POLICY BRIEF

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Economic Survey of Portugal, 2004

Summary

Convergence of the Portuguese economy toward the more advanced OECD economies seems to have halted in recent years, leaving a significant gap in per capita incomes. The proximate cause is low labour productivity, as employment rates across the board are substantially higher than the EU average. Nor is there a shortage of capital goods in aggregate. But capital equipment in the business sector is not always efficiently used or allocated, and new technologies are not readily adopted. Furthermore, the Portuguese labour force – even its younger members – have had less formal education than workers in other EU countries, including among the new entrants from Central and Eastern Europe, and workers in Portugal also have less access to training than in many other countries. Traditional Portuguese low value-added highly labour-intensive products now face increasing competition from developing countries and from the new EU entrants.

The key medium-term challenge is thus to step up growth through policies that raise human capital and encourage the mobility of the labour force and the diffusion of technological advances. Competition needs to be stiffer, especially in the privatised utility sectors, where incumbents still exercise dominant market power. And the climate for doing business and investing needs to be further improved, so as to encourage firm start-ups and expansion and to allow greater innovation. The authorities have identified the weaknesses in the economy and have legislated for a notably wide range of measures to improve performance. The key is to carry through and deepen these reform programmes and ensure effective implementation.

An important example is recent reforms to the overly large public administration, which have yet to be translated into significant downsizing or substantial reallocation across all areas of government. This

This Policy Brief presents the assessment and recommendations of the 2004 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.

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is all the more disturbing because a poorly-motivated administration with considerable job security could result in a slower implementation of reforms in other areas.

Effective implementation of reforms to contain the growth of public spending and deliver better outcomes is important for several reasons. Most urgently, excessive growth in public expenditure in the closing years of the 20th century led to the need to slash spending in the face of the subsequent international downturn in order to limit the growing budget deficit. With the economy showing tentative signs of recovery only in 2004, there has been continued resort to one-off operations and budget freezes to satisfy the 3 per cent deficit limit set by the Maastricht Treaty. It is important that these measures be phased out soon and replaced by more decisive implementation of programmes to raise the efficiency and quality of public expenditure. This would help solve the chronic problem of structurally weak public finances, and permit Portugal to ride out its typically sharp cyclical experiences without having to cut or postpone fundamentally important programmes. In the longer term, further consolidation is necessary as an ageing population will begin to make increasing demands on the public purse to finance pensions and health care.

Reforms to health care, the subject of a special chapter, have recently been put in place, along lines recommended in past Economic Surveys. They are intended to improve the quality of delivery without raising costs, and to slow the growth of costs in the future. The reforms create better managerial and incentive structures for hospitals and general practitioners, reduce waiting lists, and reduce the costs of pharmaceuticals. An important aspect of the reforms is the setting up of an independent regulatory agency with responsibilities and powers to ensure that citizens have equitable access to health care and that the suppliers are delivering high-quality services. Early indications are that there have been savings in spending on pharmaceuticals and improvements in hospital services. Effective implementation of the wide-ranging programme will be key to achieving durable results, but additional measures may be needed to further raise efficiency, reduce current cost pressures and improve health status. ■

How is the Portugal economy performing?

Portugal has the lowest per capita income in the euro area and until the recent enlargement, it also had the lowest in the EU. Brisk growth in the last years of the 20th century led to some convergence with living standards in the more advanced EU countries, largely thanks to the reforms that began some 15 to 20 years ago. Liberalisation of the financial sector, far-reaching privatisation and deregulation, high investment and improved human capital delivered notable results. Falling real and nominal interest rates in the run-up to euro entry fuelled private sector demand and weakened the government's incentives to control primary spending. This also led to the build up of major imbalances, including a large external deficit and high household and corporate indebtedness. The structural budget deficit was also allowed to widen in the late 1990s, forcing the authorities to undertake a drastic corrective programme to reduce the excessive budget deficit during the economic slowdown. The adjustment process in the private sector, compounded by public sector retrenchment and a depressed international environment, led to a protracted period of weak activity for three years running, with real GDP actually falling in 2003. The recovery in activity is likely to be slow. Recent strong cyclical movements make it difficult to estimate potential GDP growth accurately, but it is likely that actual GDP will remain below potential for some years, postponing the catching-up process. ■

What are the main policy challenges?

