

ASSESSMENT AND RECOMMENDATIONS

Economic activity has remained strong

1. The economic expansion continued for a seventh year in 2000, as strengthening demand from Portugal's EU trade partners more than offset a downturn in private consumption. GDP growth of 3¼ per cent was reflected in increasing employment, and the unemployment rate fell to a record low of around 4 per cent. The disinflation process, which had taken the rate of price increase down to just over 2 per cent in 1999 was interrupted from April, the harmonised CPI rise reaching over 4 per cent in early 2001, somewhat above the EU average. The rise in oil prices combined with the weaker euro contributed to this outcome. However, despite slowing domestic demand, Portugal's more advanced position in the cycle appears to have increased pressures on resources, as the gap between actual and potential GDP has closed. The current account deficit has continued to widen, reaching 10¼ per cent of GDP in 2000.

Output growth is projected to ease but inflation will remain above the euro-area average

2. While the business climate continues to be positive and the increase in EU transfers should underpin investment, output growth is projected to ease slightly in 2001 and 2002. Monetary conditions have tightened, as the ECB has gradually raised rates since November 1999: the three-month Euribor rate rose above 5 per cent in the last quarter of 2000 and credit-market rates have risen more or less in parallel. Enterprises have maintained their borrowing, the depreciation of the euro having limited the degree of monetary firming for the export-oriented sector. But households are now highly indebted, and are rapidly affected by variations in short-term interest rates (most borrowing being at variable rates). Household spending is likely to continue to slow as consumers rein in their borrowing and the saving ratio has stabilised. Overall, with no stimulus expected from public consumption, GDP growth of just below 3 per cent is projected for 2001. Unemployment should stabilise at its structural rate of around 4 per cent. Against the background of an economy which will continue to operate near to its potential and despite an assumed easing in the average oil price to below \$30, inflation may not fall below 3 per cent over the next two years, which would be 1 percentage point above the average in the euro area.

The current account has widened and could be a sign of overheating...

3. Under the OECD's world trade assumptions, the current account deficit could remain at around 10 per cent of GDP up to 2002. In countries with a national currency, this level of deficit would be a considerable source of exchange-rate tension, but within the EMU the economy is insulated from strains emanating from the external sector. The deficit, in fact, relieves domestic supply pressures. Nevertheless, even within a monetary union the deficit is a cause for concern. In the first place, to the extent that it reflects a growing gap between supply and demand, it could be an indicator of inflationary pressures to come. Indeed, inflation and its possible effects on Portugal's external competitiveness, are probably the

major elements of uncertainty in the projections. Since 1999 there has been increasing wage drift, and discipline will be needed in the 2001 wage negotiations to ensure a more moderate outturn. It is essential that a wage-price spiral be avoided, the consequences of which would be a further deterioration in cost competitiveness or tighter margins, serving to lower exports and investment. In either case, in the absence of wage moderation, there would be a widening of the current account deficit, leading to a more marked slowdown in activity as adjustment become necessary. This risk would be aggravated in the event of a deterioration in the external environment -- as noted, Portuguese output growth depends heavily on activity in Europe.

... while private sector debt has risen too fast

4. More fundamentally, the external deficit may be a symptom of inadequate domestic saving. Even allowing for the normal net inflows of capital transfers into Portugal, of around 2 per cent of GDP, the deficit is high and has been associated with a sharp increase in private sector debt, rather than an inflow of foreign direct investment. Insofar as low capital mobility formerly prevented the pursuit of optimal consumption and investment patterns, greater capital-market integration would be expected to raise Portuguese foreign borrowing and the external deficit would not be of concern. Moreover, as is noted below, prudential rules have been tightened and financial sector risk indicators (such as non-performing loans) do not display any untoward shift towards greater risk-taking. Nevertheless, even if, as projected, the external deficit now stabilises, it would be associated with a continuing deterioration in Portugal's net foreign asset position. This indebtedness increases the vulnerability of the economy to a change in economic conditions in that it increases the possibility that a severe demand adjustment may be needed. The more expeditiously domestic saving is increased, the greater the probability of maintaining a relatively smooth growth path.

