# 5 The economy

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## 5.1 Portugal, a small open economy by the sea

With its surface of 92,226 square metres and its population of around 10 million people, Portugal accounts for little over 2% of the European Union's total surface and population. The EU is a club of a few very big countries and several quite small ones. Portugal, despite its small weight, both surface and population-wise, stands at the middle of the rank of the club in both size indicators. What about the Portuguese economy? The following plot shows the recent evolution of the Portuguese GDP. The choice of the initial year (1981) is rather arbitrary – it has the advantage of putting the turn of the millennium approximately in the middle of the period. It is also five years before Portugal joined the European Union (actually, European Community at the time), which sets the stage for the record that was to come (Figure 5.1).

The Portuguese GDP accounted for 1.4% of the EU-27 GDP in 1995; it reached a maximum of 1.67% in the beginning of the century (2002 and 2003); in 2022, it was 1.52%. The total EU GDP considered here takes into account all the EU-27 countries, some of which were not part of the Union in 1995, and excludes the one which was part of the Union and is no longer (the United Kingdom). Therefore, Portugal represents an even smaller share of the EU economy than of its surface or total population. It is, by all accounts, a small country.

As a small open economy, Portugal trades a lot with the rest of the world, in particular with its EU partners. The combined weight of imports and exports on GDP amounted to 53% in 2005 and reached 65% in 2019. It decreased in 2020 to 61%, a natural consequence of the pandemic that collapsed the main exporting industry of the country – tourism. In 2022, it reached a peak of 78%.

What about trade deficits? Between 2012 and 2019, the value of exports was just slightly above that of imports, with a maximum foreign trade coverage ratio of 104.4% in 2016. Other than that, Portugal has consistently imported more than it exports. There is, however, a stark contrast between goods and services. The value of Portuguese goods imports has always been higher than that of its exports. By contrast, service exports are much more valuable than imports; in fact, just before the strong pandemic shock on the tourism sector, the coverage ratio of service imports had reached more than 200%.

Due to its reliance on the rest of the world, the Portuguese economy accumulated external deficits throughout the decades. This is reflected in the high level of external indebtedness of the country, which led to a demanding conditional bailout by the IMF,

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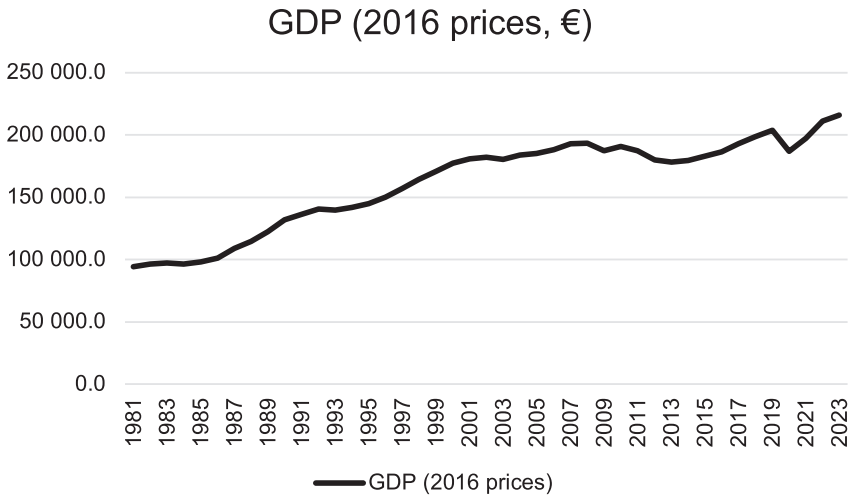


*Figure 5.1* The Portuguese GDP

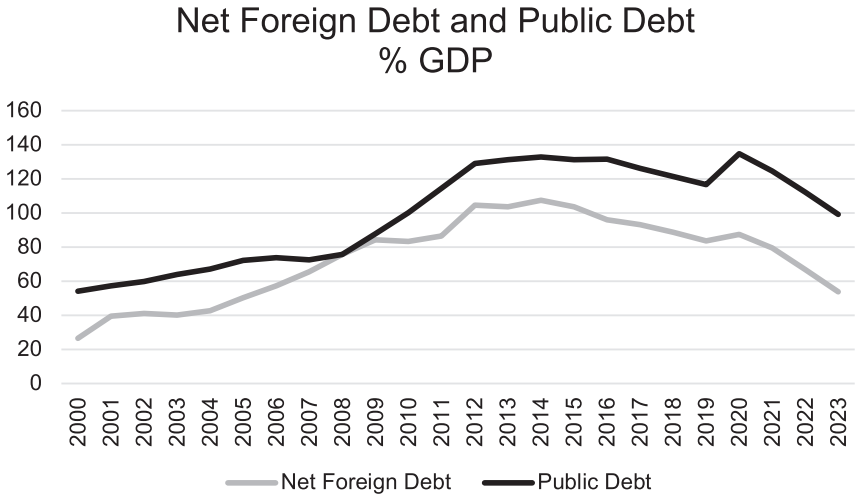


*Figure 5.2* An indebted country.

the European Commission, and the European Central Bank in 2011. Portugal officially graduated from the programme in 2014, after three years of a deep social and economic crisis, that saw unemployment reach 17.1% in 2013, after a spectacular and rapid increase from 10.8% in 2010.

Public debt, shown in Figure 5.2, stood at 54% of the GDP at the turn of the century, first surpassed the 100% threshold in 2010, and grew to reach a peak of 133% of the

GDP in 2014. In 2019, just before the pandemic hit, Portugal had a public debt of 117%. In 2023, the public debt reached 99,1% of GDP, an important milestone after 13 years in which it remained above the 100% threshold.

Portugal has started to overcome the chronic dependence on the rest of the world following the great recession of 2008–2011, through a boom on the export of tourism services. In the graph above, this corresponds to a period in which external indebtedness and public debt remain fairly constant as a share of GDP, and start to decrease steadily as of 2014–15. The net foreign debt stands at 54% of GDP in 2023. Indeed, the pre-pandemic period coincided with a very sizeable peak in the export of tourism services. The weight of tourism on GDP increased from around 4% in the beginning of the century to 8.5% in 2019. While the tourism export growth has contributed to attenuate the external deficit of the country, it left the economy in a vulnerable situation during the pandemic years. The Portuguese economy was among the four hardest hit ones (together with Spain, Italy, and Greece), and saw its GDP shrink by 8.4%.

