CONFIDENCIAL

PORTUGAL—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

A. Introduction and Macroeconomic Outlook

1. **The Portuguese economy faces considerable challenges.** Competitiveness indicators have suffered, economic growth has been anemic, and the current account deficit is at 10 percent of GDP. The global crisis exposed Portugal's weak fiscal and financial position with public debt at around 90 percent of GDP at end-2010 and private sector debt about 260 percent of GDP. Banks that financed this build-up in debt now have the highest loan-to-deposit ratio in Europe.

2. **To address these challenges we have embarked on a balanced and focused reform to correct external and internal imbalances and boost potential growth and employment.** Our strategy envisions bold and upfront structural reforms to improve competitiveness, an ambitious but credible pace of fiscal adjustment, and measures to ensure a stable and dynamic financial system. Large support from the international community will help reduce the social costs of adjustment. It will also allow us sufficient breathing space to establish a strong record of policy implementation before going back to markets.

3. **Growth is expected to recover only gradually over the next three years.** Output is expected to contract around 2 percent in 2011 and 2012 on account of needed fiscal consolidation, general confidence effects that led to the request for international financial support, and adjustments in the banking system. In addition, general market concerns for Euro area periphery countries are also likely to weigh on sentiment in the near term. Nevertheless, as markets regain confidence in the economy and structural reforms begin to deliver, activity is expected to start recovering in 2013 onwards.

B. Reducing Public Debt and Deficit

4. **Our fiscal targets are ambitious but realistic.** We will target a deficit of 5.9 percent of GDP in 2011, 4.5 percent of GDP in 2012 and—consistent with the Excessive Deficit Procedure deadline agreed with the EU—3 percent of GDP in 2013. This will stabilize public sector debt by 2013. This deficit path reflects an appropriate trade-off between the need to take decisive and frontloaded actions to restore market confidence while ensuring that the pace of adjustment does not take an excessive toll on growth and employment.

5. **Our program is fully specified and carefully balanced between expenditure and revenue measures.** The 2011 budget already entails a significant effort, with discretionary fiscal measures amounting to some 5¼ percent of GDP. The deficit target for 2011 takes into account that the recession is now expected to be deeper and that some SOEs have been reclassified and included in the general government. To reach our target for 2011, we will compress some spending (¼ percent of GDP) relative to the 2011 budget, particularly in subsidies to SOEs and health spending. Additionally, to reach the targets for 2012–13, we

need to take measures of 5.1 percent of GDP in 2012–13. These measures are fully specified in this MEFP at the outset. As to the policy mix, expenditure measures account for 3.4 percent of GDP and revenue measures for 1.7 percent of GDP. The priority given to expenditure measures is in line with the need to reduce the public sector's large claim on resources. The fiscal adjustment will be supported by well-specified structural reforms.

6. **Our program entails cuts in expenditures:**

- Following the 5 percent average cut in public sector wages this year, wages and pensions will be frozen through 2013, except, in the case of pensions, for those in the lowest categories. In addition, a special contribution levied on pensions above €1,500 will be introduced in 2012 but will exempt those in the lowest categories. Through a policy of only partly replacing separating staff, we will reduce the number of civil servants at the central government by 1 percent in both 2012 and 2013. The rationalization of the public administration at local and regional governments will provide further reduction in costs, including a reduction in employment by 2 percent annually.

- Better means-testing procedures will protect lower income families while making savings in social security non-contributory benefits. Rationalization of curricula and creation of school clusters, without damaging access, will cut costs in education. In addition, savings will be made through curtailing transfers to local and regional governments, other public bodies and entities, and SOEs.

- Our strategy depends also on improving decisions regarding capital expenditures. We will suspend the implementation of all new PPPs and large infrastructure projects until a thorough feasibility assessment is completed. No public funds or guarantees will be provided for the construction of the New Airport in Lisbon, and the high speed train project to Porto will remain suspended for the duration of the program. In addition, stronger controls will be put in place to rationalize new capital expenditures. Finally, line ministries will be required to request a pre-authorization of the Ministry of Finance (MoF) before engaging in new capital expenditure contracts.

- We will streamline spending on defense, SOEs, regional, and local governments. We will (i) submit a draft law by end-2011 revising the Military Funding Law to impose expenditures ceilings and enforce a zero-new-spending commitments rule; and (ii) reduce defense personnel and compensation by at least 10 percent during 2011-2014. In addition to measures detailed below (¶23) we will reduce SOE fringe benefits by at least 5 percent per year over 2011-2014 and will align wage compensation policies to those of the general government.

