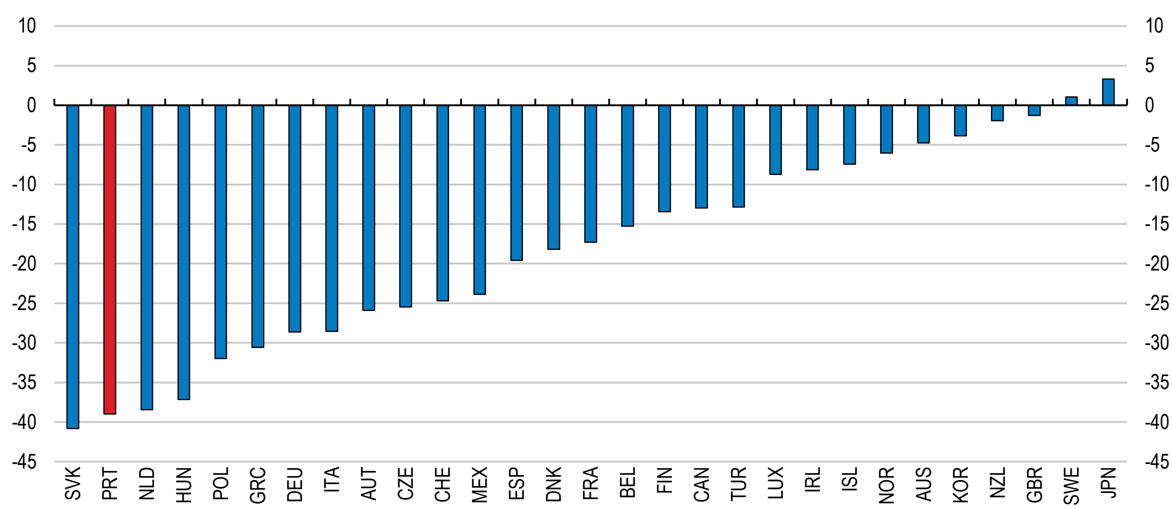
KEY POLICY INSIGHTS

The Portuguese economy continues to recover, with past structural reforms and more favourable global economic conditions contributing to the upswing. The economy has largely been sustained by strong export performance since 2010, but domestic demand is now also growing solidly. After receding in the five years following the crisis, employment has picked up and the unemployment rate has fallen from 17% to below 7%. Over the same period, the economy has notably increased its reliance on some renewable energy sources, such as wind power.

Portugal has been very active in pursuing important reforms. These have included cutting unnecessary red tape for businesses (*Simplex* and *Simplex+* programmes), improving the firm restructuring and insolvency framework (*Capitalizar* programme), facilitating innovation collaborations (*Interface* programme), amending labour regulations to reduce duality and promoting greater use of digital services among the population (*INCoDe 2030* and *Partnership Digital Skills+* programmes). Between 2003 and 2013, Portugal witnessed the second largest decline among OECD countries in the OECD Product Market Regulation indicator (Figure 1). Nevertheless, some product market regulations remain overly strict compared with other OECD member countries and the gap between the rigidity of employment protection legislation for permanent and temporary workers is relatively large, contributing to a high level of labour market duality. Furthermore, there is room for improving the efficiency with which reforms are implemented, notably through the judiciary.

Figure 1. Past structural reforms helped the recovery

Percentage change in the OECD Product Market Regulation Indicator, 2003-13



Source: OECD Product Market Regulation Indicators.

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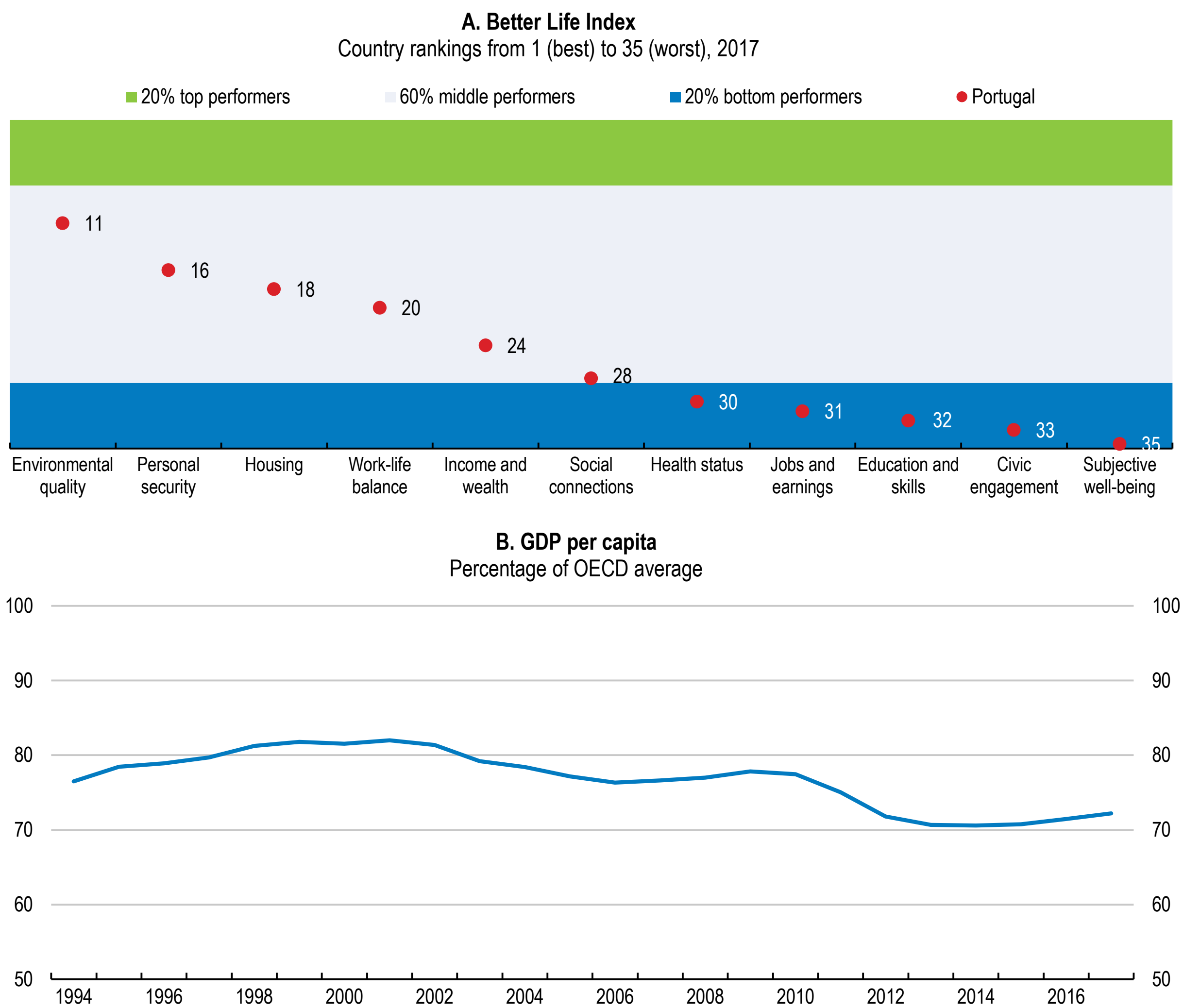
Indicators of wellbeing are mixed (Figure 2, Panel A). Portugal ranks above the OECD average along dimensions such as environmental quality and personal security. However, citizens have a surprisingly low self-perception of their wellbeing. This partly stems from wide gaps in wellbeing relative to other OECD countries in the areas of health, skills and civic engagement. Wellbeing through jobs and earnings also remains low, reflecting a lack of economic convergence with OECD countries over the past few decades (Figure 2, Panel B). Furthermore, poverty rates are high compared with other OECD countries, suggesting that some members of the population are finding life considerably tougher than those represented by the average.

Figure 2. Wellbeing can be improved along multiple dimensions



Note: Each well-being dimension is measured by one to four indicators from the OECD Better Life Index set. Normalised indicators are averaged with equal weights.
Source: OECD (2017), OECD Better Life Index, www.oecdbetterlifeindex.org, and OECD Compendium of Productivity Indicators.

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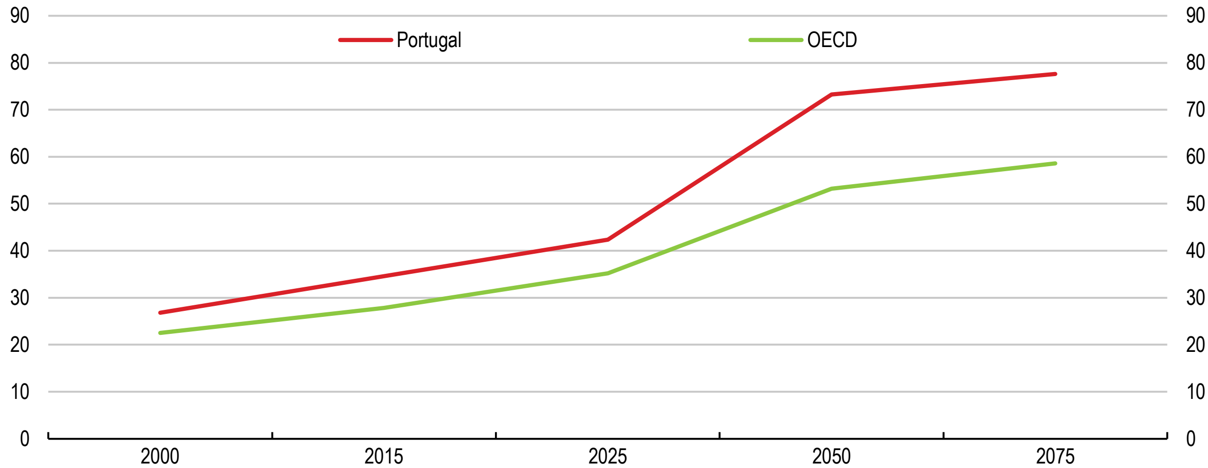
At the same time, the population is ageing rapidly, with the ratio of old-age to working-age population anticipated to rise from around 35% in 2015 to just below 80% by 2075 (Figure 3).

Holding all else constant, this trend will have a significant impact on public finances and lead to a reduction in economic growth over the coming years.

Figure 3. The population is expected to age rapidly

Projected old-age dependency ratio, %



Note: The old-age dependency ratio is defined as the number of individuals aged 65 and over per 100 people of working age defined as those aged between 20 and 64.
Source: United Nations, *World Population Prospects – 2017 Revision*.

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The capacity for fiscal policy and the financial sector to support the economy may be challenged by the legacies of the financial crisis in the form of a very high stock of public debt and an elevated level of non-performing loans on bank balance sheets. The latter partly reflects inefficiencies in the judicial system and the insolvency regime that may have contributed to a high level of forbearance by banks. Diminished fiscal and financial buffers relative to the pre-crisis period increase the fragility of the economy in a time of heightened uncertainty and global economic risks.

Looking forward, Portugal should capitalise on its very impressive recent export performance by continuing to promote firms conducting international trade and entering new markets. To do so, productivity growth across the business sector must be revived through policy settings that facilitate the expansion of high potential enterprises. That said, such policies must be coupled with well-functioning institutions that ensure their efficacy. In particular, the efficiency of the judicial system should be improved to ensure timely contract enforcement, which is crucial for market transactions.

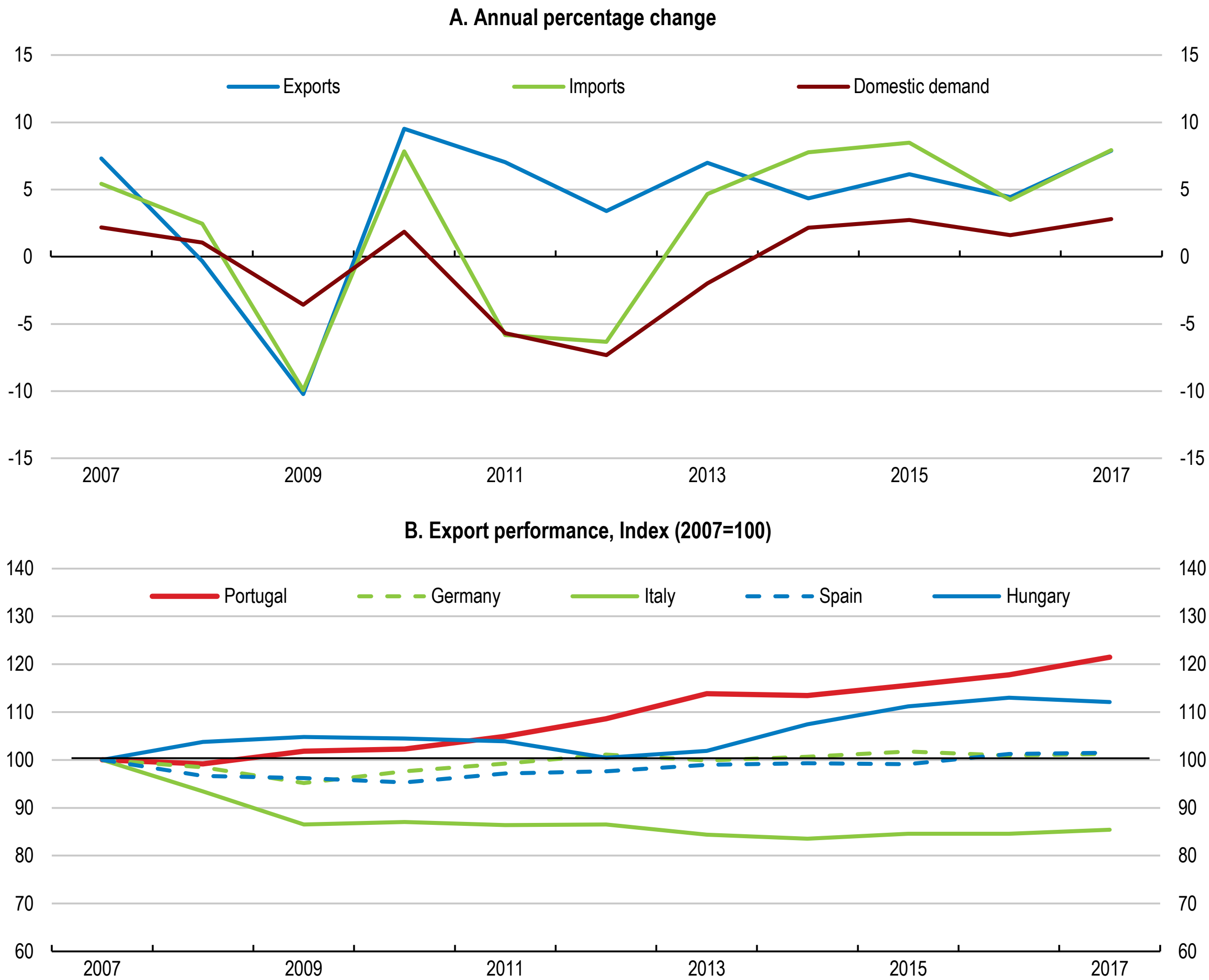
Against this background, the main messages of this *Survey* are:

- There has been progress in improving public finances, reducing private debt and the health of the banking system, but further efforts can improve resilience to economic shocks.
- The economy is still less outward-oriented than many other small European economies. Export performance can be further improved through policy settings that better enable exporters to innovate and grow.
- There is scope for further reforms that promote the efficiency of the judicial system, thereby spurring business activity.

Recent macroeconomic developments and short-term prospects

The Portuguese economy continues to grow at a solid pace. Strong exports sustained economic activity in the years immediately following the financial crisis, but both rising investment and private consumption have recently also positively contributed to growth (Figure 4, Panel A and B).

Figure 4. Strong exports sustained activity



Note: In Panel B, export performance measures the expansion of a country's exports relative to the expansion of import demand from its trading partners. Improvements in export performance reflect rising market shares in the imports of trading partners.
Source: OECD Economic Outlook (database), September 2018.

