



“Better Policies” Series

PORTUGAL

REFORMING THE STATE
TO PROMOTE GROWTH

MAY 2013



OECD “Better Policies” Series

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PORTUGAL: REFORMING THE STATE TO PROMOTE GROWTH

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FOREWORD

Over recent years, Portugal has implemented ambitious and courageous reforms to restore the sustainability of public finances, reduce external imbalances, and put its economy back on a path of strong, jobs-rich growth. Indeed, after two decades of strong economic growth and convergence in living standards towards the levels of more prosperous OECD countries, Portugal's performance weakened in the 2000s, productivity growth slowed and competitiveness deteriorated.

Improving economic performance and the wellbeing of all Portuguese requires continued efforts, building on recent achievements. To illustrate the benefits of ongoing adjustment, the policies that have been put in place over the last 5 years to make product markets more competitive and the labour market more dynamic are likely to raise Portugal's potential GDP by about 3½ per cent by 2020. The potential benefits from further reforms to improve product and labour market regulation, to upgrade education and skills, and to enhance innovation are also very large.

Restoring Portugal's potential for strong, inclusive growth also calls for a comprehensive reform of the State to improve its ability to plan, design, steer and implement reform. Portugal needs an efficient public administration to enable private sector development in a competitive global environment, as well as to meet social demands through cost-effective service delivery at a time when the public finances need to be strengthened. Important reforms of the State, including its organisation and human resource management, are therefore urgently needed to face these challenges.

Despite the hardships brought about by the crisis, Portugal is now faced with a unique opportunity to modernise its economy, as well as building a fairer, more cohesive society and a more efficient, dynamic public administration. Drawing on the experience of OECD member countries, the analysis and advice reported in this document aim to provide Portuguese policymakers not only with a compass but also with a policy map of a brighter future. The OECD looks forward to continuing to accompany Portugal in this journey.



Angel Gurría

OECD Secretary-General

INTRODUCTION

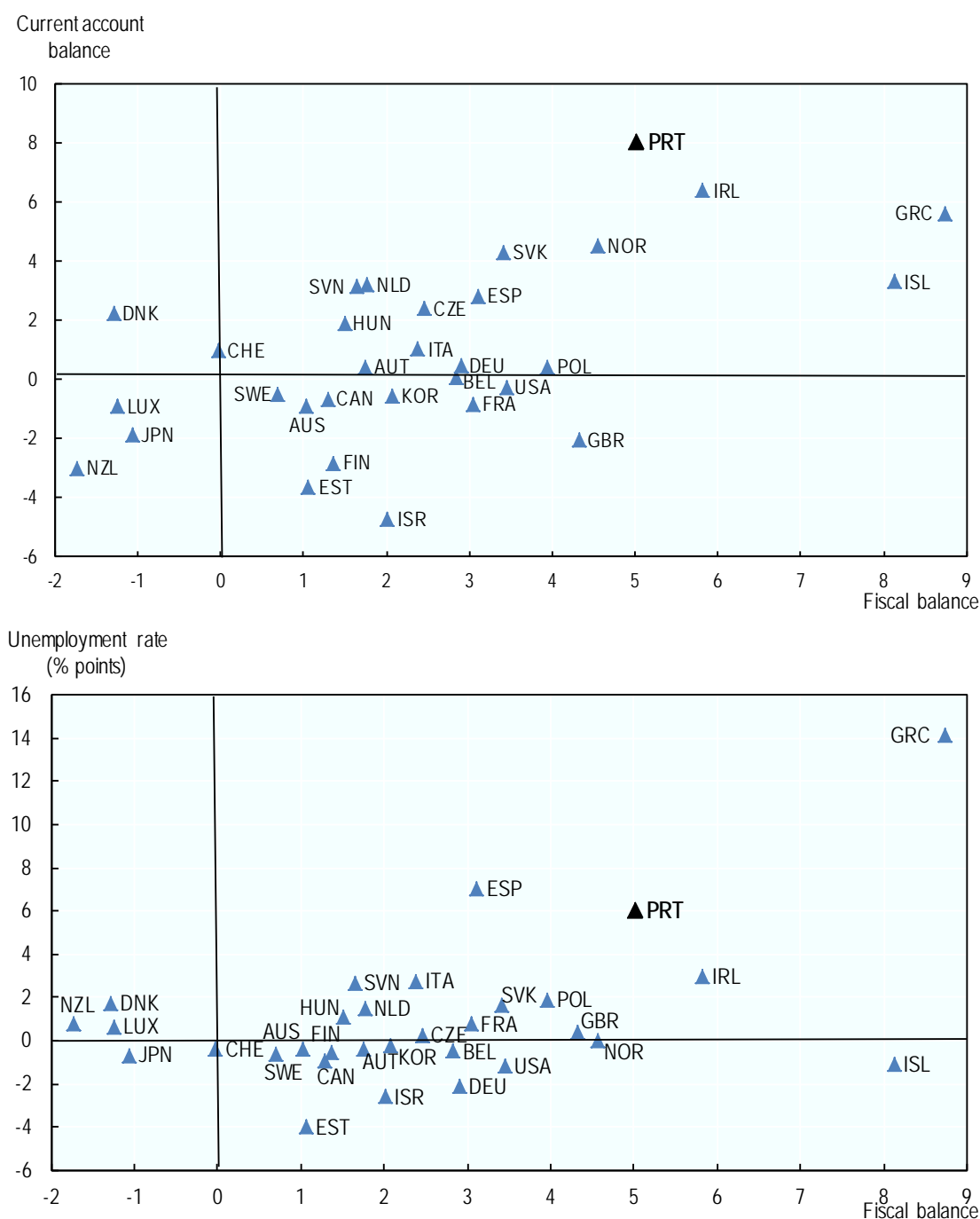
Following nearly two decades of robust economic growth and convergence towards higher living standards, Portugal's performance weakened after 2000; productivity slowed substantially, and competitiveness deteriorated. Structural reforms to modernise the economy, combined with a favourable external environment, supported growth in the years just before the crisis, but this was insufficient to continue narrowing the wide gap in living standards between Portugal and wealthier OECD countries. The global crisis exposed underlying weaknesses of the Portuguese economy, which was still excessively geared towards domestic demand and continued to lose competitiveness, leading to unsustainable external imbalances.

In recent years, Portugal has implemented ambitious structural reforms to restore the sustainability of public finances, reduce external imbalances and put the economy back on a path of strong, jobs-rich growth. Reforms to bolster the fiscal framework, broaden tax bases and enhance labour market and competition policies have been important steps forward. This progress is reflected in one of the greatest degrees of responsiveness to OECD *Going for Growth* recommendations following the crisis. Portugal has also recorded one of the sharpest reductions in fiscal and external imbalances in the OECD since 2009. This ongoing rebalancing – on the back of renewed reform impetus – has been paramount in assuring markets of Portugal's capacity to implement reforms, and in restoring debt sustainability and external confidence.

The short-term social and economic costs of rebalancing have been high, but, given the magnitude of the required adjustment, less acute than in some euro area partners (see figures below). While it is essential to pursue fiscal and external adjustment, it is also crucial to minimise the drag on growth, to maintain social cohesion and to lay the groundwork for stronger, more equitable growth over the long term.

The authorities are advised to abide by the revised nominal fiscal targets as long as growth does not deviate from the underlying assumptions, allowing the automatic stabilisers to come into play should downside risks materialise and output fall more than projected. Moreover, Portugal needs a comprehensive strategy to boost productivity and restore competitiveness with pro-growth structural reforms that go beyond the short-term imperative of fiscal consolidation, while making it sustainable over time. The simulations reported below show that the reforms put in place to date to improve competition in product markets and enhance labour market regulation could raise the level of Portugal's potential GDP by some 3½ per cent by 2020. Further reforms could bring even higher gains.

**FIGURE 1. OVERVIEW OF THE RECENT ADJUSTMENT
CHANGE OVER THE PERIOD 2009 TO 2012, PER CENT OF GDP**



Source: OECD Economic Outlook database (November 2012)

The State plays a major role in this strategy – from design to implementation – and as regulator, provider of key services and planner of infrastructure. To enhance the government’s role as a catalyst for such structural transformation, it will be essential to reform the State and public administration.

The first part of this report details the key ingredient of a strategy to foster productivity and competitiveness in Portugal. The second part assesses the reforms of the tax and transfer system that are needed to sustain growth, employment and social cohesion. The third part examines the State and public administration that are needed to underpin this strategy and ensure success.

MAIN FINDINGS AND RECOMMENDATIONS

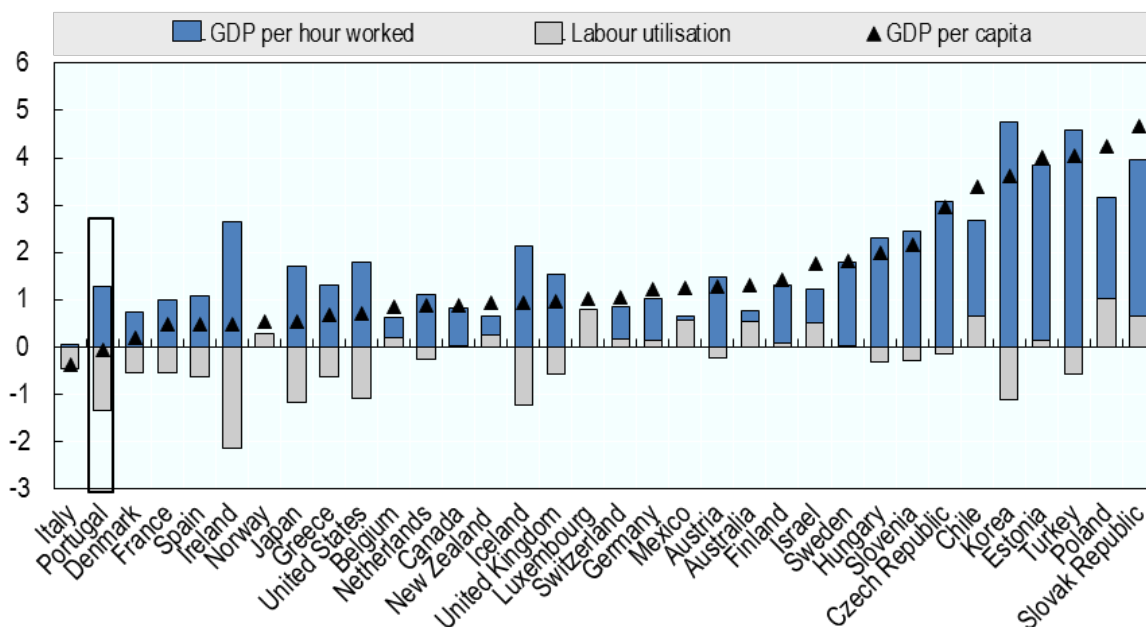
- ✓ Deep structural reforms are critical to successfully rebalancing the economy, restoring sustained growth and maintaining social cohesion.
- ✓ The gains from structural reforms are potentially large:
 - Already approved pro-competitive reforms in product market regulation, including in network industries, combined with implemented labour market reforms to reduce employment protection for regular contracts could boost productivity and potential GDP by around 3 ½ per cent by 2020.
 - Labour market reforms to reduce employment protection for regular contracts will also promote social cohesion by reducing labour market segmentation.
 - Gains to be reaped from further reforms are nonetheless still substantial.
- ✓ New sources of growth could be generated by more efficient investment in infrastructure and innovation, which could help Portugal take better advantage of global value chains.
- ✓ Despite the progress made, human capital remains the Achilles' heel of the Portuguese economy. Upgrading human capital will require further reforms of education and occupational training systems, as well as of the functioning of the labour market.
- ✓ Wage-setting mechanisms have been an obstacle to regaining competitiveness and have likely contributed to job losses for the low-skilled. Abolishing administrative extension of collective agreements beyond cases in which companies account for less than 50% of employment in a given sector is essential to promote firm-level bargaining and restore competitiveness.
- ✓ Further improvements in the tax code, to shift the burden of taxes away from labour in a revenue-neutral manner, by further broadening the tax base and increasing environmental taxes, would also enhance competitiveness and contribute to fairer income distribution.
- ✓ The efficiency of social spending needs to be increased so that poverty prevention schemes can continue to be sheltered from fiscal adjustment, and in order to address the medium-term pressures associated with population ageing.
- ✓ The State has a key role to play in the design, implementation and monitoring of reforms, as well through its role as provider of social, education and judicial services.
- ✓ Public human resource management reforms are needed to support the structural reform agenda and lay the groundwork for strides towards a more efficient and effective State.
- ✓ Effective reform of the State requires attention to a range of interdependent issues aimed at strengthening public administration capacities, resilience and leadership for the reform tasks ahead. The Centre of Government has a critical role to play in orchestrating reforms.
- ✓ The reform of the State needs to include a strengthening of the institutional and process framework for sustainable fiscal management.

PART I. BOOSTING PRODUCTIVITY AND RESTORING COMPETITIVENESS WITH STRUCTURAL REFORMS

Comprehensive structural reforms to revive productivity and competitiveness are critical to rebalancing the economy and restoring sustained growth.

Over 2001-2011, Portugal's GDP per capita stagnated (Figure 2). Potential growth, currently estimated at below half-a-per-cent per year, has suffered from a declining contribution from both employment and productivity. In particular, trend productivity convergence to euro area levels has slowed substantially. A revival of productivity growth is therefore essential to re-igniting the growth engine and raising living standards towards those of the more prosperous EU partners.

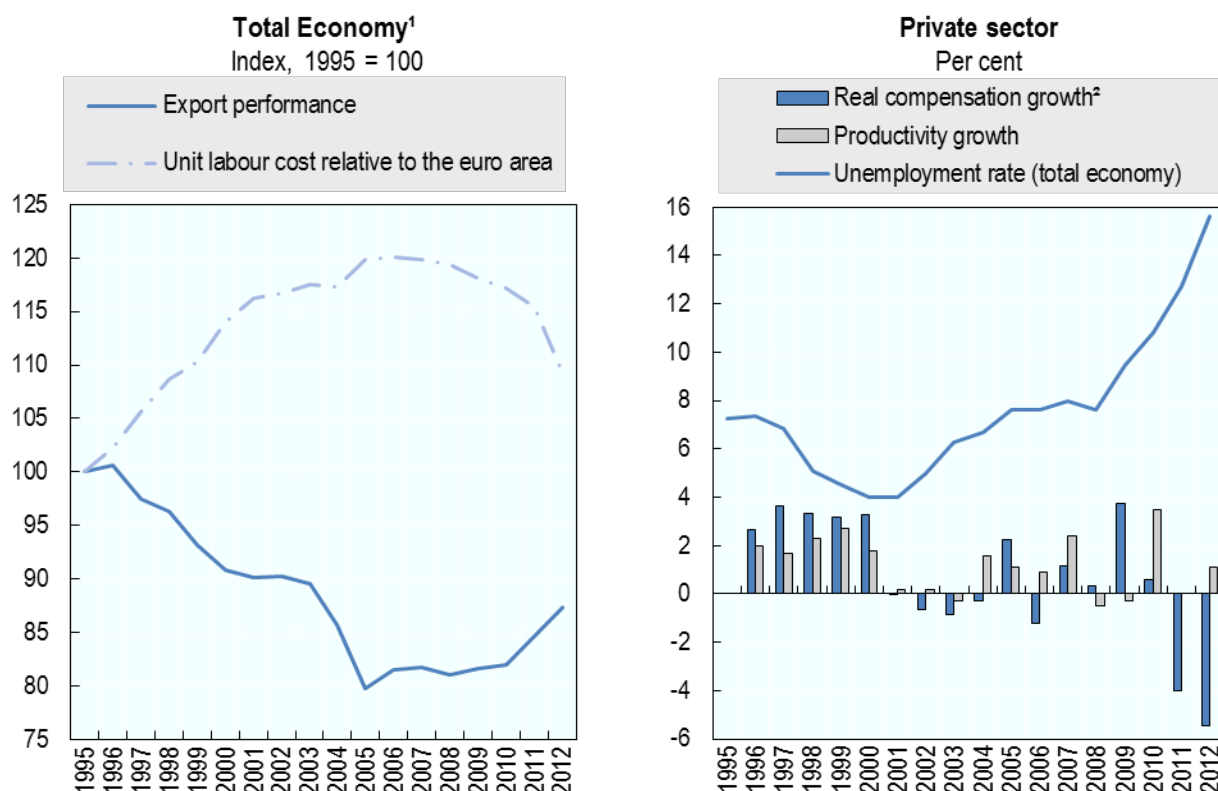
FIGURE 2. GDP PER CAPITA GROWTH AND ITS COMPONENTS, 2001-2011, PER CENT



Source: OECD Productivity Database OECD, Annual National Accounts Database

With wage growth outpacing productivity, unit labour costs increased faster than in large euro area countries in the run-up to the crisis, and Portugal steadily lost external competitiveness (Figures 3 and 4). Insufficient competition has resulted in capital allocation shifting away from the tradable sector to non-tradables, further exacerbating losses of international market shares (Figures 3 and 5).

FIGURE 3. DEVELOPMENTS IN COST COMPETITIVENESS



1. 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.
2. Compensation per worker in the private sector deflated by the harmonised consumer price index.

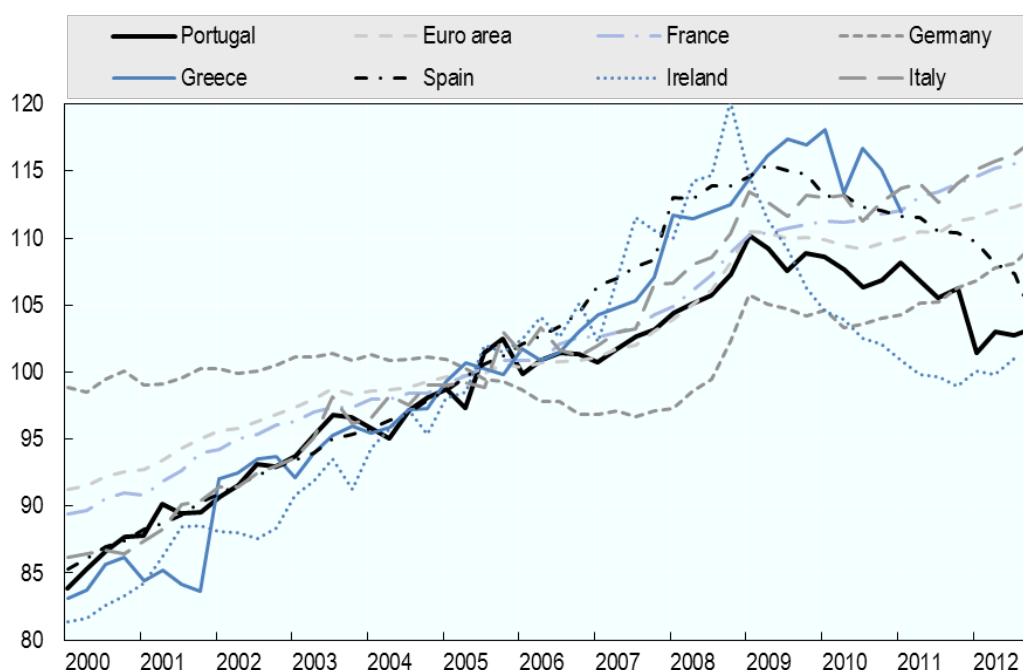
Source: Bank of Portugal and OECD (2013), OECD Economic Outlook database.

More recently, while unit labour costs have started to moderate (reflecting the large cuts in real wages) and international market shares have begun to recover on the back of strong exports, the external adjustment also reflects to some extent a contraction in domestic demand and therefore imports. Further sustainable rebalancing depends largely on the ability to boost productivity growth in all sectors of the economy.

Boosting productivity requires in particular a business environment that is more conducive to investment, innovation and job creation, as well as major investment in human capital. To narrow the wedge in unit labour costs relative to other euro area countries and regain international market share, wages will need to rise in tandem with productivity growth, and the tax system will need to be reformed to shift taxation away from labour.

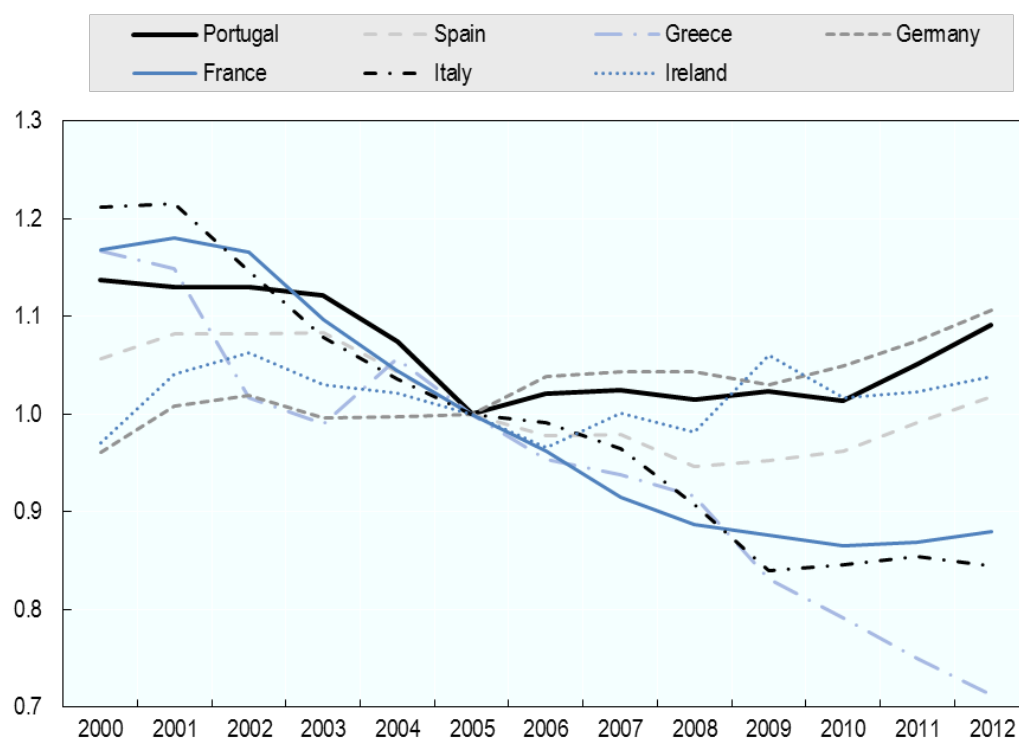
Expanding Portugal's involvement in international trade, which, despite significant growth in recent years, remains relatively low given the small size of its economy, requires in particular a stronger role in global value chains. This calls not only for higher productivity and value added in the industrial sector, but also for a vibrant services sector that supports the competitiveness of manufacturing firms. Recent OECD work shows that for major players in global value chains, much of the value creation in fact involves the incorporation of services into manufacturing. High-quality and high-productivity services, such as transport, telecommunications, and business and financial services, are of critical importance in enhancing Portugal's position in global value chains. These reforms would make the Portuguese economy more dynamic and resilient, but also more attractive to FDI that could in turn generate substantial spill-over effects and accelerate further productivity growth.

FIGURE 4. TRENDS IN UNIT LABOUR COSTS (TOTAL ECONOMY, INDEX 2005 = 100)



Source: OECD Early Estimates of Quarterly ULC Indicators – Total economy.

FIGURE 5. DEVELOPMENTS IN EXPORT PERFORMANCE IN INTERNATIONAL COMPARISONS (2000-2011)



Source: OECD Economic Outlook database.

The State has a key role to play in this comprehensive reform agenda, either as steward of strategic orientations or provider of key services. This is particularly the case regarding the business regulatory environment (Chapter I.1), infrastructure and innovation policies (Chapter I.2 and I.3), investments in skills (Chapter I.4) and labour market regulation (Chapter I.5).

Chapter I.1. Further improving product market regulation and the business environment

Sharpening competition in product markets is an important lever for raising Portugal's productivity, growth and cost-competitiveness. Intense competitive pressures can encourage firms to cut costs and prices, improve quality and innovate.

To support competitiveness, further progress should in particular focus on reducing administrative burdens and continuing to foster competition in sectors that provide core inputs to other industries (network industries and professional services).

Portugal's business climate has improved over time, as documented in the last OECD *Economic Survey of Portugal*. Significant further steps have been taken, including relinquishing the government's "golden shares" in publicly listed companies and major revisions of competition legislation. In addition, measures to ease the licensing and permits system are under way.

While the markets for manufactured goods are directly exposed to international competition, competitive pressures in non-goods sectors, such as network industries, wholesale and retail trade, ports and professional services, are still limited. Outputs from all these sectors are widely used as inputs by other industries, implying that shortcomings can have wide ramifications and hamper productivity growth throughout the entire economy. For instance, prices in sectors such as electricity and gas have remained high, which weighs on both household purchasing power and the business sector's international competitiveness. As a result of insufficient competition, until the crisis capital allocation was diverted from the tradable sector. Policy changes in areas such as telecoms and energy have been geared towards reducing the returns of these sectors, although there is still scope for stronger competition. In addition, despite the progress made, including the arbitration law and the tax arbitration law, the inefficiency of the civil justice system and persistent licensing problems at the local level are further undermining the business environment.

Potential gains from product market reforms

Further reforms of product market regulations can contribute significantly to raising growth and living standards. Empirical estimates suggest a significant link between product market reforms that enhance competition on one hand, and multi-factor productivity on the other¹. Simulation exercises can provide an initial approximation of the quantitative benefits of product market reforms, based on product market regulation measured by sector-specific policy indicators produced by the OECD. By focusing on sourcing relationships between different sectors of an economy, these estimates are able to capture the economy-wide effects of reform action in individual sectors (Box 1).

¹ Bourlès, R., G. Cette, J. Lopez, J. Mairesse, and G. Nicoletti (2010), "Do Product Market Regulations in Upstream Sectors Curb Productivity Growth? Panel Data Evidence for OECD Countries", NBER Working Papers No. 16520.

Box 1. Estimating the impact of structural reforms

The impact of structural reforms productivity and growth is difficult to quantify. The OECD has developed an empirical framework that evaluates the impact of reforms in product markets and the labour code based on experiences in 15 OECD countries and 20 industries over more than two decades. While structural reforms are much broader than product and labour market reforms these simulations are a useful illustration of their potential impact on GDP and productivity.

