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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Portugal were reviewed by the Committee on 9 April 2008. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 25 April 2008.

The Secretariat's draft report was prepared for the Committee by Bénédicte Larre, David Haugh and Claudia Cardoso under the supervision of Stefano Scarpetta. Research assistance was provided by Roselyne Jamin.

The previous Survey of Portugal was issued in April 2006.

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BASIC STATISTICS OF PORTUGAL

THE LAND

Area (thousand sq. km)	91.9	Major cities, resident population in thousands (2006)	
		Greater Lisbon	2 224
		Greater Porto	1 818

THE PEOPLE

Population 2006 (31 XII, thousands)	10 599	Civilian labour force (2007, thousands)	5 583
Number of inhabitants per sq. km	115	Civilian employment (2007, thousands)	5 135
Net natural increase 2005-2006 (thousands)	3.4	As a percentage of total	
Net increase 2005-2006 (thousands)	29.5	Agriculture	11.7
		Industry (including construction)	30.7
		Services	57.6

PRODUCTION

Gross domestic product, 2007 (million of euros)	162 919	Gross domestic product at factor cost by origin (2007, per cent of total)	
Gross domestic product per head, 2007 (euros)	15 360	Agriculture	2.7
Gross fixed capital formation, 2007		Industry (including construction)	24.5
Per cent of GDP	21.7	Services	72.8

THE GOVERNMENT

Public consumption, 2007, per cent of GDP	20.4	Composition of Parliament	
Public investment, 2007		(Number of seats, April 2008)	
Per cent of GDP	2.4	Socialist Party (PS)	121
Per cent of total investment	11.1	Social Democratic Party (PSD)	75
Total general government current revenue		Unitarian Democratic Coalition (CDU)	14
2007, per cent of GDP	43.1	People's Party (PP)	11
		Leftwing Block (BE)	8
		Independent	1
		Total	230

FOREIGN TRADE

Exports of goods and services		Imports of goods and services	
2006, per cent of GDP	22.2	2006, per cent of GDP	34.2
Main exports as a percentage of commodities exports, 2006 (SITC)		Main imports as a percentage of commodities imports, 2006 (SITC)	
Transport equipment	12.9	Transport equipment	10.9
Machinery and equipment	18.6	Machinery and equipment	18.7
Textiles, leather, clothing	14.5	Textiles, leather, clothing	6.8
Other manufactured products	36.5	Other manufactured products	35.3

THE CURRENCY

Monetary unit: euro		Currency unit per $, average of daily figures:	
		Year 2007	0.7305
		March 2008	0.6441

Executive summary

Portugal has made significant progress in fiscal consolidation and has launched important structural reforms to modernise the economy and enhance growth. After a weak performance from 2001 to 2005, output growth recovered in the past two years and, in 2007, it reached 1.9%, still insufficient to close the large income gap with wealthier OECD countries. Reaping the full benefits from globalisation in terms of faster and more sustainable growth and a durable decline in unemployment will require securing fiscal consolidation, improving the business environment and enhancing the adaptability of the labour market.

Securing the results achieved in fiscal consolidation remains a priority. *The excessive fiscal deficit of 2005 was reduced to 2.6% of GDP in 2007, thanks to a broad consolidation strategy. But efforts should continue to further reduce the deficit and strengthen the medium-term budgeting framework. Moreover, addressing underlying problems in spending control will require implementing fully the public administration reform, improving the performance of state-owned enterprises, continuing the health care reform and dealing with ageing-related pressures on the health budget, and monitoring the sustainability of the contributory pension scheme, taking additional measures if developments require.*

A deepening of the reform process is required to raise productivity and help the economy adjust to the changing international environment. *The economy is in the process of adjusting to rapid changes in world trade and there is significant potential for Portugal to reap more benefits from globalisation. The government has already made significant progress in improving the business environment, through a wide range of reforms, including a simplification of administrative procedures to do business. Full implementation of these reforms is essential, together with an easing of pervasive licensing procedures. A high priority should also be given to strengthening competition across the whole economy and particularly in key infrastructure sectors, such as telecommunications, electricity and transportation, to enhance the quality, efficiency and quantity of the services they provide. This would have a direct effect on the cost-competitiveness of firms in Portugal, facilitate trade flows, domestically and internationally and make Portugal a more attractive destination for FDI, which has the potential to boost productivity.*

Further reforms are needed to develop human capital and facilitate labour market adjustment in the changing environment. *A broad strategy is required to promote job creation and labour mobility. Reform proposals aimed at enhancing the adaptability of the labour force should be implemented, to address rigidities in labour market regulations and improve the efficiency of active labour market programmes to support job seekers. Effective training is also required to improve the skill match for new entrants and help displaced workers in sectors affected by structural adjustments. The government has launched a broad initiative to upgrade competences of young people and adults at risk. As the scale of the programmes expands, efforts should focus on monitoring the implementation and evaluating results to ensure that programmes meet private sector demand and needs.*

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Assessment and recommendations

Portugal's performance has improved, the expansion has broadened, but growth is too slow to narrow the income gap

Over the past two decades, spurred by EU membership, Portugal has undertaken a wide range of reforms to liberalise the economy and open it to foreign trade and investment. These reforms paid off in terms of GDP growth and Portugal managed a significant catch up towards the living standards of more affluent OECD economies until the early 2000s. Thereafter, growth stalled, unemployment increased substantially, and the convergence process suffered a reversal, and it was not until 2005 that economic growth picked up again, thanks in part to a renewed effort at macroeconomic and structural reforms. A forceful fiscal consolidation brought the deficit down from more than 6% of GDP in 2005 to 2.6% in 2007, and inflation moderated to about 2½ per cent, just above the euro average. The on-going structural reforms, if fully implemented, will contribute to raising potential growth in the future; but the short-term outlook remains worrisome, as the external environment is not expected to be as benign as in recent years. The downturn in the United States, tighter credit market conditions internationally and risks of negative spillover effects in Europe imply that Portugal will face weaker foreign demand in 2008. This is likely to slow its exports and overall expansion. Looking ahead, potential growth, estimated at around 1½ per cent, is too low to narrow the income gap with richer OECD countries. Securing fiscal consolidation provides a solid base for deepening and broadening structural reforms and encourages the necessary adjustments to put the economy on a higher growth path.

Slow potential growth in the 2000s mostly reflects weak productivity gains. In order to achieve a stronger and more sustainable economic expansion, the policy challenge is to remove remaining bottlenecks to productivity enhancements, building on reforms already implemented. The international environment has changed and Portuguese firms face an urgent need to adapt to new patterns of consumption and production across the world. The way forward is to embrace globalisation and to facilitate the structural transformation of the productive sector. Portugal can count on several assets that will support its growth-enhancing strategy: *i)* a sound fiscal policy that is bringing the deficit down to a more sustainable level and strengthening public finances; *ii)* membership in the EU, with the benefits arising from trade integration and the substantial financial support for human and capital development; *iii)* an ongoing process of transformation in manufacturing with the diversification of products and markets, which is delivering encouraging results in terms of export performance; and *iv)* substantial foreign direct investment (FDI) over the years, which has strengthened the country's export capacity and generated positive spillovers in the domestic economy. Building on these assets, Portugal needs to pursue structural reforms to raise its growth potential; and the current downside risks to the external outlook should not undermine fiscal consolidation. In fact, sound fiscal policy is an asset for facing the international economic and financial uncertainties.

Portugal must focus on continuity and forceful implementation of its policy strategy in order to take advantage of globalisation

Taking advantage of globalisation to allow sustained improvements in standards of living requires both macroeconomic stability and structural reforms. The government has made advances in its comprehensive strategy to achieve sustainable public finances and boost growth, with action in several interrelated areas: strengthening the fiscal situation, including a broad public administration reform that is expected to improve public sector efficiency; modernizing the economy with a focus on improving the business environment; and fostering job creation and enhancing human capital. Following such a broad approach is sound, owing to complementarities across these reforms. Many of the programmes implemented are starting to deliver positive results. The reduction of the fiscal deficit is the most tangible one, and it is important to maintain the prudent policy stance and deliver further progress in reducing the deficit. This report focuses on three main challenges that Portugal must address:

- Securing progress in fiscal consolidation.
- Embracing the new global environment and maximising the gains from integration in the world economy, by enhancing the business environment, strengthening competition and upgrading infrastructure.
- Increasing the adaptability of the labour market, while protecting workers at risk, and upgrading competences.

The significant results achieved in fiscal consolidation should be secured and the deficit reduced further…

There has been a notable improvement in the fiscal position in Portugal over the past two years, with the fiscal deficit falling from 6.1% of GDP in 2005 to 2.6% in 2007. The government has introduced a deep and wide-ranging fiscal consolidation programme, which includes both short-term measures and in-depth reforms. The programme is particularly noteworthy for using medium-term measures to directly tackle the unsustainable current expenditure growth that was the ultimate cause of large fiscal deficits in the past. The programme's success is clearly evident from the marked fall in current expenditure growth since 2005, while improvements in tax administration also helped to increase revenue. *Going forward, the government should build on this very good progress and work towards securing a strong fiscal position in the medium-term.*

… by maintaining the momentum of in-depth reforms on the spending side

At the core of the consolidation programme are efforts to control spending and improve efficiency of the public sector. The two key pillars of this strategy are the public administration reform and the reform of contributory pension schemes. The in-depth public administration reform is well underway. In particular, the control of admissions and recruitment has already made a large contribution to the consolidation efforts, while the reform of careers and remunerations of civil servants is intended to enhance efficiency in the public administration. A mobility pool was introduced as a mechanism for the reassignment of civil servants to other positions in the public sector or to the private sector, thereby helping adjustments in the public sector workforce. *The government will need to maintain the reform momentum in order to lock in the gains, including ensuring the full implementation and acceptance by civil servants of the new performance based human resource management system. The government will need to take further measures to ensure that the mobility pool is effective and efficient, helping the reallocation of labour without imposing too high costs on future budgets.* The pension reform has significantly reduced, although not eliminated, future gaps in the social security contributory system. *It is important to monitor future developments and assess whether further measures are required to ensure the system's sustainability.*

The government should also continue to implement reforms to improve the efficiency of the health system, and it should directly tackle ageing-related pressures on the health budget, by taking offsetting expenditure, or revenue, measures. Greater efforts are also needed to improve the efficiency and profitability of the state-owned enterprises sector where some enterprises are making large losses. The government has introduced important reforms for state-owned enterprises (SOEs), including hospitals, imposing stricter reporting requirements and allowing the linking of senior managers' pay to performance. Measures should be taken to build on this progress, in particular by increasing benchmarking and performance evaluation of SOEs and strengthening the transparency of information about their financial situation. It is also necessary to ensure a clear separation of ministerial ownership and regulatory responsibilities for all SOEs in order to reduce the risks of conflicts of interest.

… and consolidating the medium-term budgeting framework

The increase in transparency of fiscal accounts and steps toward performance budgeting are helping strengthen the budget framework. *These initiatives provide a good basis for introducing a multi-year expenditure rule. International experience suggests that such a rule would further consolidate the overall budget framework* and reduce reliance on more temporary expenditure control measures. For expenditure rules to be effective, they should be easy to understand and monitor, and flexible enough to deal with the business cycle. It is also important to employ prudent budget assumptions, particularly about economic growth. As elsewhere in the EU, forecasts in Portugal have been over-optimistic in the past leading to deficit surprises. Although recent forecast performance has improved, *it is important to enhance public scrutiny ofthe economic and financial forecasts used in the Budget.*

Portugal should further strengthen framework conditions, to take fuller advantage of expanding world markets

Portugal needs to seize the opportunities created by rapidly expanding world markets. For a small economy such as Portugal's, greater integration in the world economy is particularly important because of the opportunities for scale economies, specialisation and access to technology that it brings. The challenge is to take greater advantage of the country's high level of openness and increase export growth while reinforcing its attractiveness for FDI flows that have the potential to boost productivity. Rapid changes in global trade have been particularly challenging for Portugal, because they have weakened its traditional comparative advantage in labour-intensive manufactures. As a result, overall export performance was disappointing in the decade to 2006. To lift trade performance, the economy must adapt by boosting the productivity of domestic firms, diversifying their market and product orientation and by raising overall product quality. There are encouraging indications that this transformation has already started and that Portugal is again the target of important new FDI inflows that will assist this change. *To ensure that this adjustment continues on a durable basis, the ongoing reforms should continue, focusing on strengthening framework conditions, improving the business environment, fostering competition across the economy and facilitating trade and investment through enhanced infrastructure.*

The focus should be on reducing trade costs, making the country more attractive to FDI and strengthening spillovers from FDI

Tariff barriers to trade have been reduced in line with the EU internal market and trade policies but there is still room to lower non-tariff barriers. The costs of customs controls and document processing have in the past been amongst the highest in the OECD. In this context, *the measures implemented by customs to reduce the costs of exporting and importing through extensive improvements in information technology (IT) systems are an important step forward and should be fully implemented*. Moving ahead quickly to streamline the customs code by removing non-EU penalties and fully recognising tariff classifications of other EU members would also help to encourage trade.

FDI inflows have been significant over time, underpinned by some large investments by European multinationals. However, Portugal's FDI inflows pale against those observed in other small catch-up European countries, suggesting that there is potential to increase the flows into Portugal. Formal barriers to FDI are comparable to those in other OECD countries. *A notable exception is air transport where restrictions are the highest in the OECD; these should be lowered to encourage competition and tourism*. But FDI flows are also driven by broader considerations that include corporate taxation, product market regulations, labour market settings and the level of human capital. *To encourage FDI and maximise benefits from increased inflows, broad policy measures are required to improve the business environment and upgrade human capital. The Policy Framework for Investment developed by the OECD can assist the ongoing reform process*. Advances on this front would attract more technologically advanced FDI, and help linkages between foreign firms and suppliers to develop more widely in the domestic economy, thereby maximising technological spillover effects. Increasing FDI would also help the structural adjustment to changes in global trade, by increasing productivity and developing a more diversified export base.

Much has been done to ease regulation and reduce the cost of doing business; but there is ground to go further

There has been a significant improvement in the business environment in Portugal. The government has introduced a broad range of measures, in particular the simplification of administrative procedures (SIMPLEX), to improve the effectiveness and efficiency of public services and lower the costs that government administration and regulations impose on citizens and firms. These reforms have already had notable results in areas such as the time to start a business and the scale of document filing obligations. An important part of this process is a notable expansion of e-government and IT use, which has allowed significant efficiency gains. There is room to build on this progress and move ahead. The aim should be to achieve the best practice in the OECD. In particular, licensing, which involves all levels of government, remains burdensome across the board as nearly all economic activities require some kind of licence. *The central government should fully implement reforms to reduce these licensing costs and collaborate with municipal governments to improve the processes also at the local level.* To boost services exports and build on strong growth in business services exports, *the government should also work towards harmonisation with, or mutual recognition of, the standards in its larger trading partners:* these cover a range of areas, including for instance professional qualifications and technical standards.

To boost productivity growth, promoting competition should be high on the policy agenda…

Portugal has made progress in enhancing competition domestically; and regulators are taking important steps to further boost competition. By putting pressure on firms to innovate, improve quality and lower prices, greater competition is a powerful catalyst for boosting productivity and growth, as illustrated by the example of Australia. *Therefore, the government should give higher priority to competition-enhancing reforms.Consideration should be given to doing a comprehensive review across the whole economy for identifying and removing remaining unnecessary regulatory restraints on competition. Such an exercise should also aim at developing regulations and regulatory actions that actively encourage vigorous competition between existing players and facilitate the entry of new firms.*

… and reforms should continue to further upgrade and increase competition in telecommunication, electricity and transport infrastructure

The efficiency, quality and price of infrastructure services (communication, energy and transport) are important factors influencing the cost-competitiveness of firms, the attractiveness of the country to foreign investors, international trade flows and consequently Portugal's productivity growth. Significant progress has already been made in increasing physical infrastructure assets, especially the highway network, deepwater container port capacity, electricity transmission capacity with Spain and telecommunications networks.

Restrictive regulations have been gradually reduced; large strides towards fully liberalized market frameworks have been made; and competition is increasing. Nevertheless, port, electricity and some telecommunications prices remain high; large incumbents still dominate the electricity and telecommunications sectors; and there is substantial scope to increase efficiency and competition across all infrastructure sectors.

- In *telecommunications*, *it is important to continue to foster competition between different networks and firms*. Action should be taken to increase the ownership independence of the copper wire and cable networks following the cable network spin-off by Portugal Telecom. Mobile termination charges remain high and should be lowered, preferably with no discrimination of termination charges between calls within a firm's own network and calls from other networks, so as to remove network externalities that favour larger firms. A proposal in this direction has been presented by the sector regulator.
- The *electricity industry* is in transition from a regulated to a fully liberalised market. *The government should continue to encourage greater competition in generation* by issuing licences to build new power stations to non-incumbents and, eventually, including renewable generators in the wholesale market. In the meantime, *the virtual power plant scheme should be extended to allow non-incumbents greater access to current generation capacity. Transmission capacity with Spain needs to be further increased* and it is important that government facilitate this by ensuring that there are no administrative and regulatory obstacles impeding the planned capacity expansion. *At the retail level, regulated tariffs should be phased out* as *planned and consideration given to extending this to all consumers*.
- *In transport,* bottlenecks still remain in railways, at the Lisbon airport and in logistics. Furthermore, port charges are high and the state-owned railway companies are making large losses. The proposed new investments in high-speed rail and for the new Lisbon airport should be based on transparent cost-benefit analysis and be used to promote competition. *Continuing to lower cargo handling and processing costs at ports through better IT systems and an expansion of logistics platforms should be a priority. To increase efficiency and lower port prices, it would be appropriate to promote yardstick competition among the ports. In rail, the government should introduce performance contracts for both the state rail and rail track companies with clear performance and financial targets, to help strengthen efficiency*. This would prepare the ground for introducing open competitive tendering for rail services that would further increase efficiency in the sector.

The measures taken to improve the functioning of the labour market and facilitate structural change go in the right direction…

The labour market performance is worrisome. Although participation rates are relatively high in international comparison – including for women and the low-skilled – employment trends have deteriorated since the beginning of the 2000s. The unemployment rate has doubled over the past five years, reaching 8% in 2007, with a growing share of long-term unemployment, as the labour market was not able to get job-seekers back into work as effectively as in the past. Employment protection legislation, overall, remains restrictive in comparison with other OECD countries. To facilitate the adjustment of the economy to the forces of globalisation and reduce the social costs of the adjustment process, policies have to focus on easing labour market regulations that hinder workers' mobility, while reinforcing the support to job losers. Several reforms have been made over the past few years, including changes to the labour code, stronger controls of undeclared work, bringing the social security schemes of the private and public sectors closer and tighter eligibility conditions for unemployment benefits. These measures are an important step to strengthen work incentives and facilitate workers mobility; but more needs to be done to further improve the adaptability of the labour market.

A new framework for active labour market policies (ALMP) is under discussion. It envisages rationalising the programmes in place and improving their effectiveness. It is important to move ahead with the reform, so as to improve the effectiveness of activation strategies, especially given the large financial resources allocated to active programmes. *The new framework, when approved, should be implemented without any delay, in particular the evaluation and rationalisation of activation programmes, and a strong focus should be given to improving the performance of the public employment services. Experience elsewhere shows that activation programmes can have a positive employment impact, but substantial results cannot be expected from reforming ALMP alone and it remains important to also press ahead with a broader labour market reform.*

… but more needs to be done to enhance labour market adaptability, while providing effective support for displaced workers

Additional measures are needed to improve the functioning of the labour market. A further easing of employment protection legislation should be undertaken. Current dismissal rules are relatively stringent, in particular for individual dismissals, and procedures tend to be long and costly. By expanding the scope of formal dismissals carried out according to the rules, measures that ease regulations would reduce uncertainty for the employer about the specific cost of dismissal when hiring and could thus increase job creation, in particular with regular contracts. It would also allow workers to benefit from greater certainty that the rules will apply upon termination of contract. Conditions for temporary employment should also be relaxed: these jobs are often used by young cohorts as stepping stones for more durable employment in the future. It is important to combine the easing of employment protection legislation for temporary work with an easing for permanent work to avoid worsening the dualism of the labour market.

The government has launched a comprehensive review of labour relations, with the stated objective of fostering job creation, reducing the segmentation of the labour market and enhancing mobility, while improving the protection of displaced workers. The conclusions, presented in the "White Book on Labour Relations" at the end of 2007, address several of the problems that are impeding the adjustment of the labour market. They have been under discussion with the social partners in the first half of 2008, with a view to presenting a reform proposal to the parliament. The changes envisaged include revisions to the labour code as well as specific measures to facilitate the application of the law. There are also suggestions for reviewing bargaining procedures to give more room to agreements at the enterprise level and for increasing the adaptability of working time. The White Book proposals go in the right direction and, if enacted, would represent a step forward.

… and a strong effort at upgrading competences is a sine qua non *to improve the school to work transition and the employability of adults*

Increasing human capital is essential to improve the adaptability of the workforce to the on-going structural transformation and to foster stronger productivity growth. Portugal suffers from a large education gap *vis-à-vis* the rest of the OECD and action is required not only to raise the education attainment of the population, but also to review the type of education provided and its quality, as was highlighted in the special chapter of the 2006 *OECD Economic Survey*. Measures are being implemented to address supply bottlenecks, especially in technical education and vocational training, and to enhance teachers' performance. The focus given to diversifying training supply for adult workers and developing skills certification has a strong potential to attract a wider public in lifelong learning.

The government's strategy to upgrade competences and provide the skills that are needed in the labour market is centred around the *Novas Oportunidades* initiative. The initiative includes two main pillars: *i)* providing new opportunities to young people at risk of dropping out of school; and *ii)* offering learning opportunities to adults with low educational attainment, based on the recognition and certification of acquired skills. Key steps have already been achieved in implementing this initiative, for instance the development of the network of *Novas Oportunidades* centres, the diversification in the supply of courses (notably double certification courses) for the young people still in education, and the recognition and certification of skills for adults. And the first results, in terms of attendance, are encouraging with a notable increase in the proportion of young people enrolled in technical and professional courses at the secondary level, and strong demand of adults for the recognition of competences and for lifelong learning. More should be done to develop the information base, to undertake systematic field monitoring and conduct rigorous evaluations of the results. But, as the scale of application of the programme expands, the most difficult task is to ensure the quality of the services provided. It is also a *sine qua non* for the success of the government's strategy to enhance human capital.

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Chapter 1

Economic performance and key challenges

After a weak growth performance in the first part of the 2000s, more recent economic developments have been encouraging. The recovery that started in the course of 2005 gathered momentum in the following two years, underpinned by exports, and the budget deficit has been reduced to more sustainable levels. Nevertheless the income and productivity gaps with high income countries in the OECD are large and have been widening. GDP growth is not high enough to allow a catch up with standards of living in more affluent OECD countries. Many structural measures have been undertaken in recent years, and the structural reform process should be deepened in order to improve Portugal's growth performance on a sustained basis. Policies should aim at raising the economy's capacity to adjust smoothly to the changing international environment and seize new opportunities created by globalisation. This chapter identifies three main challenges that Portugal must face to achieve stronger growth: i) *maintaining the momentum of fiscal consolidation to achieve sound public finances, a prerequisite for sustainable economic growth;* ii) *embracing globalisation and facilitating the adjustment to the changing economic environment; and* iii) *reforming the labour market and enhancing human capital, to promote job creation and allow a durable decline in unemployment in a period of deep structural transformation.*

After joining the EU in the mid 1980s, Portugal undertook a wide range of reforms to liberalise the economy and improve macroeconomic performance. The reforms paid off, contributing to economic growth and allowing Portugal's living standards to converge with those in richer OECD countries, with per capita GDP rising from below 60% of the OECD average in 1986 to close to 70% in 2000, excluding the central European countries from the average. However, the early 2000s saw a stagnation of GDP growth in Portugal and a reversal of the convergence process. The economy has been experiencing a mild expansion since 2005, driven by a surge in exports, and there are signs of a pickup in investment. But the labour market performance remains weak: unemployment rates have risen to high levels and the incidence of long-term unemployment has also increased.

The overall challenge for Portugal is to boost productivity and income growth on a sustained basis to resume convergence in living standards with high-income countries in the EU and the OECD. The Portuguese economy is facing a new global environment, and its policy settings have to adjust to deal with it effectively. The current trade mix is still heavily oriented towards labour intensive products – where competition from abroad is strong – and the relatively low human capital level suggests that the economy is quite exposed to the forces of globalisation. In a rapidly changing economic environment, Portugal needs to speed up its structural transformation to gain from globalisation trends rather than losing out to the challenge from lower-cost emerging market economies elsewhere. This will involve further moving its specialisation pattern towards more sophisticated (high-skill) products. To cope with the changes it faces, Portugal should foster a regulatory environment that emphasizes competition so that resources move easily towards the most profitable areas. In a similar way, it should have a flexible labour market that helps people move quickly from declining sectors to expanding ones, while also prompting participation in the labour market. It also must develop adequate competences and qualifications to facilitate its specialization in high-skill activities. Cross-country evidence shows that many relatively small OECD countries which were similarly lagging behind the US in the mid 1990s have managed to achieve significant convergence in the new global environment (*e.g.* Greece, Hungary, Ireland, Poland and the Slovak Republic) (Figure 1.1).

Providing the right environment for productivity-enhancing measures also requires that the great strides Portugal made in fiscal consolidation in 2006 and 2007 be continued. The ongoing public administration reform is contributing to the reduction of the budget deficit and the important measures taken in the health sector and pension systems are also helping to improve the sustainability of public finances. This progress should be kept up.

This chapter starts with a review of Portugal's recent growth performance and the outlook, discussing ways to achieve stronger growth over the medium-term. The much-improved fiscal position provides a solid base for deepening and broadening structural reforms to modernize the economy and encourage the necessary adjustment to boost productivity growth. In achieving this, Portugal faces a number of challenges today, including: *i)* securing a solid fiscal position; *ii)* embracing globalisation and maximising

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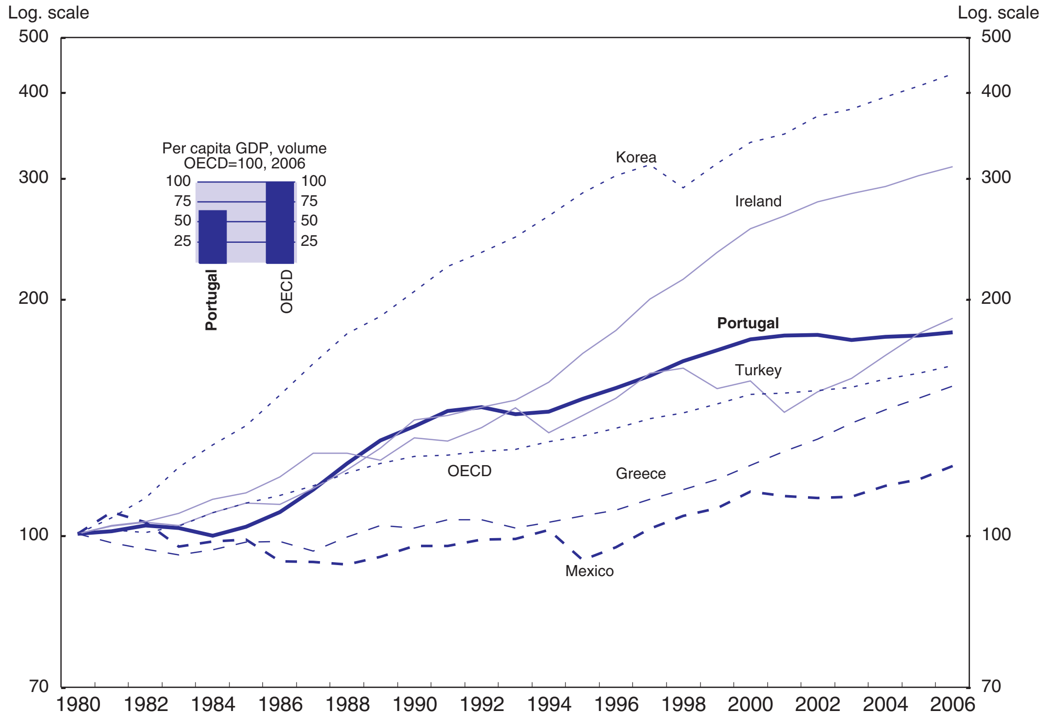
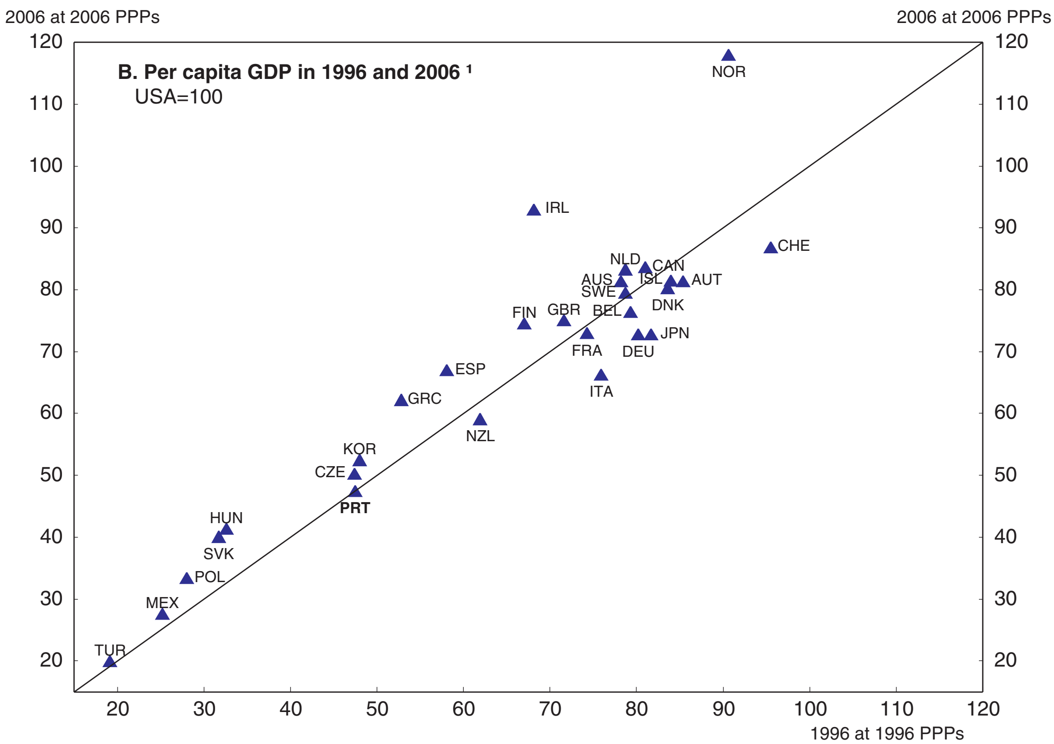
Figure 1.1. **Portugal's growth performance in comparison**





1. Luxembourg is situated 123.8 and 143.8 in 1996 and 2006 respectively; its population is augmented by the number of cross-border workers in order to take account of their contribution to GDP.

Source: OECD, *National Accounts database*; *Going for Growth 2008*.

StatLink http://dx.doi.org/10.1787/342415263633

benefits from openness; and *iii)* facilitating the adjustment of the labour market and promoting human capital development.

Recent growth performance and the outlook

Recent developments

After growing by 3.8% per year on average over a decade and a half prior to 2000, Portugal's per capita income stagnated overall between 2000 and 2005. Export performance weakened and there was a marked correction in investment after the boom of the late 1990s. The convergence in living standards towards the average of the euro area countries reversed. The recovery that started in 2005 gathered momentum in the following two years, although remaining below average growth in the OECD. Portuguese exports grew strongly on the back of solid growth in the European markets, with some gains in market shares. Domestic demand strengthened in the second half of 2007, and the acceleration in consumption and investment offset weaker export growth. Higher food and energy prices brought harmonised consumer price inflation to 2.5% in April 2008 while core inflation declined somewhat, and the unemployment rate was 7.6% in the first quarter of 2008. The budget deficit was reduced from 3.9% of GDP (national accounts definition) in 2006 to 2.7% in 2007, well below the target of 3.3%. As in the rest of the euro area, banks have experienced difficulties in accessing wholesale funding and tightened credit conditions since mid 2007.

The expansion is expected to continue, though at a slower pace…

Taking into account the 1 percentage point cut in the value added tax (VAT) rate to be introduced as from mid 2008 and other measures already in place or announced, the government projects a further reduction in the budget deficit to 2.2% of GDP in 2008. This target appears to be within reach and a small additional decline in the deficit is expected for 2009. Other factors shaping the outlook include high commodity prices, with crude oil prices assumed to stay at $120 (price for a barrel of Brent crude) over the projection period and non-oil commodity prices stabilising at the high levels reached in April 2008. In the United States, GDP growth, after stalling this year, is projected to recover next year. In the euro area, growth is expected to slow this year, with activity gaining momentum during 2009.[1]

Against this backdrop, the expansion in Portugal is projected to slow somewhat in 2008, averaging about 1½ per cent and edging up to just under 2% in 2009 (Table 1.1). Private consumption is expected to be affected by a decline in consumer confidence and banks' greater caution to lend, while investment spending may weaken because of weaker export growth and tighter credit conditions. Employment growth is projected to be just enough to absorb the expansion of the labour force, keeping the unemployment rate below 8% over the forecast horizon. The VAT rate cut is projected to delay some durable goods consumption to the second half of the year and to damp inflation in 2008. Furthermore, the large negative output gap should help to keep core inflation moderate over the forecast horizon and headline inflation is set to come down to 2% by the end of 2009.

… and there are risks on both sides

The adverse effects on activity of the financial market turmoil, high commodity prices and general weakening in the external environment are incorporated in the projections, but significant downside risks remain. Weaker-than-expected growth in the euro area and persistent tight credit conditions could inhibit growth more than projected. There are also

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Table 1.1. **Recent trends and outlook**

Percentage changes

	Volume (2000 prices)				
	2005	2006	2007	2008	2009
Demand and output					
Private consumption	2.0	1.1	1.5	1.4	1.6
Government consumption	3.2	–1.2	0.3	0.5	0.5
Gross fixed capital formation	–0.9	–1.0	3.2	3.0	3.1
Final domestic demand	1.6	0.2	1.6	1.6	1.7
Stockbuilding[1]	0.0	0.1	0.0	0.1	0.0
Total domestic demand	1.6	0.3	1.6	1.6	1.7
Exports of goods and services	2.0	9.2	7.1	4.0	5.3
Imports of goods and services	3.5	4.6	5.4	3.7	4.3
Net exports[1]	–0.8	1.1	0.1	–0.2	0.0
Memorandum items:					
GDP at market prices	0.9	1.3	1.9	1.6	1.8
Harmonised index of consumer prices	2.1	3.0	2.4	3.0	2.2
Unemployment rate	7.7	7.7	8.0	7.9	7.9
General government financial balance[2, 3]	–6.1	–3.9	–2.7	–2.2	–2.0
Current account balance[3]	–9.5	–10.1	–9.8	–11.6	–11.6

1. Contributions to changes in real GDP (percentage of real GDP in previous year).
2. Based on national accounts definition.
3. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

some encouraging developments in Portugal, which can have a positive impact on its growth performance. If changes in the structure of the economy continue at the same pace as in the past few years, this could help to maintain the positive export performance observed recently. The progress achieved in fiscal consolidation is another important factor shaping the outlook. The on-going reforms in the public administration are expected to underpin further fiscal consolidation in the years ahead. Through confidence effects, the improvement in the fiscal situation can exert a positive influence on investors' decisions in the current uncertain international environment.

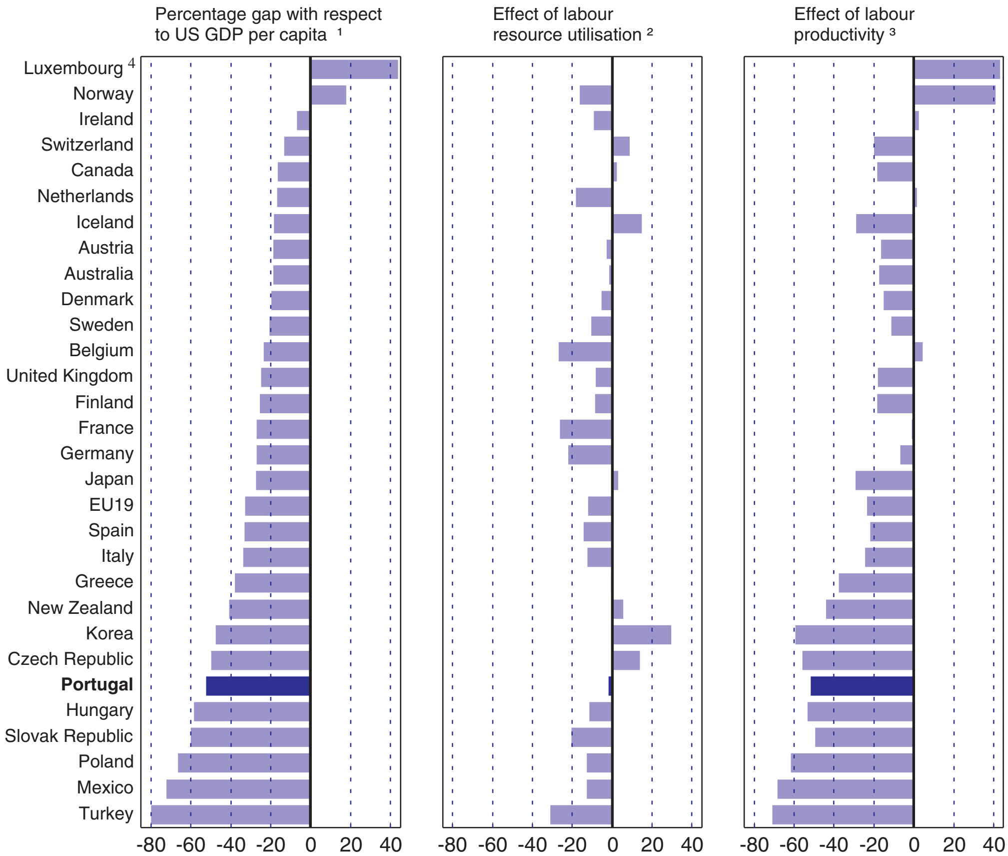
Lifting Portugal's growth performance over the medium term

Looking ahead, Portugal's potential output growth, estimated at around 1½ per cent, is insufficient to resume convergence and rapidly close the income gap with richer countries, pointing to the need to raise the growth of potential output through structural measures. The main challenge is indeed for Portugal to lift its performance over the medium term. In particular, the gap in GDP per capital relative to more affluent countries in the EU and the United States is mainly due to the large gap in labour productivity, while labour utilisation compares favourably with many other OECD countries (Figure 1.2).

The slowdown in output per capita growth in the 2000s is due to a marked slowdown in trend productivity growth (Figure 1.3). This contrasts with the pattern in the 1990s, when output growth was driven by productivity. Over the two sub-periods, demographic trends remained a relatively minor component of growth. The employment rate continued to have a positive impact on growth after 2000, while the share of the working-age population in total population started to be a drag on growth in GDP per capita. Over the previous period, they both had a small positive contribution. In the future, the more rapid increase in the share of older cohorts in total population, in Portugal as in other OECD countries, will

Figure 1.2. **The sources of real income differences**

2006



1. Based on 2006 purchasing power parities (PPPs).
2. Labour resource utilisation is measured as total number of hours worked divided by the population.
3. Labour productivity is measured as GDP per hour worked.
4. In case of Luxembourg, the population is augmented by the number of cross-border workers in order to take into consideration their contribution to GDP.

Source: OECD, *Going for Growth 2008*.

StatLink http://dx.doi.org/10.1787/342418804317

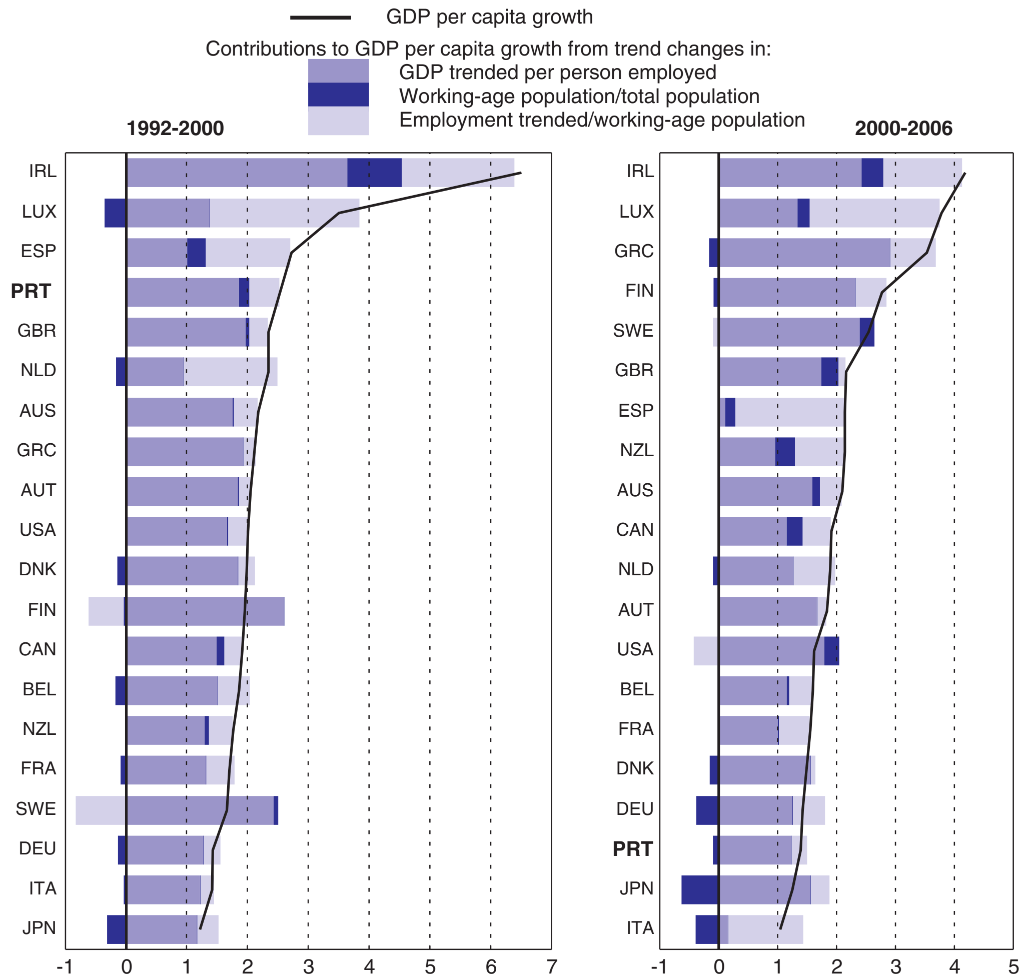
contribute to maintaining a negative working-age effect. This makes it all the more important to achieve more rapid labour productivity growth in order to boost economic growth over the medium term.[2]

To shed further light on the driving forces of growth, output growth can be broken down into changes in factor inputs and changes in total factor productivity.[3] Much of Portugal's GDP growth in the early 2000s appears to be accounted for by the accumulation of labour and capital inputs. By contrast, Portugal stands out in comparison with the EU average because of the negative contribution of multifactor productivity (Figure 1.4). Looking at the capital input, the contribution from information and communication technology (ICT) capital deepening was not very large, in line with the pattern observed on average in the EU15, while the United Kingdom (and the United States) recorded a larger contribution from ICT capital in 2000-05.

Although there are different ways to develop a growth-friendly policy framework, the range of policy measures that would help boost labour productivity growth in Portugal

Figure 1.3. **The driving forces of GDP per capita trend growth**

Average annual percentage change



Source: OECD, *Analytical database.*

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include: enhancing educational outcomes, facilitating trade and FDI, increasing competition, lowering the cost of doing business, and addressing rigidities in the labour market which impede mobility and lengthen the duration of unemployment spells. Some of these are among the priorities identified as key drivers of growth across OECD countries (OECD 2008, *Going for Growth*).

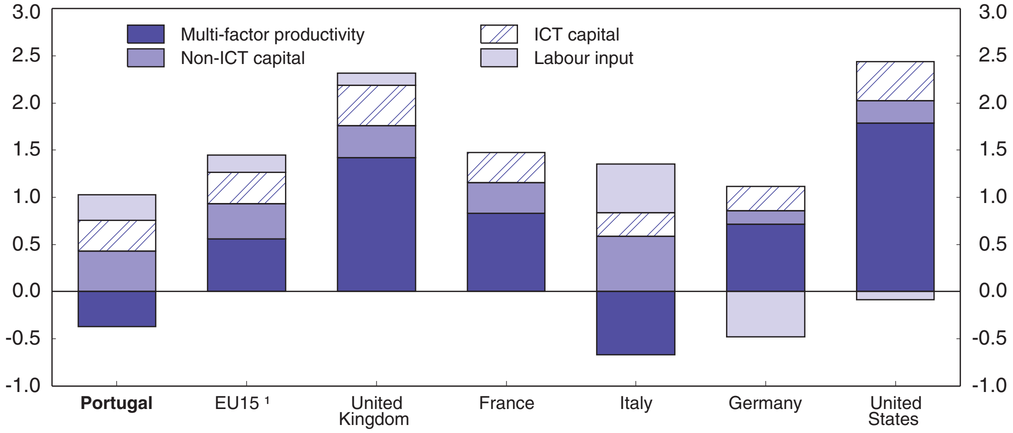
Understanding labour productivity dynamics

Shift and share analysis of labour productivity

The increase in labour productivity (measured as GDP per hour worked) slowed considerably after 2000, from 3.6% per year on average in 1985-2000, to 1.2% between 2000 and 2005. Detailed sectoral data allow the change in productivity to be broken down into a "between-sector effect" to reflect the reallocation of labour between sectors and a "cross-sector effect" that reflects the interaction of productivity changes and employment shares (Box 1.1). A sectoral analysis over the last 25 years shows that the growth of productivity within sectors

Figure 1.4. **Breaking down GDP growth in Portugal and selected OECD countries**

Contributions to GDP growth, 2000-2005



Source: OECD, based on the *EUKLEMS database*.

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remained quite substantial in Portugal before and after 2000; what changed drastically was the impact of reallocation of labour between sectors, which turned negative in the most recent period (2000-2005), as labour went into less-productive sectors (Figure 1.5, Panel B). This negative "between sector" effect reflects the shift of labour from manufacturing to construction and retail trade in particular, which have lower labour productivity levels. The 2000-05 developments stand in sharp contrast to developments in the previous decades. A similar change also occurred after 2000 in other countries, such as Ireland, the Netherlands and the United Kingdom, but the effect in those countries was very small in scale. Moreover, the large negative cross-sector effect recorded in Portugal over the past 20 years reflects gains in employment share of sectors with slower productivity growth (*e.g.* construction and retail trade) as well as losses in employment share of sectors with faster productivity growth.

