

Chapter 1

Raising business investment

In the context of a strong recession from which the economy only emerged in 2014, total investment in Portugal has been low, reducing the economy's growth potential. Without stronger investment, growth performance is bound to decline over the next years, but raising investment also matters for wage and productivity developments. Low investment is related to both financing constraints and a lack of competitiveness. Many Portuguese corporates are heavily indebted and are facing strong deleveraging needs, which places strong limits on their capacity to invest, while banks' lending capacity may be curtailed by large amounts of non-performing loans. The regulatory stance could be used to strengthen incentives for banks to resolve long-standing NPLs, in combination with public support for banks' efforts to offload legacy loans from their balance sheets. The costs of doing so could be reduced by improvements in insolvency rules which are vital for the recovery values of collateral. Stronger investment incentives could result from a better business climate, possibly as a result of further efforts to simplify dealing with the licenses, the public administration and the judicial system. Reducing entry restrictions in professional services would be one way to improve access to non-tradable inputs, which affect the competitiveness of Portuguese firms, as would be further efforts to reduce rents in the electricity sector or stronger competition in the ports sector. Implicit barriers to the entry of new firms, which often turn out to invest strongly as they grow, could be reduced through reforms in wage bargaining mechanisms and changes in the support measures for research and development.

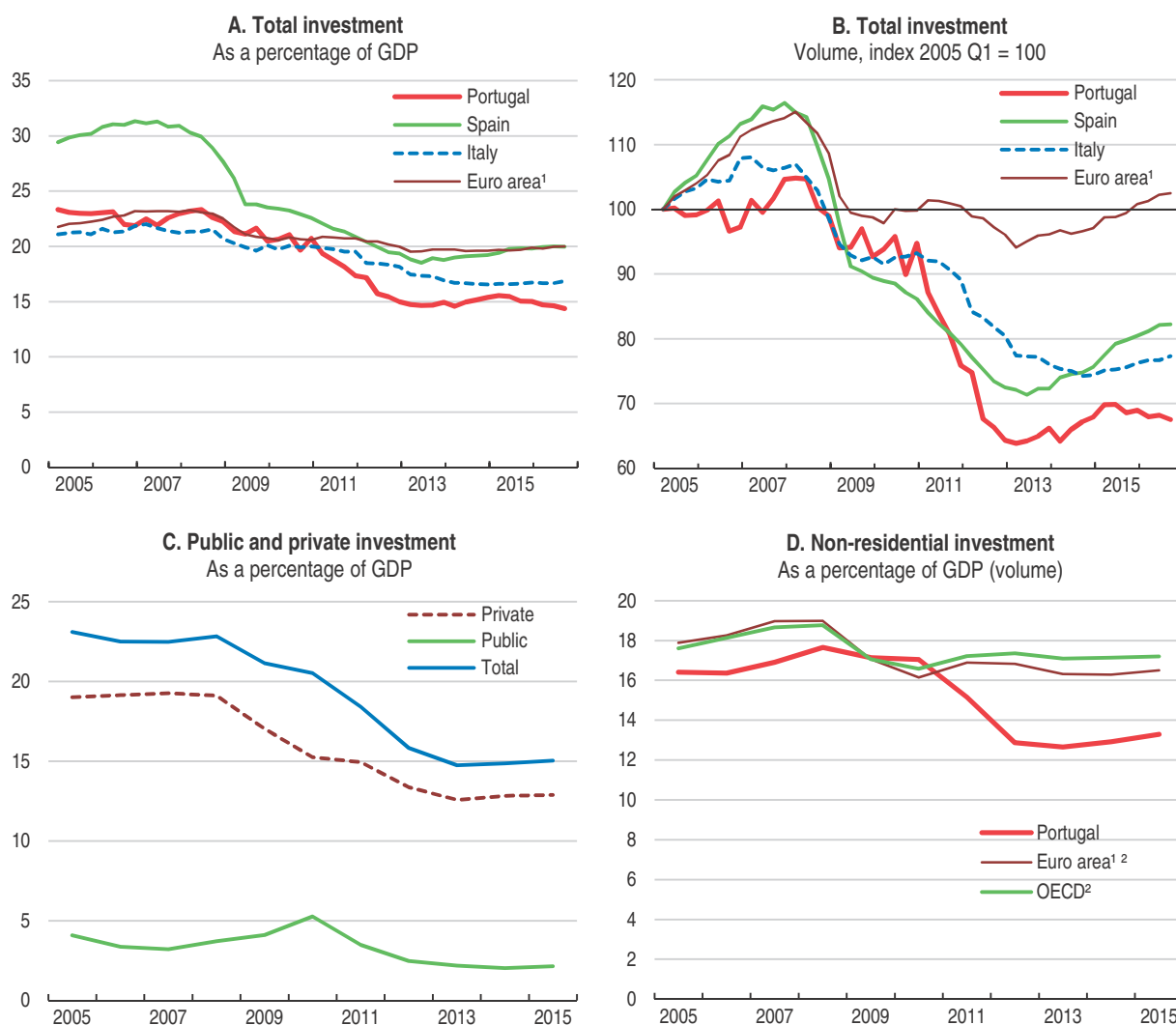
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Investment remains sluggish and concentrated in non-tradable sectors

Investment has come down

In the context of a strong recession from which the economy only emerged in 2014, total investment in Portugal has been low in comparison with other euro area countries (Figure 1.1, Panel A). Starting from a lower middle position among OECD countries in 2008, total investment in Portugal has been low in comparison with other euro area countries (Figure 1.1, Panel A). Starting from a lower middle position among OECD countries in 2008,

Figure 1.1. Investment



1. Euro area countries that are also OECD members (including Latvia).

2. Unweighted averages including Latvia; the OECD aggregate excludes Turkey.

Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database) and INE (2016), "Main Economic Indicators", *National Accounts Tables*, Instituto Nacional de Estatística.

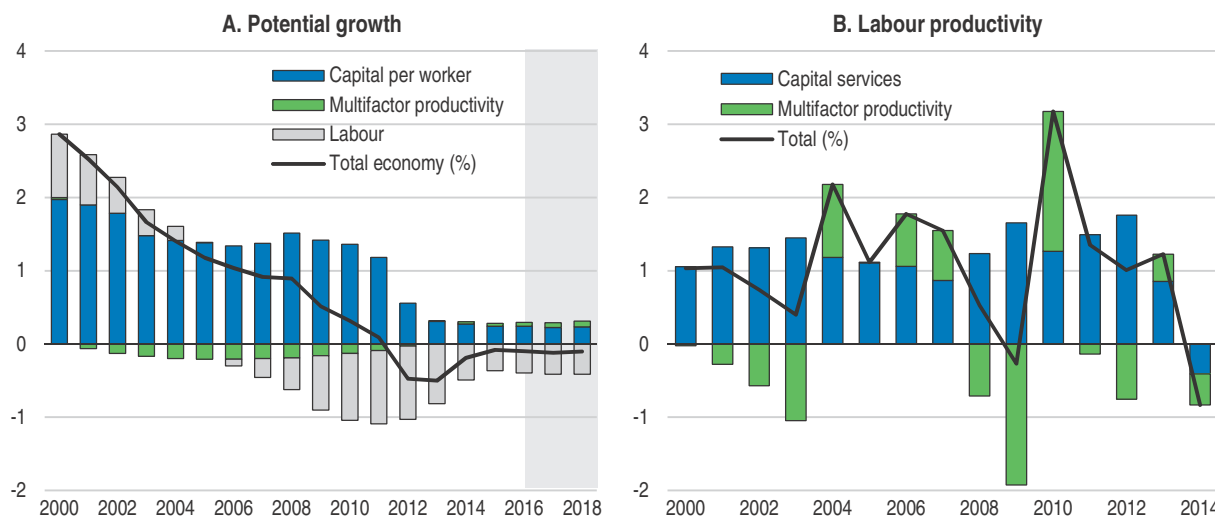
the current low level largely reflects a marked decline starting in 2010, when Portugal's investment rate fell by 5.3 percentage points over the course of five years. This decline was significantly more pronounced than the more moderate decline in investment seen by other euro area or OECD countries. In volume terms, Portugal has had a less pronounced surge in investment since before the crisis than other euro area countries, and following the sharp post-crisis decline, investment is now more than 30% below 2005 (Figure 1.1, Panel B). Private and public investment account for roughly similar shares of this decline, falling from 15.3% and 5.3% of GDP in 2010, respectively, to 13% and 2.3% in 2015 (Figure 1.1, Panel C).

Non-residential investment, which at 13.6% is the fourth-lowest in the OECD, has experienced similar declines as overall investment, with a marked decline starting in 2010. However, non-residential investment has recovered somewhat in 2014 and 2015 (Figure 1.1, Panel D). Turning this around and rebuilding the capital stock is one of the key challenges for the economy.


The recent low investment levels have reduced the economy's growth potential, which measures how fast GDP can grow over a longer horizon, when both labour and capital are fully employed (Figure 1.2, Panel A). Since 2012, investment has hardly exceeded the depreciation of the existing capital stock, meaning that growth of the productive capital stock has almost stalled. This comes in addition to declining labour inputs, which are the result of demographic changes, low labour participation and low employment. These declining factor inputs explain the low potential growth rate of the Portuguese economy, which OECD estimates currently put below 0.5%. Without stronger investment, growth performance is bound to decline to such low levels over the next years.

Figure 1.2. **Low investment has curbed potential growth and labour productivity**

Decomposition of potential growth and labour productivity, percentage points



Source: OECD (2016), "GDP per capita and productivity growth", OECD Productivity Statistics (database) and calculations based on OECD Economic Outlook: Statistics and Projections (database).

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Raising investment also matters for wage and productivity developments. Low investment limits the growth of labour productivity, which represents the wage increases that Portuguese workers can pocket without deteriorating the competitiveness of Portuguese companies. In fact, the contribution of the capital stock to labour productivity growth has declined over the last few years (Figure 1.2, Panel B). Investment raises productivity directly, by increasing the capital stock that each worker has at her/his disposal, but also indirectly, as technological progress embedded in new capital goods often allows improvements in the use of other resources or a better organisation of production processes, which is often referred to as multi-factor productivity.

Continued progress on the rebalancing of the economy will require an investment boost

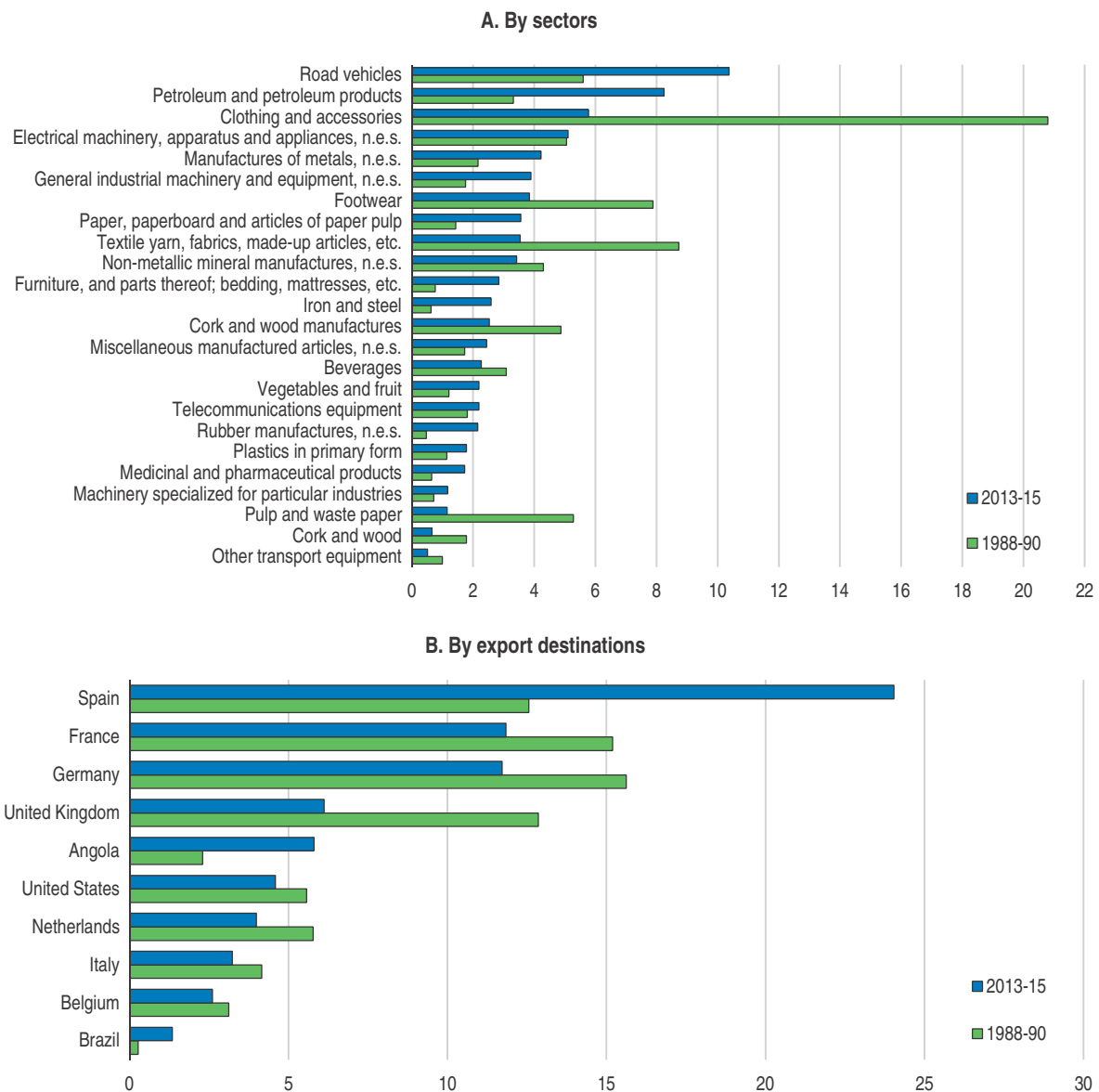
Investment is also needed to support the substantial structural change that the Portuguese economy is undergoing. After many years of credit-fuelled expansion of the non-tradable sector that led to a massive misallocation of resources and declining export performance, there have been encouraging signs of a reversal towards tradable sectors in recent years (Reis, 2015).

Since 2011, exports have increased significantly, both in volumes and relative to GDP. Portugal now exports over 40% of GDP, up from 27% in 2005. Improvements in the competitiveness of Portuguese exporters have underpinned this improvement in export performance, but price competitiveness has not been the only driver of export growth. In fact, non-price factors such as innovation and product differentiation have become increasingly important for explaining the success of Portuguese exporters, particularly in high-value added goods (Bank of Portugal, 2016). This may be an indication that the improvement in exports is of a structural nature. Further reasons to assume that strong exports are here to stay include the diversification of exports across sectors observed in recent years (Figure 1.3) and the fact that a larger number of firms now export, a process that has started even before the crisis. A remarkable 16% of goods' exports originated from young exporters in 2014, reflecting a restructuring process of exporting sectors (Bank of Portugal, 2016).

For this process to continue, however, it is important that new firms get access to finance for their investment needs and that the overall framework conditions are conducive to their entry and growth. Indeed, there is some evidence that the rise of new firms among exporters is losing momentum (Bank of Portugal, 2016). This underlines the need for further improvements in policies.

More broadly, investment will be key for building on the recent export success. A more substantial expansion of tradable activities will not be possible without large investment in these sectors, particularly given the depletion of existing capital stocks after years of low investment. Without stronger investment in export sectors, it will be difficult to support further structural rebalancing towards tradable sectors, which is one of the objectives of Portugal's National Reform Programme.


