European Commission

ISSN 1725-3209 (online)
ISSN 1725-3195 (print)

EUROPEAN ECONOMY

Occasional Papers 222 | June 2015

Macroeconomic imbalances Country Report – Portugal 2015

Economic and Financial Affairs

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This paper exists in English only and can be downloaded from
http://ec.europa.eu/economy_finance/publications/.

Luxembourg: Publications Office of the European Union, 2015

KC-AH-15-222-EN-N (online)
ISBN 978-92-79-44900-0 (online)
doi:10.2765/681320 (online)

KC-AH-15-222-EN-C (print)
ISBN 978-92-79-44899-7 (print)
doi:10.2765/440027 (print)

European Commission
Directorate-General for Economic and Financial Affairs

Macroeconomic imbalances

Country Report – Portugal 2015

EUROPEAN ECONOMY Occasional Papers 222

Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Portugal is experiencing *excessive macroeconomic imbalances, which require decisive policy action and specific monitoring*. Portugal exited the economic adjustment programme in 2014 and is currently subject to post-programme surveillance and European Semester surveillance. Despite considerable progress achieved during the programme, both as regards economic adjustment and policies, important risks remain linked to the high levels of indebtedness, both internally and externally, and across various sectors and deserve close attention. There are also strong deleveraging pressures in the context of low growth, low inflation and high unemployment.

Excerpt of country-specific findings on Portugal, COM(2015)85 final_ SWD(2015)41 final, 26.02.2015

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EXECUTIVE SUMMARY

Between May 2011 and June 2014, Portugal benefited from financial assistance in support of an economic adjustment programme which also covered the surveillance of imbalances and monitoring of corrective measures. Portugal is still affected by very high private and government debt, vulnerability of the financial sector due to weak bank profitability and an ongoing deterioration of asset quality, limited access of corporations to credit, high levels of unemployment and bottlenecks in network industries, services, regulated professions and public administration. These weaknesses constitute risks for economic growth and financial stability, thus requiring decisive policy actions.

This Country Report assesses Portugal's economy against the background of the Commission's Annual Growth Survey, which recommends three main pillars for the EU's economic and social policy in 2015: investment, structural reforms, and fiscal responsibility. In line with the Investment Plan for Europe, it also explores ways to maximise the impact of public resources and unlock private investment. Finally, it assesses Portugal in the light of the findings of the 2015 Alert Mechanism Report, in which the Commission found it useful to further examine the existence of macroeconomic imbalances or their unwinding. To this end, this Country Report also provides an in-depth review (IDR) of Portugal's economy in line with the scope of the surveillance under the Macroeconomic Imbalances Procedure.

The main findings from the IDR analysis as regards imbalances and macroeconomic risks are:

- **Portugal tackled thoroughly its external imbalances but, starting from deep-seated external weaknesses, the rebalancing is still ongoing.** The traditionally high structural current account deficit has been closed, exports increased, helped also by improved efficiency and product quality, and the tradables sector gained in importance. However, the net international investment position is still very negative and rebalancing through sustained current account surpluses will not only take time but requires stronger economic growth, higher exports, and more attractiveness for foreign direct investment.
- **The high debt of Portuguese firms still weighs on firms' performance and impedes new investments, one of the key priorities of the new Commission, while households' indebtedness declined markedly.** Deteriorating growth prospects and changing attitudes towards risk have prompted non-financial corporations to adjust their balance sheets, although to a lesser extent than households.. The high corporate debt ratio represents also a concern for banks' balance sheets and Portugal's wider financial stability.
- **General government debt has reached very high levels, also by bringing off-budget operations on record.** While the increasing path in gross public debt is expected to reverse in the short term, government debt dynamics remain vulnerable to adverse shocks and impose a high interest burden on public finances.
- **The economic crisis has led to a sharp decline in employment.** Although the labour market situation has recently improved, unemployment remains high and the labour market segmented. However, the economy experienced a substantial real wage adjustment in recent years, and Portugal's real effective exchange rate trends are conducive to falling unemployment and the necessary further external rebalancing. Yet there is a risk that unemployment stabilises at high levels in a low growth environment.

The Country Report also analyses other macroeconomic and structural issues, and the main findings are:

- **Portugal is advancing reforms of the fiscal system.** This applies for strengthening the fiscal framework and implementing new measures to fight tax fraud and evasion and reforms of the public administration, including at the local and regional level. Initiatives to improve the operating balance of state-owned enterprises continue and renegotiations of several Public-Private Partnerships are near conclusion. The sustainability of state-owned hospitals is being addressed, but their stock of arrears is still high.

- **Portugal is making some progress with structural reforms.** In the energy sector, excessive rents and the electricity tariff debt are being addressed. Several infrastructure projects listed in Portugal's long-term transport plan are progressing. Reforms of product markets, services and regulated professions are advancing, although not in a comprehensive way. However, the lack of a systematic approach to monitoring and evaluating reforms makes it difficult to assess their full impact on the functioning of the economy.

Overall, Portugal has made some progress in addressing the 2014 country-specific recommendations. Decisive measures have been taken to stabilise the financial sector and to overhaul the corporate insolvency and debt restructuring framework. Active Labour Market Policies have been strengthened. The assessment of recent reforms of collective bargaining is mixed, as not all of them promote the alignment of wages and productivity at firm level. No progress has been achieved on strengthening social assistance, including the minimum income scheme. Education and training have undergone important reforms and implementation is now crucial to prove their effectiveness in improving students' performance. Network industries are still facing efficiency and sustainability challenges. Housing, product and services markets reforms are facing delays, especially the full implementation of the European Services Directive. While the competition and regulatory framework is being improved, no progress has been made in reducing the late payment of commercial debts by the administration. Some progress has been made to increase transparency in public procurement and the judiciary.

The country report reveals the policy challenges stemming from the analysis of macro-economic imbalances:

- Low competition in product markets and low responsiveness of wages to productivity at the firm level impact on the competitiveness of exports and thus on external imbalances.

- Slow restructuring of highly indebted but viable companies and slow orderly exit of those firms that have no viable operating models keep the corporate debt levels high.

- Relying on cyclical effects does not facilitate compliance with the medium-term budget framework or help to reduce the high public debt level in a sustainable manner.

- Labour market policies and the functioning of the collective bargaining system influence the risk that unemployment stabilises at its current high level.

Other challenges are:

- Coverage of social assistance is low.

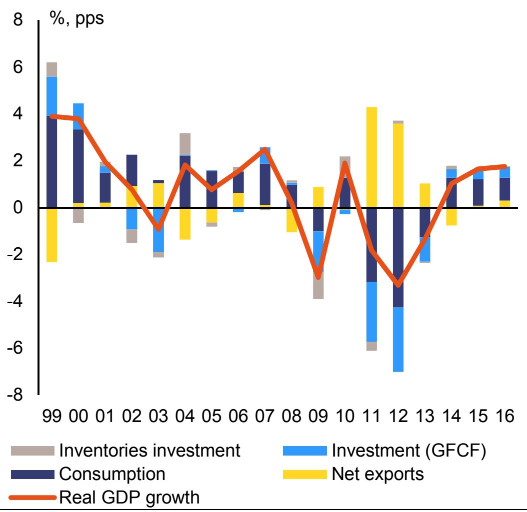
- Education and training outcomes are not clearly aligned with the labour market and links between public research organisations and business are weak.

- In the transport sector, the new transport regulatory authority is not operational yet. Liberalisation measures in ports concessions, railways and metropolitan public transport are slow, thus not stimulating investment.

1. SCENE SETTER: ECONOMIC SITUATION AND OUTLOOK

After a prolonged recession, the Portuguese economy started to recover in 2013. Real GDP has been growing in year-on-year terms since the fourth quarter of 2013, following eleven consecutive quarters of negative growth. Recently, economic growth has been driven by accelerating private consumption and investment. The latest economic sentiment data and confidence indicators suggest that domestic demand is continuing to recover, with imports growing faster than exports. Economic expansion is expected to accelerate slightly in the medium term as a result of gradually improving financing conditions and external demand.

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



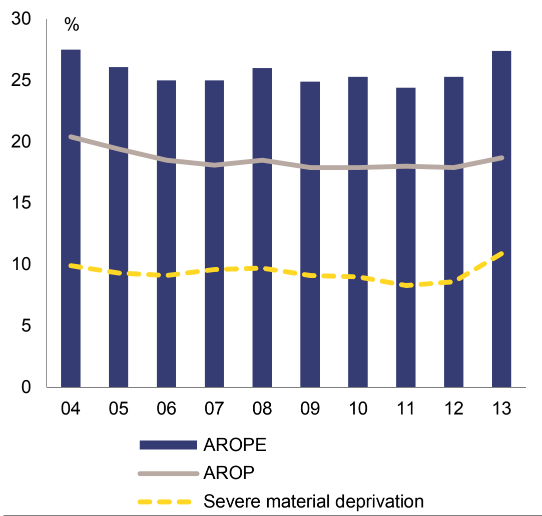
Source: European Commission

Inflation is projected to rise moderately in the medium term. As measured by the Harmonised Index of Consumer Prices (HICP), it fell to -0.2% in 2014, mainly as a result of sharp fall in energy prices. Positive figures are expected by the second half of 2015 as wages rise and oil prices stabilise. However, high unemployment levels, subdued domestic demand and low oil prices are expected to contain inflationary pressures in the near future.

The labour market situation has been improving since the spring of 2013. In the first three quarters of 2014, employment growth averaged 2% year-on-year, thereby outpacing GDP growth. However, the decline in unemployment has recently come to a halt and the unemployment rate has stabilised since October 2014 with the employment reduction. Looking ahead, job creation is set to slow down and employment growth is expected to become more aligned with GDP growth.

Poverty indicators are traditionally very high in Portugal compared to the EU average and have deteriorated further in the wake of the financial and economic crisis. The number of people threatened by poverty or social exclusion rose by 220,000 between 2007 and 2013. This represents an increase to 27.4% of the total Portuguese population in 2013 (see Graph 1.2). The gap between Portugal and the rest of the euro area (23%) has thus widened. Low-work-intensity households and households with children have been particularly badly affected by poverty and social exclusion.

Graph 1.2: **Poverty indicators in Portugal**



(1) AROPE: People at-risk-of poverty or social exclusion, i.e. individuals who are at-risk-of poverty and/or suffering from severe material deprivation and/or living in household with zero or very low work intensity.
(2) AROP: At-risk-of poverty rate, i.e. share of people with an equivalised disposable income below 60% of the national equivalised median income.
(3) Severe material deprivation: Share of people who experience at least 4 out of 9 type of deprivations: people cannot afford to i) pay their rent or utility bills, ii) heat their home adequately warm, iii) cope with unexpected expenses, iv) eat meat, fish, or a protein equivalent every second day, v) take a week's 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.
Source: European Commission

Poor labour market performance has been a key factor in the increase in poverty. The proportion of low work intensity households rose by 5.9 pps between 2008 and 2013. In the same period the number of jobless poor (at risk of poverty and living in low work intensity household) went up by almost 50%. The disparity between the top and bottom 20% of the income distribution grew bigger in 2013 and the Gini coefficient remains above 34%, compared to a EU28-average level of 30.5% in 2013. The 7.6 pps. increase in the poverty gap([1]) between 2008 and 2013 was the second largest in the EU after Greece and the poverty gap now stands at 31.2%.

Fiscal consolidation continued in 2014, while the accumulation of arrears has been halted and the stock of arrears reduced. The general government deficit reached an estimated 4.6% of GDP at the end of 2014 (3.6% of GDP without one-offs), down from 4.9% of GDP in 2013 (5.2% of GDP without one-offs). Risks to the projection relate to cash-accrual adjustments and to the one-off operation related to Novo Banco. The arrears strategy has halted the accumulation of new arrears and begun to reduce the outstanding stock (by about 0.3% of GDP over 2014). According to the Commission's winter forecast, the plans underpinning the 2015 budget are not sufficient to reach the deficit target, revised by the government to 2.7% of GDP, but would instead lead to a deficit of 3.2% of GDP. Under the no-policy-change assumption, the deficit is forecast to stand at 2.8% of GDP by 2016. Risks around the projections relate to macroeconomic developments, continued efficiency gains in revenue collection, budget-neutral implementation of the envisaged tax reforms, and possible spending slippages.

The consolidation effort has been slackening since the end of the economic adjustment programme. In 2014, the Constitutional Court overturned key provisions on public wage and pension cuts in the initial 2014 budget and the budgetary plans for 2015. There were no measures of similar quality and scale to compensate for the resultant shortfalls, which have been offset mainly by additional revenue from the economic recovery. Thus, the scale of the discretionary measures underpinning the recent budgetary strategy has been substantially reduced over time and the projected improvements in headline deficit derive mainly from the ongoing cyclical recovery. The structural balance is forecast to decline by 0.1% of GDP over 2014-2016, with a procyclical loosening of the fiscal stance of around 0.6% of GDP in 2015. The current budgetary strategy is hence considered to be less sustainable than the one in place at the end of the Programme. Given the high level of public debt and financing needs, significantly more ambitious reforms - especially on the expenditure side - will be needed to comply with the medium-term budget framework.

The gross debt-to-GDP ratio is forecast to have reached about 129% of GDP by the end of 2014 and to fall to 125% of GDP in 2015. Higher deposits and the depreciation of the euro are the main reasons for the recent upward revisions in the projected debt stock at the end of 2014, while the net debt is estimated to have reached 121% of GDP at the end of 2014 (lower than previously anticipated). The downward path expected from 2015 should be supported by debt-reducing operations, the projected economic recovery and primary budget surpluses if fiscal discipline is maintained.

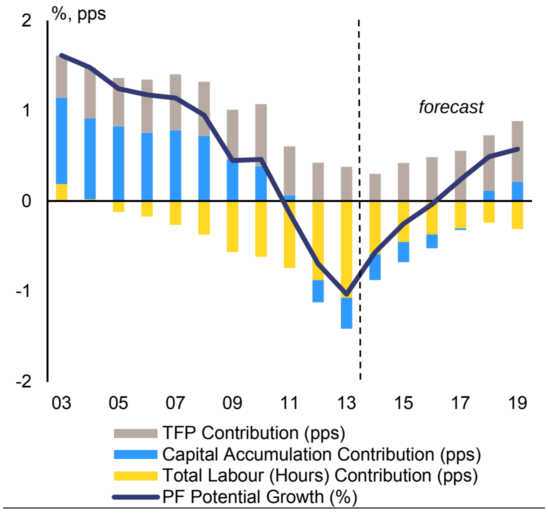
After Portugal joined the European Monetary Union, competitiveness was undermined by rapidly rising nominal unit labour costs and deep-seated structural problems in the product and labour markets. As a consequence of persistent current account deficits, Portugal accumulated a high external debt, which was mirrored domestically in the rising indebtedness of both the private and the public sectors. Portugal started to address these imbalances when the financial and economic crisis broke out in 2008. Gradual deleveraging in the private sector and some rebalancing of production from the non-tradable to the tradable sector have since helped to improve external sustainability and contain macro-financial risks. After its peak in 2013, unemployment has been reduced but remains at high levels.

Portugal's deep-seated structural problems have set potential growth on a downward trajectory since the late 1990s. This was

([1]) The poverty gap is defined as the difference between the median equivalised total net income of persons below the at-risk-of-poverty threshold and the at-risk-of-poverty threshold, expressed as a percentage of the at-risk-of-poverty threshold. It provides an indication of the severity of poverty for those experiencing it.

aggravated by an inefficient allocation of resources, as investment was mainly channelled to the non-tradable sectors. During the 2000s, potential growth showed a downward trend mainly due to negative growth contributions of labour supply and investment, while the growth contribution of total factor productivity (TFP) has been fairly stable. Between 2009 and 2013, strong increases in unemployment and a slump in investment activity accelerated the decline in potential growth. In the medium term, potential growth is expected to be supported by a recovery in investment and further improvements of the labour market (Graph 1.3).

Graph 1.3: **Contributions to potential growth in 2003-19**



Source: European Commission

However, potential growth is not projected to resume the growth rates it experienced before the economic and financial crisis. The main impediments to a further acceleration of potential output are ongoing deleveraging pressures in the corporate sector (holding back investment), an unfavourable demographic outlook and persistently high unemployment (dampening labour supply), as well as the workforce's low average skill levels combined with outstanding inefficiencies in product and labour markets (dragging on TFP growth). Structural rigidities keep the potential growth rate from returning to around 2%, which would be necessary to ensure public debt sustainability.

Box 1.1: **Economic surveillance process**

The Commission's Annual Growth Survey, adopted in November 2014, started the 2015 European Semester, proposing that the EU pursue an integrated approach to economic policy built around three main pillars: boosting investment, accelerating structural reforms and pursuing responsible growth-friendly fiscal consolidation. The Annual Growth Survey also presented the process of streamlining the European Semester to increase the effectiveness of economic policy coordination at the EU level through greater accountability and by encouraging greater ownership by all actors.

In line with streamlining efforts this Country Report includes an In-Depth Review — as per Article 5 of Regulation no. 1176/2011 — to determine whether macroeconomic imbalances still exist, as announced in the Commission's Alert Mechanism Report published on November 2014.

This Country Report includes an assessment of progress towards the implementation of the 2014 Country-Specific Recommendations adopted by the Council in July 2014. The Country-Specific Recommendations for Portugal concerned public finances, labour market and social policies, the financial sector and access to finance, network industries, housing, product and services markets, the modernisation of public administration and the evaluation of structural reforms.

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

	2008	2009	2010	2011	2012	2013	Forecast 2014	2015	2016
Real GDP (y-o-y)	0.2	-3.0	1.9	-1.8	-3.3	-1.4	1.0	1.6	1.7
Private consumption (y-o-y)	1.4	-2.3	2.4	-3.6	-5.2	-1.4	2.1	1.8	1.5
Public consumption (y-o-y)	0.4	2.6	-1.3	-3.8	-4.3	-1.9	-0.5	-0.3	0.2
Gross fixed capital formation (y-o-y)	0.4	-7.6	-0.9	-12.5	-15.0	-6.3	2.4	2.9	3.1
Exports of goods and services (y-o-y)	-0.3	-10.2	9.5	7.0	3.1	6.4	3.8	5.0	5.4
Imports of goods and services (y-o-y)	2.5	-9.9	7.8	-5.8	-6.6	3.6	5.9	4.9	4.8
Output gap	0.2	-3.3	-1.9	-3.5	-6.1	-6.4	-4.9	-3.1	-1.4
Contribution to GDP growth:									
Domestic demand (y-o-y)	1.1	-2.8	1.1	-5.7	-7.0	-2.3	1.6	1.6	1.4
Inventories (y-o-y)	0.1	-1.2	0.9	-0.4	0.1	0.0	0.2	0.0	0.0
Net exports (y-o-y)	-1.1	0.9	-0.1	4.3	3.6	1.0	-0.8	0.1	0.3
Current account balance (% of GDP), balance of payments	-12.1	-10.4	-10.1	-6.2	-2.1	0.7	.	.	.
Trade balance (% of GDP), balance of payments	-9.4	-6.7	-7.1	-3.5	0.1	2.1	.	.	.
Terms of trade of goods and services (y-o-y)	-2.3	4.8	-1.3	-2.0	0.2	1.6	1.8	1.6	0.4
Net international investment position (% of GDP)	-95.1	-107.9	-104.3	-101.0	-113.8	-116.2	.	.	.
Net external debt (% of GDP)	75.2*	84.8*	83.2*	85.9*	103.0*	.	.	.	.
Gross external debt (% of GDP)	202.67	225.51	226.73	218.8	235.3	226.6	.	.	.
Export performance vs advanced countries (% change over 5 years)	-1.1	-0.3	0.7	-0.2	-6.8	1.5	.	.	.
Export market share, goods and services (%)	0.4	0.4	0.4	0.4	0.4	0.4	.	.	.
Savings rate of households (net saving as percentage of net disposable income)	-1.1	2.7	1.3	-0.9	1.1	1.7	.	.	.
Private credit flow, consolidated, (% of GDP)	15.9	5.3	5.3	0.4	-2.7	-2.4	.	.	.
Private sector debt, consolidated (% of GDP)	196.2	204.1	201.5	204.2	207.8	202.8	.	.	.
Deflated house price index (y-o-y)	1.2	1.4	-0.5	-7.2	-8.4	-2.2	.	.	.
Residential investment (% of GDP)	4.7	4.1	3.6	3.3	2.7	2.3	.	.	.
Total financial sector liabilities, non-consolidated (y-o-y)	3.0	6.7	6.3	-8.8	-3.1	-4.2	.	.	.
Tier 1 ratio[1]	.	.	.	.	.	.	.	.	.
Overall solvency ratio[2]	.	.	.	.	.	.	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances)[2]	.	.	.	.	.	.	.	.	.
Change in employment (number of people, y-o-y)	0.5	-2.9	-1.4	-2.3	-4.0	-2.7	1.8	0.7	0.7
Unemployment rate	8.7	10.7	12.0	12.9	15.8	16.4	14.2	13.4	12.6
Long-term unemployment rate (% of active population)	4.1	4.7	6.3	6.2	7.7	9.3	.	.	.
Youth unemployment rate (% of active population in the same age group)	21.5	25.3	27.9	30.3	37.9	38.1	34.7	.	.
Activity rate (15-64 year-olds)	73.9	73.4	73.7	73.6	73.4	73.0	.	.	.
Young people not in employment, education or training (%)	10.2	11.2	11.4	12.6	13.9	14.1	.	.	.
People at risk of poverty or social exclusion (% of total population)	26.0	24.9	25.3	24.4	25.3	27.5	.	.	.
At-risk-of-poverty rate (% of total population)	18.5	17.9	17.9	18.0	17.9	18.7	.	.	.
Severe material deprivation rate (% of total population)	9.7	9.1	9.0	8.3	8.6	10.9	.	.	.
Number of people living in households with very low work-intensity (% of total population aged below 60)	6.3	7.0	8.6	8.3	10.1	12.2	.	.	.
GDP deflator (y-o-y)	1.7	1.1	0.6	-0.3	-0.4	2.3	1.0	1.0	1.4
Harmonised index of consumer prices (HICP) (y-o-y)	2.7	-0.9	1.4	3.6	2.8	0.4	-0.2	0.1	1.1
Nominal compensation per employee (y-o-y)	2.6	2.4	2.1	-1.8	-2.1	3.5	-0.5	0.7	0.8
Labour productivity (real, person employed, y-o-y)	-0.2	-0.3	3.4	0.1	0.8	1.6	.	.	.
Unit labour costs (ULC) (whole economy, y-o-y)	2.8	2.7	-1.2	-2.0	-2.9	1.9	0.2	-0.2	-0.2
Real unit labour costs (y-o-y)	1.0	1.6	-1.9	-1.7	-2.5	-0.4	-0.8	-1.2	-1.5
REER[3)] (ULC, y-o-y)	0.5	0.0	-2.5	-2.1	-5.5	2.4	-0.5	-2.5	-0.9
REER[3)] (HICP, y-o-y)	-1.4	-0.4	-3.5	1.4	-1.4	0.0	0.7	-1.0	-0.9
General government balance (% of GDP)	-3.8	-9.8	-11.2	-7.4	-5.5	-4.9	-4.6	-3.2	-2.8
Structural budget balance (% of GDP)	.	.	-7.5	-5.5	-2.3	-2.0	-1.2	-1.7	-2.1
General government gross debt (% of GDP)	71.7	83.6	96.2	111.1	124.8	128.0	128.9	124.5	123.5

(1) Domestic banking groups and stand-alone banks.
(2) Domestic banking groups and stand-alone banks, foreign-controlled (EU and non-EU) subsidiaries and branches.
(3) Real effective exchange rate.
(*) Indicates BPM5 and/or ESA95
Source: European Commission, 2015 winter forecast; ECB

