

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.

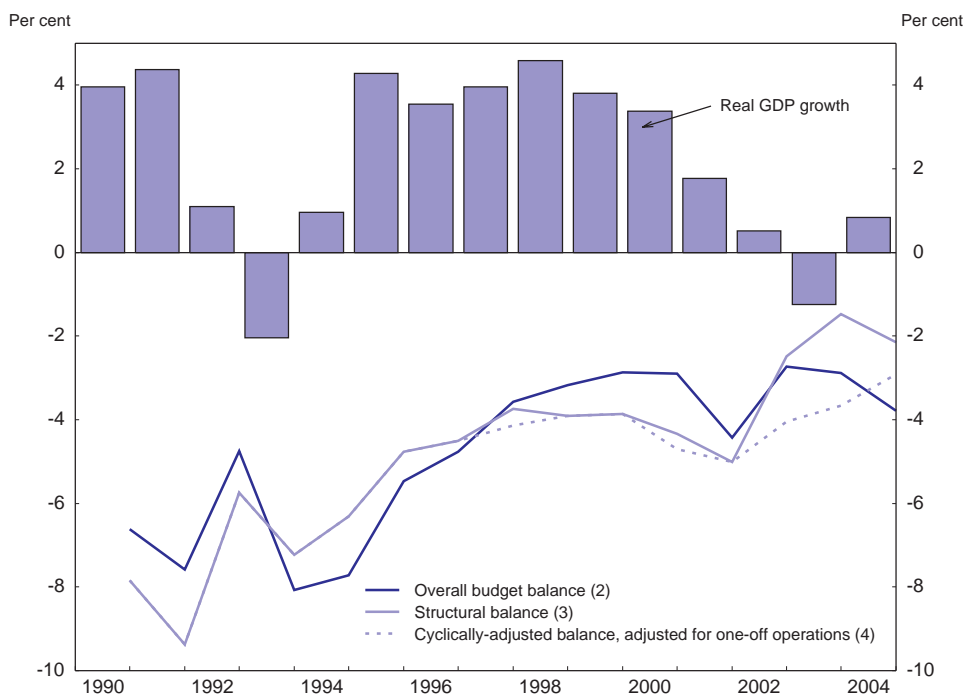
A bloated public sector. Available indicators point to an overly large public sector in Portugal given the quantity and quality of the services that it provides, both in the main spending areas of education and health, and in the central administration. The public sector is generally characterised by 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, 1990-2004¹**



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.*

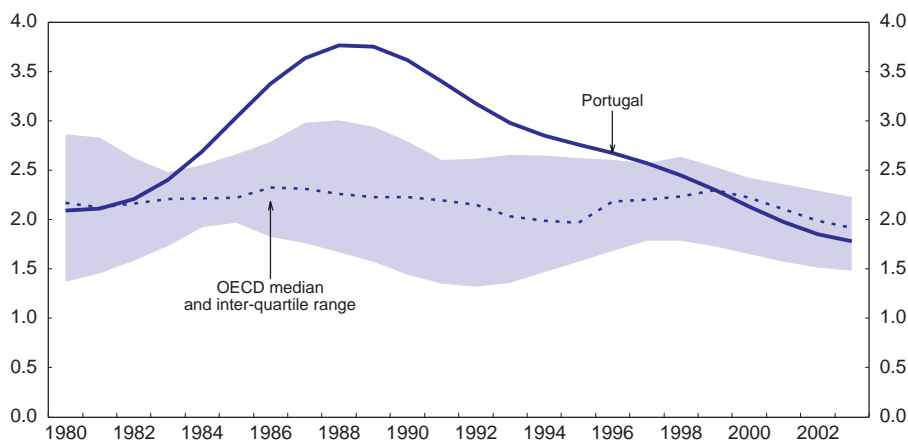
The roots of the persistent weakness of public finances lie on the spending side. Public spending has been growing rapidly since the mid-1990s. Total expenditure increased by 1.3 percentage points of GDP between 1995 and 2001 while it fell by 3.6 points on average in the EU; as a result, it is now close 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 growth¹**
Percentage changes



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

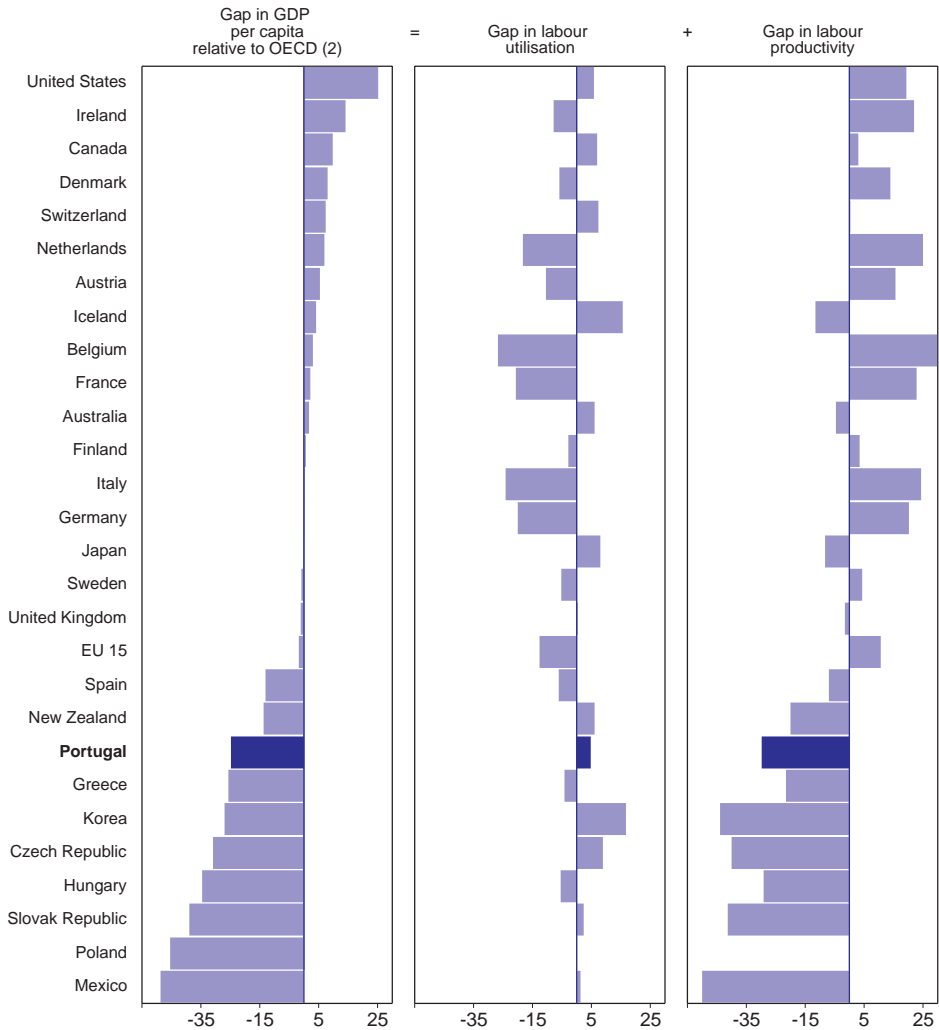
Source: OECD, *Economic Outlook 75* database.