Product market reforms

The benchmarking of product market reforms relies on the OECD Product Market Regulation (PMR) indicators, which quantify detailed regulatory measures in non-manufacturing sectors and allow for consistent comparisons across countries and over time. The PMR indicators are compiled on the basis of detailed information provided by countries on laws, rules, as well as market and industry settings, and cover energy (gas and electricity), transport (rail, road and air) and communications (post, fixed and cellular telecommunications), retail distribution and professional services. Detailed questionnaires are submitted to OECD countries every five years. The most recent vintage of internationally comparable indicators refers to the status of regulations as of February 2013. The sectoral indicators are defined to take values in a 0-6 range in increasing order of stringency.¹ The policy impact simulations factor in intersectoral spillovers and sourcing relationships to evaluate the overall impact of changes in the regulatory stance on the total economy.

While there are obvious uncertainties surrounding such empirical exercises, they clearly suggest that reforms of product market regulations hold great potential to raise growth and living standards. The simulations reflect the changes in regulations that took place between 2008 and 2013 in the sectors and activities covered in the PMR indicators. Since the effects of policy reforms on productivity and growth materialise over a number of years, the simulations cover the period 2009-20. In other words, the simulations consider the reforms that have already been implemented and can be gauged by changes in the PMR indicators between 2009 and 2013.

Labour market reforms

As for reforms to the labour code, the simulations are based on the OECD Employment Protection Legislation (EPL) indicators, which measure the stringency of regulations across OECD economies.² As in the case of the PMR indicators, the EPL indicators are compiled on the basis of answers from OECD member countries to a detailed questionnaire on their regulations governing individual and collective dismissals, as well as hiring on temporary contracts. Country information is then integrated with the OECD's own reading of legislation, collective bargaining agreements and case law. The indicators are updated about every five years. The most recent vintage of internationally comparable indicators refers to the status of regulations as of January 2013. The individual indicators are then aggregated and normalised, so that the overall EPL indicator takes values in a 0-6 range in increasing order of stringency.

The simulations factor in the reforms undertaken in Portugal between 2008 – the latest year for which internationally comparable information is available for OECD countries – and February 2013. As noted in the main text, the stance of EPL in Portugal has moved significantly closer to the OECD average over this period of analysis. Moreover, to ensure consistency with the PMR simulations, and given that the effects of structural reforms on productivity and growth take time to materialise, the simulations refer to the period 2008-20.

¹ For more information on the modelling framework see R. Boursès, G. Cetté, J. Lopez, J. Mairesse, and G. Nicoletti (2010), "Do Product Market Regulations in Upstream Sectors Curb Productivity Growth? Panel Data Evidence for OECD Countries", *NBER Working Papers* No. 16520, NBER, Cambridge, MA.

² For more information on the modelling framework see A. Bassanini and R. Duval (2009), "Unemployment, Institutions and Reform Complementarities; Reassessing the Aggregate Evidence for OECD Countries", *Oxford Review of Economic Policy*, Vol. 25, No. 1.

For Portugal, such simulations suggest that the product market reforms undertaken since 2009 – including improvements in the electricity, gas and retail trade sectors – combined with labour market reforms have already started to raise the levels of productivity and potential GDP and, overall, by 2020 will have led to a 3 ½ per cent increase in these levels. The potential gains from further reforms remain nonetheless large.

Strengthening the institutional framework

The regulatory framework plays an important role in ensuring effective competition. Portugal has taken further welcome steps to strengthen this framework, including, in 2012, the long-needed reform of competition legislation and the introduction of a new court specialised in competition issues. The 2012 changes to competition law aligned Portuguese legislation with EU law on merger control, increased the efficiency of the appeals process for competition law cases and extended the authorities' powers to carry out inspections and audits while guaranteeing greater accountability and transparency. A framework law to strengthen competition in regulated sectors by granting regulators more independence and autonomy has been submitted to Parliament. The success of these reforms will depend on strict enforcement, the provision of adequate resources for the Competition Authority and the effectiveness of the new specialised court on competition issues.

Lesser administrative burdens that reduce market-entry costs and foster entrepreneurship are a necessary complement to more competition-friendly product market regulation. The simplification of administrative procedures has progressed under the Simplex Programmes (which aim to enhance the quality of laws, reduce administrative burdens on business and provide easier access to legislation through electronic publication of regulations and codification of laws), and licensing for some services was abolished in 2011. A new industrial licensing regime (SIR) was approved in 2012, implementing a shift from *ex-ante* to *ex-post* control. Furthermore, a detailed calendar was set up with specific milestones for the revision of important legal regimes such as environment and territorial planning, industrial, commercial and tourism licensing.

However, a number of remaining license requirements, particularly at the local level, should be reconsidered in order to make it easier for new businesses to start up and grow. The government is carrying out a more comprehensive “zero authorisation” reform in 2013 and is planning to extend the *Simplex* programme to all municipalities and all levels of public administration. This reform has the potential to substantially improve the business environment and should be implemented without delay.

Particular attention is required regarding environment-related requirements. The enactment of many laws and regulations in the 2000s initially resulted in the business community's facing a complex set of environmental requirements. The situation has improved, but further efforts are needed to streamline and simplify environmental requirements so as to reduce the administrative costs of compliance. One of the changes already under way is the review of the legal regime for Environment Impact Evaluation in order to increase the speed and effectiveness of regulation and reduce associated costs.

Going forward, and more generally, international experience shows that a broad review and overhaul of legal and regulatory restraints on competition can help improve the regulatory framework. For example, Australia's “national competition policy” programme reviewed about 1 800 national and state laws over a period of about six years. The OECD's Competition Assessment Toolkit provides a flexible methodology for moving in this direction. It can assist the government not only in identifying but also in revising policies that unduly restrict competition.

In Portugal, the government has been involved in several segments of the economy where there is no clear case for public intervention. Although significant progress has been made in privatisations and is still under way, public provision of services still affects competition and the quality of corporate governance.

- ✓ Planned privatisations should be carried through and extended to air transport. However, privatisation should be conducted within a pre-established pro-competitive regulatory framework to avoid transforming public monopolies into private ones.
- ✓ The proposed governance framework for State-owned enterprises (SOEs) will also contribute to a level playing field between State-owned and private businesses. Operational break-even for SOEs was achieved in 2012 and should be maintained. The planned restructuring of the water company *Águas de Portugal* should be fully implemented. The postal office *CTT* is scheduled for privatisation in the second half of 2013.

A business environment conducive to investment and innovation requires an efficient judiciary with accessible processes and efficient judicial review and appeal systems. In Portugal, the judicial system has typically been slow to resolve civil and commercial disputes, resulting in large numbers of pending cases and a high level of regulatory uncertainty for business. For instance, the World Bank Group's "Doing Business" puts the time needed to resolve commercial disputes in Portugal at 547 days, which is about twice as long as in the five best-performing OECD countries on this indicator.

Greater adoption of information and communication technologies (ICTs) by the courts can contribute to greater productivity and reduced processing times by improving case flow management, and by generating statistics that could be used to monitor and evaluate court performance. The most recent report by the Council of Europe's Commission for the Efficiency of Justice (CEPEJ) notes significant "eJustice" reforms in Portugal, accounting for a 25% increase in judicial expenditure between 2008 and 2010. Moreover, further developments of courts' IT systems have taken place recently. This major investment in hardware and software has allowed for significant improvements in Internet connectivity, availability of videoconferencing facilities, and use of case management systems. Furthermore, the government has formulated two draft laws to enhance the efficiency of the judiciary, and implementation is expected in early 2014 after adoption by Parliament. These are significant measures, but the authorities should make sure that their implementation does in fact reduce the backlog of cases and lead to faster judicial decisions. The government's plans to prepare quarterly reports on the status of implementation of measures to reduce the judicial backlog are a step in this direction.

Making the regulation of network industries more competition-friendly

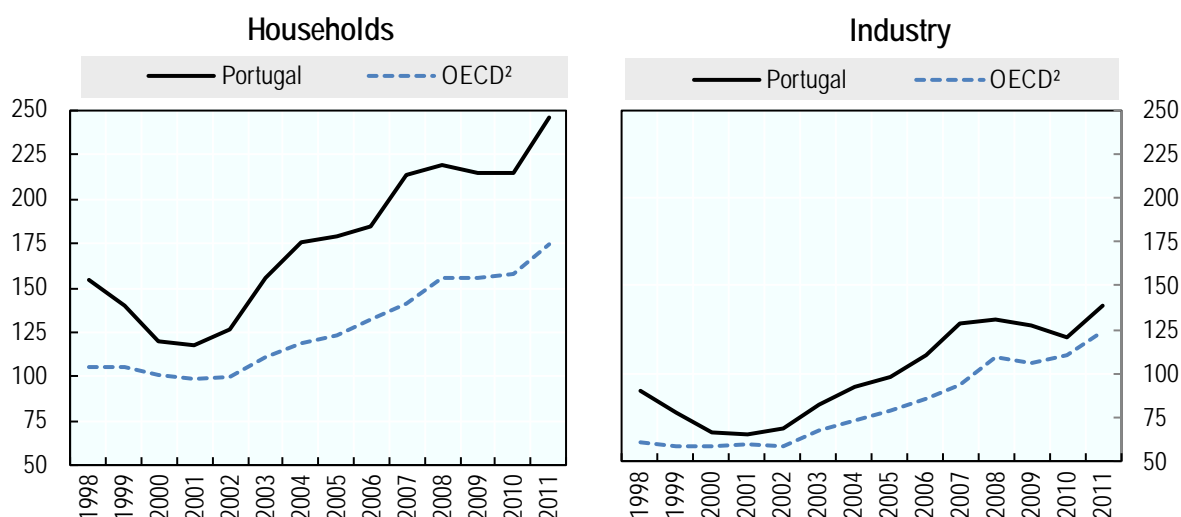
In network industries, competition-friendly reforms, if well-designed, can lead to higher productivity, better quality and often lower prices.² Portugal has made significant progress over the past decade in reducing competition-restricting regulations, as reflected by the improvement in the OECD overall indicator for restrictiveness in network industries. These improvements are also reflected in a more highly dispersed market structure in telecoms, more consumer choice and the abolition of regulated prices for gas and electricity. However, in 2008 Portugal's restrictive regulation indicators for airlines, postal and rail services and the natural gas sector were still above the OECD average. Despite significant steps taken by the Portuguese authorities since then, rents and market concentration persist, and prices for electricity and gas are still high by international standards, weighing on the overall competitiveness of the Portuguese economy as well as on households' purchasing power.

² Høj, J.C., M. Jimenez, M. Maher, G. Nicoletti, and M. Wise (2007), "Product Market Competition in OECD Countries: Taking Stock and Moving Forward", *OECD Economics Department Working Papers*, No. 575.

Electricity sector

The electricity sector in Portugal has been liberalised over time, but competition is still limited and prices remain above the OECD average (Figure 6). Although the generation of electricity is now formally open to competition, in practice it functions under remuneration schemes, such as power purchase agreement (PPA), guaranteed compensation mechanism (CMEC) and feed-in tariffs, and is highly concentrated in the hands of the incumbent, *Energias de Portugal* (EDP). Further increasing the transmission capacity between Portugal, Spain and France would reduce the incumbent's market power.

**FIGURE 6. EVOLUTION OF ELECTRICITY PRICES
USD PER MEGAWATT HOUR¹**



1. Total price in USD. The 2011 data for OECD are OECD estimates.
2. Unweighted average of 28 countries in panel A and 23 countries in panel B.

Source: IEA (2013), "End-use prices: Energy prices in US dollars", IEA Energy Prices and Taxes Statistics (database), January

Generation-support mechanisms must be cost-effective, and costs (feed-in tariffs for renewables as well as cogeneration and financial mechanisms like PPAs and CMECs in the case of fossil-fuel power and large hydro plants) have to be fully borne by all consumers. In this context, the planned reduction in overall support to the electricity sector by around 1% of GDP over the period 2012-20 is a step forward in further reducing excessive support. The review of contracts and subsidies to producers will lower the expected cumulative real price growth until 2020 by about one-sixth. Notwithstanding Portugal's comparatively high retail prices, there is still a significant difference between the costs of electricity and the tariffs paid by consumers. As a result, some regulated companies in the electricity sector are accumulating a so-called tariff-debt, which is estimated at around EUR 3 billion in 2012 and is scheduled to increase until 2014 before being eliminated by 2020.

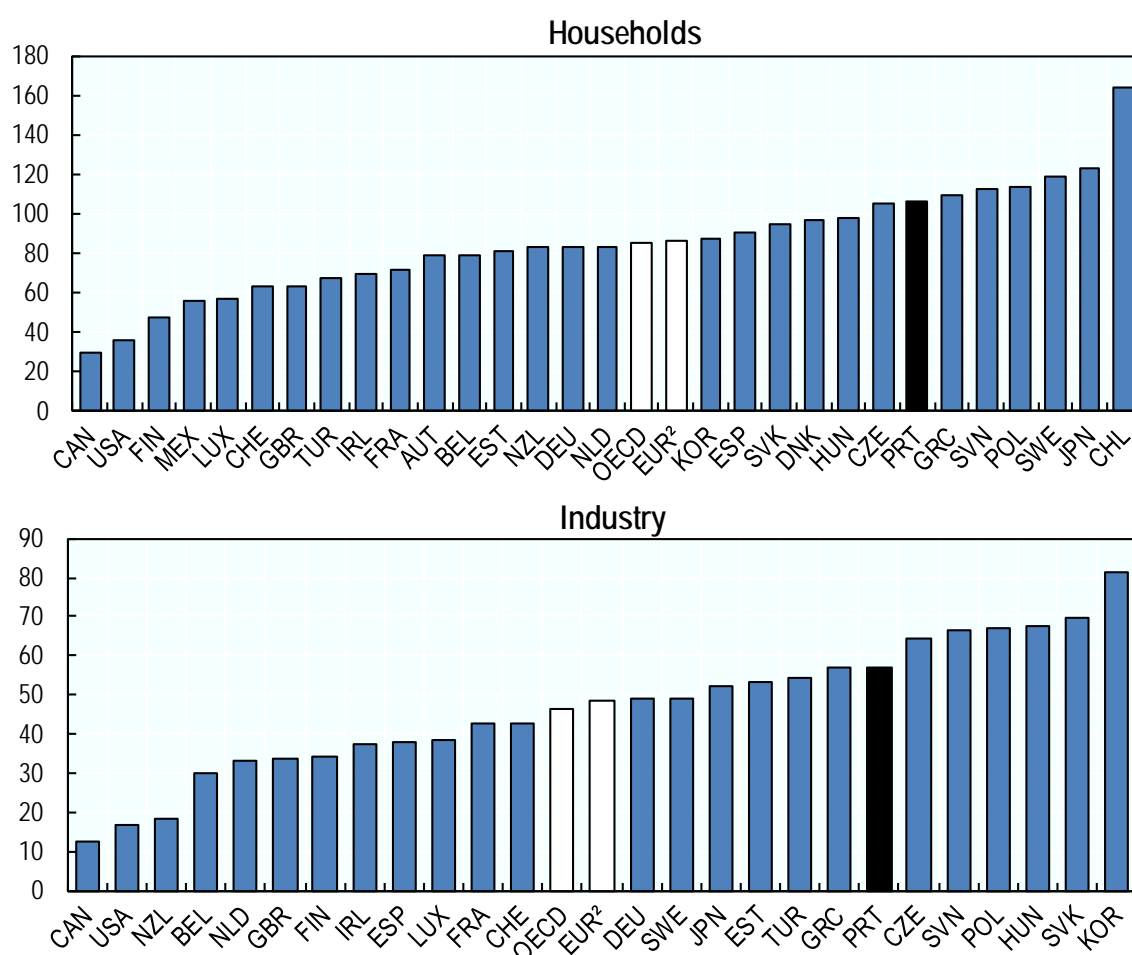
At the retail level, consumers can now choose their provider. The phasing-out of regulated tariffs as of January 1, 2013 will encourage more consumers to switch providers and should be conducive to the entry of new companies and competition. The regulator, ERSE, that will oversee these logistical operations, should also ensure that switching electricity providers becomes easier in the future.

Gas

New gas-fired electricity generation and increasing industrial demand have increased the need for cost-competitive natural gas supply in Portugal. Despite formal market liberalisation, wholesale and retail gas markets remain highly concentrated, and prices are still high (Figure 7). Work on a joint Iberian gas market began in 2008 but has been hampered by high cross-border transport charges between Portugal and Spain. To encourage competition, once the Spanish reform of the national gas tariff methodology is completed, full implementation of the recent inter-governmental agreement to reduce the cross-border charges to zero will be necessary.

Considering the high level of contractual congestion, despite no physical congestion at the main interconnection point (Badajoz) and the degree of market concentration in the main LPG terminal (Sines), competition in gas markets would be encouraged by ensuring that capacity allocation mechanisms work effectively, promoting entry and developing secondary markets for capacity.

FIGURE 7. GAS PRICES IN INTERNATIONAL COMPARISON, USD PER MEGAWATT HOUR, 2011¹



1. Total price in US dollars using purchasing power parities. Data for 2010 for Italy. The OECD and OECD Europe aggregates are unweighted averages.

2. OECD Europe.

Source: IEA (2013), "End-use prices in US dollars", IEA Energy Prices and Taxes Statistics (database), January.

Telecommunications

A stronger regulatory framework in the telecommunications sector has contributed to improved services, growing competition and lower prices. Historically, prices have been relatively high by international standards. Recent regulatory action limiting termination charges has led to price drops and may lead to even lower prices in the future. With the rapid rise in the delivery of communication services via bundled services on mobile phones, greater competition in the mobile market would have benefits on several fronts. Despite recent improvements in the regulatory framework, the incumbent Portugal Telecom (PT) retains significant market power in several markets (including fixed telephony services and fixed broadband).

Retail trade and professional services

According to OECD product market regulation indicators, the regulation of retail trade and professional services is more restrictive in Portugal than the average for OECD or European Union countries. Therefore, trend productivity growth in the wholesale and retail trade has been among the lowest in the OECD. Small inefficient traditional enterprises continue to play a large role, even as information technologies and economies of scale have spurred productivity gains in many other countries (Nordás *et al.*, 2008). Revising local licensing could improve competition in retail trade.

Many professional services – which are key production inputs in other industries – are self-regulated by professional bodies. This may potentially reduce competition, creating scope for economic rents to the detriment of innovation, although the establishment of a horizontal legal framework aiming at improving the functioning of self-regulated professions reduces this risk. The Government is also currently amending the statutes of those associations and will submit them to Parliament shortly. Ongoing deregulation of professional services and guarding against restrictions to competition by professional bodies and associations could reduce input prices for a wide array of businesses.³

In this spirit, the authorities are also reviewing requirements for regulated professions that are not self-regulated, with a view towards reducing unjustified requirements. Further progress is also under way – and urgently needed – with respect to full implementation of the European Services Directive, in particular regarding the information available at the points of single contact, which are meant to facilitate cross-border trade in services.⁴

³ In 2011, 173 professions were fully deregulated. Then, a specialised commission analysed 187 regulated professions and issued 7 deregulation recommendations (which were accepted and translated into law). The remaining regulated professions are currently being analysed by the Government to continue the elimination of any unjustified or unnecessary requirements.

⁴ Over 50 out of nearly 70 Portuguese legal regimes have already been aligned with the European Services Directive. The implementation of the European Qualifications Directive was concluded, easing the recognition of qualifications and the provision of professional services.

Key OECD recommendations

- ✓ **Reduce distortions in capital allocation** that favour the non-tradable sector by strengthening competition in product markets.
- ✓ **Reduce administrative burdens** at the local level. Fully implement the proposed zero authorisation initiative to speed up local licensing, as planned.
- ✓ **Continue to improve the civil justice system** and speed up civil and commercial case resolution to improve the business climate.
- ✓ Continue to simplify and streamline environmental requirements and reduce associated administrative compliance costs, particularly for small and medium-sized enterprises.
- ✓ **Electricity:** Make market entry and switching providers as easy as possible. Ensure that electricity generation support is made cost-effective and that costs are fully passed on to all consumers.
- ✓ **Gas:** Fully implement the recent inter-governmental agreement between Portuguese and Spanish energy regulators to reduce cross-border natural gas charges to zero.

Chapter I.2. Enhancing transport infrastructure

The State has a key role to play in promoting highly productive transport infrastructure and services that are essential for enhancing productivity and competitiveness. The main challenges faced by Portugal are to address funding arrangement issues and improve the efficiency of the already well developed road infrastructure, while further developing rail freight and its integration with ports. Policy actions include selecting investment projects, introducing competitive pressures where possible and getting incentives right.

Infrastructure investment boosts economic growth beyond its direct impact on the stock of capital. Better infrastructure, particularly in transport, can facilitate and enhance the division of labour, encourage the adoption of new organisational practices, and strengthen competition.⁵ In addition, it can generate time savings, reduce congestion, and stimulate international trade and foreign direct investment. Transport improvements have implications for the location of industry and can increase the size of the market that companies can serve, with attendant productivity gains.⁶

For the last 30 years, transport infrastructure investment in Portugal has been highly intensive, focused mostly on roads, and particularly the development of the motorway network, but also covering railways (electrification of several long-distance lines and capacity increases in suburban lines), airports (new terminals in Porto and Faro, several marginal capacity increases and a new cargo hub in Lisbon) and sea ports (specialised terminals and railway links in all ports). This emphasis was confirmed in the 2005 Plan for Investment in Priority Infrastructure. ITF data show that between 1992 and 2010 Portugal's investment in inland transport infrastructure amounted about 1.2% of its GDP, to be compared with an OECD average (excluding Japan) of approximately 0.8%.

Financing issues

A key issue regarding infrastructure in Portugal is funding arrangements. Reliance on availability-based PPPs, notably in the case of highways since 1998, has adversely affected public finances. Between January and September 2012, government loans amounting to EUR 851 million were extended to *Estradas de Portugal* (the public agency operating highways), as at the height of the financial crisis no bank finance could be secured. The PPPs are being restructured, and all public corporations within administrations are included in the 2012 budget, so that liabilities are now more transparent (see Part 3). The scarcity of national funding has increased reliance on user charges, and this can improve efficiency if the charges are well structured. However, the renegotiation of motorway concessions has transferred back to *Estradas de Portugal* a significant part of the responsibility for maintenance, with expected savings but also increased risk. A sustainable model to sufficiently fund this publicly owned company is therefore needed to avoid quality-of-service problems in the future.

⁵ Sutherland, D., S. Araujo, B. Egert, and T. Kozluk (2009), "Infrastructure investment: links to growth and the role of public policies", *OECD Economics Department Working Papers*, No. 686, OECD, Paris.

⁶ Combes, P.P., T. Mayer and J.F Thisse (2008), *Economic geography: the integration of regions and nations*, Princeton University Press.

The current pressure on Portuguese public finances and the associated consolidation process more generally imply that public investment has to be selective, and that efficiency needs to improve. Privatisation of transport can also help relieve the fiscal strain, at least temporarily. Public transport in Lisbon and Porto is slated for privatisation, the freight rail operation CP Carga is up for sale in 2013, and the airport operator (ANA) has been privatised. Other new revenue sources include the levying of tolls on all former SCUT motorways (freeways), since the last quarter of 2011.

Cutting costs and raising prices will not close the financial gap of certain public transport companies, implying a need for subsidies. Environmental externalities as well as returns to density may justify such subsidies, although, in line with the *OECD Guidelines on Corporate Governance of SOEs*, it is important that any such subsidy be explicit and shown in the government's accounts, as a return for an agreed level of services, rather than being in the form of an accumulation of non-transparent losses. To this end, the Government has started to sign Public Service Contracts and expects to extend this practice to all transport companies by the end of this year. Public transport companies should continue to be required to achieve at least operational break-even after subsidies under such an agreement or face corrective actions.

Road

The motorway network is now more than six times as extensive as it was in 1990. Coverage indicators are high by EU standards, both in per capita and per square km terms. According to Eurostat data, in 2010 Portugal had 0.26 km of motorway per 1 000 inhabitants, versus 0.03 in 1990 and a European Union average of 0.12 km. Road infrastructure and maintenance spending as a share of GDP in Portugal is 25% above the OECD average (Figure 8). The over-emphasis on road infrastructure behind this development has been questioned over the last decade. The marginal returns to road-building decline as the network becomes more developed, and concern about climate change leads to a preference for a modal shift towards rail transport.

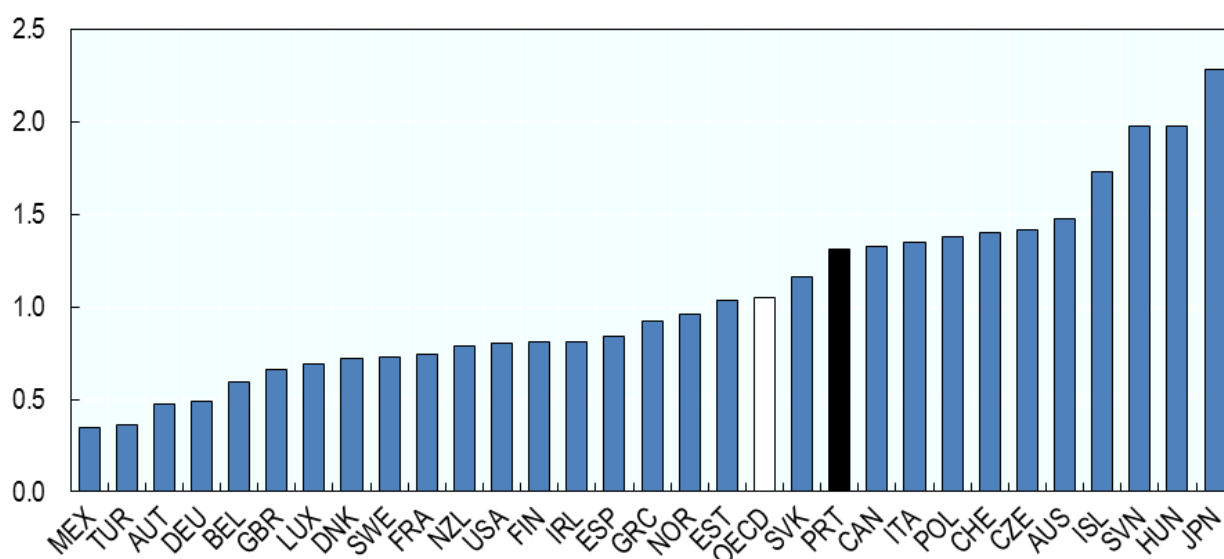
At the same time, there may still be some scope to reduce congestion and travel time through better connectivity⁷, and there is also leeway for increasing road pricing.