The pace of fiscal consolidation has been slow

5. In these circumstances, the setting of fiscal policy is the main instrument available to authorities to dampen demand pressures and bring inflation and the current account deficit down. The general government budget deficit has continued to decline in line with Portugal's commitments to the Stability and Growth Pact, falling to 1.4 per cent of GDP in 2000. But since 1997 the pace of fiscal consolidation has been slow, as most of the gains from higher revenues and lower debt payments have been used to increase primary current spending. On a cyclically-adjusted basis and excluding exceptional revenues from the sale of mobile telephone licences in 2000, net lending narrowed only very slightly over the period 1998-2000. This has implied a broadly neutral fiscal stance. Given the advanced stage of the cycle, a faster pace of deficit reduction would have served the aims both of fiscal consolidation and better control of demand pressures.

Budget implementation problems have emerged...

6. The problems encountered during the implementation of the 2000 budget are an indication of the additional difficulties that budgetary policy now faces, the opportunity to step up fiscal consolidation having gone unexploited at a time when conditions would have facilitated the process. Planning and control problems have emerged on both the revenue and expenditure sides. Total revenue was lower than expected in 2000, in part due to tax cuts to limit the domestic impact of higher international oil prices, while current expenditure pressures intensified after the budget was approved. To meet budget deficit targets an intra-year spending freeze was implemented, falling disproportionately on capital outlays, with primary

current spending being allowed to increase by 1.7 percentage points of GDP. Against this background, the 2001 budget may pose severe challenges. It envisages a further reduction in the general government deficit to 1.1 per cent of GDP, which on a cyclically-adjusted basis and excluding the non-recurring receipts from the sale of mobile concessions in 2000, implies a significant planned policy tightening. However, as in previous years, the authorities expect consolidation to be achieved mostly through an increase in current revenue, which might not materialise, raising the spectre of another intra-year spending freeze. The continuous reliance on contingency measures suggests fundamental weaknesses in the budget process, which must lead to inefficiencies in the composition of public spending. Short-term expedients should not be allowed to substitute for longer-term budget discipline, which should include measures preventing budget revenues being used to smooth fluctuations caused by international oil prices. More fundamentally, the budget process should be re-examined so as to ensure more realistic spending and revenue programming, within a longer-term budget consolidation strategy that does not require continual fine-tuning in the face of short-term disturbances. The new framework law for the state budget, currently under discussion, should ensure that progress is made towards better budget planning and implementation, based *inter alia* on multi-annual financial programming and activity-based budgeting.

... calling for better control over public spending

7. The medium-term budget programme, 2001-04, does not yet incorporate significant progress in spending control, but the public finance consolidation programme now being drawn up offers an important opportunity to reassess and restructure programme priorities in the light of their cost and efficiency. Meeting the objective of budget balance by 2004 continues to depend on significant annual increases in the tax take, over and above the rate of growth of GDP. This means that the deficit could remain subject to predictive error. Even if the extra tax receipts do materialise, raising the tax burden by over 1 percentage point of GDP could harm Portugal's competitive position. This is not the most effective way of supporting the strong export-oriented growth on which budget consolidation partially depends. On the spending side, convergence to the productivity levels in more advanced EU countries requires that reductions in net capital outlays be avoided, so that a high ratio of capital spending to GDP is justified. But this should point to the need for stronger efforts to control primary current expenditures, including actions designed to address the structural causes of spending overruns. These originate in three main areas: *i*) the health sector, which is plagued by inefficiencies that have not been fully addressed by recent reforms; *ii*) the public sector payroll bill, where spending per employee has been growing rapidly, due to generous wage increases and strains related to pension benefits; and *iii*) the social security system, where population ageing will present a growing challenge to the "pay-as-you-go" scheme. Each of these areas requires remedial attention.

