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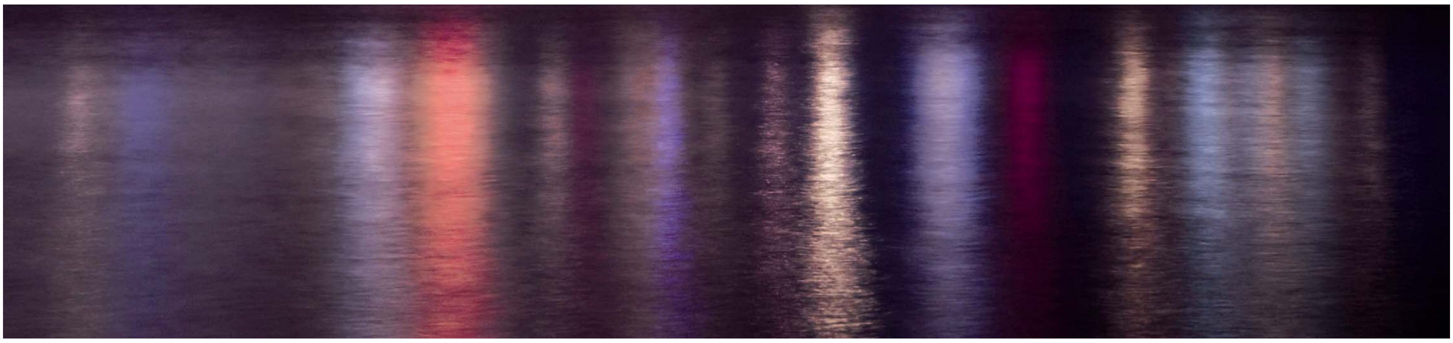
OVERVIEW



Summary

Portugal has started down a long road of economic adjustment to boost growth and correct an excessive reliance on debt. The government is resolutely implementing the EU-IMF financial assistance programme of fiscal adjustment and reform. Accordingly, significant legislation has been passed, with broad political support, to improve the performance of the labour and product markets. In addition, many OECD recommendations of the last survey have been adopted. The authorities should ensure effective implementation of these ambitious reforms. Returning to a sustainable fiscal position is a pre-condition for restoring confidence, investment and growth. The authorities should therefore aim to meet the headline deficit targets in the EU-IMF programme. However, the government may need to let automatic stabilisers play at least partially if risks materialise and growth turns out much lower than projected in the programme, while sticking to its structural fiscal targets to restore investors' confidence. At the same time, credit to the economy should be supported by promoting swift recognition of bad loans, and ensuring that the banks maintain the required capital ratios and the pace of convergence towards the indicative target for the loan-to-deposit ratio does not thwart economic activity. Special attention should be paid to the financing conditions of small and medium-sized enterprises, notably by making firms more reliant on equity and less on debt, and by re-directing EU funds. Fundamental structural reforms are central to boosting potential growth and shifting economic activity from low-productivity domestically-orientated sectors to tradable goods and services. Vigorous reforms of the labour market would combat duality and boost competitiveness.

Structural fiscal reforms are required to return to fiscal sustainability. Still-high bond spreads indicate that the government faces additional challenges to regain full market access within the programme period. Structural measures are required to tackle a long history of excessive spending growth and substantial liabilities that have been built up non-transparently through payment arrears, state owned company losses and public-private partnerships. The introduction by the government of a medium-term budget framework, better financial management tools, a fiscal council and greater transparency in fiscal accounts are welcome. In addition, the fiscal framework would be significantly reinforced by introducing a clear, operational expenditure rule for general government, in line with the new European fiscal framework. Local and regional government finances have generated large negative surprises and reforms to their fiscal frameworks are also required, as envisaged.

A wide range of structural reforms is required to raise productivity and rebalance the economy towards international trade. Although legally liberalised, many markets remain concentrated due to significant barriers to entry, hampering competition and innovation. Streamlining business licensing procedures, as planned, would encourage firm entry, competition and employment. Portugal's international trade is limited, considering the relatively small size of its economy, pointing to potential gains from increased participation in global value chains. It is important that the government follows through on efforts to improve the business environment, including in the markets concerned by privatisations, and reduces distorting incentives that have biased investment away from the tradable sector. This will help to attract foreign direct investment. Education levels in the workforce are still far below the European average and need to improve further, despite the significant progress in the younger generation, to enable firms to expand into more productive activities.

Further reforms of the labour market are necessary. Institutional settings have stifled employment and generated a dualistic labour market that undermines productivity growth, as workers with short-term contracts are less likely to invest in human capital and those with permanent contracts have insufficient mobility. Efforts are going in the right direction to reduce duality, with significant reforms legislated recently, such as the reduction of severance payments, following an agreement with social partners. However, dominant firms impose wage and working conditions on others via the administrative extension of collective agreements, reducing competition and entry, thereby hurting competitiveness. Dualism would be further eased by reducing severance pay and tackling delays and uncertainty in litigation over dismissals. Finally, cutting non-wage costs for the low-paid could help boost employment prospects of the less qualified.

Key recommendations

Macroeconomic policies to stabilise the economy

- The government should aim to meet headline deficit targets in the programme, notably through abiding by the budgeted expenditure at all levels of general government. If risks materialise significantly and growth is far lower than projected in the programme, the automatic stabilisers could be allowed to operate at least partially.
- Introduce an explicit and easily enforceable public expenditure rule consistent with revenue projections and medium-term fiscal objectives and in line with the European fiscal framework.
- Support to local and regional governments should be accompanied with improvements in the fiscal framework.
- Pay special attention to financing conditions of small and medium-sized enterprises, notably by making firms more reliant on equity and by re-directing EU funds.
- Ensure that the pace of convergence towards the indicative target for the loan-to-deposit ratio does not thwart economic activity.

Structural policies to rebalance the economy and boost growth

- Maintain the momentum in justice reform to speed up civil and commercial case resolution.
- Fully implement the proposed zero authorisation initiative to speed up local licensing,
- Ensure that electricity generation support is made cost-effective and costs are fully passed on to all consumers. This requires further reducing excessive support to both wind farms and cogeneration, and to fossil-fuel power and large hydro plants.
- Further reduce severance pay and introduce binding arbitration in conflicts over dismissals.
- Further promote firm-level wage bargaining by abolishing administrative extension of collective agreements.
- Lift education levels by focusing the evaluation system more on tracking individuals and cohorts over time in order to inform policy changes to improve education outcomes of children from lower socio-economic backgrounds.

Assessment and recommendations

Challenges facing Portugal

The global crisis exposed underlying weaknesses and imbalances in the Portuguese economy, which has entered a deep recession with high unemployment. Labour market regulation had long been ill-equipped to create jobs and wide-ranging structural reforms were needed to help get the unemployed back to work and foster reallocation of labour from non-tradable to tradable sectors. International capital flows have dried up and weak growth prospects resulted in a loss of market confidence and sharply rising interest rates (Figure 1), despite the fact that Portugal has steadfastly implemented an ambitious three year European Union-International Monetary Fund (EU-IMF) financial assistance programme since May 2011 (Box 1).

The programme is expected to remain on track but the balance of risks to growth is skewed to the downside. The size of the consolidation in 2012 is very large and the risk that fiscal targets are not met because growth undershoots expectations in a credit constrained and weak international environment is significant. Therefore, the government faces additional challenges to regain full market access within the programme period.

Against this uncertain backdrop, this Economic Survey examines progress in implementing structural reforms required to boost growth and reduce imbalances, while achieving fiscal consolidation (Annex A1). Chapter 1 discusses structural fiscal reforms and the pace of fiscal consolidation. This is followed by an analysis of the reforms to rebalance the economy, such as how to reinforce financial stability, improve labour market performance and achieve better investment allocation (Chapter 2).

Box 1. The EU-IMF Adjustment Programme

On May 2011, Portugal agreed with the European Union and the International Monetary Fund on a far-reaching reform programme to restore market confidence and raise potential growth. The three-year programme is backed by substantial international financing (around EUR 78 billion). The three main goals of the programme are: *i)* implementing a credible fiscal consolidation supported by structural fiscal measures and better fiscal control over public-private partnerships (PPP) and state-owned enterprises (SOE); *ii)* safeguarding the financial sector against disorderly deleveraging through market-based mechanisms supported by backed-up facilities; and *iii)* implementing deep structural reforms to boost potential growth, create jobs, and improve competitiveness (including through fiscal devaluation). Quarterly reports published by the EU and the IMF indicate satisfactory programme implementation, with quantitative performance criteria met, as well as most structural benchmarks, albeit some with minor delays. This box presents the main measures already implemented or in the course of implementation.

Regarding **public finance management**, the government is implementing a new Budgetary Framework Law, which includes multi-annual budgeting; a Fiscal Council was created and is progressively becoming operational; a new Commitments Law aims to ensure better control of expenditures and to tackle payment arrears; the first stage of the merger of tax and customs administrations was executed; a fiscal adjustment programme for the Madeira Autonomous Region was launched; a support program for local administration was agreed upon; quarterly budget reporting for the general government is in place; new local and regional financing laws are to be presented by the end of 2012; and costs are being reduced in SOEs, with the aim to reach operational balance for most of them in 2012.

Concerning the **financial sector**, a special onsite inspection program has reviewed the banks' loan portfolio; most banks have already been recapitalised through private and public funds to meet both European Banking Authority (EBA) and Bank of Portugal core tier one targets; the bank resolution framework is being redesigned; and bank deleveraging is being carefully monitored.

On the **labour market**, the authorities approved a new labour code, agreed with social partners, including one of the main confederations of unions; the changes include a reduction in severance payments, more flexible individual dismissals and working time arrangements, reduction of overtime pay, and some more scope for firm-level wage negotiations. Further reduction of severance entitlements is expected as well as the creation of out of court procedures to settle labour disputes.

To enhance the **business environment,** the government amended the insolvency regime to support the early rescue of viable firms; the transposition of the Professional Qualifications Directive is underway; a "zero authorisation" project to minimise licensing costs is being introduced, although difficulties remain in making it fully operational; the reform of the judicial system is reallocating judicial resources (new judicial map) and a new code of civil procedure will be submitted by end 2012 to speed up the judicial process; a new urban lease law was approved, aiming at faster eviction procedures and introducing a sunset clause of five years for most old contracts under rent control; a new Competition Law has been approved, increasing the responsibilities of the Competition Authority, and new competition and intellectual property courts have been created; a new arbitration law has been adopted; and a review of the main national regulators is underway. Privatisations of energy companies EDP and REN with significant premiums over market price have yielded EUR 3.3 billon, or two-thirds of expected privatisation receipts under the programme.

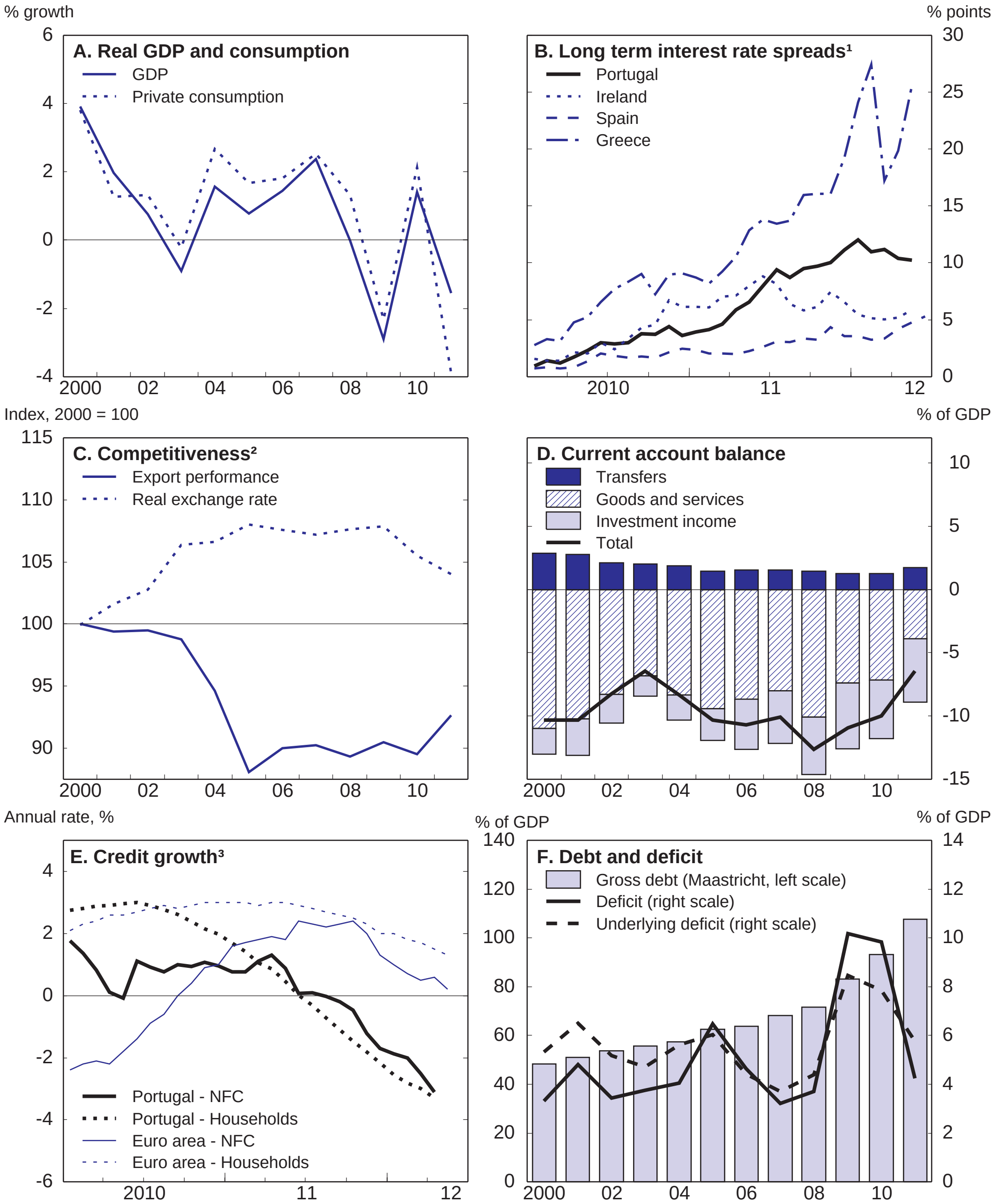
To **reduce rents in sheltered sectors** of the economy, the authorities are engaged in a number of renegotiation processes. In electricity, the review of contracts and subsidies to producers will lower the expected cumulative real price growth until 2020 by about one-sixth, while in the telecom sector, mobile termination rates will decrease considerably; measures aim to reduce the public cost of pharmaceuticals from 1.5% of gross domestic product (GDP) to 1% of GDP in 2013; a full review of all 36 PPP by an international auditor has been completed with a view of possible contract renegotiations.