Congestion is already a significant concern in the two main metropolitan areas, which increases commuting time.⁸ By contrast, the average degree of congestion is still relatively low in the rest of the country. In addition to better public transport, there is room for higher and more finely differentiated road user charges. As in many OECD countries, road pricing is underdeveloped. Furthermore, tolls are differentiated only by vehicle type and hence have very low effectiveness in addressing externalities. In cities, parking fees are the only existing form of road pricing. Although in use in many municipalities, their degree of differentiation is modest, as are the amounts collected.

⁷ OECD (2012), "International Benchmarking of Road Transport Infrastructure and Performance: Measurement and Policies", *OECD Economics Department Working Papers*, WP1, No. 19, OECD, Paris.

⁸ In the 2010 Eurotest inspection of local public transport systems, Lisbon ranked only 22nd out of 23 European cities as regards travel time. See <http://www.eurotestmobility.com>.

**FIGURE 8. INFRASTRUCTURE AND MAINTENANCE SPENDING ON ROADS
PER CENT OF GDP, AVERAGE 2001-09¹**



1. Data refer to: 2001-08 for Australia, Greece, Italy, Japan, Luxembourg, Norway, Sweden and Switzerland; 2001-07 for Austria, Korea and Portugal; 2004-09 for Hungary; and 2001-03 for the United States. The OECD aggregate is an unweighted average of data shown.

Source: H. Braconier, M. Pisu and D. Bloch (2013), "The Performance of Road Transport Infrastructure and its Links to Policies", OECD Economics Department Working Papers, No. 1016.

Railways

Against the need to reduce excessive reliance on road transport, the authorities have developed an ambitious integrated approach for railways. Expanding rail capacity can be expected to have growth benefits and boost private investment, more than investing in roads,⁹ and the growth-enhancing effect of improved rail infrastructure particularly great for rail freight. Two of the authorities' main objectives have been to enhance the connections with Spain and intermodal platform development, both of which aim to reduce the freight costs associated with Portugal's geographical location at the edge of Europe. These include an improved freight train connection between Madrid and the main ports in the south (the project *Linha de Transporte de Mercadorias*). Ultimately, these improved connections are to be extended to ports in the north of the country. The authorities expect the project to decrease exporters' costs by 40% and to increase rail freight capacity by 80%.

However, investments in physical capacity are necessary but not sufficient, and they should be accompanied by efficiency gains in railway operations as well as by an expansion of the capacity and sophistication of the associated logistical systems.

The government has been promoting competition in railway freight operations since 2007 by granting access to new operators and, in line with EU directives, the freight market is now open to any company that meets certain financial and technical requirements. This welcome initiative to improve competitive conditions requires careful design of a

⁹ Employment effects may be lesser than for road transport, however. Furthermore, the spatial distribution of productivity benefits from rail investment is likely to be highly uneven, being particularly large in the Lisbon area and in the North. Thus there appears to be a trade-off between reducing regional disparities and raising overall growth.

transparent price-setting mechanism that would encourage efficient use of scarce network capacity while preserving incentives to maintain quality and expand capacity as appropriate. The government should ensure that access prices are set in a clear and transparent way; moreover, total costs of the track operator could be benchmarked internationally to minimise the need for subsidies, in case the access fee is set below full recovery cost. By international standards, the charges by the national rail track company, REFER, for utilising and managing infrastructure are below average, particularly for freight, and REFER is incurring large, albeit declining, operating losses.

The government has also announced the privatisation of the freight branch of the State-owned rail operator *CP Carga* in 2013. The structural separation of the main rail terminals currently owned by CP Carga, ensuring non-discriminatory access to all rail freight operators, should precede privatisation, as it is important to have a pro-competitive framework in place before privatising.¹⁰

Going further in the gradual liberalisation of the railways, Portugal is now ready to consider establishing free entry (subject to access fees) in passenger transport as well, which would further boost productive efficiency and service quality. Lasting improvement of the performance of the national operator of train services, *Comboios de Portugal* (CP), may also require further rationalising networks in addition to the rationalisation carried out in 2011/12 by continuing to close under-utilised and unprofitable lines and replacing them with bus services (where viable).

Ports

Promoting competition in the port sector is complementary to increased integration of the port and railway network, which is expected to make it easier for customers to choose between ports. Port improvements have significant potential to reduce transport costs and enhance logistics in the distribution sector. Improved connections between ports, notably Sines, and the European hinterland would improve the ports' competitive position.¹¹ To this end, combined efforts should be undertaken with the neighbouring Spanish authorities on transition to European gauge. Another important element for ensuring strong competition is a transparent tendering process, without the possibility for incumbents to renew concessions other than by going through a new tender. This would encourage more firms to enter the industry, which currently features little contract-switching. A new performance-based model for future concessions also is being developed and should improve operational incentives. An ambitious revision of the legal framework governing port work, which was submitted to Parliament in September and has been in effect since 1 February 2013, substantially lowers wage costs and removes constraints on labour optimisation. Port use fees have already decreased by 20%.

¹⁰ Ten years after the adoption of the 2001 OECD Recommendation concerning Structural Separation in Regulated Industries, experience shows, notably in the railway sector, that structural separation remains a viable strategy to advance market liberalisation. See <http://www.oecd.org/daf/competition/50119298.pdf>.

¹¹ The market potential of the port of Sines is strengthened by the upgrading of the Panama Canal, as this boosts the attractiveness of non-Suez routes and favours the use of deep-water sea ports. Investments in Sines itself would also strengthen the port's competitive position.

- ✓ Policies to improve public infrastructure should be pursued, **but investments must be selective and rely on cautious and transparent cost-benefit analysis**. The fiscal implications of multi-year contractual spending commitments under PPPs and concessions should be fully transparent.
- ✓ **Increase the efficiency and profitability of SOEs**. Ensure effective performance monitoring and further reduce the scope of the public enterprise sector.
- ✓ **Increase reliance on user charges** to improve the sector's financial health and increase its efficiency.
- ✓ Combine investments in the physical capacity of railways **with efficiency gains in their operations**.
- ✓ **Enhance competition in the port sector**, in particular by encouraging more contract-switching in the tendering process for concessions.

Chapter I.3. Boosting innovation

Innovation has a major role to play in boosting productivity and non-cost competitiveness. Portugal's research system has improved significantly in recent years, and Portugal has invested heavily in scientific human capital. Despite the recent increase in private-sector investment and progress in the ability to translate research into innovation, strengthening industry-science linkages (e.g. business funding of public research, university start-ups or mobility of human resources) remains a major challenge.

To enhance its innovation performance, Portugal needs to increase the impact of existing public research while strengthening the innovation performance of its industrial sector. Boosting Portugal's innovative capacity also requires improvement in the overall business environment, as well as in the skills of the labour force.

Strengthening the commercial impact of public research

Gross expenditure on R&D (GERD) had expanded by 15.9% annually between 2005 and 2010, as a result of an intensive effort by the government to upgrade the national innovation capacity. However, and even if the current level is nearly double that of 2005, it has declined slightly since 2009 due to funding cuts.

More could be done, however, to increase the impact of existing public research. Portugal performed well in terms of patents filed by universities and public research institutions between 2005 and 2009, but the share of public R&D expenditures financed by industry as a percentage of GDP was at the bottom of the OECD in 2009,¹² and the creation of new high-tech firms from academia has also been weak. Recent reforms, such as the revision of university statutes, intend to facilitate inter-sectoral mobility by allowing university teachers to move to companies to develop projects. Furthermore, the Strategic Programme for Entrepreneurship and Innovation (+E+I), launched in December 2011, includes a host of measures aimed at promoting knowledge transfers from academia to industry.

As in other countries, in addition to measures to support entrepreneurship, the main areas for policy actions are measures to improve the ability of university tech transfer offices (TTOs) to link with industry, *inter alia* through support for academic patenting. OECD evidence on university tech transfer suggests that the effectiveness of TTOs in linking with business depends on critical mass and expertise, proper organisational structures and proper incentive schemes. The weak performance of TTOs in many countries has led to efforts to consolidate operations and develop new organisational models and incentives that could be useful examples for Portugal. One example is the Idea Evaluation initiative at Chalmers' University of Technology in Sweden, which brings together entrepreneurs and senior academics to evaluate the commercial potential, including the business plans, of student inventors and entrepreneurs. In Finland, the Aalto Centre for Entrepreneurship (ACE) offers innovation, marketing and start-up services for Aalto University researchers, students and other stakeholders. In addition, it facilitates innovation and growth entrepreneurship by developing research and education in these fields across all Aalto schools.

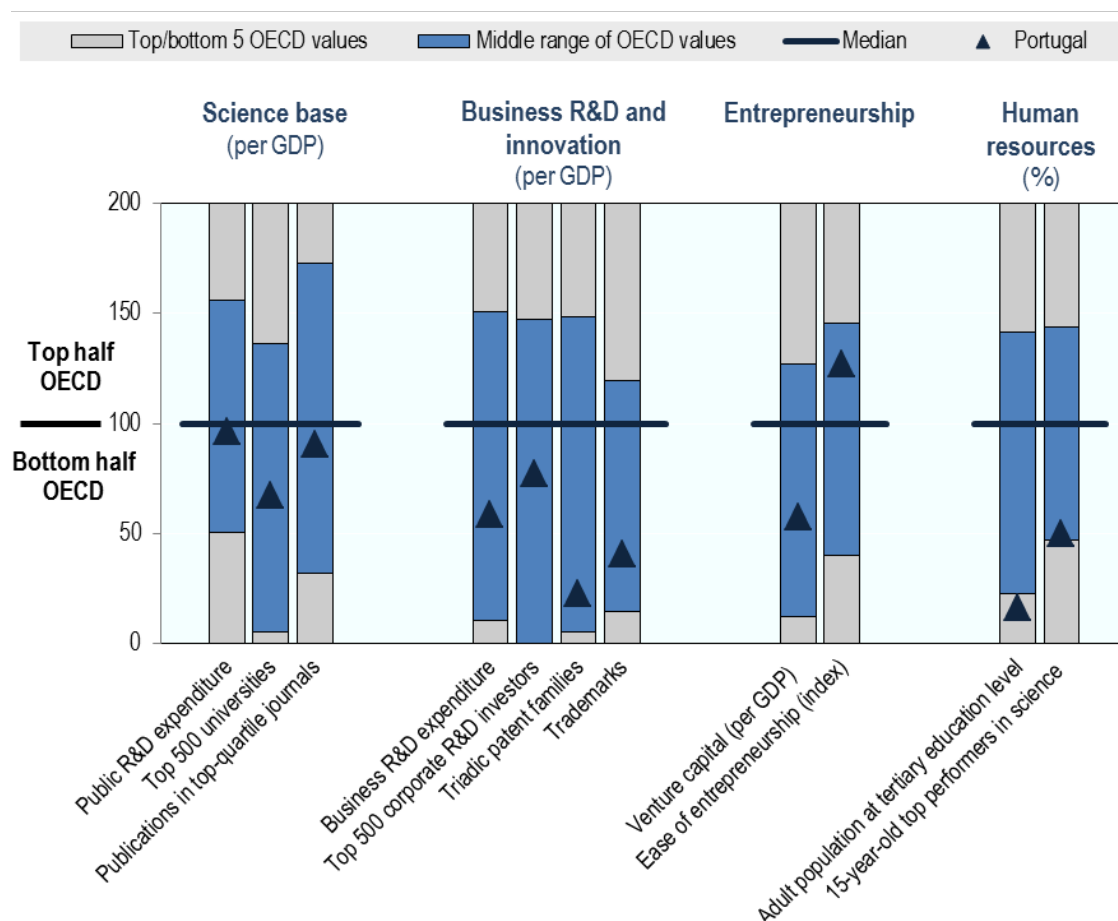
¹² For instance, in 2010 businesses funded 0.6% of higher education R&D in Portugal, versus 6.2% in the EU (see *OECD Main Science and Technology Indicators 2012-2*).

Strengthening industrial innovation and entrepreneurship

The innovation performance of Portuguese industry remains modest, in terms of patents and trademarks. That corresponds to a relatively low level of BERD (0.7% of GDP in 2011 versus an OECD average of 1.6%) (Figure 9). Portugal has few large R&D-performing firms and few entrepreneurial firms. Venture capital (VC) expenditure remains low. In 2011, the total amount of venture capital invested in SMEs fell significantly to EUR 12.9 million, 87% less than in 2008, due to investors' extreme risk aversion as a consequence of the financial crisis (OECD, *SME Financing Scoreboard*). As a consequence, the Government implemented a new strategy, concentrating resources for public VC investments through the merger of three public VC operators into a single entity – Portugal Ventures – to invest in innovative entrepreneurial projects with global potential and based on internationally referenced R&D.

Strengthening business innovation is a major challenge for Portugal. Public support for business R&D and innovation is mostly indirect (provided through tax credits).¹³ Raising the business sector's innovative capacity will also require continued efforts to make the business environment more conducive to innovation by reducing administrative burdens on business and strengthening competition (see Chapter I.1).

FIGURE 9. COMPARATIVE PERFORMANCE OF PORTUGAL'S SCIENCE AND INNOVATION SYSTEM, 2011



Source: OECD Science, Technology and Industry Outlook 2012

¹³ According to OECD figures, direct support (subsidies and procurement) to R&D represented €55 million (2010), while indirect incentives – the SIFIDE tax credit scheme – amounted to about €426 million (2010).

Strengthening the skills composition of the labour force

Increasing Portugal's innovative capacity also implies raising the level of human capital, with regard to industry's needs in particular (see Chapter I.4). Although human capital remains a major bottleneck, with only 15% of the adult population possessing tertiary-education degrees in 2010, the proportion of science and engineering (S&E) graduates in 2009 was above the OECD median, as a result of significant investment in universities over the recent past. The efforts should focus on medium-level skills in the labour force, entailing investment in secondary and tertiary (but not necessarily PhD) education. Special efforts to strengthen the managerial skills of Portuguese entrepreneurs are also needed to enhance the innovation capacity of business sector.

Against this background, the Government is reorganising its Vocational and Education Training (VET) system to further align it with market needs and is discussing the creation of professional schools of reference in some specific sectors (see Chapter 1.4).

Promoting eco-innovation

Harnessing innovation to improve environmental performance can lead to new industries and new jobs in the coming years. Environmental companies and related employment have increased in recent years, especially in the renewables, waste and water sectors. The wind and solar energy clusters represent good examples of green development, merging generation of power from renewable sources, production of the necessary technology and equipment, and job creation. However, the trade balance in environmental and renewable energy technologies is still in deficit. Employment in the environmental goods and services sector is still composed mainly of low-skilled workers.

Portugal should therefore consider further promoting eco-innovation, with a view to enhancing productivity, international competitiveness and the growth prospects of its economy. This would require a comprehensive framework for promoting eco-innovation and employment in eco-industries, including increased public support for R&D. In the current fiscal context, such an increase could be supported by the EU structural funds (that provide funding for R&D, ICTs and innovation as part of regional smart specialisation strategies) or by reserving or ring-fencing funds from the sale of State-owned assets for R&D investment, as Norway and Chile have done. This comprehensive strategy should also include improved co-operation among competent authorities and with universities, the private sector and financial institutions, and investment in higher education and training. Last, it would entail "greening" jobs in strategic sectors of the economy. In particular, eco-innovations create new employment opportunities in areas such as tourism and industry. Portugal has already had some success in promoting eco-innovations in textiles, ceramics, aeronautics, waste management and electricity distribution (via smart grids).

Key OECD recommendations

- ✓ **Create stronger incentives and better channels for marketing academic research**, for example by encouraging entrepreneurship at universities and engineering schools.
- ✓ Improve framework conditions for entrepreneurship.
- ✓ Sustain investment in secondary and tertiary-level education (but not necessarily PhDs).
- ✓ Develop and implement a comprehensive framework for promoting eco-innovation and employment in eco-industries.

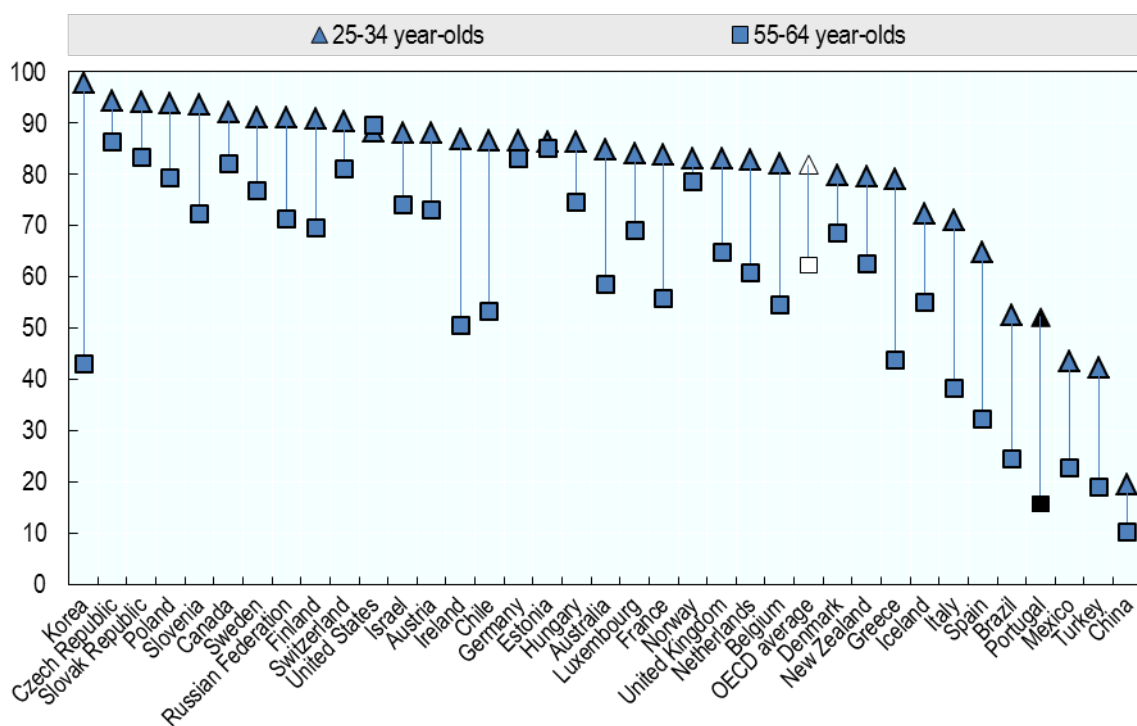
Chapter I.4. Promoting skills development

Human capital shortage is a key obstacle to higher productivity and growth in Portugal. Low educational levels across the workforce are a major reason for Portugal's productivity gap, as they limit the ability of firms to move away from low-productivity activities and adapt to technological change. At the same time, the education system in Portugal does not seem to perform well in equipping youth with the skills needed in the labour market.

Promoting skills development requires further improvements in both initial education and adult training. Both can be achieved to some extent by improving the efficiency of existing spending.

Portuguese youth are today entering the labour market with higher attainments and better skills than previous generations. However, there is still a long way to go, with only 32% of the working-age population (25-64) having attained upper-secondary education in 2010, compared with an OECD average of 74% (Figure 10).

FIGURE 10. POPULATION THAT HAS ATTAINED UPPER SECONDARY EDUCATION¹ (2010), PERCENTAGE, BY AGE GROUP



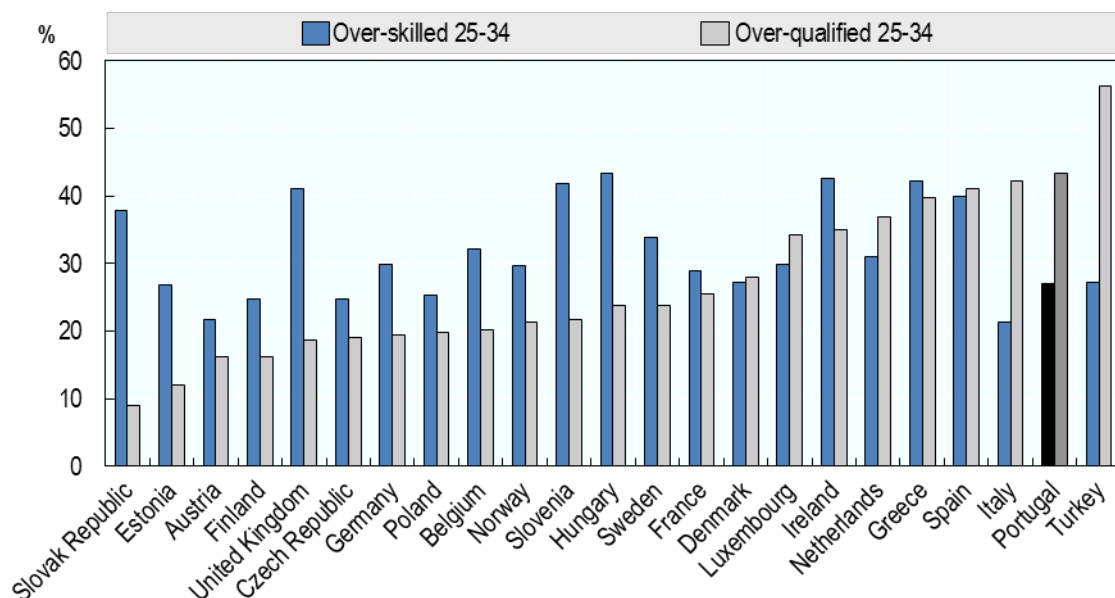
1. Excluding ISCED 3C short programmes.

Source: *Education at a Glance: OECD Indicators 2012*, Chart A1.2

In addition, while Portugal ranks among the countries with the highest incidence of over-qualification – with young people being hired in jobs for which they are too qualified – this does not translate into high rates of over-skilling – where young people report feeling that they could cope with more demanding tasks at work (Figure 11). An explanation is that young people's qualifications do not fully translate into work-relevant skills, and they are hired for jobs that could be carried out with a lower qualification level. Another explanation is that the increase in the share of tertiary and upper-secondary graduates in the country has not been matched by an increase in the demand for workers with these qualifications –

as firms take time to adapt their productive processes to the availability of a more highly skilled workforce. If this is the case, innovation policy may help make better use of available human capital (see Chapter I.3).

FIGURE 11. OVER-QUALIFICATION AND OVER-SKILLING AMONG 25-34-YEAR OLDS, SHARE OF TOTAL WORKERS IN AGE GROUP



Source: OECD calculations based on the European Survey of Working Conditions, 2010.

Improving skills through better initial education

The Government has implemented a series of measures to address education-related challenges. Investment in school-based teacher training and school leadership, a consolidation programme to create larger school units, and the introduction of school evaluation routines yielded significant gains in the 2009 PISA test scores for reading, mathematics and science. In addition, since 2012 compulsory education continues up to the 12th grade (18 years old) instead of 9th grade. Despite these significant achievements, many children still do not make satisfactory progress at school. This is reflected in high rates of grade repetition, which is an ineffective and costly way to support poorly performing students. Schools in which a high percentage of students have repeated one or more grades tend to perform poorly in PISA, even after accounting for the students' socio-economic and demographic backgrounds. Providing extra teaching time for students who fall behind and taking into account their needs so that they can catch up with their peers is a much better way of supporting those with learning difficulties than grade repetition. Moreover, such support is not necessarily more costly than grade repetition, which accounts for almost 10% of annual national expenditure on primary and secondary education (Box 2).

Box 2. Calculating the cost of grade repetition

Grade repeaters: The number of 15-year-old students who have repeated a grade at least once in primary, lower-secondary or upper-secondary schools (i.e. cumulative number of 15-year-olds who have repeated a grade at least once) is computed based on students' responses to Q7a, Q7b and Q7c of PISA 2009 Student Questionnaire

(http://pisa2009.acer.edu.au/downloads/PISA09_Student_questionnaire.pdf)

Costs. The costs of grade repetition are estimated by adding the direct and opportunity costs. The direct costs consist of the costs of education systems providing an additional year of education. The opportunity costs consist of the costs of delaying students' entrance to the labour market by one additional year. The opportunity costs are estimated based on the following two assumptions: repeaters attain at most lower-secondary level (Scenario A), and repeaters attain around the national average education level (scenario B).

Based on Scenario A, the total annual costs of grade repetition in Portugal are 9.6% of total expenditure on primary and secondary education. Based on Scenario B, the total annual costs of grade repetition in Portugal are 12.5% of total expenditure on primary and secondary education.