Table 1.2: **The MIP scoreboard for Portugal**

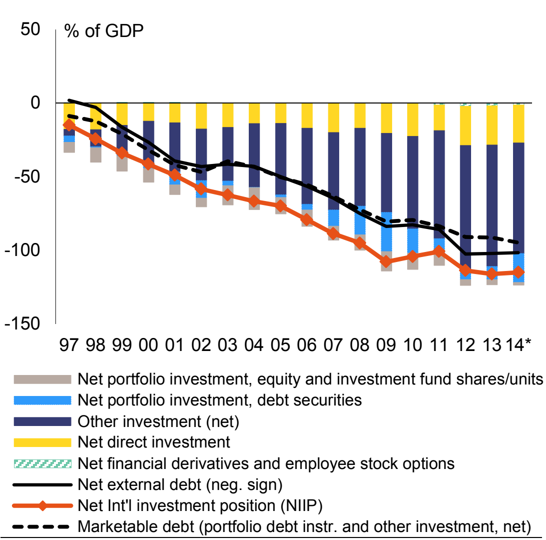
			Thresholds	2008	2009	2010	2011	2012	2013
External imbalances and competitiveness	Current Account Balance (% of GDP)	3 year average	-4%/6%	-10.8	-10.8	-10.9	-8.9	-6.1	-2.5
		p.m.: level year	-	-12.1	-10.4	-10.1	-6.2	-2.0	0.7
	Net international investment position (% of GDP)		-35%	-95.1	-107.9	-104.3	-101.0	-113.8	-116.2
	Real effective exchange rate (REER) (42 industrial countries - HICP deflator)	% change (3 years)	±5% & ±11%	2.0	1.0	-3.1	-3.0	-4.0	-0.6
		p.m.: % y-o-y change	-	0.6	-0.6	-3.1	0.7	-1.6	0.3
	Export Market shares	% change (5 years)	-6%	-12.6	-8.8	-7.8	-8.9	-15.7	-5.3
		p.m.: % y-o-y change	-	-4.1	0.7	-9.3	0.9	-4.6	7.7
	Nominal unit labour costs (ULC)	% change (3 years)	9% & 12%	4.5	6.6	4.2	-0.6	-6.0e	-3.0e
		p.m.: % y-o-y change	-	2.8	2.7	-1.2	-2.0	-2.9e	1.9e
Internal imbalances	Deflated House Prices (% y-o-y change)		6%	1.0b	1.0	-1.0	-6.5	-8.3	-2.5
	Private Sector Credit Flow as % of GDP, consolidated		14%	15.9	5.3	5.3	0.4	-2.7e	-2.4e
	Private Sector Debt as % of GDP, consolidated		133%	196.2	204.2	201.5	204.2	207.8e	202.8e
	General Government Sector Debt as % of GDP		60%	71.7	83.6	96.2	111.1	124.8	128.0
	Unemployment Rate	3-year average	10%	8.7e	9.3e	10.4e	11.8e	13.6e	15.0
		p.m.: level year	-	8.5e	10.6e	12.0e	12.9	15.8	16.4
	Total Financial Sector Liabilities (% y-o-y change)		16.5%	4.4	8.9	11.5	-4.6	-3.7	-5.3

Flags: b: break in time series. e: estimated.
Note: 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 according to the old standards (ESA95/BPM5). (2) Export market shares data: the total world export is based on the 5th edition of the Balance of Payments Manual (BPM5).
Source: European Commission

2. IMBALANCES, RISKS AND ADJUSTMENT

Portugal's Net International Investment Position (NIIP) remains very negative, notwithstanding the recent substantial current account adjustment.(2) The NIIP deteriorated sharply in the first decade after the introduction of the euro, but its decline slowed down after 2010, reaching about -115% of GDP in 2014 (Graph 2.1.1). A high level of net external debt makes the economy vulnerable to reversals of capital flows or sudden hiatuses. To improve the NIIP in the long term, persistent and sizeable current account surpluses are needed. The problem is aggravated by the fact that past current account deficits fuelled inefficient spending on private consumption and investment in construction and property, rather than increasing the productive capital stock, which would have improved the economy's ability to repay foreign debt. Indeed, low investment efficiency appears to be a particular problem in Portugal as its 'incremental capital-output ratio' (ICOR)(3) is relatively high, pointing to low investment productivity (Table 2.1.1).(4)

Graph 2.1.1: **Breakdown of Portugal's Net International Investment Position (NIIP)**



Source: European Commission

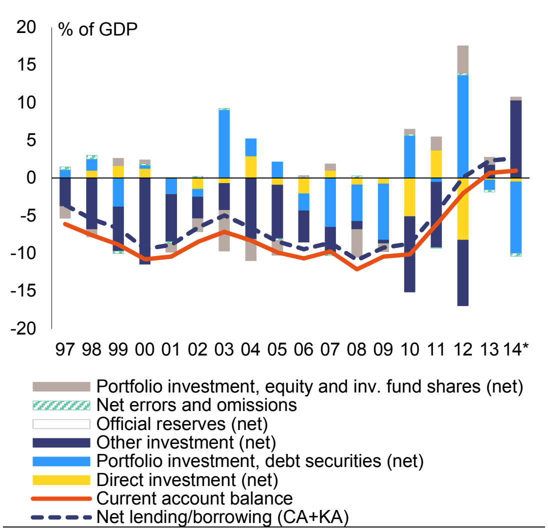
Table 2.1.1: **ICOR (5-year average growth) in selected euro area countries**

ICOR (average growth in %)	1994-1998	1999-2003	2004-2008	2009-2013
Ireland	2.2	3.8	2.0	-3.4
Greece	6.5	5.6	-2.9	-2.9
Spain	7.3	6.9	11.3	91.6
Italy	10.4	50.9	8.3	4.7
Portugal	**8.0**	**6.8**	**35.2**	**-4.5**

Source: European Commission

Low investment efficiency may be the consequence of Portugal's lost attractiveness as an investment location. Since the mid-1990s, other investment, mostly through banks, has been the most important source of current account financing, fuelling the credit booms which preceded the economic and financial crisis (Graph 2.1.2). At the same time, inward FDI dried up, partly as a result of Asia and Eastern Europe's emergence as competitors for FDI, and partly because of home-made problems such as rigid labour and product markets and a difficult business environment. The recent pick-up in the inflow of FDI is related to privatisation. Portfolio investment became increasingly important in financing the current account between 2007 and 2009 reflecting to some extent a hunt for yield.

Graph 2.1.2: **Current account financing**



Source: European Commission

Sustained sizeable current account surpluses would be required in order to halve the very negative NIIP within ten years. The Commission estimates that Portugal would need to run average current account surpluses of around 2.5% of GDP over the next decade to halve the negative NIIP (currently about -115% of GDP) by

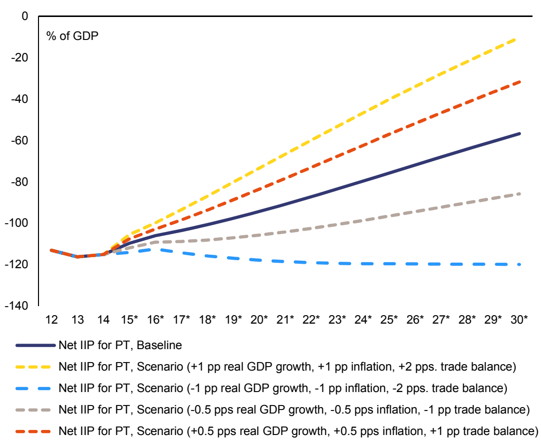
(2) Greece and Cyprus are the only EU countries reporting a more negative International Investment Position than Portugal.

(3) The inverse of the ICOR = *(I/Y)/(ΔY/Y)* is a measure of output growth associated with any given investment. Other things being equal, a lower ICOR indicates higher quality or efficiency of investment.

(4) Baldi et al. (2014), 'Weak Investment Dampens Europe's Growth', DIW Economic Bulletin, DIW.

2024. Average current account surpluses of around 0.5% of GDP would reduce the NIIP to -80% of GDP by 2024 (Graph 2.1.3). However, Portugal's external debt position is sensitive to macroeconomic shocks. For instance, a simultaneous 1 pp. permanent drop in the increase of real GDP and the GDP deflator, combined with a fall in the trade balance of 2 pps of GDP, would stop the decline in the negative NIIP from falling further. Conversely, a positive growth, inflation and trade balance shock of similar size would lead to a substantial improvement in the NIIP to around -47% of GDP by 2024.

Graph 2.1.3: **NIIP sensitivity to macroeconomic shocks**



Source: European Commission

The sustainability of Portugal's external position also depends on the structure of its financing. The composition of the NIIP has changed significantly since 2004 with the share of other investment now clearly predominant (Table 2.1.2).([5]) This shift from portfolio investment to debt in financing the NIIP increases external vulnerabilities.([6]) NIIP financing through FDI, which can be viewed as the most sustainable option, as it not only allows risk sharing with foreign investors but also brings technology and entrepreneurial spirit to the economy, has improved recently as a result of the privatisation process.

Table 2.1.2: **Structure of the NIIP**

	2004	2009	2013
Portfolio Investment (%)	21	34	9
FDI (%)	22	18	21
Other Investment (%)	56	48	70

Source: European Commission

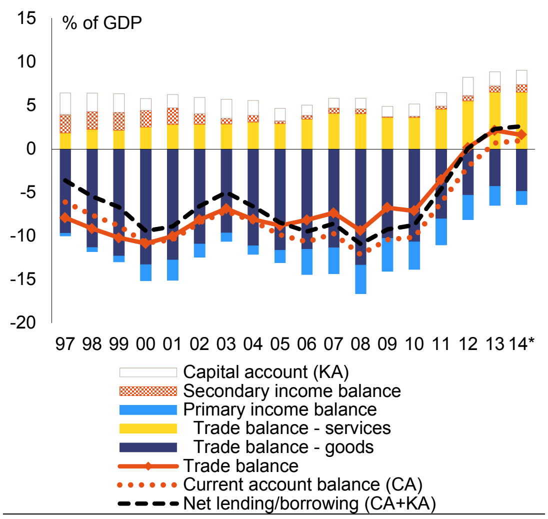
Portugal had a substantial current account deficit for many years which started to reverse with the onset of the economic and financial crisis. Starting from a deficit of around 12% of GDP in 2008, the current account is expected to have posted a surplus for the second consecutive year, at around 1% of GDP in 2014 (Graph 2.1.4).([7]) The positive trajectory of the current account has been mainly due to the remarkable improvements in the trade balance, reflecting both import compression due to weak domestic demand and improved external competitiveness. This contrasts with the persistently negative primary income balance, which is linked to the past strong increase in net external debt and includes interest payments linked to portfolio and other investments. The deficit in the primary income balance will be a drag on the current account balance for some time to come. However, owing to a reversal in migration flows and additional support from family members abroad in times of crises, remittances from Portuguese citizens working abroad have risen significantly in recent years (reaching 1.6% of GDP in 2013), thereby contributing to a substantial increase in the balance of transfers. Traditionally positive, the balance of capital transfers, mainly from the EU, is also likely to remain stable in the coming years. The improvement in the current account is reflected in Portugal's net external lending position, which turned positive in 2013 as a result of the gradual deleveraging in the household and non-financial corporations sectors and the fiscal consolidation leading to reduced general government deficits (Graph 2.1.5).

([5]) Other investments include the financing received during the economic adjustment programme, which accounted for about 40% of total NIIP in 2013.

([6]) It is riskier to finance the current account through loans than through equity as equity flows allow risk sharing between domestic and foreign investors, while debt flows do not.

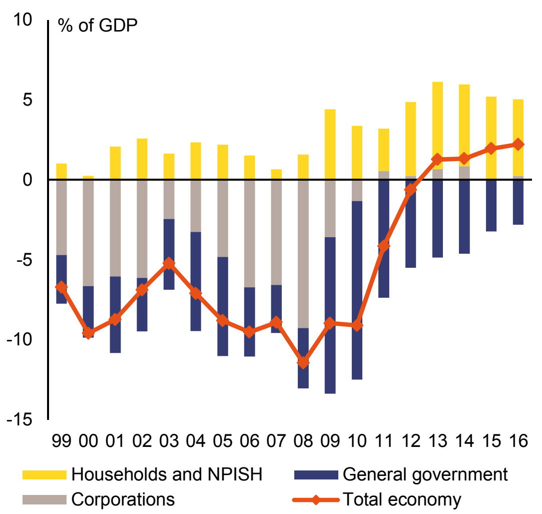
([7]) The current account and net lending/ borrowing components are reported in accordance with the BoP methodology under the reviewed ESA2010 and BPM6. The measurement of the current account using National Accounts provides a similar picture of a marked turnaround of the current account balance since 2008, although it is estimated to have remained negative still in 2014.

Graph 2.1.4: **External position and its components**



Source: European Commission

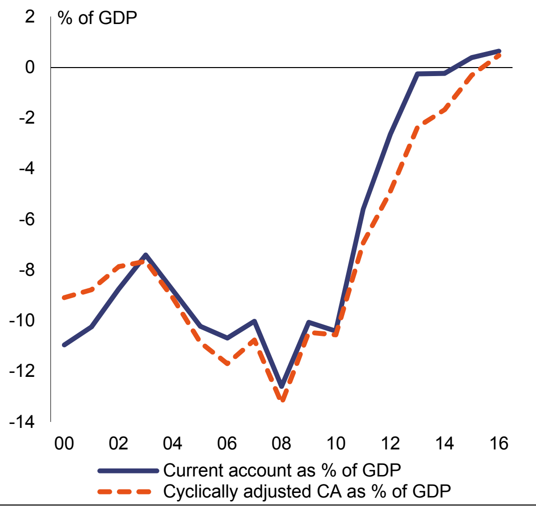
Graph 2.1.5: **Net lending/ borrowing by sector**



Source: European Commission

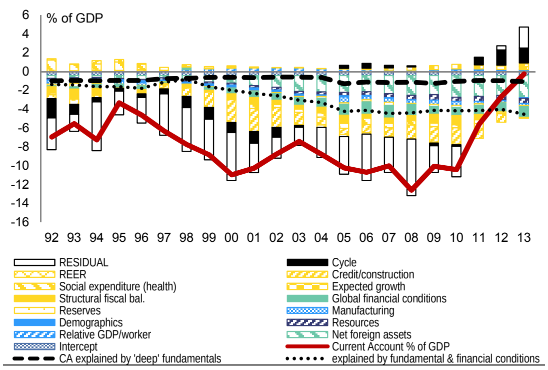
The adjustment of the current account has been largely structural. Despite the import compression during the recession, cyclical drivers played a limited role in the current account adjustment between 2010 and 2013 (Graph 2.1.6), accounting for only about 18% of the 10 pps. of GDP total increase in the current account balance (Graph 2.1.7).([8]) Structural fiscal consolidation is estimated to have contributed about 10% to the current account rebalancing in 2010-13, while the fall in private sector debt, the slump in construction activity and the slowdown in private sector borrowing each contributed around 5% to the total adjustment of the current account.

Graph 2.1.6: **Portugal's headline and structural current account balance**



Source: European Commission

Graph 2.1.7: **Breakdown of Portugal's current account into cyclical and structural components**



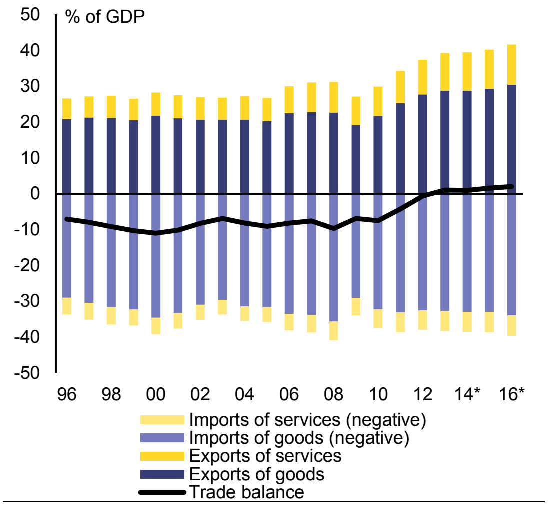
Source: European Commission

Despite the substantial structural improvement of the current account, Portugal's external position remains vulnerable. In particular, the highly negative net foreign asset position has become a major drag on the current account, in itself implying a structural deficit of around 3.5% of GDP.

([8]) About 54% of the swing in the current account in 2010-13 is presumably due to "residual" structural factors, such as improved product and geographical specialisation of exports.

A robust export performance contributed to the external rebalancing of the Portuguese economy. Export growth was subdued in the 2000s. Since 2008, however, this trend has been reversed by significant improvements in external competitiveness, and exports' share in GDP rose from 27% in 2009 to around 40% in 2013 (see Graph 2.1.8). This is still a relatively low level compared with other small and open economies in the euro area. It is a reminder that the rebalancing towards export-led growth needs to continue in order to sustain the improvement in the current account.([9]) Export growth was driven mainly by exports of goods, which increased their share in GDP from 19% in 2009 to 29% in 2013. In the same period, Portugal's export market share increased as annual export growth outpaced growth in foreign demand for Portuguese exports products by 3.7% on average, In National Accounts terms.

Graph 2.1.8: **Imports and exports of goods and services as a proportion of GDP**

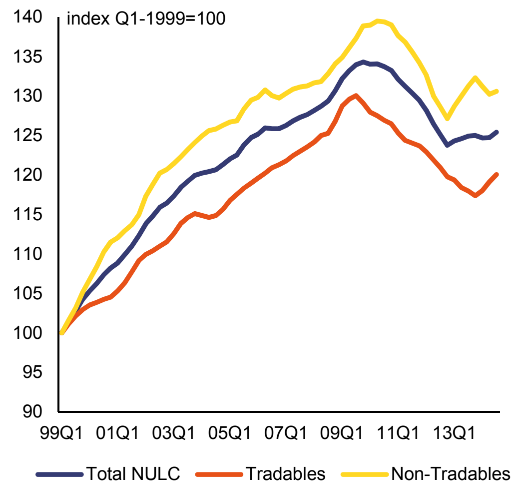


Source: European Commission

Imports have been compressed by falling domestic demand during the economic and financial crisis. Falling expenditure on investment and consumption weighed on import demand during the economic downturn and compensated for the additional boost to imports provided by the recovery in exports. As a result, the import share in GDP remained fairly constant at around 38% between 2010 and 2013 (Graph 2.1.8). However, this share is set to increase as the economic recovery is increasingly led by domestic demand (see Section 1).

The recent upswing in exports was supported by favourable trends in nominal unit labour costs (ULCs) developments. In the first decade after the introduction of the euro, nominal unit labour costs rose faster than in other euro area countries, due to faster increases in nominal compensation per employee and lower growth rates in productivity. This was particularly the case in the first years of the euro. The upward trend in ULCs in the tradable sector reversed in 2010 and ULCs fell by an average of almost 7% by the end of 2013, owing to productivity increases coming along with job cuts (Graph 2.1.9). However, the fall in ULCs in the tradable sector seems to have reversed recently, highlighting the challenge of generating employment while containing price pressures in the tradable sector. The correction of nominal ULCs in the non-tradable sector did not get under way until 2011, and this adjustment was dampened at the end of 2013 by a reinstatement of a part of the wages in the public sector that had been cut to support fiscal consolidation.

Graph 2.1.9: **Nominal ULC trends in tradable and non-tradable sectors**

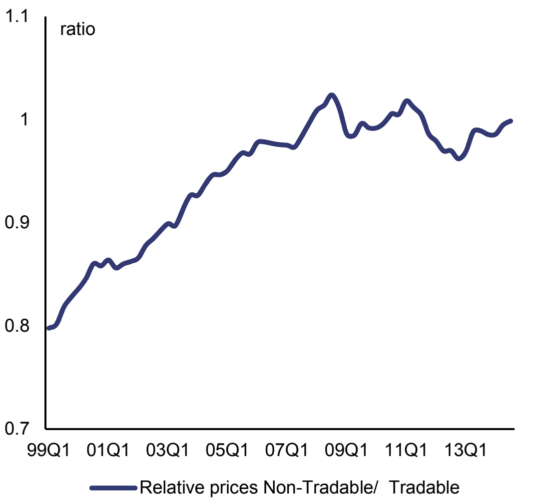


Source: European Commission

([9]) Exports still account for a small proportion of GDP in 2013 in comparison with other countries in the euro area such as Ireland (105%), The Netherlands (83%), Belgium (83%) or Austria (54%).

Successful rebalancing of the economy from the non-tradable sector to the tradable sector also requires flexibility in product markets. Further product market reforms are necessary to tackle structural weaknesses and rigidities in the non-tradable sector, especially the network industries. This would cut production costs for exporters and boost competitiveness in general. Relative prices rose until the onset of the economic crisis but adjusted markedly in 2010-12 (Graph 2.1.10) as structural reforms dampened the rising prices of non-tradables; another even more significant factor was the shift in the export product mix to higher value-added exports with higher price tags. Both trends are conducive to the further rebalancing towards the tradable sector.

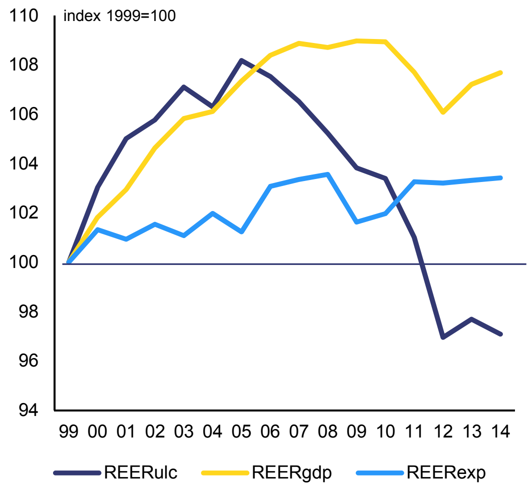
Graph 2.1.10: **Relative prices of tradables and non-tradables in Portugal**



Source: European Commission

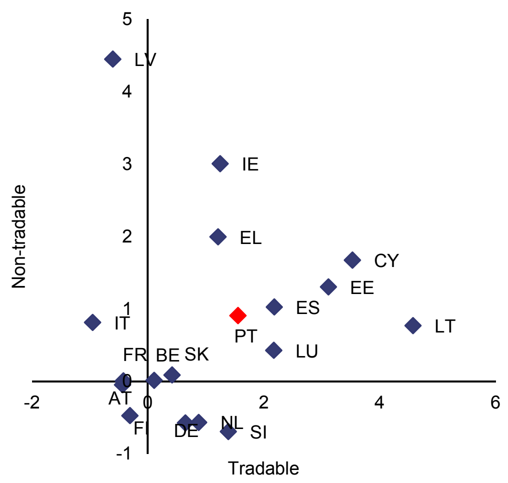
In addition, the real effective exchange rate has adjusted significantly in recent years. The stronger adjustment occurred in the ULC-based real effective exchange rate (Graph 2.1.11). That adjustment was particularly marked between 2010 and 2012, when unit labour costs fell with productivity growing faster than the nominal wage. The significant drop in employment contributed to productivity growth, while nominal wage rigidities limited the extent of nominal wage adjustment, which might only have occurred at the margin, i.e. for new contracts.

Graph 2.1.11: **Real effective exchange rates in relation to the EA-17**



Source: European Commission

Graph 2.1.12: **Average growth rate in profit margins (2010-13)**



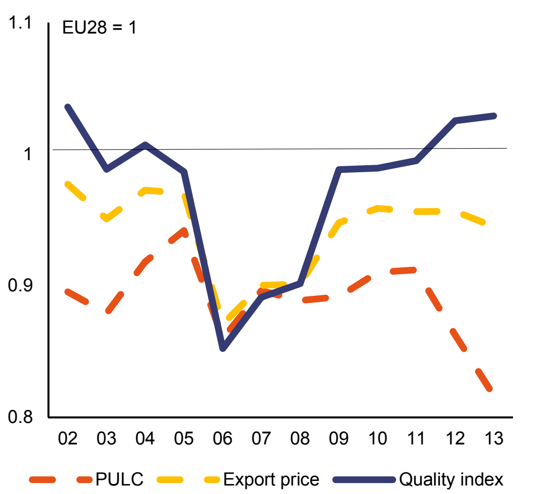
Source: European Commission

The adjustment in both real wages and unit labour costs is consistent with the challenges of unemployment absorption and external rebalancing. The adjustment achieved needs to be preserved in view of the internal and external equilibria.([10]) In addition, wage differentiation may facilitate the reallocation of resources towards

([10]) See European Commission, 'The Economic Adjustment Programme for Portugal tenth review', European Economy, Occasional Paper 171, 2014', pp. 41-43.

tradable sectors, contributing to productivity growth and higher export capacity. Graph 2.1.11 shows that the sharp downward adjustment in ULC-based real effective exchange rate (REER) was accompanied by a more muted decline in the REER based on the GDP deflator. This is consistent with the adjustment of real wages to the labour market slack, but may indicate a more limited responsiveness of price-cost margins to weak economic conditions. Nonetheless, developments in unit labour costs alone could play an important role in boosting the export sector as long as profit margins are higher in the tradable sectors, so that resources are shifted to tradable industries. Graph 2.1.12 shows that profit margins in the tradable sectors grew somewhat faster than in the non-tradable sectors between 2010 and 2013.

