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The Economic Adjustment Programme for Portugal
Fourth review – Spring 2012

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Directorate-General for Economic and Financial Affairs

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OUTLINE OF THE REPORT

EXECUTIVE SUMMARY

A joint EC/ECB/IMF mission met with the Portuguese authorities in Lisbon between 22 May and 4 June to assess compliance with the terms and conditions of the Fourth Review of the Portuguese Economic Adjustment Programme. *The objectives of the Programme are to restore sound public finances, improve competitiveness and put Portugal's economy back on the path of sustainable growth and job creation. This report provides an assessment of compliance and summarises the findings of the mission.*

Economic activity has proven more resilient than projected at the last review, but unemployment has risen faster than expected. *GDP in the first quarter declined by 0.1 percent compared with the fourth quarter of last year, which compares with a projected fall by more than 1 percent. For the year as whole, the economy is now expected to contract by 3.0 percent as against a previously projected 3.3 percent. A moderate recovery is foreseen for 2013, as in the previous review. The rebalancing of the economy is progressing at a swift pace. Exports have outperformed expectations and more than offset weaker domestic demand. The current account deficit is projected to shrink to 3½ percent of GDP this year, from 10 percent just two years ago. The fast increase in unemployment has continued in the first months of the year and the unemployment rate is now estimated to reach 15½ percent on average in 2012. While a temporary increase in unemployment seems inevitable in the current economic downturn, its unexpectedly strong rise suggests that other factors are also at play. The development reflects, in part, the transition from domestically-oriented towards export-led growth with declining employment in the non-tradable sector not yet being offset by sufficient job creation in the tradable sector.*

The target for the general government deficit of 4.5 percent of GDP in 2012 remains within reach but budgetary risks have increased significantly due to a less tax-rich composition of growth affecting tax revenue performance*. The 2012 budget contains ambitious consolidation measures of around 5½ percent of GDP, the bulk of which are on the expenditure side. The fast adjustment of the economy away from the non-tradable to the tradable sector should bring the economy back on a robust and sustainable medium-term path, but comes at the cost of a lower tax intensity of growth. In addition, higher-than-projected unemployment weighs on social security budgets. While budgetary execution on the expenditure side remains on target revenue performance has fallen behind expectations as tax bases are shrinking more rapidly than previously estimated. The government expects to compensate the resulting gap through savings on net interest payments, the reprogramming of EU funds in conjunction with the increase in the EU's co-financing rate and a tight budgetary execution, but downside risks to the achievement of the target have increased substantially. The government's medium-term fiscal strategy of April 2012 projects the deficit to decline to 3 percent of GDP in 2013, in line with the Programme target. This requires structural consolidation measures of some 2 percent of GDP, which will be assessed in more detail at the next review.*

Improvements in public finance management should help detect, and correct, potential budgetary slippages and, in combination with a deep public sector reform, put public finances back on a sound footing. *Monitoring of budgetary execution has been reinforced by the introduction of commitment controls and expenditure ceilings as well as intra-annual cash targets for all spending categories. Conditions are thus being put in place to avoid the accumulation of payment arrears in future but full implementation still has to be assured, as witnessed by the renewed rise in arrears in recent months. The settlement of arrears in hospitals and local governments, for which the government has set aside EUR 1.5 billion and EUR 1.0 billion, respectively, provides the opportunity to obtain the commitment by all levels of government to fully adhere to the new framework. Revenue administration is being strengthened and the reform of the public administration, which envisages significant staff reductions, is expected to lead to substantial efficiency gains and savings. Progress has also been made towards reforming the fiscal governance of regional and local governments. The restructuring of ailing State Owned Enterprises remains on track and the legal and institutional framework for Public-Private Partnerships has been reinforced with a view to containing fiscal risks. Important savings have already been realised in the health sector, particularly on pharmaceuticals, and the authorities now focus on the restructuring of the hospital sector where substantial efficiency gains can still be reaped. To achieve the ambitious budgetary targets in 2012 and beyond it is paramount that these reforms are followed through with determination.*

The deleveraging of the financial sector is evolving in an orderly fashion. *Banks' liquidity situation has improved in recent months as a result of non-standard monetary policy measures by the European Central Bank and a resilient deposit base. However, credit to the economy remains very tight which is a particular concern for the financing of SMEs. The authorities are finalising an assessment of the effectiveness and impact of existing support schemes to SMEs with a view to facilitating their access to credit. The recapitalisation of the banking system is on target. The recapitalisation should ensure, by the end of June, a minimum core tier (CT1) capital ratio of 9 percent including the capital needs resulting from the European Banking Authority capital exercise, the partial transfer of pension funds to the state social security and the special on-site inspections and, by the end of the year, the achievement of a minimum CT1 capital ratio of 10 percent. The total state contribution to the recapitalisation in June is expected to amount to EUR 6½ billion, of which some EUR 5 billion will be drawn from the 12 billion-strong Bank Solvency Support Facility created under the Programme.*

Further progress has been made with reforms to raise the long-term growth potential of the economy. *Important reforms on the labour market aimed at removing rigidities and improving productivity have already been legislated through a revision of the Labour Code. However, in view of the need for a rapid improvement of competitiveness, additional measures will be necessary to support wage adjustment in line with productivity. To this effect, the government plans further changes in the system of severance payments and a reform of the extension of collective agreements to non-signatory firms. Furthermore, in the elaboration of the budget for 2013 the government will explore the possibilities of a deficit-neutral reduction in social security contributions for specific segments of the labour force. Important advances have been made as regards removing rigidities in the housing rental market, privatising state companies, making ports more competitive, and increasing the efficiency of the judicial system. Some progress has also been made in reducing undue burden on consumers and taxpayers by increasing competition and reducing rents in the network and sheltered services sectors. However, the recent reform in the electricity sector, while containing a number of steps towards bringing the electricity system on a sustainable path, has stopped short of fully eliminating undue rents in certain segments of the system. More determination is needed to push through reforms in areas that touch on sensitive political and vested interests.*

While Programme implementation remains overall solid, risks have increased over past months. *In addition to the fiscal risks already mentioned, risks are also related to the continued tensions in the euro area which may impact on the Programme through various channels, affecting for instance the real economy (growth, trade and investment), financial markets, or confidence, including general contagion risks. Developments in this respect require close monitoring to ensure timely policy response to deviations from programme projections.*

The Programme's financing projections remain valid. *The Programme is supported by loans of EUR 52 billion from the European Union and EUR 26 billion from the IMF's Extended Fund Facility. Approval of the conclusions of this review will allow the disbursement of EUR 4 billion (EUR 2.6 billion by the EU and EUR 1.4 billion by the IMF) in July 2012.*

I. INTRODUCTION

1. The report assesses compliance with the conditions of the Fourth Review of the Portuguese Economic Adjustment Programme. The assessment is based on the findings of a joint European Commission (EC)/European Central Bank (ECB)/International Monetary Fund (IMF) staff mission to Lisbon from 22 May to 4 June.[1] In accordance with the Council Implementing Decision amending Implementing Decision 2011/344/EU on granting EU financial assistance to Portugal[2], the mission assessed compliance with the conditionality associated with the fifth disbursement and progress towards the key objectives of the Programme of sound public finances, restoring competitiveness and putting Portugal's economy back on the path of sustainable growth and job creation. It also revised the specific policy conditionality while keeping unchanged its main objectives.

2. The Economic Adjustment Programme was agreed by the Ecofin Council on 17 May 2011 and by the IMF Executive Board on 20 May. The Programme, which covers the period 2011-2014, entails an external financing by the European Union, the euro-area Member States and the IMF of some EUR 78 billion[3], for possible fiscal financing needs and support to the banking system. One third will 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. So far, EUR 53.1 billion (of which EUR 30.5 billion by the European Union and EUR 22.6 billion by IMF) has already been disbursed.

3. A successful completion of the Fourth Review will pave the way for the release of the next loan instalment of around EUR 4 billion. This instalment will bring EU and IMF financing to around EUR 57 billion, representing more than 70 percent of total available financial assistance.

4. Budget targets remain unchanged, as Programme implementation continues to proceed at a good pace. The fiscal scenario was not modified. While the strong decline in domestic consumption and a very sharp increase in unemployment put the fiscal projections under stress, the outlook for economic activity in 2012 is actually better than projected. The deficit target of 4.5 percent of GDP in 2012 has remained unchanged and the medium-term fiscal strategy as set out in the April 2012 update of Portuguese Stability Programme is consistent with the Programme targets, in particular with the reduction of the government deficit to 3 percent of GDP in 2013.

5. In the area of structural reform, a number of dossiers have been closed, but a lot remains to be done to complete the agenda. Important reforms have been adopted in the labour market and the housing market with the passing of the revised labour code and the urban lease and renewal laws. Regulatory reform is making headway in various areas, including the general competition framework, and the judicial reform is advancing on schedule. But many reforms still await completion. The budgetary framework needs to be made operational and budgetary execution and commitment controls have to be implemented at subnational levels. The reform of the electricity sector requires further action. The liberalisation of the regulated professions in line with EU legislation has picked up momentum, although steps are needed to complete the reforms in the construction and real estate sector as well as in the regulated professions. The reform of the judicial system requires actions on several fronts to consolidate the achievements so far. The monitoring of the implementation of structural reforms will continue to be a major task over coming staff missions.

6. Challenges to Programme implementation need to be overcome by maintaining - and stepping up in some cases – the reform efforts. On the domestic side, pressures from vested interests must be resisted, also after legislative proposals have moved from the Council of Ministers to the Parliament. The significant increase in unemployment could also exert strains on political consensus of the country; therefore maximum efforts should be devoted in distributing the burden of adjustment in an equitable manner. From the external side, negative spill-overs from other euro area countries could cloud the economic outlook for Portugal either via reduced trade prospects or by threatening access to financial markets. So far, however, external adjustment has advanced at a good clip and the Portugal sovereign retains access to short-term financing.

[1] The cut-off date for the macro-economic and fiscal projections of this report is 1 June 2012.
[2] OJ L 269 of 14.10.2011
3 The IMF share of the Programme was set in Special Drawing Rights. Due to the lower Euro Exchange rate, since May 2011, the projected payout by the IMF in Euro has become higher, so the current projected Programme total is EUR79 billion.

7. Revisions to the Memorandum of Understanding reflect mainly advances in reform implementation. In most cases, adjustments are the result of the evolution of specific reform measures, either because the measure has been completed and therefore dropped from the MoU or because the measure has advanced to another stage and conditions had to be modified accordingly. Occasionally also deadlines were adjusted, given changed circumstances.

8. The reform momentum continues also in areas outside the Memorandum of Understanding, in part supported by EU Funds. Noteworthy are the government initiatives to simplify licensing requirements to industries; the reduction in national holidays that will become effective in 2013; and the ambitious aims of making Portuguese agriculture more competitive and productive. Various reforms receive direct technical assistance from the European Commission, not least through the Portugal Support Group, and the IMF. Significant additional EU financing in the form of grants is also provided in the context of the restructuring of European Funds. In addition, a larger lending envelope of the European Investment Bank is expected to become available soon. These initiatives provide additional leverage to the financial assistance by the EU to Portugal beyond the financing envelope of the Adjustment Programme and the substantial liquidity provision by the ECB to Portuguese banks.

II. ECONOMIC DEVELOPMENTS AND OUTLOOK

MACROECONOMIC OUTLOOK

9. Real GDP was unexpectedly stable in the first quarter of this year. Output declined by 0.1 percent over the previous quarter, which is significantly less than the 1.4 percent fall projected during the previous Programme review. A stabilisation in investment activity following its steep decline in the final quarter of 2011 and a better-than-expected export performance offset a strong fall in domestic consumption in the first quarter. Adverse economic developments in some important export markets have been partly compensated by a further increase in market shares. On the other hand, the situation in the labour market worsened sharply in the first quarter of 2012, as employment slumped by 4.2 percent year-on-year and the unemployment rate reached 14.9 percent. Consumer confidence has slightly recovered from its multi-annual low at the end of last year, but confidence in industry remained depressed while confidence in the construction sector deteriorated further. In May, HICP inflation decelerated to 2.7 percent from 3.7 percent one year ago, thereby significantly narrowing the positive inflation differential vis-à-vis the euro area. HICP inflation at constant tax rates, i.e. not accounting for the effect of indirect taxes and administered prices, was 0.9 percent in April, down from 2.4 percent a year ago. At constant tax rates, HICP inflation in Portugal has been below the euro area average almost continuously since the beginning of 2008.

10. Economic activity is expected to fall by 3 percent in 2012, implying an upward revision compared with the previous review. This revision is entirely due to a larger contribution of net external trade to growth, while domestic demand (including inventories) is still forecast to subtract 6.7 percent from real GDP in 2012. Export growth has been revised upwards significantly to 3.5 percent, taking into account the stronger-than-expected performance in the first quarter and assuming further albeit dissipating gains in export market shares for the rest of the year. As a consequence, the rebalancing of the economy away from the non-tradable to the tradable sector should continue at a fast pace with the current account deficit narrowing by a further 3 percent of GDP, after a 3.1 percent adjustment in 2011. While some of the adjustment is related to the steep fall in imports of consumer durables, particularly cars, a significant part appears to be of a structural nature and is not likely to reverse when domestic demand gains traction again (see Box 1).

11. The labour market situation is expected to worsen further in 2012, and unemployment might reach 15½ percent of the labour force. The faster than expected rise in the unemployment rate is partly explained by the fast rebalancing of the economy away from more labour-intensive non-tradable sector, with job losses in construction, wholesale and retail trade, and hotels and restaurants amounting to almost two thirds of the overall job losses over the past year. There are also indications that some labour hoarding that occurred in the initial phase of the crisis is now being reversed (see Box 2). The worsening labour market situation and economic slack should continue to put pressure on wages and price mark-ups. In view also of declining commodity prices, HICP inflation has been revised downwards by half a percentage point to 2.7 percent in 2012.

Table 1: Projections of main macroeconomic aggregates

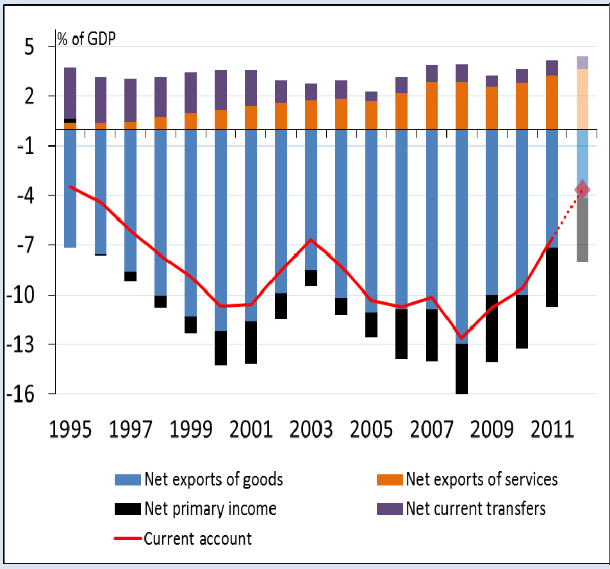
	June 2012 (4rd review)			Feb 2012 (3rd review)			Difference		
	2011	2012	2013	*2011*	*2012*	*2013*	2011	2012	2013
	year-on-year volume change								
Gross domestic product	**-1.6**	**-3.0**	**0.2**	*-1.5*	*-3.3*	*0.3*	-0.1	0.3	-0.1
Private consumption	**-3.9**	**-6.0**	**-0.5**	*-3.8*	*-5.8*	*-0.9*	-0.1	-0.2	0.4
Public consumption	**-3.9**	**-3.4**	**-2.7**	*-3.1*	*-2.9*	*-2.6*	-0.8	-0.5	-0.1
Fixed investment	**-11.4**	**-12.2**	**-0.5**	*-11.3*	*-11.8*	*0.7*	-0.1	-0.4	-1.2
Exports of goods and services	**7.4**	**3.5**	**3.5**	*7.2*	*2.0*	*4.7*	0.2	1.5	-1.2
Imports of goods and services	**-5.4**	**-6.2**	**0.9**	*-5.7*	*-6.9*	*1.9*	0.3	0.7	-1.0
	contributions to real GDP growth								
Domestic demand excl. inventories	**-5.7**	**-6.8**	**-0.9**	*-5.4*	*-6.6*	*-0.9*	-0.3	-0.2	0.0
Change in inventories	**-0.3**	**0.1**	**0.1**	*-0.5*	*-0.1*	*0.2*	0.2	0.2	-0.1
Net trade	**4.4**	**3.7**	**1.0**	*4.4*	*3.4*	*1.1*	0.0	0.3	-0.1
Employment (y-o-y change)	**-1.5**	**-4.2**	**-0.7**	*-1.5*	*-2.5*	*0.2*	0.0	-1.7	-0.9
Unemployment rate (level)	**12.9**	**15.4**	**15.8**	*12.7*	*14.4*	*13.9*	0.2	1.0	1.9
HICP (y-o-y change)	**3.6**	**2.7**	**1.1**	*3.6*	*3.2*	*1.3*	0.0	-0.5	-0.2
Current external balance (% of GDP)	**-6.6**	**-3.6**	**-2.5**	*-6.7*	*-4.0*	*-3.4*	0.1	0.4	0.9

Source: European Commission

Box 1: External Adjustment in Portugal

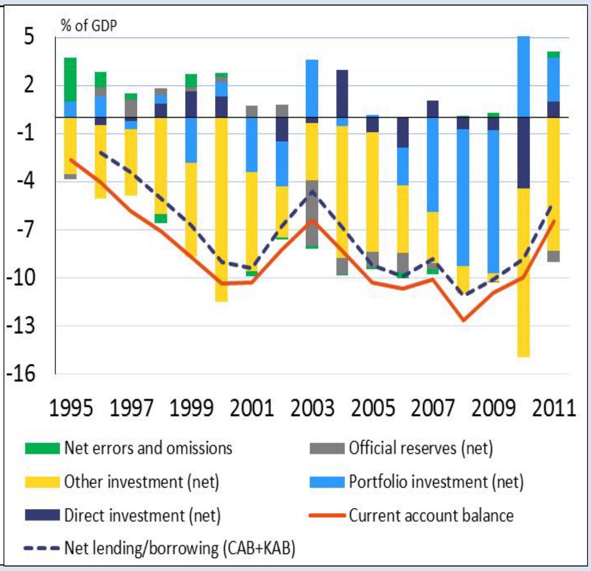
Prior to the crisis, Portugal had a persistently large current account deficit which averaged 10 percent of GDP from 2000-2010. The most important component was a massive trade deficit that rose to over 12 percent of GDP at its peak. This was partly offset by a slowly rising services trade surplus, which however never exceeded 3½ percent of GDP. Two other long-term trends have contributed to the deterioration of the current account balance. First, the positive transfer balance shrank from over 3 percent of GDP in the mid-1990s to below 1 percent, as remittances and transfers from the EU dwindled. The second trend is the rising snowball effect resulting from a mounting net external debt, which accumulated as a result of the large current account deficits. As the net external debt rose to 110 percent of GDP in 2009, the resulting interest and other payments to foreigners pushed the primary income deficit from zero in the mid-1990s to currently 3½ percent of GDP.

Graph I - Current account decomposition



Source: Commission services

Graph II - Current account financing



Source: Commission services

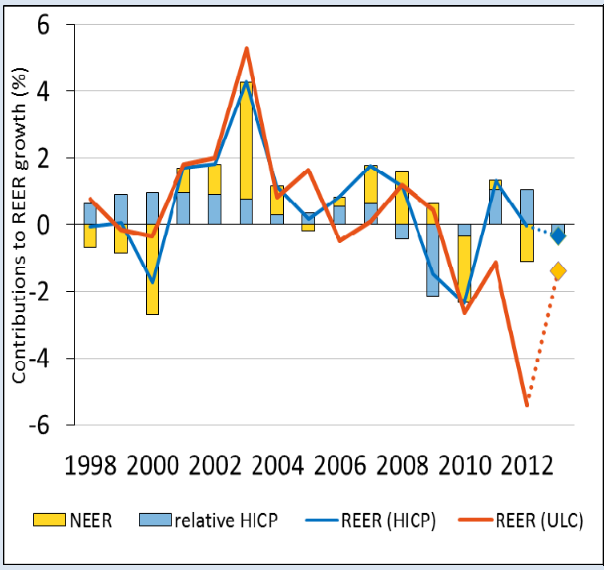
Since the onset of the crisis, the current account deficit has seen a sharp decline: from its peak of almost 13 percent of GDP in 2008 it halved to 6½ percent of GDP in 2011 and is projected to fall to 3½ percent in 2012, the lowest level in 17 years (see Graph I). The bulk of the adjustment fell on trade in goods, with the deficit declining by more than 5½ percent of GDP. Although the larger part of this adjustment was due to a steep decline in imports, in line with the fall in domestic demand, robust export growth based on rising market shares contributed by more than 2 percentage points to the correction in the trade balance. Moreover, the services surplus has continued its rising trend. The question arises whether the recent correction of Portugal's current account deficit, as impressive as it appears, is both sufficient in magnitude and structural in nature to ensure external sustainability. A number of factors ought to be considered.

First, the current account deficit has been financed mainly through debt rather than foreign direct investment (see Graph II). This contrasts with many catching-up economies where current account deficits often go along with significant FDI inflows that provide for future growth possibilities and hence improvements in the current account. It remains to be seen whether recent large privatisations are already a sign of foreign companies having regained confidence in Portugal as an investment location. Their interest in investing in Portugal could arguably be further boosted by the ongoing structural reforms.

Second, the correction of the high primary income deficit requires persistent surpluses in the balance of trade and services. This implies that the economy needs to continue its rebalancing from the non-tradable to the tradable sector and increase the exports' share in GDP. Recent trends in export diversification in terms of product mix and geographical orientation are encouraging. Moreover, improvements in external price competitiveness that occurred in past years (see Graphs III and IV) will also assist Portugal to continue gaining export market shares. On the basis of current projections, further improvements in price competitiveness can be expected due to wage restraint but also improvements in labour productivity.

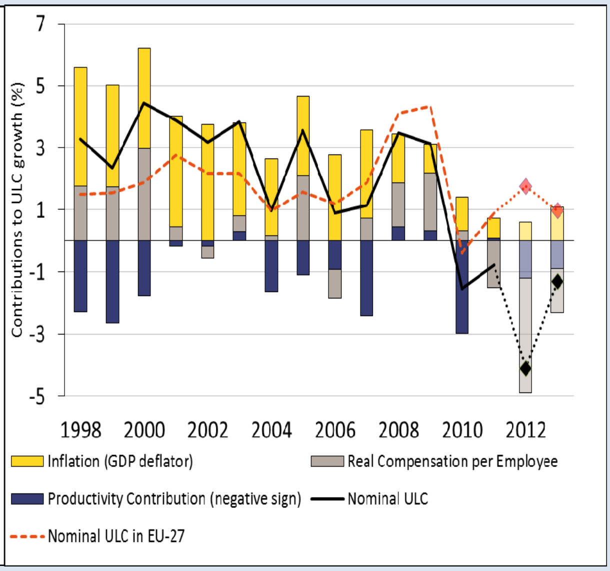
Third, the massive fall in imports in the recent past suggests that at least some of the correction in the current account balance is of a cyclical rather than structural nature. This means that once the economy recovers a part of this correction will be reversed. The extent to which this will be the case can be estimated through current account regressions that control for domestic and trade partners' output gaps.* According to these estimates, the sizable improvement in the current account balance over the past three years is to a large degree structural in nature (see Graph V). Portugal's underlying (i.e. cyclically adjusted) current account deficit declined by 6 percent of GDP between 2008 and 2011, i.e. almost the same amount as the actual current account deficit. The analysis also shows that the structural improvement in the current account is set to continue in 2012, albeit at a somewhat lower speed than the headline deficit suggests. The recent adjustment may be linked to increased deleveraging efforts by the private sector. Households have markedly increased their savings since the onset of the crisis and corporations tend to scale back borrowing. Both contributed greatly to the marked reduction of the economy's demand for external funding (see Graph VI).

Graph III - Decomposition of REER



Source: Commission services

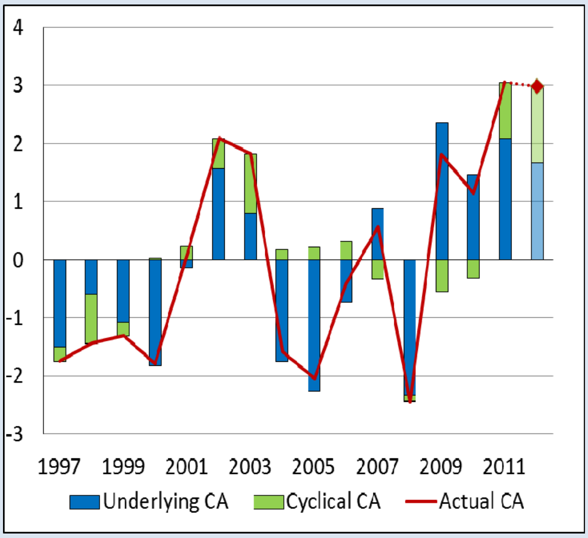
Graph IV - Decomposition of unit labour costs



Source: Commission services

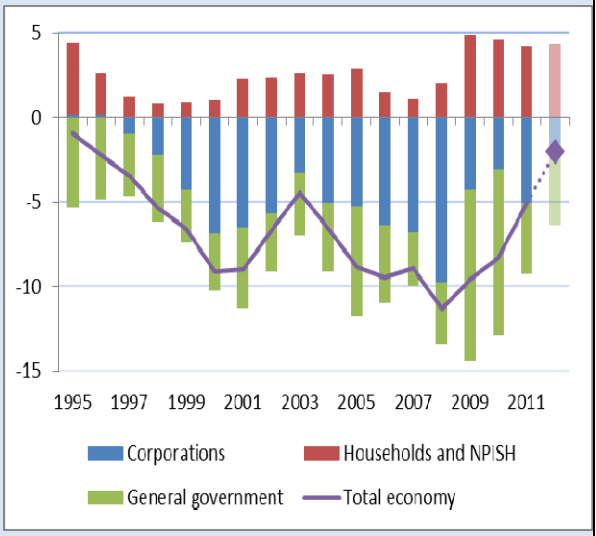
Overall, the data show a substantial external adjustment that has taken place over the past few years, a large part of which appears to be of a structural nature. At the same time, in view of the unfavourable initial position, i.e. the huge stock of net foreign liabilities, the adjustment so far has gone little more than half way the distance towards a sustainable current account position, which is necessary to bring Portugal's external debt on a steady downward trend. Indeed, the rising snowball effect linked to the increase in net external debt requires a sustained improvement in competitiveness. To preserve external debt sustainability an undershooting of the REER is needed.

Graph V - Change in the underlying and cyclical current account balance



Source: Commission services

Graph VI – Net lending (+) and net borrowing (-) in % of GDP



Source: Commission services

*Estimates are based on the methodology in M. Salto and A. Turrini, *Comparing alternative methodologies for real exchange rate assessment*, European Commission Economic Papers 427, September 2010. Note that point estimates of underlying current account balances are only indicative and subject to a significant margin of error.

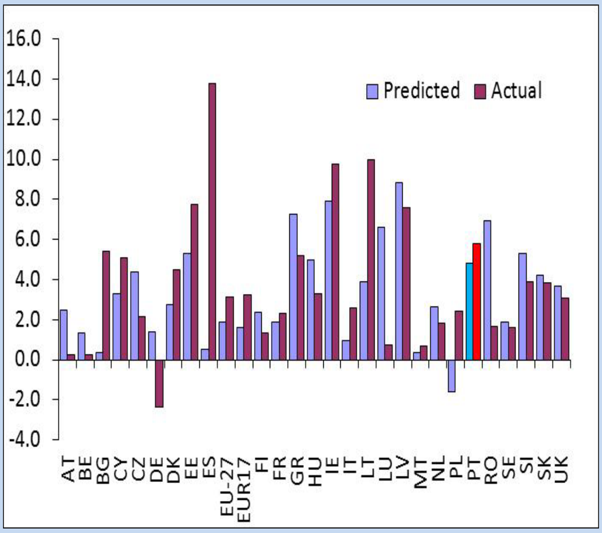
BOX 2: RECENT UNEMPLOYMENT DEVELOPMENTS IN PORTUGAL

Between Q1-2001 and Q1-2012 the unemployment rate in Portugal increased by about 10 percentage points, of which about 7 percentage points since Q1-2008. As witnessed by the developments of the NAWRU and the long-term unemployment rate, this increase reflects structural factors, including labour market institutions and skills levels which constrained job dynamism in a context of changes in the international division of labour. However, unemployment fluctuations reflected also the boom-bust cycle spurred by the fall in interest rates and expectations of rapid income convergence linked to the adoption of the euro which triggered a decline in private savings and increases in wages that turned out to be unsustainable in a context of low productivity growth. The worldwide 2008-2009 recession was an additional source of labour market weakness and the ensuing recovery too short-lived to change the trend before output growth turned negative again in 2011.

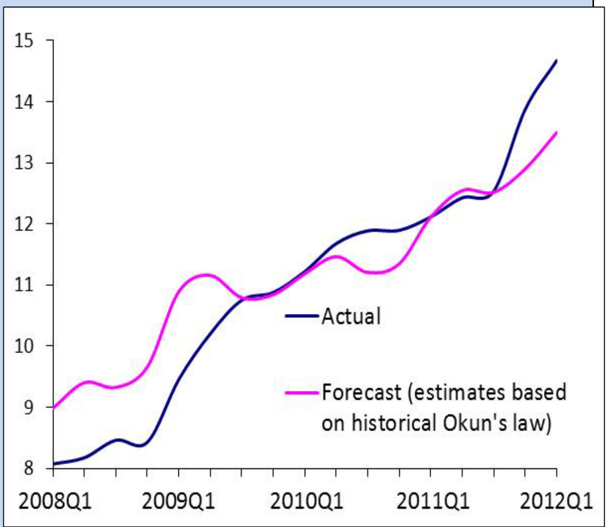
Because of these developments, employment has decreased by more than half a million people since 2008. Construction alone accounted for 33 percent of total employment losses. Other sectors with significant contributions to the total employment losses include manufacturing (23 percent), agriculture (16 percent), and wholesale and retail trade (15 percent). Job destruction was particularly strong in Q4-2011 and Q1-2012. Almost 200,000 jobs were lost in these two quarters (non-seasonally adjusted) and the unemployment rate increased by more than 2pps. Construction contributed with more than 50,000 job losses and manufacturing with more than 35,000. Hotels and restaurants together with wholesale, retail trade and transport also registered important job losses.

Okun's law is a simple way to assess how the slack in the labour market follows the slack in economic growth. It suggests the existence of a negative relationship between GDP growth and unemployment changes. Graph I displays the change in the effective unemployment rate and the one predicted by Okun's law for all EU countries over the period Q1-2008 to Q4-2011. In the case of Portugal, the effective rise in unemployment is broadly consistent with the increase predicted by Okun's law. However, the quarterly profile reveals that the actual unemployment rate was below the level predicted by Okun's law in 2008 and at the beginning of 2009 (Graph II). Thereafter, Okun's law was a relatively accurate description of the relationship between GDP growth and unemployment, as evidenced by small difference between the actual and predicted unemployment rates. However, after Q3-2011 the increase in unemployment is stronger than what could be predicted by Okun's law.

Graph I - Changes in unemployment rate 2008Q1-2011Q4: actual and Okun's law prediction



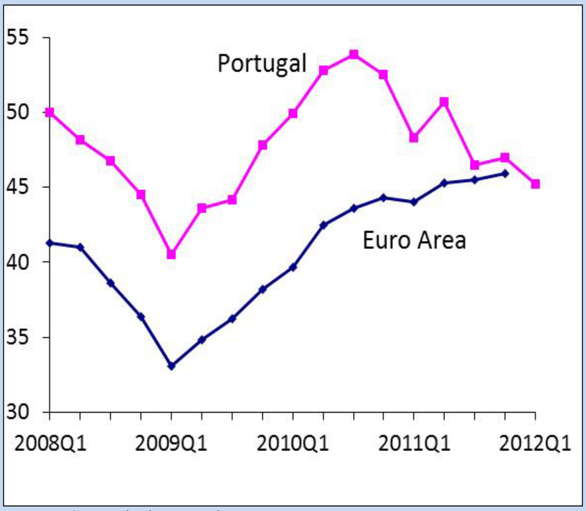
Graph II - Unemployment rate



Note: Okun's law prediction from a panel estimate on EU countries over the period 1996Q1-2008Q1 with country fixed effects and period fixed effects

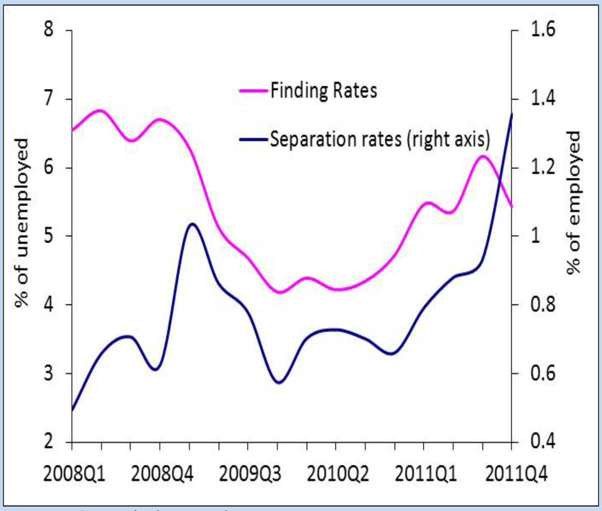
Recent developments in unemployment reflect a number of factors, including the effect of an initial labour hoarding amidst uncertainty about the depth and nature of the crisis, the concentration of job destruction in some labour-intensive sectors in more recent quarters, a deterioration in job finding probability and an increase in the job destruction rates. At the early stages of the recession, employers may have preferred to keep their workers rather than dismiss them. With the double dip recession, economic agents updated their expectations to a longer period of economic adjustment with a consequent impact on hiring and firing decisions. Although the increase in unemployment may reflect a decline in the job finding probability, this effect does not seem to drive the large increase in unemployment. The declining share of workers displaced for more than one year (Graph III) suggests that the increase in unemployment rate is the outcome of intensified job destruction in the recent quarters. Calculations of the job finding and job separation rates based on unemployment duration data according to the methodology developed by Elsby et al, 2008,* suggest that the increase in unemployment in the last quarters is associated with an increase in both rates, but especially the job separation rate (Graph IV).

Graph III - Long-term unemployment rate as a share of total unemployment



Source: Commission services

Graph IV - Finding rates and separation rates in Portugal



Source: Commission services

* Elsby, M., Hobijn, B. and Sahin, A. (2008). "Unemployment Dynamics in the OECD" NBER WP 14617

12. The economic outlook remains broadly unchanged for 2013 when a mild recovery is expected to take hold. Exports are projected to post continuously solid growth rates which should trigger a rebound in equipment and machinery investment and offset a further decline in domestic consumption. Unemployment is projected to peak in the first quarter of 2013 and decline thereafter at a gradual pace. The current account adjustment is set to continue albeit at a slower pace due to smaller adjustments in the trade balance (see Table 5 in Annex 2). Moreover, the primary income deficit is expected to keep increasing.

13. Risks to the macroeconomic outlook appear broadly balanced in the short term, but downside risks prevail farther out. Assuming that the current trend of export diversification in terms of product and geographical mix continues, Portugal could further increase its export market shares and generate higher-than projected export growth. However, tight financing conditions which affect particularly small and medium-sized enterprises might constrain the adjustment. Moreover, high and still rising unemployment may depress consumer confidence further. For 2013, there are also some downward risks to headline GDP growth linked to negative carry-over effects. Finally, significant uncertainties are related to the continued tensions in the euro area.

FISCAL DEVELOPMENTS

14. Budgetary execution for the first four months of the year was in line with the monthly profile targeted in the budget. Direct tax revenues were above target, with a positive year-on-year change driven mainly by the performance in personal income tax, whose collection slightly increased in the first 4 months of the year despite some delays in refunds to households (see Table 2). Indirect tax revenues recorded a lower outturn relative to the annual target. This is partly explained by a higher volume of VAT repayments, among which a large one-off reimbursement to one company. On the expenditure side, primary expenditure declined as foreseen, despite a significant increase in unemployment benefits expenditure, with cuts in personnel costs and spending on goods and services being the main drivers.[4] Moreover, the annual decrease in the compensation of employees may be stronger than currently estimated as the 2012 budget measures will have a sharper impact on this expenditure item in June and November.

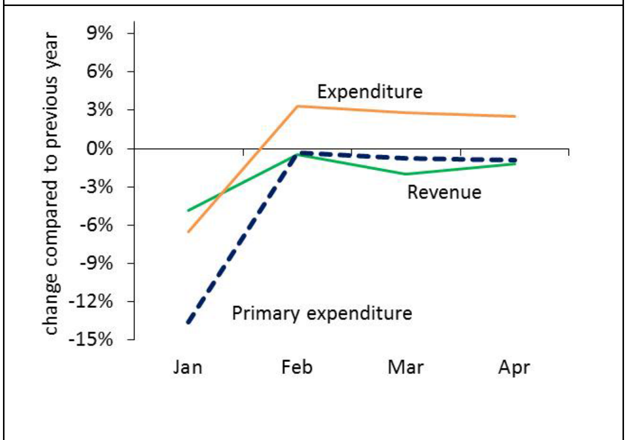
[4] Budgetary execution data for May, which became available only after the review mission, indicate that compensation for employees declined by more than projected and there was a substantial decline in purchases of goods and services.

Table 2: Execution rates of the budget, January-April cumulated (in percent)

State budgetary execution rates (%)	2011 Budget objective mn Euro	2012 Budget objective mn Euro	Jan - April 2011 %	Jan - April 2012 %
Tax revenues	**34,386.4**	**35,135.5**	**29.7**	**28.1**
Direct taxes	14,613.2	14,449.0	25.2	26.4
Indirect taxes	19,773.2	20,686.5	32.9	29.4
Non-tax revenues	**5477.8**	**6910.8**	**20.9**	**16.1**
Current non-tax revenues	4,234.6	3,570.2	22.1	27.8
Capital revenues	1,243.2	3,340.6	16.9	5.5
Effective revenues	**39,864.2**	**42,046.3**	**28.5**	**26.0**
Current expenditure	**46683.8**	**45643.7**	**27.9**	**28.8**
Employees	10432.1	8813.3	28.6	31.5
Primary current expenditure	**40,310.2**	**38,313.9**	**30.3**	**31.0**
Capital expenditure	3,482.0	2,678.0	22.8	38.0
Primary expenditure	**43,792.2**	**40,991.8**	**29.7**	**31.4**
Effective expenditure	**50,165.8**	**48,321.6**	**27.5**	**29.3**
Overall balance	**-10,301.6**	**-6,275.3**		
Primary balance	**-3,928.0**	**1,054.5**		
Social security execution rates (%)	2011 Budget objective mn Euro	2012 Budget objective mn Euro	Jan - April 2011 %	Jan - April 2012 %
Current revenue	**24003.6**	**24114.1**	**32.4**	**32.1**
Social security contributions	14,096.8	13,592.0	32.3	31.3
Current expenditure	**23618.5**	**24045.7**	**26.8**	**30.9**
Unemployment benefits expenditure	2,122.4	2,184.8	33.4	41.7
Overall balance	**374.2**	**62.9**		

Source: Ministry of Finance (DGO Bulletin data of Jan and May 2012).
* Comparable universe (excluding reclassified SOEs)

Graph 1: Budgetary outturn for January-April 2012 (Cash data)

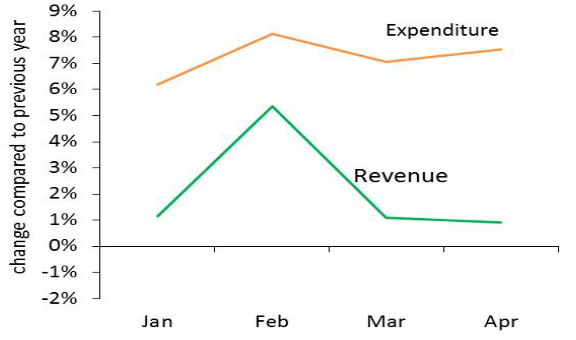


Source: Ministry of Finance and Commission services
Note: Includes non-consolidated data for the State, Autonomous Funds and Services and Social Security); Primary expenditure includes data for the State subsector only.

15. When compared with the previous year, the state budget deficit widened in the first four months of the year. In January-April 2012, revenues of Central Government and Social Security decreased by 1.1 percent when compared with last year, while expenditure increased by 4.1 percent (see Graph 1). However, this comparison must consider several one-off factors. Notably, corporate income tax revenues in 2011 were extraordinarily high due to the anticipation of dividends distributed in December 2010 before the tax hike. On the expenditure side, an effective increase by 4.1 percent is mostly the result of higher interest payments during the first quarter and an exceptional capital transfer related to the debt amortisation of the national television broadcaster (RTP).

16. The faster than expected contraction of domestic demand acts as a drag on tax revenues. The rapid rebalancing of the economy in favour of net exports is having a negative effect on revenues from several indirect taxes. This concerns the value added tax, the taxes on tobacco and on alcoholic beverages and especially the motor vehicle tax, as car sales fell by 50 percent in the first quarter of 2012. Downside risks for personal and corporate incomes taxes are also

Graph 2: Budgetary outturn for Social security in January-April 2012 (Cash data)



Source: Ministry of Finance and Commission services
Note: Includes non-consolidated data for Social security

large for the rest of the year due to the worsening in economic activity.[5]

17. The rapid rise in unemployment is starting to weigh on the social security budget (see Graph 2). The supplementary budget for 2012 had foreseen some increase in social transfers on account of adverse labour market developments. While so far the path of social transfers, notably pensions, unemployment benefits and employment support, has been in line with the supplementary budget's implicit target, the situation is likely to worsen in the latter part of the year. When compared with the previous year, social security revenues in January-April decelerated, while spending on unemployment benefits caused a surge in expenditure, with about 42 percent of the budget allocation being executed in the first four months of the year, compared with 33½ percent last year (see Table 2).

18. Risks to the budgetary target in 2012 are tilted to the downside as a consequence of the change in the growth composition and higher-than-expected unemployment. Based on budgetary execution data up to April, the review mission estimated a fiscal gap due to unexpected changes in macroeconomic developments and a one-off VAT reimbursement to a large company at around ½ percent of GDP for the year as whole. This gap is expected to be broadly offset by savings in net interest payments, the reprogramming of EU funds in conjunction with the increase in the EU's co-financing rate and a tighter budgetary execution. However, these measures may not be sufficient to close the fiscal gap if tax revenues are falling further behind target as a consequence of the rapid decline in the tax-intensity of output growth. Developments require close monitoring to ensure timely policy reaction to deviations from Programme projections.

