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# **Labor Markets in Portugal: Recent Performance and Challenges for Development in the European Context<sup>1</sup>**

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<sup>1</sup> Prepared for the conference on 'Desenvolvimento Económico Português no Espaço Europeu: Determinantes e Políticas' organized by Banco de Portugal. For comments, please email: [daniel.traca@insead.edu](mailto:daniel.traca@insead.edu)

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# I. Sumário executivo

## *Os mercados de trabalho em Portugal: Performance recente e desafios para o desenvolvimento no contexto europeu*

Este estudo tem três objectivos fundamentais. Em primeiro lugar, analisar o desempenho do mercado de trabalho em Portugal, em confronto com as experiências europeia e norte-americana. Em segundo lugar, antecipar os principais desafios que se apresentam a médio prazo. Em terceiro lugar, avaliar a adequação do actual enquadramento institucional dos mercados de trabalho em Portugal a uma resposta efectiva a esses desafios, e sugerir o sentido das reformas.

### **1. Desempenho e enquadramento institucional**

A performance do mercado de trabalho português nos últimos 30 anos foi marcada pelo sucesso na manutenção de taxas de desemprego baixas, em particular no confronto com os níveis atingidos no resto de Europa. Nesse sentido, o desempenho em Portugal aproxima-se dos resultados nos Estados Unidos. Dois elementos da criação de emprego em Portugal são, no entanto, preocupantes. Por um lado, durante a década de 1990, e ao contrario da tendência europeia, a percentagem de emprego com escolaridade básica sobre a população total cresceu, enquanto que a proporção de emprego com escolaridade terciária diminuiu. Por outro lado, a contribuição do sector público foi claramente excessiva, com a proporção do funcionários públicos no emprego total a crescer de 8% em 1970 para 17% em 2000.

Em contraste com o baixo índice de desemprego, Portugal apresenta uma elevada duração media de desemprego. A proporção de desempregados de longa duração (mais de um ano) oscilou nos anos 1990 em torno dos 50%: um valor superior à media europeia, e cinco vezes mais elevado que para os Estados Unidos. Esta duração excessiva do desemprego reflecte a falta de dinamismo no mercado de trabalho português, com fluxos de trabalhadores entre tarefas, industrias e empresas e entre desemprego e emprego muito inferiores aos dos Estados Unidos, por exemplo. (Blanchard e Portugal, 2001)

A performance acima descrita não é surpreendente, se tivermos em atenção o enquadramento institucional do mercado de trabalho português. Por um lado, o reduzido desemprego é consequência da reconhecida flexibilidade dos mecanismos de negociação salarial, que permitem uma grande variabilidade por região, indústria e empresa, e que garantem uma adequação dos salários à produtividade.

Por outro lado, a longa duração do desemprego e a falta de dinamismo nos fluxos laborais são consequência de uma legislação de protecção ao emprego extremamente rígida, que diminui os incentivos à mobilidade e dificulta o ajustamento do volume de emprego à conjuntura económica específica da empresa e da indústria. Um outro elemento a ter em conta é a falta de eficácia das políticas activas de emprego em Portugal. Por um lado, os centros de emprego têm um papel extremamente diminuto no *matching* de desempregados e empregadores. Por outro, uma proporção surpreendentemente baixa do investimento publico em formação profissional tem sido afectada aos desempregados; a maior parte da despesa publica com formação profissional tem beneficiado trabalhadores com emprego, cuja formação devia ser paga pela respectiva empresa.

## **2. Desafios para o futuro**

A tendência fundamental para os mercados de trabalho dos países industrializados nos próximos anos é o incremento da volatilidade da procura de trabalho. Por outras palavras, uma maior flutuação das necessidades de emprego ao nível da empresa, indústria e região. Entre os factores que contribuirão para esta tendência encontram-se: a expansão da *globalização*, ao nível das trocas comerciais e dos movimentos de capitais; a alargamento do espaço europeu a Leste e a integração das trocas comerciais dentro do mesmo espaço; a implementação do EURO, com a perda dos mecanismos cambiais de ajustamento, o aumento da concorrência no mercado europeu, e as restrições à expansão do sector publico; o aumento da inovação tecnológica; e finalmente, as mudanças institucionais nos mercados de capitais.

O reenquadramento institucional dos mercados de trabalho, no sentido fazer face ao aumento da volatilidade da procura de trabalho, constitui assim o desafio fundamental das próximas décadas. Dois factores críticos de sucesso são a flexibilidade e a adaptabilidade. A flexibilidade refere-se à capacidade dos salários reflectirem

correctamente as flutuações da procura de trabalho, de forma a evitar situações de desajustamento entre custos de trabalho e produtividade que levem a despedimentos e ao aumento do desemprego. A adaptabilidade relaciona-se com a aptidão da força de trabalho e das instituições para tirarem partido das oportunidades em sectores em expansão, através da mobilidade entre regiões, indústrias e empresas. Se a presença de flexibilidade garante que o aumento da volatilidade da procura de trabalho não resulte num aumento do desemprego, é a adaptabilidade que assegura a maximização da competitividade, com a afectação dos recursos humanos e de capital às actividades de maior produtividade.

### **3. Capacidade de resposta no caso português**

A questão que se levanta é a de saber até que ponto o desempenho dos mercados de trabalho em Portugal, em termos de flexibilidade e adaptabilidade, abonam uma resposta efectiva ao desafio da volatilidade. O enquadramento institucional actual augura um sucesso intermédio, com uma performance adequada em termos de flexibilidade, mas pouco auspiciosa em termos da adaptabilidade.

A descentralização e competitividade dos mecanismos de negociação salarial é uma característica fundamental dos mercados de trabalho em Portugal, e sugere uma resposta apropriada em termos de flexibilidade. Num ambiente de volatilidade, isto implica que os salários tenderão a acompanhar as flutuações da procura de trabalho, assegurando a manutenção do baixo desemprego. O contra-ponto, no entanto, será um aumento da volatilidade salarial e da incerteza, com a consequente necessidade de mecanismos de estabilização intertemporal do rendimento (seguros, crédito, activos financeiros).

É ao nível da adaptabilidade que o mercado de trabalho em Portugal está menos preparado. Três elementos são fundamentais para assegurar a adaptabilidade: a escolaridade da força de trabalho, de forma a assegurar a capacidade do trabalhador aprender novas tarefas e transportar o seu capital humano entre actividades, indústrias e empresas; a facilidade de contratação e despedimento, no sentido de facilitar a criação de novas empresas para tirar partido de novas oportunidades; e as políticas activas de emprego, particularmente ao nível da ligação entre empresas e desempregados, no

sentido de melhorar a eficiência de *matching*, e da utilização produtiva dos períodos de desemprego para a formação profissional e aquisição de capital humano.

Conforme foi descrito anteriormente, é ao nível destes três elementos que o quadro institucional dos mercados de trabalho em Portugal é menos eficaz: o nível de escolaridade é baixo, a protecção ao emprego excessiva, e as políticas activas, em termos de *matching* e formação profissional, altamente ineficazes. Assim sendo, as sugestões principais deste estudo para a reforma institucional no mercado de trabalho em Portugal são as seguintes:

(i) Liberalização da legislação de protecção ao emprego

- Permitir maior flexibilidade na determinação das condições de *rescisão* do contrato entre o empregador e o trabalhador, adequando a combinação entre segurança no emprego e outras condições do contrato às características do trabalhador e da indústria.
- Reduzir as barreiras ao despedimento colectivo por razões económicas, por forma a permitir a sobrevivência às crescentes flutuações da procura de trabalho.
- Reduzir os entraves processuais ao despedimento individual.

(ii) Aumento da eficácia das políticas activas de emprego

- Contestabilidade. Aumentar a concorrência nas actividades do serviço público de emprego, com a possibilidade de produção privada mesmo em sectores de provisão pública. Por exemplo, na Austrália, agências privadas recebem um pagamento do estado pela colocação de trabalhadores em novos empregos.
- Experimentação e avaliação. Promover novas e originais actividades, com competição entre diversas regiões. É no entanto fundamental, uma avaliação constante dos resultados destas iniciativas.
- Focalizar a formação vocacional nos desempregados. Em geral, as empresas estão melhor habilitadas para determinar os parâmetros da formação de capital humano específico à sua actividade.
- Separar as políticas do mercado de emprego das políticas sociais, de forma a permitir aos funcionários do serviço público de emprego um empenho total nas funções de *job matching* e formação vocacional.

## II. Introduction

The last quarter-century has been a period of heightened challenges for labor markets in industrialized countries, namely for Portugal. The next quarter-century is likely to be even more testing. The widely acknowledged role of labor market rigidities in hindering the competitiveness of the EU area highlights the relevance of labor market performance for the challenge of economic development.

The main goal of this study is to bring to light the shocks that will affect labor markets in the EU area, in the medium term, focusing on the case on Portugal. Drawing on labor market developments and performance of the last 30 years, we uncover the main drivers of change in the near future, and assess potential outcomes. We conclude by suggesting directions for reform, aiming at fostering competitiveness.

### *International background over the last 30 years*

The difficulties of labor markets in the OECD over the last 30 years are well known. After a period of striking rise in the standard of living of European workers in the 1950's and 1960's, with low unemployment and high wage growth, the performance of labor markets from the 1970's to the mid 1990's was lackluster. Slow wage growth and widening wage differentials in the flexible labor market of the United States were matched in rigid Europe by a dramatic and prolonged rise in unemployment rates, striking mainly the young and unskilled.

Recently, the second half of the 1990's saw sharp declines in unemployment rates in many European countries, namely: the Netherlands, the UK and Ireland. Instrumental to these successes, particularly in the Netherlands, has been the liberalization of labor market institutions, highlighted in the recommendations of the OECD *job strategy* of 1994. Non-reformers like France, Germany and Italy have lagged behind. Meanwhile, unemployment in the United States fell to its lowest level, fuelled by the longest expansion in that country's history.

### *Comparative features and performance of labor markets Portugal*

Against this international background, the performance of Portuguese labor markets had some unique features. While the unemployment rate has remained low, closer to the flexible US benchmark than to the high unemployment in the rigid EU area, the

proportion of long-term unemployment has been extremely high, mimicking the features of other EU member countries. Job creation in Portugal has been higher than the European average, but much lower than US levels.

A striking feature of job creation in Portugal has been the ability to create low skilled jobs during the 1990's, in contrast to the dwindling number of opportunities for unskilled workers in Europe. On the other hand, sagging job creation for the highly skilled in Portugal contrasts with the increasing skill intensity of employment in the rest of the EU, and is a reason for concern. Another remarkable feature of job creation in Portugal has been the steep increase in the share of employment in the government sector.

Driven by economic convergence, productivity growth has remained strong, but highly volatile, and has been matched closely by compensation. Remarkably, the share of labor is much lower in Portugal than for the US or the EU average.

The low unemployment rate of the Portuguese labor market is predicated in the flexibility of its wage-setting mechanisms. A relatively competitive and decentralized system of wage bargaining, where Trade Unions underbid each other to sign an agreement with the employer, ensures that wages remain in line with productivity, for the different industries and firms.

Other features of Portuguese labor markets are much less proficient. Taxes and benefit systems are near the European average, but considered too high. Employment Protection Legislation for regular workers is the most restrictive in the OECD, leading to a large and growing share of fixed-term contracts in employment, despite very severe institutional limitations on temporary work. Finally, active labor market policies in Portugal are very inefficient, with the role of the public employment service in job placement well below other EU countries and a perverse trend in public sponsored vocational training, whereby the majority of investment has been allocated to employed workers.

### Upcoming Trends

In this context, some new striking challenges loom for labor markets in Portugal, and more generally, in Europe. We identify three main drivers of economic change: the expansion of trade and capital flows, at a global and European scale; the increased pace of technological change and institutional changes in capital markets; and the

implementation of the European Monetary Union (EMU), along with the fiscal constraints of the stability pact.

The repercussion of these dramatic structural changes for labor markets can be summarized in two main trends: a shift in the relative demand toward skilled worker, continuing a trend of the last twenty years, and an increase in labor demand volatility. Responses to the increase in demand for skills must encompass an effective education policy. Because others in this conference will address the challenges for the education system, they are beyond the scope of this study. Hence our main object of analysis is the rise in labor demand volatility, and the policy responses it entails.

#### *Policy Responses to Labor Demand Volatility*

Responses to enhanced labor demand volatility are determined by the *adaptability* and *flexibility* of labor market institutions and the workforce. Adaptability captures the ability of workers and their employers to adjust to a shock by moving to another region (in the case of a country-specific shock) or another industry (for an industry-specific shock). Flexibility depicts the ability of wages and prices to adjust to the shock, bringing the real wage in line with marginal productivity in the different industries and/or countries.

In an adaptable environment, workers move from countries, regions and industries where shocks reduce productivity, to those where productivity is higher, enhancing the standard of living. Flexibility is also important, for it ensures that wages adjust to maintain full-employment. Without adaptability, flexibility constitutes only a second-best outcome. The worst-case scenario is a rigid labor market, with low adaptability and flexibility, where an increase in labor demand volatility is likely to increase unemployment and hinder wage growth.

While the determinants of flexibility are well recognized, involving a decentralized wage bargaining system, with scope for variability across firms, industries and regions, the sources of adaptability have been less studied. We speculate that several factors are key. On the one hand, education, by providing general human capital transferable across firms and industries and increasing the ability to track down opportunities, raises the ability of workers to move to industries and firms fast, as the occasion arises. On the other hand, two aspects of labor market institutions are key to enhance adaptability: a liberal

employment protection legislation reduces barriers to entry, and reduces the cost of moving to expanding industries; while an efficient active labor market policy ensures that search costs are low, reducing the duration of increasingly frequent unemployment spells and ensuring continuous access to training opportunities.

#### *Implications for Portuguese labor markets and directions for reform*

Given these success factors, the features of Portuguese labor markets mentioned above imply a moderate success. On the one hand, the flexibility of wage formation systems in Portugal ensures that the country will be able to face heightened labor demand volatility without the fear of unemployment. In this sense, the consequences are likely to be more serious in the rest of Europe, where wage-setting mechanisms are more centralized and less sensitive to unemployment.