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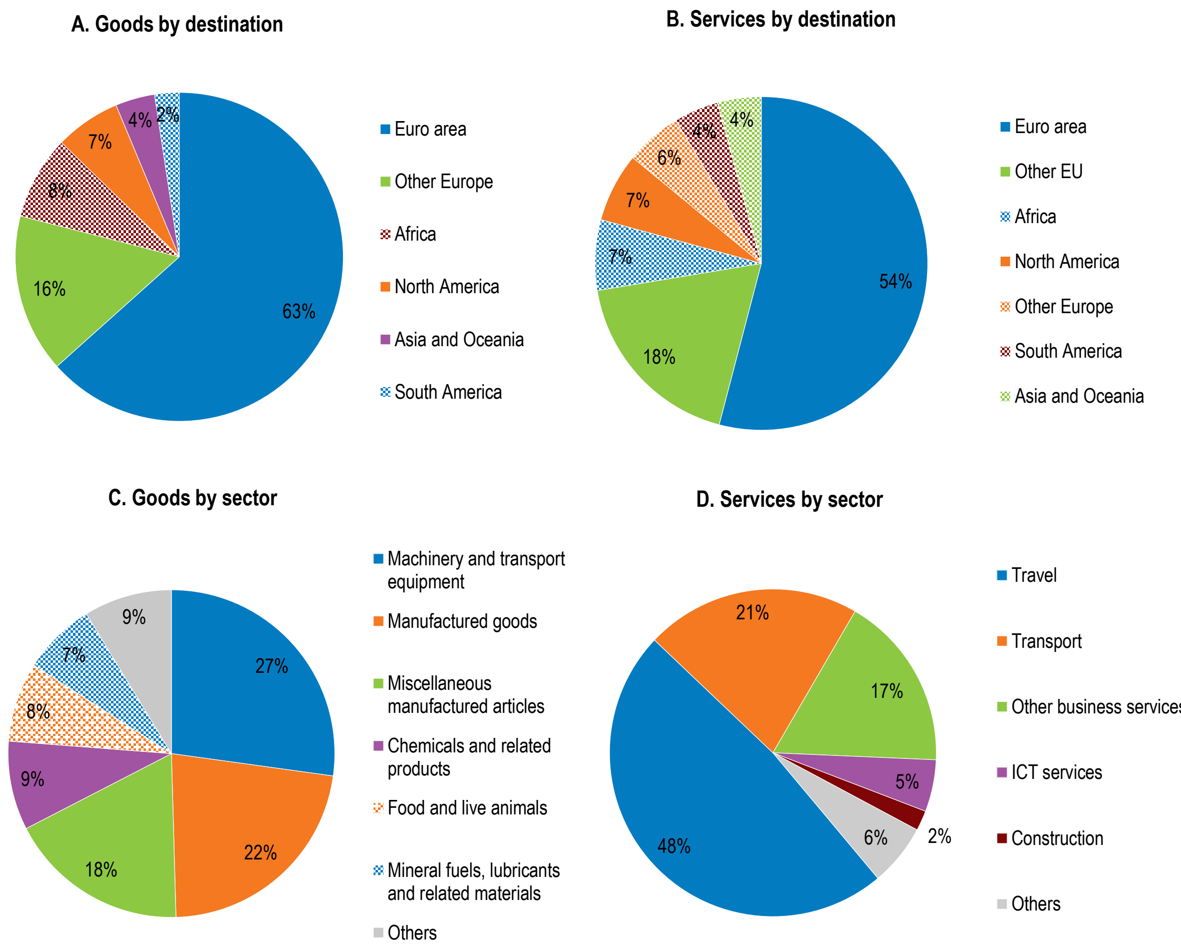
Exports have been bolstered by the strong performance of the tourism sector. Between 2010 and 2017, average annual growth in travel and tourism exports was above 10%. By that time, tourism accounted for close to half of all services exports (Figure 5). Strong growth in tourist arrivals has coincided with an increase in the supply of tourist accommodation and low-cost airlines flying to Portugal as well as some increase in security risks in some competitor markets (Chapter

1). Nevertheless, there have also been strong gains in exports of goods industries such as chemicals and machinery.

Figure 5. Travel and tourism now accounts for almost half of services exports

Share of exports by sector and destination, 2017



Note: In Panel C, Others include crude materials, beverages and tobacco, animal and vegetable oils, and commodities and transactions. In Panel D, Others include insurance and pension, construction services, and other services.
Source: OECD International Trade Statistics.

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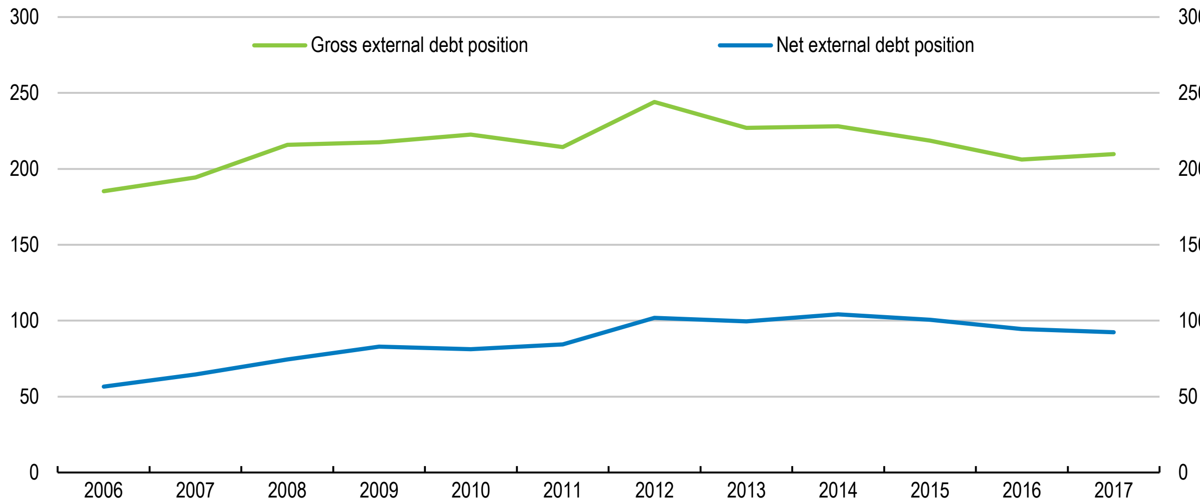
An improvement in cost competitiveness has played a role in the export recovery, with export prices relative to Portugal's competitors depreciating by around 6% since 2009. However, improvements in export product quality (Gouveia et al., 2018) have also been important (see Chapter 1). Furthermore, in the last few years, foreign demand has stabilised: weighted according to importance for Portuguese exports, average annual trading partner growth was 3½% from 2013-17 compared with close to zero in the 2009-12 period. The sustained strong performance of exports has pushed the trade balance positive, helping begin reverse external imbalances. Nevertheless, net external debt remains around 90% of GDP (Figure 6) and imports have been rising strongly since 2013.

Figure 6. External imbalances remain high

Percentage of GDP



Source: World Bank Quarterly External Debt Statistics, OECD Economic Outlook (database), and Statistics Portugal.

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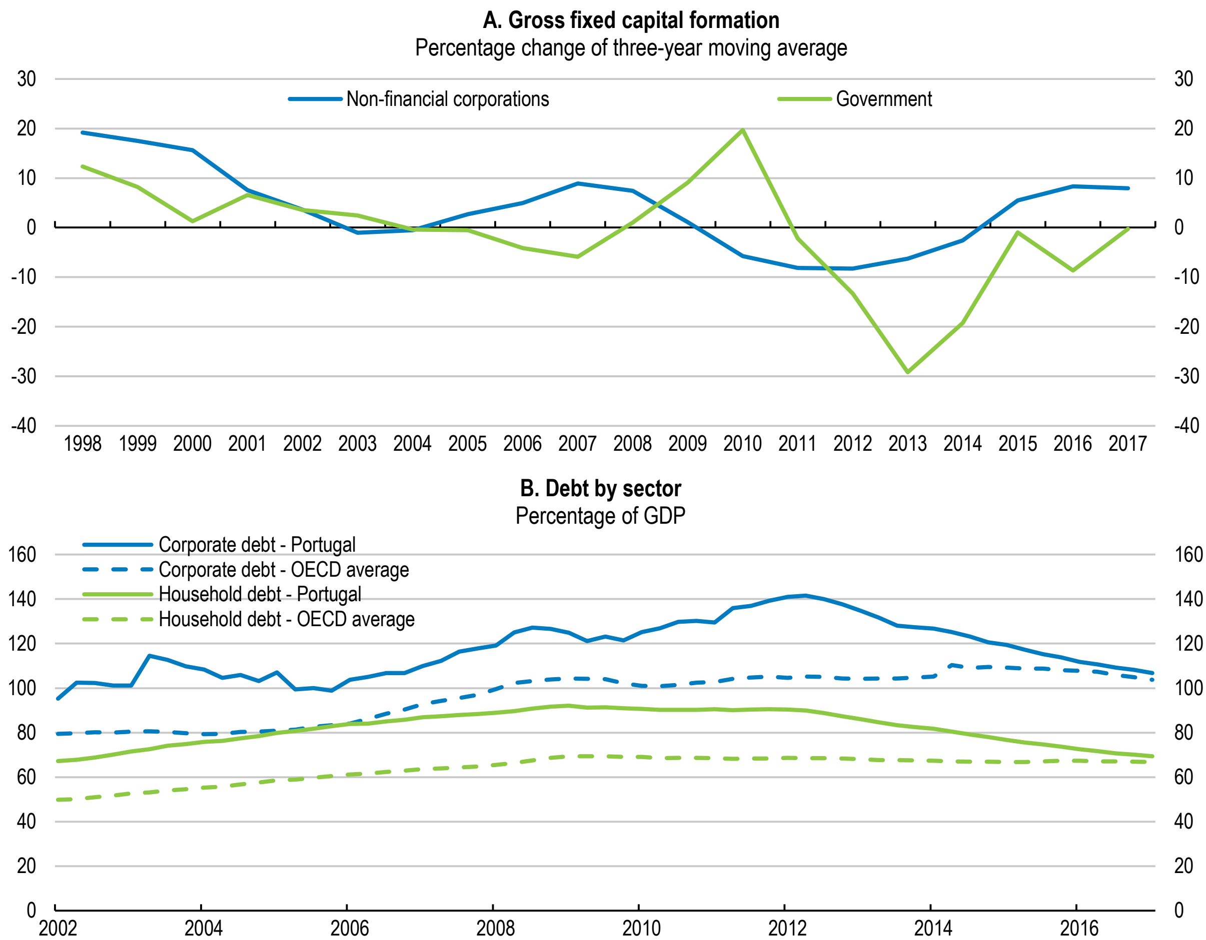
Investment has begun to rise again after receding each year between 2009 and 2013. The recovery has been driven by an increase in spending by non-financial corporations combined with public investment exerting less of a drag on growth (Figure 7, Panel A). Machinery and equipment investment has recovered particularly strongly. In the past few years, such investment has been supported by new contracts from foreign-owned firms for vehicle manufacturing in the country. Between 2017 and mid-2018, capacity utilisation in the vehicle manufacturing sector jumped from 60% to 96%.

Credit to the non-financial corporate sector continues to recede, despite significant deleveraging already having occurred. Corporate debt as a share of GDP has now declined to around OECD-average levels (Figure 7, Panel B), with an increased share of investment funded from retained earnings. In 2016 and 2017, strong growth in European Union funding has also supported investment growth.

Figure 7. Investment has recovered despite ongoing corporate sector deleveraging



Source: Statistics Portugal.

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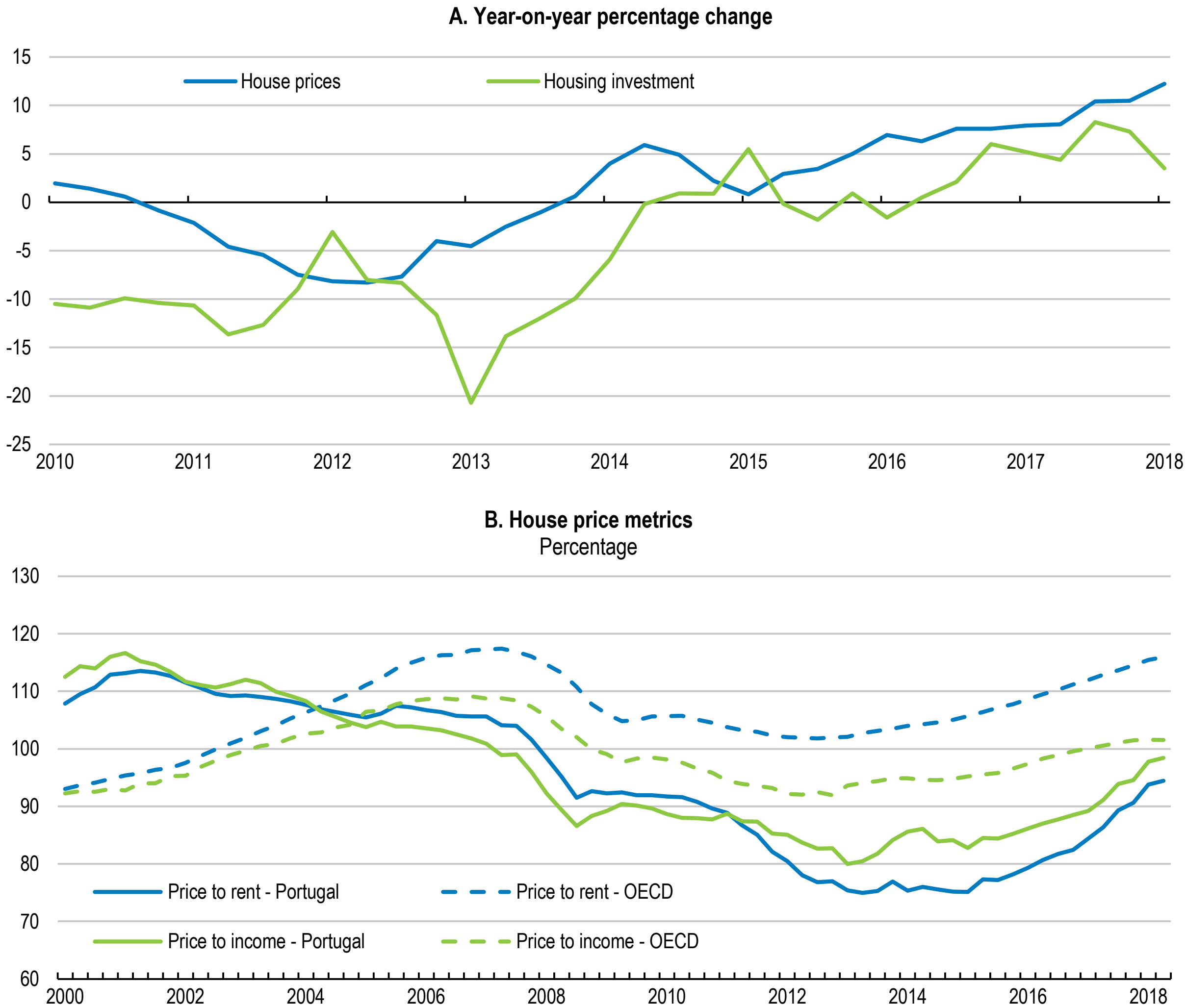
Housing investment has also recovered, responding to strong growth in both new and existing dwelling prices (Figure 8, Panel A). So far, rising house prices have not been accompanied by an increase in the stock of housing credit, though the flow of new loans has been increasing since 2013. The boom in the tourism sector and demand by non-residents (responding to government incentives tying visas to dwelling purchases) have been significant factors behind the strong growth in house prices in some locations (Bank of Portugal, 2018). Nevertheless, measured as a ratio of household incomes or rents, a proxy of an equilibrium price, the level of house prices is not elevated compared to the average OECD country (Figure 8, Panel B). While a steep increase in borrowing costs could pose a risk to dwelling prices, the central bank introduced new macroprudential regulatory measures in early 2018 that should help reduce the probability of new household borrowers becoming overly indebted. In particular, new caps on the loan-to-value ratio for property loans, the debt service-to-income ratio and loan maturity have been implemented.

Figure 8. House prices have risen strongly



Source: Statistics Portugal, OECD Analytical House Price Indicators.

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Private consumption activity has been solid since the end of 2013, growing by around 2% per year. This reflects growth in private sector earnings: employment has benefitted from the robust recovery, especially in some labour-intensive sectors, and wages have risen as the labour market has tightened.

The fiscal stance is expected to be slightly expansionary in 2018 before being broadly neutral in 2019 and 2020. The authorities must continue to balance the objectives of improving the fiscal position at the same time as sustaining the economic recovery. In doing so, they must ensure adherence to counter-cyclical fiscal policy: in case growth surprises on the upside, all windfall revenues should be used to reduce the public debt ratio faster than currently planned.

Economic activity over the next few years will be supported by the recovery in the labour market. An anticipated slowdown in the pace of activity in Portugal's major trading partners, such as Spain, Germany and the United Kingdom, will be a headwind to growth. In 2019 and 2020, GDP growth is expected to be 2.1% and 1.9% respectively (Table 1). A gradual further reduction in economic slack will prompt a slight increase in inflation over the coming years.

