



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

EUROPEAN ECONOMY

Occasional Papers 202 | October 2014

The Economic Adjustment Programme for Portugal 2011-2014



Economic and
Financial Affairs

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KC-AH-14-202-EN-N (online)
ISBN 978-92-79-38816-3 (online)
doi:10.2765/85246 (online)

KC-AH-14-202-EN-C (print)
ISBN 978-92-79-38817-0 (print)
doi:10.2765/85282 (print)

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European Commission

Directorate-General for Economic and Financial Affairs

The Economic Adjustment Programme for Portugal

2011 – 2014

ACKNOWLEDGEMENTS

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EXECUTIVE SUMMARY

This report has been prepared to provide a general overview and assessment of the performance of the Portuguese economy under the EU/IMF adjustment programme and the remaining challenges ahead. Portugal's recent exit from the Programme implied the lapsing of the 12th and final review of programme implementation. In consequence, the final compliance report under the Programme – which was intended to also provide a more holistic review of programme implementation since May 2011 – could not be presented. Accordingly, this report has been prepared, on a sui generis basis, to describe the progress throughout the Programme under various key headings, notably the adjustment in the macro-economy, the consolidation of public finances, stabilisation and reinforcement of the financial sector, and structural reforms.

Portugal suffered from low GDP and productivity growth for more than a decade before the outbreak of the economic and financial crisis in 2009 and the request for external financial assistance in spring 2011. Potential output growth had been on a steady downward trend, with competitiveness being undermined by rising unit labour costs and deep-rooted structural problems. As a consequence of persistent current account deficits, Portugal had accumulated a high external debt, which was reflected in high household, corporate and fiscal imbalances. The period from 2009 up to the request for financial assistance was marked by a significant increase in both government deficit and debt to GDP ratios and a worsening economic outlook, amid a sharp deterioration in global economic and financial conditions. This led to rising pressures on the external financing of Portuguese debt with sharp increases in interest rates, reflecting a deterioration of confidence among investors and divergent developments across the euro area sovereign bond markets. In parallel, the banking sector, which was also heavily dependent on external financing, was increasingly cut off from market-based funding and had to step up reliance on the Eurosystem. Amid consecutive downgrades of Portuguese sovereign bonds by the main credit rating agencies, and faced with widening financing needs, the Portuguese government became unable to refinance itself at rates compatible with long-term fiscal sustainability.

Following a request by Portugal on 7 April 2011, the European Commission, the ECB and the IMF negotiated an economic adjustment programme (henceforth "the Programme"), aimed at restoring access to market-based funding, enabling the return of the economy to sustainable growth, and safeguarding financial stability in Portugal, the euro area and the EU. The Programme covered the period May 2011 to June 2014⁽¹⁾ and entailed a financial package of some EUR 78 billion for possible fiscal financing needs and support to the banking system.

The Programme foresaw comprehensive action on three fronts: First, there was a credible and balanced fiscal consolidation strategy, supported by fiscal-structural measures such as better control over public expenditure, Public-Private-Partnerships (PPPs) and state-owned enterprises (SOEs), which aimed at breaking the increase in the gross public debt-to-GDP ratio and putting it on a firm downward path in the medium term. Second, efforts to safeguard stability in the financial sector through market-based mechanisms were supported by ring-fenced Programme financing (BSSF); central to these efforts were measures to foster a gradual and orderly deleveraging of bank balance sheets, reinforced capitalisation of banks and improved banking supervision, while ensuring adequate financing of the economy. Third, there were deep and frontloaded structural reforms to boost potential growth, create jobs, and improve competitiveness; in particular, the Programme contained reforms of the labour market, the judicial system, network industries and housing and services sectors. While addressing fiscal, financial and structural imbalances, an important aim of the Programme was to mitigate possible negative social impacts. In particular, tax increases and benefit reforms were designed so as to minimise their impact on the lowest income groups.

In the face of challenging circumstances, Programme implementation over the past three years has been successful overall in improving public finances, stabilising the financial sector and bringing the economy back on a path of recovery. Fiscal adjustment has been important, as evidenced by the

⁽¹⁾ The programme was extended by six weeks to end-June 2014 for procedural reasons.

substantial improvement in the nominal and structural government deficit over 2011-2013, with the 2013 nominal deficit target overachieved and the 2014-2015 nominal deficit targets reaffirmed by the Government at the time of the twelfth review mission. This implies that the public debt-to-GDP ratio will peak in 2014 and remain on a firm downward path in the medium term. Ambitious reforms across all main sectors of the economy have helped to make the economy more flexible and competitive, reduce significantly external imbalances and rebalance growth away from the non-tradable towards the tradable sector. Budgetary consolidation, structural reforms and efforts at both the national and the European level to safeguard financial stability have improved the financing conditions in the economy and gradually restored access to sovereign debt markets. In combination with a generalised improvement in sentiment towards the euro area, strong Programme implementation has been instrumental in allowing Portugal to regain investor confidence and to conduct a number of successful bond exchanges and issuances, smoothing the profile for future debt payments and establishing a substantial cash buffer.

The economy has returned to a mild recovery path amid positive growth rates in several quarters and evidence of continuously rising business and consumer confidence. The recovery was initially led by exports but is becoming increasingly broad-based as private consumption, in particular, has picked up. Labour-market conditions continue to improve, with employment increasing and the unemployment rate falling. This suggests a continued firming of the recovery throughout 2014 and 2015, the pace of which will however be moderated by several constraining factors, notably remaining market rigidities, the continued high indebtedness of the economy, and a likely weaker-than-expected evolution in the euro-area economy.

The fiscal targets set by the Programme for 2014 and 2015 were reaffirmed by the Government during the 12th review mission and thereafter. According to the latest Programme forecast from May 2014 the nominal government deficit was expected to fall to 4% of GDP in 2014 and to 2.5% of GDP in 2015. The 12th review mission identified, however, important downside risks to the targets in both years, some of which have already materialised while new ones have arisen. In May, July and August the Constitutional Court (CC) has issued three rulings on measures contained in the 2014 budget and on measures planned for the 2015 budget which - together with a partial replacement measure reintroduced by the government - led to a net fiscal gap of 0.3% of GDP in 2014 and of about 0.7% of GDP in 2015. Not yet reflected in the latest forecast is the debt management strategy of transport SOEs with a legacy debt burden which will also have an impact on the 2014 nominal deficit. In addition, recent bank rescue operations could also be accounted by the statistical authorities as deficit-increasing. On 16 September, the Parliament approved a second Supplementary Budget (SB) for 2014, which plans to compensate the fiscal gap resulting from the CC decisions (net of the partial replacement measure) and newly identified pressures on budget execution in 2014 - in total 0.4% of GDP - by the fiscal impact of macroeconomic revisions (i.e. improved labour market situation and private consumption outlook) and an upward revision of revenue collection owing to higher efficiency in the fight against fraud. The second SB however does not include any additional consolidation measure. As a result of these events, the 2014 headline deficit could go up to 7.5% of GDP in ESA-2010 terms and 10% of GDP in ESA-95 terms, in both cases depending on an assessment by statistical authorities of some operations. The balance net of one-offs is still estimated to reach 4% of GDP, although risks are tilted to the downside (for example due to the delays in implementing one-off revenues foreseen in the consolidation package). This fiscal adjustment strategy is of lower quality than the initial plans, as it is less based on permanent expenditure reductions and minimises the necessary structural adjustment. It also departs from the commitment, which the authorities made during the Programme, of implementing compensatory measures of equivalent size and quality should legal or execution risks to the target materialise after CC rulings. Still, as most of the reasons for increasing the 2014 headline deficit are temporary, the attainment of the 2015 target remains within reach if the authorities present additional measures in the 2015 budget so as to replace those which were ruled unconstitutional by the CC and if they stand ready to specify new measures should the macroeconomic outlook for 2015 deteriorate.

Fiscal-structural measures under the Programme have put emphasis on institutional reforms to improve public financial management, to rationalise and control public expenditures and to limit fiscal risks. Public financial management has been substantially improved to strengthen the budgetary process, public entities' accountability and the monitoring of budget execution at each level of the government. Nevertheless, steps remain to be taken to create more predictable and transparent fiscal processes, to fully align national legislation with EU fiscal governance rules and to fully implement the new regulatory framework, in particular with a view to fully arresting the accumulation of new arrears. The revision of the regulatory framework for PPPs will help to minimise fiscal risks in the future, while renegotiations of contracts have advanced and should secure significant savings through 2019. The operational results of state-owned enterprises have improved markedly and the comprehensive debt strategy recently launched should restore their financial sustainability and pave the way for a successful tendering of concessions. The receipts from an ambitious privatisation agenda exceeded the initial Programme target. Significant steps were taken by the authorities to curb tax evasion and improve compliance, which is starting to bear fruits, though further reforms of the tax administration will be necessary in support of the ongoing fiscal consolidation, to improve tax fairness and to reduce compliance costs for taxpayers. Public administration reforms were wide-ranging though challenges remain towards further rationalisation and modernisation while ensuring an efficient delivery of public services within the limits of the budget. Notably, a significant reduction in the personnel of the public administration was achieved, including through early retirement and mutually agreed contract termination, while several attempts of the Government to reduce public sector wages were mostly ruled unconstitutional. The implementation of a comprehensive reform of the health sector aimed at improving its efficiency and cost-effectiveness, inducing a more rational use of health services and controlling public expenditure on health.

The key achievements in the financial sector segment of the Programme have recently been overshadowed by the turbulence surrounding the failure and the resolution of the third largest bank in the country, Banco Espírito Santo (BES), after the Programme had ended. Nonetheless, taking a broader view, the Portuguese banking sector has been stabilised, even though financing conditions in the economy remain difficult. Without prejudice to the results of the forthcoming Comprehensive Assessment, the capitalisation of the banks seems to be generally adequate, while their access to market-based funding continues to improve, notwithstanding a rather shortlived period of uncertainty preceding BES's resolution. The negative trend in non-performing loans appears to have stabilised, although operating conditions remain challenging. Despite some improvements in recent months, access to bank credit for companies, and notably SMEs, at reasonable cost is still constrained, calling for reinforced efforts to ensure adequate financing of the economy, including by encouraging alternative financing sources for the corporate sector. Meanwhile, the very high level of corporate debt remains an important impediment to investment and growth.

The Government has adopted a wide range of structural reforms under the Programme, including in the labour and product markets, network industries, services and regulated professions, the urban lease market and the judiciary, and in the public administration. Early signs of the effects of these reforms are already visible, although the lack of a comprehensive and systematic approach to monitoring and evaluation makes it difficult to assess their full impact on the functioning of the economy. Significant scope for additional reforms remains in key areas. For instance, with regard to labour market reform, a further reduction in labour market segmentation and improvements in the collective bargaining system are necessary to make wages more flexible and responsive to economic and firm-specific conditions, while the impact on employability of active labour market policies and vocational training needs to be enhanced. In the transport sector, addressing weaknesses and gaps in the long-term transport plan, implementing further reforms in the ports system to pass on cost savings to end users, and a strengthening of competition in the railway and metropolitan transport sectors are required. In the energy sector, swift implementation of further actions to tackle remaining excess rents is necessary so as to reduce energy costs for the economy. The transposition of the Service Directive needs to be completed and there is room for further improvements in the business environment and competition.

Programme implementation has thus stabilised the economic and financial system and provided the basis for Portugal's return to a path of sustainable growth and job creation. However, the economy remains vulnerable to future negative shocks and further progress is still required in consolidating public finances, safeguarding financial stability and improving the competitiveness, flexibility and resilience of the economy. To this end, continued effective implementation and a speedy completion of the outstanding budgetary commitments and structural reforms will be crucial to reap the full benefits of the measures already undertaken. Indeed, the country urgently needs a credible medium-term strategy for sustainable growth, based on a broad political understanding, whose implementation would make the economy more dynamic so as to facilitate economic adjustment, support fiscal consolidation, accelerate financial deleveraging and further reduce the high levels of unemployment and poverty.

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INTRODUCTION

1. The Economic Adjustment Programme for Portugal was agreed by the ECOFIN Council on 17 May 2011 and by the IMF Executive Board on 20 May 2011. The Programme, which covered the period 2011-2014, entailed external financing by the European Union, the euro-area Member States and the IMF of some EUR 78 billion, ⁽²⁾ for possible fiscal financing needs and support to the banking system. One third was to be financed by the European Union under the European Financial Stabilisation Mechanism (EFSM), another third by the European Financial Stability Facility (EFSF), and the remaining third by the IMF under an Extended Fund Facility.

2. This report assesses the overall implementation of the Programme and sets out future policy challenges for the Portuguese economy. The assessment includes the findings of a joint staff mission of the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) to Lisbon from 22 April to 2 May 2014 in connection with the 12th programme review which was, in fact, not concluded. In accordance with the Council Implementing Decision amending Implementing Decision 2011/344/EU on granting EU financial assistance to Portugal, ⁽³⁾ the mission assessed compliance with the conditionality associated with the respective disbursement and progress towards the key objectives of the Programme in terms of sound public finances, restoring competitiveness and putting Portugal's economy back on the path of sustainable growth and job creation. Developments in the months since the end of the programme are also taken into account.

3. The Programme ended in an unconventional manner when, on 12 June 2014, the Government allowed the Programme to lapse without disbursement of the final tranche of EUR 2.6 billion in assistance. On 30 May, the Constitutional Court ruled several important consolidation measures in the 2014 budget as unconstitutional. This ruling opened a budgetary gap of 0.4% of GDP vis-à-vis the deficit target of 4% in 2014, with follow-on effects in 2015, which the Government had committed to replace with measures of equivalent size and quality so as to achieve the agreed budgetary targets. There were, however, further rulings expected from the Court on 2014 measures and 2015 budgetary plans, which could widen the gap. Accordingly, the Government decided to wait for these further rulings so as to address the implied budgetary gap in a comprehensive manner. When it became clear that the Court's next rulings would come well after the scheduled end of the Programme at end-June, the Government decided not to ask for a further extension but to allow the Programme to lapse without disbursement of the final tranche of EUR 2.6 billion in assistance and without formal conclusion of the 12th review. This decision was publicly announced by the Government on 12 June, followed by a joint statement by the EC, ECB and IMF.

4. The remainder of this report examines progress under the Programme and remaining challenges under various headings. Section 1 reviews the adjustment in the macro-economy, while Section 2 reviews the consolidation of the public finances based on expenditure/revenue measures, as well as fiscal-structural measures. Section 3 focuses on steps to stabilise and reinforce the financial sector, while Section 4 examines progress in a wide-ranging set of structural reforms. Section 5 reviews the evolution in sovereign financing conditions. The annexes present technical information relevant to the report.

⁽²⁾ The IMF share of the Programme was set in Special Drawing Rights (SDR). Due SDR rate fluctuations, the projected pay-out by the IMF in Euro has become higher, so the current projected Programme total is around EUR79 billion.

⁽³⁾ OJ L 269 of 14.10.2011

1. MACROECONOMIC ADJUSTMENT

5. The Portuguese economy was characterised by weak growth over a protracted period before the onset of the crisis in 2009.

Throughout the previous decade, potential output declined due to low productivity, while competitiveness was undermined by rapidly rising unit labour costs and deep-rooted structural problems. As a consequence of persistent current account deficits, Portugal accumulated a high external debt, which was mirrored domestically in the rising indebtedness of households, the corporate sector and the State.

6. Already before the start of the Programme in 2011, a process of rebalancing the Portuguese economy from the non-tradables to the tradables sector had begun.

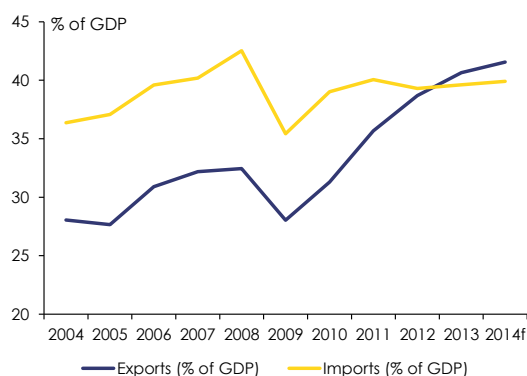
In the tradable sector, unit labour costs decreased by almost 5% between 2009 and 2013, while the adjustment in the non-tradable sector started only in 2011, leading to a decrease in unit labour costs of 1.5% between 2011 and 2013. In both sectors, the reduction of unit labour costs was driven by cuts in employment and wage restraint. Notwithstanding these developments, the reallocation of the labour force toward the traded sector remains limited, mainly hindered by the significant segmentation in the labour force. Still, the rebalancing of production contributed positively to the profitability of companies, which should improve the prospects of a further recovery of fixed investment in the coming quarters (see Box 1.1).

7. In the period 2009 to 2013, the turn-around of the current account balance exceeded expectations moving from a deficit of 11% of GDP to a surplus of 0.4% of GDP – the first surplus in more than 40 years.

This adjustment process was partly due to a compression of internal demand amid reduced private consumption and investment but was supported by improving competitiveness due to wide-ranging labour and product market reforms, with an annual decline in unit labour costs relative to the euro area of 2% over 2011-2013 crucially supporting export growth. The share of exports in GDP has been increasing since 2009 (Graph 1.1), but, at about 40% of GDP in 2014, this share is still low relative

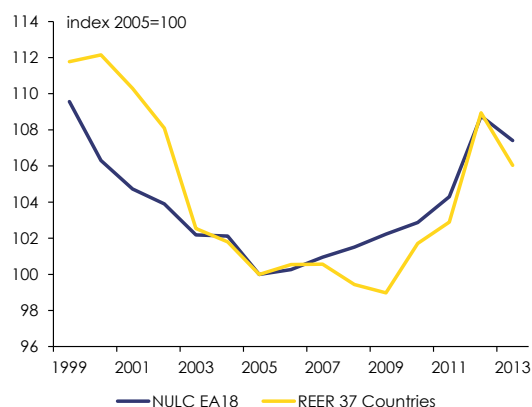
to other euro area economies of a comparable size. ⁽⁴⁾

Graph 1.1: External trade as a share of GDP



Source: Commission services

Graph 1.2: Nominal unit labour costs and real effective exchange rate



(1) NULC and REER series are inverted. An increase means improvements in external price competitiveness.

Source: Commission services

⁽⁴⁾ The amount of exports as a share of GDP in 2013 remain low compared to other European Union Member States such as Ireland (108%), the Netherlands (88%), Belgium (86%) or Austria (57%), according to Eurostat data.

Box 1.1: Corporate Profitability in Portuguese Tradable and Non-Tradable Sectors

The rebalancing in the Portuguese economy requires a reallocation of resources across economic sectors. Regained competitiveness of the economy will ultimately benefit the tradable sector and thereby help in channelling idle productive resources into these activities, minimising the social and economic costs of the adjustment. Against this backdrop, the developments in relative profitability between tradable and non-tradable sectors are of particular interest, as the expected differential of returns on investment is the main incentive for reallocation of resources. This box addresses the issue of tradables' relative profitability using firm-level evidence, and assesses whether relative profitability developments have been favourable to the on-going rebalancing and whether they have been reflected in recent investment patterns.

In Portugal, two concurrent drivers appear to have helped to restore the relative profitability of tradable industries. First, subdued domestic demand resulted in a fall of the relative price of non-tradable sectors. Second, a slower pass-through of wage cost reductions into tradables' prices supported profit margins (see the discussion of this mechanism in European Commission, 2013a). In order to attract and retain new capital, however, tradable sector firms' profitability will ultimately also need to improve in absolute terms, depending greatly on economic conditions at home and in main trading partners. In parallel, an improvement of financing conditions will also be a necessary condition in order to foster the reallocation of resources (European Commission, 2013b).

A large firm-level dataset covering the period 2004-2012 is used to study developments in corporate profitability and investment.⁽¹⁾ The sample excludes sectors related to public administration, health and social services, and education, since a large share of these activities is performed by public entities. However, the relevance for rebalancing of developments in public administration and other non-market services should not be underestimated in the rebalancing process. The finance and insurance industry is also excluded from our analysis due to a fundamentally different nature of their activities compared to other productive sectors. For the purpose of this box, tradable and non-tradable sectors are identified using a widely-used split.⁽²⁾ Although this definition is relatively standard (e.g., it is used in the Commission's AMECO database), it may prove somewhat crude in capturing actual tradability of specific sectors in some countries (see table I for an overview of the share of foreign demand in value added by sector in Portugal and selected EU countries).

Table I: Share of directly or indirectly exported sector value added, 2009

	Agriculture & fishing	Mining & utilities	Manufacturing	Construction	Trade, transport, hotels and food services	Finance & business services	Public & social services	Total
PT	25	22	52	4	20	18	2	18
IE	n/a	32	75	2	43	74	6	49
EL	17	13	28	2	25	8	2	14
ES	30	15	40	2	14	22	4	15
SI	28	31	80	12	36	22	4	33
IT	18	17	46	4	16	14	2	16
DE	28	18	58	5	22	23	5	24
FR	43	13	52	2	16	15	3	16

Source: OECD TiVA, Ameco, own calculations.

Note: The latest available observation in the TiVA database is 2009. The use of data from differing sources can skew the shares to some extent, in particular for sectors with low shares in the economy.

⁽¹⁾ The data are obtained from the Bureau Van Dijk Orbis database. In order to avoid double-counting of corporate groups, firms that are known to be majority-controlled subsidiaries are excluded from the analysis. The final sample contains about 108,500 firm-year observations (as of 2012 this represents some 12,000 independent firms).

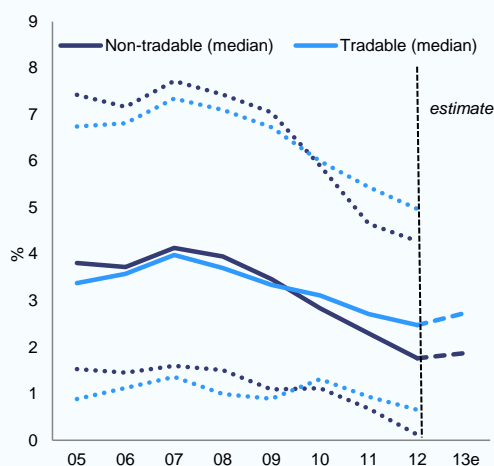
⁽²⁾ Our definition of tradables covers agriculture, forestry and fishing, industry except construction, trade, transport, accommodation and food service activities, and information and communication.

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Box (continued)

We estimate firms' 2013 financial data, which are currently not available for a representative number of firms in the Orbis database, using a micro-level model of the change in profitability as a function of i) GDP growth and ii) the industry confidence indicator from the DG ECFIN business surveys. The estimated equation $\Delta ROA_{it} = \alpha_0 + \alpha_1 ROA_{it-1} + \alpha_2 GDP_{gr_t} + \alpha_3 Confid_{st} + \varepsilon_{it}$ also captures, via the lagged level of profitability, the profitability mean-reversion phenomenon (see for instance Fama and French, 2000). The equation is estimated separately at the level of 2-digit industries in the NACE rev. 2 classification. A similar model is used for estimating changes in investment, except that the aggregate gross fixed capital formation is used instead of GDP.

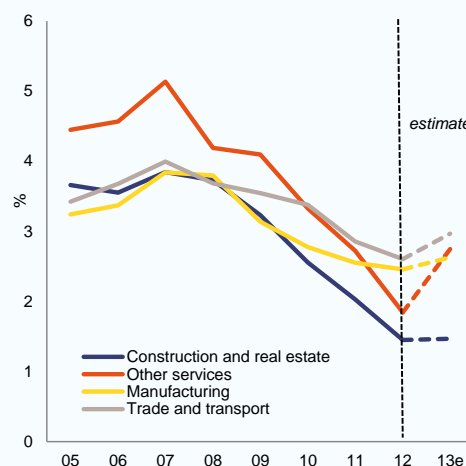
Graph I: Profitability in tradable and non-tradable sectors, medians and quartiles



Source: Orbis, own calculations

Note: Profitability measured as the return on assets after tax. The solid line represents the median, the dotted lines the upper and lower quartiles. Data for 2013 estimated using the actual 2013 GDP growth and the DG ECFIN business survey data.

Graph II: Profitability in selected industries, medians



Source: Orbis, own calculations

Note: Profitability measured as the return on assets after tax. The lines represent industry medians. Other services include accommodation, food and specialised professional services. Data for 2013 estimated using the actual 2013 GDP growth and the DG ECFIN business survey data.

Graph I presents the distribution of firm profitability (medians and quartiles) in tradable and non-tradable sectors using our simple definition. The inversion of relative profitability in favour of tradables occurred around 2010, and affected the bulk of the distribution of firms (both quartiles show the same inversion). The improvement of tradables' relative profitability further continued in 2012, although both sectors' absolute profitability continued to decrease in that year. Our estimates of 2013 developments suggest that the favourable profitability differential further widened during 2013 and that this movement involved an improvement in tradables' absolute profitability for the first time since 2007.

In order to take into account the limitations of the simple T/NT split, Graph II presents a more disaggregated look at the typical profitability in selected industries. The data confirm that a great deal of the non-tradables' downward adjustment, as seen in Graph I, came from the construction and real estate sector. Notably, the pre-crisis profitability level of the construction sector was not above the other sectors, unlike in countries that have experienced real estate booms. Instead, the other services sector, ⁽³⁾ which covers also industries with limited tradability, enjoyed higher levels of profitability in the pre-crisis period and suffered a sharp retrenchment afterwards. The manufacturing, trade and transport industries went through a profitability

⁽³⁾ The other services sector covers accommodation, food, and professional services (e.g., law, consultancy, and technical services).

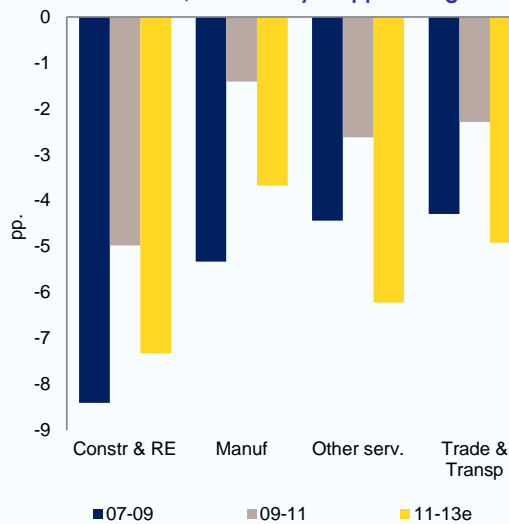
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Box (continued)

contraction in 2009-12, which was milder than in the services industries. The estimates for 2013 suggest a stark profitability difference between the construction sector, which remains stuck at the subdued 2012 profitability levels, and the other sectors whose profitability seems to have rebounded. In particular, the rebound signalled in the other services industry deserves close monitoring as it could signal a slowing-down or an interruption of the rebalancing process.

How did these developments in typical firm profitability affect firms' investment behaviour? Graph III analyses the median change in firms' investment rates in the same industries as above over three successive two-year periods. The figures suggest that investment rates decreased in all sectors and in all three post-2007 periods, showing a double-dip pattern. These contractions in private investment had an adverse effect on economic activity and came on top of compressed public investment. Based on our estimates for 2013, none of the four sectors' investment rates (measured as a share of fixed assets) seems to have started to recover to their pre-crisis levels. The relative change in investment is only occurring because the construction sector, and more recently other services, reduced their investment sharper than the other sectors. There has been no sign so far of an increase in the manufacturing industry's investment activity that would mirror the improved profitability prospects.

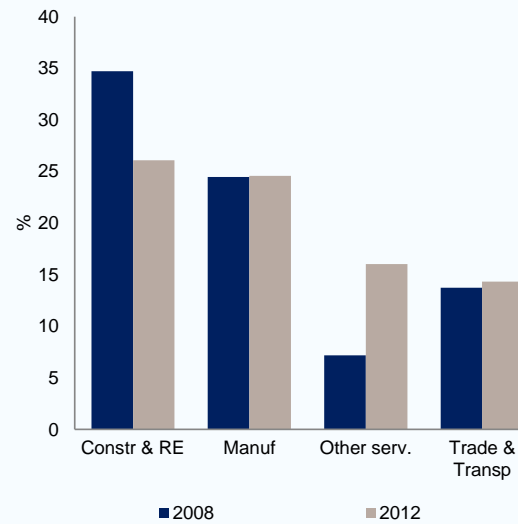
Graph III: Changes in firms' investment rates in selected industries, median 2-year pp. Change



Source: Orbis, own calculations

Note: Investment rates calculated in gross terms as the change of fixed assets plus estimated depreciation divided by previous year's fixed assets. The median pp. change of investment rate over each period is presented. Data for 2013 are estimated using the actual 2013 GFCF growth and the DG ECFIN business survey data.

Graph IV: Leverage in selected industries, medians



Source: Orbis, own calculations

Note: Leverage defined as non-current liabilities divided by total capital (non-current liabilities plus equity). The medians are calculated for each industry and year.

The strength of the response of investment to profitability is likely to be country-specific, vary across periods, and be subject to specific shocks such as uncertainty.⁽⁴⁾ Part of the reasons behind Portugal's lacklustre investment in manufacturing and other tradables could also be related to the still tight financing conditions in 2013 (see European Commission, 2013b, for a discussion of the role of financing difficulties in

⁽⁴⁾ See Mulkay et al. (2000) as regards the variability across countries, Bloom et al. (2007) as for the responsiveness of investment to demand and profitability shocks in periods of uncertainty. An assessment of the effects of uncertainty in the euro area is presented by European Commission (2013c).

(Continued on the next page)

Box (continued)

the rebalancing process). Another factor could be the deleveraging pressures experienced by highly indebted firms. As can be seen in Graph IV, a significant reduction in firm leverage occurred in the construction sector between 2008 and 2012, while no apparent changes can be seen in the manufacturing, and transport and trade sectors, suggesting that deleveraging was in early stages as of 2012. Leverage in the "other services" industry even increased over this period, albeit from a low level.

In summary, based on our estimates, 2013 could have been a turnaround year in which tradable sectors pursued their gradual improvement in relative profitability and, for the first time, saw signs of a possible rebound in absolute profitability. Any rebound in other services' profitability should be monitored closely to ensure that it is not excessively driven by the less tradable components, which would not be compatible with a durable rebalancing of the Portuguese economy. There were no signs, as of 2013, of an improvement in investment activity in tradable industries, likely owing to the joint effect of deleveraging pressures, financial constraints and persisting economic uncertainty. Going forward, the on-going stabilisation in financial conditions and improving access to finance could signal a possible improvement in investment over the coming quarters, provided that profitability prospects continue improving on the back of a gradual macroeconomic recovery.

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8. Having contracted more rapidly than expected in 2011 and 2012, the economy has been on a mild recovery path since spring 2013 and growth is expected to strengthen further in 2014 and 2015. A relatively favourable external environment and the projected further improvement in cost competitiveness should ensure a continued strong export performance. Moreover, domestic demand is projected to contribute positively to GDP growth for the first time since 2010, driven by a moderate pick-up in fixed investment and private consumption. As the

rebound in domestic demand also translates into higher imports, the contribution of net exports to growth will be diminished.