The most pressing policy challenge is to stabilise the economy

The economy has started rebalancing, but the situation remains fragile. The huge current account deficit has dropped to 6.4% of gross domestic product (GDP) in 2011 (from 10% in 2010), due to weak domestic demand and strong exports that have resulted in sizeable gains in market share (Figure 1). Strong export performance reflects robust growth across a wide range of exported goods and services, most prominently in transport equipment, and has been accompanied by increased geographic diversification. Limited prospects at home are arguably pushing firms to become more export oriented and they have been helped by recent improvements in cost competitiveness (Figure 1), which go beyond the impact of cuts in public wages. Ensuring a sustainable correction of external imbalances – i.e. lasting beyond the short run internal demand contraction – will require further cost and non-cost competitiveness gains through labour cost restraint and productivity growth, supported by wide-ranging structural reforms.

Since 2010, fiscal consolidation has gathered pace, weighing on public consumption and investment, and on household disposable income (Figure 1). Despite large-scale reliance on Eurosystem liquidity and resilient deposits, bank deleveraging has induced credit strains, which intensified towards the end of 2011, also weighing on private sector demand. Private consumption alone is expected to shrink by about 13% in 2011-13, a large fall even by the standards of recessions induced by excessive indebtedness (IMF, 2012).

Figure 1. Key indicators



1. Ten-year government bond spreads relative to the German rate.
2. Export performance is the ratio between export volumes and export markets for total goods and services. The real exchange rate is a harmonised competitiveness indicator based on unit labour cost indices for the total economy.
3. Loans adjusted for sales and securitisation. NFC: non-financial corporations. Households include non-profit institutions serving households.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* and *Main Economic Indicators* (databases), July; ECB (2012), *Statistical Data Warehouse*, European Central Bank, July; and Bank of Portugal (2012), *Indicadores de Conjuntura*, June.

Table 1. Short-term outlook

	Current prices (billion euros) 2008	Percentage change, volume 2006 prices[1]				
		2009	2010	2011	2012	2013
Real gross domestic product	**172.0**	**–2.9**	**1.4**	**–1.5**	**–3.2**	**–0.9**
Private consumption	115.0	–2.3	2.1	–3.9	–6.8	–3.2
Government consumption	34.5	4.7	0.9	–3.9	–2.9	–2.4
Gross fixed capital formation	38.6	–8.6	–4.1	–11.4	–10.1	–3.2
Stockbuilding[2]	1.2	–1.1	0.1	–0.4	0.4	0.0
Total domestic demand	189.3	–3.2	0.8	–5.7	–6.4	–3.0
Exports of goods and services	55.8	–10.9	8.8	7.4	3.4	5.1
Imports of goods and services	73.1	–10.0	5.4	–5.5	–5.7	–0.1
Net exports[2]	–17.3	0.7	0.6	4.4	3.5	2.1
Memorandum items						
GDP deflator	. .	0.9	1.1	0.6	0.1	0.4
Consumer price index (harmonised)	. .	–0.9	1.4	3.6	3.1	0.7
Unemployment rate (% of labour force)	. .	9.5	10.8	12.8	15.4	16.2
Household saving ratio[3]	. .	10.9	10.2	9.7	10.5	12.1
General government financial balance[4]	. .	–10.2	–9.8	–4.2	–4.6	–3.5
General government financial balance (net of one offs)[4]	. .	–9.8	–8.8	–7.3	–5.4	–4.3
Gross government debt (Maastricht definition)[4]	. .	83.1	93.3	107.8	114.5	120.3
Current account balance[4]	. .	–10.9	–10.0	–6.4	–4.0	–2.2

1. Projections from 2012 onwards. The cut-off date for these projections was 15 May 2012.
2. Contribution to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
3. Gross, as a percentage of disposable income.
4. As a percentage of GDP. Debt figures include the following cumulative amounts for Bank Solvency Support Facility: EUR 1 billion in 2011 (0.6% of GDP), EUR 8 billion in 2012 (4.8% of GDP) and EUR 12 billion in 2013 (7.2% of GDP).

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May.

Tight credit conditions and a worsening external environment are deepening the recession in 2012 (Table 1). As the result of fiscal improvement in 2011 being partly attributable to sizeable one-offs, the plan to meet fiscal targets in 2012 is very ambitious and will depress demand further. As global conditions improve, exports accelerate and the pace of fiscal contraction eases, growth is projected to gradually pick up in the second half of 2013. However, rising unemployment along with the waning impact of indirect taxes hikes and of the rise in oil prices, should reduce inflation over the projection horizon. Following the substantial reduction in 2011, the current account deficit will continue to shrink. The public debt-to-GDP ratio will rise further in 2013, but will then begin to fall as the fiscal deficit narrows and growth rises.

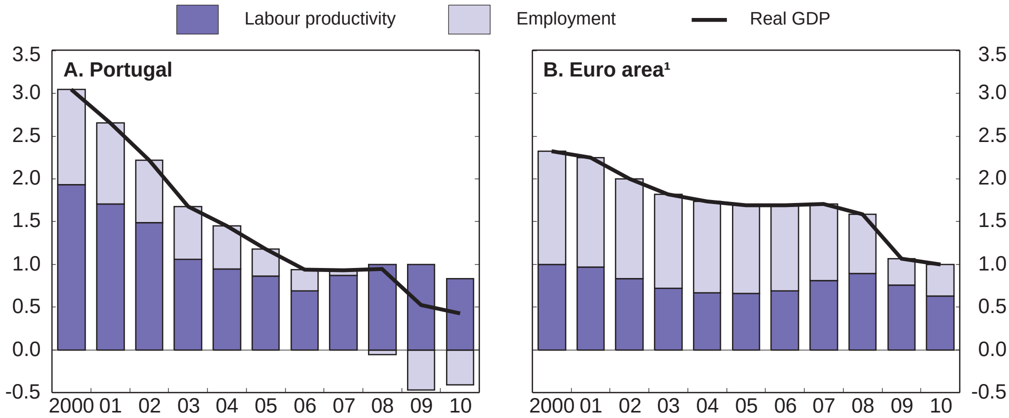
Downside risks are mainly on the external side. Increasing turbulence caused by an intensification of the euro area sovereign debt crisis could undermine confidence in Portugal's prospects, penalising exports and further increasing credit strains. Domestically, the credit squeeze could also intensify, especially if necessary bank deleveraging were pursued at too fast a pace. Indeed, a too rapid and simultaneous deleveraging of both the private and public sector entails the risk of fuelling recession. On the upside, exports have performed well recently and could continue to grow above expectations. Successful implementation of the programme could also boost confidence and domestic demand.

Raising growth in a sustainable way is the long-run challenge

Stronger long-run economic growth is required to raise living standards and enable Portugal to durably reduce its high levels of public and external debt. Over the past decade, potential growth has been hampered by a declining contribution from both employment and productivity (Figure 2), which underscores the need to improve on both counts. Employment has ceased to contribute to growth altogether, whereas trend productivity convergence to much higher euro area levels has slowed down substantially. Despite recent progress in export performance and market diversification, international trade is low given the small size of Portugal's economy; the average of exports and imports over GDP was only 37% in 2011, versus 43% for the average EU country. Moreover, investment has been to a large extent directed towards non-tradable sectors, often with little benefit for productivity growth.

Figure 2. Potential growth

Contribution of employment and labour productivity to potential GDP growth, per cent



1. Euro area countries that are also OECD countries.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections*, May.

Weak productivity and trade need to be further tackled by reducing government-directed investment in transport infrastructure, incentives to homeownership and economic rents in general, so as to facilitate resource reallocation towards the tradable sector. A more flexible and less dualistic labour market would yield productivity gains through better job matching, improved incentives to invest in human capital and also enhanced competition between firms. Product market reforms in sheltered sectors would enhance productivity growth by spurring innovation. Combined labour and product markets reforms would make the economy more attractive for export-oriented foreign direct investment (FDI) and have the potential to yield employment gains relatively fast (OECD, 2012). Ambitious reforms currently being implemented by the authorities in these directions and further steps needed are discussed below.

Raising growth and living standards sustainably will also require continuing efforts to contribute to climate change mitigation and – more generally – to make a more efficient use of environmental resources in consumption and production. Portugal's energy-related CO_2 emissions are low in international comparison, both in per capita and in relation to GDP, as are greenhouse gas emissions, and the country has made further progress over the past 10 years. Environmentally-friendly policies, in addition to sectoral change, have contributed to these improvements.

The government has placed a strong emphasis on increasing the share of renewable energy generation, the share of environmentally related revenues is higher than the OECD average and the share of public research and development (R&D) spending related to the environment is among the highest in the OECD (OECD, 2011a).

Portugal has made good progress in reducing air pollutants, with sulphur oxide emissions declining by more than 60% – well above the average in the OECD – and nitrogen oxide emissions by more than 10%. However, the level of nitrogen emissions is high in relation to GDP compared to other countries. Around 40% of these emissions are due to road transport. Local air pollution incidents related to ground level ozone concentrations still occur in large cities and combined with high levels of particulate matter from the growing number of diesel vehicles, pose threats to human health. Portugal should encourage greater use of existing public transport infrastructure including through better road pricing to tackle these issues.

Agricultural pollution is also of concern due to a highly intensive use of pesticides and fishing enterprises exploit some species beyond biologically safe limits (OECD, 2011b). As discussed below, given the tight fiscal position, achieving environmental goals will more than ever necessitate using policy instruments that benefit both the fiscal position and the environment.

Financial stability

The crisis has put domestic banks under pressure

Although they initially weathered the global crisis relatively well, thanks to no substantial direct exposure to toxic assets and to the absence of a real estate bubble, Portuguese banks have been particularly vulnerable to a shift in investor sentiment owing to excessive reliance on foreign borrowing and a major increase in exposure to government bonds (especially in 2010). The sovereign debt crisis led to a loss of access to wholesale debt markets in 2010, forcing banks into reliance on Eurosystem financing. Banking system net income turned negative in 2011, largely due to growing credit impairments and the materialisation of market risks, such as losses in financial assets portfolios, but also due to several non-recurring events.

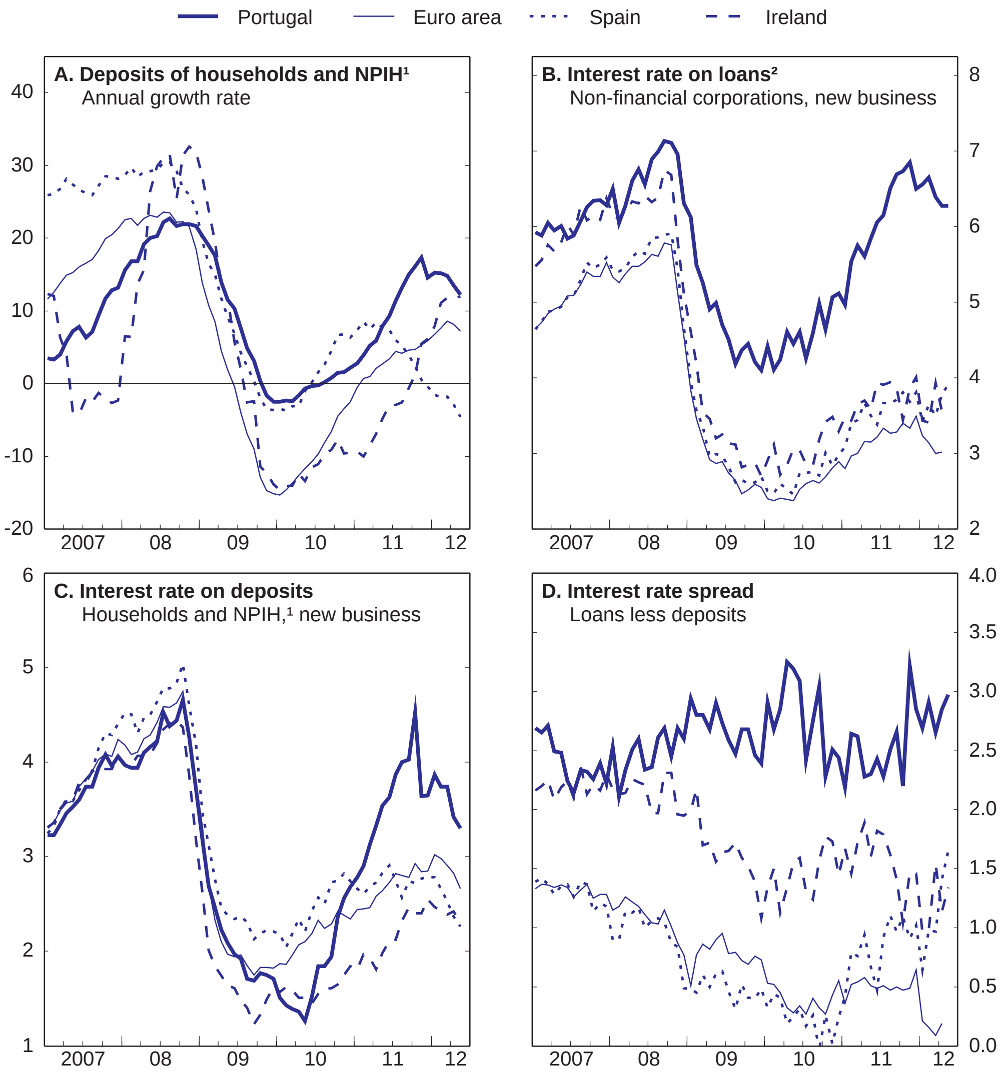
Bank deleveraging is tightening credit

To reinforce financial stability and ease the return to wholesale market funding, banks are raising Core Tier 1 ratios to comply with targets set by Bank of Portugal (10% at end-2012) and, for four of the largest groups, by the European Banking Authority (9% by 30 June 2012, computed under slightly different and more demanding rules, plus a capital buffer for sovereign exposures). For this purpose, some private banks will need public funds, which will be provided under the EUR 12 billion Bank Solvency Support Facility (BSSF) included in the financial envelope of the EU-IMF programme. In June, the government provided public funds to three major banks, allowing them to comply with both of those requirements in terms of solvency ratios. To increase reliance on more stable sources of funding, the eight largest banking groups (accounting for 83% of the banking system's assets) are also reducing their individual loan-to-deposit ratios to an indicative target of about 120%, to be met by end-2014. Mostly due to a surge in deposits (Figure 3), fuelled by shifts in the composition of households' financial asset portfolios, notably as a reaction to bank financial incentives (higher rates on deposit accounts), the eight banks as a whole have lowered their ratio to about 130% at end-2011, a 30 percentage points reduction from June 2010. However, further deposit growth will likely be more moderate, and there is considerable dispersion across banks in loan-to-deposit ratios. While five banks are already below, or very close to, the indicative 120% target, the other three major banks were still above 140% at the end of 2011.

