Executive summary

Portugal has been strongly hit by the COVID-19 crisis with a larger fall in GDP than the OECD average, reflecting in large part a significant population of micro-firms with limited capacity to adapt to stringent containment measures, especially in the tourism sector, as well as relatively high exposure to disruptions in global value chains (GVCs). Although the recovery is now in process, with GDP expected to return to pre-crisis levels by mid-2022, there is considerable scope to strengthen the recovery, and reduce vulnerabilities to future shocks by revitalising progress Portugal has made in recent years in developing a dynamic entrepreneurial ecosystem.

This will require higher productivity and more innovation. This will require leveraging the potential of small and medium-sized enterprises (SMEs) that constitute the industrial fabric of many regions and countries, and foreign direct investment (FDI) that contributes to the knowledge base and capital stock of host places.

Portugal has seen significant growth in FDI in export-oriented manufacturing industries (e.g. mineral and metal products, chemicals, machinery, agri-food, transport material) over the past decade, motivated by low labour costs, a skilled workforce, a strong SME sector with research and development (R&D) capacities and good infrastructure (e.g. digital, financial). Despite this strong growth, key indicators – such as value added and export shares in high-tech manufacturing and services, and FDI stocks relative to GDP – remain below those of peer countries (e.g. Czech Republic and Slovak Republic). Further developing these high-tech sectors could strengthen the potential for FDI-SME spillovers, especially because the capacities of SMEs in these activities to absorb knowledge and technologies from foreign affiliates are already well-developed (particularly in the Lisboa Metropolitan Area). Portuguese SMEs contribute significantly to value added and exports and are relatively more innovative and digitised than those in many other OECD economies. However, Portugal has a large population of relatively low productivity micro firms with low absorptive capacity, compared to the OECD average, and FDI is concentrated in the Lisboa Metropolitan Area and the Norte region, which lowers the spillover potential for those micro firms, particularly in other regions.

Value chain linkages between foreign and domestic firms in Portugal are stronger than in some peer countries (e.g. Belgium and Hungary). Foreign affiliates source more intensively from local suppliers (often SMEs), particularly in high-tech manufacturing and lower technology services, increasing the scope for spillovers in these sectors. Additionally, domestic firms benefit more from (quality) inputs produced locally by foreign affiliates than in peer countries. SMEs in Portugal are less well integrated in innovation networks than in other European economies, although partnerships between foreign firms and SMEs are widespread in terms of technology licensing.

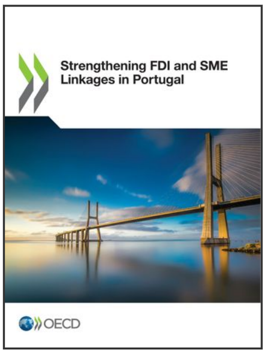
Labour mobility from domestic to foreign firms in skill-intensive activities is enabled by wage differentials. The higher wages offered by foreign firms attract skilled workers which (without enabling policies) may have negative impacts on SMEs, especially in less developed regions. Increased skills demand due to increasing FDI in Portugal also incentivises SMEs and workers outside FDI firms to invest in skills and thus further increases supply in the medium term. In the short-run, however, skills are scarce and therefore FDI entry may crowd out skilled workers from domestic firms. This negative productivity spillover is more likely in less developed Portuguese regions – where many low productivity SMEs and micro firms operate.

Many public institutions are involved in the design and implementation of policies that enable FDI spillovers on Portuguese SMEs. The main implementing agencies report to different line ministries and operate within specific policy domains, making inter-institutional coordination imperative for the effective implementation of policies that span several policy areas. Inter-ministerial collaboration is promoted through three highlevel advisory councils that focus on the areas of entrepreneurship and innovation, regional development, and the internationalisation of the economy. However, the councils often lack a clear mandate and resources to facilitate policy coordination across the FDI-SME diffusion policy areas. Institutional silos are less pronounced in the management of the EU Structural and Investment Funds, which require a higher degree of collaboration among ministries, implementing agencies, and national and subnational operational bodies. Furthermore, the use of comprehensive monitoring and evaluation frameworks is limited to government institutions involved in the implementation of policies supported by the EU funds. With the exception of the Agency for Development and Cohesion (AD&C), none of the other implementing agencies, whose role is crucial in enabling FDI-SME diffusion, have a dedicated unit or internal capacity to systematically evaluate the impact of their policy initiatives.

One of the major factors influencing Portugal's policy mix is the desire and necessity to accelerate its transition to a knowledge-based economy. Another factor lies in the availability of the EU Structural and Investment Funds, which have been used to fund the government's policy priorities in the areas of investment, SME and entrepreneurship, innovation and regional development through the Portugal 2020 Partnership Agreement. Portugal's policy mix also presents a relatively high degree of selectivity, which is driven by its national and regional smart specialisation strategies; many policies target specific types of firms – in particular SMEs – priority sectors and value chain activities, as well as specific geographic areas. Strengthening SME absorptive capacities and promoting FDI-SME partnerships appear to be the main objectives pursued by the current policy mix. A large number of policies also target the attraction of knowledge-intensive FDI and the establishment of value chain linkages between foreign and domestic firms. The labour mobility and competition/imitation channels receive little attention from policymakers, however.

Financial incentives for R&D and innovation, technology acquisition and digital transformation have been the major instruments used to strengthen FDI-SME spillovers. Many initiatives include additional financial support for the development of products and services through business-to-business and industry--science collaboration, reflecting the importance given to networks in creating, accessing and sharing new knowledge. The type of instrument used to promote FDI-SME spillovers depends, however, on the pursued policy objectives. Whereas most policies supporting SME absorptive capacities make use of financial instruments, the attraction of knowledge-intensive FDI is pursued mainly through regulatory measures such as special investment regimes for different types of FDI and residence-by-investment schemes. Similarly, technical assistance, information and facilitation services are usually offered to promote value chain linkages and strategic partnerships, reflecting the crucial role that matchmaking services, networking events and supplier development programmes play in bringing together foreign investors with local suppliers, business networks, universities and other actors of the Portuguese innovation ecosystem.

The two regions of Portugal analysed, Norte and Alentejo, are distinctively different from each other and also exhibit substantial heterogeneity within themselves: The highly technologically driven Alentejo Litoral is decoupled from the rest of Alentejo's economy; in Norte the important engines of Porto and Braga differ vastly from the inner hinterland regions. This distinction shows the value of place-based policy responses that can complement nationwide policies. There is room to better connect the EU's Smart Specialisation Strategies to policies relating to FDI attraction; for example showcasing Norte's expertise in high technology manufacturing or the strategic location of the port of Sines in Alentejo – avoiding the use of other measures (e.g. financial incentives) that can be counterproductive and lead to a race to the bottom. This can improve the likelihood of FDI-SME linkages occurring. These links can be crucial for regional development but at the same time regional development policies can improve the strength of FDI-SME linkages. Further efforts should be made to improve the interconnectedness, including funding, of these policy objectives. Policies should be designed and implemented at the appropriate scale with input and coordination from all levels of government. And in order to tackle future challenges, resources should be dedicated to developing and circulating regional statistics relating to the monitoring of policy implementation.



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