Contraditório think-tank

Briefing

Portugal: hedging austerity using future* | Luís Faria

I was wondering what was the best way to start an article on Portugal with a rosy opinion. I thought it would be interesting to descant on the recent promises of a brave new economy but after decades of successive reformers who never really were, I thought that it would be too risky even for a risk taker. To be honest the situation in Portugal is a bit of a puzzle. It seems to me that the country is facing a dissociative identity disorder where a fraction of the society is saying that Portugal is like Greece – on the verge of the abyss -, others believe that Portugal is like Ireland – a credible reformer – and, finally, there are the predominant deluded conformists, defenders of the Portuguese singleness. I would like to be an optimist but after so many decades of reformers that never were, I have decided to start my analysis with a good albeit provocative example: Germany.

“The biggest economy in the euro area, Germany’s, is in a bad way. And its ills are a main cause of the euro’s own weakness”. We were in 1999 and The Economist magazine called Germany the new sick man of Europe, still suffering the pains of reunification. German government set up a plan to deal with the problem and proposed the ambitious Agenda 2010. The government’s plan was to boost the ailing economy focused on reductions in health care benefits, restructuring labour regulations, tax cuts and an overhaul of the pension system. The sick man of Europe has reborn from its own ashes and currently presents enviable growth[1] and unemployment[2] rates for European standards.

When profligate governments create public finances havoc some pundits tell us that their behaviour is in the best interest of its citizens and aiming at promoting growth and job creation and should be forgiven. However,

* A previous version of this article was submitted to CFR in February 2012 and published in April.

[1] 3.0 per cent in 2011, Eurostat: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb020

[2] 5.7 per cent in February 2012, Eurostat: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=une_rt_m&lang=en - the lowest rate since the reunification.

when the government and taxpayers of a more ascetic country object to finance this profligacy with their taxes, then the same pundits get angry. Forgiving irresponsible behaviour and criticizing people who don't want to help negligent countries seems morally perverse. Prudence is as human as reckless expending; therefore, ascetics, savers and reformers should not be attacked for doing the right thing.

Contrary to Germany, Portuguese forecasted growth is -3.3 per cent to 2012 and unemployment rate in February was 15 per cent[3]. For decades Portugal has had a political system incapable of delivering reforms. What we have assisted instead is the successful attempts of insiders to protect themselves from the effects of economic integration and the globalization of markets. After being admitted in the euro area Portuguese real wages increased 10 per cent fuelled by a consumption boom and low interest rates; productivity has been flat and consequently unit labour costs boomed. Among the underlying factors condemning the Portuguese economy are the lack of competition in the goods and services markets offering the incumbents – or "national champions" - large rents while potential entrants face high barriers; insignificant productivity growth and excessive red tape.

Portugal most recent labour market reform unfortunately ignored the fact that the inefficiencies created by the lack of competition in the product and service markets have a way of trickling down to the labour market. The cross-country relation between the two indexes is striking. If product market regulation increases total rents, the incentives for workers to appropriate a proportion of these rents are increased, leading to more labour market regulation. This suggests that a similar argument may apply to deregulation. Product market deregulation may, by decreasing total rents, lead to a decrease in the incentives of workers to appropriate the now smaller rents, and thus make it easier to achieve. In a competitive industry, where there are no rents, there is little to extract in wage bargaining and therefore less incentive for unions to bargain.

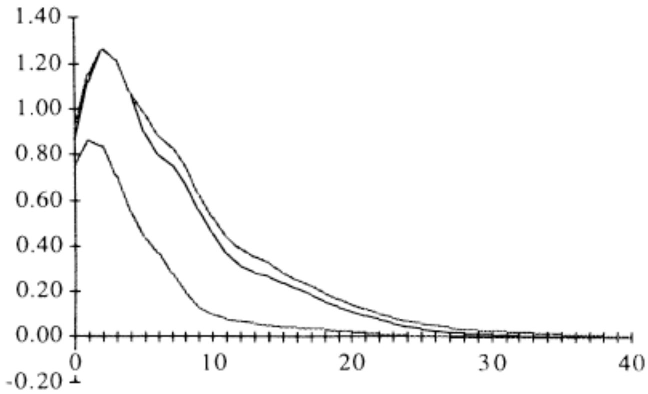
The design and the sequencing of deregulation should start from the product market and, consequently, by lowering the

[3] http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=une_rt_m&lang=en - this unemployment rate is a record high.

