

## 2. Structural policies to lift Portugal's living standards

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

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

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

## A broad-based strategy to upgrade knowledge and skills

### *Reforms in the education sector*

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

#### *Seeking efficiency gains*

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

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

Ongoing measures	Stage of implementation
<b>Pre-primary, primary and secondary education</b>	
Further expansion of <i>pre-primary education</i>	<ul style="list-style-type: none"> <li>target is 90 per cent of national coverage; implementation has started; it depends on local authority initiative.</li> </ul>
<p><i>Programme for basic education</i>: the Framework Law for education is being legislated:</p> <ul style="list-style-type: none"> <li>Integration of levels 1 to 6 (age 6 to 12) into the new basic cycle; curriculum reform;</li> <li>Integration of secondary school levels 7 to 12; curriculum reform;</li> <li>School concentration and regrouping;</li> <li>ICT infrastructure;</li> <li>Courses in ICT have become compulsory at the secondary level (level 9);</li> </ul>	<ul style="list-style-type: none"> <li>planned for 2007;</li> <li>planned for 2007;</li> <li>closing down of schools with less than 5 students: launched in 2003-04, to be completed by September 2004;</li> <li>being developed; including pilot programmes in partnership with major ICT companies to be launched as from end 2004;</li> <li>phased in starting in 2004;</li> </ul>
<p>The reform of <i>upper secondary education</i> (levels 10 to 12) was approved in early 2004:</p> <ul style="list-style-type: none"> <li>the curriculum has been revised; flexibility is introduced to move from one stream to another;</li> </ul>	<ul style="list-style-type: none"> <li>applicable 2004-05 in level 10 only, 2005-06 in level 11 and 2006-07 in level 12;</li> </ul>
<p><i>At all levels</i> :</p> <ul style="list-style-type: none"> <li>Regrouping schools and reducing the number of management units;</li> <li>Comprehensive evaluation system of education and teaching.</li> </ul>	<ul style="list-style-type: none"> <li>has started to be implemented;</li> <li>implemented in all non-tertiary schools over 2004 and 2005;</li> </ul>
<b>Vocational training and professional schools</b>	
<ul style="list-style-type: none"> <li>Revision of the vocational curriculum, aimed at reducing drop-out rates;</li> <li>Introduction of a system of grants to attend vocational training;</li> <li>Creation of a technical school network (the EDUTECH programme).</li> </ul>	<ul style="list-style-type: none"> <li>guidelines proposed ;</li> <li>pilot project introduced;</li> <li>implementation has begun: 20 schools to be in place by 2006;</li> </ul>
<b>Higher education</b>	
<ul style="list-style-type: none"> <li>Creation of a general and independent system of evaluation and certification of courses, for public and private universities and polytechnic institutions.</li> </ul>	<ul style="list-style-type: none"> <li>evaluation system: implementation has begun;</li> <li>certification: in preparation.</li> </ul>

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

### *Improving education outcomes in terms of quality*

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

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

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

Table 2.1. **Indicators on ICT application in education**  
Upper secondary education, 2001

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

1. Total number of students in schools divided by total number of computers available to students.

2. Percentage of students in schools where principal reported that the most serious obstacles to the use of ICT in teaching is:

  i) Insufficient number of computers for students' use.

  ii) Teachers' lack of skills in using computers for instructional purpose.

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

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

#### *Improving cost-effectiveness and quality in higher education*

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

#### *Preliminary assessment*

It is still too soon to have a view of the full scope of the reform undertaken, as all the details on specific applications are not yet available and, as is usual in this area, unambiguous results will take several years to become apparent. The delay in approving the Framework Law for compulsory education, which is an important plank of the strategy, is unfortunate. However, a succinct examination of the ongoing reform thrust leads to a generally positive assessment. Through some of the measures already implemented, it appears that the education system is becoming more oriented to outcomes, the focus being now on quality instead of just quantity. The new culture of incentives and competition that is being developed should be conducive to better results. The secondary education

reform in particular would achieve one of its main objectives if, through the newly-introduced flexibility and revised curriculum, it brought students to complete successfully the final level and raised student proficiency (*i.e.* as measured in the PISA testing for reading, mathematical and scientific literacy). The new focus on ICT, with the introduction of compulsory classes in secondary schooling and development of technical schools, is appropriate to provide the required tools to school leavers for the transition to a knowledge-based economy: by increasing basic skills in science and technology for those who choose to enter the labour market without going into higher education it should facilitate absorption of new technologies throughout their active period. Assuming that technical education becomes attractive for an increasing share of students, it should facilitate the school-to-work transition. At the higher education level, finally, outcomes should improve as the quality of secondary education improves, courses are re-organised and universities have more autonomy to set admission requirements. It is appropriate to strengthen the scientific streams, but it will take time to reduce the considerable lag Portugal has in the number of science and technology graduates.<sup>5</sup> As discussed in Chapter 1, substantial gains in terms of multifactor productivity can be expected from a comprehensive strategy, such as the one set in motion to increase the effective duration of schooling and improve the quality of outcomes. For this to happen, it is important to carry through without delay the various components of the reform, given the important complementarities involved, and to maintain the momentum over a long period of time.

