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## Portugal: Selected Issues

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PORTUGAL

**Selected Issues**

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Approved by the European Department

August 8, 2007

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## I. PORTUGAL'S EXPORT REBOUND IN 2006: RECOVERY OR BLIP?<sup>1</sup>

**Objective:** To understand Portugal's export performance in 2006 and assess whether it might augur a sustained recovery.

**Results:** The strong rebound of Portugal's exports in 2006 was led by external demand. While the structure of the export sector is changing, it does not appear enough to eliminate the competitiveness gap for the whole sector.

**Policy implications:** As external demand is forecast to remain robust, a gradual recovery of exports is likely, but export market shares seems unlikely to be regained without significant gains in cost competitiveness.

### A. Introduction

1. **Following several years of dismal performance, Portugal's exports rebounded strongly in 2006.** During the 1990s, rapid productivity growth in Portugal's export sector led to an export boom, contributing to the impressive economic performance in the run-up to euro adoption. However, the export sector ran into serious trouble since the early 2000s, as competitiveness was eroded with rapidly rising unit labor costs (ULC), and market shares were lost to Asian countries with similar export structures and very low wage costs. As a result, Portugal's export performance suffered during this period, growing at an average rate of 2.5 percent a year in real terms. Thus it was surprising to many observers that exports registered near 9 percent growth in 2006, and such performance continued into the first few months of 2007.

2. **Will this rebound last? The answer will have profound implications for the growth outlook in the near to medium term.** This chapter aims to provide evidence to make such an assessment, first by examining the factors underlying the recent export rebound, and second by searching for signs of fundamental changes in the structures of the export industries during the last decade.

### B. What Explains the Export Rebound since 2006?

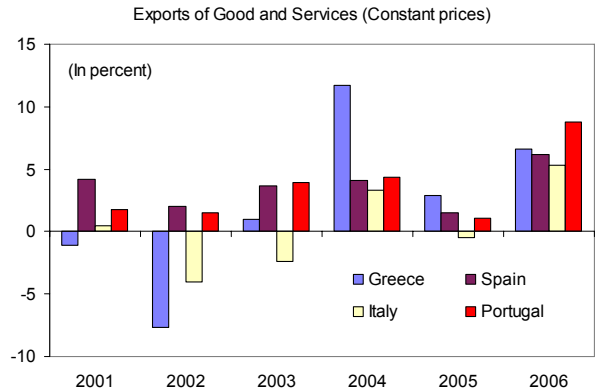
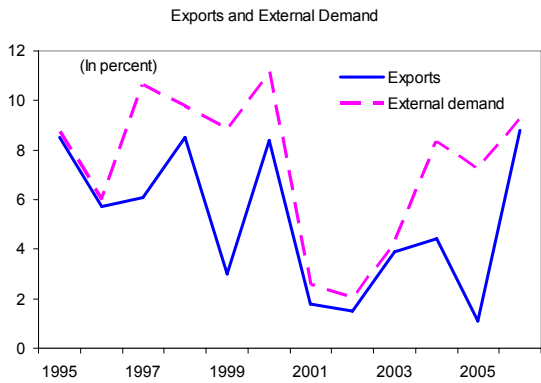
3. **The strong rebound of Portugal's exports in 2006 was led by strong external demand, while price competitiveness has not improved.** The demand for Portugal's exports, as measured by real total imports of Portugal's trading partners, grew by 9.3 percent in 2006, which was about the same rate as Portugal's export growth, and consequently Portugal's export market share stabilized in 2006. By contrast, Portugal's exports did not

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<sup>1</sup> Prepared by Yuan Xiao.

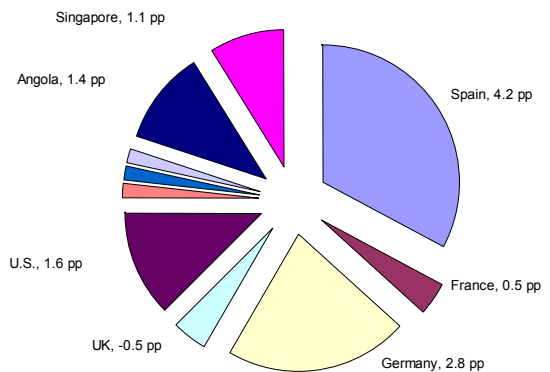
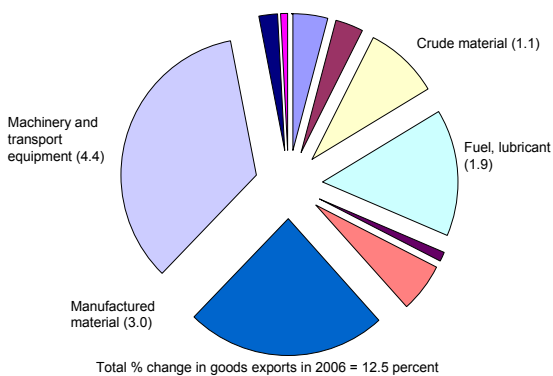
respond as much to demand in the previous years, resulting in a loss of market share. For example, external demand increased by 7.3 percent in 2005, while Portugal’s exports only grew by a 1.1 percent.

**4. The demand-driven export boom in 2006 appeared to be a widespread phenomenon.** Many countries in the European Union (EU) experienced high export growth in 2006. In particular, countries such as Greece, Italy, and Spain, which had experienced a similar export slowdown in the early 2000s, also had a strong export rebound in 2006.



**5. In 2006, growth of merchandise exports was mainly driven by machinery, transportation equipment, manufactured materials, and crude materials to Spain, Germany, U.S., Angola, and Singapore.** Spain remained the largest export market for Portugal, accounting for 4.2 percentage points out of 12½ percent total increase of Portugal’s merchandise exports (in nominal terms). However, newer markets such as Angola and Singapore also contributed significantly to the export growth.

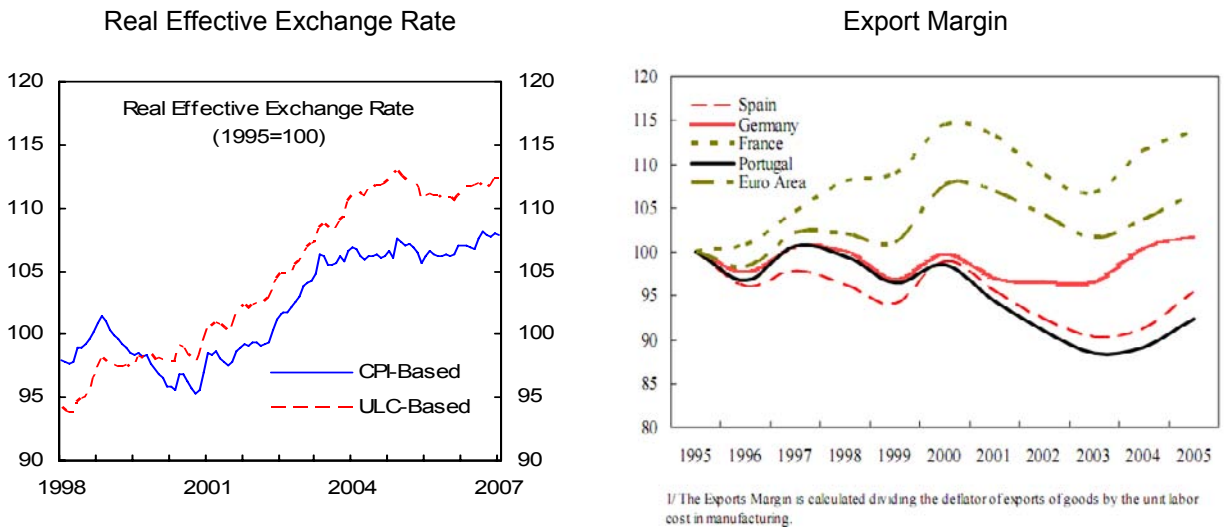
Contributions to Export Growth in 2006



6. **Service exports enjoyed similar buoyancies, rising by 15.4 percent in nominal terms in 2006.** Tourism and transportation contributed to over half of total growth. Other service exports, such as construction, communication, services in trade, leasing, legal work, and agriculture, accounted for the rest of the service growth.

