NEC
CONNECTING ECONOMICS

FRAMEWORK CONDITIONS

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Why is it important to evaluate the ease of doing business in a country?

Today’s world is a far more interconnected environment than it has ever been, hence facilitating the trade of goods and services across countries and continents on an unprecedented scale. As a result, the competition among firms of different countries has increased, and companies compete in a multitude of markets. Moreover, there seems to be a strong relationship between a country’s economic output and how easy it is for companies to operate their business activities. By facilitating the way firms conduct their day to day activities, countries help them become more competitive and efficient. So, if countries make improvements in this area, they will be fostering economic growth and, arguably, also increasing their potential GDP, given that the easier it is to do business, the more attractive it is to make investments, which can then lead to increases in capital and productivity. Moreover, by improving the ease of doing business, governments will make their state more sought after for foreign direct investment, which has become an indispensable factor to foster boosts in a country’s economy and wealth.

Objective

The aim of this report is to evaluate Portugal’s position in terms of ease of doing business, compared to the rest of the EU. As discussed earlier, the generation of output and wealth are intrinsically linked to a country’s ease of doing business, so by assessing the Portuguese performance and exposing any of its bad results and make recommendations in this regard we hope to lead reforms aimed at resolving set problems and therefore result in Portugal having a more competitive economy and being more attractive for foreign direct investment

We decided to compare Portugal with the EU average, following a recommendation from the GPEARI, given that we believe that on the one hand, our country mostly competes with fellow EU countries for foreign direct investment, and, on the other hand, the similarities among EU countries make them the most suitable for comparisons.

Main determinants of investment:

Some of the determinants that affect investment in a country, namely private investment, are:

Investment Determinants	How do they impact investment?
Taxes	The higher taxes are, and the more complicated a country’s tax system is, the harder it becomes for businesses to invest or to attract FDI. Lower taxes lead to higher corporate profits, which then theoretically can be used by companies to invest more, (this is not completely consensual among economists, though).
Institutional Quality	Countries with strong institutions and well-oiled public regulatory and business administrations are attractive for investors. When there is a lagging judicial system and very complex bureaucratic procedures, companies have to spend a lot of time trying to work those issues out, as well as to hire accounting and legal services for a longer period (hence increasing costs). Thus, firms are

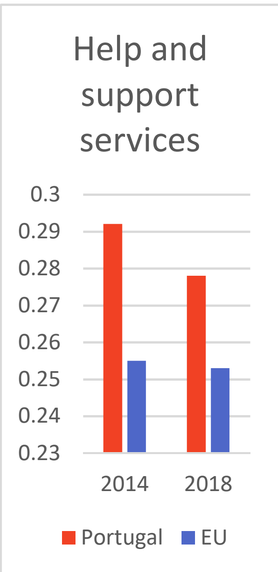
	overall less efficient and slower when conducting the necessary operations.
Interest rates	Low interest rates facilitate companies’ access to loans, as their opportunity cost is lower, meaning they will look for countries where this happens. Better access to financing, through lower interests on loans, facilitates private investment in projects.
Business Confidence	The more confident entrepreneurs and business leaders are about the overall economic output, the more likely they are to make an investment. If investors are pessimistic about the future of the economy, they will likely abandon projects or delay them, as these may not be profitable in a recession. Moreover, the firm might need those financial resources to endure a downturn.
The expected return on investment	Firms will likely invest in countries where, on average, other firms are making good profits. If a company’s objective is to maximize profit, they will most likely choose destinations where that profitability is more assured.

Having these determinants in mind, our work will look into how well Portugal and the EU as a whole perform in a few of them and assess how well-placed to attract investment Portugal is, based on how our ‘competitors’ are performing. Namely, we will assess the Taxes and Institutional quality variables by analysing the Services Trade Restrictiveness Index developed by the OECD, the Paying Taxes and the Resolving Insolvency indicators both worked by the World Bank. The reason for assessing these variables is the fact that determinants such as the interest rates, business confidence and expected return on investment are not directly affected by policy changes in the government. For instance, interest rates are set by the ECB, so there is not much the Portuguese government can implement to improve the investment through that mechanism. Besides this, we believe that business confidence and expected profits are subjective determinants that differ from company to company and depend on the state of the economy, which is not something the government can influence directly. The government’s role in the economy is to make sure all the necessary institutions and requirements are there to facilitate the business activity and intervene at times it feels the output is not at the desired level. So, given that the purpose of this report is to assess Portugal’s position in terms of framework conditions, which are seen as the rules, requirements and institutional characteristics that order business activity, we find focusing on the Taxes and Institutional Quality determinants to be the best option.

