

Economic Survey of Portugal, 2006

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Summary

Portugal's economic performance has deteriorated markedly since 2000, with the slowdown turning out to be more severe and prolonged than in most other OECD countries. This lack of resilience reveals structural weaknesses. Meanwhile, with low growth and weak control of public expenditure, the fiscal deficit has remained at unsustainably high levels, reaching close to 6% of GDP in 2005. Despite the existence of a large output gap, the high fiscal deficit leaves no room to stimulate demand. The government has embarked on a strategy that aims at consolidating public finances and enhancing growth and it is important to strengthen these efforts. Without more wage restraint and higher productivity growth, there is a clear risk that Portugal's competitiveness continues to deteriorate and the income gap vis-à-vis the OECD average widens further.

Immediate and forceful implementation of the planned spending reforms is needed to put public finances on a sustainable path and improve efficiency.

The key is to carry through the structural reforms initiated to address the chronic weak control of public spending, including the public administration reform, the ambitious health reform that started under the previous government and the overhaul of the civil servants pension system. To ensure fiscal sustainability over the longer run, additional measures are needed, in particular a fundamental reform of the general pension system, the adoption of binding medium-term expenditure ceilings and more systematic cost-benefit assessment of public investment. In addition, further simplification of the tax system would help both to raise more revenue and to foster economic growth.

This Policy Brief presents the assessment and recommendations of the 2006 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.

Improving the educational achievements of the younger generation is a priority. Portugal has a considerable human capital lag within the OECD, and the EU in particular. Continued action to improve and diversify education services is required, with a view to reducing the number of early school leavers who have limited competences. Efforts are needed to support the effective use by schools of their (recently devolved) autonomy as this would help adapting teaching to local needs and supporting low achievers. It would also be desirable to increase the awareness of students on the high returns to schooling.

Modernizing the economy through tertiary education, training and innovation would raise productivity and help Portugal cope with global competition. Portugal needs to continue shifting away from traditional labour-intensive products into higher value-added activities. The tertiary education system needs to be rationalised and diversified, and its scientific capacity strengthened. The system's financing should be reviewed to ensure a more equitable access to a broader public. The participation of adults in training activities should be stimulated, by targeting support towards needy groups, enhancing the quality of training courses and evaluating the effectiveness of existing programmes. Innovation in firms and research institutions should be enhanced by developing the links between them and by ensuring the effectiveness of tax incentives.

Creating a more dynamic business environment, enhancing competition and facilitating labour market adjustments are also needed to achieve a higher growth path. While the regulatory framework for doing business has improved markedly, further measures are needed to ease firm creation and facilitate the exit of poorly performing firms. Strengthening product market competition throughout the economy would raise efficiency and improve consumer welfare by reducing prices. Portugal's labour market is characterized by traditionally high participation rates but a high share of short-term contracts in total employment. Easing labour market regulations would help to foster job creation on regular contracts and facilitate the reallocation of labour to its more productive use and should be accompanied by ensuring adequate job-search support and providing well-designed activation services to help transitions to employment. ■

What are the main challenges?

Following a period of convergence to EU average living standards, the catching-up process has stalled since 2000. Real GDP growth averaged less than 1% between 2000 and 2005 and the on-going recovery remains fragile, with annual growth expected to remain below 2% in 2006-07. Slow growth in this decade reflects both cyclical and structural weaknesses which are mutually reinforcing. The accumulated output gap since the beginning of the slowdown is among the largest in the euro area and potential output growth is estimated to be currently about half what it was in the second half of the 1990s. Trend productivity growth in the business sector which, at 3% per year, was above average until the late 1990s has fallen to around 1% in 2004-05, constrained by the protracted period of low productive investment. Portugal's export performance has deteriorated in a global environment where competition has become harsher.