It is not a coincidence that these four economies share a geography which is prone to the export of tourism services. A simple and telling way to illustrate how the reliance on tourism explains part of the pandemic crisis is to zoom into Portuguese regions. In 2019, more than one-third of the overnight stays in hotels and similar establishments by non-residents were concentrated in the southern region of Algarve. The analysis of electronic transactions shows that Algarve (together with the archipelago of Madeira) saw the largest contraction in the Spring of 2020. In addition, in August 2020, these were the only regions whose volume of electronic transactions was significantly lower than the average of the previous years. All remaining regions were back on track, and Lisbon was just slightly below (Carvalho et al. 2022).

Unemployment records (more precisely, the number of individuals registered in local employment offices, a necessary condition to be eligible for the benefits) paint the same picture. Due to data unavailability, we cannot include the archipelagos of Madeira and Azores in this comparison. Still, there were only two regions in mainland Portugal with a consistently higher number of registered individuals throughout the pandemic crisis than in the same month of 2019. These two regions are Lisbon and the Algarve. However, while the number of unemployed in Lisbon is just between 10 and 15% above the 2019 figures, the one in Algarve reaches a height of more than twice as many unemployed in the summer months of 2020 and 2021 than in the equivalent months of 2019 (Peralta et al. 2022).

This raises the question of whether Portugal bears too high a risk due to its reliance on the tourism sector. While a thorough discussion of this concern is out of the scope of this chapter, I would highlight that, on the one hand, a more diversified economy is always better insulated against shocks. On the other hand, it is possible that tourism export is particularly vulnerable to large shocks, given that it entails cross-border movement of people, likely to come to a halt in the face of disruptive events such as a disease outbreak, natural disasters due to extreme climate phenomena, or political risks (e.g., terrorism). Therefore, it is conceivable that a small open economy that relies disproportionately on tourism services for its exports is exposed to higher risks than another with a similar concentration on another sector.

## 5.2 The 21st century: a mixed record

In 2000, the Portuguese GDP per capita was just below 12,500 euros. In 2019, it amounted to a little less than 21,000 euros (at 2016 constant prices); by 2023, it had fully recovered

from the pandemic shock, at constant prices. The 21st century was, therefore, a period of economic growth. However, compared to the last 20 years of the 20th century, growth failed to deliver a similar convergence with the European Union living standards.

Indeed, in 1981 the GDP per capita was just above 1,000 euros, also at 2016 constant prices. The conclusion is obvious: the Portuguese standard of living, as measured by the GDP per capita, increased (roughly) 12-fold in the last 20 years of the 20th century, and did not even double in the first 20 years of the 21st century. Lower growth rates are a natural consequence of the higher level of economic development. Nevertheless, convergence with the European Union slowed down, implying that other countries with similar levels of development converged more rapidly. In 2000, the Portuguese GDP per capita was 85% of the European Union (EU-27) average. As of 2022, it amounts to 79%. The lower growth rates of the 21st century put Portugal on a diverging path with its EU counterparts.

The pandemic was the second crisis that hit the Portuguese economy in the century. The GDP per capita grew every year since 1960, except in 2003, in 2009, between 2011 and 2013, and then in 2020. The GDP contraction triggered by the global financial crisis, followed by the sovereign debt crisis in the Eurozone countries, was a fierce one: it was only in 2015 that the GDP per capita recovered its pre-crisis level. Unemployment, in turn, increased from 5% in 2002 to 17.1% in 2013. For this reason, the period roughly coinciding with 2003–2013 is sometimes named "the lost decade" of the Portuguese economy. It ended with the official date of termination of the financial and economic assistance programme of 2011–2014, during which Portugal was bailed out by the European Commission, the IMF, and the European Central Bank. About five years later, the pandemic caused the greatest shock in several decades. Public debt, which amounted to 117% of the GDP just before the pandemic, hampered the country's ability to accommodate the shock. Still, given the massive amount of public spending implemented to face the crisis and the GDP contraction, public debt jumped to more than 135% of the GDP level in 2020.

GDP per capita tells us a lot about the average economic situation of the people that live in the small open economy by the sea, but it hides considerable heterogeneity among individuals. When these asymmetries are considered, the picture that emerges is somewhat different: the Portuguese economy has been making modest progress both in absolute and relative terms.

Since 2004 we have a representative survey that allows for EU-wide comparability of income poverty, material deprivation, and inequality: the Survey on Income and Living Conditions (EU-SILC). It is a standardized representative survey collected by all the EU countries (and some other European countries, on a voluntary basis), and it was created with the purpose of being used as a tool of social monitoring in the EU. The poverty rate, that is, the share of individuals who live in households with equivalized disposable income (including social transfers) below the poverty line, decreased just slightly, from 20.4% to 18.4%, between 2004 and 2021. It had, however, reached an all-time low of 16.2% just before the pandemic. When compared to the remaining EU countries, Portugal is faring better in recent years than it was at the beginning of the century. In 2004, only Ireland had a higher poverty rate than Portugal. In 2022 the poverty rate in Portugal is slightly below the the EU-27 average, and there are 11 countries with higher rates. While there is still a lot of progress to be made, poverty decreased, in absolute terms, and the country also improved its relative position with regard to the EU average.