Medium-term fiscal goals are unambitious

8. As for Portugal's medium-term budget-deficit objectives, these wholly comply with the Stability and Growth Pact requirements, but the goal of achieving budget balance by 2004 is unambitious and should be brought forward. If there is a cyclical downturn, the 3 per cent budget deficit limit should, in normal circumstances, be respected while allowing built-in stabilisers to operate. However, growth as strong as that assumed in the Programme would push output to a level where it would probably be at or even above potential in 2004, according to OECD estimates, which implies that budget balance is planned to be achieved only at a

level of activity close to the cyclical peak. A significant surplus at that point would be necessary to ensure balance for the budget over the cycle, as should be the aim. Specifying the budget constraint in this way would act to correct the deficiency in national saving. It would also further reduce the risk of having to resort to disruptive pro-cyclical action to prevent the deficit limit from being breached in the event of a sharp correction to private saving emanating from the strong surge in indebtedness noted above.

The tax system has positive features, but also major flaws

9. For budgetary and efficiency reasons, tax reform is one of the most pressing items on the structural reform agenda, as recognised in recent legislative initiatives. The system has developed positively in the past decade. Following the 1989 tax reform, tax bases have been broadened and statutory tax rates lowered. Successful steps have been taken to raise tax compliance and these contributed to faster revenue growth in the latter half of the 1990s. The introduction of the VAT has brought a major improvement to the tax system. At 34 per cent of GDP, the overall tax burden is not especially high, and is not out of line with other OECD countries with similar per capita incomes. Aggregate marginal tax wedges on labour income are somewhat below the OECD average for most wage and family situations, so that distortions to the labour market from this source should be limited. However, there are some features of the tax system, such as the non-neutral taxation of capital and the design of some tax benefits and tax incentives, which increase the excess tax burden, while tax avoidance and evasion contribute to a widespread perception of a lack of fairness of the system. While retaining the positive features of the system, including, especially, the low overall tax/GDP ratio, reform of the tax structure to increase efficiency and equity has become a policy priority. Several measures were approved at the end of 2000, and the reform process is still in progress.

More uniform tax enforcement is essential...

10. One of the most important problems with the income tax system relates to the taxation of self-employed and small businesses, where tax enforcement is difficult. Revenues received from these groups, which embrace large numbers of potential taxpayers, are very low. In order to address this problem, a simplified tax regime was introduced at the beginning of 2001. This should be seen as a first step in the fight against tax evasion. However, for greater fairness and neutrality, a more accurate assessment and auditing of the income of the self-employed and micro businesses is required, calling for reliable bookkeeping. The generosity of tax breaks should be reconsidered, as well as the still low contributions of the self-employed to the social security system. Additional revenues from a base broadening of this sort would allow a reduction in the personal income tax rates and social security contributions, which in turn would help to reduce disincentives to work in the “declared” (formal) economy. In this context, tax law should be made clearer and more definitive, court processes accelerated, the process of investigation for tax evasion made more expeditious, and the training for inspectors enhanced. Some measures to ease bank secrecy for tax purposes were taken in December 2000, which constitutes a move in the right direction.

... as is an overhaul of tax breaks allowed under the

11. Reforming the company tax system provides an even greater challenge. The corporate income tax rate is gradually being lowered. However, tax incentives for the business sector complicate tax administration and increase economic costs. Due to the difficulties in verifying if all the deducted items are effectively

corporation tax

connected to the firm's activity, and not associated with tax evasion practices, a large amount of inadmissible losses are presented for tax purposes, reducing fiscal revenues. Currently, a very small number of corporations pay the bulk of corporation tax receipts in Portugal. Incentives and deductions need to be re-assessed and further streamlined to allow base broadening and a harmonisation of the corporate income tax rate at a single relatively low rate. This would reduce the current bias in favour of small businesses.

