



Economic Survey of Portugal, 2008

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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

This Policy Brief presents the assessment and recommendations of the 2008 OECD Economic Survey of Portugal. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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. ■

What are the main challenges?

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.

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. ■

How should fiscal consolidation be secured?

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.*

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.

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 of the economic and financial forecasts used in the Budget.* ■

What can be done to get more out of globalisation?

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

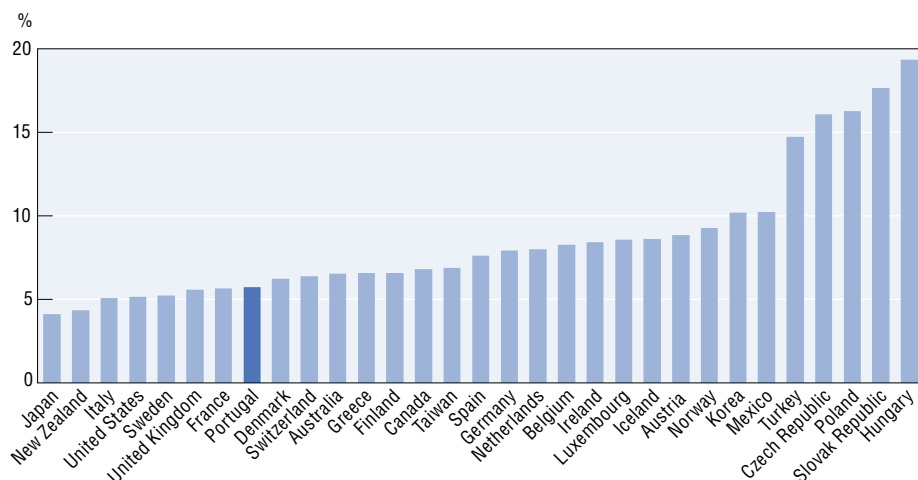
advantage in labour-intensive manufactures. As a result, overall export performance was disappointing in the decade to 2006. To lift trade performance, the economy must adapt by boosting the productivity of domestic firms, diversifying their market and product orientation and by raising overall product 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.

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;

Figure 1

MANUFACTURING EXPORT GROWTH IN COMPARISON



Note: 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.

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.

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. ■

How to promote competition domestically and improve infrastructures?

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.*

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. ■*

How to facilitate the adjustment of the labour market?

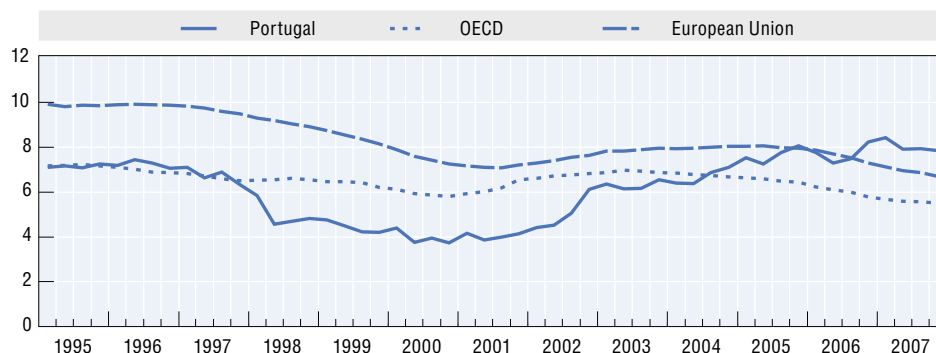
The labour market performance is worrisome. Although participation rates are relatively high in international comparison – including for women and the low-skilled – employment trends have deteriorated since the beginning of the 2000s. The unemployment rate has doubled over the past five years, reaching 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.*

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

Figure 2
UNEMPLOYMENT RATES
IN COMPARISON



Source: OECD, Analytical database.

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. ■

What about education and training?

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

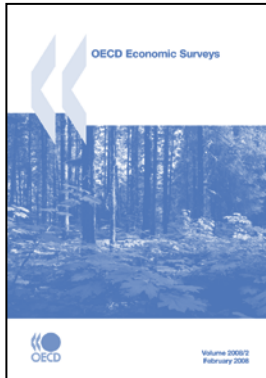
of competences and for lifelong learning. *More should be done to develop the information base, to undertake systematic field monitoring and conduct rigorous evaluations of the results. But, as the scale of application of the programme expands, the most difficult task is to ensure the quality of the services provided. It is also a sine qua non for the success of the government's strategy to enhance human capital.* ■

For further information

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Economic Outlook No. 83, June 2008.

More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2008 edition.

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