OECD Economic Surveys PORTUGAL

OCTOBER 2014

OVERVIEW

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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.

Executive summary

- *Main findings*
- *Key recommendations*

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Main findings

Following many years of a credit-fuelled expansion of the non-tradable sector and declining export performance, the financial crisis triggered a severe recession, leading to high unemployment and public debt. The authorities have been implementing a wide-ranging structural reform agenda, which is helping to rebalance the economy towards the export sector. This is still work in progress, however. Public and private debt is high, translating into high external debt. Low expected inflation will create further challenges for debt reduction. Unemployment is falling, but it is still too high, and is a factor creating inequality and poverty. Against the background of a need to increase investment and also to reduce external debt, a sustained increase in exports will be key for creating jobs, and enhancing social inclusion.

Fiscal policy and financial stability. Significant budget consolidation over the last years has strengthened the fiscal position and enhanced Portugal's access to market financing. Fiscal consolidation became more tilted towards the revenue side in 2013, following several rulings from the Constitutional Court that voided spending reductions. The banking sector has suffered from more difficult access to funding in the aftermath of the financial crisis. Prudential ratios have improved but banks' balance sheets remain under pressure due to still high ratios of non-performing loans, and corporate debt remains very high.

Boosting export performance. A successful rebalancing of the economy is underway as competitiveness has improved and export performance has risen. Further progress is needed, but is held back by weak competition in services sectors including electricity and wage bargaining mechanisms that hamper the market entry of firms. An overburdened judicial system and a high tax burden, in particular for large firms, curb the productivity in exporting sectors. Innovation performance suffers from the lack of an effective connection between research in universities and the private sector, while the structure of tax credits for research and development can be a barrier to market entry.

Reducing inequality and poverty. Portugal has one of the most unequal income distributions in Europe and poverty levels are high. The economic crisis has halted a gradual long-term decline in both inequality and poverty and the number of poor households is rising, with children and youths being particularly affected. Recent tax reforms have probably increased the progressivity of taxes, but transfer payments are biased towards older workers, which is not the most efficient tool to reduce inequality and poverty. Conversely, benefit levels in the minimum income support scheme are low and the coverage of unemployment benefits is narrow. Overall, transfer programmes suffer from overlaps and insufficient targeting. In the education system, high drop-out rates are associated with frequent grade-repetition, increasing also inequality as children of disadvantaged families are more likely to drop out. Vocational courses and adult education are being developed but do not play a major role in Portugal yet, although they could lead to a more equitable distribution of income.

Key recommendations

Fiscal policy and financial stability

- Achieve planned structural fiscal consolidation targets but allow the automatic stabilisers to operate.
- Continue to improve public sector efficiency by further reducing the number of civil servants; enhance the efficiency of the tax system including by eliminating tax exemptions and expenditures.
- Ensure a timely and consistent recognition of losses by enforcing recent guidelines and continue to encourage banks to raise capital, when needed, by issuing equity and retaining earnings.
- Continue to develop the central bank's stress testing framework consistent with the Single Supervisory Mechanism, and continue to request banks to hold capital for unexpected losses.
- Assess the performance of the recently introduced insolvency procedures and enhance them if necessary.

Boosting export performance

- Strengthen competition in non-tradable sectors through further regulatory reform. Phase out electricity generation schemes with guaranteed prices sooner than currently planned.
- Promote wage bargaining at the firm level, including by abolishing administrative extensions of wage agreements.
- Improve the links between researchers in universities and the private sector. Consider allowing refunds of research and development (R&D) tax credits for loss-making firms, or extending the carry-forward period.

Reducing inequality and poverty

- Strengthen the social safety net by reducing overlaps between programmes and ensuring better targeting, which could generate resources to eventually raise benefit levels of the minimum income support scheme RSI in a fiscally-neutral way.
- Make unemployment benefits independent of age and reform eligibility requirements to widen their coverage.
- Continue to scale up active labour market policies and closely monitor programme performance.
- Scale up adult education and back to school schemes in order to help the unemployed and those in need to gain relevant skills.

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Assessment and recommendations

- *Macroeconomic outlook*
- *Strengthening financial stability*
- *Improving fiscal sustainability*
- *Further raising competiveness and export performance*
- *Making future growth more inclusive*

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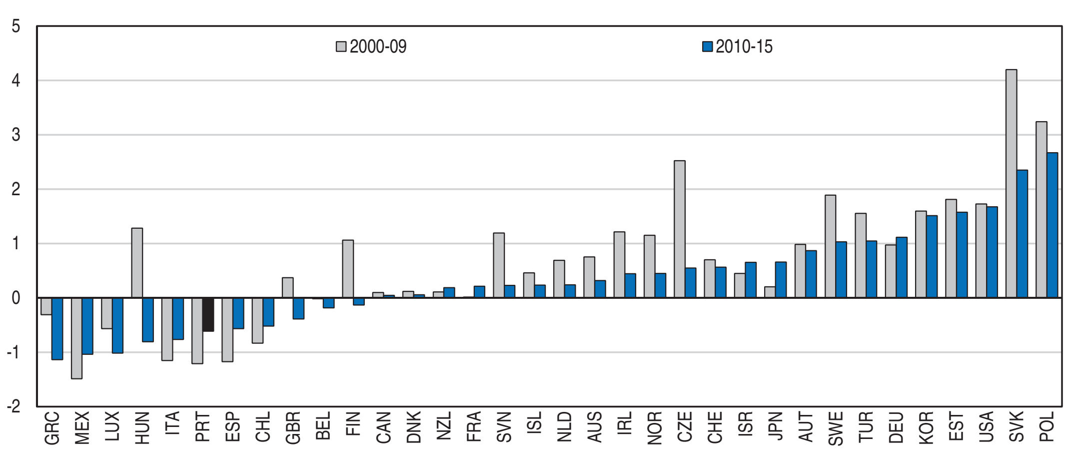
Portugal has made significant reform progress in the context of a deep economic crisis, which has paved the way towards exiting the Economic and Financial Assistance Programme in June 2014. A wide-ranging structural reform agenda is underway and numerous reforms have already been implemented. The rebalancing of the economy towards more international trade is on the right path, but it is still work in progress. The first chapter of this survey has recommendations on how to achieve greater competitiveness and export performance. This is key for creating jobs and reducing unemployment. Unemployment has been one of the main reasons why the incomes of many households have declined during the recent crisis years, which has led to an increase in inequality and poverty. The second chapter assesses possible strategies for ensuring that the weakest among Portuguese citizen are sufficiently protected.

The decade preceding the economic crisis was characterised by a decline in export performance and a credit-fuelled expansion of the non-tradable sector, while both productivity and GDP growth were dismal (Figure 1). These trends appear to be reversing. Following a three-year recession, growth turned positive in early 2013, buoyed by an improvement in competitiveness and export performance (Figure 2, Panel C). Strengthening export performance in both goods and services has also helped to turn the deficit in both the trade balance and the current account into a surplus (Figure 2, Panel A).

Nevertheless, as the Portuguese economic recovery continues, domestic demand, especially investment (see the next paragraph) will expand, and the current account position will tend to deteriorate. In any event, further structural improvement in the current account balance will be needed to durably reduce Portugal's external debt and international investment position, which stand at 221% and -124% of GDP, respectively (Figure 2, Panel B).

Figure 1. **Average annual total factor productivity growth in 2000-09 and 2010-15**

Per cent[1]



1. 2001-09 instead of 2000-09 for Estonia. Data for 2014 and 2015 are projections.

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

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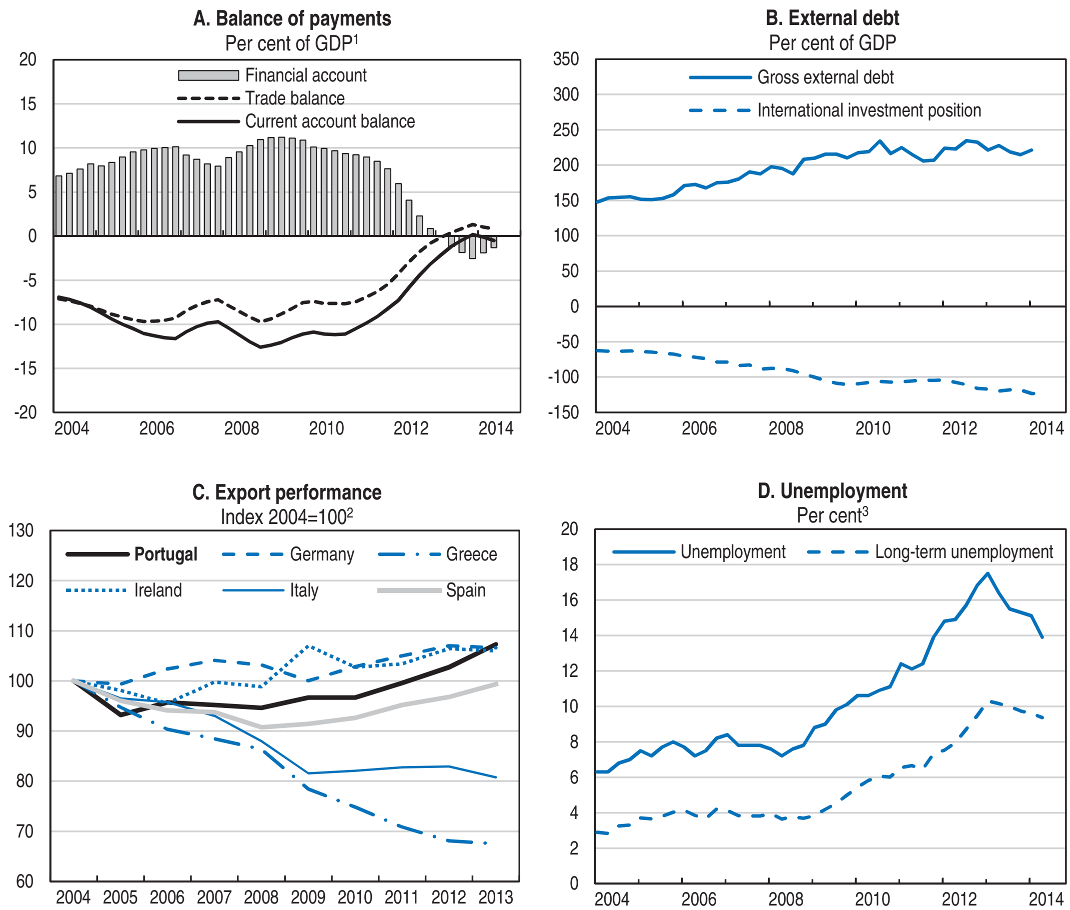
Figure 2. **Macroeconomic indicators**



1. Balance of payments basis, four-quarter moving average.
2. Export performance is the ratio between export volumes and export markets for total goods and services.
3. Long-term unemployment refers to the share of unemployed persons who have been looking for jobs for 12 months or more to total labour force.

Source: Banco de Portugal (2014), "Main Indicators" and "General Statistics", *BP stat*, September; World Bank (2014), "Quarterly External Debt Statistics/SDDS", *World DataBank*, September and OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), September.

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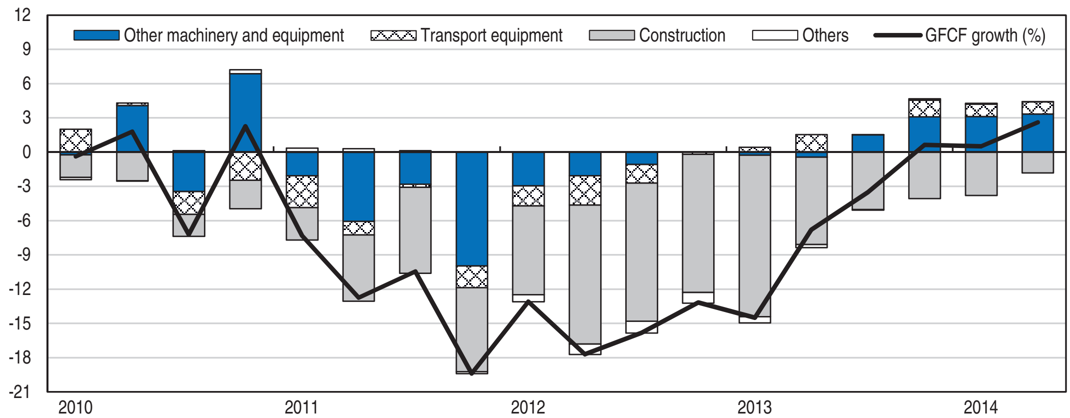
Investment has been declining in recent years, although it appears to have reached its trough in most sectors and is growing again (Figure 3). Nevertheless, even though the allocation of investment has improved, current investment levels are not sufficient to maintain the current capital stock, much less to meet the requirements of an expanding export sector. Positive announcements in some specific sectors such as the development of a new product line in motor vehicles and recent policy reforms suggest that investment will indeed rise. But more investment means more imports, and to make this possible while still improving the current account, public and private consumption will have to be a smaller fraction of GDP than in the past. Fiscal consolidation will do some part of that, but household savings will also need to go up.

The crisis raised unemployment to historically high levels. Overall unemployment peaked at 17.5% early 2013, while youth unemployment went up as high as 42.5%. However, in 2013 employment began to rise and the unemployment rate has fallen to 13.9% since, although long-term unemployment has declined at a slower pace (Figure 2, Panel D).

