

**CONFERENCE HELD BY THE BANCO DE PORTUGAL ON “PORTUGUESE ECONOMIC  
DEVELOPMENT: DETERMINANTS AND POLICIES”:  
A PERSONAL SUMMARY\***

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## 1. INTRODUCTION

On the 24 and 25 May 2002 the Banco de Portugal held a conference with the main purpose of encouraging economists from the academy to reflect upon the challenges of economic development in Portugal.

The main subject of the conference was the so-called “real convergence” of the Portuguese economy. The focus was on “how and where should the economy converge” rather than on “whether the economy is converging”, and what role do government policies play in this process.

Economic development is a very wide and open subject. Therefore, the conference encompassed a general subject and some more specific subjects.

The general topic dealt with the analysis of overall growth and development and also with the “establishment of facts” on Portuguese real convergence. The specific subjects suggested by the hosts were as follows: Polarisation or dispersion of growth in Europe; Laws and institutions in the development process; Public finances and growth; Factor markets and growth; Human capital and growth.

This article summarises the addresses delivered at the conference as well as the main indications of economic policy they contain. This synthesis is personal and, therefore, is probably subjective. Also, it is not intended to do justice to the techni-

cal details of contributions. Above all, and paraphrasing a well-known definition of culture, it represents what the author recalls after having forgotten what he had learnt in reading the different contributions.

## 2. CONVERGENCE

Economic growth is important. First, for the obvious reason that through growth, citizens may aspire to a better standard of living. A differential of one percentage point (p.p.) in the average rate of growth of output would double the average standard of living in approximately two generations. But there is also a relative component in growth, i.e. Portugal’s performance compared to other economies: are we getting poorer or wealthier than citizens, for instance, in Southern European countries?

The article by Pedro Lains, “Economic growth in Portugal in the long run: investment, productivity growth and structural changes in Portugal, 1910-1990,” attempts to answer these questions. Among the four poorest countries in Europe-15 — Portugal, Spain, Greece and Ireland —, Portugal was the country which converged more quickly in the course of the 20th century. In particular, in the period 1913-1998, real output *per capita* grew, at an average of 2.79 per cent in Portugal, against 2.2 percent in Spain, 2.29 per cent in Greece and 2.19 per cent in Ireland. In contrast, the nine wealthier countries grew only by 2.06 per cent.

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However, convergence has not been uniform over time: in the period between the two wars (1913-1950) the annual convergence rate stood at 0.19 per cent; in the so-called “golden age” — the period from 1950 to 1973 — the Portuguese economy converged at an annual rate of 1.85 per cent; in the post-revolution period, the annual convergence rate declined further to 0.44 per cent. Nevertheless, even during this period, growth in Portugal stood above that in Spain and Greece and was only exceeded by that in Ireland.

The path of the economy in the course of the 20th century was, rather surprisingly, very positive. What does it tell us about the future? Can that pace of growth be extrapolated? Or, on the contrary, does the deceleration recorded in the last quarter of the last century already anticipate a profound waning of convergence?

The contribution by Pedro Pita Barros, “Convergence in productivity: Portugal and the European Union”, gives a pessimistic perspective on those issues. Analysing how aggregate developments detected by Lains were reflected on the structure of Manufacturing, Barros shows that productivity in Manufacturing has grown at declining rates and, more importantly, a concentration of industrial output persists in sectors that make little investment in research and development. As these sectors are considered by the author as being of low growth in the long run, the maintenance of the specialisation pattern would impair growth dynamics.

On the contrary, according to de Freitas (“Portuguese Economic Growth: A manifest *Anti-Fado*”), there is some hope. For better or for worse, the past evolution cannot be automatically extrapolated. As in the past, it will depend on the choices made concerning policy and institutions. Illustrating his argument, Lebre de Freitas shows that in OECD and EU countries there is no inverse relationship between the initial income level *per capita* and subsequent growth: countries which are relatively poorer do not grow more rapidly and, thus, convergence in this set of relatively wealthy countries does not necessarily occur.

What is behind the different growth rates in OECD countries? What is the margin for economic policies? What policies should be favoured? The remaining contributions to the conference attempted to answer these issues. But, as an intro-

duction, Lebre de Freitas anticipates — on an empirical basis — the significant role of factors such as the quality of human resources (measured by the availability of skilled labour force), the quality of institutions (reflected in the efficiency of justice and in bureaucracy, corruption, respect for private property and the credibility of commitments made by the State) and, finally, the flexibility of labour legislation.