### **Adult training**

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

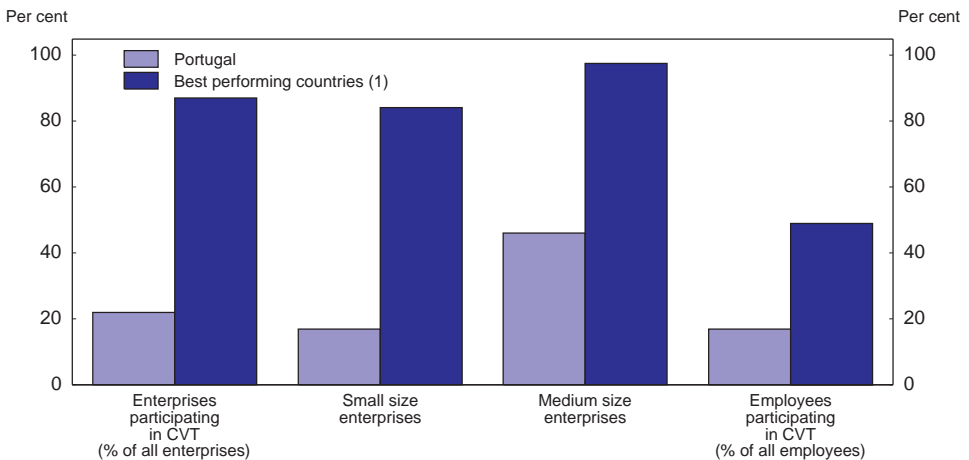
#### *Increasing access to training*

Public spending on labour market programmes is not high in international comparison (1.5 per cent of GDP vs. more than 2 per cent in most European

countries); and Portugal stands out for the relatively high share of the total that it typically spends on active measures (training and youth measures in particular) as opposed to passive measures (unemployment benefits and early retirement). This seems validated by the relatively low unemployment rate. Regarding continuous vocational training in firms, an increasing number of enterprises, those of larger size normally, are financing training they provide or promote, but the proportion remains quite small. Overall, Portugal is well below the European average in the proportion of enterprises offering training, the participation of the adult workforce in job-related training and in the intensity of such training (in terms of average number of hours devoted) (Figure 2.1).<sup>7</sup>

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

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



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

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

#### *Improving the effectiveness of the training system*

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

#### *Preliminary assessment*

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



### Box 2.2. Reform of adult training: measures announced

Measures announced	Stage of implementation
<i>On-the-job training and lifelong learning</i>	
<ul style="list-style-type: none"> <li>• Reorganisation of recurrent education to make it effective</li> <li>• Law for Professional Training, aimed at promoting lifelong learning</li> <li>• Targets for minimum annual hours of certified training applicable to all workers<sup>1</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Announced, as part of the reform of secondary education</li> <li>• Proposal discussed with social partners, submitted (May 2004) to Parliament for approval</li> <li>• Rules approved in the new Labour Code applied since December 2003</li> </ul>
<i>Creating a qualification structure</i>	
<ul style="list-style-type: none"> <li>• Comprehensive qualification framework combined with accreditation systems</li> </ul>	<ul style="list-style-type: none"> <li>• Work in progress</li> </ul>
<i>Developing evaluation systems for lifelong learning (LLL)</i>	
<ul style="list-style-type: none"> <li>• Specific indicators on efficiency and impact of professional training</li> <li>• Indicators on employment/education/training developed for the National Employment Plan</li> <li>• Specific indicators (for population aged 25 to 64) developed in the LLL national strategy</li> </ul>	<ul style="list-style-type: none"> <li>• In place</li> <li>• In place</li> <li>• In place</li> </ul>
Quantitative indicators	<ul style="list-style-type: none"> <li>• In place</li> </ul>
Qualitative indicators	<ul style="list-style-type: none"> <li>• Work in progress</li> </ul>
<i>Modernisation of Public Employment Services</i>	
Introduction of information systems and technology at the central level and in regional employment centres	<ul style="list-style-type: none"> <li>• Being developed: objective is to equip the entire network of centres by end 2004</li> </ul>
<i>Measures related to continuous training for employees</i>	
<ul style="list-style-type: none"> <li>• Support for training initiatives of the worker: subsidising employee (per hour of training taken) and firm to compensate for opportunity costs</li> <li>• Rotating employment-training scheme: subsidising firms that promote continuous training, while replacing workers in training by registered unemployed</li> </ul>	<ul style="list-style-type: none"> <li>• In place</li> <li>• In place</li> </ul>
<i>Training programmes for entrepreneurs</i>	
Programme to develop management training in enterprises of 50 or less employees (GERIR)	<ul style="list-style-type: none"> <li>• Promoted by Ministry of Economy; implementation has started</li> </ul>
Programme to improve management skills and organisation competencies (REDE)	<ul style="list-style-type: none"> <li>• In place since 1997, reorganised in 2002 to increase flexibility (shorter-duration actions) and focus on specific enterprise needs</li> </ul>