Currently, around 22% of non-residential investment takes place in the manufacturing sector, significantly more than the 16% before the crisis (Figure 1.4). The three service sectors that include significant shares of tradable activities – wholesale and resale trade, information and communications services and accommodation and food services – together account for 30% of total gross fixed capital formation. Still, around half of

Figure 1.3. **Portugal's merchandise exports by sectors and destinations**Share of total merchandise exports, per cent¹

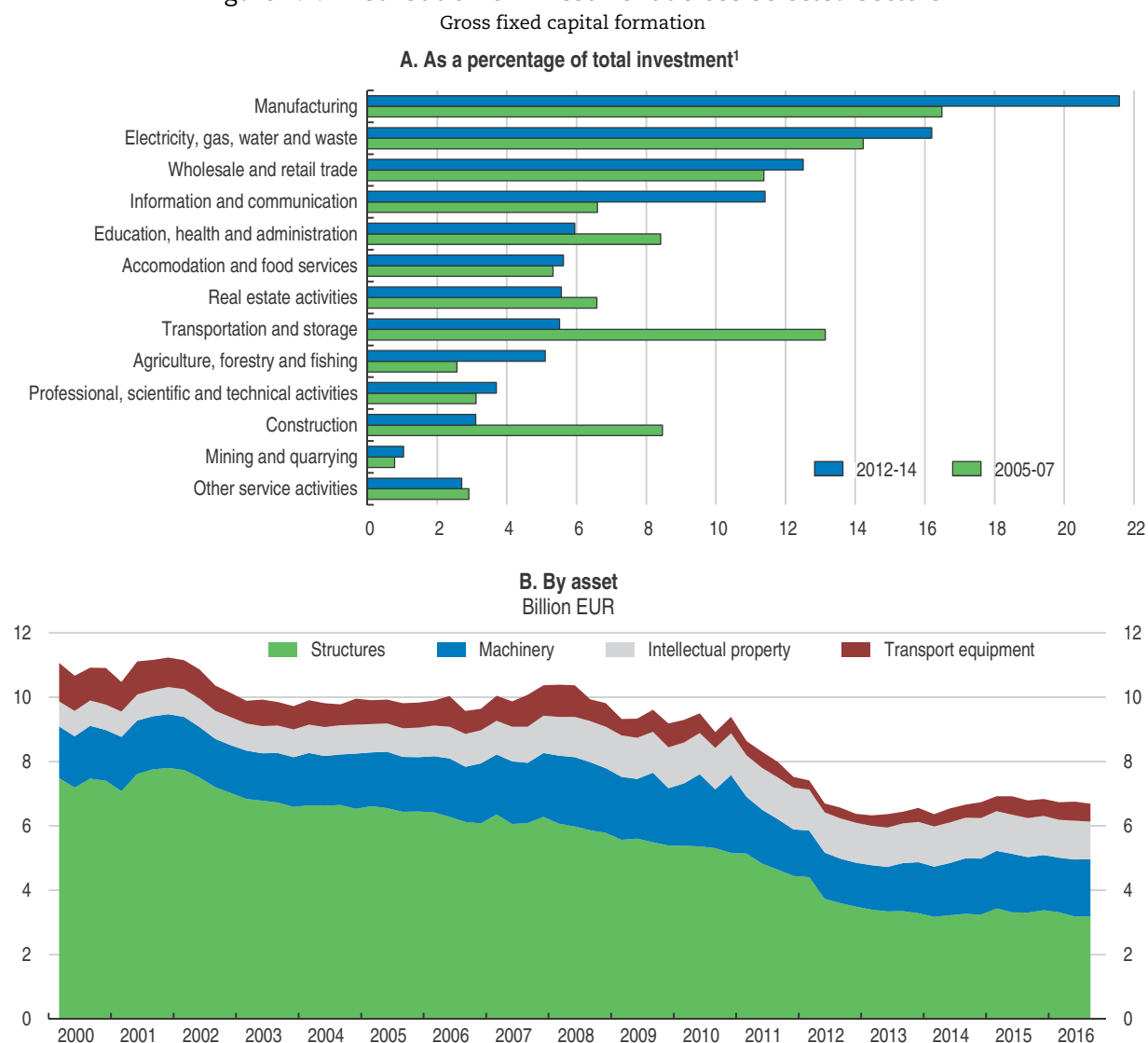
n.e.s.: Not elsewhere specified.

1. Average of observation periods (i.e. 1988-90 and 2013-15).

Source: UN Comtrade Database.


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Portugal's gross fixed capital formation is taking place in sectors with largely non-tradable activities, down from 64% before the crisis. Approximately half of gross fixed capital formation is spent on structures and buildings, while machinery and transport equipment, whose share has been rising since 2012, account for slightly less than a third (Figure 1.4, Panel B). Investment in machinery and equipment has fallen short of scrapped capital since mid-2015.

Figure 1.4. **Distribution of investment across selected sectors**

1. Average over the period.

Source: INE (2016), "Gross fixed capital formation of enterprises by economic activity and legal form" and "National Accounts" tables, Instituto Nacional de Estatística.

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Investment in knowledge-based capital is crucial for technological upgrading and competitiveness

Investment in knowledge-based capital (KBC, see Box 1.1) has risen more strongly than investment in physical capital in several OECD economies (Andrews and Criscuolo, 2013). In contrast, it is comparatively low in Portugal (Figure 1.5). Spending is low both on the traditional ICT-related assets like software or databases and on other KBC assets such as organisational capital and training. KBC is an important determinant of long-term productivity growth. It has been estimated to account for one-fifth to one-third of labour productivity growth in the market sector of the US and EU economies (Andrews and Criscuolo, 2013; Corrado et al., 2013; Roth and Thum, 2013). Investments in knowledge capital also contribute to better innovation outcomes. For example, manufacturing firms

Box 1.1. Knowledge-based capital: Definition and measurement

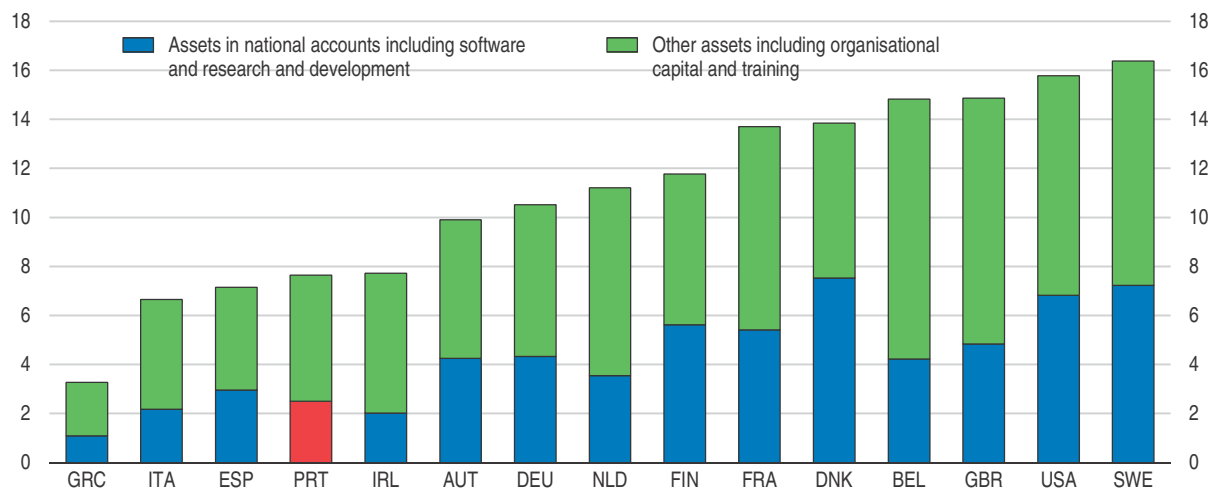
Knowledge-based capital (KBC) encompasses all assets that lack physical substance but, like physical capital, generates economic benefits that can be retained by firms at least to some extent, for a period that exceed one year (OECD, Science, Technology and Industry Scoreboard 2015). KBC is usually understood to contain three main components (Corrado et al., 2009):

- Computerised information including software. This is regularly recorded as part of gross fixed capital formation in national accounts.
- Innovative property comprises research and development (R&D), mineral exploration and artistic originals, new architectural and engineering designs and new product development in financial services.
- Economic competencies, which comprise firms' human and structural resources such as firm-specific training, brand equity, and organisational capital.

While R&D and software are included in the national accounts definition of investment, other components like investment in design, new financial products, advertising, market research, training and organizational capital are not.


Figure 1.5. Investment in knowledge-based capital

Knowledge-based capital (KBC) assets as a percentage of business sector gross value added, 2013¹



1. Investment in KBC can be subdivided into three main groups: computerised information (e.g. software and databases); innovative property (e.g. scientific and non-scientific research and development, copyrights, designs and trademarks); and economic competencies (including brand equity, aspects of advertising and marketing, firm-specific human capital, and organisational know-how and capabilities).

Source: OECD (2015), OECD Science, Technology and Industry Scoreboard 2015: Innovation for Growth and Society.

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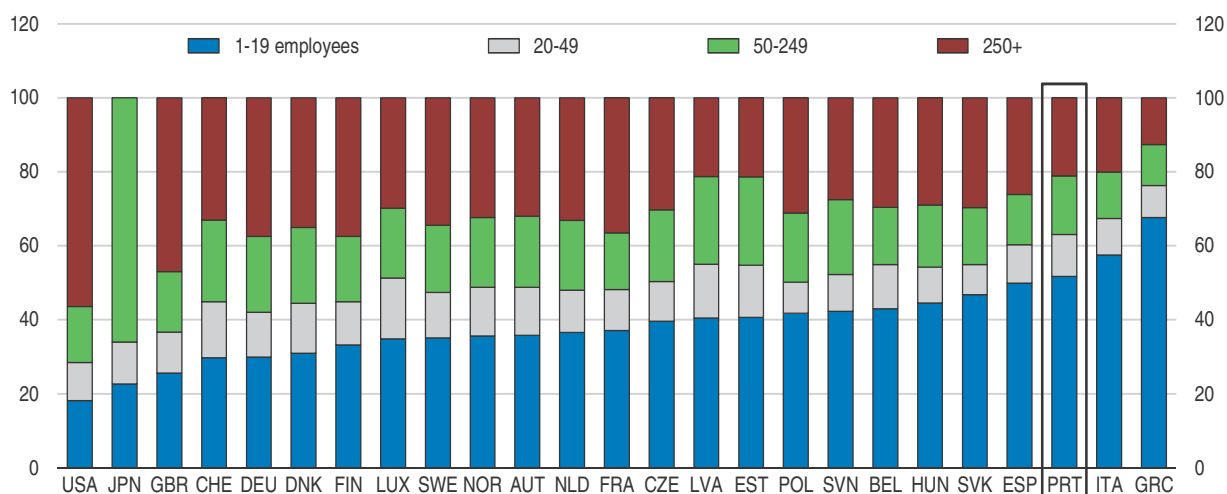
that exhibit a higher level of software investment generate more patents for a given level of R&D expenditure, and their investment in R&D is more highly valued by equity markets (Branstetter et al., 2015). Investment in several KBC components, notably business processes or organizational structure, are particularly important sources of productivity growth in many services (Dabla-Norris et al., 2015; Goodrich et al., 2016).

The firm size distribution is skewed toward small enterprises

A salient feature of Portugal's economy is that industry structures are heavily skewed towards small firms (Figure 1.6). While other countries also have a majority of small firms, the decade-long downward shift in the firm size distribution that Portugal has experienced is unparalleled among other advanced industrial economies for which data is available (Braguinsky et al., 2011). Even after accounting for changes in data coverage and the structural shift towards non-tradable sectors in the run-up to the crisis, much of the "shrinking" of the average Portuguese firm remains unexplained (Braguinsky et al., 2011). This size distribution poses particular challenges for investment, as larger firms often struggle less than small firms with crucial determinants of investment such as access to international markets or to finance.


Figure 1.6. **Employment by enterprise size class**

Total business economy, per cent, 2012¹



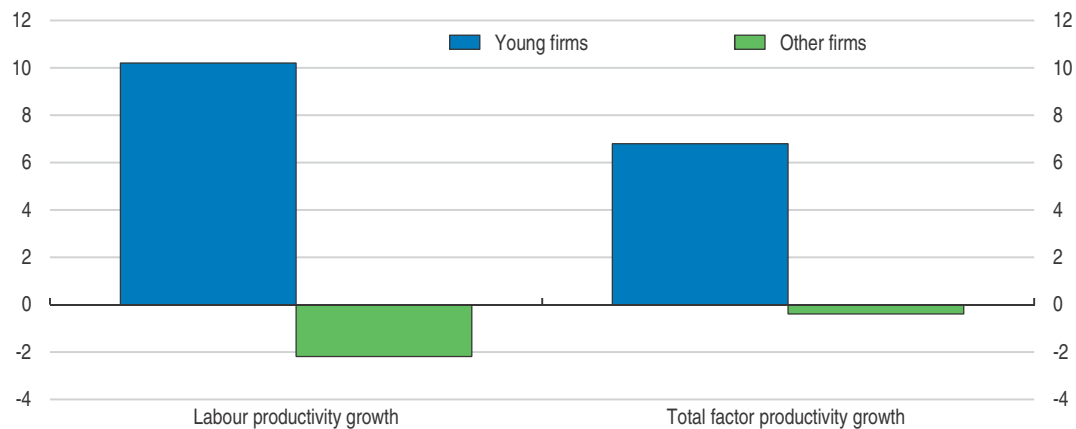
1. Data cover 2011 for Ireland, Israel and Turkey; 2013 for Korea and New Zealand. The size class "50-249" refers to "50+" for Japan. For further details of data coverage see Chapter 2, Figure 2.5 in the source publication.

Source: OECD (2015), *Entrepreneurship at a Glance 2015*.

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With less scope for exploiting economies of scale, small firms often have lower productivity, with the exception of dynamic startups that begin small, before growing rapidly (Criscuolo et al., 2014; Altomonte et al., 2012). Firm-level analysis from a census of Portuguese firms suggests that new market entrants have stronger productivity growth than more mature firms, both with respect to labour productivity and MFP (Figure 1.7). They also create three times more jobs than other firms and account for almost half the jobs created (Criscuolo et al., 2014). In 2013, firms aged 5 or less accounted for 26% of gross fixed capital formation.

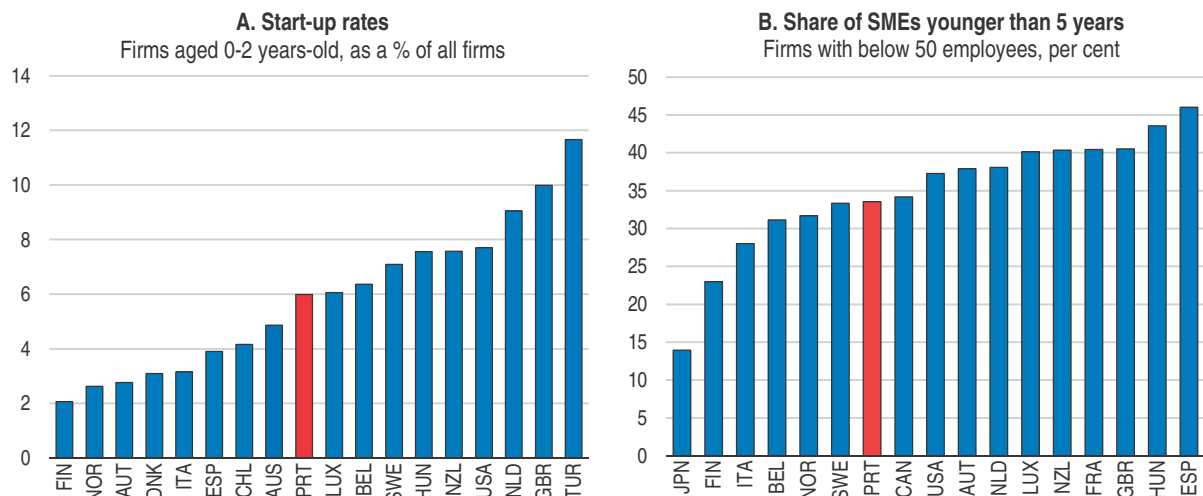
Portugal has fewer young firms (aged 0-2) than other countries, and a large share of Portugal's small firms are mature and not start-ups (Figure 1.8, Panel A). Resources for new entry and growth can only become available if there is firm exit at the same time. Only 30% of small firms are younger than 5 years old, and almost half of Portuguese small firms are more than 10 years old (Figure 1.8, Panel B). In contrast to recent market entrants, these firms are generally net job destroyers and have weak productivity growth (OECD, 2015a; Criscuolo et al., 2014). Larger shares of mature small firms often go along with lower productivity growth (Figure 1.7, OECD, 2015a).