Portugal's key medium-term challenge is to raise income levels. Since employment rates are already high (and unemployment low) this will require sustained increases in labour and total factor productivity. Policies are required that enhance human capital, facilitate labour mobility, intensify the use of Information and Communication Technology (ICT), raise managerial efficiency and create a favourable climate for private investment.

Portugal also needs to address the chronic problem – recently in a more acute phase – of weak public finances to ensure that the catching-up process will not be jeopardised by fiscal difficulties. Fiscal consolidation in the upswing would have obviated the need for procyclical policies in the downswing. More fundamentally, severe difficulties lie on the spending side: rapid growth of primary spending over more than a decade has put Portugal among higher-spending countries, considering its income level, while the cost-effectiveness of service provision has been doubtful. Getting spending under better control, including via a more efficient public sector, would permit more resources to go to the development needs of Portugal. The ongoing reform in the health sector is a good example of the strategy to improve the quality of public services and meet the population needs, while seeking to limit pressures on public expenditure over the medium-term. Thus the government's focus on curbing the fiscal deficit, engaging in public sector reforms and raising productivity growth is welcome. ■

What should be done to raise productivity growth and allow catching up in living standards?

There is indeed considerable scope to accelerate the convergence process through raising productivity, and current policy strategies recognise this. The economy's trade specialisation has typically been in low-skill labour-intensive sectors, in which it faces rising competition from some of the new EU members, where wages are lower and whose labour forces are generally higher-skilled, and from other low-wage countries outside the OECD. The Portuguese productive sector is responding to the shift in relative prices, and to enjoy durably stronger growth, Portugal needs to continue to move away from traditional labour-intensive low value-added products. The most promising strategy to address the catching-up challenge is to:

- raise the skills of the Portuguese work force, to accelerate the shift towards higher value-added and more competitive products;
- ease restrictive employment protection legislation for established workers, which creates labour market segmentation, hinders mobility and restrains technological and managerial innovation;
- intensify the use of Information and Communication Technology;
- raise public awareness of the advantages of competition, building on the new Competition Law and Authority;
- create an environment where the private sector invests and innovates, and where firms are encouraged to expand if they are successful.

Government programmes to address these issues are at various stages of development. The key is to carry through and deepen these reform programmes and ensure effective implementation. ■

Are insufficiencies in the education and training systems being appropriately addressed?

Despite a big improvement in the past decade, Portugal still ranks close to the bottom of the OECD in terms of educational attainment of the population and student performance. Value for money in the schooling system is poor, as evidenced by the combination of below-average student performance with a close to average level of spending per student. The acquisition of higher skills, in school or on the job, would make the labour force more adaptable; it would also foster the use of new technologies and innovation in production processes and management. More educated workers would be able to move to higher productivity jobs or to positions where their productivity can grow more rapidly over time.

Aware of the urgent need to further raise the quality of education services, reforms have been undertaken: *i)* measures have been launched at all levels of formal schooling, modernising the curricula and introducing flexibility, although the Framework Law setting the principles for the reform of compulsory schooling was still being legislated in mid-2004; *ii)* a new focus is put on professional schooling and technical education; *iii)* changes are being made to the operating and financing of tertiary education; *iv)* rationalisation of the network of schools has started with the regrouping of very small schools. The strategy to push forward the transformation of Portugal into a knowledge-based economy and to improve the cost-effectiveness of the education system seems broadly adequate. Measures starting to be implemented, such as systematic evaluations of schools and teachers and allowing universities to set their fees and recruitment requirements more freely, are promising. Educational reforms will be more effective when the Framework Law for compulsory education is approved and implemented throughout the education system.

Revamping of vocational training and life-long learning is envisaged. Some of the framework conditions are being developed, such as the national certification system and evaluation tools. But plans to make recurrent education effective and promote lifelong learning are at a more preliminary stage. Ongoing discussions with social partners are promising. They should lead to policy measures; thereafter, swift implementation and close monitoring of results will be key, given the importance of upskilling the existing workforce. ■

How well does the labour market perform?