Major new players in world trade with lower labour costs are competing in Portugal's traditional product markets, while new EU members are increasingly specializing in the medium- and higher-technology products, where Portugal is also developing. Thus, Portugal did not take full advantage of the opportunities created by membership in the EU and the euro area to enhance growth on a sustainable basis. Losses in export market shares have been aggravated by the appreciation of the real exchange rate (as measured by Portuguese unit labour costs relative to those in its trading partners), while a real depreciation through greater wage restraint could have been expected (and would have been desirable) in a period of large slack in demand. As a result of economic weakness and lax policies in the past, the fiscal deficit reached close to 6% of GDP in 2005, an unsustainably high level.

In view of the large output gap, some support from macroeconomic policies would in principle be appropriate. However, given the other macroeconomic imbalances, there is no room to stimulate demand. The high fiscal deficit does not allow expansionary fiscal policy, or even letting automatic stabilisers fully operate; and short-term interest rates are set by the ECB according to conditions prevailing in the entire euro area. The only macroeconomic tool left to underpin the recovery (on which the government has, however, only limited influence as it is in the hands of social partners) is reversing the appreciation of the real exchange rate by additional wage restraint, thereby helping to crowd-in net exports, and preventing a further rise in unemployment. Experience in other countries has shown that a clear understanding of the seriousness of the situation and consensus among social partners can significantly accelerate the process of restoring competitiveness.

At this critical juncture for the Portuguese economy, structural reforms to revive growth are all the more important. Consolidation of public finances is another requirement. It is not only urgent to satisfy European fiscal rules but is also desirable for its own sake, as the effects on growth should be positive over the medium and longer term, at least compared with the alternative of running high deficits which undermine confidence, lead to recurrent fiscal crises, and thereby induce instability. Consolidation would create room for

automatic stabilisers to operate fully during future downturns, which would enhance resilience. Consolidation is also required to prepare for the ageing of the population. Finally, if consolidation is associated with improving cost-efficiency and the quality of public services, it would also enhance growth by contributing to a friendlier business environment.

Given its low level of productivity Portugal has a large potential for catching-up. Low human capital, heavy administrative burdens on firms, weak innovative performance of the business sector, restrictive labour market regulations and lack of competition in some sectors have become major impediments to productivity growth in the new international environment. Overall, Portugal must address four main challenges:

- Putting public finances on a sustainable path.
- Improving the performance of the education system, at the primary and secondary levels and in vocational training.
- Modernizing the economy to face global competition by enhancing tertiary education, training and innovation, and by continuing to give high priority to science and technology development.
- Creating a more dynamic business environment, strengthening competition and improving the functioning of the labour market.

Continuity and effective implementation of the required reform strategy are key to ensure sizeable and durable results. ■

How can public finances be put on a sustainable path?

Consolidation efforts in 2002-04 failed to durably reduce the fiscal deficit below the Stability and Growth Pact threshold of 3% of GDP, and Portugal was again submitted to the excessive deficit procedure with a deficit of close to 6% of GDP in 2005. New efforts are required and in an even more depressed economic environment than four years ago. The strategy followed between 2002 and 2004 combined a rise in the indirect tax rate, emergency spending cuts or freezes and one-off measures with more in-depth medium-term measures on the spending side.