Figure 1.7. **Young firms experience faster productivity growth**Average annual productivity growth, per cent, 2006-11¹

1. Young firms are defined as those aged five years-old or less.

Source: OECD calculations based on data from Integrated System of Business Accounts (Sistema Integrado de Contas, SCIE).

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Figure 1.8. **Start-up rates are low and a large share of SMEs are mature**Average 2009-13¹

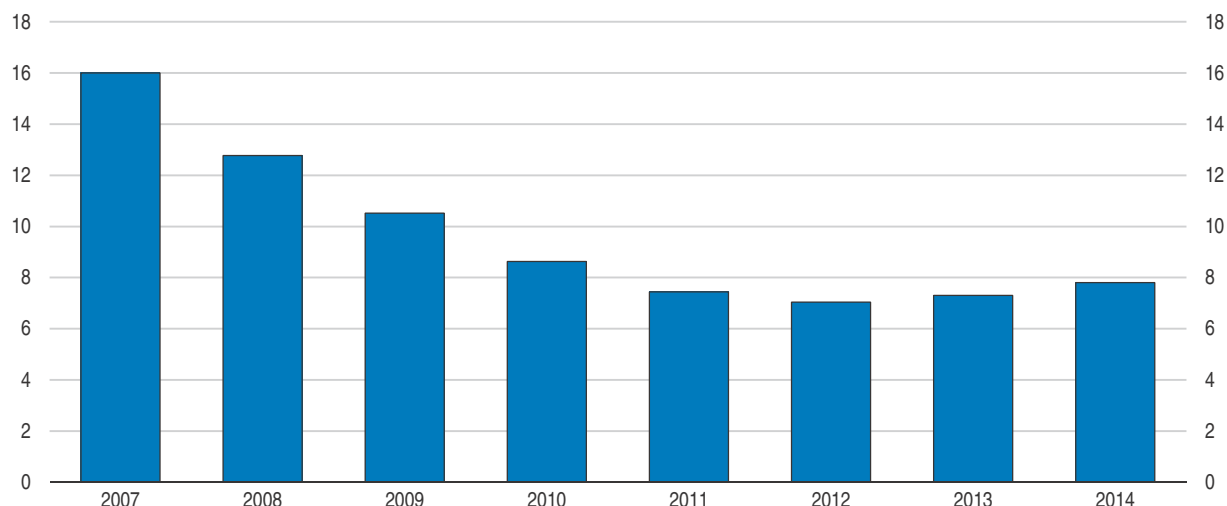
1. Entry rates calculated as number of entrants with positive employment over total number of units with positive employment. Figures report averages for the period 2009-13 conditional on availability. Owing to methodological differences, figures may deviate from officially published national statistics.

Source: OECD DynEmp v.2 Database; C. Criscuolo et al. (2014), "The Dynamics of Employment Growth: New Evidence from 18 Countries", OECD Science, Technology and Industry Policy Papers, No. 14.

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The economic impact of these misallocations may be sizeable. Dias et al. (2016) estimate that misallocated labour and capital shaved off 1.3 percentage points of annual GDP growth during 1996-2011. In other words, if capital misallocation had not worsened over the last two decades, Portugal's productivity growth would have been much closer to the best performers in the OECD. Capital misallocation is reflected in a declining ability of more productive firms to attract capital and grow. From 2007 through to 2014 the positive difference in the amount of capital going to high and low productivity firms halved, correlating with the decline in MFP at an aggregate level. Figure 1.9 shows the extent to

Figure 1.9. The allocation of capital has deteriorated over time
Investment differential between high-productivity and low-productivity firms



Note: The chart shows the sensitivity of firm capital growth to the lagged level of MFP, based on an OLS production function estimates. The estimates are based on a firm level regression of the growth in the real capital stock on the lagged deviation of firm MFP from its industry-year average (MFPT-1), interacted with time trends (trend and trend-squared). The regression also controls for firm age, firm size classes, industry and year fixed effects. The analysis is based on a sample of around 85000 continuing firms in the non-farm business sector (i.e. NACE Rev. 2 10-83, excluding 64-66.).

Source: OECD calculations.

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which capital investment is undertaken by high productivity firms relative to low productivity firms. Over time, this differential has fallen, which suggests that capital reallocation has become less productivity-enhancing over time. However, there is a slight rebound in this measure in the last two years.

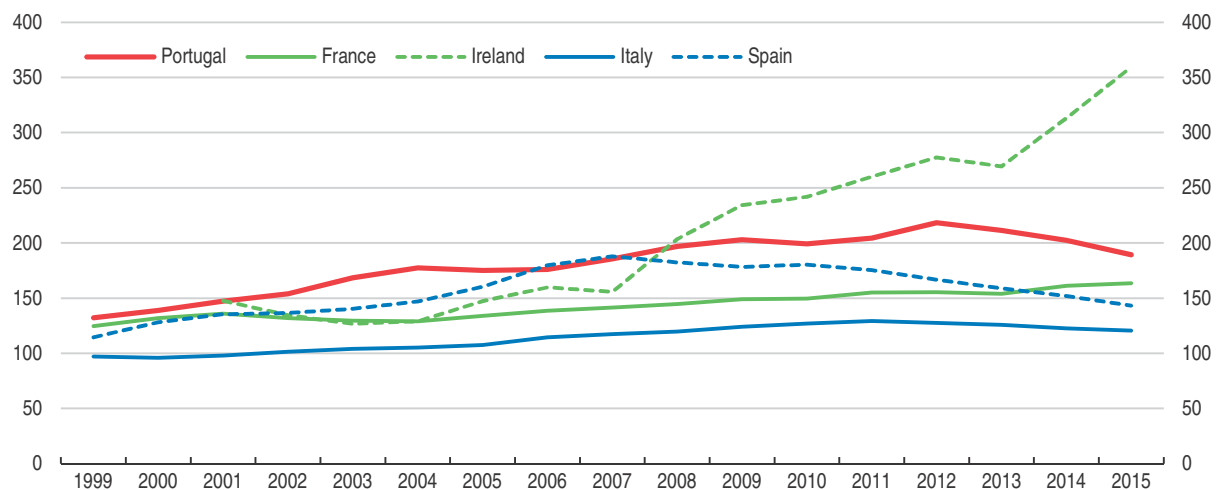
The remainder of this chapter will discuss possible explanations for Portugal's sluggish investment performance, and possible policy reforms that could address them. The next section will focus on financing constraints, i.e. cases where firms would want to invest but are facing difficulties in financing these projects. The section discusses the corporate indebtedness and banks' asset quality, but also the role of well-functioning insolvency mechanisms and of tax incentives for corporate financing. The following section will discuss ways to increase expected returns on investment through policies that can raise the competitiveness of companies operating in Portugal and avoid creating implicit barriers to entry or post-entry growth.

Addressing financing constraints

High corporate debt and weak legacy assets are weighing on financial conditions


Many Portuguese corporates are heavily indebted and are facing strong deleveraging needs, which place strong limits on their capacity to invest. On average, non-financial corporates face a debt load of 145% of GDP using the definition of the Bank of Portugal or 198% using the national accounts definition, which also includes insurance, pension, and standardised guarantees. On the latter definition, the debt load of Portuguese corporates is the fourth highest in the OECD (Figure 1.10). Since a peak in 2012, corporate indebtedness has come down by 17 percentage points of GDP, to a large extent as a result of the exit of highly indebted firms rather than deleveraging of existing firms (Bank of Portugal, 2015).

Figure 1.10. **Corporate non-financial sector debt¹**
As a percentage of GDP



1. Debt is calculated as the sum of the following liability categories, whenever available/applicable: special drawing rights; currency and deposits; debt securities; loans; insurance, pension, and standardised guarantees; and other accounts payable.

Source: OECD (2016), "Financial Dashboard", OECD National Accounts Statistics (database).

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These average numbers mask strong differences across firms. While some firms have manageable debt levels, there are still many firms whose high debt load puts their long-term viability into question and which have no scope for investing at all. In 2014, the last year for which firm-level census data are available, 30% of Portuguese firms spent 100% of their cash flow on servicing their financial obligations while 21% had debt exceeding 100% of their annual gross value added. Many of these firms are in non-tradable sectors such as utilities, construction, transport, financial, real estate and professional services. In some of these, demand has been declining as the economy began to shift towards tradable activities, making it even harder to generate sufficient returns to pay off loans.

For many legacy firms with extremely high debt levels, exit is likely to be inevitable. Delayed recognition of financial distress among legacy firms will only hold back the economy's adjustment process and can curtail the growth prospects for high-potential firms, who need financial resources to invest and human resources to grow. Empirical research shows that excessive frictions on the exit margin can harm the entry of new firms and the growth of viable firms (Adalet McGowan et al., 2017; Andrews and Cingano, 2014). One mechanism through which this collateral damage can occur is that new firm entry without exit will bid up factor (i.e. labour and capital) prices rather than absorbing the resources freed by exiting firms, which raises production costs. Empirical evidence suggests that Portugal had almost 15% of total capital sunk in mature but financially weak firms in 2013 and estimates suggest that reducing this share would be associated with significant improvements in investment and employment in the remaining firms (Adalet McGowan et al., 2017).

For those firms that have scope for investing, financing these investments is or may become a major challenge. Business investment can be financed either from internal sources, i.e. retained cash profits, or through financing that is external to the firm. The scope for internal financing has diminished in recent years, as the average profitability of non-financial companies, measured as EBITDA relative to turnover, has declined from nearly 12% in 2010 to below 9% over the period 2011-14. Again, there are stark differences across firms. Firm-level census data suggest that median profitability is significantly higher for less

indebted firms than for highly indebted firms. Comparing firms with debt of less than 50% of gross value added with those exceeding 100% of gross value added, this difference is almost 5 percentage points on average, or 2 percentage points when comparing medians.

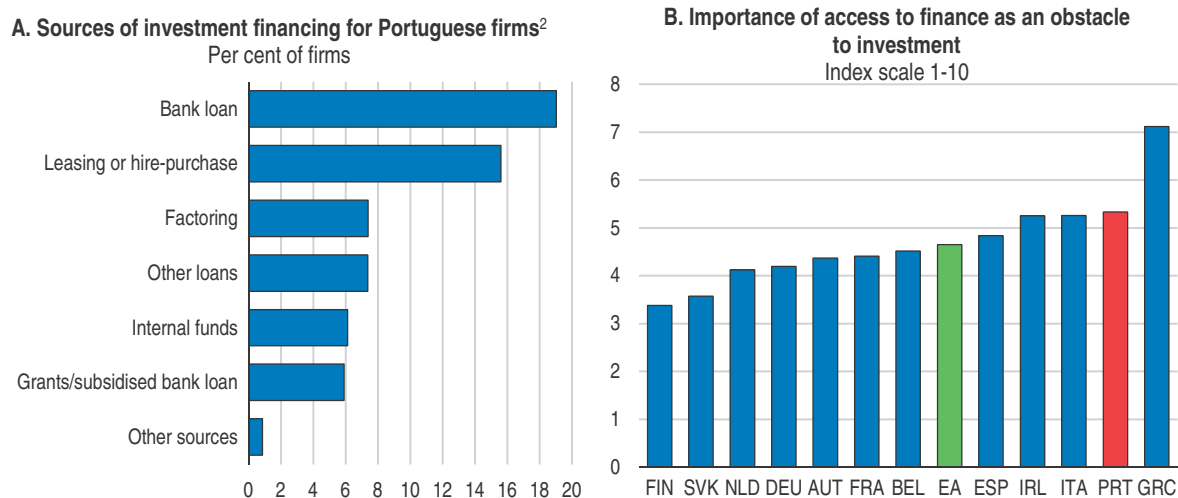
The conditions for firms to obtain financing from external sources have also become more difficult. Bank loans are the principal external source of investment financing for all but the largest Portuguese enterprises (Figure 1.11, Panel A). Credit to non-financial corporations continues to contract, mainly due to the construction sector, although at a decreasing rate (Figure 1.12, Panel A). Loans to exporting firms are growing. To some extent, this is mirroring euro area-wide developments, although in France, Germany and Italy, credit growth has already turned positive. The ongoing credit contraction is also reflected in the perceptions of Portuguese SMEs. In a recent survey by the European Central Bank on SME financing, Portuguese respondents had the second highest incidence of mentioning access to finance as an obstacle, higher than the euro area average (Figure 1.12, Panel B). To some extent, the credit contraction may also reflect subdued credit demand.

Credit is not only scarce but also expensive. When asked about the principal limiting factor to get external financing, the first response by Portuguese SMEs is the high interest rate (ECB, 2015). Portuguese companies are facing the second-highest interest rates in the euro area. Compared to Spanish firms that finance an investment project through a bank loan, for example, Portuguese companies have to achieve more than 100 basis points higher returns on investment to break even, although these spreads have now returned to pre-crisis levels.

The tight credit conditions for those firms that have the potential to invest are closely related to the excess indebtedness of other companies, with the link being the domestic banking sector. Banks' deleveraging needs and the high interest rates they charge on loans reflect their own challenges, principally weak assets and high funding costs, which have led to sharp declines in bank profitability, exacerbated by low economic growth. Non-performing loans (NPLs) make up 12% of the total gross loans of Portuguese banks. This is more than in other euro area countries except Greece, Italy and Ireland (Figure 1.13,

Figure 1.11. **The most pressing issues and the perceived importance of access to finance**

Small and medium-sized enterprises, first semester of 2016¹



1. Responses to questions are weighted percentages in Panel A and weighted averages in Panel B.

2. "Internal funds" covers retained earnings or sale of assets. "Other sources" covers debt securities issued and equity investment in the firm.
Source: ECB (2016), "Survey on the access to finance of enterprises (SAFE)", Statistical Data Warehouse, European Central Bank.