Table 1. Macroeconomic indicators and projections

Annual percentage change, volume (2011 prices)

	2015 Current prices (billion EUR)	2016	2017	2018	2019	2020
Gross domestic product (GDP)	**179.8**	**1.9**	**2.8**	**2.1**	**2.1**	**1.9**
Private consumption	117.7	2.4	2.3	2.2	1.8	2.0
Government consumption	32.6	0.8	0.2	1.0	0.2	-0.3
Gross fixed capital formation	27.8	2.3	9.2	4.6	6.0	5.0
Housing	4.4	5.1	6.4	1.7	5.0	4.8
Final domestic demand	178.2	2.1	3.0	2.4	2.2	2.1
Stockbuilding[1]	0.6	-0.1	0.0	0.0	0.0	0.0
Total domestic demand	178.8	2.0	3.0	2.4	2.2	2.1
Exports of goods and services	72.6	4.4	7.8	5.8	4.3	4.0
Imports of goods and services	71.6	4.7	8.1	6.2	4.8	4.5
Net exports[1]	1.0	-0.1	0.0	-0.1	-0.2	-0.2
Other indicators (growth rates, unless specified)						
Potential GDP	. .	0.9	1.2	1.3	1.3	1.1
Output gap[2]	. .	-5.2	-3.7	-2.9	-2.2	-1.3
Employment	. .	1.2	3.3	2.3	1.1	1.1
Unemployment rate	. .	11.1	8.9	7.1	6.4	5.7
GDP deflator	. .	1.8	1.5	1.4	1.4	1.4
Harmonised consumer price index	. .	0.6	1.6	1.3	1.5	1.4
Harmonised core consumer price index	. .	0.9	1.2	1.1	1.4	1.4
Household saving ratio, net[3]	. .	-3.7	-4.1	-5.2	-5.8	-6.0
Current account balance[4]	. .	0.6	0.5	-0.9	-0.4	-0.1
General government fiscal balance[4]	. .	-2.0	-3.0	-0.7	-0.2	0.1
Underlying general government fiscal balance[2]	. .	0.9	1.0	0.8	0.9	0.7
Underlying government primary fiscal balance[2]	. .	4.6	4.6	4.2	4.1	3.8
General government gross debt (Maastricht)[4]	. .	129.2	124.8	121.1	118.4	115.0
General government net debt[4]	. .	104.0	108.1	105.1	101.8	98.4
Three-month money market rate, average	. .	-0.3	-0.3	-0.3	-0.2	0.2
Ten-year government bond yield, average	. .	3.2	3.1	1.8	2.0	2.3

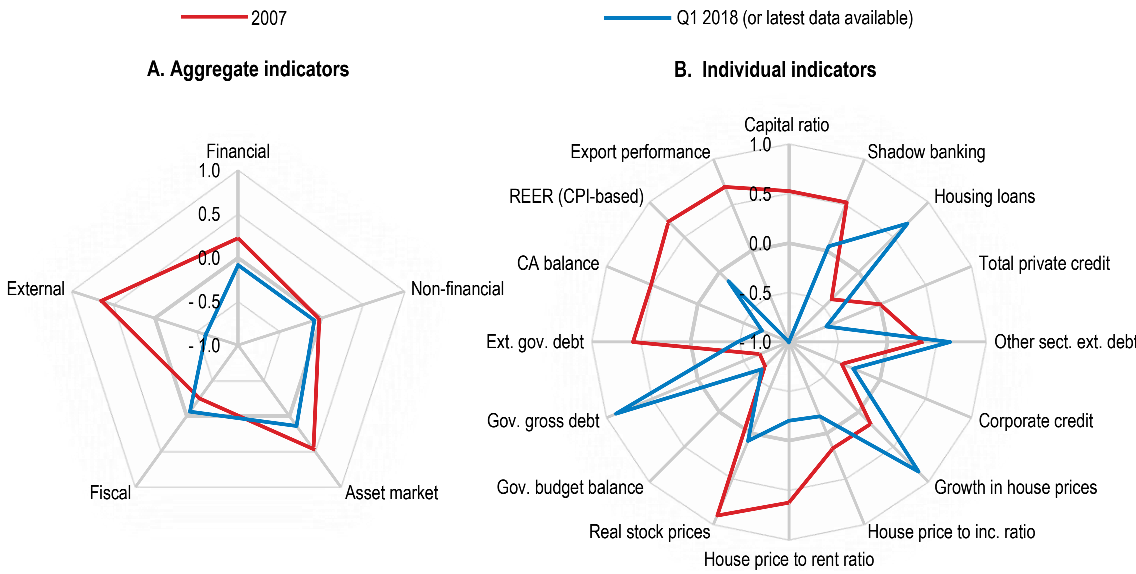
1. Contribution to changes in real GDP.
2. As a percentage of potential GDP. Based on OECD estimates of cyclical elasticities of taxes and expenditures. For more details, see OECD Economic Outlook Sources and Methods.
3. As a percentage of household disposable income.
4. As a percentage of GDP.
Source: OECD (2018), OECD Economic Outlook: Statistics and Projections (database).

Risks to the outlook include a tightening in financial conditions. In particular, an increase in interest rates, potentially stemming from the normalisation of monetary policy by the European Central Bank, may negatively impact business and household spending (Figure 9). On the upside, further improvements in the competitiveness of Portuguese exports could manifest in larger export market share gains than is currently factored into the projections.

Portugal is also potentially vulnerable to exogenous shocks that are not factored into the central forecast scenario (Table 2). A trade war that results in a significant increase in policy barriers to trade between the EU and other large countries, such as the US, could derail the recovery given the economy's increased reliance on the external sector. Similarly, turbulence that is transmitted across emerging markets could have a negative impact on the Portuguese business sector. For example, Brazil and Angola account for over 10% of the stock of Portugal's outward foreign direct investment. In addition, a disorderly conclusion to negotiations around United Kingdom's planned departure from the European Union could reduce exports.

Figure 9. Macro-financial vulnerabilities remain high in some areas

Index scale of -1 to 1 from lowest to greatest potential vulnerability, where 0 refers to long-term average, period



Note: Each aggregate macro-financial vulnerability dimension is calculated by aggregating (simple average) normalised individual indicators from the OECD Resilience Database. Individual indicators are normalised to range between -1 and 1, where -1 to 0 represents deviations from long-term average resulting in less vulnerability, 0 refers to long-term average and 0 to 1 refers to deviations from long-term average resulting in more vulnerability.
Source: Calculations based on OECD (2018), OECD Resilience Database, September; and Thomson Reuters Datastream.

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Table 2. Possible shocks to the Portuguese economy

Vulnerability	Possible outcome
Brexit	A significant increase in policy barriers governing relations with the United Kingdom in the areas of trade, investment and labour markets could have negative economic effects on Portugal. The direct effects could be material, given the United Kingdom is Portugal's fourth largest export market.
Turbulence in emerging market economies	Financial or political shocks in important emerging-market economies, such as Angola and Brazil, could negatively impact the profits of Portuguese firms and the export sector.
Rising protectionism	As a small open economy, any significant increase in policy barriers to international trade would have a detrimental impact.

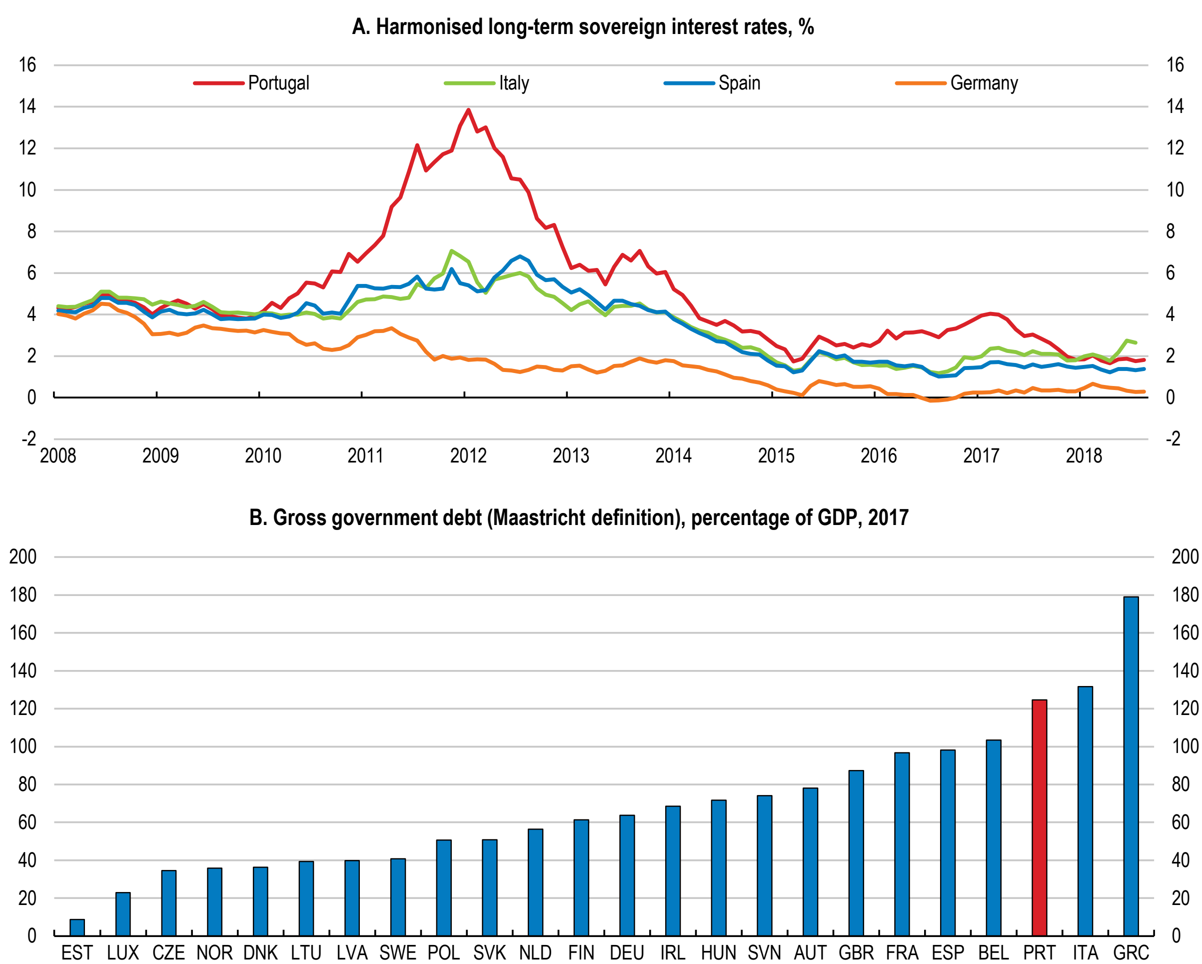
Strengthening the sustainability of public finances

Portugal's fiscal position has improved significantly; after peaking at 11.2% of GDP in 2010, the fiscal deficit gradually declined to 2% of GDP in 2016 and it would have been even less than 1% of GDP in 2017 if not for the recapitalisation of the state-owned bank. Indicators of the structural budget balance suggest that there was a significant discretionary fiscal contraction between 2010 and 2014.

With the economy expanding and credit rating agencies upgrading their rating of Portuguese sovereign debt, interest costs have declined. After peaking at 14% at the beginning of 2012, long-term interest rates on government bonds are now below 2% (Figure 10, Panel A). Debt-servicing costs have also been reduced by the ongoing amortization of bonds that were issued at very high interest rates during the financial crisis.

With the improvements in fiscal balances, public debt has fallen from its peak of 130.6% of GDP in 2014 to around 121.1% of GDP in 2018 (according to the Maastricht criterion). Nevertheless, the public debt burden remains very high compared with other OECD countries (Figure 10, Panel B). This severely limits the capacity for fiscal policy to respond in the event of future economic shocks. Currently, the cost of debt servicing represents around 8% of public expenditures. A rise in interest rates could increase this cost. Nevertheless, under a scenario of stable interest rates, debt-servicing costs will decline given there is still a pipeline of high-cost public debt that is scheduled to mature over the coming years.

Figure 10. Sovereign borrowing costs have eased but public debt remains high



Source: OECD Economic Outlook Database; OECD calculations.

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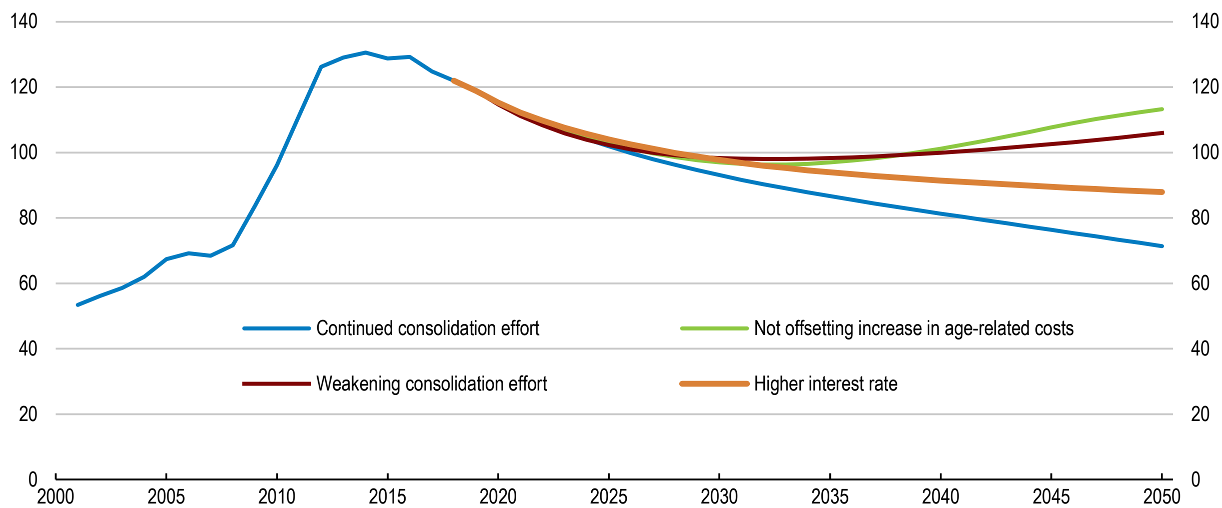
Under the government's current plans, the public debt ratio will decline quite rapidly, to 102% of GDP in 2022. Thereafter, the path of public debt will be highly dependent on the pace of fiscal consolidation and the government's ability to introduce new measures that offset the rising costs of ageing (Figure 11). Indeed, incorporating the increase in ageing-related costs currently projected by the European Commission into a public debt simulation analysis, the public debt burden would rise above 110% of GDP by 2050 holding all else constant.

Figure 11. Sustained primary budget surpluses are needed to durably lower public debt

Gross government debt as a share of GDP



Note: After 2020, the "continued consolidation" scenario assumes a continuation of the policy stance of 2020 with a structural primary surplus of 2.2% of GDP each year over the projection period, inflation of 1.5% and real GDP growth averaging 1.4% in line with assumed productivity growth. The "not-offsetting increase in age-related costs" scenario takes the continued consolidation scenario and then includes European Commission projections for public pensions, long-term care, health, education and unemployment benefits (European Commission, 2018a). These projections suggest ageing-related costs will add 1.5 percentage points of GDP (using the projections of GDP from the "continued consolidation" scenario as the denominator) to annual government spending at their peak in 2045 compared with 2016. The "less consolidation" scenario assumes that the structural primary surplus gradually declines from 2.2% of GDP in 2020 to 1% of GDP in 2030 and is held constant thereafter. The 'higher interest rate' scenario assumes that interest rates rise by 0.5 percentage point, taking five years to fully flow through to debt-servicing costs.
Source: Adapted from OECD (2018), OECD Economic Outlook: Statistics and Projections (database), June; Guillemette, Y. and D. Turner (2018), "The Long View: Scenarios for the World Economy to 2060", OECD Economic Policy Paper No. 22., OECD Publishing, Paris; and European Commission (2018a), "The 2018 Ageing Report - Economic and budgetary projections for the 28 EU Member States (2016-2070)" Directorate-General for Economic and Financial Affairs.

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Improving the efficiency of public spending

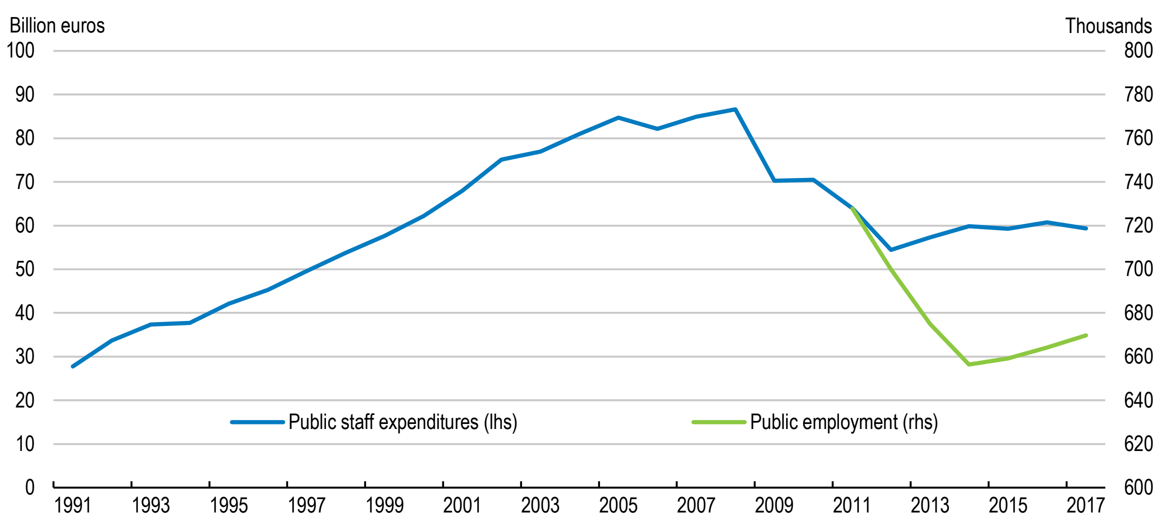
Both the revenue and expenditure side of government accounts present opportunities for improving fiscal sustainability. On the expenditure side, the government has embarked upon a "bottom-up" public expenditure review, designed to prompt line ministries to generate efficiency gains that can work towards containing expenditure. The government's ability to achieve the anticipated reduction in the overall public debt burden substantially depends on savings identified through this ongoing review, in addition to sustained favourable economic conditions (Portuguese Public Finance Council, 2018).

The ongoing expenditure review is intended to be a permanent feature of the government's fiscal framework, with multiple policy initiatives running in parallel and at different stages of formulation and implementation. The review is currently focused on a set of priority areas including health, education, justice, public real estate management, state-owned enterprises, public procurement, internal administration and human resource management but will expand to cover new elements over time. Each year, the State Budget provides an update of the various strands of work associated with the review. This includes plans for future policy initiatives and quantitative estimates of the fiscal impacts associated with some of the initiatives that have been undertaken.

At the same time as identifying cost-savings within the existing policy framework, the authorities must undertake more fundamental structural reforms that improve the efficiency of public spending. The deep temporary cuts to public sector wages in the 2010-15 period have now been reversed and public employment is rising again (Figure 12). However, public sector wages still depend mostly on years of experience, rather than the performance of the worker (IMF, 2018). The premium in public sector pay for high-skilled civil servants is also relatively low, making it difficult to attract highly qualified staff from the private sector (IMF, 2018).

To improve efficiency and ensure that the public service is an attractive career option for talented individuals, reforms should strengthen the relationship between public sector pay and the performance of the individual worker. Over the coming years, there will also be a need to reallocate employment across the public sector to reflect nascent demographic changes. For instance, resources devoted to the school system should be rationalised as the population ages at the same time as those allocated to the health system are reinforced.

Figure 12. Public staff expenditures are rising at a slower pace than prior to the crisis



Source: Bank of Portugal, and Statistics Portugal.

