"Better Policies" Series

PORTUGAL

DEEPENING STRUCTURAL REFORM TO SUPPORT GROWTH AND COMPETITIVENESS

JULY 2014

OECD

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Foreword

Having been hit hard by the global crisis, the Portuguese government has taken action to put its economy back on track, and to correct external and budgetary imbalances. Public finances have strengthened, and the current account deficit has closed on the back of gains in competitiveness and improvements in export performance. Portugal has also been able to reduce income inequality and contain the increase in poverty, despite undergoing a severe crisis with record levels of unemployment. As Portugal successfully exits the EU-IMF-ECB-supported programme and emerges from recession, it is more important than ever to build on these achievements.

At the request of the Portuguese authorities, the OECD has carried out an assessment of the impact of the reforms implemented to date on the economy's longer-term growth outlook. The analysis is based on OECD indicators of the restrictiveness of Product Market Regulation (PMR) and the strictness of Employment Protection Legislation (EPL). It updates the OECD report *Portugal: Reforming the State to Promote Growth,* published in 2013.

According to the OECD's *Going for Growth* exercise, Portugal is among the OECD countries with the best recent track record of responsiveness to structural reform recommendations. The reforms undertaken since 2009 to promote competition in product markets and enhance the dynamism of the labour market are expected to raise productivity and potential GDP by at least 3.5% by 2020.

This document also highlights some key priorities to support economic growth and competitiveness through further productivity-enhancing structural reforms. Reducing regulatory barriers further could boost the economy by as much as 5.5% by 2020. Needed reforms include lowering the restrictiveness of transport and professional services regulations, as well as continuing to tackle labour market rigidity and segmentation. Our analysis also provides options to improve the mix of skills of the labour force, enhance the innovation performance of businesses, and pursue tax reform in support of growth and inclusiveness.

We welcome the opportunity to provide timely input into Portugal's policy-making process and look forward to supporting the country as it continues on a path towards a durable economic recovery and sustained improvements in the wellbeing of the Portuguese people.

Angel Gurría

Secretary-General, OECD

1. Introduction

Over the last few years, Portugal has made significant progress in addressing long-standing imbalances. Fiscal accounts have improved in line with programme targets, sovereign access to financial markets has been restored and, underpinned by significant improvements in competitiveness and export performance, the current account deficit has been closed. Alongside these macroeconomic improvements, structural policy reforms have begun to improve labour and product market performance, opening the way to sustain stronger and more inclusive growth. To achieve this objective, Portugal needs to extend and deepen structural reforms.

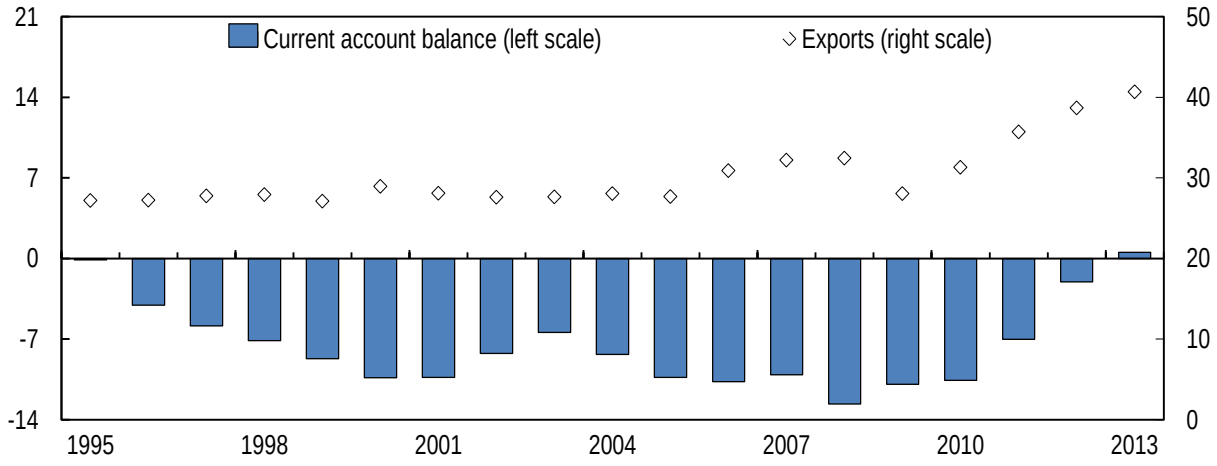
Adjustment and reform are bearing fruit

Portugal is emerging from a long and deep recession, which has left a legacy of high unemployment (15.2% in March 2014) and lower household incomes. Recent economic indicators have suggested some positive trends, including declining unemployment and strong export growth. The authorities' determined reform efforts are bearing fruit earlier than had been expected at the beginning of the EU-ECB-IMF programme. As global conditions improve and domestic demand recovers, the economy should gradually pick up strength.

Significant progress has been made in improving Portugal's external position, as evidenced by the elimination of the long-standing current account deficit and strong growth in exports. By end-2013, exports had increased to over 40% of GDP, compared to less than 30% of GDP before the crisis (Figure 1). Despite this significant increase, the share of exports in GDP is still low for a small open economy like Portugal, and there is scope for further progress.

Figure 1. Current account balance and exports

Per cent of GDP



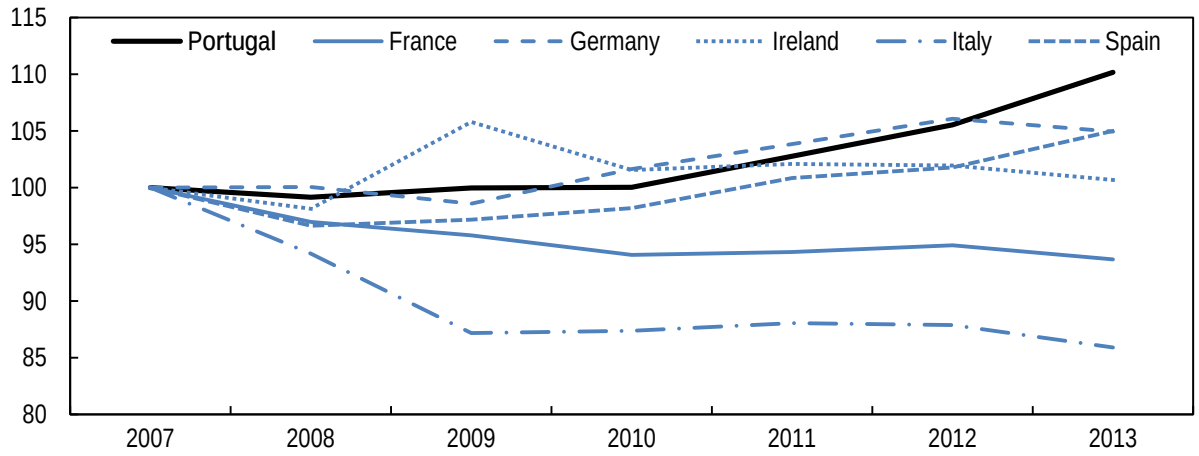
Source: OECD (2014), OECD Economic Outlook: Statistics and Projections (database), April.

Exports have been driving economic growth on foot of sustained gains in market share by Portuguese exporters since 2010, outpacing most of their European competitors (Figure 2). These gains have been broadly based, and are testament to the flexibility of Portuguese firms to shift to external markets in to the face of stagnating domestic demand, and to marked improvements in international competitiveness. Unit labour costs experienced a particularly large fall in 2013 (Figure 3), originating largely in the public sector. The regular work week of central government employees was raised from 35 to 40 hours with no pay rise in September 2013. This adjustment builds on earlier ones in the tradable sector.

Yet, Portuguese exporters continue to be at a potential disadvantage vis-à-vis international competitors across a number of dimensions, notably with respect to access to inputs from non-tradable sectors which can be improved through further pro-competition reforms in domestic product markets. Further progress and stronger competition is needed in sectors such as energy, communications, transport and professional services (**Chapters 3 and 6**). Moreover, there is significant scope to improve firms' access to finance and to enhance the skill-set of employees (**Chapter 5**). Portugal will also have to address remaining impediments to labour-market performance, particularly with respect to collective wage bargaining agreements and the duality in its labour market (**Chapter 4**). Streamlining administrative procedures further to make them more business-friendly will also support future export performance, and on Portugal's ability to attract foreign direct investment into tradable sectors.

Figure 2. Export performance

Index 2007 = 100[1]

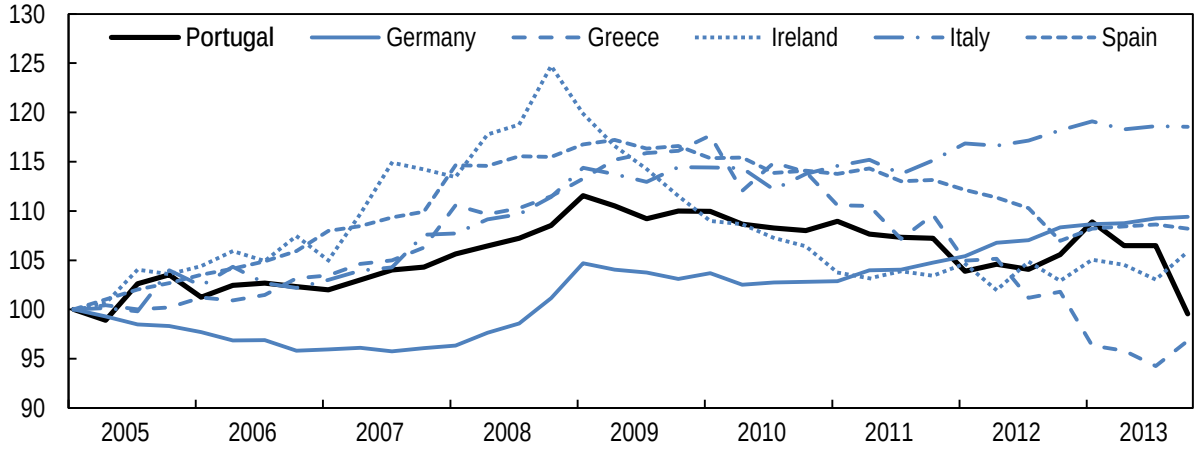


Export performance is the ratio between export volumes and export markets for total goods and services.

Source: OECD (2014), OECD Economic Outlook: Statistics and Projections (database), April.

Figure 3. Unit labour costs

Index Q1 2005 = 100[1]



Seasonally adjusted. Unit labour costs (ULCs) are calculated as the ratio of total labour costs to real output. Early estimates of quarterly ULC use employment and not hours worked as measure of labour input. Data for Greece from Q2 2011 onwards are estimates.

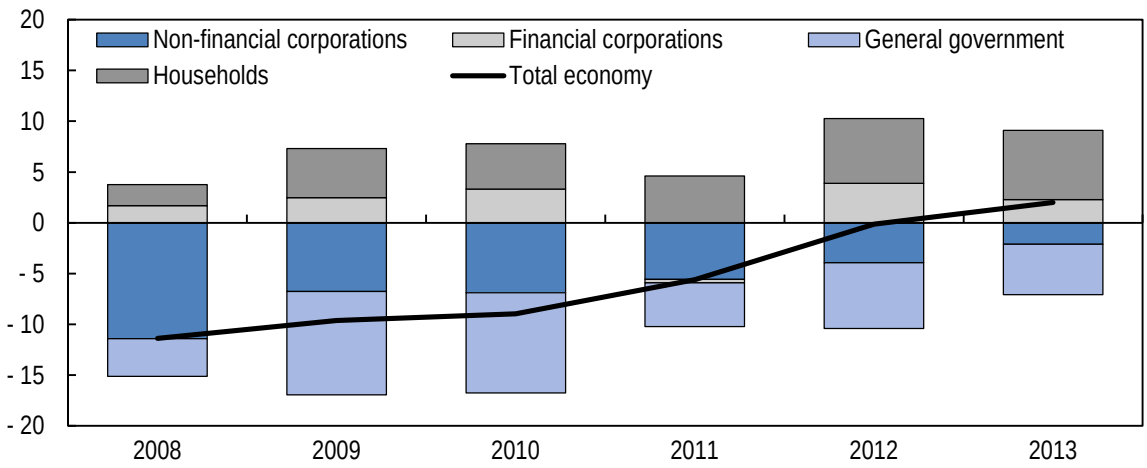
Source: OECD (2014), OECD Productivity Statistics (database), April.