Box 1.1. **Shift and share analysis of labour productivity**

The overall change in labour productivity (GDP per hour worked) can be broken down into 3 effects: a within sector labour productivity change, a between sector effect and a cross-sector effect.

Within-sector effect: it measures the contribution of changes in productivity in each sector to total productivity changes, holding the share of employment of each sector in total employment constant (the sum of the change in productivity in each sector weighted by the initial share of labour employed in that sector).

Between-sector effect: it is the part of productivity growth due to the reallocation of labour across sectors that have different levels of productivity (the sum of the share of employment of each sector weighted by the initial labour productivity in that sector).

Cross-sector effect (interaction of changing employment shares and changing productivity) This term is positive if sectors with faster-than-average productivity growth gain employment share and negative if sectors with faster productivity growth lose employment share – or if sectors with slower productivity growth gain employment share (the sum of changes in labour productivity multiplied by changes in employment share of each sector).

Box 1.1. **Shift and share analysis of labour productivity** *(cont.)*

The analysis of labour productivity growth in Portugal compared with 3 other EU economies from 1970 to 2005 (the Netherlands, Ireland and the United Kingdom) reveals the following main results:

- Considering total labour productivity growth, Portugal outperformed the Netherlands and the United Kingdom over the period 1985-2000. After 2000, this trend reversed. Ireland outperformed Portugal in all the sub periods.
- Portugal's recent slowdown in labour productivity growth reflects the reallocation of labour between sectors, as labour went into less productive activities. Abstracting from this effect, productivity gains within sectors were substantial and provided a large positive contribution to overall labour productivity growth.
- In Ireland and the United Kingdom, a reallocation of labour to less-productive sectors also took place in 2000-05, but on a much smaller scale than in Portugal.
- In the Netherlands, in 2000-05, there was both a mild slowdown in productivity growth within-sectors and a small negative effect from the reallocation of employment between sectors.

Sectoral contributions to productivity growth in the business sector

Considering sectoral contributions to productivity growth in the business sector, there is a notable shift at the start of the 2000s: after a significant positive effect in the second half of the 1990s, market services contributed relatively little to growth in 2000-05. In particular, the contribution from the trade, transport and communication sector, which typically includes many ICT-intensive industries, turned negative in Portugal, unlike the situation in the United States, the United Kingdom, and Germany for instance (Figure 1.6).

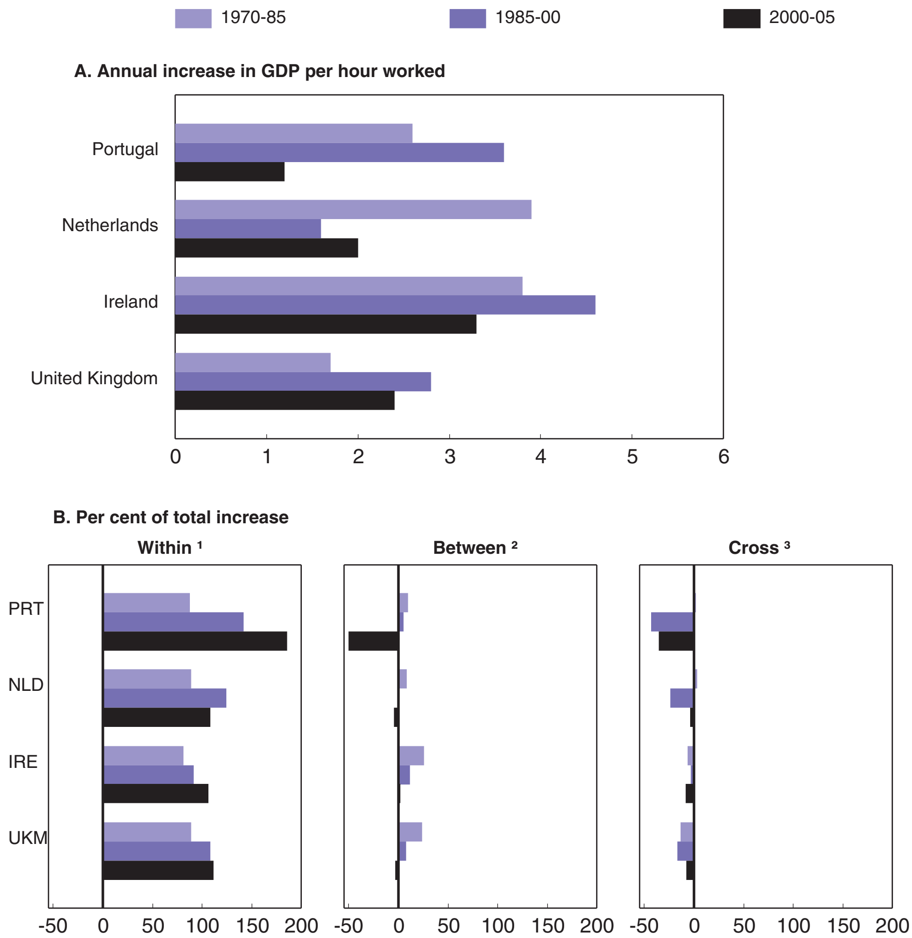
Key challenges facing the Portuguese economy

Recent developments and the medium-term outlook point to the need to consolidate the substantial progress made in fiscal consolidation and to move ahead in structural reform. Portugal needs to facilitate and hasten the adjustment of the economy to the new global environment in order to lift per capita income rates durably and re-establish convergence towards living standards in richer OECD countries. A key condition is to further improve the business environment to promote an efficient allocation of resources – both labour and capital – and strengthen firms' productivity performance and their incentives to innovate and adopt leading technologies. In this context, easing product market regulations is of major relevance to improve productivity performance, including through stronger innovation activities. This will involve reducing competition-restraining regulations in product markets. Another important policy priority for Portugal relates to human capital development and the adaptability of the labour market, where policy settings should allow the efficient allocation of resources, while providing adequate protection to those more at risk.

Securing fiscal consolidation

Portugal has made considerable progress in fiscal consolidation over the past three years. In response to an unsustainable deficit of 6.1% of GDP in 2005, the government embarked on a broad fiscal consolidation programme that has yielded good results. The

Figure 1.5. **Labour productivity growth: shift and share analysis**



1. Within: within sector labour productivity.
2. Between: productivity growth due to reallocation of labour across sectors with different levels of productivity.
3. Cross: productivity growth from shift of employment across sectors with different productivity growth rates.

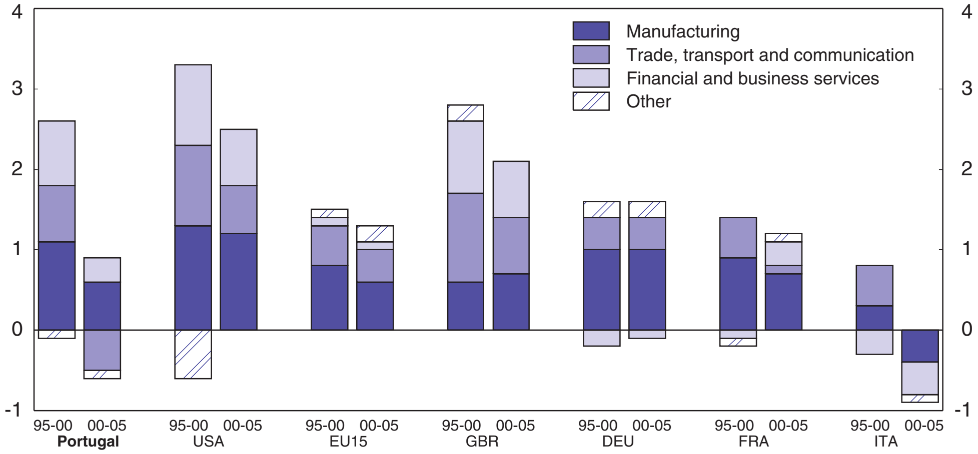
Source: OECD, based on the *EUKLEMS database*.

StatLink http://dx.doi.org/10.1787/342483658525

targets set for the reduction of the fiscal deficit were exceeded and the deficit fell to 2.6% of GDP in 2007, based on the Stability and Growth Pact definition (and 2.7% of GDP on a national accounts basis, Figure 1.7). Besides short-term measures with immediate effect, such as the strict control of civil service admission and tax rate increases, the government introduced a wide range of structural reforms that tackle underlying causes of the former rapid growth in current spending. A clear sign of the consolidation programme's success is the turnaround in the rising government spending-to-GDP ratio after 2005, reversing an upward trend in this ratio that had started in 1998. The in depth and comprehensive reforms to the pension system and the public administration are important for the consolidation effort and will bear fruits over the medium term. Reforms in the health sector and improvements in revenue collection have also played a role in the deficit reduction.

Given the continuous progress in implementing the consolidation programme and substantial results already achieved, the main fiscal policy challenge is about securing consolidation over the medium term. Many of the key measures of the public

Figure 1.6. **Sectoral contribution to productivity growth in the business sector**



Source: OECD, based on the *EUKLEMS database*.

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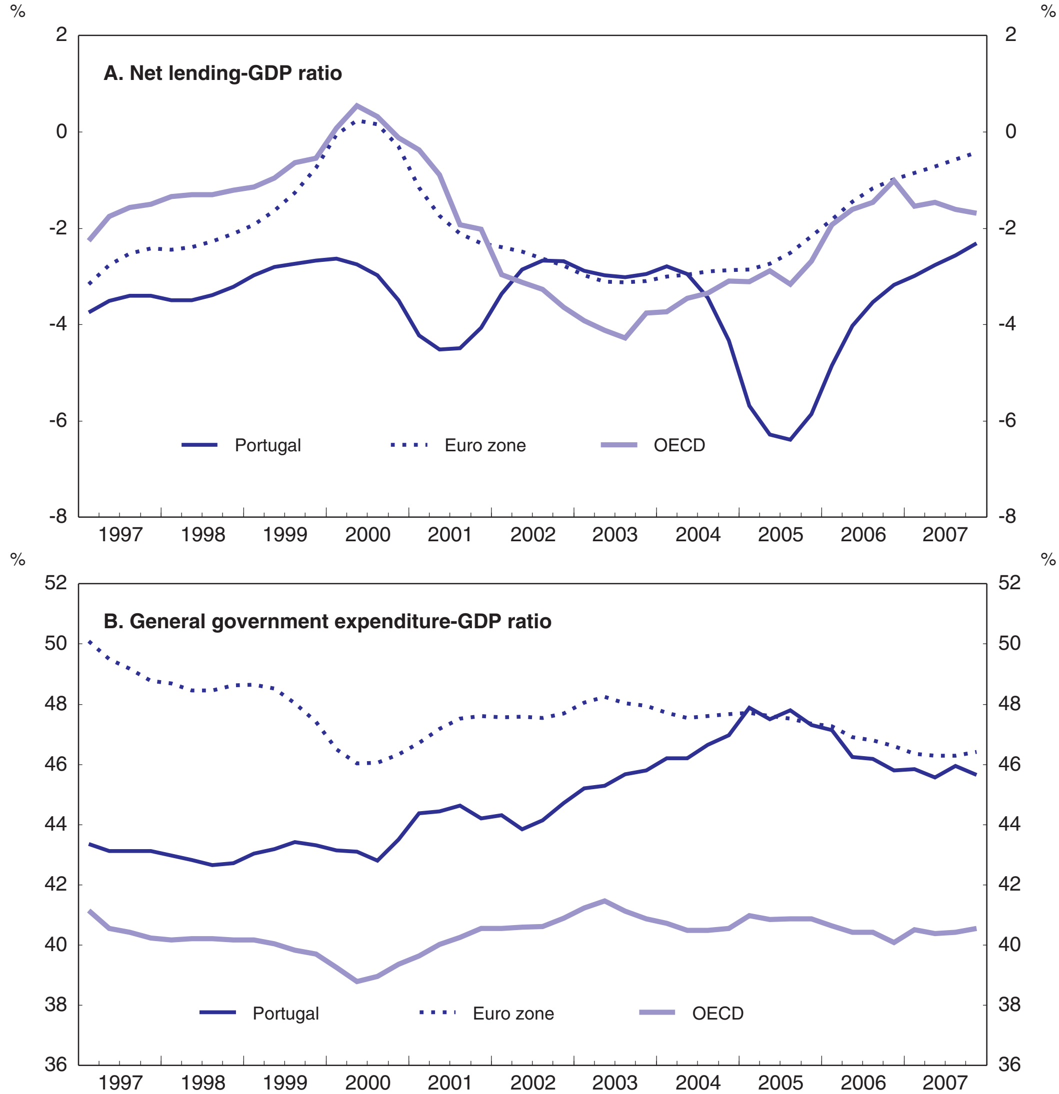
administration reform have already been put in place. The government should maintain the momentum of reform: fully introducing all the elements of the new career, pay and contracts system in the public administration, firmly establishing the new performance based system in the civil service and ensuring the effective operation of the mobility pool. Significant results have also been recorded in reducing future gaps in the contributory pension scheme, but more measures may be required to ensure the sustainability of the system in the longer run. Reforms to the health system have already helped to increase efficiency and reduce costs, but further action is needed to develop benchmarking of individual hospitals, increase competition among pharmacies, and tackle spending pressures related to ageing that will likely increase and will require financing. In addition, performance across state-owned enterprises (SOEs) is mixed and there is substantial room to improve monitoring, increase benchmarking, raise efficiency and reduce losses in some enterprises, thereby reducing the burden of these SOEs on the Budget.

The Budget management framework has been improved, including by introducing greater transparency in the fiscal accounts. However, expenditure control still relies to some degree on relatively fragile, short-term institutional arrangements, such as very close control and oversight of admissions to the civil service by the Minister of Finance. Introducing more formal framework tools for expenditure control will be important to reduce the reliance on such short-term measures. Another part of the framework that could be improved is the macroeconomic forecasting process. Accurate economic forecasting is notoriously difficult, although forecasting accuracy has increased recently. Despite this, there are opportunities to improve the process and further safeguard against errors, such as over-optimistic forecasts, which occurred in the past and were followed by negative fiscal surprises. Chapter 2 reviews fiscal policy in Portugal and discusses the following key points:

- progress in consolidation;
- implementation of the public administration reform;
- expenditure control, including pension reform, health system efficiency, and the performance of SOEs;
- strengthening the budget management framework.

Figure 1.7. **Fiscal indicators**[1]

As per cent of GDP



1. Based on national accounts definition.

Source: *OECD Economic Outlook No. 83 database.*

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Maximising the gains from integration in the world economy

Embracing globalisation

A number of studies point to the strong links between trade, FDI and growth. Historically, Portugal's growth was underpinned by trade, going back many centuries.[4] More recently, trade was boosted by joining the European Union in the mid 1980s. In 2007, total exports and imports reached about 67% of GDP, which is significantly higher than in the mid 1990s, although the ratio remains low in comparison with ratios in other small EU economies (Figure 1.8). Total goods and services exports grew by an average 6.2% per year in volume in the decade to the mid 1990s. However, there was a decline in export growth (to below 5% per year) in the following 10 years, and Portugal lost market shares.[5]

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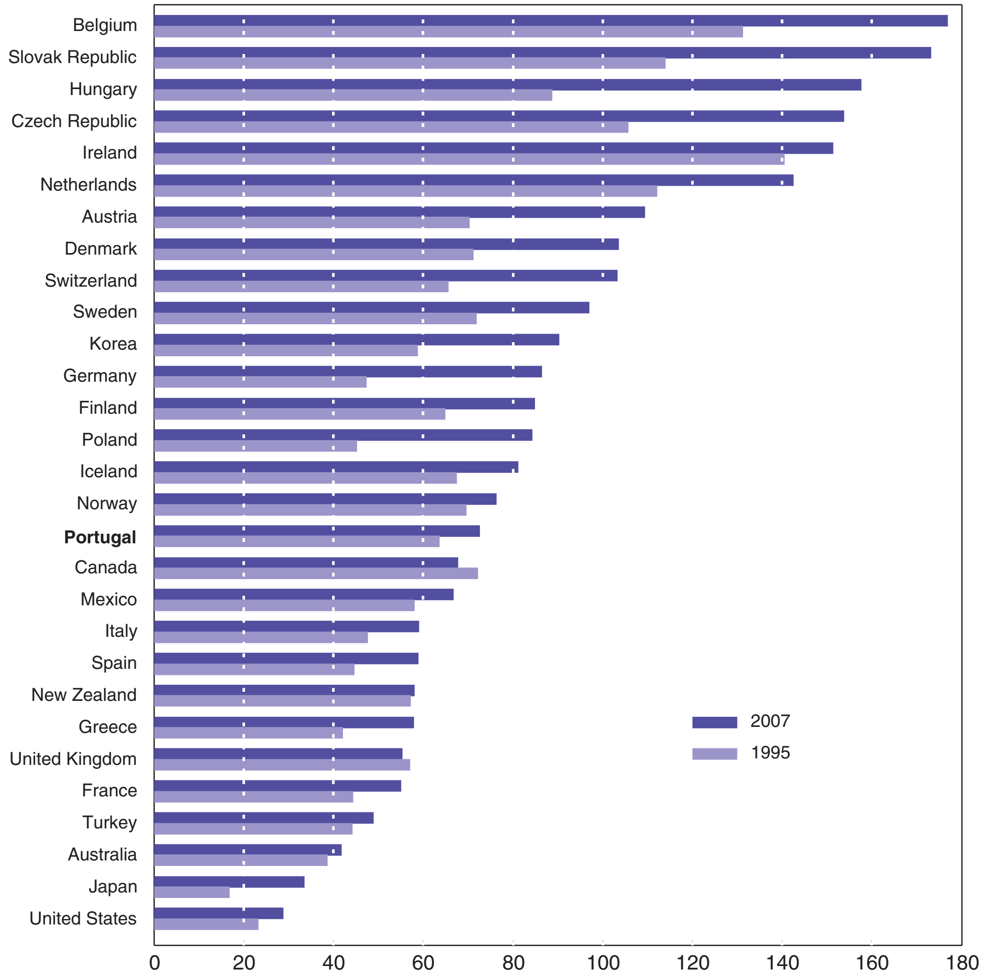
Figure 1.8. **Trade-to-GDP ratio**

Total goods and services as per cent of GDP, current prices



Source: OECD, *National Accounts.*

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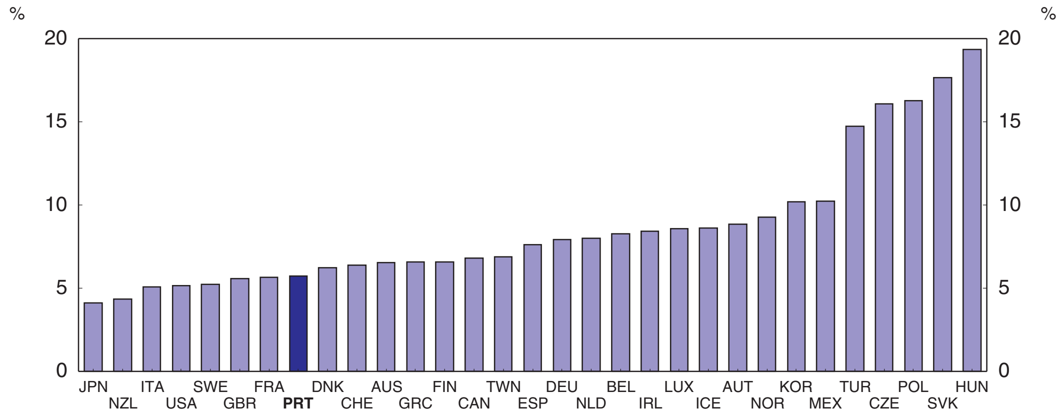
Manufactured goods exports, which account for the bulk of Portugal's exports, expanded by about 5% per year in value terms on average in the 10 years to 2005, below the OECD (and EU) average. Portugal's results were particularly disappointing in comparison to the 10 to 20% annual growth rates recorded by the strongest OECD exporters (Czech Republic, Hungary, Ireland, Poland, Slovak republic and Turkey) (Figure 1.9). Portugal's export performance in manufacturing, measured in relation to world imports has deteriorated since the mid 1990s. However, manufacturing export performance turned slightly positive in 2006. Although it is difficult to conclude that recent improvements can be sustained, other encouraging signs include: an ongoing shift to higher technology and value added goods; a diversification of markets; and substantial new foreign direct investment (FDI) that will help to boost exports in future years.

The loss of market share in the 2000s to some extent reflects the expansion of new players in world markets (Coe, 2007).[6] Therefore, in itself it is not a cause of concern. As total world trade expands, the market in which countries trade also expands. Hence, Portugal

Figure 1.9. **Manufacturing export growth in comparison**[1]



1. Manufacturing is defined using the Harmonised System categories. The average growth rate is calculated for the period 1996 to 2006. For some countries the period is shorter due to unavailability of data.

Source: OECD, *International Trade Statistics.*

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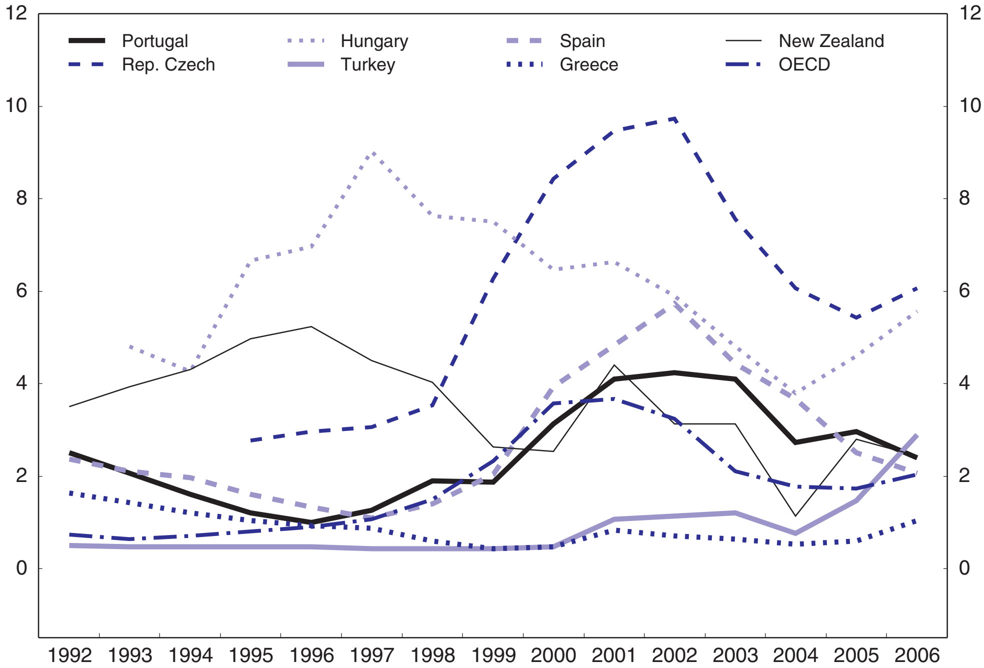
could have a shrinking share of a larger market. However, the Portuguese economy is more directly exposed to the current forces of globalisation than many other countries: because of a trade specialisation in sectors such as textiles, clothing and leather, Portugal's exports compete directly with those from emerging markets (mostly in dynamic Asia). Furthermore, its strong specialisation in motor vehicles implies that it is also exposed to significant changes in the global auto industry, including the increasing presence of new EU members.

The emergence of new economies in global trade is lifting world demand for goods (especially raw materials and investment goods) and services, creating new opportunities; and it is changing the global pattern of comparative advantage, putting countries under pressure to adjust to the shifts in consumption and production patterns across the globe. Portugal is experiencing an on-going structural transformation that is improving productivity in traditional industries, diversifying markets and moving the product mix to higher technology goods and services.[7] The adjustment process is costly, but at this juncture, the best way to manage the change is to facilitate the transformation. This requires having flexibility in product and labour markets, but also providing effective support to job seekers, including workers who lose their jobs as a result of the restructuring. Because of the large pool of low-skilled labour in Portugal, upgrading competences of the population is an important policy priority to facilitate the shift into higher value-added production. Trade growth and FDI inflows are likely to be enhanced by the on-going improvement to framework conditions. Greater trade integration, in turn, and higher FDI inflows would help Portugal to take full advantage of the expanding world market, boost productivity and GDP per capita, allowing a resumption of the convergence process.

Portugal has recorded significant inflows of FDI over time, with a marked increase starting in 1999.[8] Over the period 2000-06 the FDI/GDP ratio averaged a little less that 3.7% of GDP per year, a significant source of investment capital, although several fast-growing European countries have recorded much higher FDI inflows in proportion to their GDP (Figure 1.10). Furthermore, the share of new firms in new foreign investment into Portugal was limited over the period. However, there are encouraging signs for FDI, for instance an increase in the number and value of large FDI investments recorded between 2006 and 2007 by the investment promotion agency, AICEP, and a more positive opinion about

Figure 1.10. **Gross foreign direct investment compared**[1]

As per cent of GDP



1. Three-year-moving averages.

Source: OECD, *International Direct Investment database*.

StatLink http://dx.doi.org/10.1787/342605012711

the attractiveness of Portugal as an investment location, according to a wide survey of potential foreign investors.

Enhancing the business environment, strengthening competition and upgrading infrastructure

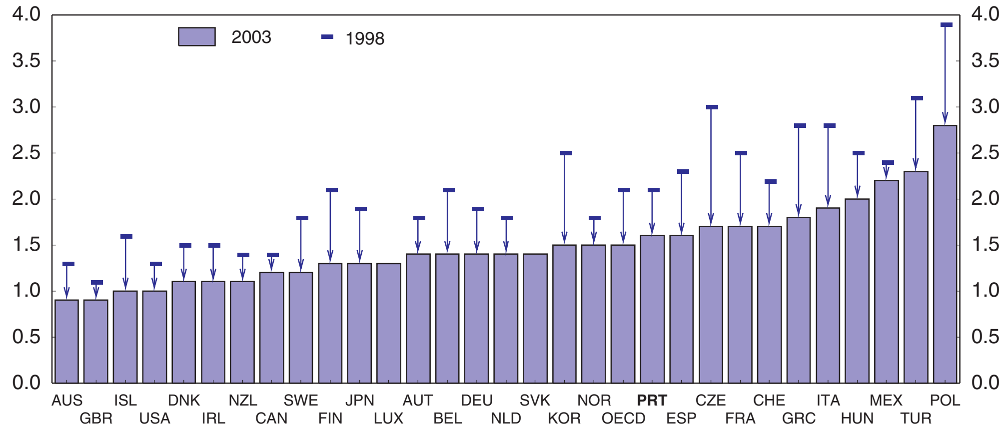
Evidence suggests a strong link between regulations and the degree to which they promote or inhibit competition and productivity and output growth (Nicoletti and Scarpetta, 2003; Conway *et al.*, 2006).[9] With a view to promoting more intense competition, Portugal has strengthened the legal framework and enforcement of competition policy. However, further efforts are desirable to strengthen the effectiveness of the competition authority in enforcing competition.

There are three interrelated channels from product market regulation to growth: *i)* the reduction of slack through enhanced competition; *ii)* innovation and technology adoption; and *iii)* reallocation of resources. There are also indirect channels between regulations and growth, through trade and FDI for instance. The cost of doing business, such as the complexity of administrative procedures, including licenses and permits, may also impede productivity growth by slowing down the creation of more productive firms or the destruction of less productive firms.

To gauge the ability of the economy to cope with the forces of globalisation, and to identify the policies that are the most likely to induce higher and more sustainable growth, it is important to understand the regulatory framework in which firms operate in Portugal and the competitive pressures they face to innovate and adopt leading technologies. The OECD aggregate indicator of product market regulation (PMR) shows a significant easing of PMR in Portugal and in other OECD countries between the late 1990s and the early 2000s (Figure 1.11).

Figure 1.11. **Product market regulation in OECD countries**

Scale 0-6 from least to most restrictive of competition



Source: OECD, *Product Market Regulation database*.

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Additional measures have been taken in Portugal in the past few years, as part of an ambitious set of reforms to alleviate the administrative burden on firms. This includes the broad SIMPLEX programme to simplify business interactions with government, for instance through the development of e-government. There are also good results recorded in a number of areas, such as a reduction in the time and cost to start a business. These actions will result in a further decline of Portugal's PMR indicator. However, other countries have also moved in the same direction and, therefore, the change in Portugal's relative position in the OECD cannot be assessed until after the ongoing updating of the OECD PMR indicators is completed (Autumn 2008). There is ground to continue to improve the regulatory environment, in order to promote an efficient allocation of resources – both labour and capital – and to strengthen firms' productivity performance. Improvements to the judicial system have also been introduced to deal with recurrent problems, such as case backlogs, which have been a major bottleneck for doing business in Portugal (Box 1.2).

Reforms take time to bring benefits. Some illustration of the potential benefits of undertaking regulatory reforms early and forcefully is provided by empirical analysis, based on simulations from cross-country/cross-industry regressions. In particular, Conway *et al.,* (2006) estimate that if Portugal's sectoral regulations had been eased by bringing them to the least restrictive in OECD countries in 1995, productivity growth over the period 1995-2003 would have been significantly higher (up by about 1.3 per year).[10]

Regarding competition, an area of particular concern is that of infrastructure, including transport, communications and electricity. More efficient infrastructure would improve the efficiency of the overall economy, as well as Portugal's international trade performance, for instance by helping firms to access reliable low-cost energy supply and telecommunications services. It would also contribute to increasing the attractiveness of the country to foreign investors. There is also scope to improve logistics and reduce transport costs. Since Portugal joined the EU, there has been a spectacular development of

Box 1.2. **Reform of the judicial system**

In 2005, the government introduced a new reform programme for the judicial system. The reforms have four priorities: making legislative changes to allow for re organisation and simplification of the system; implementation of new technologies in courts; introducing a new model of management and organisation of the courts; and the construction of new courts and new court-rooms.

The reform programme involves the simplification of procedures through greater use of IT, removing some processes from the courts and increasing the use of alternative dispute resolution to resolve litigation. Changes in the law and regulations, necessary for the implementation of these measures, have been approved, and pilots for procedures are being tested. The courts are already using some new technologies. Implementation is foreseen to continue actively in 2008. To achieve the government's goals, public investment on the judicial system is budgeted to grow by 31.4% between 2007 and 2008. Another important reform for 2008 is the re organisation of the judicial system, which aims at increasing management efficiency. Changes include the redistribution of courts geographically, the re organisation of tasks across the various courts, and the change in the tasks and responsibilities of the courts' presidents. In 2008, the government also plans to enlarge the role of the "justice of the peace" and arbitration centres for intellectual property and administrative law cases as well as improving the quality of justice processes and acts through the greater use of IT in justice procedures and acts (e-mail, video conference, and digital recording).

infrastructure, in particular the transport system, largely financed by EU structural funds (Box 1.3). However, prices of several infrastructure services, such as electricity and some telecommunication services, remain on the high side in comparison with other OECD countries, despite price declines over recent years. An important way to lower prices and increase efficiency in this area is to increase competition and strengthen the regulatory framework. Progress towards these goals has been uneven: regulations in place in 2003 appeared as relatively stringent in international comparison, unnecessarily restricting competition in key network industries, although some changes since then may improve the indicator. Furthermore, industry regulations should be further improved with a view to facilitate competition. Access to key network assets, in some cases controlled by state-owned or private incumbents, remains difficult, inhibiting new entry. Dominance by large incumbents in industries such as telecommunications, electricity, rail and airlines means that increasing competition is a major task that requires a strong commitment by the government, regulators and the Competition Authority.

The challenge is for Portugal to embrace globalisation and further integrate with the world economy, adjusting efficiently to changing global trade and investment patterns and reaping more benefits from its openness. Chapter 3 examines these issues, focusing on the following points:

- improving Portugal's trade performance;
- promoting FDI and increasing the linkages with the domestic economy;
- creating a dynamic business environment to face the challenge of globalisation;
- Strengthening competition and improving regulations in specific sectors, notably transport, telecommunications and electricity.

Box 1.3. **European funds**

Since 1989, Portugal has received significant transfers from the EU Structural Fund (for regional policy) and the Cohesion Fund (for national policy) for investment in infrastructure, physical capital and human capital. These transfers, which averaged 6% of GDP per year from 1989 to 2006, under Community Support Frameworks (CSF) I, II and III, have helped finance large transportation and environment-related infrastructure in Portugal. Moreover, CSF III (2000-2006) put a special focus on developing information and communication technology (ICT). The EU funds programmes have helped to dramatically improve infrastructure and raise living standards.*

The national management framework for the 2007-2013 EU transfers, the National Strategic Reference Framework (NSRF), includes three thematic programmes (Factors on Competitiveness, Human potential, and Territorial enhancement), five regional programmes in mainland and four regional programmes in autonomous regions. The overall framework includes € 21.5 billion to support investments, which are also co-financed by the Portuguese government. With the objective of lifting productivity faster, the NSRF puts greater emphasis on improving human capital than previous EU funds programmes; and the human potential programme, in particular, gets the largest share of the NSRF (29%). The implementation of the NSRF emphasises greater selectivity in determining which projects to fund, which is appropriate as it will help increase net benefits from the EU funds programmes.

In addition to the € 21.5 billion projected in the 2007-2013 programmes, the EU may also provide Portugal with additional grants for the development of projects within *Trans-European Transport Networks*. Due to its enhanced economic performance, the Lisbon region is above the threshold for full assistance and will receive less EU funding than previously.

EU funds are expected to decline in the longer run. As there is a strong possibility that the current package will be the last large one for Portugal, it is all the more important to ensure strict project selection, based on cost-benefit analysis. Longer-term financial sustainability and economic feasibility of projects must be also carefully checked to ensure that the financing does not compromise fiscal balances in the future. The likely fall in EU funds after 2013 also means that Portugal will have to rely more heavily on private funding sources for investment.

* EU Commission (2005), *Third progress report on cohesion: Towards a new partnership for growth, jobs and cohesion*, COM/2005/0192.

Facilitating labour market adjustment and developing human capital

Portugal is one of the EU countries most exposed to the current forces of globalisation, as noted above, because of its traditional export mix, but also because of the low education levels and competences of a relatively large proportion of the labour force that impedes the shift to high-value added, high-tech production.[11] Furthermore, in a world of accelerated change, labour market policies should facilitate the structural transformation of the economy. OECD experience shows that countries with relatively flexible labour and product markets suffer smaller increases in long-term unemployment in periods of deep structural changes. By contrast, policy settings that rely on rigid employment protection legislation (or policies that resist change) are likely to become increasingly costly.

Portugal's unemployment has crept up from 4% of the labour force at the beginning of the decade, a rate significantly lower than the EU average at the time, to close to 8% on average in 2007, 2 percentage points above the EU average (Figure 1.12). And long-term

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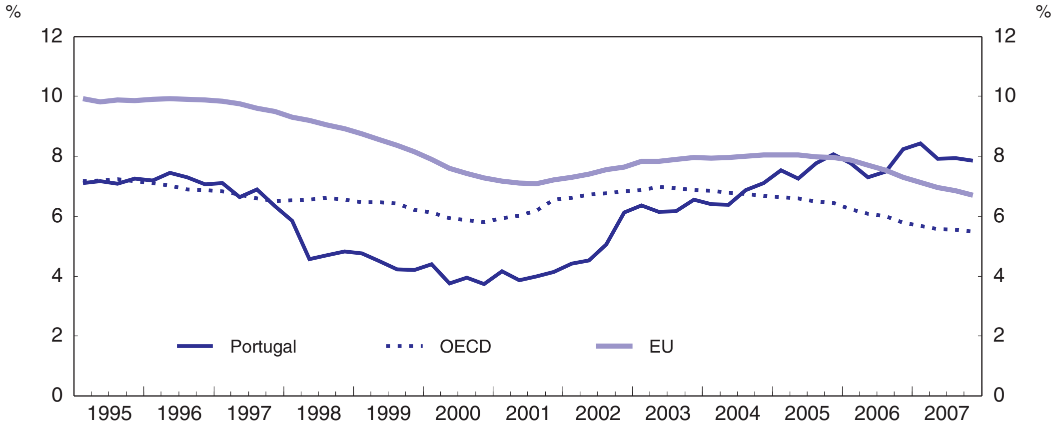
Figure 1.12. **Unemployment rates in comparison**

1995-2007



Source: OECD, *Analytical database.*

StatLink http://dx.doi.org/10.1787/342630167552

unemployment has reached a record high. While total employment stagnated during most of the period, the number of workers with short-term contracts has increased, and self employment continues to account for a large proportion of total employment.

In Portugal as in several other OECD countries, especially in Europe, labour market reforms have been late and rather limited. Labour market settings and regulations that were broadly adequate to cope with changes during most of the 1985-2000 period have not allowed a smooth adjustment to the changes in the global environment in the post-2000 period. The labour market has remained heavily regulated, while control systems, at least until recently, were inadequate; and increasingly generous social protection created disincentives to work. There appears to be scope to ease employment protection legislation, which, overall, remains more restrictive than in most other OECD countries, and better articulate labour market and social policies.

Faced with the substantial deterioration of labour market outcomes, the government has defined a broad strategy, encompassing: efforts to enhance flexibility in the workplace; improving activation and support of displaced workers, while aiming to preserve incentives to work; and promoting initiatives to improve the level of qualifications of the population. Several important reform measures have been taken over recent years. Others are being considered. A broad review of labour relations, including the labour code, led to the publication at the end of 2007 of the "White Book on Labour Relations", which makes specific reform proposals. The overall direction of the reform strategy is appropriate. There is not a one-size-fits-all policy package that can improve the functioning of labour markets; rather different policy mixes are applied in different countries, with varying degrees of success (OECD 2006, *Reassessing the Job Strategy*). The key will be to find the appropriate balance between flexibility and social protection. Sound welfare policies, especially active labour market interventions, have an important role to play, because they can smooth the transition from one job to another, while preserving incentives to take up employment. A few European countries have been rather successful in taking action to increase labour market flexibility, while improving social protection, to ensure some degree of security to workers. This model would have to be adapted to the Portuguese context, because it pre-supposes high cost effectiveness of the intervention programmes. Nonetheless, it should be an essential component of the broad strategy to improve the functioning of the labour market. To reduce the costs of adjustment to the changing environment, policies have to focus on helping the young people seeking a first job as well as providing support to job losers so that they adjust to new jobs regardless of the sector or industry in which they were working.

The efforts underway in education policies and lifelong learning to catch up with the rest of the OECD are also appropriate. Portugal ranks at the low end in the international literacy survey, PISA. Rapid progress in raising education attainments and the quality of education services would likely bring large benefits in terms of economic growth. Several measures have been undertaken in the education sector. There has been a diversification of upper secondary education, including the development of technical education and vocational courses, which are likely to improve the school-to-work transition and help the young at risk getting higher-productivity jobs. There are also initiatives to increase participation of adults in lifelong learning. Increasing the competences of those who have already left school is of high relevance to improve the flexibility of the Portuguese workforce to deal with trade-related and other structural shifts. It can also contribute, as shown by international evidence, to attracting higher-technology foreign investment in manufacturing and services as well as maximising technological spillovers through linkages with domestic firms. Moving further ahead in this direction would contribute to the expansion of the more modern and innovative part of the economy. Up-skilling the labour force can only be a long process, requiring continuity in implementation and close monitoring of results to ensure cost-effectiveness and the relevance of courses.

Portugal therefore is faced with two major tasks: improving the functioning of the labour market to reduce its dualism and to facilitate mobility; and closing the human capital gap. Chapter 4 discusses the following points in more details:

- Increasing labour market flexibility, while improving the effective protection of workers.
- Strengthening the effectiveness of active labour market programmes to facilitate employment or re-employment of job seekers.
- Continuing with the implementation of the education reform, with a view to improving employment prospects of the youth and facilitating the school-to-work transition.
- Up-skilling the labour force to improve its competences and adaptability.

Concluding remarks

The Portuguese economy is at a decisive juncture. The public finances are much improved and fiscal management is sound, but it is important to continue the progress in fiscal consolidation. The process of structural reforms, spurred by EU Directives, continued in the 2000s and the economy has managed to keep abreast of progress made in the European Union to ease product market regulations. In particular, measures have been undertaken to modify legal and regulatory restraints on competition. It is important to maintain the momentum of reforms to facilitate the adjustment of economic structures to the new global environment and promote a solid improvement of living standards. Labour market reforms have been insufficient to reverse the deterioration of labour market outcomes. There is now a strong political will to move ahead with important measures for the labour market and the current efforts at consensus building can help the process of policy reform. It is important not to delay the reforms under consideration. Ensuring more flexibility coupled with better protection and activation programmes is the way to promote job creation and ensure a smoother reallocation of labour across sectors. Upgrading the competences of both the youth and adult population is a key ingredient to enable a broader share of people to take advantage of work opportunities and participate in the process of economic growth.

Notes

1. The OECD projections are those published in the *OECD Economic Outlook 83* (June 2008).
2. For an in-depth analysis of growth in the OECD at large, see OECD (2003), *The Sources of Economic Growth in OECD Countries*.
3. The methodology typically used in growth accounting exercises has limitations and results are affected by the specification of the production function and the measurement of the productive factors. So the results should be interpreted as indicative only.
4. Portugal's discoveries in the 15th century were instrumental in building a global trading network that stretched across all continents, including with India and China and as far east as Timor, north of Australia. (See Rodrigues, J. N. and T. Devezas, *Pioneers of Globalisation: Why the Portuguese Surprised the World*, Centro Atlantic, 2007.)
5. In value terms, total exports of goods and services have increased by 6½ per cent in the 10 years to 2006, down from 12½ per cent in the previous 10 years.
6. *Cf.* Coe, D.T. (2007), "Globalisation and Labour Markets: Policy Issues Arising from the Emergence of China and India", OECD, *Social, Employment and Migration Working Papers*, No. 63, OECD Publishing.
   StatLink http://dx.doi.org/10.1787/057638253043
7. Evidence of large structural shifts is provided in D. Hamilton and J Quinlan (2008), "Globalisation and Europe: Prospering in the New Whirled Order". For example, the motor vehicles sector underwent a deep structural transformation in the early 2000s, with half of the jobs lost from 2003 to 2006 due to off-shoring, notably to new EU member states. (*www.amchameu.be/Pubs/globalizationeuropeFINAL.pdf*). These structural changes appear to have brought benefits in terms of exports and investment in the sector.
8. Some caution is required in interpreting FDI flows because they are affected in particular by transactions carried out by firms located in off shores.
9. More intense competition affects growth directly by boosting productivity (OECD, *Going for Growth*, 2007, Box 6.1).
10. Conway, P. and G. Nicoletti, (2006), "Product Market Regulation in the Non-Manufacturing Sectors of OECD Countries: Measurement and Highlights", *Economics Department Working Papers* No. 530, OECD, Paris.
11. For a more complete review of globalisation and the European Union, see Rae, D. and M. Sollie (2007), "Globalisation and the European Union: Which Countries Are Best Placed to Cope?", *Economics Department Working Papers* No. 586, OECD, Paris.

ANNEX 1.A1

Progress in implementation of previous OECD recommendations

This table reviews action taken on recommendations from previous *Economic Surveys*. More detailed recommendations that are based on analysis in this *Survey* are listed in the relevant chapters.

Recommendations	Action taken since the previous *Survey* (April 2006)
Competition, regulation and infrastructure	
Keep the momentum of actions to promote competition, continuing close coordination between the Competition Authority, the sector regulators, government and the judicial system	Ongoing
A. Electricity	
Proceed with the liberalisation of the electricity market in preparation for MIBEL	MIBEL joint spot market with Spain launched, July 2007
B. Gas	
Facilitate competition through improved regulation	Introduction of third party access to the transmission grid. A gradual increase in the proportion of market open to consumer choice and firms eligible to operate in the gas market
C. Telecommunications	
Enhance competition in the telecommunication sector, including separating the ownership of the copper wire and cable networks	Cable network spun-off into a separate company in November 2007; but the ownership of the copper wire and cable network companies still needs to be more independent
Promote a business friendly environment	
Promote the timely implementation of measures to reduce red tape and other costs of doing business, such as starting a business and obtaining licences	In progress, notably with the streamlining of procedures to run a business, use of e-government and broad implementation of the SIMPLEX programme including some steps to reduce the licensing burden
Simplify tax system and broaden the income tax base	Action taken to reduce tax evasion and fraud
Improve labour force skills and competences	
A. Ensure better value for money in education	
Continue the rationalisation of the school network	Implementation well advanced
Find a better balance between wage and non-wage expenditure	Under implementation, with the rationalisation of human resources and better cost control
Continue to strengthen teachers' initial and on-the-job training	Under implementation
B. Continue to improve the relevance and quality of curricula	
Continue to modernise curricula at all levels and monitor the implementation and impact of changes	Under implementation, notably with a focus on mathematics curricula
Develop vocational and professional education	Under implementation, including with the *Novas oportunidades* initiative

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Recommendations	Action taken since the previous *Survey* (April 2006)
C. Improve evaluation systems at all levels of education	
Reform the teachers' evaluation system and use it for promotions	Introduction of a new evaluation system, to be linked to career progress
Further develop systematic evaluation of programmes and use results to influence policy decisions, school management and users' choice	Under implementation
D. Support poor achievers in school and prevent drop out	
Identify students at risk and limit the use of repetition to deal with low achievers	In progress, notably *via* closer monitoring and reinforcing alternative education paths
E. Improve the higher education system	
Streamline programmes and reorganise the system; improve relevance and quality	In progress
F. Enhance life-long training	
Encourage training and retraining of those already in the labour force	On-going, including with the *Novas oportunidades* initiative
Consolidate the Recognition, Validation and Skills Certification System	In progress, with good results already seen
Improve the functioning of the labour market	
Ease employment protection legislation for permanent contracts, to facilitate labour market adjustments and rebalance job creation towards regular rather than short-term contracts	Under discussion, in combination with a simplification of procedures
Ensure the set up for short-duration contracts is flexible , with a view to allowing the adaptability of the workforce	Revision of regulations for short-term contracts under discussion
Advance the reform of the unemployment benefit system, striking a balance between income support for job seekers and fostering re-employment, through tightening of benefit programmes and effective active labour market policy (ALMP)	Eligibility conditions to unemployment benefits tightened; intervention of public employment services strengthened; reform of ALMP under discussion
Control costs and improve performance of health care	
Deregulate the pharmacy sector	Liberalisation of retail pharmaceuticals prices (March 2007) allowing pharmacies to give discounts to consumers. Liberalised ownership of pharmacies. Proposal to allow hospital pharmacies to sell to the public
Set reference prices at the price of the cheapest generic	Changed the public co-payment from a fixed percentage of the branded medicine price to the same fixed percentage of the generic price
Favour integration of provider networks	Ongoing reorganisation of the hospital services network to improve efficiency and health outcomes

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Chapter 2

Securing fiscal consolidation

Portugal has made good progress in reducing the fiscal deficit in 2006 and 2007, with a wide-ranging consolidation programme, including shorter-term measures and structural reforms to address problems in spending control. In particular, the comprehensive reforms to the public administration and the pension schemes tackle some of the main underlying drivers of spending growth and are likely to continue paying dividends in the medium-term. The main fiscal challenge for Portugal is to secure the results achieved in fiscal consolidation and reduce the deficit further, in particular by: completing the implementation of the public administration reform; continuing the health care reform; improving the performance and efficiency of state-owned enterprises; taking further measures to ensure the sustainability of the contributory pension scheme if developments require it; and dealing with ageing pressures on the health budget. The progress achieved in fiscal consolidation and budget management provides a solid base on which further improvements should be made to strengthen the medium-term fiscal framework and enhance the efficiency and effectiveness of public finances.