The detailed descriptions of indicators used for the computation and calculations are presented in the <http://www.oecd.org/pisa/pisainfocus/48362484.pdf>

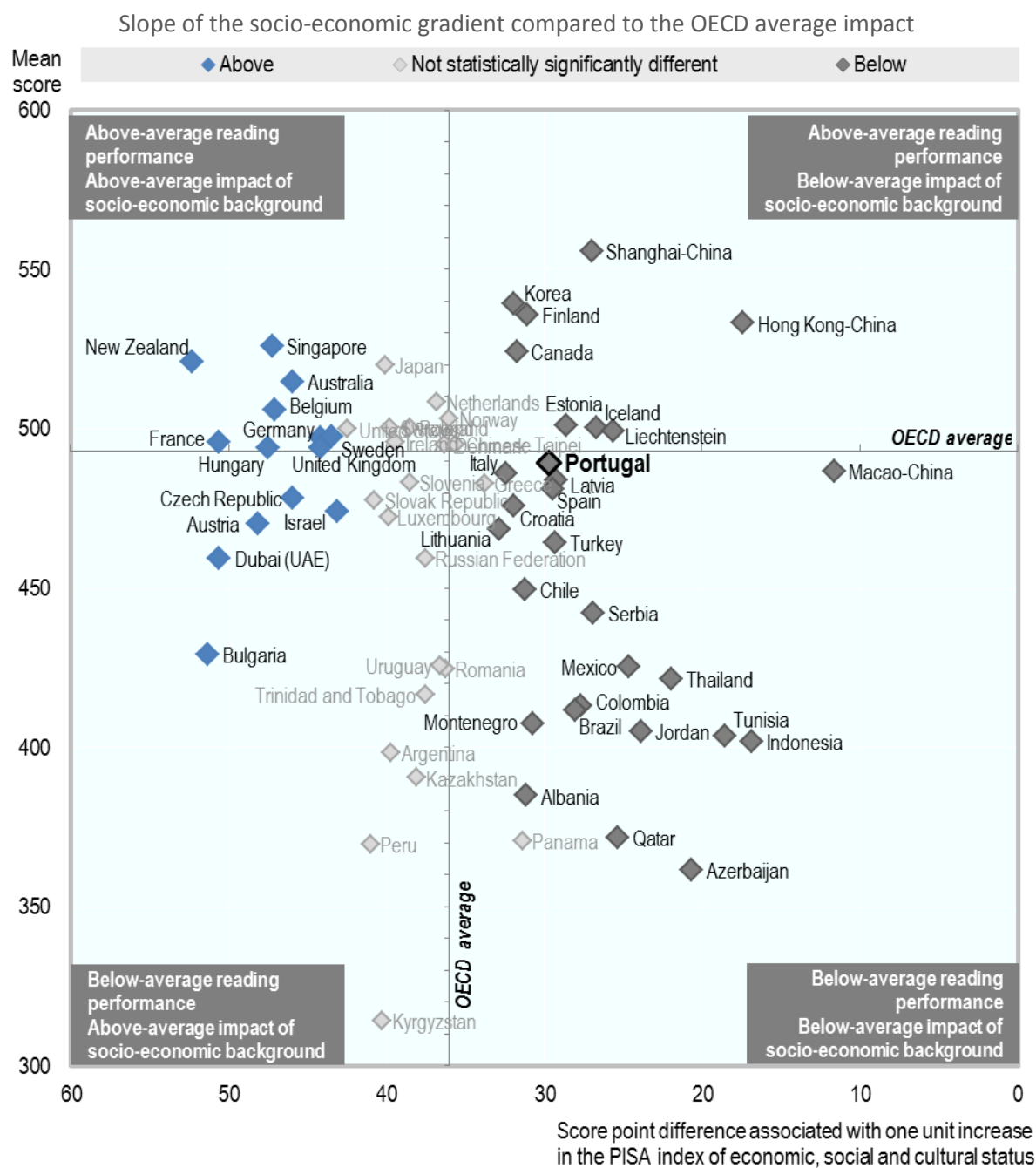
In 2012 several measures were taken to improve students' performance, reduce grade repetition and school drop-outs. While the impact of socio-economic background on students' PISA performance in Portugal is below average (Figure 12), an important equity issue is indeed associated with drop-out, which remains strongly linked to socio-economic background. These measures include the reinforcement of study support and support to students with learning difficulties, and the creation of temporary groups with homogenous support needs, exceptional alternative educational paths tailored to students most in need.

Furthermore, the Government relies on several pillars to improve the performance of the education system including: (1) strengthening student's essential knowledge base, including through the strengthening of curricula, definition of curriculum standards and teaching hours in core disciplines; (2) enhancing the quality of teaching, with the aim of improving the match between actual needs and current skills, and making better use of already installed capacity in the training centres; and (3) strengthening evaluation, including by implementing national exams at the 4th, 6th and 9th grades in both Portuguese and Mathematics.

In this context, it is also worth reconsidering the structure of spending. While the small size of classes explains most of the differences in salary costs compared to the OECD average (Figure 13), OECD analysis suggests that better teachers have a greater impact on students' outcomes than small classes.

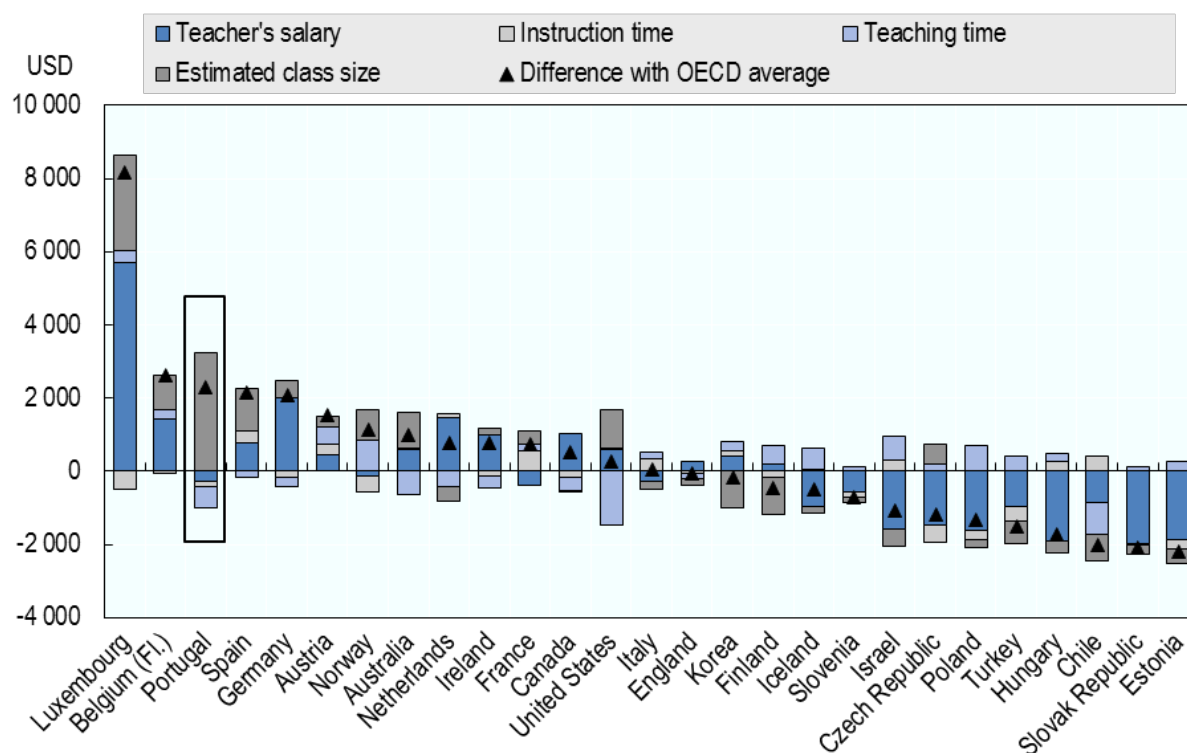
Improvements could also be achieved through greater use of school, teacher, and student evaluation tools to provide targeted and timely support where it is most needed. This requires a greater focus on progress in the evaluation and assessment system, as initiated for the 2012-13 school year; collecting information over time on individuals and cohorts; instituting development appraisal to complement the current assessment appraisal for teachers; and shifting resources towards a system-wide analysis of outcomes.

FIGURE 12. EDUCATION QUALITY AND EQUITY



Source: OECD PISA 2009 Database, Table II.3.2.

FIGURE 13. CONTRIBUTION (IN USD) OF VARIOUS FACTORS TO SALARY COST OF TEACHERS PER STUDENT, AT UPPER-SECONDARY LEVEL OF EDUCATION (2010)



Source: OECD Education at a Glance. Table B7.4. (www.oecd.org/edu/eag2012).

Ensuring a better match between education and the needs of the economy

Policy actions to improve the match between skills acquired at school and labour market needs include more employer involvement in setting school/university curricula and more work-experience opportunities while studying.

Portugal should do more to make the most of its vocational education and training (VET) system. The Government should first ensure that the right input mix is put in place so that VET programmes both provide basic business skills and preparation for self-employment, and help to cope with the demands of new industries and technologies. This means, in particular, giving students adequate career guidance to assist them in course selection and fostering a close partnership with business to ensure that training is relevant to the labour market and students have substantial workplace learning experience. Recent policy initiatives, such as giving firms more influence over training choice and attempts to better target training, are a move in the right direction, but it will be important to continue tracking the labour market outcomes of training participants and adjust programmes accordingly.

The experience of OECD countries might help Portugal to overcome some of the main challenges in building up a more effective VET system. The cases of Denmark and Switzerland are a good illustration of the importance of effective employer engagement. In these countries, at least 75% of students enrolled in VET programmes spend at least half of the programme in the workplace. As a result of this employer involvement, students and their families see the labour market value of the programme, while employers benefit from lower hiring costs and productivity gains in the long run.

The Government plans, for the 2013-2014 school year, to give more focus to the technical component and the education/training in work context and to create Professional Schools of Reference in key areas, in partnership with private companies.

Supporting adult training

A country can also develop the skills it needs by encouraging and enabling people to learn throughout life by means of on-the-job training and training for adults. This is particularly important in Portugal given the large share of the population with low educational achievements and the lags involved in education reforms to improve the skills of the workforce. Based on previous adult skills surveys, Portugal displays some of the lowest levels of key information-processing skills of all the countries studied. Participation rates in job-related training among the adult population remain below the OECD average, especially among the younger age groups. Improved levels of key information-processing skills, such as literacy and numeracy, should yield significant economic and social benefits to Portugal. Gains can be amplified by the successful implementation of active measures to foster the demand for such skills in the economy and society. Of particular concern is the fact that widespread levels of low proficiency in these key skills can generate poor health outcomes and low participation in adult training, in addition to low productivity levels.

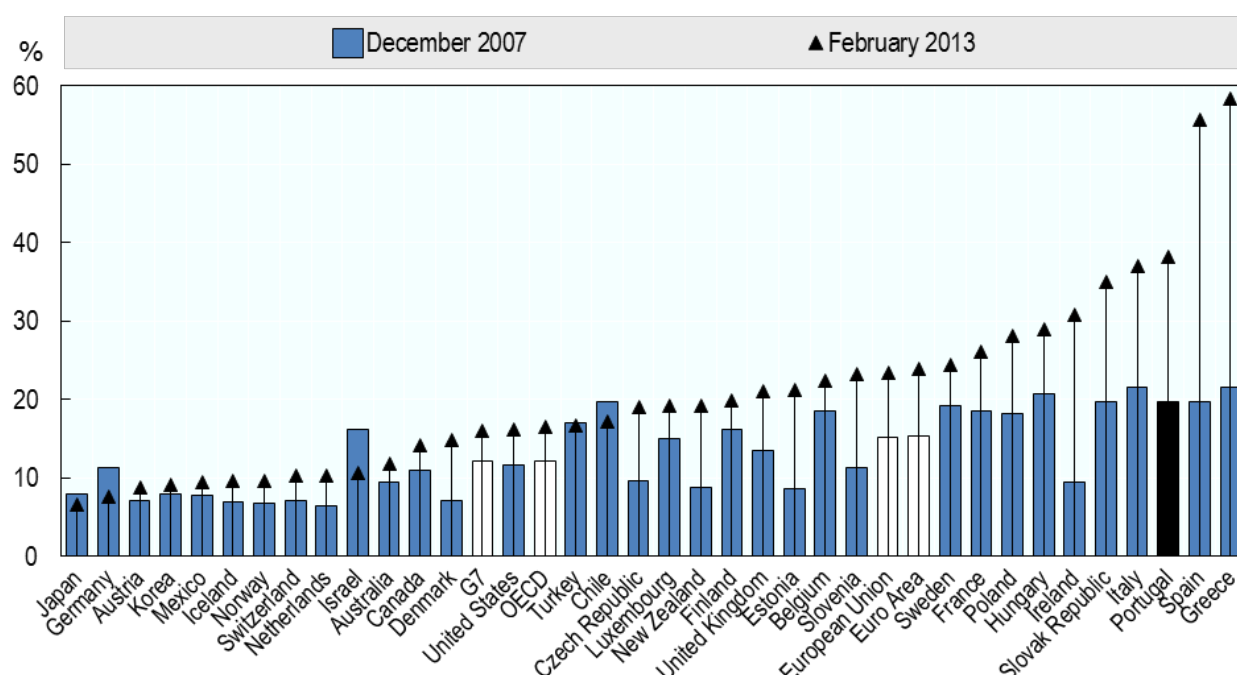
A new network of centres will build on the *Novas Oportunidades* programme and continue to promote qualifications, with a strong focus on informing, orienting and placing young people and adults in either VET, further studies or employment. The Portuguese Government's National Reading Plan, launched in June 2006, is another important step towards improving the development of key information-processing skills in the country. But the plan needs to be complemented by additional efforts to improve the quality of initial schooling and to build an effective system of adult education and training.

Avoiding the human capital scars of the crisis

The deep and protracted economic crisis and the associated increase in long-term unemployment (see Chapter I.5) may lead to human capital depreciation and withdrawal from the labour force, with permanent effects on levels of productivity and growth. Training and job search support for young people, who were very badly hit by the Great recession, and more generally for the long-term unemployed, is therefore important.

The recent crisis resulted in a 20-percentage-point increase in the youth unemployment rate, which stood at 39% in November 2012, the third highest in the OECD after Greece and Spain (Figure 14). Contrary to the situation in most OECD countries, it is young people with tertiary qualifications who had the highest unemployment rate, at almost 41% in November 2012. However, the youth unemployment rate differential across qualification levels shrank as a result of the crisis, as young people without qualifications were much more adversely affected than highly qualified youth; their unemployment rate rose by 23 percentage points, compared with just 8 percentage points for their highly qualified counterparts.

FIGURE 14. YOUTH UNEMPLOYMENT RATES, DECEMBER 2007-FEBRUARY 2013 ^{1,2}
SHARE OF TOTAL WORKERS IN AGE GROUP



1. For Israel, the series have been chained to take into account the break series in 2012.
2. December 2012 for Greece, Italy (number of unemployed only), Norway, Slovenia, Turkey and the United Kingdom; January 2013 for Chile, Estonia and Hungary; March 2013 for Canada and the United States; 2012 Q4 for New Zealand and Switzerland.

Source: OECD calculations based on the OECD Short-Term Indicators Database.

The share of young people neither in employment nor in education or training (NEET rate) – at close to 13% in 2011 – was below the European and OECD averages. The number of inactive young people not enrolled in education declined in the aftermath of the great recession, which limited the increase in NEETs despite the rise in youth unemployment. The incidence of long-term unemployment among unemployed young people was also relatively stable following the crisis. At 34.4%, it stood somewhat above the EU21 in 2011, although it was 10 percentage points higher than the OECD average.

Tackling youth unemployment in the current context of tight budgets requires investing in cost-effective labour market measures. For unemployed young people, particularly those without work experience, job-search support when they register at the public employment service has proven very effective and relatively inexpensive. On the other hand, the long-term unemployed and the low-skilled who are at higher risk of becoming NEETs need more focused help, including training and subsidised work experience opportunities.

To reduce the existing NEET rate, Portugal would have to tackle the group of disadvantaged youths who are totally inactive – not employed, not in learning and not looking for work. For this group, comprehensive programmes, possibly residential, with a focus on work-based learning and a strong adult mentoring component, are the only initiatives that, while costly, have proven successful internationally. The United States Job Corps is an example of good practice in this area. The Job Corps programme targets young people aged 16-24 from low-income backgrounds who face one or more barriers to employment, such as lacking qualifications or being a foster child, a teenage parent or a homeless youth. Most participants reside in campus-like housing and engage in academic education and vocational training aimed at attaining an upper secondary qualification. The programme

also involves adult mentoring and placement services to help young people find work when they complete their schooling. Most, although not all, of the rigorous evaluations conducted have shown that the programme, while expensive, is cost-effective.

More generally, to prevent the cyclical rise in Portugal's unemployment from becoming permanent and leaving the associated long-term scars, it is essential to strengthen the effectiveness of active labour market programmes (ALMPs), in particular in terms of counselling, placement and job-search assistance (see Chapter I.5).

Key OECD Recommendations

- ✓ **Use evaluation systems to raise educational attainment:** track individuals and cohorts over time to inform policy changes and ultimately improve the learning outcomes of children from lower socio-economic backgrounds.
- ✓ **Reduce grade repetition** by investing in alternative ways of supporting those with learning difficulties.
- ✓ **Involve employers in updating vocational education and training curricula development,** monitor the labour market outcomes of participants, and adjust programmes accordingly.
- ✓ **Build an effective system of adult education and training** to help develop the key information processing skills that are currently in deficit.

Chapter I.5. Improving labour market performance

Productivity growth in Portugal has also been held back by the segmentation of the labour market, which limits the mobility of permanent workers and thus the market's ability to match jobs with workers, and discourages human capital accumulation by temporary workers. In addition, it places most of the burden of adjustment on temporary workers, contributing to widening inequality. In addition, and despite recent measures to limit it, administrative extension of collective agreements continues to stifle competition - as dominant firms use it to avoid being undercut by new competitors - and is weighing on competitiveness.

A key priority, to complement other reforms to remove obstacles to job creation, is therefore to push ahead with measures to reduce labour market segmentation and ensure that wage developments are more in line with productivity. The reduction of segmentation, combined with more equitable unemployment benefits and better support for job-seekers, is also key to upholding social cohesion.

At 15.7%, Portugal's unemployment rate was well above the OECD average of 8% in 2012; and, at 54%, long-term unemployment was very high. Furthermore, the youth unemployment rate has increased markedly since the onset of the global economic crisis, reaching a historic high in 2012 of nearly 38%, more than twice the corresponding rate for the OECD area (16%). These poor labour market outcomes seem to reflect a combination of weak aggregate demand compounded by structural shortcomings in Portugal's labour market. The latter relate, in particular, to the areas of employment protection, wage bargaining, active labour market policies and unemployment benefits which, consequently, have been the focus of reform. Fostering labour mobility and retraining may also be necessary to accommodate the structural shift to a more dynamic tradable sector.

Addressing labour market segmentation

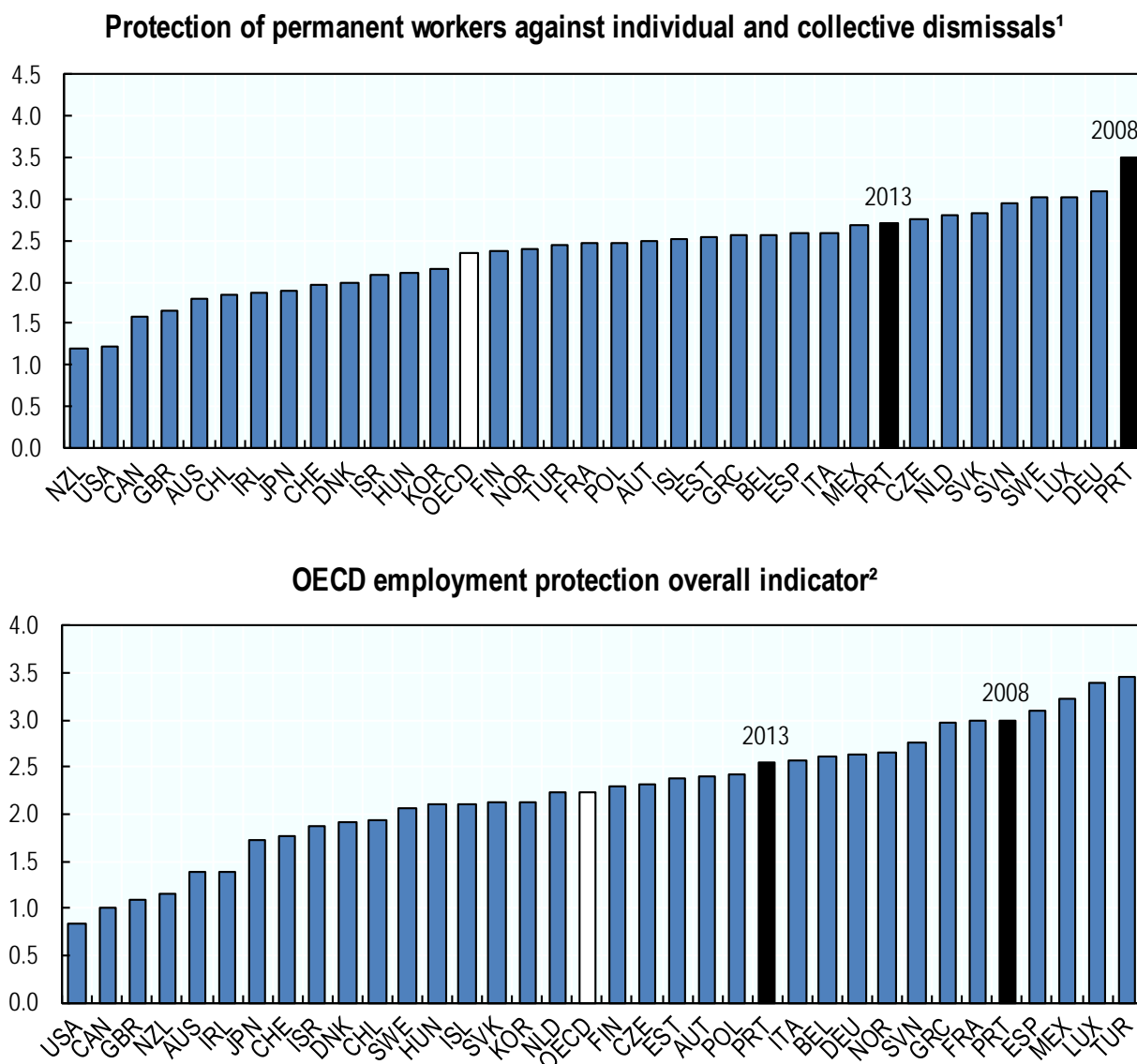
Recent reforms have brought employment protection for regular standard contracts in Portugal closer to the OECD average and should help address labour market segmentation and support productivity growth.

While the 2009 Labour Code reform had left Portugal with the highest level of protection for permanent workers in the OECD, reforms introduced in 2011 and 2012 have noticeably reduced it (Figure 15).¹⁴ Individual dismissals for economic reasons no longer need to adhere to a pre-defined order of seniority, while those based on worker capability have become possible in a wider range of circumstances. In both cases, the obligation to transfer the employee to another suitable position was eliminated. 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 a further reduction has been announced for before the end of 2013. Existing contracts preserve entitlements accrued under the old rules, thus preventing the risk of short-run adverse employment effects in the current difficult economic climate. The change in employment protection legislation reported above since 2008 would suggest that these

¹⁴ The main amendments include encouraging the use of flexible working time arrangements, a reduction of the amounts due in case of overtime work and the elimination of four public holidays and of the employee's entitlement to three additional vacation days per year based on seniority. Moreover, the reform included a revision of the legal framework on reduction/suspension of the employment contract for economic reasons.

reforms should contribute to boost the level of productivity and potential GDP. By reducing the labour market segmentation that condemns many workers, especially younger and unskilled ones, to insecure employment, the reform will also foster equity and social cohesion.¹⁵

FIGURE 15. STRICTNESS OF EMPLOYMENT PROTECTION LEGISLATION ACROSS THE OECD
SCALE FROM 0 (LEAST STRINGENT) TO 6 (MOST RESTRICTIVE),
2008 FOR OECD COUNTRIES, 2008 AND 2013 FOR PORTUGAL



1. Weighted average of two sub-indices: protection of permanent workers against individual dismissal and specific requirements for collective dismissal.
2. Weighted average of three sub-indices: protection of permanent workers against (individual) dismissal, regulation of temporary forms of employment and specific requirements for collective dismissal.

Source: OECD Employment Protection Database; OECD calculations based on unpublished, revised data for Portugal.

¹⁵ See Chapter II.2. Portugal has the sixth most unequal income distribution in the OECD, and it is the most unequal country in Europe.

Nonetheless, employment protection for permanent workers remains comparatively high. Even though the authorities have reduced severance pay, and will reduce it further before the end of 2013, protection for permanent workers remains higher than the OECD average and could be reduced further. The trial period for open-ended contracts is too short, at 90 days for most workers. Last the introduction of binding arbitration, as an alternative to courts (already in force but only on a voluntary basis), could also help reduce the high costs and uncertainty stemming from lengthy litigation over dismissals.

Reforming wage-setting mechanisms

Wage-setting mechanisms, including for the minimum wage, have until recently been obstacles to regaining competitiveness and job creation for the low-skilled. Wage bargaining takes place mainly at the sectoral level between the trade unions (which have the exclusive right to negotiate on the workers' behalf, although the new labour code allows this authority to be delegated to Workers Councils in the case of corporations with over 150 employees) and employers' associations (generally dominated by the largest firms, which do not necessarily account for the largest share of total sectoral employment). These collective agreements were administratively extended to entire industries (through the *portarias de extensão*), which gave extra clout to those sitting at the negotiating table and effectively stifled firm-level bargaining, discouraging the entry of new firms and competition in product markets. While hourly manufacturing wages slowed as a response to the crisis, and have even been declining over the past two years, these bargaining arrangements have limited such downward adjustment.

In May 2011, the Government froze both the minimum wage and administrative extensions of sector-level collective agreements. The former measure is intended to last over the time frame of the EU-IMF programme (though with possible escape clauses), while the latter lasted until October 2012, when the conditions under which extension can still take place were defined. The authorities have also lowered the threshold above which firm-level bargaining is possible from 500 to 150 workers, though union approval is still required above this new threshold. The authorities are advised to go further by keeping the minimum wage unchanged until there are clear signs of labour market recovery. In the longer run, they should also aim at abolishing administrative extension altogether, which would help support firm-level bargaining and foster more dynamic labour and product markets.

Reducing non-wage labour costs

The authorities have also increased working time by up to seven days per year and introduced more flexible working time arrangements. These reforms should lower unit labour costs in the medium-to-long run, improve competitiveness and facilitate future adjustment through hours worked rather than numbers of jobs. The short-term employment gains from reducing the labour tax wedge on low-skilled workers could be more sizeable (see Chapter II.1).

Reviewing the unemployment benefit system and strengthening active labour market policies

In 2010, and for those covered by the system, unemployment benefits were among the most generous in Europe in terms of benefit level and duration. Benefit duration also increased with age, while tight eligibility requirements limited the coverage of young workers and excluded the self-employed. The 2012 reform of unemployment benefits addressed some of these equity concerns by lowering the minimum required contribution period for unemployment insurance from 15 to 12 months and by extending benefit entitlement to self-employed workers who meet certain requirements.

The reform also tackled some disincentives to work by lowering the ceiling on monthly unemployment benefits to €1048, introducing a 10% benefit reduction after six months and reducing the maximum duration. Under certain conditions, job-seekers who take up a full-time job paying less than their former unemployment benefits are also able temporarily to retain part of the latter. However, the duration remains heavily age-dependent, as larger cuts in the duration of unemployment insurance for older workers are partly offset by longer provision of unemployment assistance.¹⁶ The reform's effectiveness is also undermined by a protracted phasing-in period. The Government is currently assessing how to further reduce benefit dependency, and also the adverse effects on long-term unemployment stemming from the design of the unemployment benefit system. To do so, the authorities are advised to make benefit duration less dependent on age and to shorten it 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 end, if needed.