9. Real GDP increased by 0.3% q-o-q (0.9% y-o-y) in the second quarter of 2014. The positive second quarter results only partially offset the negative outcome in Q1 when GDP unexpectedly declined by 0.5% q-o-q mainly due to one-off factors such as bad weather, the Easter effect and temporary closures of production facilities in Galp (oil refinery) and Autoeuropa (car

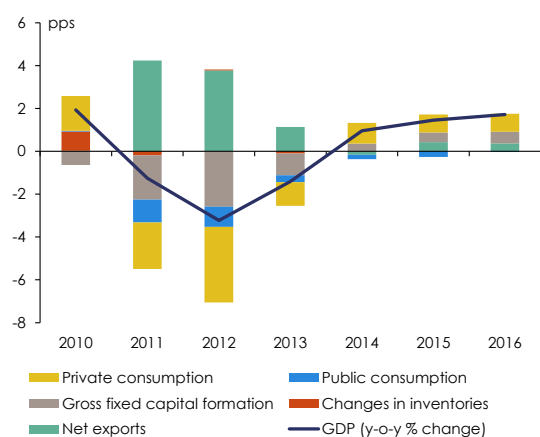
Table 1.1: Latest projections of main macroeconomic aggregates

	(September 2014)				SWD (June 2014)			
	2013	2014	2015	2016	2013	2014	2015	2016
Gross domestic product	-1.4	1.0	1.5	1.7	-1.4	1.0	1.5	1.7
Private consumption	-1.7	1.5	1.3	1.3	-1.7	0.7	0.8	0.8
Public consumption	-1.8	-1.1	-1.5	-0.2	-1.8	-1.6	-1.5	-0.2
Fixed investment	-6.3	2.4	2.9	3.5	-6.6	3.3	3.8	4.0
Exports of goods and services	6.1	3.9	5.5	5.3	6.1	4.7	5.7	5.3
Imports of goods and services	3.1	4.4	4.6	4.7	2.8	3.7	4.2	4.3
Domestic demand excl. inventories	-2.4	1.1	1.0	1.4	-2.5	0.6	0.8	1.1
Change in inventories	-0.1	0.0	0.0	0.0	-0.2	-0.1	0.0	0.0
Net trade	1.1	-0.2	0.4	0.4	1.3	0.4	0.7	0.5
Employment (y-o-y change)	-2.8	2.0	0.8	0.9	-2.8	0.9	0.8	0.6
Unemployment rate - Eurostat definition (%)	16.4	14.4	13.5	12.8	16.5	15.4	14.8	14.2
HICP (y-o-y change)	0.4	0.0	0.4	0.7	0.4	0.4	1.1	1.5
Current external balance (% of GDP)	0.3	0.3	0.5	0.5	0.4	0.8	1.2	1.3

(1) Under ESA-95 methodology
(2) Cut-off date mid-September 2014
Source: Commission services

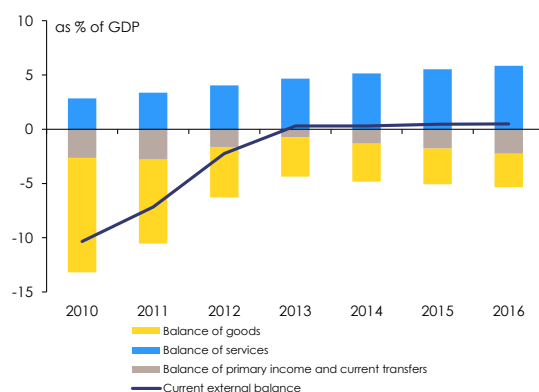
plant). However, the weaker than expected oil export evolution indicates that temporary stops of production at the oil refinery had an impact on the second quarter results as well. Therefore, the effect of the negative one-off factors from Q1 might be fully reversed only in the third quarter. Real GDP is forecast to grow by 1.0% in 2014, unchanged from the forecast underlying the Staff Working Document for Portugal, published in June. However, the composition of growth is now projected to shift even more to domestic demand, while net external trade is now forecast to contribute negatively in this year. The outlook for the forthcoming years, 2015 and 2016, remains broadly unchanged from the previous forecast.

Graph 1.3: Contributions to GDP growth



Source: Commission services

Graph 1.4: Current account balance



Source: Commission services

10. The labour market situation is set to improve further. In the second quarter of 2014, employment expanded by around 2% in y-o-y terms, and the unemployment rate declined further to 14.0%. The recent trend is expected to continue, and total employment is forecast to grow up to 2% in 2014 and by around 1% each in 2015 and 2016. Combined with an expected decline of the labour force by around 0.5% on average in 2014 and the subsequent years, this implies an average unemployment rate of 14.5% in 2014 and a further fall below 14% in 2015 and 2016.

11. Consumer price inflation has been subdued, but is projected to accelerate moderately over the coming years. Since early 2014, inflation (HICP) has continuously decreased, reaching -0.1% last August. The decline was

mostly due to falling prices for food and non-alcoholic beverages. Inflation expectations have diminished in the recent months, in line with the negative inflation. This suggests a substantial downward revision of annual HICP inflation to 0.0% in 2014. However, strong wage growth of 2.6% y-o-y in the second quarter and positive core inflation of 0.4% in August 2014 should exert upward price pressure in the coming quarters. The HICP inflation rate is expected to accelerate to 1% by the 2016.

12. The ongoing transformation of the economy toward export-led growth must continue, if the recovery is to be sustained. The reforms initiated during the Programme are expected to raise the medium-term growth potential of the economy, provided that the reform momentum persists. A sustained increase in potential growth is held back by remaining rigidities in the functioning of markets, the relatively low-skills level of the workforce and, recently, strong net emigration which has contributed to reducing the total population by an estimated 1.5% between 2010 and 2014. (The labour force is estimated to have shrunk by about 4% in the same period.) In order to return to a potential growth rate of around 2%, which is necessary to ensure public debt sustainability, the structural reform agenda needs to be further deepened and widened. Research by the European Commission and other institutions such as the OECD and IMF have unequivocally demonstrated the high potential for structural reforms to boost medium-term growth in Portugal (see Box 1.2).⁽⁵⁾

13. Risks to the medium-term outlook appear to be tilted to the downside. The external growth environment could worsen as a result of geopolitical tensions, changes in the policy stance in the United States or problems in the emerging economies. Domestically, policy uncertainty, further necessary fiscal consolidation efforts and high private sector indebtedness could weigh more heavily on private consumption and investment than projected. The materialisation of such risks could weaken the main drivers of economic growth and/or result in a sudden change in the favourable investor sentiment, which has helped to lower Portuguese long-term interest rates. The resilience of the medium-term growth projections to such risks will depend crucially on continued budgetary discipline, a sound financial sector and further progress in structural reform.

⁽⁵⁾ See Varga J., R. Werner and J. in 't Veld (2013), *Growth Effects of Structural Reforms in Southern Europe: The case of Greece, Italy, Spain and Portugal*, EC European Economy, Economic Papers No 511; European Commission (2014), *Market Reforms at Work in Italy, Spain, Portugal and Greece*, EC European Economy No. 5/2014, Brussels; OECD (2013), *Portugal: Reforming the State to Promote Growth, Better Policies*; and IMF (2013), *Portugal: Selected Issues Paper*, IMF Country Report No. 13/19.

Box 1.2: Potential Impact of Structural Reforms on Growth

Structural reforms are crucial for boosting growth. Economic models that reproduce the key economic relationships of a country can provide estimates on the potential growth effects of reforms. A benchmarking analysis based on the Commission's QUEST model for Portugal indicates that structural reforms aimed at narrowing the gap vis-à-vis the average of the three best EU performers on key indicators such as improving effective competition in the economy and shifting the tax burden away from labour could raise GDP by 4½% in a 10-year period. Some of the reforms could have an effect even within a relatively short time horizon. The model simulations suggest that the largest potential gains could be reaped from reducing final goods markups e.g. through increased competition on product markets, followed by measures shifting the tax burden away from labour towards consumption and by reinforcing the resources and effectiveness of active labour market policies.

The OECD considers Portugal a top reformer among the OECD countries, but its reform agenda must be deepened and extended. In an attempt to quantify the impact of product market reforms, the OECD report presents three scenarios: (i) reforms undertaken since end 2008, (ii) adding further 20 percent reduction in the strictness of regulation, and (iii) alignment with the OECD best practice.

The increases in level of GDP by 2020 vary from 3% in the first scenario to above 8% in the last one. In the case of labour market reforms, the effect is more negligible, only increasing 0.5% of GDP (see Table I). Notwithstanding differences in methodology and the selection of product market reforms, the OECD results seem to be in line with recent work in ECFIN on the impact of structural reforms.

Table I: Macroeconomic impact of structural reforms – comparing EC and OECD results

Reforms	EC		OECD		
Methodology	The closure of the gap vis-à-vis the average of the three best EU performers		Reforms undertaken since end 2008	20 % reduction in the strictness of regulation*	Aligning Portugal to OECD best practice*
Period	5 years	10 years	12 years	12 years	12 years
	GDP % relative to baseline				
Product market	2.3	3.2	3.0	5.0	8.5
Labour market	0.5	0.5	0.5		

*Note: Different scenarios in the case of product market reforms.
Source: OECD, Commission services.

References:

European Commission (2013), "The growth impact of structural reforms", Chapter 2 in QREA No. 4. December 2013. Brussels; http://ec.europa.eu/economy_finance/publications/qr_euro_area/2013/pdf/qrea4_section_2_en.pdf

OECD (2014), "Portugal: deepening structural reform to support growth and competitiveness". July 2014.

2. FISCAL CONSOLIDATION

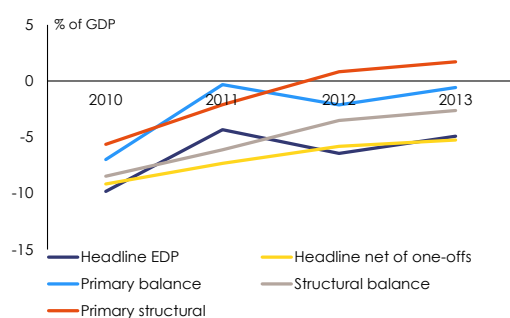
ACHIEVEMENT OF DEFICIT TARGETS

Much has been achieved under the Programme to structurally reduce the budget deficit and thereby put the public debt on a sustainable path. However, going forward, it will be important to maintain strict budgetary discipline and to ensure the durability of the adjustment. More specifically, the fiscal position must be further consolidated in order to reach the structural deficit target of 0.5% of GDP by 2017.

Fiscal adjustment over 2010-2013

14. Efforts to reduce the large fiscal imbalances that had built up before the Programme have been impressive. Between 2010 and 2013, the general government deficit for Programme purposes more than halved from 9.8% to 4.5% of GDP. Correcting for the impact of the cycle and one-offs, the structural adjustment amounted to 6.0% of GDP in the period 2010-2013 and the adjustment of the structural primary balance has been 7.5% of GDP. In this context, permanent consolidation measures totalling some 12.5% of GDP (ex-ante assessment) were implemented between 2011 and 2013. The difference between the top-down consolidation outcome in terms of deficit reduction and the bottom-up approach of ex-ante consolidation measures can be explained by the negative budgetary impact of the economic downturn, underlying budgetary pressures and the over-estimation or partial or non-implementation of some of the fiscal measures as quantified ex-ante.

Graph 2.1: **General Government budget balances**



Source: INE, Commission services

15. The deep economic recession and other budgetary pressures have constrained the pace of fiscal consolidation. A marked fall in domestic demand and a surge in unemployment weighed heavily on revenue collection (with indirect taxes falling by 2% and social contributions falling by 2.5% between 2010 and 2013), despite revenue-increasing policy measures such as the reduction in the number of goods taxed at the lower VAT rates or the broadening of the social contributions base. On the expenditure side, unemployment benefits in 2013 were 40% above their 2010 level. Beyond the negative impact of the cycle, other underlying pressures limited the consolidation, such as a steep rise in interest payments (1.5% of GDP), PPP contracts and the increase of public pension spending by 11%, partly demographically-induced and despite significant pension-cutting measures like the "extraordinary solidarity contribution" on pensions.

Table 2.1: **Fiscal adjustment 2010-2013**

	2010	2011	2012	2013
Balance - Programme purposes (2)	-9.8	-4.0	-6.0	-4.5
Balance - EDP	-9.8	-4.3	-6.4	-4.9
Budget deficit, net of one-offs	-9.2	-7.3	-5.8	-5.3
Structural balance	-8.5	-6.0	-3.3	-2.4
Primary balance	-7.0	-0.3	-2.1	-0.6
Structural primary balance	-5.6	-2.0	1.1	2.0
Fiscal adjustment	0.2	3.6	3.1	0.9
Fiscal effort (EDP definition)	0.3	2.4	2.7	0.9

(1) Fiscal adjustment measures as the change in the structural primary balance; fiscal effort defined as the change in the structural balance.

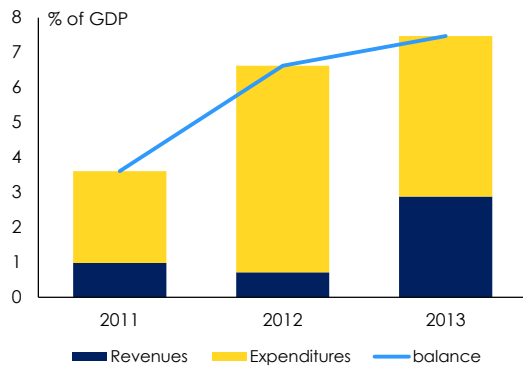
(2) For the purposes of the Programme, the budget deficit in 2011 excludes the impact of BPN recapitalisation (about 0.4% of GDP), in 2012 it excludes the impact of CGD recapitalisation (about 0.5% of GDP) and in 2013 the BANIF recapitalisation (about 0.4% of GDP).

Source: INE, Commission services

16. The composition of the primary fiscal adjustment was tilted towards the expenditure side. In the period 2011-13, expenditure cuts contributed about 60% to the primary structural fiscal adjustment, i.e. excluding interest payments (see Graph 2.2), while the remainder came from revenue increases. However, the composition of the adjustment is roughly balanced between revenue and expenditure when looking at the total adjustment including interest payments, due to the increase in interest rates, which has partly offset some of the effort to reduce expenditures. It should also be noted that the weight of expenditure-based consolidation declined significantly in 2013, when various important expenditure-reducing measures

were substituted by revenue-side measures as a consequence of Constitutional Court rulings.

Graph 2.2: Cumulated change Primary Structural Balance Revenues/ Expenditures from 2010



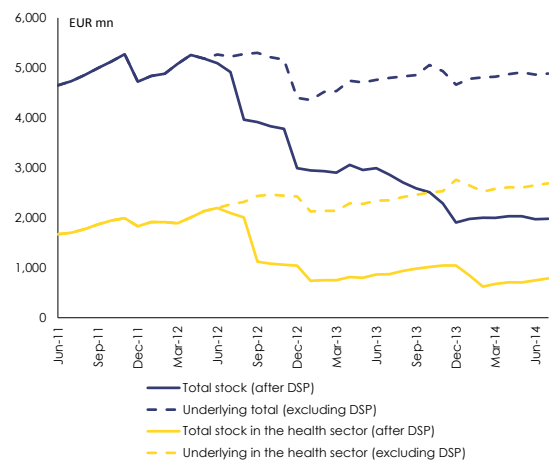
Source: INE, Commission services

17. On the expenditure side, consolidation has been achieved via reductions in the public sector wage bill, intermediate consumption and public investment whereas, on the revenue side, consolidation was mainly attributable to income tax increases. Various consolidation measures aimed at addressing the public sector wage bill, which at the outset of the Programme was diagnosed as high by international comparison. Measures included downsizing public employment, revising remuneration policy and adjusting entitlements and privileges of public-sector employees. Altogether, these measures resulted in a reduction of the public-sector wage bill by 16% within three years, notwithstanding a series of adverse Constitutional Court rulings on measures related to this expenditure item (see Box 2.1). Intermediate consumption has been cut by about 18% since 2010, but it is uncertain to what extent this reduction can be considered permanent. Gross Fixed Capital Formation has been more than halved with respect to its level at the beginning of the Programme and stands now at 1.4% of GDP, a rather low level by international comparison. On the revenue side, the main category of taxes that supported consolidation were taxes on income and wealth, in particular following the reform in 2013 of the personal income tax, which raised the average tax rate in line with European standards and managed to boost PIT collection by almost 30%, yielding extra-revenues worth 2% of GDP. The success of the reform was ensured through speedy introduction as well as effective

accompanying measures to fight tax fraud and evasion.

18. The stock of arrears has been more than halved over the Programme period due to several debt settlement programmes (DSPs). The combined stock of arrears for the general government sector and state-owned enterprises (SOEs) outside the general government fell from about EUR 4.3 billion (2.5% of GDP) at the beginning of the Programme in May 2011, to about EUR 2 billion (1.2% of GDP) by July 2014. With the bulk of the DSPs completed,⁽⁶⁾ the remaining arrears are largely concentrated in the state-owned hospitals, the local governments and the Autonomous Region of Madeira. However, the outstanding stock of arrears remains elevated and further efforts will be needed to achieve its full clearance in the post-programme period.

Graph 2.3: Evolution in the stock of arrears over the programme (EUR mn)



Source: Ministry of Finance, Commission services

19. The Programme's goal of arresting the accumulation of arrears has not been fully attained. Despite the payment of about EUR 2.9 billion of arrears under specific DSPs between June 2012 and July 2014, the total stock of arrears has been reduced by only EUR 2.3 billion over the Programme horizon, implying the accumulation of almost EUR 600 million in new arrears (between May 2011 and July 2014). The accumulation of

⁽⁶⁾ At the local level, some applications to the Support Programme for the Local Economy (PAEL) are still pending an approval by the Court of Auditors.

Box 2.1: Constitutional Court Rulings on Reform Measures

The Portuguese Constitutional Court delivered several rulings on measures which were taken by the Government as part of the Economic and Financial Adjustment Programme. Assessing several measures contained in the Budget Laws between 2011 and 2014 (some rulings are still outstanding), the Court pointed out that these measures must be considered of a temporary and extraordinary nature to deal with a fiscal emergency situation.

The Court examined several measures contained in the Budget Laws between 2011 and 2014 with regard to legitimate expectations of citizens protected under the constitutional principle of trust in a stable behaviour of the state. It expressed this view with regard to salary cuts for the public sector, the extraordinary solidarity contribution on higher pensions (CES), and the solidarity surcharge applicable to the upper income level as well as to certain taxation measures. However, the Court considered these measures to be proportionate due to their temporary nature and given the context of a fiscal emergency situation. Thus, they were not considered to be infringing the principle of trust.

In the view of the Court, the constitutional principle of equality contains the notion of equality of burden sharing which requires that all citizens should contribute in an equal manner to the public burdens according to their ability to pay. As a consequence, fiscal consolidation cannot be based on budgetary measures affecting only civil servants. The Court nevertheless accepted a certain degree of differentiation in treatment between public and private sector employees and accepted, within limits, wage cuts in the public sector due to their exceptional and temporary character in the Budget Laws. However, the suspension of both the holiday and the Christmas allowances for civil servants and pensioners was not considered to be proportional and thus rejected.

The Budget Law for 2014 established a broader framework for the reduction of wages in the public sector which, in the view of the Court, had an innovative and general scope. However, the Court considered this framework still to be a temporary emergency measure for fiscal consolidation purposes rather than a structural measure. According to the Court, this new scale of wage cuts imposed a much heavier burden (of fiscal consolidation) on civil servants than on the rest of the population, which could not be justified anymore by invoking the extraordinary character of the measure. The measure was therefore declared unconstitutional due to the violation of the principle of equality of burden sharing. A subsequent law phasing out the existing wage cuts in the public sector until 2018 was considered by the Court to be of structural rather than of budgetary nature. The law provided that the specific steps of the successive phasing out of the wage cuts between 2016 and 2018 are to be determined by the annual Budget Laws and included the possibility that the cuts are maintained until 2018. The Court deliberated that, after the termination of the Program, no additional sacrifice could be expected from civil servants. The extent and uncertainty of the remaining (possible) wage cuts for the upcoming years were therefore considered to be unbalanced. The Court declared the measure unconstitutional due to the violation of the principles of equality and proportionality.

In the context of the Budget Law for 2014 the Court discarded also the new calculation formula for surviving dependants' pensions (which was, in contrast to the wage cuts, considered to be a structural reconfiguration) and the extraordinary levy on unemployment and sickness subsidies. However, a cut in the pension supplements of employees in SOEs was accepted by the Court as well as the diversion to the State budget of 50% of employers' contribution to the special health care scheme ADSE.

Beyond the Budget Laws, the Court also saw the principles of equality of burden sharing and legitimate expectations violated by the reduction in pension benefits granted within the pension scheme for the public sector as well as by the new rules for the recalculation of pension benefits already in payment. In the view of the Court, these measures could only be justified within the context of a comprehensive structural reform of the pension system which encompasses a fair balance between sustainability of the public pension system, proportional equality and solidarity between generations. A new law replacing the CES by a sustainability contribution was considered by the Court to be a part of such structural reform of the pension system.

(Continued on the next page)

Box (continued)

However, the Court discarded this reform by declaring the measure unconstitutional due to a violation of the principle of trust. Pursuant to the Court the progressivity of the pension cuts intended by the sustainability contribution infringes the contributory principle underlying the pension system and violates legitimate expectations of pensioners and contributors to the system.

With regard to legislation concerning the requalification scheme and dismissal of civil servants the Court considered some provisions unconstitutional as they disproportionately affected the constitutional guarantee of job security. It also saw this guarantee affected by amendments to the Labour Code setting out criteria for dismissal of people employed under private law for reasons of inadequacy for the job. The Court declared these provisions unconstitutional, maintaining other amendments, such as the bank of hours, the reduction in overtime compensation and the suspension of a number of public holidays and vacation days. The Court also approved the 40-hours working week in the public sector.

Sustainable and permanent fiscal consolidation and structural reforms in line with the Portuguese Constitution as set out by the Constitutional Court will require an efficient and comprehensive framework which does not rely on temporary and extraordinary measures. However, the rulings of the Court do not give clear guidance on the legal outline of such a framework. The Court draws its legal reasoning from very general constitutional principles, such as the principle of equality, the principle of proportionality and the principle of a democratic state based on the rule of law (principle of trust). The margins of these principles are not clear-cut and deviating opinions of dissenting judges as well as academic discussions show that these principles are very broad and amenable for various interpretations. This is particularly true and fundamental when it comes to the definition of the margins of the Government's scope for discretion with regard to its political decision-making and activity. The Court has been criticized for repeatedly choosing the narrower interpretational alternative and thus fencing in the discretionary power of the Government with regard to fiscal and structural reforms. Current and future Portuguese governments, which will have to ensure continued fiscal consolidation and structural adjustment as the basis for sustainable economic development within the euro area, will continue to be faced with the uncertainties of how the Constitutional Court will interpret these margins and the underlying constitutional principles.

Table 2.2: Stock of arrears (EUR mn)

Subsector	2011			2012				2013				2014				Jul14-Dec13	Jul14-Jul13	Jul14-May11
	May-11	Aug-11	Nov-11	Feb-12	May-12	Aug-12	Nov-12	Feb-13	May-13	Aug-13	Nov-13	Feb-14	May-14	Jun-14	Jul-14			
Central Government excluding HNS	289	274	325	165	135	122	105	57	56	53	51	36	36	34	34	4	-21	-255
HNS classified in General Government	429	245	266	194	202	36	24	28	14	30	22	16	13	14	12	2	-19	-416
Reclassified entities	90	94	77	50	61	39	33	18	19	18	17	1	0	0	0	0	-18	-90
Local Government	1,745	1,762	1,709	1,660	1,613	1,488	1,373	1,136	970	824	735	674	629	536	531	-137	-351	-1,214
Regional Government	401	1,103	1,321	1,215	1,261	1,254	1,280	938	1,053	765	580	509	486	478	474	-42	-429	73
RAA	0	8	23	6	7	10	14	5	4	4	8	3	3	2	2	0	-1	2
RAM	401	1,095	1,298	1,210	1,253	1,244	1,267	933	1,049	761	572	506	482	475	473	-42	-428	71
Total	2,954	3,478	3,698	3,284	3,271	2,939	2,815	2,177	2,113	1,690	1,405	1,236	1,164	1,062	1,052	-173	-838	-1,902
Total Consolidated	2,783	3,314	3,532	3,166	3,157	2,836	2,712	2,104	2,048	1,641	1,365	1,195	1,126	1,034	1,024	-166	-814	-1,759
Memorandum items:																0	0	0
Other entities outside General Government																0	0	0
Enterprises excluding HNS	12	11	14	18	32	40	50	45	51	82	97	113	132	139	139	34	65	127
HNS (EPE hospitals)	1,501	1,528	1,725	1,497	1,994	1,086	1,018	784	858	984	825	693	773	799	817	204	-133	-683
TOTAL	4,296	4,854	5,271	4,881	5,185	3,961	3,780	2,933	2,957	2,707	2,287	2,001	2,031	1,971	1,980	77	-882	-2,315
Clearance strategy																		
HNS arrears stock adjustment related to the arrears clearance strategy				0	1,315	1,383		1,478	1,478	1,488	1,800	1,901	1,901	1,901	1,901	0	423	1,901
Local arrears stock adjustment related to the arrears clearance strategy				0	0	0		108	274	375	459	479	533	542	549	81	210	549
Regional (Madeira) arrears stock adjustment related to the arrears clearance strategy										257	388	429	443	450	453	64	336	453
TOTAL after HNS and Local arrears adjustment	4,296	4,854	5,271	4,881	5,185	5,276	5,164	4,518	4,709	4,827	4,934	4,811	4,907	4,865	4,884	222	87	588

Source: Compiled by DGO; data from ACSS, DGTG, DGAL, DGO, Madeira and Açores; Commission services

new arrears has been mostly concentrated in the health sector (about EUR 400 million in 2013 alone), due in particular to persistent operating losses of twelve state-owned hospitals. In order to bring this trend to a halt and meet the Programme target of non-accumulation of arrears, the Government has allocated additional resources of up to EUR 300 million in 2014 to close the operational imbalances and fully fund the investment needs of the relevant state-owned hospitals. These transfers will be disbursed to the extent that new imbalances emerge during the year. In parallel, strategic plans have been formulated with the relevant hospitals to address their financial structural imbalances. Moreover, the health administration (ACSS) is taking new measures to better control the accumulation of arrears in hospitals by obliging all entities of the health system (SNS) to report monthly about the debt and credits in a more reliable, timely and precise manner and by ensuring implementation of the Commitment Control Law. All the other sectors seem to have successfully halted the accumulation of arrears in recent months.

Fiscal consolidation in 2014, 2015 and beyond

20. At the end of the 12th review mission, Portugal was projected to reach the headline targets both in 2014 (4% of GDP) and 2015 (2.5% of GDP). The structural effort was however substantially revised down to 0.6% of GDP in 2014 (it was estimated at 1% of GDP at the time of the initial 2014 Budget) due to, among other things, the overachievement of the 2013 target without a revision of the 2014 target; the

improvement in the macroeconomic outlook; and a change in the methodology to calculate the output gaps. Since the end of the Programme, other events with relevance for the fiscal situation have occurred (see below).

21. Specific one-off operations, some of which are still subject to statistical analysis, could push up the headline deficit figure in 2014. The first of these operations concerns the transport SOE debt management programme launched by the Government to address the debt overhang of some companies with legacy debt burden and to restore their financial viability. These operations are estimated to have a 3% of GDP impact in ESA-95 terms in 2014. Under ESA-2010, however, some of these SOEs would be reclassified within the general government perimeter as from 2010 already, implying that the deficit-increasing operations in 2014 are limited to the financing of companies remaining outside, which amounts to 0.7% of GDP. Two other recent one-off operations are related to the financial sector: the sale of BPN Crédito (0.1% of GDP) and the Banco Espírito Santo resolution, which could also be accounted by the statistical authorities as deficit increasing (amounting to 2.9% of GDP, related to the subscription of Novo Banco shares by the Resolution Fund). In any case, given the one-off nature of these operations, no further impact is expected in 2015.

22. Successive Constitutional Court (CC) rulings over the last months on several 2014 Budget measures and 2015 budgetary plans had an impact on the government's budgetary

strategy. In its 30 May ruling, the Constitutional Court struck down three measures in the 2014 budget: the public sector wage cuts, the changes in survivors' pension entitlements and in social contributions from unemployment and sickness benefits, with the ruling on the wage cut being effective as from the time of the ruling and all the other rulings being effective from 1 January 2014 (for further details on the ruling see Box 2.1). In another ruling on 30 July, the Court ruled as constitutional the redesigned CES (net annual yield of 0.3% of GDP in 2014) as well as the diversion to the State budget of 50% of employers' contribution to the special health care scheme ADSE (no budgetary impact). On 14 August the Court ruled as constitutional the reinstatement of the public-sector wage cut which was in force between 2011 and 2013, though only until 2015 (included). On the contrary, it ruled unconstitutional the progressive sustainability contribution from pensions, which would replace the CES in 2015. The combined effect of these rulings is estimated to have opened a fiscal gap of 0.3% of GDP in 2014 and an additional 0.4% of GDP in 2015 (since in addition the government withdrew the planned increases in employees' social security contributions and in the standard VAT rate, meant to complement the pensions' sustainability contribution in 2015). Finally, a ruling from the Court on a revenue measure is still pending, since the increase by 1 pp of beneficiaries' contributions to the public workers' special health care scheme ADSE was submitted for scrutiny to the Court at the end of June. During the Programme the Government had committed to implement compensatory measures of equal size and quality, should adverse legal or other budgetary execution risks to the achievement of the targets materialise.

23. To realign the 2014 budget with the 4% of GDP deficit (excluding specific one-off operations), the Parliament approved on 16 September a second Supplementary Budget (SB) for 2014. The second SB plans to compensate the fiscal gap resulting from the CC decisions and newly identified pressures on budget execution (in total 0.4% of GDP) mainly by the fiscal impact of macroeconomic revisions (i.e. improved labour market situation and private consumption outlook); by the upward revision of tax collection as a result of improved efficiency in fight against fraud and by the use of budgetary

reserves. In particular, the revisions of the second SB, vis-à-vis the 12th review forecast, include: higher expenditure on compensation of employees, which are due to CC decisions and slippages in execution, as apparently some of the measures intended to reduce public employment are lagging behind schedule and yielding less savings than foreseen; higher expenditure on intermediate consumption and higher investment pressures; downward revision of the local and regional administrations' balances; higher social contributions and lower unemployment benefits, from improved labour market situation; higher indirect taxes, reflecting the improved private consumption outlook and efficiency in fighting tax evasion. The second SB does not explicitly include additional consolidation measures.

24. Taking into account these developments, the deficit net of the specific one-offs is still estimated to reach 4% of GDP in 2014, although risks are tilted to the downside and the quality of the fiscal adjustment is lower.