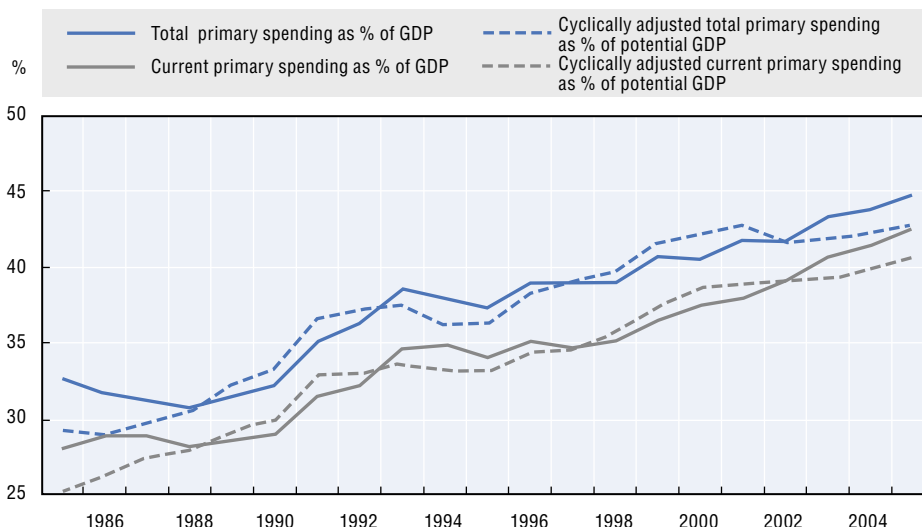
This strategy was appropriate to deal with the urgency of the situation while addressing Portugal's weak expenditure control with measures that typically take time to show results. However, the reliance on one-off-measures may have reduced the sense of emergency and commitment to undertake the painful structural reforms required. Implementation was too slow, in particular as concerned the much needed public administration reform. Emergency measures were able to control the wage bill over the short term but other expenditure items, especially pensions, continued to increase strongly. Taxes were lowered rapidly once the deficit was below 3%, even though the underlying situation had not improved. Despite some consolidation measures the deficit increased to close to 6% of GDP in 2005, partly because of the decision to stop one-off-measures.

The government that came to office in early 2005 is committed to bringing the deficit to below 3% of GDP by 2008. The strategy combines short-term measures to control the wage bill with tax hikes and more in-depth spending reforms. In addition, the control of budget execution is being strengthened. A major difference with the 2002-04 programme is the decision to stop relying on one-off measures in a context where Portugal has been granted more time to get its deficit under 3% of GDP.

Success in achieving the consolidation targets will depend heavily on progress in spending reforms. A fundamental reform of the civil servants pension system brings it gradually in line with the general pension system. Further positive steps have been taken to continue the ambitious health reform initiated under the previous administration. The government has also reengaged a reform of public administration that includes many commendable measures, such as alignment of legal conditions of employment, career and remuneration in the public administration with the private sector and a major restructuring of central administration. The reforms already approved or under preparation are going in the right direction and, if fully implemented, are likely to succeed in bringing the deficit below 3% of GDP over the next few years.

Although fiscal consolidation could have a short-term cost in terms of activity, experience elsewhere shows that this cost can be minimized if consolidation is credible, which implies resolute and consistent action that delivers solid results. *Therefore it is important that the authorities remain committed to achieving the projected fiscal consolidation without slippage and that the planned structural reforms on the spending side are launched quickly and implemented forcefully.* Ongoing steps to improve statistical information on spending at all levels should continue. Consideration should also be given to improving

Figure 1.
PRIMARY GOVERNMENT SPENDING IN PORTUGAL



Source: OECD, Economic Outlook No. 78 database.

the fiscal framework drawing from successful experiences in other OECD countries, in particular adopting medium-term expenditure ceilings that are consistent with the desired consolidation path and strengthening the role of independent economic advisors councils in the preparation of the budget and the assessment of final outcomes.

The consolidation programme nevertheless needs to be complemented by additional reforms to strengthen expenditure control. A key pending reform is the reform of the general pension system to ensure its viability. The system is under strong pressures arising not only from the ageing population but also from its maturation and the high replacement rates granted to pensioners. Updated official simulations show that the system will likely be in deficit by 2007, and could be financed thereafter for only 7 years by the pension trust fund. Therefore action is urgent. A working group has been appointed and some of its proposals are being considered, such as introducing incentives to increase the effective retirement age. *It is important that action in this area is not delayed. More radical changes should be envisaged, such as adjusting replacement rates and/or the retirement age for changes in life expectancy and limiting the costs of transition by a relatively rapid phasing-in.* ■

Would simplifying the tax system help competitiveness?