### C. Recent Trends in the Export Sector

7. **Portugal's price competitiveness has not improved in recent years.** Both CPI and ULC based real effective exchange rates showed moderate appreciation in 2006, and various indicators of external competitiveness still point to a gap of 10–20 percent.<sup>2</sup> On the other hand, the export margin, as calculated by dividing the deflator of exports of goods by the ULC in manufacturing, appeared to have started rising since 2004.



8. **Significant changes to the structure of Portugal's exports have taken place since the mid-1990s.** Reflecting the increasing dominance of Asian countries in the sector, the share of textile and footwear exports continues to shrink. On the other hand, shares of machinery and transport equipment, chemicals, materials, and refined fuels have been expanding.

<sup>2</sup> See Chapter III.



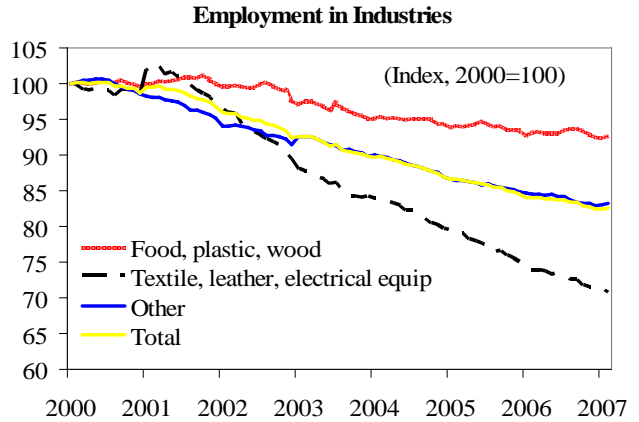
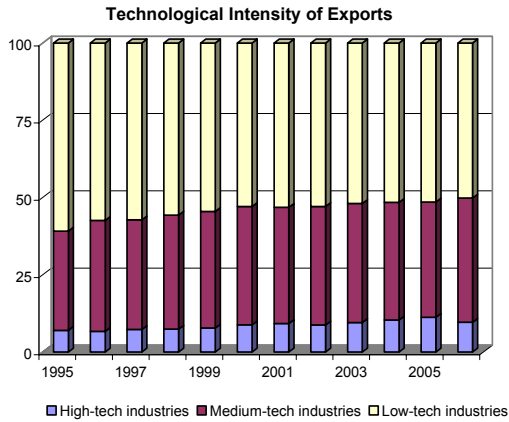
Share in Portugal's Merchandise Exports

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Food and live animals	3.9	4.0	4.0	3.8	3.9	4.1	4.5	4.4	4.5	4.8	4.7
Beverages and tobacco	2.6	2.6	2.5	2.6	2.5	2.5	2.7	2.7	2.6	3.0	3.0
Crude materials except fuels	4.4	4.6	4.0	4.1	4.4	3.6	3.4	3.4	3.6	3.8	4.4
Mineral fuels and lubricant materials	2.3	2.3	1.6	1.8	2.6	1.9	2.0	2.4	3.0	4.3	5.5
Animal and vegetable oils	0.7	0.7	0.5	0.4	0.4	0.5	0.5	0.4	0.5	0.5	0.6
Chemicals and related products	4.4	4.7	4.8	5.0	5.7	5.5	5.8	6.2	6.7	6.9	6.8
Manufactured materials	21.9	22.5	23.3	23.2	23.8	24.2	24.7	23.6	23.9	23.6	23.6
Machinery and transport equipment	31.6	31.3	33.3	34.2	34.4	34.8	34.4	34.8	34.1	32.2	32.5
Textiles, footwear and others	28.0	27.1	25.9	24.8	22.2	22.7	21.8	21.9	20.7	18.6	16.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

9. **Gradually, Portugal's manufacturing exports have been shifting to higher technology products,<sup>3</sup> although the progress decelerated during the recent economic slowdown.** In the mid-1990s, low technology exports, such as textiles and footwear, accounted for about half of total manufacturing exports, but by 2006 their share had declined to just over one-third of the total. This decline was offset by rising medium-low technology exports such as manufactured materials, whose share rose from below 20 percent to over 25 percent, and medium-high technology exports such as machinery and transport equipment,<sup>4</sup> whose share rose from 25 percent to 30 percent. Meanwhile, high technology exports also increased slowly, although their weight is still very small. On the other hand, the expansion of high and medium-high technology exports slowed noticeably after 2001.

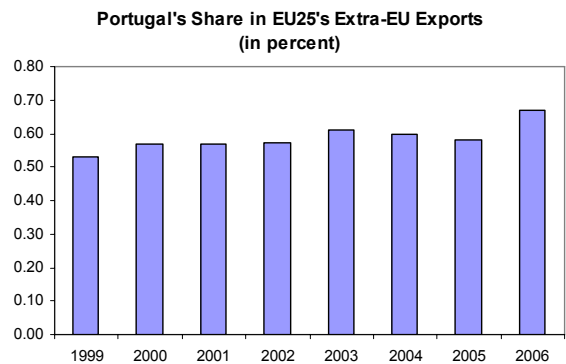
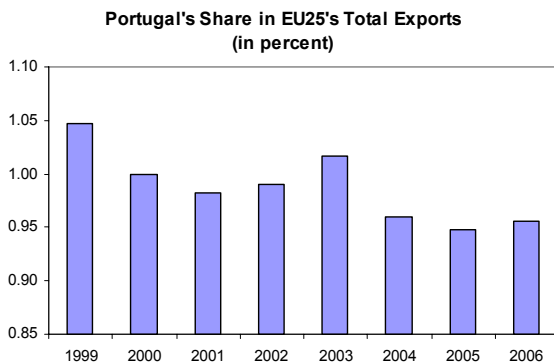
<sup>3</sup> The classification is based on OECD Science, Technology and Industry Scoreboard 2005. High-technology industries include aircraft and spacecraft; pharmaceuticals; office, accounting, and computing machinery; radio, TV, and communications equipment; and medical, precision, and optical instruments. Medium-high-technology industries include electrical machinery and apparatus; motor vehicles; trailers and semi-trailers; chemicals excluding pharmaceuticals; railroad equipment and transport equipment; and machinery and equipment. Medium-low-technology industries include building and repairing of ships and boats; rubber and plastics products; coke, refined petroleum products, and nuclear fuel; other non-metallic mineral products; and basic metals and fabricated metal products. Low-technology industries include wood; pulp; paper; paper products; printing and publishing; food products, beverages, and tobacco; and textiles, textile products, leather, and footwear.

<sup>4</sup> For example, the establishment of a Volkswagen plant in Portugal has led to increasing vehicle exports. In 2006, 98 percent of vehicles made in the Volkswagen plant were for export to destinations such as Germany, UK, Australia, Spain, France, and Italy.



10. **Such a shift in the export structure has also seen employment trends of the various sectors of manufacturing.** While total employment has declined in the economic slowdown, the reduction in the traditional sectors has been particularly significant.

