium term, Portugal is classified as being at high risk based both on the fiscal sustainability indicator S1 and the debt sustainability analysis (see Debt Sustainability Monitor 2016). In particular, the fiscal sustainability indicator S1 reaches a value of 6.0 pps. of GDP (based on the Commission 2017 winter forecast), indicating that a cumulative improvement in the structural primary balance of 6.0 % of GDP (relative to the baseline) would be required over 5 years from 2019 onwards, in order to reach the reference value of 60 % of GDP by 2031. These risks are mostly related to the distance of the debt-ratio from the 60 % reference value.

Long-term fiscal risks in the country are assessed as low, largely thanks to pension reforms. The S2 indicator for long-term fiscal risk assessment shows that an upfront fiscal adjustment limited to 1.2 pps. of GDP is required to stabilise public debt in the long term. This low sustainability risk has improved following recent pension reforms. Yet, given a structural primary balance of 1.7 % of GDP in 2018, the future required level of structural primary balance would be 2.9 % of GDP. If age-related expenditure were to increase as indicated in the 2015 Ageing Report (European Commission 2015), the S2 indicator would require an adjustment of 1.2 % of GDP, to make allowance for risks arising mainly from healthcare spending.

High and rising ageing costs pose still a risk to fiscal sustainability. In the medium term, higher fiscal risks are expected to be related largely to the costs for financing pensions and the need to reverse the ongoing accumulation of arrears in the healthcare sector. Despite recent reforms, public pension spending is expected to rise over the next 10 years until benefit and coverage curbs take effect. This leads to an overall decline in pension spending of about 0.7pp of GDP between 2013 and 2060 (European Commission 2015). The situation is different for the healthcare sector, which represents the largest share of Portugal's ageing costs and which is expected to post the EU's largest by 2060 (2.5 % of GDP against 0.9 % EU average). Further, the continued accumulation of delayed payments in hospitals adds more strains to debt reduction and sustainability in the very short term.

Several reforms have improved the long–term sustainability of the pension system. Pressure for the sustainability of the debt path is mostly related to the large distance of the present debt-to-GDP ratio from the 60 % reference value, rather than to pension related costs. Past measures include introducing disincentives to early retirement, raising the pensionable age from 65 to 66 for both sexes, and linking future increases to life expectancy at age 65. The automatic adjustment of pension to life expectancy has done much to reduce pension costs in the long-term. Short to medium-term costs however remain high.

New measures in the pension system are explored, but it is unclear how they will affect cost reduction. The government has launched a comprehensive study of the pension system with measures expected to be applied in 2018, at the earliest. These measures might entail a reduction in the early repayment penalties for workers with about or more than 40 years of service. They could include harmonising current benefit schemes and means-testing procedures. Overall, the authorities are committed to issuing a package of new measures that will be budget-neutral. It will not alter the current plan to eliminate extraordinary budgetary transfers to the pension system by 2019. In the meanwhile, the 2017 budget includes the earmarking of a new progressive tax on real estate assets to the social security's Financial Stabilization Fund (worth EUR 160 million in 2017 according to the 2017 Budget). The government is presenting this earmarking as an alternative to excessive reliance on conventional budgetary transfers. Yet, overall the expenditure side of the sustainability of the pension system in the short to medium-term remains unaddressed.

Portugal has made efforts to ensure access to quality healthcare. Several steps have been taken to make the healthcare sector more efficient and sustainable. Procurement of goods and services is now centralised, creating important savings to the National Health Service. The use of generics eligible for public reimbursement has been expanded, pharmaceutical prices have fallen, waiting lists have been cut and the number of family health units has increased. More recently, the authorities have set up a reform working group with a three year mandate. The latter has focused mainly on i) improving the IT system (including eliminating duplicate records, records of deceased patients etc.), ii) human resource planning aimed at recruiting qualified staff in difficult areas, iii) pilot projects in areas with gaps in the National Health Service. At the same time, access to primary healthcare continues to expand, while the emphasis is increasingly shifting on prevention measures, such as vaccination campaigns (see section 4.3).

Weak accounting and managerial controls lie behind the rising stock of arrears in hospitals, which undermines the health sector's viability. While the hospital reform continues, budgetary planning and implementation in the hospitals remain an important issue. Late payments (arrears) continue to increase, denoting weaknesses in accounting control mechanisms and managerial practices. The stock of arrears in the health sector has increased by EUR 90 million from December 2015 to December 2016. Yet, in October the increase from December 2015 was about 307 million (or 68 %) as arrear repayments occurred mostly at the end of the year. On the one hand, these were possible thanks to the use of centralised allocation to the reversal of wage cuts, the use of some centralised appropriations and the authorisation of using cash balances at the end of the year. On the other hand the extension of the tax on alcoholic drinks (IABA) to sweetened drinks (the levy on drinks with added sugar should be worth EUR 80 million in 2017) is earmarked to address the sustainability of the National Health Service. While these measures sufficed to reduce the existing stock of arrears, they do not entirely address the factors behind their continued accumulation. The most recent report on budgetary execution (October 2016) confirms the increasing indebtedness of state-owned hospitals. Accurate and balanced budgeting, enhanced controls and effective enforcement of the commitment control law could help improve efficiency and quality in this sector. An inadequate system of incentives for the compliant hospitals may lead to overspending.

In spite of short term savings in the health care sector, Portugal lacks a comprehensive long-term strategy to addressing the health-related costs of ageing. The health sector is covered by the recently launched spending review. Savings from the sector are expected to amount to EUR 134 million between 2017 and19. Yet, there is still a need to clarify in more detail how these savings will be achieved. Given the major cost compression undertaken during the economic adjustment programme, any new saving measures need to be carefully designed so as to avoid compromising access to primary healthcare.

4.1.3. FISCAL FRAMEWORK, PUBLIC ADMINISTRATION AND SOES*

Implementation of the reformed Budget Framework Law adopted in 2015 has been slow. The Law is designed to make budget units more accountable, strengthen the medium to long-term focus of public finances by introducing programme-based budgeting and align the deadlines for presenting of the stability programme and the draft budget to Parliament with European Semester requirements. It allows for a three-year transitional period to apply most new features. Albeit nearly a year late, the authorities have recently approved the rules on the operation of the new Budget Framework Law implementation unit ([13]), a first milestone in its implementation, and have set a timetable for 2017 activities. However, the decree law setting up the new budgetary programmes is still outstanding. Given the cumulated delays in the implementation of the new Budgetary Framework Law, there is a risk that this may not be completed by the 2018 target.

The current spending review appears would benefit from a more comprehensive and strategic approach. The authorities have started a spending review that focuses mainly on the health and education ministries, state owned enterprises, (centralised) public procurement and real estate management. This review falls short of a comprehensive approach that would encompass the public sector at large and be guided by a set of concrete savings targets ([14]). On the contrary, arrears in hospitals have been growing since the beginning of the year, indicating a lack of control over spending especially in the health sector.

There are set-backs in public administration reforms. Ongoing public employment reforms have not led to the expected containment of the wage bill. Despite the civil servants rotation policy (2:1 replacement rule) introduced in 2016, the wage bill is on the rise, pointing to some weaknesses in the efficiency of this reform and possible negative implications from the return to the 35-hour working week for public employees, mainly in the healthcare sector. The scope of the revised requalification scheme has also been reduced. Local administration reform measures have been delayed. Following some delays, the Municipality Support Fund (FAM – a debt workout mechanism for over-indebted municipalities) has only recently started disbursements.

There is still no framework to guarantee the financial sustainability of state owned enterprises. State Owned Enterprises (SOEs) monitored by the Ministry of Finance's UTAM unit had a total indebtedness of EUR 32 billion in the second quarter of 2016. However, there is no concrete plan to tackle this large debt stock. Transport sector firms account for most indebtedness. The rail and road infrastructure manager (IP) alone represents 27 % of total indebtedness of SOEs reaching 62 % when added to the rail transport company (CP) and the Lisbon and Porto metros. IP has recently signed a five-year Public Service Obligation contract, but a more long-term operation of sustainability has not been defined. The authorities are revising the operating and financing model for SOEs providing urban transport in Lisbon and Porto. However the

([13]) The Portuguese Public Finance Council in its capacity as an independent institution for the monitoring of public finance issues is to participate in the technical committee of the new Budget Framework Law implementation unit.

([14]) In September 2016, the Eurogroup endorsed a set of shared principles for improving the quality of public finances through spending. http://www.consilium.europa.eu/en/press/press-releases/2016/09/09-eurogroup-statement/

high debt and negative operational results of the cities' metro system remain worrying and their long-term sustainability is still not ensured. New investments are being planned, but a governance scheme and financial framework to ensure long-term sustainability is still being defined. In the case of Lisbon's bus transport company Carris, it was decided to transfer ownership to local government while the debt will remain with central government. The reinstatement of career progression for employees of SOEs may further adversely affect the firms' financial situation. The burden placed on public finances by public private partnerships (PPP) is set to continue. Extraordinary subsidies and compensatory payments to IP are expected to more than double compared with 2016 mostly as a result of the five year Public Service Obligation contract recently signed. The cost of PPP contracts until their end has been revised up by over EUR 500 million with respect to the value estimated in the 2016 budget as the amounts were recalculated using 2017 prices. The Court of Auditors also recently drew attention to the fact that the current monitoring does not take full account of the risk to public finances. The Government intends to improve oversight of spending by SOE's through an ex-ante and ex-post assessment of investments, activities and their financial impact together with a more regular monitoring. But this does not amount to a comprehensive plan to tackle indebtedness and long-term financial sustainability by setting concrete targets.

4.1.4. TAXATION*

Measures have been proposed to improve tax compliance and the tax administration's efficiency. The authorities are taking steps to make the tax administration more efficient by recruiting new tax auditors and gradually reorganising the tax administration's local presence. Measures to further step up the fight against tax evasion and fraud are also under way. The dedicated Taxpayer Services Department for large companies is now expected to take over wealthier households as well. An annual plan for combating tax evasion and fraud is set to replace the current three-year programme, thus enabling the Tax Administration to strengthen its oversight. Portugal is imposing further requirements as regards banks' obligations to provide data on all non-residents bank accounts, resulting from the exchange of information with other countries, limits on cash payments and the end of bearer shares.

Dealing with taxes is time-consuming and complex. The average number of payments necessary to comply with all tax obligations is small (8). At the same time, the average number of hours needed to meet such obligations (243) remains the 5th highest among EU countries (World Bank, 2016). However, Portugal continues to simplify its tax administration with a view to reduce tax evasion and improve tax compliance. Following past efforts to improve the efficiency of the tax administration, there are plans for a series of new administrative simplification measures for several taxes between 2016 and 2017 under the Simplex Programme. A number of measures were already adopted in 2016, (e.g. non-habitual residents may register online for Personal Income Tax purposes, and the invoicing rules for the Value Added Tax (VAT) special regime for small and medium-sized enterprises were simplified).

Minor tax policy shifts have been implemented. As set out in the government programme and the 2016 budget, the introduction of a lump-sum allowance per child, replacing the family quotient introduced in 2015, is now effective. The reduction in VAT on restaurant food to the intermediate rate of 13 % took effect on 1 July 2016.

Reduced VAT rates are still used heavily, although VAT reforms during the crisis had broadened the tax base to some extent ([15]). Portugal's VAT gap as a percentage of theoretical VAT liability of 12.5 % is close to the EU average of 14.0 %, indicating that the efficiency of VAT collection is around the average. However, Portugal's VAT policy gap of 50.9 % is clearly above the EU average of 43.8 %. This is because it has a high VAT rate gap (11.1 % compared with an EU average of 5.3 %), while the exemption gap is in line with the EU average. The VAT rate gap shows the reduction of revenue (as a percentage of GDP) due to the use of reduced VAT rates. The still broad use of reduced rates implies significant revenue losses.

([15]) CASE, 2016, Study and Reports on the VAT Gap in the EU Member States:2016 Final Report TAXUD/2015/CC/131 https://ec.europa.eu/taxation_customs/sites/taxation/files/2016-09_vat-gap-report_final.pdf

The authorities plan to reform several taxes but the timelines are not yet defined. These reforms include revising the number of income brackets in the Personal Income Tax and making it more progressive while creating a salary supplement for lower wages; and other tax reforms addressing firms' chronic under-capitalisation. The 2017 budget includes revenue from the extension of two taxes that is going to be fully earmarked to the sustainability of the national health system and the Social Security's Financial Stabilisation Fund. These are: (i) the extension of the alcoholic drinks tax (IABA) to include sweetened drinks, which is forecast to be worth EUR 80 million in 2017; and (ii) the new progressive tax on real estate portfolios (portfolios above EUR 0.6 million, on top of the existing recurrent real estate tax IMI that has been relatively low in EU comparison) which should yield EUR 130 million in 2017. Despite the need to address some outstanding issues, ensuring the stability of the tax system is also considered a key aspect of the country's capacity to attract investment.

Despite some positive recent developments, the debt-equity tax bias in corporate taxation remains a challenge. Investments financed by debt are taxed less than those financed by equity. As a result, the difference in the cost of capital for investments financed by debt and equity in 2016 was the fifth highest in the EU and well above the EU average ([16]). In recent years, the government has tried to tackle this problem by introducing new rules on limitation of interest deductions and an Allowance for Corporate Equity (ACE). Further measures are envisaged as part of a programme adopted in July 2016 (*Programa Capitalizar*), though they are not yet in place. In line with the *Capitalizar* programme, the 2017 state budget law widened the scope of the allowance for corporate equity. The impact of these measures remains to be seen and will be closely monitored. The impact of an ACE depends on its design features and notably its anti-tax avoidance framework. An alternative, more robust measure, the Allowance for growth and investment, was recently proposed by the Commission within the Common Consolidated Corporate Tax Base ([17]).

([16]) https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2016_taxud.pdf

([17]) European Commission (2016a), Impact assessment accompanying the proposals for a Council Directive on a Common Corporate Tax Base and a Common Consolidated Corporate Tax Base (CCCTB), SWD(2016) 341 final. European Commission (2016b), Communication from the Commission to the European Parliament and the Council, 'Building a fair, competitive and stable corporate tax system for the EU', COM(2016) 682 final.

4.2. FINANCIAL SECTOR AND INDEBTEDNESS

4.2.1. BANKING SECTOR*

The banking system's main challenges remain weak asset quality, thin capital buffers, low profitability and relatively high exposure to Portuguese sovereign debt. While asset risk has broadly stabilised, banks profitability in 2016 remained weak because of a sluggish business environment, high costs for low quality assets, and lower trading gains than in 2015. In seeking to optimise assets' allocation, banks have slightly increased exposure to domestic and higher yielding foreign sovereign debt while some lenders have a large exposure to companies tied to emerging market economies that have recently underperformed on the market. However, the structure of banks funding is improving, with a loan-to-deposit ratio close to 100 % since end-2015, a higher share of customer resources, and slightly lower funding from the European Central Bank.

Banks carry on the deleveraging of their balance sheets while new loans to households are on the increase. Total banking system assets continued to decline, falling by 24 % between the end of 2010, when the deleveraging started, and Q2-2016. As in previous years, the fall in the credit portfolio contributes most to the fall in the system's assets. Looking at recent trends in lending volumes, by the end of 2015, total credit to households shrank by 2.2 % year-on-year driven by the fall in loans for house purchase (-2.9 % year-on-year), whereas loans for consumption and other purpose rose by nearly 1 %. In the same period, loans to Portuguese firms (adjusted for sales of credit portfolios) fell by 1.3 % year-on-year. Nevertheless, gross flows of new bank loans to households increased considerably in 2015. The volume of new mortgage loans is now comparable with the average last seen in 2011. Consumer lending is once again strong reflecting more consumer confidence and backed by easing credit standards and low interest rates.

Assets quality and low profitability continue to put pressure on the system's solvency levels. All Portuguese lenders comply with the minimum capital requirement of 8 %, while the average Common Equity Tier 1 (CET1) ratio for the banking system was 12.1 % in Q2-2016, 0.8 percentage points higher than at the end of 2014 and stable if compared to the end of 2015. Nonetheless, Portuguese banks are currently among the weakest-capitalised credit institutions in the Eurozone. This highlights dire solvency pressures coming mostly from the difficulty for banks to generate capital from internal resources, through earnings retention. Such pressures are set to continue in 2017. Portuguese banks are facing increased regulatory and prudential capital requirements through additional capital buffers imposed through Pillar II requirements and also on Portugal's systemically important institutions.

The profitability of Portuguese banks is still very weak. After four years of losses, the banking system became profitable in 2015, given a substantial decrease in impairments and provisions, and large trading gains booked from the sale of sovereign bonds. In 2016, however, most banks just have broken even as the system-wide return on equity at the end of June 2016 was just 0.3 %. This reflects a significant fall in income from financial operations and an increase in the flow of impairments. By contrast, net interest income increased, driven by a larger reduction in interest costs than in interest income, following the re-pricing of deposits at lower rates. The overall differential between the headline credit rate and the average remuneration rate paid by banks on deposits is gradually rising. Ongoing deleveraging, the relative importance of loans with indexed interest rates and low spreads in the banks' credit portfolios negatively impacted on the income from credit to customers. Overall, recurring revenues remain strongly affected by the low interest rate environment and subdued business levels. Other income items such as net commissions and income from international activity have accounted positively to revenue generated in 2015 and 2016.