7. **On the revenue side, the focus is on increasing the share of consumption taxes and reducing tax privileges:**

- The higher VAT, PIT, and CIT rates in the 2011 budget will remain in effect through 2013. The list of goods and services subject to reduced VAT rates will be revised in 2011. The recurrent property tax (IMI) will be enhanced by a reassessment of the property values starting in the second half of 2011and by rate increases from 2012 which will help compensate for a reduction of property transfer tax (IMT). Excise taxes on vehicles and tobacco will be raised. Electricity taxation will be introduced from January 2012. The convergence of deduction treatment of wages and pensions for tax purposes will be concluded by end-2013.

- A comprehensive revision of tax exemptions will yield 0.5 percent of GDP. We will freeze all existing tax benefits and incentives, and roll back some of them. On personal income tax, we will set a global cap on health, education and housing allowances, differentiated according to tax bracket; and phase out the allowance on mortgage expenses through legislation to be approved by end-2011. On corporate income tax, we will by end-2011 (i) eliminate exemptions—including those subject to the sunset clause of the Tax Benefit Code—and all reduced rates; (ii) limit the deduction of losses; and (iii) limit the carryover period to 3 years. The temporary exemption of the annual property tax will be considerably reduced by end-2011.

8. **In choosing fiscal measures, we have taken care to protect vulnerable groups.** The 5 percent cut in nominal public sector wages and the freezing of pensions in 2011 exempt those earning the lowest wages and pensions. The special contribution on pensions will be levied only above a monthly threshold of €1,500. The means-testing program is being enhanced by applying unified and consistent selection criteria throughout the transfers system. In the health sector, an exemption threshold will be introduced to protect the more vulnerable from the proposed "moderating fees" (for health care) increases and the reduction in exemptions. The exemption threshold based on the value of the property will be kept.

C. Streamlining the Public Sector

Public Financial Management (PFM)

9. **The strategic focus of the budget will be sharpened.** A fiscal strategy for the general government will be published by July 2011, and thereafter in April annually, specifying 4-year medium-term economic and fiscal forecasts. This will include supporting analysis and underlying assumptions and 4-year costings of new policy decisions (structural benchmark). Starting with the budget for 2012, budgets will be prepared within the context of the fiscal strategy and will report information to allow for an assessment of performance against this strategy. An independent fiscal council will be established by end-September 2011 to assess the government's performance against the fiscal strategy.

10. **The budget process will be further integrated.** SOE, PPP, and social security decisions with fiscal implications will be integrated with the budget process to reduce

fragmentation. Capital expenditure decisions will be taken in a medium-term context, with enhanced monitoring and control, through the implementation of a public investment information system, as announced in the 2011 budget. Top-down budgeting with indicative expenditure ceilings and a medium-term budget framework for the central government budget will be introduced in the 2012 Budget and will be put into full effect with the 2013 budget. A new budget framework law incorporating some of these reforms has been approved by Parliament and is awaiting Presidential assent. A proposal to revise the local and regional financial laws will be submitted to parliament by end-2011 in order to fully adapt them to the principles and rules of the new budgetary framework law. We stand ready to refine further the budget framework based on inputs from EC and IMF staff.

11. **Expenditure control will be strictly enforced and arrears will be monitored and reported regularly.** Standard definitions of arrears and commitments will be approved by May 2011(prior action). Any changes to the budget execution procedures necessary to align with these definitions will be implemented by end-2011, aided by technical assistance from the EC and IMF. Until then, existing commitment control procedures will be enforced to prevent the creation of new arrears. We will conduct and publish a comprehensive survey of arrears by August 2011 (structural benchmark), covering all general government entities, as well as SOEs classified outside the general government sector. Following the survey, arrears of general government, will be monitored and published monthly.

12. **Fiscal reporting will be strengthened.** Consolidated general government cash-based reports will be developed and initially reported to the EC and IMF, before moving to external publication by December 2011. We will adopt a standard double entry-based chart of accounts and accounting policies consistent with International Public Sector Accounting Standards by end-2012. Starting with the 2012 budget, we will enhance our annual tax expenditure reports following international standards so that they (a) cover central, regional, and local governments; (b) use a more comprehensive concept of tax expenditures; and (c) include the methodology used for estimating such expenditures.