11. **Portugal's merchandise exports have diversified into markets outside the EU.** Although the share of exports to EU countries had accounted for about 80 percent of Portugal's total merchandise exports for many years, in 2006 this share dropped somewhat, as exports to U.S., Angola and Singapore etc., expanded rapidly. It remains to be seen whether this signifies a new trend. Compared to other EU countries, Portugal's share in intra-EU exports continued to dwindle. However, Portugal's share, compared to other EU countries, holds up surprisingly well in extra-EU exports despite the recent economic slowdown, and Portugal has been able to expand the share gradually.

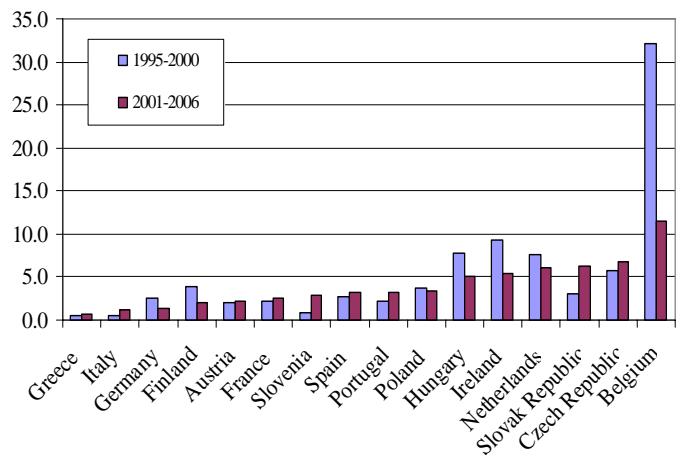
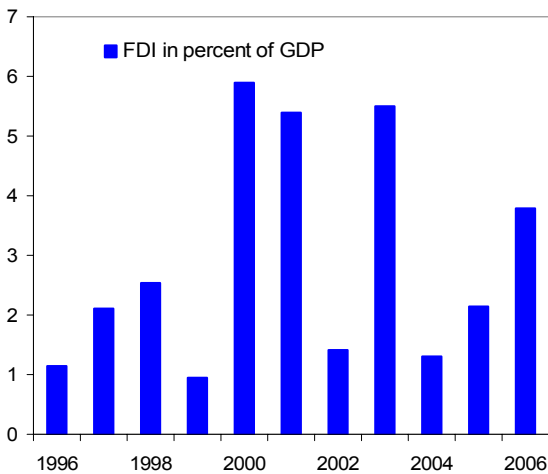


12. **The structure of service exports remains largely unchanged.** Tourism and transportation are the largest sectors in service trade. Overall service exports are somewhat less volatile than merchandise exports, and should play an important role in sustaining export growth.



13. **Investment in the export industries, in particular FDI, will play a critical role in fostering productivity growth and export recovery.** Business fixed investment dwindled since 2001, but in 2006 it started to grow again, rising by 3 percent. FDI slowed in 2004 and 2005, but recovered in 2006. FDI inflow in terms of GDP is about average within the euro area, but lags new EU members. Data from the Portuguese Investment Agency (API) show that large investment projects have been established in a wide range of sectors, including those of automobile, pulp and paper, and ceramic and glass, electric and electronic equipment, food, and tourism. About 40 percent of FDI signed via API are related to the automobile sector, and 8 percent is related to electronic equipment. It is likely these will be the sectors leading export growth in the medium term.

Net FDI inflow as Percent of GDP



**D. Conclusion**

14. **The rebound of Portugal’s exports in 2006 took place again a background of a global export surge, led by strong demand.** Unlike in previous years, Portugal did not lose market share. But the economy’s competitiveness gap still exists.

15. **Changes in Portugal's export sectors are taking place, although it would be premature to project a sustained recovery at this point.** Signs are mixed. On one hand, external demand is strong, Portugal's exports are moving up the technology chain, and investment is recovering. On the other hand, the export rebound has just unfolded for one full year, similar recoveries have fizzled out, and the changes already taking place in some "pockets" of export industries do not seem to have resulted in a fundamental shift of the whole sector in terms of competitiveness. Thus while Portugal's exports are likely to be buoyed by continuing global demand, export market shares seems unlikely to be regained.

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## II. MAKING PORTUGAL'S TAX SYSTEM MORE PRO-GROWTH<sup>5</sup>

**Objective:** To assess whether, and how, Portugal's tax system (both policy and administration) could be made more supportive of growth, while not undermining revenue.

**Main results:** Although Portugal's tax structure is broadly sound and the tax ratio not particularly high, it does seem to impose some excessive burdens on the economy through its administration; complexity; numerous exceptions; and frequent changes.

**Policy implications:** In terms of tax law, streamlining the PIT and CIT, reducing and simplifying tax deductions and benefits, and further simplifying administrative requirements. On tax administration, adopting a functional organizational, establishing a central taxpayer assistance function, implementing a full Large Taxpayer Unit, adopting risk management systems for audit selection, and strengthening enforcement activities.

### A. Background

1. **The tax ratio has increased in recent years, but remains relatively low.** The current tax system stems from the late 1980s, when the VAT and income tax were introduced. Since then, the tax system has responded positively, and amidst many legal changes, the tax ratio has increased over the past decade, from 32.7 percent of GDP in 1995 to 36.3 percent of GDP in 2005.<sup>6</sup> In 2006, it increased further, reaching 36.7 percent,<sup>7</sup> driven mainly by the VAT rate increase (from 19 percent to 21 percent in 2005), buoyant income tax receipts, and improved tax administration. Nevertheless, the tax ratio is low compared to other industrialized countries and is below the EU average (40.9 percent of GDP in 2005).

2. **The tax system relies relatively heavily on consumption taxes.** Consumption taxes contributed 42 percent of total revenue in 2005, compared to the EU average of 34 percent. Such a reliance is typically seen as positive for long-term growth (see Box 1). The share of social contributions is at the EU average (34 percent), but direct taxation (24 percent) was below the EU average (31.7 percent). Even though this reliance is affected by the statutory

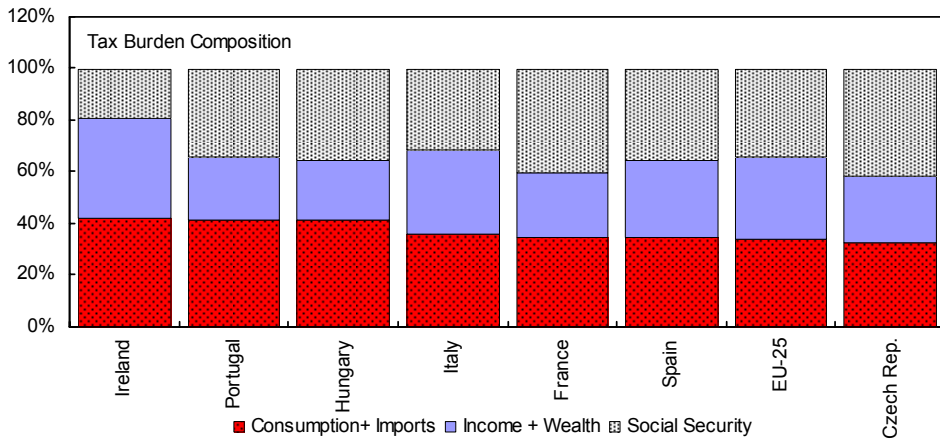
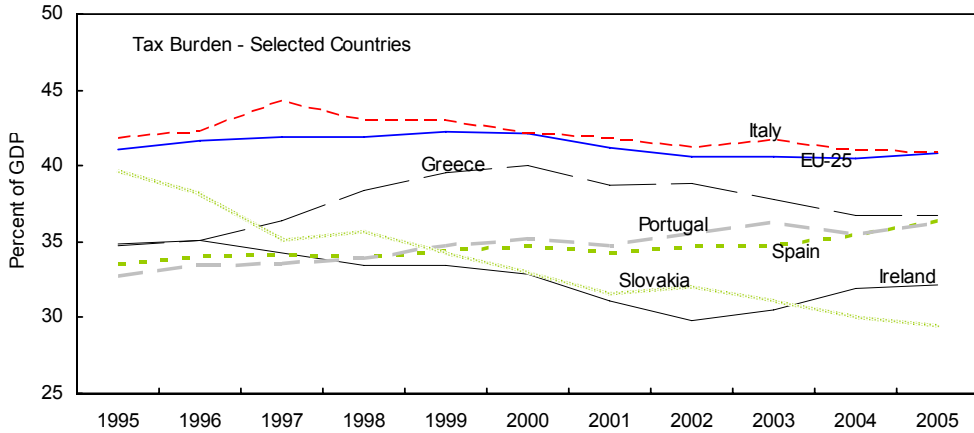
<sup>5</sup> Prepared by Andrea Lemgruber (FAD).