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

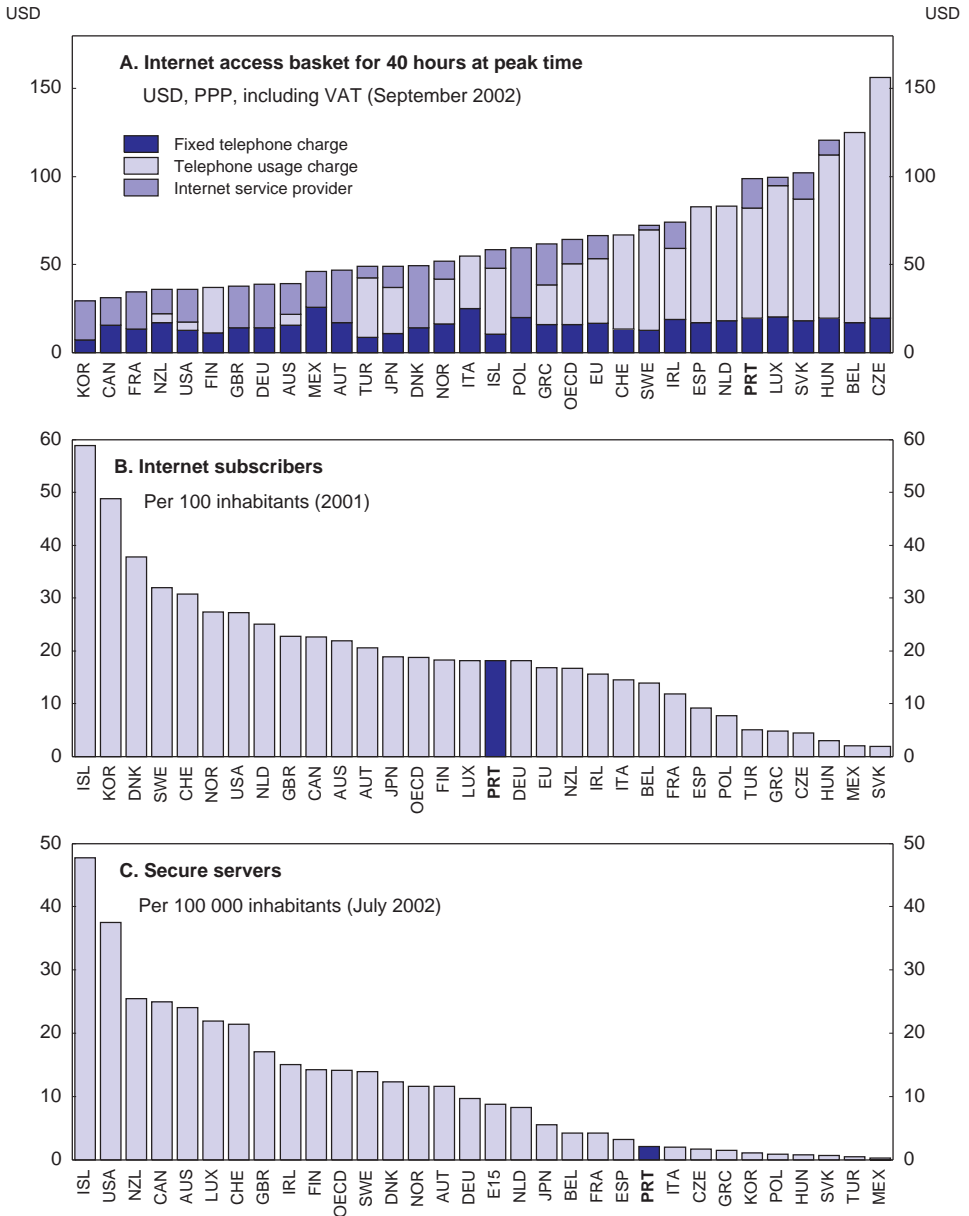
(high unemployment rates and skill mismatch<sup>11</sup>), strong policy action is needed to ensure that the workforce adapts to changing demand and to facilitate its mobility across sectors and regions. It would be particularly important to further develop teaching methods focused on adults who are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

### ***Helping the transition to a knowledge-based economy***

#### *Promoting the diffusion of ICT*

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

Figure 2.2. Internet indicators: an international comparison



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

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

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

### *Preliminary assessment*

The various measures introduced over the past few years to speed up the diffusion of ICT and strengthen relationships between industry and science are an important component of the overall strategy to boost productivity. Their effectiveness is enhanced by the fact that they are complemented by policies to foster human capital development in science and technology. Implementation of these as a package should help maintain Portugal’s attractiveness to foreign investment of high quality (*i.e.* medium and high technology). Whether technology is imported or developed locally is not as important for productivity growth as the fact that framework conditions will allow technology transfers across sectors and firms of

different size. For that to happen, other policy measures are also required, as reviewed below: effective product market competition, absence of barriers to entry and enough dynamism in firms creation and destruction, so as to allow the replacement of least productive by more productive firms.

### **Reforms to use the labour force effectively**

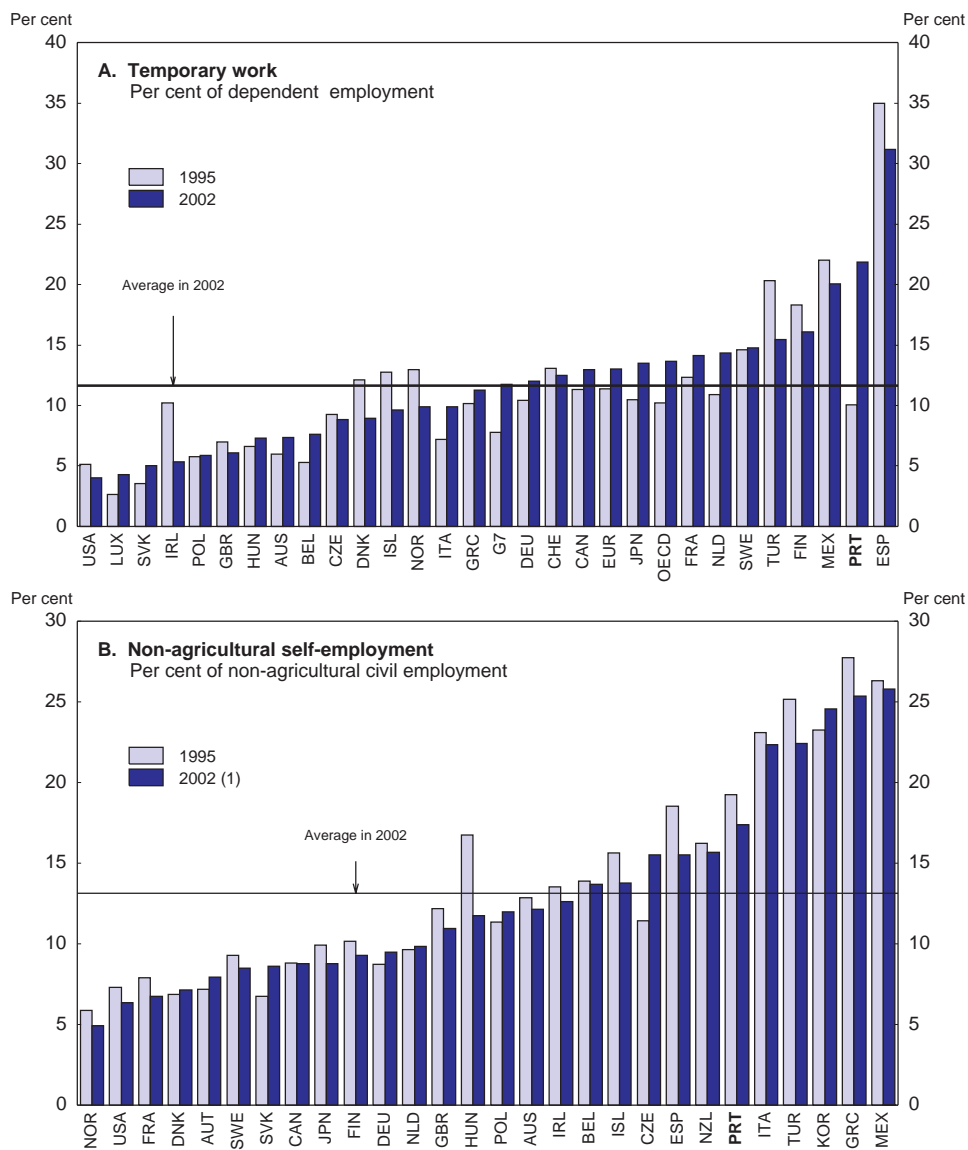
An increase in labour mobility and continued adjustment of wages (and prices) are the keys to facilitating the adjustment to structural changes and translating human capital improvements into income gains. Even after some easing during the 1990s, employment protection legislation (EPL) remained relatively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