Services Trade Restrictiveness Index

The indicator

The services trade restrictiveness index, as the name suggests, is a measure of the openness of a country's economy to the trade of services provided by citizens/companies from other countries. More specifically, it measures the way regulation for each area affects services trade for the analysed area. It compares a country's openness in a given market relative to what a perfect market competition would look like in that market. The scores of the index range from 0 to 1, with zero being the optimal score, given to countries whose regulation is completely permissive in the analysed sector. The measures with which the index is calculated are mostly binary, as they tend to be answers to yes/no questions. When treating numerical values, thresholds are defined in order to enable the usage of the binary scale. The index has been computed since 2014 and for 22 different sectors, which we divided in 4 different groups (as done in a report from the Portuguese national productivity board), so as to make the analysis less burdensome. These groups were: distribution chains and transportation; help and support services; digital networks; and infrastructure services. Given the small time-frame of the data, we will only include the initial and final values for the 4 groups. We will analyse the data and address the standout points.



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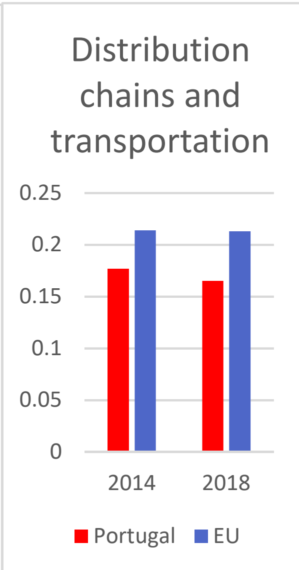

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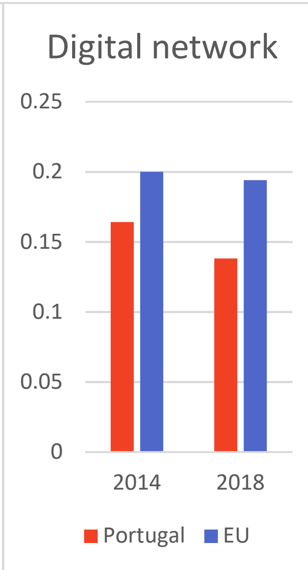

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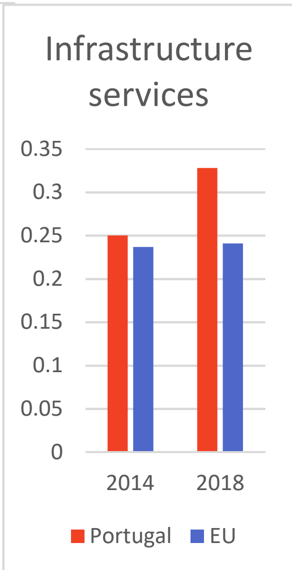

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1-In terms of help and support services (accounting, legal, commercial banking, and insurance), we can see that both Portugal and the EU changed positively, (more so in the first case). In spite of its stronger evolution, Portugal is still way behind the EU in this group. This can be explained by the relatively high values of index for the legal and accounting sectors. Accounting services also cover auditing, and both are regulated professions in Portugal. Regarding chartered accountants' firms, at least 51% of the equity shares must be held by licensed accountants, while statutory auditors must own at least 51% of the equity shares of an audit firm.

2-In distribution chains and transportation, both EU and Portugal had slight improvements, and Portugal beat the EU in both years, having had a larger improvement as well. Nevertheless, nothing stands out in this group of sectors. Some of the reasons for Portugal's good performance are the existence of good infrastructures (highways, ports...) and well-defined distribution channels, as well as the existence a variety of companies that operate in this type of market, combined with regulatory practices aimed at ensuring fair competition between Portuguese and foreign companies.

3-Regarding digital networks, we could see that in 2014 Portugal was already ahead of the EU average, and that became even more evident in 2018, as a relatively significant improvement in the Portuguese index was unmatched by an extremely slight one in the EU average. In spite of this difference, none of the sectors displayed a difference worth noting, and there were no significant reforms.

