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Portugal: Rebalancing the Economy and Returning to Growth Through Job Creation and Better Capital Allocation

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PORTUGAL: REBALANCING THE ECONOMY AND RETURNING TO GROWTH THROUGH JOB CREATION AND BETTER CAPITAL ALLOCATION

ECONOMICS DEPARTMENT WORKING PAPERS No. 994

By Álvaro Pina and Ildeberta Abreu

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ABSTRACT/RESUMÉ

Portugal: Rebalancing the economy and returning to growth through job creation and better capital allocation

Low growth and huge current account deficits have characterised the Portuguese economy over the past decade. Easy credit in global markets, combined with the absence of incentives to limit loan-to-deposit ratios until recently, made it possible to finance internationally high levels of consumption and investment relative to gross domestic product (GDP) through over reliance of the banking sector on wholesale funding. This led to high households' and firms' indebtedness and made banks vulnerable to shifts in investor sentiment. However, investment and credit were mostly directed to sheltered sectors, giving rise to an oversized road infrastructure, electricity generation capacity and housing stock. Weaknesses in labour market institutions further held back productivity and hampered wage adjustment, making it harder to gain cost competitiveness.

The deleveraging process set in motion by the loss of access to foreign financing is helping to rapidly reduce external deficits, but also has the potential to generate a damaging credit contraction, which enhances the importance of alternative financing strategies for firms, such as greater reliance on equity. To restore growth, Portugal needs to foster the reallocation of both labour and capital, essentially towards the tradable sector. Building on recent policy initiatives or commitments, this will require reforming public policies that have long distorted investment allocation, ensuring that banks adequately recognise and provision problematic loans and, on the employment front, reducing labour market segmentation and increasing targeted training. Reforms in wage setting, labour taxation, unemployment benefits and activation policies will foster job creation, thus enhancing output growth while avoiding high unemployment becoming entrenched and threatening social cohesion. This Working Paper relates to the 2012 *OECD Economic Survey of Portugal* (www.oecd.org/eco/surveys/portugal).

JEL classification codes: F32, G21, G28, J52, J64, J65, L94, R31

Keywords: Portugal; macroeconomic imbalances; banks; financial regulation; deleveraging; credit allocation; unemployment; labour costs; activation policy; wage bargaining; labour market segmentation; housing; ener*gy.*

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Portugal: Rééquilibrer l'économie et renouer avec la croissance par la création d'emplois et une meilleure affectation des capitaux

L'économie portugaise s'est caractérisée ces dix dernières années par une croissance faible et des déficits volumineux des paiements courants. L'accès au crédit facile sur les marchés mondiaux, conjugué jusqu'à ces derniers temps à une absence de dispositifs incitant les banques à limiter leur ratio prêts/dépôts, a permis de financer à l'international une forte consommation et des investissements élevés par rapport au produit intérieur brut (PIB), par un recours excessif du secteur bancaire aux marchés de la dette internationaux. Ce phénomène a abouti à un endettement important des ménages et des entreprises et a rendu les banques vulnérables à un retournement de la confiance des investisseurs. Cela étant, l'investissement et le crédit ont été principalement orientés vers les secteurs protégés, donnant naissance à une infrastructure routière, à des capacités de production d'électricité et à un stock de logements surdimensionnés. Les carences des institutions du marché du travail ont encore sapé la productivité et entravé l'ajustement des salaires, rendant encore plus difficiles les gains de compétitivité-coûts. Le processus de désendettement déclenché par la perte de l'accès aux financements internationaux contribue à réduire rapidement les déficits extérieurs mais pourrait également engendrer un resserrement du crédit préjudiciable pour l'économie, ce qui accroît l'importance de stratégies de financement alternatives pour les entreprises, telles qu'une plus grande dépendance sur les fonds propres. Pour renouer avec la croissance, le Portugal doit favoriser le redéploiement de la main-d'œuvre et du capital, pour l'essentiel vers les secteurs exportateurs. En s'appuyant sur les récentes initiatives et engagements politiques, il lui faudra engager une réforme de ses politiques publiques qui ont longtemps faussé la répartition des investissements, veiller à ce que les banques comptabilisent et provisionnent comme il se doit leurs prêts problématiques et, sur le front de l'emploi, réduire la segmentation du marché du travail et renforcer les formations ciblées. Des réformes concernant la fixation des salaires, l'imposition du travail, les allocations chômage et les politiques d'activation stimuleront la création d'emplois et renforceront de ce fait la croissance de la production tout en évitant l'enracinement d'un chômage élevé mettant en péril la cohésion sociale. Ce Document de travail se rapporte à *l'Étude économique de l'OCDE du Portugal*, 2012 (www.oecd.org/eco/etudes/portugal).

Classification JEL: F32, G21, G28, J52, J64, J65, L94, R31

Mots-clés: Portugal; déséquilibres macroéconomiques ; banques; régulation financière; réduction de l'effet de levier ; allocation du crédit; chômage; coûts salariaux; politique d'activation; négociations salariales; segmentation du marché du travail ; logement; énergie.

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Portugal: Rebalancing the economy and returning to growth through job creation and better capital allocation

by Álvaro Pina and Ildeberta Abreu[1]

The crisis made imbalances unsustainable

After a lost decade, the Portuguese economy has embarked on a challenging process of economic adjustment and reform. Over 2001-10, real GDP growth averaged a meagre 0.6%, and unemployment almost tripled. Labour market institutions have held back productivity growth and hampered wage restraint, damaging external competitiveness. An array of product market inefficiencies and rents, especially in sheltered sectors, also hurt productivity and competitiveness, not least by distorting investment allocation. Insufficient risk perception allowed excessively high consumption and investment to be intermediated by domestic banks through international wholesale debt markets, especially as there were no incentives, such as a target for the loan-to-deposit ratio, to slow down lending until recently. Combined with poor export performance, this led to high external deficits and indebtedness. Despite a growing tax burden, public debt has also increased markedly, reflecting chronic difficulties in managing and controlling public expenditure, of which government-directed investment projects are a good example.

While many of these problems have been long identified and discussed (*e.g.* Blanchard, 2007), the global financial and sovereign debt crises have made them more acute and, when external private financing dried up, unsustainable. Since May 2011, Portugal has been steadfastly implementing an ambitious three-year European Union-International Monetary Fund (EU-IMF) financial assistance programme. It is important to ensure that the inevitable short-run costs of the on-going macro-financial adjustment do not degenerate into a deeper recession, and that continued structural reform efforts help to minimise the risk of unemployment becoming structural and lay the ground for sustained and balanced growth. After outlining how imbalances built up, this working paper discusses policies to rebalance the economy and return to growth, focusing on restoring the banking system to health, fostering efficient investment allocation and creating more and better jobs through improved labour market performance.

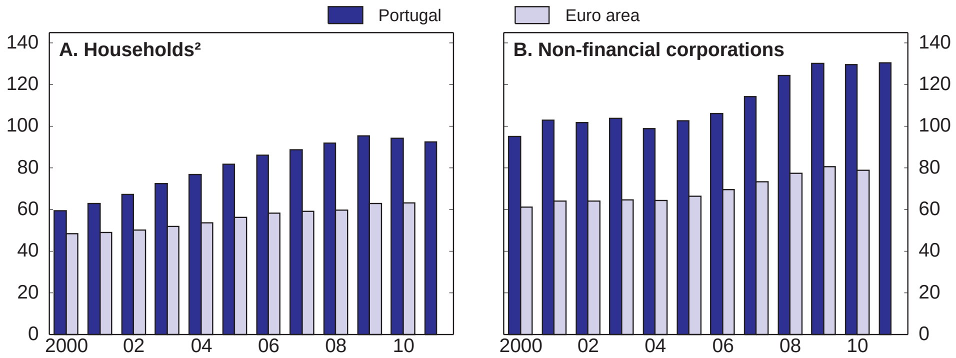
Macroeconomic imbalances have grown larger over the past decade

The very high current account deficits, of almost 10% of GDP on average during 2001-10, led to a sharp deterioration of the international investment position from –39% of GDP at end-2000 to –107% ten years later. This was reflected in the growing indebtedness of households and firms (Figure 1). Portugal lost substantial export market share until 2005, with no signs of any significant recovery until 2011, while imports were fuelled by high private consumption and (to a lesser extent) investment (Figure 2). After some ten years of persistent, though moderate, real appreciation, cost competitiveness essentially stagnated around the mid-2000s and did not start to recover until 2010, despite rising unemployment (Figure 3).

1. This paper was produced for the OECD Economic Survey of Portugal, published in July 2012 under the authority of the Economic and Development Review Committee. Álvaro Pina is an economist at the OECD Economics Department and Ildeberta Abreu is an economist at the Economics and Research Department of the Bank of Portugal, seconded to the OECD during the period of Survey preparation. The authors are grateful to Pierre Beynet, Andrew Dean, Robert Ford, David Grubb, David Haugh and Stéphane Sorbe for valuable comments and suggestions on earlier drafts as well as for discussions with Portuguese officials and independent experts. Special thanks go to Desney Erb for statistical assistance and Maartje Michelson for editorial assistance.

Figure 1. Financial debt[1]

Per cent of GDP

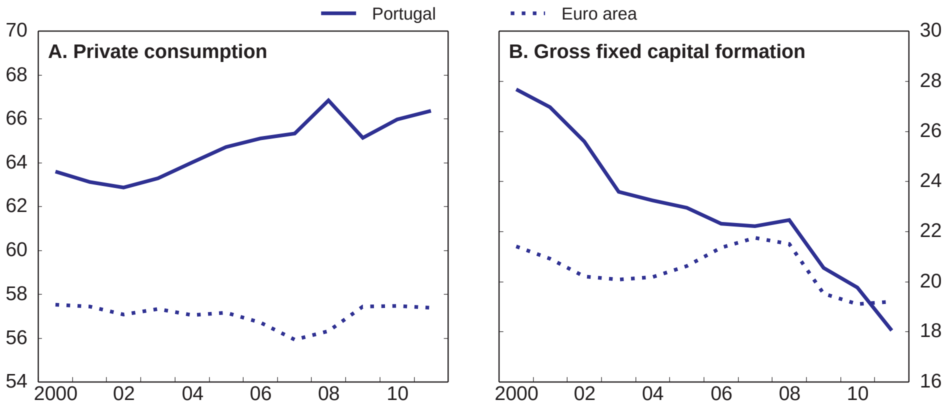


1. Loans plus securities other than shares.
2. Including non-profit institutions serving households.

Source: Eurostat (2012), "Economy and Finance", *Eurostat Database*, May.

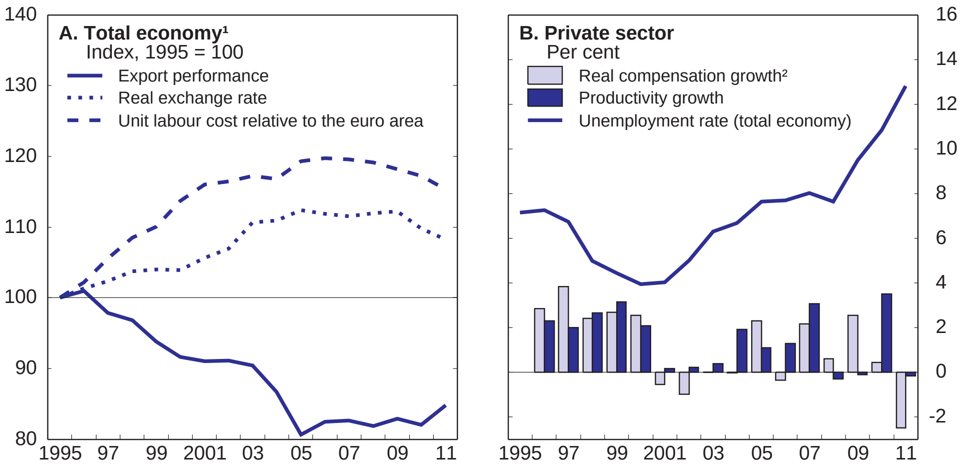
Figure 2. Private consumption and gross fixed capital formation

Per cent of GDP



Source: Eurostat (2012), "Economy and Finance", *Eurostat Database*, May.