Portugal recorded a significant improvement in its fiscal position in 2006 and 2007. This turnaround has reflected a notable shift in fiscal policy from successive periods of increasing deficits interrupted by incomplete and short-lived consolidation phases to a comprehensive and wide-ranging effort to reduce the deficit. In 2005, the government introduced a new consolidation programme which brought the deficit down from an unsustainably high level of 6.1% of GDP in 2005 to 2.6% of GDP in 2007, one year earlier than planned, based on the Stability and Growth Pact definition (and 2.7% of GDP on a national accounts basis.

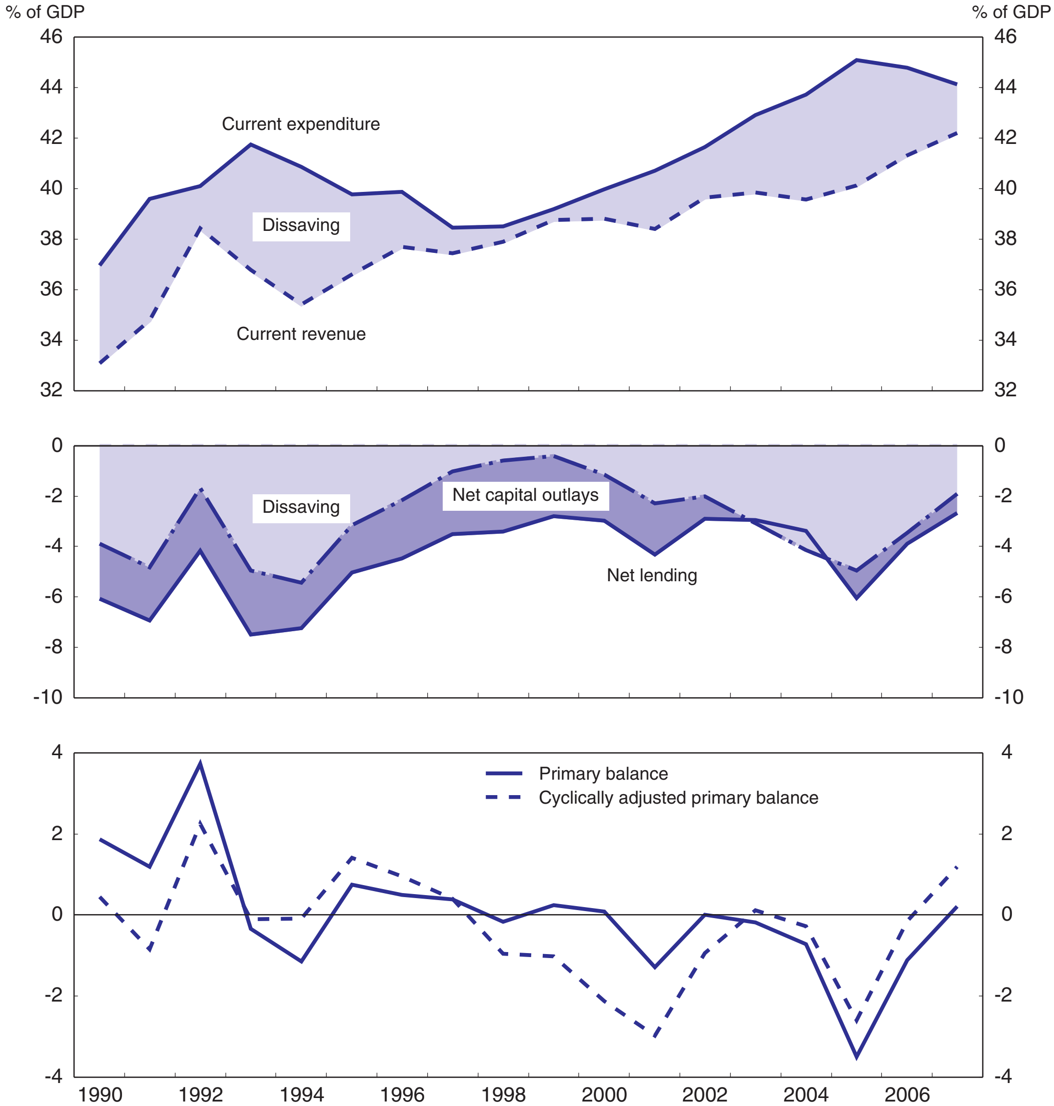
The consolidation programme combines both shorter-term measures to reduce the deficit and, more important for the future, a wide array of structural reforms to tackle long-term problems in expenditure, revenue and public finance management. There has been notable progress to date in implementing reforms and the fiscal deficit has dropped markedly. However, more remains to be done to secure this consolidation and reduce the deficit further. Further strengthening the budget management framework, particularly through a greater use of fiscal rules, would also help to improve fiscal management in the medium-term. Reducing the deficit further and ensuring that public finances are sustainable are important to ensure macroeconomic stability that is a pre-requisite for strong economic growth on a durable basis. A sustainable fiscal balance will help to foster investment growth and GDP growth by reducing uncertainty. At the same time, the reforms that modernise the public administration will enhance the efficiency and effectiveness in the public sector, thereby contributing to raising productivity of the economy at large.

This chapter first examines Portugal's fiscal management record and draws out some lessons from this. It then discusses the significant progress already made in implementing structural reforms underpinning fiscal consolidation in the longer run and identifies the main areas where additional steps are required. Finally, it examines how the budget management framework could be further strengthened to safeguard against future large imbalances. Key policy recommendations are summarised in Box 2.7 at the end of the chapter.

Fiscal consolidation is underway

Over the last 15 years, the fiscal balance went through three broad phases (Figure 2.1). First, from 1993 to 1998, in the run-up to Economic Monetary Union (EMU), the fiscal deficit fell from 7.7% to 3% of GDP. Second, starting in1998, there was an upward step change in current spending growth which, although not immediately apparent in the headline balance, eventually pushed the deficit to 6.1% of GDP by 2005. Third, in 2005, faced with an unsustainable fiscal position, and in breach of the EMU Stability and Growth Pact (SGP) limit for fiscal deficits of 3%, the government commenced a marked consolidation process and the deficit decreased to 2.6% in 2007, based on the Stability and Growth Pact definition. The three phases are marked out by different patterns of current expenditure growth (Figure 2.2).

Figure 2.1. **Public sector budget aggregates**[1]



1. Based on national accounts definition.

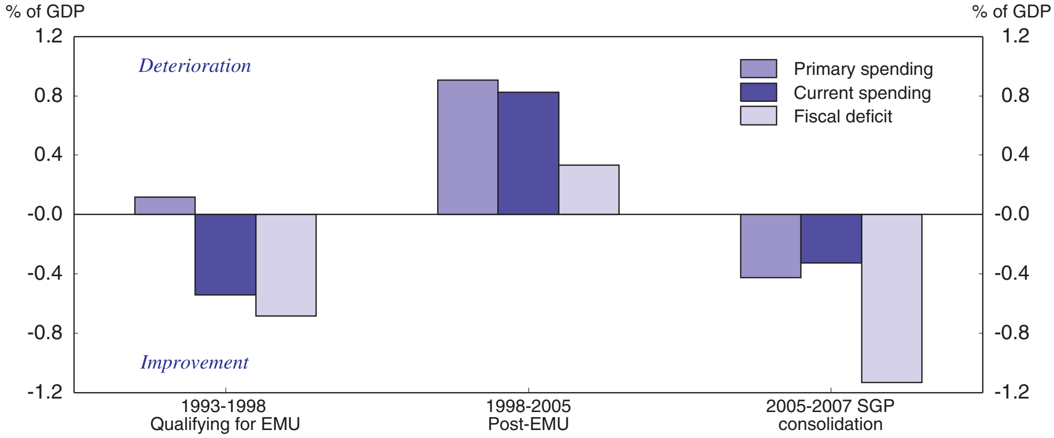
Source: OECD Analytical database.

StatLink http://dx.doi.org/10.1787/342634764240

The consolidation from 1993-98 was achieved through a marked slowdown in current spending growth relative to GDP growth, which resulted in current spending falling by 3.5 percentage points of GDP (national accounts definition). The largest contribution to the fall in current expenditure growth came from reduced interest payments as a result of interest rate falls in anticipation of Portugal entering the Economic and Monetary Union (EMU), with property income paid by government falling by 4 percentage points of GDP. Furthermore, both government consumption and social security spending growth also slowed down compared to GDP growth during this period (Figure 2.3). This was enough to slow growth in primary current expenditures (current expenditure less interest payments) as a percentage of GDP to 0.1 percentage point per year on average between 1994 and 1998, down from 1.3 percentage points per year between 1989 and 1993. In May 1998, the European Council confirmed that Portugal met the criteria for EMU.

Figure 2.2. **Fiscal policy phases**

Percentage points of GDP: average annual change[1]



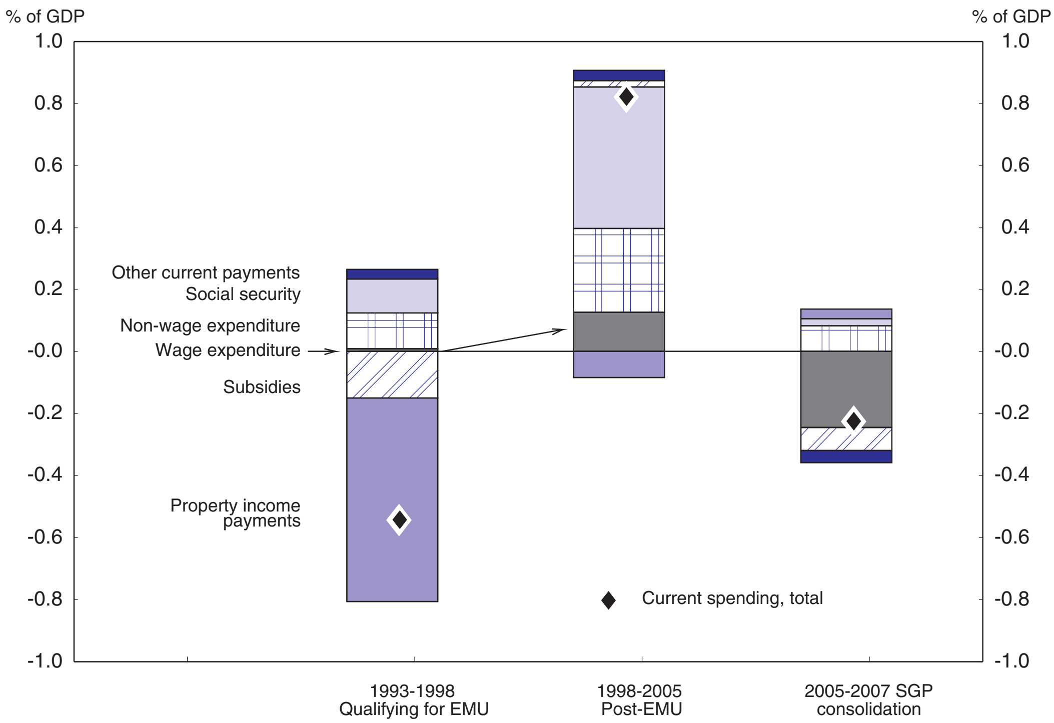
1. Based on national accounts definition.

Source: *OECD Analytical database.*

StatLink http://dx.doi.org/10.1787/342636531545

Figure 2.3. **Breakdown of current spending**

Percentage points of GDP: average annual change[1]



1. Based on national accounts definition.

Source: *OECD Analytical database.*

StatLink http://dx.doi.org/10.1787/342667600611

Starting in 1998, there was an upward step change in current spending and primary spending growth and this trend was maintained through until 2005. Current spending increased by 6 percentage points of GDP in total over the 6 years to 2005, to reach 45% of GDP. Debt servicing costs continued to fall as a share of GDP, but at a more moderate rate than in the years before 1998. However, non-wage consumption expenditure rose by 2 percentage points of GDP and social security payments by 3.9 percentage points over the period. The underlying effect of the change in spending on the headline fiscal balance was not immediately apparent with the headline deficit fluctuating through this period before sharply deteriorating in 2005. These fluctuations were caused by notable increases in the revenue to GDP ratio in 1999 and 2002 (the latter partly in response to an increase in the VAT rate). From 2002 to 2004 net capital operations also masked the underlying fiscal deterioration. Higher capital receipts, lower capital payments and lower public investment as percentage of GDP contributed to a smaller headline deficit.

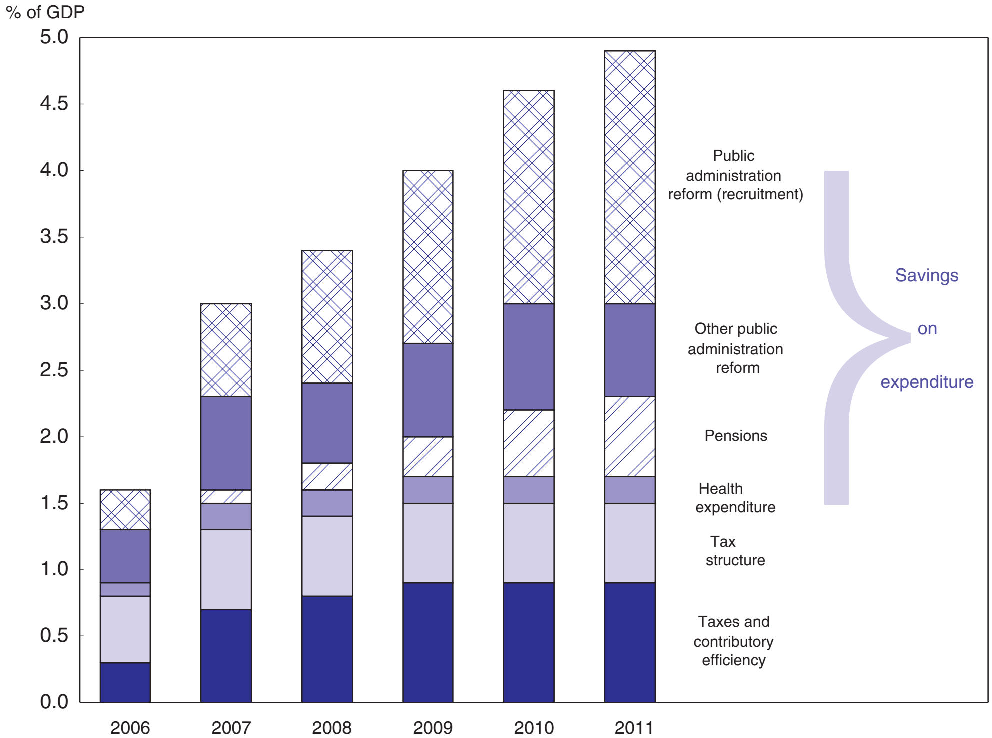
A large range of factors contributed to the increase in the deficit through to 2005. Some of the deterioration can be attributed to over-optimism in budgeting about future GDP and, therefore, revenue growth (OECD, 2006). However, this is only a partial explanation since the slowdown in growth only began in 2001, two years after spending exhibited the upward step change. Over-optimism about the net tax collection effects of the 2001 tax reform package, and the impact on revenue from corporate tax cuts in 2002 also contributed to the increased deficit. However, as identified in previous *OECD Economic Surveys of Portugal*, the main driver of the increased deficit was rapid growth in current primary spending. Underlying this trend were unsustainable social security spending and personal expenditure, calling for significant reforms in order to durably reduce the deficit.

Securing consolidation through structural reform

The Stability and Growth Programmes (SGP) 2005-09 and the successive vintages have combined both short-term and longer-term structural changes designed to tackle underlying spending pressures. These programmes can be distinguished from the previous stability programmes by the results achieved and a greater effort to implement reforms that tackle the underlying drivers of unsustainable spending growth. The most important evidence of consolidation achievements is the clear downward step in current and primary spending growth relative to GDP growth in 2006 and 2007, after a series of unsuccessful attempts between 1999 and 2005. The challenge is to maintain the structural reform momentum, especially now that the immediate pressure of a very large fiscal deficit has been reduced to below the 3% limit set by the Stability and Growth Pact. OECD work shows that delaying fiscal consolidation reforms, even for short periods, is politically costly. Simulations show that in the case of Portugal, even a delay of 2 years would increase the political costs of consolidation by around 15% in terms of the greater required size and abruptness of changes in the fiscal balance (Cournède, 2007).[1]

The main consolidation measures under the SGP are expected to save 4.9 percentage points of GDP between 2006 and 2011 with about 3½ percentage points attributable to expenditure reduction. The measures can be grouped into three main areas: restructuring the public administration; curbing social spending; and increasing revenue through tax changes, more efficient tax administration and higher collection of pension and health insurance contributions (Figure 2.4). Restructuring the public administration is expected to make the largest contribution, saving 2.6 percentage points of GDP over the programme period followed by increases in tax revenue and social security contributions (1½ percentage

Figure 2.4. **Expected impact of the main consolidation measures**



Source: Stability and Growth Programme 2006-2011, December 2007.

StatLink http://dx.doi.org/10.1787/342667608368

points) and curbing social spending (0.8 percentage point). The largest contributor to the public administration reform is the control of admissions and recruitments, which is expected to save 1.9 percentage points over the 2006-2011 period.

Some key measures that have already been implemented include: raising the VAT from 19 to 21% in July 2005, strengthening tax administration, reorganisation of the public administration structure (PRACE), reducing the numbers of civil servants and freezing automatic promotions (see Annex 2.A1).[2] These changes, along with particularly buoyant corporate tax receipts associated with the pick-up in growth after 2005 and improved tax administration including significant gains in efficiency by combating evasion and fraud more effectively, have contributed to a large decline in the budget deficit. Between 2005 and 2007, the headline fiscal deficit shrank from 6.1% of GDP to 2.6% and the cyclically-adjusted deficit fell by around 2.5 percentage points. Other important measures will make a notable contribution to fiscal consolidation in the longer-term. They include the convergence in the civil servant pension scheme towards the general pension scheme, introduced in January 2006, and the reform of the general social security system introduced in January 2007.

While impressive progress in reducing the deficit has been achieved, further work remains to be done to secure further reductions. Going forward, controlling current spending will be the main tool for reducing the deficit as there will be less support from revenue increases, whether discretionary or cyclically induced. Further efforts will be required in the areas of public reform administration, social spending, tax administration and public accounts management. In particular, further consolidation will also require replacing effective but temporary arrangements with more sustainable reforms, which are more complex to implement. In particular, the government still needs to fully implement the new civil servant pay and career scheme to replace the freeze on automatic promotion and wage increases that cannot last indefinitely. According to the last SGP, capital spending is projected to increase in 2008, after declining in both nominal and real terms from 2005 to 2006, making it all the more important to control current spending.

Public administration reform and government efficiency

The ambitious public administration reform comprises an overhaul of the Portuguese civil service in two main areas: a reorganisation of the central administration; and a broad reform of human resource management, concerning recruitment, careers, contracts and pay (Box 2.1). Fully implementing the reform is important for ensuring that the fiscal consolidation process is sustained. Expenditure on civil servants rose by 0.8% of GDP from 1999 to 2005, contributing to the deterioration in the fiscal balance. Moreover, total expenditure on civil servants as a proportion of GDP in Portugal is the 4th highest in the OECD, despite the fact that civil servants account for a share of total employment below the OECD median (Figure 2.5). Measures to control wage expenditure and improve its efficiency are crucial in tackling an important underlying structural driver of spending.

Box 2.1. **Principal measures of the public administration reform**

The wide-ranging and in-depth reform of the public administration is a major component of the budgetary consolidation strategy that commenced in 2005. The reform goals go beyond fiscal consolidation, and include enhancing the quality of public services and strengthening the governance of public institutions. By improving the overall efficiency of the public sector, this reform can contribute to a better allocation of resources in the economy and ultimately higher economic growth.

The main reform areas are human resources management and the re-organisation of the public services and the principal actions are:

Human Resources Management:

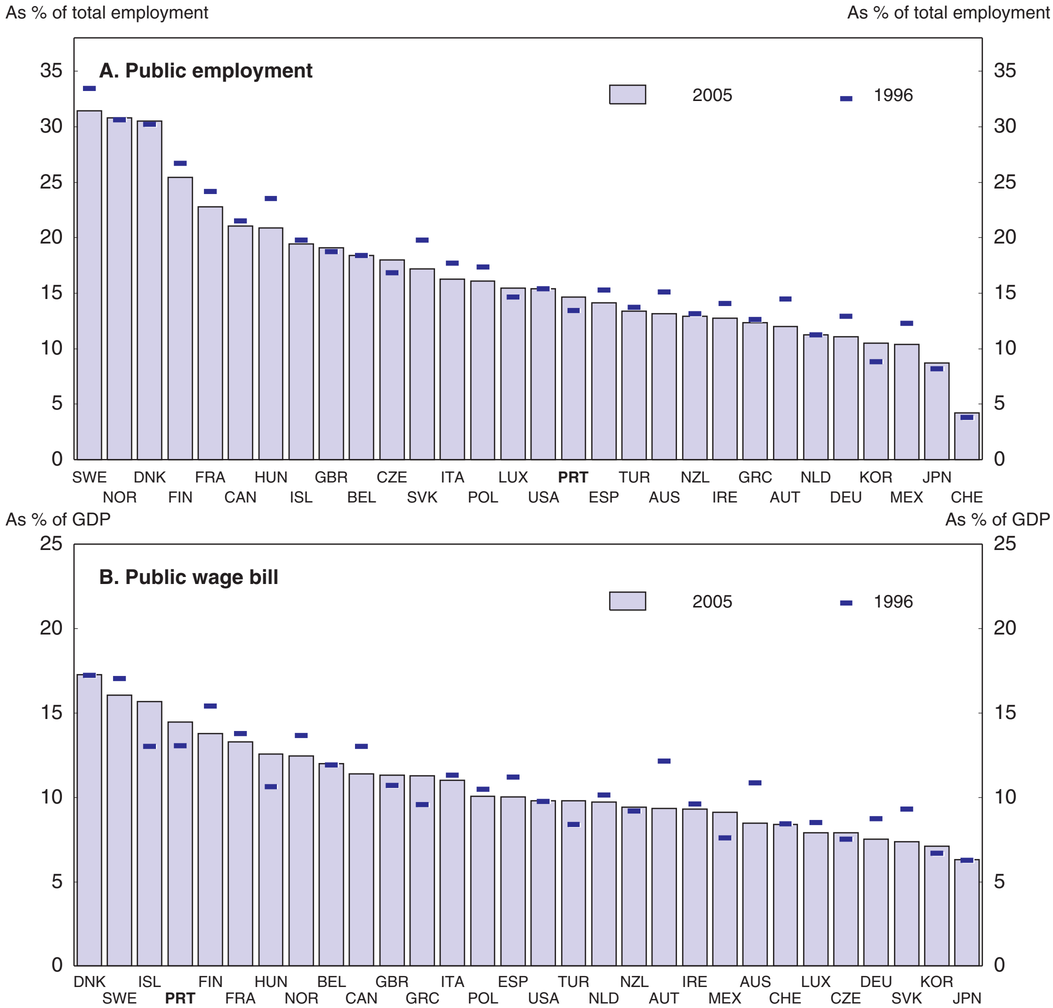
- Reform of contracts, careers and remuneration schemes.
- Reform of the services, management and staff performance assessment systems.
- Introduction of an internal mobility scheme (the mobility pool).
- The rule limiting recruitment to one new civil servant for every two leaving.

The Restructuring Programme for the State's Central Administration (PRACE):

- Redesign of structures, roles and responsibilities of the public services.
- Introduction of shared services [*e.g.*, the Company for the Shared Management of Public Administration Resources (GeRAP) and the National Public Purchasing Agency (ANCP)].
- Reduction of the number of models of regional division (from 30 to 2 models) for public services.

Significant progress has already been made in reforming the public administration. The reorganisation of the state sector is largely complete and there has been a 26% reduction in the number of general directions and public agencies as well as a 22% reduction in senior management positions. The principal task still to complete in

Figure 2.5. **Public sector size**



Source: OECD, *Analytical database*.

StatLink http://dx.doi.org/10.1787/342672056687

reorganising the public administration is to restructure the local and regional services provided by the central government. The aim is to reduce the number of organisational structures for delivering services from the current 30 to just two. The first is a five-region model and the second is an 18-district model. The 18 district model will be used to deliver security, social security and financial assistance. All other services will be delivered using the five-region model.

As part of the reorganisation of the public administration, the government has also begun operating an employee mobility scheme to facilitate the rationalisation of services and help increase public sector efficiency. Under the scheme, departments and ministries can send surplus employees to a central pool. Managers from other departments are required to recruit from this pool first (Box 2.2).

The pool is in principle an innovative way to improve efficiency in the public sector; but how it works in practice will be a crucial determinant of the net gains to the government in terms of spending and productivity. It can also assist the implementation of

Box 2.2. **Public employment pool**

While in the employment pool, employees are paid a percentage of their former salary. In the first two months in the pool (phase 1) employees are paid 100% of their salary, in the following 10 months (phase 2) they are paid 5/6 of their salary. After 1 year (phase 3) in the pool, their salary falls to 2/3 and other benefits are adjusted accordingly. They can remain in the pool receiving 2/3 of their salary indefinitely and they continue to receive related benefits. In each phase, employees are paid on the basis of 14 months per year, as in their career as civil servants, and they keep their rights to vacation and special leave. There is an obligation to attend training, if it is offered. The period in the pool counts for retirement entitlements.

During the first year (phases 1 and 2) in the pool, employees remain at the disposal of the state and cannot seek a private sector job. After one year, they can seek a private sector job, but can be requested to come back to work for the state. If they are offered a job in the public administration, employees have to accept it. If they find a job in the private sector, they continue to receive a percentage of the last salary they received in the pool from the government (under the extraordinary scheme). At any time, an employee in phase 1 or 2 has the right to move to the following phase without delay.

There is an extraordinary scheme for employees who are in the pool in phases 2 or 3. Under this scheme, employees have no rights and no obligations. They receive 70% of their last income (in the pool) during the first 5 years, 60% in years 6 to 10, and 50% thereafter. They receive their salary on a 12 month-basis and do not have paid vacations. They do not have to undertake training or to accept a job offer from the government. An employee must enter the extraordinary scheme for a minimum of 12 months.

the overall reform, by providing a mechanism for dealing with workers who are no longer required, but who have been nominated as civil servants for life, and therefore cannot be made redundant. It is still too early to see how effective this scheme will be in reallocating workers to more efficient jobs as department reviews are still under way. In order to prevent the scheme from being too costly, it is important to enforce the mechanisms in place to prevent abuse. Containing costs also requires the scheme to improve the matching of employees and jobs and the organisation of the remaining workforce. The net benefit for the government and the economy overall from this scheme depends on salary savings and the net productivity gain from an employee shifting to the pool or through the pool to another state job.

A determinant of how well the scheme promotes better matching of employees and occupations is the incentives the scheme provides to seek a new job. On the one hand, employees remaining in the pool can retain 2/3 of their last salary, which may be too high to encourage them to seek employment again in either the public or private sectors, thus creating a disincentive to leave the pool. On the other hand, the disincentive is reduced by the fact that, if they find a job in the private sector, employees who leave the pool still receive a portion of their last salary in the pool, which implies a reduction in the effective marginal tax rate. Nevertheless, there is a risk that the scheme creates a large group of low productivity employees who remain in the pool indefinitely at still considerable cost to the state. The mobility scheme should be accompanied by programmes to assist employees to find new employment in either the public or private sectors, for example job counselling and retraining. Continued payments in the pool could be made conditional on employees meeting these obligations.

Considerable progress has been made in advancing the human resource management component of the public administration reform. The remaining challenge is the full practical implementation of the new human resource management system. Changes have already been made to recruitment rules with a general one-in-for-two-out rule, although the exact rule depends on the area. The rule, which will remain in place through to 2009, has been successful in reducing the workforce from 748 000 in 2005 to around 709 000 in 2007. While effective in controlling public employment, the rule might undermine the trend increase in the quality of the civil service. The one recruitment for two exits could reduce workforce quality, as the low productivity workers stay while the best leave for new opportunities, with replacements for only 50%. This has not as yet been an issue: almost all exits have been made by people going into retirement who are generally replaced by younger and better qualified workers, which has contributed to improvements to the overall qualifications in the public sector. Between 1996 and 2006, the proportion of employees with a university degree rose from 40% of total employment to 49%, while those with lower secondary education or less fell from 38% to 29% of the total (Figure 2.6).

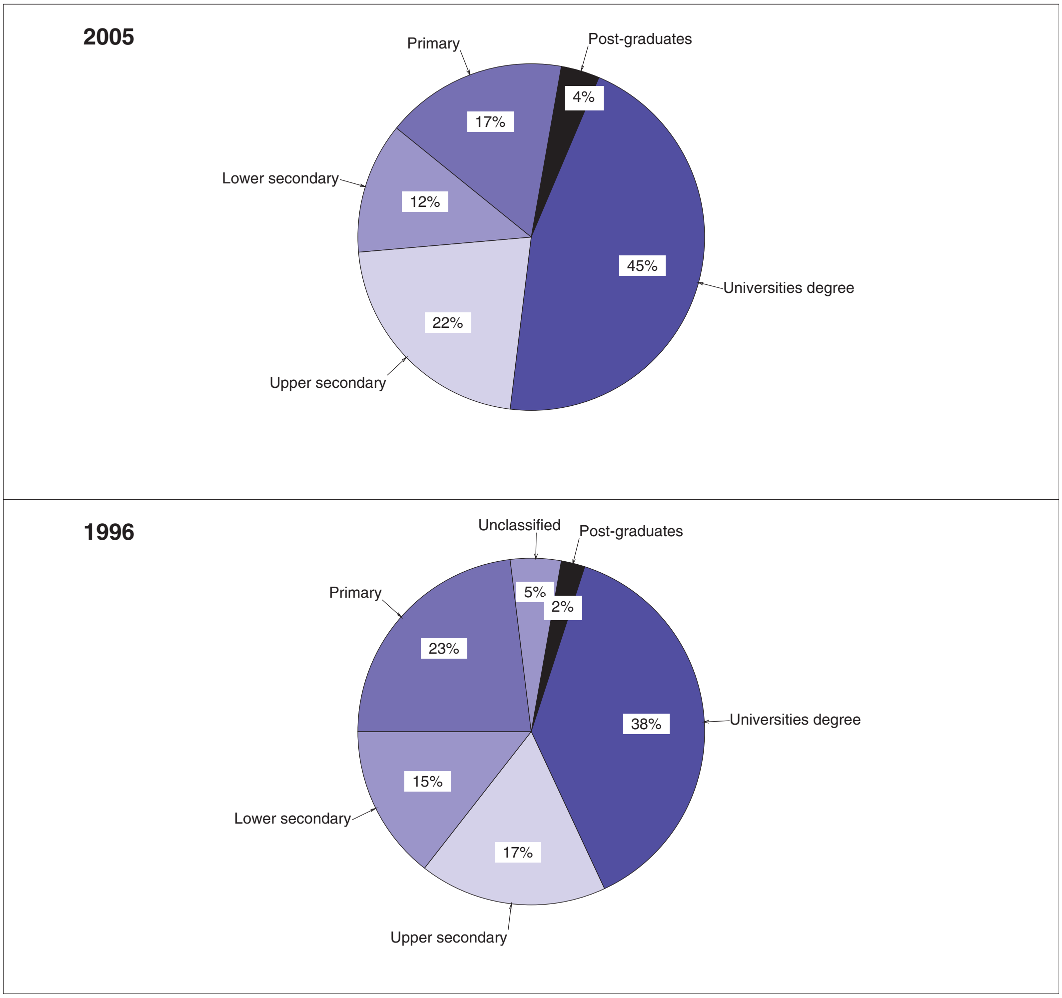
Changes to human resource management also include adopting a new system for careers, contracts and pay that will replace the current temporary measure of freezing automatic promotion and wage top-ups. The law to establish the new careers, promotions and salaries scheme has been in force since March 2008. The measures include reducing the number of employment contracts from the current seven to just two types: appointment by nomination for employees performing core state functions (judiciary, security forces, diplomats and criminal investigators); and a contract with very similar rules to the private sector for other civil servants. A key difference is that instead of nomination, which previously applied to all public servants and was for the whole working life, there will be a contract that can end, in line with practices in the private sector. Similarly, the number of careers has been reduced from 1 400 down to three – high-skilled staff (with tertiary education), administration clerk (with secondary school equivalent education) and support staff.

Changes to the remuneration system in the new human resource system include dropping automatic progression of salaries every 3 years that caused wage drift; reducing the number of salary scales from 30 to one; linking pay increase and promotions directly to performance evaluations; introducing fixed bonuses of 8-9% of the annual base salary. Bonuses will be paid to approximately 5% of staff who have the highest or second highest evaluations. Managers at the director general level have greater discretion over the personnel budget, including deciding how to allocate extra funds to pay increases, bonus payments or hiring new staff. The career, promotions and salaries law introduces bonuses and limits allowance increases rather than maintaining allowances as a fixed proportion of the salaries. Furthermore, the evaluation of services provided by ministries, which is a component of employee evaluations, came into force in January 2008. Finally, senior managers have been assigned 3 main criteria by the government for 2008: budget management, the reduction of delays in making payments to suppliers and their achievements in evaluation of employees.

As a whole, the reforms to human resource management represent an important step forward in improving the efficiency and effectiveness of the public service in Portugal and will help to reduce structural pressure on current spending. The government should not

Figure 2.6. **Public sector qualifications structure**

As per cent of public employment



Source: National authorities.

StatLink http://dx.doi.org/10.1787/342700562470

delay the practical implementation of these reforms; to facilitate implementation, provision of training should be considered to improve the managers' ability to adopt the performance evaluation system. This will help increase the return from the change and minimise the possibility that poor execution leads to dissatisfaction.

As well as contributing to fiscal consolidation, reforms to the public administration can also contribute to overall economic growth by improving the efficiency of public services. The government has introduced other complementary reforms that will strengthen the overall contribution made by the public administration to efficiency in Portugal, including promoting e-government (Box 2.3) and the SIMPLEX programme to reduce the administrative and regulatory burdens on business (Chapter 3).

Box 2.3. **E-government**

E-government is an important element of the public administration reform. The Agency for the Public Services Reform, within the Secretary of State of Administrative Modernisation (SSAM), executes and coordinates the e-government policy. All other ministries are also involved in the definition and implementation of e-government projects.

E-government initiatives include: introducing electronic processes (in some cases replacing paper processes, while in others they are an alternative to paper processes); introducing electronic identification; and implementing e-procurement. The process of removing legislative or regulation barriers to implementing e-government is ongoing. The changes aim to grant legal validity for electronic documents, in order to make them perfect substitutes for paper documents. Ensuring that access to the data is secure and that information sharing between public services complies with privacy rules is a main concern. Part of the process of moving towards electronic processes involves introducing electronic IDs. The goal is to give every citizen and firm a digital multi-identification authentication that could be used whenever they have to interact with each other or with the public services.[1] Meanwhile, the public administration should have the tools for a safe electronic communication between departments.

The implementation of e-government processes is expected to improve further the efficiency of public services and reduce costs, due to the elimination of duplicated processes, the replacement of paper by electronic processes, and the scale economies of shared services. For example, the online portal of Social Security (*Segurança Social Directa*) enables citizens and firms to submit information online, which can then be accessed by different Ministries such as the Ministries of Labour and Finance. Also the promptness and correctness of public responses to citizens and firms is likely to be improved, helping the competitiveness of the overall economy. Additionally, the enhanced sharing of information and greater transparency will allow for a better control of public services performance and of rules compliance by citizens and firms.

The number of government services online has increased, time and costs to users have fallen and, in some cases, public expenses have fallen. However, there is no global cost-benefit analysis for these projects yet. E-government expenditure must be justified through estimates of the expected costs and benefits of a project and a framework for evaluating outcomes. Such an approach would permit the proper assessment of expected returns on investment in e-government, improve accountability for achieved results and help to ensure that resources are being spent on the highest net gain projects.

The development of e-government could face some demand-side obstacles. In 2005, Portugal had a low percentage of households with a home computer (42.5%), compared with the OECD average (23 countries) of 59.8%. In the same year, the percentage of households with Internet access was 31.5%, in Portugal, and 50.4%, in the same group of OECD countries[2] and in 2006 the demand of e-government services was lower in Portugal than in EU27 countries.[3] However, the percentage of public services available online in Portugal was 60%, while in the EU25 countries the average was 48%.[4] There is a risk that only some private users will switch to e-government procedures meaning that the government will have to continue to provide simultaneously both e-government and traditional over-the-counter, services: which would increase costs. Low skills are constraining the demand for e-government services, since a significant part of the population is not able to use either computers or the Internet; and therefore government training and education programmes in this area are important complementary measures. However, the results will take some time to materialise. In the meantime, the government will have to maintain the traditional

Box 2.3. **E-government** *(cont.)*

front-offices, thus constraining savings in this area. In the short-term, the main cost savings from e-government will probably come from back-office services, if complemented by necessary reforms in the public administration.

E-procurement is being gradually adopted by the state. The aim of e-procurement is to decrease the cost of public acquisitions, by enlarging the set of potential suppliers and raising the transparency and efficiency of the process. The plan is to have a centre of e-procurement (*Central de Compras*) within each ministry. By December 2007, eight Ministries were already using their own centre, including two of the ministries that account for the largest proportion of public expenditure: the Ministry of Education (20 services and 312 schools are involved, with an average cost reduction of 14.2%) and the Ministry of Health (45 services are involved, with an average cost reduction on acquisitions of 21.7%).

1. The Electronic Certificate for firms is already implemented. For citizens, a "Citizen's Card" is being introduced. It will replace the existing identity card, taxpayer card, Social Security card, voter's card and National Health Service user's card, and will have a chip with digital certificates and other information. (See *www.cartaodocidadao.pt*.)
2. OECD Data Source – Statistics.
3. According to Eurostat the percentage of individuals who have used the Internet, in the last 3 months, for interaction with public authorities was 30% in the EU27 and 19% in Portugal. The percentage of enterprises which use the Internet for interaction with public authorities was 63% in the EU27 and 60% in Portugal. (In *http://epp.eurostat.ec.europa.eu/portal*.)
4. Data available on *www.planotecnologico.pt*.

Improving expenditure control

Pensions

Including pensions, social security payments increased by 3.9 percentage points of GDP from 1999 to 2005. This alone accounted for more than half of the total increase in the current spending-to-GDP ratio over the period. Pension expenditure on both private and public sector pensions accounts for around 75% of social security payments and is a big driver of this overall trend.[3] Pension growth reflects two main factors, the rise in the number of pensioners owing to population ageing and a rise in the average pension. Ensuring more moderate growth in pension expenditure is important for improving the fiscal balance and recent reforms to the system will help achieve this.

In October 2006, the government agreed with social partners on a new framework for the general social security sub-system. This reform was enacted in 2007 and the main features of the reform have also been introduced in the civil servant system.[4] The general reform includes four principal measures: a larger financial penalty for early retirement; a new rule for updating pensions; bringing forward the date of transition to a new pension calculation formula; and introducing a new sustainability factor that adjusts the pension payment for rising average life expectancy (Box 2.4).

These changes are a considerable step towards tackling a major underlying structural driver of current spending growth. It will serve to underpin fiscal consolidation in the medium term and contribute to the long-term sustainability of public finances in Portugal. The European Commission and official estimates of the effect of the reform is that it will reduce the deficit in the social security account by 4 percentage points of GDP by 2050, mostly due to expenditure reductions but still leave a gap of 6% of GDP in 2050 (Figure 2.7). However, simulations using the Bank of Portugal's MISS model[5] suggest that savings could be higher depending on worker behaviour (Bank of Portugal, 2007). In particular the

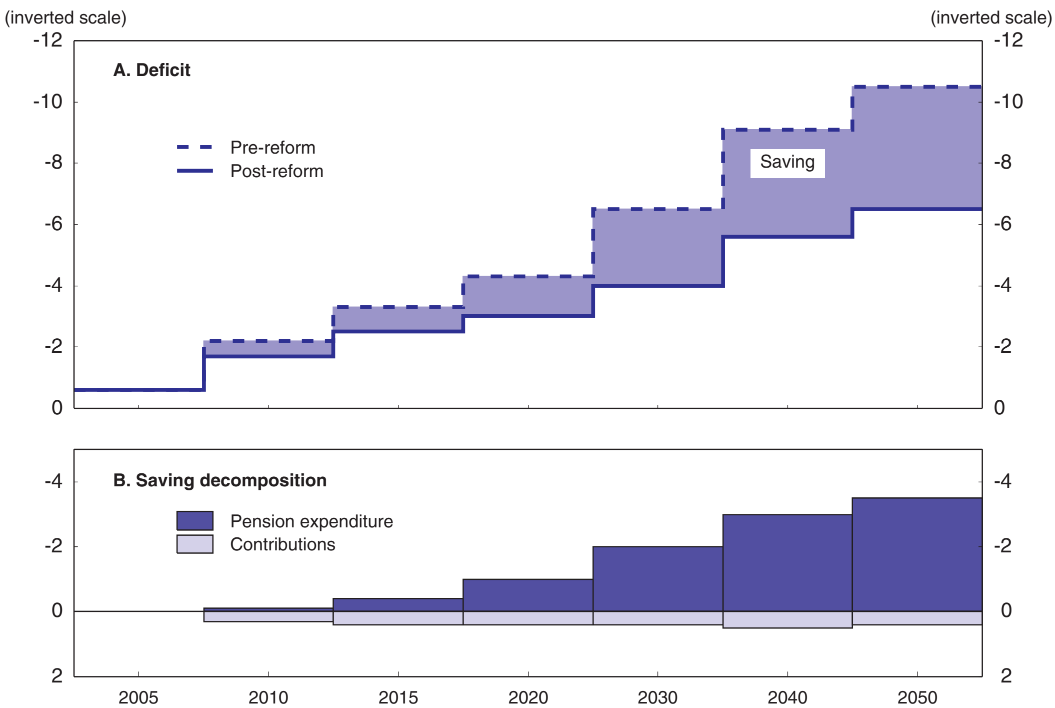
Box 2.4. **Pension reform measures**

The financial penalty for early retirement was raised from 4.5% per year to 0.5% per month (or 6% per year on an annual basis). This rule is in force as of 2008 in the general system and from 2015 it will be extended to the civil service system. A new updating rule was introduced, which removes discretion from updates by using a formula that is a function of past CPI, real GDP growth and the pension level. The update rule is progressive in that updates of lower level pensions are greater than for higher level pensions for a given level of the CPI and GDP growth. If GDP growth is below 2%, only the CPI is used for updating pensions. In 2002 the formula for calculating pensions was changed from taking account of only the best 10 out of the last 15 years of a career to taking account of earnings over the entire contributory career.* This was due to be introduced in 2017 but was brought forward to 2007 for the general system and 2008 onwards for the civil service system. A sustainability factor was introduced in 2008 and involves multiplying the pension formula by a penalty factor equal to the ratio of life expectancy at age 65 in 2006 and life expectancy at age 65 in the year before retirement.

* Decree Law 35/2002.

Figure 2.7. **Pension deficit and expenditure pre- and post-2006 reform**

As per cent of GDP



Source: Ministry of Labour and Social Solidarity and Ministry of Finance.

StatLink http://dx.doi.org/10.1787/342740765510

Commission results are consistent with all workers being prepared to accept the financial penalty of the sustainability factor and retiring at the legal retirement age of 65. At the other extreme, if everyone postpones retirement until the sustainability factor cancels out, then the deficit would be reduced by approximately 7 percentage points. Even in this extreme case, however, a social security deficit would still occur in the coming decades, suggesting that further pension reform may need to be carried out.

Health

Health is a large component of government expenditure, and spending developments in this area have important implications for the overall fiscal balance and its evolution. In 2005, public current expenditure on health was 14.9% of general government total outlays; and public total expenditure on health was 7.4% of GDP.[6] Achieving expenditure control and efficiency in this sector faces a number of challenges, including pressures related to the ageing of the population as well as rapid price inflation associated with technological improvements and with the fact that suppliers have a much stronger role in determining what is consumed than for services more generally. Increasing efficiency and improving expenditure control has potential for improving health outcomes, by saving resources that can then be utilised elsewhere in the health sector to deliver more and higher quality health services.

To improve efficiency, expenditure control and health outcomes, a reform of the health sector was launched in 2002. The reform includes: reorganising hospitals; changes in the pharmaceuticals payments regime; liberalizing ownership of pharmacies and allowing for new pharmacies within hospitals; the reform of primary health care; the implementation of the long-term care network (mostly for the elderly, and also the chronically ill); and improving the management of human resources for the sector.

The reforms implemented so far have had a notable impact on government health expenditure and also some positive effect on efficiency, with growth in expenditure on the National Health Service (SNS – *Serviço Nacional de Saúde*) decreasing from 7.8%, in 2004, to 4.9% in 2005, and 0.3% in 2006. Reorganizing the hospital services network,[7] changing the business model for hospitals and adopting some measures to reduce public expenditure on pharmaceuticals have been the main factors contributing to this.

The enterprise-hospitals (Box 2.5), in particular, exhibit evidence of improved efficiency that has not come at the expense of decreasing quality and access. In 2006, total hospital costs decreased by 1.3% and production increased (*e.g.* consultations increased by 4% and surgeries by 3.6%). However, despite these cost reductions, and apparent efficiency gains, the hospitals still made a loss. Consequently, in 2006, debt owed to suppliers increased 14% (only taking account of hospitals that were enterprises in 2005 and 2006, and so could be compared). From 2005 to 2006, the average payment duration increased from 246 to 478 days.[8] Although interest is not paid on supplier debt, it is likely that suppliers incorporate the cost of payment delays in their product prices. The increase in payment delays is also likely to undermine the bargaining position of hospitals when negotiating supply contracts in the future. To ensure that hospitals are not compromised in supply negotiations and/or paying higher prices, the government should, provided hospitals are efficient, ensure that prices continue to be fixed at market prices so that hospitals do not make systematic losses.