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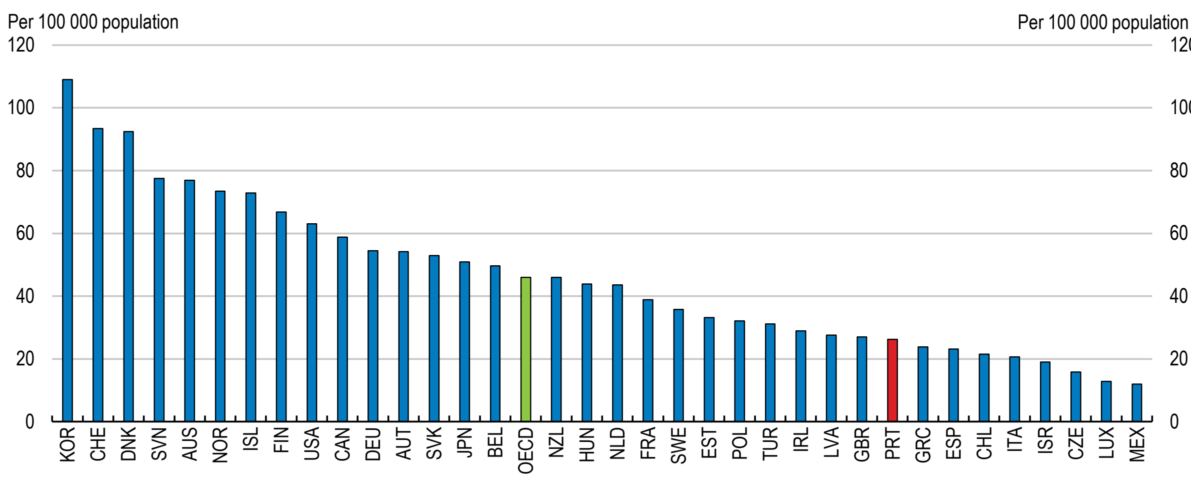
As the share of the old age population increases, public health spending will too. Government spending on health is anticipated to rise very fast compared with other European countries, from 5.9% of GDP in 2016 to 8.3% in 2070 (European Commission, 2018a). Private healthcare coverage is low and out-of-pocket payments for healthcare in Portugal are some of the highest in the OECD (OECD, 2017a). As such, there is little potential to increase the share of private contributions to future healthcare costs without jeopardising healthcare access for low-income households.

The government has already been active in improving the efficiency of public health spending, partly in response to the recommendations of the EU-IMF financial assistance programme. Initiatives have included pharmaceutical pricing reforms that reduced costs and improved transparency. In addition, efficiency gains by health providers have been encouraged by the introduction of performance-related remuneration in primary care (OECD and European Observatory on Health Systems and Policies, 2017). Nonetheless, Portugal lacks a comprehensive strategy to tackle the health-related costs of ageing (European Commission, 2018b).

Part of the solution will be to further move treatment to primary care settings, as has been done in many other OECD countries. However, the availability of nurses is key to providing primary and home care. While there has been a strong increase in the number of nurses over the past decade in Portugal, shortages persist. Furthermore, the number of nursing graduates in recent years has been low (Figure 13), partly reflecting a reduction in the volume of students accepted by nursing programmes through the financial crisis (Moreira and Lafortune, 2016). Going forward, the authorities should ensure that enrolment restrictions in nursing programmes (i.e. "numerus clauses") take into account the rapidly ageing population and the necessary reorientation of treatment toward primary care. Not to do so risks a deterioration in health care quality or increase in health costs.

Figure 13. A low number of nursing graduates compounds existing shortages

Nursing graduates, 2017 or nearest year



Source: OECD Health Statistics 2017.

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A cycle of hospitals building up arrears that are subsequently financed by central government transfers has been a consistent pattern in the health system over many years. Their accumulation impedes the efficient operation of hospitals, not least via the impact on supply chain relationships, raising costs. Such arrears reflect both inadequate budgeting and, in many cases, poor hospital management. In response, a new joint unit overseen by the Ministry of Finance and Ministry of Health is working on measures to raise the accountability of hospital management and to find efficiency savings through centralised procurement. This unit was responsible for new initiatives announced in the State Budget 2019 that coupled an increase in the annual budget of hospitals with increasing their accountability through new performance monitoring and managerial evaluation procedures.

Public expenditures on old-age benefits as a share of GDP have grown rapidly compared with the average OECD country over the past few decades. Furthermore, the increase in the old-age dependency ratio would be set to raise pension expenditures by 10½% of GDP by 2050, holding all else constant (Ministry of Finance, 2018). Portugal has a public pay-as-you-go earnings-related pension scheme, including a minimum pension as well as an additional means-tested safety net. There are also some voluntary private pensions, which can be defined benefit or defined contribution, though their share in overall pensions is small.

Significant reforms to the public pension system taken up until December 2017 have improved the sustainability of the system in the face of these demographic challenges, according to estimates by the European Commission (European Commission, 2018b). For example, the statutory retirement age in the public pension system was raised from 65 to 66 in 2014 and future increases linked to the evolution of life expectancy, bringing the current retirement age to 66 and 4 months. Pathways into early retirement have also been restricted, although significant differences in the penalty for early retirement depending on workers circumstances creates inequities in the system (OECD, 2019). Early retirement options for the unemployed over the age of 57 are also still available, which may disincentivise the reintegration of older unemployed workers into the labour market (OECD, 2019).

The improvement in the sustainability of the pension system has come at the cost of shifting much of the burden onto future generations. The use of "grandfathering clauses" partly shielded existing retirees from pension reforms that reduced the generosity of pension formulas.

Raising revenues in a growth-friendly manner

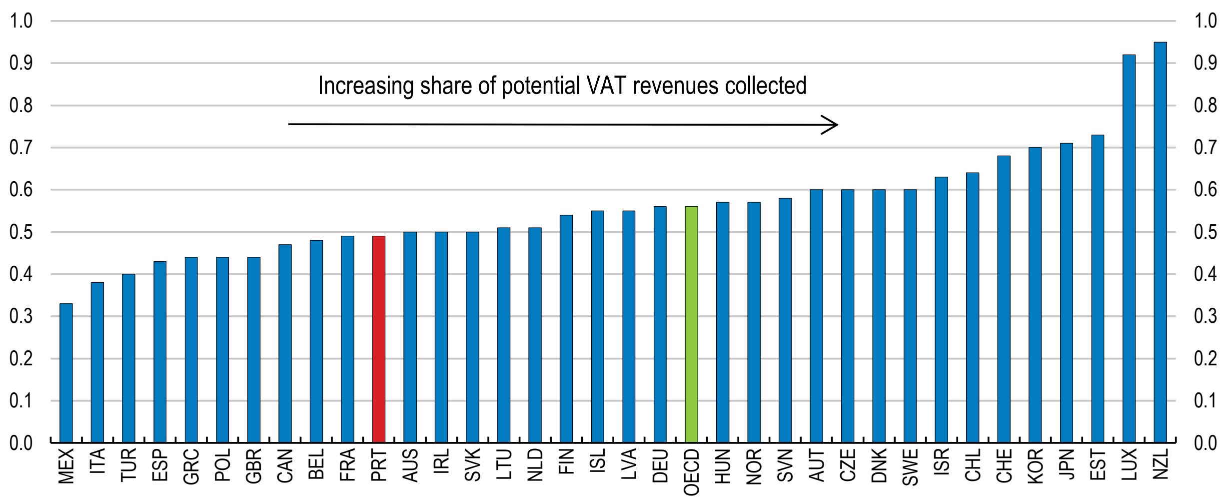
On the revenue side, total general government receipts increased from 40.4% of GDP in 2009 to 42.7% of GDP in 2017. Recent revenue-raising measures have included a tax on sugary drinks and an additional real estate tax. These initiatives have contributed to better pricing of negative externalities (in the case of the former) and a more efficient tax mix through increasing the share of revenues derived from the taxation of immovable property, which is one of the least distortive types of taxation for long-run GDP per capita (Johansson et al., 2008). The increased revenues will help fund a reform to the personal income tax system that will include an increase in the number of tax brackets which the government expects will reduce tax receipts modestly.

There is the potential for additional tax reforms that improve the efficiency of the tax system as well as fiscal sustainability (for an estimate of the short-run effects of selected tax reforms, see Box 1). For example, the share of government revenues derived from property taxation could be further increased. To the extent that revenues are raised by increasing tax rates, the distributional consequences of such adjustments should be evaluated and offsetting measures introduced where necessary.

The value added tax (VAT) in Portugal is characterised by a range of goods and services that are exempt or taxed at a reduced VAT rate. More than half of the potential VAT revenue in Portugal goes untaxed as a result of exemptions, reduced VAT rates and weak tax enforcement and tax evasion. The VAT performance is lower than the OECD average (Figure 14). Weakening the revenue-raising capacity of consumption taxes, such as VAT, is undesirable given that such taxes are less harmful for economic growth than those on personal income and corporates (Johansson et al., 2008). The introduction of a reduced VAT rate for restaurant and catering services in 2016 narrowed the tax base and such changes can favour high-income households who are more prone to consuming restaurant meals. Moreover, the experience of other European countries, such as France, suggest that the stimulatory impact of such measures on employment are modest (Benzarti and Carloni, 2017).

Figure 14. Most potential VAT revenues are untaxed

VAT Revenue Ratio



Note: The VAT Revenue Ratio is the ratio between the actual value-added tax revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption.
Source: (OECD, 2016[13])

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Fuel excise taxes continue to be lower for diesel fuel than for petrol. However, the former typically produce more emissions of particulate matter and the nitrogen oxides most relevant for air pollution. The government is undertaking a gradual convergence in the excise taxes; and raised the tax on diesel by 2 cents per litre and reduced the tax on petrol by 2 cents per litre in January 2017. Even so, this convergence process has some way to go, given that the excise tax gap between petrol and diesel remains over 20 cents per litre. Furthermore, additional reductions in the petrol tax should be reconsidered given that the current level of taxation may insufficiently reflect the full environmental consequences of petrol use (Santos, 2017). There is also scope for raising taxes on other energy sources, including coal and natural gas, where pricing does not adequately reflect their environmental impact (discussed further below).

Box 1. Quantifying the fiscal impact of selected policy recommendations

These estimates roughly quantify the annual fiscal impact of selected recommendations in this Survey, as some of them are not quantifiable given available information or the complexity of the policy design.

Table 3. Illustrative annual fiscal impact of recommended reforms

	% of GDP
Expenditures	
- Increased spending on active labour market programmes	-0.5
Additional revenues	
- Impact of structural reforms	+0.4
- Improve the design and the enforcement of the VAT	+1.4
- Increase in environmental taxation	+1.3
TOTAL	+2.6

Note: The estimated effects abstract from behavioural responses that could be induced from policy changes, in line with past OECD work modelling long-term scenarios (Johansson et al., 2013). The estimates are short-run effects and are based on: i) the assumption of an increase in active labour market spending as a share of GDP to the average of the top quintile of the OECD (from 0.6% to 1.1% of GDP): ii) the annual GDP impact of the structural reforms quantified in Box 2 (five-year effect): iii) the assumption of an increase in the VAT revenue ratio to the OECD average; iv) the assumption of an increase in environmental taxation as a share of GDP to the average of the top quintile of the OECD (from 2.2% to 3.5% of GDP).
Source: OECD calculations

Some aspects of the corporate income tax system may not support aggregate productivity growth. Larger firms, that are on average more productive in Portugal (OECD, 2017b), face a higher statutory corporate income tax rate as a result of surcharge rates that rise with the level of taxable profits. Furthermore, small and medium-sized enterprises can benefit from a slightly lower statutory CIT rate.

The government is also planning to introduce a preferential tax rate for companies located in the interior of the country. While such measures have been introduced in some other OECD countries, such as France, a potential unintended effect of this type of policy is to encourage profit-shifting within the country or to divert activity to interior regions from substantially more productive areas (such as Lisbon in the case of Portugal). Public policy interventions that support small firms and lagging regions are desirable where market failures exist. However, the authorities should be cautious about undertaking such interventions by introducing distortions into the corporate tax system. A more advisable approach would be to reallocate the public funding to other policy interventions that are currently in existence and that could have longer-term effects on the economic development of interior regions. For example, public investment in complementary public assets in these regions could be boosted. The government has established a working group that will review existing tax exemptions and report their findings by the end of March 2019 (Table 4).

As discussed further in Chapter 1, tax administration is an area that remains particularly cumbersome for businesses. Both tax accountants and businesses highlight frequent changes in tax laws as the most significant contributor to complexity in the tax system (Borrego et al., 2015). Other factors include the extensive use of special provisions and ambiguity in the tax law language. In this context, the authorities should simplify the tax system, partly through reducing the use of exemptions and special provisions. Once this is achieved, ensuring the stability of the tax system should be the key priority.

Table 4. Past recommendations related to improving fiscal sustainability

Recommendation	Action taken since the February 2017 Survey
Reduce tax exemptions, special rates and tax expenditures.	The Minister of Finance has created a working group to review existing tax benefits (i.e. exemptions, special rates etc.) through a cost-benefit analysis of current tax expenditure. The working group shall present a report by the end of March 2019.

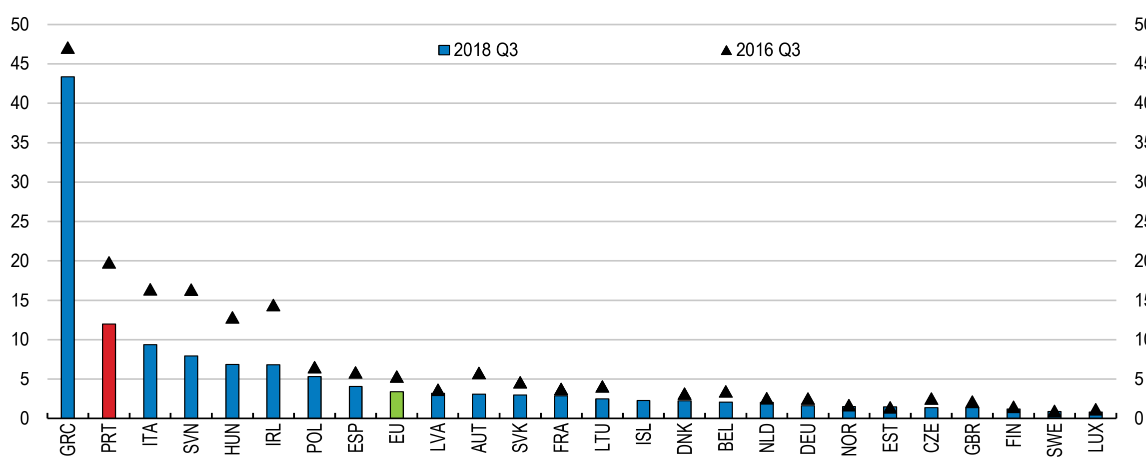
Enhancing financial stability

Portugal has emerged from a severe banking crisis with a deleveraged, recapitalised and restructured banking sector. Loans to customers have declined significantly over the past 10 years and they currently account for around 60% of total assets. At the same time, the banking sector's funding structure has become more stable, with increased deposits and equity-financing and less reliance on funding from securities and interbank markets.

The quality of assets in the banking system has been improving over the past years. The stock of non-performing loans (NPLs) in the Portuguese banking sector has decreased more than 35% (around 18 billion euros) from June 2016 to June 2018 (Figure 15). Additionally, the NPL ratio has also decreased by about 6.2 percentage points in a context where the deleveraging effort has been reducing its denominator. The loan-loss coverage ratio in the banking sector is high (Figure 16), as impairment provisions against NPLs have increased in the past few years. Banks have enhanced their risk assessment on new loans, with interest rate spreads reflecting stronger differentiation by the risk profile of borrowers than prior to the crisis (Bank of Portugal, 2017). The value of loans to low-risk firms in recent years has been markedly higher than that to high-risk firms (Bank of Portugal, 2017). Nonetheless, the stock of non-performing loans remains one of the highest across OECD countries, despite having declined notably in the past few years (Figure 15), weighing on banks' profitability and solvency (see below).

Figure 15. The NPL ratio in Portugal remains elevated

Non-performing exposures by country as a ratio of total outstanding exposures



Note: The following 7 banks are considered: Banco BPI SA; Banco Comercial Português SA; Caixa Central de Crédito Agrícola Mútuo, CRL; Caixa Económica Montepio Geral; Caixa Geral de Depósitos SA; Novo Banco; Santander Totta.
Source: European Banking Authority (EBA), "EBA Risk Dashboard".

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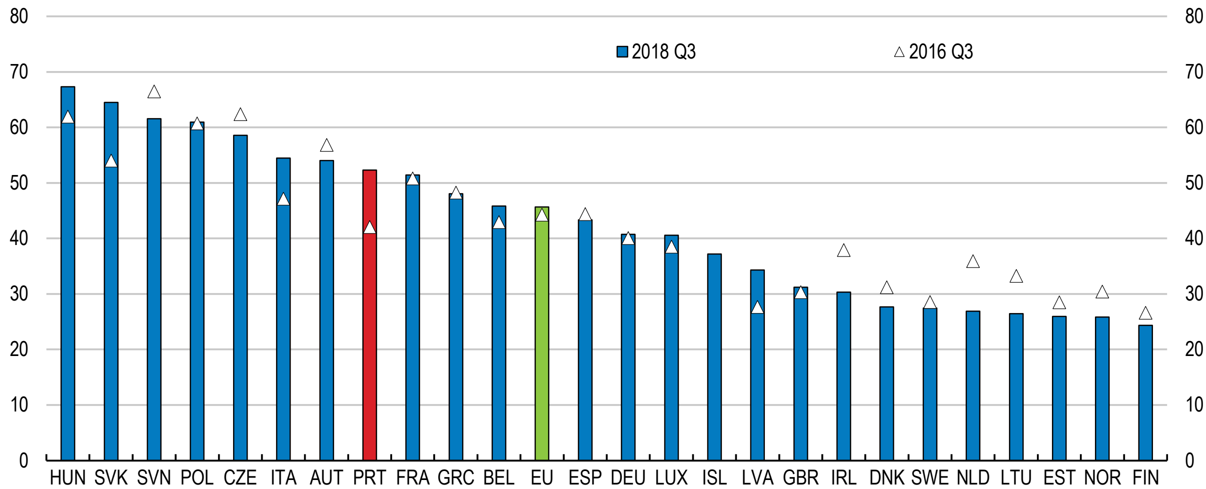
Figure 16. The loan-loss coverage ratio is high in Portugal

The coverage ratio as a percentage of NPLs



Source: EBA, European Banking Authority (EBA), “EBA Risk Dashboard”.