Reforms to make the unemployment benefit system more equitable and boost back-to-work incentives should go hand-in-hand with active labour market policies (ALMPs), which are crucial to keeping job-seekers close to the labour market and enhancing their human capital. To prevent the cyclical rise in Portugal's unemployment from becoming permanent, and to avert the associated long-term scars, it is essential to strengthen the effectiveness of active labour market programmes, in particular in terms of counselling, placement and job-search assistance. In Portugal in 2010, expenditure on active labour market programmes was 0.7% of GDP, slightly above the (unweighted) OECD average. Active expenditure reportedly increased by about 0.20% of GDP, or about 40%, from 2007 to 2010, but more than half of this increase appears to be attributable to a statistical break in reported training expenditure after 2009. At about USD 2 500 in PPP terms in 2010, active expenditure per unemployed person was less than in most other high-income OECD countries, including low-spending countries such as Italy, Korea, Japan, and the UK, and budget constraints will make it difficult to obtain funding for ALMPs in proportion to the scale of the challenge. Moreover, the effectiveness of Portugal's main activation programmes in improving the long-term employability of participants needs to be assessed.

The Government has consequently launched a set of new ALMP measures, such as *Estímulo 2012* (a hiring subsidy of up to €420 subject to companies providing training) or *Impulso Jovem* (comprising several components, including the reimbursement of social security contributions). Overall, in 2012, more than half a million people benefitted from ALMPs and the outcomes of these measures are being evaluated in order to adjust the programmes as required.

There are several areas in which further steps should be considered. There is substantial scope for improving job search assistance in Portugal, via better targeting of resources, more outreach to employers and better use of available information on job-seekers and posted vacancies. In particular, job centres should more actively manage referrals to programmes so these can target unemployed persons who would benefit the most, and so prevent bottlenecks arising from high demand for participation. Efforts in this direction have already started. Monitoring and sanctions, while very strict on paper, are in practice far less stringent, as proof of job search is often perfunctory and benefit cancellation seldom enforced. Welcome progress has been made in the evaluation of programmes to help the unemployed, and these efforts should be further strengthened and used to channel scarce resources into the most effective programmes.

¹⁶ See OECD Economic Survey of Portugal 2012 for more details.

- ✓ **Continue to tackle labour market rigidity and segmentation** by implementing the already agreed further reduction in severance pay and introducing binding arbitration to settle disputes over dismissals.
- ✓ **Further promote firm-level wage bargaining** by abolishing administrative extension of collective agreements.
- ✓ **Make unemployment benefit duration less age-dependent** and ensure that changes to eligibility prove effective in improving benefit coverage, especially for young workers.
- ✓ **Strengthen the impact of measures to help the unemployed find jobs** through: i) more active management of job search assistance and referrals to labour market programmes; ii) focusing on programmes that improve the employability of participants; and iii) maintaining and improving the system for monitoring the integration of participants into the labour market.

PART II. SUPPORTING EMPLOYMENT AND SOCIAL COHESION WITH TAXATION AND SOCIAL POLICY REFORMS

The State has a major role to play in Portugal's growth revival agenda through taxation and social transfers. Since 2011, the imperative of fiscal consolidation has led to the broadening of the tax bases and increases in tax rates (both direct and indirect), as well as substantial cuts in spending, including in social expenditure.

The key challenge regarding the tax system is to make it more supportive of growth and more conducive to employment (Chapter II.1). Progress made in tax collection efficiency, as well as the measures taken to fight tax fraud and evasion, can do much to improve the fairness of the tax system, while increasing revenue. In addition, base-broadening and the reduction in tax expenditure are already steps towards reducing the complexity of the tax system and eliminating possible distortions in the allocation of resources.

However, high labour taxes, including social security contributions, constrain employment and weigh on competitiveness. By contrast, environmental and property taxes, which are less distortive, are still relatively low. For now, the authorities are focusing their efforts to redress employment and competitiveness on wage moderation, through reforms of the wage bargaining agreements, and on measures to promote stronger productivity growth (Part I).

The option of shifting the tax structure away from labour taxes has not been pursued as a means of reducing unit labour costs. However, this option has much potential for fostering job creation, especially for low-income earners, and could be considered over the longer term. Shifting the tax burden away from labour can be done in a revenue-neutral manner by raising less distorting taxes (including environmental taxes) and further reducing tax expenditures.

Some of the structural reforms in progress will yield the dual benefits of boosting productivity and also promoting equity. This is especially the case of reforms designed to address the duality of the labour market, support the human capital development of the labour force and improve the quality and coverage of the education system. However, these effects will only be felt fully over the medium term. In the short term, social programmes have a major role to play in ensuring that the burden of the ongoing adjustment is shared fairly and in supporting social cohesion. Therefore, where possible, it is essential that particular attention be given to protecting social safety nets from fiscal consolidation. Further reforms of the health care system should also aim at continuing to ensure better access for the poorest groups. Beyond this short-term challenge, the social system also needs to be prepared for the spending pressure that will arise with the ageing of the population. This will, in particular, require a focus on efficiency gains in health spending and completion of the pension reform.

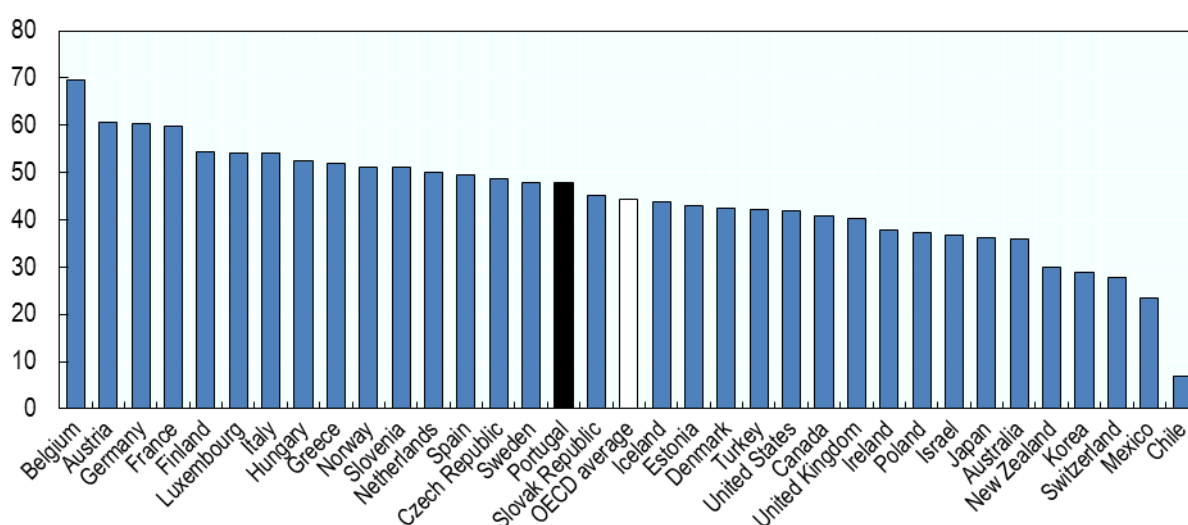
Chapter II.1. Improving the structure of the tax system

Raising more revenue, while reducing public expenditure, is part of the Government's fiscal consolidation strategy. Since 2011, measures have been taken to restructure the rates of the most relevant taxes, as well as to broaden their base, and these were followed by considerable reductions in tax expenditures. The key challenge is to complement progress in base-broadening with further reforms to make the tax system more supportive of growth and competitiveness and to ensure a fairer distribution of income.

Shifting the tax burden away from labour

The tax system could be made more growth-friendly and conducive to employment by shifting the tax structure in a revenue-neutral manner away from labour taxes, including social security contributions, towards less distorting taxes.¹⁷ Portugal has traditionally relied more heavily than the average EU or OECD country on goods and services taxes, as opposed to corporate income tax (CIT), personal income tax (PIT) and social security contributions (SSCs). However, this was due in part to narrow PIT and CIT bases, reflecting extensive tax expenditures, which have been reduced in recent years. In 2012, most marginal tax rates were relatively high, and the marginal tax wedge on labour was still above the OECD average, even before the recent decision to raise personal income tax rates (Figure 16).

FIGURE 16. MARGINAL TAX WEDGE (PER CENT OF TOTAL LABOUR COSTS), 2012¹



1. Income tax plus employee and employer contributions less cash benefits for a single person without children at the income level of the average worker.

Source: OECD, Taxing Wages.

¹⁷ Arnold, J., B. Brys, C. Heady, A. Johansson, C. Schwellnus and L. Vartia (2011). "Tax Policy for Economic Recovery and Growth", *Economic Journal*, Volume 121, Issue 550.

One way to reduce the labour tax wedge (and hence labour costs) that could be considered is to lower SSCs. This is particularly important given the substantial cumulative loss of cost competitiveness and market share over the last decade. Cutting SSCs can be particularly effective in creating jobs if cuts are concentrated on low-wage earners. For example, employers' contributions could be made progressive in terms of the level of wages, as opposed to the current flat rate. Or reductions could be targeted below a certain wage threshold. Changing SSCs could be part of a broader reform of social security financing that would make the system less reliant on contributions and more on general revenue.

To finance lower tax rates on labour, additional revenue should be raised from taxes that have less impact on Portugal's competitiveness, such as property and environmental taxes, and by further reducing tax expenditure.

Getting more from property taxes

The Government is currently concluding a reform of property taxation, which will raise the revenue from property taxes to levels that are comparable to those of both EU and other OECD countries. Recurrent taxes on real estate, like the *Imposto Municipal sobre Imóveis* (IMI), have a relatively small impact on growth; they are also less distortive than transaction-based taxes, such as Portugal's *Imposto sobre Transmissões Onerosas de Imóveis* (IMT), which increase revenue volatility and discourage geographic mobility. IMI revenue will increase as a result of the base-broadening resulting from the reform of property valuation. The reform has also brought in regular updating of property values, and introduced safeguard clauses that take into account low-income homeowners' ability to pay, and the IMT should be phased out as planned by the Government.

Rationalising VAT by further reducing the scope of exemptions and reduced rates

Portugal used to make extensive use of reduced VAT rates, and the resulting revenue losses due to policy and imperfect compliance and administration were substantial. Although the objective of reduced rates is to alleviate the tax burden on low-income households and support weaker economic sectors, the targeting of such reductions is often poor, and a large share of the benefits accrues to better-off families. Likewise, applying reduced rates to some sectors, such as the hospitality industry, is a poor way of supporting low-skill employment opportunities.

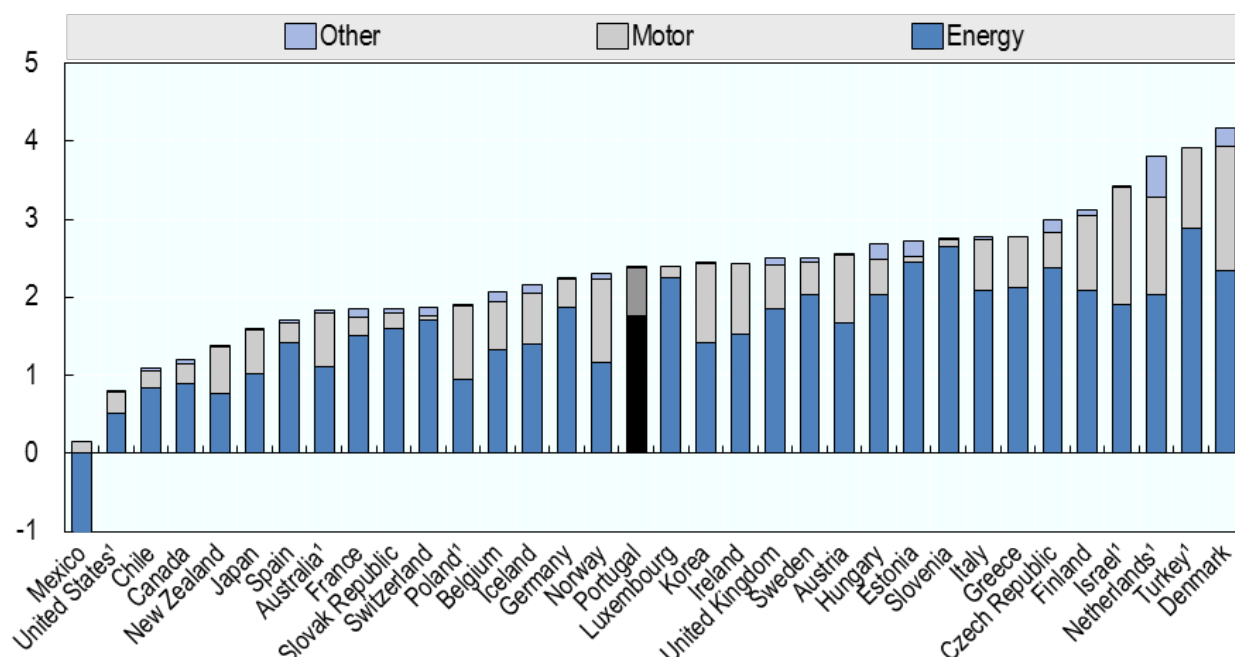
As part of the Memorandum of Understanding (MoU) with the Troika and in line with EU and OECD recommendations, Portugal has significantly revised the scope of VAT rates, triggering a wider use of the normal VAT rate from January 2012. The use of VAT exemptions has also been reduced (e.g. VAT exemption applied to agricultural products was revoked), in order to achieve greater efficiency. The authorities are advised to build on recent progress and continue to extend the scope of application of the standard VAT rate. Social objectives can be met more effectively through the social safety net than by means of reduced VAT rates.

Raising revenue from environmental taxes

Expanding environmentally-related taxes and removing harmful tax concessions and subsidies could help fiscal consolidation without hampering economic recovery. Portugal has made progress in *expanding the use of environmentally related taxes*, by introducing waste and water taxes, a tax on inefficient light bulbs, and CO₂ emission-based vehicle taxes. Portugal should consider introducing other taxes (e.g. on air pollutants, pesticides and packaging materials) and restructuring existing taxes to better reflect environmental

externalities (e.g. linking a component of fuel taxation to the carbon content of fuels and to emissions of local air pollutants). For instance, the tax rate is significantly lower on diesel than on gasoline, despite the greater greenhouse gas emissions and other pollutants per litre of fuel. Raising diesel tax rates to the same level as gasoline in energy terms (per unit of energy consumed) could raise additional revenues.¹⁸

FIGURE 17. REVENUES FROM ENVIRONMENTALLY RELATED TAXES IN PER CENT OF GDP, OECD COUNTRIES, 2011



Source: OECD/EEA database on instruments used for environmental policy and natural resources management

In addition, fiscal consolidation and economic recovery objectives could be achieved more efficiently if Portugal allowed greater flexibility in the use of revenues from environmentally related taxes, which are now partly earmarked for specific funds. Reducing tax expenditures, such as removing preferential fuel tax rates for the agricultural and fishing sectors, would also help increase revenue as well as encouraging the switch to more fuel-efficient and less polluting equipment.

The 2010-13 Stability and Growth Plan foresees strengthening environmentally related fiscal measures with a view to better maintaining their incentive function and improving fiscal sustainability. However, *excise duty exemptions* still apply to different uses of energy products and categories of users. *Reduced value added tax rates* apply, among others, to agriculture. Water and waste taxes to be paid by licenced operators were introduced in the late 2000s, but many municipalities that directly provide water and waste services do not pass these taxes on to consumers. However such measures, aimed at supporting poorer segments of the population, are usually a costly way to pursue equity objectives; they entail tax revenue losses, distort competition and investment decisions, and, by lowering end-use prices, can reduce incentives to use energy and natural resources efficiently. These drawbacks can be avoided, and social objectives achieved more efficiently, by providing targeted support to the affected groups. In the long term, phasing out energy-related tax

¹⁸ For instance, according to OECD estimates these revenues could exceed EUR 1.3 billion per year based on data underlying Taxing Energy Use (2013)

concessions is a more cost-effective way of reducing energy consumption than providing tax credits and other forms of support to households and businesses for the purpose of investing in energy efficiency and renewable energy equipment, and most tax credits have now been abolished. Elimination of fuel tax exemptions for sectors not covered by emissions trading would help send a price signal about the cost of carbon emissions, while also raising revenues¹⁹ (OECD, 2013b).

Enhancing tax efficiency by reducing complexity and tax expenditures

Tax complexity hampers productivity and growth in a variety of ways. Portuguese tax laws are complex and frequently amended, resulting in excessive compliance costs and uncertainty in the minds of individuals and firms about their long-term incentives. Despite some recent progress, notably in the area of PIT, CIT and VAT the Portuguese tax system is still characterised by extensive tax expenditures, which narrow tax bases and hence require higher tax rates. This undermines revenue, raises compliance costs and may be detrimental to the perceived fairness of the tax system. In the area of corporate taxes, effective rates are significantly lower than statutory rates due to numerous base-narrowing provisions, although several measures, such as the imposition of direct levies on certain expenditures through the CIT system, have managed to broaden the tax base. Many of these tax expenditures increase administrative and compliance costs and further hamper productivity by distorting investment.

The Government has engaged in a comprehensive CIT reform aimed at boosting investment and international competitiveness by simplifying the CIT system, reinforcing legal certainty and restructuring Portuguese international tax policy in light of European and international legal developments. This is a step in the right direction, and reform should proceed as planned and lead to further streamlining of CIT provisions, the abolition of inefficient tax expenditures and further base-broadening. In the medium term, when the fiscal situation permits, this could allow for some reduction of the CIT rate.

Further improving tax administration

Increasing tax revenues by improving taxpayer compliance and reducing the costs of revenue administration by improving operational efficiency are also part of the Government's fiscal consolidation strategy. Good progress was made in 2011 and 2012 [e.g. creation of a new integrated tax and customs authority – *Autoridade Tributária e Aduaneira* (AT) – but critical reforms still need to be fully carried out and will require close attention by AT officials in 2013 and beyond. In particular, efforts to implement the multi-year plan to combat fraud and avoidance need to be sustained, and especially those initiatives designed to enhance processes for managing tax-compliance risk and increase auditing capability. The recently implemented VAT invoicing reform is a key step towards curbing tax fraud and evasion. The re-organisation of the internal structure and functions of the AT needs to be completed.

A Large Taxpayer Office was set up at the end of 2012. Effective arrangements for the sharing of information between AT and the Social Security administration have now been set up. It is essential that both the Large Taxpayer Office and these arrangements are continuously enhanced. Moreover, reforms to streamline the network of local branches should be pursued systematically (with a view to achieving the target of closing half of them by mid-2014).

¹⁹ OECD (2013), Inventory of Estimated Budgetary Support and Tax Expenditures for Fossil Fuels 2013.

Administrative review mechanisms have traditionally been slow, contributing to more court litigation, although decisions on taxpayers' initial complaints (*reclamação graciosa*) have recently been coming through much more promptly. The authorities should make further progress in the administrative appeal mechanism (*recurso hierárquico*) and encourage greater willingness by the tax administration to reverse a previous decision when assessing an appeal.

For the longer term, consideration should be given to integrating the collection of social security contributions with tax administration, an arrangement well established in many EU Member States (*e.g.* Estonia, Ireland, the Netherlands, Slovenia, Sweden, and the United Kingdom). It will also be important to improve the collection of the major taxes (*i.e.* employer withholding, personal and corporate income tax instalments, and VAT) for larger businesses.

Key OECD recommendations

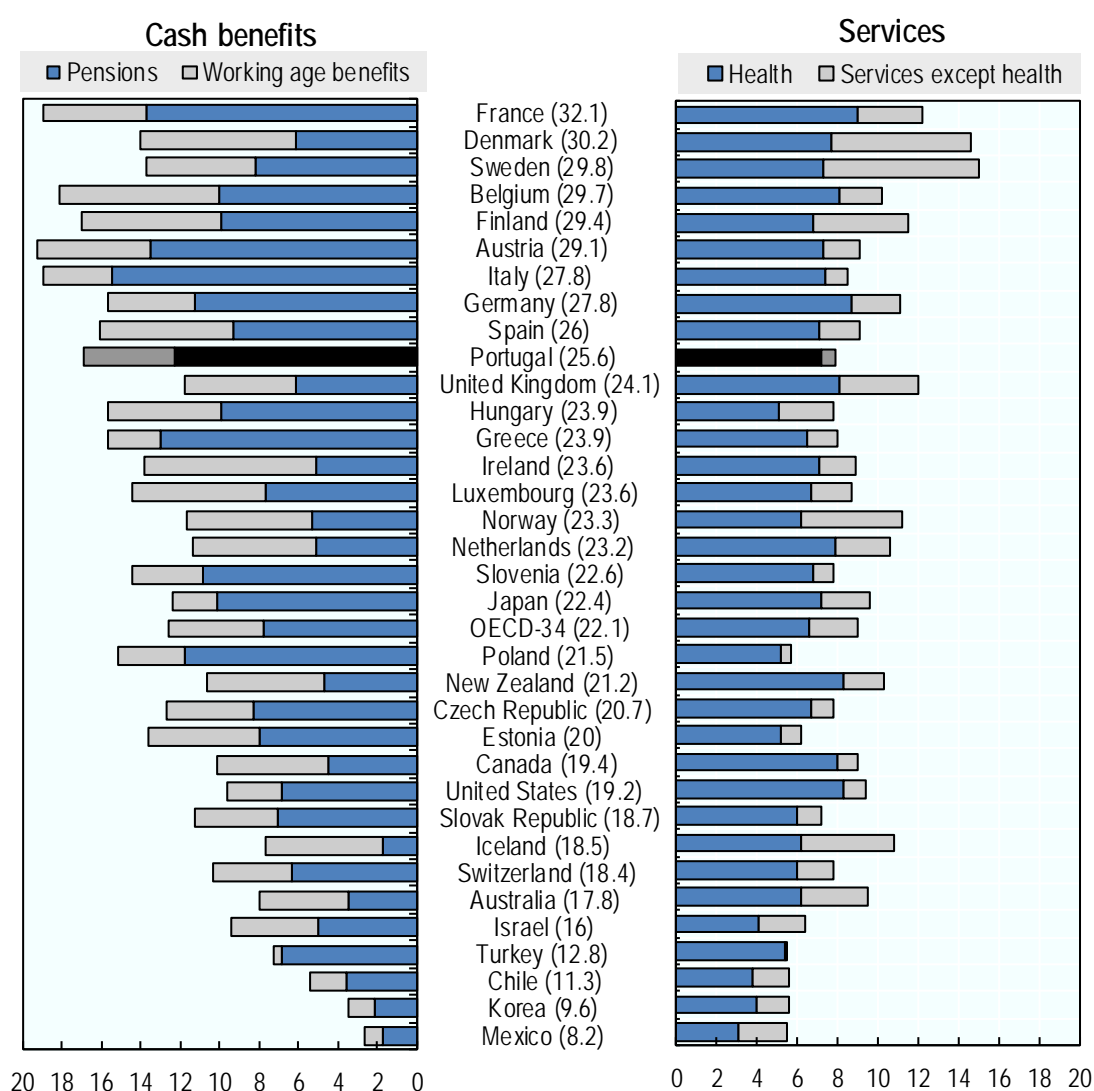
- ✓ In the medium term, in a revenue-neutral way, consider **reducing taxes on labour while increasing less-distorting taxes** – such as recurrent taxes on residential property and environmentally-related taxes. To maximise job creation, focus on lowering employer social security contributions for low-wage workers.
- ✓ **Continue to broaden tax bases** by extending the application of the standard VAT rate to a wider range of goods and services, and by further reducing tax expenditures.
- ✓ **Continue to broaden the use of environmentally-related taxes** by introducing other such taxes (*e.g.* on air pollutants and pesticides).
- ✓ **Review the current array of tax exemptions and discounts**, with a view to phasing out those that are costly and environmentally harmful; ensure that water and waste management taxes are passed on to final users; provide targeted support for those households adversely affected by energy, water and waste prices.
- ✓ **Conclude the CIT reform** to effectively simplify the CIT system and boost investment and competitiveness, while preserving internationally accepted standards.
- ✓ **Continue efforts to further improve tax administration** by integrating the collection of social security contributions with tax administration.

Chapter II.2. Promoting social cohesion

Public social expenditure amounted to 26% of GDP in 2012 (above the OECD average of 22%). Health care outlays and pensions account for the lion's share of public social spending (Figure 18). The crisis has had a high social cost because of the increase in unemployment, and the ongoing fiscal consolidation may constrain the ability of social policies to fully meet needs.

Against this background, one immediate priority is to ensure that programmes of core importance to social cohesion are preserved to the fullest possible extent. The existing scope for efficiency gains should therefore be fully exploited.

FIGURE 18. PUBLIC SOCIAL EXPENDITURE BY BROAD SOCIAL POLICY AREA, IN PERCENTAGE OF GDP, IN 2009



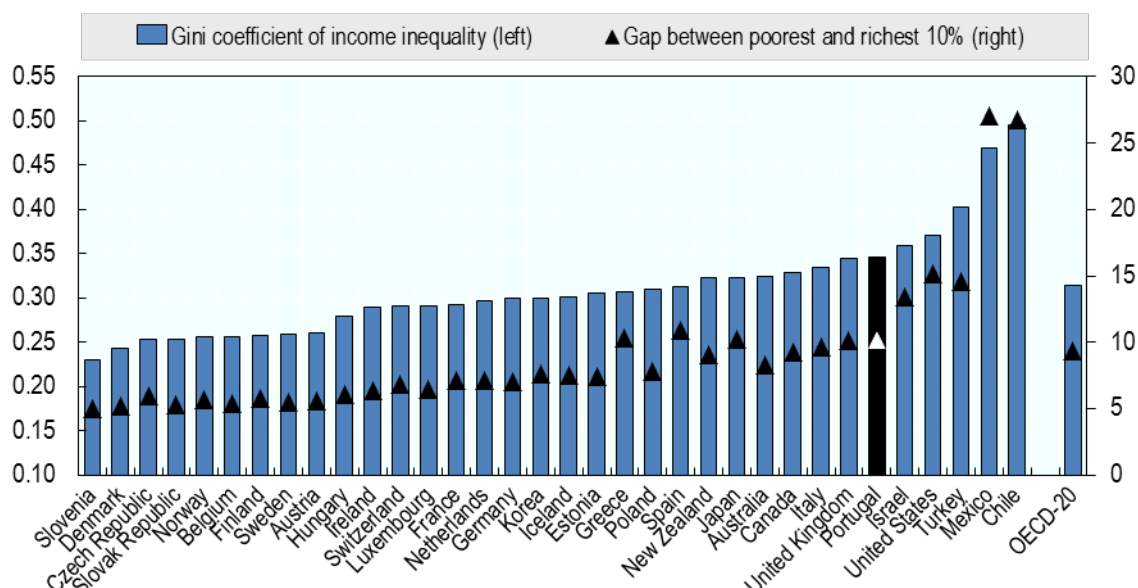
Note: Spending on Active Labour Market Programs (ALMPs) cannot be split into a cash/services breakdown; it is however included in total public spending (shown in brackets). Income support to the working-age population refers to spending on the following SOCX categories: Incapacity benefits, Family cash benefits, Unemployment and other social policy areas categories. Data for Mexico have been estimated and the reference year for Switzerland is 2008.