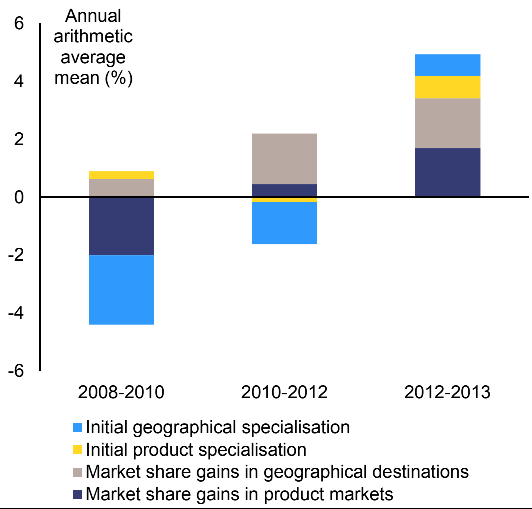
Graph 2.1.13: **PULCs, quality and prices of Portuguese exports, by comparison with the EU28 average**



Source: European Commission, Joint Research Centre, IPTS institute

Portugal has improved its capacity to compete in export markets by improving in production efficiency and product quality. Relative physical unit labour costs (PULCs)([11]) in Portugal fluctuated at about 90% of the EU average until 2011, but have since dropped markedly, highlighting the competitiveness gains resulting from lower production costs (Graph 2.1.13). This fall, however, has not been matched by a similar fall in relative export prices, which suggests that Portuguese exporters have managed to extract higher profit margins from their exports, possibly by 'upgrading' their export product portfolio. Indeed, there is evidence of continued improvement in the quality of Portuguese exports by comparison with the EU average. This is captured by the 'Quality Index' (Graph 2.1.13), which measures the capacity of exporting companies to charge higher prices. However, while the quality of Portuguese exports has outperformed the rest of the EU in some specific sectors, Portugal's export sector still specialises in products with lower average prices and quality.

Graph 2.1.14: **Geographical and sectoral breakdown of export market share growth in Portugal**



Source: European Commission

Both product and geographical specialisation have contributed to the increase in export market shares since 2010. The unfavourable geographical specialisation and product mix of Portugal's exports led to falling export market shares between 2008 and 2010. However, this trend has since reversed and export market shares are now being boosted as Portugal's exporters make inroads into faster growing export markets with export products that are in greater demand. Due to the recovery in the main European trading partners,([12]) the initial geographical specialisation

([11]) Physical unit labour costs (PULCs) are defined as the unit labour cost, in euros, of producing a given quantity of an export product.

([12]) The three main Portuguese trading partners belong to the euro area, i.e. Spain, Germany and France. They account for about 50% of total exports.

has recently boosted Portugal's export market shares (Graph 2.1.14).

Despite recent improvements in the structure of its exports, Portuguese firms are still specialised in relatively cheap and low-quality products. Since 2006, the share of capital goods in Portuguese exports has only increased by 1.4 pps, while the share of consumer goods fell by 1.3 pps. Capital goods are generally high value added products which compete through good quality. In 2013, the share of capital goods in Portuguese exports was still markedly lower than their share in aggregate EU28 exports (see Table 2.1.3). Portugal's higher proportion of consumer goods in total exports signals the need to strengthen higher value-added production.

Table 2.1.3: **Structure of goods exports by broad economic category (in %)**

Portugal	2006	2009	2013
Intermediate goods	56.0	52.8	55.9
Capital goods	8.4	9.9	9.8
Consumption goods	35.6	37.3	34.3
EU28	**2006**	**2009**	**2013**
Intermediate goods	53.0	51.2	54.2
Capital goods	18.7	17.6	17.1
Consumption goods	28.3	31.2	28.8

Source: European Commission

Portuguese exports of services have remained broadly constant as a proportion of worldwide service exports over the last decade. Growing exports of transport services were broadly offset by the decline in tourism and other services (Table 2.1.4). Transport sector services are characterised as high value added and their expansion may reflect significant productivity gains. Overall, exports of services have been growing in importance in the Portuguese economy. Portuguese exports of services accounted for 27% of total exports of goods and services between 2007 and 2013 - 3 pps. higher than between 2000 and 2006. The ratio of Portuguese exports of services to GDP also rose from an average of 6.5% (2000-06) to 8.9% between 2007 and 2013. Despite this increase, Portuguese exports of services as a proportion of GDP are still lower than in other small and open European countries, such as Belgium, Ireland or the Netherlands.

Table 2.1.4: **World market shares for services (in %)**

	2000-2001	2012-2013
Total Services	0.6	0.6
Transportation	0.4	0.8
Travel	1.1	1.0
Other services	0.3	0.3

Source: European Commission

So far, Portugal has made significant progress to date in adjusting its external and internal imbalances. However, despite major improvements, the adjustment is not complete and large external liabilities still represent a major source of vulnerabilities. The NIIP position has worsened further, as recent improvements in the current account are not sufficient to counterbalance the negative changes in the NIIP. In the past, substantial improvements in cost developments, particularly in the non-tradable sector, along with the improved quality of exported goods, have boosted competitiveness and exporters' capacity to participate successfully in international markets. Further improvements of cost developments will have to take place in a low inflation environment and may be hampered by existent inefficiencies and rigidities in the domestic market. Wide-ranging reforms in product and services markets could help ensure that capital is allocated efficiently to where it is most productive and would produce higher productivity and long-term growth.

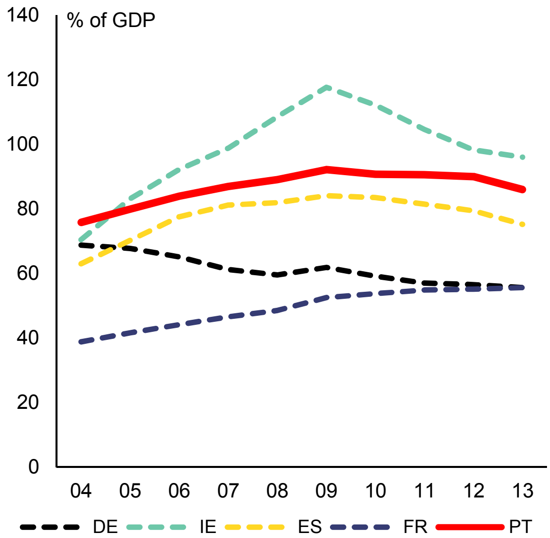
2.2. DEBT OVERHANG AND DELEVERAGING

Portugal has undergone a severe recession characterised by corporate financial distress, a struggling banking sector and accelerating public debt. In the post-Programme context, the high financial leverage of Portuguese firms continues to be a critical factor constraining firms' performance and impeding economic recovery. This section first looks at trends in household and, in particular, non-financial corporate sector indebtedness and at key policy measures taken to improve the financial situation of non-financial corporations (NFCs). The second part of this section highlights public debt sustainability issues.

Deleveraging dynamics in the private sector

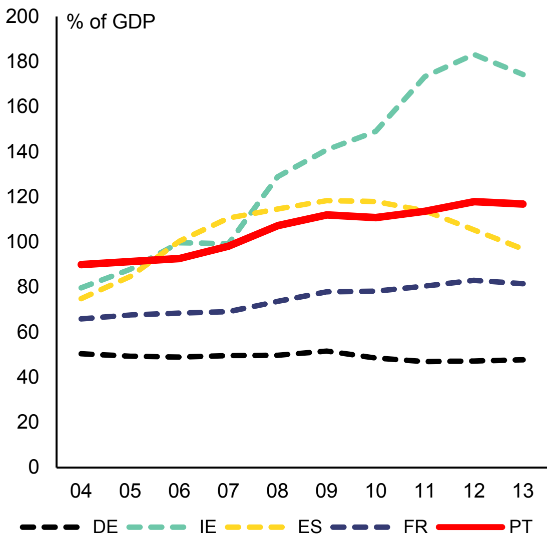
Portugal has made significant progress with reforming its economy in the context of a deep economic crisis. Three years of determinated efforts have enabled the country to successfully exit the economic adjustment programme in June 2014. Undeniably, Portugal has come a long way in improving its private sector imbalances, one of the Programme's key areas. In recent years, the households' savings rate rose considerably to about 10% of disposable income (from 7% in 2008), while indebtedness fell from nearly 95% of GDP in 2009 to just over 80% of GDP in the final quarter of 2014. This allowed the highly leveraged financial sector to significantly lower its loans-to-deposit ratio which resulted from a higher stock of deposits and decreasing stock of loans. The household sector adjustment is even more remarkable as it occurred in the midst of a pan-European financial crisis and against the background of declining disposable income. Nonetheless, the difficult financial situation of Portuguese households is reflected in the large number of insolvent borrowers, which started to rise as far as back in 2008. Between January and November 2014, the number of individuals filing for bankruptcy reached 12,979, over three times as much as in 2010, according to Instituto Informador Comercial (IIC). However, 2014 marks a 2% improvement when compared with the same period in 2013. According to Banco de Portugal, the ratio of non-performing household loans continues to rise, reaching 4.9% in the third quarter of 2014 (up by 0.2 pp. quarter-on-quarter), and around 660,000(individuals – representing about 15% of all individual borrowers – had overdue loans.

Graph 2.2.1: **Household indebtedness as a percentage of GDP**



Source: European Commission

Graph 2.2.2: **Private NFC indebtedness as a percentage of GDP**

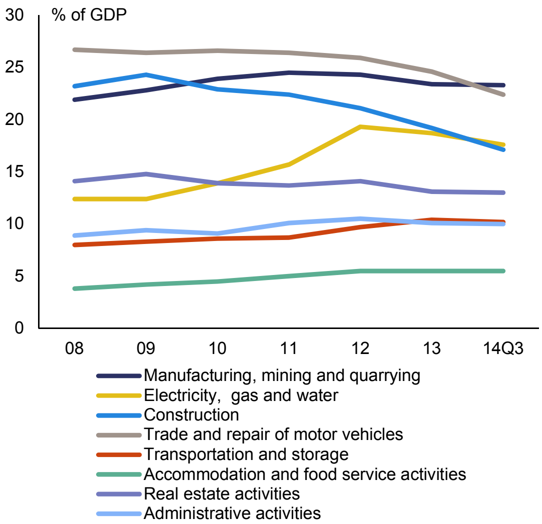


(1) Excluding trade finance and intercompany lending.
Source: European Commission

Deteriorating growth prospects and changing attitudes to risk have prompted non-financial corporations to adjust their balance sheets, although to a lesser extent than households. The very high indebtedness of non-financial corporations, both by historical standards and compared to other euro area economies, remains a major vulnerability of the Portuguese economy. There is a vast literature confirming the importance of liquidity, financial structure and financial distress on firm performance. Recent empirical studies, often based on experience from previous economic and financial crises, suggest that corporate debt levels above 90% of GDP([13]) can act as a major drag on economic growth, as higher indebted companies are less likely to invest and hire. Portuguese private corporate debt stood at 149.2%([14]) of GDP in September 2014, which is some 18 pps. lower than the peak level of 167.4% in 2012. Accounting for the total NFC sector debt including public corporations and all inter-company lending, the stock of debt amounts to a staggering 172% the GDP, which is close to double the above mentioned threshold. For a significant set of corporations the balance sheet adjustment has been rather disappointing on average, and Portugal's corporate sector remains one of the most indebted in Europe. This high level of corporate indebtedness hinders corporate profitability and has a negative impact on the investments required to stimulate growth in the tradable sector.([15]) Moreover, the high debt ratio of Portuguese non-financial corporations represents a major concern for the banks' balance sheets and the country's wider financial stability, through the large number of non-performing loans (NPLs) and corporate bankruptcies.

Pursuing orderly deleveraging in the various highly indebted sectors of the Portuguese economy, while at the same time stimulating economic growth, remains a key challenge. The banking sector plays a crucial role in this context by reallocating of resources to the most productive and innovative segments of the economy. A selective approach to corporate credit is essential to ensure the long-term viability and competitiveness of private sector firms. The internal rebalancing of the Portuguese economy depends on striking the right balance between deleveraging on the one hand and reallocating resources on the other. This is further complicated by a low-growth and low-inflation environment in Portugal, representing a challenge to the operations and profitability of Portuguese firms and to the domestic banking sector, which is highly exposed to low interest rates through a large stock of legacy mortgages.([16])

Graph 2.2.3: **Breakdown by sector, total debt-to-GDP ratios**



Source: Banco de Portugal

Table 2.2.1: **Debt-to-equity and return on equity ratios, broken down by sector**

	Debt-to-Equity		Return-on-Equity	
	2008	2013	2008	2013
Agricultural and Fishing	2.2	1.6	-1.2%	-0.6%
Manufacturing and Energy	2.1	2.2	5.7%	7.3%
Construction and Real Estate	3.5	3.1	-2.6%	-4.0%
Distributive Trade	2.7	2.3	4.5%	2.7%
Transportation and Storage	6.2	12.1	-6.4%	6.1%
Accommodation and Food Services	2.5	3.5	-6.1%	-20.1%
Information and Communications	2.0	1.3	12.6%	1.5%
Other Services	2.8	2.2	8.0%	5.6%

Source: INE

The leverage picture is quite mixed across different economic sectors. Measuring indebtedness against the level of economic activity conceals the major differences that exist between sectors. Breaking figures down by sectors and key corporate ratios – such as debt-to-equity and return-on-equity (ROE) – is far more telling from an analytical perspective. The optimal debt-to-equity ratio may be considered to be about 1, i.e. when a firm's liabilities are equal to its equity, but the ratio is very industry-specific as it depends on the proportion of current and non-current assets.

([13]) E.g., Cecchetti et al. (2011), 'The Real Effects of Debt', BIS Working Papers No 352.
([14]) Non-consolidated. The consolidated debt level was about 120% of GDP, Ministry of Economy.
([15]) Goretti, M. and M. Souto (2013), 'Macro-Financial Implications of Corporate (De)Leveraging in the Euro Area Periphery', IMF Working Paper No. 13/154.
([16]) Most mortgages have a very low but fixed mark-up on the Euribor.

Table 2.2.2: **Importance of SMEs in the Portuguese economy**

	Number of enterprises			Number of employees			Value added		
	Portugal		EU28	Portugal		EU28	Portugal		EU28
	Number	Proportion	Proportion	Number	Proportion	Proportion	EUR bn	Proportion	Proportion
Micro	739,555	95.4%	92.4%	1,230,990	42.8%	29.1%	15	22.4%	21.6%
Small	30,732	4.0%	6.4%	588,424	20.4%	20.6%	15	22.6%	18.2%
Medium-sized	4,547	0.6%	1.0%	444,610	15.4%	17.2%	14	21.6%	18.3%
SMEs	**774,834**	**99.9%**	**99.8%**	**2,264,024**	**78.7%**	**66.9%**	**44**	**66.5%**	**58.1%**
Large	722	0.1%	0.2%	613,790	21.3%	33.1%	22	33.5%	41.9%
Total	**775,556**	**100.0%**	**100.0%**	**2,877,814**	**100.0%**	**100.0%**	**66**	**100.0%**	**100.0%**

Source: EC Enterprise and Industry, 2014 Small Business Act for Europe (SBA), Portugal factsheet

The optimal ratio also varies according to the size and ownership structure of the business. Nevertheless, for most companies the maximum acceptable debt-to-equity ratio is 1.5-2. In Portugal, the NFC debt-to-equity ratio, defined as total liabilities over total equity, was recorded as 2.82 in 2008, falling to 2.51 by the end of 2013. For SMEs this ratio reached almost 3 in 2008 and declined to 2.48 in 2013. Looking at individual sectors, the largest financial imbalances in the economy at the end of 2013 were to be found in the construction and real estate sector, with a debt-to-equity ratio of 3.1, accommodation and food services (3.48), and transport and storage (12.11). The corporate sector's difficult economic situation is also highlighted by the return on equity (ROE). The ROE (Table 2.2.1) for the construction and real estate sector (-4% in 2013) has remained negative since 2008. Accommodation and food services fared even worse with a ROE of -20.1% in 2013. Generally, close to half of private-sector firms have been burning their equity or posting negative profits over the past 5 years.

SMEs have traditionally played a much bigger role in the Portuguese economy than in other EU Member States and are the most vulnerable companies. According to the 2014 Small Business Act for Europe (SBA), in 2013, they accounted for 79% of jobs and 66% of value added, both of which are considerably higher proportions than the EU average. Moreover, 95% of firms in Portugal - about three percentage points above the EU average - are microenterprises. They also generate more than 40 % of private sector jobs. Most SMEs are active in services, manufacturing and trade, and in all of these areas they provide the majority of jobs.

Given their size, SMEs (especially microenterprises) are heavily dependent on the domestic banking sector. This makes them vulnerable to the sharp tightening in credit conditions that has occurred in recent years, as banks have experienced funding pressures and rapidly deleveraged their balance sheets. Typically, microenterprises have far less power than larger firms to negotiate debt rescheduling with banks. The high refinancing needs linked to short-term liquidity for financing current operations have only aggravated microenterprises' liquidity constraints. As most Portuguese SMEs entered the crisis already highly leveraged (with debt-to-equity ratios approaching 3, or financial debt amounting to 12 times EBITDA,([17]) rolling over debt became difficult as profits fell. High leverage has forced Portuguese SMEs to dismiss staff and engage in rapid deleveraging. Not surprisingly, between 2008 and 2013 Portuguese SMEs shed over 350,000 jobs, a 13.5% cut in their total workforce in 2008. Value-added and the total number of SMEs also declined, the latter to a much lesser extent. Most of deleveraging by NFCs after the peak in June 2011 (some EUR 18 billion in nominal terms) was attributable to SMEs. Their share in the debt-to-GDP ratio dropped from 94.5% in 2012 to 84.8% in the third quarter of 2014. In general, over 20% (Table 2.2.3) of Portuguese firms were finding it difficult in 2013 to cover their debt service expense from EBITDA and were encountering some solvency problems. This suggests that there will be more deleveraging and, probably, insolvencies in future.

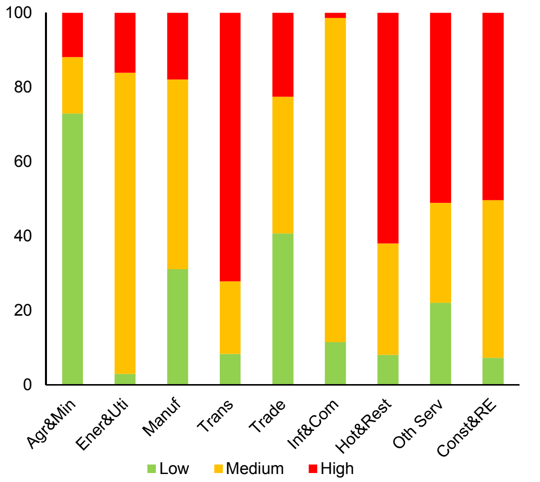
([17]) EBITDA: Earnings before interest, taxes, depreciation, and amortisation; source: BACH Database.

Table 2.2.3: **Corporate solvency risk heat map**

		Debt/ Capital employed		
		< 0.7	0.7 to 0.9	> 0.9
Debt/ EBITDA	> 12x	10.9	5.6	21.1
	6x to 12x	20.5	16.2	2.9
	< 6x	17.5	4.2	1.2

Source: European Commission, ORBIS Database

Graph 2.2.4: **Distribution of corporate solvency risk by sector**



Source: European Commission, ORBIS Database

Debt can pose systemic risk to the banking sector. Recent years have been marked by the worst financial crisis that has ever faced the Portuguese banking sector. Portuguese banks' funding structure and business model based on a reliance on wholesale funding, an oversized branch network and generous financing of mortgages and non-tradable sector activities, are currently undergoing major changes. Most banks have sought to boost market confidence by reducing their loans-to-deposits leverage and raising capital, despite the low profitability environment. But many credit institutions remain fragile on the asset side, as non-performing loans (NPLs) have continued to rise until recently. Portuguese banks' exposure to NFCs has been a major challenge since the onset of the economic crisis. The non-performing loan ratio in this segment reached 18.7% by the third quarter of 2014, with some banks facing corporate NPL at well above 20%. About 90% of credit to the NFC sector is concentrated in 10% of the firms with bank credit.([18]) Among these firms, overdue credit as a proportion of the total shot up to nearly one third by mid-2014. This mainly reflects the position of the over-leveraged construction sector, in which around half the debtors with big bank exposures have credit overdue.

While coverage ratios (loan loss provisions as a percentage of NPLs) in the NFC segment have improved (currently standing at about 60%), the capacity of the banking sector to withstand losses from a wave of NPLs appears to be limited without additional capital injections. In a worst-case scenario where all NPLs were fully written off and without taking the collateral into account, banks' capital would be cut by about a third. Nonetheless, the results of the Comprehensive Assessment of Portugal's three biggest banks,([19]) which the European Central Bank finalised in published in autumn 2014, suggest that the top-three Portuguese banks covered in the test are adequately capitalised under the baseline assumptions.([20]) Even though, at the current juncture, risks to the banking sector's capital position appear to be contained, financial stability could be strengthened by adopting a more pro-active approach to cleaning up specific large and risky corporate loan exposures. Granting credit to viable projects and not compromising non-financial sector deleveraging remains a key challenge for banks. This means that the criteria for granting and monitoring credit must be appropriate to the current situation, so that new credit is used efficiently to finance profitable and productive projects. Furthermore, in a scenario of prolonged low interest rates, it remains paramount to ensure that incentives are not created to delay recognition of losses by the banks.

([18]) Financial Stability Report, November 2014, Banco de Portugal.

([19]) Before the decision by Banco de Portugal to apply a resolution measure to Banco Espírito Santo, Espírito Santo Financial Group had been subject to the comprehensive assessment carried out by the ECB and it had concluded the Asset Quality Review (AQR) phase of the Comprehensive Assessment, which had focused on the review of the loan portfolio, in line with the procedure applicable to all the Portuguese banks. However, Novo Banco was excluded from the disclosure of the AQR results, published on the 26th October 2014 due to the fact that its opening balance sheet was not available and thus it was not possible to conclude on the impacts on the bank's solvency ratios.

([20]) Banco Comercial Português, which failed the stress test's adverse scenario, submitted a capital plan to the ECB. The plan was subsequently accepted by the ECB.

The policy response has been appropriate although its impact has been slow. Most Portuguese NFCs are chronically short of capital, and the country in general would benefit greatly from more foreign direct investment. Action has been taken at various levels to address the multiple and challenging aspects of the complex high corporate indebtedness issue. It is imperative to accelerate restructuring by corporations that, although indebted, are still viable. Equally authorities must enable firms that have no viable operating models to make an orderly exit from the market.

Portugal has taken major steps to overhaul its corporate insolvency and restructuring framework, giving it a stronger focus on the recovery of firms rather than their liquidation. A new debt restructuring mechanism inspired by US Chapter 11 provisions has been added to the bankruptcy code to allow fast-track restructuring before an insolvency proceeding begins. One of its features is the possibility for courts to enforce out-of-court agreements between the debtor and a majority of creditors. For micro and small firms, a specific out-of-court mechanism (SIREVE) has introduced more rapid mediation by a new public mediator agency with electronic platforms to reduce paperwork and guarantees to companies and creditors during the negotiation phase. SIREVE and PER (special revitalisation process) have both been recently revamped; SIREVE becoming leaner and now has a financial assessment system, financial filters and improved seniority rules for new money and investors. The number of businesses starting insolvency proceedings fell by 7.6% in 2013, the first drop in five years, one reason for this being the efficient use of PER that covered 985 companies, according to 2014 Small Business Act for Europe (SBA). In general, the authorities have stepped up efforts as regards corporate debt rescheduling since the launch in May 2014 of the Strategic Plan for Corporate Debt Restructuring. Changes to the Commercial Code now promote the issuance of quasi-equity/hybrid instruments such as non-voting shares, while also allowing for easier and fast-track procedures to issue company bonds, thus promoting restructuring rather than company liquidation. Portugal also continues to offer relatively good conditions (in comparison with its European peers) for entrepreneurs who, despite past failure, wish to start a new business. Changing social attitudes towards insolvency are reducing the stigma of business failure.([21]) Banco de Portugal is promoting debt rescheduling among NFCs and has continued to introduce tighter supervision of credit institutions. In addition to cross-cutting inspection programmes, Banco de Portugal has recently implemented an 'Early Warning System' for supervisory purposes, to identify firms (including SMEs) that are very likely to default because their debts are too high. This may indirectly promote early corporate debt rescheduling. Moreover, Banco de Portugal has issued a set of recommendations on procedures to identify and manage credit at risk (Special Assessment Programme). This will encourage more conservative impairment standards across the banking sector. All these initiatives have had a positive impact on reducing financial difficulties and indebtedness in the corporate sector. Debt rescheduling tools have been made available to highly leveraged corporations and incentives to capitalise have been set up, but an arduous task still lies ahead. According to the IMF, episodes of high growth in corporate indebtedness are generally followed by deleveraging processes, in which approximately two thirds([22]) of the original increase in debt is subsequently reduced. Applying this percentage to Portuguese firms, debt reduction would still have to shave off some 40 percentage points of private corporations' indebtedness.

Public debt sustainability

General government debt has reached very high levels. In the context of the global financial crisis and subsequent recession, the very high fiscal deficits, the reclassification of off-balance items and entities in the general government perimeter and the stabilisation interventions in the financial system have put general government debt on a

([21]) EC Enterprise and Industry, 2014 Small Business Act for Europe (SBA), Portugal factsheet. Despite the unfavourable economic environment for SMEs in Portugal, 2.4 new businesses were set up in 2013 for every one that closed. The number of new companies created — 35,296 — was 12.8 % higher than in 2012, and growth was consistent throughout the year and in all sectors, except for electricity, gas and water. Most new businesses were created in the services sector (accounting for almost one third of all new firms), trade (16 %) and accommodation and food services (11 %).

