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OVERVIEW

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OECD BETTER POLICIES FOR BETTER LIVES

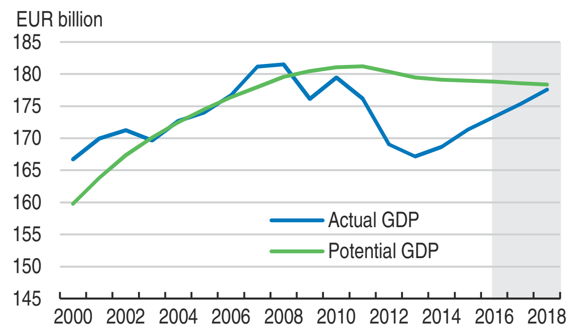
This Overview is extracted from the 2017 Economic Survey of Portugal. The Survey is published on the responsibility of the Economic and Development Review Committee (EDRC) of the OECD, which is charged with the examination of the economic situation of member countries.

Executive summary

- *The economy is recovering*
- *Investment is still very low*
- *Improving skills is crucial for raising prosperity*

The economy is recovering

The economy's growth potential has declined



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

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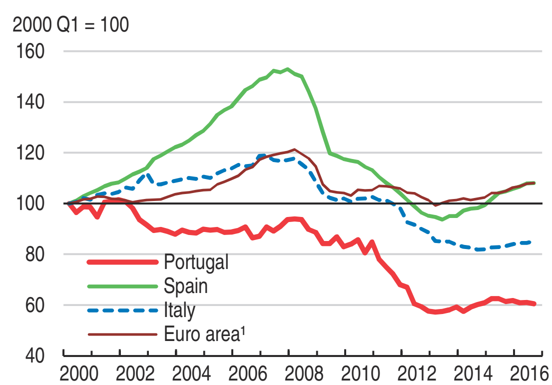
Portugal's economy has gone through a gradual recovery from a deep recession. A wide-ranging structural reform agenda has supported this recovery and the ongoing reduction of imbalances built up in the past. Stronger investment, skills, and productivity will increasingly be the basis for sustainable income gains.

Investment is still very low

Total gross fixed capital formation



1. Euro area countries that are also OECD members (including Latvia).

Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database).

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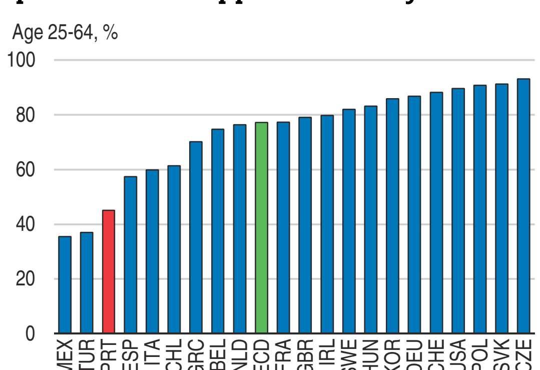
Continuing the rebalancing of the economy will require more investment. Removing distressed legacy loans from bank balance sheets, addressing bottlenecks in insolvency procedures and opening up new sources of financing play a key role in this context. Incentives for new capital investments could be strengthened by improvements in judicial efficiency, administrative reform, product market regulation reforms or lower labour costs. A systematic evaluation of past reforms could help to identify areas for a new wave of structural reforms.

Improving skills is crucial for raising prosperity

Population with upper secondary education



Source: OECD (2016a), *Education at a Glance 2016.*

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Overcoming a legacy of a low skilled labour force is key for higher living standards. Despite progress, the education system could do more to raise skill levels and reduce the link between learning outcomes and socio-economic backgrounds. The high share of early school drop-outs and frequent grade repetition would be reduced by improving teacher training and exposure to best practices and shifting resources towards primary education and students at risk. Unifying the current fragmented Vocational Education and Training (VET) system into one dual VET system, and more monitoring and evaluation, could enhance its effectiveness. Efforts need to continue to raise the skills levels of the low-qualified adult population.

MAIN FINDINGS	KEY RECOMMENDATIONS
Macroeconomic policies	
Structural reforms have improved productivity and competitiveness.	Maintain momentum for structural reforms, in conjunction with a continuous ex-ante and ex-post evaluation of reforms.
Public debt is high and poses risks in the weak growth environment.	Continue gradual fiscal consolidation to ensure the decline of public debt without jeopardising the recovery.
The efficiency of consumption taxes is undermined by the still frequent use of exemptions and special rules.	Reduce tax exemptions, special rates and tax expenditures.
Large stocks of non-performing legacy loans pose vulnerabilities for the banking sector and are limiting investment funding.	Strengthen current regulatory incentives for reducing non-performing loans (NPLs), including through write-offs and sales. Support the development of a market for distressed debt, notably through the creation of asset management companies.
Strengthening business investment	
Lengthy insolvency procedures make corporate loans more risky. The tax system encourages debt financing.	Improve the workings of insolvency rules by: • reconsidering the privileged treatment of public creditors • enlarging the scope for simple-majority decisions among creditors • shortening out-of-court settlement procedures.
Bottlenecks raise costs and curb competition, which holds back firm performance and reduces incentives to invest.	Revise land use regulations and limit discretionary powers of municipalities in licensing procedures. Ease entry requirements for professional services. Further reduce trial length and the backlog of pending court cases by expanding court capacity and assigning specialised judges to specialised courts.
Improving skills	
Until recently, Portugal has favoured general education over vocational training.	Perform a thorough evaluation of all vocational training programs. Unify the different systems of vocational education by establishing a single dual VET system, including work-based learning in companies.
Frequent grade repetition harms learning outcomes in Portugal and exacerbates inequalities.	Provide more and earlier individualised support to students at risk of falling behind to reduce grade repetition. Improve teachers' training and shift more resources towards primary and pre-primary education.

Assessment and recommendations

- *The economy is progressively recovering and rebalancing*
- *The outlook is becoming more challenging and vulnerabilities are rising*
- *Managing limited fiscal space*
- *Safeguarding financial stability*
- *Strengthening investment financing*
- *Improving the business climate to boost investment*
- *Raising skills*
- *Making growth more sustainable*

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.

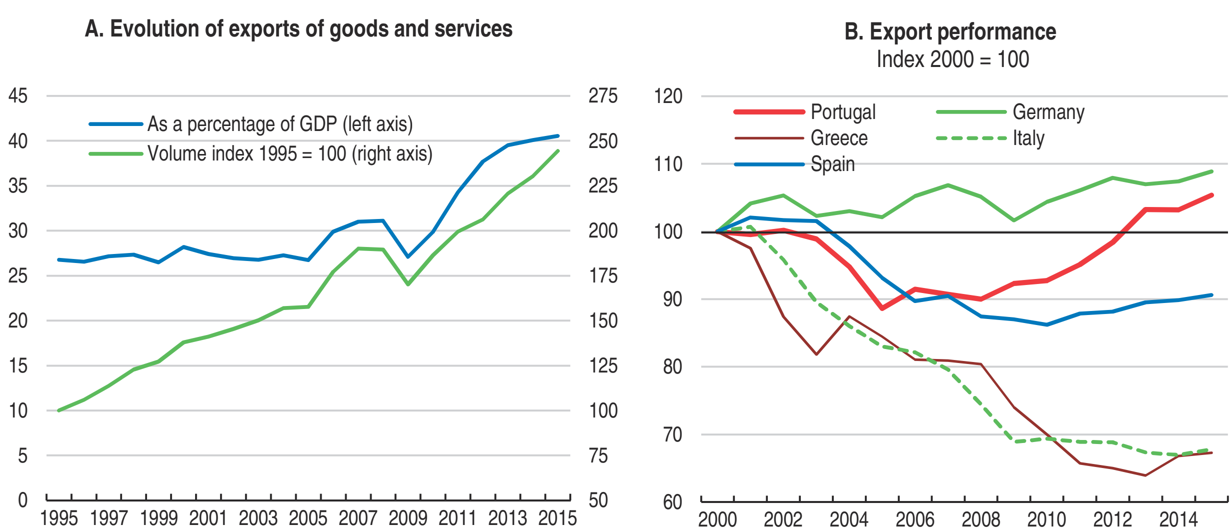
The economy is progressively recovering and rebalancing

Portugal has undertaken an ambitious structural reform programme since 2011. Reforms have spanned across a wide range of policy areas, product markets, labour markets, taxes, regulations and the public sector. These reforms have supported a gradual recovery of the Portuguese economy, with additional tailwinds resulting from highly accommodative monetary policy and low oil prices.

Past structural reforms have also led to a successful rebalancing of the economy towards exports, which appears to be gaining ground. In light of the economy's weak historical export performance, this is a remarkable achievement. When Portugal joined the European Union in 1986, its exports were intensive in relatively inexpensive labour, but this comparative advantage eroded with China's accession to the World Trade Organisation in 2001, the end of the multi-fibre agreement in 2005 and the Eastern enlargements of the EU in 2004 and 2007. Policy responses at that time included strengthening private and public consumption and an expansion of non-tradable sectors, financed by better access to external credit in conjunction with joining the Euro. Banks were the principal channel for these credit inflows, and current challenges in the banking sector are partly a legacy of this period.

The global financial crisis implied abrupt changes in access to external finance, with endemic high fiscal deficits and rising public debt leading to an external assistance programme in 2011. Since then, exports have increased significantly, both in volumes and relative to GDP (Figure 1, Panel A). Portugal now exports over 40% of GDP, up from 27%

Figure 1. **Exports have improved**



Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database).

How to read this chart (Panel B): Export performance measures the expansion of a country's exports relative to the expansion of import demand from its trading partners. Improvements in export performance reflect rising market shares in the imports of trading partners.

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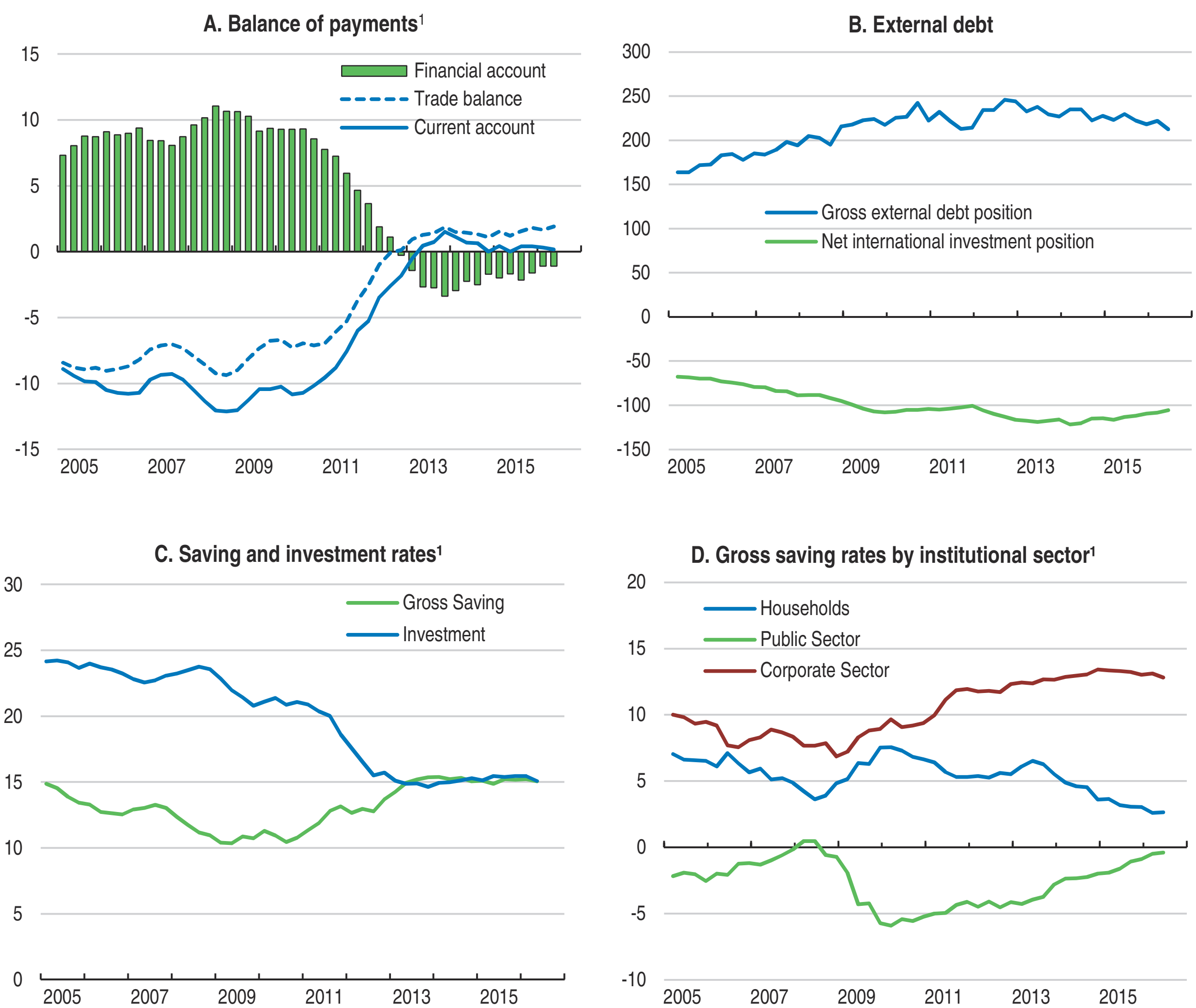
in 2005. Among other things, this reflects a larger number of firms that export than in the past, a process that has started even before the crisis. Improvements in the competitiveness of Portuguese exporters have underpinned this improvement in export performance (Figure 1, Panel B). Micro data suggests that the improvement in exports is of a structural nature (Bank of Portugal, 2016; Chapter 1 of this *Survey*).

Stronger exports have allowed a reversal in external imbalances. External liabilities and the international investment position have narrowed to 216% and -109% of GDP respectively, and the current account deficit has turned into a surplus (Figure 2, Panels A and B). Domestic savings have risen, reflecting rising saving rates in the public and corporate sectors, while household savings have declined (Figure 2, Panels C and D). As low

Figure 2. **External imbalances have declined**

As a percentage of GDP



1. Four quarter moving average.

Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database); Eurostat (2016), "National accounts (ESA 2010)", *Eurostat Database* and World Bank (2016), "Quarterly External Debt Statistics/SDDS", *World DataBank, INE: National Accounts.*

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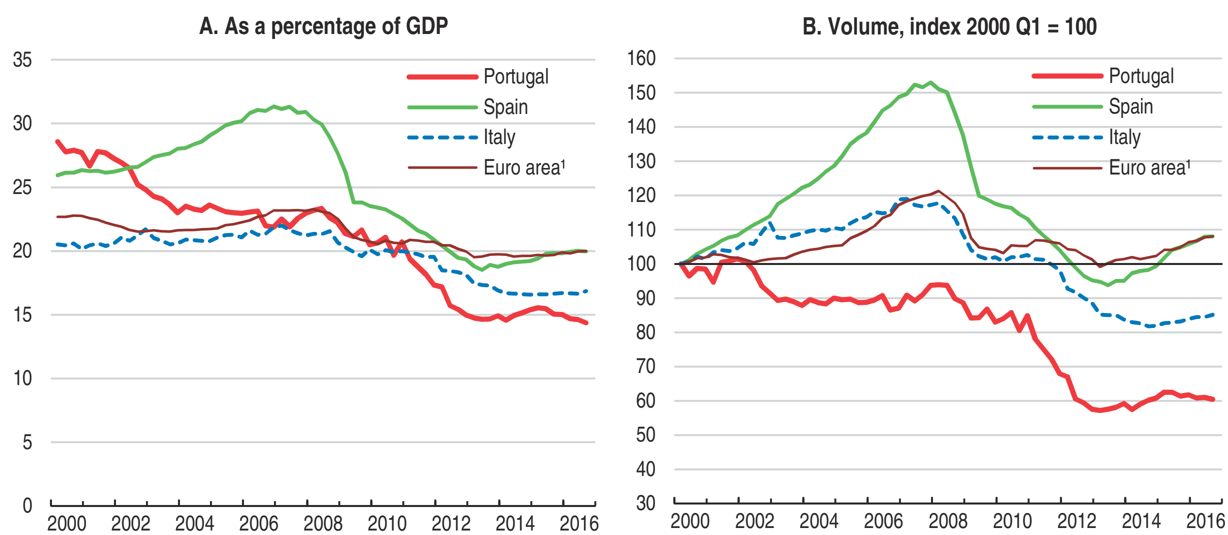
domestic demand in the context of the economic downturn has been part of the closing of the current account, additional structural improvements will be required to cement this early progress and ensure its continuation once import demand recovers.

Further expansions of export activities will require more investment in these sectors. Investment has been significantly weaker than in other euro area economies, particularly since 2010, when the investment rate dropped by 5.3 percentage points over the course of five years (Figure 3, Panel A). In volume terms, Portugal has had a less pronounced surge in investment since before the crisis than other euro area countries, and following the sharp post-crisis decline investment is now more than 30% below its 2005 level (Figure 3, Panel B). Private and public investment account for roughly similar shares of this decline, falling from 15.3% and 5.3% of GDP in 2010, respectively, to 13.0% and 2.3% in 2015. European Structural and Investment Funds (ESIF) now amount to 1.9% of GDP and finance a large part of public investment. During the first half of 2016, investment has fallen even further. Turning this around and rebuilding the capital stock is one of the key challenges for the economy.

Figure 3. **Investment**

Total gross fixed capital formation



1. Euro area countries that are also OECD members (including Latvia).

Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database).

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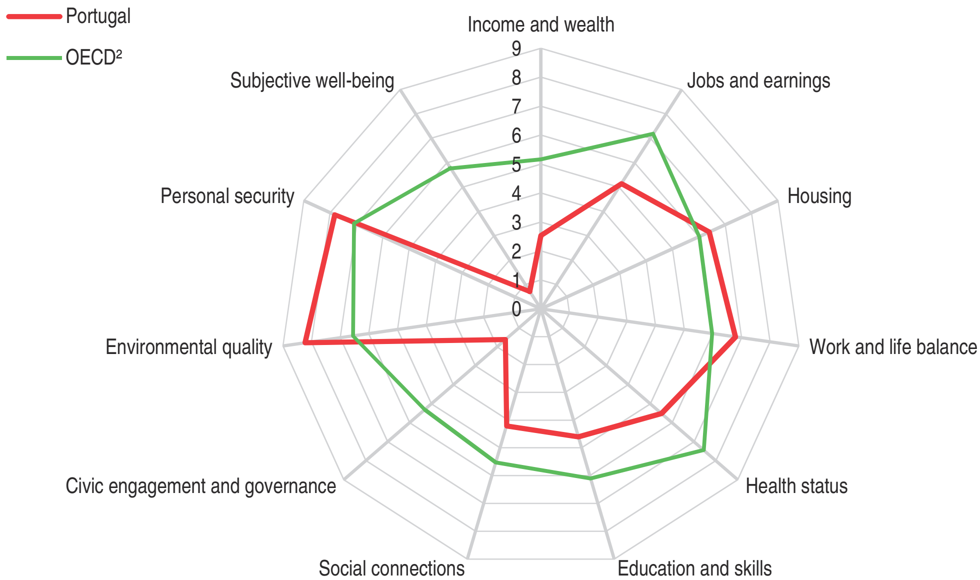
Well-being outcomes show a mixed picture (Figure 4). While Portuguese citizens have a remarkably low self-perception of their well-being, they rank above the OECD average with respect to work and life balance, housing, personal security and environmental quality. However, there are wider gaps in well-being relative to other OECD countries in key areas such as incomes, jobs, education, health, governance and social connections.