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

### **The new Labour Code**

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

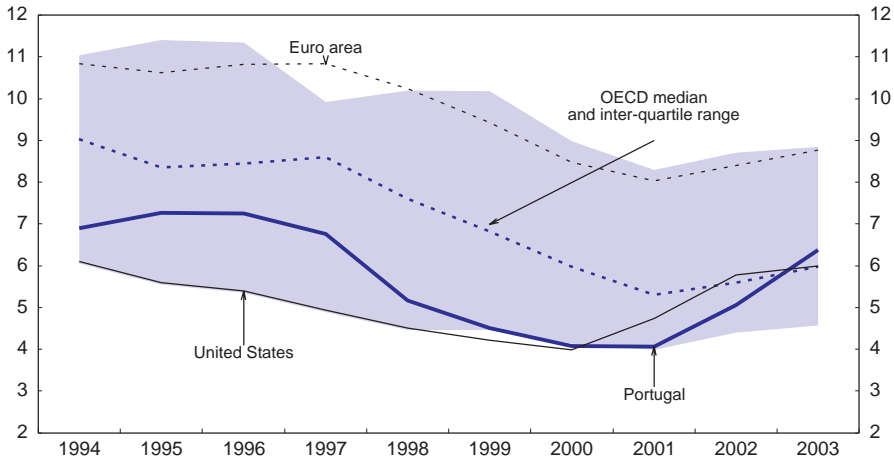
Figure 2.3. **Types of employment**  
Per cent



1. 1999 for Belgium.

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

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



Source: OECD, *Main Economic Indicators*.

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

### ***What remains to be done***

The Social Contract for Competitiveness and Employment being discussed between the government and social partners will include objectives in

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

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

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



development of entrepreneurs is an important component. To make the most of the “knowledge-based society”, all levels of managers and employees will have to be trained on how to share knowledge.<sup>26</sup> Portugal could use its “social pact” framework to explore these issues.

## **Promoting effective competition and moving forward in sectoral reform**

### ***Changes in the legal framework and institutional setting for competition policy***

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

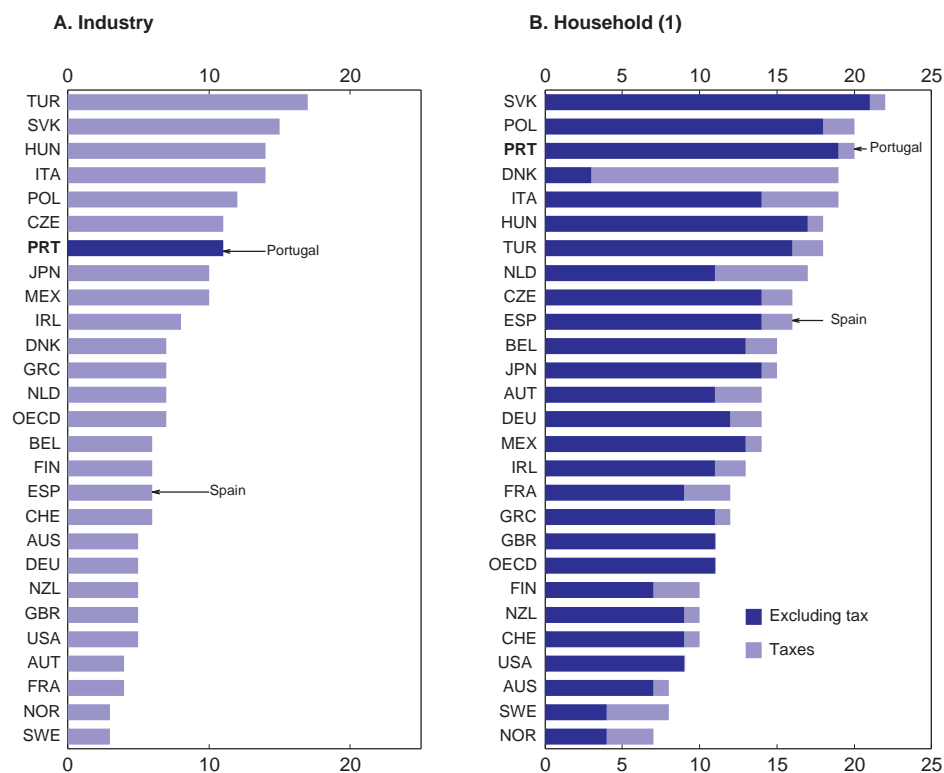
### ***Progress in privatisation and sectoral reform***

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

is a tendency to distort the allocation of resources to the detriment of the consumer and the efficiency of the economy.

