The Impact of Regulation on International Investment in Portugal

HIGHLIGHTS

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OECD

Certain reforms are needed to address investment challenges weighing on Portugal's appeal to foreign investors

Portugal could benefit from further investment to support long-term productivity growth and to accelerate digitalisation and the transition to a carbon-neutral economy by 2050. Despite recent improvements, overall investment levels remain relatively low, particularly with respect to productivity-enhancing assets. Foreign direct investment (FDI) can be a vehicle for capital renewal and innovation, as well as for the dissemination of digital-intensive and greener technologies. However, certain aspects of Portugal's regulatory landscape and business environment may partly hold back foreign investment and their potential society-wide contributions. Targeted reforms can help to strengthen Portugal's appeal for FDI and the country's broader sustainable development prospects.

The OECD report **The Impact of Regulation on International Investment in Portugal** benchmarks Portugal's regulatory set-up for investment against a group of European peer economies, identifies possible bottlenecks and assesses to what extent a more business-friendly environment could bring more FDI to the country. The report proposes policy actions that the government of Portugal could consider in its efforts to increase the level of FDI in the economy, by further streamlining business regulation and creating a more favourable investment climate. Below are the main findings and recommendations of the report.

FDI strengthens the Portuguese economy and supports its sustainable development

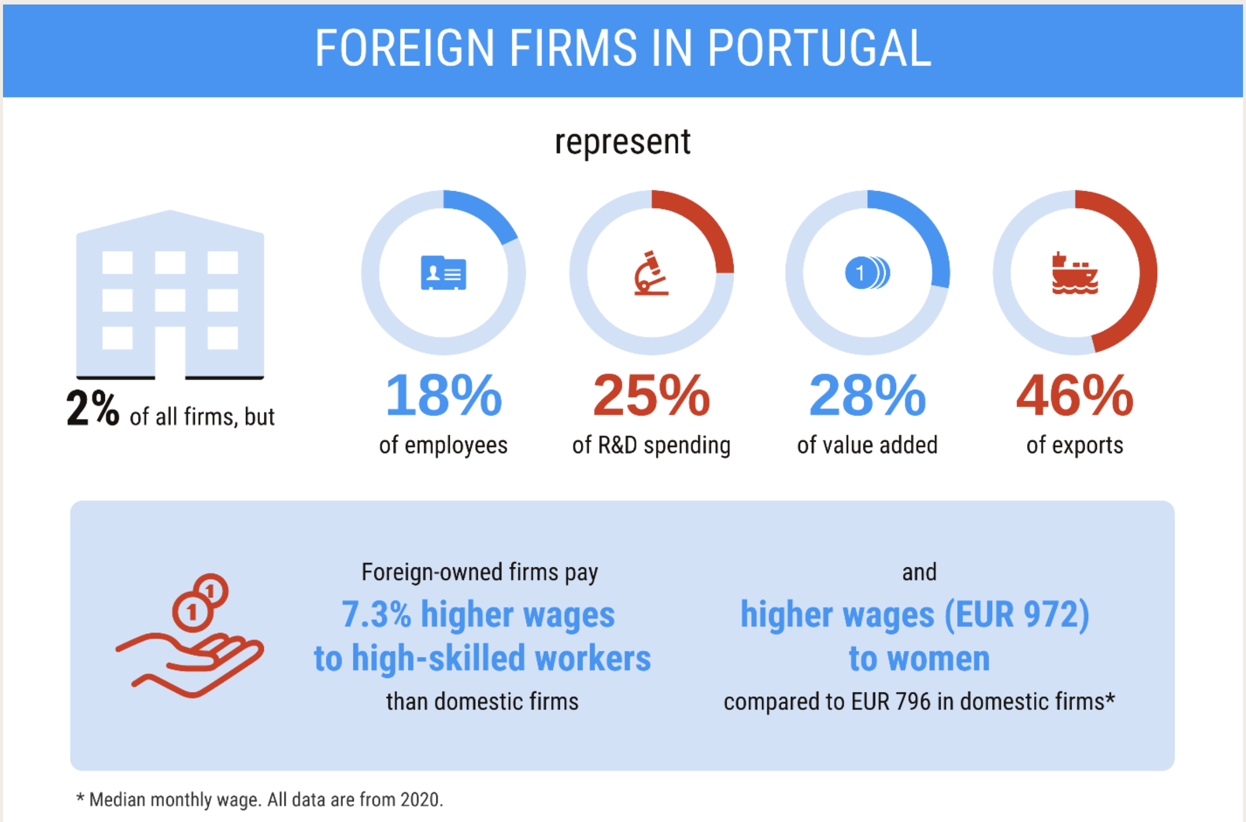
Foreign investment plays an important role in Portugal's economic activity and job creation. In 2020, foreign-owned firms represented only some 2% of all firms in Portugal, but employed 18% of the domestic workforce, accounted for 28% of total value added and were responsible for 46% of total exports. By purchasing goods and services from local firms and selling them abroad, they help domestic businesses access new markets and improve the competitiveness of their products.