Determining whether the government is receiving an efficient service in return for its payments to the hospital sector requires effective evaluation and this could be improved. Despite the relevance of global figures for fiscal control, it would also be important to continue to analyse data on the performance of each hospital to allow benchmarking. A previous obstacle to this has been removed by advances in benchmarking techniques

Box 2.5. **Enterprise-hospitals**

The 2002 reform created three categories of public hospitals: hospitals SA (*Sociedade Anónima, i.e.* public corporations under the corporate law, 100%owned by the state); public hospitals (SPA) (within the public administration); and public-private partnership (PPP) hospitals (OECD, 2004). In 2005, a new legal framework was implemented, transforming the hospitals SA into enterprise-hospitals (EPE – *Entidade Pública Empresarial*). At the same time, some public hospitals were transformed into enterprise-hospitals and others were organized as hospital centres,* also with the legal status of enterprise-hospitals. One of the rationales for the recent change in the legal status of hospitals SA into enterprise-hospitals was to allow greater involvement of the Ministry of Health and the Ministry of Finance in strategic planning for hospitals, in order to improve the management of the national health system. EPE status confers an autonomous model of institutional organisation within the public central administration. The Minister of Health is responsible for approving the strategic plans and guidelines for the enterprises-hospitals. Together, the Ministers of Health and Finance are responsible for approving enterprise-hospital annual budgets as well as the production contracts (establishing production and prices), accounts, and investments, and for nominating their management boards. The management boards are responsible for managing the hospital according to the approved plans. The acquisition of goods and services is done under private contracts law. The enterprise-hospitals contract all new workers in accordance with private labour law, while workers that have the status of civil servants can retain it.

* The hospitals centres (*Unidades locais de saúde*) result from the merger of hospitals that provide different type of services (full service, secondary care) in one unique enterprise, allowing for a more articulate management.

which make it possible to control for the differences in the population under care. Benchmarking would provide an important tool for improving efficiency and controlling public expenditures on health, without decreasing the quantity and quality of services.

Comparing performance across hospitals is also complementary to the transfer of management responsibilities from physicians and nurses to professional management which was introduced in enterprise-hospitals. These institutions have large budgets and senior managers have significant autonomy. It is important that managers be accountable and that they have incentives for better performance. Consideration should be given to linking the earnings of senior managers to performance targets. The government should also allow a sufficient "*numerus clausus*" in medical schools and ensure that the procedures for recognising foreign medical degrees in Portugal are neither too long nor too costly,[9] in order to ensure that human resources are sufficient to meet the demand and avoid mistakes caused by fatigue and paying costly overtime rates owing to staff shortages.

A significant component of the public health budget is spent on pharmaceuticals and reforms have been taken to transfer more of their costs from the public sector to households, by introducing a reference price system in the co-payment.[10] In 2005, the SNS per capita expenditure on pharmaceuticals increased 2.5%, while the private per capita expenditure increased 5.5%. In 2006, the SNS expenditure on pharmaceuticals decreased 1.4%, and, between January 2007 and September 2007, compared with the same period of the previous year, the fall was of 1.7%. The liberalisation of the ownership of pharmacies helps to lower entry barriers for new firms and is an important complement to the liberalisation of retail pharmaceuticals prices approved in March 2007 that allows pharmacies to give price discounts to consumers, where previously prices were at fixed regulated levels. A complementary measure is to allow pharmacies within hospitals to sell to the general public rather than patients only. This should also improve competition and lead to lower prices. The law to introduce this has been approved; but, in March 2008, it was not yet implemented and was facing legal challenges from the retail pharmacists.

Although out-of-hospital pharmaceutical costs have fallen, the costs of pharmaceuticals used in hospital have continued to increase, rising 3.1%, in the first semester of 2007, compared with the same period of the previous year. In order to contain this trend, the state implemented new rules for the use of pharmaceuticals within hospitals, controlling the range of products available. This can potentially prevent the use of expensive pharmaceuticals for which there are cheaper alternatives. However, it is also important that the new rules do not block the purchase of products with high positive net benefits, despite their costs. Since 2002, the government has used a single buying agency that negotiates directly with the suppliers, including pharmaceutical companies. If the supplier is on the single agency catalogue, the hospitals that are still part of the public administration have to buy through the catalogue; otherwise, hospitals can negotiate individually with the supplier (the enterprise-hospitals are free to negotiate whether the supplier is on the catalogue or not). The single buyer agency can help to lower costs, but hospitals should be free to purchase elsewhere if they can find a lower price.

The net effect of raising household pharmaceutical co-payments on the overall budget is lower than the total payments made by households because the individual income tax (IRS) allows individuals to deduct 30% of their out-of-pocket expenses on health. Such deductions are widespread in EU countries (Joumard, 2001). The budget should report total resources applied to health, including tax deductions.[11] Tax expenditures such as deductions reduce tax receipts, and hence are equivalent to the use of public resources. Including tax deductions in the health budget would increase transparency in the fiscal accounts in this area so that the full effect of health expenditure on the fiscal position and tradeoffs are clearer. It would be useful to assess who is benefiting from the deduction and what type of services and goods are being subsidized, and compare that with alternative uses of public resources, to ensure that expenditure allocation is really meeting government policy goals in health.[12]

The focus of the health reform has now turned to primary health care and long-term care. A global reform of the primary health care system is in progress, splitting the medical and nursing services into small and flexible units, paid according to production, while the administrative tasks are concentrated, in order to gain scale economies and to improve coordination. The increase in long-term care services, justified by the ageing of the population, is in an early stage of implementation. While the reform of the primary health care is expected to help fiscal consolidation, the implementation of long-term care services will likely increase public expenditures on health, since the ageing of the population will require extra government resources to meet needs. However, it is important that expenditure increases be offset by other measures to ensure that they do not contribute to the overall rapid growth in the current expenditure-to-GDP ratio as occurred in the past. Explicit trade-offs need to be made and age-induced expenditures need to be accompanied by cost saving measures, expenditure cuts or revenue raising efforts.

State-owned enterprises

Stated-owned enterprises (SOEs) account for a significant proportion of national economic activity. In 2006, SOE value added was 3.7% of GDP and SOEs accounted for 2.5%

of total employment. Despite privatisations since 1989, there are still SOEs operating in many sectors, including transport, infrastructure management, health, banking and insurance, water and regular mail services. The overall size of the SOE sector and its broad presence across sectors means increasing SOE profitability and efficiency is a powerful tool to improve the fiscal position. Because these enterprises also provide important inputs to the economy, gains in SOE efficiency would also have positive effects on the cost-competitiveness of other sectors and the overall economy. Several issues need to be addressed to improve efficiency and increase profitability. First, greater effort needs to be made to benchmark SOE efficiency and determine the cause of losses in some firms. Second, there should be greater transparency in the effect of SOEs on the government's accounts. Third, governance arrangements for SOEs should be improved.

The total financial flows from the state to SOEs, including both operational and capital flows, were € 704 million in 2006. SOEs earn revenue from user charges and some also receive subsidies in return for public services that they supply. After receiving total operational subsidies of € 631 million, total non-financial SOEs made an operational loss of € 230 million in 2006. However, individual SOE financial performance varies considerably. Some SOEs, particularly the national and urban underground rail companies, are making large losses, while other SOEs are profitable. The cause of losses is unclear. The losses, for SOEs that have to provide public services, could be a result of under-subsidisation or inefficiency, or both. For these sectors, even after receiving public subsidies and other compensation, operational results have been highly negative and the situation deteriorated from 2005 to 2006. It is essential to assess what the causes of the operational losses in public services are and this requires determining whether SOEs are under subsidized and/or inefficient. To evaluate efficiency, the state should benchmark SOE company performance against the private sector and internationally. To do this benchmarking requires improved evaluation, through clear and transparent information about SOE accounts and operations.

Recent reforms introduced by the government should help to improve the information available for evaluating SOEs. In March 2007, the Council of Ministers approved a resolution that established principles of good governance for SOEs, based on the 2005 *OECD Guidelines on Corporate Governance of State-owned enterprises*.[13] The conclusions of a preliminary evaluation report in July 2007 showed that only 6 out of 78 SOEs provided all the information required by the Ministry of Finance Directorate-General of the Treasury and Finance (DGTF).[14] The information provided included management, operational and financial data, and is to be published on the website of the Ministry of Finance. It is too early to fully evaluate the results of the resolution but the report shows that there is a lot to be done.

In spite of recent progress, transparency in the public accounts still needs to be improved, most notably regarding the provision of information on the net worth of the public sector as whole, and the SOE sector, in particular. Over the past few years, and as a result of the budgetary crisis, the focus has mostly been on the general government balance. The national accounts methodology implies that the latter does not reflect the evolution of the SOEs financial position. In order to improve information and transparency, it would be appropriate to have a more comprehensive annual report on SOEs financial performance, on a consolidated basis. The report should also include all debt owed by SOEs, including debt both guaranteed and not guaranteed by the government. Although the government may not guarantee the debt, it still affects the net worth of the SOE asset and the income flow after interest that the government can expect to receive from the SOE.

A number of entities formally classified as public corporate entities (*EP – Empresa Pública* or *EPE – Entidade Pública Empresarial*) have been created as a way to gain managerial flexibility. However, some of these entities are considered as part of the general government sector on a national accounts basis. To improve transparency, it would be important to have clear public accounting rules about whether or not public entities are part of the government sector, based on their degree of autonomy and the nature of their activities. In particular, the government should consider bringing into line the rules used in the public accounts for defining a SOE with those used in the general government national accounts. This implies clearly distinguishing between enterprises that sell to the market, which should be outside the general government sector, and enterprises that do not, which should be incorporated in the general government sector.

Improving governance arrangements would also help to increase SOE efficiency. SOEs usually have a *soft budget constraint* that eliminates the risk of bankruptcy, no matter how inefficient their management (Estrin, 1998). This exacerbates the agency problem the state owner faces with SOE managers and it is important that the state uses the appropriate instruments in order to solve this problem. The financial reference framework for 2008 includes some quantitative targets, for example a minimum improvement of the Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) margin of 10% and a maximum increase of net debt of 85% of the increase of assets (*i.e.* the increase in assets can be matched by a maximum increases of 85% in debt funded liabilities).[15] The focus is on intermediate targets, such as cost reduction, improvement of productivity and financial sustainability, rather than on profit maximization. Profit maximisation rather than intermediate targets should be the objective for SOEs as this allows managers greater discretion to achieve the desired outcome of the state. The new legislation allows Ministers to consider compliance with goals in the evaluation of the executive public managers, and to link their remuneration to results.

Government reforms to improve governance of SOES started in March 2007 and continued in August 2007. The measures introduced strengthened financial control mechanisms and special information reporting duties for public companies. Three levels of management planning were established: the Council of Ministers is responsible for strategic planning for all the SOEs; the Minister of Finance and the Minister of the respective sector are jointly responsible for general planning for specific sectors, and also responsible, together with the DGTF (exercising shareholder functions), for enterprise specific planning. Within the Ministry of Finance, the government also established the Cabinet for Monitoring SOEs, Public-Private Partnerships and Concessions (the GESAPC), to strengthening the supervision and control of the SOEs.

The dual system of joint ministerial responsibility has the advantage of enhancing the balance of financial goals and public service objectives, but conflict of interests could rise as the same state departments are simultaneously clients, shareholders, regulators, and auditors. In order to improve governance of the overall sector, the ownership interest (Minister of Finance) should be separated from sector policy (Minister of the sector) to eliminate conflicts of interest. The concentration of SOE ownership in one ministry would improve consistency of the ownership policy, and the acquisition of expertise for supervising and controlling the SOEs management and performance. The SOEs should be responsible to the Minister of Finance for maximising the government's return subject to the regulatory constraints set down by the sector regulator. The evolution towards a centralised model of ownership is complementary to both increasing liberalisation and regulatory changes in markets such as utilities or transport (OECD, 2005). For SOEs that partially provide public services or are monopolies, an independent regulator setting prices for those public or monopoly services may help to distinguish losses caused by inefficiency from losses caused by prices set below cost and under-subsidisation, thereby making it easier for the Minister of Finance to monitor performance of the SOE.[16] For some enterprises owned and managed by the state-owned holding company, PARPÚBLICA, this separation already exists.

Revenue measures and public accounts management

Revenue changes and tax administration

The consolidation programme relied heavily on revenue measures from 2005 to 2007. Increases in current revenue contributed to 60% of the decrease in the fiscal deficit from 2005 to 2007, with current receipts growing from 40.1% of GDP in 2005 to an estimated 42.2% of GDP in 2007. Tax changes and improvements in tax administration have both contributed to the increase in revenue. Tax increases include the increase in VAT from 19 to 21% in July 2005, the increase in tax on oil products and tobacco and the creation of a new income tax bracket with a rate of 42% for incomes above € 60 000. Improvements to tax administration include: reducing tax fraud and evasion through a variety of measures, such as increasing the number of tax inspectors, publishing a tax debtors list, and making greater use of IT for auditing and cross-checking purposes. At the same time, efforts have also been made to improve tax administration efficiency and reduce the administrative burden on tax payers.

Public accounts management and transparency

Rigorous control of the fiscal position requires the government to provide transparent, comparable financial information that is regularly monitored and analysed. This can help to ensure that budget obligations are met and that the government achieves its goals and can take measures to correct over-spending and improve expenditure efficiency in a timely fashion. The government has taken important steps to significantly improve the public accounts and how they are monitored. Information quality has been notably improved by: providing historical and projection information in the Stability and Growth programmes (SGP) for government accounts on the internationally comparable System of National Accounts (SNA) basis; introducing a human resources database for the public administration; and imposing stricter reporting obligations on sub-national governments coupled with financial penalties for non-compliance.

Since 2006, quarterly government accounts, on a public accounts basis, have been available across the whole government sector at both the national and sub-national levels on a consistent and comparable basis, including information on large spending areas such as the National Health Service and civil servant pensions. In 2007, the National Statistics Institute (INE) and the Bank of Portugal introduced quarterly government accounts and public debt information on an SNA basis. In addition, the position of ministry-level financial controller has been introduced to strengthen financial control over budget implementation and assessment. Part of the duties of the financial controller are to provide monthly updates of budget progress in their ministry, highlight areas of significant budget risk and propose ways to improve public spending quality. A budget technical support unit has also been set-up to provide technical support to the Parliamentary Budget and Financial Committee on budget matters such as budget drafting and monitoring implementation.

Major improvements have been made to improve fiscal accounts transparency but consideration could be given to additional reporting. These include reporting global expenditure in areas such as health, including traditional spending items and tax expenditures such as tax deductions for private health expenditures, and also reporting a fully consolidated government debt position including all debts owed by SOEs, whether they are guaranteed by the state or not.

Using fiscal rules to further improve medium-term public finance management

An important asymmetry that makes managing the fiscal balance challenging in all countries is that policy can easily set expenditure on a path permanently inconsistent with GDP growth whereas policy changes tend to only temporarily shift revenue growth away from GDP growth. This asymmetry means that the probability of generating large fiscal deficits is high as policy decisions can easily shift the relative balance between revenue and spending growth and lead to rapid changes in the balance.

There is evidence of this asymmetry in Portugal where the fiscal deficits in the first half of the decade were ultimately caused by structural policy settings in areas such as pensions. These settings generated spending growth well beyond GDP growth and even revenue growth, including fiscal drag that allowed revenue to grow as a percentage of GDP. To help counter this natural policy asymmetry in fiscal policy and secure the fiscal consolidation in the medium-term, the government should adopt an expenditure rule to complement the budget balance rule imposed by the Stability and Growth Pact (SGP) and measures it is already taking to improve the budget management framework. OECD cross-country work has found econometric and historical evidence that fiscal consolidations are more successful when a budget balance rule is accompanied by an expenditure rule (Guichard *et al.*, 2007).[17] There are a number of reasons for the success of expenditure rules, including not only that they exclude cyclically volatile revenues but also that they can be (and often are) designed to let expenditure stabilisers work in a downturn and to save windfall gains during an upturn (Anderson and Minarik, 2006); they are typically more transparent than all but the simplest budget balance rule; they allow spending ministers and ministries to be held accountable (Atkinson and van den Noord, 2001); and they can make the availability of financial resources predictable for policymakers and programme managers.

An expenditure rule needs to be carefully designed and accompanied by the right institutional framework. OECD experience suggests there is no one-size-fit-all rule for all countries but successful rules have several features. These include that they are easy to understand, manage and monitor. They also allow automatic stabilisers to work, make spending ministers accountable for their expenditure and are flexible enough to cope with the business cycle. To deal with the cycle, it may be preferable to simply exclude from the rule cyclical spending items such as unemployment benefits, rather than using an over-the-cycle rule, such as that used in the United Kingdom. This is because an over-the-cycle rule is complicated to implement and monitor because of uncertainties in estimating potential growth and the cyclical position of the economy.

Expenditure rules should be multi-year, although the political economy considerations suggest that the electoral mandate of the government is the longest period that can be realistically achieved as a new government would always want to reserve the right to change the rule. Nevertheless, a rule that is associated with good fiscal management is likely to be maintained even if there is a change in government as the political cost of changing such a rule would be high.

An expenditure rule can potentially lead to allocative inefficiency as it can bias spending towards items that are politically sensitive and difficult to cut (Sutherland *et al.,* 2005). To counter this, some countries have excluded capital spending from the expenditure rule as is the case for golden rules in Germany and the United Kingdom. However, excluding capital expenditure creates its own allocative bias towards physical capital investment and away from human capital investment. It may be preferable to include capital spending in the expenditure rule and rely on other framework tools to ensure allocative efficiency.

International experience suggests that a rule would be complementary to the institutional reforms already made or underway in Portugal, including introducing greater transparency and monitoring in the public accounts, reforms to public sector management to foster greater efficiency and accountability in the public sector and moving towards performance budgeting. Transparency in public accounts is vital for the success of any expenditure rule in ensuring a durable consolidation, as European experience shows that fiscal rules tend to induce greater use of one-offs and creative accounting to get around them (Koen and van den Noord, 2005). This highlights that introducing these rules is also a political economy issue: for the rule to be successful, there must be a clear commitment to the budget discipline that it implies.

Experience in OECD countries indicates that for an expenditure rule to operate successfully it is also important that the budget management framework incorporates *ex post* assessment of expenditure performance (Guichard *et al.,* 2007). The Portuguese authorities' programme budgeting project, which is being phased in from 2006 to 2010, will help to assist *ex post* assessment as well as providing a tool for achieving allocative efficiency across different programmes and inter-temporally (Box 2.6). The intention of the project is: to structure the budget according to programmes defined by the government's policy priorities; and to ensure that these programmes will have objectives, targets and indicators attached to them. Moreover, performance data will be used to draft and implement the budget and assess policies and the services used to achieve them. The project is a government priority and successfully implementing it would help improve the groundwork for introducing an expenditure rule.

For expenditure and other fiscal rules to be effective and secure fiscal consolidation, it is also important to employ prudent budget assumptions, particularly about economic growth (Joumard *et al.,* 2004). Official growth forecasts used in budgeting have been found to have an optimistic bias in several EU countries (Jonung and Larch, 2006). The *OECD Economic Survey of Portugal 2006* also showed that official forecasts over-estimated GDP growth in Portugal in the early 2000s. This bias can arise from a variety of sources, including analytical errors, but political influence is also a possible cause.

Consideration could be given to reducing forecast bias by establishing a committee of experts in macroeconomics and forecasting to review and suggest improvements to the forecasts to be used in the Budget. By involving the committee in approval of the forecasts, greater expertise would be brought to the projections. Furthermore, the committee process

Box 2.6. **The programme budgeting project**

The government launched the programme budgeting project in 2006, as part of the fiscal consolidation process, with the objective of establishing a renewed budgetary framework that is able to face the two major tasks of ensuring budgetary discipline and increasing the quality of public finances, by improving the efficiency and effectiveness of public spending. In order to benefit from external technical expertise, the Minister of Finance has appointed a Committee for Programme Budgeting, chaired by an independent Portuguese economist and including a budget specialist from the OECD. The Committee wrote an interim report in May 2007, which the Government presented to the Parliament as work in progress. The final report is due in 2008.*

The project aims at renewing the budgetary framework by introducing three major innovations to current arrangements: the evaluation of outcomes, a multiyear budgetary framework, and an expenditure rule. These innovations are consistent and coordinated with the broader reform in Public Administration, in particular the new performance assessment system and more generally the new human resources management framework.

International experience shows that such broad changes in budgeting take some years to design and implement, owing to information system requirements and the need to learn by doing. With that in mind and following a suggestion by the Committee, in February 2008, the Minister of Finance put in place a small full-time working group in charge of implementing pilot programmes in the state budget for 2009. The working group, coordinated by a private sector economist is currently working with the Ministries of Health, Higher Education and Foreign Affairs, in order to develop pilot programmes for these areas. The execution of these pilots, both in terms of efficiency and effectiveness, will start to be monitored in 2009.

As a complement to this project, the Ministry of Finance engaged the OECD to produce a Budget Review, which started in January 2008. A preliminary report was due in April, followed by a peer review; and the final report is to be released in the summer of 2008. The OECD will make its recommendations for improvements based on a comparison of current budgetary procedures in Portugal with best international practice.

* See: *www.min-financas.pt/download_en.asp?num_links=0&link=inf_economica/ProgrammeBudgeting.pdf.*

would make political intervention more difficult as the credibility of those on the committee would be at stake (Bogaert *et al.*, 2006).

Concluding remarks

Portugal has made very good progress in reducing the fiscal deficit, using a wide ranging programme of structural reforms that will continue to pay dividends well into the future. Challenges that remain to anchor results achieved and reduce the deficit further include: fully implementing the human resources reform in the public administration; improving efficiency in the SOE sector; further closing the financing requirement in the contributory pension deficit; and tackling ongoing pressures of ageing on the health budget. Finally, further strengthening the budget framework in Portugal, including by introducing an expenditure rule, would help to secure the notable achievement in fiscal consolidation, contributing to medium-term macroeconomic stability and hence economic growth (Box 2.7).

Box 2.7. Main recommendations for securing further fiscal consolidation

Public administration reform

- Ensure the full implementation of the new human resources system in the public administration. Introduce training for managers to enhance the human resource management ability required in the new performance based system.
- Introduce programmes to assist employees in the mobility pool in finding new employment in the public or private sectors, *e.g.* through retraining and job search support, to increase the effectiveness of the pool.

Pensions

- Monitor and evaluate future developments and, if appropriate, take measures to ensure sustainability in the contributory pension schemes.

Health

- Strengthen benchmarking across hospitals to improve efficiency and control of public expenditures on health. Ensure that hospitals are paid market level prices to help prevent that they make systematic losses that would compromise them in supply negotiations and/or lead to higher input prices.
- Increase competition between pharmacies.

State-owned enterprises

- Increase benchmarking and evaluation of SOE performance and efficiency and strengthen the transparency of information about their financial situation.
- To improve governance of SOEs, consider separating the ownership interest (Minister of Finance) from regulation (Minister of the sector and/or sector regulators) to eliminate conflicts of interest. Make SOEs responsible to the Minister for achieving final objectives rather than intermediate targets such as cost cutting, to increase SOE manager autonomy.
- Link top SOE manager pay to performance-based criteria consistent with the overall objectives of the SOE.

Public accounts transparency

- Introduce further reporting to increase transparency, including reporting total government debt inclusive of total SOE debt (whether guaranteed by the state or not) and global expenditure on health inclusive of traditional expenditure items as well as tax expenditures.

Medium-term public finance management

- Introduce an expenditure rule to help maintain spending discipline and prevent a return to large fiscal deficits.
- Enhance public scrutiny of the economic and financial forecasts used in the budget to avoid potential bias.

Notes

1. This estimate is derived from simulations where governments aim to reduce debt to zero by 2025 to prepare for ageing population pressures. Political loss is measured as a weighted sum of the speed at which the fiscal balance has to change and the size of the required adjustment. The greater the speed of adjustment, the higher the loss because abrupt swings in the fiscal policy can destabilise the economy and this is unpopular with the electorate. The larger the size of the required deficit adjustment, the higher the political cost because the balance between taxes, entitlements and spending will be shifted by more, raising greater opposition in the population

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that benefits from the current arrangements. If a government delays attempts to meet its fiscal consolidation target the delay will raise political costs by increasing the future required speed and size of the adjustment of the fiscal position to meet the target.

2. From July 2008, the normal VAT rate will decrease to 20%.
3. Between 2003 and 2005 social security payments increased 1.2% of GDP of which 1% was due to pensions.
4. The reform to the general scheme was enacted in Law No. 4/2007 of 16 January 2007 and Decree-Law No. 187/2007 of 10 May 2007. The rules for the civil servant system were changed to converge towards the main features of the general social security system by Law No. 52/2007 of 31 August 2007 and Law No. 11/2008 of 20 February 2008.
5. See Cunha and Pinheiro (2007) for a detailed discussion.
6. Source: *OECD Health Data* 2007.
7. The reform aims to centralise some services, such as emergency rooms and maternity services, reduce the number of full service hospitals and transform small local hospitals into health units for less complex secondary care or palliative care. Groups of different units are organised as "hospital centres".
8. The average values hide differences between enterprise-hospitals. From 2005 to 2006, 29% of total enterprise-hospitals were able to diminish the payment time, while the rest increased it. In 2006, 19.4% of total enterprise-hospitals took more than 1 000 days to pay debts. (See "*Relatório de Acompanhamento dos Hospitais EPE em 2006*", available in *www.hospitaisepe.min-saude.pt*.)
9. Importing foreign medical staff is not a perfect substitute for Portuguese trained medical staff. Eastern European physicians are the most probable candidates to work in Portugal and there are additional language costs involved in employing them (Minister of Health interview with *Semana Médica No.* 406, September 2006).
10. Before the reform, the public co-payment for any medicine was calculated as a fixed percentage of the price of that medicine; now, it is the same percentage but of the price of the substitute generic medicine, which is usually lower. This way, the public co-payment is fixed, in line with the price of substitute products, and the patient pays the difference if he decides to buy (or the doctor asks him to buy) more expensive medicines.
11. In 2005, tax deductions were € 545 million, representing 5% of the total public expenditure on health of € 10 993 million (*OECD Health Data* 2007). Tax deductions were available for health expenses and health insurance expenses. For more detailed figures, see *www.dgci.min-financas.pt/pt/divulgacao/estatisticas/estatisticas_ir/*.
12. This type of deduction benefits more those with higher incomes, who are more highly taxed. Households with very low income, who are not taxed, will not benefit from this deduction even if they have out-of-pocket health expenditures.
13. Also in March 2007, the law on the new *Statutes of Public Manager* was approved (Decree-law No. 71/2007). This law followed the 2005 *OECD Guidelines on Corporate Governance of State-owned enterprises.*
14. The six SOEs that provided all the information required were: AdP – Águas de Portugal, SA; CTT – Correios de Portugal, SA; REFER – Rede Ferroviária Nacional, EP; Metro – Metropolitano de Lisboa, EP; EDIA – Empresa de Desenvolvimento Infraestrutrural do Alqueva, SA; and EDM – Empresa de Desenvolvimento Mineiro, SGPS, SA. (18 provided almost all the information; 35 provided the information partially; and 19 did not provide information.)
15. Definição do quadro de referência financeiro para os instrumentos previsionais de gestão (IPG's) do exercício de 2008 do Sector Empresarial do Estado(SEE), in *www.dgtf.pt*.
16. For example, an independent regulator could set the total price of a service such as underground rail rides to the public based on an analysis of costs and international benchmarking, the Minister of the sector, as the client, would decide how much of that total price they wanted to subsidise and the Minister of Finance, as owner, would require the company to maximise its profit subject to those constraints.
17. Several OECD countries use or have used expenditure type rules including Germany, Finland, Japan, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States. (See Jourmard *et al.* (2004) for further details.)

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ANNEX 2.A1

Status of the main budgetary consolidation measures

	Impact from	Legislation stage	Implementation progress
		REVENUE	
Taxes on income and wealth			
Measures tackling tax evasion and improving the efficiency of Tax Administration	2005	Several administrative measures	Under implementation
New income tax bracket of 42% for incomes above € 60 000	2006	Article 68 of Budget Law 2006 (Law nº 60-A/2005, 30 December)	Implemented
Limiting the deductibility of capital losses (IRC)	2006	Decree-law 211/2005	Implemented
An increase of the coefficient of taxation for independent workers	2007	Article 46 of Budget Law 2007	Implemented
The special deduction for pensioners (IRS) was reduced since 2006	2007	Article 53 of Budget Law 2006, Article 46 of Budget Law 2007 and Article 42 of Budget Law 2008	Under implementation
Taxes on Production and Imports			
Increase in VAT rate from 19 to 21%	2005 (July)	Article 18 of Law 39/2005	Implemented
Update of oil tax above inflation rate	2006	Article 49 of Budget Law 2006 (Law nº 60-A/2005, 30 December)	Implemented
Update of tobacco tax above inflation rate	2006	Article 83 of Budget Law 2006 (Law nº 60-A/2005, 30 December)	Implemented
		EXPENDITURE	
Public administration reform			
PRACE (Programme for Restructuring Central Public Administration)	2006	Council of Ministers Resolution 39/2006, 21 April Decrees-Law 201 to 215/2006, 27 October Decree-Law 200/2006, 25 October	Implemented
The creation of the Company for the Shared Management of Public Administration Resources (GeRAP) and the National Public Purchasing Agency (ANCP), for managing public resources and procurement	2007	Decree-law 25/2007, 7 February Decree-law 37/2007, 19 February	Implemented
Rule "two for one", aiming at hiring at most one employee for every two leaving the public administration	2006	Council of Ministers Resolution 38/2006, 18 April Decree-Law 169/2006, 17 August	Implemented
Special mobility scheme	2007	Law 53/2006, 7 December	Implemented
Local and regional finances	2007	Law 2/2007, 15 January Framework Law 1/2007, 19 February	Implemented
Social security reform			
New rules for calculation pension amount and updating pensions; enhanced financial penalty for early retirement and incentives to extend working life	2007	Law 4/2007, 16 January Decree-Law 187/2007, 10 May	Implemented
CGA sub-system becomes equivalent to Social Security	2008	Law 52/2007, 31 August	Under implementation

	Impact from	Legislation stage	Implementation progress
Unemployment benefit: the duration depends now also on the contributory career; the unemployed must actively search for a job	2007	Decree-law 220/2006, 3 November	Implemented
Health			
Primary Health Care Network includes the implementation of Family Healthcare Units (USF); and an incentive payment scheme for health professionals in USFs (The experimental remuneration scheme)	2008	Decree-law 298/2007, 22 August	Under implementation
Introduction of new medicines in NHS institutions is accompanied by an agreement with the supplier for expenditure control	2007	Decree-law 195/2007, 3 October	Implemented
Amendment of the remuneration scheme for overtime	2007	Decree-law 44/2007, 23 May	Implemented
BUDGET FRAMEWORK			
Creation of a budget technical unit in the Portuguese Parliament	2006	Parliamentary Resolution 53/2006, 7 August	Implemented
Creation of finance controllers within the ministries	2006	Decree-law 33/2006, 17 February	Implemented
Monitoring Public-Private Partnerships	2006	Decree-law 141/2006, 27 July	Implemented
Increasing the supervisory powers of the Court of Auditors	2006	Decree-Law 48/2006, 29 August	Implemented

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Chapter 3

Maximising the gains from integration in the world economy

The Portuguese economy is open to the rest of the world, with low formal barriers to trade and FDI, and this helped its growth performance in the past. However, export performance has been disappointing over the past decade, trade integration in the global economy could be higher, and there is potential for more foreign direct investment (FDI). The economy is in the process of adjusting to accelerated changes in world trade and there is significant potential for it to benefit more from globalisation. There are encouraging signs about the economy's capacity to seize this opportunity, including growing product and market diversification, a shift towards higher technology exports, some correction of the earlier increase in relative unit labour costs and recent large FDI inflows. The outlook is brighter than in earlier years. The government has already made significant progress in enhancing the business environment, through a wide range of reforms, including the SIMPLEX programme. However, further action should be taken to facilitate the adjustment of the economy and reap more benefits from openness. Non-tariff barriers, such as the cost of custom processes, should be reduced, and an easing of product market regulations would contribute to making the economy more efficient. Portugal also needs to strengthen competition and improve regulations in key infrastructure sectors, such as telecommunications, electricity and transportation, to enhance the quality, efficiency and quantity of the services they provide. This would have a direct effect on the cost-competitiveness of firms in Portugal, facilitate trade flows, domestically and internationally, and make Portugal a more attractive destination for FDI.

Increasing trade and FDI have played an important role in Portugal's convergence towards higher living standards in the past. But the international environment has changed and since the beginning of this decade, the economy has not been able to seize the new opportunities created by globalisation. Integration in the world economy can still be an important engine of growth, particularly as domestic market size and opportunities to gain from specialisation and economies of scale are relatively limited in a small economy such as Portugal. The challenge is to allow firms to fully develop their potential in line with the economy's comparative advantages, increase productivity and diversify export activities. Improving framework conditions for doing business in Portugal would be a key factor in attracting greater foreign investment and lifting export performance by giving firms easier access to higher quality production inputs and public services at lower prices. It would also help boost productivity by increasing innovation, lifting returns to scale, increasing technological and production process spillover effects between domestic and foreign firms and providing resources, particularly labour, that allow firms to move into higher productivity activities. International experience shows that product market regulation, including the administrative and regulatory environment for business, has significant effects on productivity, exports and FDI.[1]

The government has been making strong efforts in recent years to improve the administrative environment for business, under the broad umbrella of the SIMPLEX programme and the *Technological Plan*.[2] The challenge is to build on progress already made and continue to improve the business environment to attract greater foreign investment and to ensure that firms fully develop their export potential. This, in turn, requires: lowering non-tariff barriers; facilitating linkages between domestic firms and FDI investors; reducing the regulatory burden on business; improving firms' access to capital; promoting competition in the domestic market; lowering costs and improving efficiency of transport and other infrastructure; enhancing human capital; and improving the adaptability of the labour market.

This chapter discusses trade and FDI performance in Portugal. It highlights progress achieved, but also stresses the need for additional measures to promote greater trade integration and FDI inflows and to strengthen linkages between foreign investors and domestic firms. It then identifies the main areas for deepening the reform process: further easing product market regulation, particularly licensing; facilitating financial market development to increase SME access to capital; strengthening competition; and improving key infrastructure services. The key recommendations are summarised in Box 3.4 at the end of the chapter.

Improving Portugal's trade performance

Portugal's integration in the world economy and trade structure

Trade integration, measured as total exports and imports in proportion to GDP, has increased slightly to 67% in 2007, which is below the OECD average (Chapter 1, Figure 1.8).

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Import penetration (imports of goods and services as a share of domestic demand) also indicates that, despite some increase in the past decade, trade integration was still relatively low in 2005, at around 35% (Figure 3.1). The 2005 penetration rate is below the rate predicted by economic factors, such as per capita income, population and transport costs, and could increase further. This penetration rate is low, especially given the small size of the economy, reflecting the fact that firms are not exploiting the full benefits from international supply chains. For instance, several faster growing small OECD countries, including the Czech Republic, Hungary, Ireland and the Slovak Republic, have higher (and higher-than-predicted) import penetration rates (OECD, 2005e). Both the import penetration and trade-to-GDP ratios suggest that there is significant potential for Portugal to expand trade with the rest of the world and reap significant gains from integration in the world economy.

Portugal's main exports are manufactured goods and travel services. Exports of goods account for 75% of total exports in 2007, of which over 90% are manufactures. Principal exports by industrial sector include textiles and clothing, motor vehicles, electrical equipment and chemicals, rubbers and plastics. While the share of exports of the dominant textile and clothing sector contracted from 1995 to 2006, the automotive industry grew to become Portugal's second largest export sector (Box 3.1). Services exports account for a substantial 25% of total exports in 2007, with travel services (tourism) accounting for over half of this. The majority of Portugal's exports go to other EU countries. Portugal's four largest trading partners are Spain, France, Germany and the United Kingdom.[3] However, Portugal is beginning to diversify its markets, with exports to non-EU countries increasing from 19% of total goods exports in 1995 to 23% in 2007.

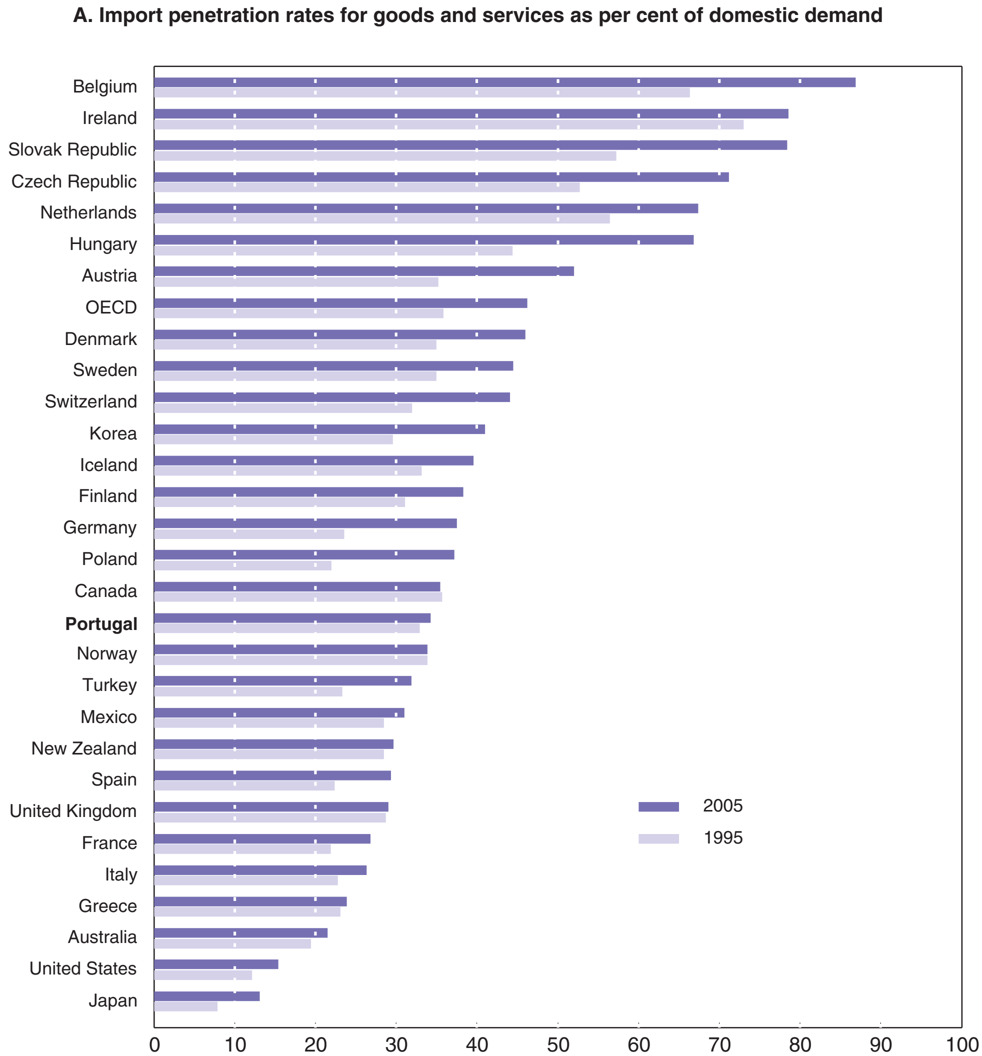
Manufacturing trade performance: actual and potential

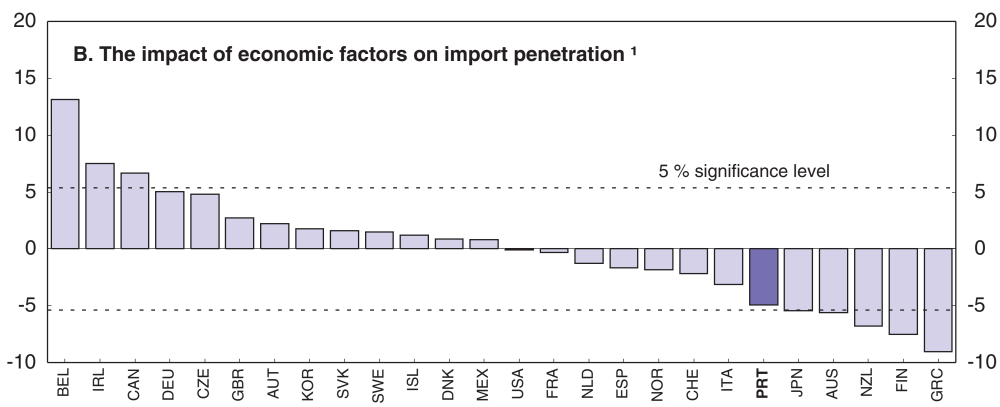
Between 1995 and 2006 overall, Portugal's export performance was weak, although indicators of trade integration suggest that the economy has significant potential to further integrate with the world economy. Portugal's overall export market share in world imports of goods and services from 0.62% in 1995 to 0.54% in 2007, this decline being driven by a fall in the share of goods exports from 0.58% to 0.46%, while the share of services exports has tended to fluctuate around 0.8% of total world imports over the period.[4]

Manufactured exports are the principal driver of total export growth, and Portugal's export growth in this category is far below that of other catching-up countries. From 1996-2005, Portugal recorded approximately 5% annual growth in manufactured exports. In the same period, small European catching-up countries, including Poland, the Slovak Republic, the Czech Republic and Hungary, experienced growth rates of between 15 and 20%. Portugal's exports also grew more slowly than those of the small high-income European countries such as the Netherlands, Belgium, Austria and Ireland where annual growth rates ranged from 7 to 11%.

To further examine this relatively slow growth in manufactured exports and the sources of the decline in market share for goods, a constant market share analysis for manufactured exports has been conducted over the 10 years to 2006.[5] Following the methodology in Cabral and Soares-Esteves (2006), the analysis is used to break down the percentage change in total market share into three main components (Figure 3.2). The first component is the contribution of the change in market shares in each of 99 individual markets to the total market share change (market share effect).[6] The second component is the part of the total change in market share that results from the geographical

Figure 3.1. **Indicators of trade integration**





1. Import penetration (1995-2005 average for goods and services) is estimated as a function of population, per capita income and transport costs. A negative (positive) residual indicates that import penetration is below (above) the level predicted by economic factors.

Source: OECD, *National Accounts.*

StatLink http://dx.doi.org/10.1787/342757785237

Box 3.1. **The automotive sector in Portugal: Export performance, FDI linkages and challenges**

The automotive industry is now Portugal's second largest export sector. Despite a slower expansion recently, in 2006, the industry accounted for 3.6% of manufacturing employment, 13.5% of manufactured exports and around 1.5% of GDP. FDI has played a major role in the sector, supported by financial incentives for investment, in particular, through EU funds and tax benefits for investment. Since the 1980s, two major projects, Renault, and particularly the joint venture Ford-Volkswagen (Volkswagen (VW) Autoeuropa), have been at the core of the automotive industry development in Portugal. The Renault project ended in the late 1990s and the VW Autoeuropa project now plays a dominant role in vehicle production, while suppliers of auto parts are more numerous. A closer examination of developments in the automotive industry helps to illustrate general trade and FDI issues, in particular the factors affecting export performance and the development of linkages between FDI investors and domestic suppliers.

Export performance

In the past decade, the sector went through two major phases, with auto and auto parts exports growing by an annual average of 14.5% from 1995 to 2000, followed by average annual growth of 1.3% between 2000 and 2005. The exports of autos declined between 2000 and 2005, mainly due to the reduction of VW Autoeuropa's production, while exports from the auto parts sub-sector continued to grow. The decline in auto production was associated with several factors, among which the most notable have been: *i)* the end of the product cycle at VW; *ii)* concerns about the flexibility of the labour force and productivity; and *iii)* uncertainty about the cost-competitiveness of production in Portugal, which would determine whether further investment in new models would be made. Although the auto parts sub-sector performance is partly linked to auto production, with VW Autoeuropa being a major client, the parts industry continued to grow because it exports a high proportion of its production (80% according to an Associação de Fabricantes para a Indústria Automóvel (AFIA) enquiry), and has a wide range of clients, which allows an important diversification of risk and decreases the monopsony (single buyer) power of VW.

Since 2005, the automotive sector as a whole has shown signs of recovery after a slowdown in vehicle production. In 2006, exports of the automotive sector grew briskly, by 11%, and growth continued into 2007. A number of factors have contributed to the pick-up. First, there was an increase in FDI in the sector, with VW recently making a € 540 million investment and introducing a new cycle of models. Increases in domestic demand for parts and vehicles exports are expected to continue given the VW announcement in January 2008 of greater investment in Portugal and a doubling of car production by 2010. Second, the auto parts sector continues to expand, with strong exports. There has been a diversification of markets. Traditionally the main destinations of automotive sector exports have been Western European markets, mainly Germany, France, and Spain. From 2000, overall, the growth of auto parts exports was also partly driven by sales to Central and Eastern Europe, Turkey and the United States, the main clients being VW, GM, Renault, DaimlerChrysler and BMW. Third, there has been a recovery in productivity following the significant slowdown that occurred in the late 1990s and early 2000s in absolute terms and relative to larger EU countries (Germany, France and Spain). In more recent years, productivity in the sector picked up and it has been growing in line with productivity in the automotive sector of larger EU countries.

Box 3.1. **The automotive sector in Portugal: Export performance, FDI linkages and challenges** *(cont.)*

Linkages between FDI investors and domestic suppliers

Developing linkages between foreign firms and domestic suppliers is important because they can help generate higher exports in the longer-term, even if the original FDI investor then decides to leave. For example, although the Renault project in Portugal ended in the late 1990s, the Renault group maintained many of its suppliers in Portugal and is still the second largest client of the Portuguese auto parts sector. The earlier Renault investment helped to develop the capacity of Portuguese suppliers and prepare them for exporting or supplying other assembly lines. It shows that if linkages between the foreign investment and domestic industry are developed – and this supposes adequate quality of domestic firms' output – even a temporary FDI investment may be a catalyst for a more durable increase in exports. The automotive sector is one of the sectors where linkages between FDI investors and domestic firms are more evident and these linkages have been associated with a majority of firms having quality certification (97% of domestic firms).

Challenges

In the automotive sector, Portugal is competing directly at a global level; and the local branch of VW is competing with its counterparts within the company world-wide. Portugal's main comparative advantage in this sector is that: *i)* the country ranks favourably regarding the rule of law and security; *ii)* it is located close to the larger European markets; and *iii)* the workforce has already acquired skills and experience. The main challenge Portugal has to face in maintaining the level of FDI already in place and attracting new inflows is to further improve the business environment for vehicle production so that current investors remain committed to new investments and products. This will also help to attract new projects of product development, integrated product processes, and/or assembly operations. The government has put in place a strategy to increase cooperation between firms, the R&D sector and the government in order to encourage the development of the industry. This includes launching specific R&D cooperation programmes with the US Massachusetts Institute of Technology and the German Fraunhofer Institute to boost high-technology content output from the industry, and introducing a supplier development programme to build on the opportunities provided by the new product cycle at VW Europa.

specialisation of Portuguese exports (geographical effect). The final component is the product structure effect, which is the contribution of the product specialisation of Portuguese exports. Geography and product effects will be positive (negative) if Portugal is relatively specialised in fast (slow) growing markets relative to the world average.