Portugal's banking sector compares rather unfavourably with most of the euro area countries when it comes to efficiency figures. The cost-to-income ratio remains locked at 60 %. The average efficiency of banking operations has hardly improved with cost-to-income at 59.9 % at the end of 2015 and 60.4 % in mid-2016, only a fall of 5.1 percentage points from 2014. Nevertheless, efforts are being made to adjust the structure of banking operations and employment to the new environment – in that context the top nine lenders in the country have cut operational costs by 6 % over the first three quarter of 2016. Taking into account the banks' limited capacity to generate gross income in the current macroeconomic environment, the recovery in the Portuguese banking system's profitability is likely to rely mainly on continuously reducing operational costs while at the same time safeguarding the integrity of the risk assessment and internal control processes among banks.

The high amount of non-performing loans continues to weigh on the banking sector's aggregate balance sheet. The non-performing loan (NPL) ratio ([18]) remains high (20.1 % against 19.6 % in end-2015) and still rising for some sectors of the economy, in particular non-financial corporations, active in the construction and real estate sectors. These corporations have also a high share of overdue loans for more than two years. In contrast, bad loans in manufacturing, hotels and restaurants have stabilised and even improved. The quality of credit to households is relatively of better quality and seems to have stabilised over the past year. In addition to high levels of NPLs, some large banks have a high share of foreclosed real estate assets on their balance sheet, which puts additional asset risk pressure on the banking system as a whole. Given moderate economic growth prospects, the ratio of non-performing loans is not expected to improve substantially. Without decisive action, the stock of problematic assets will remain very large and costly, and will jeopardise the efficient reallocation of financial resources available on banks' balance sheets.

The distribution of NPLs has been highly unequal among Portuguese banks with non-performing exposure ratios ranging from below 5 % to over 30 %. Close to ¾ of the total non-performing loan stock and 70 % of the corporate NPLs are held by the six largest banks in the system at the end of 2015 with a very high concentration of corporate bad debts (over 60 % of the total exposure) among just two lenders in the system. The coverage of NPLs has been steadily increasing reflecting the significant build-up of impairment flows. The accumulated credit impairments on the aggregate balance sheet of the banking sector represented about 9.1 % of gross credit granted to the resident private sector at the end of June 2016. However, banks differ in terms of accumulated impairments on NPL: at end-Q3 2016, the average coverage ratio for corporate NPLs was close to 80 % and ranged from 50 % to 95 %.

Although some actions have been taken recently to address the large stock of non-performing loans, there is no comprehensive strategy with clear deadlines. Early warning systems for viable firms have been improved and a task force set up to tackle the core problem. It was decided recently, for tax purposes to write-offs loans that had been overdue for more than 2 years and had 100 % impairments; these write-offs would also have to be derecognised from the banks' balance sheet. Moreover, current recapitalisations and the arrival of new shareholders in some of the large Portuguese banks may also lead to a reduction in such loans. The authorities have also presented a tripartite strategy to tackle the problem. This involves:

- revising the existing legal and judicial package, including provisions to streamlining and accelerating processes under PER (Special Revitalisation Process) and SIREVE (Extrajudicial Business Recovery System), expected to be implemented already in 2017;

- relying on the measures taken by individual banks in the form of an internal review of each non-performing loan by the banks under the supervision of the Central Bank. This would lead to a clear assessment of the loans' viability and specific restructuring arrangements for each case. Although the granular examination of these loans is a step in the right direction, there is no timeline nor are there any obvious incentives to banks to undertake this costly process;

- encouraging banks to partly outsource the servicing of their non-performing loans. Whether this would be followed by the establishment of a proper market of distressed assets, including new underlying regulation, is not clear. Overall, an overarching strategy in line with the recent proposals presented in the Single Supervisory Mechanism (SSM) non-performing loan guidance is still missing.

([18]) European Banking Authority (EBA) data. Note that the EBA definition of NPLs here corresponds to the share of non-performing loans over total loans and is then different from the EBA non-performing exposure (NPE) indicator which encompasses both loans and debts.

Banks are taking steps to improve their capital ratios through attracting some fresh equity. State owned Caixa Geral De Depositos (CGD), the largest bank in Portugal, is in the process of increasing its equity base by some EUR 5 bn in total. This is being done through a set of measures entailing the transfer of EUR 499 m of assets from Parcaixa to CGD, the conversion into equity of EUR 945 m of Cocos and two other operations planned for March 2017, namely a direct recapitalisation by the State in the amount of EUR 2.7 bn and a EUR 0.5 bn issuance of subordinated debt to private investors. Banco Commercial Portugues (BCP) Millennium, the second biggest bank in Portugal, recently raised its capital by EUR 1.3 bn in total through the issuance of shares. For the Chinese financial conglomerate Fosun, this implied an increase in its stake to 23.9 percent from the 16.7 percent they had previously offered to buy for 175 m. BCP repaid EUR 700 million CoCos to the state on 9 February. Banco Portugues de Investimento (BPI)'s main shareholder, the Spanish Caixabank, launched a takeover bid for the bank, a move that was welcome by investors following a long standing dispute with BPI second biggest shareholder (Angolan Santoro group) over BPI's subsidiary in Angola. Finally, Novo Banco's sale process has recently entered in its final phase with private equity funds leading the acquisition discussions. Additionally, virtually all banks in the system are restructuring their franchise to support earnings in parallel selling non-core assets to improve their capitalisation – these asset sales are however dependent on current market conditions and valuations.

4.2.2. INSURANCE SECTOR

The Portuguese insurance market is open and competitive but still under pressure from crisis-legacy issues. With EUR 12.7 billion (equivalent to 7.1 % of GDP) in underwritten premiums the value of the Portuguese insurance market is about the European average. The sector consists of close to 80 insurers with the top five firms representing two thirds of the market, 11 000 employees and a country-wide distribution channel including over 23 000 brokers. The insurance business is dominated by the life insurance segment, representing about 70 % of gross premium income in the non-life insurance sector. Compensation for the workmen is also provided, which is a line of business specific to Portugal. Portuguese insurers were heavily affected by the economic and financial crisis. The crisis created considerable volatility in the value of assets on Portuguese insurers' balance sheet and affected the insurance product mix with sales of life risk products linked to banks loans plummeting while bank lending continued to contract. The business model of the Portuguese insurance sector is based on strong links between banks and insurance companies. This means it is under pressure, mostly because of the challenging situation within the Portuguese credit institutions. Faced with crippling losses, in recent years, banks sold some of the biggest insurers in the country, representing about 40 % of the market. The recession weighed on the motor insurance while heavy competition and high unemployment plunged the once profitable workmen compensation segment into heavy losses. Life insurance was experiencing a revival prior to 2014 but 2015 and 2016 saw a strong reversal as economic uncertainty took hold and interest rate guarantees had to be reduced to levels close to zero. Implementing Solvency II is challenging in the current weak macroeconomic environment, which is also reflected in the recent EIOPA stress test results.

4.2.3. HOUSING MARKET

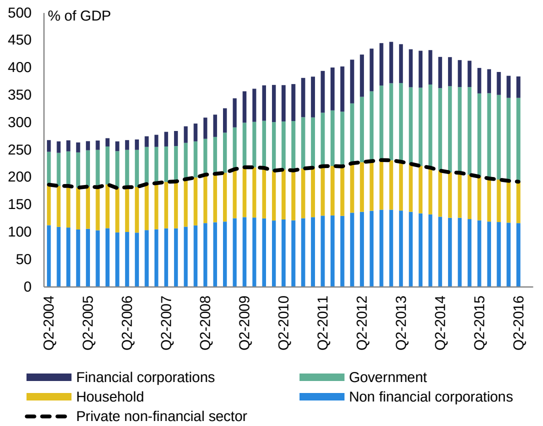
There are signs of step-backs in the housing market reforms. The original framework aimed to make the housing market more dynamic by better balancing the rights and obligations of landlords and tenants. Over a period of five years, it phased out, the old system of open-ended leases in which rents were frozen and contracts could not be terminated by landlords, and provided for rents to be updated so as to achieve gradual alignment with market levels. It also introduced more flexibility in the choice of contract duration, set better incentives for renovation and provided a new and fast extrajudicial eviction procedure. A law which simplified administrative procedures for renovation works was adopted as part of the same package. Concerns remain about the current Parliament's proposal to further extend the transitional period for certain categories for 10 years (more 5 years). In particular the proposal concerns "old household" (contracts before 1990), namely tenants aged 65 or over or disabled, whose household income is below a certain threshold. For "commercial lease contracts" (from before 1995), it covers microenterprises; entities of public, national or municipal interest; student republics; shops and entities of historical and cultural interest. This change, on top of those already introduced after the end of the economic adjustment programme ([19]), would further weaken the original scope of the reform. All these amendments to the original frameworks will reduce and delay the full benefits of the reform, which was designed to be fully applicable from 2017, by extending the transitional period and enlarging the scope of exemptions. The requested ex-post assessment of the lease reform has been halted and it is impossible to know exactly how many contracts that are covered by exemptions and benefits for a transitional period. The main reason for this is that existing monitoring procedures remain limited in scope, without full interoperability between different relevant data sources (registry of buildings, utility contracts, and means testing of households). Moreover, it remains impossible to gather sound evidence on the shadow economy in the rental market in the absence of the comprehensive study on the shadow economy in that market that the Portuguese authorities committed themselves to carrying out with a view to tackling housing tax evasion and fraud more effectively.

4.2.4. PRIVATE INDEBTEDNESS*

Deleveraging has been proceeding slowly. At present the Portuguese private sector remains one of Europe's most indebted in relation to GDP. Within the private sector, the stock of non-consolidated debt for all household was equivalent to 77 % of GDP in June 2016 (compared to 82 % at the end of 2014) whereas for non-financial corporations this was over 117 % of GDP, down by 9 pps. from the end of 2014. For both households and non-financial corporations, the deleveraging that took place over the last quarters was due to GDP growth and changes in inflation. The process of deleveraging was particularly difficult for microenterprises where over a third make no profits.

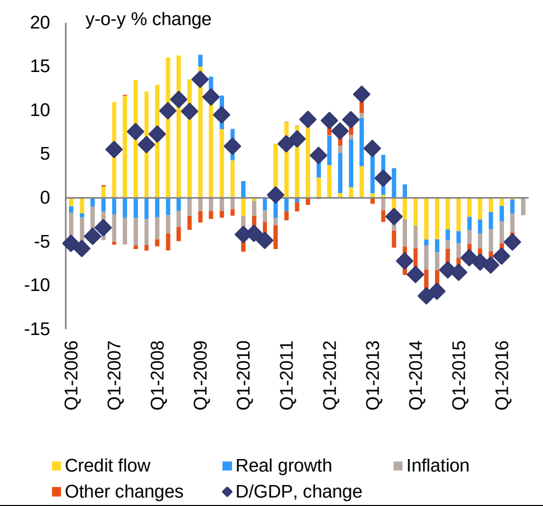
([19]) European Commission, Post-Programme Surveillance Reports, Portugal, Winter 2015/2016 (p. 31) and Summer 2016 (pp. 30-31)

Graph 4.2.1: **Debt breakdown by sector in 2002-2016**



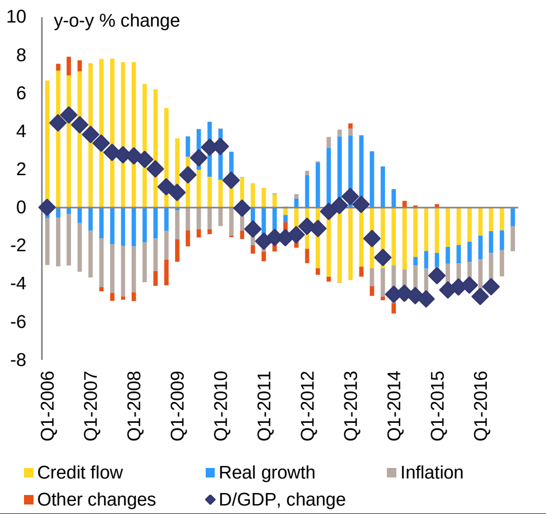
Source: European Commission

Graph 4.2.2: **Breakdown of year-on-year changes in debt-to-GDP ratios, NFCs**



Source: European Commission

Graph 4.2.3: **Breakdown of year-on-year changes in debt-to-GDP ratios, households**



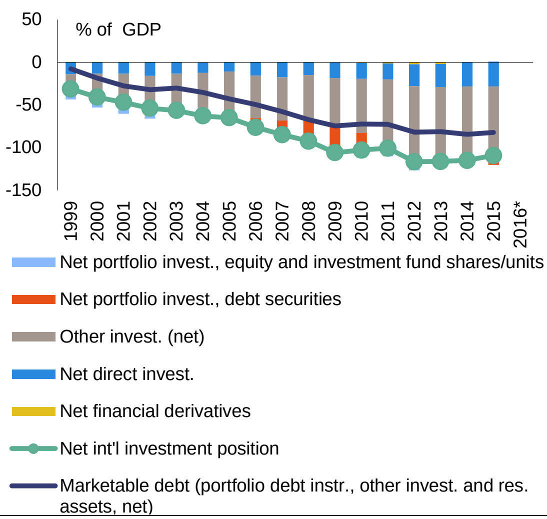
Source: European Commission

The authorities see several possible approaches to addressing high indebtedness. Apart from the approach to non-performing loans discussed above, these include i) the streamlining of the procedures for debt restructuring, in particular more flexibility in the PER and SIREVE schemes and stepping up mediation and coordination among creditors, ii) creating mechanisms that facilitate the debt-to-equity swap within a recovery plan, iii) early warning systems for companies that are in difficulties but still viable, iv) allocating more resources to speeding up insolvency proceedings, including enforcement of collateral, and v) using new IT systems in the insolvency and liquidation procedures. The legislation for these measures is expected to enter into force by April 2017. The authorities are committed to improving the retention of profits through changes in the tax system, to allow for early and fast restructuring by facilitating out-of-court arrangements and improving creditor coordination.

4.2.5. EXTERNAL INDEBTEDNESS*

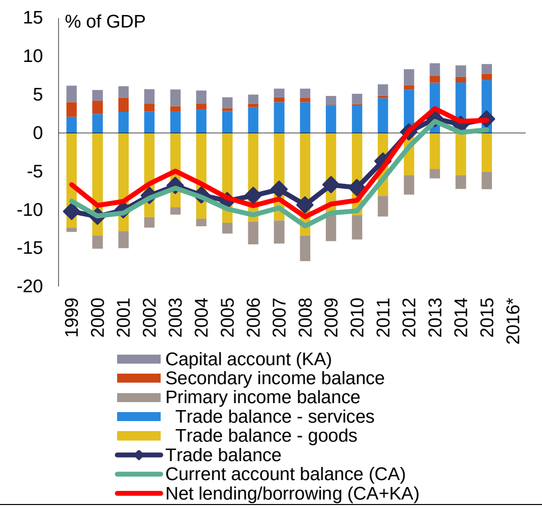
Long-term debt (other investment) mostly from the general government remains the largest component of the net international investment position (NIIP), followed by net direct investment. The overall composition is tilted towards marketable debt, rather than FDI and other equity investment, which tend to be more stable, allow for better risk sharing and facilitate the transfer of expertise. Since its peak in 2012, at -116.5 % of GDP, the Portuguese investment position (NIIP) gradually declined to -110 % still very high, in 2015, reflecting improvements in the trade balance (a compression of imports and expansion in export services, particularly tourism), the continuous though slow deleveraging of the private sector and higher income transfers from remittances further to large migration outflows. Despite this adjustment in the current account, a more sizeable adjustment would be needed to reduce the NIIP to more sustainable levels. The Commission estimates that Portugal would need to run average current account surpluses of around 1.6 % of GDP until 2025 to halve the negative NIIP (about -55 % of GDP), as compared to the 0.1 % of GDP in average current account adjustment recorded since 2013.

Graph 4.2.4: **Breakdown of Portugal's Net International Investment Position (NIIP)**



Source: European Commission

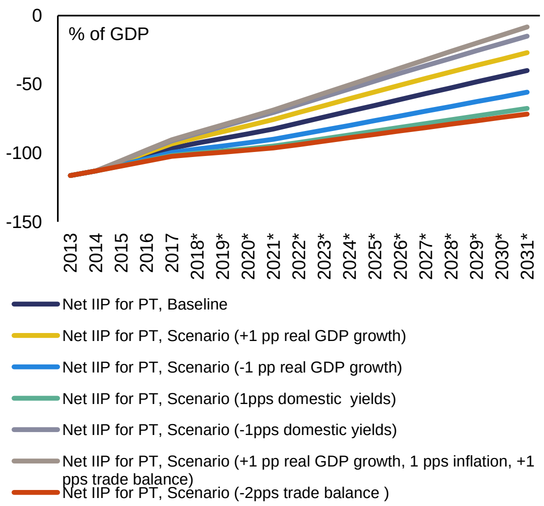
Graph 4.2.5: **Current account financing**



Source: European Commission

A simulation of unfavourable macroeconomic developments shows that an adverse interest rate shock is the most important risk to the NIIP. The NIIP is particularly sensitive to domestic interest rates while a negative shock to GDP growth affects it less (Graph 4.2.6). Keeping all other relevant variables constant, larger trade deficits lead to a slower pace of adjustment. A domestic demand stimulus could thus lead to higher trade-balance deficits, if it is not matched by measures to increase productive capacity.

