

**BANCO DE PORTUGAL CONFERENCE ON  
"PORTUGUESE ECONOMIC DEVELOPMENT IN THE EUROPEAN UNION":  
A PERSONAL SUMMARY\***

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## 1. INTRODUCTION

Following a similar initiative in 2002, Banco de Portugal organised a conference this year, held on 11 and 12 March, on the theme "Portuguese Economic Development in the European Union".

This article is a summary of the addresses made in the conference as well as the main guidelines for economic policy that can be drawn from them. This work is highly personal and represents only the opinion of the writer. There is also no claim to do justice to the technical details of the addresses themselves. This article will give more emphasis to those addresses which have a direct bearing on policy.

There were 13 addresses (available on [www.bportugal.pt/events/conferences/IIDEP/default.htm](http://www.bportugal.pt/events/conferences/IIDEP/default.htm)) and they covered a wide range of themes, as diverse as "rules on public expenditure" and the regulatory framework for professions, minimum state pensions and wage mobility, the lessons to be drawn from the "40 hours law" and the articulation of sector regulators with the country's Competition Authority. Notwithstanding the diversity of themes, it is possible to separate the addresses into two main groups. In one, the major concern relates to control of the level of public expenditure and how quality in expenditure can be assessed, with the latter point understood as the best way to reach the aims at which expenditure was targeted.

In the second group the focus is on how markets function and are regulated, both for labour and for goods and services.

What is the relationship between these two themes and economic development, which was the purpose of the conference? Tiago Cavalcanti ("Business Cycle and Level Accounting: The case of Portugal") showed that the lower level of productivity in Portugal relative to the USA at the end of the 20th century (46 per cent lower) can be put down to two factors: less economic efficiency in the overall use of resources (also known as total factor productivity) and, to a lesser extent, distortions in the labour market. Economic efficiency is usually associated with the diffusion of new technologies, infrastructure quality, market competition, and the legal and institutional systems. Public expenditures provides for goods and services which have a specific value to consumers but use resources which would otherwise be available for consumption and investment. The higher the level of public expenditure, or the less efficient its use, the greater the likelihood that the opportunity cost will be higher than potential benefits. In these circumstances, any increase in expenditure from levels which are already high is often compared to an adverse technological shocks. On the other hand, labour market distortions are linked to income tax and other factors such as protectionist labour laws which make it difficult to match workers with available jobs and hamper the flow of resources between companies and industries.

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### 2. PUBLIC EXPENDITURE: LEVEL AND EFFECTIVENESS

#### 2.1. Expenditure rules

In certain countries in the EU, such as Holland and Sweden, there are formal restrictions on public expenditure (known as “expenditure rules”) that are imposed over and above the rules of the Stability and Growth Pact. This situation, which seems to be at the centre of attention at the moment, is somewhat paradoxical, if we look at the macroeconomic policy instruments that have been lost as a result of European monetary union. As António Pinto Barbosa pointed out in the session dedicated to Budget Policy and Social Security, this stemmed fundamentally from an “unromantic” view of governments as economic agents with limited information and their own aims, and these aims are not necessarily consistent with the “general interest” of the community. Democratic regimes have biases in favour of inflation and public expenditure and frequently use budget variables with electoral purposes in mind. The path of the Portuguese budget through the 90s is detailed in the address given by Álvaro Pina (“Fiscal Policy in Portugal: Discipline, Cyclicity and the Scope for Expenditure Rules”) and it gives a very clear illustration of these two factors. Portugal recorded the biggest rise in public expenditure in the EU (3.4 pp of GDP) especially marked in primary current expenditure, which grew twice as fast in real terms as GDP. On top of this, expenditure was strikingly pro-cyclical. In the light of this evidence, one should be sceptic of arguments that oppose to “rules” (or the Pact itself) in the name of economic stabilisation. The work of Linda and Francisco Veiga (“Political-Economic Cycles in Portuguese Municipalities”) is highly eloquent on this point. It demonstrates how municipal expenditure, above all in terms of investment, (and above all in the item “Other buildings and construction”), rises significantly in an election year and occasionally in the year before. Municipal councils manoeuvre economic policy to illustrate their competence at election time, thus boosting their chances of re-election.