Over the 1996 to 2006 period, Portugal's total market share has been on a declining trend, with a total loss of –16.1%. Of this loss, –3.5 percentage points have resulted from the unfavourable geographical specialisation and as much as –8.6 percentage points reflected the unfavourable product market specialisation of Portugal, while –11.9 percentage points reflected the market share effect, which is due to other factors, such as cost-competitiveness and how well the products made in Portugal match changing customer tastes.[7] With the exception of Spain, all of Portugal's major markets were growing less than the world average over the period, leading to the negative contribution from geographical specialisation. Product specialisation in clothing, textiles and footwear was the main factor behind the negative product specialisation effects. The greatest market share losses

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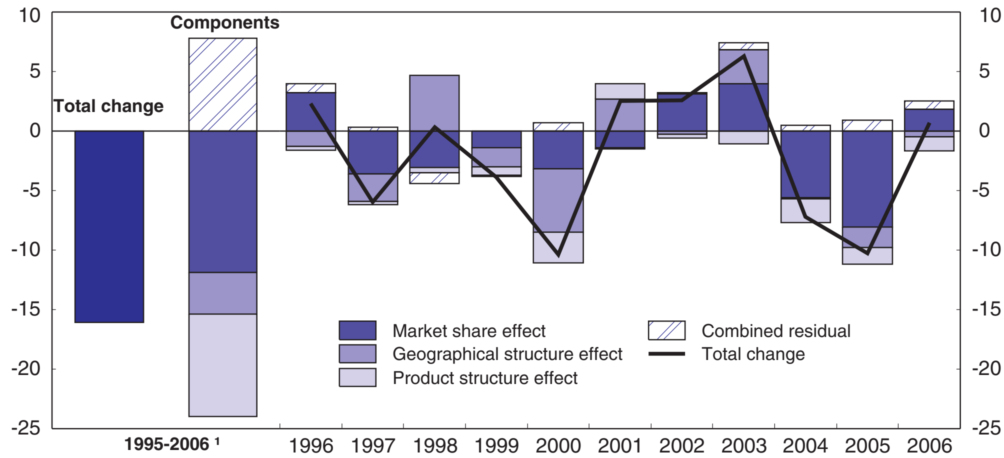
Figure 3.2. **Breakdown of change in total market share of manufacturing exports**



1. The total change in market share and components is not always exactly equal to the sum of the annual changes.

Source: OECD, International Trade Statistics.

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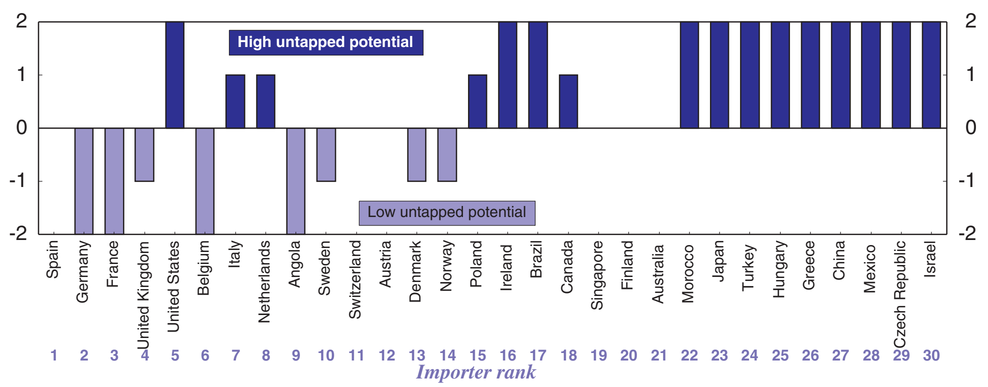
occurred in markets where emerging economies from Eastern Europe and East Asia have made large gains. Market share losses of the scale of those observed in Portugal have also been experienced by other OECD countries, but a special feature of Portugal's export performance is that it has been particularly affected by the product mix. The most recent evidence available shows signs of adjustment, with a stabilisation in Portugal's market share in 2006, but it is too soon to conclude on how durable the improvement may be.

Portugal's trade diversification away from some of its large traditional markets is broadly consistent with its trade potential, as derived from a gravity model of global trade (see Helmer and Pasteel, 2005). In this model, trade potential is measured as the difference between the exports predicted by the model (based on distance, relative barriers to trade, tariffs, border, language, conflicts) and the actual level of exports, divided by the actual level of exports.[8] Figure 3.3 shows the total export potential of Portugal in 2003 *vis-à-vis*

Figure 3.3. **Export potential for Portugal, 2003**[1]



1. Scale from –2 to 2. Trade well above predicted on a gravity model basis *i.e.* based on the size and distance of the economies, potential very low (–2). Trade well below predicted on a gravity model basis, high untapped potential (+2). Countries are ranked according to their share of Portugal's exports.

Source: UNCTAD/WTO International Trade Centre.

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30 destination countries ranked in decreasing order of share in Portuguese exports. The export potential is shown on a scale of –2 to +2 from very low untapped potential (much stronger-than-predicted trade) to high untapped trade potential. A value of zero indicates that the level of exports is in line with the model predictions.

The results show that in several of its large markets, Portugal's overall export potential appears to be more than fully exploited.[9] This includes Germany, France, the United Kingdom and Belgium, where exports were higher than predicted in 2003; and, in line with the predictions of the model, subsequent market performance has been weak. Trade with Spain was in line with predictions in 2003 and market performance has been strong. With Italy and the Netherlands, despite apparent potential, Portugal has lost market share. The United States stands out as the market with the largest absolute potential (a large market with high untapped potential) and Portugal has managed to gain some market share there. Despite having already much stronger-than-predicted trade with Angola, Portugal has continued to record strong export growth.[10] Finally, there appears to be large export market potential with some of Portugal's minor export destinations, including large economies such as Brazil, China, Japan, Mexico and Turkey.

In addition to the still fragile stabilisation of Portugal's market share in 2006, there are some encouraging signs for future performance. Portugal's export product mix has been steadily moving away from lower technology products towards, medium and high technology goods over time (Amador, Cabral and Ramos Maria, 2007). Furthermore, Portugal's export specialisation is moving towards products with higher implied productivity levels (a good's implied productivity is the weighted average of per capita GDP of countries that export that good, where the weights are the revealed comparative advantage of each country in that good) as measured by the EXPY index (Lebre de Freitas, 2008).[11] Between 1990 and 2005, exports with "very high" and "high" income content increased from 28% of total goods exports to 44%. At the product level, 33 products accounted for two thirds of total goods export growth from 1990 to 2005. Among these 33 products, FDI investors had a large presence in approximately 75% of the products with "high" and "very high" income content. This suggests that FDI is playing a key role in transforming the Portuguese export sector towards higher income products. Finally, the decrease in relative unit labour costs since 2004, if it can be maintained, will also help to underpin goods export performance in the future.

Another key factor explaining the evolution of export performance over the past decade is wage dynamics in relation to productivity growth. Relative unit labour costs in manufacturing were on a broadly upward trend from 1997 to 2004, leading to a deterioration in the cost-competitiveness of Portuguese firms (Blanchard, 2006) (Figure 3.4). This period was followed by an improvement after 2004 and it is important that this improvement continues.[12] The earlier deterioration in the relative cost of producing in Portugal has likely contributed to the large loss in manufactured export market share from 1999 to 2005. Figure 3.5 compares the trends in Portugal's relative unit labour costs *vis-à-vis* the ten countries which joined the EU in 2004, with Portuguese export market performance in world markets, for 11 broad industries over the 1999-2005 period.[13] The results show that a deterioration in Portuguese unit labour costs relative to those in the EU 10 over the period tended to be associated with a loss in Portuguese export market share (quadrant III), while improvements in cost competitiveness were generally associated with gains in market share (quadrant I).

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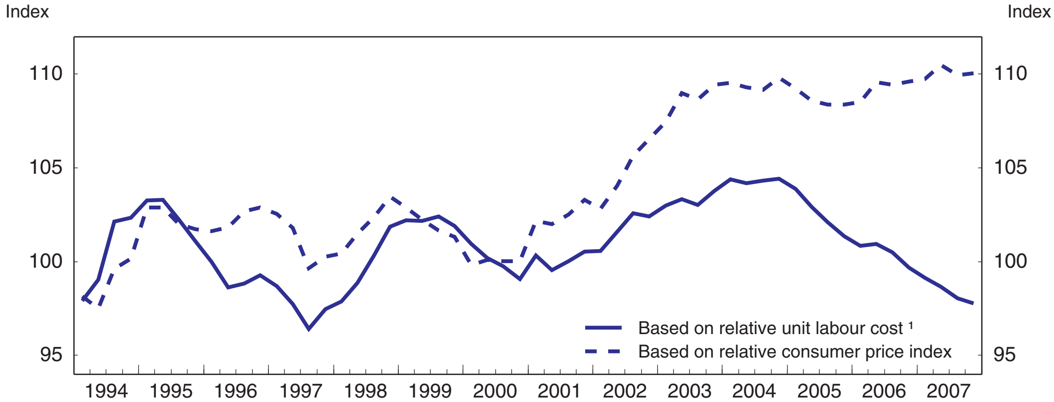
Figure 3.4. **Real exchange rates**

2000 = 100



1. Unit labour costs in the manufacturing sector in a common currency for 42 countries.

Source: OECD, *Analytical database.*

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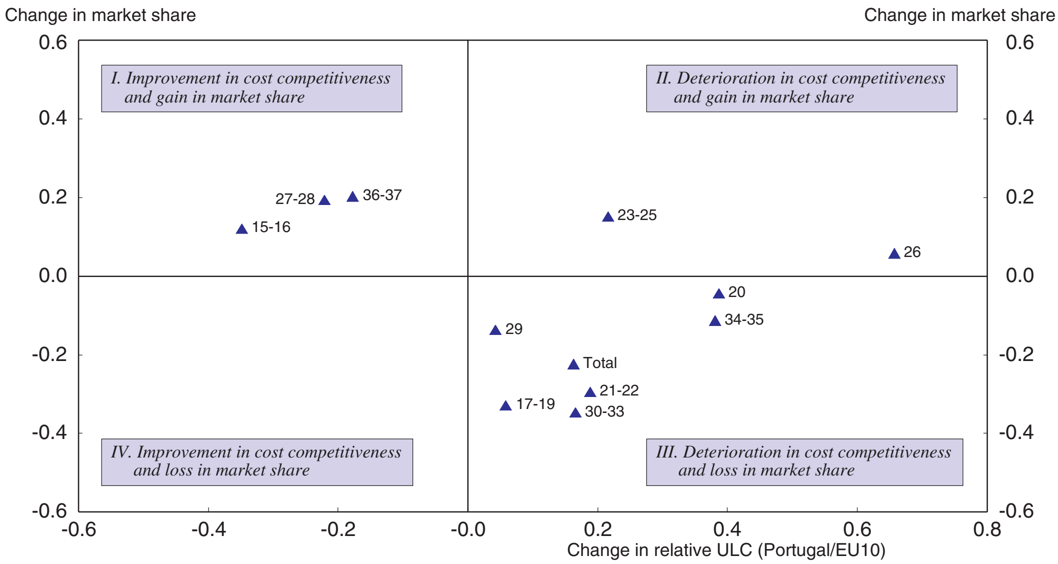
Figure 3.5. **Portugal's cost competitiveness and export performance**

1999-2005



Note: ISIC REV. 3 classification.

15-16 = Food, beverages and tobacco.
17-19 = Textiles, textile products, leather and footwear.
20 = Manuf. of wood and of products of wood and cork, except furniture; manuf. of articles of straw and plaiting materials.
21-22 = Pulp, paper, paper products, printing and publishing.
23-25 = Chemicals, rubber, plastics and fuel products.
26 = Manuf. of other non-metallic mineral products.
27-28 = Basic metals and fabricated metal products.
29 = Manuf. of machinery and equipment n.e.c.
30-33 = Electrical and optical equipment.
34-35 = Transport equipment.
36-37 = Manufacturing n.e.c.
Total = Total manufactured products.

Source: OECD, *ITCS database.*

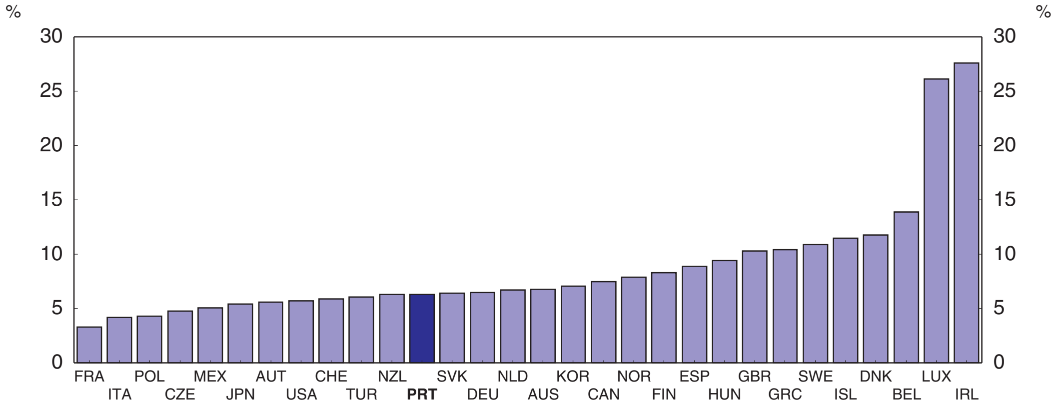
StatLink http://dx.doi.org/10.1787/342883580802

Services trade performance: Actual and potential

The share of Portugal's services exports rose from 21% to 25% of total exports over the period 1995 to 2007. There was modest growth in financial, insurance and construction services over the period, while other business services grew considerably, and they accounted for 18% of total services exports in 2007, up from 8½ per cent in 1995. Computer and information technology (IT) services also grew much faster than average, although from a low base, and they reached 1.2% of total services exports in 2007. However, overall services exports growth still remains modest in comparison with many other small European countries (Figure 3.6).

Figure 3.6. **Total export of services growth**[1]

Average growth, 1995-2005



1. 2000-2005 for Belgium and Luxembourg.

Source: OECD, *International Trade and Balance of Payments database*.

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In assessing trade performance in services, it is important to note that, as is the case with many other countries, services are not always exported directly from Portugal, but rather are sold abroad by developing a commercial presence and either building the enterprise or repatriating profits to Portugal. The turnover of Portuguese-owned affiliates abroad in the services sector is slightly larger than total annual services exports (of € 12 billion in 2005) (OECD, 2005e). There have been sizeable outflows in the financial services sector from 1995 to 2005, suggesting that services are being provided in this sector through investment in other economies.

Concerning tourism, Portugal's visitor numbers have grown in line with the OECD average from 1995 to 2005. Numbers increased solidly from 1995 to 2000, remaining unchanged until 2005. In 2006 and 2007, however, there was a significant recovery, with the number of tourists increasing by 6% in 2006 and 9% in 2007. Many factors that inhibit goods trade also affect services trade, including product market and labour market regulations, human capital, as well as the overall tax wedge on labour, which combines social security contributions and income tax. Decreasing the tax wedge on labour to the lowest level in the OECD would help to boost services exports.[14] Good governance (including the quality of government services and the ability to regulate in a way that promotes private sector development), infrastructure quality and a common language are also important for trade (Box 3.2).

Trade policy: further reducing non-tariff barriers

An indicator of the restrictiveness of trade policy shows that Portugal retains a slightly more restrictive stance than the OECD (and EU14) average (Figure 3.7) As a member of the

Box 3.2. **Trade, investment and the importance of a common language**

It is common to regard geographical distance as a barrier to trade and investment, but distances in interpersonal communication and cultural terms can also be an obstacle. A common language provides a tool of communication and also enables a better knowledge of cultural norms as a language reflects many aspects of culture. Through both the direct communication and cultural channels, a common language can help to facilitate trade between countries and the development of joint projects.

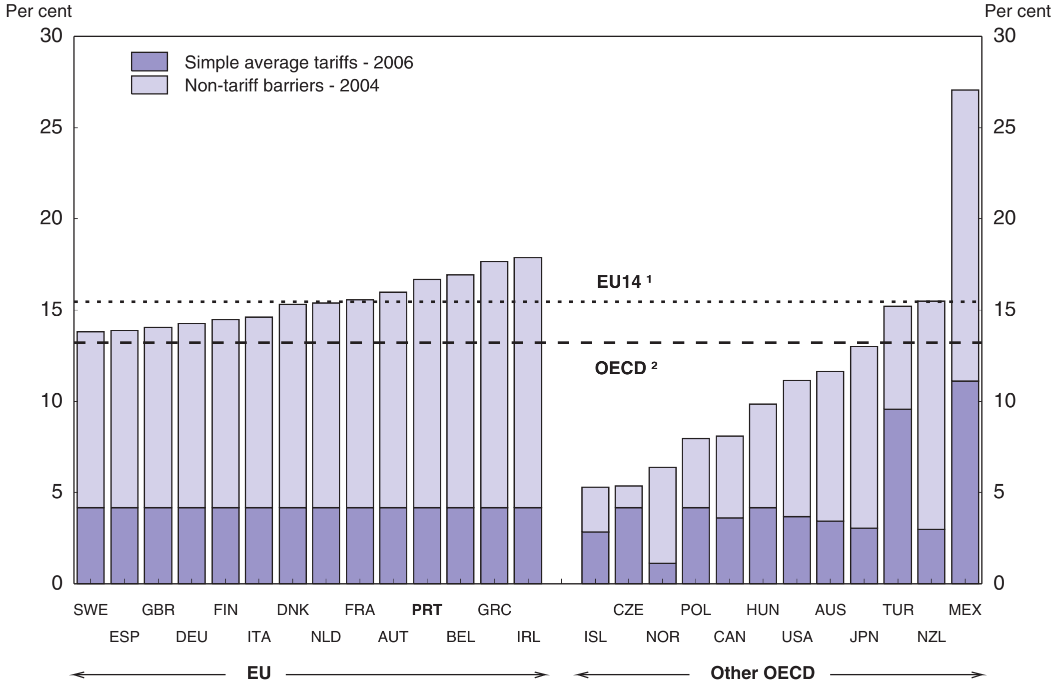
Language skills are crucial for growth and jobs. Trade models based on distance often take into account other aspects, such as common language or past colonial relationship. For many firms, especially SMEs, international businesses and contracts may be lost as a result of lack of language skills and intercultural competence. Firms that do, or aim to do, business internationally face the challenge of improving communication skills in order to improve performance (CILT *et al.*, 2006). The solution to allow communication when people do not speak the same language is translation, but direct communication is more effective in promoting trade (Melitz, 2007). All types of trade are improved when agents share the same language. However, given the specific nature of services that frequently require direct communication, common language improves trade in services more than trade in goods: trade of services can be 1.9 times higher between trading partners with a common language, everything else equal, while for goods trade, the estimate is 1.6 times higher (Kox *et al.*, 2007).

Personal communication also affects foreign direct investment (FDI), because it reduces the information asymmetry between foreign and domestic interlocutors (Goldberg *et al.*, 2005). In the banking sector, for example, a common language is an important determinant of foreign bank entry in a new country (van Horen, 2007).

The improvement of language skills is a task both for governments and enterprises. National education and training systems should be able to provide people the appropriate language skills for either working on national enterprises that do business internationally or working for foreign investors that do not share the same mother-tongue. It is important to get the maximum returns from these investments and to recognise that in an increasingly global world, it is impossible to know the first language of every trading partner necessary for doing business. Increasing English language skills in Portugal should be a priority, as English use is so widespread worldwide and English is becoming the *lingua franca* in business communication. It is also frequently established as a corporate language, even in firms that operate in countries where the mother-tongue is an international language, such as Portuguese (CILT *et al.*, 2006).

In 2005, Portugal launched the Curriculum Enrichment Activities (CEA) programme for the 1st cycle of compulsory education. One of the main goals is to make the teaching of English compulsory in the 3rd and 4th years of school. Another possible avenue for improving language skills is for the government to work with enterprises in developing language programmes, in order to prepare their workers for multilingual communication. Supporting the use of Portuguese, which is an international language with almost 230 million speakers around the world, can also contribute to promoting a common language. Portugal has been developing, in partnership with the States Members of the CPLP (*Comunidade de Países de Língua Portuguesa*), a strategy of reinforcement and use of Portuguese as a language of international communication. In countries where the Portuguese diaspora is present, the approach is to introduce and to guarantee the education of Portuguese in foreign curricula (from basic schools to universities).

Figure 3.7. **Total trade barriers (tariff and non-tariff) in comparison**



1. EU14 is EU15 minus Luxembourg.
2. OECD does not include Korea, Luxembourg and the Slovak Republic.

Source: Kee, Nicita Olarrega (2005); *UNCTAD's TRAINS database.*

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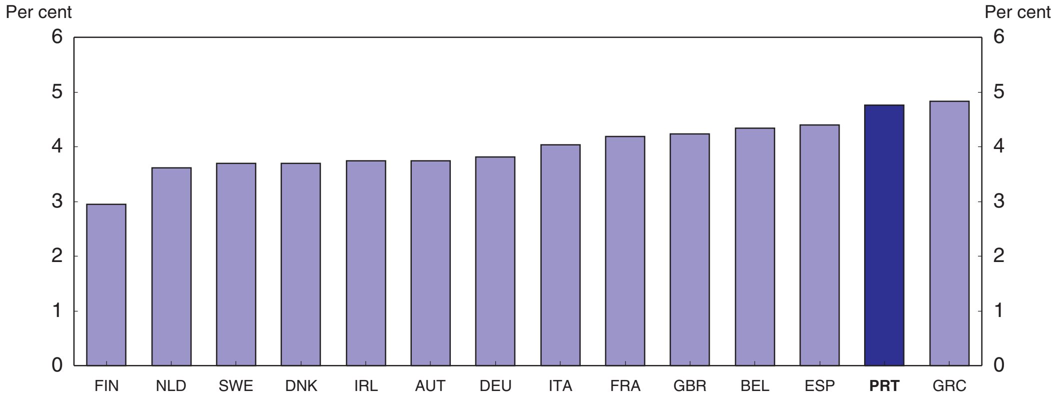
EU customs union, Portugal applies EU most favoured nation (MFN) tariffs, which are relatively low, as in most non-EU OECD countries. The sectors with higher tariffs in the EU are tobacco, manufacturing, clothing, food manufacturing, fishing, textiles, leather and motor vehicles.[15] On a trade-weighted basis, the effect of EU tariffs for manufacturing products is slightly more restrictive on Portugal than on most other EU countries, reflecting the particular mix of Portugal's imports (Figure 3.8).

According to Kee *et al.* (2005), in 2004 non-tariff barriers in Portugal, including customs procedures and technical requirements, were slightly above the OECD average. As a member of the EU, Portugal applies the EU Customs Code. However, differences in treatment of traded goods can still vary across EU countries, because of differences in implementation by the national authorities and additional Portugal-specific regulations. A comparison of the costs of customs and technical controls and documents for importing a container shows that in 2007 Portugal had one of the highest costs in the OECD, suggesting that there is significant room for improving the efficiency of these processes (Figure 3.9). Some of these costs likely arise from high port and airport charges; however there is also room to lower costs imposed by customs.

The Portuguese authorities have introduced reforms to lower customs costs and improve processes and it is important that these reforms be fully implemented. The overall aim is to improve IT systems used by customs in Portugal to align them with those applied more widely in the EU. To date, more progress has been achieved for exports processing than for imports, with electronic declarations for exports transmitted between customs and firms. Import declarations still require the delivery of paper forms to customs,

Figure 3.8. **Trade weighted tariffs for manufacturing in the EU, 2004**[1]



1. Weighted average tariff rates with weights given by import values in each industrial sector from the STAN database.

Source: UNCTAD and OECD, *STAN database*.

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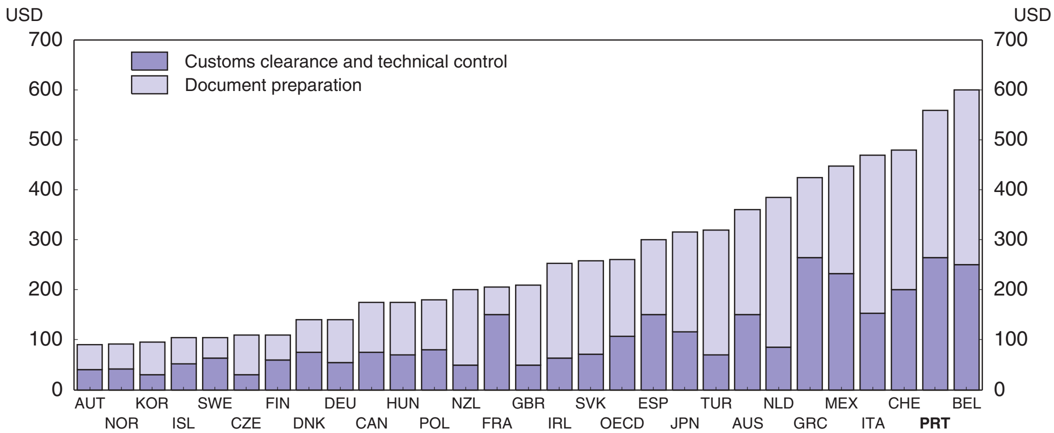
Figure 3.9. **Customs and document costs of importing a container, 2007**[1]



1. Costs refer to importing a 20-foot container.

Source: World Bank, Doing Business 2008.

StatLink http://dx.doi.org/10.1787/343080585767

although some efficiency gains have been made by sending forms electronically for pre-validation. Besides customs procedures, there are also substantial inefficiencies in export and import logistics. The customs services should continue to work with firms involved in freight logistics, ports and airports with the aim of creating an integrated IT system that all actors can access to follow cargo through export and import procedures, transport and storage. An important step that has been taken in this direction is the integration of the Customs IT System (SDS) with the Common Port Platform IT system (PCOM) being introduced in the three largest Portuguese ports (Lisbon, Sines and Leixões). Another step towards this integration is the electronic summary declaration form that customs services are introducing in cooperation with the three largest ports. Further efforts should continue to be made in this direction, moving ahead to improve both IT and associated processes and creating a unique IT system for the whole logistics chain.

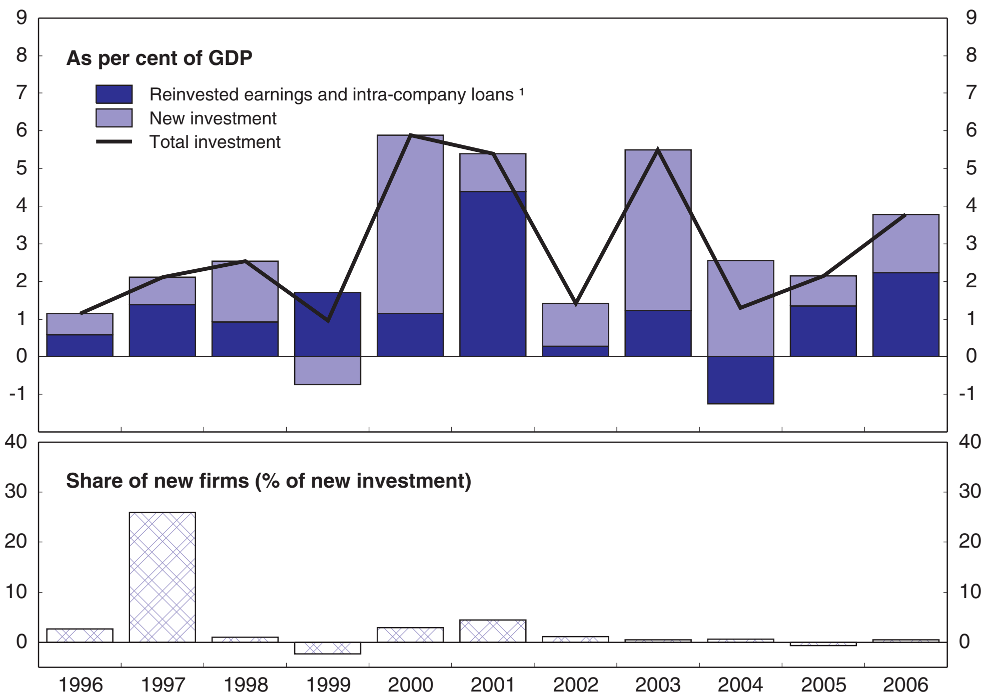
Improving customs also requires increasing certainty for importers. The authorities could improve certainty and reduce complexity for importers by automatically recognising the classification of goods for tariff purposes by other EU member states.[16] They should also examine the justification for having Portugal-specific penalties, which are not required by EU law, for non-compliance with the customs code and other regulations.

Promoting FDI and increasing linkages with the domestic economy

FDI performance

FDI inflows to Portugal have been solid over time, averaging 3.4% of GDP per year from 2000 to 2006. However, they remain below those in the small European catching-up countries. In line with the general trend in the OECD, there was an upsurge in FDI investment in Portugal in the early 2000s, with new investment by existing foreign firms playing a particularly large role. This has been followed by a period of lower FDI since 2004. The share of new firms in total new investment tends to be very small, with the bulk being done by existing FDI investors (Figure 3.10). Although it is the total FDI inflow that is of first-order importance as a vehicle for technology transfers and a stimulus to innovative activity, the low share of new firms in total investment is also a matter of concern. This is because investment by new firms is likely to be more sensitive to the perceived attractiveness of the country as an FDI location than further capital injections by existing firms. Furthermore, capital invested by a new firm is more likely to help diversify the economy in terms of technology and sector exposure than capital injections by existing firms.

Figure 3.10. **Gross foreign direct investment in Portugal**



1. Include other.

Source: Ministry of Economy.

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Recent indicators are encouraging for future FDI flows including the entry of new firms. The investment promotion agency, AICEP, recorded a notable increase in the number and value of large FDI projects from 2006 to 2007 and a survey of multinationals indicates that the attractiveness of Portugal as an investment location is increasing.[17] Greenfield investments account for a third of the flow recorded by the AICEP for 2007. Investments are in a variety of industries but they are particularly dominated by the chemical industry, which is favourable for future export growth as this sector is a fast expanding part of the world market. The January 2008 Volkswagen announcement of greater FDI investment and a doubling of car production in Portugal by 2010 is also a clear sign that the country has increased its attractiveness. It is also favourable for export growth going forward as autos are second largest export sector in Portugal.

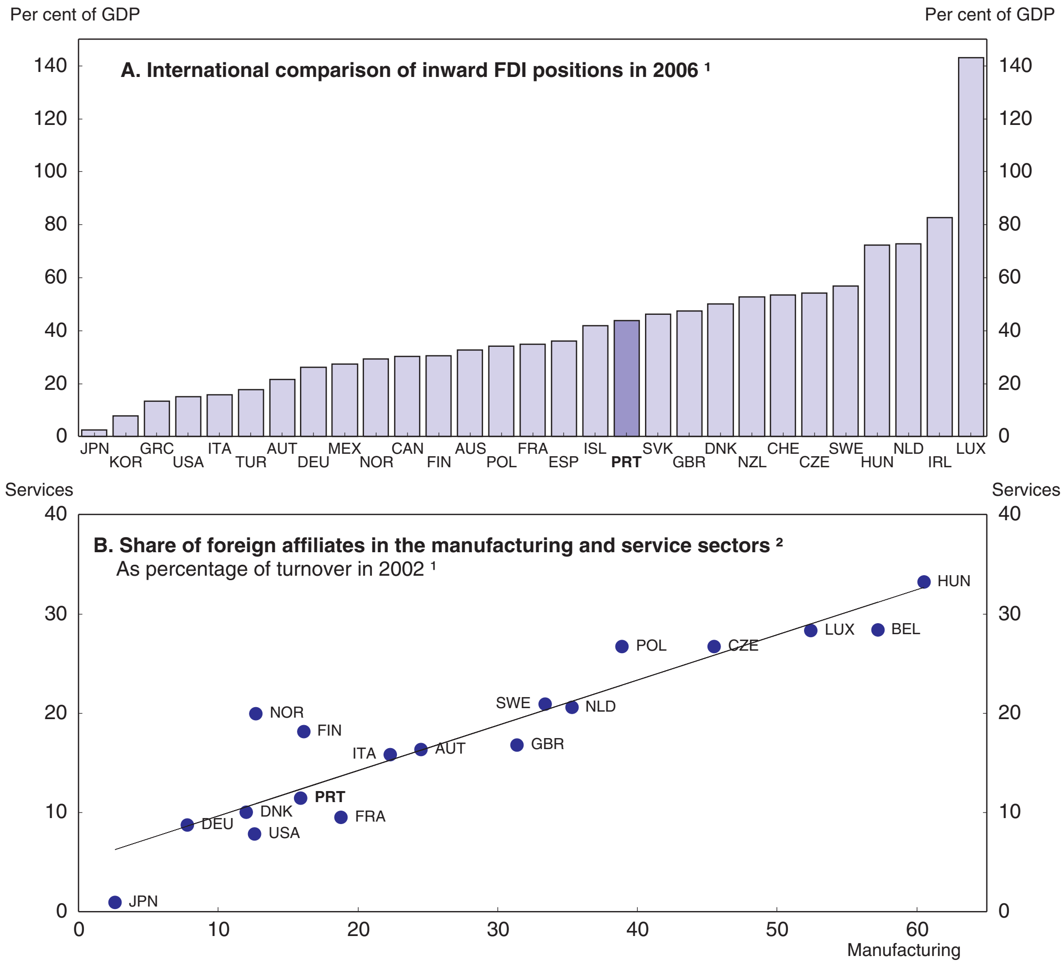
The inward FDI stock is around 45% of GDP, which is below the level in some other small catching-up European countries. The share of foreign affiliates in services and manufacturing turnover is also smaller in Portugal than in several other comparator countries in Europe (Figure 3.11). Although only indicative, sector data show that a significant proportion of FDI inflows is in business services, while flows into manufacturing, and other service sectors and infrastructure sectors, such as hotels, transport and communications, tend to be relatively small.[18] The lower FDI stocks and presence of foreign firms in turnover in comparison with other European catching-up countries suggests that Portugal could attract higher FDI and has potential to gain further from FDI. Furthermore, comparing the export specialisation in manufactures and tourism with the relatively small FDI flows to these areas suggests that the economy is not yet fully reaping the complementarities between trade and FDI, although significant efforts are being made to reverse this situation.

The benefits of further increasing FDI in Portugal are illustrated by the contribution to productivity and innovation that current investors already make. FDI firms have brought a range of benefits to Portugal. In particular, labour productivity of foreign affiliates in 2002 was 50% higher than the national average in the manufacturing sector and twice as high in the services sector (Figure 3.12). They also make a large contribution to R&D activity and technology, accounting for around 45% of total R&D in the manufacturing sector, even though they only account for around 15% of manufacturing turnover. Foreign companies are also responsible for close to 40% of all patents registered domestically and 30% of patent applications involve a foreign co-owner. Technology payments to foreigners actually exceed domestic business enterprise R&D.

Reviewing policy settings and other factors that influence FDI

FDI flows are affected by a broad range of policies, including border barriers, taxation, product market regulations and labour market settings. FDI also depends heavily on the level of human capital (see Chapter 4). In Portugal, the overall business environment, including restrictive product and labour market regulations and the limited availability of skilled human capital are probably the greatest impediment to higher FDI flows. Areas of particular concern for foreign investors cover insufficient labour market flexibility, as well as product market regulations, including licensing procedures, which remain very cumbersome by international comparison. By contrast, taxation, merger and acquisition rules and border barriers are likely to play a minor role in inhibiting FDI. Indeed, there is identical treatment of domestic and foreign firms regarding merger and acquisition rules, which generally helps to facilitate FDI.

Figure 3.11. **International comparison of inward foreign direct investment positions**



1. Or latest year. See the source for the exact year.
2. The data used for foreign affiliates are broken down by industry of sales to be compatible with national total data.

Source: OECD, *International direct investment database* and OECD *Economic Globalisation Indicators*, 2005.

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Simulations based on cross-country, time series data (see Hajkova *et al.*, 2006) suggest that the estimated positive effect of lower taxes on FDI is reduced by half once other policies, including border policies and labour and product market settings, are taken into account. Furthermore the quantitative effect of labour and product market policies on FDI is much greater than taxes suggesting that improving the overall business environment should have the highest priority.[19] Nevertheless, since taxation may be contributing to lower FDI flows to Portugal consideration should also be given in the longer run to reducing corporate tax rates. Portugal's corporate tax rate, at 27.5% in 2006, was below the OECD median of 29%, but above that prevailing in some of the small European catching-up countries, including Hungary, Ireland, Poland, the Czech Republic and the Slovak Republic, which have attracted higher FDI inflows than Portugal. The policy implication would be that, once the fiscal position has been consolidated on a sustainable basis and there is a solid budget surplus, a reduction in the corporate tax rate should be considered.

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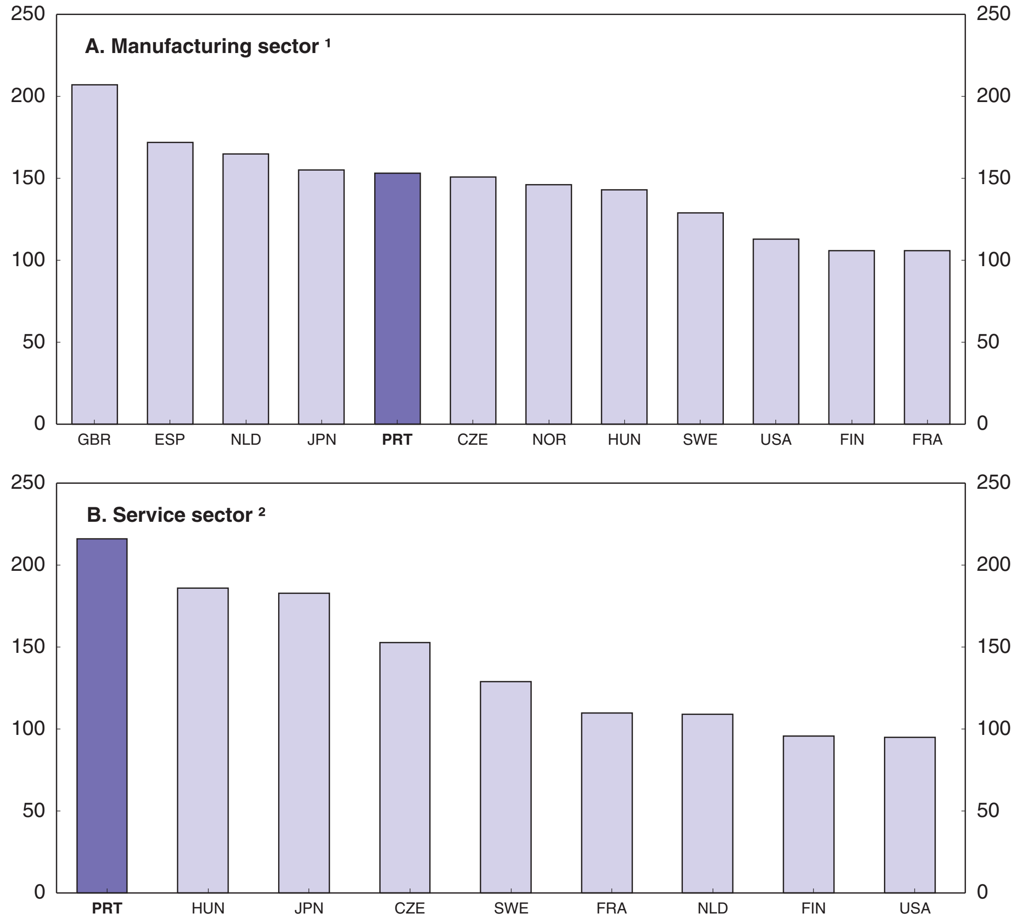
Figure 3.12. **Labour productivity of foreign affiliates relative to the national average**

In 2002, national average = 100



1. Manufacturing sector: 2000 for Spain; 1999 for the United Kingdom.
2. Service sector: 2001 for the Netherlands; 2000 for Sweden and Japan.

Source: OECD Economic Globalisation Indicators, 2005.

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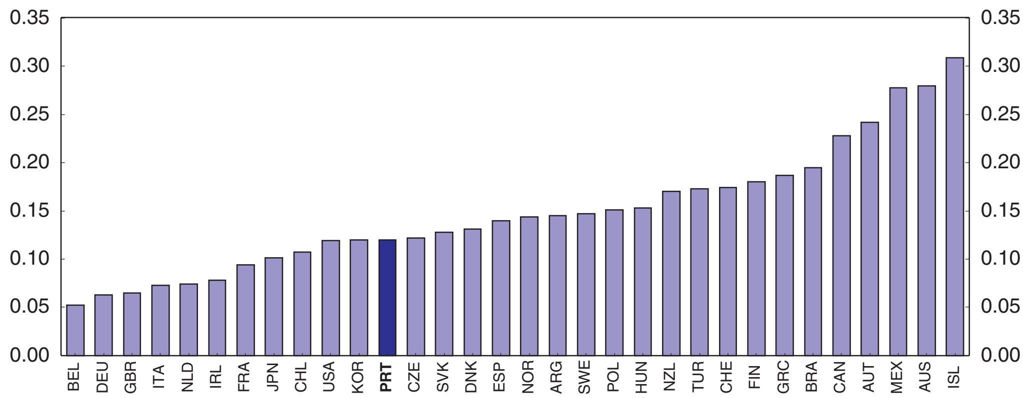
Formal border barriers to FDI are not high overall compared with other OECD countries (Figure 3.13). As in most other OECD countries, equity, management and operation restrictions account for the bulk of the barriers, while screening requirements play a smaller role. Air transport, however, is a notable exception, having the highest restrictions in the OECD.[20]

There are nonetheless internal regulations, such as restrictive product market regulations (PMR) that inhibit FDI flows (see below). Regulatory burdens are partially reduced by preferential administrative treatment for some investments.[21] In particular, the government applies preferential administrative treatment to large investment projects considered to be of national importance under the Projects of National Interest programme (PINS). The programme offers some benefits, as it reduces the number of regulatory steps and time taken to set up an operating business in Portugal. The simplifications of procedures in the context of PINs should also continue to be used to help make changes

Figure 3.13. **Foreign direct investment restrictiveness index**[1]

2006



1. Index scale of 0-1 from least to most restrictive.

Source: Koyama and Golub (2006).

StatLink http://dx.doi.org/10.1787/343204351128

under the overall administrative simplification programme, SIMPLEX. However, it potentially suffers from the "picking winners" risk, as smaller – or non-selected – investments may turn out to be the most successful in the end. The government's on-going actions to improve the overall business environment, such as those to reduce the administrative burden on business in the SIMPLEX programme, is a superior policy, as it will help facilitate all types of investment (domestic and foreign alike) and should eventually remove the need to apply preferential programmes.

Increasing benefits from FDI by strengthening spillovers and linkages to domestic firms

Important benefits from higher FDI include the knowledge and technology transfers that often accompany direct investment. Investors transfer know-how to their subsidiaries and, in many cases, also their direct business partners; this know-how also has the potential to spill over more generally into the host economy. Vertical transfers to domestic suppliers of manufactured inputs have been demonstrated by empirical evidence (Kugler, 2006). Spillovers can also occur when domestic firms employ workers trained by FDI firms. Knowledge and training spillovers have been occurring in Portugal. In some cases, FDI firms in Portugal are assisting domestic suppliers to achieve higher quality standards.[22] FDI firms have also developed training centres that train not only their own employees but also workers from other firms and school-age students enrolled in vocational programmes. An example is the ATEC Training Academy developed as a partnership between FDI investors in Portugal (*e.g.* Volkswagen Autoeuropa, Siemens, Bosch-Vulcano) and the German-Portuguese Chamber of Commerce and Industry.[23]

Another important benefit from higher FDI is the supply chain linkages that develop between foreign direct investors and domestic firms. Foreign investors have a number of motivations for developing supply chain linkages with domestic firms. They are usually keen to outsource locally, as local production represents a potential source of cost savings and security of supply. Empirical evidence shows that even if multinational companies initially import most of their supplies, eventually, they switch to domestically sourced goods (OECD, 2002). Multinationals may also want to source locally because this provides competition for international suppliers. In Portugal, an additional factor that contributes to the incentives for FDI investors to source locally is the country's peripheral location in Europe and the distance to foreign suppliers, which imply that high savings in transport costs can be achieved by using local suppliers. Developing supply chain linkages can provide an important boost for exports from the SME sector, since a firm that has developed the capability to supply a large FDI investor is more likely to be able to also export its products.

Strong linkages between FDI investors and domestic suppliers have developed in the electronics and auto sector; but linkages seem to be weaker in other sectors. Indeed, in the 1990s, there was no clear evidence at the aggregate level of intra-sectoral positive spillover effects in Portugal as measured by the effect of FDI on domestic firms' labour productivity (Flores, Fontoura and Santos, 2007). To be a successful supplier, domestic firms need not only to have the technical capacity to produce high quality products, but also to have the flexibility to deliver on time and to adjust quantities as demand fluctuates.

Policies can encourage spillover effects and building linkages by supporting training centres, promoting coordination of domestic firms and foreign investors, and assisting domestic firms to improve their product quality and cost competitiveness. The National Strategic Reference Framework (NSRF), defined by Portugal to apply EU structural and cohesion funds over the period 2007-13, includes support for firms' investment.[24] One of the purposes is to help firms in improving their management and organisation skills, the conception and design of products, and quality certification. Within the EU framework, and in the context of the *Technological Plan*, there are also programmes aimed at building clusters around larger investment projects, for example the wind industry cluster.

International experience suggests that programmes to promote linkages can be successful. Singapore and Ireland are good examples. In the case of Singapore, for instance, financial and organisational support was provided to foreign affiliates to assist local suppliers, reducing the risk to the foreign firm of building supplier linkages. However, experience in these two countries also shows that these programmes are expensive; and more generally, that success depends on the availability of large pools of skilled workers and small firms with the capacity to become suppliers. The success of the programmes also depends a lot on the collaboration of existing investors and sufficient resources being assigned to the government's investment promotion agency. Furthermore, FDI promotion efforts aimed at strengthening the linkages with domestic firms are more effective when complemented with flanking policies that improve the investment climate. For instance, increasing human capital and product market competition will help increase incentives to invest and raise the absorptive capacity of local firms, thereby enabling closer linkages with foreign investors and domestic firms. Pursuing a comprehensive approach to creating an attractive investment climate would help mobilise investment by both foreign and domestic firms. The *Policy Framework for Investment* developed by the OECD can be usefully applied to facilitate such a process (OECD, 2006d).