Foreign companies also contribute to job quality and gender parity in the workplace by:

- Employing more top qualified workers than domestic businesses in most sectors of the economy.
- Paying higher wages than domestic firms; 7% higher than Portuguese firms in the case of high-skilled occupations.
- Paying higher wages to female employees than domestic firms; in 2020, the median monthly wage of women working in foreign firms was EUR 972, compared to EUR 796 in domestic firms. In many sectors, foreign companies also employ more women in senior positions than their domestic counterparts.

Foreign businesses support innovation, and digital and green transition efforts:

- Foreign firms account for 24% of R&D expenditure in Portugal.
- Foreign affiliates have, overall, 1.1 to 2 times greater uptake of high-end digital technologies (e.g. 3D-printing, industrial and services robots, internet of things, Big Data and artificial intelligence) than domestic firms.
- ICT training for employees is more common in foreign companies, 62% of which provided ICT training compared to 36% of domestic firms.
- Renewables accounted for 96% of cross-border mergers and acquisitions (M&As) in Portugal's energy sector in 2012-22 – a stark contrast to most peer economies, where the average share of renewables was 37%.



The time is right to step up efforts to attract FDI

Portugal has one of the highest levels of inward FDI stocks across OECD countries (71% of GDP in 2021), but total (domestic and foreign) annual investment to GDP remains among the lowest in the EU. Like many other developed countries, Portugal has a rapidly ageing and decreasing population, which will weigh on labour's contribution to economic growth in the long term.

In line with Portugal's strategic priorities for the next decade, Portugal should strive to mobilise further investment to support long-term economic growth and modernise its manufacturing and services sectors. Portugal would also benefit from more investment in ICT assets broadly across sectors and firms to support its digital transition and sustain its reputation as a technology and innovation hub.

FDI can also continue to support Portugal's transition to a carbon-neutral economy by 2050. Russia's war of aggression against Ukraine has further underlined the potential benefits of continuing to leverage foreign investors' interest in Portugal's renewables sector and expanding renewable energy production capacity.

In addition to helping weather some of the economic challenges posed by Russia's war against Ukraine, foreign investors may also provide crucial support for the implementation of Portugal's Recovery and Resilience Plan (RRP) in the wake of the COVID-19 pandemic. The timing is apt to pursue reforms targeted at increasing Portugal's appeal for FDI, as structural reforms envisaged in the RRP are being scoped across many policy areas.

Overly strict regulation can hold back FDI projects

Domestic regulation affecting market entry and operation of foreign businesses in the host country may hold back foreign investment. In addition to explicit restrictions to FDI, such as rules limiting foreign investors' equity participation in locally incorporated companies, factors shaping a country's general business environment (e.g., business licensing, tax compliance, judicial system) may add challenges for foreign companies. Regulatory barriers may influence FDI indirectly by unintendedly increasing business costs in one location versus another, notably if the rules are excessively stringent compared to regulatory frameworks observed elsewhere. OECD research shows that lifting such regulatory barriers can have a positive impact on investment.

LIBERALISING REFORMS

could **increase FDI activity** in Portugal:

13% more cross-border **M&A deals***

6% more **greenfield** projects*

* Estimated FDI impact of reducing services trade restrictions on par with more open economies.

Businesses call for a more services-oriented approach

Systematic simplification efforts, e.g., as part of the Simplex programme, have already reduced administrative burden for firms. Nonetheless, foreign investors continue to perceive interactions with Portuguese public administration as burdensome in many areas and call for a more services-oriented approach in administrative processes.

Investors consider that the necessary licenses and permits to start or expand operations, such as environmental licenses or construction permits, take a long time to obtain and processes lack predictability.

Firms also spend more time preparing, filing and paying taxes in Portugal than in most peer countries. Foreign investors consider that tax regulation remains too complex, changes too frequently and clarification on new rules is difficult to obtain.