Graph 4.2.6: **NIIP sensitivity to macroeconomic shocks**



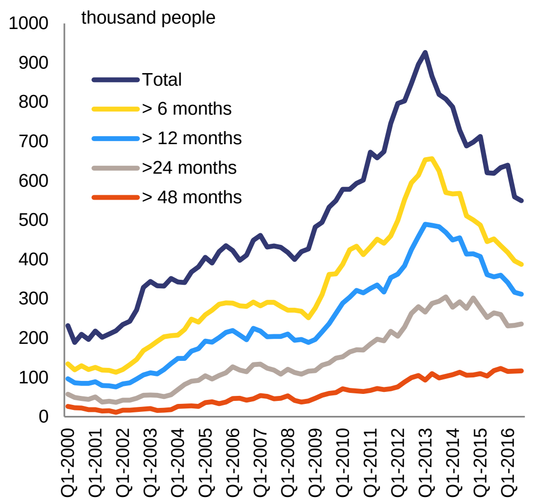
Source: European Commission

4.3. LABOUR MARKET, EDUCATION AND SOCIAL POLICIES

4.3.1. LABOUR MARKET AND ACTIVE LABOUR MARKET POLICIES*

In an improved labour market situation, challenges remain. Unemployment rates continued to fall in 2015 and 2016, as reported in Section 1, but are still higher than in the years before 2008 and higher than the EU average. Long-term unemployment — which accounts for over half of total unemployment — risks stabilising at a high level The government has negotiated with the social partners a mid-term agreement on how to improve labour market conditions. The agreement covers topics such as labour market segmentation and collective bargaining.

Graph 4.3.1: **Unemployment by duration**



Source: European Commission

Labour market segmentation remains high, weighs on the prospects of young people and has the potential to increase labour market volatility. Despite the growth of permanent contracts, labour market segmentation remains high. New entrants, in particular, are exposed to temporary and precarious contracts: 53.5 % of employees under 30 work on temporary contracts (against an EU average of 33.3 %). This adversely affects young people’s career prospects and incomes, given the wage gap between temporary and permanent workers. Such contracts are also particularly sensitive to business cycle fluctuations; youth unemployment thus reacts more strongly to recessions than unemployment in general (Hüttl 2015). The last-in-first-out workforce adjustment strategies, often adopted by firms, exacerbate this effect (Scarpetta 2012). Thus, extensive use of temporary contracts may aggravate volatility in labour markets, thereby failing to dampen economic fluctuations.

Recent reforms notwithstanding, some aspects of labour law may still discourage firms from hiring permanent workers. The employment protection legislation reform implemented during the economic adjustment programme lowered severance payments in case of fair dismissals. It thereby improved employers' perception about flexibility of hiring and firing practices ([20]). However, legislation on unfair dismissals was left unchanged. There is a large gap between the current high level of compensation due for dismissals deemed to be unfair and that awarded in cases of fair dismissals ([21]). Moreover, a worker’s reinstatement in his or her previous job can be established in court if the dismissal is deemed unfair. This may create incentives to challenge fair dismissals in court ([22]) and, coupled with inefficiencies in the judicial system, lead to uncertainty about firing costs. This may, in turn, provide incentives for companies to hire on a temporary basis (on the interaction between judicial efficiency and EPL strictness, see European Commission, 2016c). Since the recent reforms affect only new employment contracts, the full impact of the reform might take time to show results in terms of shifting the share between temporary and permanent contracts.

Additional reasons for persistent segmentation include the structure of employment incentives, currently being reviewed, and the fact that labour inspections are relatively ineffective. The recent increase in ‘activation’ schemes has contributed to a recovery in employment, but some of the available schemes have created incentives to boost fixed-term employment (see below). This

([20]) Employers’ perception about flexibility in hiring and firing practices (World Economic Forum's survey of business leaders) has improved after the 2012 reform. From 2.38 in 2012 to 3.27 in 2016 (7 being the least rigid), the largest increase in the EU over that period. It is now close to the (unweighted) EU average of 3.6.

([21]) Severance payments per year of work amount to 12 days for open-ended contracts and 18 days for temporary contracts in the event of fair dismissal, and between 15 and 45 days in the event of unfair dismissal.

([22]) Portugal had the third highest litigation rate in Europe in 2013 (European Commission, 2016c).

has prompted the Government to redesign in January 2017 its employment support programme to promote hiring on open-ended contracts while restricting support for temporary contracts to specific cases such as the very long-term unemployed. However the expected impact on reducing segmentation seems limited as only 15 000 people are foreseen to be covered by the programme. As regards labour inspections, the Authority for Working Conditions has launched a public competition to hire 80 additional labour inspectors. This additional capacity, together with the planned interconnection of data between the services of the labour inspectorate, Social Security and Tax Authorities should enable more effective identification of bogus self-employment and other labour infractions.

Minimum wage increases are not aligned with inflation and average productivity developments. The government has increased the monthly minimum wage (paid 14 times a year) by 5.1 %, to EUR 557 as of 1 January 2017. This increase overcompensates for recent increases in consumer prices, which rose by 0.6 % in 2016, and average labour productivity, which remained more-or-less stable (European Commission's 2016 winter Forecast). This adds up to a similar development in the previous year. Moreover, the minimum wage rose faster than the average compensation per employee (which rose by 1.4 % in 2016), following a trend that started in 2007 ([23]). In spite of the recent significant increases in the minimum wage, average wage growth has been moderate (and sometimes negative) in recent years, pointing to a limited impact on overall cost competitiveness so far ([24]) but leading to an increasing wage compression. The latter may reduce the returns to skills and therefore the incentives to invest in them. The Government is monitoring the impact of minimum wage developments, namely through quarterly reports which are published and discussed with social partners.

Increases in the minimum wage can reduce in-work poverty and increase aggregate demand but also involve risks to the employment of low-wage groups. Evidence shows that minimum wage increases may help reduce (in-work) poverty (European Commission, 2016a) ([25]). In 2013, before the most recent increases in the minimum wage, more than 20 % of minimum wage earners in Portugal were at risk of poverty. Increases in the minimum wage can also have a positive impact on aggregate demand if not outpaced by possible negative employment effects, depending on the relative position of the minimum wage in the wage distribution. The higher the minimum wage in the overall distribution, the more binding it is, making it more likely that some firms will forego filling some low-productivity jobs. The potential negative effect on employment is more marked for groups with a higher share of low-wage workers, such as young people and low-skilled workers (European Commission, 2016a). In a context of employment recovery, these risks have not materialised so far.

The minimum wage covers a rising share of workers increasing the potential negative effect on low-productivity jobs. The Portuguese minimum wage was one of the highest in the EU relative to the median wage in 2015 (57 %; OECD data). The two recent increases also significantly extended its coverage. The share of workers earning the minimum wage rose from about 12 % to 16 % in October 2014, and to around 21 % in the first nine months of 2016. It is expected to rise further in 2017, as the increase in the minimum wage is higher than the forecast increase in employees' compensation. At the same time, the share of workers earning the minimum wage among new contracts increased from below 25 % in early 2014 to around 38 % by mid-2016 (Portuguese Cabinet of Strategy and Planning, 2016).

More workers were covered by new collective agreements in 2016. From January to August the share of workers covered by newly signed collective agreements in the private sector rose to 26 %. It was expected to reach 40 % by the end of

([23]) Between 2011 and 2014 the minimum wage was frozen. See the 2016 Country Report (European Commission, 2016) for a detailed comparison of minimum wage developments with relevant economic variables.

([24]) The impact on average unit labour cost could even be negative, if increases in the minimum wage eventually have a negative effect on low-productivity jobs.

([25]) The incidence of this effect cannot be assessed yet, as the most recent in-work poverty figures reflect 2014 incomes (i.e. before the latest increases in minimum wages). See Section 4.3.2 for details.

2016, compared with 20 % in 2015. This increase is largely due to collective bargaining at sector level, with 90 % of workers covered by sector agreements. In the first three quarters of 2016, wage increases agreed in collective agreements amounted respectively to 0.8 %, 1.4 % and 1.5 % year-on-year respectively. This was above the consumer price index which increased by 0.5 % on average year-on-year in those quarters while productivity slightly declined. Nevertheless, nominal wage growth in 2016 is expected to remain moderate (see Section 1). Administrative extension of collective agreements increased significantly in 2015 and 2016 following the 2014 flexibilisation of the representativeness rule. They remain however still below the pre-crisis level.

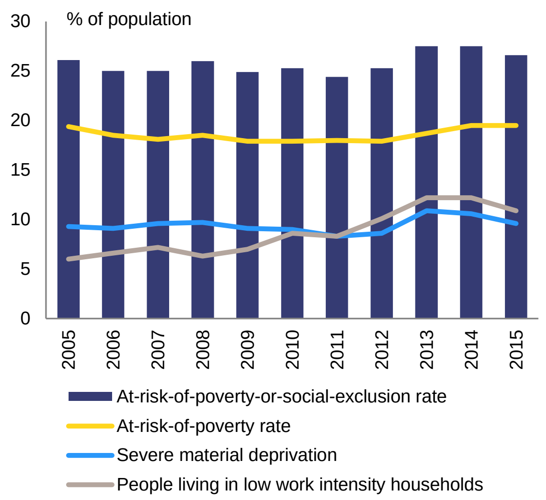
Active labour market measures continue to foster transitions into employment, although the share of participants among jobseekers is falling. The percentage of registered unemployed people following active labour market measures fell from an average of 26 % in 2015 to 18.2 % in 2016. The Government published a preliminary assessment study on active labour market policies in June 2016 (Portuguese Ministry of Labour 2016). This highlights the need to slow down the overall supply of active labour market measures, in line with the resources available from the European Social Fund (ESF) until 2020 (active labour market policies are largely co-financed by the ESF), while focusing these policies on schemes that foster job creation on permanent contracts. The study also shows that 38 % of trainees were integrated in the labour market after having completed a traineeship and 27 % were offered an open-ended contract. Additionally, 65 % of those who were initially hired through hiring incentives are employed one year after the financial support has ended, but less than 30 % have an open-ended contract.

Portugal is developing one-stop shops for employment, with a particular focus on addressing the problem of long-term unemployment. Although still in a definition phase, once implemented, these would improve coordination between employment and social services and increase the 'activation' of unemployed people, in particular the long-term unemployed. The obligation for people registered as unemployed to turn up twice a month at the Public Employment Services (PES) has been revoked and replaced by personalised schemes, including towards long-term unemployed.

4.3.2. SOCIAL POLICIES

Indicators of inequality, poverty and social exclusion have improved in 2015 ([26]), in line with the fall in unemployment. The at-risk-of-poverty or social exclusion rate (AROPE) fell from 27.5 % in 2014 to 26.6 % in 2015, although it is still nearly 3 percentage points above the EU average. This is a result of the reduction in severe material deprivation (from 10.6 % to 9.6 %) and in the percentage of people living in low-work-intensity households (from 12.2 % to 10.9 %). The ratio of total income received by the 20 % of the population with the highest income to that received by the 20 % of the population with the lowest income (S80 / S20 indicator) is falling, but remains above the EU average and one of the highest in the EU (see Section 1).

Graph 4.3.2: **Main social indicators**



Source: European Commission

However, in-work poverty remains high and has not fallen in the first few years of the labour market recovery. Historically, in-work poverty has been higher in Portugal than in most EU Member States but it was on a declining path before 2008. In 2015 (the data reflecting 2014 incomes), it stood at 10.9 %, against the EU

([26]) The data refer to 2014 incomes.

average of 9.5 %. The slight increase in in-work poverty, as compared to the previous two years, seems to indicate that the first period of the labour market recovery, which started in early 2013, increased median income more than that of low-wage earners. A large proportion of atypical employment contracts and high involuntary part-time employment may also contribute to this trend. In-work poverty among individuals with temporary contracts was twice that of people with a permanent contract (13.3 % v 6.5 %, respectively) in 2015. In addition, households with dependent children are particularly vulnerable to in-work poverty (12.7 % compared to 11.2 % in the EU). The minimum wage increase of October 2014 is not yet fully reflected in the latest wave of social indicators, since they reflect 2014 incomes. The same holds for the subsequent increases until January 2017, which might potentially have a reducing effect on in-work poverty.

Several measures were adopted in 2016 to improve the income conditions of people in low-income households. After some measures to widen the coverage of the minimum income scheme ([27]) in early 2016, the number of individuals benefiting from the scheme has been increasing steadily since March (when the changes became effective). The number of beneficiaries rose to 214 000 in November 2016, while the mean value rose to EUR 252.70 per household. Though this is considerably below the poverty threshold, it represents an increase of 17.9 % in the monthly mean value per household if compared to February. While the minimum income on its own is not sufficient to reduce the risk of poverty, it plays an important role in mitigating the intensity and severity of poverty.

Changes in child benefits and in social benefit for the elderly have a positive, though limited, impact on poverty reduction. Given the large proportion of children at risk of poverty or social exclusion (29.1 % in 2015), in January 2016 the government increased monthly child benefits by between 2 % and 3.5 % as well as the extra income given to lone parent families from 20 % to 35 %. However, the increase in general child benefits for households is marginal, while the monthly increase in the extra amount paid to single parent households is slightly more significant.

Older people continue to show lower risk of poverty and social exclusion than the working-age population. The impact of the fiscal adjustment in recent years was sharper for young and working-age people than pensioners. Government spending on education and social benefits for family and children fell by 16 % between 2007 and 2014, while expenditure directed towards older people, such as healthcare and pensions, increased by 14 %. In 2015, the AROPE among those aged 65 and above was 21.7 %, against 25.2 % among 25-54-year-olds. However, the risk of poverty or social exclusion for older people remains higher than the EU average. In this regard, the reference value of the elderly solidarity supplement was increased through three legislative changes from EUR 4 909 in 2015 to EUR 5 084 in 2017. This social benefit may help reduce the at-risk-of-poverty rate for the elderly, although the number of people benefiting from the measure has fallen slightly by comparison with 2015. According to the Portuguese authorities, some potential beneficiaries are failing to claim their entitlements because they are unaware of the eligibility criteria. In 2016, the authorities launched a national awareness campaign to tackle this issue.

A new social benefit was introduced for unemployed who no longer have access to unemployment benefits or assistance. This benefit, established in March 2016, is payable for a maximum of 180 days. It amounts to 80 % of the last social assistance benefit paid. Like the unemployment assistance scheme, it is means-tested ([28]). According to the National Reform Programme, this measure is designed to reach 70 000 people until 2020. Up until November 2016, 3 065 people were covered.

Overall, the health of the Portuguese population is good yet some indicators point to potential inequalities in access. Access to primary health care is limited; in 2015, 10 % of the population did not have a family doctor. One reason for this is the

([27]) In January, the reference value of the Social Support Index was increased from 42.5 to 43.2 % and the equivalence scale for calculating the minimum income scheme was reinstated, widening its coverage.

([28]) The household should not have movable assets worth more than EUR 100 613. Its monthly income per capita should be under EUR 335.

uneven geographic distribution of doctors. Consolidating current government action to recruit family doctors and promote their mobility could be beneficial in the context of a well-oriented health care reform. However, it is not yet possible to give a full assessment of the results of the reform. There is a high share of out-of-pocket expenditure and a low share of public financing of pharmaceutical expenditure, even though the state covers 100 % of spending in some cases (Eurostat/WHO data). Mortality due to respiratory diseases and healthy life years for females rank among the worst in the EU. Portuguese women live longer periods with disease or disability than the EU average, which shortens their working lives. This could be due in part to a shortage of health promotion and disease prevention activities which tend to address healthy life styles and disease screening.

4.3.3. EDUCATION

The Portuguese school system has improved its basic skills outcomes but performance gaps linked to students' socioeconomic background remain a challenge. Portugal is continuing to reduce early school-leaving. With a rate of 13.7 % in 2015, the country is moving towards the Europe 2020 national target of 10 %. The 2015 Trends in International Mathematics and Science Study shows that fourth-year pupils (nine-year-olds) in Portugal improved their performance in mathematics between 2011 and 2015. The 2015 OECD Programme for International Student Assessment (PISA) showed that Portugal had improved its average performance levels. The share of low achievers in reading, maths and sciences among 15-year-olds dropped. The proportion of low achievers is now lower than the EU average in reading and science but slightly higher in maths. The impact of socioeconomic status on student performance is closer to the EU average but remains significant. Rates of low achievers are below 10 % among the upper social quarter but around 30 % among the lower one. The gap in performance between non-immigrants and both first and second-generation immigrants is small, especially in reading and science.

The government is implementing a plan to promote school success. Approved in March 2016 it is designed to address education inequalities and preventing school failure. The plan is based on a closer cooperation between schools and municipal authorities so as to develop specific strategic plans adapted to their local needs. It provides schools with additional teaching hours to implement pedagogical projects and improve students' basic skills. In June 2016, 663 education centres had joined this Plan most of which will benefit from 100 additional teaching hours over the 2016-2017 school year. Each school will also benefit from 10 specific training actions provided by 91 training centres. This Plan, although it does not preclude the implementation of the Autonomy Contracts signed over the past three years with more than 200 schools nonetheless puts their renewal and continuation on hold.