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. *Areas 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 gap¹**

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 I.1. Sources of growth in real GDP per capita: selected OECD countries¹

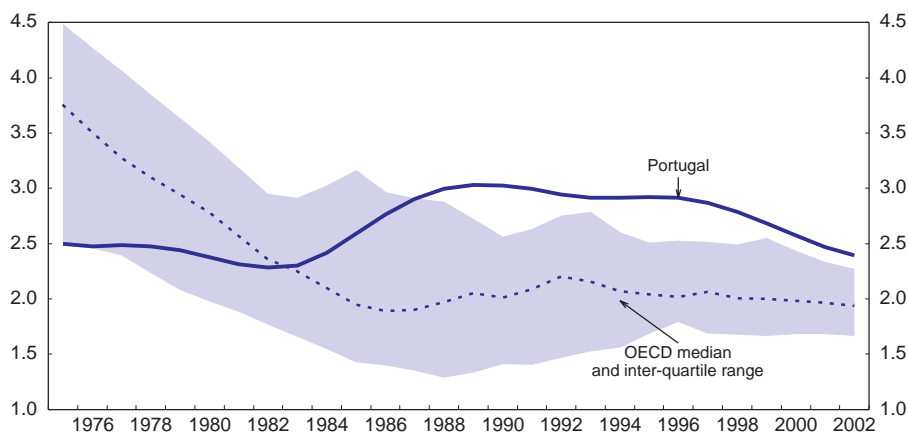
Average of annual changes in per cent

	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	..
<i>Contribution from:</i>																				
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 $(ET \cdot HRS) / POP = POPT / POP \cdot LF / POPT$ (participation rate) $\cdot ET / LF$ (employment rate) $\cdot HRS$; while labour productivity is defined as: $GDPV / (ET \cdot HRS)$; 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 sector¹
Percentage changes

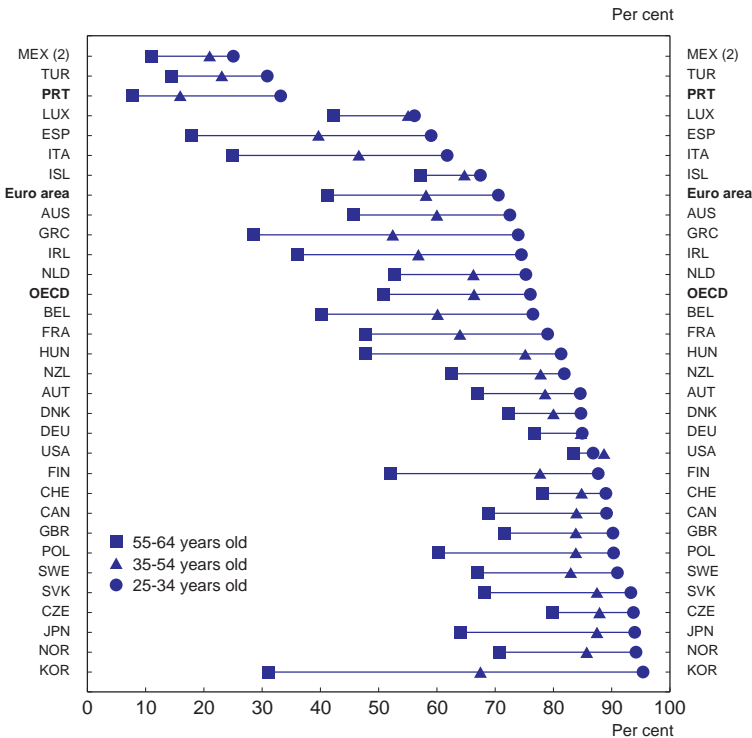


1. Adjusted for the business cycle using a Hodrick-Prescott filter with lambda 100.
Source: OECD, *Economic Outlook 75* database.