4-Finally, in infrastructure services (construction, architecture, and engineering), Portugal had an extremely significant worsening in its index, which went up by 0.078, the largest difference observed. While in 2014 Portugal was almost on par with the EU average, in in 2018 it was 0.087 higher. It is worth noting that the EU average also increased, but only marginally. The engineering sector was responsible for this increase in the index, having gone up from 0.192 to 0.391. This is due to the fact that since 2017, citizenship of an EEA country or a country that has signed a reciprocal agreement with Portugal is a prerequisite to practice in the area. In addition, commercial presence is a requirement in both engineering and architecture services. Counteracting these factors, the reciprocity requirement for admission to the Portuguese Order of Architects was repealed in 2015.

Final thoughts about the indicator

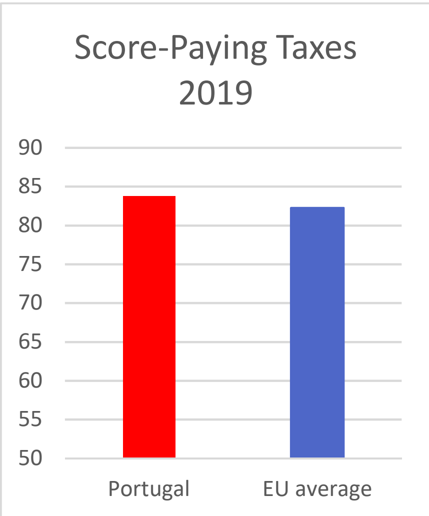
All across the board, we can see a common trend of increasingly open regulation, and Portugal is no exception to this trend. In fact, Portugal beats the average in most of the indicators, and it tends to have larger improvements as well. There are still some sectors in which Portugal lags behind other European Union countries and their average, though, and these are the legal, accounting, architecture and engineering ones. It stands out that all four sectors have Orders responsible for their regulation, in which one has to be registered in order to perform the job. Moreover, the processes for registration can be difficult for foreigners, especially when bilateral agreements between countries are required. It is worth noting, however, that the bureaucracy involved is also heavy for Portuguese workers, so the high values of the STRI can be explained partially by this factor, and not only by barriers exclusive to foreigners. Throughout this analysis, as it usually happens in reality, we treated increased openness as an improvement. In sectors like these, however, it is paramount to consider whether it benefits those who receive the services. In the cases of architecture and engineering, it probably does, given that as long as the quality of the degree is ensured, there is nothing about being a foreigner that makes bad work more likely (the end of the reciprocity requirement in architecture is probably based on this reasoning). In accounting and legal services, however, strict requirements may be justified, as knowledge and familiarity with the regulations definitely improve the quality of the service.

Paying taxes

Indicator and Methodology

The indicator Paying Taxes is used (by Doing Business) to measure the costs that taxes represent to firms and, consequently, to the whole economy. The indicator assumes that the more flexible and business-friendly a tax system is, the better, which is why countries with lower taxes and more efficient tax codes rank higher.

Various data points are compiled into the "Paying Taxes" indicator": the time taken to prepare, file and pay some specific major type of taxes and contributions, the total number of taxes and contributions paid, the number of tax payments per year, a firm´s tax liability as a share of a firm's profit and a Postfiling composite Index, based on four components—time needed to comply with VAT refund, time needed to obtain VAT refund, time needed to comply with a corporate income tax correction and time to complete a corporate income tax correction.



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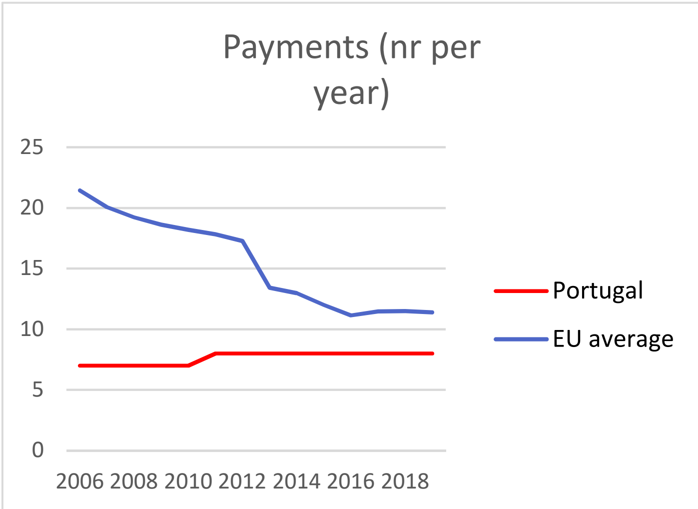