Figure 3. **Sources of growth in gross fixed capital formation (GFCF)**

Percentage points



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

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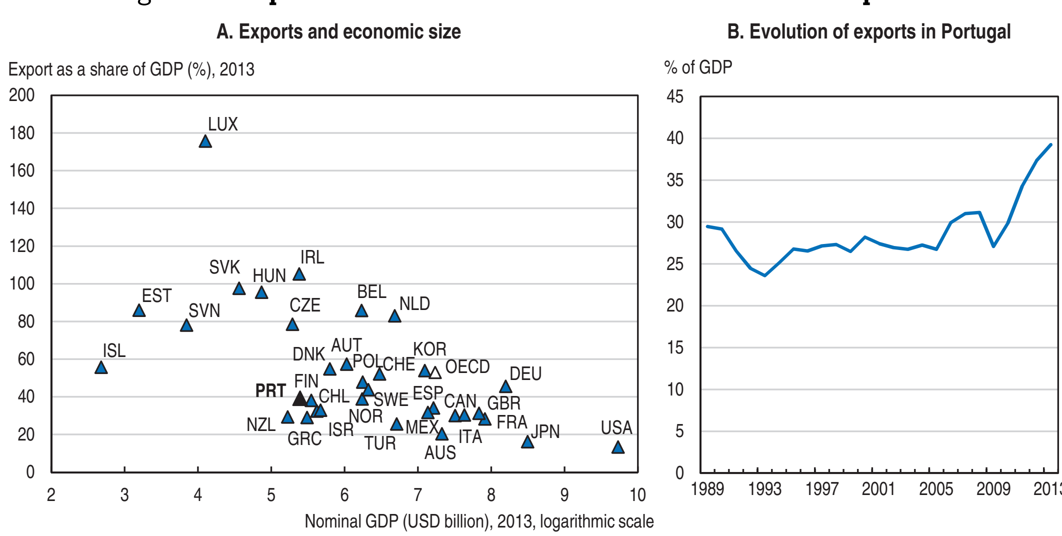
Exports have risen from 27% of GDP in 2009 to 39% of GDP in 2013, and export performance has improved (Figure 2, Panel C). This rebalancing of the economy is a positive development. It will allow the economy to import more in the future, particularly investment goods that are needed for growth and that strengthen the efficiency of domestic production. However, although exports have increased significantly (Figure 4, Panel B), they will need to increase further. Considering the small size of its economy, which is typically related to a stronger weight of international trade in GDP, Portugal exports less than other similar countries, several of which export a significantly larger share of GDP than Portugal (Figure 4, Panel A). Therefore, Portugal's transition towards a stronger export sector and insertion into global value chains has still some way to go.

Figure 4. **Exports and economic size in international comparison**



Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* and *OECD National Accounts* (databases), September.

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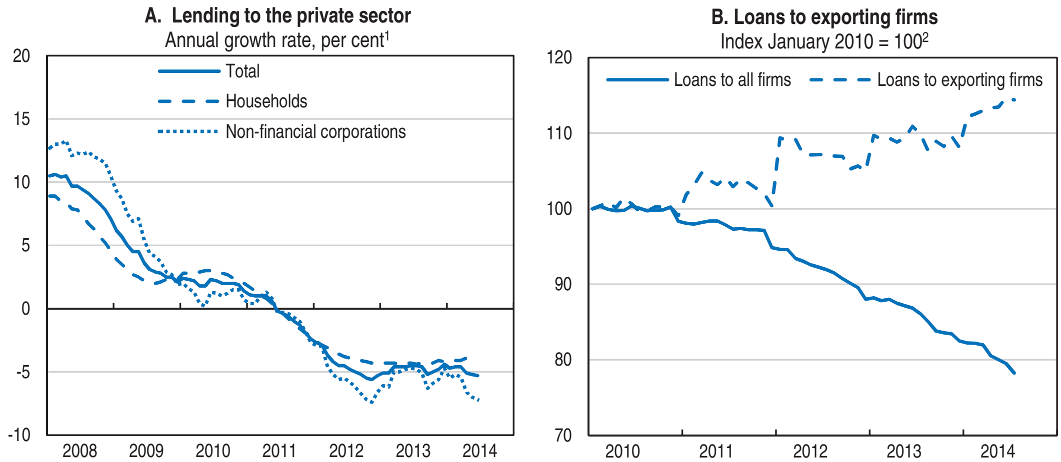
Figure 5. **Lending to the private sector**



1. Loans of other monetary financial institutions (excluding securities and including credit to emigrants) to households and non-financial corporations. Adjusted for securitisation.
2. Private-owned exporting companies, defined as follows: a) companies that export more than 50% of the turnover; or b) companies that export more than 10% of the turnover and the total amount exceeds 150 thousand euro. In order to capture the dynamics of the exporting sector while avoiding large fluctuations in the yearly samples, only companies that comply with these criteria in the last 3 years are considered.

Source: Banco de Portugal (2014), "Main Indicators", *BP stat*, September.

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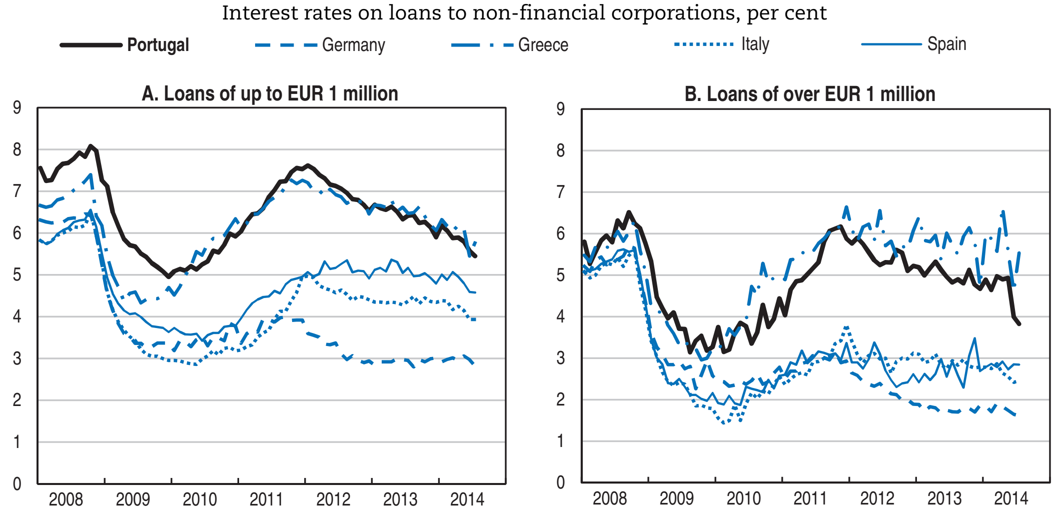
Reflecting the improvement in export performance, credit to export companies has started to rise. Given the rise in the number of exporting firms, however, credit constraints are likely to play a role even among exporters. At the same time, for all other companies and for households, credit is still contracting (Figure 5, Panels A and B). For firms, this is largely driven by declining stocks of loans to small and medium enterprises. Although loans to large companies from domestic banks have also declined since mid-2013, financing from foreign sources has increased. Credit in the construction and real estate sector has fallen the most.

The cost of credit remains high (Figure 6, Panels A and B), which may – among other factors such as banks'credit risk assessment – reflect the fact that banks still face financing

Figure 6. **Credit conditions**

Interest rates on loans to non-financial corporations, per cent



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

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constraints and high funding costs which are being passed on to companies. A recent positive development is the narrowing of the gap in lending costs between large firms and small and medium-sized enterprises (SMEs). The authorities are also setting up a Development Financial Institution to provide financing to SMEs, which will be operational before the end of the year.

Macroeconomic outlook

The economy is projected to grow by around 0.8% in 2014, with growth gradually rising thereafter. Exports will continue to lead the strengthening recovery as growth in Portugal's export markets, especially the euro area, picks up. All else equal, this will also lead to further improvements in the current account balance. Continuing needed fiscal consolidation, high private-sector debt levels and high unemployment will hold back domestic demand. However, the unemployment rate will continue to fall gradually and employment will rise. As economic slack is and will remain sizeable, inflation is set to remain very low.

Risks are tilted to the downside, and if negative risks materialised they would entail significant costs. With inflation having turned negative in early 2014, there is a risk that deflation might become more persistent, in the context of low inflation in the euro area. This could possibly derail the recovery and making debt reduction more difficult. This risk is particularly relevant for loans to the highly-indebted corporate sector, where over 40% of firms with bank loans are unable to cover their debt service expenses from operating income. The end of the external assistance programme has gone smoothly, but a rise in tensions could raise financing costs somewhat, as illustrated by the brief spike in spreads in July 2014 following concerns about the solvency position of Banco Espírito Santo (BES), the second-largest private Portuguese bank, which entered into a resolution procedure early August 2014. There are upside risks linked to the continuation of export growth. Any successful policy reform that enhances competitiveness, including by reducing the cost of non-tradable inputs, would strengthen export performance more than assumed in the projection. This would boost growth, narrow the cyclically-adjusted current account deficit and further bolster international confidence in the Portuguese economy.

Table 1. **Macroeconomic indicators and projections**

Annual percentage change, volume (2011 prices)

	2011 Current prices (million EUR)	2012	2013	2014	2015	2016
GDP	**176 167**	**-3.3**	**-1.4**	**0.8**	**1.3**	**1.5**
Private consumption	115 961	-5.2	-1.4	1.5	0.5	0.8
Government consumption	34 983	-4.3	-1.9	-0.4	-1.0	-0.5
Gross fixed capital formation	32 452	-15.0	-6.3	1.1	2.9	3.4
Housing	5 750	-20.5	-15.6	-3.9	1.0	1.1
Final domestic demand	183 396	-6.8	-2.3	1.0	0.6	1.0
Stockbuilding[1]	312	0.1	0.0	0.7	-0.2	0.0
Total domestic demand	183 709	-6.6	-2.4	1.8	0.4	1.0
Exports of goods and services	60 410	3.1	6.4	3.2	5.4	5.8
Imports of goods and services	67 952	-6.6	3.6	5.6	3.0	4.6
Net exports[1]	-7 542	3.6	1.0	-0.9	1.0	0.6

Table 1. **Macroeconomic indicators and projections** *(cont.)*

Annual percentage change, volume (2011 prices)

	2011 Current prices (million EUR)	2012	2013	2014	2015	2016
Other indicators (growth rates, unless specified)						
Potential GDP	..	-0.2	-0.1	0.2	0.4	0.6
Output gap[2]	..	-5.4	-6.6	-6.0	-5.2	-4.3
Employment	..	-4.2	-2.8	1.4	0.5	0.6
Unemployment rate	..	15.5	16.2	14.1	13.3	13.0
GDP deflator	..	-0.4	2.3	0.9	0.7	0.9
Harmonised consumer price index	..	2.8	0.4	-0.2	0.2	0.4
Harmonised core consumer prices[3]	..	1.2	0.1	0.2	0.5	0.5
Household saving ratio, net[4]	..	1.0	1.4	0.1	0.4	0.4
Current account balance[5]	..	-2.0	0.5	-0.4	0.5	1.0
General government fiscal balance[5]	..	-5.5	-4.9	-4.9	-2.9	-2.3
Underlying general government fiscal balance[2]		-4.5	-2.2	-1.6	-0.9	-0.8
Underlying government primary fiscal balance[2]	..	-0.2	2.0	2.7	3.3	3.3
General government gross debt (Maastricht)[5]	..	120.7	124.8	127.3	128.3	127.9
General government net debt[5]	..	82.1	88.8	92.2	93.3	93.4
Three-month money market rate, average	..	0.6	0.2	0.2	0.1	0.1
Ten-year government bond yield, average	..	10.5	6.3	3.8	3.2	3.2

1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. Excluding energy, food, alcohol and tobacco.
4. As a percentage of household disposable income.
5. As a percentage of GDP.

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

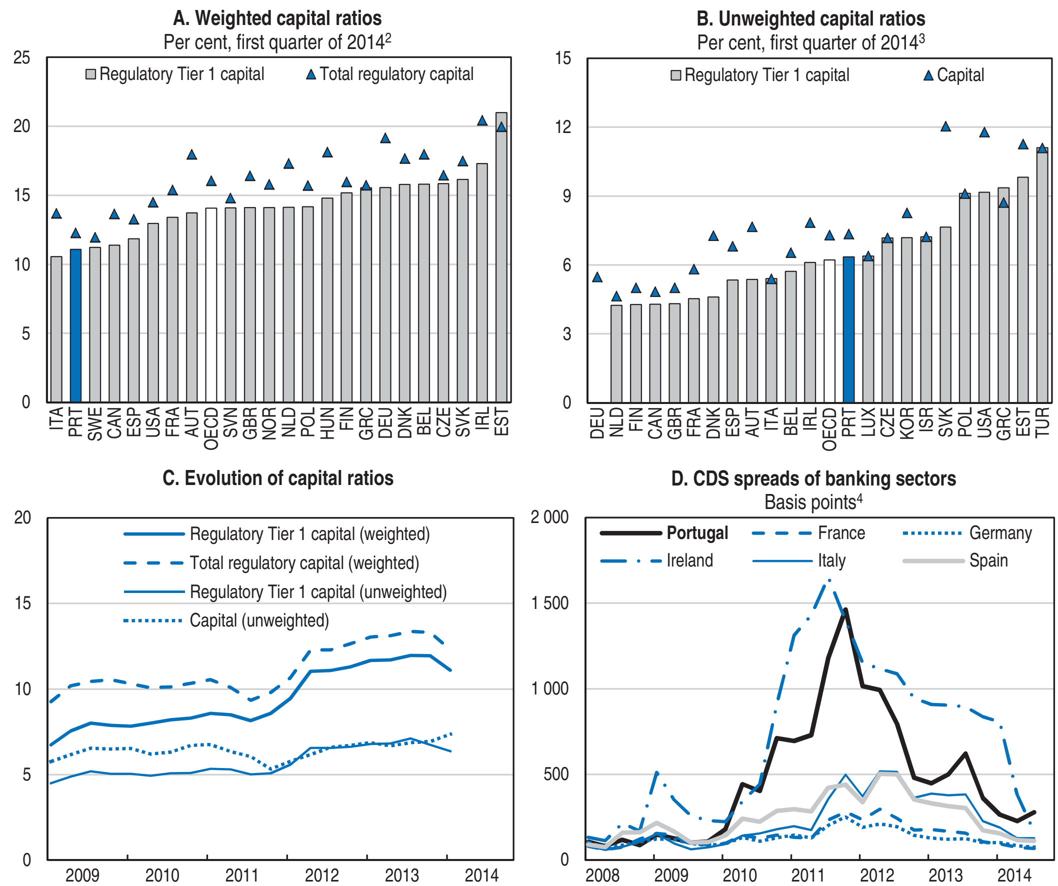
Strengthening financial stability

The banking sector remains fragile

The banking sector has suffered from difficult access to wholesale funding in the aftermath of the financial crisis and has since relied more strongly on deposits, which have been resilient, and on access to liquidity support from the Eurosystem. To reinforce market confidence and comply with capital ratio requirements, banks have increased their capital, notwithstanding low profitability; they have significantly strengthened their capital ratio (Figure 7, Panel C). Some banks, including most recently Novo Banco, the bridge bank created out of BES's healthy assets, have also benefitted from EUR 9.5 billion provided under the Bank Solvency Support Facility, part of which has been reimbursed. Although banks' weighted capital ratios are still below OECD average, their un-weighted capital ratios are higher (Figure 7, Panels A, B and C). This improved situation of banks has led to a decrease in credit default swap (CDS) spreads, despite the recent brief spike related to the resolution procedure of BES (Figure 7, Panel D).