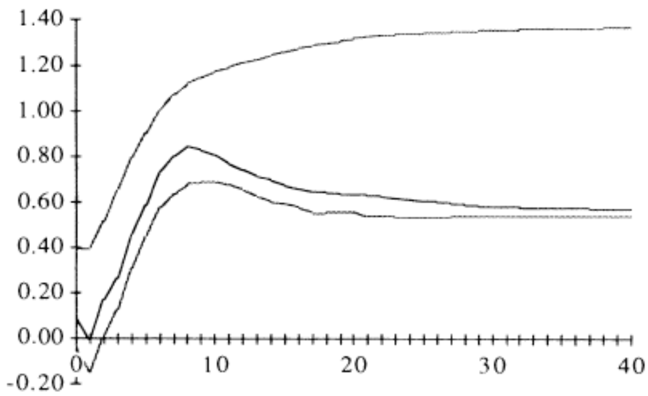
price of goods, deregulation raises the real wage. Moreover, to the extent that it also reduces barriers to entry, it leads to a fall in unemployment. Finally, by decreasing total rents, reduces the incentives for workers to appropriate a proportion of these rents, and this is likely to facilitate labour market deregulation. A sample of OECD member countries shows that market deregulation is associated with a significant increase in aggregate employment growth. Economic science still gives useful explanations that politics should consider studying before taking some policy decisions. Lack of competition in the goods and services markets feeds into the problem of labour market lack of flexibility. Portugal's successive labour market reforms have ignored that this two issues are interconnected and should take empirical economic evidence more seriously.

Citizens in Portugal could definitely benefit from consumer gains from liberalization of goods and services markets and lower prices throughout the economy. Some authors in economic literature defend that a big overhaul could make deregulation politically easier to enact. Instead of selecting and fighting industries one by one, the opposition of vested interests could be defused by deregulating the entire economy. The key to eliminating inefficient, unproductive subsidies to minorities is to implement tax reductions for all.

There is in Portugal a murky and deterministic temper nowadays. However, the alternative to the bleak economic atmosphere of last decades is definitely on the supply side. Economic science and empirical evidence have demonstrated that long-term sustainability is on the supply side.



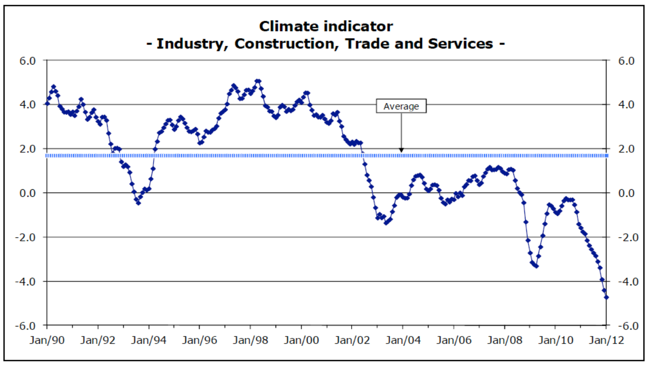
Output Response to Demand



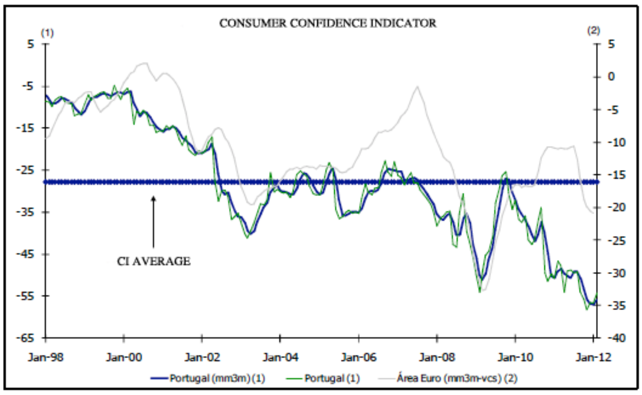
. Output Response to Supply

Source: BLANCHARD & QUAH (1989), American Economic Review

Decisive action in this field is absolutely necessary in Portugal to change people's confidence in government and the economy. If people do not perceive that fiscal consolidation will be accompanied by an improvement in the economy, consumer and business confidence decline. Both are necessary to avoid a slowdown.



Source: Statistics Portugal



Source: Statistics Portugal

In this gloomy economic environment it will be extremely difficult for Portugal to go back to the markets in 2013 and avoid a default or another bailout. However, Portugal should implement decisive reforms rather then reacting to markets. Portugal bears the burden of decades of weak competitiveness and is on the brink of insolvency. Its economic activity often escapes the constraints of law and markets and there is a clash between business activity and the wider public interest. The reforms implemented by the government so far mainly focus at balancing public finances - not very successfully in 2011 as it was only achieved by one-off measures.

Almost all major structural reforms are still to be implemented: liberalizing the economy across the board; simplification of tax code; cutting red tape and taxes; restoring fairness to the judicial system; assuring the protection of property rights and individual freedom. Portugal should restore value creation instead of protecting rent seeking and those in business must learn what taking risks mean. Verbalizing the importance of free markets, entrepreneurship and competition will not reassure the markets. Portugal needs to put its money – or what rests of it - where its mouth is and decisively implement long-term structural reforms, not only to benefit from immediate credibility but essentially to reshape the laws and institutions in which markets are embedded, to restore decency and smarter government, as pillars of a brighter future.

Luís Faria, President of Contraditório think-tank