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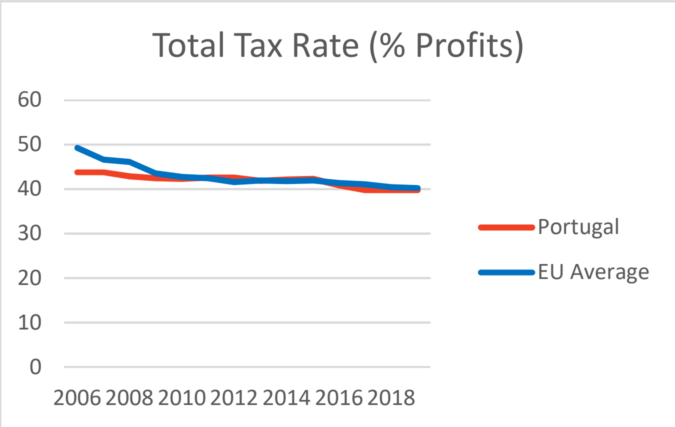
We assumed that for the competitiveness of a country, and keeping every other variable constant, the lower this indicator is, the more competitive the respective economy is in tax matters, as it represents less costs to Doing Businesses, and this is a relevant aspect related to the attraction of investment. In 2019, according to the estimated data used by Doing Business, (5) Portugal is less competitive in the fiscal domain than the EU average. Despite this, we should see this as a simplistic analysis that does not allow for greater conclusions, as it ignores trends, differences in other EU countries and outliers.

Therefore, we will make a more detailed analysis of each of these variables, in a temporal perspective and also by comparing with the average data of all EU countries.

(6) We can start by seeing that the EU average has a clear decreasing trend of the number of payments of taxes and contributions per year, following an opposite trend to the one of Portugal. It should also be noted a really accentuated decrease in this indicator by some countries analysed, like Poland, Bulgaria and Latvia, which, combined with other countries, help to explain this decreasing trend. In Portugal, despite a one unit increase in 2010 compared to 2009 (this was likely the result of the financial crisis which made more difficult for companies to conduct their day to day operations, meaning it was not as easy to have the necessary liquidity to pay taxes),

the number of these payments still continues to be lower than EU average during these years, showing a favourable aspect to the attraction of foreign investment. We can expect that this comparative advantage is sustainable, as in 2019 (using DB forecasted data), only 3 countries (Poland, Latvia and Sweden), had less than 8 payments per year, like Portugal had.



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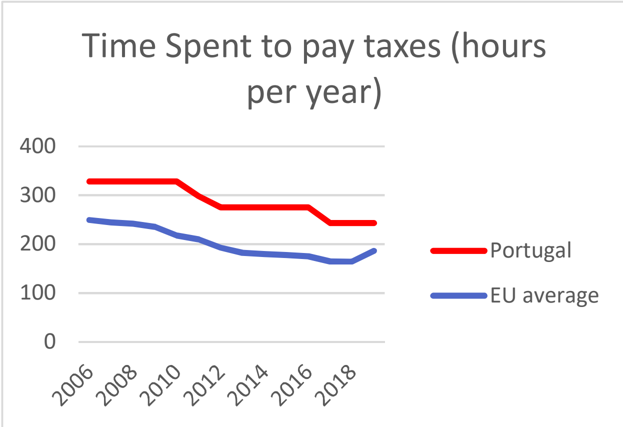