In contrast, performance in terms of adaptability is likely to be sub-standard. Indeed the three less efficient aspects of Portuguese labor markets, as recognized by the OECD in 1998, correspond exactly to the main elements of adaptability; namely: the low skill attainment of the labor force, the extreme strictness of employment protection legislation, and the inefficacy of active labor market policies. Hence, while unemployment and severe stress are not at risk, reform of labor markets to improve adaptability are crucial to ensure that Portuguese labor markets will obtain maximum benefit for the changes that are likely to occur in the next 30 years.

We conclude that reform of labor market institutions in Portugal is key to ensure improved competitiveness and a successful response to the challenges ahead. The main directions for reform include: (a) the relaxation of employment protection legislation, and (b) an increased experimentation and monitoring of active labor market policies, in a contestable framework and in interaction with the private sector.

#### *Remainder of this study*

Section III addresses the performance and institutional developments of labor markets over the last 30 years in Portugal, vis-à-vis the international developments in the US and the EU. In Part 1, we present traditional labor markets indicators of unemployment, job creation, and compensation. Part 2 looks at the implications of the rigidities that shaped European labor markets, and the recent reforms. Finally, Part 3 uncovers the features of

labor market institutions in Portugal, in comparison with its European partners. Section IV looks at the future, in the medium term, in Portugal and Europe. In Parts 1 and 2, we anticipate the key drivers of economic change, and address their implications for labor markets. Part 3 looks at the appropriate policy responses to these shocks. Finally, Part 4 evaluates the readiness of Portuguese labor market institutions, and suggests avenues for reform. Section V concludes.

### **III. Performance over the last 30 years**

This section addresses the performance of labor markets in Portugal over the last quarter-century, against the background of international developments in the United States (US) and the European Union (EU). The comparison with US data is important as benchmark, due to its well-recognized flexibility. The evaluation against EU data serves a double purpose: first, the EU data can be used as a benchmark for a rigid labor market, given the well-known constraints to market forces in the labor markets of Continental Europe; second, it allows us to assess the features of the labor market in the EU and in the EURO area, within which the Portuguese economy is to become increasingly integrated.

In this context, all throughout this paper, we report the simple average for the available EU member countries for the various variables, instead of the aggregate (weighted average) EU value. Since labor market policies are defined at the level of each member country, the simple average is a better measure of the implications of the different policies followed in the different countries. (The weighted average would give excessive weight to the extremely rigid policies of Germany, France and Italy.)

Part 1 depicts several indicators of labor market performance, for Portugal, the US and the EU. We focus on the data on unemployment, job creation, and wages and productivity. Part 2 addresses the labor market rigidities that characterize the labor markets of Europe, their consequences and the evidence on reform. Finally, part 3 looks at the features of Portuguese labor markets, assessing its rigidities vis-à-vis the international benchmarks.

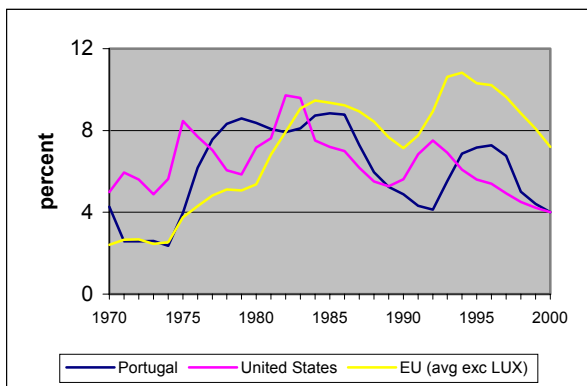
#### **1. *Labor market performance: Portugal, United States and the EU***

##### **i. Unemployment**

###### *Unemployment rates*

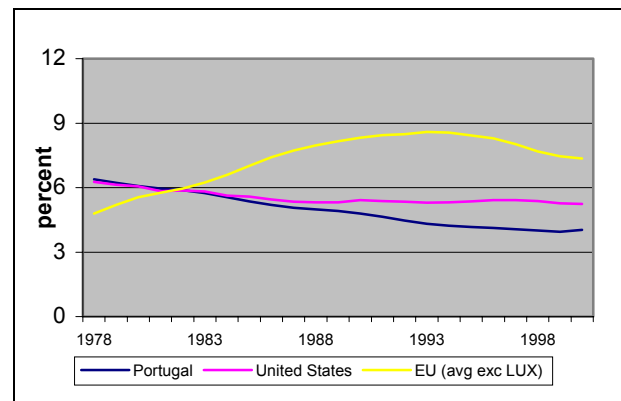
We start by looking at the evolution of unemployment. Figure 1 captures the evolution of unemployment rates in the European Union, the United States and Portugal, starting in 1970. Figure 2 presents estimates of the Natural Rate of Unemployment (NAWRU - Non-Accelerating Wage Rate of Unemployment) from the OECD, for various years.

Figure 1 - Unemployment rates in Portugal, EU and US



Source: OECD; Economic Outlook Database

Figure 2 - Natural rate of unemployment (NAWRU)



Source: OECD; Economic Outlook Database

Over the last 30 years, the performance of unemployment in Europe can be divided into three phases. The first one, which started after WWII and lasted until the mid-1970's, was a period of low unemployment accompanied by high wage growth, fuelled by increases in productivity and capital accumulation. By contrast, from the mid-1970's to the mid-1990's, the performance of European labor markets was lackluster. This second period was characterized by a dramatic and prolonged rise in unemployment rates. The upward trend eased between 1985 and 1990, but regained speed in the early 1990's, reaching an all-time high in 1994. This increase in unemployment was due, not only to cyclical factors, but also to structural elements that augmented the natural rate of unemployment (Figure 2). Finally, the third period, starting in the second half of the 1990's saw a recovery in many countries, with sharp declines in historically high unemployment and in the NAWRU. This recovery did not happen in all countries (and thus is under-represented in the EU average): the Netherlands, the UK and Ireland are success stories, while France, Germany and Italy lag behind.

By contrast, in the US, the unemployment rate increased from the mid-1970's to the mid-1980's, due to cyclical factors. By 1985, it had returned to its historical equilibrium level of around 6%. In the second half of the 1990's, unemployment in the US declined to historical lows. All throughout, the NAWRU has remained relatively stable, just above 5%.

Finally, the evolution of the unemployment rate in Portugal post 1970 is distinct from the rest of Europe. During the 1970's, the unemployment rate suffered a dramatic rise, heavily influenced by the return of Portuguese nationals from its former colonies; Portugal's labor supply rising by no less than 14% between 1973 and 1980 (OECD, 1996). The 1970's produced also dramatic social, political and economic events, which, along with previous backwardness, implied that Portugal entered the 1980's with an economy beset by severe structural problems. Hence productivity failed to rise, and job growth was insufficient to absorb the increased labor supply.

Unemployment finally started to decline in the mid 1980's, as a result of a shift to market-oriented policies and special factors linked to accession to the EU, like the inflow of structural funds. By the mid-1980's structural unemployment in Portugal was already lower than the EU average, at around 6% (Figure 2). However, the structural reforms and high growth of the mid-1980's managed to further reduce unemployment, with the NAWRU falling consistently, to just above 4% in the late 1990's.

A striking feature of Figure 1 and Figure 2 is that from the mid-1980's (starting around 1987 in Figure 1), the Portuguese unemployment rate runs parallel to that of the EU, capturing the influence of EU-wide cyclical factors in the Portuguese economy, but at a much lower level: the unemployment rate in Portugal is consistently four points below the EU average during the 1990's. Indeed, the average level of the unemployment rates in Portugal is much closer to that of the flexible US labor market than the EU. In particular, the rate of structural unemployment - NAWRU - was lower in Portugal than the US by 1%, in the late 1990's.

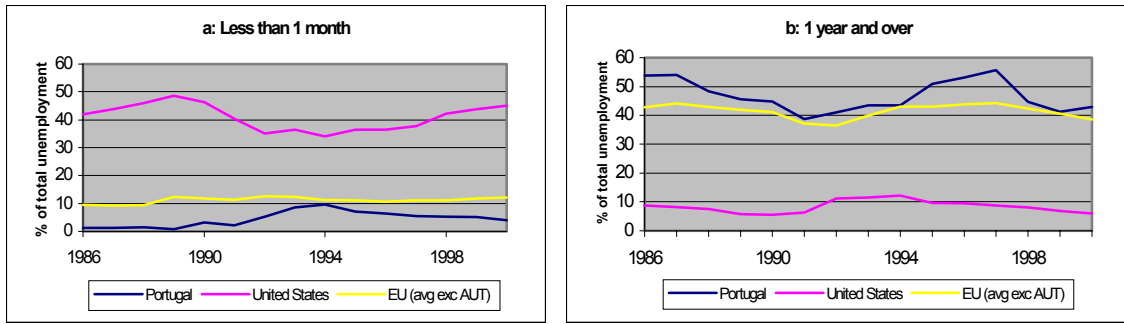
### Duration

Another key aspect of unemployment is the duration of unemployment spells. Figure 3 provides data on the compositions of unemployment pools by duration.<sup>2</sup>

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<sup>2</sup> The labor force survey for Portugal suffered a change of coverage in 1992, which generates a statistical irregularity in the series for that year. In the figure, the values for 1992 were obtained as the averages of 1991 and 1993.

Figure 3 - Unemployment by duration

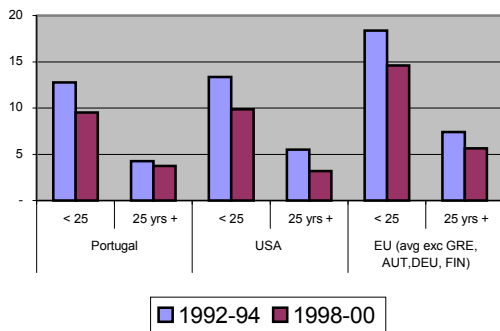


Source: OECD (2001), Labor Force Statistics

As expected, given the higher rate of unemployment in Europe, the long term unemployed (1 year and over) constitute a much higher proportion of the unemployed in Europe. This fact is a major reason for concern, given its implications for the depreciation of a worker's human capital and the subsequent loss of motivation for job search. However, the striking feature of Figure 3 is that, in terms of duration, Portuguese unemployment is much closer to the EU average than to US levels. This contrasts sharply with the numbers for the unemployment rate mentioned above (Figure 1 and Figure 2), where Portugal was much closer to US levels.

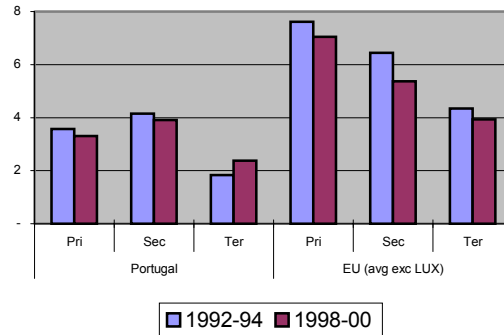
Composition by age and educational attainment

Figure 4 - Unemployment rates for youth (<25 yrs) and older (25 yrs +) workers



Source: OECD, Quarterly Labor force Statistics

Figure 5 – Unemployment rate, by educational attainment - aged 25-59



Source: EUROSTAT, Labor Force Survey

The incidence of the unemployment in Europe is very diverse, varying by education levels and age groups. Figure 4 and Figure 5 show the disaggregated unemployment rates

by age and by educational attainment.<sup>3</sup> In terms of age distribution, Figure 5 shows that unemployment is mostly a youth phenomenon, with unemployment rates for the less than 25 years old more than five points higher than older workers both in the US and the EU, and also for Portugal. Nevertheless, the relative incidence of youth unemployment is slightly higher in the EU.

By contrast, the decomposition of unemployment by educational attainment (for older workers) presents a distinct picture between Portugal and the EU. Data for the US was not available, since the source was EUROSTAT. In the EU, unemployment is mostly an unskilled issue, with unemployment rates falling sharply as educational attainment rises. In Portugal, the unemployment rate is highest among those with secondary education, followed closely by the least skilled, and is lowest for those with tertiary education. However, the effect of tertiary education on the likelihood of unemployment is much less pronounced in Portugal than in the EU. Moreover, while in the EU the unemployment rate for the highly skilled fell in the second half of the 1990's, it has increased in Portugal. By contrast, that of the low skilled, already low by EU standards, has fallen further. As we will see below, this evidence highlights the extraordinary ability of Portuguese labor market to create jobs for the low skilled.

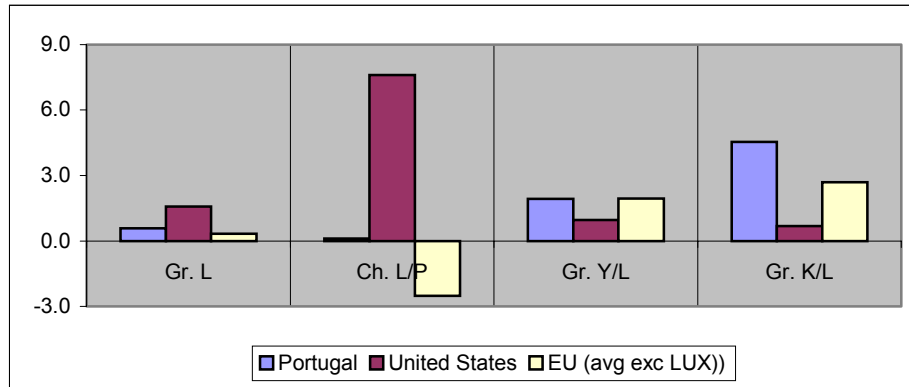
## ii. **Employment and job creation**

To complement our assessment of unemployment, we review job creation among OECD countries. Figure 6 presents estimates of net job creation relative to working-age population, output and capital stock, as reported in Garibaldi and Mauro (1999).

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<sup>3</sup> It should be noted that unlike most other data presented here, which is sourced from the OECD, the data by educational attainment is based on EUROSTAT. For this reason, they are not entirely comparable.