Table 3: Stock of arrears in 2011 and 2012 (in EUR million)

	2011							2012 (1)		(2)	(3)=(2)-(1)	
Subsector of the General Government	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Δ Mar-Jan**	**% total**
Central Government excluding NHS	312	309	274	314	351	325	162	190	204	191	1	4%
NHS classified in General Government	346	407	362	385	421	428	363	219	194	156	-63	3%
Reclassified entities	58	86	94	99	84	77	67	66	71	63	-2	1%
Local Government	1,716	1,708	1,717	1,726	1,684	1,661	1,606	1,633	1,644	1,677	44	33%
Regional Government	923	969	972	998	1,080	1,161	1,158	1,228	1,241	1,333	105	26%
Total	3,355	3,478	3,419	3,522	3,620	3,651	3,355	3,335	3,353	3,420	85	67%
Total Consolidated	3,181	3,283	3,262	3,338	3,433	3,492	3,252	3,223	3,240	3,303	80	65%
Other entities outside General Government												
Enterprises excluding NHS	13	11	11	8	10	14	18	10	17	21	12	0%
NHS incorporated hospitals	1,718	1,941	1,988	2,047	2,110	2,120	2,055	1,695	1,697	1,755	60	35%
p.m.: health sector inside + outside GG	*2,064*	*2,348*	*2,350*	*2,432*	*2,531*	*2,548*	*2,418*	*1,914*	*1,891*	*1,911*	-3	38%
TOTAL	4,912	5,236	5,261	5,393	5,552	5,626	5,325	4,928	4,954	5,080	152	
p.m.: percent of GDP	*2.9*	*3.1*	*3.1*	*3.2*	*3.2*	*3.3*	*3.1*	*3.0*	*3.0*	*3.0*		

Source: Ministry of Finance and Commission services
Note: Consolidated data concerns data net of intra-government sector arrears

19. Payment arrears inside and outside the general government have increased again.[6] At the end of March, the combined stock of arrears for the general government sector and entities classified outside the general government is estimated at about EUR 5 billion, or 3 percent of GDP (see Table 3). Local and regional governments account for some 60 percent of the stock, while incorporated hospitals classified outside the general government account for another large share (35 percent). Following the good performance at the turn of year, the stock of arrears crept up again in February and March. Arrears accumulation remains a concern in particular for

[5] Budgetary execution data for May, which became available only after the review mission, indicate that the performance of direct taxes deteriorated significantly, with both personal and corporate income taxes falling behind targets.

[6] Arrears are defined as payables/creditors that have remained unpaid for 90 days or more beyond any specified due date (regardless of any contractual grace period). In case no due date is specified, arrears are defined as payables/creditors that have remained unpaid for 90 days or more after the date of the invoice or contract.

regional and local governments as well as for hospitals outside the general government. Therefore, performance during the next few months needs to be monitored closely to assess whether the mechanisms put in place are sufficient to avoid the build-up of new arrears on a sustained basis and, if necessary, implement swiftly corrective measures.

FINANCIAL MARKETS AND FINANCIAL SECTOR DEVELOPMENTS

20. The situation in the financial market is improving but remains fragile. The decline in Portuguese yields, which started early 2012, has continued until June, although interrupted by recurrent spikes on account of tensions in the euro area. Portuguese banks have remained effectively closed off from international financial markets for the past 26 months resorting to ECB borrowing. From May 2010 until February 2012, i.e. the second round of the Long-Term Refinancing Operations (LTRO), ECB borrowing was oscillating between EUR 40-50 billion but has increased since then.

Table 4: Soundness indicators of the Portuguese banking system

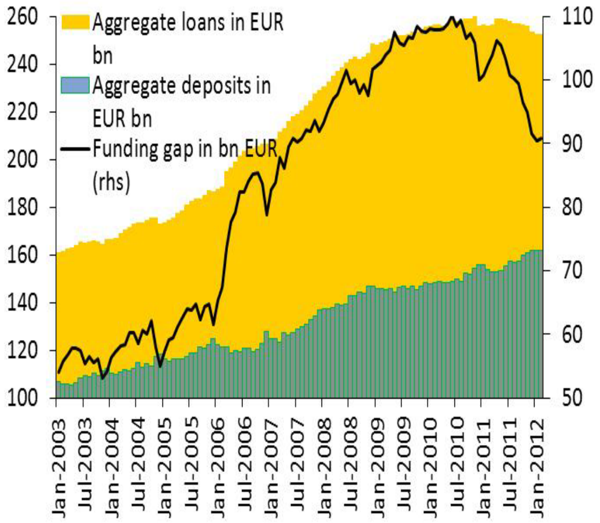
%	2009Q4	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1
Return on Equity (1)	6.0	7.2	7.6	7.1	6.7	6.2	4.3	2.4	-3.5	2.3
Gross Income on Assets	2.8	2.5	2.6	2.6	2.7	2.4	2.5	2.5	2.5	2.6
Cost to Income Ratio	56.8	57.7	57.1	57.2	57.6	59.1	58.3	59.0	61.5	55.8
Non-Performing Loans	4.8	5.4	5.5	5.8	5.2	5.5	6.2	6.9	7.5	8.1
Coverage Ratio	59.0	63.2	62.9	60.8	61.5	60.7	57.7	55.3	56.7	53.7
Capital Adequacy Ratio (2)	11.6	11.3	10.9	11.0	11.1	11.4	11.0	10.1	10.7	10.7
Core Tier 1 Ratio (3)	7.9	7.8	7.8	8.0	8.1	8.4	8.7	8.5	9.6	9.7
Loan-to-deposit ratio	161.5	163.4	166.6	158.4	157.8	156.7	149.7	146.2	140.2	137.4

Note: (1) Income before minority interests /Average shareholders' equity before minority interest
(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

21. Deleveraging continues but risks of a credit crunch remain contained. Deleveraging is proceeding as foreseen, with the banking system's loan-to-deposit ratio falling from 156.7 percent in the first quarter of 2011 to 137.4 percent in the same quarter of 2012. The reduction in the loan books was achieved partly through selling performing loans abroad, but the scope for future sales of foreign loans is limited as the stock of these assets is diminishing and international demand receding. Due to the scarcity of domestic primary funding and intense competition among banks, deposit rates remain elevated. As a consequence, to protect their intermediation margins banks have hiked interest rates for new loans which in turn has discouraged demand. In 2011, loans to private sector companies decreased by 1.7 percent year-on-year. The issuance of new corporate loans over the past 12 months amounts to 85 percent of the ten-year pre-crisis average. Newly granted housing loans also fell sharply below their pre-crisis average although, due to their long maturity, the year-on-year decline in mortgages amounted to a mere 1 percent in March 2012. Consumer loans, which are redeemed faster, declined by 5 percent year-on-year in March (Graph 4).

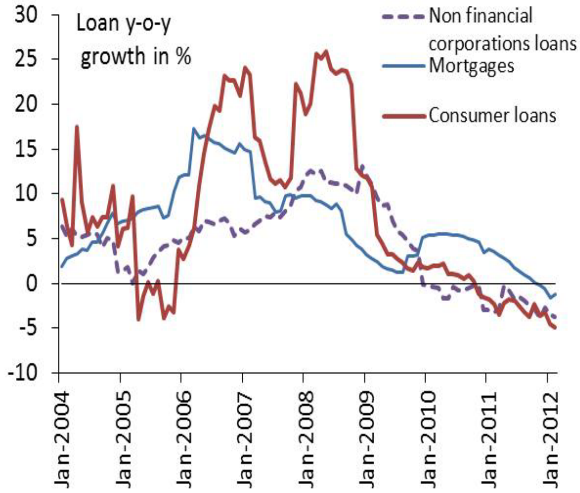
22. Deposits keep on growing and their remuneration has somewhat decreased. According to the latest data available, aggregate deposits grew by 5.5 percent on a year-on-year basis (March 2012). This overall growth figure hides different trends for company and houshold desposits. While company deposits have been shrinking slightly, growth of household deposits has remaind robust since the start of the Programme. As household deposits constitute three quarters of the total, aggregate deposits increased at a healthy pace (Graph 5). Intense competition among banks has been an important factor behind this increase. Interest rates offered for new time deposits rose from 1 percent to above 4.5 percent (Graph 6). To mitigate risks of a possible 'deposit war', in November 2011 BdP imposed a capital deduction if a savings product offered a rate 300 basis points above the comparable Euribor rate. In April 2012, this was refined through the introduction of a system of variable spreads in accordance with the terms of the deposit starting at 225 basis points up to 300 basis points, thereby imposing higher penalties for short-term depostis. This measure lowered interest rates offered for new deposits by more than one percentage point. However, so far lower deposit rates do not seem to have trickled down to lending rates.

Graph 3: Funding gap evolution



Source: Bank of Portugal, Reuters

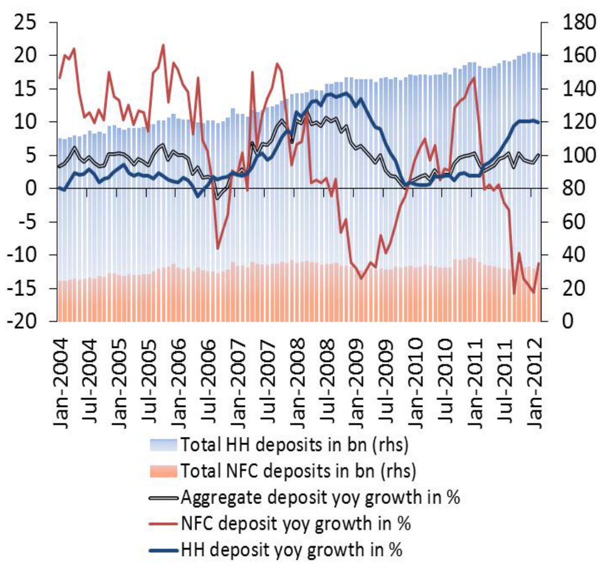
Graph 4: Stock of performing loans



Source: Bank of Portugal

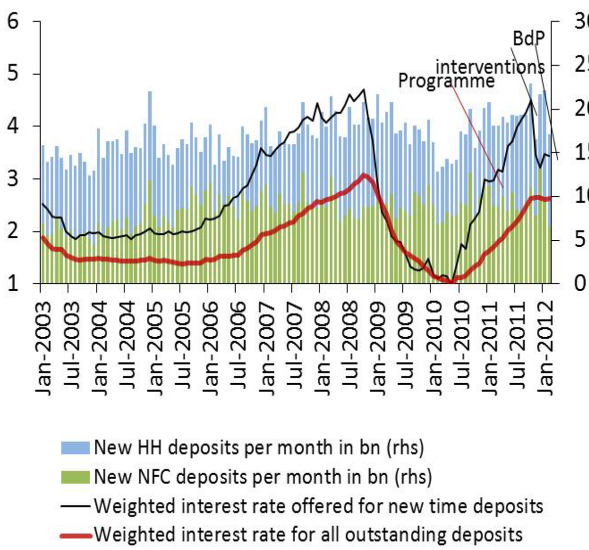
23. Only about one half of the banks reported more restrictive credit supply conditions in the first quarter of 2012, which contrasts with earlier quarters where credit tightening was almost universal. Factors responsible for the tightening credit conditions were the cost to the credit institutions' capital position, the marginal cost of funds, balance sheet constraints, and the increasing risks associated with the collateral offered by borrowers. The April survey showed a marginal increase in demand for company loans for the first time since the Lehman bankruptcy, albeit coming from low levels. This is explained by greater needs for working capital and for debt restructuring whereas fixed investment and mergers and acquisitions prompted less loan demand. The deteriorating outlook for the housing market led to lower demand for, and at the same time tighter supply of mortgage loans. For consumer credit, banks reported that a moderate tightening was matched by reduced demand.

Graph 5: Deposit growth in EUR billion and in relative terms



Source: Banco de Portugal

Graph 6: Interest rate paid on deposits and new deposits in EUR billion



Source: Banco de Portugal

24. The major banks returned to moderate profitability in the first quarter of 2012, after a difficult year 2011. In the fourth quarter of the previous year, results of the banks had been depressed due to higher levels of impairments on credit and the financial asset portfolio but also to several non-recurring events arising from additional loan impairments following the special on-site inspection and the recognition of losses due to the transfer of the banks' pension funds to the social security system. Nevertheless, as core profitability of the banks remained intact, with gross income including interests, commissions, fees and financial operations of about 2.5 percent of assets, major banks posted again moderate positive results in the first quarter of 2012. Lower operating costs contributed favourably to banks' profitability at the start of the year. However, interest income from lending continues to be under pressure from the ongoing deleveraging process. Also, the recognition of loan impairments continues to weigh on the results. Both factors may exercise a significant downward drag on bank profitability in 2012.

III. PROGRAMME IMPLEMENTATION

25. The joint EC/ECB/IMF staff mission concluded that the implementation of the Programme is on track. Authorities are implementing a remarkable consolidation effort of some 7 percent of GDP over 2011-2012. The 2012 budget target of 4.5 percent of GDP remains within reach, even though downside risks have increased. Improvements in public financial management are aimed at tighter spending controls, risk assessment and the application of corrective action in case of deviations. Significant improvements are also being made in the tax administration, in addressing fraud and tax evasion and the reinforcement of the tax appeals system. An ambitious reorganisation of the public sector is moving ahead swiftly while shadow budgeting through PPPs, SOEs and other public bodies is increasingly monitored and reduced. Over the past few months also major steps have been undertaken towards raising the efficiency of local and regional governments, including a redrawing of administrative borders. Arrears are beginning to be settled in line with a dedicated strategy and controls to limit the build-up of new arrears are being implemented.

26. The adjustment of the banking system is proceeding, but the recapitalisation of banks will need state support. Some banks will not be able to meet the target of a CT1 capital ratio of 9 percent by June 2012 through the mobilisation of private capital, and consequently will need to resort to the funds of the Bank Solvency Support Facility under the Programme. This will use some EUR 5 billion of the Facility's total of EUR 12 billion. An additional EUR 1.6 billion will be injected directly by the state in CGD bank, which is already 100 percent state owned. In parallel, the regulatory framework of the banking system is being strengthened as regards the supervision and resolution mechanism.

27. Structural reforms have advanced in several areas, with the passing of the urban lease reform being particularly noteworthy. In addition to the housing reform, other important dossiers include the reform of the labour code and the ongoing reform of the judiciary system. Rents in the electricity sector will be reduced, although for some important schemes to a lesser extent than hoped for. Important sectoral reforms are in preparation in the goods and service markets, notably the ports sector with the revision of the port-specific labour code. However, despite progress, further steps are required to complete the reforms in construction and real estate sector as well as in the regulated professions. An annex to this report provides a detailed list of the measures taken to meet the conditionality for this Fourth Review.

Table 5: Summary of compliance with policy conditionality for the Fourth Review

	Status
Fiscal policy	The quarterly quantitative performance criteria on the general government cash balance and debt for Q1-2012 were met. The 2012 budget contains ambitious structural consolidation measures, the bulk of which are on the expenditure side. Budgetary execution for the first four months of the year is on track; however, budgetary risks are tilted to the downside as higher unemployment and the growth composition is becoming more unfavourable for fiscal consolidation than projected.
Financial sector	The third phase of the Special on-site Inspection Programme (SIP) was completed and its recommendations are currently being implemented. The sale of BPN bank was finalised following approval by the European Commission. Banks' funding and capital plans and the respective implementation are on schedule to meet the 9 percent EBA CT 1 requirement by end-June 2012. Crisis management measures are being taken, in particular regarding prevention early intervention, and resolution framework.
Fiscal-structural	Public finance management: Reforms are progressing apace. A multiannual budgetary framework with expenditure ceilings, as required by the Budget Framework Law, was prepared for the first time and published in the fiscal strategy document. Budget execution is being closely monitored and the assessment of fiscal risks is gradually improving. Tax expenditures were thoroughly estimated according to an internationally agreed methodology. Arrears: Arrears are not yet on a downward path. All conditions for applying the commitment controls law are now in place, but implementation is not yet completed. In conjunction with a dedicated strategy, EUR 1.5 billion have been attributed to the settlement of arrears in the health sector. Payments have already started. The Support Programme for the Local Economy provides a credit line of EUR 1 billion

	to settle arrears and short term debt under certain conditions. Revenue administration: The government continues improving revenue administration through various reforms. Efforts continue to curb non-compliance, focusing attention on high-evasion sectors and taxpayers. A plan to implement e-invoicing mechanisms to facilitate VAT compliance and improve control has been developed. Regional and local governments reform: The law on the administrative reorganisation of local entities entered into force, allowing for the reduction in the number of parishes by at least 25 percent. Draft laws on the governance of local SOEs and the reduction in the number of management positions and administrative units will help contain fiscal risks and improve public finance management at local level. The adjustment programme of Madeira shows an overall good compliance, despite some delays. Public sector reform: The implementation of PREMAC to reduce the number of management positions and administrative units is progressing smoothly. Detailed statistics on public sector employment and wages were published for the first time. The regime of public employment is being reformed in line with the private sector Labour Code. SOEs and PPPs: Progress towards reaching operational balance, on aggregate, by the end of the year is positive. A draft law to strengthen SOEs governance will be soon submitted to Parliament. A preliminary strategy to unwind Parpública was prepared; a strengthened approach is expected in the framework of a broader strategy to deal with all SOEs debt due in the second quarter of 2012. A new legal and institutional framework for PPPs has been approved; it foresees the creation of a Technical Unit responsible of monitoring all PPPs. A detailed PPP study prepared by an international auditing firm is to be published in June. Privatisation: The sales of government stakes in EDP and REN were completed. The direct sale of Caixa Seguros is expected to take place in 2012. The sale of ANA and TAP were slightly delayed, but the necessary proceedings have started and the selection of bids is expected to be completed by end-2012. Health: The authorities have implemented a wide set of measures in the area of pharmaceuticals. Those include, inter alia, a compulsory INN (active substance) and regular monitoring of prescription behaviour and feedback to physicians. Greater focus is now being placed on the hospital sector as authorities are to implement the strategy to pay arrears and to optimise the existing hospital network.
Reform of labour, goods and services markets	Labour market and Education: A proposal to revise the mechanism for extending collective agreements is under preparation. The date for submitting legislation to Parliament was extended by one quarter to September 2012. The authorities are also working on proposals to align severance payments to the EU average and to define the setup of a fund to finance part of severance payments. Both the new level of severance payments and the fund are expected to enter into force by 1 November 2012. Detailed action plans to improve the quality of secondary education and vocational training have been presented. Energy: Some progress has been made in reducing the undue burden on end-users by reducing rents in electricity sector. Investment incentives granted retroactively have been withdrawn and a revision of the support-scheme for co-generation (under special regime) is ongoing. Additional efforts are nevertheless still needed. The transposition of the Third Energy Package to liberalise the electricity and gas sectors is still progressing at a satisfactory pace. Telecommunications: The requirement of allowing market players to enter the universal service segment through a transparent and non-discriminatory public tender has not been yet met. Significant delays have been accumulated. Postal: Law 17/2012 transposing the Third Postal Directive was published on 26 April and entered into force on the following day. Transport: An ambitious revision of the legal framework governing port work has been finalised and is now in the consultation phase with a view to submitting it soon to Parliament. In the railway sector, the privatisation of CP Carga has been delayed by one year.

	Services and professions: New legal frameworks foreseen by Q2-2012 representing about one half of the specific regimes requiring amendments to comply with the Services Directive have been approved by the Government. Significant steps forward have also been achieved on the recognition of professional qualifications and the government has already submitted the relevant legislation to Parliament. Progress in regulated professions remains however rather slow. The horizontal legal framework on public professional associations has been submitted to public consultation. The deadline to submit draft laws to deregulate certain professions has been extended. Despite some progress, delays are also observed in ensuring compliance of the construction and real estate sectors with the Services Directive as well as in making fully operational the Zero Authorisation project for bars, restaurants, retail and wholesale.
Reform of framework conditions	Housing market: The law for amending the urban rental legislation was adopted by the Parliament. Judicial system: Reforms are advancing on schedule: backlog clearance is making progress; a roadmap was presented to adjust court districts; the implementation of new arbitration procedures is being completed. Public procurement: The revised public procurement legal framework is close to completion. Business environment: The "Simplex Export" programme is well on track. The government is finalising a report to identify the major problems underlying the difficult access to credit for SME and their difficulties in getting access to international markets. Obstacles to free movement of capital / special rights: By recent decree law, the government reiterated the existence of acquisition caps in the share capital in the transmission system operator of electricity and natural gas or of any companies controlling it. The government has decided to postpone the sale of CGD's stake in Galp, thus maintaining a situation of special rights by the State.
Data submission	Requirements under the Programme have been observed. Work is ongoing to improve further data submission.

FISCAL POLICY

Budgetary execution in 2012

28. The quarterly quantitative performance criteria on the government cash balance and on the stock of government debt for end March 2012 were met. The achievement of the ceiling on the cash balance for the first quarter was met and even overachieved due to changes occurred in the intra-annual profile of the 2012 budgetary execution. Therefore, the ceilings on the cash balance for the next quarters of the year remain unchanged. The indicative target of non-accumulation of arrears by the general government sector was not met (see also Table 3 above).

29. The 2012 budget, as amended by its March supplement, is ambitious and based on high-quality consolidation measures worth 5½ percent of GDP[7]. Most of the effort is accounted for by expenditure-reducing measures, mainly wage and pension cuts, but also expenditure cuts in the health sector. In addition, reductions in public sector employment are to continue and access to some social transfers to be tightened. On the revenue side, the consolidation measures for 2012 rely mostly on higher indirect taxation, as the VAT structure changed, with more goods and services being taxed at the higher intermediate and standard rates. Regarding direct taxation, the focus is mainly on broadening the tax base by reducing deductions and exemptions applicable to personal and corporate income taxation.

30. The impact of the consolidation measures on the headline deficit is more than offset by underlying unfavourable developments and, more importantly, by the dissipation of large one-off measures in 2011. The pace of the deficit reduction is not favoured by the macroeconomic environment. Higher interest

[7] To arrive at the improvement in the primary structural balance, which is the customary measure of budgetary consolidation in structural terms, the overall consolidation effort of 5½ percent is reduced by 1½ percent of GDP representing the 'budgetary drift', i.e. the change in the budget balance due to the short-term impact of automatic stabilisers and autonomous longer-term budgetary shifts, e.g. because of ageing.

expenditure contributes further to a slowdown in the pace of consolidation by 0.8 percent of GDP in 2012. Moreover, the dissipation of the positive net effect of large one-off transactions in 2011 mechanically contributes to an increase in the headline deficit in 2012. Among the deficit-decreasing one-off transactions in 2011 was the transfer of the banks' pension funds to the public social security system and the extraordinary temporary surcharge on the 2011 taxable income. These were partly offset by deficit-increasing one-off measures, particularly the reclassification of the investment of a PPP due to the introduction of tolls, the recapitalisation of troubled bank BPN and the recording of debts of a financially troubled SOE and of a failed PPP agreement both in the remit of the Madeira regional government.

Table 6: Arithmetic of the government deficit: from the deficit in one year to the next

(+) means balance-improving impact; (-) means balance-reducing impact	% of GDP
2010 balance (observed)	**-9.8**
Primary balance drift in 2011	1.5
Change in interest expenditure	-1.0
Dissipation of one-offs and non-recurrent effects from previous year	0.7
New consolidation measures	4.3
2011 balance (estimate)	**-4.2**
Primary balance drift in 2012	-1.6
Change in interest expenditure	-0.8
Dissipation of one-offs and non-recurrent effects from previous year	-3.3
New consolidation measures	5.4
2012 balance (target)	**-4.5**
Primary balance drift in 2013	-0.1
Change in interest expenditure	0.0
Dissipation of one-offs and non-recurrent effects from previous year	-0.4
New consolidation measures	2.0
2013 balance (target)	**-3.0**

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.

The Primary Balance Drift includes the change in the balance lev el that would take place without discretionary measures. It includes the impact of economic activ ity on the balance and the structural increase in expenditure in real terms, e.g., the increase in pension expenditure.

Risks to the fiscal targets

31. The 2012 target for the general government deficit of 4.5 percent of GDP is achievable, but downside risks are starting to materialise. In particular**,** the growth composition is tilting more strongly towards net exports and away from domestic demand, as is evidenced by the more pronounced fall in private consumption and the substantial worsening of the labour market situation. However, lower net interest payments, savings from the increase in the co-financing rate and subsequent reprogramming of EU Structural Funds and a tighter budgetary execution will help offset these developments. The government is committed to closely monitor developments in the months ahead and assess whether policy adjustments are needed to achieve the target.

32. In 2011-13, the improvement in the cyclically-adjusted primary balance, net of one-off measures, is estimated to amount to more than 9 percent of GDP. In the April fiscal strategy document for the period 2012-2016, the authorities confirmed the commitments to reduce the deficit to 3 percent of GDP by 2013 and to move towards a balanced budget position in the period after the Programme. The large consolidation effort in 2012 constitutes a good basis for reaching the target in 2013. In addition, the Programme envisages measures of some 2 percent of GDP for 2013. To a large extent, they are the continuation and deepening of the consolidation measures already adopted in 2012, notably by broadening tax bases and reducing primary expenditure through further rationalisation in the public administration, the SOEs, and the health sector. This path is in line with the Council Recommendations under the ongoing Excessive Deficit Procedure**.**

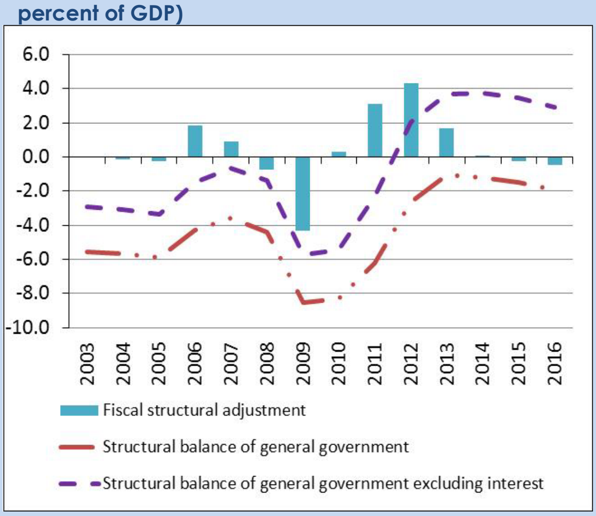
33. Fiscal adjustment in Portugal is adequate and supportive to the growth-enhancing structural reform agenda. Fiscal multipliers do not seem to have been affected by the financial crisis so far. There is no indication that the fiscal consolidation has an overly restrictive impact on growth, which is heavily affected by other factors that are transmitted through the financial markets (see Box 3). Furthermore, the composition of the consolidation, which is expenditure-based and the reduction in tax distortions should help lift the growth potential in the medium-term.

BOX 3: FISCAL ADJUSTMENT IN PORTUGAL, 2009-2016

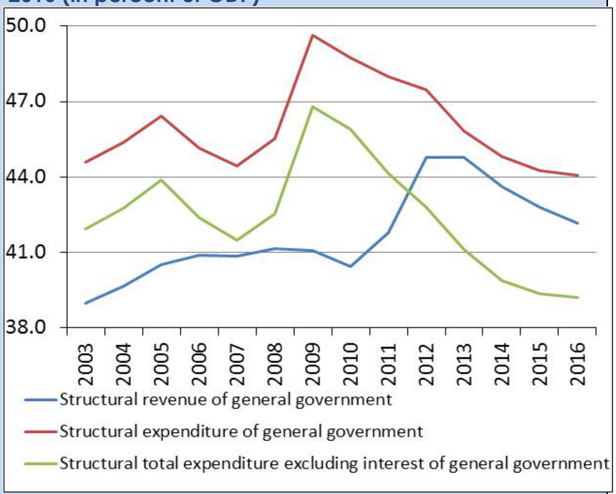
The current fiscal adjustment in Portugal relies on a strategy to reduce the public debt relative to GDP over the medium-term by bringing the primary structural balance (i.e. the headline budget balance corrected for one-off measures, the economic cycle, and excluding interest payments) from the -5½ percent of GDP in 2009 and 2010 to a surplus of about 3 percent of GDP over the medium term. The size of the estimated structural adjustment is large: above 9 percent of GDP over 2011-2014 (see Graph I). Some minor consolidation already started in 2010, one third of the adjustment took place in 2011; another 6 percent of GDP remains to be achieved over 2012-13.

Previous episodes of fiscal consolidation in Portugal were more modest in size and did not last long enough to ensure a decreasing path of the debt ratio. In the middle of the last decade, Portugal embarked on a process of fiscal consolidation, under the Excessive Deficit Procedure at that time. The structural deficit declined from about 6 percent of GDP in 2005 to 3½ percent in 2007 on the back of both falling expenditure and rising revenue ratios. However, the structural deficit surged to about 8½ percent of GDP in 2009 and 2010, when in response to the financial crisis Portugal implemented a large fiscal expansion, with discretionary measures mostly on the expenditure side. Graph II shows a historically high structural expenditure ratio of the general government, relative to a rather constant structural revenue ratio.

Graph I. Structural balances in Portugal, 2003-2016 (in percent of GDP)



Graph II. Structural revenues and expenditures, 2003-2016 (in percent of GDP)



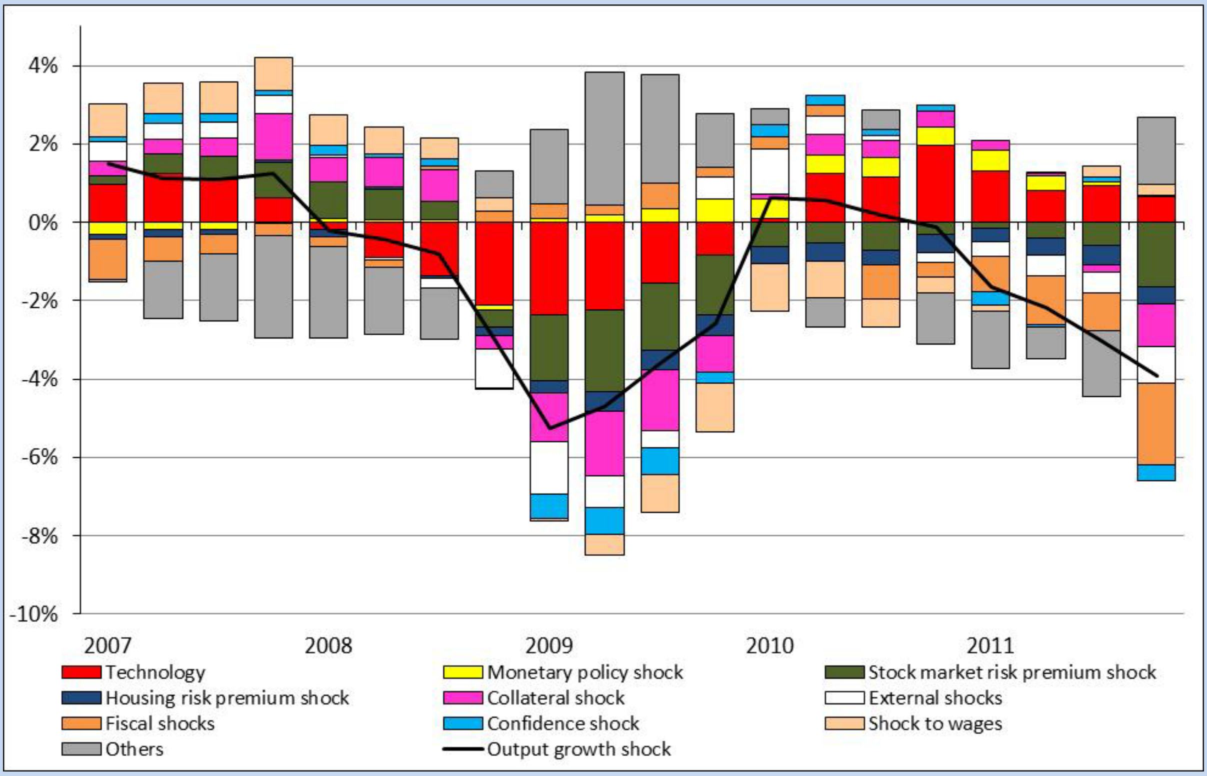
Note: Structural adjustment based on potential GDP - Excessive deficit procedure; forecast values: see annex
Source: Commission services

A successful adjustment strategy aimed at bringing down the public debt ratio and regaining sustainability of public finances needs to reverse past trends in terms of expenditure restructuring, but also in terms of tax policies. Over 2011-14, the structural revenue ratio is estimated to increase by about 3 percentage points, while structural primary expenditure relative to GDP is expected to fall by more than 6 percentage points. The medium-term strategy is frontloaded and designed in a manner that is supportive for economic growth, with a focus on cuts in non-productive spending, while revenues are raised in a manner that reduces distortions, notably by increasing the tax base, and reducing tax credits, tax benefits and allowances.

GDP GROWTH SHOCK DECOMPOSITION AND FISCAL MULTIPLIERS IN PORTUGAL

A newly estimated DSGE model of the European Commission, allows to analyse the impact that the recent fiscal policy changes might have had on output growth in Portugal based on using quarterly data for Q1-1995 to Q4-2011.* It shows that roughly half of the decline in output growth in 2011 relative to potential might be attributed to the reduction in government consumption and investment (Graph III). Nevertheless, recent developments are dominated by other factors notably the risk premium shocks on housing and the stock market, the tighter lending conditions (collateral shock) and the deceleration in world trade (external shock). Despite the significant impact of fiscal consolidation on output, the model suggests that there is neither an additional multiplier effect of an increase in government expenditure on private consumption nor a significant crowding-out of private demand. Consumption growth was mainly driven by the collateral shock (tighter lending conditions) and the shock to wages (negative employment effect due to wage rigidities), while investment growth was mainly driven by the stock market risk premium shock.

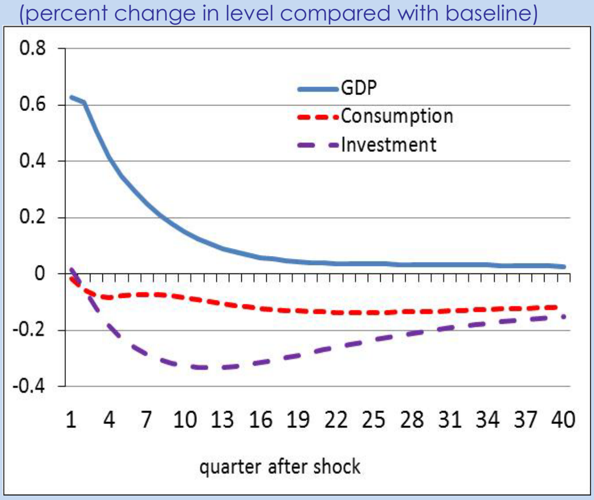
Graph III: Impact of various shocks to year on year GDP growth



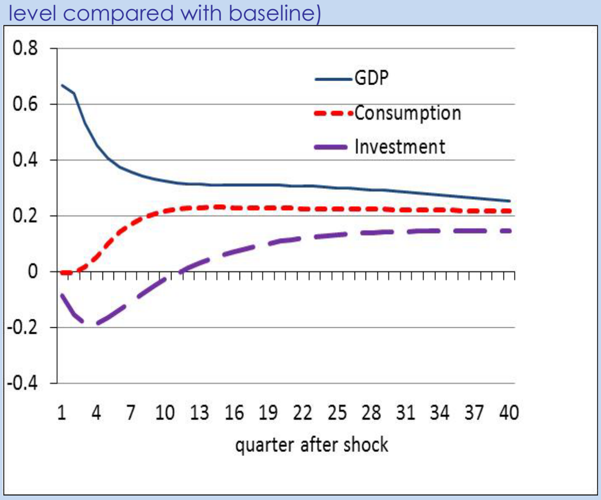
Source: Commission services.

GDP multipliers for government consumption and investment shock are estimated to be between 0.6-0.8, in line with standard estimates for Portugal. However, the economic impacts of government consumption and investment are quite different in nature. For an increase in government consumption, there are negative co-movements with private consumption and investment (see Graph IV). Furthermore, its positive impact on GDP fades away to less to less than 0.1 percent after 3 years, while the negative impact on consumption and investment is permanent. By contrast, government investment results in positive co-movements with private consumption. Private investment is also crowded in, after an initial crowding out effect. The model indicates that government investment results in a sustained positive growth impact (Graph V). These results show again ins a stylised way the importance of the right type of budget consolidation to have a lasting positive impact on economic growth.

Graph IV. GDP, consumption and investment responses to a government consumption shock (percent change in level compared with baseline)



Graph V. GDP, consumption and investment responses to a government investment shock (percent change in level compared with baseline)



Source: Commission services. Shocks normalised to 1 percent of GDP.

* In 't Veld, J., Pagano, A., Ratto, M., Roeger, W. (2012). "Debt sustainability analysis based on an estimated structural model for Portugal", unpublished manuscript.

34. Debt projections point to a stabilisation of the debt ratio by 2013 and a steady fall afterwards. Government debt, which stood at 107.8 percent of GDP in 2011, is projected to peak at around 118½ percent of GDP in 2013 and decline thereafter. The debt ratio in 2013 is estimated to be higher than in the third review mainly due to an accounting revision affecting the end 2011 debt position, the downward revision in nominal GDP, and the government's strategy to support local governments by means of a credit line amounting to EUR 1 billion to settle arrears and short-term debt. The declining debt profile starting in 2014 seems to be robust against weaker growth prospects (see Box 4).

FISCAL STRUCTURAL REFORMS

Fiscal policy framework

35. In April, the authorities prepared a fiscal strategy document (DEO) for the period 2012-2016, in line with the requirements of the Stability and Growth Pact and the Budget Framework Law. The DEO includes, for the first time, a multiannual budgetary framework with expenditure ceilings for the budget programmes and the central administration as specified by the Budget Framework Law. Expenditure ceilings are binding for each spending category for the year 2013 and indicative for the subsequent years. Future reports should further develop the forecast and fiscal risk sections and provide additional information on policy measures including four-year cost estimates. The Fiscal Council, which is now operational, assessed the DEO, pointing to some areas of improvement such as sounder macroeconomic forecasts and the extension of the expenditure ceilings to subnational governments and to spending that is financed by other resources than tax revenues such as charges and fees, asset sales and international transfers.

36. Overall progress in public financial management reforms maintains a good pace. In addition to the DEO, the authorities prepared a fiscal risk report. The report provided ample information on general fiscal risks and specific contingent liabilities, including those arising from PPPs and SOEs. The authorities will work closely with the EC and the IMF to further improve the content and the readability of the report for the 2013 Budget, in particular by providing a more comprehensive macroeconomic risk assessment, quantifying fiscal risks whenever possible and developing alternative risks scenarios. The report on tax expenditures was substantially improved in its details and follows an internationally agreed estimation methodology. In the coming months, the authorities will start the assessment of tax expenditures to evaluate whether they achieve their policy objectives in a cost-effective manner. [see Box 5]

37. A closer monitoring of budget execution is being put in place. Expenditure programme coordinators meet monthly to assess budget execution, identify deviations and define corrective measures. The process is still at its early stages; there have only been few meetings until now and the quality of preparation varies among coordinators. Following the improvement in the budgetary monitoring system through the development of intra-annual targets on a cash basis and monthly assessments of deviations against fiscal targets, the authorities will present a proposal to reduce budgetary fragmentation at the central administration level by end-June.

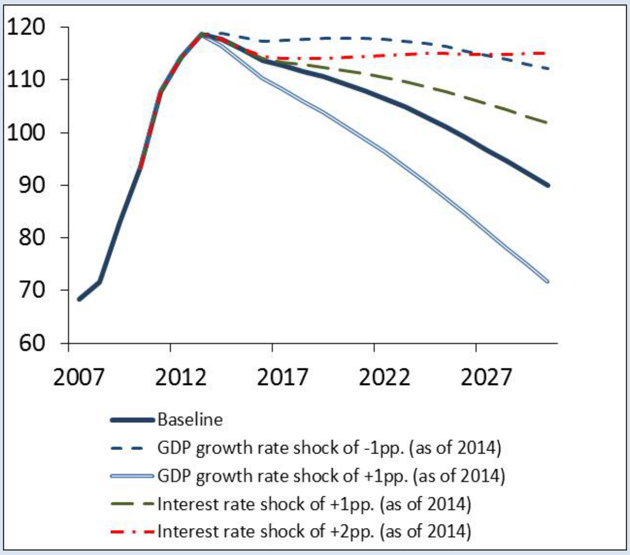
38. The Budget Framework Law will be revised by the end of the year. The revision will take into account the reinforced EU governance framework ('six–pack', 'two-pack') and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union ('fiscal compact'). The new Budget Framework Law will be consistent with the revision of the regional and local financing laws, which are also due by the end of this year. In view of this revision, the operational design of the medium-term budgetary framework, including the medium-term fiscal strategy, decision-making and prioritisation process, carry-over rules, commitment controls, and appropriate contingency reserves and related access rules will be defined in early 2013.

39. To maintain the reform momentum in public financial management, the authorities will outline their reform plans for the next three years. Given the wide scope of the public financial management reform agenda, a dedicated report will be prepared by mid-September and attached to the Budget with a view to taking stock of the progress achieved and presenting proposals for the way forward.

Box 4: Government Debt and Fiscal Sustainability in Portugal

Under the Programme scenario, government debt is projected to peak at 118½ percent of GDP in 2013 before starting a gradual decline. The baseline long-term calculations shown below incorporate the Programme scenario up to 2016. The precise calculations for these figures are shown in Table 7 of Annex 2. The turning point is the result of achieving a primary surplus of over 3 percent of GDP, combined with a modest GDP growth. After 2016, it is assumed that: (i) the structural primary fiscal balance remains unchanged at a surplus of 3 percent of GDP; (ii) nominal interest rates are 5 percent; (iii) nominal GDP growth stays close to 4 percent (2 percent growth in volume terms plus 2 percent inflation); (iv) ageing costs are taken into account according to the projections in the forthcoming 2012 Ageing Report of the European Commission; and (v) the expected fiscal impact of PPPs costs and bank recapitalisation costs of EUR 12 billion over the Programme period is factored into the analysis.

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

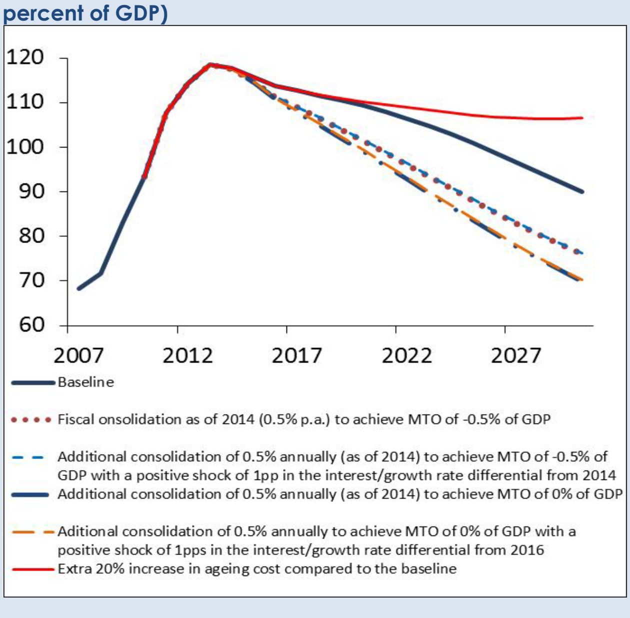


Source: Commission services

Full observance of the Programme plans ensures a gradual decline of the debt ratio over the longer term. A credible consolidation path is self-reinforcing, as it contributes to attaining market access and hence should assure sufficiently low interest rates for the Portuguese government. Nevertheless, for a large number of years the debt ratio would remain higher than before the current crisis. The graphs in this box present a sensitivity analysis with respect to macro-economic risks, the impact of different 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 to macro-economic assumptions by considering a shock to real GDP growth and hikes in interest rates as from 2014. A lower GDP growth rate or a higher interest rate on maturing and new debt by one percentage point would significantly slow down the pace of debt reduction. However, neither of the two shocks would jeopardise the declining debt ratio profile. Nevertheless, a nominal interest rate of about 7 percent as of 2014 would jeopardise the declining debt profile in the medium-term. Conversely, upside risks to growth in the medium-term given the significant structural reform measures already undertaken may result in visibly lower debt-to-GDP ratios and a higher pace of debt reduction.