Figure 3. Developments in cost competitiveness



1. Export performance is the ratio between export volumes and export markets for total goods and services. The real exchange rate is a harmonised competitiveness indicator based on unit labour cost indices.
2. Compensation per worker in the private sector deflated by the harmonised consumer price index.

Source: Bank of Portugal and OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May.

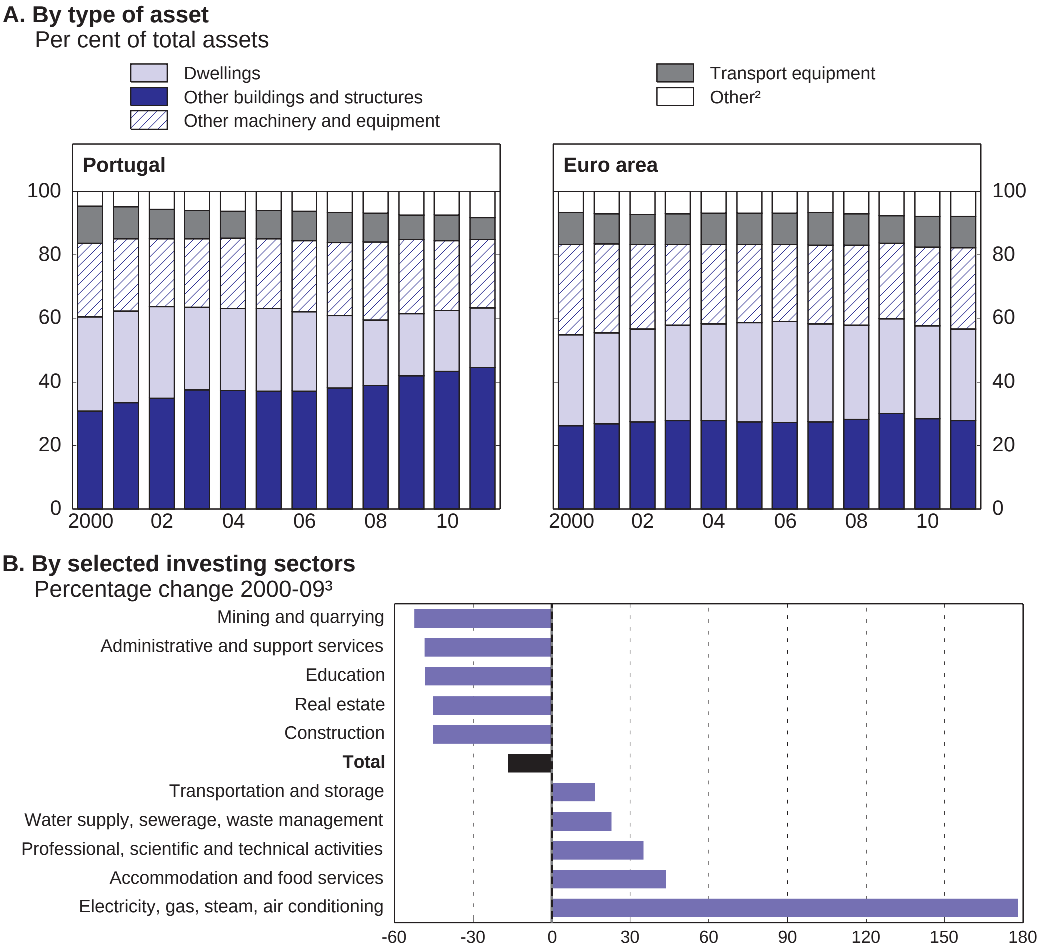
A highly inefficient labour market, where poor institutions predate the crisis, has weighed both on wage and productivity developments. Despite soaring unemployment since 2000, significant downward adjustment of private sector real wages only started in 2011 (Figure 3). Explanations for this include widespread administrative extension of collective agreements, long-lasting unemployment benefits (especially for older workers) and pervasive labour market segmentation, all of which cossets insiders and places the burden of adjustment on the fringe of temporary workers (Marques *et al.*, 2009; Centeno and Novo, 2012). Large minimum wage increases in 2006-11 further worsened matters. Until 2010, there was no consistent policy of wage restraint in the public sector, which has some influence on private wage-setting (Lamo *et al.*, 2008). Poor labour market institutions have also hampered productivity. Segmentation limits the mobility of permanent workers, and thus the quality of their job matches, and discourages human capital accumulation by temporary workers (Centeno and Novo, 2012). Administrative extension stifles competition between firms, as dominant firms use it as a way to exclude new competitors.

Though declining relative to GDP, investment has remained above the euro area average for most of the past decade (Figure 2), but its allocation has failed to spur productivity growth. A continued emphasis on government-promoted transport infrastructure, with both traditional public capital formation and public-private partnerships (PPP) adding to the substantial investment from the 1990s, likely accounts for more than half of the excess of the share of non-residential construction (other buildings and structures) relative to the euro area (Figure 4). In 2000-09, public capital formation, mostly non-residential construction, was on average 1 percentage point of GDP higher than in the euro area, and an almost as large differential has been estimated for PPP investment flows (Kappeler and Nemoz, 2010), mainly road projects (Haugh and Sorbe, 2012).

As a result of distorted incentives for homeownership and poor rental market performance, housing investment remained skewed towards new dwellings (rather than renovation). Although declining, investment further expanded the housing stock, already large at the turn of the century. Amidst shrinking investment in most sectors (though, in the case of construction and others, from a high starting point), energy stands out as an exception (Figure 4), with investment increasing from 0.6% of GDP in 2000 to 1.6% in 2009 (against a stable 0.6% for the 20 EU countries for which data is available). This increase has been partly due to incentives for electricity production which caused a surge in wind farms (with concomitant network expansion) and, to a smaller extent, in other generation technologies, leading to excessive production capacity.

Financial sector developments have mirrored these trends in indebtedness and investment allocation. Large-scale resort to international wholesale debt markets has filled a yawning gap between credit and deposits in the domestic banking system. Portuguese banks had the fourth highest euro area credit-to-deposit ratio in 2009 (after Estonia, Ireland and Slovenia), and the fourth largest increase since 2000 (Beck *et al.*, 2000). In addition, the allocation of credit to construction-related activities has been reinforced, to the detriment of tradable sectors (Figure 5).

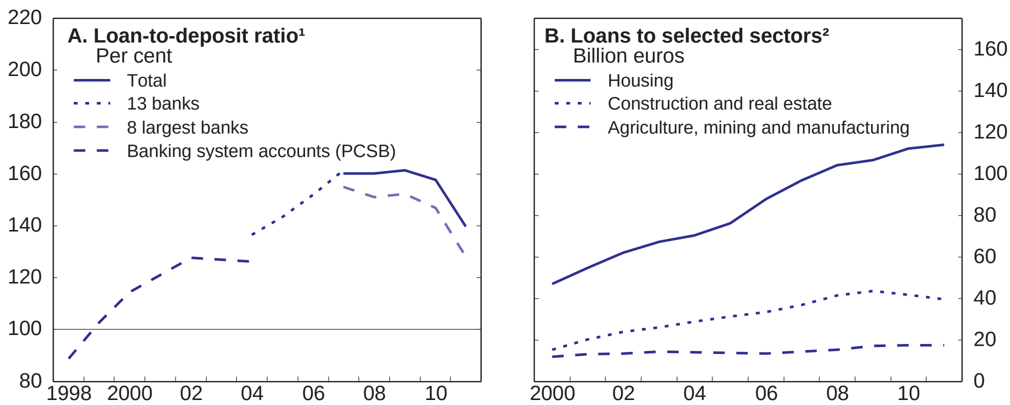
Figure 4. Investment allocation by assets and sectors[1]



1. Gross fixed capital formation.
2. Cultivated and intangible fixed assets.
3. In real terms according to the NACE Revision 2 European Classification of Economic Activities.

Source: Eurostat (2012), "Economy and Finance", *Eurostat Database*, May.

Figure 5. Banking sector developments



1. Based on International Accounting Standards (IAS) except for PCSB: *Plano de contas do sistema bancário*.
2. Loans to households and non-financial companies. Average of monthly data.

Source: Bank of Portugal.

Wide-scale adjustment began in 2011

The correction of macroeconomic and financial imbalances started in earnest only in 2011. The gradual loss of access to foreign financing by the sovereign and domestic banks over the course of 2010 and early 2011 was increasingly replaced by official capital flows (Merler and Pisani-Ferry, 2012), mainly through Eurosystem financing and EU-IMF financial assistance. Despite sizeable terms-of-trade losses, the current account deficit narrowed substantially in 2011 (from 10% to 6.4% of GDP), due to both declining import volumes and a strong export performance. While the former stem from internal demand weakness, the latter reflects robust growth across a wide range of exported goods and services, most prominently in transport equipment. This has been accompanied by increased geographic diversification, with major increases (though often from a low base) in sales to countries as diverse as Algeria, Angola, Brazil and China. Limited prospects at home are arguably forcing firms to become more exported oriented. Recent improvements in cost competitiveness, especially vis-à-vis non euro area partners, have also helped export performance (Figure 3).

Unwinding macro-financial imbalances

Managing bank deleveraging to ensure adequate credit supply

Bank deleveraging is essential to reinforce financial stability and ease the return to wholesale market funding, and will accompany the necessary reduction of indebtedness of households and non-financial firms. Core Tier 1 ratios need to comply with targets set by the Bank of Portugal (9 and 10% at end-2011 and end-2012) and, for four of the largest banking groups, by the European Banking Authority (EBA) (9% by 30 June 2012, computed under slightly different and more demanding rules, plus a capital buffer for sovereign exposures). Further, the eight largest groups, accounting for 83% of the system's assets, are to reduce their loan-to-deposit ratios towards an indicative 120% target by end-2014. However, if pursued at too fast a pace, necessary bank deleveraging has the potential to threaten an adequate credit supply to viable firms and worsen recessionary dynamics.

Progress has been made in increasing Core Tier 1 ratios, through both numerator and denominator (Table 1). Among the eight largest banks, three already reached the 10% target in 2011 and a fourth one (covered by EBA requirements) has reached that target in 2012 with private funds only. The others, which include the three banks with the largest needs for sovereign capital buffers plus a smaller institution, have resorted to (or are expected to require) public support for recapitalisation, funded, apart from the state-owned Caixa Geral de Depósitos, under an EU-IMF programme facility of EUR 12 billion. The EBA sovereign buffer has been by far the most important determinant of increased capital needs (Table 1), largely reflecting banks' exposure to Portuguese sovereign debt, which surged in 2010. Other major determinants, dating from 2011 but with impacts on regulatory capital deferred until June 2012, have been the recognition of actuarial losses associated to the transfer of banks' pension funds to the general social security regime and additional credit impairments under the Special Inspections Programme (see below).

Rules for bank recapitalisation with government funds should strike a balance between safeguarding taxpayers' interests, minimising the risk of political interference in credit allocation and creating incentives for private shareholders to reimburse public support as soon as feasible. Under Portuguese legislation, recently revised and compliant with EU competition rules, the government can inject funds using either common equity or hybrid debt instruments, such as contingent convertible securities (CoCos). Shares will be bought or subscribed at a substantial discount relative to market prices and are entitled to a priority dividend, but confer no voting rights in ordinary management decisions (except for those shares in excess of 50% of total common equity, which is a relatively high threshold). Hybrid debt instruments can make up to 50% of eligible capital and will pay an interest rate initially set between 7 and 9.3%. This rate increases over time, which reinforces incentives to shorten the duration of public support. Banks requiring public funds must submit recapitalisation plans containing *inter alia* their intended business model, governance reforms and the schedule for public divestment. In case of non-compliance (assessed by the Bank of Portugal) or, in any case, after five years, all remaining public capitalisation instruments (shares or others) will be converted into shares with full voting rights.