High rates of grade repetition weigh on education costs, social inclusion and labour market outcomes. With 31 % of students having repeated an academic year, Portugal shows the third highest rate in the EU (PISA, 2016). The social gap is significant, with rates over 52 % among disadvantaged students and less than 9 % among advantaged ones. This is estimated to increase public education costs by EUR 250 million a year. The upward trend in grade retention has reverted in 2014-2015 but remains high at 15 % in secondary school (National Education Council 2015a). Successive grade retention increases the risk of dropping out of school and lowers attainment expectations (OECD, 2012), translating into lower professional achievement and wages. The previous programmes of basic vocational education and training for students required to repeat several academic years are now over. The government proposes to tackle school failure by improving tutoring support to students and reasserting the value of transferable skills in the curricula. Students experiencing difficulties will have four hours of tutoring a week with teachers who have received special training. The new tutoring system is also expected to help make better use of teaching staff and reduce the number of teachers without jobs.

The composition of the teaching force shows some mismatch. The failing demographic trend and consecutive reforms of the curricula in primary and secondary education have reduced teaching needs in some areas. A significant number of teachers have thus been left with no professional assignment. On the other hand, limits to retraining these trainers as well as budget constraints to recruiting new teachers have limited the possibility of dealing with new requirements, such as special education needs (National Education Council 2015b) with specific skills and in the regions where those are required. The rise in the average age of teachers has also increased the average cost of teaching hours since older teachers have higher salaries and shorter teaching schedules. There is also a worrying segmentation in terms of contracts. Many new teachers are hired on a fixed-term contract, although they are actually filling a permanent position. This creates inefficiencies in human resources management and career uncertainty for teachers. Possible improvements in this area will probably be explored by the upcoming School Resource Review on Portugal led by the OECD.

While graduates have a high employment rate, many seek opportunities abroad, which limit the effectiveness of spending in higher education. According to the Emigration Observatory, Portugal is one of the European countries with the highest rates of highly qualified individuals who emigrate (11 %). Demand for tertiary qualifications is however increasing with graduates' employability rate in the labour market (81.5 %) exceeding that of people with upper secondary qualifications (68.3 %) ([29]). But limited career prospects and low wage levels limit the economic return on the education investment. They make highly skilled youngsters look for better opportunities abroad (European Commission 2016b) and in some cases might make higher education less attractive. In particular this may have contributed to the fall in enrolment of about 30 % between 2011 and 2014 (PORDATA). Enrolment stabilised in 2015 and rose by 2.2 % in 2016.

The higher education offer is quite heterogeneous and does not necessarily match actual demand. So far, the polytechnic institutes have been at the centre of the strategy to modernise higher education. Decree Law No 63/2016 upgrades the higher education technical vocational courses (*CTeSP*) by integrating them into the Legal Regime of degrees and higher education diplomas. This increases further an already dispersed scope of higher education programmes. Yet, it is expected to consolidate the new upward trend in enrolment on such courses and encourage cooperation with business. Business sciences, computing, personal services and engineering are sectors where CTeSP courses are expanding most. Universities have not been included in this modernisation effort. The low mobility of academics in Portuguese universities also limits their competitiveness in terms of quality of teaching and projects, which reduces their efficiency (National Education Council 2015b). The Government has requested a higher education review to explore avenues for reforms in the higher education system. Few universities have engaged in specific cooperation projects with companies at regional level. However, the Government has made some efforts in encouraging the interaction between universities and the business sector, but a comprehensive and integrated strategy is missing. The upcoming second phase of the National Skills Strategy project could open up new opportunities to make progress on this issue.

The low level of skills among the Portuguese labour force is an obstacle to innovation and economic transformation. The Government's new initiative to promote adult education Programa Qualifica – is based, namely, in the establishment of the ‘Qualifica’ centres focused on promoting adult qualification by recognizing, validating and certifying prior learning and competences acquired by adults in different life contects complemented by vocational education and training adapted to each individual. The revamped ‘Qualifica’ centres, that replaced the previous network of specialized Centres on adult qualification, have been reinforced with upskilled staff. The government has also launched the ‘Qualifica passport’, a new online tool that not only registers the learning and competences acquired by adults, but also allows to understand what the adult lacks in order to achieve a certain qualification. The outcomes of the National Skills Strategy project could help boost efforts to tackle adults' skills gaps. The Vocational Education and Training system further expanded the number of people enrolled and the number of trainings provided in 2016. However, the remaining overlap between programmes undermines the system's efficiency and its effectiveness in terms of labour market integration (European Commission 2016b).

Digital skills remain a barrier for upgrading the labour force skills. About 22 % of people in the

([29]) Eurostat data (lfsq_ergaed) referring to Q3 2016.

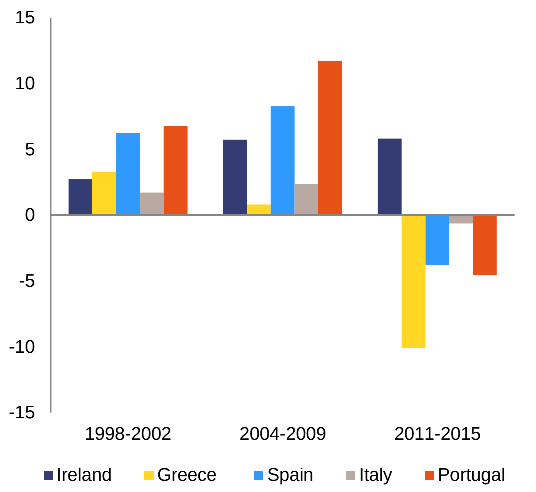
Portuguese labour force have no digital skills (mostly because they do not use the internet regularly), about double the EU average. Only 54 % has basic or above basic digital skills (63 % EU average) (Digital Scoreboard 2017, European Commission). In a global context of rapid digitisation of organisations and work environments, insufficient digital skills can hamper productivity and the transition towards a higher value production structure. The digital skills deficit also applies to the Portuguese population, chiefly the elderly, low-income and low-education groups. This situation is acknowledged in the Portuguese Digital Agenda Strategy, although few details on budgeting or implementation measures are currently available. Together with limited affordability and switching costs, it might be hampering the take-up of broadband and digital services ([30]).

([30]) Of Portuguese households 68 % subscribe to fixed broadband (EU 74 %). There are 55 subscriptions to mobile broadband per 100 people (average of 84 in the EU).

4.4. INVESTMENT

4.4.1. UBLIC AND PRIVATE INVESTMENT*

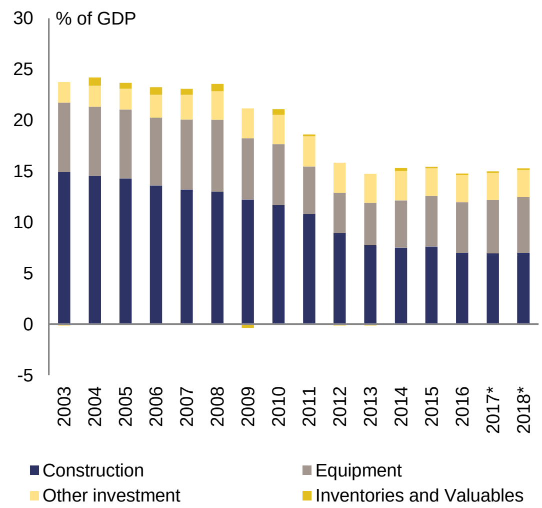
Graph 4.4.1: **Investment productivity**



Source: European Commission

Portugal suffers from low investment and, during the last years, from low investment productivity. Overall, weak growth prospects and difficulties in the financial sector and in the business environment have contributed over past years to low investment activities. After some rebound in 2015, construction investment fell again in the first half of 2016 (Box 4.4.1). Over the last quarters, investment in machinery and equipment has fared better than construction investment. Strong growth in transport equipment has been the main contributor to positive dynamics of investment in machinery and equipment. However, once market saturation is reached, the growth rate is expected to decline. Over the medium term, investment is set to gather pace.

Graph 4.4.2: **Investment and its components**

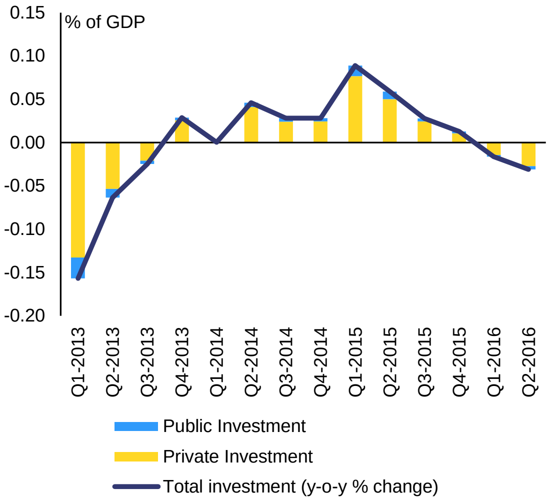


Source: European Commission

Greenfield foreign direct investment (FDI) remains below pre-crisis levels in Portugal. The empirical results show that FDI can have a significant positive impact on growth by enhancing domestic capital accumulation, particularly in the most productive areas. In this respect, an adequate public infrastructure and an investment-friendly labour market and reduction in the cost of doing business could raise the marginal return of capital in general and stimulate foreign direct investment inflow.

Subdued public investment has also played a role in holding back private investment. From a theoretical perspective, public investment can have both positive and negative effects on private investment. According to empirical evidence, expansionary effects and crowding-in prevailed in Portugal in the past (Afonso and Aubyn 2008). Thus, taking into account the delay in budget execution processes over the first half of 2016 and the likely increase in implementation of projects co-financed by EU funds, a more positive outcome in public investment and some positive spillover to the private sector could be expected over the forecast horizon.

Graph 4.4.3: **Private and public investments**



Source: European Commission

4.4.2. ACCESS TO FINANCE AND INVESTMENT INCENTIVES *

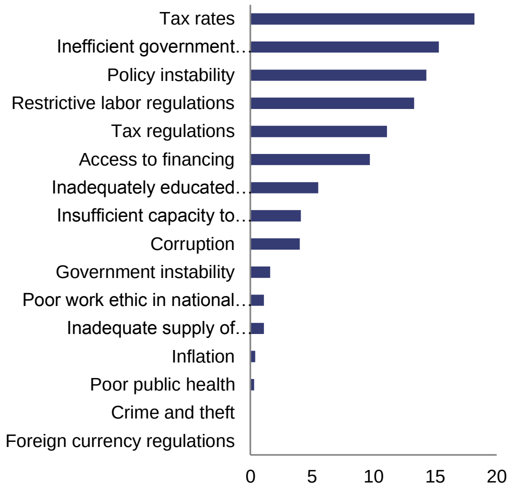
Credit conditions have been gradually improving on the demand and the supply side but access to finance remains a major concern for small and medium-sized enterprises (SMEs). According to the 2016 European Central Bank Survey on access to finance (SAFE), 27 % of Portuguese SMEs reported an increase in bank loan availability in 2015, while in 2016 this percentage fell to 24 % (against a growing EU average of 21 %). Access to finance, however, remains the fourth most important (and growing) concern of 11 % of Portuguese SMEs (compared to an average of 9 % at EU level, which is falling). Bank loans remain the most relevant form of external financing for 57 % of Portuguese SMEs (50 % at EU level). Demand for credit went up as the percentage of SMEs who applied for a bank loan rose substantially, from 22 % to 27 %, against a stable EU average of 27 %. At the same time, supply restrictions also seem to have eased as the loan application rejection went down dramatically: while, in 2015, 11 % of Portuguese SMEs applied for a bank loan but were rejected, in 2016 the number decreased to 4 %, against a stable EU average of 7 %. However, the percentage of Portuguese SMEs which did not manage to get the full amount of loan rose from 34 % to 42 %, against a falling EU average that reached 30 % in 2016.

In July 2016, the authorities have launched the Capitalizar Programme designed mainly to encourage private investment. The programme establishes new credit lines for SMEs, the creation of specialised funds that would participate in private investments and changes in the tax regime to support investment. Credit lines are managed by the Financial Institute of Development (FDI) and financed by the European Structural and Investment Funds jointly with the public counterpart. The new lines enacted entail state guarantees and higher amounts of credit than those granted in the past, plus — in some cases— the involvement of financial intermediaries which would co-invest in SMEs. Investments in such businesses would benefit from co-participation from public funds, such as the Equity and Quasi-Equity Funds, or Fundo 200M, which seek to create synergies with local and foreign private investors, including through venture capital and business angels schemes. As regards taxation, changes (also included in the Budget Law) entail provisions that confer neutrality on the tax treatment between debt and equity financing; expand of the amount of investment benefiting from tax credit and defer and simplify the VAT payment for the import of raw materials. Finally, the programme also grants tax reliefs to individual investors who purchase shares in start-ups or small enterprises for at least four-years.

4.4.3. BUSINESS ENVIRONMENT/THIRD PILLAR OF THE INVESTMENT PLAN*

After having achieved some catching-up, Portugal's business environment weakened recently in international comparison. Compared with the previous report, the 2016-2017 World Economic Forum's Global Competitiveness Report underscored that Portugal's relative ranking has fallen from 38th to 46th out of 138 countries. The most problematic areas for doing business in Portugal include tax rates regulations, inefficient government bureaucracy and policy instability, access to finance and restrictive labour regulation (graph 4.4.4).

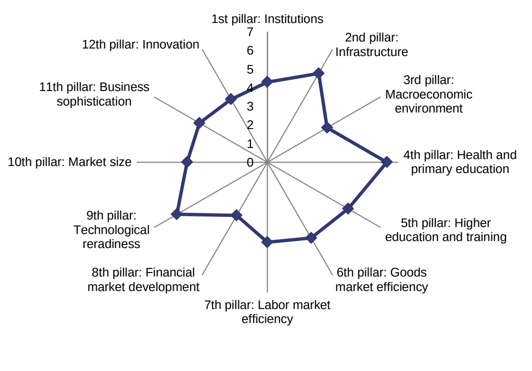
Graph 4.4.4: **Most problematic factors for doing business**



Source: World Economic Forum, Executive Opinion Survey 2016

According to the report, the main problems still lie with the macroeconomic developments (and related expectations) and financial markets. The underperforming macroeconomic environment reflects the fact that Portugal has been recovering unevenly from the global financial crisis with public debt still at a high level. Financial markets in Portugal remain weak with the banking sector still burdened by high levels of non-performing loans.

Graph 4.4.5: **World Economic Forum's 2016-2017 Global Competitiveness Report, Portugal**

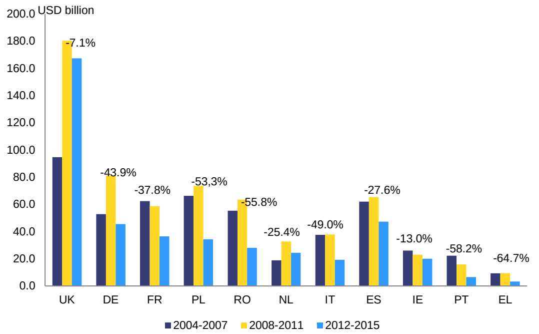


Source: World Economic Forum, Executive Opinion Survey 2016

Reforms implemented in recent years have improved the businesses' perception of the environment for doing business, but challenges remain. According to the World Bank's Doing Business Report for 2017, in the last year most of the ratings remained stable with some improvements in resolving insolvency and paying taxes, including by enhancing the online filing system of taxes and decreasing the corporate income tax rate. However, there are aspects of taxation which may pose difficulties to investors, such as the remaining debt bias, complex tax administration and the risk of unpredictable and instable tax rules. Moreover, challenges persist in various areas including services, regulated professions, and better regulation.

Regulatory bottlenecks and delays in adopting structural reforms are holding back investment. Regulatory and administrative barriers as well as cumbersome approval procedures still impede investment and growth potential increase in Portugal. Thus, the decline in greenfield foreign direct investment since 2008 can be explained only partially by a cyclical pattern and financial market distress. Empirical studies suggest that there are other factors, besides the Great Recession and systemic shocks hitting the euro area, behind the collapse in greenfield FDI ([31]).

Graph 4.4.6: **Foreign direct investment**



Source: European Commission

Inefficiencies have been identified in the areas of the judicial system, including insolvency framework implementation, public procurement, sector-specific regulations, including energy and transport, the business

([31]) Canton E., Solera I, (2016), "Greenfield foreign direct investment and structural reforms in Europe: what factors determine investments?", European Commission, Discussion paper 033. Available at: http://ec.europa.eu/economy_finance/publications/eedp/pdf/dp033_en.pdf

environment and the innovation framework. Efficiency indicators for civil, commercial and tax litigation remain poor and insolvency court proceedings are still long. Despite progress, there are still shortcomings as regards the transparency and reliability of public procurement data and procedures. Transparency in concession contracts and public-private partnerships is still hindered by contracting authorities' lack of the necessary expertise to manage complex contracts. Reform measures concerning port concessions and the governance model for urban transports have been stalled. The efficiency and sustainability of the electricity sector are challenging mainly due to a still high tariff debt.