Bank deleveraging is increasingly taking place via credit contraction (Figure 1). Constraints to credit supply, especially for firms, may be aggravating recessionary dynamics in the economy. The Euro Area Bank Lending Survey points to a considerable tightening of loans to firms, which is more intense than the contraction in firms' credit demand. Sectoral surveys also show credit constraints, which are highest in construction, but have been increasing also in manufacturing and services,. Small and medium-sized enterprises (SME) have been on the whole more affected than large firms, some of which have access to external financing. The strong rise until recently in interest rates for new loans (Figure 3) partly reflects higher rates on deposits, although pressure on deposit rates has been eased by participation by Portuguese banks in the recent three-year European Central Bank (ECB) long-term refinancing operations and additional capital requirements for deposits paying high rates (introduced in November 2011 by the Bank of Portugal to tame excessive bank competition for deposits). Spreads between new loans and new deposit rates, which are becoming higher in international comparison (Figure 3), reflect the rise in the overall credit risk and uncertainty in the Portuguese economy.

Figure 3. Banking sector indicators

Per cent



1. NPIH: non-profit institutions serving households.
2. Loans other than revolving loans and overdrafts, convenience and extended credit card debt.

Source: ECB (2012), "Money, Banking and Financial Markets", *Statistical Data Warehouse*, European Central Bank, July.

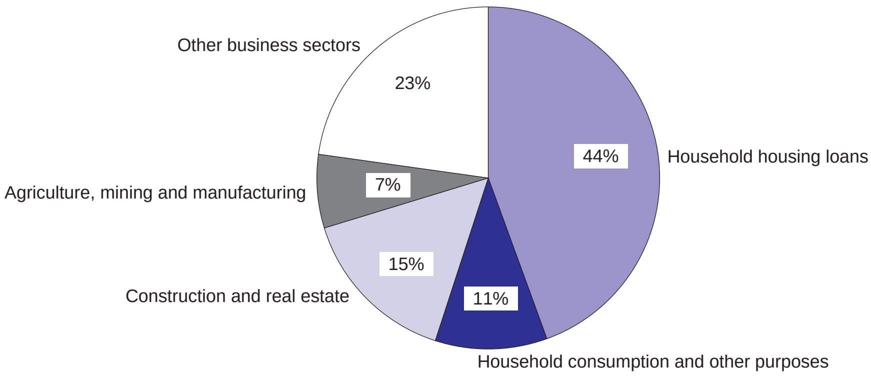
While higher capital ratios and lower loan-to-deposit ratios are essential for financial stability, bank deleveraging risks aggravating credit contraction, as mentioned previously. The authorities should ensure that the pace of convergence towards the indicative loan-to-deposit ratio target of about 120% by end-2014 does not thwart economic activity. This degree of flexibility is made more important by the fact that those banks further away from the target have on average a larger weight of loans to firms in their portfolios. More generally, to minimise the risk of credit rationing, the authorities should keep the remainder of the EUR 12 billion envelope for further capital increases if needed, even after 2012 capital targets are met, as losses from credit impairments put downward pressure on risk-weighted assets. In bank recapitalisation operations, the authorities should pay attention that the potential costs to taxpayers and the final beneficiaries of the funds are fully transparent so as to reduce moral hazard and maintain public support (IMF, 2009).

Reducing barriers to efficient credit allocation

Removing distortions to credit reallocation across sectors would foster productivity-enhancing shifts in investment composition. Over the past decade, credit has been overwhelmingly directed towards construction-related activities and other sheltered sectors, to the detriment of tradables (Figure 4). Recent developments do not yet indicate a significant reversal of those trends. While loans to construction and real estate have started to shrink markedly, credit to the transportation, education and healthcare sectors has continued to expand. State-owned enterprises (SOE) are important players in these sectors, although they only account for about 5% of outstanding credit to non-financial corporations, as a large part of them has been reclassified within the general government sector.

Figure 4. Loans of financial institutions to households and non-financial corporations[1]

2011



1. Financial institutions excluding the Central Bank. Total loans of EUR 257 billion, average of end of month figures.

Source: Bank of Portugal (2012), *Boletim Estatístico*, June.

On-going efforts to improve SOE operational performance will gradually ease financing pressures, while a number of measures foreseen in the 2012 Supplementary Budget will more immediately ease credit reallocation and help defuse credit strains. These include up to EUR 3 billion of credit assignment from the banks to the central government for loans to local governments, hospitals and SOEs inside general government, while maintaining the obligations of the debtors. In addition, measures will include a EUR 1.5 billion settlement of arrears by the state to public hospitals outside general government and EUR 1 billion to repay local government arrears. More generally, credit reallocation will be fostered by removing distortions which have favoured investment in sheltered sectors, such as housing, transport infrastructure or energy, as addressed elsewhere in this Survey.

It is also essential that banks refrain from “ever-greening” problematic loans, and continue to clean up their balance sheets. International experience, not least from Japan in the 1990s, shows that delaying loss recognition tends to depress productivity growth, slow economic recovery and thus increase total costs to be borne either by the private or the public sector (OECD, 2012). Non-performing loans reached 7.5% of total loans in December 2011, with the steepest rises in construction and real estate. The central bank’s supervisory capabilities have been strengthened following the Special Inspections Programme, which examined the credit portfolios and stress-testing methods of the eight largest banking groups (with overall positive results), and banks have been required to identify all instances of restructured loans (even if still performing) due to financial difficulties of the borrower. The authorities should continue to use supervisory tools to promote swift recognition of bad loans.

Box 2. Core recommendations on financial stability

- Remove barriers to credit reallocation by tackling incentives to investment in sheltered sectors, “ever-greening” of problematic loans.
- In bank recapitalisation operations, ensure that the potential costs to taxpayers and the final beneficiaries of the funds are fully transparent.
- Pay special attention to financing conditions of small and medium-sized enterprises, notably by making firms more reliant on equity and by re-directing EU funds.
- Ensure that the pace of convergence towards the indicative target for the loan-to-deposit ratio does not thwart economic activity.

Fiscal policy

Significant risks remain on the path to debt sustainability

The government achieved a headline deficit of 4.2% in 2011, less than half the 2010 deficit and lower than the programme target (5.9% of GDP). However, this included significant one-offs, notably the transfer to the government of private pension assets of 3.5% of GDP – in exchange for future liabilities. Excluding one-offs and cyclical effects, the underlying deficit was around 6% of GDP, which implies that the actual fiscal consolidation in 2011 was only about 2 points of GDP in 2011 (Table 2). This is nonetheless a remarkable achievement compared to previous years.

Table 2. General government revenue and expenditure

Per cent of GDP

	1995-2000	2001-08	2009	2010	2011	2012[1]	2013[1]
Current revenue	36.4	38.9	38.8	38.7	40.3	40.5	40.9
Current expenditure	38.2	42.5	47.9	47.8	47.4	46.5	46.2
Gross saving	–1.8	–3.6	–9.1	–9.1	–7.2	–6.0	–5.3
Total revenue	37.7	40.4	39.6	41.4	44.7	42.0	42.7
Total expenditure	41.7	44.7	49.8	51.3	48.9	46.6	46.2
Net lending	–4.0	–4.3	–10.2	–9.8	–4.2	–4.6	–3.5
Memorandum items							
Underlying fiscal balance[2]	–4.8	–5.1	–8.5	–7.9	–5.8	–2.4	–0.8
Underlying primary balance[2]	–1.4	-2.6	–5.9	–5.1	–2.3	1.4	2.9
Gross debt (Maastricht definition)	53.3	60.5	83.1	93.3	107.8	114.5	120.3
Net debt	30.3	45.9	64.5	63.7	54.0	81.2	85.1
Capital transfers and payments	0.8	0.7	1.0	2.0	1.2	0.6	0.8
Capital tax and transfers receipts	1.2	1.5	0.7	2.7	4.4	1.5	1.8

1. Projections.
2. Per cent of potential GDP. The underlying balances are adjusted for the cycle and for one-offs. For more details, see *OECD Economic Outlook* Sources and Methods.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May.

The government targets a headline fiscal deficit of 4½ per cent of GDP in 2012 and 3% in 2013 as part of the EU-IMF programme (Table 3). Due to the need to make up for the large one-offs in 2011, such targets will require a large underlying fiscal consolidation of about 3½ per cent of GDP in 2012 - 1½ percentage point more than in 2011 – and about 1½ per cent of GDP in 2013. To achieve this, the government is using a wide range of measures in 2012, of which around two-thirds are on the expenditure side and one third on the revenue side. They include reducing wages and staff in the public service, cutting pensions, increasing the list of goods and services taxed at the standard value-added tax (VAT) rate and reducing tax expenditures. The government expects public debt to peak at 116% of GDP by 2013 before declining.

Table 3. Stability Programme targets and assumptions

Per cent of GDP[1]

	2010	2011	Targets and assumptions				
			2012	2013	2014	2015	2016
Public balance	**–9.8**	**–4.2**	**–4.5**	**–3.0**	**–1.8**	**–1.0**	**–0.5**
Expenditure	51.3	48.9	47.5	45.9	44.6	43.8	43.0
Revenue	41.4	44.7	42.9	42.9	42.8	42.7	42.5
Public debt (Maastricht definition)	93.3	107.8	113.1	115.7	113.4	109.5	103.9
Real GDP growth (%)	1.4	–1.5	–3.0	0.6	2.0	2.4	2.8

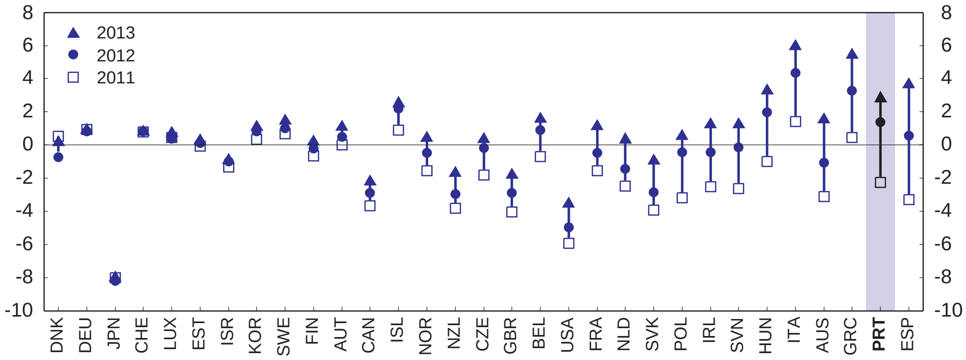
1. Revenue and balance include a number of one-offs of which the most notable is a positive one in 2011 of 3½ per cent of GDP corresponding to the transfer to the government of the assets of banks' pension funds, in exchange for overtaking future pension liabilities.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May for historical series of 2010-11 and Ministry of Finance (2012), *Documento de Estratégia Orçamental 2012-2016* for targets and assumptions of 2012-16.

The expected pace of consolidation between 2011 and 2013 is among the most rapid in the OECD (Figure 5). On the one hand, major consolidation is needed to restore debt sustainability and convince markets that Portugal can exit from the programme and return to the bond market within the programme horizon. On the other hand, fiscal consolidation reduces growth which could, in turn, undermines political support and market confidence.