13. **We will start publishing a comprehensive report on fiscal risks as part of the annual budget.** This will commence with the 2012 Budget and will be consistent with international best practices (structural benchmark). The report will take into account risks, including those related to forecast expenditure and revenue, contingent liabilities, the debt composition, the banking system, all PPPs, all SOEs, and natural disasters.

Public-Private Partnerships (PPPs)

14. **We will undertake a comprehensive review of PPPs and concessions to reduce the government's financial exposure.** The PPPs have exposed the government to significant financial obligations, and exposed weaknesses in its capacity to effectively manage these arrangements. The review will comprise two parts:

- We will request technical assistance from the EC and the IMF to undertake an assessment by August 2011 of at least the 20 most significant PPP and concession contracts, including the major *Estradas de Portugal* PPPs. The technical assistance report will identify the key areas of concern and prepare the terms of reference for a more detailed study described below (structural benchmark).

- Based on this assessment, we will recruit a top tier international accounting firm by December 2011 to complete a more detailed study of PPPs and concessions by March 2012 (structural benchmark). It will assess the scope to renegotiate any PPP or concession contracts to reduce financial obligations without expropriating investors. The review will identify and, where practicable, quantify major contingent liabilities and any amounts that may be payable by the government. All PPP and concession contracts will be made available for these reviews.

15. **We will substantially enhance the annual report on PPPs to strengthen reporting and approval mechanisms.** Starting with the July 2012 report, the annual reports will detail all future cash flows and include a discussion of the government's obligations on an ongoing basis. The legal and institutional framework for assessing and entering into PPP or concession agreements as well as monitoring its execution will also be reviewed and strengthened under the supervision of the MoF and in consultation with EC and IMF staff by end-2012. We will not enter into any new PPPs or concessions at the central or local government levels until at least the completion of these reviews and legal and institutional reforms.

State-Owned Enterprises (SOEs)

16. **The MoF's central role in the financial governance of SOEs will be enhanced to cut operating costs and streamline the sector.** We will by July 2011 (i) complete concrete plans to reduce the overall operating costs of central government SOEs by at least 15 percent over 2009 levels; (ii) review tariff structures to reduce subsidization; and (iii) apply tighter debt ceilings for 2012 onwards. In consultation with EC and IMF staff, we will review the level of service provision of SOEs by September 2011 as an input into the budget. A report will be prepared by February 2012 that reviews the operations and finances of SOEs at all levels of government. It will also assess SOEs' financial prospects, the potential exposure of the government, and scope for orderly privatization (structural benchmark). It will include a systematic assessment of the future prospects of all SOEs. We will not create any additional SOEs at the central or local government levels at least until the completion of these reviews and will prepare a plan by end-2011 to strengthen governance of SOEs.

Privatization

17. **We plan to accelerate our privatization program.** The existing plan, elaborated through 2013, covers transport (Aeroportos de Portugal, TAP, and freight branch of CP),

energy (GALP, EDP, and REN), communications (Correios de Portugal), and insurance (Caixa Seguros), as well as a number of smaller firms. The plan targets front-loaded proceeds of about €[5.3] billion through the end of the program, with only partial divestment envisaged for all large firms. However, we are committed to go even further, by pursuing a rapid full divestment of public sector shares in EDP and REN, and are hopeful that market conditions will permit sale of these two companies, as well as of TAP, by the end of the 2011. We will identify, by the time of the second review, two additional large enterprises for privatization by end-2012. An updated privatization plan will be prepared by March 2012.

Health Sector

18. **A comprehensive reform will improve efficiency and effectiveness in the health care system.** Amongst other reforms, moderating fees will be increased by September 2011, indexed to inflation by end-2011, and exemptions will be substantially reduced by September 2011. In order to protect the more vulnerable, means-testing mechanisms will be put in place.

Revenue Administration

19. **The revenue administration will be modernised.** The domestic tax administration, customs administration, and the information technology service will be unified. We will complete a study by end-September 2011 to assess the feasibility of the new structure taking over the collection function of the social security administration. The structure, to be designed in consultation with EC and IMF staff, will be organized around core business functions and complemented by a taxpayer segmentation approach, mainly through the adoption of a Large Taxpayer Unit. The design of the new structure will be completed by end-2011 and fully implemented by end-2012. The structure will streamline local branches, closing down at least 20 percent of local offices in both 2011 and 2012.