<sup>6</sup> European Union (2007).

<sup>7</sup> Staff estimates, preliminary.

tax structure, is also a result of the relatively high, though declining, VAT productivity<sup>8</sup> and the weak revenue response of the income taxes (mainly due to generous base reductions and non-compliance).

Figure1. Portugal: Tax Burden and Composition, 2005



Source: European Union 2007.

<sup>8</sup> VAT productivity refers to average VAT revenue (as a percent of GDP) per percentage point of the standard VAT rate.

### Box 1. Characteristics of Pro-Growth Tax Systems

While the level of taxation will affect growth, so too will its structure and administration. For a given level, pro-growth tax systems should be:

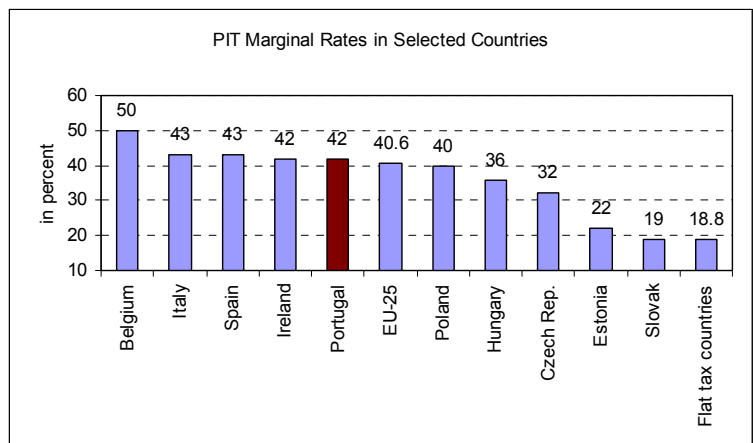
- **efficient**, in the sense of non-distortionary (e.g., taxes on goods and services), with a broad base (e.g., few deductions, benefits, and exceptions) and low rates;
- **stable, simple and predictable**, as frequent changes and complex rules hinder long-term investment and distort planning;
- **low-cost to administer and to comply with.**

Such a pro-growth structure tends to imply less reliance on direct, progressive taxes, with other government objectives, such as equity, being met by greater use of redistribution via budgetary allocation, rather than through taxation.

## B. Tax Policy

3. **The personal income tax (PIT) structure is highly progressive and the many deductions add complexity.** The adoption of a new marginal rate of 42 percent in 2005 goes against the worldwide trend of reducing both the marginal rate and the number of brackets.<sup>9</sup>

The new rate is also slightly above the EU-area average and could affect the labor market. Besides, it is not likely to yield much revenue as the bulk of the taxpayers are concentrated in the lower brackets.<sup>10</sup> The various deductions and tax credits reduce considerably the effective tax rate, which was 10.3 percent in 2005, despite the high



progressiveness of the tax. Pension incomes also remain favorably taxed in relation to the

<sup>9</sup> Between 2000 and 2004, the maximum marginal PIT rate was reduced over 5 percentage points in eight OECD countries (Belgium, France, Germany, Greece, Luxembourg, Mexico, the Netherlands, and Slovak Republic), and by 3.1 percentage points in all OECD members on average. Eleven OECD countries reduced the numbers of tax brackets between 2000 to 2005, only Canada, Portugal and U.S. increased the number of brackets during this period (Relatório sobre Simplificação do Sistema Fiscal Português, pages 19–21).

<sup>10</sup> A DGCI study (IRS 2004–05) shows that 88 percent of the taxpayer were concentrated in the 12 to 24 percent brackets in 2005.

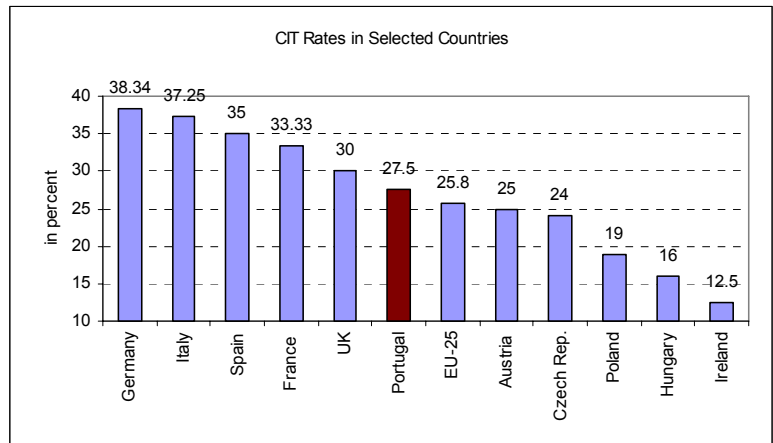


wage income, which introduces distortions between the types of income and a possible incentive to retire. There thus appears scope to streamline the PIT, reducing both the rates and brackets, while also broadening the base.

4. **The corporate income tax rate (CIT) is slightly above the EU average. CIT rates were gradually reduced from 39.6 percent in 1997 to 27.5 percent in 2004, following the EU trend. Despite this reduction, revenue collection has performed well due to some cuts in deductions and better**

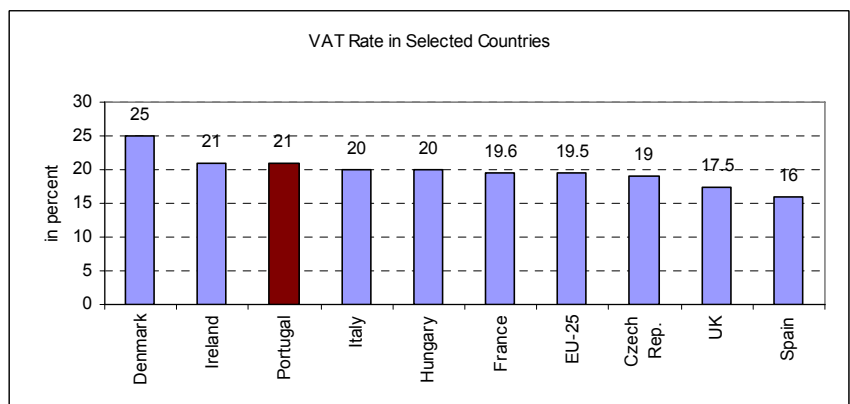
**administration. Currently, the rate is slightly above the EU-25 average (25.8 percent) which is very much affected by the low rates levied in the Eastern European countries and Ireland. The CIT is a sensitive area in terms of FDI attraction and should be monitored given that these countries compete with**

**Portugal to attract FDI. However, Portugal has special incentives for attracting FDI which reduces the tax burden for foreign investors. Furthermore, deductions and exemptions lead to an effective tax rate of 17 percent in 2005.<sup>11</sup>**



5. **The standard VAT rate is slightly above the EU average and higher than Spain's. With the 2005 VAT rate increase to 21 percent (from 19 percent), Portugal's standard rate is above the EU-15 average (19.6 percent) and considerably higher than its neighbor, Spain,**

**(16 percent).<sup>12</sup> This gives rise to concerns about cross-border shopping within a free-trade area. This may happen not only due to the standard rate but also the difference between the reduced rates (7 percent and 4 percent in Spain in comparison to**



<sup>11</sup> DGCI, IRC 2003–05

<sup>12</sup> Other countries in similar situations have a large VAT rate gap. For example, Germany (16 percent) and Denmark (25 percent).