Source: OECD (2012), *Social Expenditure (SOCX) Update*, June 2012, www.oecd.org/els/social/expenditure

The economic crisis has exacerbated social challenges in Portugal. Despite important progress in reducing income inequality, the gap between rich and poor was already wide before the crisis and has remained broadly unchanged since. In 2008, Portugal had the sixth-most unequal income distribution in the OECD and was the most unequal country in Europe. In 2008, the income of the richest 10% of Portuguese was ten times that of the poorest 10%, compared with a ratio of 7 to 1 for Europe and 9 to 1 for the OECD average (Figure 19). A contracting economy and high levels of unemployment are likely to have widened these income gaps even further.

Like most other OECD countries, Portugal also faces spending pressures associated with population ageing, due to a relatively steep increase in longevity and low fertility rates, with many families having only one child. In 2011, with 1.35 children per woman, Portugal had the third-lowest fertility rate in the OECD, after Hungary (1.26) and Korea (1.23). As total fertility rates are sensitive to income shocks, such as the one brought about by the crisis, a further dip in Portuguese fertility cannot be ruled out.

FIGURE 19. DIFFERENCES IN INCOME GAPS BETWEEN RICH AND POOR ACROSS OECD COUNTRIES (2008 OR LATEST YEAR AVAILABLE)



Notes:

- The Gini coefficient ranges from 0 (perfect equality) to 1 (perfect inequality).
- Gaps between poorest and richest are the ratio of average income of the bottom 10% to average income of the top 10%. Income refers to disposable income adjusted for household size.

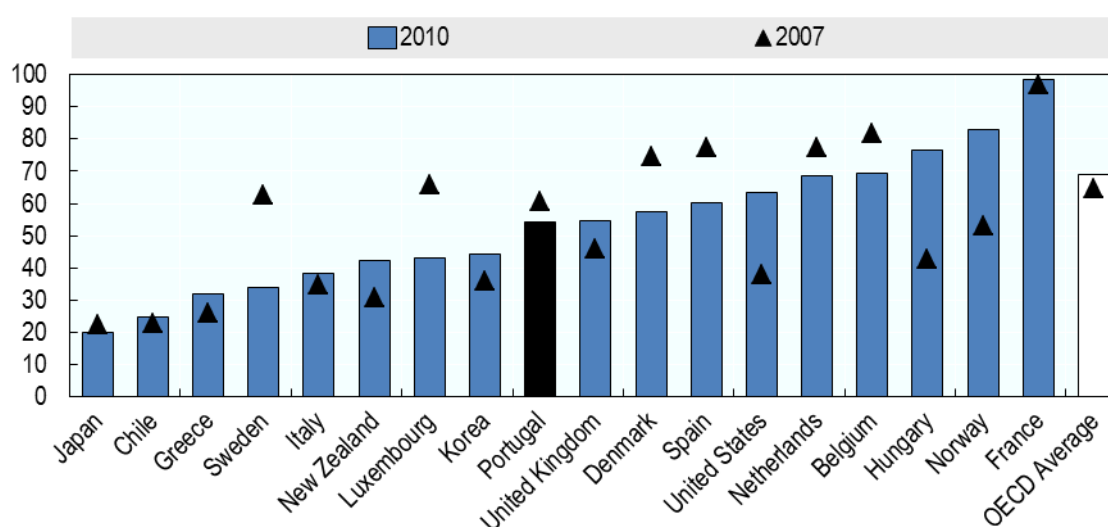
Source: OECD Income distribution and poverty database (www.oecd.org/els/social/inequality).

Sheltering social assistance

In Portugal, where the coverage of unemployment benefits is relatively low (see Chapter I.4), social assistance programmes, such as *Rendimento Social de Inserção* – (RSI), have played an important role in cushioning the effects of the crisis on vulnerable social groups. Moreover, as mentioned above, the coverage of unemployment benefits (comprising either unemployment insurance or unemployment assistance programmes) was lower in Portugal than the OECD average over the period 2007-10. While the coverage rate averages about 70% of the unemployed in the OECD countries, it is only 55% in Portugal (down from 60% in 2007) (Figure 20), reflecting the strictness of the eligibility criteria, despite efforts to make them more flexible.

Social assistance programmes are targeted at poor families and individuals (especially young people) who are not eligible for unemployment insurance.²⁰ In this context, a key policy requirement for avoiding a rise in poverty is to ensure that these programmes continue to be funded adequately. This may entail reallocating resources to underwrite spending on these programmes, but also improving the targeting of these programmes and ensuring resources are allocated to those who need them. The existing scope for efficiency gains should be exploited, notably in the health sector, as this would not only generate savings that could finance poverty reduction efforts, but would also help address the impact of ageing (see below).

FIGURE 20. UNEMPLOYMENT BENEFIT RECIPIENTS, AS A PERCENTAGE OF THE UNEMPLOYED POPULATION (AVERAGE 2007 – 2010)



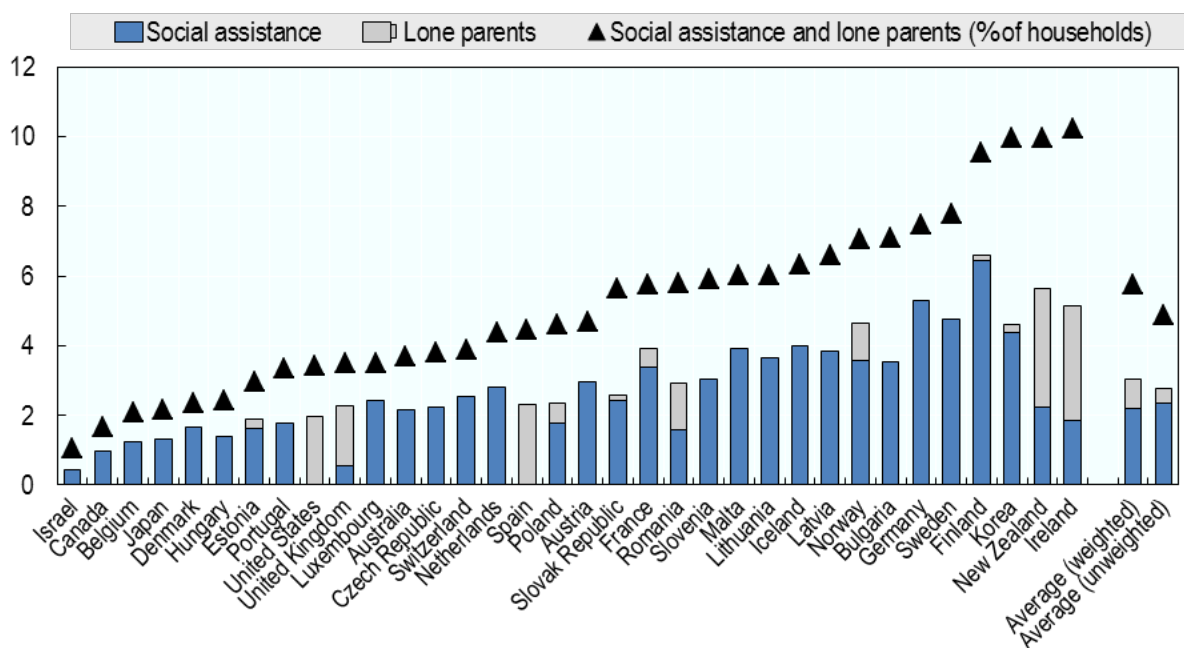
Note: The figures shown in this chart refer to all unemployment benefit recipients as a ratio of all unemployed persons, as measured according to the standardised definition of unemployed in labour force surveys.

Source: Calculations based on the forthcoming OECD SOCR database on social benefits recipients.

Although RSI programmes have been expanded recently, their participation rates remain relatively modest as compared with those in other countries with similar schemes, including Spain. The participation rate is less than 2% in Portugal, i.e. below the OECD average of about 3% (see Figure 21). Expressed as a percentage of households (to better reflect the coverage of the entire population), the participation rate is about 3%, compared with 5% in the OECD-EU countries. This could however be partly explained by better targeting of the Portuguese programme, where 89% of resources are allocated to the poorest 20%, compared with an average of only 65% in other European countries. In 2010 and 2012, the eligibility criteria for the RSI had already been tightened considerably (for example, means testing now takes into consideration the financial holdings of individuals).

²⁰ Unemployed who no longer have access to unemployment benefit, but meet the means testing criteria, also have access to Social Unemployment Subsidy (*Subsídio Social de Desemprego*)

FIGURE 21. PARTICIPATION RATES IN NON-CATEGORICAL SOCIAL ASSISTANCE AND LONE-PARENT PROGRAMMES, RATES ADJUSTED BY HOUSEHOLD SIZE, AS A PERCENTAGE OF 15-64 POPULATION, AVERAGE 2007-2010



Notes:

- Non-categorical social assistance includes all assistance programmes paid in cash and not targeted at specific groups. Some countries provide specific social assistance for lone parents (typically classified under the FAMILY branch). Those programmes are added to non-categorical social assistance. Ordinary and extraordinary child allowances and family and child tax credits are not included. Bulgaria is not included because of missing data. The other countries not appearing in this figure do not have non-categorical main income replacement benefits (or they were not reported by their administrations). Rates are averages over the period 2007 – 2010, except for Hungary (2009 – 2010), Belgium, Israel, the Netherlands (2007 – 2009) and Spain (see the note below). USA Includes Temporary Assistance for needy families. Germany: A significant proportion of Social Assistance recipients are already accounted for under Unemployment Assistance. Spain: The *Rentas Mínimas de Inserción* is a non-categorical social assistance benefit managed and supplied by local administrations. France: The lone parent benefit API was merged with minimum income RSA in 2009. Mexico: The programme *Oportunidades* is often a supplement and not an income replacement benefit, therefore not included. Korea: In administrative records, recipients of Social Assistance are expressed as numbers of people, even if the benefit is awarded to families.
- These benefits are "individualised" (only one member of the household entitled to the benefit is counted in the caseloads). For this reason, raw participation rates do not reflect the total number of actual beneficiaries. An estimate of the participation rate for all de facto beneficiaries was computed by using the number of households. The number of households is estimated using the total population and the average size of households in each country.

Source: Calculations based on the forthcoming OECD SOCR database. For household size by country, OECD Family database.

Further targeting family support policies

Family support policies not only reduce the risk of in-work poverty, but also play a key role in promoting gender equality and improving fertility rates, which is also a challenge for Portugal. In recent years, spending on family benefits has been about 1 percentage point below the OECD average of 2.3%. Spending has been reduced and eligibility criteria tightened. Further targeting should be considered in order to maintain, and where possible

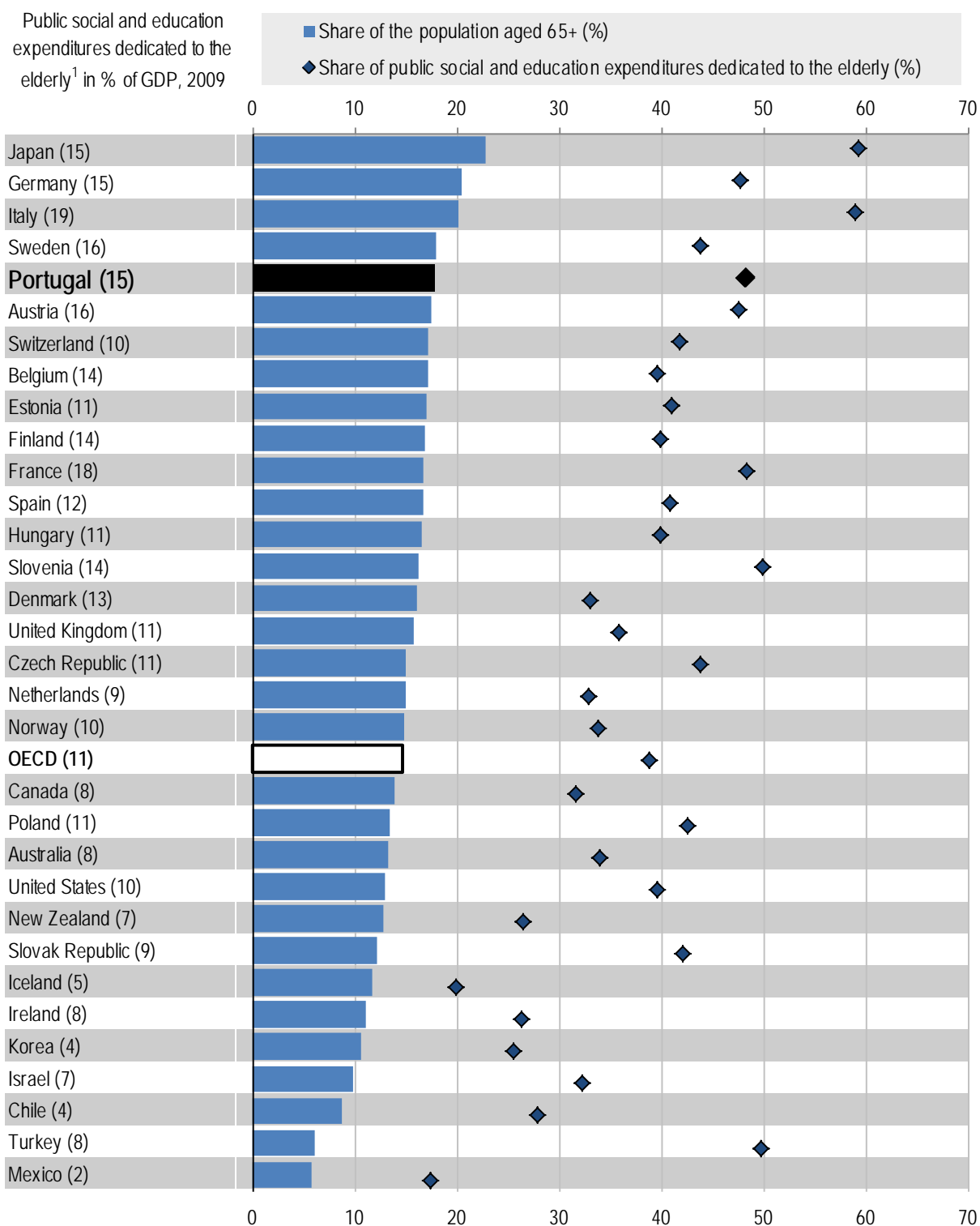
expand, childcare support for low-income families, help achieve a better balance between work and care commitments, and reduce poverty risks.

Even though the Portuguese system contains many entitlements to unpaid, time-bound support for parents with young children, many parents cannot afford to take much unpaid leave or work part-time on a permanent basis. Pre-school childcare enrolment in Portugal has tripled in the last decade to around 65% (OECD average is 58%). Nevertheless, capacity constraints in subsidised childcare remain, and differences between the take-up of formal childcare services, by income group, are amongst the widest in the OECD (an enrolment gap between high- and low-income families of around 40%).

Addressing the impact of ageing on social expenditure

The proportion of elderly people in the population was around 18% in 2012, and on average they received 48% of aggregate social spending (including education) (Figure 22). As in many other OECD countries, population ageing in Portugal will be a key driver of future increases in social expenditure. While more could be done to further increase health spending efficiency, policies aiming at making pensions even more sustainable are also essential.

FIGURE 22. MOST SOCIAL SPENDING GOES TO THE ELDERLY
SHARE OF PUBLIC SOCIAL SPENDING, INCLUDING EDUCATION,
GOING TO THE POPULATION AGED 65 AND OVER



1. Public spending on the elderly includes old age cash benefits, survivors' benefits, and services for the elderly and the disabled.

Source: OECD (2012), *Social spending after the crisis*.

Improving health expenditure efficiency

Portugal has substantially improved the health of its population over the past decades. Life expectancy at birth was 79.8 years in 2010, slightly above the OECD average (79.7 years), following a rapid increase of 8.4 years since 1980, thanks to reductions in prenatal, infant and adult mortality. During the same period, total health expenditure has increased from 5.1% to 10.7% of GDP, overtaking the OECD average of 9.5%. Currently, about two-thirds of health care spending is financed by the public sector, and given the rapidly ageing population, health spending is likely, as in the other EU countries, to increase even more without further reforms.²¹

There is still scope for improving the efficiency of the health system. For instance, hospital survival for life-threatening diseases, such as stroke and heart attack, remains low compared with the OECD averages. Looking at the prevention of chronic diseases, the incidence of diabetes, which is often preventable through lifestyle changes, is the third highest among the OECD countries (following Mexico and the United States). Furthermore, while the number of nurses has increased substantially over the past ten years in Portugal, the ratio of nurses to doctors remains relatively low (as is the case also in other Southern European countries), and there is room to achieve a better skills mix and division of labour to reduce the cost of health service delivery.

Several reforms have been introduced in recent years, resulting in some containment of health care costs. The emphasis of the reforms is on promoting rational use of hospital services, limiting pharmaceutical costs and reducing hospital costs. Specific measures include strengthening primary care to reduce unnecessary visits to specialists and the use of emergency care; cutting generic drug prices and promoting their use; changing the pricing and reimbursement of pharmaceuticals; and centralising the purchase and procurement of medical goods. Reducing the costs of public hospitals is particularly important as they have been incurring the highest losses among State-owned enterprises. This is currently being pursued through the development and use of appropriate benchmarking indicators. These efforts have reduced public health spending from 7.2% of GDP in 2009 to about 6.2% in 2012. Maintaining the reform efforts is, however, needed to further improve efficiency in the health system, while ensuring quality of care and promoting equitable access. For example, although some effort to develop clinical guidelines has been made, experience in other countries suggests that these will be of limited effect unless payment systems reward those providers that follow them.

Traditionally, women have cared for elderly relatives, but this role has been declining over time, reflecting increasing female employment and a breakdown of extended family networks, particularly in urban areas. The National Long-term Care Network was created in 2006 to provide long-term care (LTC), social support and palliative care through co-ordination among different providers including hospitals, primary care centres and social security services. Despite the rapid population ageing, LTC spending (as a share of GDP) and the number of LTC workers are among the lowest in the OECD. Experience in other countries is that care responsibilities negatively affect women's labour force participation choices. Although Portugal's female employment rate is currently higher than in many other countries, if population ageing is not to put this achievement at risk Portugal will need to progressively introduce policies that support family carers.

²¹ See De la Maisonneuve and Oliveira Martins (2013) "Public spending on health and long-term care: a new set of projections", *OECD Economics Department Working Paper*, forthcoming.

Pension system and recent policy changes

Not only is the share of the population over the age of 65 relatively high (28%, compared with the OECD average of 24%), but the population is also ageing very rapidly. Since the early 1990s, Portugal has undertaken substantial reforms of the pension system for private-sector workers. These reforms have involved: a reduction of accrual rates, increased incentives to participate in pension schemes, the introduction of penalties for early retirement and increased rewards for late retirement, the introduction of a targeted complement as well as the introduction of a demographic sustainability factor (longevity factor). Since 2006, benefits have been equalised across all workers (*i.e.* for men and women, and the public and private sectors). However, this reform only applies in full to new civil service entrants.

The effective retirement age in 2011 was 66.2 for men and 65.1 for women, with normal pensionable age being set at 65 years for both men and women. There is a strong incentive to remain in the labour force for more than 40 years of service, insofar as pensions will be increased by 1% for each month.

Early retirement has been suspended until the end of 2014, but after this date reform is likely to be needed to tighten the conditions for early retirement. The current rules allow for early retirement at age 55 with 30 years of contributions and a penalty of 0.5% for each month which, on the basis for example of retirement 5 years early, implies a 30% cut in benefits. There are also generous retirement options for workers who become unemployed after age 52; they can retire from age 57, provided they have contributed for at least 22 years, but penalties do apply.

Key OECD Recommendations

Assistance and family policies

- ✓ To the fullest possible extent, shelter social assistance from spending cuts.
- ✓ **Reform unemployment benefits** to ensure better coverage, while reducing dependency and promoting activation.
- ✓ **Maintain and expand childcare support for low-income families**, to help them strike a balance between work and care commitments and reduce the risk of in-work poverty, while avoiding the creation of poverty traps.

Health sector

- ✓ **Improve hospital performance** by continuing to develop clinical guidelines, strengthening the monitoring and evaluation of medical practice and introducing reimbursement mechanisms linked with evidence-based care delivery.
- ✓ **Further strengthen preventive care and health promotion** by increasing the role of health care professionals in primary care and embedding incentives for providing these services in payment schemes.
- ✓ **Secure the appropriate supply and skill mix of health professionals** to respond to the current and future needs of the population, particularly people with chronic conditions and long-term care needs, by training more nurses and care personnel and promoting task-sharing among different professionals.

Pensions

- ✓ Abolish early retirement.
- ✓ **Consider a faster alignment of civil service schemes on those in the private sector**, while at the same time diluting grandfathering so that it is not only new entrants who are concerned.

PART III. EQUIPPING THE STATE TO SUPPORT ROBUST AND INCLUSIVE GROWTH

The State has a major role to play in creating an enabling environment for stronger growth and well-being in Portugal. It is the key enabling actor in all of the areas covered in the first part of this report. This includes not only the State's role in the design, development, implementation and monitoring of reforms, but also its role as regulator and service provider. The State is the only actor that can take the lead in identifying, enabling and steering the necessary pro-growth structural reforms, and in achieving the highest levels of excellence in the delivery of supportive public services for business and citizens.

This issue is not unique to Portugal. Across the OECD there is growing awareness of the importance of strong public administration for the success of all other reforms. However, missed reform opportunities over the past two decades, and especially when the economy was still in a catch-up phase, suggest that the State's ability to play this key role in steering reforms needs to be improved. This is even more the case now that this ability is being further challenged by ongoing and necessary fiscal consolidation, not least through its impact on human resources in the public sector. Important reforms of the State, including its organisation and human resource management, are therefore urgently needed to confront this challenge and support the reform agenda. This would help smooth the impact of fiscal consolidation and lay the groundwork for a more efficient and effective State to move forward.

Reforms of the State would also contribute to making the Government more responsive to the needs and demands of the population, by ensuring that public resources are used more efficiently, by improving the quality of public services and public administration, and by ensuring that the costs and benefits of adjustment are shared more equitably. This strengthening of the link between Portuguese citizens and their Government will in turn build support for comprehensive structural reforms.

For the public administration to be more effective in formulating policy advice, delivering services and planning and implementing structural reforms, it is essential to strengthen the Centre of Government and the senior civil service (Chapter III.1), develop further systems and processes for the monitoring and evaluation of reforms to support implementation (Chapter III.2), improve human resource management (Chapter III.3) and continue to improve fiscal management at all levels (Chapter III.4). All of these issues are interdependent and essential for both successful reform of the State and effective implementation of the entire reform agenda.

Chapter III.1. Improving the Government's capacity to steer and lead policy

The Portuguese Government's capacity to steer and lead policy will be essential to the success of the on-going rebalancing and pro-growth policies. This capacity largely depends on the strength of the Centre of Government (i.e. the body that provides direct support and advice to the head of Government and the Ministries) and the senior civil service. Further steps to reinforce them would not only boost the effectiveness of reforms but also foster trust and confidence by showing that the State has a clear strategic agenda in which it can engage partners in society and the economy.

Improving the agility and responsiveness of the public administration can strengthen political trust. This in turn can prompt more support from senior civil servants for the Government's strategic agenda and make responses to current challenges more effective.

Strengthening the Centre of Government for greater effectiveness

An effective Centre of Government (CoG) is essential for steering policy development and implementation. It can help overcome ministerial and departmental stovepipes that thwart co-operation and create wasteful overlapping and duplication of policies and institutions. A well-functioning CoG helps sustain a comprehensive long-term vision, manage risks and crises and ensure that reforms are widely agreed across Government and effectively implemented. It has a key role in communicating on reforms, securing support, and checking that reforms are implemented.

In Portugal, the Presidency of the Council of Ministers is the key central body under the authority of the Prime Minister that provides assistance to the Council of Ministers. But the central Government is relatively fragmented. With some notable exceptions, including the *Simplex* programme for administrative simplification,²² the Presidency of the Council of Ministers has struggled to foster true co-operation across ministries, and line ministries have often been required by law to co-operate so as to implement horizontal programmes. This might stem in part from a tendency to work separately and, possibly, to perceive the Presidency as a controller or a whip rather than as a partner in developing and implementing public policies. As a result of this "silo" Government, it is difficult for Ministries to interact with each other on shared issues, and for the CoG to promote a "whole of government" attitude.

A committed team around the Prime Minister is currently steering policy development and implementation, in part overcoming these challenges and helping guide the Government's response to the crisis.

This is a welcome development, but as the Government moves from crisis-response to long-term policy-making, it will nonetheless be essential to strengthen the ability of the Presidency of the Council of Ministers to steer and foster co-operation across the Government on the structural reform agenda. It will be especially important to institutionalise and enhance co-operation across ministries to facilitate the development of truly horizontal programmes that address cross-cutting issues such as education and competitiveness.

22 OECD (2010), *Better Regulation in Europe: Portugal 2010*. OECD Publishing, Paris.

Breaking silos within public administration is a challenge shared by governance systems across the OECD. Experience from other OECD countries suggests that the CoG tends to be most effective when it has a hub that provides comprehensive oversight and, above all, advice and assistance not only to the head of Government but to Government members as well. The CoG must also have the ability to effectively co-ordinate and foster co-operation across line ministries to ensure the development of coherent policies in line with strategic plans. Mapping the functions and responsibilities of ministries would be a good start towards identifying areas for co-ordination and co-operation that would be the CoG's responsibility.

The CoG also needs to leverage institutionalised and personal networks to enhance co-operation and co-ordination. In Portugal, a number of informal networks have emerged, especially around certain horizontal programmes like administrative simplification. It is important to scale up these experiences, for example with regard to economic, social or EU issues of a horizontal or complex nature.