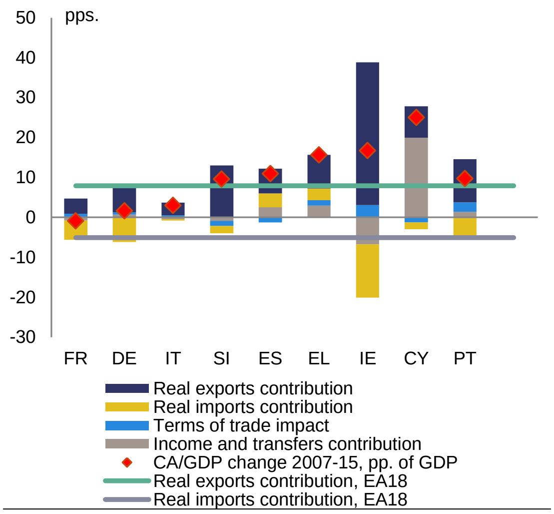
Low levels of efficiency and transparency persist in the Portuguese public administration. Administrative burden and the lack of homogeneous implementing practices across the country are delaying the reform of procedures. The main persistent weaknesses in the business environment are restrictions on business services and regulated professions. The weak performance of business services hampers a more flexible and efficient allocation of resources, a faster adoption of new technologies and the introduction of innovative business models. All this has a detrimental impact on investment, growth and employment. The possible support to the investment environment which EU Funds could provide has not yet been fully exploited either. In particular, financial instruments financed by EU structural funds are still being developed and cannot fully ease access to finance for start-ups and small and medium-sized enterprises.

Unfavourable framework conditions and inadequate alternative financial incentives continue to curtail Portugal's performance in the area of innovation. Information and communication technologies are lagging behind and the cooperation between business and academia is not strong enough. This is having a negative impact on the innovation capacity of the Portuguese economy.

4.4.4. EXTERNAL COMPETITIVENESS*

The improvement in the current account over the past years is still insufficient to bring about a substantial reduction in external imbalances. From a deficit of about 12 % of GDP in 2008, the current account of Portugal was broadly balanced in 2012-2015 and is projected to post small surpluses in the medium run. However, these are still far below the benchmarks needed for substantial reduction in the large stock of external liabilities. The current account adjustment during the crisis years was driven by a strong drop in investment and the parallel consolidation effort by fiscal policy. A change in the fiscal consolidation strategy since the end of the programme with relaxed structural consolidation efforts and emphasis on nominal deficit targets leads to expectations of at best lower surpluses. This shows the policy dilemma when aiming at surpluses which are sufficient to reduce external liabilities: (Efficient) investment is necessary to push potential growth and help modernise the Portuguese economy. Consequently, a current account surplus calls for increased savings; this necessarily entails a (temporary) decrease of consumption.

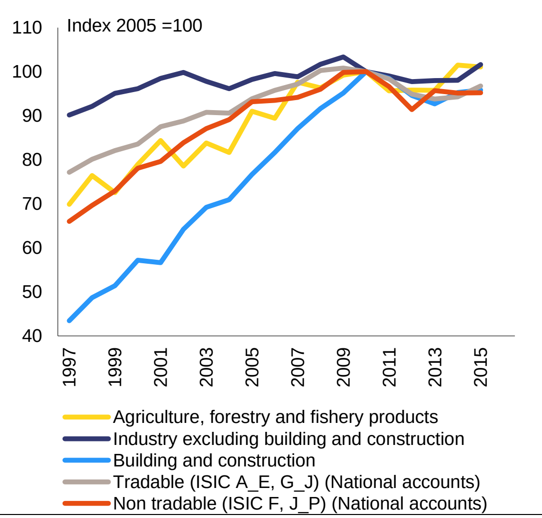
Graph 4.4.7: **Component contributions to change in CA balance 2007-2015**



Source: European Commission

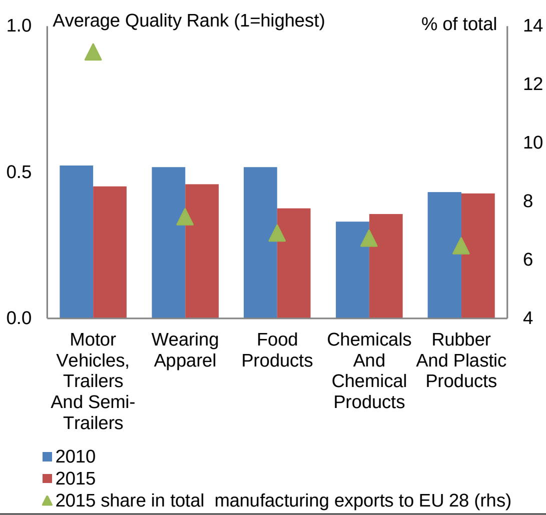
The trade balance adjustment is underway though it is proceeding at a moderate pace. It was composed largely of improvements in exports, mainly services and in particular tourism, against some import compression resulting from weak domestic demand at a time of low disposable income. An improvement in the terms of trade has had a positive impact on the trade balance. The process started in 2008 with significant improvements in export performance. This was especially visible for goods, whose share in GDP rose from 19 % in 2009 to 28 % in 2015. Between 2010 and 2013, improvements in export price competitiveness and product quality contributed to the trade balance adjustment. Within this, the improvement in price competitiveness was facilitated largely by a reduction in unit labour costs in the tradable sector vis-à-vis the non-tradable. After 2013, following sustained import growth, the trade balance stabilised. Nonetheless, recent data point to some adverse changes in price competitiveness, as unit labour costs started growing again towards the end of 2015 and accelerated further to 2.5 % year-on-year in the third quarter of 2016. Despite some progress achieved in 2012-2013, the quality of exports seems to have deteriorated especially as regards food products. In addition, despite the increase in the share of exports over GDP, the market share of many Portuguese products continues to fall. Data show that Portugal has lost market share in 8 of the largest 10 sectors of its economy between 2013 and 2015. In gross terms, the country's export market share improved substantially in 2013 and 2014 but fell by 1 % in 2015.

Graph 4.4.8: **Nominal unit wage costs by sector**



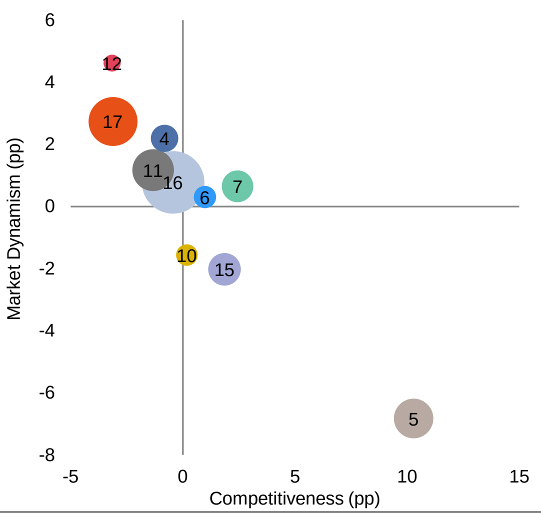
Source: European Commission

Graph 4.4.9: **Average Quality Rank in the 5 biggest exporting manufacturing sectors**



Source: European Commission

Graph 4.4.10: **Dynamism and Competitiveness of Exports (goods) on top-10 sector destinations (2013-2015)**



(1) The size of the bubble indicates the share in total exports. Market dynamism is the difference between the annualised growth rates of world exports per market and global world exports. Competitiveness is the difference between the annualised growth rates of Portugal's exports per market and world exports per market.
(2) The numbers inside the bubbles identify the sectors according to sections of HS Commodity Classification as follows: 4. Prepared Food stuffs, Beverages, Tobacco; 5. Mineral Products; 6. Chemical Products; 7. Plastics and Rubber; 10. Pulp Of Wood And Paper; 11.Textiles And Textile Articles; 12. Footwear, Headgear, Umbrellas; 15. Base Metals; 16. Machinery; Electrical Equipment; 17. Vehicles, Aircraft, Vessels ;
Source: European Commission

Box 4.4.1: **Investment Box**

Section 1. Macroeconomic perspective

Portugal experienced the highest decline of investment in the EU during the economic crisis. According to Eurostat data investment contracted by about 33.8% in real terms between 2006-2008 and 2013-2015, compared with 10.1% in the EU28. Total investment in 2015 accounts for 15% of GDP, 5 pps lower than the EU28 average. The investment contraction was driven mainly by the fall in demand, tight financing conditions, general government deficit and debt constraints as well as low investment efficiency mainly in non-tradable activities such as construction. EU funds are estimated to have a significant impact on investment and, as a consequence, on GDP growth. The share of cohesion policy transfers in total public investment has increased significantly in recent years and is estimated to have reached 71% in 2014-2017. However, the implementation of the new generation of programmes 2014-2020 financed by this policy was still at its first stages in 2016.This is broadly consistent with past experience showing that Cohesion policy payments normally take place slowly at the beginning of a new programming period and then accelerate at a later stage.

Section 2. Assessment of barriers to investment and ongoing reforms

Public administration/ Business environment	Regulatory/ administrative burden	CSR
	Public administration	
	Public procurement /PPPs	CSR
	Judicial system	
	Insolvency framework	
	Competition and regulatory framework	
Labour market/ Education	EPL & framework for labour contracts	
	Wages & wage setting	CSR
	Education	
Financial Sector / Taxation	Taxation	CSR
	Access to finance	CSR
R&D&I	Cooperation btw academia, research and business	CSR
	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

In addition to the macroeconomic constraints highlighted above, despite progress in some fields, regulatory barriers and rigidities in product and labour markets continue to hamper business growth, competitiveness and investment in Portugal.

Main barriers to investment and priority actions underway

The vulnerability of the financial sector due to a high level of non-performing loans and underdeveloped capital markets limit access of corporations and SMEs to finance and productive lending. The Capitalizar Programme approved in July 2016 is aimed to foster alternatives to bank financing, but it is still too early to assess its impact.

In addition, weaknesses in the Portuguese business environment hamper TFP growth, business activities and foreign investment. Still persistent bottlenecks concern inefficiencies in public administration, where the effective coordination between central and local public administration is weak and judicial system: The competition in public procurement is still a problem and the use of direct awards remains high., The innovation performance is low, and there are still restrictions in some services and regulated professions as well as network industries.

The limited scope for wage bargaining at firm level, in view of a centralised wage setting system, and the low average skill levels among the workforce may weigh on the efficient allocation of labour in the productivity growth.

4.5. SECTORAL POLICIES

4.5.1. R&D AND INNOVATION*

Despite some progress, the economy does not make the most of its scientific production and related human resources. R&D intensity fell from 1.58 % of GDP in 2009 to 1.28 % in 2015, diverging further from the EU average of 2.04 % and the national target. The main reason for the decline was a contraction of business enterprise R&D expenditures from 0.75 % of GDP in 2009 to 0.60 % in 2015. Public R&D intensity fell after 2009, but there are signs of recovery (2009: 0.69 %; 2015: 0.66 %). This reduction of R&D investments adversely affected productivity growth ([32]). Portugal has made much progress in improving its human resources base in science and technology and its scientific excellence. The country produces more science and engineering graduates and has more researchers in the labour force than the EU average (Eurostat). Highly cited scientific publications increased from 7.6 % in 2006 to 9.0 % in 2013 but the country still ranks only 16th in the EU. However, Portugal ranks low (around one fifth of the EU average) on public-private scientific co-publications and patent applications. This shows that there are difficulties in developing technological outputs from R&D activities. Portugal occupies a very low (24th) position as regards the Innovation Output Indicator, which measures the extent to which ideas from innovative sectors are able to reach the market. This constrains the transition towards a more innovation-driven economy.

There is no integrated strategy for cooperation between academia and business to deliver the skills and knowledge needed for innovation. The governance and finance systems of Portuguese universities do not provide the most efficient environment for university-business cooperation and innovation. Career paths in academia are based mainly on publications, and cooperation with the private sector or work within it is seen as a career gap with no impact on career progress ([33]). The tertiary education attainment rate for 30-34-year-olds has risen substantially over the past decade. Yet the country ranked only 23rd within the EU in 2015. The high emigration rate of graduates (see Section 4.3) further reduces the number actually reaching the labour market. Moreover, many businesses lack absorption capacity for the highly educated. For the relatively few firms in knowledge-intensive sectors that do have the absorption capacity, universities do not seem to be supplying enough of the skills needed. The Digital Skills and Jobs coalition addresses the issue. The country is among the EUs' worst performers as regards new computer science graduates among the 25-34-year-olds (Eurostat). The increasing demand for ICT professionals is not being met by the current supply ([34]). Firms perceive universities as being too bureaucratic to invest in. Companies contract only a small amount of R&D services from other institutional sectors and R&D spending financed by national business enterprises is only 35 % of the EU average. Additionally, firms do not perceive academic publications as relevant sources of information for innovation (FCT, 2013). Nor are they inclined to take on more qualified human resources such as PhD holders despite the tax incentives in place for companies employing PhD holders ([35]). The new diploma 'Fostering Scientific Employment' (Decree-Law 57/2016) was adopted in 2016 with the aim of improving researchers' working conditions and career prospects. This is important in a context of highly unstable research careers.

In spite of the efforts made, there is still a lack of structured coordination between the various incentives for commercialising research outputs. Portuguese regional clusters encourage knowledge and technology transfer between universities and low-medium technology-intensive manufacturing industries. The Recognition of Competitiveness Clusters (Decree 2909/2015) reshaped cluster policy to instigate public-private collaborative partnerships and networks (OECD, 2016). But value added in high-tech manufacturing is only 0.57 % of total value added (EU average 1.69 % 2014 Eurostat). The National Innovation Agency funds R&D programmes that promote cooperation between universities, firms and R&D performing organisations. The National Reform Programme 2016 also includes a set of initiatives

([32]) During the period 2007-2016 total factor productivity has declined and then registered a small recovery (AMECO).

([33]) The State of University-Business Cooperation in Portugal (2013).

([34]) The study "e-skills in Europe-Portugal" estimates a shortage of 9.600 ICT specialists in 2016, which may expand to 15.000 by 2020.

([35]) In 2015 Portugal ranked only 17th in the EU terms of Researchers (FTE) employed by business as % of total employment.

to foster knowledge transfer and strengthen the link between R&D and innovation in companies. The 2016 programme for modernising and upgrading polytechnic institutes focuses on matching R&D activities to regional needs. Tax credits to business R&D (SIFIDE) rose between 2006 and 2014 (OECD R&D Tax Incentives). Yet there is no regular and consistent monitoring to assess whether the initiatives are effective.

Framework conditions are not conducive to an innovation-friendly environment, as barriers to competitiveness still persist. Portugal is a "Moderate Innovator" in the European Innovation Scoreboard but ranks in the top 10 in terms of SMEs innovating in-house. The government aims to foster balanced development of the collaborative economy showing willingness to accommodate innovative business models in the regulatory framework. A framework for short-term rental activities for tourists has been introduced, and legislation to enable platforms to provide passenger transport services is being prepared. Portugal stands out from the EU average in entrepreneurial activity, especially in enterprise birth rates and entrepreneurial intention ([36]). This is in line with the remarkable progress in "Starting a Business" from the World Bank Doing Business Report 2016. Nevertheless, business survival rates are below 50 % reflecting unfavourable framework conditions for business growth, innovation and scale-up. High-growth innovative enterprises (HGIEs) represented only 0.07 % of firms in 2014, half the EU average and the country dropped 8 positions in the 2016 Global Competitiveness Report. Firms' technological and managerial capabilities are still holding back competitiveness, especially in SMEs (European Commission, 2017c). The National Strategy for Entrepreneurship (*Startup Portugal)* launched in 2016 aims to improve the business ecosystem, provide alternative ways of financing, and promote the internationalisation of start-ups.

4.5.2. COMPETITION IN PRODUCT AND SERVICES MARKETS*

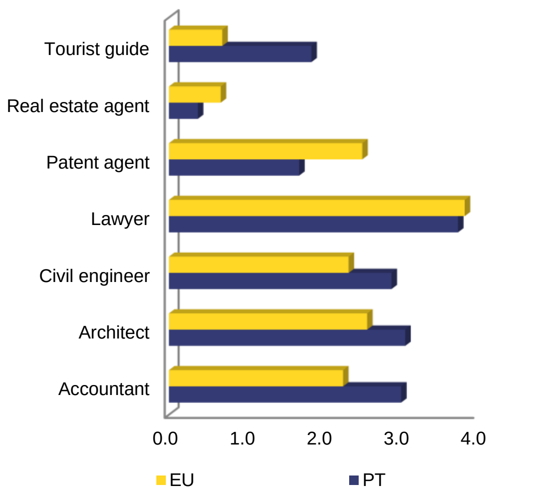
Administrative and regulatory barriers still restrict competition in the market for professional services. The by-laws regulating certain professions are less ambitious than the framework law in terms of opening up these sectors to competition. They also raise concerns as regards the direct or indirect effect of restricting competition in the market for professional services thereby increasing prices, reducing offer choice and innovation and lowering the overall quality of services. According to a new indicator developed by the Commission ([37]), the level of restrictiveness in Portugal is higher than the EU average for civil engineers, architects, accountants, and tourist guides. It is lower than the EU average for patent agents and lawyers, although access to the latter profession is more tightly restricted than for any other profession in Portugal. Furthermore, the business churn (or turnover) rate for legal activities is lower than both the EU average and the overall Portuguese economy as a whole, thus pointing to relatively low dynamism and competition in the sector. However, according to the national action plan submitted in the context of the mutual evaluation exercise, Portugal is not planning any major reforms of regulated professions. At the same time, there is an ongoing study by the National Competition Authority, in cooperation with the OECD, on the nature and impact of persistent barriers, the results of which are due in early 2018. The regulatory burden on service providers remains high; this includes reforms not covered in the context of the EU-IMF programme of financial assistance or agreed upon under that programme and not yet approved or implemented ([38]). In turn, these regulatory barriers give rise to lengthy, complex, and expensive administrative procedures put in place to control compliance with substantive requirements. Particular problems in business services stem from restrictive reserved activities, as well as from legal form, shareholding, management, multidisciplinary and advertising restrictions. Corporate groups of professional companies are banned. Innovation and investment are stifled.