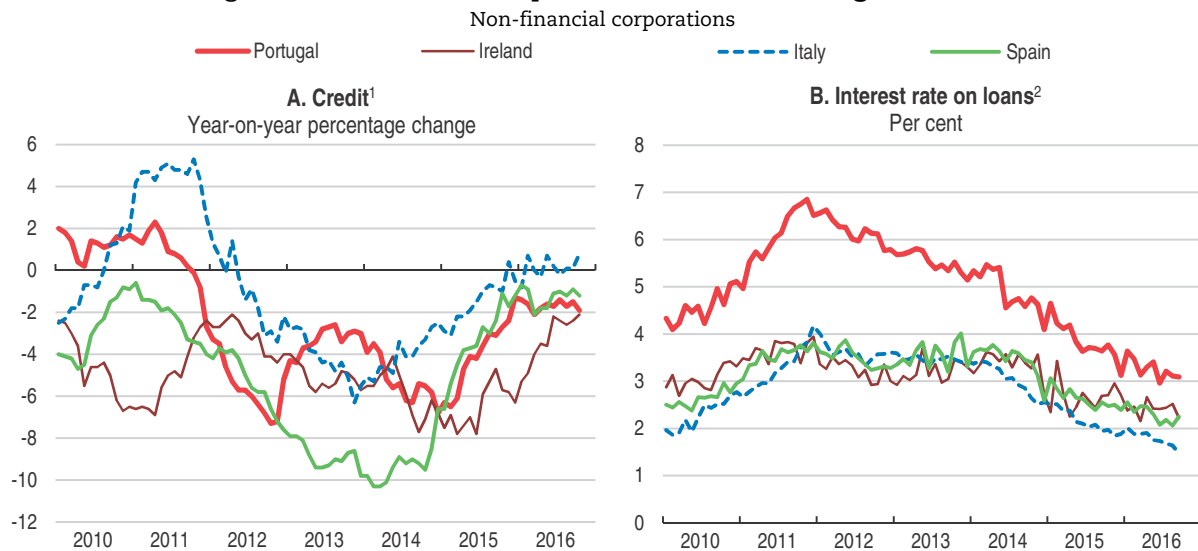
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Figure 1.12. **Credit developments and financial fragmentation**

1. Loans adjusted for sales and securitisation.

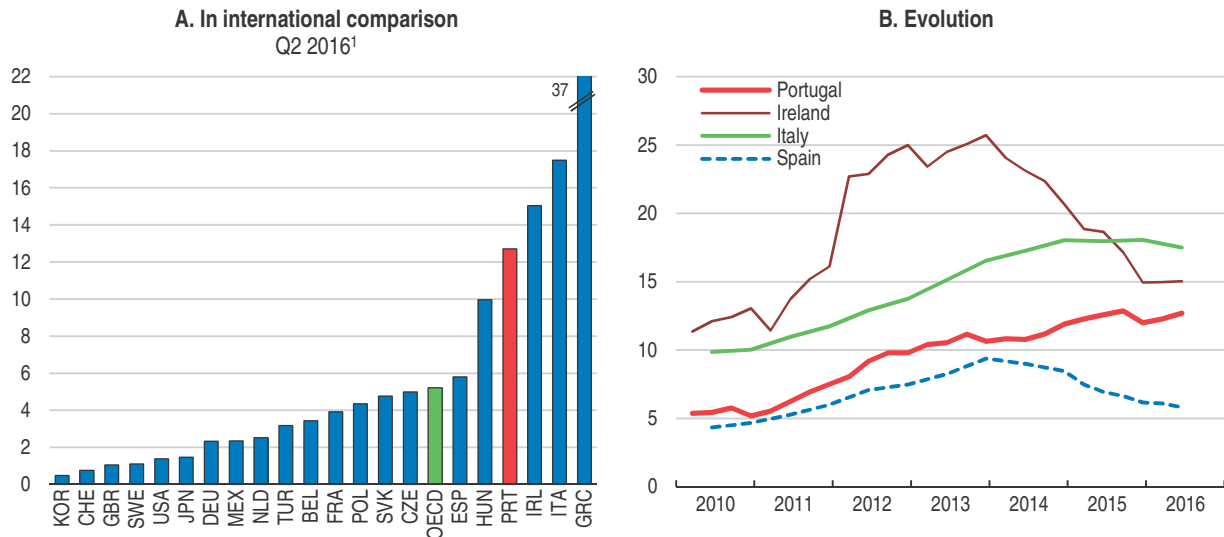
2. Interest rates on new business loans other than revolving loans and overdrafts, convenience and extended credit card debt.

Source: ECB (2016), "Balance sheet items" and "MFI interest rate statistics", Statistical Data Warehouse, European Central Bank.

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Figure 1.13. **Non-performing loans (NPLs)**

As a percentage of total gross loans



1. Latest data available at end of period: Q1 for Japan, the United Kingdom and Turkey, Q4 2015 for Switzerland; 2014 for Germany and Korea. The OECD aggregate is an unweighted average of the latest data available for OECD countries including Latvia.

Source: IMF (2016), *Financial Soundness Indicators (FSI Database)*, International Monetary Fund.

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Panel A). NPL ratios have begun to stabilise as of 2016, similar to developments in other European countries (Figure 1.13, Panel B). Some banks are more affected than others, with one major bank having almost 23% of NPLs while two major banks have less than 5%. Among corporate loans, 19.7% are non-performing, a large part of which for more than 3 years. NPLs amount to over 30% of banks' capital after accounting for provisions, which

implies potentially significant recapitalisation needs in case the value of collateral turns out smaller than expected. Solving the challenges related to NPLs rapidly is a key issue for Portugal and requires a comprehensive approach.

When NPLs are not recognised and kept on balance sheets without provisioning, the income streams they generate typically fall short of other loans, particularly when loan conditions are adapted in order to avoid formal defaults through evergreening. When NPLs are recognised, they are subject to the higher risk weights on impaired assets and therefore crowd out substantial lending volumes for other companies (Aiyar et al., 2015). Doubtful loans also imply significant vulnerabilities for banks, which may make them less willing to lend. If there are many loans more or less close to a threshold where they would become non-performing, trigger events may move significant parts of the loan portfolio above that threshold, so that recognising them as non-performing would become inevitable. This could potentially lead to large provisioning needs or write-offs at the same time. This may be one of the reasons why banks with weak assets often eschew risks and are more reluctant to lend to new firms that are risky but have potentially high returns (Diwan and Rodrik, 1992).

Existing empirical evidence suggests a negative correlation between investment and the stock of non-performing loans (EC, 2015). Bank-level evidence from euro area banks finds that banks with high NPL ratios tend to have lower interest incomes, capital ratios, higher funding costs and lower lending growth (Aiyar et al., 2015). Estimates suggest that the amount of new lending capacity resulting from a reduction of NPL could be in excess of 8% of GDP (Aiyar et al., 2015).

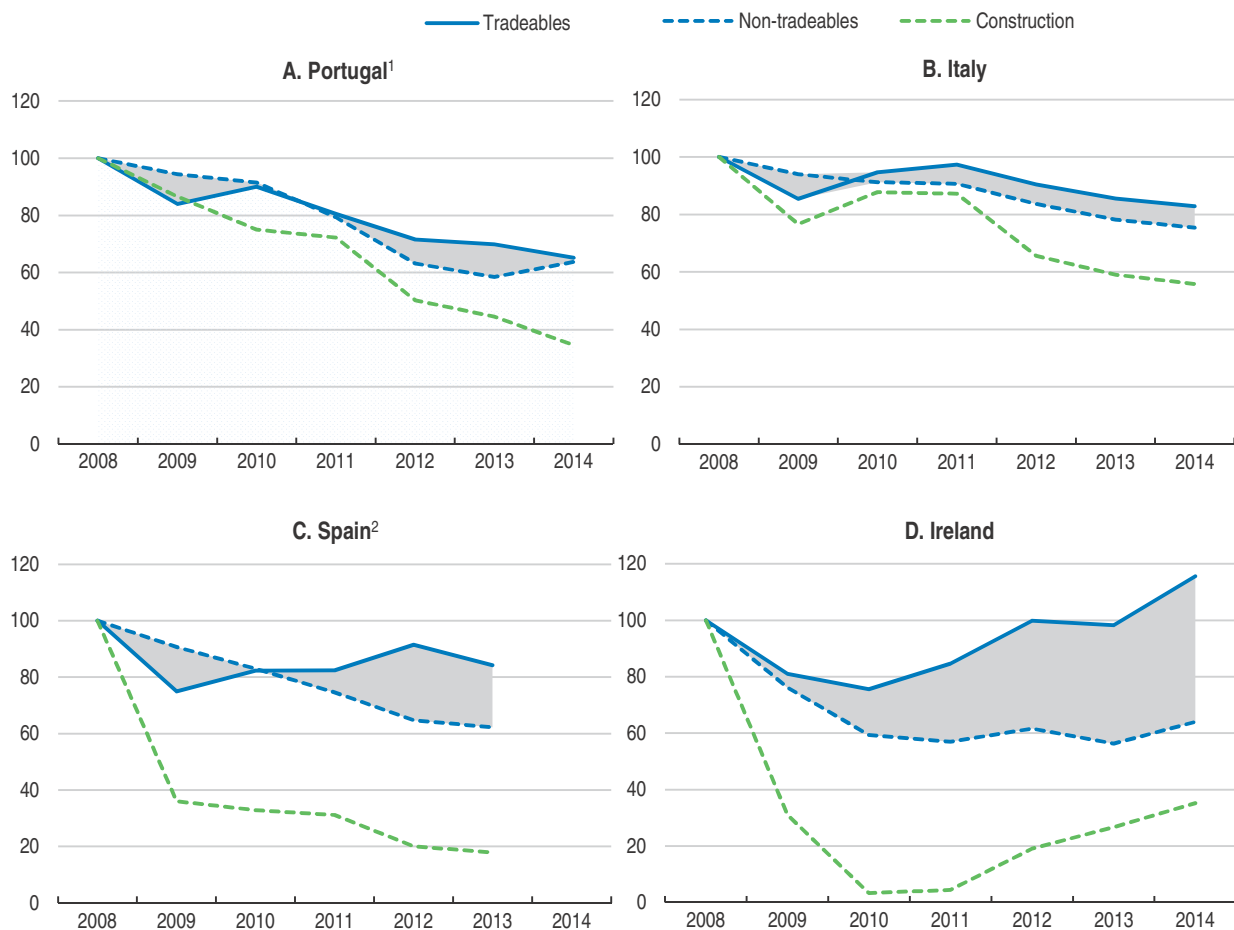
High NPL ratios also act as an obstacle in strongly needed adjustment processes in the economy. When financial resources are tied up with firms in declining sectors, most notably non-tradable sectors, this reduces the credit available that rising firms in tradable activities need to grow. Evidence from four euro area countries that accumulated current account deficits before the crisis – just like Portugal – suggests that countries where NPL ratios have started to decline as of 2014, i.e. Ireland and Spain, both of which had external assistance programmes that financed national strategies to clean up of bank balance sheets, have been more successful in redirecting investment from non-tradable to tradable activities than those, where NPL ratios continue to rise, notably Portugal and Italy (Figure 1.14).

More pro-active policies for dealing with NPLs could boost corporate investment

Portuguese banks have been facing challenging times since the outbreak of the financial crisis. On the other hand, regulatory requirements and stress tests have become more stringent, which resulted in the need for several Portuguese banks to raise more capital. In this context, banks face incentives to delay the recognition of loan losses within the limits set by current regulation. Renewing outstanding legacy loans at favourable terms even if the debtors' payback potential is low is one way to delay loan loss recognition, as opposed to recognising such loans as non-performing. Unlike Ireland and Spain, Portugal has not taken measures for a systematic clean-up of bank balance sheets, like the creation of a special vehicle to absorb legacy assets, preferring instead a more moderate case by case approach. Fiscal space in the context of high public debt levels was deemed insufficient to do what Spain and Ireland did.

Figure 1.14. **Investment by sector in four euro area countries**


Gross fixed capital formation, index 2008 = 100



1. OECD estimate for 2014.

2. Provisional data from 2012.

Source: Eurostat (2016), "Annual National Accounts", Eurostat Database; and INE (2016), "National Accounts" tables, Instituto Nacional de Estadística.

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Banks do not only have incentives to delay loan loss recognition, they also face a clear informational advantage. For outsiders, including policy makers and supervisors, it can be hard to get a reliable gauge of how widespread the renewal of loans to firms with low profit and investment potential is. Portugal's banking supervision is in line with international standards, in some areas even more demanding, and the recent practice of regular on-site inspections by the regulator is reassuring. Still, there are limits to how much supervisors can detect. Weaknesses and fraud in two banks could not be spotted early enough to prevent their failure and several billions of Euros in losses for taxpayers. Banco Espírito Santo (BES), the largest private lender at the time, had to be rescued in 2014, and Banco Internacional do Funchal (BANIF) required a central bank intervention in 2015, in the course of which its assets were sold to another bank. In addition, past asset reviews have not considered EUR 3 billion of NPLs that banks had parked at above-market prices in so-called restructuring funds (Nogueira Leite, 2016).

The necessary improvement in asset quality and resulting boost in investment finance are unlikely to materialise without decisive policy action. Such policy action entails risks and has to be balanced against the limited available fiscal space and against the possible effect on banks and their ability to raise new capital, but betting on time to solve the issue entails risks as well. This is not only because it affects the health of bank balance sheets over many years, but also because of the significant external effects in terms of locking up sizeable fractions of credit with firms that are unlikely to invest, which are not accounted for by banks. Relying on a mix of policy strategies is often the most effective way to achieve this, including tightened regulatory policies, developing markets for distressed debt and improving insolvency frameworks.

The regulatory stance could be used to strengthen incentives for banks to resolve long-standing NPLs. Differentiated capital requirements could provide stronger rewards to banks that implement a credible and sufficiently ambitious plan for off-loading non-performing loans, which could make it easier for them to raise capital. This could also include strong penalties for banks that are not taking strong action or fail to comply with the plan approved by the supervisor. In addition, European regulations leave the details on write-off modalities, the accrual of interest income for NPLs and the rules for the valuation of remaining collateral to national supervisors, and this could be used to strengthen the incentives for reducing NPLs. Risk weights for NPLs could differentiate between new NPLs and those that have been kept on balance sheets for longer than a certain threshold, thus creating stronger incentives to write-off or sell long-standing NPLs (OECD, 2016b). Spain imposed a progressive reduction of the value of loan collateral after two years, for example. Such measures could be part of a strategy of defining clear operational targets for NPL reductions over time, as practiced in a few Eastern-European countries (Albania, Montenegro, Slovenia and Romania, see Aiyar et al., 2015).

Parallel to strengthening regulatory incentives for NPL recognition, policy makers could support bank efforts to offload legacy loans from their balance sheets and get higher recovery values by developing distressed debt markets. Despite higher NPL stocks than in the United States, European markets for distressed debt are currently less than a quarter of those in the US. Specialised asset management companies (AMCs) for distressed assets provide a liquid market for NPLs and are often better at dealing with impaired assets than banks, in particular small banks, for which managing distressed asset portfolios can be resource-intensive. AMCs bring scale economies, better technologies and experience to the fore, which banks' comparative advantage is probably stronger in arranging new lending and separating the loan administration from the credit officers that originated the loan may also foster a more objective asset evaluation. Specialised AMCs may also have better expertise in securitising bundles of distressed loans, which has helped banks to fetch higher prices for NPL portfolios in some countries. Securitisation allows the bundling of bad loans in a way that the resulting security can still be attractive for a wide range of investors.

A number of countries have made positive experiences with AMCs, including in Europe (Sweden, Ireland, Latvia, Slovenia and Spain) and in Asia (Indonesia Malaysia, Korea, Thailand and Japan). AMCs can be either private or public, and either centralised or bank-specific. In Japan in the late 1990s, a centralised public AMC was able to take on difficult assets eschewed by other investors and was instrumental in resolving disputes among creditors, and it also improved the transparency of the NPL market by setting

standards of disclosure and publishing information on collateral (Jassaud and Kang, 2015). In Spain, a centralised AMC of mixed public and private ownership, SAREB, acted as a catalyst for the take-off of distressed debt purchases.