Examples of good practices in other OECD countries that could be useful for Portugal are presented in Box 3.

Box 3: Relevant international experience

Ireland's Cabinet Secretariat

The Cabinet Secretariat organises and manages Cabinet meetings and monitors the legislative programme. Separate policy units within the office shadow work in priority areas of concern. Staffed with a mix of both political advisors and official staff, the office is able to co-ordinate quickly with units in line ministries, providing policy advice from both a technical and political point of view.

Inter-ministerial co-ordination in Denmark

The Ministry of Finance plays a key role in co-ordinating activities related to the Government's Cabinet Committee of Economic Affairs, which deals with the Government's economic policy. Ministers meet on a weekly basis to assess proposals and initiatives having significant consequences for the economy and the budget. The Committee is chaired by the Minister of Finance, with the Ministry of Finance serving as the secretariat. The Ministry of Finance also hosts preparatory meetings with permanent state secretaries of the participating ministries ahead of the weekly Cabinet Committee meeting. These preparatory meetings give line ministries an opportunity to discuss policy solutions and gain overall perspective on how their proposals would impact the Government as a whole.

Estonia's EU Secretariat

The European Union (EU) Secretariat in the Government Office has established a horizontal council of high-level civil servants to discuss EU matters and ensure that Estonia speaks with a single voice at the EU level. The Secretariat's working culture is to engage with Parliament and to work in close co-operation with other ministries. As a means to enhance this culture, the EU Secretariat rotates its staff through the EU departments of the Ministry of Foreign Affairs and other ministries.

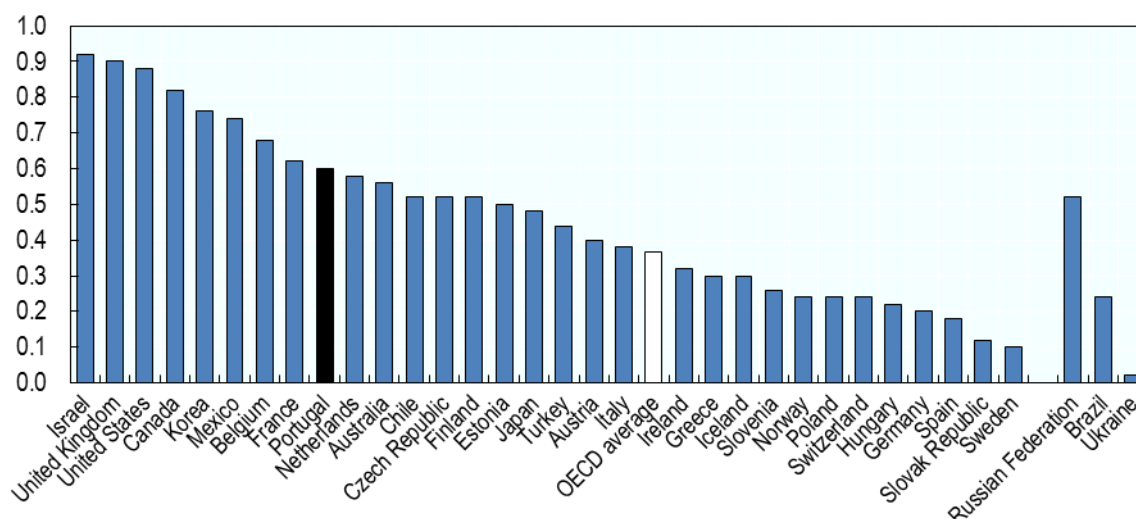
Source: OECD (2011), Estonia: Towards a Single Government Approach, OECD Public Governance Reviews, OECD (2012), Slovenia: Towards a Strategic and Efficient State, OECD Public Governance Reviews

Strengthening the capacities of the senior civil service

The Government's capacity to steer and lead policy also relies on a well-managed and competent cadre of senior civil servants. These senior officials are responsible for executing high-level policy directives quickly and effectively, and for harnessing the institutional knowledge and experience of the civil service to contribute to evidence-based decision-making. Portugal, like most OECD countries, has a distinct group of senior civil servants who are recruited and managed according to different human resource management (HRM) practices than the majority of the civil service. Portugal makes somewhat greater use of separate HRM

practices for senior managers than is customary in the OECD (Figure 23). However, these arrangements need to be evaluated to assess their effectiveness in fully serving the needs of the Portuguese Government and in helping to augment its capacity to deliver public services.

FIGURE 23. USE OF SEPARATE HRM PRACTICES FOR SENIOR CIVIL SERVANTS IN CENTRAL GOVERNMENT (1 INDICATES GREATEST USE)



Source: 2010 OECD Survey on Strategic Human Resources Management in Central/Federal Governments.

Previous OECD work has identified several common elements in recent reforms of senior civil service management. Some reforms have focused on the quality of senior management in order to strengthen performance and attract the best talent. Reforms of the recruitment and selection of senior managers have introduced greater transparency and an emphasis on competencies. Many countries have taken steps to introduce more competition for senior management positions by opening up the senior levels to external recruitment. In this regard, Portugal has recently implemented a reform requiring all senior managers to be recruited through an open, merit-based competition conducted by a public commission (CRESAP).

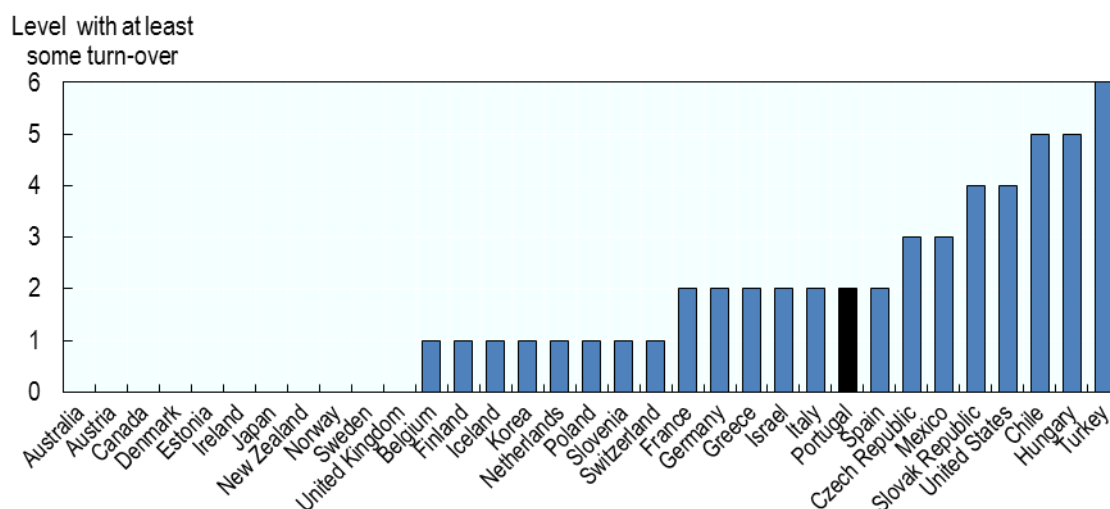
Ensuring effective partnership and communication between the senior civil service and ministers

Civil servants need to be accountable to and respond to the current elected Government so as to effectively develop and implement the policies for which the Government is ultimately accountable to citizens. At the same time, it is important that civil servants provide objective and non-partisan advice to policy-makers to allow them to take the best decisions in support of the country's development. Some policy change is to be expected through the electoral cycle insofar as political leaders need to provide quick responses to citizens' pressing demands, and to deliver on campaign promises. Nevertheless, structural reforms need to be implemented over a fairly medium-to-long-term horizon in order to be effective.

Portugal has a relatively low turnover of civil servants at each change of government (Figure 24) – a positive feature which can lend stability and continuity to government policies. However, structural reforms like privatisation and administrative simplification have often failed to survive the electoral cycle or have faced some interruptions. In addition to measures to improve the design and implementation of reform over a medium-term horizon (see Chapter III.3), it is also important to foster good communication between the

administrative and political levels to ensure that political leaders are aware of both the long-term impact of reforms and the possible costs of their reversal.

**FIGURE 24. TURNOVER OF CIVIL SERVANTS WITH A GOVERNMENT CHANGE
2010, LEVELS 1(=HIGHEST) TO 6(=LOWEST)**



Note: Data for Luxembourg are not available. Data on turnover in level 5 and 6 are not available for Portugal and the United States. Data on turnover in level 6 only are not available for the Czech Republic, Hungary, Israel and Spain. In New Zealand, a change of government does not affect the employment of public servants. The exception to this is a small number of public servants employed in Ministerial offices on an event-based contract, with the event triggering the termination of their contracts being the conclusion of their relevant Minister's term in office.

Source: OECD (2011), *Government at a Glance 2011*.

Key OECD recommendations

- ✓ **Foster greater co-operation between the centre and line ministries**, for instance by scaling up horizontal networks and co-ordination mechanisms involving both senior civil servants and secretaries of state.
- ✓ Assess the effectiveness of existing inter-ministerial co-ordination mechanisms and refocus them on priority areas decided by the Council of Ministers.
- ✓ Ensure that the senior civil service has the capacities to perform effectively, *e.g.* by **developing a competency framework for senior managers that outlines common skills requirements**, such as leadership and capacities to engage in policy development and implementation.
- ✓ **Assess the effectiveness of lines of communication between the political and administrative levels** and ensure that senior civil servants participate in policy development to facilitate objective assessment of various reform options.

Chapter III.2. Strengthening the reform process from design to implementation and monitoring

Portugal has launched many fiscal and structural reforms over past decades. However, these have not always yielded the desired results, reflecting weakness in implementation and insufficient monitoring. Robust implementation requires a reform design process embedded in a long-term vision of the country's future, strong evidence-based policy design, as well as strong monitoring and evaluation of progress.

Enhancing the long-term vision of reform design

Reform design is the first step in ensuring strong implementation. It should build on robust evidence of the costs and benefits of various reform options. Moreover, to be effective, this analysis needs to build on a shared long-term vision of the country's future (see Box 4 for an example of taking a long-term vision approach to reform).

Portugal's emphasis on reforming the State is part of such long-term vision. But for this vision to deliver targeted results, it is essential that it be shared widely amongst stakeholders within and outside government to ensure widespread support for reform over time. Otherwise, it is more likely to be poorly implemented, if not actually reversed. This challenge of reform implementation is shared by many other OECD countries.²³

²³ The implementation of policies and programmes is the most important weakness to emerge from recent OECD public governance country reviews. GOV/PGC(2012)14 "Strategic Lessons from the Comprehensive Public Governance Reviews".

Box 4. Finland's long-term vision

In 1993, following a deep economic crisis, the Finnish Government sent Parliament the first Government Foresight Report. This initial report presented views on major future developments and optional scenarios for Finland. It provided a plan for the kind of future society that the Government was seeking to create through its actions. Since then, a Government Foresight Report has been submitted to Parliament during every electoral period. The scope of reporting has progressively shifted from a whole-of-society approach to a narrower focus on a single, albeit still cross-cutting, issue such as global climate change and energy policy.

Responsibility for the horizontal Government Foresight Report rests with the Prime Minister's Office, which prepares the report in co-operation with individual ministries. The Prime Minister's Office also commissions overviews, statistics, surveys and studies directly from individual researchers and research institutes to serve as a basis for the project. Throughout the report's development, the Prime Minister's Office discusses its progress with the Prime Minister and other Cabinet members. This occurs through an initial seminar, chaired by the Prime Minister, to define the subject matter in more detail and discuss different perspectives, and the Government's evening plenary session, during which initial findings and positions are reviewed. A Parliamentary Committee for the Future evaluates and responds to the policies outlined in the Government Foresight Report. The Committee's responsibilities also include assessing activities related to the development of new technologies.

In addition, regional Future Fora provide an opportunity for dialogue on national and regional challenges and opportunities. The Future Fora are one-day events involving two Cabinet members and representatives of the Committee of the Future. Approximately 150 to 200 people are invited, including municipal decision-makers, regional and local authorities, entrepreneurs, and representatives of non-governmental and labour organisations.

Source: OECD (2010), Finland: Working Together To Sustain Success, OECD Public Governance Reviews, OECD Publishing.

Strengthening evidence-based design and policy-making

A shared long-term vision is effective only if it translates into policies and programmes that build on solid evidence and are designed to maximise impact. Through the *Legislar Melhor* initiative, Portugal has taken initial steps towards including impact assessment for new laws and regulations. An explanatory note is attached to the draft bills approved by the Council of Ministers and sent to Parliament. It includes some assessment of the costs and benefits of the proposed bill. Parliament is also taking a more pro-active role in assessing new proposed bills, which includes developing its own capacity to assess the impact of proposed legislation.²⁴

These are important steps that need to be enhanced and, if possible, scaled up so that proposed reforms and their implementing legislation are grounded in solid evidence and sound macro- and micro-economic analysis.

It is also important to ensure that the results of impact assessments are widely shared and inputs obtained from relevant stakeholders outside government at an early stage of reform design, *e.g.* through the use of green and white papers, an approach used in some OECD countries and by EU institutions. Green papers help governments, without committing them, to engage with actors within government, and with business and citizens, in order to join forces in exploring policy options and their likely impact. Such a process reduces the risks of overlooking better options or disregarding the negative consequences of proposed policies. Stakeholder participation in policy-making at an early stage also improves the likelihood of compliance by increasing the legitimacy of policy responses and may therefore reduce the costs of enforcement. White papers serve to present the policy proposals that the Government has developed.

²⁴ OECD (2010), *Better Regulation in Europe: Portugal 2010*. OECD Publishing, Chapter 4.

Tracking performance and reform progress

To successfully steer and monitor policies, governments need to be able to chart their course. Performance-measurement and evaluation provide the needed dashboard that tracks policy implementation, identifies success and failures, and produces the information that is needed to allocate resources, design new policies and guide implementation. Linking the resources that are required for implementation to performance can also provide a powerful incentive to achieve results. In addition, measuring and evaluating performance enhances transparency and contributes to bolstering the accountability bond between governments and citizens, thus helping to build trust. Measuring is also crucial for benchmarking policies through a set of indicators and basing policy-making on solid evidence-based analysis.

Portugal is still in the early stages of strengthening performance measurement and evaluation (Table 1). It has restructured budget preparation around programmes, laying the groundwork for the use of performance information in preparing the budget. However, a robust framework to measure performance has not been developed. Developing such a framework entails defining concrete and measurable objectives assessing whether they have been achieved. This process needs to build on clear objectives, good-quality data and a culture of continuous learning and improvement. It would be advisable to keep this system as simple as possible and to select information that is relevant for both the political and the administrative levels.

TABLE 1. USE OF A STANDARD PERFORMANCE BUDGETING FRAMEWORK

Country	Applying to all line ministries and agencies	Applying only to line ministries	Optional	Line ministries and agencies using own framework
Australia	□	□	□	■
Austria	■	□	□	□
Belgium	□	□	□	■
Canada	■	□	□	□
Chile	■	□	□	□
Czech Republic	□	□	■	□
Denmark	□	■	□	□
Estonia	■	□	□	□
Finland	■	□	□	□
France	■	□	□	□
Germany	□	□	□	■
Greece	□	□	□	■
Hungary	□	□	□	■
Ireland	□	■	□	□
Italy	□	■	□	□
Japan	■	□	□	□
Korea	■	□	□	□
Luxembourg	□	□	□	■
Mexico	■	□	□	□
Netherlands	□	■	□	□
New Zealand	■	□	□	□
Norway	■	□	□	□
Poland	■	□	□	□
PORTUGAL	□	□	□	■
Russian Federation	■	□	□	□
Slovak Republic	■	□	□	□
Slovenia	■	□	□	□
Spain	■	□	□	□
Sweden	□	■	□	□
Switzerland	■	□	□	□
Turkey	■	□	□	□
United Kingdom	□	□	□	■

Source: OECD (2012), "Budgeting Levers, Strategic Agility and the Use of Performance Budgeting in 2011/12" GOV/PGC/SBO(2012)10.

The key value of performance information is at the operational level. The system should accommodate agency managers who are the first producers and users of performance information. It is important that this information be used by managers in the day-to-day operations of government agencies responsible for delivering public services. Measurements need to be complemented with more in-depth qualitative analysis to avoid rewarding policies that are not achieving their intended results, or that are achieving perverse outcomes.

In moving forward with performance management and evaluation, it is essential for Portugal to be realistic and clearly evaluate what can be done with the resources available, and to set a timetable with clear milestones. Box 5 includes examples of emerging good practices in performance measurement and evaluation which could be useful.

Box 5. Performance measurement and review in Sweden, Austria and Australia

In **Sweden**, the Government has worked with performance objectives since the 1980s. The Swedish performance system is based on 27 expenditure areas determined by the Parliament. The expenditure areas are divided into 47 policy areas. Most of the policy areas are subdivided into activity areas. Goals for policy areas and activity areas are formulated within the budgeting process. The purpose is to convey a transparent picture of the objectives and actual impact of activities in each policy area. Goals are proposed by the responsible minister and approved by Parliament, and they have proved stable over time.

In **Austria**, the move towards performance measurement and evaluation combines fiscal sustainability with better transparency and a sharp focus on results. Ministers have to decide on their priorities and communicate them in a transparent and binding way. Members of Parliament have to vote not only on resources, but on stipulated performance outcomes. This strengthens the strategic dimension of policy-making.

In **Australia**, strategic reviews focus on examining the continuing relevance and performance of ongoing programmes and activities and are not necessarily about finding savings. They are endorsed by either the Prime Minister or the Cabinet's Expenditure Review Committee. They are led by an independent eminent person or a senior civil servant.

Source: OECD (forthcoming), Poland: Implementing Strategic-State Capability, OECD Public Governance Reviews, OECD Publishing.

Key OECD Recommendations

- ✓ Sharpen the long-term focus of public administration reform and consider mechanisms to integrate national stakeholders into reform design and implementation, *e.g.* through the use of green and white papers.
- ✓ **Assess evaluation capacity within and outside government** and consider possible partnerships in carrying out strategic reviews.
- ✓ Ensure that major reform proposals are based on robust analysis of possible reform options.
- ✓ Assess the recent introduction of programmatic budgeting and consider additional steps towards the use of performance information in preparing the budget.
- ✓ Consider a system of targets, objectives and evaluations for policy priorities, keeping it as simple as possible.

Chapter III.3. Improving human resource management

Portugal has sought to reduce operational expenditures as part of its fiscal consolidation process. However, without adequate planning these measures can have a significant negative effect on the capacity and performance of the public workforce, and in turn undermine progress on Portugal's pro-growth agenda. While Portugal's public workforce management compares favourably with that of other OECD countries, to ensure effective application of good human resource management (HRM) practices the overall framework and strategic planning of HRM need to be improved. Strategic planning can also be instrumental in supporting employees' motivation to deliver public services at a time of strong pressures associated with fiscal consolidation.

A strategic framework for HRM

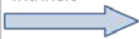

By many measures, Portugal's management of its public workforce compares favourably with that of other OECD countries. For example, Portugal makes greater use of performance assessment in HRM decisions in its central government than any other OECD Member country. This has been achieved through the introduction of an integrated system of performance assessment in the public administration (SIADAP), which is a major asset in its modernisation strategy. In addition, Portugal's use of strategic HRM practices is well above the OECD average, and it has achieved a good balance of women and men in the central government workforce.

However, the combination of a career-based employment system, a relatively limited central HRM office in the Ministry of Finance and Public Administration, and extensive delegation of HRM practices to line ministries may limit the consistency and effectiveness of good practices in HRM. For example, the co-existence of a centralised system for hiring employees and the delegation of HRM responsibilities may cause strains. Moreover, the absence of a strong central body may result in a lack of mechanisms to ensure that ministries will follow civil service policy.

A more far-reaching examination of HRM practices in Portugal would help ensure that its restructuring efforts are achieved in an effective manner by building on existing strengths in the management of the public workforce.

In the context of cuts in workforce numbers and pay, the Portuguese public service is confronting a variety of challenges related to its image and attractiveness as an employer, and the insecurity of its workforce. Strategic human resource management needs therefore to include an emphasis on improving employee morale and motivation in order to maintain its capacity to deliver public services. When increasing employee compensation is not an option, some Governments in OECD countries have begun to take a more holistic approach to employee rewards. The United Kingdom, for example, has recently developed a more structured approach to and understanding of "total rewards", which include base pay, bonuses, benefits, holidays and intangible rewards, such as professional development and satisfaction, all of which motivate different employees in different ways (Figure 25). Combining financial and non-financial incentives shows the increasing willingness of Government to highlight the package of rewards that employees receive and to try to cost those benefits. Furthermore, emphasising these rewards can help motivate public employees without substantially increasing payroll costs.

FIGURE 25. TOTAL REWARDS IN THE UNITED KINGDOM

	Common examples	Reward elements	Definition	
Intrinsic  Elements which contribute to internal value or motivation	1. <i>Quality of work</i> 2. <i>Work-life balance</i> 3. <i>Inspiration/values</i> 4. <i>Enabling environment</i> 5. <i>Growth/opportunity</i>	Engagement factors		Total reward
Extrinsic  All the things to which we can assign a monetary value	6. <i>Tangible benefits e.g. car, professional memberships, discounts</i> 7. <i>Retirement</i> 8. <i>Health and welfare</i> 9. <i>Holidays</i>	Active benefits Passive benefits		
	10. <i>Stock/equity</i> 11. <i>Performance shares</i>	Long-term rewards or incentives		Total remuneration
	12. <i>Annual incentive</i> 13. <i>Bonus/split awards</i> 14. <i>Team awards</i>	Short-term variable		
	· <i>Base salary</i> · <i>Hourly wage</i>	Base cash		Total direct compensation
			Total cash	

Source: McDonald, Paula (2009), presentation given at the 5th Regional Meeting of the Working Group on Civil Service and Integrity, OECD-MENA Initiative, 16 June 2009, Rabat, Morocco.

Strategic workforce planning

Portugal, like the majority of OECD countries, has responded to the financial crisis with consolidation measures that include cuts to operational expenditures. Among these cuts is a reduction in the size and cost of its public workforce. Specifically, Portugal has implemented a variety of wage restraints — progressive pay cut in 2011 (3,5% starting at base monthly salary of €1 500, up to 10%), a pay freeze since 2012 and the elimination of holiday bonuses — a 2% annual reduction in personnel through 2014, and a recruitment freeze since 2011. These measures have been accompanied by major reforms in the legal framework for public employees, a new career system, and new pay scales. However, without adequate planning, these measures can have a significant negative effect on the capacity, performance, and motivation of the public workforce.

Previous OECD work²⁵ has highlighted several lessons learned from Member countries' experience with workforce restructuring measures. Portugal may wish to consider two lessons in particular:

²⁵ OECD (2011), *Public Servants as Partners for Growth: Toward a Stronger, Leaner and More Equitable Workforce*, OECD Publishing, Paris.

1. Large-scale downsizing is often the most problematic option for workforce adjustment. Assessments have highlighted a variety of negative effects on workforce capacity, as well as on trust and morale. In addition, studies have questioned the long-term sustainability of staff reductions achieved in this way.
2. Recruitment freezes are also a detrimental approach to downsizing, because they are indiscriminate and limit the ability of organisations to restructure and reskill. Moreover, as they tend to be protracted, the negative impact on the morale of staff and managers, and on the capacity to deliver services, is likely to be significant.

One way to mitigate the negative effects of restructuring is the use of strategic workforce planning — a core HRM process that helps organisations identify, develop and sustain the skills it needs for a productive workforce. Although recent reforms in Portugal have included the introduction of workforce planning to help the central Government anticipate and respond to new challenges and to maintain a structured, representative, and appropriately sized workforce, the impact of these reforms has yet to be felt. Canada’s experience with workforce planning over the last two decades provides a useful example of how Governments can manage the effects of restructuring on their workforce (Box 6).

Box 6. Strategic Workforce Planning – Public Service Renewal in Canada

Canada has set a goal of balancing its budget by 2015-16. Efforts to cut spending have focused on finding savings in operations and enhancing productivity, as well as better aligning spending with the priorities of Canadians. These cuts in operational expenditures, including the modernisation and reduction of back office operations, will result in the loss of 19 000 jobs out of 260 000 employees, a cut of about 7.5% that highlights the need for effective strategic workforce planning.

Canada’s current planning effort builds on its experience with workforce reductions in the 1990s. Then, the Government lacked the tools to identify the skills it was losing as a result of across-the-board cuts. The current approach is more nuanced, aimed at achieving a leaner and more agile public workforce. While recruiting has slowed, it has not been frozen, allowing the civil service to continue to acquire specific skills for which it has identified a need.

In 2006, the Government of Canada launched a “Public Service Renewal” initiative to improve and modernise the core functions of the public service. The Government has acknowledged the need to continue implementing Public Service Renewal despite fiscal restraint, as it considers this initiative essential to ensuring service excellence. Budget cuts have presented the civil service with an opportunity to achieve Public Service Renewal through re-purposing employees and focusing on recruitment of new talent to fill gaps and ensure demographic balance. The four pillars identified in 2006 remain the foundation of Public Service Renewal in the context of fiscal restraint.

- Integrated Planning - To align goals, resources and results is more important than ever. Organisations need access to comprehensive data to align limited resources accordingly.
- Recruitment - Targeted hiring based on integrated plans and areas of need, including at senior levels and at entry level, may slow down, but it cannot stop, insofar as targeted recruitment to acquire key skills will be necessary.
- Employee Development - To continue the pursuit of excellence remains a priority despite fiscal restraint, albeit in an innovative, renewed way.
- Workplace Renewal - To address how civil servants work has highlighted the need for greater “back office” efficiency in responding to Canadians.

Source: OECD (2012), “The Government Workforce of the Future: Innovation in strategic workforce planning in OECD countries”, GOV/PGC/PEM(2012)1/FINAL.

- ✓ **Emphasise “total rewards” for public employees** — including non-financial rewards to help motivate staff when budgets are constrained.
- ✓ **Consider a more far-reaching examination of overall HRM practices** to ensure that restructuring efforts result in a motivated workforce that has the technical and management skills to implement effective performance measurement and policy monitoring and delivery of public services.
- ✓ **Consider greater use of strategic workforce planning** to help mitigate the effects of across-the-board reductions on the capacity, performance, and motivation of the Portuguese public workforce.