### 3. OPENING THE BLACK BOX

More growth requires more and better inputs or a more efficient use of those prevailing. The conference provided important ideas on how this could be achieved.

#### 3.1. Transport infrastructures

Transport infrastructures are important for development in as far as accessibility to consumer, input or knowledge markets is an important determinant of decisions on the location of economic activities.

The contribution by Armando Pires (“Economic Accessibility and Welfare: Evidence in the Iberian Peninsula”), presents indices of the economic accessibility of the different peninsular regions, reflecting the trade costs incurred. This work reveals the importance of transports and accessibility and provides a pessimistic diagnosis: given the current trade pattern, the Portuguese regions record very low accessibility indices.

There seems to be room for important improvements in accessibility; given the externalities involved, this is, in turn, a privileged area for government intervention in the economy. The importance of this intervention as a development factor has long been recognised in Portugal, and a substantial effort of public investment in transport infrastructures has been made since the late 1980s.

Transport infrastructures not only directly promote growth by facilitating a more efficient use of resources, but also have indirect effects via increasing employment and investment. Taking all these effects into account, Pereira and Andr az (“Public Investment in Transport Infrastructures and the Economic Performance in Portugal”) estimate that the investment made in transport infrastructures in the 1980s and 1990s has recorded an

annual rate of return of around 16 per cent, clearly above that expected for private investment. This investment has had thus an important impact on economic growth. Breaking down investments, authors found stronger effects on output from investments in ports and in the national and municipal road network.

Besides its effect on growth potential, investment in accessibilities is frequently justified by the correction of regional disparities. António Teixeira (“Transport Policies in the Light of the New Geographical Economy: The Portuguese Experience”), analyses investment in transport infrastructures in this perspective. The reduction in transportation costs induced by these investments does not necessarily lead to the regional dispersion of industrial activities. There is a critical threshold which has to be overcome, otherwise there might be an intensification of industrial polarisation. Investment made in Portugal over the last decades of the last century was not sufficient to overcome that threshold. However, the author estimates that the pursuance of the prevailing expansion plan of the road network will lead, in the future, to a more balanced distribution of economic activities.

It is interesting to note that, using a different methodology, the mentioned article by Armando Pires also indicates how a reduction in trade costs leading to what he calls “a more complete Iberian integration” will not bring greater geographical equality. On the contrary, it will tend to benefit mainly those regions which are already more advanced, *inter alia*, Lisboa e Vale do Tejo.

These effects, perhaps paradoxical in the light of common sense, should be seen in perspective, since there is no evidence that sustained economic growth benefits from a uniform geographical distribution of economic activities. The decrease in the regional inequality is, strictly speaking, an extra economic purpose.

### 3.2. Human Capital

The connection between education and economic growth has been obvious for economists since the beginning of their Science. Even Adam Smith had argued that public money should be invested in education on the basis that benefits from education are felt by not only those who benefit from it but also by society as a whole (c.f.,

Gylfason, 1999, page. 21 and citations contained therein).

We have already seen in Lebre de Freitas how quality of human resources measured by an index of skilled labour availability is an important explanatory factor of different growth paths in OECD countries. Also in Lains it is estimated that, for the period 1973-1990, the contribution of human capital (measured by the average number of years of education of the labour force) for an annual output growth of 3.9 per cent stood at 1.6 per cent, almost the same level as that of the accumulation of physical capital.

Overall, the level of education of the population increases growth potential. If this happens is because, at an individual level, more educated employees tend to be more productive. As more productive employees are better paid, it is possible to measure part of the effects of education through its effect on wages. Typically, however, this measure of private benefits will underestimate overall effects of education given the externalities mentioned in the introduction of this section. Pereira and Martins (“Education and Wages in Portugal”), acknowledged that employees in Portugal benefit from a high rate of return of education: on average an extra year of education gives rise, in employees otherwise comparable, to an increase of wages of around 11 per cent. This is a high rate by international patterns (on average in developed countries it reaches a value of 8 per cent) and probably reflects the already mentioned relative shortage of skilled employees. This interpretation seems likely if we notice that the rate of return is particularly high for higher education (18 per cent) and, within it, for degrees in Engineering.