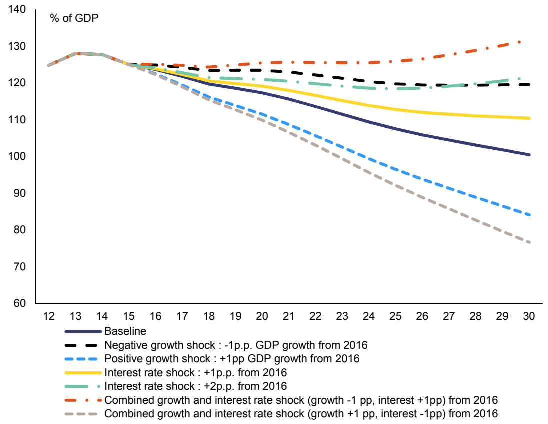
([22]) Bornhorst, F. and M. Ruiz-Arranz (2013), 'Indebtedness and deleveraging in the euro area', Euro Area Policies: 2013 Article IV Consultation, Selected Issues Paper, IMF Country Report No. 13/232.

steeply rising trend. From 2010 to 2013 the gross debt-to-GDP ratio increased by over 30 pps and it may have approached 129% of GDP by the end of 2014, one of the highest public debt levels in the euro area. Higher deposits and the depreciation of the euro are the main reasons for recent upward revisions in the projected gross debt stock at the end of 2014. The level of net debt reached an estimated 121% of GDP at the end of 2014, slightly lower than previously anticipated, as a result of recent cash management operations. The primary balance, which records surpluses since 2013, reached an estimated 0.4% of GDP in 2014 and should be above 1.5% of GDP in 2015 and 2016, moderating future financing needs.

While the the gross public debt-to-GDP ratio is expected to reverse its current rising trend in the short term and public debt is considered sustainable under plausible scenarios, debt dynamics are vulnerable to adverse shocks. Supported by the projected economic recovery, expected primary surpluses and debt-reducing operations, the debt-to-GDP ratio is expected to fall to 125% of GDP in 2015 and to continue falling gradually after that. Furthermore, model simulations of debt sustainability have been carried out that incorporate the scenario of the 2015 winter forecast until 2016 and other technical assumptions for the medium term (i.e. structural primary fiscal balance at 2.1% of GDP surplus as of 2018; nominal interest rates at around 4-4.5% of GDP; nominal GDP growth rate of 3-3.5%; ageing costs in line with the Commission's 2012 Ageing Report). For the baseline scenario, the results point to a gradual fall in the debt ratio in the long term. Nevertheless, given the very high starting point, the debt ratio is projected to remain above its pre-crisis level (66% of GDP in 2008) for many years to come, not falling below 100% of GDP before 2030.

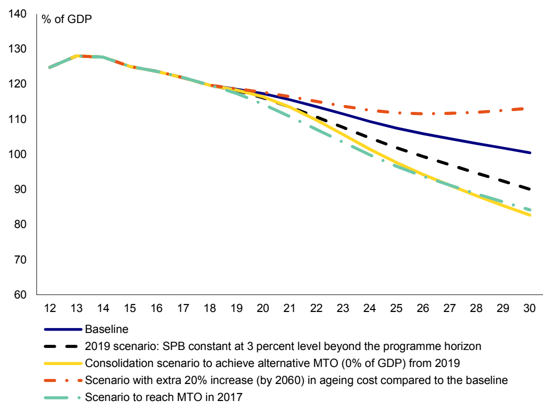
Sensitivity analysis suggests that the declining debt-to-GDP trajectory is sensitive to financial market volatility and vulnerable to adverse economic developments. Overall, the debt sustainability analysis reveals that the debt reduction path of the baseline is robust across a number of reasonable scenarios, but plausible shocks could considerably worsen the dynamics of Portugal's public debt (see graphs 2.2.5 and 2.2.6). Shortfalls in nominal growth, sharp interest rate rises or slackening fiscal efforts could put the public debt ratio out of control. An unsustainable debt trajectory would potentially have a very adverse impact on Portugal's economic stability and could have negative outward spillovers via the sovereign risk channel.

Graph 2.2.5: **Macroeconomic risk - growth and interest rates**



Source: European Commission

Graph 2.2.6: **Fiscal consolidation and ageing costs**



Source: European Commission

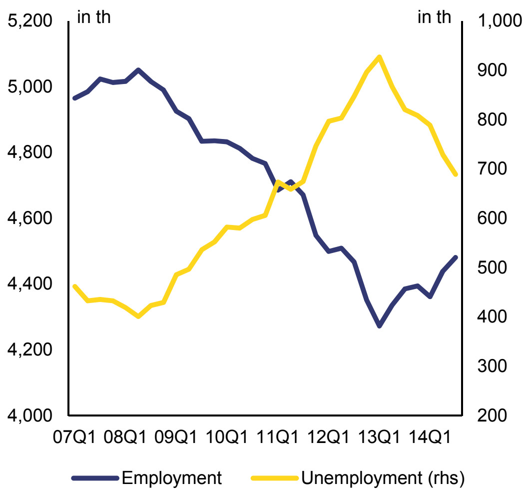
The very high level of government debt places a heavy burden on public finances. High public debt implies less fiscal room for manoeuvre in the event of adverse shocks, with potential detrimental implications for growth and jobs. This highlights the need for continued stabilisation of public finances.

Budgetary discipline and fiscal and growth-enhancing structural reforms are needed to safeguard fiscal sustainability and achieve a significant reduction in the debt path. The current very high debt ratio implies a significant adjustment burden, requiring the conditions underpinning falling debt to be steadfastly maintained in the coming decades. In particular, sustainability is attainable only if budgetary discipline is maintained over time, with continued progress towards the medium-term budgetary objective. Achieving the deficit targets and lowering the primary expenditure-to-GDP ratio in the medium term would generate fiscal space for growth-enhancing public expenditure and further tax reforms. In addition to making progress with fiscal adjustment, it will be essential to strengthen fiscal responsibility through stronger control over government expenditure and to improve revenue collection, if budget promises are to be kept. In particular, fiscal structural reforms designed to strengthen the framework for public financial management and continued reforms of the revenue administration must be firmly implemented in the years that lie ahead (see further details under Sections 3.1.2 and 3.1.1). Finally, a sound path to reduction depends on medium and long-term economic growth. This means perseverance with structural reforms will be essential (further details under Section 3).

2.3. LABOUR MARKET

The Portuguese labour market is showing signs of recovery as of 2013, following the deep-rooted adjustment in recent years. Recent wage developments have been conducive to the adjustment process and the overall labour market performance is starting to benefit from reforms implemented during the adjustment programme. Nonetheless, several challenges remain, the most important being the prompt absorption of the large pool of unemployed, which weighs heavily on both economic growth and the social situation. For economic growth to be sustainable and with a view to strengthening the export sector and contributing to external rebalancing, a substantial part of the unemployment needs to be absorbed by the tradable sector. A well-functioning labour market is key to achieve this goal, while contributing to lift Portugal's growth potential.

Graph 2.3.1: **Employment and unemployment**

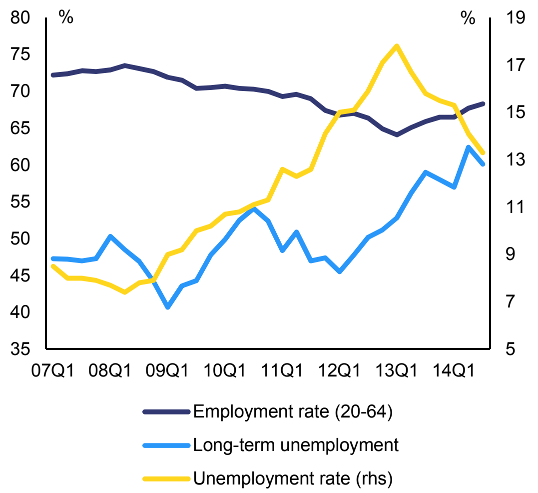


Source: European Commission

The economic crisis has had a drastic impact on employment. Total employment fell by about 730,000 (14.5%) between the peak in the second quarter of 2008 and the trough in the first quarter of 2013 (Graph 2.3.1). Unemployment rose by 525,000 in this period. The construction sector alone lost 244,000 jobs, almost halving employment in the sector. Manufacturing also lost about 180,000 jobs (about 20%); however, employment in the sector has risen in the recent quarters. A key facet of Portugal's economic recovery will be absorbing of the large pool of unemployed people.

The labour market situation has recently improved, but unemployment rates remain high, while employment rates are far below their 2008 peak. The employment rate among 20-64 years old - traditionally high in Portugal - has fallen significantly since the start of the economic crisis, from 73.1% in 2008 to 65.6% in 2013 (Graph 2.3.2). However, it has been rising since the first quarter of 2013 and, according to the most recent data, stood at 68.3% in the third quarter of 2014 (72.3% for men and 64.6% for women).

Graph 2.3.2: **Employment and unemployment rates and long-term unemployment**



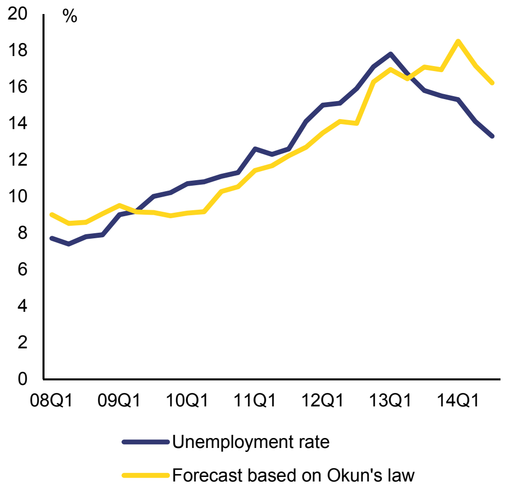
Source: European Commission

After a steep rise between 2008 and 2013, the unemployment rate has been falling since the second quarter of 2013. However, it was still high at 13.7% in the third quarter of 2014 (13% for men and 14.5% for women). Long-term unemployment as a proportion of total unemployment stands at over 60% (Graph 2.3.2). It has risen significantly in the last year, reflecting a fall in the separation rate and a slow pick-up in the hiring rate. The large proportion of people unemployed for more than one year, in turn, can create difficulties with absorbing unemployment (i.e. "hysteresis" effects).([23])

([23]) The unemployment gap in 2014 (difference between the NAWRU and the unemployment rate) is about 2.4%. However, the NAWRU itself varies with the cycle leading to overestimation of structural unemployment in crisis periods. Estimations of the NAWRU for Portugal, controlling for its determinants (TFP growth, growth in net

Youth unemployment is particularly high, but is on a decreasing trend. The youth unemployment rate stood at 32.2% in the third quarter of 2014 (34.5% among women). Nonetheless, joblessness is declining, down from a peak of 42.5% in the first quarter of 2013. The percentage of under-30s currently not in education, training and employment (NEETs) has been rising since 2009, reaching 16.7% in 2013.

Graph 2.3.3: **Unemployment rate, actual and predicted based on Okun's law**

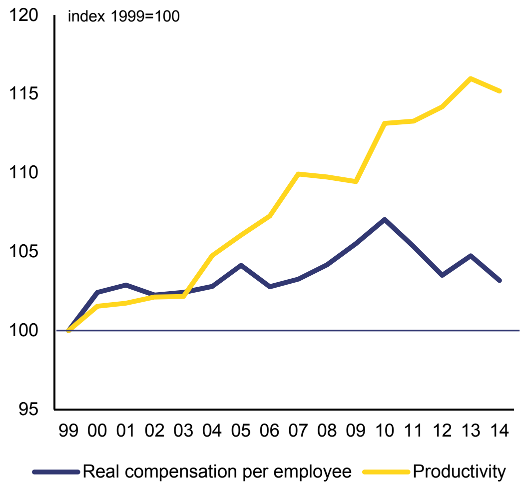


Source: European Commission

Over the past year, the fall in unemployment outpaced GDP growth. The drop in the unemployment rate has been much more pronounced than expected on the basis of the historical relationship between unemployment and GDP (Graph 2.3.3). This suggests that specific factors might have played a role, such as the decline in active population([24]) and the effect of the labour market reforms, including the substantial adjustment in real wages that has occurred in recent years and the stepping up of active labour market policies.([25])

The economy has undergone a substantial real wage adjustment over the past few years. Real wages had already been growing below productivity before the economic crisis (Graph 2.3.4). This trend became more pronounced after 2010, owing to a moderation in nominal wages growth and a sustained growth in labour productivity.

Graph 2.3.4: **Real compensation per employee and labour productivity**



Source: European Commission

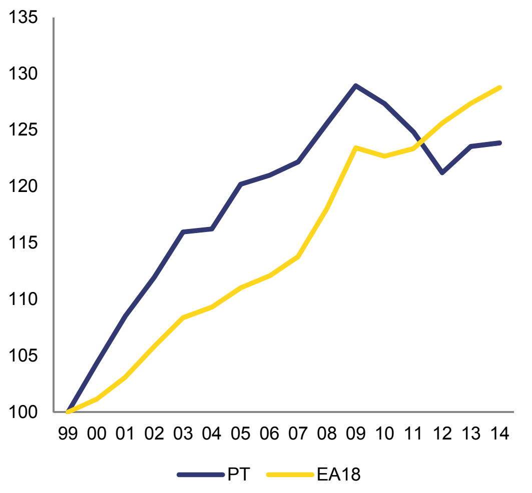
In addition, nominal unit labour costs adjusted significantly. Also in this case, the adjustment was more relevant after the crisis, after a period when unit labour costs in Portugal grew significantly faster than the euro area average (Graph 2.3.5). During the period 2010-2012, unit labour costs declined (see also Section 3.1).

capital stock, tax wedge and active and passive labour market policies), hint at structural unemployment that is considerably lower than the NAWRU (ECFIN's Labour Market Developments 2013, pp. 84-89). Nonetheless, the same report shows a sharp increase in skill mismatches after the crisis (p. 76).

([24]) Population projections suggest that the working–age population would shrink by 4.9% over the period 2013-2020 and a further 14.6% over the period 2020 to 2060 (Ageing Report 2015). Active population aged 25-54 already declined by more than 200 000 people between 2010 and 2014. Outward migration may have played a role. While outward migration could have functioned as an adjustment channel during the crisis, the loss of active population will weigh on potential growth, unless Portugal succeeds in creating the conditions to attract the population it lost due to emigration during the recent crisis.

([25]) Between the first and the third quarter of 2014, employment rose by 120,000 people. The number of people in employment programmes rose from 65,900 in January 2014 to 151,000 in September 2014 (85,000 people).

Graph 2.3.5: **Nominal unit labour costs**

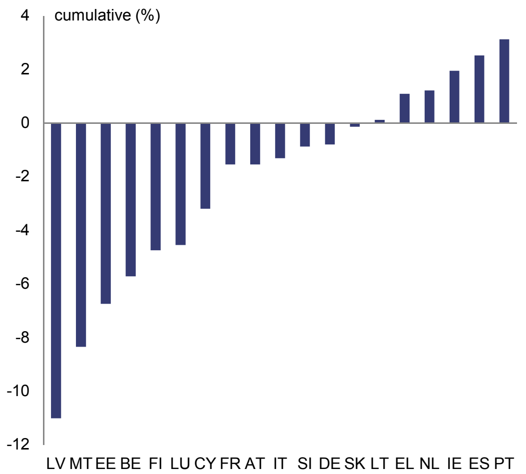


Source: European Commission

The adjustment carried out so far has increased the share of employment in tradable sectors. Between 2010 and 2013, employment growth in the tradable sector outpaced that in the non-tradable sector; indeed, the difference was the highest among the euro area countries (Graph 2.3.6). However, these data also reflect the fact that more jobs have been lost in the non-tradable sector. Once employment has recovered, there will be a need to assess whether labour has been actually reallocated across sectors (see also Section 3.1).

The skills composition of the labour force weighs on productivity and on the reallocation of labour to higher value-added sectors. In 2008, low-skilled workers accounted for some 68% of total employment, compared with a euro area average of just 27% (Graph 2.3.7). The proportion of highly skilled workers has since increased, owing to rising workforce education levels and higher unemployment rates among low-skilled workers. In 2014, low-skilled workers accounted for 50% of the total (against a euro area average of about 21%), while the share of highly skilled workers in the labour force rose to 25% (7 percentage points below the average in the euro area). The share of middle-skilled workers remains relatively low. That underlines the importance of quality and attractiveness of vocational and educational training as well as the prevention of early school leaving. In this regard, the recent increase in numbers of young people not in employment, education or training (NEETs) is particularly worrying. The skills composition of the Portuguese labour market is a factor explaining the very wide gap in value added per worker between Portugal and the rest of the euro area.([26])

Graph 2.3.6: **Gap between employment growth in the tradable and in the non-tradable sectors: 2010-13**



(1) The tradable sector comprises: i) agriculture, forestry and fishing; ii) industry (excluding construction); iii) wholesale and retail trade, transport, accommodation and food service activities. The non-tradable sector comprises: i) construction; ii) financial and insurance activities; iii) real estate activities; iv) professional, scientific and technical activities; v) administrative and support activities; vi) public administration, defence, education, human health and social work activities; vii) arts, entertainment and recreation; other service activities; activities of household and extra-territorial organizations and bodies.

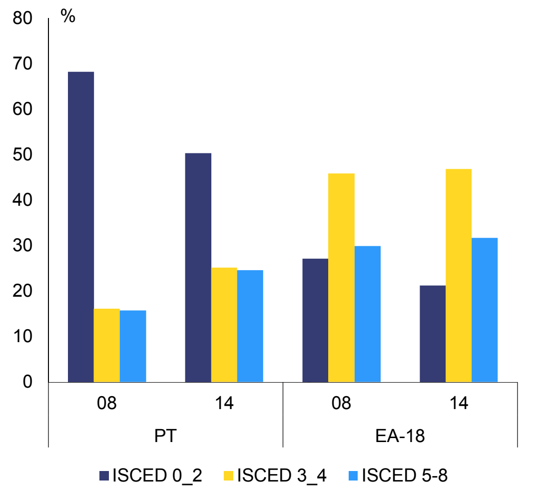
Source: European Commission

Job-matching has become less efficient during the crisis, but shows signs of improvement. The estimated Beveridge curve (Graph 2.3.8), plotting the unemployment rate against the job vacancy rate, has shifted outwards since 2008. In particular it showed a significant leap after the end of 2011, indicating less efficiency in job-matching (both unemployment and the number of job vacancies rose), along with a general deterioration of labour market indicators. However, the situation seems to

([26]) Varga et al. (2013), 'Growth effects of structural reforms in Greece, Italy, Portugal and Spain', European Economy, Economic Papers 511, show that decreasing the share of low-skilled workers and increase the share of high-skilled workers can contribute substantially for GDP growth in Portugal.

have been improving since the end of 2013, as the unemployment rate has started to decline alongside a roughly constant job vacancy rate.

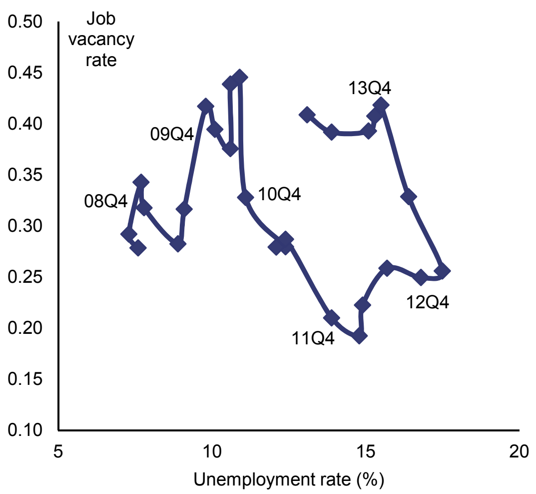
Graph 2.3.7: **Employment by education level**



(1) ISCED 0_2: less than primary and lower secondary education; ISCED 3_4: upper secondary and post-secondary non-tertiary education; ISCED 5_8: tertiary education.

Source: European Commission

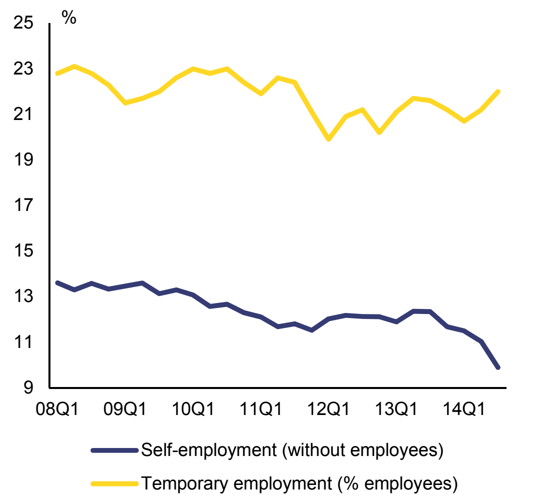
Graph 2.3.8: **Beveridge curve**



(1) Job vacancy rate = total number of vacancies/ (total number of vacancies + total employment).
Source: European Commission

The proportion of employees on temporary contracts remains high, although a substantial share of new contracts are being concluded on a permanent basis. Legislation enacted during the Programme aimed at aligning incentives for employers to hire on open-ended contracts for permanent posts. The share of fixed-term contracts has dropped during the crisis, as they are the first to be hit by economic downturns. More recently, with rising employment, the share of people on temporary contracts has risen again (Graph 2.3.9). Nonetheless, a very significant fraction of employment is being created on permanent contracts, which could be evidence of an improved balance in employment protection between permanent and fixed-term contracts. An effective reduction in labour market segmentation could contribute to enhance labour productivity. In addition, the share of self-employed people without employees in total employment fell, possibly indicating lower use of self-employment contracts in situations where work is being done by employees.

Graph 2.3.9: **Temporary employmen tand self-employment**



(1) Self-employment as a proportion of total employment.
Source: European Commission

The labour market needs to support the economy's adjustment challenges. Substantial adjustment needs remain: (i) the employment rate is a long way below the 2008 peak and there is a risk of unemployment stabilising at high levels, given the low growth and the increase in labour market mismatch, reducing potential growth and entailing a negative impact in terms of poverty and social exclusion; (ii) the external adjustment carried out so far needs to be sustained, given the sizeable level of negative net foreign assets.

Portugal implemented a comprehensive labour market reform agenda during the economic adjustment programme. To encourage job creation in open-ended contracts and address duality, severance payments for permanent contracts have been reduced, while the definition of fair dismissals has been eased. Working time has become more flexible to contain employment fluctuations over the cycle, accommodate differences in work patterns across sectors and firms better, and enhance firms' competitiveness. To facilitate wage adjustment, measures have been taken to increase scope for bargaining at firm level. Unemployment insurance benefits have been revised to increase incentives for a rapid return to work, while guaranteeing a sufficient level of protection and easing eligibility. Active labour market policies have been streamlined to make them more effective in supporting job creation, strengthening activation and providing more effective training opportunities. The remainder of this chapter provides an overview of the most recent measures.

Three measures have been taken recently in the area of collective bargaining, but not all of them favour the alignment of wages and productivity at firm level. Law 55/2014, adopted on 25 August 2014, encompasses two measures. First, it reduces the survival of collective agreements that have expired and not been renewed; second, it introduces the possibility of temporarily suspending sectoral collective agreements at firm level. The reduction of the survival period of expired collective agreements, by curbing automatisms in their renewal, has the potential to induce greater dynamism in collective bargaining.([27]) The possibility of temporarily suspending sectoral collective agreements might make contractual adjustment more flexible at firm-level, but it requires the intervention of the original signatories of the sectoral agreement, which is likely to limit its effective application.([28]) A third recent additional legislative measure alters the criterion for extending([29]) collective agreements. According to this measure, a decision to extend an agreement no longer has to take into account the representativeness of signatories in the sector, as was required since 2012. A less stringent criterion based on the composition of signing employers' associations has been introduced instead.([30]) The consequent potential renewed generalisation of extensions of collective agreements is likely to hinder efficient wage adjustment at firm level.

During the crisis collective bargaining has declined substantially. The number of sectoral collective agreements fell from 172 in 2008 to 36 in 2012, while the number of extensions fell from 137 to 12 in the same period. Firm-level collective agreements also declined considerably (Graph 2.3.10). The number of employees covered by collective agreements fell from almost 1.9 million in 2008 to some 225,000 in 2014. These developments show the difficulty social partners were facing in reaching agreements during the crisis. However, collective bargaining is slowly picking up. Differentiation of wages, including a broader scope for adjusting wages at firm level, is necessary in order to facilitate job creation in the tradable sectors and to avoid a situation where the burden of adjustment falls entirely on new contracts. In this regard, scarce diffusion of work councils poses a limit to the take-up of firm-level bargaining.([31])

([27]) The changes in the survival regime reduced the duration of collective agreements after their expiration from 18 months to one year. In addition, the law reduced from five to three years the time needed for a collective agreement that make its expiry depend on the existence of a new agreement to enter in a period of survival.