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

**Figure 2.5. Electricity prices in selected OECD countries**  
In US dollars per 100 kWh (using PPPs) in 2002 or closest year available



1. Price excluding tax for the United States.

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

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

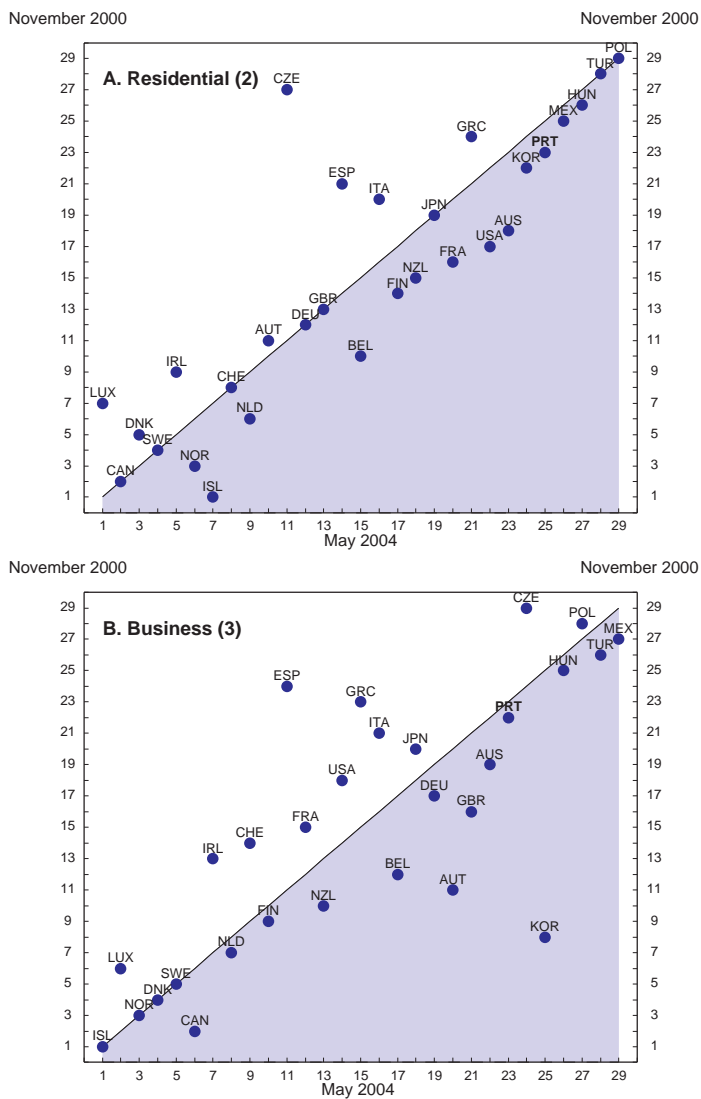
An agreement to create the Iberian Electricity Market (MIBEL) has been signed.<sup>30</sup> The creation of MIBEL is expected to improve capacity and efficiency in the sector. The agreement foresees a doubling of inter-connexion capacity between the two countries. In the preparation phase, Portugal plans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

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

### **Assessment**

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

Figure 2.6. Telephone charges in OECD countries 2000 and 2004  
 Rankings of OECD basket of telephone charges in ascending order (lowest price = 1)<sup>1</sup>



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

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

### **Improving the business environment**

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

### ***Reducing the cost of doing business***

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

### Box 2.3. On the informal sector and low productivity

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

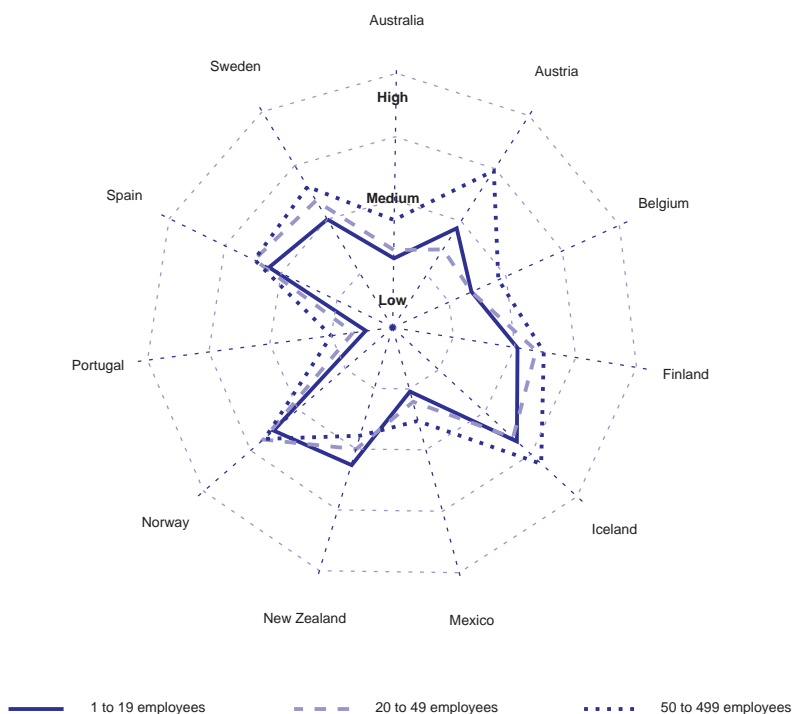
\* As noted in the OECD *Economic Survey of Portugal*, 2001, Portugal has a "long-standing history of poor compliance", tax enforcement being particularly difficult in small businesses and among the self-employed. Informality is pervasive in the non-tradable sector, such as retail trade in food, restaurants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