20. **A revenue administration strategic plan for 2012-14 will be prepared by end-October 2011** (structural benchmark). This will include concrete actions to combat tax fraud and evasion. We will also prepare a report by end-2011 assessing the current state of our tax information systems, and propose the next steps to strengthen the information technology function. We will submit to Parliament by end- 2011 a law to reinforce the auditing and enforcement powers of the central revenue administration to exercise control over the whole territory of the Republic of Portugal, including currently exempt tax regimes. The law will also give to the central tax administration the exclusive power to issue interpretative rulings on taxes with national scope, in order to ensure its uniform application.

21. **The operational capacity of the revenue administration will be strengthened.** The audit workforce will be increased to 30 percent of total employees of the tax administration by the end of 2012, mostly through reallocation of staff in the public sector and within the tax administration, and adopting a clear risk management approach for taxpayer selection. We will enhance third-party information to support audit.

22. **We will facilitate an orderly and efficient resolution of tax cases.** Tax tribunals will be specialized in large cases and will be assisted by independent tax specialists similar to the pool used for tax arbitration by January 2012. A temporary task force of judges will be established to clear cases worth above €1 million by end-2012. The new tax arbitration law will be implemented by end-July 2011. We will include the application of above-market interest charges on the outstanding debt over the entire court proceeding, and impose a special statutory interest on non-compliance with a tax court decision. We will conduct a review of audit performance by end-September 2011 incorporating qualitative indicators in the current quantitative model. An integrated information system between the revenue administration and the tax tribunals will be adopted by end-2011.

Public Administration and its Perimeter

23. **The structure of public administration will be streamlined.** A second phase of the public administration restructuring program (PRACE 2007) will be implemented for central government by end-2011. A similar program for local governments will be launched by April 2012. The objective will be to improve efficiency, and reduce the size of public administration across all levels. We will reduce the number of central government employees by at least 1 percent a year over the duration of the program, with at least 2 percent reduction at the local level, through a policy of only partly replacing separating staff, while at the same time increasing mobility across the administration. As part of these reforms, we will reduce management positions and administrative units by at least 15 percent (on average, over end-2010 levels) by end-2011 for central government and end-June 2012 for local governments, and reduce the number of local branches of line ministries.

24. **The creation of new public and quasi-public entities will be controlled more strictly and the existing number entities will be streamlined.** In conjunction with the SOE review, a comprehensive survey of public and quasi-public entities, including associations, foundations and other bodies, across all levels of government will be published by December 2011. Based on this survey, the administration responsible for public entities will decide to close or maintain them. A new set of public administration laws regulating the creation of SOEs, foundations, associations, and similar bodies at the central and local levels will be adopted by July 2012. We will move immediately to make any legal changes required to enhance monitoring, reduce operating costs and temporarily stop the creation of any new public or quasi-public bodies (including SOEs) at the local level.

25. **We will work with the regional government to bring about similar changes at their level of government.** These efforts will cover preventing creation of SOEs, PPPs, concessions, and any other quasi public entities. We will work to reduce management positions and administrative units by at least 15 percent and put in place a new set of public administration framework laws. We will also work with regional governments to reduce the number of their employees by at least 2 percent a year over the duration of the program.

26. **Local government administration will be reorganized.** There are currently around 308 municipalities and 4,259 parishes. By July 2012, the government will develop a consolidation plan to reorganize and significantly reduce the number of such entities. We will implement these plans based on agreement with the EC and the IMF. 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.

D. Protecting the Financial System amidst Deleveraging

27. **While the Portuguese banking system has weather the crisis well so far, bank liquidity remains under pressure.** 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. Banks will be encouraged to take actions to strengthen their collateral buffers. Subject to approval under EC competition rules, the authorities are committed to facilitating the issuance of government guaranteed bank bonds in an amount of up to €35 billion, including the existing package of support measures.