Fiscal consolidation and private sector deleveraging are progressing

The pre-crisis years had been characterised by excessive levels of indebtedness across the economy, but progress has been made in repairing both public and private balance sheets (Figure 4). The fiscal deficit is expected to decline to 4% of GDP in 2014, while the primary balance will be positive for the first time in 20 years. Under reasonable assumptions on the future development of prices and interest rates, a continuation of the current consolidation strategy implies a gradual decline of public debt relative to GDP.

Figure 4. The economy is deleveraging

Net lending and borrowing in per cent of GDP

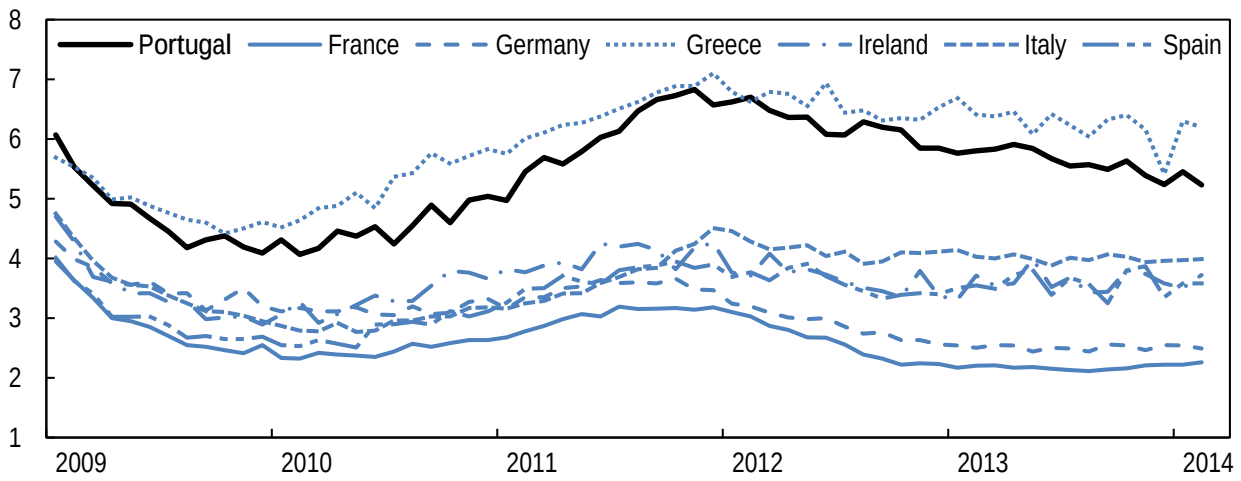


Source: INE (2014), "National Accounts Statistics", Instituto Nacional de Estatística, March.

Non-financial companies still bear a very high debt burden of 230% of GDP, which is the third highest corporate debt level in the OECD, after Luxembourg and Ireland.[1] Debt on this scale limits credit flows to the corporate sector and, together with European banking fragmentation and other factors, leads to much higher financing costs for Portuguese companies than most of their European competitors (Figure 5). At the same time, the high debt levels also put a burden on banks' balance sheets. Non-performing corporate loans are at high levels, and more than 40% of corporate debt has been issued by companies whose earnings are insufficient to cover interest expenses. More will have to be done to alleviate the debt burden on firms that are economically viable, while avoiding the "evergreening" of loans to firms that are not. Further strengthening the banking system further will also help improve access to finance for small and medium-sized enterprises, which have suffered most during the crisis.

Figure 5. Interest rates on bank loans

Interest rates on loans to non-financial corporations, per cent per annum[1]



Note: Figures refer to total loans (defined for cost of borrowing purposes) to non-financial corporations. The total for maturity is calculated by weighting the volumes with a moving average.

Source: ECB (2014), "MFI Interest Rates", Statistical Data Warehouse, European Central Bank, April.

Portugal's key challenge now is to build on the reform momentum and not take the recent decrease in spreads as granted. Further progress in reforming product markets, labour markets, and deleveraging in the financial system will be necessary to lock in some of the recent achievements and extend them across the economy, notably to the non-tradable sector, to boost potential growth. The following chapter describes the potential gains from these reforms.

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[1] For comparison, non-financial corporate debt in Spain amounts to 180% of GDP, in France to 157% and in Germany to 100%. All of these numbers are based on the debt definition applied in the OECD Financial Dashboard, May 2014.

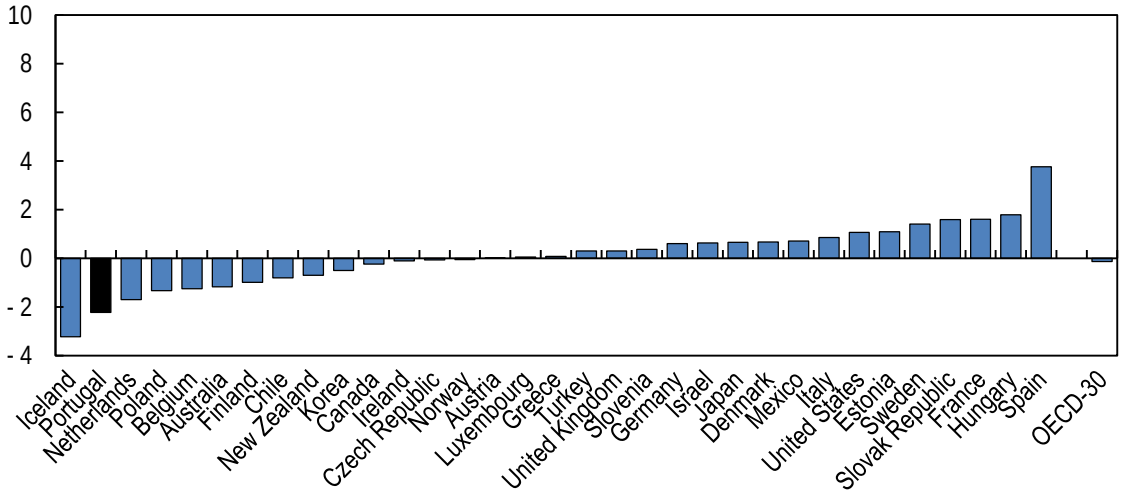
Social solidarity has been protected

Portugal's fiscal consolidation and deleveraging have been carried out in a relatively equity-friendly manner. Between 2007-11, Portugal actually experienced the second largest decline in income inequality in the OECD, as measured by the Gini coefficient (Figure 6). However, the improvement in income distribution was concentrated in the 2007-9 period. Inequality has hardly changed since, remaining stuck at a high level (the sixth highest in the OECD). The relative poverty rate has also declined sharply over this period, an achievement that has been maintained despite a difficult economic environment (Figure 7).

Despite adverse recent trends in poverty, Portugal's ability to contain the negative social consequences of the crisis is remarkable, especially given that the rise in unemployment was concentrated among lower-income households. It demonstrates the redistributive power of automatic stabilisers, such as unemployment benefits, but is also the result of reforms that have protected vulnerable social groups. For instance, the 2010 pension reform involved cuts for pensions above EUR 1,500 and froze indexation for all except the lowest pensions, although these pension cuts were deemed unconstitutional by the Constitutional Court in April 2013. In 2012, the necessary contributory period to access unemployment benefits was reduced from 450 to 360 days, expanding their reach. Social security was also extended to "dependent" self-employed workers who work mainly with only one contracting entity.

Figure 6. Inequality: Change in Gini coefficient of household disposable income

Percentage point change between 2007 and 2011



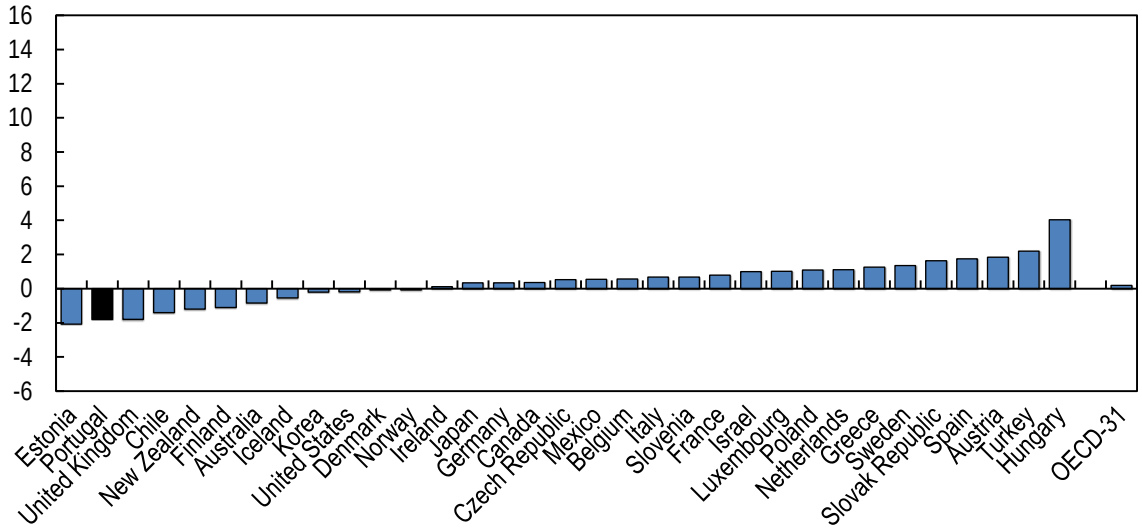
Note: 1. Increasing values of the Gini coefficient indicate higher inequality in the distribution of income. Disposable income is obtained by subtracting income tax and employees' social security contributions from gross income and is adjusted to reflect differences in household needs depending on the number of persons in the household.

2. Data for 2007 refer to 2006 for Chile and Japan; and 2008 for Australia, France, Germany, Israel, Mexico, Norway, New Zealand, Sweden, and the United States. Data for 2011 refer to 2009 for Japan; 2010 for Austria and Belgium; and 2012 for Australia, Finland, Hungary, Korea, Mexico, the Netherlands and the United States. For Hungary, Mexico and Turkey data on market income inequality are not available. There is a break in the series in 2011 for the United Kingdom, and results are not strictly comparable. 2011 data for Ireland and the United Kingdom are provisional. OECD-30 average excludes Hungary, Mexico, Switzerland and Turkey.

Source: *OECD Income Distribution Database (via www.oecd.org/social/income-distribution-database.htm)*.