On the revenue side, there is no room to lower taxes before the public finances have been put on a sustainable path. Nevertheless, there is ample room for further simplification of the tax regime, which is as important for competitiveness as lowering tax rates and can help to improve the efficiency of tax collection. Already, the tax administration has started to deliver results in terms of tax collection over the past two years. The abolition of some tax benefits and exemptions in the 2006 budget is also an appropriate step. However the creation of a new personal income tax bracket, with a higher marginal tax rate, complicates the system and creates additional disincentives to work. *A tax reform that really simplifies the tax system is needed. In the meantime, refraining from revising the tax legislation from one year to the next, as has happened in recent years, would make the tax system easier to manage and would facilitate long-term decision-making by economic agents. Indeed, re-establishing macroeconomic stability will be the key to ensuring that the necessary structural reforms to improve education, the labour market and the business environment can be successfully pursued.* ■

What needs to be done in the education sector?

Despite substantial progress in the past decades, a large share of the young leave school before completing upper secondary education and the achievements of students in PISA are among the poorest in the OECD. In addition, the education system has not been able to limit the repetition of low education from one generation to the next and to foster inter-generational mobility as fast as other countries. The factors behind the poor performance of the education system have been well identified. Below average outcomes do not result from a lack of spending on education, but from the low efficiency of the system.

The authorities' key objective is to reduce school failure and early drop-outs by increasing the quality and relevance of education services without endangering fiscal consolidation. *Efficiency gains are being sought by closing very small schools and making better use of teaching staff, but more needs to be done to rationalise the system and achieve better quality without spending more.* To reduce incentives to dropouts, the social contribution rebate for companies that hire young workers has been eliminated unless they have completed 12 years at school or are in training. New programmes have been launched to improve teachers' training in core topics, modernise the curricula, strengthen vocational and technological streams and make them more attractive, and provide individualised support to low achievers. The new administration has announced its determination to go further in giving autonomy to schools ("putting schools centre stage") which is in line with the growing presumption that the devolution of responsibilities to schools brings efficiency. ■

How can the number of early school leavers be reduced?

The recently launched programmes rely on initiatives that should be taken at the school level to adapt curricula and teaching practices to local needs and support students at risk of school failure. However, schools have made little use of their autonomy so far. This reflects for a large part the lack of leadership in schools that stems in particular from the way school principals are selected and trained, and the lack of incentives and information for teachers to play their new role. *More needs to be done to address these issues and ensure an effective use of recently devolved autonomy by schools and teachers. Efforts are needed to improve evaluation systems and channel the results to both the providers of educational services (teachers, school principals) and the users (children and parents).*

The relatively low value of school for society at large is also an issue. In an economy that until recently created plenty of unskilled jobs, education was not highly valued by the labour market. And still today, although private returns to education are high, the often uneducated and poor parents and their children do not always fully appreciate potential benefits of more education. *Raising the perceived value of schooling for the students and their families is desirable. Revamped education and career guidance services could play an instrumental role by increasing awareness that more schooling can provide high long-term private returns. They could at the same time ensure a better school-to-work transition for those who decide to leave school and inform them of the possibilities to reengage in studies later on.* ■

What more should be done to enhance human capital?

To enjoy durably stronger growth, Portugal needs to move away from traditional labour-intensive low value-added products and increase its specialisation in medium- and high-tech activities. This requires fostering the development of a knowledge-based economy. Improvements in initial education outcomes are not enough to meet the rising and changing demand for skills in today's global environment. Attention needs to be given to the coverage and quality of tertiary education, which are below standard, in particular as regards science and technology, and hence impede the

diffusion of knowledge. Finally, Portugal lags in business R&D and innovation, including not only the creation of new products, services or processes, but also the diffusion of existing knowledge. *To facilitate the dissemination of knowledge and practices across manufacturing and service sectors and improve the innovation performance overall, specific innovation policies and, more important, framework conditions have to be improved.*