Figure 4. **Well-being outcomes: Better Life Index**[1]

2016



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

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

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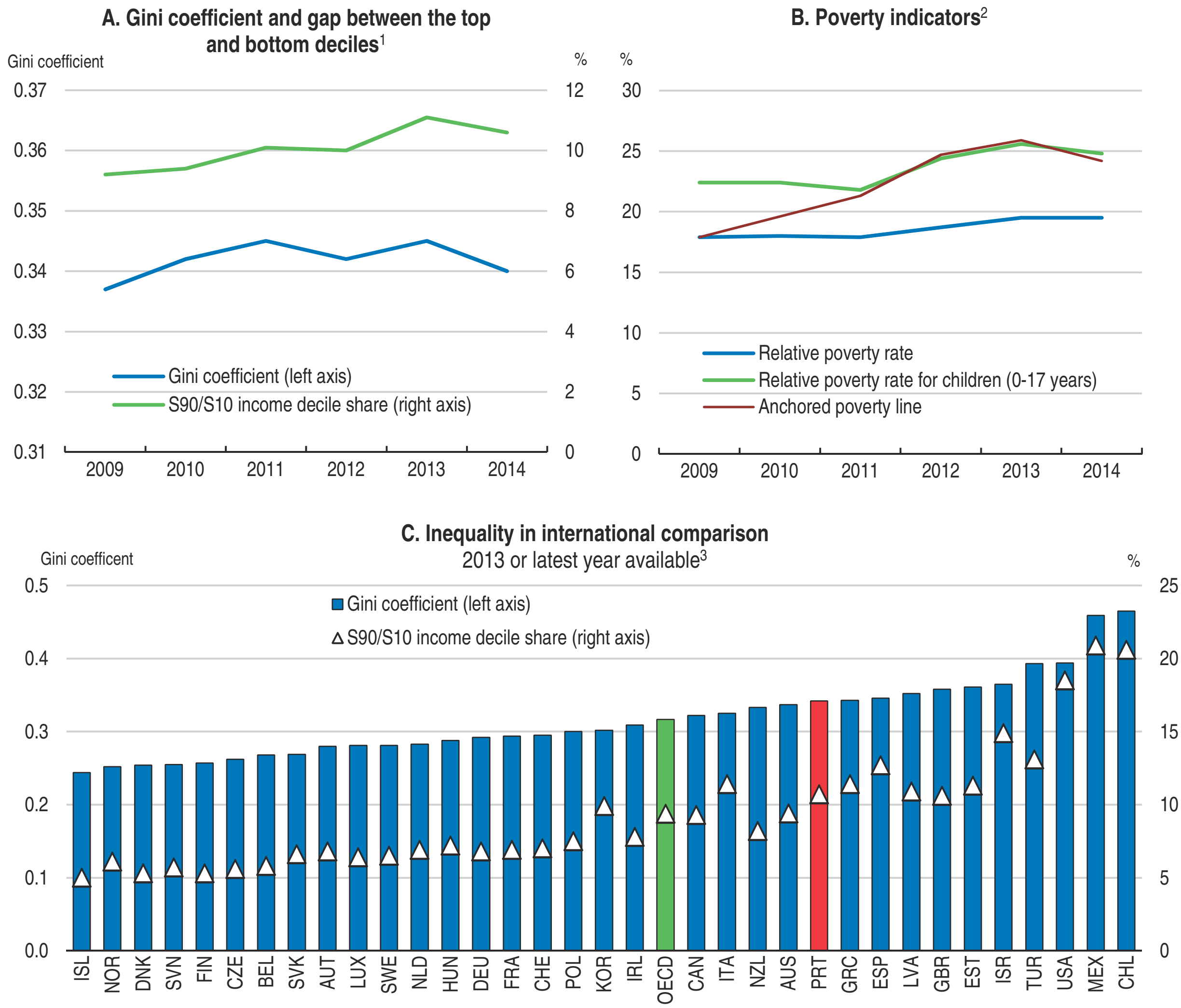
Portugal also has one of the most unequal income distributions in Europe, and both inequality and poverty have been rising since the crisis (Figure 5). Children and youths were most affected by rises in poverty, with a 3 percentage point rise in poverty in this age group, while poverty among pensioners has fallen by almost 6 percentage points since 2009.

Reducing inequalities in opportunities will be key to making growth more inclusive in the longer term. This will require rethinking some of the current governance mechanisms that afford advantages and rents to specific groups. For example, in labour markets, those with acquired rights and permanent contracts have maintained significant advantages, even though a less rigid labour market would improve the employment opportunities of the young and the unemployed. Pension reforms have placed the burden of adjustment on the young and on future retirees while those with acquired rights, particularly public sector pensioners, enjoy significantly more generous benefits than future retirees. Negotiations between workers and firms often represent only small fractions of workers and incumbent firms, while potential market entrants or the unemployed do not have much voice. The low levels of competition in many services sectors benefit small incumbent interest groups but harm those who use these services. Moving towards a more inclusive economy will involve starting a discussion on how to remove privileges and rents and provide more equal opportunities for all. Some fine-tuning has improved parts of the social safety net (Table 1).

Figure 5. **Inequality and poverty**



1. The Gini coefficient is calculated based on household equivalised disposable income after taxes and transfers. The S90/S10 ratio is the share of income received by the top decile divided by the share of income of the bottom decile
2. The relative poverty line is defined as 60% of the median equivalised income after social transfers. The anchored poverty line applies a constant definition of the poverty line based on 2009 so that its trajectory over time is not affected by changes in median incomes.
3. 2014 for Australia, Finland, Hungary, Israel, Mexico, Netherlands and the United States; 2012 for New Zealand. The OECD aggregate is an unweighted average of data shown (including Latvia).

Source: C. Farinha Rodrigues (2016), "Inequality in Portugal", PowerPoint presentation, ISEG, Universidade de Lisboa; and OECD (2016), "Income distribution", *OECD Social and Welfare Statistics* (database).

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Table 1. **Past OECD recommendations on inequality and social benefits**

Recommendations in 2014 Economic Survey	Actions taken since 2014
Strengthen the social safety net and raise benefit levels of the minimum income support scheme RSI.	Changes to Portugal's guaranteed minimum income scheme, which excluded many children and youths from the programme and reduced transfer payments but had only a small budgetary impact, have recently been undone. This is likely to attenuate poverty among children and youths going forward.
Make unemployment benefits independent of age and reform eligibility requirements to widen their coverage.	No action taken since 2014.

Against this background, the main messages of this *Survey* are:

- Growth has been slow and faces renewed headwinds, posing difficult policy choices, especially for fiscal policy.
- The fragility of banks needs to be resolved sooner rather than later to reduce fiscal risks and restore credit growth. Reducing the amount of non-performing loans on bank balance sheets is key.
- Restoring investment will be fundamental to raising prosperity and ensuring competitiveness. This will require comprehensive action on many fronts, including strengthening banks, reducing corporate debt, more efficient insolvency procedures and improvements in the business climate.
- In the long term, better skills will be critical to improving well-being and reducing high levels of inequality.

The outlook is becoming more challenging and vulnerabilities are rising

Growth prospects will increasingly depend on policies that allow the economy to compete successfully and generate new income opportunities. At present, structural bottlenecks continue to hold back growth and exacerbate vulnerabilities. Addressing some of these challenges now will lay the foundations for robust growth over the next years, but this calls for renewing the momentum of structural reforms. Implementation of reforms could be improved and a systematic evaluation of the structural reforms already undertaken would allow future reform needs to be better defined. Current efforts in this direction, including the establishment of a dedicated unit in the Ministry of Finance, are welcome.

Against this background, moderate annual growth of 1.2% is projected for 2017 (Table 2). Private consumption has played a stronger role recently but is projected to lose steam as job creation is too weak for consumer spending to continue expanding at its current pace (Figure 6, Panel A). Investment is expected to remain weak against the background of contracting credit and bottlenecks in the implementation of structural reforms to improve the business climate, which have affected confidence. Confidence indicators have recently improved. Exports will grow less than in previous years, partly due to dampened demand from China and Angola, but continue to act as a buoyant force behind growth over this year and next. Against the backdrop of low growth, a higher minimum wage and remaining labour market rigidities, decreases in unemployment are projected to be much slower than over the past two years, and unemployment will likely remain at double digit levels, among the highest in the EU.

Unemployment has been declining, but it remains at the uncomfortably high levels of 10.5% (Figure 6, Panel B). Among youths, unemployment of 26.1% reflects significant remaining challenges in the labour market. Rising unemployment has been the main cause behind the increases in income inequality in the aftermath of the financial crisis. Long-term unemployment has fallen less than the general unemployment rate, and remains at 6.2%, after a peak of above 10% in 2013.

Table 2. **Macroeconomic indicators and projections**

Annual percentage change, volume (2011 prices)

	2013 Current prices (billion EUR)	2014	2015	2016	Projections 2017	Projections 2018
Gross domestic product (GDP)	**170.3**	**0.9**	**1.6**	**1.2**	**1.2**	**1.3**
Private consumption	111.1	2.3	2.6	2.0	1.2	1.2
Government consumption	32.5	-0.5	0.8	1.1	0.2	0.3
Gross fixed capital formation	25.1	2.3	4.5	-2.0	0.7	1.6
Housing	4.2	-1.1	4.3	-3.1	0.5	1.3
Final domestic demand	168.8	1.8	2.5	1.2	1.0	1.1
Stockbuilding[1]	-0.2	0.4	0.0	0.1	0.1	0.0
Total domestic demand	168.6	2.2	2.5	1.4	1.1	1.1
Exports of goods and services	67.3	4.3	6.1	3.3	3.7	4.0
Imports of goods and services	65.6	7.8	8.2	3.6	3.6	3.6
Net exports[1]	1.7	-1.3	-0.8	-0.1	0.1	0.2
Other indicators (growth rates, unless specified)						
Potential GDP	..	-0.2	-0.1	-0.1	-0.1	-0.1
Output gap[2]	..	-5.8	-4.3	-3.1	-1.8	-0.5
Employment	..	1.6	1.1	1.0	1.1	0.6
Unemployment rate	..	13.9	12.5	11.0	10.1	10.1
GDP deflator	..	0.8	2.1	1.5	0.9	1.1
Harmonised consumer price index	..	-0.2	0.5	0.7	1.1	1.1
Harmonised core consumer price index	..	0.2	0.6	0.9	0.8	1.1
Household saving ratio, net[3]	..	-3.3	-4.0	-3.6	-3.5	-3.5
Current account balance[4]	..	0.1	0.4	0.1	0.5	0.7
General government fiscal balance[4]	..	-7.2	-4.4	-2.5	-2.1	-1.9
Underlying general government fiscal balance[2]	..	-0.7	-1.1	-0.8	-1.1	-1.6
Underlying government primary fiscal balance[2]	..	3.5	2.9	3.2	2.8	2.3
General government gross debt (Maastricht)[4]	..	130.6	129.0	130.2	129.5	128.2
General government net debt[4]	..	107.9	108.5	108.1	108.1	107.4
Three-month money market rate, average	..	0.2	0.0	-0.3	-0.3	-0.3
Ten-year government bond yield, average	..	3.8	2.4	3.1	3.1	3.1

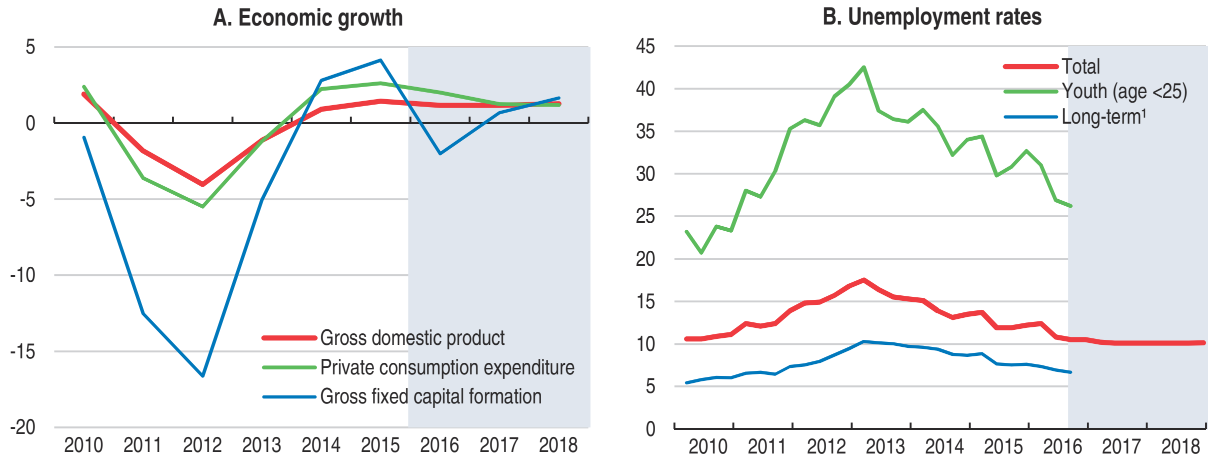
1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of household disposable income.
4. As a percentage of GDP.

Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database) with projections from "OECD Economic Outlook No. 100", November.

Downside risks stem from the fragility of the financial system which is highly vulnerable to external shocks and the high indebtedness of the private and public sectors. A rating downgrade of Portugal's sovereign debt could make access to external finance, including banks' ability to get ECB funding, more difficult. The banking sector remains constrained by weak profitability and a high share of non-performing loans. A continuing fragility of the banking system in the context of low growth could lead to a deterioration of public finances. Confidence in Portugal's banks could also suffer from contagion due to further difficulties in European banks. On the other hand, the successful implementation of a more determined policy stance towards reducing corporate debt and repairing banks' balance sheets, as described below, could restore confidence and allow more resources to flow into new productive investment. Beyond these short-term vulnerabilities, the economy is subject to a number of medium-term vulnerabilities, notably the large size of non-performing loans (Box 1 and Figure 7). Weakening world trade could also curb the prospects for stronger exports.

Figure 6. **Growth and unemployment**

Per cent



1. Unemployed persons who have been looking for jobs for 12 months or more as a share of the total labour force.
Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database); and Banco de Portugal (2016), "General Statistics", *BPstat* (database).

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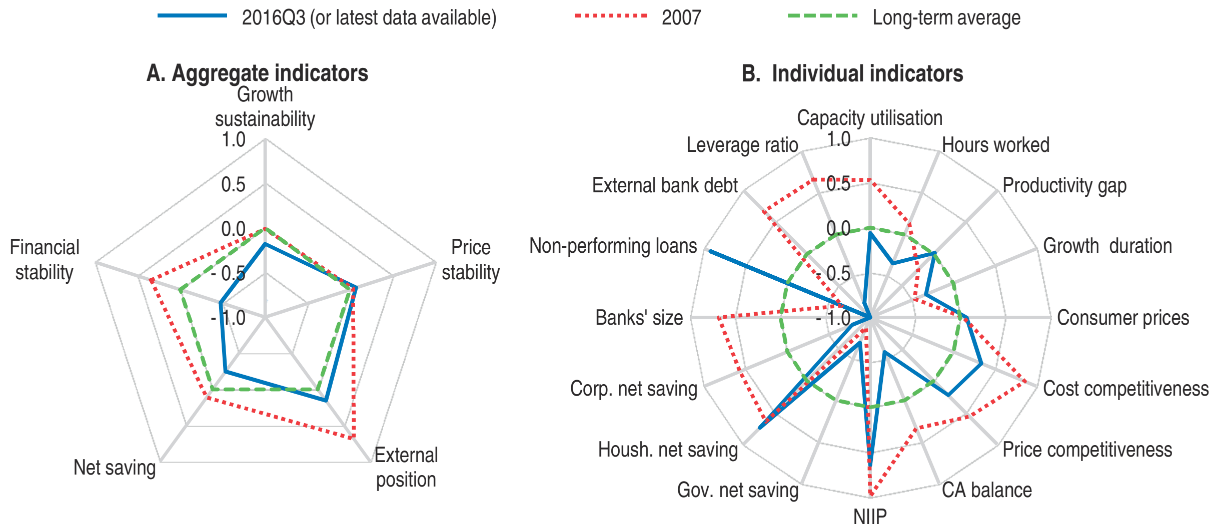
Box 1. **Medium-term uncertainties about the Portuguese economy's growth prospects**

Uncertainty	Possible outcome
Fragile banks	Adverse developments in the banking sector, in Portugal or at the European level, could lead to the need for further public support, while fiscal space is limited, and the bail-in of private creditors.
Stagnation and renewed tensions in Europe	A slower than expected recovery in main European trading partners would reduce export demand for Portugal.

Looking ahead, maintaining the current pace of growth will require improving the economy's growth potential, which has come down significantly due to years of low investment growth and a shrinking labour force (Figure 8). Stronger investment will be needed to rebuild the economy's capital stock and support further structural rebalancing of the economy towards tradable sectors, which is one of the objectives of the National Reform Programme. Raising the skills of the labour force will also lift potential growth. Both investment and skills have additionally important implications for raising multi factor productivity, and productivity improvements are the basis for higher wages and hence of living standards in the long run.

Figure 7. **Macro-financial vulnerabilities**

Deviations of indicators from their real time long-term averages (0), with the highest deviations representing the greatest potential vulnerability (+1), and the lowest deviations representing the smallest potential vulnerability (-1)[1]



1. Each aggregate macro-financial vulnerability indicator is calculated by aggregating (simple average) normalised individual indicators. Growth sustainability includes: capacity utilisation of the manufacturing sector, total hours worked as a proportion of the working-age population (hours worked), difference between GDP growth and productivity growth (productivity gap), and an indicator combining the length and strength of expansion from the previous trough (growth duration). Price stability includes headline and core inflation (consumer prices), and it is calculated by the following formula: absolute value of (core inflation minus inflation target) + (headline inflation minus core inflation). External position includes: the average of unit labour cost based on real effective exchange rate (REER), and consumer price based REER (cost competitiveness), relative prices of exported goods and services (price competitiveness), current account (CA) balance as a percentage of GDP and net international investment position (NIIP) as a percentage of GDP. Net saving includes: government, household and corporate net saving, all expressed as a percentage of GDP. Financial stability includes: banks' size as a percentage of GDP, the average of the share of non-performing loans of non-financial corporations and that of private individuals (non-performing loans), external bank debt as percentage of total banks' liabilities, and capital and reserves as a proportion of total liabilities (leverage ratio).