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 population¹**
Population with at least an upper-secondary qualification, 2002



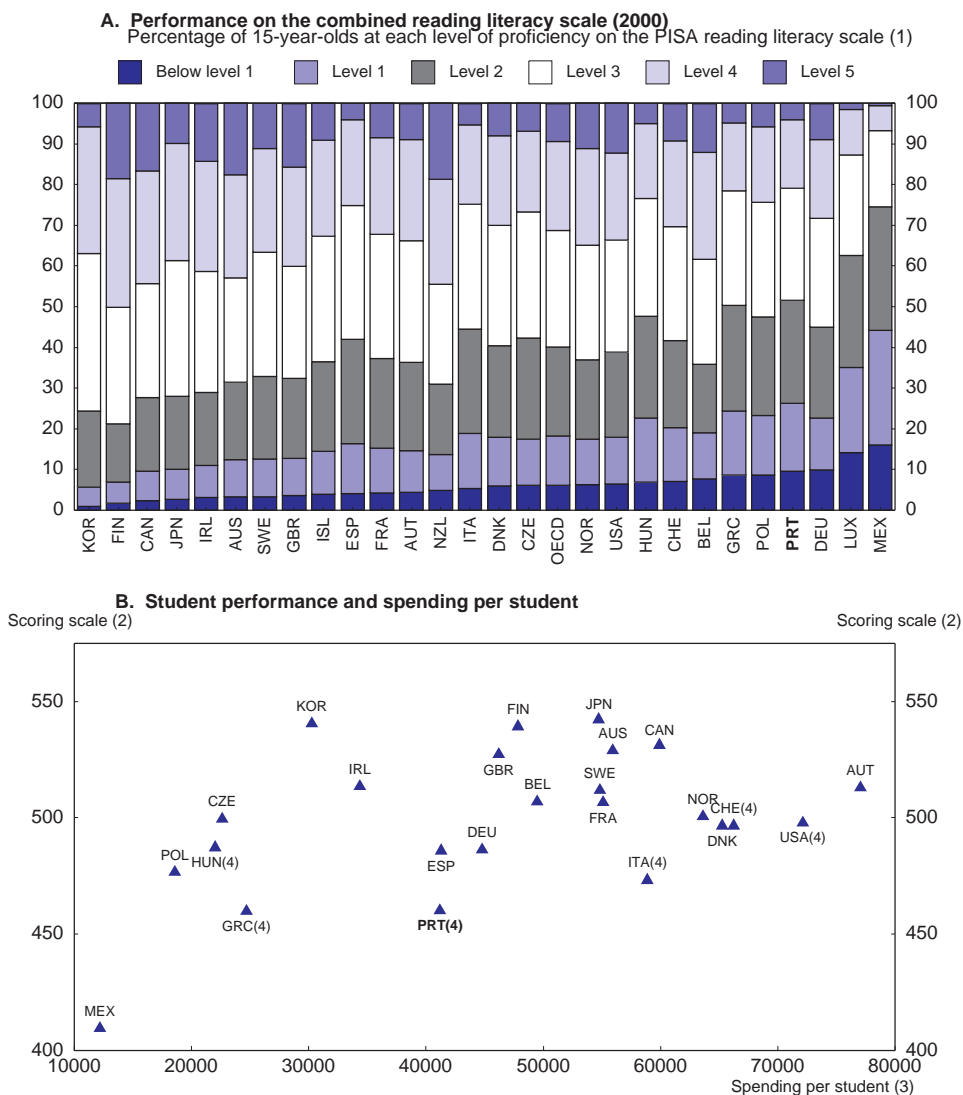
1. Per cent of each age group.
2. 2001 data.

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



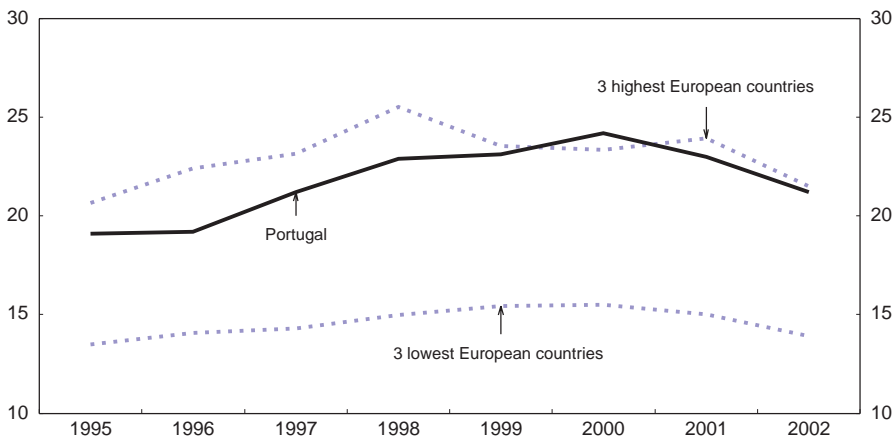
1. For the definitions of levels see OECD, *Literacy Skills for the World of Tomorrow: further results from PISA 2000* (2003).
 2. Average performance across the combined reading, mathematical and scientific literacy scales in 2000.
 3. Cumulative expenditure on educational institutions per students 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 prices¹



1. Including investment by state-owned enterprises.

Source: European Commission (Eurostat), Structural Indicators.