Figure 6 - Job Creation, 1980-97



Average employment growth (Gr. L); Change in employment to working age population (Ch. L/P); Average growth of output to employment (Gr. Y/L); and Average growth of capital to employment (Gr. K/L).

Source: Garibaldi and Mauro (1999); Table 1

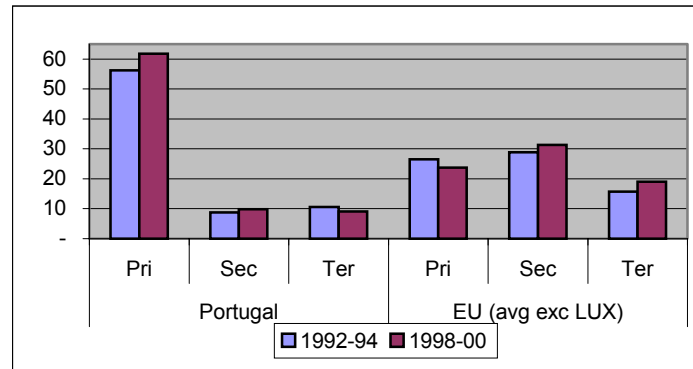
Like with unemployment, the net job creation experience has varied widely across OECD countries, with the Atlantic providing a clear divide: the United States have clearly outperformed most Continental European countries, both in absolute terms and relative to working age population, particularly if we ignore some outliers like the Netherlands and Ireland.<sup>4</sup> Moreover, the growth of job creation in the United States has contributed to an increase in the labor intensity of production, relative to the average EU member. In Portugal, a relatively high rate of capital accumulation, related to the catch-up process of the last 20 years, has also contributed for an increase in capital intensity of production.

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<sup>4</sup> A widely held view is that most job creation in the US has taken the form of low quality service jobs. Garibaldi and Mauro (1999) show that, indeed, a considerable part of employment growth among the fast job creators has taken place in the retail sector, while countries with unfavorable initial conditions (such as a high share of the labor force in agriculture) have done worse. However, statistical analysis to account for the role of sectoral differences show that only one fifth of differences in job creation can be accounted for by differences in sectoral composition of employment.

## Educational attainment

Figure 7 – Employment by educational attainment, as share of **total** adult population (aged 25-59)



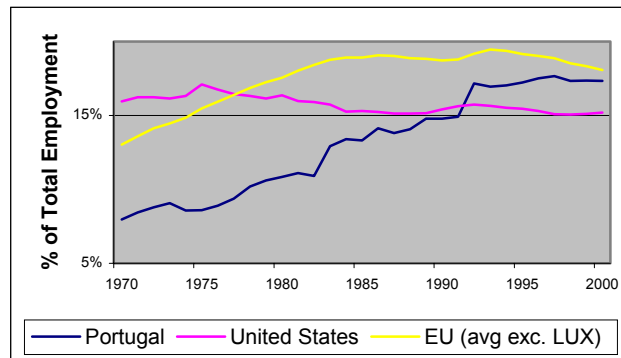
Source: EUROSTAT, Labor Force Survey

A striking feature of employment and job creation in Portugal has been the ability to create jobs for the low skilled, which has produced the low unemployment rates mentioned above. In fact, Figure 7 shows that in Portugal, over the last decade, job creation by educational attainment has followed a very distinct pattern from the EU. Relative to total population, employment in Portugal has increased for workers with primary education and fallen for those with tertiary education, while the reverse is true in the EU.

Two factors can be behind the unskilled-jobs created in Portugal: a benign interpretation is that it is due to low disincentives to employment of the low paid; a more pessimistic view is that it represents a pattern of specialization according to comparative advantage in the EU context. This view is given strength by the lackluster performance of job creation for skilled workers. Since productivity growth requires an increased proportion of high skilled workers, the inability to create jobs for the highly skilled in Portugal is worrisome, if interpreted in light of the second view. Addressing this issue in further detail is beyond the scope of this study.

## Government employment

Figure 8 - Government Employment



Source: OECD, Economic Outlook Database

Another element of job creation is the role of the public sector. Figure 8 depicts the evolution of government employment as a proportion of total employment. Government employment in the public sector has remained stable in the US, just above 15%, with a slight decrease after the mid-1970's. In Europe, the 1970's and 1980's saw a dramatic rise in the share of government employment, depicting the growth of the welfare state. From the mid 1990's, the trend was inverted, as the *Welfare State* began to be scaled down.

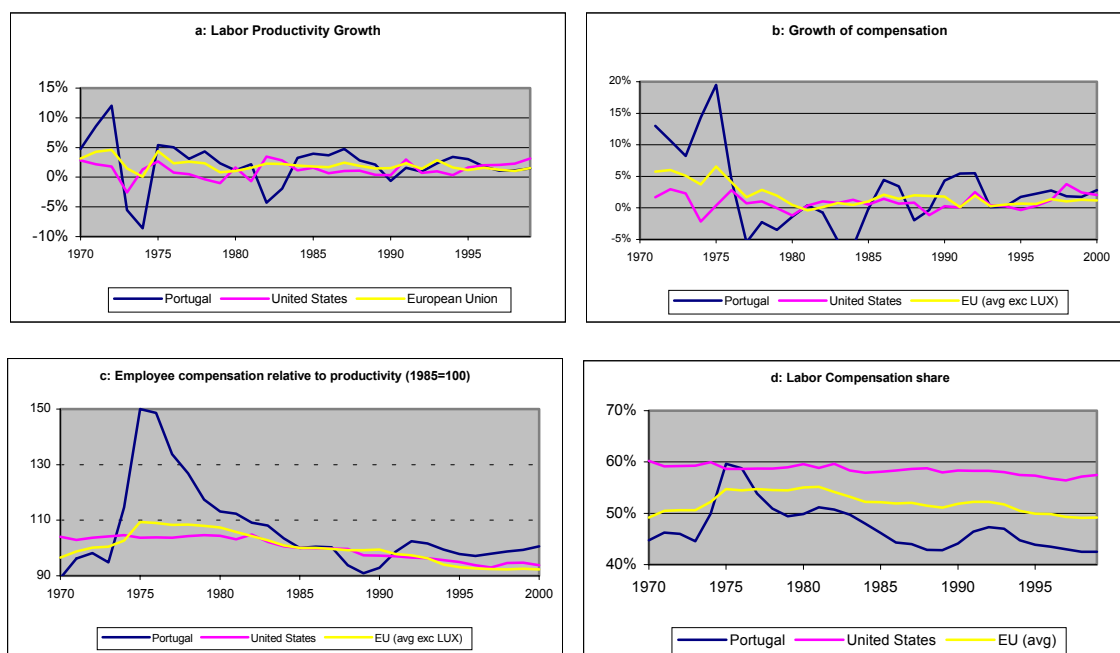
For Portugal the rise in government employment is dramatic: from just above 8% in 1970 to over 17% in 2000, approaching the EU average at a fast pace. Two periods of dramatic increase in the proportion of government employment in total employment are the years of 1983 and 1991. Public sector jobs are usually highly sheltered from lay-off risk. Moreover, a recent study by Portugal and Centeno (2001) provides evidence that public sector wages in Portugal are higher than in the private sector, and that this difference is the highest among EU countries. As a result of high wages and high employment, Portugal has the second highest ratio of personnel expenditure in the public sector to GDP among EU countries (Portugal and Centeno, 2001).

The reigning explanation for the growth of the public sector from cross-country studies is that governments have used public-sector employment as a tool for generating and redistributing rents (Gelb et al., 1991). Rodrik (1999) argues that the expansion of safe public sector jobs arises as a policy response to increased volatility in the private sector, due to expanded exposure to international trade. In any case, the magnitude of the

Welfare State in Portugal is clearly insufficient to explain that such a high proportion of the labor force is involved in the delivery of public services. As we will mention below, the need for reform of the public sector, namely by reducing its size, is a key challenge for Portugal, which will have implications for its labor market.

### iii. Productivity and wages

Figure 9 – Productivity, Compensation and Labor share<sup>5</sup>



Source: OECD, Economic Outlook Database, National Accounts Database

To conclude, Figure 9 displays the evolution of productivity and wages. The background for the comparative performance of the US and the EU can be summarized as follows. Starting from the mid 1970's, the growth rate of productivity declined from an average of 5% to a miserly 2%. The slowdown was even more pronounced in Europe, as many countries were still in a catch up phase, after WWII. Consequently, the growth of compensation fell in Europe and the US (Figure 9b). However, the slowdown of the growth of real compensation happened with a lag in the average EU member, causing an increase in the wages to productivity ratio in Europe vis-à-vis the US (Figure 9c). At the

<sup>5</sup> OECD data on productivity and compensation differs from that of the Bank of Portugal, for the mid-1970's, and seems to overestimate the productivity decline in that period. Nevertheless, in order to allow for comparisons across different countries from a single source, we use OECD data.

root of the different speeds of adjustment to the productivity slowdown are differences in labor market institutions, as we will see below. As argued by Blanchard (1997), a slower wage response increased the labor share in Europe in the 70's. However, as firms took the increase in wage costs as an incentive to become more capital intensive, demand for labor fell, causing unemployment and reducing the labor share.

Capturing the convergence process, productivity growth in Portugal has remained above the EU average, after the events of the 1970s, except for the economic crisis of the early 1980's. Wage and productivity growth in Portugal are extremely volatile, relative to the US and the EU average. This is due to a well-know cycle of boom-and-bust that characterizes Portugal's macroeconomic variables. Figure 9c: shows that the adjustment of Portuguese wages to productivity, after the wage explosion of the post-revolutionary period, took about ten years. Since 1985, the ratio of compensation to productivity has remained stable (possibly a steady-state), apart for a compensation crunch at the end of the 1980's. Finally, the labor share in Portugal has followed the adjustment of wages. Surprisingly, it is considerably lower than the EU average or the level for the US, possibly due to the country's lower capital intensity.

## **2. *Labor Market Rigidities and Reform***

### ***i. Labor markets and The Welfare State***

Overall, most economists agree on the sequence of events that has brought about Europe's sustained high unemployment. The story can be summarized as follows. The initial rise in the rate was triggered by a series of adverse shocks during the 70's and the early 80's, itemized in Box 1. Once these shocks subsided, certain institutional features of European labor markets kept unemployment rates from falling.<sup>6</sup>

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<sup>6</sup> Blanchard and Wolfers (2000) show that the interaction of some labor market institutions with cyclical and structural shocks contributes to explaining the increase in European unemployment over time as well as the heterogeneity in unemployment evolutions across EU. Their results indicate that whereas cyclical and structural shocks contribute to the general increase in unemployment, the interaction of these changes with different national labor market institutions seems to explain some of the heterogeneity of unemployment evolutions.

### **Box 1 - Shocks affecting European labor markets in the 1970's and 1980's**

- Labor force trends (rise in female participation, slowdown in long-term decrease in the length of the workweek),
- Technological change that is complementary with skills and reduces the need for unskilled workers, even in services, but whose progress has decelerated considerably, generating a productivity slowdown;
- The emergence of a number of Third World competitors that gain market shares in the manufacturing sector;
- Macroeconomic shocks such as the hike in oil prices in the mid 1970's or the rise in world interest rates, starting from the early 1980's.

On the other hand, European labor market rigidities arose over the years, with a series of rules and regulations aimed at promoting social justice and improving the standard of living of workers, which became known as the *Welfare State*.

### **Box 2 - Taxonomy of labor market institutions**

- Wage-formation: includes the centralization and coordination of wage-bargaining and the role of the minimum wage;
- Tax and benefits systems: comprises the characteristics of subsidies to unemployment and the level of taxation of labor through income taxes and social security contributions;
- Employment protection legislation (EPL): covers the laws regulating the procedures for separation, including collective dismissals, and alternative forms of employment (e.g. temporary work);
- Active labor market policies (ALMP): involves the activities of the Public Employment Service (PES) in its three main functions: the job-brokerage or placement function, the implementation and monitoring of systems of income support to jobseekers, and the improvement of the employability of jobseekers through vocational training and skill upgrading.

Deconstructing labor market institutions into the four key elements summarized in Box 2, a large theoretical and empirical literature (the latter using mostly cross-country studies) has analyzed the effects of the rigidities introduced on unemployment and labor market performance (for a recent review of the literature, see Nickel and Layard, 1998). Below we summarize the main conclusions of this research.

#### *Wage-formation*

There is some evidence that different collective bargaining arrangements affect labor market outcomes. Calmfors and Driffill (1988) suggest that either highly centralized and fully decentralized bargaining systems lead to somewhat lower structural unemployment

compared with intermediate systems, because they help to restrain the wage claims of insiders. (For a recent discussion, see Elmeskov et al., 1998).

#### Tax and benefit systems

Price incentives affect the structural rate of unemployment on both the demand and supply sides. On the demand side, high tax wedges and social security contributions raise the cost of labor, causing a decline in the demand for labor and a substitution towards capital-intensive techniques. Recent studies seem to suggest a significant effect of taxes on labor on unemployment. The impact is stronger and more robust when wages are negotiated at the sectoral level with a lack of coordination, and thus, may not fully adjust to the tax-hike. (See, for example, Elmeskov et al., 1998).

On the supply side, generous unemployment insurance and other non-work benefits reduce the opportunity cost of unemployment, and reduce the search effort of the unemployed. Elmeskov et al. (1998) provide evidence that very generous unemployment benefit systems – in terms of both levels and duration – may contribute to structural unemployment.