Table 1. Data on bank recapitalisation for the eight largest groups

Million euros

A. Progress in Core Tier 1 ratios	End of period			
Bank of Portugal definition	2009	2010	2011	Jun-2012[1]
Core Tier 1 (CT1) capital (A)	21 591	22 631	25 283	30 457
CT1 increase due to conversion of non-core into core elements[2]	16	16	2 528	0
Other CT1 increases	3 990	1 024	124	5 174
Total capital requirements (B)	22 999	23 162	21 732	21 775
Core Tier 1 ratio (%) [A/(B*12.5)]	*7.5*	*7.8*	*9.3*	*11.2*

B. Increased Core Tier 1 needs and capitalisation measures to meet EBA targets

December 2011 to June 2012

Factors generating increased Core Tier 1 capital needs	5 681	**Capitalisation measures**	7 886
Shortfall in 31.12.2011 for a EBA CT1 ratio of 9% (excluding factors below)	523	Of private sources	1 236
Special Inspections Programme (deduction to 31.12.2011 CT1 capital)	436	Of public sources	6 650
Pension Funds transfer (deduction to 31.12.2011 CT1 capital)	962	Caixa Geral de Depósitos (shares plus CoCos)	1 650
Sovereign capital buffer (4 groups)	3 718	Private banks – shares[3]	500
Other	43	Private banks – CoCos[4]	4 500

1. Forecast. Figures in the table reflect the information available in July 2012 and therefore do not yet take account of subsequent events, such as capital increases or additional requests for public support for recapitalization.
2. Does not include repurchases of debt instruments.
3. Share capital increase underwritten by the Portuguese State, and subscribed by private investors in September 2012.
4. Of which up to EUR 200 million would have been converted into shares if a share capital increase of that amount, subscribed by private investors, had not been completed by 30 September 2012.

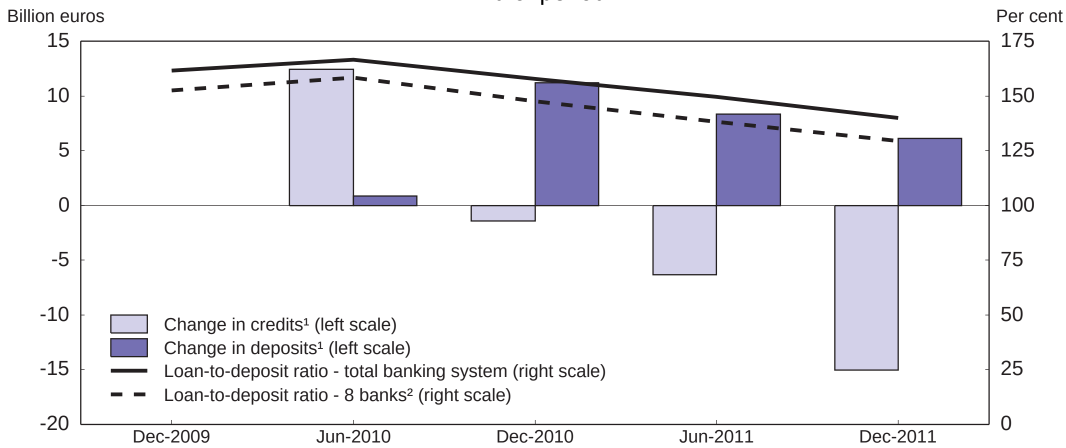
Source: Bank of Portugal.

Based on the recapitalisation plans submitted by the three largest banks requiring public support (two private and one state-owned), the authorities made available more than EUR 6.5 billion of public funds, of which up to 5 billion from the EU-IMF programme facility (Table 1), allowing the banks concerned to exceed both EBA and Bank of Portugal minimum capital requirements by a considerable margin. While funds in the two private banks have been injected through contingent convertible securities (initially amounting to EUR 4.5 billion and paying an initial interest rate of 8.5%), the government could have ended up with a sizeable equity position in those institutions, had private shareholders left unsubscribed recent rights issues. In these and any future recapitalisation operations, the authorities should ensure that the potential costs to taxpayers and the final beneficiaries of the funds are fully transparent, so as to reduce moral hazard and maintain public support (IMF, 2009). Further, as envisaged, the authorities should keep the remainder of the EUR 12 billion envelope for further capital increases if needed, even after 2012 capital targets are met. This will help to minimise the risk of credit rationing, if losses from credit impairments, likely to stay high or even increase in the near future, put downward pressure on capital and hence on risk-weighted assets as well.

Banks have been reducing their loan-to-deposit ratios, which for the banking system as whole fell from a peak of 167% in June 2010 to 140% in December 2011 (Figure 6). The ratio for the eight largest banks as a whole was reduced likewise, to around 130%. However, there is considerable dispersion across banks. While five of those eight banks are already below, or very close to, the 120% indicative target, the other three were still above 140% at end-2011. The contrast between both groups continued to hold in mid-2012, though with some increase in dispersion among the more highly leveraged institutions.

Figure 6. Recent developments in banks' loan-to-deposit ratio

End of period



1. Since the previous semester.
2. The definition of the loan-to-deposit ratio relevant for the 120% indicative target is slightly different from the one depicted (generally 1-2 percentage points higher).

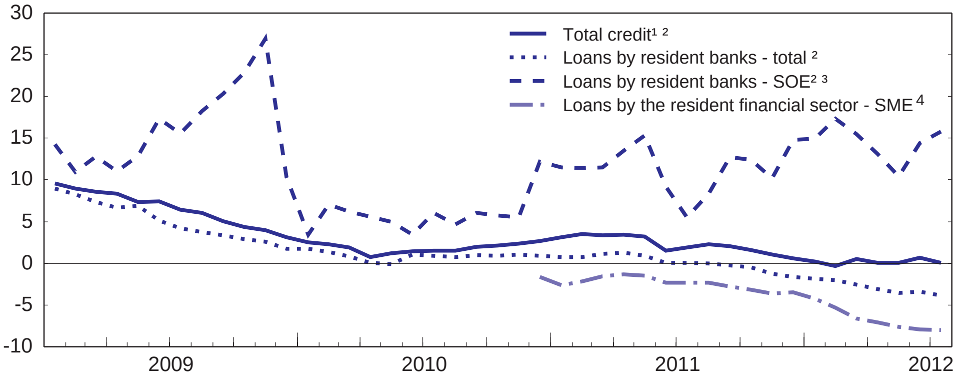
Source: Bank of Portugal.

Deposits have been growing vigorously since mid-2010, and account for most of the progress so far in reducing loan-to-deposit ratios. Contributions to deposit growth initially came from non-financial firms and non-monetary financial institutions but, in 2011, mainly from private individuals and general government. Attracted by higher rates on deposits, households have adjusted the composition of their financial asset portfolios away from other savings instruments managed within banks' financial groups (*e.g.* by investment funds or insurance companies) or non-tradable public debt (saving certificates). Unspent funds from the EU-IMF programme have enabled general government deposits to more than double in 2011. However, the potential for further deposit growth will wane over time. Developments until mid-2012 suggest that deposits by private individuals, though still posting robust year-on-year growth, are slowing down, while the more volatile deposits by firms are decreasing.

Over the course of 2011, a progressively larger share of the loan-to-deposit ratio decline has come from the numerator, not only through growing credit impairments (further addressed below) and credit portfolio sales, but also as a result of considerable reduction of loans to firms and households. Overall developments in domestic bank loans nonetheless hide stark differences in financing conditions across non-financial firms (Figure 7). Total credit granted by either resident or non-resident entities has displayed a more benign trend, as some private sector large firms and non-financial holdings have managed to increase their external financing (Bank of Portugal, 2011). Lending by domestic banks to state-owned enterprises (SOE) outside general government has steeply increased, reflecting continued operational losses and the need to replace non-resident lenders in rolling over maturing debt, though it should be borne in mind that those enterprises only account for little more than 5% of outstanding loans by the resident financial sector to nonfinancial corporations. In contrast, small and medium-sized enterprises (SME), traditionally more reliant on resident lenders, especially banks, have witnessed major falls in credit. This is in line with credit constraints reported in sectoral surveys, which are highest in construction, but have been increasing also in manufacturing and services. These constraints also hamper the ability of SMEs to tap supports for internationalisation and research and development (R&D) co-financed by EU funds.

Figure 7. Credit to non-financial firms

Annual change, per cent



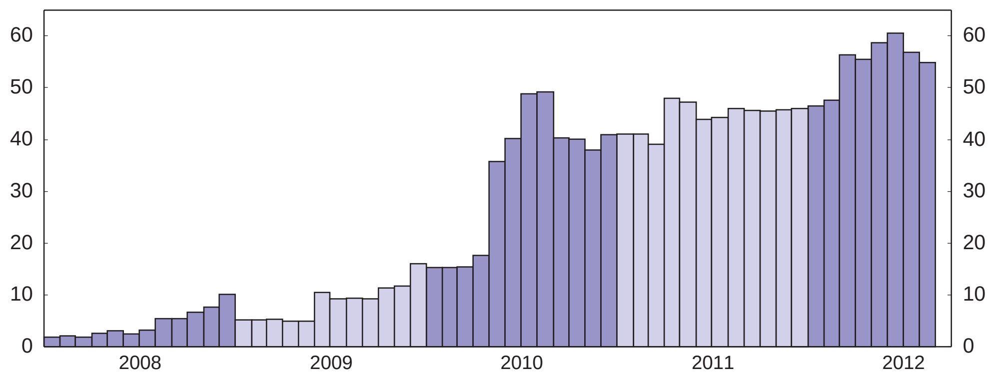
1. On a consolidated basis, covering loans, debt securities and trade credits. Includes credit granted by non-resident entities.
2. Figures are adjusted for securitisation operations, reclassifications, write-offs/write-downs, exchange rate changes and price revaluations. Whenever relevant, the figures are additionally adjusted for credit portfolio sales, as well as for other operations with no impact on non-financial corporations' effective financing.
3. State-owned enterprises (SOE) which do not consolidate under general government.
4. Includes loans to small and medium-sized enterprises (SME) by monetary and non-monetary financial institutions. Year-on-year rate of change.

Source: Bank of Portugal (2012), *Indicadores de Conjuntura* and *Boletim Estatístico*, September.

To ease pressure on deposit rates, the Bank of Portugal introduced in November 2011, and reinforced in April 2012, additional capital requirements for deposits paying high rates, currently defined as those in excess of a 225-300 basis point spread (depending on term) over a market reference rate (often the Euribor). Helped by bond issuance operations under a EUR 35 billion state guarantee facility (eligible as Eurosystem collateral), as well as by further measures to increase collateral availability taken in February 2012, Portuguese banks took advantage of the two recent three-year European Central Bank (ECB) long-term refinancing operations to both extend the maturity of their Eurosystem funding and increase its overall amount (Figure 8). However, apart from some decrease in interest rates on new loans to non-financial firms (rates which remain nonetheless very high), financing conditions in the economy have not eased yet. Indeed, bank lending surveys suggest that some further tightening of credit standards in loans to firms took place in the first semester of 2012 (especially as regards long-term lending) and was likely to continue, though more moderately, in the third quarter.

Figure 8. Provision of Eurosystem liquidity to Portuguese banks

End of month, billion euros



Source: Bank of Portugal (2012), *Boletim Estatístico*, September.

While lower loan-to-deposit ratios are essential for financial stability, deleveraging pursued at too fast a pace risks aggravating the contraction of credit and economic activity. Exporting firms, on which hopes of sustained growth depend, are vulnerable to credit constraints, as involvement in international trade tends to increase the need for working capital and investment to enlarge capacity will eventually become necessary. The growth of loans by the resident financial sector to exporting companies, though still posting positive figures, has declined markedly to 1.5% in the second quarter of 2012 (year-on-year). The authorities should ensure that the pace of convergence towards the loan-to-deposit ratio indicative target of about 120% by end-2014 does not thwart economic activity. The degree of flexibility stemming from the target's indicative nature is made more important by the fact that those banks further away from the target have on average a larger weight of loans to firms in their portfolios.