12 percent and 5 percent in Portugal). This problem is also affected by the relative excise rates of the two countries and, in general, Spain has lower excise rates than Portugal.<sup>13</sup> More generally, reducing the VAT rate would have an immediate and substantial effect on revenue (which would need to be offset elsewhere) and could not be expected to have a lasting impact on growth.

6. **There seems ample scope to simplify taxes, which could reduce noncompliance and administrative costs while supporting investment.** Some important steps have already been taken as the adoption of SIMPLEX<sup>14</sup> that, among other things, greatly reduced the time needed to open a business in Portugal.<sup>15</sup> However, as pointed out by OECD (2006, page 10), “[a] tax reform that really simplifies the tax system is needed. In the meantime, refraining from revising the tax legislation from one year to the next, as has happened in recent years, would make the tax system easier to manage and would facilitate long-term decision-making by economic agents”. A working group on this issue was established in 2005,<sup>16</sup> which recommended adopting simplified accounting and administrative obligations for small and medium enterprises;<sup>17</sup> streamlining administrative requirements in general (including the reduction of the number of existing returns); streamlining tax deductions, credits and benefits; harmonizing and accelerating the publication of legal interpretations and the response to specific requests made by taxpayers, and expediting the decision making of the tax courts.

7. **There may also be scope for streamlining tax expenditures.** Here too the government established a working group<sup>18</sup> whose reports notes that Portugal has a relatively

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<sup>13</sup> For example, in terms of oil products: leaded gasoline (404.8 euros /1000 liters in Spain and 620 euros/1000 liters in Portugal); GLP (57.5 euros/ton in Spain and 106.5 euros/ton in Portugal); natural gas (1.15 euros/cylinder in Spain and 2.72 euros/cylinder in Portugal); beer (range from 0 to 13.56 euros in Spain and from 6.6 to 23.18 euros in Portugal).

<sup>14</sup> Other examples of SIMPLEX 2006 measures are electronic requests for VAT refunds; seizure procedures using official electronic information; and initiating a project for a “simplified enterprise information return” aiming at a global information return. For 2007, the measures focus on new on-line services.

<sup>15</sup> 2007 Doing Business Report. The report considered Portugal as the top reformer in business entry in 2005/2006.

<sup>16</sup> The final report was published in April 2007 under the title “Simplificação do Sistema Fiscal Português”, Cadernos de Ciência e Técnica Fiscal, n. 201.

<sup>17</sup> It seems a contradiction that SME businesses can opt for a presumptive system in the CIT but are still obliged to fulfill full accrual accounting.

<sup>18</sup> The final report was published in December 2005 under the title “Reavaliação dos Benefícios Fiscais”, Cadernos de Ciência e Técnica Fiscal, n. 198.

complex and generous system of tax benefits, which may negatively affect efficiency and equity. Tax benefits are also typically a source of legal instability. Independent from any change to the system of tax benefits, it also seem advisable to better measure of the size of the benefits, their results, and develop a permanent control and monitoring process.

8. **Any further changes in the tax law should be done in a consolidated manner after a broad review and without the prospect of further changes for considerable time.** While there is scope for some changes to the tax law, as indicated above, this should be considered together with the need to minimize recurrent changes. As mentioned in Box 1, stability and predictability are major elements of a pro-growth tax system. Thus any changes should be done in a consolidated (rather than ad hoc) manner, after a substantial review, and with the expectation that further changes would not be undertaken for a considerable period.

### C. Domestic Tax Administration

9. **The tax administration (DGCI)<sup>19</sup> has made impressive improvements in recent years, bringing it more in line with international best practice.** Such improvements were mainly based on IT investments which contributed to updated registers; expansion of the use of electronic filing;<sup>20</sup> more reliable databases; and better cross-checking of information. The audit function was also improved, partially addressing a long-standing need for additional auditors (which still remains well below the OECD average as a share of total employees).

10. **There is still considerable scope for further improving tax administration, broadly along the lines the government envisages.** Two main areas stand out: (1) taxpayer services, to reduce compliance costs and promote a better business environment; and (2) enforcement, to reduce evasion and promote fair competition.

11. **DGCI lacks a taxpayer assistance function at the central level which means that services are offered by local offices without a coordinated delivery strategy.** In the 2006 survey,<sup>21</sup> two-thirds considered the on-line services as very good and good but only 11 percent gave the same evaluation for the local offices (*Serviços de Finanças*). Against this background, beyond the establishment of a central taxpayer service function, it would be recommendable to implement a full functional Large Taxpayer Unit (the LTU currently only

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<sup>19</sup> The DGCI administers taxes on income, consumption and property, and has around 11,187 employees in 2006, down from 13,702 in 2001 (mainly due to retirements). Although structured by function, it still mixes functional and tax-types structures within departments, unlike most modern tax administrations.

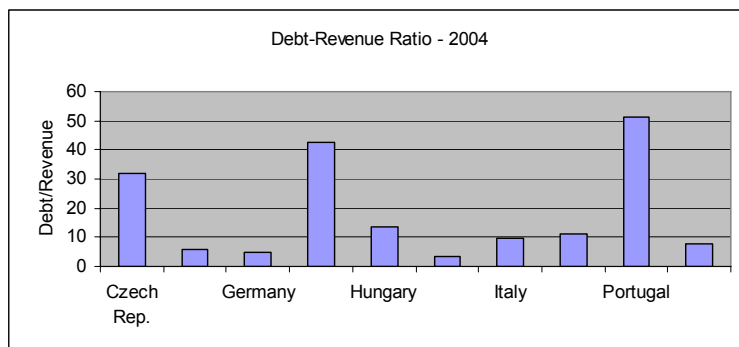
<sup>20</sup> OECD (2006) Comparative Series. Electronic filing for PIT was raised from 24 percent in 2004 to 48 percent in 2006. In terms of total returns, more than 60 percent of the private taxpayers are now submitting their tax returns using the internet (electronic submission is compulsory for corporations).

<sup>21</sup> Simplificação do Sistema Fiscal Português, p. 179.

performs audits). This would be important to deliver specialized service to large taxpayers and be more client-oriented regarding large investors.

12. **In terms of enforcement, DGCI needs a risk system for case selection to better focus audit resources.** The informal economy is high, with most recent estimates suggesting 22.6 percent of GDP for 2002,<sup>22</sup> even though no study on tax evasion or relevant tax gaps has been undertaken. Audits results have been improving over the past two years but targeting audits at high-risk sectors where most non-compliance occurs would be more efficient than the current system, which lacks the support of an automated risk scoring system.

13. **Debt enforcement has been a major problem — its arrears stock reached half of total collections in 2004, one of the highest in the OECD.**<sup>23</sup> About half of the cases are more than three years old. A major strategy to cope with this problem is in place based on the new Electronic Register of Assets for Seizure,<sup>24</sup> which helped double seizures in 2006. DGCI is also publishing a list with the debtors' names on the internet, and the value of arrears recovered reached 1 percent of GDP in 2006. While about 70 percent of the arrears are securitized (which reduces the revenue impact of recovery), the recovery of these arrears will improve voluntary compliance and overall fairness of the tax system. DGCI should also bring all its powers to bear on this problem, which should also include the write-off option given the age of the debts.