#### Employment protection legislation (EPL)

The key intent of EPL is to enhance job and income security, benefiting worker satisfaction and longer-term attachment, which in turn favor the accumulation of firm- and job-specific skills. The theoretical implications for unemployment are unclear, since EPL should reduce both lay-off rates and hiring rates. Hence it is not surprising that empirical results are somewhat mixed, with weak evidence of a positive effect of EPL on structural unemployment (Elmeskov et al., 1998; OECD, 1999; Heckman and Pagés, 2000). However, EPL's has the potential for several other perverse effects on labor markets:

- Enhancing the dualism of labor markets, by favoring “insiders”;
- Shifting firms preferences to adjusting working hours when responding to demand shocks;
- Biasing firms against “risky” workers, such as young workers and the long-term unemployed, in order to reduce the likelihood of a bad match;
- Discouraging job creation and job destruction, by taxing work-force adjustments and raising a “firing” cost;

- Making the unemployment pool more stagnant, due to lower inflows and outflows, i.e. less employment turnover, and longer durations. (See OECD, 1999 for empirical evidence).

Active labor market policies (ALMP)

The evidence points to a positive and significant impact of expenditure in the Public Employment Service (PES) in reducing unemployment. The significance rises if Sweden, with a very high spending on labor market programs, is removed from the panel (Scarpetta, 1996; and Nickell and Layard, 1998).

**ii. Directions for reform**

In 1994, OECD member countries agreed on a *Jobs Strategy* that contained a wide-ranging set of policies to enhance employment growth, reduce unemployment and increase prosperity. They focused on the areas of labor market reform, education and training policies and business environment; the latter including macroeconomic stability, innovation and product market competition. The main recommendations in the area of labor market reform are summarized in Box 3.

**Box 3 - Labor market reforms from the OECD Jobs Strategy (1994)**

- Increase flexibility of working time (both short-term and lifetime) voluntarily sought by workers and employers
- Make wage and labor costs more flexible by removing restrictions that prevent wages from reflecting local conditions and individual skill levels, in particular of younger workers
- Reform employment security provisions that inhibit the expansion of employment in the private sector.
- Strengthen the emphasis on active labor market policies and reinforce their effectiveness.
- Reform unemployment and related benefit systems – and their interactions with the tax system – such that societies fundamental equity goals are achieved in ways that impinge far less on the efficient functioning of labor markets.
- Improve labor force skills and competencies through wide-ranging changes in education and training systems.

The implementation of labor market reforms in OECD countries has been extremely uneven. A number of countries with high and persistent unemployment have been hesitant to implement reforms that affect core workers. For example, few changes have been made to stringent employment protection for workers with regular contracts, whereas most countries have eased regulations for temporary contracts (fixed-term and

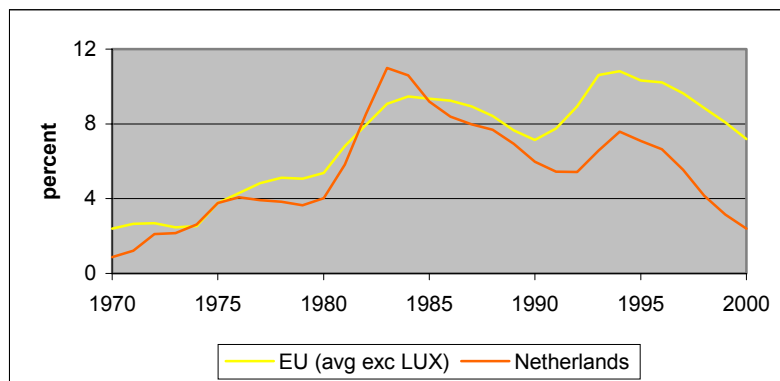
temporary work agencies). Moves toward decentralized wage bargaining have been implemented in a number of countries, but most have been reluctant to reform minimum wages or, more generally, to allow a widening of the earnings distribution. In addition, only a few countries have significantly reduced the level and maximum duration of unemployment benefits and other non-employment benefits; while many have preferred to tighten the eligibility criteria.

### iii. Successful reformers and recent developments

As mentioned above, the mid 90's witnessed a change in unemployment trends. In the US, unemployment reached a 30-year low in 1998, fuelled by one of the most resilient economic expansions in that country's history. This included a decline in an already low rate on natural unemployment. In the EU, unemployment also showed signs of easing, with a decline in the NAWRU.

However, the experience of individual member countries in the EU has been diverse. Some countries have achieved significant reductions of structural unemployment: the UK, Denmark, Ireland and the Netherlands; and more recently Spain. Meanwhile, France, Italy and Greece, along with Finland and Sweden, recovering from recession, have seen rises in structural unemployment (OECD, 1999). In assessing the role of labor markets reforms on the decline in unemployment, OECD (1999) argues that countries that have progressed most along the lines of the recommendations of the OECD jobs strategy (see Box 3) have experienced the most significant improvements in labor market conditions.

Figure 10 - Unemployment in the Netherlands



Source: OECD, Economic Outlook Database

Among the successful performers, the reforms in the Netherlands provide some interesting insights.<sup>7</sup> Figure 10 shows the striking evolution of unemployment rate in that country. Assessing the implementation of Jobs Strategy recommendations, the OECD estimated that sufficient action had been taken in 30% of its recommendations, the highest level after the UK with much fewer recommendations.

Notably, the *Wassenaar* agreement of 1982, reached through negotiations between government, unions and employers resulted in several key reforms, including the end of wage indexation, and decline in minimum wages and labor taxes. To address the problem of low-skilled workers the government introduced permanent tax-relief for firms hiring low-wage workers (up to 115 percent of the minimum wage) and temporary tax reductions for hiring the long-term unemployed. It also encouraged the creation and use of both bottom pay scales, which are close to the legal minimum wage, and “opening clauses”, which allow workers to be paid below minimum wages set in collective agreements. In 1986-7, the unemployment subsidy was significantly curtailed, both in terms of the replacement rate and duration. Some relaxation of employment security has also been introduced. Finally, the *Wassenaar* agreement eased rules on part-time work, making part-time employees eligible for full social security benefits, including unemployment and disability insurance.

As a result, employment growth surpassed an already high rate of growth of the labor force, with job creation focusing on the service sector. Strikingly, part-time employment has accounted for two-thirds of the net jobs created since the early 1980’s, with the share of part-time in employment reaching 47 percent (the highest in the EU) in 1997 (OECD, 1998). Box 4 summarizes the main lessons from the experience of the Netherlands and other countries for the implementation of labor market reforms:

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<sup>7</sup> In Ireland, the decline in unemployment was driven mostly by structural reforms outside the labor markets, which have paved the way to an increase in investment rates, financed by the inflow of foreign capital. However, several reforms, including limits on wage increases, reductions in income taxes, a cutback in unemployment benefits, and the adoption of active labor market policies in the late 1980’s have also played a role. The relatively long lag to the beginning of employment growth in 1993 raises some questions about the role of these reforms on the decline in unemployment.

#### **Box 4 - Success factors in the implementation of labor market reform**

- Complementarities among different policies, namely between macroeconomic adjustment and structural reform, imply that comprehensive reforms tend to be more successful (see Coe and Snower, 1997).
- Generally speaking, structural reform generates improved labor market performance with a relatively long lag. Indeed, some of the countries with significant falls in structural unemployment began implementing reforms in the early to mid-1980.
- Consensual changes, obtained by co-ordination between employers and workers' representatives have a higher chance of success. In the Netherlands (1982) improved co-ordination of wage bargaining via-tripartite agreements between unions, employers and the government, was key to obtain wage moderation accompanied by macroeconomic stabilization measures.
- Successful reforms arose as part of a comprehensive package combining wage restraints with other initiative that helped soften the impacts of the restraints on workers.

### **3. Comparative Features of Portuguese labor markets**

As we have shown in section III.1, the overall performance of labor markets in Portugal has been much stronger than its European counterparts. Box 5 summarizes the performance of Portuguese labor markets over the last 30 years, based on the data presented in section III.1.

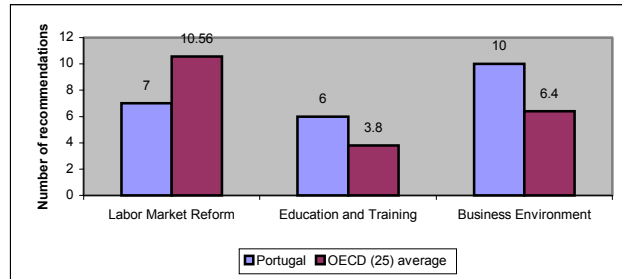
#### **Box 5 – Summary of the recent Portuguese labor market performance**

- Low unemployment rates, closer to the flexible US benchmark than the high unemployment in the rigid EU area;
- High proportion of long term unemployment, closer to EU area levels;
- High overall job creation, by European standards, but less impressive than the US miracle;
- High job creation for the low skilled, and sagging job creation for the highly skilled;
- High growth of employment in the government sector, rapidly catching-up with European levels;
- Relatively strong, but highly volatile, productivity growth, due to economic convergence; followed closely by compensation over the last 15 years, after a period of slow recovery from the post-revolutionary excesses.
- The share of labor on national income is lower for Portugal than for the US or the EU average.

In this context, the recommendations of the OECD jobs strategy for Portugal stressed the challenges of reforming the education system to match the demand for skills and other structural reforms in privatization and fiscal convergence, instead of the reform of labor market institutions (see Figure 11). Overall, seven recommendations were made in the

area of labor market reform, six in the area of education and training and ten for the reform of the business environment.

Figure 11 - Recommendation from the OECD *Jobs Strategy*



Source: OECD (1999)

In terms of labor market reform, the key recommendations were: to reduce the tax burden on labor income, to improve the efficiency of active labor market policies, and to improve the labor-force skills and competencies (OECD, 1996). Below, we analyze the comparative features of Portuguese labor markets along the four dimensions highlighted in Box 2 (pp 16).

### **i. Wage-formation**

Wage formation in Portugal is characterized by sectoral wage bargaining with limited coordination between bargaining units (OECD, 1996). There are three bargaining regimes. First, a company can negotiate its own collective agreement with one or several unions (single-firm contracts). Second, several companies can form a coalition and negotiate with trade unions (multi-firm contracts). Third, employers' associations, normally at the industry level, negotiate with trade unions (sectoral contracts). Negotiations usually set wage floors, giving the employer room for *manoeuvre*, as actual wages significantly exceed industry-wide agreements (Hartog et al., 2001). Although a worker is covered by a specific collective agreement if and only if he or she is affiliated with the respective trade union and the firm has signed the contract, negotiated contracts are widely extended at a sectoral level by the government. Consequently, 90% of workers in the non-agricultural sector in 1995 were covered by some form of collective bargaining (OECD, 1996).

The rate of unionization has suffered a sharp drop during the 1980's. There are two workers' confederations (CGTP and UGT), organized along political lines, and a

significant number of independent trade unions. The CGTP is based on many small trade unions, organized mostly at the industry level; while the UGT is organized at the level of profession or category. Although the confederations can negotiate and sign collective agreements, they have preferred to play an advisory role to the participating trade unions (Hartog et al., 2001).

In Portugal, the representation of trade unions and their ability to negotiate depends on union membership. The ambiguity in the representation of each trade union undermines the potential for coordination among unions; often creating a situation of competition that ensures wage flexibility (Portugal and Centeno, 2001). Employers' associations are able to reach agreements with the least demanding unions, while waiting for the government to extend them nationwide (Addison and Teixeira, 1999). This flexibility is captured in the low unemployment rate, and in the very high dispersion of labor costs in Table 1. In addition, empirical research suggests that nominal wage growth responds rather strongly to the rate of unemployment compared with most other OECD countries (OECD, 1996).

Figure 12 - Labor Cost Dispersion

Dispersion of inter-sectoral labor costs in 1989		Dispersion of labor costs by size of industrial firms in 1988	
Portugal	0.277	Portugal	0.253
United States	0.276	Ireland	0.239
Japan	0.268	Belgium	0.237
Spain	0.216	Germany	0.143
Germany	0.181	Netherlands	0.120
United Kingdom	0.170	Italy	0.116
France	0.156	United Kingdom	0.108
Italy	0.142	Denmark	0.030
		France	0.133

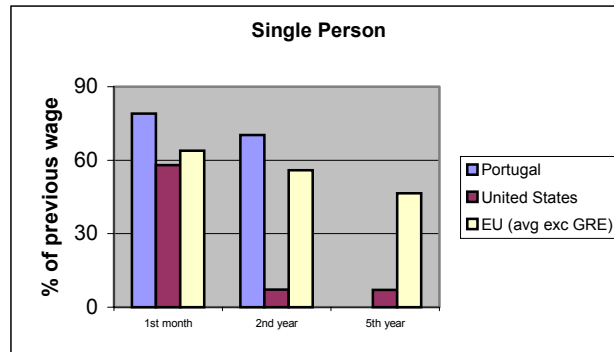
Source: OECD (1996); Table 25, pp 85

## ii. Tax and benefit systems

On the supply side, transfers to out-of-job individuals have historically been low in Portugal. For unemployment insurance, although the level is near the median for industrialized countries, the provisions are quite restrictive. Beneficiaries must have been contributing for at least eighteen months in the previous two years (Bover et al., 2000). Means-tested unemployment assistance, unrelated to earnings, is also low in international comparisons. In 1997, a minimum guaranteed income scheme has been introduced nation-wide, ensuring a family income dependent upon family status and employment

income. Gouveia and Farinha Rodrigues (1999) provide a description of the program, and assess its implications for the distribution of household incomes and poverty, as well as for the size of government expenditures. An analysis of its consequences for labor supply and for labor markets was not available at the time of this study.

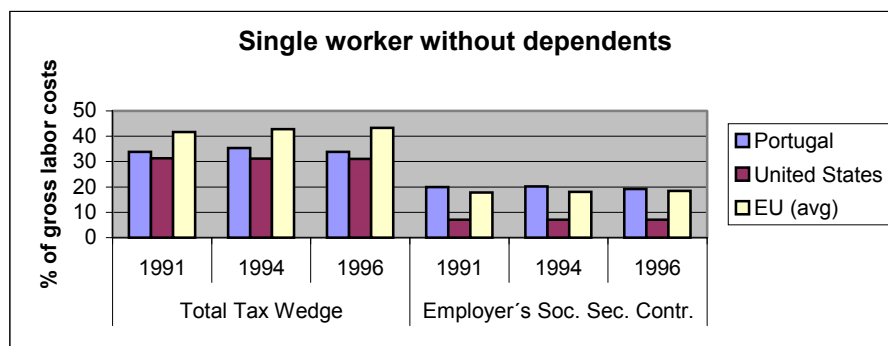
Figure 13 - Unemployment benefits by time of benefit receipt, 1997



Source: OECD (1999), Table A.1, pp112

On the demand side, labor taxation is near the average for EU countries. However, like in most other European countries, it is considered too high, and an obstacle to job creation. In its 1996 recommendations, the OECD suggested the reduction in overall taxes on labor income, with the view of reducing labor costs and fostering employment. In its 1999 assessment it acknowledged that, although some action had been taken, still more was necessary.