An updated (EC) fiscal forecast that takes into account these developments is displayed in Table 4. The headline balance could rise to 10% of GDP in ESA-95 and 7.5% of GDP in ESA-2010 terms (in both cases pending an assessment by statistical authorities of some key operations), whereas the balance net of one-offs is still estimated to record a deficit of 4% of GDP. These budgetary plans still imply the achievement of a primary surplus (net of one-offs) for the first time since the beginning of the crisis, projected to be 0.4% of GDP. However, the adjustment is deemed to be of lower quality than the initial plans for several reasons. The improvement in the structural balance is now estimated at only 0.5% of GDP (a lower value than at the 12th Review mission and at the time of the initial budget). Also, as the measures ruled out by the CC have not been replaced by other expenditure-reducing measures, the consolidation strategy is now less based on expenditure compression and relies more on projected macro-related revenue performance. The new strategy implies that the extra-revenue from economic recovery and budgetary reserves are now used to support higher public expenditure, while one of the programme objectives in the fiscal area, in particular for 2014, was pursuing a permanent expenditure-based fiscal consolidation, expected to make the adjustment more durable and conducive to medium-term output growth. Finally, the

Table 2.3: Evolution in 2014-2015 fiscal forecasts

	12th Review Mission forecast		Updated EC preliminary forecast (mid-Sep)	
	2014	2015	2014	2015 (targets)
Balance - Programme purposes (2)	-4.0	-2.5	-4.0	-2.5
Balance - EDP	-4.0	-2.5	-10.0 (ESA-95) / -7.5 (ESA-2010)	-2.5
Budget deficit, net of one-offs	-3.9	-2.6	-4.0	-2.6
Structural balance	-2.0	-1.3	-1.8	-1.1
Primary balance	0.4	1.8	-5.7	1.8
Structural primary balance	2.4	3.1	2.5	3.2
Fiscal adjustment	0.6	0.7	0.5	0.7
Fiscal effort (EDP definition)	0.6	0.7	0.5	0.7

(1) Fiscal adjustment measured as the change in the structural primary balance; fiscal effort defined as the change in the structural balance.

(2) For the purposes of the Programme, the budget deficit in 2014, excludes the impact of SOE debt management programme, of capital injection into Novo Banco and of the sale of participation in BPN Credito (about 6% of GDP altogether in ESA-95).

(3) Needs confirmation that none of these would be taken into account for programme purposes.

(4) The 2014 EDP balance forecast is a preliminary estimate, with the deficit-increasing impact of some operations still pending on the decision of statistical authorities.

Source: Commission services

amount of discretionary measures underpinning the budgetary targets for 2014, which is important for the EU budgetary surveillance framework to which Portugal is now subject after having exited the programme, has been substantially reduced over time. It was estimated at 2.3% of GDP at the time of the initial Budget, and was revised down to 2.1% of GDP already at the time of the 12th review mission due to some implementation delays and underperformance of some measures (see Fiscal Strategy Document). Taking into account the latest developments, the package of consolidation measures is now estimated to be 1.8% of GDP. Finally, this assessment still includes one-off revenue measures, worth about 0.2% of GDP, for which implementation plans are not concrete at this stage (i.e. CTT health fund transfer, sales of concessions and special dividends from the sale of excess oil reserves).

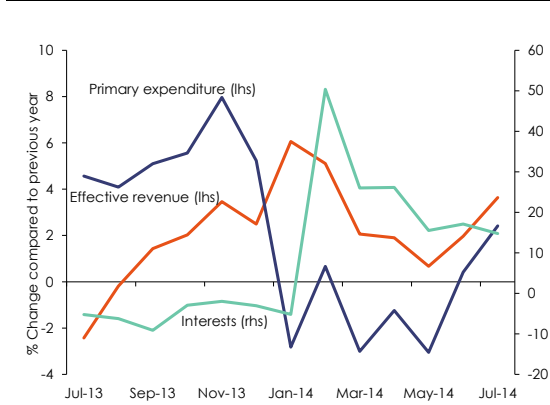
25. The improvement in the cash balance in the first seven months of 2014 (net of one-offs) is mainly due to the good tax performance.

Up to July the general government cash balance deteriorated EUR 389 mn relative to the same period last year (EUR 5.823b deficit up to July 2014 versus EUR 5.434b up to July 2013). However, excluding one-offs, the cash balance has improved by about EUR 823 mn in this seven-months period, a progress that is broadly on track with the intra-annual consolidation pattern: the cash target compatible with the 4% of GDP target

implies an overall reduction in the cash deficit of about EUR 1.5b in 2014, from EUR 8.9b in 2013 to EUR 7.4b in 2014. This cash result (net of one-offs) reflects an increase of 2.4% in revenues and 0.3% in expenditure compared to the same period last year. ⁽⁷⁾ Indirect taxes, mainly VAT, continued their upward trend (see Graph 2.5) in line with the private consumption recovery, also reflecting the increased efficiency of the new measures to combat tax evasion and the underground economy, such as the reforms in e-invoicing and improvements in transport documentation. Direct taxes, however, are experiencing a downward trend, seemingly due to the intra-annual distribution of reimbursements. The CIT projection for the year has been effectively revised downward in the second SB. Reductions in unemployment benefits and increases in social contributions reflect the improved situation in the labour market and underpin the good prospects for the Social Security balance (see Graph 2.6). At the central government level (see Graph 2.7), personnel expenses grew by almost 10% and the acquisition of goods also shows a positive growth year-on-year.

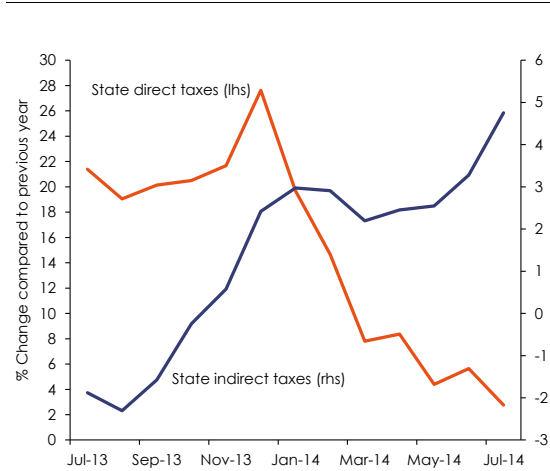
⁽⁷⁾ UTAO calculations.

Graph 2.4: **General Government consolidated accounts (cash-data)**



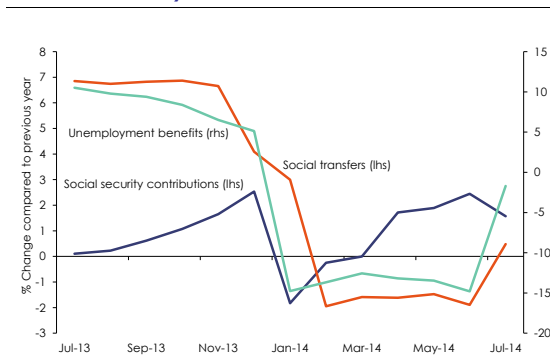
Source: DGO, Commission services

Graph 2.5: **State budget execution: Revenue (cash-data)**



Source: DGO, Commission services

Graph 2.6: **Budgetary outturn for Social Security (cash-data)**

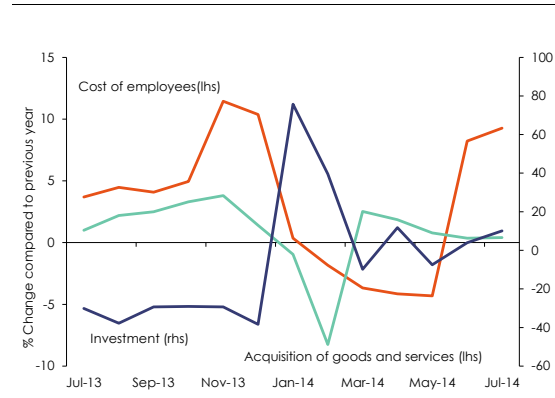


Source: DGO, Commission services

26. Risks to the attainment of a 4% of GDP headline deficit (excluding specific one-offs) are tilted to the downside. While the second SB already plans to use some of the budgetary reserves, there remain a number of negative risks in 2014:

i. *Risks related to the macro-economic outlook:* The risks to the macro-economic outlook concern the fiscal impact of recent revisions, i.e. lower-than-projected revenue and higher-than-projected social spending cannot be excluded. In addition, risks to the macro-economic scenario are themselves tilted to the downside, which could have further repercussions on the budget execution.

Graph 2.7: **Central administration budget execution (cash-data)**



Source: DGO, Commission services

ii. *Risks related to pressures on budgetary execution:* notably, the second SB revises up personnel costs, intermediate consumption, social transfers and investment expenditure, reflecting identified pressures on the budget which may still be higher than expected in this revision.

iii. *Risks related to forthcoming Constitutional Courts rulings:* the increase by 1 pp of beneficiaries' contributions to the public workers' special health care scheme ADSE was submitted for scrutiny to the Court at the end of June (worth about 0.2% of GDP in 2014 and with some follow-on effect in 2015 for the full year impact).

iv. *Implementation risks:* Beyond the underperformance and implementation delays in some measures taken into account in the second

Table 2.4: **Arithmetic of the government deficit evolution**

	(+) means balance-improving impact; (-) means balance-reducing impact	% of GDP
2011 balance (observed)*		-4.0
p.m. 2011 balance (without one-offs)		-7.3
Primary balance drift in 2012		-4.0
Change in interest expenditure		-0.3
Dissipation of one-offs and non-recurrent effects from previous year		-3.0
Consolidation measures		5.8
One-off measures		-0.6
<i>of which Bank recapitalisation</i>		-0.5
2012 balance (observed)*		-6.0
p.m. 2012 balance (without one-offs)		-5.8
Primary balance drift in 2013		-2.0
Change in interest expenditure		0.0
Dissipation of one-offs and non-recurrent effects from previous year		0.6
Consolidation measures		4.0
Restatement of the 13th and 14th salary and pension		-1.5
One-off measures		0.3
<i>of which Bank recapitalisation</i>		-0.4
2013 balance (observed)*		-4.5
p.m. 2013 balance (without one-offs)		-5.3
Primary balance drift in 2014		-0.6
Change in interest expenditure		0.0
Dissipation of one-offs and non-recurrent effects from previous year		-0.3
Consolidation measures		1.8
One-off measures		-5.9
<i>of which Bank recapitalisation</i>		-3.0
2014 balance (preliminary estimate)		-10.0
p.m. 2014 balance (without one-offs)		-4.0
Primary balance drift in 2015		0.7
Change in interest expenditure		-0.1
Dissipation of one-offs and non-recurrent effects from previous year		5.8
Consolidation measures		0.8
One-off measures		0.0
2015 balance (target)		-2.5
p.m. 2015 balance (without one-offs)		-2.5

(1) Balance in year t equals balance in year $t-1$ plus nominal primary balance drift in year t , plus the impact of the change in interest expenditure in year t , plus the impact of the dissipation of the one-offs and non-recurrent measures from year t , plus the impact of new consolidation measures in year t .

(2) The Primary Balance Drift includes the change in the balance level that would take place without discretionary measures, removing the effect of one-off measures. It includes the impact of economic activity on the balance, including the composition of growth, and the structural increase in expenditure in real terms, e.g. the increase in pension expenditure.

(3) The 2014 balance forecast is a preliminary estimate in ESA 95 terms, with the deficit-increasing impact of some operations still pending on the decision of statistical authorities.

* For the purposes of the Programme, the budget deficit in 2011 excludes the impact of BPN recapitalisation (about 0.4% of GDP), in 2012 it excludes the impact of CGD recapitalisation (about 0.5% of GDP), and in 2013 the BANIF recapitalisation (about 0.4% of GDP).

Source: INE, Commission services

SB (e.g. underperformance of the requalification programme), some further measures planned for 2014 could have a yield below the expected value again because of lower-than-expected performance or delays in or non-implementation. In particular:

- Implementation risks concern the cost reductions foreseen in line ministries. The ministerial expenditure savings of the initial consolidation package were introduced via expenditure ceilings for each line ministry. In light of significant slippages of such expenditure ceilings in the past, and even during the execution this year, the attainment of the estimated savings crucially hinges on maintaining the agreed expenditure ceilings (as revised by the second SB). The government had committed during the Programme to strict monitoring of budget implementation by line ministries through regular reporting to the Council of Ministers, with a special focus on the measures in the budget related to the public expenditure review (i.e. CTT health fund transfer, sales of concessions and special dividends from the sale of excess oil reserves).

- Risks are also associated with the envisaged one-off measures still pending to be implemented in the short time remaining until the year end (e.g. sales of concessions). Similar measures often suffered significant delays in the past. Moreover, the recording of these transactions as deficit-reducing would have to be confirmed by Eurostat.

27. Further efforts will be necessary in the post-programme period to reach the 2015 fiscal deficit target, the medium-term objective by 2017 and to put the adjustment achieved so far on a sustainable footing. At the end of the 12th Review mission the authorities confirmed the Programme deficit target of 2.5% of GDP in 2015, thus implying the correction of the excessive deficit in that year as requested by the Council in its Excessive Deficit Procedure (EDP) recommendation of 21 June 2013. Furthermore, Portugal is bound to achieve the medium-term objective of a structural deficit of 0.5% of GDP by 2017 and to ensure that the debt-to-GDP ratio is on a sufficiently decreasing downward path towards the 60% of GDP threshold, in compliance with the EU fiscal governance framework.

28. Under the current macro-fiscal scenario and taking into account recent developments, the achievement of the 2015 fiscal target of 2.5% of GDP deficit requires consolidation measures amounting to about 0.8% of GDP (EC preliminary internal estimates). This confirms the amount deemed necessary to achieve the 2015 target at the time of the 11th and 12th review missions. In addition, should part of the entire amount of the provisional allocation be used in 2014, this will also have to be rebuilt, which could require additional measures up to 0.3% of GDP.

29. The 2015 Budget needs to present a solid consolidation package consistent with the deficit target. This implies, among other things, additional measures to the package presented at the time of the Fiscal Strategy Document, in order to compensate for recent developments. At the time of the 11th and 12th Review missions, the government had put forward the broad lines of a consolidation package for 2015 worth 0.8% of GDP. The measures included: savings from a further re-organisation and streamlining of SOEs; further expenditure cuts across line ministries, including via increased savings from the health sector through agreements to cap annual public expenditure on pharmaceuticals or through the introduction of a claw-back on health-impacting industries in an effort to reduce SOE hospitals' structural imbalances; some increase in excise duties; the rationalisation of ICT-related costs in public administration; additional reductions in public employment which will be attained mainly by attrition, non-renewal of some contracts in areas with over-employment and the extension of the 2014 requalification scheme targets to 2015; reductions in contracted studies, consulting and other projects. The package also contained a plan to replace some temporary measures by structural measures in 2015. In particular, the CES was planned to be replaced by a progressive sustainability contribution from pensions, which would be complemented by moderate increases in employees' social security contributions and in the standard VAT rate. The package also foresaw the phasing out of the temporary wage cuts in the public sector over five years, provided consistency with the objective of containing the total wage bill. A more detailed specification of these measures was included in the 2014 Fiscal Strategy Document. On the back of recent developments

Table 2.5: Overview of Fiscal Consolidation Measures for 2015 (net yields) - Updated estimates (Sep 2014)

REVENUES			EXPENDITURES		
	EUR mn	% of GDP		EUR mn	% of GDP
<i>Permanent</i>			<i>Permanent</i>		
Horizontal	125	0.1	Public Administration	167	0.1
ESF Funds for requalification programme	50	0.0	Mutual agreement termination of contracts	48	0.0
Contributions to ADSE, SAD and ADM	75	0.0	Requalification programme	49	0.0
Increase in VAT rate (by 0.25 pp)	0	0.0	Attrition	140	0.1
Increase in Employees' Social Contribution	0	0.0	Reinstatement of 20% of wage reduction	-70	0.0
Sector-specific	115	0.1	Pensions	-561	-0.3
			Extinction of Extraordinary Solidarity Contribution	-561	-0.3
			Sustainability Contribution on Pensions	0	0.0
			Other measures	366	0.2
			Savings on ICT costs	138	0.1
			Savings in external studies/consultancy	179	0.1
			Savings from Aproximar programme	49	0.0
			Sector-specific measures (line ministries)	629	0.4
TOTAL permanent revenues (a)	240	0.1	TOTAL permanent expenditure cuts (b)	601	0.3
<i>One-off</i>			<i>One-off</i>		
			Concessions of Oceanario and other	41	0.0
TOTAL one-off revenues (c)	0	0.0	TOTAL one-off expenditure cuts (d)	41	0.0
TOTAL revenue increase (A) = (a)+(c)	240	0.1	TOTAL expenditure savings (B) = (b)+(d)	642	0.4

Source: Ministry of Finance, Commission services

(i.e. ruling out of the sustainability contribution by the CC, withdrawal of increases in VAT rate and social contributions by the government and reduction of the wage cuts in the public sector in 2014), the value of this consolidation package should be revised down to about 0.5% of GDP (EC estimates). This implies that the Government will have to specify further measures in the 2015 Budget in order to achieve the agreed 2.5% of GDP deficit target.

30. Temporary consolidation measures adopted during the Programme need to be replaced by durable structural measures. A number of fiscal measures were adopted during the crisis on a temporary basis in the annual Budget Laws and then extended into subsequent budget years. Overall, these measures amount to about 1.2% of GDP in 2014 and include the cuts in public workers' compensation, the "extraordinary solidarity contribution" from pensions (CES), the 3.5% surcharge on the personal income tax, the levy on the energy sector and other measures such as the suspension of the indexation of wages and pensions to inflation (excluding the minimum pensions) and the suspension of early retirements in the private sector introduced in 2012. The authorities confirmed that the suspension of early retirements will be lifted as from 2015, increasing budgetary pressures on pension expenditure next year. No indication of the plans regarding the

remaining temporary measures has been provided. In particular, while the government initially intended to phase out the temporary wage cuts in the public sector over five years (starting in 2015), provided this was consistent with the objective of containing the total wage bill, the CC has ruled wage cuts unconstitutional as from 2016. The Government has not presented any alternative measure or indicated possible avenues to contain the wage bill over the medium term. In addition, the plans for a structural pension reform need to be reformulated following recent Court rulings. In any case, the replacement of transitory measures by structural measures should be consistent with the budgetary targets and the medium-term commitments under the EU fiscal framework.

Debt developments

31. The public debt-to-GDP ratio in Portugal is over 130% and is among the highest in the euro area. In the context of the global financial crisis and subsequent recession, very high fiscal deficits and the reclassification of off-balance items and entities in the general government perimeter resulted in public debt increasing from around 95% of GDP in 2010 to close to 130% of GDP by end-2013. Public debt is projected to stand at 131.3% of GDP in ESA95 terms at the end of 2014 (net debt at about 124% of GDP). The upward revision of the end-2014

debt ratio compared with the projections at the time of the 11th Review is mainly related to the BES resolution (0.4% of GDP of loans from banks to the Resolution Fund are to be accounted as debt-increasing) as well as due to the SOE debt management operation to redeem the debt of some companies with a high legacy debt burden currently classified outside the general government perimeter (see also paragraph 21 above). Under the new ESA-2010 rules, five out of the seven of these companies will be included in the general government perimeter anyway, and therefore only the financing of the debt of the two companies expected to remain outside the general government perimeter will have an effect on the 2014 debt developments which is much smaller. Moreover, the expected upward revision of nominal GDP is estimated to more than offset the impact of the reclassification of the respective SOEs. Overall, preliminary estimates suggest that the end-2014 debt-to-GDP ratio could be around 127.5% in ESA-2010 terms. Irrespective of the accounting of this operation, the debt path is expected to turn around in the second half of this year, supported by the use of cash deposits and the ongoing reallocation of the Social Security portfolio from foreign assets to government securities. Beyond 2015, the debt-to-GDP ratio remains on a firm declining path under the Commission's no-policy-change projections. The debt ratio could fall even faster if supported by continued fiscal consolidation in line with EU budgetary requirements (see Box 2.2 for further details).

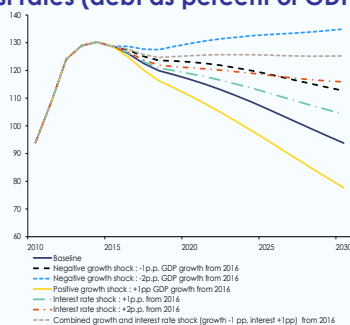
Box 2.2: Public Debt and Fiscal Sustainability in Portugal

Under the Programme scenario, government debt is projected to reach 131.3% of GDP by end 2014 in ESA 95 terms, up from 129% of GDP at end-2013, and to decline progressively thereafter. The debt-to-GDP ratio at end-2014 is now projected to be some 3.5 percentage points higher than at the time of the Eleventh Review – mainly driven by the SOE debt management operation recently launched by the government to restore the financial viability of companies with a high legacy debt burden. Nevertheless, the path of the debt-to-GDP ratio is still expected to turn downward in the second half of 2014 as a result of a small primary surplus, combined with a positive, albeit still modest, GDP growth rate. The baseline long-term calculations shown below incorporate the Programme scenario up to 2018, which includes fiscal consolidation measures up to 2015 and reflects no-policy-change assumptions for the outer years. More details on these figures are shown in Table 7 in the annex. After 2018, it is assumed that: (i) the structural primary fiscal balance remains unchanged at a surplus of 2.7% of GDP; (ii) nominal interest rates are around 4.5%; (iii) nominal GDP growth is between 3.5 and 4%; (iv) ageing costs are taken into account following the Commission's 2012 Ageing Report projections; and (v) the expected fiscal impact of PPPs costs are factored into the analysis.

Full compliance with the Programme's consolidation path and a medium-term nominal growth rate of 4% ensure a gradual decline of the debt ratio over a long time horizon. Nevertheless, given the very high starting point, the debt ratio would remain higher than before the current crisis for a significant number of years, reaching pre-crisis levels only towards the end of the next decade. Sensitivity analysis suggests that these findings are relatively robust with respect to underlying assumptions; still, the debt path remains vulnerable to negative economic developments. The graphs in this box present a sensitivity analysis with respect to macro-economic risks, the effect of alternative fiscal consolidation paths, and the potential impact of contingent liabilities such as reclassifications and other changes in the government perimeter.

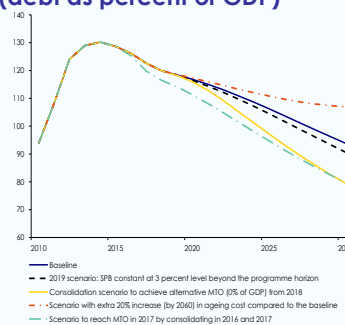
Graph I illustrates the sensitivity of the debt trajectory to macro-economic assumptions by considering a shock to real GDP growth and hikes in interest rates as from 2016. The analysis suggests that a lower GDP growth rate by one percentage point or a higher interest rate on maturing and new debt by two percentage points could significantly slow down the declining debt-to-GDP trend. Moreover, a combined growth and interest shock could put at risk the declining trend over the medium term and a larger negative shock to medium-term growth could put the debt on an explosive path. Conversely, a positive shock to medium and long-term growth on account of the structural reforms undertaken would result in visibly lower debt-to-GDP ratios and a faster pace of debt reduction. ⁽¹⁾ Combined with lower interest rates, the pace of the debt reduction could increase even further.

Graph I: Macroeconomic risks-growth and interest rates (debt as percent of GDP)



Source: Commission services

Graph II: Fiscal consolidation and ageing costs (debt as percent of GDP)



Source: Commission services

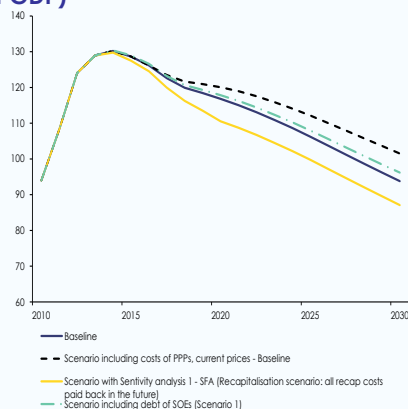
⁽¹⁾ Not taking into account the positive indirect effects of the higher GDP growth on the fiscal balance.

(Continued on the next page)

Box (continued)

Additional fiscal consolidation beyond the Programme horizon would clearly accelerate the debt reduction path (Graph II). In particular, reaching the Medium-Term-Objective (MTO) of a structural deficit of 0.5% of GDP in 2017 as per Fiscal Compact requirements would require a cumulative fiscal effort of about 0.7% of GDP in 2016 and 2017 and reaching a primary surplus of close to 4.0% by 2017. Maintaining the MTO over the longer term horizon will require primary surpluses of over 4% up to the middle of the next decade, declining gradually to close to 3.0% until the end of the projection horizon. Under these assumptions, the debt-to-GDP ratio would accelerate its decline already in 2016, falling below the pre-crisis ratio around the middle of the next decade and maintaining the sustainable downward path thereafter. A slower pace of consolidation but aiming at a more ambitious MTO of zero percent would also accelerate the debt reduction. On the other hand, if ageing costs are allowed to rise significantly (simulated as a 20% increase), ⁽²⁾ the fall in the ratio would be severely curtailed, stabilising at a high level in the absence of compensating fiscal consolidation.

Graph III: Changes in General Government perimeter (debt as percent of GDP)



Graph III illustrates the impact of changes in the government perimeter. The inclusion of all gross costs of PPPs would lead to an increase in the level of the government debt and delay its decline. The ongoing renegotiation of PPPs contracts will limit the cost of a reclassification scenario. With the currently ongoing SOE debt-management operation, risks related to outstanding SOE debt are significantly reduced compared with earlier projections. In addition, the envisaged privatisation programme combined with the necessary reforms to reduce SOEs operational costs will also contain the risks stemming from SOEs. By the same token, a quick repayment of the bank recapitalisation funds to the Government would accelerate the adjustment towards lower debt-to-GDP ratios.

Source: Commission services

Overall, the debt sustainability analysis reveals that the debt reduction path of the baseline is robust across a number of plausible scenarios. However, the current very high debt ratio implies a significant adjustment burden, which will require that conditions underpinning the declining debt path are steadily maintained over the next decades. In particular, the solid reduction path crucially hinges on medium and long-term economic growth, pointing to the necessity of persevering with the implementation of structural reforms, and it is only attainable if budgetary discipline is maintained also after the end of the Programme period.

⁽²⁾ According to the EU ageing report, Portugal is currently among the low-risk countries where the increase in age related expenditure is amongst the lowest in Europe.

FISCAL-STRUCTURAL POLICIES

The budgetary adjustment process has been flanked by a range of fiscal-structural measures to enhance control over government expenditure and improve revenue collection. These measures relate to public financial management, state-owned enterprises (SOEs), privatisations, public-private partnerships (PPPs), revenue administration, regional/local fiscal frameworks, public administration reform and health-sector reforms.

Public Financial Management

32. Recent changes in the public financial management system have allowed for better control of the budgetary process by the Ministry of Finance. A detailed Public Finance Management action plan for the period 2013-2015 was published with the 2013 budget. The action plan aims at improving the legislative framework and legislative procedures, improving the institutional capacity and reorganising the management of the public administration. In particular, the Ministry of Finance adopted in 2012 a new model that increases the responsibility of line ministries for the execution of their budgets under stringent supervision by the Ministry of Finance. The role of budget coordinators in line ministries and their interactions with the Ministry of Finance have been reinforced and the Commitment Control Law (CCL), approved in 2012, has limited the build-up of arrears by linking commitments to available funds and also by allowing for a better control of the budget execution. Nevertheless, the implementation of the law needs to be reinforced in order to entirely arrest the accumulation of new arrears. A recently established unit within the Ministry of Finance, in charge of monitoring arrears in the public sector, is expected to play an important role in this process. However, the role of budget coordinators also needs to be better defined, ensuring that the coordinators have the adequate skills and the necessary powers to exert the necessary control at all stages of the budgetary process.

33. The budgetary framework has been strengthened during the Programme and will be further reinforced. The law contains most of the elements guiding the budgetary process, in terms of timing, responsibilities at each stage of the process as well as regarding the content of the relevant documentation. The 2011 reform of the Budget Framework Law (BFL) has addressed several weaknesses in the budgetary process. In particular, it has established a multi-annual framework with expenditure and budget balance rules. By enlarging the scope of the law, it now applies to all entities that are part of the general government as defined in national accounts. It requires programme budgeting and accrual accounting for all entities, and it creates an independent Fiscal Council. The most recent amendment of the BFL on 10 July 2014⁽⁸⁾ has aimed at completing the transposition of the Six-Pack and the Fiscal Compact. The Commission is currently assessing the transposition of the Fiscal Compact for all signatories. Nevertheless, further challenges remain which are in particular related to the highly fragmented structure of the budget. A broader reform is foreseen by the end of 2014, which is to address the shortcomings identified by the technical group responsible for the reform of the BFL at the end of 2013. Notably, the reform aims at streamlining the budget appropriation structure, reducing further budget fragmentation, strengthening accountability relations, and imparting a medium-term to long-term orientation to public finances. In view of the scope of the reform and the aim of bringing forward a comprehensive and stable legal framework, it is crucial to ensure broad-based support from all relevant stakeholders who should be engaged in the reform process. Parallel to the reform of the central fiscal framework, the local and regional fiscal frameworks have also been substantially strengthened during the Programme period (see paragraph 44 below).

⁽⁸⁾ Diário da República, 1.ª série — N.º 131 — 10 de julho de 2014

Table 2.6: **Financial statements and employment of SOEs in the transport sector**

in EUR million

	Transport SOEs (includes the railway infrastructure manager)					
	2010	2011	2012	2013	2013-2010	
Income Statement						
Operating Income	753	788	775	791	39	5%
Sales (wo IFRIC)	549	563	596	613	64	12%
Operating Subsidies (indemnities)	199	218	172	172	-27	-14%
Other subsidies and financial compensations	5	6	7	6	2	33%
Operating Expenditure	-998	-885	-770	-788	210	-21%
Cost of Goods Sold	-84	-82	-48	-46	37	-45%
External services and supplies (wo IFRIC)	-458	-417	-395	-391	67	-15%
Personnel Costs (wo severance payments)	-456	-385	-328	-351	106	-23%
Adjusted EBITDA	-245	-97	5	3	249	-101%
Net Income	-1,091	-1,094	-753	-433	658	-60%
Balance Sheet						
Assets	7,815	7,852	8,656	8,383	568	7%
Equity	-5,325	-6,681	-7,051	-7,014	-1,689	32%
Liabilities	13,140	14,533	15,707	15,398	2,258	17%
Indebtedness (financial debt)	10,590	11,320	11,811	12,626	2,035	19%
Employees at year-end (nr.)	16,406	14,611	13,982	13,383	-3,023	-18%

Source: DGTF and DGAEP (labour) quarterly reports; Commission services

State-owned enterprises

34. At the beginning of the Programme, the financial situation of a number of state-owned enterprises (SOEs) outside the government perimeter entailed large fiscal risks. In addition, SOEs were having a negative impact on the private sector insofar as they absorb a substantial part of bank lending, they are able to charge relatively high prices for the services rendered and they attract high-skilled workers that could otherwise be employed in the tradables sector. Several SOEs have been structural loss-makers and have accumulated large amounts of debt in the past. In particular, transport companies (including the railway operator CP and the railway infrastructure manager REFER as well as urban transport companies), the road infrastructure manager Estradas de Portugal (EP) and state-owned hospitals were sources of concern. The transport SOEs (including REFER) accounted for 80% of the SOEs' total debt (excluding Parública, EP and state-owned hospitals) in 2010 and about 89% at end-2013 (i.e. 13.4% of GDP).