([36]) "Framework Conditions for HGIEs" (2017)

([37]) The European Commission has developed a new composite indicator on the extent to which most existing barriers restrict access to and the practice of regulated professions. It is based on data collected from Member States, complemented by desk research. This new indicator has many similarities with the Commission indicator of barriers in business services published in 2015, but also differs from it in certain ways. COM (2016) 820.

([38]) Such as the reform of legal services, university and construction services.

Graph 4.5.1: **Restrictiveness indicator, 2016, Portugal and the EU**



Source: European Commission

Land regulation and construction fees might create obstacles to investment. Municipalities retain great discretionary power when it comes to implementing land use rules. Consequently, the time needed to obtain licenses varies across municipalities depending on their effectiveness and administrative capacity. There is no consistent implementation strategy applicable nationwide. Fees for access to and operating on the construction market are higher than in other EU countries. Moreover, there is no direct link with the underlying administrative costs. This hampers new investment in construction. At a national level, an evaluation of the fees and permit procedures will not be available until mid-2017 which is later than was initially agreed between the European Commission and the Portuguese authorities (i.e. by the end of 2016). According to a recent study([39]), the system of fees imposed on construction service providers in Portugal for initial registration and subsequent renewal is complex, linked both to the category of construction works to be performed and to a percentage of the wage salary index for public administration officials. Changing the category of construction works is subject to a fee based on a calculation methodology similar to that applicable to the initial fee. A recent reform has simplified calculation and partially reduced fees, but they remain high and linked to the category of construction works to be performed, with no direct link to the underlying administrative costs.

([39]) European Commission, Simplification and mutual recognition in the construction sector under the Services Directive, MARKT/2014/087/E, Final Report, November 2015

4.5.3. ENERGY, ENVIRONMENT AND CLIMATE CHANGE

The elimination of the electricity tariff debt and phasing-out of regulated prices are taking longer than initially planned. According to the government's calculations, the outstanding electricity tariff debt will be eliminated at the earliest in 2022. It might however derail to 2026 in a pessimistic scenario diverting even further from the original 2020 elimination target and keeping the upward pressure on energy prices. The phasing-out of regulated prices has been postponed once more, this time to 2020 instead of 2017. The consequences are uncertain. On the one hand, as there is a fixed end date for the regulated price, consumers are forced to change and might simply remain with the incumbent player. On the other hand, keeping the regulated price means that there is a reference price around which energy retailers can set their own price which might decrease the price variety offered by energy retailers.

Efforts are being made to make the energy system more sustainable. The remuneration method for electricity capacity mechanisms is being changed to cut system costs. Instead of a regulated capacity payment, a more market-based approach will be established based on auctions that will have a ceiling price in order to control the overall cost. Capacity payments will no longer cover investment costs due to the current overcapacity, but will be used to ensure short-term generation adequacy. The government is also considering reducing the structural costs associated with the current interruptibility schemes by setting a competitive mechanism for the remuneration of this service. New contracts for renewable energy capacity are being remunerated at market price based on the result of tendering schemes with no feed-in tariff. The interest rate paid for the accumulated tariff debt has fallen following renegotiation. An independent audit requested by the Government gave indications of market manipulation by electricity incumbent EDP. As a result the Portuguese energy regulator together with the competition authority proposed to the

Government a recuperation of the overcompensation to guaranteed production of EDP's hydro-electric power plants. These measures could help containing energy prices and improve the functioning of the electricity market. Nevertheless, they will most likely have a small impact on the tariff debt reduction. A growing demand for electricity and decreasing renewable production cost seem to be the only factors large enough to front-load the tariff debt elimination without price increases.

Limited electricity interconnection with the EU and fossil fuel subsidies remain a barrier to decrease overcapacity in the energy system. The Iberian electricity market is well integrated with price convergence between the two countries as a result of their market coupling. Electricity interconnection with the rest of Europe however remains limited, which poses obstacles to exporting the overcapacity resulting from growing renewable production and falling demand. The transport sector could absorb part of this production as it currently uses quite a small share of electricity. The Government is introducing an open market regulation for an automobile electric charging network which could be a step in this direction. Fossil fuels remain the main source of energy used, which makes it difficult for Portugal to reduce its energy dependency. The high level of environmentally harmful subsidies (EHS) in Portugal also favours fossil-fuel based solutions, such as company cars and diesel over petrol. In 2016, Portugal had the EU's third largest tax exemption for diesel compared with petrol and subsidies to fossil fuels accounted for 0.2 % of total government expenditure in 2014 (Eurostat). Fossil fuel subsidies and other EHS hold back the use of more sustainable energy sources such as renewables. In doing so, they also stand in the way of using the existing excess capacity in terms of electricity production delaying the elimination of the tariff debt. The measure announced in the 2017 Budget Law intended to increase tax on diesel while cutting on petrol help reduce EHS. Portugal is also implementing a Framework for Climate Policy and a national programme for climate change for the period 2013-2020.

Waste management impedes more efficient resource use. Portugal underperforms in terms of waste management. In 2014 49 % of municipal waste was landfilled (EU average: 28 %). Portugal's resource productivity is half the EU average. The opportunities for waste prevention and in particular for recycling, that would improve the resource efficiency and therefor the competitiveness of the Portuguese economy, are not fully developed. The waste management tax also seems to fall short of providing the right incentives for reducing waste for landfill or incineration. At the current pace (16 % recycled and 14 % composted), Portugal would need to make an extraordinary effort to go from 30 % to the recycling target of 50 % of municipal waste by 2020.

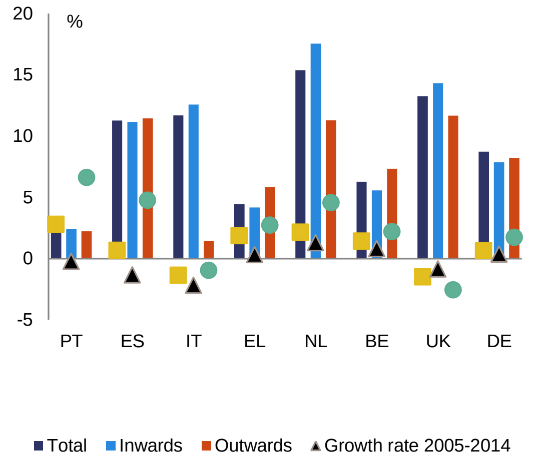
4.5.4. OTHER NETWORK INDUSTRIES

Performance indicators for Portuguese ports remain low in international comparison. Portuguese commercial ports continue to increase their freight throughput. It totalled 60 million tonnes of freight in the first three quarters of 2016, a 5 % increase over the same period in 2015. Labour productivity increased in 2013 and 2014, as value added was higher compared to average personnel costs. This improvement may be a result of revising the port labour law which aligned it with the general law. However, Portuguese commercial ports have not yet managed to exploit their strategic geographical position to the full. Their EU share in goods handled is relatively low even by comparison with ports in neighbouring countries. Thanks to the 2014 increase port labour productivity is now higher in Portugal by comparison with its peers, though it is lagging behind German and Belgian ports. In international rankings Portuguese ports are particularly lengthy in import and export procedures ([40]). The quality of port infrastructure ranks lower than for most of Portugal's European peers. The elimination of the port user tax (TUP Carga) did not contribute fully to reduce port user fees as at least part of the savings seem to have been absorbed by port operators. The renegotiation of port concessions has re-started in the second half of 2016. It could improve competitiveness and freight throughput if it genuinely brings down costs for port users not only for operators. Concession contracts that provide the correct incentives to maximise throughput and create capacity to handle a wide range of cargo sizes may help increase port

([40]) Trade by Sea index of the World Bank Doing Business.

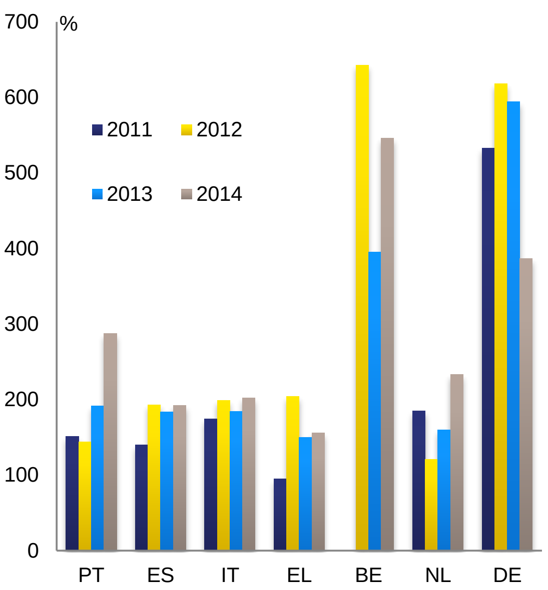
competitiveness ([41]). A general framework for port concessions that would contribute to a better concession contract design is expected but still not in place.

Graph 4.5.2: **Shares for selected countries of total EU maritime transport of goods, 2014**



Source: European Commission

Graph 4.5.3: **Wage-adjusted labour productivity of the ports sector**



Source: European Commission

Investment in rail infrastructure is not optimising the performance of the freight sector. Total rail density in Portugal is low and it has been falling, with rail freight traffic intensity among the lowest in Europe. The density of electrified rail lines is also low despite the overcapacity in electricity production. Rail investment has also been below the country-specific estimated trends in recent years (European Commission 2016e). Restrictions on operating of long freight trains in port rail access remain, decreasing the efficiency of both rail and maritime transport. These findings suggest possible benefits from improving the networks, in particular if investments are well-targeted and take advantage of interconnections with the already dense network of roads. The Government's investment plan in the rail network might be positive step in this direction.

Portugal has witnessed a vast improvement in water infrastructure but is lagging behind in terms of asset management efficiency and economic and financial sustainability. Some municipalities have accumulated high tariff deficits and debts through economically and financially unsustainable operations. There are also visible inequalities between prices of services in inland and coastal regions, hampering social and territorial cohesion. The authorities remain committed to the goal of water and sewerage sector reforms, but they are being delayed. The second stage of the water sector reform would help shift the emphasis from building infrastructure to efficient asset management. The aim is to merge water and sewerage municipal retail management services and promote the integration of bulk and retail activities. This would help ensure the financial sustainability of the system, including arrears. The reform would allow for tariff harmonisation at national level plus economies of scale and scope stemming from higher synergies in the value chain. Contrary to what previous intentions however, the State Budget contains no commitment to meet the 2017 reform deadlines.

([41]) Estudo sobre concorrencia no setor portuario (July 2015), Portuguese Competition Authority.

4.6. PUBLIC ADMINISTRATION

Efficiency of public administration*

Despite progress in reducing the administrative burden on businesses, there are hurdles in easing procedures across the country. A number of measures have been brought in under the economic adjustment programme, the aim being to improve the business climate and boost investment, by lowering firms' costs and increasing the return on their investment. Despite some progress, there have been delays in simplifying local and central administrative procedures with little coordination between the various layers of the public administration. At a central level, there is the need to request visa and approvals by various ministries on a single procedure. At a local level, reforms seem to have been implemented in different ways, resulting in different quality standards for municipal services. Moreover, not enough has yet been done to ascertain the impact of the reform agenda implemented so far, so it is impossible to assess the extent to which this matches the original goals and to tackle corrective action if necessary.

Regulatory framework*

The implementation of the new administrative simplification programme seems to be lagging behind ambitions. The Portuguese authorities have approved a new simplification programme, called SIMPLEX+. This contains a fairly ambitious package of measures for citizens and businesses. As regards business, the programme introduces a cross-cutting approach including provisions to simplify business inventory, ease business information, reduce red tape for exporters and simplify tax declaration procedures. Responsible declarations by qualified professionals and companies are also replacing authorisations of electricity and gas installations in buildings. Although these measures are promising, implementation of the SIMPLEX + package seems to be lagging behind ambitions. Most of those measures relevant to businesses are only to be implemented from 2017 onwards. Sector-specific reforms are not included. The methodology for quantifying the costs associated with administrative procedures has not been published yet,but a scientific study is being developed by a Portuguese public University in order to assess the impact of SIMPLEX measures, addressing administrative burdens reduction, compliance improvement, savings generated (time and money), among others. No detailed ex-ante impact assessment has yet been conducted to select the adopted measures, on the basis of criteria including priority and benefits. Nor is there any robust ex-post evaluation system to assess whether they really help to contribute to boost competitiveness and growth. However, a process called "Monitoring +" is being implemented, aiming to ensure a better interaction between public entities and both companies and citizens; a better assessment of private stakeholders' perception on changes; as well as to measure the impact of SIMPLEX on people's lives and business activity.

Transparency and public procurement*

Portugal is making progress with increasing transparency and combating corruption in public administration, but there is no overarching strategy. In March 2016, an ad-hoc parliamentary committee for improving transparency in public office was set up to examine revisions of existing legislation. Although the results of its activity are not yet available, it seems reasonable to expect that some legislative improvements may be necessary (e.g. in the field of whistle-blower protection, asset declarations, conflict of interests and revolving doors). The biggest challenges so far in making the integrity framework work have been enforcing existing provisions and building up adequate monitoring and sanctioning capacity. Progress has been made on the prosecution side. Anti-corruption appears to have become a real priority for the national prosecution services and more efficient processes for case and resource management have been put in place ([42]). Yet, it remains to be seen whether these will be reflected by improvements in final conviction rates for high-level corruption and the application of penalties that provide stronger deterrents ([43]). On the preventive side, the

([42]) Examples of measures included in the 2015 Anti-corruption Action Plan of the General Prosecutor's Office are: allocating a single experienced magistrate to complex cases, creating joint investigative units under the coordination of a prosecutor, using secure information gathering and sharing between law enforcement officials, securing continuity of resources between the different phases of the judicial process and specialised recruitment of expert assistance for complex economic and financial crime cases.

([43]) The number of convictions in corruption-related cases has been relatively consistent over the years 2011-2014, although there has been a drop in the number of acquittals corruption prevention plans set up in each public institution have so far been largely formalistic. They are not fully adapted to each organisation nor are they complemented by adequate monitoring.

Transparency and reliability of public procurement data is improving while the use of direct awards remains high. The authorities are making efforts to improve data quality and reliability in the dedicated online public procurement platform (BASE). The Institute for monitoring public procurement (IMPIC) is now playing a more important role using a more systematic and automated system to correct data in BASE. Warnings mechanisms are being introduced to reduce entry errors and filling mistakes that, nevertheless, remain significant. According to the 2015 report on Public procurement in Portugal, published in November 2016 by IMPIC, e-procurement is well developed in the country. Nevertheless, the e-procurement platforms are not yet genuinely interoperable and the costs for using these platforms appear to be high for small companies, according to the Government Computer Systems Administration (CEGER) which has received a number of complaints. The authorities have proposed measures designed to remedy these shortcomings, within the SIMPLEX + Programme. According to the 2015 IMPIC report which uses BASE data ([44]), contracting authorities in Portugal often make use of the direct award procedure. This holds both for contracts covering goods and services (90.3 %) and for public works contracts (87.0 %). Portugal is still in the process of implementing the 2014 EU Directives on Public Procurement. The relevant draft legislation includes a number of provisions to increase the mandatory number of bidders and to restrict the use of direct award. If effectively set up as prescribed by the draft legislation, biennial procurement plans would also be a key tool in limiting the use of direct awards to exceptional circumstances.

Ex-ante and ex-post public procurement controls remain limited. Audit authorities in Portugal believe that there are deficiencies in the monitoring and control capacities at the execution phase of contracts. This applies in particular to public-private partnerships where contracting authorities lack the expertise needed to structure, negotiate and monitor complex contracts. The mandate of the Ministry of Finance's unit for PPPs (UTAP) is restricted to public-private partnerships managed by the central administration. There are no plans to expand its remit to cover concessions, regional and local public-private partnerships. Since April 2016, it has been obligatory for all local authorities to report all public-private partnerships and concession contracts to a central registry set up to map those contracts more satisfactorily. This exercise is still ongoing. The Central Purchasing Body (eSPap) has awarded Framework Agreements that include several suppliers to increase the transparency and competition in the public purchase of the contracting authorities entering into these agreements. However, in a broader perspective, Portugal still lacks a comprehensive public procurement policy covering all layers of the public administration. To fill this policy gap, increase openness and avoid collusion in public tenders, the Portuguese Competition Authority, in co-operation with eSPap, is making efforts to disseminate best practices and raise awareness of public procurement issues within public bodies However it is doing this in its advocacy capacity which is non-mandatory.