Investors find Portugal's R&D tax incentive effective, but other funding opportunities and incentives, such as government support for companies' digital and green energy transitions, might be too complicated to apply for or insufficiently aligned with business needs. Many investors are also not aware of existing support mechanisms in the area of green and digital transitions.

1. **Simplify business licensing and permit procedures**, such as industrial licensing, construction permits and sector-specific licensing (e.g. in health, life sciences), following the example of the recent changes in environmental licensing. Ensure authorities' capacity to issue licenses within time limits and enforce tacit approval to increase predictability for investors.

2. **Reduce tax compliance time and costs**: further streamline corporate taxation (e.g. by continuing to reduce special tax provisions), strengthen information and assistance services, and increase digitalisation in tax administration. Help taxpayers adapt to new rules through timely guidance and appropriate transitional periods.

3. **Assess and streamline investment incentives**, where possible, to ensure that they reach intended objectives while keeping added complexity to the tax system at a minimum. Promote take-up of existing incentives to support firms' green and digital transitions, e.g. through guides and information campaigns.

CHALLENGES TO BUSINESS OPERATIONS IN PORTUGAL

3 in 4 investors
view **administrative delays**
and **red tape**
as obstacles to operations (2022)

It takes nearly **90 days**
to **obtain an operating license**
- more than twice as long as in peer countries (2019)

Tax compliance requires
243 hours per year
compared to 50 hours in Estonia (2019)

47% of firms
see **tax administration** as a major constraint
- compared to 3% in Slovakia (2019)

Better business regulation and a more efficient justice system could boost investor confidence

Portugal has improved regulatory impact assessment (RIA) practices and stakeholder participation in the drafting of regulation in recent years, e.g., through the introduction of competition impact assessments and the ConsultaLEX online portal. Yet, OECD indicators show that Portugal lags behind peer countries in both areas. For instance, RIA documents are not made available online and ex-post evaluation of existing rules is not mandatory. Foreign investors also report difficulties understanding regulation and coping with sudden changes in legislation in Portugal.

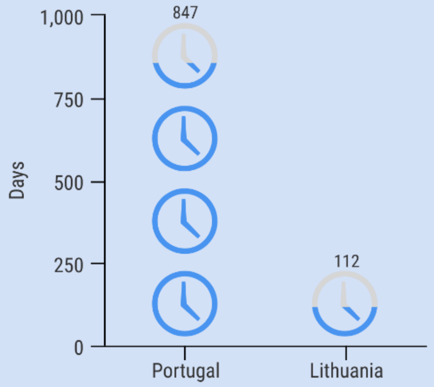
Long judicial proceedings may also undermine Portugal's FDI attractiveness, while equally affecting domestic investors. Portugal has undertaken reforms in its justice system and improved the efficiency of its courts in recent years, but the duration of proceedings remains long compared to peer countries, particularly in administrative courts.

1. **Make broader use of regulatory impact assessments and engage the private sector more actively in law-making** to ensure that business regulation fulfils its intended purpose while avoiding unnecessary administrative burden for firms. The good practices implemented as part of the recently developed consultation process for the scoping of business licensing reforms could be generalised to the drafting of other business regulation.

2. **Further reduce the length of court proceedings** by increasing digitalisation in courts, strengthening human resources in support functions, and making more extensive use of out-of-court mechanisms.

JUSTICE SYSTEM

One in two Portuguese companies
view the **duration of judicial proceedings**
as a high or very high obstacle (2022)



Estimated time to resolve a case
in a first instance administrative court (2020)

Nearly 2 years and 4 months
The time required to resolve an
administrative court case
More than 7 times as long as in Lithuania

Policy action is needed to ensure that the labour market remains attractive for investment

Competitive labour costs compared to many other European economies, a skilled workforce and the quality of higher education institutes contribute to Portugal's appeal as an investment location. However, investors increasingly face shortages of certain types of talent, such as IT and engineering professionals, technicians, and middle management.

While boosting the domestic supply of skilled labour via the educational system is important in the long run, fully leveraging existing and planned skills development initiatives and facilitating the entry of foreign talent can contribute to addressing urgent skill shortages. Yet, many investors do not use or are not aware of government support for skill upgrading, and bottlenecks in the entry of non-EEA talent thwart efforts to recruit workers from abroad.

Moreover, labour market duality along the type of employment contracts continues to affect productivity growth and social equity, despite recent measures limiting the excessive use of temporary contracts. Investors view the strict regulation of dismissals of employees with open-ended contracts as one of the main challenges of doing business in Portugal.