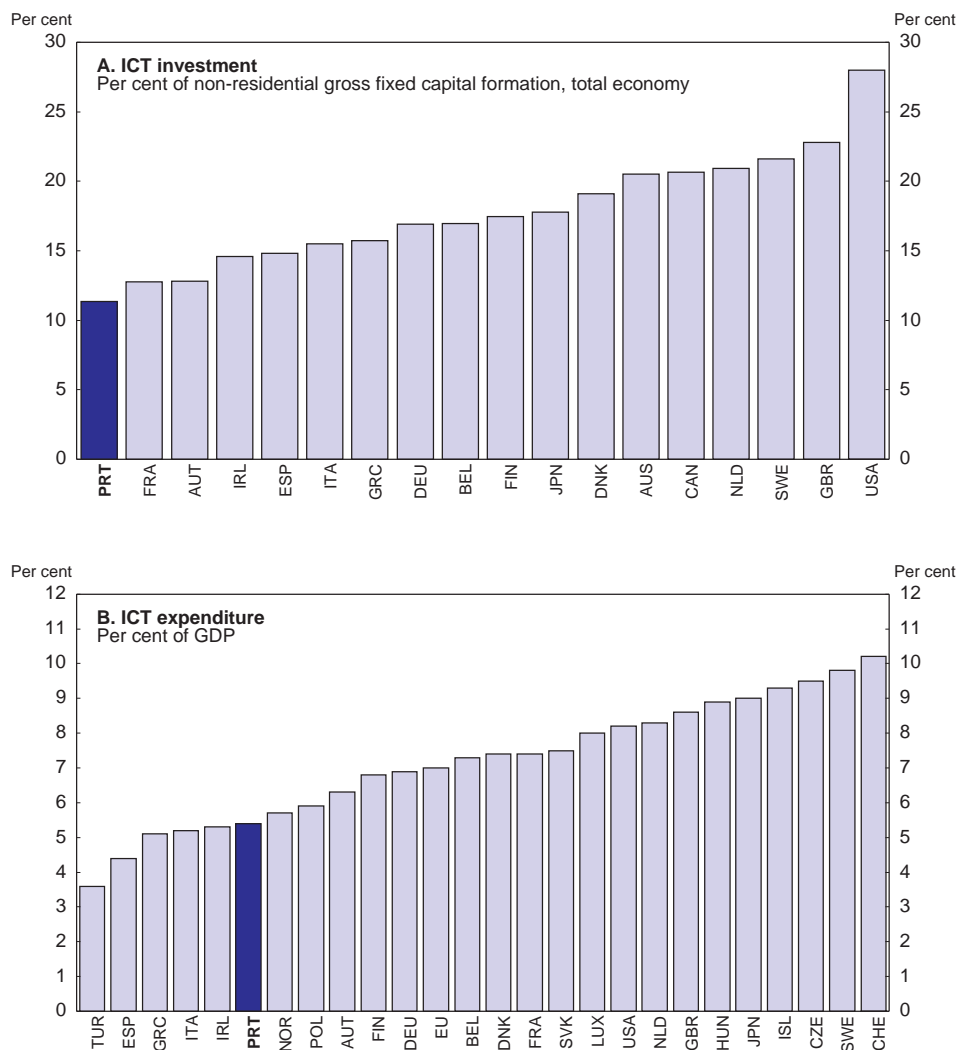
Portuguese ICT investment (including equipment and software) represents a much lower proportion of non-residential investment in Portugal than in most other OECD countries. Using a comprehensive measure of expenditure on ICT equipment and services, Portugal is also lagging (Figure 1.8). Portugal's poor 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

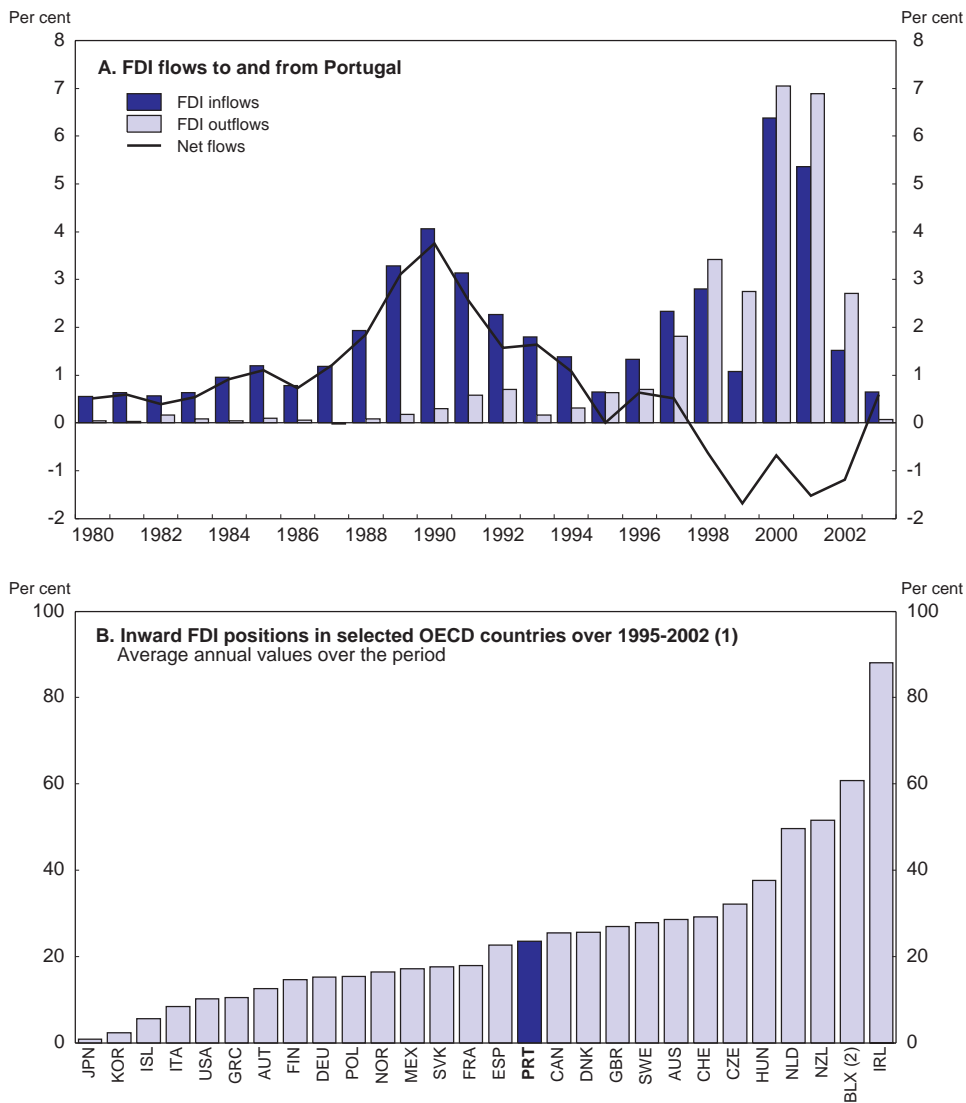
Figure 1.8. **Indicators of ICT investment and ICT expenditures¹**
In selected OECD countries, 2001



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.