28. **We see a balanced and orderly deleveraging of the banking sector as critical to eliminating its funding imbalances on a permanent basis.** The process should take place in an orderly manner within the Eurosystem framework and consistent with the IMF/EU adjustment program, taking into account the need to reduce reliance on Eurosystem funding and to continue to support the more productive sectors of the domestic economy, not least SMEs. The BdP and the ECB, in consultation with EC and IMF staff, will include clear periodic target leverage ratios and will ask banks to devise by end-June 2011 institution-specific medium-term funding plans to achieve a stable market-based funding position. Quarterly reviews will be conducted in consultation with EC and IMF staff, and will examine the feasibility of individual banks' plans and their implications for leverage ratios, as well as the impact on credit aggregates and the economy as a whole, and the BdP will then request adjustments in the plans as needed.

29. **To bolster the resilience of the banking sector, we are asking banks to further strengthen their capital buffer, while augmenting the bank solvency support mechanism.** The BdP had already required banks to raise their core Tier 1 capital level to 8 percent and significant progress has been achieved in reaching this level. However, the environment has become more challenging lately, and to further enhance confidence in the solvency of the banking system, the BdP will now direct all banking groups subject to supervision in Portugal to reach a core Tier 1 capital of 9 percent by end-2011 and 10 percent at the latest by end-2012 (structural benchmark) and maintain it thereafter. If needed, using its Pillar 2 powers, the BdP will also require some banks, based on their specific risk profile, to reach these higher capital levels on an accelerated schedule, taking into account the indications of the solvency assessment framework described in paragraph 31. Banks will be required to present plans to the BdP by end-June 2011 on how they intend to reach the new

capital requirements through market solutions. However, in the event that they cannot reach the targets on time, ensuring higher capital standards may temporarily require public provision of equity for the private banks. We are thus augmenting the bank solvency support facility in line with EU state aid rules, with resources of €12 billion provided under the program that takes into account the importance of the new capital requirements. This will be done in a way that preserves the control of the management of the banks by their non-state owners during a first phase and allow them the option of buying back the government's stake. The banks benefitting from equity injections will be subjected to specific management rules and restrictions, and to a restructuring process in line with EU competition and state aid requirements, that will provide the incentive to give priority to market-based solutions.

30. **We will streamline the state-owned CGD group to increase the capital base of its core banking arm as needed.** With 23 percent of the system's assets, this bank plays a central role in the financial system and we realize that its balance sheet should be optimized. The CGD bank is expected to raise its capital to the new required levels from internal group resources and improve the group's governance. This will include a more ambitious schedule towards the already announced sale of the insurance arm of the group, a program for the gradual disposal of all non-core subsidiaries, and, if needed, a reduction of activities abroad.

31. **The BdP is further intensifying its monitoring of the banking sector.** It is stepping-up its solvency and deleveraging assessment framework for the system as a whole and for each of the eight largest banks, and will seek an evaluation of the enhanced assessment framework by end-September 2011 (structural benchmark) by a joint team of experts from the EC, the ECB and the IMF. By end-June 2011, the BdP will also design a program of special on-site inspections to validate the data on assets that banks provide as inputs to the solvency assessment. This program will be part of a capacity building technical cooperation project put in place with the support of the EC, the ECB, and the IMF that will bring together Portuguese supervisors, cooperating central banks and/or supervisory agencies, external auditors and other experts as needed. The BdP will provide quarterly updates of banks' potential capital needs going forward and check that their deleveraging process remains on track and properly balanced. Whenever the assessment framework will indicate that a bank's core Tier 1 ratio might fall under 6 percent under a stress scenario over the course of the program, the BdP, using its Pillar 2 powers, will ask it to take measures to strengthen its capital base.

32. **The BdP has kept a watchful eye on the banking sector and will continue to strengthen banking regulation and supervision.** The efficacy of the supervisory function is being permanently improved. This has included the reorganization of the function into three more focused departments last year and the setting-up of an interdepartmental committee for the purpose of financial stability monitoring and macro-prudential supervision. An internal bank evaluation system is currently being developed and is being fine-tuned. Disclosure on non-performing loans will be improved by adding a new ratio aligned with international practices to the current ratio that covers only overdue loan payments by end-September 2011

(structural benchmark). Still more focus will be put on on-site inspections and verification of data accuracy with technical assistance from the IMF, in the context of the data verification exercise for the new solvency assessment framework. New resources will be allocated for the recruitment of additional specialist banking supervisors. Close coordination will be maintained with home and host country supervisors, within the EU framework for cross-border banking supervision.