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

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

#### **Better legislation and regulations**

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

Figure 2.7. Levels of compliance as perceived by firms<sup>1</sup>

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

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

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

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

### **Financing investment**

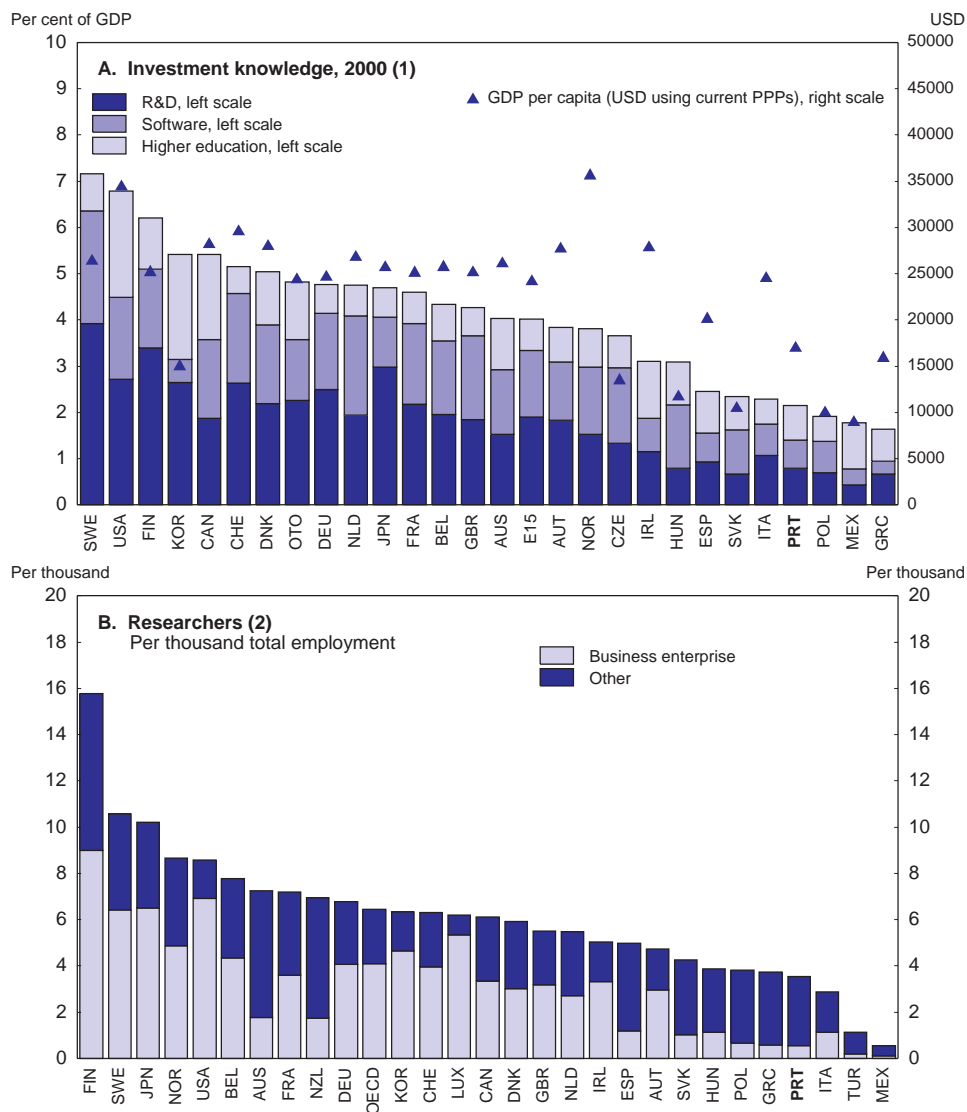
Steps had to be taken to improve the effectiveness and coherence of the main financing instruments for supporting business investment and enterprise modernisation. The conditions for support have been tightened. For instance the main financial instrument for investment support and the modernisation of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

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

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



Figure 2.8. Innovation indicators



1. For Canada and the United States post-secondary non tertiary education is included in data for higher education; for Belgium, data for higher education only include direct public expenditure. 1999 for Belgium, Denmark and Greece.

2. In 2002 or closest year available. 2001 for Portugal.

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

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

### ***Changes in corporate governance***

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

### ***Preliminary assessment***

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

This array of measures and of legislative changes can contribute to increasing firm dynamics, which has been found to boost productivity gains. It is an appropriate, even if still incomplete, response to injunctions from the business community and analysts, both national and international, concerned about the heavy burden imposed on enterprises by the complexity of the legal and administrative framework and the lack of information, as generally reported. The

implementation of all measures included in the government's programme, in particular the reduction of fees and fiscal burdens related to enterprise development and restructuring, merger and divestiture operations, should help reduce the bias that allowed least productive firms to operate. Enhancing the quality of public services is also important (Chapter 3).

### **Concluding remarks**

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

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

### Box 2.4. Implementing structural reform: an overview

Proposals*	Action taken	Assessment/recommendations
<b>I. Improve labour force skills and competencies</b>		
<ul style="list-style-type: none"> <li>• Raise the quality of formal education, enhancing vocational and technical programmes</li> </ul>	<i>Pre-school education</i> broadened	Continue with implementation
	<i>First 6 years of school</i>	
	– Reform measures are announced	Proceed with reform
	– Increasing computer equipment of schools	Continue with implementation
	<i>Secondary education:</i>	Continue with implementation
	– Ongoing revision of the curricula	
	– Creating technical schools and developing professional schools	
<ul style="list-style-type: none"> <li>• Improve the incentives faced by teachers and school managers, as well as their accountability</li> </ul>	Ongoing evaluation of schools	Monitor results and disclose, rewarding best performers
<ul style="list-style-type: none"> <li>• Improve quality of tertiary education, maintaining an even-handed treatment of public and private institutions</li> </ul>	Creation of a systematic and independent system of evaluation and certification of courses/universities	Continue with implementation
	Closing or merging courses with very few students	Continue
	Admission procedures and tuition fees are set by each institution	Should help improve outcomes
<ul style="list-style-type: none"> <li>• Facilitate access to training and support lifelong learning</li> </ul>	Ongoing negotiations with social partners to promote training in firms	Continue to explore options for more and better training
	Consolidation of national certification system	Step up implementation
<b>II. Moving to a knowledge-based society</b>		
<ul style="list-style-type: none"> <li>• Seize the benefits of ICT diffusion</li> </ul>	Steps taken to spread out ICT among households and companies, schools and other public areas	Improve regulatory framework for the telecommunications market to enhance competition, in order to reduce Internet access tariffs
<ul style="list-style-type: none"> <li>• Develop managerial skills</li> </ul>	Specialised training for managers	Monitor results and expand