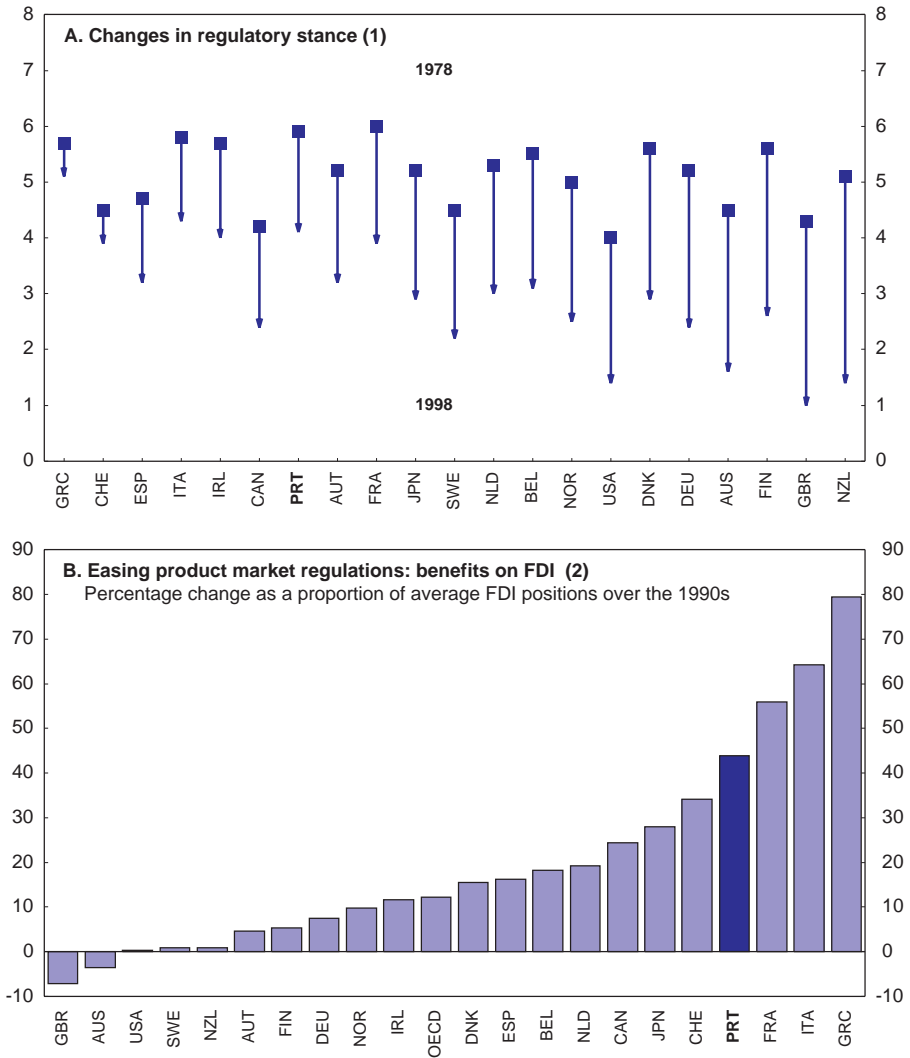
Export performance and trade specialisation

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).

the 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 (*Programa para a Produtividade e Crescimento da Economia*, PPCE), launched in 2002, was accompanied by important initiatives to make competition policy more effective.