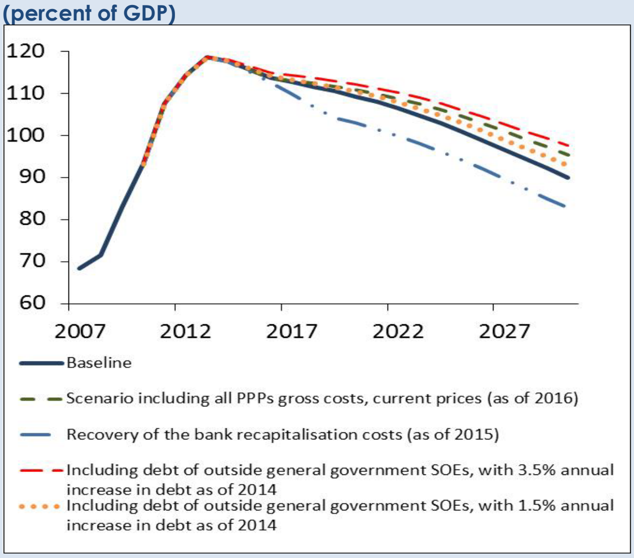
Graph II: Fiscal consolidation and ageing costs (debt as percent of GDP)



Source: Commission services

Additional fiscal consolidation beyond 2014 and the Programme horizon would clearly accelerate the debt reduction path (Graph II). Additional fiscal consolidation of 0.5 pp. annually starting from 2014 would achieve the Medium Term Objective (MTO) of a structural deficit of 0.5 percent by 2015 and would significantly accelerate the fall in the debt-to-GDP ratio, bringing it well below 100 percent by 2020. On the other hand, if ageing costs are allowed to rise significantly (simulated as a 20 percent increase), 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 the general government perimeter (percent of GDP)



Source: Commission services

Graph III illustrates the potential impact of changes in the government perimeter. The inclusion of all gross costs of PPPs and the debt of all state-owned enterprises (SOE) classified outside general government would move government debt noticeably up, especially if further increases in SOE debt are not reined in. On the other hand, privatisation and an effective strategy to reduce SOE debt would contain the budgetary risks from SOE activities. By the same token, a quick repayment of the bank recapitalisation funds to the government would quicken the adjustment towards lower debt-to-GDP ratios.

Overall, the debt sustainability analysis reveals that the debt reduction path of the baseline is robust across a wide range of scenarios. Even in a setting which combines a number of adverse shocks, a solid reduction path is attainable if fiscal constraint is maintained after the end of the Programme period.

Reduction of arrears

40. Payment arrears remain yet to be set on a sustained downward path.[8] Recent data point to a renewed rise in arrears, following their decline at the end of 2011.[9] Although all conditions for applying the commitment controls law[10] are now in place, implementation at all levels of government is not yet fully completed. The Finance Ministry's Directorate General of Budget has organised several information sessions, among others with representatives from other Ministries, the National Health System and SOEs within the government perimeter. More efforts in this area are needed to ensure an adequate level of training across the whole general government. IT systems are being transformed to facilitate compliance with the requirements of the law, but some sectors are still lagging behind. Given the acute necessity to curb the accumulation of arrears in the health sector, provisions are being implemented to adapt the IT systems and improve the reporting and the definition of available funds. A decree-law clarifying the main concepts of the commitment controls law was published[11] and the operational manual is being updated. A technical assistance mission by the IMF and the EC will take place by end-June to support the implementation of the commitment controls law, the definition of availability of funds and the arrears-clearing process.

41. The settlement of the stock of existing arrears has started. In conjunction with a dedicated strategy, the supplementary budget allocated EUR 1.5 billion to the settlement of arrears of the health sector caused by chronic underfunding of this sector through the state budget since 2005. The main creditors and debtors have been identified and payments of arrears are expected to take until August. Negotiations are being centralised to ensure adequate discounts by creditors, although hospitals can also start negotiations individually. The arrears strategy sets a number of prior conditions, notably the implementation of commitment controls and the validation of arrears. The General Inspection of Finances (IGF) audited 62 hospitals and concluded that the regularisation of arrears could start.[12] By 23 May, EUR 26 million had been paid to the main creditors. A new EUR 1 billion credit line of the central government will also help municipalities to reduce their stock of arrears (see below).

[8] The overall figure should be revised downwards by about EUR 500 mn after misreporting (double-counting) has been detected in the health sector.
[9] Latest information shows a continuous rise in arrears between January and May 2012.
[10] Lei n° 8/2012 of 21 February, Diário da República, 1ª série – N° 37.
[11] Decreto-Lei nº 127/2012 of 21 June, Diário da República, 1ª série – Nº 119.
[12] Except for the University Hospital of Coimbra, where the audit could not be finalised.

Revenue Administration

42. The government continues improving its capacity to collect revenues. While proceeding with the consolidation of the merged Tax and Customs Authority (*Autoridade Tributária e Aduaneira,* AT), the authorities will also strengthen the linkages between the revenue collection units of the Social Security and the AT. The analysis of the cost and benefits of the merger of the revenue collection units of the social security and the AT resulted in the recommendation to keep the two institutions separate at this stage and suggested alternative measures to improve synergies in the shorter term. To this end, the government will prepare by August a draft proposal to enhance the exchange of information between both institutions and study ways how to implement the remaining recommendations to improve control and simplify compliance. Furthermore, progress is being made in reducing the number of local tax offices, increasing the workforce devoted to auditing in the tax administration and putting in place a full-fledged Large Taxpayer Office by the end of the year. The ongoing evaluation of more than 5 million properties in 2012 has proven complex but is on schedule. The process is expected to lead to an increase in property tax revenue by around EUR 250 million in 2013, which will be used by municipalities for the consolidation of their budgets.

43. The treatment of tax appeals in the judicial system is being improved. High value tax cases (above EUR 1 million) are especially monitored through a task force of tax judges that is working well. The IT application that allows linking cases and events of the tax administration with those of the Fiscal and Administrative Tribunals is progressing adequately and is expected to be finalised by July. Following some analysis of the impact of VAT issues (i.e. regularisation of bad debt) on backlog enforcement cases, the authorities will prepare by August concrete measures and timelines to reduce this impact, taking into account tax fraud and erosion risks.

44. The tax administration is implementing the strategic plan to combat fraud and evasion for 2012-2014. The authorities have developed a plan to implement VAT e-invoicing in Portugal. The plan consists of five different modules and aims at facilitating compliance and improving control. The investments in IT systems to support some of the measures of this plan have already been made. One of the key elements proposed in the package is to strengthen final consumers' incentives to ask for invoices, notably in hard-to-tax sectors, by allowing tax incentives. Based on a cost-benefit analysis, the government will proceed with the implementation of this scheme in the second half of the year. It will be reviewed early next year to take stock of its costs and benefits.

Regional and local governments

45. Madeira is implementing its adjustment programme broadly in line with the conditions agreed with the central government. The monitoring report on the Economic Adjustment Programme for the Autonomous Region of Madeira shows an overall good compliance, despite some delays, e.g. of the medium-term budgetary framework and the arrears strategy. Some important steps towards fiscal consolidation were introduced, notably by moving tax rates closer to those of the mainland and by reducing expenditure. While the deficit in 2011 was EUR 236 million larger than initially expected, bringing the deficit to 21.7 percent of the regional GDP (up from previously estimated 17.1 percent), budgetary control has improved considerably, not least because Treasury functions are being carried out by the central government. Arrears continued to build up in the first quarter of 2012 which is explained by the delay in providing programme financing. For the clearance of arrears that had built up in the past, the objective is to balance the region's specificities – essentially the large number of small suppliers – with the strategy applied to the rest of the Republic. The Ministry of Finance will provide technical assistance for implementing the law on commitment controls and IGF will reinforce the auditing process in the region.

Box 5: Tax Expenditures in Portugal

The OECD (2010)* defines tax expenditures as "provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax". They can take the form of exemptions (amounts excluded from the tax base), allowances (amounts that can be deducted from the tax base), rate reliefs (reduced rate applied to a category of taxpayers or transactions), tax credits (amounts deducted from the tax liability), and tax deferral (delay in tax payment). Governments introduce tax reliefs for a variety of reasons including to correct market failures or to redistribute income.

Following the inventory on tax expenditures in October 2011, Portuguese authorities prepared a very detailed report. It covers central, regional and local administration taxes susceptible of generating tax expenditures. Tax expenditures are estimated as foregone revenues and quantified by subtracting all forms of tax expenditures from a benchmark for each tax. Whilst the benchmark definition entails a high degree of subjectivity by its nature, it is defined according to general tax principles, such as universality and equity of the tax system. According to this methodology, the report provides detailed information on the amounts of the different types of tax expenditures and on their objectives or functions. Tax expenditures are quantified by tax category for the years 2010, 2011 and 2012.

The report estimates the revenue forgone due to tax expenditures (despesa fiscal) in 2010, for all taxes, at EUR 15.2 billion, or 8.8 percent of GDP (see Table I), which is more than double the average of 4.2 percent of GDP for a sample of seven OECD countries.** International comparisons are inherently difficult to perform in this area given the subjectivity attached to the definition of the benchmark, the arbitrariness in the categorisation of types of tax expenditures and other methodological discrepancies. Nonetheless, one can say that Portugal's recent methodology for estimating tax expenditures falls within international best practices. And caveats notwithstanding, the above indicator supports the general belief that the Portuguese tax system has been characterised until recently by the extensive use of special provisions or tax expenditures.

Table I - Tax expenditures by tax

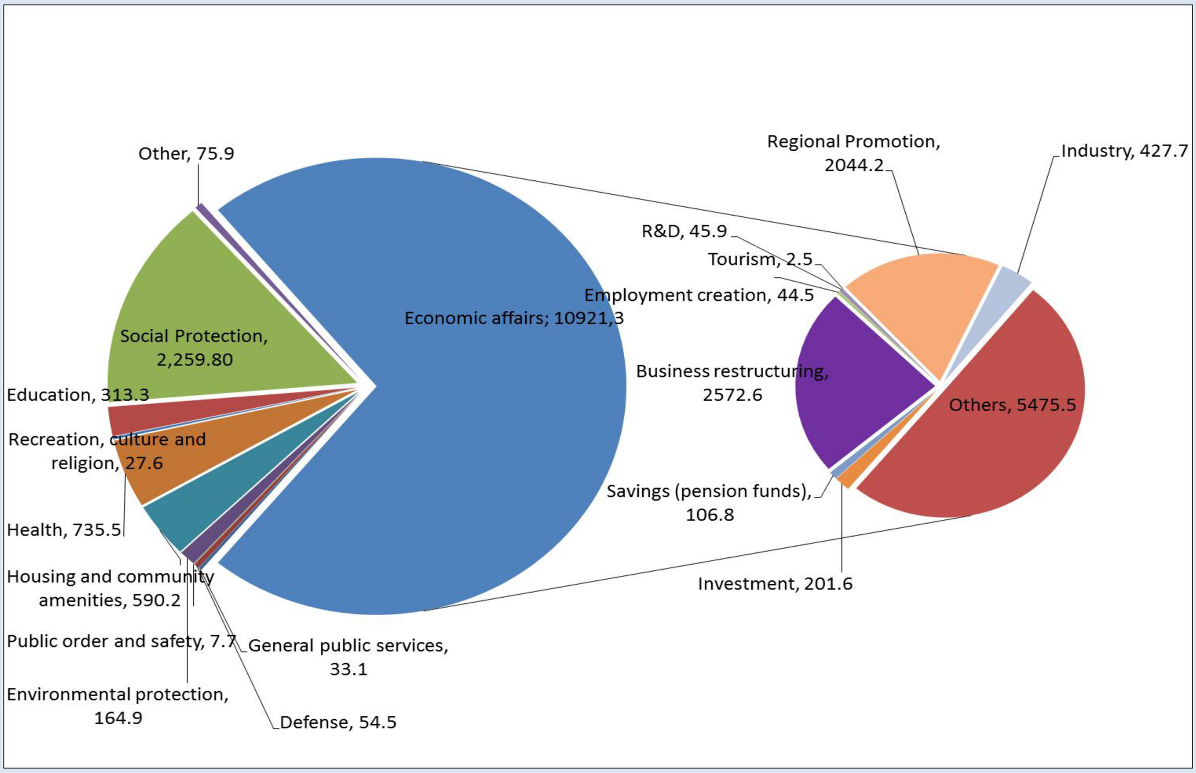
Tax	(EUR millions)			Difference in levels	(% of GDP)		
	2010	2011 (P)	2012 (P)	2010/2012	2010	2011 (P)	2012 (P)
VAT	5304.7	6017.8	4280.0	-19.3	3.1	3.5	2.6
PIT	3969.7	3746.1	3095.1	-22.0	2.3	2.2	1.9
CIT	4585.6	2439.4	1281.3	-72.1	2.7	1.4	0.8
Oil	658.1	392.7	375.4	-43.0	0.4	0.2	0.2
Vehicles	474.7	373.2	341.1	-28.1	0.3	0.2	0.2
Alcohol	127.7	107.9	111.3	-12.8	0.1	0.1	0.1
Tobacco	44.9	42.0	48.2	7.3	0.0	0.0	0.0
Stamp	11.0	13.7	14.4	30.9	0.0	0.0	0.0
Circulation	6.7	7.3	8.0	19.4	0.0	0.0	0.0
Total	**15183.4**	**13125.6**	**9554.8**	-37.1	**8.8**	**7.7**	**5.7**

Note: (P)… projected
Source: Tax expenditure report, Portugal 2012

The numerous allowances and exemptions existent in the Portuguese fiscal system were introduced for economic, social and cultural reasons (see Graph I). However, it is unclear whether these objectives were achieved in the most efficient way, as, in many cases, tax expenditures only add complexity to the tax system, increasing administrative burden and compliance costs. They can also generate deadweight losses by distorting resource allocation, encouraging and rewarding rent-seeking across economic activities for tax purposes, as well as increasing tax evasion and avoidance. Finally, though some special provisions are motivated by equity goals, others may induce regressive impacts, insofar as many tax expenditures benefit high-income groups (e.g. tax relief on mortgage interest) and introduce tax avoidance instruments for top-income earners. On the other hand, tax expenditures may be of value, for example, for R&D or training, but they should be limited in scope, clearly defined and minimise distortions.

Following the above policy line, tax expenditures have substantially declined over the past two years in Portugal, supporting the broadening of tax bases and the fiscal consolidation process. This will also likely eliminate some distortions in resource allocation, resulting in a simpler and more efficient tax system. Tax expenditures reached EUR 13 125.6 million or 7.7 percent of GDP in 2011 and EUR 9 554.8 million or 5.7 percent of GDP in 2012 (see Table I). By tax, the most significant curbs of tax expenditures over the last two years have occurred in the Corporate Income Tax (CIT, 72 percent), oil tax (43 percent), Personal Income Tax (PIT, 22 percent) and VAT (19 percent). A closer look indicates that the reduction of tax expenditures in the Corporate Income Tax mostly comes from abolishing reduced rates and more importantly from abolishing tax exemptions (about EUR 3 billion since 2010), thereby fulfilling the objective of streamlining the taxation of corporate income. In VAT tax expenditures were cut via the reduction of goods subject to reduced rates. In particular, energy products are now subject to the VAT standard rate. In Personal Income Tax the largest drop in absolute terms was achieved through reductions in tax credits, such as health expenses and health insurance premiums as well as tax credits and deductions for housing loans, repayments of capital and rental payments (about EUR 800 million cuts in PIT tax expenditures since 2010).

Graph I: Tax expenditures by function in 2010 (million euros)



Going forward, the authorities will assess whether each tax expenditure is fulfilling the objectives for which it was created, evaluating whether its benefits actually outweigh its fiscal and economic costs and whether the objectives could be reached at lower costs via measures on the expenditure side of the budget. This assessment will serve as a basis for better targeting tax expenditures in the future even if effort has already started. The evaluation methodology should be transparent and also follow international best practices. The estimation and assessment of all tax expenditures should be done periodically and will be completed for the first time for the 2013 budget.

* OECD(2010): "Tax Expenditures in OECD Countries".

** Unweighted average of values reported for the latest actual year available (from 2004 to 2008) by Canada, Germany, Korea, the Netherlands, Spain, UK and USA.

46. A range of measures has been launched to strengthen fiscal consolidation and public finance management also at the local level. These measures include the reduction of the high number of parishes, a draft law on local public enterprises, a draft law on the number of managers and administrative units in municipalities, and the implementation of the law on commitment controls at local level (see above). Given the high degree of political autonomy granted to local governments by the Portuguese Constitution, this process is politically and legally challenging. In addition, many of the 308 municipalities are in a difficult financial situation, with 53 of them in a situation of structural financial imbalance which jeopardises the provision of public services.[13] For these reasons, a 'Support Programme for the Local Economy' (PAEL) was agreed at the end of May 2012 between the central government and the National Association of Municipalities (ANMP) which covers many of the above issues and provides a credit line of EUR 1 billion to settle arrears and short term debt, subject to specified eligibility criteria and conditions (see Box for further details).

[13] The total debt of municipalities is EUR 8 billion, of which about EUR 1.6 billion of arrears. The conditions for structural financial imbalance are described in Article 9 of DL n° 38/2008 of 7 March.

47. The law on the administrative reorganisation of local entities[14] entered into force, paving the way for reducing the number of parishes from currently 4529 by 25 to 30 percent. The merger of parishes will be structured around some clearly defined criteria such as population, economic activity and infrastructure. A technical unit in the Parliament will be created to assist the process. Municipalities can present their proposal of merging parishes to the Parliament until the end of August. The Parliament with the assistance of the technical unit will then have one month to approve it or present a counter-proposal. The reorganisation of parishes will be completed before the next local elections scheduled for 2013.

48. The revision of the local and regional finance laws is in progress. A working group including the various levels of government and external experts is preparing a draft revision of the laws by end-June. In addition to this process, the authorities will create a working group to propose common revenue forecasting guidelines for subnational governments ahead of the 2013 budgetary exercise. Data requirements to support the revenue projections will be identified, balancing the need to preserve tax secrecy and the elaboration of sound revenue forecasts.

49. The law on the administrative reorganisation of local entities[15] entered into force, paving the way for reducing the number of parishes from currently 4529 by 25 to 30 percent. The merger of parishes will be structured around some clearly defined criteria such as population, economic activity and infrastructure. A technical unit in the Parliament will be created to assist the process. Municipalities can present their proposal of merging parishes to the Parliament until the end of August. The Parliament with the assistance of the technical unit will then have one month to approve it or present a counter-proposal. The reorganisation of parishes will be completed before the next local elections scheduled for 2013.

Box 6: The Support Programme for the Local Economy (PAEL)

At the end of May 2012, the government and the Association of Municipalities (ANMP) agreed on a Memorandum of Understanding (MoU) in which the municipalities and the State agree to work together to achieve the objectives regarding local administrations that Portugal has committed to in the EU/IMF adjustment programme. One of the instruments that will support this close cooperation is the creation of a credit line of EUR 1 billion to the municipalities for servicing short-term debt and the settlement of arrears (PAEL). This is expected to stimulate the local economy by increasing the liquidity of local suppliers. The PAEL, which will be formalised through the signature of a contract between each municipality and the State, includes a number of general commitments by the signatory parties which will be monitored by the central administration during the execution of the contract. In particular, local entities will ensure the application of the law on commitment controls, facilitate inspections by auditors (IGF) and the Directorate-General for Local Affairs (DGAL) will develop a dedicated manual that will take into account the specificities of municipalities concerning the implementation of the law on commitment controls.

The MoU also states that local authorities will work towards reducing the number of parishes, as well as cooperate in the legislative reforms needed to fulfil the State's commitments in the EU/IMF adjustment programme. In addition, municipalities will contribute to the costs of the ongoing evaluation of property that will lead to an increase in property tax revenues (IMI) as specified in the law. In return, the corresponding increase in IMI receipts of around EUR 250 million in 2013 will accrue entirely to the local authorities for the purpose of fiscal consolidation. EU Structural Funds will be reallocated to promote youth employment and school equipment. The government will prepare by July a document indicating the procedures and responsible administrative units for monitoring, controlling and auditing this programme.

An annex to the MoU further specifies the eligibility criteria and conditions for access to the PAEL. These distinguish between municipalities with a structural financial imbalance ('Programme I'), which have to meet tougher conditions, including raising fees and tax rates (e.g. IMI) to the maximum, and other municipalities with a temporary financial imbalance ('Programme II'). The 53 municipalities under 'Programme I' have about EUR 555 million of arrears. They have to present detailed adjustment programmes to ensure fiscal sustainability in the longer term, including specific measures to reduce expenditure and increase revenues. The 255 municipalities falling under 'Programme II', with about EUR 936 million of arrears, have to present a simplified adjustment programme and consolidation measures. The payments of arrears, in compliance with the principles laid down in the general strategy for the settlement of arrears, are released in three instalments for 'Programme I' municipalities for a maximum maturity of 20 years and in two instalments for 'Programme II' municipalities for a maximum of 14 years. The interest rate of the loans corresponds to 15 basis points above the rate paid by the central government.

[14] Lei n° 22/2012 of 30 May, Diário da República, 1ª série – N° 105

[15] Lei n° 22/2012 of 30 May, Diário da República, 1ª série – N° 105

50. The revision of the local and regional finance laws is in progress. A working group including the various levels of government and external experts is preparing a draft revision of the laws by end-June. In addition to this process, the authorities will create a working group to propose common revenue forecasting guidelines for subnational governments ahead of the 2013 budgetary exercise. Data requirements to support the revenue projections will be identified, balancing the need to preserve tax secrecy and the elaboration of sound revenue forecasts.

Streamlining the public sector

51. Advances in the reorganisation of the public sector are noticeable, going beyond the Programme requirements in some areas. Detailed and complete statistics on public employment in the first quarter of 2012 compared with end-2011 were published for the first time in May (see Box 7). This is an important step towards streamlining the public administration as data can be used to monitor the stock and flows of employees across different sectors of the public administration and review wage scales. The implementation of the Public Administration Restructuring Programme (PREMAC) to reduce the number of management positions and administrative units by 27 percent and 40 percent, respectively, is progressing smoothly and will be fully completed by September. The compulsory census of foundations was completed in February. A task force under the coordination of IGF has been created to evaluate their costs and benefits with a view to supporting decisions on whether they ought to be closed or continued.

52. The regime of public employment is being reformed in line with the Labour Code for the private sector. The reform includes (i) more flexible working time arrangements; (ii) a 50 percent reduction of compensation for extra time work; (iii) a reduction of holidays as applied in the private sector; (iv) an elimination of compensatory resting time; (v) an application of the student-worker regime; and (vi) new rules of compensation for the termination of temporary contracts as in the private sector Labour Code. In addition, a scheme is being designed to promote mobility between branches of the same public service without distance limit and between different services within a 60 km limit. A protocol signed with 12 academic institutions will grant top managers and public employees a 25 percent fee reduction for masters and post-graduate studies.

SOEs, PPPs and privatisations

53. Progress towards reaching operational balance, on aggregate, by the end of the year is well on schedule. Data for the first quarter of 2012 show an operational deficit of EUR 1 million compared with EUR 40 million a year earlier.[16] In contrast, financial results worsened due to higher interest rates and interest swap losses. SOEs' total debt reached about EUR 30 billion in the first quarter, nearly 5 percent higher than a year earlier. A comprehensive strategy to deal with all SOEs debt is therefore warranted and will be prepared by July. The strategy will also cover the state holding Parpública, for which the authorities presented already in April options how to unwind it.

54. SOEs' governance will be strengthened. The draft law, soon to be submitted to Parliament, distinguishes between commercial and non-commercial public enterprises. The former are subject to market discipline and competition whereas the latter receive public support, on the basis of a programme contract, for providing a public service. In both cases, the powers of the Ministry of Finance in the management process have been strengthened. Notably, a dedicated Technical Unit will be created to support the management of SOEs, closely monitor their financial and operational developments and provide an ex-ante opinion on whether the creation of any new SOE is in the public interest. The law applies to central and local SOEs (the latter within constitutional limits) and the government will encourage the autonomous regions to implement similar requirements.

[16] Data exclude health sector SOEs, Estradas de Portugal and Parpública. The latter reported operational surpluses in the first quarter, whereas the health sector SOEs' operational balance deteriorated.

Box 7: Employment in the Public Sector

The MoU has a number of conditions related to employment in the public sector. Staff admissions in public administration should be limited to achieve annual staff decreases in 2012-2014 of 2 percent per year in the central administration and in local and regional administrations (in full-time equivalents). The government should ensure the implementation of this measure at local administration level and promote the initiatives needed so that each region will present its plan to achieve the same target. By the end of this year, the government should prepare a comprehensive review of wage scales in the general government, to identify unwarranted differences in remuneration between the public and the private sector for similar qualifications.

Table I - Employment in public administrations by subsector

	Employment		
	Dec. 2011 *('000)*	March 2012 *('000)*	*(change in %)*
Central	457.2	454.6	-0.6
- of which: education and science	235.8	235.7	0.0
Azores	14.7	14.6	-1.2
Madeira	17.3	17.2	-0.3
Local	122.2	122.4	0.1
Total	**611.4**	**608.7**	**-0.4**

Source: Portuguese government - Directorate-General for administration and public employment

To monitor the implementation of these objectives, the government created a legal basis in November 2011 to re-design the 'Information System on the Organisation of the State' (SIOE). For the first time, Portugal now has a tool that ensures the collection of information essential to monitor the evolution of human resources of General Government entities.The SIOE allows providing data on the human resources of the State on a quarterly basis, starting from the last quarter of 2011 onwards. These cover all integrated services, autonomous services and funds, Social Security Funds, and non-profit institutions of central, regional and local administrations. State-owned enterprises within the general government perimeter at central and regional level are also included. Additional protocols have been signed with the Autonomous Regions and with the representatives of municipalities in order to ensure the data reporting. In order to guarantee the timely and accurate report by the reporting entities, the law foresees sanctions such as the retention of 10 percent of transfers from the State Budget. The SIOE is managed by the Directorate-General for Administration and Public Employment (DGAEP) in the Ministry of Finance

On 15 May 2012 the first official report on the first quarter of 2012 was published, and subsequent reports will be published 45 days after the end of each quarter. At the end of 2011, the public administration employed 611,415 persons which represented 11.1 percent of the active population and 12.9 percent of all employed. The central administration had a share of about 75 percent, the administrations of Madeira and Azores together of about 5 percent and the local administration of about 20 percent. By the end of the first quarter of 2011, employment in public administration had been -0.4 percent lower compared with the end of 2011, with all administrative levels contributing to the reduction except for the local level which had remained broadly stable. In terms of status, about 84 percent of the employees in central administration (including state-owned enterprises) had an open-ended contract and about 16 percent a fixed-term contract. The database also provides information about employment by functions which is largest for teachers (about 150,000), technical and administrative assistants (about 83,000), higher technicians and security/police (more than 50,000 respectively). Furthermore, salaries of full-time employees are presented which are on average EUR 1,600 in January 2012, varying between about EUR 4,300 for judges and EUR 760 for operational assistants.

Table II - Flows of entries and departures of employees by ministries and main reasons

	Entries (E)		Departures (D)		Balance (E-D)	
	total	of which: new recruitment	total	of which: definitive departures	total	of which: new recruitment less definitive departures
Education and science	6507	4060	6000	4384	507	-324
Health*	4276	1255	3694	2083	582	-828
Defence	971	554	1365	939	-394	-385
Other	1647	241	2692	1213	-1045	-972
Total	**13401**	**6110**	**13751**	**8619**	**-350**	**-2509**

Source: Portuguese government - Directorate-General for administration and public employment
Note: * includes public enterprises (EPEs)

55. The privatisation programme is broadly on track. The sales of government stakes in the energy companies Energias de Portugal (EDP) and Redes Energéticas Nacionais (REN) have been completed yielding about EUR 3.3 billion of proceeds. The direct sale of CGD's insurance arm (Caixa Seguros) to a final buyer is expected to take place in 2012. The tender for the privatisation of the national air carrier (TAP) and the airport operator Aeroportos de Portugal (ANA) will be launched in the third quarter, with a view to completing these transactions in early 2013. The privatisations of the cargo handling subsidiary of the rail company CP (CP Carga) and of mail company Correios de Portugal (CTT) are foreseen in 2013. The partial sale of the public television channel (RTP) and private concessions are being considered for transport services in Lisbon and Porto upon completion of restructuring of the public transport firms in these cities. For the public utilities company Águas de Portugal (AdP) an assessment of the scope for introducing private capital and management and privatising waste management functions is being carried out. Throughout the process, the authorities remain committed to consult the European Commission to ensure respect of competition and state aid rules.

56. The legal and institutional framework for PPPs has been reinforced with a view to containing fiscal risks. The new regime[17] imposes stricter requirements on the public partner at the launching and execution stage regarding budgetary effects and the evaluation of the costs and benefits of a PPP. The scope of 'public partners' has also been enlarged to cover all SOEs and other entities such as Services and Autonomous Funds. A new Technical Unit within the Ministry of Finance will have a decisive role insofar as it will supervise all the stages of a PPP from inception to extinction. The Technical Unit will monitor the execution of the PPP contract and identify any situation which may worsen the public sector's financial position. As opposed to past practices, all relevant documents will be publicly available. Regions will be encouraged to design a framework with similar requirements. The new regime is expected to end with malpractices and legal uncertainties in PPP arrangements which have led to a substantial financial burden for the taxpayer. For instance, the Court of Auditors recently contested the legal validity of side contracts, with financial obligations for the State exceeding EUR 700 million, in the context of the renegotiation of some road PPP contracts.

57. An international consultancy is auditing 36 PPP contracts and the final study is expected by end-June. The study will assess the costs and benefits of renegotiating PPPs contracts to reduce the government's financial obligations. For certain PPPs and concession contracts, the renegotiation process has already started before the completion of the study, due to financial or legal imperatives.

Healthcare sector

58. The past three months have been dedicated to deepen and fine-tune policies in the area of pharmaceuticals in order to attain the expenditure target of 1.25 percent of GDP for 2012. Authorities have implemented a wide set of measures, including compulsory e-prescription, changes in distribution mark-ups, changes of countries used in the international reference price system and in the pricing of generics. All these measures are leading to a reduction in prices and the removal of administrative and legal hurdles to entry for generics. More recently, compulsory INN (active substance) prescription has been legislated and is now under implementation, together with prescription guidelines and regular monitoring of prescription behaviour and feedback to physicians. These measures should ensure a more rational use of medicines and a greater use of generics and realise additional savings to those already made in 2011. They are complemented by an agreement with the pharmaceutical industry setting the target of reducing expenditure by 300 million EUR in 2012. All these measures are likely to ensure that the MoU target for 2012, i.e. 1.25 percent of GDP for public pharmaceutical expenditure, can be attained. The priority is now to ensure the full implementation of the measures and assess their impact on volume, value and market share of generics.

59. Greater focus is now being placed on the hospital sector as authorities are to implement strategies for paying arrears and optimising the existing hospital network. Several measures have been put in place to reduce operational costs in hospitals. In addition to the reduction in base wages and overtime pay, hospitals are reorganising working schedules to reduce total overtime, optimising the utilisation of diagnostic and treatment capacity in order to reduce sub-contracting of private providers, and making greater use of centralised procurement of medical supplies. Moreover, several hospitals have been merged into existing hospital groups, which should lead to the concentration of medical departments and laboratories and the reduction of excess capacity. These measures should ensure that the target of a 15 percent reduction in operational costs from 2011-

[17] Decreto Lei N° 111/2012, of 23 May, Diário da República, 1ª série – N° 100

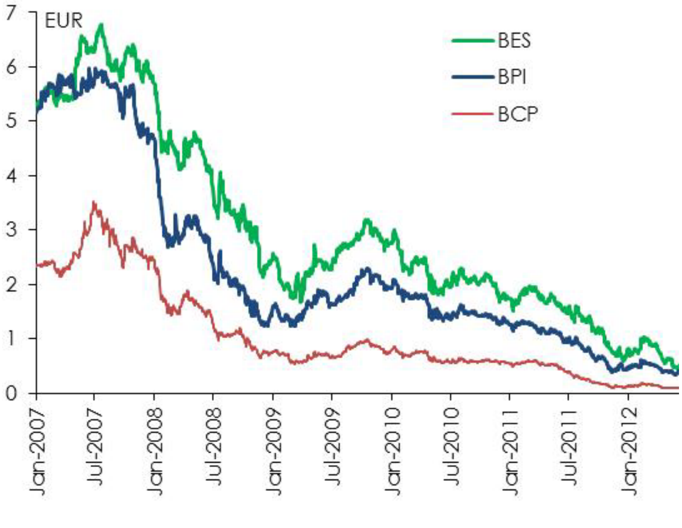
2013 is achieved. However, the closure of obsolete hospitals is lagging behind schedule. Hospitals are also implementing the law on commitment controls and started to settle arrears (see section on arrears above). Further reforms are, nonetheless, necessary to ensure that the efficiency goals are attained and new arrears do not build up. These include: legislative changes to increase flexibility and mobility of health staff within and between regions and changes in the implementation of hospital budgeting procedures. Moreover, it is important to recognise good performers notably through the implementation of benchmarking along a number of dimensions.

FINANCIAL SECTOR

60. The further reinforcement of Portuguese banks' solvency ratios remains crucial. Following successful efforts to meet by end-2011 the 9 percent Core Tier 1[18] (CT1) requirement under the Programme, banks need to raise further capital to comply with the European Banking Authority's (EBA) requirements by end-June. The regulatory capital by end-June will incorporate the impact of the transfer of banks' pension funds to the public social security system, as well as the results of the special on-site inspection programme (SIP). A detailed analysis of the asset book values and their risk-weighting on the quality of banks' assets led to a moderate 0.3 percentage points decrease in the sector's CT1 ratio to 8.8 percent, equivalent to an additional capital need of EUR 0.5 billion for the sector. The SIP also resulted in a specific recommendation to the eight biggest banks to adapt their stress test models. The reinforcement of the banks' capital ratio to levels at par with international peers ensures a higher degree of stability of the Portuguese financial system as a whole, given the intensification of credit and market risk.

61. To comply with the rules, banks' capital base will be strengthened by about EUR 7.5 billion in the second quarter. This represents a considerable reinforcement of about 25 percent of the banks' CT1 capital, with the funds coming from both public and private sources. Espírito Santo Financial Group (ESFG) concluded a EUR 500 million capital increase by en-April and its banking subsidiary Banco Espírito Santo (BES) successfully issued EUR 1 billion to its existing shareholders in May 2012. Similar share price developments are observed for the other major Portuguese banks reflecting the bleak earning prospects in the upcoming years and the conditions under which the state is likely to participate in the capital as specified in the recapitalisation scheme recently adopted in Portugal. Given the nature of the shortfall, strongly related to the sovereign buffer required by the EBA exercise, Banco Comercial Português (BCP) and Banco Português de Investimento (BPI) will have to rely to a large extent on public funds provided by the Bank Solvency Support Facility (BSSF), the assistance Programme's back-stop facility containing EUR 12 billion, but will endeavour during the second half of the year to replace part of the funding from the BSSF by private capital. The recapitalisation of the state-owned Caixa Geral de Depósitos (CGD) will be funded directly via the state budget.

Graph 7: Major listed banks' share price developments



Source: Reuters

62. The government recapitalisation is limited to viable banks in line with EU competition rules. A ministerial ordinance stipulates that a restructuring plan has to be submitted and specifies the capital instruments that can be used (equity in the form of preferred shares and hybrids, such as contingent convertible bonds, eligible as CT1), the entry and exit price, the remuneration and the rights attached to the state's participation. If the share of the state exceeds 50 percent of the capital, voting rights will be granted. The discount for shares bought by the state will be at least 35 percent for non-voting shares and 25 percent for voting shares. The exit price is to be fixed by internationally recognised experts. The

[18] The definition of Core Tier 1 ratio in the Programme differs from the EBA definition, which is narrower. Thus, in general plans to meet the EBA CT1 ratio of 9 percent will allow banks to also meet the 10 percent CT1 ratio required by the Programme.

decree spells out that remuneration will be in line with state aid rules. For hybrids, the initial remuneration is between 7 percent and 9.3 percent, depending on the features of the instruments, and will include step-ups to encourage exit. If the payment of the coupon of the hybrids is not possible in cash, shares will be offered. The capital injection is for a maximum of 5 years, but a buy-back clause allows for early repayment of the state aid. During the period of public investment, the bank is expected to make a contribution to the financing of the economy, in particular SMEs and households. Furthermore, the remuneration of board members cannot be higher than 50 percent of the average level earned in the two years preceding the public capital injection.

63. The sale of Banco Português de Negócios (BPN) was completed in March. The European Commission ruled that the sale of BPN complied with EU competition and state aid rules. The three special purpose vehicles that took over BPN's bad loans in 2010 have failed to recover any significant amounts from these assets so far. Collateral value is continuously decreasing and the government intends to outsource the management of the assets to a professional third party with a mandate to gradually recover the assets over time. The party managing the assets will be selected through a competitive bidding process and the mandate will include proper incentives to optimise the recoveries. CGD's exposure to BPN has been replaced by exposure to the SPVs. CGD's partially state-guaranteed claims on these SPVs will be settled in cash over time. CGD pursues its divestment plans from non-strategic assets and the planned sale of its insurance and health arm.

64. Crisis management measures are being taken, in particular regarding an early intervention and resolution framework. By July 2012, a resolution fund will be set up and supervisory notices on recovery plans (an element of the early intervention measures) will be finalised. Rules applicable to the setting-up and the operation of bridge banks[19] in line with EU competitions rules will be adopted by end-September 2012, while for resolution plans the deadline is end-October 2012. Portugal has committed to revising the national framework when the EU Directive on resolution becomes available in its definitive form.

65. The indebtedness of the private sector is monitored continuously. BdP figures show a slight progress in the deleveraging of households with a decline in the debt-to-GDP ratio from 94.3 percent at the end of 2010 to 92.4 percent at the end of 2011 driven in particular by a reduction in mortgage loans. A report is being prepared assessing the effectiveness and impact of existing support mechanisms to SMEs with a view to facilitating their access to credit and improving competitiveness, but progress since the last review has been slow. Furthermore, a framework is being established for out-of-court debt restructuring for households and for viable SMEs.

STRUCTURAL REFORMS

Labour market

66. The revised Labour Code has been approved by Parliament and published in the Official Gazette. The main changes include an alignment of severance payments of current employees with those of new hires, an easing of the definition of individual fair dismissals, an increase in the flexibility of working time, and a larger scope for collective bargaining at firm level. The legislation will enter into force on 1 August. In addition, two decree-laws revising the unemployment insurance system entered into force on 1 April.

67. The authorities are working on proposals to align severance payments to the EU average and to define the setup of a fund to finance part of severance payments. The government has prepared a study where it presents a comprehensive survey of severance pay systems in the EU-27. The findings of the study regarding EU-wide practices are similar to those indicated in the MoU. As for the compensation fund, preliminary drafts were discussed in previous review missions, but further progress has been slow and a proposal for setting up the fund is not yet finalised. Both the new level of severance payments and the fund are expected to enter into force by 1 November 2012.

68. A proposal for revising the mechanism for extending collective agreements is under preparation. Currently collective agreements are extended to non-signatory firms in the sector in an almost automatic manner. The agreed conditionality requested the definition of criteria for extending collective agreements. As a necessary condition for extension, a collective agreement must cover at least 50 percent of workers in a sector (i.e. a majority of workers in the sector is employed in firms affiliated to the negotiating employers'

[19] A bridge banks hosts the good assets or essential functions of a failing bank amidst a resolution procedure. It is extinguished e.g. by being sold to another institution.

association). Other quantitative and qualitative considerations will need to be taken into account before the extension when the 50 percent threshold is reached. The date for submitting legislation to Parliament was extended by one quarter to September 2012.

69. The government has granted 12 extensions of collective agreements. These agreements were concluded in the first half of 2011 and the notice for extension had been published in that period. To limit their impact, these extensions will affect wages only after the publication date. Data on the representativeness of these collective contracts submitted by the authorities indicate that of the 12 agreements 7 reach the 50 percent representativeness threshold requested by the MoU. The estimated impact on the wages of workers initially not covered is substantial in a number of cases. Looking forward, systematic provision of data on the representativeness and wage effects of the extension of collective agreements is needed.

70. Work proceeds to improve activation and other active labour market policies. An evaluation study and an action plan to improve the system will be ready by June. In the meantime, the government published a plan to restructure the Public Employment Services (PES) and implemented a wage subsidy scheme for unemployed registered with PES for more than 6 months (*Estímulo 2012*). This programme started in February and has placed around 2000 unemployed until May. The plan also foresees a more rapid response from the services in activating unemployed after registration with the PES. The programme *Vida Ativa* aims at assigning the unemployed to short-term training initiatives, according to their schooling levels, within 45 days after registration with PES. In addition, the unemployed registered with PES for more than 6 months will be entitled, under specific circumstances, to accumulate unemployment benefits with full time work during a certain period of time in case they accept a job offer below the unemployment benefits. A programme – *Impulso Jovem* – has been launched to tackle youth unemployment. It aims to reach 90,000 young unemployed through traineeships, training programmes, schemes for reimbursement of social security contributions, entrepreneurships and financial support to SMEs. The government has proposed a major reprogramming exercise of the EU Structural Funds with a view to mobilising EUR 344 million for this programme.

71. The government has proposed a targeted reduction in social security contributions. It consists of a reduction of 90 percent of the *Taxa Social Única* paid by the employer up to a maximum of EUR 175 per month per new employee aged 18-30 who was unemployed for more than one year. This fiscal advantage is limited to a maximum period of 18 months and subject to the net creation of employment. The total cost will be around EUR 42.6 million from which EUR 29.8 million are proposed to be financed by the European Social Fund through the above-mentioned reprogramming in favour of the programme *Impulso Jovem*. In addition, the government is exploring the possibilities of a deficit-neutral reduction in the employers' social security contribution rate for specific segments of the labour market. Specific proposals for a cut equivalent to about 0.5 percent of GDP in the context of the 2013 budget preparation will be put forward at the next review.

Education

72. The authorities have developed an improved tool for monitoring education outcomes. This information system will cover all public and private schools and each student will have an identification number. The tool will serve to analyse and inform the decision making and evaluate the impact of policy decisions. It is expected to be fully operational before the start of the school year 2012-2013.