The tax system should be more neutral towards savings and investment decisions

12. Taking income and capital taxes together, taxation of the various forms of income from financial capital has been uneven, distorting saving decisions. Different forms of capital income are taxed at substantially different rates, the disparities tending to affect both the allocation of capital and firms' financing decisions. Interest payments (from both bank deposits and bonds) are taxed at an effective rate of 20 per cent, as they are fully deductible from the base of the corporate income tax. Financial capital gains, which were not taxed at the level of the individual, if shares were held for at least twelve months, have been one of the most favoured forms of passing on profits. Capital gains (as of 2001) and dividends (as of 2002) are subject to the progressive income tax schedule. This change will go some way to improve tax neutrality between corporate financing with new equity and retained earnings, but it will not remove the strong bias in favour of debt finance. Concerning the special regimes for the free-trade zones of Madeira and the Azores, they are currently reviewed in the context of the OECD initiative on potential harmful tax practices. The taxation of property is also under examination and needs to be reformed while ensuring a smooth transition so as to avoid disruptive effects on property prices. The National Land Registry should be updated to provide for a more accurate basis for assessing property and VAT on the sale of new buildings (as recommended by the Sixth EU Directive) could replace the inefficient transaction tax SISA. Greater flexibility in setting property taxes could be given to local governments, enabling them to become more responsive to the concerns of voters.

Unemployment is low, but further efforts are needed to enhance flexibility in the labour market

13. The Portuguese labour market is characterised by low unemployment and a relatively high employment rate. These favourable outcomes are the result of a high degree of wage flexibility, the continuing reinforcement of active employment policies and an increasing recourse to more flexible forms of employment (for instance, fixed-term contracts). In fact, active labour market measures have been deployed on a large scale to facilitate entry and re-entry into the labour market of population groups at risk, such as the youth and long-term unemployed. Furthermore, while the social safety net has been strengthened, unemployment-benefit and pension provisions have been adjusted to help "make work pay", thereby improving incentives to take on declared jobs. It is important to preserve the features which have given *de facto* flexibility to the labour market. One remaining element of inflexibility is employment protection legislation, which is relatively restrictive and can be an obstacle to hiring on "regular" contracts. Dismissal rules for individuals are still rather costly. The proposed fiscal incentives for employers to transform fixed-term into indefinite contracts for the young and long-term unemployed should not be seen as a substitute for an easing of restrictive job protection rules which, coupled with stricter application of labour norms, would be the best way to facilitate adjustment to the competitive environment.

Upgrading skills and competencies is essential for economic convergence

14. Recent initiatives have been taken within the framework of the National Action Plan, the lines of action being generally in accordance with recommendations made, in the context of the OECD *Jobs Strategy*, in past *Economic Surveys of Portugal*. These policies have been supported financially by considerable EU transfers. The employment strategy embraces, among other goals, the objectives of adjusting labour legislation to new forms of employment, such as part-time work and short-duration employment, while also ensuring that workers involved in such arrangements are legally protected. Adaptability of work practices is particularly crucial for taking advantage of new job opportunities. Evaluation of the results achieved by the Plan should serve to adjust and fine tune the strategy and should become a continuous and systematic process, with a view to improving the efficiency of labour-market programmes and rationalising the numerous (and sometimes overlapping) existing instruments. The process of reform should be facilitated by the considerable improvements achieved in recent years to provide wider and better education and training, which have played a role in Portugal's good labour-market performance. The continuing challenge, if the country is to successfully advance towards a skilled-based economy, lies in further enhancing skills and competencies.

Product market liberalisation should be stepped up

15. Significant progress has been made in promoting product market competition since the early 1990s, but the pace of change has slowed somewhat in recent years. The privatisation programme has been among the most ambitious in the OECD area, netting over €14 billion in the ten years to 1999. However, no major enterprises have been added to the privatisation list since 1998 and the process can be deepened. Overall, the relative size (and scope) of the Portuguese public sector remains large. State ownership is still significant in transportation (air, railroad, maritime) and finance. To the extent that eventual efficiency gains in these sectors could have strong spill-over effects on the rest of the economy, further sell-offs should be considered. It is important, however, that continued state intervention, for example through the retention of special voting rights in some companies, should not forestall the efficiency gains which are the fundamental rationale for transferring ownership to the private sector. Most crucially, while fierce competition has been generated by the liberalisation of the telecommunications sector, the opening of other network industries has sometimes been too slow or ineffective, leading to inadequate market contestability, and inefficiencies:

- In the electricity sector, recent deregulation measures taken in accordance with EU Directives, have not sufficed to create a competitive market. *Electricidade de Portugal* has kept a dominant position in generation, transmission and distribution, as the capacity of independent domestic generators remains limited and the present price structure creates little incentive for them to provide electricity directly to final consumers. Priority should be given to revising existing power-purchasing arrangements in the public system, eliminating asymmetries related to the pass-on of cost reductions to prices. Further efforts should also be made at the EU level to implement a harmonised system for cross-border tariffs.
- In the oil and gas distribution sector, a holding company (GALP) was created in April 1999 with the merger of the national gas and oil companies. The new

company has been gradually privatised and some progress has been made in developing the appropriate legal framework. However, the regulatory body is not yet in place and in the case of gas, the network is still under construction. Existing price regulations on unleaded gasoline and diesel should be abolished, and GALP's monopoly on the transport and sale of natural gas should be phased out before the 2007 deadline foreseen under the derogation Portugal obtained from the EU Gas Directive.

Finally, the present regulatory framework still has important deficiencies and needs updating, particularly with respect to the institutional setting of competition policy. Reforms should seek to give the Competition Authority enhanced administrative and financial autonomy.

***Financial sector
prudential issues
are being tackled***

16. Reforms undertaken since the late 1980s have significantly transformed the Portuguese financial sector, to the extent that most performance indicators have either converged or surpassed OECD averages and the sector is in relatively good shape. More recently, the authorities have tackled important policy issues concerning prudential regulation and supervision. The creation of a National Council of Financial Sector Supervisors and the approval of a new Securities Code have been important steps which will help ensure the future solidity and efficiency of the system. Action has also been taken to address concerns of a prudential nature that might arise from the recent rapid expansion of domestic credit and the consequent increase in household indebtedness. This has included the rise in required provisions on consumer credit and the tightening of capital adequacy rules related to mortgage loans for residential purposes. These moves have been complemented by action to build the necessary legal and prudential background for the development of mortgage-backed securities, which will facilitate banks' liquidity management, while allowing them to reduce their balance sheet exposure. Remaining to be addressed are issues related to the ongoing consolidation and restructuring of the banking system. In that regard, the easing of transferability rules for the bank employees' pension system would facilitate continued adjustment, while further privatisation in the financial sector should be envisaged.

Summing up

17. Overall, the favourable economic performance of the Portuguese economy noted in previous *Surveys* has continued, but there are a number of warning signals. Output growth has remained strong in 2000 and unemployment has fallen to a low level, but after seven years of expansion, the output gap has closed and pressures on production capacity have started to be felt. The underlying inflation differential *vis-à-vis* the euro-area average has remained around 1½ percentage points, and the current account deficit has widened, reaching 10¼ per cent of GDP. Even within a monetary union, the accumulation of private-sector debt associated with a current account deficit of this magnitude will, if no policy actions are taken, necessarily lead to an endogenous reaction by households to cut back their borrowing. There is already evidence that an adjustment process has begun, evidenced in the slowdown in domestic demand and a stabilisation of the saving ratio. But the process of restoring better balance to supply and demand will require strong support from fiscal policy, which remains the main macroeconomic tool available to ensure that the adjustment takes place at a sustainable pace. Portugal has consistently met its budget deficit targets under the Stability and Growth Pact, but these have not been ambitious given the generally

favourable economic conditions and continue to be unambitious over the next four years. Moreover, in meeting its budget deficit targets, Portugal has increased both tax revenues and current expenditures sharply relative to GDP in the last few years. In the future, fiscal adjustment is likely to require better control of public spending, which calls for further structural reform in the health and other social spending sectors, as well as stronger action to rein in the public sector payroll. Indeed, a fiscal reform that reduces distortions, improves tax compliance and harmonises tax rates at a lower level, as foreseen in some of the current government proposals, would strengthen Portugal's supply-side performance, while also enhancing equity. This would be reinforced by further steps to increase product market competition and re-energise the privatisation programme. Combined with the on-going efforts to enhance human capital and the infrastructure, such structural reforms should allow the convergence of per-capita incomes to levels in more advanced EU partners to continue on a sustainable basis.