Short to medium-term growth prospects

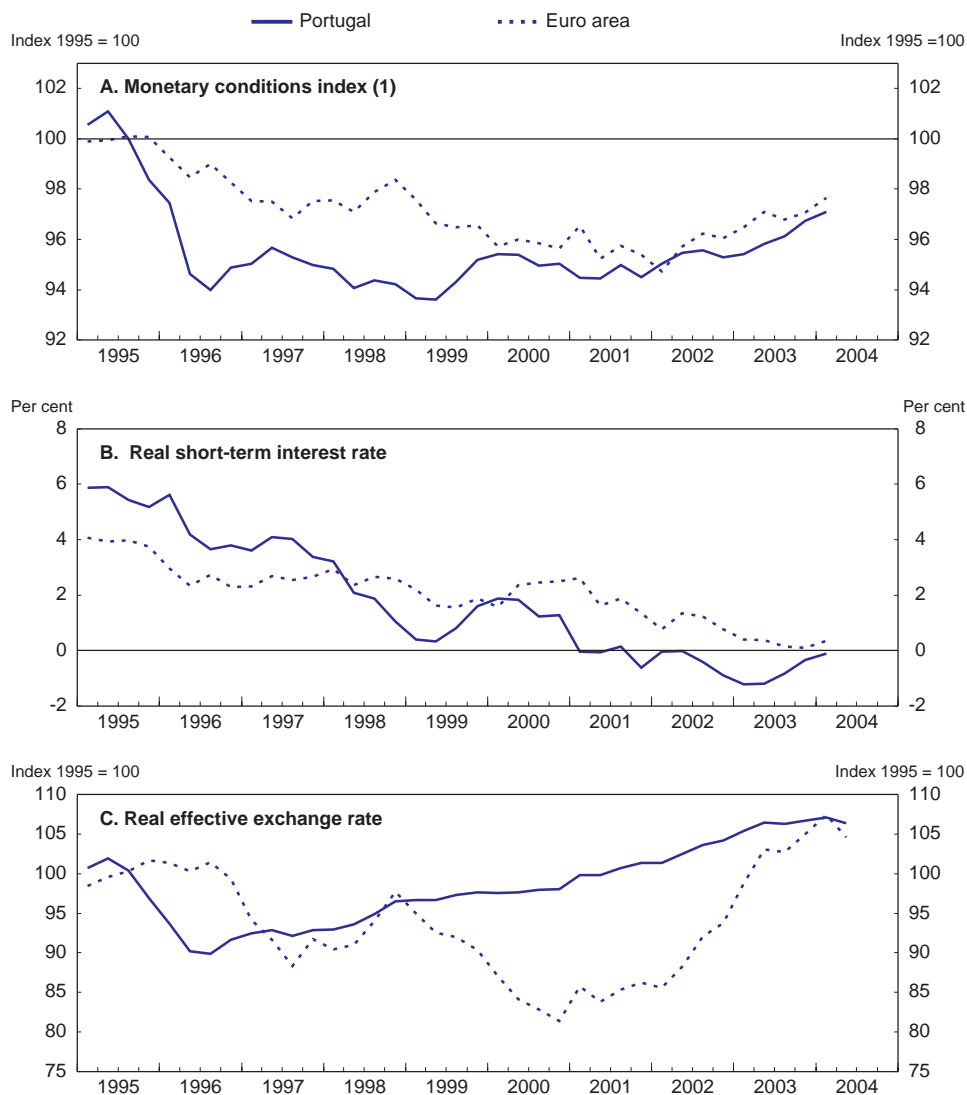
A cyclical recovery has taken root

The slowdown came later in Portugal 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.

Monetary 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

Fiscal 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 I.A1 Table I.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.

The Portuguese recovery appears very dependent on the pace of the upturn in Europe 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

To 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 multi-factor 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).

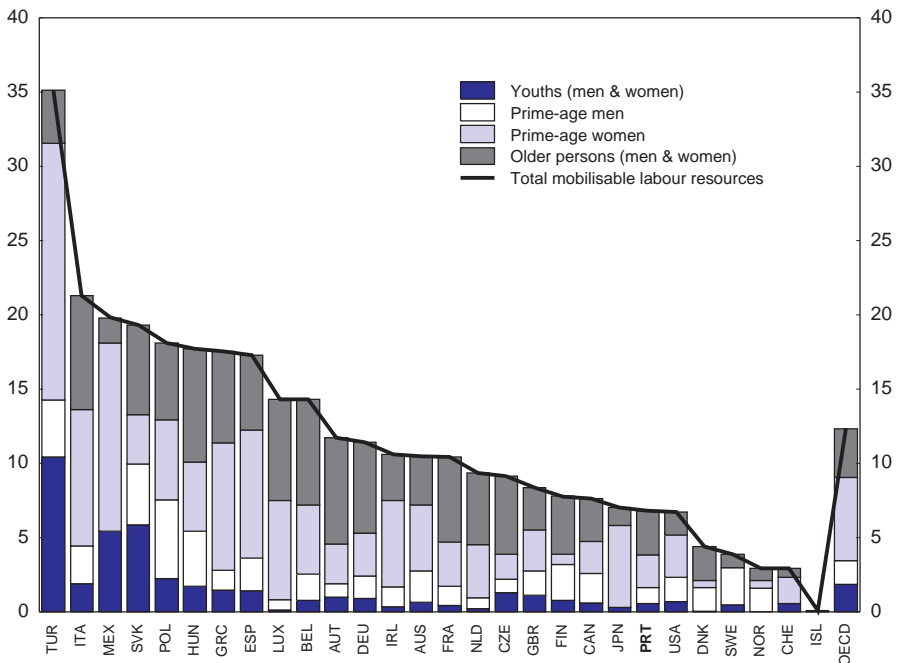
Stronger gains could be expected from reforms in education or business R&D, as suggested by other research work published by the OECD. Bassanini, Scarpetta, Hemmings (2001) show that in the OECD area, one year of extra schooling would raise the level of per capita GDP by 4 to 7 per cent over the medium 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 follows: 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 I.A1 Figure I.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).