Judicial system*

The performance of the Portuguese justice system is still below the EU average. In Portugal efficiency indicators for civil, commercial and tax litigation cases remain poor with a negative impact on business dynamics and attracting foreign direct investment. The efficiency of the tax and administrative courts remains challenging in terms of resolution rate and length of proceedings that are still long ([45]). Weaknesses also remain in the

over the same period (from 63 % in 2011 to 30 % in 2014). The ratio of suspended sentences for corruption-related offences remains high, with 73 % of convictions resulting in suspended sentences in 2011, 61 % in 2012, 74 % in 2013, and 73 % in 2014. Data available at http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=21215&no=2, data from 2014 pending publication.

([44]) BASE dataset does not include the totality of awarded public contracts.

([45]) According to most recent data from the Ministry of Justice, in 2015, the courts of first instance counted 34 850 new proceedings and, out of them, only 27 810 were completed.

enforcement process where claims enforcement and the capacity to resolving court backlogs are still below the EU standards ([46]). During the economic adjustment programme, the Portuguese authorities reformed the corporate insolvency and restructuring frameworks, resulting in a stronger focus on firms' recovery rather than their liquidation by introducing out-of-court insolvency frameworks (PER and SIREVE). According to the national statistics from the Ministry of Justice for Q2-2016, PER proceedings took an average of 4 months and 19 days. The implementation of PER appears to be in line with the benchmark duration indicated in the law (a total of 35 procedural days and 2 or 3 months for negotiations between the debtor and the creditors). SIREVE frameworks have raised some doubts about their efficiency. It still takes up to 40 months to conclude insolvency court proceedings. To address implementation shortfalls, the Ministry of Justice published an initial evaluation of the insolvency tools PER and SIREVE in May 2016. This also contained a set of recommendations designed to tackle their implementation shortfall and inefficiencies. The availability of judicial statistics remains limited and they still do not cover tax and administrative tribunals. The High Council for Tax and Administrative Courts still produce no statistical data, which impedes any in-depth analysis of case-load metrics.

In addition, pending cases amounted to 75 372 at the end of 2015.

([46]) The proceedings for civil and commercial cases remain long (lasting on average 17 months) as well as the average duration of enforcement cases that is still 44 months.

Box 4.6.1: **Selected highlights**

Socially inclusive education: combating school failure in Portugal

Over the past few years, Portugal has set up several successful initiatives to tackle education inequalities, reduce school failure and raise the average level of basic skills of the population.

A **first step** was to introduce an "improvement contract" as part of the TEIP programme (Educational Territories with Priority for Intervention) the third round of the programme launched in 1996, inspired by the French ZEPs (Priority Intervention Zones). Schools with a large proportion of students at risk of failure, situated in low-income neighbourhoods, with families living in poor conditions, are entitled to an “improvement contract” which provides additional funding and support. In addition, these schools are allowed to recruit their own teachers. They also benefit from special time credits, enabling them to arrange additional learning activities and more individualised teaching, along with counselling and social support initiatives. The “More School Success” programme focuses on alternative and innovative classroom teaching strategies and arrangements. It is an “umbrella” designation introduced in 2009 to provide institutional support to modelsdeveloped at the regional or local level such as “TurmaMais and “Fenix”. These projects, which have proven their effectiveness were not initiated by the education authorities but were developed in schools with the support of education specialists from academia.

The **second step** was to increase schools’ capacity to draw up policies tailored to local needs which had often been undermined in the past by a highly centralised education system. Schools' autonomy to design and implement measures conducive to high-quality learning is already legally established in Portugal. Introducing autonomy contracts for schools between 2012 and 2015 opened up new opportunities in this area.

The new National Programme for the Promoting School Success launched in March 2016 was a **third step** designed to reinforce schools’ autonomy and expand it to encompass pedagogic programmes with a focus on teaching and learning issues. The national plan covers local plans drawn-up and implemented by schools with the support and under the supervision of a national committee of experts. It prioritises prevention with 37% of its measures targeting the 1st stage of basic education (from the first to the fourth year of primary school) and 35% of those targeting the first year of primary education. *Phase 1* of implementation (April 2016) involved training of 160 local trainers working in schools. *Phase 2* enabled these local trainers to support 2 811 headteachers and teachers in developing local plans to tackle school failure, in cooperation with municipal authorities. Today, 99% of all basic and secondary schools in Portugal have a strategic action plan in place to promote school success, accounting for 2 936 measures defined by schools and validated by the programme's committee of experts. In *phase 3* which got under way in September 2016 the local plans will be implemented with the full-time support of 1 294 teachers and involvement of 35 000 teachers nationwide.

ANNEX A

Overview table

Commitments	Summary assessment([47])
2016 Country specific recommendations (CSRs)	
CSR1: Ensure a durable correction of the excessive deficit, in accordance with the relevant decisions or recommendations under the excessive deficit procedure, by taking the necessary structural measures and by using all windfall gains for deficit and debt reduction. Thereafter, achieve an annual fiscal adjustment of at least 0,6 % of GDP. Conduct, by February 2017, a comprehensive expenditure review and strengthen expenditure control, cost effectiveness and adequate budgeting at all levels of public administration. Ensure the long-term sustainability of the health sector, without compromising access to primary healthcare. Reduce the reliance of the pension system on budgetary transfers. By the end of 2016, refocus ongoing restructuring plans of state-owned enterprises (SOEs).	Portugal has made **limited progress** in addressing CSR1 (this excludes an assessment of compliance with the Stability and Growth Pact).
Ensure a durable correction of the excessive deficit, in accordance with the relevant decisions or recommendations under the excessive deficit procedure, by taking the necessary structural measures and by using all windfall gains for deficit	• The compliance assessment with the Stability and Growth Pact will be included in Spring when final data for 2016 will be available.

([47]) The following categories are used to assess progress in implementing the 2016 country-specific recommendations:

No progress: The Member State has not credibly announced nor adopted any measures to address the CSR. Below a number of non-exhaustive typical situations that could be covered under this, to be interpreted on a case by case basis taking into account country-specific conditions:

• no legal, administrative, or budgetary measures have been announced in the National Reform Programme or in other official communication to the national Parliament / relevant parliamentary committees, the European Commission, or announced in public (e.g. in a press statement, information on government's website);

• no non-legislative acts have been presented by the governing or legislator 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 that would need to be taken (unless the CSR explicitly asks for orientations or exploratory actions), while clearly-specified measure(s) to address the CSR has not been proposed.

Limited progress: The Member State has:

• announced certain measures but these only address the CSR to a limited extent;

and/or

• presented legislative acts in the governing or legislator body but these have not been adopted yet and substantial non-legislative further work is needed before the CSR will be implemented;

• presented non-legislative acts, yet with no further follow-up in terms of implementation which is needed to address the CSR.

Some progress: The Member State has adopted measures that partly address the CSR

and/or

the Member State has adopted measures that address the CSR, but a fair amount of work is still needed to fully address the CSR as only a few of the adopted measures have been implemented. For instance: adopted by national parliament; by ministerial decision; but no implementing decisions are in place.

Substantial progress: The Member State has adopted measures that go a long way in addressing the CSR and most of which have been implemented.

Full implementation: The Member State has implemented all measures needed to address the CSR appropriately.

and debt reduction.	
Conduct, by February 2017, a comprehensive expenditure review and strengthen expenditure control, cost effectiveness and adequate budgeting at all levels of public administration	• **Some progress in conducting a comprehensive expenditure review.** The authorities have started a spending review exercise, mainly based on efficiency measures that involve the health and education ministries; state-owned enterprises and (centralised) public procurement and real estate management). This spending review still falls short of a comprehensive approach since its scope only covers the central government and focused on efficiency savings stemming from streamlining services.
Ensure the long-term sustainability of the health sector, without compromising access to primary healthcare	• **Some progress in ensuring the long-term sustainability of the healthcare sector.** As Portugal is expected to have the highest increase in healthcare costs in the EU by 2060, more efforts for cost compression should be pursued including by integrating primary care, hospital services and continuous care. However, health care prevention and access to primary health care have been improved which will definitely help Portugal meet the long term challenges facing its health care sector, Nonetheless, the increase stock of arrears adds strain to the system's fiscal sustainability in the short-term.
Reduce the reliance of the pension system on budgetary transfers.	• **Limited progress in reducing the reliance of pension system on budgetary transfers.** The draft budget for 2017 includes the earmarking of a new progressive tax on real estate portfolios (on top of the IMI) to the social security's Financial Stabilization Fund (worth EUR 160 million in 2017 according to the 2017 draft budgetary plan 2017). Although this earmarking is being presented by the government as an alternative to the excessive reliance on classical budgetary transfers, this does not address the expenditure side of the pension system sustainability.
By the end of 2016, refocus ongoing restructuring plans of state-owned enterprises (SOEs).	• **No progress in refocusing restructuring plans of state-owned enterprises.** In terms of their operational performance state-owned enterprises fared well in 2016, as shown by their positive EBIDTA (earnings before interest, tax, depreciation and amortization). However, indebtedness remains very high resulting in persistent negative net income. The government so far has not presented any concrete measures to significantly restructure state-owned enterprises.

CSR2: In consultation with social partners, ensure that the minimum wage is consistent with the objectives of promoting employment and competitiveness across sectors.	**Portugal has made limited progress in addressing CSR2:** • **Limited progress in ensuring that the minimum wage is consistent with promotion of employment and competitiveness.** The minimum wage was raised most recently in January 2017, from EUR 530 to EUR 557 i.e. above expected inflation and average productivity increases. While increasing aggregate demand and reducing in-work poverty, in a context of low inflation and high unemployment, continued increases in the minimum wage above productivity might put upward pressures on the overall wage structure, with the risk of affecting employment and competitiveness perspectives. The government established a structure to monitor the impact of minimum wage developments, through quarterly reports which are published and discussed with social partners.
CSR3: Ensure the effective activation of the long-term unemployed and improve the coordination between employment and social services. Strengthen incentives for firms to hire through permanent contracts. Ensure the effective activation of the long-term unemployed and improve the coordination between employment and social services Strengthen incentives for firms to hire	**Portugal has made some progress in addressing CSR3** • **Limited progress in ensuring effective activation of long-term unemployed and in improving coordination between employment and social services**. The rate of long-term unemployment remains one of the highest in the EU, despite active labour market measures targeted at long-term unemployed which have been developed in recent years. To address this, the government produced an assessment of active labour market policies. However, no specific measures targeted at integrating the long-term unemployed into the labour market have been adopted since then. The public employment service's planned increased use of online platforms instead of face-to-face-services should enable staff to focus on more personalised services for the long-term unemployed. As part of the ongoing administrative simplification process, one-stop shops for the long-term unemployed are being developed, although this initiative has not yet reached the implementation phase. • **Some progress in strengthening incentives for firms**

through permanent contracts.	**to hire through permanent contracts.** The Government redesigned its employment support programme to promote hiring on open-ended contracts while restricting the financial support for temporary contracts to specific cases such as the very long-term unemployed. However, the expected impact of the new measure in reducing segmentation is limited in view of the low number of people to be covered.
CSR4: Take measures, by October 2016, to facilitate the cleaning up of the balance sheets of credit institutions and address the high level of non-performing loans. Reduce the debt bias in corporate taxation and improve the access to finance for start-ups and small and medium-sized enterprises via the capital market.	**Portugal has made limited progress in addressing CSR 4**
Take measures, by October 2016, to facilitate the cleaning up of the balance sheets of credit institutions and address the high level of non-performing loans	• **Limited progress in facilitating the clean-up of credit institutions' balance sheets and addressing the high level of non-performing loans**. • By Resolution of the Council of Ministers N. 42/2016 of 18 August 2016, the government approved the *Capitalizar* Programme**.** Under the programmes's "corporate restructuring" strand, the government intends to improve existing mechanisms for restructuring the balance of viable economic enterprises and the recovery of credits. The government is also taking action to revise its **insolvency regime** through the following**:** mechanisms to control the access to the PER (implementation period: first quarter of 2017); access of judicial administrators to the Citius dataset, the IT system to support the activities of the courts) (fully implemented); the right of judicial administrators to directly access the various databases (implementation planned for the first quarter of 2017); creation of electronic certificates (expected to be implemented in the first quarter of 2017); possibility of exemption from holding a meeting of creditors; changes to the legal framework to the new registration rules on cross-border insolvencies and interconnection of registries. • The tax law has been changed to remove disincentives to write-off. The central bank is conducting additional supervisory work, including by assessing banks' capability to manage non-performing loans, The central bank is also providing guidance to banks on how to

	screen different types of non-performing loans, and how to manage them. They are also considering an external servicing of loans, although the details have not been provided as to whether this would entail the creation of a market of distressed assets. Overall, a comprehensive strategy appears to be lacking.
Reduce the debt bias in corporate taxation and	• **Some progress in reducing the debt bias in corporate taxation**. The 2017 draft budgetary plan includes broadening the scope of the allowance for corporate equity (ACE) regime. The regime now applies to all companies (previously it applied only to small and medium-sized enterprises) and shareholders (not only individuals and venture capital investors). In addition, the allowance has been increased from 5 % during 4 years to 7 % during 6 years.
improve the access to finance for start-ups and small and medium-sized enterprises via the capital market.	• **Limited progress in improving the access to finance for start-ups and small and medium-sized enterprises via the capital market**. Under the Capitalizar Programme, the government has put forward measures to ease businesses' financing needs. A new credit line with a mutual guarantee has been made available and will allow financing to companies of more than EUR 1 billion in financing for companies. In parallel, the government has put in place another programme (*Programa Semente*) to finance for start ups and small enterprises in their early stages (seed capital), helping them to raise equity finance by offering tax reliefs, for at least two years, to individual investors who purchase new shares in such companies, These programmes are expected to improve the financing of companies in Portugal, provided that they are swiftly and fully implemented.
CSR5: Increase transparency and efficiency in public procurement as regards public private partnerships and concessions. By the end of 2016, improve and accelerate administrative and licensing procedures, accelerate tax litigations and reduce regulatory barriers, especially in business services. Incentivise cooperation between universities and the business sector.	**Portugal has made some progress in addressing CSR5**
Increase transparency and efficiency in public procurement as regards public private partnerships and	• **Some progress in increasing transparency in public procurement.** Transparency and reliability of public procurement data is improving. The institute for Monitoring Public Procurement (IMPIC) is moving

concessions	from a case by case approach on correcting data in BASE to a more systematic and automated system. Access to procurement data by control and prosecution authorities is not automatic, because of the legal framework on data protection, which hampers efficient checks and investigations. By Decree N. 18/2016, the government has established quarterly monitoring and reporting procedures related for local and regional public private partnerships and concessions. The use of direct awards remains high and there are weaknesses in the tender procedures due to: (i) insufficient justification underpinning the recourse to direct awards; (ii) splitting of contracts; (iii) lack of capacity and professionalization an (iv) limited checks.
By the end of 2016, improve and accelerate administrative and licensing procedures,	• **Limited progress in improving and accelerating licensing procedures by the end of 2016**. The SIMPLEX + initiative includes some cross cutting simplification measures, yet to be implemented, but progress in enhancing the business environment has largely stalled in relation to sector specific regulation.
accelerate tax litigations	• **Some progress in accelerating tax litigations by the end of 2016.** The Tax Administration has drawn up a multiannual plan to combat fraud, improve tax collection and simplify tax procedures. The 2017 draft budgetary plan introduced provisions for the tax authorities to: reduce response time for issuing binding rulings (Autoridade Tributária) to a maximum of 75 days in all urgent requests, significantly reduce the deadline for urgent requests; also, assess the possibility of reducing the costs of urgent binding ruling. Despite these efforts, the tax courts' clearance rate remains low.
and reduce regulatory barriers, especially in business services.	• **Limited progress in reducing regulatory barriers especially in business services by the end of 2016**. Previous reform efforts targeting the most restrictive business services, including regulated professions, were halted and, in some cases, reversed. Restrictions on corporate groups for professional firms and restrictive regulation of legal professions (legal form, shareholding, management, multidisciplinary, advertising restrictions) set to remain in place.
Incentivise cooperation between universities and the business sector.	• **Some progress in incentivising cooperation between universities and the business sector**. New initiatives announced include the creation of collaborative laboratories, technological centres for engineering activities and new business innovation contracts. The government is currently preparing a revision of the Higher Education system. The new programme to modernise and revamp polytechnic institutes focuses

	on matching both R&D activities and dual VET programmes (CTeSPs) with regional needs. The Innovation Agency (ANI) is working to increase knowledge and collaborative innovation and has identified further potential players to bring into the innovation eco-system (including businesses and research organizations). It is also pushing for more collaboration as a priority for further action. However, there is no overall comprehensive strategy to foster cooperation between universities and the business sector: cooperation still relies mostly on isolated initiatives from specific universities or businesses.
Europe 2020 (national targets and progress)	
Employment rate target (20-64 years old): 75 %	69.1 % (2015). It increased compared to 2014 (67.6 %) but remains well below the national target for 2020.
R&D target: 3 %	R&D intensity has been declining since 2009. The situation is particularly worrying for business spending on R&D, which dropped significantly between 2009 and 2015. 1.28 % (2015)
Greenhouse gas (GHG) emissions target: -National Greenhouse gas (GHG) emissions target: 1 % in 2020 compared to 2005 (in non-ETS sectors)	Portugal's non-ETS emissions decreased by 24 % between 2005 and 2015. The country has achieved its 2015 target (a 2 % emission reduction) by a 22 pps. gap. According to the latest national projections based on existing measures, non-ETS emissions will decrease by 25 % between 2005 and 2020. The key measures being implemented are the framework for climate policy (*QEPiC - Quadro Estratégico da Política Climática*) and the 2013-2020 national programme for climate change "*Programa Nacional para as Alterações Climáticas*" (PNAC 2020). Portugal is implementing the 2015 green tax reform that introduced transport-related fiscal measures for the 2020 horizon, including carbon tax, higher taxes for vehicles with high CO2 emission factors and tax incentives (Law 82-D, 2014).
2020 Renewable energy target: 31 %	With a 27.8 % renewable energy share in 2015, Portugal is above its 2015/2016 interim target of 25.2 % as established in the Renewable Energy Directive ([48]).