Private debt management companies exist in Portugal and have seen substantial business growth. Relative to the stock of recognised outstanding NPLs, however, their portfolios are small. This market currently lacks transparency as the vast majority of completed loan sale transactions do not disclose the parties involved. The principal challenge for stronger AMC engagement, however, is the remaining pricing gap between what investors are willing to pay for what banks expect to recover. Banks are unwilling to sell large portfolios at the prices currently offered by potential buyers as this would lead to significant losses and recapitalisation needs.

While some degree of additional loss recognition for banks is probably inevitable and would be part of any effort to move distressed assets from bank balance sheets to specialised AMCs, it is important to note that developing distressed debt markets is not a zero-sum game. Put differently, the question is not about forcing losses on banks for the benefit of the wider economy. There is substantial scope for the public sector to get involved into the development of such markets in various forms. This could raise their efficiency and attract new buyers that are currently not investing in these kinds of assets. An outward shift of the demand curve would then result in higher prices, all else equal, and hence help to close the pricing gap.

The scope for public intervention in this area has recently been limited by new EU rules on state aid and the new bank recovery and resolution directive (BRRD). Under these rules, selling assets to AMCs above market price may trigger a bail-in of junior and even some senior debtholders, and the implementation of a restructuring plan for the bank. Spain's successful AMC, for example, was set up before these new rules came into play. While it is clear that replicating what Spain did is no longer an option now, a better definition of what exactly is compatible with the BRRD would be helpful. In particular, Portugal should seek clarification on the boundaries of public support for AMCs without triggering a bank restructuring. Determining market prices for bundles of assets for which liquid markets are currently lacking will inevitably involve some judgement.

It would also help to clarify the exact circumstances under which the need to correct a market failure or a serious economic disturbance can be invoked as an exception clause. Considering the systemic dimension of the problem in Portugal, the notion of a serious economic disturbance does not seem far-fetched, and the inexistence of a market is usually taken as an indication of market failure in other contexts. The remaining scope for using AMCs should be exploited to the fullest extent possible.

One example for greater AMC involvement that appears to be compatible with state aid rules is the model recently pursued by Italy and a similar approach could be viable in Portugal. In Italy, a special purpose vehicle has been created for the securitisation of banks' distressed loan portfolios. State guarantees will be available for senior tranches of these securities provided they obtain ratings similar to Italian government bonds. The guarantees will be offered at prices that reflect credit default swaps of Italian borrowers with similar credit rating as the senior tranches and hence satisfy the EU requirement to apply market prices for guarantees. While the guarantees would be priced to reflect risks, their mere existence could encourage a wider range of investors to venture into this new kind of assets in Portugal as well, despite the lower sovereign rating.

Under the arrangement negotiated between the European Commission and Italy, providing guarantees for senior tranches of NPL securities requires the successful sale of at least half of the junior tranche. Joint efforts by private banks, co-ordinated by the public sector, have led to the creation of two private funds (called *Atlante I and II*) meant to buy junior tranches of NPL securities with lower return expectations than private equity bidders. Such a concerted effort by banks can act as a catalyst, but it can also create moral hazard by penalising banks with stronger loan portfolios that have pursued a more prudent business model of lower risks and lower returns in the past.

Improving insolvency rules

Given that a large share of Portugal's distressed assets are loans to corporate borrowers, well-working insolvency frameworks are crucial to restructure companies that are still viable and to allow a speedy recovery of non-viable companies' assets before they lose value. Portugal has taken important steps to overhaul its corporate insolvency and restructuring framework, giving it a stronger focus on the recovery of firms rather than their liquidation. However, differences between the rules and their actual implementation persist and the reforms have not led to a significant decline in NPL ratios as in Spain and Ireland (EC, 2016).

The bankruptcy code was amended by a new debt restructuring mechanism inspired by US Chapter 11 provisions in April 2012, which was meant to allow fast-track out-of-court restructuring. The new out-of-court procedure, called *Processo Especial de Revitalização* (PER), makes negotiations between the debtor and a majority of creditors more attractive by granting court approval and enforcement to such out-of-court agreements. However, PER has had an approval rate of only 50% so far, and the share of settlements actually implemented and adhered to is even lower. These out-of-court settlements take significantly longer than the 4 months allowed for out-of-court negotiations under US law, even though evidence on the exact average length of out-of-court settlements is inconclusive. Official statistics put their average duration at close to 5 months, while private analysts put the average duration at 7 months (APAJ, 2015).

Gatekeeping could be improved as there is evidence that owner/managers have used the PER procedure for the mere purpose of buying time and/or removing assets from the firm. In around 8% of the approved cases that went through the PER, the debtor company failed to comply with the terms of the negotiated agreements, which triggered either a standard insolvency procedure or a new negotiation under the PER framework. An embargo period for the same firm to apply for another PER exists only in certain cases but should be extended to all firms, including those that breach the conditions of an existing out-of-court settlement only to apply for a new one. Shortening the procedure, and with that the stay on assets, to the 3 months mentioned in the law would also reduce incentives for abuse. That said, the existence of a stay on assets is important to give the firm time for a restructuring, and the absence of such a stay period in another out-of-court procedure created in 2012 (SIREVE) may explain why that procedure is not being used widely.

Failure of PER negotiations is often due to tax authorities and other public creditors, who are generally unable to accept any cuts on their claims and often even fail to define their position in time (APAJ, 2016). Although PER rules require only a simple majority for agreeing on a restructuring plan (the so-called "cram-down") and provide for equal treatment of all creditors, tax authorities regularly claim *de facto* veto rights on the basis of General Tax Law. In practice, tax authorities and other public sector creditors often end up

blocking restructuring plans under PER. Brazil's experience shows that reducing the privileges of tax authorities can speed up insolvency procedures and improve recovery rates (Araújo et al., 2012; Arnold and Flach, 2017). Recently announced policy plans in the context of the Capitalizar programme to improve the flexibility and co-ordination of public sector creditors in insolvency proceedings should be carried through. Recently announced policy plans to improve the flexibility and co-ordination of public sector creditors in insolvency proceedings go into the right direction but should be implemented earlier than the third quarter of 2017 as currently envisaged.

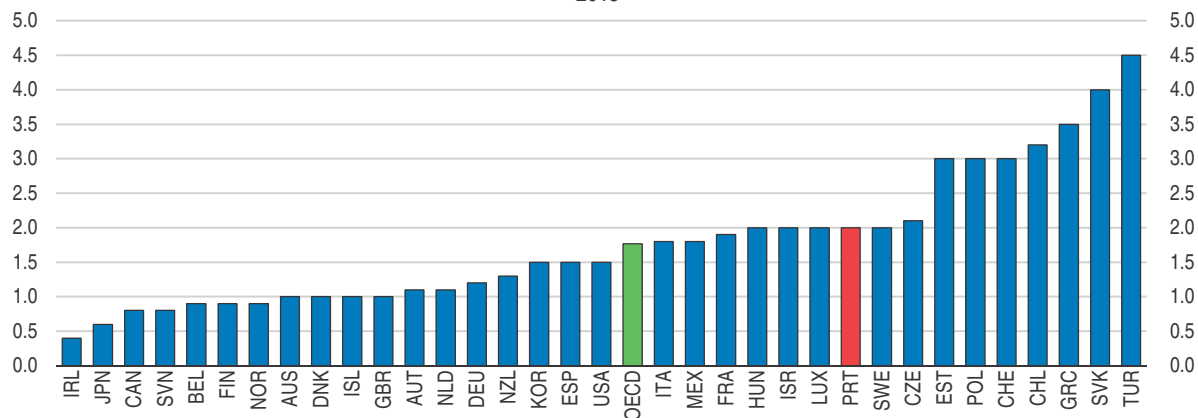
Another frequent reason for failed PER procedures is that insolvency administrators and creditors lack information to evaluate the economic potential of a firm or the value of their assets. For example, on-site inspections by insolvency administrators are currently not possible.

Four years after their inception, the out-of-court insolvency frameworks PER and SIREVE should now be subjected to an in-depth evaluation, which could help to identify remaining bottlenecks and refine the framework as needed. The preliminary evidence available so far suggests that the time savings fall short of the benchmark duration mentioned in the law. Privileges and veto rights for tax and social security administrations could be reconsidered and the access to information could be improved. More rapid insolvency procedures are particularly helpful for new market entrants, as firm-level research based on data from 21 OECD economies suggests (OECD, 2016).

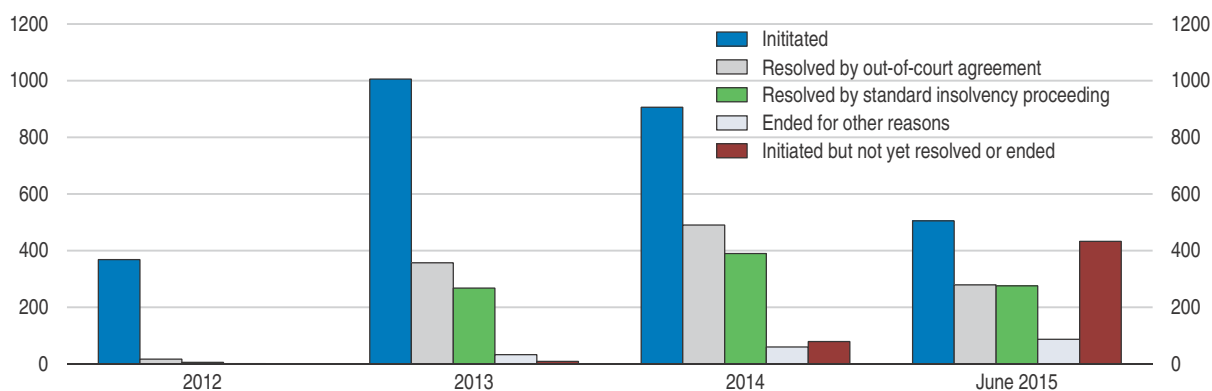
Beyond out-of-court settlements, the regular in-court procedure for insolvency cases has not changed much over the years. The number of insolvency cases has been on an increasing trend since 2010, with 41% more cases recorded in 2015 than in 2010. According to the World Bank's Doing Business database, insolvency cases going through courts take 2 years for a benchmark case in Portugal, which is slightly more than the OECD average of 1.7 years. At the same time, countries like Ireland, Japan, Belgium or the United Kingdom take less than a year to process insolvency cases through the court system (Figure 1.15). It may be worth to improve the functioning of the insolvency framework, which is vital for separating viable firms from non-viable ones and which has a direct bearing on recovery values and the prices that investors will be willing to pay for NPL-backed securities.

Investing more resources into insolvency courts and improving their efficiency would be one possible way forward. Even more judges could be transferred to commercial courts, which appear to be the most overburdened part of the court system. Offering more specialised training to judges may lead to faster procedures and better recovery rates, as suggested by international evidence (OECD, 2013, World Bank, 2004). Another way to speed up insolvency cases would be to extend the scope for simple majority decisions. The special veto right for tax and social security authorities should also be reconsidered in the case of insolvency cases that go through courts.

For many micro companies, personal insolvency also plays an important role, in particular with respect to the limit entrepreneurs' ability to start new businesses after an insolvency case. The availability of a "fresh start" can reduce the costs and the stigma of failure associated with insolvency, which is one of the commonly cited barriers to entrepreneurship. In Portugal, the discharge periods for entrepreneurs after an insolvency case are typically longer than the 3-5 years applied in many European countries (Carcea et al., 2015). Micro companies are also affected by the widespread practice of pledging

Figure 1.15. **Insolvency framework**A. Years required to resolve an insolvency case¹
2015

B. Number of out-of-court settlements



1. Time from the company's default until the payment of some or all of the money owed to the bank taking into consideration eventual delay tactics. The OECD aggregate is an unweighted average including Latvia.

Source: World Bank (2015), *Doing Business 2016: Measuring Regulatory Quality and Efficiency* (database); and APAJ (2015), "Processo Especial de Revitalização", *Turn Analysis*, No. 7, 2nd quarter, Associação Portuguesa dos Administradores Judiciais.

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personal assets for corporate loans. While this practice is used by banks as a commitment and disciplining device, it also blurs the borders between the company and the individual, and can act as an impediment to growth or to hiring a professional manager.

Reducing the corporate debt tax bias for a more balanced financing mix

The differential corporate tax treatment of debt and equity has created incentives for businesses to accumulate excessive amounts of debt in the corporate sector in the past. Reducing the differences in corporate tax treatment is essential to reduce the reliance on debt financing in the future. Until end-2016, interest expenses can currently be deducted from taxable corporate income, but the remuneration of equity financing could not. Tax neutrality with respect to debt and equity financing is not only relevant for firms that are large enough to receive external equity financing. In fact, it even matters for the majority of Portuguese firms that are very small, as it is widespread practice for owner/managers to extend loans to their own companies rather than providing equity, and distributing a large part of profits.

Legislative changes that came into effect in January 2017 have sought to address these tax distortions in two ways. Firstly, stricter limits are now being imposed on the tax deductibility of interest expenses. As of 2017, deductible interest expenses are capped at EUR 1 million or 30% of EBITDA (cash flow income), whichever is higher. This is in line with Action 4 of the BEPS Action Plan.

Secondly, these legislative changes have also included the establishment of a tax allowance for corporate equity (ACE). Several countries, including Italy, Belgium and Brazil, have introduced such measures and evidence suggests that it can be effective in reducing corporate leverage (De Mooij, 2011). However, the exact design of such a scheme matters, particularly to avoid windfall gains for investment undertaken before the introduction of an ACE and strategic tax planning. In order to stimulate new investment, an ACE should only apply to new equity investment, as is the case for Portugal's new ACE. In the past, Portugal has had an ACE that was restricted to SMEs and equity provided by venture capitalists. These restrictions, which had rendered the ACE largely ineffective, have now been lifted. The new ACE seems well-designed, but its performance should be monitored carefully to see if further refinements are needed.

The removal of previous tax distortions will have a stronger impact when combined with a strategy to lead more medium-sized firms into stock market listings, as an alternative to debt financing. This would be a realistic option for around 50-80 Portuguese companies, but high listing fees on Portugal's only stock exchange are currently a major deterrent for these companies. A co-ordinated government programme to bring more firms to the stock market, called ELITE, has been successful in Italy. Measures that could be part of such a strategy in Portugal include regulating fee schedules for the listing of mid-caps by the monopoly stock exchange operator. The economic rationale for this could be similar to universal service provisions in telecommunications, where public intervention has for years reduced the cost of network access for clients for whom these would have otherwise been prohibitively high. Just like a fixed-line network, a stock market exchange has characteristics of a natural monopoly, which may well justify regulatory interventions. Measures included in the Capitalizar programme may contribute to reducing listing costs.

Providing advisory services, as done under Italy's ELITE programme, would also be useful. Currently, Portugal has no independent investment banking company that could advise firms in going public or attracting equity investment and the prospectus directive requires the backing of a financial institution in this process. Commercial banks have only weak incentives to assist companies in finding alternatives to the bank financing they provide.

Many firms without sufficient credit history find it hard to access bank credit lines, particularly when their principal assets are their human capital and a few innovative ideas. Recent government initiatives have aimed to open up additional channels of finance for companies in the context of the new Capitalizar programme, including business angels, venture capital and other instruments. Entities with public participation, including a venture capital firm and business angel-type financing, are meant to co-finance start-ups in an early stage with a particular focus on innovative, scientific and technology-based companies, as well as on export-oriented companies. Broadening financing options, as intended by the recent programme Startup Portugal, is a welcome initiative as developing market-based finance for SME could help to alleviate credit constraints of SMEs (OECD, 2015b, c). However, it will be important to monitor and evaluate the progress of these initiatives to ensure their cost-effectiveness.