Fostering credit reallocation and a smaller reliance on debt financing

Deleveraging should be accompanied by the removal of distortions to credit reallocation across sectors, to enable productivity-enhancing shifts in investment composition. While distortions in housing and energy are discussed below, financing pressures from SOE (Figure 7), mostly in non-tradable sectors, are hampering reallocation, which underlines the importance of on-going efforts to improve their operational performance (Haugh and Sorbe, 2012). When appropriate, cancelling or buying back PPP road projects (Haugh and Sorbe, 2012) would also have a payoff in terms of reallocating credit away from construction.

On the credit supply side, it is essential that banks refrain from "ever-greening" problematic loans, as the ensuing protracted loss recognition would tend to depress productivity growth and slow down recovery. To this end, several welcome steps have been recently taken by the Bank of Portugal. Supervisory capabilities have been strengthened following the Special Inspections Programme, which examined on-site the credit portfolios and stress-testing methods of the eight largest banking groups (with overall positive results). Further on-site inspections are planned, which is welcome. Faced with major sales of banks' non-performing loans to outside vehicles (*e.g.* venture capital funds, often headquartered abroad), the central bank has required detailed information reporting and imposed high risk weights on banks' exposures to those vehicles, which may be used to defer losses in case of insufficient haircuts. Further, banks have also been required to identify all instances of restructured loans (even if still performing) due to financial difficulties of the borrower. In this respect, the recent corporate insolvency law amendments, as well as the extra-judicial conciliation framework now being finalised, are expected to facilitate the early rescue of viable firms. The authorities should make data on restructured loans public and continue to use supervisory tools to promote swift recognition of bad loans. As discussed above, this may make it necessary to provide banks with more capital support.

Credit reallocation to viable SMEs would also be promoted by reversing the 2011 steep increase in the prudential risk weight attached to loans granted under government-sponsored credit lines. These loans benefit from a private sector credit guarantee, part of which enjoys in turn a government fund counter-guarantee, amounting in general to 37.5% of the loan. As the fund providing the counter-guarantee is by its legal setup considered to have the same risk as a credit institution for prudential purposes, exposures to the fund (*i.e.* 37.5% of the guaranteed loans) saw their risk weights soar from 20 to 100% in 2011, as did exposures to credit institutions, when Portuguese sovereign debt lost investment grade. Higher risk weights made those loans less attractive to banks. The authorities could reconsider that aspect of the legal setup of the counter-guarantee fund, thus allowing for lower risk weights on loans under SME credit lines.

As deleveraging proceeds, companies will need to become less dependent on credit and more reliant on equity, of either national or foreign origin, which *inter alia* will make the economy more resilient to financial crises (Ahrend and Goujard, 2012). Foreign direct investment (FDI) accounts for a below-average share of total external liabilities (16% in 2010, against 26% across the OECD), notwithstanding low statutory barriers. In the past, the prospect of foreign investors taking majority stakes at large companies was sometimes regarded with reservations (Ministry of Finance, 2011), in sharp contrast to an attitude of often benign neglect towards high current account deficits. Yet FDI can be an important source of technology transfer and, in times of tight internal credit, may also ease access to external market financing. Opening up the economy and reducing external imbalances are important goals under the EU-IMF programme.

Portuguese firms have a high debt-to-equity ratio, which increases their vulnerability to downturns and deteriorating operational earnings (IMF, 2012). Reluctance to opening shareholder control to new partners has been a long-standing barrier to capital market entry by many SMEs. Additionally, the corporate income tax regime has long favoured debt finance over equity finance, a bias worsened in recent years by the introduction and subsequent increase of a tax rate surcharge for profits above certain thresholds (*derrama estadual*) in the context of fiscal consolidation, as well as by the increased taxation of capital gains on equity shares (since 2010), though the latter is welcome from an income distribution viewpoint (OECD, 2010a). An allowance for corporate equity, introduced in 2008, has so far been scantily availed of, possibly because its scope is limited to SMEs, among other constraints. The authorities should take further steps to alleviate the debt bias embedded in the tax system. One among several possibilities would be to limit interest payments deductibility, and use the ensuing increase in revenue to reduce the corporate tax rate.

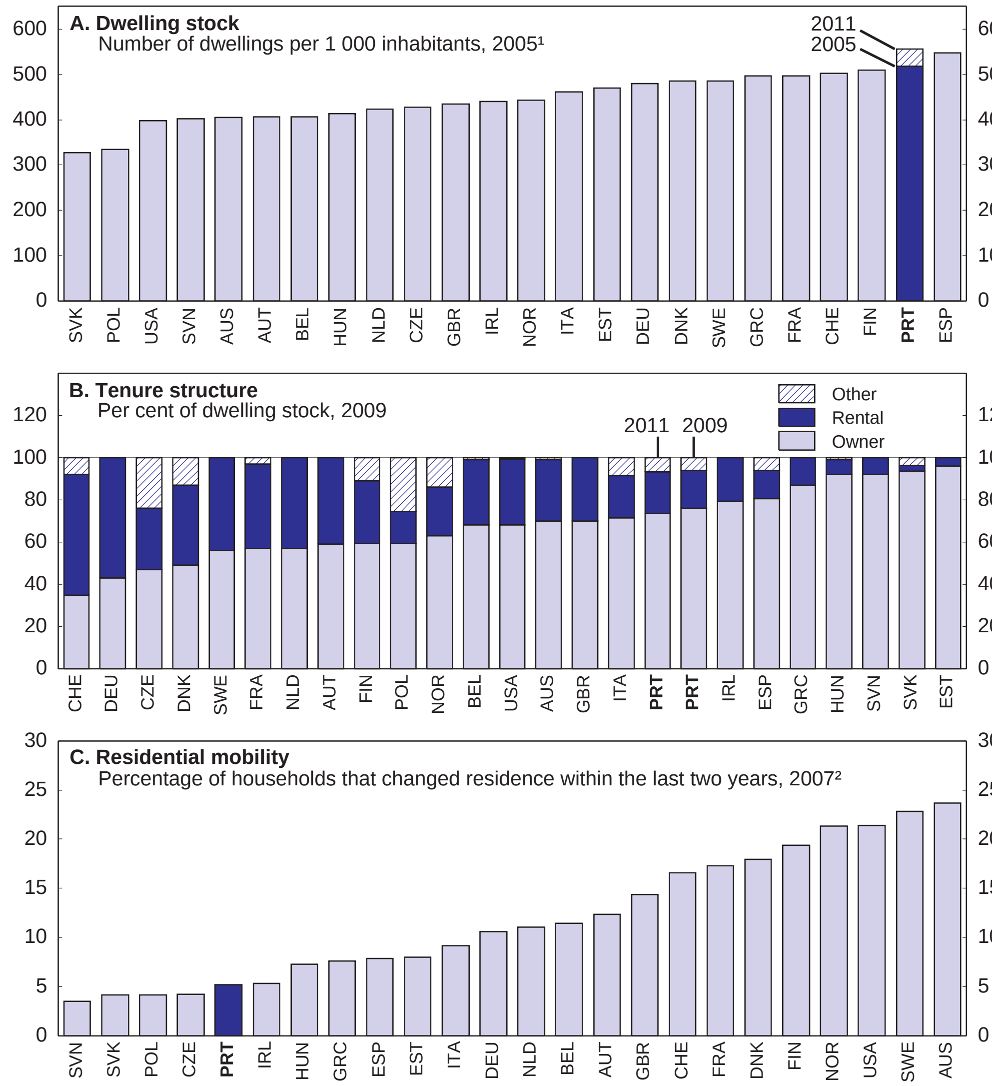
Removing distortions to investment allocation

Housing market reforms to improve capital allocation and increase labour mobility

Rental market and tax policies excessively favoured homeownership and biased capital allocation

Portugal has a housing stock among the highest in the OECD area, mostly owner-occupied (Figure 9). Over the past decade, investment in new dwellings, though on a declining trend, expanded the stock per inhabitant by around 15%, with an increasing share of vacant homes (13% of the stock in 2011, which is relatively high by European standards; OTB, 2010). Around one-third of the stock requires renovation, as investment has been largely slanted to new construction (AECOPS, 2009). The increasing level of homeownership went along with growing indebtedness of households (around 80% of loans to households were for house purchase – Figure 1). It also helps to explain low residential mobility, as homeowners are generally found to be less mobile than tenants (Caldera Sánchez and Andrews, 2011). In turn, this can be an obstacle to efficient job-matching.

Figure 9. Housing structure in international comparison



1. 2001 for Belgium, Czech Republic and Greece; 2003 for Australia and Italy; 2004 for France and Switzerland.
2. The low mobility rate in some Eastern European countries does not seem reasonable and may reflect problems with the underlying data. However, this is difficult to verify as there is no alternative data source.

Source: D. Andrews, A. Caldera Sánchez and Å. Johansson (2011), "Housing Markets and Structural Policies in OECD Countries", *OECD Economics Department Working Papers*, No. 836 and INE (2011), *Censos 2011, Resultados provisórios*, Instituto Nacional de Estatística.

The increase in homeownership in Portugal over recent decades is partly due to ageing and rising disposable income but also importantly to easier access to credit and to rental market and tax policies, as in other OECD countries (Andrews and Caldera Sánchez, 2011). Poor rental policies have resulted in a malfunctioning and small rental sector (20% of dwellings in 2011, which is below that in most OECD countries). Regulations governing tenant-landlord relationships favour tenants more than in other countries (Andrews *et al.*, 2011). In particular, long and cumbersome eviction procedures have been a major hurdle to the supply of rental housing. Long-standing rent controls for older contracts (33% of the total, 70% of which paying rents below EUR 100 per month) create rigidities, as tenants are reluctant to give up tenure security and below-market rents. This has strongly discouraged investment in dwelling maintenance, which has also been held back by red tape and complex regulations for renovation. Limited supply and high risk for landlords have resulted in high rents for newer contracts. The preferential tax treatment of owner-occupied housing is likely to have helped to divert capital from more productive investments. Imputed rents are not taxed and, until 2011, mortgage interest and principal payments were tax deductible. For most properties, taxable values under recurrent immovable property taxes have long lagged behind market value and significant exemptions have persisted, though progress is now underway (see below).

Thorough implementation of reforms is essential to increase the supply of rental housing

The new urban lease legislation, which will come into force in mid-November 2012, is an important step forward in balancing rights and obligations of landlords and tenants as regards eviction procedures of non-complying tenants. Until now, landlords had to go through the courts and enter eviction procedures (*acção executiva*), the latter alone taking sixteen months on average. The new legislation creates an extrajudicial procedure which aims at reducing average eviction time to around three months. If the tenant opposes the eviction, the ensuing judicial process will have an urgent nature. The efficacy of the new procedures is still uncertain and the authorities should be ready to take corrective actions, if warranted, to ensure that both extrajudicial and judicial processes effectively decrease the eviction time of non-complying tenants, as envisaged.

The new legislation also tackles rent controls, an area where past reforms have largely failed. Under the new rules, old contracts (those predating 1990) can be renegotiated and, in case of no agreement, landlords can choose between contract termination with compensation and a five-year contract with an updated rent subject to an annual maximum of 6.7% of the property taxable value, after which full liberalisation applies. However, wide-ranging exceptions apply, for both residential and non-residential leases. Residential tenants who are aged 65 and over (60% of the pre-1990 residential leases, which amounts to 20% of total residential lease contracts) or have a level of disability over 60% cannot be forced to leave even after five years, and the above rent ceiling will persist. This lacks means-testing. Except for low-income old or disabled people, the authorities should ensure that after this five-year transitory period any ceiling to these rents is no longer below market values.