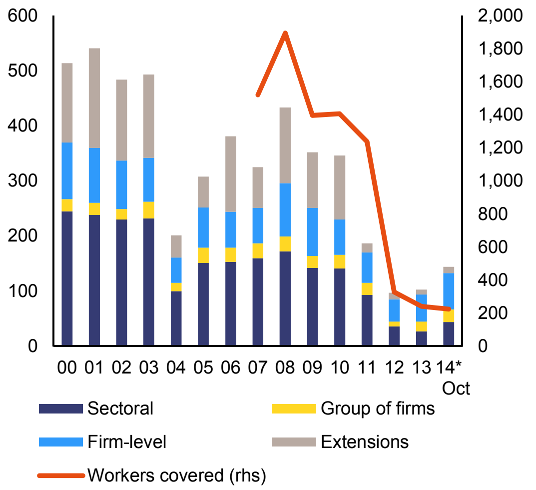
([28]) According to PT authorities, this requirement is justified in view of the Constitution, which attributes the worker representation's monopoly to trade unions.

([29]) That is to make collective agreements legally binding for all employees and employers in a certain sector.

([30]) In May 2011, the government temporarily suspended the common practice of extending sectoral collective agreements to all firms in the sector. In November 2012, it introduced a quantitative criterion for extensions of collective agreements which established that sectoral collective agreements could be considered for extension only if the employers' associations' signing the agreements employed at least 50% of workers in the sector. In June 2014, a new legislative change made extension possible if SME's accounted for at least 30% of the employers' associations signing the agreement.

([31]) Firm-level collective agreements prevail over higher level agreements, as no favourability clause exists. However, the number of collective agreements at firm level is limited. Various measures have been taken to boost firm-level bargaining or the adaptability of sectoral collective agreements at firm-level: (i) the 2009 Labour Code revision introduced the possibility for unions to delegate to

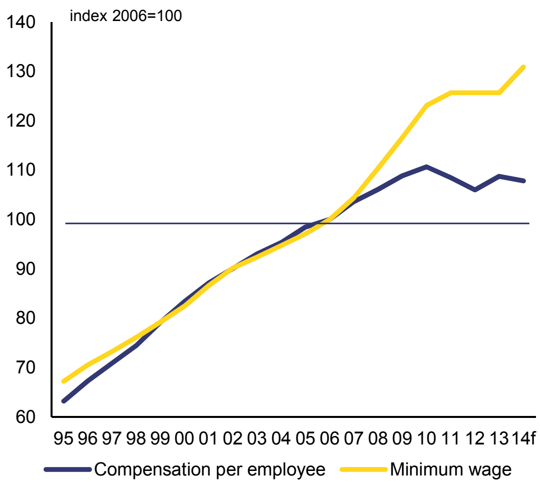
Graph 2.3.10: **Number of collective agreements and workers covered**



Source: MSESS - DG for Employment and Industerial Relations

Having been frozen during the economic adjustment programme, minimum wages were raised in October 2014. During the programme, the minimum wage would have been raised only if justified by economic and labour market developments. This implied its freeze during the programme. The Council of Ministers decided in September 2014, following an agreement with social partners, and effective from October 2014 until December 2015, to increase the monthly minimum wage (paid 14 times per year) from EUR 485 to EUR 505 (i.e. by 4.1%) and to cut employers' social security contribution (TSU) for workers already receiving the minimum wage by 0.75pp. to 23%.([32]) Despite the freeze in recent years, the minimum wage has risen significantly faster than the average wage in nominal terms since 2008 (by 18.5% vs. 3.5% between 2008 and 2014, see Graph 2.3.11). Consequently, it became more binding, with the proportion of workers covered by the minimum wage rising from 5% in 2005 to 12.9% in 2014. That proportion reaches 21% in the accommodation and food service activities sector and in the other service activities sector. The expected immediate effects of the latest increase on employment and competitiveness are relatively small. A continued monitoring of the possible effects on the employment prospects of the most vulnerable groups is envisaged.([33]) At the same time, this measure contributes to preserving labour incomes for those at the bottom of the wage scale.

Graph 2.3.11: **Nominal compensation per employee and the minimum wage**



Source: European Commission

works councils the possibility of concluding firm-level collective agreements in firms employing 500 or more workers; (ii) the 2012 Labour Code revision lowered the threshold for delegation to 150 workers; (iii) the 2012 Labour Code revision also introduced the possibility of sectoral collective agreements setting the conditions under which the agreement could be changed at firm level. No use has ever been made of these options.

([32]) A detailed description of the recent developments relating to the minimum wage in Portugal can be found in: 'Post-Programme Surveillance for Portugal', European Economy. Occasional Paper 208, December 2014, pp. 32-34.

([33]) Two empirical studies produced in 2011 found (small) negative employment effects of the increases in the minimum wage between 2006 and 2011, before the latest package of labour market reforms: Carneiro et al. (2011) 'Estudo sobre a Remuneração Mínima Mensal Garantida em Portugal – Relatório Final'; and Centeno et al. (2011), 'The Impact of the Minimum Wage on Low-wage Earners', Banco de Portugal – Economic Bulletin. Further information and data can be found in a report produced by the Ministry of Economic Affairs and Employment at the end of 2012 (available at http://www.portugal.gov.pt/pt/os-ministerios/ministerio-da-economia-e-do-emprego/documentos-oficiais/20121216-salario-minino-2013).

The reform of the employment protection legislation implemented during the economic adjustment programme eased the definition of dismissal based on redundancy and unsuitability and lowered severance payments. Severance payments for open-ended contracts were cut from 30 to 12 days per year of work. For temporary contracts, severance payments were cut from 36 (or 24 for contracts longer than 6 months) to 18 days during the first three years of the contract. One of the objectives of this reform was to align incentives for employers to hire on an open-ended contract for permanent posts, reducing segmentation. Continued monitoring of the impact of this reform is needed to analyse both job creation involving permanent contracts and transition rates from temporary to permanent contracts. Aggregate data show a decline in the share of temporary employment during the crisis, explained by more intensive job shedding among temporary contracts. More recently, the proportion of temporary contracts is rising with the growth in employment. As the macro data hide labour market flows, detailed analysis is needed, based on data on employment creation by type of contract.

During the economic adjustment programme, Active Labour Market Policies (ALMPs) were streamlined to make them more effective in supporting job creation, strengthen activation and offer more effective training opportunities. Over the same period, the Public Employment Services (PES) were also reformed to improve their efficiency. In January 2015, Portugal adopted a new framework law for employment policy,([34]) which aims at further rationalising the set of ALMPs and the role of PES, as well as at establishing the principle of systematic evaluation of the different ALMP programmes in the Standing Committee for Social Dialogue. Portugal continues to make progress in this area. Overall, the total number of unemployed people covered by employment measures([35]) rose from 141,335 in 2013 to 205,247 in 2014, while numbers of participants in training measures, according to IEFP data, went up from about 466,547 to 524,821 in the same period. ALMPs seem to have played a key role in reducing unemployment over the past year with a 25% increase in the number of placements, from 84,402 in 2013 to 105,518 in 2014. However, the measures need careful monitoring to ensure that they are effective. In particular, transition rates from employment subsidies into regular employment need to be analysed, as already happens with traineeship measures. The same applies to the effectiveness of the training programmes in making the groups concerned more employable.

Despite improvement throughout the Public Employment Services (PES) reform, the PES caseload remains very heavy. Efficiency can be improved further by taking a bolder approach to the digitalisation of services, including automated matching, and by further specialising staff to deal with more difficult cases. In addition, the PES's role - in profiling, providing appropriate job counselling and job search assistance, and enforcing sanctions where job search requirements have not been met - needs ongoing monitoring. The diploma([36]) which frames the cooperation between public and private employment services has been approved and there are plans for two pilot projects involving of partnership between the public and private employment services.

Measures have been taken to fight the upsurge of youth unemployment and NEETs, notably through the implementation of the Youth Guarantee (YG). Implementation of the Youth Guarantee started on 1st January 2014 and progress is underway. Between March and December 2014, 67,317 people aged under 30 and not in employment, education or training (NEET) took part in measures classed as a 'Youth Guarantee quality offer' once they had been registered by the Public Employment Services for a maximum of four months. These included, on the basis of IEFP data, work placements, vocational training and traineeships.

([34]) Decree-Law No. 13/2015, 26 January 2015

([35]) Employment measures such as hiring incentives and traineeships were aggregated in two groups: "Stimulus Employment Programme"; and "Employment Traineeships", making it easier for the unemployed to know which measures are available. Short term trainings targeted at employability created in 2013 - "Transversal Training" module and "Vida Ativa" measure – have increased their implementation in 2014.

([36]) Decree-Law No. 13/2015, 26 January 2015

Portugal is making substantial efforts to put the Youth Guarantee into practice([37]) and involve all relevant governmental and non-governmental partners in implementing it. The PES – Youth Guarantee Coordinator Entity – is conducting awareness-raising campaigns to involve partners better able to reach out to young people not in employment, education or training, namely NGOs and social institutions. An IT Youth Guarantee platform has been set up to enable monitoring of the young people benefitting from the programme. In spite of these progresses, there are substantial challenges to be addressed, including the PES' capacity as Youth Guarantee coordinator to engage the Youth Guarantee network's various partners, and the need to reach all non-registered NEETs. Additionally, there is little evidence that future skills needs are identified before youth guarantee offers are designed.

([37]) Two new measures, covered by the Youth Guarantee Implementation Plan, were adopted in July 2014: *Active Youth Employment Programme* (offering socio-professional integration of young people with low qualifications and furthest from the labour market, within a work project of limited time duration) and *Investe Jovem Programme* (a financial and technical support granted to young unemployed, between 18 and 30 years old, who present a viable business idea). The *Retomar* programme, another new measure, consists of a yearly financial support for students who have dropped out of education, providing incentives for them to complete their studies.

3. OTHER STRUCTURAL ISSUES

3.1. TAXATION, FISCAL FRAMEWORK AND OTHER FISCAL STRUCTURAL POLICIES

Taxation

The tax policies adopted recently imply a slight shift towards a more growth-friendly tax structure. Under the 2015 budget, the corporate income tax (CIT) reform initiated in 2014 is to be continued by cutting the standard rate by a further 2 percentage points. The CIT reform was designed to promote competitiveness and investment, to help make Portuguese companies more international and to simplify the complex CIT system. It also addressed the high debt-bias in corporate taxation by strengthening the limits for the deductibility of net financial expenses. The burden-reducing reform of personal income tax introduced in 2015 is designed to address demographic issues (e.g. by introducing a family quotient system and reforming tax credits for family expenses), simplify the taxation system (e.g. by introducing simplified pre-filled tax statements) and help entrepreneurs (e.g. by reducing their taxable income during the first two years of activity, to help start-ups). In parallel, the green taxation reform is designed to help promote a more sustainable economic development model. New green taxation measures include raising the rate of tax on the purchase of polluting vehicles, depending on CO2 emissions, and introducing a tax on plastic bags. The additional revenue raised by this green taxation reform is to be allocated to reduce the tax burden on labour (i.e. assumed revenue-neutrality of the above-described personal income tax and the green taxation reforms). Higher revenue is also expected in 2015 from recurrent property taxation (from the non-continuation of a safeguard clause that impeded too sharp increases in the property tax bill), while the transaction tax has not yet been phased out. Some excise duties and indirect taxes (e.g. on tobacco) will also rise under the 2015 budget. Overall, these reforms mark some progress towards the goal of improving the growth-friendliness of the tax structure. The scope for further shifting taxation towards less distortionary taxes should be explored on the basis of a comprehensive evaluation of recent tax reforms. The yields from a relatively growth-friendly but little used source, such as inheritance, estate and gift taxes, could be improved.

The action taken by Portugal in recent years to broaden its VAT base and improve VAT efficiency needs to be assessed. The country has reduced the scope of application of reduced and intermediate rates.([38]) Although the VAT policy gap was estimated at 52% for 2009-2012 (the arithmetic average for the EU is 41.4%,([39]) the indicator may not yet reflect the base-broadening measures introduced in 2011 and 2012. Instead of introducing further legal changes, Portugal could consider comprehensively assessing whether efforts to broaden the VAT base have actually made the VAT system more efficient.

The full budgetary and economic impact of recent tax reforms will need to be monitored. In particular, close attention should be paid to ensuring that the personal income tax and green taxation reforms are implemented budget-neutrally. The impact of these reforms on the progressive nature of the tax system must also be closely monitored, as there is a risk that high-income households may benefit more than low-income households. The impact of the green taxation reform on the Portuguese economy should also be closely monitored, to make sure that competitiveness and investments are not adversely affected. The impact of the CIT reform on productive investment and on the high level of corporate debt (as detailed in section 3) is a key issue for the Portuguese economy. In 2014, the gap between the effective marginal tax rate on investment financed with equity and debt in Portugal was still one of the highest in the EU.([40]) The CIT reform included a number of measures designed to boost investment, such as revamping the R&D tax credit (SIFIDE II) and extending the carry-forward period for tax losses from 5 to 12 years. Portugal lags behind the EU average as regards gross domestic expenditure on R&D (1.4% of GDP in 2013) and it had a foreign direct investment inflow of only 1.4% of GDP in 2013. Effectiveness of the patent box system also needs to be monitored.

([38]) Electricity and natural gas were shifted from the reduced rate (6%) to the standard rate (23%) in late 2011; foodstuffs and restaurants have been taxed at the standard rate (23%) since 2012, having previously been subject to the intermediate rate (13%). VAT rates for cultural services and sporting events were also raised in 2012.

([39]) '2012 Update Report to the Study to quantify and analyse the VAT Gap in the EU27 Member States', p. 64: http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/vat_gap2012.

([40]) ZEW (2014), 'Effective tax levels using Devereux/Griffith methodology', Project for the European Commission.

Portugal has continued to improve tax compliance and combat tax evasion by making the tax administration more efficient. Over the past few years, the country has been investing in tax-related IT systems, such as the e-invoice system, which has proven successful in improving tax compliance and yielded significant additional revenue. According to available statistics, around 9 billion invoices were registered and communicated to the tax administration in 2013-2014, with a 10% increase in the last year over 2013. The resources allocated to auditing have also been increased with the recruitment of 1,000 additional tax auditors. The 2015 budget announced further measures to increase efficiency in curbing tax fraud and evasion, including the reinforcement of the Large Taxpayer Office and the recently adopted 2015-2017 Strategic Plan to combat tax and customs fraud and evasion. Some of these measures mainly imply further exploiting the potential of e-invoicing and the unified monthly returns, by strengthening existing procedures and better cross-checking all relevant information. Other recent measures (e.g. the mandatory communication of inventories for taxpayers with turnover above EUR 100,000) can also be fairly effective, especially those targeting sectors where fraud is likely to be high, such as the rental market. Overall, given the high reliance of the revenue projections underpinning the budget on yields from anti-fraud measures, implementing these measures effectively is a top priority. For the plan to be effective in yielding additional revenue, critical capacity must be developed within the tax administration to handle the vast amount of relevant data gathered through the e-invoice system.

The revenue administration needs to pursue its reform agenda, and more must be done to improve taxpayer compliance. Organisational reforms are under way in the tax administration, including the planned integration of local tax offices into the *Aproximar* programme, the progress made by the Risk Management Unit, and the recently created Taxpayers' Services Department. Yet there is ample scope for further reforms to modernise the revenue administration and further improve taxpayer compliance. These include more efforts to combat tax fraud in the housing market, improving information-sharing arrangements with financial institutions, and strengthening the anti-money-laundering framework. Interaction between the judicial system and tax collection also remains an issue, with a high level of litigation, whereas a high level of undisputed tax debt as a percentage of the annual net revenue collection remains. The special task forces of judges assigned to tribunals dealing with high value cases are no longer in place. Although some efforts have been made to increase the availability of IT systems, and thresholds for tax appeals have been raised so as to reduce the burden on the tax courts, the present situation suggests that a more thoroughgoing reform of litigation procedures for taxation is needed.

Fiscal framework

The reform of the Budget Framework Law and other Public Financial Management reforms will further improve the domestic fiscal framework. The proposed Budget Framework Law reform, based on an analysis of outstanding fragilities in the system and recommendations by relevant stakeholders, is designed to: improve the formulation of numerical fiscal rules; streamline budget appropriations; reduce budget fragmentation, which remains high; make the various budget units more accountable; improve the budgetary cycle calendar and strengthen the medium-term budgetary framework, which includes defining more stringent expenditure ceilings. Technical complexities have delayed the reform process by comparison with initial plans, and the legislation is now expected to be put in place in the first quarter of 2015. Once the legislative process is completed, the focus should move to implementation under the strong leadership of the Ministry of Finance. Another major improvement in the fiscal framework is the recently concluded reform of the Commitment Control Law (CCL), which should further strengthen discipline and budgetary control and prevent any new accumulation of arrears.

Efforts should continue to improve The accounting and reporting framework needs further improvement. The October 2014 IMF Fiscal Transparency Evaluation([41]) identified further challenges to be met to achieve advanced levels of fiscal transparency and suggested that Public Financial Management be strengthened further. The Ministry of Finance and the standard-

([41]) IMF Country Report No 14/306, October 2014.

setting body are preparing a new public-sector accounting framework based on internationally accepted standards. Following public consultation, the plan is to submit the project for Government approval and draft the implementation manual in 2015, while practical implementation will extend into 2017.

Challenges related to structural-fiscal policies in the fields of pensions and the health system

The budgetary impact of population ageing poses a challenge to Portugal's medium and long-term sustainability, especially as regards pensions and healthcare policies. A challenge in these areas was identified in the 2014 European Semester (CSR1).

Pensions

Portugal's recent pension reforms have made the system more financially sustainable, but the impact on future pension adequacy is less certain. According to ESSPROS data, pension expenditure rose from 11.3% of GDP in 2007 to 13.9% of GDP in 2012 (EU-28 in 2012: 12.8%). The recent reform measures were designed to cut pension system costs in the short, medium and long term. Measures to improve the financial situation of the pension system include suspending pension indexation (except for the lowest benefits); introducing disincentives to early retirement; cutting the highest pensions; raising the pensionable age from 65 to 66 for both sexes, and linking future increases to life expectancy at age 65. Updated calculations of ageing costs based on the reform measures and the latest available demographic projections will be made available in the first half of 2015.

Lower pensions have been protected comparatively well during the crisis. Between 2011 and 2012 (last data available from the Institute for Social Security), the average annual old-age pension (all schemes included) fell from EUR 4,907 to EUR 4,748. There are substantial differences between the average pension entitlements of (i) men and women; and (ii) pensioners under the general statutory scheme and the scheme for public employees (CGA, now closed).([42]) Overall, however, the economic crisis has affected pensioners' income less than that of the rest of the population. The median relative income ratio rose from 92% to 94% between 2012 and 2013 (EU-28: 93% in 2013), showing convergence between the median equivalised disposable income of the over-65s and that of persons up to the age of 64.([43]) Further, recent trends in poverty and social exclusion among the elderly suggest that the incomes of the most disadvantaged have been relatively well protected during the crisis (see Section 3.2).

In the medium and long run, the adequacy of pensions will crucially depend on longer and less interrupted working lives for both men and women, given that the Portuguese population is set to age substantially over the next few decades. Based on Eurostat data, the old-age dependency ratio is expected to increase from 29.4% in 2013 to 63.9% in 2060 (EU-28 in 2060: 50.2%), posing a threat to both the adequacy and the sustainability of the pension system. The labour market participation of older workers, however, has tended to fall over the past decade. The employment rate of men aged 55 to 64 fell from 62.1% in 2003 to 58.5% in 2008, and a low 53.2% in 2013 (EU-28 in 2013: 57.5%), while the employment rate of older women has stagnated slightly above 40% (EU-28 in 2013: 43.3%). Currently, only 4.1% of 55-64-year-olds are engaged in life-long learning. There are hiring incentives in place that target unemployed people over the age of 45.

The rise in the legal retirement age and the link with changing life expectancy in the future is expected to improve the medium-term sustainability of the pension system. The fact that the mechanism is automatic makes the pension system more transparent and may also signal to individuals and to the social partners that retirement practices must change. If pensions are to cover pensioners' needs, people will need to

([42]) According to Bettio et al. (2013), women's mean monthly pension income in Portugal was EUR 512, compared with EUR 766 for men. According to the Social Security statistics and the CGA annual report for 2012, average monthly pensions under the general statutory scheme and the CGA were EUR 402 and EUR 1287 respectively.

([43]) This relative improvement in the income situation of the elderly may be explained by shrinking wage incomes, rather than by any actual improvement in pensioners' incomes.

retire later in the future.([44]) This is why the recent pension reforms must be accompanied by measures to incentivise longer working lives, support the employability of older workers, and allow for a more gradual transition from work to retirement.

Health system

The Portuguese health system faces a fiscal sustainability challenge as, according to the 2012 Ageing Report, public health expenditure is projected to rise more than the EU average.([45]) In 2012, health expenditure accounted for 9.5% of Portugal's GDP. Portugal has one of the lowest shares of public expenditure in total health spending (63%, compared with the EU average of 73%). Out-of-pocket payments as a share of total health expenditure increased between 2007 and 2012 by 4.5 pp (the highest increase in the EU). The fact that some 14% of the population have no family doctor continues to pose problems. Waiting times for selected types of planned surgery lengthened between 2010 and 2013, reversing the previous trend and confirming the recent rise in unmet medical needs. This indicates that there is a need to step up efforts to maintain existing levels of access to healthcare.

Health system reforms in Portugal continue to produce results. Hospital-sector reforms and cost optimisation have contributed in recent years to savings in the healthcare sector. Arrears in the hospital sector remain a challenge, although they have been significantly and steadily reduced since 2012. Total debt was reduced by EUR 150 million in 2014, and EUR 250 million are still available from the equity injections in state-owned hospitals earmarked to further reduce the stock of arrears during 2015 (around EUR 560 million, in December 2014). The National Health Service budgets for 2015 and 2016 will probably include significant increases in staff costs, as there are plans to reverse public officials' wage cuts. However, the 2015 budget is still set to cut overall health spending, showing a continuing commitment to reform.

Progress has been made on hospital reform and other healthcare-related reforms. A report on establishing reference centres has been adopted, and the Portuguese authorities are in the process of reclassifying hospitals, an important task. Centralised procurement continues to save the National Health Service money. Generics eligible for public reimbursement in the outpatient sector have continued to expand their market share, resulting in less spending on medicines. Similarly, spending on pharmaceuticals can be cut by negotiating pharmaceuticals prices with the industry. The new role of Family Nurse should improve prevention and health promotion in Primary Care Centres. The authorities have also launched initiatives to increase and incentivise the supply of health professionals in areas where access to healthcare is particularly problematic.

Other fiscal-structural policies

Thanks to the restructuring of operations in state-owned enterprises (SOEs), their operating performance continued to improve in 2014. A further EUR 309 million was allocated to state-owned hospitals to halt new arrears, improve their operating balance and provide additional healthcare services. The 2015 budget provides for state-owned hospitals to reach an operating balance on their own in 2015. As with transport sector SOEs, the restructuring of operations that started during the Programme continued throughout 2014. The adjusted EBITDA is close to positive for the third year in a row. The operating improvements, mainly stemming from a general rise in commercial revenue, combined with further personnel cost compressions (despite the Constitutional Court ruling) have more than offset the drop in public compensation of EUR 50 million (from the 2013 level) or EUR 250 million (from 2010). Downsizing continued successfully in 2014, with some 3,400 jobs shed by comparison with 2010 levels.

Mergers of several SOEs and urban passenger transport concessions continued in 2014 and will be concluded this year. The mergers between the railway (REFER) and the road (EP) infrastructure operators, and between the water and sewerage branches of Águas de Portugal are

([44]) The 2015 Pension Adequacy Report (forthcoming) provides a projection of replacement rate levels for 2053, pointing to a fall from 92.3% of average earnings in 2013 to 79.5% in 2053; for low earners (66% of average wage) the fall is steeper, from 90% to 77.6%.

([45]) These projections will be updated in the first half of 2015 when the new Ageing Report 2015 is published.

progressing. As regards the latter, the consultation of the municipalities involved in the merger of 19 companies into 6 was concluded. The legislative process will follow and is expected to be finished during the first half of the year. The urban transport concessions in Porto are expected to close in January, bringing about EUR 150 million savings to the public exchequer during the 10-year length of the contract. Similarly, the Lisbon services are to be put out to tender at the beginning of February, just after the public service obligation (PSO) contracts have been finalised. It is expected that contracts will be awarded by the end of the second quarter of 2015. The purpose of the tender is to further cut that part of taxpayers' costs that relates to public compensation.

Public-private partnership relating to roads saved more money than expected in 2014. Savings from renegotiating concessions, lower toll collection costs, fewer financial rebalances, and more toll revenue resulted in savings of over EUR 370 million in relation to the base case, exceeding the latest Government forecast by 10%.