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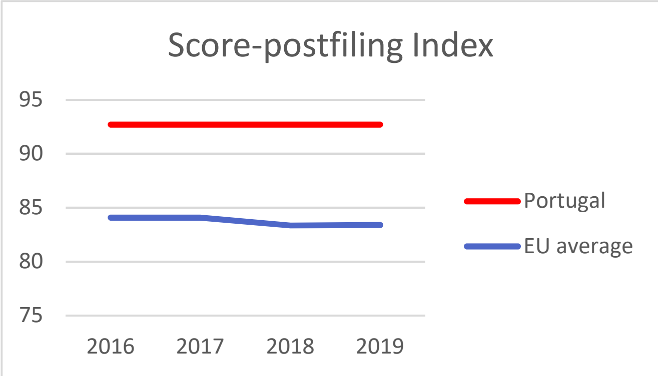
(7) The total tax rate, as a share of firms' profits, measures the amount of taxes and mandatory contributions borne by the business in the second year of operation, as a share of commercial profit. Portuguese taxes appear to represent less than EU average ones when compared to national and EU profits. Both the EU average and Portugal present mainly a decreasing trend, meaning an increasing trend in competitiveness. It should be noticed that some countries like Luxembourg and Ireland have some of the smallest levels of total tax rates to profits, whereas France and Bulgaria have some of the highest. Portugal appears to be converging with EU average, despite the fact that it did not present relevant changes across time. One possible explanation for such might be the fact that the government has consistently run budget deficits across the entire Portuguese democratic history, which limits its ability to lower taxes for companies as it risks making those deficits more negative. Moreover, we have to take into consideration the political and ideological factors, as the current government is run by a left leaning party supported by an agreement with other left-wing parties which emphasises redistribution of wealth and the stimulus of household consumption that requires a reduction in some specific type of taxes and an increase in spending, like in public employees' wages or pensions. So, the deficit is no longer able to accommodate tax decreases for companies. Therefore, reducing corporate taxes isn´t always considered the main priority, as it can fail to stimulate enough the economy, representing, therefore, lower government revenue.

(8) Time Spent to pay Taxes measures the hours taken to prepare, file and pay the corporate income tax, value added or sales tax, and labour taxes, including payroll taxes and social contributions. Contrasting with previous analysed variables, Portugal is less competitive regarding the time spent to pay taxes than EU average. Until recently, both Portugal and the average of the countries of the European Union showed a decreasing trend of time spent to pay taxes. It should also be noticed the outstanding performance of Estonia in this domain, which also means that Portugal and every other country could perform really better. One possible explanation for why the Portuguese nation lags behind, even though it has a low number of average tax payments, could be the fact that the tax code is very unstable in Portugal, changing considerably between different legislative periods. Moreover, it could also stem from a lagging fiscal agency or from the fact that firms have difficulty in obtaining the necessary cash reserves to pay their taxes.



(9) The postfiling index is based on four components (time to comply with VAT refund, time to obtain VAT refund, time to comply with a corporate income tax correction and time to complete a corporate income tax correction). This is the indicator which exhibits less variances, as there is no country showing big changes in the years studied. As in the previously studied one, Portugal is less competitive in this indicator, and doesn't seem to be changing this bad performance recently. One possible reason for this may be the fact that the VAT is considerably high (on average 23%) and that the whole procedures related with tax compliance and refund is very burourcratic and complex which makes companies encure in added expenses with accounting and legal services and doesn't allow them to truly focus on their main activities.

Resolving Insolvency Index

Indicator and Methodology

The resolving insolvency index is a collection of indicators that have been developed by the World Bank since 2006, even though some of the sub-indicators only exist since 2014 and the methodology has change over the years for some of them. This indicator helps government entities and other institutions to have an overview of how prepared a country is to resolve insolvencies which might be an important factor to consider for a company when deciding to invest. If a firm sees that in the event of its investments going insolvent it may be too difficult of a process or that it cannot recover much of the capital investment it might decide not to invest in the given country.

Doing Business studies, the time, cost and outcome of insolvency proceedings involving domestic entities, as well as the strength of the legal framework applicable to judicial liquidation and reorganization proceedings. The data for the resolving insolvency indicators is derived from questionnaire responses by local insolvency practitioners and verified through a study of laws and regulations as well as public information on insolvency systems. Nonetheless, it is important to point out that the World Bank makes a case study for particular industry which then generalizes to the whole country. The assumptions of the indicator are that it only studies companies that:

- Are in the hotel business
- Operates in the economy's largest business city
- Has downtown real estate, where it runs a hotel, as its major asset

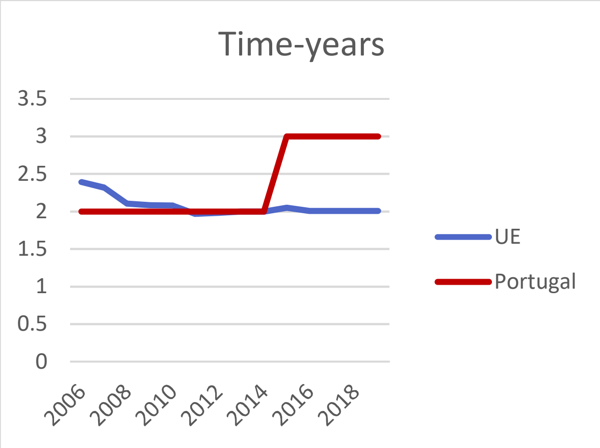
- Has 201 employees and 50 suppliers, each of which is owed money for the last delivery.