A key challenge for public participation in venture capital activities, for example, will be to find instruments that increase the quantity of venture capital without diminishing its quality. Private investors will generally have stronger incentives to maximise returns than public entities, and may hence invest more into identifying the most promising investment projects and providing quality mentoring to these firms. The track record of Canadian government-sponsored venture capital, for example, points to the importance of these two issues, with private venture capital typically outperforming public venture capital on both counts (Brander et al., 2008). By contrast, funds that operate like independent, limited partnership venture capital funds and where the selection and mentoring of investment projects is done by private partners have been successful in the United States (Lerner, 1999) and Australia (Cumming, 2007). Passive public participation in such funds could even raise the returns for private investors by capping its own returns while leaving its entire investment at risk.

Making best use of external funding sources

Foreign direct investment (FDI) inflows and EU structural transfers account for significant shares of investment in some sectors, although for FDI, a direct comparison with investment financing from domestic savings is hard to establish. During 2012-14, greenfield FDI inflows amounted to around 3.9% of gross fixed capital formation. Comparing total FDI inflows to total gross fixed capital formation (GFCF), the ratio is about 20%, but this can only be considered an upper bound as it also includes brownfield investments, which do not add to capital formation as they are merely transfers of ownership.

Attracting more FDI is another important way for Portugal to raise investment. Besides opening up new sources of investment financing beyond domestic savings, FDI is typically associated with productivity benefits as multinational enterprises are typically among the most productive firms (Arnold and Javorcik, 2009; Arnold and Hussinger, 2010; Girma et al., 2005; Helpman et al., 2004). This productivity advantage can generate significant spillovers and strengthen the productivity of domestic firms through sourcing relationships or the transfer of know-how (Blalock and Gertler, 2008; Javorcik, 2004; Keller and Yeaple, 2009).

The structural reforms enacted have boosted Portugal's attractiveness as a destination for FDI, but in the future, a greater emphasis on policy continuity could bolster confidence and reduce uncertainties, which are often an important consideration for foreign investors (see, for example, Ruane and Goerg, 1997, for the Irish case). An earlier bipartisan agreement in favour of a continued decline of the corporate income tax rate was recently dismissed, some privatisation plans have been delayed or modified after they were signed, and there are discussions about restricting access to the so-called individual bank of hours to sectors where it is part of collective agreements. This measure has been an important component of giving more work-time flexibility to firms by allowing a maximum of 150 hours per year to be used in agreement between the employee and the employer. A recent decision to bail in a select number of secured bondholders of the resolved Banco Espírito Santo have also been interpreted as undermining policy certainty.

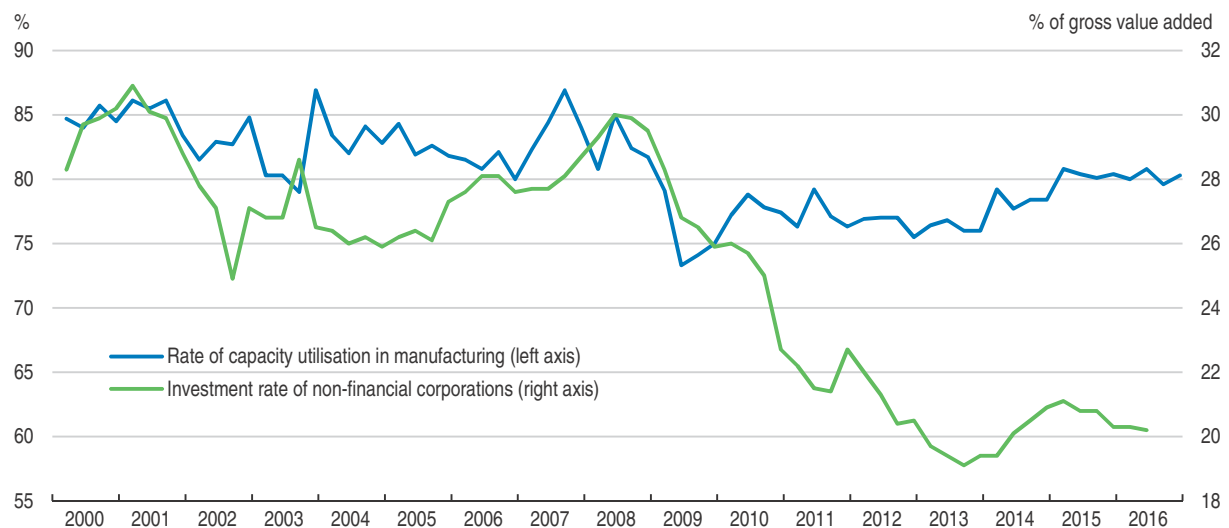
EU structural funds have become large relative to public investment, which declined from 5% of GDP in 2010 to 2.1% in 2015. At 1.9% of GDP, European funding now amounts to 80% of Portugal's public investment or 12.5% of total investment, although not all of the projects funded by these funds are investments in the sense of national accounts. Therefore, it is only possible to make approximations for certain sectors. In the transport sector, for example, EU transfers amount to 16% of the sector's investment. A new strategy

for allocating these funds, called Portugal 2020, has recently been designed and aims to support the structural transformation of the economy towards export sectors. Main spending areas include support for manufacturing companies' internationalisation and innovation efforts and to strengthen the ties between firms and the scientific community. Portugal's National Reform Programme provides the framework for a more effective use of EU funds.

Improving the business climate to raise the returns on investment

Access to finance is not the only obstacle to higher investment. There may also be cases where firms could finance an investment project but prefer to hold off because the expected returns on the project may not be sufficiently attractive. Structural policy reforms that reduce the cost of doing business in Portugal and/or allow firms to become more productive could make more potential investment projects worthwhile. There are reasons to believe that demand is not the only limiting factor for Portuguese companies, and that structural reforms on the supply side of the economy could have significant effects on investment. In manufacturing, for example, after years of low investment, capacity utilisation has edged up again since 2014 and has now almost returned to pre-crisis levels (Figure 1.16).

Figure 1.16. **Rate of capacity utilisation in manufacturing and investment rate of non-financial corporations**



Source: OECD (2016), *Main Economic Indicators* (database); and INE (2016), "Quarterly economic accounts for non-financial corporations", *National Accounts Tables*, Instituto Nacional de Estatística.

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Policy reforms in areas such as regulation, the judicial system, services sectors including utilities and the labour market have led to impressive improvements in historical comparison. These reforms have in all likelihood had a significant impact on cost competitiveness and on productivity. OECD estimates suggest that product market reforms undertaken since end 2008 will raise the level of GDP by 3% by the year 2020. However, the reform momentum has slowed down visibly since the end of the external assistance programme, and reform implementation has fallen short of initial ambitions in several key

areas. In some areas, much has changed, for example in labour markets. In other areas, such as product market reforms and the regulation of non-tradable sectors, there is scope for further progress, particularly with respect to implementation.

An assessment of where the greatest bottlenecks remain is hard to make and will likely differ across firms, particularly as the same reform may affect firms' investment incentives through more than one channel. The costs of intermediate inputs from non-tradable sectors and labour costs affect firms' input costs and hence their competitiveness. But at the same time, access to higher quality services or better matches between employees and employers also affect the productivity with which Portuguese companies operate. Better regulation or a better judicial system can reduce transaction costs and thereby also raise productivity. Finally, many rules and institutional features discussed in this section can also act as implicit barriers to firm entry and post-entry growth, and should be subjected to a critical review in light of Portugal's skewed firm size distribution.

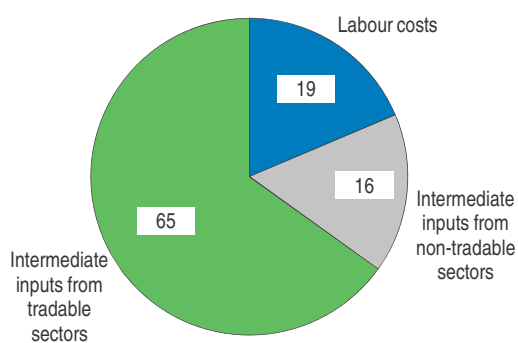
Regulation in services and utility sectors

Services sectors, including utilities, provide essential inputs into tradable activities, accounting for 16% of the direct costs of Portuguese companies, i.e. without accounting for the share of services in the value added of tradable inputs (Figure 1.17, Panel A). Since services inputs often have to be sourced domestically, their prices are an integral ingredient of competitiveness in the tradable sector and hence a driver of the returns on investment in these sectors. In the past, product markets in services sectors have traditionally been characterised by low levels of competition and significant rents, an outcome that was intimately linked to weak regulatory policies. As a result, the price increases in non-tradable sectors have far outpaced tradable goods inflation (Figure 1.17, Panel B).

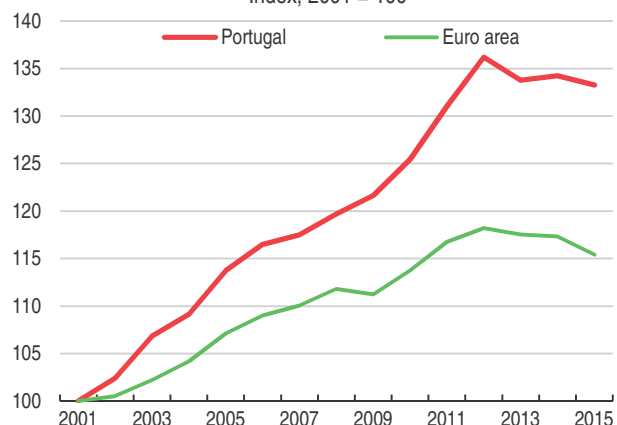
An ambitious reform agenda has led to improvements in some areas and the shift in relative prices has reverted slightly since 2012. However, firms' views on the progress achieved in this area are rather sobering, and survey results suggest that product market

Figure 1.17. **Determinants of cost-competitiveness in tradable sectors**

A. Simplified cost breakdown in tradable sectors
Percentage of costs of goods sold, mid-2000s



B. Prices of non-tradables relative to tradables¹
Index, 2001 = 100



1. Ratio of harmonised index of consumer prices of non-tradable to tradable sectors (2015 = 100).

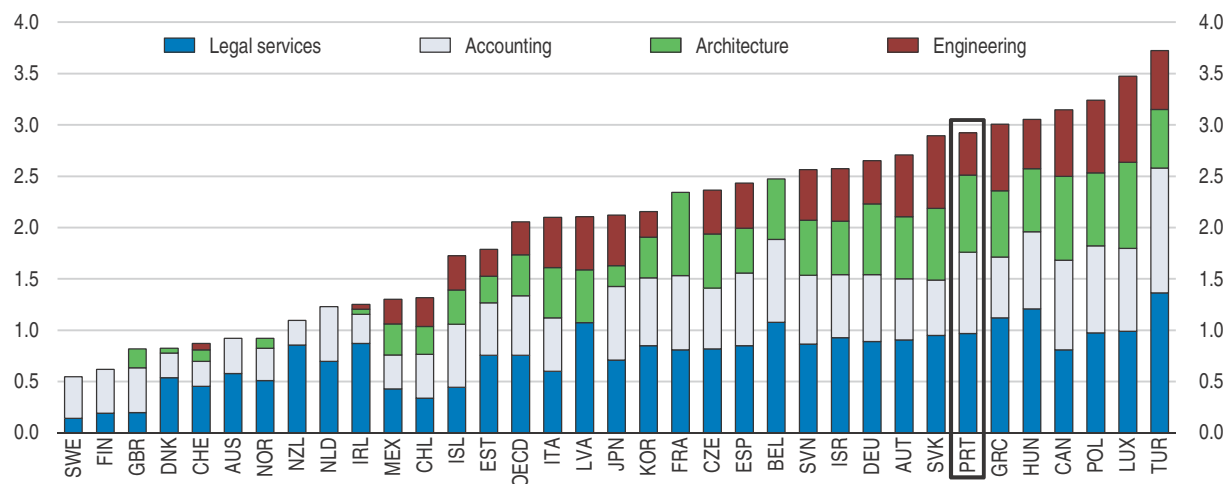
Source: OECD (2012), "STAN Input-Output", STAN: OECD Structural Analysis Statistics (database); and Eurostat (2016), "Harmonised Index of Consumer Prices", Eurostat Database.

reforms are the reform area where least noticeable progress for downstream users has been achieved (Gershenson et al., 2016, Chapter 7). The scope for further progress in product market reforms is also highlighted by the fact that the strong price increases in non-tradable sectors have not been made up and compared to the situation in 2001, non-tradable prices remain high relative to tradable prices.

Professional services


In professional services such as accounting, legal, architecture or engineering services, competition remains weak and regulation is more restrictive than the OECD average, as reflected in the OECD Product Market Regulation (PMR) (Figure 1.18, Panel A). The OECD Services Trade Restrictiveness Indicator (STRI) points to barriers to competition through international trade in accounting, auditing and legal services. Regulatory provisions that can stifle competition include the strong role of professional associations for regulating entry, a setting that typically favours current insiders over potential entrants. Regulation by professional associations should be monitored closely by public authorities to avoid excessive restrictions on entry and safeguard competition. Exclusive rights that reserve certain tasks for members of a particular profession, as well as regulations of prices and fees or the form of business, further restrict competitive pressures and should be reconsidered. Entry restrictions may be one reason for the substantial misallocations of resources documented in professional services in Portugal (Dias et al., 2016).

Figure 1.18. **Regulation of professional services**
Index scale of 0-6 from least to most restrictive, 2013¹



1. Data may no longer fully reflect the current situation in fast reforming countries. The OECD aggregate is an unweighted average of data available (including Latvia). Measures included in the index cover entry restrictions (education requirements, shared/exclusive rights, compulsory chamber membership and quotas) and conduct regulations (prices and fees, marketing/advertising, form of business and inter-professional co-operation).

Source: OECD (2016), OECD Product Market Regulation Statistics (database).

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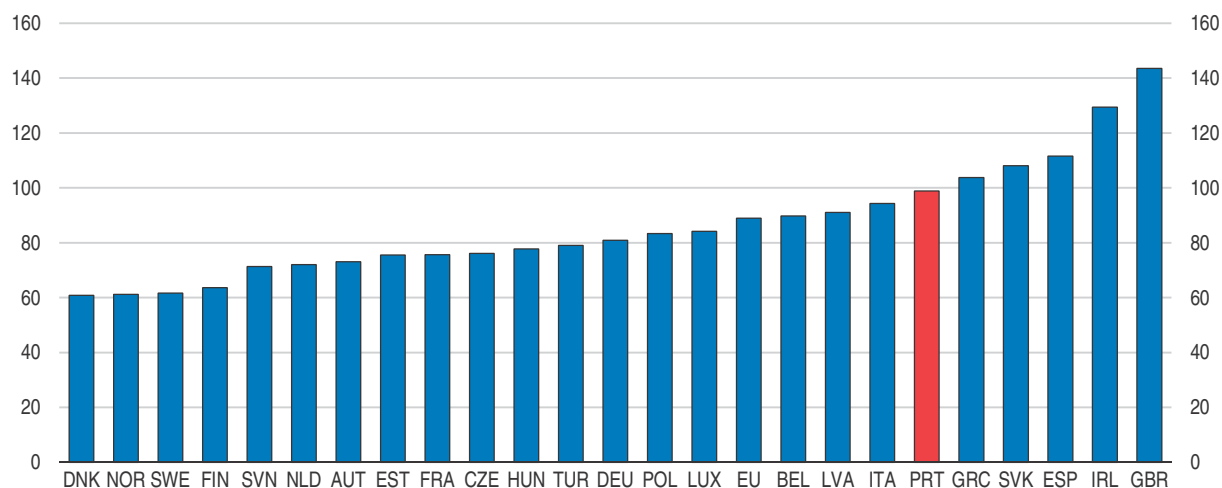
A new framework law that reforms regulations in 18 professional services was approved in 2013, and the bylaws of all professional bodies have now been published. But service providers still face significant entry barriers and cross-border competition is also reduced by existing regulations. For example, in accounting services, an EU nationality is required to obtain a license to practice and there are restrictions on owning shares in

accounting firms, combined with specific nationality and licensing requirements for board members and managers of accounting firms. The investment regime is similarly complex for legal services, although there are no nationality requirements for lawyers. Current rules also contain provisions that impede companies from being active in several regulated professions at the same time. This rule implies unused economies of scale and scope and can act as an impediment to firm growth, while the consumer benefits of such restrictions are unclear.