Figure 14 - Tax wedges and employer social security contributions<sup>8</sup>



Source: OECD (1999), Table A.4; pp119

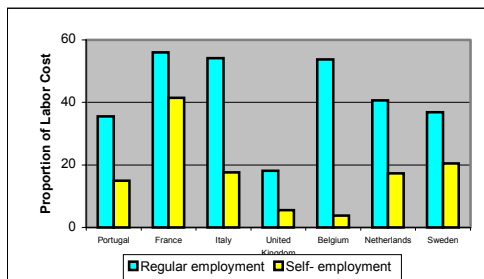
<sup>8</sup> Total tax wedge includes income taxes, employer and employee social security contributions, but not indirect taxes.

### Self-employed

One factor that has minimized the effects of labor taxation, with perverse effects on other features of the labor market, is the preferential treatment of the self-employed, in terms of contributions to social security. Figure 15 shows that in Portugal, the social security contributions by self-employed imply much lower labor costs than regular employment. Consequently, arms-length employment relationships have gained ground relative to contractual links to employers, captured in the high proportion of the self-employed in total employment depicted in Figure 16. However, given that the social security contributions for the self-employed in Portugal are not abnormally low, vis-à-vis other European countries, the relatively high proportion of self-employed in Portugal requires an additional explanation.

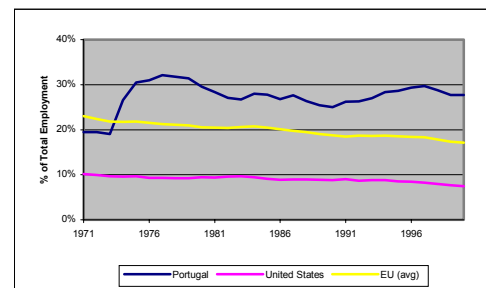
Centeno (2002) finds that for 18 OECD countries, the cost of self-employment, measured by the ratio of social security contributions by the self-employed to nominal GDP per capita, is an important determinant of the share of self-employment. He finds also, that accounting for the latter, labor market rigidity (e.g. hiring and firing restrictions) expands the share of self-employment. In this light, we will see below that self-employment in Portugal arises also as a response to the strictness of employment protection legislation.

Figure 15 - Social Security Contributions: self-employed and regular employment



Source: OECD (1996); Table 29, pp 99

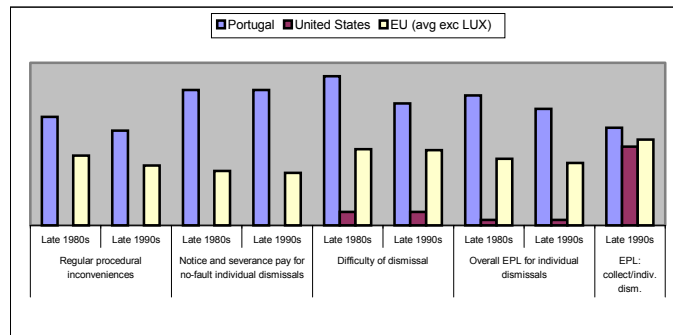
Figure 16 - Self-employed as a proportion of total employment



Source: OECD; Economic Outlook Database

### iii. Flexibility of employment and working time

Figure 17 - Strictness of EPL for individual and collective dismissals (regular employment)

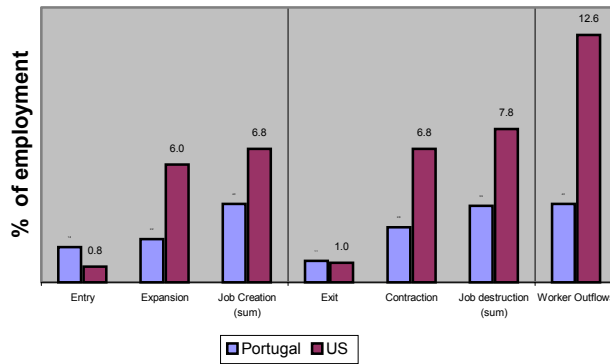


Source: OECD Employment Outlook (1998);  
Tables 2.2 (pp57) and 2.4 (pp65)

The Achilles heel of Portuguese labor markets lies in the obstacles to the adjustment of employment on the part of firms, embodied in an extremely restrictive employment protection legislation (EPL). Figure 17 shows the comparative rankings of Portuguese EPL, in each of the three dimensions: *procedural requirements* that must be followed from the decision to dismiss to the actual termination, *notice and severance pay* requirements, *difficulties of dismissal* related to the requirements faced by employers in the case of unjustified or unfair termination, as well as the relative strictness of collective dismissals. Even more striking, despite some liberalization in 1990's, Portugal had the most restrictive EPL in the EU (and among OECD countries) in the late 1990's, according to the OECD. Collective dismissals require administrative authorization, and are a minority in Portugal, with 14.5% of total dismissals in 1996 (Bover et al., 2000).

The strictness of EPL has implications for the turnover in Portuguese labor markets. Blanchard and Portugal (2001) find strong evidence of reduced turnover, compared with the US market, despite the similarity of unemployment rates (see section III.1.i). Figure 18 presents their estimates of quarterly job and worker flows for Portugal and the US, obtained from household data surveys.

Figure 18 - Job Flows and Worker Outflows in Portugal and US



Source: Blanchard and Portugal (2001)

As the figure shows, quarterly job creation in Portugal stands just above 50% of the corresponding levels for the US, with the entry/exit margin capturing a disproportionate amount of the labor turnover in Portugal.<sup>9</sup> Blanchard and Portugal (2001) argue that the lower turnover in the Portuguese labor market, particularly with respect to the expansion/contraction margin, arises due to the higher EPL in Portugal. Instead, Portuguese firms, characterized by their extremely small size may have been using the entry/exit margin in adjusting to shocks. In Figure 19, we present a table that provides a summary of the different elements of employment protection legislation in Portugal. For comparison, we show also the conditions in the United States.

Figure 19 - Employment Protection Regulation and Practice, Portugal and United States

Component	Portugal	United States
Administrative procedures for individual notice and dismissal	<p><b>Notification procedures:</b> Written notice to employee and employee representative justifying the reasons for dismissal and the lack of suitable alternatives. In case of individual termination for unsuitability, a replacement must be hired. In case of economic redundancy, employee representatives can call in the Labor inspectorate to verify justification of dismissal</p> <p><b>Delay:</b> After initial notification, a minimum of two weeks for employee or works council to present their views, and a further 5 days before final notice is issued</p>	No prescribed procedures. Only a few states prescribe a “service letter” a certain period after dismissal, noting the reason for termination.
Required notice and severance pay for individual dismissal	<p><b>Notice:</b> 2 months</p> <p><b>Severance pay:</b> 1 month per year of service</p>	No legal regulations (but can be included in collective agreements)

<sup>9</sup> Interestingly, comparable annual data provides a different picture, with job creation and destruction levels slightly higher in Portugal than in the US. This difference captures the intra-year adjustments of establishments in the US, along the contraction/expansion margin.

Figure 19 - Employment Protection Regulation and Practice, Portugal and United States(cont)

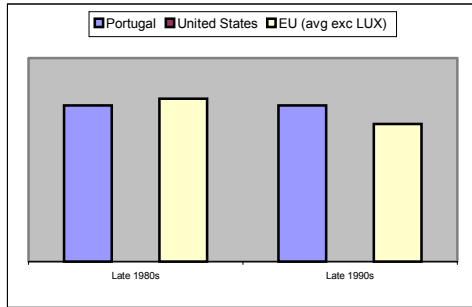
Component	Portugal	United States
Conditions under which individual dismissals are fair or unfair	<p><b>Fair:</b> Disciplinary reasons. After 1989 and 1991 revisions: economic grounds and lack of professional or technical ability. Dismissals for individual redundancy must be based on urgent needs and must not involve posts manned by workers on fixed term contracts. Dismissals for lack of competence are only possible after introduction of new technology or change to job functions.</p> <p><b>Unfair:</b> Dismissals where employees could have been reasonably, in view of their skills and abilities, transferred or retrained</p>	<p><b>Fair:</b> With the exception of the public sector, it is generally fair to terminate an open-ended employment relationship without justification or explanation, unless the parties have placed specific restrictions on terminations.</p> <p><b>Unfair:</b> Equal employment opportunity principles and dismissal of employees with physical or mental impairment, if work can be performed with appropriate workplace adjustment.</p>
Compensation and related remedies following unjustified dismissal	Employee can choose between reinstatement with full back pay counting from the date of dismissal to the actual court sentence; or compensation of one month of pay per year of service	Reinstatement, if in violation of National Labor Relations Act or Equal Rights Act. A wrongfully discharged worker under a fixed term contract is entitled to damages corresponding to potential earnings over the life of the contract.
Procedures and standards for collective dismissal	<p><b>Definition:</b> 2+ workers, in firms &lt; 51 employees; 5+ workers, otherwise.</p> <p><b>Notifications:</b> Duty to inform and consult with works council or trade union delegation. Notification of Labor inspectorate required.</p> <p><b>Negotiation:</b> Consultation on alternatives to redundancy, selection standards and ways to mitigate effects. Written agreement to be reached, if necessary via conciliation of Labor inspectorate.</p> <p><b>Delays:</b> 75 days if agreement on procedures can be reached; 90 days otherwise.</p>	<p><b>Definition:</b> In firms &gt;100 employees, 50+ workers in case of plant closure; 500+ workers in case of layoffs; 50-499 workers, if greater than 1/3 of workforce.</p> <p><b>Notifications:</b> Duty to inform affected workers and labor unions, where they exist, as well as state and local authorities.</p> <p><b>Delays:</b> 60 day notice period.</p>

Source: OECD Employment Outlook, June 1999

### Fixed term contracts

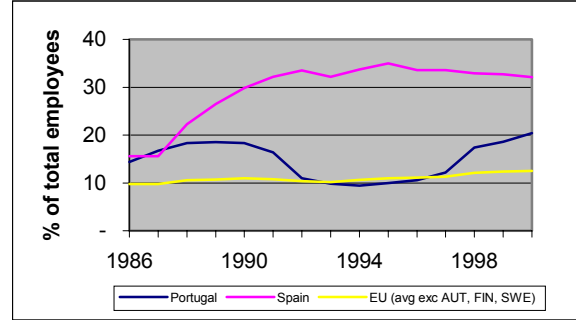
An increasingly important way to circumvent strict EPL, in Portugal and the rest of the EU, is the use of fixed-term contracts. Temporary employment, which includes also a fast growing but relatively small number of workers employed in temporary work agencies, is also the object of severe legal restrictions in most EU member countries, including Portugal. Figure 20 shows the relative strictness of legislation on temporary employment. Among 26 OECD countries, Portugal ranks 19<sup>th</sup> in the strictness of its regulations of fixed-term contracts. Fixed-term contracts are permitted, *inter alia*, for business start-ups, launching a new activity of uncertain duration, and recruiting “risky” workers.

Figure 20 - Strictness of regulation for fixed-term contracts



Source: OECD Employment Outlook (1998); Table 2.3, pp63

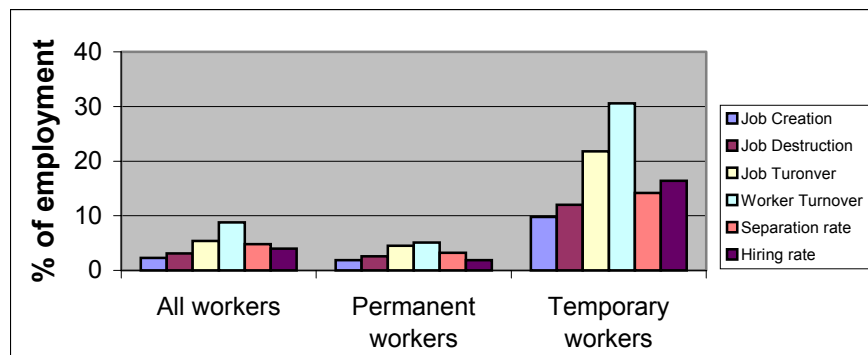
Figure 21 - Fixed term contracts as a proportion of total employment



Source: Eurostat, Labor force survey

As a consequence of high firing costs for regular workers, due to EPL, fixed-term contracts, with a traditional duration of six-months, have gained increasing weight in Portugal. Figure 21 captures the relative incidence of fixed term contracts as a share of total employment. Fixed-term contracts remained near the EU average between 1992 and 1997, with around 10% of total employment. However, despite legislative changes in Portugal in 1989 that made fixed-term contracts more restrictive (Bover et al., 2000), fixed-term contracts have suffered a dramatic increase, in recent years, reaching 20% in 2000.

Figure 22 - Job turnover and worker turnover, by type of contract (1991-98)



Source: Varejão and Portugal (2001)

The relevance of temporary workers is even more striking in terms of flows. Figure 22 presents evidence for job and worker turnover in Portugal for 1991-98, i.e. before the recent (post-1997) surge, from Varejão and Portugal (2001). Job turnover captures the creative-destruction of work posts, while worker turnover captures the hiring and separation of workers, regardless of whether the post was created or extinguished.

Overall, fixed-term contracts accounted for 62% of all accessions and 43% of all separations, while the turnover of temporary workers was about three times larger than that of permanent workers (29 and 10 percent of total worker turnover, respectively).