Global Score

The first indicator we will analyse is the Global Score which gives us an average view of the performance of the different parties in the overall indicators. In this graph, we can see that Portugal has been well above the EU since the indicator's creation, maintaining more or less the same score over time (about 80), whereas the EU average has seen its score rise steadily going from a score of 60 in 2006 to the current 70.
However, it is important to state that in 2014 the methodology of some indicators was altered, which may explain the drop in the score for Portugal in that year.

Reasons behind Portugal's good performance

Having this in mind, one explanation for why Portugal has been consistently higher than the EU is because of how the indicator is derived. For example, the indicator only takes into account the firms experiencing insolvency in the hotel business in the main business city of a country. For Portugal, that city is Lisbon, which is well-prepared for tourism activity, and we may be above other countries that are not as developed in this branch of the economy and, nonetheless, tare better suited for other activities. If so, this indicator might give us a distorted view of reality. Nevertheless, on a country to country comparison as of 2019 we score 80, whereas Germany and Finland score 90 and 92, respectively, meaning we still have some room for improvement.



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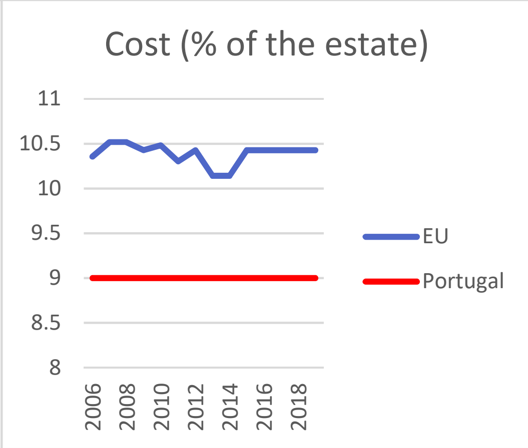

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The indicator on graph 1 "measures the time from the company's default until the payment of some or all of the money owed to the bank. Potential delay tactics by the parties, such as the filing of dilatory appeals or requests for extension, are taken into consideration". As presented on graph 1, on the one hand we have the EU that has seen its time to solve the insolvency process decline and, on the other hand, we have the Portuguese path that has seen the time to resolve skyrocket in 2014-2015 and hasn't declined ever since.

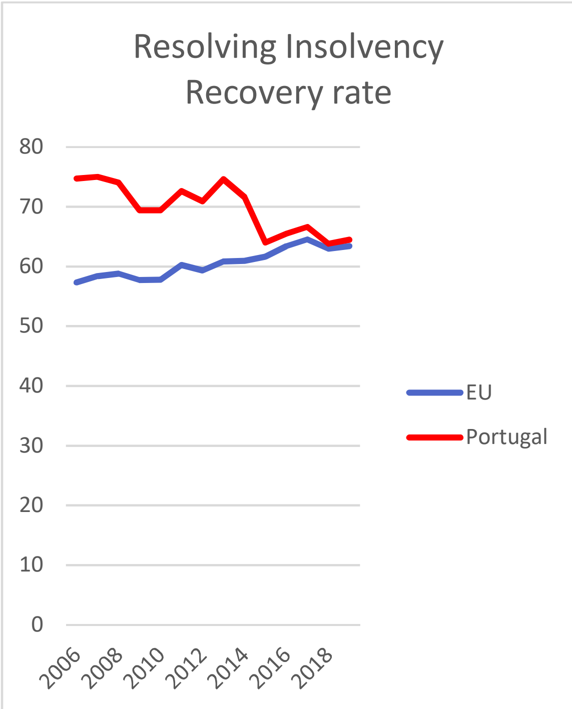
The decrease in time required for the insolvency process in the EU can largely be explained, because of individual decreases in countries such as the Czech Republic which saw its time decrease from 9,2 years in 2006 to 2,1 in 2019 or like Romania which went from 4,6 (2006) to 3,3 (2019), these decreases have likely occurred, because these countries have transitioned from planned economies of communist legacies and have taken measures towards reaching market economies, as well as harmonizing procedures in relation to other EU countries. Now, regarding the Portuguese case, one can see that time to resolve the insolvency process greatly increased. This may be caused because of a lagging judicial system and too much "red tape" in regulations and legal requirements, but also by some change in legislation that increased the time necessary to resolve those procedures.

