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Portugal

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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– to contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and

– to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

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Publié également en français.

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Executive Summary

Convergence of the Portuguese economy toward the more advanced OECD economies seems to have halted in recent years, leaving a significant gap in per capita incomes. The proximate cause is low labour productivity, as employment rates across the board are substantially higher than the EU average. Nor is there a shortage of capital goods in aggregate. But capital equipment in the business sector is not always efficiently used or allocated, and new technologies are not readily adopted. Furthermore, the Portuguese labour force – even its younger members – have had less formal education than workers in other EU countries, including among the new entrants from Central and Eastern Europe, and workers in Portugal also have less access to training than in many other countries. Traditional Portuguese low value-added highly labour-intensive products now face increasing competition from developing countries and from the new EU entrants.

The key medium-term challenge is thus to step up growth through policies that raise human capital and encourage the mobility of the labour force and the diffusion of technological advances. Competition needs to be stiffer, especially in the privatised utility sectors, where incumbents still exercise dominant market power. And the climate for doing business and investing needs to be further improved, so as to encourage firm start-ups and expansion and to allow greater innovation. The authorities have identified the weaknesses in the economy and have legislated for a notably wide range of measures to improve performance. The key is to carry through and deepen these reform programmes and ensure effective implementation.

An important example is recent reforms to the overly large public administration, which have yet to be translated into significant downsizing or substantial reallocation across all areas of government. This is all the more disturbing because a poorly-motivated administration with considerable job security could result in a slower implementation of reforms in other areas.

Effective implementation of reforms to contain the growth of public spending and deliver better outcomes is important for several reasons. Most urgently, excessive growth in public expenditure in the closing years of the 20th century led to the need to slash spending in the face of the subsequent international downturn in order to limit the growing budget deficit. With the economy showing tentative signs of recovery only in 2004, there has been continued resort to one-off operations and budget freezes to satisfy the 3 per cent deficit limit set by the Maastricht Treaty. It is important that these measures be phased out soon and replaced by more decisive implementation of programmes to raise the efficiency and quality of public expenditure. This would help solve the chronic problem of structurally weak public finances, and permit Portugal to ride out its typically sharp cyclical experiences without having to cut or postpone fundamentally important programmes. In the longer term, further consolidation is necessary as an ageing population will begin to make increasing demands on the public purse to finance pensions and health care.

Reforms to health care, the subject of a special chapter, have recently been put in place, along lines recommended in past *Economic Surveys*. They are intended to improve the quality of delivery without raising costs, and to slow the growth of costs in the future. The reforms create better managerial and incentive structures for hospitals and general practitioners, reduce waiting lists, and reduce the costs of pharmaceuticals. An important aspect of the reforms is the setting up of an independent regulatory agency with responsibilities and powers to ensure that citizens have equitable access to health care and that the suppliers are delivering high-quality services. Early indications are that there have been savings in spending on pharmaceuticals and improvements in hospital services. Effective implementation of the wide-ranging programme will be key to achieving durable results, but additional measures may be needed to further raise efficiency, reduce current cost pressures and improve health status.

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

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The economic situation and policies of Portugal were reviewed by the Committee on 5 July 2004. The draft report was then revised in the light of the discussions and given final approval as the agreed report by the whole Committee on 13 July 2004.

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The Secretariat's draft report was prepared for the Committee by Bénédicte Larre, Stéphanie Guichard and Pedro Duarte Silva under the supervision of Nicholas Vanston.

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The previous Survey of Portugal was issued in February 2003.

Assessment and recommendations

Growth performance improved over the 1990s, but public finances lack strength and the catching-up process has stalled

Portugal has the lowest per capita income in the euro area and until the recent enlargement, it also had the lowest in the EU. Brisk growth in the last years of the 20th century led to some convergence with living standards in the more advanced EU countries, largely thanks to the reforms that began some 15 to 20 years ago. Liberalisation of the financial sector, far-reaching privatisation and deregulation, high investment and improved human capital delivered notable results. Falling real and nominal interest rates in the run-up to euro entry fuelled private sector demand and weakened the government's incentives to control primary spending. This also led to the build up of major imbalances, including a large external deficit and high household and corporate indebtedness. The structural budget deficit was also allowed to widen in the late 1990s, forcing the authorities to undertake a drastic corrective programme to reduce the excessive budget deficit during the economic slowdown. The adjustment process in the private sector, compounded by public sector retrenchment and a depressed international environment, led to a protracted period of weak activity for three years running, with real GDP actually falling in 2003. The recovery in activity is likely to be slow. Recent strong cyclical movements make it difficult to estimate potential GDP growth accurately, but it is likely that actual GDP will remain below potential for some years, postponing the catching-up process.

The priorities are to spur potential growth…

Portugal's key medium-term challenge is to raise income levels. Since employment rates are already high (and unemployment low) this will require sustained increases in labour and total factor productivity. P*olicies are required that enhance human capital, facilitate labour mobility, intensify* *the use of* Information and Communication Technology (ICT), *raise managerial efficiency and create a favourable climate for private investment.*

… and to ensure sustained fiscal discipline

Portugal also needs to address the chronic problem – recently in a more acute phase – of weak public finances to ensure that the catching-up process will not be jeopardised by fiscal difficulties. Fiscal consolidation in the upswing would have obviated the need for procyclical policies in the downswing. More fundamentally, severe difficulties lie on the spending side: rapid growth of primary spending over more than a decade has put Portugal among higher-spending countries, considering its income level, while the cost-effectiveness of service provision has been doubtful. Getting spending under better control, including via a more efficient public sector, would permit more resources to go to the development needs of Portugal. The ongoing reform in the health sector is a good example of the strategy to improve the quality of public services and meet the population needs, while seeking to limit pressures on public expenditure over the medium-term. Thus the government's focus on curbing the fiscal deficit, engaging in public sector reforms and raising productivity growth is welcome.

To raise productivity growth and allow catching up in living standards, more reforms are needed

There is indeed considerable scope to accelerate the convergence process through raising productivity, and current policy strategies recognise this. The economy's trade specialisation has typically been in low-skill labour-intensive sectors, in which it faces rising competition from some of the new EU members, where wages are lower and whose labour forces are generally higher-skilled, and from other low-wage countries outside the OECD. The Portuguese productive sector is responding to the shift in relative prices, and to enjoy durably stronger growth, Portugal needs to continue to move away from traditional labour-intensive low value-added products. The most promising strategy to address the catching-up challenge is to:

- *raise the skills of the* Portuguese *workforce, to accelerate the shift towards higher value-added and more competitive products;*
- *ease restrictive employment protection legislation for established workers, which creates labour market segmentation, hinders mobility and restrains technological and managerial innovation;*

- *intensify the use of Information and Communication Technology;*
- *raise public awareness of the advantages of competition, building on the new Competition Law and Authority;*
- *create an environment where the private sector invests and innovates, and where firms are encouraged to expand if they are successful.*

Government programmes to address these issues are at various stages of development. The key is to carry through and deepen these reform programmes and ensure effective implementation.

The level of human capital is still very low

Despite a big improvement in the past decade, Portugal still ranks close to the bottom of the OECD in terms of educational attainment of the population and student performance. Value for money in the schooling system is poor, as evidenced by the combination of below-average student performance with a close to average level of spending per student. The acquisition of higher skills, in school or on the job, would make the labour force more adaptable; it would also foster the use of new technologies and innovation in production processes and management. More educated workers would be able to move to higher productivity jobs or to positions where their productivity can grow more rapidly over time.

Reforms to improve the education system require swift and continuous implementation…

Aware of the urgent need to further raise the quality of education services, reforms have been undertaken: *i*) measures have been launched at all levels of formal schooling, modernising the curricula and introducing flexibility, although the Framework Law setting the principles for the reform of compulsory schooling was still being legislated in mid-2004; *ii*) a new focus is put on professional schooling and technical education; *iii*) changes are being made to the operating and financing of tertiary education; *iv*) rationalisation of the network of schools has started with the regrouping of very small schools. The strategy to push forward the transformation of Portugal into a knowledge-based economy and to improve the cost-effectiveness of the education system seems broadly adequate. Measures starting to be implemented, such as systematic evaluations of schools and teachers and allowing universities to set their fees and recruitment requirements more freely, are promising.

Educational reforms will be more effective when the Framework Law for compulsory education is approved and implemented throughout the education system.

... and more efforts are needed to enhance the scale and quality of adult training

Revamping of vocational training and lifelong learning is envisaged. Some of the framework conditions are being developed, such as the national certification system and evaluation tools. But plans to make recurrent education effective and promote lifelong learning are at a more preliminary stage. *Ongoing discussions with social partners are promising. They should lead to policy measures; thereafter, swift implementation and close monitoring of results will be key, given the importance of upskilling the existing workforce.*

The labour market performs rather well, but obstacles to job mobility should be reduced

Portugal's labour market performs rather well, coping with structural changes without a durable increase in the unemployment rate, while employment rates are higher than the European average, especially for groups typically under-represented in the labour force. This has been achieved through flexible real wage adjustment and the expansion of atypical contracts. Even so, labour mobility is low, in a context of rather restrictive employment protection legislation (EPL). The labour market is segmented: established workers who enjoy a high level of protection coexist with self employed and workers on fixed-term contracts, and informality is pervasive in certain activities. The reform to the labour legislation, which has been applied since the end of 2003, should make the labour market more responsive to both cyclical and structural forces: *i*) it should enhance the responsiveness of wage settlements to productivity and skill differentials across economic sectors; *ii*) it extends the possibility of using fixed-term contracts under certain conditions; and *iii*) it allows better control of absenteeism and fraudulent claims to sick leave. However, *the reform does not fully address the need to ease general job protection legislation. This aspect should be put back on the reform agenda, as it would help to strike a better balance between job security and increased labour mobility*. It would also facilitate hiring under permanent contracts and be conducive to higher productivity growth.

Much remains to be done to intensify the penetration of ICT and innovation…

Despite progress made in ICT access and use, Portugal is not keeping up with the rapid development of the Information Society in many other OECD countries. To some extent, measures such as upgrading human skills in the Portuguese working-age population at large and facilitating workers' mobility in the job market, will contribute to closing the gap. Complementary actions are probably still needed. *Among these, a key element would be to reduce users' costs in the telecommunication market, by enhancing competition there. Efforts to modernise management and train entrepreneurs would also contribute.*

… and efforts should continue to improve the climate for doing business and investing

Portugal's investment rate is relatively high, reflecting large inflows of EU structural funds and FDI over many years. There is a very dynamic private sector which operates in an open and competitive environment. The cost of doing business, reflecting administrative procedures, licensing, lack of transparency and predictability of tax and other regulatory obligations, was often perceived as being high (as illustrated by various indicators developed at the OECD). Administrative procedures for creating new businesses have been streamlined. However, the complexity of business taxation and regulation continue to limit private investment, inhibit entry of new firms, discourage existing profitable firms from expanding and permit unprofitable firms to survive through recourse to informal activities and non-compliance with tax obligations and regulations. Measures were introduced, starting in 2002, as part of the broad-based "Productivity and Growth Programme" to improve the business climate. In particular:

- Tax and administrative simplification is continuing, which is appropriate.
- A new incentive regime was launched in mid-2003 to foster capital formation, including through targeted tax breaks.
- The reform of the Bankruptcy Law, which was urgently needed, has been approved and should now be speedily implemented. The antiquated legal system acted as a deterrent to adequate restructuring of businesses in trouble.

The government's strategic intervention to foster investment includes commendable initiatives, for instance integrating all administrative procedures in a single agency and encouraging venture capital. However, *the government should also take steps to further reduce the number of administrative procedures, and refrain from distorting market forces through tax incentives and subsidies*. Helping a sector or a firm would set an unhelpful precedent and it would run against efforts made over past years to improve the allocation of resources by ensuring a level-playing field.

Recent steps to promote effective competition are promising: continued efforts are required

Portugal has made key advances in 2003 to promote competition, with the creation of an independent and financially autonomous Competition Authority and the approval of a new Competition Law. However, effective competition is still low in certain sectors, particularly in the network industries where prices for specific services or consumers remain relatively high.

- While furthering the process of privatization, *the state should be careful to refrain from past practices, such as retaining special voting rights in companies operating in "strategic sectors", which risks distorting or discouraging private investment to the detriment of consumers and the efficiency of the economy*.
- The creation of the Iberian Electricity Market (MIBEL), still to be implemented, is expected to improve capacity and efficiency of the electricity sector. In preparation, Portugal has further opened its retail market for electricity. *Competition issues are being examined in the European Commission to ensure that the structure of the new market be conducive to effective competition and secure reliable supply of electricity at low prices for Portuguese industry and households over the medium to long-term*.
- *The lack of competition and concomitant high prices in some fixed telecommunication services, where the incumbent retains market power, continues to require forceful action from the Competition Authority and the sector's regulator, in tandem*.

Fiscal consolidation since 2002 has been sizeable

Because the cyclically-adjusted budget position was allowed to deteriorate during the late 1990s upturn, Portugal was confronted with the need to undertake fiscal retrenchment in the downturn, after the deficit exceeded the 3 per cent limit by a wide margin. Reducing the budget deficit and ensuring sustainability of public finances over the longer-term has been the overriding policy priority since 2002, despite a weak external and domestic economic environment. The government's strategy over the past two years has included spending cuts and freezes and sizeable one-off operations, in combination with more in-depth reforms to put public finances on a sustainable basis over the longer run. The areas for reform include: public administration, the health care sector and education services and rules governing fiscal relations with sub-central governments (and autonomous funds). The government's two-pronged strategy seems appropriate. The deficit was maintained below 3 per cent in 2002 and 2003 despite the cyclical weakness. Achieving quick results through emergency cuts and one-off measures with limited demand effects has given more time for the implementation of necessary in-depth measures and for reaping the results in terms of spending control.

The medium-term deficit reduction programme is appropriate but not easy to achieve

The authorities' 2004-07 Stability Programme foresees an average annual reduction of the structural budget deficit of about ½ percentage point of GDP per year, mainly achieved through expenditure side adjustments, while the corporate income tax rate is cut by 5 percentage points in 2004 and again in 2006. This approach is in line with earlier OECD recommendations. The groundwork has been laid for long-lasting reforms with the approval of important legislation: closing down government agencies, re-allocating civil servants; rationalising the school network; raising private tuition fees in universities; promoting the use of generic pharmaceuticals; incorporating some hospitals and creating public-private partnerships in others. However, meeting the medium-term targets will not be an easy task.

- First, achieving the 2004 deficit target of 2.9 per cent of GDP is likely to require more one-off measures than budgeted. The macroeconomic scenario underlying the budget is prudent, but revenue projections that assume increased compliance appear rather optimistic. According to OECD estimates, which also envisage some slippage in current expenditure, the deficit could be about 1 percentage point higher than budgeted.

- Second, achieving a steady reduction of the structural deficit implies forceful implementation of the approved structural reforms. But there seems to have been delays in the implementation of the reforms, judging from the heavy reliance of the 2004 budget on spending freezes and one-off measures.

Implementation of the public administration reform needs to be accelerated…

Implementation needs to be accelerated, especially in some areas of public administration reform. Most of the legislation to improve human resource management has already been approved: a new organisational model for central administration, a new framework for public institutes, a new status for managers imposing performance requirements and reinforcing managerial autonomy and accountability. There have already been some achievements in terms of closure or merger of public institutes and schools and restructuring has started in two ministries. However, *implementation needs to be stepped up as enhanced effectiveness of the public administration would be a key factor in achieving the intended results in many other reform areas.* The "employment pool", created to encourage mobility of civil servants, has yet to be used on a significant scale. The legislation introducing individual contracts in the public sector, to give more flexibility to human resource management, has been approved. It is too early to judge the eventual success of these reforms, but success is crucial because public sector employment is recognised as being excessively large relative to the services provided in many areas, while staff mobility is very low.

… and to be complemented by a strong pension reform

Once fully and effectively implemented, in-depth reforms in education, health care and the public administration are likely to improve cost-effectiveness in the public sector and spending control. However they will be insufficient to meet ageing-related pressures on public finances in the longer run.

- Official simulations suggest that the expected population ageing will increase public expenditure on pensions by 2.6 percentage points of GDP by 2020. The pension system for private workers will be in deficit by 2015, thereafter financed for a further 10-15 years by the pension trust fund. The generous public sector pension regime is already in deficit.

- The pension reform initiated a few years ago with the definition of a new benefit formula for disability and old-age pensions for private sector workers will have only a minor impact on spending.
- The legislation on a second-pillar complementary regime envisaged in the framework law is still in preparation.
- Regarding the public sector regime, the changes introduced to the benefit formula in 2004 will not suffice to cope with pressures coming from the ageing population.

Therefore, a more radical reform of both the public and private employees' pension schemes is imperative. A number of options could be considered, including: incentives to raise the effective age of retirement; reducing the annual accrual rate; limiting indexation of standard pensions to inflation rather than wage developments; increasing the (low) effective rate of taxation of pension incomes; and adjusting replacement rates for changes in life expectancy [of pension cohorts]. Several of these options would probably need to be combined to significantly improve the sustainability of the pension systems.

A reform of the health care system has been launched to control cost and improve performance…

In another area, the comprehensive reform to increase efficiency of the health care system launched in 2002 should help put public finances on a sounder medium-term path. The reform has two main aims: to deliver better-quality public health services than at present but at no higher cost; and to reduce the underlying growth rate of public health-care spending over the medium term. New legislation has been approved over the last two years, including: the separation of the functions of regulation, financing and provision of health care services; setting up new models of financing for providers, which impose harder budget constraints; the introduction of incentives towards productivity, management and quality improvements in both primary health care centres and hospitals; the possibility for the private sector to play a larger role in service provision; and the promotion of generic drugs. In contrast to previous attempts of gradual reforms, which were never fully implemented, the strategy has been to create a big bang in the health sector, making reform efforts essentially irreversible.

… addressing most of the sector's weaknesses

The reform is an important step forward. It addresses the most serious weaknesses of the system identified in earlier OECD *Economic Surveys*, in particular:

- It places public providers under pressure to provide cost-effective services via changes in the way they are managed (especially with regard to organisation, budget, staff remuneration and monitoring of results).
- More than one-third of public hospitals (34, mostly medium-sized) have been incorporated. Higher production and some productivity gains seem to have been achieved already.
- A specific programme to reduce waiting lists addresses a key source of patients' dissatisfaction and of inequitable access to health care. First results show a significant reduction in waiting time, partially obscured by a concomitant increase in demand for treatment.
- The progressive strengthening of the long-term care network, which is relatively under-developed in Portugal, should help reduce the overcrowding of hospitals by (ageing) patients requiring long-term care rather than acute health care.
- The new pharmaceutical policy designed to curb expenditure (which had been growing at double digit rates over the last decade), by putting pressure on the pharmaceutical industry to reduce prices and by increasing cost sharing, has had an immediate impact. Spending decelerated in 2003 and the generic market share more than tripled, to over 6.5 per cent by early 2004, though still low in international comparison.

Implementation of this wide-ranging reform programme requires flanking measures…

Now that most legislation has been approved, the key challenges lie in its implementation and monitoring, and in consolidating recent achievements. Although short-term positive results may be easy to reach, sustained improvements will be more difficult to achieve. The reform strategy should thus be strengthened. Dissemination of information about the reform process and progress needs to be improved in order to help garner public support, and, as importantly, to facilitate external assessment of results and identify areas where corrective actions are necessary. Efforts are also needed to ensure that progress in efficiency is followed by improvements in quality of care and health outcomes, where Portugal still lags more advanced EU countries. *This calls for putting more emphasis on quality in the benchmarking of health institutions and putting in place mechanisms to avoid adverse selection practices. The regional health administrations also need to be modernised to fulfil the new tasks as purchasers of health care assigned to them in the reform. The introduction of a new independent regulatory body is an important step in the reform process. Lastly, the reform needs to be better integrated in a medium-term strategy. The National Health Plan and the programmes it contains are a possible vehicle for this but, at this stage, the articulation between the ongoing reform and this 10-year plan is not yet clear.*

... and more will have to be done to increase efficiency further and improve health status

The reform also needs to be completed by additional measures to release its full effects. In particular, to further increase efficiency and reduce current pressures on costs, the reform should:

- *seek more actively the integration of the various provider networks (primary care, hospitals, long-term care) so as to reduce wasteful duplication of acts and improve the quality of follow-up of patients across the system;*
- *put in place additional measures to tackle excessive expenditure, such as assessments of new technologies before they are generalised in public health care, measures to curb hospitals' expenditure on pharmaceuticals and additional measures to consolidate the recent slowdown of spending on drugs sold in pharmacies;*
- *consider measures to limit excessive demand for health services, for instance by increasing co-payments (with safeguards to promote equity of access) and rationalising reimbursements so as to avoid duplication of care and limit excessive requests for second or third opinions;*
- *enhance medical prevention and early detection of illnesses, which tend to improve health outcomes and to reduce costs of health care associated with late detection;*
- *consider other actions which could almost certainly improve the population's health status, with very little impact on public finances, for instance running information campaigns on the benefits of "healthy life-styles" and road security.*

Summing up

The recent downturn has been severe and the economic recovery is slow. Despite continuing fiscal consolidation efforts, keeping the budget deficit below 3 per cent in 2004 will not be easy. Forceful implementation of in-depth reforms initiated in the public administration, the health care sector and education services is required to improve spending control and deliver better outcomes. In addition, a strong pension reform is imperative to put the private and public pension systems on a financially sustainable path. The key medium-term challenge for Portugal is to close the income gap with more advanced OECD countries. A broad-based strategy has been launched to increase labour and total factor productivity. A *sine qua non* for its success is to ensure effective implementation and sustain the momentum of reform over the longer term.

1. Key challenges and issues

Overview

Portugal's key medium term challenge is to raise income levels, to close the still large gap with more advanced OECD countries. This will require policies and reforms that raise output growth in a durable way, especially via higher labour and total factor productivity. Thanks to average annual GDP growth of about 3½ per cent since the mid 1980s, Portuguese living standards have much improved. However, there have been protracted periods of weak growth when the catching-up process stopped, including the most recent downturn. At this point in time, it is hard to know how much of the ongoing weakness is cyclical and how much may be more structural. Besides the corrective measures aimed at addressing the fiscal problems, the rest of the reform agenda is as important to ensure stronger growth on a sustained basis. Stronger potential growth will also speed fiscal consolidation. The country has a number of strengths that can help in the catching-up process. However, it also has some important structural weaknesses which should shape the reform agenda.

The country faces a more urgent challenge as well: curbing the fiscal deficit and putting public finances on a sustainable path. The steady upward trend in public spending starting in the 1990s, and the speed with which the fiscal balance deteriorated after 2000 means that redressing the public accounts via emergency measures and deeper structural reforms has become a clear and continuing priority. This would have been the case even without the additional spur provided by euro-area membership obligations. Indeed, Portugal had the unpleasant experience of being the first EU member country to be submitted to the "excessive deficit procedure" by the European Commission in October 2002. A series of corrective measures have been adopted in response, but it is not clear that they will be sufficient to contain expenditure on a durable basis.

This chapter starts with a brief review of the country's main strengths and weaknesses (Box 1.1), and then analyses in some detail the key challenges currently facing the economy and elaborates on short and medium-term growth prospects.

Box 1.1. Main strengths and weaknesses of the Portuguese economy

Main strengths

A responsive labour market. The Portuguese labour market has several positive features, especially compared with many other continental European countries. Employment rates are relatively high, including among groups that are usually unemployed or not in the labour force: youths, women and older workers. Both actual and structural unemployment rates are low and there is little evidence of skill mismatch on the labour market. Real wages react flexibly to changes in demand, facilitating adjustment despite rather restrictive employment protection legislation – at least until recently. However, labour mobility is low.

High levels of infrastructure and business-sector capital stock. In part a result of co-financing via the EU structural funds, but also reflecting policy priorities, the Portuguese transport infrastructure has been much improved in the past two decades, and further progress is planned. The geographical disadvantage of being a country at the EU periphery has thus greatly lessened – and in fact peripheral EU countries have had better growth records than those at the centre in recent years. EU membership has also made Portugal an attractive destination for foreign direct investment (FDI). For several years, Portugal has had one of the highest business investment rates in Europe.

Commitment to liberalisation. The Portuguese authorities have made strong efforts to follow EU directives concerning privatisation, deregulation, etc., especially in network industries, and have a good record in this respect. There is now little direct state ownership, and there are plans to reduce further the small part that remains.

A sound financial sector. The Portuguese banking sector is healthy, there is strong competition in the commercial bank sector, but without undue risk-taking, and firms and households are not constrained by lack of access to credit on competitive terms.

Respect for the rule of law. Despite long-drawn-out judicial procedures, Portugal fares well on the usual indicators of integrity and independence of the legal system, enforceability of contracts and freedom from widespread corruption in civic and public life.

Euro-area membership. In the first half of the 1990s, the cyclically-adjusted general budget balance averaged a deficit of over 7 per cent of GDP. In the second half, it dropped to around 4 per cent. Inflation (private consumption deflator) fell from an average of 9 per cent to under 3 per cent over the same period. There were some negative transitional features: the unemployment rate rose sharply as the underlying fiscal deficit shrank, but soon fell back to earlier levels. As in other formerly high-inflation countries in the run-up to the euro, nominal and real interest rates fell to historically low levels, and remained there, spurring investment demand and permitting higher household borrowing.

Box 1.1. **Main strengths and weaknesses of the Portuguese economy** (*cont.*)

Main weaknesses

Low levels of human capital. The average number of years of education among Portuguese workers is one of the lowest in the OECD area, and younger workers have only a little more formal education than older workers, an unusual feature among OECD countries. Adult workers can also expect to receive comparatively little training when in work, especially in small firms. Portugal has typically specialised in the production of labour-intensive low value-added traditional goods. It now faces increasing competition from low-wage countries outside the OECD, as well as from the new EU members, which generally have a more highly skilled labour force.

A fragmented private business sector. Portugal has a large number of very small firms, many family-owned and run, and a small number of large firms. Medium-sized enterprises are uncommon. Entrepreneurial activity is high – Portugal had the highest entry rate for new firms among the nine countries in the OECD analysis of firm dynamics and a relatively low rate of exits. But new firms are small, and the survivors tend to grow rather little in terms of employment (as in other European countries). This pattern may reflect a reluctance on the part of the owners (who are usually actively involved in the business) to expand the firm in a context of strict or cumbersome regulations, avoiding both the risks and the rewards associated with expansion. The share of self-employment is high and informal activities are pervasive in various sectors.

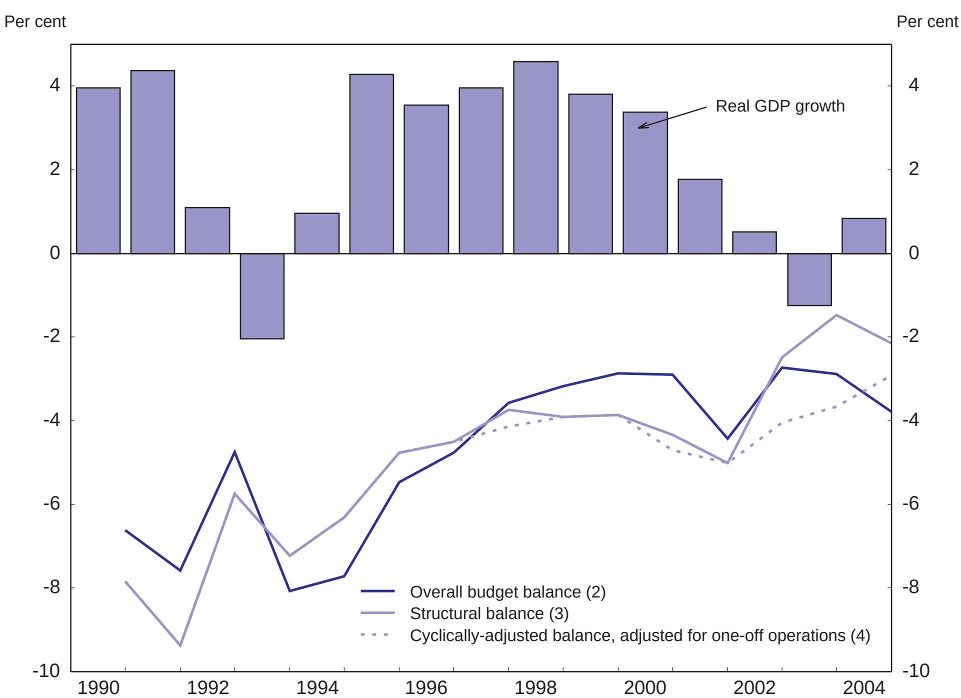
Lack of managerial and marketing skills. Measuring managerial quality is not easy, but a body of evidence suggests lack of managerial talent. The fact that a large share of firms remains small, attempting to reduce costs by means such as declaring losses for tax purposes and evading regulations, rather than productivity-enhancing practices denotes a lack of managerial ambition and talent. A relatively low use of ICT in the business sector reflects the prevalence of outdated management style, which compounds the problems arising from the low education attainment of the workforce. The comparative absence of well-known distinctively Portuguese product brands on markets in Europe (or even in Portugal itself) points to a concomitant lack of marketing skills, possibly resulting in lowered opportunities to reap economies of scale.

A bloated public sector. Available indicators point to an overly large public sector in Portugal given the quantity and quality of the services that it provides, both in the main spending areas of education and health, and in the central administration. The public sector is generally characterised by low mobility and poor human resource management.

The fiscal challenge

The weakness of public finances has been a lasting problem for Portugal. After a period of rapid decline in the general government budget deficit, from 1995 to 1997, to meet the criteria for participating in the euro area the pace of fiscal consolidation slowed considerably despite brisk growth and falling interest payments that could have permitted an acceleration of the process. Starting in 2000, in a context of weaker economic activity, it became increasingly difficult to achieve fiscal targets. The government had to rely on mid-year spending freezes and cuts, but it did not suffice to curb the widening of the deficit which, as became evident in spring 2002, had reached 4.3 per cent of GDP in 2001, making Portugal the first country to be subjected to the EU excessive deficit procedure (Figure 1.1). A drastic corrective programme was implemented, combining short-term and one-off emergency measures as well as some more structural ones. This strategy brought the deficit back below 3 per cent of GDP in 2002, but it did not succeed, in a recession

Figure 1.1. **Budget balances, 1990-2004**[1]



Note: Budget balances are measured at end-year.
1. National accounts basis. 2003 and 2004 are partly OECD estimates, as prepared for *Economic Outlook* No. 75, released on 11 May 2004.
2. As a percentage of GDP.
3. Cyclically-adjusted budget balance, as a percentage of potential GDP.
4. Budget balance excluding the cyclical effect and the impact of the non-cyclical factors, occurring only once in time, which as from 1997 have reduced the budget deficit, as a percentage of potential GDP.

Source: OECD, *Economic Outlook* No. 75 (June 2004); OECD, *National Accounts*.

context, to reduce it further. Given that spending freezes may lead to inefficiencies if maintained for too long and that there is little margin left for additional one-off measures (see chapter 3), implementation of already approved long-term measures is imperative. *Additional measures will be also needed to reduce the deficit further given spending pressures expected to arise with the ageing of the population, in the pension system and health care sectors in particular.*

The roots of the persistent weakness of public finances lie on the spending side. Public spending has been growing rapidly since the mid-1990s. Total expenditure increased by 1.3 percentage points of GDP between 1995 and 2001 while it fell by 3.6 points on average in the EU; as a result, it is now close to the EU average and much higher than in most other OECD countries. Primary expenditure rose even more quickly, by an average of 4.3 per cent annually over the same period. Spending is also high in view of relatively poor outcomes, especially as regards education (see below) and health (see Chapter 4), suggesting low efficiency. The main factors responsible for this situation have been identified in Bronchi (2003). They include flaws in the budget management process, inefficient human resource management, the limited role of private-public partnerships and out-sourcing, and inefficient local government spending. Reforms proposed in 2002 to address them were reviewed in the 2003 *Economic Survey of Portugal*. A follow up on their implementation is presented in Chapter 3.

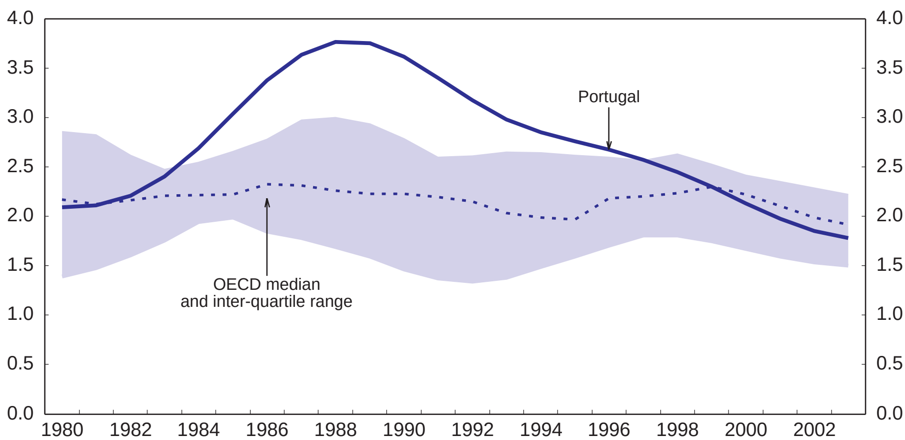
A reduction in corporate tax rates has increased competitiveness of businesses and can help attract FDI. At present, corporate tax rates are not higher than average in the EU (Figure 3.3 below), though they are generally higher than those in the new EU members from central Europe. The 2004 budget introduced a cut in the corporate income tax rate by 5 percentage points, and an additional cut is scheduled for 2006. These cuts, although desirable, will be sustainable in the medium term only if the government manages better and lasting control of public spending and more effective tax collection.

The catching-up challenge: lifting productivity growth

When Portugal joined the European Union in 1986, per capita GDP stood below 60 per cent of the average for the area; in 2002, it stood at close to 70 per cent (measured in PPP terms). Real GDP per capita grew at a respectable average of 3½ per cent per year over the period 1987-2000, following accession to the EU, significantly above the growth rates in other OECD countries during most of the period (Figure 1.2 and Figure 1.A1.1 in Annex 1.A1). Growth performance was mostly export led, and accompanied by a rapid expansion of private consumption and investment. FDI inflows rose and transport and communication infrastructure improved as a result of large-scale EU funding. A growth differential of 1 percentage point with the European average, if maintained, would imply a steady but by no means spectacular rate of real convergence.[1] In Portugal, the income gap is mostly explained by low

Figure 1.2. **Per capita GDP trend growth**[1]

Percentage changes



1. Adjusted for the economic cycle using a Hodrick-Prescott filter with lambda 100.

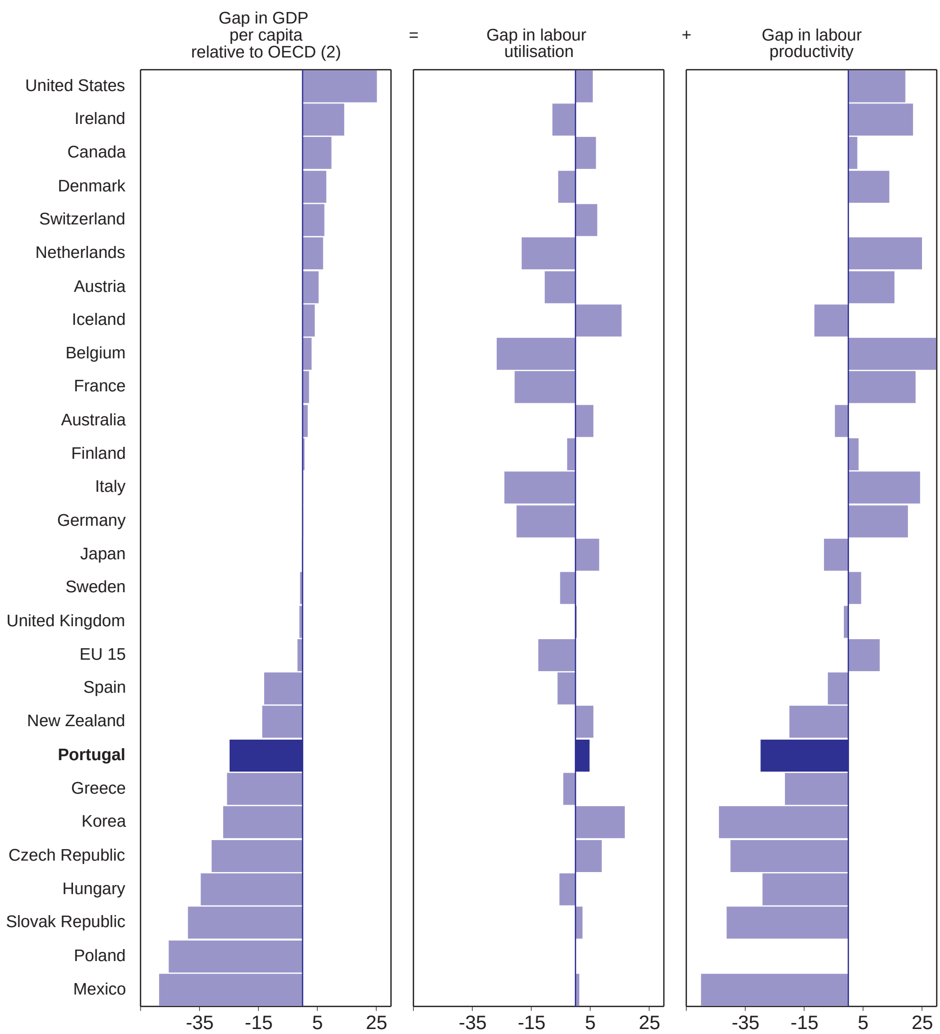
Source: OECD, *Economic Outlook 75* database.

labour productivity, as labour utilization is relatively high when compared with other European countries (Figure 1.3).

Convergence in the late 1980s and 1990s was achieved thanks to important progress in developing human and physical capital. The reform process also included measures aimed at the labour market, far-reaching privatisation, deregulation, and the liberalisation of telecommunications and the financial sector. These have already delivered notable results. The trend rate of labour productivity growth averaged 3 per cent per year in 1994-2000, well above most other OECD countries and contributed the most to income growth (Table 1.1 and Figure 1.4). But this performance weakened over the cyclical downturn that followed, productivity stagnated (measured on a per-hour basis) while it was still growing in other catching-up countries, such as Greece, the Czech Republic, Hungary, Poland and the Slovak Republic. By 2002, average productivity per person was still some 40 percentage points below the EU average and 50 points below that of the United States. And although benefits from past reforms take time, it is not clear that much productivity improvement is still in the pipeline. There is a need to deepen the reform process, even where notable advances have been achieved. And there is much unfinished business to address in a number of areas, to lift productivity more rapidly. A*reas where progress needs to continue to be made include: upgrading skills and human capital; boosting investment in new information technology; enhancing international connections to boost trade and foreign investment; and creating a more business-friendly environment for both domestic and foreign firms.*

Figure 1.3. **Breaking down the income gap**[1]

Percentage point differences in GDP per person relative to OECD, PPP-adjusted, 2002



1. See "The proximate determinants of GDP per capita" in Annex 1.A1, Table 1.A1.
2. The gap in GDP per capita is only approximately equal to the sum of the two components shown as there is a small additional demographic effect (differences in the share of population that is of working age). Productivity is measured on a per-hour basis. Differences in productivity per hour across countries should be interpreted with caution, because of the imperfect harmonisation of the measurement of hours worked.

Source: OECD, Productivity database (November 2003).

Table 1.1. **Sources of growth in real GDP per capita: selected OECD countries**[1]

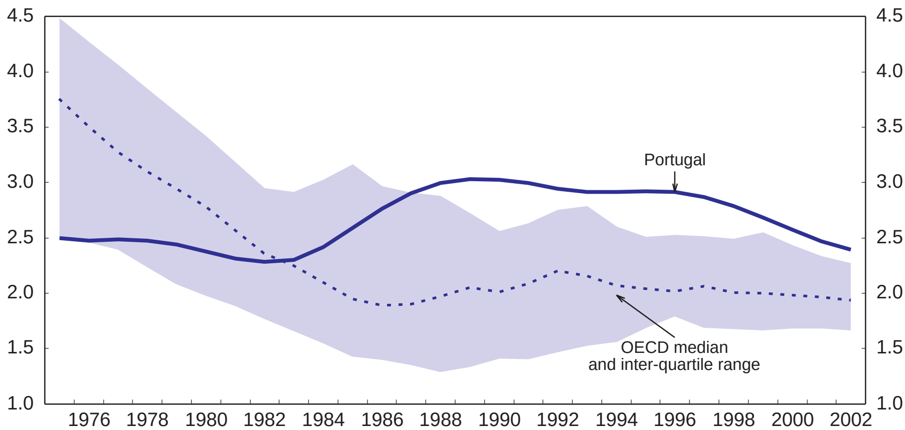
Average of annual changes in per cent

	Portugal			Greece			Ireland			Spain			Czech Republic		Hungary		Poland		Slovak Republic	
	1994/ 1987	2000/ 1994	2003/ 2000	1994/ 1987	2000/ 1994	2003/ 2000	1994/ 1987	2000/ 1994	2003/ 2000	1994/ 1987	2000/ 1994	2003/ 2000	2000/ 1994	2003/ 2000	2000/ 1994	2003/ 2000	2000/ 1994	2003/ 2000	2000/ 1994	2003/ 2000
Real GDP	3.2	3.9	0.3	1.8	3.2	4.1	4.7	9.8	4.8	2.6	3.7	2.4	2.0	2.7	3.6	3.4	5.4	2.1	4.1	4.1
Population	–0.2	0.4	0.7	0.6	0.8	. .	0.2	0.9	1.4	0.2	0.4	1.4	–0.1	–0.2	–0.1	–0.3	0.0	–0.4	0.2	. .
Real GDP per capita	3.4	3.5	–0.4	1.1	2.4	. .	4.6	8.8	3.3	2.4	3.3	1.0	2.1	2.9	3.7	3.7	5.4	2.5	3.9	. .
Labour input (hours worked)	0.7	0.5	–0.4	0.4	0.2	. .	0.5	3.3	–1.1	0.2	3.5	1.1	–0.1	–1.6	1.2	0.5	–0.2	–1.9	0.2	. .
Contribution from:																				
Working-age population (share of total population)	0.6	0.0	0.0	0.3	–0.4	. .	0.7	0.9	0.4	0.5	0.2	–0.7	0.5	0.3	0.1	0.2	0.7	0.9	0.7	. .
Labour force participation (share of working-age population)	0.8	0.4	0.7	0.2	0.6	0.2	0.1	1.7	0.1	0.3	1.8	2.2	–0.2	–0.3	–0.1	0.4	–0.6	–1.2	0.0	0.2
Employment (share of labour force)	0.1	0.5	–0.8	–0.3	–0.3	0.6	0.3	1.9	–0.1	–0.4	1.5	–0.1	–0.8	0.4	0.8	0.2	–0.3	–1.4	–1.0	0.5
Hours worked per employed	–0.8	–0.5	–0.3	0.3	–0.1	0.3	–0.7	–1.3	–1.5	–0.2	–0.0	–0.3	0.4	–1.9	0.3	–0.3	0	–0.1	0.4	–3.4
Labour productivity	2.7	3.1	0.0	0.8	2.7	3.3	4.1	5.4	4.5	2.3	–0.2	–0.1	2.3	4.6	2.5	3.2	5.6	4.4	3.8	6.9

1. Growth in real GDP per capita is decomposed into growth in labour input variables and growth in labour productivity. Growth in labour input is derived from the following identity (ET*HRS)/POP = POPT/POP*LF/POPT (participation rate) * ET/LF (employment rate)*HRS; while labour productivity is defined as: GDPV/(ET*HRS); where ET = total employment; HRS) = hours worked per employed; POP = total population; POPT = population of working age; LF = labour force; GDPV = real GDP. Data for the period 1987-1994 are not available for the Czech Republic , Hungary, Poland and the Slovak Republic. Differences in productivity measured on a per-hour basis across countries should be interpreted with caution, because of the imperfect harmonisation of the measurement of hours worked.

Source: OECD, *Economic Outlook* No. 75, May 2004 and *Economic Outlook* 75 database.

Figure 1.4. **Trend productivity growth**
Output per hour worked in the business sector[1]
Percentage changes

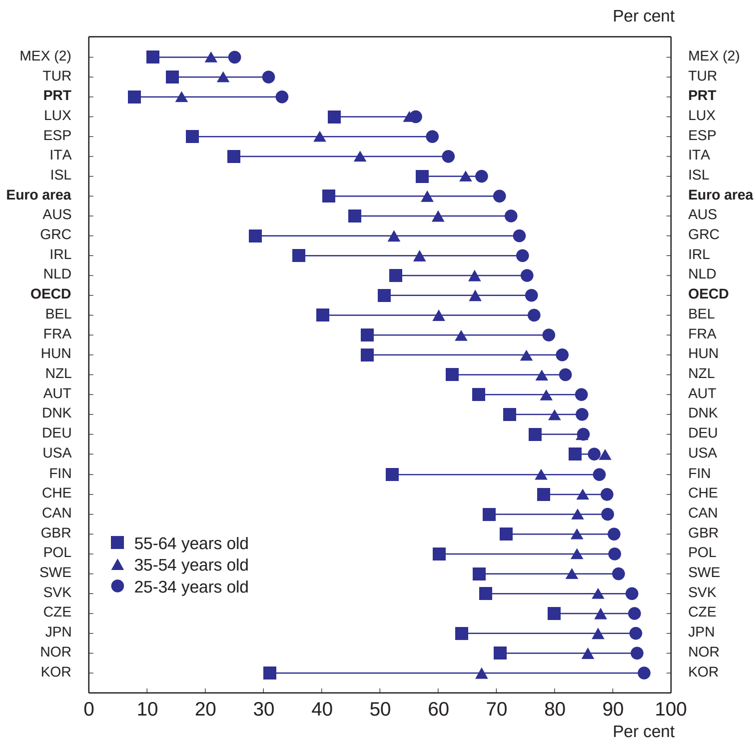


1. Adjusted for the business cycle using a Hodrick-Prescott filter with lambda 100.
Source: OECD, *Economic Outlook 75* database.

Investing in human capital

Human capital is a crucial factor of growth, both directly by improving the quality of the labour input and because it facilitates adoption of new technologies. Improving access to education has been a priority of government policies in Portugal over the past 20 years. With substantial financial support from the EU, considerable progress has been made: enrolment rates have been raised and the number of years of schooling that students in the system are expected to attend has risen by two years since the mid 1980s, almost reaching the OECD average in 2001. However, Portugal's human capital still lags *vis-à-vis* the rest of the OECD: only a third of the young adult population (25-34 age group) has reached at least an upper secondary qualification, while the proportion is above two thirds in most other OECD countries, including the new EU members (Figure 1.5).[2] Portugal's mediocre performance reflects, to some extent, the fact that progress in enrolment is relatively recent, but also high failure and drop-out rates, raising the question of the quality (and attractiveness) of schooling. In addition, those who do complete high school show some of the poorest results in terms of literacy, according to the OECD 2000 Programme for International Students Assessment (PISA) (Figure 1.6). On the combined reading literacy scale of 15-year-old students, Portugal is at the bottom of the OECD league, much below most new EU members.[3] Better educational attain-

Figure 1.5. **Educational attainment of the working-age population**[1]
Population with at least an upper-secondary qualification, 2002



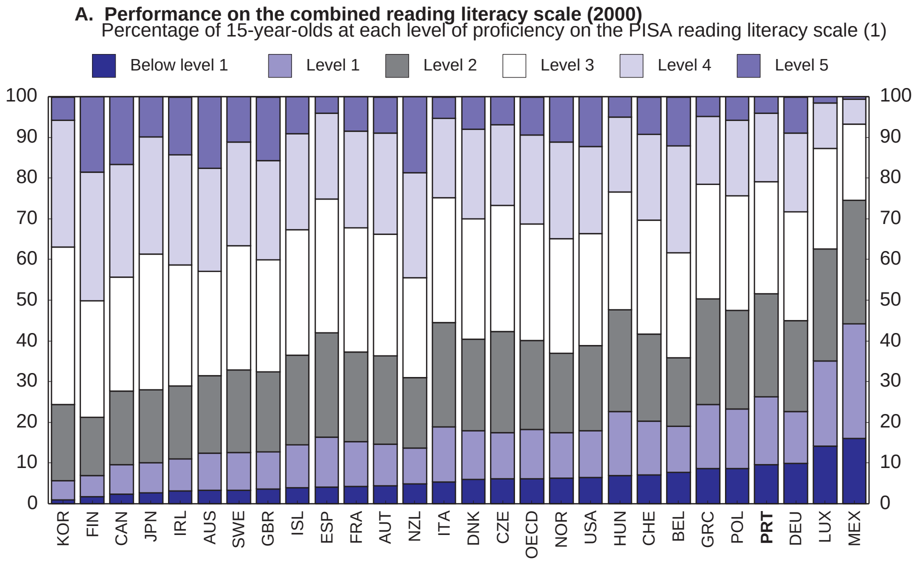
1. Per cent of each age group.
2. 2001 data.