Several features from Figure 22 are worth noting. First, fixed-term contracts are related to temporary tasks, as indicated by the higher job turnover in this category. Second, worker turnover, relative to job turnover, for workers with temporary contracts is much higher than for permanent workers. Third, the hiring rate is higher than the separation rate for temporary workers, while the opposite is true for permanent workers.

Varejão and Portugal (2001) argue that the last two facts are related to the notion that these fixed-term contracts are used as a screening device, with four to five percent of workers initially hired with fixed term contracts actually receiving a permanent contract.

However, a more pessimistic view is presented in Blanchard and Landier (2000), who present evidence of higher relative worker turnover for temporary workers in France. They argue that this arises as a perverse effect of the differences in firing costs between regular employment and fixed-term contracts, as this asymmetry makes firms more reluctant to keep workers that were hired with fixed-term contracts on regular jobs, even if a match turns out to be quite productive. From this perspective, fixed-term contracts provide a poor substitute for reform of employment protection legislation and may result in more low-productivity entry-level jobs, with the negative implication that firms will reduce the investment in the worker, which is key to expand productivity.<sup>10</sup>

In addition to temporary contracts, Portuguese firms have tended to circumvent employment regulations with arms-length relationships through self-employment procedures (see Figure 16). Furthermore, Portugal's small firms being much smaller than in other European countries, probably find it easy not to comply fully with employment regulations, as they do not pay taxes and social security contributions. Perhaps for this reason, according to OECD (1997, pp. 68) employer surveys show that, in 1994, only

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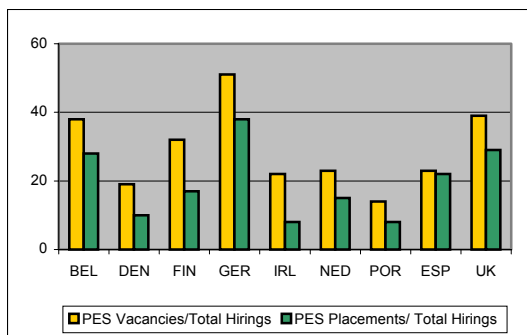
<sup>10</sup> Blanchard (2000) presents evidence that the easing of fixed-term contract legislation in France has increased turnover, without substantially increasing unemployment duration. This intuition is also consistent with the high labor flows between unemployment and fixed-term contracts in Spain documented by Bover et al. (2000).

33% of employers (36% for companies with 500+ workers) claimed that hiring/firing practices were very important or important reasons for not employing more people. Of course, the extent of selection bias in the sample must be taken into account.

#### iv. Active labor market policies

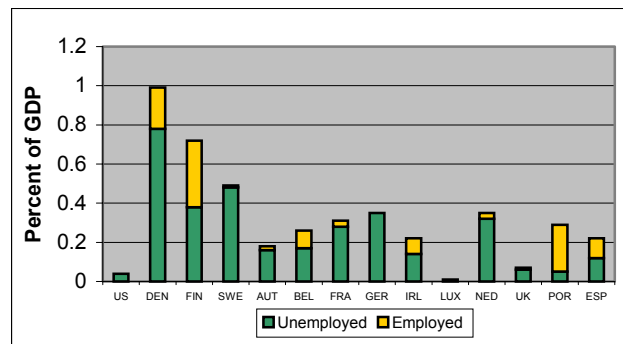
The Institute for Employment and Vocational Training (*Instituto de Emprego e Formação Profissional, IEFP*), which operates under the supervision of the Ministry of Labor and Solidarity, is responsible for the public employment service in Portugal. Charana and Rodrigues (2001) provide a description of its activities. Figure 23 and Figure 24 provide some evidence on the activities of the IEFP in the fields of job placement and training, vis-à-vis several other countries.

Figure 23 - Vacancies and Placements in the PES, relative to Total Hiring



Source: OECD (2001), pp 37; Table 1

Figure 24 - PES Expenditure in Training, relative to GDP



Source: OECD (2001), pp 51; Table 2

In terms of job brokerage, the placement activities of the IEFP in Portugal play a much smaller role in terms of labor market turnover, than in most European countries. Vacancies posted in the IEFP and subsequent placements through the service constitute only 14 and 8 percent, respectively, of total hirings. On the other hand, the expenditure with training is about average for the sample of countries in the table. However, Portugal is the only country with a larger share of training expenditure on the employed than on the unemployed. An important determinant may be the low unemployment rate in the country – note that the expenditure in training for the unemployed is similar to the US, with a similar unemployment rate. However, the extraordinarily high expenditure with

training of the employed raises questions about the matching of that training to the needs of the specific job of the employed worker.

In its 1996 report, the OECD concluded that the overall performance of ALMP in Portugal has been unsatisfactory, and suggested as key areas for reform: more evaluations of the existing policies and targeting of the long-term unemployed. In a recent review (OECD, 1998), the OECD pointed out that no progress had been made in these directions.

In sum, the labor market institutions in Portugal can be summarized in the following points:

**Box 6 - Summary of labor market institutions in Portugal**

- **Wage formation:** decentralized and flexible.
- **Labor taxes:** high, but in line with other EU countries; biased toward the self-employed.
- **Unemployment subsidies:** Moderate levels but very strict criteria.
- **Employment Protection:** Extremely strict, including legislation of temporary work.
- **Active labor market policies:** Ineffective job placement role; low level of vocational training for the unemployed, with perversely large role for training of the employed

## **IV. Challenges for the next 30 years**

Section III of this study addresses the challenges facing labor markets in Portugal, and more generally in Europe, over the next 30 years. Part 1 identifies the fundamental drivers of change, and Part 2 assesses the implications for labor markets. Two key trends for labor markets are outlined: the continuation of the shift in labor demand toward the highly skilled and an increase in the volatility of labor demand. Focusing on the latter, we speculate on the implications for labor markets and on the critical factors of success in coping with this new trend in Part 3. Finally, Part 4 looks at the Portuguese labor markets in comparison with the success factors outlined, and suggests directions for reform.

### **1. Drivers**

At the same time that it pushes through with its continuing structural convergence to Europe, the Portuguese economy will be affected by some new fundamental changes, in the medium to long-term. These changes, which will have an effect also on the rest of Europe, are predicated on three key drivers, summarized in Box 7. Although they represent a vast potential for the improvement of the European competitiveness, these changes pose important challenges to the functioning of labor markets. Moreover, their impact for the different member countries will be differentiated. Next, we address each of these drivers in detail.

#### **Box 7 - Drivers of structural economic change in Europe, in the medium term**

- The expansion of trade and capital flows, at a global and European scale;
- The increase in the speed of technological change and institutional change in capital markets.
- The implementation of the European Monetary Union (EMU), and the fiscal constraints of the stability pact.

#### **i. Trade and capital flows.**

The increased integration of goods and capital markets is a well-known feature of the last twenty years. At a global level, the volume of international trade and capital flows has expanded at a much faster rate than the growth of output. At the same time, global integration has expanded in geographical depth, with the increasing role of developing countries in the world economy. At a European level, the completion of the Single

European Market has increased economic integration, both in terms of trade and flows of capital.

These trends are likely to continue, and gather increasing pace. On the one hand, the increased awareness that developing countries have gotten the shorter end of stick in the Uruguay Round has focused the new round of WTO negotiations in improving the conditions for those countries. A key element of these negotiations will be improving the market access of developing countries to industrialized countries, namely the European Union. Particularly noteworthy is the accession of China to the WTO. On the other hand, at an intra-European level, the deepening of the Single European Market and the eastward expansion of the EU will also augment the competitive pressure on product markets, which will trickle down to the labor market.

The increased pressure will have two implications for labor markets. First, the factor endowments of Eastern European and other developing countries imply that poorer countries in the EU, like Portugal, will be the most affected in terms of unskilled labor competition. Second, the increased competition and economic integration will enhance volatility and uncertainty in labor markets. We address each of these aspects in turn.

*a*    *Unskilled-labor Competition*

The low level of skills and capital abundance in Portugal has produced a pattern of specialization and comparative advantage that will suffer most from the increased competitive pressure from Eastern European and other developing countries, with a similar factor endowment. As these countries obtain improved access to the currently protected EU markets in sectors such as textiles, clothing and footwear, the Portuguese terms of trade are likely to deteriorate.

It should be noted that the increased competitive pressure from developing countries, outside the EU, and from Eastern European countries, within the EU, will arise not only due to trade, but also due to the increased mobility of capital, with the flow of investment to lower wage countries. In addition, Eastern European countries will also imply increased rivalry in the demand for EU structural funds.

Overall, the competitive pressure from Eastern European and other developing countries is likely to hurt mostly those with less skills, and working in labor-intensive industries in direct competition with low-wage countries. This is clearly the case of Portugal. For countries with a larger skill base, or for individuals with higher skill attainment, such competition will imply increased benefits, due to the gains from trade.

***b*** *Volatility and uncertainty of labor demand*

Another consequence of the increased integration of trade and capital markets for labor markets is the increase in the volatility of labor demand. As described in Traca (2001), increased international competition increases the volatility of labor demand, in the presence of local/industry specific productivity shocks for two reasons: first, the increased elasticity of demand reduces the compensating price-effect that occurs when industries are shielded from foreign competition; second, international exposure allows the pass-through of external productivity shocks to domestic labor markets. Bhagwati and Dehejia (1998) have addressed this as *kaleidoscopic comparative advantage*. Using data from the United States, Traca (2001) shows that indeed industries more open to international competition have higher wage volatility.

The increased integration of product markets at a global and European scale is likely to generate a similar process of increased volatility of labor demand. This will not only arise due to trade with Eastern European and other developing countries, like the structural adjustment of the previous section, but also due to the increased integration within the EU and with other developed countries.

**ii.** **Technological and institutional change**

A key aspect of the end of the 1990's, which is likely to carry on in the medium- to long-term future, are the changes to technology and capital market institutions.

***a*** *Technological change*

The computer revolution of the last 20 years has produced a dramatic change in society. Although this has generated an unprecedented surge in productivity growth, fuelling the longest expansion in history in the United States, technological change, in particular of

the type that has arisen from the computer and Internet revolutions imposes added pressure on labor markets.

- *The complementary between the new technology and the skills of the labor force.* One of the key features of the technology revolution has been the extent to which it has substituted the unskilled worker in the factory floor and, on the other hand, increased the demand for skilled workers, able to handle complex machines.
- *The “riskiness” of innovation.* The process of innovation is risky and fraught with uncertainty. The computer and Internet revolutions have taken place in the context of micro-enterprises, with many of them going under in a short period of time. Even for large companies, the risk of being replaced by upcoming companies and losing competitive advantage means high risk of bankruptcies and contractions of economic activity. Easy adjustments of labor costs become key to survival.
- *Increased competition due to the reduction in the cost of information.* The expansion of the Internet will increase (product and labor) market competition. As mentioned above, this increase in competition is likely to expand the volatility in labor markets, as firm- and industry-specific shocks will no longer be passed on to consumers, being absorbed instead by the labor margin in the firm.

***b*** *Institutional change*

Another important driver of labor market changes will be the institutional changes in product and capital markets. In product markets, increased de-regulation will lead to greater competition, with the already mentioned effects on the volatility of labor demand. On capital markets, a less noticed change has been happening across Europe, with the interests of the shareholder gaining increased preeminence in the minds of managers – the presumption of shareholder value maximization is that all changes that increase the value of the stock are the sole objective of the shareholder. This represents a dramatic change from traditional forms of management in Europe, which were focused on the interest of the stakeholders, including the firm’s labor force. The cross-national aspect of value-based management has also increased in the last decade, and is likely to intensify within Europe, with the advent of the EMU.

From this perspective, and given the problems of short-termism in capital markets, the increased focus on shareholder value will reduce the commitment of the firm to the worker and the willingness to ensure workers through *labor hoarding*. Firms will be more likely to expand and contract their labor force, according to the needs of profitability. This trend has become increasingly clear in countries like France and Germany, where

traditional forms of stakeholder management were more entrenched, and the changes are more striking.

### **iii. European Monetary Union**

Last, but not least, a dramatic change will occur in the European economies with the advent of the EURO, in the context of European Monetary Union (EMU). The implications of monetary unification in the literature are well established, and relate to the loss of the exchange rate as an adjustment mechanism to countrywide shocks. Less attention has been paid to the role of the EURO in increasing product market competition and cross-border trade and specialization within Europe, and the consequences for labor markets. We address each of these in turn

#### ***a The loss of the exchange rate flexibility***

A key aspect of monetary unification is that the nominal exchange rate will no longer constitute an adjustment margin. Adjustments in the nominal exchange rate are useful to minimize the price adjustments necessary to reestablish the equilibrium of the real exchange rate, in response to asymmetric countrywide shocks.

Friedman (1953), in a well-know analogy, best captures the role of nominal exchange rate flexibility. He compares the gains from flexible exchange rates to those from setting all clocks back one hour in the fall and forward in the spring: it is more efficient to change the nominal time standard (the nominal exchange rate) than it is to require millions of individuals to adjust their daily time schedules (nominal domestic prices), waking up and getting to work an hour earlier or later, to the annual solar cycle (shocks to a country's demand and supply).

This analogy highlights the substitutability between exchange rate adjustments and nominal and real rigidities. If prices and wages do adjust easily, then the loss of the exchange rate as an adjustment margin will matter little. Otherwise, in the presence of nominal or real rigidities (and if mobility is low), the adjustment mechanism will start to falter and full-employment will be at risk.

### Asymmetric shocks in Portugal

As mentioned above, a key element for the consequences of the loss of exchange rate flexibility is the incidence of asymmetric countrywide shocks. Numerous empirical studies have dealt with the incidence of asymmetric shocks in the EMU area, at the level of regions and countries, in the pre-EMU period. They find that variations of output are more synchronized, and variations of real exchange rates smaller, among EU member states than among regions within individual member states (see, for example, Fatas, 1997 and Decressin and Fatas, 1995). In other words, country shocks are less important than regional shocks, which roughly average out at the country level.