However, the drawback of measuring economic fragility through the poverty rate is that the poverty thresholds depend on the median income of each country. A person is poor in the European Union if she lives with less than 60% of the median equivalized disposable income of her country of residence. Therefore, even discounting purchasing power differences, it is conceivable that a poor person in a richer country would be among the relatively well-off in a poorer one. For instance, the poverty threshold in Austria in 2019 was 15,437 euros, while in Portugal it was 6,014 per year. A more direct comparison of living conditions can be achieved by analysing deprivation indicators. According to Eurostat, a person lives with severe material deprivation if her household cannot afford four or more items among a list of nine that are considered desirable or necessary to experience an adequate standard of living. These include (absence of) arrears on utility or mortgage, ownership of durable goods such as a car or washing machine, affording a week-long holiday away from home, or eating proteins every second day. The share of severely material deprived households in Portugal more than halved since 2004, from 9.9% to 4.6% in 2020. As of 2004, only Greece had a higher share of severe material deprivation; in 2020, there are 14 countries with more deprivation. Not surprisingly, Portugal is now below the EU average.

Income inequality, as measured by the Gini index of the equivalized disposable income, also decreased, from 37.8% to 33%. In 2004, Portugal was the most unequal country of the EU-15 countries; it kept this position in 2005, with the ten enlargement countries already included in the data. In 2019, with a Gini of 31.2%, Portugal ranked eighth in the EU-27 and moved to fifth in 2021 due to the pandemic shock.

To conclude, what to say of the 21st century's record? On the one hand, the Portuguese economy made progress, both in absolute and in relative terms, in terms of poverty, deprivation, and inequality. Therefore, welfare transfers have improved as means to smooth out the differences across people in the economy. On the other hand, it was disappointing, in that Portugal fell behind the convergence path with the EU average that it had started when joining the then European Community.

There were two major crises, but these hit the other European (and world) economies as well. Therefore, the crises per se cannot explain the path of divergence. There must be idiosyncratic reasons behind the Portuguese lag. Any list of reasons for this divergence is subjective and the one presented here is no exception to this rule. As a microeconomist, I will focus on bottlenecks faced by economic agents: households and firms. A macroeconomist would likely point out macroeconomic imbalances, such as the level of public debt and overseas trade, and the impact of the common currency, which certainly play an important role. One may argue that the bottlenecks that I am about to discuss were stronger in the last two decades of the 20th century, in which Portugal was catching up more rapidly with the EU average. I take this criticism on board. Let me note, however, that convergence is a non-linear process, and that the challenges of the knowledge-based and digitalized economy of the 21st century may be more demanding. Moreover, I am not implying causality between the bottlenecks, and even less assigning any magnitude to the importance of each in the relative slowing down of the Portuguese economy. More modestly, I will just document the bottlenecks and hopefully convince my readers that they do play a role. To the extent possible, in the figures given below, I plan to provide an account of the structural characteristics of the economy. I will therefore refrain from underlining the pandemic years, due to their many specificities, and the high degree of uncertainty revolving around the day after.

## 5.3 A (subjective) list of bottlenecks

### *5.3.1 (Child) Poverty*

One of the achievements of the 21st century is the poverty decline. However, the poverty rate in Portugal is still higher than the EU average and so is the Gini index of income inequality. Moreover, the poverty rate before social transfers and pensions remained fairly stable throughout the century and, if anything, it even increased, from 40.8% in 2004 to 42.4% in 2020. These two figures suggest that income transfers became more effective at alleviating poverty. However, they also make clear that neither the system of income transfers nor the broader social state has eliminated the pervasive poverty traps of the Portuguese economy. These poverty traps get the poor people stuck in bad economic outcomes – this lost talent is a lost growth potential for the Portuguese economy.

Poverty is also a consequence of the disappointing record of Portuguese growth. While growth does not always bring about a reduction of poverty (let alone inequality), it is certainly easier to design good anti-poverty policies in a more resourceful economy. The extent to which it arises depends on good institutions, able to deliver sound, evidence-based policies. While this is a valid viewpoint, I will instead discuss why excessive poverty hampers growth, because it generates poverty traps.

Since discussing them all is outside the scope of this essay, I will highlight a particularly costly one: growing up in poverty. There is by now an extended body of research establishing causal links between growing up in poverty and children's educational and health outcomes, but also lasting impacts through adulthood in income levels and risky behaviours (National Academy of Sciences, Engineering, and Medicine, 2019). The fact that child poverty has medium to long-run consequences implies that, by and large, the Portuguese economy is now suffering the consequences of the pervasive child poverty of the last century. However, the 21st century will fail to deliver unless the current levels of child poverty are tackled.

More than 19% of the Portuguese children was poor in 2019. When it comes to material deprivation, 26% lived in dwellings with humidity problems, 13% in households who cannot afford to keep the house adequately warm, and 16% in overcrowded houses. A special module on food security from the 2018 wave of the Survey on Income and Living Conditions concluded that 9% live in households that cannot afford to buy nutritious and healthy food and that 3% felt hungry, but could not eat for lack of financial resources of the household (Esteves et al. 2021). In 2022, 6% of the children lived in households who could not afford an healthy diet, and 2% felt hungry and could not be fed due to financial constraints.

These children lag behind their peers in learning outcomes. Using results of standardized national tests between 2007 and 2018, for the fourth, sixth, and ninth grades, we found that children from households who qualify for means-tested transfers and free or subsidized school meals are 15 to 20 percentage points more likely to obtain a negative grade. Results from the OECD PISA tests show that 15-year-olds from the bottom income quartile obtain, on average, 80% of the grade of those in the top quartile (Esteves et al. 2021).

Poverty and lack of opportunity are more pervasive in some groups of the population. While it is illegal in Portugal to collect ethnicity data, the fact that non-EU immigrants face a poverty rate of 25%, compared with 10% for EU origin ones, and 17% for nationals, signals the difficulties faced by these minorities in the labour market. Immigrant students obtain lower grades in standardized 9th grade national exams, particularly in

mathematics. African-born students face the highest achievement gap. The achievement gap is lower for second-generation immigrants, i.e., students born in Portugal to two immigrant parents. Moreover, students of foreign origin are more likely to repeat grades, again with a particularly striking difference for those of African origin. These identity-based gaps are bound to create aspiration failures for the individuals, who have less incentive to invest in the future (Almeida and Nunes 2021).

The achievement gaps in the education system stemming from socio-economic class and immigrant origin are more worrisome given the need for Portugal to catch up with its EU peers in the skills of the population, an issue I discuss below.