73. To improve the quality of secondary education the government presented a detailed action plan. The number of schools under autonomy agreements is expected to increase from 22 currently to 150 by 2015. For this purpose, a new ordinance has been prepared reinforcing the school autonomy and school autonomy agreements. New agreements and renewals of previous autonomy agreements will take into consideration performance evaluation and accountability. A study is carried out to define the cost per student in public schools. The results will serve as a basis for establishing a performance-based finance mechanism in both public and private schools under autonomy agreements. The role of the General Inspectorate underwent considerable changes. A report assessing the performance of the system will be produced.

74. To improve the quality and attractiveness of education and vocational training the government presented a detailed action plan. The system will comprise four main axes: (i) Review of current vocational education and training offers to eliminate overlaps and align it to labour market needs. (ii) Creation of professional schools of reference. The project is expected to be ready for implementation in mid-2013 and will benefit from partnerships with employers and employers' associations. (iii) Implementation of a network of vocational centres. (iv) Incentives for companies to create openings for job training and apprenticeships.

Housing market

75. The reform of the housing rental market was adopted by the Parliament on 1 June and will enter into force in October. The main elements of the proposal put forward by the government have been left unchanged. The new legal framework balances rights and obligations of landlords and tenants and phases out within a transitory period of maximum 5 years the old system of open-ended leases signed before the 1990s in which rents were frozen and contracts could not be terminated by landlords. It also provides for an updating of rents and more flexibility in the choice of contract duration, sets incentives for renovation - the compensation to be paid by the landlord for the early termination of the contract, albeit higher than the value initially proposed by the government, was set at half of the value stipulated by the previous law - and provides a new and fast extrajudicial eviction procedure. A new law which simplifies administrative procedures was adopted as part of the same package. This reform is expected to make the housing market more dynamic. An assessment of its functioning under the new legal framework will be carried out by end-June 2013. Meanwhile, the government is progressing in revising the taxable value of the housing stock for tax purposes. The value of almost all the housing stock is expected to be updated by the end of the year. The increase in revenues is forecasted to be close to EUR 700 million (to EUR 1.9 billion) at the end of a transition period of 3 years. Progress on the gradual rebalancing of property taxation from the transfer tax (IMT) towards the recurrent real estate tax (IMI) as envisaged by the MoU is expected in the next budget.

Judicial system

76. Reforms in the judicial sector are, in principle, on schedule. Adjustments to the MoU reflect the successful completion of a number of measures or the follow-up to the elaboration of reform plans and road maps. The corporate insolvency law amendments to support better early rescue of viable firms entered into force on May 2012. The target to resolve the case backlog appears on track with a task force to expedite the backlog resolution being set up, quarterly monitoring put in place, and regulations adopted to ensure the oversight body's full access to the enforcement case files and tighter supervision of enforcement agents. Since the third review, an additional 20 000 enforcement cases have been cleared, bringing the total number of enforcement cases down by about 70 000 since November 2011. Concerning courts' organisation, the roadmap on judicial reform presented in January 2012 identifies quarterly milestones to reduce the number of court districts and close down underutilised courts and includes an efficient management of the court system (10 court sections have already been closed since November 2011). Following the international seminar organised by the Portuguese government in April 2012 with IMF and EC Technical Assistance, a revised roadmap is currently being prepared. The Portuguese government has made significant progress in strengthening alternative dispute resolution to facilitate out-of-court settlement. After adoption of a law on arbitration on November 2011, the authorities have taken the necessary legal, administrative and other steps to make arbitration fully operational ahead of the deadline.

77. The organisation of the court system is becoming more efficient. Specialised courts on competition matters and on intellectual property rights have become operational. A task force of tax judges has been established to facilitate the resolution of outstanding tax cases and has been working at an increased pace. Concerning the review of the Code of Civil Procedure, the government has prepared a bold proposal to speed up the judicial process. The government is currently reviewing the initial proposal, in consultations with stakeholders, in order to implement an even more ambitious reform including through expert meetings to be held at the end of July with IMF and EC Technical Assistance. In this context, both the judicial map and the Code of Civil Procedure reforms will be discussed.

Energy

78. Some progress has been made in reducing rents in the electricity sector, thereby alleviating the pressure on end-user electricity prices. A state of play was presented at the occasion of the review mission on the various measures proposed by the government to tackle excessive rents and the energy tariff deficit. The government had nominated for the negotiations the Secretary of State for Energy advised by two experts. Estimations of the total cost reduction are in the range of EUR 1.18 – 1.35 billion in Net Present Value (NPV) terms, but the exact results depend on the success of ongoing negotiations with various stakeholders. As there is a need for a comprehensive assessment of the reform once all outstanding measures have been implemented the revised MoU contains some specific measures for the next review. In particular:

- The ordinary (CMEC) scheme is one of the main factors behind the continued build-up of the tariff deficit. The government has committed to reduce the CMEC annuity discount rate from 7.55 percent to 5 percent (yielding a NPV of EUR 120 million) and to negotiate a compensation for the extension of exploitation licences of the power plants in Sines (yielding a NPV of EUR 55-75 million) and in Pego (EUR 30-50 million). These results do not fully comply with the requirements of the MoU which postulate that the rate of return should be brought in line with the cost of capital. An additional report detailing and assessing all elements of the CMEC scheme and also describing the process for the extension of the concession of the public hydro resources to existing contract holders should be delivered by September 2012.
- Investment incentives granted retroactively (i.e. prior to 2007, when the concept of the mechanism was first legislated) have been withdrawn with Executive Order 139/2012. In forthcoming legislation, the government will redesign the investment incentives for future installed capacity to take into account security of supply levels and the existence of other mechanisms, such as the interruptibility service. The details of the latter are crucial to assess the total amount of cost reductions and will be assessed in the next review. Estimates show annual amounts ranging from EUR 37 million in the first year to EUR 64 million in 2014 and decreasing to EUR 25 million by 2020.
- A revision of the support-scheme for co-generation (under the special regime) is ongoing. The Executive Order 140/2012 revises tariffs with the objective of reducing implicit subsidies by annual amounts rising from EUR 25 million in the first years to EUR 80 million by 2020 in compliance with the respective measure in the MoU. The government will further rationalise this scheme by the end of 2012 and accelerate convergence to market-based pricing for co-generation operators, in parallel with electricity market developments under the EU internal electricity and gas market legislation.
- The government has announced negotiations with the generators to limit the policy costs of renewables under the special regime, for capacity not granted by tender procedures.

Overall, these measures aimed at reducing rents represent steps in the right direction but fall short of the MoU requirements in some areas, particularly in the ordinary regime. Moreover, the measures will only make a limited contribution to the elimination of the debt of the electricity system by 2020 (the bulk will be borne by energy consumers through the allocation of CO_2 licence revenues to this end).

79. The transposition of the Third Energy Package is close to completion. The liberalisation of the energy sector in Portugal passed another milestone with the entry into force of decree-laws phasing out the remaining regulated tariffs for smaller and retail end-users of electricity and natural gas by 1 January 2013. A comprehensive risk assessment of the security of gas supplies has been prepared and will constitute the basis for further actions to ensure reliable and uninterrupted gas supplies. New legislation granting the regulator the necessary powers of arbitration and the imposition of sanctions is close to completion. The lack of a wider gas market is the key obstacle for the development of competition in the Portuguese gas market; hence the establishment of the pan-Iberian gas market (MIBGAS) is urgent. The first milestone for MIBGAS is the harmonisation of cross-border transmission tariffs between Portugal and Spain, and as the first step in this direction a public consultation on a common tariff structure was completed. On its basis, the regulators of the two countries are preparing a final proposal. The second milestone for the establishment of MIBGAS will be the introduction of a harmonised allocation and congestion management mechanism for the interconnector capacity.

Railways and Ports

80. Initial steps have been taken to make railways more efficient. The rail infrastructure operator REFER has managed to cut considerably operating costs and increase income, which reduced its operating loss significantly. However, REFER will not achieve an operating balance before 2015. The cost savings were achieved through rationalisation and closure of loss-making lines as well as reducing over-staffing. Higher income was achieved through the rationalisation of access charges and the sales of redundant properties. The operating cost is projected to fall further, whereas the income will stabilise or even slightly decrease as the revenue from the sale of property is projected to fall. Simplification of the procedures to rededicate the property from public use to a private use would fasten the sales process and further boost extraordinary income of REFER. A yield management scheme for passenger trains has been introduced as a pilot project and the result will be analysed next year in view of a possible expansion of the scheme The privatisation of CP Carga has been delayed, due to, among other things, uncertainty over the development of new rail priority corridors, which will have an impact on its future revenue. The transfer of the CP Carga-owned rail terminals to another entity is delayed too. As the lack of unbundling of freight rail terminals is one of the key barriers to entry in the sector, it is expected that it will be completed without any further delay.

81. A landmark reform of port labour is in progress and ambitious reform proposals are expected for port governance model. Making port labour more flexible and cost-efficient is crucial to enhance competitiveness of Portuguese ports on a European and global scale. Hence, it is welcome that an ambitious revision of the legal framework governing port work has been presented and is now in the consultation phase with the stakeholders. Another flagship reform - the improvement of the port governance - is still at its conception phase. A coherent country-wide port development strategy is necessary to reap economies of scale and to avoid a dispersion of scarce resources. These objectives would be best fulfilled by empowering an administrative entity to prioritise port development projects at the national level, allocate the resources in line with an integrated port development strategy and resolve disputes between ports. The new governance model should also ensure a stronger commercial orientation of port activities and make them more attractive for private investment. An independent regulatory body – the Institute of Mobility and Transport - is being created to achieve better regulation of sea and land transport in Portugal. It is important that the regulator has sufficient powers to ensure that the port operation is carried out in an efficient manner and the efficiency gains are passed on to customers.

Telecommunications and postal services

82. Work on the designation of the universal service provider(s) is behind schedule and the incumbent still maintains its dominant position in most of the markets. Important delays have accumulated in allowing market players to enter the universal service segment through a transparent and non-discriminatory public tender. The designation of the universal service provider(s) foreseen for December 2011 has not been launched. The resolution of the Council of Ministers 50/2012, published on 22 May in the Official Gazette, defined and approved the procedures for the tender, as well as authorised the costs, but the tender documents are now being finalised before its launch. While deadlines were already extended in the second review, the MoU measure has not been implemented and the European Court Ruling of 7 October 2010 has not been ensured. In parallel, a law proposal on the functioning of a compensation fund to finance net costs of universal service was submitted to Parliament at the end of May. The law will be assessed as regards compliance with EU law requirements concerning universal service financing mechanisms and the designation procedure. The telecom market regulator (ANACOM) has adopted required decisions and carried out inspections to further alleviate barriers to entry in the fixed communication sector. These measures are expected to reduce prices, improve the quality of service and ultimately decrease the market share of the incumbent. As the efficacy of these measures can only be assessed ex-post, the development of the competitive situation in the Portuguese telecom market needs to be closely monitored.

83. The main legislation to liberalise the postal sector has been finalised[20]. Conditions for an entirely liberalised postal sector to operate, including a strengthened role of the regulator, are in place. The revision of the framework law on the concession contract, and of the existing concession contract with CTT, is forthcoming.

Other services sectors

84. Sector-specific regimes in construction and real estate are not yet closed, as draft legislation remains overly burdensome notably for cross-border services. While the draft legislation on real estate activities has been simplified, a disproportionate notification requirement for cross-border service providers has been maintained under the justification of anti-money laundering purposes. Another concern relates to the cost of authorisation granted by the sector-specific regulator. Concerning the revised draft legislation on construction activity, some welcome improvements have been made such as a significant simplification of the regime applicable to private works, but shortcomings are to be noted with regard to cross border service provision. The

[20] Lei N° 17/2012, of 26 April, Diário da República, 1ª série – N° 82, transposing the Third Postal Directive.

regime for public works could also be further simplified. To allow suggestions by the EC/ECB/IMF to be incorporated, the deadline for the submission of the law to Parliament has been postponed by one quarter.

85. Significant progress on the recognition of professional qualifications has been achieved. The government has adopted 13 executive orders (portarias) that identify competent authorities and which complement Law 9/2009 on the recognition of professional qualifications. Amendments to the Law 9/2009 were approved at the Council of Ministers of 24 May and submitted to Parliament. The law should avoid any unjustified burden on Portuguese professionals in circumstances where there is no possibility of obtaining an attestation of professional experience from the Portuguese competent authority.

86. Work on regulated professions is advancing at a slow pace. The Commission on Regulated Professions has finalised a report with a proposal on the deregulation of some professions that was sent to the government end-March. The report analysed 122 regulated professions, while 24 are still to be assessed. The aim of this reform is not necessarily to get a complete deregulation of professions but the focus should be on easing access to professions with a significant economic impact. Following the submission of the report, the government has been working on the preparation of the law proposal deregulating the concerned professions (real estate agents, taxi-company owner/manager, technical director of a freight company, owner/manager of a company involved in the transport of children). Due to slow progress the deadline for submission to Parliament has been extended to July. The horizontal legal framework on public professional associations was submitted to public consultation.

87. The Point of Single Contact web platform has been further improved but difficulties remain in making the "Zero Authorisation" project fully operational. The quality of the translations provided has been improved and an e-forms tool is available. However, the full implementation of the ambitious "Zero Authorisation" project for the establishment of bars, restaurants, retailers and wholesalers has been substantially delayed. Once operational, this project will substantially reduce the administrative burden. The implementation suffered from the lack of budgetary resources in 2011 to contract services necessary for the project, difficulties and delays in hiring of staff by the Agency for Modernisation, and the complex cooperation with many different players (such as local authorities and various departments in the central administration). With these issues being difficult to solve quickly, some deadlines have been extended. The MoU measure has also been modified with a view to recognising the importance of the work to be carried out by municipalities for this project to be accomplished.

Competition and sectoral regulators

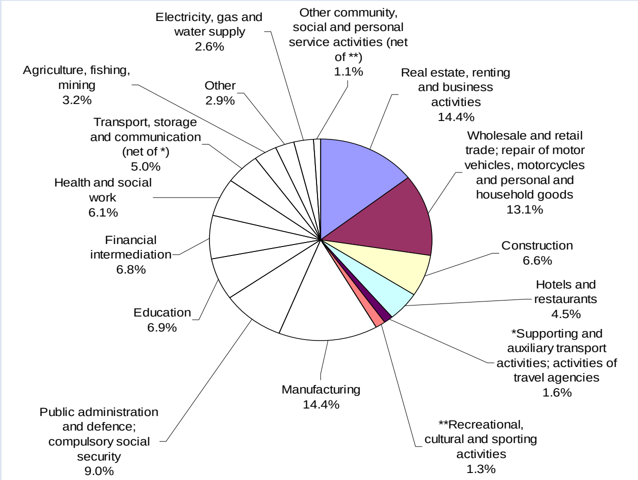
88. The government has decided to further postpone the sale of the 1 percent share of CGD in Galp, thus maintaining a situation of special rights by the State. As a consequence, the corresponding MoU measure has not been implemented and the European Court Ruling of 10 November 2011 has not been ensured. On 24 May, the EC formally asked the Portuguese authorities to provide explanations on the current situation.

89. Caps on the ownership of shareholdings in the energy transmission operators raise concerns. On 23 May, the parliament adopted a Decree-Law[21] setting a 25 percent threshold on the acquisition, directly or indirectly, by any person, of the share capital in the transmission system operator of electricity and natural gas or of any companies controlling it[22]. These restrictions do not apply to the State or any companies which it controls. A limitation on acquisitions is an obstacle to the free movement of capital and raises concern as to its compatibility with the provisions of the Treaty, in particular the provisions on the free movement of capital and the right of establishment (Art 63 TFEU and 49 TFEU, respectively), and with the MoU commitment to ensure that obstacles to free movement of capital will not be created by their action.

[21] Decreto-Lei N° 112/2012, of 23 May, Diário da República, 1ª série – N° 100

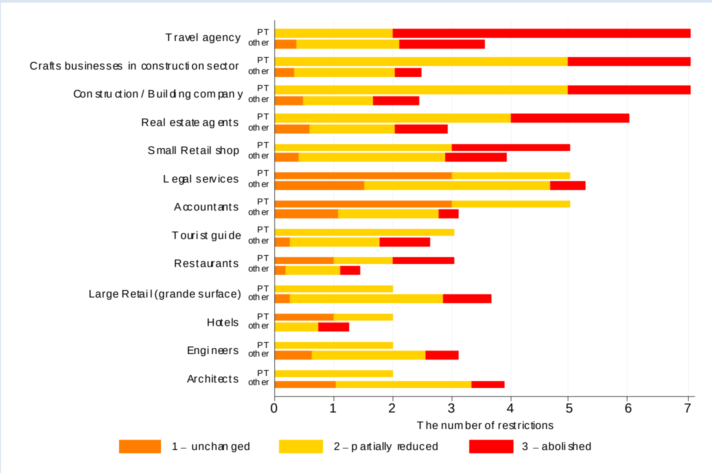
[22] These caps apply to the National Electricity Transmission Network (RNT) or companies controlling it; each operating company of the National Transmission, Storage Infrastructure and LNG Terminal Networks (RNTIAT); and the operator of the National Natural Gas Transmission Network (RNTGN) or any company controlling the operator.

BOX 8: THE ECONOMIC EFFECTS OF THE SERVICES DIRECTIVE



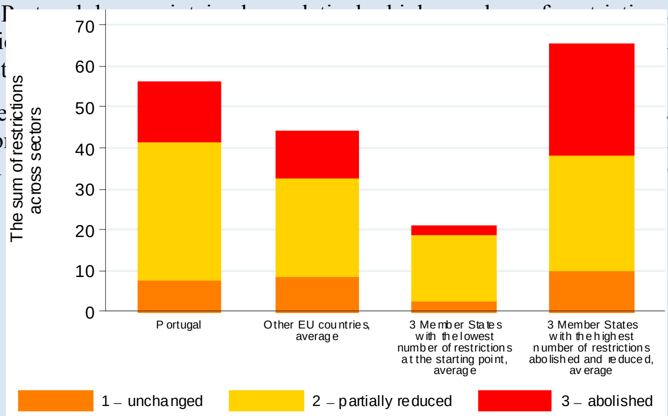
Services represent more than 75 percent of GDP and around 70 percent of employment in Portugal and are an important source of growth and job creation. While GDP grew by an annual 1.9 percent over the period 1995-2010 (−0.3 percent over the period 2008-2010), market services grew at 2.8 percent (0.6 percent during the crisis period). Services are highly embedded in the economy thus playing a significant role in a country's competitiveness either directly or as intermediate inputs. In manufacturing industries the services content is on average 27 percent. Low productivity and high costs in services therefore spill over to other sectors in the economy. Traditionally services have been isolated from strong international competition due to their non-tradability, a tight integration with the labour flows, historical reasons, etc. Clearly, however, a continuous opening up the sector and reducing barriers hampering performance brings substantial economic benefits as it stimulates economic activity and makes the economy more flexible thus facilitating resource allocation and adjustment to shocks.

The Services Directive is the major recent liberalisation effort in the sector: it removes barriers to the provision of services within and across Member States, and modernises the way in which public administrations work. The scope of the Directive is broad both in terms of requirements and sectors covered: wholesale and retail trade, construction, business-related services, most regulated professions, tourism, etc. (more than 40 percent of GDP in total). Other economically important sectors (e.g. financial, telecommunications, transport services) are covered by separate EU legislation. The transposition period of the Directive ended in December 2009. In Portugal, the Decree Law 92/2010 implemented the general principles of the Directive and made amendments to some specific regimes. As to changes to sector - specific legislation, the Government has adopted over half of the specific regimes requiring amendments and the remaining are ongoing. Initial amendments to legislation in real estate and construction are being revised as they did not go far enough.

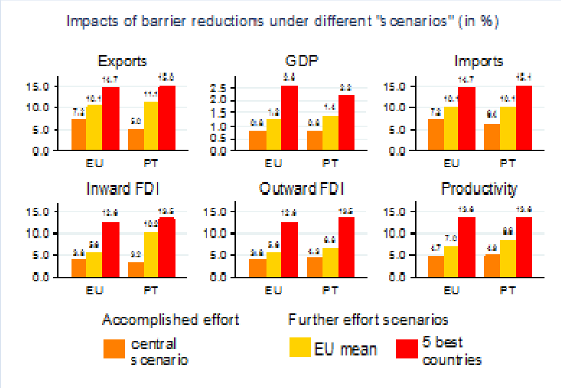


Available information on restrictions before and after implementation of the Directive in all Member States shows Portugal as an average reformer (red and yellow bars in the graph reflects partly revised and abolished restrictions, respectively)* although the figures reflect the implementation status roughly at the end of 2011 therefore not covering the all the most recent reforms under the Adjustment Programme. The starting point in terms of the number of restrictions – the total height of the bar – shows that Portugal had more restrictions than most other Member States. By sectors, the information collected on restrictions covers those sectors under the Directive that are most likely affected by its implementation (around 20 percent of GDP). Compared with other countries, P
unchanged for the moment, particularly for legal servi
partially reduced, especially in construction and real est

Using this information on the reform effort undertake
estimated the effects on trade and FDI as well as on do
scenario representing the implementation status by end



barriers (calculated for each sector) or the level of barriers of 5 best countries. This scenario is close to the full elimination of barriers in many sectors. Overall, the impact for Portugal is similar to that for the whole EU. Gains amount to an estimated 0.8 percent of GDP under present implementation (central scenario), 1.4 percent under additional effort leading to the EU mean performance and as a high as 2.2 percent under the more ambitious scenario moving to the level of the 5 best countries. Therefore depending on the degree of ambition, extra gains relative to the present implementation status will range between 0.6 and 1.4 percent of GDP in Portugal. Most of the gains would materialise already within the first 5 years after the introduction of reforms. Within the sectors covered by the analysis, an increase of about 5 percent exports and 6.4 percent in imports, 4.3 percent in outward FDI and 3.2 percent in inward FDI would materialise under the central scenario. The impact on the trade balance would be positive, considering the substantial trade surplus in the analysed sectors. If Portugal moves to the "EU mean" barriers per sector, the gains may be 1½–3 times larger than under the central scenario, and, if it is even more ambitious (the "5 best countries" scenario), the benefits may be 2½–4 times larger.



The analysis indicates the ample room for improvement in terms of barrier reduction and the considerable economic gains in terms of GDP, trade and FDI for the Portuguese economy.

* Based on Monteagudo, J., A. Rutkowski and D. Lorenzani, "The economic impact of the Services Directive: A first assessment following implementation", European Economy. Economic Papers 456, 2012 (http://ec.europa.eu/economy_finance/publications/economic_paper/2012/ecp456_en.htm)

90. The government aims to put in place an effective competition enforcement regime. A specialised Court on Competition, Regulation and Supervision has been created and has been functioning since early-April. In the first two months, 42 new cases have been brought before the court. The capacity of the new court appears modest in view of its remit. Close monitoring on the inflow of cases is required, to gauge the risk of potential backlog in view of the limited staff. The court is equipped with only one judge and a second one may have to be appointed over the course of the year if risks in terms of court backlogs are confirmed. Nominating judges with the necessary qualification and experience will be crucial as will be the provision of further training measures to those in office. A follow-up measure was added to the MoU to revisit the situation by the end of the year. In contrast to previous years, the Portuguese Competition Authority (PCA) received in 2012 all financial transfers from seven national regulatory authorities as provided for in the Executive Order. Given the enlarged scope of action of the PCA with the entry into force of the new Competition Framework Law in July, a review of the conditions for the proper execution of its mandate is the object of a revised MoU measure.

91. The revised legal framework for public procurement has been adopted. A significant revision of the public procurement code was published on 12 July. The Decree Law 149/2012 addresses in particular the regime for the award of additional works and services, errors and omissions; eliminates exemptions permitting direct awards; and removes the requirement to invest in R&D projects on contracts above EUR 25 million. A follow-up report analysing the effectiveness and impact of these amendments as well as the enhanced role of the Court of Auditors will be submitted by in the first quarter of 2013.

Business environment

92. Access to credit, especially for small and medium-sized enterprises (SMEs) remains a priority of the programme. Data show a significant contraction of credit to SME in 2011, especially in some sectors. The Portuguese authorities will present a report by the end of June to analyse the reasons underlying the difficult access to credit for SMEs. Additional and updated data on the access to credit by sectors will be provided as well. This report should be a good basis to decide whether new instruments to SME support need to be set up. In this context, the reprogramming of the Structural Funds will release additional funds from other Operational Programmes to strengthen support to SME related measures. In parallel, the government adopted a resolution (*Sistema de Indústria Responsável*) to significantly lower the licensing requirements to industries in the development of their economic activity. In addition, the legislation to request VAT exemptions for exporting firms and to simplify procedures associated with indirect exports will be made operational within the expected deadlines.

IV. PROGRAMME FINANCING

93. The planned loan disbursement volume of EUR 4.0 billion for the third quarter of 2012 was confirmed during the mission. Updated calculations during the Fourth Review mission confirmed the disbursement schedule for the Portuguese Sovereign, as set out in the original Programme design. Successful completion of the Fourth Review will allow the release of EUR 2.6 billion from the EU and SDR 1.2 billion (EUR 1.4 billion) from the IMF. The forthcoming instalment will bring total EU-IMF disbursements to around EUR 57 billion, representing more than 70 percent of total available financial assistance. The EU instalment is scheduled for July. The average interest rate on EU assistance to Portugal has been below 3 percent.

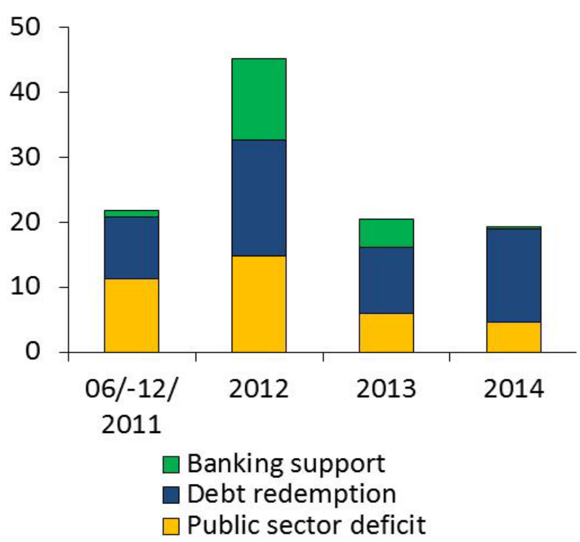
Table 7. Disbursements to Portugal after 4th review (bn EUR)

Review	EU	IMF	Total
Progr	12.4	6.1	18.5
1rst	7.6	4.0	11.6
2nd	5.3	2.8	8.1
3rd	9.7	5.2	14.9
4th	*2.6*	*1.4*	*4.0*
Total disbursed	**37.6**	**19.5**	**57.1**
Total undisbursed	14.4	7.9	22.3

Note: Total disbursements do not add up to EUR 78 bn due to changes in EUR-SDR rate.

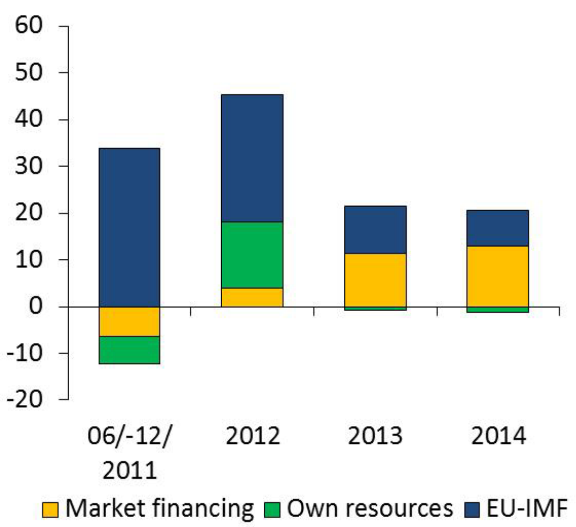
94. Financing needs for the rest of the Programme period remain in line with previous expectations. Additional financing needs result from higher budgetary costs of the Madeira programme, redemption of saving certificates and the cleaning of arrears. However, this is compensated by improved short-term financing and a downward revision in projected financing needs for state-owned enterprises. The government's cash provision to banks in the context of the Recapitalisation Programme of Portuguese credit institutions are in line with expectations and amount to EUR 6.6 billion by December 2012, of which approximately EUR 5 billion will come from the Bank Solvency Support Facility (BSSF).

Graph 8: Financing needs



Source: Commission services

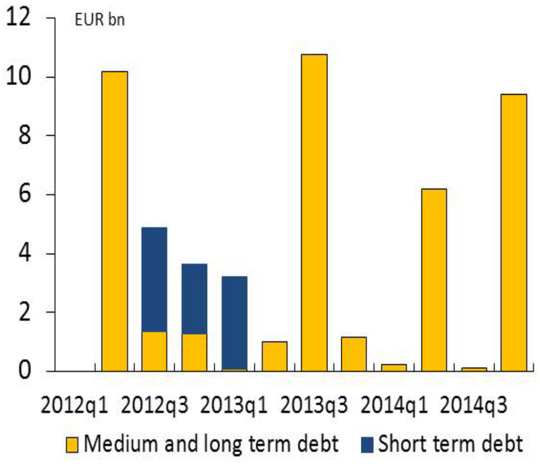
Graph 9: Financing sources



Source: Commission services
* Negative value indicates build-up of deposits.

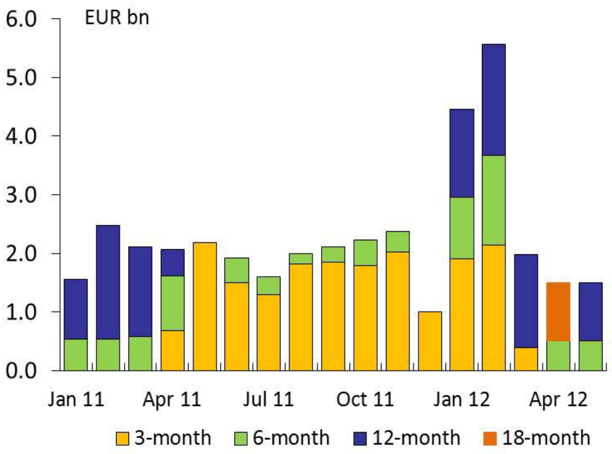
95. Portugal implements a strategy of a gradual extension of maturities. Recent funding operations by the Portuguese sovereign have been successful. On 4 April, Portugal sold EUR 1 billion of 18-month bills at a yield of 4.5 percent, which is below the rate paid for 3-month bills in September 2011. The bills have the longest maturity Portugal has sold since January 2011. Authorities are confident that the maturities can be extended further which reduces the roll-over risk. The stock of treasury bills at end-May amounted to EUR 13.9 billion.

Graph 10: Maturing debt



Source: Commission services
Note: short-term debt is defined as debt with a maturity inferior or equal to 372 days at issuance.

Graph 11: Short-term auctions (amount at issue)



Source: Commission services

96. Long-term government bond yields have fallen, but remain high. In mid-June, 10-year government bond yields traded at around 9½ percent, which is around 4 percentage points below the level of three months ago. While these are positive developments, yields still indicate that markets need to be convinced about the feasibility of Portugal regaining market access. EC/IMF/EC staff continues to closely monitor, in cooperation with the Portuguese authorities, the financing conditions for the Portuguese Sovereign and the associated risks for programme financing.

97. Continued efforts towards a full implementation of the Programme are crucial to improve market confidence in Portuguese assets. There is no need for Portugal to tap international bond markets in 2012. However a gradual return is expected for the second half of 2013 under current Programme assumption.

V. CONCLUSIONS

98. Overall, Programme implementation continues to evolve broadly according to the agreed plans. The fiscal target for 2012 remains attainable even though the growth composition and rising unemployment increase the downside risks. The economy has held up remarkably well in spite of a substantial fiscal adjustment with consolidation measures of over 7 percent of GDP combined in 2011 and 2012. At the same time, the necessary deleveraging of the financial sector is progressing in an orderly manner. At this stage, it is necessary to lock in the progress already achieved and to facilitate the necessary further adjustment with the determined implementation of structural reforms. The Fourth Review has seen the closure or near finalisation of a number of landmark reforms, e.g. in the housing market, the port sector and the judicial reform map; other issues are advancing at a good pace, such as the reforms of the central, regional, and local public administrations, public financial management, reforms of the health care sector, and the labour and product markets.

99. Some risks are outside the control of the Portuguese government. This concerns economic risks due to spill-overs from the Euro area crisis, notably the situation in Spain and Greece. By contrast, there is so far little sign that Portugal might lose the reform momentum on the important structural reforms. Legislative proposals are usually of a good quality and in line with the commitments of the MoU, notwithstanding the fact that more could have been achieved in some areas such as in reducing rents in electricity sector. Even here, however, the improvement to the status quo remains noteworthy. As more reforms are moving towards completion, the growth potential in Portugal should rise and the economy return to a sustainable patter. If current trends and political determination, including the broad political consensus, continue, the country should be able to regain the confidence of the international investment community.

ANNEXES

ANNEX 1: ASSESSMENT OF COMPLIANCE: MONITORING TABLE

Actions for the fourth review (to be completed by end May-2012)	
Fiscal-structural	
[1.2] Adopt a Supplementary Budget.	**Observed.**
[1.4] Quarterly ceilings for the consolidated General Government cash balance to be assessed.	**Observed.**
[3.1] Publish quarterly cash balance targets for the general government.	**Observed.** Quarterly cash balance targets are published in the monthly budget execution bulletin. The ongoing reinforcement of the Ministry of Finance's monitoring and supervisory role will allow to develop a process to define corrective measures in case of deviations.
[3.2] Publish the fiscal risks report (April 2012).	**Partly observed.** A draft report was submitted to the EC/ECB/ IMF but not published. An enhanced report will be published with the 2013 budget.
[3.3] Complete the annual report on tax expenditure.	**Observed.** The report estimates tax expenditures under an internationally accepted methodology. An enhanced report, with an evaluation of tax expenditures will be published with the 2013 budget.
[3.6] Strategy document for reduction of the arrears to be approved by the Council of Ministers.	**Observed.**
[3.7] Publish a fiscal strategy document for the general government every year in April, in compliance with the requirements of the Stability and Growth Pact.	**Observed.** Authorities will improve the content of the next report due in April 2013 by specifying 4-year medium term forecasts and costs of new policy decisions.
[3.9] Make operational the Fiscal Council.	**Observed.**
[3.10] The government will ensure that the new budgetary framework is also applied at regional and local level. Adequate structures of monitoring, fiscal reporting, and commitment control will be put into place.	**Ongoing.** The commitment control law is being applied and monitoring reinforced. The reform of the regional and local financing laws, due later in the year, will ensure the application of all relevant principles.
[3.12] Prepare quarterly reports on progress implementation of the Government's financial arrangement with the Autonomous Region of Madeira.	**Observed.** The next report is due in July 2012.
[3.13] Sign the service contract by end-March with a top tier international accounting firm.	**Observed.**
[3.14] New legal and institutional framework for analysing PPPs.	**Observed.** A new framework for central and local PPPs has been put in place. Regions should apply the same commitments.
[3.19] Draft law to regulate the creation and functioning of SOEs.	**Broadly observed.** The draft law has been prepared and it will soon be submitted to Parliament. A draft law on local SOEs has been sent to Parliament. Regions should adopt a similar regulatory regime.
[3.21] The sale of EDP and REN.	**Observed.**

Actions for the fourth review (to be completed by end May-2012)	
[3.23] Prepare a strategy for Parpública.	**Observed.** The strategy presents alternative scenarios for unwinding the public holding Parpública. An enhanced strategy in the context of a global plan to manage SOEs debt will be prepared by July.
[3.25] Study the costs and benefits of including the revenue collection units of the social security administration in the Tax Administration (AT).	**Observed.** The study does not recommend the merger at this stage, but it suggests alternative measures in the shorter-term to improve synergies between the two institutions to improve control and simplify compliance. An analysis of possible ways to implement these measures is due by August 2012.
[3.26 iv] Analyse the impact of VAT issues on backlog enforcement cases and assess possible options to address such cases.	**Observed.** On the basis of this analysis an action plan with concrete measures and timelines will be prepared by August 2012.
[3.29] Finalise the assessment of the net financial impact on the incentive scheme (5 percent rebate on VAT) paid through electronically transmitted invoices.	**Observed.** The proposal considers tax incentives to promote e-invoicing and combat fraud.
[3.31] Reduce management positions and administrative units by 27 percent and 40 percent, respectively.	**Broadly observed.** The process will be completed after the publication of all relevant legal acts, which is foreseen by end-June.
[3.33] Present initiatives needed for each region for the presentation of a plan aiming at reducing the management positions and administrative units by 15 percent.	**Broadly observed.** The Autonomous Region of Madeira presented plans to comply with this objective.
Financial sector	
[2.4-2.6, 2.8] Present bank capital augmentation plans [end of February] and increase banks' capital buffers resulting from the SIP exercise, the pension funds transfer and EBA requirements by June 30.	**Observed and ongoing.** The final results of the SIP and the subsequently updated funding and capital plans have been delivered by the banks and presented to the financial sector team. The central bank issued an opinion on each of the capital augmentation requiring public support. The process of recapitalising the banks is ongoing.
[2.7] Implementation of the bank recapitalisation law.	**Observed.** The law setting the framework for banks requiring a public recapitalisation (published on 11 January 2012) and its ordinance (17 May 2012) provide guidance and set the rules governing the recapitalisation process. The legislation is going to be applied in the June recapitalisation.
[2.13] Resolve BPN case.	**Observed.** BPN has been sold to the Angolan bank BIC on 30 March 2012.
[2.14-2.15] Gradually settle CGD's state guaranteed claims BPN. Commission an audit [end-March] and develop, and implement a strategy for recovery of the ex-BPN distressed assets presently under management by the SPVs.	**Ongoing.** The SPVs are undergoing a thorough audit. The auditor will provide the authorities with a report quantifying the current value of the portfolio and its potential recovery values. The government is working on identifying candidates to manage the assets in the SPVs.
[2.18] Amendments to the corporate insolvency law to better	**Observed.** The amendments became effective

Actions for the fourth review (to be completed by end May-2012)	
support early rescue of viable firms shall become effective by mid-June 2012	in May 2012.
[2.20] Monitoring of corporate and household indebtedness.	**Observed and ongoing.** The third report analysing the corporate and household indebtedness was published on 18 May, according to the previously established publication schedule. The new issue contains improved information on the SOE sector.
Health care system	
[3.46] Enact legislation which reduces the prices of medicines when patent expires.	**Not observed.** The deadline has been postponed until Q4-2012. Implementation to be considered depending on the outcome of the payback agreement for 2012.
[3.47] Complete the transfer of the responsibility of pricing medicines to the Ministry of Health.	**Ongoing.** The transfer is to be finalised by 1 September. The authorities have introduced changes to "Leis orgânicas" to consider the transfer and the legislative process in in place. The authorities wanted to ensure a smooth pricing process for April and May.
[3.51] Devise and enforce a system of sanctions and penalties.	**Ongoing.** The authorities have preferred to implement regular feedback and peer comparison, complemented by a system of targets.
[3.52] Enact of legislation making compulsory to prescribe by International Nonproprietary Name (INN) to increase the use of generic medicines.	**Observed.** Law 11/2012 has been adopted. It mandates INN prescription and pharmacies to dispense the cheapest 3 generics.
[3.56] Implement the legislation regulating pharmacies.	**Ongoing.** Legislation was approved by Council of Ministers but still requires final publication. Deadline postponed to end-June 2012.
[3.63] Comply with European competition rules of the provision of services in the private healthcare sector.	**Observed.** Analysis in relation to EU competition and EU legislation is done. A national level analysis is to be done by end 2013.
[3.65] Put in place a mechanism to ensure strong coordination between Ministry of Health and Ministry of Finance.	**Ongoing.** A number of audits by the General Inspection of Finances have taken place in hospitals to verify invoices. In addition, a tighter monthly control and monitoring mechanism is in place for the high-risk hospitals.
[3.67] Implement measures aimed at achieving reductions in operational costs of hospitals.	**Ongoing.** Several policies have been implemented including reduction in the hourly cost of overtime payment and reorganisation of work schedules to reduce overtime, optimising capacity and reducing outsourcing. €93 million savings realised for Q1-2012. The deadline has been set for end-2012.
[3.71] Achieve full interoperability of IT systems in hospitals.	**Ongoing.** A number of steps have been taken and others are in the pipeline to ensure hardware and software compatibility. This is a continuous process.

Actions for the fourth review (to be completed by end May-2012)	
Labour market and education	
[4.3] Prepare legislative proposal to: i) align the level of severance payments to the EU average; and ii) allow the severance pay entitlements financed from the fund agreed in the Tripartite agreement to be transferable to different employers.	**Partly observed.** A study was prepared on severance pay systems in the EU but the authorities have not yet presented a proposal for the new level of severance payments. Preliminary versions for the fund were discussed in previous reviews. However, a proposal for the set-up of the fund has not yet been presented.
[4.8 i] Commit that no increase in the minimum wage will take place over the Programme period, unless justified**.**	**Observed**. The minimum wage has not been increased.
[4.8 ii] Ensure wage moderation by using the available discretion in the current legislation of not extending collective contracts until clear criteria is defined.	**Not observed**. The Government has extended 12 collective agreements out of 18 analysed. The original agreements were concluded in the first half of 2011.
[4.8 ii] Present an action plan to improve the quality of secondary education services.	**Observed**. The plan broadly complies with the objectives but more information is needed on how the authorities are planning the implementation of a funding framework based on performance evolution criteria.
[4.8 iii] Present an action plan on attractiveness and labour market relevance of vocational education and training and enhancing career guidance mechanisms.	**Observed.** The plan broadly complies with the objectives.
Goods and services markets	
[5.4] Submit to the EC a Risk Assessment report on energy security.	**Observed.** The report was submitted to DG ENER.
[5.5] Take measures to set the national electricity system on a sustainable path and appoint an independent negotiator in order to help the government achieve its goals (e.g. reduce rents and stabilise the tariff debt).	**Ongoing.** A state of play was presented on the various measures proposed by the government to tackle excessive rents and the energy tariff deficit. Some elements have been addressed or partially addressed as per MoU 5.7 and 5.6 and other elements are being negotiated. The government has nominated for the negotiations the Secretary of State of Energy advised by two external experts.
[5.6] Take measures to limit the policy costs embedded in CMECs.	**Partially observed.** The envisaged reductions on the basis of the results of negotiations are very modest relative to the overall ambition of the measure. Furthermore, even these results are pending further negotiations with main operators.
[5.7] Revise the remuneration scheme for co-generation. Publish the Executive Order defining the new reference tariff **(SB, MEFP ¶41)**	**Observed.** The government has adopted by Executive Order 140/2012 the new reference tariff. To further rationalise this scheme, the government is committed to a revision of the general framework by end-2012.