However, there are differences among member countries. In a core group of countries – Germany, France, the Benelux, Austria and Denmark – asymmetric shocks have been relatively rare as variations of output and exchange rates were quite similar; by contrast, the incidence of asymmetric shocks has been rather high for **Portugal**, Greece, Spain, Italy, UK, Ireland, Sweden and Finland. The higher exposure of these countries to asymmetric shocks can be explained by their less diversified nature, due to their smaller size, and higher exposure to shocks from outside the EU.

A key issue is whether these shocks are indeed country/region-specific, affecting all industries within a region, or if they result from the interaction between industry-specific shocks and a diversified industry-structure. Bayoumi and Prasad (1997) find that the importance of aggregate, industry-specific and country- or region-specific shocks is roughly similar in Europe and the US, as each of these shocks plays an important role. Moreover, a large portion of the variance in their study is unexplained, and should be attributed to shocks that are specific to a country/region-and-industry. They show also that region-specific disturbances in the US are more important in the non-traded goods sectors, while country-specific disturbances in the EU are more prevalent for traded goods.

These historical patterns may not persist with the EMU, as, for example, monetary shocks will no longer be country-specific. Two possibilities are raised:

- Frankel and Rose (1998) argue that an increased synchronization of business cycles within the EMU may be expected, because trade linkages between European countries are likely to increase further. This outcome is predicated in

the notion that shocks are indeed country-specific, affecting all industries within a country. This is more relevant for the case of demand shocks, or if intra-industry trade is predominant.

- A different view is presented by Krugman (1993). He argues that increased trade specialization, arising from monetary integration, will increase the asymmetry of shocks at the country level. This position is predicated in the notion that shocks are industry-specific, namely productivity shocks, and their country effects are determined by the country's specialization.

The empirical evidence is scant. Krugman (1993) supports his view on empirical data for the monetary union in the US. This is in accordance with recent estimates in Traca (2001) showing that the industry-specific component constitutes the bulk of productivity shocks in the United States. Frankel and Rose (1998) present evidence on synchronization of business cycles in industrialized countries over the last 30 years.

In a recent study, Barbosa et al. (1998) presents some evidence that after 1985, with the increasing integration of the Portuguese economy in the EU, the Portuguese cycle has become increasingly correlated with the European one. They argue that this convergence is the result of increased trade, as well as ever more similar macroeconomic policies. Therefore, although scant, evidence seems to point that the integration of monetary is likely to lead to a convergence of economic cycles.

#### ***b*** *Increased trade and competition*

A less noted aspect of the effects of monetary union on labor markets is the extent to which it may increase volatility and uncertainty due to its effect on trade and capital flows. As mentioned in section IV.1.i, increased international competition implies an amplified volatility of labor demand, if shocks are industry-specific, due to the magnification and transmission effects.

The evidence that a currency union affects trade is presented in Glick and Rose (2001). Using a large annual panel data set covering 217 countries, from 1948 to 1997, they show that countries that left currency unions experienced economically and statistically significant declines in bilateral trade, after accounting for other factors. For the symmetric case, they estimate that a pair of countries that starts to use a common currency experiences a doubling in bilateral trade. In sum, it is likely that the EMU will

intensify trade and competition in the Single market, raising the potential for increased volatility of labor demand in the presence of industry-specific shocks.

***c*** ***The pressure to reduce the public sector***

Another key element of EMU are the limits to budgetary deficits and debt imposed by the *Stability Pact*, which have led to increased pressure to reduce the size of public sector employment. As was clear in section III.1.ii, the number of public sector workers and the expenses that they entail is extremely high in Portugal. Since public sector jobs are safer, the decline in public employment's share will expand private sector's more volatile jobs.

**2. Labor market trends**

Now, we look at the implications for labor markets of the three drivers of change mentioned above. We identify two main trends: the continuation of a shift in labor demand toward skilled workers, against the unskilled, and the expansion in the volatility and uncertainty of labor demand. Below, we address each of these trends in detail.

**i. Shift in the relative demand for skills**

Several shocks are likely to contribute to an expansion of the relative demand for skilled, educated workers. These shocks include the increased competition from Eastern European and other developing countries, which are abundant in unskilled labor, and the pace of technological change, which requires complementary labor force skills. If unchecked by a corresponding change in supply, this demand shift will lead, in a best-case scenario, to an increase in the relative wage of skilled workers; and in the worst-case, to a decline in the real wage of unskilled workers.

As became clear in section III.1, such trends have already been present in the labor market developments. The last 30 years have been characterized by low wage growth in the United States, particularly for unskilled workers, and increased unemployment in Europe, again for unskilled and young workers.

There has been a myriad of empirical studies addressing the causes of these trends, particularly attempting to identify the role of low-wage competition from developing countries vis-à-vis the effects of technological change. For the case of the US, these

studies have overwhelmingly concluded that the role of trade with developing countries amounts to no more than 20-30% of the increase in the wage-skill gap (see Cline, 1997 for a survey).

In terms of European unemployment, the evidence also points to a reduced role of trade with the LDC's (Neven and Wyploz, 1999; Dewatripont et al., 1999). Technological evolution and domestic policy choices are much more important factors behind Europe's labor market problems. In fact, trade with LDC's should be even less harmful for Europe than for the US, since Europe has a current-account surplus in the aggregate and is less open than the US to LDC trade.

Since the paces of technological change and exposure to low-wage competition are likely to increase, the pressures on unskilled workers are likely to mount. Responses to this challenge can be of two types: defensive, like slowing the speed of technological change and reversing the process of *Globalization*; and accommodative, such as adjusting supply by increasing the skill attainment of the labor force. In reality only the latter constitute real alternatives. Defensive policies are highly impractical, for two reasons: they are very difficult to implement and they would yield extremely high aggregate costs (undermining the gains from trade and the benefits of technological progress).

## ii. **Increased in the volatility and uncertainty of labor demand**

A second element of change in labor markets will be an increase in labor demand volatility (LDV). Box 8 summarizes the factors contributing to this trend. It should be mentioned that, even if they expand volatility, and may thus impact workers adversely, these shocks represent a vast potential for value creation, which will boost output per capita.

### **Box 8 – Sources of higher labor demand volatility (LDV)**

- The enhanced exposure to international trade and competition, not only from low-wage countries but also from other industrialized countries, due to *Globalization* and the EMU;
- The increased pace and riskiness of technological change;
- The institutional changes in product and capital markets, with de-regulation and increased market competition raising the randomness of market conditions for specific firms; and shareholders increasing the pressure for quick adjustments on labor costs;
- The contraction in the public sector reducing the supply of safe, secure jobs.

**a** Implications for labor markets

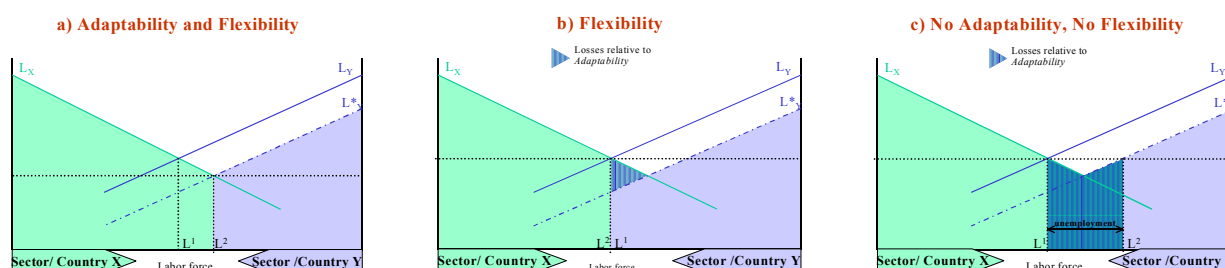
The implications of an increase in LDV to labor markets depend on the specific labor market institutions and the characteristics of the workforce; namely, the extent of labor mobility and adaptability, the wage flexibility, and the constraints on contracts (see Box 9 for definitions).

**Box 9 - Defining Adaptability and Flexibility**

- **Adaptability** captures the ability of workers and their employers to adjust to the shock by moving to another country (in the case of a country-specific shock) or another industry (for an industry-specific shock).
- **Flexibility** depicts the ability of wages and prices to adjust to the shock, bringing the real wage in line with marginal productivity in the different industries and/or countries. It encompasses also the facility to adjust working hours and shifts.

In order to address the positive and normative implications of an increase in labor demand volatility, Figure 25 presents a diagrammatic exposition of the effects of a decline in the productivity in sector/country Y in spot labor markets, under different assumptions on adaptability and flexibility.

Figure 25 - Effects of volatility under different labor market scenarios



The best response, i.e. the one entailing maximum welfare, is the movement of labor to country/industry X. This is depicted in diagram a) by the expansion in sector X employment from  $L_1$  to  $L_2$ . As workers flow from countries/industries where shocks were adverse to those where shocks were favorable, their productivity and standard of living will increase. This is possible only in the presence of *adaptability* and *flexibility*. The latter is required, as the equilibrium competitive wage will also fall. In this case, an increase in LDV raises job and worker turnover, and job insecurity.

A second best response, in the absence of *adaptability*, is that prices adjust in order to ensure full-employment. This is captured in diagram b). The relative wage of the

country/region with an adverse shock falls, ensuring the country/industry remains competitive. Note that the wage decline in sector/country Y is smaller than in the case of *adaptability*; - from this perspective, there is some substitutability between *adaptability* and *flexibility*. In this case, higher LDV means higher wage volatility, instead of job turnover. This adjustment is always worse than the mobility of labor, since workers will be stuck in low productivity countries/industries. It should also be mentioned that, in the case of a countrywide shock, the decline in the relative wage arises as a depreciation of the real exchange rate.

Finally, diagram c) captures the worst-case scenario, where there is no adaptability and no flexibility. In this case, the inability to bring down real wages in industry/country Y will hurt its competitiveness and lead to layoffs and bankruptcies. Since workers cannot move to X, the result will be unemployment, and an extremely high deadweight loss.

If shocks are temporary, workers and firms may choose to respond to increased LDV by transferring the wage and employment uncertainty to the less risk-averse employer. As shown in Traca (2000), given the limitations on labor market contracts and the nature of the shocks mentioned above, complete insurance of the worker is impossible.

Also in the case of contracts, the consequences of LDV depend on the adaptability of the labor market. The main difference in this case is that for low *adaptability*, i.e. if mobility costs are high, higher LDV implies not only higher wage volatility but also a decline in wage growth and in the labor share, as workers hedge against the probability becoming unprofitable in the event of low productivity. Alan Greenspan (1997), in a well-known testimony, suggested that: “a restriction on compensation increases has been evident for a few years now and appears to be mainly the consequence of greater work insecurity”.

In addition to increased separation rates, job turnover and wage volatility, and slower wage growth, other implications of the increase in labor market volatility are also important. Below, we speculate on some of these.

First, the end of the life long jobs has implications for the investment in the human capital of the workforce. As mentioned above, increased LDV will expand the odds of voluntary or involuntary separation, as firms are forced to contract or workers find new, more profitable opportunities in other industries and/or regions. As a result, the

attachment between the worker and the firm will become more tenuous. Hence the firm will have fewer incentives to invest in its labor force, and training will become increasingly a responsibility of the worker. Given the well know shortcomings of markets for human capital, this may hurt productivity growth. Moreover, half-hazardous responses, like the expansion of short-term contracts, are likely to be compounding factors.

Second, the slower wage growth and the decline in the labor share will put pressure on the income distribution. From this perspective, the traditional form of social contract between labor and capital that has emerged in the post-war period will be reassessed. With workers moving from job to job, the firm will no longer provide for the long-term needs of the worker's household.

Third, the end of job security has also psychological and sociological implications, as the distress and social pressure on workers increases. Recurring periods of joblessness and search, for example, will be costs associated with volatility.

Finally, fourth, the higher mobility of the labor force will cause difficulties for trade unions, namely those operating at a sectoral/regional level. Since the passage of each worker by the group will become shorter, his/her commitment will decline.

*b* *Recent empirical evidence*

There is increasing evidence of a trend toward increased volatility. Gottschalk and Moffit (1994) present evidence of a significant increase in the short-term volatility of wages in the US. Farber (1997) concluded that “after controlling for demographic characteristics, the fraction of workers reporting more than 10 and more than 20 years of tenure fell substantially after 1993. Looking at displacement rates, Aaronson and Sullivan (1997) show that “overall displacement rates were higher in 1995 than at any time since the data began, in 1979”. They show also that displacement rates for highly educated, white-collar and service workers have risen especially fast. Aaronson and Sullivan (1997) present an extensive survey of the research on turnover, job tenure and displacement. Katz and Krueger (2000) argue that national data show a slight decline in job tenure and increase in displacement rates in the mid-1990's.

For the UK, Nickell et al. (2000) shows that there has been a rise in job insecurity for British men since the early 1980's, which has come from a rise in the costs of job loss and a probability of substantial year-on-year fall in real wage. Although similar studies for continental Europe are not available, the role of temporary work and short-term contracts in the current surge in employment shows that similar trends are at work. In Portugal, the recent growth of fixed-term contracts captured in Figure 21 suggests also that the trend to increased LDV has arrived.

### **3. Policy Responses to Increased Labor Demand Volatility**

As was clear from section IV.2.ii.a, the policy responses to increased LDV must rely on a two-pronged approach to enhance *adaptability* and increase *flexibility*. This will constitute a key challenge in the medium-term, at the policy level, as well as for the individual worker. This section addresses the main determinants of *adaptability* and *flexibility*, and looks at the Portuguese case, suggesting some directions for reform. Recall that both these concepts were introduced in Box 9 (pp 42).

#### **i. Adaptability**

The determinants of the *adaptability* of the worker depend on the nature of the shock. For country-specific shocks, *adaptability* implies migration. For the case of industry shocks, the ability of workers to move across industries (inter-sectoral mobility) is key. In this case, workers will respond to industry shocks by moving to higher productivity industries. If industry structures are diverse across countries, inter-sectoral mobility must be coupled with regional mobility, as workers must move to expanding industries in different countries.