Typically, human capital is measured by variables related to education: years of education, rates of attendance and also expenditure in education. These measures have two obvious problems. First, they try to measure output through input without reflecting the quality of education provided at school. Second, they ignore that factors such as health may also improve the stock of human capital.

Notwithstanding that the Portuguese population in the past few years has recorded a marked convergence to EU average levels, several indicators point to a state of health below that in other countries. Similarly, the indicators of quality of

education such as secondary education graduation rates and the performance of students in international tests present low levels. To grow faster, Portugal needs to increase the stock of human capital.

On the other hand, public expenditure plays a key role in direct financing of human capital formation corresponding to virtually all the expenditure in education and to almost two-thirds of the expenditure in health. Therefore the question is whether it is necessary to make heavier investments or whether, on the contrary, funds should be more efficiently used. St. Aubyn ("Assessment of Efficiency in Portugal in Health and Education Sectors"), analyses precisely this question giving a clear answer: the improvement of human capital in these two dimensions does not necessarily require higher investments, but rather structural changes making its use more efficient.

### 3.3. Labour Market

As Traça remarks in his contribution "Labour Markets in Portugal: Recent Performance and Challenges for Development in the European Framework", a fundamental trend for labour markets in industrialised countries is the increase in the volatility of labour demand. In a context in which employment requirements will change considerably in terms both of location (company, industry or region) and of skills, it is crucial to have a smooth functioning of the labour market in order to avoid unemployment and ensure an efficient allocation of work to different industries and firms.

Traça identifies two critical factors for success: flexibility and adaptability. Flexibility refers to the ability of real wages to adjust, by reacting to the market signals so as to avoid mismatches between wage and productivity developments and unemployment. In this respect, past experience of wage setting mechanisms in Portugal — translated into a low unemployment rate — provide positive expectations.

The situation is less favourable concerning "adaptability". The low unemployment rate conceals high long-term unemployment and a reduced labour flows both among jobs and between unemployment and employment (vide Blanchard and Portugal, 2001). In the core of this stagnation is an extremely protectionist labour legislation and

the low efficiency of the matching between the unemployed and employers.

The evidence of the mismatch between employees and employers in terms of qualifications provided by Santos and Oliveira ("Qualifications Required and Qualifications Provided in Portugal, 1985-1997"), supports the view of a stagnant labour market and of the poor efficiency of active employment policies. The mismatch between qualifications of employees and market requirements is the source of significant productivity losses which, according to the estimates of Santos and Oliveira, may reach 5 per cent in the case of over-qualification for the function carried out.

It is interesting to note that market mechanisms seem to find ways to operate, even in adverse legal contexts, so as to respond to employer and employee requirements. A good example is the evolution of temporary contracts from their primitive function — a response to temporary employment requirements — to become an important factor of labour market flexibility, in particular concerning a more efficient employee-employer matching (vide José Varejão, "Temporary Contracts, Employment Flows and Productivity").

The aforementioned work by Daniel Traça isolates three fundamental elements to promote the adaptability of the labour force. Two are related to the educational system — both formal and lifelong — and the other to institutional changes. First, the education of labour force, intended to ensure the ability of learning new tasks. Then, the easiness of hiring and firing which ensures the easy flow of resources to sectors in relative expansion. Finally, active employment policies which improve the matching and ensure the professional training of the unemployed.

The need for "adaptability" — understood as the ability to react prompt and efficiently to market signals — is not confined to the labour market. The adoption of "flexible production technologies", which enable adjustments in the output mix at low cost, may have significant effects on overall productivity as it is documented in Faria and Bruce ("Technological Flexibility and Efficiency: Evidence from Portuguese Manufacturing Industry using a stochastic frontier approach").

### 3.4. Institutions

Today there is a consensus among economists on the importance of institutions for economic growth. However, which institutions are important and why are they important is less consensual. The most important channel through which institutions may influence growth is the impact on costs and uncertainties associated with economic transactions. Typically, economic agents have imperfect and asymmetric information, are involved in transactions that involve a great number of agents making the co-operation hard. In such a world, institutions — legal or other, such as mere rules of conduct — are important, as they reduce the costs of obtaining information, negotiation and implementation of contracts.

José Tavares (“Companies, Financial Markets and Laws: Institutions and Economic Growth in Portugal”) considers that the degree of development of the Portuguese institutions vis-à-vis those in other countries in areas such as the legal system, the internal organisation of companies and the financial system, may be highly responsible for the low level of income *per capita* and the modest convergence rate.