33. **We are stepping-up our efforts to bring closure to the case of Banco Português de Negocios (BPN).** Following the unsuccessful privatization of the bank in 2010, and taking into account the recent deterioration of economic conditions, we are now launching a process to sell the bank on an accelerated schedule and without a minimum price. To this end, we will submit a new plan to the EC for approval under competition rules. Our target is to find a buyer by end-July 2011 at the latest. To facilitate the sale, the 3 existing special purpose vehicles holding its non-performing and non-core assets have been separated from BPN, and more assets could be transferred into these vehicles as part of the negotiations with prospective buyers. BPN is also undertaking additional cost-cutting measures to increase its attractiveness to investors. Once a solution has been found, CGD's state-guaranteed claims on BPN and all related special purpose vehicles will be taken over by the state according to a timetable to be defined at that time.

34. **We will strengthen the early intervention and resolution framework.** This will allow timely and effective intervention and resolution in line with EU developments and international sound practices. Legislation concerning credit institutions will be amended, in consultation with EC, ECB, and IMF staff, by end-November 2011 (structural benchmark) to, inter alia, impose early reporting obligations based on clear triggers and penalties; empower the BdP with remedial measures to promote implementation of a recovery plan; and require credit institutions with systemic risks to prepare contingency resolution plans subject to regular review. The amendments will also introduce a resolution regime for distressed credit institutions as a going concern under official control to promote financial stability and protect depositors. There will be clear triggers for its initiation, and restructuring tools for the resolution authorities shall include (i) recapitalization without shareholder pre-emptive rights in accordance with the relevant EU framework; (ii) transfer of assets and liabilities to other credit institutions; and (iii) a bridge bank.

35. **We will strengthen the legislation on the Deposit Guarantee Fund (FGD) and on the Guarantee Fund for Mutual Agricultural Credit Institutions (FGCAM).** This will be done in consultation with EC, ECB and IMF staff, by end-2011 (structural benchmark). These funds' functions will be re-examined to strengthen protection of guaranteed depositors. These funds should retain the ability to fund the resolution of distressed credit institutions and in particular the transfer of guaranteed deposits to another credit institution but not to recapitalize them. Such financial assistance shall be capped at the amount of guaranteed deposits that would have to be paid out in liquidation. This should be permissible only if it does not prejudice the ability of these funds to perform their primary function. Further, the

Insolvency Law will be amended by end-November 2011 to provide that guaranteed depositors and/or the funds (directly or through subrogation) will be granted a priority ranking over unsecured creditors in the credit institution's insolvent estate.

36. **The legal framework will be refined to facilitate orderly and efficient corporate and household debt restructurings.** The Insolvency Law will be amended to better support effective rescue of viable firms (end-November 2011 structural benchmark), with technical assistance from the IMF, to, inter alia, introduce fast track court approval procedures for restructuring plans. General principles on voluntary out of court restructuring in line with international best practices will be issued by end-September 2011 (structural benchmark). We will also take the necessary actions to authorize the tax and social security administrations to use a wider range of restructuring tools based on clear criteria and review the tax law to identify impediments to debt restructuring. The personal insolvency procedures will be amended to better support rehabilitation of financially responsible individuals. Finally, we will launch a campaign to raise awareness of the restructuring tools available for early rescue of viable firms through, e.g., training and new information means.

37. **The government will intensify the monitoring of the corporate and household sectors, and prepare contingency plans for a large debt overhang in these sectors.** Starting quarterly, reports on corporate and household sectors will be prepared, to include an assessment of their funding pressures and debt refinancing activity. An assessment of the guarantees programs currently place and an evaluation of market-based financing alternatives will also be performed. Finally, a task force will be constituted to prepare contingency plans to efficiently deal with the challenges posed by corporate and household sectors indebtedness. These enhanced monitoring actions will put be in place by end-September 2011(structural benchmark) in consultation with EC, IMF, and ECB staff.

E. Enhancing Competitiveness through Structural Reforms

Labor markets

38. **Reforms will focus on creating new jobs, not least for the young.** We must address the fundamental problems that impede the efficient transition of workers across occupations, firms and sectors and create socially unfair privileges. To this end, in consultation with our social partners, we will adopt the following measures:

- **Reform employment protection legislation to foster flexibility and improve equity.** We will align severance payments for open-ended and fixed-term hires, submit legislation reducing severance payments for all new contracts to 10 days per year of tenure, with an additional 10 days financed out of employers' financed fund by September 2011, and present a proposal to revise severance payment entitlements for current employees in line with the reform for new hires by end-2011, without reducing accrued-to-date entitlements. As a further step, by end-March 2012, we will prepare a proposal to align the level of severance payments to the EU average, while at the same time amending the dismissal fund in a way that allows the portability of worker's entitlement to severance pay. We will prepare by end-December 2011 a proposal aimed at introducing adjustments to the cases for fair individual dismissals.