Regarding the **Cost (% of the estate)** the Doing business says that "the cost of the proceedings is recorded as a percentage of the value of the debtor's estate (namely the value of the hotel). The cost is calculated on the basis of questionnaire responses and includes court fees and government levies; fees of insolvency administrators, auctioneers, assessors and lawyers; and all other fees and costs." From the graph 2, we can conclude that even though there have been some ups and downs in this indicator for the EU average the value of the percentage cost hasn't changed that much. The same goes for the Portuguese case which has not changed at all for the 13 years on display. If it is good that we are below the average, on the one hand, meaning that companies spend, on average less with their insolvency process possibly allowing for better returns. On the other hand, we haven't seen any improvement which indicates stagnation and lack of reforms to improve our position.

Recovery Rate

Methodology

"The recovery rate is recorded as cents on the dollar recovered by secured creditors through judicial reorganization, liquidation or debt enforcement (foreclosure or receivership) proceedings (figure 2). The calculation takes into account the outcome: whether the business emerges from the proceedings as a going concern or the assets are sold piecemeal. Then the costs of the proceedings are deducted (1 cent for each percentage point of the value of the debtor's estate). Finally, the value lost as a result of the time the money remains tied up in insolvency proceedings is taken into account, including the loss of value due to depreciation of the hotel furniture. Consistent with international accounting practice, the annual depreciation rate for furniture is taken to be 20%. The furniture is assumed to account for a quarter of the total value of assets. The recovery rate is the present value of the remaining proceeds, based on end-2017 lending rates from the International Monetary Fund's *International Financial Statistics*, supplemented with data from central banks and the Economist Intelligence Unit."

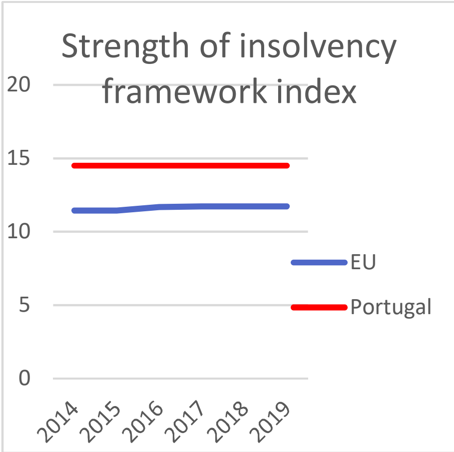


Analysis

The graph on the right shows that the recovery rate for Portugal maintained more or less the same from 2006 to 2013, however from that year onward the recovery rate suffered a big drop that has yet to be recovered, which was probably the result of the financial crisis and the collapse of major banks. The average recovery rate passed from around 75-70% to around 65%. By contrast, the average EU recovery rate has been steadily increasing over the years. This phenomenon has occurred largely due to the positive evolution in countries of the former eastern bloc. Most notably we have the case of the Czech Republic which in the year of 2006 had a recovery rate of 17,8 and now (2019) has a rate of 67,4% indicating that the country has been doing the right reforms in this field. One other case to be noted is of Romania that started 2006 with 17,5 and now has a rate of 35,4%, so even though the evolution has not been as positive it has nonetheless doubled. All this is likely the result of the fact that these countries had very bad initial position due to remains of planned economy inefficiencies.

Strength of insolvency framework

The strength of insolvency framework index is the sum of the scores on the commencement of proceedings index, management of debtor's assets index, reorganization proceedings index and creditor participation index. The index ranges from 0 to 16, with higher values indicating insolvency legislation that is better designed for rehabilitating viable firms and liquidating nonviable ones.



With regards to this indicator, there is not much to be said, as there have not been any major fluctuations over the years. However, it is important to point out that Portugal has been well above the EU average.

- Commencement of proceedings index
- Management of debtor's assets
- Reorganization of proceedings index
- Creditor participation index

All the following indicators are indicators that compose the indicator approached earlier. For each of them the pattern is the same. There have been absolutely no changes on the Portuguese index, and just a few minor fluctuations on the European one, with Portugal always well above the latter. This reflects a good positioning of the Lusitanian lands when compared to the other European partners, meaning we are better positioned to attract foreign direct investment in this regard.