([48]) Renewable energy shares for 2015 are approximations and not official data, reflecting the available data (04.10.2016). See the Öko-Institut Report: Study on Technical Assistance in Realisation of the 2016 Report on Renewable Energy, http://ec.europa.eu/energy/en/studies

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 level of 22.5 Mtoe primary consumption and 17.4 Mtoe final energy consumption.	Portugal increased its primary energy consumption by 4.9 % from 20.65 Mtoe in 2014 to 21.66 Mtoe in 2015. Final energy consumption increased by 2 % from 15.77 Mtoe in 2014 to 16.04 Mtoe in 2015. Even if Portugal has already achieved levels of primary and final energy consumption which are below the indicative national 2020 targets (22.5 Mtoe in primary energy consumption and 17.4 Mtoe in final energy consumption) it would need to make an effort to keep these levels until 2020.
Early school leaving target: 10 %	Portugal is among the three countries that have made most progress in reducing early school leaving since 2012 (Education and Training Monitor 2016). The continuous positive decreasing trend and the possible impact of the implementation of the National Plan to promote School Success put the target at reach for the country. 13.7 % (2015)
Tertiary education target: 40 %	Tertiary education attainment has been stagnating over the past years. The modernisation of the polytechnic institutes seems to have provided a new boost to tertiary enrolment but the slowdown in the previous increasing trend keeps the target relatively out of reach for 2020. 34.9 % (Q2 2016)
Risk of poverty or social exclusion target: the target envisages reducing the number of person in or at risk of poverty and social exclusion by 200 000 persons in 2020.	The number of people at risk of poverty or social exclusion rose by 72 000 between 2010 and 2015. Despite a decrease between 2013 and 2015, the national target remains far from reach.

ANNEX B
MIP Scoreboard

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

			Thresholds	2010	2011	2012	2013	2014	2015
External imbalances and competitiveness	Current account balance, (% of GDP)	3 year average	-4%/6%	-10.9	-8.9	-6.0	-2.1	-0.1	0.7
	Net international investment position (% of GDP)		-35%	-104.3	-100.7	-116.5	-116.3	-114.9	-109.3
	Real effective exchange rate - 42 trading partners, HICP deflator	3 years % change	±5% & ±11%	-3.1	-3.0	-4.0	-0.6	-1.8	-2.8
	Export market share - % of world exports	5 years % change	-6%	-6.6	-8.2	-16.0	-6.8	-5.5	2.8
	Nominal unit labour cost index (2010=100)	3 years % change	9% & 12%	4.2	-0.6	-6.3	-3.4	-2.7	0.0e
Internal imbalances	Deflated house prices (% y-o-y change)		6%	-1.0	-6.5	-8.7	-2.7	3.9	2.3
	Private sector credit flow as % of GDP, consolidated		14%	5.3	-0.9	-3.7	-1.9	-5.9	-2.3
	Private sector debt as % of GDP, consolidated		133%	201.5	204.1	211.7	204.4	192.4	181.5
	General government sector debt as % of GDP		60%	96.2	111.4	126.2	129.0	130.6	129.0
	Unemployment rate	3 year average	10%	10.5	11.9	13.6	15.0	15.4	14.4
	Total financial sector liabilities (% y-o-y change)		16.5%	11.5	-4.5	-1.8	-5.3	-7.3	-1.6
New employment indicators	Activity rate - % of total population aged 15-64 (3 years change in p.p)		-0.2%	-0.2	-0.3b	0.0	-0.7	-0.4	0.0
	Long-term unemployment rate - % of active population aged 15-74 (3 years change in p.p)		0.5%	1.9	2.6	3.5	3.6	2.2	-0.5
	Youth unemployment rate - % of active population aged 15-24 (3 years change in p.p)		2%	6.8	8.6	12.7	9.9	4.5	-6.0

(1)Figures highlighted are the ones falling outside the threshold established by EC Alert Mechanism Report. For REER and ULC, the first threshold concerns Euro Area Member States. (1) Figures in italic are not published by Eurostat, due to being according to the old standards (ESA95/BPM5), or forecasts.
Flags: empty: not available, c: confidential; b: break in series; e: estimate; f: forecast (DG ECFIN); k: backcast (DG ECFIN); j: note; o: outdated; p: provisional; u: unreliable
Source: European Commission, Eurostat and DG ECFIN (for the indicators on the REER)

ANNEX C
Standard tables

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

	2011	2012	2013	2014	2015	2016
Total assets of the banking sector (% of GDP)	325.4	330.8	302.5	271.0	251.0	234.8
Share of assets of the five largest banks (% of total assets)	70.8	69.9	70.3	69.2	69.6	-
Foreign ownership of banking system (% of total assets)	21.4	20.6	19.4	20.3	22.4	-
Financial soundness indicators:1)						
- non-performing loans (% of total loans)	5.3	7.0	7.8	12.7	14.4	14.6
- capital adequacy ratio (%)	9.8	12.6	13.7	12.3	13.3	13.1
- return on equity (%)2)	-4.2	-3.3	-9.3	-17.2	0.9	-0.6
Bank loans to the private sector (year-on-year % change)	-3.3	-6.0	-5.0	-5.2	-2.6	-2.5
Lending for house purchase (year-on-year % change)	-0.5	-2.8	-3.5	-3.8	-3.8	-3.7
Loan to deposit ratio	116.1	119.5	111.4	105.0	99.3	94.6
Central Bank liquidity as % of liabilities	9.7	11.7	11.6	8.1	7.1	6.2
Private debt (% of GDP)	204.1	211.7	204.4	192.4	181.5	-
Gross external debt (% of GDP)1) - public	58.4	82.0	86.1	98.7	92.0	83.7
- private	40.9	42.5	44.2	46.2	45.4	47.5
Long-term interest rate spread versus Bund (basis points)*	763.3	905.3	472.4	259.1	192.8	304.5
Credit default swap spreads for sovereign securities (5-year)*	773.9	818.7	355.9	173.0	137.4	216.7

(1) Latest data Q2 2016.
(2) Quarterly values are not 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: **Labour market and social indicators**

	2011	2012	2013	2014	2015	2016 [4]
Employment rate (% of population aged 20-64)	68.8	66.3	65.4	67.6	69.1	70.4
Employment growth (% change from previous year)	-1.9	-4.1	-2.9	1.4	1.4	1.4
Employment rate of women (% of female population aged 20-64)	64.6	63.0	62.3	64.2	65.9	67.1
Employment rate of men (% of male population aged 20-64)	73.2	69.8	68.7	71.3	72.6	74.0
Employment rate of older workers (% of population aged 55-64)	47.8	46.5	46.9	47.8	49.9	51.8
Part-time employment (% of total employment, aged 15-64)	10.3	11.2	11.1	10.1	9.8	9.4
Fixed-term employment (% of employees with a fixed term contract, aged 15-64)	22.0	20.5	21.4	21.4	22.0	22.3
Transitions from temporary to permanent employment	28.8	26.3	24.0	27.2	27.3	:
Unemployment rate[1] (% active population, age group 15-74)	12.9	15.8	16.4	14.1	12.6	11.4
Long-term unemployment rate[2] (% of labour force)	6.2	7.7	9.3	8.4	7.2	6.3
Youth unemployment rate (% active population aged 15-24)	30.2	38.0	38.1	34.7	32.0	28.3
Youth NEET[3] rate (% of population aged 15-24)	12.6	13.9	14.1	12.3	11.3	:
Early leavers from education and training (% of pop. aged 18-24 with at most lower sec. educ. and not in further education or training)	23.0	20.5	18.9	17.4	13.7	:
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	26.7	27.8	30.0	31.3	31.9	:
Formal childcare (30 hours or over; % of population aged less than 3 years)	34.0	34.0	36.0	41.0	:	:

1 Unemployed persons are all those who were not employed but had actively sought work and were ready to begin working immediately or within 2 weeks.
2 Long-term unemployed are peoples who have been unemployed for at least 12 months.
3 Not in education employment or training.
4 Average of first three quarters of 2016. Data for total unemployment and youth unemployment rates are seasonally adjusted.
Source: European Commission (EU Labour Force Survey).

Table C.3: **Expenditure on social protection benefits (% of GDP)**

Expenditure on social protection benefits (% of GDP)	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Sickness/healthcare	6.7	6.1	6.2	6.2	6.1	:
Disability	2.0	2.0	1.8	2.0	1.9	:
Old age and survivors	12.6	13.4	13.7	14.6	14.7	:
Family/children	1.3	1.2	1.2	1.2	1.2	:
Unemployment	1.4	1.3	1.7	1.8	1.5	:
Housing	0.0	0.0	0.0	0.0	0.0	:
Social exclusion n.e.c.	0.3	0.3	0.3	0.2	0.2	:
Total	24.4	24.2	24.9	26.1	25.5	:
of which: means-tested benefits	2.4	2.1	2.2	2.2	2.1	:
Social inclusion indicators	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
People at risk of poverty or social exclusion[1] (% of total population)	25.3	24.4	25.3	27.5	27.5	26.6
Children at risk of poverty or social exclusion (% of people aged 0-17)	28.7	28.6	27.8	31.7	31.4	29.6
At-risk-of-poverty rate[2] (% of total population)	17.9	18.0	17.9	18.7	19.5	19.5
Severe material deprivation rate[3] (% of total population)	9.0	8.3	8.6	10.9	10.6	9.6
Proportion of people living in low work intensity households[4] (% of people aged 0-59)	8.6	8.3	10.1	12.2	12.2	10.9
In-work at-risk-of-poverty rate (% of persons employed)	9.7	10.3	9.9	10.5	10.7	10.9
Impact of social transfers (excluding pensions) on reducing poverty	32.2	29.1	29.2	26.7	27.0	26.1
Poverty thresholds, expressed in national currency at constant prices[5]	4997	4777	4565	4364	4372	4489
Gross disposable income (households; growth %)	2.8	-3.7	-3.6	-0.2	-0.2	2.5
Inequality of income distribution (S80/S20 income quintile share ratio)	5.6	5.7	5.8	6.0	6.2	6.0
GINI coefficient before taxes and transfers	52.4	52.7	54.4	54.8	56.3	55.5
GINI coefficient after taxes and transfers	33.8	34.3	34.1	34.2	34.5	34.0

1 People at risk of poverty or social exclusion : individuals who are at risk of poverty and/or suffering from severe material deprivation and/or living in households with zero or very low work intensity.
2 At-risk-of-poverty rate : proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.
3 Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.
4 People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20 % of their total work-time potential in the previous 12 months.
5 For EE, CY, MT, SI and SK, thresholds in nominal values in euros; harmonised index of consumer prices = 100 in 2006 (2007 survey refers to 2006 incomes)
Source: For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table C.4: **Product market performance and policy indicators**

Performance indicators	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Labour productivity (real, per person employed, year-on-year % change)						
Labour productivity in industry	7.29	2.10	1.02	0.68	0.63	-1.81
Labour productivity in construction	-2.74	3.61	7.03	3.26	-4.06	-0.95
Labour productivity in market services	2.00	1.96	1.95	1.89	-2.54	-0.65
Unit labour costs (ULC) (whole economy, year-on-year % change)						
ULC in industry	-3.28	-0.99	-1.31	0.25	0.10	3.57
ULC in construction	4.97	-1.51	-4.06	-2.00	2.77	0.56
ULC in market services	0.34	-1.49	-2.37	-0.41	0.02	1.70
Business environment	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Time needed to enforce contracts[1] (days)	547.0	547.0	547.0	547.0	547.0	547.0
Time needed to start a business[1] (days)	5.5	5.5	5.5	4.5	4.5	4.5
Outcome of applications by SMEs for bank loans[2]	0.83	1.13	1.24	0.71	0.68	0.55
Research and innovation	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
R&D intensity	1.53	1.46	1.38	1.33	1.29	1.28
Total public expenditure on education as % of GDP, for all levels of education combined	5.62	5.27	na	5.34	na	na
Number of science & technology people employed as % of total employment	24	27	29	30	33	34
Population having completed tertiary education[3]	14	16	17	18	20	21
Young people with upper secondary education[4]	59	65	68	70	72	77
Trade balance of high technology products as % of GDP	-2.00	-1.72	-1.60	-1.56	-1.61	-1.53
Product and service markets and competition				**2003**	**2008**	**2013**
OECD product market regulation (PMR)[5], overall				na	1.69	1.29
OECD PMR[5], retail				3.29	3.97	1.83
OECD PMR[5], professional services				na	3.08	2.92
OECD PMR[5], network industries[6]				3.09	2.55	2.18

1 The methodologies, including the assumptions, for this indicator are shown in detail at: http://www.doingbusiness.org/methodology.
2 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 most of it, two if only received a limited part of it, three if refused or rejected and treated as missing values if the application is still pending or if the outcome is not known.
3 Percentage population aged 15-64 having completed tertiary education.
4 Percentage population aged 20-24 having attained at least upper secondary education.
5 Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail at: http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm
6 Aggregate OECD indicators of regulation in energy, transport and communications.
Source: European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators); SAFE (for outcome of SMEs' applications for bank loans).

Table C.5: **Green growth**

Green growth performance		2010	2011	2012	2013	2014	2015
Macroeconomic							
Energy intensity	kgoe / €	0.14	0.13	0.13	0.13	0.13	0.13
Carbon intensity	kg / €	0.43	0.43	0.43	0.42	0.42	-
Resource intensity (reciprocal of resource productivity)	kg / €	1.20	1.13	1.08	0.96	0.97	1.00
Waste intensity	kg / €	0.11	-	0.09	-	0.09	-
Energy balance of trade	% GDP	-3.4	-4.2	-4.7	-3.7	-3.5	-
Weighting of energy in HICP	%	11.68	12.73	13.79	8.59	7.86	8.25
Difference between energy price change and inflation	%	4.5	6.6	10.9	2.6	1.7	-1.9
Real unit of energy cost	% of value added	15.3	17.8	19.1	18.6	18.9	-
Ratio of environmental taxes to labour taxes	ratio	0.19	0.17	0.17	0.15	0.16	-
Environmental taxes	% GDP	2.4	2.3	2.2	2.2	2.3	-
Sectoral							
Industry energy intensity	kgoe / €	0.23	0.22	0.20	0.20	0.19	0.19
Real unit energy cost for manufacturing industry excl. refining	% of value added	14.0	16.0	16.2	15.2	15.5	-
Share of energy-intensive industries in the economy	% GDP	8.36	8.09	7.90	7.78	7.91	-
Electricity prices for medium-sized industrial users	€ / kWh	0.09	0.10	0.11	0.11	0.12	0.11
Gas prices for medium-sized industrial users	€ / kWh	0.03	0.04	0.04	0.04	0.04	0.04
Public R&D for energy	% GDP	0.02	0.02	0.02	0.02	0.02	0.02
Public R&D for environmental protection	% GDP	0.03	0.03	0.03	0.03	0.04	0.04
Municipal waste recycling rate	%	18.7	20.1	26.1	25.8	30.4	-
Share of GHG emissions covered by ETS*	%	35.8	37.5	38.9	38.2	37.7	41.8
Transport energy intensity	kgoe / €	1.14	1.09	1.03	1.04	1.09	1.09
Transport carbon intensity	kg / €	2.89	2.72	2.54	2.52	2.66	-
Security of energy supply							
Energy import dependency	%	75.1	77.7	79.2	72.4	71.2	77.4
Aggregated supplier concentration index	HHI	19.6	26.6	26.7	28.1	28.2	-
Diversification of energy mix	HHI	0.35	0.32	0.30	0.31	0.31	-

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2005 prices)
Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)
Carbon intensity: greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR)
Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR)
Waste intensity: waste (in kg) divided by GDP (in EUR)
Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP
Weighting of energy in HICP: the proportion of 'energy' items in the consumption basket used for the construction of the HICP
Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)
Real unit energy cost: real energy costs as a percentage of total value added for the economy
Environmental taxes over labour taxes and GDP: from European Commission's database, 'Taxation trends in the European Union'
Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR)
Real unit energy costs for manufacturing industry excluding refining : real costs as a percentage of value added for manufacturing sectors
Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP
Electricity and gas prices for medium-sized industrial users: consumption band 500–20 00MWh and 10 000–100 000 GJ; figures excl. VAT.
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 greenhouse gas emissions
(excl land use, land use change and forestry) as reported by Member States to the European Environment Agency.
Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2005 EUR)
Transport carbon intensity: GHG emissions in transport activity divided by gross value added of the transport sector
Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels
Aggregated supplier concentration index: covers oil, gas and coal. Smaller values indicate larger diversification and hence lower risk.
Diversification of the energy mix: Herfindahl index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels
* European Commission and European Environment Agency
Source: European Commission (Eurostat) unless indicated otherwise

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