Figure 5. Fiscal consolidation in international comparison

Underlying government primary balance, per cent of potential GDP[1]



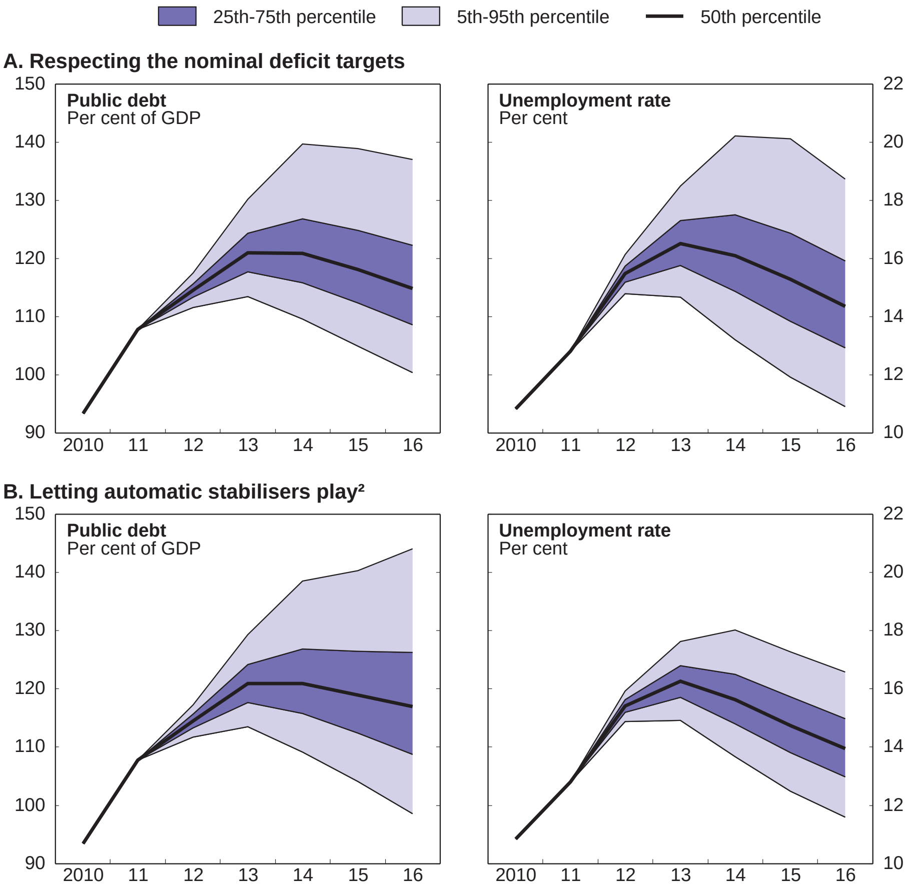
1. Countries are sorted in order of total fiscal consolidation between 2011 and 2013.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May.

Addressing this trade-off regarding the speed of consolidation is made more difficult by large macroeconomic uncertainties. In an attempt to take these uncertainties into account, the OECD has carried out simulations using a small stylised macroeconomic model where variables are affected by random shocks (Sorbe, 2012; Figure 6). The results suggest that sticking to the programme's nominal deficit targets would almost certainly put debt on a declining path over the medium term, but with a significant risk of a deeper recession and higher unemployment. In contrast, letting automatic stabilisers play would limit the recession risk, but at a significant risk that the debt-to-GDP ratio will continue to rise. On balance and given the need to restore confidence, the government should aim at meeting its nominal fiscal targets as long as growth does not deviate substantially from the programme. Nevertheless, should downside risks materialise and output fall substantially more than projected in the programme, the automatic stabilisers could be allowed to play, at least partially.

Figure 6. Assessing the risks around the fiscal consolidation programme

Stochastic simulation results under different fiscal policy programmes[1]



1. The likelihood of different debt and unemployment paths are shown with their attached probabilities, which are derived via Monte Carlo simulations on a small-scale stylised macroeconomic model where random shocks affect the different variables. The model notably takes into account the effect of financial conditions and of fiscal policy on activity, with a multiplier of 1. Interest rates on Portuguese bonds depend on a random parameter reflecting market confidence and on the debt dynamics in a non-linear way, allowing rates to explode if debt is seen as out of control. The baseline scenario is based on OECD projections (*OECD Economic Outlook* No. 91) until 2013, prolonged from 2014 onwards with the assumptions from IMF (2012), "Portugal: Third Review Under the Extended Agreement" and the targets presented in Table 3 for public deficit.
2. Respecting the structural primary deficit targets.

Source: S. Sorbe (2012), "Portugal: Assessing the Risks about the Speed of Fiscal Consolidation in an Uncertain Environment", *OECD Economics Department Working Papers*, forthcoming.

These debt simulations also show that risks around the fiscal consolidation programme would be minimised by stimulating potential growth through structural reforms and by choosing "growth friendly" fiscal consolidation instruments. In addition, an appropriate choice of consolidation instruments could lower the size of the fiscal multipliers, reducing the risks of aggravated recession when sticking to nominal deficit targets. The choice of consolidation instruments should also take into account the need to spread fairly the burden of adjustment across the population to maintain social consensus around the programme as well as, when relevant, environmental considerations.

There are strong pressures on the government's cash position

The sovereign debt crisis has created financing problems across the general government, as SOEs inside general government as well as local and regional governments no longer have access to market finance to cover deficits and payment arrears or to roll over existing debts. The central government is able to borrow using short-term treasury bills and has been doing so – with longer maturities and declining yields over the last few months – inter alia to meet SOE and local government needs (for example to repay SOE debt owed to banks). However, the risk that less financing be available from this source still exists. The government is currently proposing to meet hospital payment arrears using pension funds transferred from the banking sector. This transfer needs to be transparent and accompanied by strong incentives for hospitals to prevent further accumulation of arrears. There is a substantial risk in the current recessionary and credit-constrained environment that more SOEs currently outside the general government could fall into financing difficulties, putting further pressure on the government's already stretched resources and risking reclassification into general government, further increasing the fiscal deficit and debt.

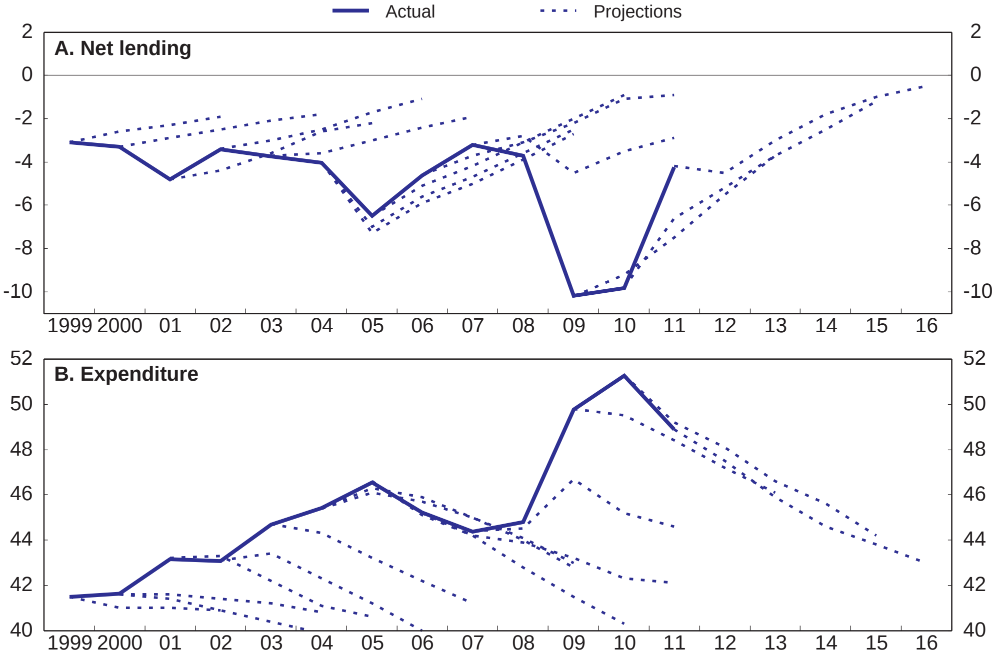
Improving expenditure control and transparency

Since entry to the euro was confirmed in 1998, the government, with the exception of a brief period at the peak of the global boom in the mid-2000s, persistently raised spending as a fraction of GDP (Figure 7). This came mainly from over-optimistic economic and revenue forecasts, and therefore expenditure plans, which is a common failing internationally (Hagemann, 2010). In addition, the authorities failed to meet those plans. Budget enforcement has also been impeded by fragmented, infrequent and limited financial reporting with financially autonomous units of the government not being held sufficiently accountable for over-spending.

Budget control has been further hampered by the non-transparent build-up of substantial liabilities to provide subsidised health and transport services. This has been partly achieved by shifting the spending burden of policy decisions into the future through the heavy use of public-private partnerships (PPP). In addition private sector (telecom and banking) pension assets were transferred to the government in 2010 and 2011 with a positive impact in general government accounts in these years, but increasing public expenditure in the future. This type of one-off should be avoided as it ultimately undermines the fiscal position and reduces fiscal credibility. In addition, SOEs have run substantial losses, which in the case of hospitals have been covered by accumulating large payments arrears. A similar strategy has been followed at the local level. Total wider government payment arrears, including SOEs not inside general government, totalled 3.2% of GDP in early 2012. Overall, this opacity surrounding the full general government position allowed the government to avoid taking corrective actions in the short-run but has ultimately exacerbated the fiscal crisis.

Figure 7. Forecasts for general government net lending and expenditure

Based on Stability and Growth Programmes, per cent of GDP[1]



1. To take account of periodic revisions to GDP, projected programme target paths for the net lending and expenditure to GDP ratios have been appended to initial starting levels rebased to the most recent data vintage for these series.

Source: Ministry of Finance (2011 and 2012), *Documento de Estratégia Orçamental*; Portuguese Republic (1998-2010), *Stability and Growth Programmes* and OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May.

The enhanced fiscal framework is welcome

The enhanced medium-term fiscal framework introduced in May 2011 provides a strong stepping stone for tackling fiscal problems. Its main elements include: in line with European requirements, a medium-term structural deficit of no more than 0.5% of GDP; a rolling budget planning that sets expenditure ceilings for the central government for the next four years; an independent fiscal council; and programme budgeting. The expansion of the State Budget reporting perimeter to the national accounts definition of general government and the progressive implementation of monthly reporting for the whole of general government are also welcome.

The framework could be better anchored and made more transparent by adding an expenditure rule for general government consistent with revenue projections and the deficit target and in line with the European fiscal framework. Such a rule would help to prevent the upward creep in spending that has characterised policy until recently and ensure that all general government spending is under control. Compliance is easily observed (unlike a structural deficit), and it would not be especially procyclical in that most automatic stabilisers work through the revenue side. Given the need to reduce both the deficit and the scale of government spending, such a rule would initially have to set expenditure growth below nominal GDP growth.

Ensuring that the framework truly contributes to fiscal sustainability will require improving important budget implementation, notably fully enacting the new system of stricter intra-annual expenditure control measures. Centred on 14 main spending programmes, this system aims to restrain both commitments and cash outlays. However, the technical capability of programme financial controllers to carry out these oversight functions and interact with the Ministry of Finance varies across ministries. To instil a greater sense of responsibility, financial controllers should be appointments assigned to named individuals rather than simply a function assigned to the head of the planning unit for example. In addition they should have sufficient time to properly carry out these functions and have access to analytical support staff, which is currently not the case in all ministries.

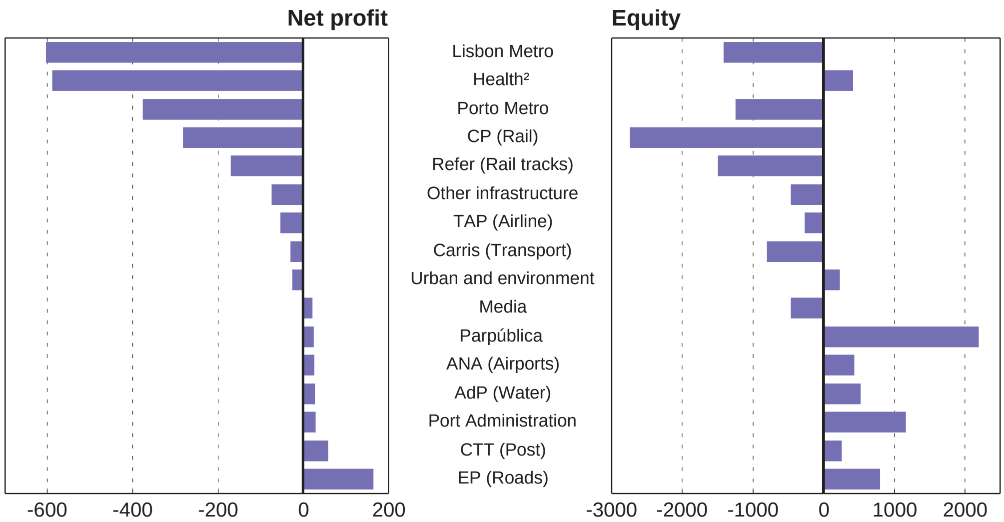
The Fiscal Council has an important role to play in assessing the government's compliance with the new framework. The resources available to it should be commensurate with its wide remit. To remove a serious constraint on recruitment, the government should relax the prohibition on board members and staff having other paid, or any other employment at all, respectively. In the first instance the Council should prioritise core functions, including assessing the macroeconomic and fiscal projections and compliance with fiscal rules as well as giving fiscal policy recommendations. There is evidence that fiscal councils that provide policy recommendations, rather than just analysis, are more effective (Debrun *et al.*, 2009). The Council's role should be further embedded in the policy debate by requiring the Minister of Finance to provide a formal response in Parliament to Fiscal Council reports.

Improve operational performance of SOEs

In 2011 the SOE sector lost EUR 1.9 billion (1.1% of GDP) on total assets of EUR 55.8 billion (32% of GDP). SOEs in the urban passenger transport, rail and hospital sub-sectors have been making large losses (Figure 8). These losses are due to large debt-servicing burdens as well as operational losses. The government aims to stop these operational losses and achieve operational balance in all SOEs excluding the rail track operator and the health sector by the end of 2012 and data for the first quarter of 2012 point to an improvement of the situation. An examination of the accounts of the worst loss-making companies in the public transport sector suggests that better controlling labour and supplier costs will be important. It may also be necessary to continue rationalising the regional rail network as most operational losses occurred in providing these services.

Figure 8. State-owned enterprise performance

By industry/company, in million euros at end 2011[1]



1. 2010 for TAP.
2. Losses in the health sector include those of a new hospital whose revenue was not fully recorded in 2011.

Source: Ministry of Finance (2012), *Boletim Informativo Sobre o Sector Empresarial do Estado: 4.° Trimestre 2011* and Parpública (2011), *Documentos de Prestação de Contas 2010*.

PPP decision making should be incorporated into the medium-term budget framework

Portugal engaged in the highest value of PPP contracts relative to GDP in Europe in the period 1990-2010, mainly for building highways (Kappeler and Nemoz, 2010; EPEC, 2010). The flow of future net government payments associated with these projects is expected to increase to almost 1% of GDP in 2015 as the latest wave of roads comes on line. The immediate policy challenge is to limit the costs and risks associated with these existing projects. To reduce costs, a mixture of measures could be taken, depending on the exact circumstances of each PPP, including: renegotiating terms; cancelling projects, when still at an early stage; or buying back the PPP (Reis, 2012, argues that buybacks would be appropriate for many road projects).