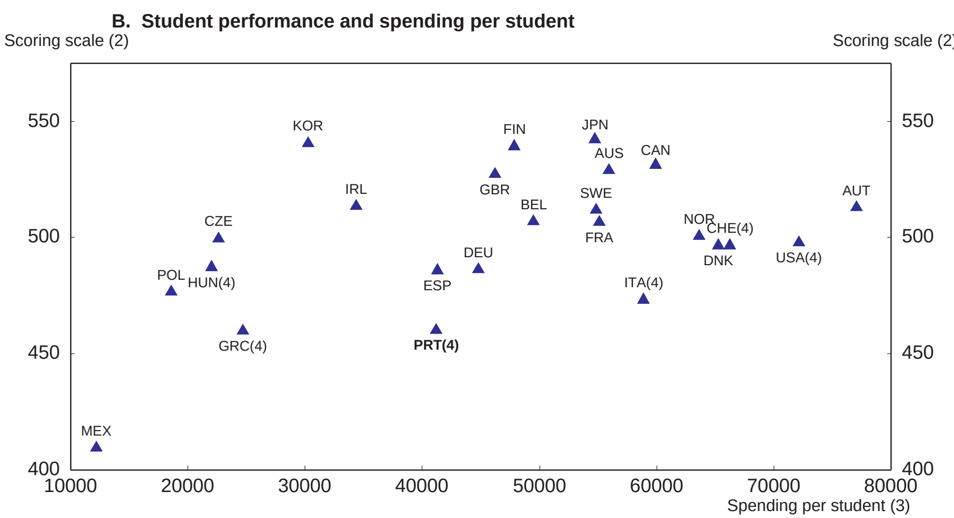
Source: OECD, Labour Market Statistics database.

ment puts countries such as the Czech Republic, Hungary, Poland and the Slovak Republic at a competitive advantage in the catching-up process.

The scale of training is insufficient, considering the low initial education of the workforce and the need for Portugal to move further into higher value-added products. Installing new equipment and adopting new technologies are easier when the workforce is more educated. Furthermore, higher skills facilitate workers' mobility, which in turn can lift productivity: more educated workers are able to move to higher productivity jobs or to positions where their productivity can grow more rapidly over time, together with better earning prospects. Participation of Portugal's adult population (age 25 to 64) in education or training is among the lowest in Europe.

Figure 1.6. **Student performance in selected countries**





1. For the definitions of levels see OECD, *Literacy Skills for the World of Tomorrow: further results from Pisa 2000* (2003).
2. Average performance across the combined reading, mathematical and scientific literacy scales in 2000.
3. Cumulative expenditure on educational institutions per students up to age 15 in USD converted using PPPs in 1999.
4. Public institutions only. For the United States public and independent private institutions only.

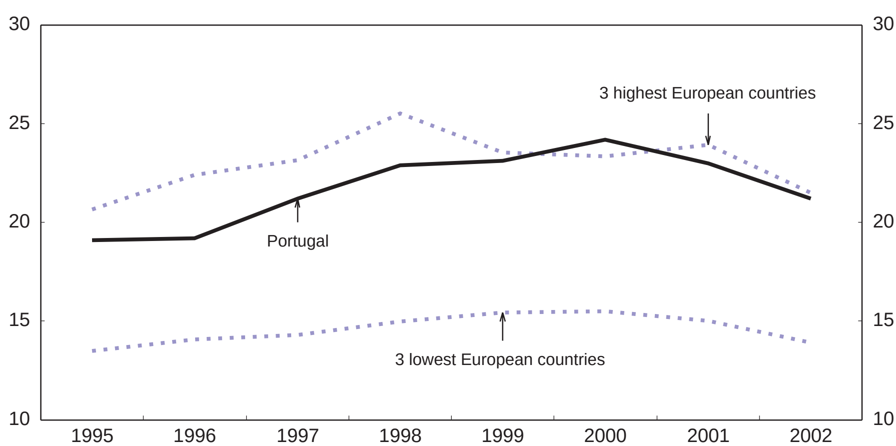
Source: OECD, *Literacy Skills for the World of Tomorrow: further results from Pisa 2000* (2003).

The challenges are thus to raise the quality of education for those who are currently in school and to train adults who have already left school. On a broad measure, Portugal appears to spend adequate resources on education, with (public) spending per student close to the European average; in particular, it spends substantially more than Hungary, Poland and the Czech Republic, but it fares worse in all the measures of education outcomes (Figure 1.6, Panel B). This might partly be because recent reforms have not yet delivered their full benefits, but it also suggests that efficiency issues deserve a prominent place in the policy agenda.[4] Indeed, the Portuguese government, aware that the remedy is not to spend more, but better, has taken important initiatives and announced further reforms in both education, vocational training and lifelong learning (Chapter 2).

Investing in physical capital

The investment rate in Portugal is among the highest in the OECD, but new investment is not sufficient in itself to ensure sustained productivity growth.[5] It also needs to be allocated to its more productive use. A substantial share of investment has gone into housing, and it cannot be excluded that investors in the business sector and managers (including the state) have not always had a sound strategic vision in guiding investment programmes.

Figure 1.7. **Fixed investment rates**
Private investment as a percentage of GDP, at current prices[1]



1. Including investment by state-owned enterprises.
Source: European Commission (Eurostat), Structural Indicators.

Portuguese ICT investment (including equipment and software) represents a much lower proportion of non-residential investment in Portugal than in most other OECD countries. Using a comprehensive measure of expenditure on ICT equipment and services, Portugal is also lagging (Figure 1.8). Portugal's poor performance in ICT investment can be related to the low proportion of skilled workers in the labour force. This combination is of particular concern given the accumulated international evidence that use of ICT is an important source of firm-level productivity growth.[6] More recent data are not available and changes are rapid in this area, but it seems unlikely that the relative position of Portugal would have changed significantly since 2001. The gap in ICT did not penalize Portugal much in the 1990s, as most of the growth recorded between 1994 and 2000 reflected mainly the labour input increase and non-ICT capital deepening. However, as shown by international evidence, ICT is likely to become a dominant factor in the acceleration of labour productivity growth over the short to medium term.[7] Aware of the importance of developing the diffusion of ICT across the economy, the Portuguese government has launched specific initiatives (Chapter 2).

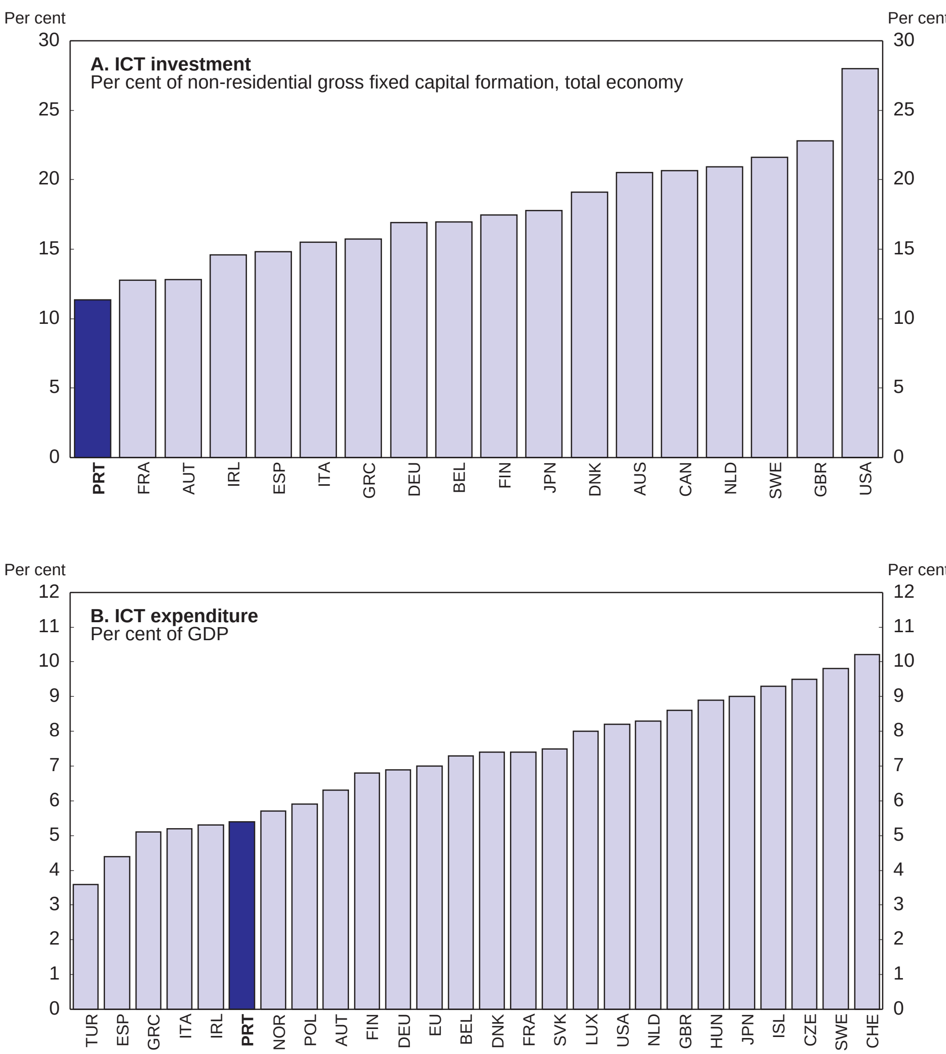
Foreign direct investment

Inward foreign investment is an important channel for knowledge spill-over, learning by doing, training of workers and saving on R&D costs. Portugal has relied on significant FDI inflows over the past, helping to diversify its productive structure and thereby broaden its export basis. The scale of gross flows has changed in nature and they are now dominated by outflows (Figure 1.9, Panel A). Since about 2000, FDI flows have largely reflected cross-shareholding in the services and network industries, between Portuguese holdings and foreign companies. For some years now, Portugal has been competing with new EU members from Central Europe to attract FDI. These have been receiving large FDI inflows, both per capita and in per cent of GDP, since the mid-1990s, showing that even before joining the EU they are already highly integrated into the EU and attractive for FDI.

Portugal's attractiveness to FDI would be enhanced by a range of actions that promote effective competition and reduce the cost of doing business. Recent OECD analysis suggests that differences in FDI positions across member countries are explained about equally by policy and non-policy factors. Basic infrastructure, transport, electricity generation and transmission, telecommunications, as well as technological capital are among the factors making a country attractive to FDI. Despite spectacular progress in developing transport infrastructures, largely financed by EU capital transfers, Portugal still lags *vis-à-vis* most other European countries (Annex 1.A1, Table 1.A1.3). Poor government efficiency and domestic product-market regulations (that impose unnecessary costs on businesses) also tend to affect FDI negatively. The complexity of the legal and administrative framework, which imposes a heavy burden on Portugal's businesses, can act as a deterrent to FDI. Seeking to

Figure 1.8. **Indicators of ICT investment and ICT expenditures**[1]

In selected OECD countries, 2001

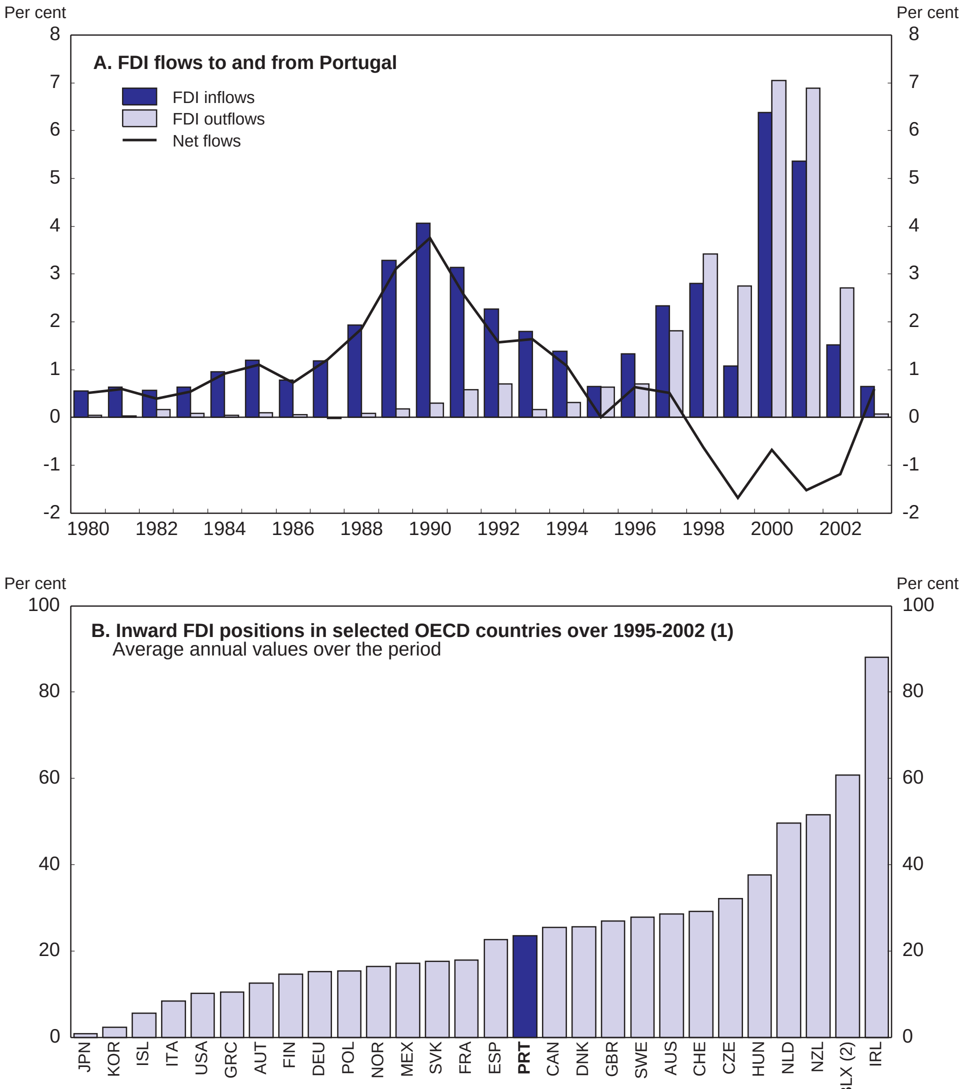


1. Information and communication technology includes office machines, data processing equipment, data communication equipment and telecommunications equipment, plus related software and telecom services. Measurement of ICT investment varies considerably across OECD countries, especially as regards investment in software, which is higher in the United States than in several OECD countries largely due to methodological reasons. These methodological issues are described in the OECD, *Science, Technology and Industry Scoreboard*, which includes several references.

Source: OECD, *Science, Technology and Industry Scoreboard*; European Commission, *2003 European Innovation Scoreboard.*

Figure 1.9. **Foreign direct investment**

Per cent of GDP



1. For details on patterns of FDI positions in OECD countries, see OECD *Economic Outlook* No. 73, June 2003, Chapter VI.
2. Belgium-Luxembourg.

Source: Bank of Portugal; UNCTAD.

increase FDI inflows, the government is taking measures in several related areas, as reviewed in Chapter 2. Ongoing efforts to improve labour force skills are also likely to affect FDI positively.

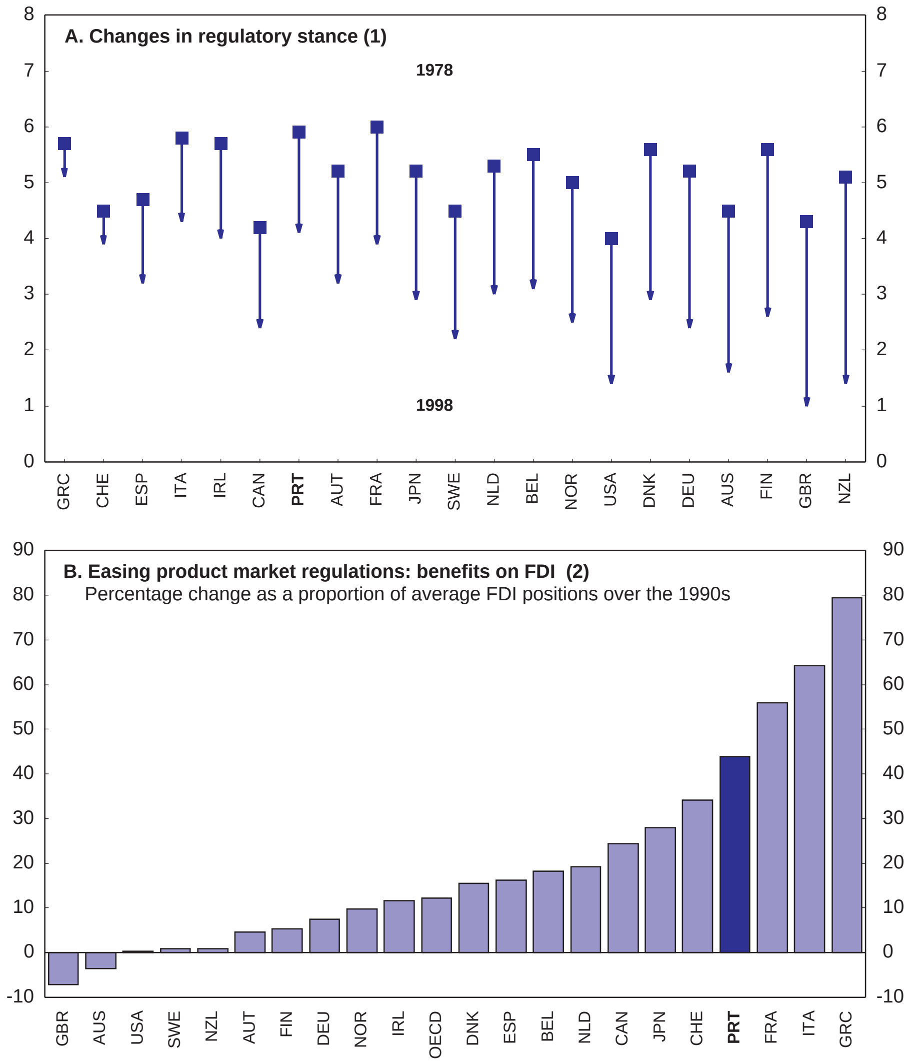
Export performance and trade specialisation

Portugal is increasingly exposed to competition from new EU members which are already well integrated in the EU for trade and FDI, as well as from other parts of the world. In the trade area, in particular, labour-intensive industries remain important, though on a lower scale than in the past. In 2002, clothing, footwear and textiles industries still accounted for about 23 per cent of manufacturing exports, compared with 40 per cent in the early 1990s. Portuguese exporters lost market shares from 1997 to 2000, with some reversal recently. A broad comparison of relative comparative advantages in Portugal and the four EU acceding countries that are OECD members suggests that trade specialisation has been evolving in a similar fashion in these countries, with a shift towards medium-high technology goods and away from labour-intensive activities, or activities based on natural resources (Annex 1.A1, Table 1.A1.2). Empirical studies suggest that the gains from EU membership for the Czech Republic, Hungary and Poland will be sizeable in terms of trade integration and FDI stocks. Trade flows for these countries are estimated to increase by over 10 per cent (both for exports and imports) and FDI inflows are estimated to double relative to average levels in the 1990s, a large part of the gains having already occurred because of the expectation of EU membership (Nicoletti *et al.*, 2003). Thus, the competitive pressures on Portugal will only strengthen over time.

Exposure of product markets to competition remains uneven

Even though trade integration and privatisation have increased competitive pressures on Portuguese producers in some sectors, there has not been much impact in others. A selective review of product market policies in OECD countries over the late 1990s and developments over the past few years suggest that Portugal could do more to keep pace with other OECD countries in easing product market regulations (Figure 1.10). As in many other OECD countries, the extent of competition is especially weak for non-manufactured products. Liberalised network industries are still largely dominated by the incumbent. In other service markets, rules and regulations are still relatively restrictive, stifling entry and business conduct. At the same time, the strength of foreign competition on these markets is low. These differences in competitive pressures may have affected productivity performance.[8] Weak competition pressure in the non-manufacturing industries is particularly problematic because high costs for the provision of services in these sectors (communications, transport, retail distribution and business services) reduce the competitiveness of downstream users. Furthermore, it also means that these sectors are under lit-

Figure 1.10. **Product market liberalisation**



1. Changes in the regulatory stance in seven non-manufacturing industries (gas, electricity, post, telecommunications, passenger air transport, railways and road freight) between 1978 and 1998. The regulatory stance is measured by a synthetic indicator ranging from 0 (least restrictive) to 6 (most restrictive). Portugal, as many other OECD countries, has taken measures since 1998 to ease some of these regulations.
2. Alignment of restrictions and regulations on those of the most liberalised OECD country.

Source: Nicoletti *et al.* (2001); Nicoletti *et al*. (2003).

tle pressure to innovate, while they would be potentially heavy users of ICT. In sum, action is called for to improve the competitiveness of Portugal, both in the manufacturing sector, where new members entering the European Union have strong competitive advantage, and outside the manufacturing sector. Aware of the need to foster investment and improve the business environment, the government's Programme for Productivity and Economic Growth P*rograma para a* Pro*ductividade e* C*rescimento da* E*conomia*, PPCE), launched in 2002, was accompanied by important initiatives to make competition policy more effective.

Short to medium-term growth prospects

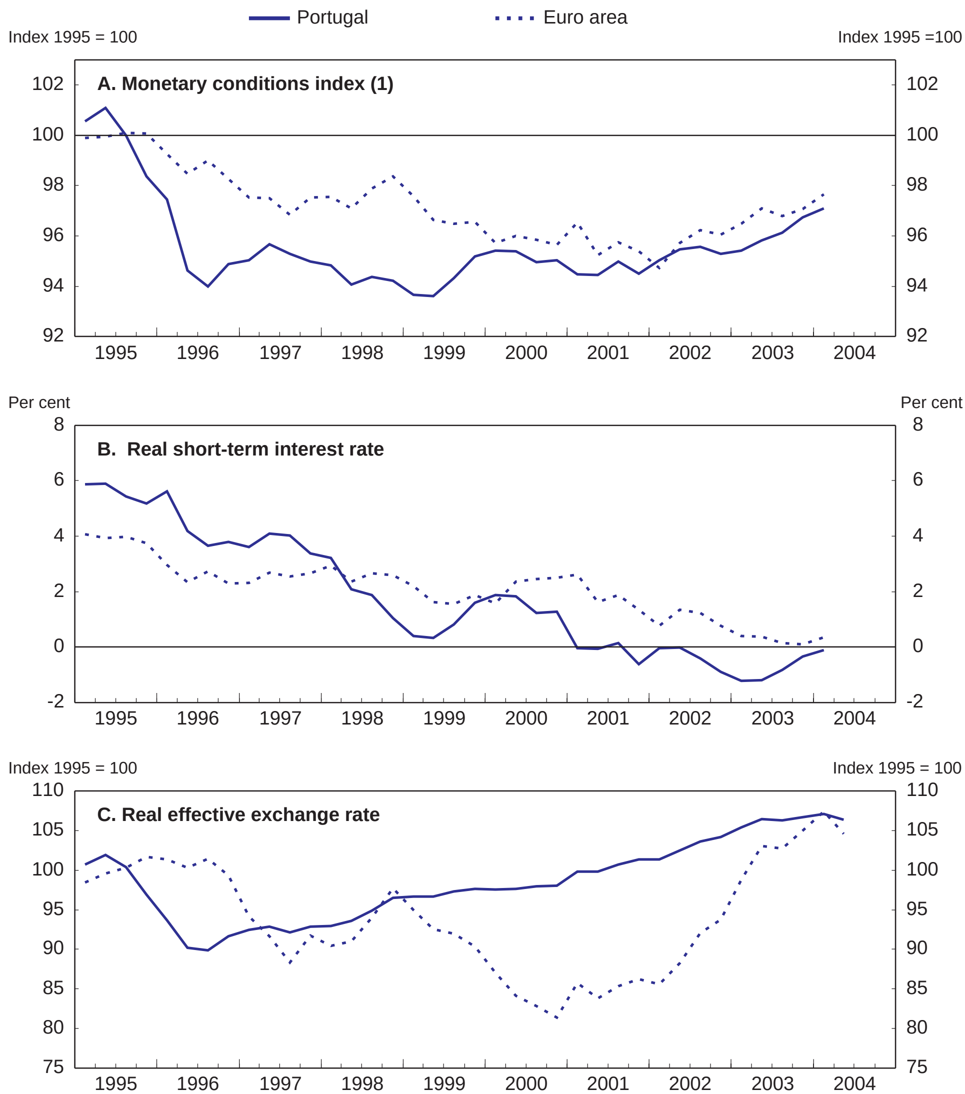
A *cyclical recovery has taken root*

T*he slowdown came later in* P*ortugal than in the rest of* EU, *but it was more pronounced*. Portugal was in recession in 2003, with GDP contracting by 1.2 per cent as falls in all domestic demand components intensified. This does not necessarily mean that the Portuguese economy has become fundamentally less resilient to shocks than its European partners. The shocks affecting the Portuguese economy have been more severe: private demand had to adjust downwards after the euphoric period that followed the entry in the EMU and led to excessive spending and indebtedness in a context of lower interest rates and a re-evaluation by agents of their permanent income. Furthermore, the fiscal stance was tightened as Portugal decided to undertake the long-needed fiscal consolidation.

M*onetary conditions have remained easy despite* the appreciation of the euro and the increase in real short-term interest rates reflecting lower inflation (Figure 1.11). By early 2004, monetary conditions were close to their early 1996 level. Banks tightened credit standards for non-financial corporations and consumer loans in early 2004. Household indebtedness continued to rise, reaching 110 per cent of disposable income in 2003.[9]

F*iscal restraint is continuing in* 2004. Public demand will contract as most spending freezes have been extended, to be phased out only later and gradually when the structural measures to curb expenditure more efficiently start having an impact. However, some support to activity will come from the corporate income tax cut of 5 points in January 2004 designed to boost investment and competitiveness. Moreover, many one-off measures adopted to curb the deficit have little demand impact. This strategy is broadly appropriate, but implementation of in-depth measures should be stepped up and further action will be needed to contain spending pressure over the medium term, as discussed in more details in Chapter 3.

Figure 1.11. **Monetary conditions**



1. The Monetary Conditions Index is defined as MCI = MCI[t – 1]*(1 + (r – r[t – 1])/100 + (e/e[t – 1] –1)/w), where:
   r is the real short-term interest rate, CPI deflated;
   e the real effective exchange rate, based on unit labour costs in manufacturing;
   1/w the weight of the exchange rate relative to the weight of the interest rate (0.40 for Portugal, 0.15 for the euro area).
   A decline of the MCI implies looser monetary conditions.

Source: OECD, *Economic Outlook 75* database; OECD*, Main Economic Indicators*.

… but the immediate outlook is for modest growth

A *gradual recovery in activity is expected, starting in early* 2004. Several of the imbalances that built up during the previous upturn have been unwound. The current account deficit continued to narrow in 2003, reaching its lowest level since 1997, reflecting both a contraction in imports and a moderate acceleration of exports in line with external markets. With employment contracting and nominal wages decelerating, inflation has slowed and unit labour costs have stabilised. By early 2004, the inflation differential with the euro area was down to ¼ percentage point. Exports are a dynamic force in the recovery, as external demand picks up.[10] Private domestic demand is expected to pick up only with a lag in Portugal, given the current levels of indebtedness of private agents and weak confidence indicators. Investment is expected to remain sluggish until 2005 (Annex 1.A1 Table 1.A1.4). Employment will recover only slowly, and wages should continue to decelerate. Overall, Portugal's GDP growth is likely to remain among the weakest in the OECD in 2004, with a negative output gap among the highest in 2005. In this context, the inflation differential *vis-à-vis* the euro area should remain around current low levels.

T*he* P*ortuguese recovery appears very dependent on the pace of the upturn in* E*urope* and the degree to which it translates into demand for Portuguese exports. In this context, it is important that wage moderation continue so as not to weigh on Portuguese competitiveness. The recovery is likely to be somewhat slower than previous ones and in 2005, for the fourth consecutive year, GDP growth is expected to be slower than in the rest of the EU, implying again a setback in the catching-up process. Potential growth rate estimates have been revised down to below 2 per cent. Although this is partly due to the specific features of the current cycle, and growth is expected to accelerate in Portugal over the following years as public and private imbalances fade away, the expected acceleration might still be insufficient to ensure rapid convergence of Portugal standards of living to its most advanced European partners. Hence, measures are needed to boost potential growth.

Growth prospects over the longer term

T*o a large extent recent and current policy initiatives have focused on redressing some of the economy's shortcomings*. Reforms are under preparation or being implemented to improve competitiveness and to ensure high sustainable growth over the medium term by raising the pace of productivity growth. At the same time, the government seeks to contain public spending growth and strengthen public finances so as to cope with pressures arising from ageing population. The details of these efforts and proposals to reinforce them are discussed in the following Chapters. Some quantitative estimates are provided below to illustrate the sizeable medium- and long-term impacts that progress on the reform agenda would have on Portugal's economic performance.

The impact of structural reforms on medium-term growth

Aligning Portugal's product market regulations to those in more lightly regulated countries would bring substantial productivity gains, as shown by the analysis in the OECD Growth Project. An example of how product market liberalisation may affect multifactor productivity in Portugal is presented in Table 1.2. The exercise assumes that product market regulations (comprising in particular privatisation; entry liberalisation and removal of industry specific barriers) become as competition-friendly in Portugal as they are in the best performing EU countries on the one hand, and in the United States on the other.[11] In the first scenario, if Portugal's product market regulations were aligned to the three best performing EU countries, it would imply an improvement in Portugal's multifactor productivity growth of about ½ a percentage point over 10 years (the sum of the three columns in Table 1.2). Under the second scenario, the alignment of Portugal's regulations to the three best performing OECD countries, which include the United States, would imply an improvement in Portugal's multifactor productivity growth of as much as 1½ percentage points over a ten-year period. All the gains in output growth come from improved productivity.

Table 1.2. **Change in productivity induced by a change in product market regulation**
By component, percentage points over a ten-year period

	Privatisation	Entry liberalisation	Industry specific barriers	Total
Convergence to 3 best EU performers	0.15	0.22	0.14	0.50
Convergence to 3 best OECD performers	0.91	0.24	0.34	1.49

Source: Nicoletti and Scarpetta (2003).

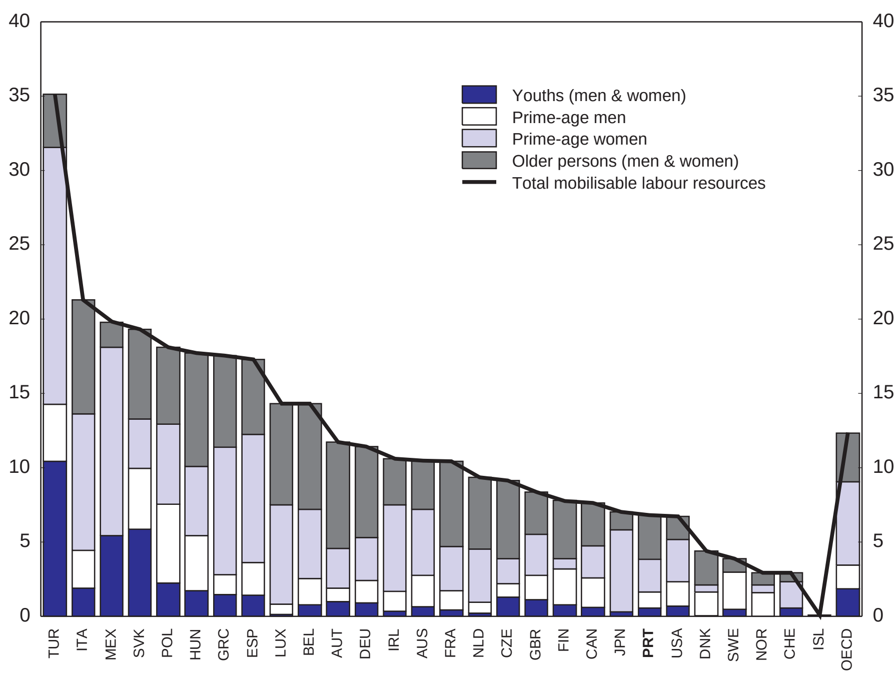
Stronger gains could be expected from reforms in education or business R&D, as suggested by other research work published by the OECD. Bassanini, Scarpetta, Hemmings (2001) show that in the OECD area, one year of extra schooling would raise the level of per capita GDP by 4 to 7 per cent over the medium term, most of the gain being achieved within 10 years. This is particularly relevant for Portugal given how far the country lags behind in the effective duration of schooling. It shows that measures, such as the ongoing ones, aimed at keeping youth in school longer and improving the quality of school education should bring substantial benefits. Work on benefits from technological catch up is also relevant for Portugal. Estimates by Bassanini and Scarpetta (2001) suggest that a persistent 0.1 percentage point increase in the share of business sector R&D spending in GDP boosts the level of per capita GDP by 1½ per cent over the medium term. Portugal lags in this area as well *vis-à-vis* the best performing EU members, and evidently the United States, with a gap in the spending ratio of 2 to 4 percentage points of GDP, so that scope for improvement appears to be large. These orders of magnitude are similar to estimates published by the European Commission (ECFIN/391/03(2003)). Thus, education, innovation and technological catch up clearly are priority areas for policy reform. Labour and product market reforms that facilitate reallocation of resources among firms and industries also have large effects on potential growth.

The scope for increasing participation rates is limited

Over the rest of the decade, increases in labour utilization are unlikely to contribute more to GDP *growth than they have in the recent past.* According to the OECD medium-term baseline scenario which covers the period to 2009, demographic developments and participation rates are projected to allow an increase in the labour force of

Figure 1.12. **Scope for raising participation rates**

Demographic composition of mobilisable labour resources,[1] percentage



1. Mobilisable labour resources are defined as the potential increase in employment that could be achieved by specific policies. For details on the calculation, see OECD *Employment Outlook* 2003. Age groups are defined as follow: youths: 15-24 years old; prime-age: 24-54 years old and older persons: 55-64 years old. Employment rate indicators by population groups are shown in Annex 1.A1 Figure 1.A1.2.

Source: OECD, *Employment Outlook* 2003.

¾ per cent annually. Policy measures in the areas of taxation, welfare and the labour market can boost employment rates or hours worked, but there appears to be little margin for raising participation rates in Portugal (Figure 1.12). Concerning the youths, most of those who are not in school are already in the workforce (Annex 1.A1 Figure 1.A1.2), so that activity rates are unlikely to increase much. Looking ahead, this age group might even be increasingly inactive, because of an increase in school enrolment, which is both expected and desirable. Concerning prime-age adults, there seems to be a small margin for additional participation of women in the 25 to 54 year age group.[12] There is also some scope for an increase in activity rates of older workers although, based on international benchmarking, it is not very large. However, the relative importance of the category of workers aged 55 to 64 years in the workforce will rise over time, so it is important that Portugal acts without delay to put in place policies to encourage future cohorts of workers to delay effective retirement. A reform of the general pension system, such as the one currently under study, would contribute to the extent that it succeeds in creating stronger disincentives for early retirement. Better health status of older population would also increase the likelihood that this population group would remain productive until retirement. A better-performing health care system in combination with healthier lifestyles, partly the result of education and information campaigns, would contribute to this outcome.

Summing up

There is scope to resume and accelerate the convergence process towards the income levels in the most advanced OECD countries, given the large gap in productivity levels between Portugal and the OECD average (or even the EU average). The various strengths and weaknesses of the Portuguese economy imply that rather little extra growth is possible from a more extensive use of labour resources overall; however, some gains are possible from a shift of labour resources from the public to the private sector over time. Hence, in order to raise living standards more rapidly towards more advanced EU levels, labour productivity needs to rise. The main reason for current low productivity levels in the private sector appears to be low levels of human capital and of technology (ICT especially), exacerbated by a scarcity of managerial skills at all levels. Policies should be directed to improving the level of education and training of the workforce over the medium term. Strengthening managerial competences and abilities to use more advanced technologies are also desirable, although a more difficult area for official policies to reach.

To improve Portugal's performance in the short and medium-term, the reform agenda cannot be postponed. Competition from the new global environment, including the enlarged EU, constitutes both a challenge and a huge opportunity. It can help gather a consensus for stepping up implementation of the measures required to modernise the country's institutional and regulatory framework. Chapter 2 deals with the catching-up challenge, focusing on policies that can raise productivity growth. The most promising strategy in this regard is to:

- Close the skill gap of the Portuguese workforce, which is still dramatic *vis-à-vis* most other OECD countries.
- Ease restrictive employment protection legislation for established workers, that creates labour market segmentation, hinders mobility and restrains technological and managerial innovation.
- Intensify the use of Information and Communication Technology.
- Create an environment where the private sector invests and innovates more.

In the near term, continuing forceful measures to prevent the budget deficit from rising are required and they should be combined with deeper structural reforms to reduce the growth of spending in the medium and longer term. Policy issues to address the fiscal challenge are discussed in Chapter 3, including the need to:

- Remain committed to fiscal stability.
- Improve cost-effectiveness of public expenditure.
- Ensure sustainability of public finances over the longer term, including through a reform of the pension system.

Finally, in Chapter 4, the *Survey* takes a selective look at health care reform, which can contribute, if successful, both to improving the health status of the population and strengthening public finances.

The Portuguese authorities have accurately identified the main challenges facing the economy. They have put in place an ambitious programme of reforms which seems to address the most serious weaknesses in the economy. In some areas, delays in reaping the benefits of the reforms will be longer than in others. *The key for the success of the government's strategy is to carry through on the reforms launched and ensure effective implementation.*

Notes

1. Portugal's GDP per capita grew by 3½ per cent per year in the latest upswing from 1994 to 2000, *i.e.* one point faster than the EU15 average. Such a growth differential would imply catching up of Portugal GDP per capita to the EU average in about 40 years (calculated in PPPs). However, since then, potential growth estimates (measured using a Hodrick-Prescott filter) have been revised down to below 2 per cent, due to the severe fall in investment during the cyclical downturn. Much of GDP growth has been concentrated on exports with a part of the associated value added going to foreign capital. But Portugal also receives sizeable net current transfers from abroad. Perhaps a clearer measure of welfare is private consumption per capita, which at more than 80 per cent of the European average, is slightly higher than Portugal's per capita GDP (Annex 1.A1 Figure 1.A1.1).
2. In 2002, the proportion of 20-24 year olds who have not gone beyond lower secondary education and are not engaged in training was among the highest in the OECD – close to 45 per cent in Portugal, compared with below 20 per cent in the OECD, with only Mexico and Turkey faring worse. OECD, *Education at a Glance* (2003).
3. Portugal ranks below the Czech Republic, Hungary and Poland. Regarding the performance under a combined scale, which also includes mathematical and scientific literacy skills, Portugal is also at the low end of OECD countries, close to Greece, and well below the Czech Republic, Hungary and Poland (Figure 1.6, Panel B).
4. Efficiency issues in the public education system are discussed in some details in C. Bronchi (2003).
5. Investment rates are measured relative to GDP at current prices. Investment by state-owned enterprises is recorded in private investment.
6. The positive effects of ICT capital investment on economic growth over the 1990s have been the largest in the United States, followed by Australia, Finland and Canada. For more details see A. Colecchia and P. Schreyer (2002). See also, *The sources of economic growth in OECD countries*, OECD 2003, Chapter I, and OECD *Economic Outlook*, No. 73, June 2003, Chapter V.
7. Total factor productivity growth in ICT-goods producing industries also has a direct impact on labour productivity growth. In this area, Portugal, although lagging in comparison to large ICT producers in Europe (Ireland for computers and Finland and Sweden for communication equipment), is in a middle position among European countries, clearly ahead for instance of countries such as the Netherlands, Denmark and Greece, which have much smaller IT goods-producing sectors.
8. OECD, *The Growth Project*, 2003; C. Gjersem (2004).
9. Households' indebtedness had reached 103 per cent of disposable income in 2002, but only 39 per cent in 1995. The share of indebtedness related to housing credit was

63 per cent in 1995; it reached about three-quarters of total household indebtedness in 2002 and in 2003.

10. According to the OECD Spring projections, in 2004, world trade growth should accelerate to 8½ per cent (up from 4½ per cent in 2003); Portugal's export market growth should reach 6½ per cent, twice the increase in 2003. OECD *Economic Outlook*, No. 75, May 2004.
11. An example for the euro area was presented in the OECD *Economic Survey of the euro area*, (2003), assuming that product market regulations become as competition-friendly in the region as a whole as they are in the three best-performing euro-area countries (and in the United States on the other hand). The exercise was not reproduced as such for Portugal, because in several areas it is one of the three best-performing countries in the euro area.
12. *Cf.* F. Jaumotte (2004).

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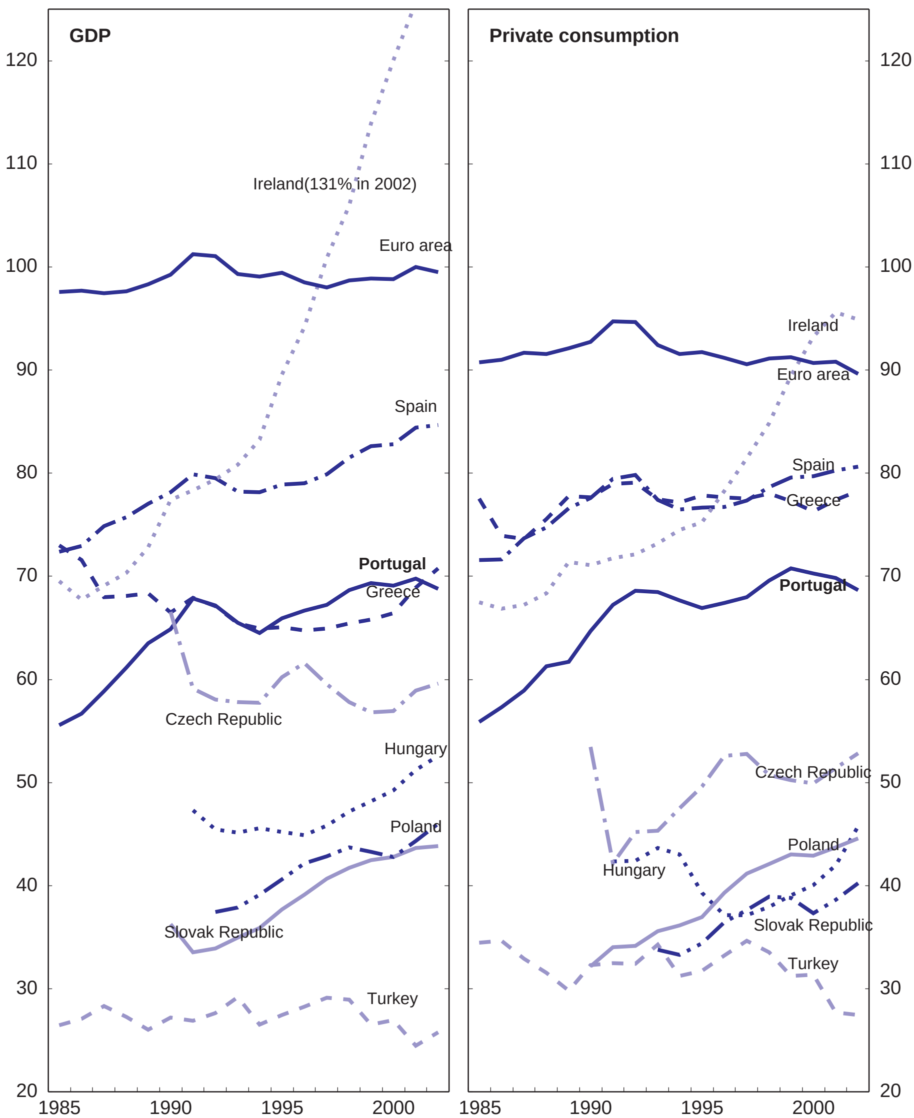
Annex 1.A1

Background information to Chapter 1

Figure 1.A1.1. **Standards of living in the OECD**

Per capita, measured in purchasing power parity exchange rates

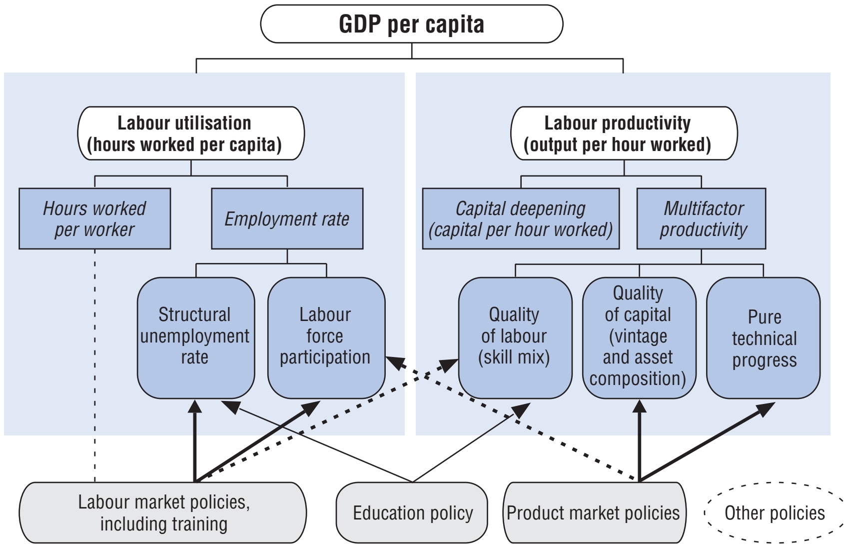
OECD[1] = 100



1. Excluding the Czech Republic, Hungary, Poland and the Slovak Republic.

Source: OECD, *National Accounts*.