Expenditure rules allow budgetary discipline but preserve room for automatic stabilisers to operate, since these function mainly through tax rev-

enue. (Álvaro Pina’s analysis of seven European countries shows that in Portugal tax revenue has the strongest pro-cyclical correlation.) The kind of rule being looked at here is something along the following lines: “For a horizon of  $T$  years, public expenditure ( $D$ ) cannot rise above  $x$  per cent per year”. This statement, however, raises a considerable number of practical problems regarding the exact definition of  $T$ ,  $D$  and  $x$ .

Pina argues that the rule should have the horizon of every government mandate, with each government legitimately empowered to specify new values for the framework. António Pinto Barbosa however, in his comment on the address, argued against this, on the grounds that there should be a “constitutional” view, independent of the political calendar. As for the concept of expenditure, Pina maintains that  $D$  should be limited to the primary current expenditure of the state sub-sector. Unemployment benefits and public investment should be excluded. It may well be that leaving out debt service payments and subsidies causes no problem, but the same cannot be said for leaving out local and regional authorities and public investment (and here the conclusions of Veiga and Veiga, *op. cit.* should be borne in mind). While genuine expenditure in terms of capital could well pay for itself, it is in practice very difficult to calculate the return on each slice of the “expenditure cake” and thus pick out what is genuinely capital as opposed to what is current expenditure. If therefore we leave public investment out of the expenditure frame defined by the rule, we are opening Pandora’s box: the accounting creativity stemming from this would strip out the idea of discipline that the rule seeks to impose. As for the limit to expenditure growth ( $x$ ), Pina proposes that growth be set in real terms (as in Holland) and not in nominal terms (as in Sweden). The point of reference should be potential GDP growth (understood as the average of the past decade, if problems involving measurement are to be avoided). This real limit would be converted annually into a nominal figure through application of the GDP deflator, laid down or validated by an independent commission. Arguments here are again divided but it seems clear that a nominal limit is more transparent and more stringent, albeit more difficult to define with all due rigour.

Independent of the specific details contained in a putative rule, what seems to be of real importance is to fix multi-year expenditure objectives. It is also of primordial importance to provide the governing and supervisory institutions with the quality and independence necessary for effective control over budgetary matters. A fundamental aspect of this discipline is also a systematic assessment of public programmes and policies.

## 2.2. Assessment of public service policies

The efficiency of public expenditure is an issue that can be seen from different viewpoints. We can, for example, take a raft of areas where the state intervenes and where specific policies already exist. We can then study how state intervention can be made with the least possible waste in resources. What we are looking at here is fundamentally an analysis of the frontiers of efficiency. Another view consists in assessing to what point the specific intervention yields the promised social benefits that are a priori its justification. And from this angle, we are also looking at who gains and who loses from the intervention. The two perspectives are of course complementary and are part of an overall cost/benefit appraisal of public sector programmes and policies.

There is at our disposal over 30 years of rigorous and scientifically based empirical assessment of programmes and policies. The large financial burden that many of them require justifies the widespread interest in the topic. The address of Mónica Dias ("The Empirical Evaluation of Social Programmes") focused on the methods available to evaluate public policies. The work of Gouveia and Farinha and Varejão are (methodologically varied) examples covering the assessment of specific interventions such as the minimum state pension and the "40 hours law".

Any method of evaluation requires the recreation of the (counterfactual) behaviour in an alternative economic scenario following "non participation in the programme" or if the programme does not in fact exist. In many areas, such as psychology or medicine, there are routine scientific assessments the causal effects of specific actions. Before any medicine is approved for general use, it must be subject to laboratory experiments in which patients are selected on a random basis and

are given the drug, while others in a control group are given an inoffensive substance known as a placebo.