PPPs remain a potentially useful investment model. However, they should be chosen only when they represent good value for money, not because they allow the government to escape budget restrictions by building up off-balance sheet liabilities. The policy framework for PPPs compares well internationally on paper but the government lacked technical expertise and political considerations interfered. It is therefore important that the decision making process for future PPPs take full account of the analysis of the new technical advisory unit being set up in the Ministry of Finance. To encourage this, the analyses of the unit, including a comparison with an ordinary public investment alternative, should be made fully available to the parliament and public. The government should also further reform how PPPs are included in budget planning. PPPs should be accounted for on the same basis as the alternative of an ordinary public investment.

Environmental measures can pay multiple dividends

The decision to institute user tolls on formerly free PPP highways is appropriate from an environmental and fiscal point of view. The government is also planning, in tandem with municipalities, to develop a package of measures to promote the use of public transport, including extending bus lanes, and increasing parking restrictions and the cost of individual transport. The authorities should be ambitious in this area, for example by widening the coverage of and increasing parking fees, introducing congestion charges in major cities and making greater use of road tolls, as increased charges for individual transport can help to reduce congestion and air pollution which is high in urban areas (air particulates exceed EU air quality standards in the Lisbon and Porto areas). These measures can also provide fiscal revenue and increase efficiency by making users pay closer attention to the social costs of individual road transport. The government should also consider increasing the enforcement of sanctions for breaches of environmental law in areas such as fishing where applied fines are low by EU standards (OECD, 2011b) and fully support the recent European Commission proposal to introduce individual transferable quotas, which has been proven as a very efficient instrument to protect the resource (Haraldsson and Carey, 2011). Reducing tax expenditures, such as removing fuel tax exemptions for the agricultural and fishing sector, would also help to increase revenue as well as encouraging the switch to more fuel efficient and less polluting equipment.

Enhancing spending efficiency will be key to successful consolidation of local finances

A number of local and regional governments have failed to cut expenditure sufficiently in response to persistent revenue declines since 2009, leading to debt accumulation. After losing access to long-term bank financing in the wake of the sovereign debt crisis, they have been relying on short-term debt and payment arrears, notably through local public companies. The central government is auditing these liabilities, of which the total extent is still uncertain, and stepping in to provide support. It will lend EUR 1.5 billion (0.9% of GDP) to the autonomous region of Madeira in exchange for fiscal consolidation and enhanced monitoring. It also agreed to set a EUR 1 billion (0.6% of GDP) credit line to help municipalities reduce their reliance on short-term debts and arrears. Such support is welcome as long as it alleviates liquidity problems of solvent local or regional authorities. However, it should be granted according to strict and transparent guidelines to ensure equal treatment of municipalities and include tight monitoring to ensure debt control is quickly regained, including by requiring municipalities to keep their funds in a dedicated account at the Treasury. If certain authorities are judged insolvent, the government should be ready to accept defaults in some instances to promote prudent future local policymaking.

In a context of durably lower revenues, successful consolidation of local finances requires enhancing local spending efficiency. The government intends to present measures before the end of 2012, including a reorganisation of local public companies, a 30% reduction in the number of parishes (the lowest tier of local government) and more inter-municipal cooperation. These measures are welcome, and would be usefully complemented by the generalisation of benchmarking and performance indicators to narrow the large efficiency disparities across local governments (Afonso and Fernandes, 2003). In addition, tighter monitoring of local revenue forecasts is needed to avoid over-optimism leading to overspending. Measures should also be taken to make local revenues less volatile, such as a shift away from taxing housing transactions towards increased recurrent taxation on immovable property, as planned.

Value for money should be paramount in spending EU funds

Making better use of EU structural and cohesion funds would help mitigate the effects of spending cuts. The full absorption of available funds (about 2% of GDP per year) remains a challenge. Portugal is actively shifting money away from cancelled or postponed infrastructure projects, such as the Lisbon-Madrid high speed train, towards other programmes, notably education related ones. As a number of selected infrastructure projects are dormant because of financing constraints, such a strategic shift should continue and focus as much as possible on the most pressing economic challenges, like supporting financing to credit-squeezed SMEs (*e.g.* through credit lines) and preventing high unemployment from becoming structural (*e.g.* through targeted training programmes). The reduced local co-financing of EU projects will also stimulate the absorption of funds. However, as it lowers the financial risks borne by local stakeholders, it reinforces the need to improve governance to secure careful project selection and adequate monitoring. In this area, there is evidence of political interference in the allocation of funds to municipalities (Veiga, 2010), pointing to a need for more transparency, evaluation and accountability in the selection of public projects.

Retaining highly skilled public sector staff is essential to government efficiency

The ability of the government to implement policies depends crucially on the skill of its civil servants. The urgent need to consolidate the fiscal position means that staff and wages are being substantially cut in tandem with increases in workload. Moreover, wages of high-skilled civil servants in the areas of law or economics were already significantly lower than in the private sector before the crisis whereas lower skilled workers are generally paid a premium relative to the private sector (Campos and Pereira, 2009). The government's current room for manoeuvre is currently extremely constrained but in the medium term the wage schedule should be steepened and more flexible individual contracts for specialists introduced. Steepening the wage schedule would bring government sector pay more in line with that in the private sector thereby helping the government to continue to attract and maintain highly qualified staff.

Box 3. Core recommendations to improve fiscal performance

- The government should aim to meet headline deficit targets in the programme, notably through abiding by the budgeted expenditure at all levels of general government. If risks materialise significantly and growth is far lower than projected in the programme, the automatic stabilisers could be allowed to operate at least partially.
- Introduce an explicit and easily enforceable public expenditure rule consistent with revenue projections and medium-term fiscal objectives and in line with the new European fiscal framework.
- Support to local and regional governments should be accompanied with improvements in the fiscal framework. Municipalities should notably be required to keep their funds in a dedicated account at the Treasury.

Education, labour and social policies

Education remains the key to long-term prosperity and social cohesion

Low education levels across the workforce explain a substantial proportion of Portugal's productivity gap (OECD, 2010a). Fewer educated workers impede the labour force's capacity to quickly learn and adapt to the fast changing global environment. In 2009, only 30% of the working age population (25-64) had attained upper secondary education compared with 73% in the OECD. From a low base in the 1970s there have been marked improvements down the generations but there is still a long way to go. Progress in education has been uneven. Upper secondary attainment is still considerably behind other countries, around 60% of the OECD average for 25-34 year-olds (48% as against 81% for the OECD), while significant progress has been made on tertiary and post-tertiary education. Nevertheless, previous education reforms are paying off with PISA (Programme for International Student Assessment) scores in reading, mathematics and science rising over time to approach OECD averages (OECD, 2010b) and resources have been rationalised with the closure of many small schools as recommended in previous *Economic Surveys*.

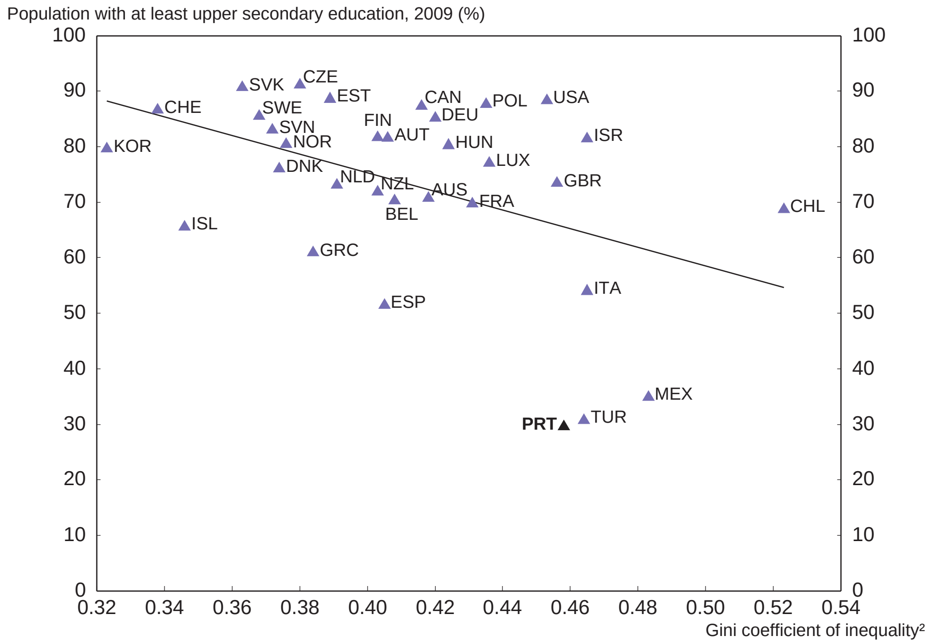
To tackle high drop-out rates the government raised the school leaving age from 15 to 18 in 2009 and under the *Novas Oportunidades* programme massively increased vocational education and training (VET) at the upper secondary school level. To enhance the results of this approach the government should ensure: the right input mix including sufficient physical resources for VET courses, which tend to be equipment and materials intensive; adequate career guidance for students to inform on course choice; and a close partnership with business to ensure that training is labour market relevant. Recent policy actions, including giving firms more influence over training choice and attempts to better target training, go in the right direction but it will be important to track the labour market outcomes of training participants and adjust programmes accordingly.

The government has progressively added to the education assessment and evaluation framework, including introducing a new teacher appraisal system in 2007 (revised in 2010). However, the approach to assessment and evaluation is not integrated and there are some important data gaps. The focus is at all levels on assessment, with insufficient use of data to indicate ways to improve learning outcomes, teacher development, school performance and the policy framework of the whole system (Pereira, 2010; Santiago *et al.*, 2012). To remedy this will require *inter alia* greater focus on "progress": collecting information over time on individuals and cohorts; instituting a development appraisal to complement the current assessment appraisal for teachers; and shifting resources towards greater analysis of system-wide results (Santiago *et al.*, 2012).

High income inequality in Portugal is linked to the dispersion of educational attainment (Figure 9), reflecting that higher wages are associated with increasing education levels, which is exacerbated further by the fact that there is a higher premium earned for better education in Portugal than elsewhere due to a relative scarcity of skills (OECD, 2010a). The relationship is two-way with family background having a particularly strong influence on the probability of dropping out of school and participating in tertiary education in Portugal and there is a longer than average tail of children who fail to reach even the basic PISA skill level (OECD, 2010b). This argues for a stronger focus in the assessment and evaluation framework on improving education opportunities and learning outcomes of children from more deprived socio-economic backgrounds, which is currently lacking (Santiago *et al.*, 2012). This would help to break down the inter-generational cycle of poverty as well as eventually helping to tackle high levels of informality.

Figure 9. Inequality and level of educational attainment

Working age population[1]



1. Population aged 25-64 for upper secondary education and age 18-65 for the Gini coefficient.
2. Gini coefficient based on income before taxes and transfers. The values of the Gini coefficient range between 0, in the case of "perfect equality", and 1, in the case of "perfect inequality" (*i.e.* all income goes to the individual with the highest income). The data cover the latest year available which is 2008 or 2009 for most countries.

Source: OECD (2012), "Income Distribution: Inequality", *OECD Social Expenditure Statistics* (database), May and OECD (2011), *Education at a Glance 2011*.

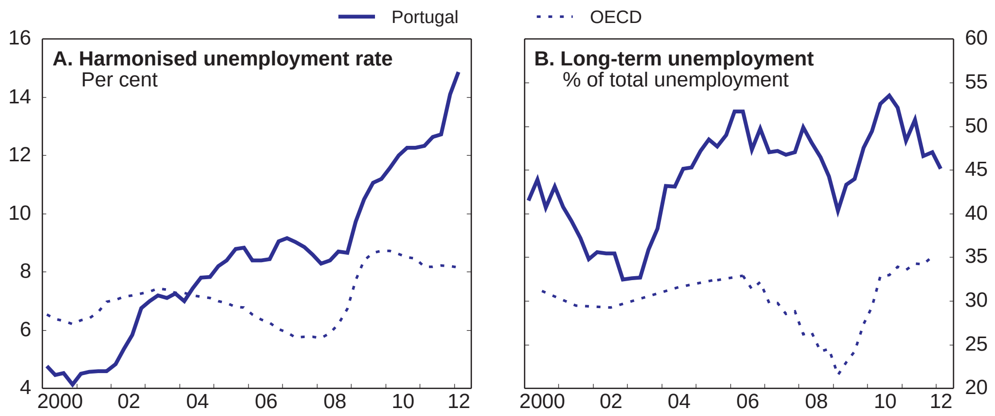
Maintaining social cohesion is an important pre-requisite for programme success

Maintaining social cohesion is an important challenge, especially against a background of high and rising unemployment. The government fostered social consensus through the tripartite agreement on labour reforms. Steps have also been taken to protect lower income individuals and place a greater share of the fiscal adjustment burden on higher income earners, for example by reducing tax credits and introducing an additional higher income tax rate for top earners. In addition, public sector pay cuts and income tax changes have led to greater percentage income falls for high income earners, having clauses to protect the lowest income brackets. However, consolidations tend to have adverse impacts on income distribution (Ahrend *et al.*, 2011), and there is some indication that certain measures between 2009 and mid-2011 may have been regressive (Callan *et al.*, 2011). In addition, recent increases in indirect taxes are likely to have had a regressive effect.

Soaring unemployment makes undergoing broad labour market reforms more pressing

The crisis has taken a heavy toll on employment, exacerbating the costs of long-standing labour market weaknesses. Pervasive segmentation keeps a high share of (mostly young) workers on short-term contracts, squandering human capital. Long-term unemployment is very high (Figure 10). Adjustment to downturns by reducing hours worked, rather than shedding workers, has traditionally been very low. Except for encouraging signs in the recent past, a decade-long rise in unemployment has failed to generate competitiveness gains through wage restraint. These problems are the joint outcome of defective settings in employment protection legislation, unemployment benefits, active labour market policies, and wage bargaining mechanisms.