Figure 7. Poverty rates[1]

Percentage point change between 2007 and 2011



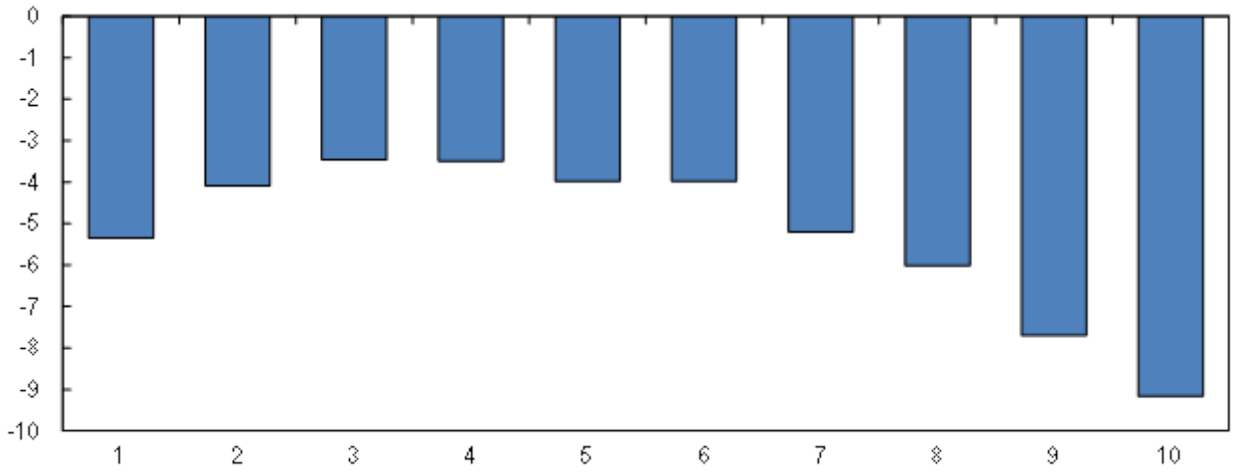
Note: Relative income poverty is the share of people living with less than 50% of the median equivalised household disposable income. Changes in relative poverty can be difficult to interpret during recessions as the current median income is usually going down, which could hide an increase in absolute poverty.

Source: OECD (2013), Society at a Glance 2014: OECD Social Indicators*.*

But while recent policy reforms in the context of fiscal consolidation have generally shifted most of the burden to high-income households, simulations suggest that the lowest income group has also suffered significant losses in disposable income as a result of reforms (Figure 8). Social transfers could therefore be used more effectively to alleviate this negative effect on the most vulnerable. In particular, the cuts in minimum income benefits during the crisis have hit the incomes of poorer households. As these benefits were already low relative to the minimum wage, the government should consider undoing the cuts as soon as the fiscal situation allows. Unemployment benefit coverage also needs to be further extended.

Figure 8. Simulated change in household disposable income due to fiscal consolidation by income deciles

Per cent of household disposable income, 2009-2012[1]



Source: Avram, S., F. Figari, C. Leventi, H. Levy, J. Navicke, M. Matsaganis, E. Militaru, A. Paulus, O. Rastrigina and H. Sutherland (2012), "The distributional effects of fiscal consolidation in nine EU countries", Research note 01/2012, European Commission, DG Employment, Social Affairs & Inclusion, December.

2. Assessing the impact of structural reforms

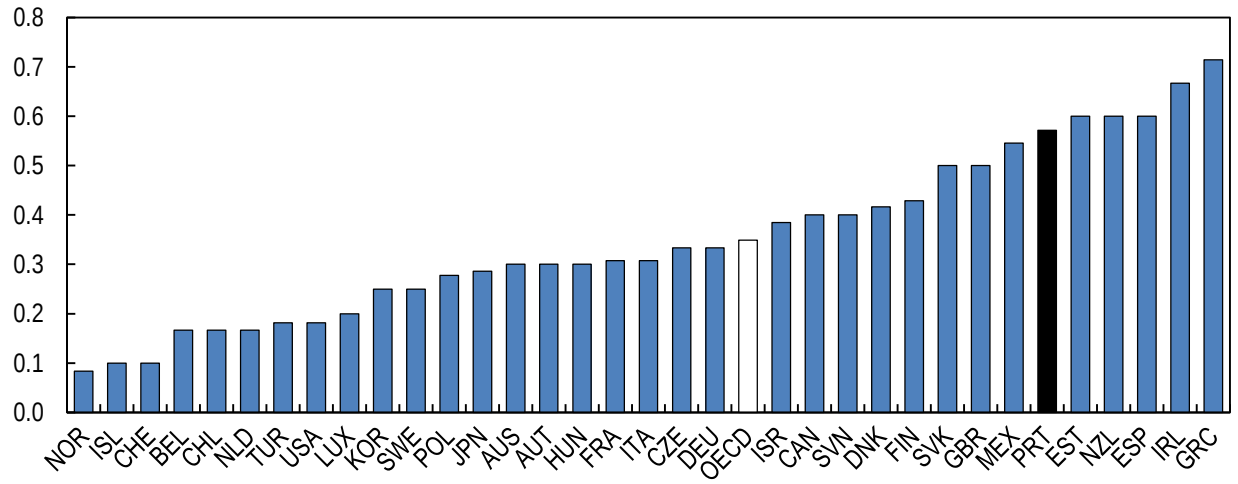
Following the economic crisis and the loss of access to financial markets, the Portuguese authorities embarked on an ambitious and fast-paced reform agenda. The shift of the economy's orientation towards the tradable sector became a matter of urgency. In line with the Economic Adjustment Programme, the authorities began to address many of the existing distortions and structural rigidities in the economy through structural reforms. While the impact of these reforms has been highly positive, there is still scope for further growth-enhancing measures in product market regulation, labour market policies and education. In particular, a move by Portugal to best practice among all OECD countries in the various areas and sectors of product market regulations would yield a further increase in the level of productivity and GDP of 5½ percent by 2020.

Portugal has been a leading reformer in recent years

Prior to the crisis, Portugal suffered from various structural weaknesses. Labour markets functioned poorly and product markets were characterised by excessive economic rents in many non-tradable sectors. Since 2011, major reforms have been made to reduce the restrictiveness of employment protection and reduce barriers to product market competition. Portugal's progress on structural reforms has become clearly visible in the regular OECD structural policy surveillance exercise *Going for Growth*. In fact, Portugal emerged as one of the top reformers during 2012 and 2013 (Figure 9).

Figure 9. Responsiveness to Going for Growth recommendations

Responsiveness rate, 2012-2013



Note: Responsiveness rates are calculated as the share of priority areas in Going for Growth in which 'significant' action has been taken. The OECD aggregate is calculated as an un-weighted average.

Source: OECD calculations based on Going for Growth 2014.

There are still large potential gains from further product market reforms

Further structural reforms, such as the easing of regulations in product markets as described in more detail in the following section, can contribute significantly to stronger growth and better living standards. Empirical estimates suggest a positive and significant link between reforms that enhance competition on one hand, and multi-factor productivity on the other.[2] 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. By focusing on sourcing relationships between different sectors of an economy, these estimates are able to capture the economy-wide effects of reform actions in individual sectors.

For Portugal, such simulations suggest that the product market reforms undertaken since end 2008 – including improvements in the electricity, gas and retail trade sectors – have already started to raise the levels of productivity and potential GDP and, overall, by 2020 is expected to have led to a 3-percent increase in their levels (Figure 10). In addition, recent labour market reforms could add about 0.5 percent to the level of productivity and potential GDP by 2020 (not shown in figure).

Potential gains from further pro-competition reforms remain large. A reform scenario could aim for a further reduction of regulatory barriers to competition by 20% in each sector on the basis of the OECD PMR indicator. This corresponds roughly to the magnitude of changes observed over the past ten years on average across those OECD countries that have implemented product market reforms. Under such a scenario, the gains in the levels of productivity and GDP per capita for Portugal would be 2 per cent by 2020, which again would come in addition to the benefits accruing from the changes made since end-2008. While there are obvious uncertainties surrounding such empirical exercises, they clearly suggest that further reforms of product market regulations hold great potential to raise growth and living standards.

A more ambitious scenario that demonstrates the full potential of reforms can be considered by simulating a move by Portugal to best practice among all OECD countries in the various areas and sectors of product market regulations. Such reforms would yield an increase in the level of productivity and GDP of 5½ percent by 2020, and even more over the longer term (Figure 7). This is equivalent to an increase in GDP growth by around 0.8 percentage points each year between now and 2020, or an annual increase in nominal GDP of EUR 1.3 billion, measured in 2014 Euros. The overall effect of product market reforms undertaken since end-2008 combined with the additional reforms needed to move to OECD best practice would deliver a total gain of 8.5 percent in the level of productivity and GDP.

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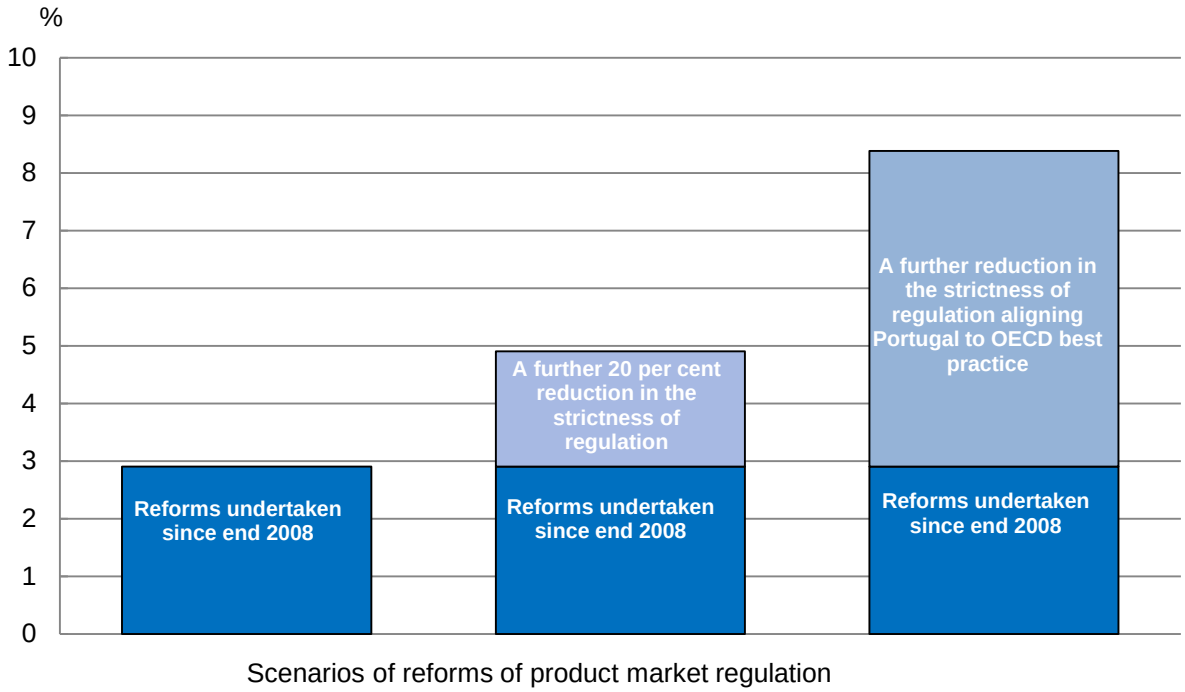
[2] Bourlès, R., G. Cette, J. Lopez, J. Mairesse, and G. Nicoletti (2013), "Do Product Market Regulations in Upstream Sectors Curb Productivity Growth? Panel Data Evidence for OECD Countries", The Review of Economics and Statistics, vol. 95(5), pages 1750-1768.

Figure 10. Expected gains from product market reforms: impact on the level of productivity and potential GDP by 2020

Per cent



Source: OECD estimates.