Another exception concerns leases to low-income tenants, which cannot in general be terminated during a transitional five-year period and will benefit during this period from a lower and income-dependent rent ceiling. Though rent liberalisation after those five years is welcome, low-income tenants of all ages will need support once the transitory period expires, and instruments to that end should be announced as soon as possible. Well-designed portable rent allowances might be considered, as these do not seem to hinder residential mobility (Andrews *et al.*, 2011). Exceptions to the possibility of contract termination also cover broadly-defined small businesses, implying that many retailers will benefit for five years from the fact that the transitional 6.7% rent ceiling will often keep rent levels below current market values, which distorts competition. If a significant divergence between market and transitional regulated rents persists, the authorities should shorten the transitory period, raise the ceiling or adopt a narrower definition of small businesses.

In a welcome move, the authorities have also changed legislation to simplify administrative procedures for renovation. The recent changes in both urban renovation and rental legislation are likely to give a much-needed boost to rental supply, made all the more necessary by the likely increase in demand stemming from household deleveraging and tighter credit. Currently vacant homes are expected to play a part in raising rental supply, especially given their upcoming higher property tax costs (updated taxable values in general plus a much higher tax rate for vacant dwellings). To foster this process, the existing financing incentives for renovation works, which are currently being re-evaluated by the authorities, should be focused on dwellings for rental.

Remove the preferential tax treatment of owner-occupied housing

Since 2011, there have been welcome steps to reduce the preferential tax treatment of owner-occupied housing. Mortgage interest deductibility is being gradually phased out and that of mortgage principal has been eliminated. Rent deductibility is also being phased out, although at a slower pace. As for recurrent taxes on immovable property, the authorities are carrying out a general updating of urban property taxable values, to be completed by end-2012, have plans for regular updating in the future, and have significantly reduced temporary tax exemptions for principal owner-occupied dwellings. The authorities should proceed with implementation according to planned deadlines and, as recurrent tax proceeds gradually increase, reduce reliance on the distorting real estate transaction tax, by levying it only on the initial transactions of property. In a second step, the transaction tax could be replaced by value-added tax (VAT) (OECD, 2010a). Even though Portugal compares favourably with other European countries regarding housing transaction costs, the weight of taxes in the costs of purchasing a dwelling is somewhat higher than average (EMF, 2010).

Addressing rents in the energy sector to foster efficient capital allocation and improve competitiveness

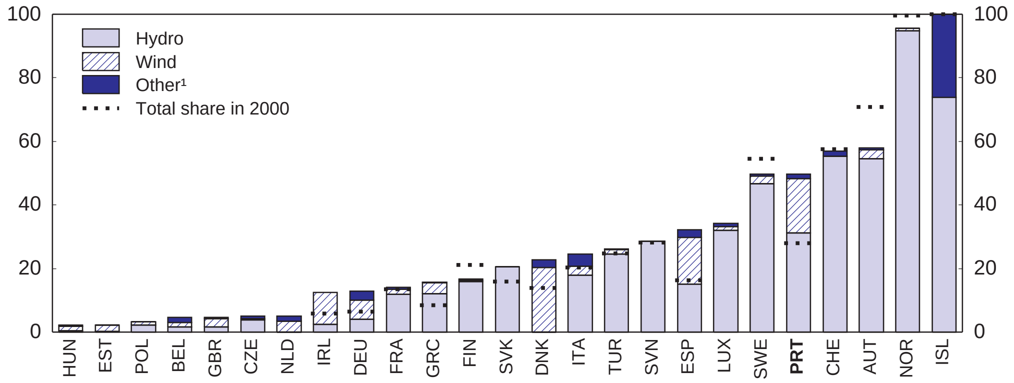
Regulatory interventions are granting unwarranted returns to electricity generators and distorting capital allocation

Opening the electricity sector to private initiative and competition and promoting renewable energy have been at the core of Portugal’s energy policy since the mid-1990s. Electricity generation has been gradually opened to competition, though the previous incumbent, EDP – Energias de Portugal, still holds a high wholesale market share (around two-thirds in 2011). Transmission and distribution have been unbundled. Transmission is carried out by a single company, REN – Rede Eléctrica Nacional, and distribution remains a virtual monopoly of EDP. An Iberian electricity market has been implemented, aided by an increase in interconnection capacity. The retail sector has two segments, a competitive liberalised market (47% of total power supplied in 2011) and a market with regulated tariffs, which are being phased out. EDP is the chief supplier in the latter segment (as last-resort supplier) and is also the largest player in the former, with a market share of 42% in terms of volume, against around 25% for each of its two main competitors (and 80% in terms of the number of clients, against around 15% for the second firm).

In recent years, Portugal has become a leader in Europe in terms of renewables (Figure 10), largely due to the rapid growth of wind power from below 1% of gross electricity production in 2000 to 19% in 2011. Progress in harnessing renewable sources plays a major role in Portugal’s contribution to the EU efforts to reduce greenhouse gas emissions and to strengthen energy security. Portugal’s emissions have been declining since 2005 and, partly because of the economic crisis, in 2009 were already slightly below their Kyoto Protocol target for 2008-12. However, the integration of such large amounts of wind power in the electricity system requires, due to its intermittent nature, excess supply capacity of other sources that can quickly respond when there is no wind (*e.g.* thermal plants) or take advantage of excessive wind power when demand is low (*e.g.* pumped hydro storage) (Lopes and Gata, 2005). Six new dams are to be constructed by 2017, three of which with pumped storage. Existing thermal plants are operating significantly below their full capacity. Therefore, there is some excess generation capacity, all the more so given the currently foreseen reduction of electricity consumption.

Figure 10. Share of renewables in electricity production

Per cent of total gross electricity production, 2010



1. Geothermal, solar, tide/wave/ocean, gas from biomass, liquid biomass, solid biomass and renewable municipal waste.

Source: IEA (2012), "Electricity and Heat Generation", *IEA Electricity Information Statistics* (database), International Energy Agency, May.

Energy policy objectives, either environmental or concerning sector liberalisation, have been largely pursued through support to producers (Box 1). Most generators currently benefit either from feed-in tariffs (*i.e.* a regulated above-market price at which all electricity produced is sold to the network) for renewables and cogeneration, or from financial mechanisms to ensure profitability for fossil-fuel power and large hydro plants. All these support mechanisms give generators a revenue per unit of electricity produced above the liberalised wholesale market price (Figure 11) and largely insulate them from market risks, such as those stemming from demand or price fluctuations. Supports are often excessively generous and hence cost-inefficient, distorting investment allocation, as argued above, and weighing beyond necessary on electricity costs and prices (see below).

Box 1. Support to electricity generators

Most electricity generators under the ordinary regulatory regime (fossil-fuel power and large hydroelectric plants) benefit either from financial mechanisms to ensure profitability or, more recently, from payments for availability:

- Power Purchase Agreements (*Contratos de Aquisição de Energia*) were created in the mid-1990s with the launch of international tenders to open the sector to private investment. Plants under these long-term contracts supply their energy in exchange for a pre-established rate of return, which is independent of their effective generation.

- The early termination in 2007 of Energias de Portugal's (EDP) Power Purchase Agreements, to facilitate liquidity in the Iberian market, was compensated with the Costs for the Preservation of Contractual Equilibrium (*Custos para a Manutenção do Equilíbrio Contratual*) mechanism. This guarantees that plants will be able to recoup the same profitability by selling production in the market as they would have obtained under the former contracts. The mechanism includes a fixed annuity, to be received for 20 years, meant to correspond to the estimated net present value of the previous contracts plus financial costs. This was done on unfavourable terms because future cash flows were discounted at a rate of around 5% (government bonds plus 0.25 percentage points) while the financial costs of the annuity are capitalised at a nominal rate of 7.55% (average cost of capital of the producer).

- The Power Guarantee Mechanism (*Mecanismo de Garantia de Potência*) was established in 2010 to remunerate generators for providing stand-by capacity available to the system. It was granted as an incentive to investment (EUR 20 000 per megawatt per annum) but applied to already existing or licensed plants. In a welcome step, the authorities have recently discontinued this scheme, and redesigned payments for availability.

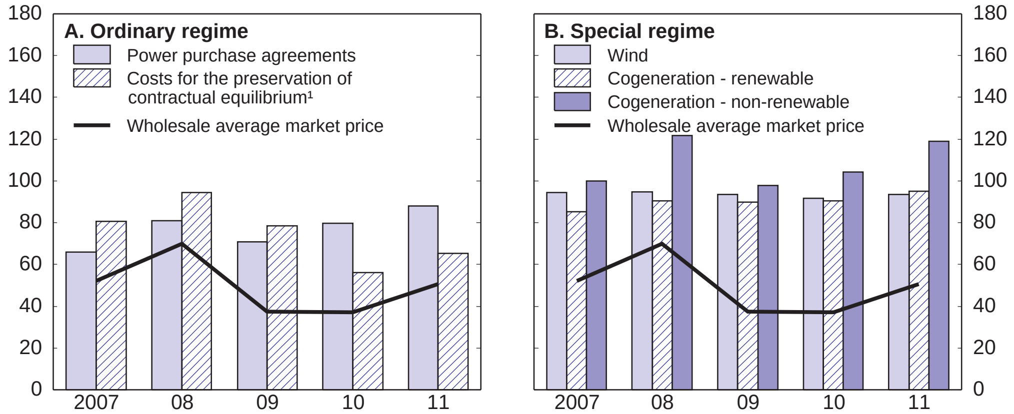
Producers under the special regime (renewables and cogeneration) benefit from the last-resort supplier obligation to buy all electricity they generate and from a pre-established feed-in tariff:

- The feed-in tariffs paid to renewables are differentiated by technology and guaranteed for a fixed time frame (15 years in most cases). They take into account environmental benefits and are adjusted monthly for inflation.

- Cogeneration benefits from a feed-in tariff paid on all production sold to the last-resort supplier plus an efficiency premium and a renewable energy premium. The feed-in tariff is indexed to inflation and to changes in the oil price and exchange rate. It is guaranteed for ten years and may be revised and extended for another ten years, but no time limit is established in the case of renewable cogeneration. Under this setup, the authorities have in recent months considerably reduced future remuneration for cogeneration so as to accelerate convergence to market-based pricing, which is welcome.

Figure 11. Unit revenue paid to electricity generators

Annual average, euros per megawatt hour



1. This covers fixed and variable costs and therefore depends on the power plants' utilisation (*e.g.* unit revenue tends to decrease in rainy years). Data in 2007 refer only to the second half of the year.

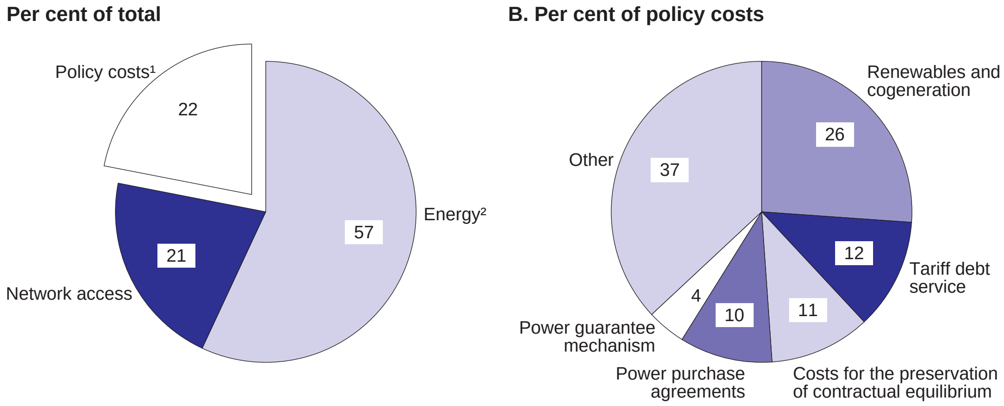
Source: Energy Services Regulatory Authority.