35. The financial situation of SOEs in the transport sector has substantially improved under the Programme, with these entities reaching operational balance on a consolidated basis in both 2012 and 2013. The operational

balance of SOEs, as measured by adjusted EBITDA,⁽⁹⁾ is recorded in Table 2.6. On the operational revenues side, price increases and a commercial focus more than covered the 14% reduction of State budget contributions (operating subsidies) with a positive balance of EUR 39 million for the whole period. On the operating expenditure side, cost compression reflects the successful downsizing of the labour force (-18% between 2010 and 2013) inducing a 23% drop in personnel costs that contributed to an overall cost reduction of EUR 210 million during those three years. It is noteworthy that the positive adjusted EBITDA achieved in 2012 was maintained in 2013 despite the legal limits to cost compression through wage bill cuts set by the Constitutional Court ruling in April 2013. Additional reforms are foreseen to lock in the improvements in operational balance by setting formal cost-reduction objectives for loss-making bodies.

36. Net losses of transport SOEs were considerably reduced during 2010-2013. In this period, net losses were reduced by 58% (or EUR 716 million). However, due to chronic financial imbalances, negative equity continued to increase in this period implying a need to bridge the gap through increased indebtedness (+19%;

⁽⁹⁾ Earnings Before Interest, Taxes, Depreciation and Amortisation excluding severance payments.

EUR 3.2 billion). As legacy debt continues to weigh on the financial results of these SOEs, the Government has launched a comprehensive debt management strategy to restore the companies' financial sustainability and arrest the accumulation of new arrears already in 2014. As part of this strategy, the State has begun to assume their short-term debts at maturity. Under ESA2010 rules, this operation is expected to entail a reclassification of three companies, including the railway operator CP, within the general government (see fiscal section for more detail). Operational and financial restructuring will help pave the way for a successful tendering of concessions. In addition, the planned merger of REFER and EP is expected to benefit from their different expertise to generate operating efficiency gains, commercial synergies related with better usage of network complementarities and the sale of non-core assets that should translate into net savings and selling proceeds expected to contribute to the new company's financial sustainability.

37. The water and sewerage branches of Águas de Portugal (AdP) are under operational restructuring. The merger of 19 companies into 6 aims to increase operational efficiency and bring about investment rationalisation in these capital-intensive sectors by ensuring the full-cost recovery of the services rendered, the application of the polluter-pay principle and the sustainable management of natural resources, in line with EU Directives. The sale of its waste branch holding (EGF) will bring about proceeds that will be channelled for debt reduction, improving AdP's financial ratios. Regulatory changes being implemented in these sectors are paramount to ensure that the new model is fully sustainable, improving the relationship between bulk service operators, retail service operators and the end-user.

Privatisations ⁽¹⁰⁾

38. The privatisation programme is set to continue beyond the end of the Programme. The EUR 5.5 billion Programme target for proceeds from the sale of companies was already reached in December 2012. By June 2014, the accumulated proceeds from privatisation amounted to about EUR 9 billion. Attracting FDI from non-EU

countries in a time of crisis, when companies have difficulties to finance new investment, was a major achievement. Since most of the companies that were privatised operate in network industries, the revision of the sector's regulatory framework and the strengthening of the institutional capacity to deal with the higher private participation in the sector were pivotal to the privatisation programme and the economic reform agenda. Higher efficiency gains, more competition and better price-quality ratios of the privatised companies induced positive spill-overs to the whole economy and ensured a better protection of consumers' interests. Several SOEs, for which the authorities seek higher private sector participation, have made progress in improving their financial results, thus reducing risks for the State budget prior to a privatisation. In particular, TAP's financial results improved significantly in 2013 and the privatisation process may be re-launched in the course of this year. The launch of the privatisation process of CP Carga in the second half of the year is subject to a satisfactory appraisal of the firm, following the agreement with REFER regarding the transfer of its terminals and the approval of the rail investment plan. As highlighted above, addressing the debt overhang of transport SOEs together with the ongoing restructuring of Lisbon and Porto's urban transport companies was key to ensuring a sound and competitive environment for the sale of their concessions. Following the launch of the consultation process in February, the tenders for the urban transport sub-concessions were expected to be launched during the third quarter of 2014. The remaining 11% of public shares in REN were sold through a market offer in June 2014. Additionally, the State's remaining 31.5% shares in the postal company CTT were sold to institutional investors in September 2014. Binding offers for the sale of the waste management company, EGF, were presented in August and a final decision to sell 95% of the company to a Portuguese bidder was taken in September 2014.

Public Private Partnerships

39. Public-Private Partnerships (PPPs) have been used extensively in Portugal, in particular to finance transport infrastructure and hospitals. The implicit government liabilities in relation to PPPs – the net present value of the flow of payments in relation to the contracts already signed – were estimated to be over 14% of

⁽¹⁰⁾ For further details on the privatisation programme see box 2.2 in the 11th review report.

GDP at the beginning of the Programme. These commitments loosen the budget constraint in the short term, but limit the flexibility of government expenditure in the medium term. In particular, the lack of adequate central control for creating and monitoring PPPs had to be addressed.

40. The institutional and legal framework of PPPs was significantly strengthened. The Programme devoted particular attention to the creation of a dedicated and skilled taskforce (UTAP) within the Ministry of Finance to assess and monitor PPPs and revise the PPP framework law. UTAP will continue to work towards enhancing fiscal transparency, improving reporting on PPPs, expanding its field of action to the health sector (in cooperation with the Ministry of Health) and the security sector, and closely monitoring and advising the PPP renegotiation process in the autonomous region of Madeira. Strengthening the capacity to manage PPPs also at regional and local level remains a challenge. The authorities are committed to undertake new PPP investments only if they pass a cost-benefit test, are affordable and in compliance with stringent tendering requirements.

41. Delays in closing the renegotiation processes of road PPPs still require attention in the post-programme period. According to an audit of the 36 largest PPP contracts in Portugal, road PPPs represented approximately three quarters of the total PPP burden on the State budget. The renegotiation of road PPPs to rebalance the contracts and bring about 30% savings to the Exchequer was therefore deemed critical. A renegotiation strategy was designed involving all partners in such deals, including banks, with the aim of achieving a new and more sustainable PPP model. The revision of the regulatory framework for the road and rail sectors will be finalised, reducing operation, maintenance, and major repair requirements, in line with EU standards and with the objective of minimising fiscal risks. Notwithstanding the delays in lending banks giving a waiver to each renegotiated contract, the authorities remain committed to finalising in the bulk of the renegotiation of road contract PPPs with all concessionaires in 2014, generating additional structural savings of more than EUR 6 billion over the life cycle of these concessions. Further steps will be taken to achieve a fiscally responsible PPP model in the post-

programme period, including on a second subset of road PPPs – Estradas de Portugal's sub-concessions – and a Security&Emergency PPP that are now under renegotiation.

Revenue administration

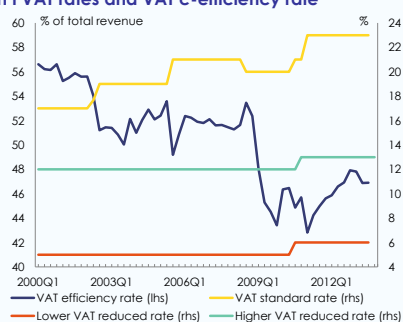
42. Significant progress has been made in reforming the revenue administration under the Programme. The agenda was ambitious and included several reforms: integrating three services (tax, customs and IT services); reorganising the tax administration around taxpayers' segments (e.g. establishing a large taxpayer unit); the establishment of a Risk Management Unit to strengthen tax compliance; the revaluation of properties to support changes to the property tax regime; unified monthly returns on personal income tax and social security contributions; the introduction of an innovative e-invoicing system that introduced mandatory invoicing and electronic transfers of invoice data, as well as tax incentives for consumers to request invoices in certain sectors. Available indicators point to a successful implementation of the measures. Other reforms foreseen in the Programme are suffering delays or have been revised, such as the streamlining of the taxpayer dispute resolution process and the planned increase in the number of tax auditors. Moreover, the plan to close a number of local tax offices, which was on the reform agenda since the beginning of the Programme as part of the tax administration reorganisation, has been finally withdrawn by the authorities who claim to envisage its integration into the Aproximar programme, aimed at a more comprehensive restructuring of the public services provided at local level.

Box 2.3: Estimating the Size of the Shadow Economy in Portugal

Unrecorded economic activities (or the shadow economy) generally describe a situation where businesses and individuals operate outside of the tax system. Indeed, unrecorded economic activities are often seen as a main cause for the so-called tax revenue gap, i.e. the difference between actual and potential tax revenues (Russell, 2012). A widely-used gauge of tax performance is the VAT c-efficiency rate (see Keen, 2013), which is derived from the ratio of actual VAT revenue and the (simplified) tax base multiplied by the standard VAT rate. ⁽¹⁾ The closer this indicator is to 1 the higher is VAT efficiency.

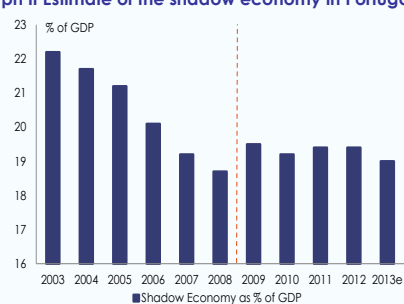
VAT "inefficiency" can have many causes, the most important being the existence of VAT rates below the standard rate and tax evasion or tax fraud. ⁽²⁾ In Portugal, the VAT c-efficiency rate dropped sharply at the beginning of 2009 with the onset of the economic and financial crisis (Graph I). Since the beginning of 2011, the situation improved somewhat reflecting the move of some goods and services from reduced tax rates to the standard rate as well as the Portuguese authorities' reinforced efforts to combat tax evasion and fraud. However, the pre-crisis levels of VAT efficiency have not been reached yet and, more importantly, the low level of VAT efficiency could also be indicative of significant unrecorded economic activity.

Graph I VAT rates and VAT c-efficiency rate



Source: Commission services

Graph II Estimate of the shadow economy in Portugal



Source: Schneider (2013)

The literature offers various methods to measure the size of the shadow economy which can be classified as direct approaches, indirect approaches or model approaches. ⁽³⁾ A well-known model approach is the Multiple Indicators of Multiple Causes (MIMIC) and, despite some limitations, it is used by different scholars. Nonetheless, the model must be ideally calibrated with other methods like the indirect currency-demand approach (Tanzi, 1983) in order to test its robustness. The MIMIC model consists of a Structural Equation Model (SEM) which statistically relates causal (observed) variables with latent (unobserved) variables that indirectly affect observed indicators (Dell'Anno, 2007; Schneider and Williams, 2013).

Schneider (2013) estimates at 19% of GDP the size of the shadow economy in Portugal in 2013 which has remained almost stable since the onset of the financial crisis (Graph II). The result is broadly in line with other studies on the Portuguese shadow economy such as Barbosa et al. (2013) that evaluate it at around 24% of the GDP in 2011, or the recent press release by the Portuguese Statistical Office (INE) which estimates at nearly 17% of GDP the size of the Portuguese "unobserved" economy. ⁽⁴⁾

The Portuguese authorities have undertaken several reforms to tackle the problem of the tax revenue losses due to unreported economic activities. For instance, an innovative e-invoicing system introduced mandatory invoicing, electronic transfers of invoiced data and tax incentives for consumers to request invoices in certain sectors, as well as many reforms of the tax administration were introduced during the Programme to strengthen taxpayers' tax compliance. However, in view of the size and relevance of the problem, the Portuguese authorities need to persevere in their efforts and consider additional measures, including efforts to fight tax evasion in the housing market and regularly measuring and also improving the estimates of tax compliance gaps, with the aim of increasing transparency and efficiency in tax collection.

References:

Barbosa E., S. Pereira and E. Brandao (2013), "The Shadow Economy in Portugal: An Analysis Using the MIMIC Model", FEP Working Paper, No 514.

Dell'Anno, R. (2007), "The Shadow Economy in Portugal: An Analysis with the MIMIC Approach", *Journal of Applied Economics Vol X No. 2*, 253-277

⁽¹⁾ To be more precise, VAT c-efficiency is calculated as the ratio between the actual VAT revenues and the standard VAT rate multiplied by nominal private consumption expenditure net of VAT revenues.

⁽²⁾ Composition effect must be taken into account, i.e. during the crisis years people tend to consume relatively more basic goods and services, which are subject to reduced VAT rates.

⁽³⁾ For a review of empirical approaches, see Schneider and Williams (2013) and/ or Schneider and Enste (2000).

⁽⁴⁾ See INE press release:

http://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=211353592&DESTAQUESmodo=2&xlang=pt

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Box (continued)

Nova Série de Contas Nacionais Portuguesas para o período 1995 – 2011 Press Release Instituto Nacional de Estatística, INE (2014), http://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaquas&DESTAQUESdest_boui=211353592&DESTAQUESmodo=2&xlang=pt

Keen M. (2013), “The Anatomy of the VAT”, IMF Working Paper 13/11.

Russell B. (2012), “Revenue Administration: Managing the Shadow Economy”, IMF Technical Notes and Manuals 10/14.

Schneider F. (2013), “Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2013: A further decline”, Research Paper, http://www.econ.jku.at/members/Schneider/files/publications/2013/ShadEcEurope31_Jan2013.pdf

Schneider F. and C. Williams (2013), “The Shadow Economy”, The Institute of Economic Affairs.

Schneider F. and D. Enste (2000), “Shadow Economies: Size, Causes, and Consequences”, *Journal of Economic Literature* Vol. XXXVIII, pp. 77-114

Tanzi V. (1983), “The Underground Economy in the United States: Annual Estimates, 1930-80”, IMF Staff Papers, pp. 283-305.

43. The efficiency of tax administration needs to be further improved in the post-programme period. The foreseen post-programme reforms will involve, inter alia, the establishment of a dedicated Taxpayer Services Department by end-2014, which will unify most services related to taxpayers. However, there is scope for further reforms to better curb tax evasion in support of the ongoing fiscal consolidation and to improve tax fairness. Available indicators point to a rather high share of the unobserved economy, (see Box 2.3 on estimates of the shadow economy in Portugal) and substantial underreporting of income, particularly for certain categories of taxpayers, which calls for more efforts to improve tax compliance, also with a view to an equitable distribution in the tax burden of the budgetary adjustment. In particular, a broader use of information from third parties (in particular financial institutions) and the strengthening of Portugal's anti-money-laundering framework would be helpful. Portugal also needs to further improve the performance of its revenue authority in areas such as the recovery of due taxes and the reduction of compliance costs for taxpayers.

Regional and local fiscal frameworks

44. Portugal has strengthened its regional and local fiscal frameworks by adapting the Regional and Local Finance Laws to the principles and rules of the revised Budgetary Framework Law. The revised Local and Regional Finance Laws were approved by the Parliament in early August 2013 and have entered into force on 1 January 2014. The subnational annual budgets are now enshrined in multiannual plans and regional and local governments are bound by balance and indebtedness rules. The scope of application has

been enlarged to all relevant public entities in the perimeter of local and regional governments as per the European System of National Accounts and the regime of data provision to support revenue projections at subnational level is also defined. Fiscal accountability has been strengthened, also limiting the scope for lower tax rates in the Autonomous Regions. Auditing and enforcement powers of the central tax administration have been strengthened and requirements for data provision to support revenue projections have been introduced. The laws envisage the establishment of two Financial Coordination Councils to enhance coordination between the central and subnational governments, gathering representatives from the central government and, respectively, from the regional and local governments.⁽¹⁾ These Financial Coordination Councils at regional and local levels have been set up in June 2014; they have, however, not yet become operational. The Local Finance Law also provides for the setup of a Municipality Support Fund (FAM) for debt workouts of financially distressed municipalities, which entered into force in August 2014. Closer coordination between the central and subnational governments will be fostered through a recently created Council of Territorial Partnership. Finally, the recent reform of the legal regime of local SOEs and improved supervision over regional PPPs is also expected to add to better fiscal management at subnational level.

⁽¹⁾ The Regional Fiscal Policy Council notably aims ensuring compliance with the provisions of the Regional Finance Law, evaluating the regional budgetary policy to ensure consistency with national fiscal objectives and the EU framework and evaluating financing needs and indebtedness. The Local Fiscal Policy Council promotes the exchange of information between the central and local administration to improve budgetary practices at local level.

45. The government implemented several more specific measures to improve fiscal discipline in local and regional governments. At local level, these include an arrears programme (PAEL), a reduction in the number of parishes (freguesias), a streamlining of administrative structures, rules for local state-owned enterprises, and a legal basis for creating inter-municipal entities. Going beyond the Programme and in order to enhance local administrations' transparency and accountability, the authorities created a website⁽¹²⁾ with economic and financial indicators for all municipalities and are planning to launch a training programme for human resources in local administrations. Continued close monitoring will be required in the future to avoid new budget slippages when access to bank loans is re-opening for regional and local authorities. Such monitoring is complicated by a considerable degree of autonomy guaranteed by the Constitution and the fact that the high number of municipalities (308) has not yet been reduced. The Autonomous Region of Madeira's adjustment programme with the State since early 2012 will continue until October 2015, providing a loan of EUR 1.5 billion on the basis of policy conditionality ensuring fiscal consolidation, similar to the conditionality under the Portugal's own Programme with the EU and the IMF. The Autonomous Region of Azores is continuing its efforts, as evidenced throughout the Programme, to maintain sound public finance based on a budget close to balance and low public debt.

Public administration reform⁽¹³⁾

46. The main objective of the public administration reform under the Programme was to improve efficiency by simplifying procedures and reorganising services. This needs to be seen in conjunction with the Programme objective of fiscal consolidation,

giving priority to expenditure reductions as being more growth-friendly than tax increases and providing a higher likelihood of consolidation being sustained. Particular progress has been achieved under the Programme in reducing the public sector wage bill (see Box 2.4).

47. Regarding working conditions, a new General Public Administration Labour Law compiles the existing rules of public sector employment and adjusts several rules to those of the private labour code. The law, which entered into force on 1 August 2014 and does not apply to police and military, includes elements such as the reduction of the number of days of annual leave, compensation for overtime work and the application of the bank of hours, while important subsets have already become effective in separate laws. The increase in weekly working time in the public administration from 35 to 40 hours aligns the usual pattern in the private sector and reduces the gap in annual working time of the public administration vis-à-vis the OECD average. However, the regional government of Azores re-introduced the 35-hours week in their administrations through collective agreements, while the regional government of Madeira delegated the decision on the weekly working time to heads of services; collective agreements to re-introduce the 35-hours week in some 200 out of the 308 municipalities are subject to approval by the Ministry of Finance. The new requalification scheme, transforming the previous Special Mobility Scheme by focusing on a re-orientation of public employees' careers towards actual needs in the administration, targets 12,000 employees in 2014 and 2015 who will be paid 60% of their previous wages in the first year and 40% thereafter. Finally, general rules on job mobility in the administration were made more flexible in terms of acceptability, for example regarding commuting distance.

⁽¹²⁾ www.portal municipal.pt

⁽¹³⁾ This overview is about transversal reforms in the administration at central, regional and local level, as foreseen in the context of the EU/IMF adjustment programme. The quantified contribution to budget consolidation of these administrative reforms has been reported in the fiscal policy sections of successive review reports. It also excludes changes in specific administrations to implement policy reforms such as, for example, the reorganisation of the Court system, the reorganisation of the tax administration, or the simplification of administrative procedures to reduce the costs of doing business.

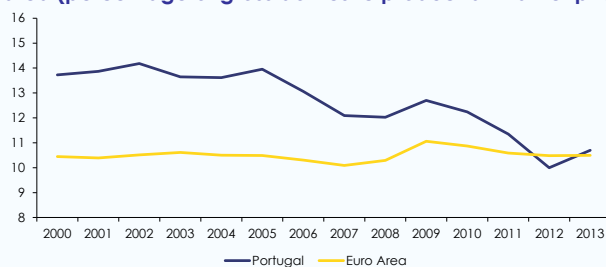
Box 2.4: Measures to Reduce the Public Sector Wage Bill

The diagnosis at the outset of the adjustment programme was that Portugal's public sector wage bill was high by international comparison. In the past, the wage bill absorbed about a quarter of primary current spending in the State budget. As a share of GDP, it was significantly above the euro area average at the beginning of the Programme but had been reduced to the average by 2013 (see Graph I) via measures to reduce public sector employment and change remuneration policies.

Regarding public sector employment, the Programme targeted a reduction of permanent staff by 2% in full-time equivalents and also a significant cut in temporary positions. A comprehensive database (Information System on the Organisation of the State - SIOE) was created in 2011, which allows the monitoring of the stock and flows of public sector employees by different activities, professional categories, types of contract and remuneration. According to this database, the target of a 2% reduction in employment per year was exceeded, with a nearly 10% reduction until June 2014 compared to end-2011, and also achieved in all different layers of government (see Table I). However, the target of the 2013 Budget to reduce the number of fixed-term contracts in the central administration by 50% was missed, as the reduction amounted to only 14% from about 73,600 to about 63,300. For 2014, a reduction of 10,000 fixed-term contracts is envisaged. Employment in state-owned enterprises (SOEs) owned by central, regional and local administrations was reduced by 10.4% from 199,621 at the end of 2012 to 178,955 at the end of the first quarter of 2014, to some extent also as a result of privatisation.

A variety of approaches were used to reduce employment. In the central administration, more restrictive rules for recruitment were established; in particular a lower replacement rate for retirees and other departures, and Ministries were obliged to reduce the recourse to fixed-term contracts. Since the end of 2013, several career-specific programmes for the termination of contracts by mutual agreement were launched for less qualified workers, teachers and senior experts in areas with over-employment; by end-April 2014 about 2,300 contract terminations had been completed. For local administrations, special provisions were set in the State budget to reduce transfers in case of missed targets for employment reduction. The 2% reduction objective is a condition in the Government's adjustment programme for Madeira.

Graph I: Compensation of employees in general government (ESA 1995) in Portugal and the euro area (percentage of gross domestic product at market prices)



Source: Commission Services

Regarding remuneration policies, there is evidence that wage structures in Portugal's public administration are out of line with those of the private sector, which has distorting effects. A study finalised for the government in early 2013, as requested in the context of the Programme, compared public and private sector wage scales for similar job profiles. ⁽¹⁾ It found that the remuneration offered in the public sector is higher than in the private sector for a considerable range of job profiles and is only lower with respect to a limited number of job profiles. Teachers' salaries stand out as having a particularly high public sector premium, while salaries for top managers in the public sector come with a significant negative wage premium. Similarly, a study by Commission staff, based on data from the European Structure of Earnings

⁽¹⁾ Mercer (2013), Análise comparativa das remunerações praticadas no sector público e no sector privado – relatório final, 22 de Fevereiro 2013.

(Continued on the next page)

Box (continued)

Survey (SES), found that public sector wages in Portugal were around 11.9% higher than in the private sector in 2010. ⁽²⁾ A positive public sector wage premium is observed at all levels of educational attainment: the largest one for workers with low educational levels (18.6%), and the lowest one for workers with high levels of education (4.5%). By job position, positive public sector wage premia are observed for all categories except managers (with a negative premium of -12.1%) and technicians (not significant). Generally, the highest gaps occur for workers in lower professional categories (e.g. 47.4% in the case of plant workers).

Table I: Change in employment in public administration from end-2011 to the second quarter of 2014

	31-dec-2011	31-dec-2012	31-dec-2013	30-jun-2014 (p)	changes in %			
					2012/2011	2013/2012	2014/2013	2014/2011
CENTRAL ADMINISTRATION	458,951	437,081	419,406	411,407	-4.8	-5.9	-1.9	-10.4
AZORES	15,177	14,837	14,501	14,495	-2.2	-2.3	0.0	-4.5
MADEIRA	17,679	17,261	16,835	16,659	-2.4	-3.5	-1.0	-5.8
LOCAL ADMINISTRATION	120,759	116,421	112,997	110,398	-3.6	-5.2	-2.3	-8.6
PUBLIC ADMINISTRATION - Total	612,566	585,600	563,739	552,959	-4.4	-5.6	-1.9	-9.7

Source: SIOE database; (p) provisional

Several measures were taken to reduce wages in the public administration. As an immediate measure in 2011, promotions and the related wage increases in the public administration were suspended. Temporary wage cuts through suspensions of the 13th and/or 14th salaries or other reductions were introduced in different forms in the budgets 2011 to 2014, with exceptions in specific sectors such as health, police and military as well as in some SOEs. However, these suspensions needed to be revised several times after relevant Constitutional Court rulings. Furthermore, the Government intends to gradually integrate all careers in a Single Wage Scale (TRU) - to replace the existing arrangement of 115 base wage levels and many exceptions - starting in 2015 with all new employees and those with mobility between careers.

The Government is revising wage supplements in the public administration to be applied from 2015. The revision builds on the results of a survey published at the end of 2013, which identified more than 280 different supplements and more than 410,000 supplement payment events with a total value of about EUR 700 million or 5% of the total wage bill. The objective is to significantly reduce the number of supplements by integrating them into the Single Supplements Scale (TUS) or by reducing them to three aggregate categories related to (i) functions or conditions in the exercise of functions, (ii) responsibilities, command or leadership, and (iii) results. As a rule, there should only be one supplement per category. On this basis, the Single Supplements Scale will be in fixed amounts and applied in a gradual process in parallel to the Single Wage Scale. The Government is also planning to eliminate wage supplements during days of absence. Police and military forces will see a revision of their wage supplements, which account for more than half of all supplements paid by the Government, in the context of their specific statutes.

Additional savings, although less important in terms of their budget impact, were achieved in different areas. Efforts towards the reduction of fringe benefits in administration and other services related in particular to the use of service cars, IT equipment as well as mobile phones, and travel allowances. To improve its self-financing and reduce the need for budget transfers, the contribution rate for the public sector health insurance sub-systems was increased. The increase in the rate from 2.5% to 3.5% of ADSE (general), SAD (police) and ADM (military) is effective since June 2014. This is expected to still keep SAD and ADM in deficit but to create a surplus in ADSE that will ensure coverage of its expected financing needs in the future. A "convergence law" entered into force in March 2014, aligning the rules for public sector pensions (CGA) with those in the general social security system. Among other modifications, it increases the retirement age (from 65 to 66 years) through changes to the sustainability factor, adjusts the reference salary for pensions' calculation and its inflation index, and suspends the pensions for those pensioners who work for the State and could choose between the pension and the salary until now.

⁽²⁾ De Castro, F., M. Salto and H. Steiner (2013), "The gap between public and private wages: new evidence for the EU". European Economy - Economic Papers n° 508, Brussels, November 2013.

48. Several measures were taken to improve the organisational efficiency and the quality of services. Considering today's standards of public service provision in a modern administration, there seems to be a mismatch in Portugal's public administration in terms of required qualifications and skills. The SIOE database shows that 36.6% of all employees in the public administration are administrative, operational or auxiliary assistants. The implementation of the Central Administration Restructuring Programme (PREMAC) to reduce the number of management positions by 27% and administrative units by 40% was completed in autumn 2012. A second phase of the PREMAC programme is considered in the context of the Reform of the State. A law reducing the number of managers and administrative units at local level by benchmarking to the size of municipalities was implemented. According to the SIOE database, for all public administration together, the number of higher managers at mid-2014 was 16.2% lower than at end-2011 and the number of middle managers was 12.3% lower. Specific rules for the recruitment and remuneration of public managers, cabinet members and regulators were defined in dedicated legal instruments. In addition, a committee on recruitment and selection (CRoSAP) was created which gives its opinion and recommends the three best candidates for appointments in top level positions in the administration.

49. Public support to foundations was scaled back. An evaluation of foundations was completed in 2012 with the objective of reducing the size of the 'parallel State'. It created the basis for decisions that 98 foundations would see no changes, 132 were changed of which more than 30 abolished, and 193 will no longer receive support from the State. Transfers to foundations in the Budget 2014 were EUR 11.4 million, which compares to EUR 20.4 million on average in the years 2008 to 2010. In addition, preliminary results to meet reporting obligations on public grants under law 64/2013 show that in 2013, out of a total amount of EUR 4.12 billion, private associations received public grants worth about EUR 890 million.

50. Strategies of shared services are under implementation in several areas. Regarding financial resources, shared services are to be used

in all 351 entities to be covered by the initiative by January 2015, of which 270 are in the central administration, 44 in the Azores and 37 in Madeira. In the area of human resources, shared services were introduced in the Ministry of Finance, but the introduction in the tax administration (AT) is lagging behind. Shared services in ICT remain to be applied in various services.

51. A significant reduction in the number of parishes (freguesias) was implemented. This reduction from 4050 to 2882 constituencies became effective after the local elections in September 2013 as the newly elected officials took office. While most of the jobs in the parishes are on a voluntary basis, the authorities estimated that direct savings of EUR 8.8 million per annum will be attained from the elimination of bodies and functions, but more importantly hard-to-quantify gains are expected from economies of scale and a better quality of merged services. Even though also envisaged under the Programme, there was no reduction in the number of municipalities (308), and a new legal provision for creating inter-municipal communities so as to better exploit economies of scale appears to experience a very limited take-up.

52. A strategy to reorganise the provision of administrative services at local level is under preparation. A key element of the Government's Reform of the State programme is the 'Aproximar' strategy, which has the main objective of reorganising the public services network at local level to improve quality and efficiency. The basic idea is to create a network of front offices ('Lojas/Espaços do Cidadão') in which citizens are assisted in their requests for administrative services, many of them available online, while back offices processing these requests will become more concentrated. In addition, mobility services will be provided to citizens living too far away from these facilities.

53. Overall, the measures taken in the context of the Programme implied good progress towards the public administration reform objectives, although a more systematic response will be required going forward. Notably, the level of employment was reduced, the wage premium vis-à-vis the private services partly diminished, some of the working conditions

aligned with those of the private sector, and strategies to improve the organisational efficiency and quality of services are being implemented. Nevertheless, many of the measures are of a temporary and ad hoc nature, falling short of a more systematic response to structural problems in the administration, also because several Constitutional Court rulings set tight limits by referring to general constitutional principles such as proportionality, legitimate expectations and equality of burden-sharing. In the medium term, the challenge for the authorities will remain to work further towards the rationalisation and modernisation of the public administration within the limits of the budget while ensuring an efficient delivery of public services by motivated and qualified staff.