### *5.3.2 Human capital*

Portugal lacks human capital. A striking figure shows how badly Portugal was at the turn of the century: in 2000, the Portuguese population had less than eight years of formal education, on average. This is equivalent to Germany in 1930 (Figueiredo et al. 2017). Only 11% of the population older than 15 had graduated from secondary education, and 7% had a higher education degree. In 2020, those figures attained 24% and 21%. Therefore, nowadays, almost half of the population has completed at least secondary education.

The generation gap is considerable: younger generations are more educated, hence time runs in Portugal's favour. As of 2020, only 6% of the residents older than 65 had finished secondary education, which compares to 30% of the ones in the 15 to 64 age interval. When it comes to higher education, the shares are, respectively, 9%, and more than one-fourth. This stems from a monumental effort of investment into higher education: in the last decade of the 20th century, the number of higher education students in Portugal increased from around 150,000 to almost 400,000 (Figueiredo et al. 2017).

However, the convergence pace has been too slow, and Portugal has not yet caught up with its EU peers. Only 55% of those older than 25 years have graduated from either secondary or higher education in Portugal, compared to 79% in the EU. This lack of human capital is particularly damaging at a time when the EU economy wants to embrace the digital transition. Not surprisingly, with a population which is less educated, on average, Portugal also lacks digital skills. According to Eurostat, only half of the Portuguese population had at least basic digital skills in 2019. This figure is slightly below the EU average of 56%, but far from the most skilled countries, such as the Netherlands or Sweden. In any case, this indicator measures basic skills such as copying files, sending emails, installing applications, making online purchases, or producing documents.

One can also look at measures of higher-level digital skills compiled by the European Commission for the Digital Economy and Society Index.[1] The share of Information and Communication Technologies (ICT) specialists in employment, as a share of the population aged 15–74, was 3.6% in 2019, while the share of ICT graduates was 2.2% in 2018. These compare with EU averages of 4.3% and 3.9%, respectively. Gender imbalances in ICT skills remain pervasive: women represent 18% of the ICT specialists' employment.

One of the consequences of the comparatively low level of education of the Portuguese workforce is that wages are low. Sluggish productivity growth of firms also explains the low wage problem. A thorough analysis of the productivity challenge of Portuguese firms is out of the scope of this chapter, but some clues are given below. For now, let me point out that low wages turn into high levels of in-work poverty. As of 2019, even before the effect of the pandemic, almost one in every 10 workers lived below the poverty line.

These 10% of workers are poor even after receiving income transfers such as, e.g., family allowances (which are means tested in Portugal).

Despite being more educated, young generations lack access to the more protected segment of the labour market with long-term contracts, higher salaries, and also the highest level of employment protection of the OECD. Portugal ranks third in the share of temporary contracts across OECD countries, with 22% of the total, twice the OECD average (Nunes et al. 2023). For workers aged less than 25 years old, the share of temporary contracts in 2019 was almost 60%, four times as much as the share for workers who are older than 35. For those in the 25–34 years bracket, temporary contracts are almost one-third of the total. Irrespective of our views on the desirability of the large protection given to long-term contracts in Portugal, it is hard to come up with a good justification for the more qualified generation to fail to qualify for the more formal and protected segment of the market.

One cannot discuss the scarcity of human capital in the Portuguese economy without acknowledging that emigration may contribute to that scarcity. This concern is often referred to in the public debate. The yearly flow of emigrants increased from 2010 until 2014, and it started to decrease thereafter. Still, according to the United Nations estimates, there were 2.6 million Portuguese citizens residing abroad in 2019, which ranks Portugal in 26th place of the total number of emigrants and eighth in terms of the migration rate (i.e., as a percentage of the population). Little is known about the skill or age composition of these emigrants. However, an analysis of census data done by the OECD (therefore limited to emigrants residing in OECD countries) suggests that they may be getting more educated. In the first census of this century (2000/2001), the share of emigrants in OECD countries with higher education was 6%, and it increased to 11% in the second census (2010/11); this is still a fairly small share of total migration, but more recent data is needed to understand if the increasing trend has continued. Note, however, that little is known about the impacts of (recent) emigration on the Portuguese economy, and that the literature points to several positive impacts of out-migration for origin countries. Therefore, while migration may be a driving part of the skill scarcity, I refrain from making claims about the magnitude or nature of its more general impact on the Portuguese economy.

As it turns out, the scarcity of skills and the generational gap in attaining well-rewarded positions in the labour market is reflected in the management of firms. This is just one of the bottlenecks faced by Portuguese firms, to which I now turn.

### *5.3.3 Financial and managerial capital*

The combined effect of the lack of human capital and the generational gap has an unexpected negative consequence for firm management. The average years of education of firm managers have increased less rapidly than that of the remaining population of workers. They are, nevertheless, more educated than workers, on average. As of 2016, almost one-half of CEOs had at most a secondary school diploma. The share with higher education was just above one-fourth (Sazedj 2019). There is a lot of heterogeneity depending on the size of the firm: in medium and large firms, more than half of the CEOs have a higher education degree. However, these represent less than 1% of the total. The lack of human capital in top positions of Portuguese firms limits their performance, and one estimate suggests that if the distribution of manager education in Portugal was similar to the US, aggregate productivity would rise by 20% (Queiró 2022).

Portuguese firms are very small, compared to their European Union counterparts. Micro firms, that is, those with less than 10 employees and less than 2 million euros of annual turnover, represent 96% of the total. Another 3.3% are small firms, that is, with 10 to 49 employees and 2 to 10 million euros of annual turnover. If one includes medium firms as well, one gets to 99.9% of the total. Micro, small, and medium enterprises absorb 77% of the workforce. The share of micro, small, and medium firms is just slightly above that of the European Union (98%), but the share of employment that they represent is substantially higher than the EU average of two-thirds. For that reason, the average firm in Portugal has a little more than three employees, while the Spanish ones have four, and the German ones have 11.