In the case of renewables, feed-in tariffs are the key support instrument. They were very effective in stimulating the development of renewable electricity, especially from wind, but too costly in some cases. Renewables support expenditures in Portugal per unit of electricity consumed were the fourth highest among EU countries in 2009 (Ecofys, 2011). In the case of wind, tendering for licensing was introduced in 2005, thus promoting cost-efficiency (IEA, 2009), and the feed-in tariff payable to the ensuing new generators was brought down to EUR 75 per megawatt hour (MWh) or below, broadly in line with values in other EU countries (OECD, 2011). However, around 80% of the existing wind capacity is still being paid under older tariffs, above EUR 90/MWh. Support goes far beyond wind farms. Cogeneration production, largely in the industrial sector, has also increased over the last years with the introduction of a significant feed-in tariff (Figure 11), indexed to oil prices, payable on all electricity produced (IEA, 2008a). As regards fossil-fuel power and large hydro plants, most benefit from financial mechanisms which guarantee a pre-established rate of return. Their effective rates of return are complex to estimate precisely but are currently clearly above their average cost of capital (Portuguese Government, 2012). Other generators have received payments for availability which have entailed a deadweight loss as they were granted as an incentive to investment but applied to already existing plants.

All costs of generation support are supposed to be passed on to prices paid by end-consumers of electricity, but so far only part of the costs has. In 2012, costs with subsidies to electricity generators passed on to end-users will account for 14% of the average electric bill and 64% of total passed-on policy costs (Figure 12). The allocation of these costs differs among consumers, falling more on households than on industrial users (ERSE, 2012), which helps explain the internationally very high electricity prices faced by households. Still, prices for industry in 2011 were already above the OECD Europe average, according to preliminary estimates. As the government decided on several occasions not to fully transmit to prices the costs of support to generators, it has created a liability to be paid in the future by all end-users of electricity. This tariff debt reached EUR 1.8 billion at end-2011 (about 1% of GDP) and is expected to be close to EUR 3 billion at end-2012 (ERSE, 2011). This crowds out credit to other sectors, as the debt has been securitised with banks (*i.e.* the entitlement to future payments is transferred to banks in exchange for an upfront payment to the electricity companies), and should be paid through future increases in electricity prices. If no reforms were implemented, eliminating the tariff debt by 2020, as the authorities have committed to under the EU-IMF programme, would require that electricity prices grow by 2.8% per year in real terms from 2012 to 2020.

Figure 12. Average electricity price structure

2012



1. Support to generators is 14% of total and other policy costs are 8%.
2. Energy and commercialisation costs of the supplier (market determined).

Source: Energy Services Regulatory Authority.

Ensuring that electricity generation support is made cost-effective

The authorities must ensure that electricity generation support is made cost-effective and costs are fully passed on to all consumers. This requires reducing excessive supports to both wind farms and cogeneration, and to fossil-fuel power and large hydro plants. Also, the authorities should avoid cross subsidisation between households and industrial users when allocating support costs. Under the EU-IMF programme commitments, the government announced in May 2012 an intended reduction of overall support costs by around 1% of GDP over the period 2012-20, but some measures are still to be legislated or negotiated with electricity generators. Preliminary estimates suggest that in overall terms the announced support reduction will decrease the real electricity price increases required to eliminate the tariff debt by 2020 by only one-fifth to one-fourth.

In the case of wind farms licensed before the 2005 reform, the authorities should reduce the costs stemming from the much higher tariffs still being paid. In August 2012, an agreement in principle to be voluntarily entered into by wind generators was reached (but still not implemented), whereby generators are supposed to pay some compensation. As regards cogeneration, the authorities have already legislated a considerable reduction in their future remuneration and committed to curbing fraud. They should also introduce a time limit for feed-in tariffs for renewable cogeneration, as best practices recommend that incentives be transitional and decrease over time to foster technological innovation (IEA, 2008b). As a contribution to EU targets, the government has committed to increasingly ambitious goals for renewables penetration, which currently stand at shares of 31% in gross final energy consumption and 55.3% in electricity consumption by 2020 (Portuguese Republic, 2010). In 2010, actual shares already stood at 24.6% and 41.2%, respectively (DGEG, 2012), placing Portugal among the best EU performers regarding the fulfilment of the 2020 targets. The government plans to keep existing commitments to renewables penetration but to suspend the award of licenses for new generation capacity with feed-in tariffs until further reassessment in 2014 (DGEG, 2012). Given the major progress already made, the authorities should expand generation from renewable sources only to the extent needed to meet environmental targets, so as to minimise short-run economic costs. In addition, under the current technology-specific support scheme, the authorities should phase-out feed-in tariffs as renewables technologies become cost-competitive (such as on-shore wind) or, if still required, choose more market-based support instruments (*e.g.* a premium in addition to the electricity market price) to incentivise further cost reductions and optimise the overall generation costs (IEA, 2011).

In the case of fossil-fuel power and large hydro plants, the authorities should reduce the rates of return currently being paid to EDP and to generators holding power purchase agreements, aiming at bringing returns closer to their average cost of capital. EDP has already communicated to financial markets that it expects a minor reduction of its returns, but authorities should aim for more ambitious results in the on-going negotiations with generators. In addition, the government has already legislated a new regime of payments for availability and suppressed the existing one. The new regime includes a subsidy to thermal plants for their availability, to be granted only after the end of the EU-IMF programme, and an incentive to investment in new hydroelectric plants.

Promoting greater competition in the energy market

Concerns about only limited competition in both electricity and gas remain. Wholesale and especially retail electricity markets are still highly concentrated. In wholesale markets, although substantial new interconnection capacity has been added between Portugal and Spain, in some months of 2010 and 2011 there was noticeable market splitting resulting in differential prices, usually a higher price in Portugal than Spain. The regulator should monitor if the foreseen expansion of interconnection capacity is enough to reduce congestion and market splitting and ensure that Portugal reaps the full benefits of the joint Iberian electricity market.

Though competition in retail electricity markets will likely increase with the phasing-out of the remaining regulated tariffs, progress may be slow as penetration in the household segment, where EDP is strongest, entails high entry costs (administrative and commercial structures). In this framework, transitory regulated tariffs should be managed so as to ensure that consumers switch to the liberalised market while levelling the playing field for competing suppliers. More generally, the powers of the sector regulator will be further strengthened by new legislation, expected to come into force soon, regarding the imposition of sanctions. Sound regulation is all the more important in the present context of full liberalisation and privatisation of natural monopoly network industries.

Despite steps towards liberalisation, wholesale and retail gas markets remain highly concentrated and prices are high by international comparison. Work on a joint Iberian gas market commenced in 2008 but it has been impeded by high cross-border transmission charges between Portugal and Spain. To encourage greater competition, the Portuguese energy regulator, in tandem with the Spanish energy regulator, should fully implement the recent inter-governmental agreement to reduce the cross-border transmission charges between Portugal and Spain to zero. Moreover, the incumbent, GALP Energia, owns exclusive contract rights to the supply of wholesale pipeline gas from Algeria, which is cheaper than sources available to competitors. The regulator should further require GALP to auction Algerian pipeline gas to other firms with no pre-set minimum price. Previous auctions have failed because the regulator allowed GALP to auction the wholesale gas at a price infinitesimally below the retail one allowing no margin for a competitor.

Reforming the labour market to create jobs and help rebalance the economy

Labour market conditions have deteriorated sharply

Portugal has suffered large-scale job losses since 2008 (around 9% up to the second quarter of 2012), which have taken total employment back to 1997 levels. Though the construction sector has been hit hardest, shedding around a quarter of its workforce, important losses have also been recorded in services (especially hospitality and trade) and manufacturing. The contraction in employment has affected young workers the most, and has fallen exclusively on the low skilled (though job creation for workers with secondary or tertiary education has not been fast enough to prevent a rise in unemployment among these groups). Unlike in most other countries (de Serres *et al.*, 2012), average hours worked have remained broadly stable, placing the full burden of accommodating lower total hours on employment.

Job losses have led to soaring unemployment, but also inactivity and emigration. The unemployment rate, at 15% in the second quarter of 2012, has risen by more than two thirds since 2008, for both cyclical and structural reasons (see below). Increases have been stronger among those with lower or intermediate qualifications and fairly proportional across age groups, though the 15-24 cohort has been somewhat more penalised than others and unemployment rates remain strongly decreasing with age. The fall in the labour force has come from those under 35 and the low-skilled. Participation rates have decreased markedly in the 15-24 age range, partly as a result of a return to school. Among those aged 25-34, however, participation rates have edged up, which cannot be explained by population ageing alone and suggests growing emigration flows. Though up-to-date statistical indicators are scarce, there is abundant anecdotal evidence of both skilled and unskilled workers moving abroad, often to Portuguese speaking countries like Brazil or Angola.

The financial and sovereign debt crises have exacerbated long-standing weaknesses of the Portuguese labour market, rooted in defective institutional settings in employment protection legislation, unemployment benefits, active labour market policies, and wage setting mechanisms. The unemployment rate had been increasing long before the crisis, with long-term unemployment accounting for about half of the total. Though overall employment barely changed in 2001-07, there were important shifts towards non-tradable sectors, with manufacturing losing more weight in the total than in other countries (2.9 percentage points *versus* 1.9 for the EU average). Labour market reforms are essential to help rebalance the economy and return to growth, by fostering labour reallocation from non-tradable to tradable sectors and getting the unemployed back to work. Building on recent progress, achieved with broad political support, reforms should continue to be pursued without delay, to stave off the threats to social cohesion and potential growth posed by high and persistent unemployment and a shrinking labour force.

Reforms in wage setting and lower non-wage labour costs can help create jobs

Shortcomings in wage setting mechanisms help to explain the difficulty in regaining competitiveness and the sharp rise in joblessness, especially among the low skilled. Wage bargaining mainly takes place at the sectoral level (Marques *et al.*, 2009), where collective agreements are often negotiated between trade unions (sole owners of the right to negotiate on the workers' side) and employers' associations (generally dominated by the largest firms), each of which accounting for only a modest share of total sectoral employment. These agreements are then administratively extended to whole industries (through the *portarias de extensão*), setting a myriad of wage floors across the economy and giving extra clout to those sitting at the negotiations table.

Administrative extension effectively stifles firm-level bargaining, thus contributing to hindering competition in labour and product markets (Bassanini and Duval, 2006; Traxler *et al.*, 2001). Individual companies can only opt out of a sectoral agreement through a firm-level one, but unless the latter is more favourable to workers, trade unions (or, in companies with a workforce of at least 500, works councils under delegation of unions) will have little incentive to negotiate. In international comparison, Portugal ranks high in the degree of administrative extension (Visser, 2011), which tends to reduce the sensitivity of wages to unemployment and thus raise unemployment persistence (de Serres *et al.*, 2012).

Upward pressures on wages were compounded by very strong minimum wage increases in 2007-10 (5.3% per year on average), followed by a further 2.1% rise in 2011. Though contributing to a decrease in inequality in the lower half of the wage distribution, those hikes have led to job losses for the low skilled, especially among youths and in manufacturing (Centeno *et al.*, 2011). Further, the share of minimum-wage earners in total employees rose from around 8% in 2006 to over 12% in 2010. For low-skilled workers, this is likely to have led to a major compression of the wage cushion (the difference between actual wages and collectively bargained wages), making firms lose an important degree of freedom in alleviating the constraints stemming from collective bargaining (Marques *et al.*, 2009).

In welcome steps, the authorities have halted further minimum wage increases and taken measures to promote firm-level bargaining, by lowering the threshold for delegation of unions to works councils from 500 to 150 workers and allowing that sectoral agreements leave the negotiation of certain matters, including wages, to the level of individual firms. Administrative extension was to be frozen until clear criteria for extension have been defined and, in preparing these, the authorities have committed not to extend any collective agreement subscribed to by employers' associations representing less than 50% of workers in a sector and, when that threshold is reached, to take account of the implications on competitiveness when deciding on extension. However, in May 2012 some pending requests for extension not complying with the 50% threshold were accepted, though with some postponement of the associated wage increases. While at a minimum the authorities need to keep their commitments regarding thresholds for extending collective agreements, they should go further and abolish administrative extension altogether. The latter would in itself promote firm-level bargaining, which could also be fostered by providing technical assistance to small firms so as to reduce bargaining transaction costs. Further, the minimum wage should be kept unchanged until there are clear signs of labour market recovery for low-skilled workers.