Structural reform priorities

Going forward, it is important to maintain the impetus of reforms by setting up mechanisms for identifying new priorities on an ongoing basis and reflecting them in the regular policymaking process. In particular, further reform priorities could be identified on the basis of an evidence-based benchmarking exercise. This would allow policymakers to assess the impact of, and amend as necessary, past reforms, while identifying those avenues of future reform with the greatest potential impact. It would also allow for measurement of both the current state of play – e.g. current levels of PMR and EPL – and progress with the implementation of reforms, as well as facilitating the benchmarking of performance in these areas against peer countries.

The OECD *Going for Growth* exercise includes regular surveillance of structural policy settings across countries, and provides recommendations on how these policies can be improved (see Box 1 for more details on the exercise). In the case of Portugal, structural reform priorities have been identified in the areas of regulation on product and labour markets, and on education. These are areas where Portugal has traditionally been lagging behind best practice among OECD economies.

In the area of labour markets, reform priorities for Portugal included reducing job protection on regular contracts and reform wage bargaining, as labour market duality and administrative extension of collective agreements hurts productivity and employment for vulnerable groups. The *Going for Growth* exercise also identified a need to reform unemployment benefits and strengthen active labour market policies.

On product markets, the exercise saw scope to strengthen competition in non-manufacturing sectors. Increasing competition in network industries and professional services would foster innovation and lower prices, thus raising competitiveness in downstream industries. It was also suggested to reduce administrative burdens at the local level, as slow and costly licensing procedures have been shown to hamper entrepreneurship and productivity.

Finally, with respect to education, reform priorities include improving outcomes and equity in education, including through vocational education and training, as good performance in this area is essential for a productive and adaptable labour force. Over the last decade, early school leaving rates have reduced substantially. Still, Portugal faces the challenge of low rates of educational attainment among those that have left the education system long ago, underlining the importance of improving opportunities for life-long learning. The remainder of this document focuses on recent reforms, and future reform priorities, in these three areas.

Box 1. Going for Growth: The OECD's regular structural surveillance exercise

The OECD's *Going for Growth* is a unique tool for the surveillance of structural policies across 39 countries. *Going for Growth* reports have been published annually for OECD countries since 2005, and since 2011 have included Brazil, China, India, Indonesia, Russia and South Africa.

The main purpose of the exercise is to identify five policy priorities for each of these countries with a view to improving long-term material living standards through higher productivity and employment. For each of the priority areas, concrete policy recommendations are formulated to address the identified challenges. Of the five priorities, at least three are selected on the basis of quantitative performance and policy indicators, in areas where performance and policy weaknesses coincide. The remaining two priorities are identified using a combination of indicators, where available, as well as country-specific expertise. This is to ensure that important policy priorities in areas that are not covered by indicators are not left out.

The matching of specific policies and areas of performance is made on the basis of empirical analysis uncovering a significant link between the two variables, generally on the basis of reduced-form (panel) regressions, where the impact of several policy and non-policy determinants on a specific area of performance is jointly estimated. Policy priorities aimed at improving labour productivity performance typically include the easing of entry restrictions into product markets and controls over business operations in markets for goods and services, policies to boost educational outcomes, to improve resource allocation throughout economies, as well as various other measures to boost efficiency in the areas of public administration, taxation and innovation.

Policy priorities aimed at improving employment generally include reducing disincentives to work at older ages, obstacles to female labour force participation, and labour taxation, as well as improving the design of disability and sickness benefit schemes and other labour market policies such as job protection, unemployment benefits and activation policies. The mapping is not always clear cut though, as a number of policies affect both labour productivity and labour utilisation, e.g. in the areas of product market regulation and job protection.

The top-level performance indicator in the *Going for Growth* framework is GDP *per capita*, which is then decomposed into labour force participation, employment, investment in various types of capital and productivity. GDP *per capita* is chosen as the metric for assessing progress in material living standards mainly for its contemporaneous availability, international comparability and relatively broad coverage. Recognising that GDP *per capita* on its own does not fully capture all dimensions of well-being, the *Going for Growth* framework is progressively integrating other indicators. For instance, the side effects of structural reform priorities on income distribution and the environment are regularly examined as part of the exercise.

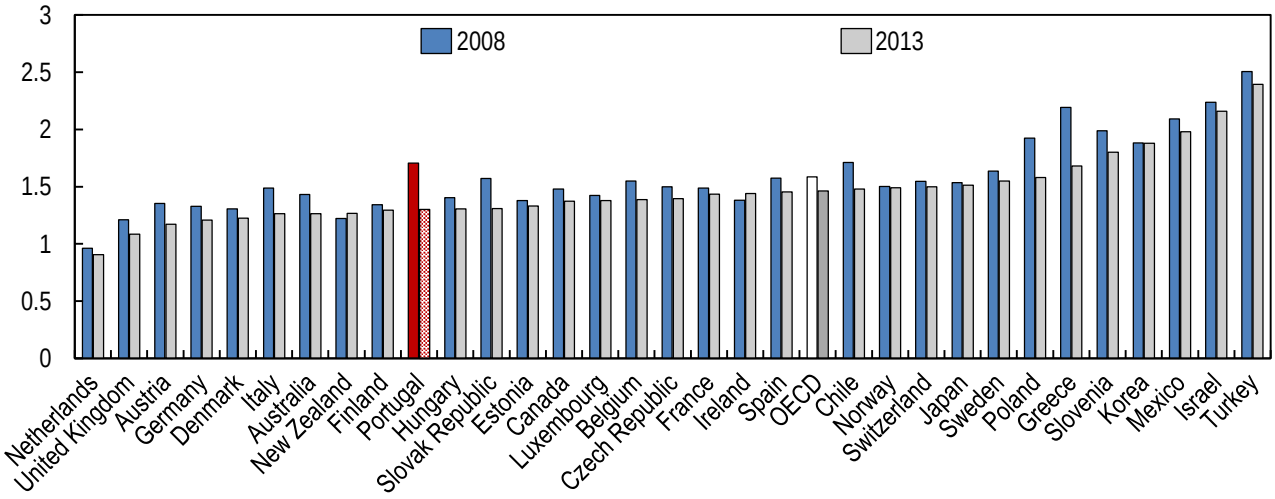
3. Further improving product market regulation and the business environment

Portuguese product markets have traditionally been characterised by weak competition, in particular in non-tradable sectors. This has been due to excessive regulation shielding incumbents. While the situation has improved substantially in recent years, particularly in network sectors, there is much scope for further progress. Areas of product market regulation where Portugal remains more restrictive than the OECD average include professional services and transport.

Product market reforms that enhance competition tend to improve multi-factor productivity as competition enhances firms' incentives for efficient production and investment. This in turn allows firms in other sectors to benefit from better inputs at lower prices. Between 2008 and 2013, Portugal has moved up 14 ranks among OECD countries in terms of how competition-friendly its overall product market regulation is, on the basis of the OECD Product Market Regulation (PMR) indicator, it is currently ranked 10th of 29 OECD economies for which data is available (Figure 11).

Figure 11. Aggregate product market regulation indicator

Index scale of 0-6 from least to most restrictive

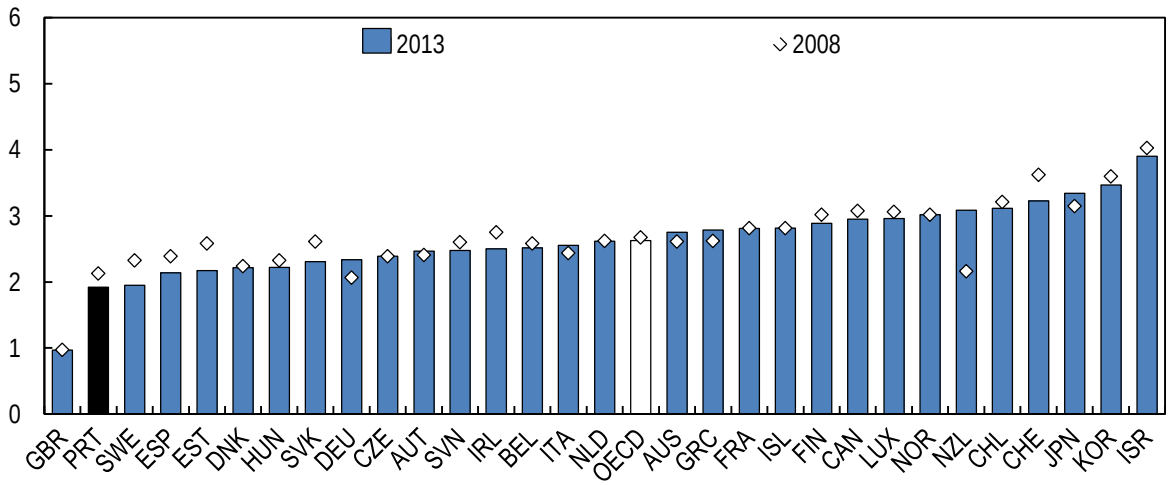


Source: OECD (2013), Product Market Regulation Database (preliminary data).

Substantial progress has been made, particularly in network sectors, where Portugal has become the OECD country with the second most competition-friendly regulation (Figure 12). At the same time, and notwithstanding the strong progress in the legislation measured by the indicators, the energy sector is still characterised by persistent economic rents and insufficient cost-effectiveness of public support for electricity generation in the electricity sector, and highly concentrated retail markets in electricity and gas.

Figure 12. Barriers in network sectors

Index scale of 0-6 from least to most restrictive

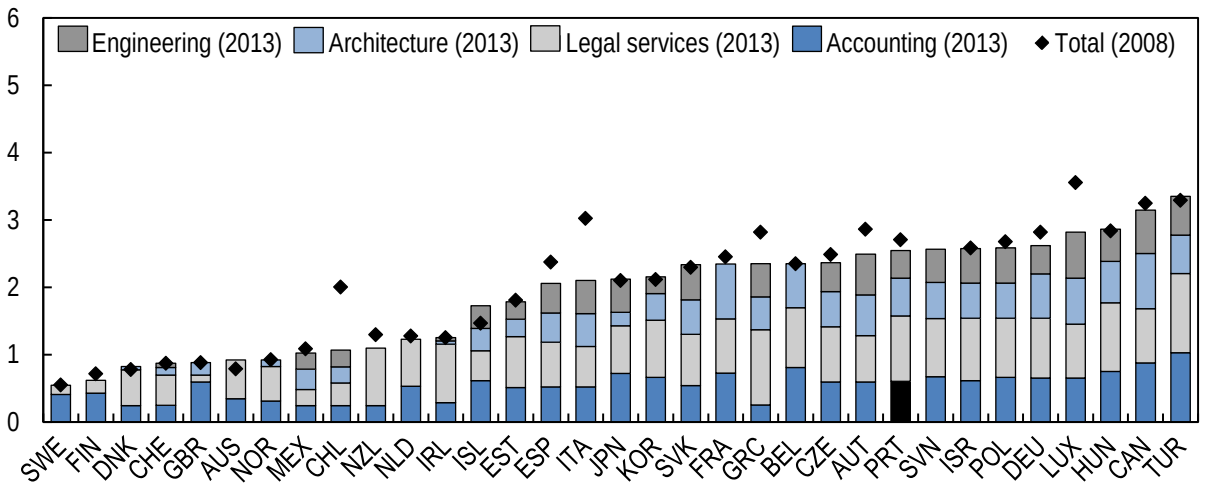


Source: OECD (2013), Product Market Regulation Database (preliminary data).