Figure 10. Unemployment developments over the past decade



Source: OECD (2012), *Main Economic Indicators* (database), June and *Quarterly Labour Market Indicators Database*, Directorate for Employment, Labour and Social Affairs, April (unpublished data); OECD (2011), *OECD Employment and Labour market Statistics* (database) and Eurostat (2012), "Population and Social Conditions", *Eurostat Database*, June.

Shortcomings in wage setting mechanisms help to explain the difficulty in regaining competitiveness and the sharp rise in joblessness. They also stifle entry of new firms and competition in product markets. Wage bargaining mainly takes place at the sectoral level (Marques *et al.*, 2009), where trade unions (which have the exclusive right to negotiate on the workers' side) and employers' associations (generally dominated by the largest firms) often account for only a modest share of total sectoral employment. These collective agreements are then administratively extended to whole industries (through the *portarias de extensão*), which gives extra clout to those sitting at the negotiating table and effectively stifles firm-level bargaining, thus hindering competition in labour and product markets (Bassanini and Duval, 2006; Traxler *et al.*, 2001). Further, upward pressures on wages were compounded by very strong minimum wage increases (5.3% per year on average in 2007-10, followed by a further 2.1% in 2011 despite a rapidly weakening economy). This has led to job losses for the low skilled (Centeno *et al.*, 2011).

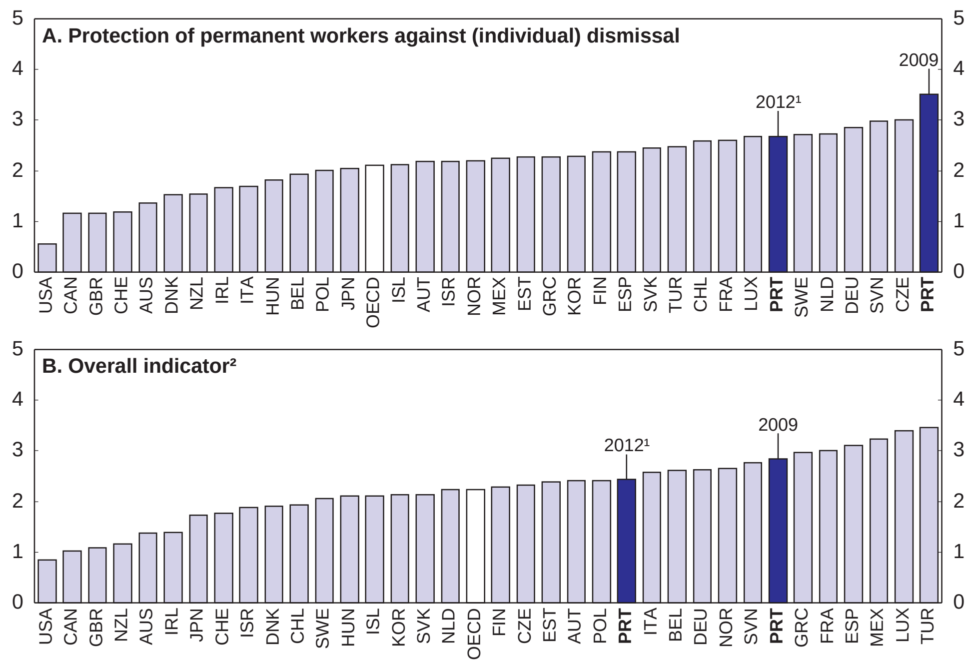
In welcome steps, the government agreed (May 2011) to freeze both the minimum wage and administrative extension, the former over the EU-IMF programme horizon (though with possible escape clauses) and the latter until clear criteria for extension have been defined. To promote firm-level bargaining, the authorities have also lowered the threshold for delegation of unions to work councils from 500 to 150 workers. Further, they committed not to extend any collective agreement subscribed to by employers' associations representing less than 50% of workers in a sector and, when that threshold is reached, to take account of the implications on competitiveness when deciding on extension. However, in May 2012 some pending requests for extension not complying with the 50% threshold were accepted, though with some postponement of the associated wage increases. While at a minimum the above commitments should be kept, the authorities should go further by keeping the minimum wage unchanged until there are clear signs of labour market recovery for low-skilled workers, and abolishing administrative extension altogether. The latter would further promote firm-level bargaining, fostering more dynamic labour and product markets.

Non-wage labour cost restraint could also help to smooth short-run adjustment and the associated employment losses. The authorities are implementing an increase in working time of up to seven days per year (as from 2013), coupled with more flexible working time arrangements (bank of hours), which decrease the need for overtime, and additional measures to reduce its cost. These reforms should lower long-run unit labour costs, improve competitiveness and facilitate future adjustment through hours worked rather than employment changes. In the short run, however, impacts on employment could be fairly muted. In contrast, reducing the labour tax wedge on low-skilled workers can yield sizeable employment gains (de Serres *et al.*, 2012), especially given the high wage elasticities of labour demand in Portugal (Marques *et al.*, 2009) and the past hikes in the minimum wage. Employment gains could materialise relatively quickly, especially for young people (OECD, 2012), while fiscal costs would be much lower than under a general cut in social contributions. The authorities should reduce employers' social contributions on low-wage workers on a permanent basis, to the extent that compensating measures can ensure compliance with fiscal targets. Though more expensive, an open-ended cut in contributions is likely more effective for employment creation than temporary marginal job subsidies, such as those recently introduced under the *Impulso Jovem* programme (targeted at long-term unemployed aged 18-30).

High employment protection on regular contracts and the ensuing labour market segmentation lower the sensitivity of wages to unemployment (de Serres *et al.*, 2012) and harm firm performance and productivity growth, as the reallocation of insiders is hindered and outsiders under-invest in human capital (Centeno and Novo, 2012). The 2009 Labour Code reform, which mainly focused on reducing procedural inconveniences and notice periods for dismissals, still left Portugal with the highest protection for regular workers in the OECD (Figure 11), and with one of the largest gaps in protection between open-ended and temporary contracts. A new round of reforms, started in 2011, has succeeded in bringing Portugal closer to the OECD average. Individual dismissals grounded on job redundancy no longer need to follow a pre-defined seniority order, while those based on worker capability have become possible in a wider range of circumstances. Severance pay has been reduced from 30 to 20 days per year of tenure (with a 12-month ceiling instead of a 3-month floor) and existing contracts preserve entitlements accrued under the old rules (which minimises the risk of short-run negative employment impacts in the current difficult economic juncture).

Figure 11. Strictness of employment protection legislation

Scale from 0 (least stringent) to 6 (most restrictive), 2008



1. Based on changes to the Labour Code due to come into force in August 2012.
2. Weighted average of three sub-indices: protection of permanent workers against (individual) dismissal, regulation on temporary forms of employment and specific requirements for collective dismissal.

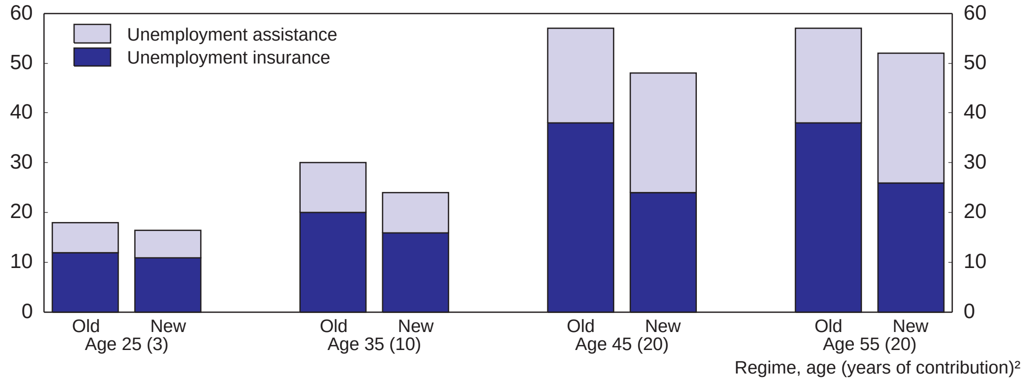
Source: OECD (2012), "Employment Protection Legislation", OECD Employment and Labour Market Statistics (database), July.

Despite these significant reforms, employment protection for permanent workers remains above average (Figure 11). Given the weak performance of the labour market, more needs to be done. The authorities should further reduce severance pay, as envisaged under the financial assistance programme, and take additional steps to tackle labour market segmentation. The latter could include a longer trial period for open-ended contracts (currently 90 days for most workers) and, to reduce the high costs of litigation over dismissals, binding arbitration (entered into on a voluntary basis) as an alternative to courts, as envisaged. In the medium term, they could consider abolishing duality altogether by moving to a single employment contract.

The unemployment benefit system has long raised concerns as regards both labour market performance and social equity. Age-increasing benefit duration leads to high replacement rates for older workers (OECD, 2010a), whereas tight eligibility requirements have translated into narrow coverage of unemployment benefits, especially among young workers. The 2012 reform of unemployment benefits goes some way in addressing these concerns. Eligibility has been expanded by lowering the minimum required contributory period for unemployment insurance from 15 to 12 months and by extending benefit entitlement to self-employed workers who meet certain requirements. To tackle disincentives to work, the ceiling to unemployment insurance has been lowered by one sixth, a 10% benefit reduction applies after six months and there are plans to allow jobseekers who take up a job paying less than the benefit to temporarily retain part of the latter. However, duration remains heavily age-dependent, as larger cuts in unemployment insurance duration for older workers are partly undone by longer provision of unemployment assistance (Figure 12). The effectiveness of reform is also hampered by a protracted phasing in. Benefit duration should not depend on age and should be shortened for older workers. The authorities should also assess whether changes to eligibility prove effective in improving benefit coverage, especially for young workers, and take further steps to that aim if needed.

Figure 12. Duration of unemployment benefits[1]

Comparison of old and new regimes at different ages, duration in months



1. Unemployment insurance (*subsídio de desemprego*) and unemployment assistance (*subsídio social de desemprego subsequente*).
2. "New" concerns the regime since the 15 March 2012 reform (Decree-Law 64/2012). The number in parentheses represents the years of contribution since the last unemployment spell.

Source: OECD calculations based on Portuguese legislation.

Active labour market policies are important to keep jobseekers close to the labour market and, when needed, to help enhance their human capital. Job search assistance has substantial room for improvement in Portugal, via better targeting of resources, more outreach to employers and better use of available information on jobseekers and posted vacancies. Monitoring and sanctions, while very strict on paper (Venn, 2012), are in practice far less rigorous, as proof of job search is often undemanding and benefit cancellation is seldom applied.

The authorities should proceed with timely implementation of their recent programme for public employment service (PES) reform (*Programa de Relançamento do Serviço Público de Emprego*), which addresses some of the above weaknesses. Further, job search monitoring should be stepped up and sanctions made less stringent (*e.g.* a temporary reduction or suspension of unemployment benefit, rather than outright cancellation) but coupled with stricter enforcement. A recent job subsidies scheme, *Estímulo 2012*, will also help to keep job search requirements credible. Training programmes, which were significantly upscaled in 2008-10, should be streamlined, better attuned to participant characteristics and labour market skill needs, and designed so as to leave time for continued job search. This will be facilitated by the major analysis of active labour market policies currently being conducted. The "Vida Ativa" programme develops this approach, by shortening the duration between PES registration and the start of part-time training programmes. Moreover, the PES is recalling specific groups of subsidised unemployed, namely those aged 45 and above or unemployed for six months or more, to direct them to training or occupational programmes. On the youth front, the authorities are enlarging and modernising the dual learning system.

Box 4. Core recommendations to improve education, labour market and social cohesion

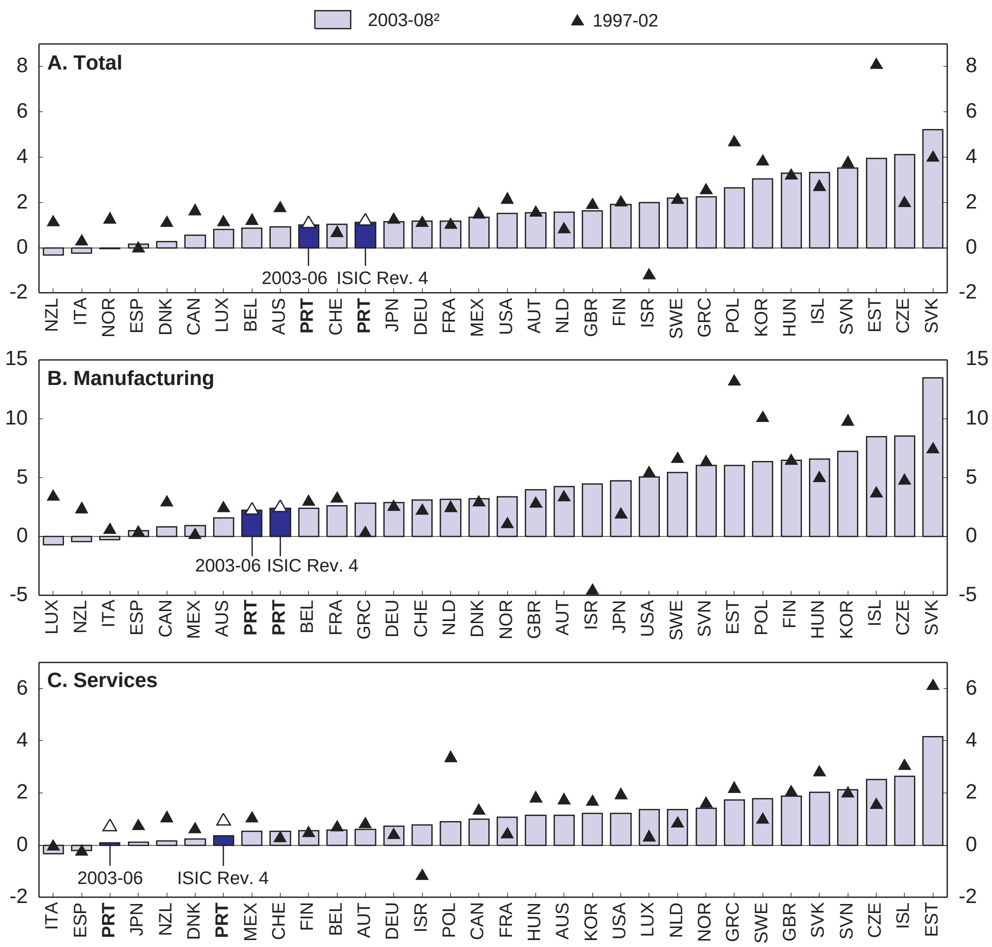
- Lift education levels by focusing the evaluation system more on tracking individuals and cohorts over time in order to inform policy changes to improve education outcomes of children from lower socio-economic backgrounds.
- Continue to tackle labour market rigidity and segmentation by further reducing severance pay and introducing binding arbitration in conflicts over dismissals.
- Make unemployment benefit duration not age dependent, and ensure that changes to eligibility prove effective in improving benefit coverage, especially for young workers.
- Further promote firm-level wage bargaining by abolishing administrative extension of collective agreements.
- To improve employment prospects for low-skilled workers and ease labour cost adjustment, reduce employers' social contributions on low-wage workers, to the extent that compensating measures can ensure that fiscal targets are met.