Source: OECD calculations based on OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database), August; OECD (2016), *Main Economic Indicators* (database), August; Banco de Portugal; and Thomson Reuters Datastream.

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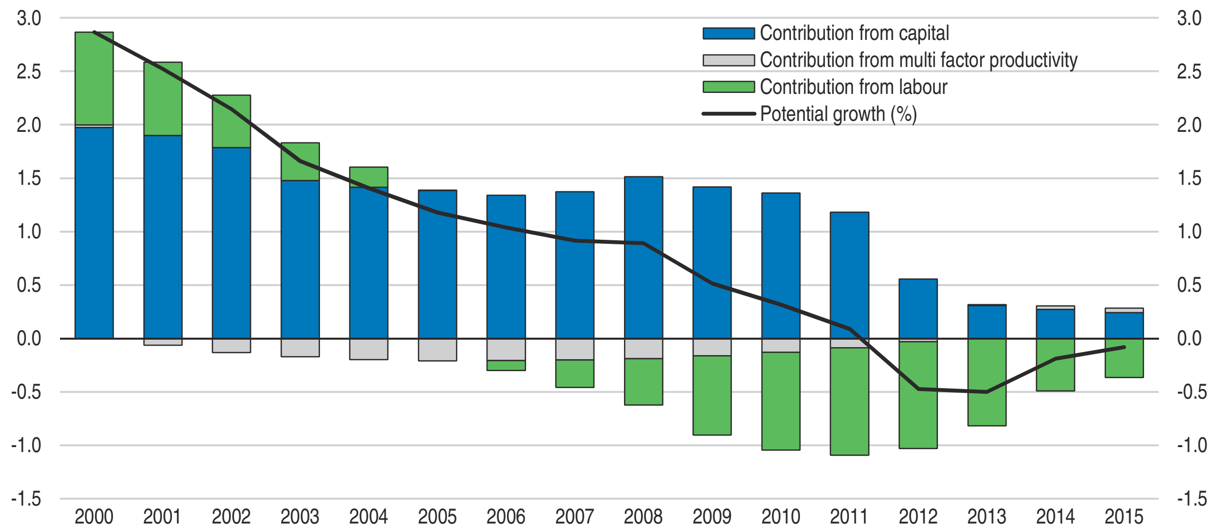
Managing limited fiscal space

Portugal has made strong progress in reducing public deficits since 2010, when the deficit peaked at 11.2% of GDP. Netting out a bank rescue that cost 1.4% of GDP in late 2015, the deficit for that year would have been at 3.0% of GDP, near the ceiling to which Portugal has committed. This is also significantly lower than in the pre-crisis period, as the fiscal deficit averaged 4.4% between 2000 and 2008. The structural deficit is smaller than 1% of GDP. The fiscal stance is broadly neutral in 2016 and 2017. In the short term, a neutral fiscal stance seems appropriate given the still fragile economic recovery.

However, fiscal policy is in a difficult spot. Putting off fiscal consolidation to support growth implies risks as fiscal sustainability remains weak. Gross public debt according to the Maastricht criterion was 129.0% of GDP at the end of 2015 and under current plans public debt is projected to decline only very slowly, to around 120% of GDP by 2030. This baseline scenario uses the projections of the latest *OECD Economic Outlook* until 2017. Under conceivable alternative scenarios to this baseline, however, the decline in public debt may not materialise (Figure 9). In a scenario where interest rates were half a percentage point higher than the baseline assumptions, public debt would remain almost constant relative to GDP. In an adverse scenario with 0.5 percentage points lower annual inflation and 0.5 percentage points lower annual growth, public debt would even rise relative to GDP.

Figure 8. **Low investment and a shrinking labour force have curbed the economy's growth potential**

Percentage points



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

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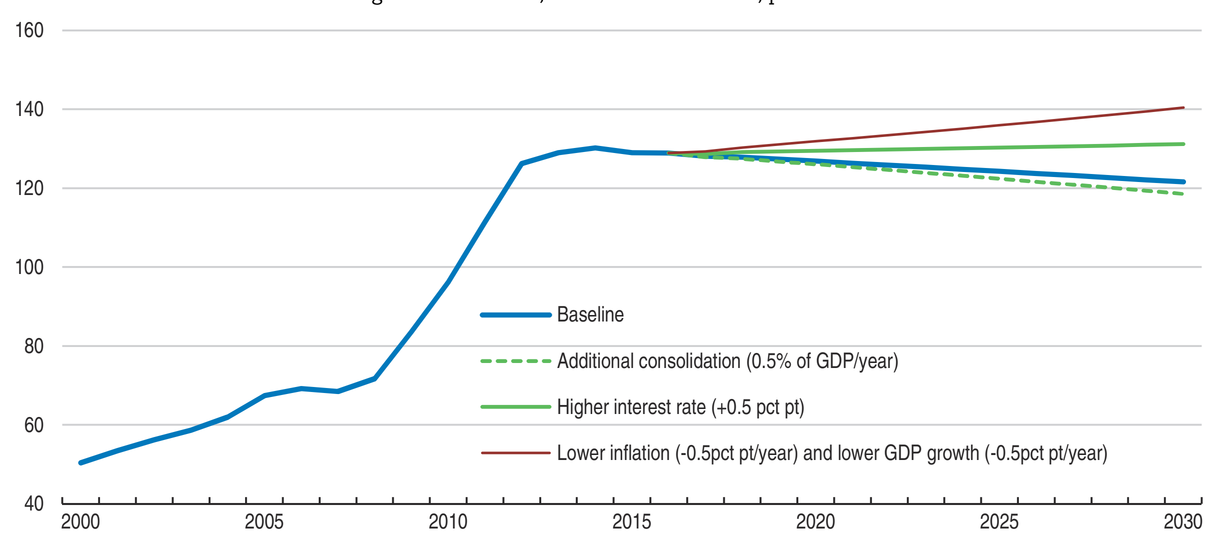
Figure 9. **Illustrative public debt paths**

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



1. The baseline consists of the projections for the *OECD Economic Outlook* No. 99 until 2017. From there on, baseline assumptions are real GDP growth of 1.2% per annum, a primary surplus of 1.6% in 2018 and 2019 and 1.5% thereafter, and an effective interest rate of 3.6%. These assumptions are in line with those in the Spring 2016 edition of the IMF World Economic Outlook.

Source: Calculations based on OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database).

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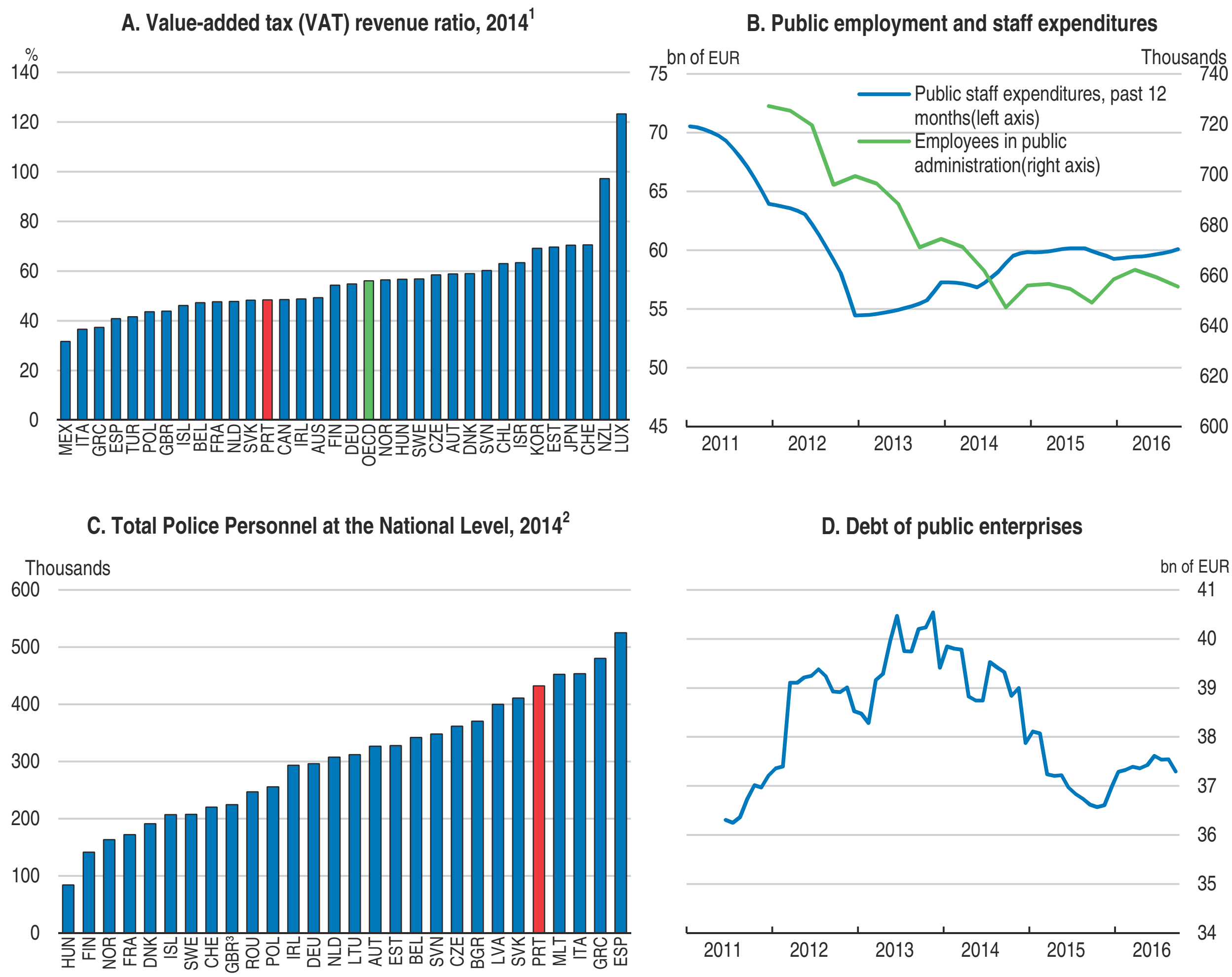
Additional risks to the trajectory of public debt include further distress in the banking sector, which could have significant one-off fiscal costs with permanent effects on debt. Conversely, a lower public deficit could put public debt on a more robust downward trajectory. One scenario in Figure 9 considers raising the primary surplus by an additional half a percentage point of GDP, taking into account its impact on growth.

Both the revenue and expenditure side of public accounts present opportunities for strengthening the efficiency of the public sector and improve fiscal outcomes. On the revenue side, consumption taxes make wide use of exemptions and reduced rates. Portugal's VAT revenue ratio, which can be seen as a measure of the efficiency of the VAT, is significantly below the OECD average (Figure 10, Panel A). Recommendations in the *2014 OECD Economic Survey* of Portugal have included enhancing of the efficiency of the tax system (Table 3).

Newly introduced VAT reductions for restaurant meals will further reduce the efficiency of VAT, but are unlikely to generate the expected positive employment effects and should be carefully assessed. France's experience suggests that the employment effects of such measures are very low, particularly compared to the foregone tax revenues (DG Trésor, 2011; Cour des Comptes, 2015). Moreover, the measure is itself regressive as

Figure 10. **Selected issues in public revenues and expenditures**



1. 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. The OECD aggregate is an unweighted average of data shown (excluding Latvia) and data for Canada and Israel cover federal VAT only.
2. Includes personnel in public agencies whose principal functions are the prevention, detection and investigation of crime and the apprehension of alleged offenders, excluding support staff like secretaries and clerks.
3. England and Wales only.

Source: Calculations based on OECD (2016), *OECD Tax Database*, *OECD Revenue Statistics* and *OECD National Accounts Statistics* (databases); Bank of Portugal; DGAEP – SIOE; United Nations Office on Drugs and Crime.

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Table 3. **Past OECD recommendations on fiscal policy**

Recommendations in 2014 Economic Survey	Actions taken since 2014
Achieve planned structural fiscal consolidation targets but allow the automatic stabilisers to operate.	Despite some slippage with respect to targets, Portugal has made strong progress in reducing public deficits since 2010.
Continue to improve public sector efficiency by further reducing the number of civil servants.	The decline in public employment has been reversed.
Enhance the efficiency of the tax system including by eliminating tax exemptions and expenditures.	Consumption taxes continue to make wide use of exemptions and reduced rates, including the recently introduced reduced VAT rate applied to restaurant meals.

wealthy households tend to consume disproportionately more restaurant meals than others. Specific consumption taxes on fuels, vehicles and tobacco have been raised in tandem with lower personal income taxes, but fuel excise taxes continue to be lower for diesel fuel than for petrol, despite the absence of an environmental justification for this (Harding, 2014). Tax expenditures related to lower fuel tax rates in agriculture and fishing should be reconsidered.

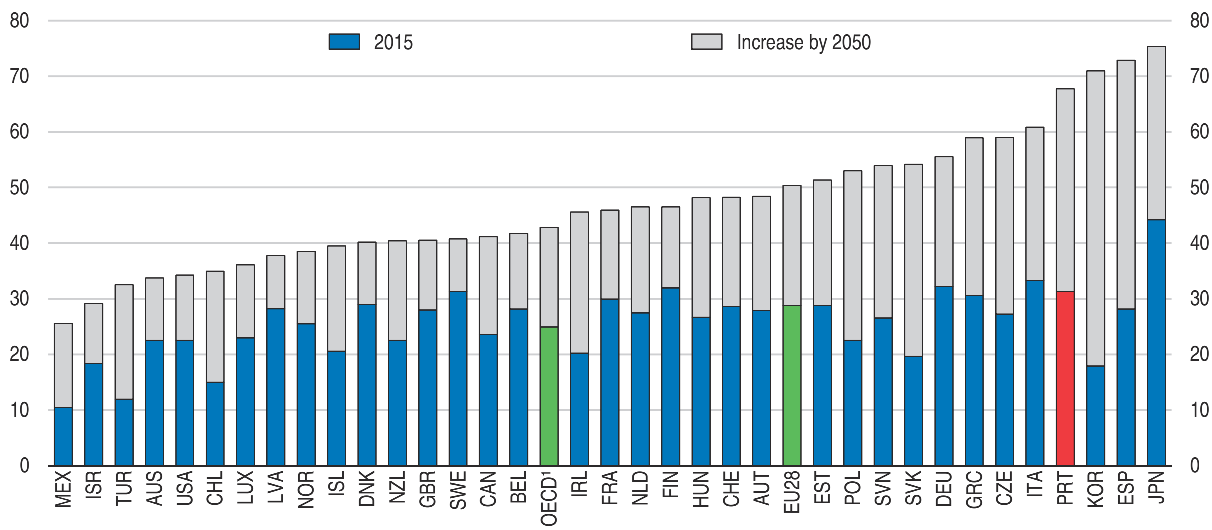
Public staff expenditures are rising again (Figure 10, Panel B). While it was expected that previous public sector wage cuts could not be made permanent (OECD, 2014a), a 35 hour work week has been reinstated for most civil servants and the decline in public employment, a continuation of which had been recommended in the *2014 OECD Economic Survey of Portugal*, has been reversed (Table 3). Public employment increased by 0.8% in the year up to mid-2016 (Figure 10, Panel B). Close monitoring will be needed to check if the commitment of one new hire for every two retirements will be adhered to. At present, staff shortages in some areas co-exist with evidence of over-employment in others, such as security forces and education. As one example, with 432 police staff for 100 000 inhabitants, Portugal's police is 36% better-staffed than police in the average EU country (Figure 10, Panel C). In education, declining student numbers have not been fully reflected in adjustments of the number of teaching staff. A mandated across-the-board nominal freeze in public intermediate consumption entails significant implementation risks and may not lead to sustainable spending restraint, as intermediate consumption could in principle be reduced by hiring staff to perform previously outsourced tasks. An expenditure review on health, education, public procurement and procurement in SOEs is ongoing. The results of this review should be implemented to ensure long-lasting efficiency gains. Measures to enhance the efficiency of social expenditures, including more means-testing of social assistance programmes and more frequent checks on recipients of sickness benefits, are welcome, but there is significant uncertainty to what extent the planned improvements will be achieved, especially in the short term.

Contingent liabilities are also a concern for the sustainability of public finances. The debt of state-owned enterprises has risen recently (Figure 10, Panel D). These enterprises continue to make losses, even if the overall losses have decreased markedly in recent years and some have started to achieve positive operational results. Operating losses have exceeded the budget forecast in 2015, largely due to state-owned hospitals. Higher losses could end up deteriorating public finances. Public-private partnerships (PPPs) are another source of contingent liabilities. Successful renegotiations of PPPs for motorways will result in savings of 13% relative to the original liabilities over the project lifetime and renegotiations for another seven road PPPs are close to being completed by another taskforce at the Ministry of Finance (UTAP). Given the success of UTAP, the government should consider expanding its remit to local PPPs and the water, sewage and waste sectors.

Aging costs are expected to rise substantially, but will remain manageable. Due to demographic developments, the old-age dependency ratio is rising significantly (Figure 11) and public pension expenditures are projected to increase from currently 13.8% of GDP to 15% in 2033, before falling to 13.1% of GDP in 2060 (European Commission, 2015). However, recent policy changes may have pushed ageing costs above these projections, which did not take into account the end of a freeze on early retirements (at the age of 60 with 40 years of contributions) or the recent plans to allow more generous early retirements terms. The relatively manageable ageing costs relative to other European countries have come at the cost of shifting much of the burden of adjustment onto future generations. With current policy plans, the gross replacement rate (pension benefits relative to working age wages) of those who will retire in 2060 will be only slightly more than half of those who retired in 2013. "Grandfathering clauses" have exempted current retirees from pension cuts and the Constitution imposes strong limits on the sort of modifications to key parameters of the system that would be required to improve intergenerational burden sharing.

Figure 11. **The dependency ratio will rise**

Population aged 65 years-old and over as a percentage of population aged 15-64



1. Including Latvia.

Source: OECD (2016), "Labour Force Statistics: Population projections", *OECD Employment and Labour Market Statistics* (database).