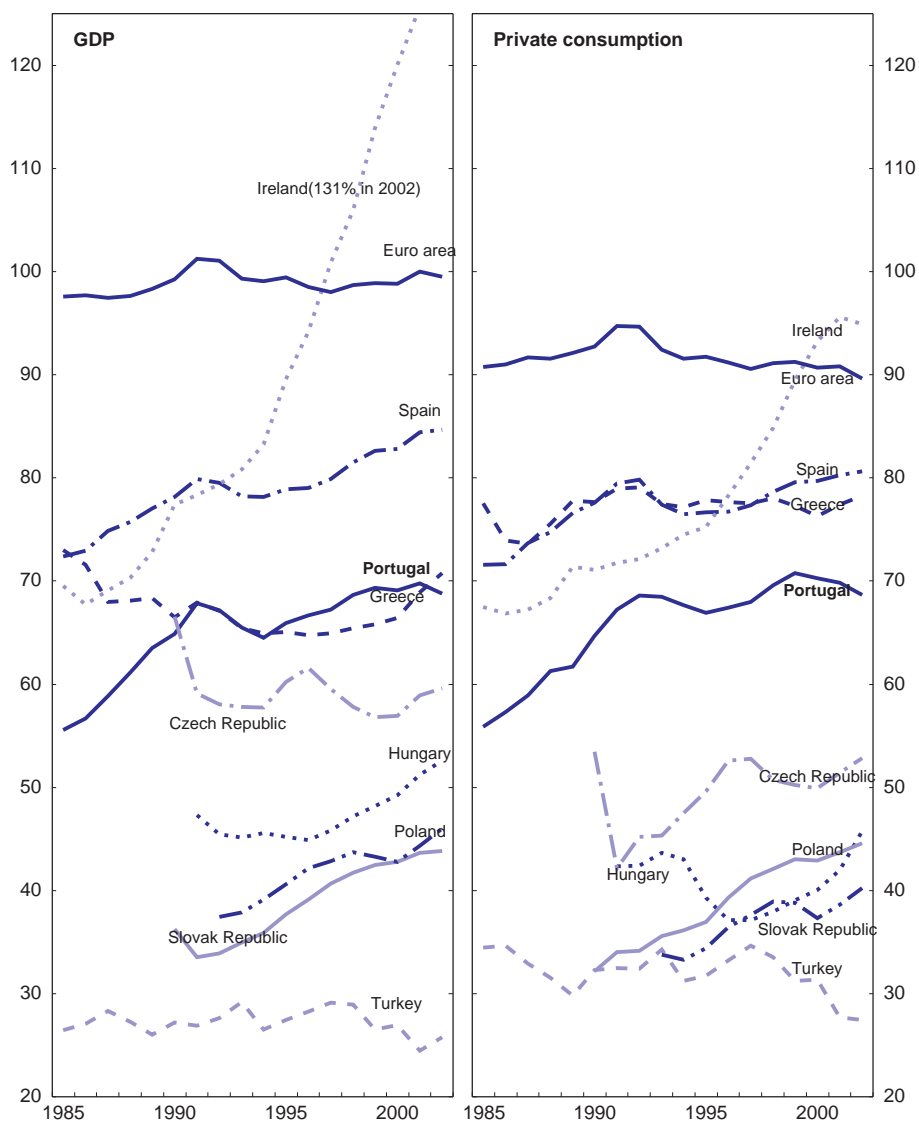
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Annex 1.A1

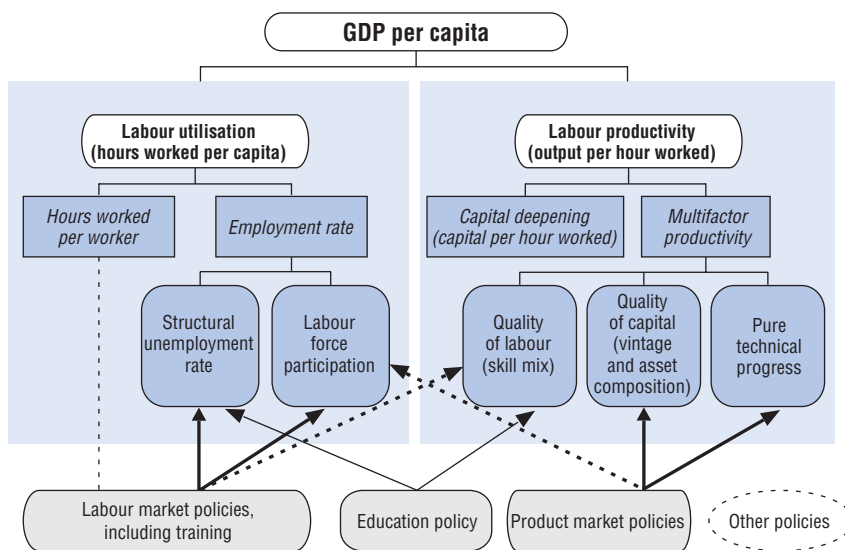
Background information to Chapter 1

Figure 1.A1.1. **Standards of living in the OECD**
 Per capita, measured in purchasing power parity exchange rates
 OECD¹ = 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 capita¹

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

Source: OECD.

Table I.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 I.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 I.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 I.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 I.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 I.A1.3. **Indicators of infrastructure**
Panel A. Composite index of transport infrastructure¹
 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 I.A1.3. **Indicators of infrastructure** (cont.)
Panel B. Composite index of telecommunications infrastructure²
 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 I.A1.3. **Indicators of infrastructure** (*cont.*)
Panel C. Composite index of electricity infrastructure³
 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 I.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
<i>Memorandum items</i>						
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.