The size of Portuguese firms is a challenge for the Portuguese economy. There is a large body of research showing that micro, small, and medium firms are more likely to face credit constraints and are more exposed to fluctuations. Indeed, they were particularly hit during the sovereign debt crisis. Estimates suggest that 15% of the Portuguese micro, small, and medium firms faced funding restrictions between 2010 and 2012, with consequences for their investment levels (Félix 2018). This creates barriers to firm growth. Moreover, these firms are less productive than their large counterparts, and the difference is greater in the Portuguese economy (Bank of Portugal 2019). Portugal has the second lowest labour productivity of micro and small firms in the European Union, after Greece.

Due to the crisis and financial frictions, Portuguese firms lack financial resources. At the peak of the financial and sovereign debt crisis in 2012, 42% of the firms were making losses. The figure went down to 37% in 2019, which is still more than one third. As a consequence, the ratio of debt over assets of Portuguese firms is sizeable: from 68% at the peak of the crisis in 2012, it went down to 61% in 2019. Moreover, Portuguese firms rely a lot on the banking sector for funding. Following the financial crisis, the banking sector went through a transition aiming at improving the balance sheets, resulting in a deleveraging process that increased the funding barriers of the firms.

This is not necessarily bad. The combined effect of these changes in the banking sector, the reform of the bankruptcy laws, and possibly some cleansing effect of the recession, led to a decrease in the prevalence of zombie firms in the economy, from a maximum of 12% in 2009 to around 2% more recently. There are several definitions of zombie firms; the one used for these figures includes firms older than 10 years old that for at least three consecutive years cannot cover total interest payments with operating income. The death of zombie firms liberates productive factors (capital and labour) which were previously sunk in these inefficient and unproductive firms. As such, it has the potential to foster growth (Gouveia and Osterhold, 2018). On a cautionary note, it is important that the phasing out of public support given to firms during the pandemic crisis avoids the inversion of this tendency.

#### *5.3.4 Institutional capital*

The term institutional capital is somewhat vague and is meant to encompass several drawbacks of the legal, judicial, and cultural set-up of the Portuguese economy, which one could also label as context costs.

International comparisons of perception-based indices of corruption systematically put Portugal on the most corrupt half of its European Union counterparts. In the Corruption Perception Index compiled by Transparency International, Portugal obtains a score of 61, below the Western Europe average of 66, and very far from the top scorers of 88

for Denmark or 85 for Finland (higher values, less corruption). It is also worrisome that 63% of the people consider that the government is controlled by private interests, 10 percentage points above the EU average. Actually, Portugal ranks 8th in the EU regarding this negative record. A red flag involves the public procurement reforms related to the pandemic, as 41% of the respondents consider that corruption increased in the previous year, according to the 2021 edition of the index.

A study by the European Parliament estimates the costs of corruption by using a battery of indicators from the Quality of Government dataset of the University of Gothenburg, for 28 EU countries in the period 1995 to 2014. It relies on regression analysis to estimate the impact of the level of corruption, controlling for important variables such as the level of human capital of the countries. The study has technical limitations, despite its use of instrumental variables to mitigate the endogeneity of the corruption indices. Technical limitations notwithstanding, the study estimates that if the Portuguese level of corruption were to match the least corrupt countries in the European Union, its GDP could witness a one-off increase of between 6 and 10% (Hafner et al. 2016).

While one may question the extent to which perception indices reflect actual institutional shortcomings, these are confirmed by the concerns raised by international institutions such as the Group of States Against Corruption, an initiative of the Council of Europe that has been benchmarking and advising countries on anti-corruption policies since 1999. The 2020 edition of the GRECO highlights the fact that Portugal had failed to implement 40% of the reforms recommended in the 2014 round of the assessment.

I now turn to the regulatory framework of business activity. In 2014 and 2017, Statistics Portugal conducted a survey to infer the costs of context faced by Portuguese firms and their impacts. It covered a wide range of costs, from licencing processes to access to funding, several instances of red tape, and the judicial system. The most important barriers to their activity pinpointed by the firms are the judicial system and licencing processes (Amador et al. 2019).

The Small and Medium Enterprises Performance Review by the European Commission compiles several indicators about the institutional set-up in which these firms operate.[2] Portugal scores below the EU average in several indicators that corroborate the findings of the costs of context surveys. For instance, the time to resolve insolvency is almost one year above the EU average. The burden of government regulations is also higher (although less than one standard deviation).

The set of indicators where Portugal scores the worst with regards to its European counterparts is in state aid and public procurement, more precisely in the percentages of businesses participating in public tenders, small and medium enterprises in the total value of public contracts awarded, and bids and contracts awarded to these firms. While the low competitiveness of public procurement may result from thin markets, it is also suggestive of a lack of openness of the tenders. The average delay in payment from public authorities is 24 months in Portugal and 16 in the EU, i.e., one-third lower. There are also dimensions in which Portugal fares better than the average EU country, including the time and cost to start a business, and the strength of the insolvency framework index, reflecting the improvement in the aftermath of the crisis, as discussed above.

The negative consequences of corruption and the regulatory environment in which the firms operate could in principle be mitigated by an efficient judicial system. However, that system in Portugal is known precisely for its inefficiency, long delays, and incapacity to recover assets. The judicial process involving the bankruptcy of *Banco Espírito Santo*, which revolves around major accusations of money laundering and fraudulent

funding of the real estate company of the same group, had seized, as of 2020, only 120 million euros out of the estimated 12 billion that were diverted. Seizing assets is the first step in the process of recovering them. This process started in 2014 and is yet to be fully resolved. Actually, the number of days to resolve litigious civil and commercial cases in Portugal (in first instance courts) was slightly below 300 days in 2020; the most efficient judicial systems in the EU resolve cases in just above 100 days. While speed may hide bad decision making, it is fair to assume that these discrepancies in the average length imply that enforcement of private contracts in Portugal is a costly process, which puts a strain on economic activity.