Portugal's labour market performs rather well, coping with structural changes without a durable increase in the unemployment rate, while employment rates are higher than the European average, especially for groups typically under-represented in the labour force. This has been achieved through flexible real wage adjustment and the expansion of atypical contracts. Even so, labour mobility is low, in a context of rather restrictive employment protection legislation (EPL). The labour market is segmented: established workers who enjoy a high level of protection coexist with self employed and workers on fixed-term contracts, and informality is pervasive in certain activities. The reform to the labour legislation, which has been applied since the end of 2003, should make the labour market more responsive to both cyclical and structural forces: i) it should enhance the responsiveness of wage settlements to productivity and skill differentials across economic sectors; ii) it extends the possibility of using fixed-term contracts under certain conditions; and iii) it allows better control of absenteeism and fraudulent claims to sick leave. However, the reform does not fully address the need to ease general job protection legislation. This aspect should be put back on the reform agenda, as it would help to strike a better balance between job security and increased labour mobility. It would also facilitate hiring under permanent contracts and be conducive to higher productivity growth. ■

Is the business environment innovative, friendly and competitive?

Despite progress made in ICT access and use, Portugal is not keeping up with the rapid development of the Information Society in many other OECD countries. To some extent, measures such as upgrading human skills in the Portuguese working-age population at large and facilitating workers' mobility in the job market, will contribute to closing the gap. Complementary actions are probably still needed. Among these, a key element would be to reduce users' costs in the telecommunication market, by enhancing competition there. Efforts to modernise management and train entrepreneurs would also contribute.

Portugal's investment rate is relatively high, reflecting large inflows of EU structural funds and FDI over many years. There is a very dynamic private sector which operates in an open and competitive environment. The cost of doing business, reflecting administrative procedures, licensing, lack of transparency and predictability of tax and other regulatory obligations, was often perceived as being high (as illustrated by various indicators developed at the OECD). Administrative procedures for creating new businesses have been streamlined. However, the complexity of business taxation and regulation continue to limit private investment, inhibit entry of new firms, discourage existing profitable firms from expanding and permit unprofitable firms to survive through recourse to informal activities and non-compliance with tax obligations and regulations. Measures were introduced, starting in 2002, as part of the broad-based "Productivity and Growth Programme" to improve the business climate. In particular:

- Tax and administrative simplification is continuing, which is appropriate.
- A new incentive regime was launched in mid-2003 to foster capital formation, including through targeted tax breaks.
- The reform of the Bankruptcy Law, which was urgently needed, has been approved and should now be speedily be implemented. The antiquated legal system acted as a deterrent to adequate restructuring of businesses in trouble.

The government's strategic intervention to foster investment includes commendable initiatives, for instance integrating all administrative procedures in a single agency and encouraging venture capital. However, the government should also take steps to further reduce the number of administrative procedures, and refrain from distorting market forces through tax incentives and subsidies. Helping a sector or a firm would set an unhelpful precedent and it would run against efforts made over past years to improve the allocation of resources by ensuring a level-playing field.

Portugal has made key advances in 2003 to promote competition, with the creation of an independent and financially autonomous Competition Authority and the approval of a new Competition Law. However, effective competition is still low in certain sectors, particularly in the network industries where prices for specific services or consumers remain relatively high.

- While furthering the process of privatization, the state should be careful to refrain from past practices, such as retaining special voting rights in companies operating in "strategic sectors", which risks distorting or discouraging private investment to the detriment of consumers and the efficiency of the economy.

- The creation of the Iberian Electricity Market (MIBEL), still to be implemented, is expected to improve capacity and efficiency of the electricity sector. In preparation, Portugal has further opened its retail market for electricity. Competition issues are being examined in the European Commission to ensure that the structure of the new market be conducive to effective competition and secure reliable supply of electricity at low prices for Portuguese industry and households over the medium to long term.
- The lack of competition and concomitant high prices in some fixed telecommunication services, where the incumbent retains market power, continues to require forceful action from the Competition Authority and the sector's regulator, in tandem. ■

What should be done to put public finances on a sound footing?