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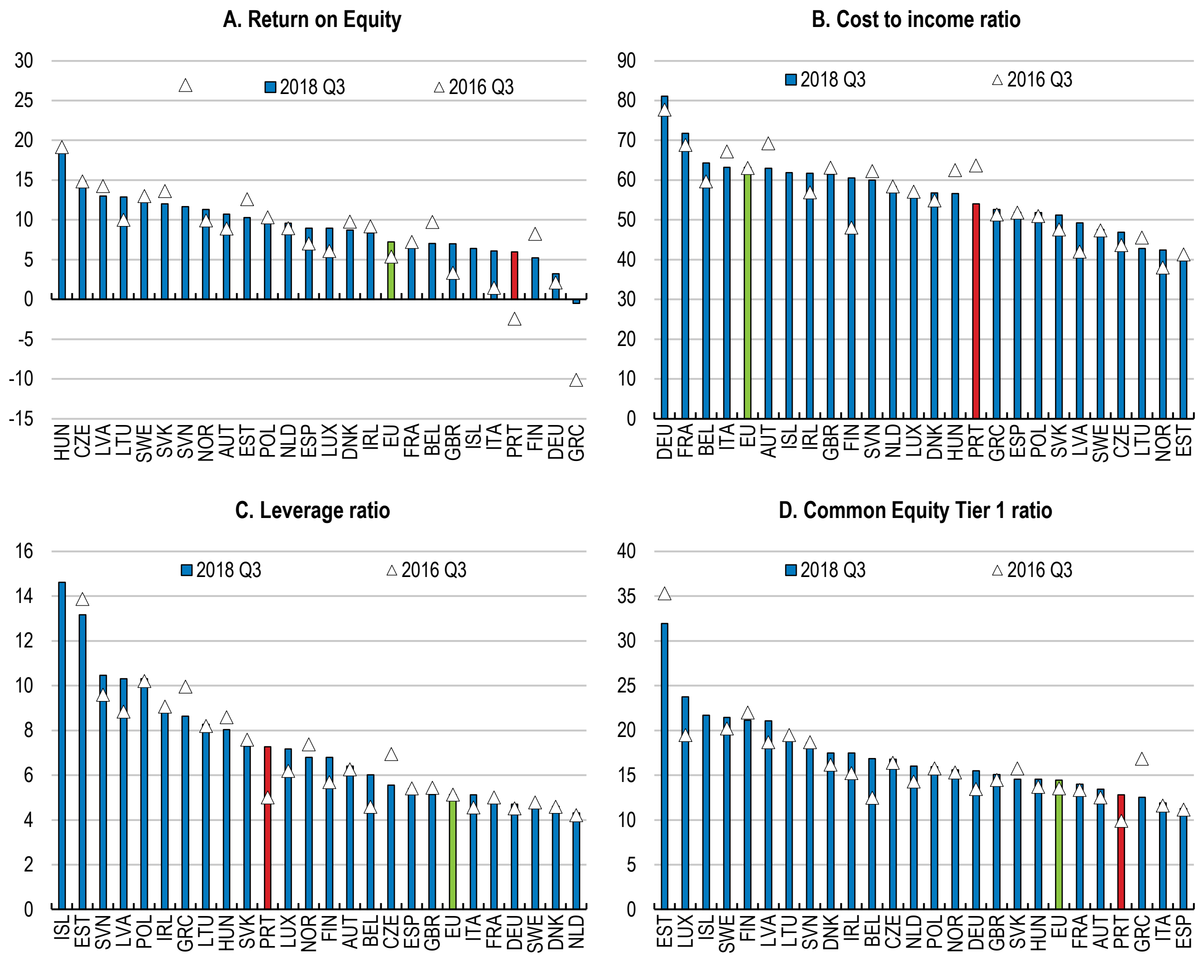
The profitability of Portuguese banks has improved, but remains low compared with institutions in other EU countries (Figure 17, Panel A). Banks have reduced operation costs by 27% since 2010, partly reflecting a decline in the number of branches and staff. There have also been efficiency improvements and the cost-to-income ratio is now below the EU average (Figure 17, Panel B). Net interest income, the most important revenue source for Portuguese banks, increased by 4.6% in 2017. Nonetheless, bank profitability continues to be impeded by additional impairments against NPLs.

Figure 17. Vulnerabilities remain in the Portuguese banking sector



Note: The calculation of the leverage ratio and the Common Equity Tier 1 ratio is based on the Basel III rules that will apply at the end of the transition period in 2019.
Source: European Banking Authority (EBA) "EBA Risk Dashboard".

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As long as banks' profitability remains low, the organic increase in their own funds will be limited. However, a number of banks injected new capital in 2017 and issued Tier 2 and AT1 instruments, improving their capital position. The sector-wide leverage ratio (the ratio of core capital to assets) is well above the EU average (Figure 17, Panel C). Nonetheless, the Common Equity Tier 1 ratio (an indicator of bank solvency measured as a ratio of banks' own funding to risk-weighted assets) remains low (Figure 17, Panel D), due to the existence of risky assets, including NPLs. The relatively low level of bank solvency leaves the sector vulnerable to negative shocks.

Improving bank and firm profitability and solvency

In order to durably raise banks' profitability and solvency, it is essential to continue decreasing NPLs. The authorities are tackling NPLs within a comprehensive European action plan and based on the national strategy, which consists of three pillars: i) legal, judicial and tax; ii) supervisory action; iii) NPL management options. Particular measures include those implemented under "*Programa Capitalizar*", prudential supervisory action within the SSM and including the NPL reduction plans submitted by banks to supervisors. Furthermore, a platform for the integrated management of NPLs has been established.

Over the past years, significant progress has been made in terms of the regulatory framework to address NPLs, in the context of the Single Supervisory Mechanism (see Annex 1). It includes, notably, the monitoring of compliance with the NPL reduction plans submitted by banks that have high NPLs. These plans include specific operational goals by asset class and time frame and the reduction goals initially stipulated have reportedly been met (Bank of Portugal, 2018). However, the targets and timetable on NPL reduction are not publicly known, thus their stringency cannot be evaluated and instances where banks deviate from the plans identified by the public. Communicating the plans and the progress in meeting them could boost the credibility of the banks and add pressure for meeting targets. However, it may compromise the prices at which banks are able to sell distressed assets if market participants are aware of the sales that any specific bank needs to make to meet their plan by a set date. Regardless, these plans should continue to be strictly monitored and competent authorities should translate performance in achieving targets into changes in capital requirements. NPL write-offs should continue to be encouraged, taking into account the measures being implemented, also at the European level, to reinforce the provisions required against NPLs on balance sheets.

In tandem with changes to supervision, the authorities could consider playing a more active role in developing distressed debt markets to assist banks in cleaning up their balance sheets. While there can be scope for the public sector to be involved in the development of distressed asset markets by, for instance, setting up public asset management companies (OECD, 2017c), current EU regulations related to state aid pose difficulties for such a reform. Furthermore, the Portuguese authorities recently conducted a study which found that the potential for a bulk transfer of the NPLs in the banking system to an asset management company is low given the characteristics of the underlying assets (Table 5).

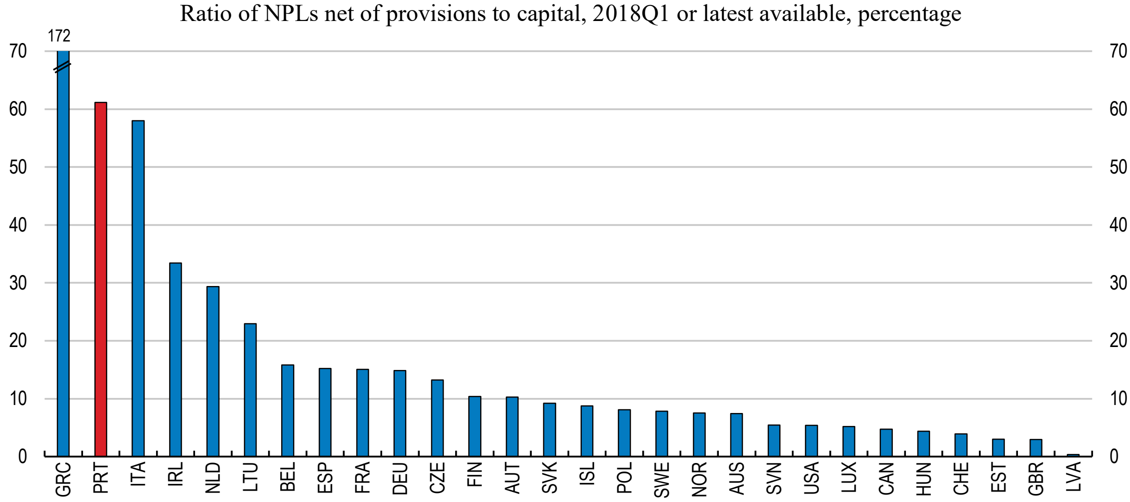
A number of policy measures have been introduced since 2016 with the aim of reducing corporate indebtedness and strengthening loan recovery. These have been under the *Programa Capitalizar* and have included promoting the use of out-of-court restructuring mechanisms as well as efficient and transparent court proceedings, partly to improve the recovery rates of creditors. The *Programa Capitalizar* also includes an early warning mechanism, which aims to inform companies of their financial situation, which is coordinated by the Portuguese government and is being developed by the Portuguese SME Public Agency (IAPMEI), in collaboration with Bank of Portugal and the Tax Authorities. These developments go in the right direction. However, most of the recent policy measures have been aimed at corporate restructuring, which is most effective for firms temporarily in distress but otherwise viable.

Further NPL resolution continues to be a challenge. The NPL ratio is particularly high for the non-financial corporations (NFC) sector, which accounts for some 65% of the total NPL stock. Since some NPLs are unlikely to be recovered, NPL write-offs should continue to be encouraged, taking into account measures adopted at the European level. Banks are still vulnerable to any reduction in the value of collateral, despite the increase in the coverage ratio (Figure 18).

More generally, high private sector indebtedness is a concern. Although having declined steadily, the stock of private sector debt remains high (Figure 7, Panel B). While about half of NFCs are not indebted at all, some NFCs are heavily indebted. Around 35% of NFCs with financial debt have an interest coverage ratio below one, leaving them sensitive to rises in interest rates. Some of these NFCs could be a source of new NPLs if faced with a negative shock.

Figure 18. The NPL net of provisions to capital ratio is high in Portugal

Ratio of NPLs net of provisions to capital, 2018Q1 or latest available, percentage



Note: The chart showing the ratio of NPLs net of provisions to capital gauges how banks would be affected in an extreme scenario where all NPLs are written off and assuming no collaterals.
Source: IMF Financial Soundness Indicators.

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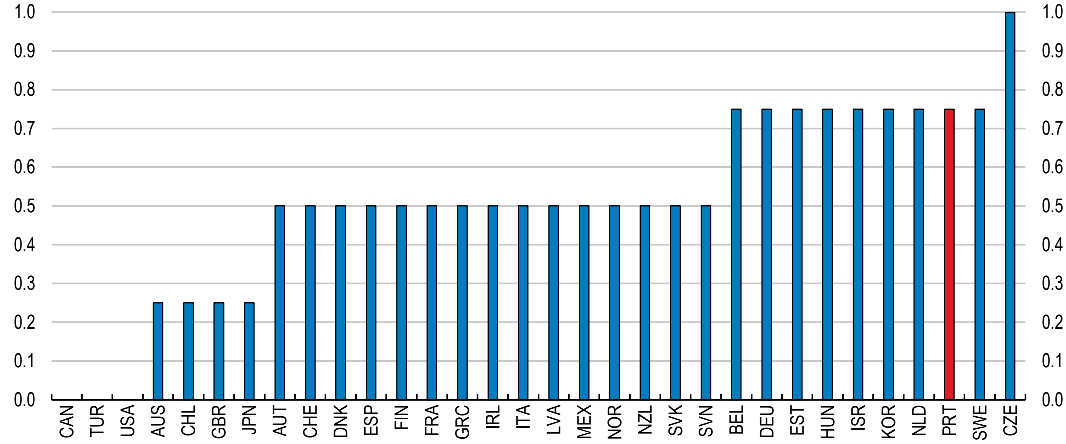
Optimising the insolvency regime

An efficient insolvency regime, allowing rapid debt resolution, improves the operation of credit markets (Andrews and Petroulakis, 2017). Along with efficient judicial processes, it is also an important condition for the resolution of NPLs. Portugal's insolvency regime for firm restructuring has become more efficient since early 2010, owing to the *Processo Especial de Revitalização*. However, the bankruptcy law is very stringent for bankrupt persons (Figure 19; (Adalet McGowan, Andrews and Millot, 2017). The time to discharge (when the exemption from pre-bankruptcy debt repayment becomes available) is 5 years, in contrast with other European countries where it is often 3 years. The exemptions from the insolvency assets (those assets left to the bankrupt entity at the time of bankruptcy) are limited to vital items only. This has resulted in the number of personal bankruptcy cases being very limited.

Figure 19. Personal bankruptcy law is stringent in Portugal

OECD insolvency indicator: Treatment of failed entrepreneurs, 2016



Note: The indicator is constructed based on the OECD questionnaire on insolvency regimes. It ranges from zero (least stringent) to one (most stringent). "Treatment of failed entrepreneurs" takes into the following aspects: time to discharge; and bankruptcy exemptions.
Source: Adapted from Adalet McGowan et al. (2017).

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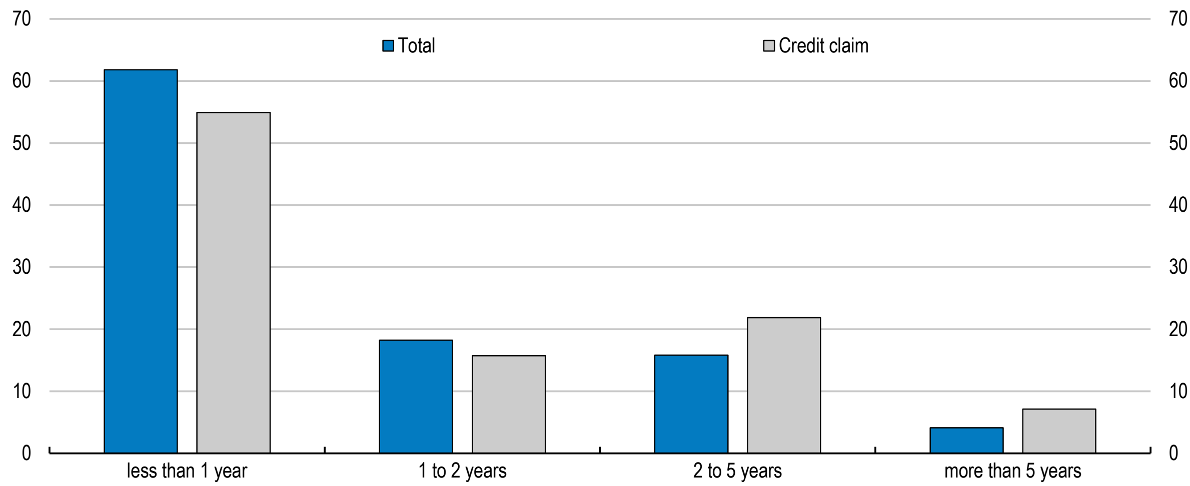
Bankruptcy law often has greater importance than corporate insolvency regimes for small businesses (Armour and Cumming, 2008). Entrepreneurs often use personal finances prior to incorporating and obtaining limited liability protection (Berkowitz and White, 2004; Cumming, 2012) and lenders often require them to make personal guarantees. In Portugal, such guarantees are common practice: while collateral requirements are among the highest across OECD countries (around 80% of the cases; OECD, 2018a), the collateral usually takes the form of business assets and personal guarantees of business owners. Such collateral requirements help banks to screen out risky businesses, but once the firm defaults, banks can be negatively impacted as repossession of collateral is not easy in practical terms. Rather, banks should adopt a business model focusing more on the assessment of the business plan and cash flow.

Such personal guarantees of business owners make insolvency proceedings very complicated. This is because an owner of a failing firm that has given personal guarantees becomes liable, causing them to risk bankruptcy if they cannot pay out all liabilities. Such collateral enforcement often requires court proceedings, which can be long in Portugal (Figure 20, see also Chapter 2). Such proceedings are costly and the collateral value can decline markedly during the proceedings. This is reflected in a very low recovery rate; just 5% on average (Ministry of Justice, 2017).

Figure 20. Court proceedings for credit claims can take a long time

Share of court proceedings by duration, %



Source: Ministry of Justice.

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Bankruptcy law should be made less stringent, thereby making bankruptcy a viable solution for some highly indebted people. Such a reform typically involves reducing the time to discharge, as was recently the case in other European countries such as Spain and Ireland. In these countries, such reforms resulted in a rise in the number of persons choosing to file for bankruptcy. Less stringent bankruptcy regulation may negatively affect credit supply (due to creditors having less rights in legislative terms), as shown in Berkovitz and White (2004), but it would effectively ensure the right of creditors who otherwise continue forbearance instead of pursuing long and uncertain court proceedings for credit claims.