Privatisations continue with a view to freeing additional capital and refocusing SOEs on their core business. Taking advantage of improved financing conditions for the sovereign, the Government began to refinance bank loans of SOEs inside the general government and outside it (notably CP, Carris, STCP, Parque Expo, Empordef and EDIA), as their debt has matured to replace the more expensive bank loans by cheaper Treasury funds. The Treasury covered EUR 5.7 billion of SOEs' financing needs in 2014, thereby alleviating their interest burden. To further strengthen the financial position and refocus several SOEs on their core business, the plan to privatise some subsidiaries is being pursued, including EGF, CP Carga, EMEF and Carristur. Given the TAP airline's need for an equity injection, the Government relaunched a privatisation process after a failed attempt in 2012. These privatisations are all expected to be concluded by mid-2015.

Public administration reforms designed to improve the efficiency and quality of public expenditure have continued, but more slowly and with a smaller budgetary impact than initially expected. Employment in the public administration is expected to continue falling, mainly through attrition, but probably at a much slower rate than in recent years. The termination of fixed-term contracts, the implementation of the requalification scheme and the termination of contracts by mutual agreement are contributing much less to reductions in the number of jobs than previously planned. The introduction of the single wage-scale and the single supplement-scale in 2015 will make the remuneration system fairer and more transparent, but is not expected to save any expenditure.

3.2. SOCIAL POLICIES

Portugal experienced a sharp increase in poverty and social exclusion in 2013. The number of people living at risk of poverty or social exclusion increased by 210,000 between 2012 and 2013, making it more difficult to reach the national 2020 target. The increase in the percentage of people at risk of poverty or social exclusion was the highest in the EU (2.1 p.p. from 25.3% in 2012 to 27.4% in 2013). Severe material deprivation increased by 2.3 p.p., affecting 10.9% of the population in 2013. The poverty gap for the working age population([46]) stood at 31.2% in 2013, marking the second largest increase in the EU compared to beginning of the crisis.([47])

The increasing levels of poverty and social exclusion have been affected by the rising levels of unemployment up to 2013. The sharp increase in both unemployment and long-term unemployment translated into worsening poverty indicators. Between 2008 and 2013, the share of low work intensity households increased by 5.9 percentage points (the fourth largest increase in the EU), while the number of jobless poor (at risk of poverty and living in low work intensity households) reached 564,000 in 2013.

A weakened social protection system and policy measures adversely affecting disposable income had a negative impact on the social situation. The impact of social transfers (excluding pensions) in reducing poverty decreased by 2.5p.p in 2013 (26.7% in 2013 compared with 29.2% in 2012), suggesting that the inadequate social protection system was unable to cope with the sudden rise in joblessness and the consequent increase in poverty. Additionally, some of the recent policy measures had a negative impact on disposable income. Cuts in non-pension benefits disproportionately affected the very poor (bottom decile). Policy changes also adversely affected children under the age of 10.([48])

Households with children have been particularly affected by poverty and social exclusion, also owing to a reduced impact of family benefits and social transfers.([49]) In 2013, children were at greater risk of poverty or social exclusion than the rest of the population – 31.6% against 27.4% of the overall population – and Portugal had the largest increase in the EU. These figures follow a major reduction in childcare benefits, with two series of cuts implemented respectively in November 2010 and January 2012. Between October 2010 and August 2014, 591,971 beneficiaries lost access to child benefits, i.e. one in every three beneficiaries. In total, the state reduced spending for the support of families with children by 30% between 2010 and 2011.([50])

Older people have been relatively sheltered from the risk of poverty and social exclusion during the crisis, although the incidence of severe material deprivation has increased. The proportion of over-65s at risk of poverty and social exclusion decreased from 27.7% in 2008 to 20.3% in 2013 (EU-28 in 2013: 18.3%). Since 2011, however, the severity of poverty and levels of severe material deprivation increased slightly in this age-bracket.

While some measures were taken to protect the most disadvantaged groups,([51]) no key policy changes have been implemented or planned recently to ensure an adequate coverage of social assistance. According to the most recent national data, unemployed people not covered by unemployment protection or by the minimum income scheme (RSI) accounted for 47.9% of all jobless people, on the basis of September 2014

([46]) The poverty gap is defined as the difference between the median equalised total net income of people below the at-risk-of-poverty threshold and the at-risk-of-poverty threshold, expressed as a percentage of the at-risk-of-poverty threshold. It gives an idea of the severity of poverty for those experiencing it.
([47]) The increase amounted to 7.6 percentage points with respect to 2008.
([48]) See De Agostini et al. (2014), 'The effect of tax-benefit changes on the income distribution in EU countries since the beginning of the economic crisis', EUROMOD Working papers 9/14. https://www.iser.essex.ac.uk/research/publications/working-papers/euromod/em9-15
([49]) Decree-Law 133/2012.
([50]) Baptista et al. (2014). Portugal Country Profile, European Social Policy Network.
([51]) The minimum pension was adjusted by more than the inflation rate and the minimum wage was increased from EUR 485 to EUR 505 in October 2014, contributing to protecting lower pensions and low income earners. The temporary 10% increase in unemployment benefits for couples where both partners are unemployed and have dependent children was maintained. Active Labour Market Policies have been streamlined and take into account the (re)integration of vulnerable groups in the labour market. The Solidarity Complement for the elderly with low pensions was also maintained, having a positive impact on the lowest incomes of the elderly.

IEFP IP data. The unemployment benefit coverage rate of the long-term unemployed dropped significantly between 2010 and 2012 (from 39% to 26%), while slightly rising to 29% in 2013.([52]) Similarly, the coverage rate for the short-term unemployed went down from 45% in 2010 to 39% in 2012, then increasing to 41% in 2013.([53]) The figures on the Minimum Income Scheme show a steady decrease since new rules took effect in July 2012. In October 2014([54]) there were approximately 207,000 beneficiaries, meaning that nearly 131,000 people had lost their benefit entitlement since June 2012 - over 38% of the total.

([52]) Commission services calculations based on the OECD tax and benefit model.
([53]) The slight increase in 2012-13 might reflect the reforms introduced on unemployment benefits (reducing the period necessary to become eligible) in 2012.
([54]) Available at: http://www4.seg-social.pt/estatisticas.

3.3. EDUCATION AND VOCATIONAL TRAINING POLICIES

Portugal has undertaken a comprehensive reform of its education system, but effective implementation remains key to bring positive outcomes. National and international assessments show that students' performance level is stagnating with a share of low achievers exceeding the EU average.([55]) The revision of curricula in primary and secondary education and the definition of new learning outcomes are expected to improve students' performance in basic skills, such as maths and Portuguese. However, it disregards several cross-cutting key competences such as learning to learn and entrepreneurial skills. Increased autonomy for schools and the introduction of a new funding formula based on schools' performance encourages quality programmes. In-service training for teachers is being addressed through a new system of trainings and credits. However, this critical part of the reform is jeopardised by the lack of resources, trade union support and social ownership.

Disparities in education performance and early school leaving (ESL) linked both to the socio-economic and migrant background of students are high. PISA data show that equity in education outcomes worsened significantly between 2003 and 2012. Grade retention is often used as response to low performance, but has shown to be inefficient and to increase the risk of ESL. The new education monitoring tool should help implement preventive actions by identifying students at risk of school failure. Several initiatives such as the TEIP (programme for schools in socially vulnerable areas) have proven to be efficient and the 2015 budget provides for extra support for early childhood education and care which should help mitigate social disadvantages at an earlier stage. However, difficulties facing low performers must be targeted and schools must be helped to effectively develop quality programmes if disparities are to be reduced.

Recent reforms are designed to upgrade the vocational education and training system, but making it more attractive is also a challenge. As part of the strategy to address early school leaving Portugal has introduced more, and more diverse, vocational courses in secondary education, such as the *new basic vocational course* for the 14-years-olds, which offers new opportunities to students at risk of retention. To upgrade vocational education and training (VET) and make it more relevant to the labour market, much more training is now at the work place and specific indicators have been introduced for monitoring the quality of apprenticeships. The creation of the *Centres for Qualification and Vocational Education* has also helped boost VET enrolment rate. The new short tertiary education cycle *superior technical professional courses (TeSP)* aims at developing close links with regional businesses; 94 courses are registered covering a total of 2.775 students in 40 different locations. 65% of the existing TeSP focus on business administration, ICT and services. However, a shortage of funds is holding back implementation. The same applies to the *professional schools of reference*, the legal framework for which was approved in April 2014, but which have not been opened yet.

While tertiary educational attainment keeps increasing the employment rate of graduates has decreased significantly since 2008.([56]) In order to improve the skills synergies between the education system, the labour market and economic growth policies, the Ministry of Education is working, together with the OECD and the European Commission, on a *National Skills Strategy*. A diagnosis report on how to improve the quality and labour market relevance of education outcomes is set to be presented during the first quarter of 2015.

Portugal is making progress toward more efficient and targeted public expenditure in education. The reorganisation of the public schools network, in tandem with the new funding formula, if effectively implemented and monitored, should help make more efficient use of teachers and ultimately make education spending more efficient, especially if the level of performance is improved. The 2015 budget foresees a 9.6% reduction of the education spending in primary and secondary schools compared with the 2014 estimate, mainly by cutting the number of teachers engaged in non-

([55]) PISA 2012 results and Preliminary analysis of the 2013 national final exams: GAVE. *Análise Preliminar dos Resultados — Provas finais de ciclo: Exames finais nacionais* 2013.

([56]) According to Eurostat data, tertiary education attainment rate increased 10 pp from 2008 to 2013 and employment rate of graduates decreased 15 pp during the same period.

teaching activities. However, the capacity of the teaching force to implement effectively new quality programme deserves attention.

Portugal has made significant progress in improving its education system but the upgrade of its human capital and educational outcome remains a challenge to ensure competitiveness and growth capacity. Early school leaving and disparities in performance hamper the development of high level skills, and tertiary attainment remains low([57]) compared with other EU countries. The shortage of digital skills in the Portuguese population as a whole and in the work force in particular([58]) is a brake on performance in the country's competitiveness in the digital economy. Efforts to improve digital literacy and regular internet use are necessary to promote digital inclusion. Unemployment rates also show that there is a need to make education and training more adaptable and responsive to emerging needs. Education should therefore remain high up on the policy agenda over the coming years, as a major driver of sustainable economic growth and productivity.

([57]) In 2014, the number of applications to higher education rose for the first time since 2008 and the number of students placed in vocational courses at polytechnic institutes, increased by 18% compared to 2013. The employment rate of graduates is well below the EU average and only very marginally higher than that that of young people having completed only lower secondary education.

([58]) In 2012, over half (55%) of the Portuguese population had low digital skills or none at all, and only 24% of individuals were empowered with above basic digital skills. As for the workforce, 48% of individuals had none or low digital skills (39% in the EU). Only 1.7% of employed people were ICT specialists, whereas the EU average is 2.8% of ICT specialists in the workforce.

3.4. STRUCTURAL MEASURES TO IMPROVE COMPETITIVENESS

Reforms have been adopted in order to improve competitiveness, increase flexibility and improve the business environment, but further action is needed in a number of areas. A wide range of reform measures have been adopted to alleviate nominal rigidities, facilitate adjustment, reduce excessive rents and encourage the reallocation of resources to the tradable sector. Significant measures have also been taken to cut red tape and make the judicial system more efficient. However, significant structural weaknesses remain in key areas, including services and regulated professions, public administration and network industries (particularly energy and transport). In addition, robust and systematic monitoring and impact assessment tools are needed to assess the impact of reforms.

The national competition and regulatory framework has been improved, but actual implementation must be carefully monitored. The Competition Authority Decree Law, published in August 2014, provides the Competition Authority with a new financing model for 2015 and beyond. This will address the problem of annual executive orders to provide funding for the Authority on a one-off basis for each calendar year. This financing model must be carefully monitored, to ensure that it is appropriate and that the Portuguese Competition Authority performs its duties effectively. The range of transfers for which the bylaws provide may not be sufficient to cover a scenario of modest growth in and after, 2016, once the public service salary cuts are progressively reinstated and bearing in mind that important new tasks will need to be carried out, including more advocacy.

The national regulatory authorities' new framework has not been fully implemented yet. Under the economic adjustment programme, a new framework law setting out the main principles underpinning the functioning of the principal national regulatory authorities (NRAs) and the competition authority was adopted. Following this adoption, the bylaws of the respective NRAs were amended to reflect the principles of the new legal framework. The bylaws concerning the Securities Market Commission (CMVM), the Insurance Regulator (ISP) were published at the beginning of January 2015, while the Communications Regulator (ANACOM) and the Civil Aviation Authority (ANAC) were approved by the Council of Ministers at the end of December 2014 and are now awaiting for presidential promulgation and publication. The Transport Regulator (AMT) is not fully operational yet, despite the recommended deadline of the end of September 2014, since amended provisions, notably as regards directors' cooling-off period, were only recently published to ensure consistency with the framework legislation.

Reforms of Portuguese services markets and regulated professions have yet to be completed. For Portugal, the impact of barrier reductions from the implementation of a sub-set of services covered by the Services Directive will increase the overall GDP by 0.8% in line with the EU 27 average.([59]) Some important pieces of legislation remained unchanged after the termination of the macroeconomic adjustment programme, limited progress has been made in aligning the outstanding sector-specific legislation with the Service Directive and there is no political will to amend legislation on universities. Laws on construction services and copyright collective management societies are delayed in Parliament. In addition, limited progress has been made towards improving access to a number of highly regulated professions. To this end, a framework law reforming professional services governed by professional associations was adopted in 2012 under the programme, introducing rules and principles. This was to be followed by amendments of the statutes and internal rules of these professional bodies, to bring them into line with the principles laid down in the framework law. 18 such statutes needed amendment. None of the 18 bylaws has been approved yet: nine draft bylaws for highly regulated professions are reportedly finalised but, not yet approved by the Council of Ministers; the remaining nine draft bylaws are experiencing delays, mainly due to non-compliance with the framework law for highly regulated professions and with EU law.

The reform of the licensing regime continues to progress but with experiencing some delay. Limiting the number of procedures to follow and the time and cost required to start a business is important to achieve a competitive environment

([59]) Monteagudo et al. (2012), 'The economic impact of the Services Directive: A first assessment following implementation', European Commission Economic Papers 456, June 2012, p.30. The 0.8% increase was estimated for a reform effort until 2011.

for firms. The European Commission has estimated the potential impact of changes in entry costs between 2011 and 2014 on entry dynamics in Portugal on the basis of its own calculations. The predicted increase of the entry rate due to the decrease in the cost to start a new firm would be from 12.4% to 13.1%, whereas the potential combined effect of the reduction in the number of procedures needed to start a new business and in the time needed to start exporting could increase the Portuguese entry rate from 12.4% to 13.6%. Licensing regimes are being streamlined to establish the overall principle of ex-ante declarations with ex-post control. The Portuguese authorities have adopted some of the outstanding decrees on licensing, particularly a new law on commercial licensing, but a number of them are delayed

Work is ongoing, although with some delay, to reduce administrative burden. Authorities are carrying out inventories of the most burdensome regulations and drafting roadmaps to tackle them. A first inventory was completed in 2014. Portugal is to complete a new inventory by March 2015 which will cover sectors not addressed in the former. Another key measure to reduce administrative burden is the "one-in, one-out" principle which was adopted in May 2014 but its effective implementation is yet pending on the approval of the relevant methodology. An Inter-Ministerial Network for Administrative Modernisation (RIMA), is expected to play a pivotal role in beefing up the governance framework for administrative simplification, although its main focus is on the central administration.

Access to financing remains costly and difficult for most SMEs, even though credit conditions have been gradually improving over the past two years. This is a result of the size and organisational features Portuguese SMEs that, similarly to their European counterparts, are largely dependent on bank funding. All other funding sources such as capital market financing remain rather an exception than a general pattern. Moreover, the ongoing deleveraging of the corporate sector continues and one of its aspects is the strong differences between companies, which is reflected in the interest rates applied to corporate lending. These have slightly eased since the end-2012, mainly for loans below EUR 1 million, but remain elevated (on average at 4.83%in November 2014) when compared to the Euro area average of 1.83%.[60]. The high lending rates for local SMEs are correlated to a large extent with the banks' (still elevated) own financing costs and their risk perception regarding the outlook for domestic SMEs in general. Nonetheless, both the ECB lending survey and the Portuguese Bank Lending Survey mention that fewer Portuguese business owners report a fall in banks' willingness to lend.[61] The government is looking for solutions to ease the current constraints by strengthening existing instruments and fostering the use of alternative financing mechanisms.[62] Among others, Portugal is setting up a specialised development financial institution (DFI) to promote greater efficiency and effectiveness in the management of financial instruments for supporting SMEs. The DFI is also expected to address market failures which hamper some SMEs to access funding. The set of financing tools that the DFI will provide to the local SME segment will include both debt and equity (or quasi-equity) funding. Despite its formal establishment, the DFI is not operational yet as there are significant legal and operational requirements to be settled. As the DFI was created to manage the financial instruments supporting SMEs under the ESI Funds (European Structural Investment Funds), significant delays in finalising its operations could hinder the deployment of the ESIF-funded programmes to finance SMEs projects.

The liquidity of businesses continues to be aggravated by long delays in payments, in particular by the public sector. No new measures have been taken or commitments made to tackle late payments by the public sector. The European Commission has initiated an infringement procedure against Portugal for failure to fully transpose the Late Payment Directive, excluding the healthcare sector.

Portugal lags behind the EU average as regards the involvement of business in science and innovation, in terms of public-private cooperation in R&D activities and in the

[60] Banco de Portugal and ECB Lending Survey, November 2014.
[61] Survey on the access to finance of enterprises in eth euro area, European central Bank, November 2014.
[62] 2014 SBA factsheet Portugal, European Commission, 2014.

transfer and commercialisation of knowledge.([63]) It has stepped up investment in research and innovation investments over the past decade with a remarkable average annual real growth rate of 7% between 2000 and 2007. Despite this, its performance is still below the EU average.([64]) Portugal's overall R&D intensity fell from 1.58% in 2009 to 1.36% in 2013. Public R&D intensity diminished by an average annual growth of 0.4% from 2008 to 2013, reaching 0.59% in 2013. Business R&D intensity has also fallen since 2009; by 2013 it was only about half of the EU average in 2013 (Portugal: 0.65%, EU: 1.29%).

Policy incentives for cooperation between public bodies conducting research and businesses remain weak. Given the weak and scattered policy incentives for the cooperation between public research organisations and businesses, and the lack of adequate innovation-friendly framework conditions for business investment in research and innovation, Portugal has been unable to overcome its companies' structural orientation towards activities that are not knowledge-intensive. The Innovation Agency (AdI) that promotes cooperation projects between research and industry has been given a stronger role and its governance streamlined, which is expected to improve productivity and competitiveness. A new scheme for PhD studentships in industry has been established by the Foundation for Science and Technology (FCT) to leverage productivity and competitiveness. However, there is still a need to effectively implement stronger incentives for public-private cooperation, more effective mechanisms for knowledge transfer and efficient investment in research and innovation. To help Portugal make the transition to a more knowledge-intensive economy, the following are needed: an investment-friendly environment for business investment in research and innovation, to avoid a situation in which researchers face different conditions in the public and the private sector, closer links between higher education and the business sector and further improvements in the allocation of funding on the basis of performance criteria. It is also very important to increase the broadband take-up, by tackling the reasons underlying low rates of broadband subscription and internet use. Portugal lags behind significantly in fixed and mobile broadband take-up and in internet use.([65]) The Digital Agenda Strategy for Portugal, approved in 2012, does not specify improving the actual broadband take-up as one of its goals nor does it mention the affordability of internet.

Reforms have been carried out to modernise the Portuguese justice system, but close monitoring is needed. The new Judicial Organization Act was implemented in 2014. It aims to improve the efficiency and professionalism of court management with significant benefits in the organisation and management of the judiciary, performance accountability and service provision. The new code of civil procedure, which became effective in September 2013, introduced significant changes to expedite the resolution of cases. However, according to the 2015 EU Justice Scoreboard, proceedings in civil and commercial cases continue to be lengthy (386 days). The number of enforcement cases is still falling slightly whilst disposition time remains long (1045 days in 2014).([66]) In general, there is scope to strengthen measures promoting evaluation of courts' activities, use of online tools (e.g. for online publication of judgements) and conducting surveys among court users or legal professionals. Reforms relating to the Tax and Administrative Tribunals are proceeding more slowly than other judicial reforms. A better use of operational tools such as annual work programmes, performance targets and IT systems to support tax courts appears necessary to improve the current situation. The rise in insolvency cases has highlighted the need to increase resources and training for first instance courts in this field. As regards highly regulated professions in the justice sector, draft laws show

([63]) In 2012 public expenditure on R&D financed by business enterprises was very low (0.007% of GDP), pointing to a very low level of cooperation between business and science, with Portugal among the bottom five EU countries. In 2011 the number of public private scientific co-publication per million people stood at 17 in Portugal (EU average: 53).

([64]) Portugal scores 19 in the Innovation Union Scoreboard 2014 and 24 in the European Innovation Output Indicator 2014.

([65]) As regards the five main drivers of the digital economy, Portugal ranks 13th out of 28 Member States for connectivity, 20th for human capital, 15th for use of internet services, 12th for integration of digital technologies by business, and 7th for digital public services.

([66]) Estatísticas trimestrais sobre ações executivas cíveis (2007-2014), Bulletin 20, http://www.dgpj.mj.pt/sections/siej_pt/destaques4485/estatisticas-trimestrais9480/, Q2 2014 data, p. 2

that the Government intends to limit the ambition of reforms previously agreed upon during the economic adjustment programme.

Transparency in monitoring and reporting of public procurement procedures is being improved, but challenges remain. Portugal is reviewing the BASE portal, an online platform that provides a detailed data on all public procurement contracts. This enables the Court of Auditors and the Inspectorate for Finances (IGF) to step up and streamline their scrutiny. Remaining gaps concern the transparency of concessions and delays in publishing data on contracts awarded by local and regional authorities. A dedicated and skilled taskforce (UTAP) at the Ministry of Finance is working to improve fiscal transparency and reporting on PPPs, but the regional and local levels are outside its remit and there is no consistent framework for establishing equivalent structures. In the area of conflict of interests, incompatibilities and revolving doors, where legislation is largely in place, significant shortcomings remain in terms of maximizing the impact of transparency in preventing corruption by effective monitoring, implementation and sanctions. Since the publication of public procurement codes in 2012, all public administrations are obliged to have plans for tackling corruption on the basis of risk assessment, but progress in monitoring and analysing such risks has been slow and has not resulted in an integrated strategy for the prevention of corruption. According to the EU Anti-Corruption Report, published in 2014, the reasons for such shortcomings also include weaknesses in the law enforcement, prosecution allegations of corruption, preventive action on party funding and in control systems in urban planning decisions. Overall, much remains to be done to prosecute high-level corruption and complex corruption and economic and financial crimes effectively and to improve rates of final convictions and sanctions.

Progress in effectively implementing the urban lease reform and comprehensively monitoring the Portuguese housing sector has been limited. The Portuguese Government has recently enacted amendments to the urban lease law which risk undermining the soundness and effectiveness of the overall framework. In particular, changes to the commercial lease framework have enlarged the universe of companies covered by the transitional period([67]) to micro enterprises (about 95% of Portuguese companies) and to non-profit institutions which cover areas of 'national interest'. The transitional period, already relatively long, has also been extended by one additional year. These two changes might create legacy privileges and dual markets and prevent the Portuguese housing market from becoming more dynamic. The legal arrangements covering works in lease buildings have been changed so that landlords can terminate a lease contract only in case of structural works that are validated by the local authority. By the recommended deadline (the end of December 2014), the authorities had not done anything to develop more comprehensive and reliable monitoring procedures, which are essential to overcome the lack of data and for a systematic analysis of the impact of recent reforms on the housing market and on trends in that market. The authorities announced their intention of stepping up efforts to combat tax evasion in the rental market. However, by the recommended deadline (the end of December 2014), they had not provided the comprehensive study to identify the shadow economy in the rental market, which had been requested under the programme. At the end of January 2015, the authorities issued a decree setting up a working group tasked with implementing a monitoring model of the housing market. The authorities confirmed their commitment to providing a study on the shadow economy in the Portuguese rental market according to the following roadmap: implementation of the tax measures to curb (January-May 2015); data compilation and assessment (June-July 2015); report finalisation (end of August 2015)

The lack of a comprehensive and systematic approach to monitoring and evaluation makes it difficult to assess the full impact of reforms on the functioning of the economy. Portugal's government effectiveness is close to the EU average ([68]), yet Portugal is less effective in using

([67]) The 2012 urban lease law envisaged a 5 year transitional period for the existing open-ended lease contracts signed before 1990 (around 30% of the total contracts), taking into account social criteria for vulnerable households and micro entities for commercial leases. An additional 2 year transitional period was foreseen for the commercial lease regime under certain circumstances.