This kind of experimentation is rare in economics and other social sciences. Even if it were possible, it would not provide an assessment of programmes and policies before they are implemented. (Dias has defined this as a "structural approach" requiring the use of economic theories to build "laboratories" which allow for an evaluation of the reaction of the agents and the effects of the interventions.) But even without experimental information, it is possible to carry out assessments of programmes and policies that have in fact been implemented. The counterfactual behaviour mentioned above can be supplied by external and exogenous circumstances and this leads to what could be considered a controlled experiment (natural or quasi-experiments). We can see common examples of this in the regional variations that occur when certain programmes are implemented. Sometimes it is the passage of time ("before and after the intervention") that allows for control groups to be set up as if a controlled experiment was being undertaken. José Varejão's work, ("Reduction in the Working Week and Employment: Lessons of the 40 Hours Law") provides an illustration of a "natural experiment" since the measure in question, the law of 40 hours, can be considered an unforeseen factor; the control group will be the establishments not covered by the obligation to cut the number of hours; and the experimental group is made up of the comparable establishments which fall within the scope of the new law.

Miguel Gouveia and Carlos Farinha ("What Point Minimum Pensions?") gave an address that covers a highly relevant programme. When a pension provided according to the existing social security laws is below the minimum requirement, it is topped up to reach the minimum figure. A big number of pensioners benefit from this topping up, which is financed through the country's state budget and gives rise to considerable public expenditure. A number of governments have adopted policies leading to gradual increases in minimum pensions up to the minimum wage as part of the fight against poverty. Gouveia and Farinha show that minimum pensions are an expensive and inefficient way of reaching this objec-

tive. Only 31.25 per cent of people in a family household receiving minimum pensions are in fact below the poverty line (that is, they get an income below 60 per cent of the average income for an equivalent adult in active employment). This situation stems from the fact that pensions are not given on a "means-tested" basis. So an increase of pensions from 60 to 70 per cent of the minimum wage can be expected to lead to very low results in terms of poverty, since 64 per cent of this rise will end up being spent on people who are already above the poverty line.

The fundamental message is that the minimum wage is a poor reference point for social policy and there should be an effective means-testing procedure put in its place. The authors provided a simulation with an alternative programme, where the real situation of beneficiaries was more rigorously controlled. The result was that with half of the outlay it would be possible to achieve more significant advances against poverty. This work therefore gives us a very clear idea of something that is often mentioned but not always identified: wastage in the expenditure of public funds.

Interventions by the government do not always result in public expenditure, but they always have an effect on the way resources are allocated. "Work-share" programmes (reductions in the maximum limit that a working week can last) have been popular in Europe since the end of the 70s, partly in response to high levels of unemployment. The catchphrase has been "working less so that everyone can work". Such measures, however, have little solid basis in economic theory: there is an unequivocal rise in labour costs and this is followed by a fall in the total number of hours worked. The effects on employment are, however, ambiguous and the matter comes down to an empirical issue.

José Varejão's address ("Reduction in the Working Week and Employment: Lessons of the 40 Hours Law") looked at the impact of the law that brought in a standard 40-hour week in 1996. The variables analysed were number of hours worked, overtime, wages and employment. The study shows that the measure had the predicted effect of reducing the number of hours worked per establishment, an increase in overtime and an increase in the hourly wage rate. As for employment, there is a wide-ranging picture: in those companies

where the influence of the measure is more heavily felt or where there is a big proportion of workers on the minimum wage, employment clearly falls. In aggregate terms the effect on employment is slight. As the author points out, at a time when Europe is moving towards a 35-hour week, and even if the motives are not strictly economic, it is important to bear in mind the real costs of such a shift.

Pedro Martins and Paulo Guimarães also gave addresses that have potential relevance for policy-making, in spite of the fact that neither of them refers to any specific public initiative.

Direct Foreign Investment is usually seen as having a positive impact on total productivity and thus on potential for growth in economies. Governments compete for it, often at the cost of mean huge public investments. It is therefore important to assess the real benefits provided by direct foreign investment. Pedro Martins ("Wage Differentials and Wage Spillovers of Foreign Firms: Evidence from Different Estimators") assesses this through its effects on salaries. An argument for this perspective could be the sharing of the gains from greater productivity of foreign companies.

Foreign companies pay on average 32 per cent more than domestic companies. However, controlling for features such as the educational level of the work force, the sector and size, those pay differences vanish. Does this mean that direct foreign investment has no impact? Not necessarily. In the first place, wages may not be the best indicator for assessing these benefits. Moreover, the characteristics mentioned above that "explain" the wage differential, are more frequently associated with foreign companies. The advantage of being foreign may therefore not derive from invisible factors associated with "residence", but rather to the facts that these companies are bigger and employ a more highly-educated work force.