Table 1.A1.1. **The proximate determinants of GDP per capita**[1]



1. The diagram only identifies the influence of policies covered in Chapter 2.
Source: OECD.

Table 1.A1.2. **Panel A. Change in the trade specialisation of Portugal**

	Main comparative advantages	RCA[1] 1993	Share of exports[2]	RCA[1] 2002	Share of exports[2]
1	84: Articles of apparel and clothing accessories	17.5	20.3	7.7	10.6
2	85: Footwear	8.8	9.6	4.7	5.7
3	78: Road vehicles	–8.9	5.3	3.6	16.1
4	63: Cork and wood manufactures (excluding furniture)	4.1	4.5	3.5	4.1
5	65: Textile yarn and related products	2.0	7.8	2.9	7.1
6	77: Electrical machinery, apparatus and appliances, n.e.s.	1.7	7.2	2.4	9.2
7	66: Non metallic mineral manufactures, n.e.s.	3.2	4.8	1.7	3.3
8	11: Beverages	2.4	3.1	1.4	2.3
9	25: Pulp and waste paper	2.2	2.3	1.4	1.5
10	64: Paper and paper manufactures	0.6	2.4	0.9	3.0
11	82: Furniture and parts thereof	0.6	1.2	0.9	1.9
12	69: Manufactures of metal, n.e.s.	0.4	2.4	0.5	3.0
13	28: Metalliferous ores and metal scrap	1.4	1.6	0.5	0.6
14	79: Other transport equipment	0.6	1.1	0.2	0.8
15	74: Other industrial machinery and parts	–1.6	2.1	–0.1	3.4
16	76: Telecommunication and sound recording apparatus	–0.4	2.8	–0.2	3.2
17	51: Organic chemicals	–0.7	1.1	–0.4	1.0
18	05: Vegetables and fruits	–0.7	1.0	–0.5	1.3
19	71: Power generating machinery and equipment	0.0	1.5	–0.9	1.0
20	03: Fish, crustaceans, molluscs and preparations thereof	–1.3	1.3	–1.2	1.2
21	89: Miscellaneous manufactured articles, n.e.s.	–1.9	1.9	–2.2	1.5
22	33: Petroleum, petroleum products and related materials	–4.1	3.4	–5.7	1.8

n.e.s. = not elsewhere specified.
1. RCA: Revealed comparative advantage indicator, $(X_i/X - M_i/M) \times 100$.
2. As a percentage of total exports in respective year.

Table 1.A1.2. **Panel B. Change in the trade specialisation of Czech Republic** (*cont.*)

	Main comparative advantages	RCA[1] 1993	Share of exports[2]	RCA[1] 2003	Share of exports[2]
1	78: Road vehicles	3.6	9.0	6.5	15.2
2	66: Non metallic mineral manufactures, n.e.s.	4.5	6.1	1.9	3.8
3	69: Manufactures of metal, n.e.s.	1.8	4.6	1.6	6.0
4	82: Furniture and parts thereof	0.3	1.5	1.6	2.6
5	62: Rubber manufactures, n.e.s.	0.0	1.0	0.9	2.3
6	74: Other industrial machinery and parts	–4.0	3.5	0.8	6.7
7	32: Coal, coke and briquettes	3.9	4.4	0.7	1.0
8	24: Cork and wood	1.3	1.7	0.7	1.0
9	81: Prefabricated buildings, sanitary, heating and lighting	1.1	1.8	0.6	1.2
10	71: Power generating machinery and equipment	1.1	2.2	0.4	3.1
11	63: Cork and wood manufactures (excluding furniture)	0.6	1.1	0.4	0.9
12	51: Organic chemicals	1.2	2.8	0.3	1.1
13	84: Articles of apparel and clothing accessories	0.8	2.4	0.2	1.5
14	65: Textile yarn and related products	2.6	4.8	0.2	3.4
15	02: Dairy products and birds' eggs	1.5	1.8	0.2	0.5
16	67: Iron and steel	6.6	10.2	0.1	3.9
17	72: Specialised machinery	–2.8	3.8	0.1	3.3
18	93: Special transactions and commodities not classified	1.1	1.7	0.0	0.0
19	85: Footwear	0.7	1.5	–0.2	0.3
20	28: Metalliferous ores and metal scrap	0.0	1.5	–0.2	0.6
21	89: Miscellaneous manufactured articles, n.e.s.	0.5	4.3	–0.3	4.6
22	73: Metal working machinery	0.4	1.7	–0.3	1.0
23	64: Paper and paper manufactures	–0.4	1.5	–0.4	1.7
24	57: Plastics in primary forms	0.2	1.6	–1.1	0.9
25	77: Electrical machinery, apparatus and appliances, n.e.s.	–1.6	4.1	–1.7	10.1
26	33: Petroleum, petroleum products and related materials	–6.0	1.1	–3.4	0.9

See notes on Panel A.

Table 1.A1.2. **Panel C. Change in the trade specialisation of Hungary** (*cont.*)

	Main comparative advantages	RCA[1] 1993	Share of exports[2]	RCA[1] 2002	Share of exports[2]
1	76: Telecommunication and sound recording apparatus	–0.3	2.7	9.4	15.6
2	71: Power generating machinery and equipment	–0.3	1.4	5.7	10.9
3	84: Articles of apparel and clothing accessories	6.5	9.1	2.1	3.7
4	01: Meat and meat preparations	6.0	6.3	1.7	1.9
5	82: Furniture and parts thereof	0.6	1.6	1.1	2.0
6	04: Cereals and cereal preparations	0.9	1.3	1.0	1.2
7	05: Vegetables and fruits	4.2	5.0	0.9	1.5
8	78: Road vehicles	–0.6	6.4	0.6	8.7
9	85: Footwear	1.8	2.8	0.4	1.0
10	22: Oil seeds and oleaginous fruits	0.9	1.0	0.4	0.4
11	00: Live animals other than animals of division	1.3	1.4	0.3	0.4
12	51: Organic chemicals	0.9	3.4	0.3	1.5
13	11: Beverages	1.8	2.0	0.2	0.3
14	28: Metalliferous ores and metal scrap	1.5	1.7	0.1	0.4
15	57: Plastics in primary forms	1.9	3.2	0.1	1.4
16	29: Crude animal and vegetable materials, n.e.s.	0.7	1.1	0.1	0.3
17	89: Miscellaneous manufactured articles, n.e.s.	–1.1	1.9	0.0	3.7
18	24: Cork and wood	0.4	1.2	–0.1	0.4
19	79: Other transport equipment	–6.5	1.5	–0.1	0.3
20	87: Professional and scientific instruments, n.e.s.	–0.8	1.0	–0.2	1.3
21	66: Non metallic mineral manufactures, n.e.s.	0.9	2.3	–0.5	1.1
22	68: Non-ferrous metals	0.1	2.2	–0.5	1.5
23	59: Chemical materials and products, n.e.s.	–0.8	1.0	–0.7	0.6
24	54: Medicinal and pharmaceutical products	0.2	2.8	–0.8	1.4
25	67: Iron and steel	1.3	3.5	–0.9	1.1
26	72: Specialised machinery	–1.5	2.0	–1.1	1.6
27	69: Manufactures of metal, n.e.s.	0.4	3.0	–1.3	2.1
28	65: Textile yarn and related products	–3.0	2.3	–1.7	1.3
29	33: Petroleum, petroleum products and related materials	–4.2	3.6	–2.0	1.5
30	74: Other industrial machinery and parts	–1.9	2.6	–2.5	3.0
31	77: Electrical machinery, apparatus and appliances, n.e.s.	1.6	6.8	–5.7	11.2

See notes on Panel A.

Table 1.A1.2. **Panel D. Change in the trade specialisation of Poland** (*cont.*)

	Main comparative advantages	RCA[1] 1993	Share of exports[2]	RCA[1] 2002	Share of exports[2]
1	82: Furniture and parts thereof	3.6	4.1	6.3	7.0
2	84: Articles of apparel and clothing accessories	9.8	11.2	3.2	4.7
3	79: Other transport equipment	5.1	5.4	3.1	6.5
4	71: Power generating machinery and equipment	0.0	1.5	2.8	5.3
5	32: Coal, coke and briquettes	8.0	8.1	2.6	2.9
6	63: Cork and wood manufactures (excluding furniture)	1.7	2.0	1.9	2.5
7	69: Manufactures of metal, n.e.s.	1.6	3.9	1.7	5.4
8	68: Non-ferrous metals	5.7	6.7	1.3	3.0
9	05: Vegetables and fruits	2.3	3.8	1.0	2.4
10	01: Meat and meat preparations	0.4	1.3	0.7	0.9
11	02: Dairy products and birds' eggs	1.0	1.6	0.6	0.7
12	77: Electrical machinery, apparatus and appliances, n.e.s.	–0.8	4.3	0.5	7.4
13	66: Non metallic mineral manufactures, n.e.s.	1.2	2.8	0.4	2.3
14	24: Cork and wood	1.9	2.0	0.4	0.6
15	64: Paper and paper manufactures	–1.4	1.0	0.4	3.3
16	78: Road vehicles	–0.3	5.2	0.4	9.2
17	28: Metalliferous ores and metal scrap	–0.3	1.1	0.3	0.8
18	00: Live animals other than animals of division	1.0	1.2	0.3	0.3
19	85: Footwear	0.7	1.3	0.1	0.7
20	52: Inorganic chemicals	0.7	1.2	0.1	0.5
21	27: Crude fertilisers other than division 56, and crude minerals	0.4	1.1	–0.2	0.2
22	89: Miscellaneous manufactured articles, n.e.s.	–2.6	1.8	–0.3	3.3
23	51: Organic chemicals	–0.3	1.5	–0.5	1.0
24	67: Iron and steel	4.4	6.7	–0.5	2.6
25	72: Specialised machinery	–2.7	2.0	–1.5	1.8
26	74: Other industrial machinery and parts	–3.8	1.9	–2.3	3.0
27	65: Textile yarn and related products	–5.1	2.2	–2.7	2.3
28	54: Medicinal and pharmaceutical products	–2.0	1.5	–3.3	0.5

See notes on Panel A.

Table 1.A1.2. **Panel E. Change in the trade specialisation of the Slovak Republic** (*cont.*)

	Main comparative advantages	RCA[1] 1997	Share of exports[2]	RCA[1] 2002	Share of exports[2]
1	78: Road vehicles	0.5	20.0	8.4	10.5
2	67: Iron and steel	9.9	8.2	5.4	13.2
3	84: Articles of apparel and clothing accessories	4.0	4.4	3.0	5.3
4	82: Furniture and parts thereof	1.3	3.4	2.2	1.9
5	64: Paper and paper manufactures	2.0	3.7	1.5	3.8
6	62: Rubber manufactures, n.e.s.	1.6	2.6	1.3	2.3
7	85: Footwear	1.1	2.0	1.3	1.9
8	24: Cork and wood	1.9	1.3	1.2	2.0
9	66: Non metallic mineral manufactures, n.e.s.	1.8	2.4	0.8	3.2
10	68: Non-ferrous metals	1.7	2.2	0.7	3.3
11	51: Organic chemicals	0.5	1.9	0.4	2.6
12	57: Plastics in primary forms	1.3	1.5	0.2	2.3
13	79: Other transport equipment	1.3	1.0	0.0	2.6
14	58: Plastics in non-primary forms	0.2	0.8	–0.4	1.4
15	73: Metal working machinery	–0.2	0.8	–0.5	1.0
16	69: Manufactures of metal, n.e.s.	0.3	3.5	–0.6	3.3
17	77: Electrical machinery, apparatus and appliances, n.e.s.	–1.0	7.2	–0.7	5.4
18	74: Other industrial machinery and parts	–2.0	4.3	–0.7	2.9
19	76: Telecommunication and sound recording apparatus	–1.6	1.8	–1.0	1.6
20	72: Specialised machinery	–1.6	1.7	–1.2	2.3
21	89: Miscellaneous manufactured articles, n.e.s.	–0.8	2.5	–1.3	2.6
22	71: Power generating machinery and equipment	–0.4	2.0	–1.3	1.7
23	65: Textile yarn and related products	0.0	2.7	–1.4	3.5
24	33: Petroleum, petroleum products and related materials	–2.5	5.2	–1.6	4.4
25	54: Medicinal and pharmaceutical products	–1.5	0.9	–2.0	1.5

See notes on Panel A.
Source: OECD, *Annual Foreign Trade Statistics*.

Table 1.A1.3. **Indicators of infrastructure**

Panel A. Composite index of transport infrastructure[1]

United States 1995 = 100

	1980	1990	2000
Australia	68	60	70
Austria	29	34	62
Belgium	25	34	66
Canada	101	89	86
Czech Republic	12	9	14
Denmark	40	51	79
Finland	36	45	62
France	21	31	47
Germany	17	25	36
Greece	29	34	37
Hungary	11	13	21
Iceland	26	33	74
Ireland	18	48	83
Italy	19	21	27
Japan	18	19	22
Korea	4	7	12
Mexico	7	6	8
Netherlands	29	33	46
New Zealand	45	57	82
Norway	40	53	84
Poland	3	2	3
Portugal	**9**	**13**	**41**
Spain	18	28	53
Sweden	42	63	78
Switzerland	60	74	110
Turkey	4	4	7
United Kingdom	23	31	37
United States	77	87	102

1. The indicator covers the length of motorways per capita and aircraft departures per capita.

Table 1.A1.3. **Indicators of infrastructure** (*cont.*)

Panel B. Composite index of telecommunications infrastructure[2]

United States 1995 = 100

	1980	1990	2000
Australia	58	69	116
Austria	55	66	114
Belgium	54	72	104
Canada	65	90	116
Czech Republic	36	39	88
Denmark	68	84	126
Finland	59	79	128
France	59	88	115
Germany	58	71	100
Greece	40	51	103
Hungary	27	31	84
Iceland	57	78	123
Ireland	47	67	111
Italy	50	68	113
Japan	63	79	119
Korea	40	66	105
Mexico	35	45	76
Netherlands	63	78	115
New Zealand	53	75	98
Norway	57	82	133
Poland	24	27	70
Portugal	**34**	**50**	**104**
Spain	47	62	105
Sweden	79	98	140
Switzerland	66	82	111
Turkey	26	44	71
United Kingdom	59	79	116
United States	69	89	116

2. The indicator includes the numbers of mainlines and of mobile phones per capita, the share of digital lines as a per cent of total lines, answer seizure ratios and fault clearance rates.

Table 1.A1.3. **Indicators of infrastructure** (*cont.*)

Panel C. Composite index of electricity infrastructure[3]

United States 1995 = 100

	1980	1990	2000
Australia	90	97	100
Austria	67	70	75
Belgium	80	83	84
Canada	88	96	93
Czech Republic	76	76	78
Denmark	74	79	79
Finland	78	85	89
France	76	82	84
Germany	80	81	81
Greece	86	84	90
Hungary	76	76	75
Iceland	87	91	101
Ireland	70	76	81
Italy	76	83	83
Japan	87	93	94
Korea	81	81	83
Mexico	79	79	77
Netherlands	76	78	83
New Zealand	89	92	92
Norway	97	105	107
Poland	73	76	73
Portugal	**77**	**79**	**74**
Spain	74	80	82
Sweden	87	93	94
Switzerland	78	83	83
Turkey	77	73	75
United Kingdom	79	81	81
United States	93	98	101

3. The indicator includes measures of transmission efficiency, generating capacity per capita and reserve margin.
Source: Nicoletti, G. S. Golub, D. Hajkova, D. Mirza and K. Yoo (2003, *op. cit.*).

Table 1.A1.4. **Short-term projections**

	2000	2001	2002	2003	2004	2005
	Current prices billion €		Percentage changes, volume (1995 prices)			
Private consumption	71.6	1.2	0.5	–0.8	1.5	2.4
Government consumption	23.7	3.3	2.7	–0.6	–1.0	–0.6
Gross fixed capital formation	32.4	0.7	–5.2	–9.6	1.8	6.2
Final domestic demand	127.7	1.4	–0.5	–2.9	1.1	2.7
Stockbuilding[1]	0.8	0.0	0.0	0.0	0.0	0.1
Total domestic demand	128.5	1.4	–0.5	–2.9	1.2	2.8
Exports of goods and services	36.4	2.0	2.6	3.9	5.2	6.4
Imports of goods and services	49.4	1.0	–0.5	–1.0	5.2	6.5
Net exports[1]	–13.0	0.2	1.1	1.8	–0.4	–0.6
GDP at market prices	115.5	1.8	0.5	–1.3	0.8	2.4
GDP deflator	_	4.4	4.7	2.3	2.2	1.7
Memorandum items						
Harmonised index of consumer prices	_	4.4	3.7	3.3	2.0	1.7
Private consumption deflator	_	3.9	3.6	3.4	1.9	1.8
Unemployment rate	_	4.1	5.1	6.4	6.6	6.1
Household saving ratio[2]	_	11.5	12.4	12.5	12.3	11.8
General government financial balance[3]	_	–4.4	–2.7	–2.9	–3.8	–3.2
Current account balance[3]	_	–9.5	–6.7	–5.1	–4.6	–5.0

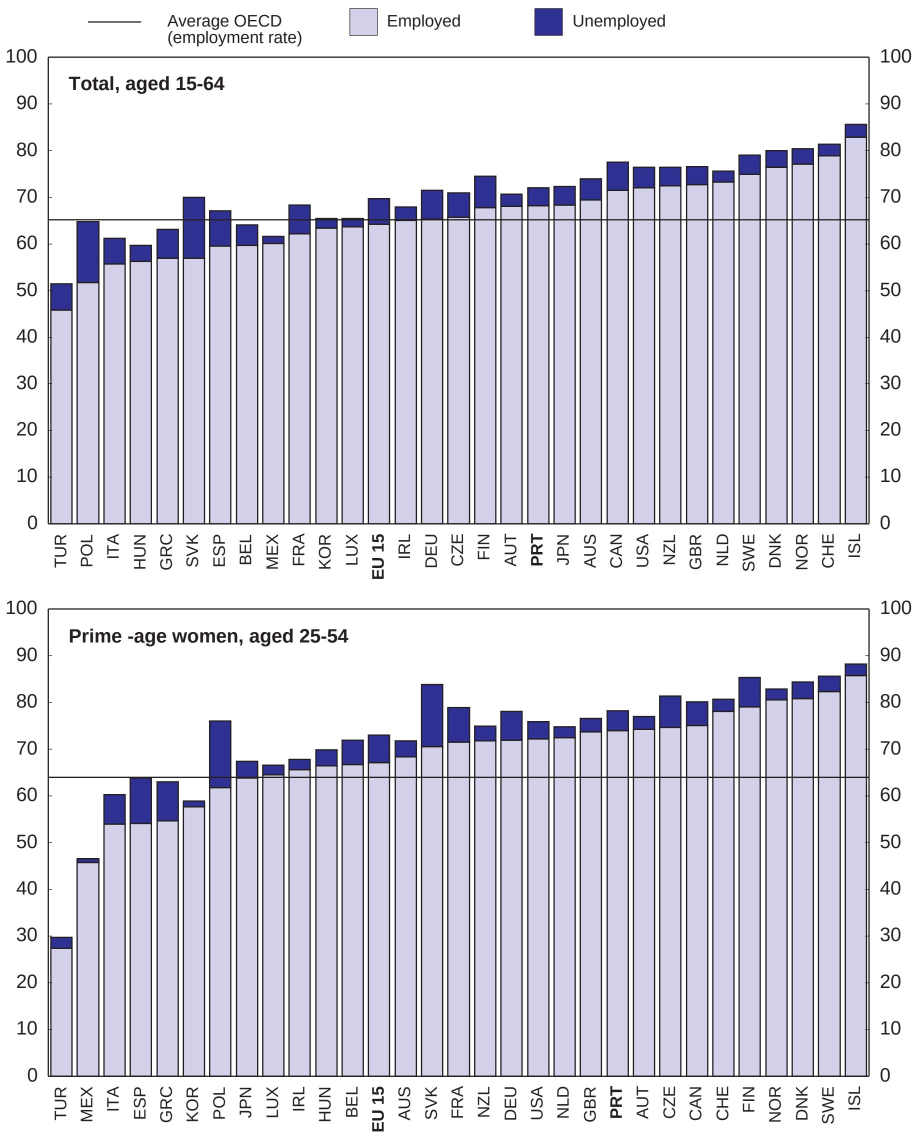
Note: The cut-off date for information used in the compilation of the projections is 21 April 2004. More recent data show a decline of 1.2 per cent in real GDP in 2003. Data in previous years were also revised somewhat.

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of disposable income.
3. As a percentage of GDP.

Source: OECD *Economic Outlook* No. 75.

Figure 1.A1.2. **Employment rate indicators**

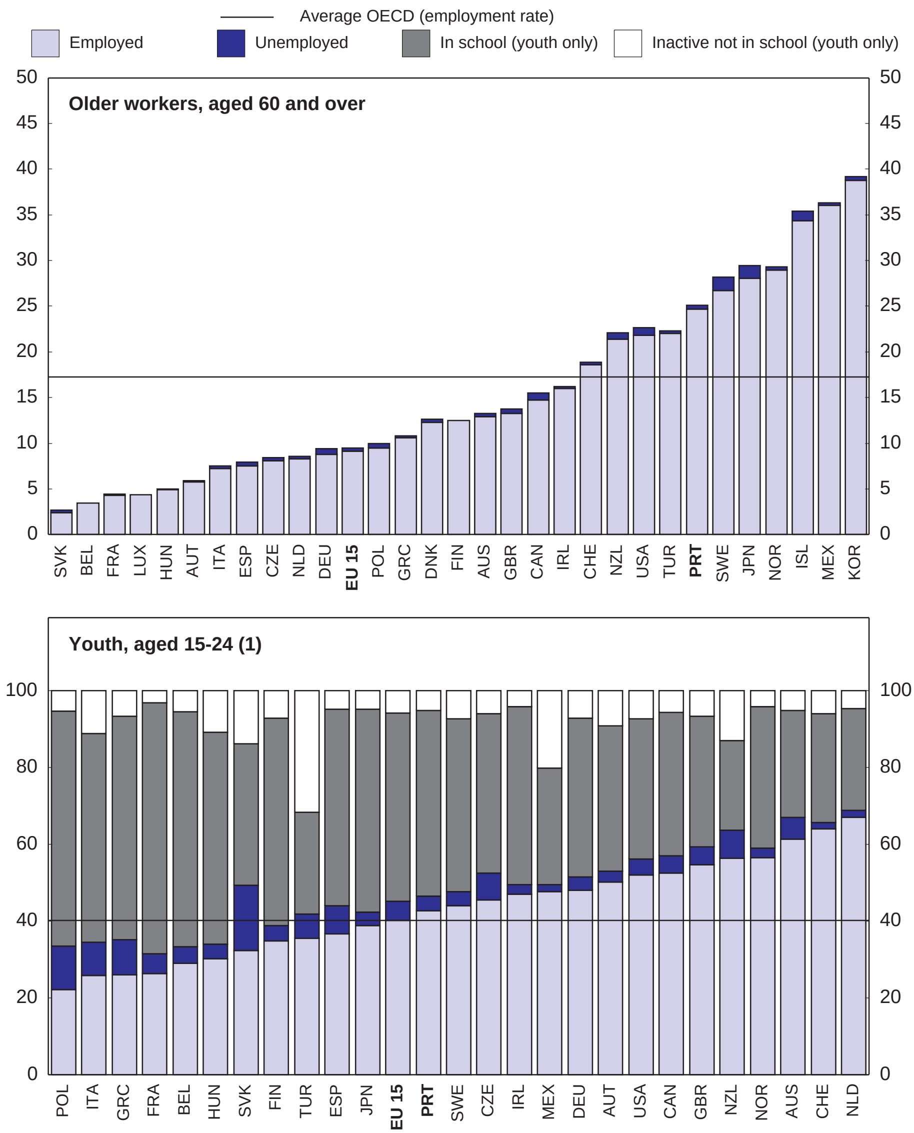
Percentages of the indicated groups, in 2002



Source: OECD, Labour Force Statistics database.

Figure 1.A1.2. **Employment rate indicators** *(cont.)*

Percentages of the indicated groups, in 2002



1. 2001. OECD and EU 15 refer to population-weighted average for the available countries.

Source: OECD, Labour Force Statistics database.

Box 1.A1.1. The EU cohesion policy

The instruments of Cohesion policy

Cohesion policy, which aims at convergence of lagging countries and regions, is implemented through *two main instruments*: structural funding and the more recent Cohesion Fund.

i) *The Structural Funds*, which have been in place since the creation of the European Community, represent by far the largest share of the budget allocated to cohesion policy. They typically had both a regional focus (to develop lagging regions) and a horizontal focus (to facilitate the adaptation of workers to changes).* With the Agenda 2000 package, for the period 2000-06, an effort of simplification has been made and the structural funds now follow three main objectives:

1. Development and structural adjustment of lagging regions – 70 per cent of the Structural Funds.
2. Development of border regions and regions in industrial decline.
3. daptation and modernisation of education and training systems.

ii) The other main pillar of cohesion policy, the *Cohesion Fund* was introduced in 1993, with a clear national focus, rather than a regional one, to provide financial support specifically to the least prosperous member countries (Greece, Ireland, Portugal and Spain), whose GDP per capita was then lower than 90 per cent of the EU average, by funding investment projects for environment and transport infrastructure.

The combination of the various instruments has meant that countries with a similar level of national GDP, such as Sweden and Italy, for instance, have received very different shares of EU funds, depending on regional inequalities.

The overall budget for cohesion policy

The overall budget for cohesion policy amounts to 213 billion euros over the period 2000-06. The major part (195 billion euros) is allocated to the Structural Funds; while 18 billion are allocated to the Cohesion Fund for Greece, Portugal, Spain (and Ireland until 2003 only). Under Agenda 2000, budgetary resources allocated to each member state will not be modified, over the period 2000-06. However the overall resources will increase by 22 billion euros earmarked for the new member countries in 2004-06.

Portugal will have received substantial transfers, equivalent to some 2.6 per cent of GDP each year from 1989 to 2006. The transfers under Community Support Frameworks (CSF) I and II, which covered the 1989-1999 period, have allowed important infrastructure development in transportation and increasingly in environment-related infrastructure (water supply, water treatment and sewage). Under CSF III (2000-06), 23.8 billion euros are to be provided to Portugal, equivalent to about 3 per cent per year of GDP. A special focus is put on the development of information and communication technology (ICT). Investment projects, co-financed by CSF III funds are expected to represent about one fifth of total investment, a sizeable amount being earmarked for transport infrastructure.

Box 1A1.1. **The EU cohesion policy** (*cont.*)

Looking ahead

Structural funds are not expected to shrink for the existing member countries under the 2000-06 agenda, but they might come down in the longer run as a result of the EU enlargement, unless eligibility criteria for the different funds are modified. By then, the decline in resources from EU transfers into Portugal will have to be offset by other sources of funding for investment, private investment especially. But also the real convergence of Portugal is expected to be more advanced, so that investment needs would be comparable to those of its more advanced EU partners.

* The previous packages (Delors I and Delors II packages, corresponding to Community Support Frameworks I and II) covered the period 1989-93 and 1994-99, respectively. Prior to 1989, Cohesion Policy was financially much smaller and rather unstructured.

2. Structural policies to lift Portugal's living standards

The authorities have undertaken a wide range of reforms to improve competitiveness and ensure faster growth to lift Portugal's living standards. Given Portugal's already high degree of labour utilisation, the most promising way of closing the gap in per capita income with more advanced countries more rapidly is by raising productivity growth. The enlargement of the EU opens new opportunities for Portugal, provided measures are taken to meet the competition from the newcomers. The government's policy agenda for growth, designed against the background of the Lisbon strategy, is at different stages of implementation. It includes:

- a Framework Law on compulsory education, being legislated in mid-2004; reforms of secondary and tertiary education, starting to be implemented;
- a new Labour Code, implemented as from December 2003, with related regulations;
- new institutional settings and legislation for competition policy;
- the further development of infrastructures; an agreement for the creation of an Iberian electricity market; more specific measures to support investment and help small and medium size enterprises, as identified in the Programme for Productivity and Economic Growth (PPCE);
- changes to legislation and regulations to facilitate firm creation and exit (*i.e.* the new bankruptcy law and the venture capital regime).

This chapter focuses on selected policies identified in Chapter 1 as the most promising to achieve faster productivity growth, in particular those aimed at: *i*) further developing human capital and speeding up the transition to a knowledge-based economy; *ii*) facilitating labour market mobility in response to shifts in costs and demand; *iii*) a broad-based approach to improve the level of competition in the economy, building on recent efforts to improve the institutional setting and legal framework; and *iv*) reducing the cost of doing business in Portugal, to enhance firm dynamism. A synthesis of the main recommendations for reform is presented in Box 2.4 at the end of this chapter.

A broad-based strategy to upgrade knowledge and skills

Reforms in the education sector

The combination of relatively poor student performance with an average level of spending per student, underlined in Chapter 1, points to the need to undertake measures that can both improve the quality of outcomes and the efficiency of the schooling system.[1] The authorities are aware that immediate policy attention is needed. A framework law for education was approved in May 2004, setting the principles of the reform of compulsory schooling (age 6 to 15). It is aimed at improving the quality of schooling, including by integrating the various cycles of basic education, by revising the curriculum, and establishing national examinations at various stages. But the regrouping of schools has started and a comprehensive evaluation system of all non-tertiary schools is being developed. The reform of upper secondary education was approved at the start of 2004, and several initiatives have already been taken: *i)* administrative reorganisation and rationalisation of the supply of education services to address inefficiencies; *ii)* modernisation of the curricula; *iii)* introduction of national examinations; and *iv)* implementation of school evaluations. The main objective is to raise the quality of teaching, reduce the number of dropouts and early school leavers and ensure that those who finish school are properly prepared to enter the job market. A target was set for the reduction in the proportion of early school leavers: from 45 per cent in the early 2000s to less than 25 per cent by 2010. A new focus is put on vocational training and technical schools. New financing schemes are being introduced to provide opportunities to low-income students (grants for vocational training, a merit-based loan scheme for low-income students).There are also important reforms in higher education, both to achieve efficiency gains and improve quality of outcomes. Box 2.1 presents a synthesis of ongoing measures and their implementation stage.

Seeking efficiency gains

Rationalisation of the supply of education services is an integral part of the education reform with a view to making better use of existing resources. In basic education, regrouping of schools in less populated areas has started, despite initial resistance from the teachers' union and a lack of cooperation among municipalities. The primary school network is the main target, though some secondary schools are also being closed: by March 2004, 312 primary and 42 secondary schools, half of those schools with fewer than five students, had been closed; by September this year all of them should be. The target is to close all schools with fewer than 10 students by 2007. The ongoing school regrouping, merging and shutting implies a re-allocation of managers and teachers. Teachers are relatively young and some of them have been trained during their career, so they should be able to shoulder new (more advanced) teaching responsibilities. On the other hand, in upper secondary education especially, a large proportion of

Box 2.1. Reform of education and vocational training: ongoing measures

Ongoing measures	Stage of implementation
Pre-primary, primary and secondary education	
Further expansion of *pre-primary education*	• target is 90 per cent of national coverage; implementation has started; it depends on local authority initiative.
Programme for basic education: the Framework Law for education is being legislated:	
• Integration of levels 1 to 6 (age 6 to 12) into the new basic cycle; curriculum reform;	• planned for 2007;
• Integration of secondary school levels 7 to 12; curriculum reform;	• planned for 2007;
• School concentration and regrouping;	• closing down of schools with less than 5 students: launched in 2003-04, to be completed by September 2004;
• ICT infrastructure;	• being developed; including pilot programmes in partnership with major ICT companies to be launched as from end 2004;
• Courses in ICT have become compulsory at the secondary level (level 9);	• phased in starting in 2004;
The reform of *upper secondary education* (levels 10 to 12) was approved in early 2004:	
• the curriculum has been revised; flexibility is introduced to move from one stream to another;	• applicable 2004-05 in level 10 only, 2005-06 in level 11 and 2006-07 in level 12;
At all levels :	
• Regrouping schools and reducing the number of management units;	• has started to be implemented;
• Comprehensive evaluation system of education and teaching.	• implemented in all non-tertiary schools over 2004 and 2005;
Vocational training and professional schools	
• Revision of the vocational curriculum, aimed at reducing drop-out rates;	• guidelines proposed ;
• Introduction of a system of grants to attend vocational training;	• pilot project introduced;
• Creation of a technical school network (the EDUTEC programme).	• implementation has begun: 20 schools to be in place by 2006;
Higher education	
• Creation of a general and independent system of evaluation and certification of courses, for public and private universities and polytechnic institutions.	• evaluation system: implementation has begun; • certification: in preparation.

teachers are insufficiently trained in the use of most recent teaching methods and tools, including Information and Communication Technology (ICT). Rationalisation is also progressing at the Ministry of Education: more than 1 000 civil servants are to move, about two-thirds of them (teachers and non-teachers) to return to teaching or managing schools, and some 400 to be assigned to other posts in the public administration (via the public employment pool) (Chapter 3).

Improving education outcomes in terms of quality

With a view to facilitating the school-to-work transition and filling a gap in the Portuguese formal education system, a top priority of education policy is to develop vocational training, including through the creation of a network of technical schools. Secondary education in professional schools (for youth aged 16 to 18) has been provided on a large scale, with EU financing. The re-organisation involves expanding the network and revising programmes, in response to business demand. Technical schools are also being created in partnership with industrial corporations and business associations, who bring co-financing and help prepare programmes (EDUTEC network).[2] A new system of grants to attend vocational training has been implemented in the Lisbon region (Lisboa e Vale do Tejo). This project is to be extended to the rest of the country.

Another important priority has been to introduce ICT courses on a compulsory basis in secondary education (level 9). All schools have been equipped with computers and internet access (the objective is to have one PC for 10 students by end 2004) and teachers are getting ICT training (Table 2.1).

The modernisation of school curricula is seen as a way to keep students in school and reduce the drop-out rate. New programmes and new schoolbooks are progressively being introduced in primary and secondary education, with the process

Table 2.1. **Indicators on ICT application in education**

Upper secondary education, 2001

	Portugal	Average 14 OECD countries	Denmark	Finland	Ireland	Spain
Ratio students/computers[1]	**14**	9	3	5	13	16
Reported obstacles to ICT use[2]						
i) Lack of computers	**24**	17	18	10	19	28
ii) Teachers' lack of skills	**14**	10	18	14	9	12

1. Total number of students in schools divided by total number of computers available to students.
2. Percentage of students in schools where principal reported that the most serious obstacles to the use of ICT in teaching is:
   i) Insufficient number of computers for students' use.
   ii) Teachers' lack of skills in using computers for instructional purpose.

Source: OECD, *Education at a Glance* (2003).

due to be completed by 2007. Finally, an evaluation system has been launched to develop accountability of teachers and school managers, based on benchmarking. The first stage has started with the evaluation of the whole education system; then each school will receive guidelines on performance indicators for costs, achievement and quality, from which they will provide self-evaluation.[3] It is intended that improvements in performance will be rewarded.

Improving cost-effectiveness and quality in higher education

The poor adaptation of university curricula to needs of employers of university graduates and the weak relationship between scientific research in universities and practical application of its results have led to a reorganisation of responsibilities. When the government took office in 2002, the responsibilities of the Ministry of Education were split, with the Ministry continuing to cover primary and secondary education and with university education and scientific research being regrouped in a Ministry of Science and Higher Education. The new structure was judged more likely to strengthen links between universities and enterprises. The framework law on financing approved in August 2003 established the financial autonomy of institutions. Under the new regime, applied as from the year 2003-04, tuition fees are set by the ruling bodies of each institution within a given range.[4] Requirements to apply to higher education after completing secondary education have been tightened, with the introduction of minimum marks at admission procedures, set by each institution. Furthermore, students who do not achieve a minimum standard in their courses will be excluded from public universities or other higher education institutions, a measure aimed at using scarce public resources more efficiently and improving the quality of student performance. Measures include reorganisation of courses and of institutions as well as changes in the curriculum. A new evaluation system is being progressively introduced, concerning the quality of teaching and working conditions; it should facilitate the re-organisation process, including closing and merging courses with few students.

Preliminary assessment

It is still too soon to have a view of the full scope of the reform undertaken, as all the details on specific applications are not yet available and, as is usual in this area, unambiguous results will take several years to become apparent. The delay in approving the Framework Law for compulsory education, which is an important plank of the strategy, is unfortunate. However, a succinct examination of the ongoing reform thrust leads to a generally positive assessment. Through some of the measures already implemented, it appears that the education system is becoming more oriented to outcomes, the focus being now on quality instead of just quantity. The new culture of incentives and competition that is being developed should be conducive to better results. The secondary education reform in particular would achieve one of its main objectives if, through the newly-introduced flexibility and revised curriculum, it brought students to complete successfully the final level and raised student proficiency (*i.e.* as measured in the PISA testing for reading, mathematical and scientific literacy). The new focus on ICT, with the introduction of compulsory classes in secondary schooling and development of technical schools, is appropriate to provide the required tools to school leavers for the transition to a knowledge-based economy: by increasing basic skills in science and technology for those who choose to enter the labour market without going into higher education it should facilitate absorption of new technologies throughout their active period. Assuming that technical education becomes attractive for an increasing share of students, it should facilitate the school-to-work transition. At the higher education level, finally, outcomes should improve as the quality of secondary education improves, courses are re-organised and universities have more autonomy to set admission requirements. It is appropriate to strengthen the scientific streams, but it will take time to reduce the considerable lag Portugal has in the number of science and technology graduates.[5] As discussed in Chapter 1, substantial gains in terms of multifactor productivity can be expected from a comprehensive strategy, such as the one set in motion to increase the effective duration of schooling and improve the quality of outcomes. For this to happen, it is important to carry through without delay the various components of the reform, given the important complementarities involved, and to maintain the momentum over a long period of time.

Adult training

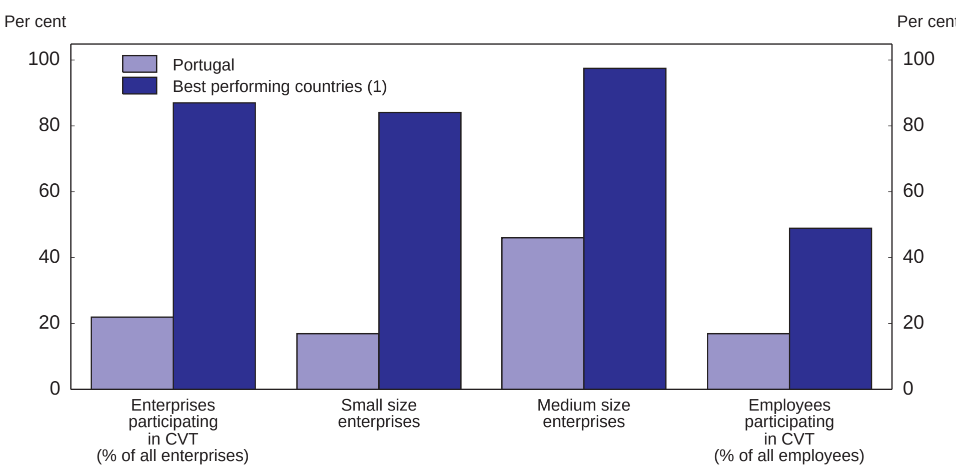
Beyond formal education, there are three main factors that justify additional efforts to promote training in the workplace and improve its quality. First, the traditional Portuguese productive structure of large numbers of small enterprises has typically been associated with lack of management skills. This implies that enhanced training for entrepreneurs (both new and those in place) is likely to bring rapid benefits in productivity and competitiveness. Second, even if until now Portugal has been recording high job creation, including for the low skilled, looking ahead, the new competitive environment will require a shift of the employment structure in favour of medium-and high-skill occupations, this trend being reinforced by skill-biased technological change. Indeed ICT capital investment and skilled job creation, two areas where Portugal has a considerable lag, are complementary (Chapter 1). Third, as a higher proportion of the labour force is drawn into work, and population ages, it becomes imperative to develop effective lifelong learning to increase productivity.[6]

Increasing access to training

Public spending on labour market programmes is not high in international comparison (1.5 per cent of GDP vs. more than 2 per cent in most European countries); and Portugal stands out for the relatively high share of the total that it typically spends on active measures (training and youth measures in particular) as opposed to passive measures (unemployment benefits and early retirement). This seems validated by the relatively low unemployment rate. Regarding continuous vocational training in firms, an increasing number of enterprises, those of larger size normally, are financing training they provide or promote, but the proportion remains quite small. Overall, Portugal is well below the European average in the proportion of enterprises offering training, the participation of the adult workforce in job-related training and in the intensity of such training (in terms of average number of hours devoted) (Figure 2.1).[7]

There is growing agreement that co-financing schemes can play a role in increasing the level of training, and in reducing the inequalities in access to training.[8] A wide variety of such schemes exist in OECD countries, including tax deductions for training expenditures, levy/grant schemes, payback clauses and apprenticeships, working time/training time accounts. Portugal is using (and increasing the scale of) several of these, including with EU co-financing. The largest share of EU structural funds was traditionally allocated to initial training, and a smaller proportion was used to support programmes for adult training in enterprises. EU structural funds allocated to education and initial training initially helped Portugal close part of the dramatic gap in the supply of education: starting

Figure 2.1. **Continuing vocational training (CVT) in selected OECD countries**
Per cent



1. Denmark, Finland, Ireland, the Netherlands, Norway and Sweden.
Source: European Commission (Eurostat).

in the late 1980s the length of compulsory schooling was raised from six to nine years, which required a substantial development of infrastructure and teacher training.[9] Large financial support continues to be provided through the 2000-06 education, training and employment package, supporting ongoing efforts to improve the quality of formal education, providing funds for training and lifelong learning and including measures to modernize the services in charge of employment policies and training.[10] A particular feature of the 2000-06 package is the fast development of the continuous training component, with more than 550 000 people covered by 2002, up from less than 200 000 two years earlier.

Improving the effectiveness of the training system

In-firm training is receiving increased attention from the government and the business sector. A new process of dialogue was launched in 2003 with the social partners, with a view to promoting lifelong training in the workplace, the negotiations being a part of a broader tripartite agreement – the Social Contract for Competitiveness and Employment – which also covers issues related to safety in the workplace, fighting tax fraud and avoidance, investing in innovation. The agreement that should result from these discussions is seeking ways to make earlier training commitments (established in 2001 and re-iterated in the new Labour Code of 2003) operational. Several ingredients are needed to develop an effective strategy for lifelong learning: first, a qualification structure has to be created, including the various streams and levels of formal education and initial training, but also recognizing skills and competences acquired on the job (Portugal has a large gap in this area, with little information on existing skills if they were acquired informally) – so as to ensure the portability of training acquired. Second, there should be close links between business and government institutions – so as to ensure that training services are sufficiently demand-driven. Portugal has made recent advances on these two fronts. Third, rigorous monitoring and evaluation of results are needed to adjust measures, and this requires information availability. In this regard, Portugal is now actively participating in the EU context in an effort to develop quality indicators of lifelong learning (in addition to the existing quantity indicators) (see Box 2.2).

Preliminary assessment

The widespread concern about the need to implement a lifelong learning strategy is appropriate. The measures being undertaken are already important steps, but progress appears to be too slow and implementation should be accelerated. Given delays before formal education reform delivers benefits and the low educational attainment of the current workforce, training efforts for "upgrading" or "re-skilling" workers should be intensified. Although Portugal does not have the labour market problems apparent in many other European countries

Box 2.2. Reform of adult training: measures announced

Measures announced	Stage of implementation
On-the-job training and lifelong learning	
• Reorganisation of recurrent education to make it effective	• Announced, as part of the reform of secondary education
• Law for Professional Training, aimed at promoting lifelong learning	• Proposal discussed with social partners, submitted (May 2004) to Parliament for approval
• Targets for minimum annual hours of certified training applicable to all workers[1]	• Rules approved in the new Labour Code applied since December 2003
Creating a qualification structure	
• Comprehensive qualification framework combined with accreditation systems	• Work in progress
Developing evaluation systems for lifelong learning (LLL)	
• Specific indicators on efficiency and impact of professional training	• In place
• Indicators on employment/education/ training developed for the National Employment Plan	• In place
• Specific indicators (for population aged 25 to 64) developed in the LLL national strategy	• In place
Quantitative indicators	• In place
Qualitative indicators	• Work in progress
Modernisation of Public Employment Services	
Introduction of information systems and technology at the central level and in regional employment centres	• Being developed: objective is to equip the entire network of centres by end 2004
Measures related to continuous training for employees	
• Support for training initiatives of the worker: subsidising employee (per hour of training taken) and firm to compensate for opportunity costs	• In place
• Rotating employment-training scheme: subsidising firms that promote continuous training, while replacing workers in training by registered unemployed	• In place
Training programmes for entrepreneurs	
Programme to develop management training in enterprises of 50 or less employees (GERIR)	• Promoted by Ministry of Economy; implementation has started
Programme to improve management skills and organisation competencies (REDE)	• In place since 1997, reorganised in 2002 to increase flexibility (shorter-duration actions) and focus on specific enterprise needs

1. It includes specific actions for young workers with insufficient formal education. The target is that at least 10 per cent of every company's employees should participate in continuous training. The 2001 tripartite agreement established an obligation for employers to provide training (or organize provision of training externally). The legal changes required for its application have been created in the new Labour Code.

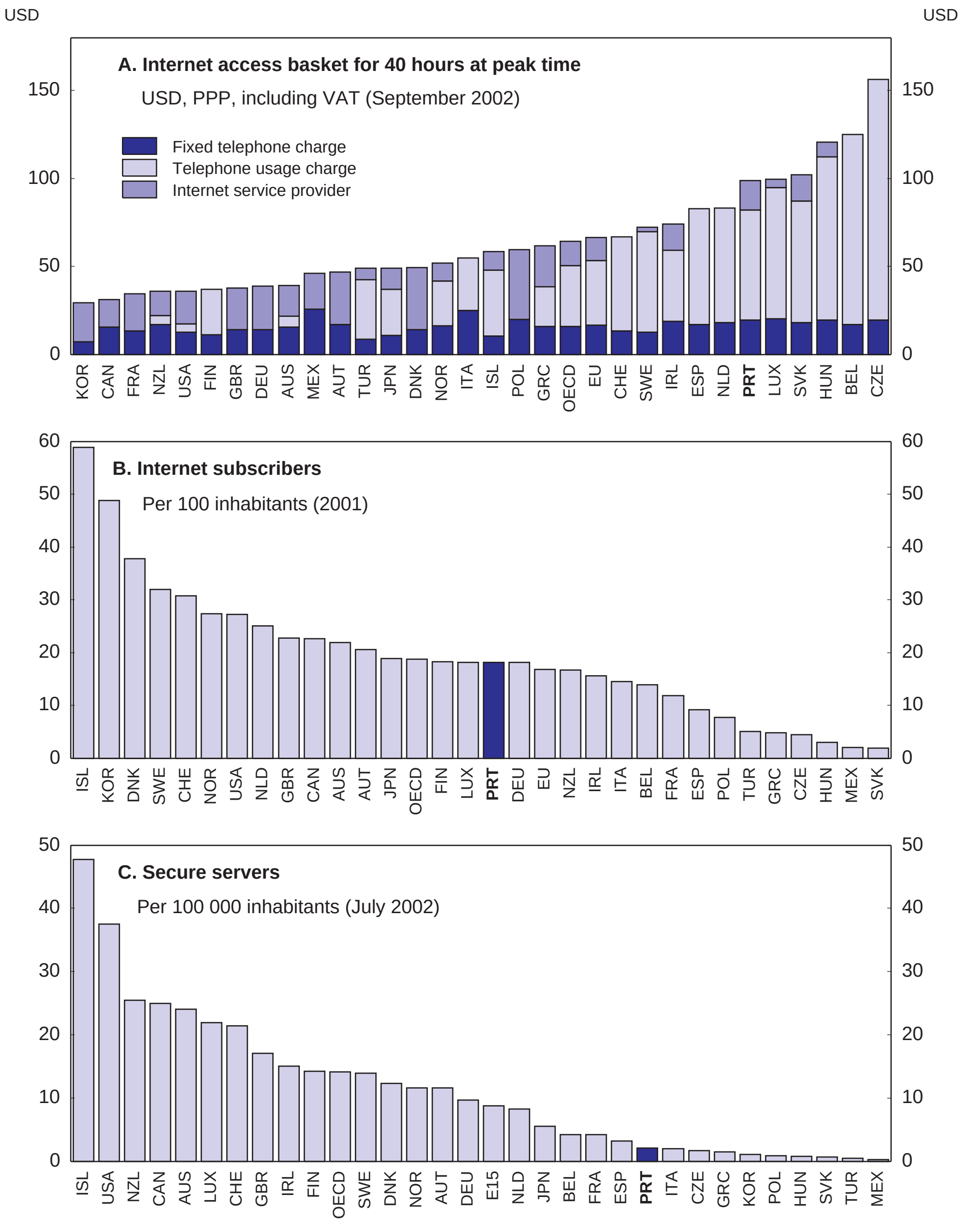
(high unemployment rates and skill mismatch[11]), strong policy action is needed to ensure that the workforce adapts to changing demand and to facilitate its mobility across sectors and regions. It would be particularly important to further develop teaching methods focused on adults who are confronted with difficulties in professional training because they lack basic schooling. The existing framework for promoting and designing continuous education with active involvement of social partners is adequate.[12] Ongoing negotiations with social partners (still unfinished in mid-2004) to promote lifelong learning in the workplace are welcome, given the lack of a training "culture" in Portugal. However, putting into the law a minimum requirement of training, as was done with the new Labour Code, may not be the best way to ensure that useful training is provided; well-designed co-financing schemes have been found to the most effective way of providing incentives to firms and workers. The integration in a single institution, the Institute for Employment and Professional Training, of the various functions related to labour market policy – employment measures, training and public employment services (PES) – is in line with international best practices, as is the fact that it operates through a network of local offices.[13] Furthermore the measures adopted in 2003 to develop information systems and improve incentives for vocational training are likely to increase the effectiveness of PES. The construction of the system of recognition, validation and certification of skills however is too gradual and should be accelerated. Finally systematic and continuous evaluation of outcomes is necessary. There have been evaluations, but these have yet to become systematic. The proposed Law on Professional Training establishes that all such actions will have to be submitted to permanent evaluation, in terms of their teaching content, their administrative and financial aspects and the matching of supply to the requirements on the labour market. Evaluation mechanisms of the ongoing labour reform have been planned.[14] Portugal should step up efforts to develop and apply the appropriate tools to ensure timely corrections of policy mistakes.