Actions for the fourth review (to be completed by end May-2012)	
[5.11] Eliminate the incentive to invest for the set of power plants existing or already licensed prior to the 2007 Decree Law governing this incentive. Redesign the Power guarantee mechanism.	**Partially observed.** With the adoption of Executive Order 139/2012, the government has eliminated the investment incentives granted retroactively. The redesign of the new power guarantee and availability mechanisms is foreseen in a forthcoming legislation.
[5.12] Launch a new tender process for designation of universal service provider(s).	**Not observed.** Following a Resolution of the Council of Ministers (50/2012), the government is in condition to launch the tender, but the tender documents are still being finalised; they have been shared with the EC/ECB/IMF on 29 May.
[5.13] Increase competition in fixed communications by adopting measures to reduce entry barriers.	**Observed.** The efficacy of the measures will be monitored.
[5.14] Liberalise the postal sector by adopting the transposition law of the Third Postal Directive.	**Observed.** The law (Lei 17/2012) was adopted by Parliament on 9 March, and further to Presidential promulgation the publication in the Portuguese Official Gazette occurred on 26 April.
[5.17 iii] Implement plans presented in the Strategic Plan for Transport.	**Observed.** Some loss-making passenger services and lines were closed.
[5.17 vi] Apply yield management on long-distance passenger ticket prices.	**Observed.** A pilot scheme has been implemented and will be assessed next year in view of a possible expansion of the scheme.
[5.22] Submit to Parliament the amendments in the areas of construction and real estate.	**Not observed.** Since last review mission, revised drafts of the law have been shared with EC/ECB/IMF. Latest drafts show some positive developments but some concerns impeding closure remain. There are no final agreements on the drafts.
[5.23] Submit to Parliament an amendment proposal to Law 9/2009 to improve recognition of professional qualifications.	**Observed.** Amendments to the law 9/2009, which transposes the Directive on recognition of professional qualifications, were approved by the Council of Ministers on 24 May and submitted to Parliament. 13 executive orders designating the competent authority for the recognition of the specific qualifications have been adopted.
[5.24] Submit to Parliament measures to reduce the number of regulated professions and to review reserve of activities that are no longer justified.	**Ongoing.** The Portuguese commission reviewing the requirements on regulated professions has advanced its work and delivered reports to the government analysing 122 regulated professions. The government will submit a law to Parliament deregulating 3 professions by July.
[5.26 i] Improve the quality of translations (in two languages at least) of the Point of Single Contact. Make available in the PSC single electronic forms for at least two procedures, seamless of the municipality.	**Observed.** Manual translations on top of automatic ones for English and Spanish allowed improving the website. While working on creating single electronic forms for tourism procedures, the Agency for Modernisation has focused on simplifying the system to the benefit of the entrepreneur.

Actions for the fourth review (to be completed by end May-2012)	
[5.26 ii and iii] Extend on-line procedures in Point of Single Contact (PSC) to all sectors under the Services Directive and for each profession. Adapt PSC to incorporate new legislation in order to reduce administrative burdens for firms.	**Ongoing.** The adaptation of the PSC to sector-specific amendments and legislation to be adopted under MoU 5.21 and 5.23 is behind schedule. Several new formalities (92 online procedures) are now available on PSC, but the full incorporation of new legislation in the portal requires the cooperation of many different players (such as local authorities and various departments in central administration) which could also further delay the process.
[5.26 iv] Make available PSC on-line procedures for the registration of establishments covered by "Zero Authorisation"	**Not Observed.** The Point of Single Contact web platform has advanced but difficulties remain in its development to make the "Zero Authorisation" project operational.
Housing market	
[6.1] The Parliament will adopt the Decree Law which amends the New Urban Lease Act Law 6/2006 and the Decree Law which simplifies the administrative procedures for renovation.	**Observed**. Both Acts were adopted by the Parliament on 1 June.
Judicial system	
[7.2] Set quarterly targets for closing enforcement cases and prepare quarterly reports on implementation status, by an inter-agency task force, with the second report to be completed by 15 May 2012.	**Observed.** Report received in May.
[7.2] Finalise the Action Plan on the small claim cases noted above with concrete measures and specific deadlines by end-May 2012.	**Observed.**
[7.3] Finalise the action plan for enforcement agents with concrete measures and specific deadlines by mid-May.	**Observed.** Action plan received in April.
[7.6] Make the specialised courts on Competition and Intellectual Property Rights fully operational.	**Observed.** Legislation has been adopted (DL 67/2012 creating both courts, Executive Orders 83/2012 and 84/2012) which made the Court functioning since 2 April.
Competition, public procurement, and business environment	
[7.9] Ensure that CGD alienates its participation in Galp.	**Not observed.** There has been no alienation of CGD's participation in Galp.
[7.10] Going beyond elimination of special rights of the State, the authorities also commit to ensure that obstacles to free movement of capital will not be created by their action.	**Not observed.** Decree Law 112/2012 of 23 May reiterating the existence of acquisition caps in the share capital in the transmission system operator of electricity and natural gas or of any companies controlling it is considered to be an obstacle to the free movement of capital and the right of establishment
[7.11] Make operational the adopted legislation establishing specialised court for Competition, Regulation and Supervision.	**Observed.** Legislation has been adopted (DL 67/2012 creating both courts, Executive Orders 83/2012 and 84/2012) which made the Court functioning since 2 April. To ensure the Court to be effectively operational, a close monitoring of the inflow of cases is required, in particular to assess whether the Court is

Actions for the fourth review (to be completed by end May-2012)	
	sufficiently staffed. This will be the assessed in a follow-up report.
[7.14] Adopt a law revising the Public procurement code.	**Observed.** Legislation has been adopted (DL 149/2012) and published on 12 July.

ANNEX 2: COMMISSION SERVICES MACROECONOMIC PROJECTIONS 2011 - 2016

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

Annual % change	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	2.1	-3.9	-6.0	-0.5	1.2	1.0	1.0
2. Government consumption expenditure	0.9	-3.9	-3.4	-2.7	-0.8	0.4	0.3
3. Gross fixed capital formation	-4.1	-11.4	-12.2	-0.5	4.6	3.7	3.1
4. Final domestic demand	**0.7**	**-5.3**	**-6.5**	**-0.9**	**1.4**	**1.4**	**1.3**
5. Change in inventories	--	--	--	--	--	--	--
6. Domestic demand	**0.8**	**-5.6**	**-6.5**	**-0.8**	**1.4**	**1.4**	**1.3**
7. Exports of goods and services	8.7	7.4	3.5	3.5	5.0	5.5	5.5
7a. - of which goods	9.7	7.6	4.3	4.0	5.1	5.8	5.7
7b. - of which services	6.3	6.8	1.3	2.0	4.7	4.9	4.9
8. Final demand	**2.4**	**-2.7**	**-3.9**	**0.4**	**2.5**	**2.6**	**2.6**
9. Imports of goods and services	5.4	-5.4	-6.2	0.9	3.3	4.3	4.3
9a. - of which goods	5.7	-6.9	-7.1	0.7	3.2	4.2	4.2
9b. - of which services	3.6	3.1	-1.4	2.0	3.8	5.0	4.8
10. Gross domestic product at market prices	**1.4**	**-1.6**	**-3.0**	**0.2**	**2.1**	**1.9**	**1.9**
Contribution to change in GDP							
11. Final domestic demand	0.7	-5.7	-6.8	-0.9	1.4	1.4	1.3
12. Change in inventories + net acq. of valuables	0.1	-0.3	0.1	0.1	0.0	0.0	0.0
13. External balance of goods and services	0.6	4.4	3.7	1.0	0.7	0.6	0.6

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

Annual % change	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	3.8	-0.4	-3.4	0.6	2.3	2.5	2.6
2. Government consumption expenditure	0.4	-7.9	-10.4	-2.8	-0.5	1.2	1.4
3. Gross fixed capital formation	-1.5	-9.5	-9.9	1.2	6.2	5.4	5.0
4. Final domestic demand	**2.1**	**-3.6**	**-5.9**	**0.1**	**2.5**	**2.8**	**2.8**
5. Change in inventories	--	--	--	--	--	--	--
6. Domestic demand	**2.2**	**-4.0**	**-5.5**	**0.2**	**2.4**	**2.8**	**2.8**
7. Exports of goods and services	13.4	13.3	5.2	4.7	6.2	7.1	7.4
8. Final demand	**4.6**	**-0.1**	**-2.8**	**1.4**	**3.5**	**4.1**	**4.2**
9. Imports of goods and services	10.4	2.1	-3.7	1.7	4.0	5.8	6.1
10. Gross national income at market prices	3.3	-1.3	-2.7	1.3	3.4	3.4	3.4
11. Gross value added at basic prices	1.7	-1.1	-3.6	1.1	3.4	3.3	3.5
12. Gross domestic product at market prices	**2.5**	**-1.0**	**-2.4**	**1.3**	**3.3**	**3.4**	**3.4**

Table 3: Implicit price deflators

% change in implicit price deflator	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	1.6	3.7	2.7	1.1	1.1	1.5	1.5
2. Government consumption expenditure	-0.6	-4.2	-7.2	-0.1	0.3	0.8	1.1
3. Gross fixed capital formation	2.8	2.1	2.6	1.7	1.5	1.6	1.8
4. Domestic demand	**1.4**	**1.7**	**1.0**	**0.9**	**1.0**	**1.4**	**1.5**
5. Exports of goods and services	4.3	5.5	1.6	1.2	1.1	1.5	1.7
6. Final demand	**2.1**	**2.6**	**1.2**	**1.0**	**1.0**	**1.4**	**1.6**
7. Imports of goods and services	4.8	7.9	2.7	0.8	0.7	1.5	1.7
8. Gross domestic product at market prices	**1.1**	**0.7**	**0.6**	**1.1**	**1.1**	**1.4**	**1.5**
HICP	**1.4**	**3.6**	**2.7**	**1.1**	**1.0**	**1.5**	**1.5**

Table 4: Labour market and cost

Annual % change	2010	2011	2012	2013	2014	2015	2016
1. Labour productivity (real GDP per employee)	3.0	-0.1	1.2	0.9	1.7	1.1	0.9
2. Compensation of employees per head	1.4	-0.8	-3.0	-0.3	0.9	0.5	0.6
3. Unit labour costs	**-1.5**	**-0.8**	**-4.1**	**-1.3**	**-0.8**	**-0.5**	**-0.3**
4. Total population	0.0	0.1	0.0	0.0	0.0	0.0	0.0
5. Population of working age (15-64 years)	-0.2	-0.3	-0.3	0.0	0.0	0.0	0.0
6. Total employment (fulltime equivalent)	-1.5	-1.5	-4.2	-0.7	0.4	0.9	0.9
7. Calculated unemployment rate - Eurostat definition (%)	**12.0**	**12.9**	**15.4**	**15.8**	**15.3**	**14.8**	**14.3**

Table 5: External balance

levels, EUR bn	2010	2011	2012	2013	2014	2015	2016
1. Exports of goods (fob)	38.9	44.7	47.5	50.0	53.3	57.3	61.7
2. Imports of goods (fob)	56.2	56.9	54.4	55.3	57.6	60.9	64.7
3. Trade balance (goods, fob/fob) (1-2)	**-17.3**	**-12.2**	**-7.0**	**-5.3**	**-4.3**	**-3.7**	**-3.0**
3a. p.m. (3) as % of GDP	***-10.0***	***-7.2***	***-4.2***	***-3.1***	***-2.5***	***-2.0***	***-1.6***
4. Exports of services	14.6	16.0	16.3	16.8	17.7	18.8	19.9
5. Imports of services	9.7	10.3	10.3	10.6	11.0	11.6	12.3
6. Services balance (4-5)	**4.9**	**5.6**	**6.0**	**6.3**	**6.7**	**7.2**	**7.6**
6a. p.m. 6 as % of GDP	***2.8***	***3.3***	***3.6***	***3.7***	***3.9***	***4.0***	***4.1***
7. External balance of goods & services (3+6)	**-12.4**	**-6.6**	**-1.0**	**0.9**	**2.4**	**3.5**	**4.7**
7a. p.m. 7 as % of GDP	***-7.2***	***-3.9***	***-0.6***	***0.6***	***1.4***	***1.9***	***2.5***
8. Balance of primary incomes and current transfers	-4.3	-4.7	-5.1	-5.2	-5.3	-5.4	-5.8
8a. - of which, balance of primary income	*-5.6*	*-6.1*	*-6.4*	*-6.5*	*-6.6*	*-6.7*	*-7.1*
8b. - of which, net current Transfers	*1.3*	*1.5*	*1.3*	*1.3*	*1.3*	*1.3*	*1.3*
8c. p.m. 8 as % of GDP	*-2.5*	*-2.7*	*-3.1*	*-3.1*	*-3.0*	*-3.0*	*-3.1*
9. Current external balance (7+8)	**-16.7**	**-11.3**	**-6.1**	**-4.3**	**-2.9**	**-1.9**	**-1.1**
9a. p.m. 9 as % of GDP	***-9.7***	***-6.6***	***-3.6***	***-2.5***	***-1.6***	***-1.1***	***-0.6***
10. Net capital transactions	2.3	2.6	2.7	2.8	3.0	3.1	3.3
11. Net lending (+)/ net borrowing (-) (9+10)	**-14.4**	**-8.7**	**-3.4**	**-1.4**	**0.1**	**1.2**	**2.1**
11a. p.m. 11 as % of GDP	***-8.3***	***-5.1***	***-2.0***	***-0.8***	***0.1***	***0.7***	***1.1***

Table 6: Fiscal accounts

% of GDP	2010	2011	2012	2013	2014	2015	2016
Indirect taxes	13.4	13.6	14.6	14.7	14.6	14.6	14.6
Direct taxes	8.8	9.9	9.8	9.8	9.8	9.8	9.9
Social contributions	12.2	12.3	12.0	11.9	11.7	11.5	11.3
Sales and other current revenue	4.3	4.4	5.2	5.2	5.2	5.1	5.1
Total current revenue	**38.7**	**40.3**	**41.6**	**41.6**	**41.2**	**41.0**	**40.9**
Capital transfers received	2.7	4.4	1.4	1.4	1.4	1.4	1.4
Total revenue	**41.4**	**44.7**	**42.9**	**43.0**	**42.6**	**42.4**	**42.3**
Compensation of employees	12.2	11.3	9.9	9.6	9.2	9.0	8.9
Intermediate consumption	5.1	4.6	4.5	4.2	4.0	4.0	4.0
Social transfers in kind via market producers	4.9	4.7	4.7	4.4	4.4	4.3	4.2
Social transfers other than in kind	**17.0**	17.4	17.3	17.4	17.2	17.1	16.9
Interest paid	2.9	3.9	4.7	4.7	4.9	4.9	4.9
Subsidies	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Other current expenditure	2.8	2.5	2.5	2.3	2.0	1.8	2.0
Total current expenditure	**45.6**	**45.2**	**44.3**	**43.3**	**42.4**	**41.8**	**41.5**
Gross fixed capital formation	3.6	2.6	2.1	1.8	1.8	1.8	1.7
Other capital expenditure	2.0	1.2	1.0	0.8	0.7	0.7	0.8
Total expenditure	**51.3**	**48.9**	**47.4**	**46.0**	**44.9**	**44.3**	**44.1**
General Government balance (EDP)	**-9.8**	**-4.2**	**-4.5**	**-3.0**	**-2.3**	**-1.9**	**-1.8**
Annual % change		***2011***	***2012***	***2013***	***2014***	***2015***	***2016***
Indirect taxes	*7.8*	*0.7*	*4.3*	*2.2*	*2.4*	*3.7*	*0.0*
Direct taxes	*0.3*	*11.2*	*-2.7*	*1.2*	*2.8*	*3.7*	*4.1*
Social contributions	*0.5*	*-0.3*	*-5.0*	*0.4*	*1.8*	*1.4*	*2.1*
Sales and other current revenue	*-5.3*	*2.7*	*13.4*	*1.3*	*3.3*	*2.5*	*3.5*
Total current revenue	***2.1***	***3.0***	***0.8***	***1.3***	***2.4***	***2.9***	***3.1***
Capital transfers received	*273.4*	*61.5*	*-69.7*	*3.4*	*1.5*	*3.3*	*2.9*
Total revenue	***7.2***	***6.8***	***-6.2***	***1.4***	***2.4***	***2.9***	***3.1***
Compensation of employees	*-1.4*	*-8.2*	*-14.4*	*-2.4*	*-0.8*	*1.4*	*1.5*
Intermediate consumption	*4.2*	*-10.1*	*-5.2*	*-4.5*	*-1.5*	*3.0*	*3.0*
Social transfers in kind via market producers	*1.5*	*-4.7*	*-3.1*	*-4.2*	*1.7*	*1.7*	*2.0*
Social transfers other than in kind	*2.4*	*1.4*	*-2.7*	*1.5*	*2.5*	*2.7*	*2.3*
Interest paid	*3.6*	*32.6*	*18.1*	*2.3*	*7.8*	*3.0*	*2.6*
Subsidies	*-6.1*	*-0.9*	*2.2*	*-1.3*	*-1.0*	*2.5*	*2.5*
Other current expenditure	*14.3*	*-11.3*	*-4.1*	*-6.8*	*-10.2*	*-6.4*	*14.9*
Total current expenditure	***2.1***	***-1.9***	***-4.2***	***-1.0***	***1.1***	***1.9***	***2.8***
Gross fixed capital formation	*23.0*	*-28.9*	*-22.0*	*-9.6*	*-0.5*	*2.9*	*2.0*
Other capital expenditure	*116.9*	*-44.1*	*-15.1*	*-17.2*	*-9.5*	*2.3*	*15.0*
Total expenditure	***5.6***	***-5.5***	***-5.4***	***-1.7***	***0.9***	***2.0***	***2.9***
Nominal GDP, EUR bn	172.7	171.0	166.9	169.1	174.7	180.5	186.8

Table 7: Government debt developments

	2010	2011	2012	2013	2014	2015	2016
EDP deficit (% of GDP)	**-9.8**	**-4.2**	**-4.5**	**-3.0**	**-2.3**	**-1.9**	**-1.8**
EDP gross debt (% of GDP)	93.3	107.8	114.4	118.6	117.7	115.7	113.7
levels, EUR bn							
EDP deficit	**-17.0**	**-7.3**	**-7.5**	**-5.1**	**-4.0**	**-3.4**	**-3.4**
Gross debt	161.1	184.3	190.9	200.6	205.5	208.9	212.3
Change in gross debt	21.2	23.2	6.6	9.7	5.0	3.5	3.3
Nominal GDP	172.7	171.0	166.9	169.1	174.7	180.5	186.8
Real GDP	170.9	168.1	163.1	163.4	166.9	170.1	173.3
Real GDP growth (% change)	**1.4**	**-1.6**	**-3.0**	**0.2**	**2.1**	**1.9**	**1.9**
Change in gross debt (% of GDP)	12.3	13.5	3.9	5.7	2.8	1.9	1.8
Stock-flow adjustments (% of GDP)	2.5	9.3	-0.6	2.7	0.5	0.0	0.0
% of GDP							
Gross debt ratio	**93.3**	**107.8**	**114.4**	**118.6**	**117.7**	**115.7**	**113.7**
Change in gross debt ratio	10.3	14.4	6.6	4.3	-1.0	-1.9	-2.0
Contribution to change in gross debt							
Primary balance	7.0	0.4	-0.2	-1.7	-2.6	-3.0	-3.0
"Snow-ball" effect	0.8	4.7	7.2	3.2	1.0	1.0	0.9
of which							
Interest expenditure	2.9	3.9	4.7	4.7	4.9	4.9	4.9
Real growth effect	-1.2	1.5	3.2	-0.2	-2.5	-2.3	-2.2
Inflation effect	-0.9	-0.6	-0.7	-1.3	-1.4	-1.6	-1.8
Stock-flow adjustments	**2.5**	**9.3**	**-0.6**	**2.7**	**0.5**	**0.0**	**0.0**
Implicit interest rate	3.6	4.1	4.2	4.2	4.3	4.3	4.4

ANNEX 3: INDICATIVE FINANCING NEEDS AND SOURCES

Table 8: Financing needs and sources (EUR billion)

	2011 Jun-Dec	2012 Year	2013 Year	2014 Year	2011-2014 Total
Public sector deficit	**11.3**	**14.8**	**5.9**	**4.7**	**36.6**
Treasury balance 1/	7.1	7.1	4.9	4.1	23.2
Other public sector cash needs 2/	4.2	7.7	1.0	0.6	13.4
Amortization 3/	**9.5**	**17.9**	**10.2**	**14.3**	**51.9**
Medium- and long-term debt	4.9	12.6	9.8	14.3	41.7
Other debt (retail, repos), net	4.6	5.2	0.4	0.0	10.2
Banking support 4/	**1.0**	**12.6**	**4.4**	**0.4**	**18.4**
Financing needs	**21.8**	**45.3**	**20.5**	**19.4**	**107.0**
Market financing	**-6.4**	**4.0**	**11.3**	**12.8**	**21.7**
Medium- and long-term debt	0.0	0.0	9.8	14.3	24.2
T-Bills, net	-6.4	4.0	1.5	-1.5	-2.4
Own resources 5/	**-5.7**	**14.0**	**-0.8**	**-1.3**	**6.2**
EU-IMF loan	**34.0**	**27.3**	**10.0**	**7.8**	**79.1**
EFSM/EFSF	21.0	19.2	6.6	5.1	51.9
IMF 6/	13.0	8.1	3.4	2.7	27.2
Financing sources	**21.8**	**45.3**	**20.5**	**19.4**	**107.0**

SOURCE: Portuguese authorities and Commission services' estimates.

1/ Calendar-year basis.

2/ Includes financing to state-owned enterprises, contributions to the ESM and the economic adjustment programme for Madeira, and repayment of arrears.

3/ Central government, excl. T-Bills.

4/ Includes contributions to Bank Solvency Support Mechanism, projected costs for CGD recapitalization, costs related to BNP resolution and reassignment of bank loans to state-owned enterprises.

5/ Includes in particular privatisation receipts, and use of deposits and pension fund assets.

6/ Numbers do not add up to EUR 26 bn due to changes in EUR-SDR rate compared to beginning of programme.

Table 9: Planned quarterly disbursements

Review	Period covered by disbursement	Approximate disbursement period	Loan disbursements[1]	of which IMF [2] (⅓)	of which EU (⅔)
Approval	Jun-Sept 2011	Jun 2011	**18.5**	6.1	12.4
1	Q4-2011	Sept 2011	**11.6**	4.0	7.6
2	Q1-2012	Dec 2011	**8.1**	2.8	5.3
3	Q2-2012	April 2012	**14.9**	5.2	9.7
4	Q3-2012	July 2012	**4.0**	1.4	2.6
5	Q4-2012	October 2012	**4.3**	1.5	2.8
6	Q1-2013	January 2013	**2.5**	0.9	1.6
7	Q2-2013	April 2013	**2.0**	0.7	1.3
8	Q3-2013	July 2013	**2.8**	1.0	1.8
9	Q4-2013	October 2013	**2.9**	1.0	1.9
10	Q1-2014	January 2014	**2.8**	1.0	1.8
11	Q2-2014	April 2014	**2.6**	0.9	1.7
12	Q3-2014	July 2014	**2.7**	1.0	1.7
	TOTAL		**79.5**	27.5	52.0

[1] Data are subject to revision.
[2] IMF disbursements are defined in SDR. Actual disbursement in EUR is subject to changes in the EUR-SDR exchange rate.

ANNEX 4: PROVISION OF DATA (REPORTING REQUIREMENTS)

During the Programme, the following indicators and reports shall be shared with the European Commission, the ECB and the IMF by the authorities on the agreed periodic basis. Data for past periods should also be included in subsequent transmissions in case of revision. Other indicators may also be requested to and reported by the Portuguese Authorities.

	To be provided by the Ministry of Finance (or INE)	
1.	Data on cash balances of the State Budget. Data will include detailed information on revenue and expenditure items, in line with monthly reports that are published by the Ministry of Finance (MoF). Data on tax revenue should be decomposed in gross tax revenue received and tax reimbursements paid by the State (detailed per main individual taxes)	Monthly, 3 weeks after the end of the month
2.	Data on the cash balances of the other parts of General Government (Autonomous Funds and Services, Social Security and Other entities, including Incorporated State-owned enterprises (ISOEs) or extra-budgetary funds (EBF) not part of the State Budget, but which are, under the European System of Accounts (ESA95) and ESA95 Manual on Government Deficit and Debt rules, classified by the National Statistical Institute (INE) as part of the Central Government; [Regional and Local Governments (*Administrações Regionais and Locais*); Regional and local government-owned enterprises or companies, foundations, cooperatives, and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government, as defined in paragraph 4 of the TMoU) – progressively enlarged	Monthly, as soon as the data are available and no later than 7 weeks after the end of the month
3.	Accrual data on budget execution of the National Health System (NHS)	Monthly, 3 weeks after the end of each month
4.	Consolidated cash data on the General Government budget execution initially comprising the Central Government and Social Security and enlarging progressively the scope as in indicated in the TMoU, MoU and MEFP	Monthly, 7 weeks after the end of each month
5.	Publish information on: number of general government staff on a quarterly basis (no later than 45 days after the end of the quarter); stock and flows over the relevant period per Ministry or employment entity (i.e. new hiring, retirement flows, special mobility condition flows, and exit to other government service, private sector or unemployment); average wage, allowances and bonuses. The regional and local administration will transmit the necessary information. Information on employment in SOEs (central, local and regional) and other public entities and/or bodies will also be compiled	Quarterly, no later than 30 days after the end of the quarter (as of March 2012)
6.	Consolidated account on an accrual basis of the non-financial SOEs that are classified within the Central Government	Quarterly, 90 days after the end of the quarter (as of March 2012)
7.	Data on the past and projected financing needs of SOEs, including for the major SOEs details on the financing needs for the operational balance, capital expenditure, interest payments and debt principal repayments	Monthly, 4 weeks after the end of the month

8.	Data on arrears of: • the General Government, detailed by subsector • the incorporated (SOEs) government-owned hospitals that are not part of the General Government • other non-financial SOEs that are not part of the General Government	Monthly, 7 weeks after the end of each month (as of September 2011)
9.	Information on Public-Private Partnerships (PPP) related revenue and expenditure, for those PPP reclassified within the General Government (in line with paragraph 5.2 of the TMoU)	Monthly, 30 days after the end of the each month
10.	New guarantees granted by the State to SOEs, PPPs, banks and the non-financial private sector	Monthly, 30 days after the end of each month
11.	Detailed information on called guarantees of the State	Monthly, 30 days after the end of each month
12.	Data on proceeds from asset sales by the Central, Regional and Local Government	Monthly for Central Government Quarterly for Regional and Local Government 30 days after the end of reference period
13.	Quarterly data on General Government accounts as per the relevant EU regulations on statistics, showing also the main items of the transition from cash balances to the General Government balances in national accounts	Quarterly, 90 days after the end of each quarter
	To be provided by ESAME	
14.	Report on progress with fulfilment of economic policy conditionality on a quarterly basis. In addition, a short summary report should be sent on a monthly basis	Quarterly (report), two weeks after the end of each quarter. Monthly (short summary report) two weeks after the end of each month for which a report is not due.
	To be provided by the Debt Management Office	
15.	Accrual data on interest spending of the State	Quarterly, 7 weeks after the end of the quarter
	To be provided by the Ministry of Labour	
16.	Data on labour market as follows: a. layoffs by type b. collective agreements by type and number of collective agreements that are extended by the Ministry of Labour to non-signatory firms c. number of collective agreements that regulate the use of the Bank of Hours working time arrangement d. proportion of unemployed receiving unemployment benefits e. distribution of the unemployed in terms of amount of benefits received (mean of benefits received, median, number of unemployed receiving an unemployment benefit amount equal to the IAS and number of unemployed receiving the maximum amount of unemployment benefits allowed) f. unemployment duration	Every six months, 6 weeks after the end of each semester

	To be provided by Ministry of Justice	
17.	Publishing quarterly reports on recovery rates, duration and costs of corporate insolvency cases	Quarterly, starting in 2011 Q3, within four months after the end of each quarter.

ANNEX 5: PROGRAMME DOCUMENTS

LETTER OF INTENT

Lisbon, 27 June 2012

Mr Jean-Claude Juncker
President
Eurogroup

Ms Margrethe Vestager
Minister for Economic Affairs and the Interior
Denmark

Mr Olli Rehn
Vice President
European Commission

Mr Mario Draghi
President
European Central Bank

Dear Madam, dear Sirs,

The attached Memorandum of Understanding (MoU) describes the progress made in recent months towards the objectives laid out in our Programme. It also updates previous MoUs and highlights the additional policy steps to be taken in the months ahead.

Our Economic Adjustment Programme is on track. Economic activity has been stronger than expected in the past few months, reflecting mainly the dynamism of exports. As a result, external adjustment has continued to proceed at a faster pace than initially envisaged. In spite of this, however, unemployment has increased significantly. Budget execution so far this year has been generally in line with projections. After a large drop in December 2011, domestic arrears have increased again over the past few months, leading to several breaches of the continuous indicative target on the non-accumulation of new domestic arrears. We are confident, however, that the ongoing efforts to strengthen expenditure commitment controls and the recent increase in budgetary allocations to the health sector will help ensure compliance with the target in the months ahead.

We have made further strides toward improving our budget monitoring system and strengthening controls over expenditure commitments, and have continued to improve the overall efficiency of our revenue administration. The operational restructuring of the state-owned enterprises (SOEs) and the strengthening of the private-public partnership (PPP) framework, key reforms to alleviate risks to the fiscal consolidation process, are on track. Our policy efforts to support financial system stability have continued, and further steps have been taken to increase competitiveness, growth, and employment.

Looking ahead, risks to the budgetary outlook are tilted to the downside, reflecting mainly the rise in unemployment and a composition of growth less favourable to tax collection. We will therefore continue to closely monitoring fiscal developments in the next few months and assess whether further policy adjustments are necessary to achieve the 2012 target. Building up on the progress made so far on the structural front, we will continue to implement our wide-ranging reform agenda aimed at strengthening fiscal institutions and boosting competitiveness and growth. We will also continue to monitor the pace and composition of the deleveraging process, which needs to remain consistent with the Programme's macroeconomic projections, and complete the planned bank capital augmentation exercise according to the Programme's timeline.

On the basis of the strength of the policies defined in this letter, and in light of our performance under the Programme, we request the completion of the fourth review under the Economic Adjustment Programme, the release of the fifth instalment under the Programme in the amount of EUR 2 600 million.

We remain confident that the policies described in the current and previous MoUs are adequate to achieve the objectives under the Programme. We stand ready to take additional measures should they be needed to meet the objectives of the Economic Adjustment Programme and will consult with the European Commission, the ECB, and the IMF in advance of any necessary revisions to the policies contained in this letter and attached Memoranda.

This letter is copied to Ms Christine Lagarde.

Sincerely yours,

Vítor Gaspar	Carlos da Silva Costa
Minister of State and Finance	Governor of the Banco de Portugal

Attachments: Memorandum of Understanding (MoU); Memorandum of Economic and Financial Policies (MEFP); Technical Memorandum of Understanding (TMU).

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

June 27, 2012

I. MACROECONOMIC OUTLOOK

1. **The economic contraction in the first quarter of the year was milder than envisaged in the program.** Preliminary data indicate that real GDP contracted by 0.1 percent over the previous quarter (compared to an expected 1.4 percent), likely reflecting a stronger-than-expected export performance (see below). For the year as a whole, the expected improvement in net exports is expected to more-than-offset the deterioration in domestic demand. Taking this into account, we now expect a decline in output of about 3 percent in 2012 (compared to 3¼ percent at the time of the third review). We are concerned, however, by the sharp increase in unemployment in recent months (see below). Against the backdrop of weaker domestic demand and falling unit labor cost, and consistent with the deceleration since the beginning of the year, we now expect inflation to average 2¾ percent in 2012.

2. **Despite slowing demand in key trade partners, we expect exports to continue to contribute strongly to growth and external adjustment.** Export growth remained robust in the first quarter, at over 8.5 percent year-over-year. Non euro area trade partners have continued to make a strong contribution to export performance; and over the past year, exports have recovered for a wide range of products and services. We expect these trends to continue and, together with the expected fall in imports, to contribute to a further decline in the current account deficit to about 3.9 percent of GDP this year.

II. ENSURING FISCAL SUSTAINABILITY

3. We remain committed to achieving its deficit objectives of 4½ percent of GDP in 2012 and 3 percent of GDP in 2013—consistent with debt peaking at 118½ percent of GDP next year.

- *Budget execution has been consistent with the 2012 fiscal objectives, but risks are tilted to the downside.* Revenue and expenditure developments have been generally in line with projections, but there are early signs that the sharper-than-expected deterioration in employment and the faster rebalancing of growth away from higher-taxed domestic demand, toward net external demand, is affecting tax revenues and social security accounts. The re-programming of EU funds, lower-than-expected net interest payments, as well as tight budgetary execution will help offset these developments, but downside risks remain. In view of the existing downside risks, we will closely monitor fiscal developments in the months ahead and assess whether further policy adjustments are necessary to achieve the 2012 target.

- *Achieving the 2013 objective will entail a further structural primary adjustment in the order of 1½ percent of GDP. This will bring the cumulative structural primary adjustment in 2011-13 to over 9 percent of GDP. Measures will be designed with a view to minimizing the negative impact of fiscal consolidation on growth. On the expenditure side, which will account for about two thirds of the measures, adjustment will come mainly from further cost rationalization and efficiency gains in the public administration, the health sector, and SOEs, while limiting cuts in capital spending.*

III. PROMOTING EMPLOYMENT

4. **Unemployment is a priority concern.** The unemployment rate rose to some 15 percent in the first quarter of 2012, and the employment level is now 4¼ percent lower than a year ago. Both structural and cyclical factors have contributed to this deterioration. The former is evident from the pronounced employment losses in labor intensive non-tradable sectors. The cyclical aspects are evident from employment decline across a broad range of sectors reflecting tighter fiscal and financial conditions.

5. **Our structural agenda will deliver long-term job growth, but immediate actions are needed to counter the rise in unemployment, particularly among young workers.** Our strategy to support

employment envisages a three pronged approach: active labor market policies with a particular focus on the youth to facilitate transition to work, ways to stimulate employment demand, and continuation of labor market institutions reform.

6. **Active labor market policies:** to sustain labor demand through the downturn and increase the employability of job seekers, we have prepared a package of policies. A plan was launched to revamp the role and functioning of Public Employment Services (PES). We have introduced several new programs, supported by EU funds:

- *Estimulo 2012* provides a wage subsidy for firms that hire and train unemployed enrolled in PES centers for 6 months or more. The program has the potential to reach approximately 56, 000 unemployed. Since February, it has allowed the creation of 4,000 jobs and the placement of 2,000 high-risk unemployed.

- *Vida Ativa* is a targeted training initiative, which delivers high-employability training modules on a part-time basis, to allow the unemployed to keep actively searching for a job. The streamlined placement procedure ensures that all newly-registered unemployed will be attending a training module in no more than 45 days after enrolment in a job center. So far, 67,000 unemployed have already been referred to the training centers and 7,000 have already participated in a training module.

- *Partial accumulation of unemployment benefits and wages* is an initiative to bring into employment those that have been enrolled in PES centers for at least 6 months. It allows cumulating up to 50% of the unemployment benefit (UB), for up to 12 months, when accepting a job offer that pays gross wages below the UB.

- We have established *Impulso Jovem,* specifically to help the unemployed youth—one of the groups most affected by the crisis. We hope to reach 80,000 young unemployed, through : (i) internships, which provide on-the-job training to increase employability; (ii) other programs, which include an incentive for employers through a reimbursement of employers' social security contributions for younger (18-30 years old) unemployed workers and programs aimed at promoting entrepreneurship; and (iii) SME financing activities.

7. **Stimulating employment:** we will assess the budgetary scope for stimulating the demand for labor through tax changes. The positive effects on employment and growth of shifting away from labor taxes can persist even in the long-run, beyond the cyclical downturn. We will explore ways, to design a targeted and deficit-neutral cut in the employers' social security contribution rate. Within a budgetary envelope of around 0.5 percent of GDP, targeting could inter-alia concern younger or lower-income workers. Specific proposals for introducing such a cut in the context of the 2013 budget will be put forward at the next review.

8. Reforming labor market institutions:

- *Reforms are needed to allow firms to respond more flexibly to demand conditions. Comprehensive revisions to the Labor Code, in line with commitments under the program, were approved by the parliament in May. These revisions included measures to facilitate adjusting hours worked rather than cutting jobs, to allow better firm-worker matches, to increase productivity, and to encourage and retain investment in human capital through reducing labor market duality. Further measures will address the convergence of the regime for severance payments to the EU average and their partial financing via a compensation fund.*

- *To limit adjustment through job losses, we will reform the wage setting mechanisms. Affordable wages vary greatly across firms; to reduce job destruction from exit of firms facing wage pressure, we will promote wage developments consistent with firm-level conditions. To that end, we will formalize the criteria for extending collective agreements. The objective will be to ensure that collective agreements subscribed to in sectors where the signatory employer's associations cover less than a 50 percent of the total work force will not be extended to all firms in the sector. In* *cases where this representativeness threshold is reached, a decision on extension will be based on specific criteria aimed at preventing an undue burden on the competitive position of non-affiliated firms in the sector. The draft legislation defining these criteria and the modalities for their implementation will be submitted to Parliament by end- September (structural benchmark).*

IV. CONTAINING FISCAL RISKS

A. Public Financial Management

9. **Strengthening our capacity to better manage public resources remains a priority.** We continue to make progress across a range of public financial management reforms. Key steps over the past few months included the adoption of medium-term expenditure ceilings, an estimation of tax expenditures under an internationally accepted methodology, and an assessment of fiscal risks. The tax expenditure report and fiscal risk statements will be further refined ahead of their publication along with the 2013 budget. In addition, program coordinators are now in place to support our strengthened budget monitoring system. Given the wide scope of our PFM reform agenda, we will take stock of the progress achieved in the first year of the program and, in consultation with the EC and the IMF, develop our PFM strategy for the next three years. This will be put forth in a dedicated document, which will be prepared by mid-September (structural benchmark) and attached to the 2013 budget.

10. **In order to reverse the accumulation of arrears, we will rapidly extend new expenditure commitment control procedures and arrear claims verification to all general government entities.** The implementation of the law on expenditure commitment controls is advancing, with most government entities adjusting their systems to the new requirements. However, further efforts are needed at the subnational government level. In order to ensure across-the-board implementation of the new law, we will work with local governments and the Autonomous Region of Madeira with a view to upgrade their systems by end-July. Regarding the arrears clearance process, the Inspectorate General of Finance (IGF) is close to concluding the verification of claims in the health sector, and payments will start soon after the ongoing negotiations with the creditors are concluded. Given the new credit line aimed to settle arrears and short-term debt at the municipal level (see below), IGF will reinforce the verification of the arrear claims and commitment control systems, giving priority to those municipalities under structural rebalancing.

B. State-Owned Enterprises and Public-Private Partnerships

11. **We are making headway in ensuring state-owned enterprises are financially stable and well managed.** Operational restructuring is proceeding as planned, and we expect SOEs to reach our target of operational balance, on aggregate, by the end of the year. The financial needs of these firms have also remained within the budgeted envelope. In addition, we have approved and will shortly submit to Parliament a law reforming the governance framework for state-owned enterprises (SOEs). The new framework will grant substantially more powers to the Ministry of Finance to ensure that SOEs are financially viable and serve public interests. The creation of a dedicated unit at the Ministry of Finance will also allow detection of potential financial difficulties, so as to encourage early remedial actions.

12. **Tackling fiscal risks stemming from SOEs remains a priority.** Eliminating operational deficits will not be enough to restore financial balance in many firms, and legacy debt needs to be addressed. We have already prepared an initial report presenting options to unwind Parpública (end-April structural benchmark). However, a more comprehensive strategy to deal with all SOEs debt is necessary. We will prepare such a strategy by end-July. It will be based on a principle of full disclosure and transparency. It will also take into account the need to ensure a proper incentive structure, including maintaining a hard budget constraint, so as to avoid a new build up in unsustainable debt in the future.

13. **Our privatization program is proceeding as planned.** The sales of EDP and REN have been completed. We have selected advisors for the privatization of the airline, TAP, and the airport concessionaire, ANA, and the next step is to seek expressions of interest in these two companies; we expect the sales to be completed late this year, with the proceeds benefiting the budget in 2013. The sale of the rail

cargo firm CP Carga has been delayed in order to coordinate policies on infrastructure links with Spain and ensure economic benefits can be maximized. Legal and regulatory preconditions and internal restructuring for the sales next year of the postal company CTT and a television channel and radio station belonging to RTP are falling into place. We are also advancing in the reorganization of the water company Águas de Portugal, with a view to assessing the scope for introducing private capital and management, and privatizing waste management areas.

14. **The reform of the PPP framework, which aims at reducing the risks to the public finances, is on track.** A new legal and institutional framework, which aims at ensuring fiscally sound decisions in this area, was enacted in May. The new decree-law strengthens the role of the Ministry of Finance in assessing and monitoring fiscal consequences of PPP contracts, including through the creation of a specialized PPP unit. We will work towards finding a solution to impose similar requirements at the regional level by end-September 2012. At the same time, the study prepared by the independent accounting firm selected earlier this year is advancing, and completion is expected by end-June. For certain PPP and concession contracts, the renegotiation process started before the completion of the study, due to financial or legal imperatives. The negotiations are progressing and are expected to result in significant reductions in outlays for the state. Other than these, final decisions on renegotiation will be taken after the study's conclusion and in consultation with the EC, ECB and the IMF.

C. Revenue Administration

15. **Revenue administration reforms are proceeding apace, with a strong focus on fighting non-compliance.** We are progressing with implementation of the multi-year Plan to Combat Fraud and Evasion. Amongst other measures, we will (i) enable the tax administration to access information gathered in the context of anti-money laundering and other criminal investigations and (ii) press ahead with a wider adoption of electronic invoicing in Portugal. In particular, an incentive scheme to combat evasion through encouraging taxpayers to ask for the issuance of invoices, notably in hard-to-tax sectors, will be adopted. We will closely monitor the implementation of this scheme, and consult with the EC, ECB and the IMF on any developments regarding the scheme design. An evaluation report of the scheme will be prepared by end-March, 2013. In addition, our reforms to streamline the local branches network and implement a full-fledged Large Taxpayers Office are on track. A working group has concluded that the merger between the Autoridade Tributária e Aduaneira (AT) and the revenue collection function of the Social Security was not feasible in the short-middle term, but stressed the advantages of greater coordination between the two entities. We will, by end-August: i) prepare a draft proposal to enhance the exchange of information between the AT and the Social Security and (ii) study ways of possible implementation of the other working group recommendations to strengthen control and simplifying compliance.

16. **We continue to advance in our efforts to modernize tax appeals at the judicial level.** The task force of judges has increased the pace of its work on high-value tax cases, and we remain committed to clear the remaining such cases in courts. Based on the report already presented, we will draft, by August 20, 2012, an action plan with concrete measures and timelines to resolve the backlog related to the regularization of VAT bad debts. We will further assess the possibility of introducing transitional measures regarding the cases currently filed in courts, taking into account tax fraud and erosion risks. We are committed to improve transparency by publishing quarterly reports on recovery rates, duration and costs of tax cases in courts within four months of the end of each quarter, starting in the fourth quarter of 2012.

D. Public Administration

17. **We are committed to reducing wasteful spending in the public sector.** Significant progress is being made in streamlining the public administration and modernizing its governance. We have launched a new public employment information system for central and subnational administrations and enhanced transparency by publishing comprehensive public labor statistics for the first time. Based on the new system, a comprehensive assessment on public pay scales will be prepared by year-end. We have concluded the census of foundations, and the law regulating their creation and functioning has been approved. The final report on the central administration restructuring plan (PREMAC)—which aims at a reduction of

40 percent of administrative units and 27 percent of management positions—will be completed by end-September. Finally, the negotiations with public sector labor unions aimed at facilitating working time flexibility and geographical mobility are well advanced.