([68]) The government effectiveness indicator is developed by the World Bank as part of its Worldwide Governance evidence-based instruments than most other countries ([69]), as the consistency and quality of impact assessments is not systematically checked and the related methodology is not formalised. Relevant external stakeholders are not always able to provide meaningful and timely input into regulatory processes, and the results of impact assessment are not systematically published. Moreover, as attention is now shifting to the implementation of the several reforms adopted under the macro economic adjustment programme, it is essential to assess whether they effectively contributed to boosting competitiveness, output and employment growth. The government is planning to contract in 2015 an evaluation on the overall impact of structural reforms.

Portugal continues to implement further measures to cut the electricity tariff debt and to help keep end-user energy costs in check, although these appear insufficient to achieve the targeted outcomes. In April 2014, the Portuguese authorities presented a third package of measures designed to tackle remaining excess rents in the energy sector, further reduce the electricity tariff debt and achieve a more balanced distribution of economic surplus between different stakeholders. Some of these measures have been taken during the past year, including a major expansion of the social electricity tariff (intended to be effectively financed by reducing excess rents enjoyed by generators) and an extension to 2015 of the special levy on energy operators (which should contribute EUR 50mm to reducing tariff debt. Other announced measures, including legislation designed to redistribute windfall profits enjoyed by the incumbent on natural gas take-or-pay contracts, are in advanced stages of preparation. However, the incremental impact of these initiatives is expected to remain fairly modest, and clearing the tariff debt by 2020, while limiting price increases for end users as targeted, will likely remain a major challenge. According to the latest updated projections (October 2014), the tariff debt will peak at EUR 4.8 billion in 2015, before gradually falling to EUR 1 billion by 2020. This new estimate is about EUR 400 million higher than previous projections, which implies that the proposed headline electricity tariff increase of 3.3% for 2015 will not be sufficient to achieve the overall target for the electricity tariff debt by 2020. In parallel, this negative development poses a risk to the authorities' original target of limiting annual price increases to 1.5-2.0% above inflation. This means that meeting the 2020 debt target may call for persistently higher tariffs than those originally projected. One important factor underlying these adverse tariff debt developments is a significant rise in fraudulent electricity consumption in recent years; it will thus be of key importance that the authorities address this problem propmptly and robustly. In addition, the authorities should also continue identifying further ways of cutting remaining rents in the energy sector, so as to reduce the tariff debt faster while minimising energy price increases for households and firms. Further work is also needed to address environmental issues and weaknesses in a number of areas, especially waste and water management. It thus remains essential to adopt and implement initiatives such as the green growth strategy, announced in 2014, to encourage a transition to a more efficient and low-carbon economy in Portugal.

Portugal is taking action to improve the cross-border integration of its energy networks, but investment activity needs to be accelerated Portugal is quite well-connected with the Spanish energy networks and is working to improve these electricity and gas interconnections further. However, the current low level of electricity and gas interconnection capacity between the Iberian Peninsula and the rest of the EU is a major obstacle to establishing a regional market in the south-western region. In January 2015, the transmission system operators of Spain, France and Portugal signed a joint strategy paper on developing interconnections between the Iberian Peninsula and the internal electricity market. This paper lists shared goals and indicates which options for projects would increase the current interconnection capacity. This strategy is essential to reach the minimum interconnection level of 10% agreed by the European Council in October 2014. The need to improve cross border integration of the energy networks and to speed up the implementation of the electricity and gas

Indicators (WGI) project (http://info.worldbank.org/governance/wgi/index).

([69]) European Commission, Member States' Competitiveness Report 2014: Reindustrialising Europe (http://ec.europa.eu/DocsRoom/documents/6748/), chapter 2.

interconnection require an acceleration of investment activity.

Portugal remains on track to meet EU 2020 renewable energy targets. The share of renewables has been rising steadily in recent years, thanks to the Portuguese energy policy of reducing the country's reliance on fossil fuels. According to the National Renewable Energy Action, Portugal has made a commitment to increasing the share of renewables to 31% by 2020. In 2013 the renewable energy production accounted for 25,7% of the final energy consumption, exceeding the interim target (23,7 %) for the same year.

Portugal is on track to meet the EU 2020 energy efficiency target. The national energy efficiency target of 25% by 2020 is being fulfilled. However, further policies should be pursued to ensure that a sustainable and durable decrease of energy consumption builds on structural changes and not only on cyclical factors such as the slowdown of the economic activity. This is particularly important for the building and housing sectors where the effective transposition and implementation of the energy performance of buildings directive (EPBD-recast) deserves close monitoring.

Portugal has made little progress in making its new regulatory framework for the transport sector fully operational and in refining its long-term transport plan. In late spring 2014, Portugal adopted the legal framework for its new transport regulatory authority (AMT), which replaces three former transport regulators (rail, ports and road). This initiative was designed to ensure stronger and better coordinated regulatory monitoring, improve competition and reduce end-user costs. After passing AMT's bylaws, the Portuguese authorities were required to make the new regulator fully operational by September 2014. However, as a result of repeated delays in appointing AMT's Board and of recently published amendments to the bylaws, this essential step towards strengthening the transport sector's regulatory framework has been delayed and the AMT is not fully operational yet. In addition, Portugal has adopted an integrated strategic plan for its transport system (PETI 3+), with a view to prioritising infrastructure investments in a rationalised and cost-effective manner, coordinated across different transport modes and based on a well-defined long-term vision. EU Structural Funds are expected to support some of the investment projects under this plan. However, it still needs to be refined further. In particular, it could benefit from more focus and better prioritisation, underpinned by a sound analysis of transport demand; moreover a realistic and mature project pipeline has yet to be presented. Project preparation must therefore be a matter of priority, in particular for the larger infrastructure rail and port investments.

Although earlier reforms in Portugal's ports system are gradually producing benefits, limited progress has been made with important further measures to boost competition and cost-effectiveness. In early 2013, a new law on port labour took effect, which was intended to tackle key bottlenecks and significantly improve the competitive position of Portuguese ports. This new law required re-negotiation of collective agreements in force in Portuguese ports, and together with the gradual elimination of port use fees (TUP-Carga), it allowed a significant downward adjustment of port operating costs. In order to ensure that shippers benefit fully from these cost savings, a key next step involves renegotiating a number of port concession contracts, particularly those with a long remaining term left, in order to reduce end-user costs, to align incentives, to boost competition and to encourage investments while achieving appropriate risk-sharing between port authorities and private-sector operators. However, the legal terms and conditions underpinning these renegotiations are still unclear, throwing into question their compliance with EU public procurement rules and their effectiveness in boosting competition, investments and the overall port operations in general. Moreover, these negotiations have proceeded slowly and in a piecemeal fashion, with little concrete progress made so far; in addition, focus seems to have shifted somewhat away from the original goal of reducing port usage costs for shippers. Part of the underlying problem appears to be a lack of resources within UTAP, the Ministry of Finance body overseeing the concession renegotiations. A number of other smaller-scale reforms in the ports sector (summarised in a "chronogram" published by the Portuguese authorities in 2014 have not seen significant overall progress either.

The merger of the railway and road infrastructure managers is anticipated to deliver significant additional cost savings, but liberalisation measures in railways and urban public transport continue to proceed at a slow pace. Achieving operational balance of the rail infrastructure manager (REFER) by 2015 remains a major railway policy objective. After taking various measures to this end over the course of 2013 and early 2014 (including cost rationalisation, closure of loss making lines and staff cuts), the Portuguese authorities have announced that REFER will be merged with road infrastructure manager EP in order to achieve further cost-savings. A Planning Commission to supervise the merger was appointed in August 2014, and both the legal and operational aspects of the merger are expected to be completed over the course of 2015. Synergies from the merger are projected to be sufficient to structurally bring REFER to operational balance. In addition, Portugal is expected to launch the privatisation of CP Carga, the state-owned freight operator, after the unbundling of its terminals, which would contribute to improving the governance of the company and attracting more customers to the railway freight market. The process of transferring the terminals to REFER started in April 2014 (after repeated postponements) and is currently still under way while the privatisation process itself has yet to start. Similarly, the introduction of competition on the commercial sub-urban railway lines (Lisbon and Porto) could create new business or investment opportunities for potential entrants, but this measure has incurred significant delays as well. The tender process for the Porto public transport concessions was launched over the summer and wound up in January 2015, several months later than planned. The tender for Lisbon is expected to be launched by the end of the first quarter of 2015, just after the PSO contracts are signed.

ANNEX A
Overview Table

Commitments	Summary assessment([70])
2014 Country specific recommendations (CSRs)	
CSR1: Implement the necessary fiscal consolidation measures for 2014 so as to achieve the fiscal targets and prevent the accumulation of new arrears. For the year 2015, implement a revised budgetary strategy in order to bring the deficit to 2.5 % of GDP, in line with the target set in the Excessive Deficit Procedure Recommendation, while achieving the required structural adjustment. Replace consolidation measures which the Constitutional Court considers unconstitutional by measures of similar size and quality as soon as possible. The correction of the excessive deficit should be done in a sustainable and growth-friendly manner, limiting recourse to one-off/temporary measures. After the correction of the excessive deficit, pursue the planned annual structural adjustment towards the medium-term objective, in line with the requirement of an annual structural adjustment of at least 0,5 % of GDP, more in good times, and ensure that the debt rule is met in order to put the high general debt ratio on a sustainable path. Prioritise expenditure-based fiscal consolidation and increase further the efficiency and quality of public expenditure. Maintain tight control of expenditure in central, regional and local administration. Continue the restructuring of the state-owned enterprises. Develop by the end of 2014 new comprehensive measures as part of the ongoing pension reform, aimed at improving the medium-term sustainability of the pension system. Control healthcare expenditure growth and proceed with the hospital reform. Review the tax system and make it more growth friendly. Continue to improve tax compliance and fight tax evasion by increasing the efficiency of the tax administration. Review the tax system and make it more growth friendly. Continue to improve tax compliance and fight tax evasion by increasing the efficiency of the tax administration. Strengthen the system of public financial management by swiftly finalising and implementing the comprehensive reform of the Budgetary Framework Law by the end of 2014. Ensure strict	Portugal has made **some progress** in addressing CSR 1 (this overall assessment of CSR 1 excludes an assessment of compliance with the Stability and Growth Pact): • Some progress in fiscal structural measures. • Limited progress in developing new comprehensive measures as part of the ongoing pension reform, while some progress in proceeding with hospital reforms. • Some progress in reviewing the tax system. The PIT reform, the green taxation reform and additional measures associated with the CIT reform were adopted. Further improvements have been observed in the operationalisation of the e-invoice system, tax administration reform and other anti-fraud measures announced in the 2015 budget. • Some progress in improving the fiscal framework. The Budgetary Framework Law reform is expected in Q1-2015. A revision of the Commitment Control Law was approved in January, further strengthening budget control. • Some progress in implementing the single wage and supplement scales**.** The Law on Single Wage Scale (TRU) was published in September 2014 and has to be applied from January 2015. The Decree-law on the Single Supplements Scale (TUS) is under preparation.

([70]) The following categories are used to assess progress in implementing the 2014 CSRs of the Council Recommendation: No progress: The Member State has neither announced nor adopted any measures to address the CSR. This category also applies if a Member State has commissioned a study group to evaluate possible measures. Limited progress: The Member State has announced some measures to address the CSR, but these measures appear insufficient and/or their adoption/implementation is at risk. Some progress: The Member State has announced or adopted measures to address the CSR. These measures are promising, but not all of them have been implemented yet and implementation is not certain in all cases. Substantial progress: The Member State has adopted measures, most of which have been implemented. These measures go a long way in addressing the CSR. Fully addressed: The Member State has adopted and implemented measures that address the CSR appropriately.

compliance with the Commitment Control Law. Effectively implement single wage and supplements' scales in the public sector from 2015 onwards.	
CSR2: Maintain minimum wage developments consistent with the objectives of promoting employment and competitiveness. Ensure a wage setting system that promotes the alignment of wages and productivity at sectoral and/or firm level. Explore, in consultation with the social partners and in accordance with national practice, the possibility of mutually agreed firm-level temporary suspension of collective agreements. By September 2014, present proposals on mutually agreed firm-level temporary suspension of collective agreements and on a revision of the survival of collective agreements.	Portugal has made **some progress** in addressing CSR 2: • Limited progress in minimum wage developments. In October 2014 the government raised the minimum by 4.1% to be effective between 1 October 2014 and 31 December 2015. The increase occurred after agreement with the social partners. At the same time employers' social security contributions were cut from 23.75% to 23% for employees who had been on minimum wage without interruption, since May 2014. • Some progress in ensuring a wage setting system that promotes the alignment of wages and productivity at sectoral and/or firm level: specific measures are described below. • Limited progress as regards the introduction of mutually agreed firm-level temporary suspension of collective agreements**.** Legislation was adopted in August 2014 and enacted in September 2014: however, new rules require agreement from the original signatories of the sectoral agreement, making implementation more difficult. • Full implementation regarding the presentation of proposals on the survival of collective agreements. In August 2014 the authorities have passed legislation reducing the survival period of collective agreements expired and not renewed. • No progress concerning criteria for the extension of collective agreements: in June 2014 less stringent criteria for the extension of collective agreements have been introduced compared to those required since 2012. The potential generalisation of extensions of collective agreements is likely to hinder efficient wage adjustment at firm level.

CSR3: Present, by March 2015, an independent evaluation of the recent reforms in the employment protection system, together with an action plan for possible further reforms to tackle labour market segmentation. Pursue the ongoing reform of active labour market policies and Public Employment Services aimed at increasing employment and labour participation rates, specifically by improving job counselling/job search assistance and activation/sanction systems with a view to reducing long-term unemployment and integrating those furthest away from the labour market. Address the high youth unemployment, in particular by effective skills anticipation and outreach to non-registered young people, in line with the objectives of a youth guarantee. Ensure adequate coverage of social assistance, including the minimum income scheme, while ensuring effective activation of benefit recipients.	Portugal has made **some progress** in addressing CSR 3: • No progress in presenting, by March 2015, an independent evaluation of the recent reform in employment protection legislation. • Some progress in terms of active labour market policies implementation. However, the effectiveness of employment and training measures need to be carefully monitored. As regards the PES, despite progress achieved with the PES reform, the caseload remains very high. • Some progress in implementing the Youth Guarantee (YG) and engaging all relevant governmental and non-governmental partners in its implementation. However, substantial challenges remain, notably the capacity of PES as coordinator of the YG to engage the YG network partners and the need to reach out to all non-registered young people, not in employment, education or training (NEETs). • No progress in ensuring adequate coverage of social assistance, including the minimum income scheme.
CSR4: Improve the quality and labour-market relevance of the education system in order to reduce early school leaving and address low educational performance rates. Ensure efficient public expenditure in education and reduce skills mismatches, including by increasing the quality and attractiveness of vocational education and training and fostering cooperation with the business sector. Enhance cooperation between public research and business and foster knowledge transfer.	Portugal has made **some progress** in addressing CSR 4: • Some progress in improving the quality and labour-market relevance of the education through: the reform of curricula; the reform of teachers statutes; the development of the monitoring tool: the further development of the evaluation system for teachers and schools; the diversification of pathways implemented with new Vocational Education Training (VET) programs; an increased number of hours of on the job training in VET options; a National skills Strategy; the creation of TESPs courses (more than 90 authorisations so far but most of the beneficiaries have not yet started the programmes in practical terms). • Some progress towards a more efficient

	public spending through the rationalisation of the schools network and a new funding formula to provide more incentives to better performing schools. • Limited progress in improving cooperation between public research and business and encouraging knowledge transfer. There are still weak and scattered policy incentives for the cooperation between public research performing organisations and businesses. The role of the Innovation Agency has been reformulated and its governance has been streamlined. However, the announced action plan has not been implemented yet.
CSR5: Monitor banks' liquidity position and potential capital shortfalls, including by on-site thematic inspections and stress-testing. Assess the banks' recovery plans and introduce improvements to the evaluation process where necessary. Implement a comprehensive strategy to reduce the corporate debt overhang and reinforce efforts to widen the range of financing alternatives, including for early stages of business developments, by enhancing the efficiency of the debt restructuring tools (particularly PER and SIREVE) for viable companies, introducing incentives for banks and debtors to engage in restructuring processes at an early stage and improving the availability of financing via the capital market. Ensure that the identified measures support the reallocation of financing towards the productive sectors of the economy, including to viable SMEs, while avoiding risks to public finances and financial stability. Implement, by end September 2014, an early warning system mainly with supervisory purposes, to identify firms, including SMEs, with a high probability of default due to an excessive level of indebtedness, and which can, indirectly, promote early corporate debt restructuring.	Portugal has made **substantial progress** in addressing CSR 5: • Substantial progress in monitoring banks' liquidity and capital position and assess banks' recovery plans. Portugal has announced the following measures: – Follow-up by Banco de Portugal to the Comprehensive Assessment exercise – Analysis of pillar 1 and 2 regulatory measures to promote corporate debt restructuring or sale/transfer of underlying exposures • Substantial progress in implementing measures to reduce corporate debt overhang. Portugal has adopted the Strategic plan for Corporate Debt Restructuring (published) • **Some progress** in widening the range of financing alternatives for corporates: formal establishment of Development Financial Institution (DFI), intended to help address market failures which hamper SME access to finance (company licence issued in September 2014) • The early warning system is fully implemented. Portugal has implemented the following measures:

	– early warning system for defaults; – overhaul of corporate insolvency and restructuring framework, with stronger focus on recovery of firms rather than liquidation
CSR6: Implement the second and third packages of measures in the energy sector aimed at reducing energy costs for the economy, while eliminating the electricity tariff debt by 2020, and closely monitor implementation. Improve the cross-border integration of the energy networks and speed up implementation of the electricity and gas interconnection projects. Implement the comprehensive long-term transport plan and the 'chronogram' setting out the ports sector reforms. Complete the transports concessions for the metropolitan areas of Lisbon and Oporto. Ensure that the renegotiations of the existing port concessions and the new authorisation schemes are performance-oriented and in line with internal market principles, in particular procurement rules. Ensure that the national regulatory authority for transport (AMT) is fully independent and operational by the end of September 2014. Ensure the financial sustainability of the state-owned enterprises in the transport sector. Strengthen efficiency and competition in the railways sector, by implementing the plan for the competitiveness of CP Carga, after the transfer of the freight terminals while ensuring the management independence of the state-owned infrastructure manager and railway undertakings.	Portugal has made **some progress** in addressing CSR6: • Some progress in implementing the second and third packages in the energy sector. Portugal has implemented the enhanced electricity social tariff (part of the third package of energy sector measures) and approved the extension of the special energy levy (included in the 2015 budget). Despite some progress, excessive rents still exist and also the electricity tariff deficit needs to be further addressed, through a set of credible additional measures. Taxes on electricity have risen for customers in recent years, mitigating progress made through interconnections that lower prices thanks to competition. Overall the real cost of energy has fallen in Portugal. Some progress has been made in improving the cross-border integration of the energy networks. On 6 January 2015 in Brussels, the Spanish, French and Portuguese transmission system operators signed a joint strategy paper to develop interconnection between the Iberian Peninsula and the internal electricity market. The joint strategy paper lists shared goals and indicates which options for projects have the potential to increase the current interconnection capacity. This strategy will be important in reaching the minimum interconnection level of 10% agreed by the European Council in October 2014. • Limited progress in implementing the long-term transport plan and ports sector chronogram. These measures are longer-term so they are likely to be only partially completed by the summer of 2015. Limited progress has been observed in transports concessions for the metropolitan areas of Lisbon and Porto. These measures have incurred significant delays as well.

	The tender process for the Porto public transport concessions was launched over the summer and has been concluded in January 2015, several months later than planned. The tender for Lisbon is expected to be launched by the end of first quarter of 2015, just after the PSO contracts are signed. Limited progress has been made in the port concession renegotiations that have proceeded at a slow pace and will likely continue to do so; as a result, completion by the summer of 2015 is unlikely. No progress has been made in ensuring that the Transport regulator is fully operational (the recommended deadline was the end-September 2014). On 2 February 2015, a new amendment to the AMT bylaw was published. The amended legislation extends the AMT's establishment period (due by the end of September 2014). The new provision states that AMT is legally able to carry out its assignments from February 2015. Limited progress has been observed in the railways sector. The merger between EP/REFER is ongoing. Further progress was made with staff reductions in transport sector SOEs; this will continue in 2015. The planning commission for the EP-REFER merger was nominated in August 2014 (intended to improve transport SOEs' financial sustainability).
CSR7: Further improve the evaluation of the housing market, including by setting up, by the end of 2014, a more systematic monitoring and reporting framework and issue a comprehensive report on the shadow economy in that market. Continue efforts to carry out further inventories of regulatory burden with a view to including, by March 2015, sectors not yet covered. Adopt and implement, by the end of September 2014, the outstanding licensing decrees and sectoral amendments. Remove, by the end of September 2014, remaining restrictions in the professional services sector and enact the professional bodies' amended bylaws which have not yet been adopted under the macroeconomic adjustment programme. Eliminate payment delays by the public sector. Ensure adequate resources of the national regulators and competition authority.	Portugal has made **limited progress** in addressing CSR 7: • No progress by the end of 2014 (recommended deadline) in further improving the evaluation of the housing market, including by setting up, by the end of 2014, a more systematic monitoring and reporting framework and issue a comprehensive report on the shadow economy in that market. At the end of January 2015, the authorities published a decree establishing a working group tasked with implementing a monitoring model of the housing market. The study on the shadow economy in the Portuguese rental market is now expected to be issued at the end of August 2015

	• Some progress in continuing efforts to carry out further inventories of regulatory burden with a view to including, by March 2015 sectors not yet covered. Under the SIMPLIFICAR initiative, Portugal is implementing a road map to reduce regulatory burdens. Work is ongoing, although with some delay, to further improve the business-friendliness of the regulatory environment. This includes approving the methodology for impact assessment of legislation which includes the "one-in/one-out" rule and broadens the scope of the existing inventory of the most burdensome regulations to include new sectors, such as tourism, construction and agriculture. To this end, a governance framework for centralised regulatory simplification activities is being set up, based on inter-ministerial coordination and stakeholder engagement mechanisms. • No progress by the end-September 2014 (recommended deadline) in adopting and implementing all outstanding sectoral amendments. Some outstanding sectoral amendments, precious metals, mining and some legislation on territorial planning, have not yet been implemented. There is no political will to approve a new law on universities. Some progress was made after the recommended deadline: – the law on land registration experts was published on 9 January 2015; – the new commercial licensing regime was published on 16 January 2015; – the legal framework for the single environmental license was approved by the Council of Ministers at the end of January 2015. – copyright collective management societies, electricians, bullfighters, gas installation services and professionals, general law on construction, general law on construction professionals were all approved by the Council of Ministers and sent to Parliament during in 2014. All were approved by the Parliament at first

	reading. • No progress by the end of September 2014 (recommended deadline) in removing, the remaining restrictions in the professional services sector. However, limited progress has been made recently on removing restrictions in the professional service sector. The general law on professional partnerships was approved in the Council of Ministers of 18/12/2014 and sent to Parliament for enactment. No progress by the end of September 2014 (recommended deadline) in enacting the professional bodies' amended bylaws. None of the outstanding 18 bylaw of highly regulated professions has been implemented. 9 draft bylaws for highly regulated professions are reportedly finalised but have not yet been approved by the Council of Ministers. The remaining 9 draft bylaws are experiencing delays, mainly due to non-compliance with the framework law for highly regulated professions and with EU law (particularly the bylaws from the Ministry of Justice for lawyers, solicitors, enforcement agents, notaries) • No progress in eliminating payment delays by the public sector. • Some progress in ensuring that the national regulators and competition authority have adequate resources. The Competition bylaw was published in August 2014. As regards the outstanding NRAs bylaws, the CMVM and ISP statutes were published on 6 January 2015; ANAC and ANACOM bylaws were approved by the Council of Ministers at the end of December 2014. A new amendment to the AMT bylaw was published on 2 February 2015.
CSR8: Continue to rationalise and modernise central, regional and local public administration. Implement the reforms to enhance the efficiency of the judicial system and increase transparency. Step up efforts to evaluate the implementation of reforms undertaken under the macroeconomic adjustment programme as well as planned and future reforms. In particular, insert mandatory systematic ex ante and ex post assessments in the legislative process. Set up a	Portugal has made **some progress** in addressing CSR 8: • Some progress in rationalising and modernising central, regional and local public administration. Portugal announced a global strategic plan to rationalize and reduce ICT costs in public administration (at early stages of defining scope and

functionally independent central evaluation unit at government level, which assesses and reports every six months on the implementation of these reforms, including consistency with the ex-ante impact assessment, with corrective action if needed.	implementing roadmaps). In the context of the SIMPLIFICAR initiative, Portugal is: – implementing the road map for the reduction of regulatory burden; – further making the regulatory environment more business-friendly, which includes approving the methodology for assessing the impact of legislation including the "one-in/one-out" rule; – broadening the scope of the existing inventory of the most burdensome regulations to cover new sectors, such as tourism, construction and agriculture. A centralised governance framework for regulatory simplification activities is being set up for this purpose, based on inter-ministerial coordination and stakeholder engagement mechanisms. – Portugal has also implemented the Municipality Support Fund (FAM), a debt work-out mechanism for over-indebted municipalities which was formally established in August 2014. Preparations have started for the 2015 roll-out of the "Aproximar" strategy (designed to reorganise the public services network at local level). • Some progress has been made in enhancing the efficiency of the judicial system and increasing transparency. The code of civil procedures has been adopted but no data are yet available on the clearance rate and disposition time under the new regime. Judicial reorganisation has had a slow start. It remains to be seen the real benefits in the coming years. IT applications for the Tax and Administrative Courts are still underdeveloped. Some progress has been made on improving transparency and combating corruption. Measures have been taken to further improve transparency in public procurement and private-public partnerships. Some challenges remain in implementing transparency requirements by local and regional authorities and in effectively applying the existing legal

	framework for the prevention of corruption and conflict of interests. • No progress has been made in evaluating the implementation of reforms undertaken under the macroeconomic adjustment programme as well as planned and future reforms. No progress was observed in setting up a functionally independent central evaluation unit.
Europe 2020 (national targets and progress)	
Employment rate target (20-64 years old):75%	The employment rate has fallen on a yearly basis since the start of the economic crisis, from 73.1% in 2008 to 66.3% in 2012 and 65.4 % in 2013. Despite some recent labour market reforms to encourage job creation, the achievement of the national target of 75% by 2020 proves challenging.
R&D target: 1.36% of GDP	Portugal set a national R&D intensity target for 2020 of 3%, where public-sector R&D intensity would reach 1 % and business R&D intensity 2%. From 2000 up to the crisis years, Portugal made very significant progress towards the R&D intensity target. However, R&D intensity fell from 1.58% in 2009 to 1.36% in 2013, where public sector R&D intensity was 0.59% and business R&D intensity 0.65 %. Limited progress has been made. Portugal should make a major effort to ensure that investment in research and innovation is sustainable and efficient and to stimulate knowledge absorption by businesses.
Greenhouse gas (GHG) emissions target: -National Greenhouse gas (GHG) emissions target: 1% in 2020 compared to 2005 (in non-ETS sectors)	On the basis of the latest national projections and taking into account existing measures, it is expected that target will be met: -31% in 2020 compared to 2005 (with a margin of 32% percentage points). Key measures are being implemented: the national climate change programme "*Programa Nacional para as Alterações Climáticas*" for the period 2013-2020 (PNAC 2020) and the national low-carbon strategy "*Roteiro Nacional de Baixo Carbono*".