Despite supervisory action (see below, next section), banks remain fragile on the asset side. The amount of non-performing loans is still high, although it has recently stabilised (Figure 8, Panels A and B). Thirty-one per cent of Portuguese firms have overdue loans, up from less than 20% in 2009 (Banco de Portugal, 2014). Non-financial companies still bear a debt burden of 156% of GDP (based on the OECD debt definition), which is the fourth highest corporate debt level among the 25 OECD countries for which consolidated data are available, after Ireland, Iceland and Luxembourg. In 2012, 40% of Portuguese firms with bank loans did not generate sufficient operating income to service their obligations with

Figure 7. **Capital ratios and credit default swap (CDS) spreads**[1]



1. Regulatory capital compiled in accordance with the guidelines of Basel II (except for the United States where Basel I is applied). For France there is no information available on Basel standards. The banking sector covers banks and other deposit takers (units engaging in financial intermediation as a principal activity).
2. Or latest quarter available. Second quarter of 2012 for the United Kingdom. Capital to risk-weighted assets. The OECD aggregate covers 30 countries.
3. Or latest quarter available. Second quarter of 2012 for the United Kingdom. Capital to total assets that are not risk weighted. Capital is measured as total capital and reserves as reported in the sectoral balance sheet. The OECD aggregate covers 25 countries for regulatory Tier 1 capital and 26 for capital.
4. Five-year senior debt, mid-rate spreads between the entity and the relevant benchmark curve. Quarterly data calculated as the unweighted average of end-of-month figures. Figures for Portugal are calculated as the unweighted average of CDS spreads of two banks: Banco Comercial Português and Banco Espirito Santo.

Source: IMF (2014), *Financial Soundness Indicators* (database), International Monetary Fund, September and Datastream.

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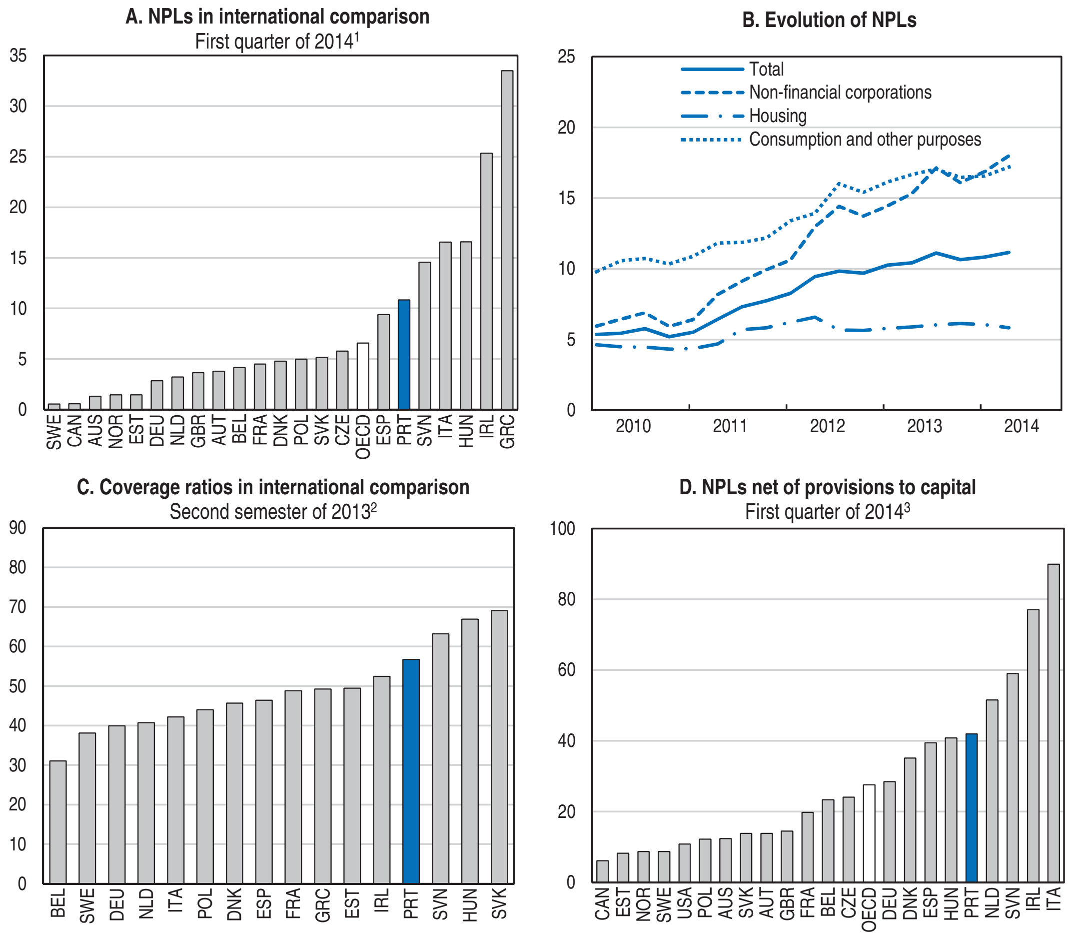
banks, highlighting the risk around firms' ability to service their debt in the future (IMF, 2014c). While coverage ratios (loan loss provisions as a percentage of NPLs) are over 50% (Figure 8, Panel C), the capacity of banks to withstand losses from non-performing loans (NPLs) without additional capital needs appears limited: in a worst-case scenario in which all NPLs were fully written off and without taking into account collateral, banks' capital would be cut by about a third, which is close to the OECD average (Figure 8, Panel D). NPLs could be underestimated as banks could restructure loans and, by "evergreening" them, avoid having to increase their provisioning needs. Supervisory action taken since 2011 required banks to increase significantly the level of provisions, attenuating risks related to evergreening.

Figure 8. **Non-performing loans (NPLs) and coverage ratios**

Per cent



1. Or latest quarter available. 2012 for Germany. Second quarter of 2012 for the United Kingdom. The OECD aggregate covers 28 countries. Non-performing loans to total gross loans.
2. Coverage ratio of domestic banking groups and stand-alone banks refers to the ratio of total loss provisions to total gross doubtful and non-performing loans.
3. Or latest quarter available. 2012 for Germany. Second quarter of 2012 for the United Kingdom. The OECD aggregate covers 30 countries. Non-performing loans to total gross loans.

Source: IMF (2014), *Financial Soundness Indicators* (database), International Monetary Fund, September; Banco de Portugal (2014), "Portuguese Banking System – Latest Developments", *Data Package*, September and ECB (2014), "Consolidated Banking Data", *Statistical Data Warehouse*, European Central Bank, September.

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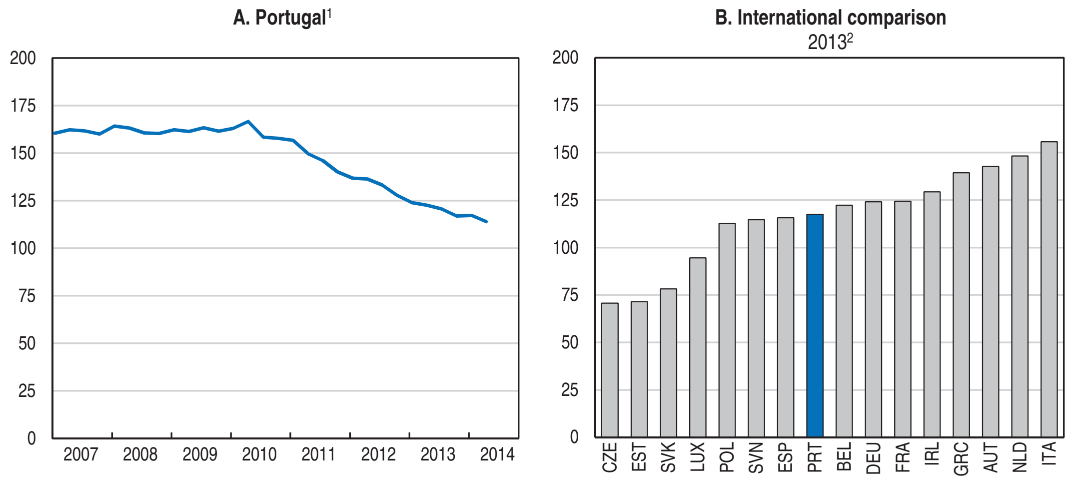
Further capital needs may arise due to a revised treatment of deferred tax assets (DTA) under the new EU directive (CRD IV), which requires deducting DTAs from core capital as of January 2014 over a period of 10 years. A new Law entered into force in August 2014 allowing the conversion of DTAs into government-backed tax credits, which would count as core capital. While the regime is similar in nature to what has been introduced in Spain and Italy, it also includes rules to mitigate the contingent liability risk for the State.

On the liability side, the increased reliance of Portuguese banks on deposits to fund their activity has resulted in a steep decrease of the loan-to-deposit ratio (Figure 9). A high ratio had been a significant weakness before the crisis. However, the reduction has partly been achieved by cutting lending, and the competition for deposits has resulted in higher funding costs for banks, although supervisory action enacted in 2012 has created

Figure 9. **Loan-to-deposit (LTD) ratio**

Per cent



1. Ratio of the sum of net loans and receivables to customers and securitised non-derecognised loans to customers to resources from customers and other loans.
2. Ratio of loans and receivables including finance leases to total deposits other than from credit institutions. Data refer to domestic banking groups and stand-alone banks.

Source: Banco de Portugal (2014), "Banking System Statistics", *BP stat*, September, Banco de Portugal (2014), "Portuguese Banking System – Latest Developments", *Data Package*, September and ECB (2014), "Consolidated Banking Data", *Statistical Data Warehouse*, European Central Bank, July.

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disincentives for banks to raise deposit rates and reversed some of their increase. While the high though decreasing reliance on European Central Bank (ECB) funding has supported the banking system, since Portugal exited from the Economic and Financial Assistance Programme the ECB accepts government debt instruments as bank collateral only if those instruments are rated "investment grade" by at least one of the four main rating agencies. As only one of these agencies currently rates Portuguese debt at this level, any negative change of the rating or outlook by an agency could have a strong negative impact on banks' financing options. At the same time, ratings by other agencies have recently improved.

Safeguarding financial stability

As Portugal has left the international Economic and Financial Assistance Programme, financial stability is critical to avoid the risk of reigniting a negative loop between the banking and the government sectors. Maintaining a forward-looking approach in capital needs is necessary to bolster the banks against negative shocks. In this context, the decision to request all systemically important banks to maintain a common equity Tier1 (CET1) capital ratio of at least 8% from January 2014 in anticipation of the ECB comprehensive assessment is welcome. Ahead of the introduction of dynamic provisioning by Basel III, the regulator should continue to request banks to hold sufficient capital for expected losses through credible stress-tests encompassing all likely risks. While the rigor of stress tests has improved considerably, further developments should be considered, taking into account other factors such as market liquidity risk and the Single Supervisory Mechanism (SSM) framework (IMF 2014a). To better assess future risks, the regulator should urge banks with no internal model to develop one. To limit the risk of credit rationing, the regulator should keep encouraging banks to improve their capital ratio by issuing equity and retaining earnings.

Financial stability could also be strengthened by adopting a more pro-active approach to cleaning up the large corporate loan portfolios on the asset side of banks' balance sheets. The corporate sector is highly indebted in Portugal (see above) and orderly debt restructuring in the non-financial corporate sector could be needed to reduce private sector indebtedness, and it could allow banks to repossess collateral before it loses value, if needed. There is also a need to strengthen firms' capital base.

Portugal has taken important steps to overhaul its corporate insolvency and restructuring framework, giving it a stronger focus on the recovery of firms rather than their liquidation. A new debt restructuring mechanism inspired by US Chapter 11 provisions has been added to the bankruptcy code to allow fast-track restructuring before an insolvency proceeding begins. One of its features is the possibility for courts to enforce out-of-court agreements between the debtor and a majority of creditors. In the past, tax authorities enjoyed a seniority status that could be detrimental to the recovery of the firms, and this has now been removed. For micro and small firms, a specific out-of-court mechanism introduced more rapid mediation by a new public mediator agency with electronic platforms to reduce paperwork bureaucracy, and guarantees to the companies and creditors during the negotiation phase. Its uptake, however, has been limited by capacity constraints of the agency (IMF, 2014b). The limitations of these new procedures should be swiftly addressed to build on their success, as they have had a success rate of over 50% by business volume. The authorities have recently intensified efforts in this area, including through a Strategic Plan for Corporate Debt Restructuring.