It is important that strict evaluation be carried out to ensure maximum returns from the use of Portuguese and EU funds, especially as the pool of skilled workers in Portugal is rather limited, which may constrain the possibility of effectively building linkages. Cost-benefit evaluations of policy interventions need to be made regularly, with a particular emphasis on the measurement and evaluation of outputs from these interventions. To ensure that government policies obtain the highest returns, detailed information is required, in particular on the extent of spillover effects and linkages and how much influence current and past policies have had on them.

Easing product market regulation

Product market regulation (PMR) is an important influence on growth, including by its effects on trade and FDI. There is evidence that both manufactured goods and services trade growth is affected by restrictive product market regulation: strict regulation not only impedes imports of services but has a large effect on exports, as it reduces the competitiveness of firms in the exporting country. Estimates by Nicoletti, Golub *et al.* (2003), in particular, suggest that an easing of the restrictiveness of Portugal's PMR in 2003 to align regulations to those prevailing in 1998 in the United Kingdom (the least regulated country in the OECD that year) would have allowed an increase in both goods and services exports of the order of 10-15%.[25] Concerning the impact on FDI, the estimates show that easing Portugal's PMR in 2003 to levels achieved in the United Kingdom would have allowed an increase of around 20% in the FDI stock.[26]

Moreover, it is not only the degree of restrictiveness of regulations that affects services trade, but also the heterogeneity in regulations across countries, by raising costs of service providers that operate in different countries (Kox and Kyvik-Nordas, 2007). Services exports, in Portugal as in many other small countries, are particularly affected by having different regulations from major trading partners. In addition, SME's, which make up the vast majority of firms in Portugal, are likely to be more affected by heterogeneous regulations than larger firms.

The OECD aggregate indicator for the restrictiveness of PMR in Portugal shows a substantial easing of PMR between 1998 and 2003 (from 2.1 to 1.6 on a scale of 0 to 6 from least to most restrictive), broadly similar to the easing recorded in the OECD on average. There have been additional measures since 2003 to further reduce the regulatory burden on firms; these would be reflected in a further decline of Portugal's PMR indicator as noted in Chapter 1.

Aware of the importance of having a good business environment for growth, and building on earlier efforts, the government launched a broad initiative to ease product market regulation (PMR) in 2005, by lowering the costs that burdensome government administration and inappropriate regulations impose on firms. The main programme is SIMPLEX, which is part of the government's efforts to implement the overall Lisbon Strategy to raise growth. The programme aims at improving the effectiveness and efficiency of public services, in order to eliminate unnecessary formalities and assist citizens and firms in meeting the remaining formalities more quickly. Key measures introduced over the past three years are: the inclusion of specific quantitative targets in programmes to reduce administrative burdens (such as one hour to create a firm), the streamlining of government processes and replacing traditional over-the-counter services with online services (see Box 2.2 in Chapter 2, on e-government). The streamlining of processes involves developing information sharing between public services, so as to eliminate the burden on firms from having to provide the same information to multiple public agencies. In this context, the "Simplified Business Information" (IES) programme introduced a common database for firms to provide information to the Ministry of Finance, the National Statistical Office (INE) and the Bank of Portugal. This is a major step towards simplifying the administrative burden while improving information collection. The internet is now widely used for communications between firms and tax authorities.

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Making greater use of online services not only decreases the time needed and prices paid by firms for these services, but also increases the exposure of firms to the use of the Internet, which could have important spillover effects.[27]

The measures implemented, or planned, under SIMPLEX affect the entire firm lifecycle, from entering the market through to running and closing the business. The most prominent measures already in place include the elimination of deeds, a reduction in the time required in one-stop shops to create a company and setting up a service to create a company online (Annex 3.A1). As a result, the time and cost to start a business have been reduced (*e.g.* the time to create a domestic public limited company was reduced from 11 days to between 4 and 5 days, less than half the OECD average).[28] SIMPLEX has also helped to reduce the number of bodies to contact and the global cost of the pre-registration and registration processes. One caveat, however, is that the fastest procedure only applies if firms use online catalogues, for example, to choose pre-defined firm names or brand names. This impedes firms' choice, and those desiring greater discretion have to spend more time. Online procedures should be further simplified, in particular by increasing the speed and ease for firms to obtain a response from government on issues over which the government wants to retain discretion (*e.g.,* firms' names).

Progress has also been made in reducing the regulatory burden of running and closing a business. Online procedures were introduced including: the online "Permanent Certificate" that eliminates the need to have duplicate paper certificates of commercial registry for several processes (the permanent certificate can be accessed whenever it is required for a procedure, through an access code); and the introduction of an online procedure that allows firms to provide the information required for several public services simultaneously. Overall, the introduction of these new simplified procedures for the dissolution of firms is a significant improvement. The process is already partly implemented, although it only applies when owners of the firm unanimously agree and there are no debts to repay. For other cases, the process was simplified by the law on firm insolvency, approved in 2004, and more improvements are expected from the adjustments introduced in August 2007. A comparison with other OECD countries shows that the time taken to close a business in 2006 was above the OECD average.[29] The government should continue to streamline the process for liquidating firms.

There is scope for further improvements in PMR. Indeed, it is important for firms not only to be able to register and create a company easily, but also to actually start running it (for example, obtaining the licences from local authorities for the use or construction of buildings such as warehouses, shops and factories). Burdensome licensing procedures involving all levels of government, including municipalities, have been a major bottleneck for doing business in Portugal. For example, industrial developments require a licence from municipal authorities to build the structures and then to start the activity. No catalogue of required licences is available and obtaining licences involves several different public services, which increases the time and costs for firms.[30] A reform of licensing is in progress. In 2006, the "silence is consent" rule was introduced, although for tourism projects only. From 2007, licensing has been replaced with a "trust-based" declaration for commerce and services activities, such as commercial buildings, restaurants and liquor shops and tourism projects. For those projects where licensing still applies, the "silence is consent" rule is to be applied. For industrial activities, the "trust-based" declaration was introduced in 2007 as a pilot project for a number of firms that altogether accounted for around 15% of licensing procedures. In 2008, further changes are intended: *i)* to extend the declaration to 85% of all licensing procedures and apply the "silence is consent" rule for the remaining 15%; *ii)* to designate a single authority (central or local) to be the only contact point of the firm; *iii)* to issue a web-based catalogue of required licenses; and *iv)* to dematerialize the licensing procedure. The government needs to take further action in line with its priority under SIMPLEX 2007 to reduce the licensing burden and ensure that this new more stream-lined system is fully implemented and is effective in substantially reducing the burden on firms. The implementation of measures planned under SIMPLEX should not suffer any delay, with the objective of achieving OECD best practice. This will also require collaboration with the municipalities since they are involved in the actual implementation of licensing procedures. Regions and municipalities are not formally included in SIMPLEX and local authorities have legal autonomy. However, the central government can spread knowledge about the SIMPLEX programme at the local level, and give budget incentives for its implementation. Consideration could be given to using contracting arrangements between the central and municipal levels to achieve agreed licensing targets in combination with measurement indicators to benchmark performance.[31] A clear assessment and publicity of the differences on administrative burdens between municipalities (*i.e.* benchmarking) may promote competition and lead to gains for citizens, firms and the services themselves.

Evaluating the effects of SIMPLEX is important for ensuring the programme leads to ongoing improvements in the business environment. From 2008, the evaluation of effectiveness of SIMPLEX measures will be made using the *Standard Cost Model* (SCM), a framework to evaluate administrative burdens. The SCM has already been implemented in ten pilot projects (OECD, 2008). The Portuguese authorities intend to improve the SCM methodology by including new variables within the model. For example, the precision of the information, such as the time needed to obtain a licence or service, is particularly important to investors but is not taken account of in the SCM, which focuses on the number of procedures. The methodology will eventually be spread to all the SIMPLEX measures.

Another important step to improve PMR is the harmonisation of regulations with major trading partners, which would contribute to boosting trade, particularly in services. OECD work shows that Portugal is one of the countries that would gain the most from reducing regulation heterogeneity through harmonisation with, or mutual recognition of, the standards in its larger trading partners, including qualifications requirements and procedures, licensing requirements and technical standards (Kox and Kyvik-Nordas, 2007).

Improving SME access to capital markets

Since the vast majority of firms are SMEs, improvements in their productivity and cost-competitiveness are important for lifting their contribution to Portugal's export performance, for example as suppliers to much larger exporting firms. Often, this requires investment that may be constrained by a "financing gap" meaning that there are significant numbers of SMEs that could use funds productively if they were available but cannot obtain finance from the formal financial system (OECD, 2006). This gap may occur because of asymmetric information problems or a lack of credit instruments suitable for financing high-risk projects such as newly established SMEs. In particular, if banks and other lenders have to cover their default risk on high-risk projects through interest-rate setting alone, then the rate of interest rate becomes prohibitively high. Greater development of the market for risk capital can assist in closing the gap. Indeed, there is empirical evidence based on firm-level data across 16 countries, including Portugal, that financial market development is particularly important for small firm entry and also growth of newly-created firms (Aghion, Fally and Scarpetta, 2007).[32] In principle, there is a case for careful public intervention to facilitate the development of financial markets. International experience suggests that the overall macroeconomic, legal, regulatory and financial environment is the critical determinant of SME access to finance. Public intervention should be regarded strictly as a secondary measure that cannot substitute for improving framework conditions.

The government has introduced a number of policy programmes to increase SMEs' access to financial markets. Since 2006, the Financial Innovation Framework for SMEs in Portugal (INOFIN) has supported SME access to capital, including equity, through the use of financial instruments, such as risk capital funds or guarantee funds. Two INOFIN programmes are already under implementation. One, FINICIA, is designed to promote access to finance for innovative start ups and small firms.[33] The other programme, FINCRESCE is aimed at more mature SMEs. In both programmes, measures include creating public-private funding partnerships. The financing of the investment projects is provided in full by private financial institutions (banks, business angels or venture capital companies) and entrepreneurs, as well as in some cases city council grants. The public participation in these programmes, through Portuguese Agency for SME Support and Innovation (IAPMEI), amounts to an average of 75% risk sharing of the total investment. The programmes also include actions to improve SME capability through providing information and training. For example, (IAPMEI) provides standard procedures and documents to the FINICIA networks, and also provides grants for business plans and coaching.

The on-going programmes are a clear improvement on the previous policy to support SME access to capital, including the financial component of PRIME, which was dominated by EU funded grants and credit with a zero interest rate for SMEs.[34] The new programmes help to improve information flows between SMEs and the private financial sector, thereby reducing funding costs for SMEs. A clear advantage of the new programmes is that they involve private sector capital, which tends to be far more discerning in selecting which projects to fund than the public sector. Another advantage is that INOFIN programmes do not attempt to target specific sectors.

Participation of public resources, however, remains very high in some projects. The authorities should aim at maximising the private sector capital invested per euro of public money and ensuring that policy remains essentially focused on correcting market failures, such as those caused by information asymmetry and facilitating financial market development through creating the right framework conditions. It is also important that public agencies, such as IAPMEI and the Business Development Agency (AICEP), coordinate their programmes closely.[35] Finally, it is very important to assess the results of these programmes. The evaluation reports on PRIME, a programme developed within the Community Support Framework III 2000-2006, included data on the financial execution of the programme (for example total investment, total subsidies, number of jobs created), but not on the microeconomic effects on firms or on the overall economy. Evaluation is a vital tool for maintaining a transparent process, assessing the effectiveness of public funds and, in the end, improving the design of future programmes.

Strengthening competition and improving infrastructure

Competition needs to be increased throughout the economy, as this would spur productivity growth by creating pressure on producers to innovate. Increasing competition in infrastructure sectors, in particular, would also boost productivity and growth, by reducing the dominance of the largest firms that provide key inputs to other industries, reducing the price and improving the quality of those inputs. This would contribute to putting the economy on a higher growth path and obtaining the full return from the economy's openness to trade and foreign investment. Infrastructure sectors, such as transport and telecommunications, provide vital inputs for production across the entire economy. The efficiency, safety, quality and price of Portugal's infrastructure are important determinants of the cost-competitiveness of Portuguese firms, the attractiveness of the country to foreign investors and, consequently, Portugal's growth performance.[36] Empirical work shows that increasing infrastructure quantity and quality can lift economic growth significantly, provided careful case-by-case cost-benefit analysis is conducted.[37]

With transport costs and delivery times being important factors in domestic and international trade flows (OECD, 2006a), increased efficiency in transport infrastructure would help to boost Portugal's trade performance. It is also important for Portuguese firms to have access to high quality, reliable and value-for-money services from the telecommunications and energy sectors. However, prices of telecommunications and electricity for industry remain relatively high compared with other OECD countries.

An overview of competition and regulation issues

The regulatory framework plays a major role in ensuring effective competition in infrastructure sectors and there is a solid body of evidence showing that liberalisation policies, if designed well, will lead to higher productivity, better quality and often lower prices in network industries (Høj *et al.*, 2007). Portugal has made significant progress in reducing competition-restricting regulations. The OECD's Product Market Regulation indicators (Conway and Nicoletti, 2006) show that regulations in network industries improved significantly over the 10 years between 1993 and 2003, with the overall indicator for restrictiveness in network industries declining from 5.1 in 1993 to 4.4 in 1998 and 2.6 in 2003. However, in 2003 Portugal's restrictive regulation indicators for electricity, airlines and natural gas sectors were above the OECD average, (Figure 3.14). They were around the OECD average in the telecommunications and post sectors and significantly below in the roads sector.

Measures taken since 2003 to modify legal and regulatory restraints on competition imply that this indicator is likely to have fallen further. The main changes that have contributed most certainly to easing the restrictiveness of the indicator for network industries are: *i)* increases in the market share of new entrants in telecoms markets; *ii)* the introduction of third-party access regulation in gas, the full ownership unbundling of gas transmission assets and allowing electricity generators to compete in the gas market (competition was restricted in all markets previously by regulation)[38]; *iii)* allowing all customers including households to choose between electricity suppliers and *iv)* allowing all electricity generators to choose between gas suppliers. These changes are likely to be reflected in a reduction of the regulation indicators for the electricity, gas and telecommunications sectors. The full benefits of the recent measures on the economy will

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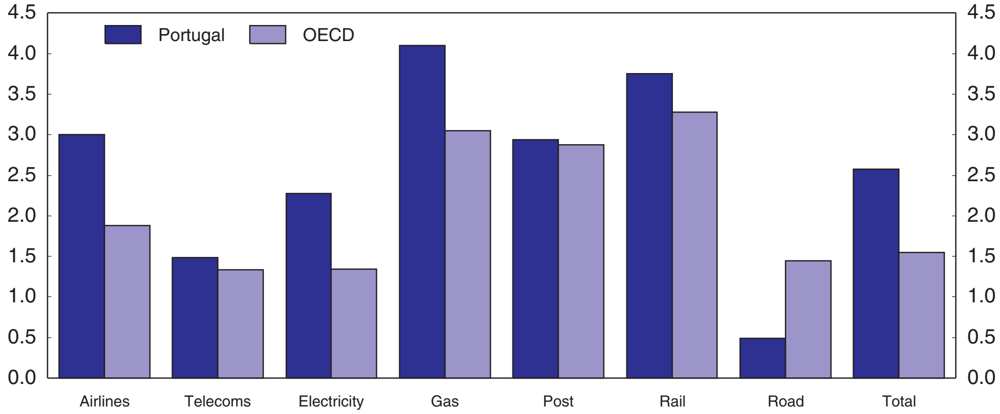
Figure 3.14. **Extent of restrictive regulation in network industries, 2003**

Scale 0-6 from least to most restrictive of competition



Source: OECD, Product Market Regulation database.

StatLink http://dx.doi.org/10.1787/343216448225

take time to come about. OECD work shows that early movers have reaped more benefits in terms of gains in labour productivity than late starters.[39]

Notwithstanding recent improvements in Portugal, additional measures should be taken to deepen the regulatory reform process. The regulation indicators show that there was substantial scope to reduce regulations in some sectors. Moreover, Portugal's relative position in the OECD may not have improved by much between 2003 and 2006, since other countries are likely to have also taken measures to correct restrictive regulations over that period. It is important to identify and eliminate unnecessary legal and regulatory restraints on competition. International experience, in particular that of Australia, shows that a broad review and modification of legal and regulatory restraints on competition contributes to ensuring strong, sustainable economic growth.[40] Identifying and correcting these restraints can be a major task. To facilitate this, the OECD has developed a Competition Assessment Toolkit, which can be usefully applied to find and correct restraints in infrastructure sectors, as well as in the economy at large.[41]

In addition to sector-specific regulation and market structure, competition in infrastructure sectors is also affected by the more general policy and regulatory environment, including public procurement processes. Telecommunications procurement and electricity infrastructure concessions are awarded in competitive public tenders.[42] Furthermore, a new public tender code for competitive tenders was adopted in January 2008. These open public tenders for government contracts and concessions are vital for competition as they increase the opportunities for new entrants to enter and establish themselves in infrastructure sector markets and also help to lower procurement costs.

Some further improvements that could be considered include strengthening the role of prices in the criteria for public procurement tenders. In particular, once a bidder has met certain pre-qualifying criteria, such as that the bidding firm is solvent and financially sound, then, price should be the key determining criteria. Consideration could also be given to applying rules more tailored to each of public works, consultants and goods and services rather than treating them as all the same under public procurement rules: for example, using negotiation for purchasing consulting services where quality is paramount and an open tender on price for standard goods and services such as paper. Greater efforts should be made to encourage competitive bidding for existing concessions, *e.g.* for ports when they expire. Furthermore, the Competition Authority should be given jurisdiction to give binding decisions on government procurement actions. Finally, the civil service needs to be more aware of, and more active in, reporting possible cartels to the Competition Authority as procurement processes have been affected by cartels in the past in variety of areas including pharmaceuticals, general hospital procurement and the purchase of helicopters for fire-fighting.

Competition in infrastructure has also been affected by the exceptional review procedure provided for in the legislation that established the Competition Authority. The government can overrule, on public interest grounds, a competition authority decision to block a merger.[43] (The government cannot use this process to override a decision by the Competition Authority to allow a merger, though). The government allowed a merger that the competition authority had blocked, which reduced competition in road infrastructure.[44] Consideration should be given to repealing the government's exceptional review power.

Improving key infrastructure sectors

Telecommunications

Telecommunications services in Portugal are improving, prices are falling, competition is growing, and the overall regulatory framework is improving; nonetheless, there is scope for further improvements.[45] Prices for fixed line telephone calls were still among the highest in the OECD in 2007, for both households and small businesses, converted at market exchange rates into US dollars (Figure 3.15), which may help to explain the high rate of substitution towards mobile phones. In Purchasing Power Parity (PPP) terms, which give a better comparison of consumer welfare across countries, Portugal's prices were also higher than the OECD average.[46] Mobile phone charges at the retail level give a more mixed picture: for low users, prices were around the OECD average, while for high users, prices were amongst the highest in the OECD in both US dollar and PPP terms. However, around 80% of mobile phone consumers use pre-paid cards in Portugal that have much lower calling rates. At the wholesale level, fixed-to-mobile phone termination charges are among the highest in the OECD (OECD, 2007). In addition, although Portugal is making overall good progress in improving the regulatory framework, it still does not provide clear enough rules for market access for new entrants (ECTA, 2007). The industry also remains dominated by the incumbent, Portugal Telecom (PT), which has a share of around 70% in fixed line and international calling and close to 70% in mobile telephony. The company also has a dominant position in the ownership of Portuguese media content, which is becoming increasingly important as multi-play bundles (telephone, Internet and pay TV) become more common. This market structure and the network features of the industry mean further efforts by the regulator, ANACOM, will be required to foster effective competition in the market.

For telecommunications services to continue improving, it is important that competition continues to grow. This requires addressing a number of issues: *i)* facilitating platform competition; *ii)* addressing high mobile telephone termination rates; *iii)* continuing to foster local loop unbundling and broadband Internet; and *iv)* addressing media content ownership.

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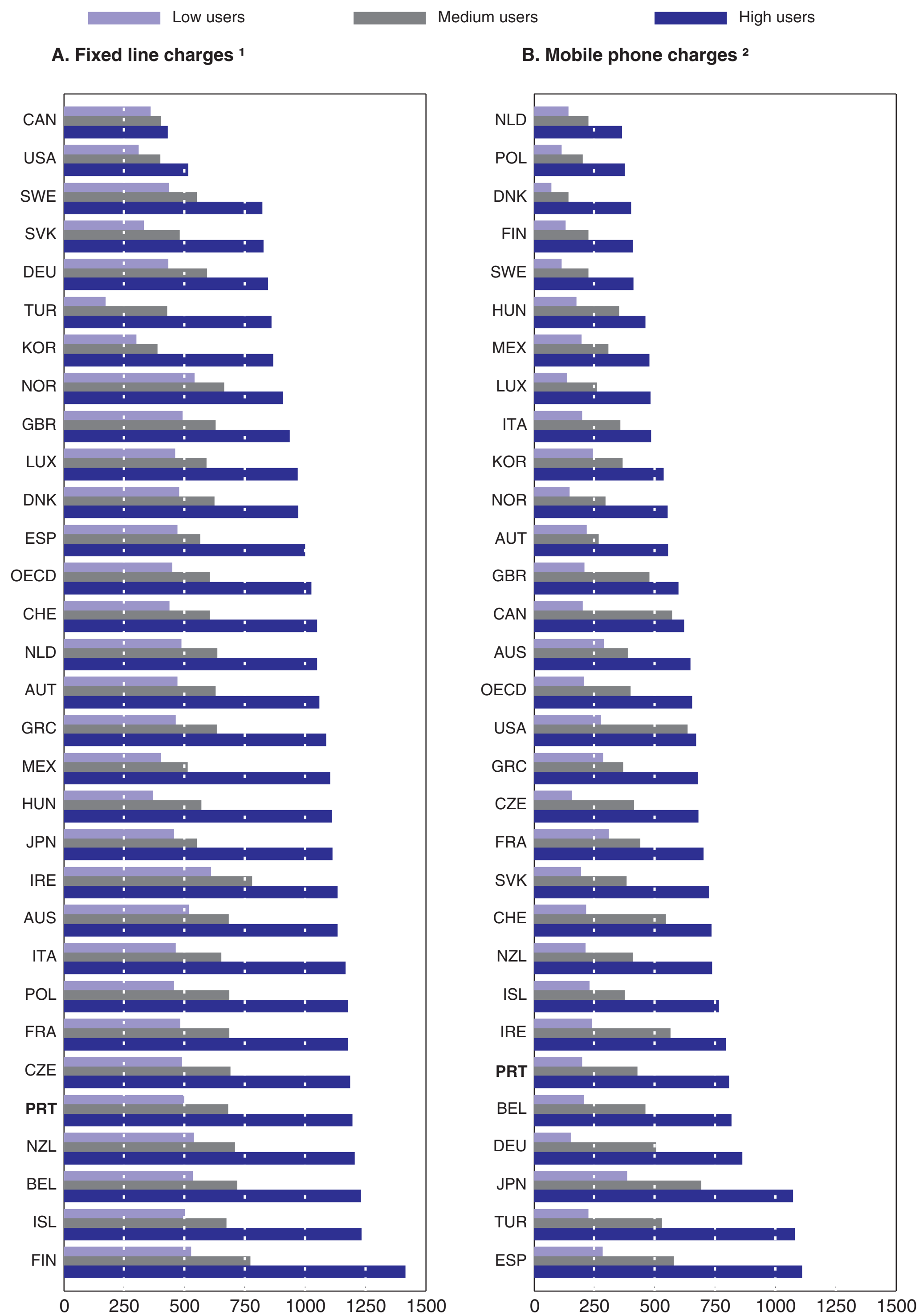
Figure 3.15. **Telephone charges in the OECD**

In USD, May 2007, by level of consumption



1. Calls to mobile networks and international calls are included, including VAT.
2. Pre-paid cards are excluded for medium and high users, including VAT.

Source: OECD, *Communications Outlook database.*

StatLink http://dx.doi.org/10.1787/343224218077

Encouraging platform competition involves facilitating an increase in the types of physical network infrastructure (*e.g.* cable TV or wireless networks) used to provide a service, for example, for voice calls or broadband Internet. A key step is to separate the ownership and control of the copper wire and the cable networks and that these networks compete actively with each other. Until recently, the copper wire and largest cable networks in the country were both part of the PT group. In November 2007, PT spun-off its 58% share in PT Multimedia, which owns the cable network, into a different company by allocating existing PT shareholders' shares in the spin-off company in exchange for their PT shares on a *pro rata* basis. A positive sign from the spin-off is that there has been an increase in offers to the market subsequently, including a new cable offer. Nevertheless, the ownership of PT and PT Multimedia remain very similar and this is likely to constrain the increase in competition as the assets will continue to have very similar owners, with the same interests. For the separation to be really effective, the cable network needs to have separate, independent owners. The government should take action to help increase independence of the owners. There is also a developing trend towards the merger of fixed and mobile services in one handset, for example using mobile virtual networks (MVN) (whereby a fixed-line company with no frequency allocation, for example, buys wholesale minutes from a mobile network frequency holder to combine with its own fixed-line service to offer in a combined retail service). Currently there is one MVN in Portugal and this is a useful avenue to encourage greater competition in the market between fixed and mobile phone operators and it should be facilitated by the regulator.

As in the rest of the OECD, Portuguese consumers have moved towards mobile phone use and away from fixed-line calls, so competition in the mobile phone market is increasingly important for overall consumer welfare. Competition has increased in this market, as evidenced by the share of new entrants; but an ongoing issue is the high termination charges levied by mobile phone companies terminating on their network. High termination charges give mobile firms with a larger market share a competitive advantage over smaller mobile firms and over fixed-lines firms, since customers will have a preference for making "on-net" calls, *i.e.* calls on the same network. Making on-net calls is more likely if you are a customer of a large mobile firm operator. Future regulatory action should help to resolve this problem. The regulator, ANACOM, is appropriately reviewing termination charges with the objective of requiring lower termination charges starting in 2008. In November 2007, ANACOM proposed lowering the ceiling on termination charges for all 3 mobile companies, although with a higher ceiling for the smallest firm. This positive discrimination in favour of the third operator is appropriate for fostering competition, but should only be temporary as the long-term goal should be to create a level playing field. Overall, though, this is a second-best solution; it would be preferable to require no discrimination in termination charges on or off network to eliminate the network externalities enjoyed by large players.

The experience of many OECD countries suggests that the potential benefits from local loop unbundling can be large.[47] Where it has been done, it has helped stimulate broadband services and has facilitated the rollout of bundled services, including Voice over Internet Protocol (VOIP), broadband Internet and television. This rapid increase in broadband access has also been accompanied by lower prices and higher speeds (OECD, 2007). In Portugal, wholesale access prices were substantially lowered and local loop unbundling is proceeding rapidly with the number of loops increasing from 80 000 at the beginning of 2006 to 240 000 by mid 2007. This is an important development that will help underpin the supply of competitively priced broadband services and greater bundled services.

Nevertheless, unbundled loop numbers in Portugal remain below the EU average. Although access prices are below the EU average, further cuts would help to further promote broadband internet competition and uptake. Lower prices would also help compensate for education levels and household computer penetration rates which are lower in Portugal than those prevailing in other EU countries and therefore act as a constraint on increased broadband use. A key consideration in setting prices is to ensure that there is a balance between encouraging entry and ensuring the loop owner has sufficient incentives to continue investing in the network. As well as setting appropriate access prices, it is important that the regulator monitors carefully the actual implementation of local loop unbundling, including the installation of competitor equipment at the incumbent's exchanges, as well as the incumbent's behaviour when customers switch. It should also monitor whether the incumbent is providing the service quality it has contracted to supply to competitors' clients. Actions by the incumbent, such as requiring a complex document process for customer switching and delays in making repairs for competitors' customers under service agreements, are an important impediment for competitors.

The dominance of PT Multimedia in media ownership is also a concern, especially given that bundled products, including pay TV, telephone and Internet, are likely to become increasingly common. Controlling a significant amount of media content gives PT Multimedia a strong advantage over other companies that would like to offer similar bundled services, affecting the ability of other companies to compete across the service spectrum. Separating the ownership of the media division of PT Multimedia should also be considered by the authorities.

Electricity

The electricity industry is composed of three main segments: a liberalised market (60% of installed generation capacity at the end of 2007), a regulated public service system (11%) and a special regime (29%).[48] *Energias de Portugal* (EDP), the private incumbent (with a minority state participation), owns 61% of total installed capacity directly. EDP plants that supply the liberalised market represent 89% of the generation capacity in the liberalised market including the current existing interconnection capacity with Spain. The regulated system consists of the Turbogas and Tejo Energia power plants (co-owned by EDP and other investors), which still have valid regulated power purchase agreements (PPAs), although the electricity they generate is sold downstream by the PPA counterpart in the liberalised wholesale market. There is also the special regime system created for renewable generation (except hydro) where, for some technologies such as wind turbines, prices are guaranteed by the government. The guaranteed price is above the price of a combined cycle gas turbine (CCGT), although as renewable technology has matured the price has decreased in recent years by 50%, to be between 5-25% above the CCGT price.[49] The generators in the special regime do not compete in the liberalised market or with each other (ERSE, 2007).[50] On the consumption side, the regulated segment continues to account for the bulk of the electricity sector, accounting for 85% of total consumption in 2006, up from 78% in 2005.

The electricity sector has been gradually liberalised over time. The most significant events include: privatising EDP in 1997-2000; unbundling the ownership of the transmission network from the incumbent generator, EDP, in 2000; allowing free entry in generation;

increasing consumer eligibility to switch suppliers, which culminated in all customers being able to switch starting from September 2006; early ending of the regulated PPAs in generation and the transferral of the corresponding capacity into the liberalised market and launching the joint Portuguese-Spanish spot electricity market (MIBEL) in July 2007.

The industry is currently in a transition phase between a regulated regime and a fully competitive market. Competition still remains limited and industrial prices are high by international standards, in both US dollar and PPP terms (Figure 3.16). A number of issues need to be resolved in order to increase competition in the electricity market and increase the efficiency of the price signals that reach consumers and electricity suppliers so they can make efficient decisions. First, transmission capacity between Portugal and Spain needs to be further increased. Second, competition should be enhanced in generation. Third, regulated retail prices need to be phased out. The future of the industry is likely to be heavily influenced by a large number of initiatives that are underway to significantly expand electricity generation and transmission networks (Box 3.3).

Increasing transmission capacity should be an important priority in this sector. There is limited supply available for purchase in the wholesale market in Portugal that is not controlled by EDP or subject to some kind of price guarantee regime, such as those in the special regime or the two remaining Power Purchasing Agreements (PPAs). This means that a significant source of competitive pressure on the Portuguese market in the nearer-term is Spain, but it is constrained by a lack of transmission interconnection capacity, which creates congestion problems leading to higher Portuguese wholesale prices than Spanish prices. The problem is likely to be reduced over time as the transmission network owner, *Rede Eléctrica Nacional* (REN), increases the transmission connections. Increasing transmission capacity has been a government priority since 2000 and transmission capacity has increased from 2000 to 2007 and a further increase is expected in the years through to 2011. The government should ensure that regulatory or administrative hurdles to building new transmission capacity are minimised.

An important consideration is that the Spanish market is also not fully competitive (OECD, 2007a). Since it cannot be relied upon entirely to generate a competitive market for Portugal, it is necessary to increase generation competition originating within Portugal as well. At the end of 2006, the government issued licences to non-incumbents to build new combined cycle gas turbines (CCGT) projects. Competitive auctions to licence 10 new major dams with an overall installed capacity of 1 100 MW is underway. If non-incumbents obtain licences for these, this would provide a further opportunity to increase competition in generation.

Despite these opportunities, an increase in non-incumbent generation capacity is not guaranteed. One obstacle is that CCGT technology is popular worldwide and demand for building this type of plant is strong, for example from China, and consequently the costs of construction are rising. Furthermore, the incumbent may well end up obtaining the licences for the dams given that synergies with its existing plants may increase its willingness to pay more at auction for the licences than new entrants would. The government has introduced "use it or lose it" deadlines of 5 to 10 years in the licences to help deal with the issue of a licence holder delaying indefinitely construction. In any case, it will take some time for these projects to be finalised and enter the market (2-4 years for the CCGT plants) and more than 5 years for the hydro plants.

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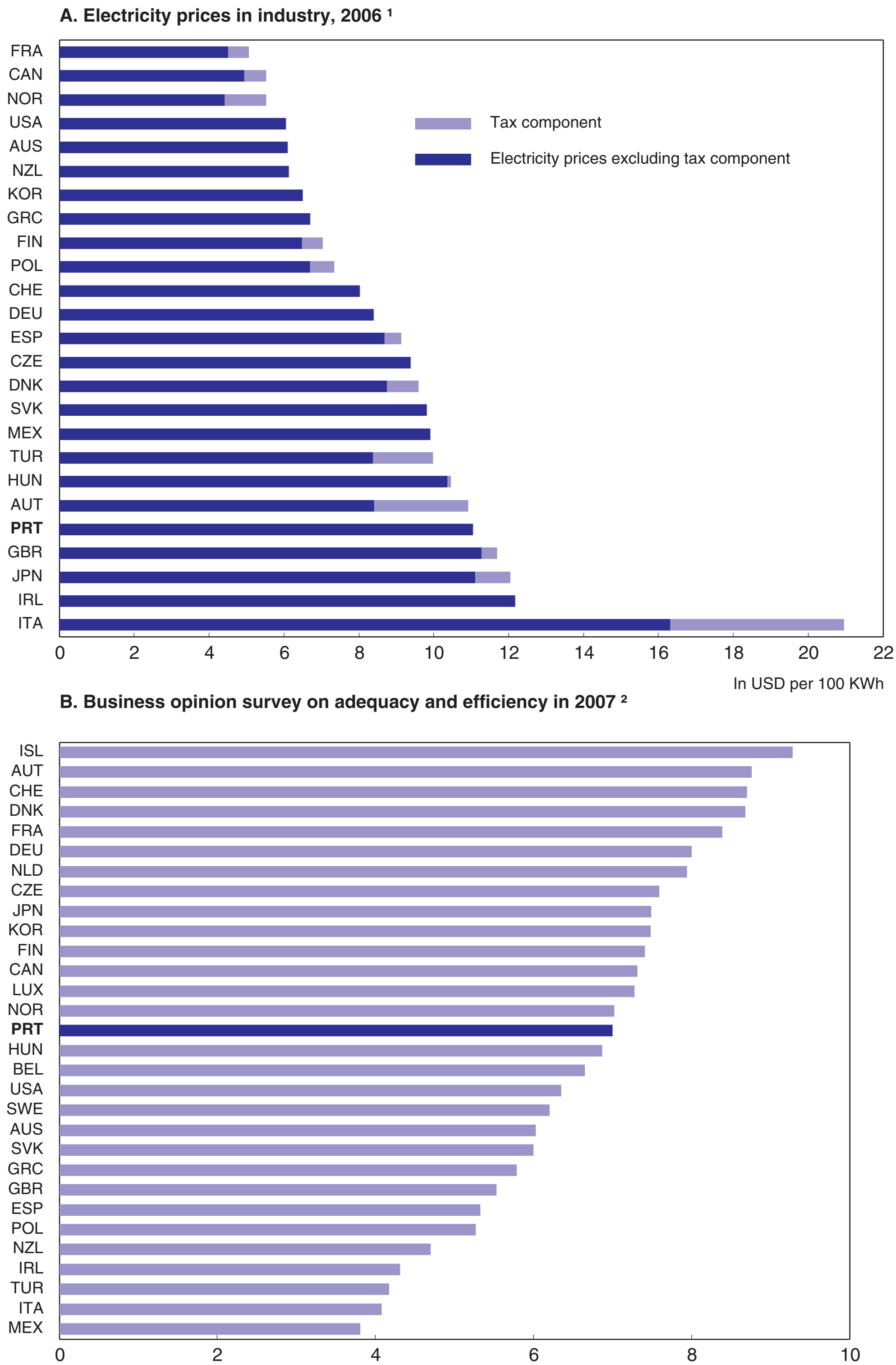
Figure 3.16. **Electricity infrastructure indicators: international comparison**



1. Or closest year available.
2. "Is the energy infrastructure is adequate and efficient?" Value 10 indicates the most positive perception.

Source: IEA, *Energy Prices and Taxes database*; IMD *World competitiveness Yearbook 2007*.

StatLink http://dx.doi.org/10.1787/343233321833

Box 3.3. **Expanding electricity generation and transmission capacity**

The government is facilitating a large expansion of electricity generation and transmission capacity in Portugal. Projects are in various stages of development and the total extra generation capacity would be over 9 000 MW or 2/3 of installed capacity in 2006. Government initiatives include:

- Issuing licences for constructing new combined cycle gas turbine (CCGT) power plants (2 400 MW) at the end of 2006.
- From 2007 to 2010, launching (licensing, launching public tender or starting construction) 10 new small dams (1 100 MW) and capacity expansion at existing dams, which in total would be an expansion in hydro capacity of 2 800 MW.
- Strongly encouraging the development of wind and other renewable generation with regulated prices, with the aim of expanding wind generation by 3 600 MW by 2012.
- From 2007 to 2010, facilitating other renewable generation projects (biomass, wave, solar, biogas). These are in various stages of development and would increase capacity by 750 MW.
- Expanding transmission capacity with Spain from 1 500 MW in 2007 to 3 000 MW by around 2011.

A competitive and efficient market needs many players. A further way to increases non-incumbent generation capacity available to the liberalised market would be to eventually incorporate the renewable generators into the wholesale market instead of having a special regime with a regulated price. In particular, as the wind sector will likely represent a large part of future capacity in Portugal, it is important that it is eventually included in the market.[51]

In the meantime, as a shorter-term measure to encourage competition until greater non-incumbent generation can be built, the government introduced a virtual power plant (VPP) scheme in June 2007 and is expanding it in 2008. The capacity available will be 500 MW by the second quarter 2008 (4% of installed capacity in 2006). Under the scheme, control over incumbent generation capacity is auctioned to the highest bidder. The option gives the holder the discretion over that capacity, when it is used to produce electricity and for how long. EDP operates the plant on behalf of the option holder.[52] By allowing non-incumbents control over EDP generation capacity, the VPP scheme should help to promote competition at the wholesale and potentially retail levels and should be further encouraged.

In the past, at the wholesale level, generators in the regulated system had long-term contracts, PPAs, with a single buyer, REN, the transmission company. These had expiry dates ranging from prior to 2010 out to 2027, with a weighted average extension until 2021. The PPAs ensured that the generators received a guaranteed rate of return. These PPAs were not compatible with a competitive Iberian wholesale market and were replaced with a compensation system (*Custos para a Manutenção do Equilíbrio Contractual*, CMEC).[53] The CMEC is a compensation payment notified and approved by the European Commission and it is designed to ensure that generators receive the same amount under market conditions as they would have received under the PPA. The compensation payment is equal to the former PPA revenue less what is received from the price in the wholesale electricity market. The CMEC payments are for a limited time period and are supervised by third parties to mitigate possible non-competitive strategies taken by the generators. A shortcoming with the CMEC compensation payments is that they allow EDP to be less exposed to market price risk than non-incumbents giving the incumbent an advantage over new entrants during the first years of the CMEC payments.

At the retail level, all consumers now have the choice of purchasing in the liberalised market or at a regulated price. The regulated retail price is set by the regulator, *Entidade Reguladora dos Serviços Energéticos* (ERSE), in a transparent way to cover the costs of supplying electricity. However, it is important that as long as regulated retail tariffs remain, the regulator has full independence to set these in line with best international practice. Appropriately, the government plans to abolish regulated tariffs from 1 January 2010 for industrial customers (medium and high voltage) and all customers with consumption above 50 kilowatts (includes SMEs). Regulated prices distort price signals and increase inefficiency in the market. Apart from the distortions introduced by regulated prices, international experience shows that free price setting in wholesale markets combined with regulated retail tariffs can lead to under-investment in generation and supply-demand imbalances (Høj *et al*., 2007). Social equity concerns and universal access to electricity do not require a regulated price and consideration should be given to abolishing the regulated tariff for all consumers. If necessary, it would be preferable to use income-targeted cash transfers to meet equity concerns.

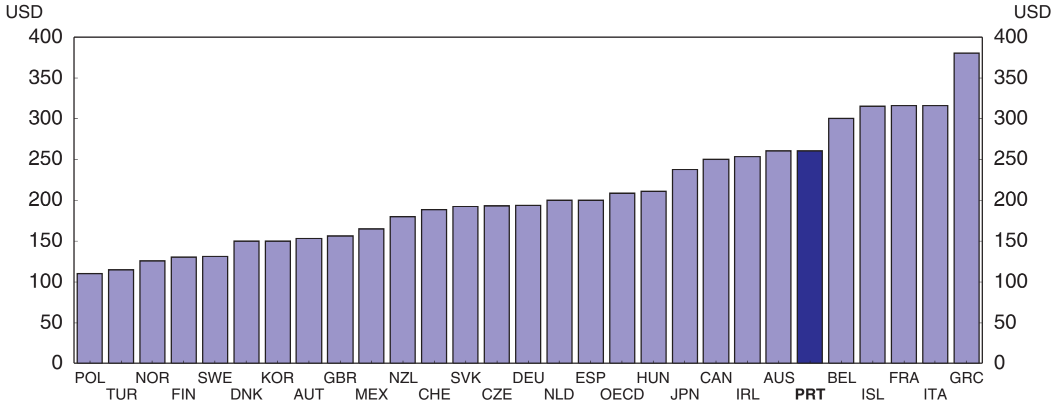
Transport infrastructure and services

Freight transport in Portugal is dominated by road, which in 2006 was carrying 87% of all freight. In contrast, maritime and rail transport accounted for only 11% and 2% of the total, respectively. Supported by EU funds, the highway network has been significantly improved; and the main transport infrastructure bottlenecks at present are in rail connections between Portugal and Spain, in ports and connections between ports and railways, in logistics[54] and at the Lisbon airport. Port charges are high by international standards (Figure 3.17), although there has been some decrease, the state-owned railway companies are still making large losses and there is a lack of logistics centres to allow the efficient transfer of cargo using multi-modal transport. Resolving these issues will require new investment to reduce bottlenecks, as well as improvements in cargo handling processes and taking measures to lift competition, with a view to lowering costs and increasing efficiency.

The government has adopted an integrated approach to improving *ports, railway links and logistic platforms*. If implemented thoroughly, it will improve the transport network available for importing and exporting from Portugal. It will also help to maximise the return from Portugal's geographical location by increasing the connections between Portugal's coast and the rest of the EU. The strategy is to improve connections between all of the 5 major ports – Sines, Lisboa, Leixões (Porto), Aveiro and Setúbal – and the railway network and also to build a network of logistics platforms. One of the aims of these projects is to upgrade connections to Spain. Railway projects already completed as part of the 2000-06 EU-supported economic development programme include building the railway connection from the port of Aveiro (situated between Porto and Lisbon) to the main Lisbon-Porto line. Connections to the ports of Leixões (Porto), Setúbal and Sines were also upgraded. The major investment projects that are planned include connecting all 5 major Portuguese ports to Spain with high-speed rail connections, carrying both freight and passengers (including Lisbon-Madrid, Aveiro-Salamanca and Leixões (Porto)-Vigo). Further

Figure 3.17. **Port and terminal handling charges associated with importing a container**

2007[1]



1. Charges refer to importing a 20-foot container.

Source: World Bank, Doing Business 2008.

StatLink http://dx.doi.org/10.1787/343320575052

upgrading the existing high-speed passenger connection between Lisbon and Porto is also planned. The launching of the first Public-Private Partnership (PPP) tender for the high-speed project is expected in 2008. These proposed investments are very large, and selection of projects should be based on a transparent economic cost-benefit analysis.

Complementary to the high-speed railway investment are plans to build a group of logistics platforms to facilitate cargo concentration, cargo splitting and inter-modal transfer. Particularly relevant to international trade are the seaport platforms and the Portuguese-Spanish border platforms. A platform has already been constructed near the main site of the Port of Lisbon; it will help to reduce cargo costs by 20%. These platforms, by helping to rapidly shift sea cargo onto land-based transport, are an important part of the supply chain. They are expected to reduce logistics costs by 10% on average.[55]

The handling processes surrounding infrastructure are also being improved. Customs and ports are working together to introduce a common IT platform (the Port Common Platform, PCOM), for cargo handling at the ports of Leixões, Lisbon and Sines. The system is operational at Leixões and Sines. The PCOM system will allow port clients to use the same system to provide cargo information in all three ports. The authorities intend to extend the system across the whole network of Portuguese ports under the Electronic Information and Procedures Programme (PIPE). These two programmes will make an important contribution to reducing currently high port costs in Portugal and are expected to improve efficiency by significantly reducing processes and paper form requirements.

As well as improving physical infrastructure and processes, it is also important to encourage greater competition in the ports and railways sectors. The government has started a reform of the Portuguese Institute for Ports and Maritime Transport (IPTM). IPTM provides common technical regulations and guidelines as well as economic regulation of ports; during a transitory period, it is in charge of the management of secondary ports.[56] Port management and pricing at major ports are now conducted independently by each port administration. In the present framework, the IPTM has a dual role as policy adviser to the government and sector regulator. The IPTM regulates port fees and charges with the strategic objective of ensuring competitiveness *vis-à-vis* other EU ports and exploiting internal complementarities.[57] It is important that future regulation is focused on promoting internal competition between the Portuguese ports to increase port efficiency including the provision of transparent information on port charging across ports to promote yardstick competition. Promoting internal competition is complementary to the increased integration of the port and railway network that is expected to make it easier for customers to choose between different ports. Port administrations should remain free to set prices, and price regulation should be restricted to dealing with the abuse of a dominant position and dealing with situations where the scope for competition may be limited between ports because of port capacity constraints or ports having a dominant position in certain cargo types.

In railways, track management and rail transport are conducted by two separate state-owned companies. The state-owned transport operator is the main company providing railway freight and passenger services in Portugal. A concession has been granted to a private sector firm for operating passenger services across the Tagus River in Lisbon and a new firm, TAKARGO, is entering the rail freight market. Access fees charged to the transport operator by the track operator only cover short-run marginal costs (part of traffic management and maintenance costs), but not total costs, including investment spending on the network (CEMT, 2005).

It is important that efficiency in this sector be improved to ensure that Portuguese firms have access to a cost-efficient rail service and that the railway system is not a continuous drag on the public purse. (see Chapter 2). The government should introduce performance contracts for both the rail track and rail transport companies. These should clearly define performance and financial targets, and management compensation should be linked to this. International benchmarking should be undertaken to help ensure appropriate target setting and improve efficiency. Government financing should be based on medium-term agreements in return for clearly defined services rather than the current ad-hoc arrangements. Promoting competition in railway transport operation through granting access to new operators would also put pressure on the national operator to improve efficiency. Recent regulatory changes will help to facilitate this. In particular, from January 2007, access rights have been extended to allow competition not only in international freight transport, but also in freight transport across the whole railway network in Portugal.[58] Access to the railway network to transport freight is now open to any company in Portugal that meets the financial and technical requirements necessary to be issued a licence by the Ministry of Transport.