- **Revise the unemployment insurance system to change incentives, increase employment, and strengthen social safety nets.** We will reduce the maximum duration of unemployment insurance benefits to no more than 18 months, and cap unemployment benefits at 2.5 times the social support index and introduce a declining profile of benefits after six months of unemployment (a reduction of at least 10 percent in benefits), without reducing accrued-to-date entitlements. To extend social safety nets, we will reduce the necessary contributory period to access unemployment insurance from 15 to 12 months, and present a proposal to extend eligibility for clearly-defined categories of self-employed. Training opportunities will be strengthened, especially for the low-skilled.

- **Ensure that labor costs support job creation and competitiveness.** Over the program period, any increase in the minimum wage will take place only if justified by economic conditions and agreed in the context of regular program reviews.

- **Define clear criteria for the extension of collective agreements,** including the representativeness of the negotiating organizations and the implications of the extension for the competitive position of non-affiliated firms. To promote wage adjustments in line with productivity at the firm level we will (i) allow works councils to negotiate mobility conditions and working time arrangements; (ii) reduce the threshold below which works councils or other workers organizations cannot conclude firm-level agreements to 250 employees per firm; and (iii) include in sectoral collective agreements conditions under which works councils can independently conclude firm-level agreements.

Fiscal devaluation

39. **A critical goal of our program is to boost competitiveness.** This will involve a major reduction in employer's social security contributions. This measure will be fully calibrated by the time of the first review. The offsetting measures needed to ensure fiscal neutrality may include changing the structure and rates of VAT, additional permanent expenditure cuts, and raising other taxes that would not have an adverse effect on competitiveness. In calibrating this measure, we will take measures to: (i) mitigate the social impact of higher consumption taxes; (ii) ensure that changes to social security contributions are compensated by allocating equivalent revenues in order not to jeopardize the sustainability of the pension system; and (iii) ensure that tax changes are passed through to lower prices. While the proposal might be implemented in two steps, the bold first step will be implemented in the context of the 2012 budget (structural benchmark, October 2011).

Competition Framework

40. **To rebalance growth toward the tradable sector, we need to foster competition in the non-tradable sector.** State involvement in private sector activities will be reduced, and the independence of sectoral regulators reinforced. We will eliminate "golden shares" and all other special rights established by law or in the statutes of publicly quoted companies that give special rights to the state (structural benchmark, July 2011).

41. **We will take bold steps to address excessive profits and reduce the scope for rent-seeking behavior.**

- In electricity, we will review the efficiency of support schemes for co-generation and renewables, assessing their rationale, levels, and other relevant design elements, including options for reducing the implicit production subsidy (by end-December 2011). We will reassess legacy support measures associated with the production of electricity under the ordinary regime, and, where possible, revise downwards the guaranteed compensation mechanism (CMEC) paid to producers and the remaining long-term power-purchase agreements (PPAs).

- In telecommunications, we will facilitate the entry in the market of new players (awarding the right to use new radio frequencies for broadband wireless access and lowering mobile termination rates, [structural benchmark, end-September 2011]), alleviate restrictions on mobility of consumers and ensure that the provision on universal service designation and the incumbent's concession contract are non-discriminatory.

- We will review and reduce the number of regulated professions (by end-September 2011 for professions not regulated by Parliament and by end-March 2012 for all others); eliminate the restriction on the use of advertising in regulated professions (end-September 2011); improve the recognition framework on professional qualifications, ease the requirements related to the establishment of foreign service providers in Portugal; and reduce the number of requirements to which cross-border service providers are subject (end-December 2011).

- We will (i) revise the Competition Law, clearly separating rules on competition enforcement procedures and penal procedures, and (ii) establish a new Court on Competition Matters and introduce greater specialization of judicial functions.