Another institutional bottleneck is the country's public policy design and implementation, which has several problems related to the utilization of sound evidence and the availability of information for policy evaluation and scrutiny. The budgetary process is at the core of the design and implementation of public policies, and it is a telling illustration of these problems. In the aftermath of the sovereign debt crisis, faced with the need to implement a budgetary framework that would allow for sound public finances and effective public policies, the parliament voted a new budgetary law in 2015 that was to be progressively implemented until 2018. The law introduced reforms aligned with best practices, such as programme-based budgeting and the adoption of international accounting standards to improve the quality of the information provided by the public sector. However, as of 2022, the law had not yet been thoroughly implemented.

Programme-based budgeting requires, in short, that the budgetary process be split into programmes, broadly corresponding to categories of public policies, accompanied by sufficient financial information about spending, on the one hand, and the outputs and outcomes related to that policy, on the other hand. Moreover, public institutions in charge of specific parts of a budgetary programme should have autonomy to implement it and be accountable in the delivery of the programme objectives. Such an arrangement requires a vast amount of credible information, but it improves both the capacity of the governmental unit in charge of the programme to monitor its implementation and that of the public and budgetary watchdogs to scrutinize the spending and the results it produces.

The limitations of the Portuguese budgetary process are best illustrated through an example. In November 2022, the Court of Accounts published a report about the implementation of the policies aimed at assisting distressed firms due to the pandemic crisis. According to the Court, the government announced 24 such measures, including credit lines and guarantees. There are five government agencies in charge of 22 of these measures, with different overlaps. In addition, two policies had no agency in charge. More worrisome is the fact that the Court reports that 15 out of the 24 policies reported no spending as of the end of 2020. Therefore, only nine policies existed *de facto*.

For this type of policy, important outputs to consider would be the number of distressed firms, or their importance in the universe of distressed firms, for instance, in terms of employment or turnover. The outcomes, in turn, would be the number of firms (or jobs) that were saved due to the policies. These pieces of information, together with the spending involved, would be an important tool for the agencies in charge of implementation to evaluate the effectiveness of the policies, which could then be abandoned, or fine-tuned, to improve delivery. Nevertheless, the Court of Accounts signals that the initial situation of the economy that each of the 22 measures wanted to address is not reported systematically, nor are there output and outcome indicators to assess their efficacy. The Court rightly points out the inability to assess the impact of these policies, some for lack of financial execution, others for lack of indicators related to their objectives, and yet

others for lack of information about the initial situation. This is just an example of the problems that are repeatedly underlined by the Court of Accounts, the Council of Public Finances, and the Parliament unit that is responsible for the analysis of budgetary information. This lack of transparency (which is just a reflection of the lack of relevant and timely information) impedes both the effective implementation and the accountability of the system.

Budget transparency is not necessarily related to corruption, but it does give an account of the possibility of the citizens to scrutinize the application of public funds. As such, it is, at the very least, an important measure of institutional quality. The Open Budget Index is compiled every year by the International Budget Partnership in several countries, taking into account the quality of the information underlying the budgetary process of the countries and the possibilities for the citizens to participate in its various stages. In 2019, Portugal ranked 23rd in the OECD, with a score of 66, implying that it provides "substantial" information. On a positive note, transparency has been increasing steadily since the index was first compiled for Portugal in 2010.

The lack of transparency of the budgetary law is illustrative of a general incapacity or reluctance of the public authorities to curate and share data for the purpose of evaluating public policy with state-of-the-art statistical methodologies. For instance, in the Inequality Transparency Index computed by the World Inequality Database, Portugal scores low relative to other EU countries due to the unavailability of anonymized tax records to analyse taxable income and wealth. A recent effort by Statistics Portugal is moving in this direction, but Portugal is still lagging behind by more than one decade in the availability of administrative data for research (and policy evaluation) purposes. While the availability of high-quality administrative data on households is still a challenge, firm-level data (excluding tax related) is widely available for research purposes. This is important because it has the potential to create a virtuous circle between academia and evidence-based public policies.

### *5.3.5 Public capital*

The country's high level of public debt and the collective trauma of the international bailout of 2011 have tied the successive governments' hands when it comes to investing in infrastructures. Of course, this ultimately results from political choices – governments can increase tax revenue or opt for a different spending mix between current and capital expenditures. This discussion is out of the scope of this chapter. For our purposes, it suffices to acknowledge that the spending constraint imposed by external debt increases the marginal cost of public funds, which leads governments to spend less than they otherwise would.

In the last decade, public investment has absorbed the bulk of the adjustment of public spending. It is conceivable that part of this phenomenon results from insufficient institutional capacity to plan, budget, and implement investment plans, besides the budget constraint. The poor institutional capacity illustrated by the example of the financial aid to firms during the pandemic also obstructs other parts of the budget implementation. Indeed, between 2015 and 2020, public investment amounted to 85% of the value forecasted in the respective State Budgets. As a share of GDP, public investment has been steadily decreasing from around 5% in the beginning of the century, with the exception of the 2008–10 period. Public investment reached a low of 1% of GDP in 2016, and never reached 2% after that.

Estimates by the Portuguese economist Miguel Faria e Castro (2021) show that the stock of public capital, as a share of GDP, decreased between 2012 and 2019; actually, in 2019, it was back to its 2002 level of around 65% of GDP.[3] Therefore, when it comes to public capital, the Portuguese economy travelled in time back to the beginning of the 21st century. This lack of public capital is reflected in the several weaknesses of the transportation, health, and education infrastructures and technology. These limitations create context costs that make the life of citizens and firms more costly (time and money-wise) to run.

The aftermath of the pandemic created a unique opportunity to catch up, as Portugal will receive 16.6 billion euros from the EU Recovery and Resilience facility, adding to around 30 billion from the Multiannual Financial Framework for the period 2021–2027. For Portuguese standards, this is a substantial amount: it is higher than the total public investment undertaken in Portugal in the ten years between 2010 and 2019. The Recovery and Resilience funding alone is higher than the accumulated public investment between 2016 and 2019. But will it deliver?