Energy

Electricity prices for medium-sized companies are among the highest in Europe (Figure 1.19). Over a third of Portuguese enterprises consider electricity costs a high or very high obstacle for their operations and 82% have noticed no improvement since 2012 (INE, 2015). A series of reforms has improved regulation and eliminated the scope for remuneration above market prices, for new entrants. Generation of electricity is formally open to competition, but unlike potential new entrants, incumbent operators benefit from legacy remuneration schemes that continue to provide sizeable rents to incumbent electricity generators. These arrangements cover the overwhelming majority of all electricity sold in Portugal, leave little room for the fluctuating “market price” at which the remainder of the electricity is sold and reduce the scope for effective competition. Legacy contracts can also help to explain the upwards trend in electricity prices.

Figure 1.19. **Electricity prices**
EUR per thousand kilowatt hours, 2015¹



1. Average national price without taxes applicable for the first semester of each year for medium size industrial consumers (annual consumption between 500 and 2000 megawatt hours [MWh]). For Italy data refer to 2007 instead of 2008 and cover data at 1st January for an annual consumption of 2 000 MWh.

Source: Eurostat (2016), “Electricity prices by type of user”, *Tables by Themes*.

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Policy indicators such as the OECD Product Market Indicators reflect the substantial regulatory improvements for new entrants and Portugal’s network sector regulation is the second most competition friendly in the OECD by these indicators. However, these new rules are not necessarily those that govern the bulk of current energy transactions which is sold under legacy contracts that were signed under different rules. Until legacy contracts expire, the PMR indicators may paint an overly optimistic picture for competition in energy

sectors. Despite new entry, the incumbent electricity producer continues to serve 85% of electricity customers. In natural gas, the share of consumers served by the incumbent gas company has declined to 27%, accounting for 55% of consumption.

Going forward, the current schedule for phasing out legacy agreements in electricity should be accelerated, including by exploring the scope for further renegotiations with incumbent companies. Without renegotiations, future price pressures will be strong. Further increases of the already high electricity prices are projected as a legacy of poor policy settings in the past, such as a massive tariff debt of over EUR 4 billion that has been accumulated over many years in which Portugal was unwilling to pass on cost increases from the surge in renewable energy sources to retail customers. Supposedly, all electricity customers are “liable” for this tariff debt, which is now being winded down through pricing above average costs. The tariff debt has only started to decline in 2016 and will continue to exert upward pressure on prices for years to come.

In the retail market for natural gas, the incumbent operator also retains a strong position, although the market is formally open to competition. The incumbent also owns exclusive contract rights to the supply of wholesale pipeline gas from Algeria, which are likely acting as a barrier to competition. Efficiency gains in energy sectors could also help to reduce prices, and could be achieved by improving international interconnection capacity. While the markets of Portugal and Spain are increasingly well connected in a common Iberian electricity market (MIBEL), better connections from Spain to France, and onward to other European countries, could allow more competition. The same holds for the common Iberian gas market (MIBGAS), which unlike electricity markets is still hampered by lack of interconnection capacity between Portugal and Spain and by cross-border transfer charges imposed by Spain. As a result, trading volumes at the spot exchange MIBGAS platform are very low.

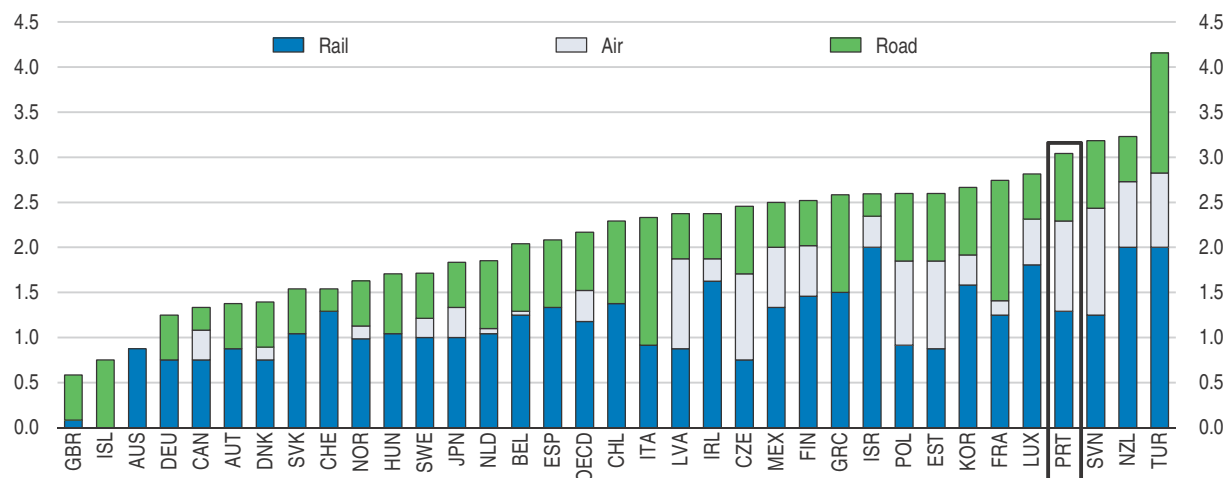
Transport services and ports

Weak competitive pressures relative to other OECD countries and more widespread anti-competitive regulations also affect the transportation sector, which is likely to expand as the structural shift towards tradable sectors is gaining ground (Figure 1.20). However, the situation is very different across segments of the transportation sector and the sector has been evolving since 2013. In long-distance rail services, network and train operations have been formally separated and ownership of merchandise terminals has been handed over from the recently privatised cargo rail company CP Carga to the network operating company Refer. This step was a precondition for competition in cargo rail services, as competitors will be granted access to these terminals.

Plans for urban transport concessions in Lisbon have been cancelled and will now be transferred to the municipality while those in Porto have been delayed. Further monitoring is needed to understand if these developments will lead to lower benefits for users, but the frequent policy changes, which also affected the air transportation segment, may reduce Portugal’s ability to attract foreign direct investment (Arnold and Javorcik, 2009; Javorcik, 2004).


A transport sector of particular importance for Portugal’s competitiveness is ports. The country relies heavily on seaborne trade, with about two thirds of the imported and half of the exported goods being transported by sea (EC, 2014). Reflecting recent improvements in export performance, some Portuguese ports have seen substantial growth in cargo

Figure 1.20. **Regulation of the transport sector**
Index scale of 0-6 from least to most restrictive, 2013¹



1. Data may no longer fully reflect the current situation in fast reforming countries. The OECD aggregate is an unweighted average of data available (including Latvia). Measures included in the index cover entry restrictions, public ownership, vertical integration, market structure and price controls.

Source: OECD (2016), OECD Product Market Regulation Statistics (database).

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volumes. The functioning and cost-effectiveness of ports is an important element of competitiveness, as port-related costs can amount to as much as 30% of total good transport costs or 10% of total production costs (EC, 2013; Gershenson et al., 2016).

The authorities have undertaken a series of reforms to reduce port user costs. A particularly rigid Port Works Law, reminiscent of the days when port labour was physically more demanding than other work, has been made more flexible, and the scope of its application has been limited to core port tasks such as cargo handling, while related activities are now governed by the regular labour code. This has reduced port labour costs and enhanced the flexibility of port labour supply. However, while these measures have reduced costs for port operators, it is less clear to what extent these improvements have been passed on to port users. While an official estimate points to a 16% reduction in port costs, a private sector study contested this finding and found cost reductions of only 2% (IMF, 2015). Over 80% of companies that use maritime transport noted no improvement since 2012 (INE, 2015).

Strengthening competition in the ports sector could be a powerful tool to ensure that cost savings for terminal operators, such as those resulting from the new Port Works Law, are passed on to downstream users. More competition would likely lead to further reductions in costs and rents, resulting in lower user charges, and there is evidence of substantial scope for this. Ports services providers have in the past been found to increase their prices to 21 times fold, and have been convicted twice by the Portuguese Competition Agency for cartel formation (OECD, 2011).

There are a number of ways to enhance the scope for competition in the ports sector (Box 1.2). Appropriate pro-competitive regulation is key to success. A strong and impartial regulator is important for establishing flourishing competition in the ports sector, which is more difficult than in other sectors but far from impossible to achieve. Competition is possible both between and within ports, either through competition between independent

Box 1.2. **Competition in ports**

A port's efficiency is associated with its ownership structure, which determines the balance between private sector efficiency and public control. Although some ports are entirely owned and operated by public port authorities (the "service port model"), most major ports have adopted a mixture of public and private ownership, under which, frequently, public port authorities provide the infrastructure and private firms provide the superstructure and employ labour (ICA, 2013). This structure, known as the "landlord model" and adopted in Portugal, allows substantial private participation to enhance efficiency and reduces public investment needs. Nonetheless, maximising the potential efficiency gains from private participation depends on careful policy design.

The efficiency gains from private participation will be greater where elements of competition can be introduced so as to provide the right incentives for keeping costs and rents low. However, the sector is characterised by significant economies of scale and the high entry costs of investing into the terminal superstructure, which have in the past supported the notion of ports being basically natural monopolies. Even though in some cases of smaller ports, this may be true and a regulated monopoly may turn out to be the most efficient operating model, in most cases there will be some scope for reaping the benefits of competition.

Concession contracts for terminal operation allocated through regular auctions can create competition for the market rather than competition in the market, and the challenge for the concession design is to strike the right balance between shorter concessions, which imply more regular competition, and longer concessions, which provide a higher return on and hence stronger incentives for investment. Concession contracts should clearly specify all relevant parameters, including the trajectory of regulated user charges, the investment requirements, the maintenance of assets, the allocation of different risks and the level of service quality to be provided.

Competition in the market is also possible in the ports sector, either between different ports or between different terminals in the same port. Intra-port competition has proven to be a particularly promising model for improving market structures, especially in cargo handling services, which account for 70 to 90% of port charges (ICA, 2013). However, even in settings with more than one market player, the long time-horizon of the infrastructure investment, the small number of competitors and the repeated market interaction between players create favourable conditions for collusion, and requires strong vigilance from competition authorities. In 2007, for example, the Portuguese competition authority fined three tug services suppliers for price-fixing and allocating customers among them (OECD, 2011).

Inter-port competition is often limited by geography. Since on-land transport is more expensive than sea-freight (ICA, 2013), ports with better connections to the final on-land destination enjoy significant competitive advantages. Contractual clauses that grant exclusivity rights to certain providers of downstream services, which may be vertically integrated with port operators, can also act as an impediment to competition. For example, the German port of Puttgarden denied access to Norwegian ferry companies to reduce competition for the port's downstream shipping business until competition authorities put an end to this practice (Bundeskartellamt, 2010).

terminals or between different services providers. Besides competition in the market, concession contracts, which are used for awarding port terminals in Portugal, allow creating competition for the market through regular renewal.

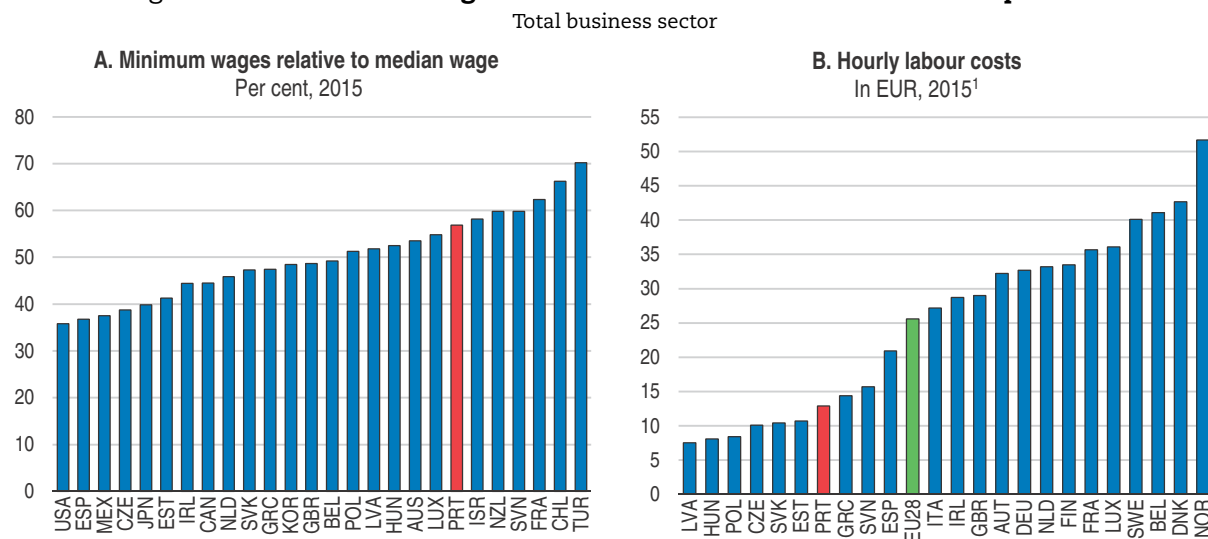
Plans to renegotiate existing port concession contracts were meant to achieve lower user costs by harnessing competition and strengthening investment incentives, but these renegotiations have recently been suspended. A new framework law for port concessions has yet to be passed and policy uncertainty is affecting investments by port concessionaires. Moving forward on the renegotiations of concessions could generate further downstream benefits by enhancing the scope for intra-port competition among terminals and incorporating service level agreements into the concession contracts, which has been omitted in the past. A lack of hinterland railroad connections is being addressed by dedicating a larger share of infrastructure investment to that latter issue, which will improve Portugal's connections with Spain and other European markets (SSPM, 2014).

Labour market reform

The outlook for labour costs, which account for 19% of the direct costs of an average Portuguese company, remains challenging. Unit labour costs relative to the euro area have declined by 1.5% between 2012 and 2015, but there has been another 5% increase in the minimum wage effective in January 2016. This recent increase brought the minimum wage to or above the salary levels of 30% of employed persons and the minimum wage has now reached almost 60% of median wages (Figure 1.21, Panel A). Further progressive minimum wage increases are under discussion. An increase to EUR 600 paid 14 times a year, for example, to be decided by social partners as contemplated in the government's programme, would be more than what 30% of employees currently earn. While these minimum wage increases can have positive effects on wage equality, there is a risk that they may exacerbate income inequalities to the extent that they reduce the prospects of finding a job for low-skilled individuals.


Current wage prospects risk undoing previous improvements in competitiveness that are vital for the exporters (Figure 1.21). In fact, they could price many low-skilled workers out of the labour market and conflict with the objective of strengthening exports as

Figure 1.21. **Minimum wages and labour costs in international comparison**



1. 2014 for Greece.

Source: OECD (2016), "Earnings: Minimum wages relative to median wages", *OECD Employment and Labour Market Statistics* (database); and Eurostat (2016), "Labour costs annual data", *Eurostat Database*.

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Portugal's declining export market share during 1996 to 2011 was largely attributable to price factors (Benkovskis, K. and Wörz, J. 2014). Labour costs are now lower than in most of Western Europe, but higher than in most Eastern European countries, some of which compare favourably to Portugal in terms of proximity to major European markets (Figure 1.20, Panel B).