42. **We commit to a number of additional measures to enhance the flexibility and productive capacity of the economy.** In particular, we will undertake a comprehensive reform of the housing market which aims at facilitating labor mobility and reducing incentives for private sector over-borrowing. We also commit to tackle low educational attainment and improve the quality of secondary and vocational education, and continue reducing the administrative burden for firms in all sectors and facilitate access to export

markets by end-March 2012. The joint EC-ECB Memorandum of Understanding further specifies these and other structural policies recommended in the MEFP.

Judicial Reforms

43. **Immediate priority will be given to improve the efficiency of the judicial process.** The current tedious judicial process coupled with a severe backlog of cases impede effective market functioning across a number of sectors. We are committed to implement the announced Judicial Reform Map without delay and take additional steps to make the judicial system efficient and effective.

44. **We aim to resolve the backlog of cases in the courts within 24 months.** An audit of the backlog cases including debt enforcement, insolvency, tax and labor cases will be completed by end-June 2011 (structural benchmark). Based on this audit, additional measures will be developed by end-September 2011 to expedite the resolution of the backlog, including (i) establishing separate Chambers or Teams involving all agencies solely for resolving the backlog; (ii) restructuring court record-keeping to take cases off the books; (iii) merging similar small debt enforcement cases; (iv) strengthening and enforcing existing regulations allowing dormant cases to be removed from the court register ; (v) imposing additional costs and penalties against non-cooperative debtors in enforcement cases; and (vi) assigning special court managers to allow judges to focus on the cases.

45. **The court system will be restructured to improve management efficiency.** Thirty-nine court units, with added management support for each unit, will be established by end-2012. This restructuring will be entirely financed through expenditure savings and gains of efficiency and is part of the rationalization effort, in order to improve efficiency in the management of infrastructure and public services. We will develop a roadmap for this reform, identifying key quarterly milestones by end-September 2011 (structural benchmark). A new internal management system will be implemented for two county courts (including Lisbon) by end-2011. The new Courts on Competition Matters and Intellectual Property Rights will become operational by end-January 2012; and we will assess the need for separate Chambers within the Commercial Courts with specialized judges for insolvency cases by end-2011. A new personnel management plan will be developed to support judicial specialization and mobility of court officials by end-2011.

46. **We will further improve the efficiency of civil case processing in the courts.** The new experimental civil procedure regime which has been applied to seven courts will be extended to four courts by end-September 2011. A report will be prepared by end-2011 on whether such regime should be applied to all courts. Finally, we will review the Code of Civil Procedure and prepare a proposal by end-2011 (structural benchmark) identifying the key areas for refinement, including (i) consolidating legislation for all enforcement cases before the court, (ii) giving judges the power to expedite cases, (iii) reducing administrative

burdens on judges, and (iv) enforcing statutory deadlines for court processes and in particular injunction procedures and debt enforcement and insolvency cases.

47. **A more sustainable and transparent budget for the judiciary is crucial to the success of the judicial reform.** We will standardize the court fees and introduce special court fees for certain cases and procedures by end-September 2011. The Ministry of Justice will develop and publish an annual plan on the allocation of resources based on court by court performance data. A workload/staffing assessment will be completed for the six pilot courts under the Judicial Reform Map and the specialized courts by end-March 2012. In addition, quarterly reports on recovery rates, duration and costs of corporate insolvency and tax cases will be published starting from the third quarter of 2011.

48. **Alternative dispute resolution (ADR) needs to be strengthened to better facilitate out-of-court settlement.** We will adopt the Law on Arbitration by end-September 2011and make arbitration for debt enforcement cases fully operational by end-February 2012 to facilitate resolution of backlog cases and out-of-court settlement. The Justices for Peace regime will be optimized by increasing its capacity to handle small claim cases by end-March 2012. To bolster the ADR regime, we will adopt measures to give priority to the ADR enforcement cases in the courts by end-2011.

F. Program Matters

49. **In the context of the arrangement, the BdP will undergo a safeguards assessment in accordance with the IMF safeguards policy.** In this regard, and to facilitate a timely completion of the assessment, the authorities have provided the information requested for the assessment to commence, and have also authorized the external auditors to provide information to and hold discussions with IMF staff. As a related matter, and given that financing from the IMF will be used to provide direct budget support, a memorandum of understanding between the government and the BdP will establish a clear framework on the modalities for the repayment of IMF financing and the servicing of interest payments and other charges. As part of these arrangements, Fund disbursements will be deposited into the government's account at the BdP pending their use.