Helping the transition to a knowledge-based economy

Promoting the diffusion of ICT

Thanks to progress made in the use of ICT, Portugal is following the development of the Information Society seen in many other countries, both in businesses and households, although it remains below OECD average in many regards.[15] Possible factors slowing down progress include the lack of human skills and relatively high costs (Figure 2.2). Given the key role this factor can play in boosting growth, a new impetus has been given, with several recent initiatives to reduce the gap. The "Internet initiative", in particular, sets out quantitative targets to promote the general use of ICT in the public administration and in homes. The government's information strategy has started to be implemented in three main areas. First, accessibility is being enhanced, seeking to generalise internet access

Figure 2.2. **Internet indicators: an international comparison**



Source: OECD, *Science, Technology and Industry Scoreboard* (2003).

via broadband, providing public points of access and lowering prices.[16] Second, as part of the education reform reviewed above, ICT skills are to be raised, through the introduction of internet in schools and specific training. Third, several projects have been introduced, through public-private partnerships, to promote the use of ICT within the academic community and by the public sector: the e-U programme ("Electronic University"), the e-public procurement programmes and on-line public services ("citizen's portal"). Harnessing ICT into government activities offers ample opportunities for efficiency and productivity gains, and it can help make the provision of government services more user-oriented. The comprehensive approach followed by Portugal to foster the diffusion of ICT is promising. There are two considerations to bear in mind: first, most other OECD countries, including those lagging in ICT diffusion, are also making fast advances, so that the pace of implementation should be quick; second, measures aimed at developing access to ICT should be accompanied by specific training on how to use new communication technology for productive purposes (see below).

Portugal must also promote stronger involvement of the business sector in R&D spending and innovation so as to successfully make the transition to a knowledge-based economy. The ability of business to transform research initiatives into processes and products is a key ingredient. Measures have been taken recently to spur innovation in enterprises and R&D activities. In particular, new instruments have been put in place in Portugal to strengthen the links between business and research institutions and to support the establishment of new technology-based firms (NEST).[17] Specific action is also undertaken to support small- and micro- enterprises in hiring highly educated technical staff, with financial compensation (QUADROS).[18] In addition, the new programme for applied business research and development (IDEIA) delivered under the joint responsibilities of the Ministry of Economy and the Ministry of Science and Higher Education, supports partnerships between enterprises and the national science organisations, active in the development of applied research, to create new products, processes or services.

Preliminary assessment

The various measures introduced over the past few years to speed up the diffusion of ICT and strengthen relationships between industry and science are an important component of the overall strategy to boost productivity. Their effectiveness is enhanced by the fact that they are complemented by policies to foster human capital development in science and technology. Implementation of these as a package should help maintain Portugal's attractiveness to foreign investment of high quality (*i.e.* medium and high technology). Whether technology is imported or developed locally is not as important for productivity growth as the fact that framework conditions will allow technology transfers across sectors and firms of different size. For that to happen, other policy measures are also required, as reviewed below: effective product market competition, absence of barriers to entry and enough dynamism in firms creation and destruction, so as to allow the replacement of least productive by more productive firms.

Reforms to use the labour force effectively

An increase in labour mobility and continued adjustment of wages (and prices) are the keys to facilitating the adjustment to structural changes and translating human capital improvements into income gains. Even after some easing during the 1990s, employment protection legislation (EPL) remained relatively strict until recently, reducing the ability of firms to react quickly to shocks. The legislation on (no fault) individual dismissals, in particular, imposed rather costly severance payments, even after a short period of work. Collective dismissals also imposed a lengthy procedure in principle (advance notice, report on the financial and technical reasons, negotiations with workers' representatives), although in practice, it does not seem to have been particularly difficult to use.[19] Partly to avoid strict EPL, the share of fixed-term contracts has risen over time.[20] Likewise, the share of self-employment is relatively high (Figure 2.3).[21]

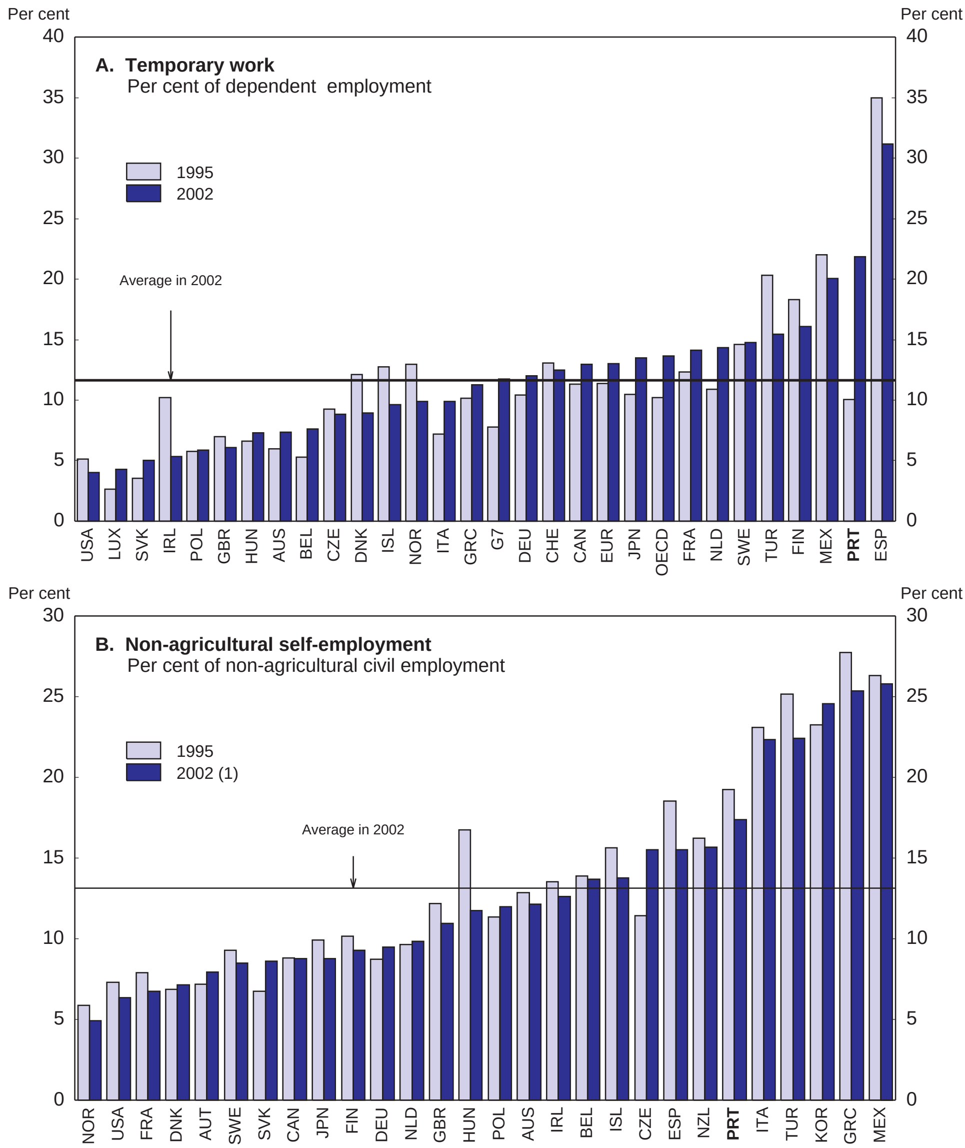
Several forces have ensured a high degree of flexibility of Portuguese wages, thus helping to offset some of the negative effects of low labour mobility and to keep unemployment relatively low (compared with the rest of the euro area especially) (Figure 2.4). In practice, firms have tended to avoid using the collective dismissal procedure, preferring to reach an agreement with the workforce – reducing working hours and adjusting wages rather than firing employees.[22] These within-firm agreements on wage adjustments to some extent have provided the needed responsiveness to cyclical developments (with limited dismissals) and contributed to the *de facto* labour market flexibility. But labour mobility across sectors and regions is low.[23] In order to make the labour market more responsive to cyclical developments and to ensure its ability to adapt to changes, a review of the labour market legislation was considered as essential. The labour legislation reform approved in 2003 represents a first important step.

The new Labour Code

The new Labour Code (*Código do Trabalho*), which came into force in December 2003, replaces individual and collective labour legislation with a unified text, deemed to be clearer and easier to apply. Some of the key measures adopted are: increasing geographical and functional mobility of workers,[24] enhancing flexibility of working hours, strengthening rules to fight (record high) absenteeism and fraudulent sick leave and revising collective bargaining procedures. The new legislation provides more flexibility in the use of fixed-term contracts, which can now be renewed up to a maximum six years (instead of three years previously);

Figure 2.3. **Types of employment**

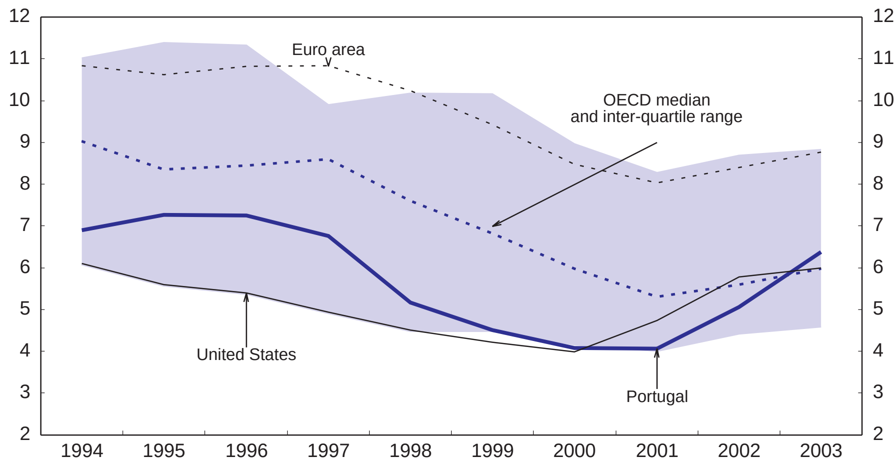
Per cent



1. 1999 for Belgium.

Source: OECD, *Employment Outlook*, 2003; OECD, *Annual Labour Force Statistics.*

Figure 2.4. **Standardised unemployment rates in OECD countries**
Per cent



Source: OECD, *Main Economic Indicators*.

at the same time it gives more transparency to these forms of contracting.[25] The reform provides instruments to overcome collective bargaining deadlocks, with the introduction of expiry clauses in collective agreements and the possibility of compulsory arbitration imposed by the Ministry of Social Security and Labour in cases where a collective agreement expires without being replaced by another. There is now more leeway to introduce flexibility in collective agreements at the firm level, regarding the rules for fixed-term contracting and the dismissal rules (including notice periods and severance payments within certain limits). Furthermore, employers now have the right to oppose the reinstatement of workers in dismissal cases under certain conditions, such as in cases where it would harm or disrupt business activity. Some of the changes introduced are expected to enhance the responsiveness of wage settlements to productivity and skill differentials across economic sectors (in line with reform priorities identified by the European Commission). The changes introduced are welcome, albeit insufficient. In combination with efforts undertaken in parallel to upgrade competences (reviewed above), they should nevertheless facilitate the reallocation of labour across occupations and sectors.

What remains to be done

The Social Contract for Competitiveness and Employment being discussed between the government and social partners will include objectives in terms of productivity gains. To reach those objectives, further measures will probably be needed: first, proposals discussed above to strengthen training will have to be actively implemented; second, work organisation will need to be further reviewed. Even though some changes in the recent reform have eased EPL and strict procedures in practice may not be all that binding, it would be appropriate in the future to re-examine the set of regulations, so as to enhance their transparency, their effectiveness and to better adapt them to reality. Of particular relevance would be to ease the procedures for dismissals. Although the conditions that can be invoked for dismissal of an individual employee with a permanent contract are already broad enough to include economic, technological or structural reasons, the procedures remain relatively cumbersome. Strict job protection still enjoyed by employees on permanent contracts is likely to reduce formal employment demand and contribute to the existence of pervasive informal activities (see below). Measures to facilitate the use of fixed-term contracts are intended to encourage employment creation in the formal sector, although in combination with strict EPL, they also risk aggravating the duality of the labour market. However, if the new legal framework creates conditions conducive to the development of collective agreements well adapted to current labour market reality, it could be a significant change, allowing more flexibility in hiring and firing within the existing legal framework, thereby helping Portugal's firms to respond to challenges such as technological changes and increased competition from new EU members. Furthermore, such an evolution could help shift employment creation more towards permanent contracts and thus would improve the balance between providing job security and facilitating the movement of people to jobs where they are more productive.

In the public administration, where internal labour mobility has been low, the government has introduced a framework that should make it easier to transfer civil servants within the administration. Implementation is slow, as will be seen in Chapter 3, and it is still not possible to dismiss civil servants.

In order to boost productivity growth, it may not be enough to ensure labour market flexibility and develop a learning culture (with higher and more technical competences). Delays before reaping benefits are particularly long in the education area. As important, attention should also be given to ensuring that there are good managers and good organisations. For instance, heightened productivity growth in the United States in the 1990s has been related not only to high ICT investment, but also to the intense learning process at the firm level on how to make better use of ICT capital. This requires new forms of management, participation and contractual relationships. One of the main problems of the Portuguese business sector seems to be that it has outdated entrepreneurial style and organisational designs, a concern that is recognised in the ongoing measures targeted to manager training (Box 2.2 above). Given the large proportion of small and medium-sized enterprises (SMEs), it is clear that the professional development of entrepreneurs is an important component. To make the most of the "knowledge-based society", all levels of managers and employees will have to be trained on how to share knowledge.[26] Portugal could use its "social pact" framework to explore these issues.

Promoting effective competition and moving forward in sectoral reform

Changes in the legal framework and institutional setting for competition policy

Increasing awareness of the possible linkages between product market policies and growth has spurred regulatory reform in many OECD countries.[27] More intense competition is likely to promote a better allocation of resources, encourage stronger managerial efforts and stimulate innovation, factors which could lift productivity growth. Portugal has made commendable progress in 2003 to promote effective competition. First, the institutional setting has been strengthened with the creation of the Competition Authority, as an independent and financially autonomous institution, with powers to perform investigations, impose sanctions and approve mergers of companies, subject to prior notification. Second, a new Competition Law has been approved.[28] For a "competition culture" to develop, there needs to be awareness at all levels (businesses, consumers, and government including the public administration) that there is a Competition Law and an Authority to enforce it. Recent actions by the Competition Authority will help increase awareness. The Authority has opened several enquiries concerning the enforcement of the Competion Law, addressing notably several infringements in the overall telecommunications market.

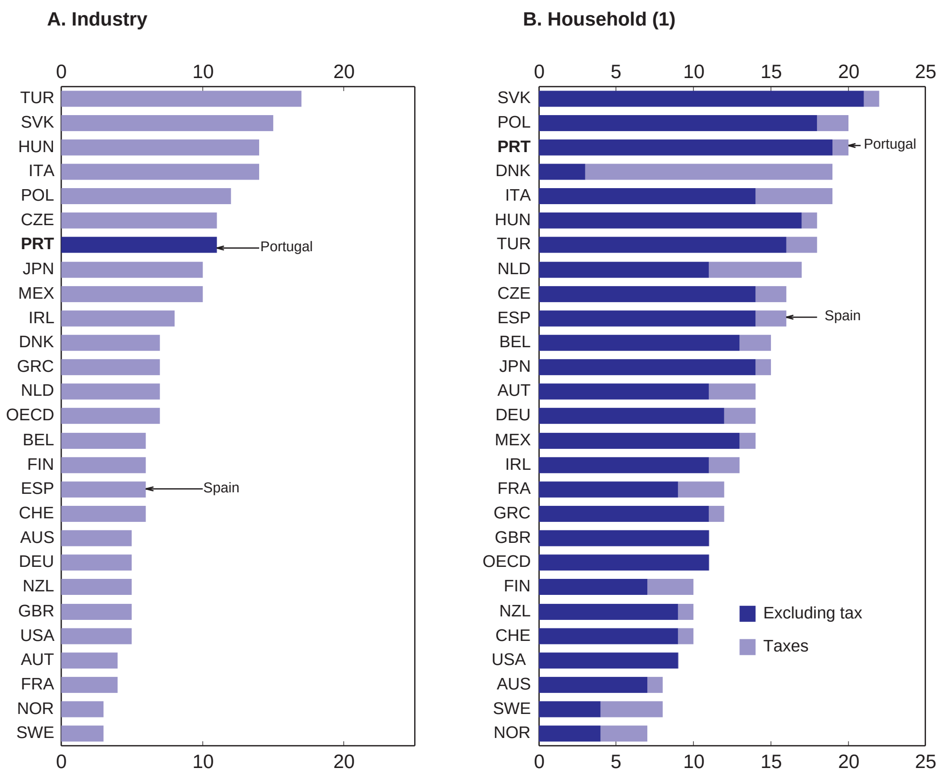
Progress in privatisation and sectoral reform

The Portuguese authorities are committed to continue the process of privatisation, envisaging the sale of enterprises in the pulp and paper, water, energy, transport and tourism sectors (listed in the Stability and Growth Programme for 2003-06). For the period 2004-05, the government announced new privatisation phases in companies such as EDP and GALP in the energy sector, and new operations such as REN (the electricity transmission network), Portucel – Tejo and Companhia das Lezírias. The process has started with the major pulp and paper company (Portucel), and sales of additional stakes of partly privatised enterprises. The policy debate is focused on the role these operations can play in promoting strategic investments. But other considerations are also at play, such as maximising government revenue. Until now, the state has generally sought to continue to exercise influence, by retaining a qualified stake in capital or special voting rights in companies operating in those sectors that are considered strategic, including energy (*i.e.* EDP and GALP), transportation, water and radio/television and telecommunications.[29] This distorts private investor behaviour and management incentives. It can also discourage other firms from competing. In either case, there is a tendency to distort the allocation of resources to the detriment of the consumer and the efficiency of the economy.

Effective competition has yet to develop in liberalised network industries, especially the *energy sector*. Despite substantial progress made, Portuguese electricity and gas prices still rank among the highest in the OECD, and they are higher than in neighbouring Spain in particular (Figure 2.5). In the gas sector, there is a government plan to restructure the sector, which involves severing oil from gas businesses and unbundling generation and transportation. Gasoline and fuel oil prices have been liberalised as from January 2004. On the electricity market, the generation sector is already liberalised, and commercial activities are undergoing

Figure 2.5. **Electricity prices in selected OECD countries**

In US dollars per 100 kWh (using PPPs) in 2002 or closest year available



1. Price excluding tax for the United States.

Source: IEA, *Energy Prices and Taxes*, First Quarter 2004.

liberalisation. The national electricity producer, EDP, still state owned for 30 per cent of its capital and little exposed to competition, is preparing for the opening up of the market to its main Spanish competitor.

An agreement to create the Iberian Electricity Market (MIBEL) has been signed.[30] The creation of MIBEL is expected to improve capacity and efficiency in the sector. The agreement foresees a doubling of inter-connexion capacity between the two countries. In the preparation phase, Portugal plans to further open its retail market during 2004, with a view to gains in terms of service quality and prices: as from July, individual consumers from Portugal will freely choose their supplier (this is already the case for businesses in Portugal and for all consumers in Spain). The newly-created Iberian market will submit both countries to the same legislation without any distinction between consumers on one side of the border or the other although a number of competition issues are being examined in the European Commission.[31] The elimination of long-term purchase agreements between generators and the transmitter should lead to more competitive prices and, once the inter-connexion capacity is expanded, prices in Portugal are expected to converge to those on the Spanish market, which are currently much lower.

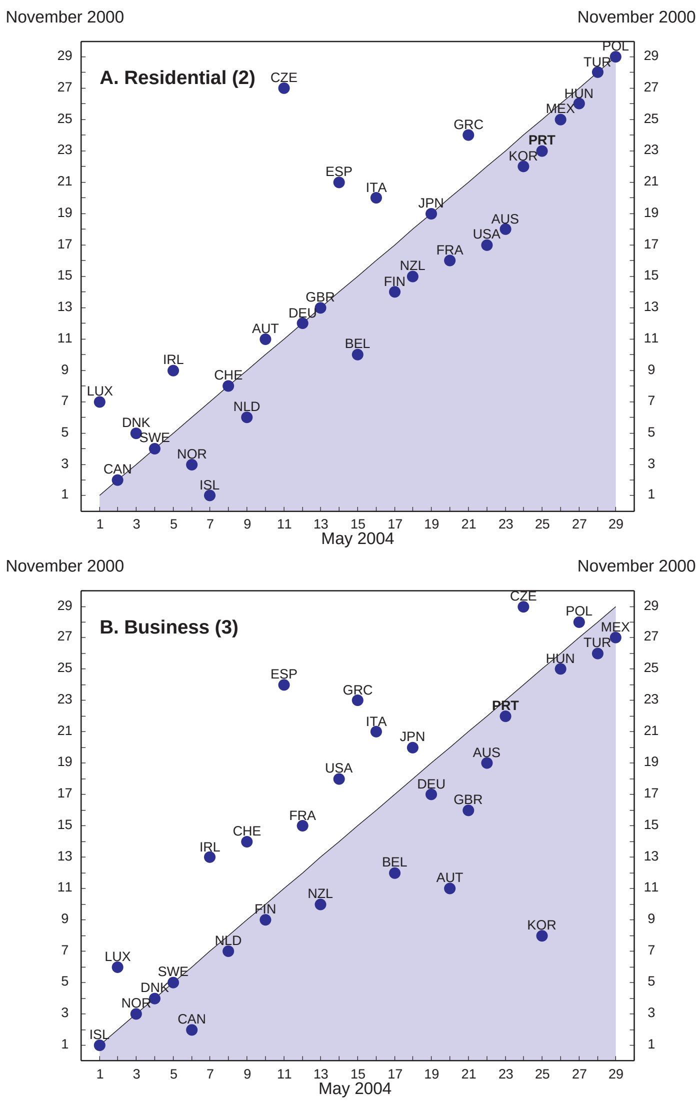
There is a lack of competition in the *fixed telecommunications market*, as stated recently by the Competition Authority.[32] Telecommunication prices have declined over the last decade as in other OECD countries with the liberalisation of the sector, but important differences remain in the price levels, suggesting that the full scope for efficiency gains has not yet been fully exploited. On the fixed network, prices have declined less in Portugal than in many other countries, and in early 2004, they were still among the highest in the OECD for international calls (in US dollars PPP adjusted) (Figure 2.6). This is because in fixed telephony, the incumbent operator Portugal Telecom still enjoys an overwhelming dominant share, in long-distance calls in particular.[33] There are ongoing efforts to reduce obstacles to effective competition, via multiple instruments, such as pre-selection, portability and revised local loop unbundling regulations.[34] Although internet penetration rates are increasing rapidly, Portugal is still lagging; further advances in competitive conditions will help reduce prices, thereby accelerating the increase in penetration rates.

Assessment

Fostering effective competition throughout the economy, including service markets and network industries, and ensuring a level playing field are likely to encourage investment and innovation, thereby potentially improving medium-term growth performance. Quantification of the gains from reforms have shown that measures to make the economy more competition-friendly can improve productivity growth substantially over the medium term (Table 1.2 in Chapter 1). The

Figure 2.6. **Telephone charges in OECD countries 2000 and 2004**

Rankings of OECD basket of telephone charges in ascending order (lowest price = 1)[1]



1. Ranking for 29 OECD countries excluding the Slovak Republic. Usage charges adjusted based on current purchasing power parities. Countries in the shaded area have below average progress.
2. VAT included. The basket includes 1 200 fixed line calls, 120 mobile calls and 72 international calls per year.
3. VAT excluded. The basket includes 3 600 fixed line calls, 360 mobile calls and 216 international calls per year.

Source: OECD, Telecommunications database.

proactive presence of the new Competition Authority (manifest in numerous interviews, seminars, recommendations and Parliamentary hearings) is contributing to increase the awareness of government officials, Parliament and the public at large to the need to carry out a sound competition policy. But experience shows that the promotion of a competition culture is a long-term effort that will continue to require major efforts by the Competition Authority, both with the business community and across the government.

Improving the business environment

At the end of 2003, the Minister of Economy released an in-depth study done in conjunction with the McKinsey Global Institute, identifying the main obstacles to overcome to lift productivity in the country. Following up on this work and other studies on Portugal's large productivity gap, the government took several initiatives, the main objective of which is to close the gap between Portugal and the more advanced European countries. To this end, reforms have been launched to modernize the production sector, seek new export markets and upgrade the export value chain. Investment support has been modified to become increasingly selective with a view to stimulate quantity but also quality (*i.e.* profitability) of investment. An important component of the strategy is to improve the business environment by reducing the cost of doing business.

Reducing the cost of doing business

The business sector at large will benefit from reforms aimed at lowering tax rates while improving tax compliance, as well as ensuring that the regulations that are needed can be met at minimal costs. Such measures would also help reduce the scale of informal activities, defined as the non compliance with tax obligations or other regulatory obligations, which has been identified as a factor in the low productivity performance of the Portuguese economy (Box 2.3 and Figure 2.7).[35] Previous work by the OECD identified a number of measures related to the tax regime and administration which would help fight informality, including: *i*) simplifying the tax system to reduce the cost of compliance; *ii*) strengthening controls and cross checking registries (tax, social security, labour market); *iii*) applying fines for evasion (but avoiding tax amnesties); and *iv*) reorganizing tax administration and developing specialisation on sectors prone to informality. The government has made recent advances in these areas. In 2003, tax control and audit were improved and sanctions were reinforced through a number of strategic measures. The corporate income tax rate was reduced in the 2004 budget, from 30 to 25 per cent at the central government level.[36] The government intends to further reduce the corporate tax rate. This would improve the competitiveness of businesses. However, by lowering tax revenues, it would make fiscal consolidation

Box 2.3. On the informal sector and low productivity

The government's report, following consultation with the McKinsey Global Institute, identifies as an obstacle to higher productivity, first and foremost, the existence of pervasive informal activities, defined here as the non-compliance to obligations, including: *i*) taxation, both income tax and VAT; *ii*) social security contributions; *iii*) standards and norms (regarding quality, safety, environmental concerns…). This phenomenon has an important impact on the economy, creating distortions.* Thus, for a given government revenue, it imposes a heavier burden on economic agents who comply. It also distorts competition among firms, allowing the survival of low productivity enterprises, which have low costs as a result of evasion. It distorts relative prices, inducing firms which operate in informality to substitute (low cost) labour for capital, so that these firms do not invest in the equipment necessary to increase labour productivity. Finally, these enterprises, in order to remain invisible, tend to use self-financing and remain small, often too small to be innovative and absorb best practices.

* As noted in the OECD *Economic Survey of Portugal*, 2001, Portugal has a "long-standing history of poor compliance", tax enforcement being particularly difficult in small businesses and among the self-employed. Informality is pervasive in the non-tradable sector, such as retail trade in food, restaurants and residential construction, but also in the car industry (Ministry of Economy, *Portugal* 2010: *Accelerar o Crescimento da Produtividade*, September 2003).

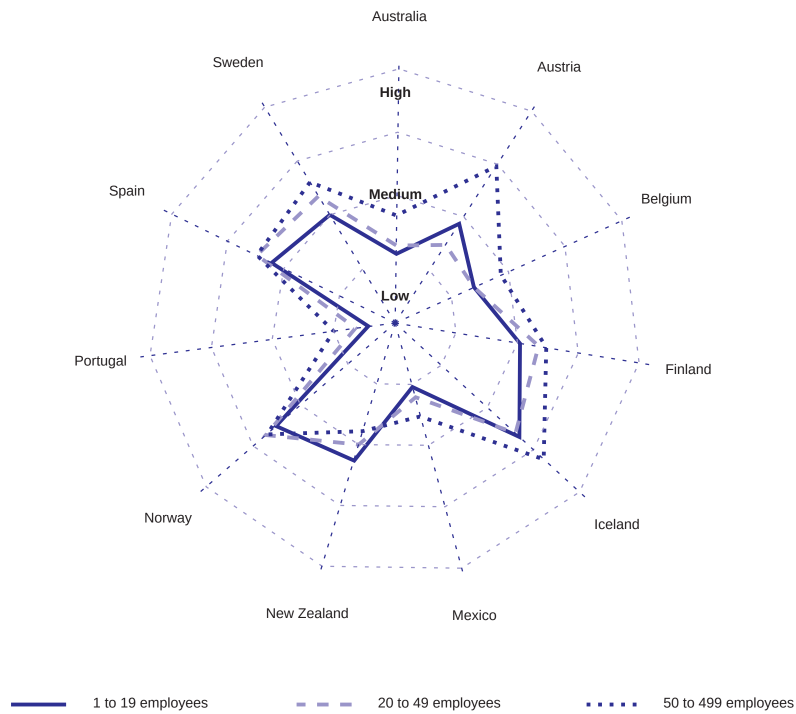
more difficult, unless the measures to reduce tax fraud and evasion and those to enhance spending control (Chapter 3) prove effective.

As part of the broad-based Programme for Productivity and Economic Growth to improve competitiveness of the Portuguese economy and foster private investment, other measures were introduced over the past two years to cut red tape, through administrative simplification and deregulation. The European Commission itself is seeking to simplify and improve the regulatory environment (ECFIN 3-Feb.2004). The development of one-stop shops in Portugal can be expected to help business start-ups and facilitate extinction of non-viable enterprises.[37] The network of specialised public notaries was privatised with a view to increasing the efficiency of the service.[38] Portugal, like many other OECD countries, has also been developing e-government services to help users.

Better legislation and regulations

Besides the introduction of a new labour code and regulations, which should reduce ambiguities and facilitate application of the law, other legislation has been introduced in the past 18 months or so. Industrial licensing has been

Figure 2.7. **Levels of compliance as perceived by firms**[1]



1. Levels of compliance with employment, tax and environmental regulations, as perceived by SMEs included in the survey (3rd quarter 1999 for Portugal).

Source: *Businesses' Views on Red Tape – Administrative and Regulatory Burdens on Small and Medium-sized Enterprises*, OECD (2001).

modernised (with new rules to facilitate licensing and a single contact appointed by public authorities to coordinate processes with various ministries and other bodies). To reduce time for issuing opinions, a tacit granting clause applies. Licensing for tourism and commerce is also under review. An investors' guide is now available on the internet, including a summary of all legislation pertaining to business investment, which is continuously updated. The Portuguese Investment Agency was created in 2002 to provide one-to-one service to investors: its purpose is to actively seek investment projects (national and foreign) and facilitate processes; but it also has an investigation role and can make proposals on behalf of investors, for instance to reduce administrative or tax costs or to adjust content of training programmes.[39]

The reform of the Bankruptcy Law, which was urgently needed, was approved in 2003. The antiquated legal system acted as a deterrent to fresh starts and perpetuated the survival of non-viable firms, because of inadequate restructuring procedures. The new legislation is intended to facilitate and speed up various procedures. By allowing more flexible schemes, it should reduce the need for legal involvement. The final objective is to allow the recovery of financially sound companies and the rapid closure of others, thus avoiding abnormal prolongation of their existence to the prejudice of healthy competition. Changes have been made to the legal framework for venture capital.

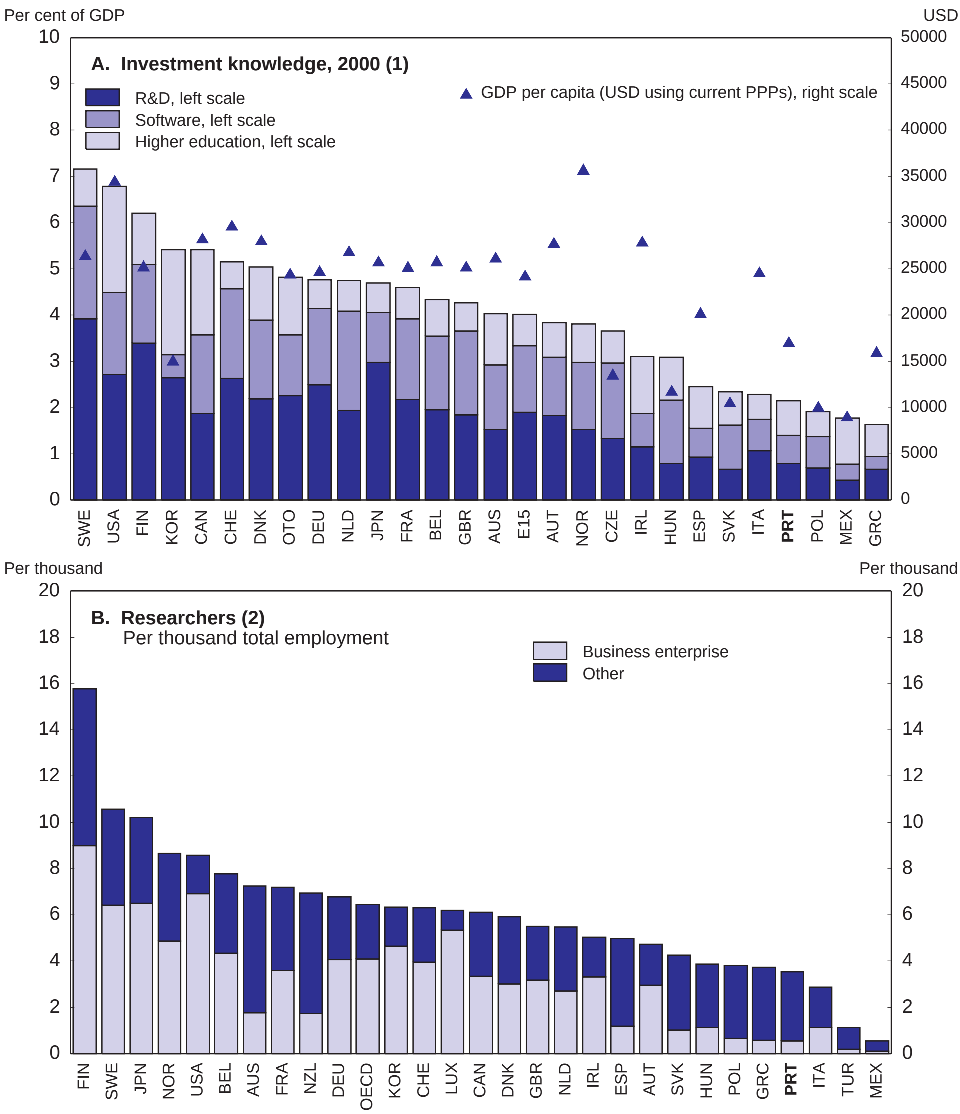
Financing investment

Steps had to be taken to improve the effectiveness and coherence of the main financing instruments for supporting business investment and enterprise modernisation. The conditions for support have been tightened. For instance the main financial instrument for investment support and the modernisation of enterprises, which was launched in mid-2003, provides support subject to results: the firm keeps the financial support only if it proves profitable, in contrast to the earlier schemes.[40] It has a clear focus on encouraging the internationalisation of the production sector. Under its three lines of action – increasing the dynamism of firms, the qualification of human resources and fostering the business environment – other innovations have been introduced, for instance, a "tax reserve" instrument for investment and innovation in enterprises producing tradable goods and services.[41]

Portugal like several other Southern European countries is lagging in the take up of new technologies, an important factor for enhancing productivity (Figure 2.8). International evidence shows that innovation often takes place where universities, laboratories and firms work closely together. Improving tertiary education outcomes (where efforts are underway, as noted above) is only one of the important levers. Other policy measures are required in complement to raise R&D investment and foster business creation. Small firms play as much of a role in innovation as large ones provided they are exposed to competition. Because the entry of new – more innovative – firms can contribute to productivity growth, the government has sought to foster business creation by supporting the development of adequate financing tools.

Venture capital is found to play an important role in several countries in the early stage of development and expansion, but it is little developed in Portugal. Furthermore, as in Spain and much of Europe, Portugal has had difficulties channelling the small amount of venture capital investment there is to early stage companies. The venture capital market has long been focused on traditional manufacturing sectors (textiles and footwear) which were defined as strategic and earmarked for venture investments by past governments under the EU structural funds programmes.However, by 1999-2000 medium-and high-technology sectors

Figure 2.8. **Innovation indicators**



1. For Canada and the United States post-secondary non tertiary education is included in data for higher education; for Belgium, data for higher education only include direct public expenditure. 1999 for Belgium, Denmark and Greece.
2. In 2002 or closest year available. 2001 for Portugal.

Source: OECD, *Main Science and Technology Indicators*; OECD, *Science, Technology and Industry Scoreboard* (2003).

have been receiving an increasing share of venture capital investment.[42] Various venture capital measures have been introduced, starting in 2002, in the context of the Programme to stimulate growth and productivity, PPCE. A new law aims at simplifying rules and regulations for the sector; tax incentives and lower capital requirements for venture funds and companies have been introduced.[43] In addition, the Risk Capital Syndication Fund will allow the establishment of partnerships between public and private risk capital companies, thus enabling risks to be shared. This measure aims at strengthening the role of government equity programmes in stimulating private venture activity.[44]

Changes in corporate governance

Most listed companies are controlled either by a family or by the state so that market forces are weak. A code established by the Securities Market Commission (CMVM) on a "comply or explain" basis since 2001 calls for at least one member of the board to be independent from the dominant shareholder and for companies to encourage the exercise of voting rights. Compliance with the code has been unsatisfactory. A new law, entering into force at the beginning of 2004, clarifies and simplifies the criteria underlying the formation of an association of small investors (*i.e.* not including institutional investors) and the requirements for registration with the CMVM. This is meant to strengthen pressure on companies to improve transparency and to lift restrictions on voting both directly and via post or proxy.

Preliminary assessment

The government's strategic intervention to foster investment includes commendable initiatives, for instance the integration in a single institution of all administrative procedures and encouraging venture capital. However, the government should refrain from distorting market forces through tax incentives and subsidies. Helping a sector or a firm, even if it is a rare occurrence, sets an unhelpful precedent. It would run against efforts made over past years to set an even-playing field which have helped to improve the allocation of resources. If targeted incentives are being used, they should be designed carefully to reduce distortions and adverse economic effects.[45] As a rule, and to avoid tax base erosion, the best approach is to have lower and more even tax rates across investments and companies.

This array of measures and of legislative changes can contribute to increasing firm dynamics, which has been found to boost productivity gains. It is an appropriate, even if still incomplete, response to injunctions from the business community and analysts, both national and international, concerned about the heavy burden imposed on enterprises by the complexity of the legal and administrative framework and the lack of information, as generally reported. The implementation of all measures included in the government's programme, in particular the reduction of fees and fiscal burdens related to enterprise development and restructuring, merger and divestiture operations, should help reduce the bias that allowed least productive firms to operate. Enhancing the quality of public services is also important (Chapter 3).

Concluding remarks

To sum up, the reforms required to increase Portugal's growth potential and reduce the gap in living standards with more advanced OECD countries, have been well identified by the Portuguese authorities. Aware of the need to step up the implementation of growth-enhancing reforms, they have launched a broad strategy and implementation has started. By 2004, most of the required legislative changes had been made, regulations had been modernized and application of the measures had started along several lines: enhancing human capital and promoting the use of new technologies, improving the functioning of the labour market, actively enforcing competition rules in the private sector, and creating an environment overall more friendly to private business.

Taken together these reforms can deliver a strong boost to potential growth. But effective implementation of the measures approved is key to achieve the intended results. Furthermore, in some of the areas, delays in reaping benefits of the reforms will be longer than in others and the strategy will have to be sustained over time. An overview of action taken in key areas of structural reform is presented in Box 2.4 below, together with main OECD recommendations. This comprehensive strategy also requires firm action to redress public finances and ensure sustainability over the longer term. These issues are discussed in the following two chapters.

Box 2.4. Implementing structural reform: an overview

Proposals*	Action taken	Assessment/recommendations
I. Improve labour force skills and competencies		
• Raise the quality of formal education, enhancing vocational and technical programmes	*Pre-school education* broadened	Continue with implementation
	First 6 years of school	
	– Reform measures are announced	Proceed with reform
	– Increasing computer equipment of schools	Continue with implementation
	Secondary education:	Continue with implementation
	– Ongoing revision of the curricula – Creating technical schools and developing professional schools – ICT courses becoming compulsory	
• Improve the incentives faced by teachers and school managers, as well as their accountability	Ongoing evaluation of schools	Monitor results and disclose, rewarding best performers
• Improve quality of tertiary education, maintaining an even-handed treatment of public and private institutions	Creation of a systematic and independent system of evaluation and certification of courses/universities	Continue with implementation Continue
	Closing or merging courses with very few students	
	Admission procedures and tuition fees are set by each institution	Should help improve outcomes
• Facilitate access to training and support lifelong learning	Ongoing negotiations with social partners to promote training in firms	Continue to explore options for more and better training
	Consolidation of national certification system	Step up implementation
II. Moving to a knowledge-based society		
• Seize the benefits of ICT diffusion	Steps taken to spread out ICT among households and companies, schools and other public areas	Improve regulatory framework for the telecommunications market to enhance competition, in order to reduce Internet access tariffs
• Develop managerial skills	Specialised training for managers	Monitor results and expand

Box 2.4. **Implementing structural reform: an overview** (*cont.*)

Proposals*	Action taken	Assessment/recommendations
III. Reforms to use the labour force effectively		
• Ease employment protection legislation	New *Labour Code* includes some easing of the conditions required forr fair dismissals	Review the rules to better adapt them to practices
• Reduce obstacles to "atypical" work contracts	Rules governing temporary employment were eased	Monitor application to avoid abuses
• Evaluate active labour market policies (ALMP)	Little progress	Carry out a systematic monitoring of all active labour market programmes, evaluate and rationalise
IV. Increase product-market competition		
• Reform institutional arrangements for competition policy • Remove entry barriers and increase competition in network industries	Creation of a independent Competition Authority and a new Competition Law	Competition Authority should continue its efforts to increase public awareness and enforce the Competition Law, imposing the adequate corrective measures and/or appropriate fines to offenders.
	Agreement to create an Iberian electricity market (MIBEL). Advances in liberalisation in Portugal	Proceed with the liberalisation in preparation for MIBEL
	Despite some liberalisation in telecommunications, incumbent has retained a strong market position	Enhance competition, in particular in the fixed-line long-distance services
• Continue privatisation process	Some operations have been launched	Conciliate the privatisation process with competition concerns
V. Promote a business friendly environment		
• Reduce red tape and other costs on doing business	*The Programme for Productivity and Economic Growth* makes further advances in alleviating procedures, including administrative simplification and deregulation	Promote the timely implementation of measures included in the *Programme for Productivity and Economic Growth*
	Reform of the Bankruptcy Law	Should help speed up procedures
	Registry and notary services privatised	Should help increase efficiency
	Corporate income tax cut	Simplify tax system and broaden the income tax base
• Stimulate firm creation and encourage productive investment	Simplification of licensing procedures	Evaluate results
	Investors' guide available on the internet	Continue while updating regularly
	Active role of Portuguese Investment Agency	Continue and evaluate results
	Revision of the legal framework for venture capital	Can help foster venture capital in more sectors and types of companies

* Proposals are based on detailed analysis provided in the current and previous OECD *Economic Surveys of Portugal.*

Notes

1. See Figures 1.5 and 1.6 in Chapter I above. Additional evidence was presented in OECD *Economic Survey of Portugal*, February 2003: see Chapter III, "The effectiveness of public spending", and Chapter IV, "Structural reform for sustaining high growth".
2. The objective is to have 20 technical schools by 2006, and about 240 professional schools by 2010. Demand from the business sector is strong; the vast majority of students who come out of these streams find a job.
3. There will be public disclosure of evaluation indicators and rewarding of best performers. The first stage will be completed by September 2004; the whole process is expected to be applied by 2005. A sample of pre-primary and upper secondary schools has already been going through yearly performance evaluation since 2001.
4. For 2003-04, the range in which annual fees were set is between 130 and 240 per cent of the monthly minimum wage.
5. This is also an objective of the Lisbon Summit, set in 2003, which foresees an increase in the number of graduates in mathematics, science and technology by at least 15 per cent by 2010 (SEC(2004)73, January 2004). This objective is linked to specific targets for R&D spending.
6. This topic was one of the main issues addressed at the Portugal-OECD Seminar on "Innovations and reforms in labour market policies" Lisbon, October 2003.
7. In the European Survey of 1999 on continuous vocational training, the main reason given by enterprises for not providing training was that staff skills matched their needs, or they could recruit people with the required skills. The cost of training per employee in enterprises who invest in training (1.2 per cent of total labour costs) is close to the European average. Half of it represents the opportunity cost for the employer, the other half being the direct cost incurred for organising courses, most of which are provided externally. Private providers account for a higher proportion of external courses, as in most other European countries, but in Portugal as in Denmark, Norway and most of the new EU members, specialised training institutions are also important providers.
8. See in Chapter 5, OECD (2003c).
9. On training in enterprises, there have been success stories, with projects helping industrial sectors keep up with technological change, but the participation of smaller enterprises (10 to 30 employees) has typically been low because of entrepreneurs' reluctance to release employees (*cf.* The European Social Fund Press Release, July 2000).
10. The programme for vocational training, lifelong learning and social measures, is funded with a total of around 1.6 billion euros from the European Social Fund and the Regional Development Fund. The education programme provides 1.2 billion euros funding in

support of support vocational schools, teachers training in ICT, and the development of computer equipment in schools.

11. There has been no evidence of rising skill mismatch in Portugal, on the contrary, Portugal is one of the few euro area countries, with Belgium and the Netherlands, having witnessed an improvement in the Beveridge curve (cf. OECD, *Economic Survey of the euro-area*, 2004).

12. In their 2001 "Agreement on employment, labour market, education and training policy", the State and social partners listed access to continuing education and consolidation of adult education among the strategic objectives for human resource development. In 2002, social partners signed a joint declaration on the National Action Plan for Employment, in which training is listed as one of the priorities for cohesion policies. In early 2004, a new law to promote lifelong learning was proposed after discussions between social partners and the State (represented by the Ministry of Social Security and Labour).