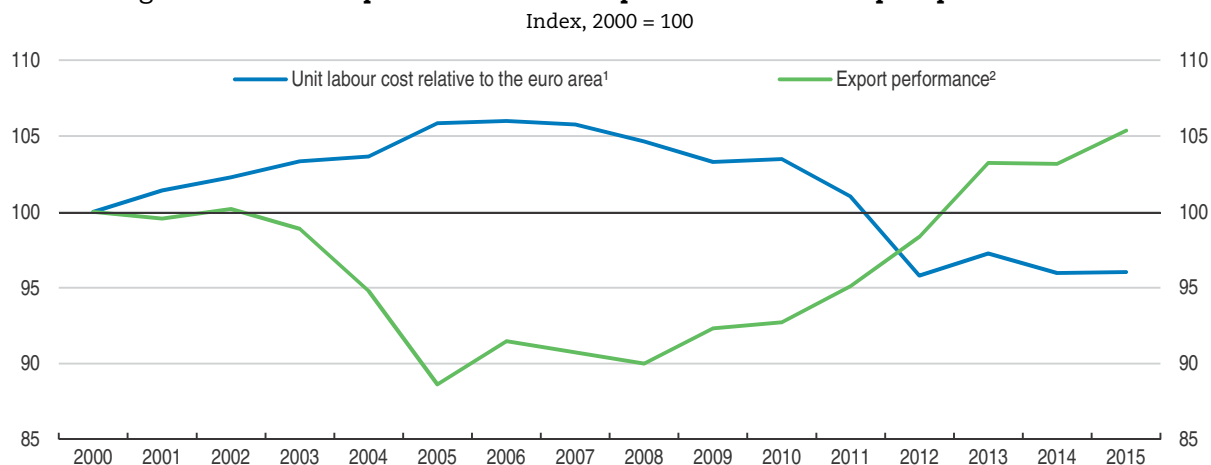
Additional wage pressures may result from a possible re-emergence of administrative extensions of collective bargaining agreements, including for firms that were not involved in the bargaining process. As of 2012, the widespread practice of such administrative extensions has come to a halt. This was the result of a new requirement that agreements could only be extended if the signatory firms accounted for at least 50% of the industry workforce, which had often not been the case in the past. In 2014, this condition was eased by introducing an alternative sufficient condition that required 30% of signatory firms to be SMEs. Given that 99% of firms in Portugal are SMEs, this new condition will be easy to meet. Extensions have since picked up, although not to the levels of 2011. Between 2014 and 2015, the number of employees covered by new or renewed collective agreements has doubled (CRL, 2016). Estimates suggest that wage increases resulting from administrative extensions have increased separation rates and reduce hiring rates, suggesting that they can jeopardise the viability of firms' investment projects (Hijzen and Martins, 2016).

Promoting firm-level wage bargaining through more stringent representativeness requirements for administrative extensions and opt-out possibilities for individual firms would result in a better alignment of wage developments and the economic health and productivity of individual firms. This in turn can strengthen the competitiveness of Portuguese firms and by doing so, raise investment incentives. Promoting firm-level wage bargaining could be accompanied with measures to strengthen worker representation at the firm-level.

The administrative extension of collective bargaining agreements to entire sectors can also act as an implicit entry barrier for new firms and competition in product markets, as one way new firms can enter the market is by paying lower wages than incumbents for some time. Current wage prospects risk undoing previous improvements in competitiveness that are vital for the exporters (Figure 1.22). Firm-level evidence suggests that a more extensive coverage of collective wage bargaining agreements reduces firm productivity significantly (Arnold and Barbosa, 2016), especially among dynamic start-ups that generate much of aggregate productivity gains. By curbing entry, administrative extensions also reduce the competitive pressures on incumbent firms and hence their incentives to improve production efficiency. Administrative extensions have also been found to reduce employment, particularly among non-signatory firms, which is consistent with extensions acting as sand in the wheels of the reallocation process of resources across firms (Hijzen and Martins, 2016).

Judicial system


A recent survey of 5 000 Portuguese companies identified difficulties with the judicial system as a major factor driving up costs, which became increasingly challenging over the last 3 years (INE, 2015). Long and costly judicial procedures drive up the costs of resolving commercial disputes, labour disputes and litigations with tax authorities. Significant court backlogs of 1.35 million cases persist despite progress made, particularly in first instance courts which deal with contract enforcement. Despite progress made, civil cases still take more than 500 days to be resolved, which is long in international comparison (Figure 1.23). Compared with other countries, Portugal spends a comparatively large share of GDP on its court system, but seems to be getting a poor return on these resources.

Figure 1.22. **Developments in cost competitiveness and export performance**

1. Euro area member countries that are also members of the OECD (15 countries).

2. Ratio between export volumes and export markets for total goods and services.

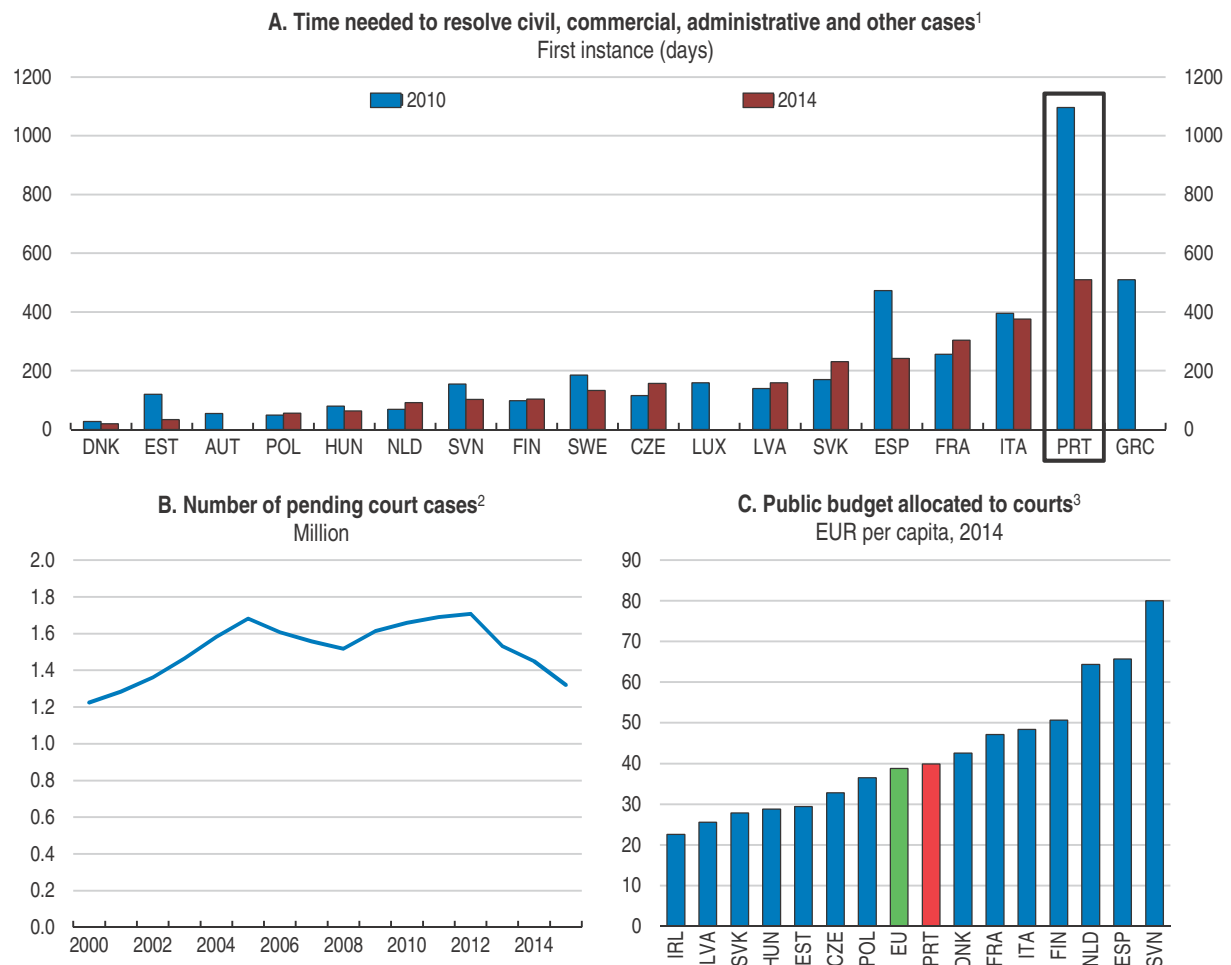
Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database).

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Excessively complicated and stringent procedures seem to play a key role. A new civil procedure code has been able to address some of these shortcomings by giving greater process independence to judges, reducing the number of appeals and allowing for mediation and out-of-court settlements at different stages of a civil process. Even though Portugal ranks fairly well with respect to its legal framework, the implementation of some judicial reforms seems to be lagging. International evidence suggests that the use of specialised courts can reduce trial lengths (Palumbo et al., 2013), but the benefits of specialisation are particularly strong if these courts are staffed with specialised judges. Portugal has specialised courts without specialised judges. In particular, it appears that there is scope to reduce trial lengths by increasing the number of commercial courts and staffing them with specialised judges. Empirical evidence based on firm-level data from 21 OECD countries suggests that more specialised courts and more rapid contract enforcement are of particular benefit for the post-entry growth of start-ups and new market entrants (OECD, 2016). Recent efforts for training judges should be continued. Finally, judges continue to be bound by overly detailed procedural codes, but giving them more discretion in case management should go along with better incentive mechanisms so that judges move up the court hierarchy based on performance rather than seniority.


Licensing requirements and red tape

Portugal has made strong progress in reducing administrative burdens for businesses. Less “red tape” reduces costs and raises the returns on investment. Recent measures plan to build on these improvements, including a new programme to simplify administrative procedures called Simplex+2016 and a single environmental licence that consolidates 11 current procedures. This useful programme includes an expansion of one-stop-shops, electronic applications and silence-is-consent rules. Future efforts should be focused on better integrating all licenses and permits needed to start a business, but co-operation among all public entities involved is crucial for that. At the local level, the pace of progress in easing procedures is heterogeneous, with some municipalities offering single windows and speedy service in almost all areas, while others are struggling to keep pace. Requiring all authorities involved in licenses or permits to publish their effective decision-making

Figure 1.23. **Performance of the judicial system**

1. Comparisons should be drawn with care as some countries reported changes in the methodology for data collection or categorisation.
2. Provisional data for 2014-15.
3. Total annual approved budget of courts which excludes legal aid and public prosecution services. The EU aggregate is an unweighted average of data for 20 countries.

Source: EC (2016), *The 2016 EU Justice Scoreboard*; Direcção-Geral da Política de Justiça; Francisco Manuel dos Santos Foundation (2016), PORDATA (database); and CEPEJ (2015), "Study on the functioning of judicial systems in the EU Member States", Part 1, European Commission for the Efficiency of Justice.

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time would improve transparency in this area. A study of municipal best practices is currently underway, and the results should be used to encourage and assist less advanced municipalities to catch up. Going forward, new laws can only be approved once the corresponding implementing regulation is drafted and regulatory changes take effect only on two specific dates in the year, which makes it easier for firms to keep up to date with current rules. Economic impact evaluations of new regulations have also become the norm and firms may net out simultaneous claims and liabilities with tax and social security authorities in the future. A decade ago, procedures, costs and delays for opening a business were 4, 6 and 19 times higher than now, respectively (World Bank, 2005 and 2015).

Despite these promising initiatives and plans, the implementation of administrative reforms seems to lag behind ambitions and needs to gain track. Despite the introduction of "Silence is consent" rules in wide areas, more than half of firms who had to deal with licenses

for starting a business considered this process a high or very high obstacle and failed to see any improvement in the process (INE, 2015). Large and industrial firms appear to struggle the most with tedious licensing requirements. Despite single windows to receive applications, behind-the-scenes consultations between different authorities can be lengthy. Overlapping competencies and a patchwork of rules defined across different laws and precedence rulings by courts create ambiguities and contradictions, leaving room for discretionary decisions, including by local authorities. A concerted effort to clean up and consolidate the fragmented set of rules would reduce complexity and the scope for corruption.

Policies governing land use can also constitute an obstacle to investment as they give strong discretionary powers to municipal governments which can block licenses for investment projects. The efficiency of municipal governments and the delays involved in obtaining licenses varies widely across municipalities. While considerations of protecting the landscape or quality of life of citizens may be legitimate objectives, they can also be abused to deny or condition the start of an economic activity. Reforms of the discretionary powers of municipal authorities had been envisaged under the external assistance programme, but were never implemented. The net benefit of investment projects for local development should be analysed on the basis of transparent and objective criteria, limiting the discretion of local authorities, which will also help to prevent corruption. In other cases, land use conversions have been granted too easily and owners of farmland have regularly lodged requests for conversion with the sole purpose of increasing the resale value of their property. This has favoured new construction projects in non-urban areas over the use of existing dwellings, leading to excessive urban sprawl which then required additional infrastructure investment, while large urban areas were often poorly maintained. The authorities should limit discretionary powers of municipalities to speed up licencing procedures further and introduce stricter deadlines for municipalities.

Avoiding implicit barriers to entry and post-entry growth from R&D policies

Given that dynamic young firms can make strong contributions to productivity growth and investment, it is important to avoid creating implicit barriers to entry or post-entry growth as collateral damage from other policies. One such example is policies to foster business R&D and innovation. In Portugal, these policies consist almost exclusively of tax credits in Portugal, but they do not allow refunds of these tax credits and R&D expenditures can be carried forward for only 8 years. Given that young firms typically lack taxable profits for the first years of operation, Portugal's R&D tax credits risk becoming an implicit entry barrier by favouring incumbents, particularly in a context of scarce and expensive credit. In cross-country comparison, more generous R&D tax credits are associated with a higher share of stagnant firms and a lower share of shrinking firms (Bravo-Biosca et al., 2013; OECD, 2015a; Appelt et al., 2016). The reason for this is that tax credits are usually counted against taxable profits, and new entrants typically lack taxable profits for a significant number of years. Portugal should consider allowing refunds of R&D tax credits or alternatively extend the carry-forward period further. This has become increasingly common in other OECD countries. For example, Australia, Canada, Denmark, Norway and the United Kingdom allow tax credits to be converted into cash refunds while Australia, Belgium, Ireland and the United Kingdom have extended loss-carry forward provisions indefinitely (Andrews and Criscuolo, 2013). Given that refunds can be costly, this may need to be coupled with specific safeguards to prevent abuse.

Recommendations for raising investment

Key recommendations

- Strengthen current regulatory incentives for reducing non-performing loans (NPLs), including through write-offs and sales.
- Support the development of a market for distressed debt, notably through the creation of asset management companies.
- Revise land use regulations and limit discretionary powers of municipalities in licensing procedures.
- Improve the workings of insolvency rules by
 - ❖ reconsidering the privileged treatment of public creditors
 - ❖ enlarging the scope for simple-majority decisions among creditors
 - ❖ shortening out-of-court settlement procedures.
- Further reduce trial length and the backlog of pending court cases by expanding court capacity and assigning specialised judges to specialised courts.
- Ease entry requirements in professional services.

Other recommendations

- Phase out electricity generation schemes with guaranteed prices sooner than currently planned.
- Improve the efficiency of ports by renegotiating concession contracts, attaching service level agreements to any new concessions and promoting intra-port competition between terminals.
- Promote wage bargaining at the firm level, including by placing more binding limits on administrative extensions of wage agreements.
- Consider allowing refunds of research and development (R&D) tax credits for loss-making firms or extending the carry-forward period significantly.

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