Considering both public and private universities and polytechnics, there is overcapacity in higher education. At the same time, access to tertiary education remains very selective. The system is not fully utilised and needs to be re-organised and rationalised, by merging or closing down some institutions and streamlining disciplines taught, in view of challenges for the future. *At the higher education level, policies should focus on increasing success rates. This should be achieved by a diversification of education streams and opportunities and quality improvements gained through enhanced scientific capacity and stronger autonomy and accountability of institutions.* While supporting higher education is a budget priority in Portugal, the low growth of the economy and the fiscal consolidation requirements clearly limit the amounts which can be spent. Adequate financing could be provided by a combination of budget resources, tuition fees and alliances with enterprises or research centres. *Raising fees for tertiary education while developing the loan system (perhaps with repayment contingent on post-graduation income) would be more equitable and raise efficiency.* Paying higher tuition fees would make students attentive to the quality and subjects being supplied, thereby putting pressure on higher-education institutions to respond to the needs. Moreover the additional resources would allow the quality of staff and research to be raised, even as coverage broadens.

Once they have entered active life, few adults participate in training activities. Yet returns to training appear to be large in terms of higher income and lower unemployment risk; and firms would also benefit from training workers. *There is no need to develop new services, but existing instruments should be rationalised.* A comprehensive approach to lifelong learning is desirable, making better use of existing education capacity. To ensure greater participation in lifelong learning, an important step has been accomplished with the development of the national certification system; but its application is only beginning. *Government action should focus on extending the application of the certification system, becoming more involved in quality assurance and stimulating demand for training by improving information and guidance about opportunities. The government should implement its plan to provide funding directly to the demand side, including firms and entrepreneurial associations, rather than the traditional financing of operators (supply), and should target its support to low-opportunity individuals. ■*

How can the economy become more innovative?

To correct the lag in innovation activity, specific policies can play a role. To enhance their effectiveness, a more systemic approach and greater continuity in policy making are required. It would be desirable to continue to give high priority to R&D, building on the existing system of scientific centres (mostly university-based), and by fostering international partnerships in science and technology and higher education.

Also, the effectiveness of spending should be regularly assessed. To strengthen business R&D, where Portugal's weakness is the most obvious, the government provides support through the reintroduction of tax incentives and is promoting the development of the venture capital market. Provided a fair degree of stability and predictability over time is ensured, public support can have positive effects, though international experience suggests that the gains to be expected are generally limited. It is crucial to move ahead to develop strategic cooperation between the private and public sectors as envisaged in the Technological Plan. Much progress is needed to strengthen the links between public research and industry, by facilitating the mobility of researchers, and by providing financial encouragement to the development of scientific networks and partnerships with the international business world. ■

How can the business environment be improved?

There has been a significant improvement in reducing the burden of regulations. The cost of doing business in Portugal has come down and red tape has been cut, but other countries have made rapid progress as well. The benchmark for the Portuguese regulatory policy environment should now be the settings in the best-practice countries rather than those of the average EU countries, where regulations tend to remain excessive.

Recent action to ease registration requirements for business creation is appropriate. *Further measures are desirable to further reduce the cost of firm creation, cut administrative overheads of running a business and facilitate the exit of poorly performing companies.* A more dynamic business environment would help Portuguese firms' competitiveness and enhance the attractiveness of the country as a location for foreign direct investment, thereby, as in the 1990s, offering opportunities for learning from international best practices. ■