13. The *Instituto do Emprego e Formação Profissional* (IEFP) operates under the Ministry of Social Security and Labour. Survey results indicate that its existence and the support it can provide for the creation of a business are well known among young job seekers or long-term unemployed seeking to open a business (cf. Ministry of Social Security and Labour, 2003).

14. Regarding training, employers are required to elaborate annual (and multi-annual) training plans as well as annual reports on the execution of continuous training obligation.

15. The percentage of households having internet access at home has been growing rapidly in Portugal, from 15.9 per cent in 2002 to 21.7 per cent in 2003, based on Eurostat structural indicators. Nonetheless, by 2003 it was still much below the EU average (45 per cent, for the EU15). [*http://europa.eu.int/comm/eurostat/Public/datashop/print-product/EN?catalogue=Eurostat&product=struct-EN&mode=download*].

16. Another instrument, a tax deduction (with a ceiling) provided since 1998 to households for the acquisition of ICT equipment, is less easy to justify. The tax incentive may have a legitimate social objective, but it is unclear whether it is achieved in the most efficient way, if achieved at all, since low-income categories do not have sufficient tax liability that can be set off against the tax break.

17. The *Novas Empresas de Suporte Tecnológico* (NEST) programme provides support to the creation of technology-based companies with venture capital financing. It is aimed at companies with venture capital financing. It is aimed at companies with still low activity, critically dependant on high-technology development which obtain up to 90 per cent funding from venture capital. These companies are granted a special status ("NEST company") with additional benefits, including support to locate in a technology park.

18. The QUADROS programme (which is one of the instruments of the new PRIME programme geared to enterprises modernisation) co-finances current cost associated with hiring graduates in marketing, engineering, technology and other areas linked to innovation and management.

19. The aggregate indicator computed by the OECD for Portugal shows: *i*) relatively stringent rules on individual dismissals; *ii*) average stringency of regulation on fixed-term contracts; and *iii*) average stringency in the requirements for collective dismissals (OECD *Employment Outlook* (2004, Chapter 2). More precisely, collective dismissals apply to cases with two workers or more in small-size firms (five workers and more in firms with more than 50 employees), while in many other countries the threshold for application

of collective dismissals rules is 10 employees or more. The condition prevailing in Portugal, however, should not necessarily be interpreted as particularly restrictive since in many cases, agreements at the firm level facilitate collective dismissals (which might even have been easier to apply than the individual procedure).

20. J.M. Varejão (2002) shows that in Portugal, as in a number of other European countries, fixed-term contracts are generally used as screening devices. High rates of transition from temporary to permanent contracts, for young workers especially, indicate that fixed-term contracts often are stepping stones towards permanent jobs, rather than dead-end jobs. As a result the social hardship and potential impact on productivity from the widespread use of short-term contracts are rather limited. Still, a non-negligible proportion of workers do remain in a chronic situation of temporary contracting.

21. The scale of contracting-out arrangements and outsourcing of services to "independent" workers, known as "green receipts", was already among the highest in the OECD in the mid-1990s, under the combined impact of strict EPL and lower social security contributions. It decreased somewhat (as a share of non-agricultural employment) in the second part of the 1990s after social security contribution rates were harmonised.

22. This is particularly true of Portuguese firms, while foreign firms operating in Portugal have recourse to collective dismissal procedures. But even foreign-owned firms often prefer to reach agreements to reduce costs during cyclical downturns by adjusting working time and wages rather than the payroll, as illustrated by the agreement reached in the AutoEuropa plant (Volkswagen A.G.) in early 2004.

23. Evidence is mixed regarding regional mobility, with a relatively high percentage of cross-border commuting, but a lower than average commuting across regions (*cf.* OECD E*conomic* S*urvey of the euro area*, 2004). Institutional features, such as different social benefit regimes for different sectors are a factor contributing to the low sectoral mobility.

24. Under certain conditions, an employer will now be able to assign a worker to another region or to another task than the one he was hired for in the firm.

25. The current regime for fixed-term contracts clarifies the rules for the use of successive contracts; it establishes specific training obligations for workers under this type of contracts and compensation to the worker if termination is decided by employer. As a disincentive to excessive use of fixed-term contracting, employers social security contributions are related to the number and the duration of these contracts.

26. Lindley (2003) notes some inconsistency between that need to foster within-firm learning and sharing knowledge and the need for greater flexibility of contracts. According to him, the link to foster adequate organisations should be found in social partnerships.

27. C*f.* OECD (2003) T*he sources of economic growth in the* OECD *countries*, which summarises findings of the OECD Growth Project. See also OECD (2002).

28. The new Competition law makes important changes from the previous legislation, regarding company mergers, abuse of dominant position, and sanctions-fines-imposed for anticompetitive practices. The new Competition Authority is taking the place of the Competition Council and the Directorate General of Competition and Trade. The scope of the Competition Law has been broadened and updated, in line with European Commission rules, namely in the area of merger control: mergers of banks and insurance companies are now included under the new Law; and the assessment of measures qualified as "state aids" has been streamlined, granting the Authority powers to issue recommendations addressed to the government and public bodies. Details on the new legislation and its application are available on the Authority's website [*www.autoridadedaconcorrencia.pt*].

29. Portugal was notified by the European Court of Justice in 2002 for its Framework Law on privatisation, which provided for the possibility of restricting foreign participation in many sectors, and changes were required. The required changes were implemented. In July 2004, the European Commission decided to close its case.

30. The agreement, signed in January 2004, setting the structures and operating rules of the Iberian Electricity Market (MIBEL) was expected to start operating in April of the same year, but the change of government in Spain could delay its implementation. When implemented, this will be one of the few concrete experiences (with the Nordic electricity market) of an integrated European energy market.

31. Legislation in Portugal is changing to move towards the creation of an electricity market. Initially, national regulators and network operators will operate in coordination; then, according to the agreement, they are to be integrated. In 2003, the Competition Authority commissioned a study on Portugal's energy market by Cambridge Economic Policy Associates. Outstanding competition issues which were identified – and are being discussed with the government – were: the local distribution of power and gas under a single operator; limited transmission capacity between the Spanish and Portuguese power grids; compensation payments for termination of existing Purchasing Power Agreements (PPAs); and the pace of liberalization of gas imports.

32. The Competition Authority, which has received several formal complaints against anti-competitiveness practices in the overall telecommunications market, from competitors of the incumbent company/groups has opened several enquiries under the Competition Law, currently under investigation. Within these enquiries, the Competition Authority coordinates with the sector regulator, ANACOM. Under the Competition Law it is mandatory for the Competition Authority to coordinate with sectoral regulators when the anti-competion practices concern regulated markets.

33. Portugal Telecom has a market share higher than 90 per cent in fixed telephony, long distance services, vs. 60 per cent in the 13 other European countries for which data are available. C. Gjersem (2004).

34. To develop competition in telecommunications, the following is underway: *i*) the sector's regulator ANACOM is holding a public consultation about issues related to the pre-selection call function, which may need to be enhanced; *ii*) an information campaign on telephone number portability was launched (by ANACOM) in mid-2003, to raise awareness of consumers about this possibility; *iii*) an analysis is being carried out on the competition situation in the latest physical stage of delivery – with the unbundling of the local loop – which is crucial to reduce the market power of the incumbent arising from control of the local loop.

35. The Ministry of Economy report, *Portugal 2010: Accelerar o Crescimento da Produtividade*, September 2003, lists the existence of widespread informality as the main factor explaining Portugal's low productivity level. Although difficult to measure, the incidence of informal employment is found to be particularly high in countries characterised by a high proportion of self employment, such as Portugal, Greece or Italy for instance. In those countries, and more generally Southern Europe, it appears to be an important determinant of the extent of illegal immigration. *Cf.* OECD (2004).

36. At the same time the municipal tax rate was lowered from 3.0 to 2.5 per cent, for an overall rate of 27.5 per cent at present (vs. 33 per cent previously). According to C. Bronchi and J. C. Gomes Santos (2002), Portugal's tax regime seemed to be on par with that in other European countries. This, however, may not be enough, given the country-specific features of Portugal in Europe (a small-size economy, located at the periphery

and non-English speaking) and to face competition from new EU members, where tax rates are relatively low.

37. By early 2004, 10 Formality Centres for Enterprises were already in place and being used by more than half entrepreneurs and investors applying to create a business; administrative procedures to create a company had been reduced to about two to three weeks. The cost of creating a company was close to 600 euros, or 4.7 per cent of gross national income per capita, lower than the OECD average.

38. Notary practices will be responsible for preliminary tasks and subsequent activities (until then carried out by Registry offices). The privatisation will be achieved in two steps: first, the number of notaries is being increased, so their services will be more available; second, private and public notaries will coexist for a while. At the same time trade register offices are being computerised.

39. By February 2004, the Portuguese Investment Agency which started to operate in 2003 had assessed some 47 contracts, reviewed 72 investment projects for a total amount of almost 5 billion euros, of which more than half were related to tourism.

40. Criteria for providing subsidies were not as clear under the operational programme for the economy (POE) previously in place. The European Commission formally accepted Portugal's new "incentive programme for the modernisation of the economy" (PRIME) in June 2003. Under this scheme, the firm's borrowing is converted into a subsidy, subject to results. The programme is geared to enterprises in industry, commerce, services tourism, construction and energy.

41. The allocation of the fiscal reserve (a reduction of 20 per cent on the tax liability for 2003 and 2004) must be used within two years, either for initial investment in tangible fixed assets (not for replacement investment) or in innovation and development; otherwise, it has to be paid back with a penalty.

42. Portugal's venture capital market is one of the smallest in the OECD, in 1999-2002: total venture investment averaged less than 0.1 per cent of GDP, about one third of the OECD average ratio. Investment in the ICT sector, including computer software, accounted for about 15 per cent of total investments in 1999-2001, while there were pockets of investment in advanced sectors such as health and biotechnology. More details are provided in OECD (2003b).

43. As a measure to reduce the bureaucracy, a single supervisory body, the stock market commission, CMVM, has been entrusted with regulating and supervising activities of the Risk capital companies (SCR) and Risk capital funds (FCR) , functions which were previously divided between the Bank of Portugal, CMVM and the Ministry of Finance. Tax measures include: *i*) the elimination of the tax on capital gains reinvested by the SCR; *ii*) the SCR's remain subject to the same tax treatment as before, thereby continuing to be exempt from the stamp duty on loans and deeds drawn up for incorporation and increase in share capital; a tax credit is introduced for SCRs. With regard to the FCRs, the tax system is becoming more flexible an holders can now opt to be taxed in the same way as the SCR shareholders.

44. In particular, the new enterprises for technological support programme (NEST) is focused on helping the creation of technology-based enterprises located in technology centres or parks, by helping them obtain financing from public risk capital companies or funds.

45. Portugal is among the countries which provide the highest tax subsidies to R&D in large enterprises (OECD, 2003a. More generally, tax incentives can be introduced on a selective basis to remedy market failures, for instance underinvestment in R&D or training.

But targeted incentives for certain sectors or activities tend to have adverse economic effects for the following reasons: *i*) they are difficult to target, as information to identify precisely market failures is often lacking; *ii*) they lead to increased tax avoidance as investors seek to characterise non-qualifying expenditure so that it qualifies for the tax break; *iii*) they sometimes subsidise activity which would occur anyway; *iv*) they are less transparent than explicit subsidies.

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3. The fiscal challenge

Reducing the fiscal deficit and securing sustainability of public finances over the medium-term has been the main macroeconomic policy priority since 2002. This is first a response to the European fiscal rules, but, more fundamentally, it reflects a political determination to ensure that Portugal's catching up will not be jeopardised by recurrent fiscal crises. A more comfortable fiscal situation would support growth by: *i*) allowing automatic stabilisers to operate fully during downturns; *ii*) improving confidence; *iii*) putting the public sector in a better position to respond to the long-term development needs of Portugal (for instance in education); and *iv*) contributing to a friendlier business environment by improving the efficiency and speed of public services. In turn, stronger growth in the long-term should help contain fiscal imbalances. This chapter assesses the strategy developed by the authorities to address this fiscal challenge. The first section reviews progress in fiscal consolidation in the short term, while the two other sections focus on longer term sustainability issues, including reforms to improve the public administration and how to respond to spending pressures related to an ageing population.

Fiscal consolidation in the short run

The programme of progressive fiscal consolidation weakened over time, ending in 2000, when the budget deficit had reached 2.8 per cent of GDP. In 2001, the deficit increased sharply to 4.4 per cent of GDP, in part reflecting changes in recording practices and definitions, breaking the 3 per cent ceiling set by the Maastricht Treaty. As a result, the European Commission launched an excessive deficit procedure against Portugal (Box 3.1). While reflecting some temporary circumstances (activity slowdown, expenditure slippage ahead of the 2002 elections), this deterioration of the fiscal accounts reflected more fundamental problems.

The consolidation efforts during the previous upturn were much too limited to leave any room for manoeuvre in a downturn. As discussed in Chapter 1, the cycle and lower interest rates explained most of the deficit reduction over the late 1990s, and there was no discretionary retrenchment (as measured by a reduction

Box 3.1. The 2001 slippage and the excessive deficit procedure

The fiscal situation deteriorated markedly in 2001, with the budget deficit increasing from 2.8 per cent of GDP in 2000 to 4.4 per cent of GDP. This slippage reflected: *i*) lower than expect revenue following the activity slowdown; *ii*) lower recorded tax receipts as a result of changes in methodology; *iii*) increased current spending, in particular from local governments, ahead of the parliamentary elections in March 2002, and *iv*) a pick-up in capital spending following the start of some EU co-financed projects (Community Support Framework III).

Although it was clear in spring 2002 that the 2001 deficit outturn was larger than anticipated, it was only in July 2002 that its true magnitude became evident, following the report of a special commission. Judging that cyclical factors did not explain everything, the European Commission decided in mid-October 2002 that Portugal had run an excessive deficit in 2001. The Council adopted a similar decision on 5 November 2002 and asked Portugal to remedy its excessive deficit situation as rapidly as possible.

The Stability Programme presented by the authorities at end-December 2002 included a package of measures to be adopted in 2003-06 designed to contain expenditures on a durable basis (see below). In the first quarter of 2003, the European Commission and the Council approved these measures as in line with recommendations to end the excessive deficit situation. The Stability Programme for 2004-07 was also approved by the European Commission and the Council. In April 2004, the Commission concluded that the Portuguese authorities had complied with the Council recommendation to put an end to the excessive deficit situation as rapidly as possible. In May 2004, the Council decided to abrogate the excessive deficit procedure in Portugal.

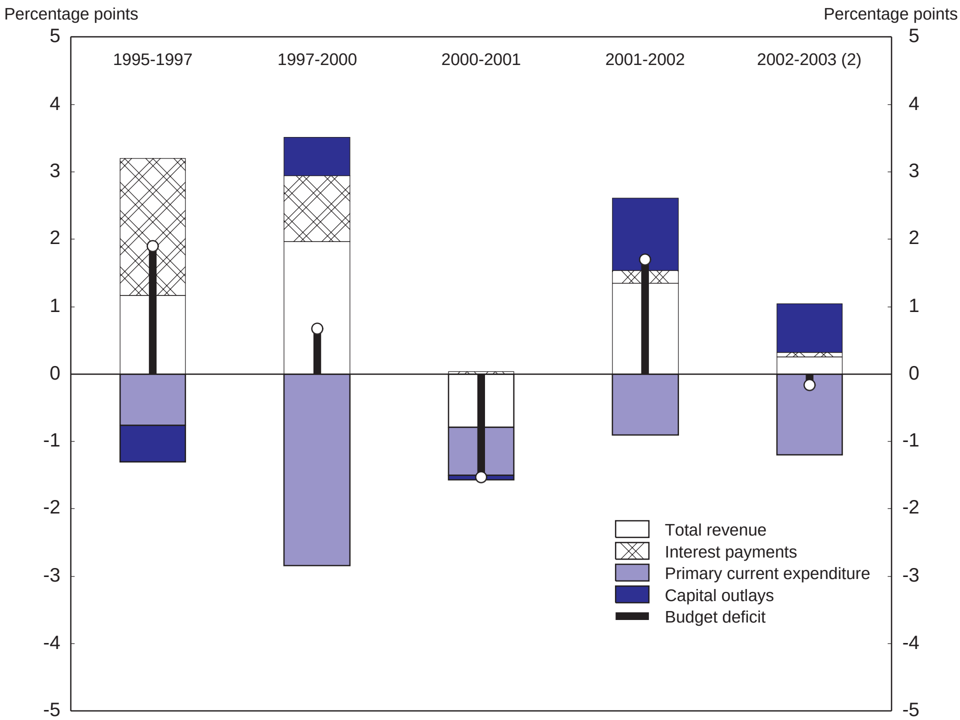
in the cyclically-adjusted deficit) in the 1997-2000 period (Figure 1.1). The resources derived from the stronger revenues and the fall in interest payments on the public debt were used to increase primary current expenditure instead of reducing the deficit (Figure 3.1). The difficulties of meeting current expenditure targets in the recent period and the 2001 slippage highlighted inefficiencies in public expenditure management that had to be addressed.

Fiscal consolidation efforts kept the deficit below 3 per cent of GDP in 2003…

Fiscal consolidation has been the overriding objective of economic policy since 2002. Portugal did not let automatic stabilisers smooth the 2002-2003 slowdown in activity and fiscal tightening came on top of a contraction of private demand (both domestic and external). The Portuguese strategy to curb the fiscal deficit has included a 2 percentage points VAT rate increase (as of July 2002), on

Figure 3.1. **Contributions to fiscal consolidation 1995-2003**

Cumulative change in budget balance in percentage points of GDP[1]



1. General government, national accounts basis. A positive change contributes to a deficit reduction.
2. OECD estimates for the 2003 budget outturn.

Source: OECD, *Economic Outlook* No. 75 (June 2004).

the revenue side, and short-term and one-off emergency measures in combination with more in-depth medium-term measures, on the spending side.[1]

- E*mergency measures* taken as early as mid-2002 included spending freezes and cuts. In particular, some public investments were deferred, public wages and hiring were frozen, and operating expenditures were cut. At the same time, subsidies to interest payments on mortgages were eliminated. Most measures affecting spending were maintained in 2003. In addition, one-off operations (sale of the fixed telecommunications network, of highway tolls and a tax amnesty) were taken in 2002, amounting to about 1½ percentage points of GDP, and additional ones had to be taken again in 2003 (see below).

- Some *structural measures* were also adopted in 2002 to put the budget on a sounder path in the medium term (closing down of some government agencies, launching of a comprehensive health care reform, public administration reform, rationalisation of education services, and approval of a budgetary stability law to better control expenditure by sub-central governments and autonomous funds). These measures and their implementation are detailed below. So far, the slowdown of health expenditure in 2003 has been the only quick and clear contribution to budget consolidation, but effects of the other measures adopted should become more visible as implementation progresses.

This strategy enabled Portugal to bring its fiscal deficit back to below 3 per cent of GDP as early as 2002. In 2003, however, the contraction in economic activity hindered further reduction in the fiscal deficit, even though current expenditure was kept under control.[2] In particular, the wage bill contracted following the continuation of the freeze on hiring and on wages above 1 000 euros, and the suspension of wage and career reclassification (Box 3.2). The immediate impact of health sector reform measures also generated some saving, mainly linked to lower

Box 3.2. Emergency policy measures to contain wage bill growth

Since mid-2002, the government approved several emergency measures in order to slow public expenditure growth, especially the wage bill. The supplementary budget for 2002, approved in May 2002, froze the renewal of individual contracts and fixed-term contracts,[1] with any new hiring requiring special permission from the Minister of Finance. Careers restructuring and reclassifications were also frozen. In the two subsequent years, the recruitment of public servants, as well as career restructuring and reclassifications, continued to be suspended.[2] Wages above 1 000 euros (1 024 euros in 2004) were frozen and those below that amount were revalued by 1.5 per cent in 2003 and 2 per cent in 2004.

As a result, the number of civil servants, as measured by subscribers to the pension system (*Caixa Geral de Aposentações*, CGA), which had been rising by 4 per cent a year in 1997-2001, increased by only 1 per cent in 2002 and diminished slightly in 2003. The total wage bill diminished by 2.6 per cent, reflecting also accounting changes that followed the transformation of 34 public hospitals into 31 public corporations (see Chapter 4).

1. In the second semester of 2002, the number of fixed-term contracts was reduced by 30 per cent and the number of contracts of provision of services by 26 per cent.
2. This recruitment freeze does not apply to teaching and military staff, and recently set local administration bodies.

spending on pharmaceutical reimbursements (see Chapter 4). Savings on the wage bill and health expenditure compensated for the substantial increase in social benefits and transfers triggered by the downturn.[3] Much weaker-than-projected activity in 2003, and hence wages and profits (with GDP actually declining by 1.3 per cent instead of the budgeted growth of 1¼-2¼ per cent), were reflected in much lower than budgeted tax revenues and social contributions (by at least 1½ percentage points of GDP). As a result, the authorities had to rely again on one-off operations to keep the deficit below 3 per cent (Table 3.1). These operations, amounting to about 2.3 percentage points of GDP, included: *i*) the recording as government revenue of the transfer of unfunded pension obligations from postal services (CTT) to the General Government (0.9 per cent of GDP),[4] and *ii*) the sale of non-performing tax and social security claims to a private financial institution at close to 15 per cent of face value (amounting to 1.4 per cent of GDP). Both operations have been agreed upon by the European Commission (Eurostat). Nevertheless, the

Table 3.1. **General government financial accounts**[1]

Per cent of GDP

	2000	2001	2002[2]	2003[2]	2004 budget[3]
Current receipts	40.8	40.1	41.4	41.7	41.4
Direct taxes	10.4	9.9	9.7	9.2	8.7
Social security contributions	11.8	11.9	12.3	12.7	12.8
Indirect taxes	14.4	14.2	15.0	15.8	15.3
Other current receipts	4.2	4.0	4.3	3.9	4.6
Current disbursements	40.2	40.8	41.5	42.5	42.5
Intermediate consumption	4.4	4.3	4.3	3.8	4.1
Compensation of employees	15.0	15.1	15.4	14.9	14.5
Social security	14.0	14.4	14.9	17.0	16.7
Interest on public debt	3.3	3.2	3.0	2.9	3.0
Other current disbursements	3.5	3.8	3.9	4.0	4.2
Current balance	0.7	–0.7	–0.1	–0.8	–1.0
Capital receipts	1.4	1.8	2.0	3.3	2.8
Capital outlays	5.0	5.5	4.6	5.4	4.7
Gross investment	3.8	4.0	3.4	3.9	3.0
Capital transfers	1.2	1.5	1.2	1.4	1.7
Overall budget balance	–2.8	–4.4	–2.7	–2.8	–2.9
Memorandum items:					
Primary balance[4]	0.4	–1.1	0.3	0.1	0.1
Primary current spending[4]	36.9	37.6	38.5	39.6	39.5
One-off operations	0.3	0.0	1.6	2.3	0.8

1. National accounts basis. Ministry of Finance presentation. Rates are calculated on the basis of the new GDP levels (revised in June 2004).
2. Provisional data.
3. The budget deficit for 2004 was set at 2.8 per cent initially, as calculated on the basis of the old GDP data.
4. Excluding "interest on public debt".

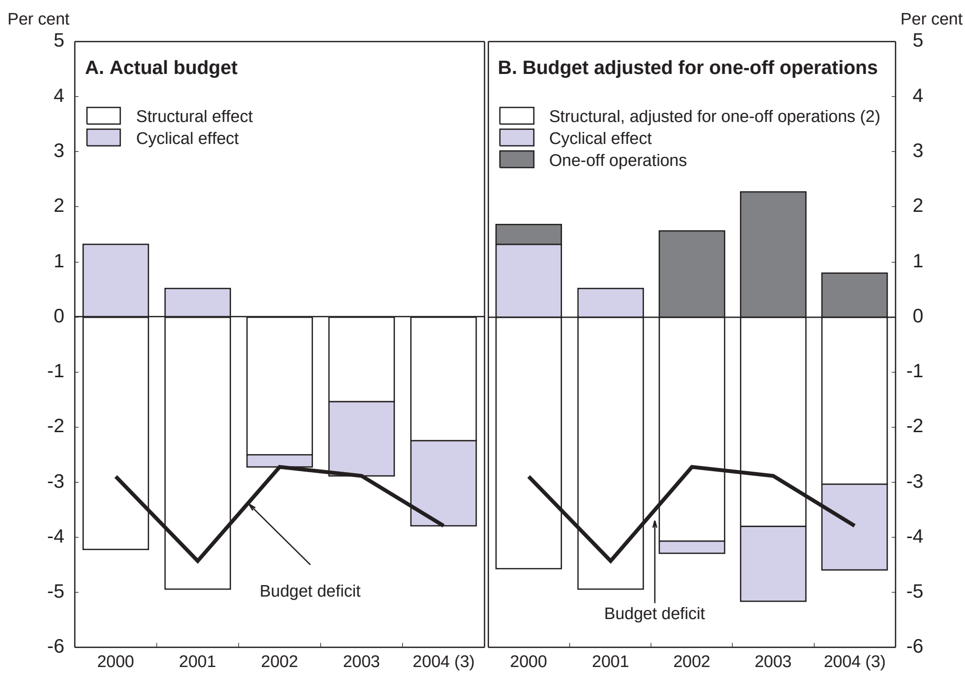
Source: Ministry of Finance.

debt-to-GDP ratio has been increasing since 2001, after reaching a low of 53.3 per cent of GDP in 2000. This reflects besides the deficit levels, the regularisation of expenditure arrears in the health sector and the weak nominal growth of GDP. The threshold value of 60 per cent of GDP set by the Maastricht Treaty was reached in 2003.

According to OECD estimates, the consolidation effort (measured by the change in the fiscal balance adjusted for the cycle) amounted to 2.5 per cent in 2002 and 1.0 per cent in 2003 (Figure 3.2 panel A). However, since a significant share of the consolidation can be imputed to one-off operations, a better idea of the consolidation effort is given by adjusting the structural deficit for the impact of these exceptional measures (Figure 3.2 Panel B). The underlying adjustment, thus

Figure 3.2. **Fiscal consolidation efforts**[1]

Per cent of GDP



1. General government financial balance. National accounts basis.
2. Excludes the cyclical effect and the impact of the non-cyclical factors that reduce the budget deficit, occurring only once in time (*e.g.* the UMTS sales in 2000).
3. Data for 2004 are OECD estimates, under the assumption that one-off measures are not higher than those budgeted.

Source: OECD, *Economic Outlook* No. 75 (June 2004).

defined, appears smaller although not negligible (½ percentage point of GDP in 2003 compared with close to 1 percentage point in 2002).

Although a more prudent fiscal policy in the late 1990s and 2000-01 would have prevented the fiscal imbalances from arising in the first place, overall the Portuguese strategy to address them thereafter has been appropriate. It has allowed for quick results in a difficult context, while also embarking on a programme of more in-depth measures to address deeply-rooted weaknesses in public finances. Some of the one-off operations, such as the 2002 sale of the fixed telecommunications network and highway tolls or the 2003 transfer of the postal services pension fund, have had the advantage of moderating the pro-cyclical stance of fiscal policy during the downturn. These measures, plus others such as freezes and cuts, have therefore been key in filling the time gap before the effects of in-depth reforms materialise. However, fiscal consolidation cannot rely on such measures for too long. Freezes in government hiring or wages as well as investment cuts, while effective in the short term, can create inefficiencies if prolonged for several years. In particular, hiring and wage freezes give distorted incentives to younger, better-educated aspirants to permanent posts in the administration and greatly complicate human resource management.[5] This could in turn slow progress towards moving to a more qualified public service, which is an essential goal of the ongoing public administration reform (see below). The repetition of cutbacks in infrastructure spending is also undesirable from a longer-term view.

The 2004 budget target will be difficult to achieve

The 2004 budget targeted a deficit of 2.8 per cent of GDP, entailing a reduction of ½ per cent of GDP in the structural balance.[6] The macroeconomic scenario underlying this budget seems reasonable, although slightly more optimistic than the OECD projections established in May 2004 (1 per cent growth in GDP compared with 0.8 per cent expected by the OECD). On the expenditure side, despite an increase in social transfers, further consolidation efforts are expected to bring savings: first, structural measures to curb expenditure in education, health and public administration are expected to start having a visible, although still limited, impact on current expenditure; second, most emergency measures decided in 2002/2003 to reduce primary spending have been maintained for 2004.[7] Moreover, one-off operations amounting to 0.8 percentage point are expected from real estate sales by the state (to be recorded as negative investment expenditure).[8]

On the tax side, the key measures are the cut in the corporate income tax rate to boost investment and competitiveness (from 30 to 25 per cent at the central government level and from 3 to 2.5 per cent at the municipal level), the creation of a fiscal reserve for investment in R&D and the reform of the taxation of assets.[9] These revenue losses are expected to be more than compensated by higher social contributions and profits following the economic recovery, better tax compliance, recovery of debt arrears to the social security system and some increases in public service prices. Current revenues are therefore expected to increase by almost one percentage point of GDP in 2004. Total revenue would still decrease because of a contraction in capital revenues, reflecting the fact that one-off operations, such as those adopted in 2003, will not be repeated.

Some options chosen in the 2004 budget can be questioned and the budget target will be difficult to achieve:

- While the tax cuts are justified to boost Portugal's international competitiveness, from a public finance point of view it would have been more appropriate to start phasing out emergency cuts and freezes as from 2004, and wait until the full impact of structural measures on the expenditure side materialised before cutting the corporate tax rate. While expenditure cuts and freezes have been effective in reducing the deficit, maintaining them for the third year in a row might prove costly in the medium term. For instance, although it is essential to avoid an excessive increase in the wage bill, the control should come from forceful rationalisation and other changes in human resource management in the public sector rather than from arbitrary freezes.
- Although the macroeconomic scenario underlying the budget is not particularly optimistic, the budget target might still be difficult to reach. On the revenue side, compliance concerning payments of taxes and social security contributions might not improve as much as expected by the authorities since the budgeted one-off revenues from securitisation were recorded in 2003 instead of 2004. According to OECD estimates, taking also into account some slippage in current expenditure, the deficit could be one point higher than budgeted.[10] The underlying consolidation effort would however remain significant (0.8 percentage point of GDP). The debt-to-GDP ratio is likely to increase slightly above 60 per cent of GDP, despite expected privatisation receipts.

Looking ahead

Looking ahead, the Stability and Growth Programme 2004-07 foresees a reduction of the deficit to 1.1 per cent of GDP by 2007, implying a structural deficit decline of about ½ percentage point of GDP each year, and a gradual reduction of the debt-to-GDP ratio to 57 percent of GDP. The reduction of the deficit will be achieved mainly through adjustments on the expenditure side, in line with OECD and EU recommendations, especially through:

- Wage restraint and reduction in public employment.
- Ceilings on annual expenditure growth in some main spending areas.[11]

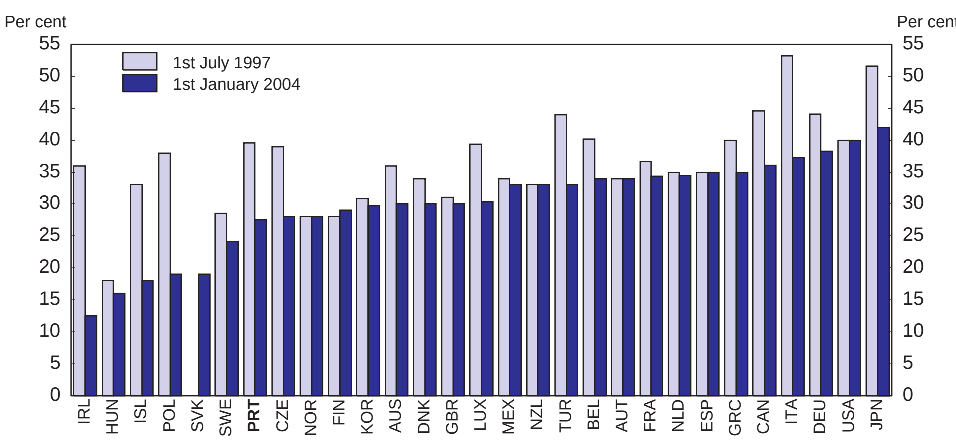
- Limits on transfers by the states to the social security system, limits on borrowing by local and regional government, requirement of balanced accounts for autonomous services.
- Forceful implementation of the structural reforms adopted since 2002.

It has been appropriately decided that these expenditure side adjustments will be independent of the economic cycle, implying that higher-than-expected revenues would accelerate the deficit reduction and lower-than-expected revenues would not stop the consolidation efforts. Given the prudent macroeconomic scenario, the risk is more on the positive side. The medium-term programme also foresees a phasing out of the recourse to one-off measures by 2007 and an additional 5 percentage points cut in the corporate tax rate in 2006, which would put the Portuguese corporate income tax rate among the lowest in the OECD (assuming that other OECD countries maintain their tax rates broadly unchanged) (Figure 3.3).

A slippage in the budget outturn for 2004 would require further consolidation efforts in the next years or a revision of the targets over the Programme period. More fundamentally, in the medium term it is important that the planned reduction in the corporate tax cut be accompanied by improved tax compliance by companies (so as to broaden the effective tax base) and further simplification of the tax laws (which is as important for competitiveness as the tax rates themselves).

Figure 3.3. **Statutory corporate tax rates in OECD countries**[1]

Per cent



1. Central and sub-central government corporate tax rates combined. For Portugal the municipal rate amounts to 2.5 per cent in 2004. Where a progressive rate structure applies, the top marginal rate is shown.

Source: OECD, Tax database; KPGM.

The main medium-term concerns remain: *i*) implementation of the already approved structural reforms, which has to be stepped up, with a view not only to reduce expenditure but also to improve the quality of public services; and *ii*) the need to launch additional reforms, especially regarding pensions, to lessen further spending pressure; otherwise the fiscal balance improvement expected to occur by 2007 will be short-lived.

Reforms have been launched to improve the quality and efficiency of public services

The programme of structural reforms to redress public finances includes measures to better control spending and, as importantly, to raise the quality of public services. In 2003, OECD recommended that Portugal adopt a set of measures in order to improve public spending efficiency and effectiveness, to turn input into more output and better outcomes. The public administration reform fits in that context. The government announced in 2003 a major overhaul of the country's large public administration. Increased staff mobility and managerial flexibility, along with a more accurate performance evaluation and personal accountability, are key elements in the reform. Rationalisation efforts have also started in the health and education sectors, aimed at building a more outcome-oriented public sector.

The public administration reform

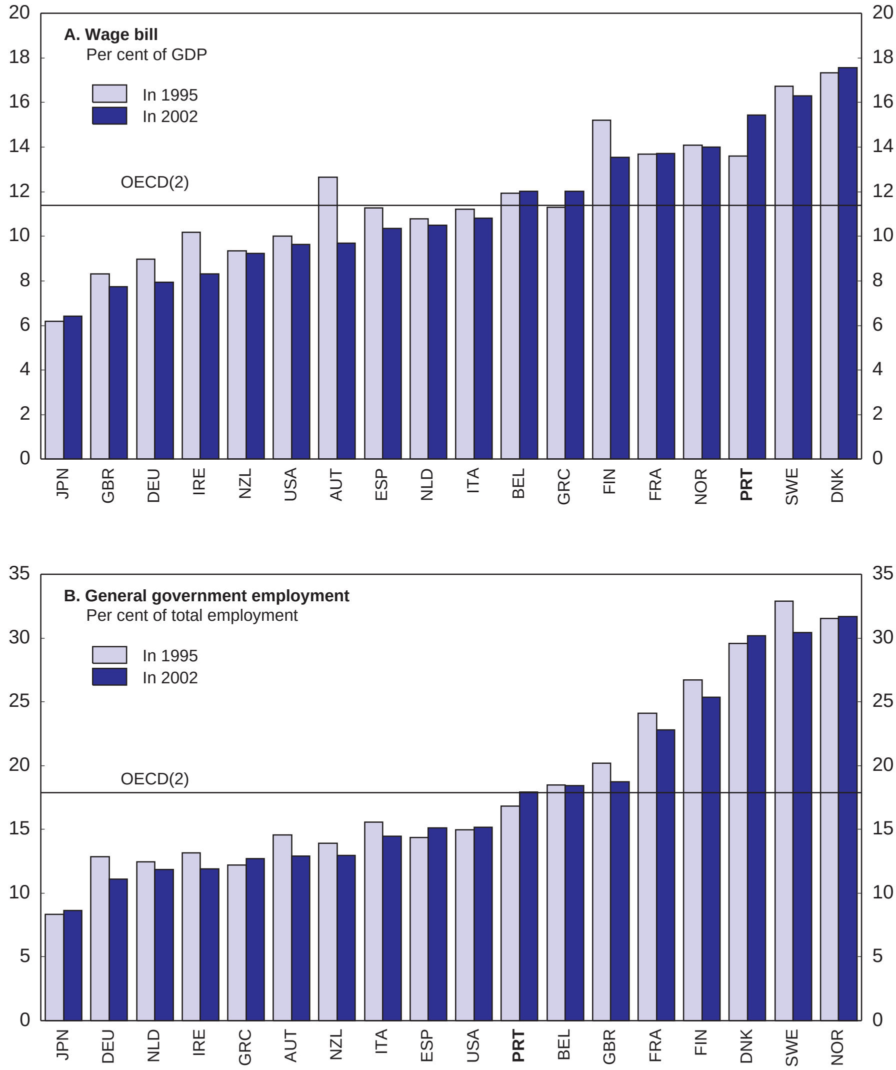
Compensation of employees in the general government increased rapidly over the late 1990s and until 2002, then reaching 15.4 per cent of GDP, well above the OECD average (Figure 3.4). The size of government, measured by employment, is close to the OECD average (Figure 3.5).[12] However, the quality of public administration services is widely considered as poor. In the last two years, the Government has adopted emergency measures to contain expenditure, especially the wage bill (see Box 3.2, above), and a vast programme of public administration reform was launched.

Increasing staff mobility

In October 2003, a public employment pool was established in order to reduce recruitment outside the public administration and to encourage mobility within the public administration (*Bolsa de Emprego Público*). At the same time, information about the internal demand and supply of public jobs has been made available online to civil servants. In June 2004, the pool included 34 public servants made redundant as a consequence of restructuring processes, who had not yet been transferred and were available for placement. Over the nine months or so since its creation, 1 197 civil servants have put their name down asking explicitly to move to another job within the public administration.

Figure 3.4. **General government wage bill and employment in selected OECD countries**[1]

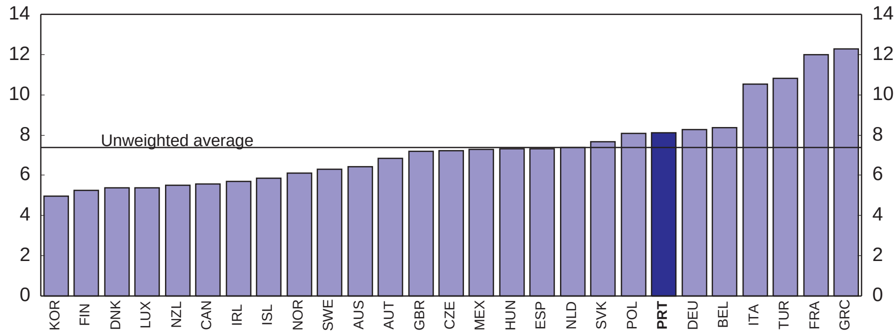
Per cent



1. OECD estimates. Excluding public enterprises, except for Japan.
2. Unweighted average.

Source: OECD, *Economic Outlook* 75 database.

Figure 3.5. **Public administration employees**[1]
As a percentage of total employees in 2002[2]



1. Corresponds to the national accounts industry branch NACE L. It includes such activities as defence, judicial services and police, foreign and economic affairs, administration of tax and social systems, regulatory and general public service activities. Public employees working in other industry branches (especially health and education) are not included.
2. 2001 for Austria; 1999 for Belgium. No data for Japan, Switzerland or the United States.

Source: OECD, *Annual Labour Force Statistics*.

Reorganising the public administration

Rationalisation of the public administration, including public institutes, was announced as a first step of a deep reform in 2002, immediately after the incoming government took office. The restructuring of the public administration has started to be implemented. So far, this process has resulted in the closing of 10 public institutes, the merging of 19 others, and it has led to the creation of 10 new bodies and the transformation of 31 into corporations. Since 2002, as well, four new public institutes were created with an integrated management of resources and improved coordination of services, so as to benefit from economies of scale.[13]

In the beginning of 2004, two new framework laws were approved, one defining the organisational model for the functioning of central administration and the other defining the purpose, principles and functioning of public institutes.[14] The new organisational and operating model for the central administration that was established sets the rules for the creation, merging and closing of services and organisations and simplifies legal formalities. Directors' autonomy concerning the design of their services' internal organisation has been increased in order to increase flexibility, and new management practices emulating private sector management models are to be introduced. Concerning public institutes, their existence will have to be economically justified. Currently, the permission to create a new institute already requires a general assessment of the existing ones under the same ministry. All existing public institutes are being reassessed according to the principles established in the new framework law. By strengthening control on the creation and functioning of institutes, the government is seeking to avoid their proliferation, to prevent the creation of additional special regimes and to avoid redundancies. Productive activities carried out by public institutes will be ruled by commercial law; alternatively these activities would be outsourced to units on public-private partnerships or even privatised. The Ministry of Economy has been pioneer in this restructuring process. It has merged several general directorates and centralised procurement, computer services, human resources and documentation centres. The Ministry of Education itself has already restructured several of its central and regional bodies.

Increasing accountability of managers

A new statute for directors has also been approved at the start of 2004 with a view to increasing managers' qualification, skills and accountability. Target-based management systems are being introduced in the public sector, whereby promotion of civil servants will be based on merit rather than seniority as has generally been the case in the past. According to the new statute, the length in office is limited to 12 years and the renewal of appointments is contingent upon performance evaluation. Furthermore, a new integrated system of performance evaluation, covering civil servants, intermediate directors and services, based on predefined objectives was established in March 2004, to be implemented as from the second half of 2004. The evaluation of civil servants will refer to objectives, behavioural competences and personal attitude; it will be subject to quotas (in order to guarantee merit differentiation), and will require interactions between the evaluator and the evaluated person. The purpose of the exercise is to achieve fairness and coherence in human resource management and to promote merit as a basis for career.

In order to raise managerial flexibility, it would also be important to bring the labour statute closer to private sector practices. A new law establishing individual labour contracts as a real recruitment alternative in the public administration has been approved, although it will not apply to activities directly related to authority or sovereignty functions. In the context of increased managerial autonomy, directors will be given responsibility for such recruitment. The selection and admission processes will be streamlined; non-fixed-term contracts will only be allowed in the case of vacancy under a service's legal quota for civil servants. It will not be possible to transform fixed-term contracts into permanent ones and compensation will be subject to ceilings.

Concluding remarks

Summing up, some important legislative steps have already been taken, or are expected to be in the near future, in order to reform public administration and the labour statute of its employees. Some of the measures have already been implemented, while others, such as additional de-bureaucratisation and decentralisation measures, are expected to be fully implemented during 2004. The reforms are critical to the longer-term target of increasing mobility and efficiency within the public administration, thereby reducing the growth of primary expenditure. The direction of the reforms is appropriate and there have been some important achievements. But the speed of implementation should be accelerated. Implementation of such a reform is not an easy task, because of the change of culture that is implied by some of the measures taken, and there is thus a risk that the process could lose political momentum. This is why it is particularly important to advance in this process without delay.

Spending areas earmarked for rationalisation

Part of the ongoing education reform aims at improving cost-effectiveness in the sector, for instance the regrouping of very small schools, re-allocation of staff, introduction of systematic evaluation and increased autonomy of tertiary education institutions (see Chapter 2). In the health sector, an ambitious reform programme has started to be implemented to further raise the quality of health services and address equity issues, while maximising the cost-effectiveness of the system. The reform process and its assessment are discussed in Chapter 4. In the longer run, there are bound to be additional pressures on health care expenditure related to ageing. Hence, in this area as well as for pension systems, measures must be taken now to ensure long-term sustainability of public finances.

Ensuring long-term sustainability of public finances

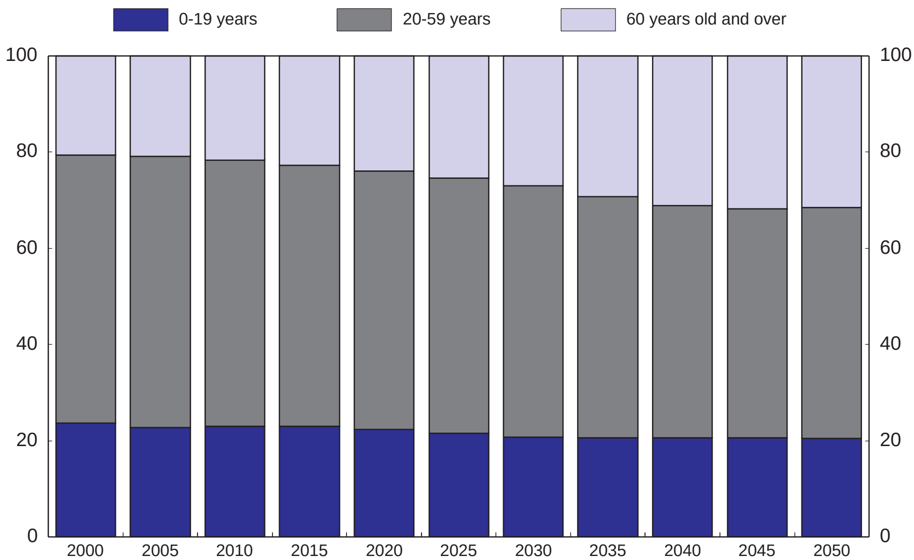
Ageing, as a result of higher life expectancy and lower birth rates, is affecting OECD countries to various degrees. This evolution will have a large impact on public finances, especially on public pension systems and health care, since expenditure in these areas are largely age-related. Portugal is not an exception in this regard and, faced with population ageing, strong in-depth measures need to be taken now in order to ensure long-term sustainability of public finances (Figure 3.6). Deep reforms can no longer be delayed, since expenditure problems are already emerging.

Medium-term pressure on health care expenditure

Over the past twenty years or so, technology and the adjustment of relative prices were the main drivers of the steady increase of public spending on health care – from around 2.7 per cent of GDP in the 1970s to over 6 per cent of the GDP in 2000-01. By then the OECD average was just below 6 per cent (up from 4.5 per cent of GDP in the 1970s). According to empirical studies, population ageing did not significantly contribute to the increase over the past two decades.[15]

Figure 3.6. **Population by age cohorts**

A. Broad age groups, as a percentage of total population



B. Population by sex and age group, in thousands

Source: European Commission (Eurostat).

Looking ahead though, ageing is expected to play a major role in boosting health care public spending, concerning acute care, as well as ambulatory care, pharmaceuticals and, a bit later on, long-term care. As a result of foreseeable demographic evolutions, public spending in health care, excluding long-term care, is expected to rise, *ceteris paribus*, by 1 to 2 percentage points of GDP between 2000 and 2050, to reach an estimated 6.4 to 7.2 per cent of GDP.[16] If factors other than population ageing, such as the development of new (more expensive) technology, are also considered, a sharper increase should be expected. Such projections, given the current and prospective fiscal situation, call for an urgent and deep reform of the health sector. Some steps in this direction have already been taken or announced and are discussed in detail and assessed in Chapter 4.