1. **Raise investor awareness of incentives for employee training**, including in digital skills and technologies. Strengthen the alignment of such training with business needs and Portugal's strategic objectives.

2. **Improve the efficiency of the immigration authority** to facilitate the hiring of non-EEA talent, for instance by leveraging digital tools and allocating more resources to the processing of applications.

3. **Continue efforts to lessen labour market duality** by further reducing the gap in protection between open-ended and temporary contracts. Consider increasing flexibility by making performance-based dismissals of employees with open-ended contracts an effective possibility, as is done in most benchmark economies, while continuing to ensure strong protection against unfair dismissals.

ENTRY CONDITIONS FOR FOREIGN WORKERS HAVE IMPROVED

A **first residence permit** is now valid for

2 years

Up from 1 year prior to 2020

No more quotas

Immigration quotas and labour market tests have been **eliminated**.

But **60% of foreign investors** still view **visas and residence permits for foreign workers** as an obstacle to operations in Portugal, mainly due to long processing times.

Reforms can facilitate market entry and promote competition in key sectors that support investment

Portugal has a relatively open regulatory framework for trade and investment in many services sectors as compared to other OECD countries. Yet, some regulatory barriers remain in sectors that provide strategic support to Portugal's priority areas for investment and inputs into other sectors of the economy.

Foreign investment in many of Portugal's professional services sectors is currently limited due to ownership restrictions combined with limitations to foreign practitioners' access to the profession. However, a recently approved reform is to open the ownership and management of professional firms to non-licensed professionals, including foreign ones.

Remaining obstacles in transport and logistics services, such as additional domestic requirements in road freight transport on top of EU-level requirements, limitations on maritime cabotage by foreign-flagged vessels and non-competitive award of auxiliary port service concessions, may restrain competition in these activities and affect foreign and domestic firms in downstream industries economy-wide. In customs, investors cite practical obstacles, such as limited opening hours of customs in ports, excessive documentation requirements and an insufficient degree of digitalisation.

Addressing the few remaining regulatory barriers in digitally-enabled services can complement Portugal's efforts to support the development of technology-based innovations and services, promoting the country's digital transformation. The regulatory set-up for digital trade is particularly relevant for sectors such as distribution, audio-visual, telecommunications, and financial services.

1. **Swiftly implement the recently approved reform to open investment in professional firms** to non-licensed professionals, including foreign investors. Revising the statutes of professional associations as part of the implementation process is an opportunity to address also other barriers to the entry of foreign professionals.

2. **Lift barriers in transport and logistics sectors** to boost competitiveness. Eliminate additional domestic requirements in road freight transport, open the maritime cabotage market to foreign-flagged vessels and adopt more competition-friendly rules for awarding auxiliary port service concessions, to align the regulatory framework with more open EU countries.

3. **Promote the efficiency of customs procedures**: improve information availability, extend opening hours of customs in ports and adapt digital solutions to improve the customer experience, e.g., electronic payment of all duties, taxes, fees and charges.

4. **Consider removing the requirement for foreign companies, exercising activities for more than one year in the country, to designate a permanent representative in Portugal** to ease cross-border digital sales for firms established abroad.

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This document is based on the publication: OECD (2023), *The Impact of Regulation on International Investment in Portugal*, OECD Publishing, Paris, https://doi.org/10.1787/688b30c8-en. It is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and the arguments employed herein do not necessarily reflect the official views of OECD member countries.

The work leading to this publication was funded by the European Union via the Technical Support Instrument, and implemented by the OECD, in co-operation with the Directorate-General for Structural Reform Support of the European Commission. The views expressed herein can in no way be taken to reflect the official opinion of the European Union.

The Impact of Regulation on International Investment in Portugal

The OECD report **The Impact of Regulation on International Investment in Portugal** examines how regulatory reforms could help Portugal build a more enabling and competitive environment for investment, in particular foreign direct investment (FDI). The report analyses trends and patterns of FDI activity in Portugal, including its broader economic, social and environmental benefits. It gives an overview of the economy-wide and sector-specific regulatory settings in Portugal compared to selected European peer economies and provides an empirical analysis of the potential effects of domestic regulatory reforms on FDI. Foreign investors' perceptions on Portugal's business environment complement these findings.

The report indicates potential areas for regulatory reforms and proposes policy measures to further improve Portugal's investment climate and support efforts to attract and retain more FDI while strengthening its contribution to sustainable development in Portugal.

Find out more about the report **here**.

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