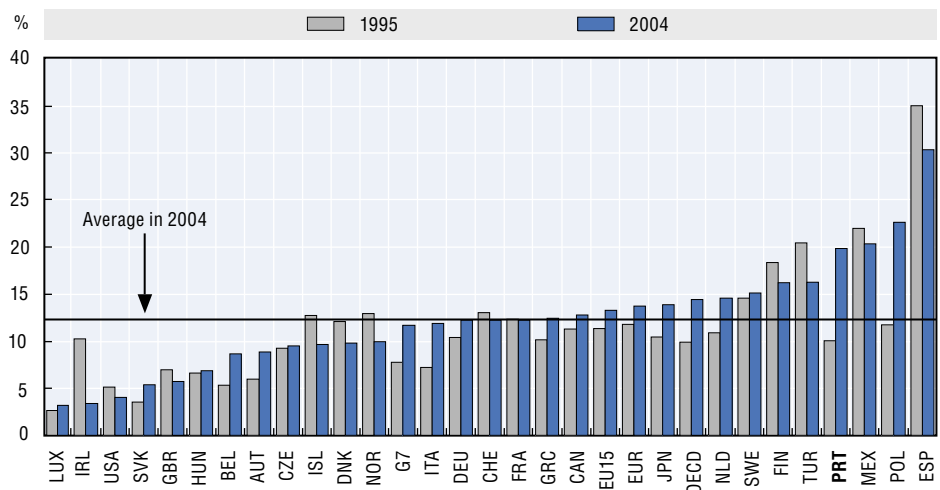
Portugal has made much progress in enhancing competition, which could be a major source for economic growth. But in a number of areas, in particular in network industries, more competition is needed. In the energy sector, the structure and regulations provide little incentive to improve efficiency and pass on lower costs to consumers, so that prices remain high by international standards. For instance, electricity prices for industry are among the highest in the EU, except for large consumers where they are at the EU average. The government has started the restructuring of the energy sector which foresees a pro-competitive re-deployment of electricity and gas assets.

An agreement has been reached with all shareholders of the companies involved, including some major European energy players. *This restructuring has the potential to raise efficiency and improve consumer welfare by reducing prices and should be carried through and accompanied by appropriate measures to facilitate consumer switching.* In the telecommunications sector, where the incumbent holds a dominant position on several markets, and despite action by the sector regulator to reduce interconnection charges, more needs to be done to ensure a level playing field. *A key step to developing competition in the sector would be to separate ownership of the fixed telephony and cable networks.* ■

What is needed to facilitate labour mobility and job creation?

Portugal's labour market is characterized by traditionally high participation, but over the past years unemployment has risen to high levels. As in many other OECD countries with relatively restrictive employment legislation, firms have favoured the use of fixed-term contracts, aggravating problems of a dual labour market, which raises equity concerns and tends to reduce incentives for firms to provide training.

Figure 2.
TEMPORARY EMPLOYMENT
Per cent of dependent employment



Source: OECD, *Employment Outlook*, 2005; OECD, *Annual Labour Force Statistics*.

Although the recent changes to the labour legislation have several commendable elements, such as increasing flexibility in collective agreements at the firm level, the overall setting for employment security remains too strict and procedures are cumbersome. International experience shows that this hampers labour mobility, inhibits the creation of permanent jobs, lengthens unemployment spells and also slows the pace of innovation within firms. *More measures are needed, including easing dismissal rules and simplifying procedures for dismissals which would make it more attractive for employers to offer regular contracts and raise the dynamic efficiency of the economy. On the labour supply side, it would be desirable to review the unemployment and related benefit system – and its interaction with the tax system – to achieve the appropriate balance between providing income support for job seekers and preserving work incentives. This should involve both enhancing the effectiveness of active labour market policies and tightening up benefit programmes and also requires improving the performance of the Public Employment Service (PES).* ■

**For further
information**

For further information regarding this Policy Brief please contact:

Bénédicte Larre ; e-mail: benedicte.larre@oecd.org ; tel.: +33 1 45 24 87 95,
or David Haugh ; e-mail: david.haugh@oecd.org ; tel.: +33 1 45 24 80 46,
or see www.oecd.org/portugal.

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Where to contact us?

OECD HEADQUARTERS

2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD Berlin Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail:
berlin.contact@oecd.org
Internet:
www.oecd.org/deutschland

JAPAN

OECD Tokyo Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD Mexico Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560 MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.ocdemexico.org.mx

UNITED STATES

OECD Washington Center
2001 L Street N.W., Suite 650
WASHINGTON DC. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

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