2020 Renewable energy target for Portugal: 31% Share of renewable energy in all modes of transport: 10%	In 2013, renewable energy production accounted for 25.7% of the final energy demand, (Source; EurObserv'ER). Portugal is above the trajectory but more action is needed to maintain this situation until 2020.
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 is on track to meet its national target, which is however, somewhat unambitious. Although primary and final energy consumption fell between 2005 and 2012, Portugal should implement further policies to bring about structural changes and a sustainable reduction in energy consumption. Discussions with the national authorities in the framework of ESIF revealed problems with transposing the Energy Performance in Buildings Directive that need urgent action.
Early school leaving target: 10%	Early school leaving has fallen gradually over the last decade from 45% in 2002 to 20.8% in 2012 and 18.9% in 2013. However, the rate of early school leaving remains among the EU's highest.
Tertiary education target: 40%	See paragraph above. Tertiary education attainment was 30% in 2013. There has been remarkable progress from rates of about 11% at the beginning of last decade. However, attainment remains significantly below the EU average. Some efforts are being made to address the skills mismatch and lack of employability of higher education graduates in Portugal. They include reforming the VET system, publishing employment rates and the rationalising career offer. However, more robust actions would be needed to improve its quality, labour market relevance and attractiveness of tertiary education.
The target envisages reducing the number of persons in or at risk of poverty and social exclusion by 200 000 persons in 2020.	The number of people living at risk of poverty or social exclusion rose by 210,000, from 2,667,000 in 2012 to 2,877,000 in 2013. Sustained efforts will be needed in the future, specially taking into account the latest data and the projected demographic trends.

ANNEX B
Standard Tables

Table B.1: **Macroeconomic indicators**

	1996-2000	2001-2005	2006-2010	2011	2012	2013	2014	2015	2016
Core indicators									
GDP growth rate	4.1	0.9	0.6	-1.8	-3.3	-1.4	1.0	1.6	1.7
Output gap [1]	2.8	0.7	-0.9	-3.5	-6.1	-6.4	-4.9	-3.1	-1.4
HICP (annual % change)	2.4	3.2	1.7	3.6	2.8	0.4	-0.2	0.1	1.1
Domestic demand (annual % change) [2]	5.0	0.8	0.5	-5.7	-6.6	-2.3	1.8	1.6	1.5
Unemployment rate (% of labour force) [3]	6.5	7.0	9.9	12.9	15.8	16.4	14.2	13.4	12.6
Gross fixed capital formation (% of GDP)	26.5	24.7	21.9	18.4	16.3	15.1	15.1	15.3	15.6
Gross national saving (% of GDP)	19.7	16.0	11.6	13.0	14.0	15.2	15.2	16.1	16.7
General government (% of GDP)									
Net lending (+) or net borrowing (-)	-3.8	-5.0	-6.4	-7.4	-5.5	-4.9	-4.6	-3.2	-2.8
Gross debt	53.6	59.5	77.8	111.1	124.8	128.0	128.9	124.5	123.5
Net financial assets	-31.5	-41.9	-54.6	-53.0	-76.3	-83.7	n.a.	n.a.	n.a.
Total revenue	38.9	40.2	41.0	42.6	43.0	45.2	44.0	43.9	44.2
Total expenditure	42.7	45.2	47.4	50.0	48.5	50.1	48.6	47.1	47.0
of which: Interest	3.6	2.7	2.9	4.3	4.9	5.0	5.0	4.9	4.8
Corporations (% of GDP)									
Net lending (+) or net borrowing (-)	-3.2	-4.5	-5.5	0.6	0.3	0.7	0.8	0.0	0.3
Net financial assets; non-financial corporations	-137.2	-131.5	-149.9	-164.2	-162.6	-164.1	n.a.	n.a.	n.a.
Net financial assets; financial corporations	-9.7	-7.5	-5.4	-2.5	1.2	-1.1	n.a.	n.a.	n.a.
Gross capital formation	13.7	13.0	13.0	10.9	10.4	10.0	10.4	10.6	10.4
Gross operating surplus	19.7	19.4	20.5	21.0	21.5	21.4	21.8	22.2	23.5
Households and NPISH (% of GDP)									
Net lending (+) or net borrowing (-)	1.3	2.2	2.3	2.6	4.6	5.5	5.1	5.2	4.8
Net financial assets	154.4	124.6	119.3	121.8	129.4	139.3	n.a.	n.a.	n.a.
Gross wages and salaries	38.3	38.2	36.8	36.1	34.9	34.6	34.3	34.1	33.5
Net property income	5.3	4.6	6.0	5.5	6.5	7.0	8.4	8.8	9.2
Current transfers received	20.3	21.5	23.0	24.8	25.5	26.8	25.9	25.9	25.5
Gross saving	8.0	7.2	5.9	5.3	6.9	7.3	6.8	6.9	6.5
Rest of the world (% of GDP)									
Net lending (+) or net borrowing (-)	-5.7	-7.3	-9.6	-4.1	-0.6	1.3	1.3	2.0	2.2
Net financial assets	28.6	60.3	95.7	106.9	118.0	116.4	n.a.	n.a.	n.a.
Net exports of goods and services	-9.1	-8.6	-8.0	-4.3	-0.7	1.0	0.9	1.6	2.0
Net primary income from the rest of the world	-0.6	-1.6	-3.5	-2.1	-2.9	-2.2	-2.2	-2.3	-2.3
Net capital transactions	2.0	1.7	1.2	1.5	2.0	1.5	1.6	1.6	1.6
Tradable sector	45.4	42.0	39.8	40.2	41.3	41.8	n.a.	n.a.	n.a.
Non-tradable sector	42.2	45.3	47.6	47.4	46.2	46.1	n.a.	n.a.	n.a.
of which: Building and construction sector	6.3	6.4	5.7	4.8	4.2	3.7	n.a.	n.a.	n.a.

(1) The output gap constitutes the gap between the actual and potential gross domestic product at 2010 market prices.
(2) The indicator of domestic demand includes stocks.
(3) Unemployed persons are all those who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.
Source: European Commission 2015 winter forecast; Commission calculations

Table B.2: **Financial market indicators**

	2009	2010	2011	2012	2013	2014
Total assets of the banking sector (% of GDP)1)	308.6	323.3	335.0	337.4	310.9	278.4
Share of assets of the five largest banks (% of total assets)	70.1	70.9	70.8	69.9	70.6	n.a.
Foreign ownership of banking system (% of total assets)	23.1	22.2	21.4	20.6	19.4	n.a.
Financial soundness indicators:						
- non-performing loans (% of total loans)2)3)	4.8	5.2	7.5	9.8	10.6	11.2
- capital adequacy ratio (%)2)3)	10.5	10.3	9.8	12.6	13.3	12.0
- return on equity (%)2)3)	7.3	7.5	-5.5	-5.4	-11.0	-24.8
Bank loans to the private sector (year-on-year % change)1)	3.1	1.7	-3.3	-6.0	-5.0	-5.0
Lending for house purchase (year-on-year % change)1)	4.2	3.5	-0.5	-2.8	-3.5	-3.6
Loan to deposit ratio1)	133.3	123.9	116.1	119.5	111.4	106.3
Central Bank liquidity as % of liabilities4)	3.5	8.3	9.1	11.0	10.9	9.2
Private debt (% of GDP)	204.1	201.5	204.2	207.8	202.8	n.a.
Gross external debt (% of GDP)5) - public	58.8	55.6	57.5	80.0	87.2	94.7
- private	42.8	40.2	45.5	46.7	47.7	47.6
Long-term interest rate spread versus Bund (basis points)*	98.9	265.3	763.3	905.3	472.4	259.1
Credit default swap spreads for sovereign securities (5-year)*	72.4	253.0	772.8	818.7	355.8	173.0

(1) Latest data November 2014.
(2) Latest data Q2 2014.
(3) A new calculation method for nonperforming loans that follows the methodology of the Financial Soundness Indicators Compilation Guide was introduced in September 2011. Historical annual data have been revised accordingly, back to 2006.
(4) Latest data September 2014.
(5) Latest data June 2014. Monetary authorities, monetary and financial institutions are not included.
* Measured in basis points.
Source: IMF (financial soundness indicators); European Commission (long-term interest rates); World Bank (gross external debt); ECB (all other indicators).

Table B.3: **Taxation indicators**

	2002	2006	2008	2010	2011	2012
Total tax revenues (incl. actual compulsory social contributions, % of GDP)	31.4	32.1	32.8	31.5	33.2	32.4
Breakdown by economic function (% of GDP)[1]						
Consumption	12.0	13.2	12.3	11.7	12.2	12.1
of which:						
- VAT	7.6	8.6	8.4	7.8	8.3	8.5
- excise duties on tobacco and alcohol	1.0	1.1	0.9	1.0	1.0	1.0
- energy	2.1	2.0	1.9	1.8	1.8	1.7
- other (residual)	1.3	1.5	1.2	1.1	1.1	1.0
Labour employed	11.3	11.4	11.7	12.2	12.7	12.2
Labour non-employed	0.6	0.8	0.9	1.0	1.2	1.2
Capital and business income	5.1	4.4	5.5	4.3	4.9	4.4
Stocks of capital/wealth	2.5	2.3	2.4	2.3	2.3	2.4
p.m. Environmental taxes[2]	3.0	2.9	2.6	2.5	2.4	2.2
VAT efficiency[3]						
Actual VAT revenues as % of theoretical revenues at standard rate	53.3	52.9	53.4	46.7	46.7	48.8

(1) Tax revenues are broken down by economic function, i.e. according to whether taxes are raised on consumption, labour or capital. See European Commission (2014), Taxation trends in the European Union, for a more detailed explanation.
(2) This category comprises taxes on energy, transport and pollution and resources included in taxes on consumption and capital.
(3) VAT efficiency is measured via the VAT revenue ratio. It is defined as the ratio between the actual VAT revenue collected and the revenue that would be raised if VAT was applied at the standard rate to all final (domestic) consumption expenditures, which is an imperfect measure of the theoretical pure VAT base. A low ratio can indicate a reduction of the tax base due to large exemptions or the application of reduced rates to a wide range of goods and services ('policy gap') or a failure to collect all tax due to e.g. fraud ('collection gap'). It should be noted that the relative scale of cross-border shopping (including trade in financial services) compared to domestic consumption also influences the value of the ratio, notably for smaller economies. For a more detailed discussion, see European Commission (2012), Tax Reforms in EU Member States, and OECD (2014), Consumption tax trends.
Source: European Commission

Table B.4: **Labour market and social indicators**

	2008	2009	2010	2011	2012	2013	2014
Employment rate (% of population aged 20-64)	73.1	71.1	70.3	68.8	66.3	65.4	67.5
Employment growth (% change from previous year)	0.4	-2.7	-1.4	-1.9	-4.1	-2.9	1.6
Employment rate of women (% of female population aged 20-64)	67.1	66.1	65.6	64.6	63.0	62.3	64.0
Employment rate of men (% of male population aged 20-64)	79.4	76.4	75.4	73.2	69.8	68.7	71.2
Employment rate of older workers (% of population aged 55-64)	50.7	49.7	49.5	47.8	46.5	46.9	47.9
Part-time employment (% of total employment, age 15 years and over)	12.2	11.9	11.9	13.6	14.6	14.3	13.1
Part-time employment of women (% of women employment, age 15 years and over)	17.4	16.6	15.7	16.5	17.0	16.4	14.8
Part-time employment of men (% of men employment, age 15 years and over)	7.6	7.7	8.4	11.0	12.5	12.3	11.6
Fixed term employment (% of employees with a fixed term contract, age 15 years and over)	22.7	22.0	22.8	22.0	20.5	21.4	21.4
Transitions from temporary to permanent employment	33.7	20.3	29.6	28.8	26.3	n.a.	n.a.
Unemployment rate[1] (% of labour force, age group 15-74)	8.7	10.7	12.0	12.9	15.8	16.4	14.1
Long-term unemployment rate[2] (% of labour force)	4.1	4.7	6.3	6.2	7.7	9.3	8.5
Youth unemployment rate (% of youth labour force aged 15-24)	21.5	25.3	27.9	30.3	37.9	38.1	34.7
Youth NEET rate (% of population aged 15-24)	10.2	11.2	11.4	12.6	13.9	14.1	n.a.
Early leavers from education and training (% of pop. aged 18-24 with at most lower sec. educ. and not in further education or training)	34.9	30.9	28.3	23.0	20.5	18.9	n.a.
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	21.6	21.3	24.0	26.7	27.8	30.0	n.a.
Formal childcare (from 1 to 29 hours; % over the population aged less than 3 years)	2.0	2.0	5.0	1.0	n.a.	n.a.	n.a.
Formal childcare (30 hours or over; % over the population aged less than 3 years)	31.0	34.0	32.0	34.0	34.0	n.a.	n.a.
Labour productivity per person employed (annual % change)	-0.2	-0.3	3.4	0.1	0.8	1.6	-0.7
Hours worked per person employed (annual % change)	-0.7	0.0	0.1	-1.2	0.3	0.6	0.9
Labour productivity per hour worked (annual % change; constant prices)	0.5	-0.3	3.2	1.4	0.5	1.0	-1.6
Compensation per employee (annual % change; constant prices)	0.9	1.3	1.4	-1.6	-1.7	1.2	-1.5
Nominal unit labour cost growth (annual % change)	3.5	3.1	-1.4	-0.9	-3.0	1.9	n.a.
Real unit labour cost growth (annual % change)	1.9	2.2	-2.1	-1.1	-2.7	0.1	n.a.

(1) Unemployed persons are all those who were not employed, but had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. Data on the unemployment rate of 2014 includes the last release by Eurostat in early February 2015.
(2) Long-term unemployed are persons who have been unemployed for at least 12 months.
Source: European Commission (EU Labour Force Survey and European National Accounts)

Table B.5: **Expenditure on social protection benefits (% of GDP)**

	2007	2008	2009	2010	2011	2012
Sickness/healthcare	6.4	6.5	7.3	7.0	6.3	6.4
Invalidity	2.3	2.1	2.1	2.1	2.1	1.9
Old age and survivors	11.3	11.9	12.9	13.1	13.8	13.9
Family/children	1.2	1.3	1.4	1.4	1.2	1.2
Unemployment	1.1	1.0	1.4	1.4	1.4	1.7
Housing and social exclusion n.e.c.	0.0	0.0	0.0	0.0	0.0	0.0
Total	22.6	23.2	25.5	25.4	25.0	25.4
of which: means-tested benefits	2.1	2.3	2.6	2.5	2.2	2.3
Social inclusion indicators	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
People at risk of poverty or social exclusion[1] (% of total population)	26.0	24.9	25.3	24.4	25.3	27.5
Children at risk of poverty or social exclusion (% of people aged 0-17)	29.5	28.7	28.7	28.6	27.8	31.7
Elderly at risk of poverty or social exclusion (% of people aged 65+)	27.7	26.0	26.1	24.5	22.2	20.3
At-risk-of-poverty rate[2] (% of total population)	18.5	17.9	17.9	18.0	17.9	18.7
Severe material deprivation rate[3] (% of total population)	9.7	9.1	9.0	8.3	8.6	10.9
Proportion of people living in low work intensity households[4] (% of people aged 0-59)	6.3	7.0	8.6	8.3	10.1	12.2
In-work at-risk-of-poverty rate (% of persons employed)	11.8	10.3	9.7	10.3	9.9	10.5
Impact of social transfers (excluding pensions) on reducing poverty	25.7	26.3	32.2	29.1	29.2	26.7
Poverty thresholds, expressed in national currency at constant prices[5]	4770.3	4725.9	4997.5	4776.7	4565.1	4363.5
Gross disposable income (households)	123499.0	122959.0	126612.0	124810.0	122848.0	121997.0
Relative median poverty risk gap (60% of median equivalised income, age: total)	23.2	23.6	22.7	23.2	24.1	27.4
Inequality of income distribution (S80/S20 income quintile share ratio)	6.1	6.0	5.6	5.7	5.8	6.0

(1) People at risk of poverty or social exclusion (AROPE): individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI).
(2) At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.
(3) Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.
(4) People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20 % of their total work-time potential in the previous 12 months.
(5) For EE, CY, MT, SI and SK, thresholds in nominal values in euros; harmonised index of consumer prices (HICP) = 100 in 2006 (2007 survey refers to 2006 incomes).
(6) 2014 data refer to the average of the first three quarters.
Source: For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table B.6: **Product market performance and policy indicators**

	2004-08	2009	2010	2011	2012	2013	2014
Labour productivity1 in total economy (annual growth in %)	1.5	0.2	3.3	0.8	1.6	1.9	n.a.
Labour productivity[1] in manufacturing (annual growth in %)	3.2	-2.6	10.0	2.6	4.3	5.8	n.a.
Labour productivity[1] in electricity, gas (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	na
Labour productivity[1] in the construction sector (annual growth in %)	0.5	-2.1	-2.3	3.1	5.0	3.0	n.a.
Labour productivity[1] in the wholesale and retail sector (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity[1] in the information and communication sector (annual growth in %)	0.8	-2.8	-5.0	3.9	0.1	-3.0	n.a.
Patent intensity in manufacturing[2] (EPO patent applications divided by gross value added of the sector)	0.0	0.0	0.0	0.0	n.a.	n.a.	n.a.
Policy indicators	**2004-08**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Enforcing contracts[3] (days)	577	547	547	547	547	547	547
Time to start a business[3] (days)	28.5	5	5	4	4	3	3
R&D expenditure (% of GDP)	1.0	1.6	1.5	1.5	1.4	1.4	n.a.
Total public expenditure on education (% of GDP)	5.1	5.8	5.6	5.3	n.a.	n.a.	n.a.
(Index: 0=not regulated; 6=most regulated)	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Product market regulation[4], overall	1.69	n.a.	n.a.	n.a.	n.a.	1.29	n.a.
Product market regulation[4], retail	3.97	n.a.	n.a.	n.a.	n.a.	1.83	n.a.
Product market regulation[4], professional services	3.08	n.a.	n.a.	n.a.	n.a.	2.92	n.a.
Product market regulation[4], network industries[5]	2.55	2.55	2.37	2.31	2.31	2.18	n.a.

(1) Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.
(2) Patent data refer to applications to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.
(3) The methodologies, including the assumptions, for this indicator are presented in detail here: http://www.doingbusiness.org/methodology.
(4) Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are presented in detail here: http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm
(5) Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).
Source: European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators)

Table B.7: **Green growth**

Green growth performance		2003-2007	2008	2009	2010	2011	2012
Macroeconomic							
Energy intensity	kgoe / €	0.17	0.16	0.16	0.15	0.15	0.15
Carbon intensity	kg / €	0.54	0.49	0.48	0.45	0.44	0.45
Resource intensity (reciprocal of resource productivity)	kg / €	1.25	1.43	1.31	1.21	1.24	n.a.
Waste intensity	kg / €	n.a.	0.23	n.a.	0.11	n.a.	0.09
Energy balance of trade	% GDP	-3.3	-4.8	-2.9	-3.5	-4.3	-4.8
Energy weight in HICP	%	8.5	9.9	10.9	11.7	12.7	13.8
Difference between energy price change and inflation	%	1.5	1.8	1.3	4.5	6.6	10.9
Ratio of environmental taxes to labour taxes	ratio	24.3%	20.3%	19.3%	18.9%	17.0%	16.3%
Ratio of environmental taxes to total taxes	ratio	9.2%	7.8%	8.1%	7.9%	7.1%	6.7%
Sectoral							
Industry energy intensity	kgoe / €	0.24	0.22	0.23	0.22	0.21	0.19
Share of energy-intensive industries in the economy	% GDP	9.2	9.3	8.4	9.3	9.2	n.a.
Electricity prices for medium-sized industrial users**	€ / kWh	n.a.	0.09	0.09	0.09	0.10	0.11
Gas prices for medium-sized industrial users***	€ / kWh	n.a.	0.03	0.03	0.03	0.04	0.04
Public R&D for energy	% GDP	n.a.	0.01	0.02	0.02	0.02	0.02
Public R&D for the environment	% GDP	n.a.	0.02	0.03	0.03	0.03	0.03
Recycling rate of municipal waste	ratio	35.3%	35.5%	39.2%	38.0%	41.1%	45.6%
Share of GHG emissions covered by ETS*	%	n.a.	38.3	37.7	34.2	36.1	36.8
Transport energy intensity	kgoe / €	1.21	1.07	1.12	1.09	1.01	n.a.
Transport carbon intensity	kg / €	3.32	2.80	2.95	2.83	2.58	n.a.
Security of energy supply							
Energy import dependency	%	84.7	83.4	81.4	75.1	77.6	79.5
Diversification of oil import sources	HHI	0.06	0.06	0.06	0.07	0.07	0.09
Diversification of energy mix	HHI	n.a.	0.35	0.33	0.35	0.32	0.29
Renewable energy share of energy mix	%	15.3	17.0	19.1	22.5	21.7	19.8

Country-specific notes:
2013 is not included in the table due to lack of data.
General explanation of the table items:
All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2000 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
Energy weight 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)
Environmental taxes over labour or total taxes: from DG TAXUD'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)
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 500–2000MWh and 10000–100000 GJ; figures excl. VAT.
Recycling rate of municipal waste: ratio of recycled municipal waste to total municipal waste
Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP
"Proportion of GHG emissions covered by ETS: based on greenhouse gas emissions (excl LULUCF) as reported by Member States to the European
Environment Agency "
Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2005 EUR)
Transport carbon intensity: greenhouse gas emissions in transport activity divided by gross value added of the transport sector
Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels
Diversification of oil import sources: Herfindahl index (HHI), calculated as the sum of the squared market shares of countries of origin
Diversification of the energy mix: Herfindahl index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels
Renewable energy share of energy mix: %-share of gross inland energy consumption, expressed in tonne oil equivalents
* European Commission and European Environment Agency
** For 2007 average of S1 & S2 for DE, HR, LU, NL, FI, SE & UK. Other countries only have S2.
*** For 2007 average of S1 & S2 for HR, IT, NL, FI, SE & UK. Other countries only have S2.
Source: European Commission unless indicated otherwise; European Commission elaborations indicated below

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KC-AH-15-222-EN-N

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