In increasing competition, an important question for the industry is whether the access fee to the tracks should be set above marginal cost to cover fixed infrastructure costs in the competitive market. There is no internationally agreed-upon approach to setting access prices to tracks.[59] Policies range from imposing no charge above marginal cost (publicly-owned systems, with subsidies paid by government) to full cost recovery. Appropriately, the Portuguese law requires price setting to be non-discriminatory. In addition, whatever approach is followed to decide whether or not the access fee should cover fixed infrastructure costs, it is important to set access prices to the network in a clear and transparent way. The government should also ensure that if access prices are set below full recovery cost, subsidies to the track operator are sufficient to cover total costs and prevent losses, which would have to be financed by borrowing at commercial rates, as this will ultimately increase the government's overall borrowing costs. However, total costs of the track operator should be benchmarked internationally to ensure that the subsidy payment is not too high, which would encourage inefficiency.

Efficient *airline and airport services* for passengers and cargo are important for trade in both goods and services, tourism in particular. Two main issues have to be addressed: first, ensuring that airport infrastructure is sufficient to cope with future growth in demand; and second, increasing competition in airline services. The main airport infrastructure bottleneck is in Lisbon, where rapid growth in passenger demand (10% between 2005 and 2006) is rapidly absorbing available capacity; and cargo facilities are also insufficient. Reports on the airport capacity in Lisbon indicate that full passenger capacity will likely be reached in the next 3 to 8 years.[60] To accommodate growth in the shorter term, *Aeroportos de Portugal* (ANA), which is the operator of all airports in Portugal (and the majority shareholder in the Madeira airport operator ANAM), is investing in upgrading the current airport and recently opened a new terminal. However, demand will eventually reach the capacity of the airport, which is ultimately constrained by runway capacity, since the airport's central city site makes it impossible to build another runway. The longer-term proposal is to build a new airport away from the centre of the city. The government plan is to sell a majority 51% stake in the state-owned ANA to a private bidder, who would then be responsible for building and running a new airport.[61] The estimated project cost of € 5 billion would be funded up to approximately 90% by the private sector, and the rest by the public sector.

One concern with the proposed financing arrangements for constructing the new airport is that they would create a private monopoly in Lisbon and in all other Portuguese cities where ANA operates airports as well, which would in turn have to be regulated to prevent monopoly pricing problems. The proposed arrangements also appear to exchange monopoly control over all Portuguese airports owned by ANA in return for a private investor providing 90% of the capital for the new Lisbon airport and only having 51% control of the new Lisbon airport asset. Consideration should be given to whether eliminating airport competition between airports within Portugal is desirable.

Increasing competition in airline services should be a priority. After the merger of Portugalia with TAP, the national airline, TAP has a monopoly on domestic flights in mainland Portugal. Although at the time of the merger the Competition Authority imposed conditions designed to prevent the abuse of this dominant position, it would be desirable, from an efficiency and consumer welfare perspective, that other firms enter the market.[62] Given the importance of tourism for Portugal, this is a sector where there are potentially strong benefits from lowering barriers to FDI. To promote entry and greater competition, the government should consider lowering formal ownership restrictions on FDI in air transport. Although some international air service agreements require majority ownership by nationals this does not apply to domestic transport or within the EU single aviation market.

Concluding remarks

Portugal has made significant progress in lowering barriers to trade and investment and this has contributed to boost growth, especially in the 1990s. Nevertheless, there is scope to go further and reduce non-tariff barriers and improve the overall business climate, as this would help promote trade and attract greater FDI inflows. In this context, the government should continue its notable on-going efforts to reduce the cost of doing business also by ensuring that measures are fully implemented. This will help firms and

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the economy take greater advantage of the opportunities provided by rapidly growing trade and investment flows. It will also help firms adapt more quickly to the challenges of producing and competing in a globalized world.

Important advances have been made to reduce the administrative and regulatory costs that firms face. But in the new changing environment, more should be done to improve product market regulation, including streamlining licensing procedures and harmonizing regulations with major trading partners. Efforts to facilitate linkages and spillovers between FDI investors and domestic firms, including deepening supply chains should continue, based on careful cost-benefit analysis. Similarly, recent efforts to facilitate SMEs' access to private sector capital by addressing market failures caused by information asymmetries are an improvement on the past grant-based financial support. Again, continuous and rigorous cost-benefit evaluation is needed to ensure that the return from using public funds offsets the cost of raising the revenue to finance the interventions.

Competition remains too weak in Portugal across many sectors, including in infrastructure sectors that provide services to the whole economy. In particular, prices remain high for some telecommunications services, electricity and port services and greater efforts need to be made to strengthen competition in these areas in particular. The government has a key role to play, providing the appropriate regulatory environment and encouraging competition through its own procurement processes. This will help to lower prices, increase innovation and quality and improve the cost-competitiveness of Portuguese firms and the attractiveness of the country for FDI. Detailed policy recommendations to promote trade and FDI, lift competition, improve the business environment and infrastructure are listed in Box 3.4.

Box 3.4. **Main recommendations on trade and FDI, business environment and infrastructure**

Reduce non-tariff barriers to trade

- Continue to reduce customs costs associated with exporting and importing, through upgrading and developing an integrated information technology (IT) system that can be used by all the main actors in importing and exporting, including customs, ports and airports and freight companies.
- Remove Portuguese specific (*i.e.* non-EU), penalties for non compliance with the customs code and other regulations.
- Use automatic recognition of the classification of goods for tariff purposes of other EU member states. Allow firms to choose to import under that classification or the Portuguese one.

Maximise the benefits of FDI

- Reduce FDI restrictions in air transport, to promote competition and tourism trade.
- Conduct rigorous cost-benefit evaluation of the programmes (such as training centres or assistance for quality improvements) which are aimed at facilitating linkages and spillovers between FDI investors and domestic firms, in order to improve policy and help maximise returns. Ensure that all forms of support are available across the board, without attempting to pick winners.

Box 3.4. **Main recommendations on trade and FDI, business environment and infrastructure** *(cont.)*

Facilitate trade and FDI through improving the business environment

Improve the product market regulatory system

- Fully implement the SIMPLEX programme to improve the administrative and regulatory environment for business-government interactions.
- Streamline the licensing process and increase collaboration between central government and municipalities, for example through contracting arrangements, as this is important for effective implementation.
- Harmonise regulations with major trading partners, particularly sector-specific regulations in services, including service sector standards and qualification requirements.

Facilitate SME access to capital markets

- Ensure public intervention to improve SMEs' access to financing remains focussed on solving market failures, such as information asymmetries. Maximise private sector capital contributions per euro of public capital at risk, and avoid outright grants or credit with a zero interest rate for SMEs.
- Conduct a rigorous cost-benefit analysis of the programmes in place to promote SMEs' access to finance (for start-ups and more mature SMEs), in order to ensure maximum returns from public funds.

Strengthening competition and improving infrastructure

- Increase the priority on price in public procurement criteria, differentiate the criteria used for procurement of consulting, infrastructure and goods and services and give the Competition Authority jurisdiction to issue decisions on public procurement concessions and contracts.
- Consider amending the Competition Law to repeal the Government's exceptional review power that allows it to overrule a Competition Authority decision to block a merger. Undertake a broad review across the economy of legal restraints on competition.

Telecommunications

- Continue to lower mobile telephone termination charges and require that there be no discrimination of termination charges between calls within a firm's own network and calls from other networks to eliminate network externalities that favour larger firms.
- Expand mobile virtual network operators (providing for wholesale purchase of mobile minutes for non-frequency holders).
- Take action to increase ownership independence of the newly separated copper wire and cable-owned networks. Ensure there is effective competition between the two networks.
- Consider separating the ownership of PT multimedia content from the rest of the company to encourage competition.
- Continue to lower access prices to the local loop to increase competition in broadband Internet.

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Box 3.4. **Main recommendations on trade and FDI, business environment and infrastructure** *(cont.)*

Electricity

- Continue to encourage an increase in non-incumbent generation through expansion of the Virtual Power Plants scheme and issuing licenses to build new generation to non-incumbents.
- Ensure that government administrative and regulatory requirements, such as licensing, do not impede construction of new transmission and generation capacity especially for non-incumbents.
- Allow the regulator full independence to set retail tariffs.
- Fully implement the plan to phase out regulated retail tariffs and replace with market tariffs. Extend the phasing out to all consumers and, if necessary, introduce direct income support targeted to low-income consumers.
- Eventually integrate renewable energy generators into the wholesale market.

Transport

- Introduce a performance contract for both the rail track and rail companies with clear performance and financial targets linked to management compensation. Internationally benchmark both the rail track and rail operators to help set targets and encourage efficiency.
- Ensure access prices to rail tracks are set in a clear and transparent way.
- Introduce competitive tendering for rail services to reduce costs and increase efficiency.
- Encourage competition in port pricing *within* Portugal by facilitating yard-stick competition between the ports where cargo type specialization makes this feasible.

Notes

1. Nicoletti *et al.* (2003a) and Nicoletti and Scarpetta (2003b); and see Chapter 1 above for a discussion of the links between product market regulation and productivity and growth.
2. SIMPLEX and the Technological Plan are pillars of the Portuguese government's overall Programme to boost growth and employment (PNACE), 2005-2008, which is the Portuguese programme re-launched in 2005 to implement the EU-wide Lisbon strategy to boost growth.
3. Spain is Portugal's largest export market, accounting for 25% of total goods exports, followed by France (13%), Germany (11%) and the United Kingdom (7%).
4. World imports are defined as the imports of all OECD countries plus Brazil, Russia, India and China.
5. Eleven product categories of manufactured exports sold in 9 destinations (Portugal's 8 largest destinations and the rest of the world) making up 99 individual markets are selected for the analysis.
6. This component is the sum of the change in market share in each market (product i to destination j) weighted by the share of that market in total Portuguese exports. It measures how well Portuguese exports are performing in each of their individual markets.
7. The difference between the change in the main components and the change in the total is due to a residual that occurs as part of the decomposition calculation.
8. This variable takes into account conflict intensity between countries defined as a clash of overlapping interests in areas such as independence, borders and the distribution of power. It is does not measure directly political or economic stability.
9. The model takes account of bi-lateral tariff levels but not other EU single market effects such as regulation harmonisation which can help to encourage trade flows. This may help to explain why

trade between Portugal and other EU members is above predictions of the model and potential for exports to EU members appears low.

10. This may reflect the historical links between the two countries not fully captured in the model.
11. The EXPY index has been found to be associated with subsequent economic growth (Hausmann, Hwang and Rodrik, 2007).
12. The real effective exchange rate based on unit labour costs after 2005 for Portugal is based on proxy series for labour compensation and real output that have not been reconciled with annual benchmark data in the national accounts. These data, which provide a more reliable data source for unit labour costs, are only available up until 2005.
13. The unit labour cost are calculated *vis-à-vis* the new EU 10 member countries that joined the EU in 2004, because these countries are often exporting the same products to the same markets as Portugal, for example, exporting cars to Germany.
14. OECD estimates show that if Portugal reduced the tax wedge on labour to that prevailing in Australia in 2000 (then the lowest in the OECD), the gain in services exports would be around 35-40% (Nicoletti *et al*, 2003a).
15. This creates a small bias in Portugal towards resource allocation in these, more protected, sectors, with a particularly high bias for tobacco, owing to a high relative tariff.
16. For example, importers have noted that Portugal does not always recognise the classification of goods for tariff purposes by the other EU member states, as required by the binding tariff information regulation in the EU Customs Code. Furthermore, the customs authority does not always issue written binding valuation decisions that remain valid for several years following a valuation audit (USTR, 2005). In a recent survey among the members of a trade association consisting of importers of products into the EC, companies observed that "binding tariff information from German authorities is still not accepted by other EU countries, especially Greece and Portugal" (USTR, 2005).
17. Based on data from the May 2007 Ernst and Young, *Attractiveness of Portugal,* report.
18. Sector FDI flows data are affected by firm financing arrangements, such as the use of holding companies, which can hide the true flow; so that these data must be interpreted with caution.
19. The estimated elasticity of FDI to a change in the marginal effective tax rate ranges between 0.3 and 0.6 in a regression without the other policy variables such as the tax wedge on labour. Once these latter variables are included, this elasticity falls by more than half. The effect on FDI of a one standard deviation in the tax wedge on labour is about ten times higher than the effect of a similar change in the marginal or average effective tax rates.
20. A company engaged in domestic or international air transport from Portugal must be headquartered in Portugal and the majority of capital and management control must belong to national entities. See OECD (2007) *Country Exemptions to National Treatment for Foreign-Controlled Enterprises*.
21. The government also has investment contracts with some investors, for example Volkswagen, where the government provides incentives such as tax-breaks, in return for investment. These investment contract projects are also in the PINS programme to assist on the regulatory simplification side but not all PINS projects fall under the investment contract category.
22. VW Autoeuropa, for example, regularly visits its suppliers to see if production processes meet required standards. Siemens works with its suppliers so that they obtain the necessary quality certification.
23. In 2005, the staff of the promoting companies enrolled in the ATEC Training Academy accounted for only about 10% of total training hours. The remaining hours were attended by workers of other firms, school-age trainees, including job-seekers looking for a first job and unemployed workers. *Cf. www.atec.pt*.
24. In Portuguese, *Quadro de Referência Estratégica Nacional* (QREN). The system of firm investment support, included in QREN, was established by the Decree-Law No. 287/2007, of 17 August 2007.
25. The effects of easing product market regulation on exports are calculated using the coefficients on product market regulation (PMR) estimated in bi-lateral trade equations, which include terms to take account of gravity and relative factor endowments. The coefficient on PMR in the bi-lateral trade equation for trading partner X is multiplied by the difference in the level of PMR in Portugal and the United Kingdom in 1998 to determine the effect on exports to trade partner X. The total

change in exports is the sum of the bi-lateral export changes over all trade partners. This estimate has then been adjusted to take account of the easing in PMR in Portugal between 1998 and 2003.

26. The PMR measure used in the FDI equations on which the simulation is based is the product of the economy wide PMR indicator and the summary indicator for regulation in 7 non-manufacturing industries. The estimates are obtained by multiplying the difference between the PMR indicator in Portugal and the UK in 1998 by coefficients on PMR from bi-lateral FDI equations. This estimate has then been further adjusted for the easing of Portuguese PMR between 1998 and 2003.
27. Online procedures have had a strong take-up rate, increasing the number of firms entering the "online environment".
28. Between 2005 and 2006, Portugal improved considerably its position in the World Bank's ranking for "Starting a business". World Bank, *Ease of Doing Business Survey*, 2007.
29. See World Bank, *Ease of Doing Business Survey,* 2007, which shows it took 2 years to close a business in Portugal, compared with an OECD average of 1.4 years (and 0.4 years in Ireland).
30. Before issuing a licence, the municipal authority has to consult a number of other entities according to the type of project. Alternatively, the investor can complete this consultation prior to submitting a licence application and provide the complete dossier to the municipality.
31. See OECD (forthcoming), "National Territorial Review of Portugal" for an in-depth discussion of using contracting arrangements and indictors to measure service delivery in order to improve collaboration between government levels and the quality of service provision.
32. Financial development is measured as: *i)* the domestic credit to the private sector/GDP ratio and *ii)* the stock market capitalisation/GDP ratio.
33. In the course of FINICIA implementation, 13 FINICIA regional informal networks have been created, gathering together 85 partners, such as universities, incubators, regional agencies, technological centres, business angel's networks and venture capital companies.
34. As part of an EU co-funded economic development programme, for 2000-2006 (Community Support Framework III), the "incentive programme for the modernization of the economy", PRIME, included resources for the "Activation of Mechanisms of Financial Innovation". The funds were used for the creation and reinforcement of risk capital funds, security investment funds, guarantee funds for securitization of credits, and mutual guarantee funds. However, the underlying investment projects supported by this part of the programme represented only 1.65% of the total investment supported by the entire PRIME programme (GGPRIME, 2007).
35. Although, quite appropriately, INOFIN does not target sectors, it may be that, particular sectors grow faster than others as a result of this programme. AICEP should ensure that its external promotion takes account of these developments.
36. A new regulatory body for roads, the Road Infrastructure Institute (InIR) was created in 2007 to: *i)* ensure the efficiency, quality and safety of road infrastructure; *ii)* safeguard use rights; *iii)* monitor the management of the road network; *iv)* ensure the effectiveness of the national road plan; and *v)* ensure that concession contracts are fulfilled and laws and regulations are observed.
37. For example, Aschauer (1989), Easterly and Rebelo (1993), Miller and Tsoukis (2001) and Calderón and Serven (2004) find that increasing infrastructure is connected with higher growth. Hulten (1996) and Aschauer (1998) also find that infrastructure quality is important for growth. However, caution about findings of very high returns is warranted (Gramlich, 1994 and Englander and Gurney, 1994). Furthermore, the effect of infrastructure spending will depend on the economy's stage of development and past returns are not necessarily a good indicator of future returns. Fernald (1997) finds that building the United States' inter-state highway system prior to the 1950s and 1960s gave a large boost to productivity prior to 1973, but that by the end of the 1980s, road investment had at best a normal return. The author explains this in line with the simple network argument that, while building an interstate network may be very productive, building a second one may not be. Simply increasing the infrastructure stock will not necessarily boost growth. To ensure an efficient allocation of resources and higher productivity requires a case-by-case cost-benefit analysis of individual projects (Englander and Gurney, 1994).
38. The full ownership unbundling of electricity transmission and generation assets was included in the 2003 indicator.
39. See Chapter 1.
40. Australia's "national competition policy" programme reviewed about 1 800 national and state laws over a period of about six years. The programme was launched in the mid-1990s, through special

legislation that resulted from an agreement among the state and national governments. To manage reviews, the programme set up a National Competition Council. Their staff of about 20 professionals was supplemented by consultants.

41. See *www.oecd.org/document/38/0,3343,en_2649_37463_39680550_1_1_1_37463,00.html* for a discussion of the Competition Assessment Toolkit.

42. In 2004 the Competition Authority recommended that the State change its process for purchasing communications services. In particular, the Authority recommended that the State issue periodical public invitations to tender, impose a 3 year maximum for contracts, decentralise procurement and have separate tenders for different types of service (mobile, fixed line) (*Recommendation No. 1/2004*, Portuguese Competition Authority). This has been adopted for telecommunications.

43. In addition to seeking judicial review, it is possible to appeal a prohibition decision to the Minister of Economy, who then may approve it on the grounds that the combination promotes fundamental interests of the national economy, which outweigh its anticompetitive effects. Article 34of the Competition Authority's Statutes, approved by Law No. 10/2003of 18 January.

44. This procedure was used to allow the merger of the Brisa and Auto-Estradas do Atlântico groups, which was previously blocked by the competition authority on the grounds that: the two competing parallel highways would then be owned by one company, creating a monopoly where there had previously been a duopoly, resulting in consumer welfare losses; and that it was not proved that efficiency gains from the merger could not be achieved without the merger. (See Portuguese Competition Authority *Press Release No. 8/2006 www.autoridadedaconcorrencia.pt*.)

45. The ranking of Portugal's regulatory framework by the European Competitive Telecommunications Association Scorecard increased from 11th place out of 19 countries in 2006 to 7th place in 2007.

46. In comparing telephone charges across countries the appropriate exchange rate depends on the purpose of the comparison. Purchasing Power Parities (PPPs) allow more accurate cross-country comparisons from a consumer welfare perspective. The PPPs eliminate differences in general price levels across countries and give a comparable measure of the price of a phone call in terms of foregone consumption of other goods and services. A higher (lower) PPP price for a phone call in Portugal implies that users have to give up more (less) other goods and services than in other countries. Care has to be taken in making inferences about relative industry efficiency from PPP converted prices. This is because, although a large proportion of Telecom company costs is for labour and goods and services purchased within the country, for which a PPP exchange is appropriate, some costs, for example imported capital equipment, are purchased at a similar price everywhere and these costs should in principle be converted at the market exchange rate. Comparing relative efficiency would require using a mixture of PPP and market exchange rates to convert the different cost components.

47. Local loop unbundling is providing compulsory access to a part of the incumbent's network at a regulated wholesale price (usually a copper wire connection from the local exchange to individual customers).

48. The generation market is very close to being 100 per cent liberalised but it cannot be regarded as fully liberalised because a significant amount of the generation in the liberalised market is eligible for CMEC compensation payments that affect the return received by some producers. The CMEC payment system is approved by the European Commission and designed to ensure that it does not interfere with the liberalised market. Nevertheless, it still represents a regulatory interference that would not be present in a fully liberalised market where the market price directly determines the return of all producers.

49. A combined cycle gas turbine plant generates electricity with a gas turbine and then the waste heat from this is used in a steam turbine to generate further electricity. This is far more efficient than conventional thermal plant where the heat from burning the fuel (*e.g.* coal) is lost into the atmosphere. It is the leading technology for building new thermal power plants in Europe and the United States.

50. The special regime includes all types of renewables (wind, wave, biomass) which have a guaranteed price. Hydro electricity is not included and does not have a guaranteed price.

51. According to REN, this wind power may supply around 40% of total consumption in Portugal by 2010.

52. EDP receives the variable production cost plus what it would have received under the power purchase agreements (PPA) in return for operating the plant.

53. Two power stations, the Turbogas and Tejo Energia plants, have maintained their long-term power purchasing agreements and do not participate in the CMEC.
54. Includes transfer of cargo from one mode to another and concentration and de-concentration of cargo, for example from rail to road transport.
55. "*Portugal Logístico*", May 2006, Ministry of Public Works, Transports and Communications.
56. Secondary ports include Viana do Castelo, Figueira da Foz, Portimão and Faro, as well as some fishing ports.
57. See "*Orientações Estratégicas para o Sector Maritime-Portuário*", *www.moptc.pt*.
58. Decree Law 231/2007.
59. See Bureau of Transport and Regional Economics (BTRE), 2003, and European Conference of Transport Ministers of Transport (CEMT), 2005, for a discussion of these issues.
60. See *www.naer.pt* for multiple studies on airport infrastructure in the Lisbon region.
61. The partial privatisation of ANA was announced in January 2007, including in the process of building a new airport for Lisbon (Resolution of the Council of Ministers, 25 January 2007).
62. See the Competition Authority decision on the merger of TAP and Portugália (June 2007).

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ANNEX 3.A1

Measures to improve the administrative and regulatory environment for business: the simplex programme

	Measure	Implementation	Results
Starting	Eliminating the obligation to draw up a public deed; the only obligatory control is now made by the commercial registry services.	Implemented (June 2006)	Elimination of 65 000 deeds per year.
	Concentration of procedures for the creation of a company in just one office.	Implemented (July 2005)	The average time to create a company is 48 minutes. 65% of the firms are created "on the spot".
	Creation of a company through the Internet.	Implemented (June 2006)	Since June 2006, 542 companies were created online. Since October 2007, the price of online procedure is 50% less than over-the-counter procedure.
	Simplification of licensing proceedings. Concentration of business licensing requests at the Formalities Centres for Firms (CFE). Online Catalogue of licenses.	Planned	
	Introduction of the online process for environmental licensing.	Planned	
Running	Simplification of mergers and split-ups processes.	Implemented (June 2006)	For each operation, reduction from 11 procedures to 5.
	Elimination of the obligation of commercial bookkeeping.	Implemented (June 2006)	Elimination of 5 types of books, for each company. Elimination of 500 000 procedures per year.
	Introduction of certification of documents and recognition of signatures by registry offices, lawyers, solicitors and chambers of commerce.	Implemented (June 2006)	Introduction of competition. Prices, in the registry offices, lowered between 28% and 60%.
	Introduction of online requests of commercial registrations for capital changes.	Implemented (December 2006)	Since December 2006, 1 829 procedures were made online.
	Introduction of online "Permanent Certificate" service, substituting paper certificate.	Implemented (December 2006)	The subscription of the Service for 4 years is cheaper than a paper certificate. Since December 2006, more than 240 000 subscriptions were made.
	Introduction of online publications of companies' procedures, in substitution of publications in the Official Journal.	Implemented (January 2006)	Since January 2006, 736 961 procedures were published online. Estimated global savings of € 17 million per year.
	Introduction of online brand request.	Implemented (December 2006)	Since December 2006, 76% of the brands were requested online.
	Introduction of "on the spot" brand acquisition.	Implemented (July 2006)	The brand is now available immediately (compared with 10 months previously). From mid-2006 to end 2007, more than 300 brands were acquired through this service.
	Introduction of online patent registration.	Implemented (September 2007)	
	Simplification of the proceedings to change companies' headquarters and place of shareholder meetings, within the national territory.	Implemented (June 2006)	For change of headquarters, reduction from 4 procedures to 1. Since October 2007, the price of online procedure is 50% less than over-the-counter procedure.
	Introduction of Simplified Company Information (online delivery of information to four public institutions, simultaneously).	Implemented (January 2007)	In 2007, more than 300 000 firms delivered the required information. An increase of more than 387% compared with 2006.
	Simplification of the procedure to reduce capital.	Implemented (January 2007)	Reduction of necessary procedures from 7 to 1.

	Measure	Implementation	Results
	Introduction of online interaction between IAPMEI (Portuguese Agency for SME Support and Innovation) and the firms, including electronic forms to access IAPMEI products and services, the use of digital signatures, on-line certification of SMEs, firms being able to access their individual situation with IAPMEI online and the creation of an online simulator by IAPMEI to help business select the support products and services most appropriate for their needs.	Simulator implemented (July 2007) Electronic forms and SME certification implemented (November 2007) Digital signature (in progress)	2 835 applications received for online certification as a SME and 1 429 concluded as at 3 April 2008. 99.6% of applications received an SME certification. Enterprises can access their individual situation regarding a IAPMEI service on-line *http://www.iapmei.pt* Simulator on line is available at: *www.iapmei.pt/simplex/simulador.html.*
	Creation of a database, with the information provided by firms to other Public institutions (tax and social security authorities), to be used by IAPMEI, when analysing investment projects.	In progress	
	Simplification, by Social Security services, of the procedure to change the social bodies of the firms.	Planned	
Closing	Public deed for dissolution became optional.	Implemented (June 2006)	
	Dissolution and extinction "within the hour".	Implemented (June 2006)	
	Establishment of the causes for dissolution, by State initiative.	Implemented (June 2006)	
Other	Elimination of the territorial jurisdiction of the commercial registry offices.	Implemented (January 2007)	
	Reduction and clarification of the prices of companies' procedures, charged by the registry offices.	Implemented (June 2006)	Prices were reduced between 47% and 80%.
	Elimination of request forms for over-the-counter requests, at commercial registry services.	Implemented (June 2006)	Elimination of 200 000 forms per year.
	Elimination of mandatory renewal of registered procedures, each three years.	Implemented (June 2006)	

Source: "Simplex – Programa 2007", in *www.portugal.gov.pt*; "Balanço IES", in *www.portugal.gov.pt*.

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Chapter 4

Improving the functioning of the labour market

While participation rates are above average in Portugal, employment has been broadly stagnant since 2000, the unemployment rate has doubled and long-term unemployment is close to 50%. The labour market has become increasingly segmented, with a large proportion of workers on short-term contracts or in self-employment. Building on measures already taken, reforms are needed to develop human capital and facilitate labour market adjustment in the changing environment. This chapter argues that what is required to promote the creation of more – especially less precarious – jobs, is a broad strategy, including labour market reforms and human capital formation. In particular, there is a need to enhance the adaptability of the labour force, addressing rigidities in the formal labour market and improving the balance between flexibility and workers' protection. Effective training is also required to improve the skill match for new entrants and to help displaced workers in sectors affected by structural adjustments. Some measures have already been taken. The government has launched an initiative to upgrade competences of young people and adults at risk. It is also reviewing labour market settings and legislation with a view to reducing the segmentation of the labour market and increasing its adaptability. The measures taken and proposed go in the right direction. Continuity in the reform process and implementation remain a challenging task.

Overview

Portugal's labour market was characterized until the early 2000s by lower unemployment rates and stronger labour force participation than the European Union average. But labour market performance deteriorated after 2001. The effect of the economic slowdown in the early 2000s was aggravated by the impact of the deep structural changes related to the forces of globalisation. Participation rates have remained relatively high, reflecting high participation rates among women and workers with low education attainment (Figure 4.1). However, the unemployment rate continued to increase up till 2007, to a level higher than the European Union average. Labour market settings and practices which seemed adequate to cope with changes until the beginning of this century have not allowed a smooth adjustment of the labour market in the changing environment of the more recent period. The slowdown in export growth and weak domestic demand have been reflected in a slowdown of job creation, and many workers affected by job losses have remained trapped in long-term unemployment or have moved into precarious jobs.

In an increasingly global environment, resources have to shift across sectors as the economy responds to shifting demand and relative price signals. It is important that resources, especially labour, can flow easily across sectors, in order to prevent long periods of inactivity or shifts into precarious jobs and low-productivity employment. Ensuring a smooth functioning of the labour market and appropriate training of displaced workers can help to reduce these hardships. Labour market settings, in conjunction with social assistance, should ensure that the most vulnerable population groups do not bear too high adjustment costs. This chapter first presents a broad overview of recent labour market developments in Portugal. Then it discusses in more detail the specific factors contributing to adverse labour market outcomes and the ways to address them. Policies to facilitate the school-to-work transition and upgrade competences of adults are examined in the following section. The chapter ends with a set of specific policy recommendations, which are summarised in Box 4.4.

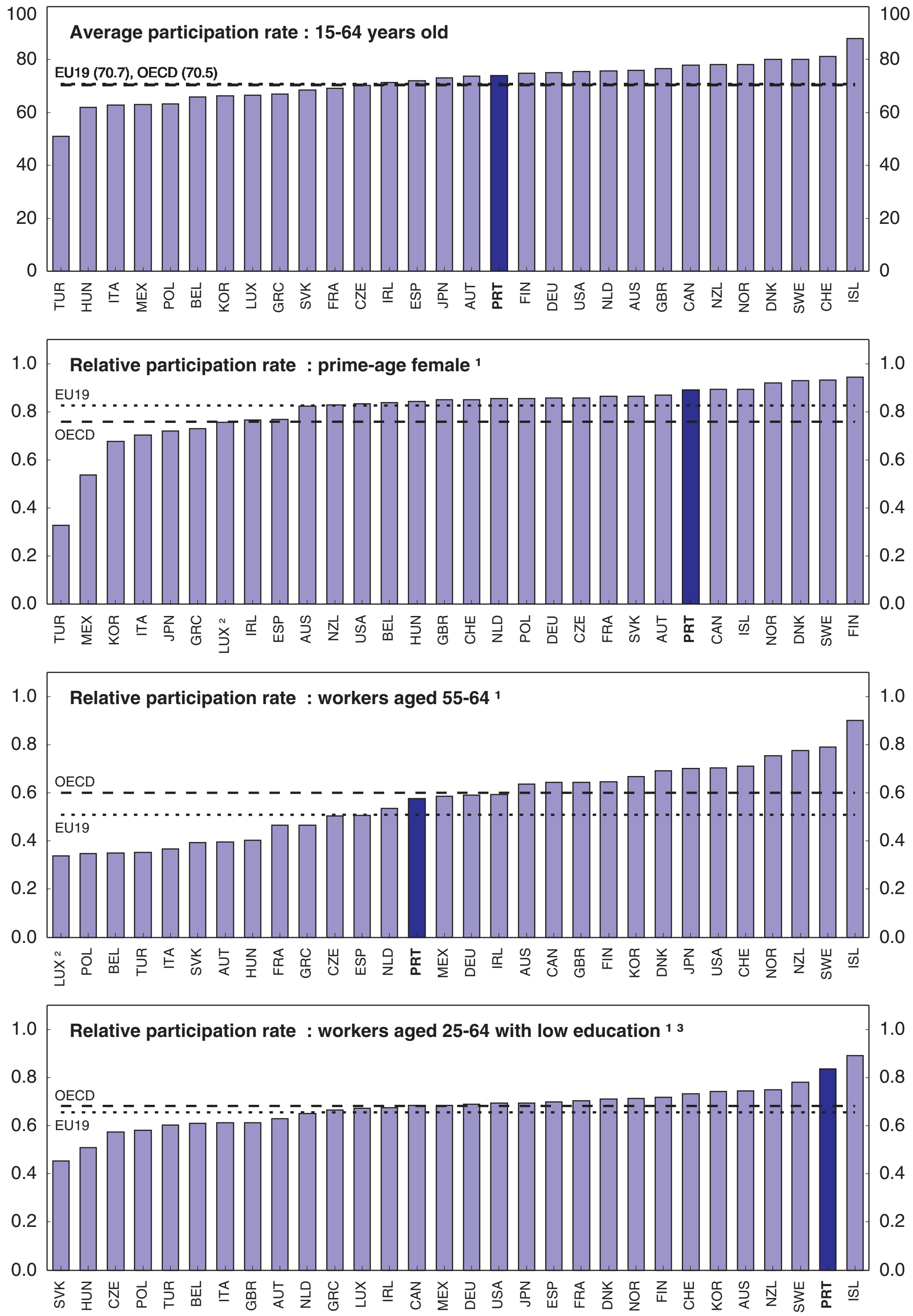
Recent labour market performance

Although employment rates stopped increasing in the early 2000s, they remain slightly above the OECD average. However, the unemployment rate has been on an upward trend, rising to 8% in 2007, twice its level in 2001, while the share of long-term unemployment was close to 50%, pointing to sluggish adjustment of the labour market.

Employment trends and labour market dynamics

Employment stagnated during most of the early 2000s, recovering in 2006 and 2007 in line with economic activity. Private sector employment grew by an annual average of 1% over the two years, regaining some of the ground lost in the previous period. The number of wage earners increased in 2006, and remained broadly stable in 2007. In both years, hiring on fixed-term contracts recorded high growth rates, while employment on regular

Figure 4.1. **Participation rates, 2006**



1. Relative to prime-age male participation ratio.
2. 2005 for Luxembourg.
3. Lower upper-secondary level of education (ISCED level 0/1/2) in 2005; 2004 for Japan.

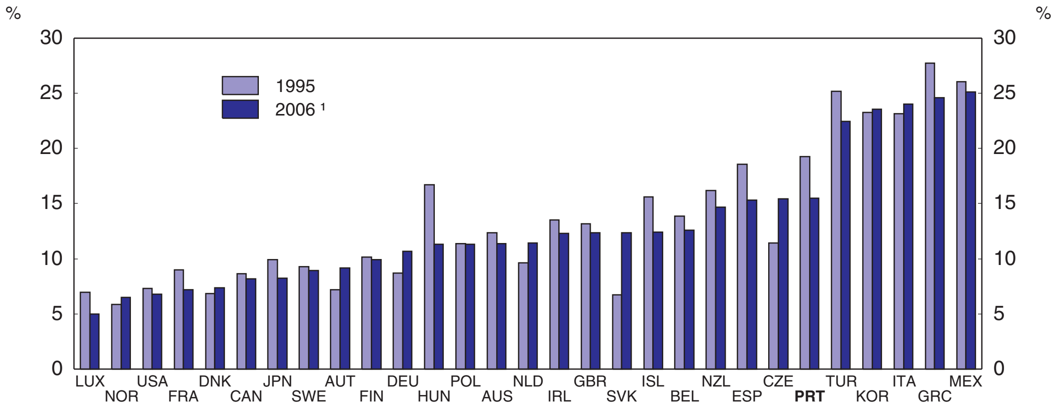
Source: OECD, *Labour Force Statistics.*

StatLink http://dx.doi.org/10.1787/343370302334

contracts fell sharply in 2007, leading to continued segmentation of the labour market. The share of self employment in total employment remains above the OECD average, despite having recorded some decline following measures taken in 2003 (Figure 4.2). The introduction of new rules in 2003 to control contracting out arrangements to "independent" workers (sometimes referred to as false independent work) explains part of this decline, as the more favourable treatment of self employment for social security purposes was reduced to converge to the regular dependent employees' treatment.[1] To the extent that the widespread use of "independent" work (rather than hiring dependent employees) gave flexibility to employers, the decline in the proportion of self-employment may reduce the overall flexibility of the labour market.[2]

Figure 4.2. **Non-agricultural self-employment**

As per cent of non-agricultural civil employment



1. Belgium, 1999; Netherlands, 2002; Luxembourg, 2004; Australia, 2005; France, 2005.

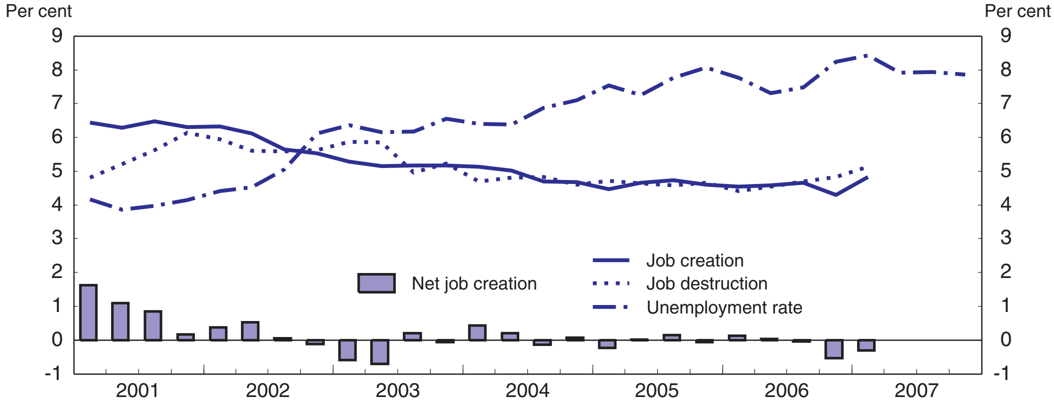
Source: OECD, *Annual Labour Force database.*

StatLink http://dx.doi.org/10.1787/343372162774

The stagnation of private employment in the early 2000s hides significant dynamism at the micro level, with intense job creation and destruction. A detailed analysis of quarterly job flow data shows quite intense dynamism in the labour market in the 2000s, but a slowdown in both job creation and destruction over the period 2001-2007 (Centeno *et al.*, 2007) (Figure 4.3). Every quarter, 24% of enterprises record positive job creation and 26% reduce their level of employment. The entry of new firms accounts for 35% of job creation, while the exit of firms accounts for 40% of job destruction. The remaining employment adjustments (positive and negative) concern a limited number of firms that expand or reduce their workforce on a significant scale, which would suggest that there are fixed costs in adjusting employment, so that enterprises go through several shocks before adjusting their workforce. The evidence by sector shows that the services sector records more frequent employment adjustments, while manufacturing has a lower rate of job destruction, but also a lower – and declining – rate of job creation. As a result, net job creation in manufacturing has been continuously negative since 2001.

The rise in unemployment observed after 2001 appears to be associated with slower job creation rather than more intense job destruction as one may have expected because of the forces of globalisation. The process of job creation and destruction is needed to allow existing firms to adapt their workforce to changes in demand and technology; it also helps

Figure 4.3. **Job creation and destruction**[1]



1. Seasonally adjusted, based on the number of dependent employees registered with social security.

Source: Centeno *et al.* (2007).

StatLink http://dx.doi.org/10.1787/343382780861

to support the process of creative destruction, whereby new, more productive, firms enter the market and relatively inefficient firms exit it. Measures, such as the on-going reduction of administrative burdens on firms, reviewed in Chapter 3, will help to facilitate these processes and promote an efficient allocation of resources and faster productivity growth. Furthermore, this analysis suggests that labour market policies that are aimed at facilitating job creation, rather than impeding job destruction, are particularly relevant to stem the rise in unemployment.

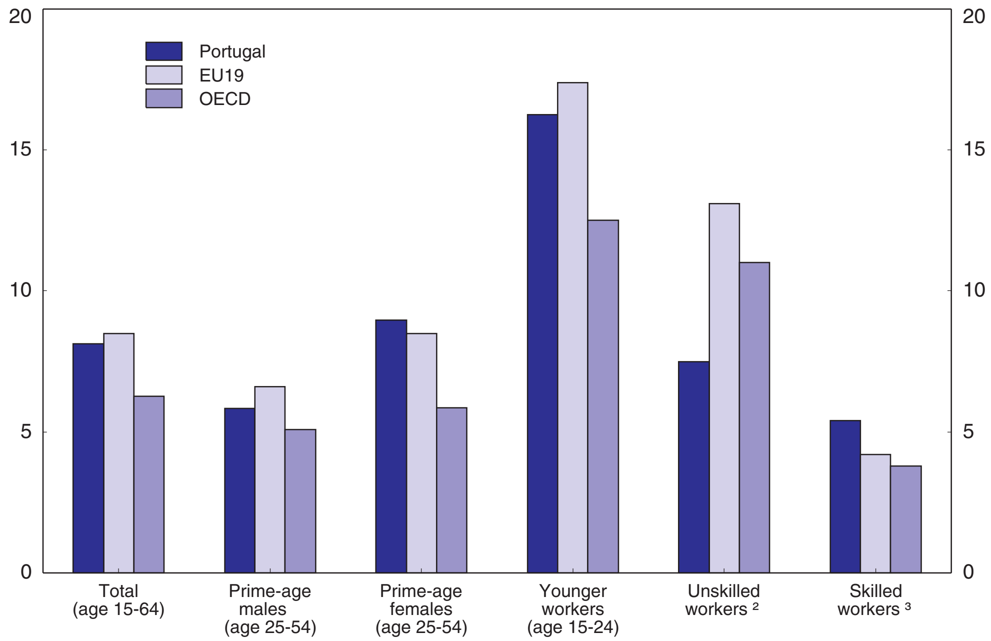
Rising unemployment and informality

The unemployment rate moved up to an annual average of around 8% of the labour force in 2007, almost 2 percentage points above the EU19 average and 2½ per cent above the OECD average (Figure 1.12 in Chapter 1). Unemployment is particularly high among some of the more vulnerable groups, as observed in EU countries more generally. Detailed information available for 2006 shows that the unemployment rate for younger workers (age 15-24) was twice the aggregate unemployment rate that year. Standing in sharp contrast to the EU (and the OECD) averages, the unemployment rate of unskilled workers in Portugal tends to be somewhat lower than the aggregate rate (Figure 4.4). This pattern is consistent with the fact that low-skill sectors have remained relatively important in terms of job creation in Portugal; but this is unlikely to remain the case in the future, judged by experience in several other EU countries where the structural adjustment process started earlier and unskilled unemployment rates have climbed to very high relative levels. In France and Germany, the unemployment rate of unskilled labour is significantly higher than the aggregate unemployment rate; it is as much as double the aggregate in the United Kingdom and the United States. Conversely, the gap between aggregate unemployment and unemployment of those who have completed tertiary education is much wider in these four countries than in Portugal.[3]

Long-term unemployment (12 months and over) has been rising rapidly in Portugal over the past few years, from less than 33% of total unemployment in 2003 to around 50% in 2007. Over the same period, the EU19 average only increased by 1 percentage point, to 46%. Persistent high unemployment reflects to some extent the rising skill mismatch between the unemployed and new job offers, in an environment of intense production

Figure 4.4. **Unemployment rates**

Unemployment as a percentage of the labour force in the same age group, 2006[1]



1. 2005 for unskilled and skilled.
2. Persons who have not completed upper secondary education.
3. Persons who have completed tertiary education.

Source: OECD, *Labour Force Statistics database* and *OECD Employment Outlook 2007*.

StatLink http://dx.doi.org/10.1787/343386856603

restructuring. In response to the deterioration of the labour market, the government strategy for the labour market is largely focussed on up-skilling the workforce, with the introduction of a new programme, *Novas Opportunidades*, and the reform of vocational training (see below).

Besides high and rising unemployment, Portugal also faces the challenge of low-productivity (and low-pay) jobs, often found in the informal sector. For example, the share of employees without a written contract, which is only a rough indicator of informality, almost doubled between 2004-05 and 2006-07, when it amounted to almost 12% of total non-farm employment.[4] The large share of self employment in total employment, with many "independent" workers engaged *de facto* in regular activities with an employer, reveals other forms of informality. The existence of a large informal sector has a high social cost, because it tends to be associated with precariousness, scarce opportunities for training and limited mobility towards more highly skilled jobs. It reflects several factors, among which the cost of doing business which may have acted as a deterrent to formal activities. In this sense, some of the measures adopted recently to simplify the creation of enterprises could help individuals with professional activities or small firms to start operating in the formal sector. Moreover, because they increase the cost of formality, rigidities in the labour market, in combination with weak control of labour regulations, also contribute to informality. There has been significant progress made over recent years in strengthening controls. The tax and the social security systems, in particular, are now better coordinated. However, regulations have been only marginally eased.

Trends in wages and cost competitiveness

In the past, wage flexibility allowed the labour market to adjust;[5] but this is more difficult in a context of low inflation and monetary union. Over the past 10 years, wage increases in excess of productivity gains in the business sector have led to a considerable deterioration in cost competitiveness, as measured by relative unit labour costs. This is mostly due to lower productivity growth. Since 2000, the real wage increase (deflated by the private consumption deflator) has slowed to an annual ½ per cent, down from an average increase of 2.7% in 1995-2000. Despite the deceleration, real wage growth has generally been in excess of productivity growth.[6] And trends have been very different across sectors. In manufacturing, contractual wage increases moderated over the 2000s; the wage drift was much more limited than in the late 1990s; and the sharp decline of employment in the sector allowed some productivity gains, leaving unit labour costs broadly unchanged over the period. Measured in relation to Portugal's trading partners, relative unit labour costs rose continuously from 2000 to 2004, this deterioration being followed by a reversal of the trend, with some improvement in cost-competiveness from 2005 to 2007 (see Chapter 3). In the service sector, on the other hand, unit labour costs have risen continuously in the 2000s in Portugal as in the euro area.[7]

Low productivity growth and low inflation have reduced the scope for labour cost adjustment to accommodate shocks. The mobility of workers and the adjustment of the workforce to the evolution of demand and technology have been difficult because of legal restrictions and burdensome procedures.[8] Furthermore, the increasingly generous unemployment benefit scheme, at least until recent measures, also impeded the reallocation of labour by weakening incentives for re-employment. As a consequence, adjustments in the labour market have increasingly been translated into higher – and especially more persistent – unemployment. Some measures are being taken to address some of the obstacles to the adaptability of the labour market. Active labour market policies are also under review. In addition, maintaining moderate real wage increases while promoting faster productivity growth would assist Portugal's trade performance in external markets, which would in turn help reduce unemployment.

Are policy settings adequate in the new global environment?