Pressure from population ageing on the pension systems

Steps were taken, starting in 2000, to improve the general pension regime sustainability

As in almost all OECD countries, ageing is affecting the Portuguese social security system. Some political concern on this issue arose in the second half of the 1990's, leading to the appointment of a Commission of Experts. The Commission published a White Paper on Social Security (*Livro Branco da Segurança Social*, 1997), which forecasts that the social security system would move into deficit between 2010 and 2015. As a response, in 2000, the Parliament approved a new Social Security Framework Law[17] that clearly separated contributory and non-contributory schemes and defined specific and adequate financing sources for each scheme (Box 3.3). The Framework Law also established the principles of a new disability and old-age pension benefit formula, which was defined in February 2002.

The new benefit formula for disability and old-age pensions, which had been established under the 2000 Framework Law was finally defined in early 2002. The revised formula takes into account the entire contributory career (capped at 40 years), while the formula applied until then had considered the average compensation of the best 10 out of the last 15 years. The wages on which benefits are based are either re-evaluated based on the CPI (excluding housing) for the period prior to 2002, or in the case of the 2002-2011 period, based on a composite index which combines the CPI and the average increase in earnings.[18] When record of past wages do not exist, some official estimate will be made according to job category and activity sector. For beneficiaries having contributed for more than 20 years, the accrual rate is based on a progressive schedule ranging from 2 to 2.3 per cent.[19] To guarantee the protection of acquired rights, a grandfather clause has been introduced to protect all workers having already completed the vesting period – 15 years of contributions – at the end of 2001 and all workers who began working before 2002 and are to retire before the end of 2016. These will get the most favourable pension value out of the following three benefit formulas: *i*) old formula; *ii*) new formula; *iii*) transition formula that corresponds to a weighted average of the

Box 3.3. Social security under the 2000 Social Security Framework Law

In Portugal, the mandatory public scheme of social security for private workers[1] is a typical first-pillar pay-as-you-go system, which is organised in three subsystems according to their purpose and their financing source.

- The *Contributory/Insurance Subsystem* comprises all pensions and income-substitution benefits of contributory nature (general regime). Contributions, which are based on wages, are paid by both employees and employers.[2] An amount ranging from 2 to 4 percentage points of the employees contribution, as well as general regime surpluses and capital gains, should in principle be channeled to the social security reserve fund (*Fundo de Estabilização Financeira da Segurança Social*, FEFSS). Regarding minimum pensions,[3] the difference between the social pension and the statutory pension (the social complement) is considered to form part of the non-contributory regime (*Regime Não Contributivo e Equiparados*, RNCE) and thus financed exclusively by the state budget.
- The *Solidarity Subsystem*, comprises the non-contributory or low contribution regimes – *Regime Não Contributivo e Equiparados* (RNCE), *Regime Especial de Segurança Social das Actividades Agrícolas* (RESSAA) and the former railways workers' regime, as well as social insertion income (formerly called the minimum guaranteed income), all of which are exclusively financed by the state budget.
- The *Family Protection Subsystem*, comprises expenditure for family protection, active labour market policies and vocational training, as well as all other family benefits, such as the family subsidy and complements for deficiency and dependency, is financed by employers, employees and the state budget (with 50 per cent of the family protection expenditure being financed by earmarked value-added tax revenues).

Social Action, mainly run by private non-profit institutions, is also exclusively financed by the state budget.

1. There is also a mandatory scheme for civil servants (see below) and a special (privately-run) trust scheme for bank and insurance employees.
2. The general contribution rates are 11 per cent for the employee and 23.75 per cent for the employer; several lower contribution rates exist for: *i*) schemes with less coverage; *ii*) employers belonging to the non-profit sector; *iii*) agriculture and fisheries workers; *iv*) and as a stimulus to employment for several categories of workers. There is also a voluntary regime, for those not covered by the mandatory regime.
3. Law 17/2000 established a fixed ratio between the minimum pension and the minimum wage as from 2004; until 2003, the minimum pension was to reach the value of 40 000 escudos (around 200 euros) per month. Later, the government announced a convergence path between the minimum pension and some pre-determined fraction of the minimum wage.

old and the new formula, where the weights are the number of years of contributions until and after 2001, respectively. Workers who began to work before the end of 2001 and are to retire after the beginning of 2017 will get the more favourable pension value out of the following two benefit formula: *i*) new formula; *ii*) transition formula. For workers who started to work after 2002 the new formula is the only one which is applicable.

National official projections on the long-term effect of ageing on social security were carried out in the context of the European Union and are included in the National Strategy Report presented in 2002.[20] According to these projections, in light of the expected ageing of the population from 2000 to 2075, social security expenditure is projected to grow by 1.8 percentage points of GDP under the 2000 Social Security Framework Law, from 9.3 per cent to 11.1 per cent (Table 3.2, Panel A). Revenues are expected to decrease by 1.5 percentage points, from 10.9 per cent to 9.4 per cent of GDP. As a result the system moves into deficit as from 2016 onwards, reaching a deficit of 1.7 per cent of GDP by 2075. The reserve fund would have a zero balance as early as 2029. A comparative projection exercise made in line with the old social security framework gave similar results: a negative balance would be registered from 2018 onwards, the deficit reaching 1.6 per cent of GDP by 2075 (Table 3.2 Panel B). The reserve fund would have a zero balance by 2032.

... but problems have yet to be solved

The Framework Law of 2000 and the new pension benefit formula which was established in 2002 after prolonged discussions with the social partners did

Table 3.2. **Social security account: official projections**[1]

Percentages of GDP

	2000	2010	2020	2030	2040	2050	2075
Panel A. Social Security Framework Law 17/2000 (including the benefit formula defined in 2002)							
Pension expenditure	6.1	7.1	7.3	7.5	7.7	7.7	7.8
Soc. Sec. expenditure	9.3	10.3	10.5	10.7	10.9	10.9	11.1
Soc. Sec. revenue	10.9	10.8	10.2	9.6	9.5	9.4	9.4
Current balance	1.6	0.5	–0.3	–1.1	–1.4	–1.5	–1.7
Reserve Fund balance	3.4	11.0	7.1	0.0	0.0	0.0	0.0
Panel B. Social Security Framework Law 28/1984							
Pension expenditure	6.1	7.0	7.2	7.4	7.7	7.8	7.7
Soc. Sec. expenditure	9.3	10.3	10.3	10.6	10.9	11.1	11.0
Soc. Sec. revenue	10.9	10.8	10.3	9.7	9.5	9.4	9.4
Current balance	1.6	0.5	–0.1	–0.8	–1.4	–1.7	–1.6
Reserve Fund Balance	3.4	11.2	8.2	1.4	0.0	0.0	0.0

1. An average annual growth of 2.5 per cent is assumed for labour productivity over the projection period. These projections include the non-contributory pensions and minimum pensions regimes.

Source: *National Strategy Report* 2002.

not result in any significant improvement to the financial sustainability of the social security system, although it introduced more complexity into the system's rules, making it more difficult for beneficiaries to understand and initially increasing administration costs. Furthermore, projections seem to have been based on rather optimistic macroeconomic assumptions, such as the growth rate of labour productivity (2.5 per cent per year, which seems high compared with past performance) and the increase in the (already high by EU standards) participation rates of the labour force. The decision to use estimated wages to compute pensions when records do not exist could be a potential source of conflict. Convergence of minimum pensions to the statutory minimum wage has been quicker than initially planned, and has proved expensive at a time of drastic budgetary consolidation, though the lowest minimum pension levels remain below the poverty line. Although the establishment of minimum pensions aims at boosting income for the poor, they are a rather blunt instrument for redistribution purposes, as only 31 per cent of people belonging to families benefiting from minimum pensions are poor, as reported in a recent study.[21]

A *new* Social Security Framework Law *was introduced in* December 2002

In December 2002, Parliament approved a new Social Security Framework Law.It implements broadly the same type of organisation as the 2000 Law, and it emphasised the relevance of creating a second-pillar complementary regime. This regime is based on a contributory ceiling on the general regime contributions, above which contributions must be channelled to private or public funds. No change was made to the benefit formula following the modifications that had been made in January that same year. And the secondary legislation approved under the previous framework law, on how each subsystem is to be financed has also been maintained. Targets and time horizons have been set for the evolution of minimum pensions.[22]

Creating a second-pillar complementary regime implies setting a ceiling on general regime contributions, above which contributions have to be channelled to private or public funds. By June 2004, discussions were still going on about setting this ceiling. Various options were being considered, most notably the possibility of setting 2 thresholds: first a lower threshold (around six times the minimum wage) above which opting-out of the pay-as-you-go public pension scheme is possible; second a higher ceiling (around 10 times the minimum wage) above which contributions to the public pension scheme would not be possible. This regime would be mandatory for certain categories of beneficiaries, still to be defined. Simulation exercises are currently underway to evaluate the long-term financial impact of the various options considered. If the results are favourable, the legislation is scheduled to be completed by the end of 2004, and take effect as from January 2005. At the same time, plans are being made to increase the penalty in case of early retirement, in order to promote a higher effective retirement age.

Much remains to be done to secure the sustainability of the civil servants pension system

The civil servants' social security scheme (*Caixa Geral de Aposentações*, CGA) suffers from a similar, but deeper, problem than the general regime. First, the ratio of pensioners to contributors almost doubled since the early 1990s. Second, the Central Government does not pay its social contributions as an employer,[23] but it makes transfers to cover the deficit. Third, the CGA pension benefit formula used to be far more generous than the general regime, paying pensions with replacement rates sometimes above 100 per cent. In addition, CGA pensions, like social security pensions, have a relatively favourable treatment under the personal income tax. Recently, CGA pensions have been affected by the same quasi-freeze policy in 2003 and 2004, as they are usually revised in accordance to civil servants' wage evolution. Nevertheless, the financial transfer from the budget to CGA to finance the gap has been rising (by 15.6 per cent in 2003 and 14.1 per cent in 2004).[24] In order to restrain excessive generosity of the system and to converge to the social security system, new entrants to the civil service since September 1993 have been under the same retirement conditions as private sector employees, including the benefit formula.

According to the official projections in the National Strategy Report, CGA pension expenditure is expected to grow from 3.6 per cent to 5 per cent of GDP, between 2000 and 2075. Over the same period, contributions and other revenues are expected to be roughly constant around 1½ per cent of GDP. Consequently, the balance, which is equivalent to the state budget transfer, is projected to increase by 1.5 percentage points of GDP, from 2 per cent of GDP in 2000 to 3.5 per cent by 2020, remaining close to that level in subsequent decades.

The 2003 budget law introduced some measures that were intended to restrain CGA future pensions and which induced a large increase in retirement. However after these were considered unconstitutional by the Constitutional Court, the Government had to make a new proposal, which was approved in January 2004. Two main changes were introduced in the civil servants retirement statute

Table 3.3. **The pension system for civil servants (CGA): official projections**

	2000	2010	2020	2030	2040	2050	2075
Pension expenditure	3.6	4.4	5.0	5.0	4.6	4.4	5.0
Contributions and other revenues	1.6	1.5	1.5	1.5	1.5	1.6	1.6
Current balance	–2.0	–2.9	–3.5	–3.5	–3.1	–2.8	–3.4

Source: *National Strategy Report* 2002.

(only applicable to those in the system before September 1993, since the others have now a regime similar to the private sector one): *i*) the relevant wage to be considered in pension's computation is net of social contributions; and, *ii*) in case of retirement before age of 60, even with a complete 36-year career, there will be a penalty.[25]

Concluding remarks

The piecemeal and gradual approach that has been followed in the pension system reforms has not so far been effective. Unavoidably, the reform plans have been subject to political changes, so that all in all what has been accomplished has been too timid, given the urgency and seriousness of the problem. Measures taken so far are not enough to solve, nor significantly postpone, the financial deficit of existing pension systems under the pressure from an ageing population. In this context, deeper and clearer reforms are urgently needed to ensure social security and CGA medium-term sustainability. The reform measures will have to include the introduction of stronger disincentives to early retirement so as to substantially raise the effective age of retirement.[26] Other options to be envisaged include: reducing the annual accrual rate; limiting indexation of standard pensions to inflation rather than wage developments; increasing the effective taxation of standard pensions (*i.e.* either through a flat tax rate, leaving aside minimum pensions, or subjecting pensions to a progressive scale); and adjusting replacement rates for changes in life expectancy of pension cohorts. Any combination of the above possible measures would improve the financial sustainability of the system. The implementation of the mandatory second-pillar scheme based on a contributions ceiling should be carefully evaluated to ensure that it contributes to improve the sustainability of public finance. Efforts made to decrease fraud and tighten eligibility criteria, concerning sick leaves and social insertion income[27], can also contribute and should be continued. The measures already taken in the civil service regime, CGA, are an important first step, especially the reduction of the generosity of CGA and its alignment to the private sector regime. Reducing the complexity and increasing transparency of the systems should also be given some attention in future reforms.

Notes

1. See OECD *Economic Survey of Portugal* 2003, Chapter II, for more details on emergency measures and Box 5 on Budgetary Stability Law.
2. The nominal growth rate of expenditure halved compared with 2002, and in real terms expenditure was almost flat. According to data published by the Bank of Portugal in February 2004, it seems, however, that the liquid debt of local governments has increased by close to 8 per cent in 2003 despite the limits imposed by the 2002 Budgetary Stability Law.
3. Part of the slowdown in the growth of current expenditure and increase in transfers is also due to the incorporation of 34 hospitals (Box 3.2), with current expenditure taken out of the budget but compensated by an increase in transfers to households which use them – under a national account circuit – to pay for services bought from hospitals.
4. This operation creates contingent liabilities, as the improvement in the government balance observed in 2003 will be compensated by an increase in government expenditure on pensions in the medium term.
5. For instance, the quasi-freeze has resulted in a reduction of the wage differential within the public sector which reduced the attractiveness of the public sector for the most qualified workers. This could slow the progress to a more highly qualified public service.
6. Since then GDP data were revised. Calculated on the basis of the new GDP, the budget deficit amounts to 2.9 per cent (see Table 3.1).
7. Operating expenditures are set to be cut by 10 per cent, the hiring freeze and wage freeze for wages above 1 024 euros will continue. Wages below 1 024 euros will increase by 2 per cent (the expected inflation rate).
8. The budget initially expected 1.1 percentage points of GDP of one-off operations. But 0.3 percentage point of GDP were supposed to come from a second round of securitisation of non-performing tax and social security claims which was eventually registered in 2003 as the securitisation was not split into two steps.
9. Concerning the corporate tax cut and extrapolating from Oliveira, Monteiro, Santos (2003), the effect of the 2004 cut can be estimated at ½ per cent of GDP (with 20 per cent of it being recorded in 2004 and 80 per cent in 2005). The tax reserve allows companies producing tradable goods and services to put aside the 20 per cent of taxes due on 2003 and 2004 and spend them on new investment or R&D in the following two years. Its maximum impact on the 2004 tax revenues is estimated at 0.1 percentage point of GDP. The revenue impact of the reform of asset taxation will be mainly felt at the local level and its scale is still uncertain.
10. The OECD projections were prepared for OECD, *Economic Outlook*, No. 75, May 2004.

11. The ceiling on annual expenditure growth is set at 4 per cent in the health sector, 1.6 per cent in primary and secondary education, and 0 per cent in tertiary education.

12. The number of civil servants, as measured by registration in the social security institute for civil servants (*Caixa Geral de Aposentações*, CGA) increased by a cumulative 22.1 per cent from 1995 to 2003, with the following pattern: 1995-97 an average increase of 1.3 per cent per year; 1997-2001, 4.2 per cent per year and 2001-03, 0.5 per cent per year only. In 2003, the number of civil servants reached close to 780 000.

13. *Entidade Reguladora da Saúde* (Health Regulatory Entity), *Autoridades Metropolitanas de Transportes de Lisboa e do Porto* (Lisbon and Oporto Metropolitan Transport Authorities) and *Centro Hospitalar de Lisboa – Zona Central* (Lisbon Hospital Centre – Central Zone).

14. Law 3/2004 (15th January) and Law 4/2004 (15th January).

15. Oxley and MacFarlan, M. (1995).

16. See Caldas and Rodrigues (2003). Official projections on the impact of ageing on long-term care expenditure are not available. According to the EU Ageing Working Group Report, expenditure on long-term care is projected to increase by approximately 1 percentage point of GDP, between 2000 and 2050 in the OECD.

17. Law 17/2000 (8th August). The previous one was Law 28/84 (14th August).

18. The composite index used for adjusting wages includes the CPI, excluding housing, (with a weight of 75 per cent) and for the remaining 25 per cent, the average increase in earnings upon which social security contributions are levied (capped 50 basis points above CPI). The composite index will be redefined before 2011, and a revised index will be applied thereafter.

19. The old accrual rate, still applicable for beneficiaries with a contributory career equal or smaller than 20 years, is a flat 2 per cent.

20. Ministry of Social Security and Labour (2002). This report was produced following the request of the Laeken European Council. See also Rodrigues, P.G. (2002).

21. Low statutory pensions are increased with a complementary payment in order to reach defined minimum pensions. Gouveia and Rodrigues (2004).

22. By 2007, at the very latest, bracketed minimum pensions (*i.e.* pensions payable to those who have contributed for many years but have a small pension nonetheless) of the general regime as well as pensions of the RESSAA and RNCE regimes will have converged to higher predetermined fractions (between 65 per cent and 100 per cent, 60 per cent and 50 per cent, respectively) of the minimum wage, net of social security contributions. Pensions complements such as those due to dependency are then added to these values. In the beginning of 2004, the Government announced that this target will be achieved in 2006.

23. Another factor that is contributing to the financial deficit of CGA is the fact that other Government levels only pay a 10 per cent employer contribution, compared with a 23.75 per cent contribution paid by private sector employers.

24. Over the period, the Ministry of Finance' contribution to finance pensions under the government responsibility (*i.e.* pensions for survivors of civil servants and of military killed or disabled in action) rose by 18.5 per cent in 2003 and 6.1 per cent in 2004

25. The penalty will be a reduction of the pension of 4.5 per cent per year of anticipation relative to the age of 60; in the private sector, there is also a penalty, but the statutory retirement age is 65.

26. The effective average age of retirement in the social security system was 64.2 years in 2003. This retirement age is unusually high, especially given that life expectancy in Portugal is on the low side. The increase in life expectancy over future decades is projected to be among the fastest in the EU. In that context, a gradual increase in the statutory retirement age should also be considered as an option over the longer term.
27. *Rendimento Social de Inserção*, previously known as *Rendimento Mínimo Garantido*, minimum guaranteed income.

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4. The ongoing reform of the health care system

The current Portuguese system providing health care and insurance was established in the second half of the 1970s, after the democratic revolution, as a response to very low health care coverage and poor health status of the population.[1] The new system has succeeded in drastically improving the health status of the population and bringing it close to the European average in many respects in less than 30 years. Despite this success, numerous shortcomings remain, and the system faces strong pressures to adapt. In 1998, the OECD *Economic Survey of Portugal* assessed the system as "beset by serious inefficiencies and misallocation of resources", identified the key challenges facing it and made various recommendations. A reform programme was initiated at that time, but it was short-lived. A new, more ambitious reform programme was initiated in 2002 under the pressure for fiscal consolidation with a view to further improving the quality of the health care system and raising health outcomes, while limiting health expenditure pressures over the medium term.

This chapter first reviews the main characteristics of the Portuguese health care system at the beginning of this decade. Then, it assesses the performance of this system in terms of both equity and efficiency, highlighting areas in need of improvement. Subsequently it describes the ongoing reform process and shows to what extent it addresses the main weaknesses of the system. Although it is still early to have a complete view of the way this reform process is being implemented and of its real impact on the functioning of the health care system, the chapter finishes by a tentative assessment of the reform as well as recommendations to help its success (summarized in Box 4.2 at the end of the chapter).

Overview of the system in the early 2000s

The Portuguese health care system was put in place in the late 1970s as a public-integrated model.[2] The insurance and provision functions are merged and health care is organised and operated by the *Serviço Nacional de Saúde* (National Health Service, NHS), which functions like any other government department. Health professionals are public sector employees paid on salary, although physicians working for the NHS are also allowed to have private practices.

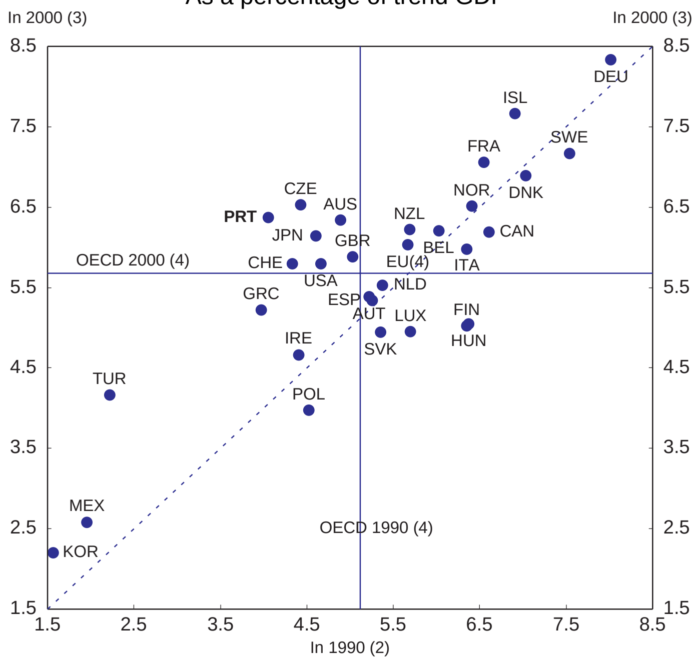
Well-identified strengths of the public-integrated model are its ability to ensure complete population coverage and to contain the growth of overall costs. On the other hand, such system usually provides weak incentives to improve efficiency and maintain quality and responsiveness to patients' needs (Docteur and Oxley, 2003). Since the mid-1990s, reforms have been introduced gradually and the system has been moving towards a public-contract model, with the private sector being given an increasing role. Providers to the NHS are organised into three networks: the primary health care centres, the hospitals and the long-term care units. The NHS was decentralised in 1993 and organised in five health regions, administrated and managed by autonomous Regional Health Administration (RHAs), responsible for monitoring the health status of the population, supervising the providers to the three networks, and allocating financial resources to providers, in the health region they manage (Annex 4.A1 reports background information to this chapter, including a description of the health care system, Figure 4.A1.1).[3]

Besides the NHS, there are several "corporatist" health insurance subsystems financed through social contributions. They cover about one quarter of the population (mainly civil servants and employees of private financial institutions) and health care is provided either directly by the insurer or through contracts with private and/or public health care providers. People covered by these sub-systems usually also have access to the NHS services. In fact, about one fourth of the population benefit from double or triple coverage via the subsystems inducing a waste of scarce resources.[4]

Over the past two decades, health care expenditure has increased rapidly as a percentage of GDP, from well below the OECD average to just above (Figure 4.1).[5] In particular, public expenditure, notably in hospitals and on pharmaceuticals, has grown faster than in other countries (Table 4.1). This trend has followed the rise in standards of living. By the early 2000s, health expenditure per capita was broadly in line with what could be expected for countries with the per capita income of Portugal (Figure 4.2). The financing of the expenditure combines public and private sources, with public financing accounting for more than two-thirds of total health care spending.[6] Ninety per cent of the NHS budget is financed by central government transfers (*i.e.* the tax system). The remaining 10 per cent comes from NHS own receipts, mainly fees for services charged by hospitals. The annual general budget establishes a ceiling for total NHS spending, usually on a historical basis. However, this initial allocation has almost never been respected and supplementary budgets have become the norm. From 1993 to 2002 spending always exceeded the initial budget by an average of 7.5 per cent (with highest overruns in 1999 and 2002, 10.8 per cent and 19.6 per cent respectively).[7] The bulk of private financing comes from out-of-pocket payments, which account for about one third of total health care expenditure and are particularly high for

Figure 4.1. **Public expenditure on health care in 1990 and 2000**

As a percentage of trend GDP[1]



1. GDP used as the denominator instead of trend GDP for the Czech Republic, Hungary, Korea, Luxembourg, Mexico, Poland, the Slovak Republic and Turkey. See Annex 4.A1 Table 4.A1.1 for more detailed data.
2. Data refer to 1991 for Hungary; 1992 for Germany; 1995 for Belgium; 1997 for the Slovak Republic.
3. Data refer to 1997 for the Netherlands.
4. Unweighted average; includes all available countries at the relevant point of time.

Source: OECD Health Data, 2004; OECD, *Economic Outlook* No. 75 (June 2004).

Table 4.1. **Categories of health spending**[1]

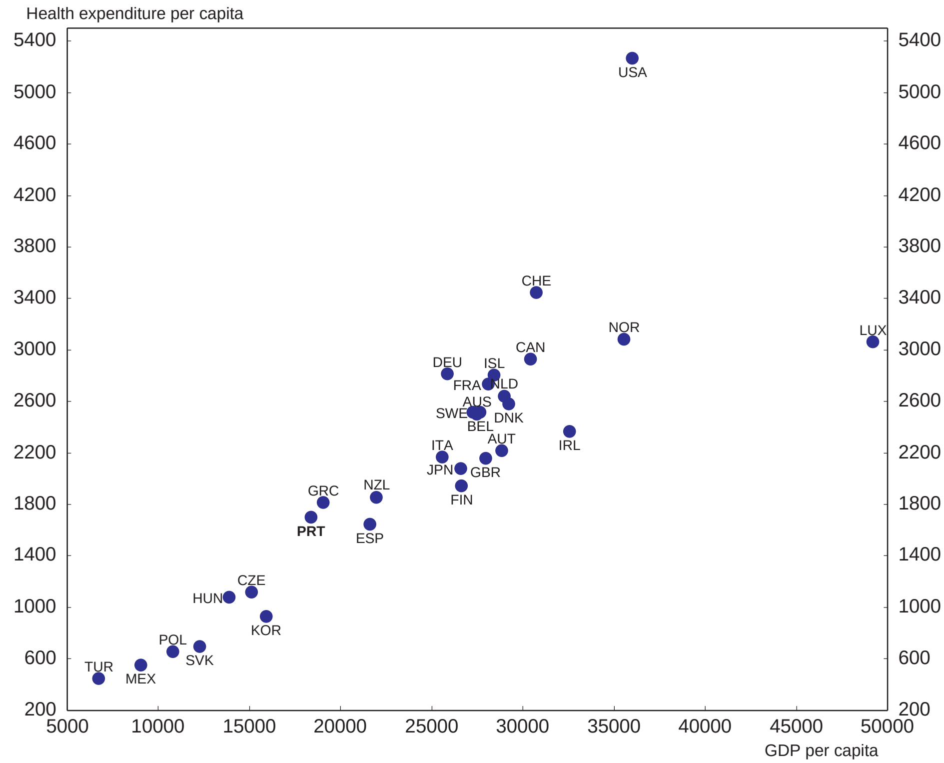
Per cent of GDP

	1980	1985	1990	1995	2001
Hospitals	1.6	1.6	2.0	2.8	. .
Public	1.5	1.4	1.8	2.6	. .
Private	0.2	0.3	0.2	0.2	. .
OECD average	3.4	3.3	3.3	3.3	3.1
Ambulatory care[2]	1.4	1.6	1.5	1.8	. .
OECD average	1.1	1.3	1.3	1.4	1.5
Pharmaceutical goods	1.1	1.5	1.5	1.9	2.0[3]
Public	0.8	1.0	1.0	1.2	. .
Private	0.3	0.5	0.5	0.7	. .
OECD average	0.9	0.9	1.0	1.2	1.4

1. Total does not match total expenditure numbers since some items have been omitted in the breakdown.
2. Public expenditure.
3. 1998.

Source: OECD Health Data, 2004.

Figure 4.2. **Per capita health expenditure and per capita GDP**[1]
In USD PPP



1. In 2002 or latest year available.
Source: OECD Health Data, 2004.

pharmaceuticals and therapeutic products.[8] The role of voluntary private health insurance is still limited in Portugal (less than 2 per cent of total expenditure), but the share is increasing.

Performance of the system

The performance of the Portuguese health system has to be assessed against both equity and efficiency objectives. The former covers equity of financing and of access to health services across the population.[9] Efficiency encompasses: spending an adequate share of GDP on the health care system (macroeconomic efficiency); and maximising productive efficiency, quality of care and the responsiveness of the system (microeconomic efficiency).

Some inequities persist in access to health services

The Portuguese system is based on the principle of universal coverage and was conceived with equity as a main policy objective. Nevertheless, there remain some shortcomings as regards both equity of access and equity of financing.

Health services are not well distributed

The geographical distribution of health services is uneven. Medical facilities (hospitals and high technology equipments) are concentrated in three main urban areas (near Lisbon, Porto and Coimbra) leaving the central part of the country under-served (particularly for high-technology equipment[10]). With doctors and nurses concentrated on the coastal areas, human resources are in short supply elsewhere. Inadequate service levels are particularly notable in rural as well as low-income urban areas (see Annex 4.A1 Table 4.A1.2). Oliveira and Bevan (2003) show important geographical inequities by comparing actual resources levels with estimated needs reflected by a capitation formula including population, gender, age, and mortality. However, no official reliable measure of geographic inequities has been designed that could be used to develop and assess corrective measures.

Although the uneven distribution reflects weak incentives for staff to work in underserved areas,[11] the problem is compounded by the overall deficit in the number of some categories of health care professionals. In particular, while there seem to be enough practicing doctors overall, nurses, technical personnel, as well as general practitioners (GPs) or specialists in obstetric, paediatric and emergency care are in short supply. An increasing number of positions have been filled by foreign professionals, mainly from Spain and Brazil, but shortages persist. Most doctors also work in the private sector to complement their flat-rate remuneration in the public sector, which limits further the resources available in the public sector (in terms of working time).[12] Perceived low flat-rate pay is also reflected in weak doctor productivity when working in the public sector. The ageing of health professionals and more than a decade of low *numerus clausus* are expected to intensify the short supplies of doctors starting in the mid-2010s when an increasing number of doctors retire.[13] Once again, low-income urban areas and some rural areas are likely to be the most affected.

The lack of certain categories of health professionals, combined with factors reducing the system's productivity (see sections below), has another unfavourable impact on equity. Waiting times to access public health care have become increasingly long in the last decade, above acceptable levels for elective surgery,[14] but also high for access to a GP or a specialist, as pointed out by patient surveys. As in most countries, this form of rationing creates inequities across the population with well-off members of the population able to avoid waiting lists for NHS services by paying for private providers or even by getting treatment and surgery abroad, sometimes making timely access to health services dependent on the patients' ability and willingness to pay.

The financing of health care is regressive

As mentioned above, the important share of co-financing for health care, pharmaceuticals in particular, results in relatively high private expenditure on health, especially when compared with other countries with public-integrated systems like the Nordic countries or Italy. The partial tax deductibility of private health expenditure, which benefits mainly higher income households, tends to amplify this regressive feature. De Graeve and Van Ourti (2003), using the 1990 household survey, find that Portugal is in the group of European countries where the distribution of health care payments is regressive (mainly because of out-of-pocket payments). A cross-country comparison of equity in access to physicians and dentists and for hospital care was performed in 2003 for 21 OECD countries in the context of the OECD Health Project. It showed that the distribution of the probability of at least one annual doctor visit (GPs and specialists combined) was significantly "pro-rich' in Portugal.[15]

Disadvantaged and high-risk groups are not fully protected

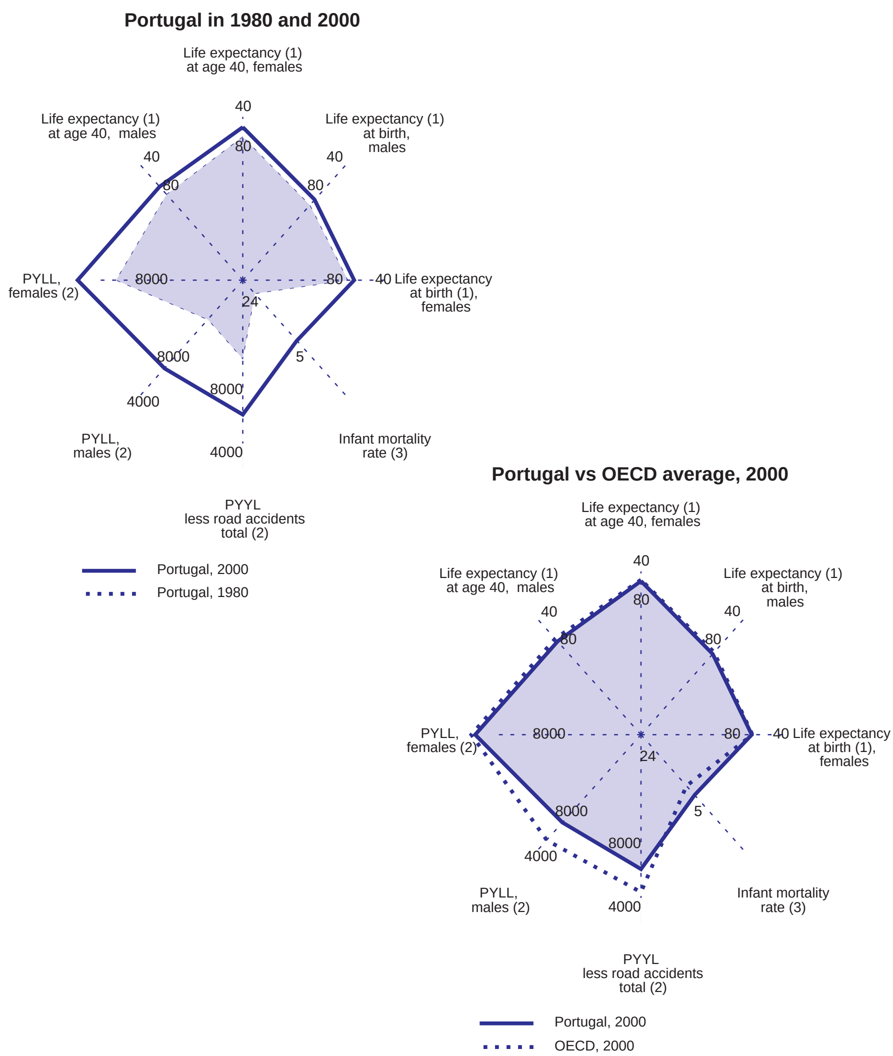
Many OECD countries have exempted the poor and other vulnerable groups from cost sharing in public programmes and/or have set ceilings on annual charges. In Portugal, poor pensioners benefit from lower co-payments for pharmaceuticals (see below Table 4.4) and the chronically ill are exempt from co-payments for specific medicines related to their illness.[16] Besides that, there are no specific programmes or exemptions to attenuate the regressive effect of high co-payments for low-income groups.

Efficiency could be improved

Public integrated systems, such as the one in Portugal, typically face problems of inefficiency and low responsiveness to patients needs. In particular, weak budget constraints and a lack of management autonomy and accountability tend to exacerbate inefficiencies in the NHS and provide poor incentives for productivity and quality. Due to limited data availability, it is not easy to assess the efficiency of the Portuguese health system and compare it with other OECD countries.[17] Nevertheless, several studies have concluded that overall efficiency is low and needs to be increased. (see for instance the 1998 OECD *Economic Survey of Portugal* and St. Aubyn, 2002).

Increased expenditure on health care has gone together with an impressive reduction in the gap in health status *vis-à-vis* the rest of the OECD, especially regarding years of potential life lost and infant mortality (Figure 4.3 and Annex Figure 4.A1.2).

Figure 4.3. **Portugal health status**



Note: A larger surface denotes more favourable status.
1. In years.
2. PYLL: Potential Years of Life Lost. Reversed scales. Rates per 100 000. OECD average excludes Belgium, the Czech Republic, Iceland, Korea, Mexico the Slovak Republic and Turkey. The Potential Years of Life Lost (PYLL) is a summary measure of premature mortality which provides an explicit way of weighting deaths occurring at younger ages (before 70 years), which are, a priori, preventable.
3. Reversed scale. Deaths per 1 000 live births. OECD average excludes Korea and Mexico.

Source: OECD Health Data, 2004.

Nevertheless, although data availability is limited, it seems that in some respect Portugal's health status has improved in parallel to other OECD countries but that Portugal remains among the worst performing countries and is still lagging most other EU countries in several areas. While much lower than two decades ago, tuberculosis incidence at 38.8 per 10 000 inhabitants in 2001 (half the incidence in the late 1970s) remained well above EU average (15 member countries). There is also some evidence that clinical outcomes lag other countries. For instance although incidence of cancer is lower than the EU average,[18] according to Campos (2003b), mortality from cancer is close to the EU average and cancer mortality for patients affected by the disease for five years is higher than in most European countries.

In fact, most countries that channel a similar level of resources into the health sector achieve superior results and some other countries, including Spain and Italy, achieve the same or better results with less spending (see Figure 4.4). To some extent, this might reflect the fact that these countries have been spending this amount of resources for longer, so that cumulative spending is higher than in Portugal, as well as the presence of other factors than health care (including lifestyles) affecting negatively health status in Portugal. However, it also suggests that Portugal's health sector might suffer from a lower degree of efficiency and that there is potential room for increasing health status via better health outcomes without necessarily increasing expenditure.

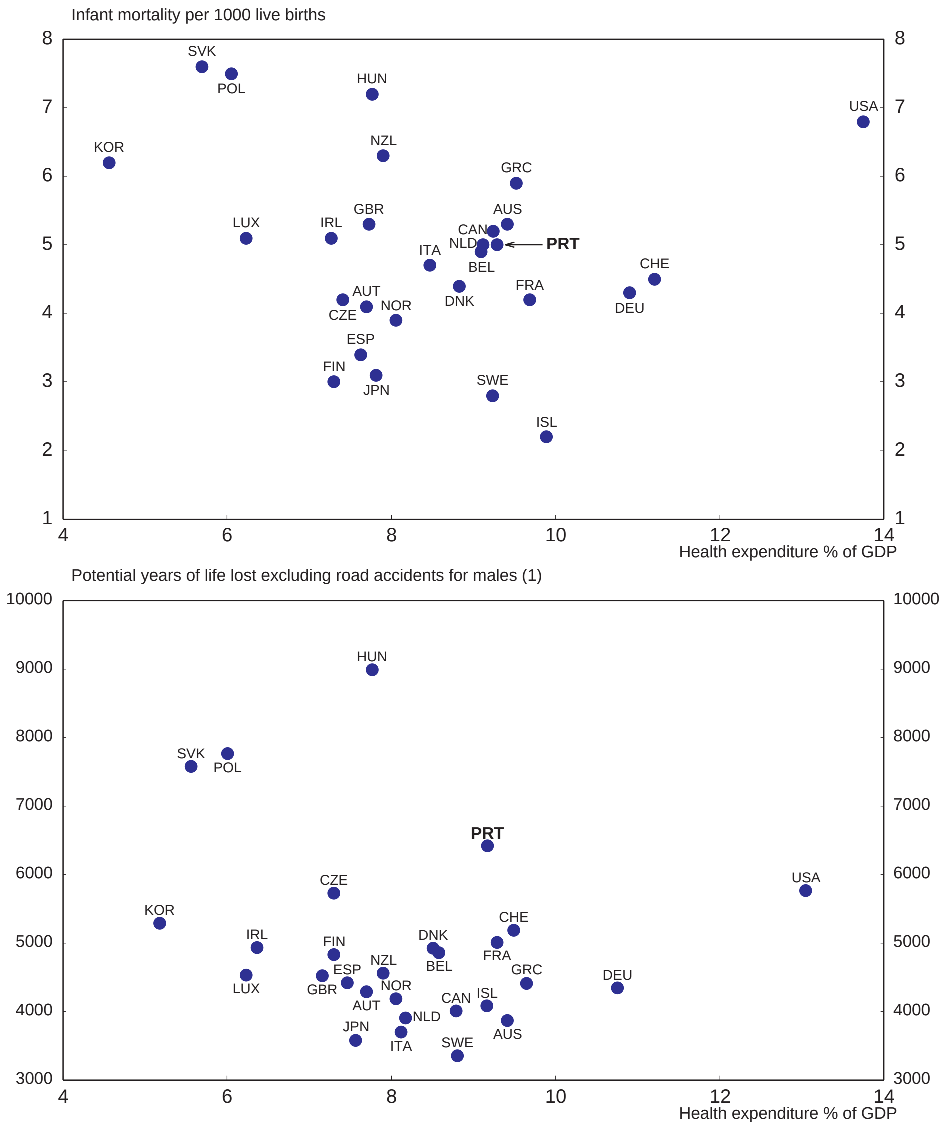
Levels of consumer and patient satisfaction are taken more and more into account by countries when assessing their health care system responsiveness. In the late 1990s, the Portuguese population was the most dissatisfied in Europe with its health care system.[19] This dissatisfaction, which seems somewhat in contradiction to the progress made in the last two decades, concerns in particular public hospitals and primary health care centres, and is largely related to waiting time, reception and equipment. Recent national surveys suggest that the degree of satisfaction has improved only moderately. In an attempt to address this quality issue, an Institute for Quality in Health (*Instituto da Qualidade em Saúde*, IQS) was created in 1999. It is in charge in particular of a voluntary accreditation programme of hospitals and primary health care centres financed with EU funds.[20]

Measures to increase health outcomes, and thereby status, without necessarily increasing expenditure are all the more necessary in the light of tight budget constraints and pressures on spending that are likely to arise in the future.

- With an ageing population, as in other OECD countries, pressures on public spending will intensify. Ageing will require progress in areas where Portugal does not perform well compared with more advanced countries, such as cancer treatments and long-term care. Not taking into account needs for long-term care, the Portuguese Ministry of Finance estimates that the increase in health expenditure by 2050 will be

Figure 4.4. **Expenditure and health status in OECD countries**

In 2002 or latest year available



Note: No data available for Mexico and Turkey

1. Males aged less than 70. For the definition of potential years of life lost see Figure 4.3.

Source: OECD Health Data, 2004.

pushed up by an additional 1 to 2 percentage points of GDP depending on assumptions on GDP and population growth (see Chapter 3 above and Caldas and Rodrigues, 2003).

- Technological progress has been a major driver of health-care costs and, if this pattern continues, there will be an additional pressure on expenditures. Such pressure will be all the more important in Portugal as the standard of technical equipment is still much below the OECD average and high-cost equipment such as imaging devices is still in short supply,[21] However, there is no explicit policy to deal with this issue as no system to assess cost-effectiveness of new technologies has been put in place, except in the area of pharmaceuticals.

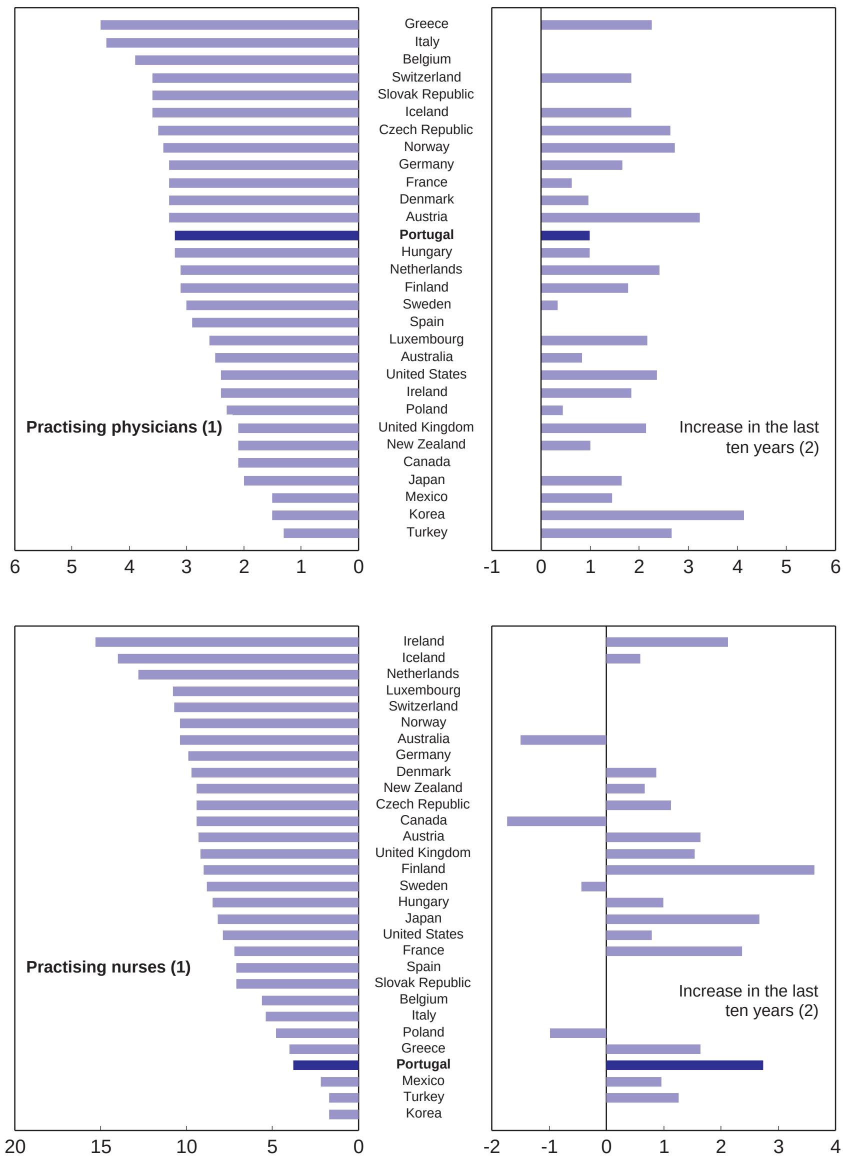
In a context where the authorities aim at lowering tax rates (see Chapter 3), a way to reconcile budget constraints and increasing demand for health is to improve efficiency at the micro level, by maximising the output of health-care services, the quality and the health outcomes with a given level of resources and costs.

Lack of information by sectors or units limits the analysis of productivity in the NHS. A few quantitative studies, such as St. Aubyn (2002), have nevertheless concluded that the sector displays inefficiencies and that the same expenditure level could buy better health than is currently the case. Potential productivity gains in the hospital sector are estimated to range from 10 to 20 per cent depending on the methodology (Pita Barros, 2003). This view is broadly shared by most health specialists in Portugal based on day-to-day observations. A rough illustration can be given by comparing the key resources used in the production of health care (acute-care beds, high-technology equipment, labour input, pharmaceutical drugs) with total spending on health care across the OECD (Figures 4.5 and 4.6 and Annex Table 4.A1.3). It shows that resources available are generally lower in Portugal than the OECD average except for pharmaceuticals, while spending is not. In particular, while resources used in the production of health care are much lower than in Italy or Finland, overall health care expenditure as a share of GDP is higher in Portugal (Figure 4.7). These findings might partly reflect relatively more expensive high-tech equipment in Portugal (given its lower GDP per capita), but they might also indicate scope to improve micro-efficiency.[22]

Besides efficiency problems typical of countries with public-integrated systems, there are additional features of the Portuguese system that may have amplified these problems. In particular, Portugal remains one of the few EU countries where performance is not at all taken into consideration in the remuneration of the health professionals in public ambulatory and hospital sectors. Doctors and nurses employed by the NHS are paid on a fixed salary according to their professional category and length of service, irrespective of productivity, providing no individual incentives to improve performance and quality. Another major source of inefficiency is the lack of integration between the different NHS provider net-

Figure 4.5. **Practising doctors and practising nurses**

In 2002 or latest year available

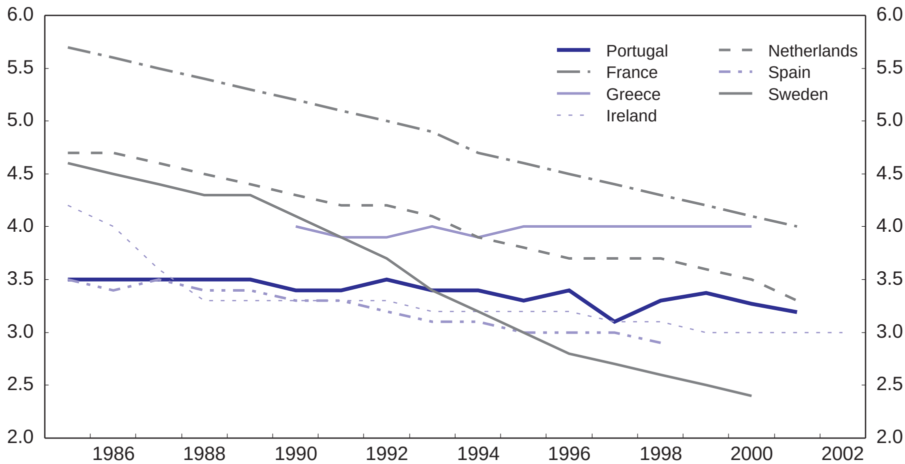


1. Per 1 000 population.
2. Average annual percentage change (when available).

Source: OECD Health Data, 2004.