Even if insolvency procedures work well, creditor banks have incentives not to recognise weak assets. Incentives could be strengthened by adopting a conservative approach in assessing impaired assets and the recent guidelines on measuring credit portfolio impairment are welcome. Also, the recent requirement to disclose more information on asset quality and credit risk management practices will support more conservative impairment standard across the banking sector (IMF, 2014b). The strict implementation of these guidelines, and the more conservative criteria requested by the Bank of Portugal before a restructured loan cease to be registered as such are welcome.

Key recommendations to strengthen financial stability

- Continue to further develop the central bank's stress testing framework, consistent with the Single Supervisory Mechanism, and continue to request banks to hold capital for unexpected losses.
- Ensure a timely and consistent recognition of losses by enforcing recent guidelines and continue to encourage banks to raise capital, when needed, by issuing equity and retaining earnings.
- Assess the performance of the recently introduced insolvency procedures and enhance them if necessary.

Improving fiscal sustainability

A successful exit from international financial assistance but the public debt outlook remains difficult

The government achieved a headline deficit of 4.9% in 2013, which was significantly below target, owing to stronger revenue than expected. The underlying deficit improved more rapidly than in 2012, and the underlying primary balance posted a significant surplus (Table 2). The fiscal framework has been enhanced over the past few years with the introduction of new budget rules and the establishment of an independent fiscal council.

Table 2. **General government revenue and expenditure**

Per cent of GDP

	2009	2010	2011	2012	2013	2014[1]	2015[1]	2016[1]
Total revenue	40.4	40.6	42.6	43.0	45.2	45.2	45.2	44.9
Total expenditure	50.2	51.8	50.0	48.5	50.1	50.1	48.1	47.2
Net lending	-9.8	-11.2	-7.4	-5.5	-4.9	-4.9	-2.9	-2.3
Memorandum items								
Underlying fiscal balance[2]	-7.8	-7.6	-5.3	-4.5	-2.2	-1.6	-0.9	-0.8
Underlying primary balance[2]	-5.0	-4.8	-1.3	-0.2	2.0	2.7	3.3	3.3
Total (nominal) expenditure growth	8.7	5.8	-5.6	-6.6	4.3	1.8	-2.0	0.5
Total (nominal) revenue growth	-4.6	3.1	2.7	-2.9	6.2	1.6	2.1	1.8
Potential (nominal) growth	1.5	0.8	-0.3	-0.6	2.2	1.1	1.1	1.5
Gross debt (Maastricht definition)	80.4	90.3	105.2	120.7	124.8	127.3	128.3	127.9

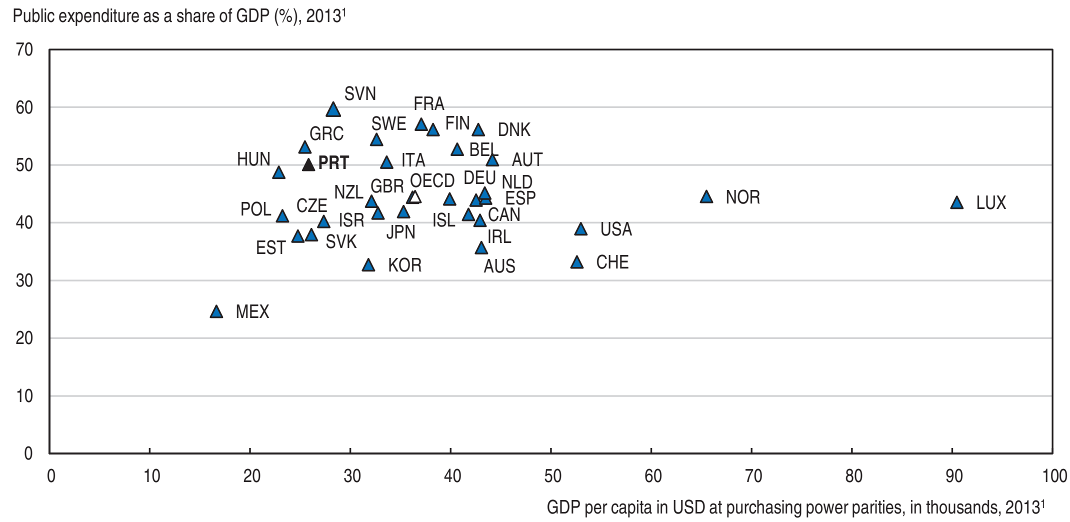
1. Projections. From 2014 onwards, the projections assume that announced government consolidation plans are implemented even if some measures have not been identified yet.
2. Per cent of potential GDP. The underlying balances are adjusted for the cycle and for one-offs. For more details, see *OECD Economic Outlook* Sources and Methods.

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

Expenditure growth was lower than (potential) GDP growth in 2011 and 2012 as a result of a significant consolidation effort on the spending side. In 2013, consolidation efforts have been achieved on the revenue side (Table 2). While tax-driven consolidations have the advantage of being rapid to implement and have potentially a lower immediate impact on activity owing to relatively low fiscal multipliers, in the longer run, from a perspective of growth and equity, fiscal consolidation should rely more on expenditure reductions, which also tend to be more sustainable than revenue driven consolidations (Cournède et al., 2013; Guichard et al., 2007). At 50% of GDP, public expenditure in Portugal is already fairly high in OECD comparison, particularly when considering the country's income levels relative to other OECD countries, as countries with higher per capita incomes tend to have higher public expenditures (Figure 10).

The better fiscal situation and a strong compliance with the Economic and Financial Assistance Programme, together with renewed market confidence, particularly following the announcement of the OMT by the ECB, has resulted in spreads on ten-year bonds falling to a level not seen since Spring 2010 (Figure 11). Better market access has paved the way for an exit from the Economic and Financial Assistance Programme in June 2014. The exit from the programme has not been without costs and entails some risks as market conditions can change rapidly. Indeed, in 2014 the government was able to return to the long-term bond market with a successful issuance of 5, 10 and 15-year bonds, at rates slightly above the average rate offered by official institutional lenders. The government has built a safety buffer by borrowing one year of financing and refinancing needs in advance

Figure 10. **Public expenditure**



1. 2012 for Australia, Canada, Greece, Ireland, Israel, Japan, Korea, Mexico, New Zealand, OECD aggregate and Switzerland.

Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* and *OECD National Accounts* (databases), October.

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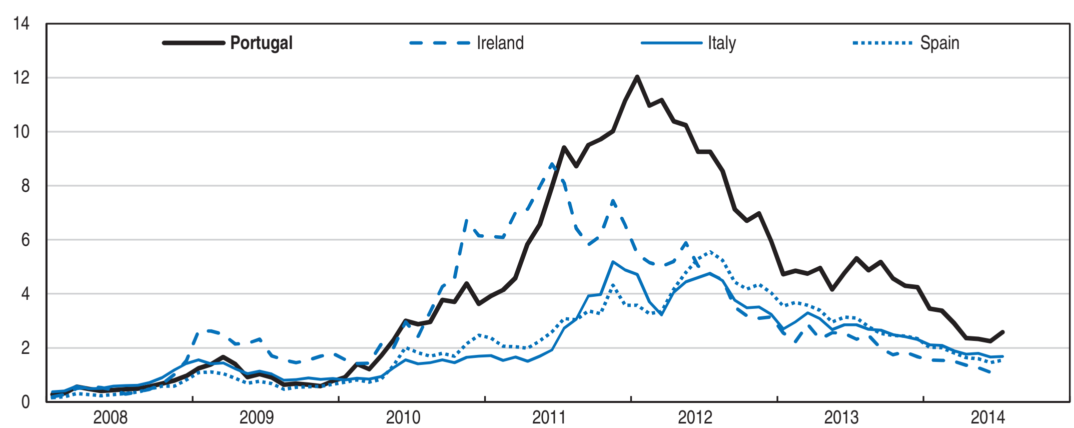
Figure 11. **Long-term interest rate spreads**

Percentage points[1]



1. Ten-year national currency-denominated government bond spreads relative to the German rate.

Source: OECD (2014), *Main Economic Indicators* (database), September.

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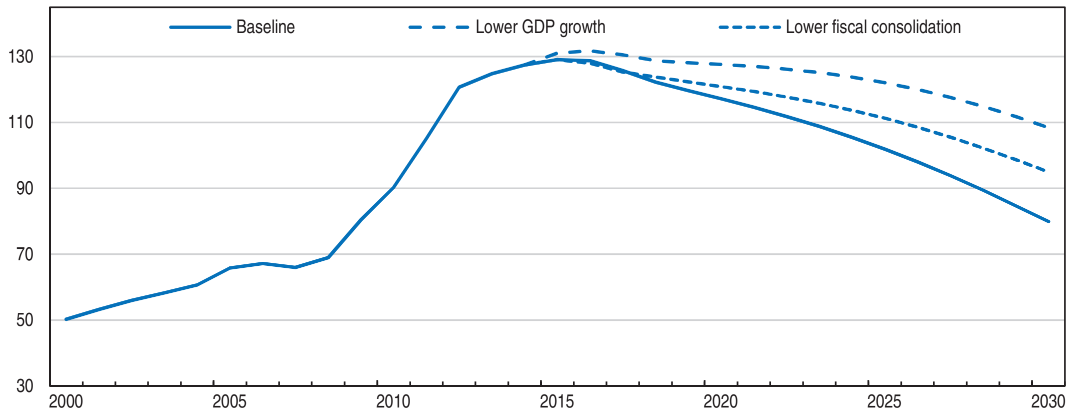
(about 5% of GDP), and 30% of it has been deposited in commercial banks rather than the central bank, notably to provide better remuneration to cover costs.

Gross public debt is at 129.4% of GDP (June 2014), but owing to the improved fiscal balance and growth prospects, on current projections and assuming that no fiscal contingency risk materialises (see below), it should decline from 2015 onwards (Figure 12). Alternative scenarios with weaker growth and less fiscal consolidation would still result in a falling debt-to-GDP ratio. In this context, the consolidation path seems appropriate and reasonably robust. In case of significant downward growth surprise the fiscal deficit should be allowed to deviate temporarily from the fiscal path, by letting the automatic stabilisers play. Long-term fiscal challenges arising from population ageing are likely to be

Figure 12. **Illustrative public debt paths**

General government debt, Maastricht definition, per cent of GDP[1]



1. The baseline assumes average real GDP growth of 1.5% over 2014-2030, with a frontloaded recovery, average inflation of 1.5% and a neutral fiscal stance (constant structural primary budget balance) from 2016 onwards. The "lower GDP growth" scenario assumes lower nominal GDP growth by 1.5 percentage points per year over the period. The "lower fiscal consolidation" scenario is identical to the baseline and assumes that additional fiscal consolidation is 1% of GDP lower spread over 2015-17.

Source: Calculations based on OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), October.

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manageable, based on simulations of tax gaps by the European Commission (EC, 2014a). Recent emigration, however, and lower growth may exacerbate the challenges associated with population ageing.

Improving expenditure management and tax collection

Adhering to the fiscal consolidation path will require further improvement in the control of expenditure management. Despite significant improvement, arrears are currently slightly below EUR 2 billion, and have accumulated notably in the hospital sector, which may imply that the sector will either need more funds or must be made more efficient. The government has created a unit in the Ministry of Finance dedicated to reining in arrears.

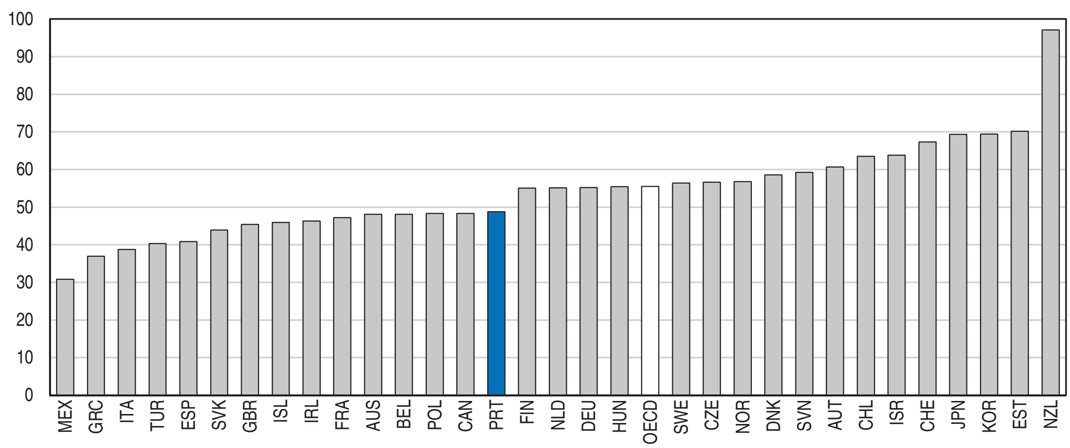
A further reduction of the number of civil servants could reduce the public wage bill going forward. Overall public sector employment has fallen by 8% since the beginning of 2012, and at 12.4% of the employed workforce, excluding hospitals and state-owned enterprises, it is now below the OECD average. Nonetheless, evidence of over-employment remains in specific areas, such as the security forces and education. With more than 450 police personnel per 100 000 inhabitants, Portugal's police are the second best-staffed in Europe. In education, average class sizes are small, even though OECD evidence suggests that class size is a far less important factor than teacher performance for student's learning progress. Public sector wage costs have been reduced on several occasions through a mixture of abolishing public holidays, an extension of the work week from 35 to 40 hours without adjusting pay, wage cuts and taxes. A progressive reduction of public sector salaries was implemented in 2011, but a further reduction in 2014 had to be undone after the Constitutional Court rejected its application beyond 31 May. The previous wage reduction was re-instated in September 2014 and will be partially reversed in 2015.