Areas of product market regulation where Portugal remains more restrictive than the OECD average include professional services such as accounting, legal, architecture or engineering services (Figure 13). Regulatory provisions that can limit competition include the strong role of professional associations, which typically favour current insiders as opposed to potential entrants, exclusive rights that reserve certain tasks only to members of a particular profession as well as regulations of prices and fees or the form of business. This is one area where there is particular scope for further strengthening competition through regulatory reform. Some important steps have been taken in this direction with the new framework law approved in 2013 which reforms regulations in 18 professional services (such as medical doctors, lawyers and engineers).

Figure 13. Regulation of professional services

Index scale of 0-6 from least to most restrictive

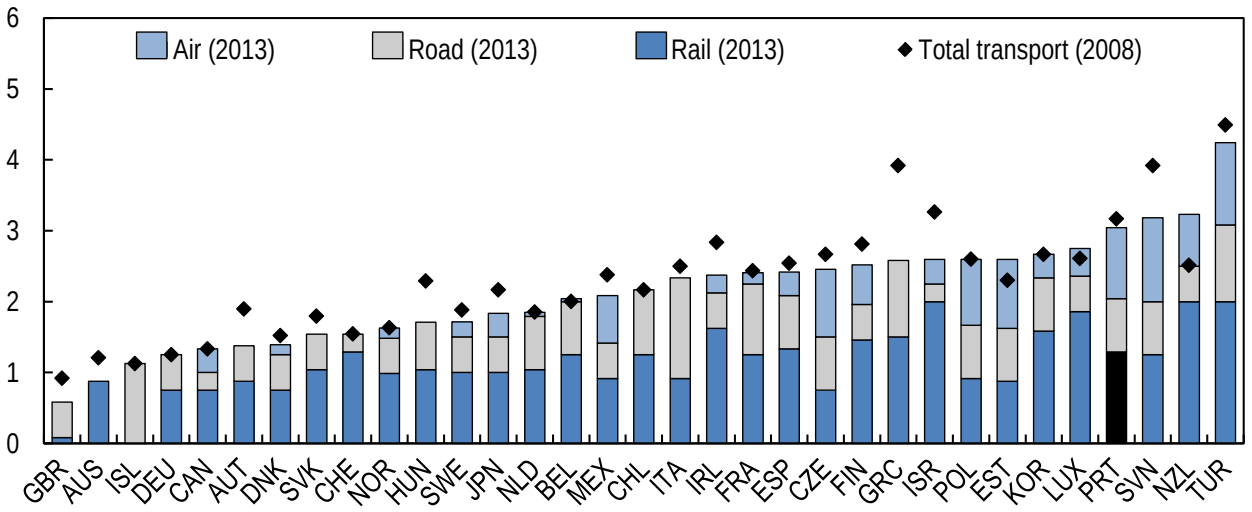


Source: OECD (2013), Product Market Regulation Database (preliminary data).

In the transport sector, Portugal still has more restrictions than other OECD economies (Figure 14). Remaining obstacles to competition include the still outstanding privatisation of the national airline TAP, the full separation of the rail network operator from train operators, and an easing of entry regulations in the road sector. Further progress seems underway in some of these areas. In the road sector, a working group to review current regulation has been established, while in railways, the government has recently made proposals for full vertical disintegration. State ownership among operators remains common, but the government has announced plans for granting concessions to some private operators. Large amounts of legacy debt in these operators represent an obstacle to faster transfer into private hands.

Figure 14. Regulation of transport sectors

Index scale of 0-6 from least to most restrictive



Source: OECD (2013), Product Market Regulation Database (preliminary data).

Beyond specific sectors, the authorities have also made progress with respect to administrative burdens on start-ups, including through a "Zero Licensing" programme which abolishes licensing for some services and almost all industrial projects. This approach should be extended to additional areas, with a view to reducing administrative burdens further. Another important development is the creation of a "one in, one out" rule, similar to the one implemented in the UK, with the goal of controlling the flow of new regulations. Under the new rule, a department proposing a new regulation generating costs to businesses is under an obligation to eliminate one or more regulations of equivalent cost.

Strengthening the competition policy framework

In recent years, Portugal's competition law has been modernised and brought into line with European guidelines. As shown in the Product Market Regulation indicator, however, there are some areas in which Portugal is still lagging other OECD countries. These include legal barriers to entry (22nd out of 29 OECD countries reported) and command and control regulation (24th out of 29 OECD countries reported).

The OECD has developed a Competition Assessment Toolkit to help identify new and existing regulations that pose unnecessary barriers to competition and to help lift the barriers identified. This can be used independently by governments and ministries but is more effective when used in a joint review with independent experts, as was the case in the recent competition review of Greece.

Inclusion of competition assessment as a standard part of regulatory impact assessment is standard in the UK Australia, Korea, Mexico (since 2013) and the United Kingdom. Thanks to these assessments, Australia has introduced major pro-competition reforms over the last decade. A widespread review of existing regulation was implemented in the 1990s, following a bipartisan agreement to establish a National Competition Policy. During a five year period regulatory reforms took place across the entire economy. The Productivity Commission found that, on average, GDP had been at least 2.5% above the estimated level without regulatory reform.

Effective enforcement of competition policy is also essential to foster a pro-competition environment. The recently approved revisions to the statutes of the Portuguese Competition Authority have increased its autonomy and granted it additional resources, but they may still be insufficient to be able to act effectively against vested business interests. In particular, the authority's unit in charge of competition assessment needs to be better supported so that it plays a central role in sector reviews of existing regulation, particularly related to barriers to entry and command and control regulation.

Key Recommendations

- **Work towards stronger competition and lower rents in the energy and transport sectors.** Screen existing regulations that contain potential restrictions on competition in these and other economically significant sectors.
- **Reduce restrictions on entry and conduct in professional services, and reduce the role of professional bodies in regulation**, including by ensuring the effective implementation of the new framework law**.**
- **Reduce administrative burdens further.** Consider extending the "zero licensing" programme to additional areas.
- **Enhance the resources and capacity of the Portuguese Competition Authority** to review regulations for their competitive effects and to make recommendations for reform.

4. Improving labour market performance

Portugal's high unemployment reflects a combination of weak aggregate demand compounded by structural impediments to faster job creation, despite the significant improvements arising from recent reforms to Employment Protection Legislation. In particular, the segmentation of the labour market has held back productivity growth and contributed to widening inequality. Therefore, a key priority to complement other reforms is to remove obstacles to job creation, to push ahead with measures to reduce labour market segmentation, and to promote that wage increases continue to be in line with productivity growth as the economy recovers. The reduction of segmentation, combined with more equitable unemployment benefits and better support for job-seekers, is also key to upholding social cohesion.

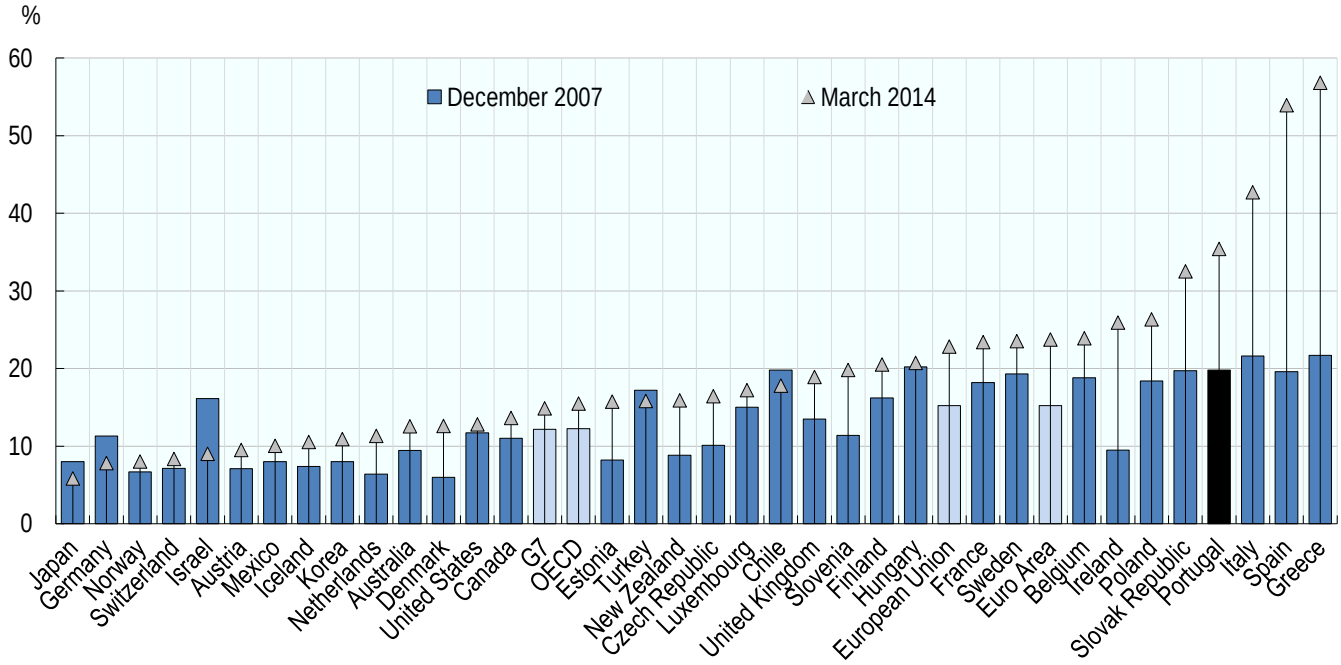
A legacy of high unemployment and labour market segmentation

At 15.2%, Portugal's unemployment rate was well above the OECD average of 7.6% in March 2014; and, at 57.9% (Q4 2013), long-term unemployment was one of the highest in OECD countries. Furthermore, the youth unemployment rate has increased markedly since the onset of the global economic crisis, reaching a historic high in February 2013 of 40.6% (twice the level in December 2007). The youth unemployment rate was reduced to 35.6% in March 2014 but remains more than twice the average rate for the OECD area (15.5%) and the fourth highest in the OECD after Greece, Spain and Italy (Figure 15). While these outcomes are linked to the crisis, they also reflect structural rigidities stemming from stringent employment protection, wage bargaining, weak active labour market policies and mis-allocated unemployment benefits.

The Portuguese labour market is characterised by a high degree of segmentation, 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, most of the burden of adjustment is borne by temporary workers, contributing to widening income inequality. Addressing segmentation is essential to restore dynamism in the labour market and has rightly been the focus of recent reform efforts. Fostering labour mobility and retraining is also necessary to accommodate the structural shift to a more dynamic tradable sector.

Figure 15. Youth unemployment rates, December 2007 – March 2014[a]

Share of total workers in age group



Note: Countries shown in ascending order of the youth unemployment rates in Q4 2013.

a) January 2014 for Chile, Greece, Turkey and the United Kingdom; February 2014 for Estonia, the G7 and the OECD averages, Hungary, Japan, Korea and Norway; April 2014 for the United States; and Q4 2013 for New Zealand and Switzerland.

Source: OECD calculations based on the OECD Short-Term Indicators Database (Cut-off date: 13 May 2014).