Figure 4.6. **Trends in acute care beds in selected OECD countries**

Per 1 000 population



Source: OECD Health Data, 2004.

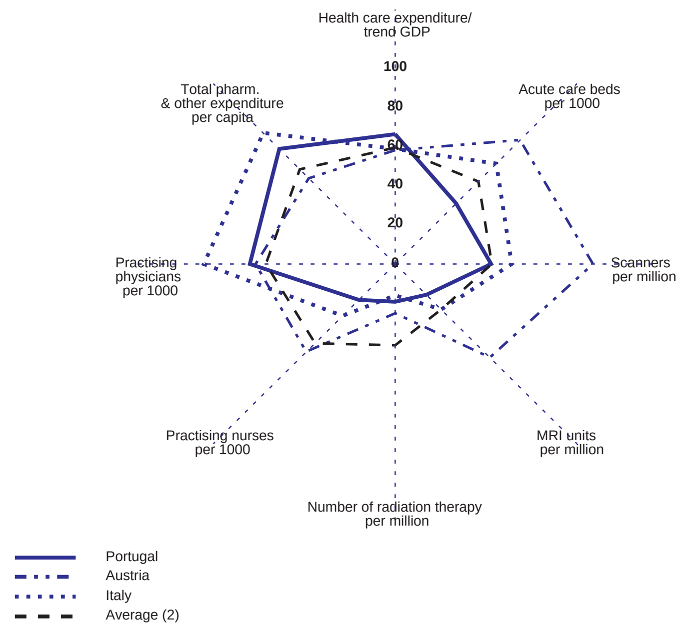
works, *i.e.* health care centres, hospitals, pre-hospital emergency, long-term care. The disconnection concerns both administrative and clinical procedures. It might result in a duplication of acts, with most tests already done at the primary care level repeated once the patient enters a hospital. The GP's role, including his ability to provide the follow-up care that the patient requires after hospital treatment, tends to be weakened because the GP does not always receive a report of the outcomes and diagnostics for follow-up.

Moreover, prevention seems to have a lower role than it deserves in Portugal. Defining the appropriate balance between prevention and cure is delicate, but it seems that the overall system efficiency might be improved by increased attention to information and prevention. Important progress has been achieved regarding vaccination against communicable diseases, but improvement in other areas is needed. Portugal has now the second highest AIDS incidence in the OECD and it is the only country where no significant decline in incidence has been recorded since the early 1990s' peak. As mentioned earlier, the fact that delayed detection contributes to a lower than EU average cancer survival rate for patients affected by the disease for five years (Campos, 2003b) calls for more active information and detection campaigns.

Finally, the system creates incentives for high demand. Patients face only a low marginal cost, apart from their own time, for obtaining a "second opinion",

Figure 4.7. **Resource use in health care supply in Portugal and selected OECD countries**[1]

In 1997



1. A larger surface denotes more favourable outcome. Data are shown relative to the highest OECD value in 1997.
2. Average of OECD countries for which the specific items are available in 1997.

Source: OECD Health Data, 2004.

resulting in a duplication of diagnostic tests and prescriptions. Both the overlapping of NHS and insurance sub-systems and the partial deductibility of health care expenditure from taxable income contribute to the problem.

The ongoing reform of the health care system

The need to improve the health care system has been clearly identified by the authorities for several years but attempts of reforms launched in the late 1990s and early 2000s did not survive the political cycle and were never fully implemented.[23] A comprehensive reform of the health care system was undertaken in 2002. In contrast with past reform programmes, which were rather gradual, the strategy now is to create a "big bang" in the health sector, making reform efforts essentially irreversible. New legislation has been approved separating functions of regulation, financing and provision of health care, setting up new models of financing (implying harder budget constraints), improving management, introducing incentives towards productivity and quality improvement, increasing the role of the private sector, and promoting the use of generic drugs. The trend towards a public contract model has therefore been accelerated. In addition, the authorities have been preparing a 10-year framework aiming at continuing to improve the health status of the population by integrating in the health strategy factors of health that are not linked to the health care system and defining guidelines for the future steps of the system reform. A strategic document was made public in 2003 as a basis for a wide public debate involving all actors including the civil society. Subsequent to this debate, a final version was presented to parliament and approved. The sections below describe the main issues for each sector of the health care delivery system as well as ongoing efforts to address them.

Primary care

Issues in primary care

Primary care plays a key role in health care since it is usually the first contact point for the population. Its role and organisation are therefore critical for the overall efficiency of health-care systems. In Portugal, primary care is organised around primary health care centres (created in 1979). People are free to choose a GP (general practitioner or family doctor) from a health centre within their residential area with whom they have to register. The GP plays then the role of gatekeeper, referring, when needed, his patients to public hospitals or private specialists approved by the NHS. Centres are directly run by the 18 districts which are part of the RHAs and do not have any financial or managerial autonomy.[24]

Several problems have been identified regarding the primary health care centres that the reform to be implemented from 2004 will try to address.

- *Global resource allocation within the health care system is not favourable to primary care*. With hospitals' wage bills and medical fees claiming the bulk of resources, health centres have typically been under-equipped, and under-endowed in terms of high quality staff, especially in poor regions.
- *The allocation of these scarce resources is sub-optimal*. The absence of financial and managerial autonomy, combined with the bureaucratic rules governing the centres, has led to inefficient patterns of service, for instance as regards consultation management and scheduling (for example medical appointments cannot be scheduled by phone in many centres). Organisational weaknesses are reinforced by lack of certain types of professionals. In particular, the shortage of nurses limits the ability to orga-

nise activity in multidiscipline teams and to develop home support programmes. Moreover, the shortage of administrative staff makes it difficult to improve organisational support.

- *Primary care supply is insufficient*. A substantial number of Portuguese (about 1 million people *i.e.* 10 per cent of the population) are waiting to be enlisted with a GP.[25] While the number of specialists per 1 000 inhabitants is among the highest in the OECD, the number of GPs is below the OECD average (see Figure 4.8) and they have to devote a significant part of their working time to administrative tasks.[26] Overtime by GPs tends to represent an important share of expenditure. While patients are usually satisfied by the quality of care received in health centres and their relationships with the GPs, waiting time and low accessibility are often mentioned as an issue by patient surveys.
- *The gate-keeping system by* GPs *has had some unwelcome effects*. While assigning a gate-keeping role to GPs usually encourages continuity and permits primary care doctors to filter and co-ordinate care, in many countries, gate-keeping has also been shown to reduce patient's choice, and hence satisfaction, potentially leading to duplication of visits and delays whenever a specialist consultation is deemed appropriate. This is especially the case when, as in Portugal, the primary care network is poorly coordinated with hospitals. As a response to delays in obtaining consultations with specialists,[27] many people go directly to emergency departments in hospitals. It is estimated, that around one quarter of the people going to hospital emergency units do not need immediate care.[28]

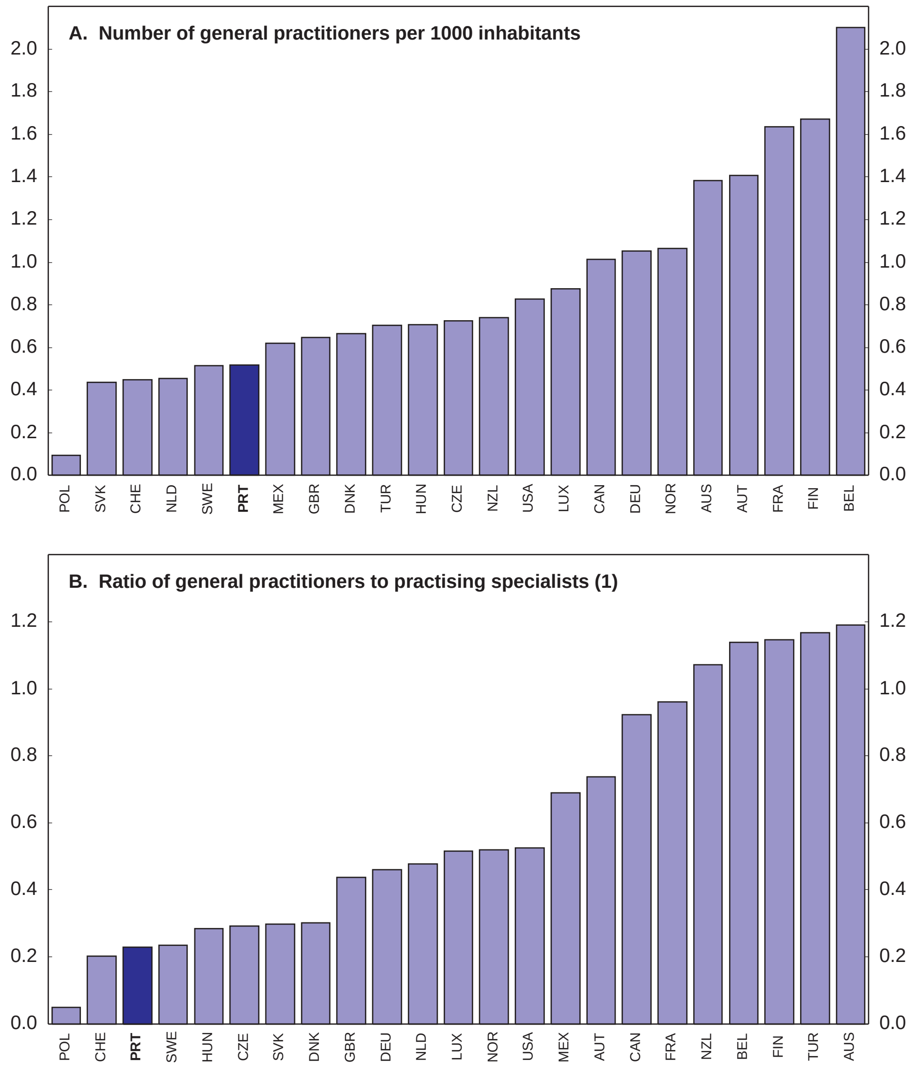
Ongoing reforms

New legislation to address these issues was approved in April 2003,[29] but its implementation was postponed until after the Health Regulatory Agency was to start its activity (see below). It provides a general framework making new forms of management and financing possible (including capitation). This general framework is supposed to be completed by additional legislation by 2005. It foresees a new model for health care recognising that activities of management and coordination must be financially rewarded, and that the accountability for professional performance (both managers and health professionals) requires strengthening. In particular, it foresees:

- *The introduction of new financing arrangements of the health care centres based on a weighted per capita basis as of* 2004. The calculation of capitation will be based on the size of the population using each centre, the demographic structure of this population, the degree of dependency of the users (number of pregnant women and patients with disabilities), and the geographic accessibility to the nearest hospital.

Figure 4.8. **General practitioners and practising specialists**

In 2002 or latest year available



Note: No data available for Spain, Greece, Ireland, Iceland, Italy or Japan.

1. This ratio should be treated with caution because of the lack of standardisation of speciality boundaries across countries.

Source: OECD Health Data, 2004.

- *The setting up of performance indicators to be published regularly.*
- *Changes in the management of centres.* The three-member council will be replaced by a single manager (preferably a doctor) appointed for three years by the Ministry of Health after proposition by the regional administrations RHAs.
- *The introduction of individual work contracts and the possibility to introduce capitation and performance components in remunerations.* The scheme will be based on lessons to be drawn from the assessment of the Experimental Remuneration Model (RRE) experience that has been extended till end-2004. Payment of doctors could be based on capitation as well as performance. Such an approach may improve the incentives to increase efficiency, which are weak in pure capitation arrangements and maybe too strong in pure performance based systems.
- *Possibilities for centres to be managed by private (profit or non-profit) entities.*

Another important aspect of the reform is to open the door for more and better integration of the primary care network with hospitals, which should help avoid duplication of tests and excessive use of hospital emergency services. Pilot projects have been launched to create computer networks between the two systems.[30] This is however at a very early stage and the new framework, while making integration easier, only considers this approach as an option.

Fifteen short-term initiatives to improve quality, access, and efficiency have already been implemented in a few pilot centres before being generalised. These include: the possibility of making medical appointments by phone; automatic referral of patients to hospital consultations; improvement of patient reception; removing more systematically patients that moved (or died) from the GP lists so as to integrate new patients; personal identification cards distributed to all users of health centres (ongoing); exchange of information on know-how and relevant experiences through the network of primary health care units. The new possibility of renewable prescriptions should also help reduce waiting time to get an appointment by reducing frequency of some patients' visit to their family doctors. First evaluations of these new pilot experiences are not yet available.

Hospitals

Keys issues

The hospital sector accounts for about half of NHS expenditure. Some progress was made in making budget allocations more therapy-based, including the introduction in 1997 of a case-mix system based on a diagnostic related group (DRG) approach. This system, which concerned less than one third of hospitals' initial budget allocation in 2000, concerned about half in 2002. Some pilot experiences to improve management were also launched in the mid-1990s.[31] As in most OECD countries, there has also been a trend to increase productivity, as shown by rising bed occupancy since 1990 and declining length of stay in hospital (Table 4.2 and Figure 4.9).

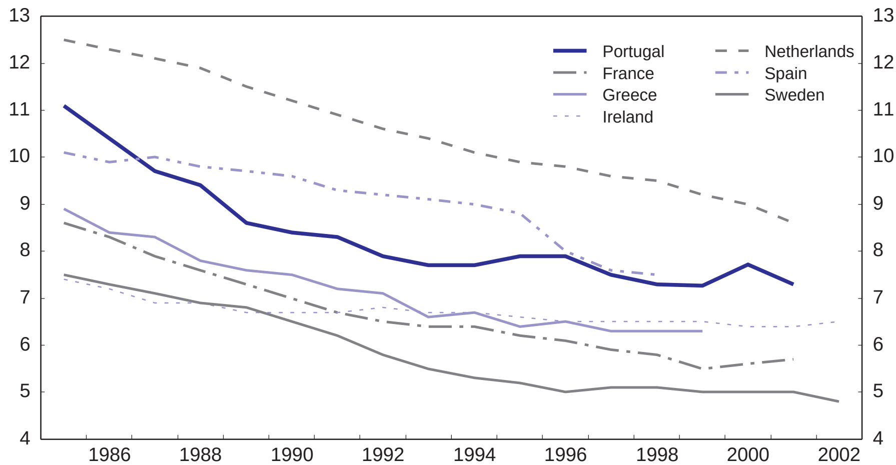
Table 4.2. **Hospital indicators**

	1985	1990	1995	2002[1]
	Average bed occupancy for acutre care (per cent of available beds)			
Portugal	67.7	66.7	72.6	69.9
United States	64.8	66.8	62.8	65.7
Germany	84.1	84.4	83.3	79.9
France	79.1	77.3	76.0	75.2
Italy	67.9	69.3	70.7	76.0
United Kingdom	76.1	. .	79.0	84.0
Greece	66.0	63.2	62.1	68.0
Ireland	75.9	84.5	82.5	84.4
Spain	72.2	73.5	76.4	77.1
Unweighted average	72.6	73.2	73.9	75.6
	Average length of hospital stay for acute care (number of days)			
Portugal	11.1	8.4	7.9	7.3
United States	7.1	7.3	6.5	5.8
Germany	18.0	16.7	14.2	11.6
France	8.6	7.0	6.2	5.7
Italy	. .	9.5	8.4	6.9
United Kingdom	8.1	5.9	7.0	6.9
Greece	8.9	7.5	6.4	6.3
Ireland	7.4	6.7	6.6	6.4
Spain	10.1	9.6	8.8	7.1
Unweighted average	9.9	8.7	8.0	7.1
	Hospital discharge rate (per 100 000 population)			
		1990	1995	2002[1]
Portugal		6 813	8 601	7 797
United States[2]		12 334	11 538	9 808
Germany		. .	18 159	19 730
France		. .	23 370	25 211
Italy		. .	15 209	14 677
United Kingdom		. .	. .	25 153
Greece		12 599	14 321	15 919
Ireland		. .	11 460	12 277
Spain		9 502	10 697	10 728
Unweighted average		. .	14 169	15 478

Note: For definitions and limits on cross-country comparability, see OECD Health Data, 2004.
1. Or latest year available.
2. Includes same-day separations.
Source: OECD Health Data, 2004.

Figure 4.9. **Trends in average length of stay in acute care in selected OECD countries**

Number of days



Source: OECD Health Data, 2004.

Several weaknesses in the management of Portuguese hospitals were identified in the early 2000s.

- *There was no effective hard budget constraint on public hospitals.* Budget allocation was based mostly on historical figures; and, in practice, the NHS directly and passively covered most unexpected expenditure by supplementary allocations. Administrative penalties for excess spending were increasingly applied, but remained rare. As a result, control of current costs was weak and the debt to suppliers, especially to the pharmaceutical industry, kept on climbing.[32]
- *Quality control was absent.* There were no standardised information systems that could have enabled the monitoring of the performance of managers and institutions. At the same time, managers and administrators were not given incentives to improve hospital performance, and had limited management autonomy, notably concerning staff policy.
- *Hospitals suffered important staffing problems.* The inflation of current costs, in the absence of effective budget constraints, has contributed to crowding out investment in capital equipment and new recruitments in understaffed areas so as to limit budget targets overshooting. While doctors per bed have been above the OECD average for many years, the number

of nurses has remained close to half the OECD average affecting the efficiency and quality of care.

- *The waiting list for non-urgent surgery for* NHS *patients was getting longer and longer*. It is estimated that in July 2002, 123 000 people (1 per cent of the population) were on a waiting list with an average waiting time of about six years. Siciliani and Hust (2003) using cross-country analysis for 12 OECD countries show that long waiting times tend to be positively associated with lower capacity (number of beds or practising doctors) and lower health spending. Salaried remuneration of doctors, that gives little incentive for productivity, and fixed budget for hospitals also tend to be associated with long waiting times. With Portugal close to the OECD average for acute beds per inhabitant, and above the average for total spending as a share of GDP and the number of practising doctors per inhabitant, key factors in the waiting list appear to have been low productivity in NHS hospitals, limited doctor availability because of time spent in private practice, and lack of nurses.
- *Misuse of emergency rooms*. As mentioned earlier, the emergency rooms were crowded with people trying to get faster access to specialists.[33]

The 2002 *reform*

An in-depth reform of the hospital sector was launched in 2002, introducing new forms of management, so as to improve efficiency and quality of service. The strategy was to transform medium-size financially sound hospitals into public corporations while leaving the largest and smallest ones under direct, but modernised, public management and to use public-private partnership (PPP) for new structures (see Box 4.1). Therefore, following the November 2002 law, four different legal statuses for hospitals co-exist: incorporated (public) hospitals ("hospitals SA"), public hospitals ("hospitals SPA"), PPP hospitals and finally, private corporations contracted by the state.

• *i*) *Incorporated hospitals* (*Hospitals* SA)

The most salient aspect of the hospital sector reform was the transformation of 34 public hospitals (half of the hospital sector health supply) into 31 public corporations, which started to operate in 2003. This transformation followed the success of pilot programmes that gave more managerial and financial autonomy to some public hospitals (see above). It creates a functional separation between the financing/purchaser entity and the provider of health care services. Multi-annual-contract programmes for 2004 and beyond have been agreed with the Institute for Financial Management and Informatics (IGIF), setting quantitative and qualitative targets, and investment needs.[34] Payments are based upon contracted production levels, with production above contracted levels plus 10 per cent paid at marginal

Box 4.1. The three categories of public hospitals after the 2002 reform

Hospitals SA: public corporations with the state as exclusive shareholder (under the corporate law). They were created through the transformation of 34 public hospitals, chosen as medium-sized ones, with a debt below 35 per cent of total expenditure and having previously demonstrated some management ability. These public corporations received their own capital* and took over all assets and liabilities of the former public units. They have financial and administrative autonomy. Hospital boards are independent and accountable for operational and financial results. The new regulation sets an upper limit on corporate hospitals indebtedness at 30 per cent of the social capital (the board approval is required when new borrowing raises the debt above 10 per cent of the social capital). The hospitals SA started to operate in January 2003 with new management teams appointed by the Ministry of Health (details on the selection criteria for those teams is not public).

Public hospitals (SPA): public institutions with administrative and financial autonomy, but under public management, (under the public sector administrative law). Concerns the 51 remaining public hospitals.

Public-private partnership (PPP) *hospitals*: public institutions with administrative, financial and asset management autonomy under contracted private management (under the public sector administrative law). Ten PPP hospitals (including eight substitutions to existing old facilities and two additional units) are planned to be built by 2010. The first one should be inaugurated in 2008 in Loures; bidding has been launched and the construction should start by early 2006. The authorities plan to issue three tenders a year, in the 2005-08 period, to complete the tender phase by early 2008 and have all units operating by end 2010.

* Hospitals were recapitalised before being transformed in corporations so as to cover existing obligations and ensure that the hospitals had enough working capital to effectively manage their balance sheets. This recapitalisation represented about 1 per cent of GDP.

cost. Reference prices are based on estimates of the volume of services performed – *i.e.* in-patient treatment, emergencies, appointments and out-patient treatment – adjusted by a case-mix index (complexity of pathologies) and weighted according to the level of technological sophistication of each hospital. Case-related payment systems are an appropriate answer to low efficiency in the context of waiting lists and unused productivity reserves. New staff are hired on individual contracts, while current staff on public contracts have been offered the option to switch to individual contracts. Very few employees changed status in 2003. Since individual contracts will include some performance-related financial incentives, hospital SA managers estimate that a majority of the young staff will opt for them, once collective agreements and career paths for people holding these contracts are clearly defined by the social partners.[35] With older staff likely to remain on protected public contracts, most hospitals will have to manage two different types of staff. Hospitals SA have also been required to prepare medium-term (three years) business plans and improvement programmes.

While the hospitals SA remain under the supervision of the RHAs, their development and performance have been monitored closely by a special task force (U*nidade de* M*issão* H*ospitais* SA) directly attached to the Minister of Health.[36] In particular, benchmarking of hospitals is made on a monthly basis, with a focus on productivity and efficacy of resource management (see Annex 4.B.). At this stage, the benchmarking includes very few quality indicators, and quality monitoring depends essentially on each hospital. There are plans to add more quality indicators in the future and launch patient satisfaction surveys. Some hospitals (for instance Pulido Valente SA in Lisbon) have also contracted auditors to run clinical audits and this is in the process of being generalised. A "quick wins" programme was launched in five pilot hospitals with the goal of testing key improvement programmes.[37]

Results for the first year of operation of the hospitals SA published in March 2004 are encouraging; activity increased more than twice as fast as costs, implying lower unit costs (see Table 4.3). The situation is however very heterogeneous from one hospital to the other, with unit cost variations ranging from +18.2 to –36 per cent. Making information about hospital debt available on a comparable basis and disseminating it in a clear and synthetic way would facilitate external assessment of the efficiency gains of the hospital SA sector as a whole. Such information is necessary to ensure that apparent efficiency gains in some hospitals do not hide higher debt. In the future, besides results published by the

Table 4.3. **Some key results of the hospitals SA in 2003**

Percentage changes from 2002

	All hospitals SA	That hospital SA with the largest unit cost increase[1]	That hospital SA with the largest unit cost decrease[1]
Provision of services			
In-patient discharges	4.2	–1.9	–1.3
Surgeries	16.3	15.9	10.4
External consultation	9.3	14.3	7.1
Day hospital sessions	17.8	22.9	22.8
Urgency episodes	1.0	–1.4	5.3
Total hospital activity indicator	8.7	–4.8	7.6
Total costs	3.9[2]	12.6	–31.1
Unit costs	–5.8	18.2	–36.0

1. All the results reported in the column refer to that hospital showing the largest unit cost increase (decrease) in 2003.
2. The cost increase is 2.4 per cent if the 2002 data are adjusted for payments to the CGA and changes in the payments of pharmaceuticals by RHA.

Source: Ministry of Health.

Ministry of Health, the Ministry of Finance will conduct financial inspection in the hospitals SA.

- *ii*) P*ublic hospitals* (SPA)

The modernisation of the management of the remaining 51 public hospitals (hospital SPA, *i.e. hospital do Sector Público Administrativo*)[38] is essential to avoid creating a two-speed system. It started in August 2003 with the adoption of new regulations that try to replicate as much as possible the hospital SA experience within the public sector. New management teams were appointed at end-2003 (details on the selection criteria are not public). Contract-programmes will be established with each hospital, setting objectives and quantitative targets, priorities and modalities for the provision of services, quality standards, monitoring and evaluation systems. A new financing scheme close to that for hospitals SA is expected to be implemented in 2005. The new legislation includes the possibility of providing additional financing to hospitals as a reward for improved outcomes, quality and productivity. Non-financial incentives for productivity (training for instance) are envisaged for staff. Special task forces have been created and trained within the five RHAs to monitor these hospitals. Performance indicators, similar to the ones used for hospitals SA, and management improvements are already monitored for 15 pilot cases.

Preliminary estimates for all SPA show that, in 2003, production increased but also costs, and debt continued to rise, by about 60 per cent. In parallel, the government has been working on a project to reduce the debt of SPA hospitals *vis-à-vis* the pharmaceutical sector. The plan concerns the debt older than 90 days for the 10 hospitals with the oldest arrears.

- *iii*) P*ublic-private partnerships* (PPPs)

The reform of the hospital sector also foresees the creation of ten hospitals under public-private partnerships (PPP schemes).[39] The legal regime was approved in 2002, and the first government programme for public-private partnerships was approved in 2003. Ten-year contracts for the operations and thirty-year contracts for the infrastructure will be granted after competitive bidding, with technical competence and economic terms offered being the most relevant criteria. Most hospitals under PPP will be linked with one university, so as to increase the number of doctors in the future. In terms of initial investment in facilities and equipments, the programme represents about 1 billion euros. The only previous experience of a PPP in the health care sector in Portugal started in 1995 with Amadora Sintra pilot experience.[40] The main lesson from that experience, which encountered mixed success, is the need to put in place a very strong legislation as regards supervision of these PPPs, which was missing until recently. It will be also important to ensure close monitoring of the performance of these PPPs which has lacked in most of the other PPP projects in Portugal (see OECD *Economic Survey of Portugal*, 2003).

- *iv) The waiting list reduction programme*

The strategy of the authorities to win quick visible results also includes a special programme to eliminate, within two years, the waiting lists for surgery (*Programa Especial de Combate às Listas de Espera Cirúrgicas*, PECLEC). The programme relies on contracting some private (profit and non-profit, if necessary foreign) hospitals, which are being paid on a DRG basis, as well as a more productive use of resources in the public sector resulting from the changes in management reviewed above, and extra financial resources provided to public services and staff engaged in the programme.[41] From July 2002 to April 2004, most of the 123 000 people that were on the waiting list in July 2002 had surgery.[42] However, while the list existing in 2002 was reduced, a new list has built up, partly maybe because much shorter waiting time has increased demand. The Ministry of Health estimates that 150 000 people were on this new list in April 2004, with the list growing on average at a pace of 6 600 people a month.

Under the new system to be implemented from June 2004 in two pilot regions, the Integrated System of Management of Patients Enrolled for Surgery (*Sistema Integrado de Gestão de Inscritos para Cirurgia*, SIGIC), any person who has been waiting more than the acceptable time (about six months) can go for surgery in any hospital (even social or private) with a convention and the state will finance it.[43]

Long-term care

Long-term care is insufficiently developed in Portugal and has long been neglected. This concerns mainly the elderly but also people who have been victims of accidents, are suffering from chronic or degenerative diseases or other physical or psychological conditions. The insufficient development of these services is related to the role traditionally played by families, in Portugal as in other southern European countries, in providing long-term care. Family patterns have changed but the availability of long-term care services has lagged. Because of the lack of appropriate public infrastructure, the elderly tend to use hospitals to seek assistance, blocking beds that would be otherwise used for acute care. In 2000, the Government approved the ISO 9001:2000 norm as national quality standard for elderly home care, together with a national plan for the accreditation of all special long-term care institutions (the *Plano Avô* – Grandfather Plan) and a Private and Social Support Plan to improve infrastructures and train staff for these institutions. To strengthen long-term care, the creation of a Long-Term Care National Network was approved in 2002 and a new bill is expected by end-2004, providing norms related to the quality, financing and general management of long-term care units. The goal is to create a strong network, including units for long-term hospitalisation, home care and day care, well integrated with primary and hospital networks. This network will be mainly built via contracting with private entities, in particular the non-profit *misericórdias*.[44] There are no estimates of the cost of this network neither of the increase in long-term care costs associated with the ageing of the Portuguese population.

Pharmaceuticals

The pharmaceutical market consists of the drugs used by hospitals and the ones sold in pharmacies. Pharmaceuticals used by NHS hospitals are financed from hospitals budget directly, and represent close to 40 per cent of total NHS spending on pharmaceuticals. The NHS also reimburses patients for drugs bought from pharmacies when prescribed within the NHS system as well as when prescribed under private treatment.[45] Private co-participation is substantial (Table 4.4). The pharmaceutical market is characterised by a freedom of prescription for doctors, largely unregulated drug prices, and monopolistic power for the pharmacists who sell drugs (see Oliveira and Pinto (2003)). Pharmacies' mark-up margins are flat and controlled by the Ministry of Finance (the retail margin is 20 per cent and the wholesale margin 8 per cent). A particularity of Portugal is the existence of a large market for copies, which developed till 1995, as the legislation did not protect patents and trade marks. The legislation was changed in 1995 but copies commercialized before that date were allowed to remain on the market.[46] On the other hand, the penetration of generic products is low compared with other OECD countries, reflecting the fact that till recently there were little incentives for the production/use of generic medicines (Figure 4.10).

Key issues

Although pharmaceutical expenditure is close to OECD average on a per capita basis, when taken as a percentage of GDP it is well above and represents

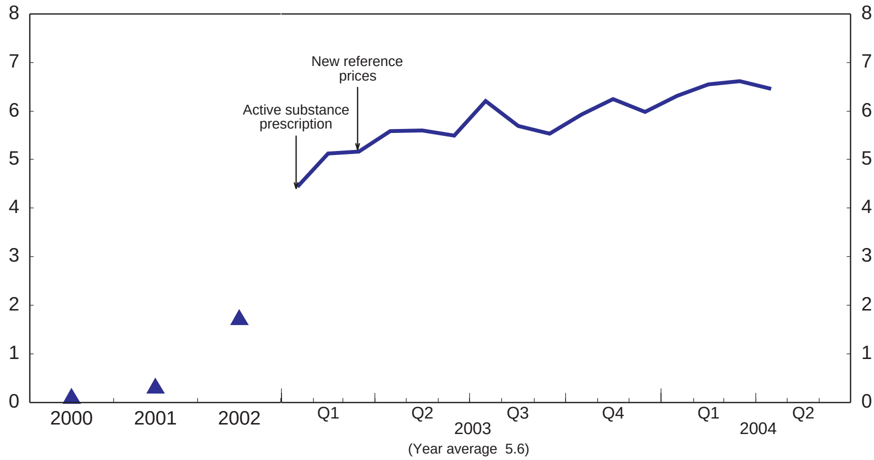
Table 4.4. **Reimbursement of pharmaceuticals**

Category	Definition consumption	Standard reimbursement rate	Reimbursement for pensioners[1]	Reimbursement if generic
A	Substances vital for survival or used to treat chronic diseases	100%	100%	100%
B	Essential drugs needed in the treatment of serious illnesses, requiring prolonged therapy	70%	85%	80%
C	Non-priority medicines, with confirmed therapeutic value	40%	55%	50%
D	New products of which therapeutic value is not yet proven (since 2000)	20%	35%	30%

1. Over 65 years of age with income not exceeding three times the minimum wage.
Source: OECD; Oliveira and Pinto (2003); Martikainen and Rajaniemi (2002).

Figure 4.10. **Market share of generics**[1]

Per cent of sales



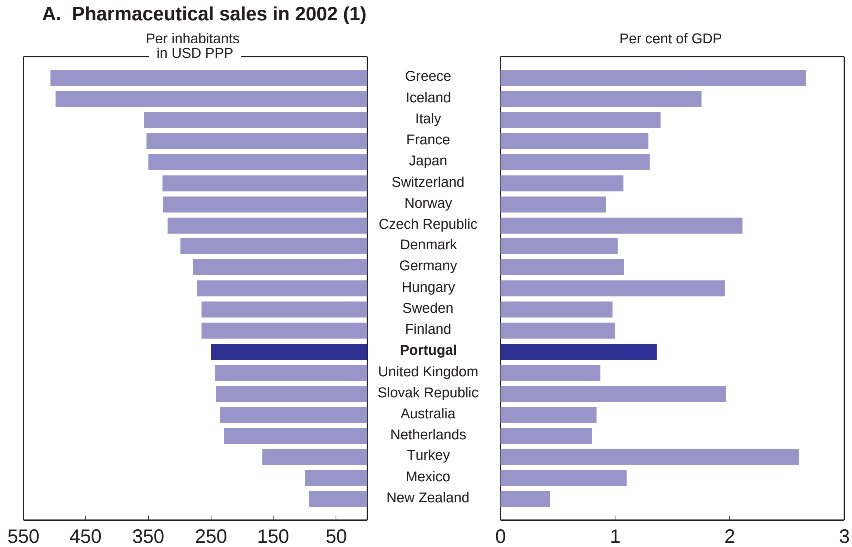
1. Annual averages are shown for 2000-02; monthly data are available starting in 2003.
Source: Infarmed.

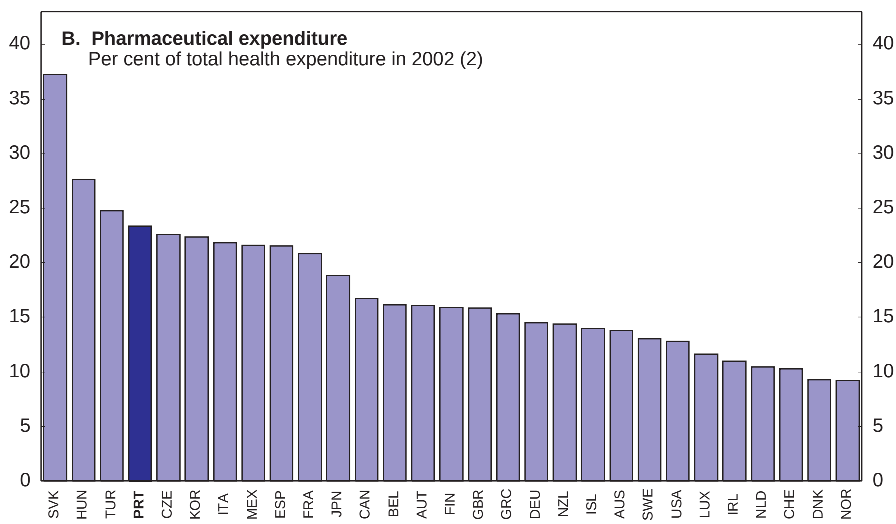
more than 20 per cent of total health expenditure, the fourth highest rate in the OECD (Figure 4.11). Expenditure grew at a double digit pace annually from 1991 to 2001. Several programmes were launched in the 1990s and early 2000s with a view to curb this upward trend by promoting a more rational use of pharmaceuticals via changes in prices and in the reimbursement system, or via agreements with the industry.[47] However, these measures were not sufficient to slow the growth of pharmaceutical expenditure.

Oliveira and Pinto (2003) identify four main factors behind the high and rising pharmaceutical consumption in Portugal:

- The high and growing level of consumption due both to high demand by patients (as a result of cultural factors but also of the deductibility provisions of health costs from the personal income tax that limits consumers' perception of real costs) and inappropriate use and over-prescription by doctors (doctors have no incentives to limit prescription)[48]
- A tendency to switch to more expensive drugs.
- A weak design (and inadequacy) of measures to control costs such as in negotiating agreements with the industry.
- Successive delays in defining policies to tackle the structural problems of the sector.

Figure 4.11. **Pharmaceutical sales in OECD countries**





1. Or latest year available. No data available for Austria, Belgium, Canada, Spain, Ireland, Korea, Luxembourg, Poland, Turkey and the United States.
2. Or latest year available. No data available for Poland.

Source: OECD Health Data, 2004.

The study also identifies the lack of competition in the pharmacy sector as an important issue. The profession of pharmacists in Portugal is for instance one of the most regulated compared with other OECD countries. Pharmaceuticals, including over-the-counter drugs, can only be purchased in pharmacies, and the location and number of pharmacies is tightly regulated, resulting in each pharmacy having a monopoly over a certain geographical area.[49]

Pharmaceuticals expenditures by hospitals have been growing even faster than reimbursement of prescriptions.[50] One factor behind this increase in spending and the growing debt of hospitals is the market structure, which favours price increases. On the one hand, producers enjoy some monopoly in many high volume consumption drugs. On the other hand, the hospital sector has shown limited ability to put in place strong central purchasing units to negotiate lower prices. For instance in 2003, pharmaceuticals companies used their market power to increase prices so as to compensate for lower margins on the retail sales market triggered by the reform (see below). The lack of effective information systems using ICT, as well as some weaknesses in management at the hospital level have also impeded spending control.

Reform in the pharmaceutical sector

It is hoped that more rational prescription habits will emerge following other changes in the accountability of health professional resulting from the reform of health care centres and hospitals. In addition, changes to the pharmaceutical drug policy aimed at reducing expenditure on drugs were approved in 2002. They concern mainly the reimbursement of drugs sold in pharmacies. Regarding prescriptions, since 1st of January 2003, drugs with a generic equivalent should be prescribed by the International Common Denomination (active substance) so that patients can choose the least expensive medicament. However, doctors kept the right to add a brand name and refuse substitution.[51] Both the physicians and the pharmacists are required to provide all the information on available generics and their costs both when the prescription is issued and when it is dispensed. A new price reference system for the cost-sharing of medicines by the NHS was set up in March 2003, whereby payments by the NHS are not higher than payment for the most expensive generic equivalent sold in the market.[52] A new and standardised prescription form was adopted which should facilitate electronic prescribing. This new form establishes specific rules concerning the number of medicinal products and packs that can be prescribed. In addition, a programme to convert pre-1995 copies (see above) into generic drugs was launched in 2003 to boost the market share of generics in the future. Producers have been given a limited delay to convert these products into generics and to reduce their price to near reference prices. There are a number of criteria that must be filled for a medicinal product to be considered as a generic and the applicant is responsible for checking that there are no patent rights in force regarding the reference medicinal product.[53]

These measures were expected to reduce both the aggregate price of pharmaceuticals (by giving patients incentives to opt for cheaper products and encouraging the industry both to reduce prices towards the reference prices and to put new generics on the market) and on volumes (by increasing cost sharing). No incentives were given to pharmacies to sell generics and the fixed margins they earn on each product sold might in fact act as a disincentive. Nevertheless, the first results of the reform are already visible. First, this new policy has led to an increase in the generic market share (to 6½ per cent in April 2004, up from 1.8 per cent in 2002) (Figure 4.10). Second, prices of pharmaceuticals with a generic equivalent have decreased by up to 50 per cent for some products.[54] Overall, NHS spending on pharmaceuticals decelerated markedly, to 3.7 per cent in 2003 down from 7 per cent or more in 2001 and 2002. There is not yet evidence, though, that demand for drugs has fallen.

Concerning the use of pharmaceuticals in hospitals, a plan to increase efficacy and quality was launched in 2000, but the achievements have been below expectations. As a result, some changes to that plan were made in November 2002 to simplify the project, clarify responsibilities and roles in the Ministry of Health, improve the information collection, and define a new framework for hospital pharmacies.[55] However, there is no evidence that expenditure slowed down in 2003 and the debt of hospitals *vis-à-vis* the pharmaceutical industry has continued to grow. A pilot project has been launched based on integrated electronic purchase arrangement managed by a central management network. If proven effective, it will be implemented in all hospitals in the future.

The Health Regulatory Agency, ERS

The creation of the Health Regulatory Agency (*Entidade Reguladora da Saúde*, ERS) was approved in November 2003. This approach, apparently with few precedents in other countries, responds to the new public, private and non-profit mix of health care providers to the NHS (for hospitals, health care centres and continuous care) and the need to separate the state's tasks of provider and financing from its regulation role. The new entity is a public body with financial and administrative autonomy (broadly in line with international best practices in designing sectoral regulatory agencies). The board is composed of a president and two members designed by the cabinet following a proposal from the Health Minister.[56] It will be financed through fines (40 per cent of the fines collected will be kept by the ERS, the rest going to the Treasury), fees on services (registration, provision of certificate) and budgetary transfers.

The ERS regulates all actors providing health care services to the NHS including private actors, excluding activities that are already submitted to a specific sectoral regulation (such as the pharmacies). It is in charge of ensuring equity in access to health care, compliance to quality requirements and protection of patients' rights and security. In particular, the ERS is in charge of preventing and fighting adverse selection and "cream-skimming", as well as supplier-induced demand, which is more likely to occur when providers are paid according to activity. At the request of the Ministry of Health, it can assess contracts with providers and rules governing the sector. The entity can impose sanctions, including fines that will be made public. It will be also the entity in charge of collecting patients' claims. The ERS will start its activity in 2004. The introduction of this independent regulatory body designed to ensure that productivity gains are not detrimental to quality and equity is an important step in the reform process. Care should be taken to redefine clearly the tasks of other structures already in charge of regulating the sector and ensuring quality of care – IGIF, the Directorate General of Health, the National Institute of Pharmaceuticals and Medicine (INFARMED) and the Institute for Quality in Health (IQS) – so as to limit overlaps.

Other aspects of the ongoing reform

As mentioned in sections above, the shortage of health professionals is a major concern to be addressed. According to a recent survey, three quarters of the Portuguese considered that this was already an important concern, and, as noted, estimates suggest that human resource problems will become even more acute over the coming 15 years in some specialties/regions.[57] In the short term, pressure on staffing could be reduced through the ongoing changes aimed at increasing productivity in hospitals and primary health care centres. For a longer-term response, the *numerus clausus* on medical students was increased in recent years to its early 1980s level. New universities have been opened and there are plans to open some more, including private ones. Plans to increase the number of nurses are under consideration.

The reform also foresees some changes as concerns emergency services in order to increase their efficiency. An important step is the efforts being made to better integrate emergency services with the hospitals.[58]

Assessment and agenda for future reforms

The reform is going in the right direction

If successful, the ongoing reform should enable Portugal to continue raising the quality of health services and the health status of the population, and solve equity issues while putting public finances on a sounder medium-term path. Most legislation has been approved in less than two years and seems in line with earlier OECD recommendations. This is already an important step forward.[59] However, now, the key challenge is the implementation of the reform. There are some positive first results and public spending on health care decelerated in 2003 (reflecting mainly lower spending on reimbursement of pharmaceuticals and a slower growth of spending in hospitals SA). However consolidating these short-term achievements will be a difficult task. Given the low starting point, regarding for instance the share of generic products on the pharmaceutical market or hospital efficiency, short-term positive results may be easy to reach, but it will be more difficult to replicate these achievements in the longer term. It is also still too early to have a broad view of the impact of measures implemented. In particular, the increase in hospital production observed in 2003 should result in better health outcomes and public satisfaction, but it is difficult at this stage to assess the medium-term impact of the reform on both public finance sustainability and micro-efficiency of expenditure. In particular, it is very likely that as supply increases demand will also increase, as already observed concerning elective surgeries. Moreover the new remuneration frameworks for health professional might result in wages increases. If, as a result, expenditures increase above what can be absorbed by productivity gains, this would imply some inevitable cost increases. The Portuguese authorities must anticipate this risk.

Several ingredients are needed to ensure durable success

Strengthening the global strategy

Availability of information about the reform process and its progress needs to be strengthened. Details on the process have not always been made public. The strategy is to win large popular support by achieving highly visible "quick wins" in some areas. This approach may backfire if there are doubts about the way the reform is conducted and the accuracy of indicators used to assess results. For instance, greater clarity about the criteria used in the nomination of new managers for hospitals and health care centres would limit polemics regarding possible unjustified appointments. In addition, the assessment of reform progress would be all the more credible if it could be confirmed externally by actors not directly in charge of implementing the reform. Overall, better communication and pedagogy about the aims and difficulties of the reform process could help improve public support, particularly if the public understands that the full impact of reforms may take some time to appear.

Moreover, more and better medium-term planning is necessary. It would help secure continuity in health policy. Past experience has shown that there have been discontinuities in health policy, due to changes in government or even changes within the same government. The National Health Plan is a possible vehicle for this medium-term planning but, at this stage, the articulation between the ongoing reform and this 10-year plan is not clear. In particular, the National Health Plan does not include enough details on how the reform is going to help achieving its goals of improving health status, and on areas were problems are foreseen. The reform strategy should, in return, integrate better the long-term goals defined in the National Health Plan, and the next steps of the reform should be designed accordingly. There is also a need to articulate better the health care reform within a broader framework considering the global environment in which the reform is being implemented. Several factors outside the health sector reform can help make the reform more effective. First, information campaigns are needed to improve public health and help changing lifestyles that put health at risk and could limit improvements in the health status. This concerns in particular road accidents, which is the 6th cause of death in Portugal, or the lack of exercise, alcohol consumption and obesity (see Annex Figures 4.A1.3 to 4.A1.7). The National Plan for an Integrated Action on the Health Factors Related to Lifestyles (*Programa Nacional de Intervenção Integrada sobre Determinantes da Saúde Relacionados com os Estilos de Vida*) which was approved in January 2004 has therefore to be implemented without delays. More recently, new national health programmes were approved related to the prevention of cardiovascular diseases and rheumatology diseases as well as the development of palliative care and elderly care. Furthermore, a better-educated population would be more able to refrain from excessive health care demand and to understand public information campaign. Lastly, efforts should be made to ensure that public and private governance strengthens and does not become an issue in the new multi-providers health sector.

Modernising the health administration

The health administration needs to be modernised, especially at the regional level. The tasks and role of RHAs are affected by the new status of hospitals and primary health care centres. Already, special task forces have been created to monitor SPA hospitals. Within the new framework, the role of the RHAs as purchasers of health care is enhanced, as well as their responsibility to the budgetary authorities for cost control and to the patients for care quality and access to care. Options should be considered to adapt the RHAs functioning and expertise to these new responsibilities and the associated costs should not be underestimated.

Further increasing efficiency and reducing current pressures on costs

Additional measures are needed to increase efficiency further and ensure that cost pressures are contained and the system is sustainable.

- More emphasis should be put on the integration of the provider networks (primary care/hospitals/long-term care). An active strategy by the authorities, besides the few pilot experiences, should help favour this integration, which is key to reduce inefficiencies and duplication of acts.
- A system to assess the cost-effectiveness of new technologies before they are generalised in public hospitals is needed to better control expenditure at the hospital level. This is all the more necessary that pro-

spective payment prices to providers will have to be adjusted regularly to take into account the impact of changing technology. In this context, the project to develop a programme for information and communication technologies in the NHS should be implemented without delay. International cooperation on this issue can help and should be sought.[60]

- Additional steps are needed in pharmaceuticals: *i*) a closer monitoring of pharmaceutical expenditure by hospitals and measures to tackle their upward trend; *ii*) a better supervision of the observance of prescription guidelines is necessary to change over-prescription habits; *iii*) setting the reference prices at the price of the cheapest generic, instead of the most expensive, could be also considered to increase price competition on the generic market (though the possible increase in co-payments might be an obstacle); *iv*) steps towards the deregulation of the pharmacy sector and the pharmacist profession, in line with the recently proposed EU Directive to cut red tape that stifles Europe's competitiveness, should be taken.
- Prevention of illness and early detection need to be enhanced using the reformed health care centres and as this would tend to improve health outcomes and reduce the cost of health care associated with late detection.
- Measures to discourage excessive demand, which are not at all envisaged by the reform, should be considered, for instance increasing the scale of co-payments (with safeguards to promote equity of access) and rationalising the reimbursement of health services so as to avoid unnecessary duplication of care and recourse to second or third opinion.