At the same time, it is worth considering introducing an out-of-court regime for firm liquidation. Such a system has recently been introduced in other OECD countries, such as Japan (OECD, 2017d). An out-of-court regime for firm liquidation should aim to start debt resolution proceedings at an early stage, to prevent the deterioration of the debtor's assets, and to make the financial state of the debtor transparent, which often reveals hidden assets. Increases in the value of collectable assets should be shared with the debtor, incentivising them to be engaged in the debt resolution process. This would complement measures implemented as part of Budget 2018 that allowed creditors to deduct losses incurred as part of the debt resolution process from their corporate taxes, thus encouraging their participation.

Table 5. Past recommendations related to improving financial stability

Recommendation	Action taken since the February 2017 Survey
Strengthen current regulatory incentives for reducing non-performing loans, including through write-offs and sales.	A comprehensive strategy to reduce NPLs has been in force since late 2016. It encompasses initiatives in 3 key pillars, coordinated among all relevant stakeholders: i) Legal/judicial, tax and other relevant reforms; ii) Prudential supervisory action; iii) NPL management options, including the possibility to develop system-wide solutions.
Support the development of a market for distressed debt, notably through the creation of asset management companies.	The Portuguese authorities conducted a study which found that the potential for a bulk transfer of the NPLs in the banking system to an asset management company is low.

Addressing medium-term challenges for the economy

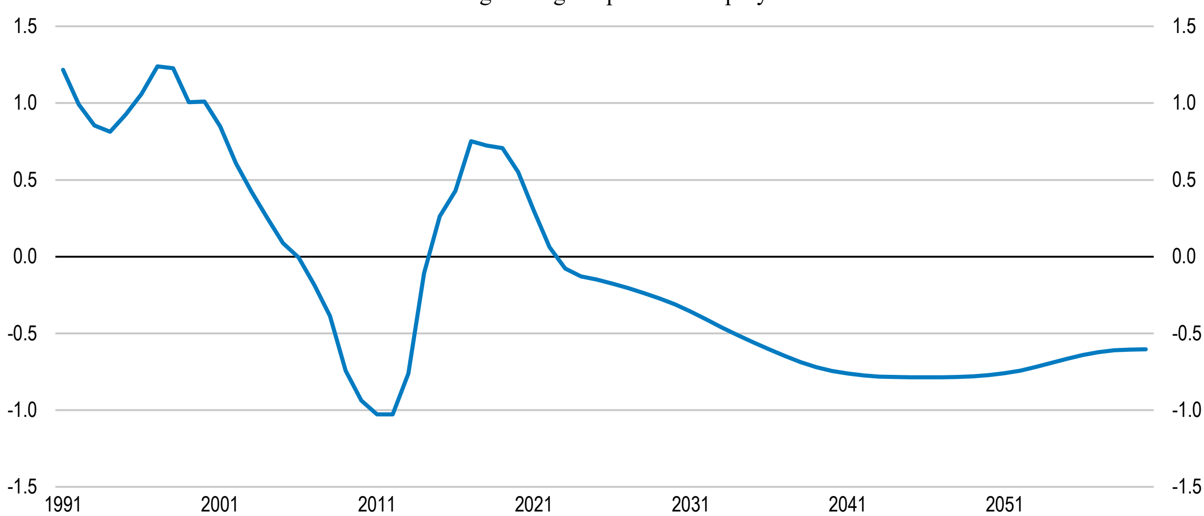
As noted earlier, wellbeing along most dimensions remains well below that in other OECD countries and there has been limited convergence in living standards over the past few decades. To further narrow these gaps, the Portuguese authorities must continue to reinvigorate the economy. Two key channels will be through ensuring that the working age population have the capability and opportunities to participate more effectively in the labour market and reawakening productivity growth.

Improving labour utilisation and reducing poverty

The pool of available labour will begin to decline from 2023 as the population ages (Figure 21). This will result in weaker economic growth, unless there are improvements in the utilisation of the existing labour resources, especially through getting unemployed or marginalised workers back into jobs. Measures that ensure that such workers have better opportunities to find jobs, improve their skills and derive the benefits from increasing their productivity will also raise the inclusiveness of the Portuguese society and overall wellbeing.

Figure 21. The pool of labour is expected to decline over the long run

Percentage change in potential employment



Note: Potential employment takes account of working age population, trend labour force participation and the equilibrium unemployment rate.
Source: OECD Long-term baseline model.

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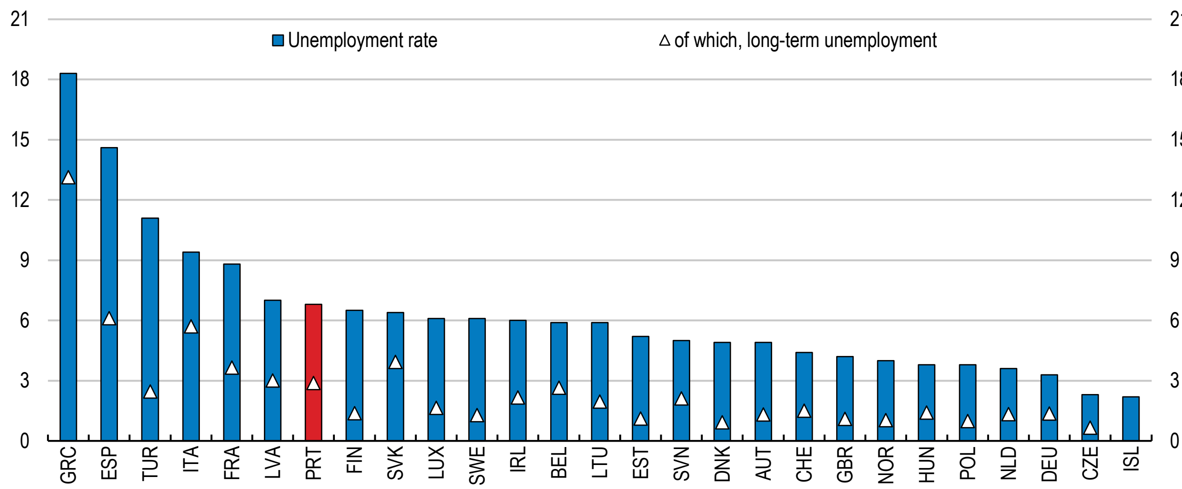
Although declining rapidly, unemployment among the youth and the low-skilled remains elevated in Portugal. This is especially the case for young people with no previous work experience. Many other young workers have only intermittent employment, moving in and out of short duration jobs. The long-term unemployment rate remains high (Figure 22), with the low-skilled representing around two-thirds of all long-term unemployed adults (Düll et al., 2018). Indeed, poor skills is among the most common employment barriers faced by the unemployed (Figure 23; Düll et al., 2018).

Figure 22. Incidence of long-term unemployment is high in Portugal

As a percentage of total labour force, 2018 Q3



Source: Eurostat Labour Force Survey database.

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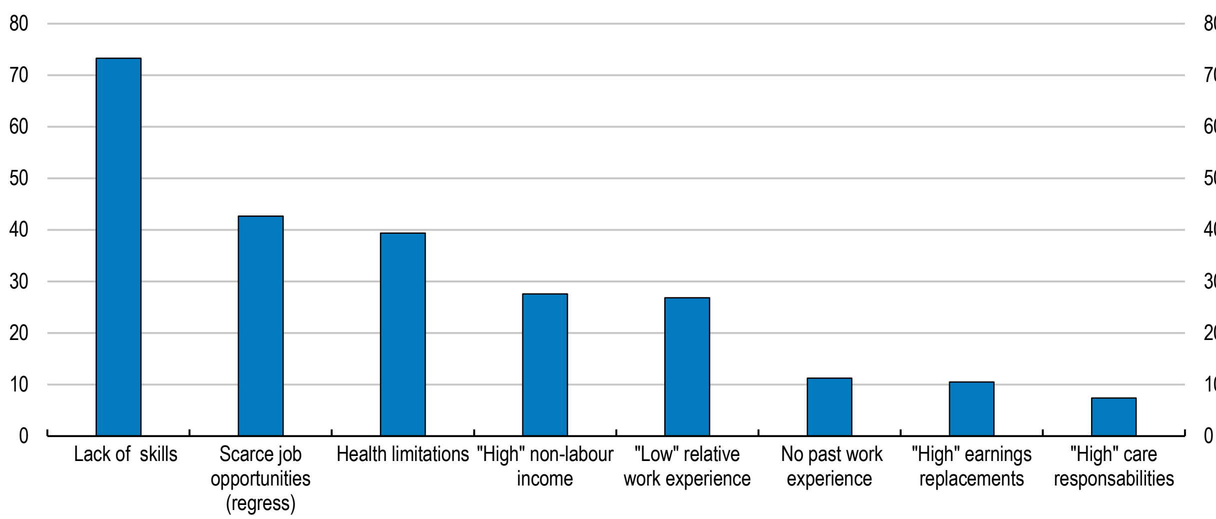
Figure 23. Low-skilled people face significant employment barriers

Percentage of those unemployed or weakly attached to the labour market facing each identified employment barrier



Note: Unemployed people often face a number of employment barriers that prevent them from returning to work. OECD (2018) attribute/estimate such employment barriers to each unemployed person. The chart reports the proportion of unemployed or people marginally attached to the labour market that face each employment barrier. An individual can face multiple employment barriers, thus the blue bars in the figure do not sum to 100.
Source: OECD (2018), "Faces of joblessness in Portugal".

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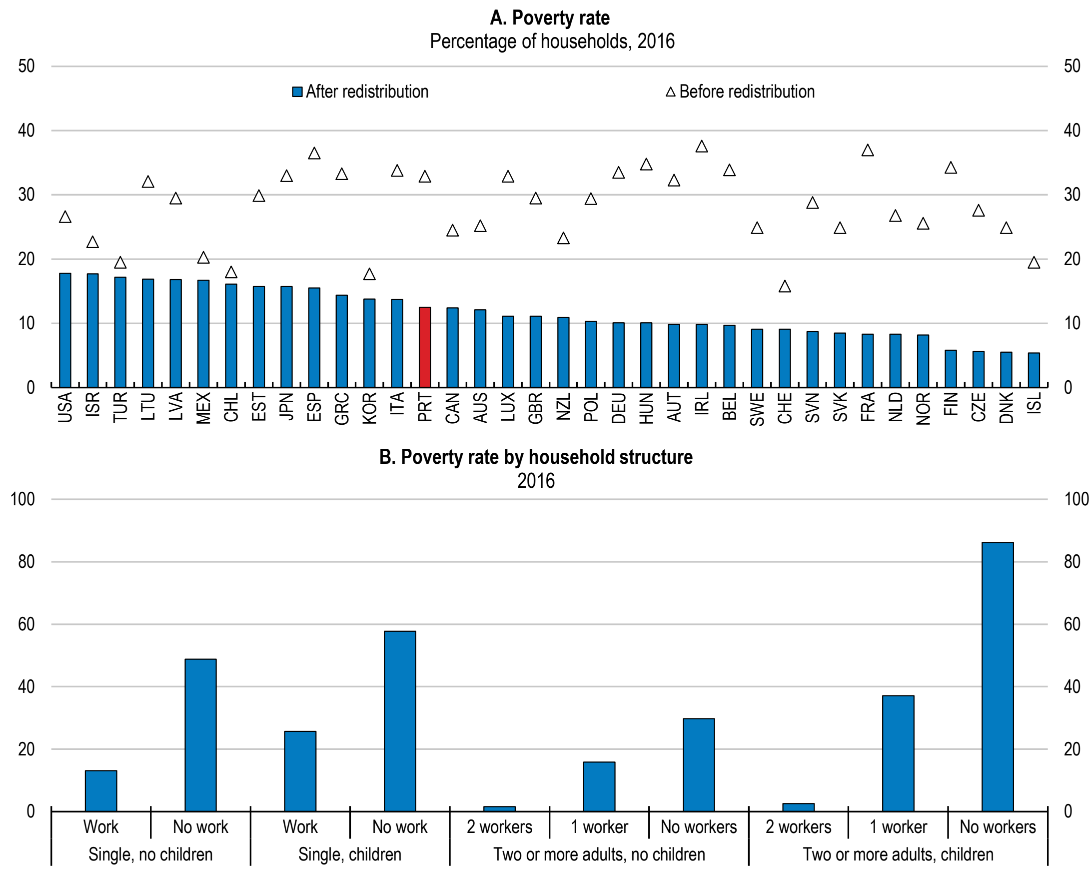
Poverty in market income is high in Portugal (Figure 24, Panel A), concentrated on jobless households with children (Figure 24, Panel B). Poverty is greatly reduced when measured in disposable income (Figure 24, Panel A), largely due to income support. The *Subsidio de desemprego*, standard unemployment benefit, is relatively generous. Those who are not eligible for unemployment insurance may benefit from various other support measures, including the *Rendimento Social de Inserção* minimum income support which is subject to a means test. This support was reduced in early 2010s in the context of the fiscal crisis, in particular for households with dependents and children. This reduction will be fully reversed by 2019, which will help alleviate poverty in such households. Such benefits should continue to be strictly conditional on active job search, which will be effective as long as relevant activation and employment support measures are in place (see below).

Figure 24. Poverty is high in jobless households



Source: OECD Income Distribution and Poverty Database.

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Public employment services have increased their support to jobseekers

Since 2012, the *Instituto do Emprego e da Formação Profissional* (public employment service) has been reformed in a comprehensive way under the programme "*Programa de Relançamento do Serviço Público de Emprego*". It has been further enhanced by the recent "One-stop-shop for Employment" project as part of the SIMPLEX+ programme. These policy initiatives enhanced coordination with other public services, notably with the Institute for Social Security and improved online services for users with digital skills. The public employment service also strengthened its job-broking function, upgrading the online vacancy database and strengthening the co-operation with employers, namely by introducing dedicated case managers for relevant employers ("Gestor+"). These measures can help jobseekers who are relatively job-ready.

At the same time, the public employment service enhanced its supports to jobseekers. It has provided a range of labour market programmes based on the individual assessment of jobseekers, including counselling, internships, hiring subsidies, training, employment on public works and referral to a job interview. In exchange, it has strictly implemented the requirements to meet with caseworkers, in particular, for the two target groups: those aged 45 years and above and those unemployed for six months and longer. This strengthened conditionality significantly raised the employment prospects of jobseekers (Martins and Pessoa e Costa, 2014). Since 2016, this approach has been strengthened to make labour market programmes more personalised and developed in collaboration with jobseekers. As part of this, greater flexibility in the frequency with which users must engage with public employment services has been introduced (i.e. depending on individual circumstances) and the criteria for the assignment of managers to jobseekers have been revisited.

Labour market programmes should raise the employability of jobseekers

Traineeship programmes, including on-the-job training, can help individuals to acquire relevant job skills and to enter the labour market. A stronger emphasis on training measures recently translated into an increase in the coverage of registered jobseekers in traineeships, from below 10% in early 2016 to above 14% in the second half of 2018. Nevertheless, participation rates in adult education and training are particularly low in Portugal, especially for those that are unemployed or inactive.

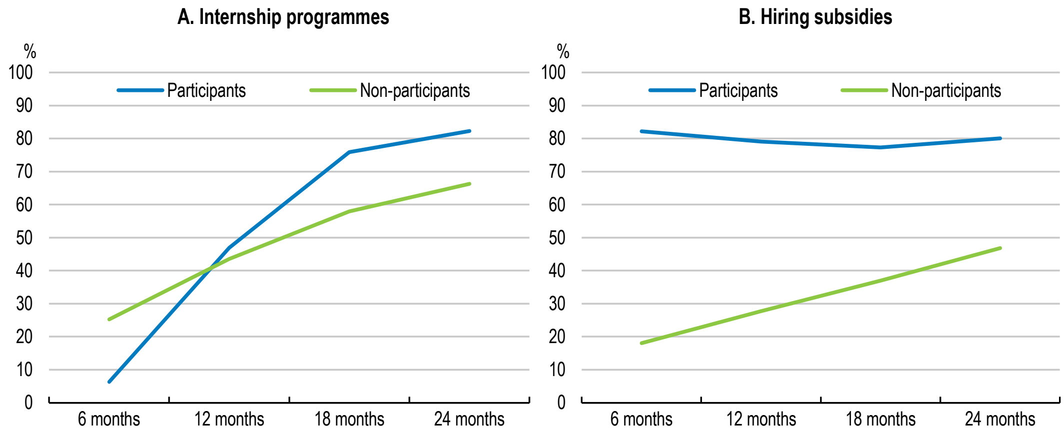
The government is strengthening professional traineeship programmes. *Estágios Emprego*, introduced in 2013, targets mainly youth aged 18-30 or those who recently completed school. Its objective includes facilitating school-to-work transition. The programme lasts for 9 to 12 months. OECD (2017e) shows that the programme significantly improves the employment outcomes of training participants (Figure 25). In 2017, the government introduced new professional traineeships ("*Estágios Profissionais*") targeted at young people that included a one-off payment to employers that hired a trainee after the traineeship had concluded (Table 6).

Some jobseekers need intensive up-skilling and re-skilling programmes. Such training programmes include "*Aprendizagem*", a dual initial vocational training programme, and "*Cursos de Educação e Formação de Adultos*" (Adult Education and Training) that provides general and technological education. These two longer-duration programmes have positive employment effects, though such effects tend to appear only several years after participation (Düll et al., 2018). It is important to note that both *Aprendizagem* and *Cursos de Educação e Formação de Adultos* are associated with a qualification level at the end of the course (MTSSS, 2018). These programmes should be expanded to reach as many low-skilled people as possible.