Firstly, at this stage, we have planned spending and, as already discussed, there are challenges in implementation. Second, the European Commission puts forward several classifications of spending, which sometimes hampers the clarity of the comparisons. Third, and perhaps more importantly, how spending generates outputs and outcomes depends on the details of the policies and their implementation, which are thus far not known. Finally, at the time of this writing, there is no information regarding the additionality of the plan, that is, the extent to which it just crowds out spending that was otherwise planned.

The Recovery and Resilience Facility is structured around six pillars: (i) **the green transition**, (ii) **digital transformation**, (iii) **economic cohesion, productivity, and competitiveness**, (iv) **social and territorial cohesion**, (v) **health, economic, social, and institutional resilience**, and, finally, (vi) **policies for the next generation**. Since some projects span several pillars, I will rely on the pillar assignment made by the Brussels-based think tank Bruegel, which keeps up-to-date information on the Recovery and Resilience Plans submitted by member states to the European Commission.[4] The Portuguese plan allocates 22% of the fund to the green pillar, 16% to the digital one, 23% to the third one, 5% to the social and territorial cohesion, 24% to the resilience pillar, and finally, 9% to the last one.

On average, EU countries allocate almost half of the funding to the green transition (43%), often combined with other pillars, in particular economic cohesion. Portugal lags behind its European peers in the green pillar, for which it allocates almost 20 percentage points less, compared to the average. Another pillar in which Portugal plans to invest less is the digital transition pillar, which receives 24% of the funding in other EU countries, on average, with particular weight given to combinations with economic cohesion and social and territorial cohesion. By contrast, Portugal plans to spend relatively more under the fifth pillar, i.e., the resilience one. While the EU average stands at 14%, even after accounting for 5% spent in projects under the digital transformation pillar combined with the resilience one, Portugal will spend 24% of the total under this pillar.

Another interesting comparison relies on the so-called seven flagship areas for investment and reforms defined by the European Union, which are the following: (i) clean technology and renewables, (ii) energy efficiency of buildings, (iii) sustainable transport and charging stations, (iv) roll-out of rapid broadband services, (v) digitalization of public administration, (vi) data cloud capacities and sustainable processors, (vii)

education and training to support digital skills. This classification is more focused, and overlaps are rare. Unfortunately, some of the spending under the green and digital transition goals of the Recovery and Resilience Facility are not classified under the flagship classification.

The Portuguese plan is the one with the highest share of uncategorized spending (44%), which includes the categories of spending related, e.g., to resilience, that do not have an explicit digital or green component. This makes its assessment more difficult. Portugal allocates a total of 31% to the first three flagship areas, together with other green investments, related to the energetic transition. This compares with an EU-wide average of 46%. Education and training to support digital skills account for 11%, while other digital investments amount to 8% of the total. These figures are aligned with the EU averages. The digitalization of public administration receives 5% of the total, below the 9% average. Broadband connection absorbs only 1.7% of the total funds, in contrast with the 7% average.

One of the conclusions that stands out from both categorizations is that Portugal plans to spend less in the green transition than its EU counterparts. The sectoral level analysis is also conducive to this conclusion, for the "Transportation and Storage" sector has a planned spending amounting to 9% of the total, which is half the EU average. This very preliminary analysis suggests that Portugal is graduating into the adulthood of the 21st century lagging behind on infrastructure, again. In very much the same way as it missed the 20th-century wave of investments in railways, it may now be missing the opportunity to invest in the necessary public capital to ensure the climate transition.

Regarding the bottlenecks identified in this essay, spending on the upskilling of the labour force is aligned with the European average. However, given the relative scarcity of skills in the Portuguese population, this may not be sufficient. The higher reliance of the Portuguese plan on the resilience pillar suggests that poverty traps may have motivated some of the projected spending. This is further confirmed by the fact that, when comparing planned spending by sectors of activity, Portugal allocates 24% of the total to the "Human health and Social Work Activities" sector, which is double the EU average. Finally, the relatively low planned spending on the modernization of public administration may point to limitations regarding the necessary capacity building for the public sector to deliver more effective, transparent, and evidence-based policy.

## 5.4 Conclusion

Where is the 21st-century Portuguese economy leading? I conclude this chapter with a visualization of where it stands, compared to its EU partners. The two graphs below – Figures 5.3 and 5.4 – exclude Luxembourg (a clear outlier, in terms of GDP per capita), and they also exclude Bulgaria, Croatia, and Romania, due to data availability in 2005. I am using 2005 as the starting point because of the availability of the Survey on Income and Living Conditions. Note that the data from the 2020 wave pertains to the households' situation in 2019, that is, before the pandemic.

The graphs plot where the countries stand in terms of real GDP per capita (measured in 2010 euros), the shares of the population living in poverty (after social transfers and pensions) and severe material deprivation, and also the Gini index (of disposable income). The countries are ranked in the circle in terms of their GDP per capita in 2005. Therefore, non-monotonicities in the real GDP per capita line of 2020 indicate that the countries changed their position in this ranking. From the picture, it is clear that Slovakia, Estonia,