Improving quality and equity in access

Further efforts are also needed to ensure that progress in efficiency is followed by improvements in quality of care and health outcomes, where Portugal still lags more advanced EU countries.[61] The benchmarking of health institutions currently in place is mainly based on productivity rather than quality, and the latter needs to be strengthened in the next stages of the reform by developing and monitoring indicators of clinical quality and responsiveness to patients needs. Finally, as the new framework increases incentives to "cream-skim" patients and other adverse selection practices, safeguards have to be put in place and the creation of the ERS by itself does not guarantee that these behaviours will be avoided. The ability of the new institution to fulfil its mandate will have to be tested. Moreover, the coordination of its work with other institutions will need to be clarified in order to avoid confusion of responsibilities and duplication of tasks.

To improve equity in access and to reduce waiting times in a durable way, staffing issues have to be solved. First, the current shortage of nurses needs to be addressed; new education/qualification schemes should be envisaged. To complement the increase in the *numerus clausus*, a good incentive system should be introduced to allocate better human resources in regions and per speciality. The new incentive system that is being developed with the support of international consultants will have to take these considerations into account. While the resulting increase of supply should contribute to reducing waiting time for surgeries, specific measures improving the demand management of waiting lists need to be considered, such as the introduction of some prioritisation of elective patients, which seems to have been successful in New Zealand or Australia (Hurst and Siciliani, 2003).

Box 4.2. Summary of recommendations to strengthen the health care reform

- **Strengthen the global strategy**
  - Improve transparency about the reform process and its progress
  - Improve medium-term planning.
- **Modernise the regional health administrations**
- **Favour more actively the integration of the provider networks to reduce inefficiencies and duplication of acts**
- **Put in place a system to assess the cost-effectiveness of new technologies before they are generalised in public hospitals**
- **Take additional steps to curb spending on pharmaceuticals on a durable basis**
  - Improve the monitoring of spending by hospitals and take measures to control their upward trend
  - Control better the observance of prescription guidelines so as to tackle over-prescription habits
  - Consider setting the reference prices at the price of the cheapest generic, instead of the most expensive one
  - Deregulate the pharmacy sector and the pharmacist profession, in line with EU recommendations
- **Enhance prevention and early detection**
- **Consider measures to discourage excessive demand**
- **Introduce more quality concern in the benchmarking of health institutions**
- **Take additional measures to solve staffing issues**
  - Consider new education/qualification schemes for nurses.
  - Define and introduce a good incentive system to allocate better human resources in regions and per speciality.

Notes

1. In the early 1970s, only 40 per cent of the population was covered by insurance for health care (the lowest share in Europe) and indicators of health status were far behind other European countries (for instance infant mortality, above 50 per 1 000, was twice the European average).
2. *Public-integrated systems* exist also in the Nordic countries, Australia (public hospitals), Italy and Greece and existed, before reforms of the early 1990s, in New Zealand and the United Kingdom. Other models are *i*) the *public-contract model*, where public payers contract at arms length with private or public health-care providers, or a mix of the two (this system exists in most of the remaining Continental European countries, Japan, and, since the reforms, in the United Kingdom and New Zealand); *ii*) the *private insurance/provider model* which uses private insurance combined with private (often for-profit) providers like in the United States or Switzerland. See Docteur and Oxley (2003).
3. The five Regional Health Administrations are Alentejo, Algarve, Centro, Lisboa e Vale do Tejo, Norte. These regions are subdivided into 18 districts.
4. See also OECD *Economic Survey of Portugal* 1998 and Oliveira and Bevan (2003) for more details. The use of the NHS patient Identity Card, mandatory since 2000, has been considered for long as a way to limit such overlapping, but it has yet to be fully implemented.
5. Total health care expenditure represented 9 per cent of GDP in Portugal in 2000 compared with 8 per cent on average in the OECD. When measured relative to trend GDP, it was about ½ percentage point above the OECD average. Based on USD purchasing power parity (PPP), Portugal's per capita spending on health care was below the EU15 average of USD 2123, and close to other EU countries, such as Greece and Spain.
6. This share does not take into account tax expenditure linked to the partial deductibility of private health expenditure, which represents between 0.2 and 0.3 per cent of GDP, according to 2000 estimates.
7. See for instance Campos (2003b).
8. There are no official data concerning the share of out-of-pocket spending in total health expenditure. Estimates range between 25 and 35 per cent, substantially higher than the 18.7 per cent OECD average. Drugs and therapeutic products account for more than half of out-of-pocket payments. The co-payment on drugs generally varies from 40 to100 per cent, depending on the therapeutic value of the drug.
9. An equitable health care system allocates health care services across the country in line with needs, does not distribute the burden of paying for health care in a regressive manner, and provides high-risk groups with adequate access to health care at favourable rates.

10. For example, the National Health Plan (NHP) mentions the case of linear accelerators for cancer treatment that are largely unavailable in central areas of the country.
11. It is only the during the internship period that financial incentives are provided to doctors working in understaffed hospitals.
12. If overtime payments, which make up a large proportion of income (about one fifth of a doctor's remuneration on average in 1999), are taken into account, the total income per doctor is high in comparison with the average wage. However, in general, doctors perceive their salaries to be relatively low. (See European Observatory on Health Care, 2004).
13. The *numerus clausus* for doctors went down from 800 in the late 1970s to below 200 in the mid-1980s and remained in the range 400-550 in the 1990s. Since 2002, it has been raised above 1 000 (see below). See *Grupo e Missão para a Saúde* (2001). The problem is even more acute for emergency services where doctors older than 55 are not permitted to work. (The statutory retirement age in Portugal is 65 years).
14. It was estimated that the average waiting time of the 123 000 people on the NHS waiting list for elective surgery in 2002 was six years (see below).
15. See Framework paper ECO/CPE/WP1(2003)10 – Figure 1. Only two countries were found to have more "pro-rich" health care than Portugal: Sweden and the United States.
16. Anti-diabetics, anti-epileptics, anti-Parkinson's, anti-neoplasm and immuno-modulators, growth and anti-diuretic hormones, specific drugs for haemodialysis, cystic fibrosis treatments, glaucoma treatments, haemophilia treatments and anti-tuberculosis and anti-leprous drugs are fully paid for by the NHS.
17. The lack of data on the system efficiency also limits the ability of the authorities to monitor and improve the performance of the health sector. In addition, it affects more directly the efficiency of the system by making epidemiological surveillance difficult. Several actions have been taken in recent years to improve health data availability. Information efforts are been made to collect data according to System of Health Account (SHA), and new data set are planned for 2005. In 2003, a national survey about Health of Youth in School (between 11 and 19) was launched; data should be available in 2004. Lastly, the Institute for Financial Management and Informatics, IGIF, coordinates the implementation of the OECD health account manual (output expected by end-2006).
18. See European Commission (Eurostat) (2002).
19. See European Commission (Eurostat) (2002). These results need to be balanced by two surveys of health care users. The 2002 survey by the *Ordem dos Farmacêuticos* shows a somewhat higher satisfaction, but does not provide international comparisons. (See Ordem dos Farmacêuticos (2002) "*Os que os Portugueses pensam dos Serviços de Saúde*"). See also *Fundação Antero de Quental* (1999) "*Sondagem Nacional sobre a Prestação dos Serviços de Saúde*". Key problems identified in this survey regarding health care centres and hospitals concern the waiting time, the organisation and lack of doctors, while the technical ability of professionals was assessed as good.
20. Twenty-one hospitals are participating into the accreditation programme and three hospitals have already received full accreditation. According to the IQS (*Instituto da Qualidade em Saúde*), the programme has already led to significant progress in terms of safety as well as efficiency. The Ministry of Health is planning to launch a parallel accreditation programme to complement work done by the IQS. The IQS is also in charge of a project setting principles for the management of inputs and processes leading to quality of results in the form of a self-regulatory strategy by the management board at each

health centre (The MoniQuOr.CS, launched in 1998). Finally, it is also in charge of issuing norms for the preparation of clinical guidelines.

21. Medical technology equipment per million inhabitants is still well below the OECD average. It is the case for computed tomography, magnetic resonance imaging scanners, radiation therapy equipments, lithotripters, and mammography equipments (see OECD, Health data, 2003).

22. Another indicator of low productivity could be the low number of NHS consultations per capita (3.4 in 1997, one of the lowest in the OECD) despite an above average number of doctors per capita, in a context where there is significant waiting time to see a doctor in the NHS. These data need however to be interpreted with caution since they say little about the relative quality of care, the length of consultations or outcomes. Moreover, they also reflect the fact that most doctors work only part time for the NHS, the rest being devoted to private practices which is not included in the data.

23. For instance, in 1998, a new regulatory framework was approved, creating management teams for primary health care centres (the "third generation health centres") with greater autonomy and financially accountable. However, this reform was only implemented on a pilot basis. A voluntary Experimental Remuneration Model (RRE) for GPs involving 500 doctors was also launched in 1998. It included adjusted "capitation" income and a system of bonus for the completion of specific health care episodes (such as pre-natal surveillance). Another pilot project, at the *Unidade Local de Saúde de Matosinhos*, near Porto, has grouped together the town hospital and four primary health care centres. These pilot-experiences have shown positive results.

24. There are 363 primary health care centres in Portugal with an average of 84 health professionals per centre (including 20 doctors and 19 nurses). Following the integration of social welfare medical services into the National Health Service in the early 1980s, some health centres also provide specialized care (mental health, psychiatry, dermatology, paediatrics, gynaecology and obstetrics and surgery). The Ministry of Health allocates funds to the RHAs, which in turn determine the budget of each centre mainly on a historical basis. A council headed by a doctor, and comprising a nurse and an administrative member, is in charge of day-to-day management.

25. According to a survey carried out by the RHAs.

26. In Portugal, general practice is in fact a speciality, requiring a specific training. In this study "specialist" refers nevertheless to physicians that are not GPs. In primary health centres, they can be offered three types of contracts: 35 hours of practice + private practice, 35 hours of exclusive practice + a bonus of 20 per cent, 42 hours of exclusive practice + a bonus of 20 per cent. It is estimated that around 15 per cent of the working time of GPs is assigned to administrative tasks. The same types of contract are used in hospitals.

27. According to a survey published in 2004 by *Teste Saúde*, 20 per cent of patients referred to hospitals for an urgent specialist consultation and half the patients referred for a non-urgent specialist consultation had to wait for two months to see the specialist.

28. See Bentes *et al.* (2004).

29. Decree Law 60/2003.

30. Financed by European funds under *Saúde* XXI a seven-year programme (2000-06) that receives financing of two European structural funds (FEDER and ESF). For more details see [*www.saudexxi.org*].

31. An experience of private management of a public hospital was launched in Hospital Fernando Fonseca Amadora Sintra in 1996. This experiment was close to that of a public-private partnership, PPP, in the sense that the business risk was transferred to the private sector. New management techniques were introduced at Hospital de São Sebastião in Santa Maria da Feira (in 1998) or more recently at Nossa Senhora do Rosário near Lisbon. Both experiences have resulted in efficiency gains. See OECD *Economic Survey of Portugal* (2003) Box 7 for more details on the experiences. A recent report by the "Tribunal de Contas" highlights the good results of Hospital de São Sebastião over 1999-2001 concerning both productivity and quality.
32. According to Apifarma, the pharmaceutical companies' association, at end-2003 the average payment delay the pharmaceutical industry was close to 11 months. Total debt reached 647 million euros, 87 per cent higher than a year ago and debt with arrears older than 90 days increase by 60 per cent in 2003.
33. At the beginning of 1999, it was announced that out-patients with referral letters from their GP would be given priority, so as to provide an incentive to patients to use primary care services and to reduce the number of patients by-passing the referral process. But to be effective, this measure would have required a well organised and appropriately staffed primary care network.
34. The contract-programmes refer only to the provision of health care to the NHS, excluding the provision of services to other health sub-systems. The latter are negotiated separately.
35. For more details see *Hospitais* SA – *Relatório Actividade*2003 on [*www.hospitaissa.min-saude.pt/ Site*HSA_*pt*-PT/*Downloads*/].
36. This task force is also in charge of supporting the development of the hospitals SA network, promoting the implementation of operational and financial improvement initiatives, helping find synergies among different hospitals, launching quality improvement programs, developing human resource management.
37. These hospitals are Amarante, Aveiro, Pulido Valente, Santa Marta and Santarém. The programme includes a reduction in waiting times for consultations and ancillary tests, the revision of reference processes between primary care centres and hospitals, and the optimization of invoicing and control of payments.
38. This group is quite diverse, including both large university hospitals and small local ones.
39. Existing examples of PPP use in the health sector are the UK (see Van den Noord (2002)) and Spain. Besides hospitals, PPP might also be considered in the future in primary care and long-term care.
40. Outside the health sector, Portugal has made significant use of public-private partnerships for large infrastructure investment (transport, water and energy for instance). See Bronchi (2003) for more details.
41. The financing is provided by IGIF to the providers selected for the programme via the RHAs.
42. In April 2004, only 8 000 people were still waiting. One third of the patients on the waiting list were directed to the private sector, 5 per cent of which contracted to foreign units (in Spain). It seems that half of the people who were directed to surgery in the private sector refused it, possibly because these people were called for surgery on short notice (as has been done in other countries in the past). See *Público* 23/01/2004).

43. The new system will be extended progressively to other regions by 2006. For more details see [*www.governo.gov.pt*/NR/*rdonlyres*/E0463BA2-9358-43CA-8A00-6CCD70A150B7/0/A*pres*_SIGIC.*pdf*]. A document defining more precisely the maximum acceptable waiting time for each pathology is under preparation.

44. *Misericórdias* are independent non-profit institutions (historically they were religious charities health care units and played a central role in the Portuguese health care system).

45. Payments by the NHS to pharmacies is under the responsibility of the RHAs, with the primary care centres and hospitals playing an intermediation role for respectively GP and hospital doctors' prescriptions. The reimbursement of pharmaceuticals prescribed under private treatment accounted for 18.1 per cent of the reimbursement by RHAs in 2001 (see IGIF, *Serviço Nacional de Saúde*, *Contas Globais* 2001). The National Institute of Pharmaceuticals and Medicine, INFARMED, created in 1993, is responsible for the regulation of pharmaceuticals and is in charge of deciding whether new products are reimbursed, as well as ensuring the quality, safety and efficacy of pharmaceuticals. For more details see Oliveira and Pinto (2003) and [*www.infarmed.pt*].

46. Copies represented about ¼ of the market in 2003. They are sold at a higher price than generic drugs and therefore companies have no incentives to convert them into generic drugs.

47. For instance, in May 1996, the government reached an agreement with the pharmaceutical industry under which the industry would make a payment to the NHS equivalent to 64.3 per cent of the growth in drug spending in excess of 4 per cent in 1997 – with no payment to be made for increases above 11 per cent, thus creating a perverse incentive for inflating expenditure by more than 11 per cent. In 2001, there were revisions to drug packaging, with smaller packets for drugs of quick and intensive use and bigger ones for drugs used for chronic illnesses.

48. As reflected for instance by a higher use of antibiotics in Portugal than in most other OECD countries (see Observatório Português dos Sistemas de Saúde, 2003).

49. All drugs, including over-the-counter ones, can only be sold in pharmacies. The location of pharmacies is highly regulated, with a maximum number of pharmacists permitted in each community. For the Ministry of Health to give authorization for a new pharmacy in an expanding residential area, there must be proof that there are at least 4 000 new clients and that there is no other pharmacy within 200 meters.

50. See Campos (2003b). In 2001, pharmaceuticals accounted for close to 17 per cent of the hospitals costs. (IGIF (2003), *Serviço Nacional de Saúde*, *Contas Globais* 2000).

51. In practice, in September 2003, it was estimated that, in the case generics were available, only 20 per cent of doctors prescribed according to International Common Denomination, the remaining 80 per cent prescribing either by International Common Denomination with a brand name or by brand name only. Furthermore, 47.3 per cent of prescriptions did not authorise substitution. See CEFAR, *Estudo sobre o Padrão de Utilização da Nova Receita Médica*, Oct. 2003.

52. For pharmaceuticals below or at the reference price, reimbursements are calculated as the rates shown in Table 4.4 applied to the effective prices. For pharmaceuticals above the reference price, these rates are applied to the reference price. Until end-2003, the reference price for the pensioners whose pension is equal or inferior to the national minimum wage will be increased by 25 per cent in order to limit the financial impact on the pensioners. This was extended to 2004. Generic drugs have to be 35 per cent cheaper than the original product (20 per cent till 2000).

53. The criteria for a copy to be converted into a generic product are: *i*) essential similarity with the reference medicinal product; *ii*) property rights relating to the active substance or manufacturing process must have expired; *iii*) a different therapeutic indication from the one authorised for the reference product cannot be claimed. When the conversion of a copy into a generic is required, it is for the applicant to verify that the reference medicinal product is not covered by a patent (be it a product or a process patent, whether granted before or after 1995).
54. Drugs with a generic equivalent represent about 20 per cent of the drugs available.
55. See *Resolução do Conselho de Ministros* No. 128/2002.
56. The President and members of the Health Regulatory Agency (ERS) have a five-year mandate (starting with two years, for the two members) renewable once. Professional activities in the two years before and after being a board member are strictly limited so as to avoid conflict of interests. Board members cannot be revoked except for serious professional fault. The agency will be staffed by people hired on individual contracts or civil servants in mobility. Of the 40 or 50 staff members, it is planned to have about ten inspectors who will be doing ground work in coordination with other entities involved in regulating the sector.
57. Health is the only sector where hiring was permitted after the 2002 budget freeze, in services that are understaffed. (However, the new hiring was based on regular civil servant contracts because the hiring freeze on fixed term and individual contracts applied also to the health sector).
58. A specialisation of emergency doctors is envisaged; some doctors will become "competent on" emergency care. A pilot experience has been launched in Coimbra. Lastly, all emergency service staff will change status and switch to private contracts as of 2005.
59. For instance, IQS and INFARMED are also in charge of ensuring quality in health care and IGIF is, among other things, in charge of ensuring equitable access to health care.
60. Such systems exist in most more advanced EU countries (such as France, the Netherlands and the UK) where health technology assessments (HTAs) of new technologies and procedures are designed to ensure that only those which pass a certain benchmark for value-for-money are admitted for public reimbursement. See Docteur and Oxley (2003).
61. Studies have shown that, in the UK, the reform of the 1990s has resulted in small improvements in some volume and efficiency indicators but has not succeeded in durably reducing waiting lists or waiting times, or clearly improving the clinical quality of care or health outcomes and, hence, patient satisfaction. See Docteur and Oxley (2003).

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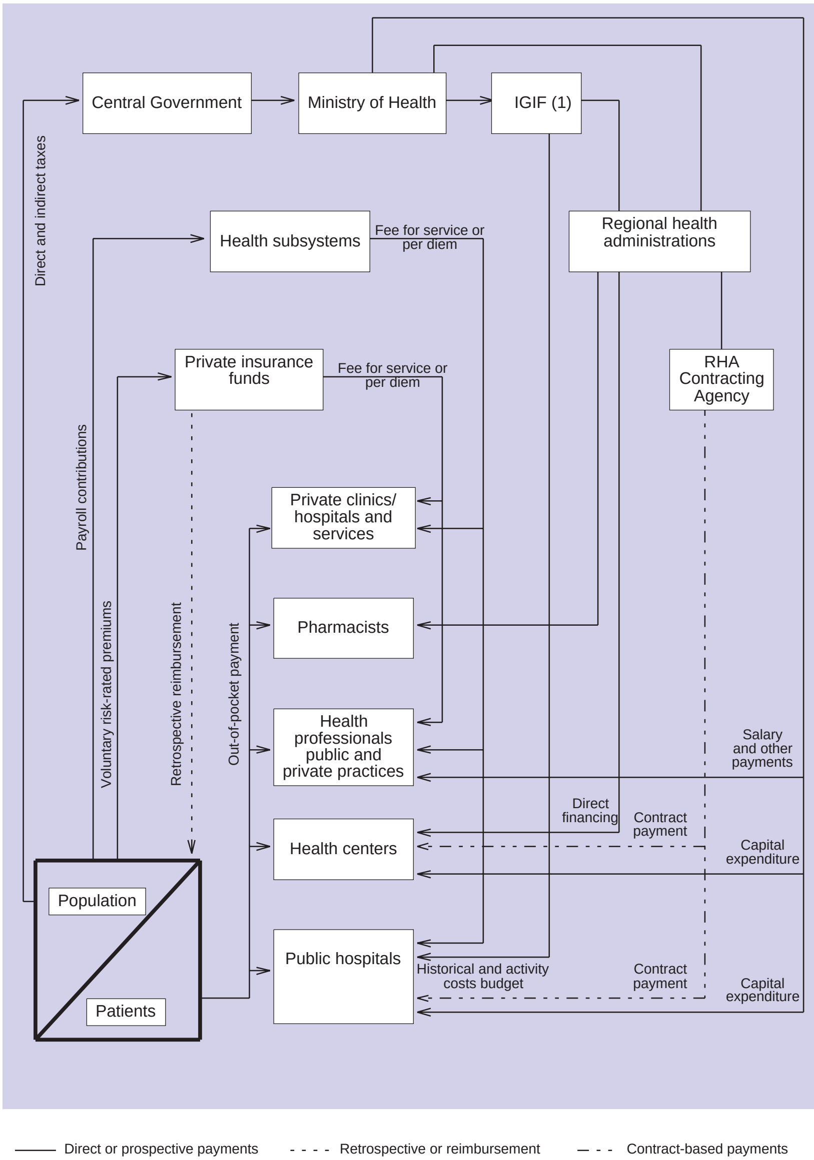
Annex 4.A1

Background information to Chapter 4

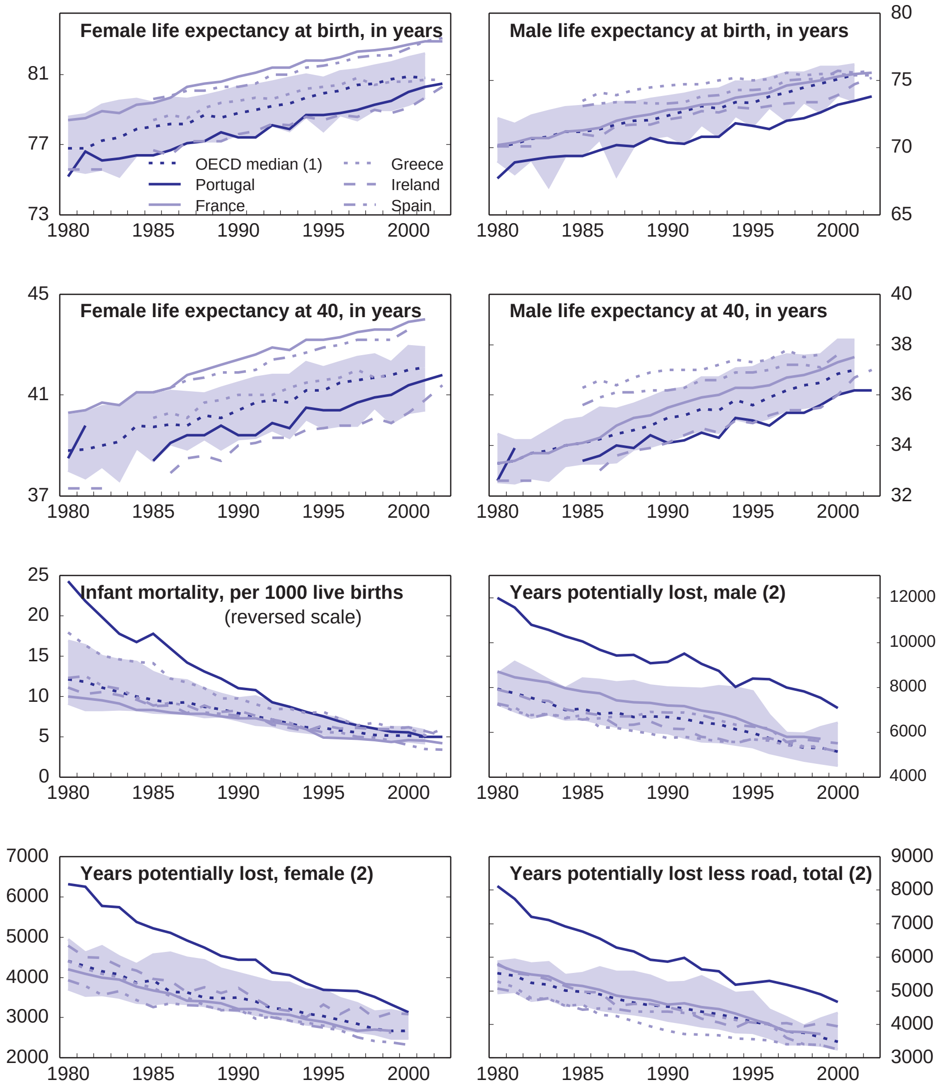
A. Background Figures and Tables

Figure 4.A1.1. **The health care system in 1999**



1. IGIF: Institute of Financial Management and Informatics.
Source: OECD Health Data, 2004.

Figure 4.A1.2. **Health status**



1. The shaded area denotes the inter-quartile range.
2. The Potential Years of Life Lost is a summary measure of premature mortality, which provides an explicit way of weighting deaths occurring at younger ages (before 70 years), which are, a priori, preventable.

Source: OECD Health Data, 2004.

Table 4.A1.1. **Public expenditure on health care**
As a percentage of trend GDP

	1980	1990[1]	2000[2]	Change 1980-1990	Change 1990-2000
Australia	4.6	4.9	6.3	0.2	1.5
Austria	5.2	5.2	5.4	–0.0	0.2
Belgium			6.2		
Canada	5.3	6.6	6.2	1.3	–0.4
Czech Republic[3]		4.4	6.5		2.1
Denmark	8.0	7.0	6.9	–1.0	–0.1
Finland	5.0	6.3	5.0	1.3	–1.3
France	5.7	6.6	7.1	0.8	0.5
Germany	6.8	6.5	8.3	–0.3	1.9
Greece	3.7	4.0	5.2	0.3	1.3
Hungary[3]		6.4	5.0		
Iceland	5.5	6.9	7.7	1.4	0.8
Ireland	6.8	4.4	4.7	–2.4	0.3
Italy		6.4	6.0		–0.4
Japan	4.6	4.6	6.1	0.0	1.5
Korea[3]		1.6	2.2		0.6
Luxembourg[3]	5.5	5.7	5.0	0.2	–0.7
Mexico[3]		2.0	2.6		0.6
Netherlands	5.2	5.4	5.5	0.2	. .
New Zealand	5.4	5.7	6.2	0.3	0.5
Norway	5.9	6.4	6.5	0.5	0.1
Poland[3]		4.5	4.0		–0.5
Portugal	**3.6**	**4.1**	**6.4**	**0.5**	**2.3**
Slovak Republic[3]		5.4	4.9		
Spain	4.3	5.3	5.3	0.9	0.1
Sweden	8.4	7.5	7.2	–0.9	–0.4
Switzerland		4.3	5.8		1.5
Turkey[3]	0.9	2.2	4.2	1.3	1.9
United Kingdom	5.0	5.0	5.9	–0.0	0.9
United States	3.6	4.7	5.8	1.1	1.1
OECD[4]	5.2	5.1	5.7	–0.1	0.6
EU[4]	5.6	5.7	6.0	0.0	0.4

1. Data refer to 1991 for Hungary; 1995 for Belgium and 1997 for the Slovak Republic.
2. Data refer to 1997 fotr the Netherlands.
3. GDP used as the denominator instead of trend GDP.
4. Unweighted average; includes all available countries at the relevant point of time.

Source: OECD Health Data, 2004; OECD, *Economic Outlook* No. 75 (June 2004).

Table 4.A1.2. **Regional health data**[1]

	Norte	Centro	Lisboa e Vale do Tejo	Alentejo	Algarve
Infant mortality rate /1 000 births, 2002	5.6	3.6	5.1	4.8	5.1
Perinatal mortality rate /1 000 births, 2002	6	4.4	6.2	6.8	7.5
Physicians' density[1] 2000	3.0	2.6	4.2	1.6	2.3
Nurses' density[1] 2000	3.6	3.5	3.7	3.7	3.1
Hospital beds[1] (NHS) 2001	2.2	2.6	2.5	2.2	1.9
Number of hospitals (NHS) 2001	26	26	28	5	3
Number of health centres (NHS) 2000	106	110	87	44	16
Population (in millions)	3.6	1.8	3.5	0.5	0.4

1. Per 1 000 people.

Source: Ministry of Health, General Directorate for Health, INE.

Table 4.A1.3. **Health employment indicators**

	Health employment density[1]			Density of physicians[1]		Density of pharmacists[1]	
	1985	1990	2002[2]	1990	2002[2]	1990	2002[2]
Portugal	10.2	11.0	13.6	2.8	3.2	0.5	0.8
United States	26.4	31.3	37.0	1.8	2.4	0.7	0.7
Germany	. .	. .	45.9	2.8	3.3	0.6	0.6
France	26.0	26.0	30.8	3.1	3.3	0.9	1.1
Italy	16.7	17.7	. .	3.8	4.4	1.0	1.1
United Kingdom	21.6	23.7	31.9	1.5	2.1	0.6	0.5
Greece	11.4	13.5	15.3	3.4	4.4	0.7	0.9
Ireland	. .	19.0	30.9	2.0	2.4	0.6	0.8
Spain	. .	13.9	17.0	. .	2.9	0.5	0.9
Unweighted average	18.7	19.5	27.8	2.7	3.2	0.7	0.8

	Dentists' density[1]		Number of hospital beds[1]		Nurse/Staff ratio[3]		Ambulatory sector Consultations with doctors per capita	
	1990	2002[2]	1990	2002[2]	1990	2002[2]	1990	2002[2]
Portugal	0.2	0.5	3.4	3.2	0.56	1.20	3.0	3.6
United States	0.5	0.5	3.7	2.9	1.05	1.36	. .	8.9
Germany	0.7	0.8	. .	9.0	0.42	0.48	5.3	7.3
France	0.7	0.7	5.2	4.0	0.39	0.50	5.9	6.9
Italy	0.4	0.5	6.2	4.6	0.64	1.04	6.8	6.1
United Kingdom	0.4	0.4	2.8	3.9	1.10	1.70	6.1	4.9
Greece	1.0	1.2	4.0	4.0	0.78	0.90	2.5	. .
Ireland	0.4	0.5	3.3	3.0	1.20	1.50	. .	. .
Spain	0.3	0.5	3.3	2.8	0.68	0.90	. .	8.7
Unweighted average	0.5	0.6	4.0	4.2	0.76	1.06	4.9	6.6

1. Per 1000 inhabitants.
2. Or latest year available.
3. Number of nurses per hospital bed.

Source: OECD Health Data, 2004.

B. The indicators used in the benchmarking of hospitals SA (Source: Ministry of Health)

The tools that are used in the benchmarking of Hospitals SA include five interconnected tables:

1. *Synthesis table*

Economic result as a percentage of total revenue

Result gap based on pre-established objectives

Global Efficiency Index (measures the relative efficiency of each hospital *vis-à-vis* average)

Average Length of Stay – ALOS (case mix adjusted)

Inpatient utilization rate

Medical FTEs per 10 beds (case mix adjusted)

Costs with overtime *vis-à-vis* total labour costs

2. *Economic performance*

Total economic result and as percentage of total revenue

Global efficiency index

Diversion from pre-established total cash operational cost objective

Diversion from pre-established total goods purchases cost objective

Diversion from pre-established external services cost objectives

Diversion from pre-established labour cost objectives

Suppliers debt as a percentage of equity

Client debt as percentage of equity

Total debt as a percentage of equity

3. *Production*

Activity volume

- Inpatient and ambulatory surgery (Inpatient users per bed, Inpatient occupancy rate, Inpatients per equivalent physician, Inpatients per equivalent nurse, Ambulatory surgery as a percentage of total surgery, Hospital transferences as a percentage of total inpatient equivalent patients, Surgery SNS (NHS) production as a percentage of current year contracted production, Inpatient equivalent patients annual evolution, Inpatient days).
- External consultation (External consultations per equivalent physician, External consultations per consultation room, External consultation SNS (NHS) production as a percentage of current year contracted program, External consultations production annual evolution).
- Emergency (Emergencies per 100 external consultations, Emergencies per equivalent physician, Emergency surgeries as a percentage of total surgery, Emergency surgeries SNS (NHS) production as a percentage of current year contracted production, Emergency surgeries annual evolution).
- Day hospital (Day hospital occupancy rate, Day hospital SNS (NHS) production as a percentage of ALOS (simple and case mix adjusted).

Surgery room (occupancy rate (considering 12 hours of availability per day), occupancy rate, monthly programmed surgeries per surgery room, ambulatory surgery annual evolution, total surgeries annual evolution).

4. *Human resources, other resources and client service*

Human resources (number of physicians FTE per 10 beds (case-mix adjusted), number of nurses FTEs per 10 beds (case-mix adjusted), other FTEs per 10 beds, overtime hours as a percentage of total labour workable hours).

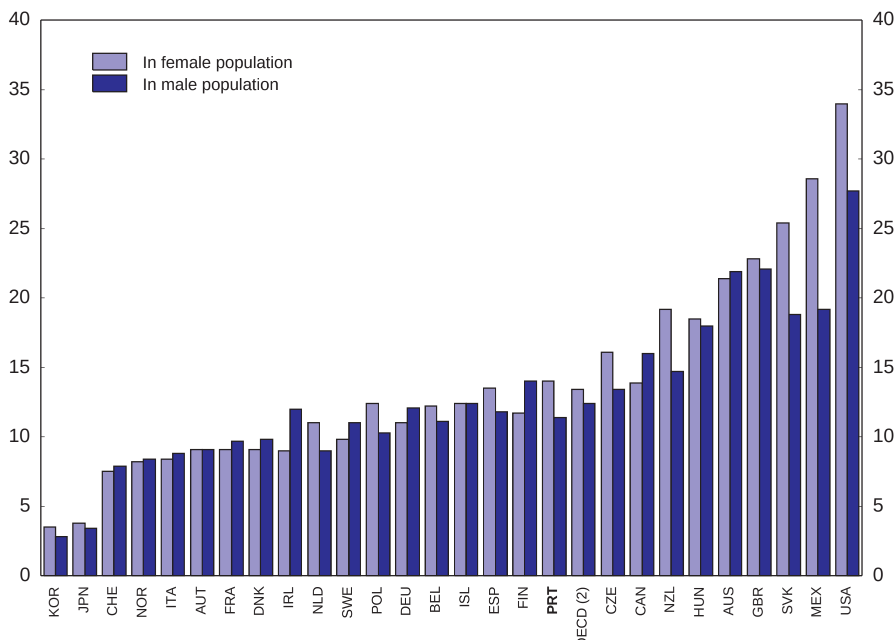
Other resources (drugs costs per patient (case mix adjusted)), other supplies and purchased goods per patient ((case mix adjusted), external services costs per patient).

Client service (client satisfaction index).

C. Non-medical determinants of health

Figure 4.A1.3. **The proportion of obese population is around OECD average**[1]

Body mass index of 30kg/m² or more



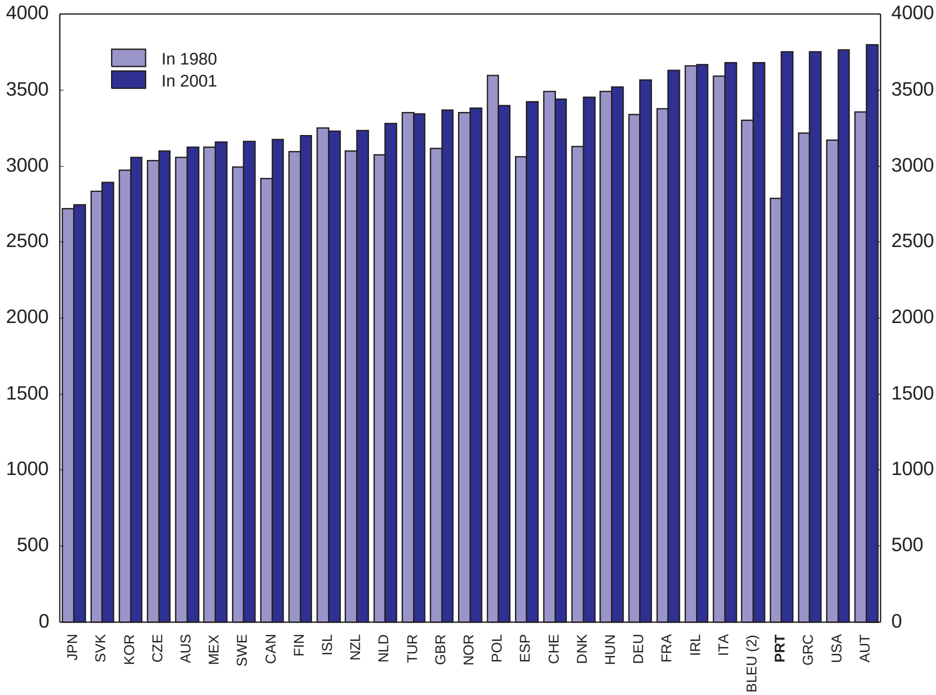
Note: Except Greece, Luxembourg and Turkey.

1. 2002 or nearest year available. Share of adult population aged 15 and over. Except Norway and the United Kingdom: 16 and over; Portugal: 18 and over; Austria, Japan and the Netherlands: 20 and over; Finland: 15-64; Canada: 20-64; the United States: 20-74 and Australia 25-64.
2. Unweighted average of available data.

Source: OECD Health Data, 2004.

Figure 4.A1.4. **Calories intake surged in the last two decades**

Total calories per capita daily[1]

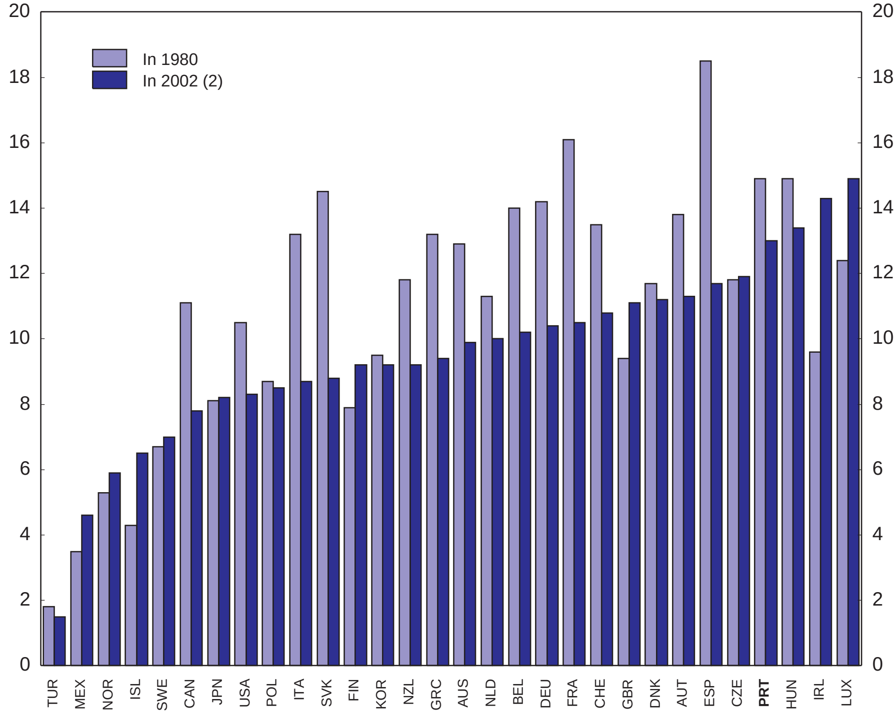


1. Refers to food consumption. Calories from wine, beer and alcohols are not taken into consideration.
2. Belgium data include Luxembourg consumption: the territorial unit is thus the BLEU.

Source: OECD Health Data, 2004.

Figure 4.A1.5. **Alcohol consumption remains high**

Annual consumption of pure alcohol in litres per adult[1]

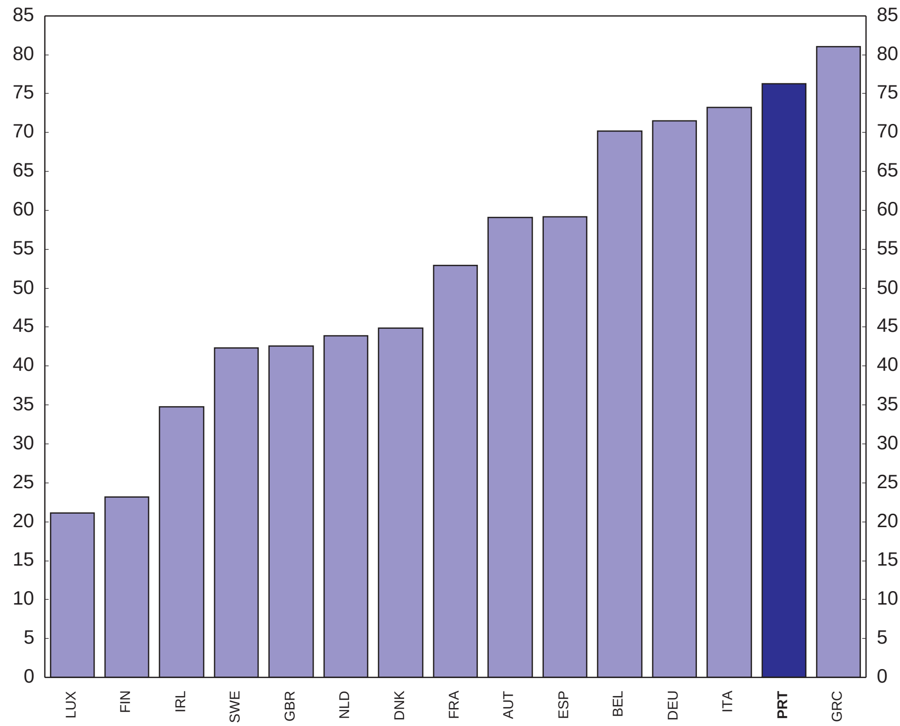


1. Population aged 15 and over.
2. Or nearest year available

Source: OECD Health Data, 2004.

Figure 4.A1.6. **The population does not exercise sufficiently**

Percentage of population which does not exercise at least twice a week[1]

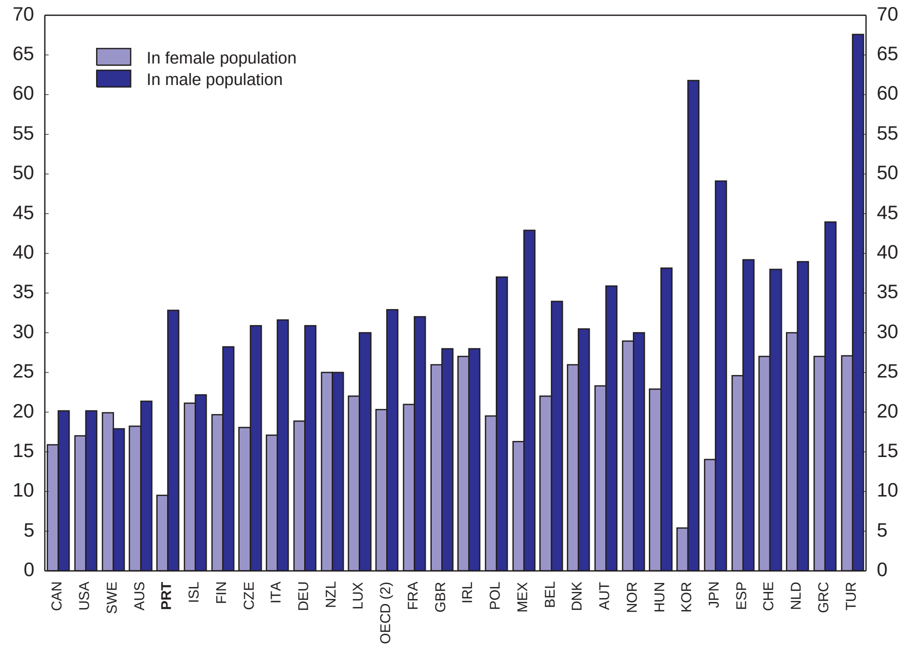


1. In 1999.

Source: Eurobarometer 52.1 – 1999.

Figure 4.A1.7. **Tobacco consumption is relatively low**

Proportion of daily smokers in the population[1]



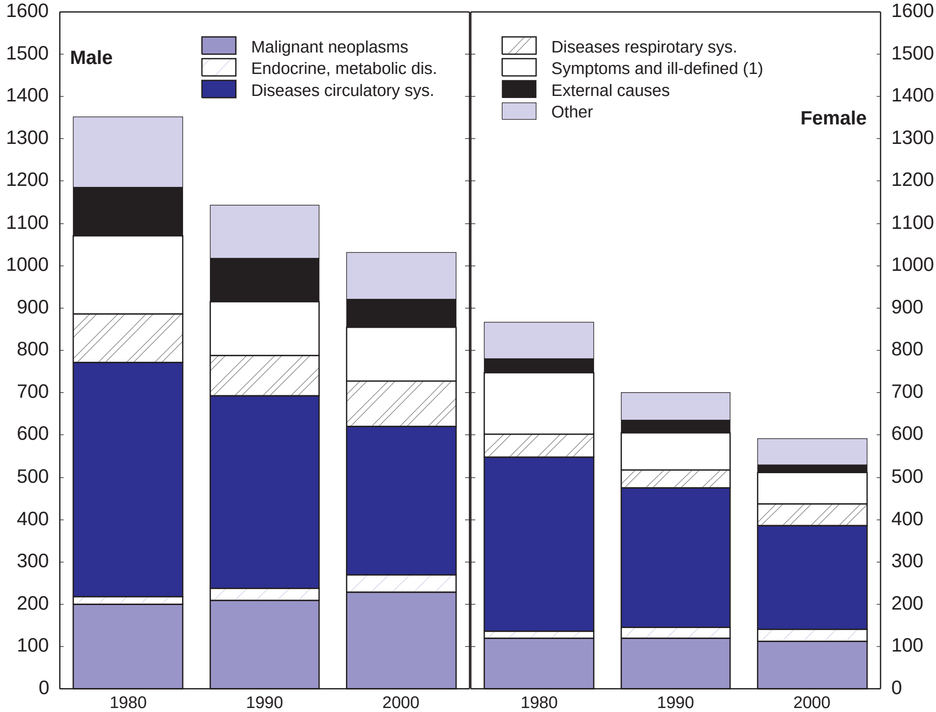
Note: Except the Slovak Republic.

1. In 2002 or nearest year available in the adult population aged 15 and over. Except Italy: 14 and over; Austria and Spain : 16 and over; Hungary, Ireland and the United States: 18 and over; Korea: 20 and over; Mexico: 12-65; Finland: 15-64; Iceland : 15-79; Norway: 16-74 and Sweden: 16-84.
2. Unweighted average of available data.

Source: OECD Health Data, 2004.

Figure 4.A1.8. **Causes of death**

Age-standardised death rates per 100 000 male/female population



1. Symptoms, signs and subnormal clinical and laboratory findings, n.e.c.

Source: OECD Health Data, 2004.

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