Progress in improving the business environment and product markets

Lifting Portugal's living standards in the long-run ultimately depends on raising trend productivity growth, which is low by international standards and especially compared with catch-up countries elsewhere in the OECD (Figure 13). Improving the business and product market environment is an important shorter-term avenue for achieving this. The government has taken a broad range of measures under the Simplex programme to improve the business environment by easing the licensing and permits system. Despite recent measures being launched, problems still exist at the local level, the civil justice system is inefficient and capital allocation is biased away from the tradables sector by excessive rents in non-tradables sectors due to insufficient competition and regulatory interventions.

Figure 13. Productivity growth by sector[1]

Average of annual growth rates, per cent



1. Based on the International Standard Industry Classification Revision 3 (ISIC Rev. 3). To provide the best possible comparison and most recent data for Portugal both ISIC Rev. 3 and preliminary Rev. 4 data are shown. Between Rev. 3 and 4. the industrial classification was updated to reflect changes that have occurred in the structure and type of economic activity in recent years. Examination of limited ISIC Rev. 4 data available for other countries suggests that the change in classification has led to a general upward revision of productivity growth.
2. To 2006 for Australia and Portugal (ISIC Rev. 3); 2007 for Japan.

Source: OECD (2012), *STAN: OECD Structural Analysis Statistics* (database), April.

Improving the legal framework

Steps to improve the justice system will benefit the whole economy

The justice system has been slow to resolve civil and commercial cases, resulting in an enormous number of pending cases (1.5 million) and particularly cases involving the enforcement of previous cases (1.2 million) (Intrum Justitia, 2011). This creates a high level of regulatory uncertainty for business, undermining investment and growth. To tackle inefficiencies in the justice system, the government is carrying out a wide-ranging reform including new insolvency law which entered into force in May and is designed to better facilitate corporate restructuring. Momentum in justice reform should be maintained with monitoring of whether the changes to the civil procedure code and insolvency laws in particular result in speedier civil and commercial case resolution. To reduce regulatory uncertainty further, the government should improve the transposition of EU directives into Portuguese law by carefully considering local circumstances when legislating. This can help to reduce the need for subsequent legal amendments to remedy practical difficulties that arise because the law is ill-suited to deal with the local conditions, which creates uncertainty and delays for firms in the meantime.

Local licensing remains an impediment despite improvements

Although improving, local licensing is still a binding constraint on business generally. According to the World Bank's *Doing Business Survey 2012,* Portugal ranks 97th out of 183 countries, due to an excessive number of procedures and long times required to obtain the necessary municipal permits for construction. Reforms to speed up the process include allowing firms to directly make all the necessary applications (electricity, telecom, environment) to various agencies rather than relying on the municipality to coordinate this process, although some of the individual steps (*e.g.* fire safety) are still slow. This tends to work better for large well-resourced firms, which are more motivated to push their own application process rather than relying on the municipality, but small firms are likely to find this onerous.

The government is planning to carry out a more comprehensive "zero authorisation" reform in 2013. For firms of up to 20 employees industrial licensing would be automatic. The reform would also give municipalities a maximum of 60 days to consider an application for 98% of firms before approval must be given and most firms are expected to receive licensing within 30 to 40 days. For the remaining 2% of applications which are more complex and involve higher risks, it is intended to halve the current deadlines. This is a promising reform, which has the potential to substantially improve the business environment, and it should proceed without delay.

Efforts also need to be made to reduce costs. The direct cost of licensing fees is not high by international comparison but "surcharges" levied by municipalities before they give licensing approval can be up to one fifth of total development costs. As a high and uncertain implicit tax on new investment, these are a particularly distorting way to raise revenue. Following steps to reduce these surcharges in the "Zero Industrial Licensing" reform, the government should eliminate them and replace them with more stable and less distorting revenue sources for local government. The zero licensing initiative can potentially help reduce surcharges by reducing the scope for municipalities to delay granting a licence in order to extract these surcharges.

In the housing sector, a reform of the policies that excessively favoured homeownership and biased capital allocation is underway

Homeownership in Portugal has long been encouraged by rental market and tax policies, and, by 2011, 73% of dwellings were owner-occupied. These incentives, along with easy credit, led to a housing stock among the highest in the OECD area (557 dwellings per 1 000 inhabitants in 2011 of which 13% are vacant homes), excessive leverage of households and limited residential and labour mobility (Caldera Sánchez and Andrews, 2011). Cumbersome eviction procedures and long-standing rent controls for older contracts have inhibited rental housing supply and discouraged investment in dwelling maintenance. In this context, the new legislation on urban rental and the simplified regulations for renovation works are an important step forward. The authorities should ensure that the new eviction procedures, both through extrajudicial and judicial processes, effectively decrease the eviction time of non-complying tenants, as envisaged.

Recent changes in recurrent taxes on immovable property are welcome, including the on-going general update of the taxable value of urban properties and a significant reduction of temporary tax exemptions for principal owner-occupied dwellings. As the tax proceeds gradually increase, the real estate transaction tax should be levied only on the initial transactions of property, and in a second step could be replaced by VAT (OECD, 2010a). As regards personal income tax, the deductibility of mortgage interest payments is being gradually phased out and that of mortgage principal has been eliminated, which is welcome.

Strengthening competition to spur a more productive and innovative economy

Intensifying competition and improving the regulatory framework are important levers for raising Portugal's trend productivity, overall growth rate and cost-competitiveness. Insufficient competition in the non-tradable sector in particular has reduced overall productivity growth (Almeida *et al.*, 2010). Greater competition is a potent force for boosting trend productivity and overall growth because it creates a permanent incentive for firms to be more innovative as well as putting pressure on them to lower costs and prices (Høj *et al.*, 2007).

The regulatory framework plays an important role in ensuring effective competition. Portugal has improved over time and significant steps are being taken to further strengthen the framework. These include: relinquishing the government's "golden shares" in publicly listed companies that allowed it to block certain strategic decisions; major revisions to competition legislation; and introducing a new court specialised in competition issues. The changes to the competition law further align Portuguese legislation with EU law on merger control, increase the efficiency of the appeals process for competition law cases and extend the Authority's powers to carry out inspections and audits in the course of sector studies and antitrust actions.

The government should also ensure that a pro-competitive regulatory framework is in place before privatising assets that are in network industries (like transport) that are crucial inputs for other industries and have the potential to generate monopoly rents such as Aeroportos de Portugal (ANA). One possibility would be to involve the competition authority in the design of the sale and the regulatory framework. Another possibility would be to examine the case for dividing these assets up before sale to generate competition. The OECD's Competition Assessment Toolkit, which provides a flexible methodology for identifying legal and regulatory restraints to competition (OECD, 2011c) could be applied in Portugal to provide sector specific recommendations on the necessary regulatory changes to ensure assets sold in the privatisation programme operate in an environment that promotes competition.

The Toolkit could also be more broadly applied in improving the legal framework of the Portuguese economy, since it is designed to identify any type of policy, law and regulation that may unnecessarily impede competition, such as: *i)* restrictions on starting new businesses; *ii)* regulations that affect the ability of businesses to compete; and *iii)* regulations that affect business behaviour by changing the incentive of businesses to act as vigorous rivals. Once these are identified, the Toolkit can assist the government in assessing and revising those policies that do unduly restrict competition.

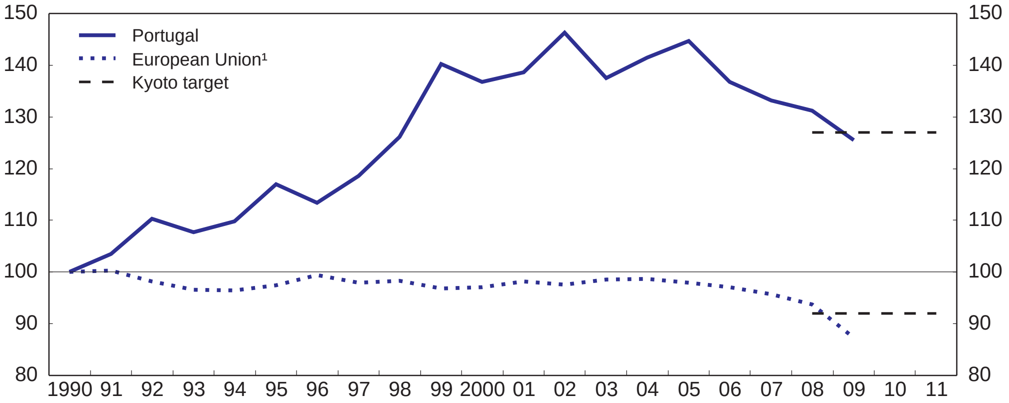
Despite positive development in the overall regulatory framework, market concentration remains high in important sectors of the economy and prices for some widely used inputs are still high by international standards. In addition several non-tradable sectors that already had high margins were able to increase them further during the 2000s (Amador and Soares, 2012). A common reason for this is that although there has been a high degree of legal liberalisation, other barriers to competition remain.

In the energy sector, addressing unwarranted returns in electricity is essential and competition in natural gas should be promoted further

Opening the electricity sector to private initiative and competition and promoting renewable energy have been at the core of Portugal's energy policy since the mid-1990s. The ownership of production is still highly concentrated on the previous incumbent and competition at the retail level is very limited (especially for households), while generation from renewable sources has increased to one of the highest levels in Europe (48% of gross electricity production in 2011), largely due to the rapid growth of wind power. Progress in harnessing renewable sources plays a major role in Portugal's contribution to the EU efforts to reduce greenhouse gas emissions and to strengthen energy security. Portugal's emissions have been declining in recent years and in 2009 were already slightly below its Kyoto Protocol target for 2008-12 (Figure 14). Energy policy objectives, environmental and other, have been largely pursued through generous support to producers. Most generators currently benefit either from feed-in tariffs (renewables and cogeneration) or from financial mechanisms to ensure profitability associated with the opening of the sector to private investment (fossil-fuel power and large hydro plants).

Figure 14. Greenhouse gas emissions

Index, 1990 = 100



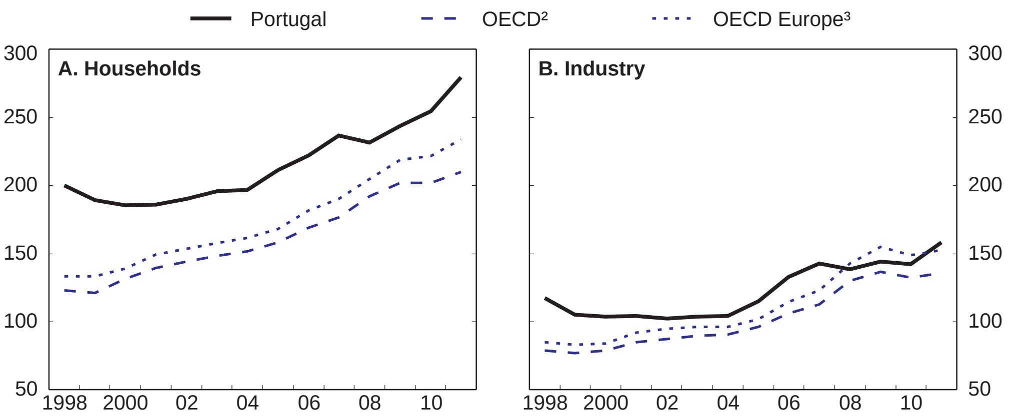
1. EU 15 member countries, *i.e.* before enlargement in May 2004.

Source: European Environment Agency and Eurostat (2012), "Environment and Energy", *Eurostat Database*, May.

The surge in wind turbine farms has increased electricity costs, through both feed-in tariffs and payments for availability, which reward the increased back-up standby of less intermittent generation. All costs of electricity generation support, either to renewables and cogeneration or to fossil-fuel power and large hydro plants, are supposed to be recovered through prices charged to end-users of electricity, with households facing in particular very high prices in international comparison. Still, prices for industry in 2011 were already above the OECD Europe average, according to preliminary estimates (Figure 15). However, the government has decided on several occasions not to fully transmit the costs to electricity prices, thus creating a significant tariff debt (EUR 1.8 billion at end-2011, about 1% of GDP), that is expected to be close to EUR 3 billion in 2012 and could increase further to around EUR 5 billion if no reforms were implemented. This crowds out credit to other sectors, as the debt has been securitised with banks, and poses pressure on future electricity prices.

Figure 15. Evolution of electricity prices

USD per megawatt hour[1]



1. Total price in US dollars using purchasing power parities. The 2011 data for OECD and OECD Europe is an OECD estimate.
2. Unweighted average of 28 countries in panel A and 23 countries in panel B.
3. Unweighted average of 20 countries in panel A and 16 countries in panel B.

Source: IEA (2012), "End-use prices", *IEA Energy Prices and Taxes Statistics* (database), July.