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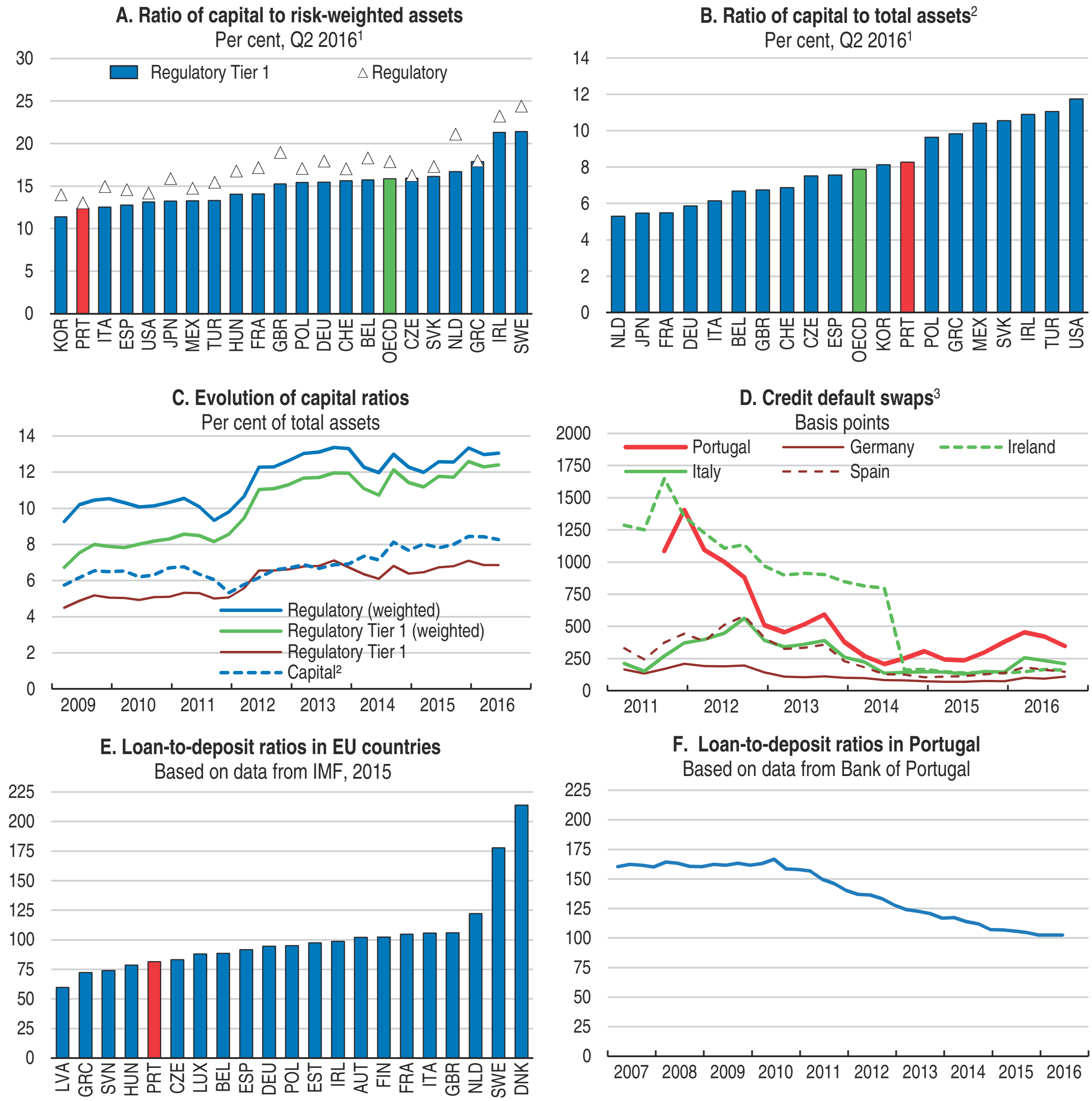
Safeguarding financial stability

Bank capitalisation has improved in unweighted and risk-weighted terms (Figure 12, Panels A-C, Table 4). More broadly, developments on the liability side of bank balance sheets reflect a return to a more traditional model of financial intermediation. Funding from deposits has increased, while funding from interbank or money markets, which was a vulnerability prior to the crisis has decreased substantially and is no longer significant. While ECB funding has supported banks, its continued availability is subject to risks as banks use mostly domestic government bonds as collateral for such funding. Only government debt instruments rated at investment grade are accepted as collateral by the ECB and currently only one of four relevant rating agencies has maintained Portugal's sovereign rating at investment grade.

Figure 12. **Banking sector indicators**



1. Or latest quarter of data available (Q4 2014 for Korea). The OECD aggregate includes Latvia and is an unweighted average of latest data for 32 countries in Panel A and 28 countries in Panel B.
2. Ratio of total capital and reserves (as reported in the sectoral balance sheet) to total assets.
3. Five-year senior debt, mid-rate spreads between the entity and the relevant benchmark curve; end of quarter data. For Portugal the series shown is an average of two banks – Banco Comercial Português and Banco BPI; for other countries the number of banks used in the calculation depend on data available.

Source: International Monetary Fund, Thomson Reuters, Banco de Portugal and European Central Bank.

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Table 4. **Past OECD recommendations on financial markets**

Recommendations in 2014 Economic Survey	Actions taken since 2014
Ensure a timely and consistent recognition of losses by enforcing precedent guidelines and continue to encourage banks to raise capital, when needed, by issuing equity and retained earnings.	High levels of legacy NPLs continue to be a challenge for banks in Portugal. Bank capitalisation has improved in unweighted terms, but risk-weighted capital ratios have stabilised at levels significantly below the OECD average.
Assess the performance of the recently introduced insolvency procedures and enhance them if necessary.	Recently announced policy plans to improve the flexibility and co-ordination of public sector creditors in insolvency proceedings can improve their functioning but further improvements are recommended in this *Survey*.

Low profitability is a major challenge for banks, and makes it hard for them to rebuild their capital through retained earnings. Banks have become increasingly reliant on deposits as a source of funding (Figure 12, Panels E and F). With 54 bank branches per 100 000 inhabitants, against a euro area average of 28, Portuguese banks also have further scope for reducing operating expenses. Market valuations of Portuguese banks have fallen by over 80% over the past 5 years, significantly more than in other euro area countries. Markets also continue to view Portuguese banks as more risky than their European peers, as evidenced by higher CDS spreads (Figure 12, Panel D).

A significant corporate debt overhang and low capitalisation of non-financial companies are reflected in weak legacy assets on bank balance sheets. Unlike in Spain, Portugal's external assistance programme did not include a major clean-up of bank balance sheets through the creation of a "bad bank" because fiscal space was deemed insufficient for this. Nonetheless, there have been repeated instances of state support for banks (Box 2). At the end of 2015, 11.9% of overall loans were non-performing according to IMF data, which is among the highest in Europe, both relative to gross loan volumes and bank capital (Figure 13, Panel A). Some banks are more affected than others, with one major bank having almost 23% of NPLs while two major banks have less than 5%. Among corporate loans, 19.7% are non-performing, a large part of which for more than 3 years. NPLs amount to over 30% of banks' capital after accounting for provisions, which implies potentially significant recapitalisation needs in case the value of collateral turns out smaller than expected (Figure 13, Panel B). Solving NPLs rapidly is a key issue for Portugal and requires a comprehensive approach.

Stronger regulatory incentives could induce banks to resolve long-standing non-performing loans. Differentiated capital requirements could reward banks that implement a credible and sufficiently ambitious plan for restructuring non-performing loans (NPLs), which could make it easier for them to raise new capital. This could also include penalties for banks that do not submit such a plan or do not comply with the plan approved by the supervisor. In addition, risk weights for NPLs could differentiate between new NPLs and those that have been kept on balance sheets for longer than a certain threshold, thus creating stronger incentives to write-off or sell long-standing NPLs (OECD, 2016b). More stringent implementing regulation on write-off modalities, the accrual of interest income for NPLs and the rules for the valuation of remaining collateral could also be considered. Some of these approaches have been successfully used in other countries. For example, Spain imposed a progressive reduction of the value of loan collateral after two years. Banks' efforts to reduce NPL stocks could be facilitated by a more favourable tax treatment of loan loss provisions, which currently cannot be held against taxable profits until a loan is actually written off.

Box 2. **Previous state support for banks in Portugal**

Public funds amounting to EUR 11.8 billion have been injected in the Portuguese banking system between 2008 and 2014, according to Portugal's audit court, equivalent of 6.6% of GDP in 2015.

Government support for bank recapitalisation largely took the form of contingent convertible debt instruments, which were remunerated at around 8.5% per annum. Being significantly above average lending rates, this presented challenges for the already weak profitability of Portuguese banks.

State support funds were reinforced under the 2011-14 Economic Adjustment Programme for Portugal, which included a EUR 12 billion Bank Solvency Support Facility (BSSF). EUR 7.25 billion of this facility have been called upon for the recapitalisation of four banks. In contrast to Ireland and Spain, Portugal's EUR 78 billion Economic Adjustment Programme was not specifically focused on the financial sector although EUR 12 billion were allocated for the sector. That amount was not entirely used.

In 2008, the nationalisation of Banco Português de Negócios (BPN) was the first state rescue in the Portuguese banking system. In 2011, BPN was sold to another private bank.

In 2008, Banco Privado Português (BPP), a small bank with less than 1% of the assets of the Portuguese banking system, received a EUR 450 million state guarantee. Following fraud allegations, the Bank of Portugal ordered the liquidation of BPP and withdrew its banking licence in April 2010.

In 2014, Banco Espírito Santo (BES), at the time Portugal's second private banking group, employing almost 10 000 people, was subject to a resolution measure. Most assets and liabilities were transferred to the newly created bridge bank Novo Banco, which received a EUR 4.9 billion capital injection from the Portuguese Resolution Fund, which in turn received a EUR 3.9 billion loan from the state. Privatisation plans exist for Novo Banco. The budget impact of the BES rescue in 2014 was 2.8% of GDP.

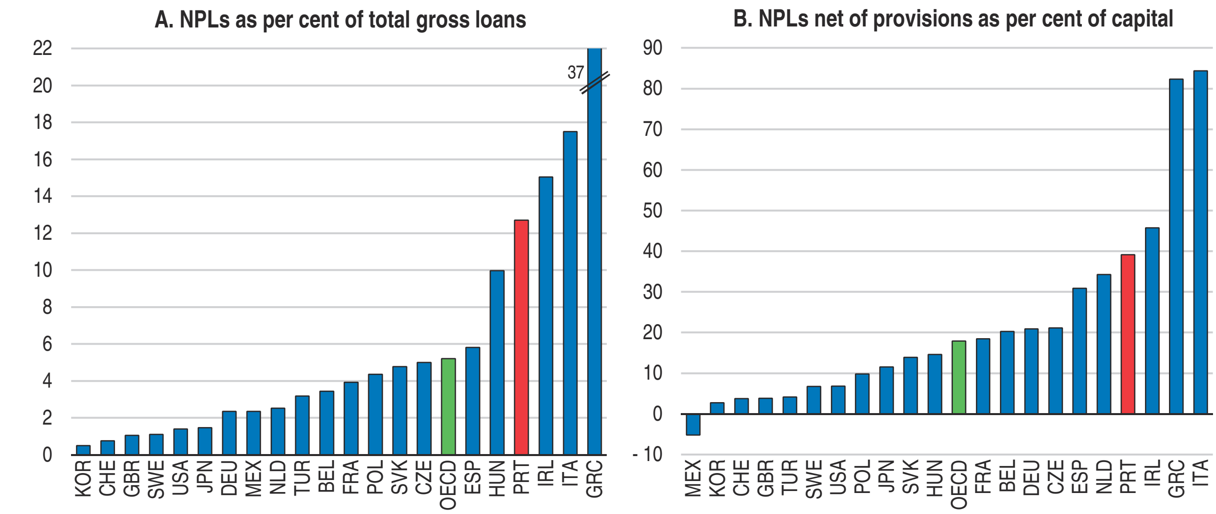
In January 2013, the Portuguese State injected EUR 1.1 billion into Banco Internacional do Funchal (BANIF), Portugal's seventh largest banking group with total assets of EUR 12.8 billion in June 2015. This support did not solve BANIF's financial difficulties and in 2015, the government decided to sell BANIF to a private bank for EUR 150 million in the framework of a resolution tool. The sale involved public support of EUR 2.26 billion to cover future contingencies, of which EUR 1.76 billion came from the state budget and EUR 489 million from the country's bank resolution fund. BANIF's public support added 1.4% GDP to the budget deficit in 2015.

Strengthening investment financing

Credit to the corporate sector is still contracting, mainly due to the construction sector. Loans to exporting firms are growing. Borrowing costs are still higher than in Spain or Italy, but this spread has returned to pre-crisis levels (Figure 14, Panels A and B). The debt of non-financial companies amounts to 145% of GDP on a non-consolidated basis (Figure 14, Panel C), placing Portuguese enterprises among the most heavily indebted ones in Europe. Since a peak of 168% in 2013, corporate indebtedness has come down by 14.4 percentage points according to OECD data, to a large extent as a result of the exit of highly indebted firms rather than deleveraging of existing firms (Bank of Portugal, 2015). Over 50% of the outstanding corporate loan stock is owed by firms that are considered as inactive (European Commission, 2016b). Around 16% of corporate loans are overdue (Figure 14, Panel D).

Figure 13. **Non-performing loans (NPLs)**

Per cent, Q2 2016[1]



1. Latest data available at end of period: Q1 for Japan, the United Kingdom and Turkey, Q4 2015 for Switzerland; 2014 for Germany and Korea. The OECD aggregate is an unweighted average of the latest data available for OECD countries including Latvia.

Source: IMF (2016), *Financial Soundness Indicators* (FSI Database), International Monetary Fund.

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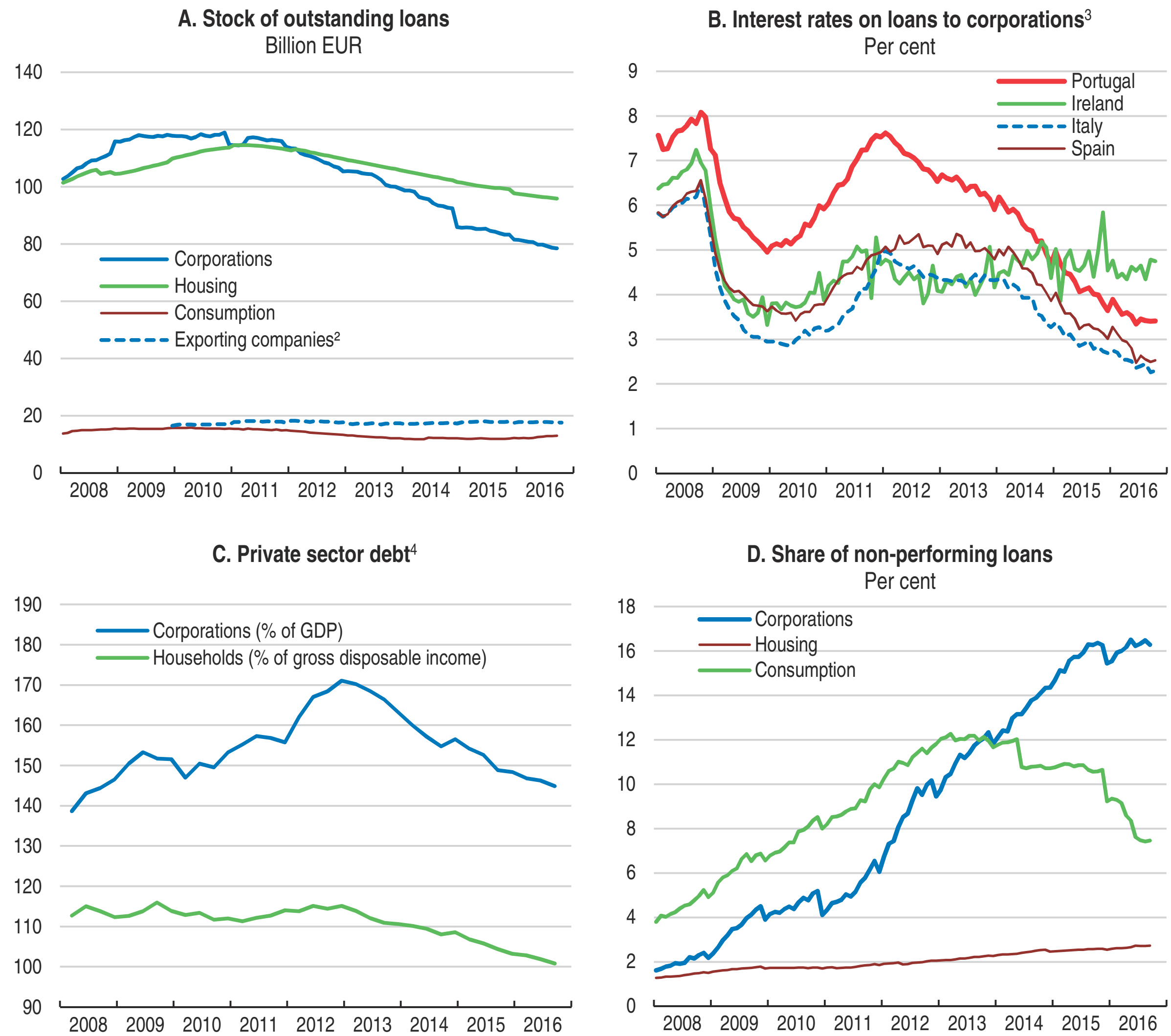
The corporate debt overhang limits the amount of financial resources available to finance investment by locking up funds in firms that have little capacity to invest, some of which may not be viable in the long term with their current debt burden. In 2014, the last year for which firm accounts are available, 30% of Portuguese firms spent 100% of their cash flow on servicing their financial obligations, and 21% had debt exceeding 100% of their annual gross value added. Although credit demand may also be subdued, delaying the exit of non-viable "zombie" firms can absorb financial resources that could be used more productively to finance new businesses and the growth of viable firms (Adalet McGowan et al., 2017; Andrews and Cingano, 2014).

In tandem with changes to supervision, the authorities should play an active role in developing distressed debt markets to assist banks in cleaning up their balance sheets. Specialised asset management companies (AMCs) for distressed assets can provide a liquid market for NPLs and are often better at managing impaired loans than banks due to their experience, scale economies and better technologies. Securitising distressed loans collected by an AMC allows creating assets that can be attractive for a wider range of investors, particularly if there is one single, transparent and standardised securitisation mechanism for SME loans. This in turn can narrow the remaining pricing gap between what investors are willing to pay and what banks expect to recover. Public support could take the form of providing guarantees for senior tranches of distressed debt securities and given the externalities of large NPL stocks on investment and growth, there is a case for the public sector to assist in bridging this pricing gap, although this has to be carefully balanced against the limited fiscal space available for such public intervention.

However, the alternative solution of betting on time to solve the issue is also a risky strategy, not only because it compromises the health of bank balance sheets, but also because investment and growth could be held hostage for years to come. The use of public funds has recently been limited by new EU rules on state aid. The authorities should seek

Figure 14. **Financial indicators**[1]



1. All corporations are non-financial (NFC) and loans are from monetary and financial institutions.
2. Privately owned and either export more than 50% of the turnover or export more than 10% of the turnover and the total amount exceeds EUR 150 000.
3. Loans up to and including EUR 1 million. Operations with an initial rate fixation period of less than one year for new business.
4. The non-financial sector debt presented includes loans, debt securities and trade credits. Households include non-profit institutions serving households.

Source: Banco de Portugal (2016), *BPstat Database*; and ECB (2016), *Statistical Data Warehouse*, European Central Bank.