Qualifica, an adult education and training package programme, came into force in January 2017. It aims at raising the qualification level of adults and their employability by tailored training pathways, mainly targeting low-skilled adults and young NEETs. It is built on the Recognition Validation and Certification of Competences, which ensures a formal recognition of non-formal learning and skills acquired through work experience. Participants in *Qualifica* are referred to relevant programmes including *Aprendizagem* and *Cursos de Educação e Formação de Adultos*. *Qualifica* is a promising programme, which combines many policy measures already proven effective at raising the employment prospects of jobseekers and ensuring as many NEETs as possible stay in touch with the labour market.

Figure 25. Labour market programmes differ in effectiveness for re-employment

Estimated employment ratios over time after the start of the programme



Note: Individuals who enrolled in one of these programmes at time t are compared to a set of "control" or similar individuals who did not enrol in that programme at time t. The control group is formed using propensity score matching techniques. More specifically, individuals are matched on the basis of age, gender, marital status, number of children, years of schooling, date of registration with the PES and previous employment history. The chart compares the employment outcome between the two groups t+6, t+12, t+18 and t+24. For Panel A, the employment outcome of the participants at t+6 should take account of the fact that most of them are still enrolled in the internship programme, which is not considered to be in employment ("lock-in" effects).
Source: OECD (2017), "Labour Market Reforms in Portugal 2011-15: A Preliminary Assessment".

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Employment outcomes will also benefit from improvements in the adult education system. As detailed in the 2017 OECD *Economic Survey of Portugal*, there is particular scope for further reforms to vocational education and training (VET) arrangements (OECD, 2017c). Although the offering of VET education has greatly expanded over the recent decade, the system is fragmented with both the governance of the VET system and VET provision divided across ministries. This increases the risk of overlaps and inefficiencies in the use of resources and reduces the effectiveness of quality control.

At present, the Ministry of Education is responsible for VET courses designed for youth at secondary education level. In addition, the Ministry of Labour coordinates and delivers VET courses through the IEFP (the Institute for Employment and Vocational Training), which also provide secondary-level education attainment (e.g. *Sistema de Aprendizagem*). The IEFP courses have a stronger dual training element, combining classroom teaching with practical experience in industry. Across OECD countries, programmes with such a work-based component tend to be associated with better employment prospects (OECD, 2015a), having been implemented in countries including Austria, Germany and Switzerland. In addition to the public VET courses, private providers also offer a variety of VET programmes. However, in some instances, there have been concerns about the quality of training provided. As recommended in the 2017 OECD *Economic Survey of Portugal,* the two VET systems under the responsibility of the government should be consolidated into a single dual VET with strong workplace training. This should be accompanied by a thorough evaluation of all the existing VET education programmes offered across the public and private sectors.

At the same time as bolstering adult education and training programmes, the authorities should focus on encouraging participation by those most in need. The OECD recently published guidance on the implementation of a skills strategy for strengthening the adult-learning system in Portugal (OECD, 2018b). This emphasised the need to overcome the motivational barriers to participating in training. To do this, information on the returns to different types of education should be disseminated, especially to those unemployed and with low skills. However, this will require the government to collect better quality data about the skills of the adult population and the returns, in terms of income and employment prospects, of accumulating different types of skills.

Hiring subsidies are another focus of the government in facilitating the transition of jobseekers into employment. *Contrato-Emprego*, in place since 2017, targets difficult-to-place workers, such as youth and long-term unemployed, and is basically reserved for permanent contracts. As also found in OECD (2017e), the impact of hiring subsidies on employment is immediate and significant. However, it is not clear if the impact is durable and tends to disappear often when subsidies terminate. It is worth evaluating the current provisions (OECD, 2017e). This is especially the case given prevailing fiscal constraints. Employment prospects can be strengthened differently, for instance, through work experience being validated by a formal qualification (such as through the Recognition Validation and Certification of Competences system). Subsidies tend to induce employers to substitute between those employees who benefit from them and those who do not (Crépon et al., 2013). Thus, hiring subsidies need to be limited to those most in need, such as those at a very high risk of long-term unemployment and extreme poverty.

Improving employment conditions for more and better quality jobs

The incidence of hiring on temporary contracts is still high. Around 18.5% of employees are on temporary contracts, one of the highest proportions in the EU. Employment protection for permanent workers remains very strict when compared with temporary workers. This is in spite of a reform undertaken in the 2011-14 period, which included a reduction in severance pay for regular workers while also introducing changes in the legal framework for fixed-term contracts. The reform did increase hiring on permanent contracts, and facilitated job flow generally (OECD, 2017e).

A Tripartite Agreement in July 2018 aimed to reduce labour market dualism by limiting the legal framework of temporary contracts, namely by lowering the maximum accumulated duration of fixed-term contracts and by narrowing the conditions under which fixed-term contracts were authorised for permanent tasks. This was a step in the right direction for reducing labour market duality while still allowing flexibility for the business sector to grow as new opportunities arose. Past reforms had established an individual bank of hours that allowed employers and individual employees to increase normal working hours by up to two hours per day (up to a limit of 150 hours per year). However, these reforms are expected to be amended, no longer allowing such agreements at the individual-worker level. The June 2018 Tripartite Agreement foresaw the elimination of the individual bank of hours, while establishing that the bank of hours can be adopted by collective agreements or by group agreements reached by consultation with workers. This policy reversal may have a negative impact on employment and business investment.

Collective bargaining has become more frequently utilised in the past few years, after having weakened in the aftermath of the crisis. Recent tripartite agreements between the government and social partners have aimed to further revitalise collective bargaining, through making it acceptable to as many parties as possible. For instance, a maximum period for analysis, consultation and issuance of extension orders was established, that contributed to decreasing the risk of having delayed extensions that required the payment of sizeable pay arrears, which was perceived to be particularly costly for firms (OECD, 2017e). Going forward, collective bargaining should remain flexible so that wages are aligned with productivity developments at the firm level. As discussed in the 2017 OECD *Economic Survey of Portugal*, one aspect of achieving this would be to introduce more stringent representativeness requirements for administrative extensions of collective bargaining agreements and opt-out possibilities for individual firms (OECD, 2017e).

Table 6. Past recommendations related to improving labour utilisation and reducing poverty

Recommendation	Action taken since the February 2017 Survey
Systematically monitor the outcomes of the different active labour market programmes with a view to concentrating resources on the more effective programmes.	A study of active labour market programmes identified that some programmes had low employability outcomes and led to poor quality employment outcomes. These findings prompted a reorientation of the main active labour market policies with the aim of promoting greater efficiency of employment supports by public employment services.
Reduce labour market duality to improve the job quality and strengthen learning incentives.	A tripartite Agreement signed by the Government and the majority of Social Partners in July 2018 aimed to reduce the maximum accumulation duration of fixed-term contracts from 3 years to 2 years. It also aimed to increase the financial contribution of employers that use fixed-term contracts excessively. Decree Law 72/2017 extended the duration of the exemptions of social security contributions for young people obtaining their first job (for a period of five years) and the long-term unemployed (for a period from three to five years), in order to promote permanent contracts.
Consolidate the two VET systems into a single dual VET with strong workplace training and perform a thorough audit of all vocational training programmes.	No action taken

Reinvigorating productivity growth

Productivity growth has notably slowed in the past two decades (Figure 26). This is a major policy challenge, since gains in living standards are driven by productivity growth in the long-run. The main determinants of a country's long-run level of productivity include regulations, governance, institutions and human capital (Guillemette et al., 2017). Implementing the related reforms recommended in this *Survey* are estimated to have marked positive effects on GDP per capita over the coming years (Box 2).

Figure 26. Productivity growth has slowed in Portugal

Annual average growth (%)

Note: For multifactor productivity, data are only available up to 2015.
Source: OECD Productivity Indicators.

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Box 2. Quantification of the structural reforms recommended in this survey

This box quantifies the effect of some of the structural reforms for Portugal recommended in this Survey based on the OECD's most recent quantification framework (see Égert and Gal, 2017). The effects are derived from a range of time-series cross-country reduced-form panel regressions on a sample of OECD countries. The estimated effects are allowed to vary across countries as a result of differences in factor shares, the level of the employment rate and a country's demographic composition. The approach is illustrative and results should be interpreted with care.

Table 7. Illustrative impact of structural reforms on GDP per capita

	Total effect on GDP per capita		
	5-year effect	*10-year effect*	*long-term effect*
Product market regulations			
Regulations in energy, transportation, communications (ETCR)	0.2%	0.3%	0.7%
Regulations in professional services	0.15%	0.3%	0.7%
Quality of institutions			
Strengthening contract enforcement	0.75%	1.5%	3.9%
Labour market policies			
Improve active labour market policies	0.15%	0.2%	0.4%
Trade openness			
Reduce barriers to trade	0.9%	1.3%	2.8%
Total	2.1%	3.6%	8.5%

Note: Calculations are based on a 10% policy change scenario, which corresponds to lowering the sub-indicator for the transport sector from 3.04 to 2.74, resulting in a reduction in the OECD indicator of Regulations in Energy, transportation, communications (ETCR) by 0.101 point; lowering the sub-indicator for the legal service sector from 3.88 to 3.49, resulting in a reduction in the OECD indicator of Professional Services from by 0.097 point; increasing the Rule of Law indicator from the World Bank "Worldwide Governance Indicators" from 1.13 to 1.24; and increasing ALMP spending per unemployed as a ratio to GDP per capita from 8.1% to 8.9%. The effects of trade openness are estimated by assuming the typically observed change of an increase by 4 percentage points in the trade to GDP ratio (the "typically observed change" is measured as the average improvement in the variable over all two year windows that showed improvements in both periods across OECD countries in the past).
Source: OECD calculations.

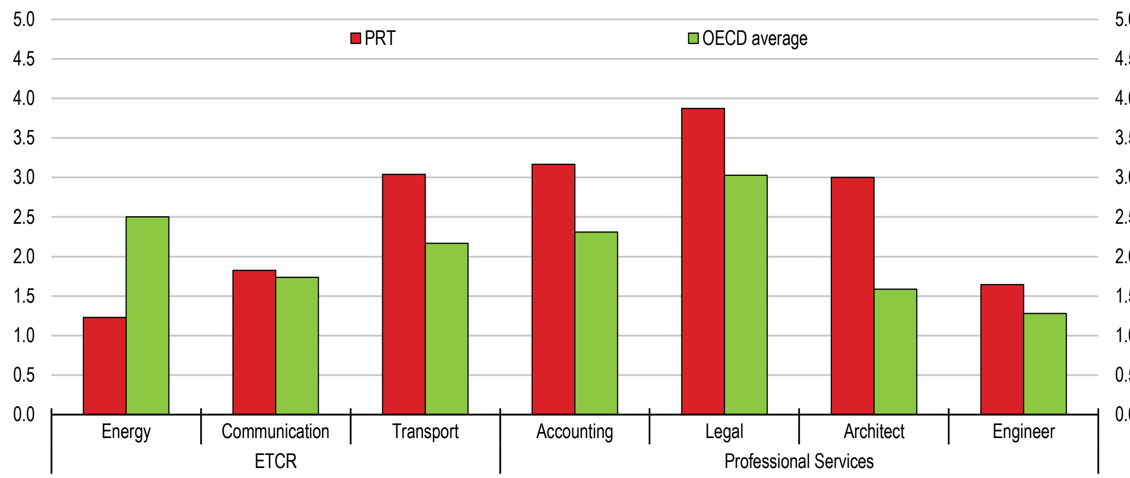
The regulatory framework can be further improved

Well-functioning product markets enhance the market selection mechanism and the efficiency of resource allocation, boosting aggregate productivity (OECD, 2015b). Firm-level empirical analysis has highlighted the strong relationship between a regulatory environment that promotes competition and productivity growth in Portugal (Carvalho, 2018).

Regulations in the services sector have direct effects on productivity as well as indirect effects on downstream industries that use services as intermediate inputs to production (Conway and Nicoletti, 2006). Indeed, tackling inefficient regulations in the services sector can reduce the price of intermediate inputs and raise the quality of products. OECD indicators of regulation in non-manufacturing sectors identify excessively stringent regulations in various professional services and the transport sector (Figure 27). Of the professional services, regulatory settings in the legal sector are particularly strict.

Figure 27. Regulation remains stringent in some sectors

OECD indicators of regulation in non-manufacturing sectors



Note: The OECD Indicators of Product Market Regulation are a comprehensive and internationally comparable set of indicators that measure the degree to which policies promote or inhibit competition. The indicator ranges from zero (least stringent) to six (most stringent).
Source: OECD Product Market Regulations Statistics (database).

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The Bar Association both represents its members and regulates the exercise of the profession. For the legal profession, a certain degree of regulation is warranted to ensure the quality of services offered. However, self-regulation tends to identify with the interests of the regulated profession, rather than the public interest (Canton, Ciriaci and Solera, 2014). Such self-regulation in the legal profession covers exclusive rights for lawyers and restrictions on entry, lawyers' fees, and the form of business (OECD, 2018c).

While the Bar Association maintains its role as self-regulator, the implementation of self-regulation can be ensured by an independent supervisory body. In Portugal, the law states that lawyers' fees are freely negotiated between the parties. The law specifies the criteria on which the fee structure should be based, including the number of hours worked, the value of claims, the lawyer's qualifications, and the complexity of cases. These criteria are very detailed and exhaustive, and not easily understood by clients, which can hamper competition in the legal services market (OECD, 2018c). The establishment of an independent supervisory body could allow for impartial assessment of legal costs and make them more transparent. Such an independent body could also deal with disputes over the legal contract brought by clients.

Productivity growth within enterprises benefits from well-functioning transport infrastructure (Kemmerling and Stephan, 2008). This is especially the case for exporting firms that rely on such infrastructure to reach end markets. Nevertheless, perception-based indicators highlight that the quality of transport infrastructure in Portugal is low compared with other southern European countries such as Spain and Italy (see Chapter 1). A particular area of focus should be improving the efficiency of the port system, which is currently impeded by a host of regulatory settings that reduce competition between operators (OECD, 2018d).

Portuguese ports follow the "landlord port" model whereby the port authority manages and invests in the main port infrastructure, while private entities are able to operate port activities. This arrangement is sometimes formalised through the concession of exclusive rights to a single private operator for a period of time, usually when ongoing private competition is not viable or substantial investment is required by the operator. However, the duration of port concession contracts in Portugal are frequently excessive, reducing the potential for market entrants that can provide higher quality services at a lower price to service the business sector. Furthermore, there is a very weak correlation between the investment spending of private operators and the length of concession contracts awarded (OECD, 2018d).

When awarding such concessions, a competitive awarding procedure should be undertaken to ensure transparency and that the best operator is given the contract. However, some concessions have been renewed at the end of a contract for an extended period without a new competitive awarding procedure, reducing the potential for the most efficient operator to provide port services (OECD, 2018d). The criterion for awarding port concessions also gives insufficient consideration to the bidder who will charge the lowest price to port users. Given the importance of these services for business sector productivity and future export performance, the likely impact of a provider on end user costs should be more carefully considered.

Improvements to the port system can achieve their maximum potential productivity benefits if combined with better connections to international rail freight services. Rail density is low in Portugal and rail links between the Portuguese and Spanish freight market have been too limited. Furthermore, differences in the rail gauge and lower maximum train lengths compared with other key European markets, such as France and Germany, reduces the potential volume of trade. In recent years, better rail connections with Spain have been prioritised, including the planned Évora-Elvas-Caia rail line that will connect parts of Portugal with Spanish transport hubs. Differences in the signalling system to other countries and sections of the train network along the Iberian Peninsula which are not electrified are also key challenges for inter-European rail connections with Portugal. These are well recognised by the Portuguese authorities and overcoming them should continue to be a priority.

Some important institutions and governance need to be strengthened

Productivity developments in the long run are not only shaped by regulation, but also by governance and institutions which implement the legislation. They comprise such elements as the rule of law, regulatory quality, government effectiveness, and control of corruption. According to recent OECD research (Guillemette et al., 2017), there is still significant scope for Portugal to raise productivity by improving governance and institutions.

Perceptions of corruption matter, not least for foreign direct investment. To improve confidence in core institutions, the authorities are committed to investigating and punishing wrongdoing. For example, the Public Prosecution Office has strengthened the collection and analysis of evidence to improve the effectiveness of anti-corruption investigations and the cooperation with audit and control bodies to improve the detection of graft (European Commission, 2018b). Associated projects were partly financed by European structural funds at a time when the budget of the Public Prosecution Office was cut. There has also been a parliamentary committee established, with the aim of improving transparency in public offices.

Trust in public procurement among Portuguese firms is low, with firms often perceiving problems with direct awards and non-competitive procedures (Eurobarometer, 2017). Of all contracts, the majority have typically been direct awards. Such contracts are sometimes justified based on extreme urgency. However, in the past, this concept was often interpreted broadly, contributing to excessive procurement through direct awards. In early 2018, a reformed Public Procurement Code entered into force, transposing European Directives. The reformed Code aims at promoting transparency and better management of public contracts, making stricter restrictions on direct awards and other conditions for higher value non-competitive procedures. To ensure that it is effectively enforced, the government has strengthened the Court of Auditors' auditing powers and capacity to perform ex-ante and ex-post control of public contracts (European Commission, 2014).

There is also a need to continue ensuring that the judiciary has the capacity to prosecute economic and financial crimes. The Public Prosecution Office and the Criminal Investigation Police must be allocated adequate resources to continue undertaking forensic investigations of economic and financial crimes, which can be long, complex and resource-intensive. When adjusting for price differences across countries, the funding of the public prosecution office on a per capita basis in Portugal is comparable with most other European jurisdictions, although it is notably lower than in some countries such as Switzerland and the Netherlands in which the available indicators suggest perceived corruption is very low. It should be noted that such comparisons of budget allocations do not take into account cross-country differences in the remits of public prosecution offices. The government has pledged to create a public registry of interests for local government officials, which should help the public prosecution office perform its duties, though this has not yet been implemented (European Commission, 2018b). Such a registry should be kept in electronic form, regularly updated and monitored.