Reform of the health sector

54. Improving the efficiency and cost-effectiveness, inducing a more rational use of health services and controlling public expenditure on health have been the drivers of health sector reforms implemented during the Programme. At the start of the Programme, public expenditure on health was generally higher than in other countries with similar levels of GDP or per capita income. Considering the available resources and the economic situation, the goal was to identify areas where savings could be made through the reduction of existing inefficiency and unnecessary consumption and by ensuring a cost-effective path of care. This would realign Portugal with peer countries in terms of expenditure patterns, while maintaining the universal access to care and the protection of the more vulnerable, without a negative impact on the health of the population. Where possible, policies tried to improve the equity of financing and access.

55. The reform process has taken into account scientific evidence gathered from academic research, think-tanks and independent agencies. The technical capacity and knowledge available at the Ministry of Health and its various agencies has proven a valuable asset and helped to develop and implement policy proposals efficiently. The authorities showed openness to discuss and adjust proposals in a politically sensitive and complex policy area, and many stakeholders have contributed to the reform.

56. Health sector reforms covered the financing and the expenditure sides and all areas of provision (pharmaceuticals, primary care, hospital care, emergency care, transport of patients). In some areas, the authorities have implemented reforms that intensified and fine-tuned previous reforms (e.g. pharmaceutical policies) or that tried to address existing policy incoherencies (e.g. in public sub-systems). In other areas, policies have initiated substantial reform plans (e.g. hospital reform).

57. In terms of financing, the specific aim of the reforms was to reduce regressive effects, improve own funding and encourage a cost-effective path of care, while protecting the vulnerable members of society. A first step was a substantial reduction of tax credits for health care estimated at about EUR 600-700 million (0.2-0.3% of GDP). As the National Health System (NHS) is tax-financed, tax credits rendered the system financing regressive. They also reduce cost-awareness and the effectiveness of referral systems and create perverse incentives to use services in a non-cost effective way (e.g. unnecessary use of private specialist care). Tax credits were reduced by two thirds through the elimination of tax credits for the highest income brackets while keeping some credit for the lowest income brackets. It is important to ensure that future tax changes will not reintroduce tax allowances for health care.

58. A second step was to revise cost-sharing schemes. The existing structure was in general considered efficient and appropriate insofar as primary care co-payments were lower than specialist care visits and emergency care. However, co-payments were not updated regularly or in line with cost evolution or inflation. They were also not fully means-tested and many different exemptions groups existed, which created some inequity in the financing of the system. Moreover, co-payments appeared to be tax-deductible, which not only induced inequity of financing but also worked against their objective of raising cost-awareness and reducing unnecessary demand. The aim was to update the existing structure to address these challenges. Changes involved: an automatic indexation to inflation, a revision of the exemption groups and a refocusing on income-related exemption with a link to the means-tested instruments used for social security. Refocusing the system of exemptions on

income and clinically-related conditions aimed at reducing the regressivity of financing. As a result, between 5 and 7 million people (out of a total population of around 10 million) became exempted from co-payments. In addition, the collection of co-payments, fees from across-the-border patients and payments from insurance companies has been improved through better ICT mechanisms and agreements with insurance companies. Overall, revenues from such payments have increased over the past three years from EUR 72.5 million in 2010 to EUR 177.7 million in 2013. It is important that efforts made so far to improve payment definition and collection (with a 90% collection target for hospital SOEs) will not abate after the end of the programme and that the progressive character of the co-payment structure remains.

59. Several reforms have targeted the financing of the public sector health insurance sub-systems (ADSE, SAD, ADM). These were considered a relic of the times when there was no universal coverage of services via the NHS and some professional groups organised their own insurance. However, these sub-systems increased patient choice for only some specific groups of the population and, resulted in inequities in the use of services vis-à-vis other groups. They also generated a cost-ineffective and unnecessary use of specialist care. Such systems created an additional cost to the State of around 0.3% of GDP. While the sub-systems' usefulness as a supplementary insurance mechanism is acknowledged, this should not come at the expense of the State if the goal is to ensure the equity of financing and access of the health system. Therefore, a reform of the public sector health insurance subsystems was initiated which aimed at improving the equity of financing and access to care while ensuring public sub-systems self-sustainability. Steps undertaken to make these services more efficient and self-sustainable (i.e. financing based solely on the beneficiaries contributions and not on employers' (State) contributions) included a reduction in unnecessary expenditure through a downward price revision and alignment with the prices the NHS pays providers and a revision of the basket of goods covered and respective reimbursement levels. In addition, contribution rates for beneficiaries were raised up to 2.25% in 2013 while the State contribution was reduced to 1.25%. In June 2014, a further increase in the contribution

rates of the public sector health insurance (ADSE, ADM, SAD) from 2.5% to 3.5% came into effect.

60. Reducing the high overall public expenditure on pharmaceuticals and ensuring a cost-effective use of pharmaceuticals was set as a health sector reform priority. At the onset of the Programme, public spending on outpatient pharmaceuticals stood at 1.2% of GDP, which was significantly higher than the EU average share of 1% and also above the level spent in some countries with similar GDP or per capita income levels. In addition, public spending on inpatient pharmaceutical was on a growing path. The consumption of generics represented a low share in overall consumption and there were administrative and legal barriers to the entry of generics - some representing a potential breach of EU legislation. Therefore, there was scope for savings on pharmaceuticals without necessarily reducing access. Savings could be attained by fine-tuning the pricing and reimbursement measures that had been implemented in previous years, by improving prescription methods for medicines and by introducing strong monitoring mechanisms with assessment and feedback to physicians and pharmacies which were lacking. Hence, a spending target was introduced to align spending with EU patterns.

61. A wide array of policies to control public expenditure on pharmaceuticals has been enacted. Reforms included changes in external and internal reference prices and therefore a reduction in prices notably of generics; compulsory e-prescription and compulsory prescription by active substance (INN prescription); changes in the pharmacies' mark-up system making it regressive to encourage pharmacies dispensing of cheaper medicines; abolishing the patent linkage and the reduction of legal and administrative barriers to the entry of generic medicines inducing a faster availability, pricing and reimbursement of generic medicines; legal changes to ensure the availability and dispensing of the five cheapest medicines of each active substance in pharmacies; the development and auditing of prescription guidelines in NHS facilities and the introduction of some binding guidelines into the e-prescription system, in addition to a pop up system; and the use of centralised procurement for hospital medicines. The e-prescription system allowed for regular

monitoring, assessment and reporting. Feedback is now regularly provided to doctors and inspections have been conducted to compare prescription and dispensing by doctors and pharmacies. Importantly, a payback agreement was signed with the pharmaceutical industry for 2012 and 2013, defining public expenditure ceilings for total public spending on outpatient and inpatient pharmaceuticals of 1.25% of GDP and 1% of GDP, respectively. Since 2010, these measures have led to savings in outpatient pharmaceuticals of more than EUR 500 million (0.3 percent of GDP). Savings in the hospital setting have amounted to EUR 150 million since 2011. Reforms have also generated significant savings for patients of about EUR 70 million. Moreover, the share of generics has increased to 45%, though still far from the objective of 60% for 2014.

62. Additional measures are needed to keep expenditure on pharmaceuticals under control. INN prescription and dispensing of cheapest pharmaceuticals need to remain compulsory. Other measures would include the development of additional prescription and clinical guidelines and ensuring compliance with guidelines through stronger auditing mechanisms and the introduction into the e-prescription system of additional compulsory and binding guidelines. Furthermore, the comprehensive monitoring system in place should be complemented by a credible and enforceable system of penalties or rewards. Other policy steps include software improvements and the centralisation of information regarding hospital-dispensed medicines and hospital inpatient medicines. Regarding inpatient medicines, reinforcing centralised purchasing and the implementation of the national formulary can be important tools to increase the share of generic and cheaper medicines in hospitals.

63. Reinforcing primary care was another health sector reform priority to ensure a cost-effective usage and reduce the use of unnecessary and costly emergency care. The creation of "Unidades de Saúde Familiares" (USFs) had given some management autonomy to primary care providers, introduced an element of performance-related payment that was unique in the public administration, and introduced a multi-disciplinary approach. The level of satisfaction among the population served by USFs and among

staff in USFs was high. However, USFs covered only one third of the population while the majority was covered by the traditional health centres (UCSPs) and almost 17% of the population remained without a dedicated family doctor due to shortages of general practitioners (GPs), in particular in more remote or deprived areas of the country. The reforms under the Programme resulted in an increase in the number of USFs from 326 in 2010 to 397 in 2013 while, at the same time, UCSPs were given partly similar performance incentives as USFs. Following the country-wide update of patient registries and the creation of a national registry, the number of patients without a GP decreased from 17% to 14%. Several steps have been taken to further develop electronic medical records and telemedicine. Starting with a pilot, Portugal has now an electronic platform of medical records accessed by primary care providers and hospitals. This platform can contribute to improve care coordination and reduce the duplication of diagnostic tests and other interventions. Telemedicine conducted jointly with e-records has already contributed to reducing the number of unnecessary visits to specialists in the field of dermatology (pilot field) and respective waiting times. The priority is to roll-out the e-medical records system to all NHS facilities and all residents and extend the fields covered by telemedicine. Other policies in the pipeline include a benchmarking exercise across all primary care facilities, comparing a set of indicators across all facilities, and a satisfaction survey.

64. Primary care supply needs to be further increased. Often, new USFs have only replaced the traditional health centres without significantly increasing primary care supply. With 14% of all residents still without their own family doctor, ensuring full coverage with dedicated family doctors remains a priority. This could be achieved through increasing the number of patients per doctors in USFs to 1900 as in UCSPs; allowing for smaller USFs (e.g. 2 GPs only) in rural, remote or deprived areas; opening about 200 vacancies in needed areas and potential contracts with non-NHS doctors in these areas; encourage GPs to move to the 40 hour (from 35 hours) contract, which should in practice increase the number of patients per doctor.

65. With hospitals representing 60% of all NHS spending, their reform was considered crucial. At the onset of the programme and on the basis of various studies it was concluded that important inefficiencies in the delivery of services existed and savings could be made by reorganising the existing hospital network. Specialisation and concentration of services was deemed necessary notably in big urban centres where many hospitals offered the same specialties including emergency, maternity and transplant services and each was served by their own administrative departments. Therefore, services have been streamlined resulting in a reduction in the number of departments and beds. Most of the 3-year Strategic Plans for hospitals with associated saving targets are agreed. A recent legal act has classified hospitals in three groups according to the profile of the population served and its needs. The dispatch also defined the services that each hospital should offer. The merger of the 3 cancer hospitals (IPOs) into one hospital group to reduce treatment variation and increase efficiency is in the pipeline. Much has been done to improve ICT in hospitals and their interoperability. A regular comparison of hospitals along a set of indicators is provided online in a specific web portal.

66. However, the reorganisation of the hospital network is far from completed. The reclassification of hospitals was met with resistance by regional authorities in defence of hospitals they considered were downgraded. These hospitals are required to reduce their service portfolio as part of the process to streamline services and generate efficiency in the sector. Priorities are now to redefine the reference networks and redesign emergency units and intensive care units, all of which derive from the hospital reclassification. In addition, there is a need to identify the network of high-tech medical equipment and defining needs, equipment reallocation or sharing of equipment across facilities. Decisions on equipment and investment will be centralised. Agreement with the regions and hospitals and the subsequent implementation are crucial to necessary budgetary savings in the coming years and tackle the remaining arrears. Staff reallocation and staff mobility remain a challenge. Hospital reform remains unpopular and meets strong resistance from the services.

67. For some hospitals, with a corresponding higher share of arrears and a negative EBIDTA in 2013, the financing has been consistently below the actual production over the years. The proposed hospital reforms can generate further efficiency gains, helping to reduce the deficit of these hospitals. However, following the substantial savings attained since 2010 as a result of ongoing reforms, there is a need to complement organisational reforms with proposed changes in the overall financing scheme of hospitals and further align funding with activity. This can help improving the financial situation of these hospitals. The need for extra funding has been recognised by the authorities but will meet strict criteria. Increased financing to these hospitals will only be possible if their production is above the regular contract, if specific structural conditions are met (e.g. hospitals with more than one location); or to compensate for operational deficits that should disappear over-time as efficiency is raised.

68. Important savings in health expenditure could be achieved through reinforcing centralised procurement in the NHS. At the beginning of the programme, centralised procurement and purchasing of hospital pharmaceuticals and medical devices had just been initiated. In 2010, 8 tenders had been completed, leading to substantial savings with reductions in prices ranging from 17.5% to 47%. In 2012 and 2013, 60 tenders were launched in total, covering medicines and medical devices but also medical services and ICT. The coding system for medical devices now covers around 70% of the value of NHS expenditure in medical devices but still allows for future development and tendering. Savings have been considerable, contributing to the reduction of hospital operating costs at a time of constrained revenues. They are expected to further contribute to a reduction in expenditure in 2014. The authorities continue to extend centralised purchasing to areas like ICT, medical images, or on-line journals. The priority now is to force all NHS facilities through a legal act to register their purchases in an e-system. Such obligation would be crucial to ensure that the potential savings from centralised tendering do indeed materialise. The establishment of an observatory for prices and acquisitions to help hospitals in purchasing medicines and medical devices should also be implemented as a

complementary measure. This would facilitate the control of acquisitions if NHS facilities used the tendered price as required. The authorities are cooperating with agencies in other countries for exchanging information and best practice.

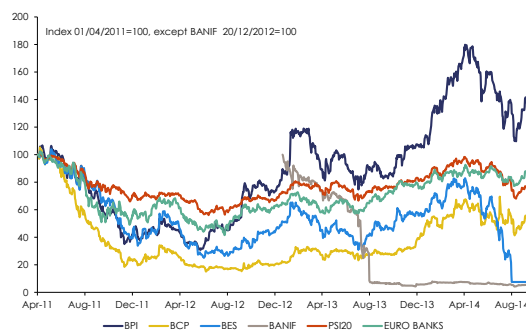
69. Health reforms have produced important savings in the sector through increases in efficiency. NHS expenditure in 2013 was about 15% (EUR 1.3 billion) lower than in 2010, while overall NHS revenues decreased by about 9% in the same period and budget transfers were reduced by 11%. Excluding regular staff remuneration, which fell in 2012 as a result of the government cutting the 13th and 14th months' salaries in the public sector but increased again in 2013 with their reinstatement, almost all cost categories including overtime payments show a consistent reduction. This cost reduction is the result of many policies including better pricing and procurement of goods and services such as pharmaceuticals, hospital outsourced services, transport of patients, and the adjustment of overtime payment scales. The consolidated deficit for the sector (central government and SOEs) declined from about EUR 833 million to EUR 126 million (EUR 150 million for hospital SOEs) between 2010 and 2013. A significant part of the overdue debt has been paid through the debt settlement programme (about EUR 1.9 billion). Nevertheless, arrears in the health sector have not been fully eliminated and about EUR 700 million remain to be settled. The challenge ahead is that to generate the necessary funding via extra revenue and efficiency gains to address the remaining arrears and avoid the build-up of new arrears. It is also important that the reforms initiated continue to be implemented.

3. FINANCIAL STABILITY

70. Since the end of the programme, developments in the Portuguese financial sector have been dominated by the problems and ultimate resolution of the Banco Espírito Santo (BES - see Box 3.1 below). However, the events relating to BES occurred against the background of a significantly reinforced banking sector due to measures adopted in the Programme – notably relating to recapitalisation, deleveraging and enhanced supervision. While the need to resolve BES has inevitably damaged the image of the Portuguese economy and financial system, the resolution was achieved without significant risk of contagion to the rest of the banking sector mainly because of these earlier Programme measures.

71. In line with developments in sovereign debt markets, funding conditions for Portuguese banks improved toward the end of the programme period, but reliance on Eurosystem operations remains significant. As sovereign yields declined (see section 5 on sovereign financing conditions), banks took advantage of an improvement in market sentiment and began issuing unsecured long-term bonds in November 2012. By the end of the programme, four out of the six biggest Portuguese banks had carried out successful bond issuances. In September 2012, Banco de Portugal (BdP) set up a platform to revive interbank lending, which was well received among Portuguese lenders. Nevertheless, Portuguese banks remain heavily reliant on Eurosystem funding, the bulk of which was accessed in the form of long-term (3-year) refinancing operations (LTRO) at the end of 2011 and early in 2012. Banks' funding and capital plans (FCP) forecast a further reduction in reliance on Eurosystem funding by the end of 2015 and in the following year. However, there are significant differences across banks, with some anticipating difficulty in substantially reducing their reliance on Eurosystem funding in the medium term while others anticipate a faster reduction but at the cost of lower profitability. Nonetheless, improvements in bank funding conditions reflect an overall recovery in investor sentiment towards the sector, as reflected in banks' equity performance (Graph 3.1).

Graph 3.1: Bank equity performance benchmarked vis-à-vis the PSI 20 index and Euro Area banks during programme years



Source: Bloomberg

72. During the Programme, the banks faced the challenge of deleveraging their balance sheets while maintaining an adequate flow of credit to the economy. At the beginning of the Programme, banks' aggregate loan-to-deposit (LTD) ratio was well above 160%, implying the need for an immediate deleveraging in order to lower the dependence on wholesale funding. Additionally, interest margins were squeezed as deposit remuneration rates moved substantially above the euro area average (Graph 3.2) and the return on EURIBOR-indexed mortgages fell sharply. Ambitious deleveraging targets have been met, with the LTD ratio now around 117%. The smoothness of the deleveraging process, coupled with steps to lower banks' funding costs - the introduction of a cap on deposit remuneration, capital injections to strengthen the lenders' CET1 ratios and the Eurosystem LTRO – have helped to maintain a supply of credit to healthy and viable firms. While there has been evidence of supply constraints, a decline in the demand for loans has been a key driver behind lower credit volumes since the beginning of the Programme.

73. Bank solvency was progressively reinforced under the Programme. Solvency levels of the banks improved markedly, with the average Core Tier 1 ratio rising from 8.4% in May 2011 to 12.3% at end-2013 (i.e. well above the 10% minimum ratio set by the BdP). In the first half of 2014 it fell to a less comfortable level (10.6%) mainly due to increased provisioning ahead of the ECB stress test (Table 3.1). The required level of banks' own funds has been

Box 3.1: The Resolution of Banco Espírito Santo

Background

Banco Espírito Santo (BES) was the third largest Portuguese bank by asset size with a balance sheet total of about EUR 80 bn and a market share close to 10%. It was the only large Portuguese bank that did not apply for a public recapitalisation under the Programme; instead the bank raised a significant amount of private capital (EUR 1 billion in early 2012 and another EUR 1 billion in 2014).

The structure of the Espírito Santo Group (ESG) – which contained BES - was very complex: Espírito Santo International SA (ESI) fully owned Rioforte Investments SA, which via another holding owned 49% of Espírito Santo Financial Group SA (ESFG), which in turn held a 20.1% stake in BES. Other owners included Credit Agricole (14.6%) and smaller relevant shareholders (up to 5%). Based on information received about some entities within the ESG in late 2013 and as part of its supervisory duties, the BdP took steps to reform BES's governance structure and asked the bank and the financial holding (ESFG) to book provisions against possible losses from holdings atop of them.

Problems emerged in BES in early July 2014, amid reports of increasing financial stress and reports of accounting irregularities in the other parts of the ESG. Three Luxembourg based holdings within the ESG (i.e. ESI, Rioforte and the ESFG) sought protection from creditors in the second half of July. BES was exposed to these entities through loans, securities and guarantees. The final size of these exposures by far exceeded figures earlier communicated to the BdP. Additionally, problems emerged in BES Angola (BESA), which has become loss making and was required by the Angolan supervision to be recapitalised. BES's total exposure to BESA was EUR 4 billion (capital and a funding line) and BES, before its resolution, had only booked EUR 198 million losses on these activities in H1 2014. Much of BESA's balance sheet was covered by a guarantee from the Angolan State worth USD 5.5 billion, but its nature and scope was unclear; the guarantee was revoked by the Angolan president once it became clear that new capital was required to keep BESA in line with local supervisory requirements.

In response to the emerging problems in BES, the BdP intervened to strengthen the bank's governance. The voting rights of the Espírito Santo (ES) family were restricted and ES family members were removed from all senior management positions and replaced by Government appointees. Subsequently, the BdP also suspended BES's top risk, compliance and audit staff and ordered a forensic audit of BES's balance sheet to detect any irregularities and/or criminal wrongdoings. On 31 July 2014, BES announced a first semester net loss of EUR 3.6 billion. With this loss the bank's capital ratio (CET1 ratio) fell to 5%, well below the regulatory minimum. As pressure on BES intensified, trading in the bank's shares was suspended on 1 August 2014 and the bank was resolved over the following weekend.

The resolution

Over the weekend of 2/3 August 2014, BES was resolved via the creation of a bridge bank known as Novo Banco. The old BES remains with further yet unrecognised losses stemming mainly from the subsidiary in Angola, the shareholders' equity, subordinated debt holdings and related deposits.

Novo Banco was recapitalised by the Portuguese resolution fund. This fund, established in February 2012, was set up with contributions from the Portuguese banking sector. In early August 2014, as the fund had not accumulated sufficient funds to finance Novo Banco's capital needs of EUR 4.9 billion, the Portuguese State provided the resolution fund with a loan of EUR 3.9 billion which came from the Bank Solvency Support Facility (BSSF) established under the Programme. The resolution fund must sell the bridge bank within 24 months. The sale's proceeds will be used to reimburse the Treasury's loan and to further strengthen the resolution fund. Should the sale yield insufficient proceeds the banking sector would have to step up its contributions to the resolution fund to allow for timely repayment of the Treasury credit line. The Portuguese lenders therefore indirectly guarantee the repayment of the Treasury loan to the resolution fund.

(Continued on the next page)

Box (continued)

The definitive allocation of assets and liabilities between Novo Banco and the remnant of BES is expected for end October/early November. After a final balance sheet for either bank has been established, a better understanding about losses will be possible. The old BES is to be wound down by mid-2016 at the latest. It contains all the "bad assets" and assets with uncertain valuation of the old BES entity including the equity exposures to BESA (the funding exposure to BESA has been transferred to Novo Banco, but fully provisioned). In a recent press statement the auditor KPMG tasked to audit BES's half year accounts refused to sign off on its final report citing the bank's and management's failure to provide adequate information on its financial position and the lack of cooperation. KPMG also warned of possible further losses claiming that the classification, recoverability and realisation of assets as well as the repayment of debts registered in BES's financial half-year results was uncertain. This may put in jeopardy the envisaged rapid sale of Novo Banco.

The decisive nature of the action taken by the Portuguese authorities was unprecedented and demonstrated a capacity to respond in conditions of urgency to preserve the banking system's stability. Spillovers from BES to the rest of the banking sector seem contained. Nevertheless, the turbulence surrounding the resolution of the third biggest financial institution in the country may weigh on future results of Portuguese lenders facing a contingent liability should the sale of the established bridge bank yield insufficient proceeds to the resolution fund.

Table 3.1: Bank soundness indicators

%	2009Q4	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Return on Equity (1)	6.0	8.2	7.6	7.1	6.8	6.3	4.5	2.5	-3.8	6.3	0.9	-0.3	-4.1	-3.8	-7.1	-6.7	-10.3	-1.4	
Gross Income on Assets	2.8	2.5	2.6	2.6	2.6	2.4	2.5	2.5	2.5	2.6	2.7	2.6	2.5	2.1	2.1	2.1	2.1	2.1	2.5
Cost to Income Ratio	56.8	57.5	57.1	57.2	57.6	59.2	58.3	59.0	61.5	56.2	53.0	56.5	58.8	67.1	68.8	69.7	71.5	58.4	
Non-Performing Loans	5.1	5.4	5.4	5.8	5.2	5.5	6.4	7.3	7.7	8.3	9.5	9.8	9.7	10.3	10.4	11.1	10.6	10.8	11.2
Coverage Ratio	65.1	63.2	62.9	60.8	61.5	60.7	55.7	52.7	54.6	51.6	49.6	50.5	54.3	53.9	53.9	52.9	56.4	57.6	
Capital Adequacy Ratio (2)	11.6	11.3	10.9	11.0	11.1	11.4	11.0	10.2	10.7	10.7	12.3	12.3	12.6	13.0	13.1	13.4	13.3	12.3	12.0
Core Tier 1 Ratio (3)	7.9	7.8	7.8	8.0	8.1	8.4	8.7	8.5	9.6	9.6	11.2	11.3	11.5	11.9	11.9	12.2	12.3	11.0	10.6
Loan-to-deposit ratio	161.5	163.0	166.6	158.4	157.8	156.7	149.7	146.2	140.2	136.9	136.4	133.3	127.9	124.0	122.6	120.8	117.0	117.2	

(1) Income before minority interests/ Average shareholders' equity before MI

(2) Excluding the banks in resolution

(3) The Core Tier 1 ratio according to Programme definition and excluding the banks in resolution

Source: Banco de Portugal

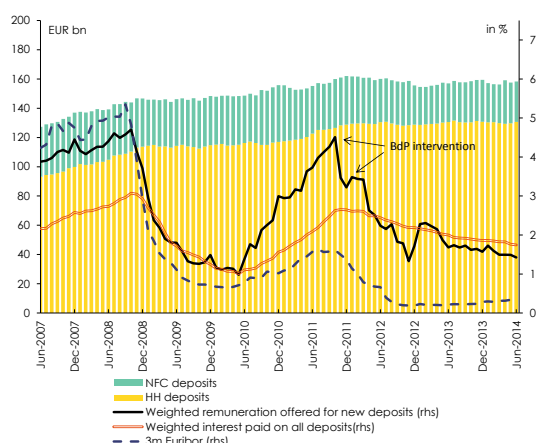
gradually increased firstly in accordance with the BdP's recommendations in 2010 and 2011, secondly in line with the capital requirements set by the European Banking Authority (EBA) and more recently with the introduction of the CRD IV/CRR rules. The improvements in solvency ratios reflect both an increase in core equity and a reduction in risk-weighted assets. EUR 12 billion of the programme envelope was allocated for bank recapitalisation, of which about half has been used by three institutions (BCP, BPI and Banif), while the state-owned CGD group received EUR 1.6 billion directly from the State budget. Over the programme duration, private investors have injected more than EUR 5 billion in bank equity. BES's resolution and recapitalisation process was financed predominantly through a EUR 3.9 billion credit line from the Treasury to the resolution fund while the remaining EUR 1.2 billion were provided by the fund and banks' advance payments to top up the resolution fund's equity (see Box 3.1). The quality of banks' credit portfolio continued to

deteriorate during the programme period (the non-performing loans (NPL) ratio is high (11.2% at mid-2014), but a slowdown in the build-up of new NPLs took place since the second half of 2013. Banks' funding and capital plans suggest further improvements across the spectrum of financial soundness indicators.

74. The capacity for organic capital generation amid low profitability remains the biggest challenge for the banks. Banks' losses reached record levels between 2011 and 2013, amid pressure from high impairment costs, higher provisioning requirements and declining domestic operating income - although some banks have offset their domestic losses with profits from their international activities. The net interest margin (Graph 3.3) worsened significantly during the crisis as the return on banks' assets is predominantly remunerated at variable rates with small fixed spreads declined and the cost of banks' funding is largely decoupled from these variable

rates. While most lenders still expect to end 2014 with a loss, this year should mark a turning point as the transformation and cost saving measures from the past few years should finally yield positive results. However, profits are not expected to recover or NPL ratios substantially decline until a robust economic recovery materialises.

Graph 3.2: Lower deposit remuneration slowly brings down the cost of funding

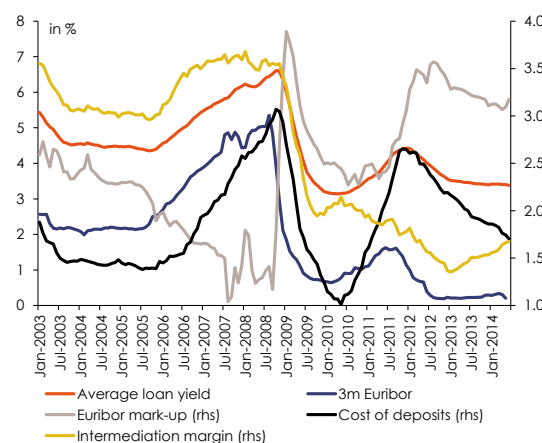


Source: Banco de Portugal

75. The bank deposit base expanded during the Programme period. Total deposits increased by 3.7%, reflecting an increase of 10% in household deposits that was partially offset by a 19% decline in corporate deposits (Graphs 3.2 and 3.4). In the early part of the Programme, banks made aggressive efforts towards meeting the end-2014 target of a loan-to-deposit ratio of 120%. The commercial strategy was similar across the board, bidding up deposit remuneration in order to increase rapidly the deposit base. The BdP intervened in November 2011 to slow down the spiralling cost of deposits and required additional capital whenever a bank offered a deposit remuneration 300 basis points above the equivalent Euribor rate. In February 2012, the threshold was lowered to 225 basis points and thereby further strengthening the measure. Consequently, the remuneration for new deposits declined, also halting and partly reversing (in 2012 and 2013) the considerable portfolio shifts that moved resident funds from insurance products into banks' savings books. Having declined in 2012, total deposits increased slightly and stabilised at around EUR 158 billion (June 2014), little below the all-time high in end-2011 (EUR 162bn). The evolution in

the household and non-financial corporate (NFC) deposit bases was very different. As corporate funding became more difficult and expensive, companies increasingly relied on their deposits to finance regular business operations. The result was a dramatic outflow of corporate funds, whereas household deposits, which in the second quarter of 2014 accounted for 83% of the aggregate deposit base, remained very stable through the Programme period.

Graph 3.3: The intermediation margin recovers mildly

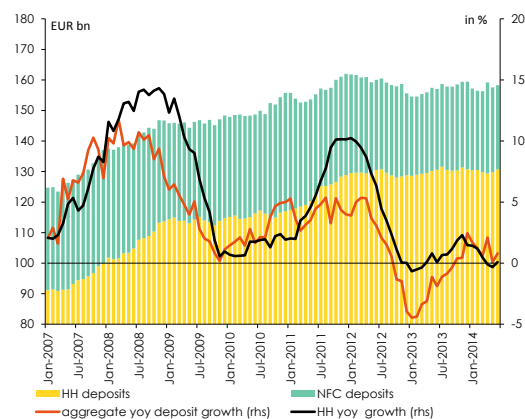


Source: Banco de Portugal

76. Borrowing cost for the corporate sector converges slowly to European averages thanks to a pronounced decline in recent months. With the economic recovery taking hold, the weighted average interest rate for new loans for the non-financial corporate sector fell below 4.5% in June 2014 from a peak of more than 6.8% at the end of 2011, amid stronger competition between banks for viable clients (Graph 3.5). Loans above EUR 1 million could be held on average for 3.92% in June 2014. New lending to corporates went up by 11.4% year-on-year between July 2013 and June 2014. This expansion was driven predominantly by new loans above EUR 1 million, which increased by 20.4%, whereas new loans below the 1 million threshold declined by 1.4% over the same period, suggesting that banks are seeking to redistribute their loan portfolio to bigger, more export-oriented companies. Likewise, lending rates are around one percentage point higher for smaller loans. The stark divergence between the cost of borrowing faced by SMEs in Portugal and their peers from core European member states has been a key

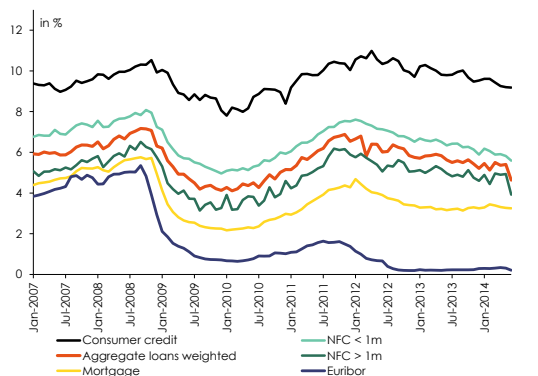
concern and reflects the risk premia for stressed southern-European economies in general.