Reforming employment protection

Recent reforms have brought employment protection for permanent and temporary contracts in Portugal closer to the OECD average (Figures 16 and 17) and should help reduce 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, 2012 and 2013 have noticeably reduced it.[3] 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

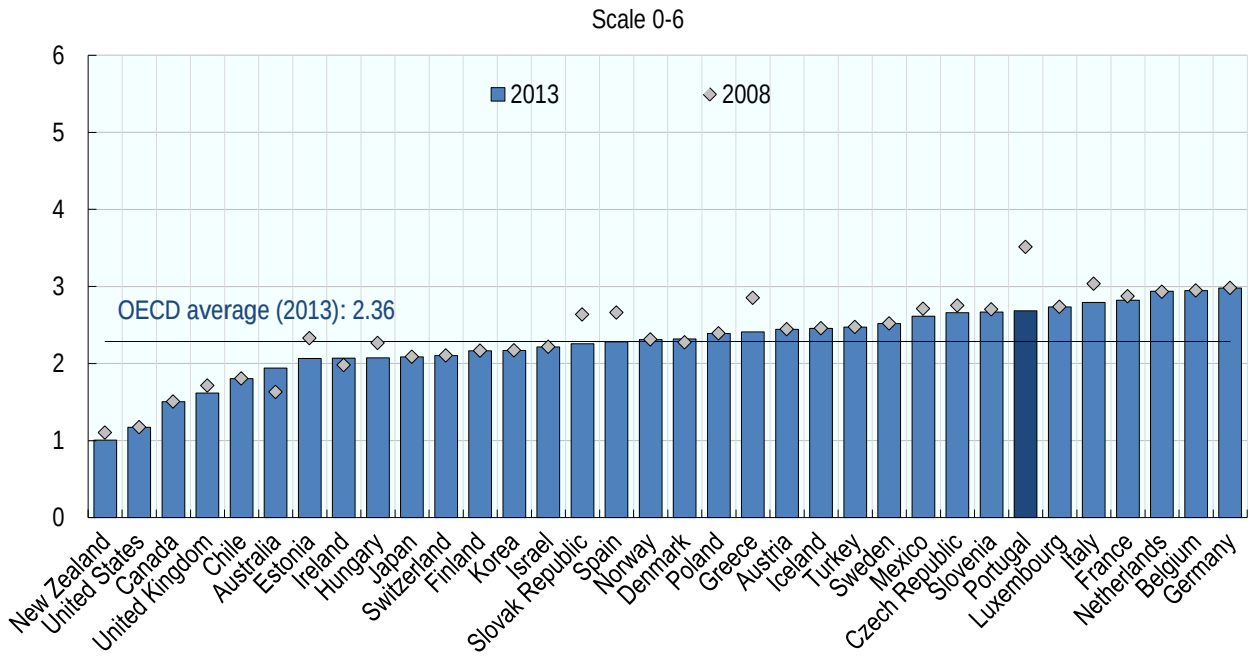
[3] The main amendments include encouraging the use of flexible working time arrangements, a reduction in the amounts due in case of overtime work and the elimination of four public holidays and of the employee's entitlement to three additional vacation days per year based on seniority. Moreover, the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

another suitable position was replaced by a requirement on the employer to assess whether, in the case of suppression of a post, the employee could be transferred to a position compatible with his professional qualifications.

Severance pay has been reduced from 30 to 20 days per year of tenure in 2011 (with a 12-month ceiling instead of a 3-month floor) and has been further reduced in October 2013 to 18 days per year of tenure for the first three years and 12 days for each additional year. 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.

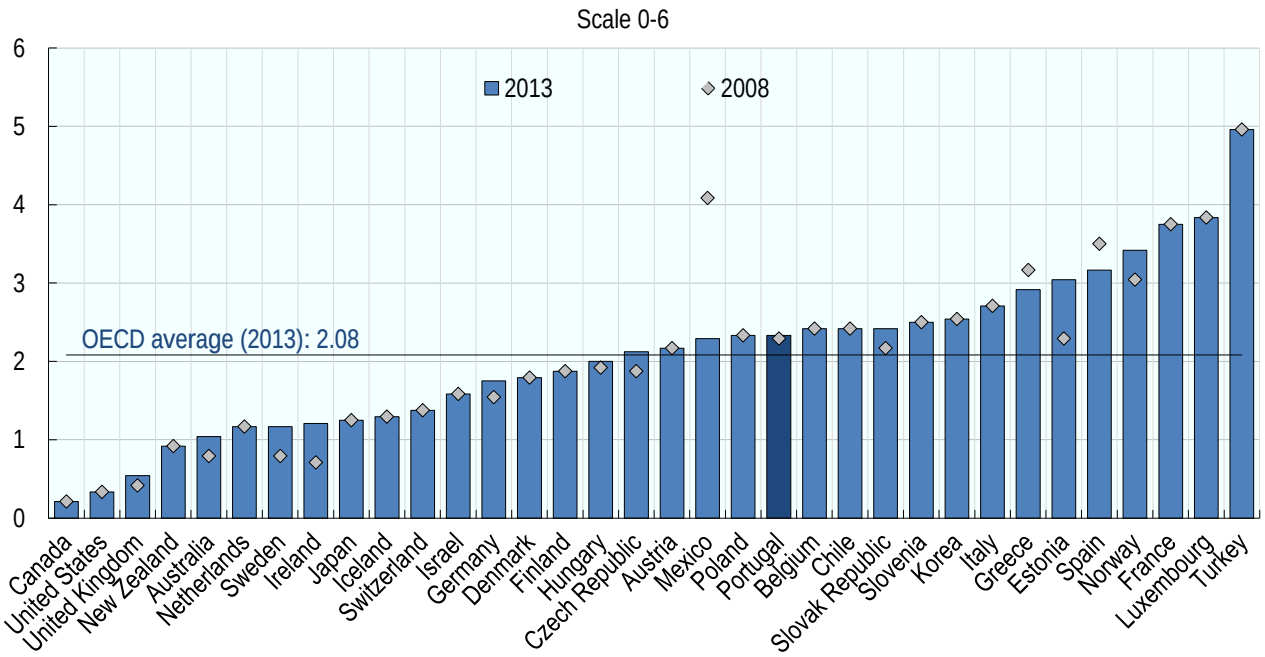
All these changes in employment protection legislation should contribute to increased levels of productivity and potential GDP (see Chapter 2). By reducing the labour market segmentation that condemns many workers, especially younger and unskilled ones, to insecure employment, the reform may also foster greater equity and social cohesion.

Figure 16. Protection of permanent workers against individual and collective dismissal, 2008-13



Source: OECD Employment Protection Database, 2013 update, http://dx.doi.org/10.1787/lfs-epl-data-en.

Figure 17. Regulation on temporary contracts, 2008-13



Note: Temporary contracts include: 1. **standard fixed-term contract** defined as a generic employment contract with a precisely-specified end date (in the form of day, month and year at which the employment relationship is set to end, if the contract is not renewed); 2. and **temporary work agency (TWA)** employment defined as the employment of workers with a contract under which the employer (i.e. the agency), within the framework of its business or professional practice, places the employee at the disposal of a third party (i.e. the user firm) in order to perform work (i.e. the assignment) under supervision and direction of that user firm by virtue of an agreement for the provision of services between the user firm and the agency.

Source: OECD Employment Protection Database, 2013 update, http://dx.doi.org/10.1787/lfs-epl-data-en.

Nonetheless, employment protection for permanent workers remains higher than the OECD average and could be reduced further. Even though the authorities have reduced severance pay in several instances, last in October 2013, these reductions affect only new contracts signed after 2011, while grandfathering all existing labour relations. The trial period for open-ended contracts remains short, at 90 days for most workers. 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 and should be further promoted. Recently, the authorities have worked towards reducing the scope for lengthy law suits following dismissals by defining a hierarchical list of criteria for companies to decide upon whom to dismiss in the case of staff reductions.

Reforming wage-setting mechanisms

Wage-setting mechanisms, including for the minimum wage, have until recently posed challenges to both 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[4]) 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*), further tightening the already strong grip of unions over collective bargaining at the firm level. These constraints on firm-level bargaining have discouraged the entry of new firms and lowered 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 authorities 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 have also reduced the scope for administrative extension of collective agreements since May 2011. But it is unclear how effective these new rules will be in limiting extensions once the current perceived need for wage moderation fades. Automatic extension is still possible as long as a significant degree of representation of the industry in question is reached. Employer associations have also recently sought to extend the rules for automatic extension, suggesting that securing the support of a number of SMEs should be admitted as a sufficient condition for extension. All in all, wage flexibility still seems to remain severely hampered, at least in principle, by the rules governing automatic extensions of collective wage agreements.

Further action will be needed in promoting collective bargaining at the firm level, including a removal of the requirement for unions to approve any firm-level bargaining outcome and abolishing administrative extension altogether. These reforms would help foster more dynamic labour and product markets. The authorities are also advised to keep the minimum wage unchanged until there are clear signs of labour market recovery.

Reducing non-wage labour costs

The authorities have 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 through numbers employed. Possible options to improve work incentives include reducing personal income tax and social security contribution burdens on low-income workers (e.g. by raising personal allowances), and introducing in-work tax credits (or equivalent benefit schemes). The latter can help to increase work incentives while at the same time alleviating in-work poverty. However, the fiscal affordability of these options has to be considered. An expert commission is expected to make recommendations on these issues by September 2014.

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[4] The new labour code allows this authority to be delegated to Workers Councils in the case of corporations with over 150 employees.

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 €1,048, 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.[5] 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 improving their skills. To prevent the cyclical rise in Portugal's unemployment from becoming permanent, and to avert the associated long-term social scars, it is essential to strengthen the effectiveness of active labour market programmes, in particular in terms of counselling, placement and job-search assistance.

The Government has adopted measures to help the unemployed back to work. It has launched a set of new ALMP measures to fight youth unemployment and more on-the-job training, such as *Estímulo 2012* (a hiring subsidy of up to €420 subject to companies providing training) and *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.

Further steps should be considered. There is substantial scope for improving job search assistance, 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.

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[5] See OECD Economic Survey of Portugal 2012 for more details.

Monitoring and sanctions, while very strict in principle, 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.

Tackling youth unemployment

Tackling youth unemployment in the current context of fiscal consolidation, especially in education, requires investment 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 falling into the trap of being neither in education nor in education or training (NEET) need more focused help, including training and subsidised work experience opportunities and other active labour market policies.

Portugal was one of the first countries to implement the "Youth Guarantee", which already covers 76,000 young people. While this programme is already delivering positive results, to reduce the NEET rate Portugal would require tackling the group of disadvantaged youths who are totally inactive. 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. Most, although not all, of the rigorous evaluations conducted have shown that this programme, while expensive, is cost-effective.

Key Recommendations

- **Continue to tackle labour market rigidity and segmentation.**
- **Further promote firm-level bargaining** by abolishing the administrative extension of collective wage agreements.
- **Make unemployment benefits 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, including youth and low-skilled workers; and iii) maintaining and improving the system for monitoring the integration of participants into the labour market.

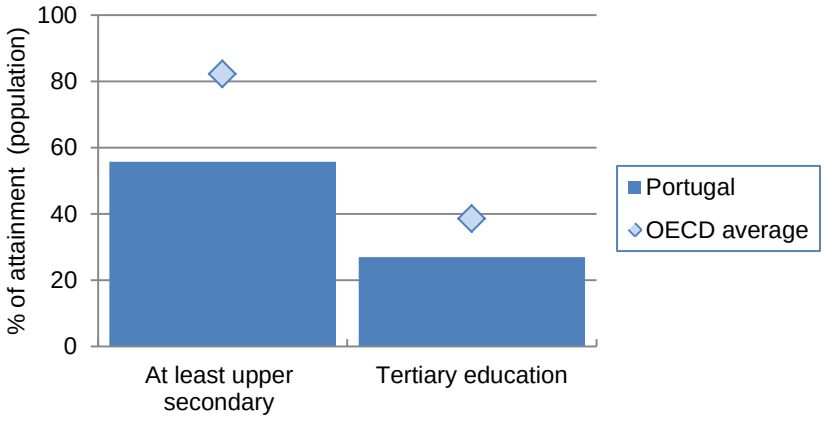
5. Promoting skills development

A shortage of appropriately qualified employees is an obstacle to higher productivity and growth in Portugal. While the education system has made major advances in both access and performance, it does not always perform well in equipping young people with the skills needed in the labour market. Furthermore, there is a legacy of low levels of education and skills across the workforce. This limits the ability of firms to move away from low-productivity activities and adapt to technological change. 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.