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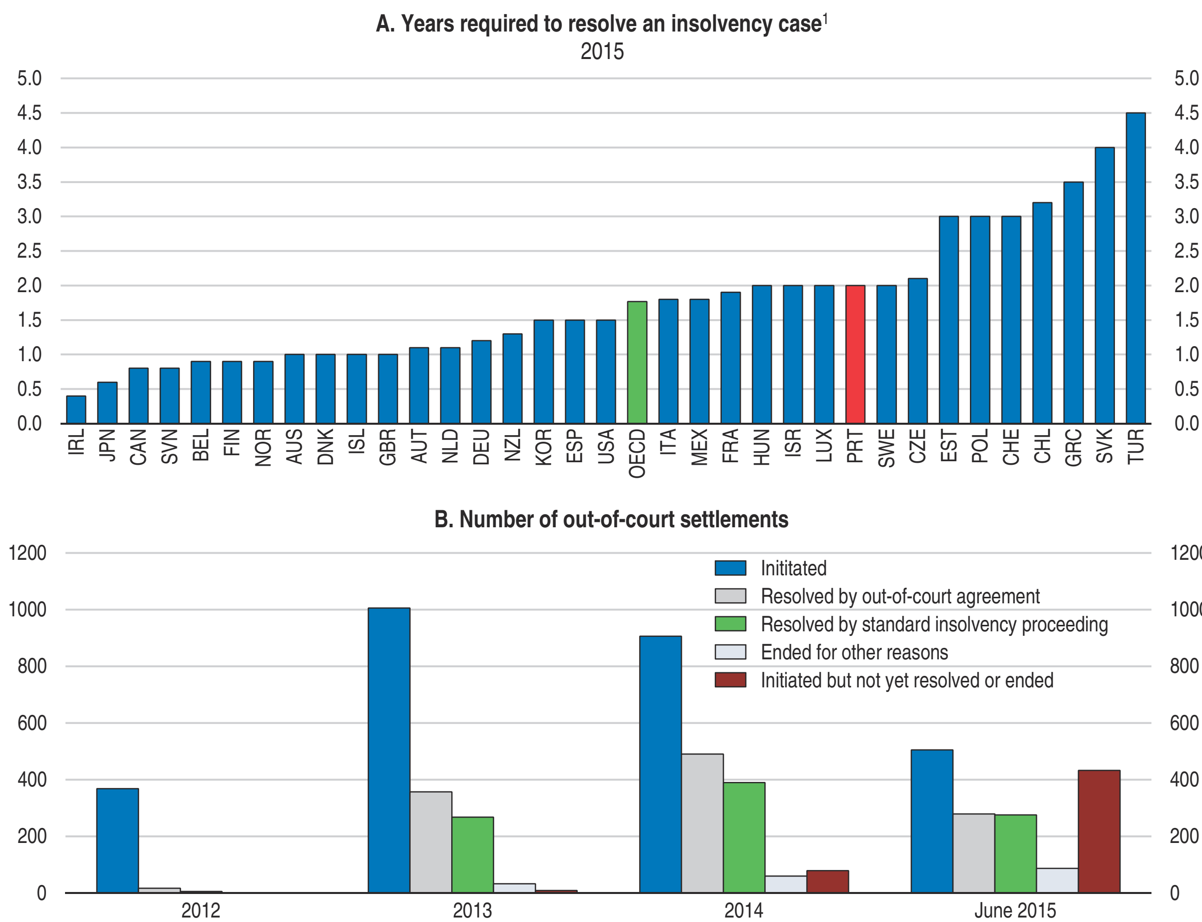
clarifications with the European Commission on the possible scope of intervention. In principle, exceptional clauses like the need to correct a market failure or a serious economic disturbance could be invoked, in light of the systemic dimension of the NPL problem in Portugal (*OECD Economic Surveys: Euro Area 2016*, OECD, 2016b).

A comprehensive strategy to reduce corporate leverage and improve access to investment financing should go beyond the narrow realm of the banking sector. Well-working insolvency frameworks are crucial for restructuring viable companies and to allow a speedy recovery of non-viable companies' assets before they lose value. This would raise recovery rates and lower the cost of removing NPLs from bank balance sheets.

Insolvency procedures have improved since 2012 (Table 4). Despite these improvements, in-court insolvencies still take an average of 2 years, which is average performance in the EU and unchanged from a decade ago, while good practice from Ireland, Japan, Belgium or the United Kingdom suggests insolvency cases can be processed in less than a year (Figure 15, Panel A). Speedy insolvency procedures translate into better recovery values of distressed loans higher prices for NPL-backed securities, so accelerating insolvency procedures would have significant benefits for Portugal. Widening the scope for decisions to be taken by a simple majority of creditors can promote a timely restructuring of viable firms. In Spain, the introduction of simple-majority decisions were part of an insolvency reform that shortened insolvency procedures and lowered the share of firms in liquidation (Adalet McGowan and Andrews, 2016). Eliminating the veto right of tax and social security authorities could also help, as Brazil's experience shows that reducing such public creditor privileges can speed up insolvency procedures and improve recovery rates (Araújo et al., 2012; Arnold and Flach, 2017). Current plans in the context of the Capitalizar programme include improving the co-ordination between different public sector creditors.

Figure 15. **Insolvency framework**



1. Time from the company's default until the payment of some or all of the money owed to the bank taking into consideration eventual delay tactics. The OECD aggregate is an unweighted average including Latvia.

Source: World Bank (2016), *Doing Business 2016: Measuring Regulatory Quality and Efficiency* (database); and APAJ (2015), "Processo Especial de Revitalização", *Turn Analysis*, No. 7, 2nd quarter, Associação Portuguesa dos Administradores Judiciais.

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Moreover, investing more resources into court capacity could also help to shorten insolvency cases. Even more judges could be transferred to commercial courts, which appear to be the most overburdened part of the court system. Offering more specialised training to judges may lead to faster procedures and better recovery rates, as suggested by international evidence (OECD, 2013, World Bank, 2004). Evidence from a Brazilian bankruptcy reform suggests that firms operating in districts with less congested courts experienced higher access to loans and larger increase in investment than firms operating in districts with more congested courts (Ponticelli and Alencar, 2016).

Following reforms in 2012, large parts of the legal insolvency rules now compare well to other countries on paper (World Bank, 2014), but differences between the rules and their actual implementation exist. One pillar of the insolvency reforms was the introduction of out-of-court settlements in 2012. However, these have been less successful than anticipated. The approval rate for out-of-court settlements is only 50% and they regularly take significantly longer than the 4 months allowed for out-of-court negotiations under US law, for example (Figure 15, Panel B). Evidence on the average length of out-of-court settlements in inconclusive. Official statistics put their average duration at close to 5 months, while private analysts put the average duration at 7 months (APAJ, 2015). Granting a stay on assets and allowing time for restructuring is a key feature of out-of-court settlements, but excessively long stays risk creating scope for abuse.

De facto veto rights for tax and social security authorities frequently lead to failures of these procedures as public sector creditors are unable to take cuts on their claims or even define their position in time (APAJ, 2015). Recently announced policy plans to improve the flexibility and co-ordination of public sector creditors in insolvency proceedings go in the right direction but should be implemented earlier than the third quarter of 2017 as currently envisaged. Access to information for creditors and insolvency administrators is crucial for evaluating the economic potential of a distressed firm or the value of its assets, but on-site inspections by insolvency administrators are currently not possible. Evidence that owners/managers have used the procedure for the mere purpose of buying time and/or removing tangible assets from the firm suggests the need for better gatekeeping, including through a generalised embargo period during which the same firm cannot apply for another proceeding. Unlike in standard insolvency procedures, out-of-court settlements can be approved by a simple majority of creditors.

The differential corporate tax treatment of debt and equity has also incentivised businesses to accumulate excessive amounts of debt in the corporate sector. Until very recently, interest expenses could be deducted from taxable corporate income, while the return on equity could not. Tax neutrality even matters for the majority of Portuguese firms that are very small and for which stock market financing is an unlikely option, as it is widespread practice for owners/managers to extend loans to their own companies rather than to provide equity.

As of 2017, deductible interest expenses will be limited to 30% of cash flow income (tax EBITDA) or EUR 1 million, whichever is higher, in line with Action 4 of the BEPS Action Plan. In addition, Portugal has established a tax allowance for corporate equity (ACE) like in Italy, Belgium and Brazil. In order to stimulate new investment, the ACE applies only to new equity investment and avoids generating windfall gains for investment undertaken before its introduction. Restricting an ACE to subsets of companies and investors, by contrast, has rendered Portugal's earlier experiments with an ACE ineffective and these restrictions have now been lifted. The new ACE seems well-designed, but its performance should be monitored and evaluated to see if further refinements are needed.

The removal of tax distortions will have a stronger impact when combined with a strategy to lead more medium-sized firms into stock market listings, as an alternative to debt financing. High listing fees on Portugal's only stock exchange are currently a major deterrent for medium-sized firms. Regulating the monopoly stock exchange operator's fee schedules for the listing of mid-cap companies could be justified by the same economic rationale applied in universal service obligations in telecommunications, where public intervention has for years reduced the cost of network access for clients for whom these would have otherwise been prohibitively high. Providing financial advice to mid-caps, as done under Italy's ELITE programme, would also be useful. Portugal has no independent investment banking company that could advise firms in going public or in attracting equity investment, or that could support them in the process, as required by the EU Prospectus Directive, and commercial banks have only weak incentives to assist companies in finding alternatives to the financing they provide.

Recent government initiatives have aimed to open up additional channels of finance for start-up companies in the context of the new Capitalizar programme, including business angels, venture capital, commercial paper and mechanisms to securitise SME loans. Entities with public participation, including a venture capital firm and business angel-type financing, are meant to co-finance start-ups in an early stage with a particular focus on innovative, scientific and technology-based companies, as well as on export-oriented companies. Broadening financing options for start-ups with innovative projects is a welcome initiative, as young firms currently account for only 3% of business investment, but it will be important to monitor and evaluate the progress of these initiatives to ensure their cost-effectiveness. A key challenge for public participation in venture capital activities will be to find instruments that increase the quantity of venture capital without diminishing its quality. Funds that operate like independent, limited partnership venture capital funds and where the selection and mentoring of investment projects is done by private partners have been successful in the United States (Lerner, 1999) and Australia (Cumming, 2007). Passive public participation in such funds could even raise the returns for private investors by capping its own returns while leaving its entire investment at risk.

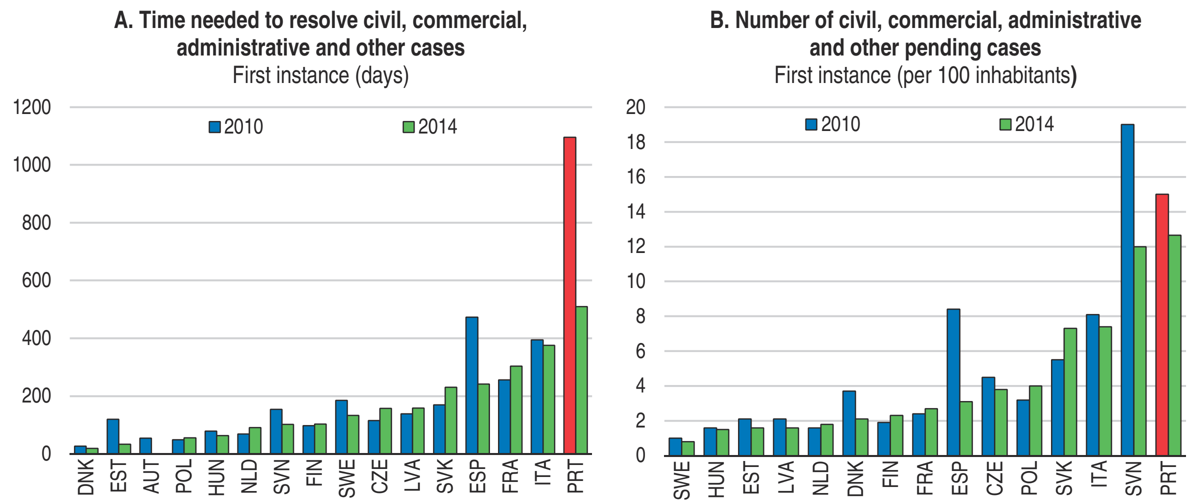
Improving the business climate to boost investment

Beyond measures that enhance access to financing, investment would also be strengthened by reforms that improve the business climate, hence reducing firms' costs and raising expected returns on investment. Portugal has undertaken an impressive array of structural reforms in this regard, but some of these have not been fully implemented.

Judicial system

A recent survey of 5 000 Portuguese companies identified difficulties with the judicial system as a major factor driving up costs, which became increasingly challenging over the last 3 years (INE, 2015). Significant court backlogs of 1.35 million cases persist despite progress made, particularly in first instance courts which deal with contract enforcement. Despite remarkable progress made, civil cases still take more than 500 days to be resolved, which is long by international comparison (Figure 16).

Figure 16. **Performance of the judicial system**[1]



1. Comparisons should be drawn with care as some countries reported changes in the methodology for data collection or categorisation.
Source: European Commission (2016a), *The 2016 EU Justice Scoreboard* and Direcção-Geral da Política de Justiça.

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A new civil procedure code has been able to address some of these shortcomings by giving greater process independence to judges, reducing the number of appeals and allowing for mediation and out-of-court settlements at different stages of a civil process. Even though Portugal ranks fairly well with respect to its legal framework, the implementation of some judicial reforms seems to be lagging (World Bank, 2015). International evidence suggests that the use of specialised courts can reduce trial lengths (Palumbo et al., 2013), but the benefits of specialisation are particularly strong if these courts are staffed with specialised judges. Portugal has specialised courts without specialised judges. In particular, it appears that there is scope to reduce trial lengths by increasing the number of commercial courts and staffing them with specialised judges. Recent efforts for training judges should be continued.

Regulation and red tape

Portugal has made strong progress in reducing administrative burdens for businesses. Less "red tape" reduces costs and raises the returns on investment. Recent measures plan to build on these improvements, including a new programme to simplify administrative procedures called Simplex+2016 and a single environmental licence that consolidates 11 current procedures. This useful programme includes an expansion of one-stop-shops, electronic applications and a wider application of silence-is-consent rules. At the local level, the pace of progress in easing procedures is heterogeneous, with some municipalities offering single windows and speedy service in almost all areas, while others are struggling to keep pace. Requiring all authorities involved in licenses or permits to publish their effective decision-making time would improve transparency in this area. A study of municipal best practices is currently underway, and the results should be used to encourage and assist less advanced municipalities to catch up. Going forward, new laws can only be approved once the corresponding implementing regulation is drafted. Economic impact evaluations of new regulations have also become the norm and firms may net out simultaneous claims and liabilities with tax and social security authorities in the future. A decade ago, procedures, costs and delays for opening a business were 4, 6 and 19 times higher than now, respectively (World Bank, 2005 and 2015).

Despite these promising initiatives and plans, the implementation of administrative reforms seems to lag behind ambitions and needs to gain track. Despite the introduction of "Silence is consent" rules in some areas, more than half of firms who had to deal with licenses for starting a business considered this process a high or very high obstacle and failed to see any improvement in the process (INE, 2015; Gershenson et al., 2016). Large and industrial firms appear to struggle the most with tedious licensing requirements. Despite single windows to receive applications, behind-the-scenes consultations between different authorities can be lengthy. Overlapping competencies and a patchwork of rules defined across different laws and precedence rulings by courts create ambiguities and contradictions, leaving room for discretionary decisions, including by local authorities. A concerted effort to clean up and consolidate the fragmented set of rules would reduce complexity and the scope for corruption. Regarding license requirements, these efforts should be focused on integrating all licenses and permits needed to start a business into one single procedure, but co-operation among all public entities involved is crucial for that.

Policies governing land use can also constitute an obstacle to investment as they give strong discretionary powers to municipal governments which can block licenses for investment projects. The efficiency of municipal governments and the delays involved in obtaining licenses varies widely across municipalities. While considerations of protecting the landscape or quality of life of citizens may be legitimate objectives, they can also be abused to deny or condition the start of an economic activity. Reforms of the discretionary powers of municipal authorities had been envisaged under the external assistance programme, but were never implemented. The net benefit of investment projects for local development should be analysed on the basis of transparent and objective criteria, limiting the discretion of local authorities, which will also help to prevent corruption. In other cases, land use conversions have been granted too easily and owners of farmland have regularly lodged requests for conversion with the sole purpose of increasing the resale value of their property. This has favoured new construction projects in non-urban areas over the use of existing dwellings, leading to excessive urban sprawl which then required additional infrastructure investment, while large urban areas were often poorly maintained. The authorities should limit discretionary powers of municipalities to speed up licencing procedures further.

Product market regulation in services and utility sectors

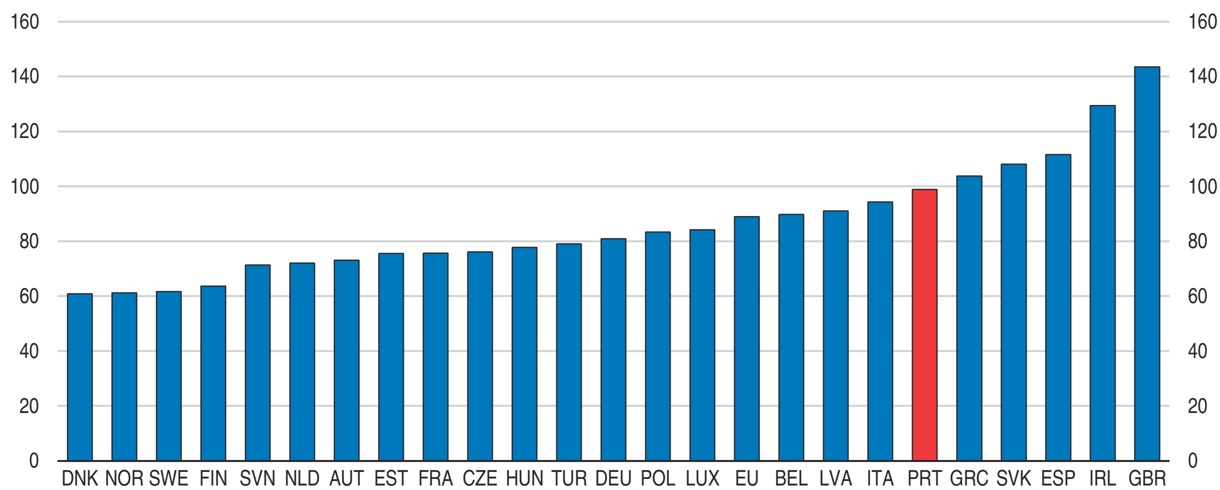
Services and utility sectors provide essential inputs for Portuguese companies, accounting for 16% of their direct costs, i.e. without breaking down the factor content of intermediate inputs. Since services inputs often have to be sourced domestically, their prices influence the competitiveness of Portuguese companies. In the past, services sectors have traditionally been characterised by low levels of competition and significant rents resulting from regulatory policies that stood in the way of competition. An ambitious reform agenda has led to improvements, but there is scope for further strengthening competition in many areas. An ongoing OECD competition assessment can help to identify concrete regulatory constraints to competition in services sectors and define further reform priorities.