<sup>22</sup> Alm, J., et. al. (2004); average for OECD/Western European countries is 18 percent of GDP.

<sup>23</sup> OECD (2006), Comparative Series. This is the most recent data available for international comparison, even though Portugal has improved over the past two years within the scope of a national plan for arrears collection.

<sup>24</sup> The system has information on assets such as bank accounts, shares, savings accounts, wages, urban property, vehicles, and others. Using this information, enforcement collection actions have been undertaken.

## D. Conclusion

14. **There seems to be significant scope to make Portugal’s tax system more pro-growth at the current revenue ratio.** Although Portugal’s tax system has a broadly sound structure and the tax burden is not particularly high, it does seem to impose some excessive burdens on the economy through its overall complexity; numerous exceptions that narrow the tax base; and recurrent changes in the tax law. Some recent measures, such as the introduction of the 42 percent PIT bracket, seem to pose additional burden without a substantial expected benefits.

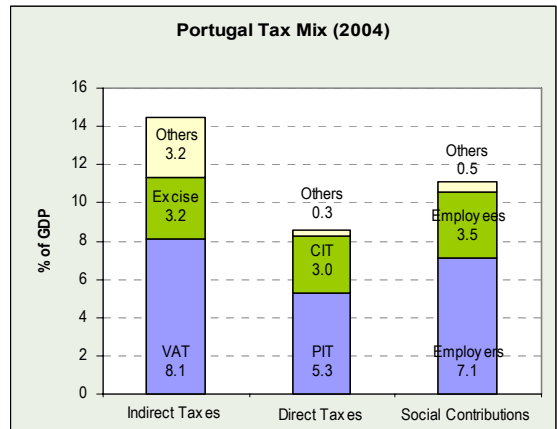
15. **Many of these problems are already known and are starting to be addressed.** For example, the government has been undertaking a series of reforms aiming at simplifying the tax system and reducing the so-called Portuguese “costs of context”. Simultaneously, substantial improvements have been achieved in tax administration in the past two years and are already showing results.

16. **Further tax system reforms could reduce the burden on taxpayers without reducing revenue.** Key reforms include: streamlining the PIT with the aim of reducing the number of brackets and the marginal rate; reducing and simplifying tax deductions and benefits (particularly in the PIT and CIT); and further simplifying legal provisions and administrative requirements, which can have an important impact on competitiveness, especially for small and medium enterprises. Recommendations on how to further improve tax administration include: adopting a functional organizational structure (i.e., eliminating departments organized by tax type); establishing a clear taxpayer assistance function at the central level; implementing a full, functional Large Taxpayer Unit that effectively delivers services; adopting risk management systems for audit selection; and strengthening enforcement activities, including with respect to tax arrears.

## Appendix I. Main Features of the Portuguese Tax System

1. The main pillars of the Portuguese tax system are the personal and corporate income taxes, the VAT, and the social security contributions.

2. The PIT is levied on worldwide annual income, net of a series of allowances and deductions. There are seven income brackets and the rates range from 10½ percent to 42 percent.<sup>25</sup> There are a series of deductions and tax credits for each of the six income categories.<sup>26</sup> The taxation unit is the family, i.e., married taxpayers are obliged to file a common return. There is a simplified regime for income from businesses and professional activities below 150,000 euros per year, in which case the net income is presumed by applying a coefficient of 0.2 to the sales (including hotel and restaurants) and of 0.7 to other income (mainly income received as consideration for services).



3. The CIT is charged at a standard rate of 25 percent, the sum of a nondeductible municipal surcharge up to 10 percent of the standard rate, which amounts for a 27½ percent as a general case. There are lower rates for the Autonomous Regions of Azores (17½ percent) and Madeira (22½ percent). Capital gains are included in the ordinary income and ordinary losses can be carried forward for six years. For companies taxed under the simplified regime (optional for those with revenues below 150,000 euros), a reduced rate of 20 percent applies on a presumptive tax base (calculated by applying a coefficient of 0.2 to sales and a coefficient of 0.45 to other revenues). However, such businesses are still obliged to full accrual accounting.

4. The VAT is charged at a 21 percent standard rate, with reduced rates of 5 percent (basic food; books and periodicals; pharmaceuticals; water and electricity; natural gas; transport; hotels and agriculture) and 12 percent (restaurant; wines and food; coffee; plants and flowers; agricultural equipment and some types of fuel). There are special favorable rates in Azores and Madeira (15 percent, 8 percent, and 4 percent). Exemptions apply for members

<sup>25</sup> The marginal rates are 10.5, 13.0, 23.5, 34.0, 36.5, 40.0 and 42.0. The 42 percent bracket was introduced in 2005, before the maximum marginal rate was 40 percent.

<sup>26</sup> The six income categories are income from paid employment, income from self employment, investment income, income from immovable property, capital gains, and pensions.

of diplomatic missions; the Catholic church; charities; armed forces; firemen associations; political parties; and cars for disabled people, among others.

5. Excise duties are levied on oil and energy products; tobacco; alcohol and alcoholic beverages; and motor vehicles.

6. Social security is financed by employees (at 11 percent of their gross wage, without any ceiling) and by employers (at 23¾ percent). The employee's contribution is withheld at source as a general rule. Self-employed individuals may choose the rate and the base of their contributions to social security. They may choose to contribute at a rate of 25.4 percent (compulsory minimum risk coverage) or of 32 percent (broader risk coverage). The base may range from one and a half to twelve times the amount of the minimum monthly wage.

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### III. THE IMPORTANCE OF LABOR MARKET FLEXIBILITY IN REGAINING COMPETITIVENESS<sup>27</sup>

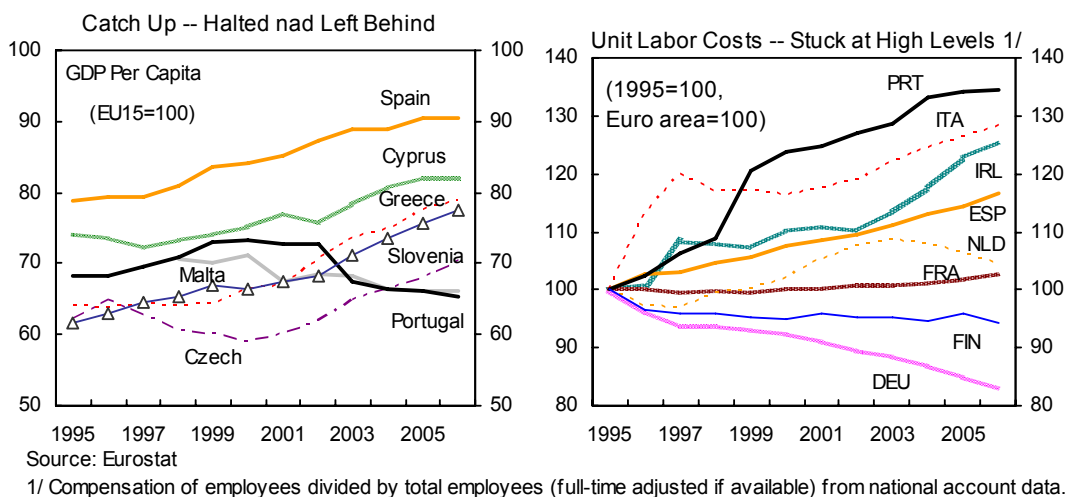
**Objective:** To assess whether labor market reforms could help Portugal regain competitiveness.