Political decision makers are often concerned with the asymmetries in regional distribution of economic activities and are receptive to programmes that involve relocation of these activities. It is therefore of considerable interest to know which of these initiatives are more likely to be successful and which are the economic activities which are most likely to respond to such initiatives. These are the questions that are answered in the work of Paulo Guimarães and Octávio

Figueiredo ("Location and Localisation of Portuguese Manufacturing Industries").

This study shows that there is only a small number of sectors which are highly clustered (above what would be expected from the mere endowment of resources in a region or from a random allocation). In some of these sectors, involving traditional industries, this clustering stems from external factors associated with historical specialisation. Some technologically advanced industries (for example, radio and television, cars or pharmaceuticals) are also found in clusters, suggesting the existence of "knowledge externalities". For these industries, public incentives for relocation will only have a modicum of success, or else the success will demand greater spending. In terms of areas of intervention, increased accessibility to the Porto-Lisbon coastal corridor is the most likely measure to succeed in spreading the economic activity throughout the country.

### 3. MARKETS

#### 3.1. The labour market

The weak dynamics of labour flows both between companies and between employment and unemployment in Portugal brings with it high costs in terms of efficiency (vide Blanchard and Portugal, 2002). The existence of flexible markets is fundamental for workers and companies to find the matchings that make employment more productive. Moreover, in a context where the needs for employment oscillate tremendously, both in localisation (company, industry or region), and in skills, it is crucial to have a labour market which functions efficiently.

The adjustment costs which characterise the Portuguese labour market imply among other things longer average unemployment spells and a higher number of companies which close (as an alternative to reducing manpower). Anabela Carneiro ("The Economic Consequences of Worker Displacement in Portugal") calculates the loss in wages among individuals who spend periods out of work following closures. This provides another measure of the costs associated to unemployment. The loss of wages is substantial and has an effect up to 4 years after the episode concerned: wages are up to 11 per cent less than if the worker had

not lost his or her job. A significant part of this loss derives from the loss of seniority in the company, which suggests the destruction of specific human capital. It is interesting to note that this cut in wages begins a year before the job loss. Faced with the risk of closure, workers are prepared to make concessions on wages. This fact in itself is symptomatic of the lack of fluidity in the market and the anticipation of a long period out of work. There are measures that could be taken to rein in these adjustment costs: an extension to the period for notification of redundancy and other measures that increase the possibility of finding new employment (help with job-searching and professional training).

Curiously enough, in spite of the rigidity of the institutions in the labour market, there do seem that some elements of flexibility spring here and there, providing ways of responding to the needs of employers and workers. From this angle, increased mobility becomes especially relevant.

Ana Rute Cardoso ("Wage Mobility in Portugal") compared wage mobility in Portugal and the United Kingdom, two economies with different levels of flexibility. It would be expected that the more restrictive framework in Portugal would lead to less wage mobility, i.e. fewer possibilities to change the relative position in the wage distribution. In other words, less labour flows between companies could stultify salary scales. This in fact does not happen, since Portugal and the United Kingdom are not very different in terms of mobility. There is considerable evidence that wage flexibility is high in Portugal, in spite of the lack of mobility (or perhaps because of it). For example, it is well known that average wages are sensitive to economic cycles (OECD, 1992) and that employers manage to adapt salaries that are based on collective contracts to the specific conditions of the company and the workers (Cardoso (2000) and Cardoso and Portugal (2003)). The mobility visible now reinforces this conclusion, albeit from a different angle.

Francisco Lima ("How much Mobility? Careers, Promotions and Wages") looks at other aspects of mobility, specifically workers transitions between firms and the gains thus made. A significant number of jobs are stable and long-term (40 per cent of workers over 35 have been with their company for over 10 years) but there is also a high proportion

of short term links, where on average 39 per cent terminate in under a year (either on the initiative of the worker or the employer). This situation relates mainly to young workers and is very often pejoratively referred to as “precarious”. In practice, however, leaving a company tends to increase wages. This is all the more so, the younger and better educated the worker, and for transitions which occur to larger companies. From this point of view, labour mobility may take the place of careers inside an organisation, and they illustrate the gains resulting from a good match between employer and employee.