Recovering competitiveness through non-wage channels helps to smooth short run adjustment costs and the associated employment losses. Instead of a fiscal devaluation tax reform, recommended in OECD (2010a) and initially foreseen under the EU-IMF financial assistance programme, the authorities have opted (in the context of the recent Labour Code reform) for an increase in working time of up to seven days per year (suppression of four bank holidays and of the up to three extra days of annual leave granted in case of no or few absences), to be implemented in 2013. Other Labour Code changes helping to reduce unit labour costs include more flexible working time arrangements (bank of hours), which decrease the need for overtime, and additional measures to reduce its cost. While these working time reforms should facilitate future adjustment to downturns through hours rather than labour shedding, and be more effective than fiscal devaluation in bringing about lower long run unit labour costs, short-run impacts on employment could be fairly muted. Varejão (2004) analyses an opposite policy decision (the 1996 decrease from 44 to 40 maximum weekly hours) and finds a very modest adverse impact on employment.

Reducing the labour tax wedge on low-wage workers can yield sizeable employment gains, while implying much smaller fiscal costs than a general cut in social contributions. There is evidence that lower tax wedges decrease unemployment (de Serres *et al.*, 2012), and that this decrease could materialise relatively quickly, especially for young people (OECD, 2012), in contrast with the more muted short-run benefits from other labour market reforms. Potential employment gains from lowering tax wedges are also maximised by the high wage elasticities of labour demand in Portugal (Marques *et al.*, 2009) and by past minimum wage hikes (which took the minimum-to-median wage ratio from 51 to 56% in 2006-10, against an average of 48% across 22 OECD countries in the latter year). As wages in tradable sectors tend to lie below the Portuguese average (OECD, 2010a), targeting a social contributions cut on those earning less than a certain threshold could also yield short-run gains in external competitiveness. Narrower targeting (*e.g.* temporary cuts requiring net employment gains at firm level, such as those recently introduced under the *Impulso Jovem* programme, targeted at long-term unemployed aged 18-30) implies lower fiscal costs and deadweight losses. However, it tends to be harder to monitor and administer, less effective in terms of employment (job creation could be deterred by the limited duration of the subsidy, or have a similar limited duration), and more likely to distort competition between firms (different job subsidies to otherwise similar firms based on the timing of hiring). The authorities should introduce an open-ended cut in employers' social contributions on low-wage workers, to the extent that compensating measures can ensure that fiscal targets are met.

Recent increases in the level and coverage of the VAT standard rate make it more challenging to cut social contributions while ensuring budget neutrality through compensating measures. It is indeed crucial that any eventual reduction in social contributions does not endanger fiscal targets. However, property taxes could offer some room for manoeuvre. Despite a large housing stock (Figure 2.9), their share in GDP has long been low (1.1% in 2009, against 1.8% for the OECD as a whole), and will remain below-average even once their expected contribution to budget consolidation in 2013 (around 0.15% of GDP) is pencilled in. Revenues from recurrent taxes on immovable property, which accrue to municipalities, are set to increase beyond 2013 (as the higher tax liability stemming from the updated property taxable values will be phased in gradually), and could free central government resources if transfers to local government are concomitantly reduced. In addition, targeting the cut on low-wage workers only (as opposed to a system of progressive rates, simulated in Bank of Portugal *et al.*, 2011) would significantly reduce potential budget costs, though it would also require that the authorities smooth the discontinuity in marginal rates around the threshold, to minimise distortions to the wage distribution, and tackle through stepped up monitoring and sanctions the increased incentive for under-declaration of earnings.

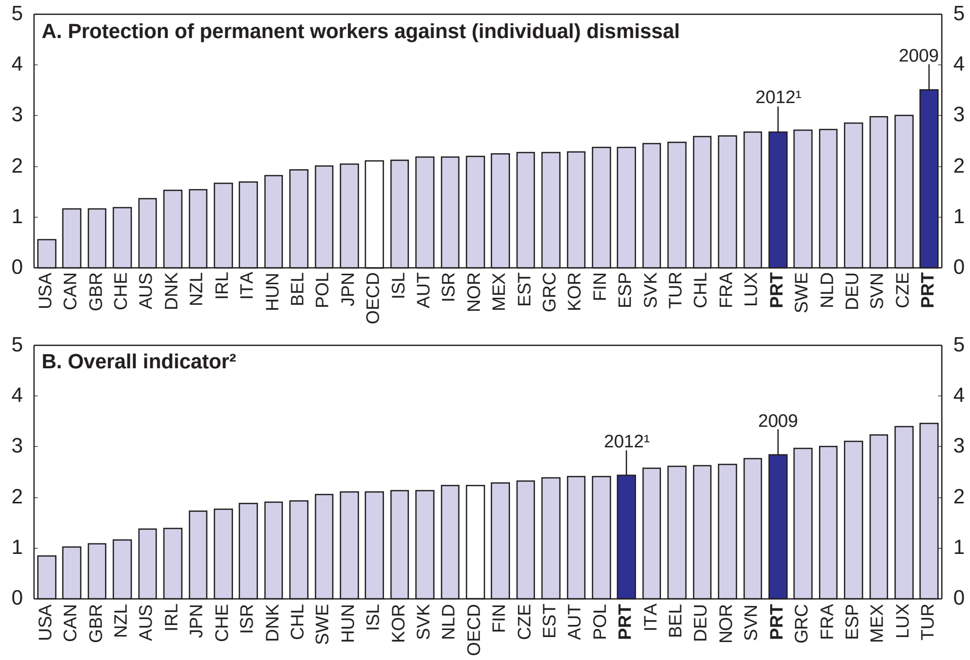
Further reducing segmentation is key to improved labour market performance

High employment protection on regular contracts and the ensuing labour market segmentation lower the sensitivity of wages to unemployment (de Serres *et al.*, 2012) and harm firm performance and productivity growth in different ways. The mobility and reallocation of insiders is hindered, whereas outsiders are caught in a vicious circle of high job rotation and underinvestment in human capital (Centeno and Novo, 2012). The 2009 Labour Code reform, which mainly focussed on reducing procedural inconveniences and notice periods for dismissals, still left Portugal with the highest protection for regular workers in the OECD (Figure 13), and with one of the largest gaps in protection between open-ended and temporary contracts.

A new round of Labour Code reforms, started in 2011 and further pursued in 2012, has tackled the more thorny issues of severance pay and causes for dismissal, taking Portugal closer to the OECD average. Individual dismissals grounded on job redundancy no longer need to follow a pre-defined seniority order, while those grounded on worker capability become possible in a wider range of circumstances (for instance, new technologies or other changes to the job are no longer a necessary condition) and the employer no longer needs to attempt a transfer to a possible suitable position. Severance pay has been reduced from 30 to 20 days per year of tenure, with a 12-month ceiling instead of a 3-month floor (while preserving accrued-to-date entitlements, as discussed below), which is still high by international standards.

Figure 13. Strictness of employment protection legislation

Scale from 0 (least stringent) to 6 (most restrictive), 2008



1. Based on changes to the Labour Code due to come into force in August 2012.
2. Weighted average of three sub-indices: protection of permanent workers against (individual) dismissal, regulation on temporary forms of employment and specific requirements for collective dismissal.

Source: OECD (2012), "Employment Protection Legislation", *OECD Employment and Labour Market Statistics* (database), July.

Despite these efforts, labour market rigidity and segmentation remain above the OECD average, and by actually more than suggested in Figure 13, since significant recent reforms in other southern European countries, such as Spain and Italy, have not yet been factored in. The authorities should therefore further reduce severance pay, as envisaged under the financial assistance programme, and do more to tackle duality. A step forward would be to increase the trial period for open-ended contracts (currently 90 days for most workers), though an excessively long duration would risk making open-ended contracts being used as temporary ones. To avoid excessively protracted temporary jobs, the authorities should also ensure that the extension of the maximum number and cumulated duration of successive fixed-term contracts, enacted in January 2012, expires as planned at end-2014 and is not renewed.

Duality also stems from the procedural costs of dismissing permanent workers (Centeno and Novo, 2012), especially when litigation is involved, as court decisions are slow and not always uniform across territorial jurisdictions. Further, it remains to be seen how courts will deal with some of the new legal provisions, such as the firms' obligation, in dismissals for job redundancy, to define relevant and non-discriminatory criteria to replace the previous seniority rule. To reduce delays and uncertainty, which penalise firms and workers alike, the authorities should, as envisaged, introduce binding arbitration (entered into on a voluntary basis) as an alternative to the judicial system in cases of dismissals. In the medium term, a possibility deserving further examination would be to abolish duality altogether by moving to a single employment contract (a flexible open-ended contract).

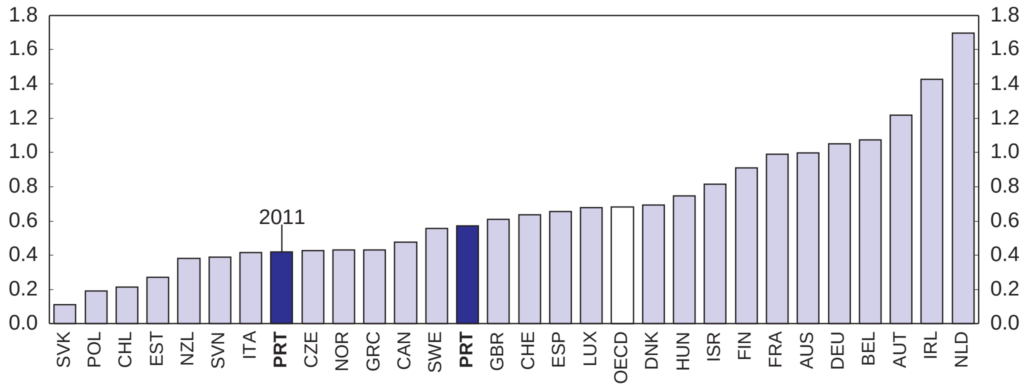
Reducing job protection on regular contracts takes time to yield productivity gains, as the reallocation of workers to better job matchings is a gradual process, and under harsh macroeconomic conditions may actually induce short-run employment losses, if lay-offs outpace job creation (Bouis *et al.*, 2012). The government has chosen to only fully apply the reduction in severance payments to new hires, while existing contracts preserve entitlements accrued under the old rules until 31 October 2012, and accumulate thereafter at the new (slower) pace if and only if the 12-month ceiling has not been reached, and only until it is reached. This has the advantage of stimulating job creation while helping to minimise short-term job loss by avoiding that firing suddenly becomes cheaper. However, it creates a disincentive to the mobility of workers with long tenure. This could be addressed by the creation of individual severance accounts, portable when changing jobs and paid from a compensation fund financed by employers' contributions. While plans to set up that fund have yet to be detailed, the authorities should avoid increasing non-wage labour costs in the current macroeconomic conditions, which could imply postponing the introduction of the scheme.

Active and passive labour market policies need further reform and integration

The unemployment benefit system has long raised concerns both as regards labour market performance and social equity. Internationally high replacement rates for older workers (OECD, 2010a), essentially driven by benefit duration strongly increasing with age, help to explain high long-term unemployment among those workers (Addison and Portugal, 2008) and may raise reservation wages (Marques *et al.*, 2009). Further, tight eligibility requirements, such as long contributory periods for employees and the exclusion of the self-employed, have led to a below-average coverage of unemployment benefits, made worse by the withdrawal of 2009/10 temporary measures to ease access and extend duration (Figure 14). Unsurprisingly, coverage ratios increase with age (from 8.5% for 15-24 year-olds and 30% in the 25-34 age range to 71.4% for those over 45, 2011 data), reflecting age-dependent benefit duration and, above all, that those on the fringes of the labour market (*e.g.* with short temporary contracts or *de facto* employees forced to be formally self-employed) are mostly young workers. Limited benefit coverage of the latter is all the more worrying as there is some indication that austerity measures in Portugal could be imposing a heavy burden on poor households with children (Callan *et al.*, 2011).