Because the cyclically-adjusted budget position was allowed to deteriorate during the late 1990s upturn, Portugal was confronted with the need to undertake fiscal retrenchment in the downturn, after the deficit exceeded the 3 per cent limit by a wide margin. Reducing the budget deficit and ensuring sustainability of public finances over the longer-term has been the overriding policy priority since 2002, despite a weak external and domestic economic environment. The government's strategy over the past two years has included spending cuts and freezes and sizeable one-off operations, in combination with more in-depth reforms to put public finances on a sustainable basis over the longer run. The areas for reform include: public administration, the health care sector and education services and rules governing fiscal relations with sub-central governments (and autonomous funds). The government's two-pronged strategy seems appropriate. The deficit was maintained below 3 per cent in 2002 and 2003 despite the cyclical weakness. Achieving quick results through emergency cuts and one-off measures with limited demand effects has given more time for the implementation of necessary in-depth measures and for reaping the results in terms of spending control.

The authorities' 2004-07 Stability Programme foresees an average annual reduction of the structural budget deficit of about ½ percentage point of GDP per year, mainly achieved through expenditure side adjustments, while the corporate income tax rate is cut by 5 percentage points in 2004 and again in 2006. This approach is in line with earlier OECD recommendations. The groundwork has been laid for long-lasting reforms with the approval of important legislation: closing down government agencies, re-allocating civil servants; rationalising the school network; raising private tuition fees in universities; promoting the use of generic pharmaceuticals; incorporating some hospitals and creating public-private partnerships in others. However, meeting the medium-term targets will not be an easy task.

- First, achieving the 2004 deficit target of 2.9 per cent of GDP is likely to require more one-off measures than budgeted. The macroeconomic scenario underlying the budget is prudent, but revenue projections that assume increased compliance appear rather optimistic. According to OECD estimates, which also envisage some slippage in current expenditure, the deficit could be about 1 percentage point higher than budgeted.
- Second, achieving a steady reduction of the structural deficit implies forceful implementation of the approved structural reforms. But there seems to have been delays in the implementation of the reforms, judging from the heavy reliance of the 2004 budget on spending freezes and one-off measures. ■

Is enough being done to reform the public administration and the pension system?

Implementation needs to be accelerated, especially in some areas of public administration reform. Most of the legislation to improve human resource management has already been approved: a new organisational model for central administration, a new framework for public institutes, a new status for managers imposing performance requirements and reinforcing managerial autonomy and accountability. There have already been some achievements in terms of closure or merger of public institutes and schools and restructuring has started in two ministries. However, implementation needs to be stepped up as enhanced effectiveness of the public administration would be a key factor in achieving the intended results in many other reform areas. The "employment pool", created to encourage mobility of civil servants, has yet to be used on a significant scale. The legislation introducing individual contracts in the public sector, to give more flexibility to human resource management, has been approved. It is too early to judge the eventual success of these reforms, but success is crucial because public sector employment is recognised as being excessively large relative to the services provided in many areas, while staff mobility is very low.

Once fully and effectively implemented, in-depth reforms in education, health care and the public administration are likely to improve cost effectiveness in the public sector and spending control. However they will be insufficient to meet ageing-related pressures on public finances in the longer run.

- Official simulations suggest that the expected population ageing will increase public expenditure on pensions by 2.6 percentage points of GDP by 2020. The pension system for private workers will be in deficit by 2015, thereafter financed for a further 10-15 years by the pension trust fund. The generous public sector pension regime is already in deficit.
- The pension reform initiated a few years ago with the definition of a new benefit formula for disability and old-age pensions for private sector workers will have only a minor impact on spending.
- The legislation on a second-pillar complementary regime envisaged in the framework law is still in preparation.
- Regarding the public sector regime, the changes introduced to the benefit formula in 2004 will not suffice to cope with pressures coming from the ageing population.

Therefore, a more radical reform of both the public and private employees' pension schemes is imperative. A number of options could be considered, including: incentives to raise the effective age of retirement; reducing the annual accrual rate; limiting indexation of standard pensions to inflation rather than wage developments; increasing the (low) effective rate of taxation of pension incomes; and adjusting replacement rates for changes in life expectancy [of pension cohorts]. Several of these options would probably need to be combined to significantly improve the sustainability of the pension systems. ■

Is the reform of the health care system addressing most of the sector's weaknesses?