Rapid changes in global trade and the expansion of international production networks are constantly generating new opportunities for production specialisation – and undermining old specialisation. For workers to benefit from globalisation as the production structure changes, businesses must be able to continuously adjust, with new firms entering and replacing obsolete ones, and existing firms continuously retooling and adapting to seize the new opportunities. Creating a business-friendly environment is a crucial factor and so are policies that facilitate labour mobility. By raising adjustment costs, restrictive labour market regulations affect the optimal allocation of resources (especially in labour-intensive industries). Low labour mobility may have hindered more efficient allocation of resources, and negatively influenced productivity growth.[9]

Moreover, restrictions to the adjustment in the number of workers (such as restrictive employment protection legislation and costly dismissal rules) tend to be more costly for smaller firms. This may have forced the closure of firms that could have adjusted successfully. There are also some restrictions on the flexibility of working hours that may be impinging on firms' productivity. An indicator of working time regulations developed by the OECD for 2005 suggests that, in comparison with 22 other OECD countries, Portugal's regulations on working hours allow for a relatively flexible allocation of working time over the year.[10] However, in practice, there is evidence of low adaptability of working hours and management. It appears that the possibilities which are allowed by the legislation and collective agreements are often not used (*White Book on Labour Relations,* 2007). To some extent this may reflect the fact that some of the collective agreements that allow for flexible hours also require very large payments in case of overtime, making it too costly for firms to use the margin for flexibility. It may also reflect traditional management practices that still prevail in many firms. Again, the burden of lack of adaptability is likely to fall more on small firms, while it is easier for large firms to negotiate with workers representatives and agree on flexible working time, time banks and overtime payments, as shown for instance at the VW Autoeuropa plant. To address concerns about the low adaptability of practices in the workplace, measures are being proposed with the objective of increasing internal flexibility (see below). Furthermore, there are relatively generous sickness benefit entitlements, the abuse of which tends to limit the number of hours worked annually (as also observed in Norway and Sweden for instance). This implies that there is some margin to increase the total number of hours worked in Portugal through a tightening of regulations on sickness benefits.

In sum, many factors have been impeding the functioning of the labour market, including a relatively generous benefit system, stringent settings for employment protection, lack of internal flexibility, insufficient human capital and inadequate active labour market programmes. The factors at work influence flows in and out of unemployment, as well as the quality of jobs which people take up. To foster the creation of more jobs and allow a durable decline in unemployment rates, a comprehensive set of labour market measures is required. The government is taking action to improve the functioning of the labour market. The institutional framework has to be adjusted to the new global environment and policies should be aimed at facilitating the reallocation of labour.[11] Progress in this direction would enhance Portugal's attractiveness to FDI and improve productivity.

Policies to improve labour market outcomes

The National Action Programme for Growth and Employment (PNACE 2005-08) highlights the importance of moving towards a framework of "flexicurity". It explicitly seeks to improve the labour relations system and social protection. Several measures taken over recent years are likely to have some favourable impact on labour market outcomes. A concerted strategy has been developed to strengthen inspection services and controls of undeclared work. A new labour code came into force in December 2003. Since then, changes were made to the law in 2006, with the objective of facilitating collective bargaining. A new labour mediation system was created in 2006. The unemployment benefit system was revised in close coordination with social partners. The social security reform came into force in 2007. A review of labour relations, including the labour law, was undertaken in 2007, leading to a set of proposals that aim at enhancing flexibility (both within firms and in contracting) and simplifying procedures to facilitate the application of the law.

At this juncture, it is important to assess the first results of the strategy under way and identify where the reform process needs to be deepened and additional measures introduced.

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Measures taken in 2006 and 2007

A number of measures taken in the past two years are expected to have an impact on labour market performance:

- Changes to the labour code were made in 2006, with the objective of facilitating collective bargaining; a new labour mediation system was created in 2006.
- A concerted strategy has been developed over the recent past to strengthen inspections services and controls on undeclared work.
- The social security reform that came into force in 2007, backed by a broad consensus among social partners, is expected to lead to increasing participation rates of older age groups.
- The greater convergence between the general pension regime and the civil servants' scheme established by a series of measures since 2005 is likely to facilitate mobility of employees between the public and private sectors.

Several changes were also made to the unemployment benefit scheme, starting in 2006, to tighten eligibility conditions and strengthen incentives to return to work. Considering initial net replacement rates and maximum benefit duration, Portugal's scheme in 2005 was comparable to the generous systems in several Nordic countries and the Netherlands, but these countries have effective activation strategies that facilitate the return to employment (*OECD Employment Outlook*, 2006). The reform of the Portuguese unemployment benefit system corrects some of the shortcomings of the previous scheme. To increase active job search by beneficiaries, it introduces the obligation to report to the employment office every two weeks; and sanctions have been increased to combat fraud. The reform establishes a closer link between the duration of benefits and the contribution period. The way benefits are calculated was modified to avoid situations where benefits were higher than the net reference wage.[12] In case of unemployment by mutual agreement, the possibility for workers to access unemployment benefits has been strictly limited. Finally, activation measures for beneficiaries were strengthened, notably through more intense intervention of the public employment services, and there has been an attempt to simplify administrative procedures with better integration of public employment services and services that grant the benefits.

The reform is already showing results: the fight against fraud and the strengthening of eligibility criteria have allowed a reduction of benefit payments, and the incidence of unemployment by mutual agreements has diminished. By combining more focused social protection for those who need it, with greater incentives for re-employment, the reform is a significant step in the implementation of the government strategy for the labour market. Looking forward, consideration should be given to the overall generosity of the unemployment benefit system, with a view to minimize possible disincentives to job search.

Employment protection legislation

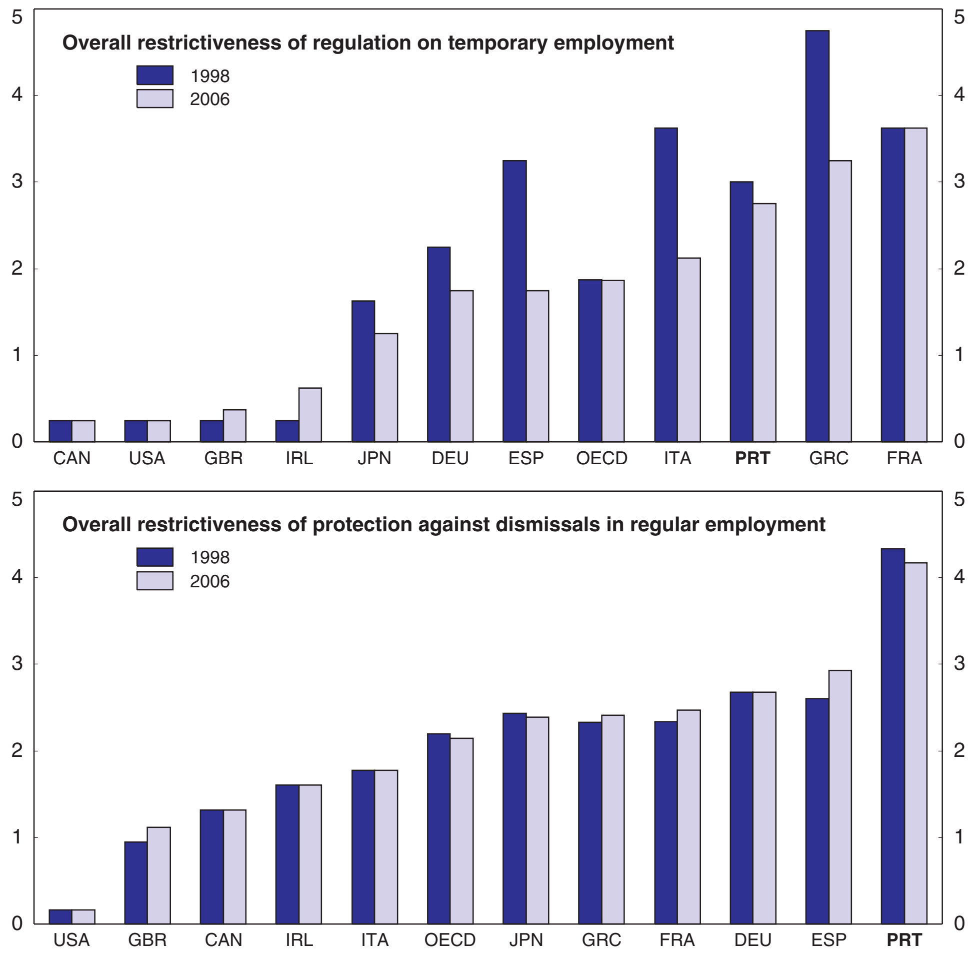
The 2003 reform of the labour code

A reform of the labour market legislation came into force at the end of 2003, but in practice it did not do much to enhance labour market flexibility. Although it had several commendable elements, the reform did not fully address the need to ease conditions for entry, exit and contracting. Some margin was created in the labour code for companies to adopt flexible working time.[13] For temporary employment, the new labour code provides more flexibility in the use of fixed-term contracts, increasing the allowed duration of such contracts. Moreover, there is now more leeway to introduce flexibility in collective agreements at the firm level regarding dismissal rules and the rules on fixed-term contracting. In the case of regular contracts, the 2003 changes eased somewhat the procedures for collective dismissal: the deadlines for initiating negotiations and taking the final decision were shortened; the priority given to trade union representatives and members of workers councils was eliminated. However, since then, there has not been much evidence of enhanced flexibility in hiring and firing or in working conditions.

Employment protection legislation (EPL), overall, remains among the most restrictive in the OECD, and even relative to many EU countries (Figure 4.5).[14] More specifically, temporary employment is restricted to a number of particular situations (which were increased in 2003), with restrictions on the maximum number of renewals and cumulated duration. In the case of regular employment, the protection of workers against individual dismissals remains one of the most restrictive in the OECD, despite the 2003 reform. In particular, severance

Figure 4.5. **Employment protection legislation**[1]

Index scale of 0-6 from least to most restrictive



1. OECD is an un-weighted average excluding Iceland for both years and excluding Luxembourg in 1998.

Source: OECD, *Going for Growth 2007* and *OECD Employment Outlook*.

StatLink http://dx.doi.org/10.1787/343434836634 payments are very high for long job tenure, which tends to impinge on labour turnover, because workers are reluctant to leave their job. Furthermore, conditions for fair dismissals are relatively limited. Before the 2003 reform of the labour legislation, the regulations on collective dismissals were slightly more restrictive than the OECD average, with the degree of stringency to a large extent reflecting the fact that collective dismissals in Portugal can be applied to situations with very few workers (2 workers or more in small size firms, 5 workers or more in firms with 50 employees or more), whereas in most other OECD countries the rules for collective dismissals apply to cases with 10 workers or more. The changes made in 2003 have eased somewhat the settings for collective dismissals: deadlines for initiating negotiations and taking final decisions were shortened; the priority given to trade union representatives and members of workers councils has been eliminated. The easing of procedures for collective dismissals that took place in 2003 is reflected in a small reduction of the OECD aggregate indicator for regular contracts.

A general problem about EPL is that, despite the 2003 reform of the labour code, procedures have remained cumbersome, discouraging the application of regulations, hence limiting their effectiveness in actually protecting workers.[15] In practice because of the difficulties created by the combination of regulations and procedures for dismissals, firms have often preferred to reach agreement with workers for a reduction of wages and hours of work rather than firing workers by using collective dismissal procedures. In the same way, informal agreements have been used to dismiss workers rather than using the legal procedures.

A further easing of employment protection legislation would help

Evidence across OECD countries shows that restrictive employment legislation (EPL) protects existing jobs, but also restrains job creation. Empirical evidence is inconclusive as to whether strict EPL increases structural unemployment (Box 4.1). Because it reduces labour turnover and delays hiring, restrictive EPL tends to hinder the movement of labour from contracting sectors or firms to expanding ones. In the Portuguese context, where deep structural changes are occurring, barriers to mobility are likely to have some negative effects on labour market performance, impeding labour market entry – and re-entry, as reflected for instance in the increasing share of long-term unemployment. The relatively high proportion of non-standard contracts in total employment is further evidence of insufficient flexibility for regular contracts. In addition to legal restrictions, the long and uncertain delays that characterise the administrative and legal procedures through which EPL is implemented and the fact that settlements are often made without going to court mean that regulations are not very effective in protecting workers.

A comprehensive reform of EPL, including some easing of the rules and simplification of the procedures, is needed and it should go hand in hand with measures to support workers affected by job losses. Such a strategy would likely bring about higher levels of employment, at least among the groups more at risk (such as the youth), and reduce the duration of unemployment. An easing of EPL on permanent contracts is needed, particularly to facilitate individual dismissals. Easing regulations and simplifying procedures would contribute to expand the scope of formal dismissals carried out according to the rules. It would reduce uncertainty for the employer about the cost of dismissals when hiring, which would encourage job creation on permanent contracts. Workers would also benefit from greater certainty that upon the termination of their contract the rules would be applied.

Box 4.1. **The impact of employment protection legislation on labour market performance**

Recent econometric estimates based on panel data undertaken within the context of the reassessment of the OECD Jobs Strategy found no significant impact of EPL on aggregate unemployment (OECD, 2006). However, EPL is found to have robust, detrimental effects on several aspects of labour market performance, including the incidence of long-term unemployment, the employment rate of the most vulnerable groups such as those in younger age cohorts, and the resilience of labour markets to shocks.

Stricter EPL for permanent workers is also typically associated with greater labour market dualism, in the form of high incidence of temporary work and lower transitions from fixed-term to permanent jobs. New hiring is likely to be delayed and, when there is job creation, regular contracts are less likely to be used. In Portugal, employers have typically used temporary contracts or hired workers on "self-employment" contracts. Strict EPL is a barrier to labour mobility, by discouraging workers from changing jobs, since long-tenure workers who quit their job have to forego their right to large severance payments. There is also evidence of EPL curbing job flows, especially in those industries that require more frequent adjustments of the workforce to cope with market and technological changes (Haltiwanger, Scarpetta and Schweiger, 2005). Finally, there is evidence that stringent EPL is detrimental to other aspects of economic performance, such as the adoption of new technologies or the ability to introduce major innovations, as these typically require some adjustment of the workforce. Only a few industries, for instance some high-tech industries, are likely to train staff and develop innovative processes with this staff. For the bulk of industries, the cost of changing the skill mix on the workplace due to stringent job protection would reduce the profitability of innovations (OECD, *Going for Growth, 2006*, Chapter 3).

A further easing of EPL for temporary employment should also be undertaken. It would facilitate entry into the labour market. OECD research suggests that fixed-term contracts make it easier for the youth to enter the labour market and thus can be a stepping stone towards career progression (Quintini and Martin, 2006). This is especially relevant for Portugal, where unemployment rates of the 15-24 years are high and a large proportion of the youth leave the education system without a qualification. School drop outs face a particularly difficult start in the labour market, and the problem seems to become more acute as the demand for higher qualifications increases. But action should not be undertaken for temporary contracts in isolation. It is important to combine the easing of EPL for temporary work with the easing of permanent work to avoid worsening the dualism of the labour market. Indeed, maintaining overly restrictive – and burdensome – protection legislation on regular employment tends to induce growing recourse to temporary contracts, with a risk that workers stay trapped in precarious jobs with little opportunity for progression through training. In this context it is especially important to simplify the procedures, so as to facilitate formal dismissals carried out according to the rules and reduce the need for court interventions. Moving ahead in these directions would allow smoother labour market adjustment, promote labour mobility and encourage job creation on regular contracts. It would also help the youth starting in temporary employment to move into permanent jobs.

As a complement to the easing of EPL, it is important to increase the effectiveness of active labour market policies, such as workplace training or job search assistance, as this can contribute to create a more dynamic labour market, while providing adequate job search support for workers. Aware of the importance of ALMP, the authorities have proposed a reform, which, in early 2008, was under discussion with the social partners.

Raising the effectiveness of active labour market policies (ALMPs)

Effective ALMPs are a key element of a strategy to shift protection from unviable jobs to displaced workers. It is an essential part of the "flexicurity" model, and it should go hand in hand with measures to ease EPL. An important consideration in this context is that the "flexicurity" model developed successfully in some Northern European countries has to be adapted to the Portuguese context. The strategy followed in these countries requires significant public spending on "activation" of the unemployed and other job-seekers, and it pre-supposes high cost effectiveness of the intervention programmes. In Portugal, the cost effectiveness of ALMPs is questionable and it would be unwise to raise the resources spent up to the high levels of spending on ALMP attained by some of the Northern European countries.

There is much scope for improvement in active labour market policies in Portugal. Spending on ALMP as a proportion of GDP is close to the OECD average, so that the problem is not the lack of resources. Furthermore, spending is expected to increase over the coming years, based on projected transfers from the European Social Funds and Portugal's cofinancing. Spending on training programmes is also expected to rise, to reach 0.72 of GDP by 2010, above the European average, although still below the amounts in a few high spending countries.[16] The main concerns about ALMPs are related to the effectiveness of the programmes and the structure of public expenditure by category of programme.[17] Portugal has seen an accumulation of measures over the years and some of the programmes in place are ill-adapted to the problems in today's labour market. According to official estimates, there are more than 50 active programmes currently operated in Portugal, generously financed by EU funds, and some of them have conflicting objectives.[18] Furthermore, administrative procedures are complex and it is difficult for potential beneficiaries to have access to some of the programmes (sometimes for lack of information).

Microeconomic studies of ALMPs in OECD countries underline that returns to different programmes vary and that the design of programmes is key. Although there are very few evaluations estimating directly the cost effectiveness of specific interventions in the OECD, a few general principles come out of OECD countries' experience. In a group of countries, including Portugal, spending on public employment services (PES) and administration is low compared with spending on the other active policies (that cover training for the unemployed and inactive, youth measures, subsidized employment and measures for the disabled). Recent evaluations suggest that if the countries in the group with low relative spending on PES and administration raised this category of spending to the levels observed in the higher spenders for this category (0.25% of GDP is spent on this category of services by Denmark, Belgium, Germany, Netherlands or the United Kingdom), it would allow more intense interventions, such as brief personal interviews with unemployment beneficiaries. And more intensive interventions (with frequent and obligatory interviews between the jobseeker and an employment counsellor as part of the intervention) have been shown to have positive employment effects.[19] In general, job-search assistance – which can have a relatively low cost – rates well in terms of bringing the unemployed back into unsubsidised activity, whereas public sector job creation is often disappointing. A more recent review of evaluations found that programmes defined as "PES and sanctions" tend to yield positive employment effects (Kluve, 2006).

A reform of active labour market policies in Portugal is under discussion with the government and social partners.[20] The authorities intend to rationalise the system by reducing the number of programmes and reassessing them every two years. The decision to maintain or end programmes in place would depend on the evaluation of results achieved and, in some cases, adjustments to the programmes would be proposed. Moreover, new programmes would be established on a temporary basis; and monitoring and evaluation systems would be incorporated in the new programmes. The on-going efforts at reforming ALMP are appropriate. Once the ALMP reform is introduced, a major challenge will be the implementation of the new framework. The difficulty should not be underestimated: the complete evaluation of programmes will take time and it is imperative to carry through the reform, cutting the programmes that are shown to be less effective, while strengthening others and introducing new ones.[21] A key element of the effectiveness of the overall strategy to improve the adjustment of the labour market and its resilience to shocks will be the effectiveness of public employment services (PES). Job search assistance and monitoring by Public Employment Services (PES) are important for delivering effective "activation strategies" for the unemployed, hence helping re-employment.

The current reform strategy: the "White Book"

A commission of experts was created to prepare the "White Book on Labour Relations", which had the task to re-evaluate the existing legal framework and propose changes to the labour law. The stated objectives were to: *i)* promote employment; *ii)* reduce the segmentation of the labour market; and *iii)* ensure mobility between different types of contracts and activities. At the same time it aimed at: *i)* providing some protection; *ii)* developing adaptability of workers and firms; and *iii)* encouraging collective contracting. The Commission concluded its work in November 2007, making a number of proposals, which were discussed with social partners over the months that followed.

The White Book envisages some revisions to the labour code and measures to facilitate the application of the law. It makes some proposals to enhance internal flexibility of firms, which remains relatively low in Portugal, regarding working time in particular.[22] There are also proposals to review collective bargaining procedures to give more room to agreements at the firm level. Specific measures are also proposed to simplify bureaucracy and administrative relationships of workers and firms with the public administration, in particular dismissal procedures. Box 4.2 reviews the main proposals published in the White Book. Some of them, if enacted, would imply an easing of employment protection legislation (EPL), with such changes being reflected in the OECD indicators. As important to facilitate the adjustment of the labour market are some of the measures that clarify and simplify procedures.

Box 4.2. **The White Book on Labour Relations: selected proposals**

Administrative procedures for individual notice and dismissal

The procedure implies a written notice to the employee and employee representatives justifying the reasons for dismissal and the lack of suitable alternatives. In case of termination for disciplinary reasons, after communication of a "guilt note", there are 10 working days for the worker and his representatives to react. It is proposed that the hearing of witnesses by the employer become optional. The next steps (5 working days for the worker and his representatives to react to the evidence collected by the employer, and the obligation for the employer to take a decision within 30 days), are unchanged. The procedures in case of termination for unsuitability and termination for job suppression remain unchanged.

Conditions under which individual dismissals are fair or unfair

Are considered as fair: dismissals for disciplinary causes, economic grounds and for lack of professional or technical capability. Dismissals for individual redundancy must be based on urgent needs and must not involve posts where people on fixed-term contracts are also employed. Dismissals for lack of competence are only possible after the introduction of new technology or new processes. It is proposed that a change in the "functional structure" of the job be added as a condition for fair dismissals.

Compensation pay and related provisions following unjustified dismissal

Limitations on the reinstatement have been proposed. Reinstatement would be made available to the employee only when it is proved that the dismissal was unjustified. If there was a valid reason for dismissal, but the dismissal process was badly conducted, the employer would have to pay some compensation, but not to reinstate the employee. Previously, reinstatement was an option for employees even if the dismissal was justified, if the process was badly conducted.

Other changes proposed for dismissals

A shortening of the procedure is proposed: reducing to 60 days the delay for the legal reaction of employee after the final dismissal notice (now the period is 1 year for individual dismissal and 6 months for collective dismissal).

A reduction of the cost of procedure for the employer is proposed: the State, and not the employer, would be responsible for salaries during delays caused by courts.

Regulation of fixed-term contracts

Fixed-term contracts are now permitted, *inter alia*, for: *a)* business start-ups, *b)* launching a new activity of uncertain duration, *c)* recruiting workers in search of their first job and long-term unemployed; since 2003, also for *d)* substitution of absent workers and *e)* seasonal or exceptional activities. The temporary contract has a maximum of 3 years, and can be renewed twice. It is proposed to have a fixed-term contract for a maximum of 3 years or, with justification, a fixed-term contract with uncertain term when the tasks are uncertain, for instance for new activities and business start-ups.

Other proposed changes to procedures: It is proposed to simplify procedures: elimination of duplicated notifications and communications to public services; elimination of unnecessary notifications; use of online notifications; adaptation of the rules for micro-enterprises. A simplification of rules has also been proposed, with a re organisation of the labour code and associated rules.

Box 4.2. **The White Book on Labour Relations: selected proposals** *(cont.)*

Regulation of fixed-term contracts

Proposals to enhance flexibility: It is proposed that an agreement on working time could be concluded at the firm level if three-fourths of workers accept it (then it is applied to all workers). If one-fourth of workers accept to have their individual working-time arrangements re-negotiated, flexibility would be applied to those workers.

Collective agreements: There should be only one commission of employees (today, in some enterprises, there are more).*

* There are currently two committees: a committee of employees and a committee of employees for safety, hygiene and health issues); issues such as the role of unions and employers associations in collective agreements should be settled by auto-regulation; non affiliated employees should be able to individually adhere to collective agreements; if revision of the agreement is not possible, a limit should be established for the duration of the agreement.

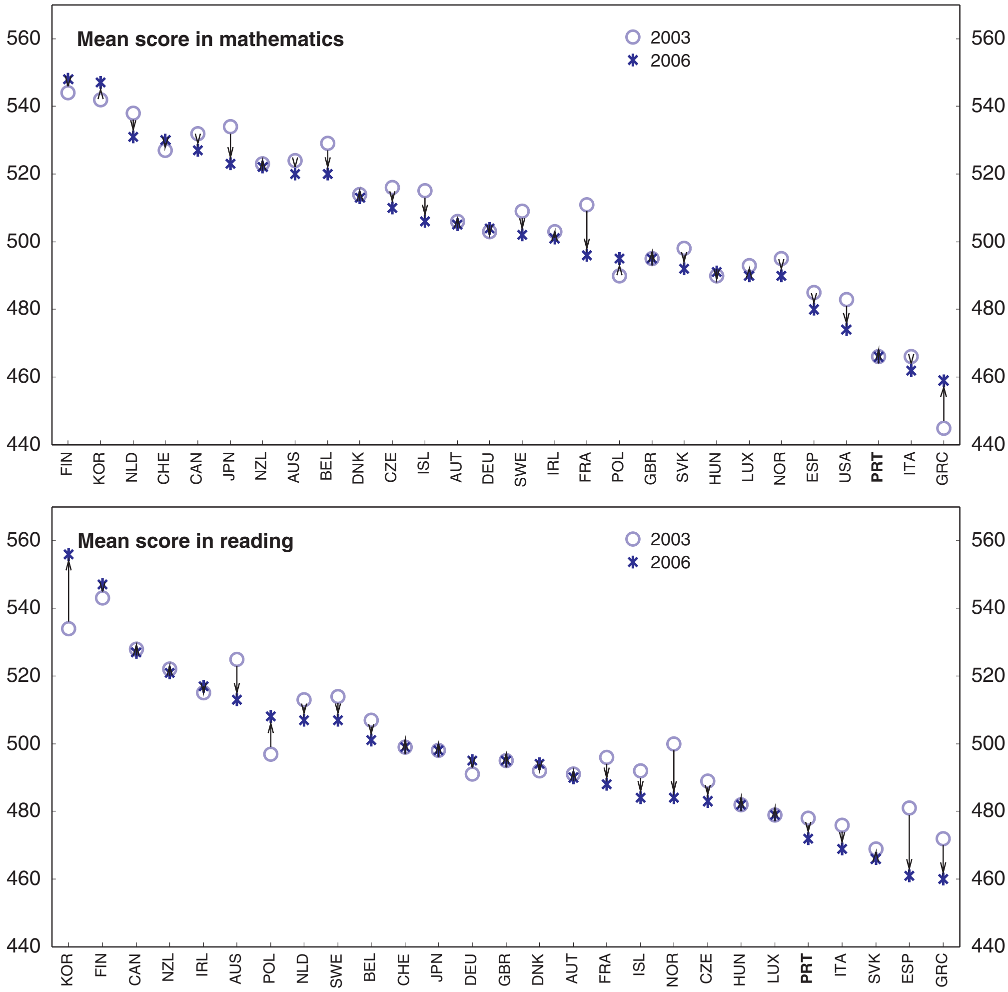
The proposals contained in the White Book go in the right direction. They would introduce some flexibility in the legal framework, but also facilitate the application of regulations, helping to improve the balance between flexibility and security. An easing of EPL, as discussed above, would likely reduce the use of informal agreements and atypical types of employment, thereby, in practice, increasing the effective protection of workers. It would also facilitate labour mobility and enhance the adaptability of companies. Greater flexibility in working hours would help the adaptability of firms and lift their capacity to compete. A more efficient allocation of working time could be achieved by making it possible to average the normal weekly hours over one year rather than 4 months, as is currently the case.

Up-skilling the labour force

One of the main challenges Portugal faces to better cope with globalisation and to promote stronger productivity growth is to close the human capital gap with other OECD countries at a faster pace. The relatively low educational attainment of the working-age population is a major factor explaining why many firms are stuck in low-productivity activities and have difficulty adopting ICT and other modern technology more widely. There are high drop-out rates and the percentage of young people aged 20 to 24 who have not finished secondary education is one of the highest in the OECD. In terms of quality of outcomes, Portugal is also among OECD countries with a weak performance, as measured by the results of 15 year-old students at PISA which remain well below the OECD average in 2006, both in mathematics and in reading ability (Figure 4.6).[23]

The value of school is not obvious to students and their parents, so that, despite high private education returns, the school dropout rate for those aged 15-19 in 2005 was significantly higher than the EU average. A high proportion of the 15 to 24 age group is working with temporary contracts, which is a common pattern in EU countries. To a large degree, temporary contracts provide a stepping stone to young individuals, before they move into jobs with permanent contracts. However, cross-country comparisons show that young people with low education find it more difficult to find permanent jobs and some stay trapped in cycles of temporary work spells followed by periods when they are neither in school nor in education (*OECD Employment Outlook*, 2008). Youth employment is also closely related to overall labour market conditions so that, as long as overall employment

Figure 4.6. **Pisa results in selected countries**



Source: OECD, *Pisa* 2003 and 2006 results.

StatLink http://dx.doi.org/10.1787/343444140131

is stagnant, it would be unrealistic to expect many job opportunities for youths. Policies that reduce obstacles to employment, as discussed above, are likely to help reduce youth unemployment as well. Besides general employment-friendly measures to facilitate the school-to-work transition, it is important to induce youths to invest in post-secondary education and vocational training, or to continue in higher education (notably in scientific and technological streams).[24] The experience of some OECD countries suggests that programmes acting on the demand side – usually reducing non-wage labour costs for youth – which have been successful have included other elements besides wage subsidies, such as training. Enhancing the human capital of youth is a key factor for improving their employment and earnings.

The shortage of human capital calls for action not only to raise the education level of the population, but also to review the type of education and its quality, as the government is engaged in doing. The policy priorities for Portugal in its efforts to enhance human capital were identified by the OECD in its 2006 *Economic Survey of Portugal*.[25] The government, well aware of the need to upgrade competences at all levels, has undertaken reform measures across the education system. An important component of its strategy is to address the supply bottlenecks in technical education, vocational training and several higher education programmes (Portela *et al.*, 2007).[26] The education reform is complemented by a reform of vocational training that includes the diversification of training supply to attract a wider public in lifelong learning. Because of the usual lags involved in improving education outcomes, developing competences of adults is an important pillar of the strategy to overcome the very large deficit in qualifications of the workforce. Most of the reform measures are part of the two-pronged *Novas Oportunidades* initiative, which aims at preventing failure at school and drop-outs and upgrading adults' qualifications.[27]

Reforming the education system

The education system should be providing the skills needed in the labour market. As with many other OECD countries, Portugal seems to experience major problems of mismatch, with some students coming out of certain fields of study facing either a high risk of unemployment or finding low-skilled jobs, while other fields of study, such as engineering, have difficulty getting enough students trained for the demand. Various measures have been launched, or are under consideration, to improve education outcomes and reduce drop-out rates. The government's strategy, which builds on previous efforts, includes several programmes that should bring benefits in the medium term: strengthening elementary schools, expanding pre-school, better detection and care of low achievers. It also includes measures which can have a clear impact soon, for instance, diversifying upper secondary education and strengthening vocational and technical streams.

Many reform measures are being implemented to improve the cost efficiency of education spending and the overall performance of the education system. The rationalisation of the school network has continued.[28] Furthermore, there has been a rationalisation of human resources in schools, allowing cost reduction, thanks to changes in teachers' timetables and regulation of non-teaching activities. Some measures have been taken with a view to strengthen teachers' skills and improve the quality of teaching: a law changing professional requirements and access to the teaching profession was passed and teachers' training has been revamped. High drop-out rates reflect several factors, among which dissatisfaction with the school system. Action is under way to improve the relevance and quality of curricula, for instance the development of vocational and technical education and the modernisation of curricula. This is important, because of the mismatch between labour market demand and qualifications obtained by people who attained post secondary – non-tertiary education, as revealed by the very high rate of unemployment for this category.[29] A clear focus has been put on strengthening education in mathematics, and changes in the mathematics curricula are being tried in primary and lower secondary schools. Some initiatives have also been launched by private companies to support mathematic education in schools, with a view to address Portugal's large gap in this area.[30]

For the success of the education reform, teachers have to be actively involved in the reform process. In the context of the public administration reform, changes were made to the teaching career and a new teacher evaluation system was introduced. Overall, the career will become more demanding and there will be performance incentives built into the teaching career. Some steps are being taken to improve the evaluation of policy effectiveness and to use the results to improve policy decisions. Finally policies are also focusing on better monitoring poor achievers among students and providing remedial support. In 2006-07 for the first time, teachers will be assigned to schools for several years (in the past about a third of teachers changed school every year); the increased stability will help strengthen pedagogical teams and facilitate their involvement.

Steps have already been taken to improve the organisation and management of schools. The regime of school autonomy, management and administration has just been revised. Coming after a long period of centralisation of decision making, school principals and teachers have not been well prepared to take initiatives and responsibilities. Teachers have started to be involved in the design of projects at school level, notably for the implementation of the national plan for mathematics. The reform of the education system is particularly important given the inability of the old system to generate better performance as shown by PISA results. It is work in progress. The key is to carry through and ensure effective implementation. To consolidate the change in culture that is underway, it is important that all players – central and local governments, school managers and teachers – be fully committed to implementing the current reform process. Additional measures will probably be needed, for example, better informing parents about school performance so that they can put pressure on schools, with special attention in low socio-economic neighbourhoods where parents may need assistance in order to play a more active role in schools.

Enhancing life-long learning

In addition to its focus on upgrading youth competences, the government has taken action to offer new learning opportunities to adults with little schooling. Given the lag in education attainment of the population, this objective is ambitious. Efforts are also being made to ensure that those who complete schooling are employable and to diversify the offer of adult education courses. In particular, double certification courses are being developed (school related and professional); and training modules are becoming more flexible to meet the needs and constraints of people who are employed. At the same time, the system of recognition and certification of prior learning and experience is being strengthened.

The "Novas Oportunidades" initiative

A key pillar of the government's strategy to up-skill the labour force is the *Novas Oportunidades (New Opportunity)* programme, which is aimed at young people at risk of dropping out of the education system and adults in need of up-skilling (Box 4.3). The recognition, validation and certification of acquired skills will be the starting point of all adult training. The recognition of previous experience in particular is a key feature of the programme and it encourages participation. Another important feature is that private sector firms are directly involved in defining the training programmes.

The programme, which was launched in 2005 as a joint initiative of the Ministry of Education and the Ministry of Labour and Social Solidarity, aims at expanding the supply of education and training with a focus on double qualification (general and professional). It involves strengthening technological education and vocational courses (provided by professional schools) as part of the more general reform of upper secondary schooling to reduce dropouts and increase the employability of those who decide not to continue into higher education.

The implementation of *Novas Oportunidades* has started, and results are encouraging. There has been an increase of the supply of vocational courses which, to some extent,

Box 4.3. **The *Novas Oportunidades* programme**

The "New Opportunity" programme's objective is to raise the basic qualifications of the Portuguese population, by acting along two main lines: tackling poor performance in the education system and providing learning opportunities to adults with low education attainment. The initiative benefits from financial support from the European Social Fund.

The *Novas Oportunidades* centres are responsible for providing information and organising the qualification of people in two ways, through double certification that will allow (certified) training and through the recognition of acquired competences. The newly-created National Agency for Qualifications allows monitoring the activities of the various centers of *Novas Oportunidades*.*

For young people, it aims at increasing the supply of courses in double certification on such a scale that half the total number of young people attending secondary education would have the possibility to access various types of courses (vocational, technological, apprenticeship, etc.) Further more it envisages setting up additional courses so that all those at risk of leaving the education system early would be able to complete the 9th grade of schooling through specialised occupational paths. The objective is to have by 2010 over 650 000 young people in courses of double certification at the level of the 12thyear of schooling.

For adults, where the actions are directed at people aged 18 and over who have not completed the 9th year of schooling, the objective is to promote their integration in formal learning. The objective is to have 1 million people certified through adult education schemes by 2010. To achieve this, a key step is recognizing qualifications acquired throughout life. Then another important condition will be to have a supply of training and occupational education matching the specific needs of adults in this category. This is a challenge for Portugal where typically the offer of training was not directed at people already in employment.

* In 2007, 268 centres were operating. By 2010 there should be 500 centres or teams operating. Monitoring and control can be achieved through an information system that collects detailed data about adults enrolled and attainment of objectives; guides and quality charts are being produced; the national catalogue of qualifications is under construction.

explains the increase in enrolment in secondary schooling, both lower and upper, after a decade-long decline in student population. By widening the options in vocational education and providing double certification, the programme seeks to facilitate entry of the young people into the labour market and to attract more adults into the process of formal learning. It has resulted in tightening the links between the schools and businesses, employers associations and other local institutions. This is appropriate since it should increase the relevance of the education programmes for the labour market and it is likely to improve employability of students who are entering the labour market and adults who are employed but may be in a precarious situation.

There has been a significant increase in the percentage of young people attending technical or professional courses at the secondary education level, involving suppliers both in the network of the Ministry of Education and the Ministry of Labour and Social Solidarity. There have also been good results in the qualification of adults in the labour force. The *Novas Oportunidades* initiative has attracted strong demand from adults both for the recognition of competences and for lifelong learning. A large number of adults (the majority of which is employed) is participating in the recognition and certification process and the supply of adult education and training courses has increased.

The financing of *Novas Oportunidades* will continue to rely largely on the European Social Fund over the coming years, and the authorities intend to develop the scale of the programme in several dimensions: *i)* completing the network of *Novas Oportunidades* centers and improving the quality of their work; *ii)* further expanding professional courses in youth education, so as to reach the target of having about half of young people in secondary education taking courses of double certification, while strengthening the relevance of the courses to match evolving needs of enterprises. These objectives are appropriate and the success of the programme in its initial years of application augurs well for its development over the coming years. Implementation will have to be carefully monitored. Many complementary structures have to be developed simultaneously to maximise the effectiveness of *Novas Oportunidades*.[31] Follow-up and evaluation of the on-going efforts will have to be done regularly, to ensure that the quality of the service provision matches the increasing number of participants in the programme and that training actually meets the demand of the private sector. The programme could play a key role in facilitating labour market adjustment, provided it is implemented on a large scale and effectively.

Building on the success of the initiative, as the scale of implementation expends, the challenge for the authorities is to apply the programme effectively, and to evaluate the results rigorously. Typically, in Portugal, the lack of information has been an impediment for evaluation of programmes.[32] A strong effort to develop the information base is required. Several OECD countries are launching a Programme for the international assessment of adult competencies (PIAAC), with the objective of assessing education and training systems and how well they generate adequate competencies. Portugal is participating in this effort, which constitutes a valuable complement to the PISA programme. It will be useful in providing a measure of human capital development of the adult population, and therefore a basis for evaluating national policies regarding skill formation.

The main policy recommendations for the multidimensional reform that is required to improve the functioning of the labour market are listed in Box 4.4.

Box 4.4. **Main recommendations to improve the functioning of the labour market**

Labour market measures

- Improve the balance between labour market flexibility and protection of displaced workers, building on recent reforms and the propositions made in the White Book on Labour Relations.
- Ease employment protection legislation both for temporary employment and for permanent contracts, particularly to facilitate individual dismissals, and simplify procedures, so as to encourage greater hiring and facilitate adjustment.
- Enhance internal flexibility, regarding working time and the organisation of work.
- Move ahead with the proposed reform of active labour market programmes when an agreement has been reached with the social partners; ensure full implementation, reducing the number of programmes and assessing costs and benefits, with a view to increasing the effectiveness of activation measures for the unemployed and other job seekers; put a strong focus on ensuring intensive contacts between job seekers and public employment services.

Box 4.4. **Main recommendations to improve the functioning of the labour market** *(cont.)*

Human capital development

- Strike a balance between general knowledge and technical skills for workers to adjust to new work practices and be innovative.
- Maintain the focus on developing human capital of youths to improve their employment and earning prospects; and continue to develop vocational and technical education to improve the school-to work transition.
- Promote life-long learning to help the workforce adjust to higher value-added production, favouring important private sector participation, both in defining the programmes needed and in supply (such as private institutions providing courses or courses being offered in private firms).
- Take measures to address the lack of qualified managers, relying on private initiative rather than public support.
- Monitor the implementation and evaluate the results of the "New Opportunity" initiative (education programmes for the young at risk of dropping out and training programmes for adults with low school attainment) as its scale expands, to ensure that programmes meet private sector demand.

Notes

1. Historically, Portuguese firms took advantage of the possibilities of contracting out for services to "independent" workers ("green receipts"). After the 2003 reform, a small bias remains in the tax-benefit package, which may still create incentives for self employment.
2. Contracting out work to "independent" workers added some flexibility to the labour market (Centeno, 2000). Centeno *et al.* (2007) stress the fact that job adjustments in recent years have taken place on a large scale among the self employed and that the smaller proportion of self employed reduces the flexibility of the Portuguese labour market.
3. According to the 2007 data for Portugal, the patterns are broadly unchanged, with unemployment rates above 16% for younger workers (aged 15-24). *Cf.* OECD, *Employment Outlook 2008* for more details on Portugal in international comparison.
4. It would seem that there is no legal requirement for employees to be given a written contract in Portugal, so that this proportion, based on the European Social Survey data, is only a rough indicator of informality. The series only go back to 2004. Over the same period, EU countries in Eastern Europe, the Czech Republic, Poland, Hungary and the Slovak republic recorded a decline in the share of the informal sector.
5. Bover, Garcia-Pereira, Portugal (2000) also note that a key explanation for the difference between a (still low) unemployment rate in Portugal and the (then very high) unemployment rate in Spain was the wage adjustment process.
6. In 2006, the change of real wages in the private sector was close to zero, due to unforeseen increase in inflation. This allowed a small improvement in cost competitiveness, since labour productivity rose a little.
7. The measurement of effective wage increases is difficult owing to a lack of data. The partial indicators available for services point to wage moderation since the start of the 2000s, but also slower productivity gains, so that Portugal's unit labour costs followed an upward path, broadly similar to trends in the euro area.
8. See Bank of Portugal, *Economic Bulletin* (Spring 2007).
9. Scarpetta and Tressel (2002) have found that the negative impact of restrictive EPL on productivity is larger in countries such as Portugal, where wage bargaining takes place predominantly at the sector level without co-ordination.

10. In international comparison, Portugal is in the middle of the range of OECD countries for the flexibility of its working-time regulations. The relative flexibility reflects the fact that there is no maximum daily hours limit; a relatively high maximum weekly limit (48 hours); the possibility to average normal weekly hours worked over a period of 16 weeks; and the fact that normal hours worked are set in collective agreements rather than by law. Flexibility would be greater still if normal hours were decided at the firm level (as in the United States, the United Kingdom or Norway) and if the averaging was possible over a whole year (as in the United Kingdom and Norway). *Cf.* Burniaux (2008).
11. The service sector has considerable potential as a source of job creation, and this is especially true in Portugal (*OECDEmployment Outlook*, 2007, and Blanchard, 2006).
12. The November 2006 reform includes a measure abolishing the increased benefit amount previously granted to unemployed with children and very low incomes. It is now stated that the benefit cannot be higher than the net wage previously earned.
13. Since then, some collective agreements introduced flexible weekly working time provisions. Source: *European industrial relations observatory* on line (2007). However, there is little evidence that in practice working hours have become significantly more flexible than was previously the case.
14. New EPL aggregate indicators were calculated by the OECD for 2006, published in *Going for Growth* 2007. For Portugal, the recently increased flexibility for temporary contracts is reflected in a small decrease of the aggregate restrictiveness indicator for these types of contracts. For regular contracts, the high degree of restrictiveness shown by the EPL indicator mostly reflects the very restrictive regulations and procedures for individual dismissals.
15. One of the limitations of the summary measure of EPL is that it does not take into account the role of labour courts and jurisprudence in the application of the law. The index is computed for "typical" permanent and temporary contracts. If procedures are too long and the outcome on the enforcement of regulations is uncertain, which seems to be the case in Portugal, as in many other OECD countries, this can be an additional impediment to effective labour market adjustment, reducing the scope of formal dismissals, done according to the rules.
16. Financial resources for ALMP are set to expand by almost 40% between 2007 and 2010, amounting to a total € 4.2 billion over the 4 years, with the bulk of the resources going to programmes for adjustment between labour supply and demand, which include training.
17. An evaluation of the impact of two main insertion programmes which have now been in place for nearly 10 years (Inserjovem for the youth unemployed for less than six months and Reage for adults unemployed for less than twelve months) shows mixed results in terms of their impact on unemployment duration. For details, see Centeno *et al.* (2008).
18. Particularly doubtful for instance seems to be the programme subsidizing employment of the young cohorts, while an increasingly important policy objective has been to retain the younger generation in school.
19. For details on activation strategies in OECD countries and the role of PES, see OECD, *OECD Employment Outlook 2007*, Chapter 5.
20. The reform was under discussion in the early months of 2008. Specific proposals are under consideration. And the objective is to have the reform approved and implemented by the middle of 2008.
21. OECD experience shows that there are cases when new programmes have a high impact at the first stage of implementation, but later they have less of an impact. To address this problem, it is appropriate to adjust the policy, including by switching to programmes of a different nature. Hence, continuous evaluation is crucial for identifying any decline in effectiveness and for designing a policy response. For details, see OECD, *OECD Employment Outlook 2005*, Chapter 4.
22. Based on evidence from the European Working Conditions Survey analysed in the White Book, Portugal has little flexibility and adaptability of hours worked and organisation of work in practice (Chapter III).
23. *Cf.* PISA 2006, Results: analysis and data.
24. The government is aware of the importance of carrying education reform through to all levels, including higher education to address mismatch problems that are also observed for skilled workers, evidence of which is seen in the high unemployment rate for persons who have completed tertiary education, relative to the aggregate unemployment rate.
25. For details, see Guichard and Larre (2006). The need to improve the coverage and quality of higher education is also discussed in the OECD *Reviews of National Policies for Education: Tertiary Education in Portugal* (2007).

26. Portela *et al*. (2007) measure the disequilibrium between supply and demand in Portugal's higher education system, identifying demand pressures on some institutions or programmes that coexist with excess capacities in others.

27. In addition, in response to specific concerns raised by the increase unemployment of highly educated people, the authorities have launched a specific programme aimed at helping the highly qualified unemployed find jobs (Intervention Programme for Highly Qualified Unemployed).

28. Over the past four years, the number of schools with fewer than 10 students declined significantly, from 27% of the total in 2002-03 to 6.9% in 2006-07. The proportion of schools working until 17 h 30 also increased, from 42% in 2005-06 to 89% in 2006-07.

29. The INE labour force survey shows that the highest unemployment rate in 2005 (11.4%) was found among people with post-secondary non-tertiary education, while the 2nd highest unemployment rate (9.1%) was found among those with lower (secondary) education attainment.

30. Source: Bloomberg news release, February 2007.

31. For instance, the school and vocational guidance and information systems are crucial in helping young people choose a suitable training path. Another requirement is to review and harmonise curricula and workload in the network of teaching and training establishments (public and private) to ensure coherence in the supply when the same qualifications are being offered. Finally the management of supplier networks should be integrated to allow rationalisation of resources. See: *www.novasoportunidades.gov.pt/*.

32. Portugal produces little information on adult education, notably about providers, so that it is difficult to assess the performance of the training system and compare it with others. Among 30 European countries, for which information on adult education providers was being collected in 2005-06, Portugal was at the bottom (25th position) for the availability of data. It did not have reliable information on the following characteristics regarding providers: the number of providers, the financial turnover, the number of people employed, the number of hours taught, or the number of learners enrolled with the providers.

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