Skills at school and on the job

Young Portuguese people today enter the labour market with higher educational attainment and better skills than previous generations. However, there is still a long way to go with only 56% of the working age population having attained upper secondary education in 2011, compared with an OECD average of 82% (Figure 18). Tertiary education attainment rates are also over one third below the OECD average.

Figure 18. Upper secondary and tertiary attainment for 25-34 year-olds, 2011



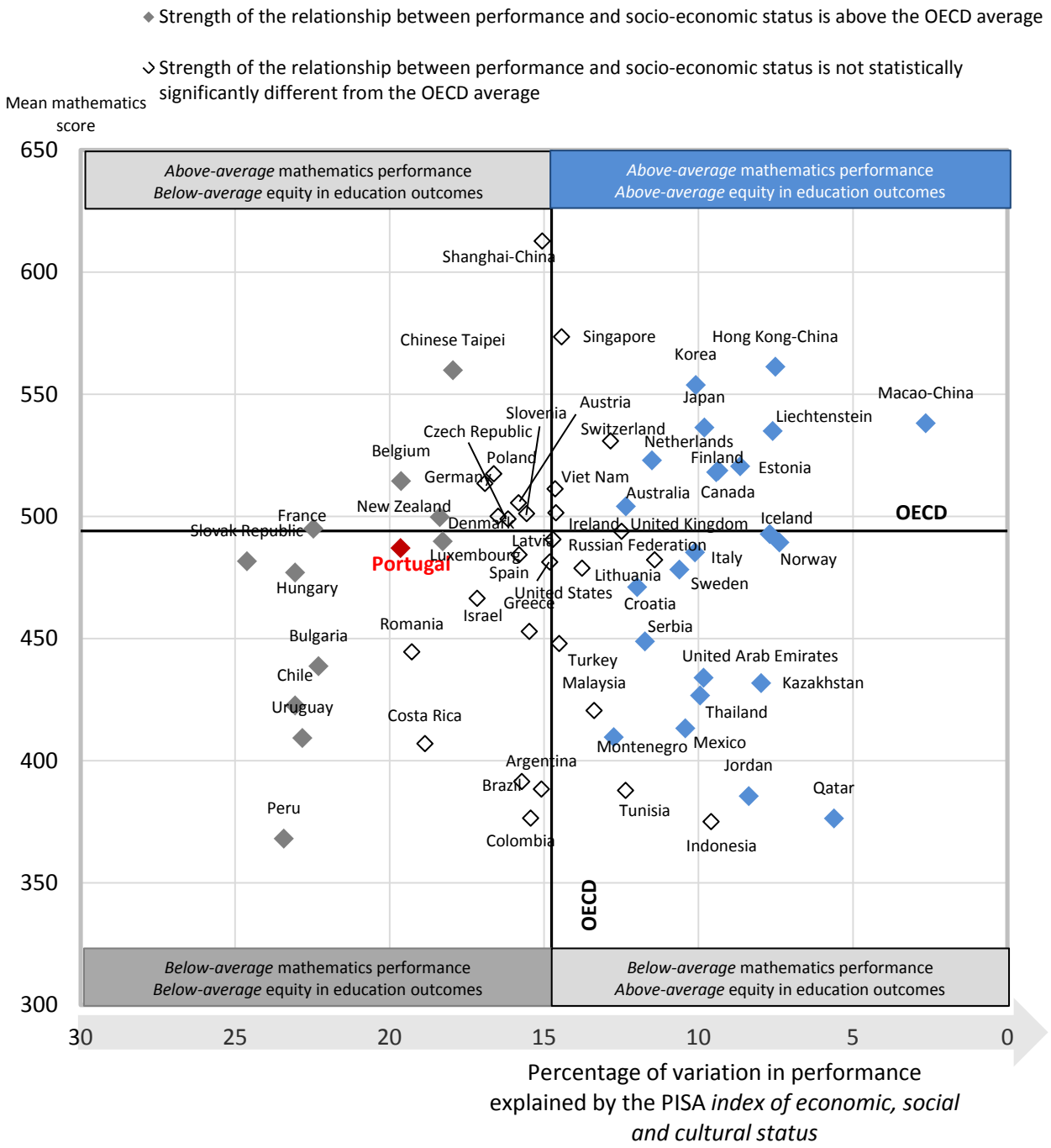
Source: OECD (2013), Education at a Glance 2013: OECD Indicators, OECD Publishing, Paris, http://dx.doi.org/10.1787/eag-2013-en.

Performance has also improved, with Portuguese students now performing in line with the OECD average in mathematics and below the OECD average in reading and science among the 65 countries and economies who participated in the 2012 PISA assessment of 15-year-olds. Portugal has increased the share of top performers in mathematics and at the same time reduced the share of low performers between 2003 and 2012.

Since 2012, compulsory education continues up to the 12th grade (18 years old) instead of 9th grade and the government has implemented a series of measures to address education-related challenges. Nevertheless, 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. Around one third of students had repeated grades at least once by age 15 in 2012. 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, and is not necessarily more costly.

In Portugal, the association between students' socio-economic background and their performance at school is more pronounced than average (Figure 19), and much of this relation lies at the school level. As a result, the socio-economic differences across schools are largely predictive of a school's performance. Policies that target disadvantaged schools can therefore be particularly effective in raising performance and equity levels.

Figure 19. Student Performance and Equity



Source: OECD, PISA 2012 Database, Table II.2.1. 1.

There is room for improving the structure of government spending on education. While the small size of classes explains most of the differences in salary costs compared to the OECD average, 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 student 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 accountability-focused appraisal for teachers; and shifting resources towards a system-wide analysis of outcomes.

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

Greater employer involvement in setting school/tertiary curricula and granting more work-experience opportunities to students will improve the match between skills acquired in education and labour market needs. This is the case for the network of Centres for Qualifications and Vocational Education, which are intended to help young students with personal choices over education.

Portugal can also make better use of its vocational education and training (VET) system. The Government should ensure that VET programmes provide basic business skills and preparation for self-employment, as well as help to cope with the demands of new industries and technologies. This includes 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 can have substantial workplace learning experience. Recent policy initiatives, such as the National Youth Guarantee Plan (*Plano Nacional do Programa Garantia Jovem*, 2013), which aims to help everyone under the age of 25 to find employment, continued education, an apprenticeship or a traineeship within four months of becoming unemployed or leaving the formal education system, shows promise. Nevertheless, it will be important to continue tracking the labour market outcomes of training participants and adjust programmes accordingly.

The experience of other OECD countries might help Portugal to overcome some of the main challenges in building up a more effective VET system. Denmark and Switzerland illustrate 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.

Supporting adult training

Education reforms take time to have an impact and a country can also develop the skills it needs by encouraging and enabling people to learn throughout their lives. Adult training is particularly valuable in Portugal given the large share of the population with low educational achievements. The Portuguese population has low levels of key information-processing skills while participation rates in job-related training among the adult population remain below the OECD average, especially among younger age cohorts. Improved levels of key information-processing skills, such as literacy and numeracy, should yield significant economic and social benefits. Gains can be amplified by the successful implementation of proactive measures to foster the demand for such skills in the economy and society. Overall, adult learning is an area requiring significant policy attention in Portugal.

Key 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 less affluent 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.

6. Boosting innovation

Innovation has a major role to play in boosting productivity and non-cost competitiveness. Portugal's research performance has improved significantly in recent years, and Portugal has invested heavily in scientific human capital. However, public and business investments in R&D and innovation have suffered since 2009. To enhance its innovation performance further, Portugal could increase the impact of existing public research, for example, through enhanced industry-science linkages (via business funding of public research, university start-ups, and improved mobility of human resources), while strengthening the innovation capability of its industrial sector. Boosting Portugal's innovative capacity also requires improvement in the overall business environment and in the skills of the labour force, including by increasing the number of science and engineering PhD holders.

Strengthening the impact of public research

Portugal's gross expenditure on R&D (GERD) expanded significantly between 2005 and 2009, but has declined since 2009, mainly in the private sector, raising challenges to some of the recent progress in Portugal's innovation capability. Portugal has a relatively strong public research sector, and performs well in terms of science and technology (S&T) publications in leading international journals (Figure 16). But linkages to industry remain weak, as indicated by the low share of public R&D expenditures financed by industry as a percentage of GDP. 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 2011, includes a host of measures aimed at promoting knowledge transfers from academia to industry. These are positive developments, but the relatively weak R&D performance of Portuguese firms, which translates into weak industry demand for and interest in academic research, remains a major barrier to improved industry-academic links.

As in other countries, in addition to measures to support entrepreneurship, the main areas for policy action include 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 technology transfer suggests that the effectiveness of TTOs in linking with business depends on critical mass and expertise, and appropriate organisational structures and 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 Chalmer's 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.

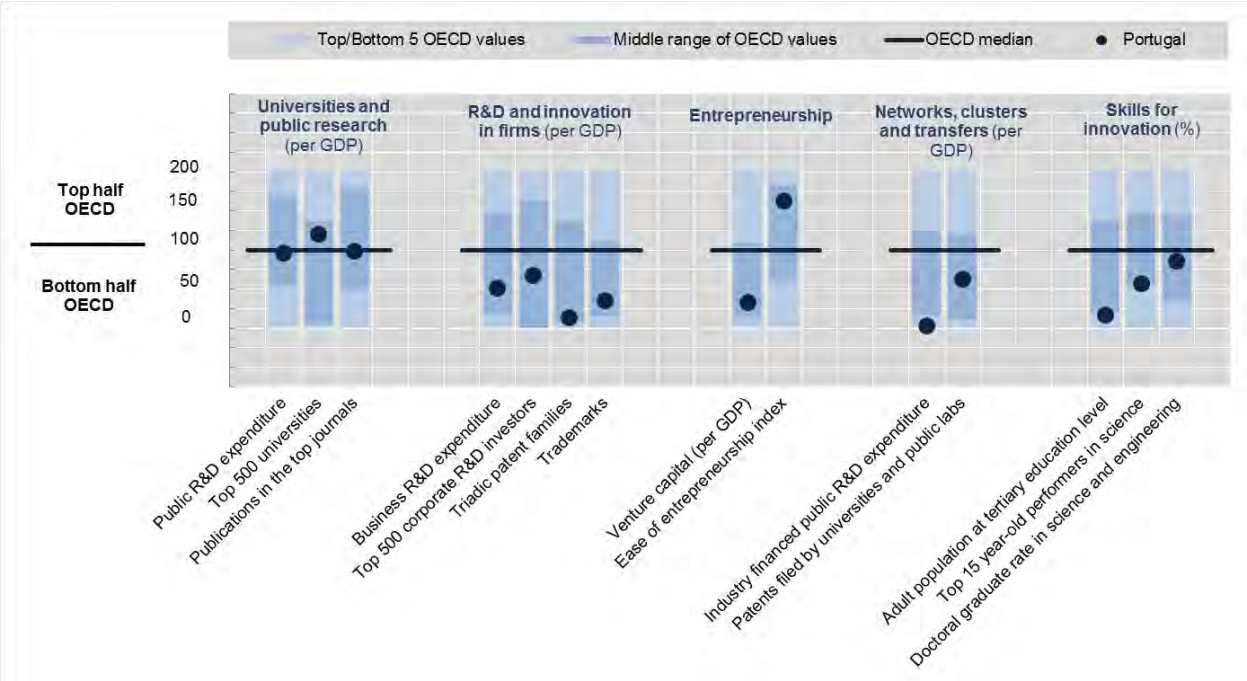
Strengthening industrial innovation and entrepreneurship

The innovation performance of Portuguese industry remains modest, in terms of international patenting and trademark applications. Also, business spending on research and development is comparatively low, at 0.70% of GDP in 2012 versus an OECD average of 1.62%. 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' risk aversion as a consequence of the financial crisis. 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),[6] although debt financing, e.g. through loans and guarantees, of business R&D investments has gained in importance in recent years. While Portugal performs well on the OECD's ease of entrepreneurship index (Figure 20), administrative burdens on start-ups remain high. As in many other EU countries, young firms account for much of the new job creation in Portugal, but older firms are relatively small, pointing to a lack of growth after firm entry. Raising the business sector's innovative capacity will require continued efforts to make the business environment more conducive to innovation by reducing administrative burdens on business and strengthening competition (see Chapter 3).