Policy recommendations and final reflections

Having analysed 3 indicators with regards to Institutional quality and Taxes we can conclude that, even though Portugal is well placed in some of the sub-indicators there is still room for improvement. As such we advise Portugal to follow and learn from the progress former eastern European communist bloc countries that have made remarkable advances in ease of doing business (mainly countries such as Estonia and the Czech Republic). Moreover, we also believe that Portugal should try to emulate very free economies like Ireland and the Netherlands which are some of the biggest beneficiates of FDI (foreign direct investment) in the EU.

Taking this into consideration, we have identified areas where Portugal gradually needs to improve in other to be more competitive in order to stimulate internal investment, as well as to attract more FDI.

Thoughts and recommendations regarding the STRI

First of all, we have identified from the STRI (Services and Trade Restrictions Index) and from a stance of a free market economy that Portugal needs to become more open in the Help and Support Services category. This belief comes from the fact that in economics one assumes the more open and freer the market, the lower the costs and the better the services, due to higher levels of competition. Thus, our country should ought to liberalize and facilitate the entrance of foreign accounting, auditing, and legal firms, through the ease of procedures for these firms to operate in Portugal. However, one must also take into account that such service providers may not have such a high level of knowledge regarding Portuguese tax law and other bureaucratic constraints, meaning there is risk the entrance of new players could see the appearance of lower quality help and support services, which could make the whole market less efficient.

Paying Taxes

Secondly, the tax % on profits in Portugal (39.8 in 2019), though in the European average, but much above countries like Ireland (26%) and Luxembourg (20.5%), should try to be reduced so as to signal investors a more business friendly attitude and increase the attractiveness of operating in the country. Nonetheless, it is important to state that there is not a complete consensus among economists that lower taxes on companies make these invest more, because they can use the decrease to distribute more profits to shareholders or companies could simply open an office for accounting purposes, so as to take advantage of the low taxes (anyway, this increases government revenue, so it may be worth it, and countries such as Ireland are profiting from this strategy). Moreover, in the Portuguese case, the reduction in taxes may not be feasible due to the existing budget deficit and the likelihood of this tremendously increasing. In order to improve this indicator, it would be better if Portugal reduced corporate taxes, but we must take into account the implied trade-offs, meaning that it may not be desirable to actually decrease this type of taxes, mainly due to fiscal discipline aspects.

Thirdly, we have come to the conclusion that the time companies take to go through the process of tax payment is rather high when compared to other countries, for example in Luxembourg companies only spend 55 hours, on average, paying taxes. It is counterintuitive that in Portugal, in spite of making only 5 payments per year, companies spend this amount of time in the payment process. Thus, the government should try to reduce bureaucracy and facilitate the whole procedure. Perhaps reforming the fiscal agency or increasingly digitalize programs. The bureaucracy in the Portuguese system is a larger problem than it may seem, one that costs companies time and money to navigate through the complex and often inefficient procedures. All in all, it is advisable for the public administration to make efforts in reducing such bureaucratic "nightmares". All in all, Portugal should concentrate efforts in modernizing, digitalizing and simplifying its fiscal procedures, while also trying to keep them stable across time.

Resolving Insolvency

Moving on to the resolving insolvency indicator, we have a few reflection points about it. The first one being about the methodology and assumptions taken to compose the indicator. We believe that by the Doing Business only evaluating the hotel industry in the main financial city of a country they may be hiding further inefficiencies in the rest of the country as a whole (one knows that the main business centre is probably the most dynamic environment, which does not correspond to the country as a whole), as well as in the rest of the economic sectors, as the country might be specialized in the tourism activity and thus rank higher in the variables, even though in other sectors it may be far behind. As a result, we find this indicator a bit misleading and if the purpose of indicator is to give an accurate representation of reality (though more simple) from which we can draw conclusions and think of ways to improve it, one could argue that this indicator fails in accurately representing reality which may lead to bad policy implementation or lack of reforms.

Having said this, we believe that the main priority of the public administration should be to reduce the time necessary to complete the insolvency process, as it is well above the EU average and when compared to our neighbour Spain, which only requires 1,5 years (half of us) and Ireland (0,4 years), it gives the impression of a not so dynamic country for investors. Moreover, this much time to take insolvent companies about of the market hurts allocative efficiency as inefficient firms are using resources (be it financial, human capital, etc.) that could have been directed to more productive firms.

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