Graph 3.4: Household deposits kept growing during the programme



Source: Banco de Portugal

Graph 3.5: Interest rate for new loans, evolution per segment



Source: Banco de Portugal

Nevertheless, the interest rates on Portuguese bank loans have been widely dispersed throughout the economic crisis, reflecting the heterogeneity of banks' lending policies and visibly benefitting larger enterprises and exporting companies. There have also been major shifts in the composition of lending portfolios. While in the pre-crisis years many of the real estate and construction companies received abundant bank funding and represented more than 30% of total corporate lending in 2007, their share had fallen to 24% in June 2014. As the economy adjusts towards export-led growth, these two sectors are deleveraging twice as fast as the remaining branches of the economy.

77. The household mortgage market shows signs of recovery, although households are using savings to repay debt. At the end of 2013, the total debt of Portuguese households was around 130% of their disposable income, about 15 percentage points below the peak reached in 2009. Since 2011, the issuance of new mortgages has fallen sharply, which is partially attributable to the considerable widening of the spread embedded in mortgage loans (see difference between Euribor and mortgage rates in Graph 3.5), but also to the fall in disposable income and the high unemployment rate. The excess of mortgage retirements over newly-issued mortgages has led to a decline in the total stock of mortgage loans by EUR 10.8 billion since the financial assistance programme began, equivalent to a drop of 9.4%. Nonetheless, even though new mortgages in June 2014 are 9 basis points more expensive than in June 2013, the 12 months aggregate volume of new mortgages grew by 11.5% in June 2014, pointing to the start of a slow recovery. Despite the mortgage interest rate spread relative to Euribor having averaged 61 basis points in 2007-2008, it keeps on floating at 300 basis points above Euribor since Programme start. Consumer lending fell by 20% during the Programme and stood at EUR 22 billion at the end of June 2014.

78. The low profitability of the Portuguese banking system remains an area of concern. The banking system posted an aggregate loss of more than EUR 3 billion in 2013 (partly due to provisioning needs) and just three large banks showed positive results for the year. Asset quality deterioration is still a problem, with impairment levels remaining high at about 6% of total gross loans and non-performing loans (NPLs) at elevated levels (11.2%), mainly in the corporate segment (>16%). However, the pace of increase in NPLs is slowing and market sentiment towards the banks has improved notably over the past year. Nonetheless, the turbulence surrounding the resolution of the third biggest financial institution in the country may weigh on future results of Portuguese lenders.

79. The BdP has expanded its supervisory activities during the programme years. On-site inspections were performed both by external consultants and by the BdP supervision staff in an effort to assess the quality of assets held, banks' risk weighting methodology and their stress testing

procedures. The rapidly worsening quality of banks' assets has been analysed via a set of general and thematic inspections, followed by impairment reinforcements and a series of general and bank specific recommendations. Since 2011, there were three major credit impairment reviews carried out in the eight largest banking groups, covering in total about 80% of the system's assets, both domestic and international. The first asset review exercise under the Programme, the Special Inspections Programme (SIP), was a wide-ranging assessment of the banks' credit portfolios including commercial paper and recognised securitisation business. The SIP yielded an additional EUR 840 million of impairments at system level and covered assets worth EUR 281 billion. In 2012, the BdP launched the Official Inspection Programme (OIP) together with two auditing firms. The OIP was a thematic review, focusing on banks' exposure to assets that were particularly sensitive to market conditions, namely construction, real estate and tourism in Portugal and abroad, covering in total assets worth EUR 69 billion. The OIP required banks to impair their assets by an additional EUR 860 million. Lastly, the eight largest banks were subject to a third round of credit impairment review executed in two phases in 2013 (ETTRIC) and 2013-14 (ETTRIC 2). The impairment deviations identified by the ETTRIC audits amounted to EUR 1.12 billion and EUR 1 billion respectively bringing the total additional impairment to EUR 3.82 billion induced by inspections over the past three years. In parallel, an additional assessment was launched in 2013 to diagnose the banks' policies and management practices over distressed and restructured loans focusing on the warning systems in place, solution design and monitoring of restructured loans. In 2013, there were also several major improvements in the stress testing methodology applied by the BdP. In addition, in order to better benchmark banks' bottom up stress test results, the supervisor began conducting regular top-down stress tests.

80. Close and continuous supervision by BdP should ensure that banks' capital buffers remain commensurate with the still challenging operating environment. In line with past credit impairment reviews, and also in anticipation of the ECB's Comprehensive Assessment, the BdP continues to monitor the adequacy of banks' impairment levels, with a particular focus on corporate clients with credit at risk. While the

authorities encourage banks to seek private solutions, they remain committed to providing further support to viable banks with resources from the Bank Solvency Support Facility (BSSF) should new capital needs arise. The BSSF will continue to be exclusively used to provide public support to the banking system beyond the Programme period. Any public support will remain subject to strict conditionality, in line with EU State-aid rules, aimed at avoiding subsidising private shareholders and preventing migration of private liabilities to the public sector balance sheet, while ensuring adequate lending to the real economy. In line with these principles, the repayment of the Treasury credit line of EUR 3.9 billion to the Resolution Fund is guaranteed by the Portuguese banks in case the sale of the bridge bank does not yield this amount.

81. In sum, the operating environment for banks remains very challenging but financial stability risks have been contained. The turbulences surrounding the resolution of the third biggest bank in the country should not put these achievements in question. The authorities have taken steps to strengthen the banking sector's capital ratios and supervision has been further reinforced by increasing capacity and multiplying thematic on-site and off-site inspections. A bank resolution framework, including a Resolution Fund that jointly with the BdP successfully managed BES's resolution, have been set up and the framework for stress-testing has been strengthened. Almost all of the large banks have continued to improve their solvency ratios in 2013. The Core Tier1 ratio stood at 12.3% at end 2013, but fell to 10.6% in first half of 2014 following increased provisioning, enhancing the sector's stability and resilience. Amid a generalised improvement in confidence in euro area peripheral debt, several banks have been able to issue senior unsecured debt and convertible debt instruments. Borrowing from the Eurosystem has seen a gradual decline since mid-2013. The deposit base continues to show resilience, with aggregate deposits stabilising close to peak levels; deposit remuneration also continued its gradual downward trend over the year, both in absolute terms and relative to benchmark rates such as EURIBOR, contributing to a lower funding cost for the banking system. However, net-interest income remains under pressure and non-standard measures by the European Central Bank (ECB) to restore the

proper transmission of monetary policy continue to play a pivotal role in easing liquidity pressures and absorbing remaining funding constraints, while strengthened collateral buffers provide an important shield against potential adverse shocks.

Private debt restructuring and corporate financing

82. During the Programme, debt restructuring and recovery tools directed at households and companies have been set up in order to facilitate the orderly deleveraging of the private sector. These tools target adjustment of the balance sheets of households, corporate entities and financial institutions, while mitigating the economic and social costs associated with household and corporate insolvencies and preserving financial stability.

83. With regard to household debt, a legal framework has been set up for financial institutions to engage in out-of-court debt restructuring including an extraordinary regime to protect mortgage borrowers in very difficult financial situations. The general regime requires banks to develop risk management systems to monitor and prevent the risk of default by borrowers, as well as guidance on a standard negotiation procedure between the credit institution and the bank client. A network of consumer protection advising entities to advise households under financial distress has been set up. The general regime put in place in end-2012 has contributed to shape a cultural change in banks' approach towards household credit risk. While applying the regime, credit institutions monitor their exposures more proactively and are directed to promptly act to mitigate the potential costs associated with their clients' default.

84. The corporate insolvency and recovery law was amended to better support the early rescue of viable firms so that they can support the economic recovery. A new in-court fast-track mechanism to solve insolvency cases entered in force in September 2012. The out-of-court tools refer to two different mechanisms. The SIREVE, mediated by IAPMEI, targets essentially micro and small firms. The PER targets larger and more complex firms, although it applies also to SMEs. Both tools aim at resolving default situations of firms through voluntary negotiated procedures among the parties involved, with little (PER) or no

(SIREVE) intervention of the judicial system. In spite of their high value added, the implementation of the new tools showed some shortcomings which will have to be tackled by adjusting some of their elements to improve the recovery of companies and facilitate the allocation of capital to the more viable companies. These include changes to SIREVE which facilitate further the agreements between creditors and improve the filtering mechanisms to direct companies for the adequate procedures. In this process, authorities build on the Commission Recommendation (2014)1500 of 12.3.2014 on a new approach to business failure and insolvency, with which Portugal is largely compliant.

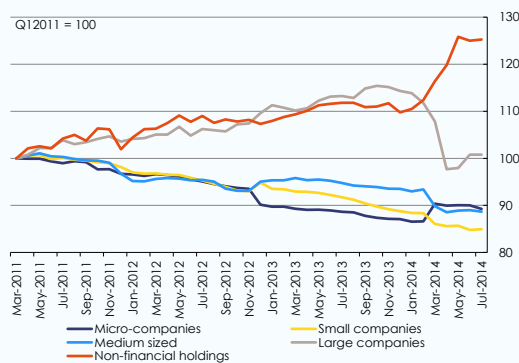
85. Additional measures to tackle the large corporate debt overhang have been designed as part of a comprehensive mid-term strategy to reduce the corporate debt overhang. In spite of low investment activity in the Programme period, aggregate corporate indebtedness remained high, reaching 146.6% of GDP in June 2014 (see Box 3.2). Measures to tackle the high levels of corporate debt aim at supporting the reallocation of capital towards the more productive sectors in the economy, notably tradable sectors, thereby addressing known bottlenecks. The authorities aim at the segmentation of out-of-court debt restructuring by size by means of changes to SIREVE, they are preparing thin capitalization rules, creating financing lines to viable enterprises undergoing a restructuring process and assessing possible changes to the legal framework of convertible instruments and preferred shares. The latter measures are expected to improve the capitalisation of the overly indebted Portuguese corporate sector.

86. Banking sector supervision-related measures are also a key element of the debt restructuring strategy. As such, the BdP continues implementing the recommendations underlying the SAP. It promotes debt restructuring through Pillar 1/Pillar 2 measures and is currently analysing potential CRD IV-related Pillar 1 and Pillar 2 regulatory measures to promote corporate debt restructuring or the sale/transfer of the underlying exposures. Close monitoring of the financial stability implications of restructuring the corporate debt overhang on banks' balance sheets will be necessary. Furthermore, it is envisaged to enhance the role of the credit mediator in

Box 3.2: Deleveraging Over the Programme Period According to Company Type

Total lending to private and public companies has barely changed between March 2011 and July 2014 ⁽¹⁾. It fell from EUR 265.2 billion to EUR 254.4 billion. Despite nominal GDP contracting by 3.5%, the implied debt to GDP ratio fell from 151.8% to 146.6%. While the aggregate number suggests that little deleveraging has taken place over that period, disaggregated data for the Programme period indicates a more heterogeneous picture, with SMEs and SOEs reducing their debt burden while large companies and non-financial holdings were able to expand their debt.

Graph I: SME deleveraged, large companies and holdings took on leverage



Source: Banco de Portugal

Table I: Lending by company sizes, segregated by domestic and foreign funding sources

	Aggregate Debt			Bonds			Loans		
	Jul-14	Mar-11	change	Jul-14	Mar-11	change	Jul-14	Mar-11	change
Micro	55.7	62.4	-10.8%	0.4	0.3	17.9%	55.3	62.1	-10.9%
Small	30.1	35.4	-15.1%	0.7	1.2	-40.4%	29.4	34.2	-14.2%
Medium	35.3	39.8	-11.3%	3.1	3.9	-20.4%	32.2	35.9	-10.3%
Large	50.2	49.8	0.8%	17.6	15.0	17.1%	32.6	34.8	-6.2%
Holding	47.0	37.5	25.3%	23.5	18.5	27.4%	23.5	19.1	23.2%
Private Sum	218.2	224.9	-3.0%	45.3	38.9	16.5%	173.0	186.1	-7.0%
SOE	36.2	40.2	-10.1%	9.8	13.8	-29.2%	26.4	26.4	-0.1%
Total Sum	254.4	265.2	-4.0%	55.0	52.7	4.5%	199.4	212.5	-6.2%
	Domestically financed debt			Bonds			Loans		
	Jul-14	Mar-11	change	Jul-14	Mar-11	change	Jul-14	Mar-11	change
Micro	28.7	37.7	-23.9%	0.2	0.3	-28.0%	28.4	37.4	-23.9%
Small	20.9	26.7	-21.8%	0.3	0.6	-54.6%	20.7	26.1	-21.0%
Medium	23.6	28.4	-16.8%	1.7	2.6	-35.9%	21.9	25.8	-14.9%
Large	17.0	19.9	-14.3%	3.6	5.2	-30.2%	13.4	14.7	-8.7%
Holding	16.5	19.4	-15.0%	7.3	9.2	-20.6%	9.2	10.3	-10.1%
Private Sum	106.7	132.1	-19.2%	13.0	17.8	-26.9%	93.7	114.2	-18.0%
SOE	9.5	14.6	-35.2%	4.5	5.3	-13.9%	5.0	9.4	-47.2%
Total Sum	116.2	146.7	-20.8%	17.6	23.1	-23.9%	98.6	123.6	-20.2%
	Debt financed by foreigners			Bonds			Loans		
	Jul-14	Mar-11	change	Jul-14	Mar-11	change	Jul-14	Mar-11	change
Micro	27.1	24.8	9.2%	0.2	0.0	376.1%	26.9	24.7	8.6%
Small	9.1	8.7	5.6%	0.4	0.6	-24.9%	8.7	8.1	7.7%
Medium	11.7	11.4	2.2%	1.4	1.3	10.8%	10.2	10.1	1.1%
Large	33.1	29.9	10.8%	14.0	9.8	41.9%	19.2	20.1	-4.4%
Holding	30.5	18.1	68.5%	16.2	9.3	74.6%	14.3	8.8	62.0%
Private Sum	111.5	92.9	20.1%	32.2	21.0	53.3%	79.3	71.8	10.4%
SOE	28.0	25.6	9.2%	5.6	8.5	-34.8%	22.4	17.1	31.2%
Total Sum	139.5	118.5	17.7%	37.8	29.5	27.9%	101.7	88.9	14.4%

Source: Banco de Portugal

The reduction in indebtedness was first and foremost evident in the 321,000 micro-companies ⁽²⁾ and the 39,000 small companies which saw their loans from Portuguese banks decrease by more than 20%. For 46% of the companies in Portugal the overall loan exposure is less than EUR 20,000 and two thirds of Portuguese firms owe less than EUR 50,000 to their bank. Typically smaller companies are heavily constrained in substituting bank lending by other

forms of external financing. Consequently, only 2% of all corporate bonds were issued by small and micro firms. Hence, these companies may have faced significant difficulties in refinancing their bank loans over the past three years. This seems to be corroborated by the large share of overdue loans below EUR 100,000, which in June 2014 amounted to 23.2%, while this rate was only 10.7% for loans above EUR 5 million.

Portugal's 6,000 medium-sized enterprises have reduced their loans by EUR 3.7 billion, while their bond issuance decreased by EUR 0.8 billion.

⁽¹⁾ All comparisons in the box span over the time frame from March 2011 to July 2014.

⁽²⁾ Micro corporations are defined as employing less than 10 employees and with a turnover below EUR 2 million, small corporations employ between 10 and 50 persons and have a turnover between EUR 2 and 10 million, medium-sized corporations account for 50 to 250 employees and a turnover between EUR 10 and 50 million whereas large corporations employ more than 250 persons and have a turnover of above EUR 50 million.

(Continued on the next page)

Box (continued)

In total, medium-sized companies had EUR 4.5 billion less in loans by July 2014 than at Programme start. On the other hand, Portugal's 1,000 largest companies, to which 19% of all private sector loans were granted, increased their debt by EUR 0.4 billion over the Programme period. While the volume of loans decreased by EUR 2.2 billion, net bonds issuance went up by EUR 2.6 billion. Domestic loans to large companies decreased by 8.7% and foreign financed loans declined by 4.4%. Domestically held bonds went down by 30.2% whereas bonds held by foreigners increased by 41.9%. Non-financial holdings, which now account for more than a fifth of non-public sector corporate debt, managed to increase their debt by more than a quarter between March 2011 and July 2014. The EUR 9.5 billion increase was split nearly evenly between bonds and loans. Similarly, for large companies the decline in domestic lending by 15% was more than outweighed by increased tapping of foreign funds which went up by 69% over the Programme period. Nevertheless, it should be mentioned that the comparison of March figures with July figures is subject to calendar effects, while the sharp fall in lending to large companies mirrored by a surge in lending to holdings suggest some data requalifications may have taken place during the past months.

Total lending to SOEs⁽³⁾ declined by EUR 4 billion to EUR 36.2 billion over the Programme period. Whereas companies included in the general government perimeter increased their debt by more than a quarter, those outside the perimeter experienced a debt reduction of more than half. As a result, three quarters of SOEs' debt is now within the government perimeter whereas before the Programme it was only half. Bonds issued decreased by two thirds for companies outside the government's perimeter, while they declined by only 12% for those counted within the perimeter. Loans to SOEs declined by 46% for those outside but increased by 58% for those inside the perimeter. These developments result from differing behaviour between foreign and domestic lenders. While Portuguese lenders reduced their loan exposure to SOEs nearly by half, foreign lenders expanded their credit to SOEs by nearly a third, while their total loans to private companies went up by only 10%. For bonds a very different picture can be drawn. Foreign lenders did not roll over about one third of SOEs' bonds, whereas domestic lenders reduced their SOE bond exposure by only 14%.

Two observations can be made. First, foreign lenders substituted for Portuguese lenders as aggregate lending by the former increased by 18% whereas the latter's decreased by 21%. Similarly, domestic bond holdings went down by a bit more than 24% and Portuguese bonds held by foreigners increased by close to 28%. Similarly for loans, domestic bank credit shrunk by 20%, which was mainly compensated through borrowing from abroad which expanded by 14%. Secondly, the smaller the company size the more difficult it becomes to tap foreign funding sources. The EUR 17 billion decline in lending to SMEs can be partly explained by the more challenging alternatives to the classic bank loan. Large companies and holdings achieved a EUR 10 billion leverage increase thanks to tapping foreign funds which more than outweighed the decline in domestic funding.

In summary, during the Programme period deleveraging in Portugal's corporate sector has predominantly taken place in SMEs which make up the vast majority of the Portuguese economy displayed by the fact that three quarters of firms owe less than EUR 100,000 to their bank whereas only 5.3% borrowed beyond EUR 1 million from their bank. Bigger enterprises and holdings in particular were able to increase their debt. In the past three years, credit supply conditions have been tighter and interest rates for loans have been higher for SMEs than for larger corporations, holdings and state-owned companies. SMEs are also more present in activities such as construction where deleveraging happens faster as their over-indebtedness is higher. Despite some areas of the economy having achieved some deleveraging, the Portuguese corporate sector as a whole remains one of the most leveraged in the European Union. The vulnerability for future crises stemming therefrom and the drag on growth rates calls for a bold solution to bring down corporate leverage in Portugal.

⁽³⁾ Both consolidated and non-consolidated in general government.

incentivising banks to move the corporate debt restructuring process forward, in particular by inter-creditor agreements regarding debt restructuring of larger firms. Additionally, an early warning system will be established by Banco de Portugal by September 2014 with a view to enhancing the surveillance of companies potentially at risk of insolvency. To monitor progress in implementing the strategy, the BdP will collect and centralise insolvency/recovery data and share it with the Ministry of Economy.

87. A number of measures have been taken to improve the short-term financing alternatives of companies.

- First, there has been a revision of the framework for commercial paper. The authorities revised the regulatory and tax environment for commercial paper. The changes are expected to facilitate the issuance and trading of commercial paper, thus improving the short-term financing conditions of companies, including by favouring issuance by smaller companies which face higher obstacles in accessing market-based funding. The effectiveness of this change in the framework will need to be carefully monitored. Meanwhile, the authorities opted not to pursue an initiative to promote the market for the grouped issuance of corporate debt, which would have provided an alternative long-term financing option for companies, including smaller ones.

- Second, the authorities reached an agreement with the EIB on a portfolio State guarantee to support investment by the EIB in Portugal. The agreement of December 2012 allowed Portuguese counterparts to benefit from financing through EIB and EIF financial instruments in spite of the downgrade of their credit ratings during the financial crisis. The agreement covers existing and new operations up to EUR 6 billion on an aggregated basis, with a margin for new transactions in the order of EUR 2.7 billion. Global loans to support lending to midcaps and SMEs signed between the EIB and credit institutions operating in Portugal totalled EUR 700 million in 2013 alone. Portugal actively supported the joint EIB-Commission initiative on risk sharing instruments for SMEs, which however was put on standby.

- Third, the outstanding amount of guarantees provided by public-private mutual guarantee companies to SME bank loans was EUR 3 billion at the end of 2012, corresponding roughly to the double amount in guaranteed bank loans to the same companies. The government announced in March 2014 an increase in the provision of new guarantees, allowing an amount of new guaranteed credit up to EUR 2 billion in 2014.

- Fourth, further initiatives to facilitate lending to SMEs have been taken, including (i) a reform of the National Guarantee System aiming at a more competitive, transparent and accountable environment for the allocation of guaranteed credit lines to SME by improving its governance, enhancing the pricing mechanisms of guaranteed loans in favour of end-users, and promoting its transparency; (ii) enhancing the features of national corporate sector databases, notably the central bank-managed Central Credit Registry and the Corporate Balance Sheet Database and broadening the scope of data available to credit institutions with the aim of facilitating a better credit risk assessment by these institutions prior to granting credit; and (iii) the creation of a Development Financial Institution (DFI), a fully state-owned financial entity, to address market failures and improve access to finance, especially of viable SMEs.

Box 3.3: The New Development Financial Institution

In September the banking supervisor issued a restricted banking license to the new Development Financial Institution (DFI). However, it will only receive the supervisor's authorisation to operate in the market once it will be incorporated. The DFI's task will be on-lending to SMEs and managing financial instruments funded by EU structural funds. The DFI is to provide on-lending to SMEs via the domestic banking sector on the basis of funds raised from multilateral financial institutions or national promotional institutions. Financial instruments to be managed by the DFI include those available to the corporate sector and which rely on European Structural and Investment Funds (ESIF) for the 2014-2020 programming period, as well as other government-supported funding instruments to companies. The DFI's business model and the legal acts for its incorporation were crafted to address market failures in the financing of SMEs while not posing additional risks to public finances. The DFI is expected to start operations with EUR 106 million of capital, debt resources of EUR 350 million and a balance sheet of less than EUR 500 million throughout the first three years of operation. While the on-lending activities will be carried out in the balance sheet of the institution, EU-funded financial instruments will be managed off-balance sheet. These include the activities of PME Investimentos (which would possibly be merged into the DFI), Portugal Ventures, the existing state-owned private equity company and the National Guarantee System (Sistema Nacional de Garantia Mútua), and also new holding funds and specialised funds to be created on purpose. For the first three years of operation the off-balance sheets items' assets will stay below EUR 1.5 billion.

The DFI will be incorporated as a financial company («Sociedade Financeira») supervised by the BdP. As the government adopted in September ⁽¹⁾ an undisclosed decree-law that leads to the reclassification of a part of the existing credit institutions as financial companies, the actual capacity of the DFI under the financial company classification will only be known once the content of such decree-law will be assessed. The DFI imposes no additional burden on or risks to public finances or sovereign credit and adheres to safeguards of supervision, public control and transparency. The respective Decree-Law and by-laws is expected to contain specific provisions in that regard. In particular, the DFI shall not: (i) not invest in debt issued or guaranteed by the public sector including non-financial state-owned enterprises outside the general government perimeter, and regional and local authorities, nor lend or issue guarantees to that sector; (ii) not take deposits or other repayable funds from the public; (iii) not engage in direct lending and limit its lending activities to on-lending through commercial banks; (iv) solely source its long-term financing from multilateral financial institutions or national promotional institutions; and (v) manage EU structural and investment funds in accordance with EU regulations and the Partnership Agreement. The Decree-Law and by-laws are expected also to contain provisions which ensure transparency of financial information according to the best international practises. The business model of the DFI will be finalised in technical consultation with the staff of the EC, ECB and IMF. The DFI will operate in line with EU State-Aid rules.

⁽¹⁾ Press release of the Council of Ministers of 12.9.2014.

4. STRUCTURAL REFORMS AND COMPETITIVENESS

88. The structural reform agenda has been geared towards enhancing competitiveness, increasing flexibility and improving the business environment. A wide range of reform measures has been adopted under the Programme to alleviate nominal rigidities, facilitate adjustment, reduce excessive rents and foster a reallocation of resources toward the tradable sector. Important measures have also been taken to reduce red tape and raise the efficiency of the judicial system. The competition and regulatory frameworks have been significantly overhauled so as to create a level-playing field for market participants and protect consumers. Various synthetic indicators e.g. by the OECD and the World Bank suggest that overall these reforms have made Portugal a more flexible economy and a more attractive investment location. While reforms are starting to bear fruit, "unfinished business" remains in a number of key areas, notably the labour market, network industries (particularly energy and transport), services and regulated professions and public administration. In light of this, the Government has documented its commitment to continue the reform efforts, focusing both on the effective implementation of the reforms already adopted and identifying and tackling remaining areas for reform. Priority areas to be addressed in the post-programme period are being laid down in a medium-term reform strategy document, adopted on 17 May 2014. In addition, the lack of a robust and systematic monitoring and impact assessment of the measures adopted during the Programme is an important impediment to evaluating the effects of the reforms, calling for a more comprehensive and systematic approach in the post-programme period.

Labour market, education and vocational training

89. Important labour market reforms have been adopted during the Programme, but further action seems necessary in a number of areas. Severance payments have been reduced and individual dismissals eased; the duration and net replacement rates of unemployment benefits have been reduced while coverage has been enlarged; working time flexibility has been increased; steps were taken to reform the wage-setting mechanism, particularly through the introduction of a quantitative threshold for the extension of collective agreements. Progress has also been

made in improving the functioning of Public Employment Services and activation policies. This has helped to make the labour market more flexible and reduce undue protection of insiders at the cost of outsiders. However, notwithstanding the recent decline, unemployment remains unacceptably high, particularly for the younger cohorts, and labour market segmentation remains an important problem. Further reforms are therefore needed to ensure sufficient flexibility in labour market so as to smoothly absorb shocks in the context of a monetary union.

90. The still high employment protection of open-ended contracts may limit the impact of the recent reform to reduce the high labour market segmentation. The reform of the employment protection legislation implemented during the programme eased the definition of dismissal based on redundancy and unsuitability and lowered severance payments for open-ended contracts more than for fixed-term contracts, with the severance payment of the latter contracts being now higher than for the former. One of the objectives of this reform is to align incentives for employers to hire on an open-ended contract for jobs of a permanent nature. It is necessary to continue to monitor the effects of this reform and the authorities need to stand ready to take additional measures in case the reform does not deliver sufficient results in tackling the high labour market segmentation.

91. The scope for wage adjustment at firm-level remains limited. A properly-functioning wage setting system is key, in view of the need to achieve competitiveness gains to allow growth through net exports and in view of the high unemployment rate. This implies that wage-setting must be able to adjust to economic conditions in general but also at sectoral and firm level. Recently enacted legislative changes, on balance, do not contribute to increase the responsiveness of wages to economic conditions at firm level. The reduction of the survival period of expired collective agreements is welcomed and has the potential to induce greater dynamism in collective bargaining. However, the possibility of a temporary suspension of sectoral collective agreements by agreement at firm level is unlikely to increase the flexibility of the contractual adjustment in the firm as it requires the

intervention of the original signatory parts of the sectoral agreement. Moreover, a recent Council of Ministers Resolution changed the quantitative threshold for the extension of collective agreements in a way that the large majority of sectoral agreements will meet the conditions for extension, which is likely to hinder efficient wage adjustment in lower-productivity firms. This measure represents a major setback in the reform of collective bargaining in Portugal. Finally, 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 and to reduce the social security contribution (TSU) of employers for workers already receiving the minimum wage by 0.75pp. to 23%. The implications of this decision for competitiveness, employment and the budget remain to be assessed.

92. Active Labour Market Policies should be further strengthened. Building on the progress achieved in the recent years, the Public Employment Services need to increase their role in addressing the needs of unemployed workers. The effectiveness of the new training modalities and employment subsidies requires continuous monitoring. Plans to improve the role of job counselling and job search assistance as well as the role of activation and sanctions need to be fully implemented and their effectiveness assessed over the medium term. The implementation of a Youth Guarantee will be instrumental in providing a good quality offer for a job, apprenticeship, traineeship or continued education to young unemployed.

93. A comprehensive reform of the educational system has been enacted with a view to tackling low educational attainment and early school leaving, as well as improving the quality of secondary education and vocational training. Substantial progress has been made in modernising the educational system. Basic and secondary education has been enhanced, including by a new information system to monitor and evaluate the educational system, improved quality of teaching, increased school's autonomy, flexibility and external evaluation. Vocational education and training has been reorganised to link curricula to the concrete needs of the labour market, thus increasing quality and employability. Tertiary education has also been rationalised,

including by establishing stronger links to business. Despite good progress, the rate of early school leaving remains relatively high and tertiary attainment still quite low. Therefore, education should remain high on the policy agenda for the coming years, if it is to become a major driver of economic growth and productivity.