[6] According to OECD figures, direct support (subsidies and procurement) to R&D represented €49 million in 2011, while indirect incentives – the SIFIDE tax credit scheme – amounted to about €180 million.

Figure 20. Comparative performance of Portugal's science and innovation system, 2013



Source: OECD Science, Technology and Industry Outlook 2014 (forthcoming).

Strengthening the skills composition of the labour force

Increasing Portugal's innovative capacity also implies raising the level of human capital in line with industry's needs (see Chapter 5). While there have been major improvements in both access and performance, human capital remains a major bottleneck, with only 17% of the adult population possessing tertiary-education degrees in 2012, as compared to 27% for the EU28. The share of science and engineering (S&E) doctoral graduates was below the OECD median in 2011. Further efforts should focus on medium-level skills in the labour force, entailing investment in secondary and tertiary education. Special efforts to strengthen the managerial skills of Portuguese entrepreneurs are also needed to enhance the innovation capacity of the 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 5).

Promoting eco-innovation

Harnessing innovation to improve environmental performance can lead to new industries and new jobs in the coming years. In particular, promoting eco-innovation would help enhance productivity, international competitiveness and the growth prospects of its economy. Environmental companies and related employment have increased recently, 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.

In February 2014, the government appointed an expert commission on tax reform which is expected to make proposals by September to promote green growth, including eco-innovation. To complement the tax reform, the government should consider laying out a comprehensive framework and national strategy for promoting eco-innovation and employment in eco-industries, including increased public support for R&D.

In the current fiscal context, such a strategy 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 framework 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

- **Ensure appropriate funding for public investment in R&D and innovation.**
- **Create stronger incentives and better channels for commercialising academic research**, including by enhancing the links of university tech transfer offices to industry**.**
- **Improve framework conditions for entrepreneurship** by reducing administrative burdens on start-ups**.**
- **Sustain investment in secondary and tertiary-level education.**
- **Develop and implement a comprehensive framework for promoting eco-innovation and employment in eco-industries**, including via the planned tax reform to promote green growth**.**

7. 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.[7] 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 2013, most marginal tax rates were relatively high, and the marginal tax wedge on labour was considerably above the OECD average largely as a result of the recent increase in personal income tax rates (Figure 21).

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 Portugal's substantial cumulative loss of cost competitiveness and export market share over the last decade. Cutting employer 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, following the trend of the last three years, and by further reducing the revenue foregone of tax expenditures.

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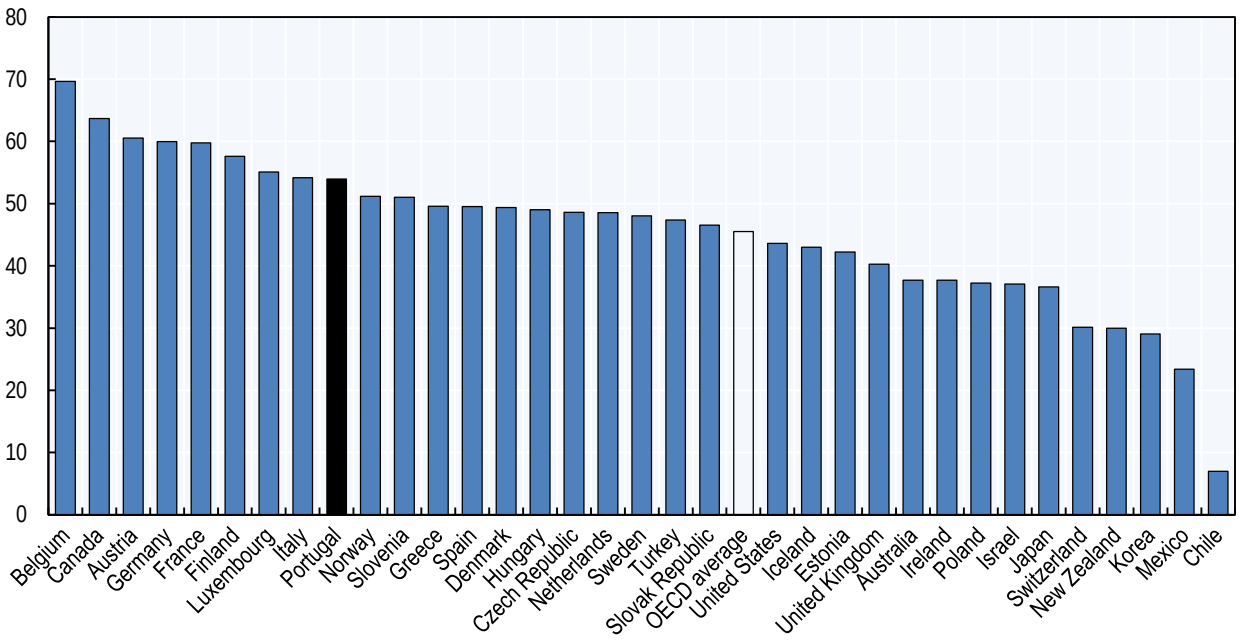
[7] Arnold, J., B. Brys, C. Heady, A. Johansson, C. Schwellnus and L. Vartia (2011). "Tax Policy for Economic Recovery and Growth", *Economic Journal*, Volume 121, Issue 550.

Figure 21. Marginal tax wedge (per cent of total labour costs), 2013[1]



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 (2014).

Getting more from property taxes

The Government has recently taken some important steps to raise more revenues from property taxes. 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. The re-valuation of housing values was concluded in 2013, and will now gradually lead to increased IMI tax revenue over time.

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.

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.

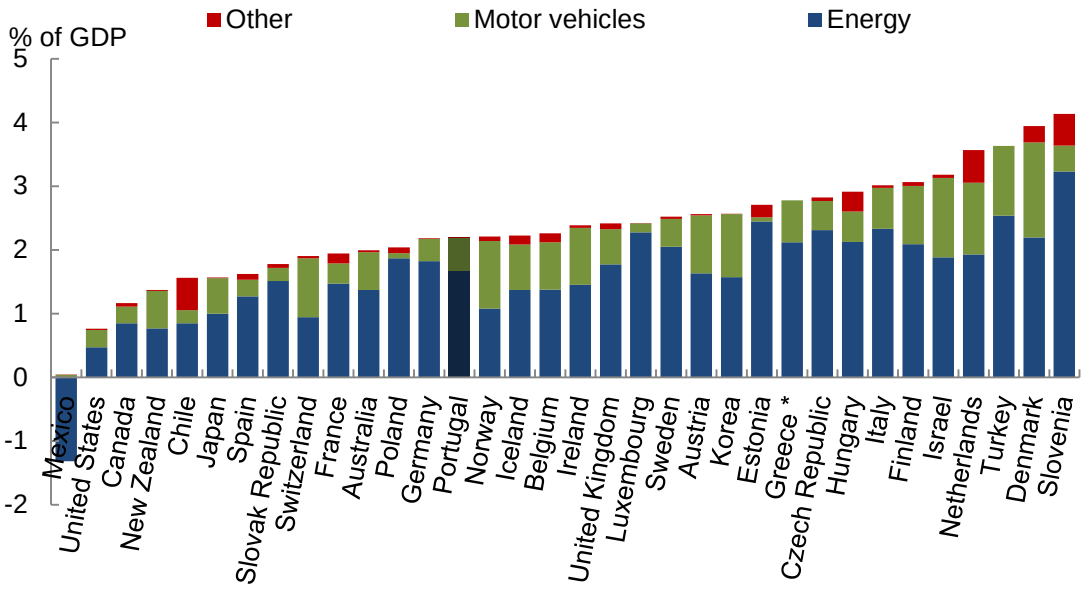
Raising revenue from environmental taxes

Expanding environmentally-related taxes and removing harmful tax concessions and subsidies could help fiscal consolidation without hampering the economic recovery. Portugal has made progress in expanding the use of environmentally related taxes (Figure 22), by introducing waste and water taxes, a tax on inefficient light bulbs, and CO_2 emission-based vehicle taxes. The expert tax commission established in February is expected to make a series of proposals by September to promote natural resource efficiency, promote sustainable consumption patterns and remove harmful tax subsidies.

Some of the specific proposals that should be considered include introducing other environmental 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). An important reform was already included in the 2014 budget law, raising the tax rate on diesel above that on gasoline, which is in line with the greater greenhouse gas emissions and other pollutants per litre of fuel of the former. This reform has also helped raise much-needed revenues.[8]

Figure 22. Revenues from environmentally related taxes in per cent of GDP, OECD countries, 2012

Note: *2011 figure.



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

[8] According to OECD estimates and based on data underlying Taxing Energy Use (2013), the additional revenues from raising diesel tax rates to the same level as gasoline in energy terms (per unit of energy consumed) could exceed EUR 1.3 billion per year.

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 has introduced some environmentally related fiscal measures with a view to better maintaining their incentive function and improving fiscal sustainability. In particular, fiscal measures were targeted towards the purchase of electric and other environmental friendly vehicles. 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 they 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 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. 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 revenues[9] (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. According to the most recent Tax Expenditure Report, the size of the tax expenditures in Portugal decreased by about 35%, from 8% of GDP in 2011 to 5.4% of GDP in 2014. Despite this recent progress, notably in the area of CIT, VAT and PIT, 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.

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

The Government has engaged in a comprehensive CIT reform aimed at boosting investment and international competitiveness by lowering statutory CIT rates, simplifying the CIT system, reinforcing legal certainty, and restructuring Portuguese international tax policy in light of European and international legal developments. This reform is a step in the right direction. Following the CIT reform and the creation of the Large Taxpayers Office, the Government has also created the Large Taxpayers Forum in the first quarter of 2014, in line with OECD recommendations. The authorities are advised to further broaden the CIT base and to abolish inefficient CIT expenditures.

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 between 2011 and 2013, including the 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 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).

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 direct and indirect tax expenditures.
- **Continue to broaden the use of environmentally-related taxes** by introducing other such taxes (*e.g.* on air pollutants and pesticides). Such proposals could be included in the recently launched green tax reform.
- **As part of the tax reform, review the current array of environmentally related tax exemptions and discounts,** with a view to phasing out those that are costly and/ or 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.
- **Continue efforts to further improve tax administration** by considering the integration of the collection of social security contributions within the tax administration.

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