It is, however, at the level of legal and judicial systems that higher gains in terms of growth potential may be recorded. The aggregated indicators considered by Tavares — Rule of Law, Risk of Breach of Contracts, Risk of Expropriation, Access to Justice, Efficiency of the Judicial System, Corruption and Compliance with Contracts — registered levels below the EU average and the “Asian tigers”. The differences are mainly pronounced concerning the indices of efficiency of the judicial system and compliance with contracts. In particular, the length of judicial procedures in Portugal is the longest of the sample. As an illustration, the procedure of collection of a cheque without provision takes almost twice the time of the EU average.

The inefficiency of the judicial system is also confirmed by the business survey carried out by Célia Cabral and Armando Bacelar (“Justice and its Impact on Portuguese Companies”). The survey reveals that, for the companies surveyed, the major problem of the Portuguese judicial system is its lack of celerity reflected, in particular, in time-consuming legal proceedings. The assessment is also very negative with regard to access costs. In

short, the large majority of companies (88 per cent) considers the judicial system as “bad” or “very bad”, i.e. slow and expensive.

## 4. CONCLUDING REMARKS AND POLICY IMPLICATIONS

Sustained economic growth is not mainly the result of exogenous factors such as technology or resources. If we compare the evolution in the course of the second half of the 20th century of countries initially as similar as Eastern Germany and Western Germany, Austria and the Czech Republic, China and Taiwan or Northern Korea and Southern Korea, we immediately realise the importance of economic regimes, institutions and policies. An important conclusion to be drawn from the conference is, therefore, the importance of choices made by societies, i.e. by all of us as citizens.

Most policies proposed are of an “horizontal” nature, i.e. directed to the fundamentals of economic growth. Among the intervention areas discussed in the conference, I would point out four: infrastructures, educational system, labour market and judicial system.

- i. It is necessary to pursue the effort of improving transport infrastructures. However, I would emphasize two points. In the early 1980s little had been done and, therefore, it was possible to obtain the high rates of return estimated in Marvão and Andraz. Presently, it is absolutely necessary to be more selective. But genuinely productive investments pay themselves through additional tax revenues and, therefore, do not generate pressures on the public debt.
- ii. The situation of the educational system — either formal or vocational training or even life-long training — is a cause of concern. The problem is not a result of the lack of investment in education, since it has accompanied the evolution of more advanced countries. It is the return of that investment that must be questioned, because no clear results are being obtained (c.f., St. Aubyn and Pereira and Martins). The problem does not seem to lie in the contents, although some authors have emphasized the need for

higher levels of exigency in subjects like English, sciences and mathematics (e.g., St. Aubyn). Still on the contents of formal education, stress was also laid on the need to ensure sound general competencies, of a wide spectrum, which facilitate the adjustment to a constantly evolving market requirements (c.f., Traça).

- iii. As outlined by several contributions, the problem of the educational system lies mainly on its the failure to recognize and reward the merit of schools, teachers, and students (e.g., St Aubyn). Such a new culture would imply an increase in school autonomy and a strengthening of competition mechanisms among them. The key idea should be “experimentation and evaluation”, i.e. to refuse global “top-down” reform projects, but instead, allow competition — with evaluation and accountability — among several curricular and governance models.
- iv. It is necessary to evaluate the results of public investment in vocational training.
- v. The labour market needs reforms which liberalise the employment protection legislation, namely on collective dismissal for economic reasons and on procedural impediments to individual dismissal (c.f., Traça, 2002). During this liberalisation process it is important not to destroy the few flexibility

elements existing in the current framework, such as temporary contracts, without having created alternatives (vide, Varejão).

- vi. The suggestions for legal and judicial reforms arising from the diagnosis carried out (vide, Tavares and Cabral and Pinheiro) indicate that, in general, Portugal does not seem to need more laws or new ones, but rather a firm and prompt enforcement of the existing legislation. The excessive trend to legal formalism results in a loss of efficiency affecting growth without clear benefits in terms of citizens’ rights.

The implementation of the proposals presented in this article naturally involves (material, social and political) costs and the — perhaps uncertain — results have a medium and long-term horizon. They assume a wide consensus at the political level as to the diagnosis and therapy to be adopted. But, only in this way may Portuguese acquire a renewed dynamics of sustainable development.

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