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

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

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

## Notes

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

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

11. There has been no evidence of rising skill mismatch in Portugal, on the contrary, Portugal is one of the few euro area countries, with Belgium and the Netherlands, having witnessed an improvement in the Beveridge curve (cf. OECD, *Economic Survey of the euro-area*, 2004).
12. In their 2001 "Agreement on employment, labour market, education and training policy", the State and social partners listed access to continuing education and consolidation of adult education among the strategic objectives for human resource development. In 2002, social partners signed a joint declaration on the National Action Plan for Employment, in which training is listed as one of the priorities for cohesion policies. In early 2004, a new law to promote lifelong learning was proposed after discussions between social partners and the State (represented by the Ministry of Social Security and Labour).
13. The *Instituto do Emprego e Formação Profissional* (IEFP) operates under the Ministry of Social Security and Labour. Survey results indicate that its existence and the support it can provide for the creation of a business are well known among young job seekers or long-term unemployed seeking to open a business (cf. Ministry of Social Security and Labour, 2003).
14. Regarding training, employers are required to elaborate annual (and multi-annual) training plans as well as annual reports on the execution of continuous training obligation.
15. The percentage of households having internet access at home has been growing rapidly in Portugal, from 15.9 per cent in 2002 to 21.7 per cent in 2003, based on Eurostat structural indicators. Nonetheless, by 2003 it was still much below the EU average (45 per cent, for the EU15). [<http://europa.eu.int/comm/eurostat/Public/datashop/print-product/EN?catalogue=Eurostat&product=struct-EN&mode=download>].
16. Another instrument, a tax deduction (with a ceiling) provided since 1998 to households for the acquisition of ICT equipment, is less easy to justify. The tax incentive may have a legitimate social objective, but it is unclear whether it is achieved in the most efficient way, if achieved at all, since low-income categories do not have sufficient tax liability that can be set off against the tax break.
17. The *Novas Empresas de Suporte Tecnológico* (NEST) programme provides support to the creation of technology-based companies with venture capital financing. It is aimed at companies with venture capital financing. It is aimed at companies with still low activity, critically dependant on high-technology development which obtain up to 90 per cent funding from venture capital. These companies are granted a special status ("NEST company") with additional benefits, including support to locate in a technology park.
18. The QUADROS programme (which is one of the instruments of the new PRIME programme geared to enterprises modernisation) co-finances current cost associated with hiring graduates in marketing, engineering, technology and other areas linked to innovation and management.
19. The aggregate indicator computed by the OECD for Portugal shows: *i*) relatively stringent rules on individual dismissals; *ii*) average stringency of regulation on fixed-term contracts; and *iii*) average stringency in the requirements for collective dismissals (OECD *Employment Outlook* (2004, Chapter 2). More precisely, collective dismissals apply to cases with two workers or more in small-size firms (five workers and more in firms with more than 50 employees), while in many other countries the threshold for application

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

20. J.M. Varejão (2002) shows that in Portugal, as in a number of other European countries, fixed-term contracts are generally used as screening devices. High rates of transition from temporary to permanent contracts, for young workers especially, indicate that fixed-term contracts often are stepping stones towards permanent jobs, rather than dead-end jobs. As a result the social hardship and potential impact on productivity from the widespread use of short-term contracts are rather limited. Still, a non-negligible proportion of workers do remain in a chronic situation of temporary contracting.
21. The scale of contracting-out arrangements and outsourcing of services to “independent” workers, known as “green receipts”, was already among the highest in the OECD in the mid-1990s, under the combined impact of strict EPL and lower social security contributions. It decreased somewhat (as a share of non-agricultural employment) in the second part of the 1990s after social security contribution rates were harmonised.
22. This is particularly true of Portuguese firms, while foreign firms operating in Portugal have recourse to collective dismissal procedures. But even foreign-owned firms often prefer to reach agreements to reduce costs during cyclical downturns by adjusting working time and wages rather than the payroll, as illustrated by the agreement reached in the AutoEuropa plant (Volkswagen A.G.) in early 2004.
23. Evidence is mixed regarding regional mobility, with a relatively high percentage of cross-border commuting, but a lower than average commuting across regions (*cf.* OECD *Economic Survey of the euro area*, 2004). Institutional features, such as different social benefit regimes for different sectors are a factor contributing to the low sectoral mobility.
24. Under certain conditions, an employer will now be able to assign a worker to another region or to another task than the one he was hired for in the firm.
25. The current regime for fixed-term contracts clarifies the rules for the use of successive contracts; it establishes specific training obligations for workers under this type of contracts and compensation to the worker if termination is decided by employer. As a disincentive to excessive use of fixed-term contracting, employers social security contributions are related to the number and the duration of these contracts.
26. Lindley (2003) notes some inconsistency between that need to foster within-firm learning and sharing knowledge and the need for greater flexibility of contracts. According to him, the link to foster adequate organisations should be found in social partnerships.
27. *Cf.* OECD (2003) *The sources of economic growth in the OECD countries*, which summarises findings of the OECD Growth Project. See also OECD (2002).
28. The new Competition law makes important changes from the previous legislation, regarding company mergers, abuse of dominant position, and sanctions-fines-imposed for anticompetitive practices. The new Competition Authority is taking the place of the Competition Council and the Directorate General of Competition and Trade. The scope of the Competition Law has been broadened and updated, in line with European Commission rules, namely in the area of merger control: mergers of banks and insurance companies are now included under the new Law; and the assessment of measures qualified as “state aids” has been streamlined, granting the Authority powers to issue recommendations addressed to the government and public bodies. Details on the new legislation and its application are available on the Authority’s website [[www.autoridadedaconcorrenca.pt](http://www.autoridadedaconcorrenca.pt)].