94. Reforms of the vocational training system and tertiary education system are advancing. Significant progress has been made in setting up the new vocational training schools of reference as a milestone of the action plan to improve the quality and the attractiveness of educational and vocational training. The new legislation is expected to be fully implemented in the school year 2014-2015, updating the legal framework for the regulation of private vocational schools in force since 1998. The new system aims at promoting the direct involvement of companies or business entities in creating new vocational training schools of reference. It will also open new possibilities for public schools to adapt their training offer towards strategic sectors and areas not yet covered by the private schools. A new type of tertiary education offer, Cursos Técnicos Superiores Profissionais TeSP, has also been adopted. This business-oriented shorter diploma lasting two academic years is currently being implemented with a view to be operational in the forthcoming school year. Various steps have been envisaged to ensure its quality and employability, including the establishment of a monitoring committee, e-registration via a dedicated platform, a special register within the Directorate General of Higher Education and a prior mandatory consultation with employers and business associations on the curricula. The authorities are determined to continue evaluating and monitoring education and training policies, building on the monitoring tools developed over the last two years. In addition, an "e-monitor" system has been developed with a view to assess the financial impact of the implementation of the programme measures. The financial indicators are quite comprehensive and detailed and include the annual and monthly budgetary execution, payments made by each school per all budgetary headings, monthly and annual cost per student per school level, and teachers' salaries disaggregated per month, school cluster and region.

Energy sector

95. Several measures are being implemented to reduce excessive rents in the energy sector and tackle the growing tariff debt ("defice tarifario"), although it appears unlikely that these will be sufficient to completely eliminate the tariff debt by 2020. The tariff debt of the electricity system was expected to reach EUR 5 billion in 2014, if no additional measures were taken. A wide range of measures has been adopted in the context of the programme to make progress on the scheduled clearing of the tariff debt by 2020, with some further measures currently in the pipeline as detailed below. A first package of measures, introduced in 2012, focused on feed-in tariffs in wind-power generation and small hydro, feed-in tariffs and conditions for cogeneration, revision of investment incentives for hydro-power (power guarantee) and renegotiation of specific elements of the CMEC scheme. The savings associated with this first package of measures are expected to amount to EUR 2 billion by 2020. However, even with this level of savings, full elimination of the tariff debt by 2020 would require real electricity price increases of close to 2% per year, which would weigh on firms' competitiveness and on households' budgets. For this reason, a second package of measures was proposed in 2013, which, together with the first package, should reduce the outstanding debt by 2020 to EUR 0.6-0.7 billion. This second package, amounting to an expected EUR 1.3 billion in savings by 2020, includes: (i) a contribution on energy generators to address windfall profits resulting from regulatory changes in Spain, (ii) technical changes to the "revisibilidade" calculation under the CMEC mechanism to correct certain distortions in the system services market, (iii) as regards Sines and Pego coal power plants, a new contribution applicable for seven years upon the expiry of their current framework; (iv) a modification of the remuneration regime for public domain hydro terrains and (v) revision of the tariff harmonisation mechanism applicable to Madeira and Azores Autonomous Regions. Additionally, a special levy on energy operators has been established for 2014. However, this levy was motivated by state budget needs rather than cost inefficiencies in the system, and only one third of the revenue (about EUR 50 million out of EUR 150 million) will be used to reduce the electricity tariff debt.

96. In the context of the 12th review mission, the authorities have presented a package of measures aimed at tackling remaining excess rents in the energy sector, improving competitiveness of the sector and achieving a more balanced distribution of the economic surplus between different stakeholders. These include: (i) extension of the 2014 special levy on energy operators to 2015 (although again with only a third of the proceeds allocated to the electricity system); (ii) amendments to widen the eligibility requirements and increasing the amount of the social tariff discount, which is applicable to electricity consumers below a certain income threshold; (iii) legal provisions to correct the balance of the benefits of Transgás, a subsidiary of Galp, under the existing long-term natural gas sale and purchase agreements to achieve a fair redistribution of windfall profits towards the natural gas system; (iv) initiatives to increase the transparency of fuel station and bottled gas (LPG) prices; (v) the establishment of a "virtual point of transaction" in the natural gas network in order to eliminate logistical and administrative barriers preventing direct gas purchases from LNG carriers; and (vi) reclassification of forest clearing costs (for fire prevention purposes) in power line corridors from a policy cost, which can be passed onto the system, to a regular activity cost, to be borne by the electricity transport network concessionaire itself. Measure (i) in this list, the special levy extension, is expected to contribute another EUR 50 million to the tariff debt reduction effort for 2015 as well. Among the new measures, (ii) and (iii) are expected to have most impact in terms of cost reduction potential. Finally, in the area of cogeneration as well as renewable energy investments, the authorities are completing legislation providing for various different mechanisms to ensure that pricing is sufficiently exposed to market pressures. Even with these additional proposed measures, eliminating the tariff debt by 2020 will remain a significant challenge. It is therefore crucial that the Portuguese authorities ensure swift implementation of all outstanding reform proposals and continue their efforts to identify further potential cost-saving measures in the energy sector.

Telecommunications and postal services

97. The telecoms and postal services markets have been opened to competition, with all measures targeted under the programme completed. A new telecoms regulatory framework was established early in the programme, facilitating the establishment of telecoms operators and cross-border communication services, and strengthening the role of an independent sectoral regulator to supervise the functioning of the market and guarantee competition on a level playing field. For mobile communications, decisive action was taken by the regulator to lower mobile termination rates, and a transparent mobile spectrum auction was launched to facilitate market entry and increase competition. For fixed communications, measures have been adopted to increase competition by improving landline mobility for consumers. New contracts were concluded for three universal services through a transparent and non-discriminatory tendering procedure. In postal services, legislation was adopted to transpose the Third Postal Directive, liberalising the entire sector and strengthening the role and powers of the regulator. In addition, an amended framework for the provision of the postal universal service was adopted, ensuring that the universal service will gradually become subject to competitive pressure. These efforts culminated in the privatisation of 68.5% of the postal services company through an IPO in late 2013.

Housing market

98. A comprehensive reform of the urban lease market has been enacted, but its impact still needs to be fully assessed. The new legal framework aims to make the housing market more dynamic by better balancing rights and obligations of landlords and tenants. It phases out, over a period of five years, the old system of open-ended leases in which rents were frozen and contracts could not be terminated by landlords, and provides for an updating of rents to achieve gradual alignment with market levels. It also introduces more flexibility in the choice of contract duration, sets better incentives for renovation and provides a new and fast extrajudicial eviction procedure. A new law which simplifies administrative procedures for renovation works was adopted as part of the same package. In early 2013, a committee was set up to monitor the

implementation of the new legal framework and assess its impact by publishing quarterly reports. Information collected so far by this Monitoring Committee, mainly from various private-sector stakeholder groups, offers some indications that the reforms are starting to show effects through, inter alia, a gradual increase in rent levels for pre-existing contracts, a lowering of rent levels for new contracts and increasing tenant mobility. However, the impact of this reform is still limited partly because of the short time elapsed since its full implementation. In September 2014, a Council of Minister Resolution introduced amendments to the new law, including by expanding the universe of beneficiaries of the phasing out period. Those changes represent a setback in the overall rental market reform in Portugal.

99. Information on the effects of the lease market reforms is anecdotal and limited in geographical scope. The lack of comprehensive and reliable monitoring procedures and datasets make a comprehensive evaluation of the effects of the urban lease market reform impossible. According to the authorities, the urban lease law is working since rents started to fall in the second half of 2011 and this trend has accelerated in the second half of 2012 when the reform was announced. However, the scope of the available data provided by the newly set up observatory, the Housing and Urban Rehabilitation Institute (IHRU), is limited, without a breakdown between old and new contracts, a clear explanation of the methodology used and a comprehensive coverage. It would therefore be essential to explore new ways to collect more consistent data on key housing market metrics, e.g. through linking up various data bases of the tax administration and a more systematic use of surveys.

100. Efforts to fight tax evasion in the rental market are still limited. Within the overall fight against tax evasion, the requested comprehensive study aimed at identifying any form of shadow economy in the Portuguese rental market is still missing. The authorities need to step up efforts to provide this in-depth evaluation with a view to enabling potential future fiscal structural measures, increase transparency, efficiency of the housing market and tax collection.

Public procurement

101. Key measures were taken to improve the transparency and cost-effectiveness of public procurement. Early in the programme, the public procurement code was revised to improve public contract award practices and to enhance competition between potential bidders. This was accompanied by amendments to the Court of Auditors' regulations to strengthen its capacity to perform ex ante and ex post audits on public contracts with a view to preventing illegal awards and enhancing transparency. Finally, a dedicated online platform ("BASE") was set up that provides a detailed and complete overview of all public procurement projects, allowing for increased and more streamlined scrutiny by the Court of Auditors and the Inspectorate for Finances (IGF) as well as by the wider public. The Portuguese authorities have committed to implementing technical improvements in the BASE portal that will enhance data reliability and enable automatic entry checks, thus overcoming the current weaknesses due to filing mistakes and entry errors by contracting authorities.

Administrative burden

102. Portugal has made substantial progress in enhancing its business environment, but the momentum must be maintained with an increased focus on the implementation of reform measures. Changes in indicators measuring various aspects of SME policy indicate progress in a number of areas: FDI in Portugal is increasing, as are the number of newly established firms and the share of exporting businesses. The greatest improvements were in the enactment of EU law into domestic law, in fostering better framework conditions and a more entrepreneurial culture as well as in insolvency proceedings for firms in distress. Other relevant measures include a new voluntary VAT cash accounting regime, which allows SME's with a turnover of up to EUR 500.000 to pay/deduct the VAT when payments from their customers/to their providers actually take place, rather than when the invoices are issued. This should help reduce cash flow issues related to VAT payments. A streamlined online platform for requesting VAT exemptions by exporters was introduced, which resulted in a reduction in the average time for the completion of a VAT reimbursement application from 42 days

initially to 8 days as of the end of December 2013. Going forward, full and effective implementation of the adopted measures will be critical to achieving the desired impact on the economy.

103. A broad set of measures aimed at reducing excessive licensing procedures, regulations and other administrative burdens for businesses has been enacted, although with some delay. In the context of the Programme, an ambitious reform agenda was developed in relation to licensing procedures. This agenda is based on the overall principle of moving from an ex-ante approach, which requires prior verification and authorisation by the administration, towards a Zero-Authorisation approach with only ex-post compliance verification. Comprehensive legislative reforms based on this new principle have been completed in several key sectors, including industry, commerce and tourism. On 30 May, a new framework law governing environmental and territorial planning was published. The new legal regime is expected to provide for more management competencies at the municipal level and significantly reduce the costs and the time required to obtain construction permits and licenses for mining and geological exploration. During the Programme various other measures were taken with the aim of improving the business-friendliness of the regulatory environment, including a "one-in/one-out" rule for new regulations which requires the elimination of an existing regulation with equivalent cost when creating a new regulation. Efforts are also underway to compile an inventory and cost analysis of burdensome regulations for businesses and to create of a roadmap to address problematic areas. A list of twelve administrative burdens has been identified with particularly high context costs for business. For six businesses the total annual amount of context costs has been estimated at around EUR 150 million. The methodology for impact assessments of legislation is now expected to be approved by end-September 2014. The inventory will be extended by end-March 2015, to include additional sectors, such as tourism, construction and agriculture.

Transport sector

104. In the transport sector, substantial progress has been made in modernising the overall regulatory framework but further efforts are needed to better define an integrated long-term transport plan. Portugal has recently adopted the legal framework for its new transport regulatory authority (AMT), which replaces three former transport regulators (rail, ports and road). The implementation of the new framework is expected to be finalised in autumn 2014 and will require close monitoring in order to ensure sufficient autonomy, independence and authority for the regulator. In addition, an important and long-standing measure under the programme was the development of an integrated long-term plan for Portugal's transport system, 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. The Portuguese authorities have formally published a proposed transport plan ("Plano Estratégico dos Transportes e Infraestruturas") in early April 2014. The plan will require significant improvement to ensure consistency between the overall policy goals, objectives and indicators. In addition, it could benefit from more robust focus and prioritisation of investment projects based on well-defined criteria and using an objective methodology, underpinned by a sound transport demand analysis by sector.

105. With regard to the port system, key reforms to enhance competition and improve its cost-effectiveness have been enacted, but scope for further progress remains. In early 2013, a new law on port labour entered into force, which was intended to tackle key bottlenecks and significantly enhance the competitive position of Portuguese ports. This new law required renegotiation of collective agreements in force in Portuguese ports, and together with the gradual elimination of port user fees (TUP-Carga) enabled a significant downward adjustment of port operating costs, with further reductions expected to materialise over coming years. In addition, Portugal started the preparation of a new package of measures further reforming the ports' governance model by reviewing the distribution of responsibilities of regional authorities and reinforcing the competencies of the regulatory

body. An action plan setting out the forthcoming steps in the reform of ports has been published. In this context, the process of renegotiating a number of key port concession contracts has been launched. The objective of this effort is to pass on a greater portion of operating cost savings to port users, aligning incentives, enhancing competition and encouraging investments aimed at further improving port operations.

106. Progress has also been achieved with the reform agenda in the railways and urban public transport sectors, although at a slow pace. A major medium-term railway policy objective is achieving operational balance of the rail infrastructure manager (REFER) by 2015. Some measures to this end were effectively implemented, such as rationalisation of costs, closure of loss-making lines and reduction of staff. Moreover, the Portuguese authorities expect to extract further savings of at least EUR 50 million from the recently announced merger between REFER and the road network operator EP. Assuming this fairly ambitious savings target can be realized by 2015, REFER should indeed reach operational balance as planned (an updated report further detailing on the expected savings stemming from the merger should be available by October). In addition, Portugal was expected to launch the privatisation of CP Carga after the unbundling of its freight rail terminals. After repeated delays, a "despacho" was signed in April 2014 to enable the immediate transfer of CP Carga's freight terminals to REFER, which will be followed by a reappraisal of the value of CP Carga by an external consultant and DGTF and the formal launch of the privatisation process until year-end. As for the policy agenda in urban public transport, the introduction of competition on the commercial sub-urban railway lines (Lisbon and Porto) has been postponed to later in 2014. A pilot project for the concession of the sub-urban Cascais railway line is being prepared and a public consultation on the best format and scope for this concession is now expected to start by end-September 2014. Plans to launch new concessions for the provision of public transport services in the metropolitan areas of Lisbon and Porto have experienced repeated delays with a significant number of bidders having expressed their interest and participating in the public consultation for further testing the sub-concession model. After signing PSO contracts with STCP and Metro do

Porto in July 2014, the tender for the Porto public transport services' sub-concessions was eventually launched in August and follows its normal path. Lisbon's urban transport services sub-concessions were intentionally delayed to avoid overlapping on time and thus reduced demand for the tender. Both the PSO contracts and launching of the tender for the Carris, Metro de Lisboa and Transtejo/Soflusa sub-concessions are now expected to occur until end-October.

Regulatory authorities

107. Important legislation to strengthen the role of key regulators and to foster competition has been enacted, but concerns remain regarding the Competition Authority's financing model. In August 2013, a new Framework Law was submitted to Parliament, setting out the main principles of the functioning of the principal National Regulatory Authorities (NRAs) and the Competition Authority. This constituted an important Programme milestone and served to endow the different NRAs (regulators of insurance and pension institutions, securities markets, energy, communications, aviation, transport, health and water and waste services) as well as the Competition Authority with strong independence and autonomy, which is a major prerequisite for an efficient functioning of the sectors involved and an effective enforcement of competition rules in the economy. Following the adoption of this new Framework Law, the by-laws of the respective NRAs were amended to reflect the principles of the new legal framework. The Competition Authority bylaws have been adopted, providing the Authority's new financing model. This is an important improvement compared to the previous system, as it addresses the recurrent problem of annual executive orders providing funding for the Authority on a one-off basis for a single calendar year. However, concerns remain regarding the adequacy of the new model in ensuring stability of funding and adequate resources to fulfil the Authority's duties. In particular, the range and the basis of contributions may not be sufficiently robust to ensure the Authority's growing needs in the medium term. The current system envisages a range of contributions between 5.5% and 7.0%, with a default rate of 6.25% in case the annual ministerial order setting out that rate is not adopted. This contribution rate is below the range of 6.75% and

8.45% estimated to cover the Authority's expected costs in the medium term. The basis of contributions may need to be adjusted to reflect the decrease of the actual revenues of other regulators due to a reduction in regulatory fees. Further amendments to the by-laws may, therefore, be necessary to ensure the effective functioning of the financing model after 2015. Beyond that, further efforts are necessary to foster competition advocacy to remove regulatory frameworks negatively impacting on competition, and to enhance innovation and dynamic competition.

Services and regulated professions

108. Portugal is completing most of the Programme measures aimed at liberalising services and regulated professions. Out of the 70 sector-specific legal amendments that were identified as necessary to achieve alignment with the Services Directive, a total of 67 are already approved by the Council of Ministers. These amendments are needed to reduce barriers to entry and facilitate the operation of businesses in a variety of legal regimes. As regards deregulation of professions that do not involve a professional association, two phases of investigation were initiated by the government following analysis from the Commission for the Regulation of Access to Professions which ended in 2013. These two phases identified and eased access requirements for 183 professional activities that were no longer justified or proportionate. For those regulated professions that are governed by professional associations, a horizontal framework law - paving the way for liberalisation - was adopted. Following this, the relevant professional associations put forward proposals for amending their statutes and internal rules to bring them into conformity with the principles laid down in the horizontal framework law, which involves removing requirements for access to and exercise of the profession that are not justified or proportionate. The authorities were committed to enact, by end-September 2014, the professional bodies' amended by-laws which were not approved until the end of the Programme, in particular those for certified accountants, engineers and technical engineers, veterinarians, pharmacists, architects and all medical and legal professions. For the 19 professions included in 18 by-laws involved in this effort, the relevant by-laws are currently under

revision, but there is no evidence yet regarding their enactment in Parliament.

109. Portugal successfully set up a Point of Single Contact (PSC) for entrepreneurs, but there is scope for further improving the content and user-friendliness of the portal. In the context of an overall simplification reform undertaken under the Programme, an e-government portal, the Point of Single Contact (PSC), has been developed to conduct administrative procedures online. Although the PSC is operational, delays have been experienced in adapting the portal to the requirements of the Professional Qualifications Directive and the Services Directive. A "Zero Authorisation" project, aimed at facilitating the establishment of small retail businesses by replacing authorisations and licensing with a declaration on the PSC, was brought to completion as well. There is also scope for further improvements of the usability and user-friendliness of the platform. The authorities are committed to ensure that the PSC is fully functional and regularly updated by end-October 2014.

Judicial system

110. The judicial system in Portugal was characterised by inefficiencies in several areas. Resolving backlogged civil and commercial cases, improving management efficiency of the court system through its reorganisation and modernisation, establishment of the Competition Court and Intellectual Property Court, adopting a new Code of Civil Procedure as well as improving efficiency of the enforcement proceeding through strengthening financing structure and authority of the oversight body became priorities.

111. The reform of the judicial system progressed as targeted, with all measures in the judicial chapter of the Programme having reached completion. The new Code of Civil Procedure, which aims to expedite the court process in commercial and civil litigation, became effective in September 2013. Among its key provisions are a limit on the number of witnesses that each party can call in civil cases and tight new restrictions that make it harder to delay hearing dates. The Code has been well-received by stakeholders and has begun to yield very positive results. The new Judicial Organisation Act, which

aims to enhance the efficiency and professionalism of court management, was approved in June 2013 and is on course for full implementation by autumn 2014. This major reform includes the closure of 54 courts, enlargement of courts' territorial jurisdiction to align them with administrative districts, the creation of court clusters to allow for greater economies of scale and professional specialisation, more flexible allocation of personnel resources where bottlenecks emerge, and the introduction of a national system of workload measurement and performance targets. This constitutes a significant change in the organisation and management of the judiciary, with a greater focus on performance accountability and service delivery, bringing Portugal in line with best practices elsewhere in Europe. In addition, the audit of all pending debt enforcement cases identified at programme commencement was completed, with all backlogged and inactive cases now closed. Enforcement proceedings have also been improved and new legislation was adopted to further reinforce oversight, strengthen professional requirements, and increase reporting duties of and competition between debt enforcement agents. Together with a new fee structure, this new legal regime should substantially improve the efficiency of the enforcement procedures. The Competition Court and Intellectual Property Court were established and fully operational. The Special Revitalization Procedure (PER) and the Companies' Recovery System through Extrajudicial Agreements (SIREVE) were introduced to help companies in serious financial distress or in an imminent insolvency situation. A task force of tax judges for cases with value above EUR 1 million reviewed relevant cases. Quarterly reports on recovery rates and duration of tax cases were duly submitted and showed certain progress.

112. With all measures in the judicial chapter of the Programme being completed, its successful implementation needs to be monitored. Performance indicators related to the results of the implementation of the Code of Civil Procedure and the Judicial Reorganisation Act, an execution of the bi-annual central management plan and annual plans for the individual courts including Tax and Administrative Tribunal and Insolvency Court, the roll-out of the new supervisory framework for enforcement agents and insolvency administrators, CAAJ as well as the effectiveness of PER and SIREVE procedures

should be closely monitored. Linking the Tax and Administrative Courts to the CITIUS portal would contribute to the publication of quarterly data on disposition time, clearance rate and the number of pending cases before 1st instance courts, Tax and Administrative Tribunals, Insolvency courts, Competition Court and enforcement cases.

5. SOVEREIGN FINANCING CONDITIONS

113. In April 2011, after several rating downgrades and loss of market access by the sovereign and its banks, Portugal requested financial assistance under an EU-IMF programme. At the time of request, Portugal's 2-year bond yields exceeded 10% and 10-year bonds were trading at close to 9%, levels no longer compatible with public debt sustainability. Portugal's funding costs remained high for more than two years, with some episodes of extreme stress, such as that related to the Greek debt restructuring and later, albeit to a lesser extent, to domestic political crisis. Except for a short window of issuance in May 2013, when the Treasury managed to issue a 10-year bond, Portugal remained cut off from the sovereign debt markets until late 2013 / early 2014.

114. Sovereign borrowing conditions improved significantly towards the end of the Programme, amid historically low global policy rates that induced general market optimism and a renewed search for yield. In early 2014, the Treasury conducted two bond issuances raising a total of EUR 6.3 billion, through a 5-year bond in January and a 10-year bond in February. The Treasury also conducted two bond buy-back operations. The first buy-back operation delivered a substantial debt reduction (EUR 0.3 billion of October 2014 bonds and EUR 1 billion of October 2015 bonds). The second operation had a minimal impact in reducing the level of debt (EUR 50 million were bought in the operation), but was helpful in bringing short-term bond yields down. Portuguese bond yields in the secondary market declined markedly in the first half of 2014 and at the time of Programme exit hovered around 3.6% for 10-year bonds and 0.7% for 2-year bonds. The long-term rates at which Portugal has recently accessed the market were similar to those that euro area "core" countries paid before the crisis and to the rates that Portugal pays on its IMF loan.⁽¹⁴⁾ The improvement in yields reflects both increased demand – particularly from foreign investors – as well as actions by the domestic Social Security Fund, which has a strategy to gradually divest its foreign assets and invest up to 90% of its portfolio into Portuguese debt. The sovereign rating is also

gradually improving (though remains below investment grade).

Graph 5.1: 10-Year Government Bond Yields for Portugal, Ireland and Germany



Source: Bloomberg, Reuters

Graph 5.2: 2-Year Government Bond Yields for Portugal, Ireland and Germany



Source: Bloomberg, Reuters

115. Taking advantage of improved financing conditions for the sovereign, the Government decided to finance several SOEs with state funds. The Treasury 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 in order to replace the more expensive bank loans with cheaper Treasury funds, thereby alleviating the SOEs' interest burden. In the first half of 2014 the Treasury covered EUR 2.3 billion of SOE financing needs and intends to cover another EUR 3.3 billion over the second half of the

⁽¹⁴⁾ The IMF loans have variable rate interest rate and gradual repayment schedule, therefore such comparison provides only a "snapshot" picture.

year. While these operations improve the financial standing of the SOEs, they evidently weaken the Treasury's cash position.

116. Portugal exited the Programme well prepared for any short-term financing challenges. Through disbursements of official loans and debt issuances in the market, the Treasury has accumulated a large cash buffer, which as of end-June stood at EUR 17.1 billion. The Treasury could freely use EUR 10.7 billion of this buffer, while the remaining EUR 6.4 billion were earmarked for the banking sector and kept in the special BSSF account. The Treasury has also made efforts to reduce sovereign financing needs during the post-programme years through announced buyback operations, covering bonds maturing in October 2014 and October 2015, as well as through some smaller scale buyback operations in the market. Barring any large negative surprise, the Treasury has pre-financed its remaining financing needs of 2014.

117. The resolution of Banco Espírito Santo (BES), which cost the Treasury EUR 3.9 billion in loans to the Resolution Fund, emerged as a major challenge soon after the Programme exit. Having the funds for financial sector ringfenced in the special BSSF account, the strategy strongly advocated by the Troika, was particularly useful in this context. Taking account of the BES resolution, EUR 2.5 billion currently remains in the special BSSF account, to cater for potential further banking sector needs associated with BES or the outcome of the ECBs Comprehensive Assessment. Meanwhile, the other Portuguese banks proceeded with the repayment of loans already received from the BSSF and the Treasury intensified issuances to compensate the significant outflow related to BES. The government expects to recover a large part of the injected funds still in 2014 and replenish the Treasury's cash buffer again. Meanwhile, the government expects to recoup the loan to the Resolution Fund relating to the resolution of BES from the proceeds of the sale of Novo Banco (the bridge bank) within the next two years.

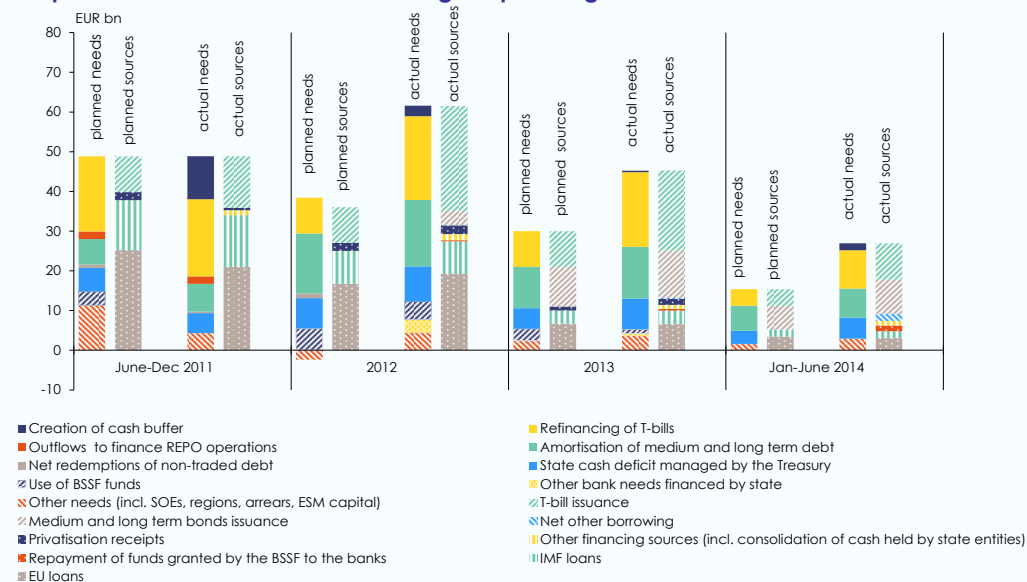
118. The Treasury actively used positive market sentiment to pre-finance a substantial part of the 2015 sovereign needs. The Treasury intended to start holding regular auctions, conducting 1-2 auctions per quarter, and to complement them by syndicated transactions towards the end of the year. The sequence was however reversed - right after the Programme exit, in early July, Portugal issued a 10-year dollar-denominated bond worth USD 4.5bn and in early September added another EUR 3.5 billion to the Treasury through a 15-year euro-denominated syndicated issuance. The auctions were left for the future. Sale of retail products has progressed well and the target of EUR 2-3 billion raised through this mode of issuance has been reached. The Treasury expects favourable funding conditions to continue, which would permit to continue debt issuance and to finish the year with a sufficiently robust cash buffer of EUR 10 billion.

119. In the medium term, however, substantial financing challenges for the sovereign remain. First, Portugal's public debt to GDP ratio is one of the highest in Europe and implies large roll-over needs in the coming years. Despite the fact that Portugal will not have to redeem any EU loans in the coming years, the Treasury will have to raise on average EUR 13 billion per year over the period 2014-2020 to refinance the medium and long-term debt alone. On top of this, it will have to fund budget deficits, accumulated arrears, and any unexpected needs and roll-over the short-term debt stock which remains fairly high. Second, Portugal currently benefits from a global environment characterised by exceptionally low sovereign rates. Any deterioration in this environment will increase borrowing costs and may shift investor strategies. To be able to cope with these challenges, Portugal needs to adhere to the strict fiscal discipline and continue structural reforms in order to revive growth and re-establish economic competitiveness on a sustainable basis.

Box 5.1: Sovereign Financing During the Programme

In retrospect, financing needs over the Programme period have substantially exceeded initial expectations. The State cash deficit, managed by the Treasury, surpassed the original projections by nearly EUR 5 billion as fiscal deficit targets were revised upwards during the Programme period. Other fiscal needs, such as funding for SOEs, the Autonomous Regions of Madeira and Azores, settlement of arrears, recapitalisation of banks outside of the BSSF (recapitalisation of the CGD and resolution of the BNP) ⁽¹⁾ and other expenses, exceeded projections by more than EUR 6 billion. The particularly large financing needs of the SOEs that emerged during the programme account for the largest part of this excess. Redemption of medium and long-term debt has also exceeded Programme projections by almost EUR 6 billion due to special operations (debt exchanges and buybacks) conducted by the Treasury. In contrast, redemptions of non-traded debt were EUR 1.7 billion lower than foreseen as a result of the changed remuneration on retail products by the Treasury, which allowed reversing partially the large outflows experienced in 2011. Also, the use of BSSF funds was much smaller than initially envisaged - EUR 6.4 billion out of EUR 12 billion envelope remained for the post-programme period (although this was reduced to EUR 2.5 billion soon after the end of the programme when BES was resolved). On a net basis, these developments resulted in financing needs almost EUR 9 billion higher than foreseen at the inception of the Programme.

Graph I: Uses and sources of funds: original planning versus the outcome



Funding sources were sufficient to cover these higher needs and to create a cash reserve. First, the Treasury did not reduce the outstanding short-term debt stock to the planned EUR 9 billion but, after initial reduction, later kept it at around EUR 19 billion, i.e. EUR 10 billion higher than under the Programme strategy. Second, bond issuances, including issuances through bond exchanges, exceeded the expected amount by EUR 8 billion, while the successful issuances of other debt, such as retail, added more than EUR 2 billion to the Treasury. Third, other flows, including cash balances of public entities held in the IGCP, made a positive EUR 5 billion contribution throughout the programme period. Fourth, the IMF loan, fixed in SDR terms, became more than EUR 1 billion larger in euro terms due to the depreciation of the euro vis-à-vis the SDR in early stages of the Programme. Finally, banks repaid a part of BSSF funds ahead of schedule, adding

⁽¹⁾ The BSSF could not recapitalise some banks due to their public ownership.