Taxation

Efficiency gains can not only be identified for public expenditure, but also for taxes. Both in value-added taxes (VAT) and in personal income taxes, exemptions could be reduced further. Since 2012, Portugal has significantly reduced the formerly widespread use of reduced VAT rates and VAT exemptions. This has improved the efficiency of the VAT system, which nonetheless remains below the OECD average (Figure 13). The authorities should build on recent progress and further extend the scope of the standard VAT rate. One way of doing so would be to abolish the current intermediate rate of 13% and to narrow the scope of application of the reduced rate of 6%. In personal income taxes, the taxation of income in kind has been revised, including by limiting the favourable taxation of company vehicles to smaller cars, but this special treatment should be abolished altogether.

Figure 13. **Value-added tax (VAT) revenue ratio**

Per cent, 2012[1]



1. 2011 for Australia, Greece, Ireland, Korea, Netherlands, Poland and OECD average. The VAT revenue ratio (VRR) is defined as the ratio between the actual value-added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. This ratio gives an indication of the efficiency of the VAT regime in a country compared to a standard norm. It is estimated by the following formula: VRR = VAT revenue/([consumption - VAT revenue] × standard VAT rate). VAT rates used are standard rates applicable as at 1 January of each year. The OECD aggregate is an unweighted average and data for Canada cover federal VAT only.

Source: Calculations based on OECD (2014), *OECD Tax Database*, *OECD Revenue Statistics* and *OECD National Accounts Statistics* (databases), October using the methodology described in OECD (2014), *Consumption Tax Trends*, forthcoming.

StatLink *http://dx.doi.org/10.1787/888933156116*

A tax expert commission was established in February to make a series of proposals to promote natural resource efficiency and remove harmful tax subsidies. There is clearly scope to strengthen the environmental benefits of taxes, for example by equalising the tax burden on diesel fuel and petrol which could reduce emissions of greenhouse gases and other pollutants (OECD estimates based on OECD, 2013a). There is no environmental justification for lower tax rates on diesel due to their greater air pollution and carbon impacts (Harding, 2014). In addition, the authorities should consider reducing fuel tax expenditures, for example preferential fuel tax rates for agriculture and fishing. These preferential rates reduce the incentives for fuel efficiency (OECD, 2013b). Fiscal incentives for an efficient use of environmental resources could also be enhanced by raising the tax rate on pesticides, which are intensively used in some agricultural activities and raise concerns for both the environment and public health. Some of the expert commission's proposals include a possible carbon tax on sectors not subject to the Emission Trading System (ETS).

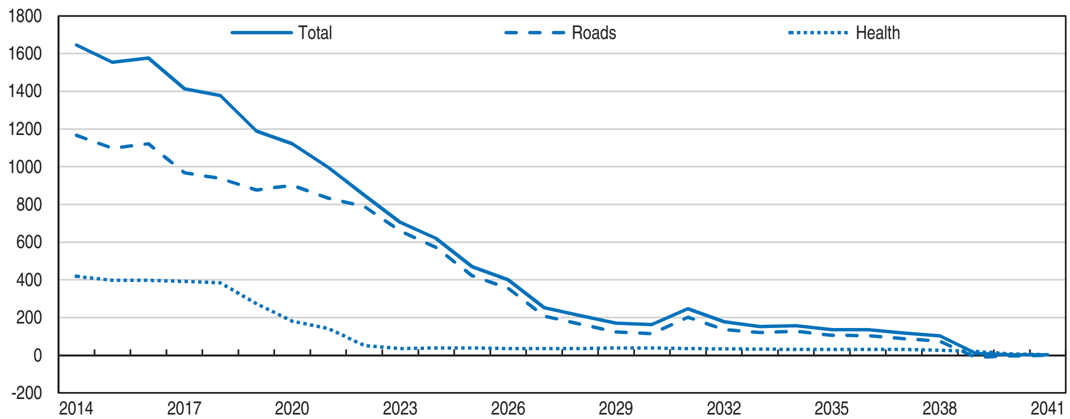
Reducing contingent fiscal risks

Public private partnerships (PPPs)

Portugal has made extensive use of PPPs over the last decades, especially for building roads. However, PPPs have sometimes been attractive for policy makers because the associated payments are off-budget and paid in the far future. This created sizeable public-sector liabilities and reduced incentives for ensuring value for money. Demand for new motorways was sometimes significantly overestimated. Government payments under PPPs amount to EUR 1.6 billion (1% of GDP) but are scheduled to fall gradually over the coming decade (Figure 14).

Figure 14. **Net public-private partnership payments by the government**

EUR million[1]



1. In 2014 prices and including value-added tax (VAT).

Source: Ministry of Finance (2013), "Orçamento do Estado para 2014, Relatório".

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At the same time, there has been evidence of excessive private rents as a result of the absence of a well-defined legal framework and systematic cost-benefit analyses (Sarmento, 2013). In particular, economic and financial rebalance clauses in PPP contracts often implied that the government ended up bearing risks that should have been assigned to the private side. From 2011, new PPP projects were temporarily frozen and a new legal framework was put into place in 2012, including a new technical unit in the Ministry of Finance, UTAP, to handle the PPP renegotiations in 2013.

Significant progress in the renegotiations with private partners will probably allow a reduction in the net present value of government financial commitments in the road sector on the order EUR 6.6 billion. For dealing with liabilities from legacy PPPs, the new approach seems adequate, and the renegotiation achievements are sizeable. With respect to future projects, PPPs should continue to be one of the financing options on the table, but only when they represent better value for money than alternatives. Most importantly, PPPs should never again be used to avoid transparency and to circumvent public sector constraints. In particular, future PPPs should be explicitly costed and accounted for in budget documentation when they are proposed and implemented.

State-owned enterprises

State-owned enterprises (SOEs) have been successfully brought to operational balance when taken as a whole, for the first time in 40 years. This was achieved through tariff increases and reductions in the number of staff through voluntary separation programmes. The governance of the sector was improved by a new framework law in December 2013. Operating expenses of SOEs are expected to remain flat in 2014 following a substantial reduction of the past years, and further savings from SOEs are planned for 2015, including in the transport sector, where several public services are to be transformed into concessions. Further progress can be made on plans to close a number of loss-making rail lines operated by the public passenger rail company CP. A significant problem for the SOEs, particularly in the transport sector, is the cost of servicing accumulated debt. These obligations, some of which have recently been re-classified to the general government, will eventually fall back on the state in one way or another.

Privatisations have taken place in the areas of electricity, airport services, postal services, and insurance services, raising more than EUR 9 billion since November 2012, which was above the initial objective of EUR 5 billion. Several privatisations have attracted foreign direct investment. Large privatisations planned – but not yet implemented – include the national airline *TAP*, for which an earlier privatisation attempt failed in 2012, and the cargo rail company *CP Carga*. Concession tenders for local public transport in Lisbon and Porto are now underway and prospective concessionaires are expected to begin operations in early 2015. In the water sector, the activities of *Aguas de Portugal*, which include water, sewage and waste management services, are to be separated in 2015 before some of them will be privatised.

Recommendations for fiscal policy

Key recommendations

- Achieve planned structural fiscal consolidation targets but allow the automatic stabilisers to operate.
- Continue to improve public sector efficiency by further reducing the number of civil servants; enhance the efficiency of the tax system including by eliminating tax exemptions and expenditures.

Other recommendations

- Finalise renegotiations of current public private partnerships (PPPs) contracts, and ensure the transparency of future PPP contracts by fully reflecting them in the budget process.
- Continue privatisations and concessions in the transport sector. Rationalise loss-making lines operated by the public passenger rail company CP.

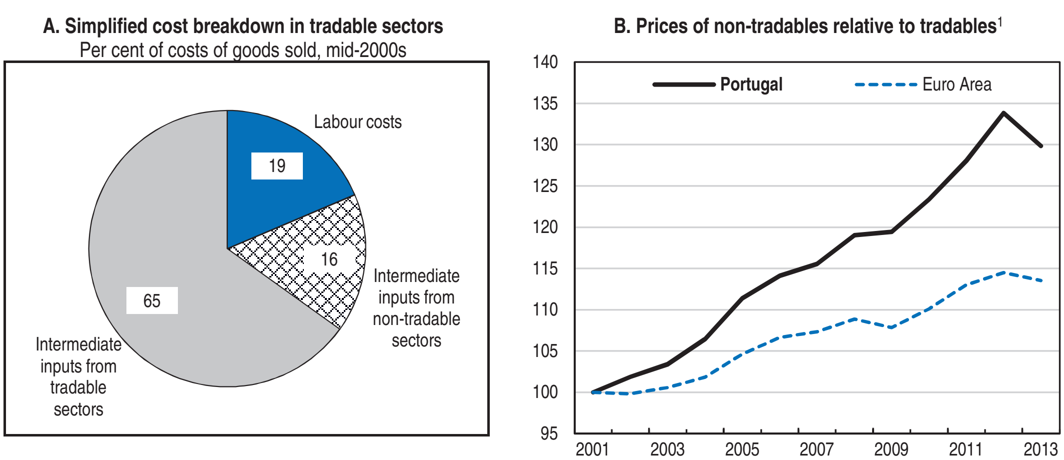
Further raising competiveness and export performance

Before the crisis, resources had been drawn excessively into sheltered non-tradable sectors, often characterised by weak competition. This encouraged economic rents and wage pressures far in excess of productivity developments, which eroded international competitiveness and export performance. Exports have strengthened since 2010. Further rebalancing the economy towards the tradable sector and strengthening export performance will be necessary to sustain growth and create more jobs. The scope for competitiveness gains will depend on the economy's ability to restrain input prices, and to enhance productivity. Enhancing innovation, the quality and the branding of exports will allow Portugal to further increase the value-added content of its exports. Portugal's value added content of its exports was 68%, slightly below the OECD average of 71% and the EU average of 87%, but higher than in a number of Central European countries. Foreign value added content is particularly high in transport equipment and electrical equipment, reflecting Portugal's strong integration into global value chains in these sectors (OECD, 2013f).

Strengthening competition in energy and continuing progress on greener growth

Inputs from non-tradable sectors are an important determinant of cost competitiveness for companies in tradable sectors, accounting for 16% of average input costs (Figure 15, Panel A). Prices in non-tradable sectors have risen significantly faster than tradable prices, even compared to other countries in the euro area (Figure 15, Panel B). In addition, improved access to non-tradable inputs can also foster productivity growth of firms in tradable sectors (Arnold et al., 2011). Thus, further action to reduce excessive rents and high prices in non-tradable sectors could spur the rebalancing process. OECD estimates suggest that the product market reforms undertaken since end 2008 – including improvements in the electricity, gas and retail trade sectors – will raise the level of GDP by 3% the year 2020. Aligning its regulation to best practice among all OECD countries would raise GDP by another 5.5% by 2020 (Chapter 1).

Figure 15. **Determinants of cost-competitiveness in tradable sectors**



1. Ratio of harmonised index of consumer prices (HICP) (2001=100) of non-tradable sectors to HICP (2001 = 100) of tradable sectors.

Source: OECD (2012), "STAN Input-Output: Input Output Database", *STAN: OECD Structural Analysis Statistics* (database), June and Eurostat (2014), *Harmonised Indices of Consumer Prices (HICP)* (database), July.

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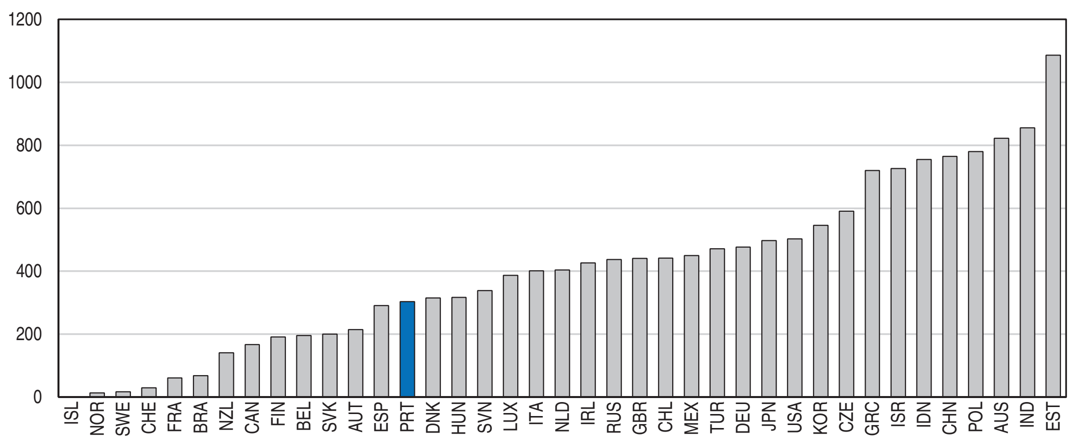
Generation of electricity is formally open to competition, but incumbent operators benefit from legacy remuneration schemes that continue to provide sizeable rents to incumbent electricity generators and are not available to potential new entrants. The surge in renewable energy sources has increased electricity costs through price guarantees for electricity from both renewable and non-renewable sources. Some non-renewable electricity generation capacity is rewarded by these price guarantees to stand ready when the more intermittent renewable energy is insufficient to meet demand. In fact, over 90% of electricity production is sold at guaranteed or subsidised prices, reducing the scope for effective competition. These electricity generation schemes are to be phased out over a 13-year horizon, but this schedule should be accelerated, including by exploring the scope for further renegotiations with incumbent companies. Such renegotiations have led to savings of EUR 3.4 billion so far.

Renewable energies have advanced at an impressive pace since 1990, and Portugal has become Europe's leader with respect to the use of renewable energy sources, hydro-energy excluded. Wind energy, which has been the driver behind these developments, has been growing at a pace of 52% per annum since 1990 in Portugal, versus 28% in OECD Europe. Similarly, geothermal electricity generation increased by almost 18% per annum. As a result, CO_2 emissions, in particular those resulting from electricity generation, have decreased since 2005 and are relatively low in Portugal (Figure 16, OECD, 2011).