**Results:** Theory and experience from other countries suggest that a flexible labor market is key in regaining competitiveness. Portugal's relatively rigid labor market may thus significantly prolong the adjustment process.

**Policy implications:** Labor market reform can significantly increase Portugal's output in the long-run. Employment protection is a key area to tackle. The government's ongoing reforms in the product market would complement efforts to increase labor market flexibility and speed improvements in Portugal's competitiveness.

#### A. Introduction

1. **Portugal is emerging from a slump that followed the boom in the run-up to adoption of the euro.** In the second half of the 1990s, a significant decline in interest rates and the prospects of faster income convergence to the level of other European countries associated with euro entry boosted domestic demand and growth. Output growth exceeded that of the euro area, allowing for a catch-up to the euro area average. The boom, however, produced some substantial macroeconomic imbalances. Household and corporate balance sheets became stretched, and pro-cyclical fiscal policy undermined public finances. Rapid wage growth persistently outpacing that of labor productivity resulted in a sustained increase in unit labor costs. Strong import growth combined with the erosion of competitiveness



<sup>27</sup> Prepared by Keiko Honjo.

prompted a substantial widening in the current account deficit and a persistent loss of export market share. As a result, growth has dropped below average euro-area levels since 2001, and income convergence with the EU has reversed.

2. **Various indicators suggest Portugal continues to face a significant competitiveness gap.**<sup>28</sup> While the standard methods of assessing competitiveness are subject to various shortcomings including uncertainty surrounding econometric estimates and the inability to fully incorporate all relevant country-specific factors, on balance they suggest a competitiveness gap of about 10–20 percent. The presence of such a gap is also consistent with the performance of exports. Until recently, export growth persistently trailed demand growth in Portugal’s major trading partners, implying significant export market share losses.<sup>29</sup>

Summary Competitiveness Gap Assessment  
(in percent)

REER (ULC) -- base 1995	13.3
PPP exchange rate ratio	-4 ~ 22
Profit Margins (2005) 1/	7.6
Equilibrium real exchange rate (ERER) 2/	15.3
Macro Balance Approach 1/	7~10
NFA Stabilizing (External-sustainability) 2/	15.5
Constant market share analysis (2005) 1/	14.0

Sources: Eurostat, OECD; and IMF staff estimates.

1/ From IMF Country Report No. 06/386.

2/ Staff estimates based on CGER methodology.

3. **The objective of this chapter is to consider how this competitive gap may be closed given that Portugal is in a currency union.** The chapter draws insights from the experiences of Hong Kong SAR and Germany in adjusting to a competitiveness shock and highlights the importance of labor market flexibility. In addition, using a four-country version of the IMF Global Economic Model (GEM), the chapter attempts to illustrate the benefits of labor market reform to help close the competitiveness gap.

## B. The Importance of Labor Market Flexibility

4. **The importance of labor market flexibility is well founded in economic theory.**<sup>30</sup> A flexible labor market is key to making the economy more productive by effectively and smoothly allocating labor. It enhances competitiveness by better linking productivity and wages and increases the speed of adjustment to economic shocks. Especially in the context of a fixed exchange rate (or a country in a monetary union), in the absence of nominal exchange rate adjustments and independent monetary policies, the labor market bears the brunt of any

<sup>28</sup> For methodologies, see *Methodology for CGER Exchange Rate Assessments*, IMF, 11/8/06, <http://www.imf.org/external/np/pp/eng/2006/110806.pdf>.

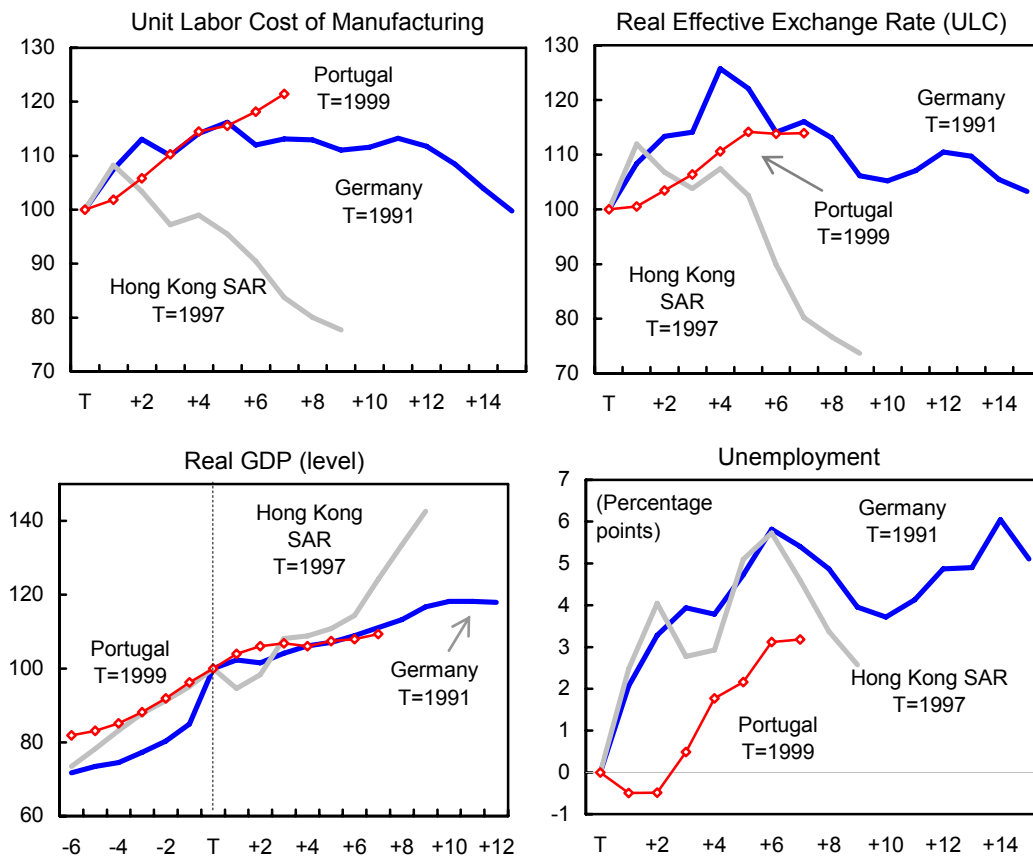
<sup>29</sup> See Chapter I for more detailed analysis of recent export performance.

<sup>30</sup> See for example Nickell (1997) and Pissarides (1997).

required adjustment in response to idiosyncratic economic shocks. Any adjustment must come from relative price and wage deflation vis-à-vis trading partners.

5. **Experience from Hong Kong SAR and Germany illustrate how a flexible labor market is key to regaining competitiveness.** Hong Kong SAR faced a large competitive shock in the wake of the 1997 Asian crisis with China emerging as a major manufacturing center and an exporting power. Similarly, Germany experienced significant cost pressures in the early 1990s as a consequence of unification. In both cases, the key to adjustment was wage moderation and labor shedding from manufacturing and low-end services towards higher value-added services, which lowered unit labor costs. The figure below illustrates the different adjustment paths in Hong Kong SAR and Germany following their competitiveness shocks in 1997 and 1991, respectively (referred to as T in the figure below), and compares them with adjustment in Portugal since 1999 (the date of euro adoption).

Comparison of Adjustment Path



Sources: IFS, WEO, CEIC database, and staff calculations.