In the energy sector, a series of reforms has improved regulation and eliminated the scope for remuneration above market prices, but only for new entrants. Policy indicators such as the OECD Product Market Indicators reflect these substantial improvements and Portugal's network sector regulation is the second most competition friendly in the OECD by these indicators. However, these new rules are not necessarily those that govern the bulk of current sales volumes, which is still sold under legacy contracts that were signed when the rules were different. Until legacy contracts expire, the PMR indicators may paint an overly optimistic picture of competition in the energy sector. Despite new entry, the incumbent electricity producer continues to serve 85% of electricity customers and the incumbent gas company serves 50% of gas clients.

Electricity prices for medium-sized companies are among the highest in Europe (Figure 17) and have been on an increasing trend due to legacy contracts. Over a third of Portuguese enterprises consider electricity costs a high or very high obstacle for their operations and 82% have noticed no improvement since 2012 (INE, 2015). Rising prices are also the legacy of poor policy settings in the past, such as a massive tariff debt of over EUR 4 billion that is now being winded down through pricing above average costs. The tariff debt has only started to decline in 2016 and will continue to exert upward pressure on prices for years to come. Stronger action to reduce the scope of application of legacy remuneration schemes, through further renegotiations of legacy contracts and accelerated phase-out schedules for guaranteed price schemes, could lead to more competitive energy prices.

Figure 17. **Electricity prices**

EUR per thousand kilowatt hours, 2015[1]



1. Average national price without taxes applicable for the first semester of each year for medium size industrial consumers (annual consumption between 500 and 2000 megawatt hours [MWh]). For Italy data refer to 2007 instead of 2008 and cover data at 1st January for an annual consumption of 2 000 MWh.

Source: Eurostat (2016), "Electricity prices by type of user", *Tables by Themes*.

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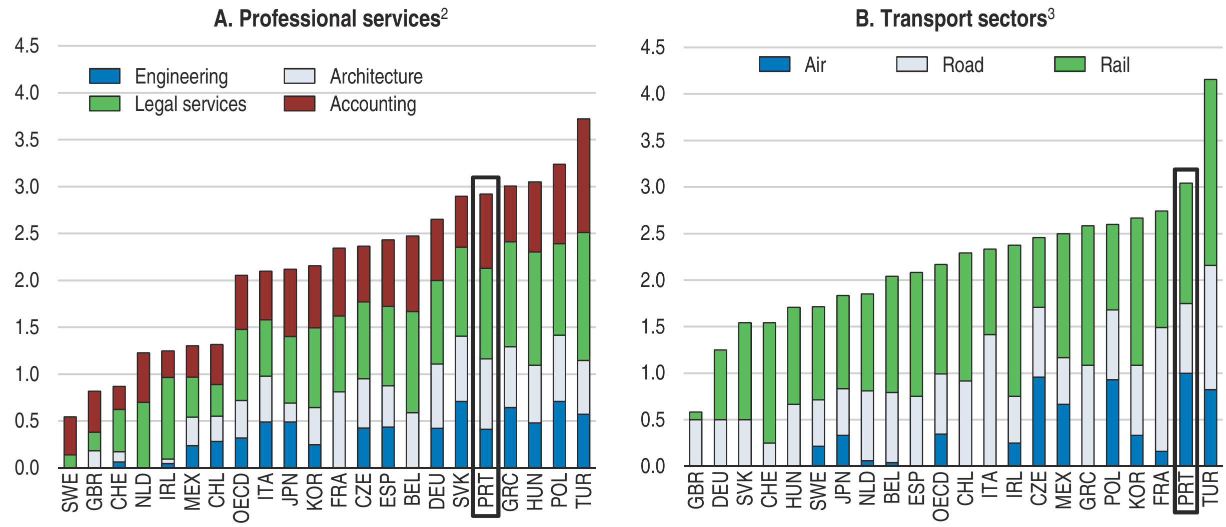
In professional services such as accounting, auditing, legal or architecture services, competition remains weak and regulation is more restrictive than the OECD average, as reflected in the OECD Product Market Regulation (PMR) (Figure 18, Panel A). The OECD Services Trade Restrictiveness Indicator (STRI) points to barriers to competition through international trade in accounting, auditing and legal services. Regulatory provisions that can stifle competition and lead to significant rents include the strong role of professional associations for regulating entry, a setting that typically favours current insiders over potential entrants. Regulation by professional associations should be monitored closely by public authorities to avoid excessive restrictions on entry and safeguard competition. Exclusive rights that reserve certain tasks for members of a particular profession, as well

Figure 18. **Regulation of services sectors**

Index scale of 0-6 from least to most restrictive, 2013[1]



1. Data may no longer fully reflect the current situation in fast reforming countries. The OECD aggregate is an unweighted average of data available (including Latvia).
2. Measures included in the index cover entry restrictions and conduct regulations.
3. Measures included in the index cover entry restrictions, public ownership, vertical integration, market structure and price controls.

Source: OECD (2016), *OECD Product Market Regulation Statistics* (database).

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as regulations of prices and fees or the form of business, further restrict competitive pressures and should be reconsidered. Entry restrictions may be one reason for the substantial misallocations of resources documented in professional services in Portugal (Dias et al., 2015).

A new framework law that reforms regulations in 18 professional services was approved in 2013, and the bylaws of all professional bodies have now been published. Unfortunately, the bylaws are significantly less ambitious than the framework law in terms of opening up these sectors to competition. Service providers still face significant entry barriers and cross-border competition is also reduced by existing regulations. For example, in accounting services, an EU nationality is required to obtain a license to practice and there are restrictions on owning shares in accounting firms, combined with specific nationality and licensing requirements for board members and managers of accounting firms. The investment regime is similarly complex for legal services, although there are no nationality requirements for lawyers.

In the transport sector, competition is weaker than in other OECD countries and anti-competitive regulations are more restrictive (Figure 18, Panel B). However, the sector has been evolving since 2013. The incumbent cargo rail company CP Carga has been privatised successfully, which has been a precondition for competition in cargo rail services. In urban transport, planned sub-concessions in Lisbon have been cancelled and will now be transferred to the municipality while those in Porto have been delayed. In air transportation, the state will retain majority ownership of Portugal's major airline TAP. Further monitoring is needed to understand if these developments can stand in the way of strengthening competition in these sectors. Moreover, frequent policy changes may reduce Portugal's ability to attract foreign direct investment, which is typically associated with productivity benefits (Arnold and Javorcik, 2009; Javorcik, 2004).

In ports, the scope of application of port-specific labour and wage regulations, reminiscent of the days when port labour was physically more demanding than other work, has been narrowed. While these measures have reduced costs for port operators, it has brought only limited benefits to port users. Over 80% of companies that use maritime transport noted no improvement since 2012 (INE, 2015). Renegotiations of port concessions were intended to reduce port user costs by harnessing competition and to strengthen investment incentives, but these renegotiations have recently been suspended. A new framework law for port concessions has yet to be passed. Uncertainty due to policy reversals is holding back urgently needed investments by port concessionaires. Moving forward on the renegotiations of concessions could generate further downstream benefits by enhancing the scope for intra-port competition among terminals and incorporating service level agreements into the concession contracts, which has been omitted in the past.

Foreign direct investment

Foreign direct investment (FDI) inflows account for significant shares of investment in some sectors. During 2012-14, greenfield FDI inflows amounted to around 3.9% of investment. Comparing total FDI inflows to investment, the ratio is about 20%, but this can only be considered an upper bound as these inflows have also financed mere transfers of ownership and not just new investment. Attracting more FDI has significant potential to boost investment. Reforms enacted since the financial crisis have boosted Portugal's attractiveness as a destination for FDI. In the future, a greater emphasis on policy continuity could bolster confidence and reduce uncertainties, which are often an important consideration for foreign investors (see, for example, Ruane and Goerg, 1997, for the Irish case). An earlier bipartisan agreement in favour of a continued decline of the corporate income tax rate was recently dismissed, some privatisation plans have been delayed or modified after they were signed, and there are discussions about restricting access to the so-called individual bank of hours to sectors where it is part of collective agreements. This measure has been an important component of giving more work-time flexibility to firms by allowing a maximum of 150 hours per year to be used in agreement between the employee and the employer. A recent decision to bail in a select number of secured bondholders of the resolved Banco Espírito Santo have also been interpreted as undermining policy certainty.

EU structural funds have become large relative to public investment, which declined from 5% of GDP in 2010 to 2.1% in 2015. At 1.9% of GDP, European funding now amounts to 80% of Portugal's public investment or 12.5% of total investment, although not all of the projects funded by these funds are investments in the sense of national accounts. A new strategy for allocating these funds, called Portugal 2020, has recently been designed and aims to support the structural transformation of the economy towards export sectors. The main spending areas include support for the internationalisation of manufacturing companies, innovation and the strengthening of ties between firms and the scientific community. Portugal's National Reform Programme provides the framework for a more effective use of EU funds (see Box 3).

Labour costs

The outlook for labour costs, which account for 19% of the costs of Portuguese companies, remains challenging. Unit labour costs relative to the euro area have declined by 1.5% between 2012 and 2015, but there has been another 5% increase in the minimum

Box 3. **Portugal's National Reform Programme**

Portugal's National Reforms Programme (NRP) of April 2016 serves as a medium-term development strategy to tackle structural constraints in three main areas: productivity and competitiveness; indebtedness and social cohesion and reducing inequality.

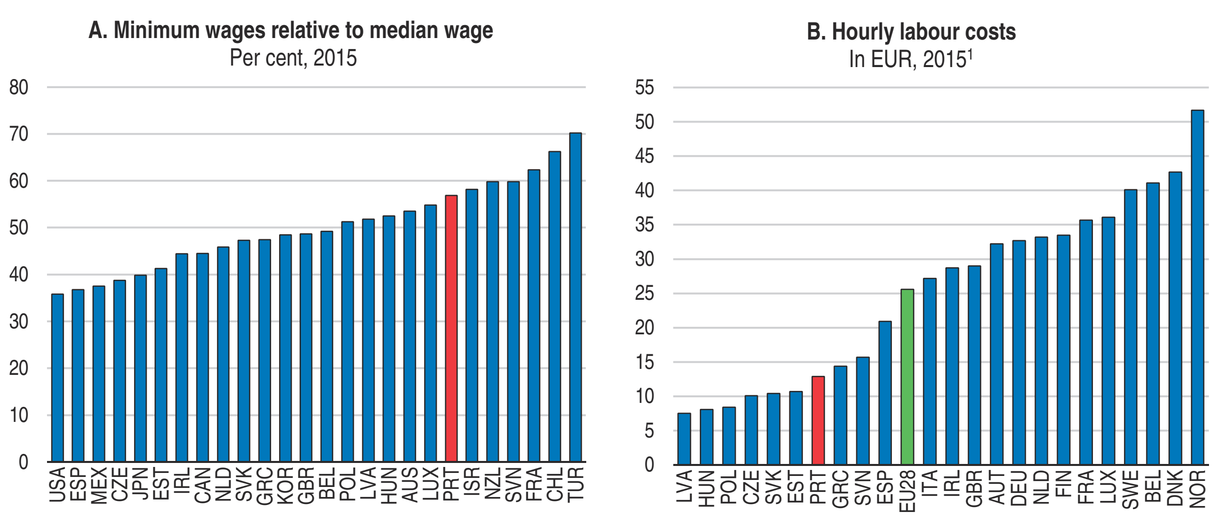
To address these challenges, specific measures have been defined in the areas of qualifications, innovation, territorial enhancement, modernisation of the State, capitalisation of firms and social cohesion and equity. The NRP provides goals and a calendar for the implementation of a total of 140 measures within these areas, with a total budget of EUR 25 billion. The envisaged reforms have been subjected to an ex-ante evaluation in order to predict their long term effects.

Within the NRP, the 'Capitalizar' Programme serves as the umbrella for policies to strengthen and diversify the diversification of the financing sources for companies, in particular young firms. Supporting seed financing through tax reliefs for individual equity investors in start-ups and measures to help SME and mid-caps access the capital market are examples of such policies. Actions in this field are also intended to contribute to tackling the NPL issue by strengthening viable firms. The qualification axis of the NRP contains measures to reduce the number of school dropouts and of NEETs (those not in education, employment or training). In particular, the "Qualifica" Programme focuses on adult education and training, complementing a process of certification with training.

wage in January 2016 and again in January 2017. The minimum wage has become increasingly binding (Bank of Portugal, 2015). The 2016 increase had already brought the minimum wage to or above the salary levels of 20% of employed persons, and it currently exceeds 60% of median wages (Figure 19, Panel A). An increase to 600 EUR, to be decided by social partners as contemplated in the government's programme, would be more than what 30% of Portuguese employees currently earn.

Figure 19. **Minimum wages and labour costs in international comparison**

Total business sector



1. 2014 for Greece.

Source: OECD (2016), "Earnings: Minimum wages relative to median wages", *OECD Employment and Labour Market Statistics* (database); and Eurostat (2016), "Labour costs annual data", *Eurostat Database*.

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Strong wage increases without similar improvements in productivity risk undoing previous improvements in competitiveness and conflict with the objective of strengthening exports, even though they may reduce wage inequality (but not necessarily income inequality). In fact, Portugal's declining export market share during 1996 to 2011 was largely attributable to price factors (Benkovskis, K. and Wörz, J. 2014). Labour costs are now lower than in most of Western Europe, but higher than in most Eastern European countries, some of which compare favourably to Portugal in terms of proximity to major European markets (Figure 19, Panel B).

Additional wage pressures may result from a possible re-emergence of administrative extensions of collective bargaining agreements to firms that were not involved in the bargaining process. As of 2012, the widespread practice of such administrative extensions has come to a halt, in line with an OECD recommendation (Table 5). This was the result of a new requirement that agreements could only be extended if the signatory firms accounted for at least 50% of the industry workforce, which had often not been the case in the past. In 2014, this condition was eased by introducing an alternative sufficient condition that required 30% of signatory firms to be SMEs. Given that 99% of firms in Portugal are SMEs, this new condition will be easy to meet. Extensions have since picked up, although not to the levels of 2011. Between 2014 and 2015, the number of employees covered by collective agreements has doubled (CRL, 2016). Estimates suggest that wage increases resulting from administrative extensions have increased separation rates and reduced hiring rates, suggesting that they can jeopardise the viability of firms' investment projects (Hijzen and Martins, 2016; Bank of Portugal, 2015). More stringent representativeness requirements for administrative extensions and opt-out possibilities for individual firms would promote a better alignment of wage developments to the situation of individual firms. Less use of administrative extensions could also encourage 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 (Chapter 1).

Table 5. **Past OECD recommendations on improving the business climate**

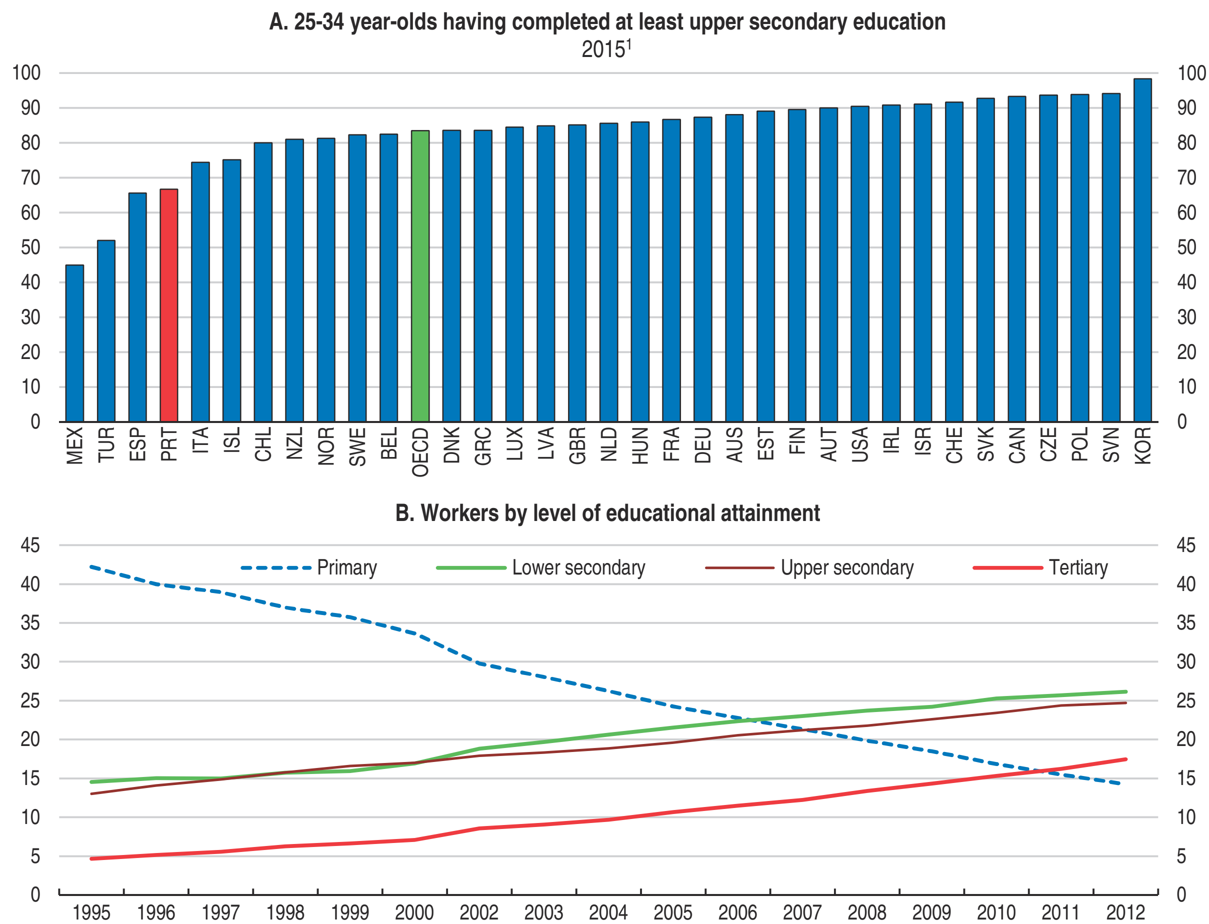
Recommendations in 2014 Economic Survey	Actions taken since 2014
Strengthen competition in non-tradable sectors through further regulatory reform.	No action taken. In key non-tradable sectors, including energy and professional services, evidence of weak competition persists. In the transport sector, plans for urban transport concessions in Lisbon have been cancelled and will now be transferred to the municipality while those in Porto have been delayed. The State will retain the majority of shares in Portugal's major airline TAP.
Phase out electricity generation schemes with guaranteed prices sooner than currently planned.	No action taken since 2014.
Promote wage bargaining at the firm level, including by abolishing administrative extensions of wage agreements.	Conditions for administrative extensions of collective bargaining agreements were eased in 2014, which may lead to a re-emergence of these extensions in the future.
Improve the links between researchers in universities and the private sector. Consider allowing refunds of R&D tax credits for loss-making firms, or extending the carry-forward period.	No action taken since 2014.