Figure 16. **CO_2 emissions from electricity generation**

Grammes of carbon dioxide (CO_2) per kilowatt hour (kWh) of electricity, 2011



Source: IEA (2013), "Emissions per kWh of electricity and heat output", *IEA CO_2 Emissions from Fuel Combustion Statistics* (database), May.

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The progress in renewable energies holds a promise for Portugal, in that it could become a leader in the application of renewable energies and export its expertise. This is particularly true for wind energy, where Portugal has taken a pioneer role. Building on this success has the potential to create jobs, but success will depend on good and cost-effective policies.

A challenge will be to establish a green industrial base in a way that minimises costs, rents, or unnecessary distortions on users, and that does not put an extra burden on fiscal accounts. At present, the price that Portugal is paying for its pioneer role in renewable energy is high, as environmental objectives in energy policy have been largely pursued through generous support to producers. Public support amounts to EUR 14 per MWh, which is third-highest in the EU, after Spain (EUR 18) and Germany (EUR 15) (EC, 2014).

Despite these high levels of public support, electricity prices are high as a result of the high tariffs still being paid to producers according to legacy agreements (see Chapter 1). Over the next 8 years, electricity prices are set to rise by an additional 1.5% to 2% in real terms as electricity prices have been kept below production costs for many years, which has led to the accumulation of a debt of some EUR 4 billion (2.5% of GDP). It is to be gradually wound down by 2020. With electricity prices already high, particularly for electricity-intensive industrial consumers, this will have significant costs in terms of competitiveness. Efficiency gains in the electricity sector could also help to reduce prices, and could be achieved by improving international interconnection capacity, in particular onwards from Spain to France and other European countries where electricity prices are lower.

Enhancing the performance of labour markets

Comprehensive reforms have improved the performance of labour markets in recent years and reduced labour costs, which are an important element of competitiveness as the wage bill accounts for 19% of direct costs in the tradable sector. Severance pay has been reduced from 30 to 12 days per year of tenure, with a 12-month ceiling instead of a 3-month floor, although existing contracts preserve entitlements accrued under the old rules through a transitory regime. Overtime pay was cut in half and working time was increased through a reduction of annual leave entitlements from 25 days to 22 days and the abolition of four national public holidays. Firms have gained more flexibility in work time arrangements, following the introduction of a bank of hours that allow a maximum of 150 hours per year to be used in agreement between the employee and the employer. 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 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.

Collective wage bargaining has typically been at the sector level between the trade unions and employers' associations. The resulting collective agreements are used to determine wage floors that became binding for the entire industry through administrative extension. This mechanism limits the scope for wage agreements to adapt to the situation of specific firms and gives extra clout to those sitting at the negotiating table. By effectively stifling firm-level bargaining, this mechanism also discourages the entry of new firms and competition in product markets, as one way new firms can enter the market is by paying lower wages than incumbents for some time.

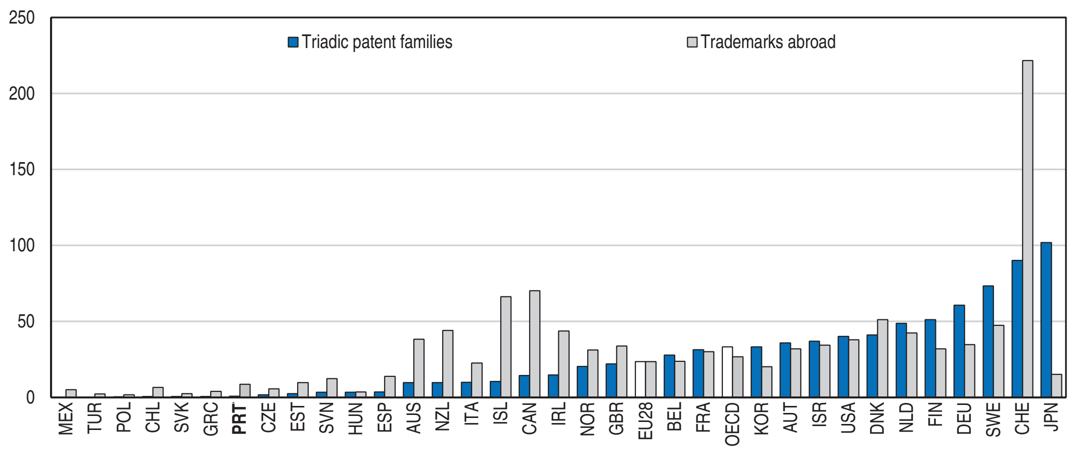
New cases of administrative extensions were effectively suspended in May 2011 and a condition that negotiating employers' associations represent at least 50% of the workers in the relevant economic sector has prevented their re-emergence since. The re-emergence of administrative extensions is planned, including by introducing alternative criteria that would allow extensions when the employer side includes 30% of small and medium enterprises; this would be an easy target to meet. However, such a change would clearly be a step backwards. Instead, more should be done to promote collective bargaining at the firm level, including by abolishing administrative extension altogether. Recent plans to shorten the survival of any expired collective bargaining agreement in the absence of a new agreement from 5 to 2 years would be a step in the right direction.

Innovation, knowledge-based capital and industry dynamics

The innovation performance of Portuguese industry has been weak, as evidenced by a low number of patents and trademarks, as has investment in knowledge capital more generally, including software and databases, innovative property and economic competencies (Figure 17).

Figure 17. **Patents and trademarks**

Average number per million population, 2009-11[1]



1. Triadic patent families are defined as patents applied for at the European Patent Office (EPO), the Japan Patent Office (JPO) and the United States Patent and Trademark Office (USPTO) to protect a same invention. Trademarks abroad correspond to the number of applications filed at in the United States, European Union and Japan, corrected the relative average propensity of other countries to file in those three offices.

Source: OECD (2013), *OECD Science, Technology and Industry Scoreboard 2013*.

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Research and development (R&D) spending is significantly below the OECD average. Expenditures by business enterprises, which are arguably closer to market demands and more likely to feed in to commercial results, are less than half the OECD average relative to GDP. A large share of R&D expenditures occurs in universities and very few new high-tech firms originate from academia. Commercial spin-offs from what were originally academic projects have played an important role for the development of industrial clusters in some countries, notably in the United States where several high-tech clusters have emerged around universities and researchers have created important start-up ventures (Capart and Sandelin, 2004; Sandelin 2003; Harayama, 1998). By contrast, in Portugal only few PhDs join the private sector, remaining in universities instead (OECD, 2014). More broadly, the lack of an effective connection between research made at universities and their commercialisation in the private sector, for example through university technology transfer offices, remains a serious issue.

Public support for business R&D and innovation consists almost exclusively of tax credits (OECD, 2013c). Going forward, finding a better balance between direct support for business R&D and R&D tax credits may be useful, as direct support can help address specific market failures such as the lack of cooperation. Since new entrants typically lack taxable profits for a significant number of years, R&D tax credits risk becoming an implicit entry barrier by favouring incumbents. Some OECD countries allow tax credits to be converted into cash refunds (Australia, Canada, Denmark, Norway, or the United Kingdom) or have extended loss-carry forward provisions indefinitely (Australia, Belgium, Ireland, United Kingdom). Portugal, in contrast, does not allow refunds of R&D tax credits and the carry-forward period for R&D expenditures is limited to 8 years. In this setting, new entrants are likely to face significant disadvantages *vis-à-vis* incumbents, particularly in a context of scarce and expensive credit. Portugal should consider allowing refunds of R&D tax credits or alternatively extend the carry-forward period further.

Key recommendations for raising competitiveness and export performance

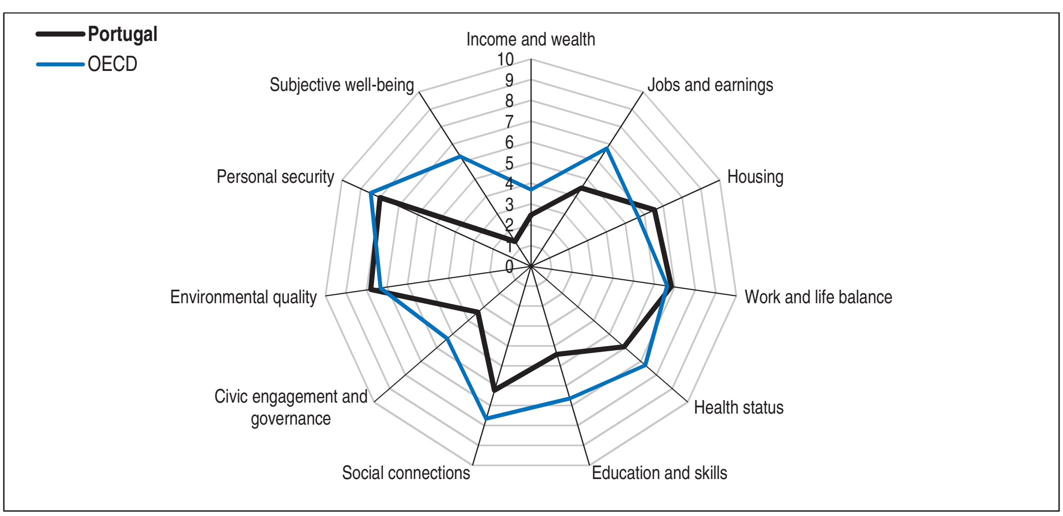
- Promote wage bargaining at the firm level, including by abolishing administrative extensions of wage agreements.
- Strengthen competition in non-tradable sectors through further regulatory reform. Phase out electricity generation schemes with guaranteed prices sooner than currently planned.
- Improve the links between researchers in universities and the private sector. Consider allowing refunds of research and development (R&D) tax credits for loss-making firms or extending the carry-forward period.

Making future growth more inclusive

Well-being and the social dimension of the adjustment process are crucial for maintaining social cohesion and political support for further reforms. The OECD's Better Life Index 2014 shows that Portugal's indicators of wellbeing are mixed (Figure 18). The subjective perception of well-being appears to be low in Portugal, with only three OECD countries having lower indicator scores in this area. Portugal is also below the OECD average in terms of income and wealth, jobs and earnings, education and skills, health, social connections and civic engagement and governance. By contrast it ranks relatively highly among the top ten OECD countries in terms of housing quality and slightly above the OECD average in terms of environmental quality and work and life balance.

Figure 18. **Well-being outcomes: Better Life Index**

2014[1]



1. Each well-being dimension is measured by one to four indicators from the OECD Better Life Index set. Normalised indicators are averaged with equal weights. Indicators are normalised to range between 10 (best) and 0 (worst) according to the following formula: (indicator value - minimum value)/(maximum value - minimum value) × 10.

Source: OECD (2014), *OECD Better Life Index*, *www.oecdbetterlifeindex.org*.

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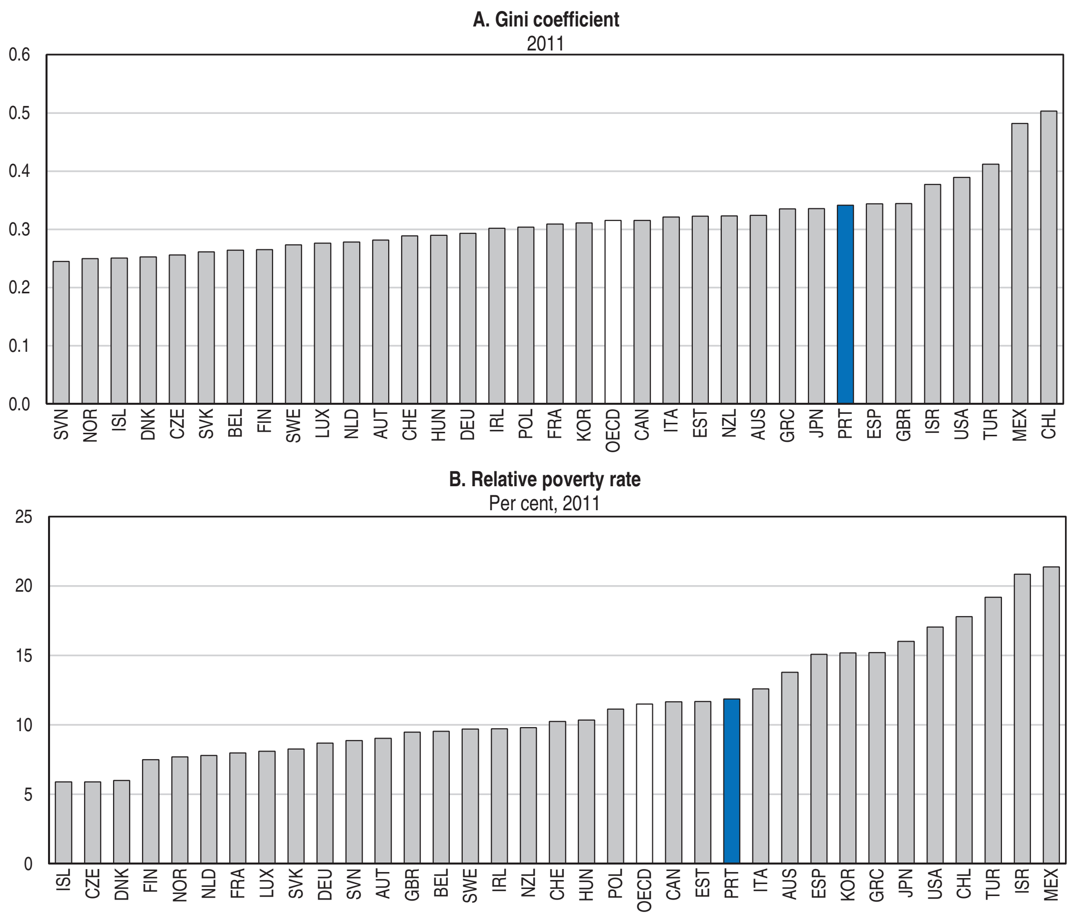
Inequality and poverty are high

By all commonly used measures, income inequality in Portugal is considerably above the OECD average. In Europe, Portugal has the fourth highest level of relative poverty and is one of the most unequal countries with respect to disposable income (Figure 19). Between 2004 and 2009, inequality had been on a downward trend, the share of income accruing to the top 10% income earners has been coming down, and lower brackets of the income distribution recorded some improvement. The economic crisis, however, put this downward trend to a halt and the Gini coefficient has been broadly stable since 2010, with a small decrease in 2012. Portuguese households felt the impact of the crisis later than those in other European countries, with the disposable incomes still rising until 2010, while they started slowing down for the European Union as a whole as early as 2008.