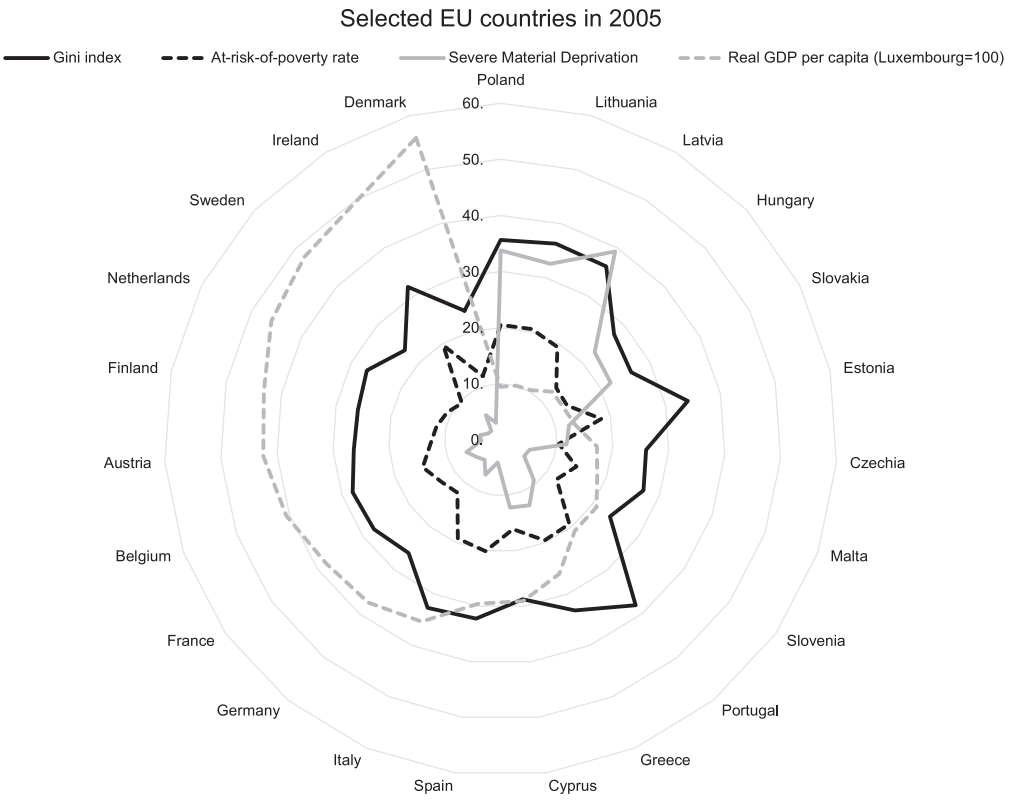


*Figure 5.3* Selected EU countries in 2005: inequality, poverty, deprivation, and GDP per capita

Czechia, and Slovenia, all of which had lower income levels than Portugal in 2005, have similar (or higher) levels in 2020.

The graphs show a spectacular decrease in material deprivation, which was pervasive in Eastern and Baltic countries in 2005. All the countries on the right-hand half of the radar (i.e., the poorest ones) improved a lot in this indicator, including Portugal. However, it had lower levels of this indicator to begin with.

The countries that had a Gini index close to 40% in 2005 were Poland, Lithuania, Latvia, and Portugal. Contrary to Poland and Portugal, the two Baltic countries did not change their level of inequality, as measured by the Gini index. It is also clear that there is a set of countries with poverty rates reaching 20% in 2005, which included Portugal. Of this, little noticeable progress was made in Poland, Lithuania, Latvia, and Estonia. As with the Gini, Portugal got to 2019 with a lower poverty rate.

Some countries, like Slovakia and Slovenia, managed to converge faster in terms of GDP per capita, while also improving the remaining indicators. Importantly, the initial conditions of these economies are very different from the Portuguese one, not the least in terms of human capital. Notwithstanding, the picture that emerges does not suggest that Portugal improved its social cohesion indicators at the expense of real GDP growth. They are more suggestive of a story of a country that managed to reach these improvements by

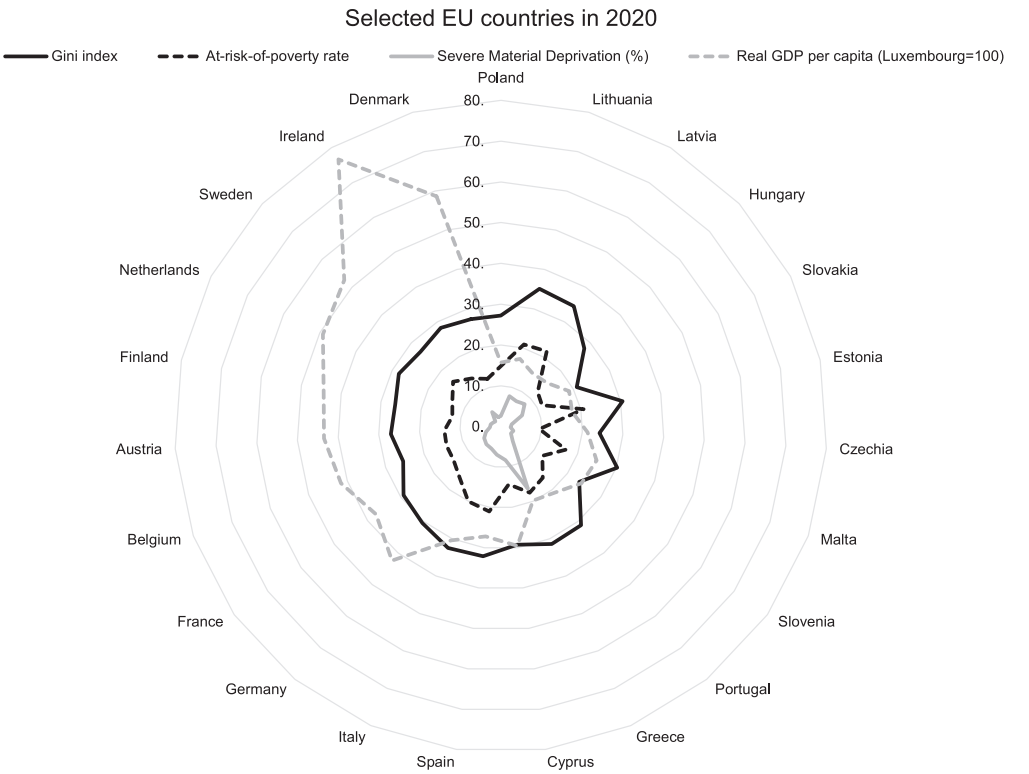


*Figure 5.4* Selected EU countries in 2020: inequality, poverty, deprivation, and GDP per capita

means of income transfers but has failed to resolve the bottlenecks that would deliver a more inclusive and thorough growth of its 21st-century economy.

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## Notes

1 https://digital-strategy.ec.europa.eu/en/policies/countries-digitisation-performance
2 The figures reported here are taken from the 2021 edition of the review and refer to the situation in 2019.
3 https://eco.sapo.pt/especiais/a-erosao-do-capital-publico-em-portugal/
4 https://www.bruegel.org/publications/datasets/european-union-countries-recovery-and-resilience-plans/

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