E. Regional and Local Public Finances

18. **A comprehensive reform aimed at putting the subnational governments' public finances on a sound and sustainable path remains a key objective.** The working group in charge of revising regional and local finance laws has further advanced its work, with support of EC and IMF technical assistance. As part of this process, and with the goal of reducing systematically over-stated revenue projections in local and regional governments' budgets, we will by end-September: (i) prepare a proposal for common revenue forecasting guidelines for subnational governments, and (ii) define the types of data to be exchanged between the central and subnational governments, striking a balance between tax secrecy protection and effective sharing of information across governmental levels. We have also made progress in streamlining local governments' administrations: (i) the law to reduce the number of parishes has been approved, and these changes will come into effect by the beginning of the next local elections; and (ii) the new regime for local SOEs has been submitted to Parliament.

19. W**e have launched a special program to support local governments under financial stress.** We will open a €1 billion credit line to help municipalities clear their arrears and amortize short-term debt. Clearance of arrears under this scheme will be subject to the principles laid out in our Strategy for the Settlement of Arrears. We will ensure that the process of alleviating local debt burdens is consistent with our fiscal consolidation targets. Municipalities in difficulties benefiting from this credit line will be requested to prepare and implement tailored adjustment programs. We will prepare by end-July a document detailing the procedures and responsible units for monitoring, controlling and auditing this program. We will also ensure transparency of the use of the credit line through the monthly publication of the amounts lent, disbursed, and used to settle arrears and other liabilities by municipality.

20. **The Autonomous Region of Madeira completed the first review of its program.** Progress has been made towards fiscal consolidation and the fiscal structural reform program is broadly on track. Nevertheless, increasing risks have been identified and the regional government is bound to adopt corrective measures in case of a deviation vis-à-vis the program targets.

V. PROTECTING THE FINANCIAL SYSTEM AMIDST DELEVERAGING AND SOVEREIGN CRISES

21. **Efforts to secure an orderly deleveraging of the economy are ongoing.** The easing of liquidity pressures and attendant augmentation of banks' capital is helping alleviate risks of an excessive credit contraction. However, with funding strains evident in certain segments, we are taking measures to ensure that the productive sectors of the economy are able to secure continued access to credit as deleveraging proceeds. To this end, the ongoing proposal being prepared to foster the diversification of financing alternatives to the corporate sector is on track to be completed by end-July. In parallel, in the context of its regular supervisory program, the Banco de Portugal (BdP) continues to evaluate banks' impairment levels and to discourage ever-greening of problematic loans. As part of these efforts, it has issued an instruction for banks to identify and report recently restructured loans due to financial difficulties. Also, BdP has launched on-site inspections focusing on those assets that are more sensitive to current market conditions. If needed, these inspections will be used to develop appropriate policy guidelines.

22. **Adequate bank liquidity remains essential to preserve financial stability.** Under conditions of heightened risks in the euro area, exceptional Eurosystem liquidity support at longer maturities and a broadening of the collateral eligibility criteria are playing a pivotal role in easing liquidity pressures and potential constraints to bank lending. We continue to encourage banks to strengthen their collateral buffers on a sustainable basis and reduce their dependence on Eurosystem liquidity over the medium term.

23. **The bank capital augmentation exercise is nearing conclusion.** The BdP has reviewed the banks' funding and capital plans for meeting by end-June 2012 the Core Tier 1 program target of 9 percent, taking into account the Special on-site Inspections Programme, the pension fund transfer and the 2011 EBA capital exercise, and has provided the Minister of Finance with a duly motivated opinion on the banks foreseeing to apply, under the relevant legislation, to public investment in order to fulfill their capital needs. Following the publication of the Ministerial Order ("Portaria") on May 17, 2012, agreement has been reached with the relevant banks on the amount, mix and conditionality of public capital support. The banks, in turn, have initiated all the necessary steps to ensure completion of the envisaged capital augmentation measures by the end-June 2012 deadline. Upon completion, these measures are expected to enable the large Portuguese banks to meet the Core Tier 1 program target of 10 percent at end-2012, as well as the end-June 2012 requirements. Banks receiving public capital support were required to draw up comprehensive business plans, aimed at enhancing the banks' resilience, inter alia through restructuring measures, better risk control and corporate governance, and cost reduction. BdP is closely monitoring the compliance of the set targets by the relevant deadlines, with a view to promptly take appropriate action in case these are not met.

24. **Resources from the Bank Solvency Support Facility (BSSF) remain available to provide further support to viable banks, if needed.** We remain committed to supporting viable banks in line with state aid rules and subject to strict conditionality in order to avoid that private shareholders are effectively subsidized by the public sector and that private liabilities migrate to the public sector balance sheet. The remaining resources in the BSSF will solely be utilized to provide public support, if needed, to the banking system.

25. **Efforts to streamline the state-owned Caixa Geral de Depósitos (CGD) are continuing.** Plans to augment CGD's capital before end-June 2012 have been finalized, utilizing cash buffers outside of the BSSF. The divestitures of its insurance arm and health sector activities to third parties are on track to be completed before end-2012, and sales of equity stakes are ongoing.

26. **We are implementing the strategy for managing the distressed assets from Banco Português de Negócios (BPN).** Following the completion of the sale of BPN to Banco BIC Portugues, we have obtained advice from an independent party on the process for recovering the assets currently held by three state-owned SPVs. On the basis thereof, we intend to outsource the management of the assets to a professional third party, with a mandate to gradually recover the assets over time. The party managing the assets will be selected through a competitive bidding process and the mandate will include proper incentives to optimize the recoveries. CGD's state guaranteed claim will be gradually settled in cash, according to the schedule agreed with the EC, ECB and IMF. Any net recoveries realized on the assets will also be applied towards the settlement of CGD's claim.

27. **BdP continues to strengthen its prudential supervision.** The BdP is pursuing multiple initiatives to enhance its supervisory organization, optimize its supervisory processes and develop and implement new supervisory methodologies and tools. Moreover, onsite inspections have been launched at the initiative of BdP that will focus on those assets that are more sensitive to current market conditions. In addition, the BdP is stepping up its monitoring of banks, including via ad hoc audits.

28. **The early intervention, resolution, and deposit guarantee framework has been strengthened.** We are in the process of adopting the implementing measures necessary for completion of the new legislative framework for banking resolution. We will pass regulations relating to the resolution fund and its funding arrangements (end-July 2012) and the BdP will finalize supervisory notices on recovery plans (end-July 2012), bridge banks (end-September 2012), and resolution plans (end-October 2012). In reviewing the banks' recovery and subsequent resolution plans, the BdP intends to give priority to banks that are of systemic importance. Moreover, we will swiftly transpose the new EU Directive on bank resolution as soon as it enters into force.

29. **We have improved the legal framework for corporate debt restructurings.** The corporate insolvency law amendments to support better early rescue of viable firms (mid-June 2012 structural

benchmark) became effective on May 20, 2012. We will continue to step up actions to raise public awareness of the new restructuring tools. In addition, we are finalizing the conciliation framework mediated by IAPMEI, a public entity, to facilitate extrajudicial corporate debt restructurings for viable SMEs.

30. **Resolving household sector indebtedness in an orderly fashion remains a key priority.** We continue to monitor the evolution of household indebtedness closely and are establishing a framework for financial institutions to engage in out-of-court debt restructuring for households.

VI. BOOSTING COMPETITIVENESS AND GROWTH

A. Goods and Services Market Reforms and Competition Framework

31. **In the electricity sector, we have taken measures that reduce excess rents and will alleviate the pressure they ultimately place on end-user prices.** Both related structural benchmarks were met in May. First, we eliminated the Power Guarantee incentive for cases where investment decisions had already been taken without the expectation of an additional incentive—i.e. for power plants already licensed prior to the law that established this incentive. Second, to accelerate convergence to market-based pricing for co-generation operators, we published the new reference tariff and the formula for updating tariffs in the transitional regime, during which tariffs will decline gradually. In addition, we are negotiating with stakeholders a reduction in the compensation paid on early termination of PPA contracts and for recouping payment for rights to operate beyond the contract period. The cumulative effect of these and other rent-reducing measures would be to reduce cumulative real price growth in electricity by 4 percentage points baseline in absence of policy change. Further commitments to ensure the sustainability of the national electricity system are described in the Memorandum of Understanding on Specific Economic Policy Conditionality (MoU) with the EC.

32. We remain committed to further correcting the impact of policies that have led to limited competition, high costs, and low productivity.

- A *landmark revision of the Ports Work Law*, which will be submitted to Parliament shortly, lowers wage costs dramatically for the workers who have traditionally enjoyed an extreme degree of protection. This, together with the early retirement for historical port workers, removes the constraints to optimizing the use of labor, by freeing the use of temporary workers and allowing for more flexibility in contracts for intermittent work periods. To ensure the transmission of substantially lower unit labor costs to the price of services in this sector, we will look to international experience with engendering competitive outcomes within the concession framework—for example in designing performance clauses (see Memorandum of Understanding 5.20).

- The *new Competition Law* was approved by Parliament, published on May 8, and will enter into force in July. Given the expanded scope of roles and responsibilities of the Competition Authority, we will review, in consultation with key stakeholders, the conditions for proper execution of its mandate. We will also monitor the inflow of cases in the specialized Competition Court, which began operations on April 2, with a view to assessing the risk of potential backlogs. Work on the report reviewing and benchmarking the responsibilities, resources, as well as the independence of the main sectoral regulators, has begun. A proposal for policy actions based on key findings will be prepared by end-September 2012 (structural benchmark), to be implemented by end-2012.

- Following a number of corrective measures already taken, we will continue to *monitor the competitive environment in the telecommunications sector*, in particular wholesale and retail broadband access and mobile origination charges, and barriers to entry into the fixed communication market.

- We are preparing a *new horizontal framework law* requiring highly regulated professions (such as lawyers, accountants, architects) to change their bylaws to ease access to these professions and limit anti-competitive practices. We will reform the functioning of the construction and real estate sectors by facilitating cross-border provision and easing establishment conditions.

B. Business Environment

33. **We are pursuing our efforts to facilitate business entry through the Point of Single Contact (PSC) platform.** We have made progress in presenting clear information for already-established and for cross-border service providers, and will seek ways to ensure stronger and faster cooperation from responsible agencies in providing the needed assistance at the local and central administration level. We have also taken a number of important initiatives to cut red tape. We intend to use the PSC platform to provide "zero industrial licensing" services for the majority of industrial firms. A recently approved decree law has committed to simplify licensing procedures where bottlenecks have been identified. In addition, reforms to remove barriers in the areas of building permits, land use, territorial planning and environment are also in the pipeline.

C. Judicial Reform

34. **We continue pushing ahead with targeted measures to reduce the backlogged enforcement cases that slow the judicial process and generate costs across the economy.** An additional 20,000 enforcement cases have been cleared, bringing down the total number by about 70,000 enforcement cases since November 2011, and the inter-agency task force has set quarterly targets for closing enforcement cases by mid-August 2012. We will prepare an initial draft bill to strengthen the legal and institutional framework for enforcement agents and to include a fee structure that incentivizes speedy enforcement by mid-August 2012, which will be further refined by mid-October 2012 based on extensive consultation including IMF/EU technical assistance and informed by cross country experience. We continue overhauling the information system to facilitate the speedy processing of court cases.

35. **We are advancing two major reforms to improve efficiency of the court system.** We have refined the comprehensive judicial roadmap to reduce the number of courts and streamline the court structure with extensive stakeholder consultation. We will prepare an initial draft bill on the judicial roadmap by mid-August 2012, which will then be revised by end-September 2012, in consultation with stakeholders and also informed by IMF/EU technical assistance, and submit the bill to Parliament by end-November 2012 (structural benchmark). We have decided to adopt an entirely new Code of Civil Procedure to speed up the judicial process rather than amending the current Code. An initial draft for the new Code of Civil Procedure will be prepared by July 6, 2012 which will then be further refined by end-September 2012, informed by stakeholder consultation and IMF/EU technical assistance. We will submit the new Code of Civil Procedure to Parliament by end-November 2012 (structural benchmark).

Table 1. Portugal: Quantitiative Performance Criteria
(In billions of Euros, unless otherwise specified)

	Performance Criteria (unless indicated otherwise)										Indicative Targets
	Jun-11		Sep-11		Dec-11		Mar-12				
	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Jun-12	Sep-12	Dec-12
1. Floor on the consolidated General Government cash balance (cumulative)	-5.4	-5.1	-6.7	-5.7	-10.3	-7.1	-1.9	-0.45	-4.4	-5.9	-7.5
2. Ceiling on accumulation of domestic arrears by the General Government (continuous indicative target) 1/	…	…	0	0.2	0	Not met	0	Not met	0	0	0
3. Ceiling on the overall stock of General Government debt	175.9	167.9	175.9	170.8	175.9	167.8	182.0	171.2	175.0	177.5	177.5
4. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the general government (continuous performance criterion)	0	0	0	0	0	0	0	0	0	0	0

1/ Domestic arrears increased by €236 million in October-November 2011. They decreased by €320 million in December, but increased again during the first three months of 2012 (by €333 million).

Table 2. Portugal: Structural Conditionality: Fourth Review Under the EFF

	Measure	Timing	Status
Structural Benchmarks			
A. Strengthen financial stability			
1	Amend relevant legislation in consultation with the EC, the ECB and the IMF to strengthen the early intervention framework, introduce a regime for restructuring of banks as a going concern under official control and strengthen deposit insurance framework.	End-Dec. 2011	Met
2	Amend the Insolvency Law to better facilitate effective rescue of viable firms. 1/	End-Dec. 2011	Met with delay
3	Amend the framework (Law No. 63-A/2008) for bank access to public capital	End-Jan. 2012	Met
4	Make effective the amendments to the Corporate Insolvency Law to better support rescue of viable firms (after completing all necessary legislative and publication requirements)	Mid-June 2012	Met
5	Prepare a proposal for encouraging the diversification of financing alternatives to the corporate sector.	End-July 2012	
B. Enhance competitiveness and address bottlenecks to growth			
6	Submit to Parliament legislation revising the Competition Law, making it as autonomous as possible from the Administrative Law and the Penal Procedural Law and more harmonized with the European Union competition legal framework.	End-Jan. 2012	Met with delay
7	Prepare a proposal on measures to be used to correct excessive rents in special (co-generation and renewables) and standard regimes (CMECs, PPAs, and power guarantee mechanism). The proposal will consider the merits of a full range of measures and cover all sources of rents.	End-Jan. 2012	Met with delay
8	Review the Code of Civil Procedure and prepare a proposal addressing the key areas for refinement.	End-Dec. 2011	Met
9	Take all necessary legal, administrative, and other steps to make arbitration fully operational.	End-Feb. 2012	Met
10	Eliminate the Power Guarantee investment incentive for the set of power plants existing or already licensed at the time of the approval of the 2007 Decree Law (264/2007) governing this incentive	End-April 2012	Met with Delay 2/
11	Publish the Ministerial Order defining the new reference tariff and formula for updating tariffs in the future for the electricity co-genereration regime.	End-April 2012	Met with Delay 2/
12	Submit to Parliament draft legislation defining the criteria for extension of collective agreements (including a majority representation threshold) and the modalities for their implementation.	End-Sept 2012	
13	Prepare a proposal to implement identified best international practices in order to reinforce the independence of the main sectoral regulators.	End-Sept 2012	Reset from mid-Aug 2012
14	Submit to Parliament a new Code of Civil Procedure to streamline and speed up the court procedures.	End-Nov 2012	Reset from end Sept 2012 3/
15	Submit to Parliament the bill to implement the judicial roadmap to improve the court structure.	End-Nov 2012	Reset from end Sept 2012 3/
C. Strengthen fiscal institutions and reduce fiscal risks			
16	Launch a tender to hire a top tier international accounting firm to review and complete a more detailed study of all 36 PPP contracts at the national level.	End-Dec. 2011	Met
17	Prepare a report on SOEs based on forecast financial statements assessing their financial prospects, potential government exposure, and scope for orderly privatization.	End-Feb. 2012	Met with delay
18	Develop a specific program for unwinding Parpublica.	End-April 2012	Met
19	Develop a PFM strategy covering the next three years, to be attached to the 2013 budget.	Mid-Sept 2012	
20	Revise and submit to Parliament the draft regional and local public finance law.	End-Dec. 2012	Reset from end-March 2012
21	Implement a full-fledged Large Taxpayer Office (LTO), to cover audit, taxpayer services, and legal functions concerning all large taxpayers, including the adoption of account managers.	End-Dec. 2012	

1/ The amendments were approved by the Council of Ministers and submitted to Parliament in December 2011, but were approved by Parliament on March 9, 2012.

2/ The two executive orders on co-generation remuneration and power guarantee incentives were signed on April 30th, establishing the legal changes to the regime, but publication was delayed to May 14.

3/ Reset to reflect more demanding nature of benchmark (i.e. a new code instead of the previously envisaged changes to the existing code)

TECHNICAL MEMORANDUM OF UNDERSTANDING

June 27, 2012

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies. It also describes the methods to be used in assessing the Program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the EC, the ECB, and the IMF before modifying measures contained in this letter or adopting new measures that would deviate from the goals of the Program, and provide the EC, the ECB, and the IMF with the necessary information for Program monitoring.

2. For Program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "Program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at spot exchange rate (i.e., the rate for immediate delivery) prevailing on the date of the transaction. The Program exchange rates are those that prevailed on May 5, 2011. In particular, the exchange rates for the purposes of the Program are set €1 = 1.483 U.S. dollar, €1 = 116.8390 Japanese yen, €1.09512 = 1 SDR.

3. For reporting purposes, the MoF and BdP will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the IMF.

General Government

4. **Definition:** For the purposes of the Program, the General Government, as defined in the Budget Framework Law, Law No. 91/2001 of August 20, amended by Law 22/2011 of May 20, includes**:**

4.1. The Central Government. This includes:

4.1.1. The entities covered under the State Budget, which covers the budgets of the Central Administration, including the agencies and services that are not administratively and financially autonomous, agencies and services that are administratively and financially autonomous (*Serviços e Fundos Autónomos* – SFA).

4.1.2. Other entities, including Incorporated State-owned enterprises (ISOE), or extra-budgetary funds (EBF) not part of the State Budget, but which are, under the European System of Accounts (ESA95) and ESA95 Manual on Government Deficit and Debt rules, classified by the National Statistical Institute (INE) as part of the Central Government.

4.2. Regional and Local Governments, that include:

4.2.1. Regional Governments of Madeira and Azores and Local Governments (*Administrações Regionais and Locais*);

4.2.2. Regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government.

4.3. Social Security Funds comprising all funds that are established in the general social security system.

- This definition of General Government also includes any new funds, or other special budgetary and extra budgetary programs or entities that may be created during the Program period to carry out operations of a fiscal nature and which are, under the ESA95 and ESA95 Manual on Government

Deficit and Debt rules, classified by the INE in the correspondent subsector. The MoF will inform the EC, ECB, and IMF of the creation of any such new funds, programs, entities or operations at the time of its creation or statistical re-classification or, in the case of Regional and Local Governments, at the time the Government acknowledges its creation.

- The General Government, as measured for purposes of Program monitoring in 2012, shall not include entities nor operations (including pension funds) that are re-classified into the General Government during 2012, but shall include those reclassified in 2011.[1]

5. **Supporting Material**

5.1. Data on cash balances of the State Budget will be provided to the EC, the ECB and the IMF by the MoF within three weeks after the end of the month. Data will include detailed information on revenue and expenditure items, in line with monthly reports that are published by the MoF.

5.2. Data on the cash balances of the other parts of General Government as defined in paragraph 4[2] will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of the month. Data will include detailed information on revenue and expenditure items. Data will also include detailed information on PPP-related revenues and expenditures for those PPP reclassified within the General Government sector according to ESA 95, and called guarantees.

5.3. Data on domestic and external debt redemptions (securities), new domestic and external debt issuance (securities), change in the domestic and foreign currency assets and liabilities of the Central Government at the BdP and other financial institutions will be provided to the EC, the ECB, and the IMF by the BdP within 40 days after the closing of each month.

5.4. BdP will provide to the EC, the ECB, and the IMF detailed monthly data on the financing of the General Government, as defined in ESA95, within seven weeks after the closing of each month.

5.5. Data on the revenues, operating expenses, capital expenditure, remuneration of personnel, EBITDA, and number of staff will be provided for state-owned enterprises (SOEs) on a quarterly basis, within 7 weeks after the end of each quarter. Aggregate data for the SOEs within the perimeter will be provided, with company-specific information for REFER, Estradas de Portugal, Metro de Lisboa, and Metro de Porto. Furthermore data for Comboios de Portugal and Parpública (outside the perimeter) will also be provided.

QUANTITATIVE PERFORMANCE CRITERIA, INDICATIVE CEILINGS, AND CONTINUOUS PERFORMANCE CRITERIA: DEFINITIONS AND REPORTING STANDARDS

A. Floor on the Consolidated General Government Cash Balance (Performance Criterion)

6. **Definition:** The consolidated General Government cash balance (CGGCB) is defined as the sum of the cash balances of the entities covered by the State Budget, the ISOE, the Regional and Local Governments, and the Social Security Funds, and other entities and EBFs, as defined in paragraph 4. Privatization receipts will be excluded from cash receipts. In 2012 and beyond, revenues from the reclassification of pension funds into the

[1] An operation refers to part of a legal entity that is involved in the production or delivery of goods and services—including government services provided on a nonmarket basis. As such, it does not include transactions relating to the assets or liabilities of an entity. For example, should an entity handle a number of PPPs, reclassifying only one PPP would be considered as reclassifying an operation. In contrast, taking over part of an entity's debt by the government would not qualify for the exclusion. On this issue, see also paragraph 13.

[2] In 2011, data exclude regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government, i.e., entities referred in paragraph 4.2.2.

general government will not be accounted for as cash revenues for the purpose of the calculation of the consolidated general government cash balance. The net acquisition of financial assets for policy purposes, including loans and equity participation will be recorded as cash expenditures, except for transactions related to the banking sector support and restructuring strategy under the Program. Called guarantees (excluding those related to the banking sector support and restructuring strategy), where entities of the General Government make cash payments on behalf of entities that are not part of the General Government, will be recorded as cash expenditures.

6.1. **The cash balance of the State Budget.** The cash balance of the State Budget will be measured from above the line, based on budget revenues (recurrent revenue plus nonrecurrent revenue, including EU revenues, minus tax refunds) minus budget expenditures of the State Budget as published monthly on the official website of the DGO of the MoF, and in line with the corresponding line items established in the State Budget. Budget expenditures will exclude amortization payments but include salaries and other payments to staff and pensions; grants to Social Security Funds, medical care and social protection; operational and other expenditure, interest payments; cash payments for military equipment procurement; and EU expenses.

6.2. **The cash balance of the Regional and Local Governments, Social Security Funds, ISOE and other entities or EBFs.** The cash balance of each of these parts of the General Government will be measured from above the line, based on revenues minus expenditures as it will be provided by the DGO of the MoF in the monthly General Government budget execution report (see Para 5), and in line with the corresponding line items established in their respective budgets. All entities including ISOE that prepare accrual-based financial statements will submit monthly cash flow statement in accordance with form and content specified by the MoF. The reporting by Local Government will be phased as set out in paragraph 8 below.

6.3 **Adjustor.** The 2012 quarterly floors on the consolidated general government cash balance will be adjusted for the cumulative amount of arrears settled in the context of the arrears clearance strategy. This includes the health sector arrears settled with the banks' pension funds transfers' resources, as well as local government arrears settled through the €1 billion credit facility created in May 2012.

Other Provisions

7. For the purpose of the program, the expenditure of the central government that is monitored excludes payments related to bank support, when carried out under the program's banking sector and restructuring strategy. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to the EC, ECB, and IMF.

8. Quarterly consolidated accounts for the General Government on a cash basis will be reported for internal, EC, ECB, and IMF monitoring 7 weeks after the reference period, starting with the first quarter of 2012. The reports will be published externally starting with December 2011 data. SOEs will be consolidated with the general government accounts starting with the first quarter 2012. The larger municipalities (defined as those with a population of 100,000 voters or more) are required to provide monthly reports under current arrangements, and their cash balance will be included in the calculation of the monthly cash General Government balance. The cash balance of the smaller municipalities, i.e. those with a population of under 100,000 voters, will be excluded until any necessary legal changes requiring them to provide monthly reports have been put in place. In this transitory period, the MoF will provide a monthly estimate of the cash balance of these smaller municipalities excluded from the General Government reports to the EC, the ECB, and the IMF.

9. **Supporting Material**

9.1. Data on cash balances of the State Government, ISOEs, Regional and Local Government and Social Security Funds will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of each month. The information provided will include general government net acquisitions of financial assets for policy purposes, including loans and equity participations, as well as called guarantees where entities that are part of the General Government make cash payments on behalf of entities that are not part of the General Government.

9.2. The MoF will submit quarterly data on General Government accounts determined by the INE in accordance with ESA 95 rules, showing also the main items of the transition from cash balances to the General Government balances in national accounts. The reconciliation will be accompanied by necessary explanatory materials for any indication of potential deviation of the annual general government cash target from the annual general government accrual target determined in accordance with ESA 95 rules.

B. Non-Accumulation of New Domestic Arrears by the General Government (Continuous Indicative Target)

10. **Definitions.** Commitment, liabilities, payables/creditors, and arrears can arise in respect of all types of expenditure. These include employment costs, utilities, transfer payments, interest, goods and services and capital expenditure. Commitments are explicit or implicit agreements to make payment(s) to another party in exchange for that party supplying goods and services or fulfilling other conditions. Commitments can be for specific goods and services and arise when a formal action is taken by a government agency, e.g., issuance of a purchase order or signing a contract. Commitment can also be of a continuing nature that require a series of payments over an indeterminate period of time and may or may not involve a contract, e.g. salaries, utilities, and entitlement payments. Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources (usually cash) embodying economic benefits or service potential. In relation to commitment, the liability arises when a third party satisfies the terms of the contract or similar arrangement. Payables/creditors are a subset of liabilities. For the purposes of the program payables/creditors exclude provisions, accrued liabilities. Arrears are a subset of payables/creditors. For the purposes of the Program domestic arrears are defined as payables/creditors (including foreigner commercial creditors), that have remained unpaid for 90 days or more beyond any specified due date (regardless of any contractual grace period). In case no due date is specified, arrears are defined as payables/creditors that have remained unpaid for 90 days or more after the date of the invoice or contract. Data on arrears will be provided within seven weeks after the end of each month. The continuous indicative target of non-accumulation of new domestic arrears requires that the total arrears at the end of any month are not greater than the corresponding total at the end of the previous month—based on the same perimeter with respect to the entities covered. This also includes arrears that are being accumulated by the SOEs not included in the General Government.

11. **Supporting Material.** The stock of arrears will be measured through a survey. Reports on the stock of arrears of the General Government are being published monthly. The MoF will provide consistent data on monthly expenditure arrears of the General Government, as defined above. Data will be provided within seven weeks after the end of each month and will include total arrears classified by the different constituent sectors of the General Government sub-sector as defined in paragraph 4, as well as the monthly amounts of (i) health sector arrears settled with the banks' pension funds transfers' resources, and (ii) local government arrears settled through the €1 billion credit facility created in May 2012.

12. **Adjustor.** The monthly change in the stock of arrears will be adjusted for any stock adjustment related to the arrears clearance strategy. This includes the health sector arrears settled with the banks' pension funds transfers' resources, as well as local government arrears settled through the €1 billion credit facility created in May 2012. This will allow monitoring the underlying flow of new arrears.

C. Ceiling on the Overall Stock of General Government Debt (Performance Criterion)

13. **Definition.** The overall stock of General Government debt will refer to the definition established by Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the Excessive Deficit Procedure annexed to the Treaty establishing the European Community. For the purposes of the Program, the stock of General Government debt will exclude: (i) debt contracted for bank restructuring, when carried out under the Program's banking sector support and restructuring strategy; (ii) IGCP deposits; and (iii) (from end-September 2011) the *'prepaid margin'* on all EFSF loans.

14. **Adjusters.** For 2012, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) revision to the stock at end-December 2011 general government debt of EUR183.33 billion. From 2013 onwards, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) reclassification of entities or operations that affects the stock at end-December of the previous year.

15. **Supporting Material.** Quarterly data on the total stock of General Government debt as defined in paragraph 12 will be provided to the EC, ECB and IMF by the BdP no later than 90 days after the end of each quarter, as reported to the ECB and the Eurostat. Monthly estimates will be provided to the EC, ECB and IMF by BdP no later than seven weeks after the end of each month.

D. Non-Accumulation of New External Debt Payments Arrears by the General Government (Continuous Performance Criterion)

16. **Definition.** For the purposes of the Program, the definition of debt is the same as in paragraph 12. An external debt payment arrear will be defined as a payment on debt to nonresidents, contracted or guaranteed by the general government, which has not been made within seven days after falling due (taking into account any applicable contractual grace period). The performance criterion will apply on a continuous basis throughout the Program period.

17. **Supporting Material.** Any external debt payment arrears of the General Government will be immediately reported by the MoF.

E. Bank Solvency Support Facility

18. €1 billion has been provided in cash and is made available in a separate dedicated account to be set up at the Bank of Portugal by end-June 2011. An additional €5 billion has been deposited so far in 2012. Future amounts for the bank support fund will be deposited into the dedicated account to the extent that there is a need for bank capital.

F. Overall Monitoring and Reporting Requirements

19. Performance under the Program will be monitored from data supplied to the EC, the ECB, and the IMF by the MoF and BdP. The authorities will transmit to the EC, ECB, and IMF any data revisions in a timely manner.

MEMORANDUM OF UNDERSTANDING ON
SPECIFIC ECONOMIC POLICY CONDITIONALITY

Fourth Update - 27 June 2012

With regard to Council Regulation (EU) n° 407/2010 of 11 May 2010 establishing a European Financial Stabilisation Mechanism (EFSM), and in particular Article 3(5) thereof, the fourth update of the Memorandum of Understanding on specific economic policy conditionality (MoU) details the general economic policy conditions as embedded in Council Implementing Decision 2011/344/EU of 17 May 2011 on granting Union financial assistance to Portugal[3]

The first disbursement of financial assistance from the EFSM took place following the entry into force of the MoU and of the Loan Agreement.

The Council Implementing Decision specifies that the release of further instalments is conditional on a positive conclusion of the reviews of conditionality that will take place throughout the three-year duration of the programme. These reviews will assess progress made with respect to the policy criteria in the Council Implementing Decision and specified in the Memorandum of Economic and Financial Policies (MEFP) and in this updated MoU, as well as Council Recommendations in the context of the Excessive Deficit Procedure.

The fourth quarterly review was carried out in May 2012. It assessed compliance with the conditions to be met by end-March and the need and scope for additional policy steps. This fourth update of the MoU reflects the findings of the fourth review. The following reviews taking place in any given quarter will assess compliance with the conditions to be met by the end of the previous quarter or, where applicable, up to date of the mission.

If targets are missed or expected to be missed, additional action will be taken. The authorities commit to consult with the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) on the adoption of policies falling within the scope of this updated Memorandum, allowing sufficient time for review. Staff of the EC, the ECB and the IMF will, in cooperation with the Portuguese authorities, monitor and assess progress in the implementation of the programme and track the economic and financial situation. Staff will also monitor whether the implementation and effects of measures taken by the Portuguese authorities fall short of the commitments of previous versions of the MoU; such commitments might be re-inserted. To this effect the authorities commit to provide all required information as soon as available. In areas where there are risks of significant delays in the implementation of policies under this programme the authorities in cooperation with the EC, the ECB and the IMF consider making use of technical assistance.

Prior to the release of the instalments, the authorities shall provide a compliance report on the fulfilment of the conditionality.

1. Fiscal policy

Objective

First, reduce the government deficit to below EUR 7,645 million (4½ percent of GDP) in 2012. This should allow to reach a deficit target of 3 percent of GDP by 2013. Second, bring the government debt-to-GDP ratio on a downward path as of 2013. Third, maintain fiscal consolidation over the

[3] On 8 April 2011, Eurogroup and ECOFIN Ministers issued a statement clarifying that financial support of the EU (European Financial Stabilisation Mechanism, EFSM) and the euro-area (European Financial Stability Facility, EFSF) would be provided on the basis of a policy programme supported by strict conditionality and negotiated with the Portuguese authorities, duly involving the main political parties, by the Commission in liaison with the ECB, and the IMF. Further to the EU support from the EFSM, loans from the EFSF will contribute to the financial assistance. The Loan Facility Agreement on the EFSF financing contribution specifies that the disbursements thereunder are subject to the compliance with the conditions of this Memorandum.

medium term up to a balanced budgetary position, notably by containing expenditure growth. This consolidation will be achieved by means of high-quality permanent measures and minimising the impact of consolidation on vulnerable groups.

Fiscal policy in 2012

The 2012 general government headline deficit target of 4 ½ per cent of GDP remains valid. Downside risks to the fiscal objectives related to the macro outlook are starting to materialise, with the growth composition tilting more strongly towards net exports and away from domestic demand, as is evidenced by the more pronounced fall in private consumption and the substantial worsening of the labour market situation. However, savings coming from the re-programming of EU funds, lower net interest payments, as well as a tighter budgetary execution will help offset these developments. The government is committed to closely monitor fiscal developments in the months ahead. In view of the existing downside risks, contingency reserves will be included in the 2013 budget to offset possible carry-over effects to 2013.

1.1. The government will achieve a general government deficit of no more than EUR 7,645 million (4½ per cent of GDP) in 2012.[4] **[Q4-2012]**

1.2. Throughout the year, the government will rigorously implement the Budget Law for 2012, as amended by the Supplementary Budget. Within the year, progress will be assessed against the (cumulative) quarterly ceilings for the consolidated general government cash balance in the MEFP, as defined in the TMU, without prejudice to full-year ESA-95 deficit targets. **[Q2, Q3 and Q4-2012]**

1.3. The measures listed below, worth 5.4 per cent of GDP, when compared with the estimated outturn for 2011 (and above 6 per cent of GDP when compared with a scenario of unchanged policies), will be carried out as adopted in the 2012 Budget Law, as amended by the Supplementary Budget, unless elsewhere specified. Overall, expenditure reduction accounts for two thirds of that fiscal effort and revenue increases for one third.

Expenditure

1.4. Ensure that the public sector wage bill decreases in gross terms in 2012 by at least EUR 3,000 million:

i. reduce wages for all general government sector employees in 2012 by (i) suspending the 13th and 14th monthly salary payments for those workers with monthly salaries of EUR 1,100 or more, (ii) suspending on average and in a progressive way the equivalent of one of those two salaries for those workers with monthly salaries between EUR 600 and EUR 1,100. Similar measures will apply to all SOEs classified inside and outside the perimeter of the government sector, and in any other public entity even if falling outside the perimeter of the government sector;

ii. reduce the number of government employees by (i) limiting staff admissions in order to achieve annual decreases of 2 per cent (full-time equivalent) in 2012-2014 in the permanent staff of central, regional and local governments, (ii) decreasing the number of temporary positions in specific areas of public administration.

iii. make room to reverse any possible slippage recorded in 2011;

iv. suspend all promotions in 2012;

[4] In 2012, operations related to the banking sector support and restructuring strategy under the programme will not be considered for the assessment of compliance with the programme target for the general government deficit. Conversely, if during the fifth review there is an agreement that there are sufficient safeguards to prevent further accumulation of arrears and the implementation of the strategy for the arrears' settlement is on track, the accrual government balance objectives may be adjusted by the amount of settled arrears.

v. reduce the overall budgetary cost of health benefits schemes for government employees schemes (ADSE, ADM and SAD) on the basis of the measures presented below under 'Health care system';

vi. savings from the public administration restructuring on the basis of the measures presented below under 'Public administration'.

1.5. Reduce pension expenditure in gross terms in 2012 by at least EUR 1,140 million by: (i) suspending the 13th and 14th monthly payments for those pensioners with monthly pension benefits of EUR 1100 or more, (ii) suspending on average and in a progressive way the equivalent of one of those monthly benefits for those with monthly pension benefits between EUR 600 and EUR 1100. The pensions of those receiving benefits below EUR 600 will be frozen and the lowest pensions will be marginally increased. In case a pensioner receives more than one pension, the consolidated pension income will be considered for the application of the thresholds defined here. These rules will also apply to subventions or subsidies paid by the government that take the nature of pensions even if designed otherwise.

1.6. Control costs in health sector on the basis of detailed measures listed below under 'Health-care system', achieving savings worth some EUR 1000 million.

1.7. Reduce costs with SOEs classified inside the perimeter of the general government on a ESA95 basis with the aim of saving at least EUR 500 million by means of:

i. sustaining an average permanent reduction in operating costs by at least 15 per cent;

ii. tightening compensation schemes and fringe benefits in line with the rest of the government sector;

iii. rationalising investment plans for the medium term. The increase in EU co-financing rates allowed for countries under an Economic Adjustment Programme and a re-programming of EU funds in the context of the current National Strategic Reference Framework (NSRF) will also give a contribution to this end;

iv. SOEs will also relieve pressure on government accounts by raising their revenue coming from market activities, including by raising tariffs and prices.

1.8. Reduce costs in the area of education, with the aim of saving EUR 380 million by rationalising the school network including by creating school clusters; lowering staff needs; centralising procurement; and reducing and rationalising transfers to private schools in association agreements and making a more intensive use of EU funds to finance activities in the area of education.

1.9. Reduce capital expenditure by EUR 200 million by prioritising investment projects and making more intensive use of funding opportunities provided by EU structural funds. The increase in EU co-financing rates allowed for countries under an Economic Adjustment Programme and a re-programming of EU funds in the context of the current National Strategic Reference Framework (NSRF) will give an important contribution to this end.

1.10. Reduce cash social transfers (other than pensions) by at least EUR 180 million by tightening eligibility criteria and decreasing average benefits in selected cases.

1.11. Reduce transfers to local and regional authorities by at least EUR 175 million with a view to having these subsectors contributing to fiscal consolidation.

1.12. Improve the working of the central administration by increasing efficiency, reducing and eliminating services that do not represent a cost-effective use of public money. This should yield annual savings worth at least EUR 130 million, the budgetary impacts will spread beyond 2012. To this end, the government will:

i. reduce the number of services while maintaining quality of provision;

ii. create a single revenue administration and promote services' sharing between different parts of general government;

iii. reorganise the provision of central administration services at local level and regularly assess the value for money of the various public services;

iv. promote mobility of staff in central, regional and local administrations;

v. reduce transfers from the state to public bodies and other entities;

vi. revise compensation schemes and fringe benefits in public bodies and entities that independently set their own remuneration schemes;

vii. reduce subsidies to private producers of goods and services.

1.13. Reduce costs in other public bodies and entities and in transfers and subsidies to SOEs classified outside the perimeter of the general government on an ESA95 basis by at least EUR 90 million. These SOEs at the level of central, regional will carry out adjustment efforts similar to those SOEs classified inside the perimeter of the general government on a ESA95 basis as listed above, namely by: rationalising investment plans for the medium term; sustaining an average permanent reduction in operating costs by at least 15 per cent; tightening compensation schemes and fringe benefits; increasing revenues from market activities, including by raising tariffs and prices charged. These adjustments will also be instrumental to contain risks that the financial situation of some of these SOEs put to government accounts in 2012 and beyond.

Revenue

1.14. Introduction of a standstill rule to all tax expenditure, blocking the creation of new items of tax expenditure and the enlargement of existing items. The rule will apply to all kinds of tax expenditure, of a temporary or permanent nature, at the central, regional or local level.

1.15. Raise VAT revenues through an increase in the efficiency of the VAT structure with a yield of at least EUR 2,024 million in 2012. For this purpose, a set of categories of goods and services were moved from the reduced and intermediate VAT rates to higher ones. This includes the additional impact of the increase in the VAT rate for natural gas and electricity to the standard rate introduced in October 2011.

1.16. Increase personal income taxes with a yield of at least EUR 265 million in 2012 (taking into account the losses of revenues as result of the reductions of public wages and pension incomes listed under 1.8 and 1.9 above) by:

i. capping and cutting substantially (by two thirds overall) tax allowances for health expenditure;

ii. (i) eliminating the deductibility of mortgage principal; (ii) eliminating interest income deductibility for new mortgages; (iii) phasing out the deductibility of mortgage interest payments for owner-occupied housing and of rents;

iii. harmonising personal income tax deductions applied to pensions and labour income;

iv. capping the maximum deductible tax allowances according to tax bracket for most of the income brackets except the bottom two with lower caps applied to higher incomes and a zero cap for the two highest income brackets;

v. revising the taxation of income in kind;

vi. introducing a surcharge on the income of the top tax bracket and increasing the tax rate on capital gains;

vii. the one-time surcharge in the context of the personal income tax in 2011 that will be collected in 2012.

1.17. Increase corporate tax revenues by at least EUR 330 million in 2012 by:

i. abolishing all reduced corporate income tax rates;

ii. limiting the deductions of losses in previous years to 75 per cent of the taxpayer's taxable profit;

iii. curbing tax benefits;

iv. increasing the rates and the basis of the state surcharge on corporate profits.

1.18. Increase excise taxes to raise at least EUR 200 million in 2012. In particular by:

i. raising taxes on car sales, tobacco and alcohol products;

ii. introducing electricity excise taxes in compliance with EU Directive 2003/96;

iii. indexing excise taxes to core inflation.

1.19. Change property taxation to raise revenue by at least EUR 50 million by reducing substantially the temporary exemptions for owner-occupied dwellings acquired as of 2012 and by increasing rates.

1.20. Increase efforts to fight tax evasion, fraud and informality to raise revenue by at least EUR 175 million for various types of taxes inter alia by increasing means available for audits, increasing penalties for the most serious tax crimes and introducing electronically-transmitted invoices.

Fiscal policy in 2013

1.21. The government will achieve a general government deficit of 3 percent of GDP or below. **[Q4-2013]** The government will assess the budgetary scope for stimulating the demand for labour through tax changes. Aiming at achieving the positive effects in the long-run, beyond the cyclical downturn, the government will explore ways to design a targeted and deficit-neutral cut in the employers' social security contribution rate within a budgetary envelope of around 0.5 percent of GDP. Targeting could inter alia concern younger or lower-income workers. Specific proposals for introducing such a cut in the context of the 2013 budget will be put forward at the **Fifth Review**.