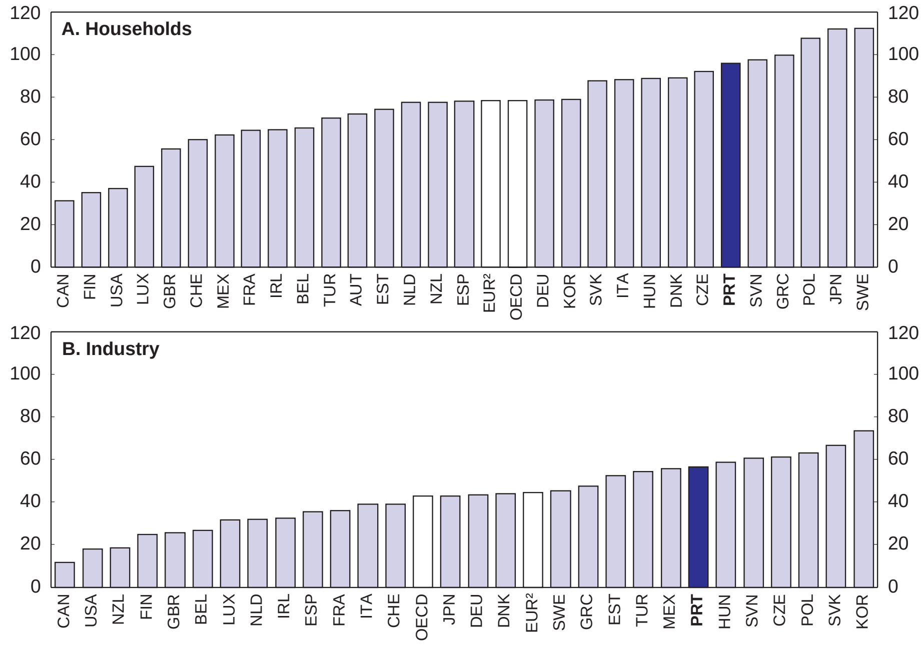
The authorities must ensure that electricity generation support is made cost-effective and costs are fully passed on to all consumers. This requires reducing excessive supports to both wind farms and cogeneration, and to fossil-fuel power and large hydro plants. Under the EU-IMF programme commitment to eliminate the tariff debt by 2020, the authorities announced in May 2012 an intended reduction of overall support costs by around 1% of GDP over the quite long period 2012-20, but some measures are still to be legislated or negotiated with electricity generators.

In the case of wind farms, even though the most recent feed-in tariffs are consistent with those in other EU countries (OECD, 2011b), the authorities should reduce the costs stemming from the much higher tariffs still being paid to producers whose licences were not granted under tender mechanisms. As regards cogeneration, the authorities have already decided to reduce considerably their future remuneration. They should also introduce a time limit for feed-in tariffs for renewable cogeneration, as best practices recommend that incentives be transitional and decrease over time to foster technological innovation (IEA, 2008). In the case of fossil-fuel power and large hydro plants, the authorities should reduce the rates of return currently being guaranteed to the previous incumbent and to generators holding power purchase agreements, aiming at bringing returns closer to their average cost of capital. In addition, the government has already committed to redesign future payments for availability.

The importance of a cost-competitive natural gas supply in Portugal is growing due to new gas-fired electricity generation as well as greater industrial demand. Despite steps towards a liberalised market, wholesale and retail gas markets remain highly concentrated and prices are high by international comparison (Figure 16). Work on a joint Iberian gas market commenced in 2008 but it has been impeded by high cross-border transmission charges between Portugal and Spain. To encourage greater competition, the Portuguese energy regulator, in tandem with the Spanish energy regulator, should fully implement the recent inter-governmental agreement to reduce the cross-border transmission charges between Portugal and Spain to zero. Moreover, the incumbent, GALP Energia, owns exclusive contract rights to the supply of wholesale pipeline gas from Algeria, which is cheaper than sources available to competitors. The regulator should further require GALP to auction Algerian pipeline gas to other firms with no pre-set minimum price.

Figure 16. Gas prices in international comparison

USD per megawatt hour, 2010[1]



1. Total price in US dollars using purchasing power parities. In panel B 2009 for Denmark and 2008 for Mexico. The OECD and OECD Europe aggregates are unweighted averages of data shown.
2. OECD Europe.

Source: IEA (2012), "End-use prices", *IEA Energy Prices and Taxes Statistics* (database), July.

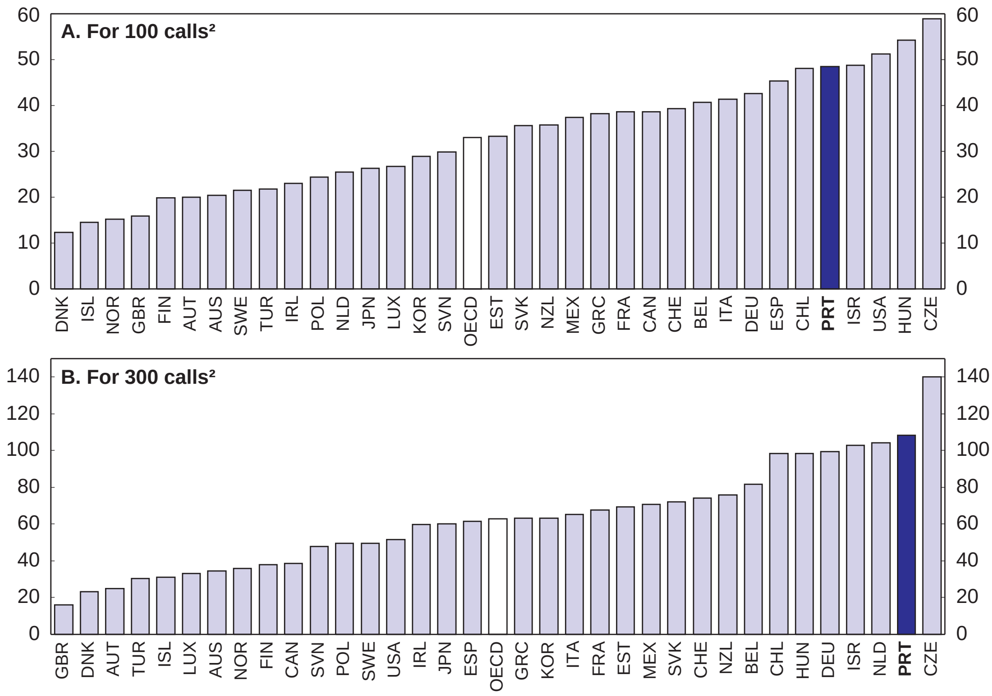
There is room to increase competition in telecommunications, the retail and wholesale sectors and professional services

There is evidence that competition in telecommunications is increasing in Portugal with market shares becoming generally more dispersed. However, from a country cost-competitiveness point of view, prices still appear relatively high for fixed line calls for business, leased lines used for connecting offices and branches, higher speed broadband internet and medium to heavy mobile phone usage (OECD, 2011d). With the rapid rise in the delivery of communication services via bundled services on mobile phones and other portable devices, greater competition in the mobile market would have benefits on several fronts. Mobile phone prices are still high by international comparison (Figure 17).

In a welcome move the telecoms regulator has lowered mobile call termination charges considerably, reducing the network advantages that firms with larger market shares have. To further level the playing field, origination charges for calls commencing on another network, which remain well above costs, should be reduced by regulation in line with termination charges as the costs of termination and origination are practically the same. Portugal should further facilitate competition by introducing a full Mobile Virtual Network Operator (MVNO) agreement allowing firms without a physical network to buy full wholesale access (*i.e.* voice, text messaging and internet) to the networks of the three existing physical networks at regulated wholesale prices.

Figure 17. Mobile telephone prices in international comparison

OECD basket including VAT, August 2010 (USD PPP)[1]



1. The OECD basket of mobile telephone charges covers subscription and usage over a one-month period (including value-added tax) and is shown in US dollars at purchasing power parities. Charges are distributed between peak and off-peak hours and are based on an average call duration. Tribal plans are not fully taken into account
2. Voice calls including SMS messages: 140 SMS for 100 calls or 225 SMS for 300 calls.

Source: OECD (2011), *OECD Communications Outlook 2011*.

Boosting competition to drive productivity improvements in the wholesale and retail sector has large potential pay-offs as it accounts for around 15% of total employment, and trend productivity growth in the sector has been among the lowest in the OECD. Although some of the distribution sector is composed of large modern retail and wholesale firms, the bulk of the sector is accounted for by small inefficient traditional enterprises, with average firm size very low compared with other European countries (OECD, 2010a). This likely lowers productivity as there is evidence of significant economies of scale in the retail sector (Nordás *et al.*, 2008). Portugal also appears to be lagging in harnessing the benefits of e-commerce. Online shopping usage is very low by international standards (European Commission, 2010).

A broad mix of reforms is needed to improve competition in the distribution sector. Changes already made to sector specific regulations include an increase in the size thresholds for when extra rules and approvals apply to large stores, and liberalising opening hours regulation. These provide a good base on which to build further reform. Improvements to local licensing procedures, lower broadband prices to encourage e-commerce and liberalisation of rent controls would all help to create a regulatory environment more conducive to investment and productivity growth in the distribution sector. The new law on urban rental specifies that small businesses holding rental contracts prior to 1995 may benefit from a five-year transitory period, in which the ceiling for rent updating is often below current market values, a provision that distorts competition and is likely to cover many retailers. If a significant divergence between market and transitional regulated rents persists, the authorities should shorten the transitory period, raise the ceiling or adopt a narrower definition of small businesses.

The distribution sector, like others in the economy, would also be aided by labour market and port reforms. Restrictive employment protection legislation may have played an important role in keeping firms in this sector, as well as elsewhere in the economy, too small (Braguinsky *et al.*, 2011). Greater competition at ports to lower transport costs and improve logistics in the distribution sector could be achieved by introducing a more transparent tendering process for renewal of port concessions to encourage more firms into the industry, which currently has little contract switching.

Professional services are an important input for many other sectors in the economy and also a potential source of export growth. Eighteen important professions including those in the accounting, architecture, engineering, health and legal fields are self-regulated by professional bodies. The government will introduce a new horizontal framework law requiring these professions to change their regulations to comply with the EU services, qualifications and selection directives. To enforce the law the government should introduce an independent regulator that can direct the associations to take regulatory action where necessary (OECD, 2007). This would help preserve the information advantages of self-regulation, while guarding against anti-competitive practices to restrict supply by the associations.

Box 5. Core recommendations on the business environment and product markets

- Maintain the momentum in justice reform to speed up civil and commercial case resolution.
- Fully implement the proposed zero authorisation initiative to speed up local licensing.
- Ensure that the new eviction procedures effectively decrease the eviction time of non-complying tenants in order to increase the supply of rental housing.
- Introduce a full Mobile Virtual Network Operator (MVNO) agreement to increase competition in telecommunications.
- Ensure that electricity generation support is made cost-effective and costs are fully passed on to all consumers. This requires further reducing excessive support to both wind farms and cogeneration, and to fossil-fuel power and large hydro plants.
- Promote greater competition in gas markets by implementing the agreement with Spain to lower cross-border transmission charges to zero.

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Chapter summaries

Chapter 1. Solid foundations for a sustainable fiscal consolidation

Owing to slow growth and a relatively weak fiscal position, Portugal's public debt had been rising for almost a decade when the global crisis struck, sharply increasing the deficit. The loss of confidence in Portuguese and other euro area sovereign bonds required international financial support. Weak fiscal performance reflects a wide range of fiscal structural problems resulting in poor control of expenditure. At both the central and local levels, this was compounded by the non-transparent accumulation of payment arrears, future spending obligations via Public-Private Partnerships (PPPs) and off-balance sheet debt in state-owned enterprises (SOEs). In line with the EU-IMF programme, the government is steadfastly implementing an ambitious front-loaded consolidation plan underpinned by a wide range of structural reforms. In a context of weak private sector demand, the government's ability to regain control over public debt dynamics depends crucially on avoiding spending overruns. This will require reinforcing the fiscal framework to improve expenditure control, tackling payment arrears and avoiding further negative surprises from loss-making SOEs, PPPs and local governments. The success of the program will also require maintaining social consensus around it, notably through continuous attention to its implications for the poorest. If growth is far lower than projected in the programme, the automatic stabilisers could be allowed to operate at least partially to reduce the risks of a deeper recession and higher unemployment.

Chapter 2. Rebalancing the economy and returning to growth through job creation and better capital allocation

Low growth and huge current account deficits have characterised the Portuguese economy over the past decade. Easy credit in global markets, combined with the absence of incentives to limit loan-to-deposit ratios until recently, made it possible to finance internationally high levels of consumption and investment relative to gross domestic product (GDP) through over reliance of the banking sector on wholesale funding. This led to high households' and firms' indebtedness and made banks vulnerable to shifts in investor sentiment. However, investment and credit were mostly directed to sheltered sectors, giving rise to an oversized road infrastructure, electricity generation capacity and housing stock. Weaknesses in labour market institutions further held back productivity and hampered wage adjustment, making it harder to gain cost competitiveness.

The deleveraging process set in motion by the loss of access to foreign financing is helping to rapidly reduce external deficits, but also has the potential to generate a damaging credit contraction, which enhances the importance of alternative financing strategies for firms, such as greater reliance on equity. To restore growth, Portugal needs to foster the reallocation of both labour and capital, essentially towards the tradable sector. Building on recent policy initiatives or commitments, this will require reforming public policies that have long distorted investment allocation, ensuring that banks adequately recognise and provision problematic loans and, on the employment front, reducing labour market segmentation and increasing targeted training. Reforms in wage setting, labour taxation, unemployment benefits and activation policies will foster job creation, thus enhancing output growth while avoiding high unemployment becoming entrenched and threatening social cohesion.

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 3 July 2012. 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 16 July 2012.

The Secretariat's draft report was prepared for the Committee by David Haugh, Alvaro Pina, Stéphane Sorbe and Ildeberta Abreu under the supervision of Pierre Beynet. Statistical assistance was provided by Desney Erb.

The previous Survey of Portugal was issued in September 2010.

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