In another area, the comprehensive reform to increase efficiency of the health care system launched in 2002 should help put public finances on a sounder medium-term path. The reform has two main aims: to deliver better-quality public health services than at present but at no higher cost; and to reduce the underlying growth rate of public health-care spending over the medium term. New legislation has been approved over the last two years, including: the separation of the functions of regulation, financing and provision of health care services; setting up new models of financing for providers, which impose harder budget constraints; the introduction of incentives towards productivity, management and quality improvements in both primary health care centres and hospitals; the possibility for the private sector to play a larger role in service provision; and the promotion of generic drugs. In contrast to previous attempts of gradual reforms, which were never fully implemented, the strategy has been to create a big bang in the health sector, making reform efforts essentially irreversible.

The reform is an important step forward. It addresses the most serious weaknesses of the system identified in earlier OECD *Economic Surveys*, in particular:

- It places public providers under pressure to provide cost-effective services via changes in the way they are managed (especially with regard to organisation, budget, staff remuneration and monitoring of results).
- More than one-third of public hospitals (34 mostly medium-sized) have been incorporated. Higher production and some productivity gains seem to have been achieved already.
- A specific programme to reduce waiting lists addresses a key source of patients' dissatisfaction and of inequitable access to health care. First results show a significant reduction in waiting time, partially obscured by a concomitant increase in demand for treatment.
- The progressive strengthening of the long-term care network, which is relatively under-developed in Portugal, should help reduce the overcrowding of hospitals by (ageing) patients requiring long-term care rather than acute health care.
- The new pharmaceutical policy designed to curb expenditure (which had been growing at double digit rates over the last decade), by putting pressure on the pharmaceutical industry to reduce prices and by increasing cost sharing, has had an immediate impact. Spending decelerated in 2003 and the generic market share more than tripled, to over 6.5 per cent by early 2004, though still low in international comparison. ■

What more should be done to achieve durable improvements in efficiency and quality of health care?

Now that most legislation has been approved, the key challenges lie in its implementation and monitoring, and in consolidating recent achievements. Although short-term positive results may be easy to reach, sustained improvements will be more difficult to achieve. The reform strategy should thus be strengthened. Dissemination of information about the reform process and progress needs to be improved in order to help garner public support, and, as importantly, to facilitate external assessment of results and identify areas where corrective actions are necessary. Efforts are also needed to ensure that progress in efficiency is followed by improvements in quality of care and health outcomes, where Portugal still lags more advanced EU countries. This calls for putting more emphasis on quality in the benchmarking of health institutions and putting in place mechanisms to avoid adverse selection practices. The regional health administrations also need to be modernised to fulfil the new tasks as purchasers of health care assigned to them in the reform. The introduction of a new independent regulatory body is an important step in the reform process. Lastly, the reform needs to be better integrated in a medium-term strategy. The National Health Plan and the programmes it contains are a possible vehicle for this but, at this stage, the articulation between the ongoing reform and this 10-year plan is not yet clear.

The reform also needs to be completed by additional measures to release its full effects. In particular, to further increase efficiency and reduce current pressures on costs, the reform should:

- seek more actively the integration of the various provider networks (primary care, hospitals, long term care) so as to reduce wasteful duplication of acts and improve the quality of follow-up of patients across the system;
- put in place additional measures to tackle excessive expenditure, such as assessments of new technologies before they are generalised in public health care, measures to curb hospitals' expenditure on pharmaceuticals and additional measures to consolidate the recent slowdown of spending on drugs sold in pharmacies;
- consider measures to limit excessive demand for health services, for instance by increasing co-payments (with safeguards to promote equity of access) and rationalising reimbursements so as to avoid duplication of care and limit excessive requests for second or third opinions;
- enhance medical prevention and early detection of illnesses, which tend to improve health outcomes and to reduce costs of health care associated with late detection;
- consider other actions which could almost certainly improve the population's health status, with very little impact on public finances, for instance running information campaigns on the benefits of "healthy life-styles" and road security. ■

For further information

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- **Additional Information:** More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at *www.oecd.org/eco*.

- **Economic Outlook No. 75,** June 2004. More information about this publication can be found on the OECD's Web site at *www.oecd.org/eco/Economic_Outlook*.

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