6. **In Hong Kong SAR, it took about six years to achieve a real depreciation to sufficiently reduce its competitiveness gap.** This involved a sharp contraction in output and employment upfront followed by sustained deflation. Hong Kong SAR's highly flexible labor market allowed nominal wage growth to turn negative, especially in manufacturing. As

a result, the real effective exchange rate depreciated by about 5 percent a year. In contrast, the adjustment was considerably slower in Germany, taking about 12 years. With less flexible labor and product markets, the real effective exchange rate depreciated only gradually at about 2 percent a year based on a sustained reduction in real wages. The comparison of two economies needs to be interpreted with some caution given that adjustment in Hong Kong SAR was eased somewhat by buoyant growth in those sectors of the economy that benefited from the growth in China.

7. **The experience from Hong Kong SAR also suggests that the adjustment process can take many years even with a highly flexible labor market.** Portugal has broadly followed Germany's path but its unit labor costs of manufacturing continue to rise. With sustained increases in real wages outpacing labor productivity growth, the real effective exchange rate has barely moved. The sluggish adjustment suggests significant rigidity in Portugal's labor market. A 10–20 percent competitive gap in this context implies the economy may be subject to a protracted adjustment phase.

### C. The Flexibility of Portugal's Labor Market

8. **Recent analysis has focused on the interaction between shocks and labor market institutions to explain different adjustment processes and outcomes.**<sup>31</sup> These studies show that institutions affect not only labor market performance but also the impact of shocks and the speed of the adjustment process. Institutions that contribute to slower adjustment in response to shocks can make the impact of shocks more persistent. Research has identified a number of channels through which different institutions influence the adjustment mechanism. For example, some institutional arrangements like replacement rates and duration for unemployment benefits have a direct impact on wages and hence affect how wages respond to disequilibrium in the labor market. Other factors like employment protection legislation or active labor market policies directly affect the flows in and out of unemployment.

9. **Drawing on the results of Blanchard and Wolfers (2000), a summary indicator of labor market flexibility can be calculated based on the institutional arrangements.** Following U.K. Treasury (2003) and using the same eight measures of labor market institutions and their estimated coefficients from Blanchard and Wolfers (2000), the indicator is constructed as a simple linear sum of the impact from each measure:

$$F_i = \sum_j b_j X_{ij}$$

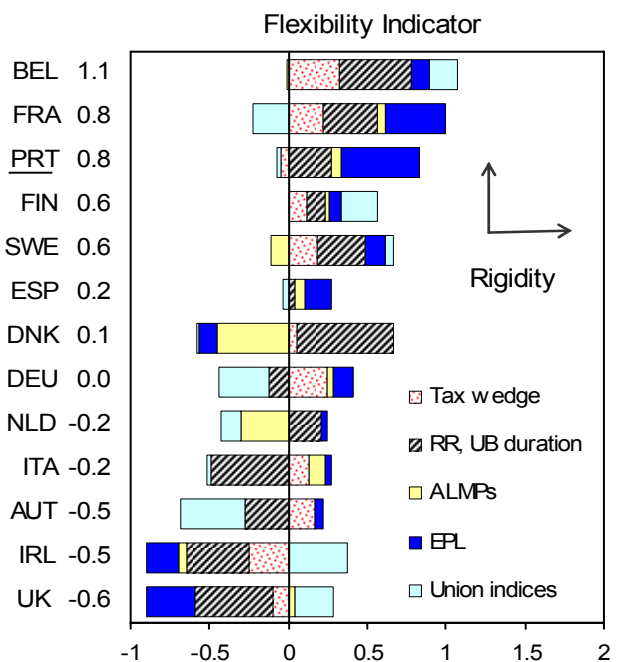
where  $i$  indicates a country and  $X_{ij}$  is a measure of labor market institutions in country  $i$ , where the measures are: the replacement rate, unemployment benefit duration, spending on

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<sup>31</sup> See for example Blanchard and Wolfers (2000), Den Haan *et al.* (2001), and Karanassou *et al.* (2004).

active labor market policies (ALMPs), employment protection legislation (EPL), the tax wedge, union coverage, union density, and union coordination.<sup>32</sup> The measures of institutions are defined so that an increase in the measure would amplify the impact of an adverse shock to the labor market by  $b_j$ . In addition, they are constructed as deviations from the cross-country average of 20 countries (EU15, the U.S., Japan, Canada, Australia, and New Zealand), thus by definition, a country with average degree of flexibility scores 0. Countries that are more (less) flexible than the average score negative (positive) value. The figure (below) sorts countries by the score and shows the decomposition by the contribution from different measure of institutions.

10. **A comparison of the flexibility indicators suggests Portugal's labor market is significantly less flexible than the average.** Key measures pushing up the score are employment protection and the generosity of the unemployment benefits. Recent reform of unemployment benefit (not reflected in the indicator) that tightened eligibility criteria and introduced better link between the duration of benefit and the period of contributions may contribute to lowering the flexibility indicator to some extent. More flexible countries are the United Kingdom and Ireland with most of the variables consistently pointing to more flexibility than the average. The contribution from different measure of institutions is less uniform in most of the countries close to average, with some factors offsetting others. For example, in Denmark highly generous unemployment benefits increase the indicator but this is offset by higher spending on ALMPs which allow the unemployed to be more effectively and smoothly matched to job vacancies.



11. **The results seem to be consistent with other indicators that point to higher rigidity in Portugal's labor market institutions and regulations.** The OECD ranks Portugal's labor market as more rigid than other euro area countries, particularly reflecting stricter employment protection and difficulty in getting back to work. Similarly, the rigidity

<sup>32</sup> The latest available data from OECD and EIRO were used. Measures of ALMPs and union coordination are multiplied by 1 so that the increase leads to less flexibility.

of employment index constructed by the World Bank following the methodology by Botero et al. (2004)<sup>33</sup> ranks Portugal 51<sup>st</sup>, compared to the euro area average of 41<sup>st</sup>. While the specific ranking of countries differs depending on the indicators, on balance, they all suggest there is a significant scope for increasing labor market flexibility in Portugal.

#### **D. Quantifying the Benefits of Labor Market Reform**

12. **The potential benefits of labor market reform can be illustrated using the IMF's Global Economic Model (GEM).**<sup>34</sup> The model incorporates monopolistic competition in labor and goods markets, which means wages can contain a markup over the marginal rate of substitution between consumption and leisure, and prices can contain a markup over the marginal cost of production.<sup>35</sup> By varying the markups in labor and product markets, the model can illustrate the macroeconomic implications of structural reform aimed at promoting competition. The paper uses a four-country version of GEM, calibrated to represent Portugal, the euro area excluding Portugal, the new EU member states (NMS), and the rest of the world (RoW).<sup>36</sup>

13. **The model simulations show that large gains in terms of GDP, employment, and consumption can result from reforming Portugal's labor market** (Figure 2 and 3). Reforms are introduced by reducing markups gradually to their level in the RoW block (U.S. and U.K. equivalent level) and their impact is assessed relative to a baseline without reform. In the long-run, output would be about 7 percent higher than the baseline owing to higher employment (hours worked) and a larger capital stock. However, labor market reforms on their own result in a fall in real wages because prices do not decline in proportion with wages, as monopolistic firms extract higher rents and limit the expansion of output. This suggests that product market reforms (goods and services) are also important.

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<sup>33</sup> Data and description are available online at <http://www.doingbusiness.org/ExploreTopics/EmployingWorkers/>

<sup>34</sup> For detailed description and calibration of the GEM, see Bayoumi (2004) and Laxton and Pesenti (2003).

<sup>35</sup> Labor market markup is defined by real wage = (labor market markup) \* (the marginal rate of substitution).

<sup>36</sup> Rest of the World is composed of U.S., U.K., Angola, Brazil, Singapore, Denmark, and Sweden, the main extra-EU trading partners for Portugal. Trade shares within the four blocks are based on the 2005 trade flows from the UN COMTRADE statistics.