Figure 19. **Inequality and poverty**[1]



1. The Gini coefficient is calculated for household disposable income after taxes and transfers, adjusted for differences in household size. The relative poverty rate is based on 50% of the median disposable income (adjusted for family size and after taxes and transfers) of the entire population. 2009 for Japan. 2010 for Belgium. 2012 for Australia, Hungary, Netherlands and Mexico.

Source: OECD (2014), "Income Distribution Database", *OECD Social and Welfare Statistics* (database), July.

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The incidence of poverty (income less than half of median income) appears fairly stable over the last four available years, and has decreased among the elderly and increased among youths. However, this largely reflects a fall in the median income itself. Using the 2009 anchored poverty line, which fixes the real value of the poverty threshold at 2009 levels and then adjusts only for inflation, the percentage of people with incomes below 60% of median income has increased by 6.8 percentage points between 2009 and 2012 (Table 3). Increases in poverty were most pronounced among the working age population, children and youths, while poverty increased only marginally among the elderly. In international comparison, Portugal has seen a sizeable increase in poverty, as only 4 OECD countries recorded stronger increases in poverty measured by an "anchored" poverty rate (Figure 20).

Table 3. **Inequality and poverty indicators**

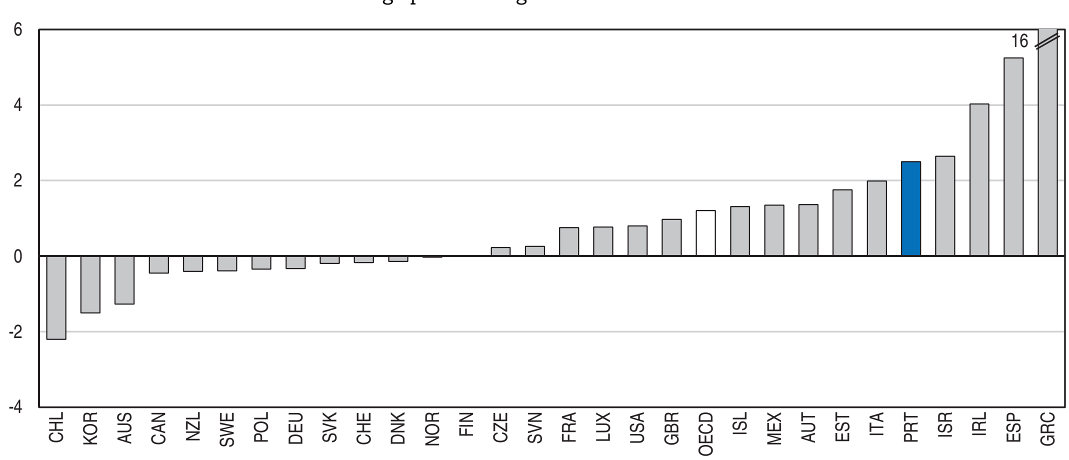
	Unit	2009	2010	2011	2012
Disposable income[1]	EUR/year	8 678	8 410	8 323	8 173
Income inequality					
Gini index		0.337	0.342	0.345	0.342
S80/S20 income quintile ratio	%	5.6	5.7	5.8	6.0
S90/S10 income decile ratio	%	9.2	9.4	10.0	10.7
Relative poverty[2]					
Poverty line	EUR/month	434	421	416	409
Poverty rate (all)	%	17.9	18.0	17.9	18.7
0-17 years	%	22.4	22.4	21.8	24.4
18-64 years	%	15.7	16.2	16.9	18.4
65+ years	%	21.0	20.0	17.4	14.7
"Anchored" poverty[3]					
Poverty line	EUR/month	434	440	456	469
Poverty rate (all)	%	17.9	19.6	21.3	24.7
0-17 years	%	22.4	23.8	26.1	30.9
18-64 years	%	15.7	17.7	20.4	23.7
65+ years	%	21.0	21.6	20.1	22.4

1. In current EUR, adjusted for household size.
2. The poverty line is defined as 60% of median disposable income in each year, adjusted for household size.
3. The poverty line is fixed at 60% of median disposable income in 2009 and adjusted for inflation and household size.

Source: INE (2014), "EU Statistics on Income and Living Conditions (EU-SILC) 2013", Instituto Nacional de Estatística.

Figure 20. **Anchored poverty rates**

Percentage point change between 2009 and 2011[1]



1. The "anchored" poverty rate is a benchmark "anchored" to half the median real incomes observed in 2005 (i.e. keeping constant the value of the 2005 poverty line). Change between 2010 and 2012 for Australia and Mexico. The OECD aggregate covers 29 countries.

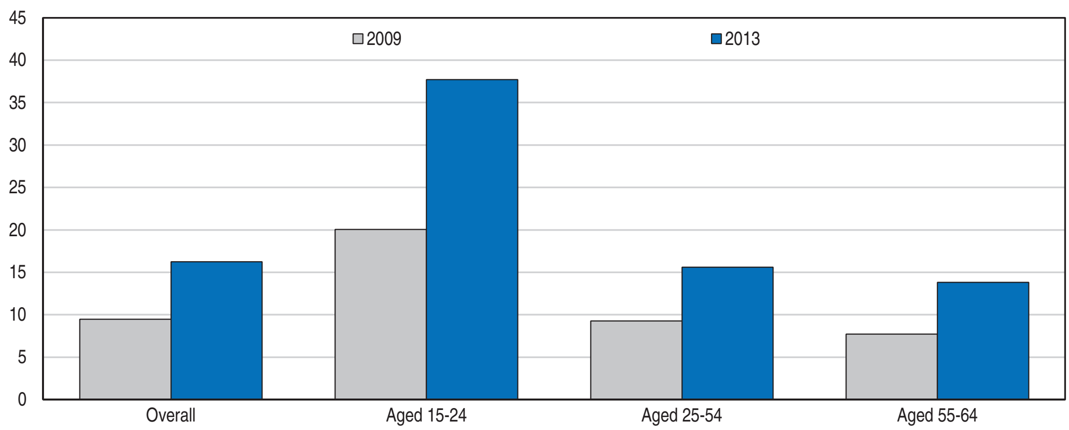
Source: OECD (2014), "Income Distribution Database", *OECD Social and Welfare Statistics* (database), July.

StatLink http://dx.doi.org/10.1787/888933156186

Losing employment is one of the principal reasons why households have suffered income losses. The unemployment rate has risen from 9.5% in 2009 to 14.0% in August 2014, with an intermediate peak of almost 17.5% (Figure 21). The rise in unemployment has particularly affected young people, whose unemployment rate rose to over 42% in the first quarter of 2013. Youth employment fell by more than half for those with below upper-secondary education and one out of six young adults aged 15-24 is neither in a job, nor preparing for employment.

Figure 21. **Unemployment rate by age groups**

Per cent of labour force



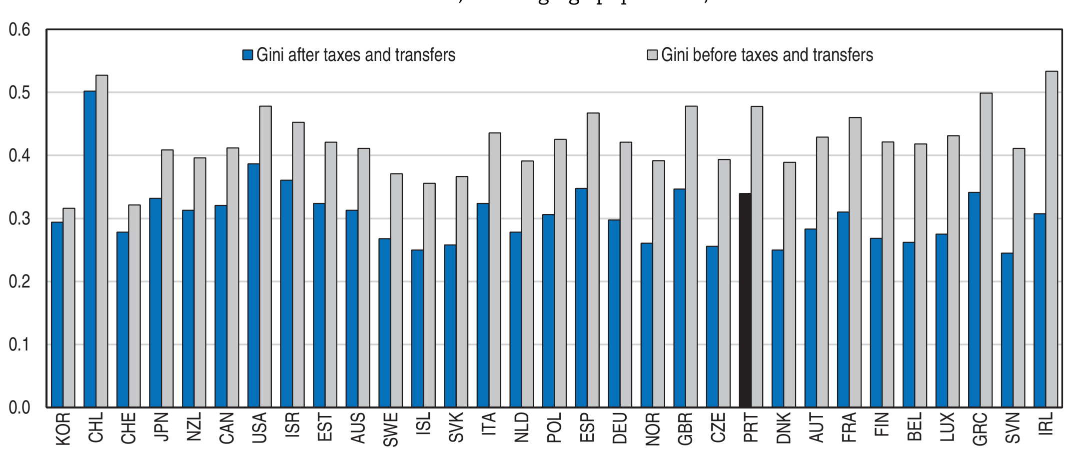
Source: OECD (2014), *OECD Employment and Labour Market Statistics* (database), June.

StatLink http://dx.doi.org/10.1787/888933156197

Taxes and transfers alleviate the inequality of market incomes substantially, reducing the Gini coefficient by about 0.14 points (Figure 22). However, those OECD countries to the right of Portugal in the figure below achieve stronger reductions in inequality through taxes and transfers, starting in most cases from already lower inequality levels. This

Figure 22. **Reduction in inequality resulting from taxes and transfers**

Gini coefficient, working-age population, 2011[1]



1. 2009 for Japan. 2010 for Belgium. 2012 for Australia and Netherlands. Working age is defined as 18-65 years old. Countries are ranked in increasing order of difference between Gini before and after taxes and transfers.

Source: OECD (2014), "Income Distribution Database", OECD *Social and Welfare Statistics* (database), July.

StatLink http://dx.doi.org/10.1787/888933156209

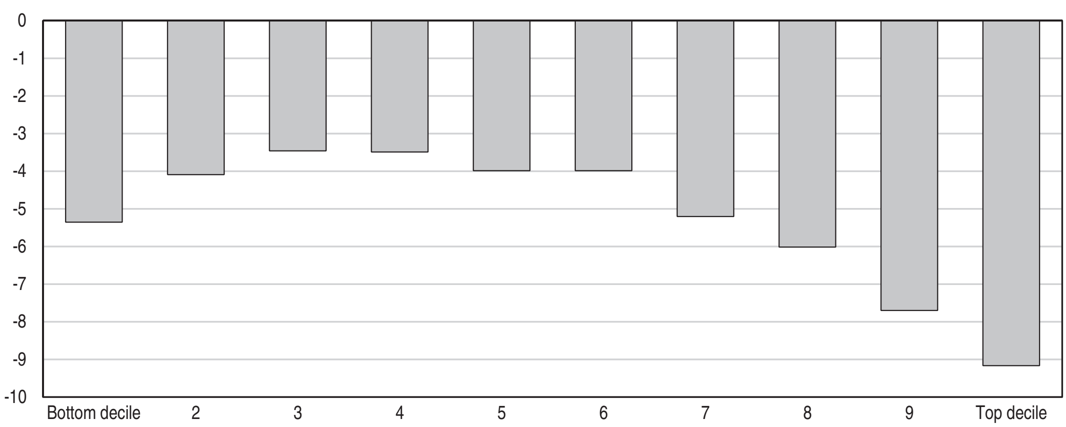
suggests that more can be done to improve equity through social policies, and given that Portugal's social expenditure are above the OECD average, such improvements could likely be achieved by making existing redistributive policies more efficient, as opposed to spending more.

Policies to reduce inequality and poverty

Raising the distributional impact of social policies will require both consolidating overlapping benefits and improving the targeting of benefits to those most in need. While recent policy reforms in the context of fiscal consolidation have shifted most of the burden to high-income households, simulations suggest that the lowest income group has also suffered significant losses as a result of reforms (Figure 23). A similar pattern was observed in Greece and to a lesser extent in Spain, whereas in Italy fiscal consolidation affected all income groups in more or less the same way.

Figure 23. **Simulated change in household disposable income due to fiscal consolidation**

By income deciles, per cent of household disposable income, 2009-2012



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*, Employment, Social Affairs & Inclusion, December.

StatLink *http://dx.doi.org/10.1787/888933156214*

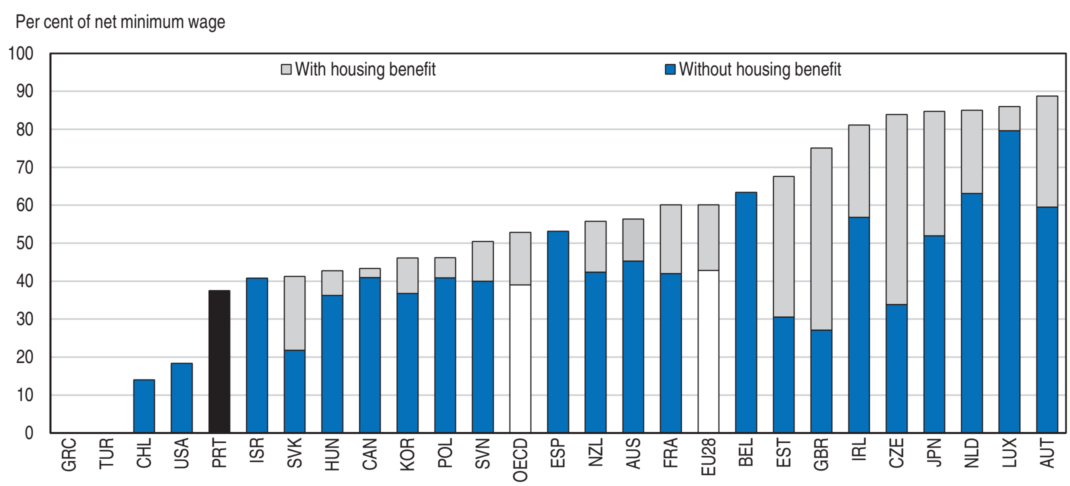
Several other programmes are in place to protect the most vulnerable individuals and households, which leads to overlapping benefits with different sets of rules. This makes monitoring difficult, facilitates fraud and jeopardises the effectiveness and efficiency of the programmes. One way to reduce the overlap and improve targeting would be to consider a cap on accumulated social benefits, which would also improve the monitoring of total benefits received by households, including those provided by local governments. Such a benefit cap could ensure that an accumulation of benefits does not generate a disincentive to work. In particular, there is a risk that marginal effective tax rates (caused by tapering benefits as income rises) can spike as one programme is piled on another. The authorities should examine the cumulative effect of these programmes and rationalise them as needed.