Raising skills

In comparison to other European countries, the average skills of Portuguese citizens are low, reflecting decades of poor education performance (OECD, 2006; Guichard and Larre, 2006). Only around 43% of the working age population and 67% of young adults have attained upper secondary education, the fourth lowest rate in the OECD (Figure 20, Panel A). 33% of young adults in Portugal have a tertiary qualification, compared to an OECD average of 42%. Improving these comparatively low education attainments will be critical to improving well-being and incomes (see Figure 4). Better skills will also reduce widening income inequality by providing better earnings opportunities to the low-skilled, which often also have low incomes.

Figure 20. **Raising skill levels remains a priority**

Per cent



1. The OECD aggregate is an unweighted average; Latvia is included and Japan excluded (no data available).

Source: OECD (2016), “Educational attainment and labour-force status”, *OECD Education Statistics* (database); and A. Almeida et al. (2016), “Economic and non-economic returns to higher education in Portugal”, Research Report commissioned by Fundação Francisco Manuel dos Santos and the Universities of Aveiro, Minho/NIPE and Porto/CIPES.

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Improving skills will also lead to stronger economic growth, by alleviating the skill shortages faced by Portuguese companies. More than two thirds of them consider finding employees with appropriate skills an obstacle to their operations (INE, 2015). At the same time, incentives for investing in skills are weak due to high unemployment and poor job quality. A solution to this vicious circle requires simultaneous action with respect to both education opportunities and labour market performance. While it takes time to address this legacy, Portugal should build on its continuous policy efforts, which have resulted in rapid improvements (Figure 20, Panel B).

More adult education for the employed and for the unemployed is one way to address the low qualifications and skills of those who have already left the education system. However, experience shows that it is difficult to reach those who would need it most, as lifelong learning activities have low take-up rates among older and low-skilled workers (OECD, 2015; EWCS, 2015). Still, Portuguese workers receive less on-the-job training than in other countries. One recent government initiative (*Cheque Formação*) is providing financial support to workers, job seekers and firms for adult training. This scheme appears useful in addressing firms' immediate training needs, but given its novelty, its success should be closely monitored and evaluated.

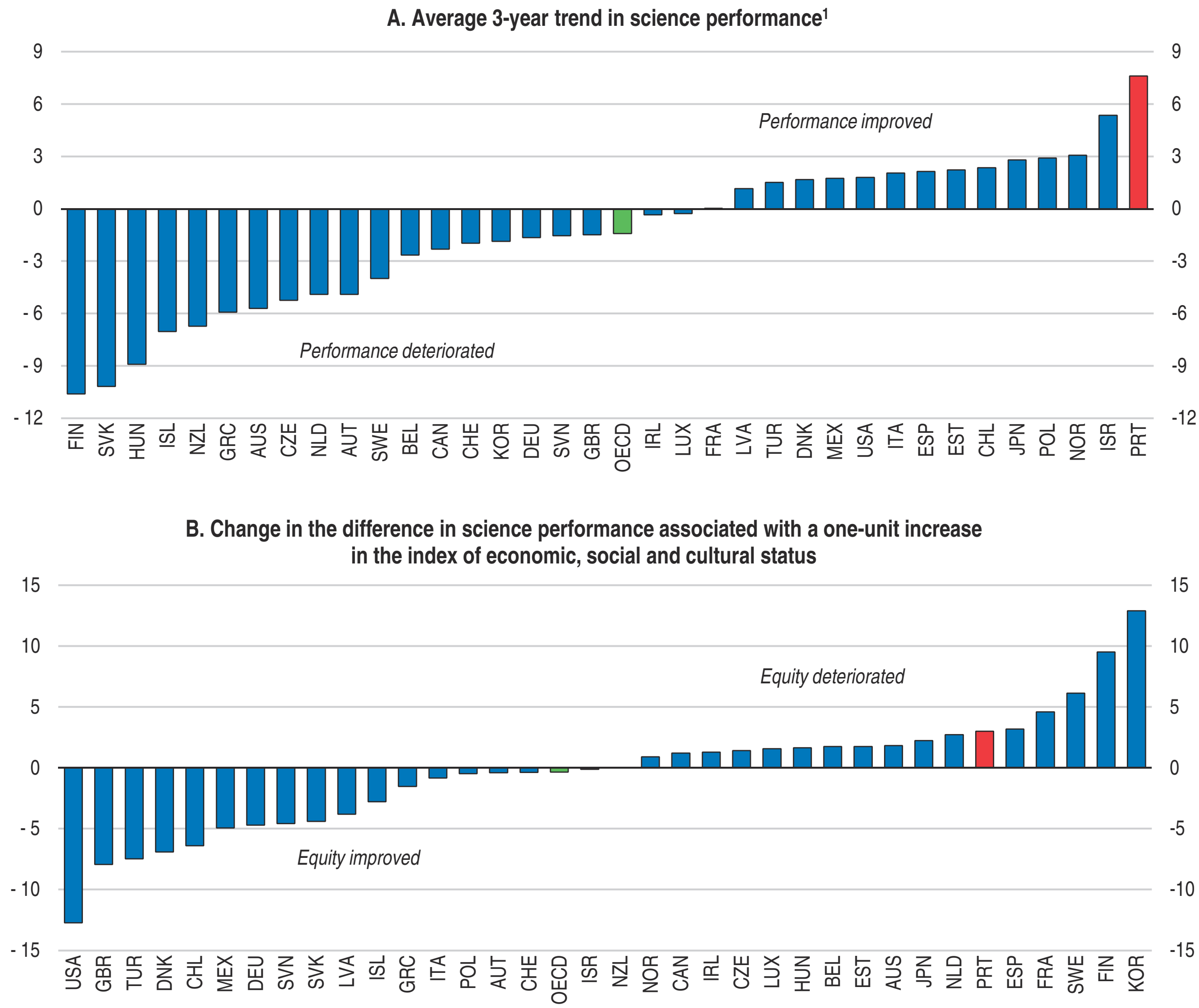
For youths, further improvements in the education system are the crucial factor for raising skills, which could improve the future for many young people with low skills and better integrate them into society. Student performance at age 15 has improved and is now above OECD average (OECD, 2016b). Beyond average performance, learning outcomes are heterogeneous and related to the socio-economic status of students. This link is higher than the OECD average and has become more pronounced over the last decade (Figure 21). Moreover, disadvantaged students are also more likely to repeat a grade and less likely to obtain tertiary education than in the average OECD country, suggesting challenges with respect to equity (see Chapter 2). The experiences of other countries demonstrate that improvements in average performance can go hand in hand with better opportunities for all citizens, including for those from less privileged socio-economic backgrounds. Mexico and Turkey, which are the only two OECD countries with lower upper secondary attainments than Portugal, have made similar progress as Portugal with respect to learning outcomes between 2003 and 2012 while improving equity at the same time (PISA, 2014). A recently launched National Programme for School Success contains measures aimed at students at risk, with a special emphasis on primary education.

Reducing grade repetition and drop-out rates

Portugal's early school leaving rate among youths aged 18-24 has come down substantially from 63% in 1991 to 14% in 2015, but it is still high in comparison to other European countries (Figure 22; CNE, 2015; Conboy, 2015). A high incidence of grade repetition is harming learning outcomes in Portugal. 34% of students have repeated a grade at least once by the age of 15, against an OECD average of 12%, and in the age group below 12, Portugal's grade repetition rate is one of the highest in the OECD. International evidence does not confirm the benefits of grade repetition for learning outcomes, but repetition exacerbates inequalities (Eurydice, 2011; CNE, 2015). More than 50% of socio-economically disadvantaged 15-year olds reported having repeated a grade at least once, compared to an OECD average of 20% (OECD, 2015). Moreover, grade repetition is a strong predictor for early school dropout.

Figure 21. **Learning outcomes can be improved**

Change between 2006 and 2015



1. The average three-year trend is the average rate of change, per three-year period, between the earliest available measurement in PISA and PISA 2015. For countries and economies with more than one available measurement, the average three-year trend is calculated with a linear regression model.

Source: OECD (2016c), *PISA 2015 Results (Volume I): Excellence and Equity in Education.*

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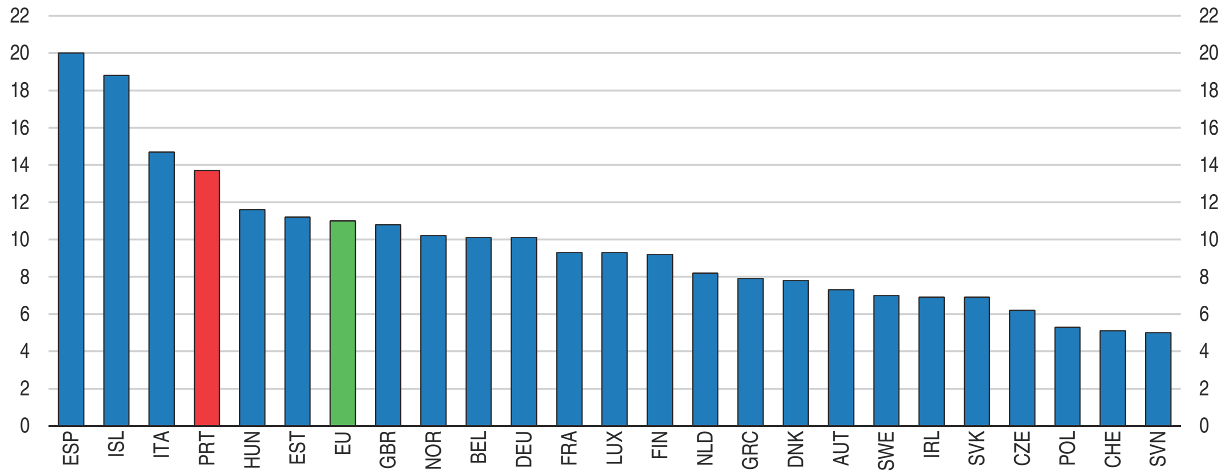
Leaving school before completing secondary education implies that students do not achieve their potential, exacerbates inequalities and narrows the skill base of the labour force. From a budgetary perspective, it also constitutes a poor use of resources. Measures to promote employment opportunities and income support for drop-outs later on in their working lives may turn out more costly and less effective than strengthening efforts in the education system, in addition to the loss of well-being related to higher exclusion, poverty and inequality (European Commission, 2013). Identifying students at risk early on and providing them with individualised support would be one way to reduce dropout rates. The government's plan to introduce mentoring for students who have repeated at least twice is a step in the right direction, but an earlier intervention would be more likely to succeed (Nusche et al., 2015).

Figure 22. **Student early school leaving rate is high**

Percentage of the population aged 18 to 24 having attained at most lower secondary education and not being involved in further education or training[1]



1. The early school leaving rate for Spain covers "school drop outs". The United Kingdom has no national target.

Source: Eurostat (2016), "Youth education and training", *Eurostat Database*; and European Commission (2014), "Overview of Europe 2020 Targets", *http://ec.europa.eu/europe2020/targets/national-targets/index_en.htm*.

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Raising quality and equity in education

Ongoing efforts to expand pre-primary education have made progress and should proceed. Children from disadvantaged socio-economic backgrounds should become the priority target. Ensuring good quality standards in pre-primary education is also crucial in light of evidence that, unlike in other OECD countries, enrolment in pre-primary education *per se* is not a predictor for lower grade repetition later on and that the benefits of early childhood education and care are conditional on quality (Reis and Pereira, 2015; OECD 2012a).

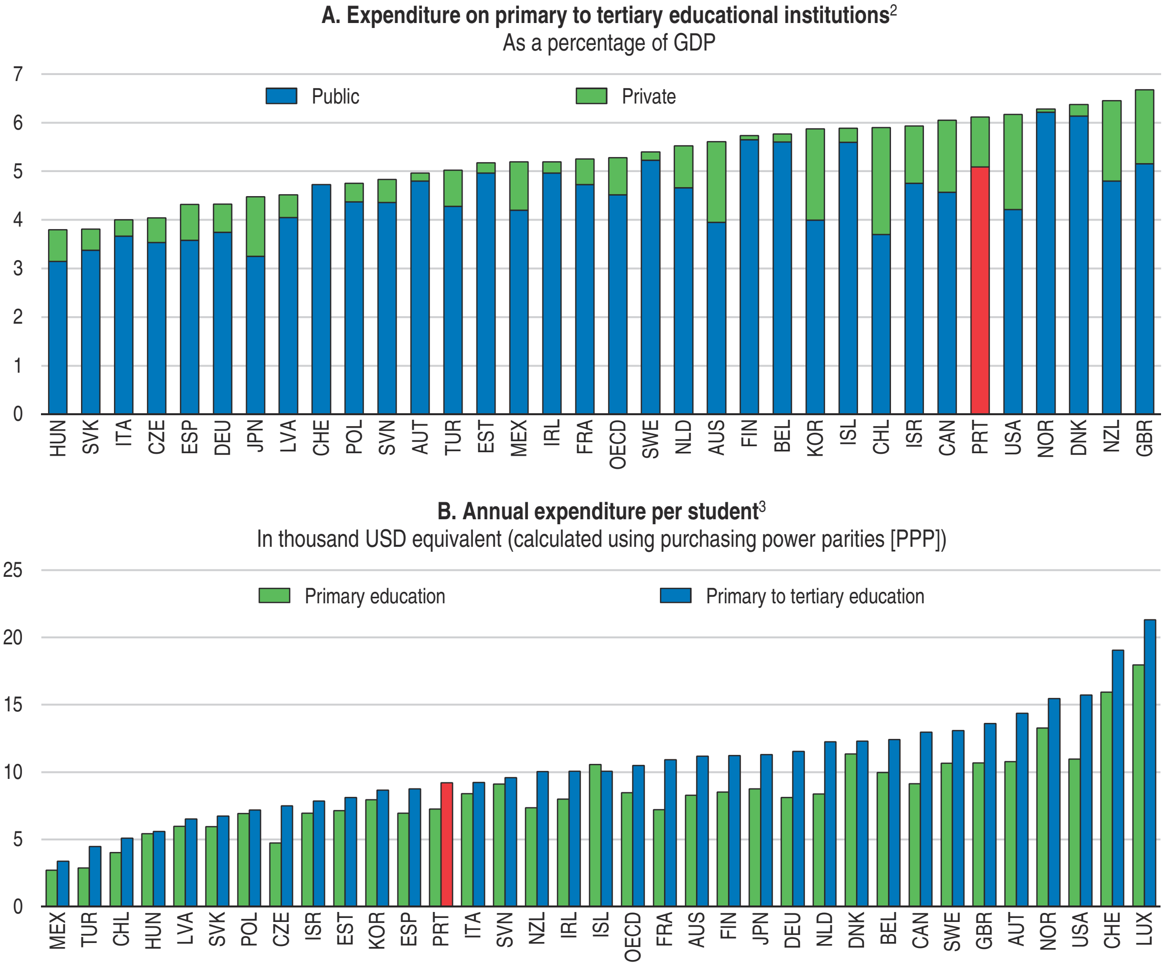
Reducing the high proportion of underperforming students will require some reallocation of resources. Education expenditure is above the OECD average relative to GDP, but annual expenditure per student is among the lowest (Figure 23). Spending could be raised in primary and pre-primary education where it is particularly low, despite evidence suggesting that the rate of return on investment in human capital is greatest in the early years of schooling (OECD, 2016a; Heckman and LaFontaine, 2007; Nusche et al., 2015).

Developing vocational education and training (VET)

Vocationally-oriented upper secondary training often leads to better employment prospects than academically-oriented training, for students who do not pursue further studies (CEDEFOP, 2013). Portugal has traditionally had a bias towards general programmes aimed at preparing for tertiary education, but the on-going development of VET has changed this. 46% of students in upper-secondary education were enrolled in VET courses in 2014, which is close to the OECD average (Figure 24). The offer of VET courses has been expanded and now encompasses a wide range of higher skilled occupations such as electronics and automation, information and communication technologies or renewable energies (OECD, 2015). Further policy efforts to raise the attractiveness of the VET system and strengthen its links to labour market needs are ongoing. Two-year technical courses in post-secondary education (TeSP) have recently been established, and both enrolment and private sector participation in these courses have been strong.

Figure 23. **Allocation of resources in education**

2013[1]



1. Expenditure in 2012 for Canada and 2014 for Chile. The OECD aggregate is an unweighted average of data shown (including Latvia).
2. Public expenditure only for Switzerland.
3. Public institutions only for Chile, Ireland, Italy, and Switzerland. Public institutions only for tertiary level for Canada, Luxembourg and Slovak Republic.

Source: OECD (2016a), *Education at a Glance 2016: OECD Indicators*.

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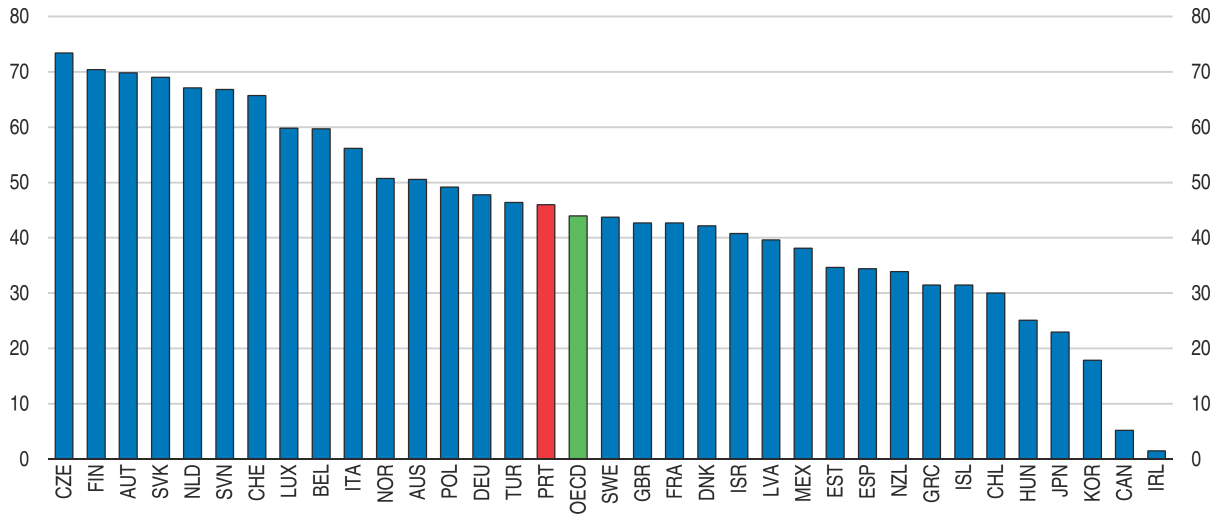
The administration of Portugal's VET system is still fragmented, despite recent policy efforts to put it under a single legal framework. The system could be streamlined, which would probably also result in a reduction of the large number of VET courses on offer. The current situation is conducive to overlaps, inefficiencies and the supply of training options that do not reflect labour market needs (Pedroso, 2011). Two almost parallel public systems are run by the IEFP (the Institute for Employment and Vocational Training) and the Ministry of Education. IEFP courses have a stronger element of dual training, combining class room teaching with practical experience in companies. As a result, these courses have a stronger link to the private sector than the VET courses run by the Ministry of Education, for which no systematic evaluation of participants' labour market performance is undertaken. The Ministry of Education has recently established Vocational Schools of Business Reference to focus on priority sectors, with a strong technical component. In addition, VET courses may

Figure 24. **Upper-secondary vocational education and training enrolment rates**

Percentage of students, 2014[1]



1. 2013 for Canada, Iceland, Ireland and Netherlands; no data available for the United States. The OECD aggregate is an unweighted average including Latvia.