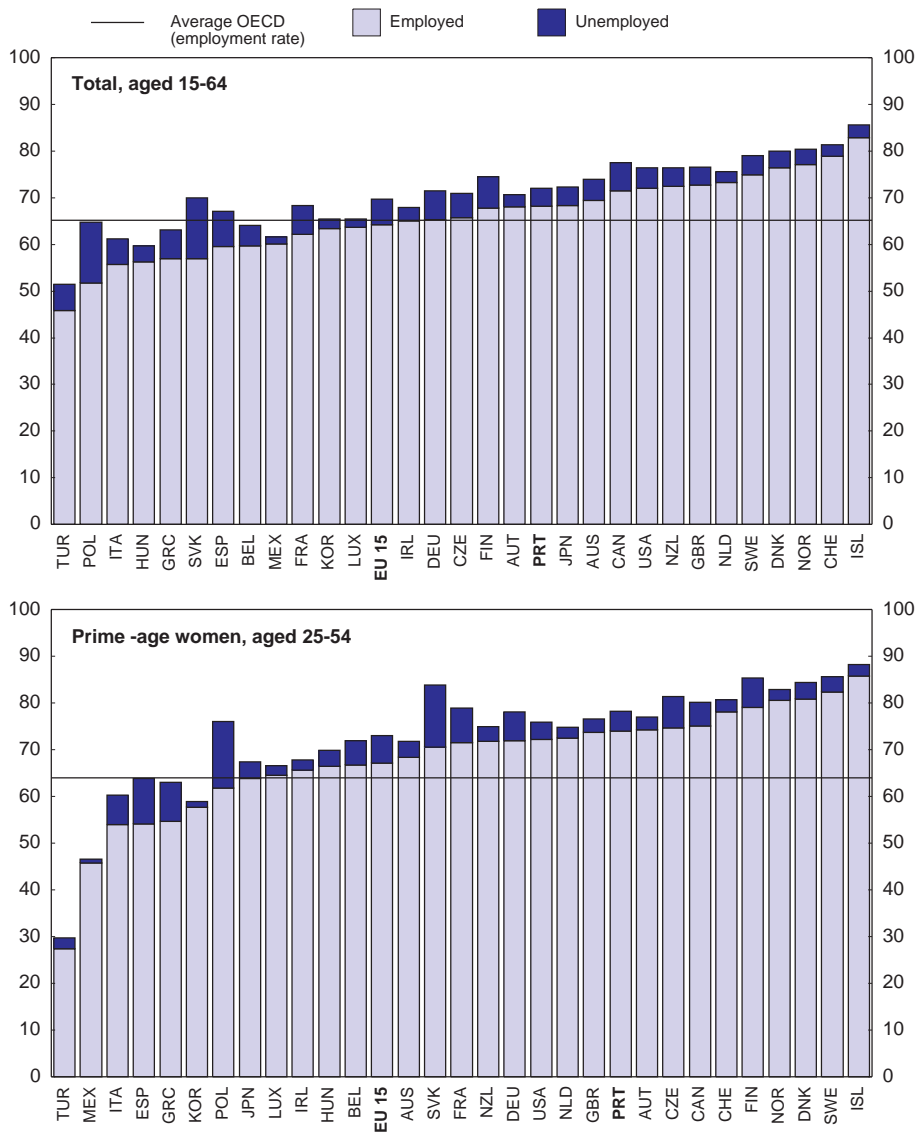
2. As a percentage of disposable income.

3. As a percentage of GDP.

Source: OECD *Economic Outlook* No. 75.

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

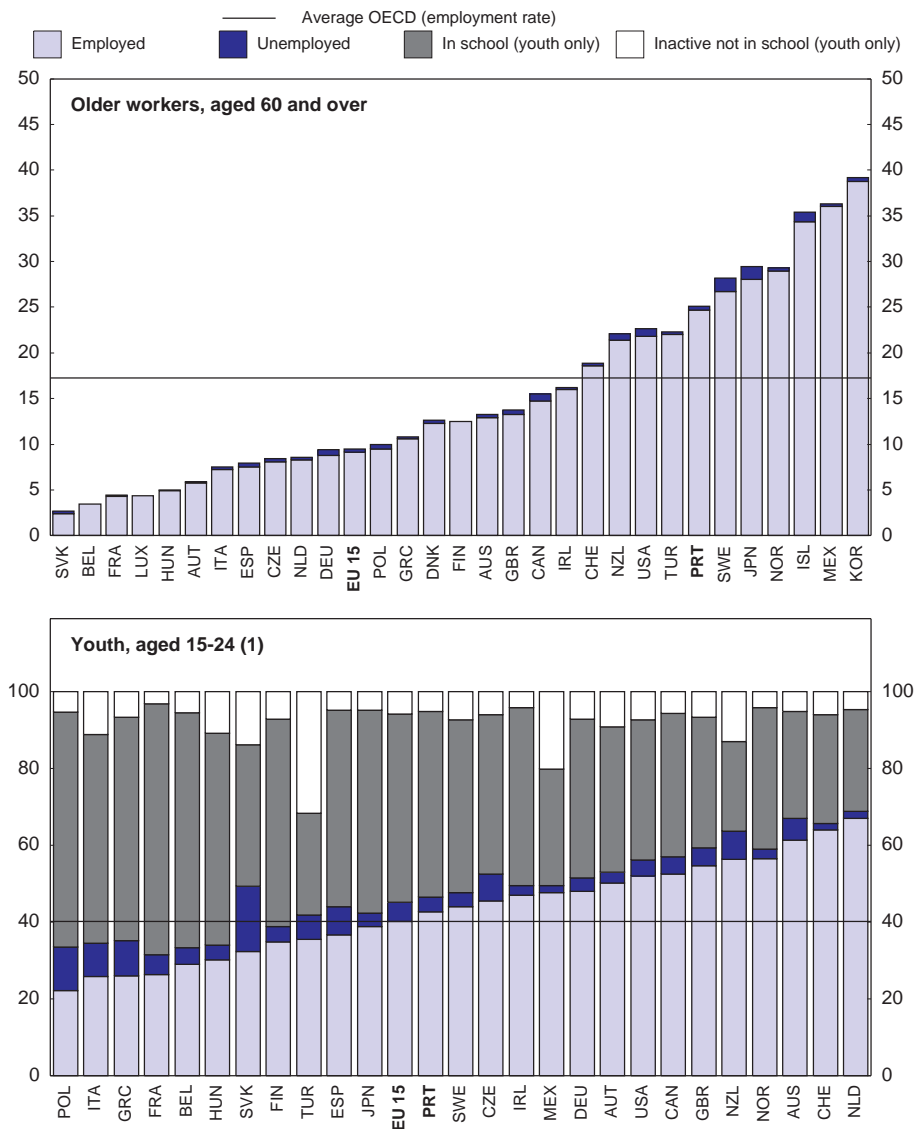
Percentages of the indicated groups, in 2002



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 I.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.

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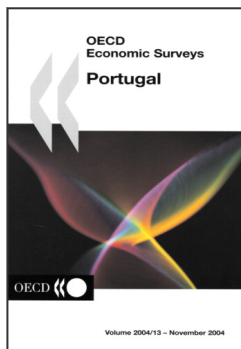
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