##### Geographical mobility

The importance of geographical mobility is likely to increase with the EMU, as the loss of exchange rate flexibility will enhance nominal rigidities in the response to country-specific shocks. Contrary to the United States, the geographical mobility of labor in Europe is extremely reduced, even at the regional level (Decressin and Fatas, 1995; Bayoumi and Prasad, 1997). Difficulties related to language barriers and other institutional factors make the process extremely costly in Europe. Although Portuguese

nationals have historically represented one of the most mobile group, with large waves of out-migration in the 1960's responding to the dramatic wage differentials between Portugal and the European core, it is unlikely that such mobility will be enough to operate as an adjustment margin.

### Education and Adaptability

We speculate that a key driver of the *adaptability* is education, and that the increase in LDV is likely to contribute to an increase in the education premium. We think so for two reasons. First, education provides general human capital, transferable across sectors and firms, while on-the-job learning of unskilled workers is specific to firm and industry (Grossman and Shapiro, 1982). Second, from an informational perspective, it improves the ability to assess market conditions, and to track down opportunities.

There is increasing evidence of a positive correlation between education and adaptability. Pissarides and Wadsworth (1989) provide evidence that education facilitates geographical mobility. Mauro and Spilimbergo (1998) show that, in Spain, the highly skilled are found to migrate very promptly in response to a decline in local labor demand, whereas the low skilled drop out of the labor force or stay unemployed for a long time. In terms of sectoral mobility, Fallick (1993) finds that education increases the probability that a displaced worker moves to a different industry.

In this context, Traca (2000) argues that less skilled workers are more likely to respond to labor demand volatility by accepting wage cuts, for the sake of increased job security; while the skilled (more *adaptable*) will suffer higher displacement rates and move to other industries.

### Labor market institutions and Adaptability

In terms of labor market institutions, a key aspect of *adaptability* is the employment protection legislation. EPL works as a barrier to entry, since it increases the costs of adjustment in case of a negative shock. In a world of high volatility, firms must be able to open and close with minimum costs, or to contract and expand the labor force to respond to markets. As mentioned above, fixed term contracts provide only an imperfect substitute.

Another factor that enhances the *adaptability* of the labor force are the *active labor market policies*. Since periods of unemployment will be more frequent, the challenge is to make them shorter and more productive. Three elements are key. First, a reduction in search costs: using technology to reveal information about opportunities, facilitating procedures for unemployment insurance, providing facilities for workers to develop job search activities (telephones, computers, etc.). Second, an intensive program and opportunities for retraining while unemployed and continuing education, which will enhance the ability to adjust to new tasks. Finally, third, elements that are crucial for regional mobility, such as the housing market, should also be addressed.

## ii. **Flexibility**

*Flexibility* of real wages to follow changes in productivity is another key factor of success is responding to LDV. It is directly related to wage-setting mechanisms, and the role and power of “insiders”. As has become clear from the previous sections, European labor market performance in this domain is unsatisfactory. Although some institutional changes have been made, attempts at reform have failed to produce the necessary overall.

*Flexibility* of real wages is also likely to suffer from the increase in nominal rigidities due to the loss of exchange rate as an adjustment margin. Hence, structural reform to increase wage-flexibility in Europe becomes paramount. According to Soltwedel et al. (1999), countries like Finland, Italy and Spain, subject to highly asymmetric shocks, with little labor mobility and extremely inflexible labor markets face a high risk of increasing unemployment.

Another important aspect of *flexibility* is the ability to adjust working hours to the demands of the marketplace. Periods of low demand should permit shorter working hours, allowing workers to devote time to other activities, including searching for alternative jobs and vocational training

To summarize, Box 10 presents the key policy responses to increase *adaptability* and *flexibility*

### Box 10– Responses to enhance adaptability and flexibility

	Adaptability	Flexibility
<b>Increase skills</b>	<ul style="list-style-type: none"><li>• Education<sup>11</sup> and retraining</li></ul>	
<b>Labor market de-regulation</b>	<ul style="list-style-type: none"><li>• Lenient EPL</li><li>• Efficient ALMP</li></ul>	<ul style="list-style-type: none"><li>• Decentralized wage setting</li><li>• Adjust of working hours</li></ul>

#### iii. Portugal: directions for reform

Finally, we address the extent to which Portuguese labor markets are ready for the challenges of the next 30 years, in terms of *adaptability* and *flexibility*, and present some directions for reform. Our conclusion is that while the Portuguese labor markets show high *flexibility*, and thus are unlikely to see increased unemployment as a result of increased LDV, they fare much worse in terms of the *adaptability* of the labor force. Recall that the *adaptability* margin entails larger benefits, since it permits workers to move to industries/regions where productivity is higher.

##### a Adaptability in Portugal

The key challenge for Portugal lies in the low *adaptability* of its labor force and markets. As we mentioned above, the three determinants of *adaptability* are: the education of the labor force, the regulation of employment protection and the active labor market policies. It is quite striking that these are also the three poorest aspect of labor market performance in Portugal, and the ones with strongest recommendations for reform in OECD *Jobs Study* (see section III.3).

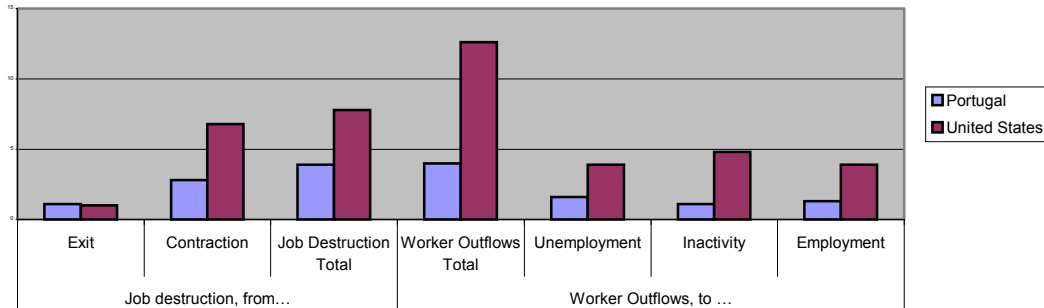
Recent evidence shows that the labor market in Portugal is extremely stagnant, with labor flows that are closer to countries like Spain, with unemployment rates 10 points higher, than to the US, where unemployment rates are similar. Comparing data for Portugal and the US, Blanchard and Portugal (2001) show that worker flows (as a proportion of employment) stand in Portugal at 21 to 28 percent of US levels, while relative job destructions number are much higher. Interpreting job destruction primarily as layoffs, and worker outflows in excess of job destruction as quits, the data shows that not only layoffs are lower in Portugal, but so are quits. In other words, US workers are much more

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<sup>11</sup> This aspect is also key, given the shift in the relative demand for skills mentioned in section III.2.i.

likely than Portuguese worker to voluntarily move out of their current position in search for better opportunities, without waiting for a dismissal.

Figure 26 – Job destruction and Worker Outflows,



Source: Blanchard and Portugal (2001)<sup>12</sup>

Bover et al. (2000) compare the labor market flows in and out of unemployment in Portugal and Spain. They conclude that flows into unemployment are higher in Spain, particularly out of temporary contract, while flows out of unemployment are similar in both countries. What is more striking, given the much higher unemployment rate in Spain, is that for the first nine months, the hazard rate (i.e. the probability of leaving unemployment in quarter) is higher for Spain. The reason is the high rate of exit to fixed-term employment in Spain.

We interpret the results of both these studies as evidence of an inability of the Portuguese labor force and markets to adapt continuously. The reason for the low *adaptability* of the labor market in Portugal can be found in many of the features mentioned above. First, extreme EPL undermines that ability of firms to react in time to shocks, and to take advantage of high productivity industries. Second, the low education level of the labor force, hinders its ability to adapt to new industries, creates the incentives for the creation of only job specific skills, which the worker cannot bring to new industries. Finally, third, despite the recent formation of Instituto de Emprego e Formação Profissional, active labor market policies are still not satisfactory, with training for the unemployed.

<sup>12</sup> Flows to employment in the US shown as average of the 2.4 – 5.4 estimate interval presented in Blanchard and Portugal (2001).

### *b* Flexibility in Portugal

By contrast to its lack of adaptability, several forces have ensured the flexibility of Portuguese labor markets, and kept wages sensitive to unemployment rates (see section III.3). From this perspective, labor markets in Portugal are unlikely to suffer increased unemployment as a result of any of the shocks described in IV.1. Instead, the implication will be an increase in wage volatility and a slowdown in wage growth, as workers (particularly the unskilled) try to hedge the increased LDV. This may be hindered by capital accumulation and convergence to the EU, which is likely to expand wages and productivity.

### *c* Directions for reform

Enhancing adaptability in labor markets, through reform of labor market institutions and of the education system, constitutes the key challenge for labor market policy in Portugal, over the next 30 years. Key areas include the relaxation of employment protection and the increase in the effectiveness of active labor market policies.

As shown in Figure 19, employment protection legislation in Portugal is extremely rigid, acting as a deterrent to the creation of new firms and preventing the adjustment of established firms to demand conditions. This factor is ever more significant, since the development of new opportunities is the best response to the rise in LDV. Sunk costs, due to required long term commitments to workers and poor flexibility in risk-sharing mechanisms between employers and workers, are likely to work as barriers to entry.

Key elements are the procedural requirements, and the severe limitations on collective bargaining. Although the reforms of 1989 and 1991 have greatly eased firing restrictions through a wider range of admissible lay-off motivations, the possibility of collective lay-offs and easier resolution of severance pay disagreements, further attention should be paid to the following areas:

- Allow more flexibility for workers and their representatives to negotiate contracts, including termination clauses, in order to make the mix of job-security and pay more responsive to the characteristics of the labor force and industry.
- Reduce relative barriers to collective dismissal - rises in LDV are likely to increase the importance of collective dismissals, for economic reasons, relative to individual dismissals on personal grounds.

- Liberalize procedural barriers to individual dismissals and increase flexibility of pay arrangements, including stock options.

Another key component of labor market institutional reform is the implementation of effective active labor market policies. Commitment to active labor market policies in Portugal has increased dramatically in recent years. However, the need for increased monitoring is evident, from past and recent experience. Furthermore, key elements deserving heightened attention include:

- Contestability of PES and exposure to market forces, to increase the effectiveness of the job placement function – One example tells the story. In Australia, for example, as from 1994, job seekers have a choice to be served by either public or private agencies, the latter being paid a set fee for successful placements that vary with the degree of disadvantage of the clients.
- Experimentation and monitoring – New and creative initiatives should be promoted. Competition and experimentation among different regional offices and governments, with a quick dissemination of success stories, is key to find new, effective formulas. It is also important to ensure that initiatives are properly monitored and evaluated on a cost-benefit basis. Evidence shows that the degree of efficiency of different policies vary considerably, and that even the same policy may have different effectiveness, according to the environment.
- Focus training on the unemployed – Evidence shows that firms are better placed, in terms of information and incentives, to provide for the acquisition of firm specific skills on the part of the worker. The activities of the PES should focus on general skill improvement for the unemployed. The current trend to the provision of training to the already employed workers seems an unwise expense of funds. Contestability and the interaction with the private sector are also a trend to be encouraged.
- Separate social policies from labor market policies – Exclusion and other social problems should be handled in a separate institutional setting from the public employment service, at the risk of diverting attention from PES workers.

Below, in Box 11, we summarize the main suggestions for reform.

## **Box 11 - Directions for reform in Portugal**

### Employment protection legislation

- Flexibility to negotiate conditions of termination on an individual, firm basis
- Liberalize collective dismissals
- Liberalize procedural barriers to dismissals and increase flexibility of pay arrangements

### Active labor market policies

- Contestability of PES
- Experimentation and monitoring, and institutional competition
- Focus training on the unemployed
- Separate social policy from labor market policies.

## V. Conclusion

This study has started by addressing the evolution of Portuguese labor markets over the last thirty years. Against the background of developments in Europe and the US, Portuguese labor markets have shown a very distinct pattern. On one hand, very flexible wage negotiating institutions and relatively low price disincentives to job search have ensured a relatively low rate of unemployment, in contrast to the towering unemployment rates in Europe. On the other, very rigid employment protection legislation and ineffective active labor market policies have produced a very sclerotic and lifeless labor market, with very low turnover and a high proportion of long term unemployed, in contrast to the dynamic US market.

We have argued that, for the next thirty years, an expansion in the volatility of labor demand is likely to be the key transformation in labor markets in industrialized countries, such as Portugal. Developments in international trade and capital flows, technological and institutional change in product and capital markets, and the implementation of the EURO all will work to raise the volatility of labor demand. Another important trend will be the increase in the relative demand for skilled labor.

The ability to respond to the increased volatility of labor demand will be determined by the flexibility and adaptability of labor market institutions and of the labor force. Flexibility depicts the ability of wages and prices to adjust to the shock, bringing the real wage in line with marginal productivity in the different industries and/or countries. Adaptability captures the ability of workers and their employers to adjust to the shock by moving to another country or industry. We have shown that while flexibility ensures that higher labor demand volatility does not generate additional unemployment, the first-best outcome is obtained only through adaptability, which allows workers and entrepreneurs to move to expanding industries, where value-creating opportunities can be found.

Finally, we addressed the extent to which labor markets in Portugal are ready to handle the increase in labor demand volatility, from the perspective of flexibility and adaptability. We concluded that the flexibility of Portuguese labor markets, particularly at the level of the decentralization of wage formation mechanisms, provides some reassurance that labor demand volatility will not generate additional unemployment.

However, in terms of adaptability, Portuguese labor markets are likely to under perform, preventing the economy from reaching the first-best outcome. We identified three main determinants of adaptability: the level of educational attainment of the labor force, the ease of hiring and firing restrictions, and the effectiveness of active labor market policies, particularly in terms of the job-brokerage and training-provision functions. In all these three components, we found the performance of Portuguese labor market institutions sub-standard. Hence, we finished our study by suggesting specific measure and directions for reform, with the aim of expanding adaptability in Portuguese labor markets. In general, these recommendations focus on the relaxation of employment protection legislation, and increased experimentation and monitoring of active labor market policies, in interaction with the private sector.

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