Chapter III.4. Strengthening fiscal management

Effective fiscal management comprises a range of dimensions, which will need attention if Portugal is to succeed in its fiscal consolidation objectives and ensure sustainability over the long term. At the national level, there is some way to go in order to secure effective institutions and processes and strengthen fiscal institutions and processes. In addition to the budget framework, the governance, regulatory and management frameworks for SOEs and PPPs warrant special attention; procurement systems need be strengthened; EU funds should be managed effectively; and sub-national public financial management needs reinforcement.

Strengthening the budget framework

For the last 20 years Portugal has suffered from weak fiscal institutions. Since entry to the euro was confirmed in 1998 Portugal has gradually but consistently raised spending as a percentage of GDP. This arose mainly from overly optimistic economic and revenue forecasts, and therefore expenditure plans. In addition, actual spending often overshot the plans. Budget enforcement was impeded by fragmented, infrequent and limited financial reporting with financially autonomous units of the Government not being held sufficiently accountable for overspending. SOEs and PPPs were used as a means of borrowing by shifting the payment burden to future taxpayers and/or off the balance sheet. Total wider government payment arrears, including SOEs not inside general government, amounted to 1.9% of GDP in December 2012.

The October 2011 changes to the Budgetary Framework Law introduced many of the key features of a best-practice budgeting framework.²⁶ It introduced an enhanced medium-term fiscal framework which, in line with European requirements, stipulates: a rolling budget planning horizon that sets central-government expenditure ceilings for the next four years; an independent fiscal council; and programme budgeting. The 2012 Commitments Law aims to ensure better control of expenditures and tackle payment arrears. Quarterly budget reporting for general government is already in place. However, experience shows that making such a package of budgeting reforms work on the ground is an iterative process which requires time and guidance.

A key issue behind Portugal's fiscal problems has been a lack of accurate and transparent spending and liability data. The expansion of State Budget reporting to the national-accounts definition of general government and the progressive implementation of monthly reporting for the whole of general government are therefore welcome developments. These elements are part of the standard package of transparency-enhancing mechanisms, as stipulated in the *OECD Best Practices for Budget Transparency* (2002). Since 2012 the State Budget includes a new chapter on contingent liabilities and another on risk assessment aimed also at improving budget transparency.

In addition, as stressed in the 2012 *OECD Economic Survey of Portugal*, the new framework could be better anchored and made more transparent if it included an expenditure rule to prevent upward creep in spending and ensure that general government spending is under control.²⁷ Moreover, important improvements to budget implementation will be needed to

²⁶ OECD *Restoring Public Finances* 2012 Update, 2012 pp. 208-209.

²⁷ Under an expenditure rule compliance is easily observed (unlike a structural deficit rule which relies on assessing the output gap, etc.), and it would not be especially pro-cyclical in that most automatic stabilisers work through the revenue side. The European "fiscal compact" rules to be incorporated into the Portuguese Budgetary Framework law, which is now before Parliament, envisages reaching a Medium-Term Objective (MTO) of a structural deficit of 0.5 per cent of GDP. This may also help limit upward creep in spending.

ensure that the new budgetary framework truly contributes to fiscal sustainability. *Inter alia*, this would require measures to improve the capability of programme financial controllers to carry out these oversight functions and interact with the Ministry of Finance (including with regard to their appointments and access to analytical support staff).

Like many other countries, Portugal set up a Fiscal Council in late 2011, to improve fiscal performance and further prevent government discretionality.²⁸ This is a welcome and potentially important development. The role of the Council is to report on fiscal objectives and budget scenarios, the sustainability of public finances, and compliance with the fiscal rule, as well as to assess the indebtedness of the autonomous regions and local authorities. Its members took office in early 2012. To be effective, however, it is important that the Council be provided with sufficient human resources, that it provide policy recommendations rather than analysis alone, and that its role be further embedded in the policy debate by requiring the Minister of Finance to provide formal responses in Parliament to Fiscal Council reports.

The custodian of the new budgetary framework is the Central Budget Authority (CBA), and in particular the budget preparation department. The modernisation and strengthening of the CBA is therefore a necessary condition for successful reform. Traditionally such budget bureaux have focused on controlling inputs and have had a somewhat limited challenge function vis-à-vis line departments on issues of policy measures, efficiency and effectiveness. However, this has changed in best-practice countries. For budgetary reform to have impact, the Ministry of Finance must be a strong hub of reform. Budget examiners (who are in charge of preparing the budget and challenge the spending requests of line departments) must develop analytical capacity to provide a consistent quality check on policy initiatives. In order to address the inherent information asymmetry, in addition to strengthening budget analysis capacity, Portugal is advised to introduce a stronger top-down budgeting technique whereby each line minister is allocated a firm ceiling but given flexibility to re-allocate within that ceiling. In addition to performance budgeting, discussed below, a stronger spending review mechanism might also be advisable. The new approach in preparation of the 2013 budget is a step in this direction.

Further improvements of the budget framework are expected. A new draft amendment (still before Parliament) incorporates the reinforced EU fiscal governance framework, including a medium-term structural deficit target of no more than 0.5% of GDP. Further enhancements of budgetary procedures and principles of budgetary management, accountability, transparency and simplification, as well as adoption of other relevant EU legislation are planned by the end of 2013. Draft Regional and Local Finance Laws applying the principles of the Budgetary Framework Law (also before Parliament, see below), set out improved co-ordination mechanisms between the central and the local and regional administrations, a multi-annual budgetary framework and tighter fiscal rules.

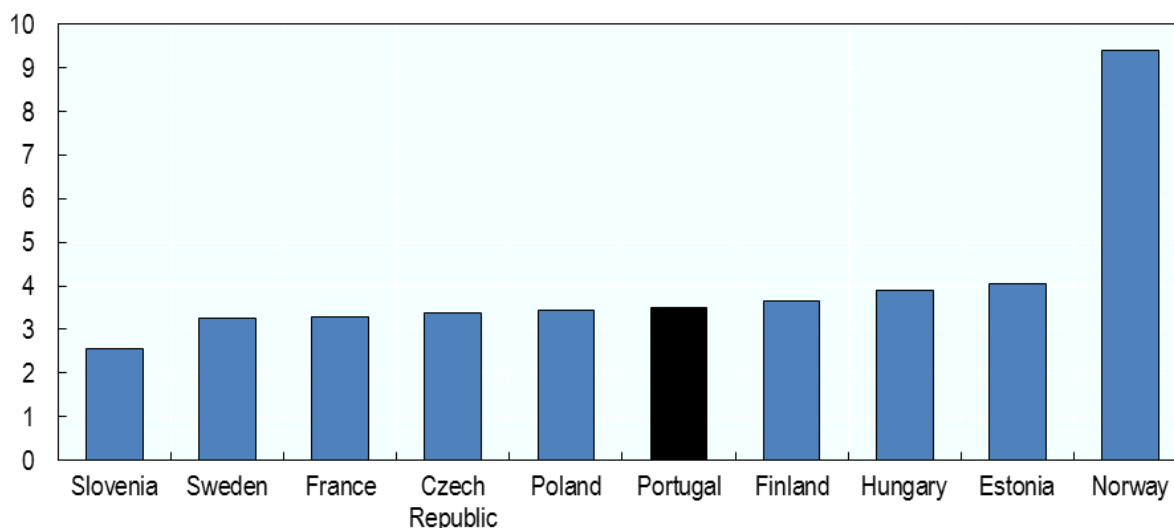
Improving the governance of SOEs and PPPs

In addition to further reducing the scope of the public enterprise sector, which, although declining, remains comparatively vast, the Government is implementing a number of measures to reduce primary expenditure by rationalising State-owned enterprises (SOEs) (Figure 26). This is notably the case in the road transport sector (see Chapter I.2). Specific measures aimed at curbing the financial burden of SOEs include greater selectivity in investment and the establishment of debt threshold ceilings, public service contracts, and

²⁸ On the effectiveness of fiscal councils, and recent experiences see R. Hagemann (2010), "Improving Fiscal Performance Through Fiscal Councils", OECD Economics Department Working Papers, No. 829.

wage restraints. Profit-maximisation rather than intermediate targets should be the objective of SOEs insofar as this allows managers greater discretion to achieve public objectives. Moreover, it is recommended to systematically link management compensation to performance. It is also essential to improve more broadly the governance of SOEs to ensure a level playing field with the private sector.

**FIGURE 26. 10 OECD COUNTRIES WITH THE HIGHEST SHARE OF SOE EMPLOYMENT
(SOE EMPLOYMENT AS % OF TOTAL EMPLOYMENT)**



Source: H. Christiansen (2011), "The Size and Composition of the SOE Sector in OECD Countries", OECD Corporate Governance Working Papers, No. 5

Despite the challenges faced by Portugal with respect to PPPs, such partnerships remain a potentially useful investment model, as long as they are affordable, ensure value for money for society and are deemed preferable to conventional public investment. In order to ensure such value for money, better PPP governance is needed.

In recent years, Portugal has undertaken substantial efforts to improve the national PPP programme, both in terms of performance and in terms of designing a prudent enabling framework. These efforts align well with the OECD Principles for Public Governance of Public-Private Partnerships (2012). They include developing a plan to reduce PPP costs by about €250 million in 2013, and by up to €400 million after 2014 through measures such as reviewing levels of service, optimising the toll collection mechanisms and reducing private partners' internal rate of return.²⁹ A full review of public-private partnerships by an international auditor was completed in 2012 and could be used in such potential contract re-negotiations.

Lessons from OECD countries show that a number of points need to be taken into account. First, capacity, interest and a clear mandate with respect to PPPs have to be found in the procuring agency, the Ministry of Finance's Budget Department, the Supreme Audit Institution and relevant economic and social regulators. Second, the appropriate tools to ensure value for money must be in place. This includes a sound process for determining the cost/benefit of a project, whether or not it should be undertaken as a PPP or traditional capital procurement (relative value-for-money test), a competitive bidding process and efforts to monitor and make sure that value for money is maintained in the operational

²⁹ IMF Country Report No. 13/18, January 2013.

phase, including possible renegotiations. Finally, transparency and affordability should be maintained by utilising a sound budgetary framework. This includes integrating PPPs into the medium- and long-term fiscal frameworks and ensuring transparency about long-term commitments and contingent liabilities.³⁰

The new PPP framework law (enacted in May 2012) is a step towards achieving these goals and ensuring value-for-money assessments and implementation of strict procurement procedures. In particular, a new technical unit was created in the Ministry of Finance to assess and monitor PPPs. This unit is now fully operational and is involved in all PPP sectors, including the Road PPPs' renegotiation process currently under way. While the new PPP unit is a good start, much will depend on the implementation of this framework and the vigour with which the spirit of the law is taken on board. The regions have been encouraged to design similar frameworks for assessing fiscal risks derived from PPPs, concessions and other public investments. The specific outcome of this encouragement is as yet unclear. In late 2013 a new annual PPP report will provide a comprehensive assessment of the fiscal risks stemming from PPPs and concessions. The report will serve as input for the budget's fiscal risks assessment.³¹

Strengthening procurement systems

Procurement accounts for 11% of GDP and about a quarter of total general government expenditure in Portugal (Figure 27). This is therefore an important area in which the Government can rationalise public expenditures, seek to enhance cost-effectiveness, and generate savings that could be earmarked for financing worthy programmes.

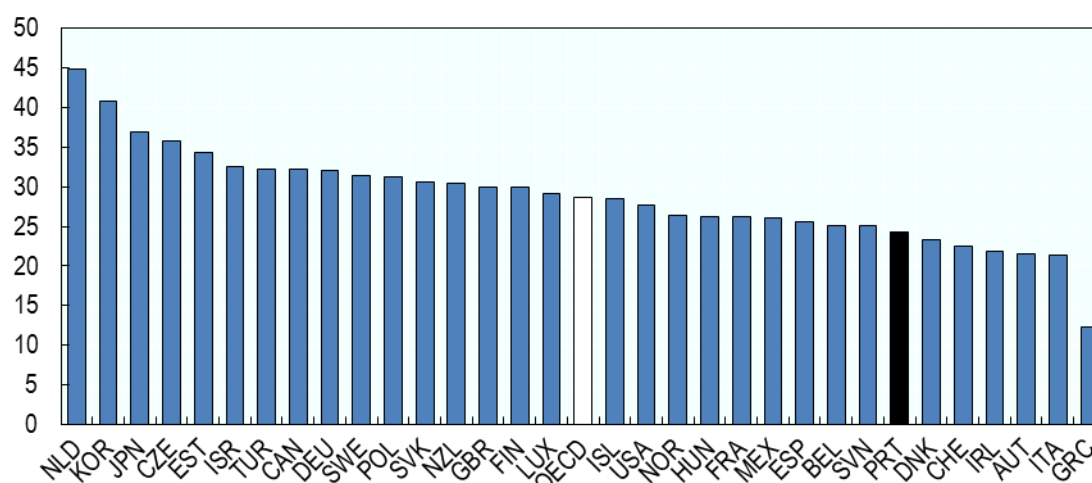
To increase productivity, Portugal has restructured its purchasing function and consolidated purchases to achieve economies of scale. The National Agency for Public Procurement³², established in 2007, has managed in recent years to professionalise the procurement function and achieve efficiency gains through the use of aggregation vehicles for the central administration (framework agreements) and investment in a state-of-the art e-procurement platform. One of the challenges facing the Government is to ensure that similar capacity is developed at the sub-national level.

³⁰ The UK experience also shows that there is a risk of overestimating future demand, and those risks might be taken better into account if PPPs were to be included as contingent liabilities in government accounts, as is current practice in a number of OECD countries. See Sutherland *et al.* (2009) *op. cit.* and Araujo, S. and D. Sutherland (2010), "Public-private partnerships in OECD countries: Identifying best practices", *OECD Economics Department Working Papers*, No. 803, OECD, Paris.

³¹ Since 2012 the State Budget has included a chapter on contingent liabilities in general, which included contingent liabilities from PPPs.

³² In 2012 the agency was merged with ESPAP (*Entidade de serviços partilhados da administração pública portuguesa*) to handle shared services for the Portuguese public administration and further increase economies of scale.

FIGURE 27. GENERAL GOVERNMENT PROCUREMENT AS A SHARE OF TOTAL GENERAL GOVERNMENT EXPENDITURES (2011)



Note: Data are not available for Australia and Chile. Data for Canada, Japan, Korea, Mexico, New Zealand and Turkey refer to 2010.

Source: OECD National Accounts Statistics

Portugal is increasingly using procurement as a policy lever to pursue policy objectives, such as SME development, innovation, and environmental protection. This is being done, for example, by dividing government contracts into small lots. Also, Portugal is increasingly promoting green criteria in its procurement procedures to promote environmental protection. However, it does not systematically verify whether green measures are actually contributing to greener products and services³³.

Managing EU funds effectively

Since joining the EU, Portugal has benefitted from significant inflows of EU funds that have had a substantial impact on infrastructure development. Beside the upgrading and expansion of motorways and railway lines, EU funds have contributed to developing ICT infrastructure and promoting the use of ICT in the public administration, an area where Portugal is at the forefront among OECD countries. Portugal appears to have been able to absorb EU funds relatively effectively. As of end-2012, almost 60% of the allocated EU funds had been disbursed by the European Commission, a disbursement rate second only to Lithuania among the 27 EU Member States.³⁴

EU funds have been a major source of financing for public environmental investment. About 15% of available EU funds in the 2007-13 programming period have been allocated to environmental infrastructure, including renewable energy sources and energy efficiency. This also reflects an increased emphasis on more innovative sectors and on more advanced solutions to traditional environmental management issues.

Programmes for allocating and using EU funds have increasingly been based on sound analysis of investment needs and identification of adequate progress indicators. They have contributed to improving environmental performance and administrative capacity in Portuguese regions.

³³ *Government a Glance*, forthcoming 2013 edition

³⁴ *EU Cohesion Funding Key Statistics*,
http://ec.europa.eu/regional_policy/thefunds/funding/index_en.cfm

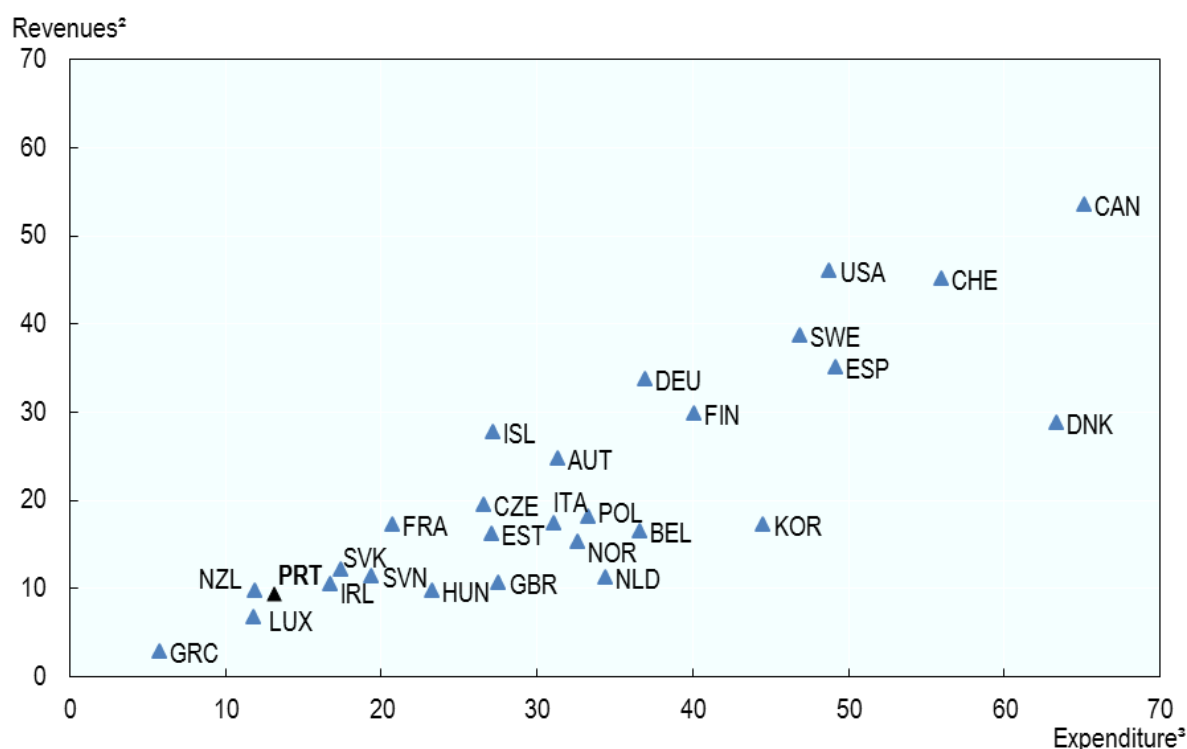
A further significant inflow of funds is expected over the next programming period (2014-2020). It is essential to ensure that these funds are used as effectively as possible in support of Portugal's strategic goals, including actions to strengthen SMEs and rebalance the economy. Portugal appears to be developing some important new ideas for how the funds might be refocused, for example less on infrastructure and more on direct support for companies through soft loans. As in many other OECD countries, regional policy and hence responsibilities for the allocation of these funds are somewhat dispersed and fragmented across different ministries and state-secretaries, making it difficult to have a co-ordinated and coherent view on how to use these structural funds. It is therefore important to fully clarify responsibilities and leadership for steering, negotiating and securing desirable changes in the allocation of EU structural funds for the new programming period 2014-2020.

Better use of EU structural funds is also crucial to making the most of sub-national expenditure and investment. It is now easier to absorb such funds, given that the EU has reduced the local co-financing requirement from 30 to 15%, although many municipalities find even this level of commitment a challenge. Improving the use of EU funds – and of limited public investment resources more generally – will require changes in governance, not least to improve (and de-politicise) project selection and design. Generalising the use of *ex ante* economic analyses and assigning a key role in project selection to more independent and accountable agencies could help.

Strengthening sub-national public financial management

At the sub-national level, Portugal is characterised by influential but financially dependent municipalities, and the absence of an elected intermediate regional level (except in the two autonomous regions of Azores and Madeira). Portuguese municipalities are relatively large, but the share of municipalities in total government revenues and expenditures is fairly low by OECD standards (Figure 28). Their fiscal autonomy is limited in other ways as well: they have only limited power to adjust the rates or bases of the local taxes and fees that constitute roughly half of their revenue, with the balance coming from central transfers and EU structural funds (especially for the poorest municipalities). Overall, the system offers few incentives and little autonomy for municipalities to improve their own revenue bases, creating a sort of poverty trap for some municipalities. Moreover, the rapidly increasing debt of sub-national governments has recently become an issue for the national government.

FIGURE 28. SUB-NATIONAL SHARES OF TOTAL TAX REVENUES AND BUDGETARY EXPENDITURES, 2009



Source: OECD (2012), *Reforming Fiscal Federalism and Local Government*, OECD Publishing, Paris.

Reducing the cyclicality of sub-national government revenue

The crisis has had a major impact on local finances, not least owing to the impact of the downturn on revenue from corporate and personal income taxes and taxes linked to housing transactions, which account for a large share of the total. Municipalities' real revenues fell by nearly 5% between 2007 and 2010. As a result, their aggregate budget deficit rose to 12.5% of revenues in 2010, from less than 4% in 2007. Since then, expenditure cuts have enabled them to return to surplus, even though national-level consolidation packages have involved cuts in transfers from the centre.

Reforms to reduce the cyclicality of local revenues could ease the pressure on Portugal's municipalities (as advocated in the 2012 OECD *Economic Survey of Portugal*). First, the taxation of housing could be shifted from transactions to recurrent levies on immovable property, as is currently being done (see Chapter II.1); this was under discussion in Parliament in early 2013. The draft of the new Local Financing Law envisages an increase in revenues from immovable property and the abolition of the transaction tax on immovable property. Furthermore, municipalities' right to 5% of the PIT revenue generated within their jurisdictions will no longer be subject to any maximum cap. The draft bill submitted to Parliament at the end of 2012 also provides for setting transfers from central to local Governments in advance on a multi-year basis; this is a positive step and should reduce uncertainty about the future. Finally, municipalities could be given greater freedom to adjust local taxes. This might also lead to more efficient public services by strengthening municipal authorities' accountability to their taxpayers. But this should not be a substitute for local efforts to rationalise spending. In one respect, however, it would be desirable to *reduce* municipal fiscal autonomy: at present, Portuguese municipalities commonly extract "compensations" from businesses moving into their jurisdictions (*e.g.* wind turbine farms, retailers). While in some cases warranted by the externalities involved, this practice tends to strengthen reliance on an uncertain revenue source and can also inhibit competition.

Enhancing the efficiency of local expenditure

There is also considerable scope for national-level reforms to enhance the efficiency of local public expenditure. Excessive fragmentation is one source of inefficiencies, with certain parishes containing only a few hundred people and inter-municipal co-operation still nascent.

A number of welcome reforms have been enacted or are being prepared to tackle these issues. A new law on local public companies was approved in August 2012, and in January 2013 Parliament approved a law (11-A 2013) to cut the number of parishes by around 30%. A new bill on a new framework law on the attribution of authority and powers to local administrations and the status of inter-municipal entities was submitted to Parliament in early 2013. Its purpose is to shift responsibilities to the administrative levels that can handle them most efficiently. The proposal to revise the laws on local finance (municipalities) and on regional finance (the two autonomous regions) was approved by the Council of Ministers in December 2012 and, in its general principles, by the Parliament in February 2013. The detailed discussion is now taking place in Parliament. After final approval, this new law will: (i) bring local and regional budgetary frameworks into line with the revised Budgetary Framework Law; (ii) strengthen fiscal accountability; (iii) limit the scope for the two autonomous regions to apply lower tax rates than on the mainland; (iv) strengthen the central tax administration's audit and enforcement powers and extend them over currently tax-exempt regimes; and (v) strengthen the requirements for data provision to support revenue projections. These reforms have the potential to substantially enhance expenditure efficiency at sub-national levels

Better governance for better investment outcomes

In response to a 2012 OECD questionnaire, the authorities in Portugal underscored the need for greater co-ordination of public investment across levels of government, sectors, and sub-national jurisdictions. Given the centralised character of Portugal's polity, the national government is advised to take the lead in fostering greater dialogue at regional level between central government representatives and local stakeholders. This would bring more bottom-up input to the investment process and result in a choice of projects that better reflects regional challenges and potential.

More can also be done to enable governmental actors at all levels to engage the private sector in major projects and to equip them with the capacities needed to do so. Such a place-based approach, focused on identifying potential complementarities among sectoral policies, is crucial to unlocking the full potential of public investment to support growth and enhance the quality of public service provision.³⁵ Such a focus is all the more important when resources are tight.

³⁵ OECD (2013), *Investing Together: Meeting the Co-ordination and Capacity Challenges Across Levels of Government*, OECD Publishing, Paris (Forthcoming).

Budget framework

- ✓ **Reform public governance**, as planned, to improve project selection and strengthen vertical (across levels of government) and horizontal (across sectors and across jurisdictions) co-operation to make public investment more efficient and effective.
- ✓ **Add an expenditure rule** to the current fiscal framework.
- ✓ Consider enhancing budget bureau analysis capacity and **introduce stronger top-down budgeting** and a spending review mechanism.
- ✓ Assess and evaluate the implementation of the reforms of budgetary practices and institutions in order to adjust and take stock of lessons from other countries.

PPPs

- ✓ **Implement improvements to the governance framework for PPPs and maintain efforts to** ensure that all relevant actors have capacity and mandate with respect to PPPs. Maintain efforts to ensure that the relevant value-for-money tools are developed and provide key inputs to the procurement process.

Procurement

- ✓ **Review the effectiveness of the public procurement function** against the *OECD Recommendation on Enhancing Integrity in Public Procurement*. In particular, the review could focus on optimising the organisation of the procurement agency to increase productivity in central government and clarifying its role against contracting authorities at the local level.
- ✓ **Develop capacity within the Government for measuring the performance of the procurement system** and verifying, with evidence-based data, whether procurement is actually helping promote policy objectives such as SME development or environmental protection.

EU Funds

- ✓ As planned, **clarify responsibilities and leadership** for steering, negotiating and securing desirable changes in the allocation of EU structural funds for the new programming period 2014-2020.

Sub-national Governments

- ✓ Ensure swift full adoption and implementation of the new local and regional finance laws so as to reduce the volatility of local revenues by shifting from a reliance on housing-transaction taxes to recurrent levies on immovable property, and by fixing central transfers on a multi-year basis.
- ✓ **Enhance local spending efficiency** through some consolidation of local authorities, generalisation of the use of benchmarking and performance indicators and further steps to foster inter-municipal co-operation.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

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