(Continued on the next page)

Box (continued)

EUR 2.2 billion to financing still during the Programme period. The financing source that fell short of the target by EUR 0.7 billion was privatisation receipts allocated to the Treasury. ⁽²⁾ The disbursed programme funds were also smaller than planned since Portugal decided not to draw the 12th Review programme tranche of EUR 2.6 billion. On the net basis, additional financing sources throughout the programme amounted to nearly EUR 25 billion. These additional funding sources altogether allowed the Treasury not only to accommodate the higher sovereign needs but to gradually build cash reserves. Portugal exited the Programme at end-June 2014 with a EUR 17 billion cash buffer of which the largest share – close to EUR 16 billion – was created during the Programme period.

⁽²⁾ The overall privatisation receipts exceeded the € 5.5 billion target; however, part of it was used for different purposes, such as general government deficit reduction, repayment of ANA's and Parpublica's debt, and others.

ANNEX 1

Assessment of Compliance: Monitoring Table

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>		<i>Status</i>
Financial Sector	[2.16.] Prepare, in consultation with the Banco de Portugal, a strategic plan, to be discussed with EC, ECB and IMF staff, aiming at addressing the corporate debt overhang and supporting the capital reallocation towards the productive sectors of the economy, while promoting financial stability.	Observed. The strategic plan was prepared and discussed with EC, ECB and IMF staff during the 12th review.
	[2.20] Submit the DFI's draft business model and by-laws for in-depth consultations with EC, ECB and IMF staff. It will be designed to ensure no additional burden on or risks to public finances.	Observed. The DFI's proposals for the business model, incorporation decree-law and by-laws were agreed following in-depth consultations with EC, ECB and IMF staff. It was designed taking account of the objective to avoid an additional burden on or risks to public finances.
Fiscal Structural	[3.1] Publish a tax expenditure report as part of the 2014 budget.	Observed. The tax expenditure report for the 2014 budget has been published. It builds on the methodology developed in the 2013 report to estimate and to evaluate tax expenditures, in line with international best practices. The report covers central, regional and local administrations.
	[3.3] Finalise targeted programmes to underpin financial sustainability in selected public entities which face structural financial imbalances, such as twelve State-Owned Enterprise hospitals and the railroad company Combóios de Portugal.	Observed. The targeted programmes for publicly owned hospitals with financial imbalances have been finalised. As regards Combóios de Portugal, a new debt management strategy has been launched, which will aim at improving the company's funding model and halt any further accumulation of arrears.
	[3.5] Publish a fiscal strategy document for the general government.	Observed. The 2014 Fiscal Strategy Document was submitted by end-April. The document spells out in detail the budgetary plans for 2015, including expenditure ceilings by line ministries, and outlines the medium-term budgetary strategy.
	[3.6] Review the Budget Framework Law (BFL) to fully transpose the relevant EU legislation and develop the key aspects and structure of the new law.	Partially observed. Some aspects of the transposition will need to be further amended / complemented.

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>	<i>Status</i>
[3.12] Following the comprehensive review of wage and supplements' scales in the general government, present in-depth studies for Transport SOEs plus REFER and Estradas de Portugal and also other SOEs.	Partially observed (scope of the measure revised). The study for transport SOEs and transport infrastructure management was presented. The analysis made will be relevant for the ongoing restructuring of these companies, but no comparison between SOEs is possible due to their specificities. Despite initially foreseen to be the second phase of the study, the analysis on other SOEs that were not included in the first study will be made on a case by case basis, as deemed relevant for their restructuring, building on the current methodology.
[3.16 i] Announce and implement the final plan to reduce the number of local tax offices by 50 per cent.	Not observed (revised objective) . The Government has cancelled the plan of closing a number of local tax offices, which was part of the tax administration reform agenda from the beginning of the programme. Instead, the authorities claim that similar objectives can be attained by integrating this reform into the Aproximar programme, aimed at restructuring the provision of public services at the local level.
[3.16 ii] Increase the resources devoted to auditing in the tax administration to at least 30 percent of the total staff.	Partially observed . The process to recruit about 1000 new tax auditors is ongoing but the indicative threshold has not yet been attained.
[3.18 ii] Make fully operational the recently established Risk Management Unit.	Observed . The Risk Management Unit is now fully operational and focused on phasing in a modern compliance risk model, improving PIT compliance management through pilot projects on high net wealth individuals and self-employed professionals and augmenting control of the monthly PIT withholding information.
[3.20] Review public financial support to private associations	Partially observed . Transfers to foundations in the budget 2014 were EUR 11.4 million, which compares to EUR 20.4 million on average in the years 2008 to 2010. In addition, reporting on public grants for 2013 was disclosed under the law 64/2013. No rules were set in view of

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>	<i>Status</i>
	clarifying and reviewing the public financial support to private associations.
[3.21 i] Present a report identifying potential overlaps of services and jurisdictions and other inefficiencies between the central and local levels of government, as well as new opportunities for decentralisation and outsourcing of services by the central government.	Partially observed. Information was provided but not elaborated in a full report.
[3.21 ii] Present a report reorganising the network of decentralised services of ministries, aiming at increasing efficiency in the public sector and the quality of services for citizens and businesses.	Observed. The <i>Aproximar</i> programme was decided by the government and is under implementation.
[3.24] Provide a comprehensive review of wage scales in the public administration.	Observed.
[3.25] Present draft legislation for a single supplement scale.	Observed. A draft decree-law was under public consultation until 22 July. The final version does not require Parliament approval.
[3.28] Make effective a new general Public Administration Labour Law.	Observed. Law 35/2014, of 20 June is fully enacted since 1 August.
Health care system	[3.35] Establish an observatory for prices and acquisitions. Not observed. The authorities are awaiting the adoption of legislation mandating that all acquisitions are registered on an e-platform.
[3.36] INFARMED shall continue to develop the national medicines formulary including four new therapeutic areas per quarter. Continue to work with professional associations and enforce the implementation of therapeutic prescription guidelines in outpatient settings.	Observed and ongoing.

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>	<i>Status</i>
[3.39] Implement the central accounting platform up to 20 hospital SOEs.	Observed and ongoing.
[3.40] Define the service portfolio for NHS hospitals and to finalise all strategic 3-year plans for hospitals. The "Contratos Programa" for SOE hospitals for 2014 should be negotiated and signed.	Partly observed. The "Contratos Programa" for 2014 have been signed and most of the 3-year strategy programmes. However, for the hospitals with the largest share of arrears and largest deficits, the 3-year strategic plans were re-opened in view of additional funding to achieve a zero deficit in 2014.
[3.41] The 3-year strategic plans shall specify the reallocation of qualified and support staff within the NHS.	Partly observed. See previous item
Labour Market and Education	[4.3] With a view to specifying measures, the Government will explore, in dialogue with social partners, some reduction in the level of compensation for unfair dismissals.
Not observed. The authorities decided not to propose any revision to the legal framework to challenge dismissals in court and informed that an agreement with the social partners on this matter would not be possible at this stage.	[4.4 iii] Present policy options, in dialogue with social partners, on the expiration and survival of collective agreements; if not implementable, study and present a proposal regarding the mutually agreed and temporary suspension of collective agreements.
Partially observed. Legislative changes, enacted in August 2014, reduced the duration of collective agreements after their expiration from 18 to 12 months. In addition, the law reduced from five to three years the time needed for collective agreements that make their expiry dependent on the existence of a new agreement to enter into a period of survival. It also introduced the possibility of a suspension of collective agreements at firm level, but subject to the agreement of the original signatories.	[4.4 iv] Study ways to foster collective agreements, in dialogue with social partners, in order to specify measures.
Not observed. In June 2014, a Council of Ministers Resolution adopted a new criterion for the extension of collective agreements, which is that 30% of the signatories are SMEs, as an alternative criterion to the one enacted during the Programme that the signatory firms to the agreement should employ over 50% of the employees in the relevant sector. The new criterion does not take into account the representativeness of signatory parts in the	

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>		<i>Status</i>
		sector.
	[4.6 i] Present in a report how the monitoring, assessment and reporting tool will be used to evaluate the impact of education policies and support the related decision making processes.	Observed. An e-monitor system has been developed under the coordination of the director general for education statistics and the directorate general for planning and financial management. The main objectives of the e-monitor are: (i) monitoring the financial impact of the implementation of the MOU measures; (ii) monitoring the key performance indicators (KIPs) of the education system; (iii) support planning, controlling and management activities of the Ministry of Education.
Goods and services markets	[5.1] Implement the plan to create a new gas and electricity logistics operator independent company.	Ongoing. A new company is in the process of being established to set up the new integrated gas and electricity logistics operator. It will then take some months for the new company to become fully operational.
	[5.2] Present additional measures to tackle remaining excess rents and to deliver cost reductions to be reflected in energy prices. Implement measures to cope with the risks of overcompensation in the adjustment calculations of the CMEC scheme, pursue the actions to eliminate the distortion on the system services market and estimate their results in terms of cost reduction. Ensure that the impact of the energy sector levy will not be passed on to end-users.	Observed. A package of further measures to reduce excess rents and end-user costs has been presented as part of the 12 th review mission, although monitoring its effective implementation will be of key importance. Measures to help reduce risks of overcompensation under the CMEC scheme were introduced and action was taken to tackle the distortions in the system services market, together with an estimate of the associated savings. At this stage there is no indication that the cost associated with the impact of the energy sector levy would be passed on to end-users.
	[5.3] Following the report on the CMEC scheme and the process for the extension of the concession of the public hydro resource by the former CAE hydro power plants, analyse the potential for correcting measures.	Ongoing.
	[5.4] Further revise the remuneration scheme for co-generation to improve efficiency of the support system. This	Ongoing.

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>	<i>Status</i>
revision will be undertaken in line with the framework of the transposition of the energy efficiency directive.	
[5.5] Revise downward the feed-in tariffs for new contracts in renewables. This must be implemented through the legal regulations that remain to be adopted under the framework of the transposition of the Third Energy Package.	Ongoing.
[5.7 iv] Reform the transport and infrastructures' regulatory framework in order to improve the effectiveness, efficiency and independence of the entities regulating the transport sector.	Ongoing. Legislation has been passed to establish AMT as the new regulatory authority for the transport sector, but AMT was expected to become fully operational only by September 2014.
[5.8] Present a long term vision of the transport system and a list of actions to improve its efficiency and sustainability.	Observed. The authorities have presented a long-term transport plan as part of the 12 th review mission. However, the plan will require significant revision to make it more focused and to better prioritize the proposed infrastructure investments, including by underpinning it with a sound transport demand forecast.
[5.9 i] Ensure that the rail regulator enjoys the independence required under the EU rail Directives. Strengthen the capacities of the railway regulator to fulfil its regulatory mandate effectively.	Ongoing. Legislation (Decree- Law 125/2014 published on 14 May 2014) has been passed to establish AMT as the new regulatory authority for the transport sector (including railways), but AMT was expected to become fully operational only in autumn 2014.
[5.9 iii] Ensure that the new Public Service Obligation (PSO) contracts concluded on rail passenger transport respect EU legislation including Regulation (EC) No 1370/2007. Develop administrative capacity for introduction of competitive tendering of PSOs.	Ongoing.
[5.9 iv] Continue to prepare the privatisation of the freight branch of the state-owned rail operator.	Ongoing.

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>	<i>Status</i>
[5.9 v] Ensure that the main rail terminals currently owned by CP Carga are transferred to another entity that will guarantee non-discriminatory access to all rail freight operators.	Observed. A " <i>despacho</i> " was signed in April 2014 to transfer CP Carga's freight terminals to REFER.
[5.10 i] Present a review of the port work law.	Ongoing. A review report of the new port work law was presented as part of the twelfth review mission, but it lacked substantial quantitative data on the evolution of port usage costs. Further monitoring will thus be required to ensure this reform achieves its targeted impact.
[5.10 ii] Ensure that the relevant regulator for ports has sufficient financial and administrative resources to carry out its function.	Ongoing. Legislation has been passed to establish AMT as the new regulatory authority for the transport sector (including ports), but AMT is expected to become fully operational only by September 2014.
[5.10 iii] Launch the renegotiation with the relevant operators for ports.	Observed. Negotiations to revise a number of key existing port concessions have started.
[5.11] Complete the adoption of Construction Laws and the others outstanding sectorial amendments to fully implement the Services Directive and submit them to Parliament with the view of approval. The proportionality of fees linked to construction activities will be ensured by adoption of the Construction Law.	<p>Ongoing. According to the information provided in May 2014 by the Portuguese authorities, the construction law has been approved by the Council of Ministers and has been sent to the Parliament. Only after the final approval by the Parliament the fees linked to construction activities will be adjusted. There is no evidence so far that this legislation has been enacted by the Parliament.</p> <p>As regards the other outstanding sectorial amendments, some amendments are still necessary to university diploma. Also the legislation relating to the commercialisation of precious metals and the collective management organisation have not been adopted yet.</p>
[5.12] Further improve the conditions for mobility of professionals in line with EU Directives.	Ongoing. 18 by-laws (for 19 professions) are currently under revision, but there is no evidence yet regarding their enactment in Parliament.

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>		<i>Status</i>
	[5.13 i] Adapt the content and information available at the Point of Single Contact (PSC) for the missing regimes to ensure conformity with the Services Directive and make available online forms and procedures for these regimes.	Ongoing. Work is ongoing to make the PSC more user-friendly, easily accessible and regularly updated by end-October 2014.
	[5.13 ii] Adapt the content and information available at the PSC for the outstanding regimes approved to ensure conformity with the Professional Qualifications Directive by and make available online forms and procedures.	Ongoing. Work is ongoing to make the PSC more user-friendly, easily accessible and regularly updated by end-October 2014.
Housing market	[6.2] Provide a comprehensive review of the functioning of the housing market.	Partially observed. The information provided by the authorities regarding the impact of the urban lease reform is still limited. Further work is necessary to improve the evaluation of the reform through a systematic monitoring and reporting underpinned by more precise and relevant data on key drivers of the market.
	[1.12] A study on the shadow economy in the housing market will be carried out with a view to seeking ways to reduce rental tax evasion.	Not observed
Framework conditions	[7.3] Approve the corresponding amendments to the bylaws of the National Regulatory Authorities. Ensure the effective functioning of the Competition Authority financing model and leave room to accommodate growing needs in the medium term.	Partially Observed. Four bylaws concerning the Securities Market Commission (CMVM), the Insurance Regulator (ISP), the Communications Regulator (ANACOM) and the Civil Aviation Authority (ANAC), have been finalised and were expected to be approved by the Council of Ministers at the end of June 2014. The authorities have not provided so far any information on the actual approval. The Competition Authority Decree Law (n. 125/2014) was published on 18 August 2014. It provides the Authority's with a new financing model. Concerns remain regarding the adequacy of the new model in ensuring stability of funding and adequate resources to fulfil the Authority's duties.

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>	<i>Status</i>
[7.5] Assess the impact of the optional VAT cash accounting regime.	Observed
[7.7] Carry out an inventory and an analysis of the costs of regulations that are likely to have a higher impact on economic activity.	<p>Observed. A first inventory of the regulatory burdens for industry, commerce and services has been carried out. An analysis of the related costs of regulations has been presented. Work in ongoing to expand the scope of the inventory to cover tourism, construction and agriculture. This secondary inventory is likely to be completed by Q1 2015.</p> <p>The authorities are also working on other simplification measures, including: identification of challenging bureaucracy (similar to the UK "Redtape Challenge"), via an open online public participation; "only one principle" initiative dispensing citizens and business from presenting documents that Administration already possesses; "local simplex" initiative to stimulate local government towards simplification and adoption of best practices; improved internal governance within the Administration through the newly established Inter-Ministerial Network for Administrative Modernisation (RIMA).</p>
[7.8] Adopt a rule that makes mandatory for all levels of Government, when creating a new regulation generating costs for businesses, to propose the elimination of an existing regulation or regulations with an equivalent cost.	<p>Observed. The relevant legislation has been published in the Official Gazette on 13 May 2015.</p>
[7.9 i] Following the submission to Parliament of the Base Law of Soil and Territorial and Urbanism Planning (Lei dos Solos), in view of its adoption, ensure the alignment with the new Industrial Licensing regime.	<p>Observed. The Base Law of Soil and Territorial Planning law was published on 30 May 2014, but it is unclear to what extent this law is aligned to the new Industrial Licensing regime.</p>
[7.9 ii] Adopt and make operational a Risk Sectorial Plan.	<p>Delayed. Still pending, following the adoption of the Base Law on 30 May 2014.</p>

<i>Actions for the Twelfth Review (to be completed by end Q1-2014, by the Twelfth Review or before the end of the Programme)</i>	<i>Status</i>
[7.9 iii] Review the legal regimes of the Territorial Management Instruments (RJIGT) and of the related regulations.	Delayed. The draft legislation has been prepared and is awaiting the publication of the Base Law for final approval at the Council of Ministers.
[7.9 iv] Adopt a legal provision for the regularisation of activities not in accordance with Territorial Management Instruments.	Observed. This legislation was approved at the Council of Ministers on 8 May 2014.
[7.9 v] Harmonise the Regional Plans – new generation will be included within the new legal regime of RJIGT.	Delayed. Timing of adoption is still unclear.
[7.9 vi] Review the Legal Regime for Urbanism and Building (RJUE) that should be aligned with the new Industrial Licensing regime.	Observed with delay. It was approved by the Council of Ministers on 29 May 2014 and published on 9 September 2014 (Decree-Law n. 136/2014).
[7.10 i] Implement a Legal Regime of Land Registration (<i>registo cadastral</i>).	Delayed. Timing of adoption is still unclear.
[7.10 ii] Create a diploma on Land Registration and Land Registration Experts.	Observed with delay The land registration experts legislation was approved by the Government on 12 June 2014 (awaiting for the approval by the Parliament).
[7.10 iii] Review the cartography for plans regime and the diploma on Cartography.	Observed with delay. The relevant legislation was adopted by the Council of Ministers on 29 May 2014 (awaiting for the approval by the President of the Portuguese Republic).
[7.10 iv] Enforce the Council of Ministers Resolution 56/2012 to collect all land registration procedures.	Observed with delay. The relevant Council of Minister resolution has been recently implemented.
[7.11 i] Review the legal regime concerning the licensing of mining and geological production and investment.	Delayed. Timing of adoption is still unclear.
[7.11 ii] Simplify the legal and bureaucratic procedures pertaining to mining and geological investments.	Delayed. Timing of adoption is still unclear.

ANNEX 2

Commission Services Macroeconomic Projections 2013-2018

Table 1: Use and supply of goods and services (volume)

<i>Annual % change</i>	2013	2014	2015	2016	2017	2018
1. Private consumption expenditure	-1.7	1.5	1.3	1.3	1.0	1.0
2. Government consumption expenditure	-1.8	-1.1	-1.5	-0.2	0.3	0.5
3. Gross fixed capital formation	-6.3	2.4	2.9	3.5	4.0	4.1
4. Final domestic demand	-2.4	1.1	1.0	1.4	1.4	1.5
5. Change in inventories	--	--	--	--	--	--
6. Domestic demand	-2.5	1.1	1.0	1.4	1.4	1.4
7. Exports of goods and services	6.1	3.9	5.5	5.3	5.1	5.0
7a. - of which goods	5.8	3.9	5.5	5.3	5.1	5.0
7b. - of which services	6.9	4.0	5.5	5.1	5.1	5.0
8. Final demand	-0.1	1.9	2.4	2.6	2.5	2.6
9. Imports of goods and services	3.1	4.4	4.6	4.7	4.7	4.6
9a. - of which goods	3.5	5.0	5.0	5.0	5.0	5.0
9b. - of which services	0.4	1.1	2.5	2.5	2.6	2.4
10. Gross domestic product at market prices	-1.4	1.0	1.5	1.7	1.7	1.7
<i>Contribution to change in GDP</i>						
11. Final domestic demand	-2.4	1.1	1.0	1.4	1.3	1.4
12. Change in inventories + net acq. of valuables	-0.1	0.0	0.0	0.0	0.0	0.0
13. External balance of goods and services	1.1	-0.2	0.4	0.4	0.3	0.3

Table 2: Use and supply of goods and services (value)

<i>Annual % change</i>	2013	2014	2015	2016	2017	2018
1. Private consumption expenditure	-1.4	1.5	1.7	1.9	2.6	2.5
2. Government consumption expenditure	4.3	-3.5	-2.7	0.5	1.3	1.7
3. Gross fixed capital formation	-7.0	4.5	5.1	6.4	7.6	7.7
4. Final domestic demand	-1.3	1.0	1.4	2.4	3.2	3.3
5. Change in inventories	--	--	--	--	--	--
6. Domestic demand	-1.3	1.0	1.4	2.4	3.2	3.3
7. Exports of goods and services	5.4	3.9	6.3	6.1	5.7	5.6
8. Final demand	0.6	1.8	2.9	3.5	4.0	4.0
9. Imports of goods and services	1.2	2.4	4.9	5.0	5.0	5.0
10. Gross national income at market prices	1.0	1.0	1.6	2.4	3.4	3.5
11. Gross value added at basic prices	0.6	1.5	1.8	2.7	3.4	3.4
12. Gross domestic product at market prices	0.4	1.6	2.0	2.9	3.5	3.6
Nominal GDP, EUR bn		168.4	171.8	176.8	183.0	189.6

Table 3: Implicit price deflators

<i>% change in implicit price deflator</i>	2013	2014	2015	2016	2017	2018
1. Private consumption expenditure	0.3	0.0	0.4	0.6	1.5	1.5
2. Government consumption expenditure	6.2	-2.4	-1.3	0.7	1.0	1.2
3. Gross fixed capital formation	-0.7	2.1	2.1	2.8	3.5	3.4
4. Domestic demand	1.2	-0.1	0.4	1.0	1.8	1.8
5. Exports of goods and services	-0.6	-0.1	0.7	0.8	0.6	0.6
6. Final demand	0.7	-0.1	0.5	0.9	1.4	1.4
7. Imports of goods and services	-1.9	-2.0	0.3	0.3	0.3	0.3
8. Gross domestic product at market prices	1.8	0.6	0.6	1.2	1.8	1.9
HICP	0.4	0.0	0.4	0.7	1.2	1.5

Table 4: Labour market and cost

<i>Annual % change</i>	2013	2014	2015	2016	2017	2018
1. Labour productivity (real GDP per employee)	-1.0	0.7	0.8	0.9	1.1	1.3
2. Compensation of employees per head	0.8	0.6	1.4	1.2	1.2	1.2
3. Unit labour costs	1.8	-0.1	0.6	0.3	0.1	-0.1
4. Total population	-0.9	-0.6	-0.5	-0.5	-0.5	-0.4
5. Population of working age (15-64 years)	-1.1	-0.6	-0.5	-0.4	-0.4	-0.3
6. Total employment (fulltime equivalent)	-2.8	2.0	0.8	0.9	0.8	0.6
7. Calculated unemployment rate - Eurostat definition (%)	16.4	14.4	13.5	12.8	12.0	11.4

Table 5: External balance

<i>levels, EUR bn</i>	2013	2014	2015	2016	2017	2018
1. Exports of goods (fob)	50.0	51.7	55.0	58.4	61.8	65.2
2. Imports of goods (fob)	56.0	57.6	60.6	63.9	67.3	70.9
3. Trade balance (goods, fob/fob) (1-2)	-6.0	-5.9	-5.7	-5.5	-5.5	-5.6
<i>3a. p.m. (3) as % of GDP</i>	<i>-3.6</i>	<i>-3.5</i>	<i>-3.3</i>	<i>-3.1</i>	<i>-3.0</i>	<i>-3.0</i>
4. Exports of services	17.4	18.2	19.4	20.5	21.7	22.9
5. Imports of services	9.6	9.6	9.9	10.2	10.5	10.8
6. Services balance (4-5)	7.7	8.6	9.5	10.3	11.2	12.1
<i>6a. p.m. 6 as % of GDP</i>	<i>4.7</i>	<i>5.1</i>	<i>5.5</i>	<i>5.8</i>	<i>6.1</i>	<i>6.4</i>
7. External balance of goods & services (3+6)	1.7	2.8	3.8	4.9	5.7	6.5
<i>7a. p.m. 7 as % of GDP</i>	<i>1.0</i>	<i>1.6</i>	<i>2.2</i>	<i>2.8</i>	<i>3.1</i>	<i>3.4</i>
8. Balance of primary incomes and current transfers	-1.2	-2.2	-3.0	-4.0	-4.6	-5.5
<i>8a. - of which, balance of primary income</i>	<i>-3.5</i>	<i>-4.5</i>	<i>-5.3</i>	<i>-6.2</i>	<i>-6.6</i>	<i>-7.1</i>
<i>8b. - of which, net current Transfers</i>	<i>2.2</i>	<i>2.2</i>	<i>2.2</i>	<i>2.2</i>	<i>2.0</i>	<i>1.6</i>
<i>8c. p.m. 8 as % of GDP</i>	<i>-0.7</i>	<i>-1.3</i>	<i>-1.8</i>	<i>-2.3</i>	<i>-2.5</i>	<i>-2.9</i>
9. Current external balance (7+8)	0.5	0.5	0.8	0.9	1.1	1.0
<i>9a. p.m. 9 as % of GDP</i>	<i>0.3</i>	<i>0.3</i>	<i>0.5</i>	<i>0.5</i>	<i>0.6</i>	<i>0.5</i>
10. Net capital transactions	2.7	2.8	2.9	3.0	3.1	3.1
11. Net lending (+)/ net borrowing (-) (9+10)	3.2	3.3	3.7	3.9	4.1	4.1
<i>11a. p.m. 11 as % of GDP</i>	<i>1.9</i>	<i>2.0</i>	<i>2.1</i>	<i>2.2</i>	<i>2.3</i>	<i>2.2</i>

Table 6: Fiscal accounts

	2013	2014	2015	2016	2017	2018
	<i>% of GDP</i>					
Indirect taxes	13.6	13.7	13.8	13.8	13.7	13.6
Direct taxes	11.8	11.4	11.5	11.6	11.6	11.6
Social contributions	12.2	12.1	11.9	11.9	11.7	11.4
Actual	9.3	9.4	9.5	9.5	9.3	9.1
Imputed	2.9	2.6	2.4	2.4	2.4	2.3
Sales and other current revenue	5.2	5.4	5.4	5.5	5.5	5.5
Sales	2.7	2.7	2.7	2.7	2.7	2.7
Other current revenue	2.5	2.7	2.7	2.7	2.7	2.7
Total current revenue	42.8	42.6	42.6	42.7	42.5	42.1
Capital transfers received	0.9	0.9	0.8	0.8	0.8	0.8
Total revenue	43.7	43.5	43.5	43.6	43.3	42.9
Compensation of employees	10.7	10.0	9.6	9.6	9.4	9.2
Intermediate consumption	4.4	4.6	4.3	4.2	4.1	4.0
Social transfers in kind via market producers	4.6	4.5	4.3	4.2	4.1	3.9
Social transfers other than in kind	18.8	18.4	18.3	18.1	17.8	17.5
Interest paid	4.3	4.4	4.4	4.4	4.5	4.5
Subsidies	0.7	0.7	0.7	0.7	0.7	0.6
Other current expenditure	2.7	2.6	2.3	2.3	2.3	2.3
Total current expenditure	46.2	45.2	43.8	43.5	42.8	42.1
Gross fixed capital formation	1.4	2.0	1.7	1.7	1.7	1.7
Other capital expenditure	1.0	6.3	0.4	0.4	0.4	0.4
Total expenditure	48.7	53.5	46.0	45.6	44.9	44.2
General Government balance (ESA95)	-4.9	-10.0	-2.5	-2.0	-1.7	-1.3
General Government balance (Programme)	-4.5	-4.0	-2.5	-2.0	-1.7	-1.3
	<i>% change</i>					
Indirect taxes	0.1	2.4	2.5	2.8	3.1	2.7
Direct taxes	27.8	-1.7	3.2	3.6	3.5	3.1
Social contributions	5.2	0.9	0.5	3.0	1.6	1.7
Sales and other current revenue	6.7	4.1	3.2	3.9	3.5	3.7
Total current revenue	9.0	1.1	2.2	3.2	2.8	2.7
Capital transfers received	-39.8	3.7	-9.0	4.5	3.0	3.0
Total revenue	7.2	1.1	2.0	3.2	2.8	2.7
Compensation of employees	7.7	-5.2	-2.5	2.9	1.2	1.5
Intermediate consumption	-1.2	5.6	1.0	0.9	1.4	1.4
Social transfers in kind via market producers	1.5	-0.1	-2.9	0.6	0.5	0.4
Social transfers other than in kind	5.3	-0.9	1.8	1.8	1.6	1.7
Interest paid	0.4	2.0	2.1	4.0	6.5	4.0
Subsidies	15.4	7.5	-0.9	1.0	1.0	1.0
Other current expenditure	4.3	-0.4	-9.0	2.5	2.8	3.4
Total current expenditure	4.4	-0.8	-1.0	2.1	1.9	1.9
Gross fixed capital formation	-13.5	40.4	-11.5	2.5	3.2	4.3
Other capital expenditure	-22.0	547.3	-93.1	8.1	3.1	-0.2
Total expenditure	3.1	11.6	-12.3	2.1	2.0	1.9
Nominal GDP, EUR bn	165.7	168.4	171.8	176.8	183.0	189.6

Table 7: Government debt developments

	2013	2014	2015	2016	2017	2018
ESA95 deficit (% of GDP)	-4.9	-10.0	-2.5	-2.0	-1.7	-1.3
ESA95 gross debt (% of GDP)	128.9	131.3	130.0	128.8	126.4	124.3
<i>levels, EUR bn</i>						
ESA95 deficit	-8.2	-16.8	-4.3	-3.6	-3.0	-2.5
Gross debt	213.6	221.1	223.2	227.5	231.5	235.8
Change in gross debt	8.8	7.5	2.1	4.2	4.1	4.3
Nominal GDP	165.7	168.4	171.8	176.8	183.0	189.6
Real GDP	172.7	171.1	168.6	165.7	162.9	160.1
Real GDP growth (% change)	-1.4	1.0	1.5	1.7	1.7	1.7
Change in gross debt (% of GDP)	5.3	4.4	1.2	2.4	2.2	2.2
Stock-flow adjustments (% of GDP)	0.3	-5.5	-1.3	0.3	0.6	0.9
<i>% of GDP</i>						
Gross debt ratio	128.9	131.3	130.0	128.8	126.4	124.3
Change in gross debt ratio	4.9	2.4	-1.4	-1.3	-2.2	-2.2
<i>Contribution to change in gross debt</i>						
Primary balance	0.6	5.6	-1.8	-2.4	-2.9	-3.2
"Snow-ball" effect	3.8	2.3	1.7	0.6	0.1	0.1
of which						
<i>Interest expenditure</i>	4.3	4.4	4.4	4.4	4.5	4.5
<i>Real growth effect</i>	1.7	-1.2	-1.9	-2.2	-2.1	-2.2
<i>Inflation effect</i>	-2.3	-0.8	-0.7	-1.5	-2.3	-2.3
Stock-flow adjustments	0.3	-5.5	-1.3	0.3	0.6	0.9
<i>Implicit interest rate</i>	3.5	3.4	3.4	3.5	3.6	3.7

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