1.22. Throughout the year, the government will rigorously implement the Budget Law for 2013. Within the year, progress will be assessed against the (cumulative) quarterly ceilings for the consolidated general government cash balance in the Memorandum of Economic and Financial Policies (MEFP), as defined in the Technical Memorandum of Understanding (TMU), without prejudice to full-year ESA-95 deficit targets. **[Q1, Q2, Q3 and Q4-2013]**

1.23. The measures listed below will be detailed and carried out with the 2013 Budget Law **[Q4-2012]**, unless otherwise specified:

Expenditure

1.24. Further measures introduced in the 2012 Budget Law with a view to reducing expenditure in the area of:

i. central administration functioning: EUR 500 million. Detailed plans will be presented and assessed **[Q3-2012]**;

ii. wage bill: decrease of 2 per cent (full-time equivalent) in the permanent staff of central, regional and local governments and decrease the number of temporary positions in specific areas of public administration;

iii. health sector: EUR 375 million;

iv. capital expenditure: EUR 350 million;

v. transfers to local and regional authorities: EUR 175 million;

vi. education and school network rationalisation: EUR 175 million;

vii. costs in other public bodies and entities, and in SOEs: EUR 175 million;

viii. health benefits schemes for government employees: EUR 100 million;

ix. freeze wages and pensions except for the lowest pensions.

1.25. In addition, the government will extend the use of means testing and better target social support achieving a reduction in social benefits expenditure of at least EUR 250 million. Social transfers will also decline following the implementation of the measures on unemployment insurance listed below under 'Labour market and education'.

Revenue

1.26. Further measures introduced in 2012 Budget Law, leading to extra revenue in the following areas:

i. personal income tax benefits and tax deductions: EUR 175 million;

ii. broaden corporate tax bases and reduce tax benefits and tax deductions: EUR 150 million;

iii. excise taxes: EUR 150 million.

1.27. Update the notional property value of all real estate assets for tax purposes to raise revenue by at least EUR 250 million in 2013. Transfers from the central to local governments will be reviewed to ensure that the additional revenues are fully used for fiscal consolidation.

Fiscal policy in 2014

1.28. The government will aim at achieving a general government deficit in 2014 in line with the Medium-Term Fiscal Strategy defined in April 2012. The necessary measures will be defined in the 2014 Budget Law. **[Q4-2013]**

1.29. Within the year, progress will be assessed against the (cumulative) quarterly ceilings for the consolidated general government cash balance in the Memorandum of Economic and Financial Policies (MEFP), as defined in the Technical Memorandum of Understanding (TMU), without prejudice to full-year ESA-95 deficit targets. **[Q1 and Q2-2014]**

With the 2014 Budget Law, the government will further deepen the measures introduced in the 2012 and 2013 with a view in particular to broadening tax bases and moderating primary expenditure to achieve a declining ratio of government expenditure over GDP.

2. Financial sector regulation and supervision

Preserve financial sector stability; maintain liquidity and support a balanced and orderly deleveraging in the banking sector; ensure adequate financing and working capital for the productive sectors; strengthen banking regulation and supervision; optimise the process for recovering the assets transferred from BPN to the three state-owned SPVs; streamline state-owned Caixa Geral de Depósitos; strengthen the bank resolution framework and reinforce the Deposit Guarantee Fund and the Guarantee Fund for Mutual Agricultural Credit Institutions; reinforce the corporate and household insolvency frameworks.

Maintaining liquidity in the banking sector

2.1. Encourage banks to strengthen their collateral buffers on a sustainable basis and to take full advantage of the broadening of the range of eligible collateral for the purpose of Eurosystem re-financing. The Banco de Portugal (BdP), in close cooperation with the ECB, will continue to monitor closely the liquidity situation of the banking system and stands ready to take the appropriate measures to maintain sufficient system liquidity. Monitor the issuance of the government guaranteed bank bonds, which has been authorised up to EUR 35 billion in line with EU State aid rules. **[Ongoing]**

Deleveraging in the banking sector

2.2. The banking system should in the medium run eliminate its funding imbalances. Monitor the banks' implementation of the funding plans aiming at an indicative loan-to-deposit ratio of about 120% in 2014. It is important that the pace and composition of deleveraging should not jeopardise the provision of appropriate credit to finance productive investment and working capital in the private sectors of the economy, not least SMEs. Fiscal adjustment and an attendant reduction in the public sector's financing are crucial for reconciling potentially conflicting objectives. In addition, the BdP will continue to take appropriate measures to discourage ever-greening of doubtful loans with a view to facilitating an effective adjustment of bank balance sheets respecting EU state aid rules. In this context, banks have been instructed to report recently restructured loans due to financial difficulties. Also, BdP has launched on-site inspections on portfolios particularly sensitive to business cycle developments and these inspections will be used to develop appropriate policy guidelines, if needed. These steps will be taken without burdening or posing risks to public resources. The Ministry of Finance, the BdP, and other stakeholders, will complete a proposal for encouraging the diversification of financing alternatives to the corporate sector **by end-July**[5]. Banks' funding and capital plans and broader credit developments will continue to be monitored closely. There is room for the necessary deleveraging to take place in an orderly manner and it is crucial that the pace and composition of the deleveraging remain consistent with the macroeconomic framework of the programme. **[Ongoing]**

Capital buffers

2.3. Finalise by **30 June 2012** the capital augmentation related to the exercise launched by the European Banking Authority (EBA) aiming at a Core Tier 1 ratio of 9% for the major banks, the partial transfer of banks' pension plans and the special on-site inspections program (SIP). Ensure in parallel that the programme target of a Core Tier 1 ratio of 10 % by end-2012 target is reached.

2.4. Monitor closely compliance with the set deadlines, with a view to promptly take appropriate action in case the deadline is not met. **[Ongoing]**

2.5. Resources from the Bank Solvency Support Facility (BSSF) remain available in line with state aid rules to provide further support to viable banks, if needed. **[Ongoing]**

Caixa Geral de Depósitos (CGD)

2.6. Continue to streamline the state-owned CGD group to increase the capital base of its banking arm as needed. The sale of the insurance and health arm is expected to take place **before end-2012** to contribute to meeting that year's additional capital needs, while the sale of non-strategic stakes is ongoing. Provide CGD with government capital support from cash buffers outside of the BSSF subject to EU state aid rules.

Monitoring of bank solvency

2.7. The BdP will continue to monitor on a **quarterly** basis the banks' potential capital needs with a forward looking approach under stress conditions.

Banking regulation and supervision

2.8. The BdP will continue to strengthen its supervisory organisation, optimise its supervisory processes and develop and implement new supervisory methodologies and tools. In this context, on-site inspections have been launched, aimed at closely scrutinising banks' portfolios which are particularly sensitive to the business cycle developments. **[Ongoing]**

2.9. In addition, the BdP is stepping up the monitoring of banks, including via ad hoc audits. **[Ongoing]**

[5] Structural benchmark in the Memorandum of Economic and Financial Policies.

2.10. BdP will remain committed to close coordination with home and host country supervisors, both within and outside the EU. **[Ongoing]**

Banco Português de Negócios

2.11. Gradually settle CGD's state guaranteed claim on the SPVs in cash, according to the schedule agreed with the EC, ECB and IMF. Any recoveries on the assets held by the state-owned SPVs will also be used to promptly repay CGD. **[Ongoing]**

2.12. Outsource the management of the assets to a professional third party, with a mandate to gradually recover the assets over time. Select the party managing the assets through a competitive bidding process and include proper incentives to optimise the recoveries into the mandate. **[Ongoing]**

Bank resolution framework

2.13. The early intervention, resolution and deposit guarantee framework has been strengthened. The authorities are asked to prepare the implementing measures. In particular, the following actions will be taken: (a) setting-up of the resolution fund with a view to ensuring its funding arrangement by **July 2012**; (b) finalize supervisory notices on recovery plans by end-July 2012, (c) adopt resolution plans regulations by **end-October 2012,** taking into account, to the extent possible in view of the deadline, the EBA recommendations and templates; (d) adopt rules applicable to setting-up and operation of bridge banks in line with EU competitions rules by **end-September 2012**. Give priority to the review of the recovery and subsequent resolution plans of the banks that are of systemic importance.

2.14. The legislator will closely follow the process of adoption of the EU Directive on resolution and revise the national resolution framework as soon as the Directive enters into force. **[Ongoing]**

Corporate and household debt restructuring framework

2.15. Implement an action plan to raise public awareness of the restructuring tools. **[Ongoing]**

Monitoring of corporate and household indebtedness

2.16. Continue the monitoring of the high indebtedness of the corporate and household sectors through the quarterly reports. A report assessing the overall consistency, effectiveness, and the impact of existing support mechanisms to SMEs will be revised by **Q2-2012.** The report will discuss policy actions aimed at improving and implementing support mechanisms to facilitate access to credit, encourage internationalisation, and improve competitiveness of SMEs in line with EU competition rules. Establish a framework for financial institutions to engage in out-of-court debt restructuring for households. In addition, finalise the amendments to the conciliation framework mediated by IAPMEI, a public entity, to facilitate extrajudicial corporate debt restructurings for viable SMEs. **[Ongoing]**

3. Fiscal-structural measures

Objectives

Improve the efficiency of the public administration by eliminating redundancies, simplifying procedures and reorganising services; regulate the creation and functioning of all public entities including SOEs, PPPs, foundations, associations; re-focus their activities to core public policy objectives and enhance their cost efficiency and fiscal sustainability; streamline the budgetary process , including by adopting new financing laws at regional and local level; strengthen risk management, accountability, reporting and monitoring of all parts of the general government. Government action will build on the recommendations provided by the IMF/EU technical assistance missions.

Public Financial Management framework

Reporting and Monitoring

3.1. Publish a comprehensive report on fiscal risks **each year as part of the budget**. The report will outline general fiscal risks and specific contingent liabilities to which the general government may be exposed, including those arising from Public-Private Partnerships (PPPs), SOEs and explicit guarantees to the banks. Technical assistance will be provided if necessary.

3.2. Publish a tax expenditure report **each year as part of the budget**. The report will define a clear methodology to estimate and to evaluate tax expenditures, in line with international best practices. The report will cover central, regional and local administrations.

3.3. To further advance the reform of the budgetary monitoring system, a proposal to reduce budgetary fragmentation will be submitted by **[Q2-2012].**

3.4. Prepare, in consultation with the EC and the IMF, a dedicated document, which will accompany the budget report, assessing reform progress in the area of public financial management and delineating next steps over the next three years. **[Q3-2012]**[6]

Arrears

3.5. The law on commitments control will be implemented across all general government entities including the regional and local administration and the SOE hospitals; the government will work with these entities so that the necessary changes in the systems are done by **end-July.** The Inspecção Geral de Finanças (IGF) will carry out inspections throughout the process to verify compliance of the commitment control system through a risk based approach. IGF will reinforce the verification of local governments' arrears claims and commitment control systems.

3.6. The stock of domestic arrears will be significantly reduced by the end of the programme period. A significant part of the existing arrears will be reduced as laid down in the strategy for the settlement of arrears. **[Q3-2012]**

3.7. Prepare a document detailing the procedures and responsible units for monitoring, controlling and auditing the programme agreed between the government and the local authorities for the settlement of arrears ("*Programa de Apoio à Economia Local*") **[July-2012].** Transparency of the use of the credit line will be ensured through the monthly publication of the amounts lent, disbursed, and used to settle arrears and other liabilities by municipality **[Q3-2012]**.

Budgetary framework

3.8. Publish a fiscal strategy document for the general government annually in **April**. The document will be in compliance with the requirements of the Stability and Growth Pact and will specify 4-year medium-term economic and fiscal forecasts and 4-year costs of new policy decisions. Budgets will include a reconciliation of revisions to the 4 year fiscal forecasts attributable to policy decisions and parameter revisions e.g. policy decisions, changes in the macroeconomic environment.

3.9. Review the Budget Framework Law to take account of the reinforced EU fiscal framework and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (fiscal compact). The revised law will also accommodate the developments in the regional and local financing laws. **[Q4-2012]**

3.10. Define in detail the characteristics of the medium-term budgetary framework, including medium-term fiscal strategy, decision-making and prioritisation process, carry-over rules, commitment

[6] Structural benchmark in the Memorandum of Economic and Financial Policies.

controls, and appropriate contingency reserves and related access rules after modification of the Budget Framework Law. **[April-2013]**

Regional and local budgetary frameworks

3.11. The government will ensure that the measures to implement the new budgetary framework at central government level will also be applied at regional and local level. Adequate structures of monitoring, fiscal reporting, and commitment control will be put into place. **[Ongoing]**

3.12. The budgetary frameworks at local and regional levels will be considerably strengthened, in line with recommendations by the IMF/EC technical assistance mission of July 2011 and the new EU fiscal policy framework. A draft proposal to revise the regional finance law and the local finance law will be discussed with EC/IMF/ECB by **[Q2-2012]** and submitted to Parliament by **[Q4-2012]**[7]. They will include the following main elements:

i. fully adapt the local and regional budgetary frameworks to the principles and rules in the revised Budgetary Framework Law, namely in what concerns (i) the inclusion of all relevant public entities in the perimeter of local and regional government; (ii) the multi-annual framework with expenditure, budget balance and indebtedness rules, and programme budgeting; and (iii) the interaction with the function of the Fiscal Council. The revision will also foresee that: (i) the Fiscal Council reviews local and regional governments own revenue projections and multi-annual fiscal plans (ii) a contingency reserve is included under the overall current expenditure envelope as a buffer against negative revenue surprises or erroneous expenditure planning, and (iii) the revised legal and institutional PPP framework is applied (see below);

ii. strengthen fiscal accountability, in particular by: (i) tighter financial requirements for regional and local SOEs and other regional and local public bodies; (ii) a revision of the regime of transfers between the State and the regions and the local authorities; (iii) strengthening the supervisory power from the State on budgetary execution and (iv) apply tighter debt ceilings combined with the adoption of a multi-tiered monitoring system as suggested by the July 2011 technical assistance mission. This reform should follow international best practices;

iii. limit the scope for lower tax rates in the Autonomous Regions vis-à-vis the rates applied in the mainland and ensure that the resulting additional revenues from increasing the regional rates are used as a priority for fiscal consolidation.

3.13. Create a working group with representatives from the Ministry of Finance, the Autonomous Regions and the local authorities to prepare a proposal for common revenue forecasting guidelines for subnational governments. **[Q3-2012]**

3.14. Proceed with identifying data needs to support the revenue projections, balancing the need to preserve tax secrecy and the elaboration of sound forecasts by subnational governments. **[Q3-2012]**

3.15. The Government's financial arrangement with the Autonomous Region of Madeira (RAM), which is in full compliance with the Memorandum of Understanding, will be implemented. The Portuguese Government will monitor progress of implementation by RAM and present the results on a quarterly basis in advance of the reviews of the Memorandum of Understanding **[Ongoing].**

[7] Structural benchmark in the Memorandum of Economic and Financial Policies.

Public Private Partnerships

3.16. Complete the study to assess the costs and benefits of renegotiating any PPP contract to reduce the government financial obligations **[Q2-2012]**. The study will be the basis for a strategic plan specifying how to deal with existing PPPs and providing a framework for future engagements in PPPs. For certain PPP and concession contracts, the renegotiation process started before the completion of the study, due to financial or legal imperatives. Other than these, final decisions on renegotiation will be taken after the study's conclusion and in consultation with the EC, ECB and the IMF. Regions will be encouraged to design a framework for assessing fiscal risks derived from PPP, concessions and other public investments, as well as for monitoring their execution. The requirements will be similar to those put in place at central level. **[Q3-2012]**

3.17. Enhance the annual PPP and concessions report prepared by the Ministry of Finance with a comprehensive assessment of the fiscal risks stemming from PPPs and concessions. The report will provide information and analysis at sectoral level. The annual review of PPPs and concessions will be accompanied by an analysis of credit flows channelled to PPPs through banks (loans and securities other than shares) by industry and an impact assessment on credit allocation and crowding out effects. This particular element will be done in liaison with the Banco de Portugal. **[Q3-2012]**

State-owned enterprises

3.18. SOEs with commercial activity will reach operational balance by **end of 2012**. This will be achieved by substantially reducing operational costs and raising revenues. To this end the government is implementing the comprehensive SOEs strategy by reviewing the tariff structure and service provision of SOEs, with numerical targets on cost reductions, including measures to realign wages or reduce employment, and additional measures as appropriate. **[Q4-2012]**. A progress report will be prepared before the **Fifth Review**.

3.19. The government will prepare, in consultation with staff from the EC, ECB and IMF, a comprehensive strategy for managing the heavy debt load of all SOEs – including Parpublica. **[July-2012]**

3.20. Submit to Parliament a draft law to strengthen governance of SOEs in accordance with international best practices. It will review the existing shareholder approach, giving the Ministry of Finance a decisive role in financial matters of the enterprises, including in regional and local SOEs, while respecting the administrative autonomy as foreseen in the law. This will enhance the monitoring powers of the central administration over all SOEs. In addition, the timing and content of financial and operational reporting will be defined. The decisions adopted at central level to improve the efficiency of the enterprises while reducing their financial burden will be implemented at all SOEs, taking into account their specificities. It will include the prohibition for SOEs within the general government to incur new debt with the private sector. **[Q2-2012]** No additional SOEs will be created until this law is adopted.

3.21. Equivalent measures on operational results, debt, restructuring and governance will be taken at the local and regional levels, while respecting their administrative autonomy as foreseen in the law. The annual and quarterly SOEs reports will assess progress towards achieving these objectives for central and local SOEs. Each Autonomous Region will provide similar annual reports. These will serve as inputs to the fiscal risks analysis in the budget. **[Q2-2012]**

Privatisation

3.22. The government is implementing its privatisation programme under the new framework law for privatisation. The privatisation plan targets front-loaded proceeds of about EUR 5 billion through the end of the programme. The sale of GALP and the small remaining stake in REN on the free market have been delayed until market conditions improve. The privatisation or concession of the cargo handling subsidiary of CP (CP Carga) will be concluded by the **second quarter of 2013**. The tender for the privatisation of the national air carrier (TAP) and the airport operator Aeroportos de Portugal (ANA) will be launched in the third quarter, with a view to completing these transactions in **early 2013**. The privatisation of Correios de Portugal (CTT) will be launched, once changes underway in regulation of this sector have their full impact, in order to complete the sale in 2013. The partial sale of a public television channel (RTP) and concessions for transport operators in Lisbon and Porto upon completion of restructuring of the public transport firms in these cities are being considered. The direct sale of CGD's insurance arm (Caixa Seguros) to a final buyer is expected to take place in 2012.

3.23. With a view to introducing private capital and management in the water company Águas de Portugal (AdP), a strategy will be prepared. This strategy will include considerations of the competitive and regulatory environment and organisational consequences. **[Q4-2012]**

3.24. The government will work together with the municipalities and regional governments in order to identify the scope for further privatisation, by preparing an inventory of their assets, including real estate. **[Q3-2012]**

Revenue administration

3.25. The Government will conclude implementation of the undergone merger of the tax administration, customs administration and the information technology service (DGITA) in a single entity, *Autoridade Tributária e Aduaneira* (AT) by **Q4-2012**.

3.26. Following the recommendations of the "Study on the potential merger of the collection units of the Tax Authority and the Social Security", the government will by **[end-August]:**

i. prepare a draft proposal to enhance the exchange of information between the collection units of the Tax Authority and the Social Security, and

ii. study ways of possible implementation of the other working group recommendations to strengthen control and simplifying compliance.

3.27. Following the creation of AT, the focus in 2012 will be to merge central and support functions and reduce the number of branches. The reform will be deepened in **2013** by targeting a business function-type structure. In particular, the following elements will be implemented:

i. review the experience with the task force of tax judges for cases with value above EUR 1 million and assess the need to establish special chambers within the tax tribunals to handle such cases **[mid-November 2012]**;

ii. reducing the number of municipal offices by at least 20 per cent per year in 2012 and 2013 **[Q4-2012 and Q4-2013]**;

iii. increase in the resources devoted to auditing in the tax administration to at least 30 per cent of the total staff, mostly through reallocations of staff within the tax administration and other parts of the public administration. The threshold should be attained by **Q4-2012**;

iv. based on the report presented, prepare draft action plan with concrete measures and timelines to resolve VAT issues related to backlog enforcement cases and assess the possibility of introducing transitional measures targeting cases currently filed in courts taking into account tax fraud and erosion risks. **[20 August 2012];**

v. publish quarterly reports on recovery rates, duration and costs of tax cases starting from **Q4-2012** within four months after the end of the relevant quarter.

3.28. The government will address the bottlenecks in the tax appeal system by progressing with clearing cases worth above EUR 1 million [**Q4-2012]** with the support of the tax court judges.

3.29. The government will draft a proposal by **[Q2-2012]** to strengthen the auditing and enforcement powers of the central tax administration to exercise control over the whole territory of the Republic of Portugal including currently exempt tax regimes. Based on this proposal, a draft law will be submitted to Parliament by **[Q4-2012]**.

3.30. The tax administration has concluded the strategic plan to combat fraud and evasion for 2012-14 and has taken important steps for its implementation. Moreover, the plan to implement e-invoicing in Portugal will be further developed **[Q4-2012]**. Measures to strengthen final consumers' incentives to ask for invoices, notably in hard-to-tax sectors, will be implemented, and EC, ECB and the IMF will be consulted on any developments regarding the scheme design. An evaluation report of the scheme will be prepared **[Q1-2013]**.

3.31. The tax administration will develop a modern tax compliance management framework as an important tool to curb non-compliance. A fully-fledged Large Taxpayer Office (LTO) will be operational by **[Q4-2012]**[8].

Public administration

Central, regional and local administration

3.32. Conclude the public administration restructuring programme (PREMAC) by the completion of procedures for the preparation, approval and publication of all legal acts by **end-June**. The final report, comprising the internal organisation and the roster of each entity, including the reallocation of human resources, will be presented in **[Q3-2012].**

3.33. As stipulated in the 2012 State budget, each municipality will have to present its plan to attain the target of reducing their management positions and administrative units by an average of at least 15 per cent by the end of 2012. **[Q2-2012]**

3.34. Prepare a detailed cost/benefit analysis of all public and quasi-public entities:

i. Based on the analysis on foundations, using the results of the compulsory census **[Q2-2012]** and recommendations, the central, regional or local administration responsible for each foundation or its financial support will decide accordingly whether to maintain, reduce or extinguish them in respect of the applicable law (see below). **[Q3-2012];**

ii. the approach on foundations – the compulsory census and the subsequent analysis, adjusted as needed - will also be applied to associations and extended later to other public and quasi-public entities across all levels of government. **[Q4-2012]**

3.35. Regulate by law the creation and the functioning of foundations, associations, and similar bodies by the central and local administrations, facilitating the closure of existing entities when warranted. In addition, the government will promote that the same objective is achieved by the regions. **[Q2-2012]**

3.36. Reorganise local government administration. There are currently 308 municipalities and 4,259 parishes. The government will reorganise and significantly reduce the number of such entities. These changes, which will come into effect by the beginning of the next local election cycle, will enhance service delivery, improve efficiency, and reduce costs. **[Q3-2012]**

3.37. Carry out a study to identify potential duplication of activities and other inefficiencies between the central administration, local administration and locally-based central administration services. **[Q3-2012]** Based on this analysis, reform the existing framework to eliminate the identified inefficiencies. **[Q4-2012]**

[8] Structural benchmark in the Memorandum of Economic and Financial Policies.

Shared services

3.38. Develop the use of shared services in the central administration by fully implementing the ongoing projects and by regularly assessing the scope for further integration:

i. complete the implementation of the strategy of shared services in the area of financial resources (GeRFIP). **[Q1-2013]** GeRFIP will also be implemented in the Autonomous Region of Madeira and in the Autonomous Region of Azores **[Q4-2013]**;

ii. fully implement the strategy of shared services in the area of human resources (GeRHuP) in the Ministry of Finance's entities **[Q4-2012]**, with the exception of the Tax Authority for which this is scheduled for **end-January 2013**. Other Ministries will follow in 2013. The Autonomous Region of Madeira will implement GeRHuP gradually;

iii. rationalise the use of IT resources within the central administration by implementing shared services and reducing the number of IT entities in individual Ministries or other public entities in line with the "Overall Strategic plan to rationalise and reduce costs on ICT in Public Administration". **[Q4-2012]**

3.39. Reduce the number of local branches of line ministries (e.g. tax, social security, justice). The services should be merged in citizens' shops covering a greater geographical area and developing further the e-administration over the duration of the programme. **[Q4-2013]**

Human resources

3.40. The 2012 budget promotes flexibility, adaptability and mobility of human resources across the administration, including by providing training and requalification where appropriate. In addition, the mobility schemes, namely geographic mobility and the regulation on mutual agreement on contract termination, will be reinforced as an instrument to manage human resources across administrations. **[Q2-2012]**

3.41. Limit staff admissions in public administration to achieve annual decreases in 2012-2014 of 2 per cent per year (in full-time equivalents) in the staff of central administration and 2 per cent in local and regional administrations (in full-time equivalents). The government will ensure the implementation of this measure at local administration level and will promote the initiatives needed so that each region will present its plan to achieve the same target. **[Ongoing]**

3.42. The government will prepare a comprehensive review of wage scales in the general government, to identify unwarranted differences in remuneration between the public and the private sector for similar types of qualifications. **[Q4-2012]** The comprehensive study of entities classified outside the general government will follow in **Q2-2013**.

Health care system

Objectives

Improve efficiency and effectiveness in the health care system, inducing a more rational use of services and control of expenditures; generate additional savings in the area of pharmaceuticals to reduce the overall public spending on pharmaceutical to 1.25 percent of GDP **by end 2012** and to about 1 per cent of GDP in 2013; generate additional savings in hospital operating costs and devise a strategy to eliminate arrears.

The government will take the following measures to reform the health system:

Financing

3.43. The revision of NHS moderating fees (*taxas moderadoras*) will result in additional revenues of EUR 150 million in 2012 and an additional 50 million in 2013. **[Q4-2012]**

3.44. In the light of the urgency and size of the savings needed in the health sector to address large arrears and budget limitations, plans to achieve a self-sustainable model for health-benefits schemes for civil servants will be accelerated. The current plan foresees that the overall budgetary cost of existing schemes - ADSE, ADM (Armed Forces) and SAD (Police Services) - will be reduced by 30 per cent in 2012 and by further 20 per cent in 2013 at all levels of general government. The system would become self-financed by 2016. The costs of these schemes for the public budget will be reduced by lowering the employer's contribution rate, and adjusting the scope of health benefits. The adjustment path will be assessed in the **fifth review**.

Pricing and reimbursement of pharmaceuticals

3.45. Enact legislation which automatically reduces the prices of medicines when their patent expires to 50 per cent of their previous price. **[Q4-2012]**

3.46. Complete the transfer of the responsibility of pricing medicines to the Ministry of Health (for example to Infarmed). **[Q2-2012]**

3.47. The government implements an annual revision of prices of medicines and of countries of reference in order to achieve cost savings. Second price revision to be published in **January 2013**.

3.48. The government will monitor monthly pharmaceutical expenditures and ensure that that the overall public pharmaceutical expenditure does not exceed the target of 1.25 per cent of GDP in 2012 and 1 per cent of GDP in 2013. **[Ongoing]**

Prescription and monitoring of prescription

3.49. Continue to improve the monitoring and assessment system of doctors' prescription behaviour regarding medicines and diagnostic in terms of volume and value and vis-à-vis prescription guidelines and peers. Feedback continues to be provided to each physician on a regular basis (e.g. quarterly), in particular on prescription of costliest and most used medicines. **[Ongoing]**

3.50. Continue to devise and enforce a system of sanctions and penalties, as a complement to the assessment framework. **[Ongoing]**

3.51. Strictly monitor the implementation of the legislation making it compulsory for physicians at all levels of the system, both public and private, to prescribe by International Non-proprietary Name (INN) to increase the use of generic medicines and the less costly available product. An implementation report will be published by **December 2012**.

3.52. Continue to publish prescription guidelines with reference to medicines and the realisation of complementary diagnostic exams on the basis of international prescription guidelines and integrate them in the electronic prescription system. **[Ongoing]**

3.53. The government will produce a report assessing the effectiveness of the enacted legislation aimed at removing all effective entry barriers for generic medicines, in particular by reducing administrative/legal hurdles in order to speed up the use and reimbursement of generics. **[Q1-2013]**

3.54. The above measures should aim at gradually and substantially increasing the share of generic medicines to at least 30 per cent of all outpatient prescription (in volume) in 2012 and substantial further increases in 2013. **[Ongoing]**

Pharmaceutical retailers and wholesalers

3.55. Effectively implement the new legislation regulating pharmacies. **[Q2-2012]**

3.56. The Government will produce an intermediate assessment of the savings related to the revision of the calculation of profit margins for wholesale companies and pharmacies. **[Q3-2012**].

3.57. If the revision does not produce the expected reduction in the distribution profits of at least EUR 50 million, an additional contribution in the form of an average rebate (pay-back) will be introduced, which will be calculated on the mark-up. The rebate will reduce the new mark-up on producer prices further by at least 2 percentage points on pharmacies and 4 percentage points on wholesalers. The rebate will be collected by the government on a monthly basis through the Centro de Conferência de Facturas, preserving the profitability of small pharmacies in remote areas with low turnover. **[Q3-2013]**

3.58. Reinforce the centralised acquisition of vehicles, utilities, external services and other cross functional goods and services by all entities included in the NHS, in order to reduce costs through price volume agreements and fighting waste. A detailed action plan will be published by **November 2012.**

Centralised purchasing and procurement

3.59. INFARMED will continue implementing the uniform coding system and a common registry for medical supplies. **[Ongoing]**

3.60. Take further measures to increase competition among private providers and reduce by an additional 10 percent the overall spending (including fees) of the NHS with private providers delivering diagnostic and therapeutic services per cent. Regularly revise (at least every two years) the fees paid to private providers with the aim of reducing the cost of more mature diagnostic and therapeutic services. **[Q4-2012]**

3.61. Implement the centralised purchasing of medical goods through the recently created Central Purchasing Authority (SPMS), using the uniform coding system for medical supplies and pharmaceuticals. **[Ongoing]**

3.62. Conduct an analysis of the market characteristics of relevant areas of service provision such as dialysis and the pharmacies sector in view of ensuring competition and fair prices in private markets. **[Q4-2013]**

Primary care services

3.63. As part of the reorganisation of health services provision and notably the concentration and specialisation of hospital services and the further development of a cost-effective primary care service, the Government reinforces measures aimed at further reducing unnecessary visits to specialists and emergencies and improving care coordination. **[Ongoing]** This will be done through:

i. increasing the number of USF (*Unidades de Saúde Familiares*) units contracting with regional authorities (ARSs) using a mix of salary and performance-related payments as currently the case. Extend performance assessment to the other primary care units (UCSPs). Make sure that the new system leads to a reduction in costs and more effective provision;

ii. setting-up a mechanism to guarantee the presence of family doctors in needed areas to induce a more even distribution of family doctors across the country;

iii. moving human resources from hospital settings to primary care settings and reconsidering the role of nurses and other specialties in the provision of services;

iv. increasing by at least 20 per cent the maximum number of patients per primary care/family doctor for health centres and by 10 per cent for the USF.

Hospital services

3.64. Implement the strategy to clear arrears in the health sector, within the overall strategy for settling and avoiding the re-emergence of arrears. Ensure standardised and tight control procedures for all health sector entities to ensure expenditure commitments stay within the budget allocated to each entity and therefore prevent the re-emergence of arrears. **[Q3-2012]**

3.65. Hospital SOEs will change the existing accounting framework and adopt accounting standards in line with the requirements for private companies and other SOEs. This will help improving the management of the enterprises and the quality of the financial oversight by the general government. **[Q4-2012]**

3.66. Implement measures aimed at achieving a reduction of at least EUR 200 million in the operational costs of hospitals **in 2012**. This is to be achieved through the reduction in the number of management staff, concentration and rationalisation in state hospitals and health centres with a view to reducing capacity. **[Q4-2012]**

3.67. Continue the publication of clinical guidelines and set in place an auditing system of their implementation. **[Ongoing]**

3.68. Improve selection criteria and adopt measures to ensure a more transparent selection of the chairs and members of hospital boards. Members will be required by law to be persons of recognised standing in health, management and health administration. **[Q2-2012]**

3.69. On the basis of the comprehensive set of indicators, produce regular annual reports comparing hospital performance (benchmarking). The first report is to be published **by end 2012** and its results should be used to establish targets for less performing hospitals. **[Q4-2012]**

3.70. Continue work to ensure full interoperability of IT systems in hospitals, in order for the ACSS to gather real time information on hospital activities and to produce monthly reports to the Ministry of Health and the Ministry of Finance. **[Ongoing]**

3.71. Continue with the reorganisation and rationalisation of the hospital network through specialisation, concentration and downsizing of hospital services, joint management (building on the Decree-Law 30/2011) and joint operation of hospitals. The aim is to adjust hospital provision within the same health region, notably in the presence of newly established PPP hospitals, adjust the activity of some hospitals from curative care towards areas such as rehabilitation, long-term and palliative care and revise emergency and transplantation structures. These improvements aim at eliminating unnecessary duplication, achieving economies of scale and deliver additional cuts in operating costs by at least 5 percent in 2013 while improving the quality of care provided. A detailed action plan is published **by 30 November 2012** and its implementation is finalised **by end-2013**. Overall, from **2011 to 2013**, hospital operational costs must be reduced by at least 15 per cent compared to 2010 level. **[Q4-2012]**

3.72. Reinforce the centralised monitoring of PPP contracts by the Treasury in cooperation with the ACSS **[Q2-2012]**.

3.73. Annually update the inventory of all health staff and prepare regular annual reports presenting plans for the allocation of human resources in the period up to 2014. The report specifies plans to reallocate qualified and support staff within the NHS. **[Q2-2012]**

3.74. Update the current legal framework applying to the organisation of working time of healthcare staff, including introduction of rules to increase mobility within and across Health Regions, adoption of flexible time arrangements and review of payment mechanisms for emergency work, the prevention regime and per call payments. In this context, overtime compensation should be reduced by 20% in 2012 and another 20% in 2013. **[Q4-2012**]

Regional health authorities

3.75. Improve monitoring, internal control and fiscal risks management systems of the Administrações Regionais de Saúde. **[Q4-2012]**

Cross services

3.76. Finalise the set-up of a system of patient electronic medical records and ensure access to all relevant health care facilities. **[Q2-2012]**

3.77. Reduce costs for patient transportation by one third compared to 2010. **[Q4-2012]**

4. Labour market and education

Labour market

Objectives

Revise the unemployment insurance system to reduce the risk of long-term unemployment while strengthening social safety nets; reform employment protection legislation to tackle labour market segmentation, foster job creation, and ease the transition of workers across occupations, firms, and sectors; ease working time arrangements to contain employment fluctuations over the cycle, better accommodate differences in work patterns across sectors and firms, and enhance firms' competitiveness; promote labour cost developments consistent with job creation and enhanced competitiveness; ensure good practices and appropriate resources to Active Labour Market Policies to improve the employability of the young and disadvantaged categories and ease labour market mismatches.

Address early school leaving and improve the quality of secondary education and vocational education and training, with a view to raising the quality of human capital and facilitate labour market matching.

Reforms in labour and social security legislation will be implemented after consultation with social partners, taking into account possible constitutional implications, and in respect of EU Directives and Core Labour Standards.

Unemployment benefits

4.1. Following the reform of the unemployment benefit system (Decree-law 64/2012 and Decree-law 65/2012 of 15 March) - which introduces a declining profile for unemployment benefits, reduces the maximum monthly amount of benefits, reduces the maximum unemployment benefits duration and increases coverage by reducing the contribution period for eligibility and by extending the system to a clearly-defined category of self-employed - the government will prepare by **Q4-2012** an analysis on benefit dependency and long-term unemployment with a view to assessing whether further measures are needed to address possible deficiencies by **Q1-2013**.

Employment protection legislation

4.2. The government will carry out reforms in the employment protection system aimed at tackling labour market segmentation, fostering job creation, and easing adjustment in the labour market. **[Ongoing]**

4.3. Severance payments **[Ongoing]**. Following the entry into force of law n. 53/2011 concerning the reform in the severance payments for new hires in line with the MoU (which reduces severance payments to 20 days per year of work for both open-ended and fixed-term contracts, while introducing a cap of 12 months of pay and eliminating the 3 months of pay irrespective of tenure for permanent contracts, and makes compulsory the partial financing of severance payments via a compensation fund) and the approval by Parliament of draft law n. 46/XII (which aligns the level of severance payments to current employees), the government will further reduce severance payments and implement the compensation fund to partly finance severance payments. Until the fund is operational, the employers remain responsible for the total of severance payments. In consultation with social partners, the Government will, submit to Parliament by **Q3-2012** draft legislation aiming at:

- aligning the level of severance payments with the EU average of 8-12 days;

- implementing the compensation fund for severance payments allowing the severance pay entitlements financed from the fund to be transferable to different employers by means of the creation of notional individual accounts.

4.4. Following the changes to the dismissal rules as stated in draft law n. 46/XII, the government will prepare a report on the effects of these changes on relevant labour market indicators by **Q3-2013**.

Wage setting and competitiveness

4.5. The government will promote wage developments consistent with the objectives of fostering job creation and improving firms' competitiveness with a view to correcting macroeconomic imbalances. To that purpose, the government will:

i. commit that, over the programme period, any increase in the minimum wage will take place only if justified by economic and labour market developments and agreed in the framework of the programme review **[Ongoing]**;

ii. ensure wage moderation by using the available discretion in the current legislation of not extending collective agreements until clear criteria are defined as foreseen by point 4.5(iii);

iii. define clear criteria to be followed for the extension of collective agreements and commit to them. The representativeness of the negotiating organisations and the implications of the extension for the competitive position of non-affiliated firms will have to be among these criteria. The representativeness of negotiating organisations will be assessed on the basis of quantitative indicators. To that purpose, the government will take the necessary steps to collect data on the representativeness of social partners. Based on this data, a collective agreement subscribed by employers' associations representing less 50 percent of workers in a sector cannot be extended. When that threshold is reached a decision on extension will have to take into consideration the implications on competitiveness of firms in the sector. Draft legislation defining criteria for extension and modalities for their implementation will be submitted to Parliament by **Q3-2012**[9], with a view to entering into force by **Q1-2013**;

iv. prepare an independent review by **Q3-2012** on**:**

  - how the tripartite concertation on wages can be reinvigorated with a view to defining norms for overall wage developments that take into account the evolution of the competitive position of the economy and a system for monitoring compliance with such norms;
  - the desirability of shortening the survival (sobrevigência) of contracts that are expired but not renewed (art 501 of the Labour Code).

4.6. The Government will promote wage adjustments in line with productivity at the firm level. Following the implementation of the organised decentralisation (which creates the possibility for collective agreements to define conditions under which works councils can negotiate functional and geographical mobility, working time arrangements and remuneration) and the decrease of the firm size threshold to 150 workers for unions to delegate power to conclude collective agreements to works councils, the government will, by **Q1-2013,** assess in a report the effects of these measures and how they are being applied in collective agreements. If needed, an action plan will be prepared in consultation with the social partners by **Q2-2013** to ensure that works councils are given the possibility to negotiate wages at firm level.

[9] Structural benchmark in the Memorandum of Economic and Financial Policies

Active labour market policies

4.7. The Government will ensure good practices and an efficient amount of resources to activation policies to strengthen job search effort by the unemployed and to other Active Labour Market Policies (ALMPs) to improve the employability of the young and disadvantaged categories and ease labour market mismatches. Following the progress made until Q4-2011, the Government will present by **Q2-2012**:

i. an assessment of the effectiveness of current activation policies and other ALMPs in tackling long-term unemployment, improving the employability of the young and disadvantaged categories, and easing labour market mismatch;

ii. an action plan for possible improvements and further action on activation policies and other ALMPs, including the role of Public Employment Services.

Education and training

4.8. The government will continue action to tackle low education attainment and early school leaving and to improve the quality of secondary education and vocational education and training, with a view to increase efficiency in the education sector, raise the quality of human capital and facilitate labour market matching. To this purpose, the government will:

i. set up an analysis, monitoring, assessment and reporting system in order to accurately evaluate the results and impacts of education and training policies, notably plans already implemented (notably concerning cost saving measures, vocational education and training and policies to improve school results and contain early school leaving). Following the progress made until Q4-2011, the government will continue to improve the system with a view to having an operational management tool by **Q3-2012;**

ii. in line with the action plan to improve the quality of secondary education the Government, by **Q3-2012**, will: (i) implement the legislation to promote trust agreements with public schools and report about progress; (ii) define and implement a simple formula-based funding framework comprising performance evaluation criteria and accountability for public schools and schools under autonomy agreements; (iii) present an assessment of the new inspection model;

iii. in line with action plan on vocational and educational training (VET) the Government will present a progress report on: (i) ways to promote the involvement of businesses in the provisions of traineeships [**Q3-2012**]; (ii) action taken to reorganise modalities for the provision of VET, improve the quality and attractiveness of VET, and to enhance students' orientation and career guidance [**Q4-2012**]; (iii) the establishment of "professional schools of reference". **[Q1-2013]**

5. Goods and services markets

Objectives

Reduce entry barriers in network industries and sheltered sectors of the economy such as services and regulated professions so as to increase competition and reduce excessive rents. These measures should help improving the competitiveness of the Portuguese economy by lowering input prices, raising productivity and improving the quality of the products and services provided. This should contribute decisively to the social balance of the programme by reducing unwarranted sector protection and rents so that all segments of the society participate in the burden sharing of the needed adjustment.

Energy markets

Objectives

Complete the liberalisation of the electricity and gas markets; ensure the sustainability of the national electricity system and avoid further unfavourable developments in the tariff debt; ensure that the reduction of the energy dependence and the promotion of renewable energies is made in a way that limits the additional costs associated with the production of electricity under the ordinary and special (co-generation and renewables) regimes; ensure consistency of the overall energy policy, reviewing existing instruments. Continue promoting competition in energy markets and to further integrate the Iberian market for electricity and gas (MIBEL and MIBGAS).

Liberalisation of electricity and gas markets

5.1. Take further steps towards the full transposition of the Third EU Energy Package. In particular, submit to Parliament the law on the penalty system of the regulator and adopt the decree-laws transposing the electricity and gas directives by **Q2-2012.** This will ensure the National Regulatory Authority's independence and all powers foreseen in the package.

5.2. Take measures to accelerate the establishment of a functioning Iberian market for natural gas (MIBGAS), through regulatory convergence and the harmonisation of the tariff structures in Portugal and Spain. In particular, in accordance with the roadmap of 30 September 2011 agreed with the Spanish authorities, the regulators of each country will:

i. present proposals to harmonise the tariffs for access to the interconnection networks taking into account the outcome of the public consultation conducted in January 2012 **[Q3-2012];**

ii. prepare a report analysing and developing options to improve the harmonised mechanism for capacity allocation and congestion management of cross-border flows with Spain, including the introduction of virtual reverse flows and other mechanisms allowing smaller players to make efficient use of the LNG Sines facility **[Q1-2013];**

iii. apply a harmonised allocation and congestion management mechanism to all the interconnection capacity between Portugal and Spain, in line with the EU network codes and guidelines in this respect **[Q1-2013].**

5.3. Clarify the national legal framework with respect to the scope of competencies of the logistics operator and define based on a cost-benefit analysis a way of convergence of the existing two platforms for electricity and natural gas. **[Q4-2012]**

Ensure sustainability of the national electricity system

5.4. Implement the measures approved in the Council of Ministers on 17 May 2012 to reduce excessive rents and to address the sustainability of the national electricity system. Cost reduction measures address the following compensation schemes: power guarantee, special regime (renewables - excluding those granted under tender mechanisms – and cogeneration), CAE's (power purchase agreements) and CMECs, and will reduce policy cost by at least EUR 1275 million in Net Present Value (NPV)[10] [**July-2012**]. The updated estimation of cost reductions that will be achieved as well as progress towards elimination of the tariff debt (defice tarifário) by 2020 will be presented and assessed in the fifth review.