In the next few years, a significant proportion of the current stock of public prosecutors will be retiring, meaning that there needs to be a strong effort in recruitment. In tandem, adequate specialised training for public prosecutors on economic and financial crime should continue to be provided. The Prosecutor General should require public prosecutors to attend such training and set aside funding for this purpose. Strengthening the capacity of the Prosecutor General should help deter corruption from occurring.

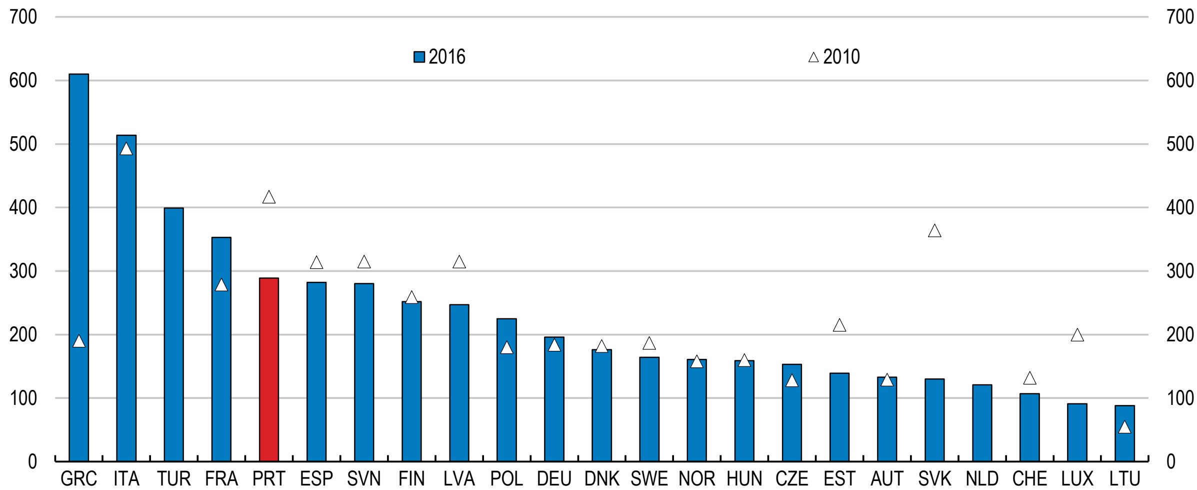
Reliable judicial systems are crucial to make sure laws and regulations are actually enforced. In this respect, court judgement should be speedy and effective. To do so, court resources should be allocated efficiently through strengthening the governance structure and workload assessment (see Chapter 2). Also, specialised courts with national jurisdiction for corruption could be considered. Such courts currently operate in some other OECD countries, such as the Slovak Republic. The appeal procedures should also be reviewed to prevent abuse.

Portuguese firms report judicial inefficiency as one of the most severe constraints to their operations (INE, 2018). Judicial efficiency, as measured by trial length, facilitates market transactions by ensuring timely contract enforcement and reducing transaction costs, thus promoting competition. It also facilitates financial transactions by ensuring creditors' rights, promoting investments and innovation. It is a critical aspect of the framework conditions needed for doing businesses and attracting FDI (Chapter 1).

Court congestion has been declining due to recent reforms, but the time to resolve a case in the court system remains long (Figure 28). In 2013, the government introduced a new Code of Civil Procedure that simplified a number of court procedures. It also introduced the Law for the Judicial System Organisation in 2014, which reformed the organisation of courts and aimed to increase the managerial responsibility of courts. Court resources have also been increased over the past few years. However, there remain significant bottlenecks in some courts (Figure 29), pushing up the average trial length.

Figure 28. Court proceedings are shorter than before, but still long

Average time needed to resolve civil and commercial cases, first instance courts, in days



Source: CEPEJ.

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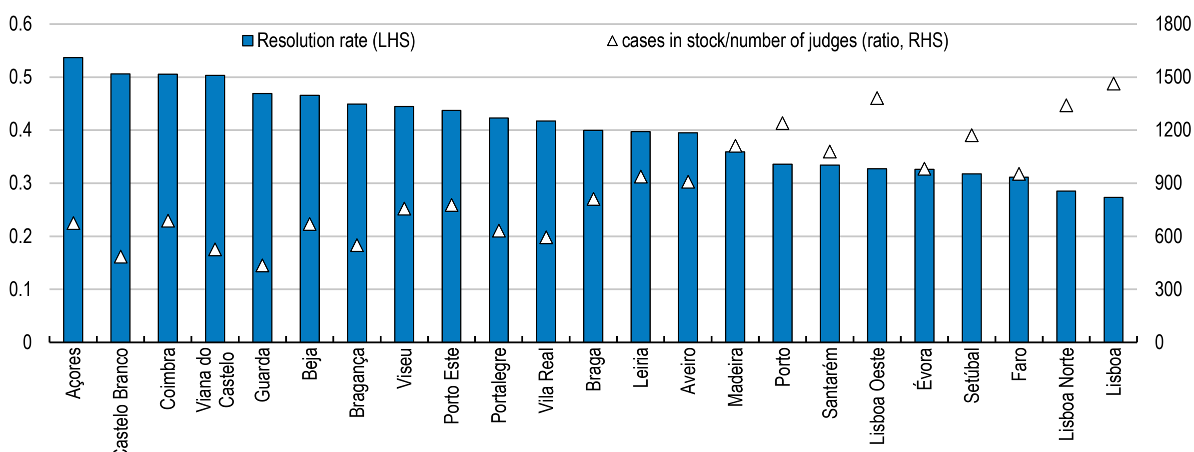
Figure 29. Significant bottlenecks remain in some court districts

Civil cases, 2017



Note: The resolution rate = the number of resolved cases / [the number of pending cases from previous year + the number of incoming cases].
Source: Ministry of Justice and High Council for the Judiciary.

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The efficiency with which the existing resources are allocated is a key factor to explain overall court performance (Palumbo et al., 2013). Inefficiencies can result from problems in workload assessment and a lack of effective management of resources. A significant challenge for judges is to identify which cases should be prioritised in order to alleviate court congestion. A new information system, CITIUS, was introduced in 2007 in order to electronically store all information belonging to a proceeding. When functioning properly, such an information system can be a powerful tool in assessing judges' caseloads. Although CITIUS was unable to identify blockages in judicial proceedings previously, the system has evolved and now includes such features as the detection of cases that have been in the system for several years. These features can serve as early warning devices, which can be more fully utilised to identify problematic cases and those that should be prioritised, so that resources can be allocated accordingly.

The governance structure of courts is a critical element for the allocation of resources. In each court, the Court President, who is a judge that is appointed by the High Council for the Judiciary, is accountable for court performance. The 2014 reform on the organisation of courts created a global managerial model including a Court President in each district court, who supervises court performance. The Court President can propose to the High Council for the Judiciary a reallocation of judges, but this reallocation may be limited by the total number of judges in the system and by the fact that the number of judges in each court district is determined by law, although allowing flexibility. In this context, the courts should be given increased operational autonomy in order to achieve the objectives for which they are responsible.

Further recalibrating the economy for greener growth

Portugal's CO_2 emissions per unit of GDP are below the OECD average (Figure 30, Panel A). However, the country has not made further progress in decoupling emissions from GDP in recent years. Portugal is on course to reach its target, agreed with the European Union, to reduce greenhouse-gas emissions not covered by the EU Emissions Trading System (ETS) by 17% by 2030 relative to 2005 levels. However, further reductions will be needed beyond this point, as net emissions worldwide need to move close to zero on a net basis around 2060.

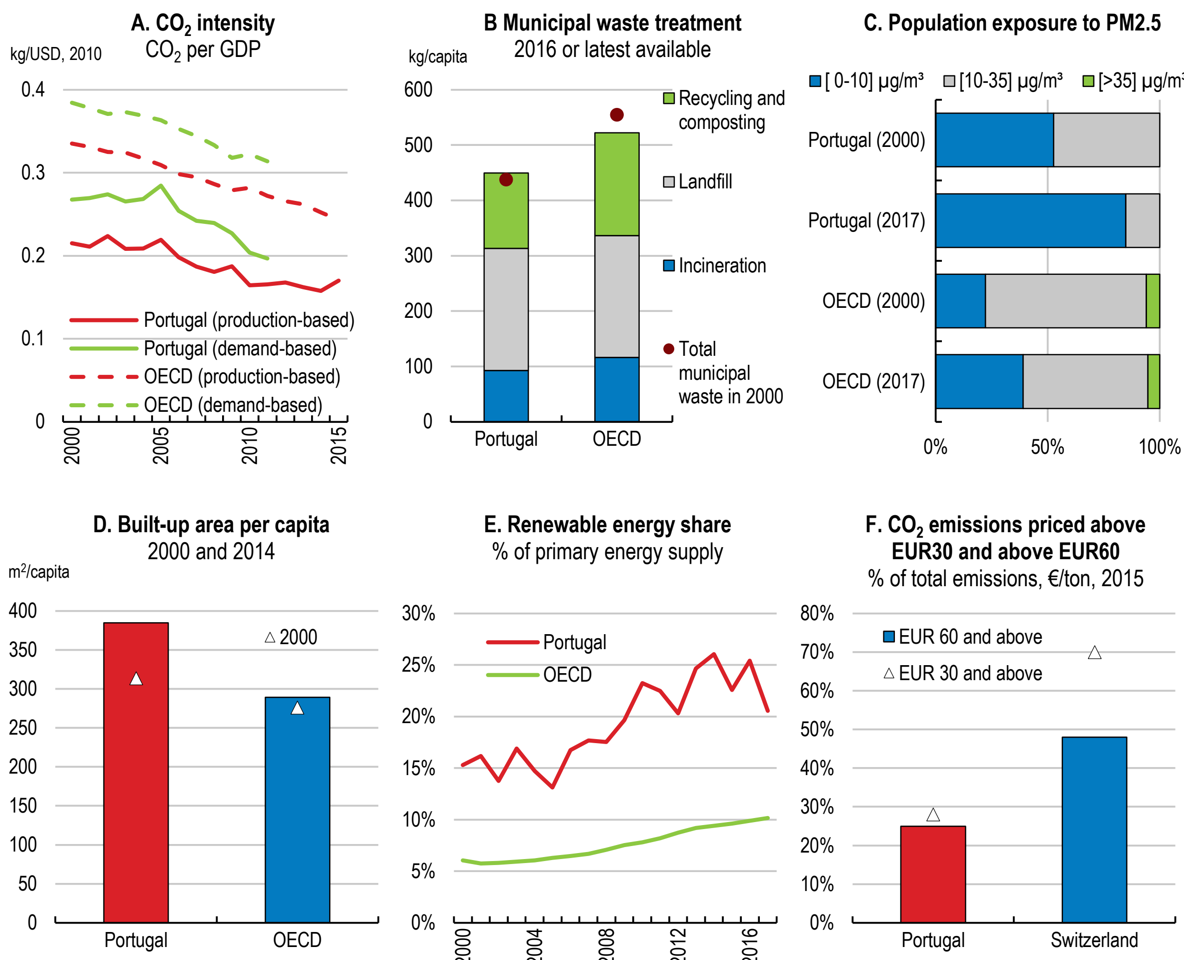
Portugal disposes close to half of its municipal waste through landfill, even though landfill generates environmental costs in terms of water and air pollution. Little waste is recycled, foregoing opportunities for reusing materials and reducing energy cost of materials processing (Figure 30, Panel B). Landfill taxes and fees in Portugal are among the lowest across the EU. Gradually and predictably raising taxes, for example in a way similar to that recently observed in the United Kingdom, will reduce landfill and encourage recycling.

Exposure to small particle emissions in Portugal is lower than in most OECD countries (Figure 30, Panel C). Nevertheless, more than 3500 Portuguese die prematurely as a result of ambient particulate matter per year, with the rate rising since 2010 (Roy and Braathen, 2017). Built-up surfaces per capita have increased markedly since 2000 (Figure 30, Panel D). Urban sprawl, with low-density housing in suburban areas, raises pollution and CO2 emissions substantially, by lengthening urban trips and making it more difficult to meet urban transport demand with public transport. Average population density in Portuguese cities is close to the OECD average but is uneven, with a high share of low-density residential areas (OECD, 2018e). Tourism may also have contributed to rising built-up areas.

Renewable energy sources account for a significant share of energy supply (Figure 30, Panel E) and Portugal is on track to meet the target of 31% of renewables in final energy consumption by 2020. The majority of fossil fuel-based energy is imported. Imports account for over 70% of energy demand, substantially higher than the OECD average. Energy supply from renewable sources increased by almost 70% between 2005 and 2016 and accounted for 55% of electricity generation in 2016 (OECD Green Growth Indicators). The surge has been driven mainly by the expansion of wind energy generation, which increased 14-fold between 2004 and 2015.

The development of renewables in Portugal has been impressive, but the high rate of widespread feed-in tariffs for such technologies has contributed to a significant tariff deficit in the electricity sector. The accumulated tariff debt reached 4.69 billion euros in 2014 (IEA, 2016). While the tariff deficit has decreased since then and the government plans to phase out all feed-in tariffs by 2020, it should ensure that efficient market mechanisms are in place for further sustainable expansion of renewables. Given Portugal's dependence on imports of fossil fuels, further investment in renewable energy not only has the potential to lower GHG emissions but also to improve energy security. Reforming electricity markets to provide high-resolution prices, better allocation of transmission and distribution networks costs, the integration of storage and more inter-connected grid systems favour the cost-effective expansion of renewable energy (IEA, 2016).

Figure 30. Green growth indicators: Portugal



Source: OECD (2018), Green Growth Indicators (database).

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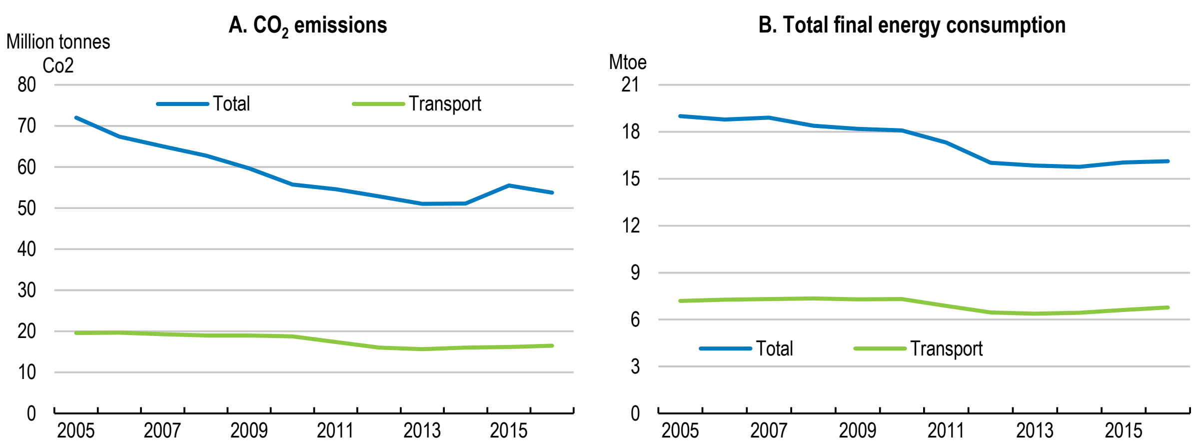
More consistent pricing of energy consumption according to its CO_2 intensity would prepare Portugal for meeting longer-term emission reduction requirements in a cost-effective manner, including by boosting incentives to reduce energy consumption and to produce more renewable energy. It could also raise more tax revenue. Pricing of carbon emissions remains low and uneven. Only 28% of emissions from energy use in Portugal are priced above EUR 30 per tonne (Figure 30, Panel F), the low-end estimate of carbon costs today (OECD, 2018f). Outside the transport sector, emissions are priced at a much lower rate. This partly reflects relatively low ETS prices in these other sectors, but domestic taxation of energy use also remains uneven. In industrial, commercial and residential use, coal and natural gas are taxed less than petrol (OECD, 2018f). As discussed earlier, in transport, diesel is taxed 40% less than petrol.

The transport sector accounts for 42% of Portugal's total final consumption of energy, higher than the EU average, and a third of CO_2 emissions. Both energy consumption and emissions in the transport sector have declined since peaking in 2005, although at a rate much lower than overall energy consumption and CO_2 emissions reductions (Figure 31). Nevertheless, energy and CO_2 intensities have hardly fallen in the last years, in contrast to the downward trend observed among other OECD countries. The Portuguese government has recently introduced a number of initiatives aimed at improving transport efficiency. These measures include a revision of the taxation for private car ownership to encourage low CO_2 emissions vehicles, development of a network of charging stations for electric vehicles and introduction of a Low Emissions Zone in Lisbon which bans high emissions vehicles from entering the inner city centre. Nevertheless, further measures are needed in order to promote greater use of public transport and its efficiency, as Portugal is currently ranked second highest in the EU in terms of the proportion of passenger cars used relative to public modes of transport (Eurostat Statistics).

Figure 31. CO2 emissions and energy consumption from transport have declined relatively slowly



Source: IEA Energy Statistics.

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Efficient collective transport schemes can contribute to lower congestion and emissions. They can also reduce the use of public space for parking. Recent simulations using micro data from Lisbon has highlighted that a shift from private car use to ride-sharing could have substantial benefits for reducing CO2 emissions, freeing up public parking and eliminating congestion (International Transport Forum, 2016). When combined with public transport, ride sharing also has the potential to provide more efficient and environmentally-friendly transport solutions at lower cost. While large-scale introduction of such modal shift would be a long-term project, the government should encourage both public transport use as well as the development of new shared transport solutions accompanied by appropriate supervision and regulations. This would improve efficiencies in the transport sector and reduce its environmental impacts.

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