Portugal's guaranteed minimum income scheme *Rendimento Social de Inserção* (RSI) is a monthly transfer that tops up the recipient's monthly income to a reference minimum income threshold. Benefits are conditional on participation in a compulsory social inclusion programme, which includes short training courses and return to work initiatives, as well as on regular school attendance for all school-age children living in the household and adherence to children's vaccination plans. Reforms undertaken in 2010 and 2012, which modified how household income per person is calculated for multi-person households, led to a reduction in the number of eligible beneficiaries by over 40%, including the loss of RSI benefits for more than 50 000 children and youths, and to a reduction in transfer payments. Moreover, compared to either the minimum wage or the poverty line, minimum income benefits in Portugal are low in international comparison (Figure 24).

With 40% of the unemployed living below the poverty line, this reduction of the last-resort income support for the poor should be reversed. RSI reference thresholds should be raised, which would lead to higher benefit levels and more eligible beneficiaries. While there is a risk of creating disincentives to work, RSI benefits in Portugal are low relative to the minimum wage in international comparison (Figure 24). Better targeting resources to households with children could be achieved by giving children a more generous weight in the calculation of RSI benefits. At the same time, control and anti-fraud mechanisms should be reinforced and the social inclusion programmes made more effective, with the aim of integrating RSI beneficiaries in the labour market whenever possible.

Figure 24. **Minimum-income benefits**

Net income level provided by cash minimum-income benefit (with or without housing assistance) for single person families, 2012[1]



1. Median net household incomes are from a survey in or close to 2012, expressed in 2012 prices and are before housing costs (or other forms of "committed" expenditure). Results are adjusted for household size (equivalence scale is the square root of the household size) and account for all relevant cash benefits (social assistance, family benefits, housing-related cash support as indicated). The OECD and EU28 (i.e. European Union) aggregates refer to the unweighted averages of those countries that have minimum wage policy and are included in the chart.

Source: OECD (2014), "Taxes and benefits", *OECD Social Expenditure Statistics* (database), June.

StatLink http://dx.doi.org/10.1787/888933156228

Tax reforms have also affected the income distribution in Portugal. In 2013, tax brackets for personal income taxes were redefined, marginal rates were raised and all incomes above the national minimum wage were subjected to an "extraordinary income surtax" of 3.5%. At the same time, tax exemptions were reduced, including for private education and health expenditures, which are overwhelmingly consumed by better-off households. The effects of these changes are still difficult to evaluate but they are likely in the direction of more redistribution. VAT reforms include applying the higher standard rate to restaurant meals and some prepared foodstuffs. On the whole, these reforms likely made VAT more progressive as well, given that many of these items are consumed more by wealthier households. In any event, reduced VAT rates are an inefficient way to support low-income households.

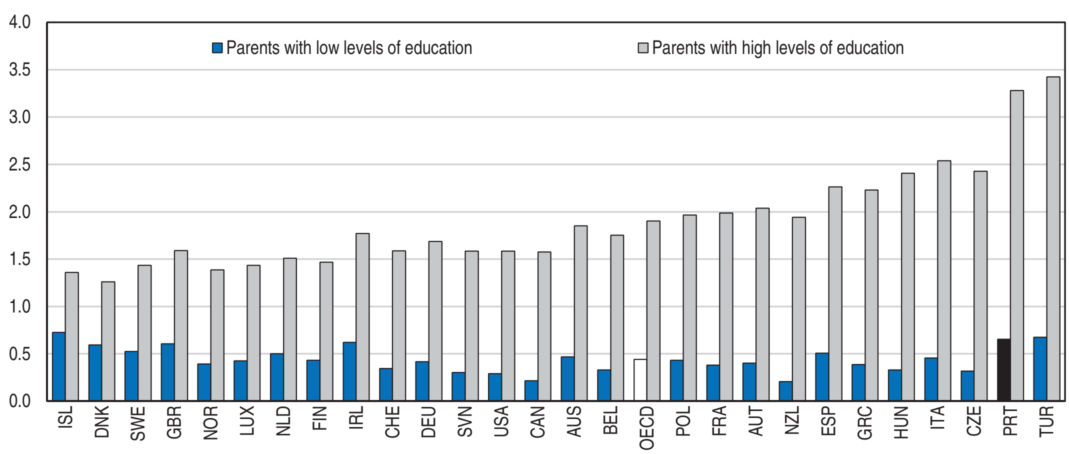
Despite recent reforms, unemployment benefits reach only about 45% of the unemployed, and they have a built-in bias towards older workers. Benefit levels remain heavily age-dependent, as larger cuts in the duration of unemployment insurance for older workers are partly offset by longer unemployment assistance. The link between age and benefit duration should be eliminated, while the eligibility conditions should be made less stringent to extend benefit coverage, especially for young workers.

Social expenditures are characterised by a general bias towards older recipients. Portugal spends 12.4% of GDP on old age and survivor benefits, compared to 8.5% in the OECD on average, whereas family benefit expenditures are only 1.5% of GDP, compared to an OECD average of 2.3%. At the same time, poverty rates have increased particularly among households with children over the period 2009-12, suggesting a need to prioritise the support given to children and youths who live in poverty or are at risk of falling into poverty. This need is reinforced by the extremely high unemployment rates among youths.

The education system could also contribute more to equity objectives. In Portugal, the association between students' socio-economic background and their performance at school is more pronounced than on average in the OECD, and much of this relation lies at the school level (OECD, 2012b, OECD, 2013e). As a result, the socio-economic differences across schools are largely predictive of a school's performance in the OECD PISA assessments, and children from highly educated parents are much more likely to participate in higher education than others, compared to other countries (Figure 25).

Figure 25. **Relationship between students' participation in higher education and socio-economic status**

Odds ratio of being a student in higher education by parents' educational level, 2009[1]



1. The chart shows the odds of someone from a low (or high) educational background attending higher education. The odds ratio is calculated by comparing the proportion of parents with low (or high) levels of education in the total parent population to the proportion of students in higher education whose parents have low (or high) levels of education. If young people from a low (or high) educational background were as likely to attend higher education as those from more (or less) educated families it would result an odds ratio equal to 1. Countries are ranked in increasing order of difference between the odds ratios of being a student in higher education with low and high educational backgrounds.

Source: OECD (2012), *Education at a Glance 2012: OECD Indicators.*

StatLink http://dx.doi.org/10.1787/888933156233

Policies that target disadvantaged schools can therefore be particularly effective in raising performance and equity levels. Moreover, the education system should put more emphasis on providing training options to less academically-inclined students by improving the vocational education and training (VET) system and by providing better support to the large number of school drop-outs.

Scaling up active labour market policies (ALMPs) can also improve labour market performance of the people with difficulties in the labour market, particularly the unemployed and youths. Recently adopted enhancements of ALMPs include short training courses, financial support for internships, a hiring subsidy paid to companies that provide training and the temporary reimbursement of social security contributions for hiring unemployed individuals below 30 or above 45 years. Going forward, career counsellors in job centres could take a more active role in managing referrals to specific ALMP programmes. This would both promote the enrolment of job seekers who would benefit the most from these programmes, and ease capacity constraints. Efforts in this direction have already started and empirical results suggest a significant positive impact on re-employment (Martins and Pessoa e Costa, 2014). 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.

Key recommendations to reduce inequality and poverty

- Strengthen the social safety net by reducing overlaps between programmes and ensuring better targeting, which could generate resources to eventually raise benefit levels of the minimum income support scheme RSI in a fiscally-neutral way.
- Make unemployment benefits independent of age and reform eligibility requirements to widen their coverage.
- Continue to scale up active labour market policies and closely monitor programme performance.
- Scale up adult education and back to school schemes to help the unemployed and those in need to gain relevant skills.

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ANNEX

Progress in main structural reforms

This table reviews action taken on recommendations from preceding Surveys*. Recommendations that are new in this* Survey *are listed in the relevant chapter.*

Financial stability

Past recommendations	Actions taken and current assessment
Tackle incentives to investment in sheltered sectors and "ever-greening" of problematic loans.	A "Corporate Debt Restructuring Strategic Plan" is being finalised, including the development of an early warning system by the Bank of Portugal.
Make small and medium-sized enterprises more reliant on equity and re-direct EU funds towards them.	A development financial institution is planned to be operational by the second half of 2014, whose tasks include managing EU funded support to small and medium-sized enterprises (SMEs) and enhancing non-debt financing for SMEs.

Fiscal policy

Past recommendations	Actions taken and current assessment
Abide by the budgeted expenditure at all levels of general government to meet headline deficit targets.	Fiscal targets were broadly met.
Introduce a consistent, explicit and easily enforceable public expenditure rule.	Fiscal efforts are made towards public budget headlines.
Support to local and regional governments should be accompanied with improvements in the fiscal framework.	A new local finance law (Law No. 73/2013) entered into force in January 2014. It contains new budgeting rules for local governments, including regarding arrears, off-balance sheet liabilities and expenditure ceilings.

Education, labour and social policies

Past recommendations	Actions taken and current assessment
Focus the evaluation system on tracking individuals and cohorts over time.	A test at the end of the 4th year has been introduced, in addition to the existing at the end of the 6th year.
Further reduce severance pay.	Severance payments for fair dismissals were reduced.
Introduce binding arbitration in conflicts over dismissals.	No progress.
Make unemployment benefit duration less age dependent, and ensure that changes to eligibility improve benefit coverage.	Despite recent progresses, unemployment benefits still display significant degree of age dependency. Coverage of benefits was extended to cover some self-employed.
Abolish administrative extension of collective agreements.	Administrative extensions were temporarily frozen, but are likely to be re-activated.
Reduce employers' social contributions on low-wage workers.	A reimbursement scheme of social contribution was implemented for young unemployed persons, but not related to low-wages.

Business environment and product markets

Past recommendations	Actions taken and current assessment
Maintain the momentum in justice reform to speed up civil and commercial case resolution.	Despite several reforms that improved court management and changed the geographic structure of the justice system, the backlog of cases remains significant.
Fully implement the zero authorisation initiative.	Implemented.
Ensure that the new eviction procedures decrease the eviction time of non-complying tenants.	An electronic platform facilitating eviction was put in place.
Introduce a full Mobile Virtual Network Operator (MVNO) agreement.	A Mobile Virtual Network Operator (MVNO) agreement has been established.
Reduce excessive support to energy generation.	Support to renewables is still substantial.

Chapter Summaries

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Chapter 1

Boosting export performance

In the years before the economic crisis, Portugal had low growth, a decline in export competitiveness and rising imbalances that included a large current account deficit and a strong expansion of the non-tradable sector. Strengthening export performance is therefore one of the principal challenges for Portugal. A successful rebalancing of the economy is underway since Portugal started an ambitious structural reform programme in 2011, but more needs to be done to build on the recent export success. This includes both measures to improve competitiveness, such as reforms in energy and services sectors, and measures to boost productivity growth, such as tax reform, improving the performance of the judicial system and better public support for research and development. Given that exporting firms are typically the top performers in their industry, and have been so even before becoming exporters, it is important to avoid policies that could slow down the possibilities for high-performing firms to gain market share, such as the extension of collective wage agreements or the design of tax credits for research and development activities. Support for small enterprises should also be designed to benefit start-ups with a strong growth performance, as well as firms that are increasing their participation in international trade.

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Chapter 2

Reducing inequality and poverty

Portugal has one of the most unequal income distributions in Europe and poverty levels are high. The economic crisis has halted a long-term gradual decline in both inequality and poverty and the number of poor households is rising, with children and youths being particularly affected. Unemployment is one of the principal reasons why household incomes declined. The tax and benefit system alleviates both inequality and poverty significantly. The tax system is markedly progressive, and recent tax reforms have likely increased this progressivity. Transfer payments, especially non-pension benefits, are reducing inequality and poverty in a fairly efficient way. Nonetheless, a number of adjustments could strengthen the equalising role of the benefit system, which is generally biased towards benefits for elderly people, while families with children should receive more support. Raising income thresholds in the guaranteed minimum income scheme could be a well-targeted way to support the most vulnerable households, in particular families with children. Unemployment benefits also contain a significant bias towards older recipients, while their coverage is still relatively low. In-work tax credits for low-income earners may be a more effective way to support low-income families than raising the minimum wage, which could lead to job losses. The education system should provide more support to students at risk of falling behind to reduce grade-repetition and drop-out rates, while further increasing class sizes would be a reasonable way to generate savings without affecting learning progress much. Scaling up vocational courses and adult education, including in the context of active labour market policies, could improve the capacity of many households to generate income and lead to a more equitable income distribution.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Portugal were reviewed by the Committee on 23 September 2014. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 6 October 2014.

The Secretariat's draft report was prepared for the Committee by Jens Arnold under the supervision of Pierre Beynet. Research assistance was provided by Gabor Fulop and Matheus Bueno.

The previous Survey of Portugal was issued in July 2012.

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