Figure 14. Ratio of unemployment benefit recipients to the number of unemployed[1]

2010²



1. Recipients of programmes classified as unemployment insurance or unemployment assistance divided by Labour Force Survey unemployment. Due to institutional specificities, the programme classification cannot ensure perfect cross-country comparability. The ratio for Portugal was 0.57 in 2010 which dropped to 0.42 in 2011 (0.46 adjusting for the break in series at end 2010). The OECD aggregate is an unweighted average of data shown.
2. 2008 for Norway.

Source: OECD (2012), *OECD Employment and Labour Market Statistics* (database), July and Ministry of Solidarity and Social Security.

The 2012 reform of unemployment benefits goes some way towards addressing the concerns above, but benefit duration remains heavily age-dependent. Eligibility has been expanded by lowering the minimum required contributory period for unemployment insurance from 15 to 12 months, with effect from 1 July, and by extending benefit entitlement to self-employed workers who get at least 80% of their annual income from a single entity (often *de facto* employees), though in this case a number of additional requirements will defer any practical application until 2013. Further, in 2012, as in 2010, a 10% increase in unemployment insurance will be granted to lone parents or unemployed couples with children. To tackle disincentives to work, the ceiling on unemployment insurance has been lowered by one sixth, a 10% benefit reduction applies after six months, and older workers will see larger cuts in unemployment insurance duration. However, for those 40 and over, the cuts in duration will be partly compensated by longer provision of unemployment assistance (*subsídio social de desemprego* – a smaller, means-tested benefit paid when entitlement to unemployment insurance ends), so that total benefit duration decreases only slightly. Furthermore, current benefit recipients are largely unaffected, and current workers will be entitled to benefits under the old rules in their first post-reform unemployment spell, compounding the risk that the reform will do little to tackle high long-term unemployment among older workers. Benefit duration should therefore be revisited and made age-independent, with much faster phasing-in provisions. The authorities should also assess whether changes to eligibility prove effective in improving benefit coverage, especially for young workers.

Job search assistance, generally a cost-effective active labour market policy (Card *et al.*, 2010), has substantial room for improvement in Portugal. The few existing formal studies point to only a modest impact on unemployment duration (Centeno *et al.*, 2009), and the share in total hiring of public employment service (PES) vacancy registration and placements (around 23 and 13% in the mid-2000s, respectively) are on the low side by international standards (Duell *et al.*, 2010, Table 3.4). Reasons include poor targeting of resources on those jobseekers most in need of assistance, shortcomings in job search monitoring and sanctions for non-compliance (further discussed below), low outreach to employers, an inefficient use of available information when matching jobseekers to posted vacancies, and limited performance assessment of PES centres and associated networks (such as the *Gabinetes de Inserção Profissional*, created in 2009). Some of these problems were likely compounded by a lack of resources, as the PES budget and staff have not kept pace with rising unemployment (Table 2). In a welcome step, the government has recently launched a programme for PES reform (Box 2), with measures to address the above weaknesses and clear deadlines for implementation. The authorities should carefully monitor the programme's impacts to inform further improvements. To foster compliance with deadlines, periodic information on the roll-out of the different measures should be made public.

Table 2. Spending on active labour market programmes

Per cent of GDP

	Portugal			Other OECD Europe[1]			OECD non-Europe[1]		
	2004	2008	2010	2004	2008	2010	2004	2008	2010
Total active measures	**0.66**	**0.55**	**0.72**	**0.69**	**0.63**	**0.80**	**0.21**	**0.22**	**0.27**
Public employment service and administration	0.14	0.15	0.14	0.17	0.17	0.19	0.08	0.06	0.06
Training	0.28	0.24	0.40	0.18	0.15	0.19	0.07	0.07	0.10
Employment incentives	0.16	0.12	0.10	0.12	0.12	0.16	0.02	0.02	0.02
Direct job creation	0.04	0.02	0.05	0.09	0.07	0.11	0.01	0.04	0.05
Other	0.04	0.02	0.03	0.12	0.13	0.14	0.03	0.03	0.03
Memorandum item									
Unemployment rate (%)	6.7	7.6	10.8	8.3	6.2	9.4	6.3	5.2	6.6

1. Unweighted averages of 19 countries for Other OECD Europe and 9 countries for OECD non-Europe, including some estimates. Countries excluded are Greece, Iceland, Norway, Switzerland and Turkey.

Source: OECD (2012), *OECD Employment and Labour Market Statistics* and *OECD Economic Outlook: Statistics and Projections* (databases), July.

Box 2. The Programme for PES Reform

In February 2012, the authorities announced an integrated set of measures to make job search assistance more effective, the *Programa de Relançamento do Serviço Público de Emprego*. This programme aims at increasing public employment service (PES) placements by 50% and PES vacancy registrations by 20% until end-2013, *inter alia* through:

- Providing job search training within two weeks of jobseeker registration, closer interaction with jobseekers and the use of profiling tools to identify those at greatest risk of long-term unemployment.
- More effective procedures in collecting and disseminating vacancies, including the promotion of partnerships with employer associations.
- Greater cooperation with temporary work and private placement agencies.
- Upgrading information technology systems to allow more interactions through internet and a better jobseeker-vacancy matching.
- Better linkages between active and passive measures, such as steps to curb fraud in proving compliance with job search requirements.
- Streamlining of active labour market programme offers and an assessment of their effectiveness.
- Restructuring of the PES agencies network and systematic assessment of their performance.

Job search and availability requirements, underpinned by systematic monitoring and credible sanctions, are important criteria for unemployment benefits eligibility, as they often lead to higher outflows from joblessness and shorter unemployment duration (Johnson and Klepinger, 1994; Graversen and van Ours, 2008). According to the letter of relevant rules, Portugal has the highest overall strictness of benefit eligibility among 36 OECD or EU countries (Venn, 2012), with one sole area of leniency (no job search requirements during participation in active labour market programmes [ALMP]). However, monitoring and sanctions in practice appear far less rigorous. Job search proof must be provided every fortnight but minimum standards are often undemanding (*e.g.* one action per week among a large menu of valid steps, like applying to vacancies, attending interviews or sending out spontaneous job applications). Further, few unemployment benefit recipients actually receive sanctions, which may be partly explained by the severity of the penalties itself (benefit is permanently lost, rather than temporarily reduced or suspended). In 2011, only 1.7% saw their job centre registration and benefit entitlement cancelled, a fairly low figure in international comparison (Gray, 2003). Job search monitoring should be stepped up, with search requirements made more demanding and extended to ALMP participants, and effective sanction enforcement. To support the latter, benefit sanctions should be made less stringent (for instance, a temporary reduction could replace outright cancellation).

With high unemployment, targeted job subsidies may be needed to keep job search requirements credible (OECD, 2010b) and to help vulnerable jobseekers get some employment experience, even though new jobs may last only for the duration of the subsidy (Centeno and Novo, 2012). In this vein, the authorities have launched *Estímulo 2012*, a scheme requiring net employment creation and targeted at those unemployed for at least six months, where employers must provide relevant training and receive for six months a subsidy of up to 60% of the salary. The above mentioned temporary cuts in employers' social contributions under *Impulso Jovem* should also be of value on this count. To further stimulate job search, the authorities have also made it possible to partially cumulate unemployment benefits and a wage. Benefit recipients who accept a full-time job paying less than the benefit amount will remain entitled to half of the benefit for six months, and to a quarter for the following six months (subject to ceilings). To increase targeting while maximising the incentive to taking up work early in the unemployment spell, this re-employment bonus is not available either in the initial or in the final six months of the benefit entitlement period. The scheme also includes provisions to prevent opportunistic behaviour by employers and employees through collusive layoffs followed by rehiring.

Programmes involving training, subsidised internships or direct job creation are generally expensive, and were substantially expanded in 2008-10 (Table 2). However, the very few existing evaluation studies cast doubts on their effectiveness. As often in other countries, participation in job creation schemes (*medidas ocupacionais*) was found not to increase the chances of finding a non-subsidised job (Nunes, 2007). Internships are useful in helping young people get a foothold in the labour market, and ambitious new initiatives in the area, like *Passaporte Emprego (*a strand of *Impulso Jovem)*, are being launched, aiming to provide a work experience and training to around 50 000 young people who have been unemployed for at least four months. Too generous subsidies for receiving firms, as was arguably the case in the past, could nonetheless entail deadweight losses by displacing unsubsidised hiring. The authorities have commissioned a systematic evaluation of how effective different measures are in fostering exit from unemployment (see Dias and Varejão, 2011, for a progress report), and should use its findings to carefully target programmes on specific groups of jobseekers. They should also remove the current general exemption from job search requirements during participation in ALMP, as planned, and design programmes so as to leave time for search. This approach is being pursued under the new *Vida Ativa* programme, which aims at providing part-time training early in the unemployment spell.

Box 3. Summary of recommendations to rebalance the economy and return to growth

Unwinding macro-financial imbalances while avoiding a credit crunch

- Remove barriers to credit reallocation by tackling incentives to investment in sheltered sectors and "ever-greening" of problematic loans.
- In bank recapitalisation operations, ensure that the potential costs to taxpayers and the final beneficiaries of the funds are fully transparent.
- Pay special attention to the financing conditions of small and medium-sized enterprises. To make firms more reliant on equity and less on debt, alleviate the debt bias embedded in the tax system, for instance by limiting deductibility of interest payments and using the increase in revenues to reduce the corporate tax rate.
- Ensure that the pace of convergence towards the indicative target for the loan-to-deposit ratio does not thwart economic activity.

Removing distortions to capital allocation

- Ensure that the new eviction procedures effectively decrease the eviction time of non-complying tenants in order to increase the supply of rental housing. Foster urban rehabilitation by cutting red tape and focusing existing financial incentives on dwellings for rental.
- Reduce the reliance on the real estate transaction tax by levying it only on the initial transactions of property. In a second step, consider replacing it by value-added tax.
- Ensure that electricity generation support is made cost-effective and costs are fully passed on to all consumers. This requires further reducing excessive supports to both wind farms and cogeneration, and to fossil-fuel power and large hydro plants.
- Given the major progress already made, further expand generation from renewable sources only to the extent needed to meet environmental targets, so as to minimise short-run economic costs. In addition, as renewable technologies become cost-competitive, phase-out feed-in tariffs or, if still justified, choose more market-based support instruments.
- Promote greater competition in the energy sector by managing the regulated electricity tariffs phasing-out to ensure that consumers switch to the liberalised retail market and entry by new players takes place. In gas markets, implement the agreement with Spain to lower cross-border transmission charges to zero.

Reforming the labour market

- Continue to tackle labour market rigidity and segmentation by further reducing severance pay and introducing binding arbitration in conflicts over dismissals.
- Further promote firm-level wage bargaining by abolishing administrative extension of collective agreements.
- To avoid increasing non-wage labour costs in the short run, delay the creation of a compensation fund to finance portable individual severance accounts.
- Make unemployment benefit duration not age dependent, and ensure that changes to eligibility prove effective in improving benefit coverage, especially for young workers.
- Step up job search assistance and monitoring, with search requirements made more demanding and extended to active labour market programmes participants, and effective sanction enforcement. To support the latter, make benefit sanctions less stringent.
- Use training and related programmes selectively, so as to maximise employability gains.
- To improve employment prospects for low-skilled workers and ease labour cost adjustment, reduce employers' social contributions on low-wage workers, to the extent that compensating measures can ensure that fiscal targets are met.

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