Source: OECD (2016a), *Education at a Glance 2016: OECD Indicators*; and OECD (2015b), *Education at a Glance 2015: OECD Indicators*.

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also be provided by private training providers, including employers and trade unions, partly with public funding. Although a certification process exists, concerns about effective quality control for these courses have been raised (OECD, 2015).

The capacity to monitor VET could be enhanced by developing indicators that monitor the labour market outcomes of VET graduates by VET pathway, course enrolment and VET provider. These indicators should be compiled regularly and be used in policy evaluation with a view towards streamlining the offer and raising the quality of VET. Indicators should also be used to better align student enrolment with the labour market needs in career guidance, starting at the end of lower secondary education. They should also be part of systematic quality appraisals, to which all VET courses should be subjected, including those run by the Ministry of Education.

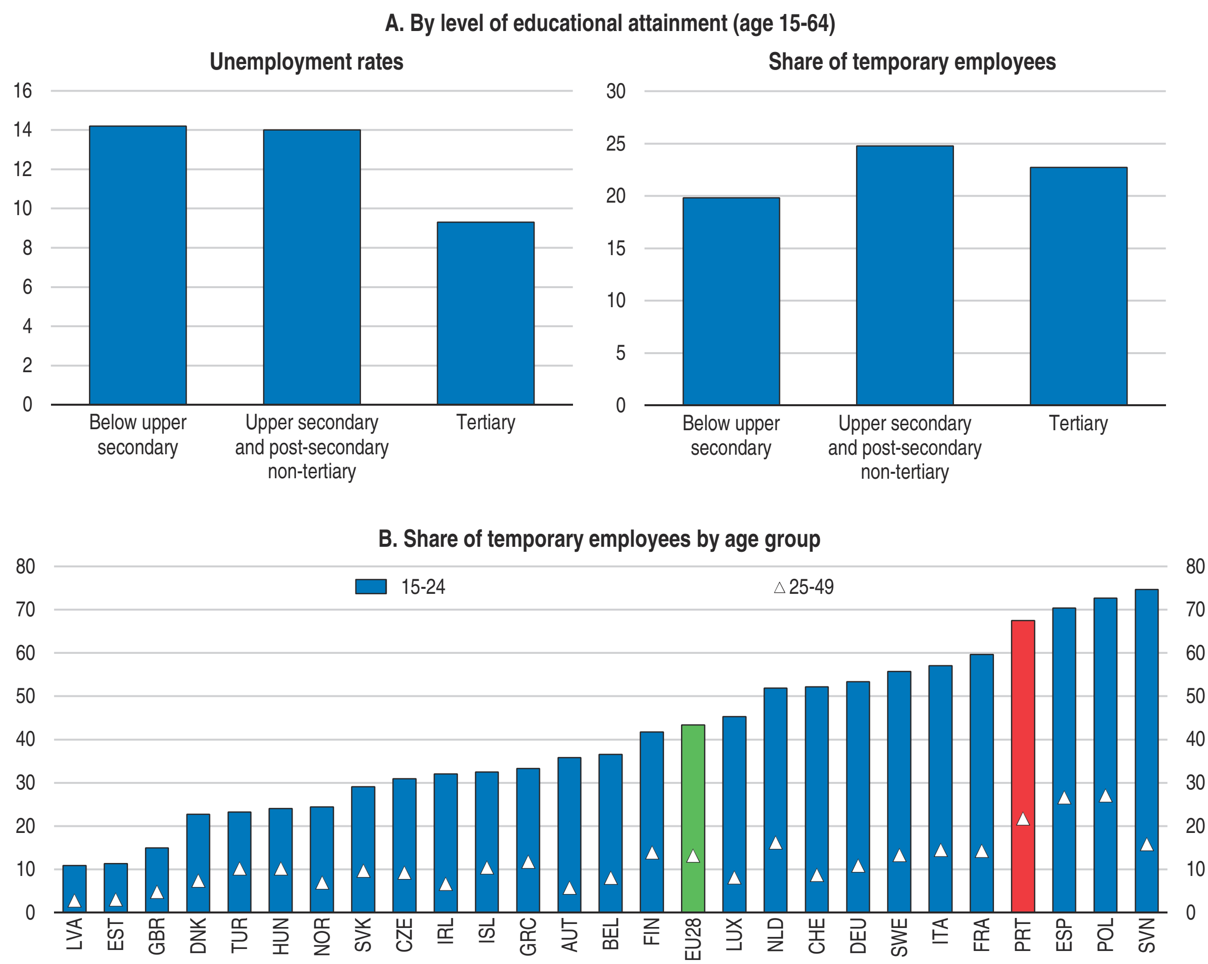
VET graduates have better employment prospects in countries where these programmes also contain work-based learning in companies, such as Austria, Denmark, Germany, Netherlands, Norway and Switzerland (OECD, 2015). Remunerated training contracts between apprentices and employers rather than schools or training centres encourage learning and raise incentives for employers to provide good quality training. Learning from these experiences could improve VET in Portugal. Portugal's comparatively high minimum wage, currently at 57% of median wages, may require financial incentives for firms to participate in such a scheme. In some Portuguese regions, however, finding businesses that could collaborate may be challenging. Students from these regions could be directed towards well-established large private VET organisers, possibly with the help of some financial assistance for students who have to move to another region.

Improve labour market signals and incentives to invest in skills

While the performance of the education system, VET and adult training are important ways to provide options for upskilling, these opportunities will only be useful if individuals take them up. Prospects for employment and job quality, and their link to training, are therefore crucial for raising skills, as getting a better job is a key motivation for acquiring skills and investing in education. Unfortunately, the labour market prospects are disappointing. Portugal's unemployment rate remains one of the highest in the OECD. Young people, who are more likely to improve their human capital than others, are particularly affected, with one third of those aged below 24 and more than a quarter of those below 30 being unemployed. Incentives for investing in skills are low, as this does not necessarily reduce the prospects of being unemployed, as unemployment rates are not lower for those with upper secondary and post-secondary education (Figure 25, Panel A). Only those with tertiary education have lower unemployment rates.

Figure 25. **The labour market remains segmented**

Per cent, 2015



Source: Eurostat (2016), "LFS series – detailed annual survey results", *Eurostat Database*.

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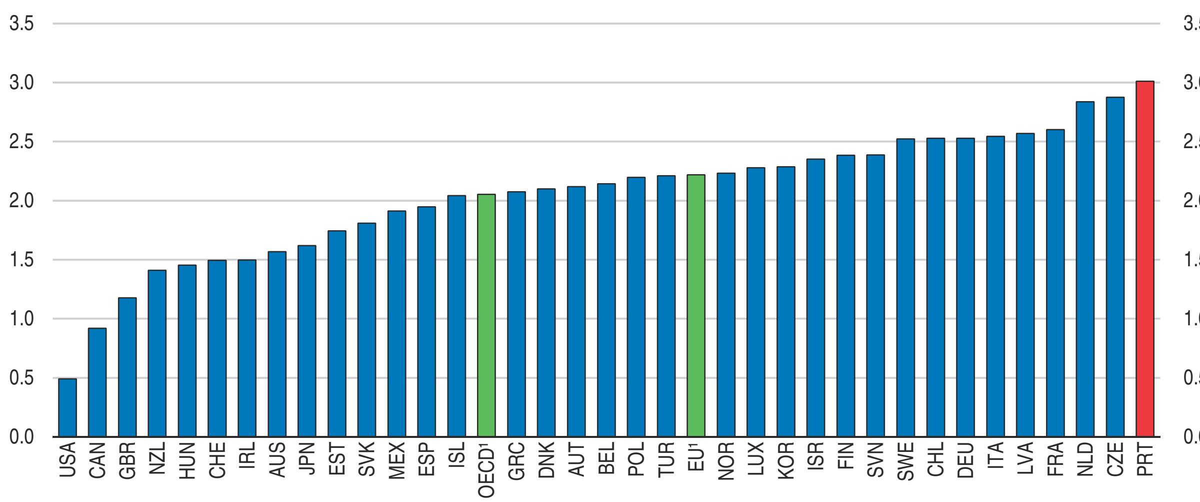
Moreover, the labour market is highly segmented into permanent and temporary contracts. The principal reason for the strong degree of labour market segmentation is the large gap in protection between open ended and temporary contracts (OECD, 2012b; OECD, 2014b; Carneiro, Portugal and Varejão, 2014). For new entrants to the labour market, this segmentation reduces the probability of obtaining a permanent contract. Better qualifications do not reduce the odds of working on temporary contracts (Figure 25, Panel A). In reality, fixed-term contracts have become a trap rather than a stepping stone to more stable employment, even for the well qualified. Among EU countries, Portugal has one of the highest shares of young workers in temporary contracts, which are frequent even among tertiary graduates (Figure 25, Panel B). The high incidence of temporary contracts diminishes the incentives to invest in human capital and reduces the incentives for on-the-job-training for both employees and employers.

Portugal's constitution sets strict limits on the policy options available to reduce labour market segmentation and most if not all that can be achieved without a constitutional change has already been done. Substantial labour market reforms undertaken since 2011 have reduced the rigidity of labour markets in several respects, for example by reducing severance payments and the procedural complexity for dismissals and by making work time arrangements more flexible through the introduction of a bank of hours. These reforms have had a positive impact, and should be maintained. Still, key aspects of Portugal's labour market rigidity have remained untouched, especially due to these constitutional limitations (Figure 26).

Figure 26. **Employment protection remains high**

Protection of permanent workers against individual dismissal, index scale 0-6 from least to most restrictions, 2013



1. Unweighted averages including Latvia. EU covers those countries that are also members of the OECD.

Source: OECD (2016), "Employment Protection Legislation", *OECD Employment and Labour Market Statistics* (database).

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Further reforms of labour market regulations would therefore require a broad consensus and take time. Still, starting a broad discussion about the best labour market policies is useful. In particular, the distributional consequences of the *status quo* are rarely discussed and reducing the gap in protection between the two segments of the labour market is crucial (Saint-Paul, 1997; Bernal-Verdugo et al., 2012; Sestito and Viviano, 2016). For instance, Italy's recent introduction of a new permanent contract with a gradually increasing severance pay led to a 5% increase in new gross hires and made firms less reluctant to offer permanent job positions to yet untested workers (Sestito and Viviano, 2016). Even for those with permanent jobs, the current rigidities provide disincentives for changing jobs, while better matches between skills and jobs could improve employees' career prospects and job satisfaction.

Table 6. **Past OECD recommendations on active labour market policies and education**

Recommendations in 2014 Economic Survey	Actions taken since 2014
Continue to scale up active labour market policies (ALMPs) and closely monitor programme performance.	Greater reliance on digital services has allowed for efficiency improvements and greater capacity to reach out to the NEETs. ALMP spending has increased, although spending per unemployed remains low. A draft evaluation of parts of the ALMP programmes has been prepared, but a more systematic evaluation of programme performance remains a recommendation in this *Survey*.
Scale up adult education and back to school schemes in order to help the unemployed and those in need to gain relevant skills.	The government has launched a new programme called QUALIFICA to expand the network of adult training centres and reach a larger share of the adult population, raise participation in lifelong learning, and ensure that the process of certification of competencies based on work experience includes formal education or training. A "QUALIFICA Passport" will track formal and informal qualifications acquired over time, which provides a basis for modular, flexible training opportunities.

Making growth more sustainable

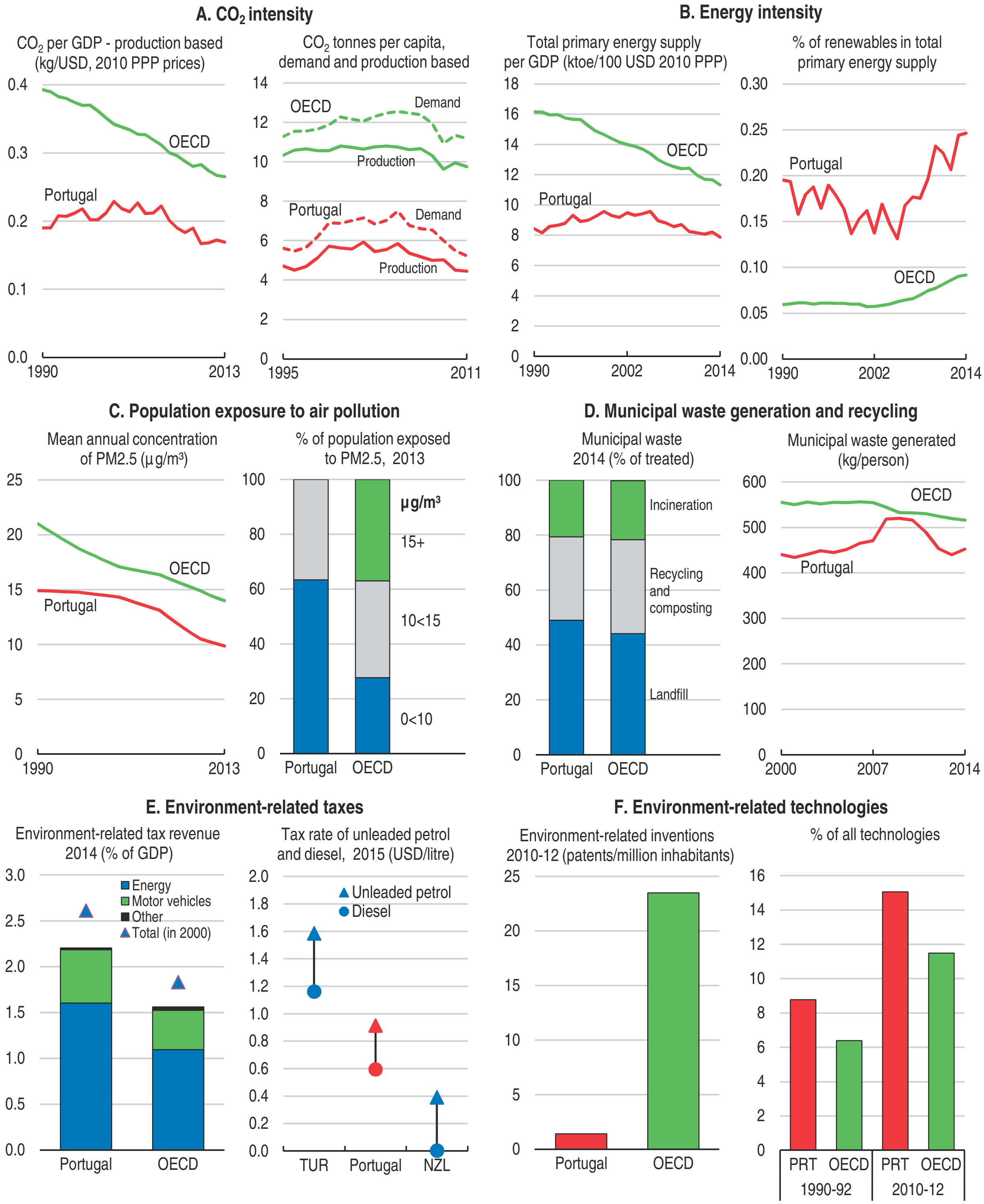
Portugal's emissions of greenhouse gases (GHG) per unit of GDP are well below the OECD average, and during the recent recession emissions fell more than overall output (Figure 27). The carbon intensity of the economy has been declining since 2000 as the contribution of renewables has been rising. The average contribution of renewables to electricity generation was some 60%, about half from hydro, in 2014. Renewables provided about one quarter of total primary energy supply, of which just over half was from use of waste and biofuels in electricity and heat production. A challenge will be to build on this progress and minimise the cost at the same time. Past achievements in the area of electricity generation from renewable sources have gone hand in hand with substantial producer rents due to high guaranteed feed-in tariffs and insufficient competition. These legacy remuneration schemes are no longer available to new entrants, but continue to provide sizeable rents to incumbent operators. In the future, more cost-effective policy measures will need to be found to continue reducing the carbon footprint of the economy.

Portugal has made rapid progress in drinking water quality, but there remain a few districts where less than 95% of the water was considered safe in 2013 (Simas, 2014); most of the country was in this category in 2003. Although Portuguese legislation embodies the cost-recovery principle, water charges to consumers have not covered expenditures, leaving local authorities in debt to water management systems, and about 20% of water consumers are still not covered by water treatment plants (MOATE, 2014).

Air quality in Portugal is better than in most OECD countries, with relatively few people exposed to levels of air pollution from microscopic particles that are likely to damage health. Nevertheless, the Global Burden of Disease study indicates that in 2013 nearly 3300 premature deaths were statistically attributable to outdoor air pollution (World Bank/IHME, 2016).

Portugal generated significantly less household waste than the OECD average until the beginning of the century when rising levels accompanied rapid economic growth at the same time as the OECD average declined. The decline following the sharp recession seems to have halted. Landfill remains the most common form of disposal, despite the introduction of a differentiated waste tax. Waste disposal authorities have often not passed these taxes on to households, limiting their incentive effect.

Figure 27. **Green-growth indicators: Portugal**



Source: OECD (2016), *Green Growth Indicators* (database). For detailed metadata, *http://stats.oecd.org/wbos/fileview2.aspx?IDFile=02a134e1-c3ec-4c5c-9a05-4ebb41a60539.*

StatLink http://dx.doi.org/10.1787/888933447866

Mainly because of higher energy taxation, Portugal generates significantly higher revenues from environmental taxation than the OECD average, and somewhat higher than the European average. Fuel excise taxes have been raised further in 2016, but continue to be lower for diesel fuel than for petrol, despite the absence of an environmental justification for this (Harding, 2014). However, tax credits, allowances and exemptions are widely used and sometimes exempt particular sectors or groups of people from environmental taxation (OECD, 2011). For example, reduced fuel tax rates in agriculture and fishing should be reconsidered. As part of a green tax reform, a carbon tax has been applied on the use of oil products in non-ETS sectors since 2015, with rates indexed to carbon prices under the EU ETS, subject to a floor.

With respect to developing new environmental technologies, Portugal is generally dependent on the results of foreign research work, as its very low rates of environmental patenting illustrate. The share of environmentally related patents in total patents has been relatively high.

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