5.5. Implement the announced measures to limit the policy costs embedded in CMECs and PPAs. In particular, as an element in revising the rate of return to bring it in line with the cost of capital at the moment the CMEC compensation was defined plus, if warranted, a risk premium of the assets that the mechanism remunerates: (i) reduce the CMEC annuity discount rate from 7.55% to 5% (yielding a NPV of EUR 120 million); and (ii) set a compensation for the extension of exploitation licences of the

[10] Computed using a discount rate of 7.55% back to June 2012.

power plants in Sines and Pego[11] yielding NPVs of EUR 55-75 million and EUR 30-50 million respectively, providing details on the valuation methodology leading to these figures. The updated estimation of cost reductions that will be achieved will be presented and assessed in the **fifth review**.

5.6. Present a report on the CMEC scheme including the foreseen annual compensation amounts to each beneficiary and past payments since 2007 and the forecast of future payments. The report will also describe the process for the extension of the concession of the public hydro resource by the former CAE hydro power plants, its correspondent economic valuation, and the rationale for the direct award instead of a tender process. The report will assess and consider all the information available within the governmental and the official bodies (General Directorates, Regulator, State representative in the contracts). **[Q3-2012]**

5.7. Implement the announced measures to limit the policy costs of renewables under the special regime - excluding those granted under tender mechanisms, in particular (i) the compensation to be paid by the generators (yielding a NPV of EUR 75 to 150 million); and (ii) the introduction of a maximum duration for the feed in tariff in small hydro plants (yielding an NPV of EUR 200 to 250 million). The updated estimation of cost reductions that will be achieved will be presented and assessed in the **fifth review**.

5.8. Accelerate convergence to market-based pricing for co-generation operators in parallel with electricity market developments under the EU internal electricity and gas market legislation. The remuneration scheme for co-generation will be further revised to improve efficiency of the support system in ensuring continued guaranteed access of operators to electricity networks and markets with the calculation of explicit subsidies based on relevant price factors in the context of a competitive electricity market. The revision should ensure that the design of the support scheme allows a dynamic correlation between electricity market prices and the efficiency premium when the values of avoided externalities are not adequately reflected in electricity and other factor prices. **[Q4-2012]**. Ensure through annual audits that plants not fulfilling the requirements for co-generation do not receive the support, and report on the progress. **[Q2-2012, Q2-2013]**

5.9. Establish the new subsidy regime under the Power Guarantee mechanism, taking into account the principles established in the Executive Order (Portaria 139/2012) of 14 May 2012 that has revoked the former scheme, namely the differentiated approach for thermal and hydro power plants. Incentives to build additional generating capacity in the future will take into account adequate security of supply levels and the existence of other mechanisms, such as interruptibility services. This new regime, replacing the one eliminated by Executive Order is estimated to reduce policy costs by about EUR 37 million in 2012, EUR 64 million in 2013 and 2014, EUR 52 million per year in 2015 and 2016, EUR 38 million in 2017, and EUR 25 million per year from 2018 to 2020 **[Q2-2012]**. The updated estimation of cost reductions that will be achieved with the new Power Guarantee mechanism will be presented and assessed in the **fifth review**.

5.10. For new contracts in renewables, revise downward the feed-in tariffs and ensure that the tariffs do not over-compensate producers for their costs and they continue to provide an incentive to reduce costs further, through digressive tariffs. For more mature technologies develop alternative mechanisms (such as feed-in premiums). Reports on action taken will be provided annually in **Q3-2012** and **Q3-2013**.

5.11. Decisions on future investments in renewables, in particular in less mature technologies, will be based on a rigorous analysis in terms of its costs and consequences for energy prices. International benchmarks will be used for the analysis and an independent evaluation will be carried out. Reports on action taken will be provided annually in **Q3-2012** and **Q3-2013**.

Energy policy instruments and taxation

5.12. Modify tax and energy policy instruments to ensure that they provide incentives for rational use, energy savings and emission reductions. In particular:

[11] Pego power plant compensation will not be included when determining the reduction of the rate of return of the CMEC.

i. subject to a cost-benefit analysis, eliminate the exemption from the tax on oil and energy products (ISP) applicable to certain industrial fuels used in cogeneration, which overlaps with the feed-in-tariff, as well as other energy and tax policy instruments, i.e. accelerated depreciation rate under the corporate income tax **[Q2-2012];**

ii. conduct a cost-benefit analysis to evaluate the effectiveness of the System for the Management of Energy-Intensive Consumption and the associated exemption from the tax on oil and energy products (ISP) for industrial fuels **[Q2-2012];**

iii. review, based on a cost-benefit analysis, the effectiveness of the other exemptions and reduced rates of the tax on oil and energy products (ISP) under the Excise Tax Code **[Q2-2012];**

iv. take measures to eliminate possible overlaps, and foster synergies, between the Plan for Promoting Efficient Consumption (PPEC) and the Energy Efficiency Fund (EEF). **[Q2-2012]**

Telecommunications and postal services

Objectives
Increase competition in the market by lowering entry barriers; guarantee access to network/infrastructure; strengthen power of the National Regulator Authority.

Telecommunications

5.13. Ensure an efficient, objective, transparent and non-discriminatory mechanism for the designation of the universal service provider(s), in compliance with the Court of Justice ruling of 7 October 2010. Re-negotiate the concession contract with the undertaking currently providing the universal service, by reducing the scope of the services covered, so as to exclude the universal service and launch a new tender process for designation of universal service provider(s). **[Q2-2012]**

5.14. Following the corrective measures already taken, monitor the competitive situation in the telecommunications sector, in particular wholesale and retail broadband access, mobile origination charges and barriers to entry into the fixed communication market. **[Ongoing]**

Postal services

5.15. Following the transposition of the Third Postal directive, further liberalise the postal sector by amending the decree-law laying down the framework of the concession contract and renegotiating the amendment of said contract with CTT, in order to reflect the new law (Law 17/2012) transposing the Third Postal Directive; ensuring in particular that the current designation period for the universal service provision is shortened to 2020 and that investment needs and return on investment are taken into account when setting new designation periods. **[Q2-2012]**

Transport

Objectives
Adopt a strategic plan to: rationalise networks and improve mobility and logistic conditions in Portugal; improve energy efficiency and reduce environmental impact; reduce transport costs and ensure financial sustainability of the companies; strengthen competition in the railways sector and attract more traffic; integrate ports into the overall logistic and transport system, and make them more competitive.

Strategic Plan for Transport

5.16. Implement the Strategic Plan for Transport for 2011-2015 **[Q4-2012]**, namely:

i. continue the reforms in the transport SOEs to achieve their EBITDA balance, by focusing efforts on the reduction of operational costs;

ii. reduce the forecast debt burden of Estradas de Portugal through the reduction of PPP contracts' scope still in the construction phase, revision of shadow-toll schemes and the adjustment of the CSR (Road Service Contribution) to the inflation level. Analyse additional measures to further reduce the forecast debt burden of Estradas de Portugal;

iii. attract new low-cost airline companies and/or routes, making use of the existing infrastructures;

iv. focus the investment priorities in projects that present a positive cost-benefit ratio and contribute to the competitiveness of Portuguese exports, namely in the port and freight rail sectors;

v. reform the transport and infrastructures' regulatory framework in order to improve the effectiveness, efficiency and independence of the entities regulating the transport sector. **[Q1-2013]**

5.17. Present a long term vision of the transport system and a list of actions to improve its efficiency and sustainability **[Q3-2012]**. It will specifically include:

i. an in-depth analysis of the transport system including an assessment of existing capacity, forecast demand, projected traffic flows, and interoperability;

ii. an in-depth analysis of the competitive position of the different transport modes vis-à-vis each other with the objective to reduce dependence on road transport;

iii. a set of priorities for investment on the basis of points i and ii taking also into account TEN-T networks, with an estimate of the financial needs and the foreseen sources of financing;

iv. an assessment of energy savings and greenhouse gas emission reductions from the transport sector.

Measures will be concrete, including the exact instruments used to achieve them. Measures will be chosen based on criteria of cost-effectiveness (comparing savings/costs).

Railways sector

5.18. Continue with the transposition of the EU Railway Packages and in particular:

i. ensure that the rail regulator enjoys the independence required under the EU rail Directives, in particular regarding the rules of appointment and dismissal of the director of the rail regulator. Strengthen the capacities of the railway regulator to fulfil its regulatory mandate effectively, including by exploring synergies with other transport regulators in the context of the revision of national regulatory agencies. **[Q4-2012]**;

ii. continue to implement the plans to bring the infrastructure manager to operational balance, in particular by reducing operational costs by at least 23 per cent in 2012 compared to 2010 **[Q4-2012].** On the revenue side, track access charges for freight services should not be increased in order to prevent a deterioration of the competitiveness of rail freight services. Reintroduce incentives to REFER to reduce costs and access charges. Provide annual progress reports on the implementation of balancing revenues and expenditures **[Q2-2012, Q2-2013]**;

iii. analyse the potential for further rationalisation in loss-making and low-demand lines and services **[Q4-2012]**;

iv. ensure that the new Public Service Obligation (PSO) contracts concluded on rail passenger transport respect EU legislation including Regulation (EC) No 1370/2007, and in particular provide a detailed breakdown of state contributions for each line under PSO **[Q3-2012].** Develop administrative capacity for a stepwise introduction of competitive tendering of PSOs starting with some suburban services. Ensure that the awarding authority has the required level of independence and competence and guarantees fair conditions of tendering **[Q4-2012]**;

v. extend the performance scheme on infrastructure charges to other operators**[Q2-2012]**;

vi. review and render more effective the yield management on long-distance passenger ticket prices. **[Q1-2013]**;

vii. to prepare the privatisation of the freight branch of the state-owned rail operator, carry out an analysis for transferring part or whole of CP Carga's rolling stock to a rolling stock operating company. **[Q3-2012]**;

viii. ensure that the rail terminals currently owned by CP Carga are transferred to another entity that will guarantee non-discriminatory access to all rail freight operators. **[Q3-2012]**; Plans will be presented and assessed in the **fifth review**.

ix. optimise the train driver certification process concerning additional authorisations by shortening lead times, simplifying and making more effective the safety rules in close collaboration with the rail regulator **[Q3-2012]**

Ports

5.19. Submit to Parliament a revised legal framework governing port work to make it more flexible, including narrowing the definition of what constitutes port work, bringing the legal framework closer to the provisions of the Labour Code. **[Q2-2012]** The revised legal framework is expected to come into force by **[Q3-2012].**

5.20. Take further steps to improve the governance model of the ports system with the objective to enhance the competitiveness and the efficiency of ports in line with the long-term vision of the transport system to be adopted (measure 5.17). The Ministry of Economy and Employment will deliver and enforce policies that ensure strong integrated policy-making, strategic planning and surveillance functions common to all ports in the country. Moreover, the Port Regulator shall have the capacity to ensure at a National level that the Port Authorities will implement policy decisions so that (i) efficiency gains and cost-savings are passed through to port customers; and (ii) concession-holders of terminals and land facilities in ports respect minimum performance criteria. **[August-2012]**

Road pricing

5.21. Adopt the necessary legislative amendments in order to achieve full compliance with Directive 1999/62/EC (Eurovignette Directive) and the EU Treaty and, in particular, to guarantee non-discriminatory application of tolling schemes to non-resident road users **[Q4-2012].** After the deadline of this measure, rebates in tolling schemes that pursue compelling reasons of territorial and social cohesion may only be applied if their compliance with the EU law is demonstrated.

Other services sector

Objectives

Eliminate entry barriers in order to increase competition in the services sector; soften existing authorisation requirements that hinder adjustment capacity and labour mobility; reduce administrative burden that imposes unnecessary costs on firms and hamper their ability to react to market conditions.

Sector-specific legislation of Services

5.22. Adopt the remaining necessary amendments to the sector specific legislation to fully implement the Services Directive, easing the requirements related to establishment and reducing the number of requirements to which cross-border providers are subject. Adopt the remaining required amendments and submit them to Parliament by **[Q2-2012]** in view of approval by **[Q3-2012]**.

5.23. Adopt the necessary sector-specific amendments in the areas of construction and real estate to make both regimes fully compatible with the Services Directive and with the Treaty on the Functioning of the European Union. This includes making less burdensome the requirements applying to cross-border providers, both for construction and real estate activities, and reviewing obstacles to the establishment of service providers such as restrictions on subcontracting (for construction) and on excessive liquidity obligations and physical establishment (for real estate). Submit to Parliament by **[Q2-2012]** in view of approval by **[Q3-2012]**.

Professional qualifications

5.24. Improve the recognition framework on professional qualifications through adoption by the Parliament of the amendment to Law 9/2009, already submitted, on the recognition of professional qualifications in compliance with the Professional Qualifications Directive **[expected by August-2012]**. Adopt the executive order (portaria) on the services provider prior declaration following the adoption of amendment of Law 9/2009. **[Q3-2012]**

Regulated professions

5.25. Review and reduce the number of regulated professions and in particular eliminate reserves of activities on regulated professions that are no longer justified. Submit to Parliament the law for professions where regulation does not involve a professional body (Ordens or Câmaras) in **[July-2012]** in view of approval by **[Q3-2012]**.

5.26. Further improve the functioning of the regulated professions (such as accountants, lawyers, notaries) for which regulation involves a professional body (Ordens or Câmaras) by carrying out a comprehensive review of requirements affecting the exercise of activity and eliminate those not justified or proportional, including: (i) adopting the measures included in 5.24 and 5.25; (ii) eliminating restrictions to the use of commercial communication (advertising), as required by the Services Directive. To achieve the two conditions above the government will, following the public consultation, submit a draft horizontal legal framework to Parliament by **[Q2-2012]**, in view of approval by **[Q3-2012]**. Upon enactment, the professional bodies will make the necessary changes in their statutes by **[Q4-2012]**.

Administrative burden

5.27. Continue the simplification reform effort by:

i. adapting the content and responsive to the new legislation to be adopted to ensure conformity with the Services Directive (see 5.22 and 5.23 above) at the latest 1 month after the adoption of each sector-specific regime, clearly differentiating information on requirements applicable to established providers and to cross-border ones, and by making available online forms and extend on-line procedures for all sectors covered by the Services Directive no later than 2 months after adoption of the sector-specific regime;

ii. adapting the content and information available at the PSC to the new legislation to be adopted to ensure conformity with the Professional Qualifications Directive at the latest 1 month after the adoption of amendments mentioned in 5.24, clearly differentiating information on requirements applicable to established providers and to cross-border ones, and by extending on-line forms and procedures for each profession no later than 2 months after adoption of amendments;

iii. making available in PSC on-line procedures for the registration of establishments covered by "Zero Authorisation" (DL 48/2011) by **[Q4-2012]**. Foster collaboration from municipalities in providing the content for the working hours map for the stores and establishments services and advertisement regimes for which they have full competence to make the PSC operational **[Q3-2012]**; and also for installation, modification and closing up of restaurants, bars and other establishment and occupation of public space regimes **[Q4-2012]**. Make fully operational the "Zero Authorisation" project that abolishes authorisations/licensing and substitute them with a declaration to the PSC for the wholesale and retail sector and restaurants and bars **[Q1-2013]**. The platform will be available to all levels of administration, including all municipalities **[Q1-2013];**

iv. extending PSC to services not covered by the Services Directive **[Q2-2013]**;

v. extending the "Zero Authorisation" project to other services sectors of the economy **[Q3-2013]**.

6. Housing market

Objectives

Improve access to housing; foster labour mobility; improve the quality of housing and make better use of the housing stock; reduce the incentives for households to build up debt.

Property taxation

6.1. The government will continue to step up the appraisal of the taxable value of the housing stock. In particular, the measures will: (i) ensure that **by end 2012** the taxable value of all property is close to the market value and (ii) property valuation is updated regularly (every year for commercial real estate and once every three years for residential real estate as foreseen in the law). **[Q4-2012]**

6.2. The government will gradually rebalance property taxation towards the recurrent real estate tax (IMI) and away from the transfer tax (IMT), while considering the socially vulnerable. **[Q3-2012]**

Comprehensive review of the housing market

6.3. Following the adoption of the amendments to the New Urban Lease Act Law 6/2006 and the Decree Law which simplifies the administrative procedures for renovation, the government will undertake a comprehensive review of the functioning of the housing market with the support of internationally-reputed experts. The review will determine whether the new legal provisions adopted are sufficient to make the housing market more dynamic and, if necessary, will propose new policy measures. **[Q2-2013]**

7. Framework conditions

Judicial system

Objectives

Improve the functioning of the judicial system, which is essential for the proper and fair functioning of the economy, through: (i) ensuring effective and timely enforcement of contracts and competition rules; (ii) increasing efficiency by restructuring the court system, and adopting new court management models; (iii) reducing slowness of the system by eliminating backlog of courts cases and by facilitating out-of-court settlement mechanisms.

Court backlog

Recognising the urgency of the judicial reform to make the judicial system more efficient and more effective, the government will:

7.1. Eliminate court backlogs by **Q2-2013.**

7.2. Implement targeted measures to achieve steady reduction of the backlogged enforcement cases. In particular, set quarterly targets for closing enforcement cases and prepare quarterly reports on implementation status, by an inter-agency task force, with the third report to be completed by **15 August 2012**.

7.3. Present the initial draft bill for enforcement agent framework (i) strengthening the authority and financing structure of the oversight body and enhancing the accountability of enforcement agents, and (ii) to include a fee structure that incentivises speedy enforcement by **mid-August 2012** which will be further refined by extensive consultation including with the IMF/EU technical assistance by **mid-October 2012**.

Management of courts

Advance with reforms aimed at improving management efficiency of the court system:

7.4. Submit an initial draft bill on judicial reform by **mid-August 2012** which will be further refined by extensive consultation including with the IMF/EU technical assistance by **end-September 2012**. Submit a Bill to implement the judicial reform roadmap to Parliament by **end-November 2012**[12].

Alternative dispute resolution for out-of-court settlement

Continue strengthening alternative dispute resolution (ADR) to facilitate out-of-court settlement:

7.5. Submit the Bill to improve the Justices for Peace regime to Parliament by **November 2012**.

Civil law cases in the courts

Further streamline and speed up civil case processing in the courts:

7.6. Prepare an initial draft of the new Code of Civil Procedure by 6 July 2012 which will be further refined by extensive consultation including with the IMF/EU technical assistance by **end-September 2012**. By **end-November 2012** [13] submit to Parliament the Code of Civil Procedure which addresses the key areas for improvement, including (i) to consolidate legislation for all aspects of enforcement cases before the court, (ii) to give the judge the power to expedite cases, (iii) to restrict the administrative burdens for judges, (iv) to enforce statutory deadlines for court processes and in particular injunction procedures and debt enforcement and insolvency cases and (v) to establish a single judge procedure for small claims, and taking into account stakeholder consultation and comparative law analysis.

Budget and allocation of resources

[12] Structural benchmark in the Memorandum of Economic and Financial Policies.
[13] Structural benchmark in the Memorandum of Economic and Financial Policies.

Remain committed to putting in place a more sustainable and transparent budget for the judiciary:

7.7. Publish quarterly reports on recovery rates, duration and costs of corporate insolvency cases starting from **[Q3-2011]**, within four months after the end of the relevant quarter.

Competition, public procurement and business environment

Objectives

Ensure a level playing field and minimise rent-seeking behaviour by strengthening competition and sectoral regulators; eliminate special rights of the state in private companies (golden shares); reduce administrative burdens on companies; ensure fair public procurement processes; improve effectiveness of existing instruments dealing with export promotion and access to finance and support the reallocation of resources towards the tradable sector.

Competition and sectoral regulators

7.8. The Government shall take the necessary measures to ensure that the Portuguese State or any public bodies do not conclude, in a shareholder capacity, shareholder agreements the intention or effect of which hinder the free movement of capital or which influence the management or control of companies **[Ongoing]**. The Portuguese State will ensure that CGD alienates its participation in Galp. **[Q2-2012]**

7.9. Going beyond elimination of special rights of the State, the authorities also commit to ensure that obstacles to free movement of capital will not be created by their action. The authorities acknowledge that the discretion granted under the amended article 13(2) of the Framework Law of Privatisations (Law 11/90 amended by Decree 3/XII of the Parliament of 5 August 2011), if used, shall be restricted solely to the concrete privatisation operation and thus used in such a proportionate manner that privatisation's implementing laws will not set or allow holding or acquisition caps beyond the privatisation transaction**. [Ongoing]**

7.10. Monitor the inflow of cases and report on the functioning of the specialised court for Competition, Regulation and Supervision, assessing the situation in terms of risk of potential court backlogs. **[Q4-2012]**

7.11. Following up on the adoption of the executive order (*portaria*) concerning the transfers of payments from regulators to the Competition Authority and the report prepared under measure 7.12 (i), the financing model of the latter will be re-examined resulting in a technical proposal by **[Q3-2012]** to be implemented by **[Q4-2012].** Given the enlarged scope of action of the Competition Authority, review with key stakeholders the conditions for the proper execution of its mandate. **[Q3-2012]**

7.12. Ensure that the national regulator authorities (NRA) have the necessary independence and resources to exercise their responsibilities by **Q4-2012** for the main NRAs and by **Q1-2013** for the others. In order to achieve this:

i. provide an independent report (by internationally recognised specialists) on the responsibilities, resources and characteristics determining the level of independence of the main NRAs. The report will benchmark nomination practices, responsibilities, independence and resources of each NRA with respect to best international practice. It will also cover scope of operation of sectoral regulators, their powers of intervention, as well as the mechanisms of coordination with the Competition Authority. The report will be completed by **[Q2-2012]**;

ii. based on the report, present a proposal to implement the best international practices identified to reinforce the independence of regulators where necessary, and in full compliance with EU law by **[Q3-2012]**[14].

Public procurement

The government will modify the national public procurement legal framework and improve public contracts award practices to ensure a more transparent and competitive business environment and improve efficiency of public spending. In particular, it will:

7.13. Submit a report analysing the effectiveness and impact of the amendments to the revised Public Procurement Code as well as of the enhanced role of the Court of Auditors in ensuring compliance with public procurement rules by **[Q1-2013]**.

Business environment

7.14. Make operational the procedures for requesting VAT exemptions for exporting firms and to simplify procedures associated with indirect exports by **Q3-2012** as part of the "Simplex Exports" programme.

7.15. As a follow up to the report delivered in January, draft a report furthering the assessment of the overall consistency, the effectiveness, and the impact of existing financing and non-financing support measures designed to provide access to finance and encourage internationalisation of companies, in particular for SMEs (therefore partially responding also to measure 2.16) by **Q2-2012**. Following results of the report, modify or adopt, where necessary, measures to facilitate access to finance and export markets for companies, in particular for SMEs. **[Ongoing]**

7.16. Promote liquidity conditions for business by timely implementing the New Late Payments Directive. **[Q1-2013]**

7.17. Continue reducing administrative burdens by including municipalities and all levels of public administration within the scope of the Simplex Programme. **[Q1-2013]**

7.18. The government is also undertaking additional initiatives to simplify substantially the administrative and other legal requirements for the exercise of an economic activity. This includes a revision of the legal frameworks of territorial planning, land use and urban and construction and industry licensing in line with the '*Programa da Indústria Responsável*' and the forthcoming Decree Law on '*Sistema de Indústria Responsável*' which aims at (i) extending the Zero Licensing to the majority of the industrial activities, (ii) creating Special Areas where the firms will benefit from exemptions of administrative and licensing requirements, and (iii) extending the use of the Point of Single Contact for the procedures needed in the start-up or alteration of an industrial activity and for the relations with the Public Administration. [**Ongoing**]

[14] Structural benchmark in the Memorandum of Economic and Financial Policies.

ANNEX 6: INDICATIVE TIMELINE

Indicative timeline of financial sector and structural measures in the Memorandum of Understanding on specific economic conditionality[37]

Actions for the fifth review (to be completed by end Q2-2012)	
Fiscal-structural	**[3.3]** Submit a proposal to reduce budgetary fragmentation. **[3.12]** Submit a draft proposal to revise the local finance law. **[3.16]** Complete the study to assess the costs and benefits of renegotiating any PPP contract to reduce the government financial obligations. **[3.18]** Prepare a progress report concerning the implementation of SOEs strategy. **[3.19]** Prepare strategy for managing the debt load of all SOEs, including Parpublica. **[3.20]** Submit to Parliament a draft law to strengthen governance of SOEs in accordance with international practices. **[3.21]** Prepare a fiscal risk analysis, including all liabilities in preparation for the annual budget. **[3.29]** Draft a proposal to strengthen the powers of central tax administration. **[3.32]** Conclude the public administration restructuring programme (PREMAC). **[3.33]** Municipalities to present plans to reduce management positions and administrative units by at least 15% by the end of 2012. **[3.34]** Prepare a detailed cost/benefit analysis of all public and quasi-public entities using the results of the compulsory census. **[3.35]** Regulate by law the creation and the functioning of foundations, associations etc. by the central and local administrations. **[3.40]** Reinforce the mobility schemes.
Financial sector	**[2.3]** Finalise by 30 June 2012 the capital augmentation aiming at a Core Tier 1 ratio of 9% for the major banks. **[2.13]** Set up of the resolution fund with a view to ensuring its funding arrangement by July 2012. **[2.16]** Revise the report assessing the impact of existing support mechanism to SMEs.
Health care system	**[3.46]** Complete the transfer of the responsibility of pricing medicines to the Ministry of Health. **[3.55]** Implement the new legislation regulating pharmacies. **[3.68]** Improve selection criteria of the members of hospital boards. **[3.72]** Reinforce the centralised monitoring of PPP contracts. **[3.73]** Update the inventory of all health staff and prepare annual reports on HR allocation. **[3.76]** Finalise the system of patient electronic medical records and ensure access to all relevant health care facilities.
Labour market and education	**[4.7]** Present an assessment of the activation policies in tacking unemployment, and an action plan for improvements.
Goods and services markets	**[5.1]** Take further steps towards the full transposition of the Third EU Energy Package. **[5.4]** Implement the measures approved in the Council of Ministers on 17 May 2012 reducing excessive rents. Present and assess estimation of cost reductions to be achieved as well as progress towards elimination of the tariff debt. **[5.5]** Implement the announced measures to limit the policy costs embedded in

[37] Square brackets identify paragraph numbers in the MoU as signed on 15 April 2012. Items that are Structural Benchmarks under the program are flagged with SB, and also identified by the MEFP paragraph number. Items that are Prior Actions under the program are flagged with PA, and also identified by the MEFP paragraph number.

Actions for the fifth review (to be completed by end Q2-2012)	
	CMECs and PPAs. Present and assess estimation of cost reductions to be achieved **[5.7]** Implement the announced measures to limit the policy costs of renewables under the special regime. Present and assess estimation of cost reductions to be achieved. **[5.8]** Ensure through annual audits that plants not fulfilling the requirements for co-generation do not receive the support. **[5.9]** Establish the new subsidy regime under the Power Guarantee mechanism. Present and assess estimation of cost reductions to be achieved. **[5.12 i]** Eliminate the exemption from the ISP tax. **[5.12 ii]** Conduct a cost-benefit analysis on the effectiveness of the System for the Management of Energy-Intensive Consumption. **[5.12 iii]** Review the effectiveness of the other exemptions and reduced rates of the ISP tax. **[5.12 iv]** Take measures to eliminate possible overlaps between PPEC and EEF. **[5.13]** Ensure an efficient mechanism for the designation of the universal service provider(s) and launch a new tender for their designation. **[5.15]** Further liberalise the postal sector by amending the law laying down the framework of the concession contracts. **[5.18 ii]** Provide annual progress reports on the implementation of balancing revenues and expenditures of REFER. **[5.18 v]** Extend the performance scheme on infrastructure charges to other operators. **[5.18 viii]** Present plans of transferring the rail terminals currently owned by CP Carga to another entity that will guarantee non-discriminatory access to all rail freight operators. **[5.19]** Submit to Parliament a revised legal framework governing port work. **[5.20]** Take further steps to improve the governance model of the ports system with the objective to enhance the competitiveness and the efficiency of ports. **[5.22]** Submit to the Parliament the remaining necessary amendment to the sector specific legislation to fully implement the Services Directive. **[5.23]** Submit to the Parliament the amendments in the areas of construction and real estate. **[5.24]** Improve the recognition framework on professional qualifications through adoption by the Parliament of the amendment to Law 9/2009. **[5.25]** Submit to Parliament a law reviewing and reducing the number of regulated professions and eliminating reserves of activities for those professions where regulation does not involve a professional body. **[5.26]** Submit to Parliament a draft legal framework concerning the requirements affecting the exercise of regulated professions with professional bodies and eliminate those not justified or proportional.
Competition, public procurement, and business environment	**[7.8]** The Portuguese State will ensure that CGD alienates its participation in Galp. **[7.12 i]** Complete an independent report on the responsibilities, resources and characteristics determining the level of independence of the main NRAs. **[7.15]** Draft a report assessing the impact of financing and non-financing support measures aimed to provide access to finance for companies.

Actions for the fifth review (to be completed by end Q2-2012)	
Judicial system	**[7.2]** Complete the third report on the implementation of targeted measures to achieve steady reduction of the backlogged enforcement cases. **[7.3]** Present a fee structure that incentivises speedy enforcement of agent framework. **[7.4]** Submit an initial draft bill on judicial reform.
Actions for the sixth review (to be completed by end Q3-2012)	
Fiscal-structural	**[3.4]** Prepare a document assessing reform progress in the area of public financial management. **[3.5]** Carry out inspections to verify compliance of the commitment control system. **[3.6]** Reduce a significant part of the existing arrears as per the strategy for the settlement of the arrears. **[3.7]** Prepare a document concerning the monitoring, controlling and auditing of the programme agreed between the government and local authorities for the settlement of arrears. **[3.13]** Create a working group to prepare a proposal for common revenue forecasting guidelines for subnational governments. **[3.16]** Encourage regions to design a framework for assessing fiscal risks derived from PPP, concessions and other public investments. **[3.17]** Enhance annual PPP and concessions report which provides information and analysis at sectorial level. **[3.19]** Develop a strategy for managing the heavy debt load of SOEs, including Parpublica. **[3.24]** Prepare an asset inventory, including real estate, owned by municipalities and regional government, examining scope for privatisation. **[3.26]** Prepare a draft proposal to enhance the exchange of information between the collection units of the Tax Authority and Social Security. **[3.27 iv]** Prepare draft action plan with concrete measures to resolve VAT issues related to backlog enforcement cases. **[3.32]** Present a report on PREMAC, including the internal organisation and the roster of each public administration entity. **[3.34 i]** Apply the approach on foundation, the compulsory census and subsequent analysis to central, regional and local administration. **[3.36]** Reorganise and reduce significantly the number of local authorities, to come into effect by the beginning of the next local election cycle. **[3.37]** Carry out a study to identify inefficiencies between central, local and locally-based central administration services.
Financial sector	**[2.2]** Complete a proposal for encouraging the diversification of financing alternatives to the corporate sector by end-July. **[2.3]** Finalise by 30 June 2012 the capital augmentation related to the exercise launched by EBA. **[2.13]** Set-up of the resolution fund with a view to ensuring its funding arrangement by July-2012.
Health sector	**[3.56]** Produce assessment of the savings for wholesale companies and pharmacies. **[3.64]** Implement the strategy to clear arrears avoiding the re-emergence of arrears.

Actions for the fifth review (to be completed by end Q2-2012)	
Labour market	**[4.3]** Draft legislation submitted to Parliament to: i) align the level of severance payments to the EU average; and ii) allow the severance pay entitlements financed from the fund agreed in the Tripartite agreement to be transferable to different employers. **[4.5 iii]** Submit to Parliament draft legislative proposal containing criteria and modalities for the extension of collective agreements. **[4.5 iv]** Prepare an independent review on how the tripartite concertation on wages can be reinvigorated and on the desirability of shortening the survival of contracts that are expired but not renewed. **[4.8 i]** Improve the system by having an operational management tool. **[4.8 ii]** Implement the legislation to promote trust agreements with public schools and present a new inspection model. **[4.8 iii]** Present a progress report on the involvement of businesses in the provisions of traineeships.
Goods and services markets	**[5.2 i]** Present proposals to harmonise the access tariffs to the interconnection networks. **[5.6]** Present a report on the CMEC scheme including the foreseen annual compensation amounts to each beneficiary and past payments since 2007 and the forecast of future payments **[5.10]** Provide annual report on revising downward the feed-in tariffs and ensuring that the tariffs do not over-compensate renewable producers. **[5.11]** Provide annual report containing a rigorous analysis in terms of costs and consequences for energy prices of future investments in renewables. **[5.17]** Present a long term vision of the transport system and a list of actions to improve its efficiency and sustainability. **[5.18 iv]** Ensure that the new Public Service Obligation (PSO) contracts respect EU legislation. **[5.18 vii]** Prepare the privatisation of the freight branch of the state-owned rail operator. **[5.18 viii]** Ensure that the rail terminals (owned by CP Carga) are transferred to another entity guaranteeing non-discriminatory access to all rail freight operators. **[5.18 ix]** Optimise the train driver certification process concerning additional authorisations by shortening lead times, simplifying and making more effective the safety rules **[5.19]** Ensure that the revised legal framework on port work is in force. **[5.22]** Approval by the Parliament of the remaining necessary amendment to the sector specific legislation to fully implement the Services Directive. **[5.23]** Approval by the Parliament of the amendments in the areas of construction and real estate. **[5.24]** Adopt the executive order (*portaria*) on the services provider prior declaration following the adoption of amendment of Law 9/2009. **[5.25]** Approval by the Parliament of the law for professions where regulation does not involve a professional body. **[5.26]** Approval by the Parliament of the draft horizontal legal framework concerning the requirements affecting the exercise of regulated professions with professional bodies. **[5.27 iii]** Foster collaboration from municipalities to make the Point of Single Contact operational. **[5.27 v]** Extend the "Zero Authorisation" project to other services sectors.
Housing	**[6.2]** Rebalance property taxation towards the recurrent real estate tax (IMT), while considering the socially vulnerable.

Actions for the fifth review (to be completed by end Q2-2012)	
Competition, public procurement, and business environment	**[7.11]** Re-examine the financial model concerning the transfers of payments from regulators to the Competition Authority which should result in a technical proposal. **[7.11]** Review with key stakeholders the conditions for the proper execution of the Competition Authority mandate. **[7.12 ii]** Present a proposal to reinforce the independence of regulators in full compliance with EU law. **[7.14]** Make operational the procedures for requesting VAT exemptions for exporting firms.
Judicial system	**[7.4]** Refine by extensive consultation an initial draft bill on judicial reform. **[7.6]** Refine by extensive consultation an initial draft of the new Code of Civil Procedure.

Actions for the seventh review (to be completed by end Q4-2012)	
Fiscal-structural	**[1.23]** Carry out measures with the 2013 Budget Law. **[3.9]** Revise the Budget Framework Law to take account of the reinforced EU fiscal framework. **[3.12]** Submit to Parliament the draft proposal to revise the regional finance law. **[3.18]** SOEs to reach operational balance. **[3.23]** Prepare a strategy for Aguas de Portugal (AdP). **[3.25]** Complete the implementation of the new structure that merges tax, customs and DGITA. **[3.27 i]** Assess the need to establish special chambers within the tax tribunals to handle cases above EUR 1 million. **[3.27 ii]** Reduce number of municipal tax offices by 20%. **[3.27 iii]** Increase to 30% the number of auditors in the tax administration. **[3.28]** Clear cases above EUR 1 million with the support of the tax court judges. **[3.29]** Submit to Parliament the draft proposal to strengthen the auditing and enforcement powers of the central tax administration. **[3.30]** Develop the plan to implement e-invoicing. **[3.31]** Implement a full-fledged Large Taxpayer Office (LTO). **[3.34 ii]** Apply the approach on foundation, the compulsory census and subsequent analysis to association and later to other public and quasi-public entities. **[3.37]** Reform the existing framework of central, local and locally-based administration services. **[3.38 ii]** Fully implement the strategy of shared services in central administration in the area of human resources. **[3.38 iii]** Implement shared services in IT. **[3.42]** Prepare a comprehensive review of wage scales.
Financial sector	**[2.6]** Complete the sale of the insurance and health arm. **[2.16]** Prepare the implementing measures in order to rend the new legal framework fully operational.
Health care system	**[3.43]** Additional revenue of EUR 150 million following the revision of NHS moderating fees. **[3.45]** Enact legislation which automatically reduces the price of medicines when the patent expires to 50% of their previous price. **[3.51]** Publish implementation report of the legislation making compulsory the prescription by INN to increase the use of generic medicines. **[3.58]** Publish an action plan concerning the reduction of costs and fighting waste. **[3.60]** Take measures to increase competition among private providers and reduce by 10% the overall spending.

	[3.65] Change existing accounting framework and adopt accounting standards in line with the requirements for private companies and other SOEs. **[3.66]** Implement measures aiming at reducing the operational costs of at least EUR 200 million. **[3.69]** Set up a system for comparing hospital performance on the basis of a comprehensive set of indicators and regular reports. **[3.71]** Reduce by at least 15% hospital operational costs. **[3.71]** Set up a system for comparing hospital performance on the basis of a comprehensive set of indicators – first regular report. **[3.71]** Publish detailed action plan to deliver additional cuts in the hospitals network operating costs of at least 5% in 2013. **[3.74]** Adopt for all staff flexible time arrangements, to reduce by at least 20% spending on overtime compensation in 2012 and another 20% in 2013. **[3.75]** Improve monitoring, internal control and fiscal risks management systems of the Administracaoes Regionais de Saude. **[3.77]** Reduce costs for patient transportation by 1/3.
Labour market	**[4.1]** Prepare an analysis on benefit dependency and long-term unemployment. **[4.8 iii]** Reorganise modalities for the provision of VET, enhance students' orientation and career guidance.
Goods and services markets	**[5.3]** Clarify the national legal framework with respect to the scope of competencies of the logistics operator **[5.8]** Revise the remuneration scheme for co-generation. **[5.16]** Implement the Strategic Plan for Transport for 2011-2015. **[5.18 i]** Ensure that the rail regulator enjoys the independence required under the EU rail Directives. **[5.18 ii]** Reduce operational costs of REFER by at least 23% in 2012 compared to 2010. **[5.18 iii]** Analyse the potential for further rationalisation in loss-making and low-demand lines and services. **[5.18 iv]** Ensure that the awarding authority for PSO contracts has the required level of independence and competence. **[5.21]** Adopt the necessary legislative amendments to achieve full compliance with Directive 1999/62/EC and EU Treaty. **[5.26]** Make the necessary changes in the statutes of professional bodies. **[5.27 iii]** Make available in PSC on-line procedures for the registration of establishments covered by "Zero Authorisation".
Housing market	**[6.2]** Bring value of all property stock close to market value and ensure that property valuation is updated regularly.
Competition, public procurement, and business environment	**[7.10]** Monitor the inflow of cases and report on the functioning of the specialised court for Competition, Regulation and Supervision. **[7.12]** Ensure that remaining NRAs have the necessary independence and resources to exercise their responsibilities.
Judicial system	**[7.4]** Submit a Bill to Parliament to implement the judicial reform roadmap. **[7.5]** Submit to Parliament the Bill to improve the Justices for Peace regime. **[7.6]** Submit draft amendments to the Code of Civil Procedure to Parliament.

Actions for the eighth review (to be completed by end Q1-2013)	
Fiscal structural	**[3.30]** Prepare an evaluation report of the scheme.
Health care system	**[3.47]** Publish second price revision for medicines (January 2013). **[3.53]** Produce a report assessing the legislation aimed at removing all effective entry barriers for generic medicines.

Actions for the eighth review (to be completed by end Q1-2013)	
Labour market	**[4.1]** Assess if further measures are needed in relation with benefit dependency and long-term unemployment. **[4.5 iii]** Enter the legislative proposal into force. **[4.6]** Assess in a report the effects of the organised decentralisation. **[4.8 iii]** Establish "professional schools of references".
Goods and services markets	**[5.2 ii]** Prepare a report analysing options to improve the harmonised mechanism for capacity allocation and congestion management of cross-border flows with Spain. **[5.2 iii]** Apply a harmonised congestion management mechanism to all the interconnection capacity between Portugal and Spain. **[5.16 v]** Reform the transport and infrastructure's regulatory framework. **[5.18 vi]** Review and render more effective the yield management on long-distance passenger ticket prices. **[5.27 iii]** Make fully operational the "Zero Authorisation" project. **[5.27 iii]** Make the "Zero Authorisation" platform available to all levels of administration, including municipalities.
Competition, public procurement, and business environment	**[7.12]** Ensure that the other national regulator authorities have the necessary independence and resources to exercise their responsibilities. **[7.13]** Submit a report analysing the impact of the amendments to the revised Public Procurement Code as well as of the enhanced role of the Court of Auditors. **[7.16]** Implement the New Late Payments Directive. **[7.17]** Include all municipalities and all levels of public administration within the scope of the Simplex Programme.

Actions for the ninth review (to be completed by end Q2-2013)	
Fiscal structural	**[3.10]** Define in details the characteristics of the medium-term budgetary framework. **[3.22]** Conclude the privatisation or concession of the cargo handling subsidiary of CP Carga. **[3.42]** Prepare a comprehensive review of wage scales in the entities classified outside the general government.
Labour market	**[4.6]** If needed, prepare an action plan to ensure works council can negotiate wages at firm level.
Goods and services markets	**[5.8]** Ensure through annual audits that plant not fulfilling the requirements for co-generation do not receive the support scheme. **[5.18 ii]** Provide annual progress reports on the implementation of balancing revenues and expenditures of REFER. **[5.27 iv]** Extend the Points of Single Contact to services not covered by the Services Directive.
Housing market	**[6.3]** Review of the impact of all housing market reforms.
Judicial system	**[7.1]** Eliminate the court backlog.

Actions for the tenth review (to be completed by end Q3-2013)	
Fiscal structural	**[1.25]** Quarterly ceilings for the consolidated General Government cash balance to be assessed.
Labour market	**[4.4]** Prepare a report on the effects of the changes to the dismissal rules on labour market indicators.
Health care system	**[3.57]** Introduce a contribution in the form of an average rebate, in case the change in the calculation of profit margin will not produce the expected savings.
Goods and services markets	**[5.10]** Annual report on new contracts in renewables. **[5.11]** Annual report on new investments in renewables. **[5.27 v]** Extend the "Zero Authorisation project" abolishing licenses to other sectors of

Actions for the tenth review (to be completed by end Q3-2013)	
	the economy.

Actions for the eleventh review (to be completed by end Q4-2013)	
Fiscal-structural	**[1.24]** Quarterly ceilings for the consolidated General Government cash balance to be assessed. **[3.25]** Merge the revenue collection units of social security administration, if cost-benefit assessment is favourable. **[3.27 ii]** Reduce number of municipal tax offices by 20%. **[3.38]** GeRFIP to be implemented in the Autonomous region of Madeira and in the Autonomous Region of Azores. **[3.39]** Reduce the number of local branches of line ministries.

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