### 3.2. Competition

There is a consensus among economists these days on the importance of institutions for economic growth (in this context, see Tavares, 2000). Which of these are important and the reasons for their importance are more open to debate. An exception can clearly be made in the existence of independent regulators who stimulate and defend competition in markets. The two addresses presented to the conference on this theme do not approach the issue in a general and abstract way. They look at specific institutions in Portugal — the Competition Authority and the Professional Associations — and they look at which structure best stimulates competition.

Pedro Barros and Steffen Hoernig (“Sectoral Regulators and the Competition Authority: Which Relationship is best?”) come to the conclusion that the overlapping of jurisdiction between entities concerned with specific sectors and the Competition Authority (which covers all sectors) may be beneficial for encouraging social well being, but there should be limits to the cooperation between them. In particular, there should not be a process of joint decision-making that means that a decision is only reached if both authorities are in agreement.

Nuno Garoupa (“Regulation of Professions in Portugal: A Case Study in Rent-Seeking”) looks at how good is the regulation by two entities that are in practice the regulators of the sector: the Lawyers and the Physicians Associations. The regulation of professional activities could be based on objectives that are “in the public interest” (as a result of the asymmetry of information, for exam-

ple). Many of the norms that act as regulatory devices are, however, merely of private interest, that is the wish to increase the income of established professionals. In the first category, there are, for example, the guarantees of adequate specialist training; in the second there are the restrictions on fees or the disciplinary powers that are exclusive to the Associations. The author has built an index of the quality of regulation and found that in the case of the medical profession, Portugal is the EU country where norms motivated by private interest are the most predominant. In the case of lawyers, although belonging to the group with lower regulatory quality, Portugal is not substantially different from Germany or France in this regard.

The study proposes various reforms. In terms of eliminating “restrictions to entry”, I would point out the opening of the Portuguese legal market to international groups or, for the medical profession, a reduction in the influence of the Association in the process of academic training and the stimulation of competition between the medical faculties so as to give a significant boost to the number of doctors. Finally, the author proposes that the Associations should be within the jurisdiction of the Competition Authority, where restrictive practices could be detected.

## 4. CONCLUSIONS

In the 1 Banco de Portugal conference on economic growth in 2002, there were general recommendations regarding policies, focusing on the bases for economic growth, such as, for example, the need for investment in infrastructures, improving the education system, making the labour market more flexible and reforming the legal system and practices.

This, the 2 conference, looked at more specific aspects of growth. In terms of the policy conclusions which can be drawn, they can be summarised as two main ideas:

1. The actions of governments must not be viewed naively. Their intervention is not always motivated by “the idea of common good”, or necessarily generates net positive benefits. This is true in macro economic policy and it is enough to look at the evidence presented to the conference on the way public expenditure evolution amplifies the effects of cyclical fluctuations in the economy or on

“electoral opportunism” in the investments of local authorities. This is also true for specific programmes and policies: the minimum pensions scheme was shown at the conference to be an ineffective instrument in the fight against poverty. There was also the evidence relating to the cost in working hours and consequently in production stemming from the 40 hours law approved in 1996.

Two consequences flow from this situation: on the one hand, there is the need for formal rules on public expenditure that impose intertemporal discipline on governments. Moreover, there is a need for regular assessment of programmes and policies, both *ex-ante* and *ex-post*, so as to provide checks on the promises of social benefits which give a reason for their existence and identify who gains and who loses from the intervention.

2. Flexible market functioning conducive to competition is fundamental for an efficient allocation of resources. The existence of restrictions to entry into industries or professions is a common form of ensuring economic rents to those who are already established, at the cost of social well being. These restrictions are frequently presented as being in defence of “the public interest”. As with

our comment on the actions of governments, we should not be naive about this. For these reasons, the activity of regulatory structures (specifically the Competition Authority), with a scope possibly extended to the professional associations, can make an important contribution to economic growth.

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