29. Portugal was notified by the European Court of Justice in 2002 for its Framework Law on privatisation, which provided for the possibility of restricting foreign participation in many sectors, and changes were required. The required changes were implemented. In July 2004, the European Commission decided to close its case.
30. The agreement, signed in January 2004, setting the structures and operating rules of the Iberian Electricity Market (MIBEL) was expected to start operating in April of the same year, but the change of government in Spain could delay its implementation. When implemented, this will be one of the few concrete experiences (with the Nordic electricity market) of an integrated European energy market.
31. Legislation in Portugal is changing to move towards the creation of an electricity market. Initially, national regulators and network operators will operate in coordination; then, according to the agreement, they are to be integrated. In 2003, the Competition Authority commissioned a study on Portugal's energy market by Cambridge Economic Policy Associates. Outstanding competition issues which were identified – and are being discussed with the government – were: the local distribution of power and gas under a single operator; limited transmission capacity between the Spanish and Portuguese power grids; compensation payments for termination of existing Purchasing Power Agreements (PPAs); and the pace of liberalization of gas imports.
32. The Competition Authority, which has received several formal complaints against anti-competitiveness practices in the overall telecommunications market, from competitors of the incumbent company/groups has opened several enquiries under the Competition Law, currently under investigation. Within these enquiries, the Competition Authority coordinates with the sector regulator, ANACOM. Under the Competition Law it is mandatory for the Competition Authority to coordinate with sectoral regulators when the anti-competition practices concern regulated markets.
33. Portugal Telecom has a market share higher than 90 per cent in fixed telephony, long distance services, vs. 60 per cent in the 13 other European countries for which data are available. C. Gjersem (2004).
34. To develop competition in telecommunications, the following is underway: *i*) the sector's regulator ANACOM is holding a public consultation about issues related to the pre-selection call function, which may need to be enhanced; *ii*) an information campaign on telephone number portability was launched (by ANACOM) in mid-2003, to raise awareness of consumers about this possibility; *iii*) an analysis is being carried out on the competition situation in the latest physical stage of delivery – with the unbundling of the local loop – which is crucial to reduce the market power of the incumbent arising from control of the local loop.
35. The Ministry of Economy report, *Portugal 2010: Acelerar o Crescimento da Produtividade*, September 2003, lists the existence of widespread informality as the main factor explaining Portugal's low productivity level. Although difficult to measure, the incidence of informal employment is found to be particularly high in countries characterised by a high proportion of self employment, such as Portugal, Greece or Italy for instance. In those countries, and more generally Southern Europe, it appears to be an important determinant of the extent of illegal immigration. Cf. OECD (2004).
36. At the same time the municipal tax rate was lowered from 3.0 to 2.5 per cent, for an overall rate of 27.5 per cent at present (vs. 33 per cent previously). According to C. Bronchi and J. C. Gomes Santos (2002), Portugal's tax regime seemed to be on par with that in other European countries. This, however, may not be enough, given the country-specific features of Portugal in Europe (a small-size economy, located at the periphery

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

37. By early 2004, 10 Formality Centres for Enterprises were already in place and being used by more than half entrepreneurs and investors applying to create a business; administrative procedures to create a company had been reduced to about two to three weeks. The cost of creating a company was close to 600 euros, or 4.7 per cent of gross national income per capita, lower than the OECD average.
38. Notary practices will be responsible for preliminary tasks and subsequent activities (until then carried out by Registry offices). The privatisation will be achieved in two steps: first, the number of notaries is being increased, so their services will be more available; second, private and public notaries will coexist for a while. At the same time trade register offices are being computerised.
39. By February 2004, the Portuguese Investment Agency which started to operate in 2003 had assessed some 47 contracts, reviewed 72 investment projects for a total amount of almost 5 billion euros, of which more than half were related to tourism.
40. Criteria for providing subsidies were not as clear under the operational programme for the economy (POE) previously in place. The European Commission formally accepted Portugal's new "incentive programme for the modernisation of the economy" (PRIME) in June 2003. Under this scheme, the firm's borrowing is converted into a subsidy, subject to results. The programme is geared to enterprises in industry, commerce, services tourism, construction and energy.
41. The allocation of the fiscal reserve (a reduction of 20 per cent on the tax liability for 2003 and 2004) must be used within two years, either for initial investment in tangible fixed assets (not for replacement investment) or in innovation and development; otherwise, it has to be paid back with a penalty.
42. Portugal's venture capital market is one of the smallest in the OECD, in 1999-2002: total venture investment averaged less than 0.1 per cent of GDP, about one third of the OECD average ratio. Investment in the ICT sector, including computer software, accounted for about 15 per cent of total investments in 1999-2001, while there were pockets of investment in advanced sectors such as health and biotechnology. More details are provided in OECD (2003b).
43. As a measure to reduce the bureaucracy, a single supervisory body, the stock market commission, CMVM, has been entrusted with regulating and supervising activities of the Risk capital companies (SCR) and Risk capital funds (FCR), functions which were previously divided between the Bank of Portugal, CMVM and the Ministry of Finance. Tax measures include: i) the elimination of the tax on capital gains reinvested by the SCR; ii) the SCR's remain subject to the same tax treatment as before, thereby continuing to be exempt from the stamp duty on loans and deeds drawn up for incorporation and increase in share capital; a tax credit is introduced for SCRs. With regard to the FCRs, the tax system is becoming more flexible as holders can now opt to be taxed in the same way as the SCR shareholders.
44. In particular, the new enterprises for technological support programme (NEST) is focused on helping the creation of technology-based enterprises located in technology centres or parks, by helping them obtain financing from public risk capital companies or funds.
45. Portugal is among the countries which provide the highest tax subsidies to R&D in large enterprises (OECD, 2003a. More generally, tax incentives can be introduced on a selective basis to remedy market failures, for instance underinvestment in R&D or training.

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

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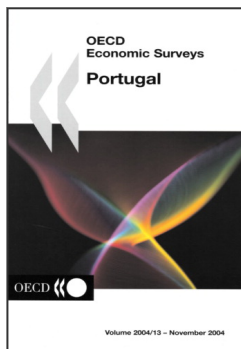
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